JOHN W. ROSENTHAL CAPITAL MANAGEMENT, INC.

May 2022 Quick Overview Summary: A Case for Being Constructive on Bank Stocks

Summary Results Table: The table below presents our performance by month and YTD as of 5/31/2022; and the last 3 years.

Results Table

2022	Fund 1[1]	Fund 2[1]	^BANK[3]	KRE[3]	S&P 500[2]	Russell 2000[2]
Jan.	-2.1%	+2.0%	-0.2%	+1.1%	-5.3%	-9.7%
Feb.	+1.2%	+0.7%	+2.1%	+3.7%	-3.1%	+1.0%
March	-5.4%	-3.0%	-8.3%	-7.2%	+3.9%	+2.1%
April	-9.6%	-9.1%	-8.2%	-10.2%	-9.2%	-11.0%
May	2.7%	2.1%	3.2%	3.9%	0.1%	0.1%
YTD	-12.9%	-7.5%	-11.5%	-9.3%	-13.3%	-17.0%
2021	37.7%	32.7%	39.7%	37.0%	26.9%	13.7%
2020	1.9%	-6.1%	-10.6%	-9.0%	16.3%	18.4%
2019	17.4%	22.7%	21.2%	27.1%	28.5%	23.7%

1. Average monthly net rate of return after fees/expenses
2. Russell 2000 is a small-cap stock market index and S&P 500 is an index tracking 500 large public companies in the U.S.
3. BANK is the Nasdaq Small Cap Bank Index and KRE is a regional bank stock ETF

Headlines:

- **Bank Stocks Popped Back Up Modestly in May While Broader Market Indices Continued to Languish**
- **Despite all the Market Turmoil, and while down, Fund 2 has Substantially Outperformed both Bank and Broader Market Indices in 2022. Fund 1 Outperformed Fund 2 Last Year and Both Funds have now "Evened-Out" over the Past 16 Months**
- **Loan Growth Continues; Up 2.7% and 2.4% QtD as of 6/13/22 at Large and Small Banks Respectively – on the Heels of Being Up 2.1% and 1.9% in Q1 22. Our Fund 1 Banks Loan Volume Increased by 6% and our Fund 2 Banks by 3% in Q1 2022 – Besting the Industry as a Whole**
- **With the fed funds futures implying a 99% chance of a 75 bp rate hike prior to their news release on May 14, the decision by the Fed to hike by 75 bp was much anticipated after inflation accelerated in May. So far this year, the FOMC has raised its benchmark 150 bps. This increase will result in more net interest income for banks**
- **The 75 bp hike will be positive to nearly all banks' EPS, but more so for banks with larger concentrations of commercial and industrial loans – like our banks. We note that most Street estimates do not include the magnitude of this hike in forecasts, which should lead to positive EPS revisions. Additionally, LIBOR rates have started to materially rise in anticipation of multiple hikes. Therefore, some asset sensitive banks will experience a significantly positive increase to net interest income (and NIMs) in 2Q22 and beyond**
- **Going forward, we expect additional rate hikes, as the current fed funds futures imply a 100% probability that the Fed Funds Target Rate will be at least 225 bp after the July meeting (another 75 bp hike). Also, FOMC participants indicated that they are prepared for ongoing increases of the target range**
- **Yield Curve Flattening as the 10/2 UST Spread Declined from 0.87% at 1/1/2022 to 0.02% as of 6/14/2022 – Quantitative Tightening Began June 1st Reducing the Fed's Balance Sheet**
- **U.S. CPI Runs Hotter Than Expected, up 8.6% YoY and 1.0% MoM as of June 10th Reporting**
- **S&P 500 Entered Bear Market Territory on June 13th, down 21% from its January 3rd high**
- **Overall Macro Uncertainty Increases – and Equity Markets have Declined Further so far in June**

So, Why Do We Remain Constructive on the U.S. Economy, Equity Markets and Especially Bank Stocks?

First and foremost, we are long-term investors, not short-term traders. Beyond interest rates there are many other key facts and figures that we can't and won't ignore. Here are some of them:

- **Banks remain very highly capitalized and are in excellent condition to weather any *possible* recession**
- **Despite some dampening of prospects for overall economic growth and even the possibility/probability of a recession, the consumer is currently on solid footing. To wit, any possible recession is more likely to be driven by supply side constraints – than caused by lack of consumer demand. Q1 GDP may have contracted – but *consumption* actually increased 2.1%. The reason GDP declined 1.5% in Q1 was due to a 4.9% drop in net exports**

- **Let's remain focused on the consumer with some additional facts:**
  - **Consumer credit as a percentage of GDP remains below pre-Covid levels at roughly 18.7% now vs. 19.2% in early 2020; indicating that consumer borrowing capacity is still good**
  - **Real disposable Income Per Capita remains above pre-Covid levels at roughly $46,000 vs. $44,000 in early 20**
  - **While there remains a lot of job openings in the economy, civilian employment has returned to pre-Covid levels with about 158 million folks currently employed and the participation rate of civil jobs has bounced back to within 0.5% of pre-Covid levels**
- **Returning to a more macro perspective, here are some additional important facts to consider:**
  - **The amount of U.S. Bank Deposits less U.S. loans remains at approximately $7 Trillion (with a T), well above the $3 Trillion level upon the onset of Covid**
  - **Housing permits and starts are running 200-300 thousand units <u>above</u> pre-Covid levels while existing vacancy rates and household formation rates are higher than current inventory levels can keep up with; all of which portends a housing market that will remain decent in the near term – despite rising interest rates. We predict borrowers will migrate to adjustable-rate mortgages as part of this process**
  - **Everyone knows about the problem with automobiles. No chips mean no production and no cars to buy. But we believe the chip shortage will eventually be solved and pent-up demand for cars will SOAR. The average age of vehicles on the road today is over 12 years. (My 2007 Yukon will <u>not</u> last forever and I will eventually have to buy a new car when this one dies.)**
  - **Reputable Industry Sources predict key commodity prices have peaked with copper forecast to decline from roughly $4.58 to $4.20; steel to decline from $0.87 to $0.69 and natural gas to drop from $5.20 to $3.47 – all these declines by 2025.**
  - **Oil prices and gasoline are another matter. When fuel prices go up, consumers are hurt directly at the pump and indirectly when higher transportation costs raise prices on everyday goods and services. Crude oil prices appear to be driving the spike as the cost of the raw material accounted for 60% of a gallon of regular gasoline on 6/14/22 (compared to 52% one year ago, and 25% in April of 2020). If and when oil companies ramp up production, (and we believe they will) supply *should* start to catch up with demand – stabilizing or lowering fuel prices.**

These stats lead us to believe that inflation can eventually be tamed, and the consumer has capacity to pay their bills <u>and they will spend</u>! Banks margins are increasing, loans are increasing, loan quality is fine, and their niche fee-based businesses are thriving.

This is our case to buy the dip. It may be the best chance to realize substantial gains since the Great Recession of 08/09 or the big dip that occurred at the beginning of Covid. It takes courage to buy when things are so uncertain. But long-term investors like Buffet and others make most of their money when markets are fearful. Please consider buying the dip!

As always, you may reach us by calling the office at 574-243-6502, John's cell at 574-276-1128, or Adam's cell at 440-667-5974. Or by email: john@rosenthalpartners.net or adam@rosenthalpartners.net

With warmest personal regards,

John and Adam