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### QUARTERLY LETTER

#### **Fear taketh away ...**

It is popular to accuse generals of always fighting the last war. We've just witnessed a time when the generals and the President did *not* fight the last war, but most of the politicians, media, investors and the public insisted on doing so. Congress called on the very civilians responsible for the failed war policies of Vietnam to give "expert" opinion on the feasibility of winning a war in the Gulf. The media featured doomsday economists and oil futures traders who told us oil prices would skyrocket and shortages and rationing were coming once again. No one mentioned the fundamental difference between the supply and demand forces operating in the 1973 refusal by OPEC to sell oil to us and our 1990 refusal to buy oil from Iraq. The public and investors bought it, and stock prices fell.

#### **... and reality giveth back.**

They began to rebound; however, as soon as it became apparent that the war would not be a disaster for the U.S, and that sufficient oil supplies were available. Within four weeks of the initial air strikes, and *before the ground war ever began*, stock prices rebounded to their pre-war levels. Both the decline and the rebound occurred in anticipation of these events, and well before any of the details were knowable.

#### **But we're still in recession.**

As we said last quarter, the depth and duration of this recession has been

increased by the war and the public's response to it. But the broad parameters of this recession still look quite familiar; the major difference this time is that the Federal Reserve acted very gradually. After squeezing the money supply since mid-1988 in order to slow the economy and inflation, the Fed began easing in late 1990. It did so because the slowdown/recession was becoming apparent and the pressure was coming off prices in many areas of the economy. True to historical form, the stock market responded upward as soon as the Fed's ease was apparent (with the timing of the war news helping to dramatize the move). Recent reports of lower inflation in the wholesale and consumer price indices indicate that the Fed can continue to ease. Yet the media focuses on the negative aspects of the recession. No mention is made of the fact that we (the Fed) slowed the economy on purpose, because the long-term beneficial effects of lower inflation and lower interest rates are expected to be greater than the short-term costs. No mention has been made of the lower bank prime interest rate flowing through to lower rates on Adjustable Rate Mortgages (which is taking effect right now), or of the savings available to fixed rate borrowers who refinance their loans.

We continue to believe that the recession will mean even lower inflation and interest rates than we were expecting. It will also give us a longer recovery. For equity prices to move up in response to these

conditions is normal. They are the signs that economic growth is coming.

#### **A Review ...**

In the summer of 1989, we wrote a "Time Bomb" essay demonstrating the effects on "income" of declining inflation and interest rates, and warning (anyone living on income) that interest rates were likely to drop in the near future. Since November 1990, short-term rates have dropped two full percentage points, from 8% to 6%. Many people living off the income from their CDs and money market funds are now seeing this time bomb explode as they are asked to roll over their CDs at the new 6% rate. In the early 1980s, when interest rates dropped, investors who insisted that they needed higher rates bought high-yield bond funds. Only later did they learn that their high-yields entailed significant risks to principal. We've been curious as to the vehicles which will be provided this time to satisfy the demands for "more income." So far, we've only seen advertisements for International Money Market Funds (the ads don't tell you that they'll lose principal when the dollar appreciates) but it's early in the game, and we expect to see additional vehicles touted. Those of you who read or kept our ensuing essay know that you can't expect to continue to receive interest rates significantly above inflation by investing in CDs, money market funds or other short-term investments. (The decade of the 1980s was an historic aberration.) The good news is that long-term rates have not yet fallen, so

that income investors can still lock in rates over 8% by buying long-term bonds. Of course, those bonds will fluctuate in price (nothing is free!). If we're wrong and interest rates increase, the price will decline. If we're right and rates decline, you will want to be sure your bonds aren't called, which is why we like Treasuries (See Reverse).

#### **and a question?**

Demographers have been telling us for years that when the baby boomers hit 40-something, they were likely to slow their spending and increase savings. But by mid-1990 only those who were searching very hard could find evidence of this. Charlie Smith says the difference between a Yuppie and a Couch Potato is a mortgage. I maintain that the biggest difference between

wanting a BMW and a Ford is an attitude. It strikes me that the war has been the best excuse in a decade for a change in attitude. With the fear of war, the American public has not bought anything postponable for six months. Will they decide that having fewer bills to pay is kind of nice? Will "Born to Shop" T-shirts become passe? Let us know what you think and what you see.

### **WHY WE LIKE LONG TERM TREASURY BONDS INSTEAD OF CDS OR MONEY MARKET FUNDS**

As we noted in our previous essay entitled "Defusing the Time Bomb" (Issue 10, October 1989), it is unlikely in the future that short-term interest rates will stay significantly above inflation rates. Therefore, to get a real return, investors must opt for long-term debt (bonds) or equity (stocks). Each of these has associated risks, some of which are well known. We want to point out some of the risks in long term bonds that are *not* well known or understood.

Volatility is obviously one risk, but so is the "risk" of the bonds being paid off or "called" early. Just as individuals borrow mortgage money to buy houses, companies borrow bond money to finance expansion. The government also borrows bond money to fund the deficit. Similarly, just as people who took out mortgages at 12% or more have since refinanced them at lower rates, companies which issued bonds at 12% or more have "called" those bonds when interest rates fell. The government has not called their bonds, because most U.S. Treasury Bonds are non-callable.

The reason we recommend long-term Treasury Bonds to investors seeking income for 3 years or more is because we want to lock in current interest rates for a long period of time. We also want the decision of when to cash in these bonds to be ours, not the issuer's. Treasury Bonds are quite liquid. They can be bought and sold on any given day. Therefore, buying a 20-year Treasury Bond does *not* lock you in for twenty years. It merely allows you to decide when to cash in. Of course, as interest rates change the price will fluctuate, but these fluctuations *win* decrease as time goes on.

A list of currently outstanding bonds appears in the Wall Street Journal every day under the heading "Treasury Bonds, Notes and Bills." Items in this listing include:

- Rate: The nominal rate or coupon. The number of dollars paid out in interest per year per \$100 of face value.
- Mo/Yr The Maturity Date of the Bond.
- Bid &Ask: Currently quoted price (fractions are in 32nds).
- Ask/Yield: The compounded yield-to-maturity based on the asking price. Note that higher coupons have higher prices so that the yields-to-maturity are similar.

As an example, on Wednesday April 17, 1991, the 8 3/4% bond maturing in 2008 was priced at 104 and 10/32 to return 8.18% compounded to maturity. These bonds can be bought and sold any day through any stockbroker. Many banks, including Mellon and Pittsburgh National, now also have this capability. They charge a fee for this service. Each quarter the U.S. Treasury also issues new bonds (borrows more money). Bonds of 3, 10 and 30 year maturities will be available at auction on May 7, 8 and 9, 1991 respectively. Check with your bank; sometimes they charge a lower fee on new issues.