

### PERFORMANCE

	FMR Performance		Dow Jones	S&P 500
	Taxable	Retirement	Industrial	Dividends*
2018 Q1	-3.96%	-2.70%	-2.49%	-0.76%
2018 Q2	5.16%	4.11%	0.70%	3.43%
2018 Q3	3.71%	3.15%	9.01%	7.71%
2018 Q4	-11.89%	-10.97%	-11.84%	-13.52%
<b>2018 FY</b>	<b>-7.69%</b>	<b>-6.98%</b>	<b>-5.63%</b>	<b>-4.38%</b>

### Market Summary - a synchronized over reaction

The stock market peaked in mid-September and the S&P 500 index of domestic **stocks fell 19.8% before bottoming on December 26<sup>th</sup>**. Even though the S&P has rebounded approximately 10%, stocks and commodities are still well below the September highs. Crude oil was \$75/barrel in early October and ended the year at \$43/barrel, down over 40%. The S&P 500 (with dividends) finished down 4.38% for the full-year 2018, the weakest annual performance since the financial crisis of 2008. Nine out of eleven S&P 500 sectors were down for the year (utilities and health care sectors were up slightly). The fear of an imminent recession caused a “growth scare” and the market-leading technology stocks: Facebook, Apple, Amazon, Netflix, Google (FAANG) declined 28% in the 4<sup>th</sup> quarter. The FAANG stocks were a major cause for the total 4<sup>th</sup> quarter S&P 500 decline of 13.52%! As weak as U.S. stocks were, foreign stocks were far weaker for the full year 2018: International equity funds were down 15%; Latin American funds down 12%; China funds down 20%. The equity mutual fund dollar outflows in the 4<sup>th</sup> quarter were equal to the outflows in the 4<sup>th</sup> quarter of 2008, which was at the depth of the Great Recession.

### The Federal Reserve Conundrum

As was discussed in the Five Mile River mid-December email blast (and letter) to clients, market volatility dramatically increased. “Macro” issues in the headlines were thought to be the obvious causes: China’s economy, tariffs, gridlock in Congress, a slowing U.S. economy in 2019, and especially, the new Federal Reserve Chairman Jay Powell (or known to some in December as the “Grinch who stole Christmas”). While the stock market has been fairly valued to richly valued in some sectors for the past two years, it was not extremely overvalued. The correction in the 4<sup>th</sup> quarter was the largest of the past six corrections since the Great Recession ended in 2009. The past ten years have seen multiple economic growth scares. However, this correction was affected by a simultaneous growth scare AND a Federal Reserve that seemed intent on raising interest rates on a pre-defined schedule, a policy which COULD have induced a U.S. recession. The key triggers causing market weakness and the abrupt December 2018

correction were: 1) FED Reserve Chairman Powell's statement in October committing the FED to a robotic, pre-ordained increase in the short-term FED FUNDS rate, and 2) on December 19<sup>th</sup>, Chairman Powell, in the face of mounting evidence of economic weakness, reiterated the FED policy for four more rate increases in 2019 and 2020!

### **The Fed Policy Change on January 4th**

The Chairman's speech on Friday, January 4<sup>th</sup> offered a clear signal that the FED rate policy had changed from the statement made as recently as the 19<sup>th</sup> of December. Contributing to this change of policy was the fact that the 10-year Treasury note **yield** had fallen from 3.2% to **2.6%** in less than four months and was almost the same as the FED FUNDS rate (**2.5%**). The reason for the decline in the Treasury 10-year note yield was that there were clear signs that the U.S. economy was slowing (housing, autos, manufacturing index, and commodity prices). In his speech, the Chairman "walked back" the prior statement regarding future auto-pilot rate increases, and redefined the FED policy, saying that "monetary policy is a forward-looking exercise and that the Board will have flexibility, if needed." Fortunately, Jay Powell is not a doctrinaire academic economist, and he is not the culprit in the FED's plan to systematically raise the FED FUNDS rate. The main problem is that the former FED Chairman Janet Yellen failed by overstaying their zero-interest rate policy (ZIRP = 0 % interest). Several times in past Five Mile River quarterly client letters, we called this prior FED behavior "behind the curve." Fortunately for the new Federal Reserve Chairman, employment is strong at record levels without inflationary pressures (the two mandates of the FED), so the recent mis-step of policy announcements did not produce irreparable damage to the markets.

### **Volatility!**

What was certainly a surprise from this awkward FED policy mis-step was the excessive swings and unprecedented markets' volatility in such a short timeframe. The irrational psychology of the markets, where perception swung from "perfect" to "hopeless" within a few days during the 4<sup>th</sup> quarter, was NOT a function of fundamentals. The main offender for extreme market volatility was, and remains, the underlying structural reality that **at least 60%** of daily domestic stock trading is controlled by quantitative programs (trading directed by mathematical computer models, index funds, quantitative hedge funds, and high-frequency traders). These electronic trading programs have altered the market structure and damaged the normal liquidity available to keep volatility under control. For example, when a computer model says to buy an S&P 500 exchange traded index fund, most of these "quant" managers instantaneously and simultaneously buy all 500 stocks in the index, and when the quant models dictate a sale, the same 500 stocks are sold. The result of quantitative trading has been exaggerated swings in stock prices and market indices.

### **Free Cash Flow and Dividend Growth**

Both as a client and as a research driven investor, we know volatility gives us the opportunity to **take advantage of mispricing**. Stock price undervaluation from these huge swings provides opportunities to add to or initiate new positions at favorable prices, while continuing to execute FMR's dividend growth strategy based on company fundamentals: FREE CASH FLOW AND DIVIDEND GROWTH. There are now numerous examples of low hanging fruit, courtesy of the 4<sup>th</sup> quarter volatility. Corrections, while usually not as severe as this past Christmas, are not uncommon in the late stages of a long economic expansion. Renewed gains, such as those seen after Christmas and the first week of 2019 (+8% rally) are reasonable to expect. There are several reasons that Five Mile River has maintained a positive outlook during the recent turmoil. Importantly, corporate profit growth is still expanding! The rate of corporate profit growth will slow in 2019 compared to 2018. In 2019 corporate profit growth

rate is projected to be between +5% to +10%, versus +20% for 2018. Nonetheless, this corporate profit growth rate is still healthy. Another positive is that the consensus estimates of GDP growth in 2019 is +2% to +2.5%, moderately down from the 2018 GDP growth of 3%+. In addition, interest rates are at very low levels by any historical standard. Also, in the last six months the Price Earnings ratio (PE) on the S&P 500 has moved from 17.5 times 2019 earnings to 14.2. Attractive stock valuations, combined with at least a partial favorable resolution of the China tariff standoff, can result in **2019 stock price appreciation of +8% to +10%**, with dividends providing on average a 3% cash yield.

Free cash flow is a key indicator of future profitability and potential investment opportunity. How companies deploy their free cash (share buybacks, capital expenditures, acquisitions, debt reduction, dividends) is a reliable metric in evaluating companies and predicting stock price performance. FMR welcomes requests to discuss examples of companies having high recurring revenues that generate growing free cash flow.

Unfortunately, the SEC and State Banking Division of Connecticut discourage mentioning stock ideas in FMR's quarterly letters and therefore FMR has discontinued writing about specific stocks. Nevertheless, FMR can discuss examples of companies having high recurring revenues that generate growing free cash flow. Please call with questions on this, or questions on the markets and FMR's outlook for 2019.

We wish you a healthy, happy and prosperous New Year!

Sincerely,

Lee

Todd

Martha

*\*The S&P 500 Index is a market capitalized weighted index of 500 companies. It is a growth-biased index because the larger the capitalization of a company, the larger the weight it contributes to the S&P 500 Index performance. The index referenced includes the dividends issued by these 500 companies. This index is used for a comparison for FMR retirement accounts.*

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