Five Mile River Investment Management LLC March 13, 2025
Client Quarterly Letter
1st Quarter 2025 – Early Report

1Q2025 Performance Data will be provided early April

Tariffs!

Digesting tariff implications creates uncertainty

Tariffs have been in the forefront of the news since President Trump was inaugurated for his second term as president. From the start, the new administration has chosen to use tariffs as a weapon and a bargaining tool. The potential implications from tariffs are so broad, uncertainty reigns. Markets do not love uncertainty! President Trump's **weaponization** of tariffs has brought about not only confusion and uncertainty: it has some countries scrambling for position changes, which seem to change daily. Since each country's tariff negotiation is unique, as will be the response, there is no way of knowing how protracted this may become. That said, FMR believes tariffs are not "all bad."

Do import tariffs cause inflation?

In 2018 President Trump imposed 20% tariffs on steel and 10% tariffs on aluminum. The result was a negligible inflation increase estimated to be less the **0.4%** which quickly disappeared. Admittedly, the current tariffs cover a far broader range of imports than in 2018. Nevertheless, there are multiple instances in history that indicate the impact of import duties can be both transitory and insignificant - if correctly managed. It is important to point out that tariff implications, by their nature, will carry uncertainties that can last months. It is Five Mile River's belief that the Federal Reserve is likely to treat the tariff's influence on inflation as transitory and will not use it as a cause for changing their current accommodative stance of lower interest rates. If anything, the implications may be cause for more rate cuts than the market is currently expecting.

What are Trump's objectives for using tariffs?

In 2024 the U.S. had the fourth consecutive trade deficit of + $1Trillion spread across roughly 100 countries. The U.S. has been consistently running trade deficits since the early '80's, but only in the last several years has their size constituted a major issue. The current trade deficit is subtracting approximately 3% points from GDP growth, an unsustainable level. Because the U.S. deficit is caused by consumption running higher than production (exports) the most elegant and fastest solution for fixing the deficit is to encourage domestic and foreign companies to locate production in the U.S.

Tariffs accomplish two separate President Trump objectives: Increase U.S. production to improve the trade deficit and employment, and to shift the components of U.S. growth away from the government and rely more heavily on private enterprises to drive the economy.

Over the past couple of months, it is estimated that over 150 new manufacturing centers have been announced to open in the U.S.!

The most favorable results from the tariffs can be a means to accomplish some very desirable outcomes and can be summarized as follows:

1) Attract construction for manufacturing facilities in the U.S.
2) Encourage (hopefully) the U.S. trading partners to lower decades' old duties that countries have imposed on U.S. exports. (A $65K U.S. made car sells after duties for $120k in India, $100k in Germany, and no sales in China.)
3) tariffs have the potential to be a significant source of income for the U.S. (trillions)
4) Prevent price dumping of goods coming into the U.S.
5) Effect foreign policy changes: forcing NATO countries to pay for agreed share of combined defense costs, stop flow of fentanyl into U.S., control immigration costs

Proposed tariffs have started to have a positive effect

Five Mile River believes that tariffs will encourage foreign investment to set up manufacturing in the U.S. Honda and Taiwan Semiconductor (TSM) are prime examples of this taking effect. TSM produces 90% of intelligent chips in the world. TSM recently completed construction in Phoenix Arizona of their first manufacturing plant for chip fabrication with $1.5B grant from the Chips Act. Recently, TSM committed to spending an additional $65B for a second and a third plant for chip fabrication in the U.S. On March 3rd Honda announced that it will be building a new plant to produce it's next-generation Honda Civic in Indiana, and not Mexico, due to U.S. tariffs.

Tariffs aren't the only source of uncertainty today!

Consumer spending accounts for 66% of the U.S. Gross National Product (GDP). When consumers back away from spending, GDP can fall, causing a recession. The government therefore tracks consumer spending as the "canary in the coal mine." Recent data for consumer spending in January and early February shows a more hesitant consumer. This input is one of the sources calling for a potential recession.

FMR continues to monitor data points in real-time to assess consumer sentiment and potential market impact. The Consumer Sentiment Index is especially important to monitor, but framing it is critical. It is a contrary indicator, the worse the index the more likely the market is bottoming. In fact, the bullish sentiment indicator has fallen from a January high of over 50% to 19% as of March 5, 2025. This indicator was last at this level at the absolute market bottom of the Great Recession on March 9, 2009.

Adding to the uncertainty is the sell-off of the equity markets in the last two weeks. It is not unusual that the markets decline in February and March as post-Christmas spending falls off. Also, winter weather across the nation has been harsh and the devastating fires in LA this year created anomalies for correctly interpreting government data.

At Five Mile River, while we monitor and weigh these risks, we are ultimately optimistic. FMR believes this is a correction within a bull market. Uncertainty should abate and yield to positive prospective economic data on employment, inflation, and growth in the quarters ahead.

There is a very favorable economic backdrop amid all the confusion:

- inflation is on a downward path as are interest rates
- employment is strong
- regulations are being relaxed
- corporate profits continue to expand
- productivity is strong
- the savings rate is decidedly positive

These are not the ingredients for a recession or even a severe correction (a decline of 20% or more is considered a severe correction).

Volatility and market corrections

FMR has communicated in past Five Mile River Client Letters that volatile markets create opportunities to make important tactical additions to client portfolios. Such an opportunity allows purchase of high-quality, undervalued stocks for client portfolios. The U.S. has been in a bull market since October of 2022. Corrections within bull markets are swift and painful. While unnerving, this is the nature of bull market corrections which typically range from down 10% to down 15%. Currently, domestic equity markets are near the lower end of this range. The NASDAQ is off just shy of 15% from its high. The S&P 500 is 10% from its high and the Dow Jones is down nearly 9%.

FMR client portfolios are well positioned for this environment. Our team established a more defensive shift for client portfolios in the fourth quarter of 2024, as was detailed in the FMR 4Q2024 Client Letter. FMR portfolio managers engaged in a series of risk management disciplines that had the effect of increasing cash positions by trimming some of FMR's winners and making additions to weightings in high quality, defensive dividend growth companies. These strategies locked in a number of 2024 gains, and because we simply did not have loss positions to offset these gains, taxes due this April may run a bit higher than usual. That said, the actions - and the tax impacts - we booked in 2024 positioned FMR client portfolios very well heading into the current environment.

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.

We invite your comments, and are always available to discuss the market, or your individual portfolios. FMR continues to research exciting new areas for investing that fit FMR client risk tolerance and profile. Within the next several weeks, Five Mile River will send to clients the 1Q2025 quarterly performance numbers along with a Five Mile River article titled "United States Electricity Demand and Investment Opportunities." This article will outline one of the most exciting sectors for today's investing.

Sincerely,

Lee Todd Martha

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