MRP CAPITAL INVESTMENTS, LLC

3rd Quarter 2016 Client Newsletter

Capital Market Update

Inside this report:

Capital Market Update	*1*
Earnings over Elections	*2*
Valuations	*4*
Non-Financial Events	*8*
Portfolio Information	*9*
Disclosures	*10*

In a market full of twists and turns, we got thrown a HUGE curveball this quarter. And, oddly enough, that curveball was a very stable market! For the quarter the price change for the S&P was 3.31%. And the only real volatility we saw occurred before the Fed meeting in September when market participants decided to price in a rate hike that never materialized.

S&P 500 3rd Quarter 2016 Chart Supplied by BigCharts.com

Thus far for the year, the S&P 500 has appreciated 6.08% on a price basis. And, even though I anticipate some market gyrations around the election, I think getting the results should have a calming effect on the markets. This could lead to a further reduction in volatility, but anything is possible. A Trump win could see Brexit like volatility, while Hillary winning should signal a continuation of our current policies and, therefore, calm the markets.

The big thing I am interested to see is how earnings come along. If they are strong, we could have formal proof that the earnings recession is over. Tie that to election uncertainty going away and that could spell gains for the markets.

Time will tell.

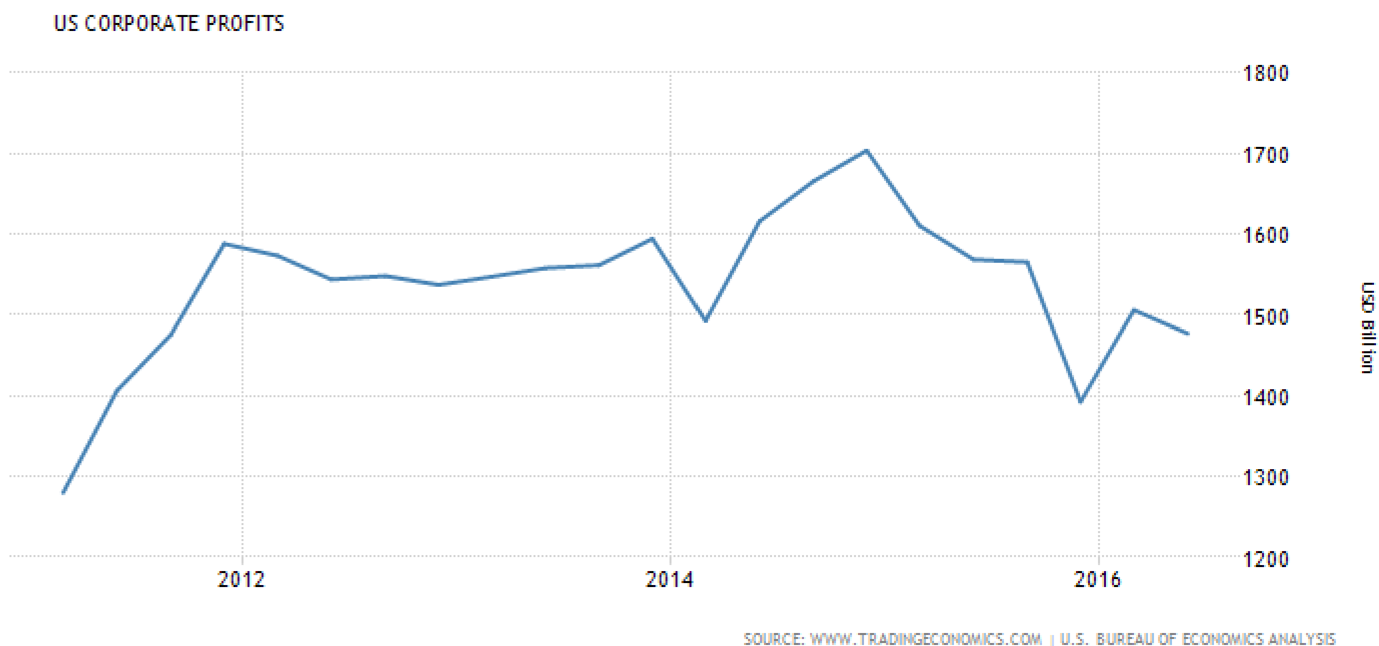
Earnings over Elections

It seems that recently all the media can focus on are these two:

It doesn't matter if you are watching a talk show, a financial news show, or a local station. It is Trump and Clinton, seemingly, 24/7. All this is fine and good, but I've noticed over the years when all the eyeballs begin to look at one thing...there is something else that is getting overlooked. Many times, the item being overlooked presents an opportunity.

One thing that is for sure is that the election is NOT getting overlooked. We all know that Trump wants to reduce the corporate tax rate to 15%. We all know that Hillary wants to raise taxes on the wealthy. We all know that Trump wants to build a wall to keep illegal immigrants from flooding across our southern border. We all know that Hillary wants to increase the number of refugees coming to the United States. So, there is nothing going unnoticed on that side of the equation.

But I wonder if everyone knows that corporate profits peaked in late 2014/early 2015 and potentially made a low in late 2015.



I wonder if people realize that Personal Incomes have been rising steadily since 2009. In the first quarter of 2009 Personal Incomes stood at $12.061 trillion and they now stand at $15.893 trillion.

I wonder if people realize that the Consumer Price Index has been steadily rising since 2009. In fact, in 2009 the CPI level was 214.537 and now stands at 240.853.

I wonder these things because there is a chance that if the prices consumers pay for goods and services rises, then the corporations selling those goods and services might be making more money. And if consumers have more money in their pockets to spend, due to higher wages, then they might buy even more of these goods and services that are rising in price. Which, in turn, means even more profit for corporations as unit sales AND prices are growing.

Time will tell, but I'm thinking when earnings normalize after the oil company write-downs in late 2015/early 2016, we might actually see overall earnings rise again. In general, rising earnings means rising equity prices.

And, like I mentioned before, no one seems to be considering this because they are totally focused on who will be our next President. So while everyone else is glued to the election, I'm trying to figure which companies might be making more money than the market expects them to make.

Valuations

About once a month, I attend an investment meeting. The bulk of these guys are Wharton grads who have vast experience in the world of high finance. In fact, one of them was a founder of Invesco. Needless to say, they have a ton of experience and add a lot of perspective to the contemporary markets events.

Last month's meeting was particularly interesting. One of the topics of conversation centered on the way our current market is using traditional valuation methodologies. The general consensus was that in the "right here and now" the market doesn't give a darn about how a company is valued. All the market seems to care about is riding the "hot" stocks and pushing their prices higher and higher.

Truth be told, I think there is a lot to that. Take a peak at the S&P 500 year to date chart, which was supplied by BigCharts.com.

As you can see from the chart, the market has appreciated nicely from the crazy volatility we saw at the beginning of the year. And, as was mentioned in the last article, the price change has been 6.08% thus far in 2016.

However when you look at some specific “hot” stocks, you will notice much higher gains.

Here’s AMZN, which is up about 31% YTD.

Here’s FB, which is up about 28% YTD.

Here’s FTNT, which is up about 23% YTD.

Here’s YHOO, which is up about 34% YTD.

As you can see from the charts, these stocks have been rallying hard this year. But when we look “under the hood” and see their valuations, I think some head scratching will follow. You see, based an trailing 12 months earnings, Amazon trades at a Price to Earnings ratio of 206.2, Facebook is at a P/E of 41.3, Fortinet 62.3, and Yahoo! 94.6.

Clearly, the market is expecting BIG things from these stocks. In fact, according to CNBC’s growth forecasts, AMZN is expected to grow earnings by 81.6% from 2016 to 2017. Meanwhile, FB is expected to grow earnings by 29%, FTNT by 24%, and YHOO by 21%.

There is no doubt that 20%+ rates of earnings growth are excellent, but perhaps some of the valuations of these stocks might be pushing the bounds of rationality.

All charts on this page are YTD charts supplied by BigCharts.com

And, on the other hand, you see some stocks that are not trading like “hot” stocks, but their valuations are super attractive.

For instance, let’s take a look at these companies:

JPM, up about 3% YTD.

BAC, down about 6% YTD.

PFE, up about 6.2% YTD.

WNR, down about 28% YTD.

JPMorgan trades at 11.3 times trailing twelve months earnings, while its earnings are expected to grow at 10% from 2016 to 2017. Bank of America trades at 12.5 times earnings and its earnings are expected to grow by 17.5%. Meanwhile, Pfizer trades at 13.7 times earnings and earnings are expected to grow at 9%. And Western Refining trades at 8.6 times earnings and earnings are expected to grow at a 37% clip.

All charts on this page are YTD charts supplied by BigCharts.com

As an investor, I think you can see that both sets of examples offer some interesting opportunities, while highlighting why my esteemed friends made the comments they did about valuations not mattering. The first set of "hot" stocks offer high growth rates of earnings, but you are paying for that growth BIG TIME. And the second set of companies are much, much cheaper and are expected to grow earnings at a pretty nice clip as well. But yet, their stock prices are in the toilet compared to the "hot" stocks.

To be frank, I've seen this type of thing play out before; specifically in the late 90s. I remember the Wall Street Journal, and other widely regarded financial publications, writing stories about all the great money managers who were underperforming the markets; names like Warren Buffett, Julian Robertson, and George Soros. In fact, many of the big names closed their funds as their fundamental analysis and proven trading strategies weren't working any more.

And, of course, all this happened right about the time those "hot" tech stocks began to fall apart and the attractively priced, solid, and steady companies began to lead the way and outperform again.

You see, valuations do matter and they always will. However, there are periods of time in the markets when trends and streaks take over. Tech stocks will rule the day for awhile, regardless of their valuation. But when their earnings "only" grow 15%, their stock prices will fall and their P/E's will correct. Oil stocks might be all the rage until the oil markets fundamentals change and those stocks will lose their luster. Etc, etc, etc.

But sooner or later, the attractively priced businesses come back into favor and investors will flock to them. Then, of course, the market then will push their valuations past the point of rational...and the whole process starts all over again!

Sidenote...Each and everyone of the stocks mentioned are owned throughout the client portfolios that have been entrusted to MRP Capital Investments to manage. So I am not cherry picking any specific type of stock. Rather I am simply trying to illustrate that a diversified portfolio will have stocks that are hot and others that are attractive long-term, but for one reason of another, are lagging in terms of performance. But, over time, paying attention to valuations can be a big key to success.

Non-Financial Events occurring this quarter

In August, Michael Phelps led the USA to Olympic gold, many times over.

In September, Charlotte erupted into riots over racial tensions.

In July, a military coup was attempted in Turkey.

In July, Henrik Stenson beat Phil Mickelson for the Open Championship in one of the best played golf tournaments the world has ever seen.

On 9/17/2016, multiple terrorist attacks hit the United States in MN and NYC.

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