MRP CAPITAL INVESTMENTS, LLC

Liquidity

2/17/2020

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Introduction

By their very nature, long-term economic trends take time to develop and play out. The last major research piece we put out was in late Spring of 2018. In that piece entitled, "Final Stages of a Bull", we discussed how our models were leading us to believe that there were fundamental reasons for the market to move higher.

Obviously, since then, time has past and with it the fundamentals have changed.

It is with those changing fundamentals and in keeping with our slogan, that we dive into this research report.

"To be at peace with your position in the Capital Markets, you must put in constant and diligent effort to comprehend what makes the markets move"

Current Economic Status

As we noted in the 3rd quarter 2019 Newsletter, we feel this is one of the most hated Bull Markets in history. We feel that way for three main reasons:

1) How the market foundation was built
2) The economy's reliance on debt financing
3) Political tension

As we discussed in that newsletter, the foundation of this Bull Market run is built upon Ben Bernanke's bailout actions taken during the 2008 Financial Crisis. Those actions can be collectively called "Quantitative Easing." The Fed (and other central banks across the globe) flooded the market with liquidity by issuing debt and, in fact, buying/assuming the debt of major financial institutions deemed to be too important to the world's financial system to be allowed to fail. And, to be frank, this response was a "text book" response for a global economic crisis. Ben Bernanke (and his cohorts) did EXACTLY what they were taught to do to fight off a 1930s Great Depression type of an event.

These maneuvers and the market's response to them showed all of us just how important liquidity is in debt based economies, which is exactly what we have in almost all of the countries that make up our global economic system. Those responses were for the markets to head higher every time the Central Banks jumped into "save the market." In fact, I think the market came to depend on continued Central Bank assistance as its rationale for moving ever higher and higher.

When you have an economy that is saddled with debt and dependent on global Central Bank cooperation and you inject uncertainty regarding that cooperation, things can get tense. I believe the Brits voting in favor of leaving the E.U. cast a shadow of doubt regarding the confidence of continued global Central Bank cooperation. And when you add in the election of Donald Trump as President of the United States of America (the world's largest economy) and his "America First" campaign slogan, the shadow of doubt gets bigger.

It is our contention that these three things, a foundation of Central Bank intervention, a global debt-based economic system, and political tension, have made investors uneasy about this market.

Nevertheless, as this is being typed, from its low on March 6th of 2009, the S&P 500 price change has been about 406.99%. Which equates to approximate average annual gain of 15.90% as the market went from 666.70 to 3380.16 over those 11 years.

S&P 500 March 2009-February 14th 2020

Chart provided by BigCharts.com

No matter how you slice those numbers, they are pretty fantastic. But when compared to other Bull Markets (or Boom Phases, as we label them), they appear a bit lackluster. Remember from our previous writings that the average Boom phase lasts 18 years and averages 1,014% in cumulative price change. Given this, it would appear our current market might have some gas left in the tank.

However, two things give us a reason to consider that our current Boom Phase could be below average. One we've already written about in the aforementioned "Final Stages of a Bull" report. Below is a cut and paste verbatim explanation of why we were thinking our current Boom could be below average.

To keep the length of this report manageable, I will only be looking at 3 past Booms and comparing them to our current one. Those 3 prior Boom Phases are the Roaring 20, the Post WWII expansion, and the 80/90s boom.

The Roaring 20s was the quickest of these 3 booms and lasted from August of 1921 through September of 1929. That timeframe saw Government Debt decline by 29%, GDP increase by 17%, CPI decline by 3.8%, and the 10 year yield fall by 1.25%. Meanwhile, the S&P 500 shot up 385% with earnings rising 237% and the P/E ratio expanding by 44%.

To be frank, this looks like one of the healthiest Boom Phases I've ever seen. It appears to have been led by a decline in Government Debt and rise in GDP and earnings.

Furthermore, it is vital to understand that my definition of a Boom doesn't move lockstep with the Bureau of Economic Analysis' definition of an expansion. In fact, the Boom of the 20s lasted through 3 recessions that averaged 11 months each. You see, the Boom phase is more powerful than any singular Economic Cycle. It is the shifting of an entire community's mind frame.

The next one we will look at is the Post-World War II Boom. In this one, The S&P 500 rose by 1,399% over a 30 year period. This phase endured 6 recessions that averaged 10 months each. GDP grew by 882%, CPI declined by 6.5%, the 10 year rose by 3.82%, while earnings grew 529% and the P/E expanded by 138%.

HOWEVER, the key to this expansion was debt. Government debt rose by 493%, but Consumer Debt rose by 2,484%!!!!!! You see, this was the timeframe that the credit card was invented and the world found out how powerful buying things with borrowed money could be.

During the 80s and 90s Boom, the S&P 500 grew by 1,253% with earnings growing 286% and the P/E expanding by 251%. CPI declined by 5.5% as the stagflation of the 70s was broken, which led to the 10 year yield falling 7.9%. Furthermore, Consumer Debt grew by 343%, Government Debt grew by 400% and GDP showed a 209% gain.

This Boom followed through on the idea that debt was a good way to get growth and was bolstered by falling interest rates. However, this was the first Boom, that we are discussing, that saw the market being driven higher in, almost, equal amounts by rising earnings and rising P/E ratios. In the other Booms, earnings growth outpaced P/E expansion by about 5 to 1.

Our current Boom has seen earnings grow by 1,509% and the P/E ratio decline by 82%. However these numbers are a bit skewed because of the MASSIVE banking write down in 2008, which had the effect of drastically reducing "as reported" earnings. Nevertheless, from the bottom the S&P 500 has risen by over 300% in this Boom.

Also during this timeframe, CPI has risen by 2% and the 10 year yield has risen 0.22%. Debt has continued its upward trend as Consumer Debt has increased by 46% and Government Debt has, essentially doubled, with its 96% gain. But GDP has shown some decent gains with its 33% increase.

*In all honesty, **our current Boom Phase appears to be the weakest on record**. We have solid market growth, but it appears to be built on the back on massive Government deficit spending with little GDP growth to coincide.*

The one positive sign for continued growth is that the numbers show that Consumers do have more room to borrow and if GDP can ramp up, then we might get to see more out of this expansion. Nevertheless, I do expect below average results from this Boom due to the apparent constraints on available room for increased Government Spending.

And, yes, that was written about a year and a half ago. So some of those numbers have changed, but we still feel the same way about the gist of the point. Government Spending appears to have some constraints upon its ability to further ramp up this market. At least on a relative basis when compared to past Boom Phases.

For the second point, regarding why we think we might end up with a below average Boom Phase, we will reference a series of events that occurred in late 2018.

The first we will reference took place on October 3rd, which we referenced in our Q4 2018 newsletter to clients. This was when Fed Chair Powell was interviewed by Judy Woodruff and said the Fed was "a long way from neutral" in response to a question regarding how many more interest rate hikes would be required to get the U.S. economy from an accommodative stance to a neutral stance.

The market hated this comment and his comments about the Fed shrinking its balance sheet on December 4th. These clumsily worded comments and answers ended up making the last quarter of 2018 one of the worst 4th quarters in market history due to our Fed Chair's staunch and adamant stance regarding tightening monetary policy.

Frankly, all of that is well and good. The Fed Chair wants to raise rates from emergency low levels (effectively zero) after the economy and markets recovered from the 2008 Financial Crisis. That makes total and complete sense. The economy was growing, employment was high, and wages were going up. All of that gives the impression that we had, indeed, recovered, the next text book step is to "normalize" interest rates.

But when interest rates were raised and with the appearance of "normal" interest rates on the horizon, markets fell apart. And then Fed Chair Powell switched from a tightening stance to an easing stance in February of 2019. That is the mystifying part of all of it.

Why would the Fed switch from tightening to easing so quickly? And, frankly, that is the trillion dollar question. But, regardless of the answer, I think we found out two things for certain. At no point in the foreseeable future will the Fed be tightening monetary policy and/or shrinking its balance sheet.

It appears that our entire global economic system is too fragile to handle “normal” interest rates and must run under “emergency” measures in order to continue to grow.

And with the idea of reducing the balance sheet and/or reducing the speed of future borrowing/spending by raising rates being off the table, the only way to “normalize” the economy is through growth.

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To put the kind of growth we are in need of in perspective, lets simply look at GDP from before the crisis to what our current GDP is now and compare that to the debt levels of the same time periods.

In 2007, global debt was $97 trillion and world GDP was $57.968 trillion. By 2018, global debt was $243 trillion and world GDP was $85.91 trillion. In raw numbers, we added $146 trillion dollars in total global debt and at the same time increased output by approximately $28 trillion. The debt to GDP ratios of the corresponding times equate to 167% in 2007 and 282% in 2018.

It becomes pretty obvious that the amount of growth we need to "normalize" the system is ENORMOUS and/or we have a "new normal." And we do think we have a new normal in the context of very low interest rates and continued Central Bank interventions for the foreseeable future.

Frankly, I don't think anyone disputes that. In fact, watching Bloomberg TV over the weekend we saw JP Morgan's Chief Investment Officer and Head of Global Fixed Income, Bob Michele, respond to the question of 'Which area of the bond market are you afraid to invest in?' with an answer that was astounding. His answer was, 'None. There really isn't an area of the bond market that I am afraid of."

Clearly, he sees a continued and non-stop need for more and more money from debt issuers EVERYWHERE in the world. And given the debt and GDP ratios that we just finished looking at, it should be clear why he sees that continued need.

To summarize our current economic status, we can say that we are in the final stages of the boom phase with an economic system that relies on debt to finance its growth. Given the need for continued growth and our reliance on debt, interest rates need to be low for an extended time period in order to give the economy enough time to grow its way back to "normal."

Data Update

One item of utmost importance is to take what we just learned, which is that we are in a Bull Market that does have more room to run, and try to stay a step ahead of the curve.

With that in mind, as the cycle progresses the next step is the Bust Phase. That is the phase where the market falls apart. And as is outlined in the original "Holy Grail" report, the four metrics that we track have distinct characteristics right before the Bust Phase starts.

The first metric is Earnings Relative to Potential. The key point in tracking this metric in our attempt to see when the Boom might change to a Bust, is how far above Potential are the Actual Reported Earnings of S&P 500 companies. To gauge this, let's take a look at the chart below, which show Earnings Relative to Potential.

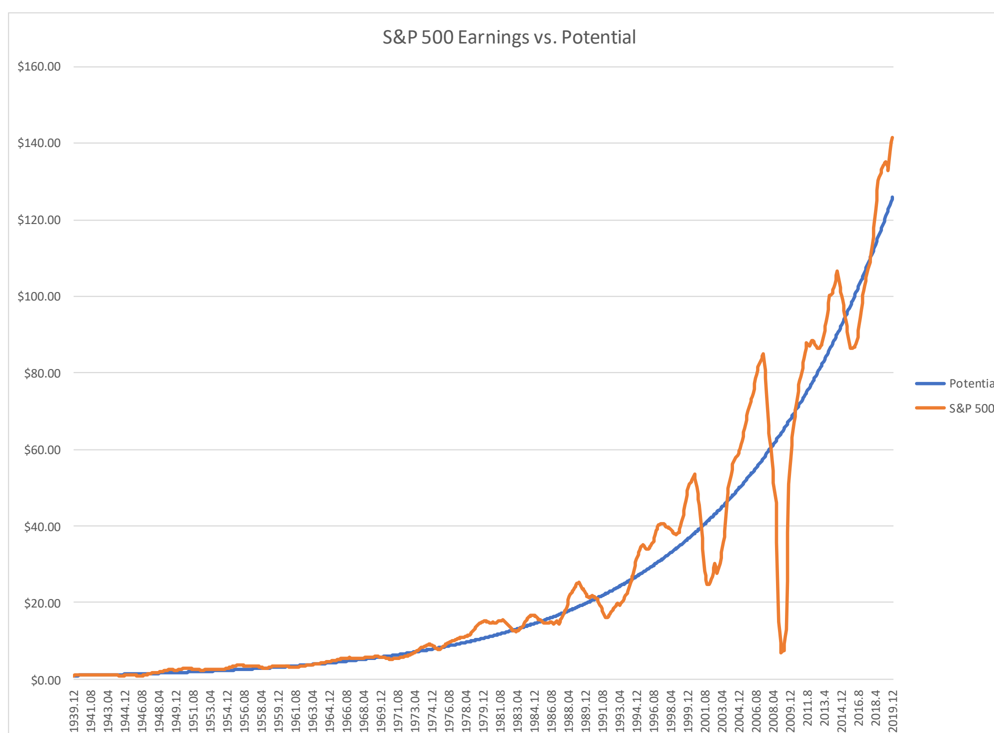


Chart provided by the MRPCI Database

As you can see from the chart, Actual Reported Earnings have risen above Potential earnings in the last few quarters. Later in the report, we will detail what impact that will have on future stock market moves.

The next metric we track is the Valuation of the Market. We do this in two ways; one is a raw 10 Year Average P/E and the other is Stock Valuations compared to Bond Alternatives.

This first chart the 10 yr. Price to Earnings Ratio.

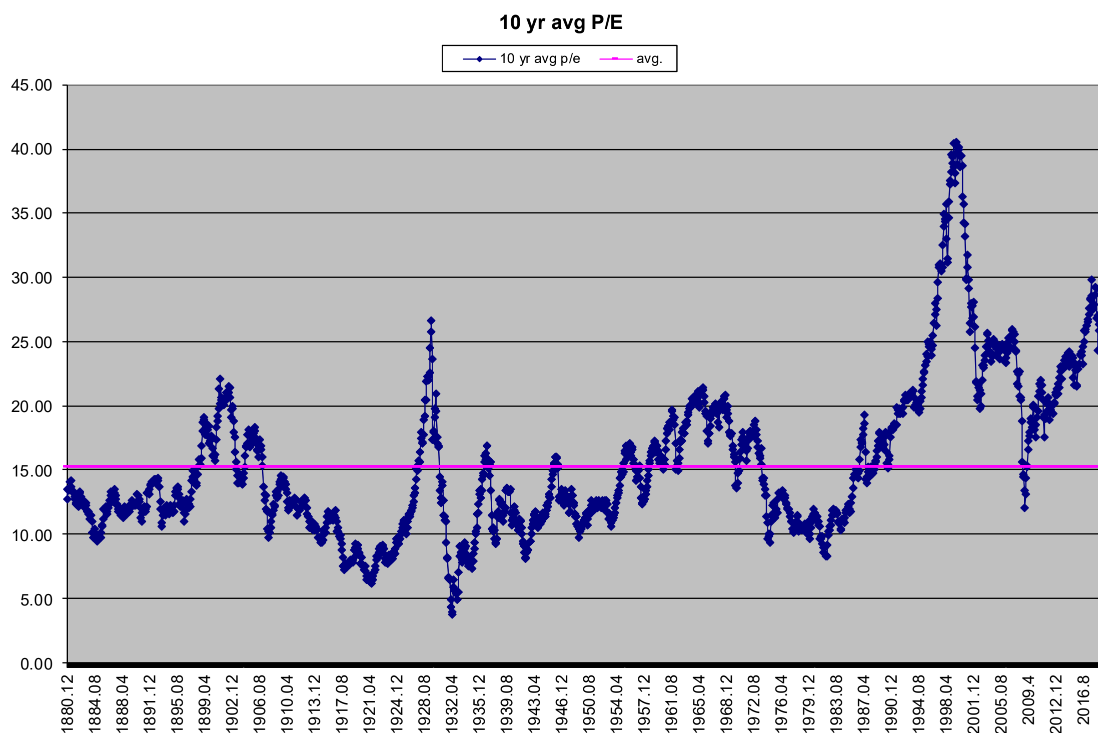


Chart provided by the MRPCI Database

By looking at this chart, you can see that P/E's are elevated.

The next valuation chart we want to look at is Stock Valuations in relation to Bond Alternatives. The Bond Alternative we use in the this chart is the U.S. 10 year Treasury.

This chart is, most likely, not one many of you have seen. It's an MRPCI developed chart that compares valuations of stocks to the 10 year Treasury. If the reading is positive, stocks are a better buy than bonds (based on valuation). And, conversely, if the reading is negative, bonds are a better value than stocks.

Currently, stocks are a better bet than bonds. And given the need for continued low rates, it would make sense to see stocks P/E's move higher rather than see bond yields push higher.

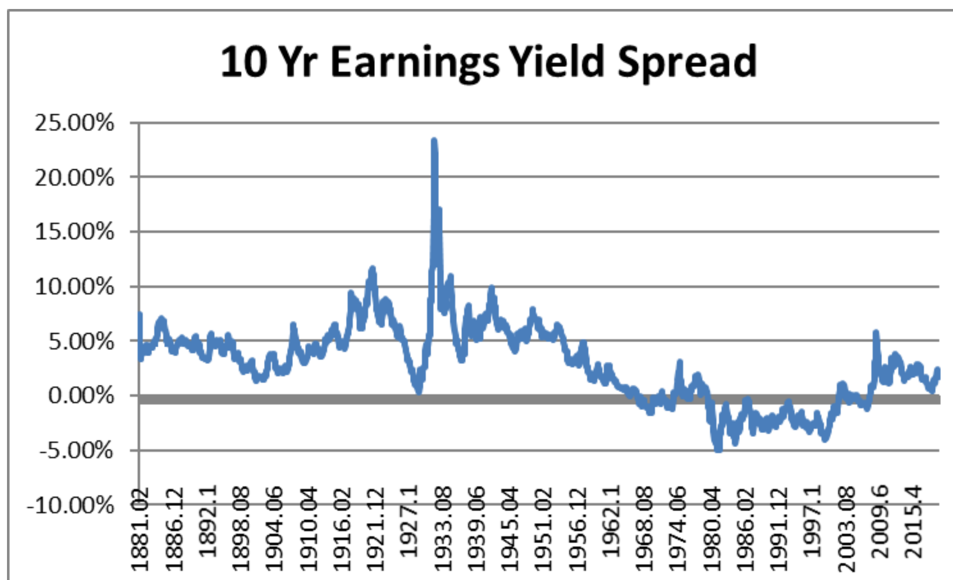
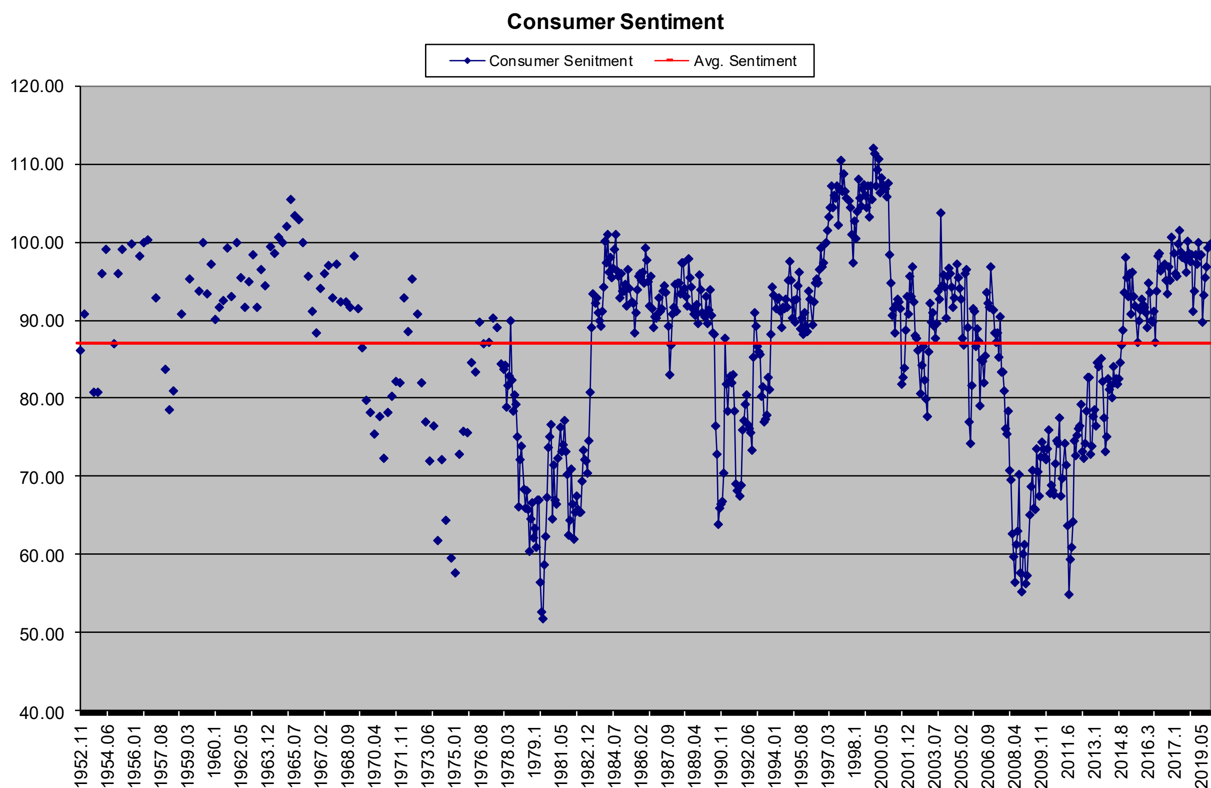


Chart provided by the MRPCI Database

The next metric we track very closely is Consumer Sentiment. We use the University of Michigan Consumer Sentiment Index to track this data point. We find this information to be important because it lets investors know the "mood of the market." Are investors pessimistic, euphoric, or rational? Below is the latest update, January 2020 , of the Index and for reference the red line is the average reading since the Index was created.

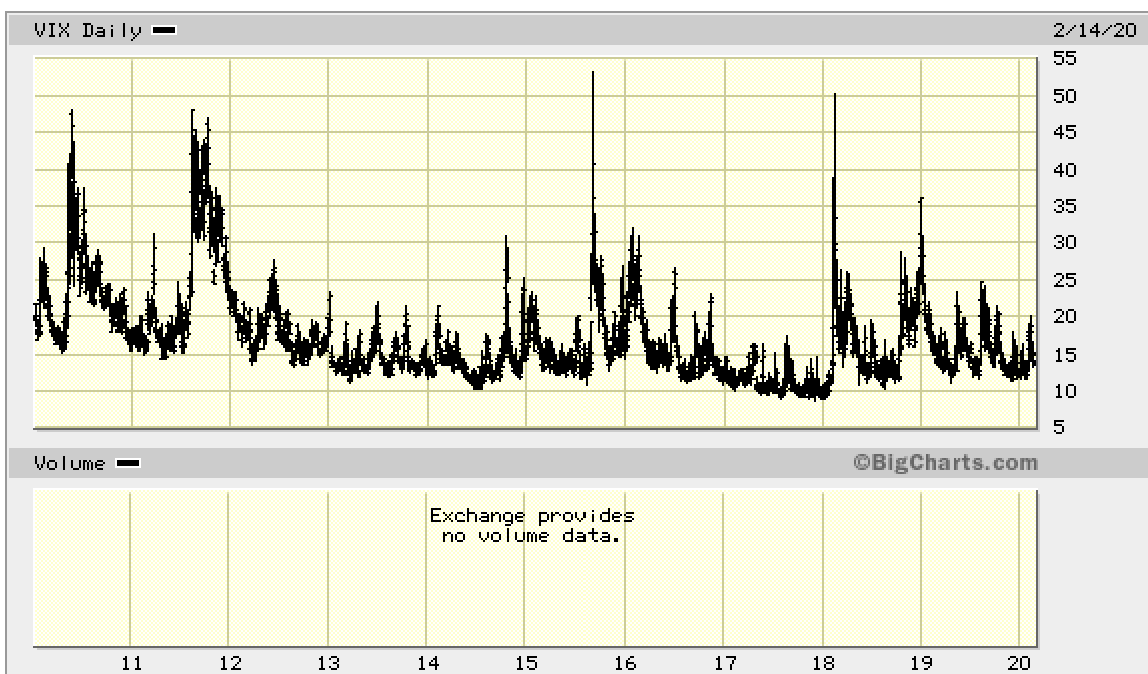


Clearly, the "mood" of the U.S. citizen is quite optimistic about their financial situation. In fact, their mood has been improving steadily since the Financial Crisis of 2008. And they are now solidly entrenched in the Euphoric stage.

In the next section of this report, we will dive deeper into what impact a Euphoric consumer/investor can have on the market.

The final metric we track as part of this analysis is, how Complacent (or Fearful) are market participants? As a general rule the longer that market participants are complacent about the risks in the market, the more dangerous the market is.

We use the CBOE Volatility Index (VIX) as a measure of Fear/Complacency. The lower the overall reading, the more complacent the market participants are. The higher the reading, the more fearful. Below is the a chart of the VIX, supplied by BigCharts.com, from the beginning of this Boom (February 2009) through were we are now (February 17, 2020).



As you can see, we have had patches of time where the market felt like the coast was clear. But that was quickly met with very large spikes in Fear (volatility). Based on this chart, I think it is pretty evident that investors are nowhere near being complacent about the risks in the market.

Timeframes and Expectations

Now that we've outlined how our current market looks compared to other Boom Phases (Below Average) and we've seen how the four main metrics we track are looking, let's take the analysis a step further and try to apply some timeframes and expectations to the timing of the end of the Boom Phase.

To get this ball rolling, I want to add another cut and paste section from the original "Holy Grail" report that detailed what to look for as the Boom transitions into a Bust.

To provide a quick summary of the information I have just shared, I have laid out the cycles and the characteristics within each stage of that cycle that will help us determine when the cycles are about to transition.

The Boom Cycle…

Begins when, normalized P/E ratio is below 10; there has been a long-period of time of below average consumer sentiment (4 years or so); earnings are off their lows, but still below trend; and the consolidation cycle yields one final pullback in the markets (historically 20%ish).

Signs the end of the boom is near...high normalized p/e ratio (20 plus), high consumer sentiment (high 90's-100 plus), earnings near peak, low to normal level of fear in the market place.

Investment Style that works best...anything and everything. Buy and hold. Throw darts at the Wall Street Journal.

Stats...Average length: 18 years

Average annual return: 14.33%

# of cyclical bears and average return during those times: 5, (15.4%)

The Bust Cycle…

<u>Begins when</u>, normalized p/e ratio are high(20 plus), consumer sentiment is high (high 90's-100 plus), earnings are near their peak, and a low to normal level of fear exists in the market place.

<u>Signs the bust is over</u>...the market experiences a huge bounce, 39% plus is a reasonable number to market the end of the bust.

<u>Investment Style that works best</u>...Cash. Money buried in your back yard or under your mattress. Maybe gold.

<u>Stats</u>...Average length: 2.5 years

Average annual return: (57.22%)

# of cyclical bulls and average return during those times: 2, 9.12%

As is detailed in the cut and paste from the old research piece, the Boom Phase ends (and the Bust Phase begins) when: valuations are high, Consumer Sentiment is high, earnings are peaking, and fear is low. Interestingly enough, our research shows that ALL FOUR of these metrics must be triggered before the Boom ends. We will take the time to go over each, and every one, in detail to see if they are triggered yet or not. And we will take the time to try to figure out how much time is left before any untriggered metrics might get tripped.

Earnings—As we've seen, earnings are already above Potential. The key here is, on average, how high do earnings go above Potential in the Boom Phase before the Bust happens. Happily, I've already done that analysis. If you refer back to the 7/21/2017 report entitled "A Brave New World", I detailed my work that showed, on average, "As Reported" Earnings peak out at 22.04% above Potential Earnings.

If the current pace of earnings continues, the "As Reported" first quarter 2020 earnings will end up being 11.6% above Potential Earnings. So, as you can see, **strong earnings can continue to drive this market higher.**

Valuations—There is no question that normalized P/E ratios are high. And that is, without question, a negative. However, there is one interesting twist in the data. The normalized P/E ratio uses an average of the market's earnings over the last 10 years and our current reading on normalized earnings includes the collapse in earnings in 2008/2009. For example, "As Reported" earnings in March of 2009 for the entire S&P 500 index was $6.86!!! For context, in January of 2008 that number was $64.25 and now is expected to be $141.58 at the end of this quarter. Nevertheless, the current reading of the market's normalized Price to Earning's ratio is high.

Furthermore, the valuation of stocks as compared to bonds still favors stocks. But we know that interest rates are highly manipulated at this time.

Putting all of this together, **I do not see the market being able to be pushed much higher, if at all, by a rising P/E ratio.**

Consumer Sentiment—In our opinion, one of the most powerful forces at work on the market is the "mood" of the investors within that market. After recording near all-time low readings during the Financial Crisis of 2008, the University of Michigan Consumer Sentiment Index (my proxy for the "mood of the market") has been posting very high readings since November of 2016.

From an investment standpoint, this metric is an indicator of the market's momentum and is a contrarian indicator at major market turning points. Continuing with the same example cited above, the low reading for Consumer Sentiment during the Financial Crisis was in February 2009 and the S&P 500 bottomed out on March 6th, 2009.

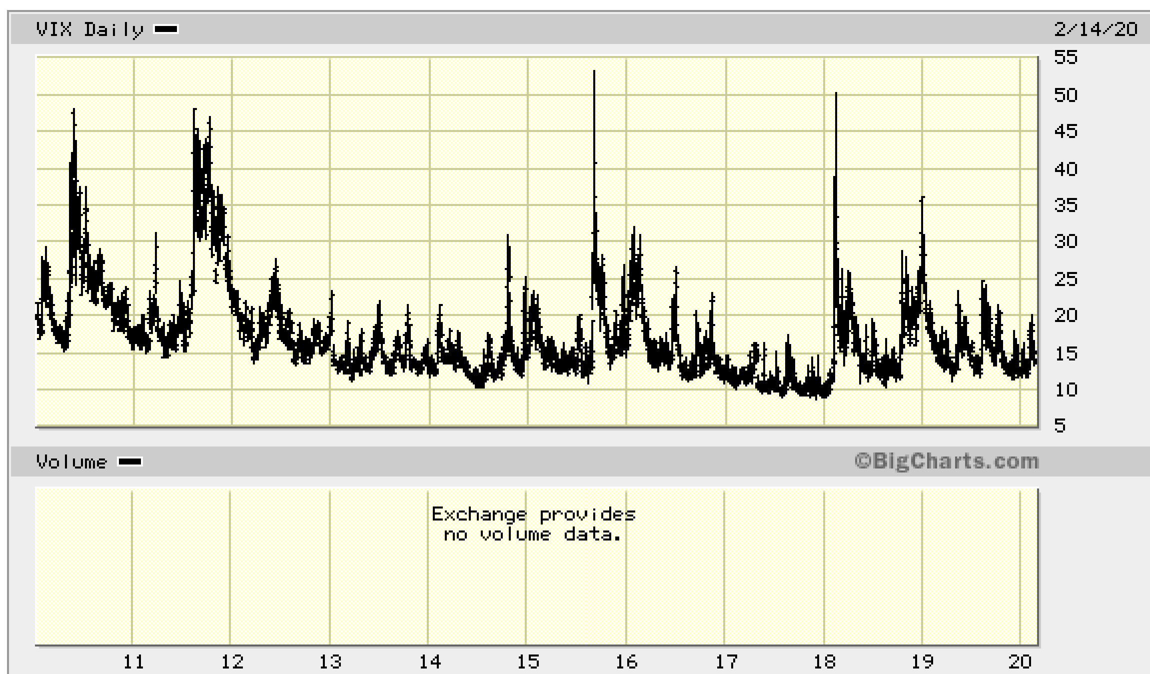
When analyzing market tops, it appears that Sentiment needs to be high enough for LONG ENOUGH to pull all the potential investors into the market before it becomes a contrarian indicator. For example during the run of the market in the late 50s and into the 1960s, the metric consistently posted readings over 90 (optimistic readings) for over 7 years, before the market pullback in late 1966. Furthermore, the Tech Bubble burst in 2000 after the University of Michigan Consumer Sentiment Index posted readings over 90 for over 4 years.

What this should show us is that our current optimistic readings, which have been going on for about 3.25 years, suggest it is vital to pay attention to how this year ends. If the consumer stays excited, this market could continue to run.

All in all, it appears that **continued high readings on Consumer Sentiment could provide a boost to the markets,** but it is vital to see how the year ends in regards to consumer confidence.

<u>Complacency</u>—One big warning sign that the Boom is about to roll over is when investors become complacent about the risks that are in the market place. As we previously mentioned, the best way to check the market's current level of complacency is to look at the VIX Index. The lower the VIX reading the more comfortable investors are; and that is fine. There are plenty of times when the "all clear" sign is out and the horizon is clear. Frankly, 2017 was one of those years. Things were good and the market behaved accordingly.

However, there are times when shocks hit the market. In fact, recently we've had some; Trade War between the U.S. and China and the Coronavirus. A complacent market would blow that off and volatility wouldn't rise too much on that news. The good news is that DID NOT happen this time around. As you can see from the chart below, the VIX was elevated through most of 2019 and has shown some gyrations in 2020, as well.



This is a good sign for the markets and shows that investors are not over-exuberant and they are, in fact, making rational investment decisions based on the facts at hand. **<u>This highlights that the markets are not irrationally priced, which suggests further gains can be made.</u>**

Conclusion

To put all of that data into a quick summary, we have:

Earnings above potential but below the average Boom Phase peak by about 11%.

Valuations are high and it doesn't appear that further gains can come from multiple expansion.

Consumer Sentiment is high and has been that way for 3.25 years. The low-end of "optimistic investors" timeframes is 4 years as Bull Markets age. So, we have a little time left before we hit that time frame. But year-end consumer feelings are vitally important to monitor.

Investors are not **complacent** at all! In fact, they are still skittish concerning this Bull Market.

And all of this needs to be looked at in the context of the following facts:

Boom Phases last, on average, 18 years and our current Boom is 11 years old.

Boom Phases, on average, generate gains of 14.33% annually and our current Boom's gains have been averaging about 16% annually.

The time frame of the Boom could be coming to an end as early as this year, but could also last another 5-7 years. 5 is more consistent with the type of below average boom we are anticipating.

Concerning when the S&P 500 could begin to top out, let's look at two prior research pieces we put out:

-In the 2016 report entitled "Earnings Recession" on page 7, we said by 2020 we could see the S&P 500 hitting 3,231.64.

-In the 1st Quarter 2016 Newsletter, we did an analysis that showed if the economy were to start clicking on all cylinders, the S&P 500 could hit 3,604 over a longer time period.

As this is being typed the S&P 500 is at 3,380. Given that, we are currently above the 3,231 target but we have a little room to run before we hit the 3,604 target. However, near market tops irrational exuberance can take over or, as we've called it previously, the market can turn into a Reflexive Bull Market and irrational behaviors can feed off of each other and push the markets into La La Land. And we will be looking for signs of that, but in the meantime logical market participants can make a solid case for a continued run higher in the medium term with the potential for a short-term pullback. But a massive amount of attention must be paid to how the consumer feels as we head into and past the election.

One major item of note is that international and emerging markets valuations have become more and more attractive as the U.S. markets have been outpacing international market's performance for quite some time.

But anything can happen in the markets and we will be watching with our eyes wide open and will be at the ready to make adjustments as necessary.

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