MRP CAPITAL INVESTMENTS, LLC

2016—The Year Ahead

Research Report 12/24/2015

Introduction

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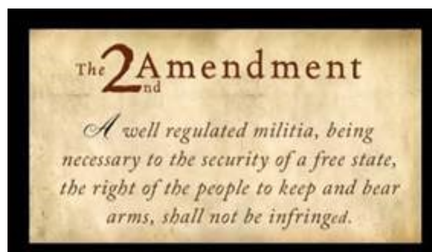
Prior to the beginning of a new calendar year, I try to get my ducks in a row for what might happen in the coming year. I find it helpful to review the current years performance and trends, as that is usually helpful in finding opportunities. And I also like to look at the indicators I follow, to get grip on the "mood of the market" and the fundamental and quantitative underpinnings of the market. And finally, I try to piece all of the clues together to try to come to some conclusion on how the market's movements might play out by year's end.

In the past, I've revealed bits and pieces of this review/forecasting process in the Quarterly Newsletters I send out and/or write a report which focuses on one specific aspect of my findings. However, this time I figured it would be good to share a large portion of the process with you all. I figured this would help us all be on the same sheet of music during the year, which I think will be key...as I believe 2016 will be choppy and have some mental anguish associated with it. Note that I didn't say it would, necessarily, be a bad year for market performance. However, I do think there are lots of moving pieces that will make 2016 challenging for people to handle; mentally and emotionally.



2015—Review

To start the analysis, let's just take a quick peak at the markets and how they did in 2015. Now, remember, I am writing this on December 24th. So, the year isn't over yet. But, we will get a pretty good picture of how it all shook out for the year.

As you can see from the above chart, provided by BigCharts.com, the S&P 500 Year-to-Date through December 23rd has gone nowhere. In fact, the price change is +0.26%. That is just about as close to flat as you can get.

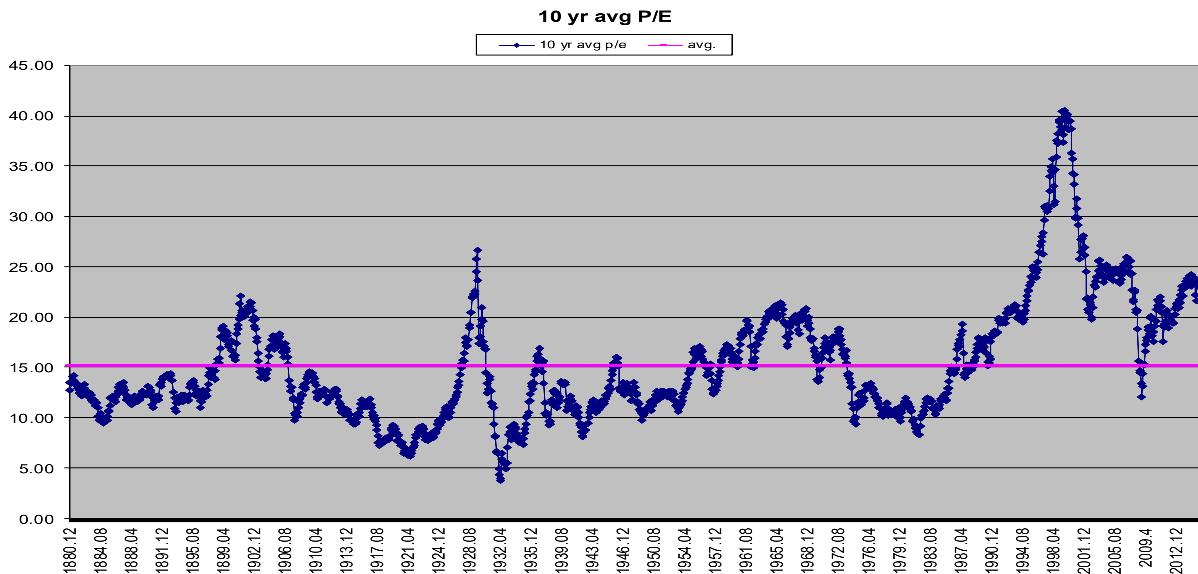
Now, there has been some BIG stories within that flat market. The Energy Sector, within the S&P, has fallen about 25% for the year. And one of the big individual stock winners for the year was Amazon.com, which is up 114% for the year as I type this. Which leads us to the fact that a few stocks drove this index into positive territory. In fact the average price return for a stock within the S&P 500 was not a positive 0.26%, but rather a negative 1.3%.

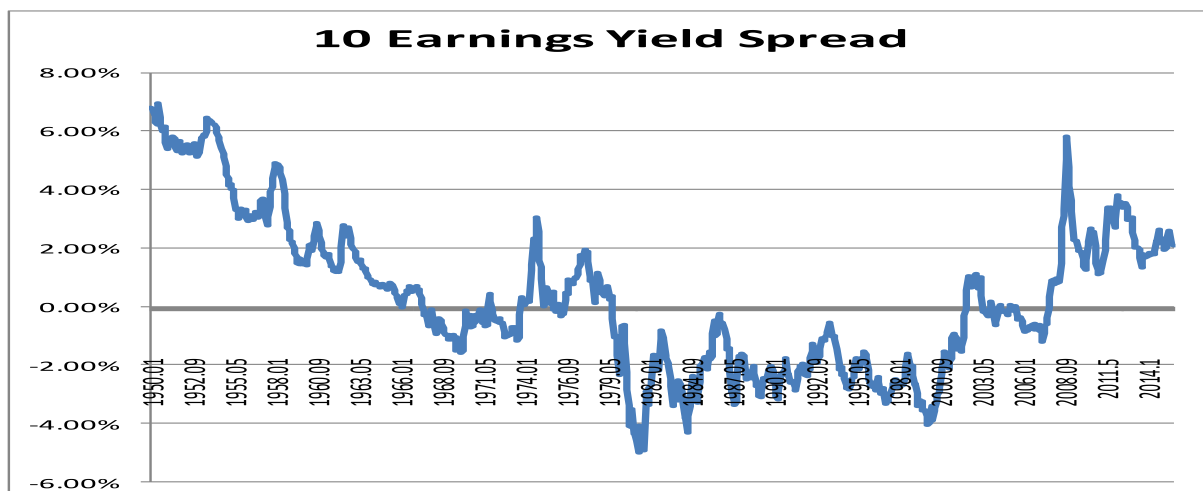
In a nutshell, a few stocks did REALLY well; while the market went nowhere; and oil got killed.

Model Readings

The next thing I do is consult my models, to see where we are fundamentally and quantitatively in terms of valuation, earnings, sentiment, and fear. I've found that by comprehending these things, we can get a really good idea of what potentially lies ahead.

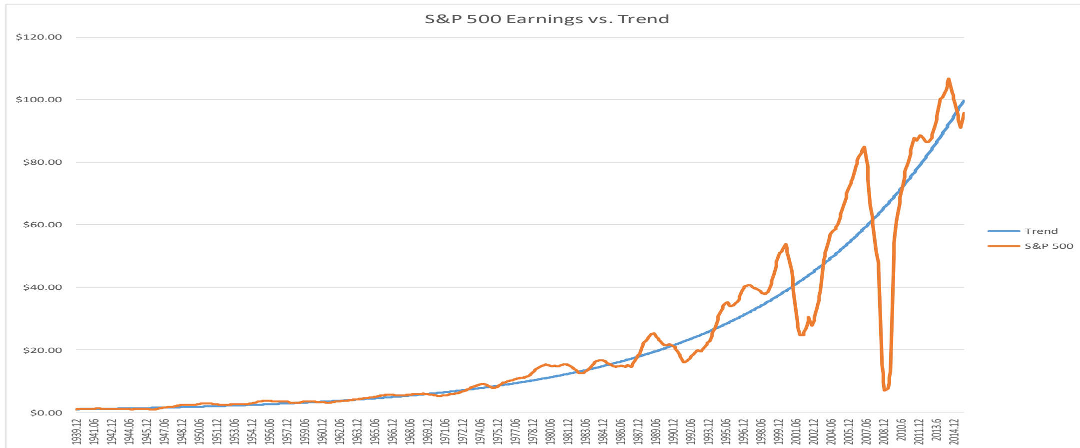
On the valuation front, as has been the case in recent history, stocks are expensive on a raw basis but cheap compared to fixed income. There can be no question that this is due to the Federal Reserve's monetary policies and the current level of interest rates. And to put this phenomena into laymen's terms; with interest rates so low and the Fed in an interest rate hiking cycle, it appears that the risk/reward spectrum clearly favors owning stocks rather than bonds.



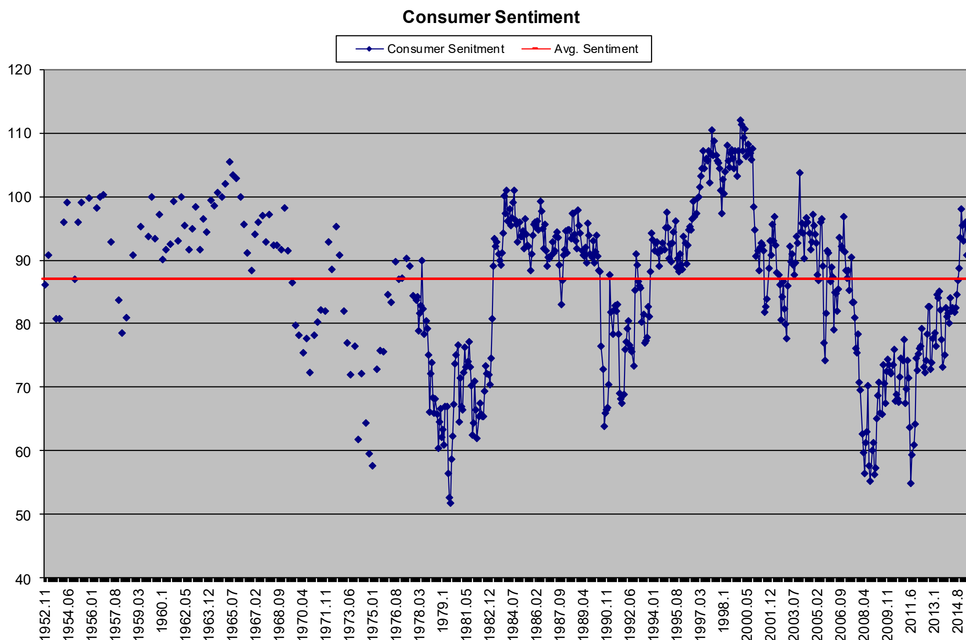


S&P 500 10 year average P/E and S&P 500 P/E relative to 10 Year Bond Yields Charts supplied by the MRPCI database

<u>In regards to earnings</u>, they have fallen pretty steadily since their peak in September of 2014. But they are now below their "potential" and have the chance to surprise on the upside.



<u>The "mood of the market"</u> remains elevated, as Consumer Sentiment remains at an optimistic level.



Both Charts Supplied by the MRPCI database

And on the “fear” front, the market seems to be reacting to important news in a reasonable manner. That is good news for the market, as one of the big dangers is when “complacency” sets in and potentially disastrous news breaks but the market ignores it. The spike in volatility or “fear” in late August of this year, clearly demonstrates a market that is not complacent.

5 year chart of the CBOE Volatility Index provided by BigCharts.com

Putting that all together, let’s us know that the market is not overly optimistic about its current situation. Raw P/E’s are elevated, but given the level of interest rates these valuations are not absurd. And when you factor in an optimistic consumer and an earnings level that is below potential, they make solid sense. All this points to a Bull Market with market participants alert and rational, which gives the market a solid fundamental and quantitative foundation to run further.

Piecing things together

On top of that, I got a real sense of deja-vu when I looked at this data. Our current place in time, in regards to the data and the trend, looks a lot like 1984 in terms of P/E ratio and Consumer Sentiment. And the Earnings vs. Potential looks a lot like 1985. So, I figured it would make some sense to take a look at how the markets performed from 1984-1989.

For starters, the S&P 500 began 1984 at a level of 164.4. and ended 1989 at a level of 348.6. That is an increase of 112%. But if we go calendar year by calendar year, we see the annual prices changes in the S&P 500 look like this…

	Beginning Level	Ending Level	% Change
1984	164.4	164.5	0%
1985	164.5	207.3	26%
1986	207.3	248.6	19.92%
1987	248.6	241.0	(3.06%)
1988	241.0	276.5	14.73%
1989	276.5	348.6	26.08%

Now, of course, I am not saying the next 6 years are going to look just like this. I am not saying that at all! But a lot of the data I track has the same feel and trend as that past timeframe did, so I wanted to analyze it. And I think a couple great items to point out were discovered.

#1—**The time frame we looked at showed some great long-term performance.** As mentioned before, the total price change of the index over this time frame exceeded 100%!! This fits in perfectly with my long-term model suggesting we are still in a Secular Bull Market.

#2—**There was a great deal of dispersion and volatility regarding the returns.** During this time frame, we saw negative annual returns and we saw annual returns in excess of 25%. That is a wide performance gap and that doesn't even highlight the fact that the Stock Market crash of 1987 occurred during this time frame. Yeah, remember October 19, 1987; aka Black Monday? The Dow Jones Industrial Index fell 22.61% on that day alone!!!!! We endured all that volatility, but yet for the overall time frame the markets were up big.

#3—**1984 was an election year, just like 2016 will be.** To be frank, I started my research for this report with the idea that election years are generally bad years for the stock market. However, as I did research I found that to be not entirely true. In fact, I found that, since 1972, the average return for the S&P 500 was 11.96%. While, during that same time frame, election years saw the S&P 500 grow, on average, 9.96%. So, yes, the returns are, on average, not as good as "normal" years, but I can't call 9.96% a "bad" year.

And, frankly, these findings form the basis for my statement in the introduction that 2016 might prove to be a challenging year for investors mentally and emotionally, but might not, necessarily, be a bad year for the market's performance.

What we need to be ready for

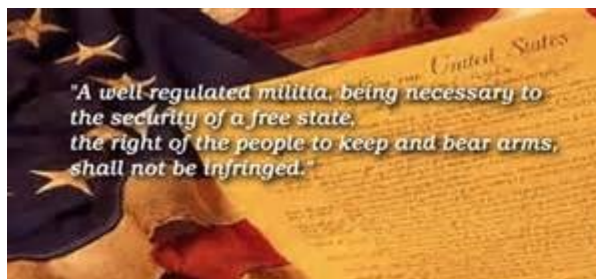
The first thing I think we all need to be ready for is VOLATILTY! It seems like from 2013 through most of 2015, volatility was low. In fact, I remember many news commentators over that time from making big deals about 2 to 3% pullbacks in the market. Frankly, that is nothing! That is the kind of pullback that happens all the time in normal functioning markets. The type of volatility I am talking about is the kind of stuff we saw from late August through right now. So, we need to be prepped and ready for this market to bump around a lot in the coming months.

I think a lot of this volatility will be caused by non-market factors. As discussed earlier, this is an election year and with that comes drama from the election process. And, add to that, the front-runners right now are Hillary Clinton and Donald Trump. Those are two characters with a lot of baggage, bravado, and track records a mile long. Mrs. Clinton is under federal investigation for her email issues and potential security breaches. And, on top of that, her involvement with the Benghazi attacks should become a highlight in early 2016 when the movie about it, *13 Hours*, is released. Meanwhile, Mr. Trump is being discussed heavily for his call to deport all illegal immigrants and ban all Muslims from entering the country.

And, let this sink in, we haven't even had our first primary!!! This stuff will get ramped up even more in the coming months.

Another item that could add to the volatility and mental anguish among people and investors is the ongoing War on Terror. Now, granted, the U.S. hasn't officially declared War on ISIS, but France has, the U.K. has, and Russia has and ISIS has declared War on the United States. So, whether we actually declare War on them seems like an irrelevant point. We are under attack and, in fact, the free world is under attack from these terrorists. I am sure that over the coming months, this will intensify.

Furthermore, this election year Right versus Left and ISIS versus the Free World, should lead to more dramatic infighting within the United States. I can see more Democrat versus Republican displays. I can see 2nd Amendment battles. I can see BlackLivesMatter picking up their antics. And, although, this doesn't have a direct impact on the market, it does impact the psyche of the people and, therefore, the investors.



So when I talk about 2016 being mentally and emotionally challenging for investors, the stock market volatility and the political issues swirling around our country (and the world) form the basis for those challenges.

Like I mentioned before, an election year might be thought of as an historically bad time to be in the markets but the data doesn't verify that feeling. In fact since 1972, 82% of the time the S&P 500 has shown gains on a total return basis during the election years with the average return being right at 10%. And that number includes the 37% decline that occurred in 2008 (which saw Obama getting elected) and the 9.1% decline in 2000 (which saw George W. Bush get elected over Al Gore).

With that, I think it is a good time to move away from the non-financial factors that should cause stress to investors and focus on data and trends that will impact market prices.

For starters, our Federal Reserve has started the process of hiking interest rates. I released a report on 6/2/2014 entitled, "Don't Fight the Fed" and in that report I analyzed past Fed tightening cycles. You can read it in full at www.mrpci.com, but the gist of it is that I found that stock market returns for the average Fed tightening cycle were harder to come by than in a "normal" market. Not that the stock market gets creamed every time, but returns were more muted than during regular market times. With this being the facts, I think we need to be ready for a year of smaller than normal returns.

When the Fed raises rates, the laws of mathematics suggest bond prices will fall. And I do think that can happen, but I do think the bond market will price in a lot of these declines before the Fed actually raises rates any further. However since the Fed has said that it will raise rates at a measured pace, I don't believe bonds will get killed in 2016. So, they can still provide a safety net that should prove useful in generating income and offsetting some of the anticipated 2016 stock market volatility.

Another impact of the Fed raising rates, should be a strengthening dollar and falling commodity prices (especially in dollar terms). All of that makes sense when applying basic economic concepts. Owning bonds that are backed by the full faith and credit of the United States of America will pay the owners more interest than they did in previous years. With a lot of the world remaining in a low, or falling interest rate cycle, these higher rates of return are attractive. Therefore, more money should flow into U.S. bonds, which are denominated in U.S. dollars. The basic laws of economics say the higher the demand for something, the higher the price will go. And with that you have the basis for the stronger dollar theory.

However we must realize, the market might move the currency higher before the Fed actually raises rates again. Whether the dollar strengthens purely from rising rates or from currency speculators is irrelevant to me. The simple fact that the pressure remains on the dollar to appreciate is a big deal for 2016.

And this will impact commodity prices too, since most commodities are priced in U.S. dollars. If you apply the basic laws of mathematics to their pricing, you will see downward pressure on their value. For instance, if the demand for a commodity, say oil, remains stagnate, but the main currency used to purchase it rises, the actual price of that commodity will fall as the purchasing power of the currency is rising. When you begin to factor in low demand for specific commodities on top of a strengthening currency environment, you will see prices of that commodity cascading lower. In fact, I think you've seen this play out in the oil market over the last few months.

Perhaps the biggest factor suggesting that the stock market has more room to run to the upside is the optimism of the U.S. consumer. As the chart on page 4 shows, the consumer is optimistic about their situation. And this generally translates into higher consumer spending; more trips being taken, more movies being watched, more golf being played, and more cars being bought.

You may ask; with all these worries, why are they so optimistic?

-**Personal incomes are high**; as reported by the Bureau of Economic Analysis, personal incomes stood at $15.467 trillion at the end of the 3rd Quarter 2015; the highest level ever recorded.

-**Jobs are plentiful**; according to the latest quarterly data released by the Bureau of Labor Statistics, the unemployment rate is 5.1% and the Civilian Labor Force is at the highest level ever recorded.

-**Inflation is non-existent**; once again, using the BLS's data, we see that the CPI index is only up 0.5% over the last twelve months. Surely, helped out by falling prices at the pump.

Putting all of that in comprehensible statement to answer the question, why is the consumer so optimistic? There have never been more people working in the United States and incomes for those jobs have never been higher. And all the while, prices for the "stuff" they want to buy is not going up. Add it all together and people in the U.S. are feeling pretty good about their situation, despite all the geo-political issues.

I really think the facts about the optimism of the citizens/consumers of the United States, combined with our place in time, sets the stage for this secular Bull Market to continue. And, to be frank, the work I've done on market cycles (which is highlighted in the "Holy Grail" report written many years ago) is syncing perfectly with how our contemporary markets have been behaving. I am afraid of going into too much detail about this, as I am sure a lot of readers may find it boring and confusing, but a few things need to be mentioned.

We are currently 7 years deep into this current Bull Market run and the gain on the S&P 500, from its low in 2009, is over 200%. The length of time and gains of the average secular Bull Market are much more robust than our current market's run. Therefore, I believe there is potentially a lot more upside. I think our major movement to the upside will continue once we get through the upcoming year.

Chart of S&P 500 1/1/2009– 12/23/2015 provided by BigCharts.com

And there are reasons why the events of 2016 could set the stage for more gains, besides my models saying so. As 2016 comes to an end, we will know who our President will be and this will eliminate a lot of uncertainty about our Country's future. And the market hates uncertainty. Furthermore, there is the possibility the Fed will be done raising rates. The research which was used to support the "Don't Fight the Fed" report, shows that the average 12 month gain in the market following the cessation of the Fed raising rates is about 18%. Those are two pretty strong reasons why gains should continue once the turbulence of 2016 calms down.

Summary

To wrap things up in a neat bow, I think we can summarize my findings and thoughts as follows:

-The underpinnings of the market do not line up with the stereo-typical end of a Bull Market scenario. Therefore, it makes sense that this market can continue to move forward.

-However, a variety of factors are in place to make 2016 a very volatile year that could produce below average returns.

-To be successful, I believe investors need to be prepped and ready for very high volatility. This entails sticking to the long-term Investment Policy Statements and applying active portfolio management tactics when market opportunities arise; such as selling into rallies and buying on the dips.

-I believe when 2016 comes to an end, a lot of the market uncertainties and technical factors that have historically negatively impacted performance will be largely eliminated. And this should set the stage for the secular Bull Market to continue.

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