MRP CAPITAL INVESTMENTS, LLC

The Path to Reflexivity

Research Report 7/31/2013

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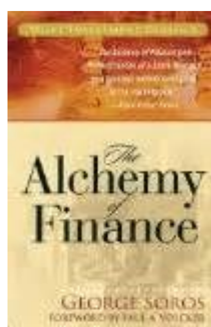
What is Reflexivity?

I put out a report a few months ago entitled "Reflexivity." I know most people don't know what the heck that terms means, so here is a brief description of what I mean when I use that term.

It is a term that I first ran across while reading George Soros' book "The Alchemy of Finance." It is essentially a human behavioral phenomena where by people's actions are influenced by their beliefs and their actions build off of each other to influence the markets. It has the impact of extending trends and taking things to extremes within markets. The results of Reflexive Markets could be seen at the end of the Tech Boom of the 1990s and the market's collapse at the end of 2008.

For more detailed information on the concept, please check out my past report, which is posted on the www.mrpci.com website, and/or read Mr. Soros' book.

Throughout the course of this report, I will talk about our current market's position and how historical precedent and the idea of Reflexivity can potentially affect it.



Current Environment

In our current market environment, I believe the health of our system relies heavily on the banks. Furthermore, I believe the Fed and U.S. Treasury know/knew this and enacted the extraordinary measures they did in 2008 (and beyond) exclusively to save the banking system and, in effect, the way of life as we know it. Frankly, I think they've succeeded in saving the system and they are now moving towards removing those extraordinary measures and helping the economy return to a normal, self-sufficient, capitalist economy.

These actions, alone, will cause market volatility. Why? Because market participants always seek to find ways to exploit current conditions to make money. If interest rates have been kept artificially low by the Fed's extremely accommodative policies, then shorting Treasuries can give investors a low-cost way to access capital which they can then deploy into other areas of the market in search of profits. In the world of financial jargon, this is called a "carry trade" and is one way investors can exploit low rates. The kicker is when these low rates begin to rise, the carry trade becomes less attractive and it needs to be unwound. This unwinding causes all sorts of movements in the market over the short-term, thereby increasing market volatility.

But, nevertheless, after all this market participant led volatility wanes, the fundamentals of the market place will show their colors. Those underlying fundamentals are highlighted by the fact that bank earnings are at an all-time high;

FDIC: Banks Net Income in 1Q Hits All-Time High of $40.3 Billion (CNBC 5/29/2013)

GDP is at an all-time high;

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013 Q1
GDP	**11853**	**12623**	**13377**	**14028**	**14291**	**13973**	**14498**	**15075**	**15684**	**15984**
PCE	8270	8803	9301	9772	10035	9845	10215	10729	11119	11350
PDI	1968	2172	2327	2295	2087	1549	1737	1854	2062	2144
Exports	-618	-722	-769	-713	-709	-388	-511	-568	-559	-536
Gov't	2232	2369	2518	2674	2878	2967	3057	3059	3062	3025

*Data taken from BEA website and is in billions of dollar

Interest rates are very low by historical standards;

Data provided by the US Treasury

Corporate balance sheets are very strong;

Companies sitting on cash pile of over $1 trillion

(CNBC, 7/26/2013)

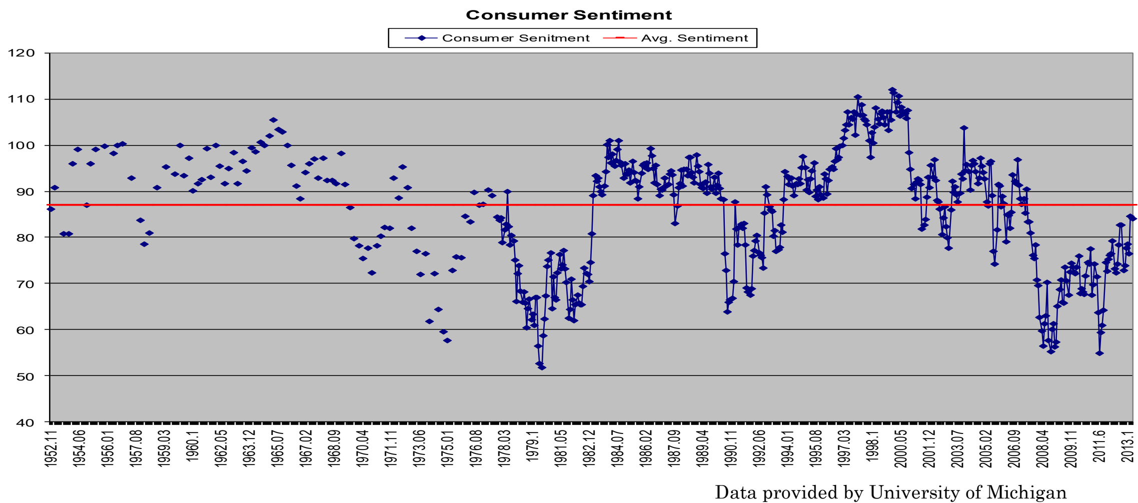
As are personal balance sheets.

Household/Non-Profits Net Worth

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013 Q1**
Non-financial Assets	$28,216	$24,825	$23,769	$23,472	$23,432	$25,188	$26,030
Financial Assets	$52,898	$43,436	$46,303	$50,385	$51,310	$55,595	$57,697
Liabilities	$14,253	$14,097	$13,874	$13,636	$13,415	$13,437	$13,378
Net Worth	$66,861	$54,163	$56,197	$60,221	$61,327	$67,346	$70,349

*Data provided by the Federal Reserve

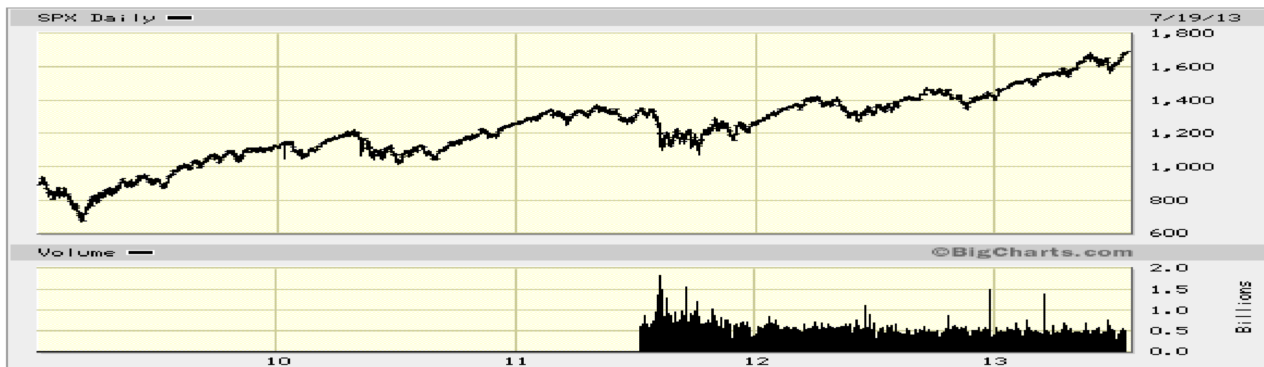
When you combine this with below average consumer sentiment, which highlights that fact that most people do not realize that things are actually in pretty good shape, you've got upside potential within this market place.



The key questions are; How much upside? And how long will it take to get there?

Upside and Timeframes

As I type this, the S&P 500 sits at 1,680. Given that this represents a 152% gain from its low of 666, people might be concerned the market doesn't have a lot of upside left. Frankly, I disagree. The numbers show us that this level of 1,680 yields a Price-to-Earnings ratio of 17.48, using Standard & Poor's "as reported" earnings of $91.88 for the S&P 500. Looking at historical data relative to the S&P 500, it appears that a P/E ratio of 20 is very achievable if Consumer Sentiment continues to rise. And with Consumer Sentiment still at below average levels, I think a strong argument can be made that a P/E of greater than 20 is in the cards. But, nevertheless, if the market were to achieve a P/E of 20, at the current earnings level, this would equate to an S&P 500 level of 1,837.



If this number were to be achieved, it would mean that equity investors would realize 9% more profits, without dividends being considered, on their investments. Given that the yield on the 10-year Treasury has "skyrocketed" to 2.56%, 9% returns look pretty darn attractive. But when you consider that Standard and Poor's Howard Silverblatt expects the indexes earnings to be $102.82 by the end of 2013, you take the imputed return up to 22.4% (as a 20 times earnings ratio at $102.82 worth of earnings equals an index level of 2,056). There is no question that a return of over 20% is very attractive.

Now, this is where things can start to get weird. IF these levels of the market were to be achieved in the short to mid-term, human behavioral influences could begin to impact the markets. Warren Buffet is quoted as saying that fear and greed run the markets, nothing else. The stage gets set for a Bull Market run when fear overwhelms the markets and sell-offs become over done and valuations become too low. It is my opinion that this happened in late 2008/early 2009. Common sense dictates that when rational investors see a market that is irrationally low, they will buy. This buying will drive the markets higher, most likely to a rational level. This appreciation in the markets will eventually stir the interest of the masses and greed has the potential to take over. Rational valuation levels can be ignored in times like this as greed and market gains feed upon themselves to drive the markets higher and higher; Reflexivity.

How long this takes and just how far the markets can run beyond rational valuation levels can be a tough thing to predict, but we can look backwards and see if a historical precedent has been set.

Why look backwards at historical data and behavior? It is my belief that inherent in the basic concept of markets is the impact that market participants, and therefore human behaviors, have on the markets themselves. In his book, Mr. Soros discusses similar concepts when he discusses Booms and Busts in the market. In general, I think he is right, but misses one crucial step; the consolidation phase. As I've previously written extensively on my Boom/Bust/Consolidate Theory, I won't bore you with it here. Nevertheless, it will come up as we discuss historical precedent set by the markets.

If we turn our attention to historical market behavior, one of the latest market Booms occurred in the late 1990s. In fact, our Federal Reserve Chairman at the time, Alan Greenspan, noticed the point within the market's behavior when it turned from a fundamentally driven Bull Market to a Reflexive Bull Market when he made his, now famous, "irrational exuberance" comments on December 5th, 1996.

At that time, the P/E on the market was 19.45 and, looking at the past data on the stock market, that level is on the higher end of reasonable. But from that moment until early 2000, the stock markets continued to move onward and upward at ludicrous speed. In fact, the S&P 500 more than doubled from that point!! And all this happened after one of the most knowledgeable economists in the world, who was armed with the most timely and robust set of data, said that rational levels of appreciation were EXCEEDED in late 1996.

THAT IS THE POWER OF REFLEXIVITY!! And, make no mistake about it, we've seen this again and again. In fact, it reminds me of a few lines from a Jim Morrison poem;

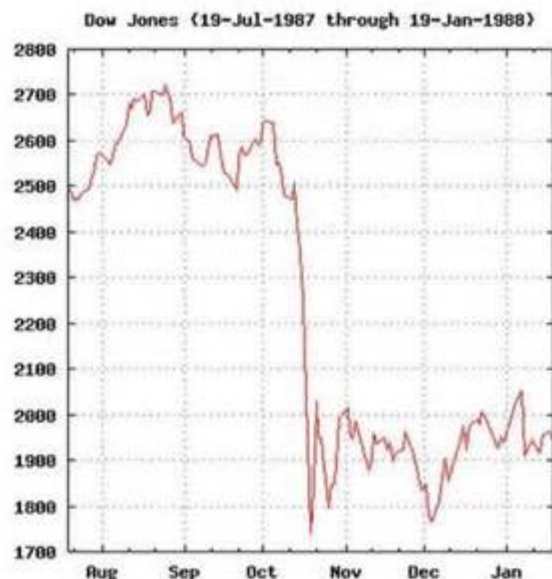
> "The program for this evening is not new,
>
> You've seen this entertainment through and through.
>
> You've seen your birth, your life, your death
>
> You might recall all the rest"

Past Reflexive Booms can be seen in the data regarding many markets including: the Roaring '20s, the Japanese stock market craze in the 1980s, and the Tulip mania in the 1600s. It happens repeatedly because, as I've said before, markets are made up of human beings and human beings are ruled by emotions. Human emotions within the markets are ruled by variants and grades of fear and greed. These Reflexive Booms are the apex of the human state of greed.

However, on this Path to Reflexivity the markets must transform from a Rational Bull Market to a Reflexive Bull Market. During this process historical data suggests that there will be multiple pull backs during the cycle. Notable pullbacks within the 1980s/1990s Bull Market where the 1987 Stock Market Crash and the 1990 recession. For educational purposes and understanding, lets take a look at each pullback within the S&P 500 from 1982-1999 in an effort to comprehend what potentially sets these micro-bear markets off.

First off, it is vital to understand that the market actually bottomed in December of 1974. From that point forward, you saw a lot of appreciation until 2000. However my work refers to the timeframe from 1975-1982 as the "Consolidation Phase" of the market, which has distinctively different characteristics from the Boom (or Bust) Phase of the market. [See The Holy Grail Research Report for more details].

From the end of the Consolidation Phase of the market until August of 1987, the S&P 500 zoomed upward. On a price basis, the S&P 500 racked up price gains of about 200% during those 5 years. In August, the market started to wobble and then on October 19, 1987 the stock market crashed. This event is called "Black Monday" and that day, alone, the Dow Jones Industrial Average fell 22.61%.



There a lot of claims by the experts regarding the reasons for this market crash and they include program trading, over-valuation, and illiquidity. But other points I find interesting are the facts that from its 1982 low the S&P 500 appreciated 200% with very few significant pullbacks and Consumer Sentiment was VERY high and had been high for over 3 years at the time of the crash. Also of note to me, was that in August of 1987, Paul Volker was replaced by Alan Greenspan as the Chairman of the Federal Reserve Board.

That sell off within the markets settled down in December of 1987 and returned to an upward path which lasted until the S&P 500 broke 360 in June of 1990. This represented a 50% gain from where it ended 1987. But when the sabers began rattling and The Gulf War broke out, the market fell about 15%. This sell off began when War was breaking out, a recession was forming, and, once again, when Consumer Sentiment was high.

As fate would have it, The Gulf War didn't last long and neither did the 1990 recession and the market resumed its march upward. 1994 did show a little volatility as the New Year was rung in with losses that lasted until April. During that time, it fell about 5% before it continued its upward bias. During this brief pause, the FOMC raised rates for the first time since 1989, Bill Clinton was President, and US Troops were pulled out of Somalia. Oh yeah, Consumer Sentiment was high.

As mentioned earlier in this report, it was in 1996 when Greenspan coined the term "irrational exuberance", but it wasn't until 1998 that the market showed another meaningful pullback. In fact, from July 1998-October 1998 the S&P 500 pulled back a little more than 10% when Long-Term Capital almost brought the World Economy to its knees with over-leverage and risk-taking amid the Russian Currency Crisis, which quickly followed the Asian Currency Crisis the year before. But with Consumer Sentiment at record levels, nothing could deter the market participants from buying on any, and all, weakness and markets quickly resumed their rally.

Less than a year later, another shock hit the market. This time from July 1999 until October 1999, the S&P 500 dipped from 1380 to 1300 (5.79%). Not major in the grand scheme of things, but yet another pull back. In fact, this was the third serious/semi-serious pullback in three years and all occurred after the Federal Reserve Chairman stated that market participants were irrational. But in similar fashion, these fears were quickly blown off by investors brimming with exuberance.

As we know now, in just a few short months following this ignored market pullback a 3 year stock market Bust began to unfold.

Bull Market Setbacks

To recap the 5 serious pullbacks which occurred within the context of the 1980s/1990s mega Bull Market run, they were:

- 9/1987-12/1987…..26.8% pullback….Black Monday
- 6/1990-10/1990…..14.8% pullback….Gulf War
- 1/1994-4/1994…….5.4% pullback…...Fed Raises Rates
- 7/1998-10/1998…..10.7% pullback…..Long-Term Capital/Currency Crisis
- 7/1999-10/1999…..5.8% pullback…....Fed Raising Rates

Below are some data points concerning the timeframes associated with these Bull Market setbacks.

Yr.	**P/E**	**Consumer Sentiment**	**Gain since last Pullback**
1987	21.42	94.4	200% since 8/1982 (5 yrs)
1990	16.95	88.3	49.5% since 12/1987 (2.5 yrs)
1994	21.35	94.3	54% since 10/1990 (3.25 yrs)
1998	29.90	105.2	159% since 4/1994 (3.25 yrs)
1999	32.88	106	34% since 10/1998 (9 months)

Where are we now?

We've gone through this history exercise to see if we can apply any of these past lessons to improve our chances of success in our current market environment. As of right now, our market has been running to the upside since February of 2009. That equates to about 4.5 years of upside momentum. Furthermore, our current market's P/E ratio is 17.48 and Consumer Sentiment is yielding a, slightly below average, reading of 85.1. And we've had two meaningful pullbacks.

Putting this into the same table as used before, the data looks like this:

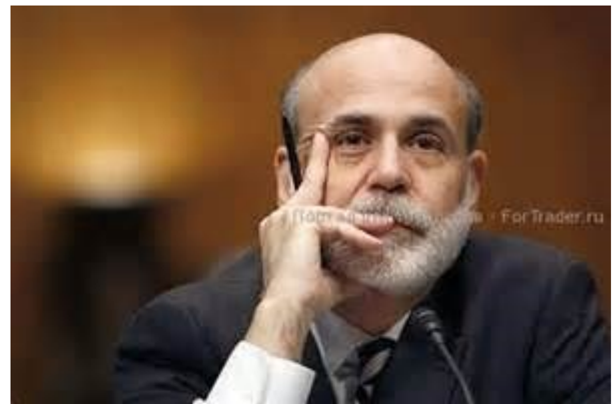
Yr.	P/E	Consumer Sentiment	Gain since last Pullback
7/2013	17.48	85.1	49.1% since 9/2011 (22 months)

Frankly, these numbers and our place and time within this secular Bull Market do not suggest a pullback is imminent. HOWEVER, there are a couple of things that have piqued my interest in the context of the next pullback:

1) Chinese Economic Data

2) The Federal Reserve Chairman changing of the guard

3) Tapering of the Fed's "extremely accommodative" policies



Before I begin discussing the three issues causing me concern, I wanted to state clearly that I believe over the next several years we will see the S&P 500 make new highs that are much higher than many people believe are rationally possible. I do believe that at some point, a few years down the road, "irrational exuberance" will over take this market, just like it has done many times in the past. I will strive to be ready for that move and ride that wave in the hopes of maximizing profits for my clients, while being cognizant of what is occurring and taking risk off the table at the correct time.

Nevertheless, I do think within the next 24 months the market will experience a Bull Market setback. Similar to my thoughts above, I will strive to have my clients prepared for that in hopes of limiting the damage. All the while, being cognizant of what if going on and trying to deploy capital into that pullback in hopes of maximizing profits from the rebound.

Concerning what might cause this next Bull Market setback (our 3rd within our current Bull Market run), I'll start with what I think is the most obvious; **the changing of the guard at The Federal Reserve.** According to the Fed, Mr. Bernanke's second term as Federal Reserve Chairman ends on January 1, 2014 (7 months from now). The scuttlebutt regarding his successor seems to be focused on Janet Yellen, current Vice-Chair of the Federal Reserve Board of Governors, and Lawrence Summers, who's held many positions of extreme financial importance within the U.S. Government.

I'm concerned about this for many reasons, perhaps the biggest, which ties into another one of my concerns for the market as a whole, is that Mr. Bernanke earned the nickname of "Helicopter Ben" due to his extremely accommodative policies during our most recent financial catastrophe. Mr. Bernanke has already begun to discuss **tapering of these policies** and the timing is perfect to remove him and insert the next Fed Chairperson to start this tapering process. Less accommodative policies will certainly impact the economy.

Furthermore, if you study the 1987 Stock Market crash, the experts cite program trading, illiquidity, and valuations as being the cause. And I'm sure they are largely correct. But I find it very interesting that just a few months prior to that occurrence Greenspan replaced Volker as Fed Chairman. Maybe this is coincidence, but maybe not. Humans run markets, humans are emotional, change causes uncertainty, the markets hate uncertainty, uncertain market participants take money off the table to be defensive. I wonder if this could happen again.

The final concern I want to talk about is the concern I have about the **Chinese economy**. I am on record since 2005 saying that I am not a firm believer in the robustness of the Chinese economy. I have preferred not to invest directly in China, rather to make investments in companies (and commodities) that benefit from the growth of China. If China's growth were to falter, it is a fact that the Global Economy would feel this slowdown. However, the overall economy of the World is very big, broad, and diverse. In my mind, this Chinese slowing could be overcome by continued U.S. growth, a recovering Europe, and other Emerging Market economies beginning to take flight.

So, yes, I am concerned about this. And, yes, I do think if data comes to the forefront regarding this potential occurrence actually occurring then the markets will sell off. However, I am very convinced that this selloff would simply be a setback within our current secular Bull Market run. But, nevertheless, selloffs are not fun to live through.

What does the long-term future hold?

I've already discussed potential short-term to mid-term issues that could impact our current markets. Those issues center around the Fed and have an eye towards China as well. And I've discussed how history suggests these potential pullbacks might take place. **Beyond that, I believe the markets will rebound and continue their upward trend.** Valuations are not too high, earnings are not too far above trend, banks are ready to lead the economy higher with further lending, and Consumer Sentiment has a lot of room to run to the upside. In fact, I believe each and every one of those points will feed off of each other to potentially push the markets to a "rational" high. "Rational" highs have historically registered 20 times earnings ratios. Using the S&P's own Howard Silverblatt's earning's estimate of $124.73, that would put the S&P 500's price level at 2,494, which represents about 50% upside from current market levels.

This is when we need to have our eyes and ears open for signs of "Irrational Exuberance" or, as I tag it, a Reflexive Bull Market. Frankly, history shows that if this were to occur the gains within the markets could be mind-numbing and almost surreal. I debated including the numbers that history suggests the S&P 500 could get to, but I've opted to not do that (even though all you have to do is apply the Reflexive Bull Market P/E ratio to future potential earnings levels to derive that number). Nevertheless, this potential occurrence will be a number of years down the road and I don't think it is necessary to discuss it now; other than to mention these number are BIG. Of course, if this potential Reflexive Bull Market run were to occur, Consumer Sentiment will have to reach sky-high levels and the stage would be set for another terrible Reflexive Bust.

Regardless of how the long-term shakes out, I'm working towards understanding how this new Fed Chairperson and tapering will affect things and keeping portfolios appropriately invested within the context of their Investment Policy Statements. First things first.

In closing, this report is focused on the equity markets. But rest assured the ideas and concepts discussed here are being applied to a variety of markets to seek to understand their potential impact and, therefore, potential investment returns for those markets.

-MRP

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