

MuhlenkampWebcast

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Amended Transcript

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Tony: Good afternoon ladies and gentleman. Thank you for joining us for the Muhlenkamp and Company webcast. My name is Tony Muhlenkamp and I'll be hosting today's conversation with our portfolio managers Ron Muhlenkamp and Jeff Muhlenkamp.

I've asked each of them to share their insights and perspectives on some of the factors driving investing in today's climate. We'll be using slides that you can find on our website as well as what you see in front of you on your screen. You can go to our website after the fact if you want and pull those down and take a look for yourself. Also, we will have time towards the end of the presentation to take questions and hopefully give you decent answers to them. You will have the opportunity to type questions in today. If we don't get to them today I will give you a call. Don't hesitate to call or email with anything that you would like to talk about.

So, with all that being said, Jeff, Ron please bring us up to date on what you're seeing.



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Agenda

“When you change the rules a little, you change the game a lot.”

- **The Dollar and Interest Rates**
- **Consumer Confidence**
- **Business Confidence**
- **What the Stock Market Has Done**
- **Changing the Rules**
- **Question-and-response session**

Jeff: Thanks Tony. This is Jeff. This is a rough agenda that we'll follow this afternoon. One of Ron's long-standing maxims is "When you change the rules a little, you change the game a lot." We think that is particularly appropriate to think about as we have a new set of politicians in Washington who have promised that they will put a whole lot of long-standing rules on the table. That will be the focus of what we will talk about today.

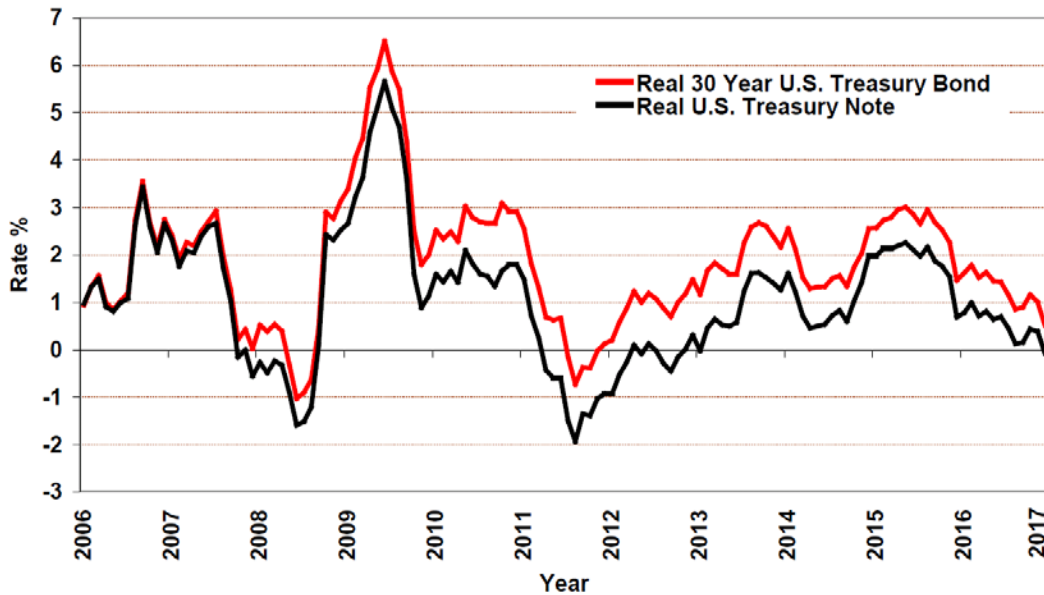
We'll briefly discuss the dollar and interest rates and move on to consumer and business confidence and then a little bit about what the stock market has done this past year, and then spend most of our time talking about rule changes.

I've got this little laser indicator here, so you may see a red dot. I'll bring it out to highlight parts of the chart that I want to draw your attention to as we go through.

We will start with interest rates...



Real 30 Year U.S. Treasury Bond Rate
Real 10 Year U.S. Treasury Note Rate
 2006-Jan2017 (Monthly)



Source: Bloomberg

This is a chart of the inflation-adjusted or real interest rate for 30-year U.S. treasury bonds in the red line and the ten-year U.S. treasuries in the black line, since 2006. Historically, long-government bonds have been priced to yield about 3% over inflation. So what we’re saying is that if you go back over the last 50 or 60 years, those two lines typically wiggle around the 3% line here. You’ll notice that they spent a lot of time below that point from 2011 to 2014 and they’re currently significantly below their long-term average today, to the point where, on an inflation adjusted basis, you are only making about a ½% on your 30-year bond. We have gotten a number of questions about whether we like bonds—we don’t. We will flesh that out in the next little bit.

When financial folks talk about bonds, one of the qualities of the bond they discuss is the sensitivity of the bond to changes in interest rates and they call that sensitivity “duration.” As a general rule of thumb, it is roughly equal to 2/3 of the remaining time to maturity of the bond.

So let me give you an example. If you own a 3-year treasury with a yield of 1% and the 3-year interest rates go up by about ¼% or 25 basis points, you should expect the price of that bond to drop by about ½% because it’s a three-year bond, the duration is about 2. So when you have a positive change in interest rates of a ¼% you get to multiply 2 by a ¼, you get ½%: the price of the bond drops by a half of a percent.

So, if for example, you were saving for your daughter’s first year of college in three years and you chose to put those savings in a bond expecting to need it in about three years, you would probably be okay. The interest rate change would cause a drop in the price of the bond. But as you get closer to the maturity of the



bond, the price would walk right back to par and in three years you get, in fact, about what you expected to get.

Now, let's think about it if we are talking about a 30-year bond. So a 30-year bond has a duration of 20. If rates simply go back to reflecting inflation we've already seen, the 30-year interest rate would go up by about 2%. If they did that, the price of the 30-year bond would drop by about 40%. So, if you held it to maturity, it would walk its way again right back to par. But, if for some reason five years from now, you said "gee I want to pay for the down payment on that house or I'm going to enter retirement and I might take that money out to fund my retirement," you're going to sell it at significantly less than par and so you are not going to get what you might have expected.

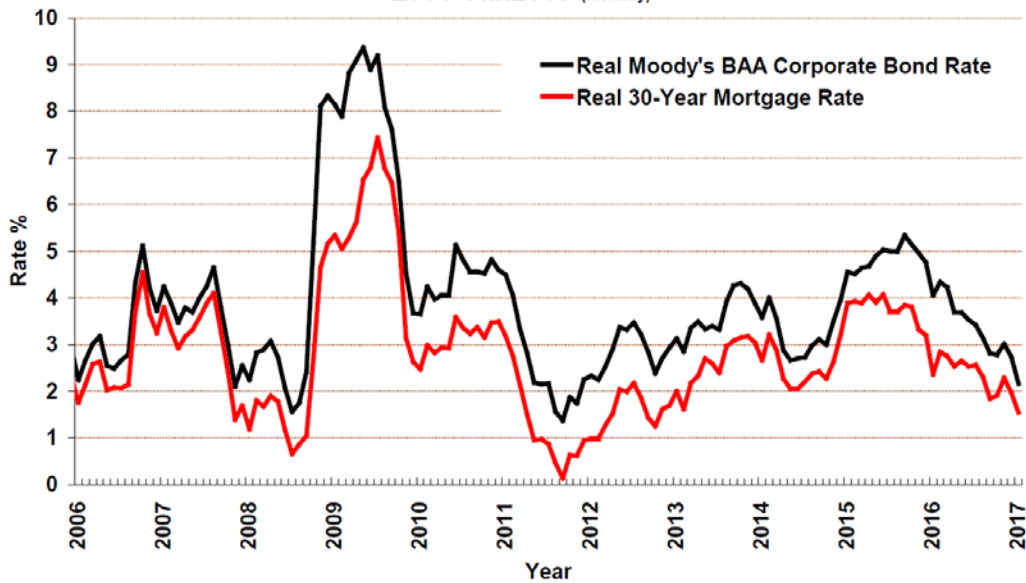
So when people ask us "Do we like bonds?" the first thing you need to think about is "why am I interested in bonds?" If I'm interested in the bond as a short-term place to put cash and I know when I am going to get out, you will probably be okay. If I'm interested in long-term building wealth, we don't think that you're going to be okay because we think, frankly, that the interest rates do not reflect current inflation. So even if you thought inflation would be steady you still have a lot of risk based on current rates. And so we are not an advocate right now for bonds for the long-term as a way to build wealth going forward. That's kind of a fuller explanation of the answer to the question: Do you like bonds?

Ron: Just as an example of that, the last time that we've seen interest rates move up for an extended period of time was in the 1970s. If at the beginning of the '70s, you bought a 30-year treasury that nominally would have yielded about 5%, by the end of the '70s when those interest rates were at 13%, that bond would have been priced at, roughly, 55 cents on the dollar. When interest rates move up, bond prices move down. Since 1980, interest rates have been on the steady downtrend. We think they have gotten below where they should be and below where historically they have been. So, the combination of what Jeff just talked about (interest rates are below where they should be) means interest rates should move up.

Also, we will say a little bit about inflation which is now probably ticking up as opposed to ticking down, that would also drive interest rates up. So we are seeing two things that should be driving interest rates up which would drive bond prices down, therefore we don't want to own bonds. If you are insisting on having a "balanced portfolio" we would suggest that the "bond portion" of that be in very short-term bonds or notes or in cash.



**Real Moody's BAA Corporate Bond Rate
Real 30-Year Mortgage Rate
2006-Jan2017 (Monthly)**



Source: Bloomberg

Jeff: Thanks Ron.

This chart is very similar to the prior one but now we are looking at the inflation-adjusted cost of debt for the consumer and businesses. The black line is the real rate on BAA Corporate Bonds and the red line is the Real 30-year Mortgage Rate, so that's adjusted for inflation.

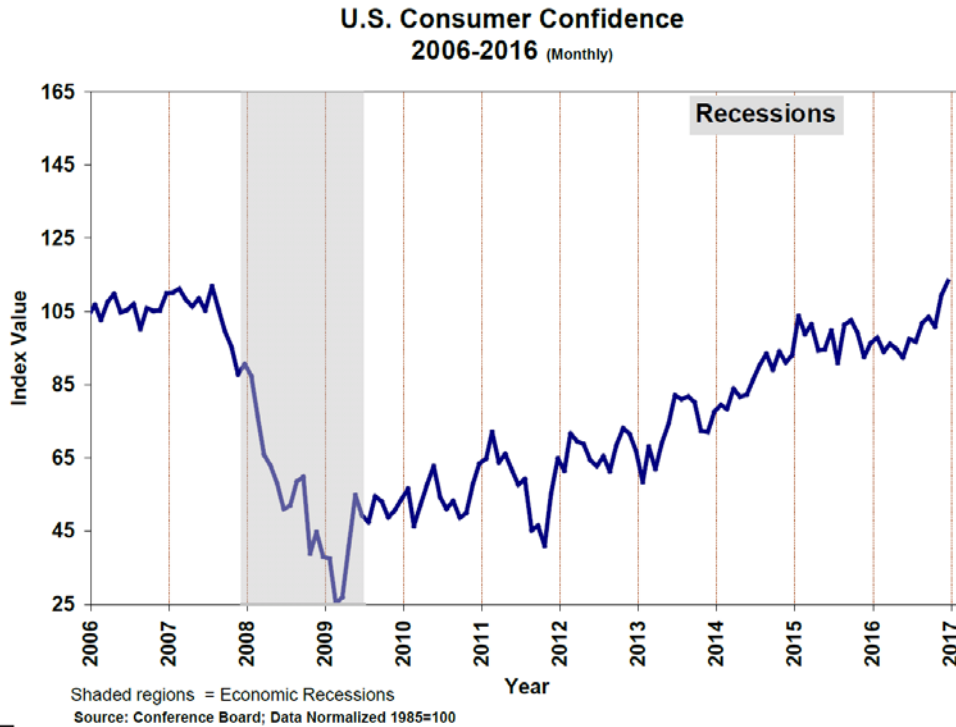
Relative to inflation, rates are quite cheap. As we talked about with treasuries, well it's the same way for corporates and for mortgages. In fact, we are seeing record levels of corporate debt refinancing earlier this year. There are probably three reasons for that: One is that there is a low spread between the rates in inflation; two is there is a large amount of debt coming due in 2017-18 (so they're trying to refinance the debt while rates are still low); and three, I suspect there's an expectation that rates are going to go up. First, because the Fed says that they are going to raise rates, and second, because there is an increasing amount of inflation visible in the economy. But that's what you're seeing in terms of cost of debt for corporations and for private citizens.

Ron: Corporations, of course, are looking at the opposite side. When we say rates are too low to be attractive as investments, corporations are saying we can borrow money cheaply (rates are too low, so we are going to do it now while we can).



Jeff: And frankly, we applaud them for doing that. We are not saying they are crazy—we’d say they’d be crazy not to lock into a good long-term rate while they can.

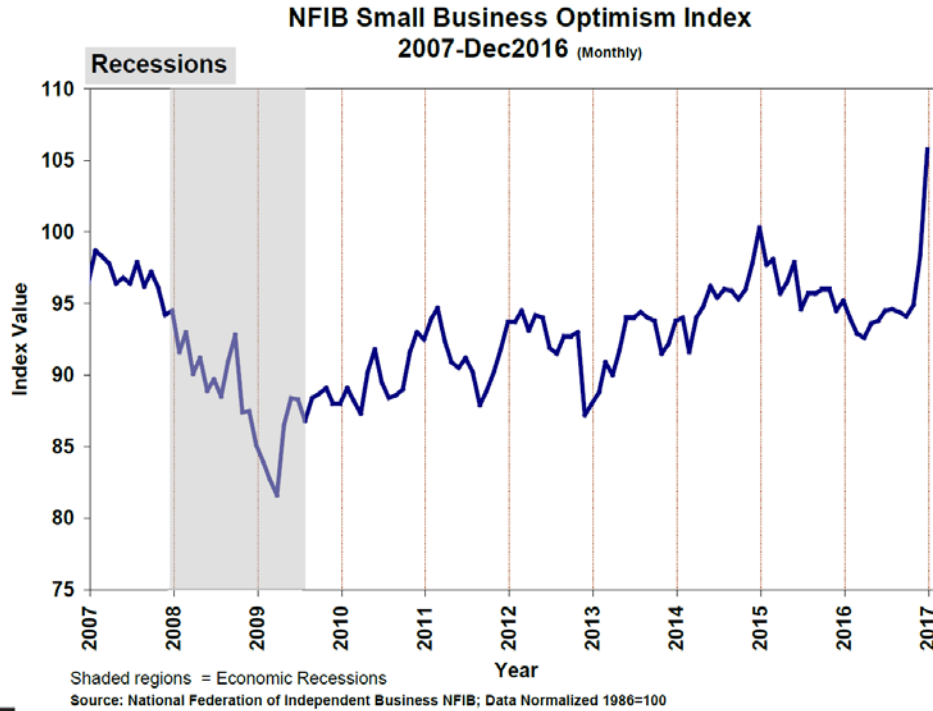
The next thing we are going to talk about, just a little bit, is consumer confidence...



We’ve shown you this chart before. This is a plot of U.S. Consumer Confidence since 2006. You can see it began at about a level of 105 and that’s just an index level. It dropped quite steeply into 2009 and has recovered at a relatively steady slope since then to the point of where now we are back to the level of confidence that consumers had way back 10 years ago. So we are back to where we were, it only took us eight to ten years to get there. But the consumer is at least saying that they are doing pretty good.

Ron: And there was a little bit of a bump after the election.





Jeff: Contrast that with small business optimism. This is a chart of the NFIB Small Business Optimism Index since 2007, and again, you can see that it declined quite sharply into the recession and came out of it fairly steadily but unlike consumer confidence it was back to prerecession highs by 2015.

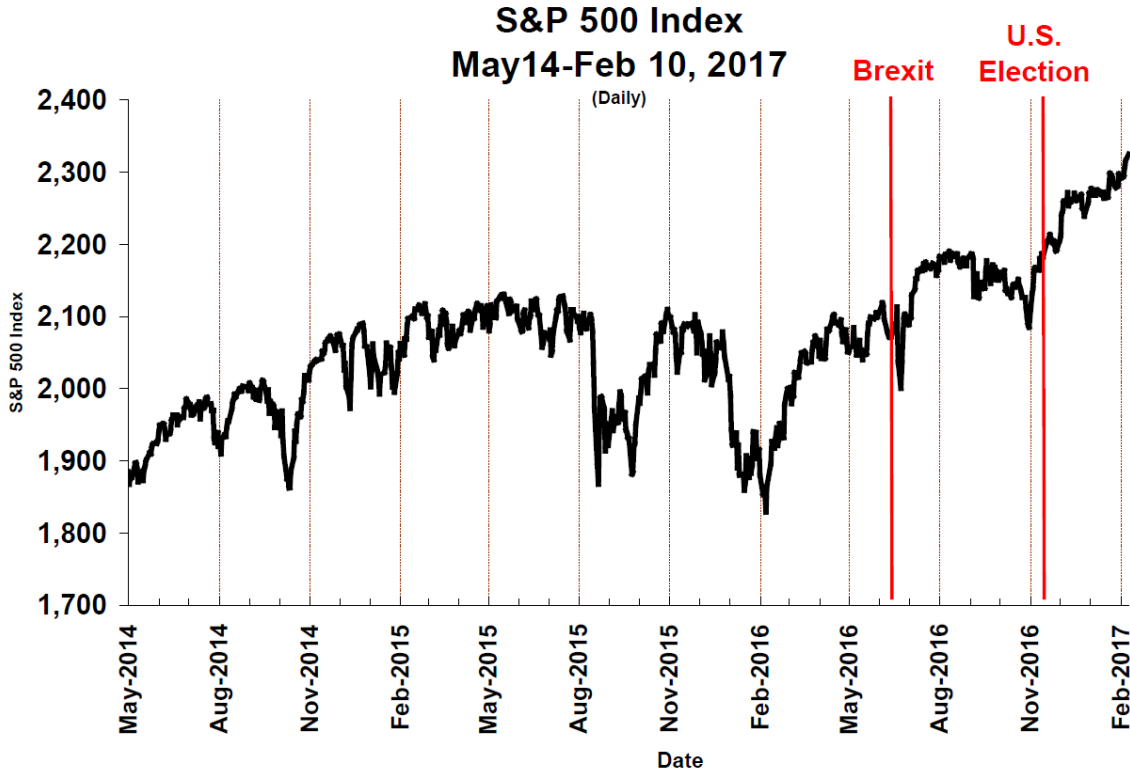
The most interesting part, frankly, is this big spike postelection. So, to the extent that small businesses are feeling more confident about their future, than they had been in the past, we think there is reason to believe that they may start spending and hiring at a rate greater than they had been. So it is possible now, that you will get economic growth at a higher rate than we have been seeing.

Ron: We've been saying since '09 that all businesses (particularly small business), were reluctant to begin businesses and they were reluctant to spend money on capital goods or hire people because, frankly, they didn't know what the rules were.

As an employer, as a small businessman, you've known for the last 8-10 years that the regulations were going up, and you were promised that your tax rates were going up, you knew that healthcare costs were going up. We've been saying for some time that we weren't done with that because half of the Dodd-Frank Rules haven't even been written yet. Since the election, the promise is that regulations won't continue, that tax rates should roll over and may come down as opposed to going up. So we've seen this big spike in business confidence. Of course it's been too soon to see whether that flows through into the actual act of spending money or hiring people. But the confidence is up and that's a good start.

Jeff: ...and that's what we've been watching for.





NOTE: The S&P 500 Index is a widely recognized, unmanaged index of common stock prices. You cannot invest directly in an index.

Source: Bloomberg



Jeff: A little bit of retrospective now about what the S&P 500 has done for the last year or so. If you recall a year ago, in February 2016, we were in the middle of a 10% correction in the markets but that wasn't really true for a lot of companies. A lot of companies saw their stock prices get cut by 30-40% and, in some cases, more. If you recall crude oil was selling below \$30 a barrel, so capital spending by energy companies was virtually nonexistent. And a fairly large number of small energy companies were going bankrupt or defaulting on their loans, and that put pressure on the stock prices of the banks that held those loans.

Business conditions for many industrial companies, at the time was pretty weak...and then things didn't get any worse. So about mid-February, the price of crude oil started to come up. The Federal Reserve, which had been saying they were going to raise rates, changed their mind and said "gee we don't think we're going to raise them now."

My personal opinion, what the market did was it saw a lot of signs that indicated a recession was coming. When they stopped seeing those signs, the markets took the recession worry off the table and started piling back into stocks and that's what drove, pretty much, the run from February through May. In May, we had about a three-week period where the markets reacted to the decision by Britain to exit the European Union (EU)—we have labeled it here Brexit. That took the markets down for a couple of weeks. They recovered pretty quickly and hit all-time highs in June or July, then sold off a bit coming into the election as people were concerned, by the nature of the election itself and concerned about what the future was going to bring.



Post-election, the markets sold off for about six hours and then rapidly reversed themselves and have been climbing ever since. So, that's kind of where we are now. A year ago, we saw a lot of storm clouds. Today, we do not see those storm clouds. So, I am not as concerned today as I was a year ago that we were entering a period of high-risk of a recession. So those indicators that we saw a year ago are not currently present, that's probably important for me to let you know.

Ron: Be aware, of course, that there are some elections coming up in Europe. A couple of the corrections that we saw in the last year were related to politics and elections—we show on here Brexit and the U.S. election. Some have asked about U.S. debt and the other problems of the world. None of those have been solved, they've been kicked down the road. So those things are still out there...nevertheless they are hard to put numbers on...nevertheless that could give us a correction this year.



Changing the rules: which rules, how much change?

Political Promises

- Repeal Obamacare
- Roll back regulations
- Tax Cuts
 - Business
 - Personal
- Renegotiate trade deals
 - NAFTA
 - Trans-Pacific Partnership
 - Relations with Germany and China

Progress so far

- Withdrew from Trans-Pacific Partnership
- Executive order to examine Dodd-Frank regulations
- Executive order to review fiduciary rule
- Dakota Access Pipeline and 2 northeast pipelines approved
- Cabinet choices
- Executive order to repeal 2 existing regs for every new one



Jeff: Then on to the topic dejour, “changing rules.” The real point of this slide is to highlight what promises have been made by the Republicans and where they have promised to make changes. They’ve said that they will repeal Obamacare and replace it with something else, but they haven’t yet told us what that looks like. The president has promised us that he’s going to roll back regulations. In fact, I think he issued a presidential directive saying that it’s going to be a two for one—if you want a new reg, you have to get rid of two old ones.

Both the president and congress have said that they are going to redo the taxes. So that’s going to result in tax cuts to both businesses and individuals. The president has said that he’s going to renegotiate trade deals starting with NAFTA and he’s going to relook the relationships that we’ve got with Germany and China. Both of those countries are large exporters and typically we are the importer of a lot of their goods. The president thinks that that has been working to our detriment. So if you look at what we’ve actually gotten done so far, it’s a whole lot smaller subset, if you will, than what’s been promised. And, in fairness, it’s only been a couple weeks and some of these are really big projects.

But we have, in fact, withdrawn from the Trans-Pacific Partnership. We have had executive orders to examine Dodd-Frank. So Ron talked about all of the Dodd-Frank rules haven’t been written. He’s [President Trump] basically put a freeze on writing any more. And they are relooking all the ones that have already been written to see which ones still make sense and which ones need to be changed.

He has ordered that the fiduciary rule (if you’re not familiar with that, that is the rule that applies to all retirement accounts and it means your broker has to change from operating in a manner that is acceptable to you to actually operating in your best interest) that has a lot of implications for the brokerage



community and how they do business, causing a lot of changes, second-, third-, fourth-order effects. He's reexamining that, not clear if it's going to come to pass or not. Then some concrete things that you have gotten done. You have gotten the Dakota Access Pipeline approved, that was up in North Dakota. That is to pull oil out of the Baaken Shale formation and allow it to get shipped down to the Gulf Coast where there's all the connections to the rest of the network in the U.S. So instead of sending that oil by rail, we are going to send it by pipeline now. That finally got approved and that pipeline is supposed to be operating in about 90 days. Then there are two gas pipelines in the Northeast here that had been planned and had been kind of slow rolled by the federal government. Those pipelines are designed to get cheap gas out of the Marcellus into both the Northeast and the Southeast to help lower the cost of energy in those sectors. So those are some things that have absolutely been done.

If you've been reading the papers, you've seen a lot of his cabinet picks have been approved, some haven't and one withdrew his name from the department of Labor. That's important because a lot of the regulations that have been promulgated over the last ten years or so wasn't as a result of additional legislative action, the law makers passed laws that were then fleshed out by the regulators that are underneath these cabinet members. So what Mr. Trump has done is he has asked a number of people with some very different thinking on how those departments ought to be run to run them. So it will be interesting to see how they go in with a completely different mindset than the department that they have been asked to run has had for a very long time.

So I can't tell you that a whole lot has changed just yet because, in fact, a whole lot hasn't changed but the point really is that a whole lot *may* change. We'll talk just a little bit about what Representative Ryan [Paul Ryan] wants to do with taxes. One of the elements to that tax policy is what's called a border adjustment. So he's going to change how companies are taxed and so there are clearly some winners and losers in that. So if you are Boeing (BA), and you are primarily an exporter, you are going to see your taxes reduced. If you are a Walmart (WMT), and you are primarily an importer, you're going to see your taxes increase. So if that comes to pass, there's going to be a shift in profitability from one to the other. Right now, everybody on Wall Street, ourselves included, is trying to figure out, one what is actually being talked about. So that's on the table, if you will, from Representative Ryan but Mr. Trump hasn't endorsed it. So there's a lot of uncertainty about whether that one very small piece actually happens.

You have to try to estimate whether it's going to come to pass and you have to try to estimate what the impact is if it does. So you're seeing the markets and folks like us trying to figure out what that means and what to watch for going forward to see how this changes—and it's really huge. So not just the boarder tax adjustment, but when you start talking about, currently corporations can deduct interest on debt, well one of the proposals is to do away with that...that would be pretty big, particularly for some businesses that are very, what we call "leveraged" or very indebted (where debt is an integral part of their business model). That may have some very traumatic impact on your business model. For individuals, there is discussion about doing away with the deduction for your mortgage from your taxes. All these things matter—some matter more, some matter less, and some of these things may not get much discussion and may be buried kind of in the corner of the law should it ever get passed and then come to surprise people. So we are in a period of time where we know that a lot of laws and regulations are back on the table to get reevaluated and we're not quite sure which way it's going to go, but we've got to pay a lot of attention to that because it will matter as we look forward.



Ron: Another part of the tax law on the table is whether companies can expense capital expenditures or whether they must continue to be capitalized and depreciated over a period of time. The point is there are enough moving parts here that any one of them you may be able to get a handle on, but we have no idea what the mix will be when Congress gets done making the sausage...

Jeff: The point is that's kind of the task of the day, if you will. There are periods when things don't change too much and you can simply rely on what you knew to be true. This is probably not one of those periods. So from a policy perspective, we've talked about that a little bit when we've talked about interest rates. What you knew to be true with bonds for the last 30 years was that they were safe. Part of the reason they were safe was that rates kept coming down. So if you had to sell it before maturity, you probably didn't lose on the price of bonds, in fact, it may have appreciated for you and there have been a number of people that have made a good living doing that, rolling bonds like that.

That may not be true anymore and so what you have come to believe as almost a truism, as an assumption that you don't even question, I would argue that you probably need to put back on the table and think about because it may not be true going forward. We'll be doing that with the laws and regulations recommending you think about bonds that way because what may have worked for 30 years, may not work for the next 10 or 15, a little bit depending on what inflation does.

Ron: Jeff, also say a word about...some people talk about the current administration being "business friendly" actually, it's a little more populist. Not necessarily in some of these things are they looking to help businesses, but they are looking to help the worker.

Jeff: When I look at what Mr. Trump has done so far, the thread that I see running through it is he doesn't care whose arm he has to twist to benefit the worker. So he's twisted Lockheed Martin's arm; he's twisted Ford's arm; he's twisted Carrier's (which is an air-conditioner manufacturer) arm. He's twisting Mexico's arm; he's interested in twisting China arm and Germany's arm. He wants good paying, and in his mind, I think, that's industrial jobs in America and he doesn't really mind...I'm not saying he doesn't care, I think he does care. He doesn't mind twisting arms to make that happen.

Well, when you twist Ford's arm to refurbish a plant in Detroit instead of building a new one in Mexico for instance, that's not necessarily going to result in greater profits for Ford, and therefore, greater returns for Ford owners or lower costs to Ford customers. You can argue whether that's good or bad, that's not really the point I want to make, I simply want to recognize whose side he's on and who is he willing to allow to be collateral damage to get what he wants done. So I think collateral damage may occur for both owners and consumers as he works to benefit employees.

So that's kind of what we had to say. So Tony, do you want to move onto questions?

Tony: We can do that. Ladies and gentlemen, you should have the opportunity here to type in a question and have it sent here to us so we can answer it and see who it's from. So go ahead, if you get a chance, type



that in. In the meantime, of course, we did have some people submit questions earlier on. There were kind of three broad themes. One of which had to do with inflation or deflation and what do we see that being a direction here currently and going forward. Jeff you talked about current levels of inflation. Where are they and are they increasing?

Jeff: I'll take a little bit of that now. I think Ron has some more thoughts on inflation.

Right now inflation is 2.3%. So the numbers just came out for the 4th quarter of last year [2016] and year on year, the CPI (Consumer Price Index) which is the common one is 2.3%. And with the 10-year rate at 2.5% and the 30-year interest rate right at 3.0% as I highlighted in that chart, interest rates do not accurately reflect, or do not show the same spread over inflation that they have historically and that causes some concern.

Ron, you have some thoughts about where inflation goes from here?

Ron: Well remember that the Fed's target for the last seven or eight years has been 2% inflation and 0% interest rates. And inflation is now up to about the 2% level or a little bit more. Be aware that because crude oil, one year ago, sold for \$30 a barrel and today it's about \$50 a barrel that has boosted the current inflationary numbers.

So, for the last year it's up to 2.3 [percent]. If crude oil levels off here, the rest of the prices are a little less than that. So we think that the 2-2.5% is kind of where things are. We expect that to drive interest rates up, but we also expect the very fact that, as Jeff talked about, interest rates are below where they should be. Remember that this whole thing of low interest rates was meant to encourage people to spend money on things like houses (and they didn't) and it was meant to encourage companies to go buy plant and equipment (which they didn't because they didn't know what the rules are). You have things a little bit across purposes here.

We had been deflationary certainly up into last year when oil hit \$30 per barrel. We think that game is over and going forward you are going to see a little more inflation. Although we don't see anything like it—the 5–10% a year numbers that we saw in the '70s. But that trend of lower inflation and lower interest rates we think is over and that's what's getting reflected here.

Tony: With that being said, we've also had questions about our portfolio. What do we own? In particular, comments on Rex Energy (REXX). How fully invested are we today? Are we close to being fully invested today? And do you have ideas on using the cash?

Jeff: We did put cash to work last year. So we start the year pretty heavy cash. We still have some...it varies a bit by account.

Ron: ...10–20%



Jeff: Round numbers, we probably put 10-15% to work last year. Some of that was in Energy. In February and March of last year some of that was in Industrials. A fair bit of it was in Healthcare which has been selling off. Healthcare was the worst performing sector last year and it has not turned around yet this year and I certainly wish it would but we found a lot of value in Healthcare and it was a little bit attractive because it's not as cyclically sensitive as a lot of the other things out there. We found that interesting but we have not yet benefited to a great degree from the Healthcare investments that we made last year.

So we have some cash, not as much as we did. We put some of it to work last year—most of that has worked out quite well. Probably the error was that we didn't put more to work. Hindsight being 20/20, there were some opportunities that we did not take advantage of that now certainly we wish we would have.

Ron: As a for instance, the U.S. has become the lowest or second lowest cross producer of crude oil and more distinctly of natural gas so that, for instance, if you're a petrochemical company and you're using natural gas to make chemicals, if you have plants in the U.S., you now have a cost advantage because our natural gas is cheaper than the other parts of the world.

So I can't quite remember what month, but in the past we bought a fair amount of Celanese (CE). Celanese is basically a commodity buyer but they are also a commodity producer and usually the margins aren't too good on commodity producers, but if you have an advantage in the product that you buy, in this case ethane and ethylene, there's room there. So we're trying to identify for long term those areas that will continue to benefit from the low cost energy produced in the United States. As I say, we're pretty good on crude but we have a distinct advantage in natural gas. Beyond that, we always look for good companies at cheap prices. We've been saying for the last year that we're finding good companies but it's tough to find cheap prices. The average company today is selling at about 19 to 20 times current earnings [P/E ratio].

The policies we see coming out of Washington result in higher growth...a couple of months ago when I said 2% growth doesn't justify 20 P/Es ...but if we can get growth in the economy up to 3-4%, it's much easier to justify 20 P/Es. That is not yet a given. We saw business confidence is jumping up so that is a hope but is not yet a given. So we have money on the side where we find good things. Frankly, we have been harvesting a couple things, things that have jumped pretty nicely for us in the year.

So it's an ongoing mix that we always do of trying to find good companies that are cheap and when they get fully priced, we'll scale back a bit. That's ongoing.

Jeff: Kind of the change on a year over year basis. We've said many, many times that we look at companies and we kind of nominate them bottom up and we edit top down. So to me, one of the big changes from a year ago is the worries that we still have from the top down have largely receded. And the big ones a year ago were frankly recessionary—those have receded. Some of the worries about European banks have receded, so we are less likely to edit because of concerns about what's going on in a broader economic perspective and more focused right now on what exactly is happening with specific companies and what's in their future.



Ron: Specifically, we've said for the last several years, companies were reluctant to spend on Capital Goods. Now, all of the sudden, we are talking about expensing capital expenditures, we're talking about changes in tax laws, we're talking about focus by President Trump on people building plants in the U.S. You know if Ford builds a billion dollar plant in the U.S. instead of in Mexico, or if we put in pipelines and the focus is on buying U.S.-made pipe...the price of U.S. Steel has jumped big time since November...frankly, more than we think is justified but that's a mix that can have longer-term implications.

Tony: Some of your decreased concerns include the coming elections in the EU (European Union). You mentioned Italy, France, and Germany are having elections...Concerning? Greatly concerning? Somewhat concerning? Remains to be seen and does the EU survive?

Ron: Less concerning than it was before Brexit. Everybody thought Brexit would kill the British economy. It killed prices for a couple of weeks. Frankly, it brought the pound down which means that buying British goods is cheaper for the rest of the world. So some of these things that were viewed as catastrophic, the markets have already taken changes in British elections into consideration...so the second or third surprise is always less traumatic than the first surprise. The fact that we've gotten through the first one or two, makes the future ones seem less threatening.

Jeff: I would say the EU continues to have a lot of problems. The EU banks have a lot of problems and all I'm saying is right now the heat has been turned down on them. So you had the heat ramp up way back in 2012 with the Greece crisis. Then they got through that, then the heat kind of came out. Then you had Brexit and things heated up and then it came out. In part everybody knows that these elections are coming. So right now, they are not a concern. Depending on how they go, they may be a big concern and, of course, sooner or later the EU has to wrestle its really big structural problems that they keep kicking down the road.

Greece is practically back in the...I don't want to say front page, it's in about page 3 or 4 of the paper. But it's got a debt maturity that they can't meet coming up. And so what's back on the table is "gee do we just hand them more money or do we actually do debt forgiveness"? So the problems haven't been solved...people are less concerned about them than they've been because they haven't come to a head. We haven't forgotten them and we are watching for signs that they start getting people's attention again. I don't have to be the first one to pay attention to it, I just have to really recognize when it's becoming a concern for the rest of the market. That's really what I'm looking for, and right now it's not. As we get closer...the first elections are actually in Belgium, in March, I believe. So that will tell us something kind of about the mood of the electorate. Then you have France behind them and then Germany behind them. So could concern over Europe ramp up? Yes, it certainly could.

If it does, what's the impact on the U.S. markets? You could make a pretty strong argument that money starts fleeing Europe for the U.S. which would argue for a run up in U.S. Treasury bond prices, so a decline in rates and it may mean more money flowing to our markets. And then, God only knows what that does to the exchange rate. It probably means a stronger dollar with all of the things that are happening. Are we watching? Yes. Is it important to what the markets are thinking right now? I would argue, no. If that starts to change, we'll talk about it.



Ron: I'm not sure if it's the good news or bad news but, with all the problems that we have in this country, we are still the world's safe haven.

Tony: So with that being said, let's shift back to the U.S. a little bit. Jeff, you said that Trump, rather than being business friendly, looks more like he's worker friendly, and if that's true, how does that impact the markets? Does it decrease profitability or do things just shift among sectors?

Jeff: We've talked about this for a while...businesses in the aggregate are more profitable today than they have ever been. We have noticed it and a number of people that we read have noticed it and everybody is kind of arguing for a return to the mean which implies that more of the profits go to the worker in higher wages and less go to the owners—returns on capital, returns on equity. It would not surprise me to see that happen and whether Mr. Trump is the driver of that or drives a little bit of that or it's simply businesses are...labor got tight and you have got to reward labor better, and so they give a better deal. It wouldn't surprise me in any way, shape, or form. So do you want companies that have always had high returns on equity and have always treated their workers well? Yes, you'd probably rather be spending there than ones who are very sensitive to pay, etc.

We will give you a couple for instances where we are seeing it. Delta Air Lines (DAL) has always been very worker friendly. They have a profit sharing program that paid out over a billion dollars to their workers this last year. And the pilots which had given up some concession six or seven years ago in their contract got all of that back and more. So Delta is paying pilots better, they renegotiated their contract.

Allegiant Airlines (ALGT) has renegotiated contracts. You're seeing contracts renegotiated for pilots across the airline industry. So over time there is this give and take and when the businesses need the workers to give a little, this time around, they did. Now the expectation is that the business gives a little back to the workers and they are. So, you see it and you bake it into your analysis and you make your decision there as to whether the returns to you, the owner, are going to be acceptable going forward or not.

Ron: I'm going to give a little different perspective on some of that. Over the last eight or ten years, if revenues are only growing at 2% (remember that GDP grew at 2%), the only way to increase profitability was to squeeze it out of cost and they started earlier and heavier than I expected. They squeezed everything out. Going forward, if you think there is a shot at 3-4% growth and you haven't been spending money on capital goods or what have you...some of your plants and machines are getting a little old...when you do that, even if you capitalize and later depreciate the expenses, it takes something out of your margins. So if you are building for the future, it costs you something in the present.

In the last 8 or 10 years companies have built less for the future than they normally would have and they pocketed in the present. So the point is all this changes.

Incidentally, when Trump tells Ford that he's going to squeeze them big time if they don't build in the U.S., if, on the other hand, he said we will allow you in the U.S. to expand your plant...he's giving them a carrot along with the stick. So he's changing the rules on both ends. So it would, in fact, change Ford's perception



of doing things. So it isn't all just stick, there are some carrots in there too. And how those shake out are different from different firms. There are a lot of moving parts going on.

Tony: So we continue to monitor...

Ron: ...and research, we talk to companies and each company is going to be a little different.

Tony: So how much of this recent market move is a result of the policies of the new administration...or the promises?

Ron: Actually, much of it was the month of November. We hear about new highs but the big move was pretty much the month of November. Much of it was that jump in business confidence. And now we are in the nut cutting of saying, "how much of that actually will get passed and what will the new rules be?" No one really knows for sure yet—no one including Congress and including President Trump.

Tony: With that being said. I think that's about all of the questions we have. Is there anything else that you want to close with?

Ron: We had a couple of questions on performance. Frankly our performance in the last 10 years has been disappointing and this is on me. What I thought coming out of '09, I said with what was being promised in taxes, what was being promised in healthcare, what was being promised in regulations...it was hard for businesses to know what the rules were and they would be reluctant to expand and to spend and, in fact, GDP (Gross Domestic Product) growth since '09 has been about 2%. It's been less than half of the speed that people projected coming out of a serious recession. The irony is we got the economics right but the markets came back as if we were coming back from a normal recession. If you get it up to 18, 19, 20 P/Es with 2% growth, you'd have to argue that things are pretty fully priced. So we got the economics right and what we said all the way through there...we said back in '09 and what have you, that when we saw the recession coming in, we started with the balance sheet. We wanted to be sure we had strong companies that would survive.

Usually when you come out of a recession, you go farther out on the limb. You buy smaller companies, you buy higher Beta kind of stock. This time around, we did not do that because we didn't trust the strength of the recovery. In hind sight, that was a mistake. So, we are back to where we were in terms of values in '06 and '07—the markets have gone by that. I haven't been able to justify the current P/Es based on the current growth rates. If you did it purely based on...people say stocks are cheap but only relative to bonds. So as we argued earlier, we think that bonds are overpriced to the extent that they are probably now dangerous.

If we continue to grow at 2% [GDP], stocks, we think, are overpriced. If you think we've got a shot at growing at 3-4%, there we can start to find some values. So with hindsight, I'm disappointed. I find it a bit



ironic that we called the economy right but not the stock prices, but unless everything shuts down, going forward, the game continues, the business continues. There will be companies that do better than average and others that do worse than average.

If you are in retail...you cannot be in retail today unless you take Amazon into account.

Some industries that used to be basically domestic have become international. Natural gas is becoming an international commodity. It had always been a domestic commodity. Because we are just now starting to get a number of ships and LNG (Liquid Natural Gas) plants to allow it to become an international commodity. So there are always changes going on. It continues and we don't see anything that really threatens a shut down.

Six or seven years ago, we were worried that the problems of the banks in Europe could affect our banks. The whole '08, '09 crisis was partly because of the susceptibility of the banks and we refer to it as the world-wide financial shut down. It took three or four years—about three years to get our banks back into shape and a couple years after that to get the European banks back in shape. Within a month or two, Greece is going to come in and ask for more money. If you are a German bank and you lent to Greece, you're not going to get paid back. The only question is how you write it off on your books...whether you do it over a short period of time or long period. So none of those big things that we have been monitoring for the last seven or eight year have been solved. Some of them have been diminished or they've learned how to handle it. Even a chronic disease, after a while, you learn how to handle it and it no longer scares you the way it used to.

That's about as good an explanation as I can give.

Tony: To recap that a little bit...coming out of the '08 recession, we focused (and focus probably isn't too strong of a word) on the economic fundamentals that we saw both in this country and around the world that said very slow growth. We are not getting a normal recovery from a normal recession. However, U.S. domestic stock market, in particular, and maybe even around the world, frankly, acted as though we were having a normal recovery from a normal recession and took off far faster and far farther than we expected at the time.

Ron: Farther. It took eight years...the longest and slowest recovery from a recession since WWII.

Tony: Continuing to focus on the economics...we aren't seeing stellar growth and we are seeing improving conditions. If we can get growth from 2% to 4%, 20 P/Es become more justifiable. In which case we're finding things that we can own but we are stock picking, we are very picky. We're emphasizing earning, balance sheets, and not paying too much for the companies that we like.

Does that remain true?

Ron: Always. That remains true.



Tony: Very good. Jeff, anything you want to add to that before I tell everyone good bye?

Jeff: A piece that I would add on there is what happened this time is you had three of the biggest central banks in the world. First the U.S. and then Japan and Europe. All started creating money and buying bonds by the trillions of dollars' worth and that has pushed the natural owners of government bonds into something else because they couldn't buy the government bonds anymore. Literally they were being taken off the market. The U.S. took \$4 trillion of government bonds off the market. Europe is still buying more bonds on a monthly basis than are being newly created by the governments of Europe. Japan is doing the same thing. So you are taking bonds off the market and you are pushing that money into what remains of the bond market, both treasuries and government bonds and into corporate bonds. So that's, in my opinion, part of the reason you've seen corporate bonds scream to all-time highs and spreads now between corporates and treasuries are very low and my suspicion is that the first-order effect is you push down the rates of government bonds, the second-order effect is you push down the rates of corporates, the third-order effect is now you push money into stock markets which pushed those prices up. All these prices are going up. When they say rates go down, obviously that means prices go up, so government bonds are priced higher and we walked you through that. We told you how high we think they are relative to inflation which is normally, historically, how they are priced and they are not being priced that way right now. And corporates aren't being priced that way right now...and stock prices have come up...so the U.S. stopped doing that about two years ago but Europe and Japan still are and that still matters. Personally, I think I underappreciated for the last eight years how much that mattered. And so, as long as it continues, you've got to factor that in and when it ends, whenever that may be, and I have honestly no idea when Japan is going to quit buying bonds and they are actually buying ETFs...they are buying stocks. And I don't know when that's going to end, but you got this big tail wind that's still there and we are still cognizant that it's there. We are kind of wary of the day when it ends and we don't know when that is. So I'm not trying to scare you, but when you think about what has happened and what's been different this time and what you didn't account for, I'm not sure we accounted for that quite right. So when Ron explains the difference between what he expected in the economy and what he expected in the markets, to me that's a big piece of it. That was a big piece that moved the markets along a little bit faster than the economy got moving and it's still there. So we are aware of that and will probably continue to talk about it as necessary as we go forward.

Today, of course, the European Central Bank is happy to keep printing and so is Japan. So I've got no news for you on that front. But I think it is a big factor to be aware of when you talk about the price of bonds and when you talk about the price of stocks. You've got these two very big buyers who are not price sensitive and they are still in the market today and they're skewing all of those markets on a global basis.

Tony: They're the guys who are going into the auction and they are taking the opening ask. They are not waiting for it to get cheaper, they're saying "yep I'll buy it now." They kind of queer the deal for everybody else at the auction trying to get it cheap.

Jeff: Frankly, if they do it long enough, we are all going to forget they are there. We are going to think this is normal and normal changes pretty quickly. So, as I said, "when you change the rules a little..."



Tony: That is the sum and substance of what we hoped to cover this afternoon. If we raised questions or if you thought of additional questions, please give us a call.

Ron: If you got answers, give us a call too.

Tony: Ron, Jeff thank you both. Ladies and gentlemen, please call us if we can help you with anything. We look forward to hearing from you. Take care.

GLOSSARY

Beta is a calculation that attempts to measure the price volatility of a security or a mutual fund in comparison with the market as a whole. The S&P 500 Index is most commonly used as the proxy for the market. If the beta is greater than 1, the price of the security has been more volatile than the market. If the beta is less than 1, the price of the security has been less volatile than the market. Note that the value of beta for a security can change with sampling frequency.

Central Banks are nationalized institutions, given privileged control over the production and distribution of money and credit. A central bank is generally responsible for the formulation of monetary policy and the regulation of member banks. Central banks conduct monetary policy by manipulating the money supply and interest rates. They regulate member banks through capital requirements, reserve requirements, and deposit guarantees. The central bank of the United States is the Federal Reserve System, or “the Fed,” which Congress established with the 1913 Federal Reserve Act.

Consumer Confidence Index is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.

Gross Domestic Product (GDP) is the total market value of all goods and services produced within a country in a given period of time.

Nominal Rate refers to the rate of stated interest before adjustment for inflation.

Price-to-Earnings (P/E) is the current price of a stock divided by the (trailing) 12 months earnings per share.

Real Rate of Return (or real interest rate) is the nominal rate minus the rate of inflation.

S&P 500 Index is weighted by market value and its performance is considered to be representative of the U.S. stock market as a whole. *You cannot invest directly in an index.*

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