Five Mile River Investment Management, LLC January 22, 2021
Quarterly Letter
4th Quarter 2020

PERFORMANCE

	FMR Performance		Dow Jones	S&P 500
	Taxable	**Retirement**	**Industrial**	**Dividends***
2020 Q1	-23.20%	-19.10%	-23.20%	-19.60%
2020 Q2	16.86%	16.14%	17.77%	20.54%
2020 Q3	4.84%	5.86%	7.63%	8.93%
2020 Q4	1.93%	1.84%	10.17%	12.15%
2020 FY	**2.16%**	**6.76%**	**6.85%**	**18.40%**

The crowning event of 2020 was Pfizer's announcement on November 9th that their vaccine had achieved a 90% (later revised to 95%) efficacy with no material adverse side effects. Equally impressive is that they were prepared to ship 100 million doses before year-end, and 1 billion during 2021 (now 2 billion)! Five Mile River wrote in both Q2 and Q3 client letters about Pfizer's confidence to deliver a COVID-19 vaccine before year-end. Their success in only nine months was truly an astounding accomplishment as sceptics were correct to point out that previous FDA approvals of vaccines had averaged over five years.

Up until November Facebook, Apple, Amazon, Netflix, and Google, (FAANG stocks), were the market leaders and contributed over HALF of the then S&P 500 year-to-date performance. November 9th, however, was a game changer on Wall Street. Performance data from November through to the end of 2020 showed that the S&P 500 was up just 5.83%, while FAANG stocks **declined**. Conversely, **FMR's performance as a diversified active manager, for November and December was up 12.68%!** The market's performance is finally shifting from a highly concentrated select few companies to the "other" 495 companies in the S&P 500. This increasing breadth of performing companies is considered a significant bullish development.

What the vaccine announcement signaled was that 2021 would be a growth year for the U.S. economy and stock market. As FMR pointed out in the Q2 letter, the 30% stock market correction this past March signaled the end of an 11-year economic and market cycle, and the start of a U.S. recession. Given the unprecedented Federal Reserve stimuli coupled with robust government stimulus programs, this vaccine announcement was THE final signal that the recession was over and that 2021 would be a very strong year. A new bull market was underway. FMR also wrote that market and economic upcycles typically last three to four years. In just a few short months we have gone from saying "How bad is 2020 going to be?" to "How good can 2021 become?"

So, economy-sensitive (value) companies are now leading the market, something absent for almost eleven years. Stock market data, which go back to 1927, shows that **the dispersion between growth and economy-sensitive (value) stocks had NEVER been wider over the past 93 years than in August 2020!**

While economy-sensitive stocks have had terrific gains in just the last several months, this performance has the potential to last multiple years. The most important reason for this durability is that the Federal Reserve's zero-interest rate policy adopted in March will likely stay in place for at least the next several years. Jay Powell, Federal Reserve Chairman, has stated that he estimates a zero-interest rate policy for the next two to three years is necessary to bring the unemployment rate back to a more normal 4% to 5%.

There are those who are predicting that it will take many years of low interest rates for the 11 million unemployed to get back to work. A longer period of Federal Reserve accommodation could set up a multi-year expansion creating another "Roaring 20's." Let it be known Five Mile River is not signing up for Charleston dance lessons, nevertheless, the next two years should be favorable for stocks, albeit sometimes bumpy.

Are stock prices extended? Are valuations stretched? Yes, there are plenty of examples: overpriced Initial Public Offerings (IPO's); FAANG stocks; and several high technology names (such as Tesla). However, these conditions alone are not a cause for a market correction. Corrections tend to be unpredictable and are typically caused by an event that changes future expectations. FMR does not try to predict corrections. Rather, FMR will hold moderately higher cash levels when there is a dearth of attractive new purchase candidates. A mitigating factor for a violent correction is the current high levels of cash on the sidelines that should cushion a market correction. Money market funds are sitting on $5 trillion in cash earning zero percent, and $4 trillion of cash sits on corporate balance sheets and private equity funds. While concerns about "the market" are real, so too is the fact that the government, corporations, as well as individuals/households are all primed to unleash an explosion of spending within months.

FMR believes that the earlier than anticipated arrival of vaccines on top of both the fiscal and monetary stimuli, will create the springboard for economic improvement in 2021. Debating whether the U.S. reaches herd immunity in 3Q or later in 2021, misses the simple point that the consumer is sitting on a historically high level of unspent income, evident in the U.S. savings rate of 13%! (The savings rate normally hovers between 2% and 4%). Increases in spending will drive economic improvement which directly translates into improved corporate earnings. Expectations that earnings will rise 22+% in 2021 could prove conservative. FMR anticipates that the S&P 500 will rise 8% to 10% (before dividends), reaching 4100 by the end of 2021. The reason FMR believes stocks will rise less than the growth in earnings is that the S&P 500 Price Earnings Ratio (P/E) will possibly decline from 23X to 20X. P/E's correlate with the 10-Year Treasury Bond price. In just the past month the 10-Year Treasury Bond has experienced a historic percentage price decline in such a short time. Because the price moves inversely with the yield, this decline is also expressed as the rise in yield from 0.80% to 1.10%. The FMR forecast of a P/E contraction is attributable to the probability that the 10-Year Treasury yield could reach as high as 1.5% to 2.0% before year-end 2021.

The cause for this price decline in the long bond is a confluence of: increased issuance of government bonds to fund the rising Federal deficit (the Federal debt is now $27 trillion); a slightly higher level of inflation; and an increase in credit demands. Because of the January 6th unrest at the Capital, there is the possibility that overseas funding of our Treasury issuance could slow, also contributing to a possible rise in yields. While FMR's forecast does call for a bond price drop, stocks should continue rising, as strengthening in the U.S. economy will drive increased earnings. This phenomenon of rising long-maturity bond yields while the short-term maturity Treasury Note yields remain low, is referred to as a steepening of the Treasury yield curve. A steepening yield curve is among the best of the eleven Leading Economic Indicators, used as a predictor for stock price appreciation (Conference Board data).

As was mentioned in the FMR 3Q20 quarterly letter, the Democratic Party control of the Presidency and of Congress carries with it several risks. President Biden has made campaign promises to raise taxes on capital gains and dividend income, as well as a plan to raise corporate tax rates. President Biden is also proposing to increase taxes on high-income earners. New laws that result in climate change regulations could be a governor on growth, however, increased infrastructure spending might be a delayed offset. While all these changes are possible, the fiscally conservative presence in both houses of Congress suggests that the economy and the stock market will not be significantly affected. One of the biggest challenges for the next administration will be to increase bi-partisanship and restore civility across parties which could go a long way to re-establishing global confidence in U.S. markets.

FMR believes that in 2021 sector rotation into energy, finance, and industrials may be one of the biggest unanticipated events. FMR increased energy exposure because of the unusual confluence of historic low valuations, AND an improving fundamental outlook for oil prices. Post Covid-19, world-wide economic improvement will drive energy demand that will reduce world inventories. Against the outlook for rising demand, world oil production is moderating. It appears that the Saudis have finally gained control over OPEC supply, just as U.S. production has declined from over 13 million barrels per day to less than 11 million barrels per day. Small U.S. exploration and production companies are disappearing at an alarming rate. Many are simply going out of business, if not being acquired, or entering forced mergers. The net result is that U.S. production (supply) is diminishing. As a backdrop, the S&P 500 currently has a record low weighting in energy at less than 3%. The energy sector had been weighted as high as 20% of the S&P 500 in the late 70's! This suggests that if a hypothetical 1% weighting is transferred/added to the energy group of the S&P 500, it could translate to **a 30+% increase** in many energy stock prices! Importantly, even the very best companies were being valued at levels not seen in over 50 years.

As always, we welcome your thoughts and questions. We wish you all a healthy, prosperous, and happy New Year.

Sincerely,

Lee Todd Martha

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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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