MUHLENKAMP

QUARTERLY LETTER, OCTOBER 2023

Fellow Investors,

Let's start, as we usually do, with a review of the most relevant developments that impact the investing environment. We'll begin with inflation. The August reported CPI inflation was 3.7%, up from the June low of 3%. Since both 3% inflation and 3.7% inflation are above the Federal Reserve's target of 2%, the Federal Reserve raised the Federal Funds Rate by .25% to a range of 5.25 – 5.5% at their July meeting. Longer-term treasury rates, though not directly controlled by the Federal Reserve, have also been rising with interest rates on 10-year Treasury Bonds moving from 3.8% on June 30th, 2023, to 4.5% on September 25th, 2023. This is likely partly due to the high deficits the federal government is running. The federal deficit in July was 7.6% of GDP (Gross Domestic Product), up from a pre-COVID range of 2.5% - 5% of GDP and not too far from the 10% of GDP deficit we ran during the '08 – '09 recession. Rising Treasury rates have caused other interest rates to rise as well. Worth highlighting is the 30-year mortgage rate which began the year at 6.6% and rose to 7.6% by September 22nd, 2023. Adding insult to injury, the average gas price in the U.S. increased by about 10% in late July and is now roughly $4.30/gallon.

So far, the economy is holding up reasonably well. Inflation-adjusted GDP grew at a 2.1% annual rate in the second quarter according to the Bureau of Economic Analysis. Unemployment, although well known to be a lagging indicator, continues to look pretty good with the August unemployment rate coming in at 3.8%, up a bit from the January low of 3.4%.

We said a year and a half ago when the Fed started raising rates that they would continue until something broke. In the second half of '22 they "broke" the housing market as buyers balked at higher mortgage rates. Somewhat surprisingly new homes sales have recovered nicely in '23, though sales of existing homes are dismal. It turns out higher mortgage rates have kept existing homes off the market as those homeowners are reluctant to exchange the low-rate mortgage on their old home for a higher rate on a new purchase, so most of the homes available for purchase are new construction. In March a couple of regional banks "broke" as their depositors fled. Some quick, generous lending by the Fed kept that problem from spreading, at least so far. We continue to keep an eye on the banks as higher rates and changing work patterns have combined to hit commercial real estate values pretty hard, and some banks are deeply involved in that industry.

So, inflation remains higher than the Fed desires and the Fed has been raising rates to fight it. Will they continue to raise rates? We'd say it's possible, but not likely, that they will raise rates much further. Why do we think so? First, the Fed recognizes that the full effects of higher rates will come with a lag. Second, the problems higher rates have caused the banking industry probably got their attention. Third, higher rates are rapidly increasing the Federal government's interest expenses. Fourth, the Federal Reserve itself is now running at a loss. That's got to be a little concerning, even if they don't talk about it. Thus, we think the Fed is likely done raising rates, or pretty close.

Do we think inflation will continue to fall? We are skeptical of that idea. In our view, more regulation is inflationary (and we are definitely seeing more regulations coming from our government), increased government spending is inflationary, higher energy prices are inflationary, and we may be seeing the early rounds of a wage-price spiral as President Biden joins the picket lines and cheers for a 40% wage increase for auto workers. The Federal Reserve is fighting inflation, but the rest of our government is not. While it is possible inflation will continue to fall, we view it as unlikely. Our best guess is that inflation will average 3-4% going forward, roughly twice the average of the period from the '08-'09 recession until the COVID recession. Historically, short-term treasury yields have been about the rate of inflation and long-term yields have been roughly the rate of inflation plus real GDP growth. Thus, if inflation is 3-4% going forward and real GDP growth is 1-2% we expect long rates to be 4-6%. The 10-year Treasury currently yields about 4.5%, so there is plenty of room for long rates to go higher without doing anything historically unusual.

As a brief aside, let's illustrate the pain bondholders have felt the last three years due to rising rates. There is a bond ETF run by iShares® that consists of treasury bonds of greater than 20 years duration (iShares® 20+ Year Treasury Bond ETF, ticker symbol TLT). The price of that ETF peaked on April 21, 2020, at $171.29. On September 26th, 2023, TLT was trading at $89.20/share. The price declined 48% in 2 years and 5 months. The iShares® iBoxx $ Investment Grade Corporate Bond ETF, ticker symbol LQD has done a bit better, losing only 26% since its peak on August 6, 2020 (corporate bonds are typically for shorter time frames, which likely accounts for most of the difference). We remain bearish on long-duration bonds. Very short-duration bonds, on the other hand, look quite attractive right now with many Money Market Funds yielding a bit over 5%.

Will the U.S. economy fall into a recession? This remains a possibility. With short-term interest rates above long-term interest rates bank lending is constrained. Higher interest rates will likely restrain consumer spending on houses and autos (the things most people finance) and may reduce business spending as well. On the other hand, high government spending is pushing money into the economy for politically favored projects at a near wartime pace and businesses are spending to make their supply chains more robust as they incorporate lessons learned during the COVID disaster. We are more optimistic that we will avoid a recession than we were six months ago and currently think the odds are about 50/50.

The environment we just described sets the context for our investments. We hold a number of companies that have both done well for us in the past and whose prospects going forward are equally bright—we are comfortable continuing to hold such investments. We have significant energy holdings, which helped us enormously in 2022 and which we think will do very well if inflation remains elevated. We continue to have exposure to the price of gold to hedge against a devaluation of the dollar. We also hold several companies simply because their stock price is significantly below our estimate of their value, and we anticipate that gap will eventually close in our favor. Our cash is now earning us a return above inflation, and we will invest it when we find a more profitable alternative.

As always, please get in touch with us if you have any questions, we'd love to hear from you.

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

Jeff Muhlenkamp, Portfolio Manager Muhlenkamp & Company, Inc.	Ron Muhlenkamp, Founder Muhlenkamp & Company, Inc.

CPI *- The Consumer Price Index ("CPI") measures the average change in prices over time that consumers pay for a basket of goods and services, commonly known as inflation. One cannot invest directly in an index.*

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

Federal Funds Rate *- the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight. It is the interest rate banks charge each other for loans.*

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

The comments made in this letter are opinions and are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Visit our website for past Quarterly Letters and other archives - https://muhlenkamp.com/
Copyright © 2023 Muhlenkamp & Company, Inc. All Rights Reserved