

**PERFORMANCE**

|          | FMR Performance |               | Russell<br>1000 Value | Dow Jones<br>Industrial | S&P 500<br>Dividends * |
|----------|-----------------|---------------|-----------------------|-------------------------|------------------------|
|          | Taxable         | Retirement    |                       |                         |                        |
| 2019 Q1  | 12.32%          | 13.35%        | 13.43%                | 11.81%                  | 13.65%                 |
| 2019 Q2  | 4.31%           | 4.00%         | 3.74%                 | 3.21%                   | 4.30%                  |
| 2019 Q3  | 1.06%           | 1.29%         | 0.92%                 | 1.83%                   | 1.70%                  |
| 2019 YTD | <b>18.41%</b>   | <b>19.41%</b> | <b>18.75%</b>         | <b>17.51%</b>           | <b>20.55%</b>          |

The Five Mile River January 12, 2019 letter forecast a rise in the S&P 500 of 8% to 10% for the full year 2019. With the S&P 500 now on track to substantially beat that forecast, what have been the factors to bring the market to this 20.55% year-to-to date rise? The market strength is not explained by the 2019 corporate profit growth this year, likely to be only flat OR up, at the most, by 5%. GDP has remained between 2% to 3% over the past two years and fails to explain the market’s strength. There were however, three significant factors that helped lift the 2019 market performance thus far:

- 1) This year began at an unrealistically low market valuation after the December 2018 market drop of 9.96% (S&P 500), caused by the comments from our Federal Reserve Chairman in the first week of December. In a statement in early January, Fed Chair Powell reversed his planned course of raising interest rates, and markets responded positively.
- 2) In 2019 the Federal Reserve lowered the fed funds rate twice. Lower interest rates have been driving Price Earnings Ratios (P/E) higher.
- 3) The international inflow into U.S. securities (stocks and bonds) came from the attraction of a strong dollar and from investors cashing out of parts of the \$15 Trillion of negative yielding bonds in Japan and many European countries.

**BIGGEST CONTRIBUTOR FOR 2019 MARKET RISE and WHERE DO WE GO FROM HERE?**

Of the three reasons above, the S&P 500 year-to-date gain of 20.55% got the most significant boost from lower world-wide interest rates. Consistently over time, declining interest rates correlate with rising company P/Es. The reasons for this are multifold, but here are two that are significant: one, earnings rise because companies can lower their interest cost on their debt by refinancing; and two, company valuation metrics improve because a company’s present value RISES when interest rates drop. Simply put, declining interest rates coupled with a rising P/E have been great for U.S. stocks thus far in 2019.

Pundits have made the case that a recession is imminent in either 2020 or 2021. Their investigational toolkit relies primarily on the negative sloping yield curve, also referred to as the inverted yield curve. This is when short-term interest rates have a higher yield than longer maturity bonds or notes. The negative sloping yield curve has

preceded most, but not all, recessions. Importantly, the negative yield curve is now reversing positively. The Federal Reserve may very well lower the fed funds rate another quarter point near the end of 2019. This year's tailwind of higher P/E's, caused by lower interest rates, is largely over because rates on 2-Year, 5-Year, 10-Year, and 30-Year notes and bonds are likely to rise from current levels. With the yield curve finally beginning to rise, it is a good sign for the economy because a steepening of the yield curve is a positive leading economic indicator.

These same recession pundits argue that we have eclipsed the "average" eight-year duration of a business cycle. The U.S. is now in its tenth year of expansion and no one really knows how long this business cycle can last. Mentioned in other FMR letters is that Australia, by comparison, is in its 29<sup>th</sup> year of expansion. Consumer confidence has ALWAYS turned down BEFORE a recession, and this metric currently remains strong. We look for U.S. economic growth to continue and possibly accelerate if this confidence indicator can be maintained. Successful tariff resolution with the E.U. and China would clearly supply more support for a growing U.S. economy.

#### MARKET and P/E HEADWINDS: TARRIFS AND OIL

The surest causes for a rise in long-term interest rates are two current inflationary headwinds: tariffs and oil. Rising inflation is the enemy of bond prices. Tariffs and oil represent real pressures on inflation that carry innumerable unintended consequences.

Tariffs and oil have the capability to cause multi-fold sources of inflation that roll into everything from a gallon of milk to the cost of a car. Why? Tariffs will result in rising car prices, however, a car purchase can be deferred. On the other hand, consumer products packaged in plastics (made from oil) will also rise in price as oil prices go up, however the purchase of a gallon of milk will not be deferred. It is significant to note that the "annualized three-month" rate of inflation per the Consumer Price Index (CPI) has been accelerating and is now 3.4% (the Federal Reserve's "inflation target" is only 2% to 2.5%).

Tariffs are gradually increasing prices for Chinese and European imported products. Even with Non-Chinese and Non-European substitution, other product alternatives will have upward price pressures as well. Tariffs are also being blamed for trade disruption that is slowing the economies of China, Europe, Japan, the UK, and the U.S. Could this slowing become recessionary? While the probability has increased, it is more likely the recession risk is mitigated by strong consumer confidence, and that a recession should not be an investment factor. The trade disputes with China, however, are significant and unlikely to be resolved quickly. Because the U.S. and China represent 40% of world trade, this skirmish and the drags caused by tariffs exert greater world economic influence than is generally appreciated. Manufacturing appears to be temporarily soft in the U.S., after declining in Europe since the start of this year. Manufacturing is now less than 10% of GDP, so this softness is not sufficient to cause a downturn on its own, but the tariff drag can reduce GDP to a 1.5% to 1.9% rate if tariffs persist.

The September 14<sup>th</sup> attack on Saudi oil production will put upward pressure on oil prices. The attack was precise, targeting a choke point that will curtail several million barrels of daily production for an extended period. Because the Saudi's oil production has now been the target of five separate attacks, the two most recently from drones, it is possible that oil prices will begin to carry a military or "war" risk premium.

#### FMR GUIDEPOSTS FOR PORTFOLIO MANAGEMENT

The political, social, and economic landscape carry multiple uncertainties, however, FMR maintains specific investing guideposts worth mentioning. Market corrections of 10% are normal, and typically occur almost yearly. The reason we focus on "bottom-up" research for FMR client portfolios is because trying to time the market is truly a loser's game. Not only does one have to make two perfect decisions (when to sell and when to buy back), BUT if one misses only the four biggest up days a year, the five-year and ten-year annual returns would be NEGATIVE! Therefore, company specific research enables FMR to take advantage of the market's volatility –

market volatility causes a miss-pricing and under-valuation of many companies' stock prices. FMR portfolio managers look for not only miss-pricing and under-valuation, but look to those companies that have free cash flow and pay out growing dividends. These are dominant companies in their industries and can grow their free cash flow in the face of headwinds. While the U.S. economy initially showed some disturbing weakness in June and July, the disappointing employment numbers for those months were revised upward on October 4th. August data including retail sales, employment, income, and consumer confidence all registered strength, and the September unemployment rate of 3.5% was an historic low. However, initial indications do show that September manufacturing was weak. Any movement in trade negotiations will move this needle positively.

On a go-forward basis, it is reasonable to assume the market will expand closer to the level of earnings growth, as the P/E expansion has probably ended. Earnings estimates could be simplistically estimated to grow at 5% to 6% because GDP is only likely to expand at 1.5% to 2%, add inflation of another 2+%, and throw in 1+% for productivity. A slow expansion in the market makes correct stock selection that much more important.

The SEC precludes FMR from sending stock recommendations to non-clients, so those of you who are interested in discussing FMR stock selection process, including this quarter's highlighted stock, please contact us.

We are always available to discuss the market, portfolio investment strategy, stock selection, and specific risk management strategies. We all wish you a delightful fall and wonderful holiday season.

Sincerely,



Lee



Todd



Martha

*\*The performance data included in this letter are not audited and have not been otherwise reviewed or verified by an outside party. While Five Mile River Investment Management, LLC endeavors to furnish accurate information, investors should not rely upon the accuracy or completeness of this information.*

*\*\*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 weighting 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 accounts.*

*This letter is not meant as a general guide to investing, or as a source of any specific investment recommendation, and makes no implied or express recommendation concerning the manner in which any clients' accounts should or would be handled as appropriate investment decisions depend upon clients' investment objectives. Any offer to sell or the solicitation of an offer to buy any interests in any securities may be made only by means of delivery of a Five Mile River Investment Management Agreement and/or other similar materials which contain a description of the material terms and various considerations and risk factors relating to such securities or fund. Different types of investments and/or investment strategies involve varying levels of risk, and there can be no assurance that any specific investment or investment strategy will be either suitable or profitable for a client's or prospective client's portfolio, and there can be no assurance that investors will not incur losses.*