



QUARTERLY LETTER, OCTOBER 2022

Fellow Investors,

Inflation remained high in the United States in the third quarter with the August 2022 Consumer Price Index (CPI) rising 8.3% year over year. The Federal Reserve continued its inflation fighting efforts by raising the Federal Funds target rate to 3.25% at their September meeting (an increase of .75%). The Federal Reserve is not alone in raising rates as most countries around the globe have followed suit in order to fight their own domestic inflation, the notable exceptions being China and Japan.

Domestically, the rapid rise in interest rates has had three noticeable affects: First, it popped the bubble in cryptocurrencies. Second, it pushed mortgage rates above 5% in June (mortgage rates at the end of September reached 7%) which triggered a rapid decline in new home sales and a modest decline (so far) in new home prices – so the housing market is basically in recession. Third, it triggered a decline in both stock and bond markets. As of September 30, 2022, the S&P 500 Index is down 24% year to date and the Bloomberg Bond Index is down roughly 16% year to date.

There have been international impacts as well. Because U.S. interest rates are rising faster and are at a higher level than most other countries, the dollar has risen relative to most other major currencies. Because commodities, particularly energy, are generally priced in dollars this exacerbates inflation in many other countries, most notably Japan and the countries of Europe. The U.S. dollar has been so strong relative to the yen that the Japanese government intervened in the currency markets to support the price of the yen—they did so by selling dollars and buying yen. Japan's ability to do that is constrained by their supply of dollars or dollar denominated assets, which is quite large, so they can do it for quite a while, but not forever. The United Kingdom also experienced some difficulties in late September in part due to dollar strength but mostly due to the ongoing European energy crisis. In order to deal with skyrocketing energy prices, the new Prime Minister, Liz Truss, announced caps on energy bills, tax cuts, and some regulatory changes to encourage energy production. The markets focused on the additional government spending and reduced government revenue and sold the Pound and United Kingdom bonds (known as gilts). As it turns out a number of pension funds in the United Kingdom had effectively borrowed money to invest in gilts and the falling prices prompted a margin call. (The strategy was called "Liability-Driven Investing" and the details are much more complicated than this, but you get the general idea.) A negative feedback loop developed from the forced selling of gilts which forced the Bank of England to intervene by pledging to buy bonds "without limit." This only days after pledging to raise interest rates to fight inflation.

While we did not predict the problems in the UK bond market, they do not surprise us. It is our belief that rising interest rates will periodically result in something "breaking." We continue to believe that at some point something important to the Federal Reserve will break and force them to make a hard choice—continue fighting inflation or address the crisis that crops up, whatever it may be. We think this will occur well before inflation gets back down to 2%, which is why we think inflation will be with us for a while. How high will inflation be going forward, and how long will it last? We don't really know. Ray Dalio (Founder of Bridgewater Associates, the world's largest hedge fund) opined that inflation in the medium term would be 4-5%, that seems like a reasonable guess to us, but we doubt it will be steady. Our guess is that the process of fighting inflation will be "two steps forward and one step back" as other problems appear and require government action to

address. We also believe that the Federal Reserve alone cannot bring inflation back down to desirable levels—in the early '80s it took fiscal and regulatory changes, in addition to monetary policy, to get inflation back down and economic growth back up. To date, we are not seeing the fiscal and regulatory changes that we believe are consistent with bringing inflation down—nobody has been elected to beat inflation, not yet. So, the short answer to the question is probably on average 4-5%, and it will last for maybe a decade, but that's a low conviction answer. We expect unfolding events will continue to shape our opinion on this topic.

As we've explained many times, our assessment of company values is based on the rate of inflation—as inflation rises, values fall. Today, the broad market has not priced in the inflation we expect, so we see few good buys. Further, markets struggle to rise in a rising interest rate environment. Thus, we have two good reasons to hold cash, which we are doing. On the other hand, we are optimistic about our energy investments in both the short and the medium term due to both the internal dynamics of the industry and the ongoing energy crisis in Europe. We continue to look for lucrative investment opportunities and will put money to work when we find them. We should also mention that rising interest rates have improved returns on cash-like investments: money market funds are now yielding above 2.5% (something we haven't seen in a decade). While still far lower than the rate of inflation it is much better than the fraction of a percent we've seen for so long and higher than savings accounts and most CDs. We don't expect interest on bank deposits in either savings or checking accounts to move any time soon as banks don't really want additional deposits—only a year ago many banks were turning new deposits away as they couldn't put the capital to work.

As always, if you have questions or comments, write or give us a call. We'd love to hear from you.

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



Ron Muhlenkamp, Founder
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CPI – *The Consumer Price Index (“CPI”) measures the average change in prices over time that consumers pay for a basket of goods and services, commonly known as inflation. One cannot invest directly in an index.*

Bloomberg U.S. Aggregate Bond Index, or the *Agg*, is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the U.S. bond market. One cannot invest directly in an index.

S&P 500® Index – *The S&P 500® Index is a widely recognized, unmanaged index of common stock prices. The S&P 500® Index is weighted by market value and its performance is thought to be representative of the stock market as a whole. One cannot invest directly in an index.*

The comments made in this letter are opinions and are not intended to be investment advice or a forecast of future events.