FIVE MILE RIVER *Investment Management, LLC*

Five Mile River Investment Management L.L.C.
Client Quarterly Letter
1st Quarter 2024

April 14, 2024

PERFORMANCE

	Dow Jones Industrial	S&P 500* (Capitalization Weighted)	S&P 500* (Equal Weighted)
2024 Q1	5.62%	10.56%	7.91%

The Strongest S&P Q1 Performance since 2019

The Q1 2024 gain in the S&P 500 of 10.56% was the strongest Q1 performance since 2019. Five Mile River's (FMR) client performance in the first quarter was in line with the S&P 500 Equal Weighted Index.

The Bull Market which began in October of 2022 is still very much intact. Why? The U.S. economy is strong, interest rates are stable and many pundits think possibly heading lower, inflation has been moderating, and corporate profits are estimated to expand 10%+ in 2024. This has been the background supporting the powerful strength in markets for the past 18 months.

FMR's Q4 2023 letter pointed to the likely broadening of participation by industries beyond technology and the "Magnificent Seven" stocks. This was clearly visible as 71% of the 500 companies rose in Q1 2024. The broadening of the number of companies rallying is certainly a hallmark of a healthy market. Under the surface of this rally there is a shift affecting multiple industries and companies. Although many big technology companies did quite well in Q1 2024, *these companies ran out of steam in March and in early April*, following a blow-out performance in January and February. In just the first two weeks of April, the drag from the weakness in these technology stocks pulled the entire market down by over 2%. FMR has consistently written that 5%+ corrections are healthy, and a necessary by-product of long-term bull markets. However, since this bull market began 18 months ago, there has not been a single 5% correction. Corrections within bull markets tend to be sharp and short. Because it is not clear whether the current interest rates are sufficient to reduce inflation to the Federal Reserve's target of 2%, the market advance has stalled since the timing for lower rates has been put on hold.

Rotation Among Industries in the Markets

This weakening trend among technology companies is likely to continue as these stocks all carry relatively high Price Earnings ratios (PEs) that are vulnerable if interest rates do not decline as much as the "experts" predict. Broadening of the participation in this bull market in Q1 implies

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positive money flows into a broader dispersion of industries (i.e. rotation). In Q1 2024 the industries which benefited the most from the market's increasing breadth were finance and energy.

FMR clients' core finance investment in JP Morgan Bank (JPM) should prove to be a stand-out performer in finance during 2024. Other than the Federal Reserve, JPM is the strongest financial entity in the U.S. It was the only bank large enough to absorb both Bear Sterns (2008), and now First Republic (2023). JPM has a fortress balance sheet, it has breadth both geographically and in product mix, and it has the scale and diversification to show strong earnings. The integration of First Republic provides an additional $2 Billion to both '24 and '25 revenues.

FMR portfolios continue to have between 15% and 24% weightings in energy companies. Rotation into energy securities is likely to continue through the balance of 2024 and could be a multi-year transition. The FMR weighting contrasts with the miserly 4.8 % S&P 500 weighting in energy. Noteworthy is the fact that a majority of money managers have held even less than the 4.8% S&P 500 energy weighting and are just now scrambling to catch up. Importantly, most energy companies are in position to drive solid earnings because of rising volumes and prices. In addition to strong earnings, the valuation of the energy sector is compelling because it has more than twice the dividend yield compared to the S&P 500 and is currently valued at a 50% discount to the PE of the S&P 500. This combination of strong fundamentals and attractive valuations suggest this sector may benefit from a possible valuation upgrade. In the attached FMR Energy Reality V.3 there is an explanation of the fundamental underpinnings behind FMR's belief that the energy sector should outperform the market over the next three to five years.

New News on Inflation and What About Interest Rates?

The 10.56% Q1 rise in the S&P 500 can be attributed to the expansion of PE's brought about by the expectation that interest rates would decline sharply, as much as six to seven separate 0.25% cuts. That expectation has now been tempered by recent Federal Reserve statements calling for only three cuts this year. There are three over-riding reasons why there may be NO rate decreases this year.

First, the trajectory for inflation had been decelerating through most of 2023, however in the last three months inflation has run hotter than estimated, therefore, throwing doubt into whether the Federal Reserve can achieve its target of a 2% inflation rate. The March Consumer Price Index (CPI) was released Wednesday, April 10, 2024, and registered a third consecutive CPI number showing that inflation is stickier than hoped. To see how inflation gets embedded in our economy, look no further than California's enactment of a $20 minimum wage for all fast-food workers. In addition, higher inflation is predictable given double-digit wage increases over the next several years from recent union wage settlements in the auto and transportation industries. While appearing isolated, these stated increases in wages have the tendency to spill over into many other jobs, companies, and consumer products.

The **second** reason rates are not likely to go lower is due to the strength of the U.S. economy. Commodity prices have moved up substantially in just the last two months, a clear indication of economic strength. Also, do not underestimate the importance of the stock market's gains that reinforce the strength of the economy. The stock market has created a powerful wealth effect. In just the last 15 months, the S&P 500 has gained over 20%, which represents a paper gain of $9 Trillion. The fact is that people shop, stimulating the economy, when their portfolios are up. With consumer spending running about $20 Trillion (or 66% of GDP), this wealth effect clearly creates a positive influence on consumption. Similarly, rising home prices and expanding incomes create the wealth effect. The power of consumption and its positive effect on the economy has taken any discussion of a recession off the table among economists who just 18 months ago were debating the onset of a recession!

The **third** reason why interest rates are unlikely to go significantly lower is that the U.S. needs high rates to attract buyers for the incomparable debt issuance that is just starting to accelerate. Up until recently, both China and Japan had been the two largest purchasers at the weekly U.S. debt auctions. Both countries are now funding/settling their trade balances, not in dollars, but in local currencies or gold. This suggests that there will be a diminishing appetite for purchasing U.S. bonds and T-Bills just as the U.S. is ramping debt issuance. To maintain the appetite for U.S. savers to purchase these government bonds, the Fed may act to keep rates high.

Where are Interest Rates Headed and What About the 2024 Outlook?

Could the next move in interest rates be unchanged or could interest rates go back up? This is currently a contrarian opinion, nevertheless, it is a consideration for FMR in their forecasting that the S&P 500 would rise roughly 9% in 2024.

The current tug of war in our stock market, after a very big technology inspired first quarter, is focused on economic growth. Are current interest rates high enough to bring inflation down to 2%? The quandary for most investors now is whether the Federal Reserve can manage these interest rate cuts without moving inflation back up, affecting economic growth. Candidly, we do not know the answer to that, but our current bias is that reaching a 2% inflation rate this year is very unlikely. Future interest rates may be higher than expected.

Taking a longer view, Jamie Dimon, JP Morgan's CEO warned last week saying, "interest rates could soar to 8% or more in the coming years." He cited the US debt, and the geopolitical stress may complicate achieving lower interest rates.

The FMR S&P 500 forecasted gain of 9% for 2024 may have already been achieved in the 2024 Q1 results. FMR anticipates that the S&P 500 will expand earnings by approximately 10+% in 2024, however, we do not believe the market's PE can rise from the 22X level currently, especially with a more uncertain outlook for interest rates.

FMR Client Portfolios are Constructed to Weather Market Turbulence.

FMR, as you have read over the years, employs conservative investment strategies based on specific valuation criteria. This limits FMR client portfolio downside exposure, as was evident in 2022 when the S&P 500 fell over 18%, whereas FMR accounts declined between 5% and 11%. FMR works with individual client financial goals and objectives and has focused client investments where there are anticipated positive earnings delivery, growth in free cash flows, and receipt of the attractive growing dividends issued by our investments.

Five Mile River wants to be responsive to changes in FMR clients' investment objectives, so please do not hesitate to have a conversation with FMR Portfolios Managers if you wish greater clarity or to initiate changes in investment style.

As is customary with FMR Q1 Client Letters, FMR offers, upon request, copies of the FMR filings with the SEC titled ADV Parts 1&2. Also available on request are FMR's Proxy Voting Guidelines, and FMR's Privacy Policies explaining the policies and processes by which client confidential information is protected. Please let us know if you would like a copy of these documents.

Wishing you an enjoyable spring and great start to the summer months ahead.

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 <u>includes the dividends</u> issued by these 500 companies. The S&P 500 Equal Weighted Index is calculated by giving all 500 stocks in the index the same weight regardless of size of the company. This index can be 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.

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