Five Mile River Investment Management, LLC January 21, 2018
Quarterly Letter
Year End 2017

PERFORMANCE

	FMR Performance		Dow Jones	S&P 500
	Taxable	**Retirement**	**Industrial**	**Dividends***
2017 Q1	4.49%	3.82%	4.56%	6.06%
2017 Q2	0.73%	1.90%	3.32%	3.09%
2017 Q3	1.03%	0.83%	4.95%	4.36%
2017 Q4	1.04%	0.44%	10.33%	6.23%
2017 FY	**9.83%**	**10.62%**	**25.08%**	**21.80%**

2017 Tax Reform Act and the Stock Market

The 2017 Tax Reform Act, the first comprehensive personal and corporate tax reform in 30 years, was passed into law December 23, 2017. The Five Mile River 3Q17 Newsletter stated that corporate tax reform was the key to further gains in the equity market. Generational tax changes, both corporate and personal, will likely ensure the continuation of what is set to become the longest economic cycle in U.S. history. Stock market valuations rose in anticipation, and will likely rise further, as the U.S. corporate tax rate is no longer the highest in the developed world.

Synchronized global growth in 2017 was the strongest in a decade, and in two-thirds of these countries growth accelerated. While all expansions eventually end, in 2018 worldwide growth is likely to broaden and deepen**. Ending double taxation on foreign corporate profits and bringing down the corporate rate from 35% to 21% were clearly big catalysts for the S&P 500 advance of 6.23% in the fourth quarter. Rising corporate earnings estimates for 2018 and for 2019 provide support for the gains of 2017, as well as the opportunity for further gains in 2018.**

There are several reasons why the 2017 Tax Reform Act should continue to have a significant effect on the stock market. The principle reasons are as follows:

1. Market valuations (price earnings ratios) rose in the expectation that domestic corporate profits would get an extra boost from the 2017 Tax Reform Act of anywhere from 5% to 10% over what was expected with the old 35% corporate tax rate.

2. The U.S. has formally had what was known as a “worldwide” tax system for corporate profits. Because of the newly passed 2017 Tax Reform Act, the U.S. will now move to what is known as a “territorial” tax system. Under the old tax code, the U.S. taxed corporations on **both** domestic and foreign profits with **no credit** for paying taxes in those foreign countries. If corporations left the foreign profits overseas in their foreign subsidiaries, they could defer paying the U.S. tax. Major U.S. international corporations (technology and healthcare sectors, in large part) did not bring their profits home to be double taxed, and invested these funds in new manufacturing plants abroad. Currently, approximately **$2.5 trillion** in cash is held offshore on the balance sheets of major U.S. multinational corporations.

3. Under the 2017 Tax Reform Act, the domestic corporate tax rate will be vastly more competitive with other developed countries, and U.S. companies will be able to bring home a significant amount of their overseas trapped cash. In the short-term it is estimated that at least $1 billion of repatriated cash will return to the U.S. since it is now taxed at only 15%.

4. Finally, the corporate part of the tax reform bill will allow companies to expense (depreciate) capital expenditures immediately, instead of the current requirement of writing down investments in plants and equipment over several years. This change increases **free cash flow** that will: fund increased domestic capital investment; allow for debt retirement; and create additional value strategies for shareholders (dividend growth and stock buy-back).

FMR is optimistic that U.S. corporations will now have greater incentives: to stay in the U.S.; to build new plants; to increase expenditures on capital equipment and manufacturing plants; and to create new and higher paying jobs. These programs will contribute to growth in the U.S. economy which has already registered two consecutive quarters of 3+% growth.

To support a sustainably higher GDP growth, two economic metrics must also expand: **increased work force and increased productivity** (output per worker). There is no magic here in this last sentence. The U.S. labor force participation rate (working age men and women between the ages of 25 and 54) is at a historical low. This is the ratio of men and women between the ages of 25 and 54 who ARE working as a percentage of this age group’s total population. From a peak in 1948 of over 96%, the current participation rate is 63%, and this does not include the age range affected by the retiring “baby-boom” generation.

Today, it is estimated that about 10 million men, or one in six prime-age men in America, are either unemployed or out of the workforce. While there is extensive data on who and why so many are out of the work force, the major factor for men is the decline of traditional jobs in the manufacturing and construction industries. At the highwater mark for male participation in **1954**, **40% of all jobs were in these two sectors.** Today, after the long decline of manufacturing in the U.S. and the end of the housing bubble, these sectors account for just **13% of the U.S. jobs market!**

How do we accelerate growth, create new jobs and train new skill sets? Certainty and sustainability in durable fiscal and tax policy, that do not change every two to four years, is mandatory for most corporations to decide to bring back their foreign jobs and build new plants in the U.S. An example of a successful and stable pro-business environment with the lowest corporate tax rate in the developed world is the Republic of Ireland with a **12.5% tax rate.** U.S. companies will now be better able to compete on the world stage.

The Federal Reserve Tightening and the Stock Market: A Caveat

In 2017 the S&P 500 was up 21.80**%** as the stock market "melted up" from bullishness on potential tax reform. Growth stocks significantly dominate this index, particularly technology names, and this index derived more than a third of its 2017 performance from just five technology companies. As the 2017 Tax Reform Act looked increasingly likely, December stock performance increased not only in technology, but across a broad range of industries and companies. This breadth in the December's stock market advance bodes well for 2018, because earnings growth acceleration is now evident across multiple sectors of the economy.

Gone almost unnoticed and with no market impact, was the Federal Open Market Committee's decision last December to raise the target range for the short-term federal funds rate from 1 ¼ percent to 1 ½ percent. Just before Christmas, the Yellen Fed stated its 2018 forecast is to both raise the federal funds rate **three times (raising short-term interest rates), and to increase the rate of selling of its $4 trillion bond portfolio (raising long-term interest rates).** Do these tightening actions make sense this late into the long, slow economic recovery? As we have discussed in past letters, the FED is late in normalizing interest rates, "behind the curve" in our opinion, and missed their "window" two years ago. So, if the FED becomes too aggressive in tightening monetary policy, they could be the countervailing force that offsets the positive impact from corporate tax reform. We do not know whether the **six new members of this FED committee** will adopt or modify former Chairman Yellen's announced policy moves. We believe that the FED would back off if inflation is still at 2% or lower. While the persistent low inflation rate remains a quandary for now, 2018 will probably experience inflation from rising commodity prices, particularly energy, along with a tightening labor force. Together these pressures will likely introduce the risk that inflation rises above the FED's 2% target. The question of "How does our newly constituted Federal Reserve Board respond?" remains to be seen.

FMR Stock Market Outlook

As a focused **dividend growth manager,** we do not spend a great deal of time on stock market forecasts. We focus on identifying companies with strategic and dominant assets that produce **large amounts of free cash flow.** Also, it is critical to have astute management motivated to create shareholder value from their business models. Trying to invest and add value by predicting price earnings ratios (P/E's) and whether earnings beat or miss quarterly earnings estimates has become a crowded short-term game with diminishing returns. The success of FMR's dividend growth strategy is evident in our consolidated performance. Five Mile River has an annualized performance of over 8% since inception in 2003, and you can review 15 years of performance of Five Mile River on the website: www.fivemileriver.com.

The **S&P 500** closed 2017 at **2679,** and if the FED does not pull away the punch bowl in 2018, the market upside, as measured by the S&P 500, could range anywhere from **+5% to +12%. This gain is a direct result of the higher earnings caused by the positive impact of the change in tax rates.** A miscalculation by the new FED committee could trigger a market decline of **5% to 10%**. If that occurred, we would expect this new board to postpone one or more of the Fed Fund rate increases until they better understood the inflation numbers and the economy's growth rate. Our expected 2018 portfolio total return in Five Mile River Portfolios range from **+6% to +9%.**

Regardless of how these two scenarios play out this year, Five Mile River's strategy will continue to seek out and own companies with increasing dividend income and long-term capital growth. These companies own strategic assets/services with significant barriers to entry, and have major competitive advantages executed by value-creating managements. In 2018, FMR **expects the absolute level of cash dividends paid in FMR portfolios to grow by 6% to 8%.** Dividends remain an important component of total stock market return. Since World War II approximately 40% of the S&P 500 total return came from dividends. We expect this component of investment return to be less volatile and more durable through different economic and market cycles. In a few words, FMR portfolios generate a growing income stream from this dividend growth strategy that is "sustainable," and a cornerstone for maintaining both income growth and capital appreciation**.**

Outlook for Energy, an industry of interest for 2018

The OPEC and Russian production cuts, started in early 2017, accompanied by continued growth in world demand, have reduced worldwide inventories sufficiently to spark a rise in energy prices. We have written previously that the cost of producing a NEW barrel of oil in the U.S. is close to $78/barrel. Given the tightening of oil's current supply/demand, and the absence of oil service spending over the past five years, it is probable that the price of oil rises to its replacement cost of $78+/barrel. This should attract new money flows into stocks in the energy sector, reversing two years of poor performance.

Please call if you have any questions regarding Five Mile River's investment strategy or stock market outlook. Wishing you a Healthy, Prosperous and Happy 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 weighting it contributes to the S&P 500 Index performance. The index referenced includes the dividends issued by these 500 companies.*

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