"The investor's chief problem and even his worst enemy is likely to be himself."
-Benjamin Graham

July 13, 2020

Dear Fellow Investor,

As we stated in our note on April 15th, "a key to avoiding major financial mistakes in the weeks and months ahead is to not get scared out of stocks. Markets are a discounting mechanism, pricing in today what it believes about tomorrow. When you get the type of correction we have seen in the past month, history suggests markets generally moved higher in the quarters ahead."

Fast forward three months and the markets have enjoyed a remarkable recovery in the face of what remains great uncertainty on both the health and economic front. For many investors, emotions have gone from get me out, to a fear of missing out. For evidence of how quickly the pendulum has swung, look no further than the likes of Tesla which has seen its stock rise more than 60% in the past ten days alone and more than 200% so far this year. Despite never turning an annual profit, shares of Tesla trade for nearly 10 times sales versus the likes of General Motors and Toyota at approximately 0.25-.60 times sales. Said another way, Tesla is currently valued at nearly $860,000 per vehicle sold in the past year versus Toyota at around $17,000 per vehicle sold over the same period. Tesla is just one example of many that have defied arithmetic of late and served to drive certain areas of the market, most notably the NASDAQ, higher on the year.

Just as we cautioned investors about panicking amid the uncertainty following a more than 30% correction in the major averages this past spring, we caution investors today about complacency in certain "growth" sectors where little attention is being given to the price being paid. While the range of outcomes from early April has narrowed, there nonetheless remains a great deal of uncertainty surrounding the economy and the future path of the virus. History has shown that business cycles don't correct in a few months after a downturn has started, and given the severity of the impact on business activity from the pandemic, it is unlikely this time will prove different. Fiscal and monetary stimulus can help bridge the gap for a while, but eventually sales and profits matter, as does price. They always do. As such, understanding what you own is crucial in navigating the waters ahead.

Portfolio Update

Our best idea remains the junior preferred securities of Fannie Mae and Freddie Mac and all signs point toward a negotiated settlement over the next six to nine months following last Thursday's notice that the Supreme Court of the United States (SCOTUS) will hear several claims of importance to the shareholders of the government sponsored enterprises (GSEs) during the next Supreme Court term.

1230 Office Plaza Drive • West Des Moines, IA 50266 • **Phone** 515.327.1870 • **Toll-free** 877.327.1870 • **Fax** 515.619.5719 • www.boylecapital.com

In order to appreciate the significance of last week's Supreme Court order, it is necessary to look to the opinion released by the Court on June 29th in the matter of *Seila Law, LLC v CFPB*. Structured similarly to the FHFA (Fannie and Freddie's regulator), a civil investigative demand (CID) brought by the Consumer Financial Protection Bureau (CFPB) was being challenged on the grounds that the CFPB was unconstitutionally structured given it was led by a single director serving a five year term who was subject to removal by the President only for cause. As a result, Seila argued, any action brought against it by an unconstitutional agency must be vacated.

In its *Seila Law* decision, the Supreme Court found 5-4 that the CFPB Director's "for cause" tenure protection was unconstitutional, and the removal restriction could be severed (majority 7-2) from the rest of the law that created the CFPB (Dodd-Frank). Consequently, the CFPB Director is now subject to removal at the will of the President. Because the Supreme Court did not eliminate the CFPB entirely, the question still remains of whether the CID issued by an unconstitutionally CFPB Director (Richard Cordray) is now enforceable as the government argued that even though it was issued by an unconstitutional Director it was subsequently ratified by a removable Acting Director in Kathleen Kraninger. These case-specific, factual, and legal questions were not addressed in the lower courts or in the Supreme Court, and therefore, the Supreme Court remanded the question for the lower courts to consider.

In the *Seila* majority, Supreme Court Chief Justice Roberts made several significant statements that pave the road for vacating the Net Worth Sweep of Fannie and Freddie's profits:

"We have held that a litigant challenging governmental action as void on the basis of the separation of powers is not required to prove that the Government's course of conduct would have been different in a 'counterfactual world' in which the Government had acted with constitutional authority….In the specific context of the President's removal power, we have found it sufficient that the challenger 'sustain[s] injury' from an executive act that allegedly exceeds the official's authority….If the removal restriction is not severable, then we must grant the relief requested, promptly rejecting the demand outright. If, on the other hand, the removal restriction is severable, we must instead remand for the Government to press its arguments in further proceedings."

Last September, the Fifth Circuit en banc Court of Appeals held that the single Director led FHFA (Federal Housing Finance Agency) violates the separation of powers under the Constitution (12-4 majority) and, like *Seila,* sought to address the defect by severing the removal provision from the law that created the agency (HERA). By a vote of 9-7, however, the en banc court refused to set aside the Net Worth Sweep. In a concurring opinion joined by Judge Owen, Judge Duncan explained that he thought the court was bound to limit the remedy for FHFA's unconstitutional structure to severance of the Director's for-cause removal protection by virtue of the remedy adopted by the Supreme Court in *Free Enterprise Fund v PCAOB*.

The en banc plaintiffs appealed this decision to the Supreme Court where it was distributed for conference (Collins v Mnuchin 19-422) on January 10, 2020, and held until after *Seila* was released on June 29th. It was taken in conference again on July 1st and July 8th with the order granting certiorari being issued on July 9th. While oral arguments have yet to be scheduled, the Supreme Court term starts in October and generally lasts nine months. Given the already crowded Supreme Court schedule for October and November, it is unlikely the hearing will be scheduled prior to the first of next year.

However, make no mistake, the *Seila* opinion is a shot across the bow to the FHFA and Treasury that the probability is high the Net Worth Sweep will eventually be set aside by the Supreme Court when the time

comes. Chief Justice's majority opinion makes clear that backward relief is possible (clearing up the confusion of en banc Judges Duncan and Owen) and unlike in *Seila*, the FHFA is not arguing that the Net Worth Sweep has been ratified by a removable Acting Director. Had the Supreme Court believed the 5th Circuit en banc court had gotten it right, the Court would not have granted cert. Given the nearly identical structures between the CFPB and the FHFA, the only interpretation of the Supreme Court's order is that it believes the en banc court got the backward relief ruling wrong and the Net Worth Sweep should be vacated.

As a result of these recent Supreme Court developments, FHFA Director Mark Calabria and Treasury Secretary Steven Mnuchin are working with a shot clock (as if they weren't already with an election forthcoming). Should they choose to roll the dice and let the legal path play out, they risk not only their professional reputations but potentially their control over the direction of housing finance in this country. According to a Presidential memo released last March and the Treasury's Housing Reform Plan released last September, the administration's objectives include ending the GSE's conservatorship and protecting taxpayers. A Supreme Court ruling vacating the Net Worth Sweep would likely require the taxpayer to cut a check for $125 billion to Fannie Mae and Freddie Mac and would forever attach Secretary Mnuchin's name to the largest legal award against the government in U.S. history.

When asked during a *Bloomberg* interview last September about a 2015 paper he wrote criticizing the Net Worth Sweep for violating the law, FHFA Director Calabria responded, "it is my intention to have us end the sweep, which I think is of questionable legality." How does Mark Calabria and the FHFA defend against the Net Worth Sweep in front of the Supreme Court when he is on record about it being illegal, and that he intends to stop it?

What happens if the Net Worth Sweep is not vacated by the Supreme Court? Both Treasury (September 2019 Housing Reform Plan) and the FHFA (2019 Annual Report to Congress) cite a desire to return Fannie and Freddie to fully private companies outside of conservatorship. How do you raise the external capital needed to put Fannie and Freddie into a safe and sound condition if the highest court in the land just blessed the taking of shareholder property by the government? The short answer is you don't.

The decision last week by the Supreme Court to hear the Collins case next term has put a finite clock on the years long saga of government theft. Either fix it administratively as originally intended by Congress when the Housing and Economic Recovery Act (HERA) was created back in 2008, or the "Robert's Five" of the Supreme Court will clean it up in the next year.

While the *Seila* decision provides a clear path on the legal front for a resolution, Director Calabria has left no doubt of his intentions to forge ahead on the administrative front. In one of his first public speeches (Mortgage Bankers Association National Secondary Market Conference & Expo 2019) after being confirmed as FHFA Director, Calabria made the following comments:

"if you look at the statute, it contemplates an end to the conservatorships. The model is very similar to how the FDIC operates. The law requires me to do what I can within my powers to fix the GSEs and then release them from conservatorship-and that's exactly what I intend to do."

True to his words, Calabria has methodically (too slowly albeit for most shareholders) gone about executing on the actions required under the law to put Fannie and Freddie in a safe and sound condition and allow them to exit from conservatorship. Since being confirmed last April, Fannie and Freddie have been allowed to retain all of their available profits, and earlier this year the FHFA retained a financial

advisor (Houlihan Lokey) and legal counsel (Millbank) to assist in preparing the roadmap for Fannie and Freddie to exit conservatorship. Central to that roadmap will be capital levels, and to that end, the FHFA released a capital rule proposal on May 20th. The rule was officially published in the *Federal Register* on June 30th and allows for public comments through August 31st.

Ultimately tasked with the responsibility of raising their own capital, Fannie and Freddie hired financial advisors on June 15th with Fannie selecting Morgan Stanley and Freddie selecting J.P. Morgan. In a press release announcing the engagement, J.P. Morgan's Chairman and CEO Jamie Dimon stated, "J.P. Morgan is pleased to be selected as Freddie Mac's underwriting advisor. We look forward to working side-by-side with Freddie Mac on this historic assignment in the months ahead."

The hiring of financial advisors by Fannie and Freddie along with the FHFA's proposal of the capital rule are significant developments that set the stage for the next administrative milestones necessary to put Fannie and Freddie in a safe and sound state; a precondition for exiting conservatorship.

Upon finalizing a capital rule, HERA requires Director Calabria to request and approve capital restoration plans from Fannie and Freddie detailing how they are going to get from their current capital levels to the final FHFA required capital level. Ultimately, any capital restoration plan needs to account for how Treasury, the largest stakeholder of Fannie and Freddie, is going to treat the $193 billion senior preferred stock that remains outstanding as a result of the Net Worth Sweep.

In a December 2019 interview with *Housing Finance Strategies,* Craig Phillips, former counselor to the Treasury Secretary and who was instrumental in constructing Treasury's housing reform plan, outlined the importance of Treasury's treatment of the senior preferred stock to a successful capital raise. According to Phillips, "Treasury has received dividends totaling over $300 billion on its original capital infusion of $191 billion. Consequently, the liquidation preference of the senior preferred stock should be reduced to zero and the Treasury should be considered 'repaid.' These actions are aligned with the interest of the U.S. Government to move forward in recapitalizing the GSEs, namely in eliminating the current significantly negative worth of Fannie Mae and Freddie Mac and removing claims that negate the value of the very common stock that must be offered to the public to raise capital."

As Phillips knows, and advisors J.P. Morgan and Morgan Stanley will make clear to FHFA and Treasury; Fannie and Freddie cannot raise private capital and cannot submit capital restoration plans to the FHFA as required under HERA until Treasury's senior preferred stock has been addressed and the Net Worth Sweep has been ended.

Consequently, once the capital rule has been finalized by the FHFA this fall, we expect Treasury and the FHFA to amend the PSPA (preferred stock purchase agreement) to end the Net Worth Sweep and write down Treasury's senior liquidation preference to zero (as recommended by Craig Phillips above); thus declaring that the taxpayer has been compensated for the risk it has assumed previously. In exchange for providing a defined and explicit backstop going forward, we expect Treasury and the FHFA (acting as conservator) to agree to a periodic commitment fee to be paid by Fannie and Freddie much like the FDIC is funded by member banks.

Amending the PSPA to end the Net Worth Sweep and write down the Treasury's senior liquidation preference can be expected to result in substantial share price appreciation for our junior preferred shares as it knocks over the biggest hurdle between current prices around $9 and par value of $25. With the Net Worth Sweep ended and the senior liquidation preference gone, junior preferred shares would have the

senior preferred claim on the GSE's assets and before a dividend could be paid out to common shareholders, the enterprises would be required to pay dividends to junior preferred shares. If one assumes it would take four years to fully recapitalize the GSEs, and at that time they would resume dividends to shareholders, the junior preferred shares would have a net present value of approximately $17 upon the aforementioned amendments (assuming a 10% discount rate). Ultimately, we expect shares to fare even better as the enterprises are likely to exchange junior preferred into common as part of the recapitalization process (similar to the AIG recapitalization) and shares of adequately capitalized GSEs will be must own securities for institutional investors starved for yield.

What would happen in the event Joe Biden wins the election and the Democrats end up with control of Congress? The bipartisan Housing Economic Recovery Act (HERA) requires the FHFA to fix Fannie and Freddie and release them from conservatorship and gives the FHFA broad authority in order to carry out that mission. In the interim agreement entered last September between FHFA (as conservator) and Treasury, allowing Fannie and Freddie to retain additional capital, Treasury and the FHFA agreed to negotiate and execute an additional amendment to the PSPA consistent with the recommendations set forth in Treasury's September 2019 Housing Reform Plan. Once the Net Worth Sweep is ended and the senior liquidation preference is written down in the previously contemplated PSPA amendment, there is little a Biden administration could do.

In a February response letter to Senator Mark Warner seeking further details from Secretary Mnuchin and Director Calabria on their plans, Director Calabria referenced the use of a consent decree as a potential means to accelerate the release of the GSEs from conservatorship. According to Calabria, "under a consent decree, FHFA would have the authority to permit an Enterprise that has reached a certain capital level below the required minimum to operate outside of conservatorship subject to a capital restoration plan….Methods for modifying a consent order are either provided for in the consent order itself or agreed to by both parties."

A consent decree can only be modified by the parties to the agreement, which in this case would be the FHFA, Fannie Mae and Freddie Mac. In the event of a Biden victory this November, Calabria and Mnuchin would be well within their authorities under HERA to execute an amendment to the PSPA (ending the Net Worth Sweep and eliminating the senior liquidation preference) and a consent decree with Fannie and Freddie prior to inauguration day. If they were to combine these actions with a legal settlement with shareholders, there would be nothing a new administration could do to alter the path forward without changing HERA and that would require 60 votes in the Senate which is unlikely (Republicans currently control 53 seats and Democrats 45 seats).

Settling with the Collins plaintiffs would also render the case before the Supreme Court moot and mean that Director Calabria would be insulated from immediate removal by the Biden administration. The *Seila* decision would provide the Biden administration a path for removing Calabria, but it would likely take several years to play out through the courts; thereby giving Calabria additional time for administrative action should he want it.

Throughout his tenure, Treasury Secretary Mnuchin has highlighted housing reform as a top priority of the administration and during his very first television interview as Treasury Secretary nominee in November 2016, Mnuchin told *Fox Business's* Maria Bartiromo "we got to get Fannie and Freddie out of government ownership. It makes no sense that these are owned by the government and have been controlled by the government for as long as these have….We need these entities that will be safe, so let

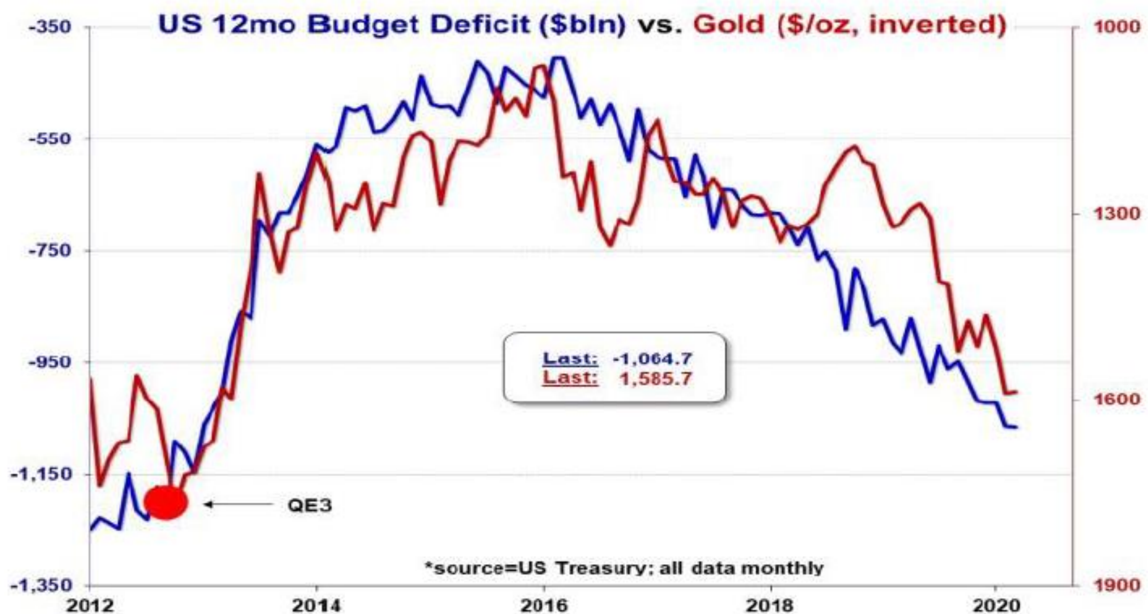
me just be clear. We will make sure that when they are restructured, they are absolutely safe and they don't get taken over again, but we got to get them out of government control."

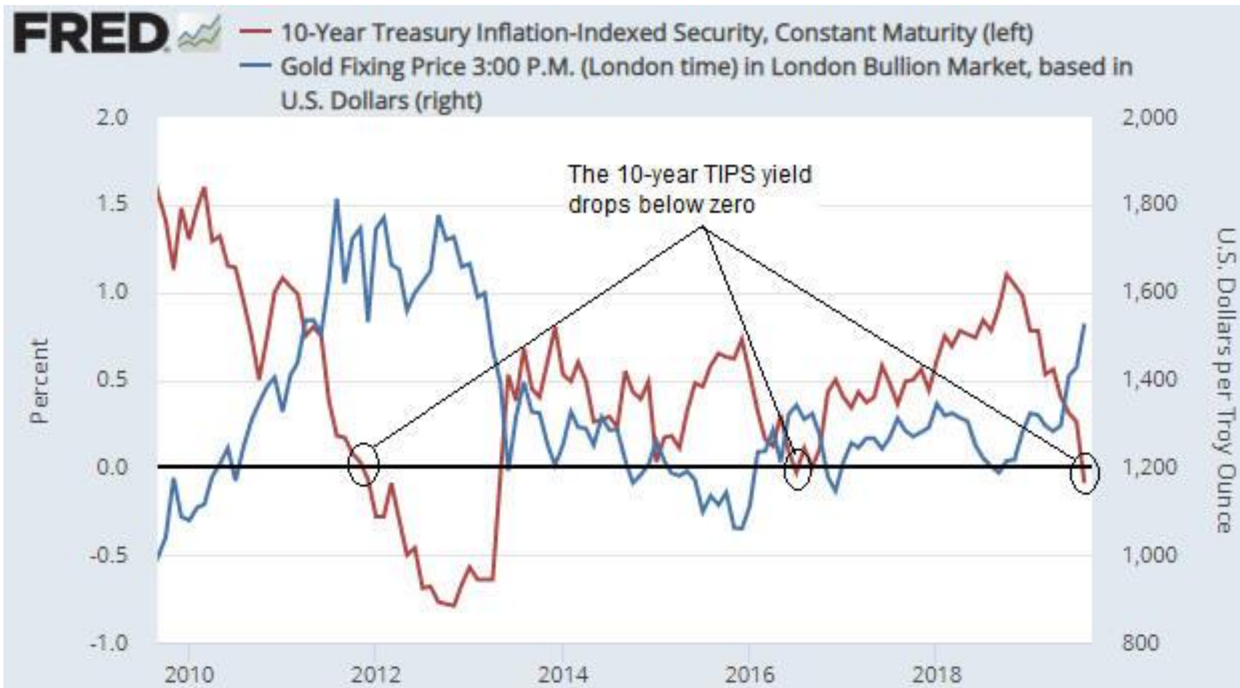
In 2017, Secretary Mnuchin told Bartiromo again, "housing reform is a priority for me. It is something that I know a lot about as I've been involved in this business for a long period of time….We can't leave these entities in the exact state they are, under government control, for the next four years. We need to solve this issue. This issue is just kicked down the road."

Director Calabria has been just as steadfast, declaring last November in a speech: "ending the conservatorships is one of my top priorities because it is what the statute requires. FHFA is not going to ask Congress for permission to do what Congress has already told us to do."

To think that Treasury would spend the better part of two years working on a plan to end the conservatorships of Fannie and Freddie and the FHFA would put out a capital rule, hire financial and legal advisors, only to take a knee on the 1-yard line seems unlikely. The puzzle has been laid out for those paying close attention and it is our strong conviction that the final pieces will be put in place by Secretary Mnuchin and Director Calabria regardless of the election outcome this fall. When those final pieces are put in place, we expect the preferred shares to appreciate substantially.

Our second largest portfolio weighting, which we have added to recently, is in gold and gold miners. In response to the Covid-19 pandemic, central banks around the world have slashed interest rates and taken other unprecedented actions to provide their economies with stimulus. According to Bank of America, major central bank balance sheets have expanded by $5 trillion and the total global fiscal stimulus is north of $18 trillion. It is likely these eye-popping numbers are just the start as global economies are faced with a significant output gap that will most likely take years to close. Deficit spending and low real (adjusted for inflation) interest rates are perfect conditions for gold as seen below.

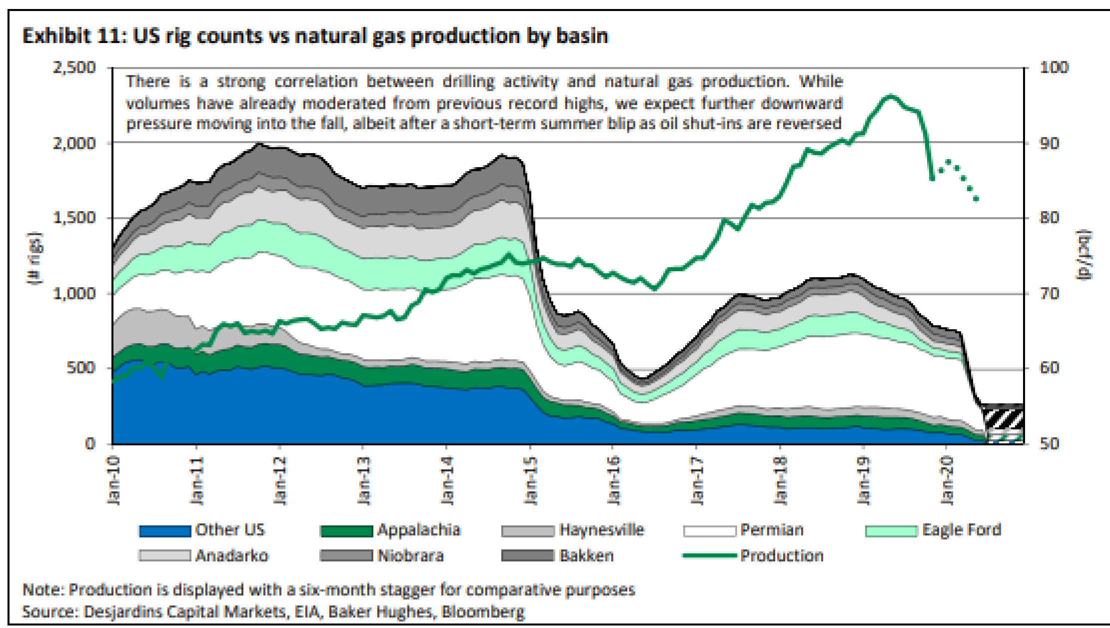




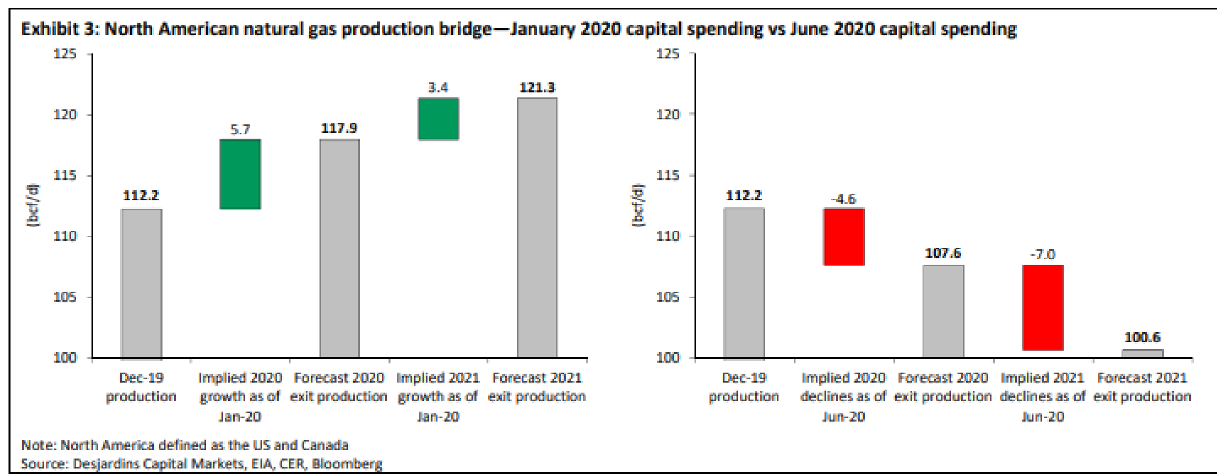
Second quarter earnings season starts in earnest next week, and to state the obvious, the results will be horrible for most companies due to the impact of the pandemic. The forward guidance given will be hazy at best, if available at all. This won't be the case, however, for most gold mining companies. As Fred Hickey noted in his July 2020 issue of *The High-Tech Strategist*:

" a year ago, the price of gold was around $1,400, so the current price means that gold miners are currently accruing an additional $400 profit margin per ounce, and with the miner's all-in-sustaining costs (AISC) on average in the $950 to $1,000 per ounce range, today's $800+ per ounce profit margins are close to twice last year's level. Second quarter production levels were depressed by government-mandated periods of mine shutdowns but in the second half, with nearly all mines ramped back up to full production, this should no longer depress results. Gold miners' revenue growth, profits, cash flows, earnings per share and dividend increases in the second half will stand out in this computer algo-driven stock market. The miners' stock prices do not come close to reflecting this reality. The HUI/Gold ratio (gold miners' stock valuations to gold ratio) at 0.158 is not even back to the 0.21 level reached in 2016, never mind the 0.40 to 0.60 levels seen consistently in the mid-2000s during the strongest phase of the bull market."

While depressed energy prices have been a boon for gold miner profit margins, they have been anything but for investors of the oil and gas sector. Amidst the pain, the seeds of much higher energy prices are being sowed with the devastation the pandemic has caused on the energy patch. The Baker Hughes Rig Counts are a weekly barometer of drilling activity in North America and since the data has been tracked beginning in 1944, the rig counts have never been lower. In the week ending July 2nd, the U.S. oil and gas rig count stood at just 263 versus 700 the same time last year (a decline of 73% YoY). In Canada, the decline in activity has been even more severe. As of last week, Canada had only 18 active rigs in the entire country. Canada's 18-rig total represents a 102-rig decrease from the year ago level (a mind blowing 85% decrease). It stands to reason that fewer rigs drilling for oil and gas should mean lower production in time. A report by Desjardins Capital Markets shows that historically there has been a 6-9-month lag between production trends and rig counts.



The Desjardins report further states, "the decline in activity could mean a supply contraction of epic proportions for natural gas production. The ultimate impact on production over the next 12-18 months boils down to how long rig counts remain depressed. The longer it takes for activity levels to recover, the greater the impact on production. And that dynamic stems from the natural declines inherent in every oil and gas reservoir, which requires constant and significant infusions of capital to keep production flat- and even larger commitments to generate growth. Based on current capex forecasts and the implied relationship between rig activity and production, we expect a significant decline in natural gas volumes between now and 2021-all else being equal. Capex forecasts today imply a 10 bcf/d contraction by the end of 2020 and a 20 bcf/d contraction by year end-2021 relative to expected production levels based on capex projections at the beginning of 2020."



In a commodity business, the cure for low prices is always low prices. Lower activity leads to lower production which eventually stimulates prices. The last time drilling activity plummeted was back in 2016 when oil prices fell below $30 and gas prices below $1.60. Over the ensuing year, oil and gas prices snapped back, and with it the share prices of many oil and gas stocks including our holding Birchcliff

Energy. Calling the turn is impossible, but the virus hasn't eradicated the business cycle. Booms follow busts and this time will be no different.

Summary

Heading into the second half of the year, our watchwords are patience and courage. Patience to allow the administrative led recapitalization of the GSEs play out over the next six months and the courage to stay the course amid volatile and uncertain markets. In addition to the core holdings outlined in this update, portfolios maintain considerable dry powder to capitalize on opportunities should market conditions present them.

Please do not hesitate to call if we can be of assistance or if there have been changes in pertinent financial information or investment objectives.

Wishing you good health and well-being,

Brian F. Boyle

Brian F. Boyle, CFA

The S&P 500 is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The index is used for comparative purposes because it approximates what an investor could earn from a passive investment in the general securities market.

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