Five Mile River Investment Management, LLC October 3, 2022
Client Quarterly Letter
3rd Quarter 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 Q3	-6.59%	-6.78%	-6.17%	-4.88%
2022 YTD	**-14.93%**	**-15.29%**	**-19.72%**	**-23.87%**

RECKONING AT THE FEDERAL RESERVE: PRICE STABILITY OR STAGFLATION?

On Wednesday, September 21, 2022, the Federal Reserve announced that it was raising the benchmark interest rate by three-quarters of a percentage point to a range of 3% to 3.25% in its latest attempt to squash the highest inflation in 40 years. Federal Reserve Chairman Jerome Powell gave an update on the Fed's economic outlook and a forecast for future rate hikes that was decidedly hawkish. He expects the year-end fed funds rate to now be 4.4%, up from the 3.4% he expected after the June meeting. Chair Powell reiterated his Jackson Hole (August 19th) commitment to 2% inflation. Credibility has been low since we started pointing out last fall that the Fed was woefully "behind the curve" in raising rates and stopping rising inflation.

The S&P finished the third quarter year-to-date a negative 23.87%, further down from the -19.96% reported for the first half of 2022. This third quarter saw both small and large cap value and growth stocks sell-off, with the more speculative high valuation technology stocks declining roughly 35%. Included in this correction were the heavily weighted mega cap S&P 500 index companies like Amazon, Google, Meta, Apple, and Microsoft, each declining roughly10% in September. It is important to note that the decline in these bell weather companies was based on lower price earnings ratios (P/Es) and NOT fundamental earnings disappointments. Higher interest rates = lower price earnings ratios as this always reduces the stock market value of high growth companies. Always.

The Fed uses the Personal Consumption Expenditures (PCE) as its preferred measure of inflation because it is more balanced and less volatile than the more well-known Consumer Price Index (CPI). A further refinement of the PCE that the Fed prefers is called the **"core" PCE inflation**, which on a 12-month trailing basis, is **4.8%** (as of the end of August). The Fed does not like to consider food and energy price increases in their deliberations because they believe that commodities are too volatile and unpredictable. This is unrealistic

thinking. To be polite, Five Mile River believes this kind of reasoning is out of touch with reality as 50%+ of the cost of food, transportation, and economic growth depends on fossil fuels.

The PCE, including food and energy, has been running over 6% for several months: 6.3% in June, 6.8% in July and 7.3% in August; the highest reading since early January 1982 which was the last year of back-to-back recessions combined with a rise in interest rates. Paul Volker served as Federal Reserve Chairman from 1979 to 1987. In 1982 Chair Volker raised interest rates **above** the rate of inflation (+12% interest rate) to crush the life out of the then persistent inflation. Today's inflation rates, as measured by the three indices are: the PCE most recently at 7.3%, the CPI running 8%+, and the Producer Price Index (PPI) running 9% to 10%. These are disappointing numbers. Unlike Chair Volker, Chairman Powell is hoping to beat today's 8% inflation rate by taking interest rates to half that percentage.

CHAIRMAN POWELL'S POLICIES COME WITH SOME PAIN

Historically, the U.S. lived through a monetary policy flip flop in the historic period from 1968 to 1982. During this period, Federal Reserve Chair Arthur Burns (served as Chair from 1970 to 1978 in the term prior to Paul Volker) presided over multiple recessions, multiple bear markets, high inflation and what has become known and adopted from the British as **stagflation**. Federal Reserve Chairman Burns insisted that inflation was "transitory" and should be ignored, before he realized he was wrong. Stagflation does not have a happy sound and more accurately describes an unhappy experience, namely blending stagnant growth and high inflation.

The U.S. is currently in a period of stagflation. Equity returns will be volatile and compressed in a range between -10% to +10%, depending on whether the U.S. has negative, positive, or flat economic growth (GDP). Clearly there is a wide variation around these equity market return numbers, but directionally the message is simple: stagflation is going to hurt, and cause pain depending on how long it takes to implement a responsible fiscal and monetary response. We need both monetary and fiscal policies working together. Today they are not at all even close to that goal in our current untenable political and economic environment. The Fed's hawkish resolve must not cave in under political pressure, and prudent fiscal government policies must follow to avoid a longer period of stagflation.

Chair Jerome Powell was still in law school during the latter part of the 1968 to 1982 nightmare of stagflation. Now, after three policy mistakes over the last roughly two years in managing interest rates, Five Mile River is hopeful that Chair Powell knows what not to do to repeat former stagflation mistakes. We all know that Chair Powell had to walk back his prior 2021 forecast that inflation was "transitory." That was his second major policy mistake following his 2018 rate hike reversal mistake. His third mistake was made during his 2022 June Q & A session with the media when he partially signaled that the Fed Board was close to a "pivot" to end raising interest rates. The stock market rallied, but soon sold off after he had to walk back the fake pivot. It is not likely he will make yet a fourth mistake, we hope. Chair Powell does not want to end his career with the entry in history books as the Fed Chair who failed at a critical moment in our monetary history. He will now need help from the politicians with prudent fiscal policies that curb government spending, and for the time being, Powell must continue his hawkish stand on interest rates.

The fight against "sticky" inflation is likely to last through 2023-24. Why? Powell's target rate of 2% inflation will be hard to achieve. It is important to point out that 64% of the PCE is made up of services. More than half of that 64% service sector is comprised of housing (rental and home purchase) and health care. We all know that prices of housing, especially rentals, and health care do not contract easily or quickly.

The **current high inflation rate was predictable** given the excessive fiscal and monetary stimuli from 2020 into 2022, mostly in response to Covid. On the fiscal side of the equation, explosive government spending caused the federal budget deficit surge to $2.7 trillion in fiscal year '21 (ended 9.30.21) and is running an

estimated $3.7 trillion deficit for fiscal year '22 (ended 9.30.22), and the deficit is projected the same for fiscal year '23. The major spending bills are comprised mainly of: the six Covid relief bills for $5+ trillion; the infrastructure bill for $1.2 trillion; the "Chips (semi-conductor) Bill" at $280 billion; and the Inflation Reduction Bill for $437 billion. On the monetary side, Powell bought back bonds totaling $7 trillion. In addition, there were significant economic benefits caused by Powell's near zero rate interest policy causing, among other inflationary effects, housing valuations increased over 20%. Inflation is predominately caused by too much money chasing too few goods. This excessive government spending in just two years, amounting to more than $8 trillion in combination with the $7+ trillion in monetary stimuli, is roughly equal to 2/3 of the $25 trillion yearly U.S. economy (GDP)! Why Powell did not anticipate high inflation and act to raise interest rates earlier is a mystery.

The strong labor market supports the rational for a mild recession which some say that we are already experiencing. Because there are more than two job openings for every unemployed worker, the labor market is very tight. One of Powell's most difficult challenges is to reign in wage price inflation, and he is hoping that his hawkish interest rate policy can ease labors' inflationary pressure.

Chair Powell recently said that we should expect some **PAIN** to stop this elevated inflation, but he did not forecast a recession. The Fed typically does not want to say that it was ever partially responsible for recessions. Who would if they wanted to keep their job? In all fairness, we would like to point out that even with an army of 400 Ph.D. economists at the Federal Reserve, their forecasts for interest rates and inflation and recessions have consistently been wrong.

STOCK MARKET EXPECTATIONS AND FIVE MILE RIVER PORTFOLIO STATEGIES

The U.S. has had two consecutive quarters of negative gross domestic product (GDP) numbers for '22: 1Q22 was -0.2% and 2Q22 was -1.7%. Rapidly rising interest rates and mortgage rates now at 7% have stopped most refinancing and have significantly impacted the housing market and, in addition, recently there are signs of slowing consumer spending.

Year-to-date the bond market losses were marginally better than the stock market losses. Unlike past stock market declines, the bond market has not provided any respite and has not been a place to hide for safety. This year's bond losses rival the worst bond drops since the end of WWII in 1949 and the Great Depression in 1930! The era of near-zero rates is over, as the fed funds rate has been raised to 3% this year with a promise of more to come. International markets have offered no solace as volatile geopolitical problems abound in Europe because of Russia and the loss and lack of reliable energy. Asia is also in turmoil with the dollar at 20-year highs, creating huge strains for other currencies like the UK pound and the Japanese Yen. Foreign exchange volatility has surged and even China has both credit and currency issues because of their Zero-Covid lockdown policies.

So, with this discouraging global picture, and the U.S. monetary and fiscal policies fueling inflation, and even with the 2022 year-to-date stock market decline of 23%+ (YTD S&P 500), **there is good news.** The stock market valuation of many U.S. companies is now attractive for long-term investors. The U.S. companies owned in your portfolios are dominant #1 and #2 in their markets with wide competitive moats and long growth runways. These companies are in a very strong position relative to other asset alternatives. They have strong balance sheets, and using Five Mile River's favorite phrase - free cash flow, growing dividends and the resources and opportunity to strengthen their supply chains by funding new capital expenditures to relocate manufacturing to the U.S., Mexico, or more stable countries. Over the past year, Five Mile River portfolio managers have emphasized and increased positions in less cyclical, stronger dividend growth companies in segments like medical devices, healthcare, data centers, cell towers, companion pet medicine and testing, real estate, and of course, a strong energy position. Expect the fourth quarter to provide both volatility and, importantly, the opportunity to invest in these kind of quality companies at attractive prices. We hope this long epistle on the economy and stock market clarifies some of the unusual events in our economy and our markets.

Please do not hesitate to email or call with questions regarding the markets, the economy, or the outlook for the markets as discussed in this letter, or if you would like to cover other market topics not included in this letter, we look forward to sharing our thoughts on other investment topics. Also, we are available to discuss your portfolio holdings, and the investment strategy that is employed for your portfolios. We would like to hear from you if there are any changes in your financial investment risk outlook. Thank you for your confidence and for allowing Five Mile River Investment Management to assist you in building a sound financial future.

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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