

Manole Capital's 3rd Quarter Newsletter:

As a long-time Sunshine state resident, we have been through our share of storms and hurricanes. We were in South Florida when Andrew struck in August 1992. We were lucky then and consider ourselves lucky to have avoided the vast devastation of Hurricane Ian last month.

Tampa Bay (our hometown) is vulnerable to storm surge, since so much of it is on the water. The pictures and videos from Naples and Fort Myers were shocking and we hope they can return to a "close to normal" life shortly. There will be tons of work needed to re-build these communities, but we would be remiss if we didn't mention the tremendous work of the electric companies to quickly restore power. The first responders were amazing and dramatically helped following this horrible storm.

As we normally do in our quarterly newsletters, we will review and address some recent macro issues, like inflation, interest rates, and the Fed. Next, we will touch on a few FINTECH items, which we hope you'll find interesting. Specifically, we will discuss Zelle and the traditional banks response to successful FINTECH start-ups like PayPal's Venmo P2P (peer-to-peer) payment platform. Then, we will discuss Senator Dick Durbin's latest attack against the card industry and recent trends we are seeing in payment land. Finally, we will review Goldman Sachs and the success (or failure) of their Apple MasterCard. Of course, we'll conclude our newsletter, as we always do, with our special Cliff Clavin section of "useless" facts and information.

Proprietary Research:

Instead of dramatically increasing the size of this newsletter, where you feel bad about printing it out (and killing a tree), we are simply adding some links to our research. A few months ago, we published a stock-specific note on payment processor Global Payments (ticker GPN). We have owned GPN for nearly two decades and it currently is one of our largest positions. We highlight spending trends, eCommerce developments and how many of our payment companies can actually benefit from inflation and higher costs. We will discuss their business, industry trends, what is driving their growth, and then highlight its compelling valuation. If you wish to read that 18-page research note, [just click here](#).

Also, each year we put our summer interns to work analyzing various financial and FINTECH implications impacting their Gen-Z generation. We publish these results on four distinct topics: payments, banking, brokerage, and cryptocurrencies. If you wish to better understand Gen-Z, [click here](#), and read our interns notes.

Introduction:

We know that volatility is the short-term price that equity investors must pay for long-term attractive returns. All investors eventually feel the anxiety and pain of volatile market. However, we choose to plan for and model in this type of volatility, so we aren't surprised when it eventually arrives. We spend all of our time doing FINTECH and company-specific analysis and have stayed true to our bottoms up, research-intensive process.

For further evidence of how the S&P 500 has been extremely volatile this year, just realize that it has declined by (1%) over 45x this year. That equates to nearly ¼ of all of its trading days. Looking back over the last 70 years, the only years with this many down (1%) days were 1974, 2002 and 2008.

Inflation, Interest Rates, and The Fed:

On Thursday October 13th, the market received the latest inflation data. US CPI (consumer price index) report from the Bureau of Labor Statistics. This measure of the average change in the prices paid by consumers for a market basket of goods and services remains a critical metric to follow. As we all know, inflation has been way too high for way too long, so many were hoping to see it begin to fall.

Headline CPI inflation did slow from 8.3% YoY in August to 8.2% in September, but Core CPI didn't drop. Core CPI excludes food and energy and it rose from 6.3% YoY in August to 6.6% in September. Unfortunately, there is ample evidence of spreading service sector inflation, which should only strengthen the Fed's mission of hiking rates.

The Fed has a dual mandate of supporting maximum employment and maintaining price stability. However, with inflation running persistently high, the Fed seems on a mission to use higher interest rates to bring prices down. This will ultimately be a painful process, but it seems to be the only Fed option to tame today's inflationary environment. To fight the impact of this crippling inflation, the Fed has raised and re-raised their Fed Funds rate. By the end of the year, the Fed will likely take interest rates over 4%. This will cool demand (especially in housing) and have a negative impact on the job market. In fact, the Fed estimates that its rate increases will cause 1.2 million people to lose their jobs. Bank of America Research is predicting an even more dire scenario, projecting job losses over 3.2 million.

As Fed Chairman Powell just said, "Reducing inflation is likely to require a sustained period of below-trend growth and there will very likely be some softening of labor market conditions. Restoring price stability is essential to set the stage for achieving maximum employment and stable prices over the longer run. We will keep at it until we're confident the job is done. We have got to get inflation behind us. I wish there were a painless way to do that. There isn't," Fed Chair Jerome Powell announced.

For months, the Fed has been delivering a 'tough love' message; interest rates will be higher, for longer, than most expect. In addition to higher rates, there is still an enormous \$9 trillion balance sheet that needs to get lowered. It doesn't help investor sentiment when Fed members seem to be cheering for markets to decline. Minneapolis Fed President is Neel Kashkari and he said "I was actually happy to see how Chair Powell's Jackson Hole speech was received. People now understand the seriousness of our commitment to getting inflation back down to 2%. I certainly was not excited to see the stock market rallying after our last Federal reserve Open Market Committee meeting because I know how committed we all are to getting inflation down. And I somehow think the markets were misunderstanding that."

Did supply-chain issues, following COVID lockdowns, help spur inflation higher? Does the economy really need to slowdown and should the Fed cause demand destruction? We aren't going to harp on how we got here and spend our time discussing theorizing about mistakes that were made or supposedly made. We prefer to understand the current situation and gauge how things will look going forward. From our perspective, we don't think it is wise to "fight the Fed" and do not expect a pivot over the next 9 to 12 months. Will the Fed continue hiking interest rates until inflation returns to its 2% target? Will it choose to look at headline inflation or base its decisions on core inflation? Either way, we do not envision an accommodating Fed anytime soon. What we do expect is a lot more volatility.

The Market:

This year's S&P 500 decline of (25%) was the 3rd worst 3-quarter start to a year since it became a 500-stock index. Of the 11 GICS (Global Industry Classification Standard) sectors, only energy is positive this year. While the Energy sector is up +53%, the laggards have been Communication Services down (38%), IT (Information Technology) down (31%) and Consumer Discretionary down (31%).

After appearing to bottom in June, the market experienced a 17% rally for a couple of months. Then, the S&P 500 fell by (9.3%) in September, which was the worse monthly performance since February 2020 (Covid-19).

Maybe we should have known September was going to be trouble. According to eToro Research (chart to the right), September has been the worst month for the S&P 500, dating back to 1950, with an average return of (0.54%). Unfortunately, October tends to be volatile too, with the epic crash of 1929 and Black Monday in 1987, both occurring in the month of Halloween. Spooky stuff!



There are some parallels between today's high inflationary environment and that experienced during the 1970's. Many are now complaining that interest rates went from roughly zero up to 4%, but the Fed (under Paul Volker) took Fed Funds from 4.6% in 1966 up to 20% in 1981. In fact, from August 1979 through April 1980, Chairman Volcker raised interest rates from roughly 11% to 17.5%. However, inflation also increased from 11.8% to 14.5%.

When inflation began to taper off, Volker made an error by slashing interest rates in the summer of 1980. This pivot was a mistake, which current Chairman Powell refuses to mimic. The Fed continues to emphasize that it does not plan on making the same mistakes of the 1970's, where it raised interest rates but then eased off to avoid a recession. It appears that the Fed is trying to avoid a decade of economic choppiness by front-loading its rate increases. They are looking to be aggressive with the Fed funds rate now, and tame inflation, so that the market can have a V-shape or at least a U-shaped recovery in 2023.

For example, the Dow Jones Industrial Average was at 983 in January 1966, which was a level it didn't exceed until October 1982. The S&P 500 peaked at 108 in November of 1968 but didn't really break out to the upside until May of 1982. Now, don't get our point wrong. We aren't looking for a 15-year bear market! We are just emphasizing that conditions are similar to today, with soaring inflation and rising interest rates.

Not everything was abysmal in the 1970's. The dividend yield for the S&P 500 was over 4%, versus today's 1.6%. Apple Computer was founded in 1976 and Home Depot started in 1978. There were great opportunities for stock pickers to identify high growth companies and benefit over the long-term. From that perspective, we view today's market in the same way, that analysts just need to do the work and find that "hidden gem" (hint: read our GPN note). All we are trying to say is that investors should be prepared to suffer through some pain, especially following a year like 2021, where the market rose by +28%. Unlike the 1970's, where many stocks were grossly overvalued at 50x earnings or even 100x earnings, we are selectively finding wonderful "bargains" today.

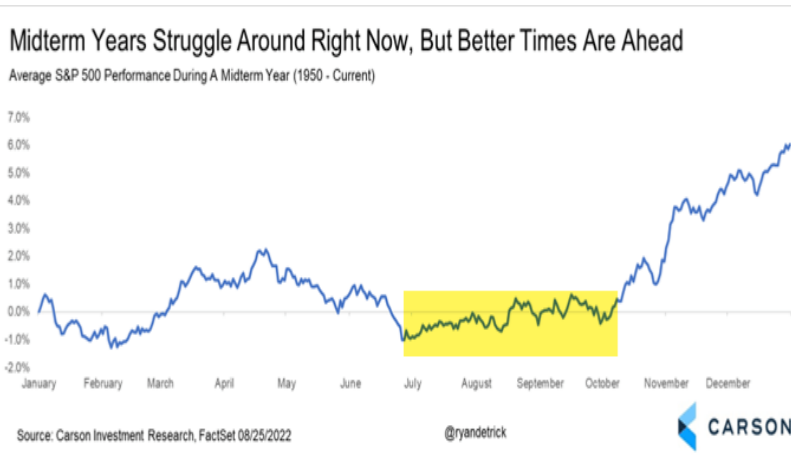
There is a fundamental flaw in the thinking that rising interest rates have to equate to a lower stock market. Higher interest rates certainly matter, but so too does business activity, consumer spending, household finances, and corporate profitability. Looking back nearly 50 years (July 1954), there have been 13 different periods of prolonged Fed Funds hikes. These have been as low as an increase of +1.8% (March 1971 to September 1971) and as high as +14.4% (January 1977 to July 1981). In 11 out of the 13 of these periods of rising Fed Funds, the S&P 500 actually increased by an average of +14%.

We know that inflation is too high, but it's almost as if nobody is recognizing that the unemployment is at only 3.5%, there is steady wage growth, household finances are in good order and corporate balance sheets have never been

healthier. As we always say...the stock market is always looking ahead and focusing on the future, not the past. The stock market will not wait for an “all clear” before moving higher. It didn’t in March of 2020, when the Covid worries were at its peak. The market will move higher well before the Fed gives us some commentary about pausing or even cutting interest rates. We know that the stock market historically rebounds well in advance of receiving 100% clarity on the issues of the day. We won’t be waiting for all of these indicators to flash “OK” because the stock market won’t either.

Mid-Term Elections:

In the one-year period following midterm elections, going all the way back to World War 2, the Dow has gained an average of +15% in post-midterm election years. Also, in each of the 5 prior instances where the S&P 500 declined by (20%) through September, the 4th quarter was positive by a median of +7.9%.



This chart from Ryan Detrick at Carson Investment Research is noteworthy. It shows that in mid-term election years, the S&P 500 tends to underperform in July through October (the yellow highlighted area) and outperform in November and December.

Another positive thought is that during mid-term election years, dating back to 1928, the S&P 500 has historically produced an average October, November, and December returns of +2.2%, +2.0%, and +1.2%, respectively. So, like Bill Murray as Carl Spackler in Caddyshack said, “So I’ve got that going for me. Which is nice.”

We chuckle at the old investing adage that says that “only monkeys pick bottoms”. Our regular readers know that the last thing we are ever going to do is market time. We will remain nimble and are prepared for an uncertain and potentially volatile 3rd quarter earnings season. Have Wall Street analysts cut their 3rd quarter, 2022 and 2023 estimates enough? Do these expectations reflect a more challenging environment or are they still modeling in steady and stair-stepped recovery scenarios? Have these analysts properly accounted for the negative impact of a very strong US dollar?

As we look forward, we believe this earning’s season will be quite interesting. We finally are seeing differentiation between winners and losers. Unlike last year, when all stocks seemed to “rise with the tide”, this year appears to be identifying and rewarding the winners and hammering the losers.

Zelle:

P2P (peer-to-peer) payments are a simple way to send or receive money, without going through a traditional bank. P2P payments have become so synonymous with simple payments that most people just say “Venmo me”. Whether you’re paying a babysitter or settling up a lost golf bet (something we know nothing about), P2P payments have become commonplace.

We have discussed the opportunity we see with PayPal’s Venmo platform ([click here](#)). We stated that PayPal’s ultimate goal was to gain physical PoS (point of sale) acceptance, with more and more consumers downloading and adopting its Venmo payment app. That is slowly occurring, but most brick & mortar merchants still don’t accept PayPal and Venmo.

We haven't written about the equivalent payment platform for the banks – Zelle. It started in late 2017, as a payment project for big banks to compete with FINTECH start-ups like PayPal's Venmo. Now, Zelle reaches roughly 80% of US checking accounts and the network claims to have 10,000-member financial institutions in its network. Zelle is a bank-owned network, essentially run by its Early Warning Services (known as EWS) group. EWS is owned and operated by Bank of America, Truist, Capital One, JP Morgan Chase, PNC Bank, US Bank and Wells Fargo and it acts as Zelle's operator and payment network provider.

During its 5 years of existence, Zelle has processed over 5 billion transactions and nearly \$1.5 trillion of dollar volume. On average, each transaction is about \$275, which is much, much higher than the typical PayPal or Venmo P2P transaction size. Many small businesses are accepting payments through Zelle, as evidenced by their +162% dollar payment growth in 2021. Consumers and businesses sent 1.8 billion payments through Zelle, up an impressive +49% YoY. Last year, Zelle did \$490 billion of transactions (up +59% YoY) which is more than 2x that was conducted on Venmo (statistics per American Banker).

The CEO of Zelle (and Early Warning Services) is Al Ko and he sees Zelle as competing with cash and check transactions, offering greater speed and immediacy of older payment methods. For Ko, he views Zelle as “digital cash” and he expects card-based payments to continue to “rule the roost.” From its inception, a key concept for Zelle's success has been this concept of trust and knowing that your bank stands behind your transactions. The early marketing campaigns centered on the safety and security of Zelle, your traditional banks way of paying for things, as compared to the “wild west” of unknown and scary online payment platforms. In one of its earliest marketing campaigns, actor and rapper Daveed Diggs says, “You can send money safely, 'cause that's what it's for, and it's backed by the banks, so you know it's secure.” This marketing angle was intentional and tried to piggyback on one of the keys to the massive growth and success of credit cards; consumers are protected from fraud. A key reason for the success of credit cards is that financial institutions act as backstops, protecting consumers from fraudulent transactions.

Recently, Bank of America was sued from fraud associated with its P2P platform and for it failing to refund consumers that were taken advantage of. It isn't just large financial institutions that are at risk, but smaller banks have also suffered from rising fraud levels. A recent study by PMNTS found that 71% of all financial institutions reported increased fraud rates and an average loss of 1.75 basis points per transaction. That same study found that 59% of financial institutions surveyed experienced an uptick in fraud, with fraud loss rates averaging 1.29 basis points per transaction. These types of losses might seem trivial, since they are reported in basis points, but one needs to understand it is happening on millions of transactions and billions of dollars of transactions.

Over the last few months, fraud on Zelle's platform has garnered some significant governmental questions. In 2021, Zelle stated that its consumer losses due to fraud were only \$440 million and that the first half of 2021 it had just 192,878 cases of fraud loss. However, The New York Times has reported that 17 million Americans in 2020 were victims of fraud on their digital wallets or P2P apps. According to Insider Intelligence, US losses from fraudulent transactions will hit over \$12 billion next year. Card-not-present payments (i.e., eCommerce and online transactions) are expected to equal \$8.75 billion in the US, up over +11.3% from last year. Clearly, fraud is an issue that needs further examination.

Now, the CFPB (Consumer Financial Protection Bureau) is looking into this issue and has stated that it will shortly issue regulations and commentary on the matter. Specifically, the CFPB asked questions about “the rise of increasingly sophisticated scams on your (Zelle's) platform and the widely documented difficulties consumers have faced in seeking relief from banks...we seek to understand the extent to which Zelle allows fraud to flourish and the steps your company is taking to increase consumer protection and help users recover lost funds.” Then, politicians from both parties lambasted Zelle for failing to protect their banking customers. At those DC hearing last month,

Senator Warren (Democrat from Massachusetts) said that she worries Zelle fraud and theft “are rampant” and that it is failing to “root out disturbing reports of a rise in fraud.” She then chastised Wells Fargo by saying that it has a “long and sordid history of misbehavior and mistreatment of its customers.” Lastly, Senator Warren then threatened the big banks and said, “the big banks (who both own and partner with Zelle) have abdicated responsibility for fraudulent transactions, leaving consumers with no way to get back their funds.” Ouch!

The American Bankers Association, Bank Policy Institute, Consumer Bankers Association, and The Clearing House issued a joint statement acknowledging that Zelle “is not free of fraud and scams” but claims the CFPB commentary and scrutiny “fail to acknowledge that 99.9% of the 5 billion transactions processed on the Zelle network (over the past five years) were sent without any report of fraud or scams.”

How Banks View Fraud:

Zelle draws a sharp distinction between the two different types of P2P fraud. The first is unauthorized transactions, where a fraudster gets into your bank account and makes a transaction. This type of fraud has been fairly rare and uncommon, but it is covered under Regulation E of the EFTA (Electronic Fund Transfer Act). The EFTA provides liability protections for unauthorized transactions, but not for authorized transactions. This essentially means that a bank is required to repay customers when funds are illegally taken out of their account - without their specific authorization.

If a victim did not authorize a transaction, then the theft is fraud; the victim can usually be reimbursed. However, it is a different story if the victim acts on instructions from a scammer. On Zelle’s website, it specifically states that “if you were tricked or persuaded into authorizing a payment for a good or service someone said they were going to provide, but they didn’t fulfill it, this would be considered a scam.” Zelle states that because you authorized that payment, you may not be able to get your money back.

The more common type of fraud are scams, cons, and deceptions. This is where the consumer authorizes a payment, but it turns out to have been a mistake or scam. The only way to protect against these fraudulent transactions is by education, information and somehow adding “smart friction points” to a transaction, that makes a user stop and think before pressing send. We receive weekly notifications from our banks about how we can avoid becoming a victim of P2P fraud, so we know this issue is painful.

We have spent decades in the payment space and find these new tricks by thieves to be devilishly ingenious and quite sophisticated. While AI (artificial intelligence) and machine learning technologies can help institutions track and combat fraud, the fraudsters always seem to be one step ahead. Want an example of this type of fraud? Well, let’s say you receive a text on your iPhone from Bank of America or your traditional bank. It claims to be protecting you from fraud and it inquires if you authorized a \$500 Zelle transaction. Since you didn’t make this authorization, you want to protect yourself from fraud and notify your bank that it isn’t legit. Next, you receive a phone call from the scammer, spoofed onto a Bank of America phone line, that walks you through the process of prohibiting this fraudulent transaction. The unsuspecting consumer receives a set of instructions that ultimately compromises their bank account information. The fraudsters have all the information they need to now withdraw funds from the individuals bank account.

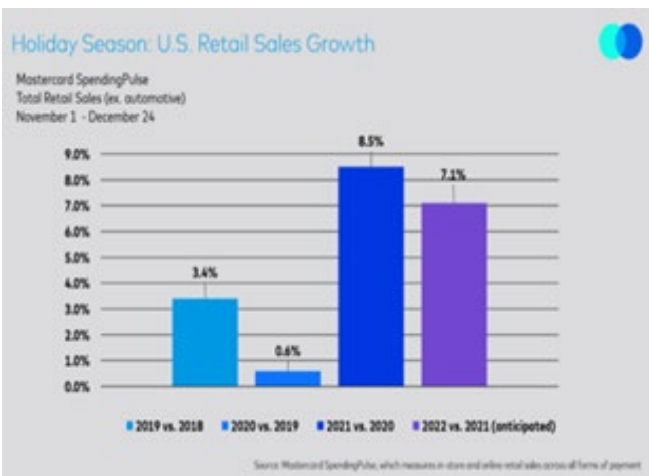
Politicians are looking to shields victims of fraudulent money transfers, even when they have been “induced” into transferring funds themselves. Banks believe they have no obligation to return money to their fleeced customers, as long as the users authenticated the transfers themselves. What happens if the liability protections are extended, and fraudsters can authorize valid transactions? How can a bank prevent its users from authorizing transfers? Is the goal to enact new and helpful legislation, or is to further regulate the big banks? If the CFPB institutes an expansion of bank liability, we imagine Zelle would scale back services, limit certain features and impose fees to cover their

additional costs. These potential changes could result in service fees for users and/or the implementation of holds on certain sized P2P payments. So much for us being able to pay out our \$20 lost golf bets on Venmo!?!?

Spending:

Some of the fundamentals and metrics we like to follow are monthly retail spending trends. Mastercard provides monthly data in their *SpendingPulse* report, and they also provide estimates for the upcoming holiday shopping season. We like these MasterCard metrics, as they capture in-store and online retail sales, across all forms of payment (not just those on MA).

Before we look ahead to the important holiday season, let's examine the last two months of spending trends. In August 2022, Mastercard SpendingPulse reported US retail sales grew +11.7% YoY and +20.4% compared to 2019. eCommerce sales in August grew +8.9% and +100.2% compared to the same period during Covid. The sectors showing strong double-digit growth were restaurants, airlines, and lodging. In September 2022, Mastercard SpendingPulse reported US retail sales accelerated sequentially and grew +11.0% YoY and +24.6% compared to 2019. eCommerce sales in September also accelerated sequentially and grew +10.7% and were +90.3% higher versus the same period during Covid. In-store sales remained strong at 11.1% YoY too. The sectors showing strong double-digit growth were electronics, as well as last month's restaurants, airlines, and lodging, while retail sectors contracting or slowing were luxury and hardware / housing related spending.



During this upcoming holiday season (which covers November 1st through December 24th), MasterCard is estimating that US retail sales will increase +7.1% YoY. Last year, US retail sales grew +8.5% YoY, as there was pandemic-induced spending and pent-up demand. Also, this was impressive growth off of a low +0.4% in 2020, which was clearly Covid-19 impacted.

Retailers are planning for certain in-store experiences, in an attempt to draw shoppers into their stores. MasterCard expects holiday doorbusters to boost traffic and drive consumers to increase spending by +7.9% YoY. eCommerce continues to grow, especially due to its convenience, and grow +4.2% YoY (up 70% pre-Covid).

Clearly, spending trends remain quite robust, despite all of the market worries. As Visa's CEO Al Kelly just said at a business conference, "the consumer still feels quite strong, and we are just not seeing these negative impacts in our numbers." Brian Moynihan, CEO of Bank of America, echoed those bullish sentiments when he said, "US consumers are in good shape and will continue to spend at an elevated clip."

Growth:

The payments industry has always been a staple of our portfolio. Why are these spending metrics so resilient, despite so many economic uncertainties? We believe it has a lot to do with the slow and steady migration away from paper cash, but also due to materially growing the card acceptance footprint. In 2012, Visa had roughly 25 million acceptance points around the world. Now, Visa has 80 million and the number exceeds 100 million, if one includes payment facilitators like Square, Adyen and Stripe. In the last decade, the number of global card acceptance points has increased by 4x. This occurs because the payment networks are leveraging technology and focusing their attention on new categories like rent, parking lots, vending machines, etc.

As we continue to highlight, global card penetration is still fairly low. While it is estimated to be at 60% to 70% in the United Kingdom, Canada, and the United States, it is only 53% in Ireland, 46% in Chile, 34% in Spain, 29% in Poland, 23% in Germany, and 21% in Mexico. Because of these factors, we are confident that we're still in the early innings of this payment secular growth tailwind.

Senator Dick Durbin:

We visited Senator Dick Durbin (Democrat, Illinois) in September 2010, just after he successfully attached his Durbin Amendment to the Dodd-Frank legislation. In fact, here's a quick picture we took of his office nameplate. Can't you tell how much iPhone cameras have improved over the last decade. My new iPhone definitely would have removed that annoying glare...



During our meeting, we were disappointed to learn that not only did Senator Durbin fail to understand the ramifications of his debit legislation, but his staff was woefully uninformed about the second derivative consequences of his un-necessary (in our opinion) amendment.

We do not believe it is the job of government to get involved in pricing of certain, well-functioning private markets (i.e., debit and credit). We feel that markets should determine price, not governments. After discussing the card industry with him and his staff, we simply do not believe Senator Durbin is necessarily looking out for everyday consumers, like he claims.

Now that Senator Durbin has introduced additional credit card legislation (last month), we wonder why he seems to hate debit and credit cards so much. Requiring credit card transactions to route to at least one network that is not Visa or Mastercard is simply foolish. To summarize this bill, if a credit card gets presented for payment at a merchant, the merchant must be allowed to route that transaction on a network that isn't both Visa and MasterCard. If one network is Visa, the other can't be Mastercard. The hope is other networks, like American Express or Discover or Pulse or Shazam will now finally be allowed to compete for this business, driving down transaction costs for all merchants.

With so many real issues facing America today, we wonder why Senator Durbin so focused on card legislation. Is he the last American that truly enjoys using cash? Does he not like getting miles, points, and rewards on his cards? Maybe it has something to do with political campaign donations he receives from large retailers in Illinois like Walgreens and McDonald's? Have any of these merchants asked Senator Durbin to assist in lowering their MDR's (merchant discount rates)? We don't have the desire or ability to investigate why Senator Durbin hates the card networks so much, but we are prepared to discuss how his rules are impacting the payment industry.

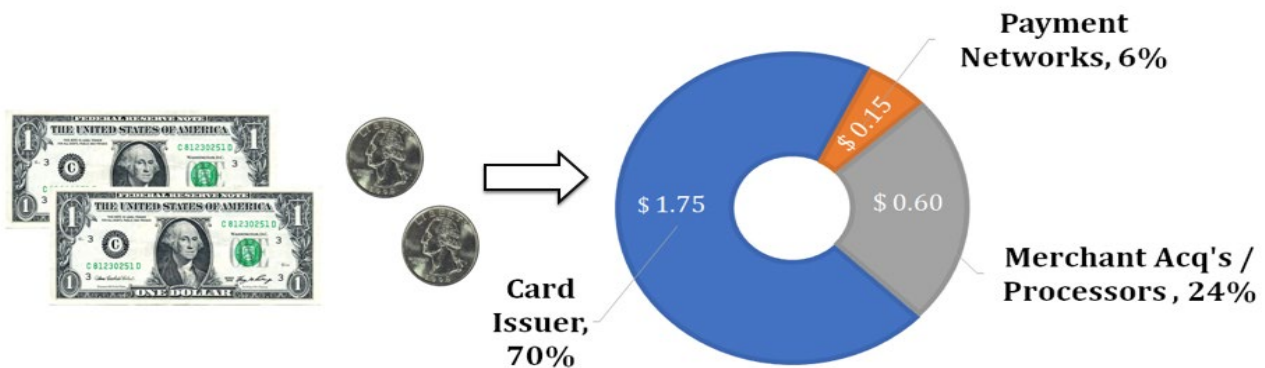
Just like he did in the much larger Dodd-Frank legislation (following the Financial Crisis), Senator Durbin is attempting to attach these credit card rules to the pending National Defense Authorization Act, a must-pass legislation. Do you want a stat that truly highlights what's wrong in Washington? Other senators offered up 900 various amendments, nothing to do with our defense, to this must pass defense bill. It appears that Senator Durbin's first attempt to attach his amendment failed (mid-October), but we are sure he'll try this again in mid-November, when the NDAA bill gets voted on again. Senator Durbin continues to work the DC system after being a Washington insider for nearly four decades of public service. Senator Durbin's desire to require merchants to have at least two, unrelated networks for credit card transactions has nothing to do with our national defense, but neither did his debit card rules (inside of Dodd-Frank legislation) have anything to do with the Financial Crisis.

Payment Economics:

Let's take a quick step back, to help frame this specific issue. Credit card interchange rates are set by the payment networks (Visa, MasterCard and American Express) and are then re-priced by merchant acquirers and payment processors, at a slight mark-up to merchants. This all-in cost to transact is called the MDR (merchant discount rate).

The interchange rates range from a low of 1.3% (grocery stores or gas stations) all the way up to 2.9% (pornography, tobacco, alcohol, etc.) of the sale. This wide range is dependent upon the network used, the type of merchant, the size of the transaction and a whole host of other factors. We created this pie chart to display how these fees get re-distributed to each party, so one can easily understand the economics of a typical \$100 credit card transaction. As you can see, the vast majority of the economics go to the card issuers and banks, for taking the vast majority of the risk while the smallest component of these fees goes towards the payment networks.

- Generates ~\$2.50 in fees



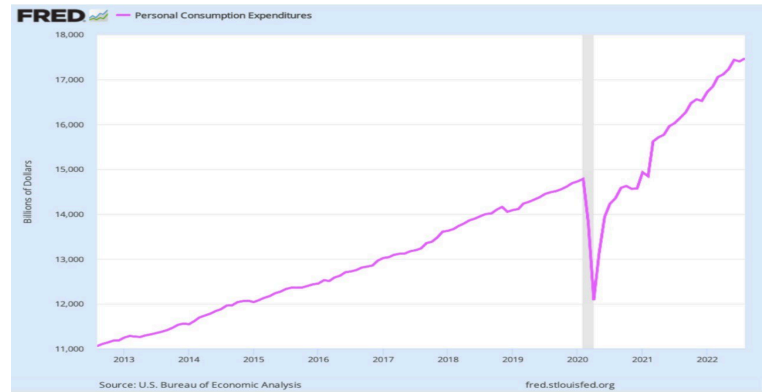
Senator Durbin's goal is to reduce credit card processing costs for big merchants, like Walgreens. Yet, large merchants (like Walgreens, Wal-Mart, Amazon, and Target) already have a built-in advantage versus smaller "mom and pop" stores; they pay a lower interchange rate than small businesses because they do significantly more transaction and generate much higher dollar volumes.

Does Senator Durbin not understand that Visa and MasterCard are arch enemies and compete everyday against each other for banking relationships? He acts like they are the same company, a monopoly and still owned by their founding member banks. This is clearly not the case, as MasterCard went public in 2006 and Visa in 2008. These two payment networks fight to get their logo (called a "bug") on every card issuer's piece of plastic or inside their digital wallet. Just because they help set interchange rates (across verticals, segments, merchant codes, etc.), Senator Durbin acts like there's a secret hotline between Mastercard (in Purchase, New York) and Visa (in San Francisco, California) to control the entire payment industry.

If this legislation passes, the card issuers will respond by dramatically cutting available credit. Unfortunately, this will impact the lowest part of our society, who has to rely on that line of credit to survive. Not only will this legislation impact the lower-to-middle class, but it will also alter the dynamic that successfully exists in the card industry. By forcing change onto this industry, the end result will be lowering lines of credit to the lower-to-middle class. If banks do not see that segment as attractive (with these pricing restrictions), they will simply back away from that sector of the market. Not only will this impact those consumers, but merchants will also be impacted. This is the dynamic that Senator Durbin does not seem to fully grasp.

You should also expect all of your miles, points, loyalty rewards to get materially lowered and even potentially cancelled. Why should a credit card company offer you benefits for selecting their card in your wallet, if the economics of offering you that line of credit have been governmentally price capped? If you recall, there used to be rewards tied to debit cards a decade ago, but they were eliminated. If Senator Durbin's legislation passes, it ultimately could end the rewards and loyalty programs of the credit card industry. If you don't believe us, just look at the Australian market and what happened there.

Nobody should forget that consumer spending accounts for about 2/3rd's of US economic activity. Just look at this US Bureau of Economic Analysis slide of PCE (Personal Consumption Expenditures). It clearly displays how PCE has been one of the key growth components of our economy. Thank goodness that Americans love to shop and spend their hard-earned money. Legislation like Senator Durbin's has the potential to impact consumer spending and our entire consumer-based economy.



There are tens of thousands of transactions every Friday evening at grocery stores, that would get declined, if debit cards were used. These transactions get approved only because a bank and issuer are offering credit to that consumer. Unfortunately, there are too many American families that don't have enough in their bank account (on a Friday night before a payroll check clears) to pay for food for the weekend or next week. Without banks offering lines of credit, these transactions simply wouldn't occur. Certain merchants understand this dynamic and appreciate the role that credit plays in everyday payments.

Another flaw in this legislation is the fallacy that merchants will pass these processing savings to their customers. It didn't happen after debit legislation a decade ago and it won't happen now. Merchants will never pass along those savings and instead will simply choose to pocket this governmental bonus as profit. Merchant acquirers and payment processors will also not pass along these savings to most small businesses. We believe that Senator Durbin is trying to enact legislation to benefit one of his largest constituents, without understanding all of the negative ramifications of his actions (yet again).

Before you feel too badly for Visa and MasterCard, one should understand that they have the EPC (Electronic Payments Coalition) and many other industry insiders and lobbyists on their side. The Chairman of the EPC is Jeff Tassey and he recently said, "This legislation would again boost retailers' bottom lines at the expense of American consumers — stripping them of their credit card rewards and usurping their choice of network while leading to a less secure, less innovative, and weaker financial system." The EPC also argues that this legislation will make transactions less secure and Tassey said "When [the] government comes in and puts hands on one side of the customer scale, like they did in the Durbin amendment [for debit networks], you have all kinds of unintended consequences."

This issue pits two very powerful lobbying groups against each other – large banks vs retailers. Will this wreak havoc on a perfectly functioning payment ecosystem? Our payment platforms handle billions of transactions and trillions of dollars in mere seconds. This back-door price control has the potential to upset the delicate balance between all of the interactions of US cardholders, merchants, acquirors, processors, and card issuers. We will continue to closely monitor Senator Durbin's tactics and hope his legislation doesn't get inserted into [legislation at midnight](#), like he did back in 2010.

Delinquencies Ultimately Matter:

As we just mentioned, spending trends remain quite healthy. One of the reasons we don't like to invest in the card issuing sector is that they are the entities that take the most risk in the payment ecosystem. As our earlier pie chart shows, card issuers earn roughly 70% of the MDR, but they are taking the most risk in each transaction. Making matters worse, there is no collateral to these lines of credit, unlike a house or car that could be foreclosed upon or re-possessed. In addition, they are enticing customers with loyalty and rewards programs, that ultimately have significant costs.

While our payment networks, merchant acquirers and payment processors do not have the same level of credit risk, we like to monitor credit delinquency trends. We analyze monthly master trust loan data to get an understanding of how consumers are spending and if they are paying back those charges. Firms like American Express, Bank of America, Citigroup, Discover, JP Morgan, Synchrony all publish monthly data on payment rates, excess spreads, cash flow and delinquencies. As consumers fail to make minimum payments, balances can balloon higher, especially when one considers that the average (according to Bankrate) US credit card interest rate is 17.96%. This is the highest interest rate on record since 1996. Analysts can track 30-day, 60-day and then 90-day delinquency rates, which unfortunately then leads to card issuers writing-off accounts at a loss.

What are recent delinquency trends? American Express has a higher-end customer and its delinquency rates are quite low at 0.8% (August 2022). Discover typically runs in the middle-of-the-pack and has a delinquency rate in August of 1.96%. This was higher by 57 basis points YoY or an increase of 40%. Both JP Morgan and Bank of America just released 3rd quarter results and reported healthy consumer spending trends and below Covid levels of delinquencies.

In addition to the monthly master trust data, Transunion provides an annual update each year on card delinquency rates. Transunion estimates there were about 500 million bank-issued credit cards in circulation this summer, up +7.5% YoY. That was a larger than expected increase in credit cards in circulation, as some card issuers seemed to be aggressively granting lines of credit to American consumers. On those half a billion credit cards, Transunion states the delinquency rates averaged 1.57% with an average balance per consumer of \$5,270.

While these are still below Covid levels, both metrics showed a noticeable increase versus last year. Many of these card issuers are working with consumers that are facing economic uncertainty and are providing some with financial assistance. Unfortunately, more and more consumers are experiencing stress, leading to higher delinquencies and loss rates for issuers. Speaking of credit losses, we will now discuss the "most successful" new credit card launched in the industry over the last couple of years.

The Apple / Goldman Sachs / MasterCard:

Back in 2019, Goldman Sachs made a splash in the card industry by working with Apple and MasterCard on a credit card. The actual card is fairly sleek (as you can see below), as customers names are etched into an Apple titanium card. The no-fee card generated a lot of hype, as many early users were quick to post their latest card on various social media sites.

The initial goal of Marcus (back in 2016) was to leverage Goldman's wonderful name brand and build a full-service digital bank. This card was a large piece of GS's ambitions to grow its retail banking franchise called Marcus. After 5 years, Marcus now has 14 million customers and \$16 billion in loan balances. Surprisingly, Marcus now represents nearly 20% of the firm's total revenue.

We thought it would be interesting to look how the Apple Card is doing in terms of loans and exposures. With over \$100 billion in assets, this has been a successful source of cheap deposits for GS. Despite having an institutional / “white shoe” brand in the investment banking and trading world, GS’s Apple Card has been a disappointment.

The original plan was to roll-out checking accounts to the masses, but this hasn’t been the windfall that some executives projected. After rolling out its simple checking accounts, Marcus wanted to then offer easy-to-use consumer lending products. This was the initial thesis GS likely had with its Apple Card. With the disappointing results in this card partnership, GS management must now be viewing this as a questionable move.

It has been widely written that GS’s consumer division is on track to lose \$1.2 billion this year, and it will likely have to set aside more in reserves to cover future loan losses. A recent Bloomberg article (on Marcus) stated that cumulative losses for Marcus exceed \$4 billion and that’s before one accounts for the \$2.2 billion deal for GreenSky (loan provider) last year. This division has encountered significant management turnover, costly overruns, and missed most of its internal profitability targets. Inside of GS, there are divisions and legions of employees that question why the company took this questionable tact. David Solomon, GS’s CEO, has steadfastly supported Marcus, but many institutional shareholders are disappointed that he continues to throw more money at this struggling entity.

How do GS’s results compare to some other card issuers? Competitors like Bank of America are enjoying record high repayment rates, while GS’s loss rate on credit card loans hit 2.93% in the second quarter. This is one of the highest levels of delinquencies of any of the major US card issuers. American Express indicated that its trends “remain strong”, especially in the SMB and premium consumer segments. Discover cited strong consumer spending and healthy credit quality. With GS ranking at the bottom of the card issuer table, one has to wonder if it is second guessing whether or not its retail ambitions in 2016 were misguided.

The early results have not been positive, largely because of selecting and granting the wrong customers with lines of credit. Roughly a quarter of its customers (and those lines of credit) went to customers with FICO scores less than 660 (defined as “fair to poor”). While we are not a believer that FICO scores are the only credit metric to monitor, it does pay to understand how certain card issuers are bypassing understanding the risks of adding new accounts. The whole purpose of a credit score is to risk rank your consumers. One can use the score at the initial acquisition of an account, or you can measure it through the entire credit cycle. We believe it is better to constantly monitor this information, but that is often viewed as overkill and un-necessary (like a belt and suspenders approach). Did GS properly assess the risk in its initial Apple Card underwriting?

When the credit cycle turns (and it always eventually does), adding some of those higher risk accounts could prove costly. Adding new accounts requires that credit card issuers calibrate their loan approval models to the underlying risk. Did GS take on lower quality clients to appease their new partner – Apple? Were these some of the conditions that GS had to agree to, that others like JP Morgan felt were too onerous? We weren’t a party to those behind-the-scenes negotiations, but we’d be surprised if Apple didn’t look for and ask for credit waivers.

These are unfortunately the decisions that become quite costly, as these are the first customers to turn delinquent in an economic downturn. The Federal Reserve Bank of New York does a survey about the mean probability of consumers being able to make their minimum debt payments. Unfortunately, this survey found that 12.2% of consumers will not be able to make their minimum debt payments (up from 10.8% last month).

We don’t point out these Marcus flaws to act as a bearish note on GS. We are simply trying to get across a couple of key investment themes. One is “stick to your knitting”. In our opinion, GS has a wonderful brand and is known around the world as one of the best institutional broker dealers. It dominates investment banking, advisory work, and

trading. Why did it need to branch out into checking accounts and card issuing? This endeavor hasn't helped GS's valuation, as it is now trading below book value.

The second point we are making is truly understanding the business you are in. When it comes to advisory work or banking or trading, GS serves its clients and acts as a valuable partner. Helping clients solve their financial issues is exactly what GS has done for decades, and what they should be doing for years to come. How does offering a \$2,000 line of credit to a Gen-Z student build on GS's brand? Maybe that consumer becomes a customer of GS's in 10 or 15 years, but we're not sure this venture was true to its culture and long-term aspirations. The card issuing business comes with tremendous balance sheet risk and further exposes GS to cyclical businesses. We simply believe it was a business venture that didn't need to occur and should be viewed as a mistake.

Looking back a few years, GS certainly was enamored with the idea of launching a FINTECH business. With its strong presence in Silicon Valley, many GS executives thought it would be simple to migrate from an institutional and corporate business, to one that could dominate an average US consumer franchise. Is launching a new high-yield savings account truly novel and inspirational? After 5 years, maybe GS management will re-assess whether or not Marcus and its "world's greatest" consumer checking account fits into its long-term business plans.

We strive to never get "married to an idea" or be too stubborn to admit when we are wrong. One of the legends of investing is Charlie Munger, the 98-yr old sidekick of Warren Buffett. We agree with Mr. Munger who said "We all are learning, modifying, or destroying ideas all the time. Rapid destruction of your ideas when the time is right is one of the most valuable qualities you can acquire. You must force yourself to consider arguments on the other side."

Conclusion:

We recently saw a research note that perfectly summarized the negative sentiment existing in today's market. This note used the jobs report and inflation readings interchangeably:

- If the **jobs report** beats expectations, the S&P 500 will decline because more rate hikes are coming
- If the **jobs report** misses expectations, the S&P 500 will decline since we must be in a recession
- If the **jobs report** meets expectations, the S&P 500 will decline because the Fed will stay hawkish

We hope you enjoyed your summer and are getting a chance to experience some fall weather. The leaves in Florida don't ever change, so we're jealous of those that get to see those bright and vibrant colors. While I'm sure it isn't fun to rake up all these leaves, they sure do look nice.

We look forward to speaking with you soon.



Warren Fisher, CFA
Founder and CEO
Manole Capital Management

Cliff Clavin Fun Facts:

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

According to Dealogic, roughly 90% of companies that went public in the US last year are trading below their offering prices. On average, these newly public companies are down more than (50%).

On August 29, 2001, Albert Pujols hit a home run and Serena Williams won a match at the US Open. 21 years later, on August 29, 2022, Albert Pujols hit a home run and Serena Williams won a match at the US Open. Aren't athletes supposed to get worse with age? Don't tell Tom Brady...

When the war started in late February 2022, there were hundreds of economic sanctions levied against Russia. We find it interesting that a year ago, Russia's average monthly oil sales into Europe was \$14.6 billion. This year, Russia has been generating \$20 billion in monthly oil sales to Europe or an increase of +37%. What happened to those damaging sanctions and threats to economically hurt Russia for its invasion of Ukraine?

Beyond Meat just had to suspend its COO, Doug Ramsey, after he was arrested and charged with 3rd degree battery / assault. Ramsey (allegedly) got into an argument at an Arkansas Razorback college football game and bit a man's nose. We enjoy college football tailgating but didn't think noses were on the menu. You can't make this type of news up, right?

The White House issued a climate report on crypto that illustrated some interesting environmental metrics. The White House found that running computers for mining operations consumes up to 1.7% of the US's electricity. In addition, it found that crypto related activity equates to 0.8% of US based greenhouse gas emissions. None of these seem compatible with the administration's goals of cutting emissions by 50% by 2030.

Bank of New York Mellon is our nation's oldest bank, but it is trying to stay on the forefront of the crypto business. In October, Bank of New York announced it will begin to accept clients crypto and act as a digital asset safeguard. In order to act as a custodian, Bank of New York needed to get approval from New York's financial regulator. Good for them, moving from safeguarding stocks, bonds, commodities to now handling crypto security. It might have a learning curve, but at least Bank of New York is focusing on their core mission (custody), and they aren't ignoring new trends and products.

Ahoy, mateys! September 19th was ***International Talk Like a Pirate Day***. Feel free to substitute "me" for "I" when saying something like "Me-thinks these 3rd quarter estimates are a little aggressive". Also, make sure to weave "arrrrghh" or an occasional "aye" when speaking.

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