



MUHLENKAMP AND COMPANY, INC.

INTELLIGENT INVESTMENT MANAGEMENT

12300 Perry Highway • Wexford, PA 15090 • (724) 935-5520 • (800) 860-3863

e-mail: [click here home page: www.muhlenkamp.com](http://www.muhlenkamp.com)

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QUARTERLY LETTER

The year 1990 was a difficult year for investors. But a major part of our job is to protect our investors in difficult years, and we did not protect you very well in 1990. We will outline what we saw in 1990, what we see now, and some of what we did right and wrong.

The major events of 1990 have two headings: War and Recession. We will discuss each separately, though their effects in 1990 were interrelated.

War

On August 2, 1990 Iraq's Saddam Hussein sent his armies into Kuwait and, within a few hours, occupied that country. He has since stripped Kuwait of most things of value excepting, of course, the oil underground. On September 18, 1990 we issued a special Interim Edition of the Memorandum entitled "Iraqnaphobia" in which we said the following:

"The effects (of the Gulf crisis) are both economic and psychological. Economically, four to five million barrels of oil per day were removed from the marketplace. This has driven the price of crude from \$18-20 per barrel to \$28-30 per barrel an increase of over 50 percent! (At the retail level, gasoline has increased 20%.) This energy cost increase will prolong the current GNP slowdown by 6 to 9 months, and deepen it into a probable recession. It will also result in higher reported inflation for the next 6 to 12 months as the higher energy costs work their way through the various price indices. In turn, these higher inflation numbers will make it difficult for the Federal Reserve to ease the money supply as soon as it would like. The net result of this delayed upturn in U.S. GNP growth is to lower economic values by 5% to 10%."

Overlaid on the economic effects are the psychological aspects of the crisis. These take two forms. First, fear and uncertainty about the eventual outcome have taken an additional 5% to 10% out of stock and bond prices. Second, our perception is that a continuing public focus on the Mid-East and its uncertainties may make people more cautious with their pocketbooks. Unlike 1987, when the American public largely ignored the stock market break, this time the trigger (a fear of war) is more immediate, and thus more likely to have real and lingering effects.

We believe it is important to put all this in context. First, the Mid-East conflict does not threaten U.S. survival or (even) prosperity. A similar situation five years ago would have raised the specter of superpower confrontation. Such an outcome is not likely today. Second, the degree to which George Bush has solicited and received international cooperation will discourage future incursions by the Saddam Hussein's of the world. It's clear

that Hussein perceived the rules of the international game to be quite different from the rules that President Bush has now made explicit."

We elaborated on this theme in our October newsletter, by which time the spot oil price had hit \$40 per barrel and traders who forecast \$50-\$60 were quoted on the news. Even at that time the futures price (for delivery a year hence) was \$25 per barrel. The difference (\$15 per barrel) was a war (or fear) premium. It's no coincidence that the bottom in the stock and bond markets coincided with this peak (so far) in spot oil prices.

When the oil price first hit the mid thirties, and gasoline hit \$1.25 per gallon, my wife Connie and I discussed the effects of the price increase. The average American drinks about a gallon of soft drinks per week, as does Connie. She also drives 8,000 to 10,000 miles per year. We concluded that if gas went from \$1.00 to \$1.30 per gallon and stayed there, and she drank water instead of cola, she'd break even. I wish we hadn't had that conversation, because since then I haven't been able to take seriously the prediction of dire economic consequences due to higher oil prices. Many people obviously do take this prediction seriously. Informal polls among well-informed people during the fourth quarter of 1990 showed over 60% of respondents thought Saddam Hussein threatened the prosperity of the United States. Thus my perception of the long-term effects of Iraq-Kuwait was very different from that of the public and the market. Hindsight says we would have served you better in the short term by selling immediately after the invasion.

It's now mid January, and although comments on the war are becoming obsolete daily, I feel the need to make a few:

First, Jean Leister and I are concerned about the safety of our offspring in the Army (even though they're still in Germany), but the useful time for concern was when they joined up.

Second, all people with loved ones in the Gulf fear for their safety. Only a small percentage of these fears will be realized, but knowledge of this small percentage helps very little. When the danger is past, the majority left unscathed will breathe a huge sigh of relief. Once again, the fear will have been greater than the reality.

Third, giving sanctions "time to work" assumed that the goal was to harm the Iraqi people, or that Hussein would respond to his people's pain and vacate Kuwait. The sanctions did succeed in making the point that the world was united against Hussein and his regime.

Finally, by way of perspective: On the first day of raids on Iraq the majority of U.S. casualties were suffered by 7 peace marchers in New York who were hit by a drunk driver. We kill 45,000 people per year on our highways. People who insist on driving lethal projectiles after inebriating themselves kill sixty per day. I do not trivialize anyone's suffering as a result of this war, but are the casualties of Operation Desert Storm more important or significant simply because we as a nation are paying such close attention to them? Further, which of the war's effects are temporary and which are permanent?

Recession

We repeat: Saddam Hussein does not threaten the prosperity of the United States. Even if he were successful in keeping Kuwait, the economic impact on the U.S. would be less than that of the oil price hikes of the 1970s on Japan (which imports all its oil). The public's response to the fear of war has resulted in a lengthening and deepening of the slowdown, making it a recession. But all the rhetoric and hand-wringing on avoiding a recession ignores the fact that the slowdown itself was done on purpose, just like every slow down or recession since World War II. We (the Fed) did it because the long-term gains from a slowdown are expected to be greater than the near term costs. What we can slow down on purpose, we can speed up on purpose, and our Federal Reserve is now beginning to do just that. Today the Fed is constrained in ways it wasn't in the past, but we view that as a positive.

Everyone knows the world has become a competitive market for goods, but not everyone knows that it has also become a competitive market for money. In 1973, when OPEC quadrupled the price of oil, the U.S. made the political decision to pay for it by printing money, rather than allowing the price of gasoline to reflect the new world price. The Arabs accepted our printed money because there was no good alternative (other than raising the price of oil again, which they did in 1978.) Today, no one has to accept our money. The Japanese economy has become much larger and their currency is trusted, partly because they didn't inflate in the 1970s. The German D-mark remains a currency to trust. On top of this, U.S. budget deficits have made us huge debtors. Foreigners won't continue to lend to us unless they trust that the dollar will hold its value. This is why we monitor the value of the dollar. Because of all this, our Federal Reserve doesn't have the option of printing money, as it did in the 1970s. Therefore inflation is less likely.

We monitor German and Japanese interest rates relative to the U.S. to see how much flexibility the Fed does have. A significant premium in foreign interest rates relative to those in the U.S. could drive down the dollar and make Fed ease less likely. Since fall, German rates have been stable and Japanese rates have declined, allowing our Fed some flexibility. The skies are not all clear; however, we can still foul things up. Nobel Laureate economist Milton Friedman says that the Great Depression of the 1930s started as a normal recession until three things happened:

- The Federal Reserve actively shrank the money supply.
- Congress raised taxes a lot (to balance the budget).
- Congress passed the Smoot-Hawley Tariff Bill, which increased tariffs on a broad range of imported goods.

This time around, we're flirting with a couple of these, but not to a great degree:

- The Federal Reserve has slowed the growth of money, but the growth is still positive.

- Congress raised taxes a little. (Estimates are that the new taxes will cost the average American \$1-\$3 per week, depending on how much you drink or smoke.)

- The General Agreement on Tariffs & Trade (GATT) talks on international trade are stalled. We would point out that a failure to lower tariffs is much less negative than a large increase.

An area of additional concern for many people is the U.S. financial system. Even with the well-publicized failure of the Bank of New England and scores of money losing S&L's the U.S. still has too many financial intermediaries. We expect additional closings and absorptions of weak players by stronger institutions, both public and private. This consolidation must occur for the system to remain viable. The fear and uncertainty that this process creates is a plus for the long term, as it forces depositors to more closely scrutinize their bank or S&L. Federal deposit insurance reform must be part of any regulatory "solution" to this problem. Once the economy is growing again, and weak institutions have been closed or consolidated, lenders with higher risk portfolios and relatively less capital should be weaned away from Federal support. Such limitations would eliminate the kind of "blank check" lending activity that created much of the trouble in the first place. Meanwhile, the Fed stands ready to put money into the system should a short-term crisis arise. We would also note that the stock market bottoms of 1982 and 1984 coincide with bank failures.

In the final analysis, the U.S. remains in charge of it's own destiny. The problems in the Mid-East exacerbated a slowdown in our economy. In our case, we allowed for an economic slowdown, but failed to anticipate the level of fear engendered by a likely (now real) Mid-East war.

Frankly, we can't find disaster in either the war or the recession. Many do see disaster. So far, that has been our error. Yet we hold to our long-term conclusions.

So where are we today, January 21, 1991?

- We are in the middle of a war. Our military is performing admirably. The planning and coordination are obviously superb. Meanwhile, the politicians seem to be keeping an unprecedented coalition together. So the worst fears of the families of most of our servicemen will not be realized.
- We are in the midst of a recession. The Federal Reserve has begun easing, as it has in each recession since WWII. So far, the actions of other central banks have not appeared to limit our Fed. Historically, loosening by the Fed in the midst of recession has been the best time to buy stocks. Balance sheet strength of individual companies remains critical.
- The elections are over. Year-end tax-related activity is over. We're in the midst of year-end earnings reports. Many companies are taking write-offs to put bad news behind them. Where we do see value, we like to also see these earnings reports or receive other assurances from management before putting your money to work.