



## MUHLENKAMP AND COMPANY, INC.

### INTELLIGENT INVESTMENT MANAGEMENT

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### QUARTERLY LETTER

The U.S. economy continues to hum along nicely. Consumer spending is moderating a bit, but is offset by strong exports. The fall in the dollar since 1985 has helped limit imports and boost exports, which is why we continue to think the trade deficit will fix itself. An improving trend in the trade deficit is now apparent; the strengthening dollar reflects this.

In terms of the Federal budget deficit, nothing is being done and probably nothing will be done until after November. Even then, we may not do much. The electorate has narrowed the political choices to those who have made the fewest promises to change things. If you adopt the thermostat theory of elections (we only get up to change things when we're uncomfortable), it implies things won't change much because the public is comfortable.

Wall Street's mood has shifted from fears of depression after the October crash to current fears of a near boom and inflation. We are sure that some

individuals have realized these fears (such as those investors who sold last October, either because they were on margin or panicked). But, in the aggregate, the public and the economy have treated the crash as a non-event.

*"The electorate has narrowed the political choices to those who have made the fewest promises to change things."*

Charlie Smith's accompanying article on the drought highlights some of the reasons why increased prices in some parts of the economy do not necessarily result in economy-wide inflation. Those who now fear inflation are looking at the pieces, not the whole picture.

Don't get me wrong, the drought is a negative and creates inflationary pressures. Higher employment is a positive, but also creates inflationary pressures. Historically high interest

rates are a positive for savers and a negative for borrowers and create disinflationary pressures. It is normal for some parts of the economy to improve while others suffer setbacks; that's the strength of a diverse economy.

If the response of the Fed to the above is to create more money, we will have higher inflation. There are; however, no current signs that it is doing so. Historically, once elections are out of the way, Washington is more likely to slow the economy than to stimulate it. We therefore look for inflation to remain in the 4-5% range. If so, interest rates should come down, making bonds attractive. Further improvement in the trade and/or budget deficits (which would strengthen the dollar) would help bonds as well. At these levels, the average common stock is fairly priced, and individual stocks should reflect the current results of the underlying companies. Our emphasis will remain on those companies and industries that are doing well in the mixed economy of 1988.

### THE CANNOTS

Historians are unsure if the words at the right came from Abraham Lincoln or the Rev. William J.H. Boetcker circa 1916. Whomever their source, they eloquently depict the juncture of economics and human dignity. This is the juncture where public policy is set, and a nation's financial rides are established. Rule number one: Personal human dignity and satisfaction comes not from having, but from doing and earning.

- You cannot bring about prosperity by discouraging thrift.
- You cannot strengthen the weak by weakening the strong.
- You cannot help the wage earner by pulling down the wage payer.
- You cannot further the brotherhood of man by encouraging class hatred.
- You cannot help the poor by discouraging the rich.
- You cannot establish sound security by spending more than you earn.
- You cannot build character and courage by taking away man's initiative and independence.
- You cannot help men permanently by doing for them what they could and should do for themselves

## **DROUGHT = INFLATION?**

Day after day the nation's breadbasket bakes in the summer drought. (Pit), the poor farmer standing in the dust with nothing to sell as wheat, corn and oat prices soar. Inflation is back, the experts tell us, and will intensify as farmers pass their misery along to the checkout counter. The reasoning is straightforward and compelling higher farm prices mean higher food costs mean increased wage demands mean higher prices throughout the economy. It makes 2 + 2 look complex by comparison. Bill is it right?

Contrary to media hyperbole, the inflation scenario is not yet fact. The first link in the chain, higher farm prices, is being forged in the midwestern heat wave. It has not yet hardened, however, and quenching rains could render it brittle. Running joke in the financial markets: A cloud appeared over Iowa one day and soybeans dropped two dollars a bushel. If it rains, prices could plummet.

But let's assume that rain does not come and farm prices continue to rise. Will retail food prices rise as well? Maybe, but perception trails behind reality. The perception is that the majority of the cost of a processed food product is in the food, and not in the processing and packaging. The reality is that for many staples the cost of the raw commodity is less than ten percent of the retail price of the final product. Wheat for example, accounts for less than eight percent of the retail value of Wheaties. Thus; higher wheat costs don't mean significantly higher Wheaties.

Say the drought is severe, and the shortage of wheat so great that wheat prices rise by 60 percent from January 1, 1988. Ignoring other cost increases (or decreases) for the time being, this results in a Wheaties price increase of about 5 percent if the entire cost increase is passed on to consumers. In reality, wheat futures have risen about 30 percent. This equates to a 2.4 percent rise for Wheaties or 4.8 percent at an annual rate. Overall, inflation was 4.4 percent annualized for the first six months of 1988, so rising wheat prices have not added significantly to inflation this year.

Our perception is faulty because we still think of ourselves as farmers. We're not. We're mill workers, truck drivers and cereal salesmen. Fewer than 3 percent of Americans farm for a living (And many of these fill out government forms for 113 to 112 of their income.) Yet because we're only a few generations from the time when nearly everyone farmed, we still view ourselves that way, and it distorts our perception of the world around us.

The next link in the inflation chain connects higher food costs with increasing wage demands. Again a product of misperception this link is no stronger than the others. The fact is that U.S. personal consumption expenditures for food are less than 16 percent of disposable income. This percentage is the lowest ever historically (down from over 40 percent in 1900), and the lowest in the world today. Food no longer accounts for the lion's share of the family budget. Yet, as Edward Hyman, chief economist for E.G. Lawrence, puts it "When food prices accelerate, wage demands accelerate. Food prices represent a large piece of PERCEIVED inflation."

Let's say, the average Joe strides into his boss's office and demands a raise because "food prices are skyrocketing!" If he's a foreman for Dow Chemical, where ethylene prices have risen for two years, he may get it. If he's a branch manager for Merrill Lynch, on the other hand, he may get a pink slip instead. This disparity is the key to the entire inflation vs. no inflation argument. For even if the first three links in the inflation chain (higher farm prices, higher food costs, increasing wage demands) are strong (and we've shown they may not be), generalized inflation cannot happen without the cooperation of the Federal Reserve. The wage/price spiral is a MONETARY phenomenon. Today, because money is growing in line with the economy there is no room for generalized price and wage increases. There IS room for pockets of strength (rising wheat, for example, and the polyethylene we package it in), but these increases are balanced by weakness in other areas (stockbroker layoffs, sliding Texas real estate). We end up with offsetting pockets of rising and falling prices within an overall muddle-through economy. Inflation scares appear periodically, only to be replaced by deflation scares six months later. Each represents the ebb and flow of a basically healthy economy, exaggerated by the media's (and the market's) tendency to focus on individual items and to go to extremes.

One trend is troublesome, however. Promulgated by the federal government, and manifested by ever debt within the economy, this trend allows all players in the most basic of economic transactions to come out winners. You lost money when your "aggressive" Texas savings and loan folded? No problem; FSLIC (read U.S. taxpayer) will bail you out. Your crops failed in the drought of 88? Just call the Feds for a disaster "loan" which will be forgiven in two years. The result in each case is more federal spending, more debt, potential inflation, and a cavalier attitude toward borrowing and defaulting in basically creditworthy people. This game of risking and having it all, with the assurance that if the outcome is not to your liking you can always go to the Federal pay window, attracts more American farmers, savers and businessmen each year. The bill will someday have to be paid.