Five Mile River Investment Management, LLC
Client Quarterly Letter
4th Quarter 2023

January 19, 2024

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%	3.98%
2023 Q3	-2.62%	-3.27%	-4.90%
2023 Q4	12.48%	11.69%	11.87%
2023 FY	13.70%	26.29%	13.87%

The Magnificent 7

With all the publicity surrounding the 2023 performance of the **Magnificent 7** (Apple, Alphabet/ Google, Amazon, Meta Platforms/Facebook, Microsoft, Nvidia, and Tesla) the reality is that you would have LOST money if you bought all seven stocks on January1, 2022, and sold them on December 31, 2023! Investing in high growth companies introduces a level of volatility/risk often omitted in the performance narrative. In 2023, the S&P 500 rose 26.3%, whereas these seven companies accounted for 2/3rds of this gain. Said differently, **without the Magnificent 7 in 2023, the S&P 500 rose 9.9%**. Five Mile River (FMR) client portfolios have held Microsoft since 2014, and Google more recently.

Can the market grow into the gain already produced? Valuations matter!

FMR typically refers to a company's Price/Earnings ratio (P/E) to assess the relative attraction or valuation of a company, an industry, or the market. The inputs affecting this ratio are multifold. FMR often chooses an investment when a stock's price lags a significant earnings improvement. In 2023, the markets delivered a most unusual gain in many stocks' prices, without commensurate earnings expansion. This can be expressed as the P/E on the S&P 500 rose from approximately 18X to 23X! As a specific example, in 2023 Nvidia tripled in price, while earnings doubled, and resulted in Nvidia's P/E rising from 25X to 50X. To assess risk, one should ask whether earnings growth can support the stock price? In 2023 the S&P 500 rose 26% while earnings only expanded 5%. Fourth quarter earnings are being released over the next several weeks, and the issue is whether managements' earnings guidance will sustain these price levels. While the S&P 500 earnings are forecast to grow 11% in 2024, the $64 question is whether this growth is too optimistic, and to what degree is the market already discounting the 11%? The FMR expectation is that the S&P 500 should rise within the historic (since 1929) average of 7% to 9%/year, which assumes only a modest lowering of the 11% growth in expected earnings, and with little change to the market's PE. A declining interest rate environment in the U.S., combined with a continuing economic expansion, should

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provide a positive market backdrop. Perhaps the question for the market is better asked about the market's cadence over the next 12 months.

Will the equity markets tolerate a six-month delay before the Federal Reserve begins lowering Federal Funds Rates? Powell acknowledges that he made a mistake in describing inflation as transitory in July of 2021 and had mistakenly delayed raising interest rates by as much as a year. Now, given that experience, it is logical to assume that Powell will wait to see inflation return to his target of 2% before cutting interest rates. This could result in rate declines starting later in 2024 and the Fed Funds rate (currently 5.25%) only declining by 50 to 75 basis points in Q3 and Q4 of 2024.

Are interest rates too rosy?

The 10-Year Treasury Bond (the long bond) rose a stunning 30% in price in just the last several months of 2023 (improving from a 5% yield to a 3.82% yield). While the long bond was rocketing higher in the closing months of 2023, it was exhibiting a level of volatility rarely seen. In addition, within minutes of Powell's speech last November 14^{th}, when he called for an interest rate decline in 2024, short-term interest rates followed a similar appreciation (or decline in yield) as did the long bond. The 12/31/24 Federal Fund's Futures Rate was priced to anticipate a drop in the Federal Funds Rate of 150 basis points, or six declines of 25 basis points each! **This run-up in both bonds and stocks is at risk for correcting, particularly if the Federal Reserve waits until July or later before lowering interest rates. Also, 2024 is a major political election year which may affect the timing of rate cuts.**

FMR believes the 10-Year Treasury Bond will be anchored close to a 4% yield. Why? There is an avalanche of debt that the government will have to sell to fund the existing deficit of $34 trillion, PLUS the new unfunded programs enacted over the past three years of another $3+ trillion. The U.S. Budget Office estimates the monumental level of government debt sales will increase every year for the next four years. In addition to funding our government, the Federal Reserve is selling its bond portfolio of $7 Trillion (Quantitative Tightening or QT). This wall of debt will create an amount of supply that limits any upside for the long bond price.

It's the Economy

Economists for the past 18 months have been searching for THE RECESSION! In hindsight, it appears that the U.S. had been living in a mild rolling recession since the pandemic. To explain this, look no further than the manufacturing side of the U.S. economy. According to the ISM - Institute of Supply Management's monthly series there has been a decline in manufacturing output in each of the past 16 months. Counterbalancing this is the fact that the consumer has kept the economy growing. There is some evidence of a potential for a slowdown in consumer spending. Conversely, consumer income and spending both appear sufficiently resilient to support continued overall economic growth. This suggests the economy should not be a drag on the estimated earnings delivery of 11% in 2024. However, any earnings disappointment will be harshly treated because both the level of earnings and the P/E will become re-rated lower. Avoiding 2024 potential casualties will be critical.

Geopolitical Risk

Iran and several other U.S. adversaries (Russia, China, and North Korea) are escalating militarily creating rising geopolitical risk. Iran's centrifuges are within days of reaching 90% purity plutonium, sufficient for producing three nuclear bombs. This had been a line in the sand for both Israel and the U.S. In addition, Iran is sending warships into the Gulf of Hormuz, all the while continuing to fund their proxy armies: Hamas, Hezbollah, and the Houthis. The latter are increasing bombing activity, targeting U.S. commercial vessels entering the Red Sea, and it is occurring despite the presence of U.S. destroyers and carriers. This past weekend the U.K. and U.S. have executed over 60 targeted air strikes in Yemen (home of the Houthis), the first U.S. retaliation of any consequence. Will this escalation continue?

How is FMR Positioning Client Portfolios?

FMR has intentionally positioned portfolios with conservatively valued investments in sectors that should continue to enjoy healthy tailwinds. FMR is actively taking precautions in the face of valuations that are clearly stretched for both bonds and stocks.

In a majority of FMR client portfolios, technology companies account for the most heavily weighted industry. The deployment of Artificial Intelligence (AI) will drive investments across many technology sectors. If AI is analogized as a gold rush, FMR wants to be in the business of selling picks and shovels. New investments in AI will flow down the technology food chain from: Silicon (Applied Materials); to cloud data center deployment (Digital Realty and Equinix); to increased capacity for cell tower deployment (American Tower and Crown Castle); and to applications deploying AI (Microsoft and IBM). This "food chain" of investments, contained in most all client portfolios, offers the ability to participate in the next wave of AI spending.

Given the very positive fundamental supply/demand for oil, higher oil prices may well become one of the hallmarks of 2024. Do increasing geopolitical risks cause a premium to the price of oil? FMR portfolio performance in 2023 was restrained by the over-weight in energy. However, if viewed over two years, FMR's energy investments are up more than 30%, far better than the two-year performance of the S&P 500 or the **Magnificent 7.** FMR's two largest energy holdings were acquired in 2023, at substantial price premiums: Pioneer Natural Resources was purchased by EXXON (closes this month); and Magellan Midstream Partners was purchased by OKE Holdings (closed in September).

Many energy companies have very attractive characteristics. Company valuations (P/E's) run about ½ that of the market. A number of the attractive energy investments pay dividends yielding as much as 4% to 6%. Also, many re-oriented their business models to better benefit shareholders through rising dividends and share repurchases. Client portfolios own companies that produce and transport oil and natural gas. Eighty percent of world-wide economic activity runs on oil and gas, while the remaining twenty percent runs on hydro, coal, nuclear, and renewables. The energy transition to renewables will be slow, probably taking decades. The U.S. is blessed with having the world's largest resources of shale oil, it is the largest exporter of Liquified Natural Gas (LNG) and has more natural gas reserves than any other country.

Health care related companies sat out the 2023 rally, and FMR took advantage of this relative price weakness, adding to this sector with investments in Merck, CVS, and Abbott. Existing holdings in JNJ, Alexandria Real Estate, Idexx, and Zoetis bring this group to the third largest FMR client portfolio weighting.

The optimal strategy for building long term wealth is to establish core holdings in companies that possess durable growth businesses. FMR chooses companies that are: #1 or #2 in their respective industries, are attractively valued, and possess business models that generate strong free cash flows, thereby enabling dividends to expand and share repurchases to accelerate. Consistent with FMR clients' investment strategies (Growth, Balanced, or Income) the stock selection may differ reflecting a particular client investment objective. Each client portfolio has been built with very attractive long-term company holdings across multiple industries, providing a diversified foundation for continued portfolio growth.

Please do not hesitate to contact us with any questions, or changes in your investment objectives. Also, if you would like to discuss your portfolio holdings, or discuss the outlook as covered in this letter, please give us a call at any time. Enjoy the winter, spring is not far behind!

Sincerely,

Lee Todd Martha

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**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 includes the dividends issued by these 500 companies. This index is used for a comparison for FMR accounts.*

***The S&P 500 performance has been driven by only seven richly valued companies (technology) and those companies have accounted for over 66.6% 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.*

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.

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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).*