MuhlenkampMemorandum

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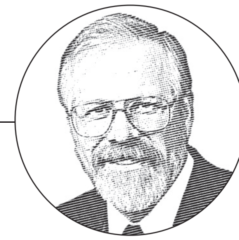
Quarterly Letter



Dear Clients,

In the fourth quarter, the S&P 500 Index was up a bit over 7% and up 1.38% for the year. Our accounts, on average, were up 3.52% in the quarter and down 5.03% for the year. (Individual performance varies by account.) The gains for the broader Index in the quarter were mostly made by a small number of large capitalization tech stocks, Facebook, Amazon, Netflix, Google, and Microsoft among them. Since only one of those companies is found in our portfolios we did not participate in the "bounce" nearly to the extent that the S&P 500 Index did. While we are not pleased with our relative underperformance in the last 90 days, we feel no urge to chase those stocks that are running and, frankly, the limited number of stocks that has participated in the upward move gives us pause.

Last quarter we highlighted that aggregate second quarter earnings and revenues for U.S. companies were actually down year over year (y/y). That sad state of affairs continued when third quarter earnings were reported with revenues down 4% y/y in the aggregate and earnings down 3% y/y. Continued low energy and commodity prices, coupled with a strong dollar, hit the energy, materials, and industrial sectors particularly hard with a number of bankruptcies in the coal industry and among the small oil and gas producers.

Several years ago we warned about the risks of searching for yield in a low interest rate world. Two of those risks manifested themselves in the fourth quarter. First, two high-yield bond funds closed their doors and stopped allowing redemptions so they could realize the best value of their remaining illiquid assets. Second, Master Limited Partnerships (MLPs) have begun cutting dividends. MLPs became popular yield investments over the last few years attracting lots of money. Many of the MLPs relied on cheap equity capital to fund their growth plans even as they paid out most of their free cash flow; that game is over, as their share prices have fallen dramatically. Kinder Morgan (the largest pipeline operator in the U.S. and an MLP up until early 2015) finally recognized that model no longer worked and cut their dividend 75% in December.

The Federal Reserve finally raised the Federal Funds Rate one-quarter of 1% in December after declining to do so in June and September. As we've said many times before, artificially low rates are bad for the economy in the long run. The small increase in U.S. interest rates will likely help reinforce the strong dollar as both the European and Japanese central banks continue to keep their rates at zero (or negative) and execute their own quantitative easing (QE) programs.

In summary, here are the main things we are seeing:

- The ability of U.S. companies to grow earnings without growing revenues is waning.
- The strong dollar makes it incrementally more difficult to grow revenues. We see no reason for a weakening of the dollar in the near term.
- Low energy and other commodity prices are wreaking havoc in the U.S. energy sector and related industrial companies. This is having follow-on effects in the bond market, which are concerning. (The spread between junk bonds and government debt is widening. This implies that investors are increasingly worried about getting their money back from all but the most solid companies and are charging a higher interest rate to lend to lower quality companies than they had been.)
- Low energy prices benefit the consumer, but the windfall is not being spent on consumer goods; in fact, a number of retail companies reported very disappointing third quarter earnings and have been hit hard in the market as a result.

We continue to believe that stocks are fairly priced, on average. As previously discussed, we have sold those companies which had met our estimate of fair value, but have been patient putting the cash back to work. We are not yet finding the values we seek. We'll let you know when we do.

With our best wishes for success,

Ron Muhlenkamp and Jeff Muhlenkamp

The comments made by Ron and Jeff Muhlenkamp in this commentary are opinions and are not intended to be investment advice or a forecast of future events.

The S&P 500 Index is a widely recognized index of common stock prices. The S&P 500 Index is weighted by market value and its performance is thought to be representative of the stock market as a whole. One cannot invest directly in an index.

Free Cash Flow represents the cash a company is able to generate after paying out the money required to maintain or expand its business.

Muhlenkamp & Company, Inc.
Intelligent Investment Management

Investment Seminar: Recap

On December 3, 2015, portfolio managers Ron and Jeff Muhlenkamp provided an update on the checklist they use to monitor the investment climate. Over the past several years, the stock market, in general, has been acting as though we've had a normal recovery from a normal recession. The items on their checklist indicate otherwise: there is a gap between how the stock market is performing and how the economy is performing.

Highlights follow; a video archive of the entire seminar is available on our website. Please let us know what you think.

Consumer Spending

During a recession, people generally work harder, spend less, and save a bit more. Once the fear of losing a job dissipates, there's typically a "snapback" in consumer spending. For example, after the deep recession of 1982-83, there were years of 5-6% growth in retail sales. More recently, after the 2000-01 recession and through 2007, growth in same-store sales averaged 3-4%.

We did not experience a snapback in retail sales after the 2008-09 recession. Each of the past five years, despite forecasts of 3.5-4% growth, retail sales have actually grown at 2-2.5%. This past year, growth in same-store sales was 2%. We believe this is a reflection of a "half-speed" economic recovery: U.S. Gross Domestic Product (GDP), when adjusted for inflation and computed on a per person basis, is growing at 1%. So, while economists report that we're ahead in the aggregate, it may feel like we're still in recession on a per person basis—a sentiment exhibited by lackluster consumer confidence, which, six years after the recession, is only now returning to normal.

From 1950-2007, the U.S. economy grew at ~2% after inflation on a per person basis. Real GDP growth at 2% per capita since 1950 results in us being three times as prosperous as our grandparents! Think of how much better you live than your grandparents did at your age. **This trend is now at risk.**

In October 2010, Ron asserted that the U.S. had chosen the path of Japan. It's now playing out. Japan's economy has been flat over 20 years. The U.S. economy on a real, per capita basis, has now been flat for seven years.

Business Investment

With every recession, there's a decrease in capacity utilization by businesses. During the 2008-09 recession, it dropped from 81% to 67%. This metric has yet to return to 80%, the historic benchmark for building new plants and/or hiring new people. (Capacity utilization is currently around 78%.) New orders for durable goods have yet to exceed 2006-07 levels. Despite very low interest rates, businesses have not borrowed to expand their physical plant. Companies, on average, have enough capacity! It also helps explain why full-time employment is only now getting back to pre-recession levels. But here's the snag: The U.S. population, grows by 1% per year, so when you examine full-time employment as a ratio, the percent of employed adults has gone from 63% (pre-recession) to 58% (today). That's 5% fewer full-time employees, per capita, than we had six or seven years ago!

We learned in the 1980-90s, there's no limit to what people are willing to spend. The question remains: Is there a limit to what they are willing to produce? If it doesn't pay for people to work, the economy won't grow. If it doesn't pay for employers to build and hire, the economy won't grow.

Credit Default/Bank Health

The credit crisis in the U.S. ended in 2009-10. Bank balance sheets are now healthy.

Velocity of Money

The velocity (turnover) of money continues to be minimal. Consumers aren't borrowing to buy houses. (They have borrowed for college tuition, which may be the next problem.) Companies aren't borrowing to build plant; (see above).

Federal Reserve (Fed) and U.S. Treasury

The Fed has begun to allow short-term interest rates to move up. We don't think an increase in short-term interest rates will have much effect on long-term interest rates; consequently, we own no bonds.

Taxes and Regulation

The debate regarding taxes is ongoing. One party argues government spending is critical and we have to increase taxes to increase spending. The other party claims, at some point, taxes and/or deficits kill the economy and we have to cut back on spending. For individuals, we've had income tax rates as high as 90% (following WW II-1964) and as low as 28% (1988), but politicians have never been able to squeeze more than 19% or 20% of GDP out of the American public to send to Washington, DC.

In the meantime, put yourself in the shoes of an employer: You know regulations are going up (half of the regulations under the Dodd-Frank bill haven't been written yet); you've been promised that your taxes are going up; and you're being pressured to raise (minimum) wages. Would you borrow money to build plant and hire people?

The European Union (EU) and Japan

Abnormal things are happening with interest rates in Europe and Japan. Negative real rates of return (nominal interest rate minus inflation) have historically happened with some degree of frequency, but negative nominal interest rates—paying the borrower to take your money for a period of time—are highly unusual. This is taking place in Japan, France, Germany, Belgium, Denmark, and Switzerland. As an example, Switzerland's central bank is intentionally generating negative nominal rates, prodding investors to get their money out of the bank and into circulation within the economy, and to keep foreign money out.

What's happening with currencies?

As our central bank (Fed) ended QE in October 2014, the European Central Bank (ECB) began its own version of QE in 2015. As a result, the value of the euro is declining against the dollar, which, while hurting the EU consumer, is helping their exporters. (Germany, in particular, is export-driven.)

The Bank of Japan (BoJ) embarked on its version of QE after Prime Minister Abe got elected in 2012. With the BoJ balance sheet expanding faster than the Fed's, the yen, too, weakened against the dollar—hurting Japanese consumers, while helping their exporters. Recently, some observers have been expecting an increase in Japan's QE, as they have been unable to reach their inflation target. The BoJ has declined to do that, but it hasn't slowed the program either.

Worth noting: In November 2014, Japan's national pension fund overhauled its allocation of assets, decreasing the amount that went into Japanese bonds and increasing the amount that went into domestic equities and foreign assets. This movement will tend to further punish the yen, while driving up the level of foreign currency they are buying. In a similar vein, Morgan Stanley published a study indicating German investors began a massive shift from European bonds into U.S. bonds in 2015, contributing significantly to the exchange rate movement. They further believe that the shift from European to U.S. bonds will continue for the rest of this decade.

With the combination of negative nominal interest rates and devalued currencies, it is no wonder Japanese and European investors are selling domestic bonds and taking their money overseas in a search of a better return.

China, Russia, and Commodities

The Chinese government intentionally encouraged growth through capital formation (building roads, bridges, buildings, factories) from 2000-2009. Recognizing further investment in those endeavors is wasteful, the Chinese government is encouraging consumption as a growth driver for their whole economy. Over the last 10 years, growth in consumption has been pretty steady at 4%.

China's shift in strategy matters because China had become the dominant source of incremental demand for commodities in the world through its focus on growth through capital formation. Since it takes 5-10 years to put a new mine into production, producers started investing in new capacity in the early 2000s, believing Chinese demand would continue to grow at previous rates. That new capacity came online early in this decade, about the time Chinese demand growth began to slow. There is now a glut in a number of hard commodities and because producers borrowed to build the new plants, they will not shut them down—they must generate cash in order to meet their obligations. Oversupply in copper and iron ore has been driving prices down since 2011; the same is true of steel and coal.

Crude oil has also been declining in price, but the reasons are different. Coming out of the 2008-09 recession, the price of crude oil on an international basis stabilized around $100 per barrel, until the summer of 2014 when U.S. shale drilling began to create an oversupply. Expectations were high going into Thanksgiving 2014 that Saudi Arabia would cut production to put a floor under oil prices. The Saudis declined to do so, in fact, increasing production since then. Russia and Iraq have also increased production—and Iran has announced its intention to do so once sanctions are lifted. Recently, the price of crude oil has stayed in a band between $35 and $50 per barrel. U.S. shale production is declining as U.S. producers cut capital investment—and the major international oil companies have cut capital outlays as well—which will have an effect on supply after a lag best measured in years. In the meantime, global oil inventories are far higher than the historical average, putting downward pressure on near-term prices.

Countries that rely heavily on the export of commodities have been impacted by the price declines. Hardest hit has been Russia, due to the collapse in crude oil prices. Brazil has also been hit hard by commodity price cuts and is in a nasty recession. Canada is slowly growing, affected by both hard commodities and crude oil. Australia has just emerged from recession. In sum, the "global commodity bust" is taking a toll on a number of countries.

It's taking a toll on a number of U.S. companies, as well. The market indicates Peabody Energy (down 96% in two years) and U.S. Steel (down 75% last two years) are at real risk of bankruptcy; Nucor, less so. A number of coal mining companies have entered bankruptcy and the remainder may do so. Steel prices are very low due to global oversupply, so the least flexible, most indebted U.S. producers are in real trouble. The oil and gas industry has quit spending money on new wells; a few of the smallest exploration and production companies are in bankruptcy. All of these industries have suppliers who are feeling the pain as well, companies like Cummins, which makes diesel engines; Titan Industries (down 75% last two years), which makes tires for large trucks and tractors; and the railroads, which have seen a large decline in coal and oil shipments, etc. This part of the economy is hurting, and the risk is the slowdown in those sectors drags the whole economy into recession.

Announcements

Investment Seminar Archive Available on Website

Visit our website for a video archive of our December 3, 2015 investment seminar. If you prefer viewing via DVD, let us know and we'll send you one.

Semi-Annual Conference Call

Join us for our next conference call, when portfolio managers Ron and Jeff Muhlenkamp discuss what they're seeing in the economy and the markets.

Thursday, February 25, 2016
4:15 pm – 5:00 pm ET

Toll-free number: (888) 862-6557
Conference code: 41568974

Request for Email Address

Email provides expanded access to time-sensitive information and educational materials, quicker delivery of the *Muhlenkamp Memorandum*, and invitations to investment seminars, webcasts, and conference calls. To be included, call us at (877) 935-5520 extension 4, or go to the "Contact Us" section of our website. Your contact information will not be released to any third party.

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