Manole
Capital Management

Manole Capital Management
Commerce Club at Oxford Exchange
E-Mail: warren@manolecapital.com
Website: www.manolecapital.com

1st Quarter 2017 Newsletter

January 2017

Introduction:

As we change our calendars to 2017, we want to wish you a happy, healthy new year. Thank you for your interest in Manole Capital. As of today, we remain the largest personal investor in our products, with a portfolio that provides excellent upside and growth.

We consider Manole Capital a boutique manager, focusing attention on a growing, secular niche – "Fin Tech". We continue to see a large opportunity for growth in this still mostly undiscovered area. While, there are hundreds (maybe thousands) of teams building diversified equity products, it is not our intention to compete with traditional, bulge bracket asset managers. Instead, we focus our attention on building concentrated, actively managed portfolios, that may not be well-suited for everyone. As you read this newsletter, we hope you will get a clear and concise understanding of our unique investment style. For specific details on our "Fin Tech" product, including holdings, composition and specific portfolio metrics, please visit our website.

In prior newsletters, we posted individual stock recommendations and company specific research. Going forward, in our quarterly newsletters, we will attempt to highlight some current market issues and trends. We will comment on what we view as important to the overall markets, such as the political environment, interest rates and inflation. While we are not macro economists and will continue to focus on doing bottom-up, fundamental research, we use this newsletter to examine bigger picture issues, and how these might impact our portfolio of companies. While we will also continue to write detailed sector and stock-related articles, these will be distributed through email and posted to our website at www.manolecapital.com.

Recapping 2016:

2016 was the most eventful year since the Financial Crisis. The 1st quarter started off terribly, with the worst ever five-day start to a year. Following a US interest rate increase in December of 2015, the worry was that higher rates would dampen growth and push the US into a recession. Investors also feared a hard landing in China, after many years of exceptional growth. By February 11th, oil hit a 12-year low of $26.21 a barrel. These crude declines took high-yield bonds and energy-related master limited partnerships down. This coincided with the Dow Jones Industrial Average (DJIA) hitting a low for the year of 15,660. The Bank of Japan embraced negative interest rates, which then impacted European interest rates. US bonds surged as investors flocked to the world's largest and safest market. By the end of March, commodities fell and gold experienced huge inflows for its best quarter (up 16%) since the 3rd quarter of 1986.

During the 2nd quarter, Apple (the world's most valuable company) had its worst quarterly drop in revenues in 13 years. The US dollar fell to a yearly low and any expected Fed interest rate hikes seemed unlikely. By the end of the quarter, Britain surprised the world with its decision to leave the European Union. While the market materially declined following Brexit, this ultimately only lasted 2 days. In the 3rd quarter, the 10-year Treasury yield fell to an all-time low yield of 1.366%, while gold hit a yearly high of $1,365 per ounce. Donald Trump became the presidential nominee for the Republican party, defeating 16 other candidates.

The 4th quarter of 2016 will not be forgotten. Brexit was the dress rehearsal for the biggest surprise of the year – a Trump presidency. On November 8th, Donald Trump beat Hillary Clinton to become our 45th US President. While the initial response was quite negative, the equity market began to look forward and forecast some of Trump's positive economic policies. Investors were enthusiastic about an expected pro-growth agenda and the equity market hit all-time highs for back-to-back days for the first time since the technology bubble. In another surprise move, OPEC agreed to reduce its output, which immediately caused a 10% rise in energy prices. The energy sector, which has struggled for the last few years, finished off 2016 strong. Crude prices rose 45% and the energy sector led the entire market with a performance of +24%. On December 14th, the Fed raised US interest rates by 25 basis points, for only the 2nd time in a decade. After Treasuries hit their low during the summer, yields surged and had their largest quarterly gain since 1994. The US dollar rose 3.1% and soared to highs not seen since 2002. For the 1st time ever, the DJIA hit 19,000 on its way towards another milestone mark – 20,000.

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The Election:

Our biggest takeaway from 2016 is *change*. American voters did not want the "status quo" and considered Donald Trump their agent of change. With a Trump administration, the agenda is calling for healthcare reform, corporate tax changes and potentially widespread de-regulation. At the same time, his more populist policies are resonating not just here in America, but across the globe. As we articulated in our Election Note last month, we believe the markets will be more volatile and unpredictable over the year. There is simply too much uncertainty within the Trump administration, and many of his antics will spook the market. On the campaign trail, Trump advocated for less regulation, lower taxes and more fiscal spending. If implemented, these policies should lift an economy stuck in its slowest recovery since the postwar era. However, for the next few months, many of his proposals will be uncertain and unknown.

Over the first few quarters of this new administration, we expect pro-growth policies to benefit the equity markets. One safe prediction about a Trump presidency is that it will be controversial. Trump will get the benefit of a unified Congressional base, but we also expect fights between conservative and moderate Republicans. Trump will be challenged to switch from terrorizing the DC establishment, to beginning to work with it to govern. It will not be easy to confirm a cabinet, pass a budget, repeal Obamacare, overturn aspects of Dodd-Frank, reform corporate taxes, fill an open Supreme Court seat as well as deal with complicated global trade deals. Whether you approve of his policies or not, decision-making and change is coming to Washington, and in our opinion, now comes the hard part.

The Market Rally:

Election Day is traditionally a high-water mark or a moment of maximum uncertainty. Once Election Day came and went, our market handled the initial shock and promptly responded. Following the surprise Trump victory on November 9th, the stock market has been rallying. The market craves clarity and despises uncertainty. Prior to the election, the market had to grapple with two very different candidates proposing very different agendas. With the victory, the stock market got some desired clarity. As we continue to get more information and predictability, the markets should react positively and the rally could be much longer and stronger than many believe. The bigger question for us remains how sustainable it is.

The S&P 500 has risen 8% since the Trump victory, which has added roughly $1.7 trillion dollars of value to the US equity market. This post-election rally matches the strong response following Ronald Reagan's victory in 1980. Since 1928, there have been four cases where a Republican has taken power following a Democrat (Eisenhower, Nixon, Reagan and Bush). Each time, the equity market fell during that president's first year in office, by an average of 10%. As the market continues to march higher, it seems that most conversations have turned towards not if, but when we will correct. Could investors be in for a similar drop? Using the same time analogy to Reagan's victory, the equity market fell by 20% after roughly 18 months. We provide some counterpoints to this Reagan era analogy, as the comparison seems inappropriate to us. First and most importantly, we do not see the conditions to merit this pessimism and we do not see the signs of a recession approaching. In 1981, the Fed was actively combating rising inflation and had to deal with double-digit interest rates. The yield curve was inverted for Reagan's first two years in office and the overall credit market was in disarray. Whether Reagan took office or not, a recession was coming in 1981.

We are in a vastly different environment today as we approach the Trump inauguration. With unemployment at 4.6%, we are currently running at a nine-year low. If current trends continue, unemployment will be under 4% in 12 months. Not only are we near full employment, but worrisome inflation has been tame at under 2%. While we believe higher inflation is coming, it is not an immediate concern. We still have an accommodating Fed, a positive yield curve, high consumer and small business confidence, relatively low household debt levels and delinquency rates, as well as a positive global growth outlook. The market is beginning to price in a stimulus program and multi-year infrastructure spend which should also boost growth. If Trump successfully reforms corporate taxes, we anticipate a continued bullish equity market. If Trump follows through on some of his de-regulation promises, we would expect the financial sector to perform quite well. This bodes well for our portfolio, as we have properly positioned and designed our product to benefit from these trends in 2017.

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Taxes:

Trump's victory will embolden Republicans to tackle one of their core tenets – tax reform. While there might be differences of opinion concerning trade and immigration, the Republican establishment seems to agree on lowering taxes and making the largest tax-code changes since 1986. The current US corporate tax rate of 35% is the developed world's highest rate. On the campaign trail, Trump called for cutting corporate tax rates from 35% to 15%. The thesis is that lower taxes equates to accelerating US economic growth and allowing American businesses to become more globally competitive. Lessening tax burdens on corporations, in theory, will ultimately benefit employees and individuals. One of the biggest impacts, in our opinion, is the benefit to the stock market. If companies can retain more of their free cash flow, they ultimately will be better off. This should lift growth, lift earnings and lift valuations. We believe this only partially reflects the positive response in the equity markets post-election.

Here's one example to prove our point: Let's assume Company ABC generates $1 billion of revenue and has pre-tax margins of 20%. In 2016, this $200 million dollars might incur a corporate tax rate of 35%. With that $70 million tax bill, net income would be $130 million. If we assume that Company ABC is currently valued at a multiple of 18x, the valuation would be $2.34 billion (18 x $130 million). Now take Company ABC into 2017 and see how it fares with a lower corporate tax rate. If we assume Company ABC generates no revenue growth and has no margin expansion, it would again post pre-tax income of $200 million. If we assume a 20% tax bill (instead of 35%), this 15% savings would equate to an additional $30 million dollars of net income (a tax bill of $40 million versus $70 million in 2016). Keeping things constant, if Company ABC is assigned a 18x forward multiple, it has a valuation of $2.88 billion. In this example, Company ABC would garner $540 million or a 23% higher valuation. All of this for a company with no revenue growth, no margin expansion and the same exact forward multiple valuation.

The House Blueprint:

The Trump administration has been very clear that tax reforms are necessary to eliminate all the incentives for companies to move jobs, innovation, and even headquarters overseas. While the above example presented is quite simple, we want to highlight the more complicated *House Blueprint* for tax reform. It is a tax plan based on destination, cash flows and border adjustability. The main point would be corporate taxes getting lowered to 20%, but there are a few other aspects to consider. Companies would be able to write-off investments immediately, instead of capitalizing and then depreciating it over several years. Companies would <u>not</u> be able to deduct net interest expense, which should lower the attractiveness of issuing debt. Today, some companies choose to issue debt, take the interest deduction and then re-purchase their own stock. This tax reform will remove the bias of debt versus equity financing.

Another difference, and its most controversial aspect, would be to create a destination-based tax. This is a cash flow tax that which would materially benefit US companies. The 20% tax rate would apply to revenue minus costs (like labor and parts). Exports would not count toward revenue, while imports would not count towards costs. There are several positives, like the elimination of transfer pricing. Not only will this significantly favor US manufacturing companies, some experts believe it can raise $1 trillion dollars over the next decade. The biggest negative would be a potential violation of WTO agreements. This tax plan relies on a theory that all currencies adjust to market conditions. If enacted, one would expect a strengthening US dollar and large swings in global currencies.

The timing of this reform and its ultimate shape are still quite uncertain. Passing the House should be easy, but moving through the Senate will be more challenging. In the Senate, 60 votes are necessary to avoid a filibuster-proof majority. It could pass tax reform along party lines if it utilizes DC political maneuvers like reconciliation. On Fox News in December, House Speaker Paul Ryan discussed his plans for passing tax reform, not just in his House, but also in the Senate. He said, "the Senate has a filibuster - except for budget reconciliation. But here's the point, for you to be able to use reconciliation and to not have a filibuster, it has to be deficit neutral and so we have to have deficit neutral tax reform." That means Republicans must raise some revenue as they cut taxes, especially since the plan is to cut corporate taxes from 35% to 20%. The *House Blueprint* would lift gross domestic product (GDP), boost capital-intensive industries like manufacturing, remove the incentive to keep cash overseas and eliminate the after-tax cost of capital.

Our current system is a territorial tax, which incentivizes companies to rearrange their operations to avoid paying higher taxes. Last year, some companies employed inversions to change their domicile and lower their tax burden. Companies can choose to book profits in low-tax countries (like Ireland at 12.5% or Canada at 26.7%) and avoid paying a repatriation tax. It is estimated that there is over $2 trillion dollars of capital sitting overseas, just waiting for an adjustment to repatriate this money back to the US. To put this into perspective, this is nearly twice the level of expected operating income for the entire market in 2017. We believe a tax repatriation will help offset some of the revenue losses of corporate tax cuts. Arthur Laffer was the first to argue that tax cuts generate added economic growth that can offset lost revenue. Many believe that employees can benefit from tax reform, in the form of higher wages and salaries. The Cato Institute has presented data showing that the burden of high corporate taxes mainly falls on the average worker, in the form of lower wages. While the intent might be for repatriated assets to go towards greater investments in manufacturing capabilities, we remain skeptical. 12 months following the financial crisis, business investment remained sluggish, down nearly 20%. Companies saw little reason to invest and it took over three more years for expenditures to regain their pre-crisis levels. We believe companies are best equipped to properly allocate valuable capital. Shareholders bear some of the burden of our excessively high tax rate and investors will benefit from a repatriation in the form of higher dividend yields and larger stock buybacks. We are firm believers that tax reform will significantly benefit the stock market.

Buybacks:

Many companies are struggling to post revenue growth and are using some financial engineering to post earnings growth. When times are difficult, management teams can employ cost-cutting measures to improve the bottom line. However, this is not a long-term recipe for success. Failing to invest in facilities, labor or research will ultimately ruin a company. It is our opinion that durable franchises need to generate revenue and free cash flow growth, while continuing to invest for future initiatives in order to deliver solid and predictable earnings growth. We continue to see an overall market that seems unable to generate organic growth. Revenue growth has been modest, with much of reported earnings growth coming from buybacks and lowered share counts. Since the start of 2009, S&P 500 companies have repurchased more than $3.24 trillion of their own stock. Over the last 12 months, S&P 500 companies repurchased over $550 billon of their own shares. Over the last 11 quarters, 20% of the companies in the S&P 500 have decreased their share count by over 4%. By lowering the share count, companies can mask weak growth and still post some EPS growth. In terms of buybacks, the IT sector continues to dominate, representing over 23% of total stock repurchased. Apple, which still has more than $200 billon of cash and other liquid investments overseas, has bought back over $30 billon of its own stock over the last 12 months. The game of cost-cutting to lift earnings has essentially been completed by many over the last few years. The artificial boost to earnings from actively repurchasing stock (lowering the denominator) has also been accomplished. Now is the time companies will need to differentiate. Now is the time companies will need to grow revenues. Now is the time where the strong businesses shine and the weak will falter.

The Dow Jones Industrial Average:

The DJIA, the most widely quoted measure of the US stock market, has lifted $1.6 trillion dollars since the election of Donald Trump, aptly named the "Trump Bump". Over the last century, this is the 2nd best post-election bounce with a six week DJIA lift of over 9%. Trump's proposed agenda of tax cuts, infrastructure spending and deregulation is pro-growth, and is being well received by the equity markets. After hitting 10,000 in 1999, the DJIA hit 20,000 for the first time in December of 2016. The media, especially CNBC and Bloomberg, have been fascinated with this psychologically important milestone of 20,000. We continue to see headlines that the DJIA has closed at an all-time high over and over since Trump was elected president. We frankly do not put much merit in the DJIA.

The DJIA was started by journalist Charles Dow in 1896. His goal was to provide a clear, straightforward view of the overall stock market. With just 30 stocks, the DJIA is a concentrated portfolio of companies weighted by its component stock prices. While many of these companies are strong brands and quite well known, it is far from diversified. To calculate the index average, one simply adds up the 30 stock prices and divides the total by the Dow Divisor. When the index was formed, the divisor was 30. After 120 years, the divisor is now quite small after hundreds of stock splits, dividend payments and component changes. Any index that sets its weights off of stock prices that have nothing to do with the size of the company is a flawed measurement. In fact, this weighting system leads to a few high-priced stocks having an outsized effect on the DJIA. For instance, out of the DJIA's 30 components, Goldman Sachs (ticker GS) has the highest stock price of ~ $240 per share. On

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the flip side, Cisco (ticker CSCO) has the smallest stock price of ~ $30 per share. The market capitalization of GS is close to $100 billion, while CSCO exceeds $150 billion. We have no problem with either company being in the index, as both are world-class companies. Our issue rather is with the weight of each position. Why should GS be 8.3% of the DJIA, while CSCO be 1.1%? Should GS have a greater weight in the DJIA than the combination of JP Morgan, Coke, Intel and General Electric? Valuation is not considered, nor is the sector the company operates in. Further, the weight, as a factor of the stock price alone, can be materially affected by arbitrary stock splits. Since the election, GS has increased by over 30%, but it accounts for nearly 1/3rd of the increase in the whole index. When we think of the US equity market, we prefer to consider the S&P 500 index or the Russell 1000. Both are comprised of hundreds of companies across every conceivable sector. In addition to being more diversified and a better overall reflection of the market, we believe the weightings are calculated fairly. Factors like the size of the company, its market capitalization, as well as liquidity measurements are all considered.

Looking Back:

It seems like just yesterday to us, but it was over 20 years ago when Fed Chairman Alan Greenspan said the equity market is trading with "irrational exuberance". Since the trough of the Financial Crisis in March of 2009, the S&P 500 is up roughly 200%. In our opinion, not enough credit has been given to Henry Paulson and Ben Bernanke for guiding the market through the crisis. Without the very aggressive Fed easing policy, there is no chance we would be hitting all-time highs. Our financial institutions, whether they would admit it or not, have greatly benefitted from the actions taken by our economic leaders during the crisis. Our banks are the strongest in the world, with the best capital ratios and the lowest leverage ratios. It is a huge competitive advantage that continues to benefit their businesses today. Some might have complained about TARP and other programs instituted to save them in 2008, but their resulting strength is the envy of the world.

Looking Forward:

Wall Street strategists all seem to be following the same game plan. As we turn the calendar, the stock market rests near all-time highs, and analysts are forecasting their estimates for 2017. Despite the significant unknowns of a Trump administration, most strategists are unwilling to deviate from the pack. All 10 Strategists in Barron's year-end forecast are calling for mid-single digit gains next year, but none are factoring in tax reform. We are always concerned when we see too much of a market "herd mentality". We believe Trump will smartly tackle economic initiatives first and then proceed to address more complicated items like healthcare. Some of the market rally we have experienced post-election is due to these campaign promises. If we are correct that a lower corporate tax rate is coming for 2017 and 2018, the market will anticipate the benefits, and once there is added clarity, it should rise.

Surprisingly, many experts are tightly around a consensus of mid-single digit revenue growth and modestly higher earnings growth. We have seen very few analysts lift expectations for a lower corporate tax rate, which obviously has the potential to be very positive for 2017 and beyond. We have seen some estimates forecast that Trump's agenda could add $10 to 2018 earnings. While strategists and analysts tend to be cautious in adjusting estimates on unknowns and unpredictable DC policies, investors on the other hand are quick to respond to incomplete information. This dynamic seems to be playing out post-election, as the stock market has sharply rallied while estimates remain largely unchanged. This difference in timing can create the impression that the market is pricey or too stretched, when it just needs analysts to do some simple math. Once analysts stop dragging their feet on revising estimates, the forward P/E ratio will come down (as earnings are revised up). This should make the "Trump rally" look more sustainable and last throughout the year.

Sir John Templeton once famously said' "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." We have seen a microcosm of at least the first three facets of that thesis since the Presidential elections. The question we now face is whether we have already hit the "euphoria" phase. The current market is trading above the historical forward P/E ratios average of 15x, but it is not alarmingly higher. As we enter the new year the S&P 500 stands at roughly 2,250. Last year, the market's total return (appreciation plus dividend yield) was up 12%. Revenue growth is expected to be a modest this year with earnings growing of 8% to $128. This equates to a simple forward price to earnings valuation multiple of 17.5x. A large component of the weak growth in 2015 and 2016 was due to specific items impacting the energy, banking and the healthcare sectors. In our opinion, the healthcare sector is quite uncertain, with unknown issues stemming from a repeal or changes to Obamacare. In addition, we are hesitant to forecast the price of oil, as tensions in the Middle East remain high and any deal between OPEC members is likely to be tenuous at best. Post-election, the rapid swing from defensive stocks to economically sensitive sectors, indicates that investors are more confident in Trump's plans than our US Fed.

Infrastructure:

According to a 2013 study by the American Society of Civil Engineers, our roads, bridges, water systems, schools and transportation systems merited a grade of D+. There were 85,000 bridges that were called "functionally obsolete" and another 14,000 dams that were considered a "high hazard". Some believe our infrastructure is dangerous, inadequate, a safety hazard and a burden on our economy. It is never good when the terms used to describe our infrastructure are "decrepit" and "crumbling". There seems to be widespread, bi-partisan support for an infrastructure bill. Importantly, we have a unique opportunity to fund and pay for these investments with historically low interest rates. There has been chatter about the possibility of issuing 100-year bonds to pay for some of these costs, but this opportunity may not be available forever. We have also heard chatter concerning the issuance of Build America Bonds (called BAB's). These BAB's have the potential to lower the federal debt burden and push some of these costs onto states, cities and public authorities which are better equipped to handle additional financing. After two costly wars and the worst recession since the 1920's Great Depression, one conservative estimate of our federal debt is roughly $19 trillion. While we do not know the potential size of an infrastructure spending bill or how it might be funded, we believe it is likely coming in 2017. This type of fiscal stimulus will have numerous benefits, but it will certainly contribute to an inflationary environment.

Inflation:

As of today, investors view rising bond yields and inflation expectations as an indication of better economic prospects. We agree. If this positive sentiment shifts, investors will be quick to sell, especially if they believe the Fed has been too aggressive. The Fed has had trouble getting inflation to reach its 2% annual target. Our central bank's preferred gauge of inflation is the personal-consumption expenditure or PCE price index. In November, this was up 1.4% year-over-year. Despite this modest level of inflation, the Fed acted and plans on tightening multiple times this year. The Fed ultimately wants to see stable, rising prices, as climbing prices is thought to be one hallmark of a healthy economy.

Many are calling the 35-year bond bull market officially over. The elusive great rotation from bonds to stocks seems to finally be occurring. Since the US election, the total market capitalization of world stock markets is up by $3 trillion, while the global value of world bond markets is down by $3 trillion. Bond yields have risen to multi-year highs as investors bet that President-elect Donald Trump's administration would begin a shift towards fiscal stimulus. In addition, this will lessen the need for our Fed's aggressive monetary policy. The promised fiscal stimulus should be reflationary for the economy, but it also will reduce the attractiveness of bonds. We worry that consensus is too aligned with this thinking. If there is an extended period of geopolitical uncertainty in 2017, we could see investors rush back into the safety of US Treasuries, especially since they offer comparatively higher yields than most other developed countries' government bonds.

Interest Rates:

At some point, rising yields will be interpreted negatively. If the Fed tightens too fast, it has the potential to shorten the growing business cycle. Chairwoman Janet Yellen recently discussed the Fed's general outlook for 2017 and beyond. Using their "dot plot", we can see that the Fed and its policy makers have gotten more hawkish. The median Fed member sees rates rising to between 1.25% and 1.50% by the end of 2017, suggesting 3 hikes of 25 basis points. Over the longer-term, the Fed sees interest rates approaching 3.0%. The market continues to forecast how many interest rate hikes it expects and the best website to monitor these expectations is CME's at www.cmegroup.com. While higher interest rates will be quite beneficial for many of our financial holdings, we remain skeptical of experiencing 3 to 4 increases in Fed Funds this year. We expect a slow and steady increase of these historically low rates, considering the 10-year Treasury is still less than half the level of 2007, well below its high in September 1981 of 15.819%.

In our opinion, there seems to be a different dynamic taking place in the marketplace. Instead of the Fed controlling interest rates, we are now seeing market forces taking over. Following the surprise election of Trump, the markets reacted and began to take a leadership position. Treasuries are typically a safe haven in times of market turmoil and uncertainty. Instead of rallying post-election, Treasuries were under pressure. Instead of waiting to see if our Fed would increase interest rates, global yields moved materially higher. Government bond prices tumbled, sending yields soaring. After the election and over the course of a day or two, the 10-year Treasury went from 1.7% to over 2.1%. 30-year bonds rose to 2.9%, posting their biggest increase in over five years. Yields did not just move here, but they climbed globally. After spending most of 2016 in negative territory, German bunds rose significantly. This was not a steady move higher, but rather it was a massive change that the market demanded.

While our Fed will meet eight times this year, the European Central Bank or ECB meets each month. These meetings will be an occasion to debate the level of global interest rates. We anticipate volatility to remain quite elevated, as we have contradictory positions from our Fed versus the ECB and the Bank of Japan. In terms of higher correlations, global markets are more tightly aligned than ever before. We have successfully globalized the world, whether we like it or not. In our opinion, this means we have successfully globalized monetary policy. When we have a global growth problem, we cannot solve it just through domestic monetary policy. It simply will not work. In the past, the Fed was able to control the US economy since we primarily had a domestic economy. Now the US is one key component of a global economy.

By keeping interest rates so low – for so long – investors were driven into riskier assets. Whether it was small capitalization or emerging market stocks, ultra-low interest rates forced investors towards riskier assets. Coordinated central banks pushed global rates lower, with 1/3rd of total sovereign debt having negative yields. These low rates allowed corporations all over the world to restructure their balance sheets. Companies sold record amounts of debt, which fueled mergers and acquisition activity, large stock buybacks, as well as higher dividend payout ratios. Over the last few years, it seems that many investors have been playing a big, macro trade. With central bankers lowering rates and essentially giving away money, it had the impact of inflating financial assets. We have come a long way from last summer, when the Swiss government could borrow money for 50 years and charge you interest for the "honor" of lending it money.

After bottoming out, the US debt markets have seen an impressive move higher. The US is tightening while many other central banks continue to ease. The dislocation and divide between US rates and the rest of the world cannot continue to be this wide. This should lead to more unpredictability and heightened volatility. In our opinion, interest rates are rising for the right reason. Even as stocks enter their 8th year of expansion, we continue to believe that the stock market represents the best area for growth and appreciation.

Risks:

When will this "Trump Bump" end? Following the inauguration on January 20th, investors will look for the administration to follow through on some of its campaign promises. If 2017 is more "normal" than the eventful 2016, we will still see significant shifts in interest rates and inflationary trends. The crutch of monetary policy seems to be coming to an end, but this will be more gradual than people think. The transition to fiscal stimulus and support will likely be bumpy and have unintended consequences. In our perspective, there is a "Big 3" of economic policies to accomplish: tax reform, infrastructure spending and de-regulation. Could Trump head down the road of attempting to fix healthcare and Obamacare first? Absolutely, but we view economic proposals as being the safer and more impactful to accomplish first. The sequencing of Trump's actions will be critical.

An additional concern is a simple loss of momentum. Economic confidence is quite high, but is not unshakeable. Confidence is always short-lived, so any event could trigger a wave of selling. The next series of events to impact confidence could be the reporting of quarterly earnings, beginning in late January through mid-February. For 4 straight quarters, 2q'15 – 2q'16, EPS for the S&P 500 declined. This negative trend was broken last quarter. The base is solid to grow from, but it is not terribly robust. In our opinion, commentary on 4th quarter conference calls will set the tone for the entire year. Will some management teams talk and guide conservatively, with the intention to set the bar low? Will others look to follow strategy and the old adage of "beat and raise" throughout the year? Will others blame the election for creating uncertainty and hesitancy leading up to the election? While we expect robust growth in 2017, some management teams might shake investor confidence by simply being too conservative.

Over the next page or so, we highlight the 3 biggest risks we see in the market – the US dollar, China and Europe.

The US Dollar:

The Fed can only do so much because it is constrained by the rest of the world. The Fed uses two key tenets for adjusting US rates – inflation expectations and the unemployment rate. Both economic indicators call for an increase in rates, but this increase has numerous ramifications across the globe. As we raise interest rates, it can have significant unintended consequences, because as the dominant global currency, the US dollar impacts the rest of the world. The value of the US dollar has lifted by over 1/3rd since the US received its credit downgrade in 2011. In emerging markets, a rising US dollar impacts the price of oil and other dollar-denominated commodities. This can materially pressure an emerging market country that exports raw materials. Also, a stronger dollar makes it more expensive for many emerging market countries to pay back dollar-denominated debt. In addition, a strong dollar can negatively impact the ability of US firms to export goods and sell their products overseas. How will domestic production suffer considering US goods are materially higher in price to imported goods? In the service and domestic economy, the strength of the US dollar should not be a problem. Consumers will enjoy a rise in buying power and a reduction in the costs of traveling abroad. We believe it is in imported goods where we will see the impact. As of today, there is broad consensus that the US dollar will continue its march higher. The Wall Street Journal Dollar Index, which measures the dollar against a basket of 16 different global currencies, rose 3.1% last year. Many view this US dollar strength continuing and this is clearly worth monitoring.

China:

Chinese regulators are attempting to wean the country off a campaign of easy money and cheap borrowing. Credit levels have skyrocketed to over $9 trillion and spurred years of impressive growth. However, this is also partially to blame for an increase in complicated and risky financial investments, a potential real estate bubble and certain infrastructure projects with questionable results. A worrisome surge in certain asset prices has led to another Chinese regulatory problem. China is struggling to keep its currency stable, as money is flooding overseas. It is estimated that over $800 billion left China last year, following nearly $750 billion in 2015. The yuan fell 6.5% versus the US dollar last year and is now hovering at levels it has not been at since 2008. Some believe the rise of bitcoin prices to $1,000 is due to a huge inflow of Chinese interest. With a foreign exchange war chest of over $3 trillion, Chinese regulators have plenty of ammunition to continue to defend the yuan. The balancing act between economic growth and rising debt levels is challenging, without having to deal with a new US president making bold and potentially inflammatory proclamations.

The US remains the world's largest trading economy. With Trump's victory and his pledge for "upending global trade", we see more uncertainty. Trump's anti-trade campaign comments are already creating policy problems with some of our largest trading allies. There seems to be no way to want a smaller trade deficit and more US manufacturing jobs, yet arrive at concessions that would be palatable to our trading partners. If negotiations do not lead to new deals, will Trump resort to unilateral actions like higher tariffs? Will he usher in an era of US combativeness with important trade partners like China, Mexico, Canada and Europe? Will he dial up his comments because it is one of his key powers as a sitting US president or will he tone down some of his political rhetoric because it is not presidential? Anti-free trade rhetoric, and starting a trade war with China are among our biggest fears, not least because China is our most important trading partner and it is a critical global trading relationship. Even before Trump takes office, there were two potential issues with China. One was a conversation with Taiwan's President, and the other was a military dustup over a sea-based drone. Over the next year, we fully expect these tensions to increase volatility and uncertainty in our stock market.

In a correlated economic world, a trade war benefits no one. Rattling a shaky global economy also has major ramifications for growth. We believe that many of Trump's comments were intended to resonate with voters and to win an election. This message was used to attract those who believe globalization has left them behind. We believe however, that following through on some of these campaign promises will be much more difficult to implement, and Trump's economic advisors will help soften his stance. We expect President Trump to be more nuanced than candidate Trump.

Europe:

The biggest question for Europe going forward is whether a fragile economic environment will positively respond to central bank stimulus, or will populist politics overtake it. Obviously, the triumph of a populist candidate looking to break up the Eurozone would threaten stability. In December, the euro reached its lowest level against the dollar since 2003, near parity. While a weaker euro is in the best interests of euro-area exports, it does have other ramifications. We are carefully monitoring if the ECB can stimulate economic growth, lower the euro and strengthen its important banking sector.

When it extended its bond-purchase program this month, the ECB needed to choose between buying bonds at extremely negative returns or gearing stimulus toward Eurozone nations that need it the most. Last month, ECB President Mario Draghi said the bank would extend the central bank's asset-purchase program from its projected March end-date until December. It did moderate the pace of purchases, like our tapering program in 2013. Every policymaker move is supposed to avoid benefiting some nations at the expense of others. Yet, any step toward aiming monetary policy at the neediest countries has been politically controversial and has been challenged in both German and European courts. We continue to see an ECB that mainly supports those countries with the healthiest economies while doing little to stimulate those that are lagging behind (i.e.: Italy, Spain, Greece). The aim of the bond-buying program is to help an economy by lowering its borrowing costs. Yet the ECB has undershot Portuguese bond purchases by well over €3 billion and has overshot purchases of German bunds by €8 billion. Clearly, Portugal needs this benefit more than the mighty Germans?

Italy is Europe's 4th largest economy and it has a debt burden over 130% of its annual output. The misfortunes of Italy's banking sector have already impacted the political environment, contributing to the government's defeat in last month's constitutional referendum. Since the beginning of the year, Monte dei Paschi di Siena, widely considered the world's oldest bank, has lost more than 80% of its value. For several months, this Italian bank was looking to raise necessary capital, but private sector investors balked. New Italian Prime Minister Paolo Gentiloni just announced that the government has approved a new €20 billion fund to step in and bail out the bank. While this essentially nationalizes this struggling financial institution, there is a lot more to the story. Yes, the fund will provide the necessary funds for it to re-capitalize. However, Monte dei Paschi is the first major test of Europe's post-crisis plan for how it handles troubled banks. The EU set ambitious rules to shield taxpayers from the cost of bank failures. They are intended to have some creditors suffer losses whenever taxpayers' cash is used. As Italy's 3rd largest lender, Monte dei Paschi has put the new government in a precarious situation. If the bank ultimately fails, the government will be blamed for risking and threatening the savings of thousands of middle-class Italians. Italy will attempt to use a "precautionary recapitalization" only intended for solvent banks that will not suffer big losses. Since half of Monte dei Paschi's bonds are held by "mom and pop" retail investors, Italy has claimed that these investors were "mis-sold" the securities and it would permit an exception to normal rules. German lawmakers believe this rescue is a "violation of the rules of the European banking union". We are concerned that the ECB is being hamstrung by political constraints and in the event of another market shock, it might not have the ammunition to properly respond.

Conclusion:

The US Presidential election is finally over, and as we start a new year, many are looking forward to change and renewal. The financial markets are no different. On the campaign trail, Trump advocated for less regulation, lower taxes and more fiscal spending. If implemented, these policies should lift an economy stuck in its slowest recovery since the post-war era. For the next few months, many of his proposals will be uncertain and unknown. Over the first few quarters of this new administration, we expect pro-growth policies to lift the equity markets. Trump will get the benefit of a unified Congressional base. Whether you approve of his policies or not, decision-making and change is coming to Washington.

As global growth picks up, the market will respond favorably. Greater clarity and transparency of what the economic environment will look like should boost activity and "animal spirits". While interest rates are certainly heading higher, they are still at historically low levels. For markets, the era of central bank dominance might be drawing to a close. We finally see the Fed raising rates due to stronger income growth, a healthier job market and modest inflation. If rates increase because of stronger economic activity, we do not see this as being a warning sign. Market-friendly fiscal policies seem to be taking the baton from monetary stimulus. With a pro-growth administration, the equity market believes the future looks bright.

We remain positive for many reasons, as we enter a uniquely attractive environment. We fully expect the market to take a breather and potentially pause, but we remain optimistic on the overall outlook. Our rule of law, political stability, property rights protections remain the envy of the world. A pro-business environment is good for US companies and we envision positive market reactions not if, but when we make favorable and sensible corporate tax reform. After Trump's inauguration, investors will expect action, not just campaign words. Ultimately, the market will need a new catalyst, and an administration that delivers on some of its campaign promises should suffice. Until then, positive sentiment will have to do.

Manole
Capital Management

Manole Capital Management
Commerce Club at Oxford Exchange
E-Mail: warren@manolecapital.com
Website: www.manolecapital.com

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A low interest rate environment coupled with muted economic growth decreased stock dispersion. When equities move in unison, passive can outperform active management. If investors focus more attention on company specific profitability and spend less time analyzing central bank policy speeches, we believe that good, active stock picking can outperform. Quite simply, if fundamentals start to matter again, we believe we are poised to deliver alpha. This dynamic is beginning to play out, as different sectors diverge.

We continue to focus our attention on the "Fin Tech" industry and stick to our area of expertise. Looking forward, the "Fin Tech" portfolio is poised to generate double-digit revenue growth next year, which is significantly higher than the market. In addition, our portfolio of companies generates high operating margins that lead to positive operating leverage and mid-teens growth of free cash flow and earnings. Unlike the broader market, we believe the growth of our holdings is predictable and sustainable. By focusing on recurring revenue models in secular growing businesses, we have confidence that we are properly set-up to capture upside. We believe significant opportunities on both the long and the short side exist, and that good individual stock selection and timely tactical repositioning can drive total returns higher.

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

Warren Fisher, CFA
Manole Capital Management

Manole Capital Management
Commerce Club at Oxford Exchange
E-Mail: warren@manolecapital.com
Website: www.manolecapital.com

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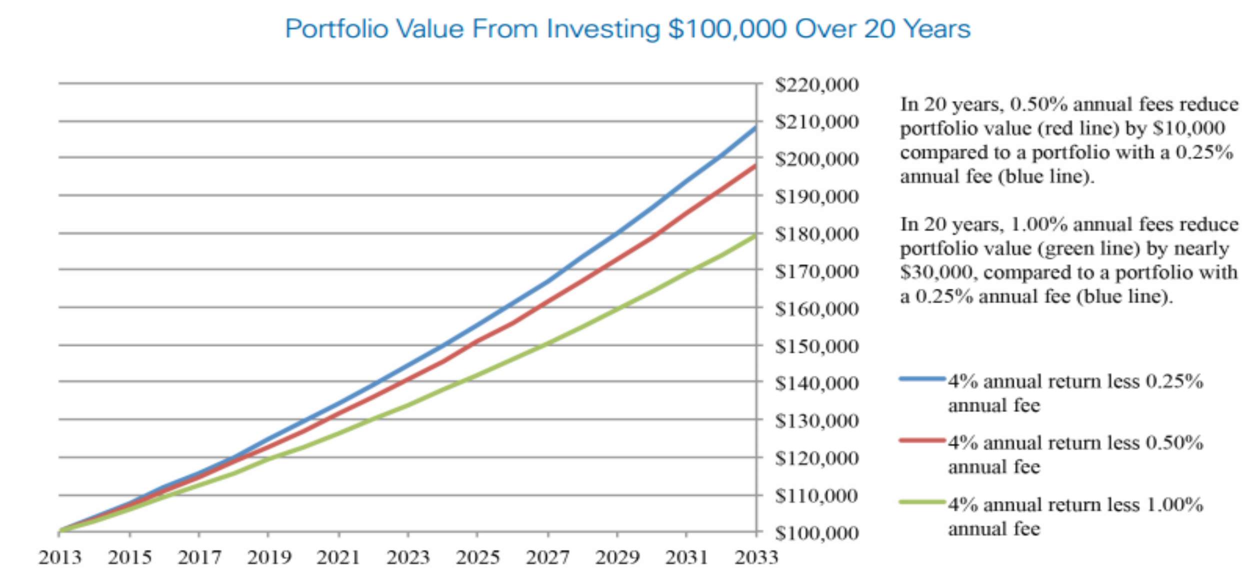

Manole Capital Management
Commerce Club at Oxford Exchange
E-Mail: warren@manolecapital.com
Website: www.manolecapital.com

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