Five Mile River Investment Management, LLC January 3, 2023
Quarterly Letter
4th Quarter 2022

PERFORMANCE

	FMR Performance		Dow Jones	S&P 500
	Taxable	**Retirement**	**Industrial**	**Dividends***
2022 Q1	0.20%	0.96%	-4.57%	-4.60%
2022 Q2	-9.04%	-9.25%	-11.25%	-16.10%
2022 Q3	-6.59%	-6.78%	-6.66%	-4.88%
2022 Q4	10.75%	10.60%	13.34%	7.56%
2022 FY	**-5.78%**	**-6.29%**	**-8.78%**	**-18.11%**

THE PROSPECTS FOR 2023

Exactly one year ago the S&P 500 index closed at a historic high of 4796. All are aware that from the high, 2022 unfolded as an ugly and volatile year from many perspectives. The 2022 decline of 18.11% in the S&P 500 (with dividends) was based on several factors. The primary cause was the Federal Reserve embarking on a far more aggressive interest rate tightening than had been anticipated. The biggest casualty from the Fed actions was the collapse among all areas of speculation that included: crypto currencies, bitcoins, non-fungible tokens (NFTs), and special purpose acquisition companies (SPACS), all down 50% to 90%. Companies selling at lofty valuations (Price Earnings Ratios or P/Es) were another casualty of higher rates, such as the here-to-for beloved technology sector that declined 25% to 40%. The Putin invasion of Ukraine in 2022 exacerbated inflation, causing supply shocks to both food and destabilizing the world oil and gas markets. All this obviously contributed to why the Fed took rates up so aggressively. With the backdrop of this difficult year in the market, there were a few bright spots with the energy stocks ending 2022 as the only sector of the S&P 500 to show a gain (+55%). The utility stocks were the next best performing sector at -1%.

As we have mentioned in past Five Mile River (FMR) Client Letters, FMR's investment strategy emphasizes companies that demonstrate consistent growth in free cash flow and the resulting growth in their dividend payments. It is this more defensive strategy in 2022 that enabled FMR's performance to substantially beat the S&P 500 and the Dow Jones.

The good news is that much of the really bad news is in the rearview mirror. Going forward, if both fiscal and monetary policy become complimentary, the U.S. economy should only have a mild slow down or a mild recession in the second half of 2023.

The path for a more bullish stock market requires the following actions to occur:

1) The Fed must stand firm and commit to finish the job of killing the highest inflation rate in 40 years.
2) The divided U.S. Congress must adopt more prudent spending plans.

Inflation indicators will continue to be watched closely as they will show whether there are supporting fundamentals for what the economists call a "soft landing." The primary question is whether the huge excess of money (M2 = currency, checking, and savings accounts) pumped into the U.S. economy cause inflation to remain elevated or not. Today the estimated M2 in our economy is approximately $21 trillion, or about $4 trillion of EXCESS money above the normal amount of liquidity that existed in the pre-pandemic period. This excess liquidity will be a positive for consumer spending which accounts for 2/3rds of GDP. Alternatively, that over-supply of cash could keep inflation elevated. This extra money in the U.S. suggests that Powell's mission to reduce inflation is likely to be a multi-year effort. Only until there is visibility for reduced inflation will the stock market improve and thereby reduce volatility. Interestingly, except for labor costs, almost all the components of the inflation indices peaked in 2022. The increasing number of corporate layoff announcements across the technology industry are likely to spread across more industries, relieving overall labor cost pressures.

History clearly shows that the first year following a bear market bottom, the S&P 500 rises well more than it had declined. FMR noted in past letters that the average bear market lasts approximately 13 months (has already occurred) and the S&P falls approximately 30% (something that has not yet occurred). It is probable that inflation tapers from the peak in 2022, and that sufficient economic weakness provides cover in 2023 for the Federal Reserve to stop raising rates. If this prospect of a soft-landing gains visibility in the first half of 2023, then history suggests the market could rise as much as 20% from that point.

What could change this forecast? The biggest risk is whether the current high inflation proves to be sticky in 2023. Given the past policy mistakes by Chairman Powell, there is the risk that Powell might commit another mistake by keeping interest rates too high, in itself causing a longer recession or a hard landing. Adding to this latter concern, the Federal Reserve Board stated on December 14th, that their expected terminal (highest) federal funds rate for 2023 is now 5.1% instead of 4.6%. A full 1/3 of the fed board members now believe that this peak rate in 2023 will exceed 6%! History shows that it normally takes 12 months for interest rate increases to slow the economy and inflation, and this provides some comfort that rates should peak in H1 2023. The hard landing risk came into focus after the December 14th meeting. Evidence that this risk has been priced into the stock market was that during the final weeks of the year, following the December 14th meeting, the S&P 500 declined 5%. Should the hard landing scenario become a reality, then there is the potential that the S&P could decline another 10% in 2023.

The ten-year bond rate was unchanged at 3.4% following the December 14th meeting. The bond market "spoke" and is now saying the hiking cycle is over. After all the discussion and analysis of the Fed's December meeting, the bond market still does NOT YET believe the Fed will raise rates over 5% as Chair Powell's hawkish talk did not move longer-term rates. Five Mile River does not believe this 10-Year Treasury Bond rate will stay at 3.4% as the fed funds rate rises. Nevertheless, the bond market is signaling that rates will not rise much from these levels, which is potentially very bullish for stocks.

Whether the economy endures either a hard or soft landing in 2023, high short-term federal funds rates for most, or all of 2023, will likely keep a lid on sky-high P/Es and favor investment in more defensive, value, and dividend growing companies. In November of 2021, with widespread speculation, high stock valuations, and rising inflation, FMR opted to significantly increase client portfolio ownership of reasonably priced "VALUE" companies. Holdings in client portfolios continue to favor large market share companies with strong balance sheets, long runways for growth, free cash flow, and above average absolute dividends. Important criteria for stock selection includes managements that demonstrate a strong commitment to increasing long-term shareholder value, growing dividends, and steady share buybacks. Quality was the correct focus for FMR client portfolios in 2022, and is the right focus for 2023, as this inflation/interest rate struggle plays out. Our best 2023 stock market performance forecast and reward/risk ratio is, +20% on the upside if the inflation fight goes better than expected, and -5% to -10% if stubborn inflation pushes into 2024 unresolved. The U.S. has to win the fight to reduce inflation, and we believe it will win. FMR's company holdings for your portfolios and your preferred strategy tilt have strong and multi-year growth runways.

Please feel free to contact Five Mile River with questions on this letter, portfolio questions, or for discussions of the investment strategy tilt for your portfolios. Thank you for your confidence and trust in Five Mile River, and we wish you a safe and healthy Happy New Year.

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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