

MRP CAPITAL INVESTMENTS, LLC

2nd Quarter 2017 Client Newsletter

Capital Market Update

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Even with all the craziness going on in the world right now, the S&P 500 put up some very solid performance in the 2nd quarter. The price change in the market was 2.74% in the quarter, which brings the year-to-date appreciation through the end of the quarter to 8.27%.



S&P 500 2017 Chart Supplied by BigCharts.com



This appreciation in the market was achieved despite a little more volatility in the market, as compared to the 1st quarter. But, nevertheless, nice gains were made.



Looking ahead, there are plenty of things that could make the markets jump around; Congressional stumbles, Presidential faux pas, North Korean antics. But on a fundamental basis, things do look pretty promising. I flesh out the “pretty promising” comment in more detail in the “Signal Through the Noise” article.

As always, the market can throw us curveballs from time to time and we are always on alert for that possibility.

Signal Through the Noise



In the last newsletter, I promised to try to find the signal the market was trying to send us through all the political and non-market related noise. And I gotta be honest, the noise is deafening.

Doing what I do, I have to be a news junkie. I need to know what is going on in all parts of the world at all times. To get this information, I have to watch financial news shows and political news shows. I need to see local news. I need international news. I have to listen to the radio. I need to get online news. By doing this over the years, I've been able to stay abreast of all market related activities.

However, lately, I've had to dig deeper and find new sources to get information because all the traditional news outlets are covering Trump. And it is not all "news." A lot of it is non-sense. Over the last few months, we've learned he gets two scoops of ice cream at dinners while his guests only get one. There are rumors he's afraid of stairs. And there have been hard hitting stories about the fact that he likes ketchup on his steak. I mean it is beyond absurd what is passing for news these days.



On top of those goofy stories, you've also got important stories, but they just aren't really market related. And, frankly, those are the ones that make the most "noise" and cause confusion. These are the ones like the Jim Comey, Mike Flynn, Lorretta Lynch stories. Yes, these are serious stories. Did Mike Flynn collude with the Russians? Did The President try to influence the FBI Director to stop an ongoing investigation? Did a sitting Attorney General actively try to stifle an investigation into a Presidential Candidate?



Heck, maybe they did happen. And, you know what, that would be shocking. BUT...would any of those stories, if true, have an impact on the amount of money Coca-Cola makes? Would they have an impact on the level of sales that Microsoft would generate this quarter? If those answers are "no", then the stories are classified as market-related noise.

One of the things that makes this kind of noise so troubling is that, at their worst, they could result in the impeachment of a sitting President. And on 5/17/2017, I put up a post on the website (www.mrpci.com) under the "Capital Market Notes" section about this exact topic. And the gist of that post is that IF Trump is impeached, Mike Pence would be President. Interestingly enough, I think the market would actually prefer Pence to be President as he would still push forward with the real news stories (tax and healthcare reform), while having a higher "likeability" factor in the Congress, and probably, the World. This would, most likely, mean a greater chance these things are implemented than if Trump leads the charge.



Importantly, that last paragraph touches on the actual signal the market is sending. That signal carries the message of optimism. Signs of this optimism are unmistakable; ***The Dow has rallied past 21,000, there have been 1.2 MILLION jobs created since the election, S&P 500 earnings are BOOMING, wages are rising, interest rates are beginning to normalize, housing values are robust, Consumer Sentiment is sky high, and the volatility in the market is very low.***



The question is why are all these good things happening? The answer is: **certainty**. The results of the election gave us certainty. We know for certain the President will be a Republican. We know for certain the House and Senate are majority Republican. Not everyone likes this, but at least all market participants have those questions answered. And the market likes certainty.

To this many will say, “Yes, but there is not certainty that they can get any of their agenda passed into law.” Of course that is true, but there is a **MUCH BIGGER POINT** than that. Yes, it is true Trump may not be able to get his tax reform and reductions passed. HOWEVER, Hillary wanted to raise taxes!!! Not just on the “rich” but also on corporations.

So, yes, it is true that the Republicans may not get tax reform and reduction figured out. BUT, the market is thrilled, nonetheless, because at least taxes won’t be going up!!! Tax reduction and reform would be icing on the cake.

And you can take that general concept and apply it to every part of the new administration’s agenda. It may not get fully implemented and passed into law, but at least additional burdens won’t be placed on the backs of corporate America.

Add all of this up and there is a very clear signal that the market likes that path this business friendly administration is taking us down.



Mystery Solved!

From time to time, I find myself totally stunned at how so many people can be completely perplexed by things that are so very obvious. Now, granted, this happens to everyone now and again; myself included. Maybe a simple fact has been overlooked or a basic fundamental rule forgotten and this leads to confusion.



However, over the last few years, these types of things seem to have been taken to an entirely new level. And this “new level” is not just focused on topics that shouldn’t be confusing. It also has a focus on specific people who should not be confused by basic facts.

Just the other day, I was listening to Janet Yellen speak at one of her latest testimony’s in front of Congress and she made a statement that she was perplexed at why productivity remained so low. And, if you look at the data provided by the Bureau of Labor Statistics, she is correct, Productivity fell off a cliff in 2011.

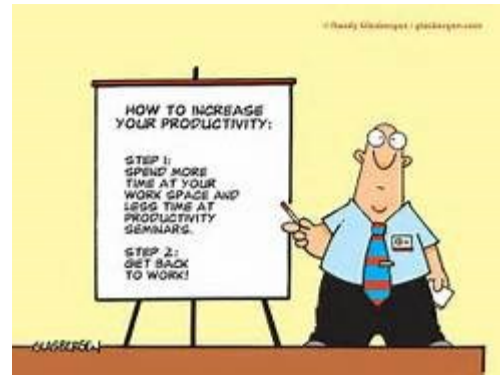


For reference here is the data from the BLS since 1998 on Productivity, which is defined as level of output per unit of labor cost.

<u>Year</u>	<u>Labor Productivity</u>
1998	3.0%
1999	3.9%
2000	3.1%
2001	2.7%
2002	4.3%
2003	3.9%
2004	3.2%
2005	2.1%
2006	0.9%
2007	1.4%
2008	0.8%
2009	3.3%
2010	3.3%
2011	0.0%
2012	0.7%
2013	0.7%
2014	0.6%
2015	0.8%
2016	0.3%

As you can see from the data, there has been essentially no gains flowing to the economy from productivity enhancements since 2011. That, of course, is a fact. But the comment from Fed Chair Yellen about the reason behind it being a mystery, strikes me as odd.

It strikes me as “odd” because Janet Yellen is the Chair of the Federal Reserve Bank, she earned a PhD from Yale, and taught economics at Berkeley, but she can’t figure out that the \$164 billion in regulatory expense added to the U.S. economy over the last 8 years is a drag on Productivity and, therefore, Growth? You see, \$164 billion in additional annual regulatory/compliance expenses adds to unit labor costs and produces NOTHING! In fact, it might even stifle future growth but that’s a discussion for another day. At a minimum, these dollars being spent produce nothing. And, therefore, the simple math shows that more dollars invested in something that produces nothing would yield a lower level of productivity per dollar spent. That is just basic math and common sense.



But, we can take this basic math out one step further. We can run some numbers to see what kind of drag this additional regulatory spending has had on our economy.

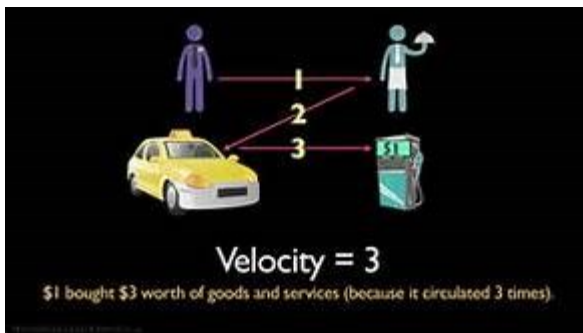
Running the numbers, we see that the drag on our GDP by increased regulatory costs was 0.88%. Which may not seem like a lot but when you figure that nominal GDP grew \$548 billion from 2015 to 2016, you notice that these regulatory costs equated to 30% of our entire nation’s growth. That is significant!

2016 U.S. GDP.....	\$18.569 Trillion
2016 Additional Regulatory Costs.....	\$164 Billion
Additional Regulatory Costs/GDP.....	0.88%

HOWEVER, this figure is only the start of the Mathematical Rabbit Trail. We must also understand that these dollars that were “invested” in regulatory controls could have been invested in things that did actually increase output. This would have resulted in a boost to GDP. By simply adding the additional regulatory costs to GDP would have boosted nominal GDP growth by almost a full percentage point to 3.9%!!!

But, you, in fact, need to consider more than that. There is a concept called the Velocity of Money. And this measures the frequency at which one unit of currency is used to purchase domestically produced good and services within a given time period. And at the end of 2016 that figure stood around 1.5.

In layman’s terms, this means that for every dollar in circulation in the economy there is \$1.50 worth of transactions. For example, Manufacturing Facility X invests \$164 billion into their plant. They buy equipment, they build stuff, and they hire people. The people they hire have to live and, therefore, they have to buy food, clothes, cars, go to the movies, play golf, etc. All of this buying and living results in \$246 billion of economic activity (\$164 billion (the investment) * 1.5 (the current velocity of money)=\$246 billion).



Adding this number, \$246 billion, to our nation’s GDP, would have resulted in 4.3% nominal GDP growth for 2016. Which, again, is pretty darn significant.

This is why I am so bothered by Chair Yellen’s comments about the great mystery of falling Productivity. It seems pretty simple to me. The government decided to add a bunch of regulations and compliance costs to our economy, which resulted in a drag on our businesses level of output per unit of labor cost. Furthermore, this lack of Productivity growth and investment in Regulations helped stifle our nation’s economic growth.

MYSTERY SOLVED...Why has productivity been so low? Too much money has been invested in things that produce NOTHING!!!

Brave New World

In the last newsletter, I wrote a fairly detailed piece entitled “Global Landscape.” This article seeks to build off of the ideas brought to light in that report.

The reason I wanted to write this follow-up is that I believe we are laying the foundation for a massive change in the global financial landscape. It is my opinion that we have put the Financial Crisis from 2008 firmly behind us and we are pressing forward into the future. A future that I have dubbed a “Brave New World.”

As noted in that last newsletter, I see the two major players in the Brave New World as the United States and China. But we’ve also seen some major tectonic shifts in the playing field as Europe and Japan have lost some of their financial clout and the Middle East has the potential to rise in stature in the coming years and decades.

This is mainly due to the massive accumulation of debt and shrinking populations in Europe and Japan, while the Middle East, led by Saudi Arabia, are seeing their populations increase along with their GDP. Additionally, their debt is MUCH less of an issue when compared to the aforementioned Euro-zone and Japan.

You’ve also got some MAJOR changes going on with the partnerships, business plans, and relationships among all of the different players. For starters, we all saw the BREXIT vote in June of 2016. No one expected that to pass, but it did. Great Britain voted to leave the European Union and regain its sovereignty and independence.

Coming up I see two massive potential game changing developments. The first one is the Saudi Arabia IPO of Aramco. Aramco is the Saudi Arabian Oil Company. It is basically the business entity that drills for, refines, and ships all the oil that Saudi Arabia has. The market is putting a \$2 trillion valuation on Aramco. Even though they are only offering 10% to the public, it will be the largest IPO in the history of the world and would generate almost 10 times the amount of economic activity as the Trump Wall. Saudi Arabia plans to use the proceeds of this offering to revamp and diversify its economy away from being so reliant on oil.



The other one is the Silk Road that China is wanting to build. This Silk Road is designed to open new trade routes as China's domestic economy slows down and is projected to lift China's cross-border trade to over \$2 trillion. And that is the key! Not only will this potentially be beneficial to China, but it could benefit all of their trading partners as well. This, then, becomes more than just an economic project. It becomes a strategic geopolitical project designed to raise China's status in the region. However, that "region" isn't just the Far East. The Silk Road expands the "region" to include the Middle East, Europe, and Africa.



Frankly, I think these two projects alone are total game changers. And judging by the returns of international markets this year, I am not the only one who thinks this. For instance;

-India's stock market is up about 17% year to date.

-The German DAX is up about 20% for the year.

-The MSCI All-Country World Index is up 11.57% for the year.

-And the Tadawul (Saudi Arabian stock market) is up approximately 40% since the U.S. elections.

And, of course, we are looking for ways to profitably invest in these trends. When BREXIT happened, many people were afraid of what might happen to the Euro-zone's economy. However, I thought the falling British Pound set that table for British exporters to make a killing as their competitive advantage on pricing just became even more compelling. And guess what happened...

Unilever, the British consumer products company, saw its stock rally 17%...



and Diageo, the British spirits maker, saw its stock appreciate over 12% after BREXIT.



So, are these developments threatening to the current global financial landscape? Yes! We are in the midst of seeing the emergence of a Brave New World. But, we are aware of what is happening and there will be plenty of opportunities to attempt to profit from these changes.

Imbalance Update

In last quarter's newsletter, I mentioned a potential imbalance building. To refresh our memory, that imbalance was a stock market that appreciates while the Fed is hiking interest rates. I call it an "imbalance" because the rate hikes are designed to slow down an economy. Therefore, a market that is rallying in the face of these speed bumps can create an imbalance.

Here are the comments I made in last quarter's newsletter verbatim:

"...we have an interesting divergence that might be upon us right now. I wrote a report a few years back called "Don't Fight the Fed". (I'm sure you all remember it!) In it, I did some research on how markets have historically behaved during interest rate hiking cycles. Well, as you'd expect, market returns have historically been below average when the Fed is in the middle of a hiking cycle. But there was ONE big exception. And that was the mid 80s hiking cycle. The Fed was raising rates during that time, but the market was rallying! In fact, it rallied right up until the October of 1987. At that time the market cratered over 25% in one single day.

There has been a lot of questioning as to why that happened. I'd argue that market fundamentals did not warrant a market rallying so aggressively during that time. Historically, markets have averaged gains of 1.97% during Fed rate hiking cycles. But during that time the market rallied 21.24%. It only makes sense that the imbalance had to be corrected. And it was...QUICKLY!!!

If our current market slows down while the Fed is raising rates, that would be welcome by me. It would show rational behavior. If it doesn't, we need to be getting prepped and ready for the imbalance that could be created to be corrected."

Until we see resolution to this potential imbalance, I am considering posting every quarter to update everyone on how it is progressing.

For the record, the Fed starting hiking rates in this cycle on December 14th 2016. Since then they have hiked two more times, to bring the total tally to 3 rate hikes this cycle. And since these hikes have started the S&P 500 has rallied from 2,271.72 to 2,423.41 (as of the end of the quarter). This represents a gain of 6.67%.



S&P 500 12/14/2016—06/30/2017

Chart provided by BigCharts.com

This, by itself, is not a problem because we do have solid fundamentals to support the rally. HOWEVER, if we see this type of gain continue while the Fed hike rates AND engages in Quantitative Tightening, by letting the size of their balance sheet shrink, then we would have an imbalance that would need to be corrected.

Rest assured this will be tracked day in and day out. But as of right now, the imbalance remains a “potential imbalance” that could develop in the future.

Non-Financial Events occurring this quarter



Sergio Garcia won The Masters and his 1st Major.



Steph Curry and the Warriors won the NBA Title.



Roger Moore passed away.



GOP Lawmakers were attacked and shot while practicing for a charity baseball game.



Islamic Terrorists bombed an Ariana Grande concert in England.

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