MANOLE CAPITAL MANAGEMENT

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10-Years Ago:

On September 15, 2008, the American financial system was on the brink of an epic collapse. It was among the darkest economic periods in US history. The Lehman Brothers bankruptcy set off a series of events that infected other entities across the globe. In fact, here is a picture of the headline from the Wall Street Journal on September 17th.

WEDNESDAY, SEPTEMBER 17, 2008 - VOL. CCLII NO. 66

U.S. Plans Rescue of AIG to Halt Crisis;
Central Banks Inject Cash as Credit Dries Up

So, who is to blame? While "greedy Wall Street" gets the majority of the notoriety, we believe the fault can be found in many participants. Certain banks had awful risk management controls, and some were grossly over leveraged. From greedy speculators to lazy credit-rating agencies to insatiable Wall Street banks to idle investors, the guilt can be widely assigned. No one entity bears specific responsibility for the Financial Crisis; everybody in the ecosystem does. Our takeaway is not to dispense responsibility but rather to learn from the past, so it does not repeat itself.

Speculators, with questionable credit scores, took advantage of lax market conditions. With little money down and often no documentation, opportunists were able to take on significant debt loads. Wall Street was more than happy to partake in the party and handle its role as intermediator of capital; it simply filled the role of financing and enabled these entrepreneurs. Many have said Wall Street was just "a bartender" fueling the party. In its role as facilitator, Wall Street securitized and pooled these combustible mortgages into various tranches, called CDO's (collateralized debt obligations). No investor could perform adequate due diligence on thousands of mortgages, so they relied on the credit agencies and their triple AAA and investment grade ratings for legitimacy. Who paid these firms for their ratings and work? Unfortunately, it was the same placement agents and fund sponsors that paid the bill. Funds were sliced into various tranches and then sold to investors that assumed real estate prices went up 5% a year in perpetuity.

The Aftermath:

The aftermath of Lehman's failure in September of 2008 had the potential of being catastrophic. After Bear Stearns was sold and Lehman Brothers failed, former CEO of Morgan Stanley John Mack said, "I knew we would be next." He is credited with steering Morgan Stanley through the crisis and resisting governmental pressure to sell the firm for $1 to JP Morgan. The Fed had to get involved to save our financial system. There was no playbook to follow as this type of debt crisis had never before occurred. The Fed and Treasury, led by Ben Bernanke and Hank Paulson respectively, simply tried anything they felt was in the best interest of our country.

A decade of reflection can distort one's perspective. Federal regulators were in the midst of a series of unpredictable financial maneuvers. After rescuing one set of creditors and putting out one fire, the feds needed to respond to another problem immediately. They swerved to take over insurer AIG, which in turn was used as a vehicle to rescue several other financial firms. Within a few days, a bailout program called TARP or Troubled Asset Relief Program was created with a $700 billion price tag. While Congress was paralyzed by typical partisan bickering, these two level-headed individuals essentially saved our system. At the time, the contagion and panic were immense. The Fed used its unlimited balance sheet to act as a lender of last resort. The Treasury Department's TARP plan was ultimately passed and was able to purchase defaulted bonds. The primary goal of all these measures was to halt this growing "crisis of confidence."

Our Fed and other central banks around the world responded to the crisis with all their powers. Interest rates were lowered to zero and massive amounts of quantitative easing (QE) ensued. Central banks buying bonds and making capital available for essentially nothing (i.e. negative rates) had the unintended consequence of boosting asset prices. Yield craving investors were forced into riskier assets, especially equities, since there was no real alternative. Some coined this the "TINA" equity market, or "there is no alternative." Adding more debt with lower credit quality was not the desired effect, but it definitely was one of the outcomes.

To this day, these two individuals (Bernanke & Paulson) continue to get blamed for their actions, instead of being treated like heroes. In 50 years, we will not be surprised to see statues of both placed directly in front of the NY Stock Exchange next to that of George Washington (seen on the right). That would be a more appropriate response, in our opinion, than the ridicule they currently receive.

Patience Wins:

Even during the midst of the Financial Crisis, in June 2008, an investor that bought the market (i.e. S&P 500) generated a solid 9% annualized return over the next decade. At that point in time, Lehman Brothers was fighting for credibility, but few envisioned it was about to fail outright. There was tremendous uncertainty and angst in the market. While the stock market was down 10% from its peak in October 2007, few envisioned it would collapse another 48%, before bottoming in March of 2009.

From that market bottom in March 2009, the S&P 500 has returned over 300%. This hypothetical investor would have needed a great deal of patience and long-term vision, but he/she would have earned, including re-invested dividends a high-single return. Considering our low inflationary environment, this is a real return that well exceeds the historical equity average since 1900.

We are not implying that you should ignore any warning signs that the market is sending; this just demonstrates that having a long-term investment process, strategy, and philosophy in good times and bad, is worthwhile and can be quite profitable.

The Lingering Impact:

Post crisis, Congress used Wall Street as a piñata. For years, Wall Street has been blamed and vilified for its role in the financial crisis. As stated, Wall Street absolutely played a significant role in the global economic rout, but it is not solely responsible. In hindsight, with Congress implementing certain regulations and aspects of Dodd-Frank, it hindered our recovery from the crisis. By instituting the Volker Rule and other onerous rules, Wall Street has been prevented to perform its critical market-making and liquidity-providing role.

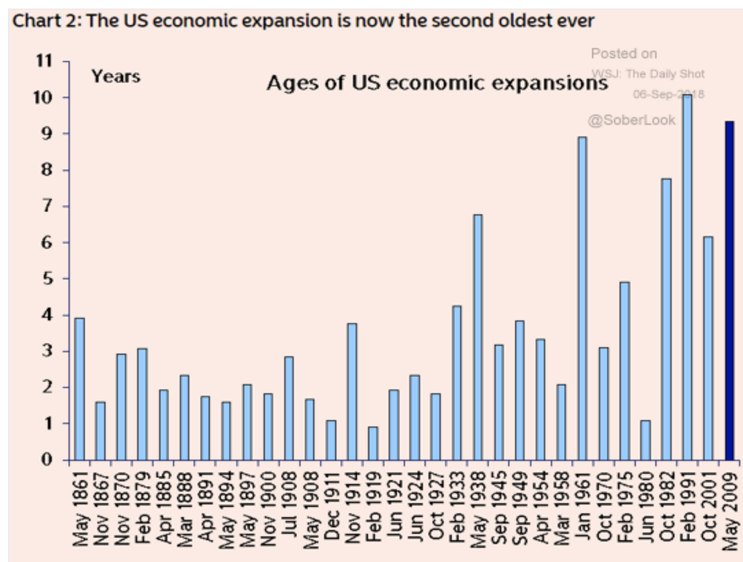
We are pleased that many American households have learned from their mistakes and lowered their leverage. Debt service levels have dramatically fallen as a percentage of disposable income from 14% to 10%. While households and banks have lowered leverage levels, US corporations, and even our government, have

dramatically increased debt. Over the past decade, the combination of sovereign, corporate, and household debt has increased by 75%. According to McKinsey Research, sovereign debt has doubled to $60 trillion and corporate debt is up 78% to $66 trillion.

Economic uncertainty and prosperity seem to be sworn enemies of each other. When uncertainty reigns, prosperity tends to fade. This leads to lower consumer confidence and spending and then chokes off private investment. Following the 1929 stock market crash, the depression lingered because economic uncertainty ruled. The normal growth that follows a market decline did not materialize, and that unfortunately led to a very weak recovery. The same can be stated following the 2008 Financial Crisis. The regulatory environment and blame game were partially responsible for somewhat tepid growth experienced. The magnitude of both of these downturns should have led to huge growth recoveries. Instead, uncertainty and doubt caused lukewarm revivals.

Baseball Playoffs:

With a historically long, 9½ year bull market raging, many analysts are wrestling with predicting the next recession. There are numerous "experts" calling for the next market correction. Ray Dalio, the founder of Bridgewater (the world's largest hedge fund) recently said on CNBC, "We are in the 8th or 9th inning or this rally." Continuing with this baseball analogy, David Tepper of Appaloosa Management stated, "Games can and do go into extra innings."



While some consider this current bull market the longest in history, we think it is still the 2nd longest. As seen in the chart to the left, between December 1987 and March 2000, the US equity market rallied for 12.3 years and increased by 582%.

The widely accepted definition of a bull market is measured from the lowest point, which clearly happened on March 9th, 2009. However, a bear market occurs when the market experiences a 20% drop from the last peak in the cycle. Some argue that our current bull market re-started in October 2011. If you recall, the S&P 500 declined 21.6%, using intraday prices of the market. This essentially would have started a new, albeit short, bear market.

Whether we call this 3,500+ days a record bull market or we split hairs and say it started in October of 2011 does not really matter. The market seems infatuated with "experts" predicting our downfall and calling for the next financial crisis. While there can be no right or wrong guestimate, we certainly must be getting one day closer to a peak of the business cycle, right? History proves that those who have had the foresight and patience (and luck) to remain long-term equity market owners, have truly benefitted.

Pessimism Doesn't Pay:

A decade ago, over a period of 22 days, the S&P 500 fell by -28%. Through the bottom, which was hit in March of 2009, the S&P 500 lost roughly half of its value. In the 4th quarter of 2008, GDP fell by 8.9%, which was the worst decline in 50 years. The unemployment rate went from 5% in January 2008 to 9.8% in January of 2010 and home mortgage defaults soared from 3.7% to 11.5%.

During this period of gloom, it would have been very difficult to imagine that US stocks were about to embark on one of the longest bull markets in history. Those bold enough to brave those headwinds, showed remarkable courage, since we were still fresh off the dot-com collapse. During this bull market, the market has handled a European debt crisis in 2011-2012, an emerging economy commodity collapse in 2014-2015, a Brexit vote in 2016, and the start of the Trump presidency in 2017. It is safe to say that the environment that existed in March of 2009 did not feel like the beginning of something wonderful. Quite the opposite!

There will always be those that remain pessimistic and feel that we are in the midst of another inflated bubble. They highlight trade wars, higher interest rates, struggling emerging markets, and a possible inverted yield curve. As central banks move from QE to QT (quantitative tightening), these investors believe a significant correction will arise to pop this bond bubble. In the last five years, US corporations have taken advantage of low yields to sell $9.2 trillion of bonds. When will this bond bubble burst? Nobody can say for sure, but we believe that equities remain the best place to invest and generate returns.

A Recession?

Forecasting recessions is hard to do, and many economists have missed with their prior predictions. To be perfectly clear, recessions happen when the economy "runs out of gas" and when growth stalls. Exactly what in our current environment would lead people to this conclusion?

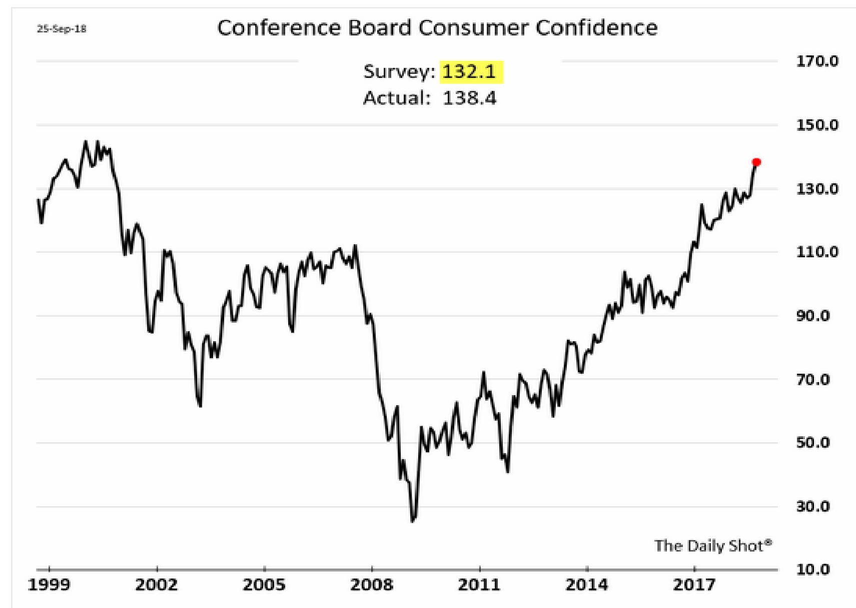
The market can make violent swings, as we experienced in late January and early February of this year. This reminded scores of investors that the stock market never calmly and steadily marches higher. There is clearly a tug-of-war between the bulls and the bears. This is wonderful and makes our markets liquid and successful. On one side, bears are concerned with tariffs, rising interest rates, inflation and high valuations. Pessimists will say that it is not wise to invest during a record long bull run. They argue that it is not the time to invest with high stock prices, ongoing trade skirmishes, DC legal issues and tumbling emerging markets. Throw in Brexit uncertainty and a fiscal spending cliff, and these pessimists will have investors sitting idly in cash. We are also concerned about these issues, but we feel the market does a great job of pricing these concerns into its valuation.

Bulls counter and believe the economy is experiencing excellent growth. Bulls see solid corporate earnings, rising confidence and outstanding consumer sentiment. The fact that so many people and investors are focused on when the bull market will end, gives some credence that it still has some life. Most bull markets end when the average investor dives in with both feet. One item we continuously monitor is retail brokerage cash levels. During the 3rd quarter of 2018, Charles Schwab reported that its accounts still had over 10% of their value sitting on the sidelines in cash. We still believe there is retail trepidation and caution.

This time of uncertainty is exactly the time to invest. Great buying opportunities are not easily identified but are capitalized by those who have a long-term horizon. Having the fortitude and patience to stay invested in the market through thick and thin is imperative.

Confidence:

Our economy is performing quite well, with robust US growth, record low unemployment levels, rising wages, modest inflationary pressures, increased small business optimism and excellent corporate earnings.



As the chart indicates, the Conference Board's Consumer Confidence Index just hit 138.4, its highest level since 2000. Small business optimism is soaring and has reached its highest level since August of 1973 according to the National Federation of Independent Business. Confidence can be contagious, and we feel like this might be the most unloved bull market we can recall.

We are not going to predict what inning this market rally is in. We are not market timers and we do not believe that it is possible to properly time the market. If it were easy, investors could simply dump equities for bonds when they knew exactly when the market cycle was coming to an end. Maybe that would have happened in 2016 when the Fed began to normalize US interest rates. Investors would have missed out on a S&P 500 return of 21% in 2017. One cannot just sit out the market.

One can state that the overall market is overvalued or pricey, but this fails to consider company specific issues. We firmly believe that it is best to do bottoms up, fundamental analysis on individual companies. We do not manage a diversified portfolio that encompasses all sectors of the S&P 500. Instead, we exclusively focus on the FINTECH sector, capturing the two largest components of the market (technology and financials). We run a concentrated portfolio, that is actively managed. Our portfolio is a collection of wonderful growth companies, that trade at prices significantly below our calculation of intrinsic value. It is our philosophy to make stock decisions and base our ownership on specific valuations, as opposed to macro factors.

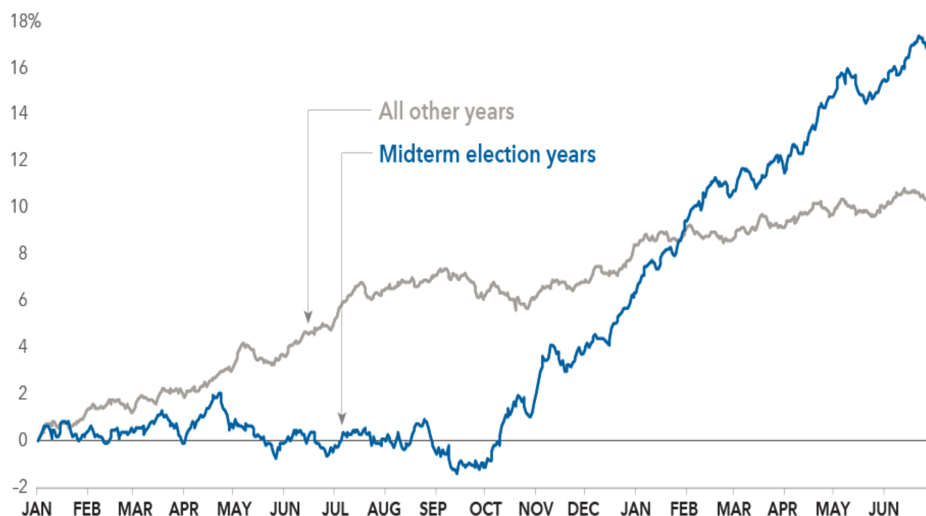
Politics:

Over the next couple of weeks, you will hopefully be voting in the mid-term elections. As we have said in the past, there is no excuse for not voting. In late August, we published our expectations with the upcoming mid-term elections. No…we didn't pick Republican versus Democrat winners and losers. We discussed how uncertainty

impacts the overall market and how we were anticipating heightened volatility. Little did we know that October was going to have this much downside. If you would like to see that quick, 2-page note, just click here or visit our website at www.manolecapital.com/research. If you want expert political analysis and polls, we suggest looking at FiveThirtyEight's website, which can be found here.

The Mid-term Election:

Here are some of our key takeaways. First, is that the incumbent of the White House typically loses seats. Midterm elections, at the midpoint of one's four-year presidential term, result in his party losing seats in Congress. Over the past 21 midterm elections, the sitting president has lost an average of 30 seats in the House and an average of 4 seats in the Senate. Only twice, has the president gained seats in both chambers. How will the markets react, if Republicans do not control all of Washington, DC? We believe that this has played out in October, with the roughly 7% market decline.



Second, and this is not a terribly bold statement, is that the stock market does not like uncertainty. Who will win and lose the midterms is still a toss-up. During this period of uncertainty, volatility tends to spike higher. Since 1970, especially in midterm election years, annualized volatility rises in August, September and October. In all other years, late summer tends to be quiet and fairly tame. During election years, when uncertainty peaks, the market tends to be flat.

As of right now, the stock market is only up 1% year-to-date. Once the election results are known, the market can climb higher. As the chart shows, the S&P 500 tends to rally handsomely post-election. History shows, dating back to 1950, that one-year post midterm election yields a 15% S&P 500 average return. This is more than double the non-midterm election year performance of 6.8%. All elections are uncertain, and nobody has a crystal ball on politics. From our perspective, long-term equity returns are generated by how companies execute and deliver in their specific business. Investors that look past short-term political volatility and focus on long-term growth, will profit.

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Conclusion:

Our economy has gone from subpar to supercharged. For the first 8 years of this bull market, US GDP averaged a paltry 1.48%. We were told by “experts” that this level of growth was all we could generate, and this was the US “new normal.” Instead of the traditional 5-year boom and bust cycle we are accustomed to, this just might have been replaced with an elongated boom cycle lasting 10 to 15 years. With the first 8 years of this bull market being so subdued, maybe this cycle will just grow lower for longer. Maybe, just maybe, the bust cycle will be shallower in depth and shorter in duration, especially since inflationary excesses are barely visible.

In fact, following a number of positive changes, our economy is now growing at more than twice that modest 1.5% level. Overall GDP growth for the 2nd quarter of 2018 was revised higher, to a remarkable +4.2%. 3rd quarter 2018 GDP growth of 3.5% marks the best back-to-back results since 2014. For the year, estimates are calling for 2.9% this year and another 2.6% next year. At the Jackson Hole Economic Symposium, Fed Chairman Jerome Powell praised the economy by saying, "Over the course of a long recovery, the U.S. economy has strengthened substantially... With solid household and business confidence, healthy levels of job creation, rising incomes, and fiscal stimulus arriving, there is good reason to expect that this strong performance will continue."

The pro-growth benefits of cutting onerous regulations, that inhibited business innovation, are slowly being removed. The individual tax cuts are boosting consumer spending and confidence is running quite high. The lower corporate rates now make the US one of the most competitive places in the world to do business and companies are both lifting wages and investing significant assets into manufacturing plants and R&D. The tax cut is only two to three quarters old, which should spur significant growth going forward. The administration’s focus on business has re-energized our economy, which has propelled our stock market to new heights. Corporate earnings are strong, the stock market reflects a historically robust economy, and the unemployment rate is at 3.5%, a level not seen since December 1969. In our opinion, there is more upside to the market, which simply reflects this historically resilient environment.

There will always be “bumps in the road” and it is perfectly normal to anticipate a slowdown. Instead of getting caught up in fears of what might come in the future, our key is to focus on the fundamentals and the long-term positive economic indicators we see. Where will the next crisis come from? We do not know, but it likely will not be a financial crisis due to the fortress balance sheet of our banks. The next crisis will likely emerge from factors, places, or risks that are not terribly obvious. From our perspective, we simply do not see the risk that is looming or imminent, but we are actively looking.

Warren Fisher, CFA
Manole Capital Management

Interesting Statistics, Metrics, Facts & Quotes:

- Since 1927, the US government has cut taxes 10 times
- The year following the tax cut, the stock market has averaged a gain of 11.3%

A Mega-Cap Market:

- The 5 largest companies in the US stock market are all technology companies
- Apple, Amazon, Alphabet, Microsoft and Facebook make up more than 15% of the S&P 500
- Over the last 12 months, these companies accounted for 1/3rd of the increase in the market
- Apple is the world's largest company, with a market capitalization of over $1 trillion.
- Apple represents roughly 4% of the S&P 500
- Back in the early 1970s, IBM represented 9% of the index
- Both AT&T and General Motors were larger as a % of the market than Apple is today
- In addition, the Top 5 companies from 1964 to 1983 held a larger % of the market versus today
- In 1980, 3 of the Top 5 largest companies were energy businesses (Schlumberger, Exxon and Amoco)
- In 1999, during the dot-com madness, Wal-Mart, General Electric and Exxon were in the Top 5

Warren Buffett makes mistakes too:

- In 1993, he purchased Dexter Shoe for 25,203 shares of Berkshire Hathaway stock *instead of cash*
- He paid $433 million in stock for Dexter, which he recently said is a "worthless business"
- That Berkshire Hathaway stock is now valued over $7.5 billion
- When possible, Buffett attempts to pay in cash instead of his growing value of equity
- Buffett's investing sidekick is the legendary Charlie Munger (94 yrs old)
- "I don't revisit mistakes to bewail them; I revisit them for their learning purposes"

Vanguard's Index Funds:

- The founder of Vanguard and the father of index fund investing is Jack Bogle.
- "I built a career out of knowing what I don't know."
- "While rational expectations can tell us what will happen..they can never tell us when"
- "When there's a gap between perception and reality, it is only a matter of time until reality wins."

Vanguard Group's S&P 500 mutual fund just turned 42 years old, but it wasn't an immediate success when it was launched. It raised just $11m, before the passive investment founder gained steam. Upon its launch, Fidelity Investments was a leader in active asset management, and Edward Johnson stated that investors would not be satisfied with "just average returns." Vanguard did not launch another index fund until the 1980s and that fund did not hit $1B until 1990. Now, Vanguard has $5T and there are new index funds created every day. Fidelity has embraced passive management and it even launched a zero-fee fund in early August.

Bankruptcies:

- Over the last year, several traditional retailers (i.e. bricks & mortar) have declared bankruptcy
- Toys R Us, Claire's, Bon Ton, Payless, Gymboree have all sought Chapter 11 protection
- The most recent to accept its fate seems to be the 125-year old Sears Holdings
- It has over 70,000 employees at over 700 Sears & K-Mart stores

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