MRP CAPITAL INVESTMENTS, LLC

1st Quarter 2016 Client Newsletter

Capital Market Update

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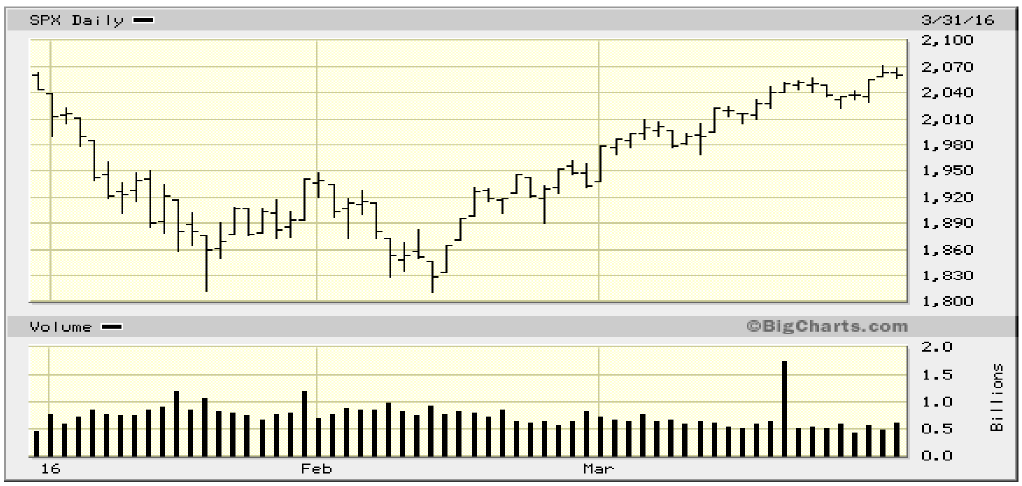
Despite getting absolutely crushed in January, and then again in the beginning of February, the S&P 500 did an improbable about face and rallied very strongly to close the quarter. The final tally in terms of price change for the S&P 500 for the 1st quarter of 2016 was 0.77%, basically flat.



S&P 500 YTD Chart Supplied by BigCharts.com

I hope the last research report I sent you all prepared you for this volatility, at least somewhat. But, to be frank, even I am shocked by just how crazy this market has been. In fact, I devoted an entire article in this newsletter to this market's wild ride .

To give perspective, the S&P 500 closed 2015 at 2,043.94. In February, it bottomed out at 1,810.10. That is an 11.4% drop, which is worse than the entire year of 2000 (remember how bad people thought the market was then?) and just about the same as the market dropped in 2001. HOWEVER, it's rally from that low has pushed the index's value to 2,059.74 Which is a 13.79% gain from the low and, as mentioned earlier, a 0.77% gain for the year. Insane!!!

All I can really say is, keep your seatbelt fastened. I don't see this volatility ending until we know who are next President will be.

Craziest Market Ever?

On 8/25/2015, in the Capital Market Notes section of my website (www.mrpci.com), I mentioned that this was one of the craziest markets I have ever seen. I went on to say further that if I ever have some down time, I would make a list of the most insane markets that I have had to navigate for clients. Since the market has been running higher for a few weeks now, I finally did find the time to think about this trivial topic.

The first market event that I have to mention is the Flash Crash. On May 6, 2010, the Dow fell over 1,000 points and then recovered all of those losses in the span of about 15 minutes!!!!! I clearly remember that day. I was sitting at my desk doing normal business activities. I glanced up to check the market and noticed it was falling like a stone. I rallied my team, at the time, and went over client portfolios and got the buy list together (this took maybe 15 minutes). And then when we went to execute those buys orders, the market had recovered. We all just stood there stunned and wondered did that just happen or did we imagine it?

The second craziest market I've been a part of was the late 2008 market. The true insanity and horror of that market really hit home on September 29. On that day, the Senate, House and Treasury Secretary Paulson reached a tentative agreement on a $700 billion liquidity program, only to see the House reject the deal during a floor vote later that day. I remember watching C-SPAN as that vote was being cast. As it become clear it wasn't going to pass, my team and I watched the Dow free fall 777 points that day. That was a sickening feeling.

I would put the market of the late 1990s as the third craziest that I have seen. To close out the 90s, the S&P 500 recorded 20%+ gains for each of the last 5 years of the epic Bull Market run. At this time I was at Merrill and I remember an advisor, who sat near me, who would call his clients every time the market sold off and tell them "Chicken's on sale" and they would buy every dip. And, you know what, they made money...as that market was going up no matter what!!

<u>I would have to say the next craziest thing I've seen has been the bond market over the last 3 years or so</u>. The Fed took emergency measures to save the economy during the 2008 financial crisis and part of that was instituting a zero interest rate policy on the Fed Funds rate. They also instituted a Quantitative Easing program to keep the yields on longer term bonds low. And, at the time, all of this made sense. The financial system had broken and emergency measures were necessary. But now, I am not so sure we need "emergency measures." However, every time they do something to boost interest rates, rates keep falling. When they ended quantitative easing, the market thought rates would spike but they didn't. Last year, the Fed raised the Fed Funds rate. But with foreign countries going to negative interest rate programs our bonds offer such a HIGH yield that demand for them remains robust and yields don't move much higher at all. It seems to be a world of forever low rates, no matter what policies are enacted.

<u>And #5 on my list of craziest markets is where I would put our current stock market</u>. August and September of last year, the S&P 500 got crushed by 10-15%...only to see it rally hard in October and recoup those losses. Then again in January and February of this year, the S&P 500 fell over 10%...only to see an incredible reversal and by the end of March the index was positive for the year. I call this trendless volatility; lots of major ups and down, but, essentially, the market goes nowhere. It is tough to deal with and tough to effectively trade, if your goals are short-term profits. In fact, some short-term players have been crushed in this market (see the Live by The Gun pt 2 article). But with some patience and a long-term focus, people can handle and thrive during a market like this.

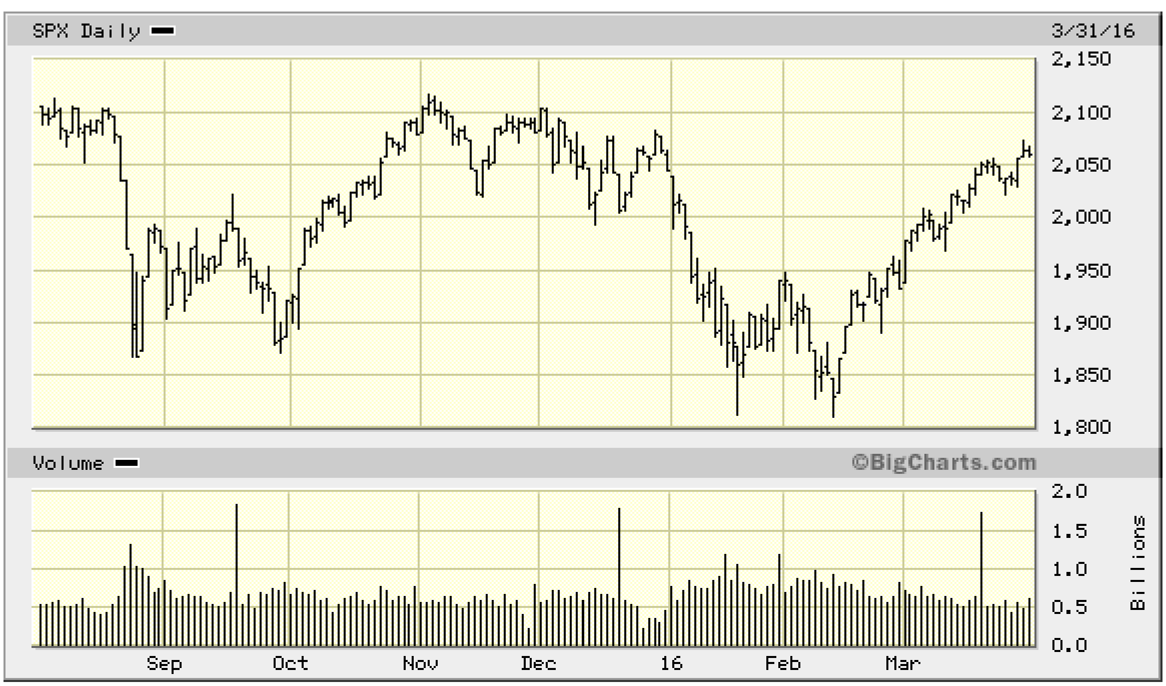


Chart of the S&P 500 8/01/2015—03/31/2016 provided by BigCharts.com

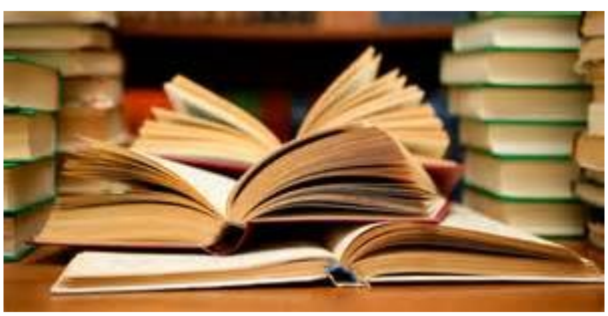
Economic Reality

In late December of last year, I wrote my "2016—The Year Ahead" piece. In that report, I outlined what my research suggested might happen during the year. The main focus of that report was on the amount of market volatility that my work suggested might unfold in 2016. Well, if the first quarter is any indication then we are in for quite a bumpy ride.



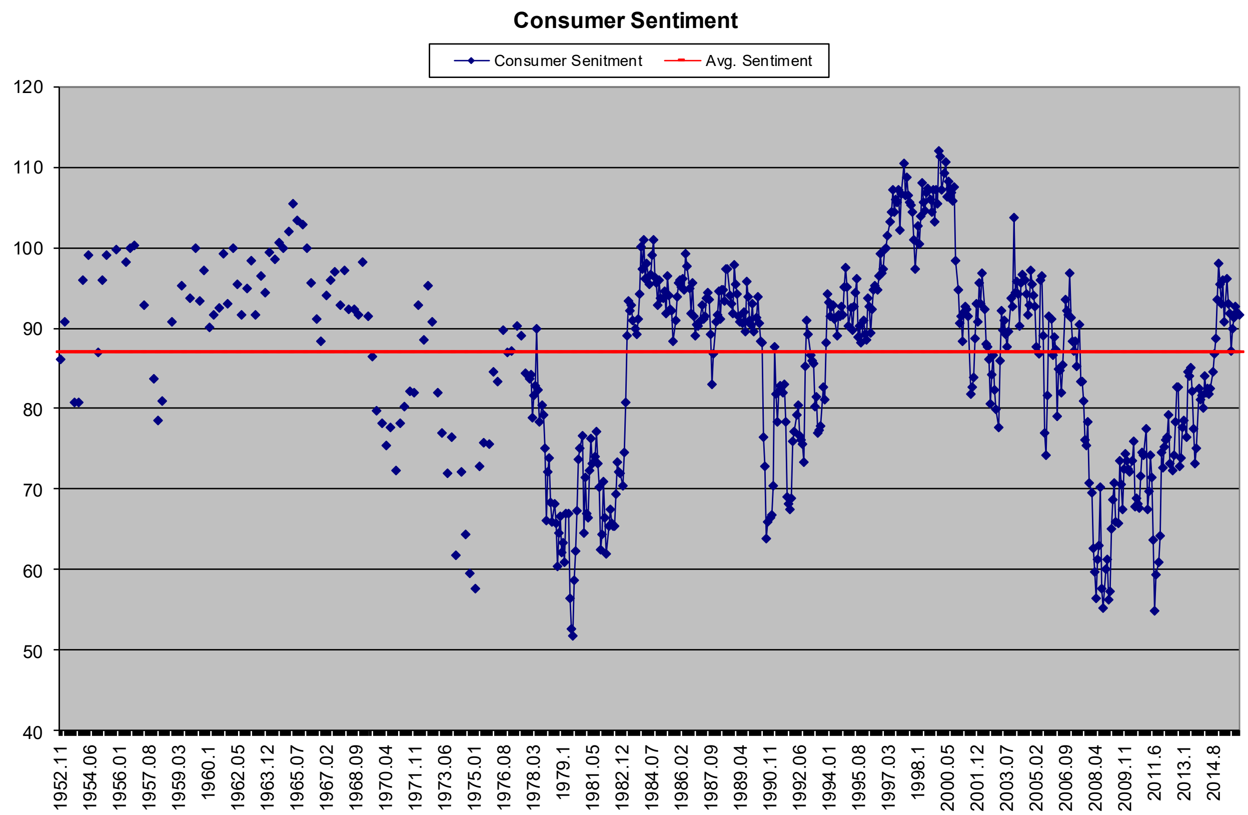
Nevertheless, there was one section of the report that generated quite a few phone calls, emails, and comments from you all. It was the part about the potential biggest driver for market upside being an optimistic U.S. Consumer and the reasons that were listed as to why the Consumer might be optimistic. Let's just say, there are a number of people who don't think the economy is in good shape and they doubt that the U.S. consumer is, in fact, optimistic.

As I always do, I listened intently and then decided to dig deeper into the data to see if I could find anything of interest.




But before I discuss what new discoveries I made, let me first restate what I highlighted in that December 2015 report. I'll skip the research findings that suggested the market will be volatile, as I think we can all agree that the market, so far, in 2016 has been VERY volatile.

In that report, during the review of my macro-model I stated that Consumer Sentiment was at an "optimistic" level. With that statement, I showed the chart of the University of Michigan Consumer Sentiment Index. I use this Index as my proxy for the mood of the Consumer (and market) as it measures the Sentiment, feelings, or vibe, of U.S. Consumer. The average reading of the Index since its inception in the 1950s is 86.99. Any reading below that number, I classify as "pessimistic" and any reading above that number I classify as "optimistic". At the time of that report, the Index reading was 92.6 By definition, that is an optimistic reading. And for context, that reading is still in optimistic range with a 91.7 reading.



Frankly, you could probably use a number of different indices to gauge the mood of the Consumer, like the Bloomberg Consumer Comfort Index or Consumer Confidence Index, and get very similar readings. The point of using a comprehensive index is the concept that it will capture all the moving parts of a person's economic life and boil it all down into one data point. Other information that surely impacts this chart are: employment status, income growth, home values, stock market gains, tax burdens, and the like. And, as you would expect, in the late 1990s, the readings where WAY above average, as the economy was BOOMING. And in 2008 the readings were near all-time lows, as the economy was in the tank.

For the "Year Ahead" report, when I took note of the fact that the University of Michigan Consumer Sentiment Index was at an above average, or optimistic , level, I then began to look into why it might be registering an optimistic reading. And after reviewing the potential "why's", I wrote the following on page 12 of that report:

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.

It was with these specific paragraphs that more than a few people had comments and questions. And it was here that I dove into some more research.

First off, it is important to understand that the comments I made above are facts, not opinion. The numbers and data quoted from the Bureau of Economic Analysis and Bureau of Labor Statistics are the actual data points that they release on an on-going basis and anyone can look it up and/or track it by using their websites.

Nevertheless, I understood why the questions and comments were coming up. There is a general sense that our economic recovery is not robust and the feeling is that our economy should be doing much better.

With this in mind, I looked into the data with an eye specifically towards the comments and questions raised. And one of the common issues brought up dealt the fact that over 90 million people are not in the labor force, while the government tries to tell us the unemployment rate is about 5%. There seems to be a disconnect here and this disconnect was my focus.

I went back in history, starting with 1945, and looked at all the times the unemployment rate was about 5%. I then looked at the number of people, on a percentage basis, that were classified as "not in the labor force." What I found was that currently 37.3% of our population is "not in the labor force", which, by the way, includes disgruntled workers not seeking employment, students, homemakers, and retirees. As you can see, not everyone in this category is there because they are in bad shape.

Nevertheless, looking back at the historical data, you see that the percentage of people "not in the labor force", during times with a similar rate of unemployment as we have now, ranged from 41.2% to 33.7%. To me, this doesn't seem to suggest that our current 37.3% reading should be sounding alarm bells. However, it may not be what we are used to. You see, the low reading of 33.7% came in 1996. As that economic boom continued to develop, the unemployment rate dipped to 4.0% and the percentage of people "not in the labor force" fell to 32.9%.

And it was upon discovering this that I had my "A-ha" moment!

What I concluded was that people can still vividly remember the late 1990s economic boom and, most likely, that is what they think of as "normal". They think when things are going well economically that it should look just like the late 90s. Now, to be intellectually honest, the 1990s economic boom was one of the greatest economic expansions off all time. And, in fact, that economy got WAY too hot and grew past what was sustainable. But, that doesn't matter. That is what people remember the Good Times looking like and that is what they want back.

After realizing this, I decided to run with it...but to also take it a step further. I took the historical data on employment and the economy and applied it to the market in an effort to truly capture what a really hot economy and market would look like.

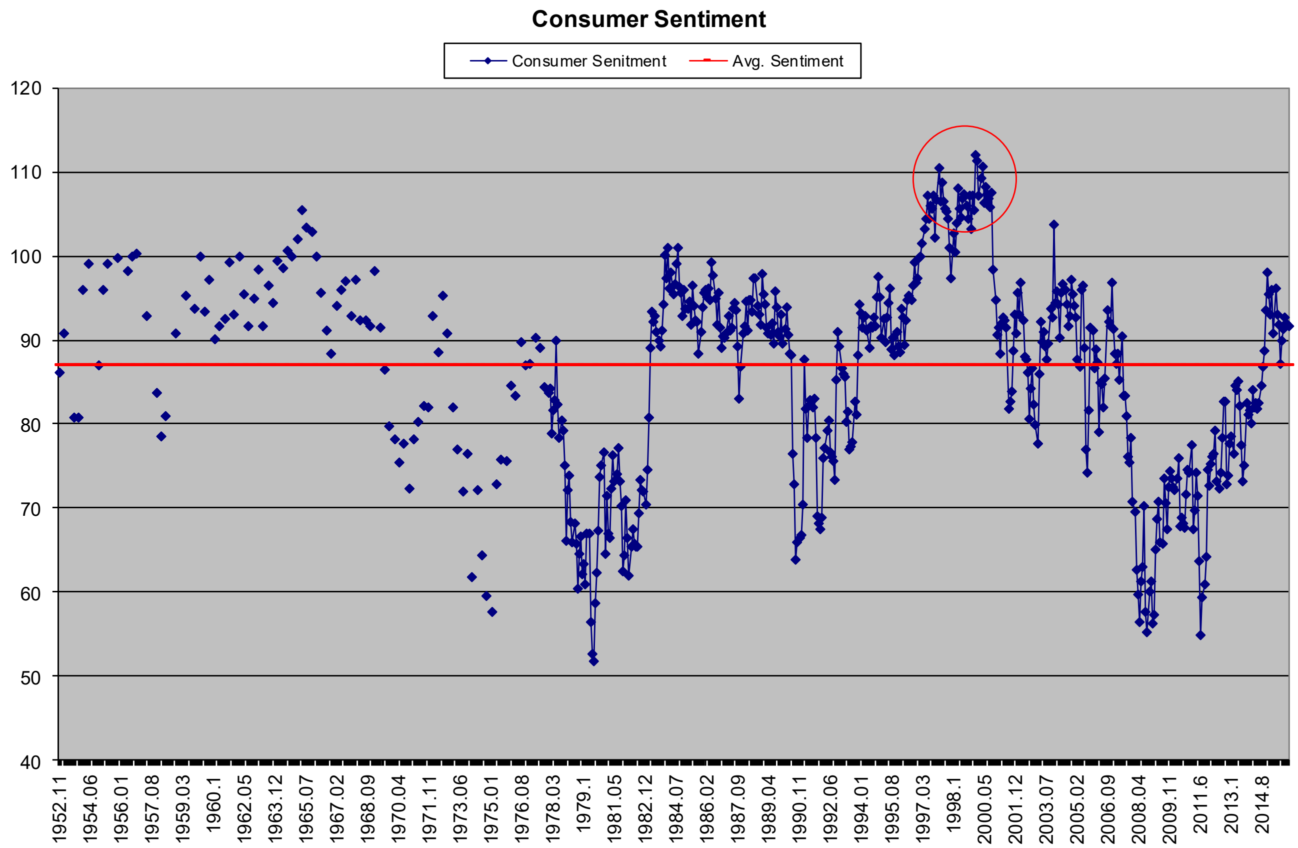
To do this, I first wanted to come up with an employment number that would give everyone a job who wanted to work. To do, this I took our current population number (250 million) and used the lowest unemployment number in recorded history (which was 2.9% in 1952) combined with the largest percentage participation in the Labor Force in recorded history (67.1% in 1997) to derive our Nirvana Labor Force; 163.407 million.

As a side note, this implies that, even at historically high Labor Force participation levels and historically low unemployment levels, there would still be 83.5 million people not in the labor force. Which would most likely be centered around the retirees, students, and homemakers. Put another way; there are over 11 million people who would work right now, if they could find a job.

Ok...back on track...with this Labor Force of 163.407 million people and using the current GDP per employee ratio, this Nirvana Economy could produce GDP of $19.6998 trillion ($1.76 trillion more than our current level).

Taking the ratio of S&P 500 earnings to GDP, implies an S&P 500 earnings level of $106. To find out the market's upside in this Nirvana economy, we need to find out the appropriate P/E level to apply to these earnings.

But here is the kicker, take a look at the Consumer Sentiment chart again. Specifically focus in on the late 1990s readings, which I've circled.



Those readings are historic highs and, of course, the economic activity of the late 1990s was historically good. If we had record high employment, record high Labor Force participation, and surging S&P 500 earnings (as is modeled in the Nirvana Economy Scenario), I would venture an educated guess that Consumer Sentiment would be back to those levels. And, if you remember, the P/E on the S&P 500 hit 37.1 during those boom times.

When you apply that P/E to the implied earnings from this type of economic boom, you get an S&P 500 level of 3,604 and this represents about a 50% gain from our current levels.

Do I think the market will do this/go there anytime soon? No. This analysis was done to simply see where the economy (and market) could go if things started to click. However, over the long-term, this is exactly the kind of thing the market should do as we near the end of the Bull Market.

With that in mind when I go back and reconcile the data I used for the "2016—The Year Ahead" piece with the Nirvana economy I just laid out, I totally understand where the frustration with our current economy is coming from.

Are there people who want to work that cant' find a job? It sure looks like it. In fact, we can make a mathematical argument there are over 11 million people, right now, who want to work, but can't find a job.

Could our economy be performing better? It sure looks like it. In fact, we can make a mathematical argument that we could be putting out about $1.76 trillion more in GDP if our economy was running hot.

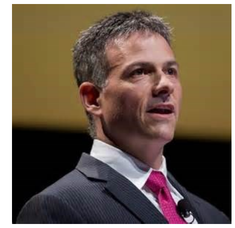
Could our citizens be feeling better about the economy? There is no question about it. Simply go back to the last chart. We are at a Sentiment reading of 91.7 and the all-time high reading was 112.

However, it is vitally important to note that our current economy is in MUCH better shape than it was in 2008/2009. There are many more jobs, much higher wages, and GDP has been growing. All of this has resulted in Consumer Sentiment ticking up for near all-time lows and trickling into optimistic territory.

And just as important to understand, the economy (and markets) do have substantial up-side to them. We are not near historically low unemployment levels. S&P 500 earnings is below potential. And Consumer Sentiment has a lot of room for improvement.

In fact, I am making the same case that I've been making for quite some time. We are in a secular (long-term) Bull Market. The 2008/2009 time frame set the stage for this Bull Market to begin running and, as time has progressed, we've seem improvement in the fun-damentals. 2016 should be a year of volatility and transition, but there is a significant chance that when all the pieces settle into place we are set and ready to continue our Bull Market run.

Live by the Gun, Die by the Gun pt. 2



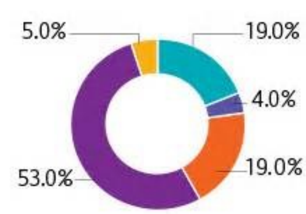
In the last newsletter, I talked about the difference between the diversified portfolio management style that I employ here at MRP Capital Management versus the rock'em sock'em hedge fund world. Many times the hedge fund guys get a lot of press for their big up years, but big up years don't necessarily make for great long-term track records. Risk control, diversification, and client focused portfolios, in my opinion, form the basis for great long-term returns.

In that same newsletter, I mentioned two highly publicized hedge fund managers whose portfolios got CRUSHED last year, while the price change of the S&P 500 was only very slightly negative. Those two guru's were: David Einhorn and Bill Ackman. Who, according to reports, lost 25% and 20%, respectively, in 2015.

And it seems the pain just keeps on coming for this crowd. Reports show the Ackman has lost another 26.4% through March 15th of this year. He has lost big on his HUGE investment in Valent Pharmaceuticals (VRX), which, as I type this, is down 73.09% year-to-date. Einhorn hasn't released any data related to his 2016 performance, that I can find. However, according to reports, he has under-performed the market by 71.1% over the last 6 years.

My point is not to pick on these two investment managers. Frankly, I could go through the list of hedge fund managers and find many that have been killed in this market. These guys are just two of the more famous hedge fund managers, which is why I picked them.

The point I am making is that this market has been extremely difficult for portfolio managers. And if you employ a concentrated, usually levered, portfolio management style that is focused on trying to generate huge returns in any, and all, years you probably got hammered this year. And one year like that, let alone multiple ones, ruins long-term track records.



This is why I employ an approach that custom tailors portfolios to my clients needs and is always diversified. Tough markets will still happen, there is nothing anyone can do to stop that, but the diversified portfolios will be buffered from the destruction that these hedge fund type portfolios face. Now, that doesn't mean losses won't occur. They most assuredly will when pullbacks or bear markets occur. However, they face a much greater probability of surviving the down draft and being in a position to thrive when the bull market forces kick back in. And this is how great long-term performance develops.

Non-Financial Events occurring this quarter

US Navy personnel captured by Iranian military in January

UN sanctions lifted on Iran in January

March Madness begins!

Nancy Reagan passed away on March 6, 2016

Belgium hit with a terrorist attack on March 22

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