Five Mile River Investment Management, LLC October 21, 2018
Quarterly Letter
3rd Quarter 2018

PERFORMANCE ***

	FMR Performance Taxable	FMR Performance Retirement	Russell 1000 Value*	Dow Jones Industrial	S&P 500** Dividends
2018 Q1	-3.96%	-2.70%	-3.52%	-2.49%	-0.76%
2018 Q2	5.16%	4.11%	1.18%	0.70%	3.43%
2018 Q3	3.71%	3.15%	5.70%	9.01%	7.71%
2018 YTD	4.75%	4.50%	3.18%	7.04%	10.56%

Federal Reserve Policy and the "Goldilocks" Economy

The S&P 500 rose **7.71%** in the third quarter. Once again, the indices referenced above are largely reflecting the performance of only a handful of companies. Close to 50% of the S&P 500's year-to-date advance of 10.56% was caused by the performance of one company, Amazon. Just TEN companies accounted for close to 100% of the S&P 500's year-to-date performance. A trend we observed in both the second and the third quarter, a trend we believe will continue, is a broadening of rising stock prices outside of this small list of companies, commonly referred to as the increasing "market breadth." It is also called the "advance/decline index" and both are used to calculate the number of stocks that are up versus the number that are down. Breadth has increased in the last six months at an impressive 7.8%, after having been flat for years. Positive breadth is new, and it reflects a market where strength is broadening beyond the small list of stocks that have been responsible for the market performance reflected in most indices.

Federal Reserve Policy

During the third quarter, stocks largely ignored both the imposition of tariffs on trade partners, as well as the dysfunctional Senate process and fight over the next Supreme Court nominee. In addition, we ended 3Q with another expected quarter-percentage point increase in short-term interest rates by the Federal Reserve Open Market Committee (FOMC) to a range between **2% and 2.25%.** Fed Chairman Jerome Powell said they would likely raise the rate one more time this year in December, and that the central bank decision was guided by economic theory, not politics. Chairman Powell said: "That's who we are. That's what we do. And that's just the way it's going to be for us." Worth noting is the change in the post-meeting policy statement: "the stance of monetary policy remains accommodative" was removed. The implication being that the FOMC is not likely to pause in their rate increases anytime soon.

This recent rate increase would be the first time in the last ten years when the Fed Funds rate will rise above the Fed's current estimated 2% core rate of inflation. Fed officials have indicated they expect to continue to raise short-term interest rates at least to 3% to 3.5% in the next five quarters. FMR believes that the conventional wisdom is incorrect because the Fed has a history of overshooting rate increases, which means we could well experience higher than anticipated interest rates sooner than expected.

The Fed's mandates are maximum employment and low inflation. Regarding employment, there are now over 155 million Americans employed, and the U.S. has the lowest unemployment rates **EVER** across a wide spectrum of demographics. The Fed's target for core inflation is 2%, and we are now at that rate. After seven years of unprecedented zero interest rate policy (ZIRP), the Fed is now laser focused on the economy overheating and the risk of inflation rising above **2%.** The problem is that inflation is not currently a threat, yet this Board still feels compelled to stamp it out as they are worried about wage inflation with the low unemployment rate. At the same time as they are raising short-term rates, they are liquidating their massive quantitative easing program by selling $1 trillion of government bonds and mortgages at the rate of $50 billion a month. As we quoted above, the FED is using economic theory and nothing more than a few models to guide this unwinding experiment. The Fed Chairman has admitted that the committee does not really know what the "neutral" rate of interest should be. The neutral rate is theoretically that level of interest rates that limits inflation but not economic growth.

Quantitative easing (the FED's bond purchasing) has clearly contributed to the nine-year bull market in stocks. Cash paid zero and consequently "There Is No Alternative" (TINA) has been the operative acronym for investors trying to earn a meaningful return. The FED's bond liquidation, along with the rising short-term interest rate, will likely have a moderating effect on stock valuations. Hence the price earnings ratio (PE) will likely be flat or down. The PE ratio for the S&P 500 is now lower than its peak in January of 2018, and significantly below the wild PE ratios of the "dot-com" era of 1997-2000 and the housing boom of 2003-2007.

The Goldilocks Economy

The key **positive** to take away from the current "Goldilocks" policy is that inflation is likely to stay under control as productivity and capital investment increasingly support an economy that is neither too hot nor too cold. Short-term stock market volatility is normal, and we do not try to time it, whether from tariffs, mid-term elections, Brexit, North Korea, China, Italian debt or a host of other "macro" headlines. A long-term mindset to investing is always best served by avoiding 99% of the continuing global random noise in making important investment decisions.

Since 1980 the stock market has suffered 21 downturns of 10% or more, yet the full-year returns have been positive in 29 of those 38 years. Five Mile River's high quality, dividend growth investment strategy is structured to provide a growing cash dividend stream, along with capital appreciation to support retirement, trust planning or income needs. Long-term investors are well served with the 6% to 8% return in which half comes from highly visible dividends. This return is far more attractive than the 10-year 3% Treasury Bond yield with a payout that does **NOT** increase. Yields on money market funds are still near zero, therefore neither cash nor bonds are an effective inflation beating long-term investment strategy.

The stock market valuation or PE at 16.8 times 2019 estimated earnings is neither overvalued nor undervalued. As interest rates continue higher over the next year, this dampening effect on the market's PE ratio will only be counter-balanced by those companies able to deliver strong earnings growth. Total S&P 500 corporate profit increases will decelerate in 2019 and 2020, as the impact of tax cuts diminish. Therefore, stock market returns are likely to moderate, i.e., +6% to +8%. The FMR dividend growth strategy, and the companies FMR has selected for portfolio holdings, can produce returns that should easily match our market forecast.

Thank you for taking the time to consider our thoughts and strategy for managing client portfolios. As always, we encourage all questions and comments about the market, individual companies, portfolio structure and are always available to discuss these and other thoughts. As we have often seen before in the fall season, we expect a volatile news cycle focused on our government's actions or inaction, along with the mid-term elections.

Sincerely,

Lee Todd Martha

**The Russell 1000 Value performance numbers are represented by the ETF of that name.*

***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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