



QUARTERLY LETTER, JULY 2024

Fellow Investors,

Economically the second quarter of '24 has been as quiet as the first quarter. Inflation as measured by the Consumer Price Index (CPI) was 3.3% on May 31, 2024. It's been within .2% of that number since October 2023. The U.S. Unemployment Rate on 5/31 was 4.0% up .2% since October 2023. Not much change there either. Real (inflation adjusted) year-over-year GDP growth in the first quarter was 1.3% and the Atlanta Fed's "GDP Now" estimate was 3.0% on June 20, 2024. In light of those metrics the Federal Reserve has maintained their Federal Funds Target Rate at a range of 5.25% - 5.5%. The Federal Funds Target Rate has been maintained at that level since mid-July 2023. With the yield on the 2-year treasury bond at 4.7% and the yield on the 10-year treasury bond at 4.3% the yield curve remains inverted (short-term interest rates higher than long term rates) which has historically been a pretty good indicator of an approaching recession. We're not willing to say "this time is different" so we still consider it possible that the U.S. enters a recession in the near future.

The year-to-date return for the S&P 500 Index is 15.29% as of the end of June with Artificial intelligence (AI) related companies and big tech in general providing most of that return. AI chipmaker Nvidia Corp led the charge with a year-to-date return of approximately 150%, becoming for a brief time the most valuable company in the S&P 500 and one of only three companies with a market capitalization of over \$3 trillion (Apple and Microsoft are the other two). Nvidia at the end of June sold at 25 times this year's sales estimates: a very high valuation and a clear indication of the market's expectation of even greater things to come than we've seen in the recent past.

You've probably not read much about it but the bond market, at least the longer end of it, is in its 47th month of a bear market. The yield on the 10-year treasury bond bottomed in mid-2020 at about .5% and has risen steadily since then to the aforementioned 4.3%. Prices of long bonds have consequently fallen over that period with the S&P U.S. Treasury Bond 20+ Year Index illustrating the decline by losing 40% of its value since its peak at the end of July 2020. Declines in the value of bonds can create problems for companies that hold bonds on their balance sheets and are forced to mark the value of the asset to the current market price (typically banks and insurance companies own lots of long-term debt). This explains the failure of Silicon Valley Bank last year and it is still creating problems for banks. A recent news item is illustrative: Norinchukin Bank (Japan) announced in mid-June that it would sell \$63 billion of its holdings of U.S. and European government bonds during the year ending March 2025 to stem the losses from bets on low-yielding foreign bonds. We'll probably be dealing with the ramifications of higher interest rates for quite a while. If we are fortunate, the problems won't cascade into a crisis.

We continue to think inflation will remain higher than the Federal Reserve target of 2%. We note that while the Federal Reserve is trying to keep inflation under control by inverting the yield curve and shrinking their balance sheet, the rest of the Federal Government is contributing to inflation with debt fueled spending and increasing regulation. With inflation currently at 3-3.5% we think the interest rate on long-term treasuries could easily be in a range of 5-7% and still be within historically normal ranges. If interest rates continue to rise, as we expect, there will be further losses on long bonds and additional stress on both banks and the Federal Government, which will see its interest expense continue to increase rapidly. (Interest expense is now the Federal Government's second biggest expense. According to the Committee for a Responsible Federal Budget, as of May 10, 2024, Net Interest spending for the first seven months of fiscal 2024 was \$514 billion, compared to \$498 billion for defense and \$465 billion for Medicare. Only Social Security spending, \$837 billion, was greater.)

We have largely maintained our holdings of energy companies as we think they'll do well in an inflationary environment much like they did in the 1970s inflationary period. We reduced some of our tech and industrial holdings as the price of certain stocks met or exceeded our estimate of their value. We are comfortable holding some cash both because the portents of a recession (primarily the inverted yield curve) have persisted but also because we are not finding good

values at the moment. When we find the value we are looking for, we will happily put that cash to work. But in the meantime, it earns us about 5% in a money market fund.

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
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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.

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).

S&P 500® Index – The S&P 500® Index is a widely recognized, unmanaged 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.

S&P U.S. Treasury Bond 20+ Year Index – Is designed to measure the performance of U.S. Treasury bonds maturing in 20 or more years. One cannot invest directly in an index.

Past performance does not guarantee future results.

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.

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