February 27, 2020

Amended Transcript

Jeff Muhlenkamp, Portfolio Manager
Tony Muhlenkamp, President

Tony: Good afternoon, ladies and gentlemen. I want to thank you for joining us. This is Tony Muhlenkamp speaking. And we're here this afternoon as we try to do once every quarter or so to get a highlight, take a look at what we're seeing as portfolio managers, usually starting with the broad picture, if you will, the 30,000-foot outlook and working our way down. We will be taking questions at the end of the presentation, so you'll have an opportunity to type those in and send those to us. If we don't get to your question or if we raise more questions than we answer today, please get in touch with me. My email is simply tony@muhlenkamp.com or you can call me directly at (724)934-5139.

As usual, what we're trying to do here is provide some background into the things we think are important as we go about investing your money, trying to ensure that we preserve your capital, grow it a little bit, and do that in ways that help you sleep at night. So, this is designed, I guess, to answer those questions that may be keeping you awake or let you know why we're sleeping well and what we're seeing. So, with that being said, we have our portfolio manager, Jeff, here. Ron is with us in spirit but not actual physical presence today, he's traveling. He does send his greetings and regards, and as usual, if you got complaints, he wants you to call me, but if you have plaudits, please let him know. He's always looking forward to that. So that being said, Jeff, why don't you kick us off, and we'll go from there.

Jeff: Thanks, Tony. Good afternoon, everybody and thanks for joining us this evening. I'll be using this little red dot here as a pointer to try and direct your attention to portion of the slide I'm looking at.

Our Checklist:	What we observe as the Current State:	Future Outlook:
1. Consumer Spending	Good	Impact of COVID-19?
2. Business Investment	Weak	Impact of COVID-19?
3. Credit Default/Bank Health	Auto Loan and Credit Card Delinquencies trending higher	Gradual degradation
4. Inflation	CPI 2.3% y/y	Unsure
5. Federal Reserve and Treasury	Federal Funds rate cut 3X, expanding balance sheet	Additional easing more likely than tightening
6. Trade	US and China "Phase 1" deal signed	Won't be an issue until after election and Corona virus crisis subsides
7. Europe	Brexit officially done, but … ECB restarts asset purchases	German recession?
8. U.S. Election	Democratic Party primary underway	Potentially disruptive
9. China	COVID-19 virus spreading	Disruptive

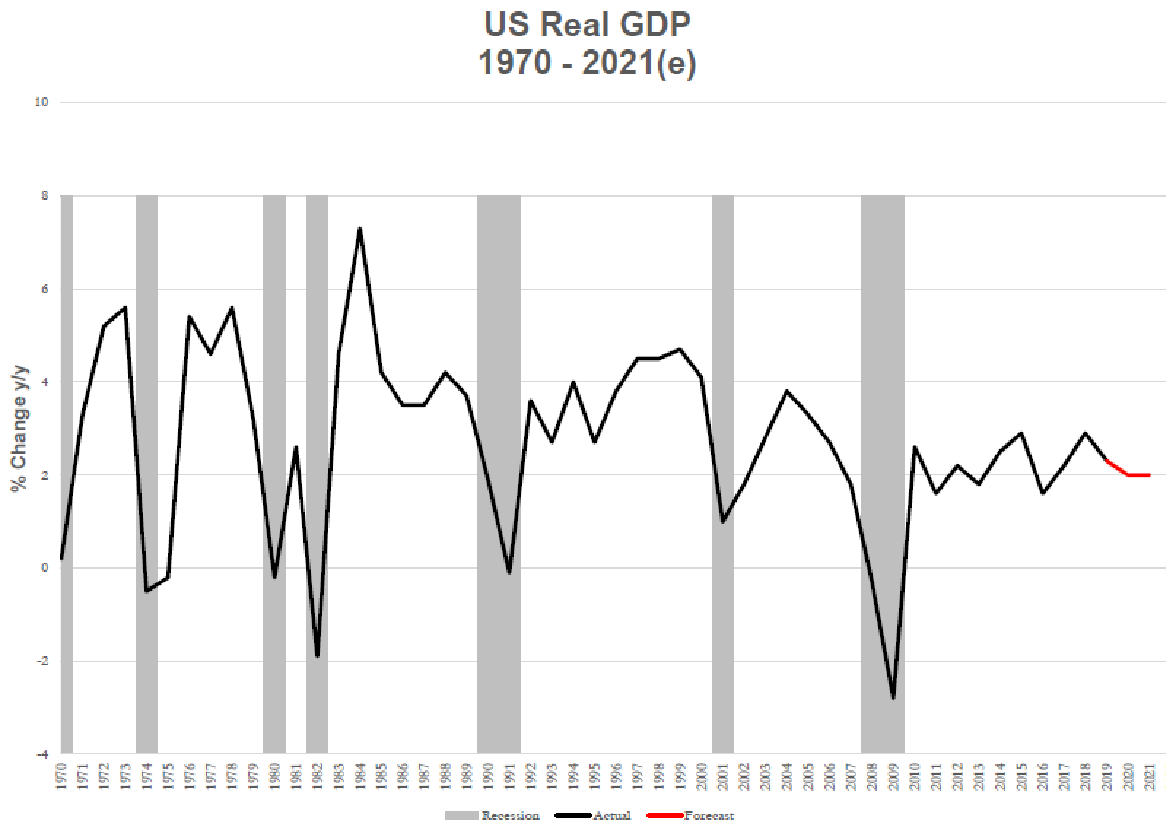
Source: Muhlenkamp & Company, Inc.

Jeff: We're going to start with the checklist that we normally start with, but this time, we're going to start at the bottom because it's kind of top of mind, I think, for the questions we've been getting and certainly from what the markets are doing.

So, there is a nasty flu virus spreading both in **China** and globally. It has proven disruptive in China mostly because of the quarantine measures that have been put in place to slow the growth. And this virus is now feeding into uncertainty about what's going to happen from a consumer perspective and a business perspective as we look at the future. So, I'll go through some charts here to give you the state of the consumer and the state of business. But now, the big uncertainty is what does this mean going forward. So, we've gotten some information, certainly, from travel companies as they try to quantify the impact on their businesses particularly the airlines and the cruise ship guys. We've also gotten some information now from Apple and Microsoft and other companies that have supply chains that are in China that are being impacted by what's going on there and what is starting to spread across the globe. So that's feeding a lot of the uncertainty that's been impacting the markets probably for the last 10 days or so. We're not seeing much change in **credit defaults** or **bank health**. **Inflation** has ticked up a little bit. Last time, it was below 2%. Now, it's 2.3%. We're not sure if that goes higher or lower. Couldn't really give you a prediction, and we'll talk about that a little more. The F**ed** has not changed what they're doing. They went from tightening a year and a half ago to easing a year ago, and they remain in an easing mode by growing their balance sheet.

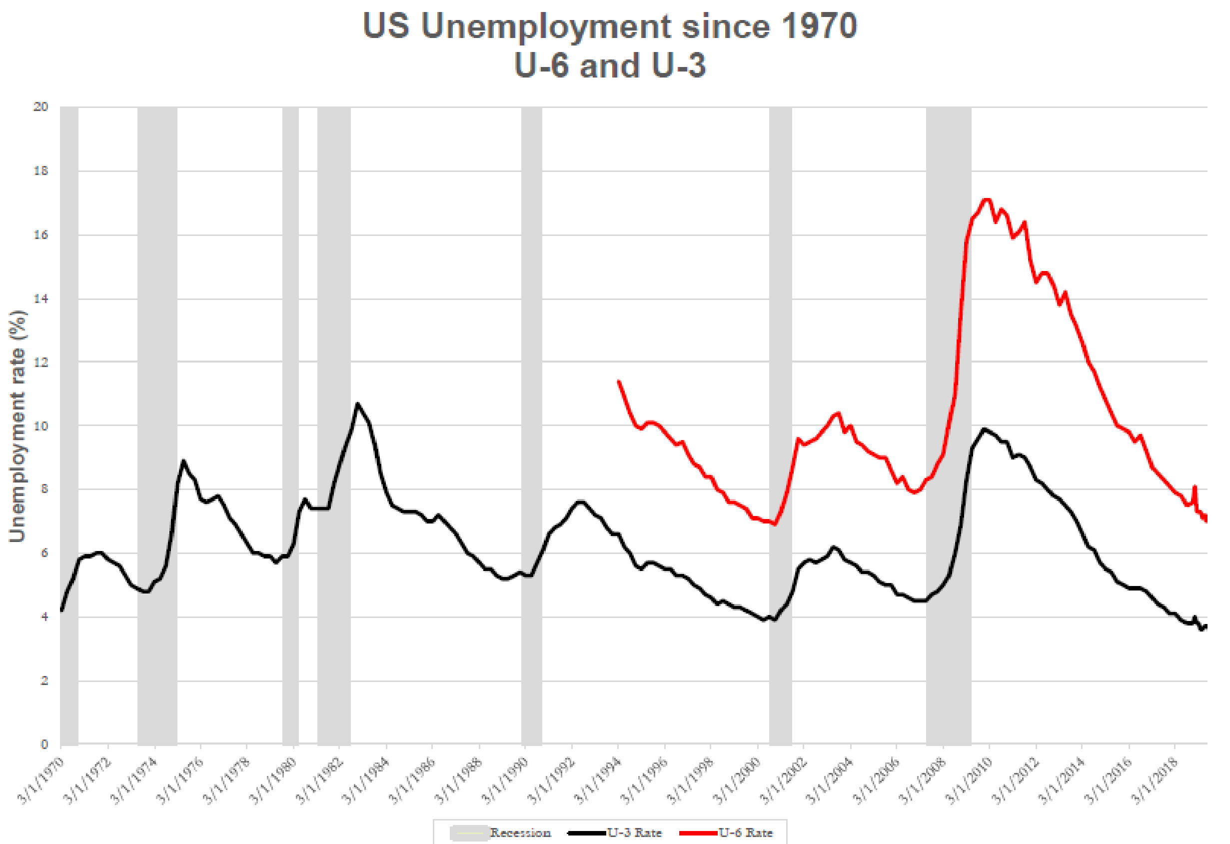
In **trade**, which was the top of mind subject last time we talked, the U.S. and China have signed the phase one deal that's alleviated some of the easier issues but hasn't really addressed some of the thornier issues. Nonetheless, after that deal was signed, it came out of the headlines, and I don't expect the trade issues are going to become top of mind for anybody until after the election, when the U.S. is ready to address it again and until after the Coronavirus yields some space on the front pages that it is dominating right now.

In **Europe**, we have had an official Brexit, so Britain has officially exited the European Union, but it really doesn't mean anything because all the economic arrangements remain in place, and they're going to spend the next two or three years negotiating new ones. So that's different in name, but not in fact. And Germany remains on the cusp of a recession—that's not really new. Number eight used to be Japan. We took Japan off because there's really not much to talk about there. There have been no changes to speak of. And we put in the **U.S. election** because there *is* the potential depending on how the election goes for kind of a dramatic shift in the direction of U.S. policy, and that will have economic implications. I think right now, the stock market is starting to pay more attention to that, and they will probably continue to pay more attention to that over the next six to nine months as we run up to the election, and you can start to get a better feel for what the possible outcomes are and what the odds are for the different outcomes. So that's the summary.



Data Sources: Bloomberg
OECD (Organization for Economic Co-operation and Development)

Jeff: Let's walk through the eaches. We'll start as we often do with U.S. Real GDP. This is a chart going back to 1970. The "real" part means we've adjusted it for inflation. In black are the actual numbers. We ended last year at 2.3% real growth. The estimates from the Organization for Economic Cooperation and Development, that's the OECD, are for about 2% growth this year, and next. They have not yet released their 2022 prediction. So they're thinking fairly stable, if low growth going forward for the U.S. We have no reason to disagree with that. This really articulates kind of our working hypothesis, which is that the U.S. will continue to grow, and then what we do through the charts is try to either confirm or deny the hypothesis. And some of the data we look at tend to reinforce this outlook, and others contradict it. No data point in and of itself is definitive, but when you put them all together, it starts to paint a picture for you or at least for us, and that's what we're are trying to articulate to you.



Data source: Bureau of Labor Statistics
via Bloomberg terminal

Last data point 1/31/20

Jeff: Next up is U.S. unemployment since 1970. We've plotted U6 unemployment numbers in red and U3 unemployment numbers in black. U3 is the most common number you'll hear. The U6 is less commonly used. That takes people who are working part-time and adds them in and counts them as unemployed. So if they're working part-time but want to work full-time and a couple other categories, they add those folks into the numbers, which is why it's higher. From our perspective, it's useful to look at both of them. We don't really have a preference for one. We're happy to look at both charts.

Tony: We don't really say one is right and the other is wrong or vise-versa.

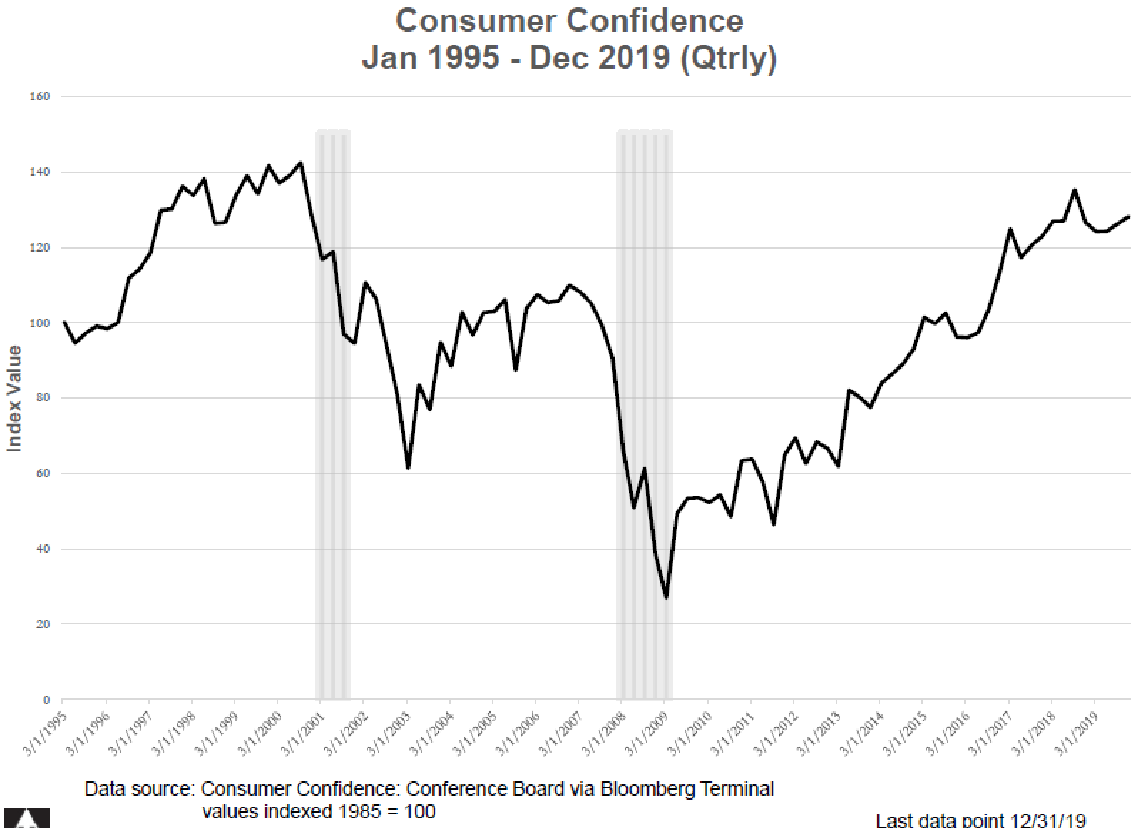
Jeff: Some people do, but we don't.

Tony: Yeah. Right.

Jeff: The key here is that relative their own histories, they're about as low as they've ever been, and most recently, they continue on a downtrend. So the little tick up here back in 2018, that was the government shutdown.

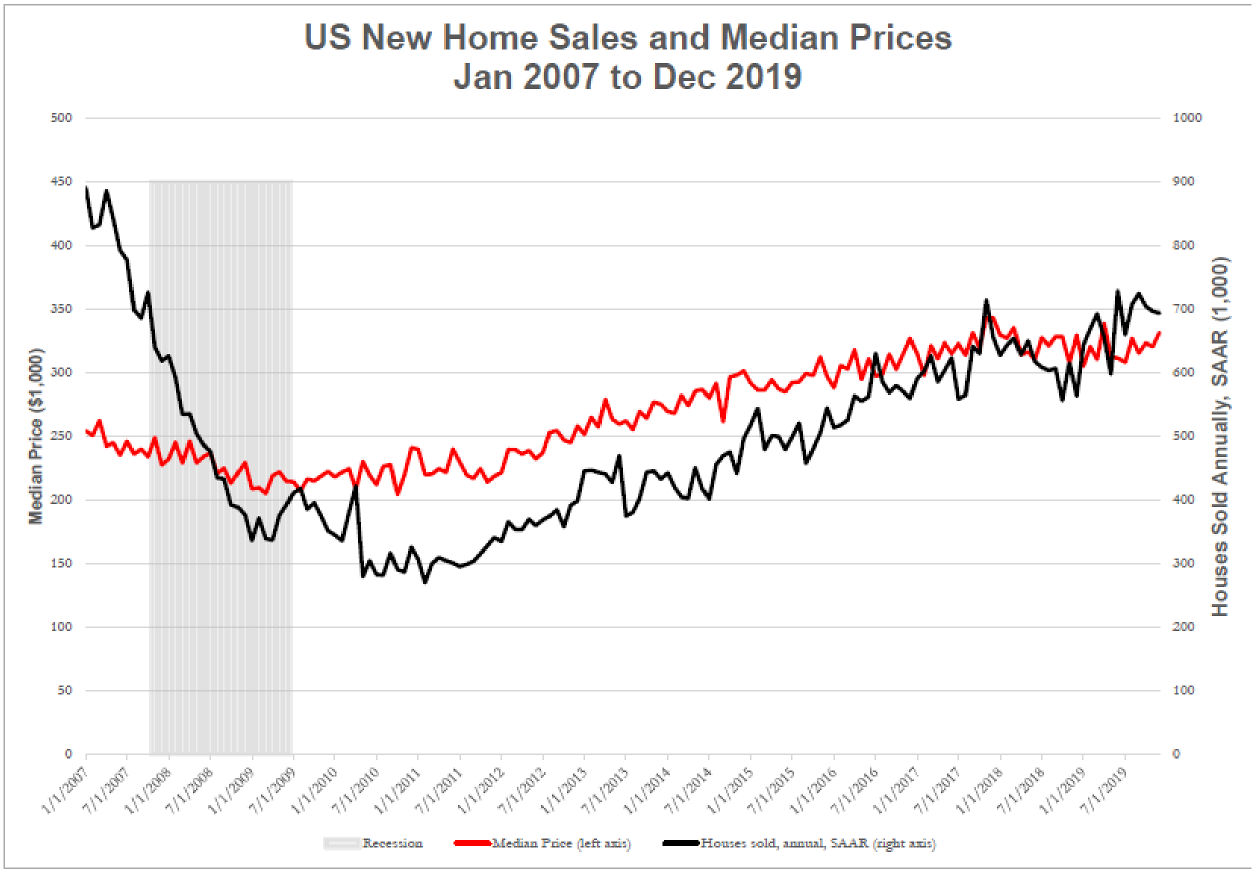
Tony: Well, they do move. They do tend to track. It would be interesting if they started to move in divergent directions.

Jeff: But they're looking pretty good right now. Now, this a lagging indicator, so by the time this start to turn up and the unemployment starts to rise, we will already be in recession. So this isn't the world's greatest way to look at what's going to happen in the future, but it is one of the things we pay attention to.



Jeff: We pay some attention to what the consumer is doing, starting with how the consumer's feeling or how he's thinking. And consumer confidence, which we've plotted here, is one way to keep tabs on that. The grey bars are recessions. This data comes to us via the Conference Board. And it's indexed to a value of 100 back in 1995. You can see the consumer confidence, as you might expect, falls going into recessions, and coming out of a recession, typically, it increases.

What we've seen coming out of 2009 is it's been on a pretty steady increase, so the trend still looks pretty good, notwithstanding the bit of a downtick we've had in the last year, year and a half or so. In terms of level, you're more confident at least on this measure than we were in the early aughts, but you're not quite as confident as we were in the late '90s. So if you say, "Gee, this was exuberance," (the level we were at in the late '90s) well, we're not quite there, but we're certainly not in the depths of despair either. So this chart looks pretty decent to us. If that starts to roll over, that would be a concern, that would tend to invalidate our hypothesis that things will continue to grow.

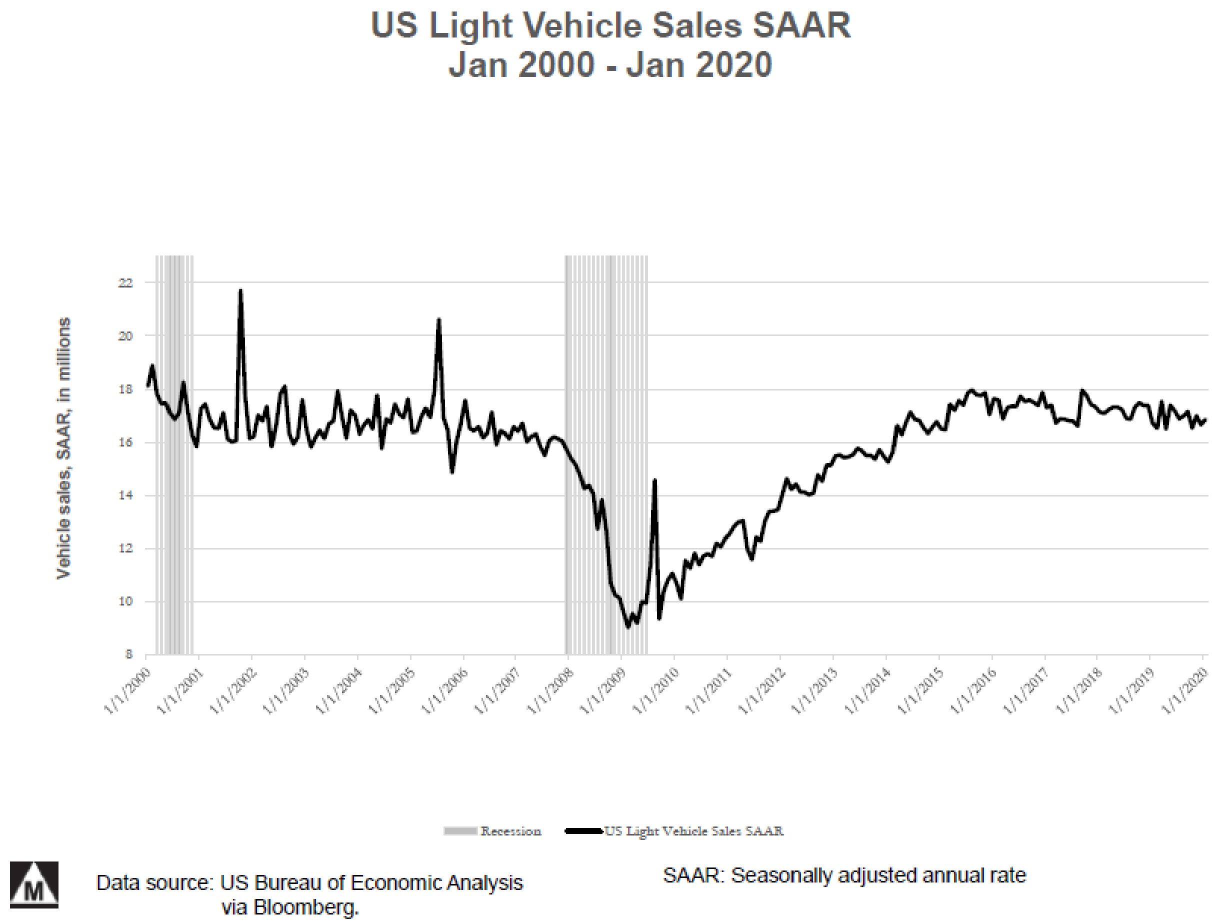


Data source: US Census Bureau via Bloomberg.

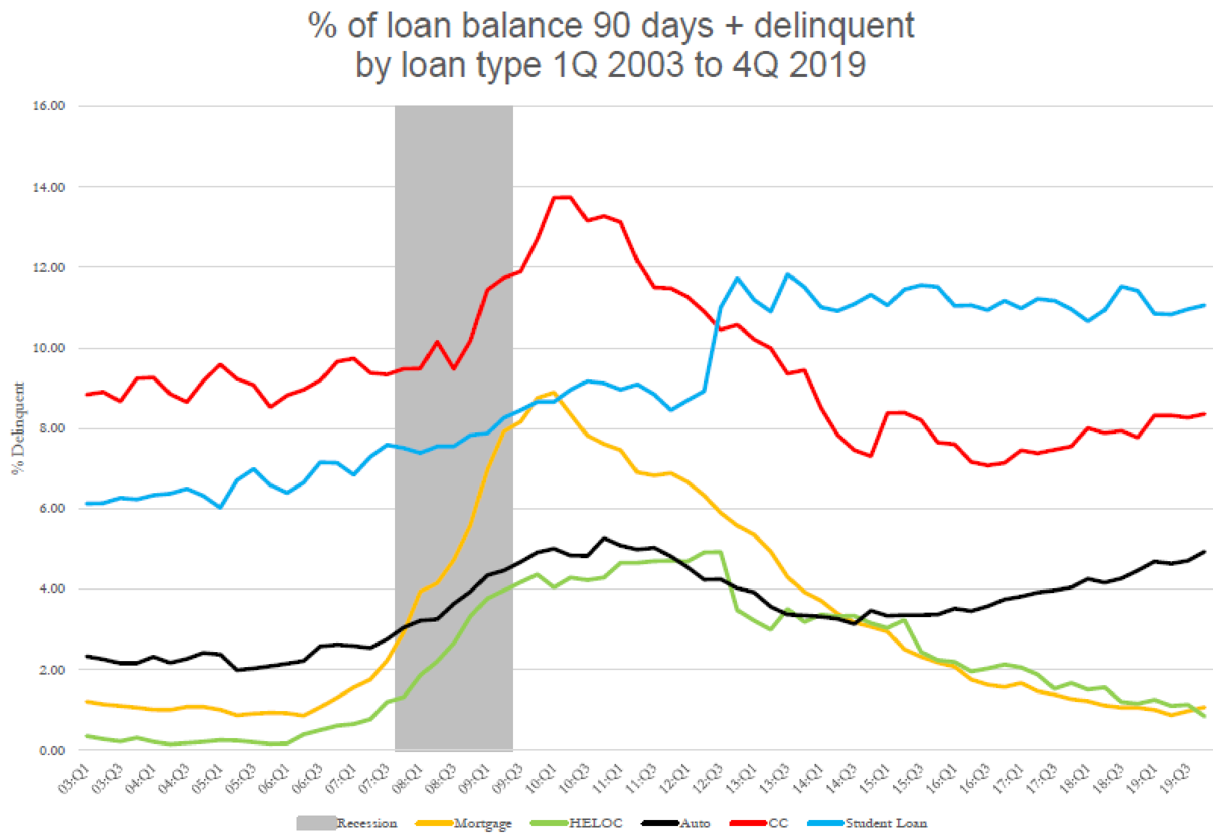
SAAR: Seasonally adjusted annual rate

Jeff: Once we have an idea of how the consumer is feeling, the next question is, of course, is the consumer spending money? We like to look at big-ticket longer-term items. They tend to be most sensitive to changes in the consumer sentiment and consumer spending habits. We have a chart here of U.S. New Home Sales. That's the black line which is mapped against the right axis. And median home prices for new sales, that's the red line, and that's mapped against the left axis.

What we've told you now, for about a year and a half is that we saw a slowdown in home sales during 2018, that bottomed in 2019 and has recovered since then. That trend of recovery continues even as new home prices are pretty stagnant. Anecdotally, what we are hearing is that lower cost new homes are selling quite briskly, but the high-end ones have been pretty slow to move. And so the consumer is very interested in affordable homes, less interested in the luxury, the move-up homes. The home builders are now shifting what they are producing to meet that demand, and this trend that we identified, really about a year ago, maybe a little more, continues. So this is kind of a positive sign for us in terms of what the consumer is doing, and the impact on the economy.



Jeff: We also keep an eyeball on U.S. light vehicle sales. This is on a seasonally-adjusted annual rate basis. This goes back to 2000. Again, you've got the recession bars, nothing too exciting here. What you saw is we peaked in about 2016, late 2015. We've had a very gradual decline for the last three or four years. So nothing too worrisome here, it actually looks quite a bit like it does in the mid-aughts, so nothing to worry about from that perspective.

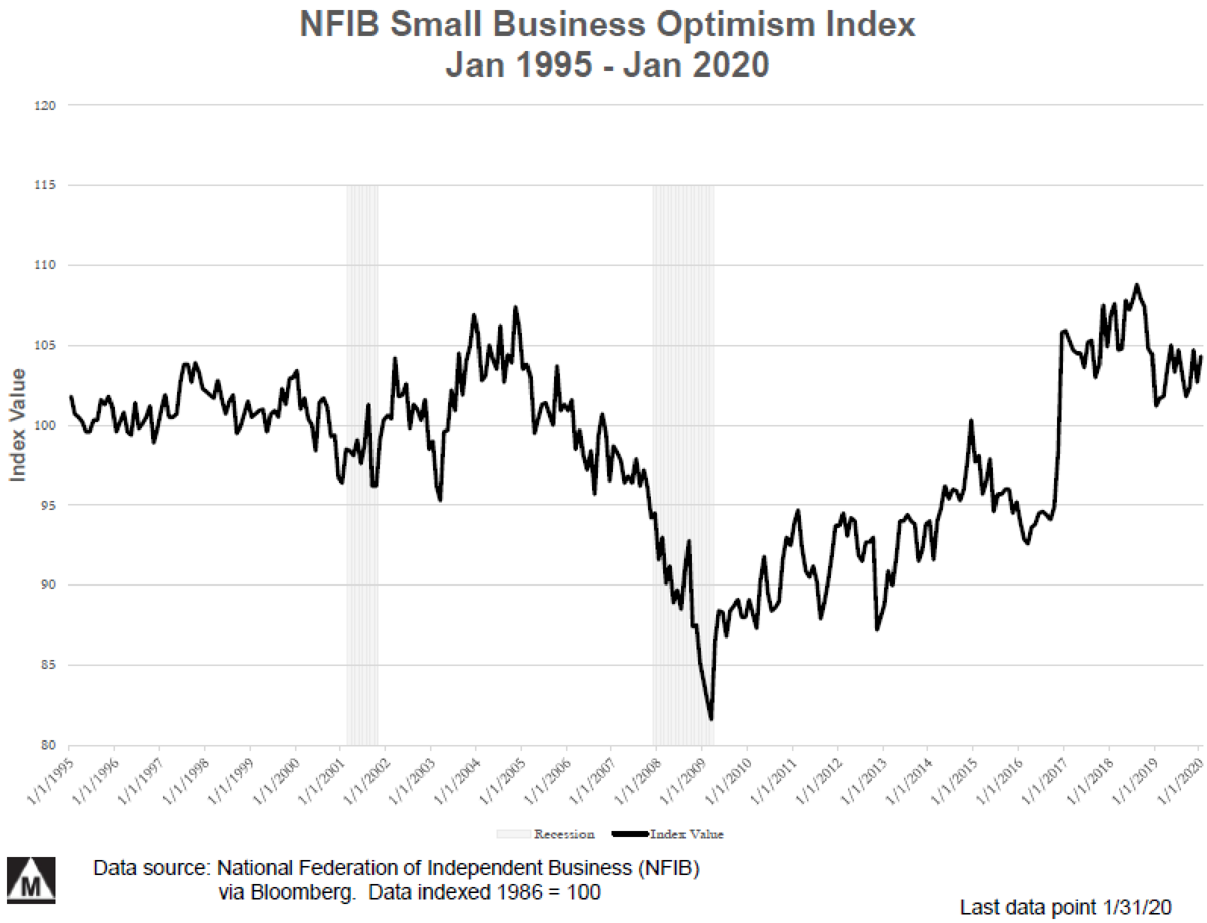


Data source: Federal Reserve Bank of New York

Jeff: We keep an eyeball too on the state of credit and how much folks are defaulting on their loans or becoming delinquent on their loans, and that's what this chart speaks to. This is from the New York Federal Reserve Bank, and it shows the percentage of loan balances that are more than 90 days delinquent from 2003 through the fourth quarter of 2019. From top to bottom, you've got student loans in blue. They had a big uptick there in 2012 and have been pretty stable since then. You've got credit cards in red. So credit card delinquencies came down and bottomed in 2016. Since then, they have been gradually moving up. That's a little bit of a concern to us, although the level remains lower than it had been pre-recession, which is kind of interesting. But that increase is a little bit of a concern.

The black line here is auto loans. That's also of concern, because they're increasing, and the level, frankly, is where it was during the recession. So auto loans are currently of a concern for us and have been for some time. We identified this two or three years ago, but it doesn't seem to have mattered really to anybody. What it did do was it kept us disinterested in anybody that holds these loans. So auto lenders, for instance, are not terribly interesting to us right now, because we think they're headed for more problems, not fewer.

And then the green line and the yellow line, those are mortgages and home equity line of credits. Both of those delinquencies continue to improve, although they are not yet back at the low levels we saw pre-recession. So no real change. The things we were worried about, credit cards and auto loans, remain a worry. They have neither gotten much better nor dramatically worse. So that's kind of the picture we see there.

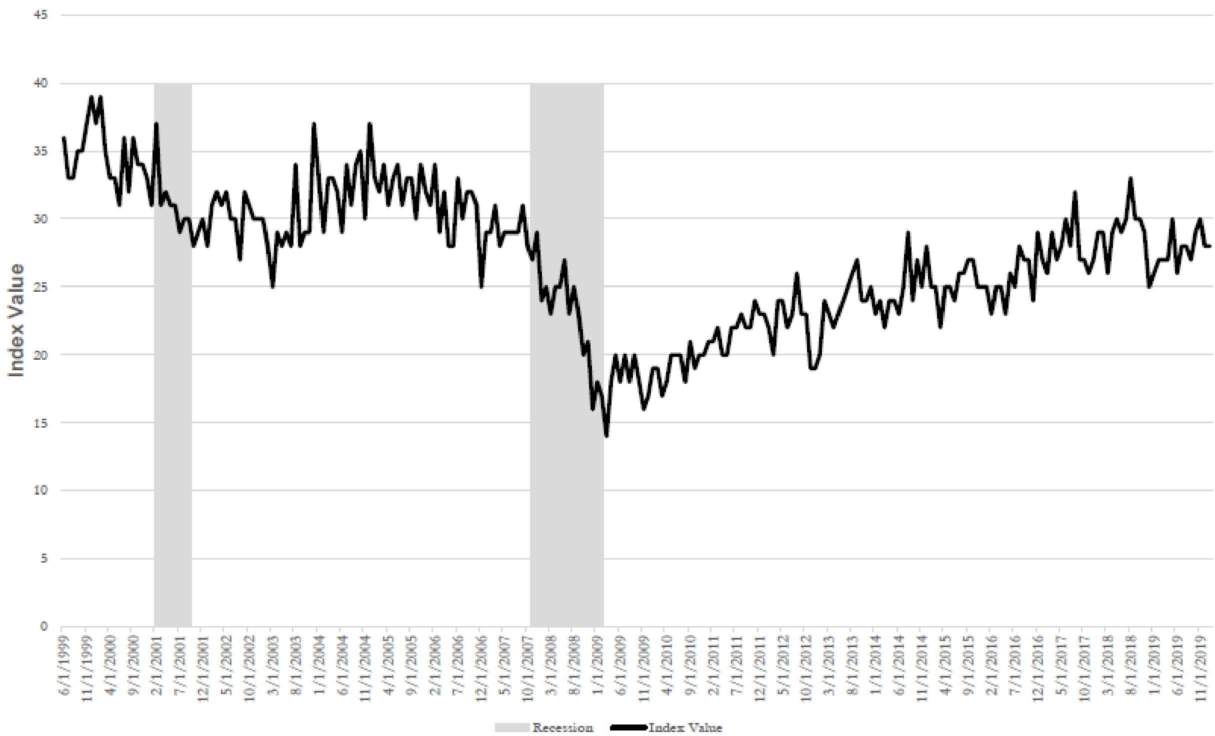


Jeff: Shifting to business, even as we looked at consumer sentiment, we try to keep an eyeball on how businesses are feeling. One of the ways we do that is with the Small Business Optimism Index that is produced by the National Federation of Independent Business.

The latest data point on this chart is January of 2020. Again, the grey lines are the recessions. Small business optimism tanked through the recession, recovered somewhat through about 2016, took a big step up post-election in 2016, and has now given some of that back. So apparently, small businesses were feeling pretty good coming out of the election. I suspect that this step down is due to the trade war that we initiated with China, and that was running hot and heavy in 2018.

So kind of two steps forward, one step back kind of a picture. Not clear if the next step is going to be down or up, and it's entirely possible that the election has a lot to do with where that goes. I'm not going to try and predict it, however.

NFIB Small Business Capital Expenditure Plans
Jun '99 - Jan '20



Data source: National Federation of Independent Business (NFIB) via Bloomberg.

Last data point 1/31/20

Jeff: We also look at, as we did with the consumer, if they feel good, are they spending? And the short answer for small businesses in terms of capital expenditures, which is what this chart is, is no, and they haven't been, and we've been telling you that.

And this is small-business CapEx plans, and it's a survey asking small businesses what their CapEx plans look like for the next 90 days. You can see that it tanks in recessions. Usually, it recovers, so it recovered a little bit in the aughts and was fairly stable, and coming out of the '09 recession, recovered a little bit, and maybe a little bit more, but never got to the level that we saw during the early 2000s. So capital expenditures by business, in this case, small businesses, have been slow throughout this expansion, which is a big part of the reason why this expansion has been weaker than normal.

Tony: So, Jeff, I'm curious why we spend the attention on small business versus, say, larger-cap or more established businesses? Is there a logic to that?

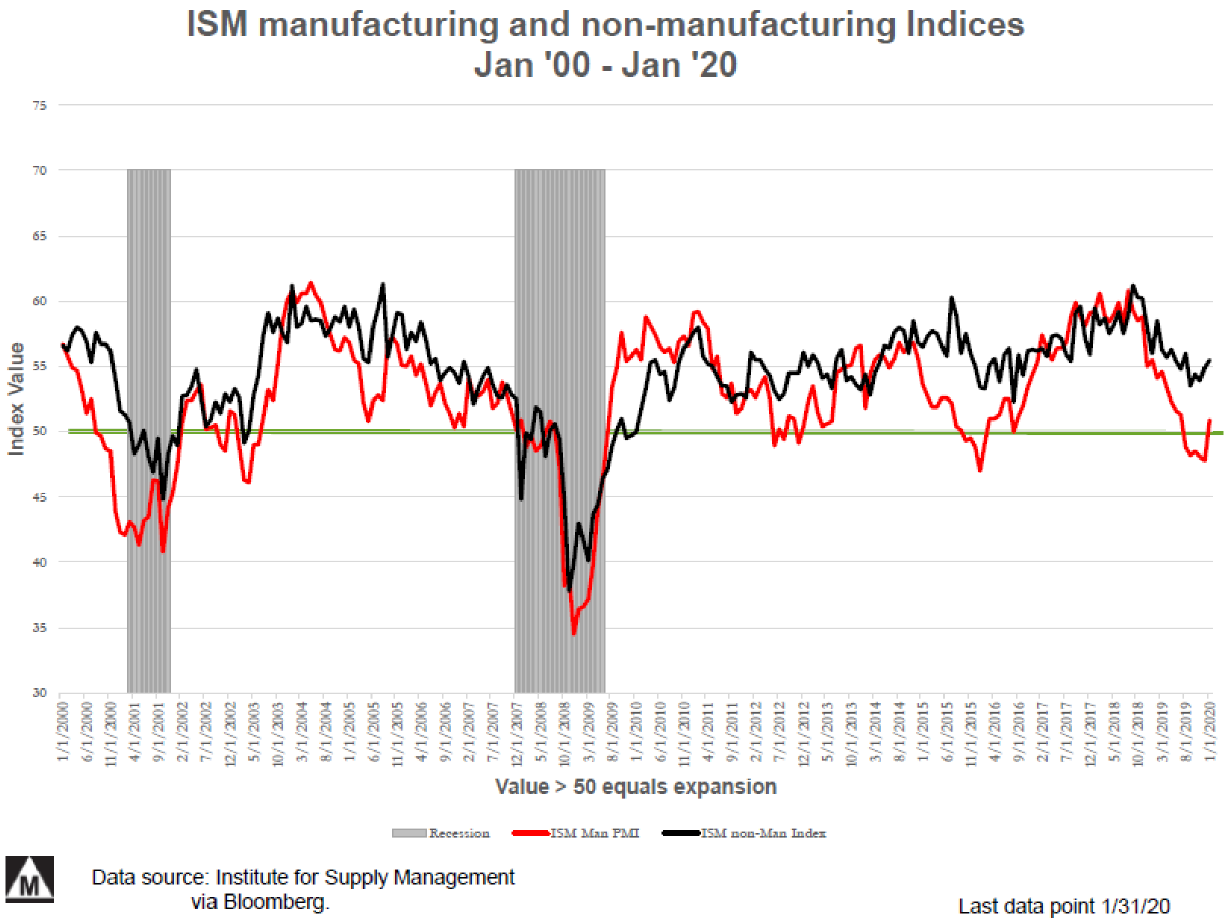
Jeff: The small businesses tend to be more sensitive to change.

Tony: Okay. You get the swing ends with them.

Jeff: So they just tend to be more sensitive. It's a more useful indicator. And don't misunderstand what this thing tells you. This doesn't mean that nobody has been spending on capital expenditures, right? In fact, in some sectors CapEx has been very strong. So if you think about Amazon spending on warehouses, or Amazon or Microsoft spending on data centers, or U.S. natural gas pipelines spending on additional pipeline capacity, those sorts of things, that has been pretty strong throughout here. What has been particularly weak, of course, is things like retail space, so some sectors are pretty good. Some sectors are pretty weak. In the aggregate, this kind of paints a picture for you. It helps illustrate what we see going on.

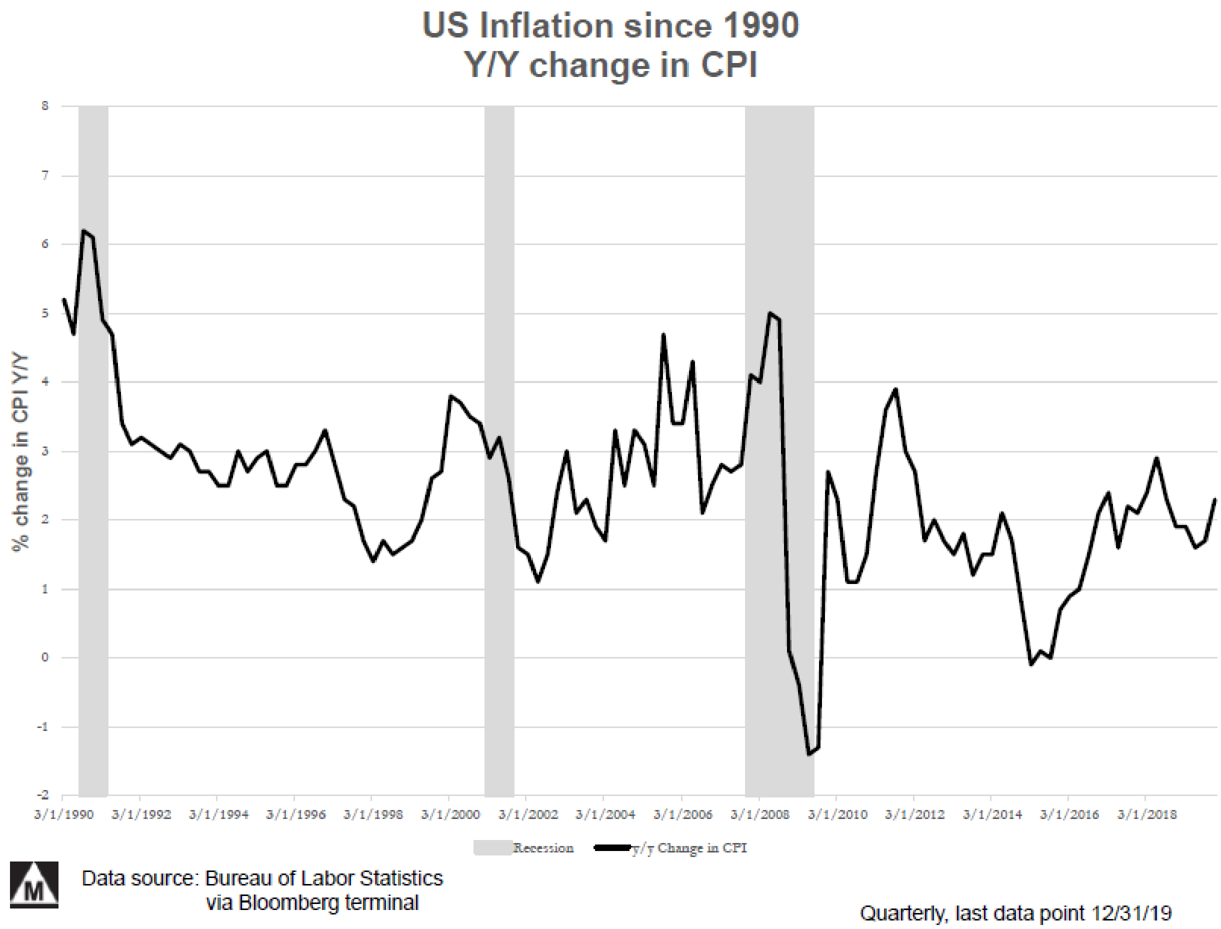
We don't throw up for our audience here today everything we look at, but we try to present charts that speak to the point or the conclusions we've come to in looking at greater data sets. So this is not the only reason we think capital expenditures have been low. But this illustrates the point very nicely without giving me 6 or 7 or 8 or 10 charts.

Tony: Gotcha. Good. Thank you.



Jeff: We also keep an eye on the manufacturing and non-manufacturing indices produced by the Institute for Supply Management. They conduct a survey every month of all sorts of businesses and then categorize it depending on whether they think they're manufacturing or service oriented. The manufacturing index here is in red. You can see that it's significantly more volatile from the non-manufacturing index which is in black. Then the green line here is the 50 level. Anything above 50 is considered an expansion; below 50, that those businesses are in contraction.

You can see that clearly, both the non-manufacturing and the manufacturing dip below 50 during the recession in '01, in 2000, 2001 and in '08, '09. Since the last recession, we've had the manufacturing index dipped below 50 now three times, while the non-manufacturing index has remained above 50 throughout. Most recently, both of them were declining up until about last quarter, and then you've had a little bit of an uptick in each of them in the last two or three months or so. So the decline was concerning, and people were starting to suspect we might go into a recession. That is illustrated, if you will, not justified necessarily, but illustrated by the decline in the manufacturing index. And then, the little uptick we've seen is a little bit heartening, but not yet definitive. But it gives us reason to believe that things are getting a little better as opposed to continuing to get worse. So, I would argue that this indicator is a little bit more positive than it was a quarter ago.



Jeff: Shifting now to inflation, we like to keep tabs on inflation as long-term investors. We think of inflation as a decline in the value of your dollar usually over longer periods of time. So that helps keep us informed of what's going on with the purchasing power of our dollar. Sometimes, when you look at things on an inflation-adjusted basis, you get a very different picture than if you don't adjust for inflation. We like to look at things both ways.

This is a chart of U.S. inflation as reflected by the consumer price index going back to 1990. We use quarterly averages in this chart, not monthly averages. So the numbers are just a little different if you looked at it monthly. The last reading here is 2.3%. So a quarter ago, we told you it was 1.7%, and in fact, it was. It's jumped up to 2.3%. The Fed's target is 2%, although they look at a slightly different measure of inflation than CPI. The last time Wall Street started to get concerned about inflation and you started to read about it more in the Wall Street Journal and in the mainstream newspapers was when it hit about 3%. Based on that, my expectation is people will ignore inflation until we get the 3% again. And if it does hit that level, you will start to hear a lot more, and in fact, people may start to price inflation into bond prices and stock prices and those sorts of things.

We'll talk about it a little later. But one of the things that would kind of upset the current apple cart is if inflation ran up today to such a level that the Federal Reserve needed to address it. And so they started raising interest rates because of the inflation that was coming. That would be a change in what they're doing that would force them to change what they're doing, and that would get the attention of the markets I'm pretty sure. But my guess is that you don't even start hinting at that until you see inflation of about 3%.

Thinking longer term, because we try to put a line in our little chart there, what do we think the future looks like. So when I think about the future of inflation, I think about inflation longer term. I'm personally unable to come to a conclusion about whether I expect higher inflation or not. I used to think Milton Friedman had it right when he said, "Inflation was always and everywhere a monetary phenomenon." Unfortunately, what's happened over the last 10 years as all of the central banks have desperately printed money seeking inflation and have yet been unable to achieve their targeted inflation makes me question whether what Milton Friedman had observed as true in the past was still true. So I'm a little but doubtful that that is an adequate explanation for inflation at least going forward.

When I think about it, it seems to me that every product or service that people buy is a combination of both labor and energy. And when I think about what's happened with labor over the last 30 or 40 years, when the Berlin wall came down and when China rejoined the global economy, suddenly, you had a vast amount of cheap labor that was re-integrating into the global workforce. And so for a period measured, in decades, in my opinion, that cheap labor kept global labor prices low. It was very hard to get wage increases in the United States because it was so easy for U.S. companies to start outsourcing some of their production, or some of their services in the case of call centers in India, to lower-wage countries. But that is pretty well done. So what we saw in '09 and '10 as companies were talking about where they were going to build the next plant, they didn't say, "We're going to put another plant in China to feed product back to the United States." What they said was, "We're going to put another plant in China because the incremental demand is in China." Probably the most recent example of that is Tesla. Tesla's just built a new factory in China, not to send cars back to the United States, but to sell cars in China. So I think that strong headwind for wages, if you will, that had been present for so long is now gone. I don't think it's a tailwind, but I think it's the absence of a downward pressure on wages globally.

When you tie that in with the renewed uncertainty from a business perspective in terms of the viability of a supply chain that stretches all the way across the Pacific, you've now had two things that have made companies in the United States very nervous about their supply chain. The first was the trade war, and the second now is the Coronavirus. So while there used to be a lot of good reasons to move your supply chain overseas to cheaper locations, there are now fewer and fewer good reasons to do that, and I can think of those three.

So, my suspicion going forward is that it's going to be a lot easier for wages to grow in the developed countries than it had been for the last 10 or 20 years because of those pressures. So that would kind of be, in my opinion as I think about it, a pro-inflationary change, if you will. Kind of a subtle, in the background change, but something that had kept a lid on inflation is now gone, so inflation, particularly wage inflation, is going to be more possible. On the other side, though, if energy is embedded in everything that we consume, whether it's a good or a service—and I think you can argue that it is—I think there are some pretty strong reasons to think that energy is going to remain cheap on a global basis going forward. And those two reasons really are fracking, not just because it's made oil cheap, because it has unlocked an enormous amount of cheap natural gas. And then, of course, the developments in solar and wind power: there was an article in the Wall Street Journal about a week ago, they put in this big solar plant in India and without subsidies it was as cheap to do that as it was to put in a new gas plant *in India*.

Now, couple things to note, right? The cost of labor in India is not the same as the cost of labor in the United States, and the cost of natural gas in India is not the same as the cost of natural gas in the United States. But the point being: in the last decade now you've got two more sources of energy that are cost-competitive that had not been cost-competitive before that. And solar continues to get cheaper. Wind continues to get cheaper even without subsidies. Natural gas is probably going to stay about as cheap as it is. So when I look at it, and I look at those two factors, I'm unable to come to a conclusion. And perhaps the answer is really kind of a mixed bag. Perhaps what you're going to see is inflation in products and services that are labor-intensive, whereas you're going to see no price changes or even deflation, if you will, in products or services that are energy intensive and that's my suspicion. But when you ask me what is my outlook for inflation, the short answer is, "I'm not sure." There's more to why I'm not sure than just that. And that's kind of the thinking behind it.

Tony: So there's counter-pressures, or countercurrents.

Jeff: In my opinion.

Tony: There's crosscurrents.

Jeff: So really, two things to take away, I don't think the answer that we were given on what causes inflation 10 years ago, I don't accept it as valid.

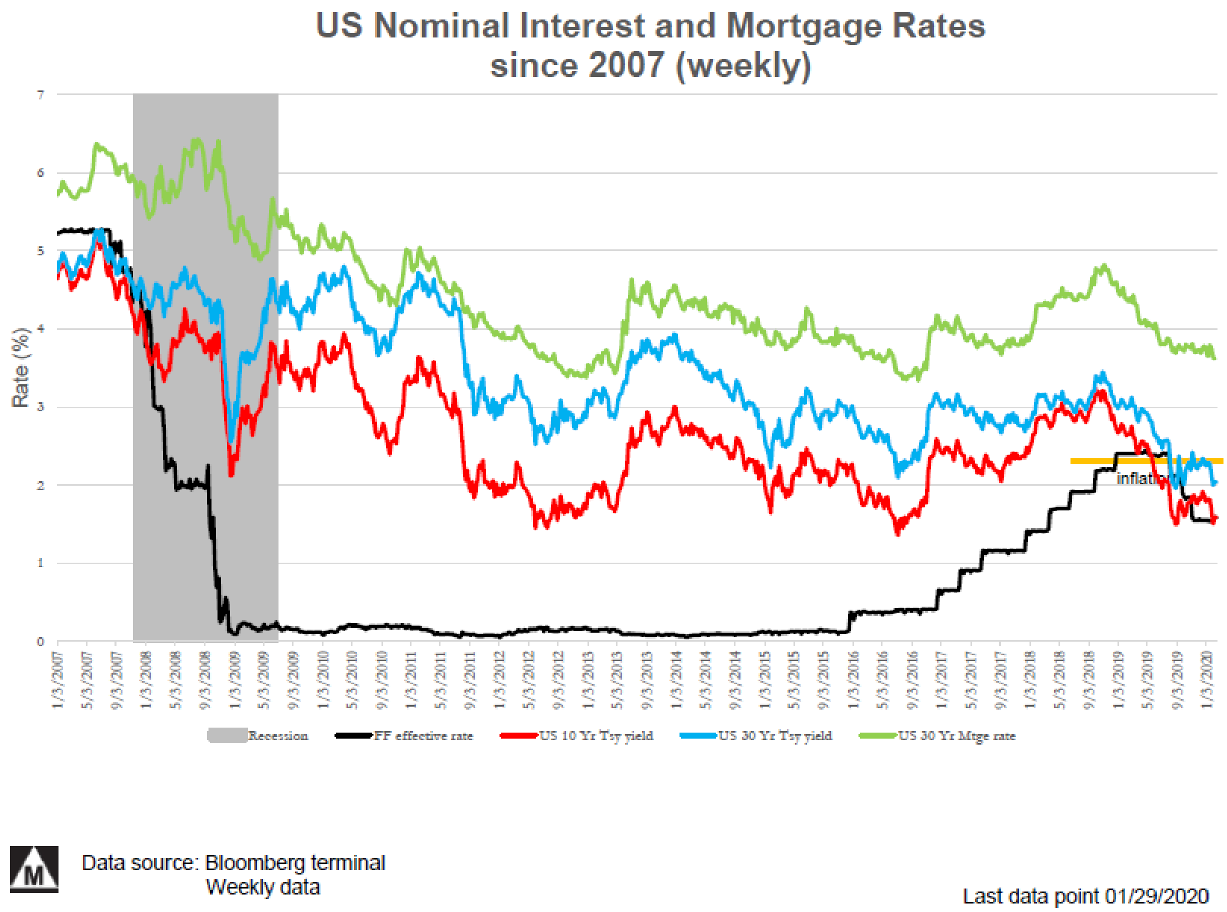
Tony: Or it's not the only answer, certainly.

Jeff: I'm just questioning it because of the last decade worth of data.

Tony: As well you should.

Jeff: And then when I try to think it through from first principles, if you will, that's kind of my thought process. So I struggle to come to a strong conclusion, so I will limit myself to simply observing we've got about 2-2.5% inflation. Recently, it's been on an uptick, and so far, the bond markets (and we'll talk about this next) have not cared. Do you want to talk about that anymore, Tony?

Tony: Other than to say, I guess we'll have to wait and see, which people hate, but sometimes, the best answer is "it depends."



Jeff: Well, and if you can't predict, the least you can do is recognize what's right in front of you, which brings us to interest rates. This is a chart of select U.S. interest rates since 2007, from bottom to top. The bottom, you've got the federal funds rate. That's the rate at which the Fed will lend to banks. It is set directly by the Fed. You can see that they took it down in three steps last year. It's at 1.5% now, give or take. In red here is the U.S. ten-year treasury rate. It peaked recently there in 2018 and has now come down steadily, had a little bounce, and is down at essentially all-time lows again. In fact, I think today, it is setting an all-time low at 1.3%. The 30-year here in blue is at 1.8%.

Tony: Good lord.

Jeff: And the green line here is the 30-year conforming mortgage, which is about 3.6%. In gold here, I put the 2.3% inflation figure from the last chart. I didn't tell you what it has been this whole time period, but the highlight is that all treasury yields are lower than the rate of inflation, right? That's the highlight here. You've also got to highlight that the ten-year is, once again, below the Federal Funds Rate, so you've got a bit of the inversion of the yield curve as you've seen these long rates come down through the short rates. So typically, what happens is the Fed, to fight inflation or to slow down the economy, will raise the short rate through the long rate. That's when they're intentionally trying to slow the economy. That's not what happened this time. The long rate has fallen through the short rate. For a period of time, the Fed was able to catch up and drop rates and get it back down below there. They're behind the power curve again. Now, Wall Street, frankly, is suspecting that they're going to drop rates further, and I would not bet against that. My guess is that they will be forced to drop rates further because they have no interest right now in slowing the economy because inflation remains at or about their target, which goes back to the statement I made on the last chart. If inflation goes higher—and my guess is 3% is when they're going to start worrying—it may force the Fed's hand into raising rates to fight inflation which would be a problem for the bond market, for the stock market, and probably for the economy.

Tony: Jeff, if I can jump in, we had a question on it. So I had the same question. Do I recall accurately that recent recessions have all been preceeded or accompanied by an inverted-yield curve, but not all inverted-yield curves lead to or accompany recessions? Is it something like that? I mean, it's an indicator, but it's not 100%. Because you can get inverted-yield curves without an accompanying recession, right?

Jeff: Well, one, when you talk about yield curves, there are certainly different ones. Some people like the 10-year versus the 2-year. Some people like the 10-year versus 3-months. When you talk to different ones, it makes a little bit of a difference. Conventional wisdom is it's got a really good track record for anticipating recessions ever since World War II. The question is (and it's a legitimate question, and I don't know the answer) is it different this time because the Fed didn't raise short rates through the long rates, but in fact, long rates fell through the short rates.

Tony: There's two ends of that curve that can move.

Jeff: Correct. And so you have to say, "Well, does that make a difference?" And the answer is, "I'm not sure."

Tony: Wait and see. It depends. There we go again.

Jeff: I'm not sure. Because there are other things going on.

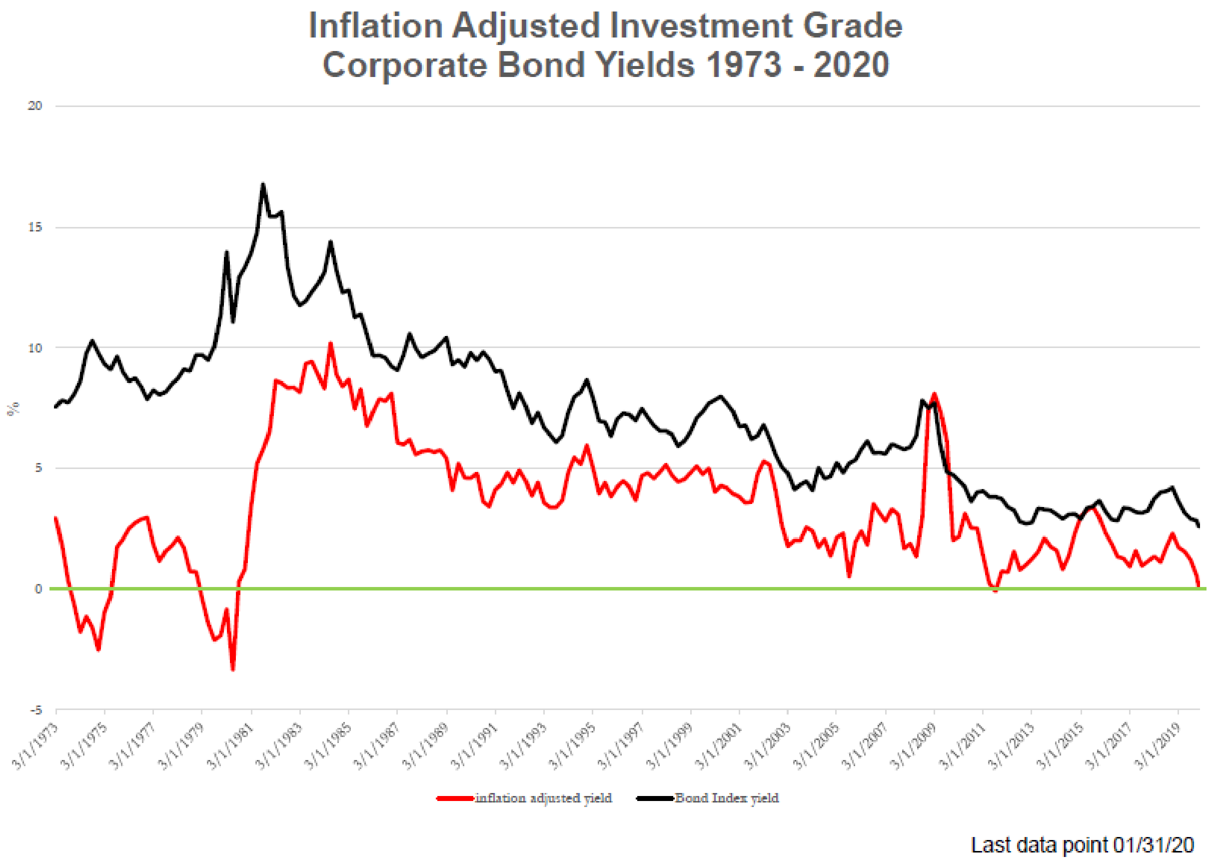
Tony: For example, inflation is another thing that goes on that can have impact on this, right?

Jeff: So is that a worrisome data point? Yes, it is. And I think I'd be foolish to say, "Oh, of course, this time was different." I think that's the foolish answer.

Tony: It's also foolish to say, "This time is the same as every other time."

Jeff: That would be safer but may not help you either. But certainly, to me, the inversion of the yield curve, we had it three or six months ago. We're right there again. It's a worrisome indicator, and it's in our books that way. That has our attention.

Tony: So it’s one of the reasons we pay attention to it.



Data source: Bloomberg terminal and Muhlenkamp and Company
Bond index is Bloomberg Barclays US aggregate corporate yield to worst (LUACYW), inflation factor is US CPI

Jeff: So we haven't talked about investment-grade bond rates, but we're going to do that now. This is a plot of an investment-grade corporate bond index in black going back to 1973. And that same index adjusted for inflation as measured by the CPI in red. What does this tell us? Back here in the mid-'70s and again, in the very early '80s, you actually had corporate bond rates that were lower than the rate of inflation. That's the green line here. That's the zero balance. So if I take my corporate bond rate and subtract inflation in, it goes negative. That's what I've got here. It pays a company to borrow money because they can pay it back with a currency that is worth much less than they borrowed, right? So it's actually paying them to borrow, which is kind of an anomaly. So we've had two instances here in recent memory: One's in 2011, and again, today where the real cost of borrowing money for that investment-grade company is zero. Right? So they could borrow it at 2-2.5%. Inflation is 2-2.5%. So assuming that their revenues and their earnings keep up with inflation, it's costing them nothing to borrow that money because they're paying it back with literally "worth-less" dollars. So that's kind of first highlight.

I will highlight to you that bond prices are the inverse of bond yields. So when we say bond yields are near their all-time low, another way to say that is bond prices are near their all-time high. And the last time bond prices got higher than this, bond prices collapsed when yields ran up in the early '80s and [Paul] Volcker beat inflation, right? So this is when you lose your butt, so to speak, in bonds (1981 to 1983). This is when you're making money in bonds (1984 – 2009), and you're set up here (2019) at a pretty high price, not the highest price ever, but a pretty high price in bonds. So even as the company can borrow at essentially no cost after inflation, if you're on the other side of that, if you're the lender, you are lending for no return after inflation. And why do I mention this? Why do I bring this up? I was at a dinner the other night from a financial adviser who wants me to work with him, and he had 20 to 30 of us couples out there, and he's giving us his pitch. It was a nice dinner, and he did a nice job. But one of the things—he shows up a slide of the Titanic, and he says, "Everybody on the Titanic thought this was the safest place in the world, and they were completely oblivious to the idea that that night, they might go swimming in freezing water." And he was relating that to the stock market, and he was suggesting that you should not be oblivious to the idea that there are risks and hazards in investing in the stock market.

And then, it occurred to me that that was not, in my opinion, a really great analogy, because in my opinion, everybody in the stock market really, really understands that the stock market might go down. I think they know that. I don't think that's a surprise to anybody. But I could be wrong. But the one market where nobody has any experience with losing money…

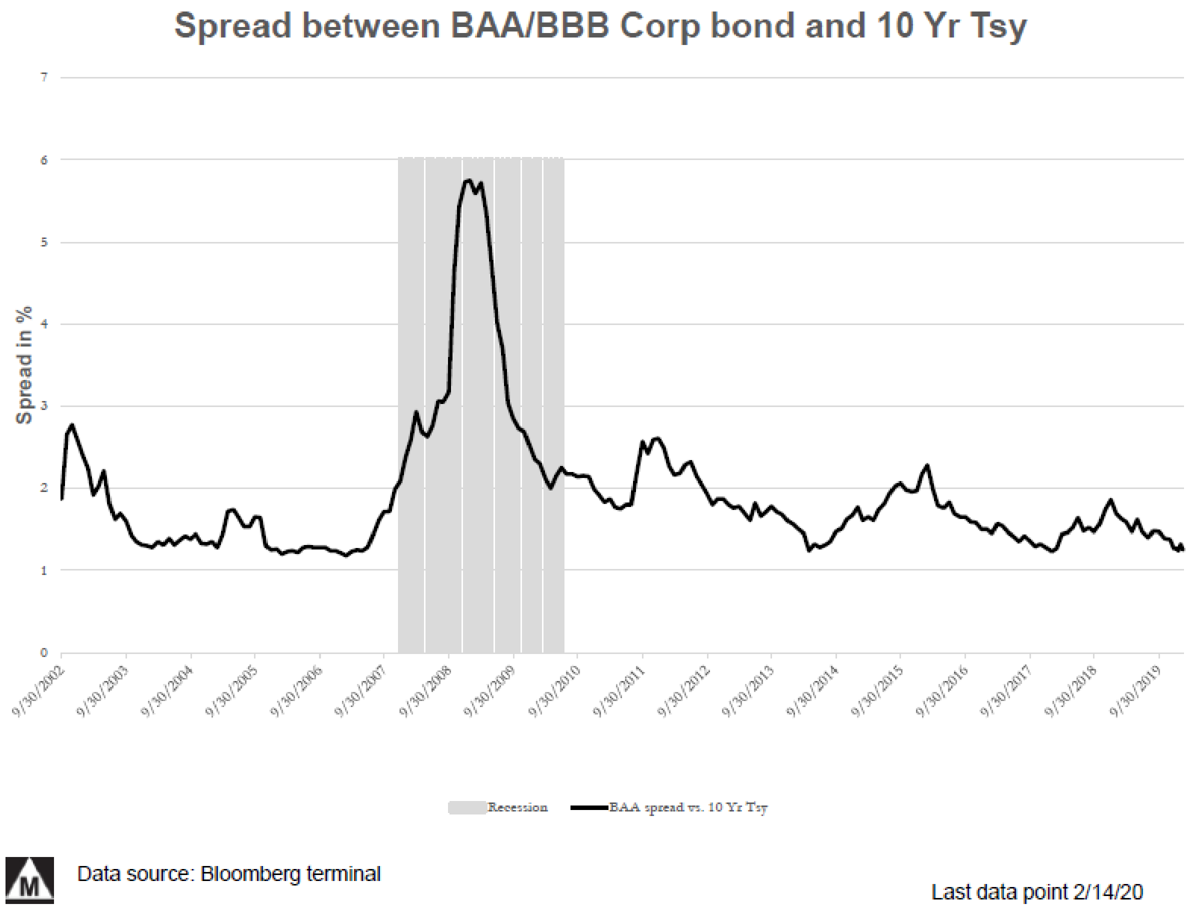
Tony: Since 1970-something.

Jeff: Since 1970-something is the bond market. So what I'm highlighting to you today is that if there's an unrecognized risk that people are oblivious to, it is in the bond markets not in the stock markets. I think people understand the risk of stock markets. I don't think they have a visceral understanding that they might lose money in the bond markets if either inflation goes up or interest rates go up. Interest rates are lower than they historically have been relative to inflation. So even if inflation stayed the same, it would not be abnormal for interest rates to go up from here on the order of 3 or 4 percent, right? So if inflation is 2%, the 10-year, historically speaking, ought to be on the order of 5%. Well, that's 4% above this. And if the 10-year went up, if the yield went up 4%, the price of that 10-year bond would decline on the order of about 25%, which I think would surprise a lot of people. So there are good reasons to be invested in bonds, but if you're invested in bonds for the long term, which is to say that you have long-duration bonds, you should be aware that if interest rates move up, you can lose money in the near term.

Tony: If you read Dad's book [*Ron's Road to Wealth: Insights for the Curious Investor*], he's commented on this numerous times. He got into the business in 1968. Well, by the late '60s, everybody knew things, for sure, about both stock and bond markets, it was guaranteed. Everybody knew it. And by the end of the '70s, all of those suppositions had gone bust, including—so the 7% Treasuries that clients owned in 1970 were now 50 cents on the dollar by 1980. And they were known as certificates of guaranteed confiscation. It can happen. It has happened, but it hasn't happened since 1980, and that's 40 years now.

Jeff: And I'm simply worried that people are making an assumption they don't understand they're making. So don't misunderstand. I think I may be even beating a dead horse here. I'm not calling for higher inflation. I'm not calling for higher rates. I'm simply saying, one, I'm telling you I can't predict them very well, but two, I want to make sure you understand if interest rates go up, the bond you hold will lose its value, that price will drop. And I want to make sure that you guys understand that so you're not making assumptions that comes out to bite you in the butt later on.

Tony: Ask me sometime how the assumptions I didn't know I was making came back to haunt me. It has a lot to do with enlisting in the Marine Corps. But that's a story for another time. So please give me a call, and I can lay that out for you in detail.



Jeff: One of the other things we keep an eyeball on is the spread between risky bonds and safe bonds. In this case, we're using a chart of the spread between Junk bonds, that's BAA, BBB, and 10-year Treasuries. The shaded part here is recession. What you see is a pattern where when lenders become worried about the return of their money, they insist on higher yields for those risky bonds relative to the safe ones. So that spread blows out. And that's very clear in the recession.

You've had three occasions where that spread has gotten relatively high. Back in 2011, when it looked like we might re-enter a recession, here in 2015, if you remember that's when the price of oil went from 80 bucks to about 30 bucks, and a whole bunch of exploration and production companies struggled to pay their bills, and then you've had one here in 2018. Currently, this spread is not giving you any kind of concerns. So this spread is about as low as it's ever been. And so our expectation is if lenders start to tighten up on their willingness to lend to charge a higher price for that lending, this will expand back up. That would be a warning sign. And my point to you is this is an absence of a warning sign here, so this is a good thing.

Our Checklist:	What we observe as the Current State:	Future Outlook:
1. Consumer Spending	Good	Impact of COVID-19?
2. Business Investment	Weak	Impact of COVID-19?
3. Credit Default/Bank Health	Auto Loan and Credit Card Delinquencies trending higher	Gradual degradation
4. Inflation	CPI 2.3% y/y	Unsure
5. Federal Reserve and Treasury	Federal Funds rate cut 3X, expanding balance sheet	Additional easing more likely than tightening
6. Trade	US and China "Phase 1" deal signed	Won't be an issue until after election and Corona virus crisis subsides
7. Europe	Brexit officially done, but … ECB restarts asset purchases	German recession?
8. U.S. Election	Democratic Party primary underway	Potentially disruptive
9. China	COVID-19 virus spreading	Disruptive

Source: Muhlenkamp & Company, Inc.

Tony: Where's that leave us?

Jeff: Where does that leave us? A lot of things have not changed, right? **Consumer spending** is still pretty good. **Business investment** is still weak. We've got reason to be very uncertain about what that looks like in the next months, depending on what happens with COVID-19. I think we've got a couple of questions. We'll answer them later.

Tony: Could you address that a little up front, too?

Jeff: What COVID-19 is going to do around the globe is very much an unknown, and I don't pretend to be an expert on it, but we'll give it a shot here in a little bit. **Inflation** is starting to tick up again, and the bond markets aren't reflecting that, right? So if you think back to the couple of charts we had on interest rates, the interest rates are coming down even as inflation is going up. So the bond markets are not paying attention to inflation at the moment. They're probably paying a lot more attention to, "Do we think economic activity is going to slow based on the Coronavirus?" The Coronavirus will pass at some point, and the bond market will start to pay attention to inflation at some point. I just don't know when.

We talked about **trade.** We talked about Brexit. Don't really have too much interest in talking about the election, other than to say that what I've observed particularly in the last week or two, as the relative strength of the different candidates in the Democratic Party changes, the stock market starts to pay more attention to the platforms of those candidates. So when Mr. Biden was in the lead, then they were looking what his platform was, and they were saying, "Okay. What are the odds of that getting enacted?" Well, now that Mr. Sanders leads, they've taken a different set of platform planks, and said, "Ooh. That's a little more likely than I thought it had been." So when he talks about government healthcare, it shouldn't surprise you that all the health insurers go down, now that he's leading in the polls. When he talks about ending fracking his first day, it shouldn't surprise you that energy companies have tanked, for instance, because market participants are adjusting their calculations on how likely some of these things are to come to pass. I think that's what's going on.

Tony: So if you do want to talk politics, give me a call. I will start by saying, in general, we look favorably upon policies that help promote and regulate free markets. And we'll leave it at that.

Jeff: Talking a little bit more about the market, in my opinion, there are a number of categories of stocks that are still very expensive. Growth stocks, particularly disruptive growth stocks, are still quite expensive. Very safe stocks, so utilities, consumer staples, REITs, for example, are expensive. And to a fair degree, they trade along with bonds. So when I tell you that bonds are expensive, have historically low yields, that means have historically high prices. Well, the bond equivalents out there in the stock market exhibit the same characteristics. They're very expensive, relative to how they've been valued historically. So those strike us as very expensive.

Tony: And that's important to us, folks, because we sincerely believe, think, and know that you can turn a good company, a good asset, a good piece of property, almost any asset—you can turn a good asset, a good company into a bad investment if you pay too much for it. And a lot of what drives markets, of course, is emotion, whether it's fear or greed, and those things can lead to prices both too high and too low. So we agree with Thomas Sowell, "Price always matters." And we're just pointing out is, a lot of things are high here.

Jeff: But not all.

Tony: But not all.

Jeff: So healthcare, for instance, as a sector, is probably fairly valued. The industrials, as a sector, probably fairly valued. You can look inside of those sectors and find companies that are expensive, and you can find ones that are cheap. But what you have to be careful of, anything that people suspect might be disrupted—they're cheap, and they may well be cheap for a reason. So you really got to dig into those. For instance, the assumption is, I think, that electric cars are the wave of the future, and that's why the market cap of Tesla is greater than the market cap of both Ford and GM, right? Tesla's the future, and the internal combustion engine is going to disappear from the face of the earth. So Ford and GM, which are tied to the internal combustion engine, are worthless.

Tony: That's a good narrative. I've read that. Yeah.

Jeff: That's, in my opinion, the narrative that is reflected in the stock prices of Tesla, Ford, and GM. So if you're going to buy Ford and GM because boy, they look cheap, you've got to have strong reasons why you think that narrative is not going to play out the way people expect it to.

Tony: Or how they can overcome it or something, yeah.

Jeff: And you have to think that, frankly, you're not going to see any profit from your investment until the narrative fails. Right. So there's going to have to be something that's going to have to change people's mind about what the future looks like. But I would argue, I've heard a lot of folks say, "The future of transportation is electric and shared and networked." And now, I have some reasons to be skeptical of a couple of points there. But there are a lot of companies like that. Right. There are a lot of companies like that. There are a lot of retail companies that look really cheap, and you got to really think, Okay, in the "Age of Amazon," which continues to grow its revenue faster than about anything else in retail, are they going to survive? Are they going to return to their historical levels of sales and profits and those sorts of thing?

So there's a fair amount of disruption, and it's real. And in betting on the cheap ones, be careful, because some of them really are value traps.

Tony: Oh, and the problem with being the value guy is sometimes, companies are cheap for a reason…

Jeff: …and you try not to miss it.

Tony: To extend that, everybody knows that the key to real estate is location, location, location, which means you have to be a real estate picker. We've all heard the phrase, "A stock picker's market." You got to pick stocks, which is what we think is true. We're also cautioning that, in our opinion, it's a bond picker's market or a muni bond picker's market. You just can't own bonds or munis. There's probably no sector or asset class across the board that we think you can own without paying attention to what's a constituent part and why do you want it and what's the price of it. So that's kind of an overall general "Be careful out there" from Hill Street Blues.

Jeff: So materials are cheap. Energy is cheap. I think I've said this before, energy is in the bust phase of a boom-bust cycle. So investors poured a ton of money into fracking and natural gas and oil, and that create a lot of supply, and that supply has now come online. That's part of the reason oil is so cheap, natural gas is so cheap. And so it's probably early days to be thinking about investing in energy though there are a couple of various (companies) that are more volume-dependent than price-dependent that are of great interest to us.

Tony: And I'm going to go ahead and make a commercial and say that's part of the reason people hire us, is to be careful of those things for them and help them navigate those waters. So there's the end of the sales pitch.

Jeff: So that's kind of the picture we're seeing. And one of the questions we received ahead of time is: "Given that tech is so expensive, why is your exposure to tech keep going up?" Well, the answer is because tech has gotten expensive.

Tony: We bought it fairly cheap. Or fairly.

Jeff: Correct. The last time we actually initiated a purchase, did a new buy in tech, was in early 2019. And other than that, we've been more sellers than buyers for a number of years, but we bought Microsoft, for instance, when it was a no-growth cash machine. And then they got a new CEO who found a new product cycle that has taken off like gangbusters, and now, Microsoft is trading at 30 times earnings and has grown at 15 or 20 percent a year. And at 30 times earnings, yeah, it's fairly valued, maybe a little expensive, and I'm not willing to put new money down, but man, as long as it's ripping, I'm probably ahead to ride it a little bit. But no, we haven't put new money to work in tech, particularly software in tech is very expensive, and the disrupters are expensive.

Tony, with that, I guess we're onto the question and answer portion.

Tony: We are. We are indeed. And we got a good question here, and I'm not entirely sure we'll be able to do this question justice, but we'll bring it up. "Inflation is killing me. I have a fixed income. I cannot make any more money, and my savings does not pay, and my country is not interested. What can I do?"

Jeff: That's a good question.

Tony: That *is* a good question. And that's a question, quite honestly, that a whole lot of people have been asking. And one of the reasons that we're seeing bonds are too high—bonds are high, people have been bidding up the things that they think will solve that question, that problem for them, so dividend-paying stocks, utilities, investment-grade bonds. Those things have all been bid up to prices that we think are unsustainable. So the short answer is (And I'm not sure the country doesn't care. It just assumes that it'll do other things, but that's a whole other conversation) what we've been helping our clients do with that, is reframe the question about income and fixed income. And we think in terms of assets and spending money, and can we grow your assets to generate cash flow to support your spending needs. So what can *you* do? Frankly, we'll sit down and talk with you about what you've got going on individually and privately because there's no one good answer for everybody. But if you can reframe your thinking from principle and income to assets and growth and cash flow, then there are some things available to you. But it does sometimes require a change of mind, which we all know is the hardest thing to do, especially after you've been successful for however long.

How's that? What do you think of that, Jeff? Is there more? Less?

Jeff: One, I would caution our listener against investing for income. I think you ought to invest for total return. That's something that Ron’s said forever. That's what makes sense to me. If you have returns, you can turn that into spending money, call it income if you want. That's not a big deal.

Tony: Cashflow.

Jeff: Cashflow. Income and capital gains. That's an IRS thing. There are places that are out of favor that look very attractive, some of which are not as appropriate for most of our clients as others, but for instance, we own pipeline companies. For most of our clients, we own it through an ETFs. So they own natural gas and oil pipelines in the U.S. They have restructured themselves over the last two or three years. They have reduced their capital expenditures so they can live within their own cash flows because as they became out of favor raising equity capital became too expensive. So a number of them are now growing their revenues, growing their distributable cash flow in mid-single digit kind of numbers. They're raising their dividend every quarter. They're yielding about 6 or 7 percent. And those are the best run of them, and the ones that the market is even more concerned about are yielding between 10-14%. So simply, again, I tell you what the yield is just to kind of give an indication, I'm not all that about the yield. I'm looking at the return, but man, if I can get 10 or 15 percent return off what ought to be a pretty stable business, that seems pretty attractive to me.

But you got to wonder, "Okay. What am I missing? The market clearly hates them. Why is that?" Is it because of the environmental, social, and governance movement, if you will, among investors that they hate anything that has a carbon footprint? That's possible. Is it because the energy sector in general is out of favor, and nobody wants to invest in energy of any sort? That's possible. Is it because a number of presidential candidates have said, "I'm going to end the use of hydrocarbons in the United States within a decade"? In which case, that pipe is going to go empty and the business goes kablooey. That's possible too. So there is risk in that investment. But if I'm earning a percent and a half, I don't expect there to be much risk there. If I'm earning 10 or 15 percent, maybe that return is justifying the risk I'm taking.

So from an income perspective, that's one of the ones—when I look at REITs, they all look expensive except the two prison REITs that are yielding 10%. So is that because people hate the thought of owning a prison? I don't know. I kind of like the fact that somebody has a prison. It keeps criminals off my street. But you can certainly see that someone might not want to own it and whatnot and so forth. So there are areas like that that we're finding, that are of interest to us. There are companies that are of interest to us. But there is no denying if I own an equity, it is subject to the volatility of the market, right? And we're seeing that in the last 10 days. The market's down, call it 10 or 12 percent, in probably a week, and it doesn't really seem to matter what you owned. It's as you've said before, Tony, "In a bear market, all correlations go to one."

That's what we see.

Tony: When stuff hits the fan, correlations go to one.

Jeff: Right. So if you need money in a relatively short time frame—if you need that money in the next three to five years, you don't really want to subject it to the volatility of the market. Even if I'm dead right about the long-term history of the company and what's going to happen to it and how much money I'm going to make, that doesn't mean the price doesn't drop 10% next month.

Tony: Less than three-year money belongs in the bank or CDs. Greater than five-year money, you can go into the markets, but whether it's stock, bond, real estate, liquid markets—illiquid investments is a whole other thing we can talk about, but as a good conservative, no matter what the hell goes on, less than three-year money belongs in the bank. And then you don't worry so much, and you can sleep better, which kind of takes me to the question I've been getting a lot, we just talked about a stock picker's market, but for the last decade, the index has been the place to be to the point where people have been asking me, "Why not just buy an index and forget about it?" And I have a short answer to that and a long answer to that. The last time I heard that question was 1999 at the peak of the tech market, and everybody knew all you had to do was buy tech, and it would go up. And if you couldn't stomach tech, just buy the S&P and you do two-thirds as well, but still, go up. And I won't bother to tell you what happened next.

So the short answer is, I think it's always a bad idea to buy something you don't understand. And few people really understand the mechanics and how an index or an index fund works. And even if you do, the fact that so many people are currently moving money into it for so many different reasons, the odds are pretty good you're investing alongside people who don't. So you need to have very good reasons other than it's worked lately. So the short answer is not everybody understands it. So be sure that you do it beforehand. The longer answer has to do with the second part of the question, which is, "Why not just buy an index and forget about it?" Frankly, nobody can just forget about it. I have yet to meet the person who can put their money in index fund and then ignore it for the next 10, 20, 30 years. I haven't found them because we're hardwired. There's so much work being done on behavioral finance, behavioral investing, check it out. But basically, evolution hardwired us to be terrible as investors. Because to survive, you extrapolate the recent past into the indefinite future. Well, that will kill you in the markets. Okay? So one of the reasons our motto is intelligent investment management is: intelligent is not the opposite of stupid, intelligent is the opposite of irrational. And irrationality in the markets gets expensive. You buy high and sell low a couple of times, and your investment does well, but the investor gets hammered.

So a lot of what we're trying to do with this presentation is give you the rationale for our thinking, the rational approach that we have to the markets and what we're seeing and thinking. We try hard not to feel. We didn't say we *feel* like inflation ought to or we *feel* that… Feelings are expensive. Emotions are expensive. Fear and greed will ruin a person. So the problem with index investing today, buy the index and forget about it, is a lot of people wind up buying something they don't understand, and they're not careful what price they're paying, and they can't just forget about it. Now, if you can do all those things, then by all means, and I've got no problem with it if you understand it, but just be careful. And if you're not sure if you understand it, or if you want to test your understanding, give me a call, and the odds are we'll both learn something. So I'd look forward to that. So there's the long answer.

We're right at the end of our time. We managed to answer the questions that came across. However, if you have questions that we didn't get to or you didn't think of, as I said, email me. This is Tony, tony@muhlenkamp.com. If I don't have an answer, we'll find one together. I promise you. Or you can call me (724)934-5139. Jeff, I want to thank you for your time and efforts. You put a lot of time and energy into preparing for this each quarter. I appreciate that. And I know that our audience, clients, and interested people do as well. So thank you very much.

Jeff: Thanks for tuning in, folks. Have a good evening.

GLOSSARY

Consumer Price Index (CPI) measures the prices of consumer goods and services purchased by households. CPI is used as a measure of price inflation.

Federal Funds Rate is 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.

Federal Reserve Board (informally referred to as "the Fed"), is the central banking system of the United States, created in 1913 by the Federal Reserve Act. The main tasks of the Fed are to supervise and regulate banks, implement monetary policy by buying and selling U.S. Treasury bonds, and steer interest rates.

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

REITs is an investment vehicle for real estate that allows investors to acquire ownership in real estate ventures. REITs are required by law to maintain dividend payout ratios of at least 90%.

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.*

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