

MuhlenkampWebcast

Join the conversation

June 4, 2020

Amended Transcript

Tony Muhlenkamp, President
Jeff Muhlenkamp, Portfolio Manager

WORKING THE PROBLEM: The Impact of COVID-19



Muhlenkamp & Company, Inc.
Intelligent Investment Management

5000 Stonewood Drive, Suite 300 • Wexford, PA 15090 • (877) 935-5520 • www.muhenkamp.com

Copyright ©2020 Muhlenkamp & Company, Inc. All Rights Reserved.

Tony: Good afternoon, ladies and gentlemen. Thank you for joining us today. Our webcast is a conversation between myself Tony Muhlenkamp, and Jeff Muhlenkamp, my brother, our portfolio manager here. The working premise behind this one, it's a little different from what we've done in the past, and it's the result of a couple of things that we've both been observing and experiencing. One, for the last couple of months, talking to our clients and trying to let them know and reassure them that we are here. The lights are on; the doors are open; it's business as usual, and we've been working with no problem. And that seems to be important to people. They appreciate hearing that, and they like to know a little bit more about how we're working the problems.

So today, we're going to talk about what we're doing to work the problem in light of COVID-19. And the other element of it is my daughters who are in their late teens and early twenties have been asking me when things will get back to normal. And I keep trying to come up with a good answer to that question, and what I have at this point is: A - I'm not sure what normal is exactly. If it's ever existed, I'm not sure I've experienced it. And B- I think the better question may be: What's next? And how do we prepare for whatever's next even if we don't know exactly what's next? And that seems to be a theme or a recurring question among our clients as well as, "what's going on and what are we doing about it"? So that's our premise today.

We're going to take a look at things from our perspective from 30,000 feet, and then we work our way down from there. So I want to thank you for joining us. There will be an opportunity here for you to submit questions if you have some questions, so we'll get to those. But if we don't get to your question today, please give me a call or send me an email. My email is simply tony@muhlenkamp.com, and we will do everything we can to answer you. So with that being said, Jeff, I'd like to start this by bringing up the slide. This is what we showed people in, what was it, February?

Jeff: Late February.

Tony: Late February. Our checklist of things to monitor and keep an eye on.



| 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: Thank you, Tony. Thanks, everybody for joining us this afternoon. This is what we were talking about and seeing in late February, most of which is kind of focused on can you anticipate the next recession which is important for us as investors and generally what this checklist was designed to do. Which means that today, it's mostly irrelevant because we are now *in* the next recession brought to us by the Coronavirus. So this was late February, I said that the Coronavirus, which at the time was still largely in China could be a big impact to us. I completely underestimated how fast and how big. Perhaps, it was a failure of imagination on my part because I did not anticipate Governors in the United States telling people to go home and stay there for a period of about six weeks or in some places longer. But that's, in fact, what happened. So a little bit, the way I think of this virus is a little different than the narrative you might have heard. My observation in the middle of March was that government entities were not, in fact, taking the lead in reacting to the virus. That was done by private enterprise. So if you remember the national hockey league, the NBA, certain universities on or about 16 March, were the first ones to say, "This is a problem. We're canceling all of our activities, sports leagues."

In the case of universities, who already had students on spring break, they told those students not to come back. First, they told them not to come back for a week, then very shortly after that, they said don't come back for the rest of the semester. Those few universities that led the charge set the example for the rest of them soon to follow. So my observation at the time, and it remains my observation is that government officials did



not direct our response. They responded to things that private individuals were already doing, and then kind of got on board with that. And I think that remains true now as we're thinking about coming out of the lockdowns. Really, the key question is not so much, "When does the governor let us get out of our house?" But "Once the governor lets us get out of our house, what do I then do?" Right? "How comfortable am I getting a haircut? How comfortable am I going to a restaurant? How comfortable am I flying on an airplane or visiting some tourist attraction or whatever it is that I'm thinking about doing?" That's the key element. And I think there's a feedback loop, if you will. So certainly, citizen behavior is influenced by what the governor has said. And it's primarily governors, not completely but primarily.

Even as what the governor says or does is influenced by what he's getting from his constituencies when he makes a decision, and then you get a lot of feedback, whether it's a protest, whether it's news articles, whether it's phone calls, whatever the case may be. So there's a feedback loop there, but in my opinion, the real decision maker that matters to me, it's not the politician. It's, in fact, the consumer. It's the citizen. What does he feel comfortable with? Unlike most recessions, this one happened very fast. So if you think about the 2008, 2009 recession, we had had problems in the banking industry and problems in the housing industry back in 2007. And they developed over a period of about a year to a year and a half, finally resulting in what we call the recession late in 2008. And then the federal government didn't get involved really trying to craft solutions to that problem until late November of 2008, and the recession bottomed, give or take in early 2009.

This time, we accelerated that timeline massively, and we went from having a reasonably functioning economy to being in literally the depths of a recession in about three weeks. It only took another two or three weeks for both the Federal Reserve and for the federal government to literally throw trillions of dollars at the problem. And that took the form of not only support for certain markets, in fact, many markets on the part of the Federal Reserve, as they were buying up different assets to include treasuries, commercial bonds, mortgage-backed securities, that sort of stuff, but also direct payments to citizens from the federal government, which they funded by borrowing primarily from the Treasury. That happened very, very, very fast, and that was, in my opinion, kind of unique. So we entered the recession very fast. The government took very big action very fast. The stock market, similarly, dropped 34% in about a month. So the reaction of the stock market was very fast. And then the way I think about it, primary economic activity—and by that, I mean, how many meals were eaten out, how many people are going on an airline flight, how many people are buying cars, that kind of primary economic activity bottomed in about April.

And so the market's seeing that kind of information go from increasingly bad to not getting any worse to now getting a little better. The markets have rebounded. And so from top to bottom, they were down about 34%. They've rebounded, frankly, about 34-35%, which leaves them, give or take, about 8% below the high they set in February. Right? When you drop 30%, then you go up 30%, you're still 9% below where you started. That's just the way the math works. And that's kind of what we've seen here. A lot of observers (and I would have to include myself in that category) are quite surprised by how far the rebound has gone and how fast it has been, because that does not reflect really the seriousness of what's going on in the economy. If you said, "Gee, the market's looking pretty optimistic," I'd have to agree. The market looks pretty optimistic. And when you think about the problems that we have really not yet put numbers to or gotten our hands around, it seems unrealistic, and that gives me a bit of caution. So talking about that point, what don't we know yet? I said that we know that the trough in auto sales, for instance, is behind us. And the trough in commercial flights, people flying on airplanes, that's behind us. Things are getting better. And we know how far we fell. But what we don't know is, and we'll use restaurants as an example: We know how many people are going to restaurants, and we can go to OpenTable and we can see that data. We don't know how many restaurants are going to survive.



We don't know how fast this increase in activity is going to pick up to a level to support the base, the number of restaurants that we have. And there are a lot of mechanisms kind of in the system, if you will, that incur delays. So if I'm a restaurant owner and I have to pay the rent to my landlord for the restaurant, he may have given me, because of the coronavirus, two or three months of forbearance on my rent payments. He may say, "Jeff, I know you're not getting anybody coming in the door. We'll just let things go for two or three months. We'll pick it up in June." So now, June comes around and I say, "Bob, I still can't make the rent payment." He says, "Okay. Well, you're delinquent now." And after a period of time of being delinquent and I still can't meet the payments, then it's going to be in default. And he's going to throw me out of the building, and he's going to take action to re-lease the building. That kind of delay is happening with every debt instrument out there, so whether it's your credit cards, whether it's your mortgage, whether it's your rent. No matter who the borrower is, those kind of delays are embedded in kind of turning a good loan into a default and repurposing that asset. It takes time. It takes time to do that. The key thing we don't know right now is how many loans of all those flavors are going to go into default and how many businesses are not coming back. And we won't start learning that until probably late this summer, early this fall.

So if you will, we fell off a cliff. We've stopped falling, but we don't know really yet how far we've fallen and how quickly we can climb back out of the hole we've dug ourselves.

Tony: Or how grievous the effect was or how much injury and damages...

Jeff: Correct.

Tony: ...we've actually sustained.

Jeff: You're still assessing the damage, and you will be assessing that damage—I mean, all the big banks, and they all reported their results. They're all reserving against anticipated losses, on the order of 2 or 3 billion for J.P. Morgan and Morgan Stanley and all these guys. And those are just estimates. They don't know. And they certainly didn't know back in April, before you even had an idea, when the things were going to start opening up. So people had estimated or made guesses, and I think "guess" is exactly the right word. They'll put some calculations to it, but it's all about the assumptions you make. They will have made some assumptions, and they will continue to refine those, but the fact of the matter is, right now, nobody knows how much of our business is not coming back from that and what the second- and third-order effects are. The business doesn't come back and the job doesn't come back, then the mortgage doesn't get paid and the auto loan doesn't get paid. The credit card gets defaulted on. How big is that, and does it concentrate in one certain spot, and, oh, by the way, that's a problem internationally as well, because there's a lot of countries in businesses internationally borrowing dollars.

Tony: So second- and third-world order consequences. In 2008 Wall Street created financial products, that found their way into pension plans and so on and they gave us a lot of trouble.

Jeff: Correct.

Tony: Is that the kind of thing that's going to happen again this time?

Jeff: That is the potential. Right? That is the potential. That's the fundamental piece of what's going on that keeps me kind of cautious, is you just don't know what those impacts are and where they get concentrated and that sort of thing. So when people say they're nervous about the markets because they've run so far, I kind of share that nervousness, but there's more than that. There's some analysis and there's some understanding of how debt works and how debt default and resolution works that means there's going to be a lag. So it's understandable that the markets have rebounded as the data has gone from less bad to actually



better, and yet, there is more to come that could potentially be quite impactful, and that is completely unknown now.

Tony: So let me shift gears on that a little bit. So that there's some understanding of how debt works and how bad debt is reconciled. We've had problems like these before and those solutions, but one of the things we're seeing, I think, in particular with central banks trying and the monetary policy that they're using to spur growth and recovery, is that the old solutions or the known solutions aren't addressing the current problems the way they used to. In other words, today's problems are yesterday's solutions. Historically, to spur the economy, what the Fed would do, would be lower interest rates and things will pick up. But if the economy got overheated, and they saw inflation, they would raise interest rates and slow things down.

Jeff: Let's talk about a little bit of the mechanism there. So typically the Fed would create a recession in order to slow down the economy and limit inflation. And the way they would create that is they would raise short-term interest rates above long-term interest rates, which makes the normal banking process, the lending process, which is borrow short-term and lend long-term, it's no longer economic. Because you're borrowing at a higher rate than you're lending. And so bank lending would decline, which slows economic activity. And then in order to get that going again, the Fed would engineer low short-term rates so it could increase bank lending again. So that was kind of the mechanism there of how that worked. Well, this time, sort of what happened is, because revenues for so many companies, went into freefall, all those companies drew down their lines of credit that they had pre-arranged, right? So now, these banks that thought they had a handle on how many loans they had made and what assets they were, and were comfortable, were forced by their prior commitments to vastly expand their loan book overnight. And so their ability and willingness to make an additional loan on top of that...

Tony: And remember, they're subject to regulation on just how much money they can loan out.

Jeff: Correct. So that's not limitless. And those lines of credit were drawn down, not to expand the business or to buy back stock. They were to meet payroll. Because nobody knew how long this revenue decline was going to happen, and everybody dove for cash. Nonetheless, the banks now have a massively expanded balance sheet, and they have no more ability to lend over and above what they had. So that mechanism of, "Gee, if I lower short-term rates, the banks can start lending again," is completely kablooeey, right? It just doesn't work because of what happened this time.

Tony: Right. Okay.

Jeff: And every time is a little different, but at some point, the ability of the borrower to borrow more, and to—if you think about what is it really to take a loan out and go buy something, you're pulling future consumption. Whatever it is you're consuming, whether it's a latte, or you're pulling that car purchase forward from next year to this year, but you're pulling that future consumption into the present. And at some point, you've reached the end of your ability to do that, right? And in my opinion, borrowers, pretty much globally, have reached their ability to reasonably draw future consumption into the present. And now, they're not willing or able to incur more debt to generate current economic activity. So to your point, yes, what used to work pretty well isn't working very well. And so what happened this time, really, the federal government tripled down on...

Tony: Stimulus?

Jeff: ...stimulus, and they did it differently. So instead of saying "Well, we're going to go build roads," what they said this time is, "We're going to hand money out to people who used to work yesterday." They did that.



Tony: A client mentioned infrastructure. Do we think the government should be going out and building roads? I mean, is there any talk of that? Or does that solve the problem?

Jeff: There has been talk of that for a long time. It does not solve the problem. It just doesn't. The government has struggled to figure out how to maintain their existing infrastructure base for a long time.

Tony: Now, you were talking about you run out the string of being able to pull forward future consumption, basically. Is that what Dalio talks about in his current work on the long-term debt cycles?

Jeff: So Ray Dalio...

Tony: Because he's arguing that we've kind of reached the end of a long-term debt cycle, and there's a reckoning due.

Jeff: That is his argument.

Tony: If I can cut to the real chase of it.

Jeff: Yeah. He studies about a dozen historical examples to draw his conclusion. And what he's saying is, historically, primarily, when countries borrow more than they can ever conceivably pay back, which they all do, right?

Tony: Throughout history.

Jeff: Throughout history, inevitably, people lend to them, lend to them, lend to them, and the next thing you know, they're all like, "Wow, you're never going to be able to pay that back are you?" And the answer, of course, for anybody who's really looking at it is, "You're right. We're not." And there's only two ways out of that according to Dalio. And one is that, basically, you default on that debt in the hard default, and that's kind of a debt inflation spiral—that's the Great Depression. And the other way is you devalue your currency. And he will lay out the examples in the past of, historically, when, for instance, the U.S. devalued its currency. In the '30s when we repriced the dollar against gold and confiscated all the gold in private hands. And then we devalued again in, I think it was, 1973 when Nixon came off the gold standard completely. And so Dalio is anticipating that one of those two things is going to happen in the U.S., and I think he thinks that we'll probably devalue against the value of the dollar. I'm not sure what exactly we're going to devalue it against. I have some questions, how we might actually do that? But at the very basic level, I can't disagree with his conclusion, that the only way out of this overwhelming debt that our government has is to basically pay it back with something that is worth less than what they borrowed.

Tony: That's not just our government though?

Jeff: No. That's a global problem.

Tony: And I'm thinking of Japan because I think Japan has had this problem for the better part of two decades now?

Jeff: Correct.

Tony: And how have they solved or approached or not solved the problem?

Jeff: Well, what they did was, they tried to spur their economy through government spending. And it was really infrastructure spending in my understanding.

Tony: That's right.



Jeff: I've heard they paved riverbeds, anything to just spend a little money and pour a little concrete. I don't know that that's a fact. But that's the anecdote that sticks in my mind. And then when the government debt became so large, then the central bank realized if interest rates went up, that the government would be consumed by paying the interest on its debt and would be unable to do anything else. So they started managing the interest rate. Currently, they are doing what's called yield curve control, but the central bank is actively managing the interest rate on...

Tony: Which is the price of money?

Jeff: Which is the price of debt, certainly for the federal government to where the 10-year JGB is at 0%.

Tony: JGB?

Jeff: Japanese Government Bond.

Tony: Thank you.

Jeff: So that's at 0%, right? They're doing that. And so the next follow-on piece to that is all of the government or the Japanese pensions, and there's some very large Japanese pensions in existence, of course, can no longer get a return on the bonds that they hold. So about two or three years ago, those pensions started to move their assets overseas and they sold the Japanese government bonds to the central bank.

Tony: So Japanese pension plans sold Japanese government bonds to Japanese central bank to raise cash that they could invest overseas, which in this case, is primarily probably the United States?

Jeff: U.S. and Europe.

Tony: So Japanese pension plans have been investing in...

Jeff: They have been shifting...

Tony: Shifting their asset allocations.

Jeff: ...their asset allocations more to overseas, okay? And the hypothesis by some smart guys (and Kyle Bass was one of them made that the argument a couple of years ago) was that that flight of capital out of Japan to overseas assets would inevitably show up in the currency.

Tony: Japanese currency?

Jeff: Japanese currency, the yen. So, if you think about that whole chain, what does it result in: a devalued yen.

Tony: So the bet was to short the yen?

Jeff: That was to short the yen and oh, by the way, this is what Dalio talks about, right, a solution to over indebtedness at the government level is to devalue the currency. So the question you've got to ask yourself today is, is that what happened? And the answer is, so far, no, not yet. And guys like Kyle Bass who bet against the declining yen have lost their money.

Tony: Has Dalio talked about Japan at all? I haven't seen it, but...

Jeff: I didn't see it in his writings, so I won't say that he did or he didn't, right?

Tony: But it might be interesting to ask. Whoever out there knows Ray Dalio, send him an email ask him what he thinks about the Bank of Japan. I'd be interested in his answer.



Jeff: But in my opinion, the idea that debt monetization where the debt incurred by the government is being completely funded by the central bank, that's debt monetization, right, which is what's happening in Japan. The idea that that is always inflationary, that has also not been proven to be true so far. And how does that affect how we think about the U.S? Well, right now, we're kind of doing that, right? So the U.S. central bank is lending money that it created for the sole purpose of lending it to the government, who is passing it out to all its citizens. But the question is: Is that going to cause inflation? And if I didn't know about Japan, I'd say, "Yeah, it probably will." But since I do know about the experience of Japan over the last decade, I'd have to say, "I'm not sure," which is an answer to your inflation question if you're asking it. In the near term, I think we'll probably see a bit of deflation in most things just because you've destroyed demand. But longer than that, I really don't know. There are some reasons to think you'll get inflation, and there's some reason, primarily, in Japan, to suspect that you won't. And I don't know.

Tony: Haven't people—economists, analysts—hasn't the argument been we should be getting inflation in this country for the last 10 years and haven't seen it?

Jeff: Well, not only has that been the argument but that's the stated goal of the Fed. The stated goal of the Fed was to generate 2% inflation.

Tony: We haven't gotten it.

Jeff: They really haven't gotten it. Yeah, once or twice, we get there or a little above, and then it comes back down. Something blew up, blah, blah, blah. But they have been actively pursuing inflation. And they really haven't gotten it.

Tony: And guys like Milton Friedman, the monetarists have argued, I believe, that inflation is always and everywhere a function of money supply outstripping the goods and services, that being more money than there are goods and services to soak it up. That's how you get inflation.

Jeff: And that assumes that what's called the velocity of money, which is really the speed with which money moves through the real economy remains constant. And in the timeframe that Milton Friedman studied to come up with that conclusion, it *was* relatively constant. What we've seen in the last decade is velocity has dropped enormously.

Tony: Well, it's a variable.

Jeff: And I believe it's an independent variable. But I haven't seen anybody that lays out what drives it.

Tony: So velocity of money in my layman's thinking, it's a derived number. But it's essentially how much turnaround? Am I borrowing money? Am I spending money? Am I leveraging assets? Is \$1 bill working its way through into three, four, five different transactions over the course of its period of time? And if people are taking their dollar bills and putting them in the mattress, in the vernacular, velocity gets real low, real fast.

Jeff: I mean. the velocity, as a number, comes out of an equation.

Tony: It's imputed.

Jeff: Yeah, it's calculated, right? But then it's the fudge factor between the money supply and GDP. And that's how most people think about it. And there aren't too many people that think about it as what it really represents and what drives it. The best that I've read is, it really goes up when people are willing to borrow money. And it goes down when people are socking it away. That's largely what you said.



Tony: I don't know this for a fact, but my observation is central banks think if they make interest rates low enough, if the price of borrowing is low enough, people will then start building. And what I'm seeing is that people won't borrow for the sake of borrowing, unless they have a compelling reason to, and oh, by the way, that requires some certainty. So for example, we have a client who runs some restaurants and with interest rates being low, we would ask him if he was opening new restaurants, opening new shops. At the time, the answer was no, because healthcare was up in the air; it was a total uncertainty. Taxes were up in the air; it was a total uncertainty. Energy policy regarding fracking was a total uncertainty. So he was looking at so much uncertainty about what his health insurance costs are going to be, about what his taxes were going to be, what his energy costs are going to be, that even though he could borrow nearly unlimited sums at zero interest, it was not viable. And I think in the real economy, what I'm seeing from our clients and our compatriots is low to zero interest rates in and of themselves is not enough to drive economic activity.

Jeff: Well, I think I agree with that. And there's another factor that, I think, is important. An economist named Ludwig von Mises, which was really a difficult read to get through...

Tony: Agreed!

Jeff: ...laid out the idea that low rates don't incite more spending, or don't spur more spending. They, in fact, spur more savings. And he laid out the reasons for that, and I'm going to illustrate for you exactly where you see this in action, right, and it's in the pensions. So as interest rates come down, pensions have to reduce the discount rate so when they look forward about their future liability...

Tony: So their actuarial assumptions...

Jeff: Let me explain it.

Tony: Please.

Jeff: Because it's hard enough, frankly. Well, a pension says, "Okay. Well, I have a pool of assets with a value today, and I have a future liability. And I've got to figure out if I've got enough assets today to meet that future liability," whether it's a pension or whether it's healthcare spending doesn't matter. And the number they use to do that, to translate that future number into a current number is called the discount rate. And most of them base it on the current risk-free rate, which is the rate on the ten-year treasury. Well, when you do the calculations, it turns out that if that discount rate comes down, then the present value of that future liability goes up, which means I need a bigger pile of assets today to meet that future liability because I don't expect it's going to grow as fast. And in fact, it can't because half of your pension is going to be invested in bonds, and you're actually making that rate. So unlike say oil, where if oil goes lower, the cure for low oil prices is low oil prices, right?

Tony: Right.

Jeff: Because people can't make any money producing oil anymore. And oh, by the way, the consumer says, "Oh, well, at that price, I'll buy a little bit more," right? And so you have a decline in supply. You have an increase in demand, and you achieve a new balance. And you'll get back to something that is sustainable. Well, it turns out that the cure for low-interest rates is not low-interest rates, because low-interest rates spur more savings. So what happens is the pension now has a shortfall in their assets, and they turned to their sponsor, whether that's your city or your school district or your state, or General Dynamics...

Tony: or the taxpayer.



Jeff: ...that's what I'm saying. The first three are all taxpayers or that corporation and say, "We need more money because we are short what we promised to pay in the future," right? And so you're sucking money out of, what I would call, the transactional economy. But that company, whether it's a General Dynamics or Goodyear Tire, whoever it is, is pulling money that could've gone to employees or could've gone to capital spending or could've gone to their investors and pushing it into the pensions, and then what is the pension doing with it? They're buying assets. They're either buying more bonds, or they're buying more stocks, or they're buying some alternative something or other. So you're pulling money, and the same thing is true if you're the California teacher's pension, right? You're pulling money out of your taxpayer base. So my taxes, if I'm living in LA go up a little bit, so I'm not going and getting quite as many Starbucks coffees or seeing as many movies or whatever it is that I would've done with that 20, 30, 40, 100, 120, whatever dollars. I'm not doing that, right? I'm giving it to the pension, and the pension is buying more bonds which drives the price (interest rate) further down. So there is a reinforcement mechanism: lower rates beget lower rates. In my opinion, that's the piece that the Fed is missing, particularly since U.S. pensions are so big.

Tony: Well, and not just the consumer, the saver, the retiree who's looking for more income on his investments has been, and will continue to be, sorely disappointed.

Jeff: The saver is in the same boat as the pension plan because he's got to do the same math. He just won't do it as formally. The person concerned about their retirement (and I suspect that's you and I) is coming to the conclusion that, "Since I can only get 2% on my 10-year, not 6 or 7 percent like I used to, I need to save more." And so when the Federal Reserve talks about, "We've got..."

Tony: save more and spend less.

Jeff: Correct, spend less, save more. And so when the Fed and those Fed governors talk about, "We've got a savings glut," I am astonished that they're not connecting the dots and realizing that lower rates begets more savings, that turns into continued lower rates. There's a reinforcing mechanism, and it's driven through the math of how you save for your future expenditure. And the place where it just lays it all out, right—all the math is laid out—and if you can track it, it's the pensions because it's all public. That's where you see this.

Tony: So summing this up, let's put a little wrap around some of this so far. Seems to me that the COVID-19 event has brought a lot of these things to a head. And the recession that was maybe this year, maybe next year, maybe two years from now, well, it's here yesterday.

Jeff: Correct.

Tony: And the cracks, if you will, in the system, that had been papered over, to some extent, and has been kicked the can down the road—I'm still thinking about the European Union, China, Japan—those have become ever more evident.

Jeff: But I would not argue that they are about to be resolved. So what you've seen in the European Union, what you've seen in the U.S, the central banks have continued to implement the same practices, right? And in the near-term, that's probably the right thing to do. I mean, in the near term, what the Fed has done is to keep debt markets functioning of a lot of flavors. And I'm not saying that's the wrong thing to do. What they didn't get out of '08 in '09 was increased the economic activity due to low rates. I don't expect they'll get that this time, but I have seen no sign from any central bank that they are giving up on the idea that low rates is what they need to do right now. And I have seen no sign from any government that they're giving up on the idea that what we need to do is spend more money, however they decide to spend it, whether that's on infrastructure or handouts...



Tony: Throwing money out of the helicopter.

Jeff: ...whatever they're doing. Nobody's worried about government debt. Central banks continue to be happy to buy that debt. The reason that I've been thinking—I know you said, "Okay. Well, that can't go on forever. What's going to cause it to fail?" The first thing that comes to mind is inflation will cause it to fail. If you saw general inflation, then the central bank would be on the horns of a dilemma. Do I allow inflation to run, or do I start to rein that in and now focus attention on the affordability of that debt? Well, that inflation has not yet appeared. So, so far, there is no problem that's big enough that highlights that what they're doing can't continue. So my suspicion is they will continue, both the central government and the central bank, to do what they're doing. And it's not my prediction that in the near term, we see inflation. It's my concern that in the longer term, we see inflation. But, and the counterexample, the reason to suspect that it may not appear at all...

Tony: Is Japan.

Jeff: ...is Japan, in which case, you got to say, "Well, how does this, which logically must fail at some point, how does it fail?" And the answer becomes, "I don't know. I can't see it."

Tony: And the people who are predicting it, who say they know...

Jeff: Haven't been right yet.

Tony: ...haven't been right yet. So for instance, Dalio was saying a currency devaluation, we haven't seen that in Japan. Someone asked us, "What is the projected national debt at the end of the year as a result of COVID-19?" MORE! How about more?

Jeff: Big.

Tony: Higher. And what you just said is, "And nobody's worried about that right now."

Jeff: That's correct. I mean, no political party is worried about it. Show me the voter that's worried about the national debt?

Tony: Not today.

Jeff: Because if the voter isn't worried, the politicians aren't going to be. I think it was Jude Wanniski in *The Way the World Works*. He said in his book, "Politicians don't lead. They just figure out what the voters wants and gets in front."

Tony: And they run real quick to get in front of it.

Jeff: And I believe that to be true.

Tony: I think we saw that with COVID.

Jeff: The observations that I made match that far better than the politician who's out there trying to tell you what you ought to be concerned about. They have no success. It's the ones that say, "Oh, I'm listening to you, and what you're saying is you're concerned about this." They have success.

Tony: They reflect back too.

Jeff: They reflect it back.



Tony: So this idea that the solutions that we have counted on in the past are no longer working have not yet prevented central banks, financial institutions, politicians from doubling down on those solutions.

Jeff: That's correct.

Tony: They're continuing, even though it's not yet, and for a decade or longer, hasn't had the desired effect.

Jeff: Right. So it hasn't had the desired effect.

Tony: But it hasn't killed us either.

Jeff: But it hasn't had obvious negative effects. And so I suspect there are negative effects. I liken it to pressure building.

Tony: And that's possible.

Jeff: But the negative effects have not yet gotten so big to force a change. And really, that change, it won't change anybody's mind. You're going to change who's in charge, and they're going to have new ideas about what needs to be done to solve the problems. You're going to have to change who your central banker is because you're not going to change their philosophy about it. It's just like that. But you are not seeing that yet. But that's a long term, going to unfold over...

Tony: A decade.

Jeff: Yeah, probably a decade.

Tony: George Friedman is saying this is the beginning of a decade where a lot of things are going to change in ways that we have not previously seen.

Jeff: Right. And essentially, he argues it from a cyclical perspective, but what he's really arguing is the old solutions have lost their effectiveness and are now creating more problems than they're worth, and we will find new solutions.

Tony: He's made that argument in the book called *The Storm Before the Calm*, which I found interesting. The rest of you, I'd be interested in your thoughts on it. Just pick it up and read it. We're at the leading edge of a decade where we're going to be looking for new solutions to existing problems, or we're going to be finding new problems that we haven't encountered before.

Jeff: And he comes at it from the relationship of civil society to government. He comes at it from a cultural perspective. He really doesn't come at it from an economic perspective, but we've kind of taken that idea and said, "Gee, that looks a lot like what we're seeing economically," and they're all of course intertwined. And all of which, to me, are just kind of expansions on a maxim that a guy named Peter Senge came up with, and I ran across years ago, and that's, "Today's problem are yesterday's solutions." So if you have a problem, you implement a solution. It makes things better, but over time, it will create another problem. There are second- and third-order effects that grow in importance and magnitude or simply gain your attention. And you realize that you have to create a new solution to correct the problems created by your last solution. That tends to happen kind of on a generational perspective which is why the children are always blaming the parents for all the problems that the parents left them, etc.

Tony: Like why didn't our parent leave us the Eden that they had inherited from their grandparents.

Jeff: Correct. Well, that's a whole other conversation.



Tony: So with this background, what are we doing? Our mandate here for our clients is threefold. One is our clients has asked us, basically, do not lose their money, to grow their money in a reasonable rate, and to do it in a way that helps them sleep at night when things are hitting the fan, which is what's been going on right now. What are we doing with our portfolios? Say, for instance, from everything you've said, I can't imagine when we think government or corporate bonds or bonds of any kind are a good place to put money today.

Jeff: I'm not interested in taking a lot of what's called duration risk. Right? So if I own a 30-year bond and if the yield goes up by 1%, then price goes down by about 20%. So if you think of bonds as a place, and I'm talking...

Tony: Investment grade or governments or treasuries...

Jeff: I'm not necessary talking about the municipal bonds. All right? Particularly, after the unrest that's been going on lately. And more than that, the coronavirus incurred a lot of expenses at the municipal level that had not been factored in.

Tony: And most municipalities are broke.

Jeff: The municipalities, many of them are going to be stressed in ways between the additional expenses of the coronavirus and the loss of revenue due to the recession. They're going to be stressed in ways that they weren't six months ago. So that's news, right? But if you want a place to park your money for a year or two and you know you're going to get it back and you're fine with making half a percent or whatever, I'm not against treasuries at all. It'll serve that purpose. The idea of investing in long-term treasuries to grow long-term wealth, that only works if rates go down from here. Now, we've been saying this for, sh*t, six or eight years now.

Tony: For several years now.

Jeff: Pardon my French, yes. And in fact, people have continued to make money on capital gains on long-dated treasuries because rates have come down...

Tony: To almost zero.

Jeff: ...to almost zero, right? So the 30-year,

Tony: What is it today?

Jeff: I think it's around 1%. It got below 1%. I admire their ability to have made that money. I have a hard time saying, "You could do that again next year and the year after." So I think if you have convictions the rates are going lower from here, I don't have that conviction, so I think there's a lot of risk there, and to me, there's little possibility of gain. But as a parking place in the very near term, those short duration bonds, they have a purpose. And you're not going to lose your money there if you pick your bond correctly. The stock market, if you look at the whole market, meaning the S&P 500, that is, on almost all measures, still very expensive. It was expensive in February. It got 30%, 34% cheaper by the middle of March, and it is back to being very expensive now with forward-looking earnings being less than they were, right? So on a P/E basis, on a forward P/E basis...

Tony: We just came through one earnings reporting season, but that was first quarter only. Corporation simply don't know how bad the damage is. That was your earlier comment, that everybody knows they're taking a hit, but nobody's quite sure how bad.



Jeff: But the point is, so “the market” as represented by the S&P 500 is expensive, and if you start looking inside that, there are a lot of companies that are, to me, very expensive. They are baking in future growth that I am personally kind of skeptical, but that's not all of the market. There are lots of parts of the market that weren't expensive going into February and March, dropped 40 or 50 percent and have bounced 10 or 15 percent. So there are significant segments of the market that got cheap and are still relatively cheap. Now, some of them, I am cautious about. So for instance, banks, most dropped by about half and have not bounced very far. And I think there's a reason for that. That's what I discussed, that nobody quite knows how many of these loans aren't going to get paid off. I think the market is correctly cautious on banks until they get more resolution on what does their loan book look like, and how many of those loans are still good. But Amazon is making new highs again, in part because that was the only place you could shop during the lockdown. That and Walmart which were the only two places still open for business but also on the belief that they're going to continue to grow revenue at 20 or 30 percent year over year.

Ron and I have an ongoing discussion about whether they can do that. I kind of hypothesize to him that if I were creating the perfect environment for Amazon to thrive in, it would have looked like: shut down every retail outlet in the country for a period of six weeks. So if that was the perfect environment, we did it. It's going to be less perfect from here. So I'm wondering if, perhaps, that was as good as it ever gets for Amazon. And neither he nor I have enough conviction, really, to go one way or another on Amazon, although it'll be interesting to see how that pans out. My personal opinion is, you have accelerated a number of things that were already happening. So whether it's the transition to work from home or online shopping or what have you, you've accelerated that, but I don't know that you've moved the endpoint in terms of share of wallet, or whatever it is that your metric is, on the final end, right? So if you think about Amazon or online shopping, my guess is that's going to be 30 or 40 or 50 or 60 percent, whatever your number is, of total consumer spend.

Tony: Retail activity. Yeah. Okay.

Jeff: And 10 months ago, we were at 10%, and you think it's going to 40%, and during the COVID crisis, it went to 39%. So my suggestion is, we got there faster than anybody expected, but we're not going to go farther necessarily. In which case, Amazon's growth tails off and starts to come in a little, and it gets harder and harder for them to justify being at 80 times earnings, right?

So there are some expensive parts of the market. There are some cheap parts of the market. We're interested in the less expensive ones where we can find value, the ones where we think the business is worth more than the market is pricing in. A lot of times, that means that we're stepping into uncertainty because certainty is very expensive in the market. So a lot of times, you're stepping into uncertainty to do that. And I did mention in the last quarterly letter that my little rule of thumb is from the time they announce recession, the next six months are generally good times to buy. I'm going to back off that just a hair just because we've seen such a big bounce. I am a little more cautious, currently, today than I was at the time I wrote that.

We did buy some in the middle of March and early April. We've adjusted our portfolio a little bit since then. I am cautious on the market going forward, primarily for the reason I explained. You don't know how many businesses are going to go bust. You don't know how many losses the banks are going to take. You don't know what the second or third-order impacts are going to be. It's going to take time for that to unfold. So there's a pretty good potential for some bad news coming down the pipe, financially, at the end of this summer or early in the fall.

Tony: Market has bounced back. Is that a V recovery that we've seen in the stock market?

Jeff: Yes.



Tony: And do we trust it?

Jeff: No.

Tony: Could test those lows again. Could go through those lows again.

Jeff: Yes. All possible.

Tony: Okay.

Jeff: Again, the market dropped faster than ever, 34%. Recovered faster than ever, give or take 34-35%. So it's now about 8% below the peak. The economy has done nothing of the sort, and that's what's got people worried, and I have to count myself among them. That's what sets up the potential for the market correcting down as the magnitude of what happened in the economy becomes more apparent. Now, is it possible that the economy comes back faster than people expect? Is it possible that the \$3 trillion that our central government sent out to businesses and homeowners and family members makes the difference? That is possible. And certainly, the amount of money that the Fed is pumping into asset markets is going to keep asset prices higher than they otherwise would be. Is that what we're seeing? I don't know. And so hard to completely trust that. Hard to be all on board to say, "Yeah, be all in. It's nothing but blue skies and sunshine from here." So we're a little bit cautious.

Tony: So we're also not making a top-down allocation? Saying, "We need to be 20, 30—we're going to cash."

Jeff: No. No, we're not doing that.

Tony: So we're stock picking.

Jeff: We very rarely do that. We're looking in places where we have either one of two things; we have a lot of confidence in what we think is going to happen for that business going forward, because of what's happening in the sector, because of what's happening with their product cycle. For whatever reason, we have a good amount of confidence in that, and we either already owned it, and we're willing to continue to own it, or the price is good because it's sold off. So that's kind of one category. And then there's the other category, and these are companies with some concern around them, about whether they're viable going forward. So whenever you have a big sell-off, the over-indebted companies, the ones that are right there on the border, if you can correctly identify the survivors, you can make a lot of money.

Tony: If you know that it's not going out of business.

Jeff: Right. It's worth playing some of those, investing in some of those, speculating perhaps in some of those, and we've done some of that, to a small degree. That's kind of, historically, normally our pattern as well, so that's not really different. But those investments in our portfolio are a little bit different. Got a good company, got a good future, right? So there's a little bit of a different flavor to it.

Tony: So talking to my daughters and talking to my clients, I asked a question: "What should I have done a year ago to prepare for what we're going through, what we've been going through?" As a way of answering, "What should I do today to prepare for whatever's next?" And it's a little bit—it would make sense for each individual. I'm advising my daughters to put three-months' rent, put three to six months of utilities (your living expenses) in the bank. So if you do have no income, you can still pay your bills. Well, what that does, in the aggregate, is continue to drive interest rates low, which means people continue to save, and it makes sense on the individual level, but it creates problems for us on the aggregate level. But I continue to think that, individually, we each need to take stock. Say, "Where have my hardships been in the last three months?"



Where did I really run into problems, and how can I address that going forward?" Because I do think that these unresolved issues, whether it's national debt, whether it's spending, whether it's continued health crises, we will continue to see these problems rear their heads, and the known solutions aren't yet working. So people need to be ready to manage themselves independently of what the governments, at any level, are able to provide for.

And frankly, we're here to try and help you with that when it comes to your dollars and cents. What we're doing for you is, where we're finding companies that are profitable and well-managed and growing, and we think are selling for less than they're worth, we're continuing to put money to work in those. Is that fair?

Jeff: Yep.

Tony: We had received some questions earlier that, I think, were pretty much addressed. And it is 5 o'clock, and I don't see any new questions coming online, so I want to thank you, ladies and gentlemen, for joining us. We've enjoyed it. Jeff and I had a practice conversation yesterday, and that was a lot of fun, and then today, we've talked about a whole other set of things, and so that was also a lot of fun. If this has created more questions than we've answered please, as I said, give me a call. Shoot me an email. It's tony@muhlenkamp.com. My direct dial is (724)934-5139. We will get you an answer. If you're working on something you think we can help you with, let us know. Be happy to do what we can. Jeff, thanks. I'm sure we'll talk about this again all tomorrow, but ladies and gentlemen, thanks very much. Enjoy the rest of your evening.

Jeff: Thanks everybody. Hope you have a good evening.

The opinions expressed are those of Muhlenkamp & Company and are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

