Manole
Capital Management

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4th Quarter 2017 Newsletter

October 2017

Initial Thoughts:

Hurricanes Harvey and Irma created enormous damage in the Caribbean, Texas and Florida. Houston is the fourth largest city in America and images of its flooded streets were shocking. Then, Hurricane Maria crushed Puerto Rico, leaving the entire island without power for potentially months to come. According to data published in the Annals of the American Association of Geographers, 1 in 12 Americans now live in a home that can expect a 1% chance of flooding in any given year. America's population continues to shift towards its coasts, now capturing 39% of our population. Approximately 15% of Manhattan and 40% of Miami are in flood-risk zones. Following Irma, two-thirds of Florida's 10.5 million homes were without electrical power. In addition, many small Caribbean countries have been devastated by these storms and the impact will be felt for years, possibly decades, to come. In Tampa, we consider ourselves lucky to have escaped relatively unscathed. Our thoughts continue to go out to the millions affected by these natural disasters.

Our Newsletter Focus:

In our newsletters, we attempt to highlight bigger picture issues and macro themes. In this note, we will address DC politics, the Federal Reserve's balance sheet plans, recent earnings results, interest rate expectations, as well as overall market valuation. As always, we try to avoid controversial social concerns, instead attempting to frame how global issues can impact our economy and the stock market. Over the last 2 to 3 months, we have written numerous pieces of research on specific stocks, as well as various secular forces that are driving our portfolio higher. If you would like to view or read these proprietary notes, please visit our website at www.manolecapital.com and click on the "Research" tab.

"Shrugging Off " Politics:

The list of potential worries facing the market seems endless. For example, our federal government narrowly avoided shutting down in September because it failed to put together a budget. The temporary solution was to simply "kick the can" into December. Without raising the debt ceiling, the US could theoretically default on its debt obligations, which would throw the global economy into a frenzy. President Trump is re-negotiating NAFTA and threatening to rip-up deals with some of our largest trading partners - Mexico and Canada. North Korea is firing rockets over Japan and making nuclear threats towards South Korea and Guam. The investigation into Russian interference into our political process continues, as does the political chaos in Venezuela and Brazil. We have experienced devastating natural disasters, impacting millions of citizens, which will take years to recover from. Throw in continuous debate on how to handle the healthcare system and one would never expect that the US stock market would be hitting all-time record highs. At time of writing, the S&P 500 has delivered a year-to-date total return of 14%.

Geopolitical events and wars are a different type of risk to the markets, because they are unpredictable. Nuclear war is an unthinkable risk investors hope and assume will never happen. Yet, North Korea recently threatened not only a nuclear attack on the US, but also hinted at an electrical grid attack using electromagnetic pulses to damage our entire infrastructure. How could one possibly plan for that? This is why businesses and the markets essentially overlook the unimaginable. Since businesses cannot fathom this event and risk, it only prices in current economic conditions and those that determine business decisions.

Social issues like immigration or protectionist trade barriers continue to be market worries, but they are not likely to cause an immediate slowdown of our economy. The US economic machine, with a GDP of $18.5 trillion, continues to churn out steady, albeit unspectacular 2% annual growth. Global warming and population growth are certainly fueling massive storms (hurricanes, tornados and earthquakes), but even this type of historic damage isn't stopping our powerful economy. In fact, one could argue that these types of events might lead to incremental growth through re-building, and potentially pave the way for a large infrastructure bill. A recent JP Morgan study observed that even devastating natural disasters cannot thwart our stock market rally. The study found that the S&P 500 falls roughly 2% when a hurricane makes its landfall, impacting certain sectors like insurance, hotels and cruise lines the most. However, other sectors like energy, basic materials and industrial equipment tend to benefit during the future re-construction.

Why We are Bullish:

We are constantly asked our opinion on the stock market and why it continues to chug along despite the list of worries mentioned above. We are not attempting to dismiss any of these global issues or political risks, but we will attempt to frame the risk. Political risk, especially in a polarized Washington DC, has always existed and will always be an unknown. In today's climate, most investors are building this risk into their framework and have come to expect little, if anything, to positively emanate from our government. Whether you're watching CNBC or Bloomberg or reading the Wall Street Journal or Barron's, you're constantly faced with bearish psychology and dire predictions. Many market "experts" continue to call for a large sell-off or expect another meltdown similar to the financial crisis of 2008. To us, this seems like the least-liked bull market that we can remember. Forgive us for having a favorable bias, but we remain positive on the economy and expect the market to trend higher.

Market economies are driven by the rhythm of our business cycle. Looking at today's environment, one could make a bullish case for equities fairly easily. Growth, while not terribly robust, has been steady and predictable. Businesses are posting solid earnings growth and balance sheets have rarely been in better financial shape. Unemployment is low, inflation is tame and many are hoping that positive business and personal tax reform will occur over the next few months. While political risk is a key component to "the new normal" and is an item we closely monitor, it continues to take a slow toll on the economy, and we do not believe it will bring an end to this lengthy market expansion. Government shutdowns, political scandals, trade wars and even traditional wars have happened before and will happen again. While every new situation presents a different set of unique problems, most of these issues can be quantifiable to businesses, consumers and investors. And so, we remain positive.

Quantitative Easing or QE:

Following the financial crisis, the Fed took a series of stimulus steps to help stabilize our economy. The Fed is on the cusp of reversing the most ambitious monetary program in world history. Its QE or quantitative easing bond buying program began in September of 2008, essentially 9 years ago with the collapse of Lehman Brothers. After taking over Fannie Mae and Freddie Mac, the Fed decided to spur economic growth and support the housing market by buying hundreds of billions of dollars of mortgage-backed securities. After deciding it needed to continue to stimulate and support economic growth, the Fed launched two additional bond-buying rounds to lower long-term interest rates.

Many critics warned of the negative and inflationary impact of QE, but this currency debasement has not materialized. As the Fed purchased its bonds, it essentially pushed investors into riskier assets like equities, corporate bonds and real estate. There is little doubt that the Fed's decade-long fiscal intervention has helped push asset prices higher, essentially lowered interest rates to zero, freed up cash for spending and helped millions of Americans re-finance their mortgages. Companies have benefited as well, from lower interest expenses and modest capital costs. With the labor market now sitting at a 16-year low, one could even argue this program benefited Main Street too.

What makes QE so interesting is that there is still vast uncertainty about whether or not it has been successful. The basic thesis was that it was intended to make bond yields go down, equities go up and the US dollar get cheaper. The three iterations of QE (between November 2008 and October 2014) each generated sizeable market gains, with a cumulative market lift of about 140%. From March 9th, 2009 through September 15th of this year, the S&P 500 is up over 340%. However, the other intended results of QE are more mixed. Looking at the entire QE period, bond yields actually went up, not down. In late 2010, with the ending of QE1, interest rates dropped significantly. With the end of QE2, towards the middle part of 2011, volatility spiked as the 10-year Treasury fell dramatically below 2%. In late 2013, the Fed said it would phase out and "taper" its bond purchase program. By allowing maturing debt proceeds to get reinvested, the Fed was attempting to take-away some of its monetary stimulus. The market ultimately had a "taper tantrum" that summer. Volatility spiked and the 10-year Treasury almost doubled to 3% by year-end.

"The Great Unwinding":

Now that we are in a more "normal environment", the Fed is beginning to raise rates and unwind its massive $4.5 trillion balance sheet. For perspective, back in 2008, the Fed's balance sheet was only $900 billion or roughly 6% of GDP. As it starts its balance sheet reduction program, the Fed's assets are nearly 24% of US GDP. The Fed hopes this process plays out quietly and is as "exciting as paint drying" according to Philadelphia Fed President Patrick Harker.

At its September 2017 meeting, the Fed announced a number of steps it intends to take for the reduction of its balance sheet. Under its well-articulated and thoroughly-signaled plans, the Fed will not directly sell its assets, but will allow a portion of the proceeds it receives each month to "run-off". The Fed will start at $10 billion per month and allow it to orderly increase, until it

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reaches $50 billion. Most expect the Fed to offload all of its mortgage securities first, but even at its maximum cap, it will take 8 years to unload these holdings. How much Treasuries the Fed decides to keep is less certain, as there is no specific balance sheet size target. Many economists expect it to ultimately be in the range of $2-3 trillion. While the market has known about this plan for months, this is the first time the Fed has ever attempted to do this. Many investors are taking this Fed action as a sign that the overall economy is on solid ground and that it can grow without persistent and further monetary support. Some worry that any mistake by our central bank, like removing stimulus too quickly, will upend years of steady growth, improvement and economic expansion.

Fed Chairwoman Yellen expects her balance sheet operation to "carry minimal market impact". On our part, we have doubts that this will be uneventful. We are modeling out various scenarios, expecting the unexpected, and we are positioned to benefit if the environment becomes more volatile. While we hope this process runs smoothly, we won't be surprised if there is unanticipated turmoil. We are certainly aware of the Fed's intentions and plans, but there's no prior textbook to analyze for the historic unwinding of this type of monetary policy. What are some of the potential outcomes? Our economy continues to be fueled by consumer spending, and that spending is driven and dependent upon consumer debt. Everything in our economy, from homes to autos to consumer discretionary items, are financed with debt. If interest rates and borrowing costs increase, many worry that this will curb our economic expansion.

In addition, the Fed owns 29% of the entire mortgage bond market, as well as 17% of all US Treasuries. While Treasuries mature on a specific date, mortgage debt can vary widely and depends on how many Americans move or decide to re-finance their mortgages (which in turn largely depends on interest rates). If it is successful in winding down its balance sheet, the Fed will quietly close this large fiscal experiment without much fanfare. Market forces will pick up the purchasing slack and other central banks will have a blueprint to follow to exit these unconventional policies. The European Central Bank or ECB will consider winding down its asset purchases in early 2018, now that its stimulus is driving robust economic growth across Europe. However, any missteps along the road could become a global hiccup to remember. Jaime Dimon, JP Morgan's CEO, was recently quoted as saying: "The Fed unwind could be a little more disruptive than people think." PIMCO, one of the world's largest fixed income asset managers, recently described this unwind as "attempting to lose weight by only eating 2 desserts a day instead of three".

The Federal Reserve:

The Fed will undergo massive change over the next year or so. The Fed is supposed to be non-political and it remains the world's most powerful financial entity. Its policies help to determine everything from the health of the American economy to the price of credit in various emerging markets. In addition to having Chairwoman Janet Yellen's term expire in February of 2018, legendary technocrat and Vice Chairman Stanley Fischer recently retired.

Every president since Reagan has asked the incumbent Fed leader to stay at their job at the start of his presidency. Would you be surprised if Trump decided to depart from traditional, prior norms? If President Trump does not re-appoint Yellen, there will be four vacancies among the twelve seats on the Fed's interest-rate setting committee. If not re-appointed, Yellen would be the 3rd Fed chair, since 1934, to only serve one term. With his tax reform policies pushing a pro-economic agenda, President Trump will look to the Fed for strong economic leadership.

Following recent Fed speeches, we get a sense that the Fed is somewhat confused about its path forward. At the recent National Association for Business Economics conference, Chairwoman Yellen said the Fed's understanding of inflation is "imperfect" and that it "remains a mystery". Yellen's background is in academia, not business. It is only natural for her to question policies and their intended and un-intended consequences. She has been publicly grappling with subdued inflation, despite a growing economy and strong labor market. This type of uncertainty, however honest, does not seem to be a trait President Trump would feel comfortable with. We can only surmise, but we believe President Trump will look for an individual to lead the Fed that is aggressive, business-like and charismatic. We envision President Trump will seek to put his own people in charge and who he stacks the Fed with will be critical to watch. No recent President has had the wide latitude to re-shape the Fed, and inadvertently the US's balance sheet, as much as President Trump.

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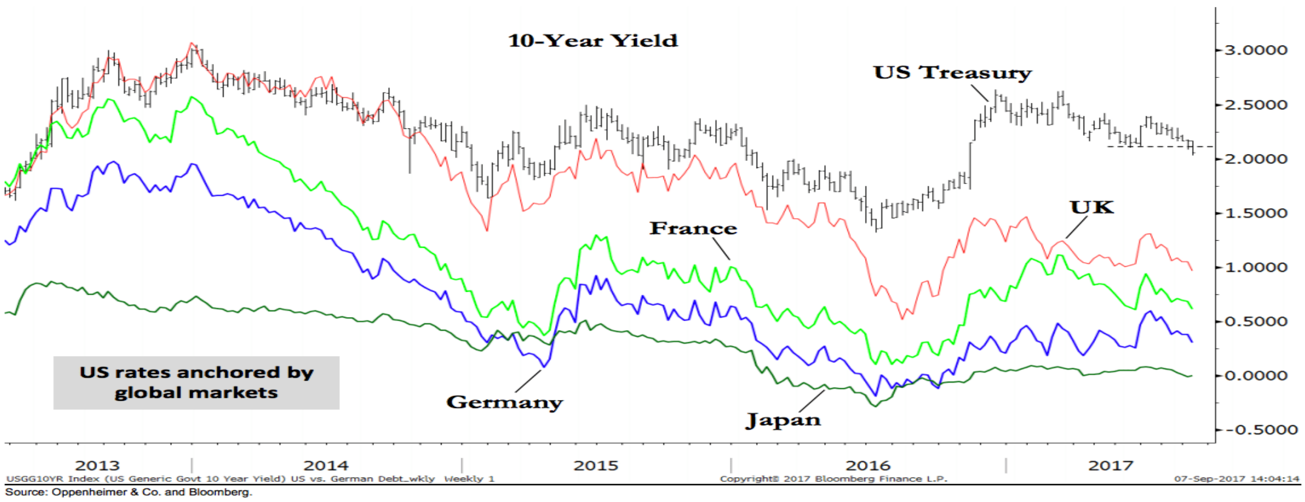
Interest Rates:

Loyal readers know that our favorite location for gauging interest rate expectations is the CME's Fed Watchtool, located here. At time of this writing, the market now expects a 72% chance that the Fed will raise Fed funds by 25 basis points in December of 2017 (to a range of 1.25% to 1.50%). Before the Fed's September meeting, there was only a 50% chance of an increase. Going back a few months, only one-third of the market was anticipating higher rates. Using the Fed's dot plots, 12 of 16 central bank officials expect to see three interest rate increases in 2018. While this would be quite positive for our financial holdings, we do not expect this to occur.

First of all, the make-up of the Fed will be significantly different (see Federal Reserve commentary above). Also, as evidenced by the chart below of 10-year yields, we do not envision the US being the lone major central bank willing to normalize its interest rates.



The Fed adheres to 2 main tenets or standards in setting interest rates. The first is full-employment, which at 4.4% is clearly being met. The second is price stability, which is measured through targeting a 2% inflation rate. While US growth has been solid, it has not led to a wildly inflationary environment. Macroeconomists remain unsure how removing this monetary stimulus will impact our economy and whether or not keeping rates low has artificially spurred growth. No Fed officials, especially a new chairman would want to be blamed for "removing the punch bowl" too early. In addition to its two key factors, the Fed has been known to allow non-economic factors to influence its interest rate decisions. With the terrible hurricanes impacting Texas, Florida and Puerto Rico, we would not be surprised if the Fed chooses to pause on its rate tightening after December. The Fed faces a very difficult trade-off. If it does not raise rates with historically low unemployment and solid financial conditions, it runs the risk of having to act quickly and in a reactionary manner to future events.

Some believe, with strong equity and debt markets, that now is an ideal time to raise interest rates and lower the balance sheet. We still believe the trend is for higher rates, not lower. Quite simply, we envision more patience out of the Fed. This type of volatility and uncertainty is wonderful for driving interest rate trades onto the derivative exchanges we own. If rates rise, we believe our portfolio is well positioned to outperform. In the event the market is wrong and interest rates do not climb significantly higher in 2018, this volatility will drive revenue and earnings growth for the exchanges. That's our kind of win-win scenario.

Every recession over the past 50 years has been preceded by an inversion of the yield curve. In the US, the flattening of the yield curve worries many, as short-term rates rise and long-term rates stay constant. According to research by the WSJ's James Mackintosh, the US yield-curve is as flat as it was back in March of 2005, February 1996 or July 1988. What is interesting about these periods of time versus today's environment? Despite also having a flattish yield curve, the S&P 500 gained at least 20% over the following two years.

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The Economic Cycle:

Are we in the early stages of economic growth? We would argue "no". We believe the US economy is in the late stages of its business cycle. If we are correct, there should be another 1 to 2 years of growth (and returns) for US equities. Does it worry us that we are in the 100th month of our current expansion, which is the second longest on record? Yes, but the overall environment remains solid. Since the Fed began to raise interest rates in December of 2015, job growth has been a healthy 185,000 per month. This furthers our belief that markets are in control, as monetary policy cannot create jobs; jobs are dependent upon capital, entrepreneurs and sound governmental policies. The current economic recovery has been one of the slowest in recent times and conservative investors and retirees continue to get close to zero interest on their savings.

Normalizing interest rates should not be the worry that many make it out to be. As long as our economy and employment continue to improve, we would not panic when the Fed slowly raises interest rates. In fact, higher rates would indicate continued economic expansion and growth. Even after raising Fed Funds again, we would not foresee that environment as detrimental. We agree with recent comments from James Grant, legendary editor of Grant's Interest Rate Observer. He believes that the Fed's policies have led to distortive effects and influenced higher valuation in other asset classes. In Grant's opinion, the Fed is "blowing a bubble" and it is "long overdue for a normalization of Fed policy." Spinning this narrative once again as a positive, higher rates would allow our Fed to maneuver and potentially lower rates in the event of a future economic slowdown.

Earnings and Valuation:

Over 98% of companies have reported their 2nd quarter 2017 results. According to Zacks Research, revenue grew 5.3% and earnings expanded by 9.4%. With 77% of S&P 500 companies exceeding earnings targets, these mostly positive results continued a recent trend (following 2 years of sub-par growth). However, fewer than half of companies experienced any price increase in the trading day following 2nd quarter earnings and fewer than one-third recorded a gain of 1% or more. Investors seem less impressed with upside surprises.

In our opinion, the market is slowly catching up to what we refer to as "the low expectations game". Companies issue guidance for revenue and earnings growth, which they feel confident is a low hurdle to exceed. Sell-side analysts follow suit and accept these easy-to-beat forecasts which become consensus expectations. Companies then "beat and raise" and get rewarded with higher valuations and improving stock prices. This well-choreographed "game" isn't new, but the response in the 2nd quarter seemed somewhat different to us. It used to be that surprises to the upside were rewarded handsomely. After an initial move higher, those companies beating earnings delivered only 0.3% of relative outperformance over the next 3 trading days (per recent Morgan Stanley study). It seems like this game is losing some of its luster. Now, beat and raising estimates seems to be almost expected by investors. Considering that valuations are higher, this is not terribly surprising. Are investors getting somewhat spoiled? One conclusion could be that the reward for beating on revenue and earnings is now expected, but the penalty for a miss will continue to be painful.

The 3rd quarter of 2017 has ended and companies will shortly begin to report results. The biggest winner last quarter was energy, with diesel up 22% and gasoline up 7%. The S&P 500 technology sector led the overall market with an impressive 8.3% rise. Financial stocks were whipsawed last quarter, but continue to closely track bond yields and were up 4.8%. Out of the S&P 500's eleven sectors, only consumer staples declined, down 2%. The overall S&P 500 continued to move higher, with the index rising 4%. Commodities were particularly volatile with orange juice up 14%, while corn was down 4% and wheat was down 12%. Over the next few months, we anticipate earnings to become the major market focus. The S&P 500 expected to grow revenue and profits by only 5% and 3% year-over-year.

Looking towards 2018, the S&P 500 is trading at 17.5x earnings, for expected growth in profits of 11%. A recent Canaccord research note stated that a 20% corporate tax rate would add over $10 per share to earnings and lower the 2018 P/E valuation to 15.6x. This is more in-line with the 5-year average forward multiple of 15.5x and the 10-year average of 14.1x.

We are often asked if valuations are too high. While one cannot deny that this is elevated versus historical averages, we believe this can be justified with an analysis of our current and future environment. We would argue that some businesses are mispriced, but we prefer to focus our attention on individual companies and their specific growth opportunities. We believe the overall equity market is fairly valued, especially in comparison to other assets. Today's forward multiple valuation reflects the positive current environment and we are comfortable with the specific companies in our concentrated portfolio.

What the simple average valuation for the overall market fails to consider is that the market is comprised of hundreds of different companies, all with different prospects, potential and growth rates. For example, Netflix trades at 88x forward earnings, while Amazon trades at 117x 2018 estimates. Some believe this is justified because both companies exhibit superior growth rates and dominate their respective markets. Some value managers, using more traditional valuation metrics, would never consider owning either company. In comparison, traditional banks trade closer to 12x forward earnings and slightly above their tangible book values. Some analysts believe this is fair considering the cyclical nature of the banking industry, high debt levels and low growth rates. Our point is that we do not view the overall market valuation in a vacuum. Growth rates matter and are a critical component to properly valuing and analyzing a company.

The Rule of 72 dictates how many years it takes for something to double in value. Simply take an expected annual return and divide it by 72. Fed Funds, back in 2015, were paying out 0.15% and would take 500 years to double in value. A CD paying 2.3% will take 31 years to double while bonds, paying 6% (their historical average from 1926 to 2010), double every 12 years. In comparison, equities have returned 12% historically and take only 6 years to double. True analysis and a proper gauge of valuation requires a deep understanding of a business, its prospects, as well as a thorough understanding of a company and its place in its specific industry. We do not believe one can simply say the entire market is overvalued.

We continue to conduct bottom's up, fundamental research and do our valuations company by company, industry by industry. We are pleased with the diversification of our portfolio and see it as an excellent mix of high-quality companies trading at attractive valuations. We believe that our portfolio is poised to grow its revenue, earnings and cash flow significantly faster than the overall market.

Conclusion:

Uncertainty in the equity markets exists, but it always has. Bear markets, defined as a drop of 20% or more, might be around the corner, but one could easily have said that two or three years ago too. Investors would have missed out on equity returns of 12% in 2016 and 14% this year. Would we be surprised with an increase in volatility? No, we would not. We actually forecast and anticipate heightened volatility over the next year. We expect more shocks in 2018, similar to the sharp market drop experienced in August of 2015, early January of 2016 or possibly even another European election surprise. Strategas Research Partners recently noted that the S&P 500 suffered drops of at least 10% in 5 of the last 7 years, with the two exceptions being 2013 (drop of 6%) and 2014 (drop of 7%). In 2017, the biggest drop has only been 3%. While it seems like we are overdue for some sort of correction, we cannot ignore the positive, underlying fundamentals of the global economy. When a correction comes, and it will come, we will assess the situation and attempt to frame the opportunity.

With a strengthening economy, robust corporate profits, and excitement over potential tax cuts, the markets are well positioned for bigger gains. At recent meetings, the Fed stated that "the market's gains are rooted in strong fundamentals and not speculation" and that "favorable macroeconomic factors provided the backing for current equity valuations". This is now the second longest bull market in history.

We have built a concentrated portfolio of high-quality "Fin Tech" companies that generate strong, free cash flow, as well as high returns on invested capital and equity. In the event of a correction, these companies, that have met our stringent list of characteristics and traits, should outperform their weaker competitors.

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

Warren Fisher, CFA
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Interesting Quotes, Statistics and Facts:

Mobile Payments:

- Many consider Silicon Valley as the dominating technology force on the planet.
- Can you name one technology or advancement where another country dominates the US?
- When it comes to mobile payments, China dwarfs the US.
- Back in 2011, China did $15 billion of mobile payments versus the US at $8.3 billion (not even 2x).
- According to data from research firm Forrester, China is now 90x the size of the US mobile payment market.
- As of 2016, China is doing $9 trillion of mobile payments versus the US at $112 billion.
- Merchants in China, like many other emerging markets, lack our point-of-sale, card infrastructure.
- In addition, more traditional credit and debit cards are simply not as widely available.
- Instead, Alibaba (through Alipay) and Tencent Holdings (through Tenpay) have embraced QR codes.
- These QR codes are used widely by smartphones owners to make purchases and pay bills.
- These two Chinese companies dominate roughly 90% of online payment volume (by transaction value).
- Other emerging markets, like Paytm in India, are quickly following suit.
- Paytm is India's largest mobile payment app (see our note here).
- When India's government cancelled 86% of its currency in circulation, Paytm pounced.
- It attracted merchants that typically don't accept cards to accept QR codes for transactions.
- The number of users skyrocketed to over 225 million.

Paypal:

- CEO Dan Schulman stated that "every time a merchant or consumer uses an additional service, their lifetime value to Paypal doubles." If interested, please re-read and click here for our detailed note on Paypal from September 2016.

The Big 5:

- The five most valuable companies in the world have a combined market capitalization of nearly $3 trillion.
- Apple, Alphabet, Microsoft, Facebook and Amazon have had a wonderful 2017, up 25% year-to-date
- This equates to an increase in valuation of nearly $600 billion.

Amazon:

- We recently wrote a piece called "Checkout Amazon", which can be read here.
- During 2nd quarter 2017 conference calls, Amazon was mentioned on ~15% of S&P 500 earnings calls.
- Amazon's earnings are not terribly impressive, but it continues to experience fantastic revenue growth.
- As it enters new industries, Amazon strikes fear into its competition.
- Over the last decade, the market value losses for traditional retailers has been staggering.

COMPANY	MARKET VALUE 2006	MARKET VALUE 2016	% CHANGE
sears	$27.8B	$1.1B	96%
JCPenney	$18.1B	$2.6B	86%
NORDSTROM	$12.4B	$8.3B	33%
KOHL'S	$24.2B	$8.8B	64%
macy's	$24.2B	$11.0B	55%
BEST BUY	$28.4B	$13.2B	54%
TARGET	$51.3B	$40.6B	21%
Walmart	$214.0B	$212.4B	1%
amazon	$17.5B	$355.9B	1,934%

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