Five Mile River Investment Management, LLC July 25, 2022
Client Quarterly Letters
2nd Quarter 2022 - Update

This is a 2Q22 update to the Five Mile River 2Q22 Client Newsletter dated June 22, 2022.

PERFORMANCE

	FMR Performance		**Dow Jones**	**S&P 500**
	Taxable	**Retirement**	**Industrial**	**Dividends***
2022 Q1	0.20%	0.96%	-4.50%	-4.60%
2022 Q2	-9.04%	-9.25%	-10.78%	-16.10%
2022 H1	**-8.92%**	**-9.13%**	**-14.44%**	**-19.96%**

The S&P 500 finished the second quarter down 20%, after a volatile sell off to as much as down 24%. This confirms the S&P 500 entered a bear market in June. Since the lows were made on June 17th, the S&P 500 has rallied 8.8% as of this letter. FMR client portfolios have performed significantly better for the first half of 2022 than did the S&P 500.

There is a central question confronting the market outlook: What is the peak level that interest rates will reach before inflation can achieve the 2% rate targeted by the Federal Reserve? Those who are bullish believe the recent 10% rally has further upside. They maintain that, according to both the Federal Reserve's own forecast and the futures market, the federal fund's rate will peak sometime in early 2023 to between 3% to 3.5% (currently 1.75%). Conversely, those who argue this is merely a bear market rally, with a likely re-test of the lows, make the argument the Federal Reserve will have to raise fed funds rates significantly higher because inflation is likely more entrenched than they now forecast.

Why do some see inflation as more entrenched? We (the Fed and the government) pushed over $5 trillion into our economy because of COVID, shutdowns, and vaccine mandates. The Fed created this excess money growth by printing new money and simultaneously raising the national debt to $30+ trillion. The scale of this action is unprecedented and how it is unwound, without a longer recession, is the key to how the economy performs for the balance of 2022 and 2023. Confirmation of either of these scenarios will take longer and NOT be resolved by the next data set on GDP and inflation that will be reported this week (July 25th).

This Wednesday, July 27th the Federal Reserve finishes its monthly two-day meeting and is likely to announce an increase of 75 basis points to the federal funds rate, bringing it to 2.5%. Inflation is now between 6% and 10% depending on which indicator the Fed and the market believe is most relevant. The bulls will argue that we are only one more 75 basis point increase from reaching the Federal Reserve's target peak rate. The issue confronting the Federal Reserve and investors after this week's data release is: How quickly can a slowing economy reduce inflation, and can inflation get down to the Fed's 2% inflation target? The longer it takes to achieve a 2% inflation rate means market volatility. Also, bear market rallies will persist.

A protracted Russian war in Ukraine will continue to put upward price pressure on both oil and natural gas, and is in a large part the cause of Europe's current recession. Upward price pressure on oil and natural gas suggests more persistent inflation than the Federal Reserve is currently anticipating, therefore causing far higher interest rates.

In fact, during similar periods of declining GDP and high inflation (stagflation) the Federal Reserve had to raise federal funds rates ABOVE the stated inflation rate. In 1982, the last period of stagflation, a 10%+ federal funds rate was necessary to kill inflation, but also resulted in the economy suffering two recessions: one in 1982 and one in 1984.

While a mild U.S. recession is now likely, the market will focus on the time of onset and its probable duration. The tightness in the labor force is a contributing factor to inflation, although employment income growth will likely be the reason why a recession could be mild. This Wednesday, July 27th will be the government's first release of second quarter GDP data, and the probability of another sequential negative quarter of GDP has risen. Technically, two successive quarters of negative GDP defines a recession, but ultimately the National Bureau of Economic Research (NBER) has the final say on defining a recession. Do not expect this group to now claim that a recession is place, because it typically takes 12 to 18 months for the NBER to define the start and stop dates of a recession.

Last fall FMR defensibly positioned client portfolios with more income producing investments (including overweighting the energy sector, the only outperforming sector in 2022 thus far), and investments that have low economy sensitivity. Market volatility does provide FMR portfolio managers the opportunity to continue to take advantage of price weakness to increase some of the best investments in client portfolios. In the FMR June 22, 2022 email FMR argued that much of the market damage had already occurred (S&P 500 down 24% on June 17th). As mentioned earlier, it appears that the U.S. economy may currently be in a mild recession, however, the duration of any recession is a question mark. As we move through a recession and looking forward, it is helpful to know that the typical stock market rise after recessions lasts five to ten years, with the S&P 500 averaging 8% to 10% growth per year.

Please feel free to call or email with questions. We do wish you a very healthy and happy remainder of the summer.

Sincerely,

**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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Please remember to contact Five Mile River Investment Management if there are any changes in your personal/financial situation or investment objectives. *Please also advise us if you would like to impose, add or modify any reasonable qualifications to your investment portfolio(s).*