PL Capital Advisors, LLC

QUARTERLY REPORT TO THE PARTNERS Q2 2022

EXECUTIVE SUMMARY

The Fed is rapidly raising interest rates after waiting too long to react to higher inflation. This negatively impacted the Partnership and the entire stock market in Q2. The S&P 500 index had its worst start to a year since 1970, and the bond market, as measured by the price of the 10-year US Treasury, had its worst first-half performance ever (since the 1700s). Bank stocks declined due to the fear of higher interest rates which is misguided because higher interest rates increase bank earnings. Banks should earn more in 2022 and 2023 than in 2021, unlike most other industries, which do less well when interest rates rise. The market risk is that the Fed overdoes it, and higher interest rates cause a severe recession. We believe a mild recession is the most likely scenario. Bank stock valuations are inexpensive (8-9x PEs), and higher credit costs from a mild recession are already substantially discounted in bank stock prices. The market is overstating the risks to bank earnings, and bank stock prices are too low. The Partnership remains almost fully invested.

In addition to the market's concern that higher interest rates will cause a recession, markets were driven lower by a continuation of the other trends we noted in the Q1 letter, namely increasing inflationary pressures, the war in Ukraine, and supply chain constraints.

THE FEDERAL RESERVE HAS MADE FOUR MAJOR MISTAKES AND MAY MAKE A FIFTH

Since 1977, Congress has required the Fed to promote maximum employment and stable prices, the so-called "dual mandate." The two mandates are inherently in conflict, which is why the Fed has difficulty managing both simultaneously. As a result, the Fed is fallible and often makes mistakes.

We believe the Fed has made four major mistakes during the years since the 2008-09 Financial Crisis and may be making a fifth currently.

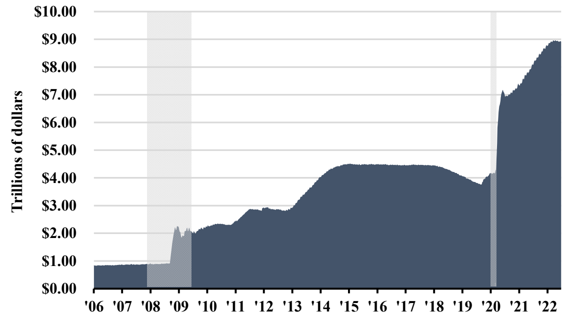
The Fed's <u>first major mistake</u> was to never unwind the $2 trillion of quantitative easing ("QE") implemented during and shortly after the Financial Crisis (2008-2012). Recall that QE involves the Fed buying massive amounts ($ trillions) of US Treasury and other securities to stimulate the economy and provide funds to financial markets, well beyond the usual amounts historically used by the Fed to manage interest rates and the money supply.

QE's unprecedented expansion of the Fed's balance sheet and concomitant increase in the money supply was necessary during the Financial Crisis. However, it should have been gradually and fully reversed over time once the Financial Crisis ended. That never happened. And not only did that not occur, the Fed also made <u>major mistake #2</u> by adding approximately $2 trillion more of QE from 2013-2016! The Fed always had an excuse as to why more QE was needed. Sadly, politicians from both parties and Wall Street encouraged the Fed.

The Fed's <u>third major mistake</u> compounded the first two. Once Covid-19 hit, the Fed engaged in even more QE than they did during the Financial Crisis. From the beginning of Covid in March 2020 to the present, the Fed expanded its balance sheet by an additional $5 trillion to $9 trillion.

Exhibit 1 below shows the Fed had a relatively flat balance sheet at $1 trillion in the years before the Financial Crisis. During the Financial Crisis and its aftermath (2009-2013), it grew to $3 trillion, then $4.5 trillion (2014-2018), and then ballooned to $9 trillion during the Covid pandemic. While not all this growth is due to QE, at least $6 trillion is the direct result of QE. And don't forget that during Covid, the US Government spent trillions supporting the economy. The combination of unprecedented fiscal spending and QE monetary policy has undoubtedly created the inflation we are all now suffering.

Exhibit 1: Federal Reserve Balance Sheet (2006-present)



Source: Board of Governors of the Federal Reserve System

Why are politicians and Wall Street supportive of QE? Because it seems like a free lunch. At least in the short run, QE is supportive of the economy (good!), lowers interest rates (good!), and supports financial asset prices (good!). But the free lunch is not free and does not last. Eventually, QE is inflationary and should weaken the US dollar on international markets. Unfortunately, the US dollar ("USD") did not decline during the past 13 years of massive QE.

If the USD had declined, it might have sent an early warning signal that QE was overdone, and the US could have avoided some of the current QE hangover. However, the USD did not decline for two reasons. One, many other developed countries in Europe and Asia also did QE, so all currencies were relatively weak, not just the USD. And two, the USD is the world's so-called "reserve currency." The USD's status as the world's de facto currency kept it from declining during this period, masking QEs negative impacts. There was no canary in the coal mine.

Interestingly, the unprecedented amounts of QE since 2009 did not cause a spike in inflation until recently. The reasons are complex, but in short, most of the QE money did not go into the "real" economy (products, goods, and services). Instead, the excess funds ended up in "financial" markets, causing inflation in financial asset prices, not consumer goods (other than housing). And no one seemed to mind inflation in financial asset prices.

Some of you are old enough to recall the inflation of the 1970s, which was also primarily created by the Fed taking actions similar to QE, but on a much smaller scale. Even with much smaller amounts of QE in the 1970s, inflation surged because the excess money supply went directly into the economy (i.e., the price of goods and services), <u>not</u> financial markets.

In economic parlance, the inflationary effect of QE in the 1970s was caused by a higher "velocity" of money (i.e., how often a fixed amount of money is used in transactions during a specified period). Velocity was very high in the 1970s, but has been very low during the past 10+ years of QE. In short, the real economy of the past 10+ years did not need all the money printed by QE. As a consequence, almost all of it ended up in financial markets.

Even with lower velocity, the unprecedented amount of QE since 2009, combined with the effects of Covid-19 fiscal stimulus, had to influence inflation eventually. And it finally did, with inflation rising to uncomfortable levels beginning in late 2020 and early 2021. At first, rising inflation had little effect on the economy and was ignored by financial markets and the Fed. It wasn't until 2022 that inflation became top of mind for the Fed, financial markets, and the entire world.

So why is inflation a problem in 2022, when inflation began to accelerate much earlier, in late 2020 and early 2021?

The primary answer is that the Fed made <u>major mistake #4</u> by downplaying inflation in 2021 and early 2022. You may recall reading stories in 2021 and early 2022 about the Fed and other commentators calling inflation "transitory." They were wrong. Not only is the current inflation not transitory, but it has also accelerated, exacerbated most recently by the effect on energy prices from Russia's invasion of Ukraine and the resulting sanctions placed on Russia and Russian oil/gas exports.

The Fed, finally aware that inflation is not transitory, now feels compelled to move quickly to quash inflation. Fear of what the Fed might do is roiling financial markets. Specifically, after the June 15, 2022, Fed meeting, Fed Chairman Jerome Powell finally admitted the Fed had underestimated inflation and announced a significant 0.75% increase in short-term interest rates (to 1.75%). Mr. Powell also announced that the Fed would do everything possible to quell inflation before it becomes permanently embedded in the economy.

The Fed has two primary ways to attack inflation. The first is by raising short-term interest rates, presumably weakening the economy enough to slow excess demand for goods and services, thereby lowering prices. Secondly, by (finally!) reversing QE (i.e., selling securities and draining liquidity from the economy—nicknamed Quantitative Tightening or "QT").

The mere prospect of the Fed raising interest rates and engaging in QT has already begun to tighten financial conditions and slow the economy. For example, mortgage rates have gone from approximately 2% to over 5% in a brief period. This will slow housing activity and reduce prices. As a result, it may lead to a mild to moderate recession, or worse, in late 2022 or 2023.

Of course, the Fed claims they are not looking to cause a severe recession, but their rapid reversal in policy and rhetoric has spooked financial markets.

The Fed's seeming panic over inflation leads some to fear they will make major mistake #5 by overreacting and causing a more severe recession than what would have occurred had they reacted sooner and more gradually in early 2021 (and been more conservative in using QE in prior years).

We believe financial markets have already discounted much of the Fed's present and future actions, as shown by bond and stock prices which have already decreased by historically significant amounts. Markets always lead.

In fact, in recent days, the bond market has experienced a decline in open market intermediate and long-term interest rates, even as the Fed is just starting their aggressive interest rate tightening regime.

Additionally, many commodity prices have recently begun to subside, declining from their 52-week highs (e.g., lumber -48%, Oil -16%, Natural Gas -32%), which may give the Fed cover not to raise rates as much as most currently believe.

We believe these recent changes in bond and commodity prices are evidence that financial markets have already discounted much of the Fed's present and future actions and that inflation is starting to wane. It also evidence of a likely mild recession, in our view.

SO HOW DOES THIS IMPACT BANKS?

Higher interest rates are generally good for banks and bank profitability for all the reasons we have explained in prior letters, including Q1 2022.

In short, a bank's net interest margin (in % terms) and net interest income (in $ terms) expand when rates rise because banks have positioned their balance sheets to do so (unlike the banks of the 1970s and 80s, which were positioned to do worse when interest rates rose).

2022 and 2023 should be the first time in recent years when bank net interest margins (in % terms) and net interest incomes (in $ terms) will ***both*** expand. This is a powerful tailwind for bank profitability.

Of course, bank credit costs typically rise during a recession.

While there will be increased credit costs if the US goes into recession, our view is that bank loan portfolios are in better shape than most believe. Recall all the panic over bank credit quality when Covid hit, and how it did not happen.

Another layer of protection is that bank stock valuations are very cheap, which has discounted increased credit costs. For example, the median bank in the Partnership trades for a very low 8.6x 2022 estimates, 7.7x 2023 estimates, 125% of tangible book value ("TBV"), and has a 3.2% dividend yield. Since banks currently earn low to mid-teens returns on tangible common equity and should make more money in 2022 and 2023, we believe 8x PEs and 125% TBV multiples are too low. But, of course, the stock market often has different ideas of how a stock or an industry should be valued.

We expect Q2 and Q3 EPS reports for the banks owned by the Partnership to be strong, buoyed by higher interest rates, hopefully restoring confidence that banking industry can make money despite a slowing economy.

We also believe nominal GDP (i.e., not adjusted for inflation) will remain positive. This is important to remember as we all live in a "nominal" world. We use nominal dollars to transact, live and work. So even if a recession occurs as measured by "real" (inflation-adjusted) GDP, there will still be a significant amount of nominal economic activity to support the economy and the banking system. For example, if inflation is +5% and real GDP is -1%, nominal GDP is still +4%. Those positive nominal dollars can be used by consumer and business bank customers to repay loans and make deposits.

On July 4th, the Wall Street Journal wrote an article titled *"If the U.S. Is in a Recession, It's a Very Strange One"*

https://www.wsj.com/articles/recession-economy-unemployment-jobs-11656947596

The article made several vital points consistent with the views we expressed in the first quarter letter of 2022 as well as this one. Of note, only 1.3 million Americans are currently collecting federal unemployment compared to 6.5 million during the 2008-2009 recession and 3 million during the two prior recessions. While at the same time, we have record job openings, and unemployment remains at a historic low of 3.6%. Additionally, businesses are swimming in nearly $4 trillion of cash; a cushion against a potential slowdown.

The current economic and financial environment does not appear to be anything close to the 2008-2009 Financial Crisis in terms of severity. Instead, we believe the current environment is more like the mid-1990s when the Fed raised rates by 3.00%, including a 0.75% increase at the November 1994 meeting. Then, like today, the broader markets and bank stocks declined in anticipation of recession.

That pessimism was misplaced. Between November 1994, when the Fed raised rates 0.75% in one meeting, and early 1998, bank stocks performed exceptionally well, up approximately 130%. Credit concerns, which had damaged bank stock prices in 1994, did not occur, and earnings grew. We believe bank stocks could have a similar period of outperformance over the next few years once the current period of uncertainty has passed.

Please feel free to contact us at any time.

Best regards,

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July 12, 2022