3rd Quarter 2019 Newsletter

July 2019

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.

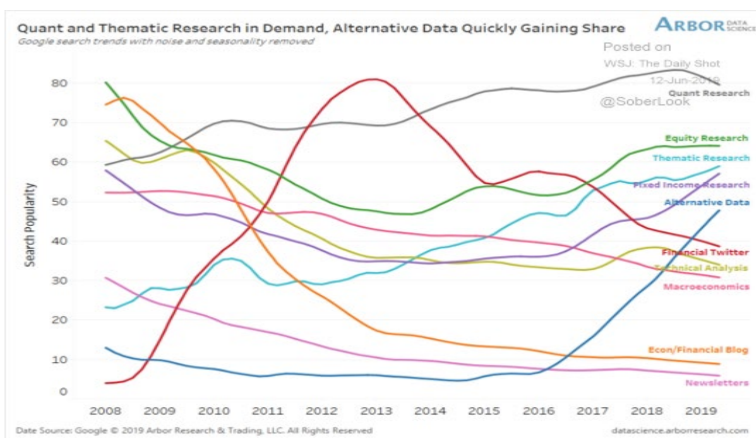
Proprietary Research:

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.

During the 2nd quarter, we were very active and published five notes. We annually conduct a Gen-Z survey, to better understand the opinions and attitudes of this budding generation regarding various financial services. Three out of 4 survey notes are attached below. A few weeks ago, we wrote a detailed (sorry if 15 pages was too long) note on WEX, one of our long-term holdings. Our last intra-quarter piece of research concerned Libra, Facebook's cryptocurrency or digital currency launch. In total, we published over 85 pages of proprietary research this quarter. Feel free to use our research as the best, all-natural way to cure insomnia.

- 2019 Gen-Z Financial Survey (Series 1 of 4): The Future of Banking (April '19)
- 2019 Gen-Z Financial Survey (Series 2 of 4): The Future of Payments (April '19)
- 2019 Gen-Z Financial Survey (Series 3 of 4): The Future of Brokerage (May '19)
- WEX: A Great FINTECH Business You've Never Heard Of (June '19)
- Libra: If Facebook & Bitcoin Had a Baby (June '19)
- 2019 Gen-Z Financial Survey (Series 4 of 4): The Future of Digital Currencies (July '19)

We publish our forward looking newsletter each and every quarter, but we recognize that quarterly opinion pieces are not necessarily "in vogue." As this Google search activity chart shows, quarterly newsletters are very much "out of favor."



As long as you find our analysis interesting, we will continue to publish our thoughts. Once again, thank you for your interest and continued support of Manole Capital Management. Happy reading!

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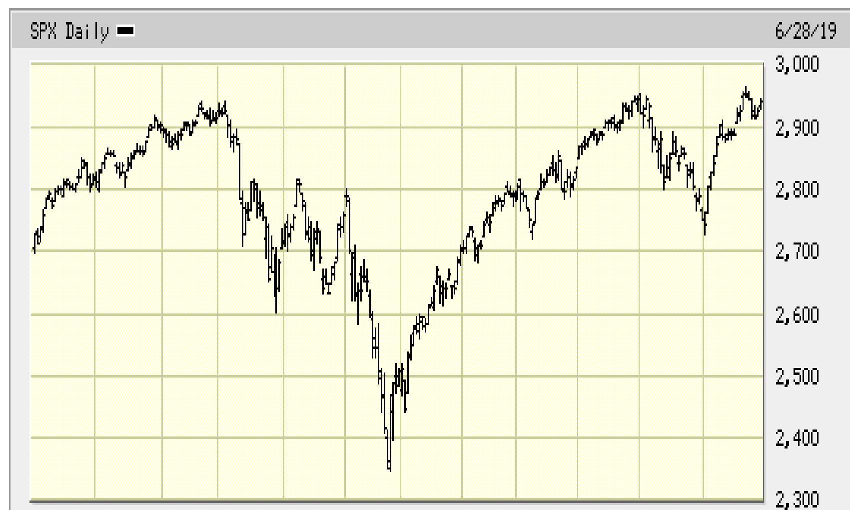
2019 Performance:



In December 2018, the S&P 500 fell by over (9.0%) and the year ended down over (4.0%). It was the first down year for the stock market since 2015 and December was the worst month of December for the S&P 500 since 1931.

When we published our 1st quarterly newsletter in early January, it seemed as if the market were in a full panic. While there were numerous market concerns (there always are), we titled our note "We apologize for being optimistic."

The 1st quarter was the best start to a year since 1998. After positive months in January, February, March and April, this positivity dramatically changed on Sunday May 5th. With a single Presidential tweet, the market negatively reacted to the breakdown of the US/China trade negotiations.

While May was "choppy," the S&P 500 positively rebounded in June. While some prefer the old adage "Sell in May and go away," that would have been a bad decision this year. We are a little more than halfway through 2019, and the stock market has delivered excellent performance. The S&P 500 is up nearly +18.5% year-to-date, which is the best 1st half-year of performance in 22 years. Just last month, S&P 500 was up over 7%, its best June since 1955.

All 11 sectors of the S&P 500 are higher this year, with the Technology sector continuing its leadership. Tech is up an impressive +27% so far this year. Consumer Discretionary, Industrials, and Materials have also been strong, each over +20%. The biggest laggard this year is Healthcare, only up +8%.

While many international markets, from Europe to Japan to various emerging countries, are barely higher than they were 10 and even 20 years ago, 2019 has been positive. This year, the Shanghai Composite is up +22%, the Euro Stoxx is up +18%, MSCI World Index is up +15% and Brazil's Sao Paulo Bovespa is up +12%. Clearly, global equity markets have been solid in the 1st half of the year.

Our Performance:

So the market has handsomely rebounded off those awful December 2018 lows. How are we doing? Well, we first want to "knock on wood." Yes, we are somewhat stupid-sticious. We believe our excellent FINTECH portfolio performance has been driven by our long-term approach, as investors and business buyers, not because we are short-term traders or momentum chasers. You should expect us to continue to "stick to our knitting" and remain entirely focused on the emerging FINTECH space.

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Back in January, we were pleased to have Fiserv (ticker FISV) acquire one of our holdings, First Data (ticker FDC) for a nice premium. Then in March, we were pleased to have Fidelity National Information Services (ticker FIS) acquire another one of our long-term holdings Worldpay (ticker WP, formerly Vantiv, ticker VNTV). Then in May, we hit the M&A payment "trifecta." Once again, two of our holdings, Global Payments (ticker GPN) and Total Systems (ticker TSS), decided to merge.

The 1st half of 2019 has been very positive for our performance, aided by so much M&A activity. We do not expect more transactions, but we won't be surprised if more companies are attracted to our payment companies and their meaningful free cash flow.

In 2019, we are pleased to report that our flagship FINTECH (long-only) portfolio is up +26.6%, which is +800 basis points better than the overall market (defined as S&P 500 Total Return). In addition, this portfolio recently was awarded Morningstar's highest rating of 5 stars. Our FINTECH portfolio is now over 4-years old, and has handily beaten Mr. Market over the 1-year, 3-year, and since inception. In fact, in early July, we have been able to double our initial FINTECH investment in a little over 4 years' time.

If you would like to see additional information on our flagship FINTECH portfolio, or any details on our multiple "flavors" of FINTECH, please visit our website at www.manolecapital.com and click the "Portfolios" tab. Our tear sheets are always available, and they capture monthly performance, top holdings, large exposures and other interesting metrics.

Up & Down Market Capture:

We want to continue to emphasize that we see tremendous volatility in the overall market. It has not been, nor will it ever be, a simple straight line upwards to the right. Our loyal readers know that we like to focus on Up & Down Market Capture. This metric is shown on every one of our monthly tear sheets under the "Risk Analysis" section. The metric is intended to show how our performance would be in the event of a + or - 10% move in the market.

As the market is rising (as it is now), one ideally wants to outperform and have an Up Market Capture above 100% (hint, hint…ours is). As the market is falling (as it was in the 4th quarter of 2018), a manager would like to see a Down Market Capture below 100% (ours is). We do not build our portfolios or manage our holdings to result in a specific market capture percentage. It simply is a byproduct of our process and investment style. As long-term investors, we do deep dives into our businesses (see our WEX note) and understand the fundamentals driving their success.

As our performance shows, in both up and down markets, we have been able to significantly outperform the market and our peers. We believe our philosophy, strategy and process, as specialists exclusively focused on the FINTECH space are the primary reasons behind our success.

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All-Time Records:

The longest U.S. expansion in history

SOURCE: National Bureau of Economic Research (year indicates start of cycle)

According to the National Bureau of Economic Research, the US is now in its longest ever economic expansion at 121 months. Starting in June of 2009, our economy has been steadily growing. While there have been "bumps in the road," the length of this expansion is now an all-time record.

The unemployment rate has dropped to 3.6%, its lowest level since 1969. In early July, the S&P 500 eclipsed 3,000, the first time it has ever reached that level. In addition, both the Dow and the Nasdaq are at all-time records. As we continue to highlight in our research, the US remains "the best house on a crappy street" and NO…that's not the name of a new show on the HGTV channel.

As the old investing expression goes, "Expansions don't die of old age," but this one is now in historical territory. We would like to see additional economic US growth, which we believe the tax reform package of 2017 helped spur along. In our opinion, the length of this expansion is impressive, but we would like to see additional and sustainable economic growth.

We are growing much faster and steadier than we did in the 2011 to 2015 periods, but we still have only grown GDP by 25%, from the start of this long expansion. As the chart shows, this expansion has grown at a pace that is much slower, compared to Reagan's & Clinton's expansion periods.

Longest US recovery on record.. is still not that *big*

Source: RBC Capital Markets, Bloomberg

Nothing in recent results indicates (at least to us), that we are headed towards a recession. As we head into 2nd quarter earnings season, we are delighted that expectations couldn't be any lower. We believe that many of our companies will be reporting results that either match or exceed sell-side estimates.

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Boy Scouts Are Always Prepared:

Despite daily record highs, we are closely monitoring and concerned with several items. We believe now is the time to be cautiously optimistic as we ensure that we are studying our underlying risks and all our portfolio possibilities. We consistently model in various downside scenarios to fully understand "what if" possibilities. When we say that we want to anticipate and that we strive never to be reactionary to issues, what do we mean?

Well, we model in various scenarios and various outcomes to understand how they will impact our businesses. If oil spikes, what is the impact to our companies? If interest rates rise or fall, which of our positions will benefit or get hurt? By modeling in various outcomes, we can minimize the "surprise" when or if something unusual occurs. It is somewhat akin to preparing for the unknown. While we were not Boy Scouts when we were young, we do like their motto "Be prepared."

With markets at an all-time high, we fully understand that risks are rising. We are positioned well, and have plenty of cash available in case any of our holdings temporarily go "on sale."

Keeping It Simple Stupid:

We strive to take-on complicated subject matter and "dumb it down"; we prefer to K.I.S.S. or "keep it simple stupid." As the #2 person at Berkshire Hathaway, billionaire Charlie Munger has a wonderful way of articulating his extremely successful investing philosophy. He says his success and long-term advantage is "consistently not being stupid, instead of trying to be very intelligent." Munger focuses on not making big mistakes and avoiding foolish decisions by sticking to his "circle of competence."

Our philosophy has been developed over 25 years in the asset management business and from roughly two decades at Goldman Sachs Asset Management. As we said on page one, this fundamental process is now considered quaint and out-of-date. We just focus on FINTECH or any "business utilizing technology to improve an established process." We do not spend time on healthcare, utilities, telecom, consumer staples, consumer discretionary, or other sectors of the market in which we do not have years of experience and knowledge in.

The asset management business has become terribly complex. The industry is filled with quantitative and algorithmic shops that simply rent pieces of paper. These quants shops have an investment process that emphasizes momentum, trading speeds, filters, and programming models, and some use AI (artificial intelligence) and algorithms to decide what to buy or sell. We are the polar opposite of this. We are long-term owners of dominant, growing FINTECH businesses.

Over the last decade, 92.2% of active asset managers have failed to deliver results in excess of the S&P 500. We believe some of this underperformance is because too many managers are generalists as they try to be masters of everything. We make mistakes all the time, but we have been wise to avoid the BIG mistake, which can often be caused by venturing outside of one's area of expertise.

If you are down 50% on an investment in year 1, it is not as simple as earning a 50% return the next year. You actually need a 200% return to get back to where you started. We will never avoid all mistakes, but we can limit their impact and attempt to make them somewhat modest and small. It can be advantageous to play somewhat conservatively and outlast the competition.

Once again, we like Munger's view that "knowing what you don't know is more useful than being brilliant." We simply focus on FINTECH and our specialty or niche. We believe one of the main reasons we have consistently beaten the market is that we have adhered to our fundamental process and concentrated on Munger's suggestion of staying in our "circle of competence."

Win by Breathing:

Another one of our silly little investment maxims is that we love to "win by breathing.' What do we mean by this? Manole Capital is a bottoms up, fundamental research company. We focus our attention on investing in FINTECH companies that meet our ideal characteristics (see here). We believe this is our "secret sauce" and the basis for our continued outperformance versus the overall market.

Over the next page, we will attempt to highlight why we avoid consumer stocks and especially those companies capitalizing on fickle trends and fads. Instead, we prefer to own several names in the secularly growing payment industry. This strategy can be summarized as attempting to "win by breathing." Let us explain….

The Consumer:

As we highlighted earlier, the Consumer Discretionary sector is up over +20% year-to-date. Some of the biggest companies in this specific sector include companies like Amazon, Home Depot, McDonalds, Nike, Starbucks, Target, General Motors, etc.

Consumer spending is still the critical engine that drives our economy, but individual choice determines winners and losers. A good description of this sector is "any good and/or service that is considered non-essential by consumers, but desirable if their available income is sufficient to purchase them." That fairly broad definition covers various distinct businesses. The Consumer Discretionary sector can be somewhat challenging to analyze since it covers many specific industries. A sell-side Consumer Discretionary analyst might be expected to understand and have a background in areas ranging from household products to fashion to fast food to construction equipment to automobiles.

Let's dive a little deeper as to why we specifically avoid Consumer stocks. There are literally dozens of automobile companies an individual can purchase. GM, Ford, Chrysler, Mercedes-Benz, BMW, Ferrari, and Volkswagen have established brands and have been around for decades. There are newcomers like Tesla, which garner significant attention and bring hybrid electric technology to the industry. Over the last few years, Tesla has experienced significant volatility and has a market capitalization eclipsing its more well-funded and well-entrenched competitors. There are dozens of pros and cons to each firm from price, style, functionality, brand, labor relations, environmental, management, balance sheet, etc. We do not plan to do an in-depth analysis of

the car industry. We simply point out that there are dozens of options and the winners and losers change constantly. Last year's winners can easily be this year's biggest losers.

Analyzing the apparel industry is even more challenging. There are hundreds of apparel companies and thousands of clothing retailers. From our perspective, this is one of the worst areas in which to invest, with the possible exception of the awful restaurant sector. Why do we avoid fashion and clothing stocks? Don't we love to look nice? Well, it comes down to fickle trends. For example, let's say you are a clothing manufacturer. You have expensive designers on staff, who you hope are correct in identifying this year's "in" fashion styles. Unfortunately, most misfire. It is really difficult to time precisely when bell-bottoms are back in style, versus last year's winner. (We can't remember if it was high-rise ripped knee jeans or acid-washed skinny jeans.)

Even if you correctly identify a fad and get the demand side of the equation correct, you still have the nightmare of supply (i.e. manufacturing) to deal with. Let us again assume you aced both the demand and supply issues; you then are either selling these clothing items at retail or through independent merchants. Distribution is tough and fads change quickly. From manufacturing to distribution, apparel companies typically generate poor margins and have little free cash flow.

Whether it is clothing or automobiles or food, we prefer to "win by breathing." When you buy that pair of jeans or pay for that dinner, we are fairly certain you will be using a credit or debit card. Nobody carries around cash anymore, right? Whether that is a Bank of America or Wells Fargo or JP Morgan or Citi card, it will likely have a Visa or Mastercard logo on the bottom right of the card. As the owner of the payment networks, we would rather earn a small amount of money each and every time that card gets swiped than be right predicting the latest fashion trends or "in" restaurant.

We prefer ***secular*** growth to ***cyclical*** growth. We favor the predictable, sustainable and recurring revenue of the payment networks to the fickle (cyclical) nature of the consumer stocks. For us, that is how we can consistently "win by breathing."

Economics, not Politics:

Over the next few pages, we will attempt to weave a few macro issues (see below) into our commentary. However, we do not have a magic 8-ball. In our complex world, there is no absolute right or correct answer. We live in a world where our success or failure is determined every millisecond between 9:30 am and 4:00 pm every Monday through Friday.

We attempt to make our investing decisions, based upon nuance, compromise, details, estimates, and trade-offs. Unfortunately, we aren't always right. Rest assured, we will stay out of the political realm. You do not need Manole Capital to discuss our personal political opinions on partisan politics. We live in a world filled with passionate extremes, TV talking heads, and where 280 characters in a tweet help state opinions as fact. That's not us! We will bore you with economic insights and detailed analysis of trends, company fundamentals, and valuations. We love visiting Washington, DC, but we have no desire to discuss political ideologies.

We all know that Washington, DC is strongly divided and partisan. Shockingly, during Fed Chairman Powell's Congressional testimony in mid-July, there was agreement on one subject. The Phillips curve is a mechanism that suggests a lower unemployment rate will lead to stronger inflationary pressures. Congresswoman Ocasio-Cortez (i.e. AOC) asked Fed Chairman Powell his thoughts on the matter, not before stating that she believes the Phillips curve "no longer describes what is happening in today's economy." Chairman Powell specifically said, "We have learned that the economy can sustain much lower unemployment than we thought without troubling levels of inflation." Then, in a CNBC interview, Larry Kudlow, acting National Economic Council Director for President Trump and a strong supply side conservative, said that he totally agrees that the link between unemployment and inflation has not been strong for years. We think this could be the first area that all parties seem to agree upon. Wow!

To allow the macro to dominate or dictate our process would be foolish, but so, too, would it be simply to ignore larger, global issues. One of the key tenets of our investment philosophy is to always look forward. We strive, at all costs, to anticipate the future.

Macro Questions:

While the following is not inclusive and in no particular order, we can easily rattle off issues that the market is currently wrestling with and nervous about.

- Hard Brexit or Reverse Brexit? Prime Minister Teressa May is out. Will Boris Johnson take over?
- US / China trade negotiations are stalled. Did a G-20 meeting help re-start this process?
- Can China manage its slowing growth, huge debt burdens and these massive HK protests?
- US Interest Rate Increases or Decreases? Was Dec's hike a mistake? How many cuts in '19 & '20?
- Is President Trump unfairly treating his self-appointed Fed Chairman? Will Powell last 4 years?
- Will Congress decide to pursue an impeachment? Any ramifications from the Mueller report?
- Which Democratic candidate will emerge and challenge Trump in '20? Will socialism prevail?
- Will more officials call for the break-up of "Big Tech"? Is capitalism troubled?
- Can the growing US student debt burden (over $1.6 trillion) simply be wiped away?
- Will a southern wall get built? Can immigration reform ever occur?
- Is inflation tamed? Will gas and oil prices hover in this manageable range?
- How low can unemployment go?
- Did the '17 US tax reform package create a short-term "sugar high" or a positive long-term impact?
- Does the US gov't have money? What will happen come September if the US debt ceiling is breached?
- What list would be complete if we didn't include North Korea or Iran?

We cannot address all of these issues. We will discuss our opinions on certain economic issues (especially interest rates and the Fed) and how they might impact our FINTECH portfolio. Let's start with the Fed, which is receiving an extraordinary amount of publicity and attention.

The Federal Reserve:

After a year-long Twitter assault on his self-appointed Fed chairman, President Trump has recently tapped two very different economists to the central bank's board. Both individuals seem well-qualified and very different, but seem to have one main similarity – a desire to lower interest rates.

Both nominees seem dovish, which is obviously what President Trump wants. However, since the Senate must confirm his nominees, simply announcing his candidates is just the first step in the process.

His four prior nominations have decided to remove themselves from consideration before the Senate approval process, knowing that they faced long odds in getting through. Anybody remember the brief nominations of Stephen Moore and Herman Cain last month?

So who are the latest nominees?

Christopher Waller comes from within the Fed's inner circle and is considered a somewhat conventional choice. A PhD economist, Waller previously was an economics professor at the University of Notre Dame before joining the St. Louis Fed in 2009. His key research focus was monetary and macroeconomic theory and the political economy, so he clearly has the resume for serving on the Fed.

Currently, Waller is director of research for St. Louis Federal Reserve Bank and has a close relationship with St. Louis Fed President James Bullard. Bullard, just happens to have been the only dissenting vote in June, when the Fed decided not to lower interest rates. The two men have co-authored numerous monetary-policy papers together and Waller helped develop some of Bullard's more dovish policy views. Specifically, both believe that interest rate policy should be lower, especially in a world with low inflationary pressures. A month ago, Waller said, "We didn't see any overheating in the economy coming, and so the question was, why are we raising rates? We didn't see any reason to raise rates just for the sake of raising rates."

The other nominee is Judy Shelton, who is considered a little bit of an outsider in mainstream economic circles. Shelton has a doctorate in business administration from the University of Utah, with an emphasis on finance and international economics. She has previous work experience at the Sound Money Project, which promotes awareness about financial privacy and monetary stability. Since the Senate has already confirmed her for her current role as the US executive director for the European Bank for Reconstruction and Development, there seems to be a slightly higher chance that her nomination can get Senate approval. However, considering the huge partisan divide in Washington, there are no guarantees.
Following the June nonfarm payrolls increase of 224,000, Shelton said the economy was "fantastic." Shelton told CNBC, "I think it shows that the pro-growth economic agenda under the administration is working. I think it shows that economies really do respond to positive policies that help create a better environment for businesses to be successful so they can hire people."

She has already received criticism for some of her unconventional and unorthodox views on monetary policy. Shelton, who has been an informal adviser to Trump, has publicly said the central bank should reduce interest rates. Upon her nomination, Shelton boldly said, “This president really gets it. His pro-growth economic agenda should not be undermined by wrongheaded Phillips Curve (inverse relationship between unemployment and inflation) thinking that punishes productive economic growth and subverts continued gains while turning a blind eye to the currency impact of additional stimulus measures by other central banks. We have high employment and low inflation; so much for the supposed trade-off.”

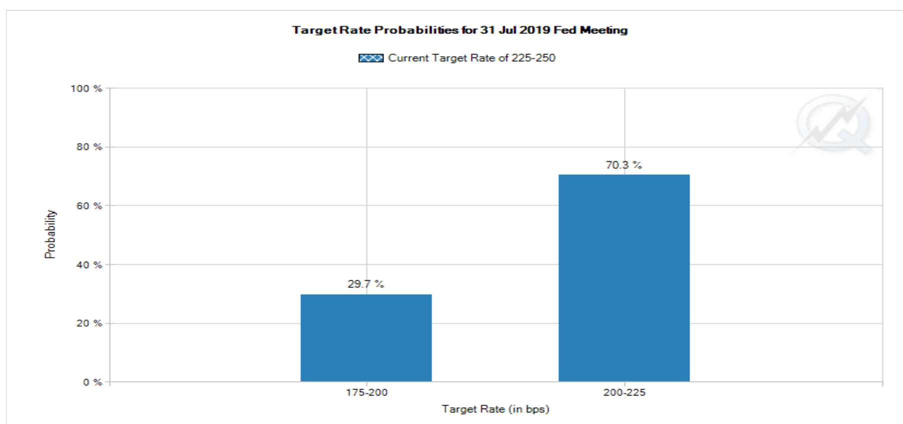
In a May Bloomberg interview, Shelton said she was skeptical as to whether the Fed’s pursuit of maximum employment, stable prices, and moderate long-term interest rates were still relevant.

Beyond these two new nominees, constant rumors are circulating that President Trump is so disappointed with his appointment of Chairman Powell, that he has begun to investigate whether or not he can replace or possibly demote him. When asked about his tenure and leadership of the Fed, Chairman Powell stated that “the law is clear” and that he fully intends to serve his four-year term.

Following a positive job report on July 5th, President Trump tweeted that the markets were at an all-time high despite the Fed’s mistakes and said, “We have a Fed that doesn’t know what they’re doing.” We believe Janet Yellen is probably pleased that she is getting well-paid on the speaker circuit and outside of daily Twitter attacks, right?

Interest Rates:

Using our favorite interest rate gauge, the CME rate watch-tool (click here), we can see that the futures market is indicating a ***100%*** chance that the Fed ***cuts*** short-term rates in late July. The market is estimating a 70% chance of a 25 basis point cut, and a 30% probability of easing by a whopping 50 basis points.



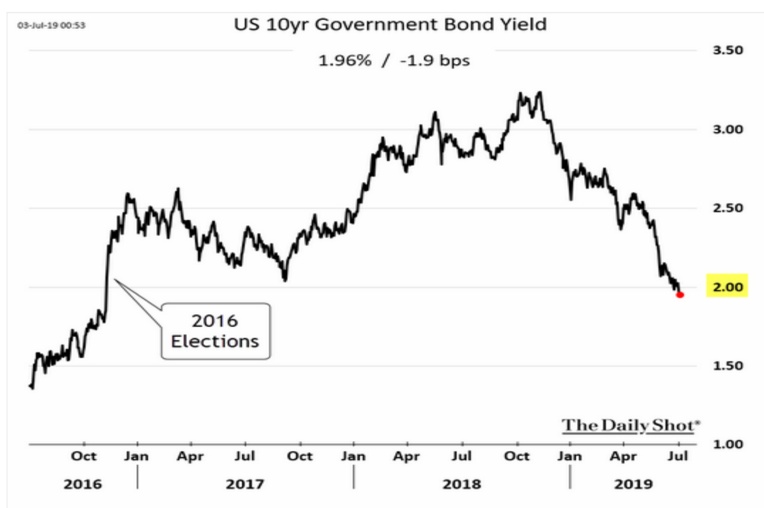
In October of 2018, Fed Chairman Powell stated that interest rates were “a long way from neutral.” Just a few quarters ago, the Fed was worried about the US economy overheating. The market heeded the Fed’s guidance and began to model in multiple interest rate increases in 2019 and additional hikes in 2020. Clearly, the market has reversed its expectations from several months ago. Fed Funds futures, which have done a better job predicting FOMC actions than their “Dot Plots”, are pricing in three cuts in 2019 and one cut in 2020.

At their June meeting, the Federal Open Market Committee (FOMC) left Fed Funds unchanged. Analyzing their commentary and signals, the market began to anticipate a willingness to possibly lower rates in the coming months. Chairman Powell reiterated that some FOMC officials "are quite mindful of the risks to the outlook and are prepared to move and use our tools as needed to sustain the expansion." This Fed flip-flopping (try saying that 3x fast), reminds us of a great song by The Clash, "Should I stay or should I go now".

Sorry! We digress...

This would not be the first time the Fed did an abrupt about face, following some market turmoil. Back in 1995, the Fed lowered rates following the Russian crisis. Again in 1998, after the volatility from the LTCM (Long Term Capital Management) problems, it also eased.

While it is not the Fed's position to ensure the US does not enter a recession, we believe it seems it will do everything in its power to help avert a downturn. The market has made the decision for the Fed, by altering the yield curve. The 10-year Treasury yield, shown on this chart, has dipped below 2.0% for the first time since the 2016 elections.



The Fed can boost financial markets, with an interest rate cut and reverse its tightening at the end of 2018. Another reason we do not expect big reductions from the Fed, is that their increases, since 2015, have cumulatively been the lowest experienced over the last 5 economic cycles.

Furthermore, the Fed could argue that the inflationary environment (half of its dual mandate) remains fairly tame. The added benefit of lower rates is that the US is still dealing with ballooning debt levels and soft productivity gains. In fact, Treasury Secretary Stephen Mnuchin has just started to emphasize how the Treasury could "run out of cash" by early September. In a letter to House leader Nancy Pelosi last week, he urged Congress to quickly begin efforts to raise the debt ceiling before the August recess. We will see if a significantly higher debt-to-GDP ratio becomes untenable for the US debt investors.

Like a good attorney or debater, we theoretically could argue for either higher or lower interest rates. The case ***for*** lowering interest rates rests on a slowdown in manufacturing, lower inflation expectations, an inverted yield curve, a very strong US dollar, and global economic uncertainty. The case ***against*** lowering rates can be made with a stock market at an all-time high, tighter credit spreads, elevated risk appetite, low unemployment, improving leading economic indicators, and stable inflationary trends.

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The Global Environment:

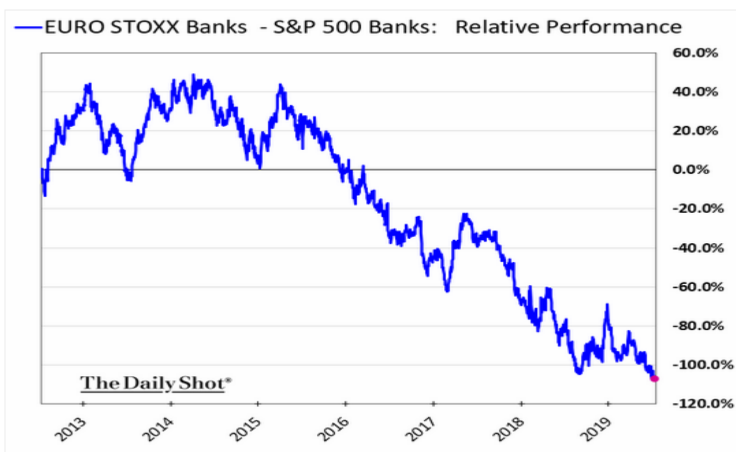
For what it is worth, the Fed still remains reasonably positive on the US economy. It can be challenging to decipher some of their commentary, but we sense that Chairman Powell is trying to balance two important items. He sees the US as the strongest economic engine on the planet, with remarkably low unemployment and solid GDP growth. Countering this, he sees a cloudy global environment and uncertainty from a threatening trade war. Chairman Powell told Congress that the outlook for US growth remains "solid," but he acknowledged that "uncertainties around global growth and trade" can act as a headwind.

Chinese growth is noticeably slowing, from its prior brisk pace. Japan has been stuck in quicksand for decades and continues to fund its economy with massive amounts of debt. Brexit has been a mess for a couple of years now and there does not seem to be a resolution in sight. The rest of Europe continues to struggle to generate even modest levels of growth and the ECB continues its ridiculous stimulus program of advocating negative interest rates.

Mario Draghi of the ECB, just completed a total U-turn on his normalization policy. We are hearing more and more concern that Europe might be entering a "liquidity trap," in which lower interest rates do not stimulate economic growth. This has been the Japanese experience since 1999, where zero interest rates failed to spur any meaningful growth.

For any economy to succeed, we feel it is critical for its banks to be well funded and possess rock-solid balance sheets. With negative yields, European banks cannot generate an adequate spread and, as the chart shows, they continue to dramatically underperform their US counterparts.

Deutsche Bank is just one example, but it is an important one. It is the largest bank in Germany and Germany is the absolute best country (in terms of growth and its economy) in Europe. If DB continues to struggle, what does that portend for banks in Spain, Portugal, Italy, Greece, etc?



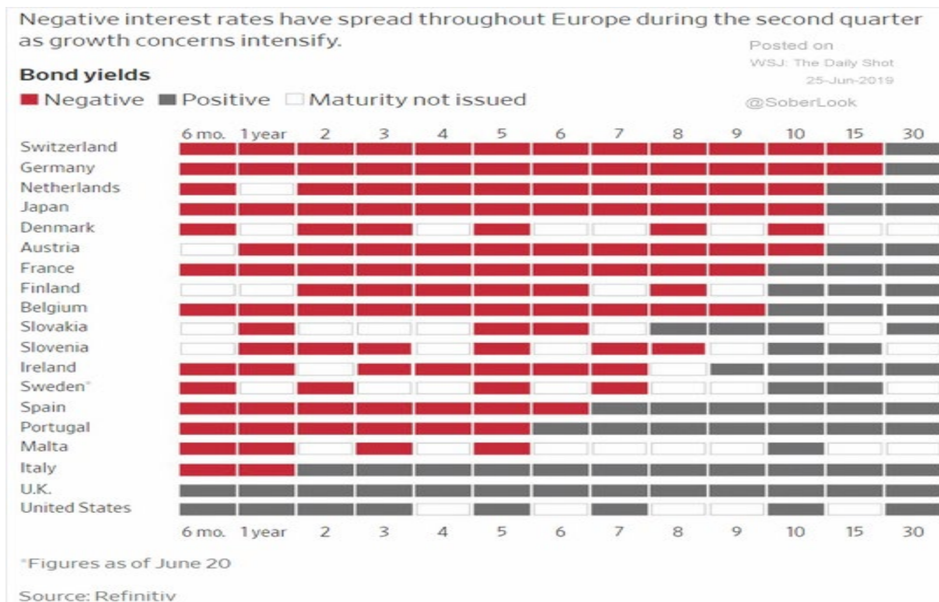
To make matters worse for Deutsche Bank, the US Justice Department just launched an investigation into whether or not it has violated foreign corruption and anti-money laundering laws.

Interestingly, prior interest rate cuts have actually helped bank stock performance. Evercore analyzed US banks stocks 1-year post rate cuts and found they trended higher. Why? Well, lowering the Fed Funds rate can steepen the yield curve, which has short-term negative earnings implications but long-term spread benefits.

Negative Yields:

We continue to struggle with the concept of $13 trillion of global bonds that all but guarantee the purchaser that he/she will receive less in repayment and interest than they initially paid.

As the chart shows, you can guarantee yourself losses by investing in 10-year notes in Switzerland, Germany, Netherlands, Japan, Denmark and Austria. Also, with massive issues with unemployment and seemingly no growth, why would anybody willingly purchase Spanish debt, 5 years out, at a guaranteed loss?



One has to wonder why the US needs to be at one of the highest interest rates in the world. In such a global economy, does the US need to attract investors by offering a yield that is higher than those of Italy or Portugal?

Let's show one more chart to highlight how ridiculous a certain country's debt is trading. Right now, Greek 10-year bond yields are roughly the same as our 10-year US Treasuries.

While it seems a little unfair to compare bonds in different currencies, this is a remarkable reversal for Greek debt, considering the country has had several bailouts and restructurings over the last decade.

There will always be questions and global uncertainty, but we continue to see "the glass as more than half full," especially for the US. Instead of sitting on the fence, how about we provide our opinion and let you decide on your own?

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Our Opinion:

We were very supportive of the Fed beginning to normalize US interest rates in December of 2015 following several years of ZIRP (zero interest rate policy). At some point in time, the Fed needed to take the US economy off of life support. With its gradual increases from 2015 to 2018, this was principally accomplished. At this point, we believe there are few economic or market reasons for the Fed to lower rates, especially since it took so long to raise them from zero.

We do not particularly care for this "insurance cut," as it has been called, and we do not believe the economic data supports easing. We believe the market is pricing in too much in terms of cuts, as well as doing so too soon. We believe, before it turns from tightening to easing, the Fed should show some patience. However, the FOMC did just drop the word "patient" from its most recent policy statement. There is an old investing saying, that a smart investor should never "fight the Fed" or "fight the tape." It is fairly obvious that the Fed will begin to take a dovish stance and lower interest rates. Whether we agree or not, the responsible thing to do is begin to understand the ramifications of lower interest rates. Are central banks essentially paying investors to buy risky assets at unjustifiable valuations? Is the Fed penalizing those yield investors seeking safer assets? Either way, we know that this is good for the equity markets. It was William McChesney Martin, the longest-serving Fed Chairman (1951 to 1970) that said the Fed's job was to "take away the punch bowl, just as the party gets going." We won't go as far as saying that the Fed is now "spiking the punch bowl", but it certainly is being quite accommodating with this pre-emptive easing.

While some are expecting a 50 basis point cut, we believe the Fed will be more modest and move in 25 basis point increments; moving in larger increments would provide a signal that things are worse than they really are. To appear independent and not purely following President Trump's wishes, the Fed might cut only 25 basis points later this month and maybe just one more minor cut later this year. We think the market has gotten a little too carried away with its aggressive easing projections.

Questions still exist, and we did not get too much clarity from recent Fed Chairman Powell's speeches. Is the Fed reacting to negative commentary coming from President Trump? Is the Fed changing its stance because of a slowing global environment? Did the Chinese trade war impact Fed thinking? Unfortunately, there is no right answer to these questions. The Fed is in a bit of a bind. If it does not cut interest rates enough, the market will negatively react, and President Trump will criticize its decision. If it decides to ease, the perception that it is not independent will begin to surface. A disaster scenario would be for the US to be considered like Turkey. Just a few days ago, President Erdogan fired his central bank governor for refusing the governments repeated demands to lower interest rates.

Either way, there is no reason to remain tied to a losing investment. We make mistakes, but the bigger problem is remaining dogmatic to that prior decision. If things change, we are not afraid to change with them. We invest and we adapt. In our opinion, that is what Chairman Powell has done. Last year, the Fed felt tightening was the right decision, with rising inflation and extremely low unemployment. The market did not like this decision and the S&P 500 fell over (9.0%) in December.

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Now, with new information, the Fed has a difficult choice to make. Clearly, growth is beginning to slow, but employment remains impressive (June was up 224,000) and inflation remains tame. President Trump just may have figured out the best way to get Fed Chairman Powell to act is to cause economic doubt and almost force the Fed to lower interest rates. If there is enough uncertainty on trade, which acts as an economic headwind, President Trump can essentially force the Fed's hand. Trade disputes, whether against China, Japan, Mexico, Canada or Europe, all increase uncertainty, which leads to heightened volatility.

Volatility:

The S&P 500, in our opinion, remains the best benchmark for the US equity market. The S&P continues to display significant volatility, but this is not something new or surprising. For example, using recent results as a guide, the market has experienced multiple 10% to 20% declines. In 2011, the market dropped (19%), following the Fed's withdrawal of QE2 and that pesky European mini-debt crisis. In 2015 and 2016, the market dropped (14%), when the Fed began its tightening program, and as the Fed moved off of ZIRP (zero interest rate policy). Then, last year, the S&P 500 experienced two drops of greater than 10%, with a 19.8% drop from a peak in September to that dreadful Christmas week decline and December 26th market bottom. What is interesting, maybe only to us, is that all three of these market drawdowns came when the Fed began tightening monetary policy with an expectation that further hikes were coming. Clearly, the equity markets prefer an accommodating Federal Reserve.

These are just a few examples of how this longest trending bull market has had significant drawdowns, during the cycle. The current environment is unpredictable, but it always is. With a Fed that is pivoting on raising rates (last December) and now might lower them, we foresee heightened volatility in 2019 and 2020. Over the 1st half of 2019, as the market rose, volatility tumbled. The CBOE Volatility Index or VIX fell 41%, which was its largest decline since 1990. Volatility is defined as "rapid and unpredictable change, especially for the worse." Those who religiously watched Game of Thrones, like us, know the constant expression "winter is coming." Trust us; volatility is coming, either from populist politics or ongoing trade disputes or something else. Rest assured; our portfolios are well-positioned for this future volatility. Our large exposures to the derivative and stock exchanges, as well as market makers and online brokerages, should do well in that type of volatile environment.

We still do not forecast a recession, but we anticipate heightened volatility, and we worry more about the downside risks than about significant upside from these levels. With US government bond yields collapsing, and attention-grabbing incidents occurring in the Persian Gulf, the market might convulse if a spike in oil prices occurs. Could a dramatic rise in energy prices be the catalyst for additional volatility? This could occur, especially with the pressure President Trump has been applying with his policy of banning all Iranian oil exports. Crude oil now exceeds $60 a barrel, and there seem to be daily tensions in the Persian Gulf. Three Iranian vessels just tried to block the passage of a British Petroleum operated tanker through the Straits of Hormuz. Since they were being escorted by the HMS Montrose, a British military ship, the Iranian speed boats backed off. While we are thankful that cooler heads prevailed, these daily incidents seem like a dangerous test of wills.

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US vs China:

We were pleased that President Trump and President Xi decided to meet at the G20 summit in Osaka, Japan, and that they agreed to hold additional meetings and discussions. Restarting trade negotiations following an amicable meeting is a positive, but we did not have any expectation that this complicated trade war would be solved with a simple, quick get-together in Japan. At this point, we believe it is a positive that both parties will reconvene and attempt to hash out their differences.

Further negotiations have been scheduled, which is a positive, but there is nothing to immediately celebrate. Any trade deal will be complicated and complex, and we do not believe we will get resolution for several months. This trade skirmish seems to be metastasizing into a technology war, from 5G to artificial intelligence to military equipment.

Making things even more complex, the US just approved a major arms sale at an estimated value of $2.2 billion to Taiwan. China's foreign ministry spokesman, Geng Shuang, immediately called this a "serious violation of international law" and a "crude interference in China's internal affairs, harming our sovereignty and security interests." This type of arms deal makes re-starting trade negotiations somewhat more challenging.

It is our belief that both parties understand that a heightened conflict does more harm than good. Does this necessarily mean that a deal will be immediately struck? No, but we do expect a finalized transaction by year-end or early 2020. Why? Because both parties absolutely need a deal to occur.

While there is no indication President (for Life) Xi is in any danger of losing power, he absolutely could use a perceived or otherwise trade "win." President Xi is dealing with multiple issues in China. As the chart shows, even if we believed Chinese economic figures (which we don't), growth has been dramatically slowing. Chinese 2nd quarter growth of 6.2% was their worst result in the last 27 years. Debt is growing at unsustainable levels, equity markets have been extremely volatile, and the Hong Kong protests are opening an entirely new political worry. China is a proud country and President Trump has significant leverage in these current negotiations. However, even if he cannot get an outright positive judgment to end this trade war, a resolution of tensions would probably suffice.

President Trump has started his 2020 re-election campaign and needs a strong stock market to help his chances. In his mind, a signed deal with China must happen closer to election day in 2020, than during the summer of 2019. Regarding the timing of a potential US / China deal, we feel President Trump's recent quote highlights this point. He said, "The quality of the transaction is far more important to me than speed. I am in no hurry, but

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things look very good!" If a transaction can be tied up in roughly 6 months, it could be the primary discussion point for his re-election campaign. We also believe President Trump's aggressive stance toward the Fed is to force interest rates lower. With lower interest rates, the stock market and business can thrive. With the market hitting all-time highs, President Trump can increase his chances for re-election.

Conclusion:

The nearly 20% stock market decline late last year has roughly been recovered year-to-date; however, the worries that existed in 2018 have not been resolved. In fact, the world remains full of skepticism and uncertainty. Just see our modest list of worries on page 8. As we know, the only certainty in the future is additional uncertainty. In any given year, the markets face a litany of concerns that keep investors on edge. One needs to remember that the US economy is extremely resilient and that stocks have a long and storied history of climbing this "wall of worry." Instead of letting headlines worry you, we recommend focusing on the long-term fundamentals and key economic indicators, which remain positive. Better yet, let us worry about it for you…

Some investors panicked during the 4th quarter decline and "went to cash." Did those investors return to the equity market this year and benefit from the rebound? Unfortunately for them, we doubt it. Investors should strive to remove emotions from their investment process and attempt to focus on the details. We are not contrarians, sector rotators, momentum chasers, or even market timers. As we stated earlier, we will attempt to K.I.S.S., focus our attention on our "circle of competence" and try to "win by breathing." There will always be temporary periods of weakness, but we are confident that our concentrated portfolio of FINTECH companies will perform well in both up and down markets.

We remain committed to investing in companies that generate recurring revenue, have predictable cash flow and sustainable business models. We are optimistic about the US equity markets and believe the economic environment is poised to continue to trend higher. Employment levels remain strong and solid wage growth of over 3% year-over-year continues to fuel consumer spending. GDP is consistent, with little evidence of a material slow down. These are not the fundamentals of an economy poised to enter a recession. Quite the contrary, these are the tenets of a thriving economy that is the envy of the developed world. With a Fed reversal, reasonable stock valuations, and a positive global environment, we remain bullish on our FINTECH portfolio.

Thank you for your continued support, and we look forward to speaking with you soon!

Warren Fisher, CFA
Founder & CEO
Manole Capital Management

Poker:
- The 50th annual World Series of Poker's Main Event just finished
- The entry fee is $10,000, for this no-limit Texas Hold 'em tournament
- This year, 8,569 players entered, just shy of the all-time high (in 2006)
- 1,269 players will wind up "in the money", but 1st prize is $10 million

Don't Be A Hacker in The Philippines:
- Hacking a bank systems is considered to be "economic sabotage"
- If caught, a hacker can receive life in prison & a fine of P5 million
- ATM fraud, by installing a skimming device, also results in life imprisonment
- Even smaller infractions are punished harshly
- The fraudulent use of a credit card is punishable with "only" 4 to 6 years of prison

Tensions with Iran:
- In June, Iran shot down a US, unmanned military drone in Intl' airspace over the Strait of Hormuz
- In previous eras / administrations, this could have started a war or a conventional military assault
- Instead of shooting rockets or launching missiles, the US took a cyber approach to attacking Iran
- In its 1st ever cyber action, the US attacked the Islamic Revolutionary Guard Corps on June 22nd
- The US infiltrated Iranian cloud technology, engaged in phishing attacks and numerous other tactics

A Day at The Pool?
- Yuiling Zhang, a Chinese woman, was arrested at President Trump's Mar-a-Lago resort in Florida
- She told the Secret Service she was there to simply enjoy using its beautiful pool
- When we visit the pool, we try to remember our favorite beverage, something good to read & a towel
- Ms Zhang had 9 USB drives, 5 SIM cards, 4 cell phones, a thumb drive carrying malware, a hard drive, several debit cards, $8,000 in cash and a radio frequency device that detects hidden cameras

World's Ugliest Dog:
- Every year, at the Sonoma-Marin Fair in Petaluma, California, it crowns the world's ugliest dog
- This year, "Scamp the Tramp" won 1st prize; his owner gets $1,500, a trophy and a trip to NYC

Jeopardy:
- During April and May, James Holzhauer had a historically good run on Jeopardy
- He had 32 straight victories and won more than $2 million in prize money
- On June 3rd, Holzhauer finally lost and 14.5 million people tuned into see the show
- That viewership was higher than the first 4 games of the 2019 NBA Finals
- In addition, it garnered more viewers than the Game of Thrones series finale
- Lastly, we are very happy to hear that Alex Trebek is fighting his illness and feeling much better

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