Five Mile River Investment Management, LLC April 25, 2018
Quarterly Newsletter
1st Quarter 2018

PERFORMANCE

	FMR Performance		Russell 1000	Dow Jones	S&P 500
	Taxable	**Retirement**	**Value**	**Industrial**	**Dividends**
2018 Q1	-3.96%	-2.70%	-0.40%	-2.49%	-0.76%

After several years of a steadily rising stock market with very few daily market price changes of more than 1%, high volatility returned with a vengeance in the first quarter of 2018. While the S&P 500 index started the new year at 2673, it ended this quarter virtually unchanged at 2640 on Friday the 30th registering a drop of 1.24% (S&P 500 no dividends). The last two months of the quarter were anything but calm. Two fast 5% to 10% corrections in February and March, were followed by rapid and volatile upside rebounds. We have commented previously that neither 2016 nor 2017 had experienced corrections, which was highly unusual. The corrections in February and March, while overdue, may not have signaled the end of the necessary resetting of so many speculatively priced securities (Facebook..). Also, we have emphasized that corrections are actually a healthy byproduct of a strong bull market, and typically bring about rotation among different sectors. In just the last month, there appears to be rotation away from technology and into energy. The math here is worthy of note, as the technology weighting in the S&P 500 is 25% of the index, while energy is only 7% of the index. Therefore, a mere 10% shift out of tech into energy implies a potential lift of 30% for the energy sector. While increased volatility and overblown "macro" concerns seemed the order of the day, by the end of the quarter, the S&P rallied to be down less than 1%, as solid company fundamentals and strength in corporate earnings ameliorated these concerns.

Investors in the Exchange Traded Funds (ETFs) space have little appreciation for the lack of liquidity in these vehicles, and in many cases ETF's are structured with leverage, representing significant risk. While the sales pitch of ETF's sounds compelling: low cost, index tracking, and tax efficiency, they are thought to be the embodiment of passive investing. However, because there are more ETF's (1500+) than stocks on the New York Stock Exchange, deciding which ETF's to own is an active process, NOT passive, whereby many of the benefits are lost. Once again Wall Street has created an entirely new asset class, ETF's, which have grown in market size to represent an entirely new dimension of market risk, one which is NOT clearly understood.

February Market Sell-Off Culprits: Stock Market Volatility and Exaggerated Macroeconomic Concerns

The first correction was caused by a spike in the Volatility Index (VIX), trapping speculative traders in some exotic, leveraged ETFs in a pure speculative bet against future stock market volatility. An example: Pro Shares SHORT VIX, Short-Term Futures ETF (SVXY). This "low volatility forever bet" got caught by the surprise of a sharp rise in volatility. In the case of SVXY, it went from $107 to $11 in a 24-hour period (February 5th and 6th). Even though this ETF traded on average 20 million shares a day, it was not a liquid instrument in a stressed market. Unable to sell this ETF, many holders chose to hedge themselves by selling the underlying S&P 500 stocks, causing the market rout over those two days in early February. Therefore, the selling in the S&P 500 in February was caused by a malfunctioning ETF, therefore the sell-off had no fundamental basis for happening. But why was there a sudden change in market volatility the first week of February?

Interest rate increases are the "tripwire" for the market, and exaggerate the macroeconomic concerns. The 10-year Treasury Note yield has increased from 2.25% to 2.95% in a span of about six months. While this absolute level is still low by historic comparison, the increased rate imposes a higher hurdle for stocks as the 10-year Treasury Note is used as a measure of the "risk free rate of return." In addition, higher rates result in rising interest payments across all variable rate debt instruments, estimated at $150 trillion! This total of variable rate debt includes mortgage and corporate debt ($10 trillion). The balance, or $140 trillion, is variable rate debt associated with derivative strategies! The tripwire analogy helps explain why seemingly benign data is now causing significant market swings. The apparent reason for the February 5th market decline, which was coincident with the spike in volatility (VIX), was the January report of labor wage inflation at 2.9%. **This one data point was extrapolated into a significantly higher inflation rate, and thus creating the potential for higher interest rates than commonly expected.** This created concern that the Fed would raise short-term federal funds rates four times this year, instead of the previously announced three times.

The Federal Reserve has announced that it is liquidating $30 billion PER MONTH of its holdings in mortgage, corporate, and Treasury debt, accumulated from 2010 to 2017 during its quantitative easing. Beginning in 2019, these sales will increase to $50 billion per month! These sales (supply of bonds) will be in addition to the budget funding which requires another $50 billion of Treasury paper sold each month. The question becomes whether the bond markets will absorb this rapidly increasing supply, knowing that the Federal Reserve will be increasing interest rates at the same time. Given the rate increase forecast by the Federal Reserve, the 10-year Treasury Note will rise from the current 2.95% to over 4.00% by year-end 2019. The other question is whether this rising tripwire will handicap bonds, as well as stocks. Fortunately, these concerns were NOT substantial enough to keep long-term equity investors from returning to stocks with most of the declines recovered by early March. Why? Corporate earnings and capital investment are accelerating this year from the first significant tax reform in 30 years.

March Sell-Off Culprit: Tariffs!

The second negative surprise was the March 1st unexpected announcement of large steel and aluminum tariffs across all imports, but really pointed at China. Initially, the short-term market traders melted into Armageddon at this outrageous proposal with memories of the disastrous Smoot Hawley Tariff of 1930. Short-term traders were wrong again. Rather these tariffs were intended to send a strong message to China, not just on aluminum and steel, but also their persistent theft of "intellectual property" from American companies. Not surprisingly, China retaliated with the announcement of equivalent dollar effected tariffs on imported U.S. goods. Remember, the process for implementing tariffs requires a six-month cooling off window before any U.S. action can be initiated. This permits ample time for negotiated settlements. It was most promising that China's President Xi announced on Tuesday, April 10th, that China would lower import duties on a broad range of U.S. manufactured goods. Once again, we witness the negotiating style of this administration which begins with a bluster of demands, then some negotiation, and then (hopefully) reaching a favorable policy settlement. While this is a style heretofore not exercised from the Oval Office, when overlaid with the interest rate tripwire, markets will experience increased volatility with probable unintended consequences. After all the above, as the quarter closed, the stock market rallied strongly across the popular indices.

Long-Term Wealth Creation versus Market Timing

FMR's investment strategy is to create long-term wealth and reliable future income. FMR does not practice market-timing, however we are consistent investors in dominant companies that generate more cash than they need to run their businesses ("free cash flow"). This strategy rewards shareholders with both share buybacks and growing dividends. FMR is not a fixed income (bond) investor in this market, however, there can be appropriate times for holding cash or investing in an allocation in short maturity bonds. Cash has essentially earned no income since 2009. Treasury, municipal and corporate bonds are likely to suffer capital losses, given the interest rate increases anticipated by the Federal Reserve. FMR's emphasis for wealth creation and capital preservation have provided attractive returns through many different market cycles.

The huge volatility of the first quarter undoubtedly whipsawed many short-term investors and speculators along with market timers. Rather than focus on these short-term volatile stock price swings than we cannot control, FMR chooses to focus on what we can analyze: **the commitment of company management to shareholder value by providing a reliable flow of income that grows at an attractive rate (above inflation).** Therefore, a large portion of FMR's portfolios follow this strategy. As mentioned before, this strategy can be tilted in three different types: growth, balanced, or income. Clients receive real cash income today and tomorrow to either re-invest or to support one's lifestyle, with a tolerable amount of risk.

We wish you all an enjoyable spring, and as always, we welcome your questions.

Sincerely,

Lee Todd Martha

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