MRP CAPITAL INVESTMENTS, LLC

2nd Quarter 2019 Client Newsletter

Capital Market Update

Inside this report:

Over time, the stock market has posted returns in excess of most other asset classes but you have to endure uncertainty. Investors, naturally, want to get compensated for that bumpy ride. This year has been a perfect example of getting paid for staying invested during the volatile times. Year to date the price change of the S&P 500 is 17.35%. If you annualize those numbers, you get close to a 40% return on your money for this calendar year alone.

Historically speaking, this has been the best start to a year in the S&P 500 since 1997 and it was the best June in the Dow since 1938. And, frankly, that is all well and good, but the key to realizing those returns is making it through the tough times, like we saw in May when the S&P fell 6.6% in that month alone.

S&P 500 2019 Chart Supplied by BigCharts.com

As we've been talking about for the past several newsletters, a lot of it comes down to earnings. If the companies can keep making big money, the market will have the fundamentals to support higher valuations. However if earnings begin to falter, the market could see some downside moves. With that in mind, a lot of our focus will be on earnings announcements and earnings forecasts from companies.

Turning Point Update

In the last newsletter, we discussed the market being at a turning point. The issues behind that turning point are:

-a market that could be driven by euphoria should we clear out all the hurdles holding back a full blown bull market (that is mainly a trade deal with China at this point)

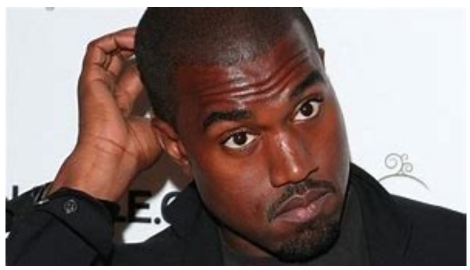
and/or

-Market fundamentals having the ability to handle further upside moves in the stock market.

Honestly, this market feels like it wants to rally. We seem to be getting data that has very divergent consequences regarding the market, but, regardless, the market seems to take that news positively.

For example, on June 7th the employment report came out. The numbers were actually very disappointing as the actual number of jobs created were 100,000 less than was expected. A rational observer of the market might take that piece of news and deduce that the economy might not be growing as fast as people are expecting as employers hired fewer people than were expected to be hired. HOWEVER, the Dow rallied that day by 215 points as investors thought that miss in employment data would prompt an interest rate cut by the Fed.

So, this market took the negative news of an employment miss as POSITIVE because interest rates might go lower.



And that is what I am getting at with this idea of euphoria taking over the market. To be frank, most every Bull Market in the history of markets has come to an end because of "irrational exuberance" on the part of investors. But what is funny about this phenomena is that investors know this fact very well. However, they get caught up in the euphoria time and time again.

One of the keys to keep our eyes on is how far this euphoria (if it, indeed, overtakes the minds of investors) takes us to the upside. Alan Greenspan, the former Fed Chair, coined this term in 1996, as he thought investors in 1996 were acting too enthusiastically about the market and market conditions. But the S&P 500 rallied for about four more years and about another 150% higher after he made his statement. And that is the power of this investor euphoria; it can completely and utterly overwhelm market fundamentals for a period of time.

Needless to say, we have our eyes all over the key metrics that can help us gauge where we are in this rational versus euphoric tug of war.

Interest Rates

In the last article we discussed a few items, but mainly the implications that a trade deal could have on market prices. However, we also briefly touched on interest rates. With the Fed meeting coming up in late July, we think that all eyes will focus on Fed Chair Powell and what he will do during that meeting. We are actually of the mindset that Powell's tone, as well as his actual decision, could be a significant driver of the markets moving forward.

We are sure you all remember his blunders in the 4th quarter of 2018, which sent the market tanking. And for inexperienced market watchers, they might not understand how significant the Fed Chair's comments are. But investors take their clues from anywhere they can get them and the Fed is a big player in the market because they set short-term interest rates and can influence long-term rates, as well.

Of course, the bond market is directly impacted by interest rates. The higher rates move, the lower prices of currently issued bonds will go because newer bonds will be paying higher rates of interest. And the inverse is true too. However, the prices of every investable asset class are impacted as well.

All things being equal, real estate prices will move lower too as interest rates are increased. Why? There are two reasons. #1—the cost to borrow to purchase real estate increases as rates move higher, so the amount buyers can afford drops because the cost to carry the loan increases. #2—The attractiveness of substitute investments, mainly fixed income investments, increase as rates rise.

And even stock prices are impacted by interest rates. Most every stock valuation model has some part of the formula that includes current interest rates. In general, the lower rates are, the more attractive stocks are and vice versa.

The stock Beta Relative to a benchmark

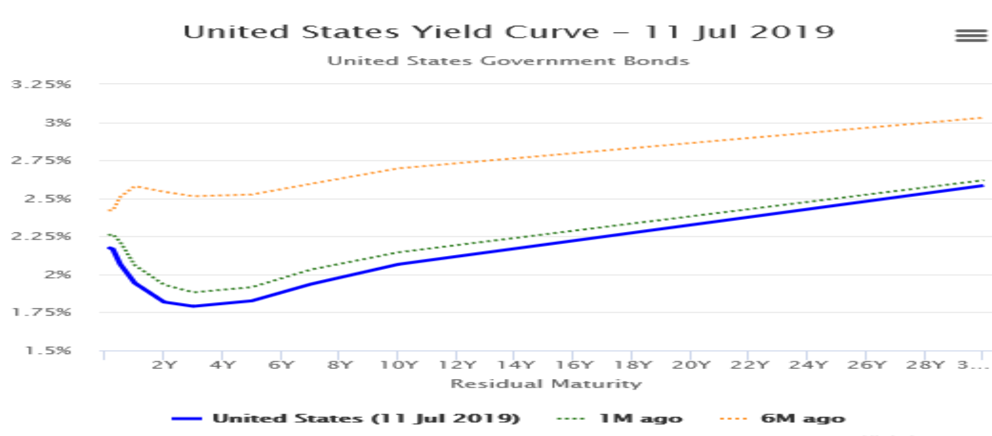
$$r = \beta(r_m - r_f) + r_f)$$

The Risk-Free Rate

The Market Risk Premium

Given all this, you can see how big of a deal Jerome Powell's comments and actions are to the markets. We would hazard a guess that by the time everyone gets this newsletter in the mail, seemingly the only thing people will be talking about on the financial news networks will be interest rates. In fact, as I type this, the market has priced in a 100% chance of a 25 basis point cut in the Fed Funds rate by Powell at the July FOMC meeting.

To be frank, with a 100% probability of that happening being priced in the only market moving event would be if he DOESN'T cut rates at that meeting.



The chart above is the current yield curve and we think it provides further evidence of the market's confidence that Powell will cut rates, as long rates have already come down prior to the Fed actually making a move regarding short term rates. Again, there is a lot of confidence in this prediction that rates are going lower. Let's hope it comes to fruition. Otherwise, a lot of trades need to be unwound, which will increase the volatility in the market.

Non-Financial Events occurring this quarter

April 15th, Notre Dame catches fire

Women's World Cup begins June 7th

June 9th Hong Kong protests erupt due to the China Extradition bill

June 13th multiple oil tankers attacked near the Straits of Hormuz

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