QUARTERLY LETTER, JANUARY 2025

Fellow Investors,

A year ago, we told you that we thought we were in an era of higher inflation (higher than we had seen from 2009 to 2021) and that it was possible we could see a recession in 2024. As it turned out, the inflation high water mark for the year occurred at the end of March with a Consumer Price Index (CPI) reading of 3.5% and bottomed the end of September with a reading of 2.4%. The latest CPI number is from the end of November, and it came in at 2.7%. We did not see a recession in 2024 and the Federal Reserve Bank of Atlanta's latest GDPNow™ estimates on 2 January 2025 is for real GDP growth of 2.6%. So, we saw inflation that's higher than the Federal Reserve target of 2.0% but not completely crazy and reasonable GDP growth. U.S. unemployment increased early in the year breaking above 4.0% in May 2024 and remaining there through the end of the year, with the November 30th number coming in at 4.2%.

Considering the relatively low CPI numbers and the gradually increasing unemployment rate the Federal Reserve cut the Federal Funds Rate by .50% at their September meeting then cut it by .25% in November and December. Interestingly, the fall in the Federal Funds Rate was NOT matched by a decline in long-term treasury rates. On the contrary, such rates have risen, with the yield on the 10-year Treasury Note rising from 3.6% on 19 September 2024 to 4.5% on 31 December 2024. The 30-year fixed-rate mortgage rate responded similarly, rising from 6.6% in mid-September to 7.3% at the end of the year. The falling short term interest rates and rising long term rates have un-inverted the yield curve and restored it to its "normal" upward sloping configuration. This makes it profitable for banks to once again borrow short term and lend long term and should result in greater bank lending going forward. As we highlighted in the third quarter the "un-inversion" often coincides with the onset of recession, but we're not seeing declining economic indicators that would suggest the odds of a recession were increasing.

The U.S. stock and bond markets in '24 looked a lot like the stock and bond markets in '23. Long-term bonds returned nothing as interest rates remained near their recent highs. The stock market was again dominated by AI related technology companies as capital spending on new servers and new server farms remained extremely robust. Other stocks did well, but once again tech led by a large margin. The returns of the three main U.S. stock indices illustrate this well: in '24 the Nasdaq 100 (tech heavy) was up 24.88%, the S&P 500© (broader, but also tech heavy) was up 23.31%, and the Dow Jones Industrial Average (much less tech heavy but also narrower and differently weighted) was up only 12.88%.

Finally, the presidential election closed out the year with a definitive and uncontested verdict. We wouldn't characterize the result as a "landslide" – Republican control of the House and Senate is very narrow, which will make passing major legislation difficult especially as Republicans are not known for their party discipline. We view it as positive that there seems to be significant interest in reducing government spending and government influence in the economy, but we are also mindful that every government program has a constituency making reducing such programs very difficult. There have been a lot of attempts to roll back government over the years, few of them have achieved much. Why is this important? To keep it simple, if the government has problems funding its expenditures, it will find a way to print what it needs and that will be very inflationary. Inflation (the declining value of a currency) is historically a huge impediment to building wealth over time. Thus, our interest in the topic.

What are we watching going forward? We think there are a few key questions:

1. Will there be any evidence of a recession in the first quarter or two? We think the odds are declining, and if we don't see a slowing economy in the first few months, we will quit worrying about a recession (for now).
2. What will inflation do? The stock market quit worrying about inflation a year ago, but if we start to see inflation numbers tick up, that could change in a hurry. Now that banks have a greater ability to lend profitably, will we see credit creation pick up and push inflation higher? Will historically large federal deficits require imaginative (inflationary) funding mechanisms? We think inflation is more likely to rise than fall.

3. Will interest rates resume their upward movement? Long-term interest rates have historically been 2-3% above inflation. Even if inflation remains between 2-3% you could easily see long-term interest rates between 4 and 6%. With the 10-year Treasury rate currently near 4.5%, there is room for higher rates.
4. What surprises will come from the Trump administration? Many of the ideas floated by Candidate Trump work against each other in terms of their economic effect. We will be watching closely to see what gets implemented. In general, we think we will be in a more "business friendly" environment the next four years than we have been the last four years, but the details will matter.

We continue to hold significant investments in energy and gold related companies both because we find good values in those sectors, and because we view them as decent hedges against inflation and currency debasement. We recently initiated several small investments in Chinese companies we find attractive and worth taking the additional risks that come with international investments. Compared to the S&P 500© (which is market capitalization weighted), we have a significantly lower percentage of our assets invested in technology companies as we find most companies in that sector are significantly overvalued and therefore unattractive. As long as the broader investor community remains enamored of all things AI and tech, that will hurt us from a relative performance standpoint, but we remain convinced that value matters and will happily buy tech should prices decline to better match the value we see in the underlying businesses. As always, we continue to search for profitable investment opportunities and will put money to work when we find them.

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

With our best wishes for your continued success and good health in 2025,

Jeff Muhlenkamp, Portfolio Manager
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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.*

Dow Jones Industrial Average (DJIA) *also known as the Dow, is one of several stock market indices. It was created by 19th century Wall Street Journal editor Charles Dow and consists of 30 of the largest and most widely held public companies listed on stock exchanges in the United States. It is price weighted. You 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).*

Nasdaq-100 *is a stock market index that represents 100 of the largest, non-financial companies listed on the Nasdaq Stock Market. It is a modified capitalization-weighted index where the stocks' weights in the index are based on their market capitalizations, with certain rules capping the influence of the largest components. You cannot invest directly in an index.*

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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