



## MUHLENKAMP AND COMPANY, INC.

### INTELLIGENT INVESTMENT MANAGEMENT

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#### QUARTERLY LETTER

The first quarter of 1989 witnessed a continuation of trends discussed in previous memos. GNP growth is moderating, but grudgingly, so the markets and the Fed have pushed up short-term interest rates one more time. T-Bill rates have now been pushed from 6% to 9% in one year. The purpose of this push is to slow the economy (economists trained in Keynesian theories believe a too strong economy is inherently inflationary), and it seems to be working.

Various measures of GNP show increasing signs that the economy is slowing down. Because hikes in short-term interest rates are viewed as beneficial in controlling inflation, long-term rates have moved up only modestly (about 1/2 of 1%) during this time. We now have an "inverted" yield curve; short-term rates are higher than long-term rates. Because yield curve inversions often precede recessions and periods of stock market decline, this has excited a lot of people. These people are flocking to buy certificates of deposit paying 9% for a year or two, just as they did when rates were 15% in 1981 and 10% in 1984.

If 9% rates are so attractive, why not buy bonds paying 9% for 20 or 30 years instead of a year or two? The only reason not to is if you expect

inflation (and therefore interest rates) to go considerably higher. Since we have concluded that monetarist and "classically" trained economists have a better record at predicting inflation than Keynesians, and since money growth has been 6% or less for over two years, we don't see much risk of significantly higher inflation any time soon. At the risk of saying "This time is different" we note that this time the Fed started slowing money growth early, in anticipation of inflation rather than in reaction to it. In fact, the Fed began squeezing before the election, which is almost unprecedented.

The recent stability in both long-term interest rates and the dollar indicates that the markets (meaning the majority of people with their money on the line) are reaching similar conclusions. The current risk in bonds is that the Fed will have to raise rates still higher to satisfy the Keynesians, or to respond to higher short-term inflation as reflected in the Consumer or Producer Price Indices. Most of the current discussion is whether rates have peaked, are peaking or are about to peak.

The risk of recession remains. Fed tightening preceded each of the U.S. recessions since WWII (although not all Fed tightenings resulted in recession). A recession is certainly more likely when the Fed is trying to slow the economy rather than speed it up, but is by no means guaranteed.

In general, recessions are bad for corporate earnings and therefore bad for stock prices. Since most stocks are now fairly priced in relation to inflation and interest rates, earnings surprises are likely to be reflected rapidly in stock prices.

So what are the options? The economy may continue stronger than desired and the Fed will push rates higher. Good for earnings, bad for bonds. The economy may fall into recession. Bad for earnings, good for bonds. The economy may "muddle through" in a slow growth mode. OK for earnings, good for both bonds and stocks. A drought or other crisis (war or budget fiasco) is always a risk.

What to avoid? Stocks or bonds of companies with weak balance sheets. A continued squeeze by the Fed to raise interest rates and slow the economy will put greater pressure on business than we have seen at any time since 1981-82. This is not a time to borrow money. This is not a time to own high-yield or "junk" bonds. This is not a time to bet on fledgling companies or venture capital.

This is a time to select companies with strong balance sheets and good earnings who can weather any storm, to set prices at which these companies are compelling values, and to be prepared to buy their stocks-or their bonds when the cumulated evidence indicates that a turn in inflation and interest rates is probable. We are doing just that.

## **WORKING OWNERS, PART II**

While we're at it, we'd like to update an article that ran in the October 1987 Memo entitled "Worker's Capitalism Triumphs." In that piece we told you that American workers, through their retirement plans, are the unknowing owners of a big chunk of U.S. corporate equity. The totals for 1988 are in, and the employee's share of the wealth is bigger than ever.

Aggregate assets of the 100 largest pension funds just passed \$1 trillion. Of the top 100 funds, 46 are corporate; the rest are public or union related. Of the 46 corporate funds, the total market value of (lie sponsor's equity is \$715 billion. Thus the 100 largest funds could buy all (lie equity of the top 46 sponsoring companies and get change back from their \$1 (trillion).

If they so desired, thirteen of the corporate funds, including those of A T% T General Motors and USX, could buy all the stock of their parent companies. The California Public Employees could buy both General Motors and Eastman Kodak. The Pennsylvania School Employees could buy USX and PPG Industries.

Though transactions such as these are unlikely (and probably could not occur due to regulatory barriers), similar purchases have been attempted in the past. In 1987, the well-heeled Air Line Pilots Association tried to buy United Air Lines with financing from their pension fund. A final price was never agreed upon, and the pilots failed to gain control, but not for lack of money. Look for more such attempts in the future as workers turn the enormous economic power of their pension funds into a force for control over their employers.

Meanwhile, workers are gaining control by another more direct route and management is showing them the way! This is thanks to a popular takeover defense called the ESOP, or Employee Stock Ownership Plan. Originally designed as a way for employers who are strapped for cash to fund a retirement plan, ESOPs allow management to sell or contribute corporate equity to the retirement plans of (supposedly) friendly employees.

Executives who fear losing their jobs as a result of a takeover will even lend ESOPs the money to buy the stock! Is [his a case of choosing the familiar "evil" over the unknown? If it is, no one will admit it. When asked why they set up ESOPs, most managers simply say they "welcome the opportunity for increased employee involvement" in the company. The possibilities for irony are tremendous in arrangements like these; stay tuned

## **WE PREFER THE JAPANESE PRONUNCIATION**

Take heart, all you Muhlenkamp and Company clients who didn't recognize the name "Legent Corp." on your portfolio appraisals; you are not alone. It turns out Duquesne Systems has rechristened itself after a merger with Morino Associates. Actually a consulting firm came up with the rather generic sounding name. Of course, we don't care if they call it chopped liver as long as the earnings keep growing at 30% per year. Keep up the good work, gentlemen.