



## MUHLENKAMP AND COMPANY, INC.

### INTELLIGENT INVESTMENT MANAGEMENT

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Issue 3, First Quarter 1988

### QUARTERLY LETTER

May all your days be Interesting.

-Old Chinese curse.

I've always thought of the above as a blessing – but 1987 was a little too interesting. Since our letter of October 23, 1987 and our meetings of October 29 and 30, 1987, several events and trends that we discussed then have become clearer:

First, the marketplace did not break down. Second, selling occurred in a large number of stocks due to margin calls the first week or two after the crash, and tax-loss selling through mid-December.

Unlike the Dow Industrials, which bottomed on October 19, the average stock bottomed between a week after the crash and the end of November. Prices were driven down by forced selling, without regard to value or relative attractiveness. Stockbrokers told us that most of the funds generated remained in cash. We, too, did some tax-loss selling, but only where we found other stocks that we preferred.

The reaction of the general public to the stock market meltdown has been very modest. Most areas of the economy are continuing the patterns in evidence before October. Consumer spending is slowing a bit from very high levels, and basic materials production is booming from very low levels. Unfortunately, this modest reaction includes our politicians, who want to spend more, not less.

As soon as tax-loss selling ended in mid-December, stock prices began moving up strongly, particularly for those companies with strong balance sheets and good earnings. Since we have been betting on this for some time, we find it heartening. Well-run banks are now being differentiated from poorly run ones, for example. We still think the entire banking group is cheap (along with most savings and loans and insurance companies), but it may require lower interest rates before these companies are fairly priced.

Interest rates and the bond market have been flat since October. This despite a continued decline in the dollar. Whether current attempts to

support the dollar will be successful, we don't know. Recent indications that the U. S. trade deficit is diminishing should help immensely.

In a nutshell, this is where we are today: Relative to inflation of 4-5%, stocks and bonds are now under priced. But as has frequently been the case for the past five years, stocks in general remain hostage to the bond market. Stocks can't move up unless bonds move up first. The bond market is in turn hypersensitive to interest rates worldwide and the dollar's value versus other currencies.

Central governments are now trying to stabilize the dollar, after helping to push it down for two years. Should they be successful, interest rates should stabilize or trickle down and selected stocks will do well. Should they be unsuccessful, the bond market will set the tone for stocks. If interest

rates hold at current levels, the key to stock performance will be individual company earnings.

## MUHLENKAMP MUSINGS ON ECONOMICS

### Basic Laws

"There Is No Free Lunch" (Milton Friedman). Therefore everything consumed must be produced. Every dollar spent must be earned. Prices are set by the (potential) buyers. No person or company can make you buy his or her product (only government can do that).

Unless the product and price attract a buyer, there will be no purchase.

Organizations don't exist, only people exist. An organization is just a number of Individuals who have some common Interest(s).

We are all volunteers. We cannot be effectively coerced into doing what we don't want to do. We can be prevented from doing what we want to do.

### Observations

People are diverse in talent, skills, desires and Interests. No matter how you write the rules, 10% of the people will fall. But the rules must be written for the 90%. The 10% can be treated as exceptions.

We cannot spend ourselves rich. We can only earn and invest to become rich.

People have three working speeds:

1. They work for someone who can't/won't fire them, typically government.
2. They work for someone who can fire them, typically a business.
3. They work for themselves.

People have four spending modes:

1. Spend their own money (money they've earned) on themselves (Private economy).
2. Spend money they've earned on someone else (Private charity).
3. Spend someone else's money on themselves (see the Senate Office Building).
4. Spend someone else's money on someone else (Government programs).

Inflation is much more detrimental to the long-term prosperity of people than is recession. When in a recession, people work harder, spend less, and are more careful about the expenditures they do make. This is a self-correcting mechanism. In inflation, the incentive of people is not to work harder, but to speculate; not to borrow less, but to borrow more; not to spend less, but to spend more. Farmers in the 1970's perceived it in their best interest not to plant corn but to borrow more money to buy more farmland. People working a forty-hour job found it in their best interest to borrow more money and buy a bigger house. We engendered a belief that you can spend yourself rich. As long as Interest rates were well below Inflation, it worked. This was done at the expense of the savers of the world. As long as our mothers were willing to take 5 1/2 percent Interest on their savings, we were able to borrow it at 7 1/2 percent (pretax) and buy houses that appreciated by 10 per. cent. This worked fine for us, but it didn't do much for our mothers. Then they got a little smarter and caused us to borrow at 16 percent. The tables turned. They remain turned today. Our mothers can still earn enough on their savings to offset inflation, pay the taxes and have a penny or two left over. Today, borrowing a lot of money to buy a big house is a losing proposition. From 1965 to 1980 It was a winning proposition. Yet, that fact educated a whole generation in the belief that they could spend themselves rich. You cannot spend yourself rich, individually or nationally.

The economy is not strengthened by spending, it is strengthened by Investment. My grandfather farmed with horses. One hundred years ago, two-thirds of the American public were farmers and they farmed with horses. We live much better than they did with a lot less effort; not because they spent a lot, not because we spend a lot, but because some people Invested time and effort (or in lieu of that, they invested savings) in ideas ranging from Ford's car and tractor to McCormick's reaper and Edison's electric power. Today we benefit from these Investments. If those people had spent their money (after all, wine, women and song have always been available), we would not have these Items today. Mr. Singer, who invented the sewing machine, when asked why, said, "For the money." We are taught today that greed is a negative emotion. In some ways, greed is great. It makes a person very easy to motivate. I am grateful that Mr. Singer was greedy. It allows me to wear much better and cheaper clothing than my grandfather did, because he was reliant on my grandmother and- her fingers and needle and thread for everything he wore.

### Further Observations

You can force people to put in their time, but you can't force them to do anything useful. Any non-market economy is evidence of this. If you want the ultimate description of how much time can be spent doing little useful work, read Alekdandr Sozheintsyn's "A Day in the Life of Ivan Denisovich".

I have an uncle who is a farmer. A few years ago he toured Russia. When he returned, he told me it was no surprise to him Russia had economic difficulties. He observed 11 people bailing hay, and in his words, doing the work he does with two. I commented that he thought of them as farmers, he said, "Yes, of course". I observed that they were working not for themselves, but for the government.