Five Mile River Investment Management, LLC January 15, 2020
Quarterly Newsletter
4th Quarter 2019

PERFORMANCE

	FMR Performance		Russell	Dow Jones	S&P 500
	Taxable	**Retirement**	**1000 Value**	**Industrial**	**Dividends***
2019 Q1	12.32%	13.35%	13.43%	11.81%	13.65%
2019 Q2	4.31%	4.00%	3.74%	3.21%	4.30%
2020 Q3	1.06%	1.29%	0.92%	1.83%	1.70%
2019 Q4	4.09%	4.73%	8.52%	6.03%	9.07%
2019 FY	**23.25%**	**25.06%**	**30.03%**	**23.75%**	**31.49%**

What fueled the 2019 Market Advance?

Unquestionably 2019 will be remembered as the year the S&P 500 surged. The 31.49% increase was the largest yearly gain in the S&P 500 since 2013, and among the largest percentage gains post WWII. Multiple asset classes rose in addition to stocks. Oil rose (+34.1%) as did safer assets such as gold (+18.1%) and bonds (S&P 500 Bond Index +13.8%). Normally these asset classes are NOT correlated to all move together. The following events are largely responsible for the rise in traditionally uncorrelated assets:

1) Easing of world-wide monetary policies. There were three rate decreases by the Federal Reserve and a coordinated easing by all major central banks.
2) An improving economic outlook in the U.S has allayed concerns about the timing of the next recession.
3) Lessening tension with China that boosted year-end trade which is likely to continue.
4) Market negatives (e.g., Brexit) attenuated toward the end of the year assuaging concerns about a U.S. recession.

It is highly unusual to have a year without a correction (a normal annual correction is 5% to 10%). In December of 2018 the market dropped 20%, which in part was setting up a strong 2019 market rebound, given the change in monetary policy announced on January 4, 2019. Throughout 2019, many pundits have tried to predict the exact timing of the next stock market correction, only to have been wrong. Why did they err? Most have underestimated the massive money flows into the U.S. equity and debt markets that have reinforced this ten-year liquidity-driven bull market. The primary liquidity drivers for 2019 and into 2020 are:

- $480 billion of equity repurchases in 2019 (probably flat in 2020)
- $3 trillion in money market funds
- $5.8 trillion in Bond funds ($1 trillion increase in 2019 probably from money market buyers)
- $2 trillion of cash sitting at private equity funds
- $3.8 trillion in 2019 mergers and acquisition volume, mostly strategic vs. private equity
- $11 trillion now in negative yielding European and Japanese debt.

The $11 trillion of negative yielding debt (see the last bullet above) was $15 trillion as recently as last August, and in only four months declined $4 trillion! The $4 trillion that left the negative yielding debt market in the last four months of 2019 is clear evidence that this money is continuing to move elsewhere. Remember, NEVER before in modern history have we experienced negative yields. A negative yielding bond means the bondholder has to make annual payments just to own it. Negative bond yields were intended to be a strong monetary stimulus, however, they have NOT pulled Europe or Japan out of their economic malaise. Our Federal Reserve Chairman, Jay Powell made it clear that the U.S. will not implement negative U.S. bond yields.

As an interesting point of comparison, the entire S&P 500 appreciation in 2019 equaled $5 trillion. T**he short list of liquidity drivers totaling $25+ trillion contributed to the 2019 rise in markets, and continues to fuel the bull markets in U.S. bonds and stocks.** Compare this $25 trillion to the $27 trillion size of all U.S. equities, and the $28 trillion size of the U.S. bond market. Clearly this liquidity can provide the fuel for a continuation of this 10+ year bull market.

The famous English poet, Alfred Lord Tennyson wrote about markets in the 1890's, and remarkably this adage has proven to be a reliable barometer over the past 130 years for judging stages within a bull market:

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

The current 18X price earnings ratio (P/E) for the S&P 500 is **elevated, but not euphoric**. The P/E is calculated as the $3270 market price of the S&P 500, divided by the $180 in 2020 estimated S&P 500 earnings. Equities are still an attractivce investment vehicle and should continue to benefit from the fact that bonds yield just 2%, the same as inflation, so bonds represent a 0% real rate of return. We at FMR believe the stock market is fairly valued although we have not reached a level of euphoria (by contrast, in 2000 the S&P 500 traded at over 30X P/E, or 66% higher than today, when one could argue the market **did** reach a state of euphoria). Many pundits believe the post WWII 70-year average P/E of 16X is reason for a reversion (correction) back to this level. What is omitted from this observation is that the **average** P/E is skewed because of the very low post WWII P/E's. And, also omitted is the fact that the S&P 500 P/E has remained above a 16X P/E for each of the last 30 years, with 2011 as the only exception.

FMR's Strategy for Wealth Creation

Five Mile River does not profess to emulate or chase an index, rather FMR's belief is that **wealth creation is best accomplished by building portfolios with great companies**. These companies have the following characteristics: dominant market shares; grown through economic down turns; generate excess free cash flow over and above their funding requirements; and policies that return this increasing cash flow to shareholders through growing dividends and share repurchases. FMR's research objective is to identify and closely follow these businesses. Client portfolios reflect this strategy and own such companies.

FMR's Outlook for 2020

FMR believes that the S&P 500 could rise 8% to 10% in 2020. While not a heroic assumption, we are forecasting that interest rates and P/E's remain constant and the S&P 500 will advance, mirroring 9.8% growth in earnings estimated for 2020. Could the individual investor return to the market in 2020, having been a NET SELLER in 2019, and could the liquidity flows mentioned above continue? Yes. History suggests, just as Tennyson predicted, that before the next recession there will be a euphoric phase, a buying frenzy that could cause the market to roar!

What will be the dominant themes for the 2020's?

The next ten years will likely be influenced by a continuation of the more significant events of the past ten years. While there were multiple important events of the past ten years, a handful stand out:

1) The Great Recession of '08 and '09 brought about coordinated world-wide central bank actions to lower interest rates. These central bank policies, still very much in force, should continue for at least the next year, and perhaps much longer. Make no mistake, the current interest rate environment is one of the critical elements for stock and bond valuations. Rising inflation could change this policy. However, Fed Chairman Powell announced before Christmas a policy change whereby the Federal Reserve would NOT raise interest rates unless inflation becomes manifest. These comments suggest Powell will remain accommodative and leave interest rates unchanged.

2) The second phenomenon of the past ten years which could have significant implications for the next ten years is the widespread adoption of cell phones, or more specifically smart phones. Quite obviously, cell phone proliferation has changed our lives, in part making us all more productive. The next wave of technology innovation will probably accompany the multi-year roll-out of 5G. This will spawn multiple new applications, many using artificial intelligence across a multitude of devices and smart(er) phones. It is evident that 5G is starting to have an impact, and 2020 will see improvement in data transfer speeds, and the beginning of a new 5G phone upgrade cycle. Ultimately, 5G will deliver speeds up to 100X 4G, which means you could download an entire movie in two to three seconds! As well, 5G will spawn growth in many adjacent industries.

3) Lastly, the economic benefits stemming from the changes in tax and deregulation policies continue to be evident in the strength of the U.S. economy. These changes in tax policy will have significant economic benefits hopefully across the U.S. economy, lasting well into the 2020's. This helps explain the longevity of the U.S. economic cycle, and why it is unlikely to be interrupted. While geo-political risks are ever present, the U.S. continues to be the world's largest and strongest economy, which argues for a continuation of international money flows into the U.S.

Much of 2020 will be consumed with election year politics. The dysfunction in Congress probably continues. Very few policies enjoy bi-partisan support. Will the infrastructure bill die in the House, or will it finally receive enough support to be sent along to the Senate? Depending on how the bill is finally written, it could have a direct economic boost. Nevertheless, precious little fiscal stimulus is expected this year from our government. What could provide an economic and productivity boost is an upturn in business capital spending. FMR is hopeful that an improving economy and stable relations with China will be catalysts for rising business confidence which could spark **broader business capital spending**. Tax incentives are now in place to energize capital expansion. These tax incentives could become the stimulus for capital investment covering everything from the purchase of a new computer to an entirely new manufacturing facility.

We welcome questions regarding Five Mile River's market discussion included in this letter, or we are happy to provide further information regarding Five Mile River's investment strategy. And we wish you a very Happy New Year.

Very 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 <u>includes the dividends</u> issued by these 500 companies. This index is used for a comparison for FMR accounts.*

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