MUHLENKAMP

QUARTERLY LETTER, JANUARY 2024

Fellow Investors,

In our January 2023 Quarterly Letter, we thought there were three questions of particular importance to investors:

1. Will inflation remain high? If so, how high will it be?
2. Will the United States enter a recession? If so, how bad will it be?
3. Will a financial crisis erupt that prompts the Federal Reserve to drop interest rates and perhaps restart quantitative easing? If so, will this cause inflation to run up again?

We stated then that we thought inflation would be 4-5%, a recession was likely, and a crisis was a possibility.

What actually happened?

- Inflation fell. Inflation fell from 6.4% at the start of the year to 3.1% at year end. (We use year-over-year changes in the Consumer Price Index (CPI) as a proxy for inflation).
- A banking crisis did erupt in the early spring as several regional banks went bankrupt, prompting the Federal Reserve to lend to a number of other banks to keep them out of trouble. The Fed did not cut interest rates, nor did they resume quantitative easing in response—they found other ways to help the banks.
- The U.S. economy expanded and there was no recession. Year-over-year inflation-adjusted GDP growth averaged about 3% for the first three quarters of '23. The fourth quarter hasn't been reported yet.

So, a pretty good outcome for the year on all three questions, somewhat better than we expected particularly in regard to economic growth.

How did bond and stock markets do? The bond markets ended the year pretty close to their starting point: the yield on the 10-year Treasury bond, for instance, began the year at 3.89%, peaked in October at 5%, then ended the year at 3.9%. Please note that bond prices move the opposite direction of bond yields: so long-term bonds sold off significantly during the year, bottomed in October, then recovered by year end. Of more interest to consumers: the 30-year conforming mortgage rate began the year at 6.6%, peaked in October at 8%, and retreated to 6.7% at year-end. Equity markets did better with the S&P 500 Total Return Index up a little over 26% for the year. This remarkable performance was largely due to a small group of large companies that Wall Street came to call the "Magnificent Seven" (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla). The emergence in March of new artificial intelligence (AI) tools sparked the imagination of tech investors which drove the move in those companies considered to be in the best position to profit from AI developments. The Dow Jones Industrial Average, by contrast, was up "only" 13.7% in 2023. Our accounts in general increased by about 14% in 2023. (Individual performance varies by account, see your annual statement for your performance if you are an investor with us). Why the difference? Our weightings in the technology sector were significantly lower than the S&P 500 and we didn't own the very best performers. That was intentional. In our view most technology companies became overvalued in 2021 and we reduced our holdings then. That benefitted us enormously in 2022 when technology companies led the market selloff, but it hurt us in 2023. Additionally, in 2023 our energy holdings performed poorly as the price of oil declined during the year. Energy was a big part of our success in 2022, but it didn't help us much in 2023. On a 3-year basis, however, our performance is pretty respectable with our accounts in general returning a little over 14% per year versus 10% for the S&P 500. (Again, if you are an investor with us, see your annual statement for your specific results).

The decline in inflation during the year allowed the Federal Reserve to be a little less vigorous about fighting inflation in the second half of the year than in the first half. The Fed raised the Federal Funds Rate four times between January and

July but left it alone after that. The Federal reserve also shrank their balance sheet steadily throughout the year (with a brief growth spurt in March when they bailed out some banks) and the balance sheet ended the year almost 10% smaller than it started the year. Although current inflation of 3% is above their 2% target, it would seem they are comfortable with their inflation-fighting efforts and show little inclination to do more. The Fed has even hinted they may reduce interest rates in 2024 and the markets are estimating that could begin as early as March.

As 2024 kicks off, we see the economy growing slowly, the Fed no longer raising interest rates but still shrinking their balance sheet, and the rest of the Federal government spending significantly more money than it is receiving (the estimated deficit in '24 is $1.8 trillion, or about $15,000 per household). In 2024, we again think there are a few questions of particular importance to investors:

- Where will inflation go—lower, higher, or stay about the same? We think similar or higher inflation is more likely over the next couple of years, but very short time frames are hard to predict.

- Will government deficits drive interest rates higher? Our deficit is unusually high given that we are neither at war nor in a recession, and the rising interest rates in 2023 dramatically increased government interest payments. Will interest rates rise to attract the money necessary to fund government expenditures?

- Will we see a recession in 2024? Historically, it is quite common for recessions to begin after the Federal Reserve begins to cut interest rates, so the shift by the Fed doesn't mean we are out of the woods yet. Higher interest rates are causing problems in the banking industry and real estate and a number of economic indicators are still at recessionary levels. We think a recession remains possible in 2024.

- What will we be able to learn from the '24 elections? We always pay attention to elections to try to get a read on what matters to voters.

In summary, we think we are in a period of higher inflation and higher interest rates than the period from 2009 to 2021. It remains possible we will see a recession in 2024.

Our investments should do well if our read of the environment is correct but should also be okay if we are wrong in part or in whole. We retain a decent cash reserve to take advantage of low asset prices that typically accompany a recession. We have significant holdings in energy, which typically do well in periods of high inflation. We expect our health care and communications services companies to be indifferent to a recession and most of our industrial companies are poised to benefit from increased government spending. We continue to look for opportunities to earn a satisfactory return on our capital and will put money to work when we find them.

As always, please get in touch with us if you have any questions, we'd love to hear from you.

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

Jeff Muhlenkamp, Portfolio Manager
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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.*

Dow Jones Industrial Average *(DJIA) is one of several stock market indices. It consists of 30 of the largest and most widely held public companies in the U.S. One cannot invest directly in an index.*

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

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.*

Past performance does not guarantee future results.

The comments made in this letter are opinions and are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

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