Five Mile River Investment Management, LLC July 25, 2021
Quarterly Newsletter
2nd Quarter 2021

PERFORMANCE

	FMR Performance		Dow Jones	S&P 500
	Taxable	**Retirement**	**Industrial**	**Dividends***
2021 Q1	6.48%	6.72%	8.29%	6.17%
2021 Q2	9.00%	8.32%	5.08%	8.55%
2021 H1	**16.06%**	**15.60%**	**13.79%**	**15.25%**

In six months, the year-to-date results for Five Mile River client portfolios have achieved what was originally anticipated for the full year 2021 performance.

FMR's 1st Quarter Client letter discussed the risk that inflation posed to the stock and bond markets. The reported June Consumer Price Index (CPI) was the highest one month increase in inflation in 30 years! Surprisingly, the stock market was unphased. Numerous costs or inflationary pressures are visible in everyday shopping: food, medical, gasoline, and real estate. Here prices are rising far faster than the Federal Reserve's inflation target of 2% to 2.5% annual increases. Federal Reserve Chairman Jeremy Powell interprets that this jump in inflation will only be transitory. Five Mile River disagrees.

There has been a great deal of ink spent on inflation recently, and it is worth mentioning three prime examples where cost/price increases are probably not temporary.

First, the U.S. is a net importer of goods. A great example of price increases is the cost of a shipping container used for freight transportation. In just one year the price rose from $4,000/container to $17,000/container, and shipment times have stretched from ten days to over four months. This cost and delay of shipping will trickle through retail pricing of all imports for the next year or longer. IN the U.S. supply chains across sectors and industries are backed up four to six months. A very visible example of supply disruptions are the auto and truck production delays caused by a semiconductor shortage. This is causing retail inventories to be down 42% year over year.

Secondly, U.S. oil production has become the largest swing factor in the global supply of oil. Production in the U.S. has fallen roughly 3M barrels/day in just the past 12 months. OPEC's stated increases in production are significantly less than the U.S. production drop. Even though the price of oil has risen from $48/barrel to $75/barrel in only six months, it is unlikely to go down since the U.S. industry is drilling below pre-COVID levels. Even though oil prices have risen substantially, there is no evidence this has induced more drilling. The current U.S. rig count is 378 and would have to rise above 600 to **start** returning the lost 3M million barrels/day of production. The oil and gas industry does not have access to the capital necessary to increase drilling, as lenders are all terrified of re-living the industry bust of 2018-2020. This drilling abatement will be a multi-year phenomenon.

Thirdly, is the run-up in housing prices. The inflation indices incorporate multi-family rental prices NOT home prices, as the home ownership component of the CPI. The Bureau of Labor Statistics calculates the monthly CPI rental prices rising at only low single digit rates. As housing prices have risen 20% plus over the past 12 months, this will surely trickle down to higher rental pricing. Therefore, elevated home prices will have a lagged influence causing rental price increases for years to come.

The Federal Reserve is assuming that inflationary pressures are temporary. The Federal Reserve uses the Personal Consumption Expenditures (PCE) as the index for inflation, NOT the CPI. The PCE **excludes** food, energy, and house price inflation, the very purchases that are rising the fastest! FMR believes that inflation will probably persist for several years and should not be characterized as short-term. The Federal Reserve's index is seriously understating the true inflationary inputs to our daily expenditures. However, the PCE will catch up with the CPI, in what could be some jaw-dropping increases, later this year.

Fed Chair Powell has repeatedly said that the economy will not reach full employment until 2023/24, and only then would the Fed back off the easy money policies enacted a year ago. FMR believes that Powell, like most Fed Chairmen and their board members over the past 30 years, are "behind the upward curve on inflation" and will have to reverse course no later than 2022 by raising rates and reducing purchases of government and mortgage-backed bonds. Being behind the upward curve of inflation means that if the Fed waits until 2022, inflation could become more intractable forcing the Fed to raise rates higher and faster than if they started withdrawing liquidity sooner and more gradually. While waiting for a rate increase or lessening of bond purchases until 2022 might provide limited short-term upside for the stock market, the pain associated with the probable tightening in 2022 could risk a period of slow growth and rising inflation (stagflation) and a more significant 20% stock market correction. Conversely, if the Fed were to announce some lessening (tapering) of their bond purchases this August, the market would probably take that in stride. This would increase the probability that the one year of economic expansion could last a more normal four years plus.

In previous FMR client quarterly letters it has been repeated that 5% to 10% corrections are a normal, roughly annual occurrence in the stock market. What becomes challenging is to identify the unexpected events that would trigger a correction. Because corrections are typically a result of an unanticipated occurrence, forecasting something that is not anticipated becomes a "fool's errand." The uninterrupted rise in the market over the past 12 months has caused FMR to be more cautious, nevertheless, FMR portfolios managers are still finding stocks that are attractively priced. The discussion below is a good example of the type of characteristics that FMR looks for in making an investment: strong and rising cash flows, dominant market competitor, attractive valuation, and excellent management.

Client portfolios are comprised of holdings which have significant long-term appreciation potential. Lee and Todd are always available to discuss your investments and portfolio strategy. We wish all FMR clients a healthy and enjoyable summer.

Sincerely,

Lee Todd Martha

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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