3rd Quarter 2018 Newsletter

July 2018

MANOLE CAPITAL MANAGEMENT

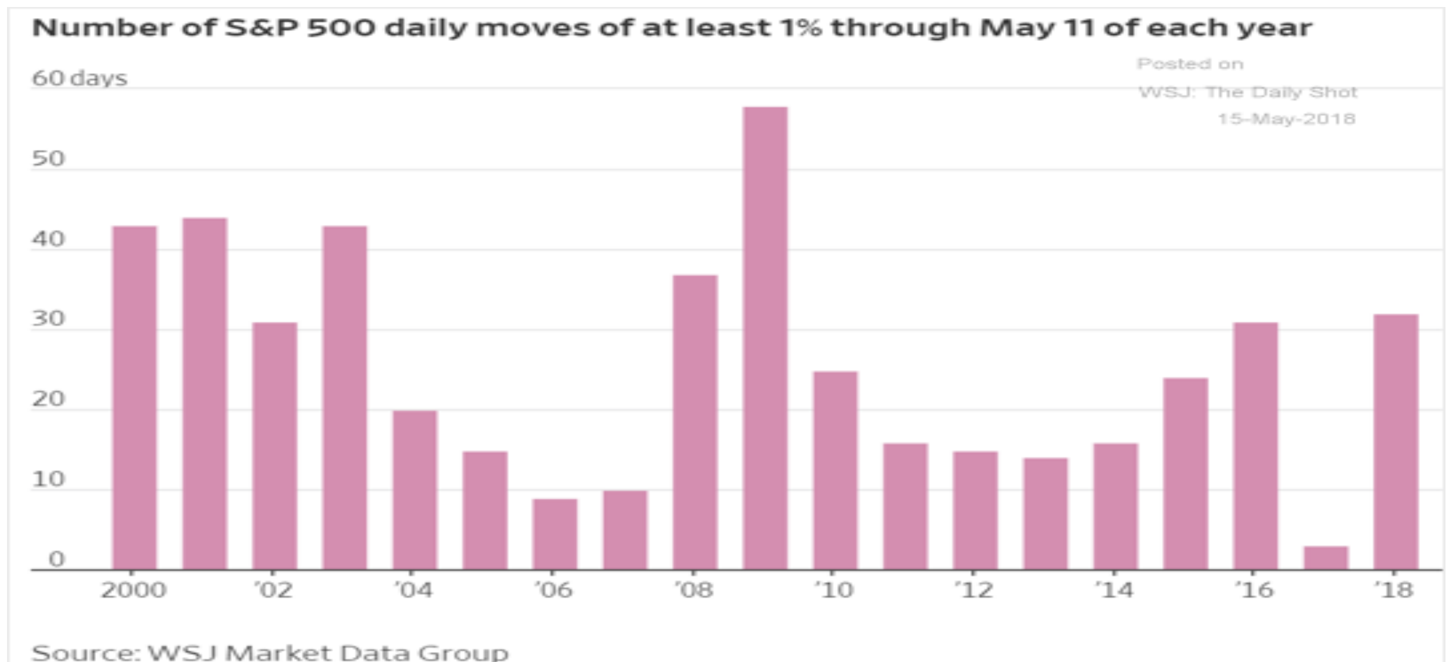
MCM

We hope you had a wonderful July 4th and are enjoying your summer so far. While Justify became the 13th horse ever to win a Triple Crown last month, our 2018 race is only at its halfway mark. Over the next few weeks, companies will begin to discuss 2nd quarter earnings and lay out their expectations for the rest of the year. For some, Christmas or Hanukah is their favorite time of year. For us, it is earnings season.

We hope you enjoy this newsletter and gain a better understanding of our short and long-term perspectives on the markets. As always, the last two pages of our newsletter highlight some interesting statistics, metrics, facts and quotes. If you wish to view any of Manole Capital's proprietary research, thematic notes, videos, prior newsletters or individual stock calls, please visit our website at www.manolecapital.com/research. All of our research is available 24/7 and is 100% free; i.e. it is never walled off behind "pay for" gates.

Volatility:

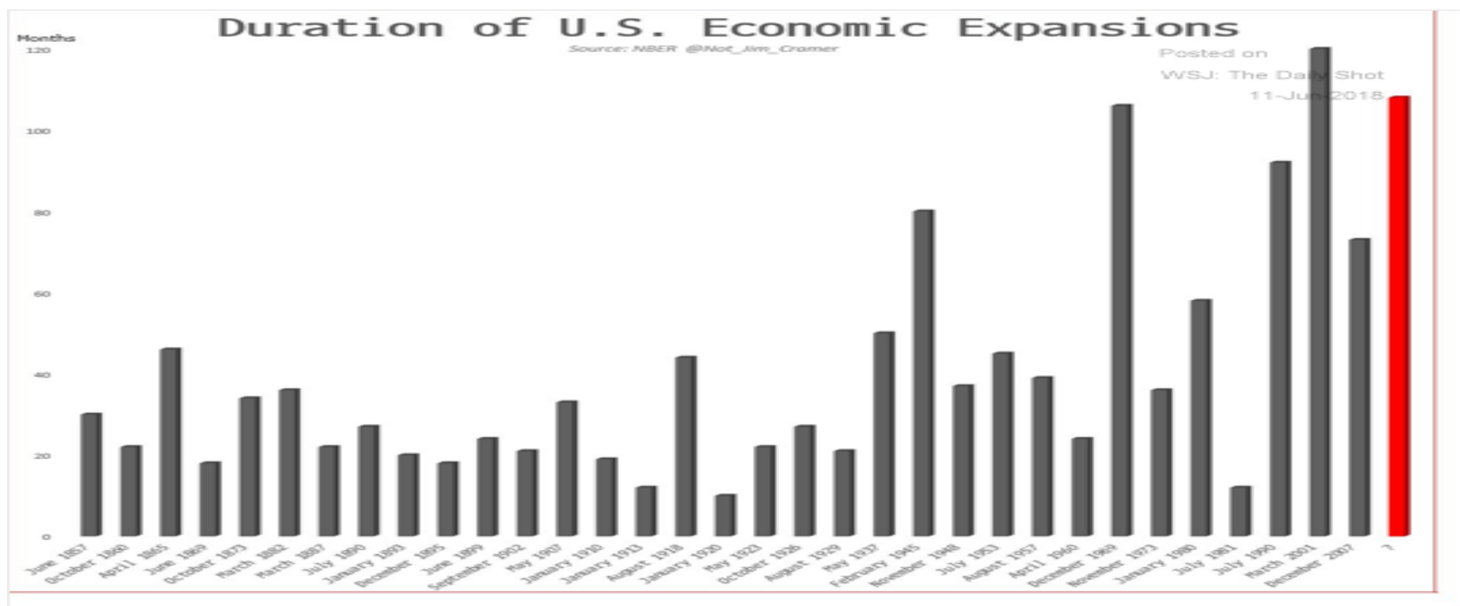
We mistakenly thought that following President Trump's November 2016 election volatility would become the norm. Instead, the stock market was fairly calm in 2017. As we know, the stock market likes stability, predictability, and certainty, so the S&P 500 rose 21% last year. 2018 has been quite different. Volatility has certainly re-emerged, but we are just now approaching a more normalized level of daily market moves. As the chart below indicates, the number of daily moves of the S&P 500 of at least 1% or more is simply back to more realistic levels. Maybe the more abnormal period was the unbelievable level of calm that existed in 2017



A Historic Bull Market?

Through the 1st half of the year, we have seen a massive US tax cut, the end of the short volatility trade, the US Federal Reserve lift short-term rates twice, tit-for-tat trade skirmishes between the two largest global economic powers, and countless other geopolitical events. Despite these ups and downs, nothing has occurred to stop this historically lengthy bull market.

The current economic recovery is now in its 9th year, which makes it the 2nd longest US economic recovery on record. With growth prospects still strong, many are predicting this bull market will eclipse the 12.3 years experienced between the end of 1987 and early 2000. Despite an endless barrage of tweets from our President, the stock market is modestly up this year. We remain bullish and expect the US stock market will begin to track individual company success. With GDP expected to double the pace set in the first 8 years of this rally, we anticipate positive results to translate to positive market returns.



Earnings:

We are strong believers that stock market performance is driven by individual company earnings growth, as opposed to macro and geopolitical events. Over the last few months, the market released 1st quarter results that had revenue growth of +8.5%, driving earnings of +24.2%. Nearly ¾ of the companies in the S&P 500 beat analyst expectations, but the response was somewhat muted. Many companies were trying to tell the market that business was quite good and laying out the framework for better than expected growth for the rest of the year. Instead of the bullish commentary lifting stocks, the market seemed preoccupied with the possibility of a denuclearized Korea and a scary, but vague trade war.

As we look forward, we are bullish that earnings growth will remain quite strong. Expectations for 2nd quarter results, per Zacks Research, are revenue and earnings growth of 8.2% and 19.0% respectively. For the 2018 calendar year, earnings per share should be up 20.2% year-over-year with revenue up 6.3%. For calendar year 2019, estimates are for looking for a more normalized, but solid earnings growth of 9.8%, coupled with revenue growth of 4.6%. Of course, we believe our flagship Fintech portfolio will outpace the market's overall growth. Using 2018 estimates, our portfolio of unique Fintech companies should grow its revenues at well over 2x the market rate, as well as grow its earnings by over 800 basis points better than the S&P 500. For the next few years, we anticipate revenue and earnings growth in the mid-teens.

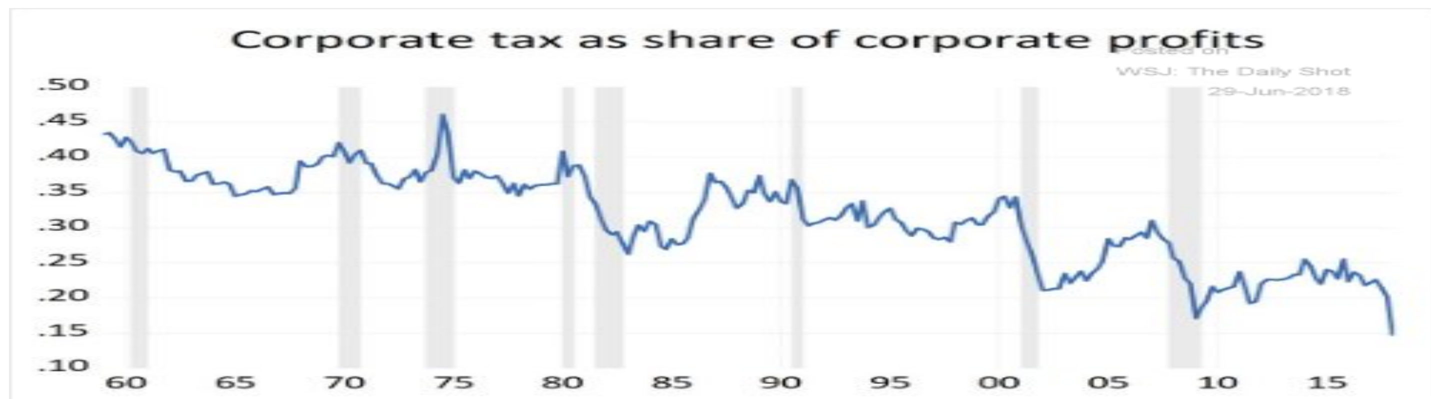
Trade War:

When the stock market is strong, traders shrug off tariff concerns and focus on a strengthening economy. The market then sells off when President Trump readies another $200 billion in tariffs, which seems to be immediately followed by an equal dollar amount of Chinese offsets. There is nothing enjoyable about this negotiation and escalating trade tension. We believe this dispute will likely continue for a prolonged period of time and that negotiations will continue to escalate and ratchet up protectionist measures. We believe there is a lesson to learn from the UK's Brexit experience. It is quite difficult, near impossible, to separate markets that are so globally intertwined. An isolationist approach will not succeed, as it makes an economy less competitive and less productive. Voters may embrace a populist wave today, but trade is global, and the genie cannot and will not get back in that bottle.

These trade related headwinds seem to be offsetting excellent earnings momentum. We will continue to keep our eyes and ears on the fundamentals. We will not hold off making investment decisions because of the uncertainty around tariffs and trade. There will be secondary and tertiary impacts to our portfolio, but our direct exposure to China and the manufacturing sector is quite small. While some companies, that rely on global supply chains, might hold off making long-term investment decisions, many of our holdings are well positioned to succeed during this period of uncertainty. We are not ignoring trade concerns and political rhetoric, but prefer to focus our attention on strong profits, positive management commentary and a remarkably resilient global market.

Taxes:

Are investors forgetting that corporate taxes are at the lowest level in the last 69 years? We are somewhat surprised that the market seems to be forgetting or discounting just how strong US businesses are. While each company has a distinct outlook and set of characteristics, the ratio of US business taxes to corporate profits has not been this strong in decades.

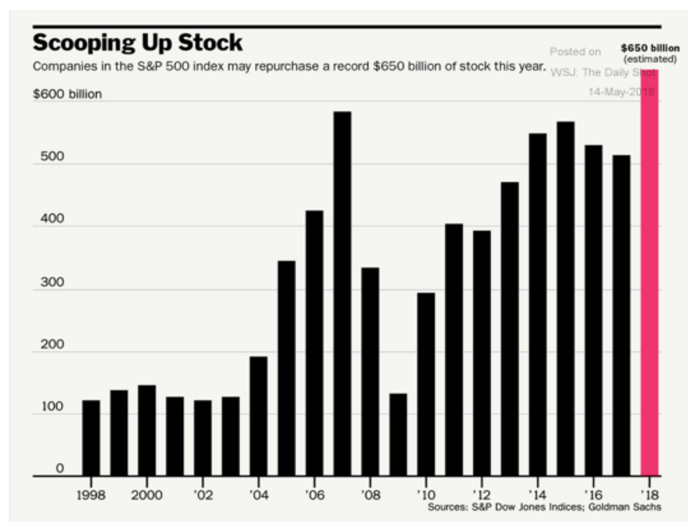


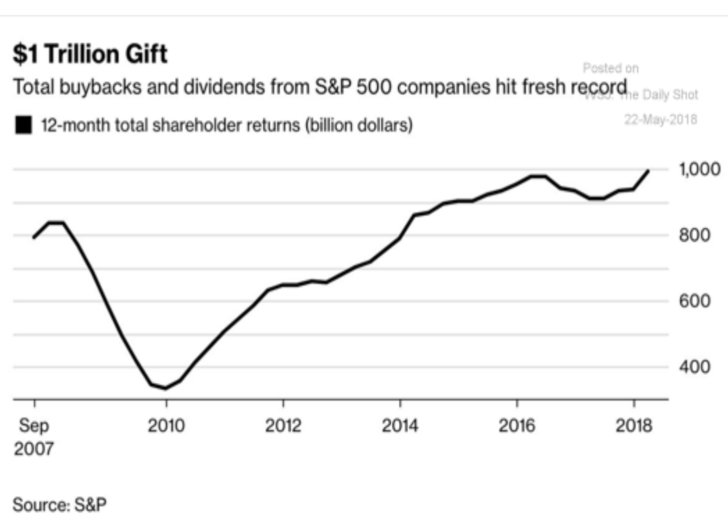
Shareholder Returns:

While US government revenue from corporate taxes is declining, Republicans are baking in that strong economic growth will ultimately help lift its tax revenues. While little has been done to offset the expense side of the equation (i.e. healthcare, defense spending, social security, etc), the US government is clearly "kicking the can" down the road for future generations to manage.

Cash and investments sitting on S&P 500 balance sheets are at an all-time high. Excluding the financial sector, cash and investments held by S&P 500 companies are steadily approaching $2.5 trillion. Each day, we see companies lifting their dividends and announcing sizeable authorizations to repurchase stock and/or acquire high-growth companies. While cash flow can be used in many ways by various management teams, early signs indicate that much of it is going towards shareholder returns. Goldman Sachs research expects S&P 500 companies to spend $1.2 trillion on buybacks and dividends, up 22% compared to an 11% increase in R&D and capital expenditures.

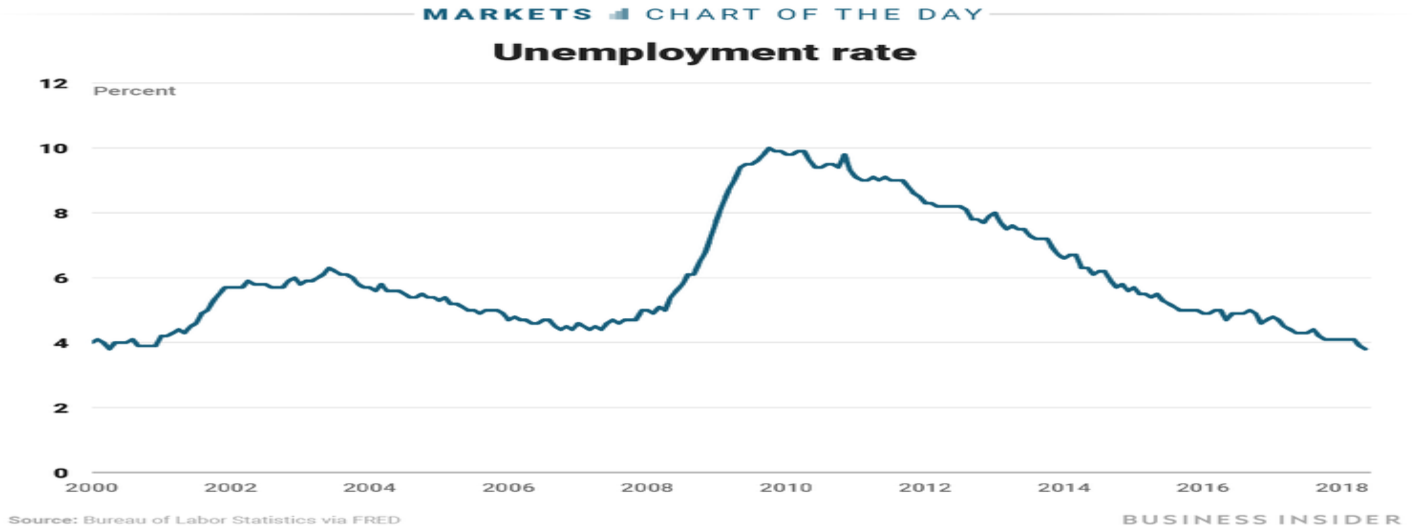
Over the last 12-months, S&P 500 companies have returned nearly $1 trillion to shareholders. The estimated value of stock that S&P 500 companies might repurchase this year is approaching $700 billion. The biggest buyers of their own stock have been companies like Oracle, Bank of America, and JP Morgan Chase. As the chart below indicates, companies in the S&P 500 should easily eclipse the prior high in 2007. Is this a warning sign of a pending recession or another Financial Crisis? We do not believe the fundamentals of that period are comparable to today's positive environment.





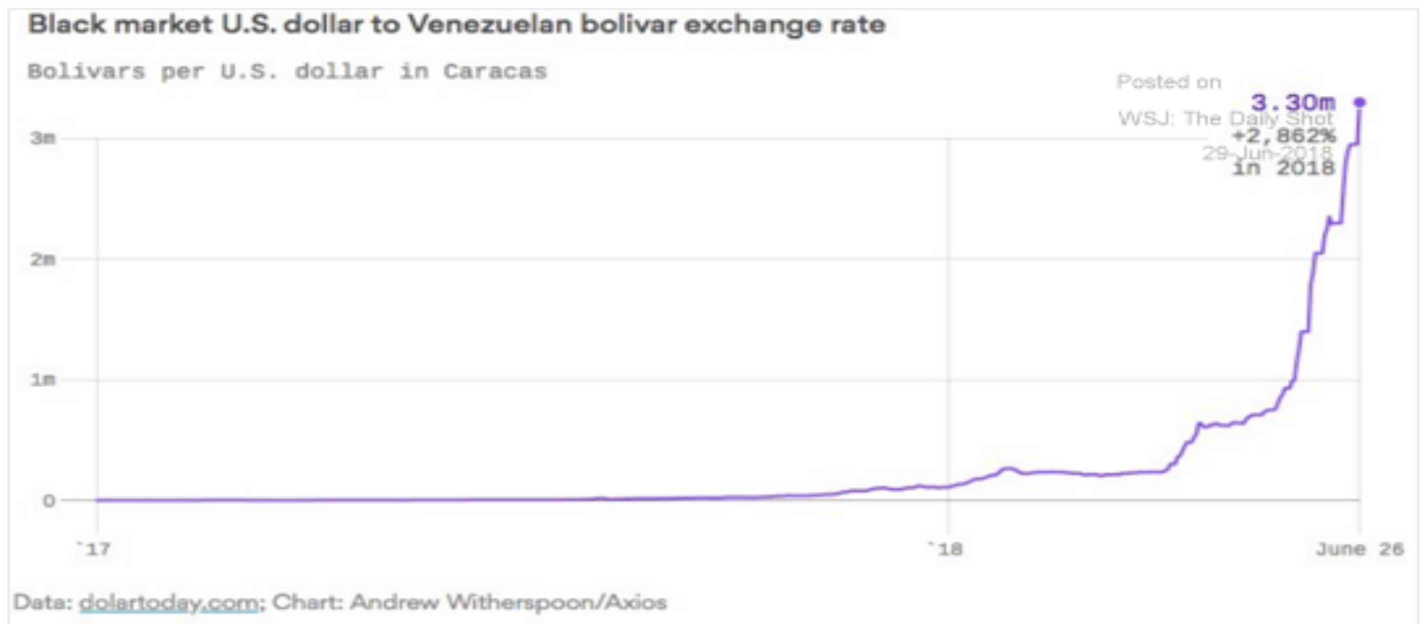
The Federal Reserve:

For years, the US Federal Reserve has been striving to meet its dual mandate of high employment coupled with a steady 2% annual inflation target. US payrolls have increased for an amazing 93 months in a row. With unemployment under 4%, and still declining, this key component of the Fed's mandate has clearly been met.



The 2% inflation target has been much more of a challenge to meet. Inflation, excluding food and fuel, is far from high. After it failed to hit its inflation target for years, we do not envision the Fed aggressively raising rates at the first sign of rising prices. The Fed raises interest rates to cool off an overheating economy. We believe today's current environment is positive but do not see levels that seem troublesome or excessive. We see the Fed continuing a gradual normalization process, even one that factors in the broader, global environment.

In the "Be careful what you ask for" camp, one can look at the fiscal and inflationary disaster that is Venezuela. One American dollar equates to 3.3 million Venezuelan bolivars. With the price of a cup of coffee exceeding a million bolivars, it is a miracle that Venezuelan society can function at all.



Interest Rates:

So far in 2018, the Fed has increased short-term rates twice. Expectations are for an additional two increases this year and possibly three more 25 basis point hikes in 2019. Our preferred gauge for understanding the market expectations for interest rates remains the CME's FedWatch tool, which can be viewed here.

We believe that interest rates will continue to climb higher, but the rate and pace may be less than some expect. Why? We find it hard to believe that our Fed will be able to lift short-term rates significantly this year and next, considering that other central banks continue to use quantitative easing and follow a loose monetary policy. For example, the spread between US and German 10- year government bonds is dramatically wide and at a level not seen since German reunification. We feel the rest of the world is still hesitant to normalize interest rate levels. Other central banks wish to continue to pump cash into their markets to fuel economic growth. We simply do not believe the Fed will aggressively raise short-term rates to cause an inverted yield curve. During recent Congressional testimony, Chairman Powell said the Fed will continue to gradually raise interest rates "for now." Considering the Fed remains data dependent, we would not be surprised to see a slowdown of interest rate increases, due to trade concerns.

Secular vs Cyclical Growth:

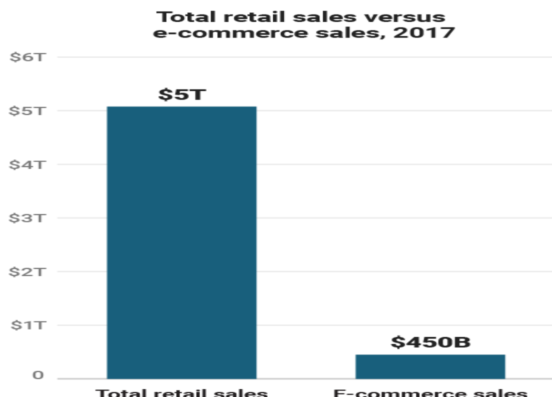
Some investors prefer to constantly switch portfolio composition and trade in and out of various sectors. We prefer to own wonderful growth companies that benefit from secular rather than from cyclical factors. Certain managers constantly search for the "hot" sector and look for momentum and macro factors to determine their portfolio weights. This is 180 degrees different from our philosophy. We are long-term investors seeking to capture value over time, not by market timing.

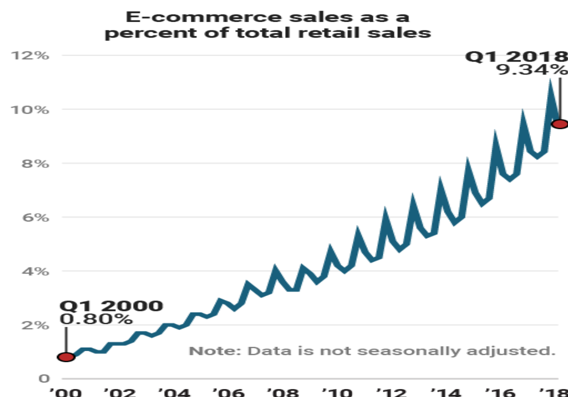
For example, the cyclical energy sector was weak in 2014, down 8%, and awful in 2015, down 21%. In 2016, energy rebounded with an impressive 27% return. The overall market was up 21% last year, but the energy sector fell 1%. Looking at 2nd quarter energy sector estimates, the Street is expecting year-over-year growth of over 140%. Energy stocks closely correlate with oil prices and the price of oil per barrel remains extremely volatile. (now at roughly $70 per barrel). We do not speculate on the price of commodities, nor are we investors in cyclical businesses. Our Fintech portfolio continues to focus on the two largest sectors in the market - technology and financials. Our financial positions should benefit from higher interest rates and elevated volatility without traditional credit sensitivity. Our technology holdings continue to be heavily weighted towards the payment industry. A focus on transaction-based business models that consistently generate recurring revenue and significant free cash flow should allow us to outperform in the event of a market slowdown.

In our opinion, the payment industry is the best example of secular growth. Our most recent proprietary research note, titled "Are You Swimming Naked?" discusses the trends we are seeing in the payment industry. If you would like to read that article, please click here. To summarize our long-term payment thesis, we believe eCommerce is still in its infancy. As the two charts below show, we are still in the early innings of eCommerce volumes as a percentage of total retail sales. We are confident that this trend, up and to the right, will continue for years to come.

TECH CHART OF THE DAY

The rise of e-commerce in the US





Source: US Census Bureau

statista | BUSINESS INSIDER

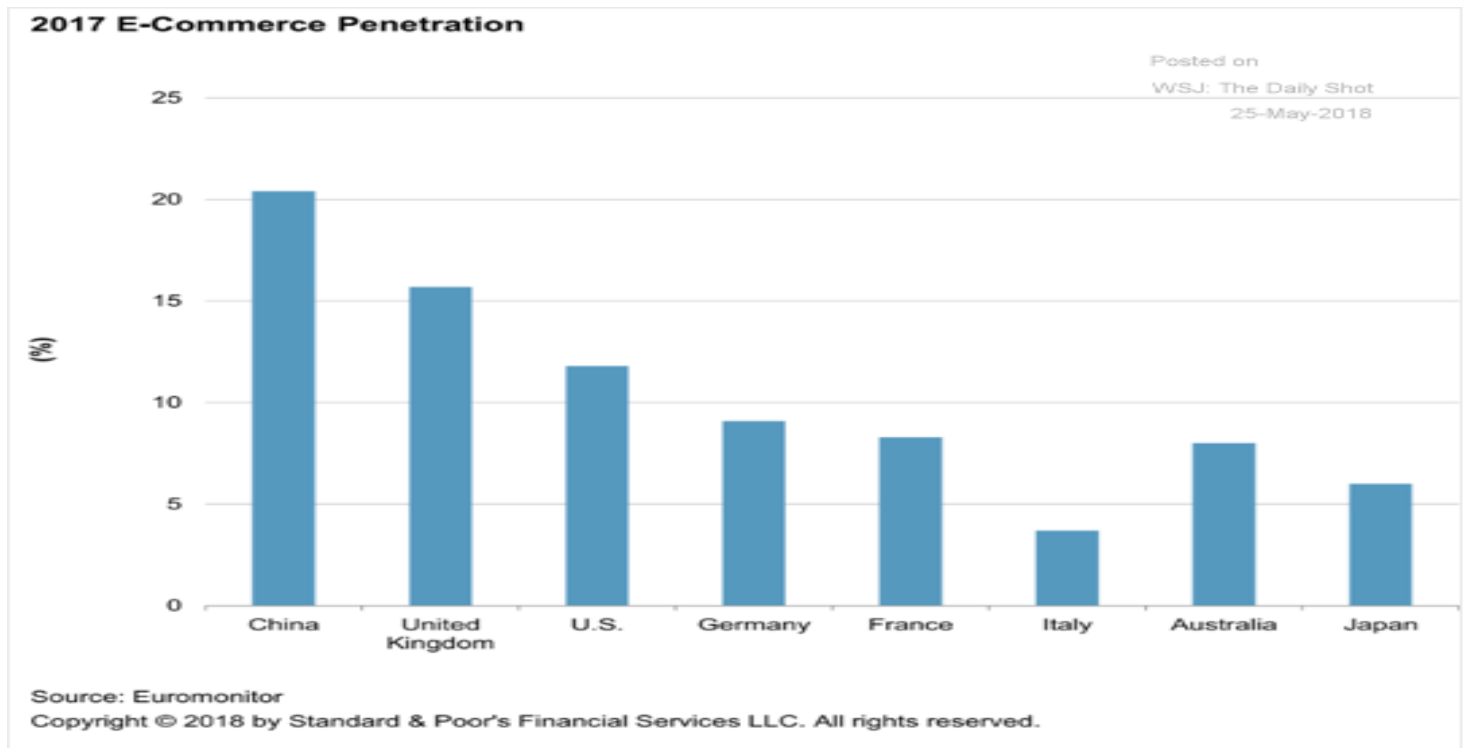
Keeping It Simple:

As phones replace our leather wallets as payment mechanisms, which mobile wallet will win? We have attempted to frame this debate in several research notes. First was The PayPal Opportunity from September 2016. A year ago, we wrote an article titled No Cash Accepted, highlighting the secular growth of the digital payments industry and the slow and steady decline of cash usage. Then, in July 2017, we wrote about Amazon's purchase of Whole Foods, titled Checkout Amazon. That note discussed how we envision Amazon altering the checkout process as well as the entire merchant-acquiring landscape.

China has embraced eCommerce, with estimates stating that it now exceeds 20% penetration. Instead of utilizing some new technology to drive mobile payment usage, China has embraced the QR code (seen right). Using one's cell phone to act as a payment mechanism, even for simple, day-to-day transactions, is becoming easy and commonplace. It is estimated that 23% of all transactions, between individuals and businesses in China are now executed through a mobile device.

eCommerce Penetration:

The US still lags behind other countries', but online eCommerce penetration continues to rapidly growth. We believe that eCommerce penetration will dwarf current levels and will grow for decades. As Amazon Prime has proven (not to be too simplistic) purchasing items online is unbelievably easy. If one purchases anything online, cash and check cannot be used. Credit cards remain the funding source of choice, as well as the safest and easiest method of payment. Emerging technologies are fueling transaction processing and global economic growth. Whether QR codes become widespread in the US, is a debate for another time. We strongly believe that the underlying funding source of sales should continue to be credit. This remains a long-term positive catalyst for our heavy exposure and weighting of the payment industry.



Technology:

In prior newsletters, we have commented on our concern with how concentrated or technology heavy our markets have become. We find it amazing that only three tech stocks (Amazon, Netflix and Microsoft) account for over 70% of the S&P 500 returns year-to-date.

We are constantly looking to identify crowded trades and there is evidence that FAANG (Facebook, Apple, Amazon, Netflix and Google) or FAAMG (with Microsoft) or even BAT (Baidu, Alibaba and Tencent) is reaching an interesting inflection point. If we combine the market capitalizations of these dominant technology companies, the sum exceeds $5 trillion. This valuation exceeds that of all the companies in the Eurozone ($4.9 trillion) and exceeds that of all the companies in Japan ($3.6 trillion).

Back in early 2009, the five largest companies in the S&P 500 were Exxon Mobile, Proctor & Gamble, Johnson & Johnson, AT&T, and Chevron. In early 2018, roughly nine years later, the five largest companies are Apple, Microsoft, Amazon, Facebook, and JP Morgan. With 4 of the top 5 companies currently in the technology sector, could this be a warning sign reminiscent of the tech-heavy Dotcom era? Well, using the S&P 500 as a benchmark, the largest sector of our current equity markets is the technology sector at 26%. For perspective, using history as a guide, technology peaked at nearly 35% of the index back in early 2000.

If we look at the rest of the world's largest equity indices, we see a vastly different percentage of technology exposure. For example, China's index has a 41% weight in technology, while Asia Pacific, ex Japan, has a 27% technology weight. Japan, once a technology leader, has a technology weighting of only 13%. On the far end of the spectrum is Europe. We find it quite telling that the European index only has a 5% weight in technology. Clearly, dominant technology companies are based in China and Silicon Valley, with only a few based in continental Europe.

Change:

We recently saw an interesting note from Seth Godin on ***change***. Less than 60 years ago, Godin stated, "The world was a twitch away from total nuclear destruction. White bread was a health food. Diabetes and obesity were relatively rare. The newspaper was the way most people heard about the news. We thought things were moving very fast, frighteningly fast. Women rarely worked outside the home, and the Rev. King was a relatively unknown preacher. No one owned a computer. The number of books published every year was quite small, as was the local bookstore. It was almost impossible to spend more than 45 minutes a day keeping up with current events. It was against the law for blacks and whites to marry in Virginia, and for gay couples to marry just about anywhere. Apartheid was mostly unremarked upon in the US. UPS never came to your house. A long-distance phone call was a big deal. Air conditioning was rare, bottled water hadn't been invented yet, there were no billionaires, there were three or four channels of TV, movies were only shown in movie theaters, most dangerous diseases would certainly kill you. The air and water were clean, but we were working overtime to make them dirty. Congress wasn't a version of pro wrestling. Milk came in only one formulation (whole), you probably worked at the same company for a very long time and relatively few people went to college."

As we look forward, maybe not 60 years forward, we continue to be amazed by the changes we experience daily. What will things be like in the future? We doubt things will be calm and stable. Uncertainty has always existed and will continue for decades to come. We like Godin's conclusion: "There is no normal. Simply the relentless cycle of change."

Conclusion:

It is our opinion that the market is wrestling with a concept and environment of "It's as good as it can get". We are not in a fantasy world, where we believe the first quarter's earnings growth rate of 25% is sustainable. However, we continue to see report after economic report showing that the economy is steadily improving. The job market is the best it has been in decades, balance sheets are flush with cash, and corporate profits are at record-highs. We are not saying that watching CNBC or Bloomberg should sway one's opinion, but these TV news channels can tend to use exaggeration for shock value.

With the market failing to price in recent earnings growth, our companies seem to be getting cheaper and cheaper on a traditional P/E basis. When Mr. Market catches up to all of this good news, equities should rise. We continue to hear from our companies that trends are positive, and business remains very healthy. Are there worries and uncertainties? Are we concerned about a global trade war? Absolutely! However, we are steadfast in believing that long-term stock prices reflect business success and earnings growth, not geopolitical concerns. As of today, earnings growth is quite good, and we are very comfortable that our portfolio positioning is poised to deliver upside over the next several quarters.

Year-to-date performance remains strong. We are pleased to be beating the overall market, as well as the trend towards passive investing. Here's looking forward to 2nd quarter 2018 results, which are just now getting reported.

Warren Fisher, CFA
Manole Capital Management

Interesting Statistics, Metrics, Facts & Quotes:

- Which company will be the 1st to reach the unfathomable $1 trillion market capitalization?
- Will it be Apple, Microsoft, Amazon, Facebook or possibly even Google?
- The battle of retail sales between *Bricks & Mortar* versus *eCommerce* can be summarized with one chart

- For designing the iconic ***I Love NY*** logo, Milton Glaser was paid roughly $2,000
- He later said, "I was very happy to do it. I was very happy about the consequences."
- Carolyn Davidson designed the instantly recognizable swoosh, that helped make Nike famous
- For her work, she made a whopping $35
- Why do we bring up these legendary logos?
- Did you happen to notice Manole Capital's new logo on the top of each of these pages?

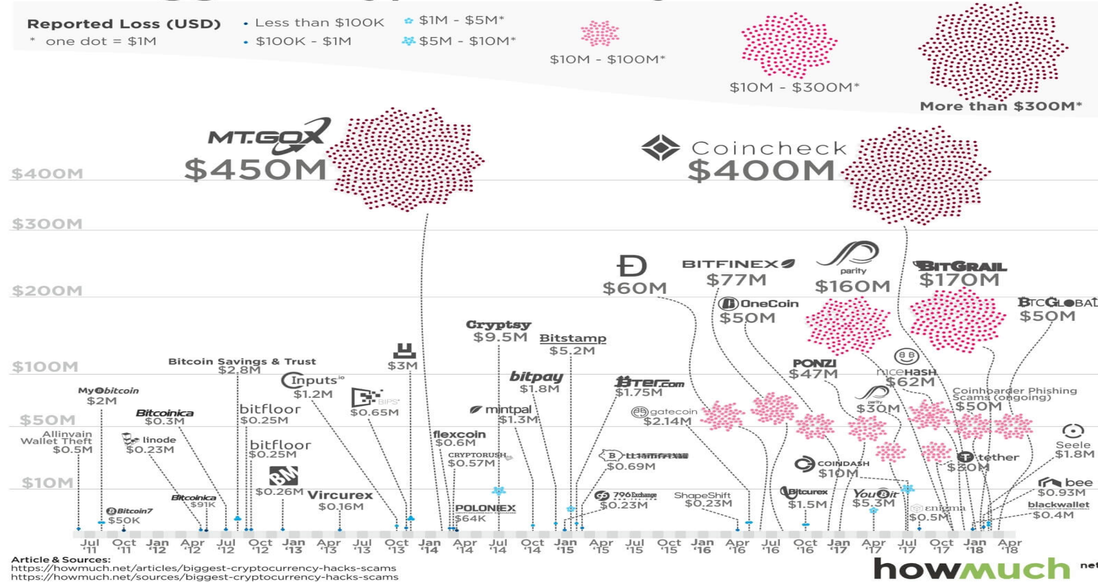
MCM MANOLE CAPITAL MANAGEMENT

Cryptocurrencies:

- Bitcoin, ICO's and other cryptocurrencies still remain quite controversial
- Here's a link to our research note on this "Fintech" topic from December 2017:
- Bitcoin mining uses more energy than the entire countries of Colombia and Greece (and 2x Ireland)

- JP Morgan recently reported that 1/3rd of centralized crypto exchanges have been hacked
- A recent WSJ report has found that more than $800 million worth of crypto has been stolen from exchanges in '18
- The US Justice Department and FBI currently have 130 investigations into virtual currencies
- If one wishes to track failed ICO's, there is an insightful website called Coinopsy to look at

- Boston University research recently analyzed over 1,000 cryptocurrencies
- It found that less than ½ (44.2% survival rate) of new ICO's last more than 120 days after launch
- Satis Group research looked at the fate of coins with a minimum of $50 million of market capitalization
- It found that 81% of these coins were scams, 11% either failed or died, while only 5.4% were promising or successful



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.