QUARTERLY LETTER, JULY 2023

Fellow Investors,

U.S. inflation as measured by the Consumer Price Index (CPI) peaked at just over 9% the end of June 2022. It has since fallen nearly as rapidly as it rose and stands at 4% as of 5/31/2023. Energy and food prices have led the decline as the world has adjusted to the disruptions in energy and food supplies created by the Russia-Ukraine War. The end of China's "Zero-COVID" policies has helped normalize supply chains and removed upward pressure on the price of goods imported from China. The U.S. employment picture remains robust, with the U-3 measure of unemployment coming in at 3.7% on 5/31/2023, only slightly worse than the 3.4% rate of 4/30/2023. In fact, unemployment has been below 4% since December 2021. In response to the improving inflation picture, the Federal Reserve decided at its June 14th meeting to leave the Federal Funds Target Rate unchanged at 5% - 5.25%. This "pause" was widely anticipated by the market. The Fed did, however, hint that two more rate increases may occur before year end. We'll see. The Federal Reserve also resumed shrinking its balance sheet in late March with total assets now showing at $8.389 trillion, near the prior low on 3/8/2023 of $8.342 trillion. A couple of weeks ago we sent out a short note in which we stated that we thought the Fed was probably done raising rates, at least in the near term, because raising interest rates was causing them to have to lend more money to banks to keep them solvent, preventing the Fed from shrinking its balance sheet and withdrawing money from the banking system. We still think that's true: further rate increases will impair financial assets and prompt additional lending by the Fed—so the two programs are working against each other. Our hypothesis remains that the Fed will stop raising rates and continue to shrink the balance sheet. Although the Fed didn't state this as the reason for "pausing" interest rate hikes, their (in)action is consistent with our analysis.

The stock market in the second quarter continued to move higher, spurred during this period by the rollout of new artificial intelligence (AI) tools that have caught the popular imagination. This drove any company with ties to AI sharply upwards, in some cases hitting new all-time highs. Much has been made of this move in the financial press with many accurately depicting the overall advance in the market as being very narrow, with few stocks participating. On closer examination, however, AI related stocks and big tech are not the only companies hitting multi-year highs: some industrial companies, some homebuilders, a few health care companies, and a smattering of companies in other industries are hitting all-time highs too. This makes it harder to dismiss the recent market run as simply a bounce in tech stocks.

With this in mind, here is our update to what we think are the most important questions today:

1. Will the U.S. enter a recession? Last quarter we said this was "very likely, maybe even almost certain." We now think it is less certain, and would say it is "possible, perhaps likely." Why the change? Continued strength in homebuilding is one. Stability in the regional banks since April helps too. Retailers have mostly worked their way through excess inventories which should result in improved orders and demand for transportation going forward. Why do we still think a recession is possible? The yield curve remains inverted, so banks can't make money borrowing short term and lending long term, reducing the availability of loans to small businesses and likely increasing the cost of those loans. Further, there are real problems in commercial real estate: operators are sending the keys to the buildings to the lender instead of trying to make payments (echoes of the "jingle mail" from 2006 – 2008 when homeowners bailed on their mortgage by mailing the keys to their mortgage lender), this could create problems in the banks that hold the loans. So, a couple of positive signs but still a lot of negative ones.

2. What will inflation do? If the Fed can hold rates at their current level (which is above the rate of inflation for the first time in quite a while) and continue shrinking their balance sheet, we expect inflation will stabilize or continue to trend downward. We would highlight that you can no longer expect prices to come down as supply chains return to normal—that's already happened. If the Federal Reserve has to start expanding its

balance sheet because of further problems in the banking system or to support the proper functioning of the treasury markets, we expect inflation will move up again. The size of the federal deficit and increases in regulation are other reasons to suspect inflation may stop declining or even increase. We have no strong conviction on which way inflation will go but find it prudent to hold some assets that will do well in an inflationary environment.

3. Will we get a financial crisis? Last quarter, we said we are in one and we think we still are, though things have settled down a lot. There remain a number of potential problems, commercial real estate being one of the most prominent. So, we're not ready to sound the "all clear" just yet.

For the reasons we just outlined, we are more optimistic than three months ago but still cautious about the investing environment. Our investing actions have matched our modest shift in outlook and we have added several new companies to our portfolios that we believe to be selling at attractive prices. We retain a fair bit of cash (earning nearly 5% in a money market fund) as we continue to look for attractive investments. We'll keep you posted.

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,

Jeff Muhlenkamp, Portfolio Manager
Muhlenkamp & Company, Inc.

Ron Muhlenkamp, Founder
Muhlenkamp & Company, Inc.

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.*

Federal Funds Rate *- 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.*

U-3 Unemployment Rate *- is the official unemployment rate. It is the total unemployed, as a percent of the civilian labor force.*

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