MRP CAPITAL INVESTMENTS, LLC

1st Quarter 2018 Client Newsletter

Capital Market Update

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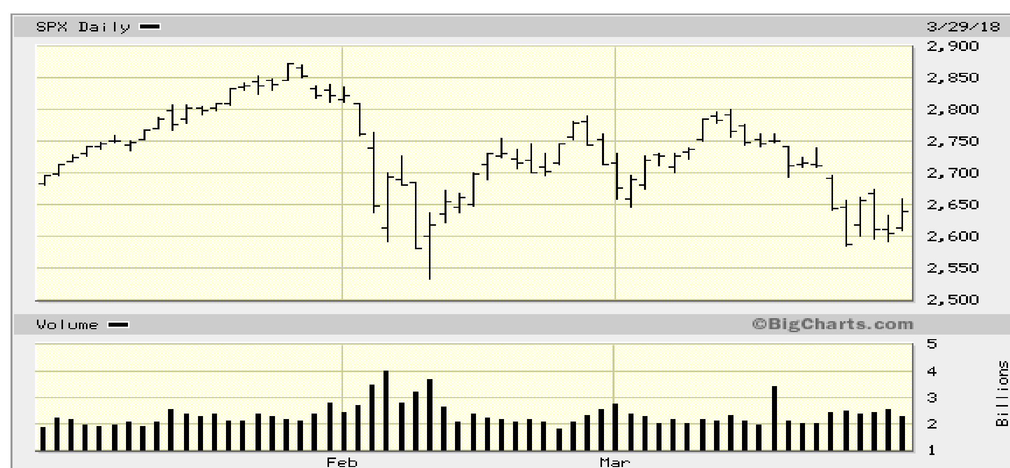
Finally this market pulled back. After a record setting run to the upside with almost no downside volatility post-election 2016, this market had a negative quarter. For the record, the S&P 500 price change was –1.22% for the quarter. This is hardly a catastrophe, but after a rip roaring run, capped by a euphoric January, the sell off did fray a lot of nerves.



S&P 500 2018 Chart Supplied by BigCharts.com

But that was to be expected. In fact, on February 22 I posted online (www.mrpci.com in the Capital Markets Notes section) a brief snippet entitled, "The Grind." The gist of that post was that the market should show lots of volatility until a clear signal has been given that earnings can withstand higher rates.

Just about the time everyone gets this newsletter, we should be starting earnings season. This will give us that signal as to whether earnings can handle higher rates or not. However, we also have two more curveballs to handle this year; Trade War rhetoric and mid-term elections in November.

We could get that clear signal that earnings are, and will be, good, but we might still have to endure highly volatile markets until the trade issues and elections are sorted out.

Imbalance Update

Precisely one year ago, I wrote an article in the Q1 2017 Newsletter entitled "A Great Chart!". In that article, I discussed an imbalance that was building in the market and the need for it to be corrected. And in every single newsletter since then, I've written an article updating everyone on where we were in regards to the size of this imbalance and reminded everyone that this imbalance would need to be resolved at some point. Given that in February we saw the market pullback 12% in rapid fashion, **I thought it would be a good time to reprint that first article in its entirety as a reminder that this volatility wasn't unexpected and we should be able to handle it in due course**. Here it is:

Great Chart!! (originally written on 3/31/2017)

Running with the comment in the last article that "the market gets ahead of itself from time to time and that is why we see pull backs and short-term sell offs", I have included the chart on the next page. {Page 4 of this reprinted article}

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.

I bring this up because we've been running hot since the election; essentially straight up. This WILL NOT continue! We will see a pullback. It might be 5%. It might be 10%. It might be 20%. But that does not, necessarily, mean the Bull Market is over.

In fact, 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 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.

What actually will happen, we don't know. But we will strive to stay a step ahead of the game and we will be armed with the knowledge that this chart captures. And that is, it is normal for markets, even Bull Markets, to have significant pullbacks every year. Hopefully, this will allow us to keep our heads and profit from this almost certain event.

—Please note the chart on the next page—

I post this article again because I think it is vital to understand that market pullbacks are a normal state of a well functioning market. 2017 was an anomaly. That year the S&P 500, essentially, went straight up with very little volatility. This makes for great fun while that is happening, but it also makes it easy for the market to get ahead of itself. Which I believe it did in January 2018. In January alone, the price change on the S&P 500 was over 6%. If you annualize that number, that would equate to over 100% as the 6% gains would keep compounding upon one another until the market would have doubled in one year. Needless to say, that would have been WAY too much given that fact that earnings are expected to grow by about 17% this year.

So, we had a pullback. Given what I just said, I hope everyone sees that was a good thing and makes for a healthier market that is set up for long-term gains. In fact, earnings are expected to be good. GDP looks healthy. And the Fed raising rates adds credence to those statements because they wouldn't be doing that if they didn't think the economy was healthy enough to withstand it.

Of course, the great run in 2017 was fun!!! Now we have a more normal market, which, as many of us have seen over the years, can still produce some pretty fantastic profits for investors who can tolerate the volatility that is inherent in the market.

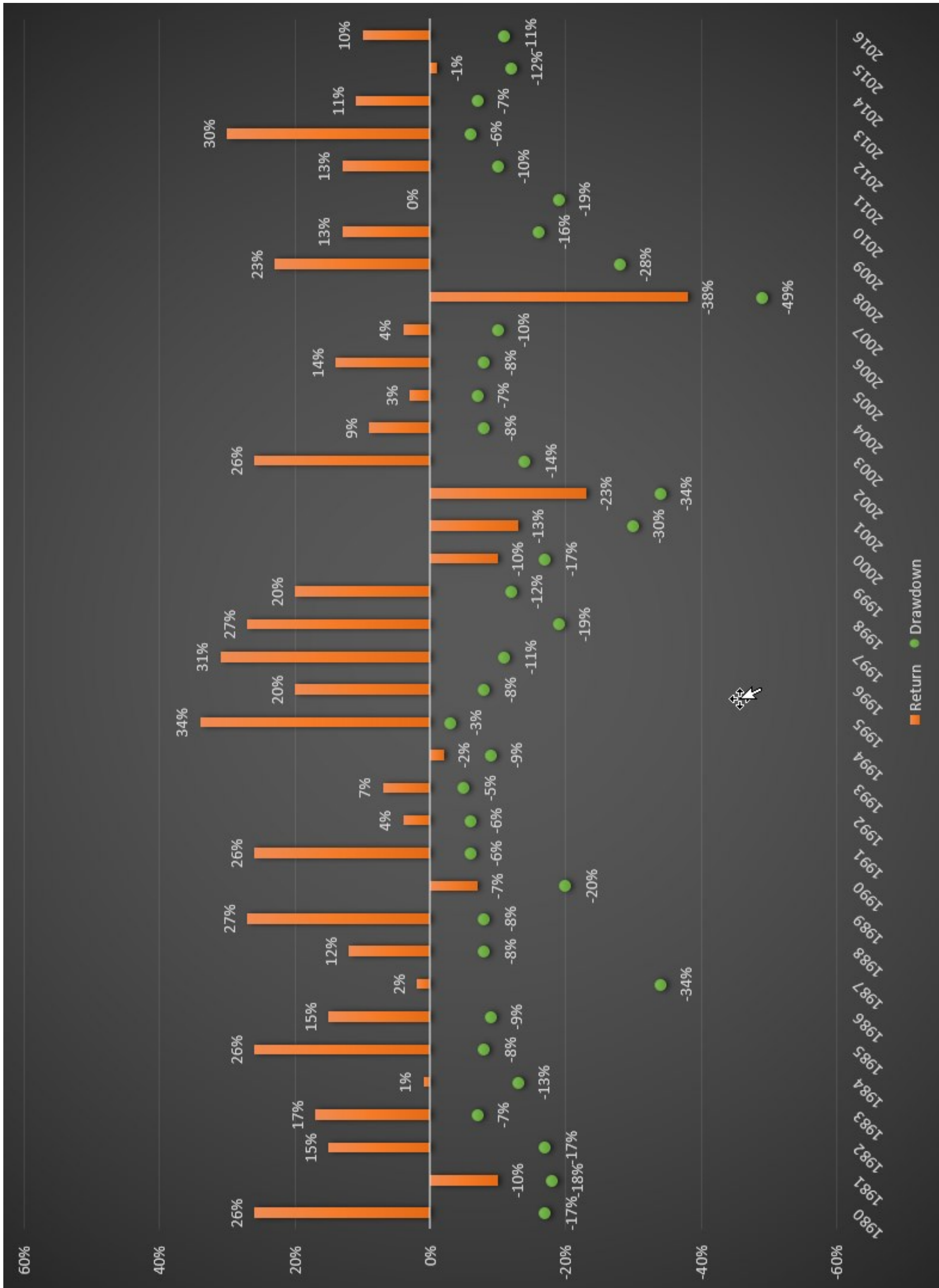


Chart was provided by Alesco Advisors and was derived from data from Factset, Standard and Poor's, and JP Morgan Asset Management. Returns are price only. Inter-year drops are largest market drops from peak to trough.

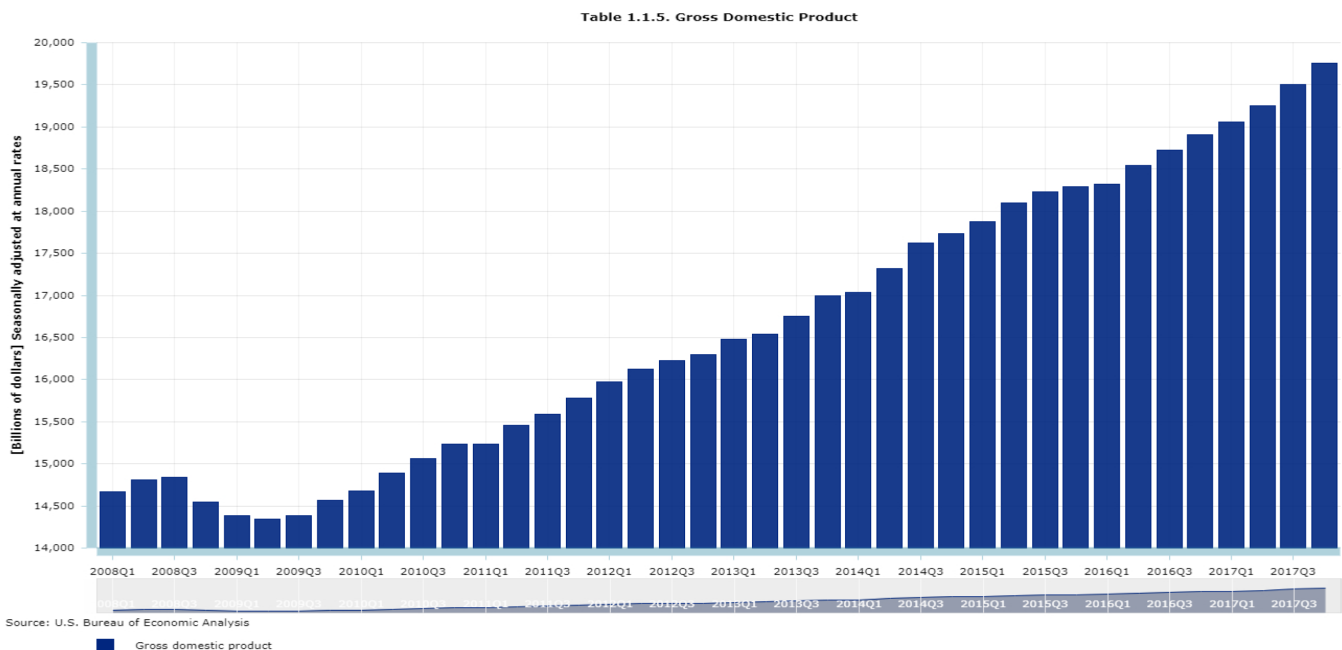
Tug of War

As mentioned in the opening article, I believe we are in a phase of the market that I call "The Grind." But really this Grind is more of a Tug of War. The main participants in this game of Tug of War are: earnings, interest rates, and geo-political entities. The result will be a volatile market that will be running to the upside one day and falling the next, depending on who has the upper hand in the match.

In the opening article, I talked about earnings versus interest rates. The groundwork for the booming earnings we've seen over the last several quarters has been this administration's business friendly policies. They initially cut the red tape that was tying up businesses by lowering regulation requirements. The market LOVED this and the path was set for gains. Their next move was to cut taxes on businesses. Again, the market LOVED this! This set the stage for the next leg of market gains in late 2017 and early 2018 as the impact of this policy change will result in higher earnings for most U.S.-based businesses.

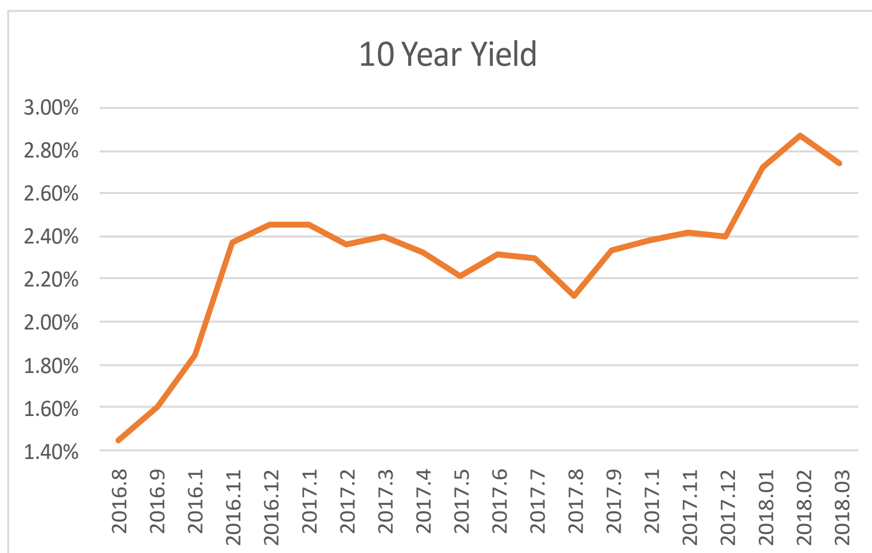
However, there is a downfall to policies that continually push business profits higher and higher. And that is the simple fact that the economy no longer needs interest rates at historically low levels. Remember, rates were taken to such low levels to save the economy from the collapse it suffered in the 2008 time frame.

For visual proof that the economy no longer needs rates at emergency levels, simply check out the chart below, which was provided by the Bureau of Economic Analysis, that shows quarterly GDP for the US from 2008-2017.



As you can see from the chart, GDP has grown by about $5 TRILLION since its trough in early 2009. And now we have corporate earnings set to show another year of very large gains. This will, undoubtedly result in further GDP gains.

Given this, it only makes sense that interest rates no longer need to be at rock bottom levels. So, of course, they are not. Below you will see a chart from the MRPCI data base showing the U.S. 10 year Treasury Yield from its short-term low in 2016 through 1st quarter 2018. As you can see, the rate has almost doubled over that time frame.



And that is one of the rounds of Tug of War going on at the moment. Market participants are excited about the rising profits of U.S. companies, but they are worried about the impact rising rates could have on future profits. Until a clear answer is provided, the markets should gyrate up and down. This can make investors worried about what will ultimately happen and can cause concern and confusion.

The other players in this Tug of War are major geo-political entities. Currently in focus are the United States, led by President Trump and Economic Advisor Peter Navarro, and China, led by President Xi.

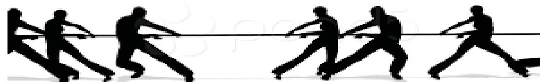
Over the past several years, China has been one of the main beneficiaries of the world embracing Globalism. As I highlighted in the July 2017 report "A Brave New World", their economy has grown to one of the biggest in the world and they've built this economy on the backs of their manufacturing sector by exporting their goods to the rest of the World.

Given the current U.S. administrations goal of creating more jobs for U.S. workers and decreasing the trade deficits that the United States has built through out the world, this places them squarely at odds with China's modus operandi.

One of the things that the United States takes issue with are the standard operating procedures of the Chinese in regards to their business operations. For example if you download the 328 page document which details all of the tariffs China puts on goods they import, you will see taxes ranging from 74% to 0%. Some of the higher taxed items include: cars/automobiles 50%+, tobacco products 50-65%, alcohol 40-65%, sugar 70%, food (in general) 25-30%, and about 25% for most fabrics. Some products have no added taxes, like many ores and basic materials. But on average (by simply eyeballing it), I'd say the average tax/tariff is north of 15%.

Meanwhile, according to the Federation of International Trade, the United States has among the lowest tariff rates in the world with an average rate of 3%.

These facts serve as the foundation for the latest game of Tug of War that has broken out. The United States is threatening to add tariffs on some of the goods it imports, specifically from China, in an effort to even the playing field for U.S. based business that are forced to compete with Chinese companies.



China, in turn, has threatened to up its tariffs.

Of course after that, the U.S. has upped its rhetoric regarding adding even more tariffs.

And the Tug of War goes back and forth, with the markets becoming ever more fearful of an all out Trade War developing.

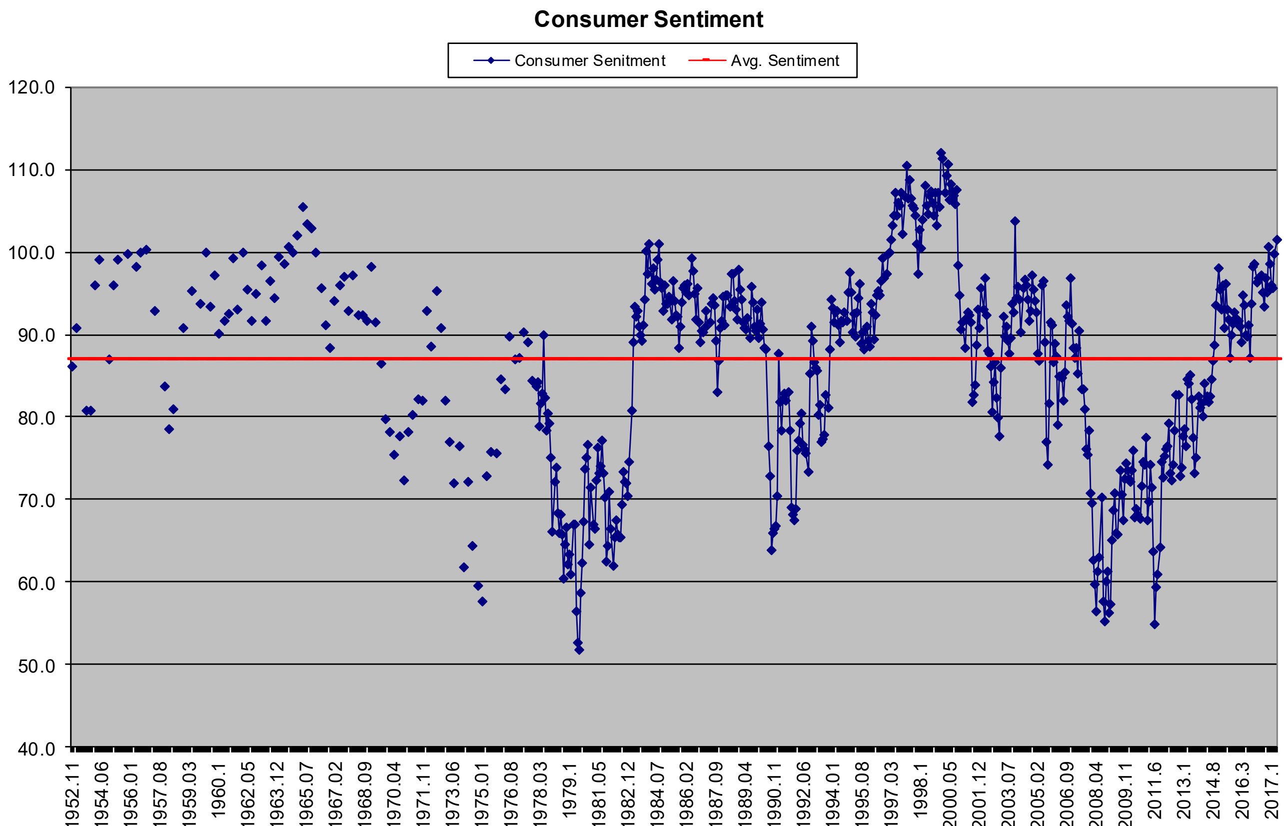
Time will tell what ultimately happens, but for now we are stuck in the middle of two economic titans playing a negotiating game. Both of them with the goal of helping the citizens of their country, first and foremost. And this will make the markets quite jumpy until an agreement (and certainty) is achieved.

In the meantime, we will remain disciplined in our approach and stick with best practices while putting our best research foot forward to stay abreast of these situations in light of each and every client's long-term goals and how they impact portfolio construction.

Disconnect

It has become obvious to me that we have a massive disconnect between the mood of the people and the reporting of many news sources. I am unsure what the exact reason for that is, but I do know that turning on the news shows creates a feeling of uneasiness to the point that is seems like the very world around us is just about to crumble. But when you look at quantitative data about people's mood and/or the economy, things look pretty amazing. Hence, my use of the term "disconnect."

Below is the data from the University of Michigan Consumer Sentiment Index. The way this index works; the higher the reported number, the more optimistic U.S. citizens feel. You will note that in the midst of the 1970s stagflation this index gave us a reading very near 50, which was an historic low and reveals the extreme economic pessimism that prevailed at that time. You will also note that in the boom times of the late 1990s, we saw readings in excess of 110, these were all-time highs and demonstrate economic euphoria.



Furthermore, after the 2008 financial crisis the mood of U.S. citizens soured and approached the 1970s lows. Since then we have recovered and our current reading of 101.4 puts us back to the same level of optimism that was demonstrated in early 1964, 1984, and 1997.

For reference, over the next 4 years the S&P 500 appreciated significantly in every one of those instances.

From 1964-1967, the S&P 500 rose 28%.

From 1984-1987, the S&P 500 rose 46.2%.

From 1997-2000, the S&P 500 rose 79.1%.

However, that is not to say that there wasn't volatility during those time frames. The biggest peak to trough drawdowns, based off month ending values, during those time frames were:

From 1/1966-10/1966, the S&P 500 fell 16.3%

From 8/1987-12/1987, the S&P 500 fell 26.84%

From 07/2000-12/2000, the S&P 500 fell 9.6%.

In fact, the 1980s data includes "Black Monday". Which, as you'll remember, was when the market fell over 25% in one single day. But, nevertheless, during that entire 4 year time frame, the S&P 500 appreciated over 45%...and that INCLUDES the 25%+ single day drop.

Why do I mention this? Because the mood of the U.S. citizen right now closely resembles each and every one of those time frames. Each time, including right now, the sentiment of the U.S. citizens was very close to an all-time high. And every time, over the next 4 years, significant gains were made in the stock market. However, the market didn't move straight up. In fact, at times there was some super charged volatility.

I hope this puts into context that what we have been going through this quarter is not abnormal at all. Markets move on fundamentals. Fundamentals have been good and improving, so over the last 12-18 months the markets have moved substantially higher. There are some questions out there right now (interest rates, trade negotiations, geo-political events) and these events are getting the attention they deserve, which is causing the markets to sell off and gyrate up and down. This is normal and is what well functioning markets do as they attempt to price in and/or discount potential future market movements.

What will ultimately happen this time, no one knows. But earnings expectations are promising, the job market is strong, wages are growing, and many geo-political negotiations are underway in regards to the question marks that have popped up. These facts combined with the historical data mentioned above puts us in a pretty good place relative to the markets.

Non-Financial Events occurring this quarter

The Winter Olympics took place in South Korea and the US Men's Curling team took gold for the first time ever.

SpaceX completed 6 launces in the 1st Quarter of 2018.

February 14th a high school student in Parkland, Florida killed 17 of his class-mates.

March 15th Stephen Hawking passed away.

February 21st Billy Graham passed away.

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