

# MRP CAPITAL INVESTMENTS, LLC

## 4th Quarter 2019 Client Newsletter

### Capital Market Update

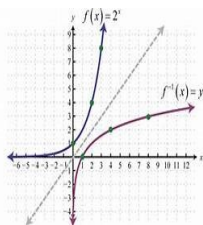
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In the last newsletter, we discussed how the “pump was primed” for a good run in the markets. As it turned out, the S&P 500 price change for the quarter was 8.53%. Which brings the final year to date price change for the market to 28.88%. No matter how you want to analyze those numbers, they are terrific. It was a BIG year for the stock market.



S&P 500 2019 Chart Supplied by BigCharts.com



However, 2019 was almost the inverse of 2018. In 2018 earnings showed incredible growth, while the market was negative. 2019 had moderate earnings growth and big stock market gains. We think what this foretells is that the market might be entering the P/E expansion phase of this bull run.



Historically, this happens as investors become more and more enthusiastic about the market’s potential. Of course, too much enthusiasm leads to overvaluation. Needless to say, we will be tracking this very closely. We need to see robust earnings growth to support the market’s valuation, if it continues to appreciate.

## 2019—A Review

As you all should be aware of, we are students of Behavioral Finance at MRP Capital Investments, LLC. We do believe that earnings, P/E multiples, debt levels, and cash flows are very important to analyze when attempting to make good investments. However, we do believe that the behavior of investors is more important than anything else. The true key to making wise capital allocation decisions is finding the intersection of good fundamentals (cash flows, earnings, etc.) and the mispricing of securities due to investor's emotional behavior.



Frankly, I think we saw this play out this year. During 2018, S&P 500 earnings grew by a little more than 20%. And I'm sure we all remember, the fairly sizable gains in the market up through the 3rd quarter evaporated in the 4th quarter of 2018 when Fed Chair Powell kept banging the drum of higher interest rates. And at the end of the year, the price change on the market was -6.2%.



That set the stage for a great 2019 as we had solid fundamentals in 2018 (20%+ earnings growth) in the face of a mis-priced market (S&P price change of -6.2%). And right from the start 2019 was a gang buster year. In January alone, the S&P price rallied almost 8%. After a few spurts of normal market volatility, the market ended up 28.8% for the year.



But what was so very interesting about the 2019 market was just how this rally became more and more hated (as we discussed in detail in the last newsletter). And to be frank, we get why the market was distrusted in 2019. Let's put it this way; if an investor knew The House was going to impeach the President, the Fed would have to cut rates several times to hold up a faltering global economy, and there would be on-going Trade War between China and the United States, would any investor have been bullish on the market's potential for 2019? Especially coming off one of the worst 4th quarters in the history of markets? Probably not!



But that's why we focus on fundamentals at MRP Capital Investments and why we overlay that fundamental analysis with our Behavioral Finance mindset. It keeps emotion out of investing, as best we can, and we focus on what we know rather than what we fear. What we fear in regards to the markets is really two things; losing money and missing out on market rallies. That's basic human nature. But what we know can get muddled in the noise of the daily news cycle, our daily lives, and our human emotions.



What do we know about 2019 and where we are right now? Of course this is a broad question with countless answers, but we will focus on 4 things right now. And these four things are the cornerstone metrics for our broad based macro analysis regarding the markets.

- 1) Earnings—S&P 500 earnings should settle out at around \$140.45/share.
- 2) Valuation—The Price to Earnings multiple on the S&P 500 is 23.
- 3) Consumer Sentiment—The University of Michigan Consumer Sentiment Index stands at 96.80.
- 4) Level of Fear in the market—The VIX Index currently is showing a normal and healthy level of fear in the market at 13.63.

What does all of that data tell us?

It tells us that as-reported **earnings** are above potential earnings, but are currently below the average peak relative to past cycles by about 11%. This tells us earnings could drive the market another 11% higher, using historical averages as our benchmark.

It tells us that purely looking at P/E **valuation**, the market appears to be fully valued. However, when you factor in how low interest rates are, you can make the case for much higher multiples on stocks.\*

It tells us that Consumers are very optimistic about their current financial situation and have been feeling this way since November of 2016. That equates to about 3 years. On average, **Consumer Sentiment** figures remain high between 4 to 7 years before their optimism begins to wane.

And finally, relating to **fear** or complacency, it tells us that the market and its participants are not complacent about the risks in the market.

If you add all of that together, you can't really make a case for the end of the Bull Market happening immediately. Historically, all four of those metrics need to be flashing warning signals. Not one of them is currently flashing a red light, but 2 of them are yellow—valuation and consumer sentiment. So entering 2020, we are cautiously optimistic about the future prospects of the market.



\*I don't want to put the actual P/E ratio that makes stocks and bonds equally attractive because at these insanely low interest rates that the Central Banks of the world have arranged, that number is so high it seems absurd. However, when you think about it, rates are so low, it's absurd too.

## 2020—A Preview

The main thing to remember about 2020 is that it is a Presidential election year. Therefore, we know one thing for sure; we have a very important piece of information that we have 0% certainty about. And that is, who will win the election? Of course, many things go along with knowing who will win the election. For starters, what will tax rates be? What will health care look like? Are we going to do housing reform? How are the judicial nominations going to be filled? And, frankly, the list goes on and on.



But the Presidential election isn't the only thing that is important in November. We have the Senate and House of Representatives that will be having major elections as well. This introduces more uncertainty into the markets as we get closer and closer to November.



What happens to the markets when you introduce uncertainty? Usually you see a dramatic increase in volatility. To be frank, volatility can be good if investors are financially, mentally and emotionally prepped to handle the swings. If this is done effectively, investors will be in a position to take advantage of the volatility when the elections are over and we switch that certainty meter on who will win the election from 0% to 100%.

And that is exactly what we will be planning to do every day leading up to the election. First and foremost, by having portfolios in a position to take advantage of the volatility caused by the uncertain outcome of the election. And secondarily, by talking about this fact frequently with clients to have them prepped and ready for the market gyrations that are almost certain to happen around the election.

We feel in order to be prepped and ready for 2020, we need to understand historical facts and context to get our expectations in the right place.



With this in mind, we found a research piece by Andrew Slimmon of Morgan Stanley to be extremely helpful. First, and foremost, his research showed that there has never been a President up for re-election that didn't get re-elected if the economy was NOT in a recession in the 2 years leading up to the election. And only 1 president was ever re-elected if a recession occurred during that time frame. This means that the economy in 2020 has an extra layer of importance for the markets this year.

Building on that, Mr. Slimmon discussed the inverted yield curve that happened last year and the timing of recessions following an inversion. He stated that the data shows that an inversion precedes a recession by about 2 years and, on average, the market appreciates about 40% from the initial inversion until the time of recession. If these historical relationships continue, a recession would occur in June of 2021, as the yield curve inverted on August 15th, 2019, and the S&P 500 should peak around 3,986, as it was 2,847 when the inversion occurred. Again, this is just using historical data in conjunction with our current markets place and time.

Furthermore, Mr. Slimmon continued on to point out that investors have pulled out over \$190 billion dollars from equities this year and put it in cash, despite the market being up over 25%. This means we have a rising market with ample amounts of fuel to send it higher with all the cash on the sidelines.



Of course, we have no idea what will actually happen in the markets this year. But we do have a firm understanding of what has happened in similar situations in the past. We will use the information as best we can, while keeping our eyes and ears open for any developing events.

## Non-Financial Events occurring this quarter



On December 18th, Donald Trump became the 3rd President to be impeached by the House of Representatives.



The Washington Nationals won the World Series.



The situation in Hong Kong continues to be the most important geo-political event taking place in the world, in our humble opinion. These protests turned violent on October 1st and people were killed on November 11th. November 27th Donald Trump signed the Hong Kong Human Rights and Democracy Act into law after Congress sent it to his desk.



Former Fed Chair Paul Volker died on December 8th.

# INFORMATION AND DISCLOSURES

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