Introduction:

From mid-October 2023 through March of 2024, the stock market ripped higher. Mega cap technology and growth stocks led the charge, but the strength was broader with outperformance in Energy, Financials, Healthcare, and Industrial sectors. In the 1st quarter of 2024, the S&P 500 hit 22 new all-time highs, with only a (1.7%) drawdown. There was a collective sense of optimism, as the S&P 500 recorded its best-performing first quarter since 2019.

The logic was simple – the Fed was going to dramatically cut interest rates and risk assets would thrive with an accommodative Fed. While inflation is well off its peak and trending toward the Fed's 2% target, the "last mile" of improvement seems to be stalling. Based on mixed data, the Fed has clearly moved from a dovish pivot in December to a "higher for longer" stance. While the Fed can cut interest rates, we fail to see the logic behind doing so. Why would the Fed cut interest rates with the economy delivering solid growth? Normally, rate cuts come with a struggling economy. That just isn't the case.

In our opinion, the market needs to consider and factor in a higher cost of capital. Economic conditions do not merit the Fed to act, although certain sectors are pleading for help (i.e., real estate, housing, mortgage players, manufacturing, etc). With a US Presidential election coming in November, the Fed is running out of time to make cuts, if it is to remain bi-partisan and outside of political influence.

The Fed, Interest Rates & Inflation:

The US economy remains resilient and is the envy of the developed world. With higher interest rates, the Fed was anticipating that the economy would begin to slowdown (lower GDP and higher unemployment). Instead, the exact opposite has occurred.

Many were expecting a pullback in consumer spending and consumption, following impressive 2nd half of 2023 growth. The logic was that higher interest rates would become a drag on consumer consumption, but this has not occurred. The US consumer powered through higher rates and continues to fuel our economic growth. While consumer savings rates remain low relative to historical norms, consumer spending and credit card debt levels are hitting all-time highs. The Federal Reserve Bank of Philadelphia released statistics for the 4th quarter of 2023 that show that 30-day and 60-day past due credit card metrics also reached an all-time high. In addition, stress can clearly be seen by the number of cardholders making the minimum payment rising quarter-to-quarter by 34 basis points. Countering this is the number of cardholders making full statement credit card payments. There seems to be a bifurcation in the US, with some consumers thriving, while others struggle every month to survive.

The Fed's second derivative thinking was that a slowdown in consumer spending would lead to a drop in consumer confidence, reduction in pricing power for businesses, pressure on margins, and cost cutting initiatives (i.e., layoffs). This also hasn't occurred. The labor market has held up quite well, with unemployment under 4%. Maybe we sound like a broken record, but we simply believe that if the US consumer is gainfully employed, he/she will spend. While GDP and growth might slow from its recent torrid pace (4th quarter of 2023 GDP was +3.4% while 1st quarter of 2024 GDP was +1.6%), we are far from recession levels. Some experts continue to forecast a recession, but economic indicators and current conditions remain solid.

On April 10th, 2024, the market sold off on "hotter than expected inflation", which was the 3rd month in a row of disappointing numbers. Since 1980, the average intra-year decline for the S&P 500 is (14.3%), so downward moves, and volatility should always be expected. In fact, from 2009 through 2020, there were nine market corrections, so pullbacks are a normal occurrence. In our last newsletter, we simply said that we didn't think that six interest rate cuts were likely in 2024; instead, we thought maybe two or three could occur. Now, following March's elevated CPI (Consumer Price Index) reading, that might be too aggressive.

Inflation remains persistent and the last 1% of its decline seems the hardest to get. Whether it is milk, eggs, gasoline, rent or car insurance, there always seems to be one aspect of CPI that remains stubbornly high. Core CPI strips out food and energy costs and was still up +3.8% year-over-year. These latest inflation readings are frustrating, but not catastrophic. The stock market might have a short-term blip, but that's because it is so focused on the latest datapoint. Job openings are still strong, and unemployment remains quite low. Plus, it sounds like the Fed feels that the current environment is sufficiently restrictive. The next logical question is whether or not the Fed should hold rates where they are or contemplate cuts. Instead of guessing about future rate changes, we prefer to use our favorite tool for gauging interest rate expectations – the CME FedWatch Tool (click here). It shows, there is only an 8.5% chance of lower rates at the June 12th meeting, a 31% chance that rates are down at the July 31st meeting and a 67% chance of rate declines by the September 18th Fed meeting. These are all significantly lower than a few months ago. While the Fed continues to express that it is "data dependent", we do think it will refrain from making interest rate cuts - as we get closer to the November Presidential election. The Fed needs to appear to be non-political and making interest rate cuts would benefit consumer sentiment, the stock market, the economy and especially President Biden. The Fed doesn't want the appearance of favoring one candidate over the other or getting the credit / blame for tilting the election.

After the latest Fed announcement (to hold rates at these levels), many Fed Presidents held interviews to present a united front on monetary policy and Fed thinking. Minneapolis Fed President Neel Kashkari said the Fed may hold rates steady for "an extended period" and he emphasized that the Fed will "need to see multiple positive inflation readings to ensure that the disinflation process is on track." John Williams, from the Federal Reserve Bank of New York, said that "eventually we'll have rate cuts," but he stated that he thought monetary policy was presently in a "very good place." Chicago Fed president Austan Goolsbee said, "right now, it makes sense to wait and get more clarity before moving." These don't sound like quotes from a Fed that is likely to begin to cut interest rates anytime soon, right?

The Market:

If economic growth is good and the labor market remains healthy, even if inflation remains persistent, investors should view this backdrop as positive for corporate earnings and stock prices. 1st quarter 2024 earnings season is well underway, and over 60% of companies in the S&P 500 have reported results. For those companies, revenues and earnings are up roughly +5% year-over-year. Nearly 80% of companies that have beaten earnings, but only 56% have exceeded expectations on revenue. Forecasts for the market, in the 1st quarter of 2024, are expecting revenue and earnings growth of +3.4% and +2.2% respectively. This follows modest results in the 4th quarter 2023, where revenue and earnings were only +3.3% and +6.8%.

Outside of a few sectors, many companies are struggling to generate growth. The one sector that continues to fuel growth and drive overall results is Technology, expected to grow earnings this quarter by an impressive +19% on a +8% top line. Not only does it represent roughly 30% of the total S&P 500 weight, but the rest of the index would be posting negative results (down 3.4%) without the Technology sector. The "Magnificent 7" are expected to increase revenues by +13% and earnings by an impressive +33% this quarter. Despite this robust growth, the "Mag 7" hasn't been immune from the market's recent weakness. In mid-April, when the S&P 500 fell for 6 straight days, these seven companies lost nearly $1 trillion in market value. After a challenging April, where the S&P 500 fell (4.1%), and some are chanting the old adage of "sell in May and go away". We couldn't disagree more! Since 1950, for the months of May through October, the S&P 500 has risen 65% of the time - by nearly 2%. When the S&P 500 was positive through April (like this year), the S&P 500 was up 76% of the time - by 4%. Rest assured that we will be actively managing your assets this summer and fall and look forward to driving performance and alpha for your account.

For the full year, S&P 500 earnings are expected to grow by +10%, following last year's modest decline. This implies a 21x current year P/E and 19x for current 2025 estimates (assuming +9% earnings growth). We'll make our standard disclosure that we are much less focused on the overall market multiple and valuations, as opposed to our individual holdings. We are a bottoms up, fundamental research shop and spend the vast majority of our time focused on the fundamentals of our FINTECH companies. Speaking of FINTECH fundamentals, let's discuss the latest news in credit cards and a $30 billion interchange settlement.

We Hope Senator Durbin Can Move onto Something Else:

We have invested in Mastercard and Visa since their IPO's, in 2006 and 2008 respectively. When both payment companies initially listed, they identified potential legal liabilities stemming from merchant interchange lawsuits. During its IPO roadshow, Visa took a somewhat differentiated tact, by shielding new public shareholders from this liability and putting the risk onto the shoulders of its banking partners, card issuers, and earliest owners.

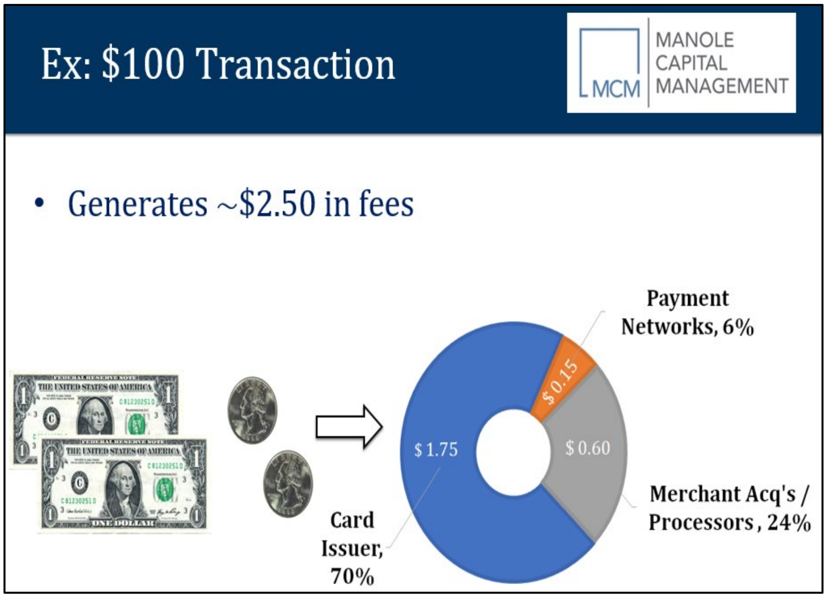
Over the last few decades, there have been numerous settlements, as well as legislation impacting payment industry. The Durbin Amendment, inside of Dodd-Frank legislation in 2010, altered debit fees. Also, a court ordered interchange settlement was approved over 15 years ago, but it was not fully embraced by the merchant community. Last year, Senator Durbin announced his intention to alter the payment environment again, with his CCCA (Credit Card Competition Act). This created a headwind for the networks, as it appeared that legislation from DC was on the horizon. We wrote numerous articles on this subject, highlighting our view that government interference in setting pricing isn't ideal. All of our research notes can be read at www.manolecapital.com, under the "Research" tab. If you don't believe us, since we clearly have a vested interest, there are additional thoughts about how the CCCA would negatively impact consumers.

Morning Consult, a Washington DC-based research firm, conducted a poll of 4,416 US adults. 69% of respondents stated that merchants would likely keep the cost savings, rather than pass it onto consumers. This is exactly what happened with Senator Durbin's debit legislation. Also, this poll found that 66% said large merchants (i.e., Amazon, Target, Wal-Mart, etc.) would likely choose cheaper, less-secure networks to process its credit card transactions. The big issue with this aspect relates to the zero-fraud liability on credit card transactions. Right now, cards issued with a Visa or Mastercard logo have a stated policy that cardholders are not liable for fraud if they notify their issuer 30-days from receipt of their monthly bill. With skyrocketing online fraud, this can become a real concern.

ICBA president and CEO Rebeca Romero Rainey recently said that it and hundreds of community banks "strongly oppose this controversial credit card legislation, as it would reduce access to credit card services, weaken cybersecurity protections, and end popular credit card rewards programs - solely to benefit large retailers like Amazon and Walmart".
In addition, Instead of DC legislation interfering with the well-functioning payments industry, another landmark interchange settlement was announced on Tuesday March 26, 2024. From our perspective, the whole payment industry can now breathe a major "sigh of relief". This legislation will impact certain players differently, but we wanted to review our early findings and explain some of the bigger ramifications on our payment industry.

Details:

Well over a decade ago, a settlement on interchange litigation failed to get enacted, as too many merchants backed out of the court-approved agreement. With this latest deal, thousands of US merchants (over 90% are small businesses), have agreed to resolve their long-running disputes over card network fees. While there is still much to learn about this new settlement, but it still needs to receive court approval by the US District Court in Brooklyn, NY, and Judge Margo K. Brodie. If it receives approval, we expect new rules in late 2024 or early 2025.



One key fact that must be understood is that while Visa and Mastercard set interchange rates, they do not earn interchange revenue. We thought it would be helpful to review our 1-page payment economics slide. This simple slide tries to show which parties or entities, within the payment's ecosystem, earn what on a credit card transaction. On a typical $100 credit card transaction, roughly $2.50 in fees can be deducted.

The differences in the MDR (merchant discount rate) depends on what product or service a company sells, its historical fraud rates, whether a card is present or not, etc. There are tons of differences, but we like to use this 2.5% as a decent average. Physical, brick and mortar retailers can pay less than 2.5%, while certain online-online merchants can pay significantly more. If you want to see an actual interchange pricing menu, click here.

Understanding who gets paid is critical in understanding the ramifications of this settlement. This is why both network stocks were fairly flat upon this announcement, while the card issuers and banks were down. Card issuers (i.e., the banks) earn 70% of this or $1.75 in swipe fees or interchange revenue. They earn the vast majority of the economics because they are taking the vast majority of the risk. These banks have real costs for providing this unsecured loan, as well as the liability risk on most fraudulent transactions. Card issuers need to spend money to attract new customers, as well as entice consumers to use their cards, offering various rewards, miles, points, etc. From our perspective, we prefer to own the payment networks, gateways, acquirors and processors.

Specifically, interchange fees will decline by four basis points for three years and they cannot be raised for five years. In addition, the agreement requires each network to ensure that its average effective credit card interchange rate (including posted rates and negotiated rates), is at least seven basis points lower than the average credit interchange rate for the 12-month period ending March 31, 2024. These reductions are expected to save merchants an estimated $30 billion (over the next five years), but once again – it comes out of the card issuer pie, not Visa or Mastercard's network fees.

On that same $100 credit card transaction, the payment networks earn a steady, predictable, sustainable, recurring revenue (per swipe) of roughly $0.15 or 6% of that $2.50. Merchant acquirers and payment processors earn the rest of the fee or 24% or $0.60 for authorizing, clearing, and settling the transaction.

In our opinion, this is the key area where the details will need to be understood. Larger merchants pay a significantly lower acceptance cost than SMBs, as they are provided volume and transaction discounts (for their scale). For example, Wal-Mart and Target pay materially less in an MDR, than the local, mom and pop retailer. Do small merchants have leverage to approach their acquirer and demand lower fees? Yes, but most won't get the majority of this decrease. Certain merchants pay one MDR, known in the industry as bundled pricing. Whether it is a credit or debit card, these merchants pay one flat rate for card acceptance. With debit pricing declining by 30% (from $0.05 on face + $0.21 fixed down to $0.04 + $0.144) and credit pricing falling by 7 basis points, acquirers will pass along *some* of this discount to their merchants.

We expect acquirers will round this discount off and keep the vast majority of the underlying transaction expense reductions for themselves. An analysis from Jefferies indicated that Square (ticker SQ) will see a material benefit from this settlement change, as many of its merchants are smaller in size. Jefferies estimates a 9-basis point increase in Square's net take rate, a 6% increase in 2025 gross profit, all based off of a 50% / 50% mix of credit versus debit and a $25 average transaction size. Once again, small merchants will get some benefit, but they don't have the embedded technology (and time) to differentiate between various card brands and payment types.

To quickly summarize, the brunt of the pain - from this latest settlement - will be borne by the card issuers and banks, with lower interchange rates. However, merchants have new rights and will look to leverage this negotiating power against their acquiror.

Steering:

In addition to lowered interchange pricing, this new agreement will allow merchants to steer payments. While merchants have been asking for this ability for years (and Visa and Mastercard have fought them for years), it is potentially a tricky customer experience to navigate.

As a consumer, I like to pay with whatever form of payment I choose. It can be cash, check, debit, credit, pre-paid, A2A (account to account), BNPL (buy now, pay later), etc. When a merchant tries to steer me to their preferred method of payment - maybe their cheapest form of acceptance - I can get a bit frustrated. I abide by their requests, especially if I want their product or service, but it can be a pain point. I know all merchants would like to have all of their transactions occur without any costs, but that's entirely unrealistic. I'd like to be the quarterback for the Miami Dolphins, but that too isn't going to happen. There is a real cost to payments, just like there is a real cost to labor, rent, electricity, etc.

We do not believe that a bored high-school cashier, at the POS (point of sale), will be able to navigate the complex world of various card brands. Will a cashier be able to remember that a Citi AAdvantage Executive Mastercard or are Platinum American Express card or a JP Morgan Chase Sapphire Reserve Visa card is permitted? We think the complexity of various cards and payment methods will simply have merchants *accept all payments* and <u>not</u> steer towards one particular brand or card.

Today, certain merchants accept Visa and Mastercard, but not American Express (due to higher costs of acceptance). Certain businesses only accept cash, and no card payments are allowed. Steering payments has existed for years, but now merchants will have more flexibility to pick and choose. We are in favor of more choice and personal freedoms, but we expect certain merchants will take advantage of the situation and botch this new power. We hope we are wrong, but only time will tell.

Surcharging:

In addition, when a merchant places a surcharge on credit card usage, it is often in excess of their acceptance costs. This can be an irritant that disrupts the shopping experience. Why should a merchant surcharge 3% or 4% for using a credit card when their cost to accept cards is only 2%? Turning card usage into a profit center isn't fair or professional. Merchants don't charge consumers for electricity (lights, air conditioning, heating, etc.). Why charge a paying consuming for picking the best form of payment in one's wallet? Gas stations have been offering a lower rate for cash for years, but the vast majority of consumers prefer the convenience of transacting with a card.

Surcharging (and steering for that matter) have the potential to really annoy customers. Merchants complain about abandoned carts online, as well as wanting to quickly move customers through the checkout line. If merchants don't handle steering and surcharging properly, it could ultimately become a major complaint and shopping bottleneck. Merchants should tread carefully on these new rights, but we envision some making mistakes to annoy their loyal customers.

Interchange Settlement Conclusion:

All of these estimates are just that…estimates. Banks and card issuers might respond with lower rewards, higher annual fees, or other actions, but we are positive that they will enact fees to make an acceptable return on their business.

In Mastercard's press release, its Chief Legal Officer and General Counsel Rob Beard said, the "agreement brings closure to a longstanding dispute by delivering substantial certainty and value to business owners, including flexibility in how they manage acceptance of card programs." In Visa's press release, their North American President Kim Lawrence said, "By negotiating directly with merchants, we have reached a settlement with meaningful concessions that address true pain points small businesses have identified. Importantly, new are making these concessions while also maintaining the safety, security, innovation, protections, rewards, and access to credit that are so important to millions of Americans and to our economy."

We agree 100% and are pleased that businesses have decided to settle these issues - without the interference of our politicians. In our opinion, this legal settlement could be a "clearing of Washington DC risk", for both Visa and Mastercard. That is, if Senator Durbin focuses on other pressing issues. The last time that DC got involved, it set price caps, curtailed usage, and tried to put its thumb on the scale to benefit certain parties. This time, economic parties and businesses freely decided how to interact with each other, and the government stayed out. If the constant suits and litigation comes to an end, we hope that payment innovation will thrive, potentially leading to increased M&A.

Speaking of M&A:

April 1st is always a mini holiday for us, as that is the day we found out about KKR's acquisition of First Data in 2007 for $29 billion. Ever since, April 1st is "First Data Day" for us, and gets celebrated with a nice bottle of red wine. Payment companies have predictable, sustainable, recurring revenue business models, that produce large amounts of free cash flow. In our opinion, that is the reason why private equity tends to find the payment space so attractive and intriguing.

The last big wave of M&A in payments occurred in the 1st half of 2019, when Fiserv bought First Data, FIS purchased Vantiv/Worldpay and Global Payments acquired Total Systems. Since those transactions, private equity has filled the void, with Thoma Bravo acquiring Bottomline Technologies for $2.4 billion (at 22x EBITDA) and Coupa Software for $8 billion (at 8x revenue), Madison Dearborn bought MoneyGram for $1.8 billion (at 8x EBITDA), EQT acquired Billtrust for $1.7 billion (7x revenue), GTCR acquired Worldpay for $17.5 billion (at 10x EBITDA) and Vista Equity purchased EngageSmart for $4 billion (at 9x revenue).

In March, rumors began to swirl that Shift4 (ticker FOUR) was receiving buyout offers, but its Board of Directors deemed the bids too low. Then, on April 1st private equity (Advent) struck again and bought Nuvei for $6.8 billion (at 17x EPS and 12x EBITDA). We owned Nuvei (ticker NVEI) and liked its scalable and flexible technology-focused payment platform, global focus, and how the company generated 90% of its volume from eCommerce and mobile payments (both secular growth areas). According to the Bureau of Labor Statistics, eCommerce sales grew +9% year-over-year in the 1st quarter of 2024, the highest annual growth rate since the seasonally strong 4th quarter of 2022. While Nuvei only processed $200 billion in volume last year and it maintained a small share of the $50 trillion payment volume TAM (total addressable market), it had a solid niche in various verticals, and a very attractive valuation. Clearly, Advent agreed and acquired Nuvei for a +48% premium to its 90-day VWAP (volume weighted average price). We expect more payment deals to occur in 2024, especially if free cash continues to flow and valuations stay this attractive.

Conclusion:

On the fundamental front, we are pleased with our portfolio positioning. M&A is picking up and our payment companies – that generate significant free cash flow - are gaining momentum. With a ton of geopolitical and macro uncertainties, our exchanges are experiencing elevated volumes and positive results. These two sub-sectors remain our largest exposures and we're excited about their go-forward prospects.

On the macro front, we are modeling that rates will stay a bit elevated, for a bit longer, especially as we get closer to the election. We think the Fed is holding steady for a few good reasons. It recognizes that economic growth remains strong, the jobs market is healthy, and inflation is running slightly hotter than they would like. Chairman Powell said, "Right now, given the strength of the labor market and progress on inflation so far, it's appropriate to allow restrictive policy further time to work."

The Fed's fight against inflation might have stalled, but it is still moving in the right direction. From everything we are hearing (from Fed officials), it appears they are in "wait and see" mode. From our perspective, that means that rates do not need to dramatically change. The combination of these issues isn't necessarily a bad thing. In fact, it likely bodes well for earnings and the overall equity market.

We hope you had a wonderful spring and are looking forward to the summer. We are always available to speak and hope to catch-up with you soon. Feel free to call us to discuss the overall market or anything in our FINTECH industry.

Warren Fisher, CFA
Founder & CEO
Manole Capital Management

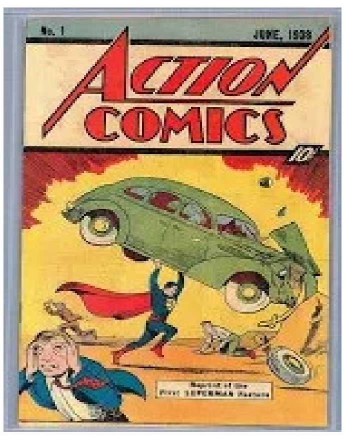
Cliff Clavin's "Useless" Information:

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

- 96% of US mortgage debt is fixed, not floating
- 39% of US homeowners have no mortgage

Over 160,000 spectators, some donning ridiculously large hats, attended the 150th Kentucky Derby at Churchill Downs. 20 horses ran a lap, but nobody seems able to beat a record set in 1973. Secretariat holds the record for fastest Derby ever, coming in at 1:59.4. It seems odd that no horse has been able to beat a 50+ year old record, when human records tend to be break speed and running records each and every year.

Before he became our 37th US President, Richard Nixon was known as a prolific poker player. He was able to amass enough winnings to help fund his very first political campaign. In January 1944, while he was stationed in the South Pacific in the Navy, "Tricky Dick" Nixon was known as a card shark. The story goes that President Nixon raked in $50 each night (roughly equivalent to $875 in today's dollars) and used that money to run for Congress in California's 12th district.



At a recent Heritage Auction, a comic book featuring Superman's first-ever appearance has sold for $6 million. The June 1938 comic is now the most expensive / valuable comic ever sold. The previous record for a comic sold at auction was $3.6 million, for a copy of "Amazing Fantasy No. 15" - featuring the debut of Spider-Man. Superman was created by Jerry Siegel and illustrator Joe Shuster in the early 1930s. Back then, Action Comics No. 1 sold for 10 cents or the equivalent of about $2 in today's dollars. Publisher National Allied Publications was a predecessor to DC Comics, which owns the rights to Superman today.

During her Iowa career, Caitlin Clark scored more points than any other college basketball player -either male or female. She was picked #1 in the WNBA draft by the Indiana Fever. Her salary in Year 1 is a modest $76,000 and it is just $338,000 for the first 4 years. This is quite different from the first pick in the NBA draft last year, who earned $55 million over the same 4 years. However, don't feel too bad for Caitlin, as she will likely earn more in sneaker endorsements than she'll earn in her professional basketball career. Nike signed Caitlin to an 8-year shoe deal worth $28 million, after an intense bidding war versus Adidas and Under Armour.

Inflation? What inflation! Take a look at the menu pricing at The Masters. $1.50 for a pimento cheese sandwich and $2.00 for a lemonade sure seem pretty reasonable to us.

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