MANOLE CAPITAL MANAGEMENT

Introduction:

In our quarterly newsletter, we start by highlighting our thoughts on the pending debt ceiling crisis. Then, we discuss a few macros issues, like the household savings, the money market and stock market, the labor environment, the Fed, inflation trends and of course interest rates.

However, instead of spending too much time delving into the macro picture, we will spend the vast majority of our newsletter focused on specific Fintech and financial issues. We believe our value add and differentiation is best exhibited in discussing issues in our area of expertise – Fintech.

In our FINTECH section, we:

1) Discuss the concept behind digital wallets and which parties are currently winning this battle,
2) Highlight P2P (peer-to-peer) payments and focus on Zelle's robust growth,
3) Review how P2P platforms are striving to become online banks.

Don't worry! At the end of our newsletter, we will still include our Cliff Clavin section of useless and totally inconsequential tidbits of information.

Debt Ceiling:

As we are writing this newsletter, the market is "stressed out" about the pending debt ceiling dispute. Technically, the US government hit its allowed debt ceiling on January 18th, 2023, but Treasury Secretary Janet Yellen has been taking extraordinary measures to avoid the issue. Why the moving target date? Well, the Treasury has eclipsed its $31 trillion debt cap, but one needs to factor in how much cash came in from tax revenues. The non-partisan CBO (Congressional Budget Office) has stated that "tax receipts through April have been less than anticipated" and "that there is a significantly greater risk that the Treasury will run out of funds in early June." The not exactly drop-dead date is now June 1st.

Much has been written about what would potentially happen if the debt ceiling isn't raised and whether or not it would trigger another global financial crisis. Here's hoping we don't get there, but let's dive a little deeper into the details.

Since the debt ceiling was enacted by Congress in 1917, the US government has been close to a breach 78 times and it was resolved and extended 78 times. That's a pretty good percentage, right? This Washington DC predicament has historically been little more than a technicality, but it occasionally becomes an issue, like it did in 2011. Back then, the US government was close to reaching its borrowing limit of $14.3 trillion (now 120% higher) and the stress ultimately caused a credit rating downgrade. Why would this time be different?

We found a quote from October of 1984, from then Senator Joe Biden, that seemed apropos for today's debt ceiling concern. Senator Biden said, "I cannot agree to vote for a full increase in the debt ceiling without any assurance that steps will be taken early next year to reduce the alarming increase in the deficits and the debt." During that 1984 debt limit debate, Senator Biden joined forces with Senator Tsongas (Democrat from Massachusetts) and asked for a smaller debt limit increase than the White House was asking for, as well as a vote to freeze all federal spending. Sound familiar? Sounds exactly like a quote we'd expect from House Speaker Kevin McCarthy. This statutory debt ceiling issue is yet another bitter partisan battle, that causes more Americans to distrust and dislike of politicians in Washington DC.

There are really only four choices and a couple of them would be unpleasant. The first is a ***clean increase*** in the debt limit, with no conditions. During the Trump administration, this occurred 3 times and dozens of times during previous presidencies. While one can hope for this option, it seems to be fading each and every day. The second option is a ***negotiated debt ceiling raise***, that solves this current impasse and gives politicians an opportunity to reach a more substantial deal later this year. House Republicans claim that this is their preferred outcome and passed their own bill last

month. That bill calls for limits on federal spending, adds $1.5 trillion to the debt ceiling and essentially is a short-term punt on the problem.

The third option is ***executive action*** that would bypass the debt limit. This would be unprecedented and might have President Biden declaring the debt limit unconstitutional, arguing it violates the 14th Amendment. This broadly states that "the validity of the public debt of the US…shall not be questioned." Another bizarre scenario has the Treasury minting a $1 trillion platinum coin to deposit at the Federal Reserve and infuse the government with enough money to pay its bills. We don't believe this will ultimately get settled with a legal fight or the creation of a $1 trillion trick coin.

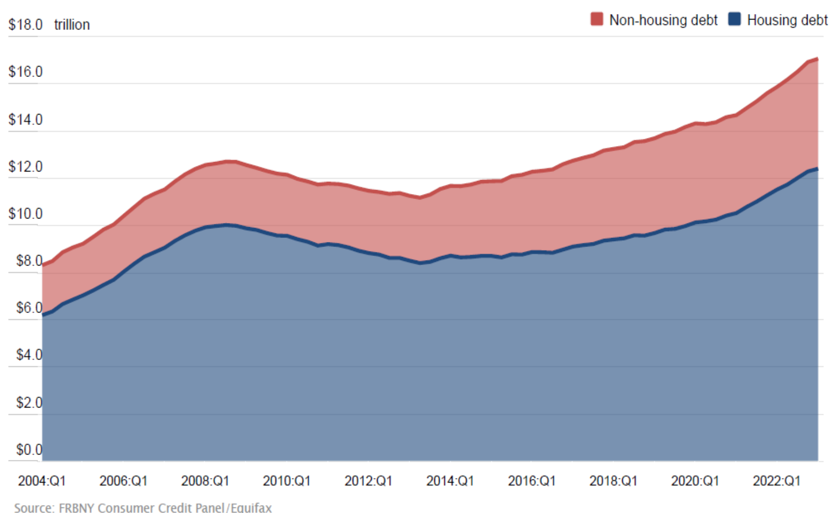
The last option, which is even worse than the third, is a government default. Moody's Analytics chief economist is Mark Zandi, and he described a government default as "financial Armageddon." Treasury Secretary Yellen emphasized that the US failing to raise the debt ceiling would be "an economic and financial catastrophe." What happens to the US dollar? What becomes of the world's RFA (risk free asset), if US debt isn't the safest of safe investments?

This debt ceiling issue is coming at an awful time for the market. Investors are still trying to figure out how this business cycle will evolve, following persistent inflation and a once-in-a-generation global pandemic. Adding uncertainty about the US government's ability to pay its bills isn't what the market wants to deal with right now. We anticipate and hope that policymakers will reach a solution that "kicks the can" down the proverbial road.

Overall Debt:

Over the last three years (2020, 2021 and 2022), the federal government had a deficit of $3.1 trillion, $2.8 trillion, and $1.4 trillion. Over the next three years, it is estimated that the deficits will be between $1.4 trillion to $1.8 trillion. The US government has over $31 trillion in outstanding debt and it's continuing to expand.

How about debt levels for US households? As this chart from the New York Fed shows, 1st quarter 2023 household debt is at a record high of $17.05 trillion, adding $148 billion in the last quarter alone. In fact, household debt balances $2.9 trillion higher than they were before COVID.



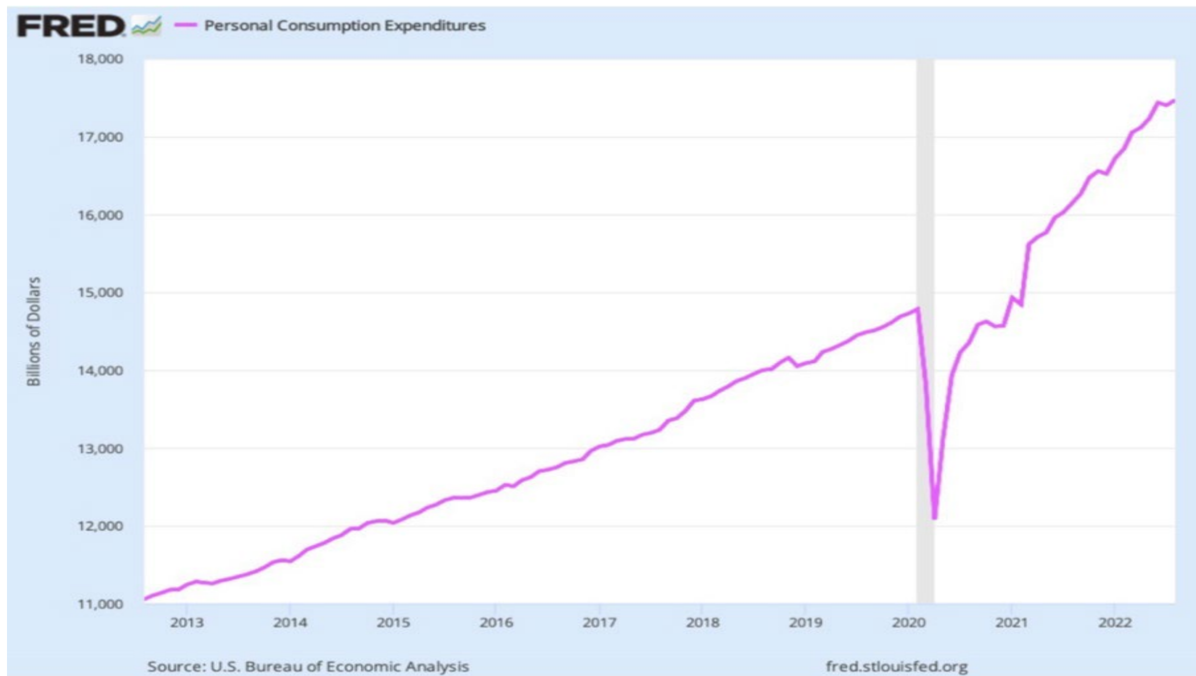
Driving this increase are Americans tapping their homes for loans, as well as soaring credit card balances and auto loans.
Mortgage debt increased by $121 billion in the first quarter, reaching a $12.04 trillion (70% of the mix). This is despite lower mortgage originations, due to the Fed's significant rate increases. The effect on homebuyers cannot be overstated, especially when one analyzes the impact of higher interest rates. Over the last year, the average monthly mortgage payment, on the median US priced home, has increased by 48% (from $1,712 to $2,542). To afford that average mortgage payment, Redfin believes an average US buyer needs to earn $108,000 per year.

Auto loan delinquencies are higher than they were before the pandemic and the average car payment has jumped to $729 per month. Also, there are more than 43 million Americans (17% of US adults) that owe $1.6 trillion in student loans. The 3-year student debt payment hiatus likely ends in September, and many Americans will have another bill of $300 to $400 per month. This will increase overall debt levels and act as an incremental spending headwind.

The last ingredient of this debt gumbo is credit card balances. Credit card debt just hit a record of $986 billion, up +6.6% quarter-over-quarter. This $61 billion sequential increase was the largest gain since the Fed began recording this data in 1999.

Recent Trends:

We focus a lot of our attention on the personal consumption expenditures and this chart from the US Bureau of Economic Analysis is telling. After a sizeable drop during COVID, the trend is continuing to grow, up and to the right. In fact, PCE (Personal Consumption Expenditures) is approaching $18 trillion.



According to research from Fidelity National Information Services, global spending on credit cards in 2022 eclipsed more than $13 trillion.

Delinquencies are rising and so too are charge-off's (i.e., bad debt). Statistics out of the NY Fed show that 4.6% of credit card debt has been shifted from "delinquent" (30 days past due) to "seriously delinquent" (90+ days past due). On credit card holders in the 18 to 29 age bracket, serious delinquency is a scary 8.3%.

We also like to track master trust loan data from the largest credit card issuers, as it can be insightful on consumer trends. Over the last 15 years, credit card issuers had significant (and cheap) assets which wasn't costing them much. Now that funding costs have increased, many issuers will be returning to the securitization market to fund their credit card balances. During earnings calls, we get the last three months of information, but the trust data gives us a monthly snapshot of current delinquencies, charge-offs, loan growth, etc. In monthly trust data, we can get an update from American Express, Bank of America, Bread Financial, Citigroup, Discover, JP Morgan and Synchrony.

Overall, these card issuers had 30-day delinquencies rise in April to 3.04%, over 100 basis points higher than last year. Charge-offs were 3.83% in April, up 163 basis points year-over-year. American Express has the highest quality customers, and its April metrics were charge-offs of 1.5%, while private-label issuer Bread Financial had the worst at 7.8%. The issuers take the credit risk (not Visa or MasterCard), but we'd still prefer that the trends were healthier and more favorable.

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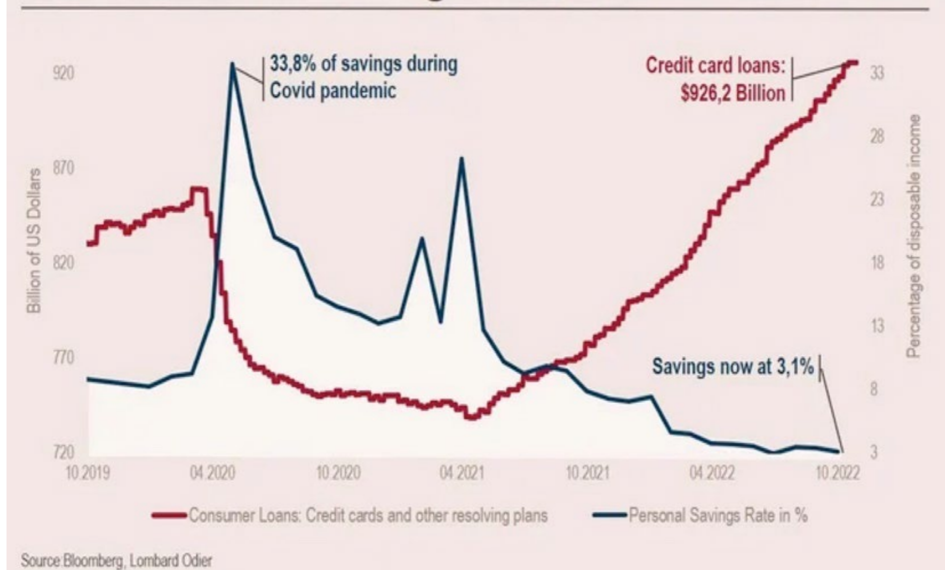
Savings Rate:

Running counter to these enormous debt levels are trends we see in the US personal savings rate. Charting savings to consumer spending is unfortunately quite uncorrelated. Take a look at this chart from Bloomberg and Lombard Odier and you can clearly see how these two trends are diverging.



In 1960, the savings rate was 10.1%. By 1970 it was 12.8% and 11.1% by 1980. There's thirty years of double-digit savings. Then, the trend starts to materially decline. It fell to 8.4% in 1990, and a dismal 4.7% in 2000. It stayed fairly modest in 2010 at 6.2%, but then things get odd. During COVID, it spiked higher to 16.8%, likely fueled by stimulus payments and the PPP (payroll protection program).

In the 1st quarter of 2020, the US personal savings peaked at 33.8%, but that was likely an anomaly. Now, the US personal savings rate has declined to just 3.7% in 2022, and June of last year was the 4th lowest month in US history at just 2.7%. With the weakening savings rate and an estimated 58% of Americans living paycheck to paycheck (CNBC Your Money Financial Confidence Survey), these types of trends aren't ideal.

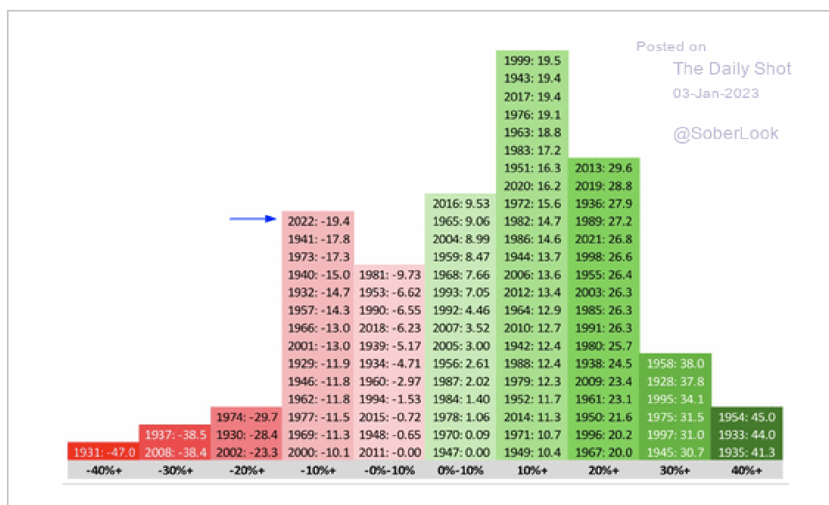
The Stock Market:

Despite this, the S&P 500 is up 7% this year and the Nasdaq is up +11%. Technology rebounded from a challenging 2022 and many large tech companies are performing quite well this year. Through mid-May 2023, year-to-date performance of some of the most popular and largest names tech names is impressive. For tech companies with market capitalizations over $1 trillion, Apple is up +35%, Microsoft +33%, Amazon +39%, and Google is +40%. In terms of contribution to the S&P 500's year-to-date return, Apple and Microsoft represent roughly half of its 2023 performance. If you add in Nvdia, Google and Meta, you have three quarters of the entire S&P 500's year-to-date return.

Back in 1982, the two largest stocks in the S&P 500 were IBM and AT&T. These companies represented 10.9% of the overall market. By 1999, the two largest in the S&P 500 were Microsoft and General Electric, which was 9.1% of the market. In 2008, the two largest market cap companies were Exxon and Wal-Mart, which were only 7.7% of the entire market. Recently, the S&P 500 has become more and more concentrated, in just a few mega cap technology stocks. Apple, and Microsoft now account for 13.9% of the entire S&P 500 or 80% more concentrated than 2008. For additional perspective, Apple's market cap is at $2.8 trillion and that is larger than the market cap of the entire Russell 2000. To conclude, it's distinctly getting more concentrated at the top.

It's Better to be a "Glass Half Full" Investor:

We are sometimes asked why we run our hedge fund, the Manole Fintech Fund, with a long-term, positive net exposure. Since our inception in 2018, the net long exposure has averaged +36%. More recently, the trailing 12-month net long average was +16% and last month's (April 2023) net long exposure was +21%. Why are we positively inclined?



This chart tells the story. If we analyze nearly a century worth of market returns, the vast majority will be positive. There will always be outliers, like 2022, with market performance declining by nearly (20%). However, over the long-term, the overall market tends to positively increase, despite typical intra-year drops.

Over the last 42 years, annual returns were positive in 32 of those years (76% of the time). However, in those four decades, the average intra-year decline was (14%). Just looking at last year's challenging market, 94% of the losses occurred on just 5 trading days.

From 1929 to 2021, there pretty much the same number of bear (26) and bull markets (27). The main difference was that the average bear market resulted in a (36%) decline while the average bull market had +114% in gains. Despite 2023 year being positive, there seems to always be a bit of volatility mixed in. For us, that leads us to be modestly net long, but with a healthy short book.

Fundamentals Still Matter:

However, as we always try to emphasize, we conduct individual analysis on company fundamentals to determine whether or not an investment enters our portfolio. In isn't terribly insightful to state that the overall market is trading at a 20x 2023 P/E multiple or 17x 2024 earnings. We prefer to understand the sustainability of growth rates, long-term margin profiles, free cash flow generation and specific company valuations.

All of this analysis is an input into our greater mosaic; understanding a business, its outlook and how management is adapting to a changing landscape. Then, we try to factor in the unanticipated. There is no way to truly model geopolitical issues, or monetary and fiscal uncertainty, except to say that we expect more volatility going forward.

Recent Results:

In our opinion, a healthy economy, with a strong labor market and consumers spending money, is what moves our markets forward. If you are invested in second-class companies, with levered balance sheets and questionable outlooks, then the forward outlook could be challenging. If you are invested in world-class companies, with recurring revenue, leading market share and generate free cash flow, you can handle turbulent conditions.

1st quarter earnings were recently released and generally showed remarkable resiliency. For those companies that delivered EPS upside, the average price change was only +0.3%, versus a historical average of +1.0%. For those that disappointed and missed earnings, the price response was nearly 2x harsher at (4.1%), versus a historical average of (2.2%).

We were generally quite pleased with how our holdings fared. Did every company of ours beat earnings and raise guidance? No, but we had most of our companies exceed expectations and conservatively guide for the rest of 2023. We have certain names (see our website for stock specific pitches) that are trading at very attractive valuations, and we have been selectively adding to our positions. Overall, we are pleased with our public exposure performance and hope/expect the trend to continue.

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Jobs:

We believe that a fully employed and well-paid labor force typically supports a strong consumer. Nonfarm payrolls were released by the Bureau of Labor Statistics (BLS) and the jobs market remains robust. April was nearly 2x what economists were expecting, with another 253,000 jobs created and 1.6 job openings for every unemployed individual. Unemployment now sits at a 54-year low of 3.4%, the lowest since 1969.

Is unemployment so low because the US doesn't have enough young adults entering the labor force? Maybe American birth rates, which have been declining for years, is to blame? Maybe it is a function of the declining number of immigrants entering the country? It could be a function of all of these issues, but the reality is that the US labor force is contracting.

A tight labor market supports higher wage growth and higher wage growth adds to the Fed's inflationary problems. If inflation isn't coming down to the Fed's 2% target, then investors worry the Fed has to continue to hike rates. This is what is commonly referred to as the "wage / price spiral", a feedback loop of rising labor costs resulting in businesses raising prices for goods and services.

The job market continues to be very resilient, despite 14 months of rate hikes. This positive employment situation gives the Fed its necessary data and ammunition to continue to raise rates, or at least keep them higher for longer.

Inflation:

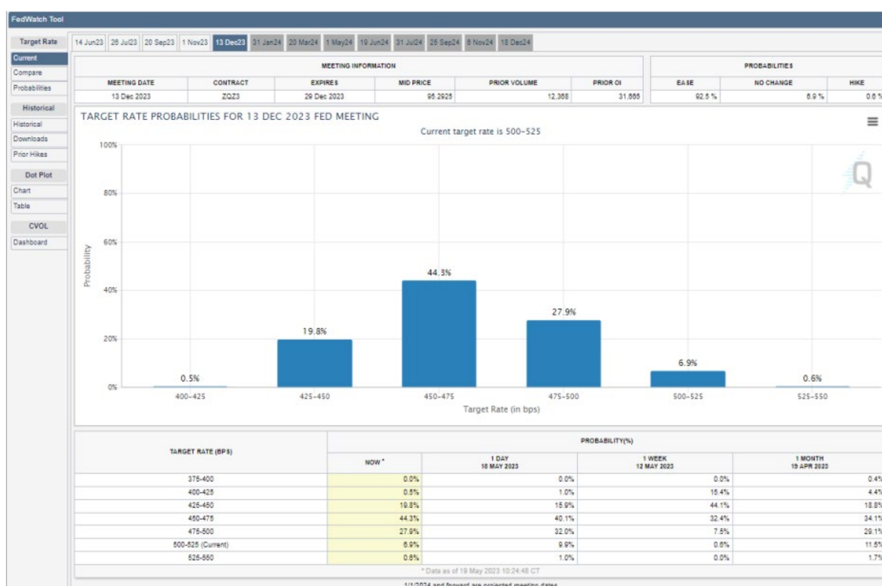
Inflation has obviously been more than "transitory", and the Fed is clearly using interest rates to cool the economy. Disinflation has begun and April's CPI reading was +4.9% year-over-year. This was the 10th consecutive decline in the CPI and the lowest since April of 2021. While this is lower than June of 2022's +9.1% annual rate (the highest since 1981), it still is more than 2x the Fed's target rate of 2%. Even excluding the volatile food and energy categories, core inflation was still +5.5%, which still presents a problem.

There is good reason to think inflation will keep falling, but it has remained stubbornly high. It is important to remember that consumer spending drives more than 65% of the US economy. On average, US consumers have been spending 7% to 9% more than 2022 for goods and services and a whopping 23% more than pre-COVID. The process of raising rates to fight inflation has caused other businesses to contract (i.e., banking, real estate, etc.), but the Fed isn't going to stray from its mandate. We believe that the Fed will keep interest rates "higher for longer", even if it impacts certain sectors and businesses.

Interest Rates:

We appreciate the difficulty of Chairman Powell's job. The Fed remains in a precarious position. On one hand, it has to raise interest rates to fight high inflation, which it says it 1 of its 2 main goals. On the other hand, the Fed has to ensure that it doesn't push the economy into a recession while juggling a crisis of confidence in our banking industry.

Our regular readers know that we don't guess where rates. Instead, we prefer to examine the CME's FedWatch Tool (click here). Using this as the market's expectations, we can see that the market isn't expecting the Fed to continue to raise interest rates. At their next meeting on June 14th, 64% expect no change to interest rates, keeping them at 5.0% to 5.25% and 36% expect another 25-basis point hike.



MEETING INFORMATION						PROBABILITIES		
MEETING DATE	CONTRACT	EXPIRES	MID PRICE	PRIOR VOLUME	PRIOR OI	EASE	NO CHANGE	HIKE
13 Dec 2023	ZQZ3	29 Dec 2023	95.2925	12,368	31,665	92.5 %	6.9 %	0.6 %

TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 18 MAY 2023	1 WEEK 12 MAY 2023	1 MONTH 19 APR 2023
375-400	0.0%	0.0%	0.0%	0.4%
400-425	0.5%	1.0%	15.4%	4.4%
425-450	19.8%	15.9%	44.1%	18.8%
450-475	44.3%	40.1%	32.4%	34.1%
475-500	27.9%	32.0%	7.5%	29.1%
500-525 (Current)	6.9%	9.9%	0.6%	11.5%
525-550	0.6%	1.0%	0.0%	1.7%

* Data as of 19 May 2023 10:24:48 CT

1/1/2024 and forward are projected meeting dates

As this chart shows, things really start to get interesting when one goes out to the end of 2023. At the December 13th meeting, 84% expect the Fed will pivot and lower interest rates. 11% expect a 75-basis point reduction, 37% expect a 50-basis points decline and 36% are anticipating a 25-basis point lowering of Fed Funds.

Market expectations appear quite different than voting members on the FOMC. In a recent CNBC interview, Minneapolis Fed President Neel Kashkari said, "I think right now it's a close call, either way, versus raising another time in June or skipping. What's important to me is not signaling that we're done."

The Fed:

The market is clearly expecting the Fed to pivot and begin to lower interest rates later this year. The Fed has repeatedly said they will be data dependent despite many calling for an end to their restrictive policies. Many analysts / experts believe continued increases will push the US economy into a recession, some expecting it later this year. In fact, at the 23 largest US financial institutions, nearly 80% of their economists are predicting a recession in 2023. Sentiment is not terribly optimistic.

St. Louis Fed President James Bullard remains hawkish, and he recently said, "I think we're going to have to grind higher with the policy rate in order to put enough downward pressure on inflation and return inflation to target in a timely manner." Bullard appears to still want to *keep his foot on the gas* and emphasized in an interview that "As long as the labor market is so good, it's a great time to fight inflation. We need to get it back to target and to get this problem behind us, so we don't replay the 1970s."

The bond market continues to send a more pessimistic signal. All-in financing costs keep rising, lending standards are tightening, demand for credit is falling aggressively, and US bankruptcy filings this year are the highest since 2010. Almost 180 degrees different, stocks are pricing in a soft landing for our economy or at least a shallow recession. In addition, equities seem to be focused on a Fed pivot, a surge in liquidity, all while corporate earnings remarkably hold up.

The old adage of "don't fight the Fed" seems apropos, but many in the market clearly are looking for a skirmish. When the Fed says it will keep rates "higher for longer", we simply nod our head and factor that into our proprietary models. During recent public commentary, Fed Chairman Powell said, "We have a view that inflation is going to come down, but not so quickly. It will likely take some time, and if that forecast is broadly right, it would not be appropriate to cut rates and we won't cut rates."

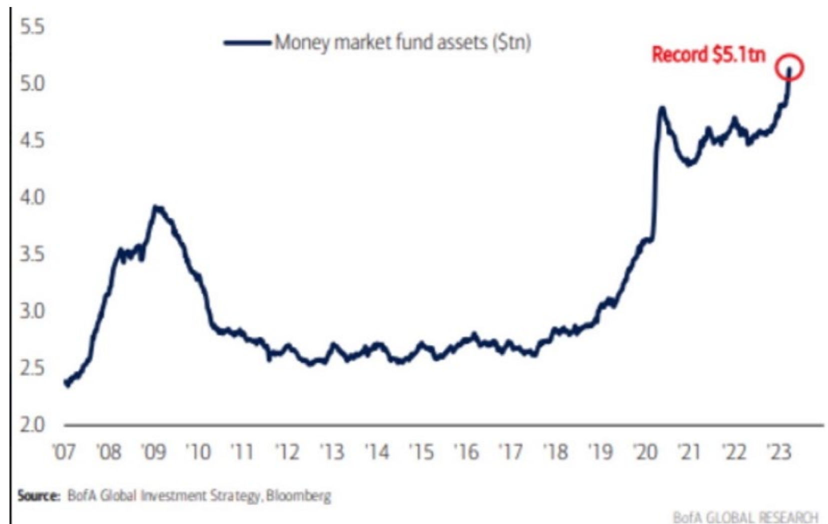
While we could see an interest rate pause, we won't be surprised if they raise rates another 25 basis points in June. We aren't going to expect a pivot and assume the Fed will rescue the economy from a recession (hoping for a "Fed Put"). We simply don't think the Fed will change its course and begin to cut rates early next year. We remain in an exceptionally tight labor market, and inflation might just be "stickier" than some expect. Ultimately, time will tell which view wins out, but we'll be prepared for any of the three rate alternatives (higher, pause or lower).

Money Markets:

Following seven interest rate hikes in 2022 and another three in 2023, Fed Funds now sits at 5.0% to 5.25%. A year ago, money markets were still paying paltry interest, but that has materially changed. With these Fed increases, money market investors can safely earn over 4% on their cash. MMFs (money market funds) have almost immediate liquidity and no insurance caps (i.e., FDIC's $250,000).

There appears to be broader secular shift occurring. For the last 15 years, money has basically been free. Now, we have a policy rate that is at 5% and digital banking allows people to move money almost instantly with a smartphone. Banks compete with each other for deposits, but also are now competing for cash with MMFs.

As this chart from Bank of America shows, money market fund assets have soared higher and are now above $5 trillion. Over the last year or so, nearly $750 billions of cash has migrated towards money market funds. Instead of parking money in a checking or savings account at a bank, earning next to nothing, investors can put their cash into a MMF and earn a decent interest rate.



After factoring in inflationary pressures of 5%, the real yield is next to nothing, but let's not get too technical. Some investors are plenty happy with 4% to 5%, especially following last year's S&P 500 decline of over (18%).

We have owned Schwab for two decades and seen it morph from a commission-based online broker into a predictable asset manager and online bank. A year ago, Schwab's bank had $152 billion of assets paying depositors less than 25 basis points. As the Fed raised rates, Schwab's customers could begin to earn more and more on their cash balances and migrated those assets over to Schwab's money market funds. Over the last year, Schwab's bank balances declined by 32% or $49 billion, but its money market assets increased by +143% or $216.8 billion.

While it earns more on the banking side of the equation than it does in money market funds, the key for us is that Schwab retained and actually grew its wallet share and assets. Other banks, that experienced volatility and declines in March and April weren't so lucky.

Banking:

25 years ago, there were 13,000 financial institutions, but now there's really *only* 4,000 banks left. Will we continue to see consolidation? With JP Morgan buying First Republic, the latest worry seems to PacWest Bancorp. In a recent security filing, it reported that it lost 9.5% of its total deposits, with most of it happening over two days. For PacWest and other regional banks, they are fighting a two-sided battle. On one side, investors are finally demanding higher yields and the media is highlighting the risk of keeping assets at struggling banks. On the other side, short sellers are eager to identify the next possible "weak (banking) link".

Smaller banks are facing rising technology costs and significantly higher regulatory burdens. Bank of Minneapolis Fed President Neel Kashkari recently said, "Having significantly higher levels of capital is our only chance to build real resilience in our financial system," and he is advocating for tougher bank capital requirements to help backstop financial institutions against distress.

It will be interesting to see what kind of policy decisions are made around regulation for institutions that are between $100 billion of assets and $700 billion of assets. As JP Morgan's purchase of First Republic shows, scale is a competitive advantage. It now has 13% of total US deposits and it manages 21% of America's credit card spending. With additional regulatory burdens coming, banks are facing a profitability headwind and 100 to 300 basis points of possible ROE erosion.

The banking sector is facing a slow-moving crisis, but we aren't sure it is enough to sink the overall health of the US consumer or economy. Credit will contract and lending standards will continue to rise. However, we do not see this problem escalating to the size and scale of previous banking crises. (see below).

Takeaway's From the Banking Crisis:

In our last newsletter (click here), we spent a considerable amount of time discussing the March banking crisis. We tried to address key questions like: Did this banking crisis need to happen? Are there other issues still lurking underneath these headlines? What are some of the key takeaways, from our perspective?

Bank failures happen in waves, with the biggest one occurring during the Great Depression. From 1930 to 1933, more than 9,000 banks failed and during the 1930's, an average of 50 banks closed per year. Since FDIC insurance didn't exist, 20% of all depositors lost all of their money. During the S&L (savings and loan) crisis of the 1980s, another 3,000 banks failed, with collective assets of $2.2 trillion. During the 2008 Financial Crisis, another 500 banks were wiped out.

Fast forward to today, and many wonder if March's failures of Silicon Valley and Signature Bank will lead to another crisis. While these were the 2nd and 4th largest failures in US banking history, there's more to understand.

We have three key takeaways from this crisis. While we attribute much of this as a company specific problem, it has clearly cascaded to other players. Across the banking sector, only about 6% of bank assets were protected by interest-rate swaps, according to studies conducted by USC, Northwestern, Columbia, and Stanford. Our first takeaway is that banks will need to improve their risk management procedures. Clearly, purchasing long-dated US Treasuries isn't the safest investment a bank can do to manage their asset and liability exposure.

Second, we believe bank profitability is going down. Costly compliance burdens are absolutely on the rise and banks will likely have to keep a more liquid balance sheet. All of these issues (coupled with risk management and hedging costs) will pressure margins and drive bank profitability lower.

Our third takeaway is unquantifiable, but it could be the equivalent of a few more interest rate hikes. We believe banks will likely tighten their lending standards and do additional tests before granting new credit. If you were running a bank today, we imagine you'd likely hold onto your capital a little tighter, especially in this type of volatile environment. With US bankruptcies hitting a 13-year high, we don't expect easing credit underwriting. This ultimately could be similar to another 50 to 100 basis points of Fed tightening. Banks will add additional risk management procedures and we anticipate these tightened credit conditions for households and businesses will be a headwind to overall economic activity.

The FDIC (Federal Insurance Deposit Corporation) Response:

In On May 1st, the FDIC issued a press release discussing their options for deposit insurance reform. It is proposing a comprehensive overview of FDIC insurance rules following "the recent failures of Silicon Valley Bank and Signature Bank". The FDIC has outlined three main options for its reform.

First, it could keep the deposit insurance framework coverage at its existing $250,000 level. Second, it could extend coverage and make insurance "unlimited" for all depositors. The third (and most likely) option is providing "targeted" coverage for different types of accounts. Businesses may want or need higher levels of insurance, while retail investors

may be comfortable with existing rules. If targeted coverage is the best path forward, there are still several unknowns to address. Who pays for the higher coverage? Will all banks pay the same rate, or will larger financial institutions continue to absorb a higher burden?

In May 2023, the FDIC Board of Directors approved a notice of proposed rulemaking, which covers a special assessment to recover costs for protecting uninsured deposits in the recent regional bank failures. Specifically, the proposed assessment will try to recuperate the $16 billion hit to the insurance fund (called the DIF) from the failures at Silicon Valley and Signature Bank. The FDIC estimates that 95% of this special assessment will be paid by institutions with assets above $50 billion. Specifically, the special assessment will be calculated at an annual rate of 12.5 basis points on uninsured deposits (not total) above the $5 billion threshold, applied on balance sheets dated December 31st, 2022. The special assessment will likely be paid over an eight-quarter window, beginning on January 1st of next year. While manageable for all banks, this fee comes at an inopportune time, as earnings are likely being pressured from a triple whammy of delinquencies, declines in deposits and higher funding costs.

Regulatory Changes:

Jamie Dimon has commented on regulations many times and he recently said, “we should not aim for a regulatory regime that eliminates all failure, but one that reduces the change of failure and the odds of contagion.” We agree, but that’s often easier said than done.

The Fed released a plain-spoken report concerning its findings from the recent banking crisis. The Fed’s Board of Governors had a few important conclusions, which faulted several parties. First, it placed blame on Silicon Valley’s management team and said it “Failed because of a textbook case of mismanagement by the bank. Its senior leadership failed to manage basic interest rate and liquidity risk. Its board of directors failed to oversee senior leadership and hold them accountable.” Ouch…

Of course, SVB’s CEO Greg Becker gave his side of the story during Senate testimony. Becker said that the Fed was to blame for keeping interest rates near-zero for too long and for failing to appreciate that inflation wasn’t transitory. In his testimony, Becker said that bank examiners and SVB employees were focused more on complying with regulation, than managing actual and potential balance-sheet risks.

SVB’s management team isn’t alone in assigning blame towards others. Michael Roffler, CEO of First Republic Bank, refused to accept blame for its bank’s collapse. During his House Financial Services Committee testimony, Roffler said that social media caused significant harm to First Republic and is partially to blame for its demise. Signature Bank’s Chairman Scott Shay echoed those same sentiments, when he said panic was “flooding through social media”, right before his bank got seized. Clearly, there’s a lot of blame to go around and SVB’s bank executives aren’t the only ones under attack.

The Fed then blamed regulators and the report said, “Regulators don’t tell banks how to manage their business, but regulators are supposed to check that a suitable plan is in place, it was created by competent managers considering the bank’s complexities, and that it is being followed. When supervisors did identify vulnerabilities, they did not take sufficient steps to ensure that SVB fixed those problems quickly enough.”

Lastly, the Fed placed blame on itself. This report stated that “The Fed did not appreciate the seriousness of critical deficiencies in SVBs governance, liquidity, and interest rate risk management. These judgements meant that SVB remained well-rated, even as conditions deteriorated and significant risk to the firm’s safety and soundness emerged.” Clearly, this banking crisis of confidence was multi-faceted.

After the Financial Crisis, the market received thousands of pages of new regulations, in the form of Dodd-Frank reforms. We expect this banking crisis will lead Washington to act. Never underestimate regulators taking advantage of a crisis by instituting more powerful controls over an industry.

Will regulatory changes impact how banks account for their bank security portfolios? Will HTM continue to ignore mark-to-mark accounting? Will all bank investments be forced to run through the income statement and bring heightened volatility and fluctuations to earnings? Can regulators force banks into solid risk management procedures? We aren't sure, but we won't be surprised to see these type of valuation and accounting changes come out of this crisis.

Fintech:

We like to start out all of our discussions by telling investors who we are. We are FINTECH investors, and we define Fintech as ***"anything utilizing technology to improve an established process."*** We realize that half of Fintech is financial, but we don't invest in traditional, credit sensitive banks. Having managed money during the Financial Crisis, we learned firsthand how certain opaque and balance sheet intensive financials could go bankrupt or insolvent.

We prefer transaction-based businesses, generating recurring revenue, with sustainable margins, and significant cash flow. From our perspective, the perfect example of a FINTECH business is the secularly growing payments industry. Names like Visa or Mastercard, that generate revenue and profit per swipe or transaction, without the underlying credit sensitivity or risk associated with that underlying line of credit.

Digital Wallets:

Everybody knows what traditional wallet's look like, and they range from old-school leather one's to our favorite Velcro OP wallet from 1980. A digital wallet is a software application that allows users to securely store and manage their payment information (i.e., credit cards, debit cards, etc.) on their favorite mobile device. Instead of carrying around physical cards or paper cash, a digital wallet allows your smartphone to become your payment device.

Digital wallets are safe and convenient, allowing their users to store, manage and easily make payment transactions. Anybody can store their favorite card and/or multiple cards to use in physical, brick and mortar retailers or for online purchases.

Unlike a traditional wallet, that can be stolen and then utilized by thieves to transact, a digital wallet has advanced encryption technology to protect a users' payment information. Nobody checks the back of a credit card to ensure that the signatures match anymore, right? If somebody steals your wallet, they could shop at any merchant, until you call and tell the issuer that your card has been stolen. However, digital wallets have embedded technology to reduce the risk of fraud and identity theft. Fraudsters would need to clone your face or replicate your exact fingerprint to unlock your phone and access your digital wallet. That's obviously much harder to do. In addition, these digital wallet payment transactions can be tokenized. That is the process of replacing sensitive data (i.e., that 16-digit numerical code on your plastic card) with unique and one-time identification numbers and symbols. This retains all the essential transaction information and data, without compromising security.

There are various forms of digital wallets. Software wallets are simply a digital wallet that is accessed from a computer or your mobile device. Hardware wallets are physical devices used to store digital assets offline, like crypto currencies. Within crypto, there can be hosted/custodial wallets, as well as self-custody or hardware wallets. Our loyal readers know that we

aren't terribly focused on the use of crypto as a valid payment mechanism, so we'll leave that product discussion and analysis for another day.

For our purposes, we are just going to focus on software digital wallets, as they are much more common and accessible. If you own an iPhone, then you have an Apple Pay pre-loaded digital wallet. If you have a Samsung phone, you have Samsung Pay available for use. Those two, along with Google Pay and PayPal, are the four most popular digital wallets today. According to the Payments Journal, PayPal has been used (over the last 12 months) by 62% of American consumers, followed by Apple Pay at 41% and Google Pay at 32%.

Growth & Adoption:

Maybe the only benefit that emerged from the COVID era was the growth it spurred in electronic forms of payment. During COVID, many people were worried that touching "dirty" paper money potentially increased the chances of catching or spreading the virus. This encouraged contactless payments and increased the use of digital wallets.

Cash usage has been declining for years and COVID just kickstarted its demise. We just saw this sign at a local store, and we couldn't agree more. We love how they added the why section and specifically said that cards increase efficiency and are more sustainable.

While purchases under $10 are still done with cash roughly half of the time, card usage continues to gain market share from paper currency. This is a secular trend that will continue for months, years and decades, and will materially benefit our payment companies.

The technology to use digital wallets has existed for over a decade, but its usage wasn't terribly widespread. With COVID and the global pandemic, more merchants decided to turn on the NFC (near field communication) capabilities in their POS (point of sale) terminals. By enabling tap-to-pay, merchants increased speed at the cash register and decreased the need for their employees to handle paper currency.

Electronic payments have migrated into the restaurant industry too. A few years ago, a waiter or waitress would present a patron with an invoice and take card or cash payment back to their terminals for processing. Now, more and more restaurants are bringing the terminal to the customer and payment can be made at the table.

Social Benefits?

Another "benefit" of digital wallets is their social feature. We personally view this as a negative, not a positive, but younger people love to post on social media (Facebook, Instagram, Twitter, etc.) what their payments are for. Some people post this transaction (and a photo) to let their all of their followers know.

When we pay $5 for a drink at Starbucks, we don't care to inform the world that we've been grossly overcharged for plain black coffee. Creating a virtual and public paper trail of your expenditures might help "tell your story", but it isn't our favorite version of transparency. As my mother always said, "to each their own."

Digital wallets have tons of advantages, that we are embracing. When we attend Tampa Bay Lightning games, we love having our season tickets easily accessible on our phones (via the Apple Pay wallet), as well as our timed parking pass. When we travel, loading the airline ticket into our Apple Pay wallet is much more convenient than printing out a paper boarding pass. Others are using digital wallets to track their expenses, budget properly, and even help them easily pay their bills. Digital wallets are still in their infancy and have decades of future growth; we believe the smartphone is simply the best interface and platform for digital wallets.

MANOLE CAPITAL MANAGEMENT

Peer-to-Peer or P2P:

Over the last several years, P2P payments have made tremendous strides in adoption and usage. Whenever something becomes a verb, like just *Venmo* me $10, you know that it has been widely embraced by society. The concept of allowing individuals to pay each other, via our smartphones, has clearly taken off.

However, the biggest flaw or issue (that we've identified) is ***interoperability***. Digital wallets allow users to pick their favorite card to make payments with. P2P acts as a bit of a "walled garden" and its funding source is still siloed. This is a critical aspect for future P2P growth, as Venmo users can't pay Cash App users who can't pay Zelle users. Visa is launching Visa+ next year and it has already signed up PayPal and Venmo as its initial customer. The global card networks seem like the perfect piece to solve this interoperability puzzle. Of course, this will only work if banks allow an independent network to serve as the gateway between disparate user bases.

From our perspective, there are three dominant P2P platforms. PayPal owns Venmo (from its Braintree acquisition in 2013), Square owns Cash App and Zelle is the bank-owned consortium run by EWS (Early Warning Services). Venmo and Cash App are more popular with younger Americans, and more of its users utilize the platform to exchange and transfer smaller sums of money. There are major differences in ownership and transaction size between P2P platforms. We will now focus on Zelle, but in our Cliff Clavin section we discuss another famous Zell (the recent passing of Sam Zell).

Zelle:

Traditional banks are desperately trying to connect with their younger consumers, so they partnered up and formed this consortium. EWS created Zelle in 2017 and it is owned by seven banks (Bank of America, Capital One, JPMorgan Chase, PNC Bank, US Bank, and Wells Fargo). Zelle has widespread financial institutional acceptance and is currently utilized on over 1,700 different banking apps. It's essentially the bank version of Venmo and Cash App.

Despite having launched 8 years after PayPal's Venmo and 4 years after Square's Cash App, Zelle has processed more than 5 billion transactions worth nearly $1.5 trillion. In the 1st quarter of 2023, Zelle processed 639 million transactions, covering a total value of nearly $180 billion. This equates to an average per transaction value of $282. That average is significantly higher than Venmo or Cash App's average and much higher than our weekly Venmo $10 golf wager. Zelle's transactions grew +29% YoY and dollar volume increased +31% YoY.

This impressive growth was driven by Zelle's addition of smaller credit unions and community banks to its platform. In addition, EWS management continues to attract usage from small businesses, which accounted for 150 million new users in 2022. We view this small business focus as a glorified version of our personal, monthly online bill payments. While we use our bank website to pay our mortgage, car payments and credit card bills, more small businesses are using Zelle to handle their monthly bill payments. With its higher average transaction size, Zelle seems like an online banking payment (accounts receivable + accounts payable) solution for small businesses. If we were running Intuit's QuickBooks franchise, we'd view this small business success as a threat.

DC Troubles:

Despite this success, Washington has put Zelle in its cross hairs (read DC testimony / transcript here). US Senators, especially Elizabeth Warren from Massachusetts, have singled out Zelle for "a high rate of scams". She claimed that frauds on Zelle were occurring "at twice the rate of other banks."

Back in October 2022, Senator Warren's issued a report that found rampant fraud on Zelle. Her report stated that the fraud dollar value on Zelle increased by more than 250% from 2020 to 2022. This scathing report also found that Zelle was not repaying consumers who were defrauded, leading to millions of lost funds for consumers. Senator Warren's report stated that *only* 47% of "unauthorized" transactions (classified by EWS as fraud) were returned to consumers in 2021 and the first half of 2022.

Following Zelle's "grilling" in Washington DC, EWS press releases emphasize internal controls and security protocols to stop "bad actors" from executing fraudulent transactions on its network. Management emphasized that it "routinely blocks high-risk enrollments from registering on the network," and that it can pinpoint fraudsters and remove them from utilizing transactional tokens.

We are attempting to highlight a few key differences between digital wallets and P2P payments. For example, a credit card transaction, handled inside of an Apple Pay wallet, has 100% customer protection against fraud. Transactions also have identifiable information, permitting chargebacks and returns. This isn't the case with P2P transactions.

Taxes:

P2P thrived because it is quite easy to use, and it's a free service. However, as more gig workers began to accept payment by Venmo or Cash App or Zelle, it created a potential tax issue. Historically, to receive tax documents (like a 1099-K), users would need to have spent over $20,000 or have conducted over 200 transactions.

The IRS has taken notice of how popular these P2P app's have become and are trying to force these networks to provide 1099-Ks for income generated over $600 per year. Taxable reporting only involves payments made under the "goods and services" tag, so daily transactions between friends or colleagues isn't IRS applicable.

Can P2P Platforms Morph into Online Banking?

While Square and PayPal are well regarded for payment processing, both have not yet cracked the digital wallet code. These platforms will ultimately succeed, *if* they are able to get consumers to leave a decent balance in their account, like an online bank.

Let's say that the average Gen-Z consumer keeps $1,000 in their Bank of America or Wells Fargo account and uses it to pay for their monthly expenses. These P2P platforms hope to replace B of A and get that cash stashed into their Venmo or Cash App account. Square has been pushing direct deposit for years inside of its payroll product. Its goal is to get employers to deposit bi-monthly payroll directly into their staffs' Cash App accounts. This way, Square essentially becomes the online bank for Gen-Z.

Once consumers are able to shop both in-store and online with these P2P balances, their "moat" will be built. We envision a day (not too far away), where we will be able to utilize a cash balance, we keep at Venmo or Cash App at local retailers. In fact, Venmo just announced that it is now accepted at Starbucks. This in-store acceptance would get accelerated, if PayPal and Square were to arrange deals with other merchant acquirers and payment processors (i.e., Global Payments (GPN), First Data (FIS), Worldpay (FIS), etc.). This seems like a key aspect of Square's ecosystem goals.

A Threat to Banks:

Jamie Dimon, Chairman and CEO of JP Morgan Chase clearly sees the risks these FINTECH companies present. In his annual letter to shareholders, he stated that all incumbent banks should be "scared shitless" of these FINTECH rivals. Not only is his bank being attacked from multiple angles, but Apple just launched a cash management program with Goldman Sachs. On the first day of Apple's savings program, it raised $400 million and eclipsed $1 billion in its first four days. Dimon specifically labeled Apple a bank the other day in an interview when he said, "It may not have insured deposits, but it's a bank. If you move money, hold money, manage money, lend money — that's a bank."

New Entrants:

Others are trying to enter the digital wallet market, but we believe "the ship has already sailed." Banks are trying to make a "last ditch effort" to be their consumers super app, instead of getting relegated and considered simple utilities. That same bank consortium (EWS) is trying to develop its own digital wallet.

In addition to these big banks, Synchrony is mulling creating its own digital wallet for its 70 million private label cards. We hate to say that something has "no shot", but this isn't a product we expect to succeed. This just seems like a legacy provider of plastic cards trying to be relevant in an increasingly digital world. In our opinion, the best these issuers can hope for is getting the top spot in an existing digital wallet. By getting that "preferred card" spot, an issuer can garner the most usage on a smartphone.

In its annual report, Synchrony stated that "in the future, we expect our products may face increased competitive pressure to the extent that our products are not, or do not continue to be, accepted in, or compatible with digital wallet technologies such as Apple Pay, Samsung Pay, Android Pay and other similar technologies." As of today, Synchrony works with Apple, Samsung, and Google. However, it seems like Synchrony is formulating a plan for its own digital wallet because it worries that it may not be able to work through other existing platforms in the future.

We have several questions on these new digital wallet offerings. How will they differentiate themselves from existing players? Banks can offer credit and debit cards, but how will they incorporate closed-loop or stored value payments? Will these new digital wallets be able to handle identification cards, loyalty cards, and airline/concert/sports tickets? How can new entrants become the preferable choice to replace the digital wallets already getting used by Americans?

Maybe merchants can offer discounts for usage, but we're not sure that will drive long-term usage. We think merchants are better at selling products and services aligned with their expertise.

Maybe issuers and banks can incentivize usage by offering more miles, points, loyalty, rewards, etc.? We think that issuers are better at lending, than they are at marketing. We don't believe that banks are the best technology innovators, but they certainly can try (and spend money). From our perspective, it is challenging to steal market share and disrupt an industry that isn't broken.

Conclusion:

We are loyal Apple users (iPhones, iPads, iMac) and find their Apple Pay to be a convenient and safe digital wallet to use. It is currently accepted at more than 90% of US retailers, so it clearly has widespread adoption. Samsung and Google users also seem pleased with their preferred digital wallets. In our opinion, these new entrants are "a bit too late to the party" to make a meaningful dent versus established players.

As of today, both Apple Pay, Samsung Pay and Google Pay have a distinct advantage in the digital wallet arena. These three firms have spent billions of dollars ensuring that their apps are easy to use on their smartphones. Plus, and maybe more importantly, the consumer experience is embedded and native to the operating system. This ties their digital wallet to the device, which cannot be replicated.

While it is possible that these banks can create a complementary product (through EWS), their late start will make this a "hard road to climb." Nobody likes to admit the fact that they don't have a strong, forward-looking opportunity to leverage their existing customer relationships. Unfortunately for these late entrants, the market has pretty much already spoken.

We hope you have a wonderful summer, and we look forward to speaking with you soon!

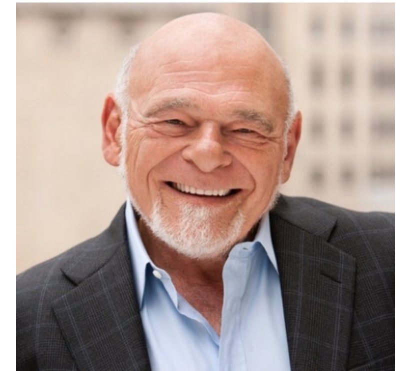
Warren Fisher, CFA
Founder and CEO
Manole Capital Management

Cliff Clavin

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

On May 1st, 1956, Warren Buffett received $105,000 from seven local investors and he used those funds to launch an investment partnership from the bedroom of a rented house in Omaha, Nebraska. This entity later became the conglomerate Berkshire Hathaway.
In New Mexico, if you are 100 years old or older, you are exempt from the state's income tax.

May 22nd is an obscure pizza / Bitcoin holiday. Back in 2010, a programmer named Laszlo Hanyecz spent 10,000 bitcoins to buy two Papa John's pizzas. 10,000 Bitcoins, sold at their peak price, would have equaled $690 million and would be worth $270 million at today's price. Hanyecz has said he doesn't regret the purchase, but we have to believe he's got a bit of regret, if not heartburn.



Legendary investor Sam Zell, at 81 years old, just passed away. Zell was an outspoken businessman that built a real estate empire from very humble beginnings. He was born in 1941 to Polish parents, who escaped to the US during the German invasion of Poland in World War 2. While an undergraduate student at the University of Michigan, Zell was managing student housing apartments.

In 1968, at the age of 27, he founded his chief investment vehicle, Equity Group Investments. According to Forbes, Zell had a net worth of over $5 billion, primarily driven by his successful purchase of distressed property. There was much more success than failure, especially with REIT's (real estate investment trusts). He popularized the tax-efficient structure of leasing and collecting rent on properties and then distributing the profits to his investors as dividends. His Equity Office Properties Trust become the first REIT added to the S&P 500 index. In February 2007, Zell sold it to Blackstone for $39 billion. However, Zell's most ambitious venture was the highly levered debt deal for media giant Tribune. This $8.2 billion deal burdened Tribune with too much debt and ultimately led to its bankruptcy filing a year later. Following its collapse, Zell said this acquisition was his "deal from hell".

Everybody needs hobbies and Zell had his. In fact, Zell had a passion for motorcycles, which led him to form a group called *Zell's Angels*. The outspoken businessman certainly was a character and was a favorite on business television shows. In 2017, Zell published a book titled ***"Am I Being Too Subtle? Straight Talk, from a Business Rebel"***, in which he talked about his experiences. We think this book will be on our summer reading list.

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