Five Mile River Investment Management, LLC — October 15, 2020
Quarterly Letter
3rd Quarter 2020

PERFORMANCE

	FMR Performance		Russell	Dow Jones	S&P 500
	Taxable	**Retirement**	**1000 Value**	**Industrial**	**Dividends***
2020 Q1	-23.20%	-19.10%	-20.61%	-23.20%	-19.60%
2020 Q2	16.86%	16.14%	21.52%	17.77%	20.54%
2020 Q3	4.84%	5.68%	9.04%	7.63%	8.93%
2020 YTD	**-5.89%**	**-0.69%**	**4.96%**	**-2.65%**	**5.57%**

Labor Day coincided with the short-term stock market top in most averages. This ended what was a historic rally rising 63.7% in just over five months. However, this rally only slightly erased the COVID-19 induced drop of 35.4% in the five weeks from February 19th to March 23rd. In FMR's last client letter dated July 20th, we stated that holding a slightly higher level of cash was the prudent strategy given the market's rally, and the growing number of uncertainties. Among the current uncertainties: 1) The outcome of the Presidential and Senatorial elections and whether they are contested? 2) Will any additional fiscal stimulus measures be approved by Congress? 3) Will there be a significant second COVID-19 wave, and is there a successful vaccine available within the next several months?

With the multiple uncertainties clouding the short-term market outlook, it is important to stand back and look at the market from a longer-term perspective. February/March of this year marked the end of the longest post WW-II economic expansion, lasting a full eleven years. The market correction that followed and the subsequent monetary and fiscal stimuli suggest that an end to this recession is not far off, AND the onset of a **new bull market** occurred in April/May of this year. Bull markets often begin during the depths of a recession and are typically named only in hindsight. This perspective suggests that the recently started bull market, if typical of past bull markets, could last FIVE years. In our July 20th letter we also cited Pfizer's encouraging outlook for a fast-track vaccine approval by October/November. Considering that Pfizer's guidance is typically quite conservative, this unanticipated possibility would be a bullish market event.

Could this perspective be too optimistic? There clearly are many differences between the current environment and past bull market starts. The pandemic now plays a critical governing influence on the pace of the economic recovery, and no forecast can overlook the timing and availability of a vaccine. However, there are compelling similarities with past recoveries:

1) The recently stated Federal Reserve policy to keep interest rates unchanged for the next three years is probably the strongest similarity with prior recoveries. The Federal Reserve has pulled out almost all available tools to keep economic activity improving. It is important to note, the current level of FED accommodation has never been this robust.

2) FMR estimates corporate profits should exceed expectations. Why? Employee productivity is normally measured in +/- 1% to 2%. In the second quarter (2Q), productivity rose an astounding 10%. This means that output for a unit of labor rose at the highest level reported in the last 50 years. This is a powerful indicator for corporate profit margin expansion.
3) Also, in the 2Q data, personal income exceeded spending by more than a trillion dollars! This suggests that there is a tremendous level of consumer liquidity. Should these savings begin to increase spending, it would be a proxy for GDP expansion and corporate revenue growth. While a large portion of this unspent income was used to pay down debt and increase savings, it still represents significant purchasing power.

There is a great deal of discussion about whether the Biden economy or the Trump economy will best serve the nation. Rarely has there been such a pronounced difference in the choices. Trump's policy of lower taxes has a proven record of stimulating economic growth. The Democratic Manifesto proposes massive spending initiatives that require increases in tax rates (corporate, personal, capital gains, dividends, and estate). Actually, the effect of the Biden plan to raise corporate tax rates from 23% to 28% is estimated to be **only a small diminution of profit growth.** The timing of any Democratic tax policy changes will probably not be in effect until 2022. The proposed Biden corporate tax rate of 28% rate, if applied in 2021, would only slightly diminish S&P 500 earnings growth from 33% to 31%. Regardless of who is president, the outlook for the next several years might be framed similar to the post WW-II period of rapid growth brought about by unleashing pent-up consumer spending, coupled with economic stimulus (which at that time was the GI Bill).

FMR anticipates 2021 S&P 500 earnings will rise 33% which is above the consensus + 25%. If FMR is correct, then the market is trading closer to a price/earnings ratio (P/E) of 18. Remember that P/E's have averaged 17 over the past two decades. Therefore, the current market valuation suggests that the S&P 500 is not overvalued. Nonetheless, there are plenty of examples of individual stocks with exorbitant valuations (Snowflake, a recent IPO, is trading at 70 times 2021 revenues and with no earnings). Many companies perceived to benefit from COVID-19 are over-valued and have the highest risk for a correction in price.

Cash on the sidelines is formidable. Money market funds total $4 Trillion in cash and Private Equity Funds total $3 Trillion, relative to the equity market's value of $25 Trillion. Nevertheless, while this provides a source of potential support, high cash levels do not preclude "normal" corrections which can drop 15%. The S&P 500 probably put in a short-term peak at 3,588 on September 2nd, and a potential correction could re-test 3,000, which is a level not seen since mid-June.

FMR client portfolios are over-weighted in healthcare investments and on average hold an approximate 20% weighting. Conversely, the S&P 500 has only a 14% healthcare weighting. FMR's attraction is based on strong fundamentals in the healthcare sector, driven by new product introductions and a rebound in elective surgeries. Also, healthcare valuations are compelling, trading at discounts of 15% to 30% to the S&P 500 P/E.

We hope you are enjoying the fall season and cooler temperatures. As always, we welcome your questions and are available to discuss Five Mile River investment strategies.

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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