MANOLE CAPITAL MANAGEMENT

Introduction:

For our quarterly newsletters, we strive to provide macro commentary on issues like inflation, interest rates, global markets and the overall economy. It is clear to us, that policy, economics and the markets remain quite intertwined. While we avoid social and certain political matters, our goal is to provide some insights into our unique investing philosophy, strategy, and process.

As always, we will sprinkle in our own opinions and thoughts, as we weave in our distinctive approach to investing in the FINTECH space. Lastly, we hope you enjoy our final page, which has interesting statistics, facts, quotes and metrics. Some items are attention-grabbing, some comical, but we hope all are thought provoking.

Proprietary Research:

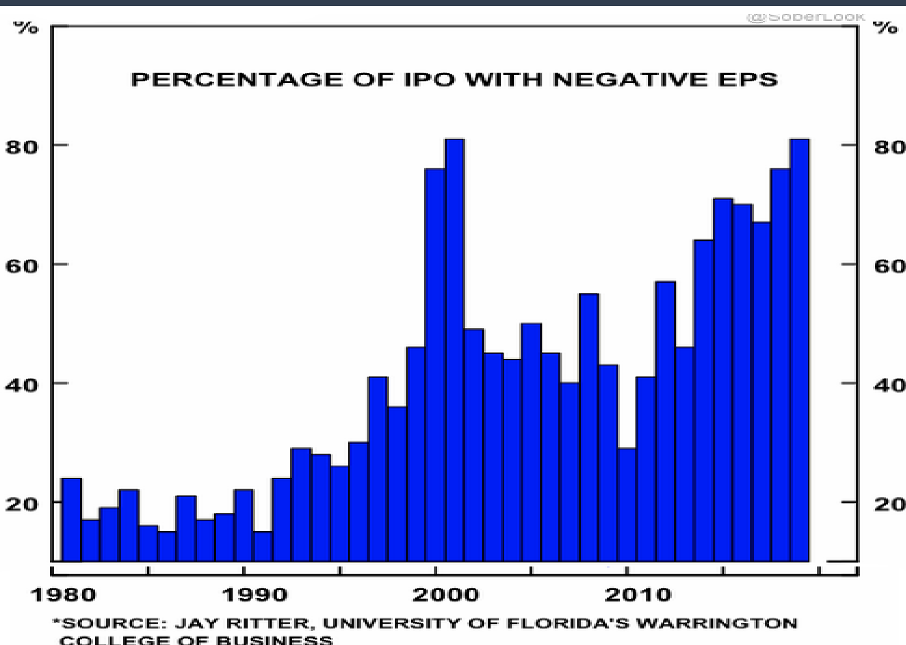
Between the writing of our quarterly newsletters, we are actively monitoring our positions, updating financial models, meeting with management teams, and creating proprietary research. Our research covers thematic pieces (elections, bitcoin, active vs passive management, etc), survey work, and specific company notes. All of our research is available 24/7 on our website at www.manolecapital.com, under the "Research" tab.

Over the last month or so, we published our thoughts on what Apple is doing in the payment sector. In our opinion, the payment sector is the quintessential FINTECH business and we remain quite interested in what Apple (with its $1 trillion market capitalization) is up to. Feel free to use our research as the best, all-natural way to cure insomnia.

Does Apple Know Payments? (August '19)

IPOs:

As we entered 2019, many thought the IPO market would be excellent and that it would be a great opportunity for companies to become publicly-traded firms. Of the dozen or so technology IPOs this year, only four (Zoom Video, Pinterest, Fastly and Cloudflare) are currently above their first day opening price. This year's initial public offerings have been the least profitable of any year since the tech bubble.



It sure seems like the public markets are not welcoming *Unicorn* IPOs or businesses that seem unable of delivering free cash flow. Chuck Schwab, founder of Schwab, has seen his share of market cycles over the last 50 years. When he was recently asked about the current state of the IPO market, he said "I would never buy a company that has huge losses and

no clear sight ahead to make money." One of the foremost researchers of IPOs is Jay Ritter, recently published the above chart showing that more and more IPOs are coming to market without earnings and free cash flow.

While names like Beyond Meat have done remarkably well, it seems to be the exception, rather than the rule. Lyft, Uber, Fiverr, Slack and Petaton are just a few examples of companies that have not performed terribly well since their listing.

It seems that generating earnings and profits is once again an important requisite to a public listing. Based upon its pre-IPO SoftBank capital raise, WeWorks had a $47 billion private market valuation. It was planning on an IPO in October, but was not receiving a warm Wall Street welcome. Ultimately, WeWorks pulled their filing and fired their controversial CEO.

3rd & 4th Quarter of 2019:

We liked the summary of the 3rd quarter from Ameritrade's chief market strategist, JJ Kinahan. He said, "stocks finished the 3rd quarter roughly where they started, but getting there was a volatile ride." The S&P 500 was up +1.2% last quarter, with Utilities its best sector (up +8.6%) and Energy its worst (down 7.1%). During the quarter, some interesting outperformers were Turkey (+12.2%), Silver (up +11.1%), Gold (up +4.3%) and the US Dollar (up +4.4%). On the flip side, underperformers were South Africa (down -13.2%), Volatility/VIX (down -8.7%) and Bitcoin (down -32.5%).

So is the glass half-empty or half-full for the US stock market? Well, 2019 only has 3 months left and year-to-date performance has been quite good. Once again, it comes down to your perspective. Despite the recent pullback in early October, the S&P 500 is 2% from its all-time high. Despite the significant angst discussed daily on CNBC, the S&P 500 Total Return is still up roughly +20% this year.

From January to April, the market was clearly expecting a resolution to these Chinese trade tensions and it was "risk on". The S&P 500 climbed approximately 20%, but then, with a simple Presidential tweet on May 5th, volatility re-emerged and the expectations for a détente collapsed. Not only have the last five months yielded little returns for the stock market, but the market is up only +4.25% over the last 12 months.

The 4th quarter just began and the early performance has been challenging. The decline over the first couple of days of October were the worst start to the 4th quarter since 1928. According to Bespoke Research, the 2-day market decline of (2.8%) was the first time ever that the 4th quarter started with back-to-back over (1.0%) declines. Would you be surprised to know, with all of these issues swirling around in the market, that the S&P 500 had its strongest first 9-months of the year since 1997? Once again…it comes back to your perspective.

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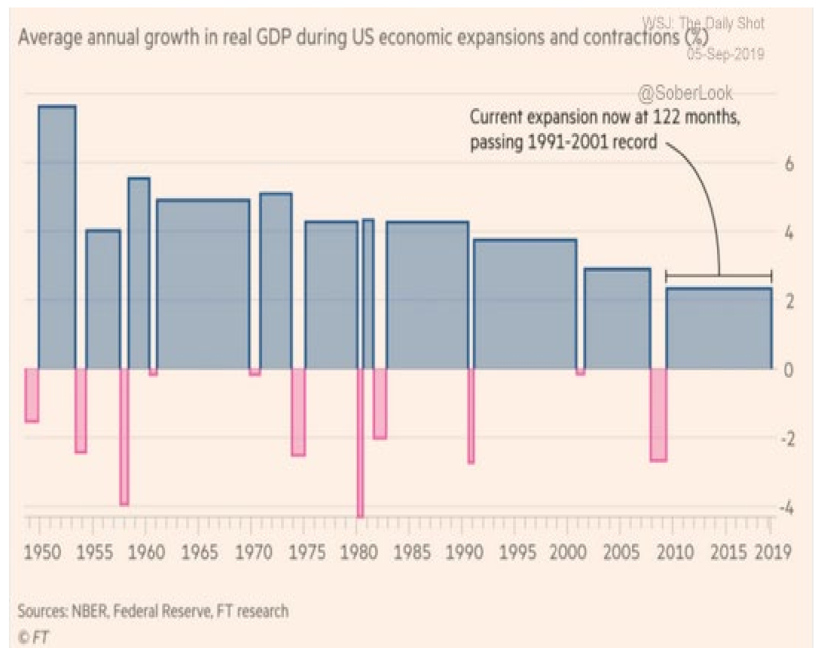
A Teenage Bull Market?

While many have discussed how the current US stock market is the longest bull rally in history (at 122 months), we believe it has actually experienced 3 mini-corrections over the last decade.



The technical definition of a bear market is a (20%) decline. In mid-2011, the market fell (19.6%) due to the European sovereign debt crisis, as well as S&P downgrading the US credit rating from AAA to AA+. While this does not actually meet the (20%) decline for a traditional "bear" market, we think it was close enough.

Then again, in 2015 to 2016, there was another big stock market sell-off. This decline started in some emerging markets, but the impact was felt around the world. From June 2015 to June 2016, the markets dealt with the devaluation of the Chinese yuan and the Chinese stock market fell by over 40%. Here in the US, commodity prices dramatically fell and crude oil prices declined from over $100 per barrel to a low of $26 per barrel. Some believe the declines were due to the Fed ending its QE (quantitative easing) policy, causing a sharp rise in bond yields. Regardless of the culprit, the US stock market declined, but once again it did not trigger that important (20%) bear market threshold.

Finally, in the 4th quarter of last year, the S&P 500 fell by (19.8%), with December declining by over (9.0%). Once again, that technical definition of a bear market was not hit, but we would argue that these series of mini-corrections should justify placing an asterisk next to this "longest ever bull market" in the record books. Instead of focusing on when the next recession will hit, we argue we are already emerging from our third mini-recession.

Is the global backdrop bad enough to be good? To be clear, we are not making the case the global economy is good; it is quite the opposite. We are making the case that the global economy and expectations are weak enough to cause a drop in market rates and a rise in global monetary accommodation.

Take A Deep Breath:

We are not industrial analysts, but the sector represents over 9% of the S&P 500. In our opinion, the industrial sector is a good representation or reflection of what the US is producing.

Last month, Honeywell's Chairman and CEO Darius Adamczyk had some interesting commentary. He suggested investors should take a step back from the day-to-day market volatility and try not to talk themselves into a recession. While he acknowledged global economic uncertainty, from the US / China trade war to Brexit, he

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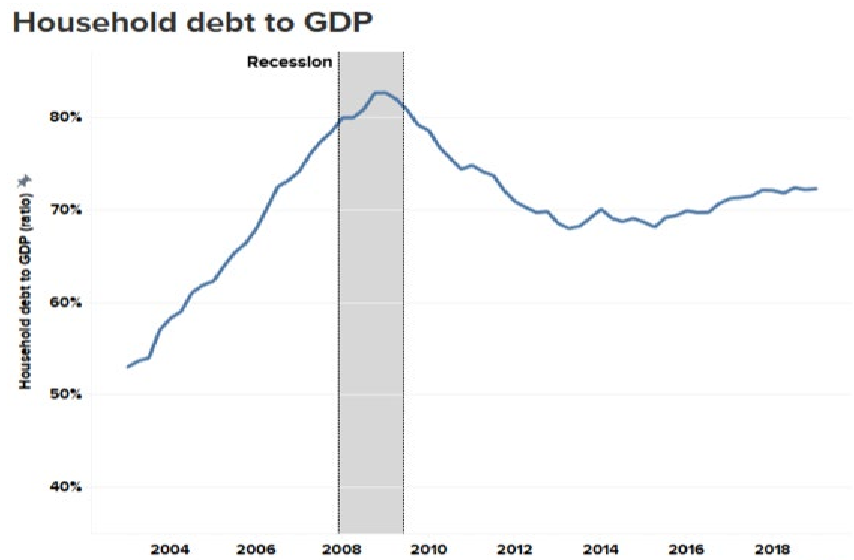
emphasized that "recessions can be self-created". Adamczyk pointed out that there is flaw with certain investors "watching the news cycle too closely" and that he "doesn't see a looming recession", at least not one in Honeywell's global franchise.

Main Street seems to be paying more attention to Wall Street, probably because more people are invested in the stock market. According to the Federal Reserve (i.e. the Fed), US household net worth currently stands at $108.6 trillion, more than double the $50.4 trillion in June 2009. The Fed credits this to a rising stock market, as well as steadily increasing real estate values.

Total US household debt stands at $15.7 trillion, which represents roughly 14.4% of total household net worth. Back in June 2009, the total household debt was a whopping 27.4% of total net worth. Whether we compare US household assets to overall debt or even to US GDP (as this chart does), there is no denying that our households are in much better shape than they were in a decade ago.



Lastly, the US balance sheet or amount of money "sitting on the sidelines", is enormous. Bloomberg reports that there is nearly $3.5 trillion in money markets assets, which is a level not seen since the flight to safety during the 2008 Financial Crisis.

Our economy is more intertwined than ever and we fully understand the concern about supply chains and how manufacturing is impacted from this trade war. However, like Adamczyk, we merely want our readers "to take a deep breath" and understand that the US economy is an amazing machine. It continues to "chug along" and deliver solid and steady growth. If an investor leaves CNBC on 24/7, there can be sense of panic that ensues. While we want to stay informed and up-to-date on all financial information and news, there can be a danger of self-creating a downturn.

Deciphering the Numbers:

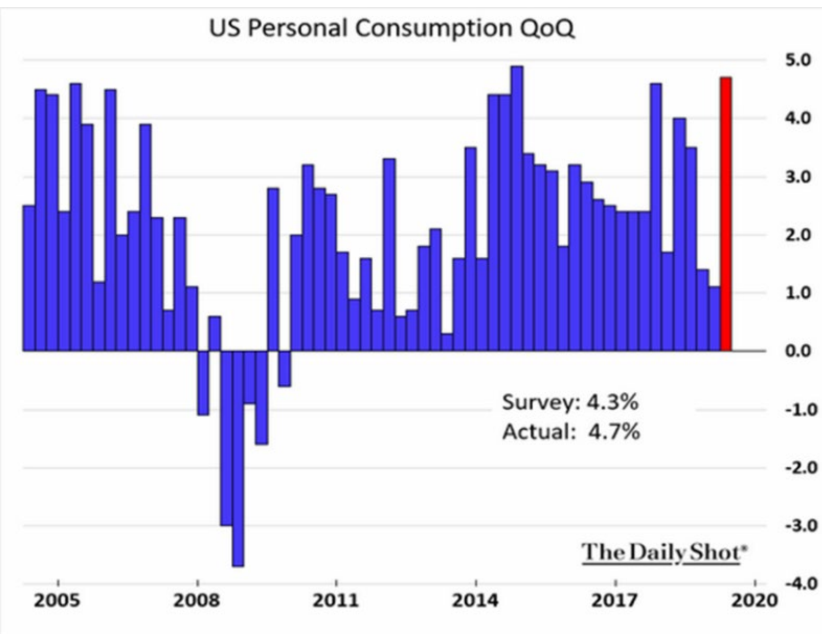
The Institute for Supply Management's (ISM) Purchasing Managers Index (PMI) were recently released and the results were underwhelming. The September ISM manufacturing index fell for the second straight month to 47.8, which was its worst result since July of 2009. This is a survey of 18 manufacturing industries across the country and a reading below 50 is considered negative.

According the Bureau of Economic Analysis, only 12% of GDP comes from the manufacturing sector. We are not trying to minimize the importance of the PMI reading, we are simply stating that consuming spending and sentiment are much more important for the US economy than an industrial manufacturing result.

After grasping the weak PMI release, the market was anxiously waiting on the monthly job report. Nonfarm payrolls came in at 136,000, slightly below consensus of 145,000 new jobs. Despite the miss, the August figure was positively revised higher by 45,000. Unemployment ticked down to 3.5%, which is a half century low. The consistently positive job numbers certainly indicate a strong labor market.

The American economy continues to "chug along" and even a slight payroll miss versus expectations led to a fairly strong market rally. Some referred to this job report as a "Goldilocks Report", in the sense it was "not too hot, and not too cold, but just right". It was good enough to lift the markets and slow enough to ensure the Fed continues its easing cycle. Quite simply, the prevailing wisdom is that the solid report underscored the strength of the US economy. The manufacturing weakness has been impacted from a global slowdown, as well as trade tensions. We believe these somewhat soft manufacturing numbers "seal the deal" for another rate cut.

Consumer Spending Drives the US Economy:



The biggest hero of this decade long bull market remains the US consumer. Consumer spending is estimated to equate to 70% of US GDP. The main driver of our economy is consumer spending. To state the obvious, consumers are likely to continue to spend, as long as they have a job. With unemployment at 50-year record lows, this bodes well for continued strong spending.

Just last quarter, the increase in consumer spending was the largest experienced since 2014. Can it really be that simple? We hate to continually simply everything to its most basic tenets, but there is something to the philosophy of K.I.S.S. or keep it simple stupid!

We believe the quintessential FINTECH business is the payment sector, which is fully intertwined to these spending levels. Are our payment companies properly identified as "Technology" stock, since Visa can process 65,000 transactions per second? Are these payment businesses "Financials", because they help move money from Point A to Point B to Point C? Are these payment companies "Consumer" stocks, since they are the transaction processor allowing customers to purchase goods and services? We don't concern ourselves with their GICS classifications, but rather are looking for wonderful businesses that meet our process, strategy, philosophy and ideal characteristics (click here) for investment.

Consumer Confidence:

Consumer confidence is "booming" and the US consumer is driving corporate profits higher. US balance sheets have never been stronger and 2nd quarter earnings results were just the latest example of this positive environment. Over the next month, we will likely see 3rd quarter growth reflect this same positive development.

Spending continues to drive corporate earnings and the US consumer is the engine of this growth. As the above chart highlights, consumer confidence has not been this high in nearly two decades.

For 2019, the US economy is expected to experience GDP growth of +2.6%. While this may not be in the 3% to 4% "perfect scenario" range, this growth is the envy of the developed world.

We should not ignore nor forget that this level of growth is actually stronger than the average annual GDP over this entire 10½ year bull-market expansion.

Picking the Low Hanging Fruit:

As the 2020 campaign approaches, President Trump faces an interesting dilemma. Does he run on a platform that focuses on controversial social issues or one that is centered on the economy and trade? We imagine that his platform will emphasizes "*MAGA*", the economy, jobs and securing trade deals. Over the next 12-months, President Trump could campaign that he secured a better NAFTA, a Japanese "enhanced trade" deal, a long-term agreement with the United Kingdom (potentially following their Brexit struggles) and another trading pact with India. President Trump's campaign should focus on the economy, and trade deals because they are much easier to enact/sign than DC legislation.

The US and China are not discussing a trade treaty that requires congressional approval, but are simply agreeing to a trade understanding. This is essentially an informal deal, whereby the US decides not to undertake additional tariffs, with China approving the purchase of $50 billion worth of US agricultural products. President Trump is quite aware that his "Round 1" deal does not require politically complex congressional approval.

As the old adage goes, "timing is everything". We were not privy to the complex trade negotiations with China and do not understand why they broke down. However, we cannot help but acknowledge some interesting timing. Would a resolution with the Chinese be helpful for President Trump, as he looks to get re-elected, a full 18 months before citizens vote? Or, would it be beneficial to resolve this dispute much closer to November

2020? We think that early-to-mid 2020 is much better timing (for his re-election), than May of 2019. We imagine Republican advertisements will focus on Trump's "economic wins".

How To Win an Election:

As we stated on page one, we will not address or discuss social issues or controversial political items. We truly believe that economics matter and help determine the average consumer's day-to-day outlook on life. While social issues tend to be some of the most important personal concerns for voters, we believe that successful campaigns tend to focus on the economy. We want to highlight the similarities we see between economic success and politically successful elections.

When Ronald Reagan was running against President Carter in 1980, the US was mired in an awful economic environment. In Reagan's closing phrase in his October presidential debate, he asked the American public "Are you better off today than 4 years ago"? Then, President Clinton's campaign strategist James Carville captured a similar economic tone, with his quote of "It's the economy stupid!" Clinton successfully beat George H.W. Bush for several reasons, but the slogan re-iterated how important economic conditions are to a campaign. While MAGA or "Make America Great Again" is a hot button for many, it hits on a similar economic theme. One of President Reagan's slogans, seen above on this campaign button, was "Let's Make America Great Again". Sounds familiar, right?

Looking back to World War 1, if the US economy did <u>not</u> have a recession heading into a re-election, the sitting President won 11 of 11 times. If there was a recession heading into the election, the sitting President lost 5 of 7. Quite simply, President Trump absolutely needs to keep the economy on firm footing, to improve his odds in November of next year.

We believe the economy will be the game plan President Trump uses to attempt to get another 4 years in the White House. With President Trump's daily tweets calling for lower interest rates, there is a clear desire to keep the stock market heading higher. We believe Trump's campaign will highlight economic strength, job growth and the US stock market. As both President Reagan and Clinton realized, getting elected or re-elected is impacted by dollars, cents and the economy.

If There Isn't A Recession Ahead Of The Re-Election, Presidents Have Won Everytime (Since WWI)			
Re-Election Date	President	Recession Two Years Before Election	Win Re-Election?
11/5/1912	William Taft (Rep)	Recession	No
11/7/1916	Woodrow Wilson (Dem)	Recession	Yes
11/4/1924	Calvin Coolidge (Rep)	Recession	Yes
11/8/1932	Herbert Hoover (Rep)	Recession	No
11/3/1936	Franklin Roosevelt (Dem)	No Recession	Yes
11/5/1940	Franklin Roosevelt (Dem)	No Recession	Yes
11/7/1944	Franklin Roosevelt (Dem)	No Recession	Yes
11/2/1948	Harry Truman (Dem)	No Recession	Yes
11/6/1956	Dwight D. Eisenhower (Rep)	No Recession	Yes
11/3/1964	Lyndon B. Johnson (Dem)	No Recession	Yes
11/7/1972	Richard Nixon (Rep)	No Recession	Yes
11/2/1976	Gerald Ford (Rep)	Recession	No
11/4/1980	Jimmy Carter (Dem)	Recession	No
11/6/1984	Ronald Reagan (Rep)	No Recession	Yes
11/3/1992	George H.W. Bush (Rep)	Recession	No
11/5/1996	Bill Clinton (Dem)	No Recession	Yes
11/2/2004	George W. Bush (Rep)	No Recession	Yes
11/6/2012	Barack Obama (Dem)	No Recession	Yes
11/3/2020	Donald Trump (Rep)	?	?

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Washington DC:

On October 8, 1998, the House voted to begin impeachment proceedings against President Clinton. The S&P 500 initially fell by (4.9%) before finishing the day down (1.2%).

On September 24, 2019, House Speaker Nancy Pelosi announced the launch of a formal impeachment inquiry against President Trump. Speaker Pelosi directed six House committees to continue their probes of President Trump "under that umbrella of impeachment inquiry." The market response was eerily similar, down (1.2%).

By the time Clinton was acquitted by the Senate in February 1999, the S&P 500 was up +28%. We do not bring this up to say that the stock market is poised for a massive move higher, simply because of impeachment proceedings. We make the point to show how certain political events in DC are not necessarily viewed the same on Wall Street. The stock market will likely view these impeachment inquiries as inconsequential and "much to do about nothing". Why?

After releasing the 5-page transcript of his call with Ukraine's President Volodymyr Zelenskiy, some are struggling to find tangible evidence that would support and justify an impeachment. Based on what we know right now, we anticipate the House will likely impeach President Trump. Within the House, estimates show Democrats have 86% support (203 of their 235 members) for impeaching President Trump. If / When the House passes a declaration of impeachment, it would then goto the Senate. However, within the Senate, we see the impeachment odds as extremely low. The Senate needs 67 votes for impeachment. With 53 Republicans, 45 Democrats and 2 Independents, we do not anticipate the Senate getting the necessary 2/3rd support for an impeachment, as it would take all the Democrats and 20 Republican senators to agree. We simply believe this will be incredibly difficult to accomplish.

That being said, if President Trump wants to keep as many Republican Senators on his side, he might want to limit his tweets attacking them, right? On October 5th, President Trump had this to say about Utah's Republican Senator , "Mitt Romney never knew how to win. He is a pompous 'ass' who has been fighting me from the beginning, except when he begged me for my endorsement for his Senate run (I gave it to him), and when he begged me to be Secretary of State (I didn't give it to him). He is so bad for R's!"

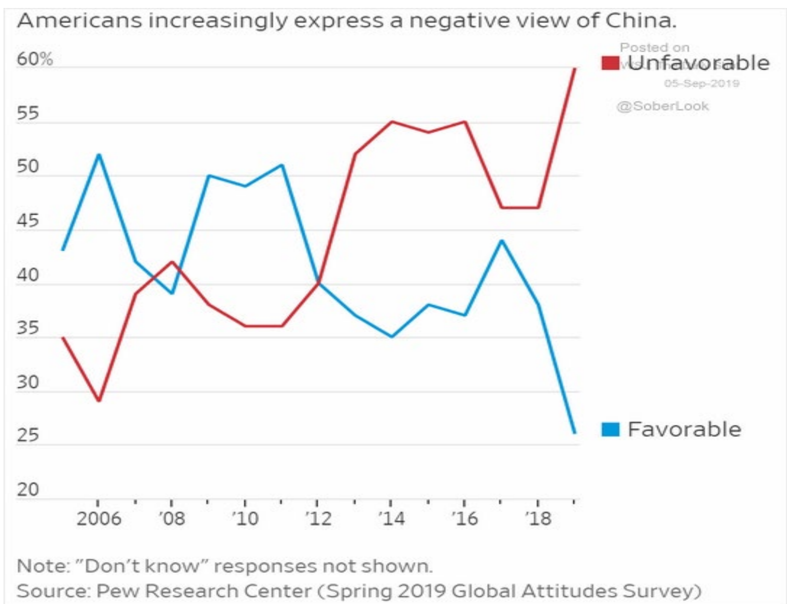
We love Washington for its wonderful museums, history and restaurants. However, we anticipate there will be nothing of legislative significance coming from DC for quite some time. House Judiciary Chairman Nadler has indicated that he would like to wrap up investigations by year-end. With the scope of the investigation still uncertain, there is now serious doubt about the time frame and how pervasive this process will ultimately be. Both the Nixon and Clinton investigations moved along fairly quickly, but we doubt this will take a similar brisk pace.

The next key date, is whether or not there will be another government shutdown in late November. Will President Trump respond to the House impeachment inquiry with additional demands for a border wall? Will DC's partisanship ever end?

This is why we love to focus on economics and bottoms up, fundamental research, and not politics. Washington and partisan politics are just too intertwined at this point in time. Unfortunately, too many in Washington have lost their ability to work together, to govern for the benefit of the American people they are elected to represent.

Does Washington Agree on Anything?

Democrats and Republicans do not agree of much, but both parties believe that the current trading relationship with the US and China needs some signficant adjustments. The Democrats may not agree with President Trump's tactics, but few Americans are in favor of intellectual property theft and unfair tariffs.



A recent Pew Research Center survey found, that American sentiment toward China has increasingly turned negative. The survey found that Americans have never had a more negative view of China than they do today.

On Wednesday October 9th, there was bipartisan agreement and a rare alignment between Republican Senator Ted Cruz of Texas and Democratic Representative Alexandria Ocasio-Cortez of New York, on one specific item. They both signed a letter to Adam Silver, the Commission of the NBA, stating how the league should show the "courage and integrity" to stand up to the Chinese government.

Over the last few decades, the NBA has made a concerted effort to generate interest and growth in the second largest economy in the world, China. Last year, NBA claims that 800 million people in China watched NBA programing on TV, digital media or their smartphones, which is more than 2.5x the entire population of the US. The NBA was the first US league to host games in China and it has hosted more than 20 pre-season games there since 2004. The Houston Rockets were one of the most popular teams in China, following the successful 8-year career of 7-foot-6-inch All-Star center Yao Ming.

The NBA was applauded for capitalizing on its huge popularity in China, with a number of financial transactions. In 2016, Lizhang Jiang became the NBA's first Chinese minority owner, when he purchased a piece of the Minnesota Timberwolves. The NBA, Tencent Holdings and national broadcaster CCTV made a 5-year deal for broadcasting rights for $1.5 billions earlier this year. Then, a month ago, co-founder of Chinese eCommerce Alibaba (Joe Tsai) became the first Chinese majority owner with his purchase of the Brooklyn Nets for $3.4 billion. Then, with one simple tweet, the NBA has become embroiled in controversy.

Then, on October 7th, a tweet from Houston Rocket's General Manager Daryl Morey complicated this budding marriage. Morey tweeted his support of the ongoing pro-democracy protests in Hong Kong and it immediately became a controversy.

Chinese sportswear maker Li Ning Co and Shanghai Pudong Development Bank Credit Card suspended cooperation with the Houston Rockets. State-sponsored CCTV immediately canceled the broadcast of all future NBA games, until further notice. How widespread did this new anti-NBA sentiment run? If a fan does a search for Houston Rockets merchandise on Chinese eCommerce sites JD.com or Alibaba, it returns absolutely no results.

The NBA released a statement that defended Morey's right to state his opinion, but also stated that he might have "deeply offended" some Chinese fans and that he "does not represent the Rockets or the NBA." NBA Commission Adam Silver has to delicately manage the financial implications of its large television contract versus a historical stance as a progressive purveyor of free speech. It is not alone in attempting to handle a Chinese controversy, as this is the same precarious situation that Starbucks, Cathay Pacific Airways, Apple and Electronic Arts have found themselves in recently. This trade war has forced businesses to walk a tight rope, between social freedoms and financial success.

China:

China is a complicated foe, as its economy is much more dependent on exports than ours. Chinese exports to the US have significantly dropped. However, China has been able to increase its non-US exports to dampen the overall impact.

The Chinese have tended to be more surgical in their retaliation to US escalation, using their buying power, with high-profile products such as soybeans. China has smartly targeted agricultural products, in key battleground states.

Chart Created by CME Group Economics.
Source: Bloomberg Professional (CNFREXP$)

At some point in time, it all comes back to economics. US farmers, many of those that support President Trump, are willing to absorb short-term pain for a long-term agreement that benefits America. The bigger question encompasses how much economic patience these farmers are prepared to provide.

One should not ignore Chinese issues; slowing growth, labor issues and increasingly troublesome protests in Hong Kong. While this lingers, President Trump continues his tariff policies and controversial tweets. While the stock market anxiously waits for his next 280 character social media message, short-term traders continue to

thrash around and whip stocks around. As we continue to highlight, the stock market hates uncertainty. Stocks are experiencing fairly wide swings both higher and lower of late. On Friday August 22nd, the US stock market had its worst day of the year, down nearly (3%). In a matter of days, those loses were erased.

The timing of this trade war is uncertain and the end rules are also an unknown. This is uncharted territory, with no historical assessment to grasp. While there are only a few select people who know how trade talks are progressing, one could argue that the 63.7 million following President Trump's twitter account have some insight, right? Are these simply negotiating ploys by President Trump? Is he using tariffs on the Chinese to get a deal, improve US manufacturing and/or impact interest rate policy?

The October round of tariffs were already delayed once, so another delay could be perceived as weak or capitulation. With the impeachment noise from the House, it could lead President Trump to retrench in his efforts against China. Looking to December 15th, that round of tariffs covers $160 billion of Chinese goods, with 2/3rds being mobile phones, smartwatches, video game consoles, computer monitors and Christmas ornaments. We believe a trade truce is more likely to occur, as we approach this deadline or early next year. We anticipate a trade deal with China will materialize, if both parties can claim some positives and media "wins". In the US, it will be likely be marketed as "the best trade deal with China ever" or at least since it entered the WTO in 2001. As this trade deals is formalized, and uncertainty is lifted, the stock market will rally and the economy will head higher.

The Fed & Monetary Policy:

President Trump has aggressively advocated for the Fed to lower rates, to help offset some of the economic damage being done by the trade war. While the Fed has somewhat complied, there is little likelihood of additional interest rate cuts making much of a difference to future economic performance.

The challenge is that the US economy's modest GDP deceleration is due to several factors. We have the anniversary of the December 2017 tax cut, the trade war has slowed business investment and confidence, significant corporate uncertainty over tariffs and supply-chain impacts. Even if US short-term rates were lowered to 1% or even 0%, it would not dramatically grow business investment. There remains too much uncertainty in corporate America stemming from this trade war. Fed Chair Jerome Powell discussed that this latest "insurance cut" was the equivalent of "an ounce of prevention is worth a pound of cure". Doctors know that there is no preventive effect from prescribing sugar pills. The necessary medicine (for global growth) requires a de-escalation of the trade war, over which our Fed has no real control.

Only President Trump can control the timing and ultimately conclude this trade war. However, he is using all of his negotiation tactics laid out in his well-known "Art of The Deal" book. Indian Prime Minister Narendra Modi just stated how President Trump is teaching him a few things about the art of negotiation. Leading into a US and Indian trade pact, Modi said, "President Trump often calls me a tough negotiator, but he himself knows the art of the deal and I am learning from him." We find it beautifully ironic that the positive quote on the front of this book is from the *New York Times.* It states that "Trump makes one believe for a moment in the American dream again."

Market Timing:

We continue to believe it is remarkably difficult to guestimate interest rates. For that matter, it is nearly impossible to predict energy prices, currencies, or any agricultural commodity. Want some proof?

Jamie Dimon cautions the 10-year Treasury yield could hit 5%: 'It's a higher probability than most people think'

A year ago, in August of 2018, a banner on CNBC (on left) mentioned that JP Morgan's Chairman and CEO was preparing the bank for 10-year Treasury yields to head towards 5%. Then, a few weeks ago, CNBC posted another banner (on right) that stated that Jamie Dimon was planning for the implications of interest rates in the US reach 0%.

Jamie Dimon says JP Morgan is preparing for the risk of zero rates in the US

Hugh Son | @hugh_son
Published 8 Mins Ago Updated Moments Ago
CNBC.com

There is no way to guess commodity prices and no way to time how long this stock market can keep on rising. Just because the bull market is over a decade old, does not mean it is close to ending. There are warning signs, from an inverted yield curve, widening credit spreads and slowing corporate earnings. However, these do not guarantee that the stock market is headed lower. We believe that rising equity prices and slowing earnings are an indication we are getting into the later stages of this cycle. This is precisely when investors need to focus on stock picking, rather than momentum or market timing. We have found, this is when investors need to understand how properly position a portfolio and how to hedge risk and minimize losses.

In the bull market of the 1990s and then again in the 2003 to 2007 time period, credit spreads widened, well before the equity market peaked. This was a clear warning to equity investors, which unfortunately went largely ignored. As we continue to highlight in our newsletters, we believe that credit is the lifeblood of an economy. When corporations or individuals or even governments can readily borrow money, the economy almost inevitably expands. By contrast, when credit dries up, economies and ultimately their equity markets drop. So now, we will address credit, interest rates and the debt market.

The Debt Market:

How low can interest rates go? While we don't know the answer to that, but we do know that there are significant risks involved with the debt markets. We are seeing widespread monetary debasement, higher commodity prices and a potentially massive bond shakeout. We are far from bond market experts, but we do value the opinion of James Grant (Grant's Interest Rate Observer), as well as Rick Rieder (Blackrock's fixed income CIO, with $2.2 trillion under management).

Grant recently offered the opinion that the market will shortly end the "38-year bull market in bonds" and Rieder has been discussing a "monetary endgame." Since yields peaked in 1981, the debt market has been in a wonderful environment. The slow and steady move downward of US interest rates has been a boon for bond investors. From their peak yields in September of 1981, long-dated Treasuries generated an impressive compound annual return of 11.0% which eclipses the S&P 500 total return of 10.8% per year.

While more and more people are looking at the yield curve for the inversion that forecasts a looming recession, we are taking a slightly different viewpoint. Yes, the 2-year versus 10-year has actually inverted and yes, this has done a decent job of predicting a recession over the next 18 to 24 months. Are the fundamentals driving this downward move? We would say that the answer to that is no. We believe that the reason the US yield curve has inverted is the enormous demand for our Treasuries. About 1/3rd of the tradeable bonds in the world, roughly $17 trillion, now have negative yields. Considering our economy is still doing well and our debt still trades at a positive yield, one can begin to understand its somewhat attractiveness.

Germany is the strongest economy in Europe and it is teetering on the edge of a recession. Japan has been struggling with delivering growth for a couple of decades, yet their debt is currently trading at negative 30 basis points for 10-year debt. Despite slower growth rates around the globe, several countries are able to issue debt that all but guarantees the buyer will lose money. Does this make any sense?

Where else are bond issuers to go, if not for the US yield? If you are looking for safety and/or capital preservation, the virtual risk-free guarantee of US Treasuries is the best option. Despite paltry yields, both Grant and Rieder agree that US Treasuries are still the "best game in town." Grant says that the worst assets to hold are "sovereign bonds, with negative yields," followed closely by "paper money (in infinite supply) at zero yield."

Interest Rates:

As our readers know, we utilize the CME's rate tool to gauge market interest rate sentiment (click here). We never speculate on where interest rates are headed but attempt to frame how our businesses will do in both up and down rate environments. A few weeks ago, the Federal Open Market Committee (FOMC) cut Fed Funds by 25 basis points, to a range of 1.75% to 2.00%. This was the second cut in as many months and it will likely continue to pursue a dovish stance for the remainder of the year and into 2020. According to the CME rate tool, expectations are at 73% for a 3rd cut this month.

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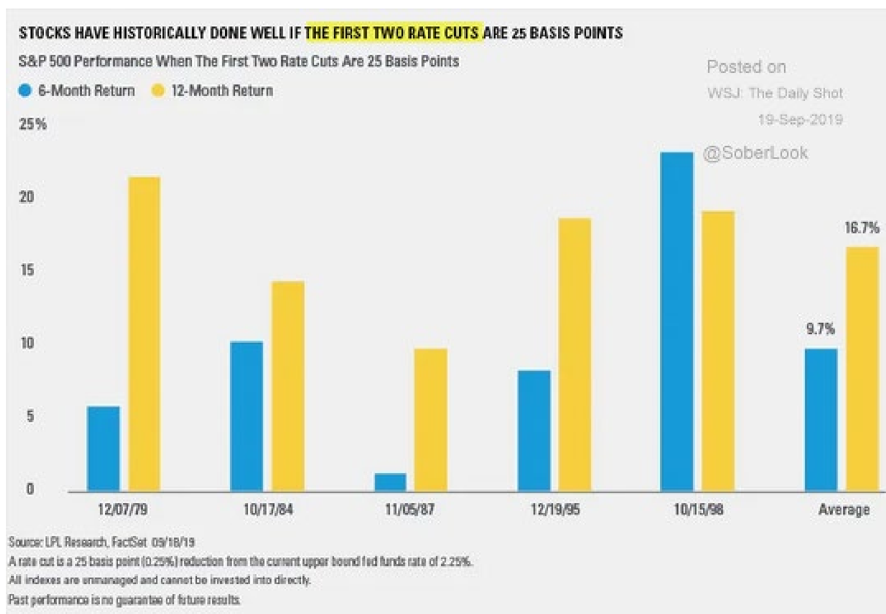
In his press conference, Chairman Powell gave himself plenty of wiggle room to make future decisions on a "meeting-to-meeting" basis. He said, "There will come a time, I suspect, when we think we've done enough. But there may also come a time when the economy worsens and we would then have to cut more aggressively. We don't know," he confessed.

To once again simplify things, lower rates bode well for the stock market. As the chart from LPL shows, stocks have averaged +16.7%, following two 25 basis point Fed rate cuts. Looking back to 1954, per Ned Davis Research, there have been 15 easing cycles (as defined by two or more rate cuts). NDR found that the median gain for the S&P 500 was +11.1% over the next 6 months and +18.3% over the following 12-months. There is clear evidence of a positive stock market reaction to two Fed interest rate cuts.



Who Are You Calling A Bonehead?

The White House remains the biggest critic of the Fed and US interest rate policy. Right before the Fed lowered interest rates last month, President Trump had a particularly interesting tweet.

He stated: "The Federal Reserve should get our interest rates down to ZERO (or less), and we should then start to refinance our debt. Interest costs could be brought way down, while at the same time substantially lengthening the term. We have the great currency, power, and balance sheet. The USA should always be paying the lowest rate. No Inflation! It is only the naïveté of Jay Powell and the Federal Reserve that doesn't allow us to do what other countries are already doing. A once in a lifetime opportunity that we are missing because of **Boneheads**."

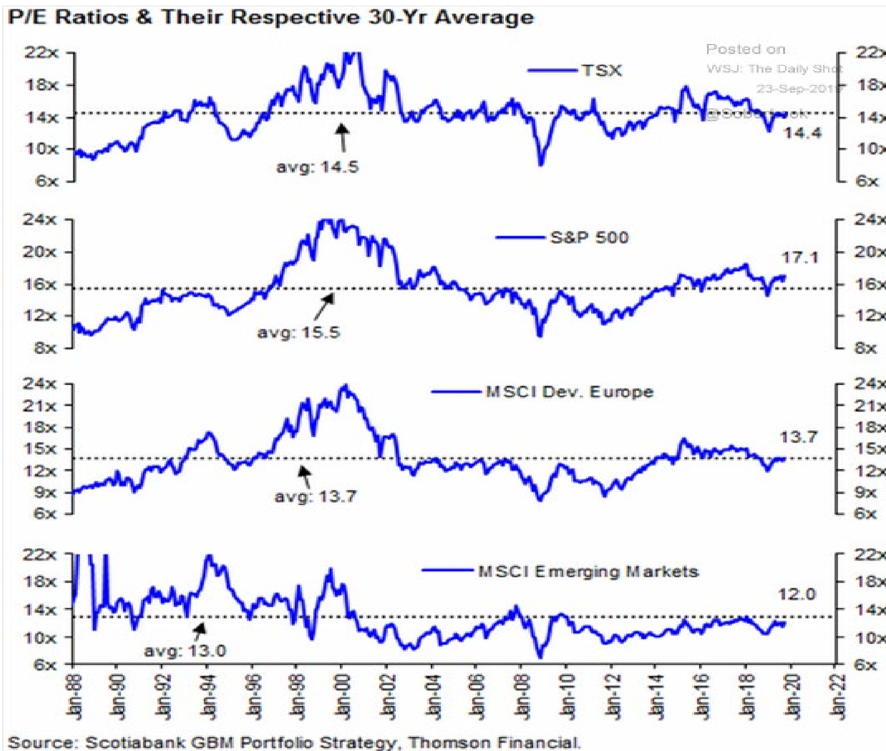
While we agree that there could be benefits to refinancing the US debt burden at lower rates, we would hesitate before calling the Fed Chairman Powell a "bonehead." After all, Chairman Powell is an individual with an undergraduate degree from Princeton, a Juris Doctor from Georgetown University's Law Center and impressive work experience at the Bipartisan Policy Center as well as the Federal Reserve Board of Governors.

Kansas City Fed President Esther George recently said, "[T]he US economy is currently in a good place with low inflation, low unemployment, and an outlook for continued moderate growth." George was actually one of two Fed dissenters last month, as she did not feel the economy merited a quarter percentage rate cut. While she did not rule out Fed support, her statements reflected a positive perspective on the US economy.

Now that we are roughly 3/4th through the year, it is clear that a global economic slowdown is more evident. Japan and Europe will be unable to spur growth with lower and lower interest rates. Their Central Banks will be forced to stimulate their economies through QE (quantitative easing). We continuously mention our astonishment that there is currently $14.7 trillion of bonds yielding less than 0.0%. Who would willingly "invest" for 30-years knowing full well that they are going to lose money? Apparently, a lot of people….

Looking Forward to 2020:

We continue to believe the US equities (especially our FINTECH portfolio) is the "nicest house in the neighborhood." The percentage of S&P 500 companies with dividend yields greater than the 10-year Treasury yield is at a three-decade high. We believe FINTECH stocks with pricing power, solid free cash flow, dominant market shares, and decent dividend yields are a good place to invest. We are not burying our head in the sand, nor are we trying to be contrarian. We are simply looking at individual business fundamentals and building our models on a company by company basis.



In terms of equity valuations, other regions outside the US are trading at or near their 30-year historical average valuation multiple (represented by P/E ratio). While the US is slightly above its long-term average of 15.5x, we believe its current above average growth rate justifies this modest premium.

Let us play along and just say that we are wrong on everything we listed above. If the inverted yield curve is actually the perfect leading indicator that signals a recession will occur, we have another 18 months before it occurs. Using history as our guide, the economy often expands nicely - after a yield curve inversion - and the stock market lifts by an average of 33% over the following 26 months.

Conclusion:

It is always better to anticipate than just react to current market conditions. In order to adopt a tactically defensive position in a declining market environment, especially one driven by fear, we must be convinced the current global growth slowdown is going to end in an imminent recession. We see no reason to change our game plan, positioning or strategy. We are fundamentally positive on the US consumer, job and wage growth as well as the US economy.

Fortunately, the US economy is strong, unemployment is near record lows and our annual GDP is pacing at a better rate than the average annual GDP for this entire record expansion. Consumer confidence is high, corporate earnings continue to impress, and household income is at the highest level in roughly 20 years. We are not ignoring macro headwinds like Brexit, trade concerns, Iran sanctions, Hong Kong protests, slowing global growth, softer economic data, and political drama in Washington. However, revised and updated trade deals are getting written. While growth is moderating, Central Banks are ready to respond with lower interest rates to spur economic growth. Despite solid appreciation year-to-date, valuations are not overly inflated.

Despite significant uncertainty, we remain positive on the US environment, especially the resiliency of our concentrated FINTECH portfolio. We are not forecasting a strong acceleration in growth, but just a continuation of some of the best fundamentals in the developed world. We are focused on the economy, as well as the specific fundamentals driving our businesses, which focus on free cash flow, have predictable and sustainable business models and are much more recession-resistant than the average company.

The main event recently has been the resumption of US & China trade talks. We believe this trade war will be positively resolved (or at least partially), over the next several months. Not ***if***, but ***when*** this occurs, the stock market will materially rally, as the change will usher in years of additional growth and success. A resolution will not only help both countries, but it will lift uncertainty and boost global growth.

In the meantime, we have an accommodating Fed ready and willing to cut interest rates and "act as appropriate to sustain the expansion." While the 3rd quarter experienced heightened volatility, with significant economic and political uncertainty, we remain optimistic about our portfolio and its ability to outperform.

We look forward to speaking with you soon!

Warren Fisher, CFA
Founder
Manole Capital Management

Lee Iacocca:

- Iacocca created Ford's legendary Mustang and is credited with reviving Chrysler
- The Lehigh University alum unfortunately passed away at age 95 last July
- Iacocca was renowned as a superb leader and was the type of CEO that investors could learn from
- "You can have brilliant ideas, but if you can't get them across, your ideas won't get you anywhere"
- "We are continually faced by great opportunities, brilliantly disguised as insoluble problems"

T Boone Pickens:

- On September 11th, 2019 legendary oil tycoon T Boone Pickens passed away at the age of 91-yrs old
- Upon his passing, Pickens provided a fascinating letter to his "fans"
- That letter laid out some of his insightful principles, that helped him amass his wealth
- "I always believed the higher a monkey climbs in the tree, the more people below can see his ass."
- "Avoid the 'Ready-aim-aim-aim-aim' syndrome. You have to be willing to fire."
- "Young people loved me because I embraced change, rather than running from it."
- "Don't look to government to solve problems, as the strength of this country is in its people."

Active versus Passive Management:

- On Sept 13th, Morningstar reported that for the 1st time ever, passive equities exceed active assets
- Passive now has $4.3 trillion in equity assets, which shows two items
- One is that we are dinosaurs and two is that the rise of robots/automation is here to stay

Leadership:

- In June, Challenger, Gray & Christmas reported that CEO's are departing at the fastest clip in 17 yrs
- CNN highlighted 52% of announced CEO departures of Russell 3000 index co's (over last 2yrs) were fired
- 24/7 Wall Street reported that August CEO departures were up by 28% year-over-year
- In late Sept, the CEO's of Juul (Kevin Burns), eBay (Devin Wenig) & We Works (Adam Neumann) all left
- John Maxwell said, "A good leader is a person who takes a little more than his share of the blame and a little less than his share of the credit."

ATMs:

- 50-years ago, Chemical Bank (now JP Morgan) introduced the first ATM in the US
- On September 2nd, 1969, a Rockville Center (Long Island suburb), NY installed the first US ATM

FICO Scores:

- For the 1st time ever, the average national credit score reached 706
- This figure (developed by Fair Isaac) is used by most lenders to determine credit worthiness
- The FICO range IS FROM 300 (on the low end) to 850 (highest score possible)
- A "good" score is typically above 700 and an "excellent" score is over 760
- Once a FICO exceeds 700, most consumers will qualify for any type of credit

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