

# MuhlenkampMemorandum

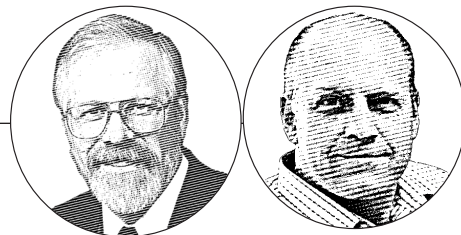
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## Quarterly Letter

By Ron Muhlenkamp, Portfolio Manager and Jeff Muhlenkamp, Investment Analyst and Co-Manager



We'll start with our views on the U.S. stock market, then briefly touch on some broader U.S. and global issues, then close with a summary of how it all ties together.

In general, we find the market is fully priced. Some sectors appear quite expensive (utilities come to mind), while others are less so (energy). If the market were a new car, you'd be paying the sticker price to buy it today—no incentives, no dealer reductions, nothing—the sticker price. So we're not very interested in buying the market at today's price. We keep looking for bargains (we are always looking for bargains), but we're not finding many. Many of the companies we own are no longer cheap and are no longer "buys," but we've found it profitable over the years to leave well enough alone with stocks that are doing well, watching closely for a change in the price momentum as a signal to sell. That's what we are doing today. There are reasons to believe momentum may reverse; margin debt, for instance, had been growing for years, but is now holding steady. If it declines, it is likely stock prices will, too. There are also reasons to believe upward momentum may continue. Savers and investors in both Japan and Europe are being punished with historically low, even negative, interest rates and are looking elsewhere for better returns. If their money comes to the U.S. markets, it could well continue to drive prices up for a time. There is no clear market direction right now and we are watching closely to see what develops.

Now let's talk about some broader topics very briefly. (Further discussion is included in the summary of our February 19 conference call starting on page 2.)

**The U.S. Economy** – Coming into the New Year most economic commentators called for 3%+ U.S. GDP (Gross Domestic Product) growth fuelled, in part, by lower oil prices. Most of those estimates have come down steadily over the last 90 days. We continue to expect 2%-2½% GDP growth, repeating the pattern we've seen the last few years.

**Earnings** – There were two big themes in earnings calls this Quarter. For energy companies, the discussion was all about how much (35%-40%) they were going to reduce their capital expenditures in 2015 due to lower crude oil prices. For international companies, the discussion was all about how much the strong dollar hurt their profits as sales in foreign currencies were translated back into dollars for accounting purposes. (Quantities of goods sold in foreign currency may have been the same, and the revenues measured in the foreign currency may have been the same, but with a stronger dollar it translates into lower dollar sales overseas.) Add in some pretty broad-based announcements of wage increases in retail and we expect overall earnings growth this year to be roughly half of what it was last year.

**Commodities** – Oil prices have been the big news for nine months now as they dropped from \$100/barrel to about \$40/barrel, then "bounced" to \$50/barrel. Now, oil prices are working their way back down because oil inventories, particularly in the U.S., continue to rise. It'll take some time to get supply and demand back in

balance, and we may see new lows in the price of crude oil in the meantime. Hard commodities (iron ore, copper, steel, etc.) continue to get hit hard as the supply brought online to meet anticipated demand from China is now excess and looking for a home.

**Central Banks** – The European Central Bank embarked on their version of "Quantitative Easing"<sup>1</sup> in the first quarter, immediately driving sovereign rates even lower in Europe and causing the euro to sell off against the dollar. This has been a big part of the strong dollar story and may be a reason for extended momentum in the U.S. markets.

The U.S. Federal Reserve Bank continues to prepare the markets for higher interest rates by wordsmithing their announcements to the nth degree. Higher rates will mean lower bond prices (not a good thing for the existing holder of bonds, or utilities for that matter), but will likely attract foreign capital fleeing negative rates and, thus, reinforcing the strong dollar. Since interest rates are currently below where we think they ought to be for economic reasons, we think rising rates, up to a point, will be healthy for the economy. You've heard us say that before.

So, where are we?

We expect continued slow GDP growth of 2%-2½% in the U.S. economy, which is still better than Europe or Japan. Chinese growth continues to slow. Inflation is not a problem anywhere around the globe—deflation is the fear.



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## Portfolio Managers: Investment Outlook for 2015

*On Thursday, February 19, I hosted a conference call with Ron and Jeff Muhlenkamp (portfolio manager and co-manager). We took a hard look at 2014 performance and hashed out what they see happening in the economy and the markets, as well as their investment outlook for 2015. A transcript and audio file are available on our website, but here are some highlights of our conversation.*

— Tony Muhlenkamp

### **Why energy stocks look interesting again...**

Since mid-2010, we had been impressed with the price spread between crude oil and natural gas. We thought the price of crude oil would come down over a period of a few years, primarily through the substitution of natural gas. So, we invested in energy stocks that we thought would benefit from a shift from crude oil to natural gas. [To learn more, visit our website to read, **Natural Gas: An Energy Game Changer.**]

Crude oil prices began to decline in the summer of 2014, as supply outstripped demand and inventories began to build. Market participants expected OPEC to cut production to maintain prices, but on Thanksgiving, they declined to do that—opting to maintain market share instead. At current prices, energy stocks are starting to look interesting again.

We have identified energy-related companies with viable business models and markets, whose stock prices are far cheaper than they were nine months ago. Some include petrochemical companies that use natural gas as a feedstock. For example, a cracker plant “breaks” ethane (a major component of natural gas liquids (NGLs), abundant in the Marcellus and Utica fields) into ethylene. Through a series of additional “downstream processes,” ethylene becomes polyethylene, which, in turn, becomes plastic. And, of course, plastics are everywhere.

We always want to own good companies at cheap prices. When prices get cut in half, we go looking for bargains.

### **Why airline stocks look attractive...**

For airlines, fuel is a major cost and, for the past nine months, they have benefitted from the lower price of crude oil. For the last three or four years, they have also benefitted gradually from the fact that managers are running the business differently. Historically, most airline managers have been retired pilots who love to buy airplanes. Anytime they started making cash flow,<sup>2</sup> they’d expand the fleet—buy new airplanes and fly more routes. Airlines are still buying new airplanes and retiring old ones, but they are now taking the cash flow and paying down debt rather than expanding the fleet.

We continue to monitor our airline investments to determine if the newfound discipline holds.

### **What’s happening with biomedical stocks...**

While we believe today’s biomedical innovations are encouraging, we are mindful that “you can turn a good company into a bad investment, if you pay too much for it.” That’s just one of the challenges of investing in a growth industry where value-oriented stock metrics may not apply. Additionally, sometimes stock prices across an industry become too expensive.

We attempt to balance our risk-reward model by owning large, multinational companies that have solid balance sheets and strong management teams. Many of these companies have collaborative partnerships with smaller, cutting-edge companies. These partnerships provide shareholders the opportunity to participate in emerging discoveries while managing the downside risk associated with owning very small companies.

Thematically, we are looking for companies that we think will develop new (“next-generation”) treatments that both improve the human condition and provide cost savings to the healthcare delivery system. Areas of interest include:

- Rethinking the approach to the war on cancer;
- Curing diseases that were previously life-long conditions; and
- Transforming the model of healthcare from disease management to disease prevention through personalized medicine.

Tammy Neff, Investment Analyst, addressed this topic at our November 12, 2014 investment seminar and wrote a primer about the drivers of biomedical innovations. To learn more, refer to our website for **Game Changers in Biomedical Science.**

### **Why we do not favor bonds...**

The only reason to own bonds is if you think interest rates are going down. Interest rates are currently minimal and the Federal Reserve recently suggested that it will start raising interest rates in mid-year.

People think bonds are safe because they’re guaranteed. Bonds are only safe when interest rates don’t go up. If interest rates go up, bond prices go down. That’s an arithmetic certainty.

For more about interest rates, be sure to attend our upcoming investment seminar/webcast on Tuesday, May 5. Details are included on the last page of this newsletter.

### **Why we think it’s a stock picker’s market...**

Last year, on average, sales of companies in the S&P 500<sup>3</sup> grew at about 4%, and profits grew at about 10 percent. Going forward, we think sales growth will be

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more like 2-3%, and profits more on the order of 5 percent. So, the growth that we've seen in corporate earnings is leveling off.

Further, while we don't see a recession in the U.S., Europe is flirting with one, and China's economic growth remains slow. These international circumstances contribute to a stronger dollar, relative to the euro and Japanese yen. For large, international companies, like those in the S&P 500, about one-third of their earnings come from overseas. (Remember, a strong dollar benefits the the U.S. consumer, but hurts U.S. companies' exports.) A stronger dollar also means that earnings reported in a foreign land are reduced when translated back to U.S. dollars for accounting purposes. We started seeing that in companies' fourth quarter reports.

All of this is reflected in our 2015 investment outlook: If the U.S. economy grows at 2%-2½% and inflation is not a problem, we think stocks, at about 18 times earnings, are fully priced. We're still finding good companies— but most of them are fully priced. (Hence, last year's capital gains distribution; we harvested some of the companies that we owned.) When the market is fully priced, we believe it favors the active stock picker.

## What's happening overseas....

On January 22, 2015, Mario Draghi, head of the European Central Bank (ECB), announced the launch of Quantitative Easing in March with an even bigger program of purchasing assets than people had expected: approximately €1.1 trillion (\$1.16 trillion) to come in €60 billion monthly installments. That's similar to what Japan has done, and to what the United States has done. In both cases, it didn't seem to help the economy much, but it did goose the stock market. While that's interesting to us, the European Union continues to have a debt problem, particularly in the southern countries.


On January 25, 2015, the Greeks elected a new government that ran on a platform of repudiating their debt. They have

made that case to their lenders (e.g. the Germans), who, in turn, have responded, "If you refuse to pay your debt, we won't lend you any more money." Negotiations are problematic, making it difficult to predict the outcome.

On a separate front, any country that produces and exports crude oil is now getting dramatically less in revenues. The poster child for that is Russia—a major exporter of crude oil. Russia is also a big borrower of U.S. dollars. When selling crude oil for \$100/barrel, Russia was easily able to meet the interest payments on their U.S. loans. At \$50/barrel, that gets a little tougher. When you throw in that Russia is engaged in a shooting war in the Ukraine, which has prompted the western countries to sanction them—which means nobody's allowed to lend them money—not only are they having difficulties paying the interest on their debt, they can't roll it over either.

We think Japan remains in a perilous position. QE hasn't worked for them yet; we don't expect it will. Japan may enter a rapid decline if its citizens start fleeing the yen because they don't think it holds its value very well. Further, in October 2014, the Government Pension Investment Fund (GPIF), which manages Japan's national pension system (the world's largest pension fund), announced that it would cut its allocation to domestic bonds by nearly half to 35 percent. GPIF raised allocations to domestic and foreign stocks and foreign bonds to 25%, 25% and 15%, respectively.<sup>4</sup>

China remains an interesting place from the perspective of having a billion people

moving up the prosperity ladder at a pretty good clip. It remains a hazardous place because the growth drivers of the past 10 years have pretty much run their course. And, in the process, China incurred a lot of debt which hasn't been fully absorbed. If China ends up defaulting, there are repercussions outside of the country. 

*The opinions expressed are those of Muhlenkamp & Company and are not intended to be a forecast of future events, a guarantee of future results, or investment advice.*

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European and Japanese central banks have adopted Quantitative Easing (they're printing money) just as the U.S. Federal Reserve is planning to continue "normalizing" its monetary policy by raising interest rates. (The first step in normalization was the end of our QE program). This has boosted the dollar versus the euro and the yen which, in turn, boosts the purchasing power of the U.S. consumer, but squeezes profitability for American exporters and lowers the dollar earnings of U.S. based international companies.

Crosscurrents anyone?

Meanwhile, stocks are fairly to fully priced, so we're trading carefully. 

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

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<sup>1</sup> Quantitative Easing (QE) is a government monetary policy used to increase the money supply by buying government securities or other securities. Quantitative easing increases the money supply by infusing financial institutions with capital in an effort to promote increased lending and liquidity. Central banks tend to use quantitative easing when interest rates have already been lowered to near 0% levels and have failed to produce the desired effect. The major risk of quantitative easing is that although more money is floating around, there is still a fixed amount of goods for sale. This may eventually lead to higher prices or inflation.

<sup>2</sup> Cash Flow represents the cash a company is able to generate after paying out the money required to maintain or expand its business.

<sup>3</sup> 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. **You cannot invest directly in an index.**

<sup>4</sup> Source: "Japanese Pension Funds Announce Portfolio Shift." *The Wall Street Journal*; March 20, 2015



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Inside this issue:

- Quarterly Letter
- Portfolio Managers: Investment Outlook for 2015

15.89	+5.34%	▲	254.23	320,000
5.34	-7.89%	▼	321.56	430,000
7.34	+5.97%	▲	100.08	120,000
7.89	+2.13%	▲	564.23	900,000
45	+6.43%	▲	765.90	600,000
67	-11.6%	▼	120.34	380,000
64	+23.1%	▲	893.23	120,000

### *Muhlenkamp & Company, Inc.* *Investment Seminar*

Tuesday, May 5, 2015  
Regional Learning Alliance  
850 Cranberry Woods Drive  
Cranberry Township, PA 16066

#### **A Stock Picker's Market**

2:00 p.m. and 7:00 p.m. ET live sessions and webcasts  
To register, please call our Client Service Department at (877) 935-5520 extension 4;  
RSVP by Thursday, April 30.

## Announcements

### **Request for Email Address**

Muhlenkamp & Company occasionally publishes information via email, so please share your email address with us by visiting our website at [www.muhlenkamp.com](http://www.muhlenkamp.com), or calling us at (877) 935-5520 extension 4. Your contact information will not be released to any third party.

### **IRA Beneficiary Designation**

Now is a good time to confirm your IRA Beneficiary Designations, so that:

- Upon your death, your IRA is distributed according to your wishes;
- Your beneficiary can preserve the tax-deferred (tax-free in the case of a Roth IRA) compounding of investment gains for years after your death; and
- Your heirs avoid the public and costly process of probate for the assets in your IRA.