Five Mile River Investment Management, LLC June 22, 2022
Client Quarterly Letter
2nd Quarter 2022

UPDATE ON INTEREST RATES, FED RATE INCREASES, BEAR MARKET, ECONOMY

Spiking energy and food prices, stock market sell-off, and concern regarding accelerating inflation have made headlines through May and June. If there is any good news, it is that we have likely seen roughly **60%** of the market correction to date if compared to average bear market declines. However, slowing economic growth and higher risk of recession are adding to concerns. What is the antidote to reverse or slow down the trends? The Federal Reserve must aggressively reverse its multiple mistakes by raising the Federal Funds interest rate faster to more than double its current 1.50% to 1.75% rate.

There have been **10 bear markets since 1956,** which are defined as declines greater that 20% of the S&P 500. As of **June 17, 2022, there are now 11 bear markets.** The past bear market declines have been 35% on average. The S&P 500 peaked on November 18, 2021, and as of this past Friday, June 17th, the S&P 500 was down 24% and the NASDAQ was down 31%. In addition, the average bear market duration length has been 391 days. Now we are 215 days from the November '21 peak. Hence, it is a 60% decline for both the average bear market correction AND at 60% of the duration of the average bear market.

The immediate triggers for the market sell-off last week were the 40-year high for the Consumer Price Index (CPI) of **8.6%**, and another record high in the Producer Price Index (PPI) of **10.8%;** both indicate that inflation was still accelerating. The CPI and the PPI increases contributed to the belief the Fed might have to raise fed funds rates higher than anticipated and possibly induce a recession.

However, as the supply chain disruption continues to heal, inflation data should show a deceleration in inflation. Tight labor market and continued supply/demand challenges in the energy market, both structural influences causing inflation, will remain. However, many cyclical components of inflation may show improvement very quickly. In just the last two months, lumber prices have dropped 60%; freight rates are down 30%+ since last year; certain raw materials prices have fallen. Small signs, however, signs nevertheless.

In response to the pandemic decline of 9% gross domestic product (GDP), Congress initiated spending which amounted to **27%** of GDP and in addition, the Fed began printing trillions of new dollars. Since the onset of the pandemic, this increase on the Fed's balance sheet increased from less than $2 trillion to $9 trillion today. The Fed has now started to unwind this "monopoly" money by reducing/selling about $5 trillion of government bonds on their balance sheet (called quantitative tightening or QT). Five Mile River client letters and email blasts have consistently stated that the Fed is dangerously "behind the curve." Both Chair Powell and belatedly, former Chair Janet Yellen have admitted they made a mistake calling inflation "transitory."

The first quarter GDP growth this year was **a negative 1.4%** and the second quarter is now forecast at **0%** in GDP growth. Small business confidence expectations have plunged to a record low. The Conference Board business confidence for 2Q22 has just fallen into recession territory. Both indicate employment, wage gains, and eventually capital expenditures are all slowing. Unemployment claims have turned up and average hourly earnings over the past four months have also slowed. This suggests that we may already be in a mild recession. To bring down structural (non-cyclical) inflation, the Federal Reserve toolbox can only address reducing consumer demand. That process continued last week with the 75 basis points (3/4%) increase in the Fed Funds rate. Simultaneously, mortgage rates have increased from 3% to over 6% now, and that increase took place in just six months.

How has this affected the Five Mile River portfolio investment strategies and stock holdings? Five Mile River was confident that the Fed was pursuing mistaken policies last fall which put them "behind the curve." We anticipated the consequences of these policies, and last fall Five Mile River portfolio managers began to tilt client portfolios to more defensive growth companies with above average dividend yields and dividend growth of 4% to 8% a year. Recent market sell-offs have provided Five Mile River portfolio managers with the opportunity to strengthen the best investments in FMR portfolios. In the three investment styles employed for Five Mile River clients, companies are chosen for their robust fundamentals that put them in the position to increase dividends, and to buy back stock to build shareholder value. These companies have high profit margins, sustainable growth, low levels of debt, and surplus cash which provides options to increase shareholder value. Five Mile River client portfolios continue to maintain strong energy positions that have performed extremely well over the last two years. The "Energy Reality" write-up included in the 1Q22 FMR client newsletter did a deep dive into why the "energy transition" will take longer than most expect. The U.S. will need options for energy creation that will include all of the following: renewables with solar and wind, natural gas, oil, carbon capture, nuclear/fusion, clean coal, hydro and possibly hydrogen.

Please contact Five Mile River if you have any questions or would like to discuss the information presented in the letter. Lee and Todd are always available to discuss the concepts in this letter or market conditions in relation to client investment strategies.

Most Sincerely,

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.*

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