



QUARTERLY LETTER, JULY 2022

Fellow Investors,

In our last letter we wrote about inflation and four other “seismic shifts” in the investing environment. This quarter we continue to focus on U.S. inflation. We expect to discuss the other four in the future as events continue to unfold.

U.S. inflation in the second quarter remained high with the May 31, 2022 Consumer Price Index (CPI) indicating an 8.6% year-over-year increase in prices, up from 7.9% at the end of February and 7% at the end of December 2021. This high, and still rising, inflation prompted the Federal Reserve to raise their federal funds target rate by .75% at their June meeting. The federal funds rate is a very short-term interest rate and the only one directly set by the Federal Reserve. This was the 3rd increase in the federal funds rate this year and the largest one yet. The Federal Reserve has also ended their bond and mortgage-backed security purchasing program, but they have not yet reduced their holdings of these securities even though they have announced plans to do so.

We are also seeing market-driven interest rates continue to rise. As of June 26, 2022 the yield on the 30-year Treasury bond is 3.26% (up from 2% at the end of December 2021) and the average interest rate on a 30-year mortgage is 5.8% (up from 3.2% at the end of December 2021). Higher mortgage rates and rising home prices have dramatically slowed new home sales forcing home builders to start cutting prices and rolling out incentives to move inventory. While we don't expect a housing bust on the order of 2006 – 2009 the rapid degradation of the housing market has prompted us to re-evaluate our investments in homebuilders.

We observed 1st quarter that the most speculative assets had begun to decline precipitously, specifically mentioning growth stocks. The price declines in these sorts of assets have continued in the 2nd quarter with the most dramatic being the roughly 50% decline in the price of Bitcoin over the last 90 days. Cryptocurrencies more generally have been hard hit with several less well-known coins failing completely, at least one crypto invested hedge fund closing, and a crypto-based online bank of sorts halting redemptions. We suspect more pain to come in this space. (We have no investments in cryptocurrencies or the companies that are dependent on them).

We continue to expect inflation and higher interest rates to generally drive asset prices lower in the bond and equity markets as described last quarter.

We also expect a financial crisis of some sort to develop. The cheap money of the last decade was fuel for any number of speculative enterprises and malinvestment. As central banks, led by the U.S. Federal Reserve, increase the price of money, and withdraw excess funds from the financial system, we expect some of these speculations will fail, some overly indebted companies will fail, and overly indebted governments will struggle to finance themselves. Sooner or later, this will create a crisis. Our guess is that as interest rates rise a liquidity crisis will develop (a shortage of dollars somewhere in the financial system) or the U.S. economy will enter a recession. This will likely be before inflation is back below the Federal Reserve's 2% target. This will place the Fed on the horns of a dilemma: does the Fed continue to fight inflation in the face of the economic pain such actions are causing, or do they reverse course, push dollars into the economy to address the recession or the crisis, and allow inflation to continue at a level higher than their target? If they reverse course, we think the

result is low growth and high inflation (stagflation). If they stay the course, the result will be sharper pain in the near term but better growth and lower inflation once the crisis resolves. We don't know which path the Federal Reserve will choose when the time comes.

The Federal Reserve is not the only portion of the government that is concerned about inflation. The White House also appears to be concerned and has floated a number of ideas about how to reduce high prices. These ideas include price caps, taxes on windfall energy profits, a "holiday" on the federal gas tax, and public shaming of several companies and industries. We don't think any of these ideas will be effective in reducing inflation as they either subsidize consumption (maintain or increase demand) or penalize production. This is the opposite of what you want to do in both cases. To tame inflation you need to either increase supply or decrease demand, or a combination of the two. You also need to stop creating money faster than you are creating goods and services. (For example, California's plan to hand out cash to taxpayers to mitigate the effects of inflation will not reduce inflation, in our opinion). We also saw these types of measures tried in the '70s. They didn't work then; we don't expect them to work now if they are actually implemented.

You may have noticed our relatively large investments in energy. Allow us to explain the reasoning behind that. We've observed that the oil and gas industry in general has under-invested in new capacity for the last few years: government policy, shareholder activism, COVID-19, and profligate spending 5 to 10 years ago all contributed to recent decisions by managements to reduce capital expenditures, cut costs, and streamline their businesses. Profitability and free cash flow have replaced growth as their primary goals. This change in goals has stabilized supply. Then, nature struck in Europe last winter when unusually calm wind conditions took their windmills offline and caused the price of natural gas to spike. Next, Russia invaded the Ukraine and Western Europe unleashed sanctions against Russian oil. Russia retaliated by first demanding payment for natural gas in Rubles, then shutting off supplies of natural gas to some European countries. This is the "perfect storm" that has driven oil and gas prices higher. We didn't predict the tough European winter or the Ukraine War, we simply observed that the energy boom and bust had played out, energy companies were cheap during COVID when the market was oversupplied due to the shutdowns, and energy companies had become better, more profitable companies. This prompted our early investments. We've also spent a fair bit of time thinking about how to invest if the current inflation continues despite, or because of, government action. We tapped Ron's expertise here as he was investing during the '70s and he recalled that energy was one of the few sectors that did well during that period. We thus have reason to believe that energy will again do well should inflation persist. Year to date our energy holdings have treated us quite well, though they have been volatile.

Considering this admittedly pessimistic outlook, we are holding a fair bit of cash. Our goal is to deploy it in good companies at excellent prices when others retreat from the market. With the Federal Reserve still increasing the price of borrowing and withdrawing cash from the system we think that opportunity is ahead of us. We expect to hear more about the state of the economy over the next several weeks as companies begin reporting quarterly results in early July. We'll let you know next quarter what we learn.

As always, if you have questions or comments, write or give us a call. We'd love to hear from you.

With our best wishes for your continued success and good health,



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The comments made in this letter are opinions and are not intended to be investment advice or a forecast of future events.