MRP CAPITAL INVESTMENTS, LLC

3rd Quarter 2017 Client Newsletter

Capital Market Update

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As I mentioned in the last Update, there were a lot of things that could rattle the markets; Congressional stumbles, Presidential faux pas, and North Korean antics. And we got all of those, and more, but the market kept moving higher. All of those items did cause the markets to demonstrate increased volatility, but, nevertheless, the S&P 500's price change for the quarter was +3.96%. And this brought the year to date change to +12.53%.

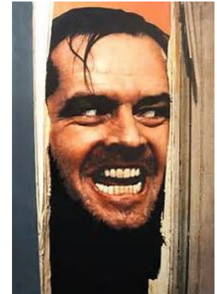
S&P 500 2017 Chart Supplied by BigCharts.com

Heading into Q4, we have all of those same issues on the table, but the markets continue to keep sending us the signal that they want to move higher. The main driver of this clear signal is earnings power. If earnings keep clicking along, I expect the market to keep following suit.

But, of course, with all of these risks at hand, we will remain vigilant and focused on the day to day gyrations, while keeping our long-term perspective in place.

Buffett's Got A Point

Ever since the February 2009 report entitled "The Beginning of the Bull…", where I called for the beginning of a mammoth Bull Market run, people have been calling me crazy. However after the market bottomed in March of 2009 at a low of 666.79, the S&P 500 has rallied almost 300%. Given the size of that rally, it appears my call wasn't crazy at all. And, to be frank, I think the market has more upside room to run.



It is my continued belief in this Bull Market that has many naysayers continuing to call me crazy. However, I have laid out in prior research pieces how market fundamentals , behavioral finance principles, and my models all point towards more for asset prices.

Given that markets need naysayers to feed off of to continue to move higher, I am happy that not everyone is onboard with my calls. You know the phrase that the market "climbs a wall of worry"? Well, I believe it is 100% true and, in fact, captures the gist of Behavioral Finance's underpinnings.

HOWEVER, I may have an ally. Warren Buffett was recently quoted in an interview making a great point about pessimism, specifically how it relates to the American economy. The article says that he noted that since Forbes created their list of Wealthiest Americans some 1,500 different people have been included and they all had one thing in common; **NOT ONE OF THEM HAS EVER BEEN A SHORT-SELLER!!!***

Buffet was also quoted as saying, "It has been 241 years since Thomas Jefferson wrote the Declaration of Independence. Being short America has been a loser's game. I predict to you it will continue to be a loser's game."

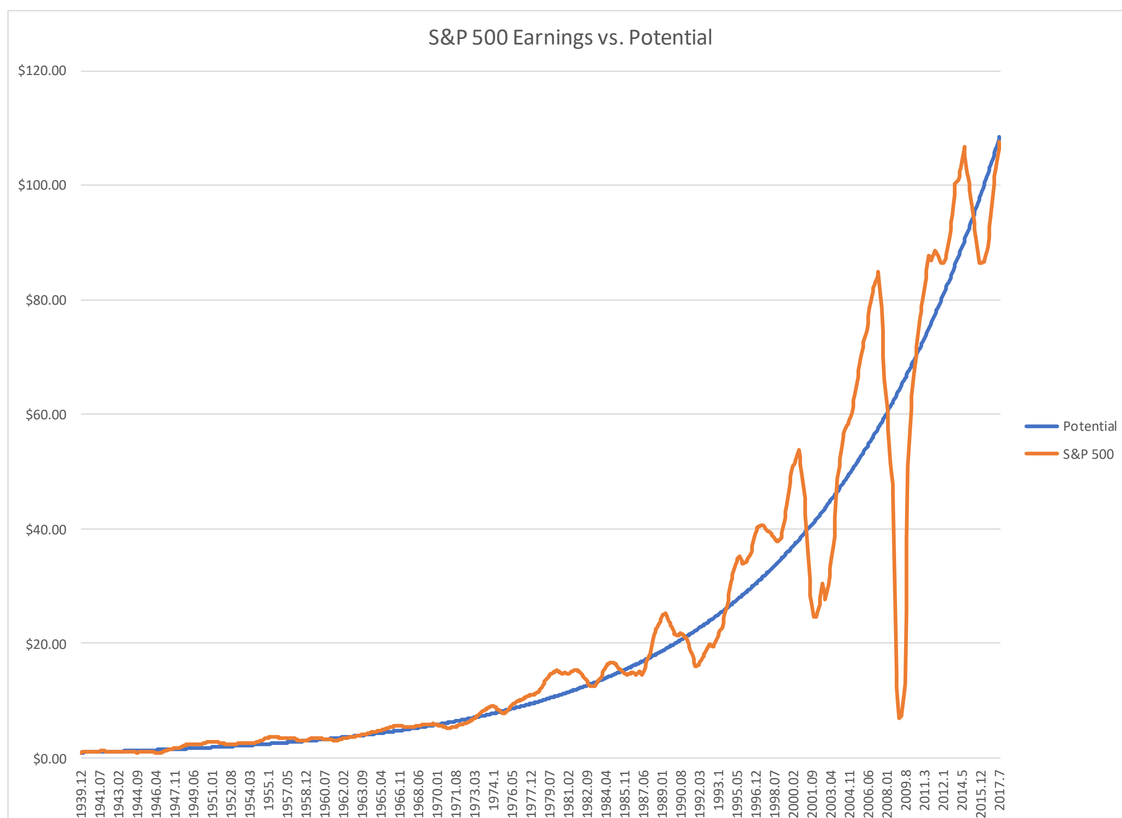
As always, time will tell if we are correct, but things are sure looking good over the horizon.

*A short-seller is someone who is betting the price of stocks will decline.

The Market Driver

As was mentioned in the opening article, the key to this market is earnings. In order to get our arms around how much upside is left in the market, we must understand how much higher earnings can go. With this in mind, let's turn our attention to earnings of the S&P 500 companies.

Below you will find a chart from the MRPCI database that appears in a lot of my research reports. Avid readers of my work will know exactly what it is. It is a chart of the actual reported earnings of S&P 500 companies versus a metric I have derived called "Potential Earnings" of S&P 500 companies.



You will note the actual earnings vary up and down around the "potential" earnings line with major troughs setting the stage for market rallies and upside peaks closely correspond with stock market tops, like the earnings peak in June 2007 before the 2008 earnings and stock market collapse.

But where it gets really interesting is that if you note that major stock market rallies are driven by earnings that go **way above** "potential." I've already pointed out the 2007 earnings peak. For point of reference, earnings peaked at that time 32.04% above potential. Other market peaks and their corresponding earnings peaks include the **2000** tech bubble, the **1984** recession, and the **1974** stagflation era. All in all, since the 1970s, we've seen 7 major earning's peaks and those peaks have averaged 22.04% above "potential" earnings. The lowest peak above potential was 14.26% (the 1984 peak) and the largest peak above potential was 32.04% (the 2007 peak).

1974

1984

2000

Wrapping all that earnings speak into a nice bow, I think it can be said that the market can go higher because there is historical precedent for earnings to go much higher. Speaking in terms of averages, I'd expected that earnings could rise another 22% from these levels. And I think we should put a range on our expectations for earnings growth to be somewhere between 14% to 32%. Of course, these expectations are driven simply by the historical data that was mentioned in the previous paragraph.

The next logical question is; what could send earnings higher? Frankly, I think these answers are quite evident. For starters, the de-regulation that the Trump Administration has embarked upon should provide a boost to bottom lines of corporate entities. In fact, we should see this boost coming through to investors in the coming quarters. After that, we COULD see tax reform and a reduction in the corporate tax rate providing the next boost. And the coup de gras for earnings COULD be the Infrastructure and Spending plan that is currently being discussed in Washington.

Of course, these are just United States centric issues that could provide a boost to profits. There are also a host of other international issue that could, and should, boost international profits. In fact, a lot of these items were discussed in the 7/25/2017 research report entitled "A Brave New World."

All in all, there are a lot of factors that are currently benefitting the corporate world and their profit margins. And moving into the future there are a lot of nice things, potentially, on the horizon. These things have the chance to boost earnings significantly. History does, in fact, show that earnings are the primary driver of the market. However, when coupled with a rising sense of optimism, the valuation investors put on these earnings can also rise. This can set the stage for a very powerful Bull Market run. Time will well if that happens and, rest assured, we will be watching very closely to see if these things materialize.

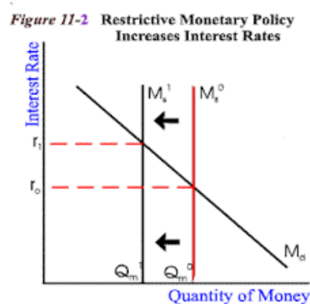
Imbalance Update

The bulk of this newsletter has an optimistic tone built on the foundation and a belief that earnings will be good. However, in the last two newsletters, we've talked about a potential imbalance that is building in the markets. And that potential imbalance is when the market moves significantly higher, while the Fed is trying to slow the economy down by raising rates.

To be brief, historical precedent shows markets that rally right up until the Fed raises rates and then they tread water. The only significant divergence in that trend came in the mid to late 80's. In that Fed tightening cycle, the market kept running right up until October 1987. I'm sure everyone is familiar with that timeframe and its colorful moniker, Black Monday. The market earned that nickname when it fell over 25% in one day and this, effectively, corrected the imbalance overnight. After that, the markets continued their upward march right through the 90s.

Obviously, we want to avoid being caught in a major pullback, even if the market moves higher immediately afterwards. This is why I track the data so closely and try to identify any market abnormalities before they become a problem. This particular one caught my eye and I think it is worth tracking and keeping everyone abreast of its status.

The key data points to track begin when the Fed started raising rates, in this cycle, in December of 2016. Thus far, they have hiked short-term rates 3 times and the current Fed Funds rate stands at 1.00%. However in addition to raising the Fed Funds rate, the Federal Reserve Bank has also embarked on "Quantitative Tightening" by allowing the longer dated bonds on their $4.5 trillion balance sheet to mature rather than reinvesting the proceeds. This is expected to raise the level of interest rates on the long end of the yield curve.



What is Monetary Policy??

It is the process by which the central bank or monetary authority of a country regulates

- The supply of money
- Availability of money and
- Cost of money or rate of interest

The Fed has the idea that these actions, in concert, will "normalize" markets after their extraordinary intervention during the 2008 Financial Crisis.

When the Fed raised rates in December of 2016, the S&P 500 was at 2,271.72. At the end of the 3rd quarter the S&P 500 was 2,519.36. That equates to a price change of 10.9%. Given that markets usually tread water during an interest rate hiking cycle, I feel the door is open to a correction, at least, equal to the size of the imbalance. However, I do not feel this correction would be a death blow to the long-term Bull Market. Rather, IF it were to occur, it could prove to be a healthy pullback that corrects some pricing froth.

S&P 500 from 12/14/2016-09/29/2017 (the length of this tightening cycle)

The reason I feel this potential event could prove to be a short-term correction is that there are significant counterbalances that off-set the pull of this imbalance. The regulatory reform embarked on by the Trump Administration does seem to be providing a boost to economic activity. Furthermore, the expected tax cuts could help offset the drag of higher interest rates.

But, nevertheless, the rise of the market during this time of interest rate "normalization" has become something we cannot ignore. In fact, it is precisely this type of typical market sell-off activity, which this market has been lacking, that compelled me to originally post the chart, which appears on the next page, in the 1st Quarter 2017 Client Newsletter.

This chart shows the annual returns of the S&P 500 since 1980. These annual returns, excluding dividends, are represented by the orange columns. However, this chart also includes the largest peak to trough draw downs of the S&P 500 for each year. These pullbacks are represented by the green circles. For example, look at the first column of the chart. The orange column shows that in 1980 the market ended up rallying 26% for the year. BUT, at one point during the year, it pulled back 17%.

And, as you can see, the market has significant pullbacks almost EVERY SINGLE YEAR! In 2003, the market was up 26% but at one point was down 14%. In 2009, it ended up showing a gain of 23% but had a sell off of 28% too.

The point of all of this is to highlight that there are a lot of great things pushing this market higher. But as the market goes higher and higher, the chance of a pullback grows. This odd occurrence of a rallying market in the face of rising interest rates does set up a reason for why a pullback might occur. IF a pullback where to occur, without a change in the fundamental landscape, that sell off would likely be followed by a resumption of the Bull Market. Which, as you can see from the accompanying chart, is fairly standard operating procedure for the markets.

Rest assured, this phenomena is being watched carefully and portfolios are being managed with this information in mind. We will be striving to have portfolios positioned to handle the market volatility that a pullback would bring AND we hope to be ready to profit from the resumption of the Bull Market, as well.

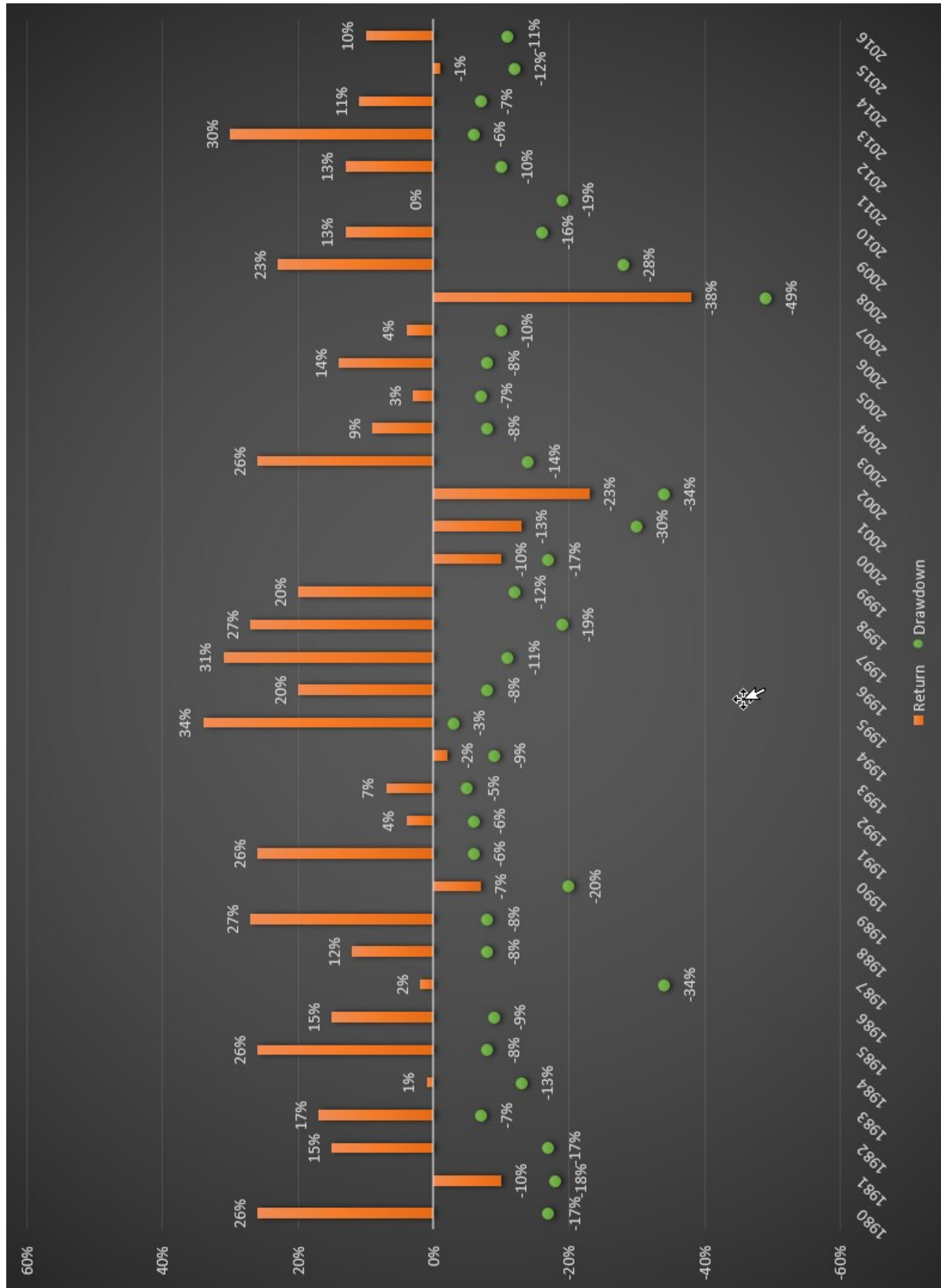


Chart was provided by Alesco Advisors and was derived from data from Factset, Standard and Poor's, and JP Morgan Asset Management. Returns are price only. Inter-year drops are largest market drops from peak to trough.

Non-Financial Events occurring this quarter

North Korea performed nuclear bomb tests and several long-range missile tests.

Multiple hurricanes ripped across the Southern U.S. and the Caribbean Islands.

A dramatic eclipse could be seen across many States.

Roger Federer won Wimbledon to claim his 19th tennis major championship.

Floyd Mayweather defeated Connor MacGregor in a dramatic Martial Artist meets Boxer fight.

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