Five Mile River Investment Management, LLC October 9, 2023
Client Quarterly Letter
3rd Quarter 2023

PERFORMANCE

	Dow Jones Industrial	S&P 500 Dividends* (Capitalization Weighted)	S&P 500** (Equal Weighted)
2023 Q1	0.38%	7.50%	2.93%
2023 Q2	3.41%	8.74%	3.99%
2023 Q3	-2.62%	-3.27%	-4.90%
2023 YTD	1.09%	13.07%	1.79%

The Wall Street narrative has been high interest rates were slowing the economy such that interest rates were close to a peak with declines probable in 2024. Now the narrative has changed because in mid-September the Federal Reserve Chairman stated that interest rates would remain "higher for longer!" This new narrative provided a catalyst for index and market selling that drove the September S&P 500 decline of 4.77%, inflicting substantial price declines across many companies, especially those richly valued.

Up until mid-September and the Federal Reserve Chairman Powell's speech, the market shrugged off some serious headwinds that emerged during Q3 such as: 1) the recurring concern of a recession highlighted by the potential for an extended UAW strike 2) the October 1st resumption of student debt repayments ($100 billion debt) that surely would dampen consumer spending 3) and the looming U.S. Debt default risk. However, Powell would not have anticipated the 12% decline of the 10-Year Treasury Bond (referred to also as a long bond). This drop in price translated to an increase in yield from 4.1% to 4.8%. Concurrent with this long bond decline, the S&P 500 was -4.77% in the month of September. Bond price movements have historically been a counterbalance to stocks. However, this counterbalance broke down in 2022, when bonds declined as much as stocks, which repeated this September.

Most market pundits have persistently forecast recessions over the past two years. However, a resilient U.S. economy has made that forecast dead wrong. Equity prices have risen in the face of rising short duration interest rates, in part because the 4% yielding 10-Year Treasury Bond was telegraphing low inflation in the future. Investors had believed that past short-term rate increases would slow the economy, and inflation would dissipate, resulting in interest rates peaking in 2024. The mid-September message from the Federal Reserve changed the narrative for the market by pushing out the timeline and level when rates would peak.

Even if the 10-Year Treasury Bond price were to fall further and yield over 5%, this would not be recessionary as many pundits now forecast. It is easy to forget the fact that the 10-Year Treasury Bond traded between

4.5% and 5.5% between 2003 and 2007 with little diminution in economic growth. Higher for longer does reinforce the Federal Reserve's resolve to slow the economy and cool inflation. But the sixty-four-dollar question is, WHEN will a weakening economy cause the Federal Reserve to lower rates?

Two Favorable Observations:

Perhaps one of the market's many ironies is that just as Wall Street changes its narrative by abandoning the forecast of short rates peaking in six months, the abrupt slowing of money in circulation (under the Fed's control) suggests that interest rates are close to peaking in Q4. Paul Samuelson, considered by some as the "Father of Modern Economics" and was the first American to win the Noble Prize in Economic Sciences, was the champion and architect of Monetary Theory. Monetary Theory states that there is a direct correlation between the rate of change of money in circulation and a parallel rate of change in the economy AND inflation. It is important to note that while Chair Powell was guilty of letting money supply grow too fast in 2021 (+20% for less than a year!). In 2023 he has reversed money growth to almost zero. If Paul Samuelson were around today, he surely would argue that the current path of money growth now ensures a slowing of the economy and a cooling in inflation.

The second potential positive will be the release of Q3 corporate earnings beginning this week. Evidence of this potential is the number of recent upward analyst revisions to Q3 estimated earnings. Should interest rates be close to peaking (money supply trends) and earnings delivery be better than anticipated, these two factors would provide a powerful catalyst for equity prices.

Even without these two positives, FMR believes there are favorable underpinnings to the equity market which include: The rate of inflation has been on a downward path for over a year; the S&P 500 is not over-valued and high real interest rates should keep inflation at bay. FMR believes that in the absence of slow money growth or upside analyst revisions, the S&P 500 should remain within a range of +/- 5% through the end of the year.

What are the risks?

There is the possibility that inflation could be more intractable than anticipated (some remember the inflation years between 1968 to 1982) requiring interest rates to rise substantially higher. This would ensure a nasty recession and concurrently a real headwind for equities. What does FMR do to mitigate this risk, no matter how small? FMR screens all stock purchases for client portfolios emphasizing the following characteristics: companies that generate cash after all expenses and working capital needs (free cash flow generators); uninterrupted dividend and earnings growth; #1 or #2 market share positions; high quality balance sheets; managements that are shareholder friendly; and attractive stock purchase prices. This strategy enabled FMR portfolios to outperform the S&P 500 in 2022's down market and should again outperform if recession becomes reality.

The Energy Industry was the ONLY sector in 2022 to show a gain and has been the best performing group in the last 21 months. The S&P 500 weightings across all 11 sub-industries have Energy as the lowest or second lowest weighted group, at approximately a 4% weighting compared with the Technology Industry at a 27% weighting. This low weighting in energy translates into the potential for a multi-year period of out-performance as other portfolio managers gradually add to energy holdings to keep up their performance for their clients. Almost all FMR client portfolios have an average of 20% weighting in energy, spread across the majors, independents, and pipeline companies.

In April of 2022, FMR published an energy paper titled “Energy Reality Today.” Provided along with this letter, also an attachment, is an updated discussion of energy titled “Energy Reality Today, 3Q Update.” With FMR’s continued successful focus on the energy, it is appropriate to continue the discussion on the Energy Industry, and the thought process behind FMR’s ongoing belief that energy investments will provide a multi-year period of out-performance in FMR portfolios. Also, with the recent rapid rise in energy prices, an update on the April 2022 Energy Reality Today is warranted. A cautionary statement is that if energy prices rise significantly above $100/barrel (bbl), there is a risk that inflation could re-ignite. If you would like a copy of the April 2022 Energy Reality Today, please contact our office and we will email or mail a copy to you.

FMR wanted to mention that client portfolios also have an overweight in Defense Contractors: Lockheed Martin, Raytheon, Northrop, and Boeing. These positions were established given the war in Ukraine and the other bad actors around the world, such as Hamas and Hezbollah.

Please do not hesitate to email or call with questions regarding the contents of this letter, the new energy write-up titled “Energy Reality Today, Q3 Update,” and/or other topics not discussed.

We are available to review your portfolio holdings or the investment strategy that is employed for your portfolio. Please let us know should there be any changes in your financial investment risk outlook. Thank you for your confidence in 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. The performance data included in this letter are not audited and have not been otherwise reviewed or verified by an outside party. While Five Mile River Investment Management, LLC endeavors to furnish accurate information, investors should not rely upon the accuracy or completeness of this information.*

***The last two Five Mile River (FMR) quarterly client letters explained that the S&P 500 performance has been driven by only seven richly valued companies (technology) and that those companies have accounted for over 90% of the 2023 S&P 500 performance. In this quarter's client letter, the S&P 500 Equal Weight Index is included in the performance chart to demonstrate how the S&P 500 Performance looks without the overweighting of the seven technology companies (each of the 500 companies in the S&P are equal weighted).*

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