MANOLE CAPITAL MANAGEMENT

Introduction:

A year ago, most economists were calling for a US recession and some were predicting 1970s-style stagflation. Not only did that not occur, but the US economy steadily grew. According to the Bureau of Economic Analysis, 3rd quarter 2023 real GDP was +4.9% and 4th quarter was a solid +3.3%. Not only is our economy growing, but the stock market is absolutely paying attention (the S&P 500 increased +26% last year). Inflation has dramatically fallen, and it isn't too far from the Fed's 2% target. Now, these same economists have backed off of those pessimistic forecasts and are predicting solid economic growth in 2024.

Since 1887, various groundhogs have been predicting future weather patterns in Gobbler's Knob Punxsutawney, Pennsylvania. On February 2nd, Phil "the groundhog" predicted an early spring and an end to winter. While winter will officially end on March 19th at 11:06pm EST, Phil continues to look for his shadow to determine the weather.

For 138 years, Phil's prognostications have been correct under 40% of the time, which isn't terribly accurate. During this span, Phil has predicted longer-lasting winters 107 times (or 84% of the time), so he clearly has a preference. An interesting Harvard Business Review would be comparing Phil's longer winter forecasts to Wall Street's bullish strategist calls, as both seem to have the same "coin toss" success rate.

Now that 4th quarter 2023 results have been released, we can begin to gauge what expectations are for the year. As of now, Zacks Research is showing that 2024 earnings are expected to rise by 5%, which sets up a relatively low hurdle for the US economy. If the Fed lowers interest rates this year (which we'll discuss shortly), it should bolster stock prices and economic growth.

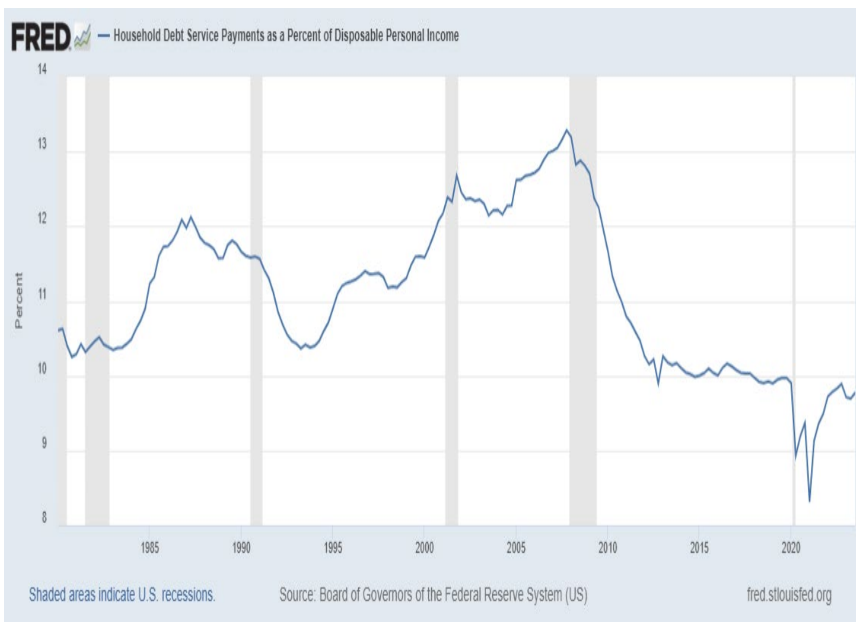
As we continue to emphasize, our economy is being driven by the US consumer, estimated to be 70% of GDP. Some experts thought that the consumer was tapped out, but holiday shopping and spending proved that wrong. If Americans are fully employed, they can earn higher wages and do what they do - spend. As this occurs, both online and in physical stores, we believe they will continue to utilize the most convenient form of payment – cards. Whether a plastic card is used or one's iPhone, both run on our networks and over our payment rails.

Looking forward, the biggest question the market is wrestling with is the Fed's monetary policy decisions. Will the Fed lower rates multiple times this year? Has inflation really been solved? Does the Fed want to become a story in an election year? The Fed will materially impact 2024 market performance, but it has historically tried to avoid impactful policy decisions in an election year. Continue reading to understand our macro perspective on these questions. Plus, everyone needs to glance at our section of ***Cliff Clavin's Useless Information***, right?

Households & Jobs:

The story that the US consumer was spent couldn't have been more wrong. While stimulus savings are mostly gone and consumer credit is at an all-time high, Americans are fully employed and getting fairly compensated. In January, the US economy added 350,000 jobs, which was roughly 2x what economists were projecting. The unemployment rate is holding steady at 3.7% and has been below 4% for over two years. According to CNN, you would have to back to the Nixon administration to see employment this strong for this long.

As we continue to emphasize, this is great news for both job seekers, the American consumer, and our economy. Personal incomes are hovering near all-time highs, wages continue to grow faster than inflation, and debt service payments appear manageable.



As this Fed Bank of St. Louis chart shows, household debt as a percent of disposable personal income is at multi-decade low. We continue to highlight growing credit card receivables and the peril of higher debt burdens, but that's just because we've analyzed these trends for two decades.

Not every American household is strong, but the vast majority are better off than they have been in decades. In our opinion, the resilient US economy rests on essentially full-employment, well-paying jobs, and the American consumers insatiable desire to spend.

With the economy continuing to perform, there seems to be a disconnect between the Fed's statements and the market's interest rate expectations. Many market participants are clamoring for lower interest rates and are projecting multiple Fed cuts this year, while the Fed is asking (borderline pleading) for patience.

Interest Rates:

Our loyal readers know that we like to use the CME's Fed Watch tool to gauge interest rate expectations. Looking here, one can see that the market is modeling in 3 to 4 interest rates declines in 2024. While a decrease in March is essentially zero (just 2.5% of a 25-basis point cut), it begins to climb in May, June, and July (reaching 72%). Before that blowout jobs number, some forecasters were thinking the Fed would lower rates 5 to 6 times this year, starting next month. We think the immediate need for lower interest rates is unfounded and there is just too much emphasis placed on predictions about the timing and magnitude of Fed cuts.

We believe the market has been too optimistic about the size and frequency of 2024 interest rate cuts. The Fed 100% agrees. On his February 4th interview on ***60 Minutes***, Fed Chairman Powell struck a cautious tone on cutting interest rates and emphasized that the Fed is still looking for signs that inflation's decline is sustainable. It seems that every Fed official is stating the same thing – "please remain patient." Fed Governor Lisa Cook said, "The disinflationary process has been, and may continue to be, bumpy and uneven." Philadelphia Fed President Patrick Harker said, "We are bound to have bumps along the road to disinflation and we need more data to assess the right path forward for monetary policy." He isn't alone in asking for some market patience. While everyone is guessing the "when and how much" of monetary policy, others are doubting the Fed will immediately act. DoubleLine's CEO Jeffrey Gundlach recently said that he "doesn't believe that May interest rate cuts are going to happen and that it is probably going to be June, if at all."

Typically, the Fed will lower interest rates to spur the economy and add some "fuel to the fire". For decades, inflation was non-existent and interest rates were used as a tool to boost growth. After the COVID induced inflationary spike in 2021 and 2022, the Fed aggressively raised interest rates 11 times. This helped tame inflation and didn't dramatically impact our steady economic growth.

All of this chatter about interest rate cuts ignores the fact that the Fed has only cut interest rates five times - during an economic expansion - over the last 50 years. In the February 1995 to January 1996 period, the S&P 500 responded with a +35% return. In the March of 1997 through November 1998 expansion, it climbed +44%. The most recent period was December 2018 through October 2019, and the market climbed by +20%. The best period was August of 1984 to August of 1986, and the S&P 500 rose by a whopping +49%. Simply stated, it is fairly rare for the Fed to ease during an expansion, but when it does, performance is stellar (averaging +31%).

Inflation:

Recent CPI (consumer price index) and PPI (producer) reports confirm that inflation is officially on the decline but remains somewhat pesky. The January Core CPI metric, which excludes volatile food and energy prices, was up +3.9% year-over-year; down nicely from +6.6% last summer, but still hotter than the market wanted to see. The Fed's preferred inflation gauge is the Core PCE (personal consumption expenditures) index, and it tells a similar story. According to the Commerce Department's Bureau of Economic Analysis, headline inflation was up +2.8% year-over-year, down significantly from last year's peak. This met consensus and was a "goldilocks" type of result - not too hot and not too cold.

While peak inflation seems to be behind us, we doubt the Fed is ready to take a "victory lap" just yet. Austin Goolsbee is the President and CEO of the Fed's Bank of Chicago. He recently said, "let's not get amped up on one month of CPI that was higher (or lower) than it was expected to be. We can still be on the path (towards 2%) even if we have some ups and downs, so let's not get too flipped out." It is kind of refreshing to hear a Fed official speak in such layman's terms, right?

In addition to Goolsbee, Kansas City Fed President Schmid had some hawkish commentary on the prospects for monetary easing. He advocated for patience with expectations for multiple rate cuts, citing inflation remaining above the Fed's target, as well as a "robust job market" and "elevated wage growth". While it appears the Fed successfully executed its

"soft landing", we believe it will be slow to declare an official victory. We believe the Fed will disappoint those wanting a rapid and sizeable decrease in interest rates this year.

We think the economy can successfully perform with the 10-year Treasury at 4.25%, Fed Funds near 4.5% to 5.0%, and a somewhat elevated cost of capital (versus the last 25 years). In our opinion, we prefer there being a true cost of capital, as it ensures that only free cash flowing businesses can get successfully funded. If capital is too cheap, we unfortunately get environments like 1999 and 2007.

We think it is bullish for the market if the Fed keeps interest rate policy somewhat elevated in 2024, especially if it is because the economy is strong, and not because inflation is stubborn. Then, this year can be about economic and earnings growth, as well as active stock picking. Regardless of their size and timing, interest rates ceasing to go higher - and beginning to fall this year – should be bullish for the market.

The Stock Market:

Is everything perfect? Absolutely not! We have a technology-focused and top-heavy market trading at all-time highs, after four consecutive strong months. The Fed successfully fought off sky-high inflation, but it is too soon to say, "mission accomplished". The US government's debt has soared from $23 trillion to a record $34 trillion, while credit card receivables are well north of a trillion dollars. Plus, the Ukrainian / Russian war just entered its 3rd year, Israel is still attempting to gets its over 100 hostages out of Gaza and tensions in the Red Sea are escalating.

Despite these points, the S&P 500 is hitting record highs, is up 16 of the last 18 weeks and continues to be driven by the "Magnificent 7" - Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla. As of now, these seven stocks account for roughly 30% of the total value of the S&P 500. The market remains infatuated with the "Magnificent 7", which was only strengthened with fantastic quarters from Facebook and Nvidia. We have discussed the implications of such a top-heavy market and highlighted the similarities between today and the Nifty 50 (in our 4th quarter 2022 newsletter, see here).

According to Factset, the 25-year forward P/E ratio for the S&P 500 is roughly 17x forward earnings, versus today's forward P/E of 20x. So, equity valuations are somewhat elevated to historical levels, but they are still a couple of P/E points cheaper than the peak in 2021. In terms of specific sector valuations, Technology is the priciest, trading at 29x versus its historical average of 21x. Consumer Discretionary isn't cheap either, trading at 25x versus its historical average of 20x. Interestingly, out of the 11 different sectors, only Energy is below its historical average, trading at a forward P/E of 12x versus 15x. As we continue to stress, unless you are buying an index fund (i.e., the overall market), it is much more important to analyze individual companies' prospects and assess specific company valuations. Is there enough strength outside of these seven stocks to extend these market's gains? We believe so…

2023 was clearly a year where the S&P 500's largest stocks outperformed the overall market. What happens following a year when the 10 largest names outperform the overall index? Well, the market has posted an average return of +14.3%, with 1998 being +39%, 2009 up +22%, 2013 up +18% and 2021 up over +29%. Over the last century or so, the stock market

performs quite well in Presidential election years, up +11.3%. However, we believe a more interesting statistic is how the market performs during easing monetary conditions and during a Fed "pause". Since 1990, the S&P 500 delivered an annualized average of +15% during the six months after the Fed's first rate cut. However, investors were really rewarded if they purchased stocks six months before the first cut, with an annualized average return of +21%. Want more statistics like this? Take a look at our ***Cliff Clavin Useless Information*** section (on the last page) for a few more interesting market trends and facts. From our perspective, conditions appear good for well-priced, secularly growing FINTECH companies. That's certainly our expectation and we didn't hear anything on 4th quarter 2023 earnings calls that alters our positive outlook.

Our Portfolio:

We aren't macro economists and do not take a top-down approach to investing. We are bottom's up fundamental investors and examine specific FINTECH stocks, analyzing valuations, catalysts, current trends, etc. Our FINTECH holdings should grow revenue and earnings at 2x to 3x the overall market. In addition, all of our holdings generate free cash flow and deliver operating margins and ROE significantly higher than the S&P 500 average. We continuously bring this point up in our newsletters and research, as it is critical to understanding our investing philosophy. Click here, to visit our website and see our goals, process, and investment strategy.

The best way to capture the economic and earnings growth we expect in 2024 is to own (not trade) secularly growing FINTECH stocks. Instead of making predictions and forecasts on market tops or bottoms, we prefer to follow Warren Buffett's advice (in his latest annual letter, click here).

We particularly liked these three themes, from Buffett's latest letter to Berkshire shareholders:

- "One investment rule at Berkshire (and Manole Capital) has not and will not change: *Never* risk permanent loss of capital. Thanks to the American tailwind and the power of compound interest, the arena in which we operate has been – and will be – rewarding *if* you make a couple of good decisions during a lifetime and avoid serious mistakes."

- "The lessons from Coke and AMEX? When you find a truly wonderful business, stick with it. *Patience* pays, and one wonderful business can offset the many mediocre decisions that are inevitable."

- Charlie Munger's advice to Warren Buffett: "add to it (Berkshire) wonderful businesses at fair prices and give up buying fair businesses at wonderful prices."

Click here for our tribute to the legendary investor and Berkshire "architect" Charlie Munger.

MANOLE CAPITAL MANAGEMENT

Conclusion:

In our opinion, the environment remains quite positive for equities, especially many of our FINTECH stocks. There seems to be a disconnect between expectations and reality, especially if one listens to the financial media. Pessimists are unhappy with the economy, irksome inflation, and worried about global tensions. While these are legitimate concerns, these issues continue to weigh on consumer sentiment which has only modestly improved from levels during the 2008 Global Financial Crisis. Does that seem right? We just don't believe so.

The financial experts are no longer calling for a recession, but we'd argue that the market is far from optimistic or euphoric. There is a persistent "wall of worry", which is exactly what we like to see. Economic fundamentals remain encouraging, and our FINTECH companies are executing on their business fundamentals.

The stock market is hitting record territory and 2024 has continued the strong momentum of late last year. This strength is driven by solid corporate earnings and an optimism about the Fed easing monetary policy. Bears believe growth expectations are misguided, inflation is sticky, the market is "ahead of itself", and pricey. The interplay of these competing views will ultimately determine how the overall market performs, but we will spend our time focused on the underlying business fundamentals of our positions. For us, fundamentals, and free cash flow drive future stock prices, not necessarily short-term sentiment.

We'd love to catch up with you and get your perspective on the economy and the market. Feel free to give us a call to chat.

Warren Fisher, CFA

Founder & CEO

Manole Capital Management

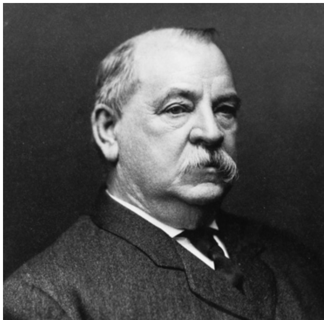
MANOLE CAPITAL MANAGEMENT

Cliff Clavin's "Useless Information":

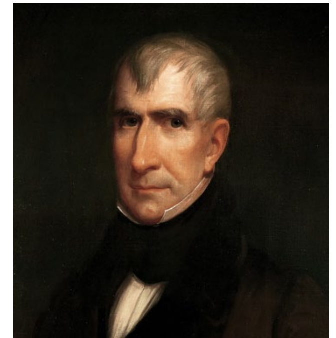
In the 1980s, one of our favorite TV shows was ***Cheers.*** The know-it-all postal worker was named Cliff Clavin and played by actor John Ratzenberger. This recurring segment of our newsletter highlights some "useless" information that Cliff would be proud of.

Market Performance: When the S&P 500 rises by more than +8% in any single month (November 2023 was up +8.9%), the average one-year forward performance has been 15.8%. Since 1950, this has happened 30 times and a year later the market was higher 27 times.

There's another interesting study of performance following bear markets, this time using the Dow index. Looking at the worst ten bear markets, the average rally in year-one is +45% and an average gain of +66% by year-three. One of our worst and recent bear market was during the Financial Crisis (October 2007 through March of 2009). Following that, the market gained +63% in year-one, +101% by year-three and +154% by year-five. Strong performance has certainly followed 2022's dismal results.



If the November 2024 Presidential election pits former President Trump (age 77) versus incumbent President Biden (age 81), it will be the first time since 1892 that the two candidates have already been president.



In that contest, it was President Grover Cleveland versus President Benjamin Harrison. President Grover was 55 years old while President Harrison was a spry 69 years old. Grover beat Benjamin and became the 1st US President to ever serve two, non-consecutive terms.

A decade ago, just 1 of the world's 10 most populous countries (India) had a leader who was over 70 years old. Today, 8 countries do and the two countries that don't (Indonesia and Pakistan) are poised to have septuagenarians after upcoming election.

Getting Older: In 1909, William Taft replaced Theodore Roosevelt as president of the US, women could not vote, and Elizabeth Francis was born. Who is Elizabeth Francis? She is the oldest living American at 114 years and over 200 days old.

Speaking of getting older….America is aging and it's a good thing! 4.1 million Americans will turn 65 in 2024, an average of 11,200 per day. Medical technology and improved healthcare obviously help, but so too do jobs. According to the Pew Research Center, roughly 20% of Americans 65 and older had a job last year, which is 2x compared to 1990. Clearly, there is a link between longevity and how a job can provide a "sense of purpose".

The "Non" Olympics: The first-ever Florida Man Games occurred in St. Augustine in February. The daylong competition featured events inspired by Florida's notoriously strange headlines. Contests like beer-belly wrestling and an "evading arrest" obstacle course were just some of the interesting events. The $5,000 winning prize went to the Cooter Commandos, from Citrus Country. I guess "congrats" are in order?

MANOLE CAPITAL MANAGEMENT

DISCLAIMER:

Firm: Manole Capital Management LLC is a registered investment adviser. The firm is defined to include all accounts managed by Manole Capital Management LLC. **In general:** This disclaimer applies to this document and the verbal or written comments of any person representing it. The information presented is available for client or potential client use only. This summary, which has been furnished on a confidential basis to the recipient, does not constitute an offer of any securities or investment advisory services, which may be made only by means of a private placement memorandum or similar materials which contain a description of material terms and risks. This summary is intended exclusively for the use of the person it has been delivered to by Warren Fisher and it is not to be reproduced or redistributed to any other person without the prior consent of Warren Fisher. **Past Performance:** Past performance generally is not, and should not be construed as, an indication of future results. The information provided should not be relied upon as the basis for making any investment decisions or for selecting The Firm. Past portfolio characteristics are not necessarily indicative of future portfolio characteristics and can be changed. Past strategy allocations are not necessarily indicative of future allocations. Strategy allocations are based on the capital used for the strategy mentioned. This document may contain forward-looking statements and projections that are based on current beliefs and assumptions and on information currently available. **Risk of Loss:** An investment involves a high degree of risk, including the possibility of a total loss thereof. Any investment or strategy managed by The Firm is speculative in nature and there can be no assurance that the investment objective(s) will be achieved. Investors must be prepared to bear the risk of a total loss of their investment. **Distribution:** Manole Capital expressly prohibits any reproduction, in hard copy, electronic or any other form, or any re-distribution of this presentation to any third party without the prior written consent of Manole. This presentation is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use is contrary to local law or regulation. **Additional information:** Prospective investors are urged to carefully read the applicable memorandums in its entirety. All information is believed to be reasonable, but involve risks, uncertainties and assumptions and prospective investors may not put undue reliance on any of these statements. Information provided herein is presented as of the date in the header (unless otherwise noted) and is derived from sources Warren Fisher considers reliable, but it cannot guarantee its complete accuracy. Any information may be changed or updated without notice to the recipient. **Tax, legal or accounting advice:** This presentation is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations. Any statements of the US federal tax consequences contained in this presentation were not intended to be used and cannot be used to avoid penalties under the US Internal Revenue Code or to promote, market or recommend to another party any tax related matters addressed herein.