MRP CAPTIAL INVESTMENTS, LLC

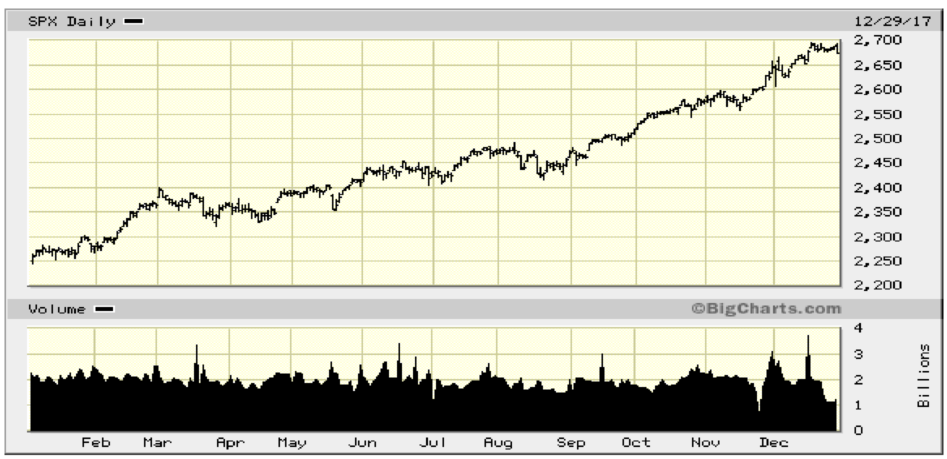
4th Quarter 2017 Client Newsletter

Inside this report:

Capital Market Update

KABOOM!!!! The 4th quarter showed nothing but a continuation of one of the greatest years in stock market history. For the quarter, the price change in the S&P 500 was 6.12%. And this makes the annual price appreciation 19.42% for the market. However simply looking at the returns alone doesn't tell the entire story.

Factoring in the extremely low-reading in the Volatility Index and the fact that the market didn't show any downside moves of significance highlights the strength of this rally.



S&P 500 2017 Chart Supplied by BigCharts.com

What strikes me as extremely interesting in the context of this market is how many people say that this is a bubble and that the rally is totally divorced from the fundamentals. Frankly, I disagree 100%. Simply looking at the fact that earnings will have grown by about 17% this year shows investors that the fundamentals are pretty darn good.

Now when you take it to the next level and factor in corporate tax cuts and continued deregulation in 2018, it seems pretty clear to me that the outlook for earnings (the #1 driving factor concerning market performance) looks pretty good.

Of course there are a lot of things that can make this market gyrate and we will be on the look out, but corporate profits do look good!

A Shift To Greed

Warren Buffett says ‘the market runs on fear or greed.’ To be frank, this comment touches on why a big part of my investment process is rooted in Behavioral Finance. To avoid writing page after page detailing what I look for, I’ll simply say that the most important thing to notice regarding the markets and Behavioral Finance is how people are reacting to information; are they fearful or greedy.

For example, when I wrote the 2009 report entitled “The Beginning of the Bull…” I noticed that every single one of the indicators that I track was registering epically pessimistic readings. Interestingly enough, these incredibly fear-ridden pieces of data were actually bullish indicators for future asset price movements. Why? It shows that people’s behavior was too negative regarding the pricing of assets and that usually means the next move for prices is to go higher.

This type of turning point in the markets usually sets the stage for the beginning movements of a Bull Market. The main characteristic of an early stage Bull Market is simply the recognition of SOME market participants that prices have gone too low and that there are some positive fundamentals regarding the economy and companies. The recognition of these pricing abnormalities allows savvy investors to pick up assets on the cheap.

As the market moves forward from these beginning stages, savvy investors can continue to buy stocks on the cheap until the mood of the market shifts due to a change in the behavior of investors. Typically, this type of shift occurs when market participants loose their negative outlook and realize that the market fundamentals are pretty good. This recognition leads to increased flows of money into “riskier” assets as the mood of the market gets more and more bullish.

Of note, on 10/20/2017 I put up a post on my website (www.mrpci.com) in the Capital Markets Notes section under the Market Thoughts tab, entitled “The Market Finally Realized We Are In a Bull.” In fact, here is a cut and paste of that post:

In February 2009, I wrote a report called "The Beginning of the Bull..." As good fortune would have it, that report, almost precisely, called the bottom of the 2008 Bear Collapse. Ever since then, I've been tracking this Bull Market and, up until now, almost no one realized we were in a Bull Market...despite the S&P 500 going from 666 to over 2,400.

Nevertheless, I am seeing all sorts of Bullish comments and behaviors from investors and people. Frankly, this should set the stage for the last legs of the Bull run. And, to be honest, this leg has historically seen some crazy behavior.

Strap in! Because if history is any predictor of the future, we could be in for a wonderfully insane rocket ride.

Here are some things I am seeing that make me say that people are behaving optimistically...

Consumer Sentiment reading over 100...https://www.cnbc.com/video/2017/10/13/the-week-that-was-consumer-sentiment-highest-in-13-years.html?play=1

Bullish Hedge Fund manager comments...https://www.cnbc.com/2017/10/20/market-beating-hedge-fund-manager-dan-loeb-is-very-bullish-on-us-stocks.html

Bears Turning Bullish...https://www.cnbc.com/2017/10/20/bullish-again-strategist-tom-lee-says-businesses-like-trump.html

We need to watch Institutional Investor allocation data. When we see them moving from under-weight stocks to over-weight stocks, we know the move will be powerful.

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Since I wrote that post, the S&P 500 has rallied another 3.82% and it sure looks like market participants are trying to make up for being too Bearish for too long. This could set the stage for further momentum regarding this Bull Market run.

As I mentioned in the post, the key is watching allocation data. Up until the time of that post, the bulk of investors were under-weight stocks. IF they move towards an over-weight position, this could spell BIG gains for equities. In fact, this can set up the next stage of a Bull Run; a Reflexive Bull (which was discussed in detail in the 7/31/2013 report entitled “A Path to Reflexivity”).

If we build towards that next step, one thing that will be noticeable will be a specific change in investor mentality. To be frank, I haven't seen this mentality since the late 90s but I can already feel it coming. The change is investors being unhappy with solid, if not big, returns.

For example, a diversified portfolio might generate 16% returns in a given year. Most of the time, investors would be ecstatic with this level of performance. However, when greed overtakes market participants 16% will seem too low and they will be unhappy. In fact, I can remember in early 2000 doing portfolio reviews with clients. In the review, I might have shown them a portfolio that returned 25%. Their response might have been something like, "Well the NASDAQ was up 85%*, why couldn't you get me those returns?"

Of course, when the NASDAQ lost all of those gains, and more, over the next couple of years, the attitude changed to a fearful one. Nevertheless, I feel the shift to greed right now and I know it can overwhelm rational thought on the part of investors.

I bring this up in an attempt to try to stay a step ahead of this emotional pull because the emotional pull will be at its strongest right when the market is set to roll over; as is highlighted in the 1999/2000 NASDAQ story mentioned above. And this can lead investors into taking too much risk at exactly the wrong time, which makes for a painful end to a Bull market run.

Of course, I am aware of the power of behavioral finance. As I mentioned in the first paragraph of this article, it makes up a big part of my investment process and is the crux of a lot of my research reports. But I think it is a good idea to keep mentioning it because the power of the emotional pull can be intense. If we can keep it all in check, we should be able to use our knowledge to generate profits and limit the risks.

*And, yes, the NASDAQ returned 85.59% in calendar year 1999.

Bitcoin

In the last article, I discussed how market participants have finally realized that we are in a Bull Market. I also mentioned that in the final stages of the Bull Market, which can last for years, some crazy things can happen.

To be honest, the "crazy things" happen when the fear in the market place fully gives way to greed. This greedy mindset will always look for the asset class that is providing the biggest gains in the most expedient way. In the last major Bull Market, which occurred in the late 90s, that asset class was technology stocks. I am sure everyone remembers the tech heavy NASDAQ being the focal point of the tech rally. We saw that index skyrocket as profit seekers kept piling their money into tech stocks in hopes of more and more gains. Of course, when the Tech Stock Bubble burst, the NASDAQ fell 80% from peak to trough as fear took over greed during the recession that followed the tech boom.

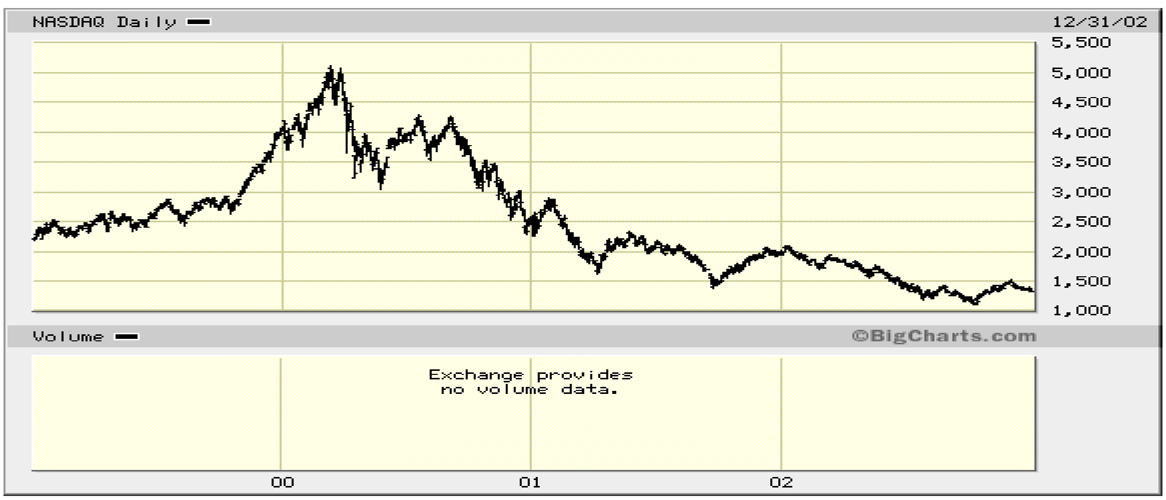

Chart of NASDAQ from 1999-2002

Well, I think we might have our poster child for greed in this Bull Market; Bitcoin. In 2017 alone, Bitcoin has rallied 1,244%. Yeah, that is not a typo; 1,244%!!!!

But, to be fair, I do think the technology backing Bitcoin is a revolutionary piece of technology. It is called Blockchain. And the gist of Blockchain is that it is a digital ledger of transactions. And it just might revolutionize the way orders are placed in our global economy. However, if you remember, the hype that led to the bubble in tech stock valuations in the late 90s DID revolutionize the way business was done. The problem WASN'T the technology underlying the stocks, the problem was the valuations of the stocks. The market participant's greed got the better of them and they bid up the prices on these stocks WAY too much. I have a feeling the exact same thing will happen to Bitcoin and other crypto-currencies.

I've been doing a lot of research into these crypto-currencies and trying to figure out how to value them and/or decipher when their bubble might burst. I think the work of Richard Bernstein might have provided a good foundation for understanding the timing of the Bitcoin bubble bursting. For the record, Mr. Bernstein doesn't work for MRP Capital Investments, LLC and/or have any affiliation with us in any way. I simply think he is the smartest market strategist I have ever met and I respect his work immensely. Below is a blurb for his December 2017 report entitled "Some Thoughts on 2018":

<u>"The requisite comment on Bitcon (our sarcastic name)</u>

After the technology and housing bubbles, investors too frequently use the term bubble. Whereas it is true that all bubbles contain speculation, not all speculation can be classified as a bubble. Bubbles are much broader than speculation in that bubbles go beyond the financial markets and pervade society.

From our research, there are five characteristics of a financial bubble:

1) *Available liquidity*
2) *Increased use of leverage*
3) *Democratization of the market*
4) *Increased new issues*
5) *Increased turnover*

Crypto-currencies clearly have all five characteristics of a bubble:

1) *Available liquidity—central banks have clearly provided a sea of liquidity.*
2) *Leverage—the upcoming listing of futures contracts may be just the beginning.*
3) *Democratization—individuals globally are active participants.*
4) *New issues—there are over 1,000 crypto-currencies.*
5) *Turnover—trading volumes have soared.*

Bubbles tend to continue until liquidity needed to speculate dries up.

The technology and housing bubbles' peaks were both preceded by an inverted yield curve. Accordingly, it is our guess that the crypto-bubble will continue until the Fed and other central banks remove too much liquidity from the economy, the availability of "greater fools" decreases, and the bubble deflates. We do not see an inverted yield curve anytime soon, so the bubble seems likely to inflate more. One would have thought that investors would have learned their lesson from the deflation of technology and housing bubbles, but that doesn't appear to be the case. The sad reality is that many more investors will likely get sucked into this bubble too."

Again, that is from the work of Rich Bernstein and his team at Rich Bernstein Advisors. The exact report is the December 2017 "Some Thoughts on 2018" piece and the quoted section is pulled from pages 6 and 7.

Will Rich be right on this call? Of course, no ones knows right now. But I do avidly read his research, and have since we were both at Merrill Lynch, and I have been extremely impressed with the accuracy of his research over that time frame, without exception.

For summary purposes, if I try to put his research into my own words; it looks like he is trying to say that this crypto-currency bubble will continue to inflate until the yield curve inverts. And since he doesn't forecast an inverting yield curve anytime soon, investors with a flair for speculative investments could try to ride this wave a bit longer.

Tax Bill

As I’ve written about in the last couple of newsletters, it is becoming next to impossible to get quality information from the “normal” media outlets. The reporting being done by the mainstream media is so biased and one-sided that flipping from the left-wing media outlets to the right-wing media sources and listening to stories about the same topic would lead one to believe that they aren’t discussing the same topic at all. You see, the bias is so deep that the end result is a vastly different story depending on which side of the political spectrum the reporting journalist supports.

Nevertheless there are vitally important news stories out there that we must get the actual information on if we are to manage our portfolios, and our lives, prudently and effectively. One of the topics that we must be able to comprehend, without partisan political bias cluttering our minds, is the tax bill that Congress just passed.

I’ll spare you any political speak and cut directly to the information that matters. The entire time the Bill was being drafted, debated, and written up, what was the one thing that was rock solid and effectively never changed? It was the business tax reduction. No matter if it was the House Bill that had 4 personal tax brackets or if it was the Senate Bill that had 7, the corporate and business pass-through tax rates were going to be dramatically lowered. No matter if State and Local tax deductions were going to be eliminated, capped, or kept the same, the corporate and business pass-through tax rates were going to be dramatically lowered.

What that tells me is that **<u>this Bill had one main goal; lower taxes on businesses</u>**. Its just that plain and just that simple. In my opinion, all the other stuff is just bells, whistles, and window dressing to get enough votes to lower the corporate tax rates.

Why was this the focus? I believe the “Powers that Be” realized that with the doubling of our national debt in the last 8 years and the accompanying slow growth rate of our economy, the only way out of our debt-laden economic issues is with a massive spurt of growth. Growth that could keep us from falling into the European, or Japanese, style of economic malaise. (For more detail on the issues with the European and Japanese economies, please reference the “Brave New World” research report written on 07/21/2017).

And to get this growth, the current Administration believes that the economy needs to be de-regulated, corporate taxes need to be cut, and a massive economic stimulus package needs to be embarked upon. Of course, only time will tell if they are correct in their analysis.

Nevertheless, there are two things investors need to look at in the wake of this bill passing. The first is the follow-on corporate actions and the other is the impact tax cuts will have on corporate earnings.

In relation to the corporate actions, I was stunned to see AT&T, within hours of the bill passing, announce $200,000,000 in bonuses to be paid to non-executive employees and the announcement of $1,000,000,000 in additional capital spending plans. But, if that wasn't enough, soon after that announcement, Comcast announced $100,000,000 in employee bonuses and $50 billion in new business investment plans in the United States. In addition to that, Wells Fargo, Fifth Third Bank, and Boeing all announced multi-billion dollar pay increases for their employees and increased charitable contributions that same night. If this type of activity continues, the growth spurt the Administration is hoping for is likely to occur.

Another crucial aspect of this tax cut is its impact on corporate earnings. Wall Street analysts project the earnings of S&P 500 companies to grow somewhere between 9% to 13% based solely on the reduction in the tax rate. What that means for your portfolio is that you could see stocks appreciate by that amount, if no additional improvements are made to corporate operations. However without any boost from tax cuts, earnings grew over 17% in 2017. So I believe there just might be some upside to the expected 9% to 13% boost in earnings for 2018.

Of course, we will have to see how all this shakes out. But for now, it looks to me like this bill was all about corporate tax relief, not high-income earner tax relief. In fact, I've had many discussions with clients, who make a lot of money, and they have said their initial projections show their taxes will be going UP in 2018. Which, quite frankly, doesn't surprise me. This is mainly a tool to give tax relief to businesses, first and foremost, in hopes of spurring economic growth.

Imbalance Update

Up until now, this newsletter has been very upbeat about the outlook for the markets. Nevertheless, I have been talking about an imbalance building in the market for quite sometime. If you reference the last two newsletters, I've defined that imbalance as being the fact that the market has appreciated at a time when the Fed is hiking rates. Historically, this rarely happens.

With this anomaly occurring, I think it is prudent to track the size of the imbalance. Thus far the market has rallied 17.69% since the Fed began hiking rates in December of 2016. If something were to happen negatively, I truly believe that downside risk should be equal to the size of this imbalance.

Given this, we are remaining grounded in "best practices" for portfolio management. Specifically, Investment Policy Statements are followed, asset allocations are prudent, and risk tolerance and objectives are in-line with portfolio construction. And, as always, we are doing our best to stay abreast of all market moving data and information.

2017 Recap

For the markets, 2017 was an exceptional year. Concerning the markets and the economy, here are some statistics:

	Last reading of 2016	**Last reading of 2017**	**% Change**
S&P 500 Price Level	2,238.83	2,673.61	19.42%
Nominal GDP	$18.729 Trillion	$19.500 Trillion	4.71%
U.S. Employed	152,048,000	153,918,000	1.22%
U.S. Personal Income	$16.028 Trillion	$16.452 Trillion	2.65%
Personal Debt	$15.882 Billion	$15.453 Billion	-2.70%
Small Business Optimism	98.4	107.5	9.25%
Homebuilder Confidence	69	74	7.25%
Manufacturing Confidence	77.8	94.6	21.6%

Let's hope the economic momentum continues throughout 2018!!!

Non-Financial Events occurring this quarter

10/1/2017 saw 58 people killed and 546 injured when gunshots rang out into the crowd of a Las Vegas concert.

12/6/2017 The USA formally recognized Jerusalem as the capital of Israel.

Massive wildfires devastated Southern California

The Houston Astros won the World Series!

Major Hollywood Power Broker, Harvey Weinstein, was accused of being a serial sexual predator by MANY women. After that, an avalanche of powerful men in Hollywood, politics, and entertainment were also accused of being serial sexual assaulters.

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