MRP CAPITAL INVESTMENTS, LLC

3rd Quarter 2021 Client Newsletter

Capital Market Update

Inside this report:

The market did sputter a bit in the 3rd quarter. In fact, the month of September saw the S&P 500's price decline by 4.76%. Despite that pullback at the end of the quarter, the S&P still registered a year to date price change of 14.68% when September came to a close.

S&P 500 2021 Chart Supplied by BigCharts.com

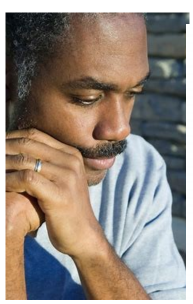
Moving forward, we expect more of the same. This entails government overspending coupled with central bank accommodation via money printing and low interest rates.

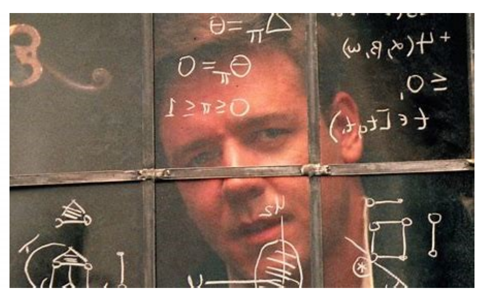
Additionally, we see two new issues developing. The first is <u>inflationary pressures</u>, which are well known and discussed in the markets. The other is <u>supply chain issues</u>. Those issues are as visible as semiconductor production shortages. And as opaque as shortages of willing labor to unload cargo ships. But these issues are not garnering too many headlines at this point. We expect that to change.

Market Check-Up

As this market goes higher and higher and higher, we feel two opposing forces building; fear and greed. Some investors see the market's move higher as a force that has momentum behind it and they jump on that train on every dip. Others see the moves higher as further steps into absurdity as the fundamentals don't seem to warrant these valuation levels. Who is right? Frankly, they both are! The momentum guys will be right up until the very moment they aren't and then the "worry warts" will have their day.

The key is figuring out when this market will turn. Determining this exact turning point is next to impossible, especially with all the emotions that these big price movements bring with them. After all, we are human beings that are very susceptible to specific stimuli driving our emotions. And making (or losing) a lot of money is, without question, one of those stimuli. Quite frankly, this is the biggest reason we develop quantitative metrics to make judgements on which cycle the market is in (Boom, Bust, Consolidation) and where we are within that cycle.





With that as a backdrop, we want to review those metrics right now. This helps us see objectively where we are in the market. A quick reminder that in February of 2009 we put out the "Beginning of the Bull…" piece in which we shared with everyone that the market's metrics that we follow were "so bad" that the Boom phase was beginning. That was 13 years ago and we are still in that same Bull Phase. For this Boom to turn into a Bust, we need those same metrics to be "so good" that there is nowhere else to go but down. How close are we to that change of market cycle? Let's find out!!!

In our attempt to find out when the Boom might change into a Bust, we follow four metrics. The first metric is Earnings Relative to Potential. We follow this metric because two things, and only two things, drive the stock market higher; earnings and the valuation multiple applied to those earnings. If we can get a good idea of how much upside we have left in regards to earnings then we know half of the picture. The chart below shows how actual reported earnings compared to the market's Potential earnings.

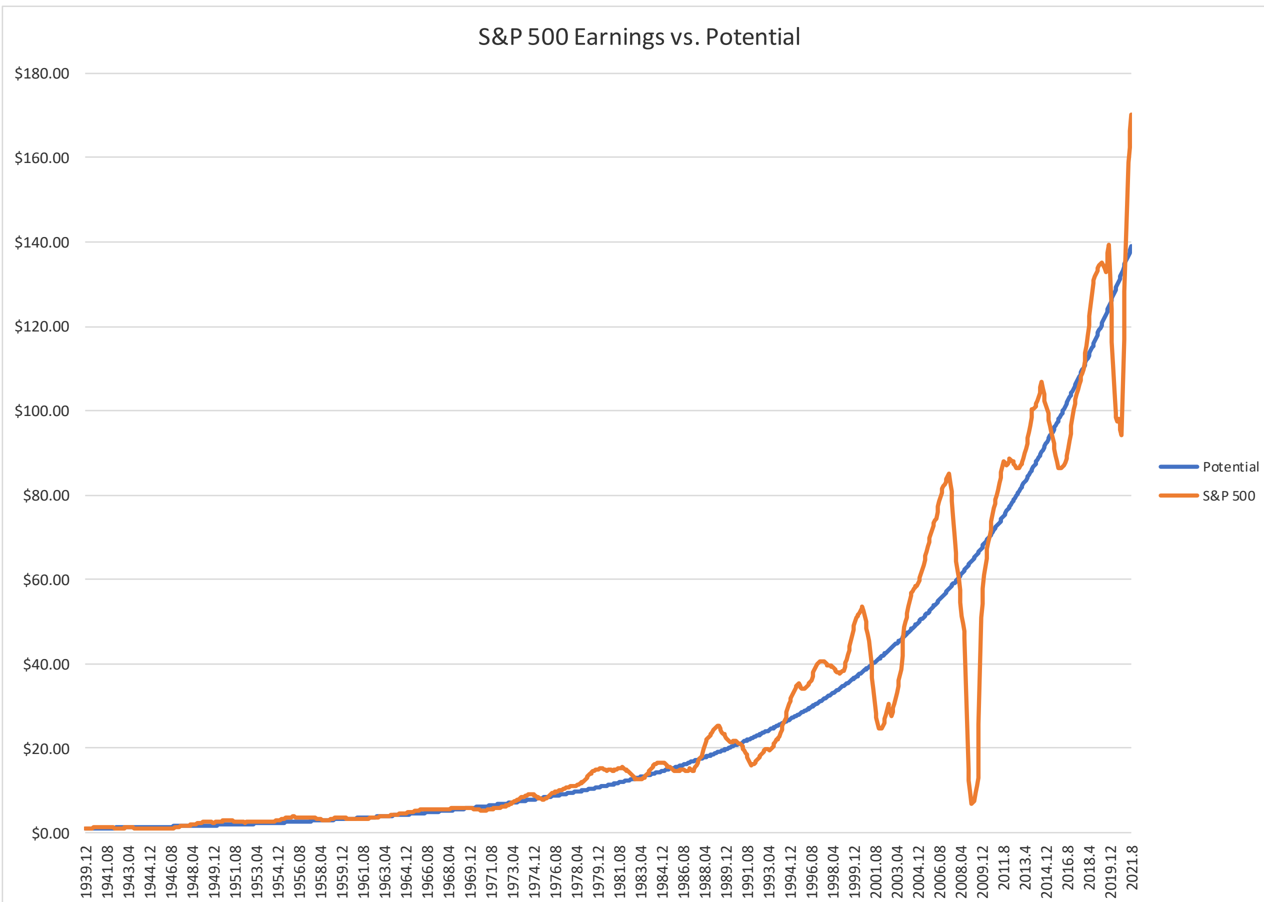


Chart provided by the MRPCI Database

As you can see from the chart, Actual Reported Earnings have risen above Potential earnings in the last few quarters.

As we said previously, the two things that determine the price of the market are: earnings and the valuation multiple applied to those earnings. Since we just looked at earnings, the next thing we need to look at is the market's valuation.

We actually look at the market's valuation in two different ways. The first one looks at how our current place in time is valued in comparison to previous market valuation levels. The second one lets us know how the market is valued versus other investment opportunities available in the market right now.

Below is a chart of the S&P 500s 10 yr. Price to Earnings Ratio. By looking at is, you can see that P/Es are very elevated relative to historical comparisons. Frankly, the only market more highly valued on this metric was the tail end of Tech Bubble in the late 90s.

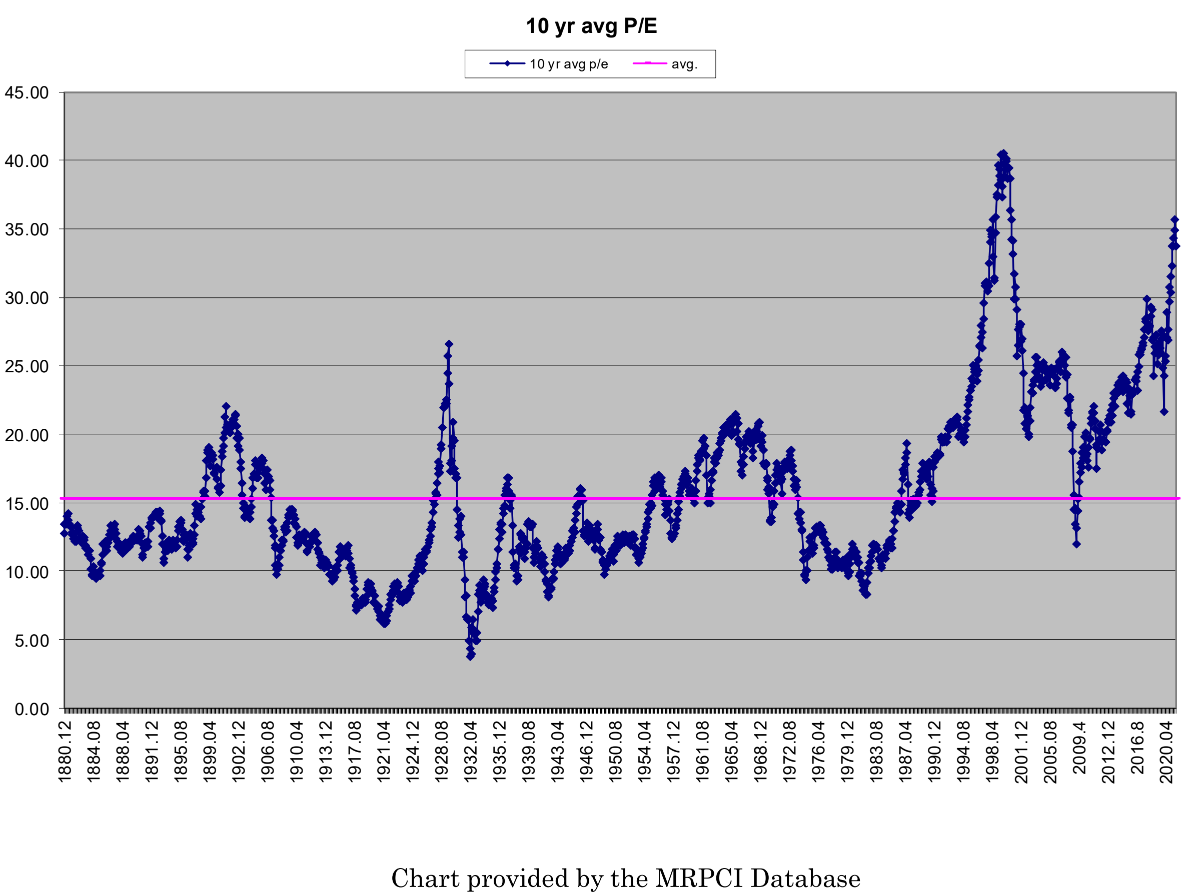


Chart provided by the MRPCI Database

The next valuation chart compares our current stock market valuations to the U.S. 10 year Treasury. Since this is an internally developed metric, we want to mention that when you read the chart, if the reading is positive, then stocks are a better buy than bonds. And, conversely, if the reading is negative, bonds are a better value than stocks.

As you can see, the greatest time to buy stocks was during The Great Depression in 1932. The reading was 23.35. If an investor would have purchased the S&P 500 on that day, they would have made 117% in 1 year and 227% over 5 years. If they would have gotten scared and bought bonds, they would have locked in a 3.56% annual yield.

The greatest time to buy bonds, as you can see on this chart, was in 1981when the reading was –5.01. At that time, you could have locked in a government guaranteed 15.32% annual return for 10 years in Treasuries.

With a reading of 1.44, stocks are currently a better bet than bonds. Given the need for continued low rates and the level of Central Bank interference in the market place, it makes sense to us that the valuation of stocks will move higher rather than bond yields push higher. In fact with the 10 year being at 1.52% when the quarter came to a close, a P/E ratio of 65.78 makes them equally valued.

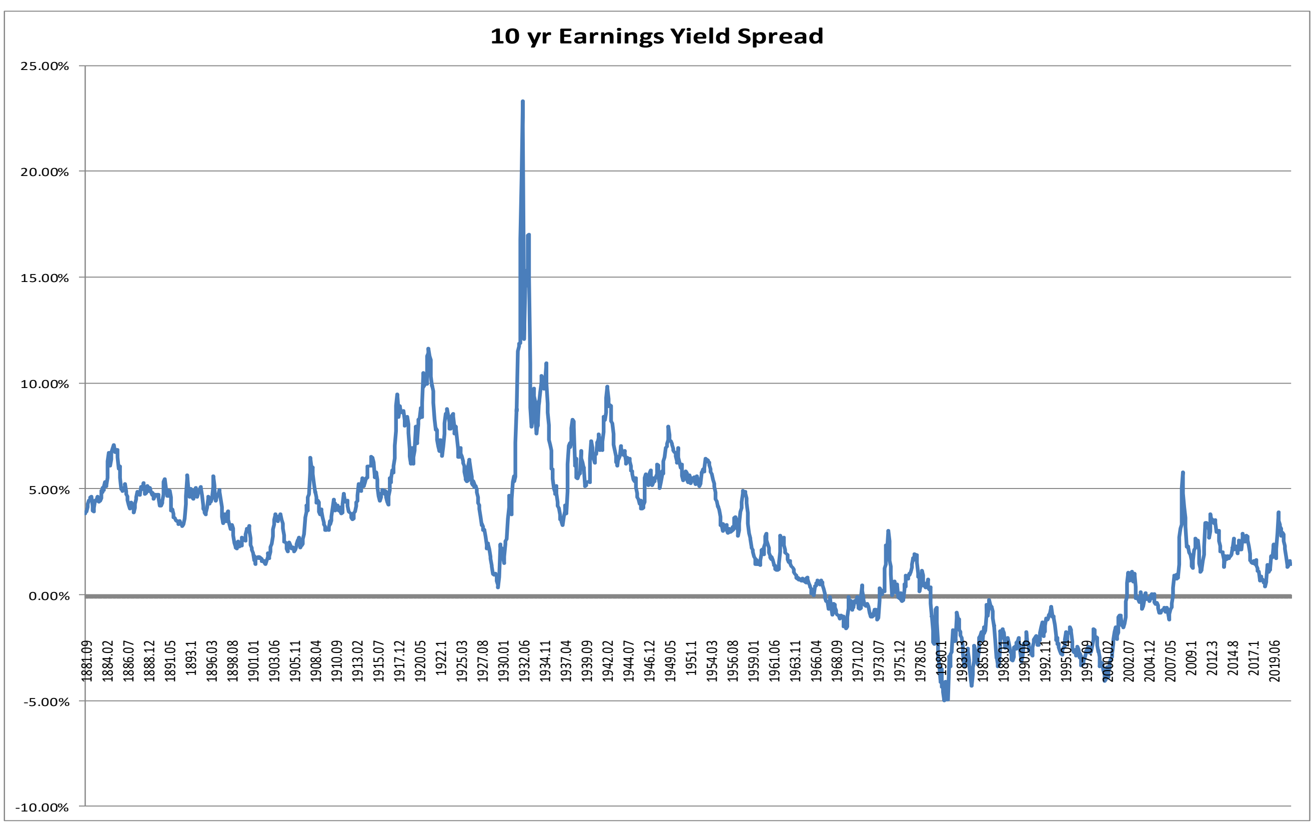
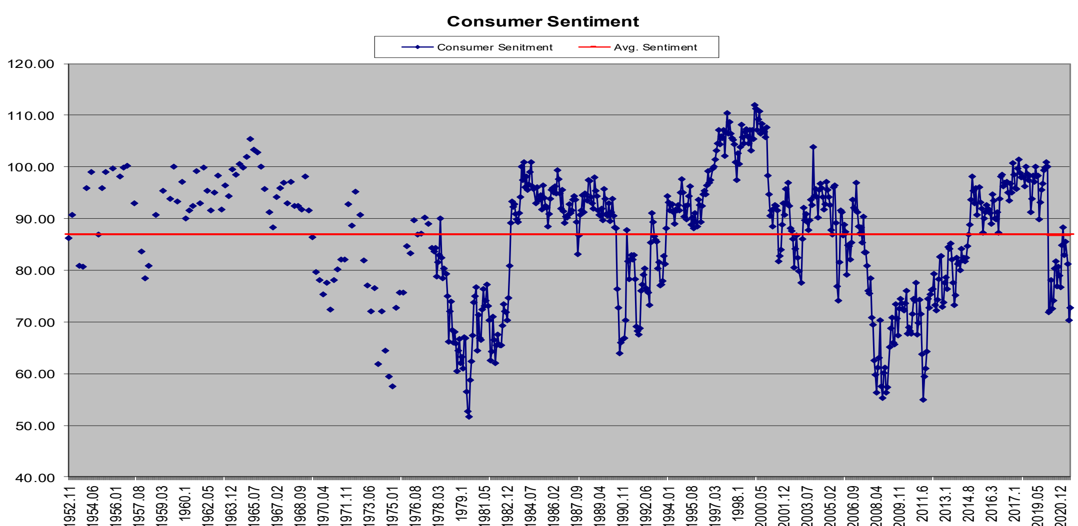


Chart provided by the MRPCI Database

The next metric we follow is an example of how we use Behavioral Finance to help us understand potential future movements in the market place. We use the University of Michigan Consumer Sentiment Index to track the “mood of the market.” Are investors pessimistic, euphoric, or rational? Having an understanding of that gives us insight about possible consumer/investor behavior. A low reading suggests there is the potential for a future increase in spending and investment by consumers. It seems contrary to common sense, but it shows that spending and investment actions are being taken by consumers/investors that are pessimistic. People who are feeling negative about their economic future are most likely to be very frugal and careful in their spending. However, as their mood improves, generally, so does their spending. This usually equates to improving profits for corporations.

Conversely, a high reading in Sentiment for an extended period of time suggests that there is the potential for a reduction in spending by consumers. This is because at the time the data was collected consumer spending would be being done during a time of extreme financial confidence. We all know that confident people spend more money than financially scared people.

Below is the latest update (September 2021) of the Index and for reference the red line is the average reading since the creation of the Index.



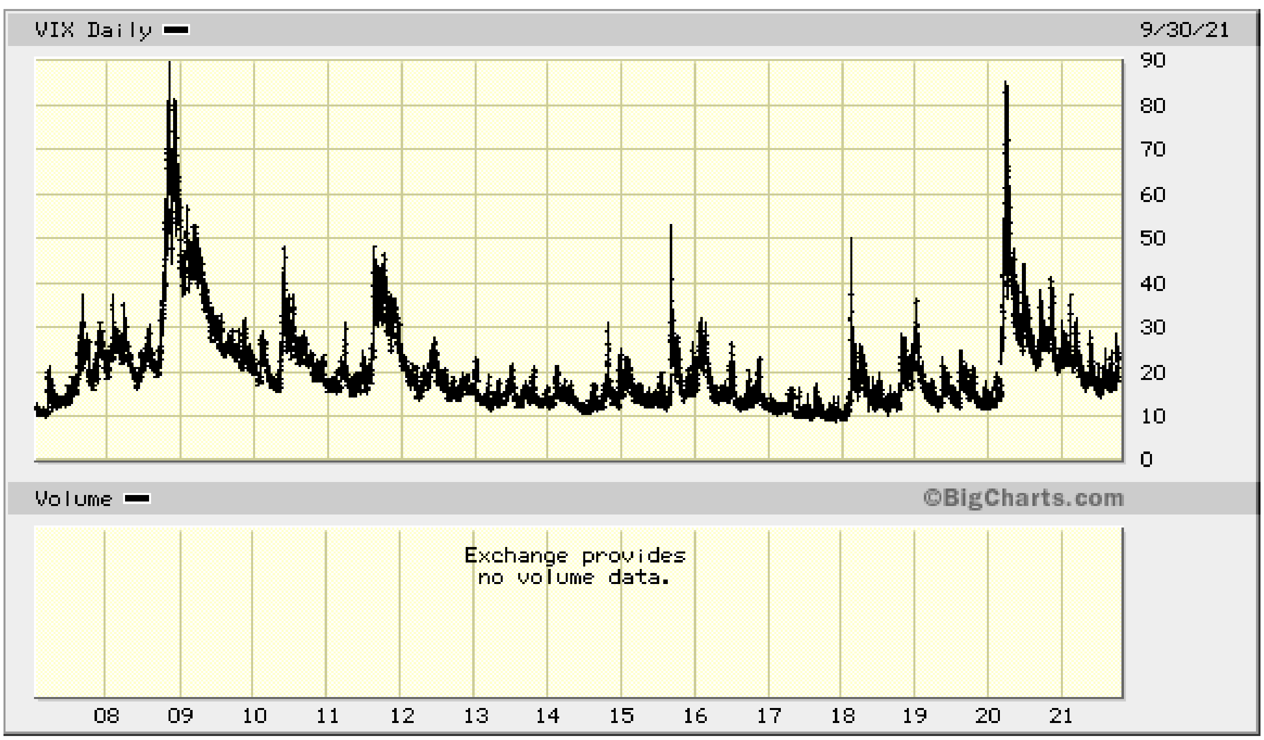
As you can see, prior to onset of COVID, consumers were very optimistic. Then after a massive drop in confidence, there was a brief bit of time after the COVID shock that they were making a move back towards optimistic. But their mood has been steadily deteriorating since April. Currently, the “mood” of the U.S. citizen is pessimistic about their financial situation.

The final metric we track is another Behavioral Finance based metric as it shows the level of fear or complacency imbedded in the market. We use the CBOE Volatility Index (VIX) as the proxy that fear/complacency.

A low reading represents a market experiencing low volatility. Low volatility suggests that there is very little selling going on and can be a sign of confidence in the market. As a general rule the longer that market participants are complacent about the risks in the market, the more dangerous the market. This is due to overconfidence about their investments and lack of fear regarding risks in the market place.

Below is the a chart of the VIX, supplied by BigCharts.com, from 2007 (a period of time before this Boom began) through were we are now (September 30, 2021).

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.



VIX Chart from 1/1/2007-09/30/2021 provided by BigCharts.com

Putting all of this data together, we see that as of the right now (end of the 3rd Quarter 2021):

Earnings are above potential by 18.35%. If you refer back to the 7/21/2017 report entitled “A Brave New World”, we showed that, on average, “As Reported” Earnings peak out at 22.04% above Potential Earnings. This would imply that, if this Bull run is average, earnings can push the market higher by another 3-4%.

Valuations for stocks are high on a historical basis. However, when comparing them to bond valuations, stocks are cheap. Per all the financial formulas, the lower bond yields are, the higher the valuation metrics for stocks should be. As we said previously, the 10 year Treasury is currently yielding 1.52%. With that, the P/E on stocks needs to be 65.78 for stocks and bonds to be equal in value. Seems crazy to hear that. But if we are honest with ourselves, its crazy to hear the yield on the 10 year Treasury has RALLIED to 1.52%.

Consumer Sentiment is below average. To get to a point where sentiment is irrationally exuberant, we would need a big move in this indicator to the upside over a long period of time. This type of move has historically brought with it a tremendous spike in spending by consumers. This spending, naturally, makes it easier for corporations to make more profits.

With regards to **Fear/Complacency**, investors do not appear to be **complacent** about the market’s risks. There appears to be a very sharp and quick reaction to all the potential market moving risks by market participants. This is a positive sign for upside potential because the less fearful investors are, the more likely they are to make more investments and take on more risk with those investments. This has a direct impact on the valuation of stocks.

What this analysis suggests is that future gains in the market need to be driven by P/E expansion due to investors becoming more enamored with their financial situations and spending more money. While eventually becoming complacent about the risks in the market and making more speculative investments.

To get a sense of "fair value" for the S&P 500, we go back to the information that supports our entire investment process, which was laid out in our "Holy Grail" report written many years ago. In that report, the data said:

-Boom Phases last, on average, 18 years and

-Boom Phases, on average, generate gains of 14.33% annually

While, today:

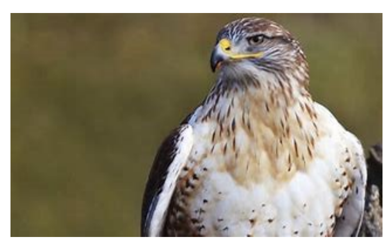
-Our current Boom is 13.5 years old

-Our current Boom's gains have been averaging about 13.97% annually.

If we simply apply average Boom statistics to our current market, which ended quarter at 4,307.53, we get a future value of the S&P 500 of 7,783. Again, that is simply taking the current reading of the S&P 500 (4,307.53) and growing it for 4.5 years (which would make our current Boom the length of an average Boom) at 14% (which is a little below the average annual gains in a Boom).

7,783 seems like a big number, but this is over the next 4.5 years. To get more comfortable with the market potentially going from 4,307 to 7783, let's remember this Bull run started with the S&P 500 bottoming out at 666.73 in early 2009. To get to the top of our last Bull run, which ended in 2000 at 1,550, it started at 109.4 in 1981. And, of course, it topped out at a whopping 31.30 before the 1929 crash. As this shows, Bull markets have been known to run way pasts price levels that are easy to predict.

To conclude this article, it appears we have more upside in this market. But we are actively watching for signs the this Bull Market is ending and is about to bust.

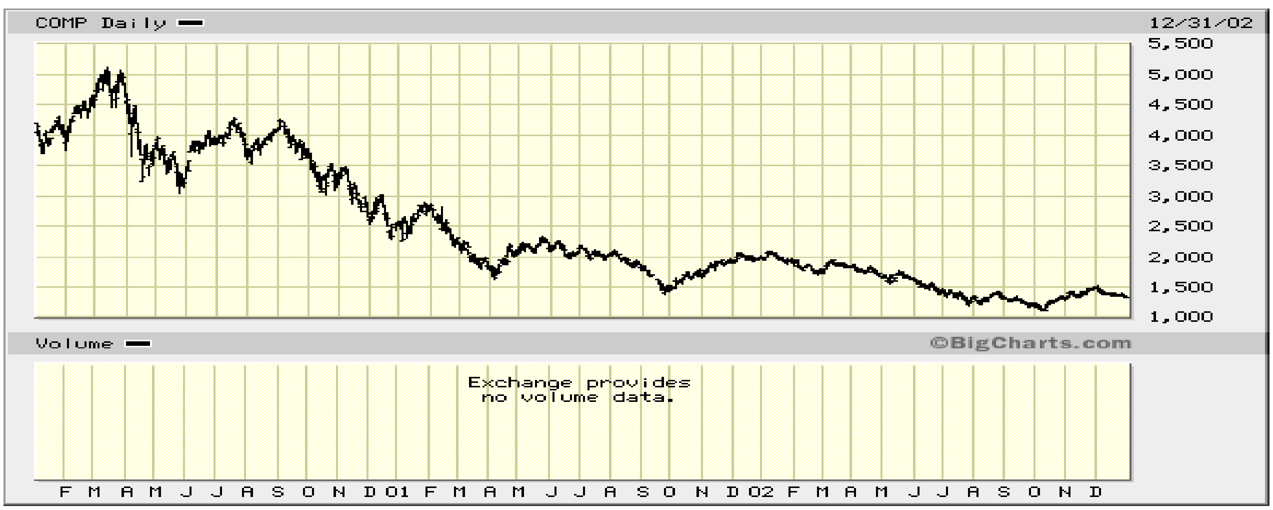


The things we know about this transition are that the Boom Phase ends (and the Bust Phase begins) when: earnings are peaking, valuations are high, Consumer Sentiment is high, and fear is low. Importantly, our research shows that ALL FOUR of these metrics must be triggered before the Boom ends.

Its Different This Time

As we've mentioned before, we feel like our careers are coming full circle. We began in the '90's during the later stages of a Bull Market that was being overtaken by euphoria and we think we are right there again. We feel this way because of how the market is pricing investments, how the market is behaving, and how investors are talking. In fact one of our favorite quotes that Bullish investors use to refute the naysayers during these periods of euphoria is, "It's different this time!"

Back in the late '90's, it was 'different this time' because of the Internet. Businesses would be more efficient, their revenues would boom, and the entire globe would open up to, even small, businesses to sell their products. And, of course, they were 100% correct. All of those things did happen. Nevertheless, from 2000-2002 the NASDAQ fell about 70%. These tech stocks that were ringing in a new age of business efficiency got absolutely smashed.



NASDAQ 2000-2002 chart provided by Bigcharts.com

If all the things people said would happen, in regards to tech adoption, did happen, then why would the stocks get creamed? Valuation! There was a revolutionary idea in the market place; the Internet. People put their money into these businesses and revenues kept climbing. But the actual profits didn't support the stock valuations and the selling began. Add in a terrorist attack, a botched Presidential election, and a recession and the selling didn't stop for 3 years.

Frankly, we feel that we are getting close to this Bull Market turning into a Bear Market. In fact, this feeling that we have is what drove us to write the previous article in this newsletter. And as that article pointed out; to get to the Bear, we must complete the Euphoric Stage.

In the Euphoric Stage, a lot of money can be made. During this phase, investors have historically overlooked many of the negatives in the market. They, typically, focus on revenue growth and make up new metrics regarding how to track a company's performance. Back in the Internet days, "number of clicks" was one of the things people discussed. "Number of visitors" to their websites was another big one. But in the end, profits need to be made in order to justify valuations.

It is this simple basic fact that many investors overlook. And, we've got to be completely candid, we didn't understand how an investor could over look that. Seriously, for the life of us, we just never understood that. Until about a month ago.

The answer to how they can over look this is because they have never seen a Bear Market! They are too new to the market. They haven't been through a full economic cycle. They are enthusiastic, excited, and have only known Bull Markets. Of course, this makes them feel invincible in the world of investing. This feeling of infallibility leads to a continued "buy" mentality with absolutely no thought of deviation from that tactic, whatsoever.

In our current market place, these exuberant investors have a lot of things going in their favor. We have record household net worth ($144 trillion) but only $46 trillion is invested in equities. This wealth is not as concentrated as it has been in the past. Large amounts of this wealth is changing hands as "Baby Boomers" are aging. In fact, Millennials are set to inherit $76 trillion and they have a higher risk tolerance than Boomers. With the lack of return in bonds, overall investor confidence in stocks has been growing. And the "buy the dip" mentality has set in and has been rewarded handsomely for years.

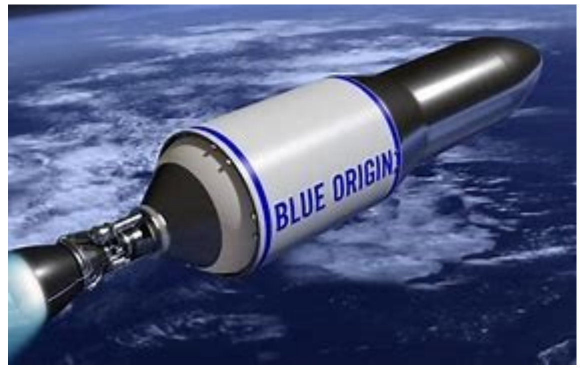
With that, it is pretty clear that there is a lot of firepower at the ready to buy more stock. It also brings some logic as to why investors are not paying attention to the tried and tested long term market risk control and valuation metrics. Combining those concepts, paints a pretty clear picture on how our market can hit the Euphoric stage and keep prices moving upward.

Of course, we will try to catch as much of this upside as possible. But we won't take our eyes off of your long term goals. Our focus will be on obtaining the financial goals that you shared with us as we started putting your assets to work in the market. We will be thrilled to generate large returns that exceed your required rate of return. However, we will not get carried away with trying to get that 1 or 2 extra percentage points of return and abandon risk control. Because we know what the next stage of the market is. In fact, we've guided many of you through Bear Markets and were in position to thrive once they were over.

Like we've mentioned many times in this newsletter, I don't think this Bear Market is imminent. I see a pretty good amount of runway left for this Bull run, but we are on the lookout for signs regarding the timing of the next cycle.

Non-Financial Events occurring this quarter

Due to COVID, the 2020 Summer Olympics were held this year (2021) with many empty seats.



Jeff Bezo's Blue Origin successfully conducted it first human test flight

7.2 magnitude earthquake devastated Haiti and killed 2,100 people

The Taliban retook the city of Kabul

Einstein's Theory of Relativity proven correct when light behind a black hole was directly observed.

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MRP CAPITAL INVESTMENTS, LLC

8440 Holcomb Bridge Road, Suite 520

Alpharetta, GA 30022

404-274-7851

www.mrpci.com