Manole
Capital Management

3rd Quarter 2016 Newsletter

Published July 2016

Manole Capital Management

Commerce Club at Oxford Exchange
Tampa, FL 33609
Phone: 813-728-3344
E-Mail: warren@manolecapital.com

www.manolecapital.com

3RD Quarter 2016:

Just as we were about finished drafting this newsletter, on the 24th of June, Great Britain made a surprising decision to leave the European Union. This came despite warnings from experts, and great confusion and uncertainty about the monumental consequences in store. This was one of the greatest displays of democracy in modern times - for Britain, never have more people been asked to make a decision so important for their country's future. It was a grueling and extremely divisive campaign, but 17+ million people voted to leave the European Union. While the "Remain" camp received 16 million votes, it lost the closest political vote in Britain's history. Importantly, Scotland voted to remain in the EU, which raises profound questions about the possibility of Scottish independence from the United Kingdom.

Was the *Brexit* camp fueled by anxiety over the economy or concerns over immigration? Was it a vote to take back English sovereignty and return control to London from Brussels and Berlin? Were all voters fully aware of the ramifications of this vote? Some believed that the country that was slowly being ruined with the over-reaching bureaucracy of EU regulations. There was a growing sense that laws were being enacted by a European Court of Justice without an adequate appeals process.

Following the *Brexit* vote, there has been widespread economic and political turmoil. Prime Minister David Cameron has announced his resignation. The market is still attempting to understand all of the ramifications of the vote. But the markets are never patient. Any uncertainty results with a simple pressing of the sell button. If a company has UK exposure, the consequences have been even more violent.

We at Manole Capital are not about to make a grand statement concerning the rationale behind *Brexit*. Instead, our opinion instead is more aligned with understanding the ramifications of this decision and properly positioning our portfolios to benefit going forward. We believe that the United Kingdom will remain a key component of Europe. This referendum does not alter that statement.

Despite the many unknowns and the fact that so many crucial issues will need to be addressed over the next year or two, we believe the fundamentals of the UK economy are dynamic and strong. British citizens will still be allowed to live, travel, study or even buy homes across the EU. There will continue to be free trade and UK companies will still be allowed to access the single market. Trade agreements will need to be revised and re-written. Immigration policies will need to be vetted. The British people have

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decided to attempt to build a better free trade partnership with the EU. It will be critical for the next British government to build a lasting relationship with the rest of the world (not just the EU). Only time will tell if the *Brexit* decision will be a positive. Instead of focusing on the negatives (which the market has clearly done), we are trying to remain neutral and examine the opportunities, while doing our best to understand all the fluid changes.

Will the UK pass laws and set taxes according to its own needs? This was absolutely the hope that the majority of British voters were seeking. The UK believes it will now be allowed to make free trade deals with growth economies around the world that were previously forbidden. The leader of the *Brexit* campaign was controversial former London mayor Boris Johnson. He recently called this decision an optimistic vote and Britain will be "rebooted, reset, renewed and able to engage with the whole world". Maybe we are being too naïve, but we are trying to remain optimistic. The specific trade agreements and regulations will need to be ironed out and this will take time. The UK will extricate itself from a legislative system that it felt was opaque and unfair. The UK will begin the process of taking back democratic control of its immigration policy, which all hope will be balanced, humane and suit the needs of both citizens and businesses.

The understanding of *Brexit* will impact commerce, trade, immigration and business. The stock market does not like uncertainty and disruption and it responded swiftly by wiping away trillions of dollars of value following the historic vote. During periods of uncertainty like this, we prefer to focus our attention on owning great franchises and doing bottom-up fundamental research. The US economy is in good hands. The fundamentals are positive and balance sheets are strong and growing. We in the US may not like the market response, but it is not our position to intervene.

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Manole's process and philosophy:

We are business buyers and investors, not short-term traders. Our focus is to do in-depth research on strong, durable franchises. We strive to buy great companies at reasonable prices. Our core belief is that value is driven by time, not timing. The process seeks to identify growth businesses with key attributes. Adhering to these investment traits leads to positive stock selection and outperformance.

The characteristics were look for are:

- ✓ Market leaders with durable competitive advantages
- ✓ High barriers to entry and "moat" around franchise
- ✓ Pricing power and flexibility to withstand market volatility
- ✓ Recurring revenues and sustainable business models
- ✓ Strong balance sheets with predictable free cash flow

Classifications:

When we mention these traits to investors, we often hear "of course"! Most investors look for these same desirable characteristics.

The S&P 500 can be segmented or broken down into 10 different sectors: Healthcare, Technology, Financials, Industrials, Consumer Discretionary, Staples, Energy, Utilities, Materials and Real Estate. We try to avoid these strict definitions and industry classifications. Instead, our investment philosophy looks for wonderful businesses and attractive valuations regardless of sector. It just so happens that many of the companies we identify during our process tend to be in the financial sector or in technology-based businesses.

What we look for in a "Financial":

In the US, there are 12,500 banks, credit unions and financial institutions. We would argue that traditional banking is a commodity business, with the commodity simply being the US dollar. In its simplest form, a bank earns the spread between its borrowing costs and its loan income, with the spread often being a function of interest rates, driven by numerous macro factors. For example, The Fed bases its Federal Funds rate on employment and inflation expectations.

Whether a broker / dealer is proprietarily trading or a bank is making loans, too much uncertainty surrounds their success. Opaque balance sheets, unpredictable trading

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results and untimely credit risks are not desired traits we look for. Quite simply, the majority of financials are credit sensitive and therefore quite cyclical / naturally un-predictable.

We prefer to understand how our companies generate their revenue and income, and within financials, we prefer transparency. The financials we own will benefit from higher volatility, all without taking unnecessary credit sensitivity and risk.

Example #1: Derivative Exchanges

On the CME Group's website, at www.cmegroup.com, investors have real time access into the number of trades that are occurring daily. The company breaks out volumes into the key products customers are trading. Whether it is interest rates, energy, commodities, equities, metals or foreign exchange, one can model the trends quite easily. When we discuss transparency, this is a perfect example. The CME has many of the characteristics we look for in companies, whether it is dominant market share, high barriers to entry, excellent operating margins and predictable free cash flow. We recently discussed our investment thesis in CME at length (visit www.manolecapital.com and the "Resources" tab for the full article).

The power of these franchises was on full display following the *Brexit* on June 24th. With US Financials falling 6% to 7%, both CBOE and CME were up. A key component to our investment thesis is how exchanges benefit from volatility. We continuously model the implications of changing interest rates, currency exchange rates, prices of energy, metals and commodities. We tend not to make bold, macro predictions on these assets, nor will we make investments on the rise or fall of a product. In this sense, we simply like to bet on transaction venue (ie: bet with the house).

What we look for in "Technology" companies:

Within technology, we tend to prefer companies with little risk of obsolescence. Once again, we are attracted to companies generating sustainable and recurring revenue. The secular growth of digital payments, for instance, should provide years, if not decades, of predictable growth.

Advice from Buffett:

Legendary investor Warren Buffett writes very readable and compelling annual letters to his Berkshire Hathaway's shareholders. In his 1991 annual report, Buffett had a great perspective on identifying the value of a franchise. He believes there are two kinds of enterprises. One is a business and the other is a franchise. If you have the right product,

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investors are comfortable paying for this positive mental association. He argues that most successful franchises have characteristics like: no close substitute, a product or service that is needed or desired, and not being subject to price regulation. Lastly, Buffett believes that a franchise can price its products aggressively and still earn high rates of return on capital. Once it is possible to identify franchise value, the real trick is to properly frame how resilient it is. Buffett describes a franchise like a "moat around your economic castle". How big is it and how durable is that franchise?

Example #2: Payment Networks:

Back in 2012, Visa and MasterCard were both under pressure from a new competitive threat. A consortium of 70 major brands and 40 big box retailers were joining forces to create the Merchant Customer Exchange or MCX. Companies like Wal-Mart, Target, Lowe's, CVS, Rite Aid, Shell, Mobil and others formed MCX to create a merchant owned mobile commerce network. MCX had a noble goal. It wanted to create a free app to let customers save time by centralizing loyalty, rewards, coupons and promotions at participating retailers checkout counters. The un-stated, but real goal was to lower their cost of accepting card transactions (called the Merchant Discount Rate or MDR in the payment industry). MCX was going to create the latest in must have payment apps. The app was called CurrenC after its original name – ISIS – became an obvious liability.

The Street was worried that these retailers were powerful enough, with their 110,000 locations, to end the dominant position of the two largest payment networks. In terms of market share dominance (according to The Nilson Report), Visa and MasterCard represent roughly 75% & 91% of all global credit & debit purchase transactions. The companies generate operating margins in the 50% to 60% range. This kind of profitability and market share dominance is always going to attract competition.

Keep it simple:

In our opinion, the beauty of these franchises is their simplicity. We are not saying it is simple to authorize, clear, process and settle global credit and debit cards transactions. In fact, it is a terribly complex transaction that often occurs in just a few seconds. The simplicity of their business model is that customers can transact easily and make payment however they wish to transact. MCX and their CurrentC app were attempting to force customers to make payment via the Automated Clearinghouse or ACH network. By using ACH and not traditional funding sources (ie: credit or debit cards), participating merchants would be able to lower their operating costs. Forcing customers to utilize a different payment methodology, rather than one they are already very comfortable using,

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was not smart.

Last month, MCX postponed and then shut down its rollout of its merchant controlled mobile wallet. However, no sooner did this happen then Wal-Mart announced the launch of its new payment app called Wal-Mart Pay.

A different type of competition:
Meanwhile, there was another potential payment threat in the works by 2014. Apple Pay was being launched with the new iPhone 6. Android Pay and Samsung Pay were also going to be released and many feared that these mobile wallets were going to threaten Visa and MasterCard's market dominance. The market assumed that Apple, with its beautifully designed phones and fully integrated operating system, would look to create and capture payment market share. It was common thinking that the world's largest company would use its ample resources to invest in a business that generates 50% to 60% operating margins.

As these new apps came to market, it was clear that these entities understood what their value add was to the consumer equation. None came out with an app that required some elaborate sign-up process or one that did not utilize traditional debit or credit cards. Instead, these phone and mobile operators recognized that Visa and MasterCard provide a valuable service, and have a wonderful franchise with a dominant and wide moat. These potential competitors decided it was a better choice to partner with rather than fight the established payment players.

Looking forward:
We do not know which mobile wallet will ultimately grow and become the latest must have app. One might have allegiance to the Apple iPhone, while others believe the Samsung phone is the latest and greatest device. We do not need to go too far back in history to remember how dominant Blackberries were in the hardware segment. It is our belief that providing customers with choice is a better alternative. All successful payment apps or newly created mobile wallets should allow bank issued credit and debit cards to act as a funding source. Behind the scenes, we expect both Visa and MasterCard to be the dominant payment networks executing these purchase transactions. This should provide years of future growth.

Growth:
The secular growth of digital payment networks will come from steady conversion from cash and check to card-based payments, and higher penetration of online purchase

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transactions, which need to occur electronically. In addition, there are emerging markets that are slowly embracing digital payments. For example, China is estimated to be an $8.4 trillion dollar market opportunity. The Chinese market should continue to grow in the double-digit range and it currently represents over half of the 9.5 billion cards issued globally.

However, despite its large card-issued market share, China Union Pay (or CUP) only represents roughly 10% of global purchase transactions. The card market in China is protected by the Peoples Bank of China, which limits the ability of foreign competitors to enter. Over the next one to two years, we believe these official rules will be opened up for players like Visa and MasterCard to begin to capture some of this growing market. Visa is partnering with China Union Pay and MasterCard has relationships with Alibaba and Tenpay. It is this type of open-ended growth and opportunity that leads great franchises to garner a high weighting in our portfolios.

Once again, this growth will be predictable, sustainable and recurring in nature. That is our definition of a formidable franchise with significant competitive advantages. These two companies clearly meet all of the characteristics we mentioned earlier.

Macro events:
We are not macro economists and will continue to focus on doing bottoms up, fundamental research. That being said, we examine bigger picture issues and how they might impact our portfolio of companies. We closely track macro data and attempt to model various scenarios or "what if" outcomes. To best position the portfolio, we attempt to put this data – viewed as numbers - into perspective.

The Federal Reserve continues to keep its benchmark interest rate target pegged to a range of 0.25% to 0.50%. For some perspective, rates are not just low within the context of recent history. Andy Haldane of the Bank of England, in a recent speech, declared that he believes that interest rates are at their lowest levels in the last 5,000 years of civilization (see chart #1).

US Jobs:
One of the biggest topics during the 2nd quarter was the dramatic fall off in non-farm payrolls released on June 3rd. Street expectations were calling for the continued trend of roughly 200,000 new jobs per month. This steady growth has led to an impressive unemployment rate of 4.7%, which is the lowest since November 2007. For perspective, the average unemployment rate (from 1948 to 2016) is 5.8%. A high was set in

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November 1982 at 10.8% and a low was set in May of 1953 at 2.5%. We are clearly closer to the low than the high. The release from The Bureau of Labor Statistics reported only 38,000 new jobs in May. In addition to revising down prior months, this represented the smallest growth in over 5 1/2 years and significantly below the 3-month average of 116,000 new jobs. Before the release, the US economy was fairly steady and consistent. This stable environment led several Fed Governors to hint that additional interest rate hikes were to be expected in the back half of this year.

Before the jobs report, expectations were that a June 2016 rate hike was 20% likely. Immediately following the report, expectations fell to 6%. Expectations for a July rate hike fell from 58% to 34%. Within two hours of the report, any rate hike for all of 2016 fell from a likelihood of 82% to 66%. While the stock market fell only 0.40% that day, the financial sector was down by well over 2%. Over half of the futures market yield was expecting two interest rate increases in 2016. This had fallen to 1 in 5 (see chart #2) before *Brexit* and now expects no change at all. At the June Fed meeting, Chairwoman Yellen sent a strong signal that it now expects only one interest rate hike this year, while the market sees less than a 50% chance of that by year end. Fed officials are looking for rates to increase to 1.6% by 2017, but this too is headed lower following *Brexit*.

Interest Rates & Negative Yields:
Economists have long believed that negative interest rates simply could not exist for extended periods of time. These academic experts thought that it would lead to higher inflation, as creditors and borrowers would trigger a logical wealth transfer. Why wouldn't you borrow endless amounts of money, especially if you'll be paid to do so?

The 10-year German Bund yield closed in negative territory for the first time ever and the spread to US Treasuries has widened (see chart #3 and chart #4). Germany now joins Japan and many other central banks (see chart #5) in experimenting with negative yields. In fact, Japan's 15-year bond went negative last month. Last year, just 6% of the Bank America Merrill Lynch Global Bond index had negative yields. Now, negative yielding bonds have increased to over 1/3rd of the total index.

For those making a living on rate spreads (ie: banks), low interest rates are obviously not a positive. European banks have been under significant pressure and there does not seem to be a life raft in sight. Some large European banks are undercapitalized, are riddled with bad loans and continue to deal with relentless regulatory changes and pressures. With modest to weak growth expectations, European banks are struggling (see chart #6).

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Following the *Brexit* decision, currency movements and a rush to the safety of government bonds have dramatically increased the amount of negative yielding global debt. Estimates (from Fitch Research) now believe that negative yielding debt is $11.7 trillion, up 12.5% since the end of May (see chart #7). Negative yielding debt, with maturities 7 years or longer, have doubled since April. With many governments continuing to utilize unconventional monetary policies, this trend should continue. Japan is the perfect example. It continues to use easing policies and its negative yielding debt has ballooned to $7.9 trillion, up 18% for the month.

Despite this, many investors are desperately looking for yield. Fixed income investors are specifically perplexed. Many are selling their bonds to central banks that buy up paper and attempt to drive down yields to spur growth. This is their stated policy and one of the few options at their disposal. It is our opinion that things have officially gotten silly when 50 year Switzerland debt trades at yields below the 1 month US Treasury (see chart #8).

Investors then look anywhere where yields are <u>not</u> negative. This leads them to US Treasuries. The two largest holders of US Treasuries are China with $1.2 trillion and Japan with $1.1 trillion. Private Japanese investors have purchased $70 billion in foreign bonds so far this year. Despite the Fed talking up the prospects of the economy and hinting at rate increases this year, overseas investors continue to have an insatiable desire for Treasuries. This has caused US yields to plunge, despite the Fed's policy desires. A year ago, there were some worries that Russia and Saudi Arabia might sell their vast holdings of US Treasuries to raise funds while energy prices collapsed. There was angst that the market would not be able to absorb this supply. This clearly is not the case.

<u>Corporate Debt:</u>
It is popular to quote how solid many company's balance sheets are these days. However, while there is over $1.8 trillion of cash on company balances sheets, much of that is concentrated in Apple, Microsoft, Google and other technology companies. A S&P study recently showed that excluding the 25 richest companies and their $950 billion of cash, the S&P 500's bottom 99% have a much higher percentage of debt versus cash than at anytime in decades. We have seen 50 US companies default on bonds or loans so far this year, which is twice the number versus last year.

The biggest purchasers of negative yielding securities are central banks. Balances sheets are expanding at a rapid pace and debt levels are rising in comparison to country

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GDP levels. Corporations also benefit from this historically low interest rate environment. Treasurers and CFO's are doing fairly straightforward math and can easily decide to issue debt to fund operations, make acquisitions or buyback stock. At these remarkably low rates, essentially everything is accretive. Over the last five years, companies have increased total debt by $2.8 trillion. There is now a record amount of corporate debt, which stands at a whopping $6.6 trillion. In our opinion, when debt levels climb at rates significantly faster than their profit levels, it could become an issue. If a company does not generate enough free cash flow in a rising rate environment, some levered companies will be in trouble.

Lower energy prices experienced last year can ultimately lead to a spiral of pain, not only for oil producers, but for banks as well. Drillers led the US shale boom, but they typically outspend their cash flow. It is costly to get land rights, move drilling rigs and generate oil even at $100 a barrel. Many independent energy producers took on significant leverage. With crude at $50, those revenues fell. The banks that lent to them have begun to set aside billions of dollars to cover these losses. Regulators and investors are pushing these banks to limit exposures to the risky oil industry. It is this type of spiral that can be dangerous.

2nd Quarter 2016 Manole Capital performance:

Specifically, the digital payments industry continues to be a great source of outperformance. We believe there are literally decades of solid growth for the payments industry. MasterCard estimates that 85% of global purchase transactions are still conducted in cash and check. The adoption of credit, debit and electronic transactions will continue to steadily grow and lower this paper percentage over time. Specific avenues of growth are coming from online purchase transactions (for eg: Amazon or eBay), the continued adoption of card payments in new venues (for eg: Square), as well as the strong secular trend of card adoption in emerging markets (for eg: India or China).

Companies that will benefit from these trends are the payment networks like Visa (V), MasterCard (MA) and PayPal (PYPL). In addition, merchant acquirers and processors will see growth in their transaction-based business models. These are less popular companies like Global Payments (GPN), Vantiv (VNTV) and Fleetcor (FLT). These are not credit sensitive companies, but rather are earning revenue and profits on every payment transaction that occurs. We are fans of toll-keeper models, as opposed to bridge-builders.

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Marketing:

We are still developing our social media strategy. Please let us know how we should stay in touch. We are continuously trying to articulate our investment process in value-added articles and research. We will continue to publish these notes on our website under the “Resources” tab (www.manolecapital.com). Going forward, we are planning to send out our information on a more regular basis – once a month. If you would like to receive this monthly update, please let us know directly or simply sign up on our website. Please follow us on Twitter (at Manole Capital) or connect with us on Linked-In. Our goal is to provide content that is engaging, relevant, customized and thought-provoking. We understand that each investor has a different perspective on how much research they would like to receive.

Conclusion:

The first six months of the year have experienced elevated levels of volatility. The global economy has been facing several challenges, which have unsettled financial markets. These unpredictable swings have changed sentiment, especially when one begins to factor in slowing global growth levels. Lingering concerns in China, the ramifications of *Brexit*, rising inflation pressures and potentially higher US interest rates will continue to be a factor going forward.

We continue to see signs of economic and financial steadiness. Energy prices have stabilized, the US economy is on firm footing and it appears that the Chinese economy has rebounded from the concern that led to the market swoon late last year. We appreciate these concerns still exist, but remain comfortable with overall sentiment and expectations. Uncertainty will always exist, especially with big issues like *Brexit* and the US Presidential election. We believe some of the market fears are diminishing and the market should react favorably. Continued market stabilizing coupled with a reasonable and cautious Fed (in terms of monetary tightening) should lead to improved prospects for the back half of the year. In prior years, it is in exactly this type of environment where we have excelled, through disciplined and effective stock selection.

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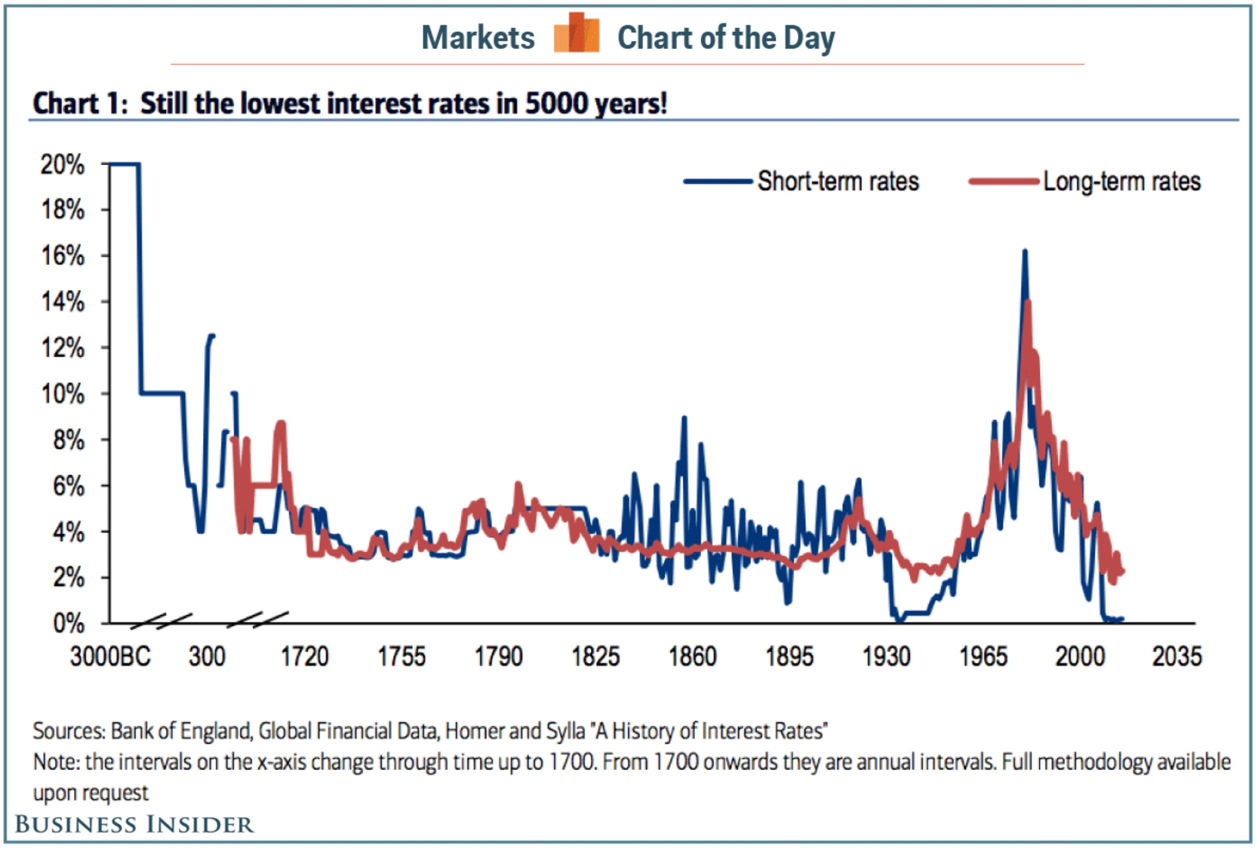
Chart #1: Interest Rates over the last 5,000 years



Check out below:
Mesopotamia, c. 3000 BC: **20%**
Babylon, Code of Hammurabi, 1772 BC: codified earlier Sumerian custom of **20%.**
Persian conquest (King Cyrus takes Babylon), 539 BC: rates of **40+%.**
Greece, Temple at Delos, c. 500 BC: **10%**
Rome, Twelve Tables, 443 BC: **8.33%**
Athens/Rome: circa the first two Punic Wars, 300-200 BC: **8%**
Rome: 1 AD: **4%**
Rome, under Diocletian, 300 AD: **15% (estimated)**
Byzantine Empire, under Constantine, 325 AD: **limit 12.5%**
Byzantine Empire, Code of Justinian, 528 AD: **limit 8%**
Italian cities, c. 1150: **20%**
Venice, 1430s: **20%**
Venice, (Leonardo da Vinci paints "The Last Supper in Milan"), 1490s: **6.25%**
Holland, beginning of the Eighty Years' War, 1570s: **8.13%**
England, 1700s: **9.92%**
US, West Florida annexed by the US, 1810s: **7.64%**
US, circa World War II, 1940s: **1.85%**
US, Reagan administration, 1980s: **15.84%**
US, Fed does hike rates in December 2015: **0.25-0.5%**

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Chart #2: Expectations for 2 interest rate hikes in 2016

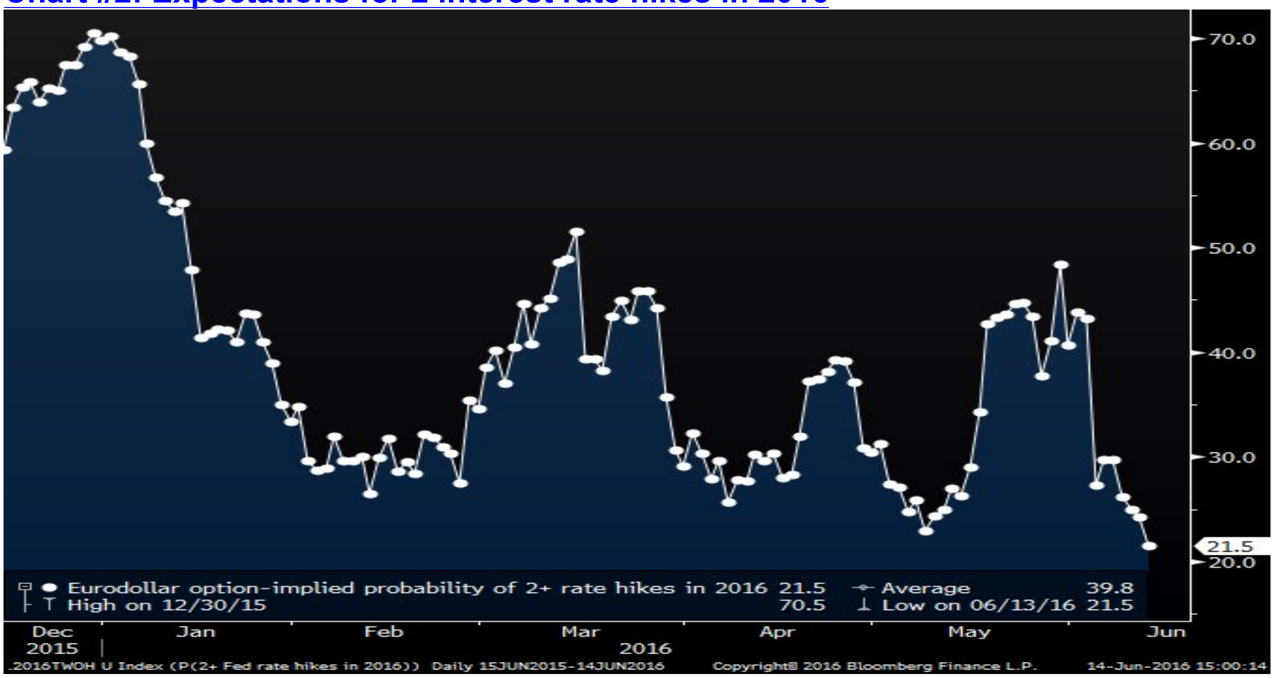

Chart #3:German 10-year Bund yield

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Chart #4: Spread between US & German 10 yr bonds

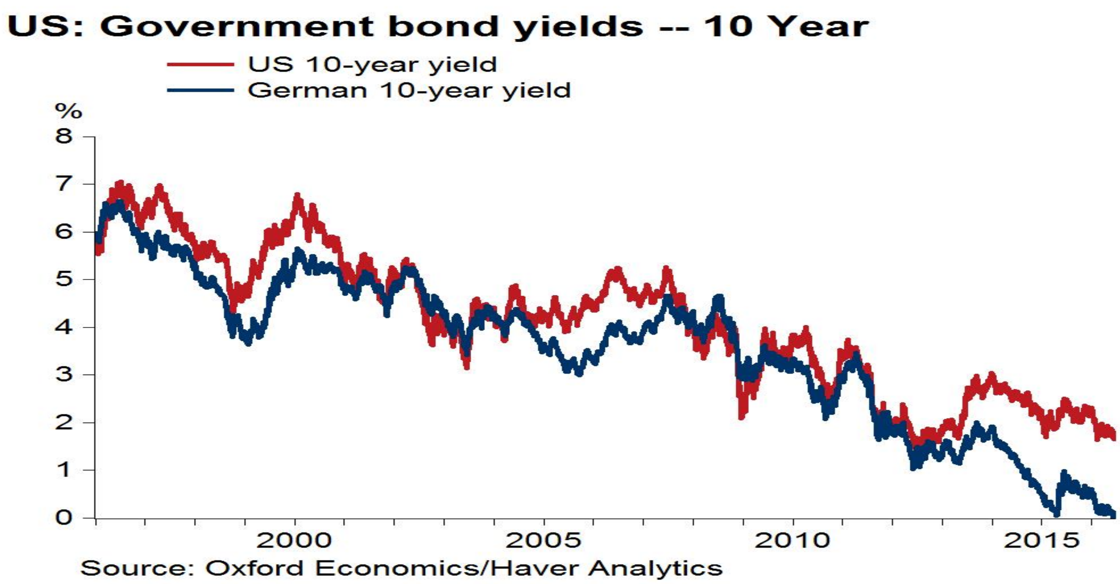

Chart #5: Sovereign Debt with Negative Yields

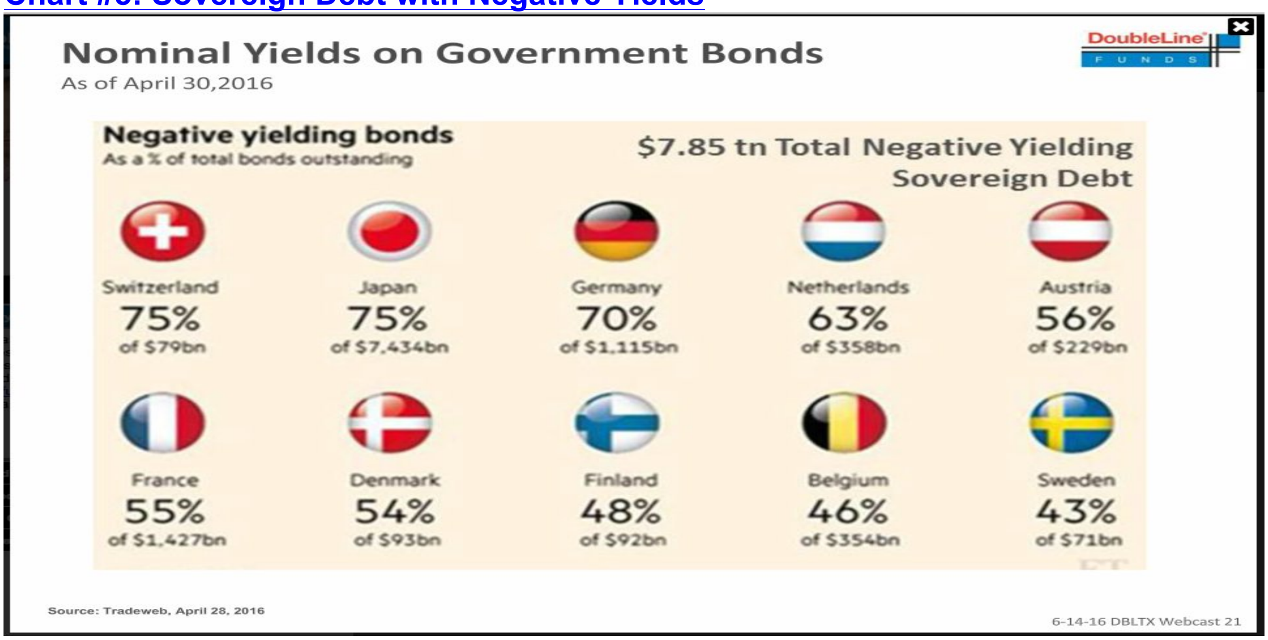

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Chart #6: European Banks:

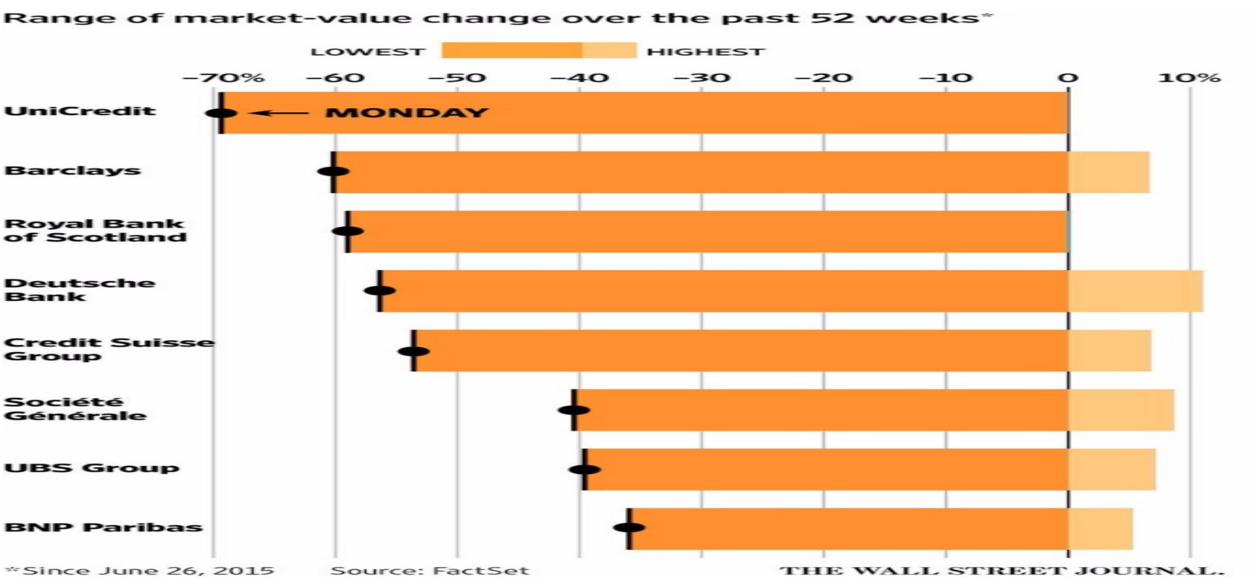

Chart #7: Total Negative Yield Bonds

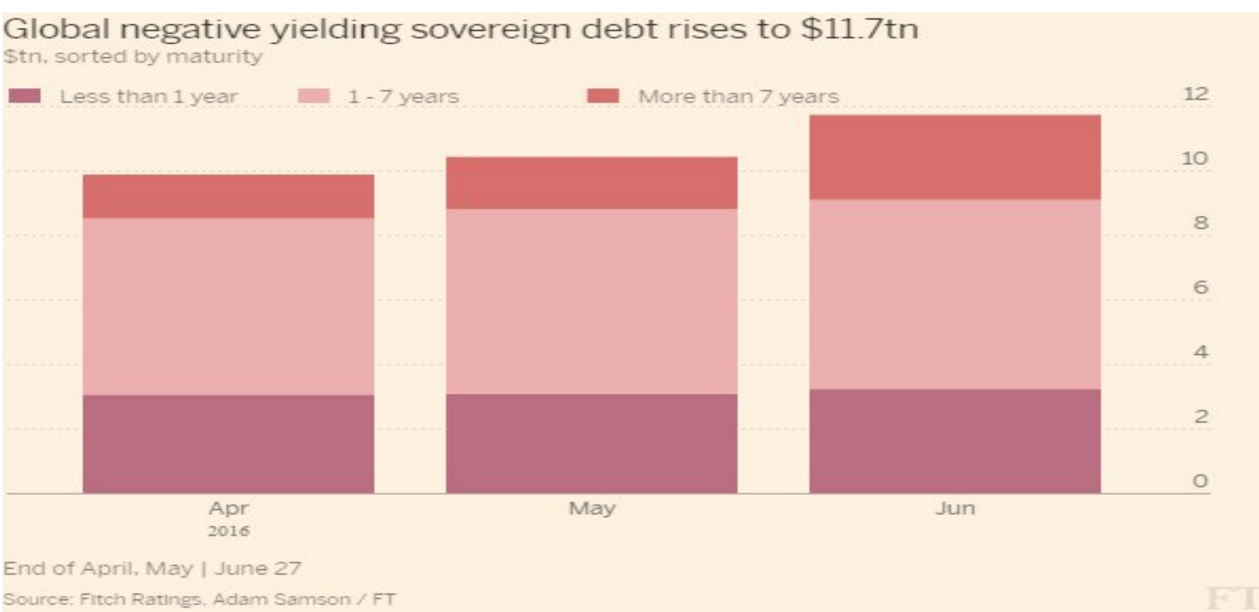

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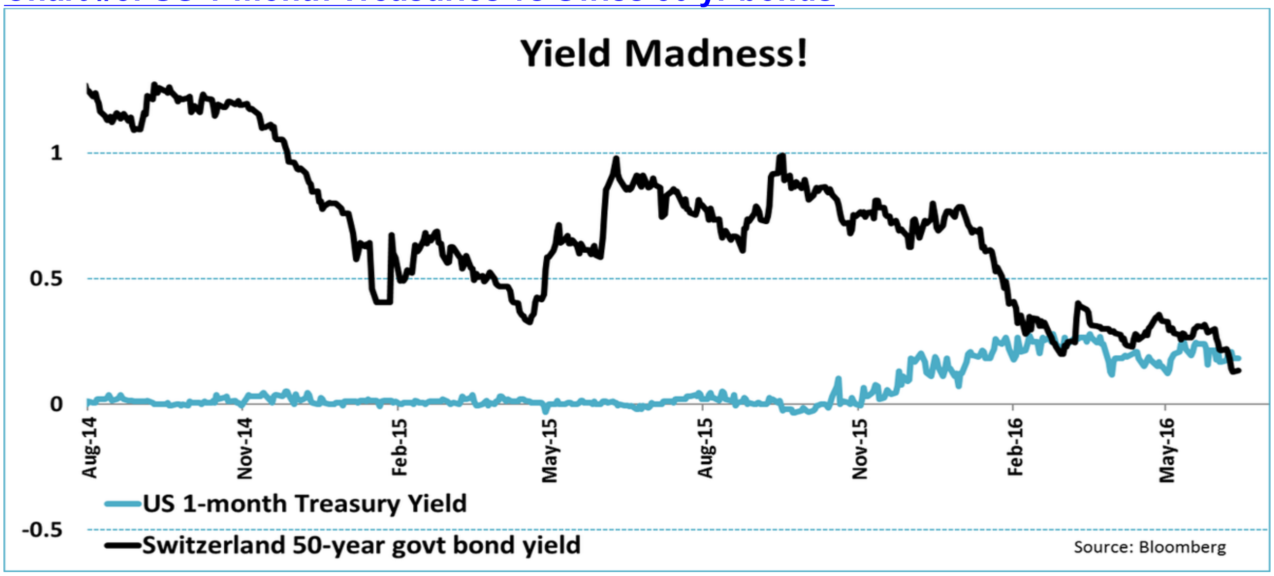
Chart #8: US 1-month Treasuries vs Swiss 50 yr bonds



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