MRP CAPITAL INVESTMENTS, LLC

Market Outlook

Research Report 11/24/2014

Introduction

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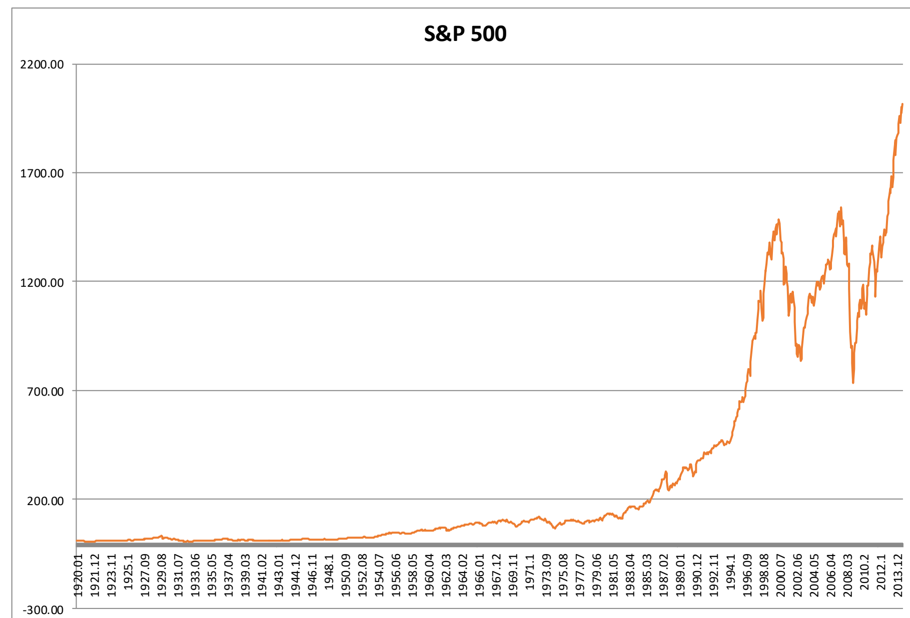
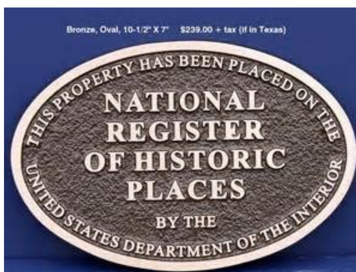
I have a macro-model that I use to gauge where the market is in relation to where is should be. One of the first steps in the process of understanding where we "should" be is to look at a long-term chart of the S&P 500. I was a bit flabbergasted when I recently took a peek at this chart. The chart is pictured below, tell me if you feel the same way I did.



S&P 500 1/1/1920-10/31/2014

Chart supplied by Bigcharts.com



The last rally from the depths of the 2008 Financial Debacle has erased all of the losses associated with that time frame and broken the entire market out to record highs. This market appreciation will prove to be truly historic as the view of the long-term chart has been completely changed because of this run.

Data Points of the Model

After the shock of seeing that chart wore off, I began to analyze all of the data points that I use to get a sense of where we should be in the market. You see, that last chart tells us where we are...but it has nothing to do with where we "should" be. So, let's dig into that. **Where should a rational S&P 500 be?**

First, let's discuss the data points that I look at and why I track them. I always start with the earnings of the S&P 500 companies relative to trend earnings. This gives me a sense of where earnings are relative to where they SHOULD be. And, as a quick reminder, I look at earnings and the valuation placed on those earnings as those are the ONLY two things that drive the markets. Understand those two things and you will have a great understanding of where a rational market should be.

So, **earnings**…

Finding the earnings of the S&P 500 companies is easy. Howard Rosenblatt of Standard and Poor's has all of this data posted on the S&P website. All one has to do in log in and check it out. Trend earnings on the other hand is a metric I developed after studying the markets. For this data, I use a base level of earnings that I grow at the same growth rate as U.S. nominal GDP. The rationale for using GDP is that this essentially measures the amount of money sloshing around in the system and I believe that you can not make more money than there is money in the system for any extended period of time.

Furthermore, I use nominal GDP rather than real GDP because of the simple fact that earnings are measured in nominal terms. No one says that the inflation adjusted earnings of Coca-Cola were $X.XX dollars. Rather they simply give you the actual number of report earnings. Well sometimes they like to pump the number up with an Operating Earnings figure, but I believe that number does us no good when seeking to understand the true earnings power of a company. Therefore, I use actual reported earnings of the S&P 500 companies for my earnings data and I use the derived trend earnings figures from the growth of U.S. nominal GDP. Then I put the data sets together in chart form to see how they have been interacting together.

What is fascinating about this chart is how much of a benefit it provides investors who keep an eye on it. Check out the major dips in earnings below the trend line, they always seem to occur around market catastrophes...and always correct themselves. And the inverse is true as well, long-extended periods of above trend earnings do not appear to be sustainable and seemingly always end in the figures reverting back through the trend line on their way to a trough below the line.

Examples of these moves are the extreme rise in earnings from 2004-2007 only to see earnings crash in 2008. Furthermore, the rise in earnings from 1998-2000 helped set the tone for an "earnings correction" that hit bottom in 2001. Both of these earnings moves were accompanied by severe market corrections.

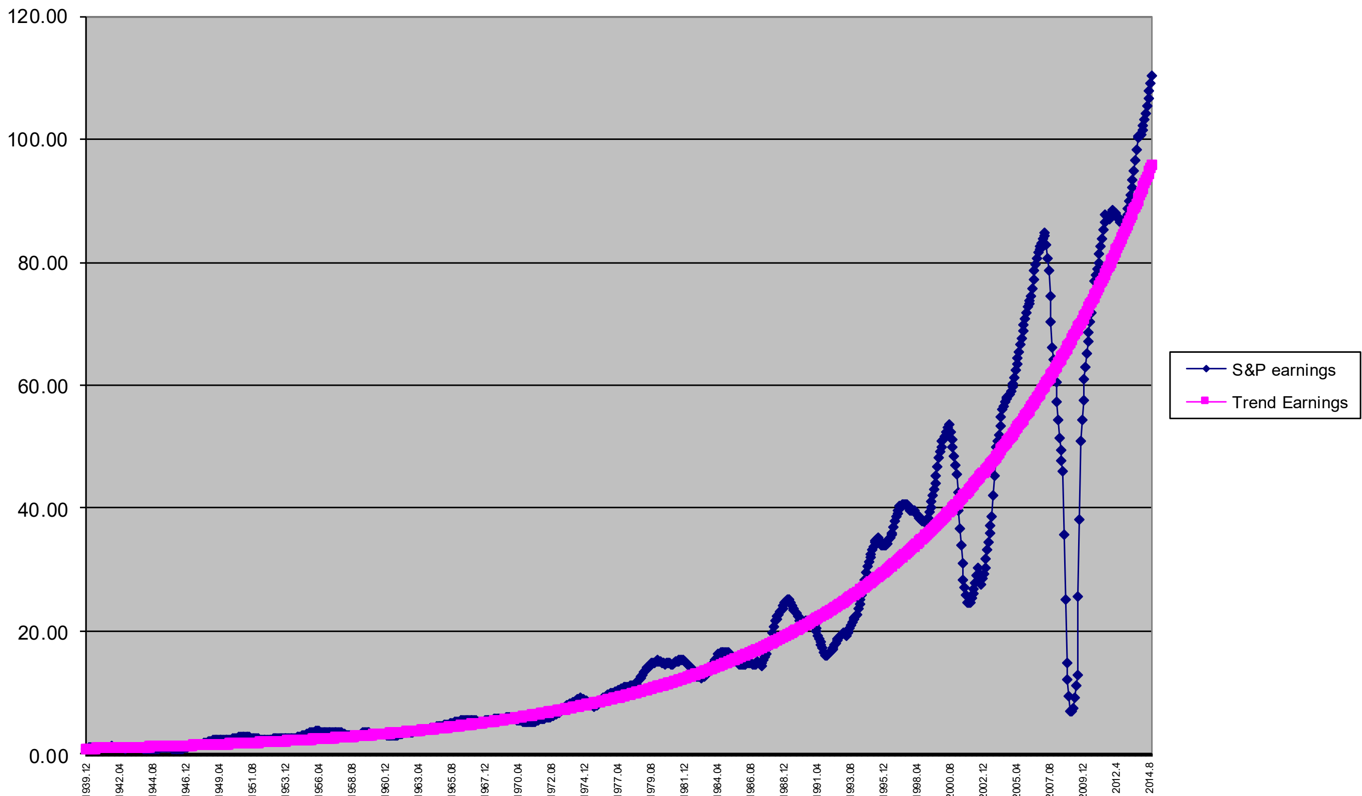


Chart Supplied from the MRPCI Database

As you can see from the chart, we are currently in an above trend earnings situation. This is explainable given all the stimulus being pumped into the system by the Central Banks, but it still doesn't change the fact that earnings are higher than they should be.

The next data point I look at closely is the **valuation of the market**. I use two basic methods to comprehend how the market is currently being valued. The first one is a basic and straightforward Price to Earnings ratio on the S&P 500. Here is a long-term chart of how the S&P has been, and is being, valued.

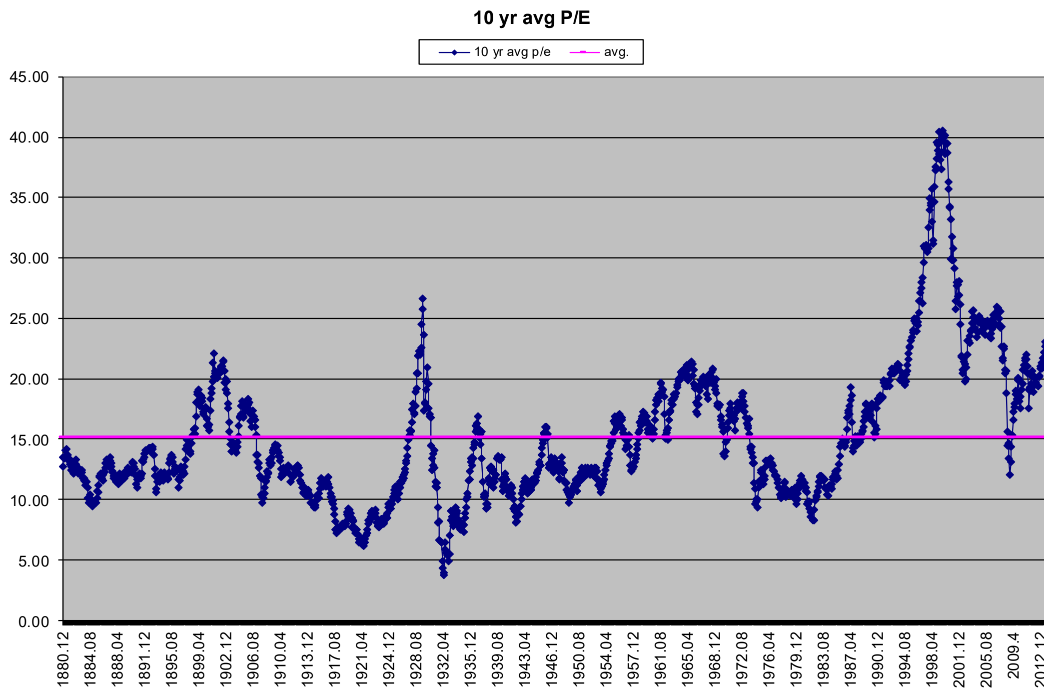


Chart Supplied from the MRPCI Database

The pink line is the average P/E ratio of the S&P 500 since 1880. The blue line is the 10 year average P/E of the market. Peaks in this ratio have occurred when the market was about to begin major sell-offs, note the 1929 and 1999 peaks of extreme valuation. Furthermore extreme below average valuations have set the stage for major Bull Markets, note the 1932, 1982, and 2009 turning points in valuation.

Our current reading on this metric puts us at a high level of valuation.

One thing I don't like about that last chart is that it only looks at the P/E ratio of the market. It takes nothing else into consideration. Given this, I feel that metric is useful but a bit naïve. I believe it is important to understand how stocks are valued relative to other investment options.

Understanding this, another data point I look at is the valuation of the market in relation to the Yield on the 10 year U.S. Treasury. Comparing stocks to bonds, we can get a feel of how expensive (or cheap) the market is while looking at other investment options. More specifically, is it a better value play to buy stocks or bonds?

The below chart takes the Earnings Yield on the S&P 500 (1/Price to Earnings Ratio) and compares it to the Yield of the 10 Year. Any positive reading on the chart means that Stocks are a better value than Bonds. And, of course, negative readings suggest bonds are the better bet. And right now, stocks are clearly more attractive on a valuation basis than bonds. In fact, the chart tells us that stocks haven't been this attractive since the 1970s.

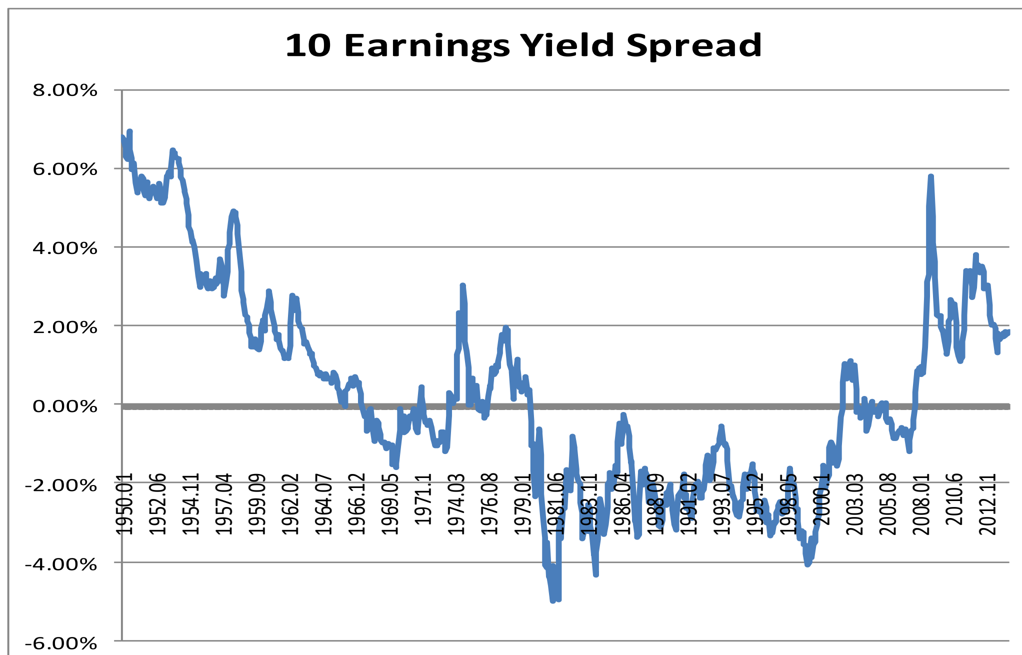


Chart Supplied from the MRPCI Database

When we combine these two valuation readings, we are faced with the fact that stocks are not "cheap" by historic standards. However, bonds appear to be priced in an abnormal way (perhaps through Central Bank manipulation) so as to make stocks the clear cut favorite investment for value conscious investors.

The third major data point that I look at is **<u>Consumer Sentiment</u>**. I am a big believer in the idea that human beings make decisions that impact the market. Therefore, human behaviors, feelings, and emotions need to tracked and understood. Along these lines, if humans are feeling bad about the markets...valuations should be heading lower. If humans are feeling giddy about the markets, valuations are probably heading higher. However, peaks and valleys in human emotion generally mark turning points in the markets and these data points need to be monitored.

As a gauge for the human "mood" surrounding the market, I use the University of Michigan Consumer Sentiment Indicator. This Indicator started out as a quarterly survey in the 1950s, but is now released monthly.

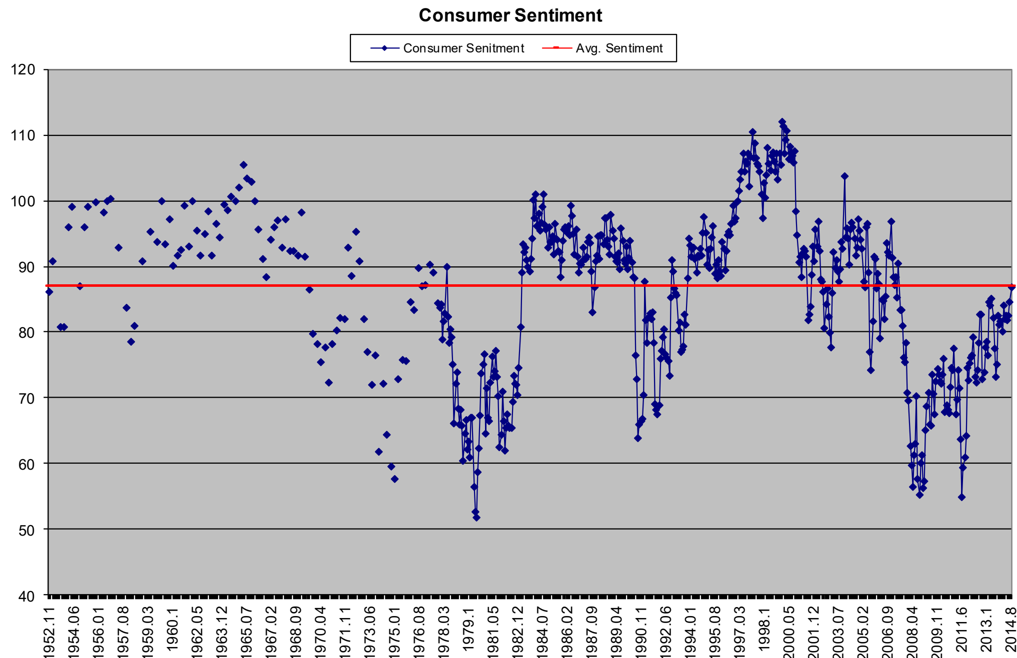


Chart Supplied from the MRPCI Database

As you can see, extremes in this chart generally mark turning points. For example, 1998-2000 marked record high levels of confidence. As more and more people became irrationally exuberant while markets continued to climb, most potential investors got fully invested. When everyone had enough time to get invested, no one was left to buy and the markets tanked. You see, I believe extended periods of time with high Consumer Sentiment can set the stage for Bear Markets. Conversely, the late 70s and the 2008 time frame registered extremely low readings on this metric. Both periods of time were followed by significant Bull Markets. Times of low sentiment can sow the seeds of Bull Markets.

As of right now, we just reached the Average Sentiment reading. Meaning we have been in a Below Average (or pessimistic) Mood since 2007; that's 6 years of negativity. And now, we've just touched on neutral. In my last report (Don't Fight The Fed), I shared some data about how the market has historically reacted when this indicator moves from below average to above average. I won't bog you down with more precise data, I'll just say it usually provides for major upside moves when this change in sentiment is made.

For some possible ideas as to "why" we are seeing such a significant rise in Consumer Sentiment, I think all we need to do is look at the jobs and income data.

As I mentioned in the "Don't Fight The Fed" report, jobs are rebounding and now it appears incomes are as well. From the Bureau of Labor Statistics, here is a table of the civilian labor force.

Year	Civilian Labor Force
2008	145,362
2009	139,877
2010	139,064
2011	139,869
2012	142,469
2013	143,929
Oct-14	147,283

This data shows that the Employed U.S. Labor Force is the largest it has ever been. This means more people than ever before have jobs in the U.S. There is no question that this has a positive impact on the psyche of U.S. citizens.

A problem we had with confidence in the economy was that for awhile jobs in the U.S. economy were shrinking and lots of people were unemployed and looking for work. Then as the jobs began to grow again and people found work, incomes were growing VERY slowly. People were finding jobs that, probably, paid less than what they were making before. So, this would have increased the Sentiment reading from where it was at during the doldrums of the economic crisis but the Sentiment indicator would not have returned to where it was before the crisis.

Now, we have jobs at all-time highs and wage growth starting to accelerate. If this can continue, I believe Sentiment will continue to rise. After all, more people than ever before have jobs and they will be making more and more money. Add in a steep decline in energy prices, and you've got a boost in discretionary cash flow. I'm sure that will make a lot of people happy.

The fourth major indicator I look at it is **market volatility**. I like to use the VIX index to get an idea of how the market is being viewed by people. High readings on the VIX means people are skittish and fearful. Low levels, the reading I'm actually most interested in, means they are complacent and ignoring the risks in the marketplace.

VIX reading for the last decade

Data provided by Bigcharts.com

You can look at this chart and see that if you buy on the peaks of fear, you generally make money in the market when fear subsides and prices normalize. However, as detailed in my report "The Holy Grail", long periods of a low VIX reading usually preceded a Bust in the market, where a bust being a multi-year stock market sell off.

In our current place in time, I do not see a complacent market. Market threatening events are being reacted to and pricing adjusted accordingly.

Data Points Summary

When we look at all of these data points in aggregate, we begin to get a more clear picture of where the market is and where it might head to. So, let's review.

#1—Earnings are above-trend.

Grade….D

#2—Valuations are high

Grade….C

#3—Consumer Sentiment just broke above an average reading for the first time in 6 years.

Grade….A

#4—Market participants do not appear to be complacent.

Grade...B-

The last major alignment of all these data points came in early 2009, when they all flashed BUY signs. In fact, I wrote two reports around that time frame with the first one entitled, "The Beginning of the Bull." Of course, the data points shined BUY signs in the depths of a major stock market correction. Since then the market has been moving higher and the data points are becoming less and less attractive as compared to that once in a generation buying opportunity. History suggests that this Boom Phase we are currently in will end when all of these metrics become unattractive, very much akin to what they looked like in the early 2000s.

Conclusion

Given this information, it appears that the market does have more upside room to run. This upside potential is largely dependent on continued improvement in Consumer Sentiment. However, there are risks of market pullbacks. These pullbacks could be centered on earnings and valuation issues. But, as I've discussed in many of my past reports, secular Bull Market runs, on average, have 5 pullbacks of 10% or more. Thus far in our current cycle, we've seen 3. The mantra is to **"buy on the dips"** in Bull Markets. Until Consumer Sentiment rises to high levels and complacency sets into the market, I would still consider buying on the market dips as the Bust Phase of the market has historically been ushered in only when all four of the above indicators are registering poor readings.

Furthermore, I believe this Bull Market won't end until we become totally irrational. And the kind of irrationality I am referring to is the kind I've written about many times in the recent past; "reflexivity." This is a concept whereby people's emotional reactions and actions actually drive the market and change the underlying fundamentals of the economic landscape. Remember Alan Greenspan's "irrational exuberance" comments? That was reflexivity in action.

From a rational standpoint my work shows that if we have an average Bull Market, then we have about 12 more years of continued upside in the market AND we will have to endure 2 more significant pullbacks of greater than 10%. Given where earnings are and where valuations are, I wouldn't be shocked to see a 1987 like correction sometime during this run. **But**, remember that 1987 selloff happened within the context of one of the greatest Bull Markets in history.

Now, will I sit around and simply accept the fact that the market will selloff a few more times during this Bull Market run? NO!! I actively manage portfolios. Given this, I will be striving to take risk assets off the table during times when I think the market might see off. [Note the "Dangerous Precedent" article in the last newsletter.] And I will try to invest assets at time when I think the market is ripe with opportunity, usually after a selloff. [Note the market actions taken after the near 10% selloff in September/October.] Will I always be right? Heck no! But by sticking with my process, I've develop a world class track record concerning investment performance. I will continue to stick to this process and do the best I can for my clients in these markets.

In ending this report I think it is important to put **our current market in a nutshell**, we saw historic lows in early 2009. This marked the end of the Consolidation Phase of the market and ushered in the Boom Phase. Growth in earnings and a return to normalized risk asset valuations has been the fuel behind the Bull Market so far. However, the next major leg up should prove to be driven by confidence returning to the world of investments. At the end of this era of confidence, irrational exuberance will reign supreme.

Note...I will be a seller during the times of irrational exuberance and many people will think I am an idiot for taking risk assets off the table while the market is running so hot. But, this should prove to be years down the road. Until then, let's hope for this Bull run to continue.

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