Five Mile River Investment Management, LLC July 13, 2024
Client Quarterly Letter
2nd Quarter 2024

PERFORMANCE

	Dow Jones Industrial	**S&P 500 w/ Dividends*** (Capitalization Weighted)	**S&P 500 EWI**** (Equal Weighted)
2024 Q1	5.62%	10.56%	7.91%
2024 Q2	-1.73%	4.28%	-2.63%
2024 FH	3.79%	15.29%	5.08%

The stock market is the most reliable of all the leading economic indicators, many argue it is the best. The issue is that the S&P 500 continues to set new highs, all the while the recent U.S. economic data suggest a broad weakening. Now, the market strength is being propelled by only a narrow handful of stocks. The Magnificent Seven (or the magnificent six or five) are obscuring a broader weakening in the market. This is clearly evident in the S&P Equal Weighted Index (EWI) performance for 2Q24 of -2.63% compared to the S&P 500 2Q24 performance at 4.28%. The perceived strength (?) of the S&P 500 is creating a disparity with the coincident weakening in the economy. The question becomes, which is correct? Some of the recent weakening data are summarized below:

- Retail sales, ex-autos, are unchanged for three months running.
- The University of Michigan survey of consumer confidence has fallen sharply in each of the last three months.
- The ISM Manufacturing Index (formerly the Purchasing Managers Index) has fallen below 50% for each of the last six months. The most sensitive index as part of the ISM Index series, is the "New Orders Index." This number for new orders from manufacturers has turned below 50%, which often signals economic contraction.
- Housing starts, permits, and overall construction have all slowed, also a sign of the breadth of of the slowing economy.

Five Mile River's (FMR) 1Q24 Client Letter discussed the reasons why the Federal Reserve would keep interest rates higher for longer. However, the recent compilation of weakening economic data signals that the Fed can now begin reducing rates. As was the case in 2021, the Fed is overstaying its policy, this time remaining too restrictive (too high for too long). Remember that the same group at the Federal Reserve called inflation "transitory" in 2021, all the while holding rates lower for longer in the face of emerging inflation. Now, is the Fed again "behind the curve" by holding rates too high for too long? The Federal Reserve's current posture is to hold interest rates and wait to lower rates until there is further evidence of lower inflation readings. Given a weakening economy this tight/high interest policy puts at risk something BREAKING.

Commercial real estate loans may be reaching the breaking point. This sector will likely continue to deteriorate because of a triple whammy: falling commercial real estate pricing; falling office rental demand; and continued constraints on the availability and cost of capital. Downtown office space, once thought to be a trophy asset, is toxic in many cities. The valuations of downtown real estate office buildings have fallen 50% in just the last two years according to the MSCI World Real Estate Index series. Two of the very largest real estate funds, BlackRock and Starwood, are experiencing record withdrawals. These two funds are emblematic of the current inaccessibility of what had been plentiful funding sources. The Mortgage Bankers Association estimates that $1.2 trillion of commercial loans mature in the next twenty-four months. It is simply NOT prudent to assume these loans all get refinanced without a hiccup. Like a game of Jenga, removing the wrong block can initiate a broader financial result. Five Mile River clients hold only one bank stock in their portfolios, JP Morgan, because it is the best managed, the largest U.S. bank, and has a fortress balance sheet.

Some interpret the market strength to assume that Artificial Intelligence (AI) growth and productivity benefits will offset the current economic weakness. Trying to determine exactly what the market is discounting is more art than science. Nevertheless, AI is described as transformational, so it is probable that the market is assuming AI will eclipse economic weakness.

For the market to be correct, AI will have to generate incremental GDP growth and productivity benefits as well. Labor productivity has averaged 1.5%/year for the last 40 years, and it would have to average at least 2% for a sustained period to offset the current economic weakness and hopefully provide a potential path for U.S. debt reduction. A period of sustained higher productivity did occur for about six years in the 1990's and early 2000's. While this boost in productivity may occur, the obvious question is whether this happens in time to prevent possible economic shocks caused by a weakening economy?

Five Mile River has positioned client portfolio investments across the AI food chain. FMR is investing in companies that are uniquely positioned to benefit from the transformation to AI. These are the companies that will continue to provide the capacity, the data, the functionality, and the energy for AI. The FMR client investments include: AI providers; semiconductor manufacturing; large data centers equipped to support AI capacity; cell tower operators; and segments of the energy sector that must step up to produce energy to support the huge AI appetite. In other words, FMR has client investments that not only offer AI solutions, but most importantly, provide the plumbing that will allow access to the necessary data volumes that AI requires.

The S&P 500 showed strength in the first half of 2024 (1H24 S&P 500 performance was 15.29% with 2Q24 contributing 4.28% to that performance). How much of this gain can be attributed to the Magnificent Seven stocks? The answer, fully two thirds of the S&P gain! The Equal Weighted S&P 500 Index tells a starkly different story with a 2Q24 performance of -2.31% and a 1H24 performance of 5.08%. The 1Q24 FMR Client Letter highlighted what appeared to be the start of a broadening of the market. However, that turned out to be a false start. Magnificent Seven's 2Q24 performance shielded a growing weakness in the broader S&P 500. This disparity between the S&P 500 and the real economy has become pronounced in the most recent quarter. How this disparity gets resolved could be a market correction, or a correction among the Seven, or more positively a broadening strength in the rest of the market.

FMR mitigates market risks by the investment strategies employed for clients and believes trying to time the market is a fool's errand. It bears repeating that FMR's research constantly uncovers industry leading businesses that generate free cash flow and pay attractive growing dividends. FMR manages risk by trimming holdings which become too large, and adding investments that are attractively priced and fit FMR's investment criteria. This investment process reduces volatility and mitigates market risk.

RTX (formerly Raytheon Technologies) is a good example of FMR's ability to take advantage of short-term price weakness to add to a quality stock in client portfolios. RTX CORP experienced a drag last year to the low 80's due to production issues in its commercial aerospace business. The discussion below highlights FMR's decision to buy and add to this holding and gives a look into the future potential for the stock's appreciation (NYSC RTX closed at $101.28 on 7.12.24).

The Defense Industry and RTX CORP

Five Mile River client portfolios have typically owned anywhere from a 4% to 9% weighting in defense and aerospace companies. Why? It is obvious that a strong defense profile on land, water, sky, and space has been increasingly important to our national strategic defense and that of our allies. The defense sector is controlled by government spending and shaped by geopolitical tensions and alliances. Commercial aerospace demand is a product of economic conditions and global travel patterns. Commercial aerospace creates a cyclical market, versus the more stable pattern of aerospace defense spending.

Global confrontation has dramatically increased. The ongoing major war in Ukraine along with the more recent war in Israel, and deadly confrontations in Lebanon, Yemen, and the Red Sea have required defensive and offensive weapons to protect American interests and those of our allies. This includes not only restocking ammunition, but also urgent requirements for air defense interceptors, artillery rounds, armored vehicles, and anti-tank weapons. Additional recent demand from our Asian allies, South Korea, Japan, and of course Taiwan, have also improved the outlook for U.S. defense companies. The current administration, Senate, and House have proposed an $850 billion 2025 budget request for the Department of Defense, a 1% annual increase. Internationally, military budgets are rapidly rising, and future defense-budget growth is likely to ramp up as more of these global conflicts remain unresolved, and the U.S. is relied upon to provide the defensive and offensive equipment solutions.

FMR client portfolios maintain significant positions in the defense sector that include Lockheed Martin, RTX Corp, and General Dynamics. Global demand continues to strengthen for commercial jet engines, military drones, combat systems (Patriot Missile Defense), private jets (Lear) and submarines (Columbia Class). Continuing orders from European allies (Spain, Netherlands, Germany, Romania) have also bolstered business with these companies. This rising demand will include much needed digital modernization utilizing AI for cybersecurity and autonomous technologies that can function and execute without human interface. The U.S. defense industry is growing rapidly to meet the current and future challenges.

RTX produces aircraft engines for both commercial and military, as well as avionics (navigation and communication systems) at their Pratt & Whitney and Collins Aerospace facilities. RTX is a major military contractor that designs and builds guided missiles and air defense systems. RTX's Patriot Air and Missile Defense System is the crucial system for intercepting and neutralizing incoming missiles and is currently critical technology for the defenses of both Ukraine and Israel. RTX Defense Systems also include the Phased

Array Radars for early-warning threats; Standard Missile-3 to intercept failing satellites; and Visible Infrared Imaging Radiometer Suite for high-resolution earth images.

RTX stock price is up 25% in 2024 as it bounced back from an over-reaction in 2023 due to the significant issue in the Pratt & Whitney's aerospace division. This issue involved powder metal contamination from a supplier to their Geared Turbofan commercial airline engines. Inspections and repairs are on-going, and the rework will likely extend into early 2026. This manufacturing issue did not pose a safety threat, and no planes have been grounded by the Federal Transportation and Safety Board. In spite of RTX's manufacturing challenge, earnings per share have continued to grow at 8% to 10% a year and will accelerate going forward from the big demand for The Patriot Defense Missile System. RTX's backlog is up to a record $202 billion in the current quarter, comprised of $125 billion in aerospace and $77 billion in defense. RTX yields 2.5% and coupled with a recently announced $10 billion share repurchase, this stock offers above-average long-term appreciation potential.

Please feel free to reach out at any time to review your portfolio holdings and/or investment strategy, or to discuss any changes in your financial objectives. We are also happy to share thoughts on the market.

We wish you an enjoyable summer season.

Sincerely,

Lee Todd Martha

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**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 <u>includes the dividends</u> issued by these 500 companies. This index is used for a comparison for FMR accounts. 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 Equal Weighted Index (EWI) is a version of the S&P 500 index however the difference is that all 500 companies of the S&P 500 are given an equal weight of 0.2% of the total index. This differs from the S&P 500 which gives the highest valued companies the largest weight in the index (otherwise known as the market cap weighted index). The EWI eliminates the mega cap concentration that produces a distorted market index performance.*

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.*

Please remember to contact Five Mile River Investment Management if there are any changes in your personal/financial situation or investment objectives. Please also advise Five Mile River if you would like to impose, add or modify any reasonable qualification to your investment portfolio/s.