1st Quarter 2020 Newsletter

January 2020

Introduction:

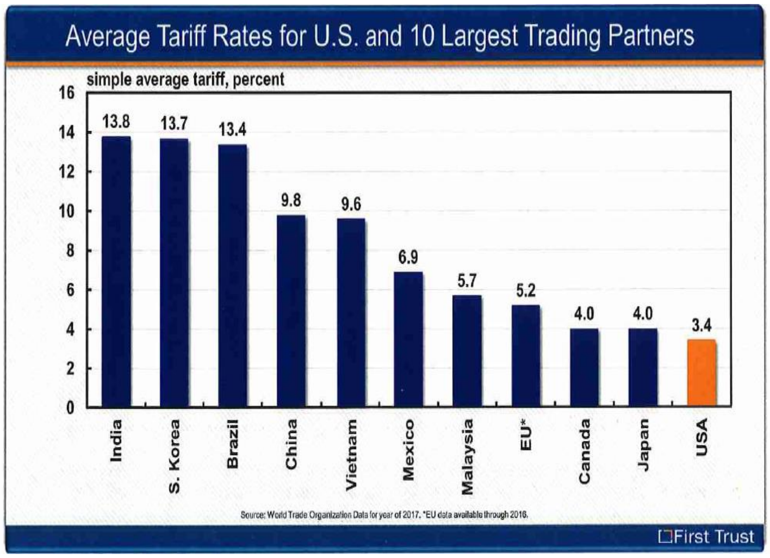
As always, a new year brings optimism. Before we recap the last decade, 2019 or even address our forward thinking on 2020, we thought we would start with the US versus China trade war. Since this has been the largest overhang on market and the issue creating the most uncertainty, let's start with this détente.

For decades, US Presidents (from both parties), failed to hold the Chinese accountable for trading abuses. Beijing was essentially robbing the US and our government accommodated these abuses because the allure of Chinese growth was too enticing. Many US companies were willing to sacrifice, just to potentially earn a sliver of China's massive market opportunity. Republicans and Democrats can agree on few issues, but both publicly stated that the trading relationship with China was problematic and unsustainable.

This looming fight was decades in the making. There are some conspiracy theories that claim that President Trump's 2017 tax reform and constant deregulatory stance was only advocated to lift the economy and better prepare the US for this larger trade battle. We do not believe that is the case, but this ongoing trade war has definitely negatively impacted both countries. A US Federal Reserve (the Fed) study stated that trade uncertainty cut our GDP by roughly 1% last year. While many doubt the accuracy and transparency of some of China's official reported figures, the 3rd quarter of 2019 was their lowest GDP result in nearly 30 years.

Negotiations with China:

Let's be clear. We would have begun this trading process with a different tact and negotiation style. Our preference would have been to build a strong coalition of nations to pressure China to act fairly. Instead of unilaterally imposing tariffs, we would have preferred a more inclusive dialogue. We simply believe that this trade dispute should have taken place at the multi-lateral level, with reforms of the flawed WTO (World Trade Organization) system. Was this unrealistic or wishful thinking? We'll never know…



This chart shows average tariff rates for the ten largest global economies. We believe it clearly demonstrates why altering the trading landscape was necessary. In order to get the US back on a competitive footing versus the rest of the world, something needed to occur. Unfair tariffs against US businesses act as a subsidy for foreign economies. These discriminating tariffs were ignored for decades, and prevented our companies from competing on a level playing field.

Clearly, President Trump handles negotiations differently, and he decided on a more aggressive form of diplomacy. Two years ago, President Trump began a campaign to bring China to the trading negotiating table through the imposition of tariffs. By levying stiff tariffs, President Trump abruptly ended an era of appeasement. While White House trade adviser

Peter Navarro insists that tariffs do not harm Americans, we have seen countless studies claiming that US businesses and consumers have borne some of these costs. If there wasn't a material impact on our farmers, why did the President pay $25 billion in taxpayer subsidies last year?

In November of 2001, when China joined the WTO, it pledged to normalize trading relationships and abide by certain fair trading practices. Over the last two decades, China has failed to follow through on these assurances. Instead, China has pursued a mercantilist policy, which has caused material harm to both US and non-Chinese companies. These unfair trade practices range from patent infringement, piracy and counterfeiting of goods, intellectual property theft, foreign ownership restrictions, currency manipulation and Beijing illegally subsidizing strategic industries. While President Trump is determined to lower our bilateral trade deficit with China, we believe lowering trade restrictions, barriers and regulations was more important.

We think successful negotiations leave both parties feeling positive about an agreement, as opposed to one side claiming victor at the expense of the other. While this agreement is structured as a deal between equals, it looks as if China is making pretty much all of the policy changes. Beijing can state that they are not changing any of their laws or regulations to fulfill these obligations, which is why the pre-liminary deal last May fell apart (causing that S&P 500 decline of -6.4%). When Beijing's trade representative says that China has agreed to "structural reforms and other changes in the areas of intellectual property, technology transfer, agriculture, financial services and currency", it is fairly clear who won Round 1 of this title fight. On the other side of the negotiation table is President Trump and it is important for him and Republicans to claim *Phase One* as a major victory, especially in an election year. Either way, global stock markets are cheering what could be a year or two of trade calm.

Phase One:

On January 15th, in the White House East Room, President Trump signed *Phase One* of this "landmark trade agreement". We personally found it somewhat bizarre to watch CNBC carry the signing of this trade deal, while at the same time CNN was carrying coverage of Nancy Pelosi signing the House's two articles of impeachment.

It is still too early to understand all of the ramifications from this *Phase One* deal, but we have reviewed some of the trade jargon and legalese. Over the next two years, China as agreed to increase its US imports by $200 billion. On agricultural purchases, China has targeted an increase of $32 billion, with a pledge to open up market access for US dairy, poultry, beef, fish, rice and pork. Also, this deal makes it much easier for US businesses to protect their intellectual property. China has approved to impose stiff penalties on theft and has established a means for the US to address any grievances. Lastly, some of the best news was buried deep in the 86-page agreement and it received very little attention. From our investment perspective, the best outcome from *Phase One* was the removal of financial services barriers for our card networks.

Will China abide by these new rules and honor its commitments? We don't know, but at least there now exists a mechanism for these parties to dialogue and an avenue for dispute resolution. In addition, the President has kept his trump card (sorry for the pun). If China fails to keep its promises, future tariffs can easily get enacted and instituted. The *Phase One* agreement cuts the initial 15% tariff in half, but it still is levied on $120 billion worth of Chinese goods.

We believe that *Phase 2* might take a while to get signed, but the takeaway is clear. There is ample evidence that US businesses paused capital expenditures and investment, while this uncertainty and trade war lingered on. With *Phase One* getting signed, US businesses have a degree of certainty. Leaders can now better manage their complex supply chains and confidently pursue their growth agendas. While negotiations are immediately beginning on *Phase 2*, we do not foresee anything materializing over the next few months. Maybe the administration pushes through a minor *Phase 2* a month or two before the November election? His campaign would probably advocate for anything that boosts the economy and stock market, if it improves President Trump's chances of re-election, right?

Some say these tariffs were worth it. Others claim the trade war materially hurt US farmers and did damage to our manufacturing sector. Some say the agreement didn't go far enough in getting China to properly behave. Either way, corporate executives are now pleased to see a de-escalation of tensions. Instead of proclaiming one side "won" this trade war, let's just agree to call it a truce that relieves a considerable amount of economic uncertainty.

Now let's take a look at the global economy and what were some of the biggest issues impacting performance over the last decade.

The Last Decade, 2010 to 2019:

The Financial Crisis still impacts our thinking, as if it just occurred. However, we are nearly 11-years from the stock market's bottom in March of 2009. What has occurred afterwards is the single longest bull market in US history. The Dow Jones Industrial Average (DJIA) index opened up in 2010 at 10,431 and closed the decade at 28,538, up 174%. Our preferred index representing the US equity market is the S&P 500, which has soared by roughly 350% from that low point. US corporate earnings have grown by more than 150%, balance sheets have never been stronger and companies have executed a record number of buybacks and dividend increases.

Not all sectors have performed equally. For example, energy was volatile and generated lackluster returns. Brent crude oil peaked in 2012 at $128.40 per barrel and bottomed in January 2016 at $27.10 per barrel. While oil started the decade at $78.49 per barrel, it ended 10-years later at $66 per barrel. Despite the advancements of shale exploration, which allowed the US to became energy independent, this was a lost decade for energy investors.

On the flip side, it would be easy to claim this period as a decade for technology innovation. On January 27th, 2010, Apple announced the creation of its iPad and its stock traded at $29.55 per share. A decade later, Apple closed 2019 at $293.65 per share, up nearly 900%. Back in 2010, Blockbuster was delisted from the NYSE. Its competitor, a start-up called Netflix, started trading that year at $7.93 per share. Netflix, which closed 2019 at $323.57 per share, was the S&P 500's biggest percentage gainer, up nearly 40x.

A decade ago, the term FAANG (Facebook, Apple, Amazon, Netflix and Google) didn't exist. Nowadays, nearly every retail investor proudly claims each of these in his or her personal portfolio. Institutional managers and index funds have these stocks within their portfolios and they now account for a whopping 12% of the total value of the S&P 500. Since the beginning of 2010, these five stocks have collectively gained an average of 1,600% (per TD Ameritrade). Apple, Microsoft and Google all now exceed $1 trillion in market capitalization and are founding members of the *Four Comma Club* (i.e. $1,000,000,000,000).

The US equity market continues to outperform Europe and the RoW (rest of the world), but this should not be a revelation to anyone. Over the last 3 decades, the US has handily outperformed the RoW markets. The flagship Shanghai Composite index dropped 6.9% for the decade ending on December 31st, 2019. While our markets more than tripled, Europe's Stoxx 600 only rose by 64%. In 9 of the last 10 years, the S&P 500 has outperformed the MSCI Emerging Market index. This US outperformance has only accelerated since the Financial Crisis of 2008. While the Financial Crisis originated in the US, our market quickly bounced back.

Following the Financial Crisis, the US government and the Fed pulled every lever imaginable to stabilize our economy. To get growth "back on track", interest rates were lowered to zero and unprecedented bailout programs like TARP, QE1 and QE2 were created. From 2008 to 2015, the Fed's balance sheet ballooned from $900 billion to $4.5 trillion. These actions was specifically designed to strengthen our banks, which tend to be the primary lender for small business and US growth.

The US Treasury and Fed forced US banks to raise capital and strengthen their balance sheets. This was quite different from the European response. European markets continue to be led by their financial institutions, as opposed to innovative technology or manufacturing. In Europe, many banks continued to rely on weak lending practices and credit. European banks remain saddled with ultralow interest rates, tightening regulations and anemic economic growth. Now, throw in some recent US trade tensions and one can easily see why Europe has underperformed. While the US economy is driven by the strength of our ingenuity and technology advancements, Europe seems to be geared off of traditional banking.

For a decade, central banks were the unrivaled drivers of the financial markets and business cycles. In a recession, the Fed has averaged a 5% cut in interest rates. With current US rates below 2%, this is impossible to accomplish. This is the dilemma that both Europe and Japan currently face. How can they stimulate their economies and spur growth, without the ability to lower interest rates any further? Central banks are now left without their principal lever over the business cycle. As former Treasury Secretary Larry Summers recently said, central banks have "exhausted their ammunition".

We will chalk up this amazing decade to a series to events. One, the Fed continued its easing policies and economic stimulus measures. When one then mixes in historically low volatility, trade progress and resilient corporate earnings, the final result is the recipe for excellent stock market gains.

2019:

Before we look forward to 2020, let's take a quick look back at 2019. A year ago, the S&P 500 fell over 9% in December and the 4th quarter saw the market fall by nearly 20%. Following a Fed error (raising rates a third time in December), the market nosedived. During 2019, the Fed decreased interest rates three times and essentially said it was not going to raise rates for the foreseeable future. Without a hint or whiff of inflation, the market can now grow somewhat unencumbered.

The market was nothing short of remarkable last year. The Dow increased 22%, the S&P 500 rose 32%, and the Nasdaq climbed 35%. If we decompose the 2019 S&P 500 performance, we can see that just four stocks (Apple, Microsoft, Facebook and Amazon) were responsible for over 20% of its total return.

Despite significant uncertainty (global trade, Brexit, Middle East tensions, impeachment, etc), the equity markets marched higher. While there were periods of volatility and some bumps in the road, the year was stellar. Global equity markets advanced, as the Stoxx Europe 600 rose 23%, the FTSE 100 was up 12%, and the German Dax increased 25%. Speaking of the German stock market, we find it interesting that the market capitalization of Apple and Microsoft now eclipse every stock listed on the German stock exchange.

Also, if we add the market capitalizations for Apple and Microsoft together, that $2.3 trillion of value exceeds all of the stocks in the S&P 500's Material, Real Estate and Utility sectors. These two companies exceed the value of the 200 smallest companies in the S&P 500 (per Dow Jones Market Data). Clearly, the stock market has become led by a select group of technology companies that dominate their respective niche, reminding of us of the original "Nifty 50" of the 1960's.

Record Highs:

It seems the US stock market is hitting daily all-time highs, with records on the S&P 500, Nasdaq and the DJIA. We recently saw an interesting TD Ameritrade report that stated that an all-time high has occurred on a stock market in 1 out of every 20 trading days, since 1928. While the media likes to sensationalize these all-time highs, they apparently are not that unusual.

Just as the markets reach these peaks, there are bears immediately calling for a recession. These same doomsayers were calling for the end of the bull market in the 4th quarter of 2018 and likely missed out on the market's rise last year. A 2020 survey by the Conference Board showed that the fear of an economic decline topped the list of CEO's worries. A year ago, a recession ranked 3rd on this list of fears. One of the risks we see is that a recessionary mind-set can become a self-fulfilling prophecy.

This CNBC "special report" came out on January 23rd, 2020, when the stock market fell by 1%. Is the stock market really in "turmoil", when it falls 1% from its all-time high? Another recession will occur and another bear market will happen again. We just do not see the ingredients that would lead to that decline.

With the new year upon us, and its strong start, we are hearing people make bold predictions about 2020. Some are saying we shouldn't expect the same kinds of gains this year as we saw last year. Well, that's not much of a prediction considering the equity market's fantastic returns last year.

The US economy is the envy of the world, and stocks are justifiably at record highs. These are historic times for our economy and the stock market reflects these positive fundamentals. Why can't things continue to steadily rise, if nothing material impacts our growth? Following an Instinet study dating back to 1920, after years where the S&P 500 gained over 25%, the following year was higher 67% of the time.

Market Timing:

We strive to follow a long-term perspective and recommend that you also take a long-term approach. We constantly talk about the inability to market time and simply do not believe it can be successfully employed. We historically have had a constant amount of cash available (i.e. 3% to 5%), to deploy when the opportunity arises. However, our preference is to remain fully invested in wonderful, securely-growing FINTECH businesses.

Let's examine the long-term success of an investor that claims to have awful timing and luck. We know quite a number of people that say that they have the worst luck and always pick the absolute worst time to invest. How would you have done putting money into a basket of equities (at all-time highs), right before significant market corrections? How would you have fared if you invested in the S&P 500 right before August 1987, the Dot-Com Crisis of March 2000 or the Financial Crisis of October 2007. Well, that "unlucky" investor would be up 925%, 105% and 100% respectively. Not too shabby, right? The volatility and ride would have been a challenge, but the result would have been remarkably positive.

We are not saying you should ignore the market's valuation, nor blindly invest. Excluding the S&P 500s gain of 32% last year, from 1926 to 2018, the US equity market has averaged an annual return of 10%. Instead of market timing, we believe in a long-term approach to investing, with a dependable process, strategy and philosophy.

2020:

Globally, we expect a positive environment, especially with these trading tailwinds. With the House of Representatives passing the USMCA trade deal, we think 2020 will be a year of shaking hands, signing ceremonies and photo-ops. While many of these trade deals have taken awhile to come to fruition, deals are getting approved and signed. We believe the US is in a "sweet spot" right now.

The USMCA trade deal replaces the 1994 North American Free Trade Agreement (NAFTA). On the same day as House Speaker Nancy Pelosi announced impeachment findings against President Trump, she heralded the accomplishment of USMCA. After threatening to derail this trade pact (due to Mexican labor laws), Speaker Pelosi agreed to proceed with a House vote. Once the labor rules were strengthened, the AFL-CIO has taken the rare step of endorsing a US trade deal with an emerging market. While the market has been focused on Chinese relations, the success of a new USMCA trade deal should not be overlooked. Canada and Mexico are our two largest trading partners and the US exports more than 5x as much to our two neighbors, as compared to China. Once this agreement passes both legislative chambers, the USMCA deal will be heralded as the largest trade agreement in the world. While each country is claiming that it will create hundreds of thousands of new jobs and usher in a wave of new prosperity, only time will tell.

Last month, the UK voted and handily elected Boris Johnson as their Prime Minister. He has emphasized a desire to proceed with Brexit and his mandate is now clear. The UK should exit the European Union shortly and we expect the US and the UK to quickly put together a trade deal, to solidify their trading terms. The US and UK generate $230 billion of trade each year and 1/5th of all UK exports come to the US. A US/UK trade deal would help to ease UK uncertainty and show that the it can drive growth and business, not just divorce itself from the rest of Europe. In our opinion, trading tensions are easing and 2020 should be an environment of tailwinds, not headwinds. We don't want to look too far out into the future, but we believe the short-term trading environment is materially improving.

Valuation:

For those bearish individuals out there, the usual crutch they lean on is valuation. As the P/E chart shows, using forward 12-months earnings, we are not above 20x. While this is far from cheap, we do not believe we are in bubble territory. While it is easy to look at the overall valuation of the market and make blanket statements, we prefer to specialize in our niche and focus just on our FINTECH industry.

We agree that certain pockets of the market are expensive. For example, we are increasingly becoming worried about corporate credit, junk bonds and the lowest rung of investment grade debt. See our last page, for some scary details. Also, we think that certain private equity names are trading at unrealistic levels. When the market gets full disclosure and transparency, it can properly assign a value (i.e. WeWork).

Whether one looks simply at earnings or even factors in corporate balance sheets (using enterprise values), valuation are high, but not excessive. When looking at an EV to forward EBITDA valuation, we just eclipsed 12x. While not cheap, the overall market is not elevated to an extreme.

We view the year ahead from a glass half full perspective. Overall fundamentals appear supportive for a continuation of equity outperformance. There are numerous positive catalysts in place for growth to come in "better than some fear". Over the next year, we think global interest rates will increase, as spreads gradually widen. As recessionary fears lessen and trade policies improve, we believe US equities will remain the best place to invest.

Now, let's dive into some specific topics and timely fundamental issues….

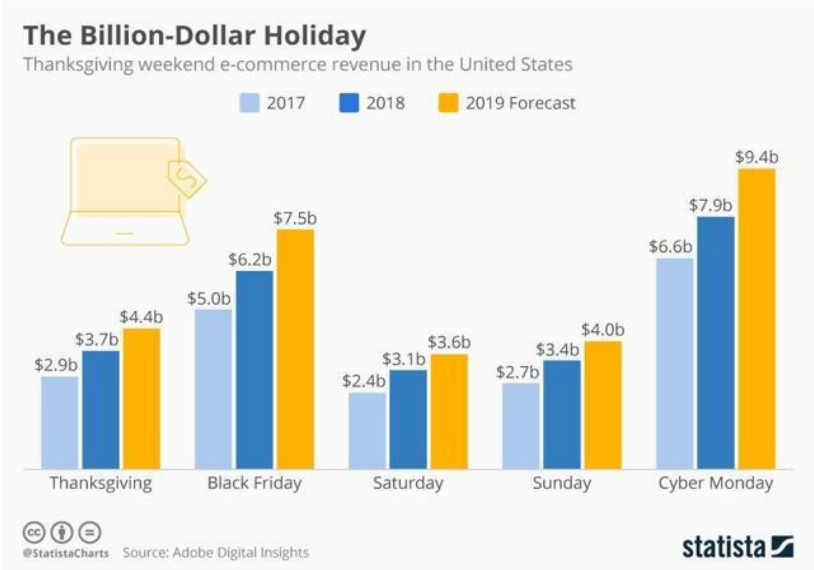
The US Consumer:

As Sir John Templeton said, "bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Where are we right now? Based on the strength on the US consumer, we would say we are in the optimism stage. The US unemployment rate of 3.6% is at a half century low point, average hourly earnings are up 3% year-over-year and household income is at its highest level in 20 years.

The US consumer represents around 2/3rd's of our GDP and is the real hero of our stock market expansion. Quite simply, when people are gainfully employed, they will spend. For example, staying on trend in the denim and jean space can be exhausting. Are hipsters wearing skinny, stretch, gently flared or ripped jeans? As the US consumer keeps their wardrobe up-to-date, it can be an expensive proposition. From our perspective, these purchases all contribute to the bottom line of our payment companies. Looking at last year's holiday shopping season provides the data we are referring to.

The bulk of the holiday shopping period can be summed up from Thanksgiving to Cyber Monday. According to Adobe Analytics, which tracks hundreds of retail websites, online sales increased to $7.5 billion on Black Friday, up 20% from last year. Cyber Monday has become the busiest online shopping day of the year and revenue grew 19% last year.

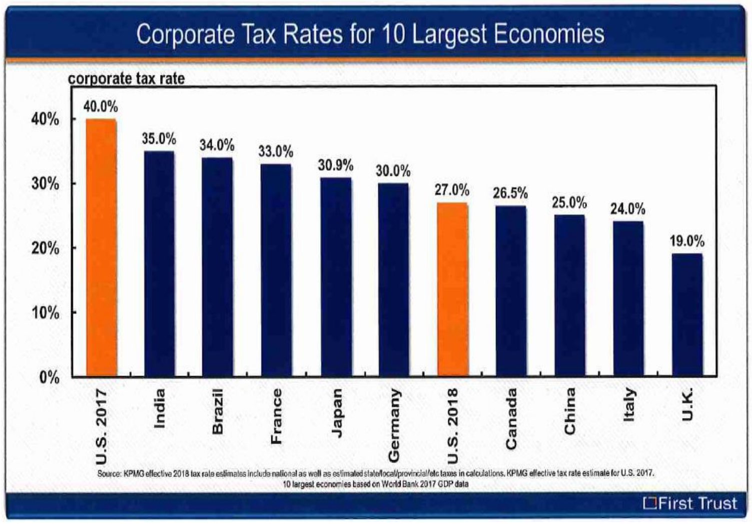
While foot traffic to US stores remains in a free-fall, the trend towards online sales continue to accelerate. More shoppers are ordering online (which requires a card) and forgoing the hassle of that retail battleground.



Growth:

Last year, US GDP grew 2.3%, falling from 3% in 2018. That year's growth might have been slightly boosted from the 2017 tax reform package, while 2018 was negatively impacted by trade tensions. While some complain that the tax reform changes only aided corporate America, at the expense of the consumer, we believe that it shortsighted.

As this chart shows, US corporate taxes were too high and needed to get more in-line with other large global economies. Now that the playing field is leveled, US businesses have a much better opportunity to succeed. As US corporations do better, their employees are better off, in the form of higher wages. This virtuous circle should allow the US to steadily grow and deliver excellent returns.



The global economy continues to grow at a 3% pace, but this is the lowest rate since the economic crisis. According to the IMF, 2020 global GDP growth will only modestly improve to 3.4%. In the US economy, we believe that the bar has been set relatively low. Some growth estimates for real GDP remain below 2%. While we would love to see 4% GDP growth here in the US, we think that could be aggressive. A stable US environment should lead to continued, steady growth of 2.5% to 3.0%.

Emerging markets may be able to grow at a mid-single digit pace, but those markets come with significant risk and volatility. We prefer the slow, but steady growth of the US. December 2019 was quite good for the market, with the S&P 500 rising by over 3%. This was the 19th time since 1950 that the stock market gained over 2.7% during December. What does the Santa Claus rally tell us for January and 2020? When the S&P 500 has gained 2.7% or more in the month of December, it then averages a nearly 1.0% rise in January and finishes the year higher 2/3rd's of the time. January 2020 is off to a wonderful start too, rising another 2%. While these little statistics make for interesting reading, we are much more focused on the fundamentals.

Many analysts are expecting the US equities market to grow 5% to 10% in 2020, which would be more in-line with its historical averages. Nobody seems to be predicting the equity markets could climb like it did in 2019, but nobody thought 2019 was going to be the best year since 2013. Corporate earnings for the 4th quarter of 2019 are just now getting released. FactSet estimates that S&P 500 earnings last quarter will fall another 1.8%, marking the fourth consecutive quarter of declines. After a few quarters of lackluster results, we anticipate a rebound and growth to re-appear. Keep in mind that there is a traditional sell-side trick of cutting one's forecasts (prior to earnings) to the point that companies can then easily report and beat Street estimates. FactSet has reported, that over the last 5 years, actual S&P 500 earnings have beaten Street estimates by an average of 5%.

Analysts are estimating that 2020 S&P 500 revenue and earnings growth will be 5.4% and 9.6% respectively. This inherently assumes that profit margins have been under pressure due to the trade war and that they will rise this year. With higher labor costs, we believe 2020 growth might be a year where average companies finally begin to struggle. Nearly 40% of US listed companies reported losing money over the last 12-months. Of this groups largest 100 companies, 75% of them still saw their stocks increase last year.

We think 2020 year could be categorized by market share gains for the industry leaders, while second and third tier players will decline. With higher volatility, we anticipate the days where "a rising tide lifts all boats" will end. This disconnect of losing money resulting in stock price appreciation should ultimately end. We believe that some investors are placing too much emphasis (and valuation premium) on market disrupters, as opposed to free cash flow generation. Manole Capital prioritizes free cash flow, which guides our process and is embodied throughout our FINTECH portfolios.

Washington / Impeachment:

On December 16th, lawmakers unveiled a new $1.4 trillion spending package, that essentially keeps the federal government funded through September 2020. Every 1 to 2 years, a government shutdown typically worries the stock market and causes a temporary pull-back. By passing this spending package, the short-term risk of a government shutdown is all but removed for another year.

Then, on December 18th, the House of Representatives voted to remove President Trump, under two different articles of impeachment (abuse of power and obstruction of justice). The votes were nearly along party lines with a couple of Democratic defections and Representative Gabbard (Democrat from Hawaii) voting "present". The ongoing Senate trial will almost certainly result in acquittal. At this point, the unknowns are the length of the Senate trial, the witness list and what are the political implications for Democratic senators running for president.

Now that impeachment has reached the Republican control Senate, the process will take a different path. Unlike in the House, the Senate does not need a simple majority to impeach. The Senate requires a 2/3rd's vote to remove President Trump from the White House. The Senate is comprised of 47 Democrats and 53 Republicans, so getting 20 Republicans to turn will be a very difficult task. Anything less than 67 votes to convict President Trump makes this impeachment process meaningless. This clearly tarnishes the legacy of President Trump, as he becomes only the 3rd US President to get impeached. However, we do not believe this will pass and therefore the market is more concerned with growth, trade and economics, rather than "DC theatre".

Whether you are a Republican, Democrat or Independent, it does not matter. Both Wall Street and Main Street believe this impeachment process is going nowhere. This is clearly what Wall Street believes, as the market has rallied throughout this Washington DC turmoil. We will get Main Street's thoughts in November.

The Election:

In less than a year, Americans will once again have an opportunity to entrust someone with the job of protecting their security and our liberties. While the actual Presidential election isn't for another 9 months, the Democratic party selection process starts soon. Iowa votes on February 3rd, New Hampshire is February 11th and then Nevada votes on the February 22nd.

Various polls show that President Trump is receiving mediocre approval ratings, but this isn't surprising. After polls failed to accurately forecast the 2016 election, these cannot be relied upon. It does seem like Team Trump has a sense of optimism around the 2020 campaign, primarily because of the economy. Why does President Trump continue to emphasize the economy, its positive growth and the records recorded daily on the stock market? It is because over half of Americans own stocks, either directly or through IRA's and 401k retirement programs. It seems as if the Trump re-election campaign will be judged on the Reagan standard of "Are you better off today than 4 years ago"?

Central Banks:

For over a decade, the Fed and other central banks have been the drivers of financial markets and the business cycle. Through QE, stimulative measures and historical low interest rates, central banks have provided the fuel for this stock market rally. We believe this era might be coming to an end. Many countries have negative interest rates, so central banks cannot lower them further. With tepid economic growth and low inflation, interest rates cannot be raised either.

Interest rates have been the primary central bank lever, so this leaves them ill-equipped to handle what could be a perilous road ahead. Just three months into the Fed's decision to re-start buying T-bills, the S&P 500 is up 11%. Clearly, this lifts markets. This is just one example of the massive stimulus global central banks continue to pump into economies around the world. We remain optimistic partly because of these dovish monetary policies.

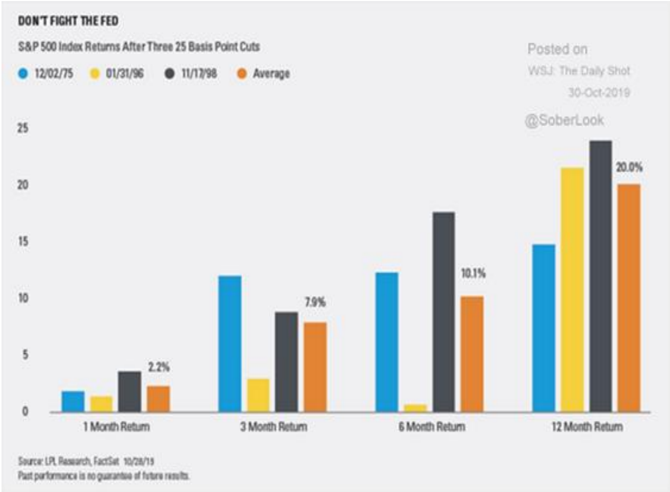
As the US economy slowly recovered, many were worried about the next big threat – inflation. Experts were justifiably calling for heightened inflation, from these historically low interest rates. With the cost to borrow essentially at zero, the logical conclusion was that inflation would begin to significantly exceed the Fed's target of 2%. Despite injecting trillions into our economy and financial system, inflation did not rear its ugly head.

A decade has passed and the Fed continues to struggle with when that inflation "day of reckoning" will occur. There are pockets of higher prices (example: college tuition, says the guy with a 17-yr old), but nothing that has reached the point where it becomes worrisome. With the economy continuing to march steadily higher and below-target inflation, we do not expect the Fed to act anytime soon.

The Fed:

In November, Fed Chairman Jerome Powell warned Congress of today's different environment. He said, "the new normal now is lower interest rates, lower inflation, probably lower growth…all over the world." In light of this new environment, he highlighted that the Fed is studying ways to alter its strategy, to develop various tools that can assist the economy when rates approach zero again. Powell can hope that Congress can generate more in tax revenue, lower spending and curtail massive deficits, but that is wishful thinking. Fiscal policy should begin to replace monetary policy, but that likely is not going to happen. For the foreseeable future, US business growth should continue to thrive. We believe these comments can be perceived as support or a "Fed backstop", which should support US equities this year.

As we discussed in our last quarterly newsletter, it can be foolish to "fight the Fed". Every bull market has minor corrections. Three interest rate increases in 2018 culminated with the S&P 500 declining by nearly 20% in the 4th quarter of 2018. In May of last year, the market fell 7% and then declined 6% in August. The Fed quickly reversed course and lowered interest rates 3 times in 2019.



As this chart shows, the stock market performs quite well following three 25 basis point reductions, with an average gain of 20%. If the Fed is on hold until it sees meaningful inflation, it might be sometime before we see rates rise again. We believe the Fed has been looking for 2% inflation for over a decade and it seems to be an unattainable goal. For those readers that were investing in the 1970s, this will sound foolish. However, one wouldn't think that a modest 2% inflation target would be un-attainable. Rather than high inflation bringing with its risks, the real worry is that we become Europe. That is, a slow growth environment, with easier monetary policies that do not stimulate the economy.

Historically, when economies began to soften, central banks could utilize a dovish rate policy to stimulate growth. At this point, the Fed and ECB have started to look around for answers. There is very little room to lower interest rates again, as Europe's experience with negative rates has yielded little benefit. Economists call this "pushing on a string". Lower rates have failed to stimulate the economy and have actually led certain investors towards riskier assets. Bubbles in real estate, private equity and equities can result from extremely low and persistent interest rates.

Europe:

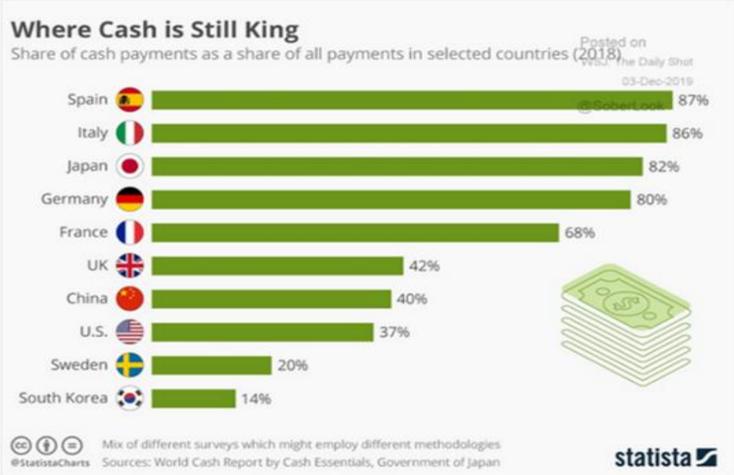
The Eurozone economy is struggling and is flirting with stagnation. The ECB (European Central Bank) lowered their economic growth projections to 1.1% this year. Christine Lagarde is the new ECB President and she takes over for Mario Draghi at a very difficult time. Interest rates cannot go any lower and her ability to provide stimulus through monetary stimulus is limited.

Germany remains Europe's largest economy and it equates to 1/5th of total European GDP. Economic growth in Germany slumped to a 6-year low in 2019, as this export powerhouse is facing numerous challenges. For example, Germany still heavily relies upon growth in the automobile industry and it is estimated to be one quarter of its manufacturing sector output. According to the VDA auto lobby group, German 2019 car production fell to its lowest level in almost a quarter of a century and is showing signs of vulnerability. German GDP growth was only 0.6% last year, which was its lowest output since the 2013 eurozone debt crisis.

Sweden's Riksbank has somewhat swum against the tide of global monetary policy by hiking its benchmark repo rate by a quarter point to 0.0% from minus -0.25%. That move, which ends 5 years of negative rates, may have other central banks acknowledging that low rates are not a "magic pill". The Bank of Japan (BoJ) voted 7-2 to keep short-term interest rates at minus -0.10% and long-term rates at around 0.0%. Kicking this unconventional monetary addiction will not be easy.

Cash is King?

No newsletter or piece of research from Manole Capital would be complete if we didn't discuss the payment sector and the opportunity we see in digital payments. Despite several years of excellent digital payment growth, at the expense of cash, there remains significant upside and growth potential.



As this chart shows, cash remains the dominant form of payments in many countries. Some are surprised to learn that developed countries like Japan and Germany still conduct the vast majority (over 80%) of their payments via cash.

Digital payments are growing in both emerging and developed markets. For example, Canada is showing that cash is no longer king. Canada has evolved into a sophisticated payments market, with wide acceptance of both debit and credit cards. For the first time ever, debit card usage in Canada has overtaken cash. *Mobile Payments Today* has reported that Canada's cash payments have decreased by 40% over the past five years. Electronic payments now account for 73% of total payment transactions and 59% of total payments value. These trends give us confidence that there are decades of growth ahead for our payment companies, as they earn *revenue per swipe* and capitalize on our theme of "winning by breathing".

So our 51st state (i.e. Canada) has embraced electronic forms of payments, but where do we stand here in the good ol' US of A? A recent Fed study shows that cards have systematically and continuously eaten away at paper check volumes. In 2018, there were 16 billion checks written, with a total value of $26.2 trillion. However, the last 20 years tells a remarkable story of market share losses. At the turn of the century, checks were 58.8% of all non-cash payments, but are now only 8.3%. If one measures the value of checks written, it has dropped from 2/3rd's market share to only 26.6%.

We feel bad for those people that are stuck behind the person paying with a paper check at the register, but it still occurs. The number of checks presented as payment was 14.5 billion in 2018, but it is falling at an annual pace of over 7% per year. The decline in paper checks is noteworthy and we feel very comfortable that check writing will continue to fall.

China and India are still primarily cash-based economies, which is high hassle and high friction. India's government has been pushing to abandon cash and go digital, partly to improve its tax collections. Moving away from physical bills was one way for the government to receive more in tax revenue, as most cash transactions happen "under the table". However, the reason digital payments eventually exploded in India was due to convenience and ease-of-use, for both merchants and consumers.

China's mobile payment resurgence was spurred on by advancements of technology and companies filling the void of traditional banking entities. The Chinese Lunar New Year is the largest annual human migration on earth, when millions of Chinese citizens travel to see family and friends. With this celebration, some Chinese gift billions of yuan with each other. Historically, these gifts occurred in cash, in red envelopes called *hongbao*. Starting in 2014, TenCent's WeChat Pay captured the imagination of millions of Chinese by introducing the ability to send money via its mobile app. Alibaba's Alipay quickly followed, allowing Chinese consumers to send and receive virtual *hongbao*, through their smartphones. Now, WeChat Pay and Alipay each have over 1 billion active users and mobile payments are exploding higher in China.

Glass Half Full:

Most news channels are more apt to show the negative, than the positive, as sensationalism makes for better TV. There are few that would claim that 2010 to 2019 was the greatest decade ever, but it certainly had its positives. Instead of solely focusing on the negatives, let's now look at some bigger picture, non-economic statistics.

The United Nations Development Report cites that "the gap in basic living standards is narrowing, with an unprecedented number of people in the world escaping poverty, hunger and disease." According to the World Bank, over the last decade, the global rate of extreme poverty fell by more than half. In fact, the World Data Lab found that half of the world's population can now be considered "middle class."

Many people claim that this growth and improvement has come at the cost of our environment. There is no doubt that we continue to impact the environment. Weather patterns are getting more violent and global warming remains a challenge. There is much we can do to lower our pollution and decrease our carbon footprint. However, death rates from air pollution have declined by 20%. In addition, companies are making significant strides in developing clean technologies. The last decade has seen wonderful growth and progress in science, technology, and innovations.

Healthcare progress has never been better. More people have access to clean water, better sanitation, as well as basic medicine and vaccines. The incidence of malaria in Africa is down by nearly 60% and HIV/AIDS deaths are down by over half. Childhood deaths have declined from 5.6% in 2008 to 3.9% in 2018 and overall life expectancy has risen by an impressive 3 years (per a UN study).

We feel that mankind can create faster than it destroys. We hope that humans can develop and repair, quicker than we squander. We simply believe in free markets, despite what the news cycle focuses on. If the last decade is used as an example, things are getting better, not worse.

Conclusion:

We never market time and believe it cannot be done successfully. We analyze all of our companies from the "bottom up" and are fundamental, active money managers. The bull market story for 2020 is economic re-acceleration. This is not the consensus viewpoint, as many foresee the end of this nearly 11-year old bull market. The US economy continues to deliver and the Fed appears to be accommodative. Inflation is nowhere to be seen, unemployment is at 50-year lows and the consumer is happy and spending. We are pleased with our FINTECH portfolios and believe that they will continue to generate outperformance.
We look forward to speaking with you soon!

Warren Fisher, CFA
Founder & CEO
Manole Capital Management

Quotes:

- "Don't confuse brains with a bull market", Humphrey Neill
- "Life is too short to wake up in the morning with regrets. So love the people who treat you right, forgive the ones who don't & believe that everything happens for a reason. If you get a chance, take it. If it changes your life, let it." Dr Seuss

Bitcoin:

- Shark Tank star Mark Cuban says there's "no chance bitcoin can become a reliable currency"
- Cuban said "it's too difficult to use, too easy to hack, way too easy to lose, too hard to understand, too hard to assess a value."

Debt:

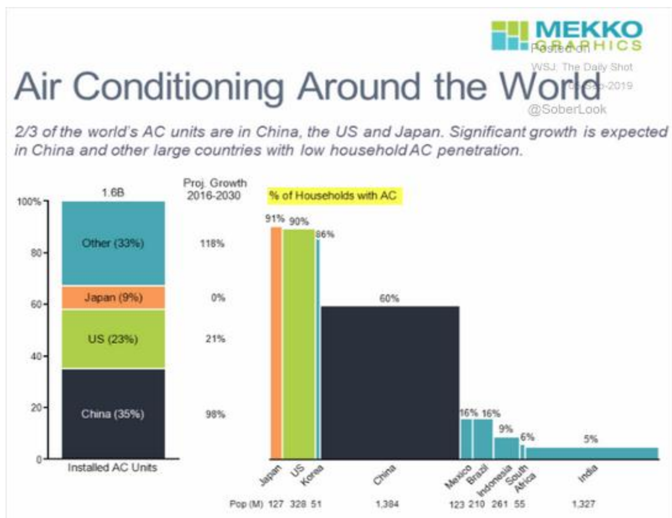
- US consumers hold $14 trillion in debt (cards, student debt), while the US gov't owes $23 trillion
- Without serious consideration for reducing gov't spending, US debt service levels are ~ $500b / yr
- A decade of central bank addiction and historically low interest rates have ballooned corporate debt
- US corporations have issued nearly $10 trillion of debt
- BBB-rated debt is the lowest rung of investment grade debt
- During the Financial Crisis, BBB-rated companies were forced to pay 7% higher rates, than quality co's
- Today, this spread is under 1.5% and investors now hold $4 trillion of BBB-rated bonds

Foreign Ownership:

- Only 3.1% of China's locally listed stocks are owned by foreign investors
- In the US, Japan and the UK, foreign ownership is 22%, 30% and 38% respectively

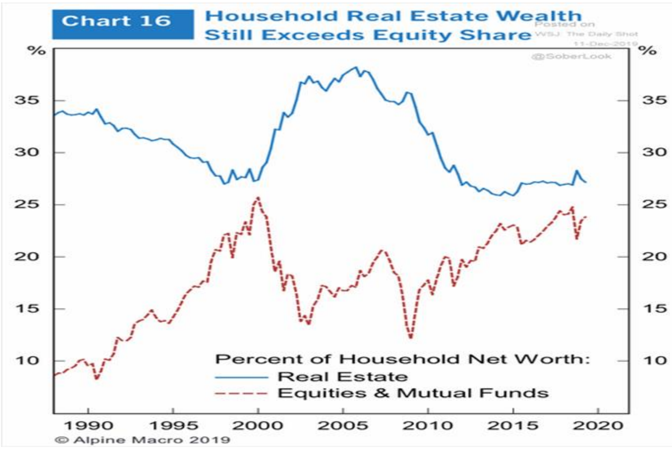
Air conditioning:

- Climate advocates say A/C's contribute to global warming
- In our opinion, A/C's were a fantastic invention
- As Floridians, we are heavy A/C users
- More people use A/C's to improve their quality of life
- Only 5% of Indian HH's have A/C; only 16% in Mexico
- Who are we to withhold cold air from the masses?



Real Estate:

- After a decade long bull market, RE > equities
- US HH real estate net worth is greater than the value of all equities and mutual funds



Football:

- The KC Chiefs will play the SF 49ers in Super Bowl LIV
- For a change, the NE Patriots & Tom Brady will not be playing
- We got a chuckle from this Boston Globe article from 2000
- Maybe the Miami Dolphins win a SB for the 1st time since '72?
- We aren't holding our breath

Patriots will regret hiring Belichick

IAN O'CONNOR

ATLANTA – Bill Belichick almost never returned fire on Bill Parcells, at least for the viewing pleasure of the Jets. When Parcells raged at his devoted aide, blistering him for being the nearest available serf, Belichick would turn

Basketball & Business:

- It was very sad to hear of Kobe Bryant's death on Sunday January 26th
- Kobe had a legendary basketball career and was just starting his business life, post-playing days
- Here's 2 links, on *The Players Tribute*
- The 1st quickly discusses Kobe's love letter to basketball, titled "Dear Basketball"
- The 2nd is Kobe's "Letter to My Younger Self", as Kobe went straight from high school to the NBA
- Both are excellent quick reads, touching on items beyond just basketball

The Players Tribune: Dear Basketball Article
The Players Tribune: Kobe Bryant Letter to My Younger Self

MANOLE CAPITAL MANAGEMENT

DISCLAIMER:

Firm: Manole Capital Management LLC is a registered investment adviser. The firm is defined to include all accounts managed by Manole Capital Management LLC. **In general:** This disclaimer applies to this document and the verbal or written comments of any person representing it. The information presented is available for client or potential client use only. This summary, which has been furnished on a confidential basis to the recipient, does not constitute an offer of any securities or investment advisory services, which may be made only by means of a private placement memorandum or similar materials which contain a description of material terms and risks. This summary is intended exclusively for the use of the person it has been delivered to by Warren Fisher and it is not to be reproduced or redistributed to any other person without the prior consent of Warren Fisher. **Past Performance:** Past performance generally is not, and should not be construed as, an indication of future results. The information provided should not be relied upon as the basis for making any investment decisions or for selecting The Firm. Past portfolio characteristics are not necessarily indicative of future portfolio characteristics and can be changed. Past strategy allocations are not necessarily indicative of future allocations. Strategy allocations are based on the capital used for the strategy mentioned. This document may contain forward-looking statements and projections that are based on current beliefs and assumptions and on information currently available. **Risk of Loss:** An investment involves a high degree of risk, including the possibility of a total loss thereof. Any investment or strategy managed by The Firm is speculative in nature and there can be no assurance that the investment objective(s) will be achieved. Investors must be prepared to bear the risk of a total loss of their investment. **Distribution:** Manole Capital expressly prohibits any reproduction, in hard copy, electronic or any other form, or any re-distribution of this presentation to any third party without the prior written consent of Manole. This presentation is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use is contrary to local law or regulation. **Additional information:** Prospective investors are urged to carefully read the applicable memorandums in its entirety. All information is believed to be reasonable, but involve risks, uncertainties and assumptions and prospective investors may not put undue reliance on any of these statements. Information provided herein is presented as of December 2015 (unless otherwise noted) and is derived from sources Warren Fisher considers reliable, but it cannot guarantee its complete accuracy. Any information may be changed or updated without notice to the recipient. **Tax, legal or accounting advice:** This presentation is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations. Any statements of the US federal tax consequences contained in this presentation were not intended to be used and cannot be used to avoid penalties under the US Internal Revenue Code or to promote, market or recommend to another party any tax related matters addressed herein.