Manole
Capital Management

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1st Quarter 2018 Newsletter

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Our Newsletter Focus:

In our quarterly newsletters, we attempt to highlight bigger picture issues and macro themes. Here, we will review our biggest mistakes, takeaways from 2017, our expectations for 2018, interest rates and inflation, as well as the implications of tax reform on the overall market. At the end of our newsletter, take a look at our section entitled "Interesting Quotes, Statistics and Facts".

As always, we will avoid controversial social concerns and instead will attempt to frame how global issues can impact our economy and the stock market. We intentionally choose not to get into political chatter, but focus on providing thoughtful policy analysis to provide context for our investment ideas. We consistently assess risk and make various trade-offs. Our process, philosophy and strategy remain constant and we remain disciplined and relentlessly look forward.

During each quarter, we attempt to discuss specific companies or bigger trends we see in the marketplace. Over the last few months, we have written numerous pieces of research on specific stocks and reviewed the bubble that we see in bitcoin. If you would like to view or read these proprietary notes, please visit our website at www.manolecapital.com and click on the "Research" tab.

Our Mistakes & There Are Many:

George Santayana once said "Those who cannot learn from history are doomed to repeat it." In 2017, we were wrong on several fronts. For example, we predicted in January of 2017 that it would be wise for President Trump to go after a "Big 3" of economic policies: tax reform, infrastructure spending and de-regulation. Maybe we are always too focused on the economy, but we view economic issues as being the safer and more impactful proposals to attempt to enact than social policies. Plus, we love the quote from Democratic strategist James Carville "It's the economy stupid!"

We felt it would be wise to sequence President Trump's actions and attempt to solve these three items first. Instead, once in office, President Trump attempted to repeal ObamaCare not once, but twice. Both efforts failed. To score a quick win, President Trump should have attacked the simplest legislation to enact, namely infrastructure. During the campaign, both he and Hillary Clinton had infrastructure bills that seemed to have rare, bipartisan support. One area President Trump has succeeded in is de-regulation. Too many new regulations were enacted after the Financial Crisis and certain rules were crippling American innovation. Companies were investing overseas more than here in the US. This administration has done an admirable job of cutting red-tape, reducing compliance regulations, and prioritizing economic growth. Last, but not least, Republicans have finally passed tax reform. We will address this in detail later on, but a tax overhaul will be the platform Republicans base their midterm election fate upon. So, we erred in the sequencing of President Trump's agenda, but he did accomplish two out of our "Big 3" policies.

Volatility:

Another failed prediction of ours was expecting elevated volatility. We envisioned a wildcard in the White House with an untamed Twitter account to lead to massive swings in the market. In fact, the exact opposite occurred. By many measures, 2017 was the least volatile year in the history of the S&P 500 index. On January 5, the US stock market set another all-time record. At 394 trading days, it is now the longest stretch in market history without a 5% drop within any six-month period. Not a single day passes without an analyst highlighting that the fear gauge, also known as the VIX, is well below its 10-year average of 19. Over the last 60 years, the VIX has averaged 15.8. For most of the year, the VIX lingered near 10. We anticipated that market volatility would be a positive catalyst for our derivative exchanges. While some worry that this "dead calm" is a flashing red indicator, we do not consider low volatility a reason to sell. Despite this subdued environment for volumes, our exchanges performed quite well in 2017. If volatility spikes in 2018, volumes will soar and we should benefit.

Security:

We take pride in Manole's security protocols and protections. However, another mistake of ours was ownership of Equifax (ticker EFX). This was clearly a stock-specific mistake and not a business fundamental error. We had a long history with this dominant credit-reporting company, which had been quite a profitable investment for us. Then, in September of 2017, it disclosed one of the largest data breaches in US history, with the hacking of 145.5 million Americans' personal data. Information like names, social security numbers, driver's licenses, addresses, and birthdates was compromised. We immediately parted ways with the company and sold our position to 0%.

This stock-specific error raises another issue of concern. In 2016, breaches at Target and Home Depot were high-profile and newsworthy events. During 2017, data breaches or ransomware plagues hit Arby's, Chipotle, Sonic, FedEx, Merck, HBO, Mondelez, InterContinental Hotels, Hyatt, Uber, PayPal, Whole Foods and many others. With daily news reports of companies getting hacked, we worry that companies are still not taking the threat seriously enough. Lawmakers are beginning to look at overhauling the data and information business, but additional rules and regulations will be too late. According to Sentieo Research, the number of S&P 500 companies that cited the risk of data breaches in the risk factor section of their annual report is less than half. In our perspective, we do not like the fact that so many companies are failing to adequately address the potential for a data-breach in their 10-k's. The data and information sector is a large component of our portfolio and one that will continue to be closely monitored.

What's In A Name:

Lastly, one of our biggest mistakes was not changing our name. Many people struggle with pronouncing Manole, which is why we have the pronunciation spelling of ***muh-NOLE-ay*** on the front page of our website. A difficult-to-pronounce name was not our biggest mistake, rather it was not changing it to Bitcoin Capital or Blockchain Capital. What do we mean?

The market has embraced companies with bitcoin and blockchain in their names, as we saw back in 2000. Back then, all a company had to do was add *dotcom* to the end of its name to get a material stock bump. Today, companies can add bitcoin or blockchain and get an undeserved benefit. For example, Long Island Iced Tea Corporation, based in Farmingdale, New York was founded in 2011 to make and sell peach and lemon iced tea. In mid-December, on the Nasdaq exchange, it had a $24-million valuation. It continues to produce and manufacture iced tea, but it simply changed its name one day to Long Blockchain. Long Blockchain now wants to explore and invest in opportunities that use blockchain technology. Its CEO Phil Thomas stated that "If you traveled to our beverage facility looking for evidence of a blockchain company, clearly you were not going to find one." What was the result of this simple name change? The one day stock market response was +183%.

What another example of how a simple name change dramatically impacting valuation? Before simply putting blockchain in its name, Riot Blockchain (ticker RIOT) was a healthcare company named Bioptix Diagnostic. This 7-person company developed technology for the detection of molecules. Once bitcoin took off and the company saw the opportunity in blockchain, in October of 2017 it switched its name and mandate from healthcare to technology. Once it added the general-ledger platform behind cryptocurrencies to its name, it experienced a 730% rise it its stock price and it now has a market cap of $300 million. If this isn't a sign of a bubble, we don't know what is.

Want another example of the silliness of bitcoin mania? Here is one last example. Back in September, a sports-bra designer languished at $0.01 per share on the over-the-counter "Pink Sheets" market. Then, Michael Poutre, a one-fifth owner of Crypto Companies, purchased the company to do a reverse merger and become a publicly traded entity. With bitcoin mania, Crypto leapt to a market capitalization of $12.6 billion last month. As the company skyrocketed in value, CEO Poutre had a paper net worth of $3.9-billion, making him one of the wealthiest people in the US. Just as in the dot-com bubble, buyers do not seem to care about what price they pay for these cryptocurrencies or companies. Bitcoin is yet another example of the madness of crowds, with speculators buying something, almost anything, crypto related. Buyers clearly intend to sell these coins to a bigger fool down the road. What will happen when governments around the world view cryptocurrencies as a threat to their fiat currencies and policies. We wonder how many buyers will be clamoring for bitcoins when the music eventually stops.

Coins:

Another area, which has received little public scrutiny involves ICO's or initial coin offerings. These ICO's have skirted SEC regulatory oversight and raised billions of dollars, but we believe a day of reckoning is coming. Instead of going public and having an IPO (initial public offering), some companies can raise money and issue coins instead. For example, a company called block.one is a newly formed software company that plans to "dominate the blockchain industry." It has the desire to create software that it would like to process "millions of transactions per second." We have a desire to be the quarterback for the Miami Dolphins, but that dream is slowly fading. For perspective, Visa has massive scale and it can handle nearly 60,000 transactions per second. Block.one has no current products and has no revenue. Each day, block.one sells two million tokens (called EOS) to "investors" that sign up on its website. These tokens have no relationship to the future software, and people sign an agreement that specifically states that these tokens "do not have any rights, uses, purpose, attributes, functionalities or features." Investors

cannot buy enough block.one EOS tokens even though they have absolutely no intrinsic value. In late December, block.one had a market value of $4.5 billion, making its 31-year old founder worth (in paper or tokens) over $1 billion. As "Fin Tech" investors, we clearly erred with our name choice.

During the 2000 to 2002 bear market, the S&P 500 fell by 49.1%. During the Financial Crisis of 2007 to early 2009, the S&P 500 fell 56.8%. We will not be surprised to see a similar decline in some of these less-than-stellar businesses. The SEC argues that the technology underlying tokens is irrelevant. When tokens are used to raise funds, they should be considered a security. Unfortunately, speculators are purchasing these tokens not to own a piece of a future project or business, but rather because they believe the tokens will skyrocket in value. During 2017, nearly $4-billion was raised in ICO's and through token sales. Our alarm bells are ringing quite loudly. We would suggest you be extremely careful if you invest in this unregulated market. Call us "old school," but this is absolutely not a fin-tech business we feel comfortable participating in.

2017 Highlights:

What a year! On the political front, it was hectic and surprising, but it ended with a major piece of tax legislation getting passed. The vast majority of global equity markets rose in 2017 with nearly half of the 35 major indexes, representing the world's biggest stock markets, hitting all-time highs. Investors cheered the combination of improving corporate earnings, strengthening economies, and central banks providing supportive monetary policies. Simply stated, the markets are reflecting a synchronized, global economic recovery.

Despite some geopolitical uncertainty, the FTSE 100 in the UK and South Korea's Kospi both set record highs. Just last month, European consumer sentiment rose to its highest level since April of 2001. The MSCI World stock index hit 58 daily record highs in 2017. Market volatility has fallen to historically low levels and many investors are using every market dip as an opportunity to buy more stock.

We like to use the S&P 500 as an overall US equity market proxy. For the year, the S&P 500 was up 22%, led by its largest sector weight, Technology, up 35%. Financials, Healthcare, Industrials, Materials and Consumer Discretionary all rose by more than 20%. The only two sectors down last year were Energy and Telecom, down 1% and 8% respectively. Interestingly, maybe only to us, was that the Energy sector was the single best performing sector for the market in 2016. Clearly, energy is a cyclical business prone to large and volatile swings. The Dow Jones Industrial Average logged over 60 record closes during the year, which was the most it recorded since 1995. The technology-heavy Nasdaq was up 30% and set 69 new, all-time highs. For the first time ever, the S&P 500 was positive every month during the calendar year and is up 21 of the last 22 months (see page 15).

US:

Above all, 2017 might be best remembered for its natural disasters. There were 16 billion-dollar events last year, with an estimated $240-billion of damages for the insurance history. Hurricane Harvey and its massive flooding, hit Houston on August 25, killing 84 people and causing $73.5 billion in damages. Hurricane Irma then hit Florida on September 6, leading to 95 deaths and $63 billion in costs. Next on September 19, Hurricane Maria crushed Puerto Rico, killing 64 people and inflicting $70 billion in damages. Many parts of Puerto Rico still lack clean water and a steady flow of electricity despite the storm having occurred 4 months ago. At the end of the year, California was ravished by wildfires, causing more damages for thousands of homes and businesses.

On a national level, sexual misconduct rocked the media, political, entertainment and business worlds. What started with harassment and assault claims again Hollywood producer Harvey Weinstein eventually led to admissions from TV hosts Charlie Rose, Bill O'Reilly, Matt Lauer and others. Political figures were dragged into the "#metoo" fury, as resignations from Congressman John Conyers Jr. (D, Michigan) and Senator Al Franken (D, Minnesota) followed. The special election for Alabama's senate seat was impacted when it was alleged that candidate Roy Moore preyed on teenage girls while he was in his 30s. This allowed a Democrat to win a senate seat in Alabama for the first time since 1992. In late December, the House of Representatives disclosed that it has paid out more than $300,000 to settle discrimination and harassment claims against its members. We are confident that this will not be the last harassment issue we hear about.

Whether you love or hate President Trump, the stock market has essentially turned a blind eye to his administration. Since his election, US markets have added $6 trillion in value. This strong move higher is not a reflection upon President Trump or his social thoughts, but rather reflects a dramatic increase in business confidence, higher earnings and faster growth. The Federal Reserve Bank of Atlanta forecasts growth for the US gross domestic product of above 3%. The entire world benefits when its largest economy is healthy and growing. For the first time in decades, the world is experiencing synchronized and vibrant growth. Global output in 2017 grew at the fastest pace since 2010, and Barclay's is estimating that global growth in 2018 will exceed 4%.

In late November, Barron's had an article highlighting that the tax bill was a "coin flip." UBS's Alan Detmeister co-wrote a note stating that any tax-reform plan would be difficult to pass and Daniel Clifton of Strategas Research said that stocks were only pricing in a 30% chance of a tax bill becoming law. Late last month, House and Senate Republicans passed the largest tax overhaul package in 31 years. How divided is Washington DC? When President Kennedy passed tax reform in 1964, he received 21 "yes" votes from Republican Senators. When President Reagan passed tax legislation in 1986, his bill received 33 "yes" votes from Democratic Senators. Even President Bush's tax package in 2001 received 12 Democratic "yes" votes. Both 2012 presidential candidates favored a corporate tax cut, but five years later this became a deeply partisan brawl. Just as ObamaCare passed without any support from Republicans, President Trump's tax reform received zero Democratic votes.

Tax Reform:

Back in 2010, Dodd-Frank was over 10,000 pages and had bizarre and unnecessary amendments addressing things like debit card routing rules. As we promised, we will not address social issues in our notes. However, we do wish a piece of legislation could emanate from Washington DC that was clear, concise, and straightforward. Why can't this tax reform bill focus just on taxes? Why must it include language and rules on healthcare mandates, abortion issues and gun protections?

Back to the tax bill and its ramifications. This is not the first swipe at tax reform Congress has taken. In fact, since 1981, the Urban-Brookings Tax Policy Center counts 55 bills as "major" pieces of tax legislation. Across the political spectrum, economic and social policies have crept into tax policy in the form of credits, deductions, and exceptions.

To summarize the Republican viewpoints, they believe this bill provides real relief to middle-income families and realizes goals conservatives have sought for decades. The centerpiece of the bill is an attempt to provide sweeping pro-growth reforms to an overly complex tax code. Not since President Reagan's historic tax reform in 1986, has this bold a tax plan been passed. Over the next year, Republicans will advertise this plan as helping the middle-class that has been squeezed by a tax code that is complicated and skewed toward special interests.

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Simplicity and The Numbers:

We do not want to get into the nitty, gritty details of the child tax credit, the changes in mortgage interest deductions, or the narrowing of state and local tax deductions. With passage of the tax bill, calculating one's taxes will be dramatically simpler. Paul Ryan (R, Wisconsin) stated that 9 out of 10 Americans will be able to file their taxes on a form the size of a postcard.

Over the next decade, households in the $20,000 to $100,000 a year in income will get $144 billion in tax cuts. A family of four earning the median income of $73,000 can expect to receive a $2,000 tax cut. The independent Tax Policy Center has concluded that 91.3% of households in the very middle of the income distribution, making $48,600 to $86,100 a year, will receive a tax cut in 2018. Considering that nearly 8 in 10 Americans live paycheck-to-paycheck, this bill should provide some much-appreciated relief, not to mention a boost for their take home pay by February (when the IRS will adjust its withholding tables). Throw in that 2/3 of our economy is powered by consumer spending, and the decision to put more money into the middle-class should spur growth and activity.

We were pleasantly surprised to see Wells Fargo and Fifth Third raise minimum wages on the day the tax bill was signed. AT&T and Comcast announced that they would use tax relief to give more money to their employees in the form of $1,000 bonuses. Boeing announced a $300-million employee-related charitable donation program, and FedEx announced it would hire additional employees to accommodate its higher growth expectations. We would love to see a stampede of companies lifting wages and reinvesting in their businesses, but we will take a "wait and see" approach. We remain skeptical and realize that many of these early announcements are more marketing than substance.

Dynamic Scoring:

The impact to US deficit levels will depend on future growth rates. While we always strive to look forward, it is helpful to gauge the impact of public policy through the mirror of historical experience. We utilize models in Excel every day, but economic models are invariably predictions and based upon the inputs. Estimates for the impact of tax reform will be quite varied, depending on which economist you ask.

In the tax reform budget, Congress set a hard $1.5 trillion limit on 10-year revenue losses. Using their models, the Congressional Budget Office believes the economy will average 1.9% growth over the next decade. Why does each small percentage of growth matter so much? Well, if the economy can average 2.6%, instead of 1.9%, the entire tax reform bill will not raise the deficit $1. In fact, we have seen that an average growth rate of only 2.3% would generate $1.3 trillion of extra revenues.

To put that CBO estimate of sub-2.0% growth rate in perspective, America grew from the end of World War II through 2008, which included 10 recessions, at an average rate of 3.4%. During the 1973 to 1982 time-period, with three recessions and four years of negative growth, America still generated 2.3% average growth. So why are estimates assuming under 2.0% growth for America over the next decade? When President Reagan claimed his tax cuts would generate 4.4% growth for five years, it was universally derided as too "rosy a scenario." Despite falling into a recession before the tax cuts even took effect, the economy actually grew by 4.4% from 1983 to 1988. In fact, the CBO underestimated economic growth by 1.3%.

US vs The World:

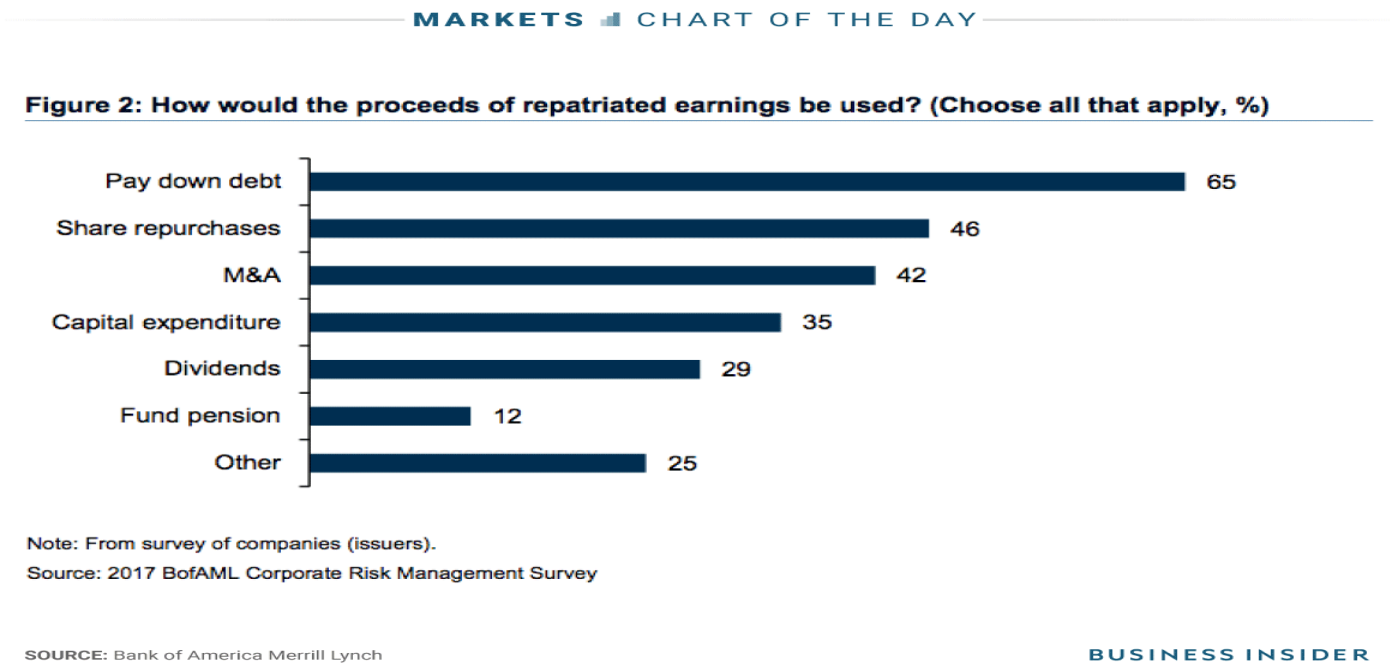
We are firm believers in American exceptionalism and feel if economic policies are in place for America to succeed, it will. Only time will tell who is right, but we believe that stimulating growth and boosting economic output will improve our prospects. Tax reform is absolutely a positive catalyst for the equity market, but it will not be a "cure all." Some companies will properly allocate capital while others will waste this opportunity. We believe that the long-term growth of the US will be more dependent on innovation, inspiration, experimentation, then simply on a lower tax rate.

For too long, US companies have moved corporate headquarters out of this country for attractive tax havens like Ireland, Cayman Islands or Singapore. In our opinion, it is obvious that tax reform will clearly advantage US companies versus their European peers. Recently, Germany's Center for European Economic Research published a report titled "Germany Loses Out in US Tax Reform." Why would a German manufacturer build its next factory at home, with its 31% statutory tax rate, more

onerous labor regulations and an aging population? America beckons with better demographics, the world's largest economy and a much lower tax rate. One could anticipate that many European companies might find it hard to resist investing in America with its 21% federal tax rate. If you believe that incentives matter for investment, job creation and economic growth, then tax reform should spur the US economy.

Repatriation:

We do not envision that all of the estimated $3.5 trillion of overseas money returning to the US will go towards building factories, raising wages, and hiring employees. There is no way to stipulate that companies repatriate cash and bypass making acquisitions, buying back stock, or returning cash to shareholders via a dividend. Companies will assess their prospects and hopefully will utilize this cash in the best interest of shareholders. In fact, a recent Merrill Lynch survey found that nearly 2/3 of companies will look to use repatriated cash to pay down debt levels.



The Biggest Beneficiary = Corporate America:

As we have articulated for nearly a year (seen here and here), the biggest beneficiary of tax reform is Corporate America. Whether you were for tax reform or adamantly against it, this tax overhaul plan will have the largest impact on corporate finance, possibly lasting for decades. We realize that this bill is modestly titled the "Tax Cuts and Jobs Act," but lowering the corporate tax rate from 35% to 21% will do wonders for the stock market. As corporations' benefit from a lower tax burden, so, too, will shareholders in the form of higher dividends and rising stock prices.

In our opinion, tax reform will be especially good for the equity market. While the stock market has more than tripled in value since 2009 (up over 375% since March,9, 2009), not everyone has participated. An eight-year average annual return of 19% is fantastic, but many households are still recovering from the Financial Crisis wreckage and are still too concerned to invest in the equity market. One ancillary hope is that those companies that see dramatic improvements in business will follow through on wage inflation and hiring.

Not all companies are in the same position to benefit from a lower effective tax rate. Zion Research Group analyzed different sectors' tax rates versus the federal statutory rate of 35%. Energy stands to benefit the most, at 45%, but the Financial sector,

at 30%, will also see a reduction in their tax bill. Healthcare and the Information Technology sectors have the two lowest effective tax-rate of 24% and 25%, but they also have the most cash stashed overseas for repatriation.

In addition, certain companies will lose tax advantages they have built into their corporate DNA. Corporate debt, for nonfinancial S&P 500 companies, is now at record highs of $6-trillion. Apple has issued nearly $90-billion in US corporate bonds since 2013. Despite having $270-billion in cash on its balance sheet, Apple could not efficiently use these proceeds to return capital to its shareholders. By issuing US debt and taking an interest deduction, Apple was bypassing the old tax regime and keeping its cash stashed overseas. Another example is Oracle, which sold $10 billion bonds in November to help it fund its stock buyback and dividend program. Under prior tax law, Oracle could write off the nearly $90-million of interest payments from its taxes at a 35% rate. Now that corporate tax rates are lowered and there will be a cap on these deductions, the decision to use debt to fund these activities is less advantageous.

As we witnessed in 2017, not all companies are equally prepared to manage through the year. We anticipate the ability to expense at 35% in 2018 and earn profits at 21% should accelerate capital spending. Couple this investment boom with the freeing up of offshore cash, and we expect higher growth. We like to see markets differentiate, when the underlying fundamentals of a business truly matter. This type of market allows active managers to deliver alpha and outperform passive products.

Political Responses:

The US Chamber of Commerce called the tax bill a "once-in-a-generation opportunity to fix the problem." The National Association of Manufacturers declared the plan "a grand slam for hardworking manufacturers." However, not everyone is cheering the tax reform plan.

Nancy Pelosi (D, California) called tax legislation "the worst bill in the history of the United States." The National Federation of Independent Business opposed the bill and claimed it "left out too many small businesses." The National Association of Homebuilders warned of a housing recession if Congress altered the amount of interest homeowners could deduct. Even some Republicans, like Senator Bob Corker from Tennessee, have warned against the potential to dramatically increase the national debt and deficit levels. As Republicans fulfill President Trump's wish for a pre-Christmas tax cut, a NBC News/Wall Street Journal poll has found that only 24% of Americans believe the plan is a "good idea" and 41% call it a "bad idea."

The $64,000 Question?

We believe the biggest question the market is grappling with is "What is priced in?" The prospect of tax reform spurred some of market's strong second half of 2017. Many were doubting Republicans could pass any legislation after failures to repeal or reform healthcare. We did not see many sell-side analysts bother to update their forward-looking estimates or consider the better prospects for growth. By late December, analysts began to alter their models to reflect the full effect of tax reform on 2018 estimates. The ballpark estimate is that the final tax bill will boost 2018 estimates by 5% to 10%. UBS strategist Keith Parker estimates that just 40% of the impact from a lower corporate rate was priced into stocks on the day President Trump signed the tax bill. How did they arrive at this number? His assumptions start with the fact that the market is perfectly efficient and immediately captures new information. From the first day that the House of Representatives passed its tax bill, the S&P 500 moved higher by 3%. This represents roughly 40% of the estimated upside from the tax package.

We do not believe the market has fully factored in a stronger economic environment and feel that the market has only begun to appreciate the forward-looking opportunity. In half of the quarters in 2017, the US posted growth rates above 3%. During 2018, we anticipate a minimum of 3% growth and actually envision one or two quarters might eclipse 4%. This will be received well by the equity markets.

Valuation:

Instead of focusing on the hypothetical, we focus our attention and time on individual company valuations. We do bottoms up, fundamental research exclusively on the emerging "Fin Tech" industry. As we enter 2018, many pundits claim the market is overvalued and expensive. With forecasted revenue and earnings growth of 5.4% and 12.3% respectively, the S&P 500 is trading

at a forward P/E multiple of 17.5x. While this is higher than the 10-year average of 15x, we feel this economic environment justifies a premium valuation.

In the 1970s, investors could have bought the S&P 500 for around 7x trailing earnings. However, to fully understand this valuation one must appreciate the environment that existed at that time. While that P/E looked quite cheap, the 10-year Treasury yield was in the double-digits. If one flips that 7x or 8x P/E, one can calculate a low-teens earnings yield. Investors comparing the risk / reward of a 10-year Treasury to the equity yield would have smartly picked fixed income, right? If one uses today's trailing P/E of 22x, one can equate that to an earnings yield of 4.5%. Then, consider that this earnings stream should grow in the high-single to low-double digits for the next few years. We understand if investors are not used to this type of growth because corporate earnings were flat for the three years prior to 2017. Given that the 10-year Treasury is at only 2.4%, paying a higher price for equities seems appropriate to us.

In our opinion, there continue to be few real alternatives to the equity markets. Real Estate has generated a solid return, but only 64% of Americans own their own houses. Yields on bonds are near record lows, and banks pay savers a paltry return on savings accounts. In fact, according to a recent KBW study, despite five interest rate increases since December of 2015, banks have allowed only 15% of the increase to trickle down to deposit rates and savers. The old adage of TINA or "there is no alternative" to equities seem apropos. With interest rates this low, investors' appetite for risk tends to increase. If rates were to significantly climb, fixed income might present a better risk / return proposition. In the meantime, equities seem to be the only way to see any material appreciation. We believe that high-quality stocks continue to be the best choice for those looking for growth and wealth creation.

As we enter 2018, The Small Business Optimism Index is at a 34-year high. While the record low was set in April 1980 at 79.7 and was almost hit during the Financial Crisis in March of 2009 at 81.6, the 107.5 November 2018 reading is just shy of its all-time high (July 1983 at 108).

2018:

Uncertainty in the equity markets always has existed. A year ago, we articulated why we were bullish for 2017 (see here). Bear markets, defined as a drop of 20% or more, might be around the corner, but one could easily have said that two or three years ago, too. Investors would have missed out on equity returns of 17% in 2016 and 22% last year. Ever since the stock market begin its post Financial Crisis rally, certain pundits have been calling it a bubble.

With bitcoin's nearly 1,700% rise last year, we thankfully now have a better example of a what a real bubble looks like. Bitcoin has all of the characteristics of a bubble and none of the traits of a viable currency. We obviously were not around for the Dutch tulip bulb mania in 1637, but we were managing money during the dot-com era. There are many similarities that we can draw upon. We will bypass this "crypto fad" and continue to invest in a "boring is beautiful" type of way. For some perspective and thoughts on bitcoin, please see our detailed note titled "The Safe(r) Way to Play Bitcoin" or simply click here.

Will the bitcoin bubble burst in 2018? We believe it will, but the impact of this bubble popping will not trigger a recession. In the near-term, we could see a bump in the road come January 19. This is when the latest spending bill extension comes due yet again. We do not believe either side is willing to shut the government down, but the rhetoric will get ratcheted up. As the deadline approaches, we expect some minor volatility, but it will ultimately just be transitory in nature.

One area of particular concern for us is the amount of money still invested at negative interest rates. According to a recent JP Morgan study, there is still $10.1 trillion in global government bonds with yields below 0%. While this is down from its peak of $12.7 trillion in July of 2016, we still have a hard time understanding why anybody would want to own a security that guarantees a loss if it is held to maturity. How is that rational? Our Fed has begun its slow "unwind" of its $4 trillion balance sheet, built over several years of quantitative easing. Just as QE was uncharted territory, this has the potential to cause volatility.

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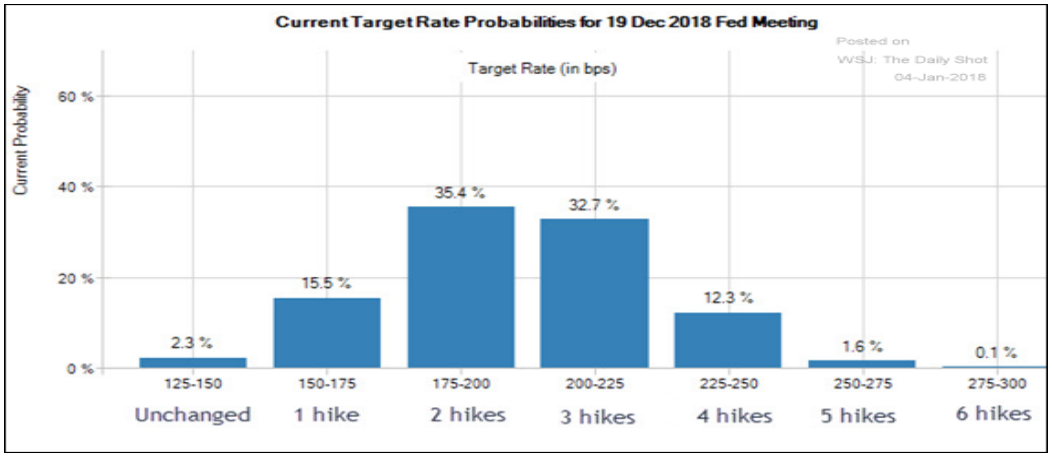
Interest Rates:

Loyal readers know that our favorite site for understanding the market's expectations for interest rate remains on the CME website (click here). The market is forecasting two to three interest rate hikes in 2018.



Since December of 2015, the Fed has made five 25-basis–point hikes in short-term rates. The highest number of consecutive rate actions in a single market cycle started in 2004 and had 17 separate increases. The second longest string of rate hikes started in 1977 whereby the Fed raised rates 14 separate times. How long can this continue? Well, an 81-month tightening cycle, from 1946 to 1953, occurred following the postwar boom when US real GDP growth was above 5%. Our point is that these 25-basis-point hikes can continue to happen for awhile without an impending problem.

The game plan the Fed continues to lay out is detailed, strategic, and well-telegraphed. At the beginning of 2017, the Fed indicated it would raise rates three times and begin to shrink its large bond portfolio. It delivered on these promises. If employment were their sole focus, the Fed would be dramatically raising rates. In November, the unemployment rate hit a 17-year low of 4.1%. If the downward trend continues, unemployment would hit levels not seen since the late 1960s. Goldman Sachs recently estimated the unemployment rate to hit 3.7% by the end of 2018 and 3.5% by the end of 2019. Economists teach that when an economy is at "full employment," it typically is 60% through that economic cycle.

The Fed:

With so many new members joining the Fed, legitimate questions arise about its ability to follow gradual rate increases in 2018. New Fed Chairman, Jerome Powell, sailed through his confirmation process, despite the political divide in Washington. When Ben Bernanke was appointed for a second term in 2010, he was opposed by 30 senators, 18 Republicans, 11 Democrats, and one independent. We do not expect Chairman Powell to dramatically alter the predictable path Chairwoman Yellen has followed. He is known for being a very pragmatic individual, and we do not envision him taking an overly aggressive rate position. Raising rates too quickly could threaten to push our economy into a recession, which certainly would anger his new boss in the White House.

In addition, the Fed has not met its second key tenet, having the US economy hit a 2% inflationary target. If tax reform and a successful infrastructure bill lead to worrisome inflation, we are confident the Fed will intercede to slow and temper growth. Without a terribly concerning inflationary environment, we expect the Fed will undershoot on interest rate hikes.

Inflation:

Inflation remains dormant in the US and we do not envision it becoming an issue. It remains quite puzzling for the Fed to decipher. The Fed's preferred inflation gauge, which excludes volatile categories like food and energy, only experienced a 1.3% in September. Are wireless phone plans and prescription drug prices to blame? Economists cannot understand why full

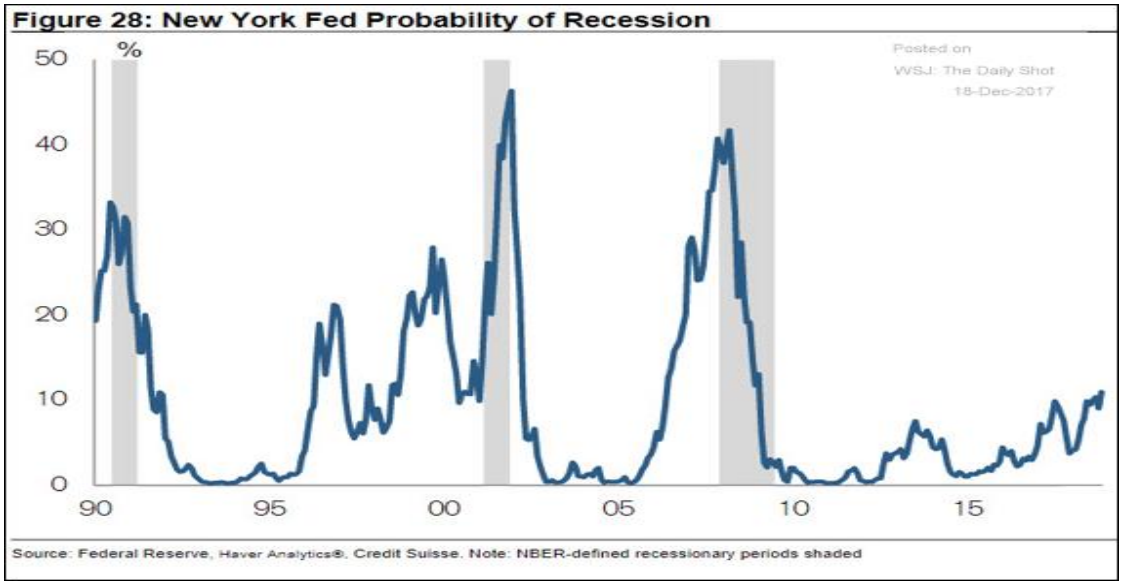
employment is not lifting wages when workers become scarce. New York Fed President William Dudley recently said that this "creates a bit of uncertainty about the best course going forward."

One risk to continue to monitor is that the economy avoids a run-up in inflation, but asset prices continue to rise. Low volatility could fuel financial imbalances and we could see bubbles form. Over the last 2 decades, we have seen expansions end this way. The first was the tech bubble of 2000, and the second was the housing market collapse of 2007. We believe that in the event growth accelerates above expectations, the Fed will pump the brakes on the economy and raise interest rates. In this environment, many of our online brokers, asset managers and derivative exchanges will dramatically benefit. We are not forecasting a significant rise in inflation beyond the 1.5% to 2.5% range.

Recessions:

Recessions come every eight to ten years with our last one occurring in 2009. However, recessions typically start when central banks act too aggressively and raise interest rates to curtail growth and keep an economy from overheating. Short-term rates above long-term rates or an inverted yield curve can be a real concern. Why? An inverted yield curve is typically a leading indicator of a coming recession, as each of the past seven recessions has been preceded by one. The Fed can control short-term rates through the fed funds, but the market sets long-term rates. Factors impacting long-term rates are inflationary threats, supply and demand issues, and global central-bank easing. Global investors are pouring into US bonds, where rates are still low, but are much higher than those of European bonds. These distortions continue to impact our interest rate yield curve.

Two-year yields have risen, but the US yield curve continues to flatten with a range bound 10-year Treasury. With five rate hikes and three more potentially coming in 2018, the worry is that we get inverted curve. A flattish yield curve can persist for quite a while as the US economy weans itself off crisis like monetary policy. We understand that while recessions are always preceded by an inverted yield curve, not all inverted curves are followed by recessions. Stated more bluntly, an inverted yield curve is a necessary, but not a sufficient recession condition.



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Geopolitics:

With the news media bringing wars in real-time to our TVs and computers, it seems odd to state that the world is entering a new era of stability. However, that is exactly what is transpiring. As the cartoon above shows, we have three leaders (Donald Trump, Vladimir Putin and Xi Jinping) defining a geopolitical balance-of-power. These three superpowers are using armed strength, alliances, and diplomacy for security. Many issues still must be addressed.

Questions Without Answers:

For example, what role did Russia play in the US Presidential election? What sanctions and ramifications will Russia face for invading the Ukraine a year ago? Venezuela seems only days away from total chaos as its economy is in tatters from government corruption. Can England successfully transition away from Europe and extricate itself from acrimonious Brexit talks?

Will Trump decide to enforce WTO rules and protectionist trade policies against China? Can China help steer North Korea away from provoking its Asian neighbors and the US? Can North Korea continue to test its military might and launch weapons over Japan without penalties? Will China anger its neighbors by continuing to buildout islands in the South China Sea?

China:

Economically, China remains a global wild card. Its leader, President Xi Jinping, seems to have full control over its government and economy. His five-year plan calls for the economy to grow at an average annual rate of 6.5%. Many continue to struggle with the accuracy and transparency of Chinese data, but there is no doubt about its economic strength and confidence. Despite worries such as escalating debt levels and inflated property values, the Chinese economy continues to expand. A World Bank report shows that outstanding bank loans reached 150% of China's GDP in November, up from 103% a decade ago. The International Monetary Fund, as well as the World Bank, has urged China to tackle its debt issues. How much of this growth is being driven by debt is hard to decipher. Chinese authorities recently took steps to halt the proliferation of small online lenders. It will be challenging for the government to face the reality that too much of its growth has been fueled by escalating debt levels. Can authorities engineer additional cuts in manufacturing capacity and switch to a slower growth trajectory without causing financial distress? This will ultimately be a complicated task for the 25-member Politburo to execute.

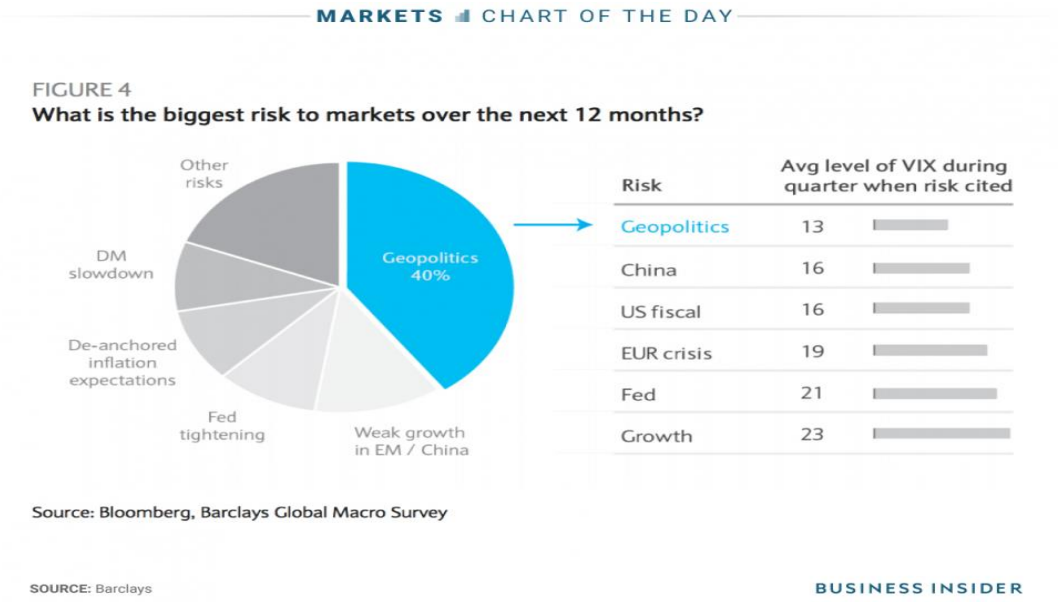
Middle East:

Could President Trump upset Iran and cause them to kick-start their nuclear program? Iran is absolutely pushing a Shiite uprising against the region's leading Sunni powers as well as against Israel. Interestingly, this has led Saudi Arabia to almost join forces with its once-despised enemy Israel to counter Tehran's influence.

In an attempt to curtail corruption, new 32-year-old Saudi Arabian leader, Mohammed bin Salman (MSB), has arrested 8 of its wealthiest 10 princes. Among this group is Prince al-Waleed bin Talal, a cousin to the crown price. He is often referred to as an

independent Saudi ambassador to the global business world and is a regular speaker on Bloomberg and CNBC. Kingdom Holdings, the conglomerate he runs, is an empire that owns large stakes in Twitter, Lyft, Citigroup, Accor, Flynas, Euro Disney, Four Seasons hotels and other global companies. Will structural reform work in Saudi Arabia or will it backfire? Will this large-scale shake-up work at weeding out corruption or will it decrease global confidence in economic reforms in the kingdom? In addition, tensions between the Saudis and Yemen's Houthi rebels continues to boil over. As Iran provides support for these rebels, it has the potential to create a new flashpoint in the Middle East. What happens to the price of oil, in the event of a strain in the relationships among OPEC members?

There's no predicting how any of these events will unfold, except to say that we hope none lead to anything unfortunate or deadly. Without a doubt, geopolitics remains the biggest risk to the overall market, but we cannot forecast these events.



Looking Forward:

We look forward to South Korea hosting the Olympic Winter Games in February, but worry about North Korea's leader using the global stage to do something crazy. We look forward to a new era beginning in Cuba. For the first time since the revolution in 1959, Cuba will not have a Castro in charge. Will democracy finally come to the island 90 miles south of Florida or will Cubans continue to endure the harsh realities of a communist regime? In June, the world will focus its attention on FIFA's World Cup. Will the story be the beautiful soccer played in Russia or the staged re-election of Vladimir Putin for another six-year term as President?

In November, Americans will pass judgement on the Trump administration in the important midterm elections. Republicans ran on a platform of tax reform and spent all of 2017 attempting to legislate it. Now that it is finalized, it will be the key aspect for their campaign. That vote will be seen as a decree on the first years of President Trump's tenure. Democrats will advertise this legislation as a corporate giveaway and tax cut for the rich. Following the midterm elections and their outcomes, President Trump will better understand if he can pass any legislation in 2019 and beyond.

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Conclusion:

Can the Republicans use the momentum of this tax reform bill to deliver on a bipartisan infrastructure bill? While the White House talks about social and entitlement reform, we absolutely believe this is a non-starter and a tough sell politically. We believe an infrastructure bill, while ultimately difficult to pass, would be a safer and smarter route to take.

We envision the tax reform bill creating a stimulus for the economy that will result in stronger sales and profits. Not all of the tax cut benefits will flow directly into stimulating the economy as some will get priced out through higher inflation. Also, some consumers will increase their savings rate and not spend all of this "found money." Even today, there is healthy debate on the prospects for our markets. A recent Boston Consulting Group survey found that 46% of investors are "pessimistic about the equity markets" in 2018, which is the highest finding since 2009.

A low interest rate environment coupled with solid economic growth should lift global markets. After years of only paltry 2% US growth, we expect the combination of regulatory reform and corporate tax cuts to unleash some "animal spirits." After years of stagnation and too much political discord, we are looking forward to a pro-growth environment. The timing of this tax reform program might be ideal to give this already long expansion a second wind. Unfortunately, a decade of slow capital investment and heightened regulatory hurdles led to tepid growth. Call us "economic optimists", but we believe the US is poised to grow again. While economic growth will not solve all of our problems, it can make some problems much easier to solve.

We continue to focus our attention on the "Fin Tech" industry and stick to our area of expertise. Looking forward, the "Fin Tech" portfolio is poised to generate double-digit revenue growth next year, which is significantly higher than the market. In addition, our portfolio of companies generates high operating margins that lead to positive operating leverage and mid-teens growth of free cash flow and earnings. Unlike the broader market, we believe the growth of our holdings is predictable and sustainable. By focusing on recurring revenue models in secular growing businesses, we have confidence that we are properly set-up to capture the upside. We believe significant opportunities on both the long and the short side exist and that good individual stock selection and timely tactical repositioning can drive total returns higher.

With a strengthening economy, robust corporate profits, and excitement over potential tax cuts, the markets are well positioned for bigger gains. At her last speaking engagement as the head of the Fed, Chairwoman Yellen stated, "When we look at other indicators of financial stability…there is nothing flashing red, or even orange" in regard to the US stock market. In late 1996, Fed Chairman Greenspan spooked the stock market with his quote that valuation represented an "irrational exuberance." We feel many people forget that the equity market doubled over a three-year period ***after*** Greenspan's critique. Given the economic and interest rate backdrop, a positive, pro-business administration, and unattractive fixed-income alternatives, we are excited about the potential for our concentrated "Fin Tech" portfolio.

We remain grateful for your trust and we are always available should you wish to chat.

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Interesting Quotes, Statistics and Facts:

Black Friday 2017:

- Adobe Analytics estimated Black Friday was up 17.9% year-over-year to a record $7.9 billion
- Criteo estimates that 40% of online sales were completed on a mobile device, up 29% year-over-year
- In addition, it is estimated that traffic at brick and mortar, physical stores fell by 1%

"Not only did e-Commerce make a major mark on the 2017 holiday season, but online sales have been growing in the 15 to 20 percent range all year long," said Sarah Quinlan, senior vice president of market insights, Mastercard. "The always-connected consumer has found a match in e-Commerce, where stores never close and the consumer has an endless amount of stores and goods to choose from."

Apple:

- On December 11th, 1980, Apple had its IPO at $22 per share
- The initial range was $14 to $17 per share, but heightened demand lifted the price
- Despite being an eagerly awaited new stock issue, Massachusetts had other ideas
- Apple was offered to the public that day, but Michael Connolly Massachusetts' Secretary of State had other ideas
- He banned its underwriters, Morgan Stanley and Hambrecht & Quist, from selling Apple in Massachusetts
- Apple's book value of $9.65 per share was below the state's required 20% minimum of its stock price
- Massachusetts had determined that Apple could not sell for more than $11.50 per share
- Apple was trading at 100x earnings
- Massachusetts had a rule that IPO's could not trade for more than 25x net earnings
- Apple personnel owned about 43% of shares outstanding, which is normally a positive sign
- Massachusetts prohibited IPO's where employees and directors owned more than 10% of total shares
- We are obviously proponents of the market determining fair-value prices, not political representatives

Coinbase:

- Coinbase is the largest cryptocurrency exchange
- It now has more clients than online broker Charles Schwab

Transportation:

- Boston's "Charlie Card" is its dominant card for public transportation
- Late last year, Boston signed a $723 million contract for a new payment system
- Users will be able to tap their credit card or use their mobile phone for riding buses and trains
- New York's MTA recently signed a $570 million contract to modernize their transportation payment system

Store-branded Credit Cards:

- If you walk into any store during the holidays, shoppers are flooded with offers for discounts
- Store-branded credit cards, can only be used at a specific retail chain
- However, they can be a wonderful way for retailers to increase sales and offer discounts
- In 2016, store-branded cards represented 5.9% of total credit-card purchase volume
- For perspective, back in 1990, they represented 18.0% of total credit volume
- If consumers pay off the entire balance, then store-branded credit cards can be wonderful
- If consumers only pay the minimum balance, the card can lead to significant debt
- A study by WalletHub states that the average APR on a store credit card is 28.26%
- The average rate on a credit card issued by a traditional bank or credit union is only 16.5%
- With brick-and-mortar retailers closing more than 4,000 stores in 1H'17, physical merchants are struggling

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S&P 500 Monthly Total Returns

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2017	1.9%	4.0%	0.1%	1.0%	1.4%	0.6%	2.1%	0.3%	2.1%	2.3%	3.1%	1.1%
2016	-5.0%	-0.1%	6.8%	0.4%	1.8%	0.3%	3.7%	0.1%	0.0%	-1.8%	3.7%	2.0%
2015	-3.0%	5.7%	-1.6%	1.0%	1.3%	-1.9%	2.1%	-6.0%	-2.5%	8.4%	0.3%	-1.6%
2014	-3.5%	4.6%	0.8%	0.7%	2.3%	2.1%	-1.4%	4.0%	-1.4%	2.4%	2.7%	-0.3%
2013	5.2%	1.4%	3.8%	1.9%	2.3%	-1.3%	5.1%	-2.9%	3.1%	4.6%	3.0%	2.5%
2012	4.5%	4.3%	3.3%	-0.6%	-6.0%	4.1%	1.4%	2.3%	2.6%	-1.8%	0.6%	0.9%
2011	2.4%	3.4%	0.0%	3.0%	-1.1%	-1.7%	-2.0%	-5.4%	-7.0%	10.9%	-0.2%	1.0%
2010	-3.6%	3.1%	6.0%	1.6%	-8.0%	-5.2%	7.0%	-4.5%	8.9%	3.8%	0.0%	6.7%
2009	-8.4%	-10.6%	8.8%	9.6%	5.6%	0.2%	7.6%	3.6%	3.7%	-1.9%	6.0%	1.9%
2008	-6.0%	-3.2%	-0.4%	4.9%	1.3%	-8.4%	-0.8%	1.4%	-8.9%	-16.8%	-7.2%	1.1%
2007	1.5%	-2.0%	1.1%	4.4%	3.5%	-1.7%	-3.1%	1.5%	3.7%	1.6%	-4.2%	-0.7%
2006	2.6%	0.3%	1.2%	1.3%	-2.9%	0.1%	0.6%	2.4%	2.6%	3.3%	1.9%	1.4%
2005	-2.4%	2.1%	-1.8%	-1.9%	3.2%	0.1%	3.7%	-0.9%	0.8%	-1.7%	3.8%	0.0%
2004	1.8%	1.4%	-1.5%	-1.6%	1.4%	1.9%	-3.3%	0.4%	1.1%	1.5%	4.0%	3.4%
2003	-2.6%	-1.5%	1.0%	8.2%	5.3%	1.3%	1.8%	2.0%	-1.1%	5.7%	0.9%	5.2%
2002	-1.5%	-1.9%	3.8%	-6.1%	-0.7%	-7.1%	-7.8%	0.7%	-10.9%	8.8%	5.9%	-5.9%
2001	3.5%	-9.1%	-6.3%	7.8%	0.7%	-2.4%	-1.0%	-6.3%	-8.1%	1.9%	7.7%	0.9%
2000	-5.0%	-1.9%	9.8%	-3.0%	-2.1%	2.5%	-1.6%	6.2%	-5.3%	-0.4%	-7.9%	0.5%
1999	4.2%	-3.1%	4.0%	3.9%	-2.4%	5.5%	-3.1%	-0.5%	-2.7%	6.3%	2.0%	5.9%
1998	1.1%	7.2%	5.1%	1.0%	-1.7%	4.1%	-1.1%	-14.5%	6.4%	8.1%	6.1%	5.8%
1997	6.2%	0.8%	-4.1%	6.0%	6.1%	4.5%	8.0%	-5.6%	5.5%	-3.3%	4.6%	1.7%
1996	3.4%	0.9%	1.0%	1.5%	2.6%	0.4%	-4.4%	2.1%	5.6%	2.8%	7.6%	-2.0%
1995	2.6%	3.9%	3.0%	2.9%	4.0%	2.3%	3.3%	0.3%	4.2%	-0.4%	4.4%	1.9%
1994	3.4%	-2.7%	-4.4%	1.3%	1.6%	-2.5%	3.3%	4.1%	-2.4%	2.2%	-3.6%	1.5%
1993	0.8%	1.4%	2.1%	-2.4%	2.7%	0.3%	-0.4%	3.8%	-0.8%	2.1%	-1.0%	1.2%
1992	-1.9%	1.3%	-1.9%	2.9%	0.5%	-1.5%	4.1%	-2.0%	1.2%	0.3%	3.4%	1.2%
1991	4.4%	7.2%	2.4%	0.2%	4.3%	-4.6%	4.7%	2.4%	-1.7%	1.3%	-4.0%	11.4%
1990	-6.7%	1.3%	2.6%	-2.5%	9.7%	-0.7%	-0.3%	-9.0%	-4.9%	-0.4%	6.5%	2.8%

LPL Research — The Daily Shot®

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