August 22, 2017

Amended Transcript

Ron Muhlenkamp, Portfolio Manager
Jeff Muhlenkamp, Portfolio Manager
Tony Muhlenkamp, President

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Tony: Good afternoon, everybody. This is Tony Muhlenkamp and I want to thank you for joining us this afternoon at our periodic webcast and conference call. You can ask questions anytime by typing them onto the screen. Our agenda for today is to start with an update of where we are and what we've been seeing and we'll close with some observations and lessons learned from Ron's last 40 years in the business. You may or may not know that 2017 is our 40th anniversary for Muhlenkamp & Company, Inc.—Ron's actually been in the industry longer than that. So nonetheless, we're going to pick his brain a little bit on the large, long-term, big picture.

I'll also mention, if for any reason you're having trouble viewing the slides on the webcast, they are currently available on our website (www.muhlenkamp.com) Finally, if you have questions that we don't get to, or you want to call and talk further, you can reach me at (724)934-5139 or send me an email at Tony@muhlenkamp.com. I look forward to hearing from you, answering your questions, sharing your comments, etc. With that all being covered, I'm going to ask Jeff to get us started with where we're at and what we're seeing and learning today. Jeff, if you would...

Jeff: Good afternoon everybody. Thanks for joining us today. Just as a minor administrative note, I've got this little pointer…you'll see it as a red dot. I'll use it periodically to help draw your attention to parts of the slide that help illustrate what I'm talking about. So hopefully that's not distracting to you.

Our Checklist:	What we observe as the Current State:	Future Outlook:
1. Consumer Spending	Slow	Slow
2. Business Investment	Slow	Slow
3. Credit Default/Bank Health	Good overall but showing Signs of weakness	Student & Auto loans stretched
4. Velocity of Money	Declining	Should Stabilize
5. Inflation	Low Inflation	Low
6. Federal Reserve and Treasury	Raising Short Term Rates	Balance sheet reduction
7. Taxes	Changes being discussed in DC	Key
8. Regulation	Slow improvement	Slow improvement
9. Europe & Japan	Banks & Politics – Less worrisome; Central Banks – Still worrisome	Mixed
10. China	Currency moves less concerning	Unclear

Source: Muhlenkamp & Company, Inc.

If you joined us on other webcasts over the last year, this list should look quite familiar. This is a checklist we use to help us keep track of what we think is important. You can see our one-word assessments or short-phrase assessments here. If it hasn't changed since the last time we spoke to you, it's in black. If it has changed, it's in red. So we'll just go through it really briefly, and then we'll look at some data that supports most of this.

Starting at the top…we view the current state of **consumer spending** as kind of slow and hesitant. And frankly, we don't expect much change. We told you last time that **business investment** had been slow, it remains slow and, frankly, we expect it to remain slow and our hopes for an increase are gradually diminishing. And we'll talk about that in a little bit.

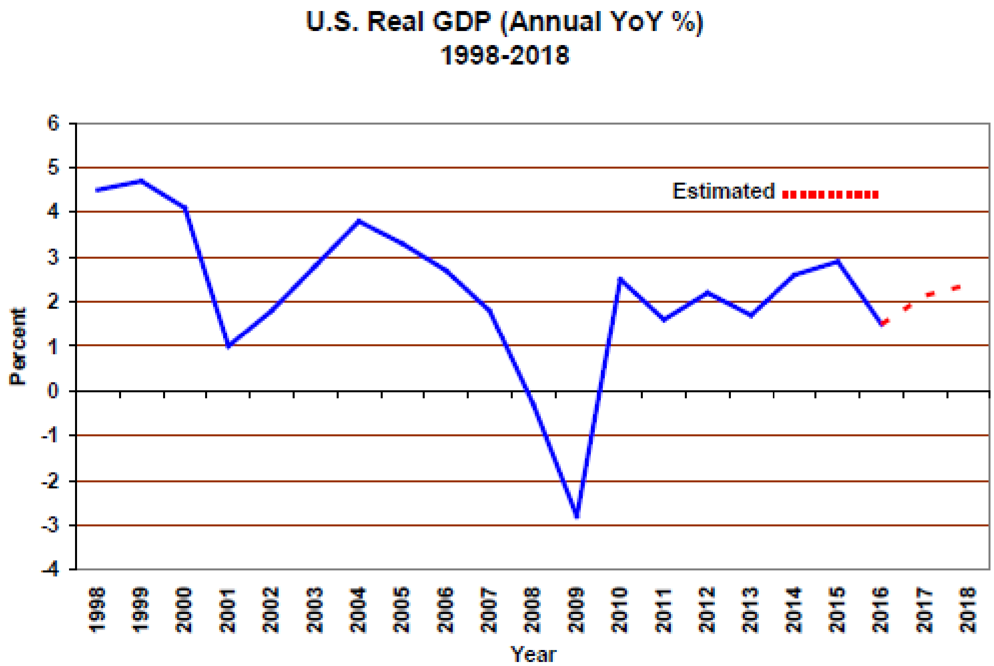
Looking at **credit defaults and bank health**, overall, banks are quite healthy and credit defaults are pretty low. Although, there is kind of an extended credit cycle, if you will, in student and auto loans and we're starting to see some upticks in delinquencies in a couple of categories as well and we'll go through that.

The **velocity of money** has been declining now for about ten years. We expect it will stabilize, although we're not going to put a time period on that. **Inflation** has been low now for about ten years. And we expect it will remain low.

The **Federal Reserve** has been raising short-term rates and we'll elaborate on that a little bit. We expected last time that they would start to reduce the size of the balance sheet. That's probably closer now than it was then...they continue to talk about it. **Taxes**…they're still talking about changes to taxes in Washington D.C. That has not changed…that's ongoing. And they really don't seem to have made much progress. We think that is key to improving the rate of growth in the economy, so we'll be watching that very closely. They also promised (they being mostly the president) that he would reduce **regulations**. We have seen slow improvement as regulations are revised or deleted. And we expect that will continue at some level.

We talked about **Europe and Japan**…we have seen some progress there. So in terms of banks, that's kind of a couple different categories. The Italians had a lot of banking problems. They had some banks that are, frankly, insolvent, they're bankrupt—they just haven't recognized it yet and until about three months ago, they weren't really doing much about it. But they found a mechanism in conjunction with the European Central Bank to start resolving that and we view that as a good thing—that's an improvement. They're working on the problem. The European Central Bank continues to buy bonds (both government bonds and commercial bonds). Although the European Central Bank is talking about ending that program (that's a change) they haven't set a date for when they're going to end it, so we'll look forward to finding out more about that. The Bank of Japan continues to buy both bonds and stocks and support their stock market and their bond market too, for that matter, and that's still a little bit worrisome (particularly if they ever decide to change that). So it's the *change* to what central banks are doing that we think have been significant in their effects on global markets, and if they change what they're doing, it may again be significant in their effects on the global market. And that's kind of where we come up with "mixed."

China…a year ago, we saw some dramatic moves in the Chinese currency, and that created some problems in the markets. Those have damped down, and so you're getting much more gradual moves, and the Chinese economy is basically coming in on predictions. So that's less concerning than it was, but they do have a lot of debt, and how that ends up being reconciled (which debts are defaulted on and which ones are made good) that remains unclear and the impact on global markets if they start defaulting on debt internally remains unclear.



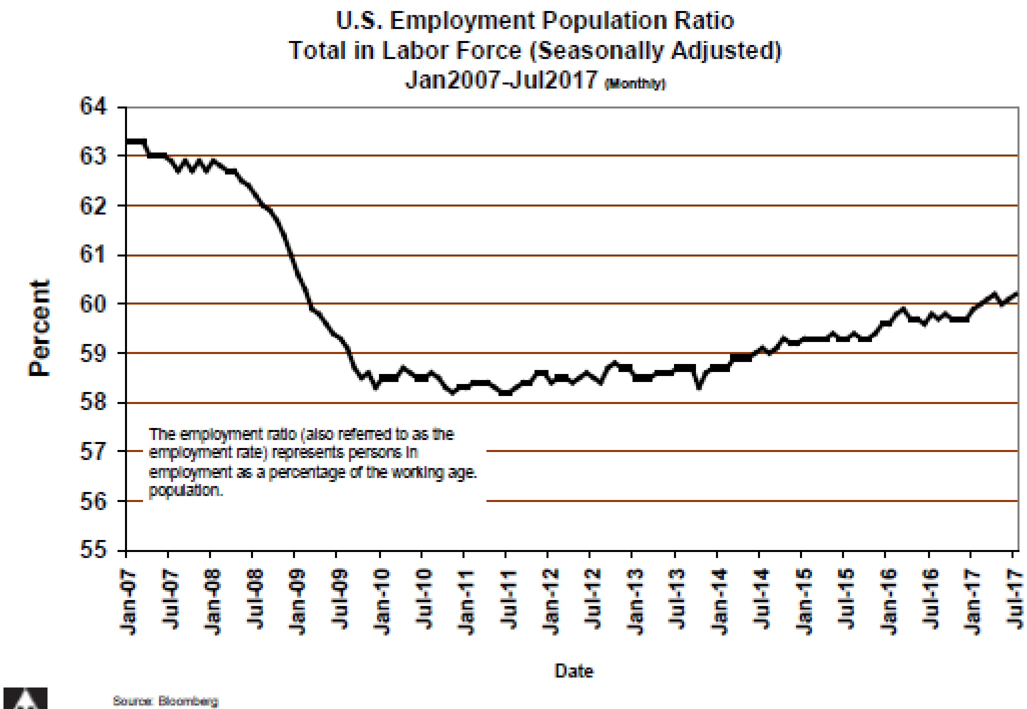
Source: Bloomberg; Estimated data OECD

So we're going to shift now and look at Gross Domestic Product (GDP) growth, which we often do kind of as a lead into what we see going on. This is a chart of U.S. Real Gross Domestic Product (that means we've adjusted it for inflation) since 1998. And, as you may know, recessions typically involved a contraction in real GDP, which you saw in 2008-2009, although you did not see it in the 2001 recession. But typically, you see a negative value here, a contraction in real GDP is a part of a recession.

Ron: What this chart does not reflect is a growth in population. Population grows by a little over 1% a year, so the real GDP per capita (which is frankly what each of us sees) is less than 1%. It would've gone to slightly negative in '01 so you don't have to be much below average to say that, in the last seven or eight years, you have not made much progress. But this is kind of where the rubber is meeting the road in the last decade.

Jeff: What we told you, and have been telling you for a while is that, prior to the recession, we saw real GDP growth in the 3% to 4% range. Post-recession, we now see it in about the 1% to 2% range. And what Ron tried to explain is that with population growing at 1% to you, the individual, 1% growth looks like stagnation. So we are right above stagnation. And that has not changed, and frankly, the dashed line on the chart is professional estimates for what it's going to be, and we see no reason to disagree with low growth going forward.

Ron: Incidentally, for most of the last seven or eight years, the estimates coming into each year were for 3 ½ to 4% growth. By the time we got to the actual numbers, it was more like 2 [percent]. So the last seven or eight years has been a continual decline or adjustment downward as the year went along.

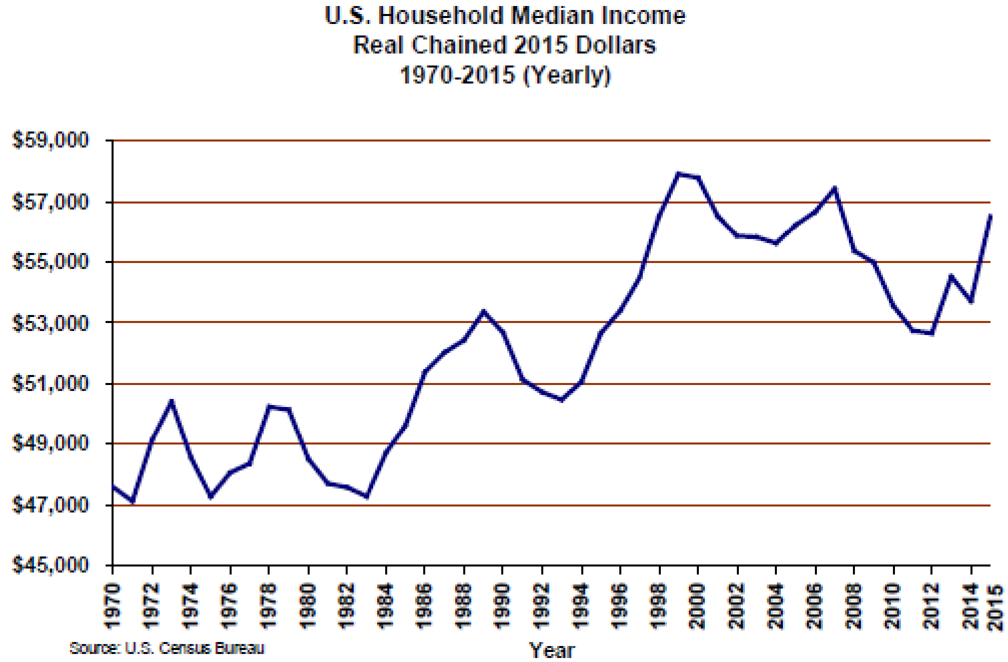


Jeff: We also like to look at particular measures of employment to get an understanding of what's going on in the economy. We prefer to look at it as the percentage of the total population which you see in this chart since 2007. We prefer that to some of the unemployment measures that you may hear about. So what you see here, is back in '07-'08, we had about 63% of the population employed. We dropped 5 percentage points during the recession, and we've gained back over the last eight or nine years only about 2% of the 5% we'd lost. So we think that the fact that we have not gone back to where we were, in terms of percentage employed, that goes a long way towards explaining low-wage inflation and low consumer spending. We're just not as employed as the percentage of the total population as we were pre-recession.

Tony: Ten years ago?

Jeff: Yes, ten years ago…

Consumer



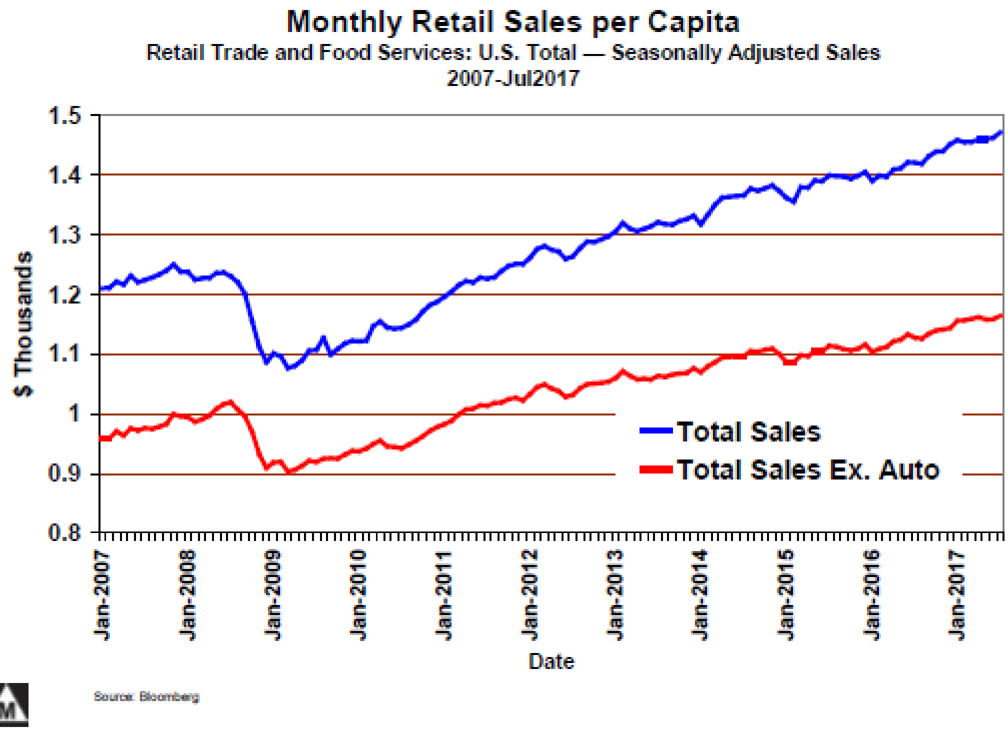
NOTE: In 1996, the U.S. Department of Commerce introduced the chained-dollar measure. The new measure is based on the average weights of goods and services in successive pairs of years. It is "chained" because the second year in each pair, with its weights, becomes the first year of the next pair. The advantage of using the chained-dollar measure is that it is more closely related to any given period covered and is therefore subject to less distortion over time.

Jeff: Sticking with kind of what the consumer's doing and seeing, this is a chart of Inflation Adjusted Median Income in the United States from 1970 through 2015. As you can see, it peaked in 1999 and has troughed twice since then (2003 and again in about 2011). When people say that wages have been stagnant for 20 years, this is what they are talking about. So if you generally rough that period out, there has been no progress in the median wage in the U.S. The last time you saw that was back in the '70s. I'm a little too young to remember the '70s directly, but as I understand it, they were fairly turbulent years.

Ron: I remember them very clearly, as it was called high inflation and high unemployment.

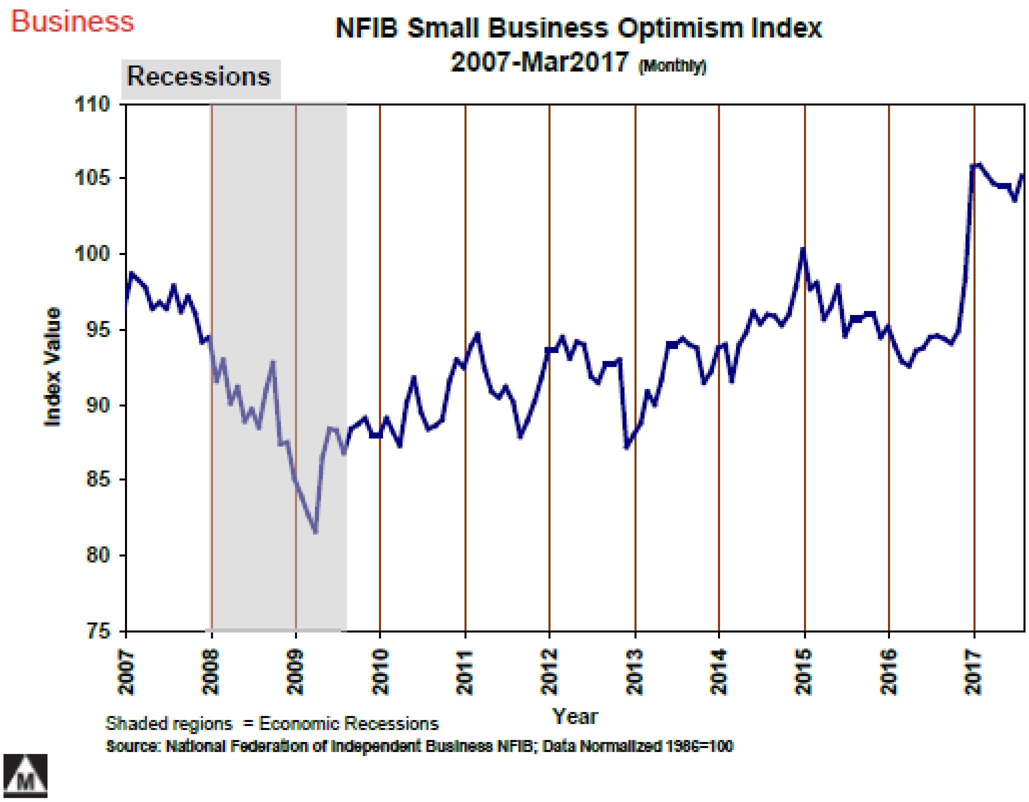
Jeff: But you're back to a situation where, for an extended period of time, median wages have not gone up. And so, frankly, it's no surprise that people are unhappy with that and interested in changing it.

Consumer



Still looking at what the consumer has been up to, here is a chart of Monthly Consumer Sales since 2007. In this case, we've divided total sales by the population to give you a per capita number. We often find that per capita numbers are more useful than gross numbers. The blue line is total sales and the red line simply backs out expenditures on autos because autos are such a big ticket item (sometimes changes in auto purchases will mask other things going on). What you saw in 2008-2009 was a pretty big drop in retail sales. That doesn't always happen in recessions…it did in the 2008-2009 recession. And what, obviously, we're paying attention to now is up here [right-hand side of the chart]. We are asking: "Okay, are things flattening out? Rolling over? What are they doing?" We've shown you this chart now, I think, twice over the last six months, but you're still in a little bit of an uptrend. So nothing too worrisome here...

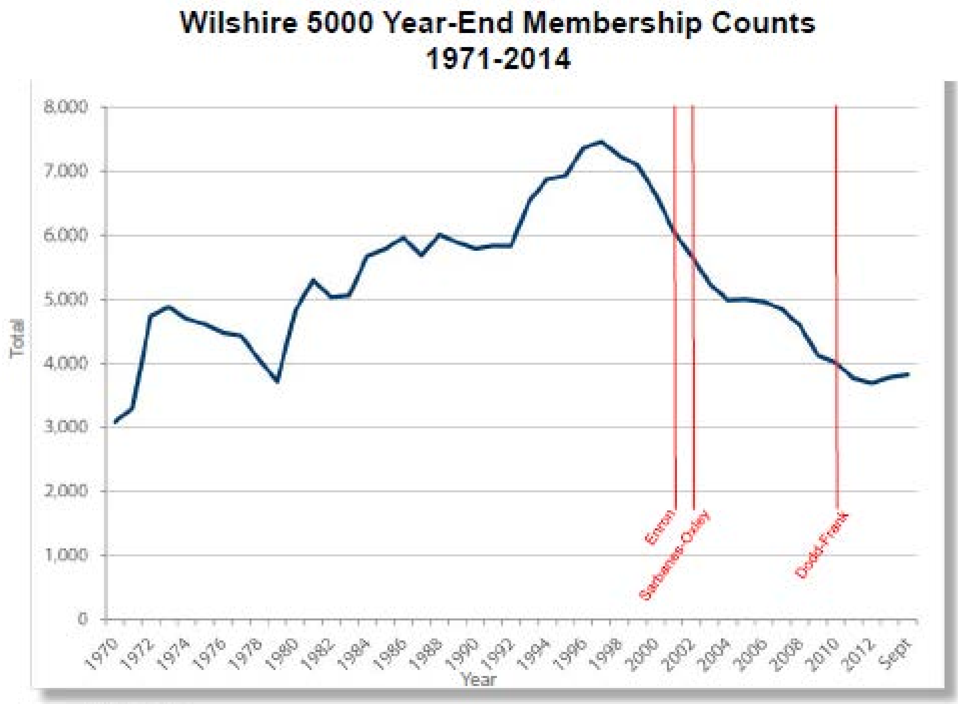
Ron: Note that this chart is nominal, it is not adjusted for inflation which would bring the slope down to some extent.



Jeff: Shifting now to what businesses are thinking and doing…this chart should look a little bit familiar to you. We used it in the first quarter newsletter. It's a graph of small business optimism since 2007. After troughing in the 2008-2009 recession, you saw a gradual increase up through 2016 (more or less) with the big spike right after the elections. So optimism for small businesses went up and has stayed fairly high now for about eight or nine months. Our expectation was that the optimism might drive increased business spending—capital spending on plant. We have not seen that yet. So that was something we've told you we've been watching for about the last six months. And I'm telling you now, we're not seeing it [increased capital spending].

Ron: What we've said for years, is that when people get fearful, they can hold their fears for six to nine months and unless it's reinforced, it starts to dissipate. What we've seen in the last nine [months] was we saw this jump in business optimism and, so far, there's been very little follow-through on either…for instance, the healthcare reform or tax reform. As Jeff said earlier, there has been some follow-through on regulations. Our suspicion is, unless this gets reinforced, either through tax reform or continued on regulations or healthcare, some of this optimism will dissipate. I can't prove that, but that's an observation over the years. We'll see what happens on the optimism side.

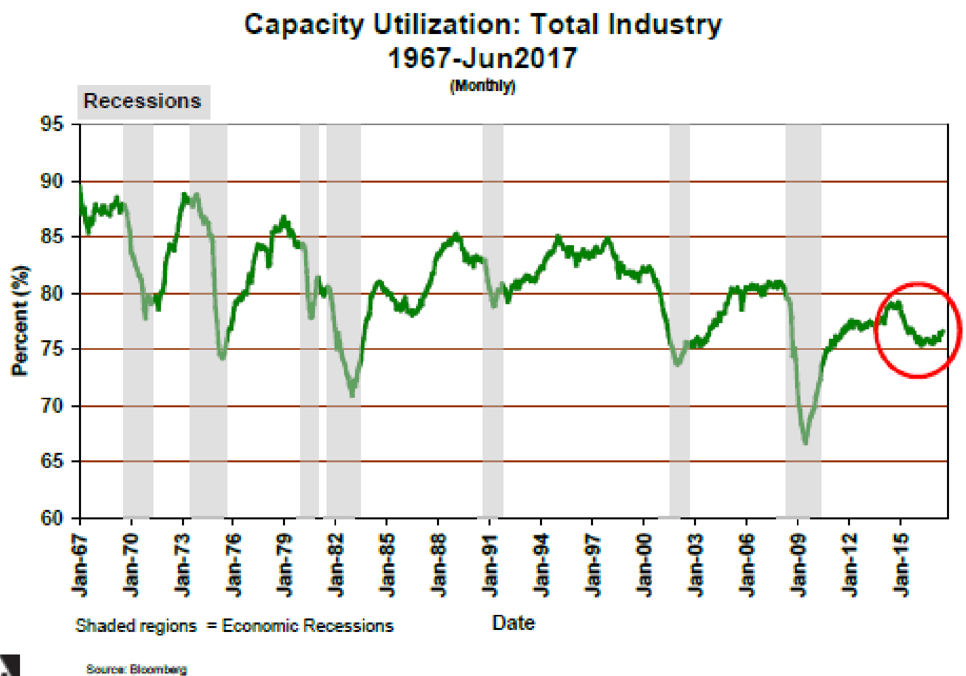
Jeff: Ron, did you want to talk about business formation as well?



Source: Wilshire 5000

Ron: Well, okay. The chart in front of you…those of you that have heard of the Wilshire 5000…this is a plot back in the mid-70s, apparently around 1972-74. The Wilshire Associates compiled a list of all the publicly owned companies (New York Stock Exchange, American Stock Exchange, over the counter) and it was roughly 5,000, as you see on this chart. By the late '90s, that had grown to something like 7,400 where it peaked just before the dotcom thing hit. Today, it's more like 3,700. I think of this as half as many public companies as we had about 20 years ago. Which would mean half as many employers. Just to put benchmarks on here, the first red line you see is…well, there was a peak-up with the dotcom bubble that then came back. And then it got hit by Enron, which lowered people's confidence, a little bit. And we got Sarbanes-Oxley (Sarbanes-Oxley was in response to Enron) and my observation was: it was going to make it much tougher on publicly-owned companies. And then, more recently, we got Dodd-Frank and you heard us say in the last few years, half of the Dodd-Frank rules hadn't been written yet. But I believe the two of those had a fair amount to do with fewer public companies than there used to be. You heard us say that in our mutual fund, the rules coming out of Sarbanes-Oxley upped our expenses for compliance, for directors' fees, and for lawyer fees, to the tune of $300,000 a year on a relatively small mutual fund. But it's made the cost of being a public company and complying with the regulations move up big time, so we have fewer public companies. Many of you know that in the last three or four years, we've had fewer companies started than we've had go out of business, either through mergers or one way or another. But this whole plot, which you haven't heard too much from anybody but us, is that there's half as many public companies as there used to be. Now we've seen it level off a little bit. We would like to see that continue to grow, but it's a hard thing for us to forecast.

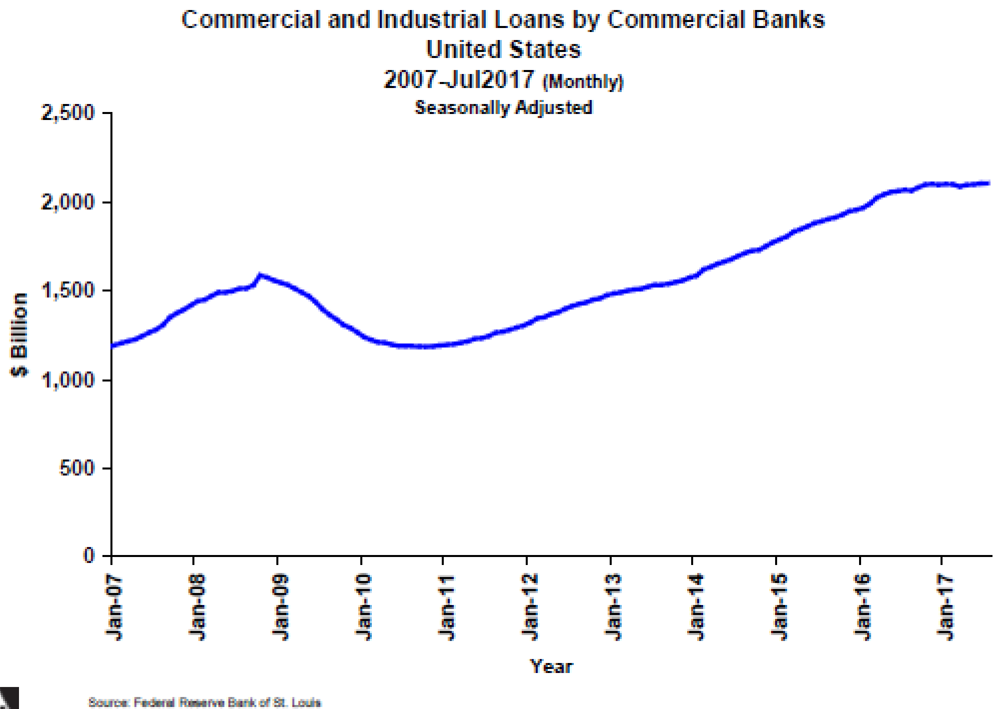
Business



Jeff: In our opinion, a big part of the reason businesses aren't investing is because they don't need to—they aren't using their existing plant at capacity, so they can increase output without adding any more infrastructure or capital spending. This is a graph of Industrial Capacity Utilization in the United States since 1967. Recessions are marked with gray bars. Capacity utilization, post the '08-'09 recession, has stabilized at about 75% or 76%. At no time, post-recession, has it gotten above what's kind of the critical point. Above 80% it starts to pay for companies to expand their plant and add more capacity, below that, it doesn't. They never really got above 79% or so, so they never even hit the trigger to start spending more money. In fact, we saw in 2015 and 2016 a decline in capacity utilization. That was one of the things we were concerned about and were watching pretty closely in terms of what was going on in the economy. That's rebounded a little bit. But until they start fully utilizing what they've already got, we don't expect them to add more. So this kind of demonstrates why they're not spending a lot of money on capital right now. They have throughout the expansion spent money on capital when it saved them money. So if they could spend $100,000 to save themselves $50,000-$75,000 dollars a year, they will go ahead and do that. What they have not done is spent more money so that they could produce more of whatever it is that they produce for the customers.

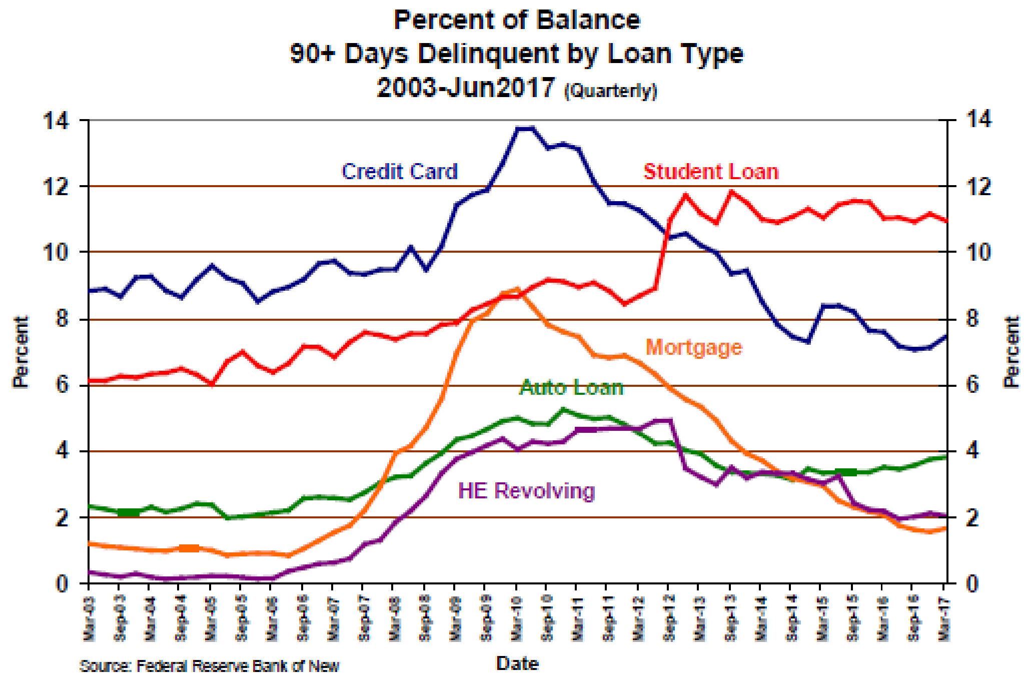
Ron: As most of you know (as we've been saying for several years) this particular expansion from the '08, '09 recession has been half speed and at a 2% growth, most companies can de-bottleneck, they can squeeze an extra 2% per year out of productivity by doing various things. As you know, what's been particularly slow in this expansion is corporate hiring and corporate capital expenditures, and that remains true. We saw the jump in November with the election on expectations. We have not yet seen the follow-through from the corporate side. And of course, we have not yet seen the fulfillment of the promises prior to the election. So that is the nexus of what should either give us a bump up in growth or not over the next 6 to 12 months. We're right at that point…

Credit



Jeff: Moving on to some credit metrics. Many times, economic problems manifest themselves first in credit markets. We like to keep an eye on them for that reason. This is a chart of total commercial and industrial loans since 2007. Typically, when business picks up, companies will take out these sorts of loans from banks to finance inventory. You can see that the total amount of these loans fell off in the recession, expanded during the expansion, and has recently levelled off…so that has our attention. If it continues to grow, that would be coincident with a continually growing economy. If it starts to decline, that'll be a warning sign for us. But right now, it's a little bit ambivalent, so we'll keep an eye on it. Mostly, we're just updating you since we showed this to you six months ago, it really hasn't changed much. So we're not learning too much from it.

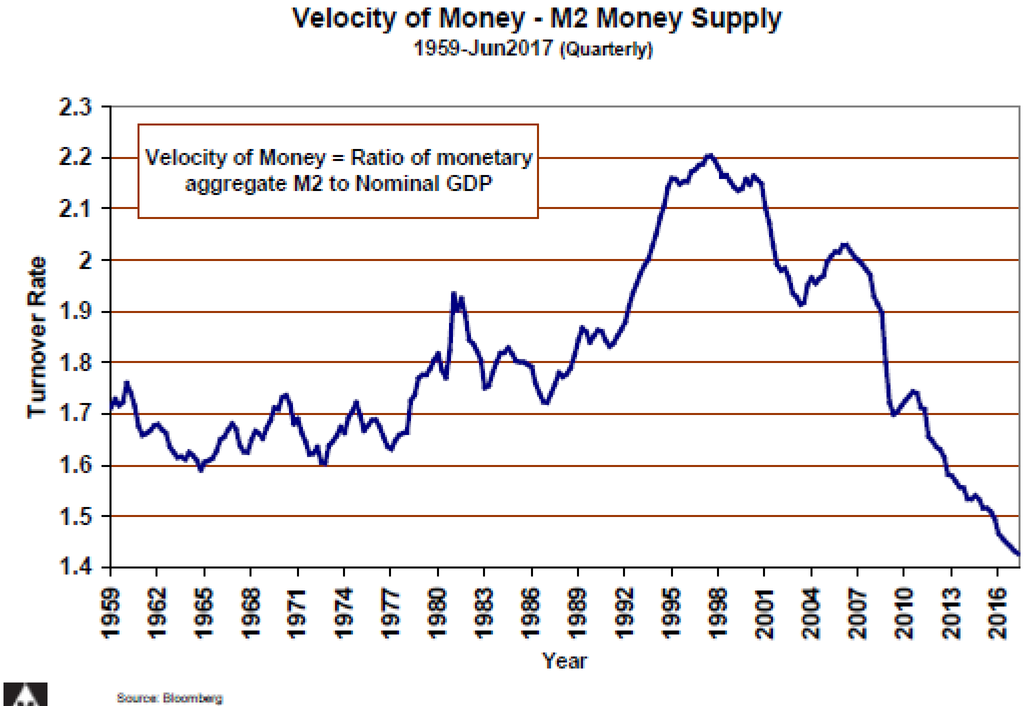
Credit



This next chart is from the Federal Reserve Bank of New York and they update it quarterly. It shows the percentage of loans, by type, that are more than 90 days delinquent. From bottom to top, you can see mortgages in orange, home equity line of credits in purple, auto loans in green, credit cards in blue, and student loans in red. So the beauty here is you can very quickly see where delinquencies are remaining fairly steady. Student loans are pretty steady. Mortgages are steady at a low level and home equity line of credit is steady at a low level. And where are they starting to tick up? A little bit in auto loans, and a little bit recently in credit cards...so those two have our attention. If we start to see them really run, that will be another big red flag that things aren't going so well in the economy.

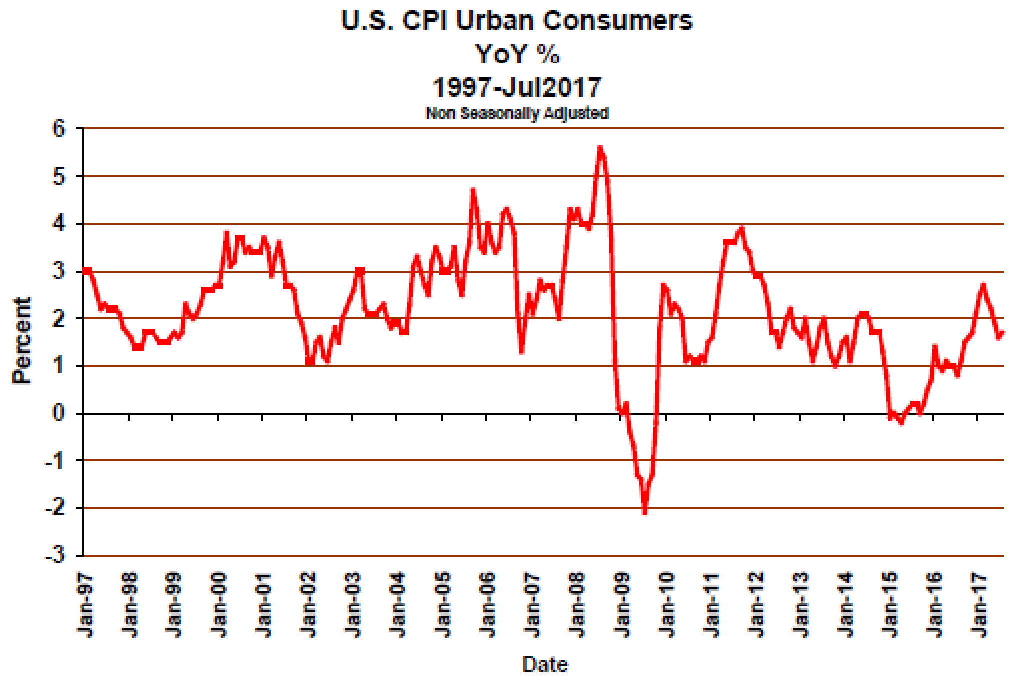
Ron: If you also look at this, you'll see that delinquencies in mortgages and credit cards ran up in the couple years after '08, '09, and have since come down. Well, recently, the run ups have been in student and auto loans. So there are some fears that the standards are not as high, for instance, in auto loans as they were. So we're not the only people watching auto loans. But the climb up in delinquencies is not a leading indicator, it's a lagging indicator—so it won't give us warning ahead of time as to where the problems are but it does tell us where the problems may end up being.

Velocity



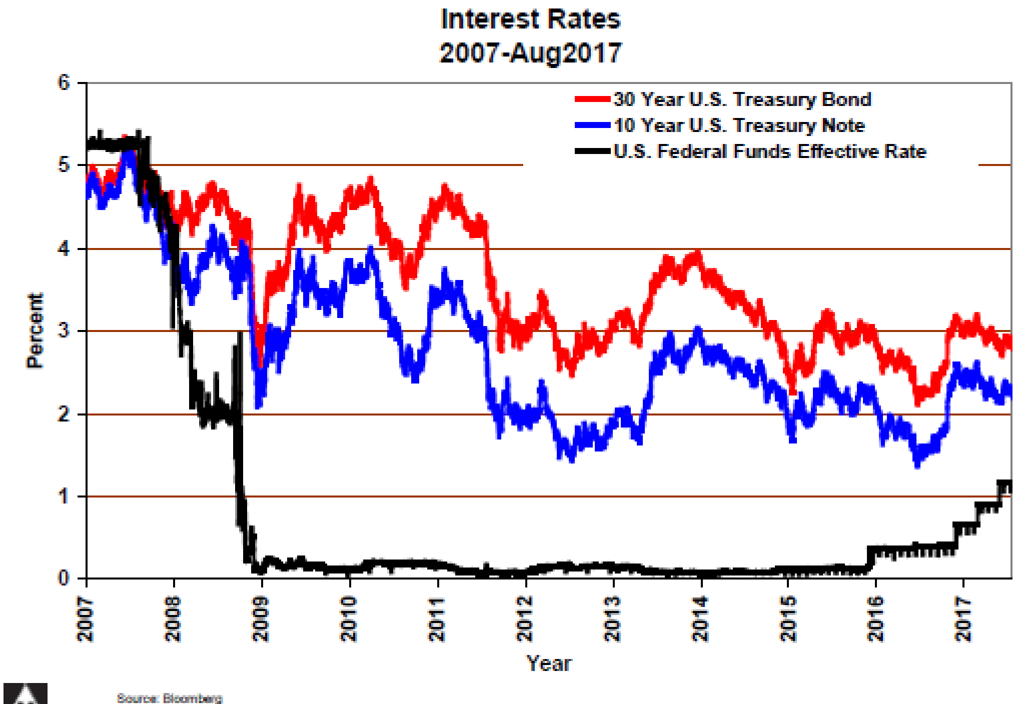
Jeff: We've also been keeping an eye on the velocity of money particularly since 2008. The velocity of money became interesting in 2009, frankly when it collapsed. Conceptually, the velocity represents the turnover of money in the economy but it cannot be measured directly or at least nobody has come up with a way to do it. So maybe it can be done, but nobody has figured it out yet. Instead what folks do is they measure the quantity of money in the economy and the quantity of goods produced and then they calculate it. The reason we are watching it is because it helps us watch for inflation. You are not likely to have inflation while the velocity of money continues to decline as it's been doing frankly since 1999. And so if we see this start to level off or to rise then we would expect inflation to start to rise and it will probably be a coincidence. So this is an indirect measure that we're looking at to help us keep an eye on inflation. And of course, like everybody else, we also watch the direct measure of keeping an eye on inflation.

Inflation



And this is the U.S. Consumer Price Index (CPI) Urban since 1997. And while there are some arguments that the consumer price index is flawed, at least it has the virtue of having some consistency and a long measurement span so we find it useful to watch. And you can see that inflation, measured by the CPI, has been low since the recession and is currently about 2%. So it ran as high as 4 [percent] in 2011, as low as zero [percent] in 2015 but, on average, it's been about 2% or a little less since the recession. Prior to that, it was more in the order of 3% so we're stepping down a little bit.

Ron: One of the keys here is the Fed's goal is 2% so their beginning to act a little differently right now with inflation at 2% than they did two years ago when it was zero.



Jeff: On that note, we'll move and take a look at exactly what the Fed has been doing. This is a chart of three interest rates. So in black, you've got the U.S. Federal Funds rate which is directly set by the Federal Reserve Bank for very short-term loans. And then in blue, you've got the 10-year U.S. Treasury Note and, in red, the 30-year Treasury note. So what you had was the Feds took the short-term rate pretty close to zero in 2009, maintained it at zero through close to the end of 2015, and since then have gone through several increases of quarter of a percentage points each since then so we're now just over 1%.

Ron: Note that that 1% is still below inflation at two [percent].

Tony: Yeah, that was my question. Are short rates or long rates roughly where they both ought to be and how do you know?

Ron: Historically, short rates have roughly equaled inflation. Meaning with no effort and pre-tax you could offset inflation with short interest rates. Today, if inflation is at two and short rates at 1 ¼ you still cannot do that.

Tony: So you've still got a negative real rate of interest on the short term?

Jeff: You're at about zero rate of interest on the 10-year and you're making a little bit less than a percent by going all the way up to a 30-year.

Ron: This, of course, is US. In Europe and Japan, negative rates go out how far, Jeff?

Jeff: Well, the negative nominal rates on the short end, I think, are done in Europe. In Japan they're at about zero nominal. On real rates they're negative out to about seven years, I think, in both Japan and Europe. The rates have run up a little bit in Europe. So six months ago, you had negative nominal rates out to about three years a year ago. You had negative real rates out to about ten years a year ago. Rates have come up a little bit really across the board. So that kind of leads into what we want to say here. Not only did the short rates come up because the Fed moved it, but the market moved longer rates up pretty dramatically in the middle of 2016 and that was global. Since then, they've given up about a third of that move, so it's come back down. So you haven't seen a steady ramp in the rates.

Ron: We received a question on the stock market bubble. We don't think that there's a bubble in the stock market relative to bonds. We do think there's a bubble in the bond market. All of you know that when interest rates move up, bond prices move down. So when interest rates are below what they should be, it would mean that bond prices are above what they should be. We believe that is currently in effect. What you saw in the last year or so as the Fed made it clear, they were going to start raising short rates. Long rates went up which means the prices of long bonds went down. If there's a worldwide bubble, that's where we think it is, in interest rates. And the key becomes our Fed, the European Central Bank, and the Bank of Japan. For the last eight years now, they have kept rates lower than would be economically normal. That had never happened to this extent before. They now face the task of normalizing those rates, which basically is allowing them to come up to normal levels. They've never done that before, so they're facing a total unknown. A few people have a few theories but none of them have great follow-up that anybody really trusts. So the question that we get faced with as the Fed tries to raise rates or to bring it or lower their bond holdings, which is kind of what the next chart is all about. Well, how much stomach will they have when the initial response of the markets is negative? You've heard me say in the past that the market's initial response to a change is always negative. So when these rates tick up a little bit, or they say they're going to sell some of their bonds or let them work off, the initial response to that will be negative and the question becomes how tolerant will the central banks be as these negative market prices come in? Or will they do what they've done basically in the last eight or nine years which was when in doubt, print more money and run the rates back down? That becomes the great question going forward, and we are on the cusp of that. Our Federal Reserve has said so. The European Central Bank is starting to say so.

Jeff: So, I'd say we've got two questions…the first question is, what will the markets do when the central banks start reducing the size of their balance sheets when Japan and Europe cease buying assets? So the first question is, how much do the markets react? And the second question is if the markets react negatively, do the central banks leave it alone and ride it out, or do they revert to type, if you will, as was Ron's thinking or concern, and start printing money again and say, "Never mind, we saw that we created a little problem, so we'll just start printing money and buying assets again?" And those are both big questions that are almost impossible to predict.

Ron: Just as a marker, the central banks believe they've been successful and when they're asked why, they say, "Well, gee, the markets are up." Well, the goal was to get the economies to grow. You've seen what's happened with our economy. Europe has been slower than us. Japan has been slower than us. But the goal of the Feds was to get the economy to grow. That's different than keeping the markets up…so all these things are not yet settled and it's going to be an interesting experiment going forward...

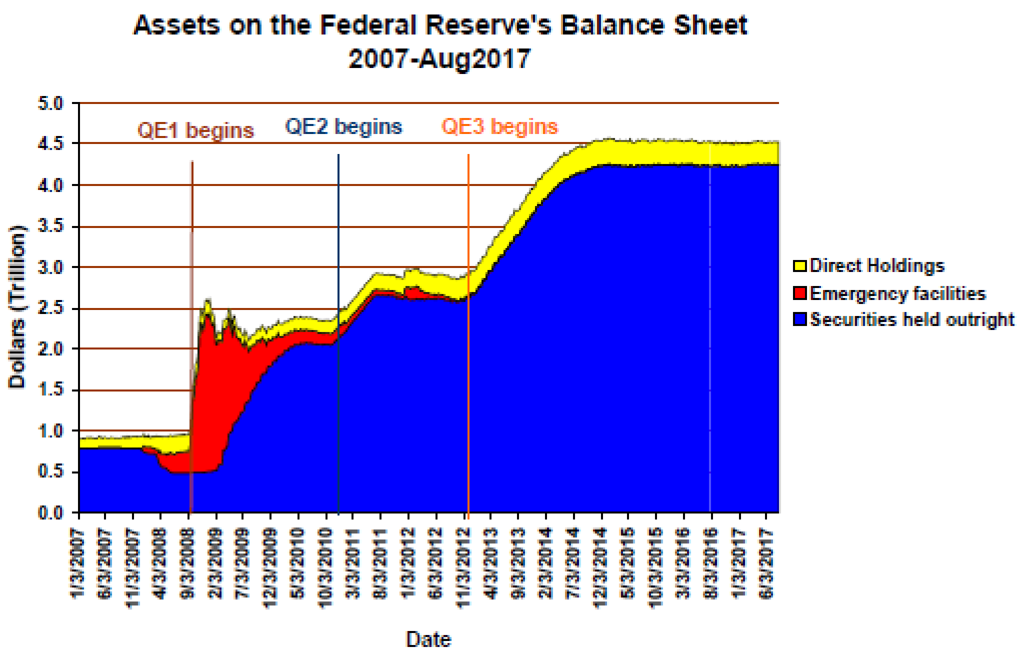
Tony: When you talk in terms of an experiment, does that mean you're trying very hard not to predict what comes out of all this?

Jeff: Well, what you try to do when you predict, or at least the good forecasters, what they try to do when they're trying to forecast something, is they try to establish a base rate. So if they say, "This sort of thing has occurred 10 times before, and 7 out of the 10 times, it turned out this way," then it gives you kind of a starting point for assessing the probabilities of a given outcome. Well, if you've never done it before, there's no way to establish a base rate. So what you're left with is simply working through the logic. And unfortunately, markets don't always run on logic and that's what, of course, all the academicians and the central bankers are doing, is they're working through the logic of what *should* happen. But it's rather difficult to say that what *should* happen is what *will* happen because markets don't (and people don't) always work that way.

Ron: So no, we're not trying to predict, because as soon as you do, you start justifying your prediction. And what you do is you set a marker out there that says, "Is the data coming in on the plus side or on the minus side?" And in the last seven or eight years, the real data for the economy has kept coming in on the minus side. Generally speaking, the price data for stocks and bonds has been coming in on the plus side. You've opened this gap.

Tony: Thank you.

Fed



Source: Board of Governors of The Federal Reserve System

Jeff: Okay. Shifting now from interest rates to balance sheet. So this is a picture of the Feds' balance sheet. You can see that they had about a trillion dollars in assets all the way back in 2008 of various flavors. And I'm not going to get into what kinds of assets they've held over that duration. But they expanded that to four-and-a-half trillion dollars by 2014 and it's remained steady since then. So what they're going to try to do is to gradually reduce their holdings. They've said it twice now, and we expect that they will, in fact, try to do that. And they will probably do it by simply not reinvesting the interest and principal when the bonds that they currently hold (either the mortgage-backed securities or the U.S. treasuries) mature. And so they will start to very gradually draw that down. And their hope is that by telling us that they're going to do it very gradually, and repeating that they're going to do it very gradually, and then actually doing it very gradually, that they will get very little reaction in the markets and in the economy. But as a practical matter, the reason that they blew out their balance sheet like this is to try to introduce more money into the economy. So they printed money, they bought these assets, with the hope that the person that got the money instead of the asset would go spend it someplace. And we won't talk about whether we think that worked or not. But if you do that in reverse, now you are pulling money in from the economy. And again, they want to do that very slowly. So, our concern is that they miscalculate. We've, frankly, been thinking about this ever since they started doing it. How in the world are they going to shrink their balance sheet, and what would that mean for the economy? And we're still thinking about it and we still don't have any historical examples where anybody's done it and gotten the outcome that they expected…I mean, nobody's ever done it. So, back to the previous discussion—no one quite knows how this is going to work out. But this is what they're trying to do. Even if they're successful, it's going to take a long time to get that down in any meaningful fashion.

Taxes and Regulation

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 (TPP)
  - Relations with Germany and China

Progress so far

- Died in Senate
- House committee approved roll back of much of Dodd-Frank. House has killed some other regulations.
- No real movement on tax cuts
- TPP dead, administration appears to be backtracking on NAFTA re-write and big changes in trade relations with China and Germany.

So far change has been limited to reduced regulations. Movement on Legislation slow. Potential for big changes in trade relationships less than it appeared 3 months ago.

And then, finally, taxes and regulation. We've used this slide for about six months to keep track of the differences between the campaign promises and the actual changes. What we've seen so far is that there has been some progress made in reducing regulations, both by Trump-appointees and by Republican legislators. For the most part, we believe those changes are positive. The repeal/replace Obamacare effort died in the Senate—I think you all probably know that—so there's one big promise, in my opinion, mostly from the Republican Party, not necessarily Mr. Trump, that has not been kept. Tax changes are still in the discussion stage, as they have been for a long time. Representative Ryan had put out a border-adjustment tax idea; that died about three months ago, so it's not quite clear what they are advocating now for changes in taxes. We haven't seen any solid proposal yet for anybody to talk about too much. So, in my opinion, that's probably still in the first inning if it's a nine-inning game...not too much progress on that.

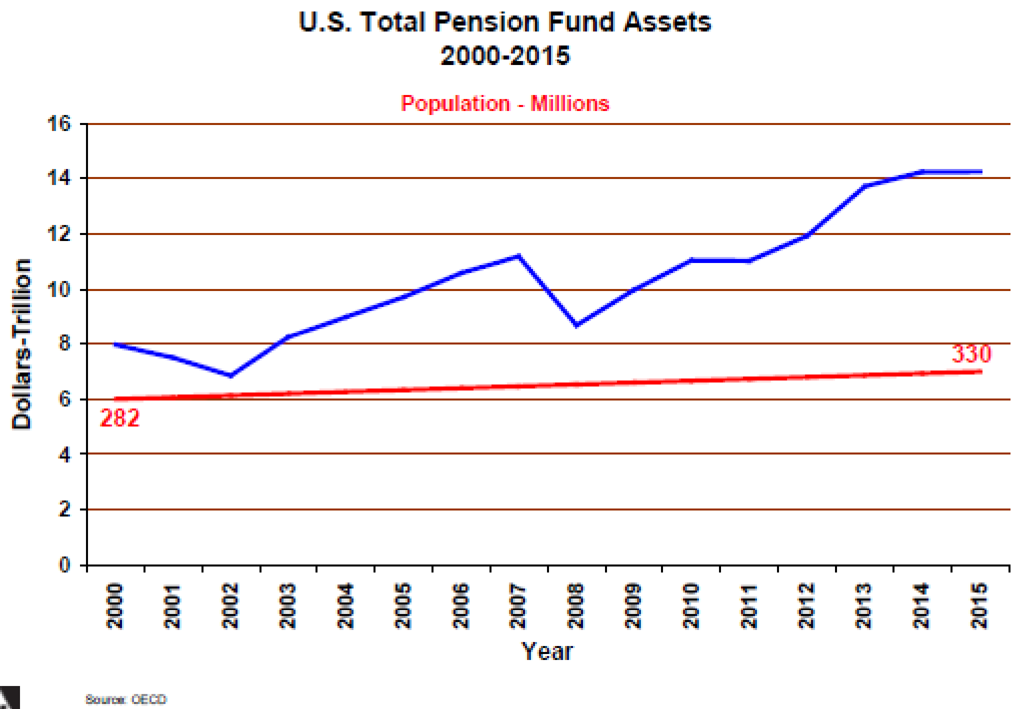
Ron: We did receive a question on what we expected out of tax reform and what we thought the results would be. We're looking for three things, really: a lowering of corporate taxes, a way of repatriating…as we all know there's trillions of dollars parked overseas because when American companies earn money overseas, they pay overseas taxes to that country, but when they bring the money back, they pay whatever the difference is and right now, our tax rates are higher than others. And we're looking for simplification. And the reason we're looking for that…right now, the U.S. in an international competition, faces higher tax rates to U.S. companies. And they have also the difference when they repatriate. So, we think that would help U.S. companies put more money into making goods, buying capital equipment to make goods, and helping all of that along. We would like to see it simplified across the board, but those are the main things that we're looking for. And, so far, it's been a promise that hasn't occurred.

Jeff: The other thing that was of concern in the January/February timeframe was that *if* President Trump acted on some of the things he had campaigned on, it would create a trade war between us and China, between us and Germany, between us and Mexico and Canada. And so what you've seen with that, we have, in fact, withdrawn from the transpacific partnership, although that's probably the wrong word since we helped create it, but we never officially signed up, or it was never approved by the Senate, and we never signed it. But we officially said, "We are not going to sign it," and so the transpacific partnership is dead. They are currently in talks with both Mexico and Canada to relook NAFTA. Most of the harsh rhetoric has come off, so it looks to us like that's going to be relatively minor changes. And, certainly, in the U.S.'s discussions with Germany and China, other political priorities have arisen—North Korea, for instance, they kind of take precedence over what we wanted to do with trade. So it now looks like trade is a bargaining chip in a larger game and most of the harsh rhetoric there has come off. So a lot of the concerns that there was going to be a trade war between us and China or us and Germany, have really come off. And that's probably a good thing.

So, that's kind of what we're seeing. Consumer and business sentiment is up. The consumer and business spending is not. There is some degradation in credit metrics. Inflation remains low. The fed continues to raise rates, and it continues to talk about reducing their balance sheet, which gives us some concern. The new administration is doing some positive things for the economy, we believe, but it's mostly at the margins and so far it's slow going. Big trade disruptions are more remote than they were six months ago and the economy continues to grow slowly—kind of a mixed bag of positive and negative from an economic, financial, and policy environment. We have no solid reasons to call for either stronger growth or a recession at this point but obviously, we continue to keep an eyeball on that. Our near-term view is more of the same as it's been for a few months and we recognize that our view forward is pretty limited. So three months from now our thinking could well change as you really can't see too far down the road. So that's where we're at today.

Ron: Just in recent weeks, we have seen a little bit of a rollover…the market in the last eight or nine years it's gone up nicely. Jeff, do we have that plot on pension fund assets?

Jeff: Yes, we do.



Ron: And we talked about central banks buying securities, this is a plot of U.S. Total Pension Fund Assets since the year 2000 and we've put alongside that a population. The population has grown by 10 or 15%, but the pension fund assets have grown much faster and note we started this plot in the year 2000 which was kind of a high in the marketplace (about half of pension fund assets are in common stocks) so when the market comes down as it did in 2000 and 2002 then goes down again in '08. But the dollars per capita…even if companies lose money they fund their pension plan. Even if the market goes down, they fund their pension plan. The amount of dollars in the market per capita per family is now in the order of $140,000 (up from about $80,000 back in 2000). So with central banks buying stocks and bonds and pension funds buying stocks and bonds, we think that's had a sizable effect on what's happening in the marketplace.

Jeff: Let me illustrate that just a minute folks. Think about what has happened…the U.S. central bank, the Japanese central bank, and the European central bank all started creating money to buy assets. Now, in America that was mortgage-backed securities in homes. In Europe that was government bonds and that was corporate bonds. And in Japan that's government bonds, and equity—so they were buying and are buying ETFs, they're buying a slice of their stock market. So there is kind of a natural buyer particularly of long-term debt and those tend to be pensions and insurance companies that have very long-term liabilities. They like to buy long-term assets. So as the price of those assets gets bid up because now there are three very large players that just entered the market, the forward returns on those assets go down. So the pension funds and the insurance companies can no longer meet their projections on returns so they have to go looking somewhere else, somewhere they didn't normally go. And typically, that's been equity markets, not completely and the reason we say that, you see anecdotes that kind of demonstrate this thinking, you can't put numbers around this, but it's the anecdotes that demonstrated it. We know, for instance, that the big Japanese pension funds for their postal workers and others changed their allocation to equities and foreign bonds and equities the same day that their central bank announced bigger buying plans. We know for instance that CALPERS (which is one of the large pension plans and the United States) has changed its allocation and has gone to alternate assets and some other things. So you've had this big push of this wave of money created by the central banks and they shoved all these guys into markets that they didn't normally operate in (or normally operate to the extent they are now) and it's driven up prices across the board. And our concern is, when that player stops playing and the central bank stop playing then what? Does the money shift back or does it stay where it's at? And that kind of has our attention…

Muhlenkamp & Company
40th Anniversary

We are pleased, proud, and grateful that we have been able to serve our clients and the community for the last forty years.

Ron will speak about:
- Lessons learned;
- Changes over the years; and
- M&C going forward.

Ron: Okay, I guess we're at part two and whether I've learned anything in the 48 years that I've been playing this game. First of all, I would mention that some of the things we've learned, we published in a book a little over 10 years ago. If you're listening to this broadcast and you don't have a copy, we still have a couple dozen copies of our book floating around here. They don't do any good in a box so if you contact us we'd be happy to send you a copy. I asked Michelle what she wanted me to talk about and she says, "Well, we would be interested in any lessons you learned, any changes you've seen, what you'd have done differently." Incidentally doing differently is not an option, life is not a dress rehearsal…you only get one shot at it.

Tony: Which comes as a great disappointment to me, let me just say.

Ron: Nevertheless, it is what it is...I might say a little bit more about that.

The greatest experience: that simply boils down to the people. So we'll talk about that in a little bit. The big thing that this shouldn't be new, but the free economies work, managed economies don't. The obvious examples are to compare East Germany to a West Germany during the time before they came together. Today, look at a North Korea versus South Korea, both were in shambles in 1950. Today, look at a Cuba which is stuck in 1950. Or in the last ten years, look at Venezuela. But the headline is "free economies work, managed economies don't". My observation is that if people are lacking food, clothing, and shelter, they will do almost anything to acquire food, clothing, and shelter. Once that food, clothing, and shelter are covered, economics is all about the incentives. And since you can't spend your way to prosperity, you can only produce your way to prosperity…folks, that's true on a personal level, that's true on the local level, that's true on a national level. Nevertheless we have economists who encourage us to spend money. Well, you can't spend your way to prosperity, you can only produce it. So the question becomes, how do you get people to produce more? And the answer has been proven time and time again, you allow them to benefit from their own efforts, in other words, you pay them. The beauty of a free market is in a free market the incentives are built in. In a free market you only get paid if you serve your fellow man in a way that he's willing to pay you. If you don't, it doesn't matter what I think my services are worth, it only matters what they're [my services or product] worth to someone else. So regardless of what I think I'm doing in terms of improving mankind, it has no value unless someone is willing to pay me to do it because I can't force anyone to buy my product. As an employer, I can't force anyone to work for me. A free market…a free economy relies on the incentive involved in producing things for your fellow man. Our headline on that is "in a free economy the consumer is king."

My observation is people have three working speeds: one speed is when you can't be fired and can't earn a bonus—typically, that's working for government. They can't fire you but you can't earn a bonus either. Second speed, which is a little faster, is when you can be fired but you can also earn a bonus or a premium—typically, that's working for private enterprise. The third speed is when people work for themselves, and frankly, the best-run private companies are those who find a way of compensating their employees in ways that the employee acts as if they're working for themselves. People have always thought of themselves as workers (with a little help from Karl Marx), and every once in a while, they get reminded that they're consumers. Well, in our economy, about a third of our people are workers, but 100% of our people are consumers. If you want to see the difference, look at how when your adolescents approach adulthood and they start spending money that they have earned. Do they act differently on the earning side? Do they act differently on the spending side? Look at how a homeowner spends their weekend versus a renter. People believe that their homeownership makes them money. I did a lot of numbers a few years ago and I concluded the only reason homeownership makes you money, is you spend your weekends doing things that people couldn't pay you to do if you were a renter, and over time, that adds up...

I know some people who don't believe that people should be allowed to own animals. If any of you have a pet, I challenge you to do an out-of-body experience: watch the interaction between you and your pet for a few days, and you tell me whether you own the dog or the dog owns you. Now in dogs there might be some give back…it's certainly not true on cats. I don't know anyone who owns a cat. I know a lot of cats who own their owners. And if you want a really good example, go visit a dairy farmer for a week. A dairy farmer does not own the cows, the cows own him.

In a larger measure, nobody really owns real estate. I grew up as a farm kid...you either lived by Mother Nature's rules or you don't prosper as a farmer. And incidentally when I got into engineering, I found out that you either live by Mother Nature's rules or your engineering doesn't work. By the way, when I got to business school, we were taught that if you can convince the hundred people in the room of something, they can make it happen. That might work in marketing…that might work in politics…it does not work in production…it does not work in farming…it does not work in engineering. Mother Nature's rules will overwhelm whatever good logic you think you brought to the game.

Then people...my observation is people have a nearly unlimited capacity to believe what they want to believe, particularly if they are "protected" (to use a Peggy Noonan term). Protected means that if they're wrong, they don't starve, they don't lose food, clothing, or shelter. I know folks who've been wrong for 40 years, but they're still making a good living because our country is so prosperous that you can be (particularly if you're an economist) wrong for 40 years. You can probably be wrong for 40 years as a weather person. We all laugh at them, but their [weather person] record is better than economists.

Second observation of people: when I watch uneducated people who make a mistake, they say, "Gee, I made a mistake." They change what they do and they go on with life. When I see educated people make a mistake, what I hear is, "Well, I would've been right if only." That's ongoing...

Third observation: people assume that others act as they themselves do. As a result, those who are willing to be liars or thieves are the first to call other people liars and thieves. I have a client, since passed away, who was so honest, he could not conceive of telling someone a lie. And his difficulty was, as a result, he couldn't conceive of anyone telling *him* a lie. Beautiful human being, but the stock market gave him fits because a lot of sales people…he asked me one day…he'd gotten a sales pitch, he says, "Is that true?" I said, "No, that's a sales pitch." And he said, "Oh, it didn't quite make sense, but I didn't think he would lie to me." And frankly, I don't think the salesman was lying because the salesman believed it. But as we come back to the top, people have a tremendous capacity for believing what they want to believe.

Just because everybody knows something, doesn't make it true. In fact, in investing, if everybody knows something, that alone makes it false.

When we get to *changes*…these two are going to come together in a little bit…the biggest change that I've seen in the last 50 years is that communications have gotten faster. And when people asked me this 10 years ago, I said, "As a result, we have more short-term cycles within the same long-term cycles". And that the long-term business cycle used to be four to five years, but we've had three experiences in my lifetime: in the '60s and the '80s and the last 10 years when the business cycle got extended. But we continue to get more and more short-term cycles.

Now, we get instant communications. The trouble is there are no filters. I'm finding I have to wait two or three days to get the instant communications from both sides of an argument so I can sit down and say, "Who makes sense and who doesn't?" Because there are no filters, you and I and anyone else can put an opinion out there, frankly, with no consequences. And in order to do some of this, we're getting these huge labels of black versus white, he versus she, payee versus payer. I've had to in many cases…I prefer the written word (makes it easier)…but in a paper that talks about "he" versus "she", I change the pronouns. Every place that says "he", I write "she" and every place that says "she", I write "he." And then I read it again and see if it sounds sexist from either reading. If it's truly neutral, it will not. But if someone claims it's sexist from one side, well then, it should be equally sexist from the other side. When I read black and white…folks, if black lives matter, then white lives matter should have an equally neutral context. But I've had to do this because those have become loaded terms. The words have much more meaning than is in the dictionary.

I said a little earlier that people had three working speeds. My observation is they have four spending modes. One mode is when people spend their own money on themselves. The second mode is when they spend their own money (money they've earned) on someone else—which is typically gifts or charity. Most of us will spend more money on a gift for our friend. We'll buy them a higher-class product than we'd buy for ourselves, which I think is kind of fascinating. A third mode is when we spend other people's money on ourselves, and I would encourage you to check the Senate office buildings to see what happens in that regard. And then, the fourth mode is when we spend other people's money on other people—which is what politics is all about.

Frankly, I think the major problem with politics is they're all on O-P-M. They're dealing with Other People's Money. I believe my observation is a major divide, it's reflected in politics because across a whole lot of parameters in this country it's between a rural mentality and an urban mentality. The rural mentality is if you got a problem fix it. The urban mentality is if you have a problem, you call somebody. I would encourage you to think about your local fire company. If it's a volunteer company, you're reflecting what I call the rural mentality. If it's a paid company, you're reflecting what I would call the urban mentality. And yes, before you jump all over me, these are not hard and fast, but I find them useful ways of thinking about things. And use them, if you don't find them useful discard them. If you do find them useful, then I've done you some good.

My grandchildren are now age 9 through 20. I've started asking them what money is for. They all think money is to buy things and I agree with that, up to a point. But once food, clothing, and shelter, and a few other things are covered, I believe that money is to build things—which looks a little bit different. I would encourage you to think about whether money…how much the purpose is to buy things and at what point the purpose becomes to build things.

Jeff pointed out to me one day that today's problems come from yesterday's solutions. When I was at school, I thought that the task of the engineers was to make life better for people, the task of the psychologist was to make people more happy with their lives. We had a 50-year reunion at MIT last year and when I went back they said, "Okay, how well have the engineers done?" and frankly I think the engineers have done pretty well. They say, "Well, how well have the psychologists done?" I can't find much evidence, that although we're living much better, that we're much happier with it.

The other thing I learned was, our educated have become more arrogant. I always knew that Harvard was arrogant. MIT's gotten just as bad...a great disappointment to me. Folks, that's some of what I've learned. There's a few other things in the book. You're welcome to a copy of it. I hope you find some of that useful. If nothing else, I expect to have some good conversations coming out of this. In the meantime, it's been a pleasure.

Oh, and where Muhlenkamp is going from here…as you'd figured out by now, our analysts remain in place, our client service and compliance remain place. We are doing less marketing than we did before. Tony's taking a good bit of the burden off me and Jeff is taking a good bit of the other half. So, I'm left to do the things I enjoy doing most, and part of that is talking to you. Thank you kindly.

Tony: Thank you, Ron. Ladies and gentlemen, we are at the end of our allotted hour. We didn't have too many questions come across the line. But if you did send in a question, we'll get back to you on it. Or if what we've had to say so far has raised questions, please give us a call. You can reach me at (724)934-5139, or you can send me an email at Tony@muhlenkamp.com. We truly appreciate you joining us. We look forward to talking with you if and when you choose. Thank you again and have a good evening.

GLOSSARY

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 Price Index (CPI) measures the prices of consumer goods and services purchased by households. CPI is used as a measure of price inflation.

Exchange-Traded Fund (ETF) is an investment fund that tracks a commodity, a basket of securities, or an index (e.g. S&P 500, MSCI EAFE), but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold.

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

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.***

Wilshire 5000 The Wilshire 5000 Total Market Index, or more simply the Wilshire 5000, is a market-capitalization-weighted index of the market value of all stocks actively traded in the United States. The index is intended to measure the performance of most publicly traded companies headquartered in the United States, with readily available price data, (Bulletin Board/penny stocks and stocks of extremely small companies are excluded). It can be tracked by following the ticker W5000.

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