# MRP CAPITAL INVESTMENTS, LLC

## 3rd Quarter 2022 Client Newsletter

# Capital Market Update

**Inside this report:**



As if investors weren't feeling terrible enough at the end of last quarter, when the S&P 500 had its worst quarter in 40 years, September closed out the 3rd quarter by posting a negative 9.34% return, which erased the gain the market had going into the month. In total, the S&P posted a price return of negative 5.28% for the quarter and that put the year to date return at negative 24.77%.


S&P 500 2022 Chart Supplied by BigCharts.com

We noted in the last newsletter that market developments had caused us to turn bearish. Given that stance, we took maneuvers to bring the risk down in portfolios. Those actions did have a big hand in helping us outperform return benchmarks for nearly every client, yet gains were nearly impossible to generate.

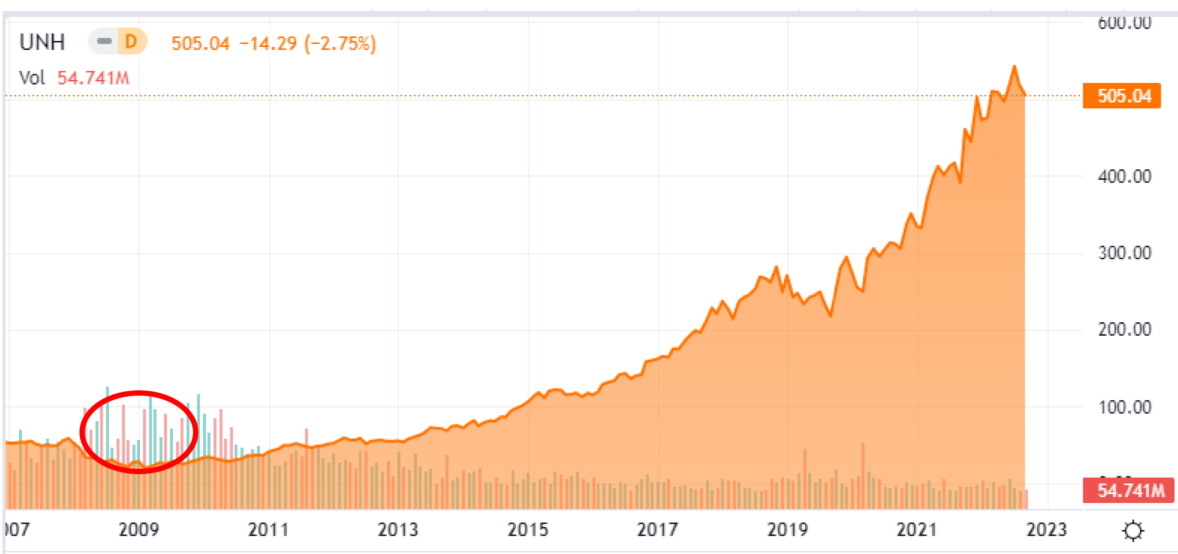
With the 1st quarter being negative, the 2nd quarter being the worst quarter in 40 years, and September being the worst month since May of 2020, there is a chance too much pessimism is priced into the market. There are certainly enough pieces of bad news to make investors nervous. But the key is to always consider, how much is already priced into the market? Due to the fact that post-election markets have historically been quite good, we are very interested to see how the market closes out the year.

# Market's Potential

There are many adages that people use when talking about investing.  One of my favorites is, **"Buy when there is blood in the streets, even if it is your own."**  With stocks down 25% and bonds down 15%, essentially every investor in the world is bleeding.  The fear in the market is pushing the amount of selling to levels that is creating very attractive valuations on many investments.  In fact, we haven't seen stocks this cheap since 2008.

Of course, there is another adage that says **"Markets can remain irrational longer than many investors can remain solvent."**  In other words, over the short-term, weird and wild stuff can happen, but longer-term, fundamentals prevail and investors eventually gravitate towards investment opportunities that offer attractive risk-return profiles.

In the fall of 2008, in a situation similar to our current predicament, we began buying United Health (UNH). It was under heavy selling pressure because the market thought Obamacare would crush their business model.  We began buying for clients around $25/share.  It took some time to settle, find its footing, and by February of 2009, it had dipped into the teens.  During those first few months, it looked like buying UNH was the wrong move, but we had done our research and we felt convinced we were right.  It started moving higher in mid-2009 and it rose to the mid-30s by the end of that year. Quite frankly, it has been a rocket ship ever since.  As this is being typed, UNH trades at $505.04, and we have trimmed the position back a few times, but it is still our largest health care holding.




United Health chart from 2007-2022 provided by Seekingalpha.com

**<u>We mention this trade because we think similar types of opportunities are being created as we speak.</u>**

It is our opinion that making investments like the one we just mentioned, include not only understanding the valuation level of the specific investment, but also understanding the market's valuation. To begin assessing the market's valuation level, we look at the earnings of the index and the P/E ratio applied to those earnings. We will also need to compare the valuation of bonds to stocks and visa versa.

[APOLOGIES FOR THE AMOUNT OF MATHEMATICAL FORMULAS WE ARE ABOUT TO USE.]

To accomplish this, we will need to understand the concept of **"Earnings Yield**." Earnings Yield is the inverse of the P/E ratio, that is 1 over the Price to Earnings ratio. This converts the P/E ratio into percentage form. For example, a market with a P/E of 20 has a 5% Earnings Yield because 1/20=0.05. By performing this calculation, you transform the valuation data for stocks into a format that can be directly compared to bonds.

Of course, stock investors require more return than bond investors because stocks are more volatile than bonds and investors need to be compensated for taking that additional risk. That extra compensation is called the **"Risk-Premium."**. The Risk-Premium of the S&P 500 over Government Bonds historically has averaged 1.06%.

Therefore, when applying these concepts, we see the 20 P/E stock becomes an investment with a 5% earnings yield, and this investment is just as attractive as a 10 year Treasury that yields 3.94%.

Gathering the appropriate data and applying those concepts, we see that:

-<u>At the end of 2021, investors were dealing with a stock market that was calling for a 3.1% 10 year yield and a bond market calling for a 38.9 P/E.</u>

At that time, the S&P 500 was 4,768, "as-reported" earnings were $197.87, and for 2022 "expected earnings" were $220, the P/E of the market was 24, and the yield on the 10 year Treasury was 1.51%.

—stock market's implied interest rate calculation................((1/24)-1.06%)=3.1%

—bond market's implied P/E calculation.........................(1/(1.51%+1.06%))=38.9 P/E

-<u>At the end of the 3rd quarter, we faced a market battling between stocks calling for a 4.23% yield and the 10 year pricing in a 20.57 P/E.</u>

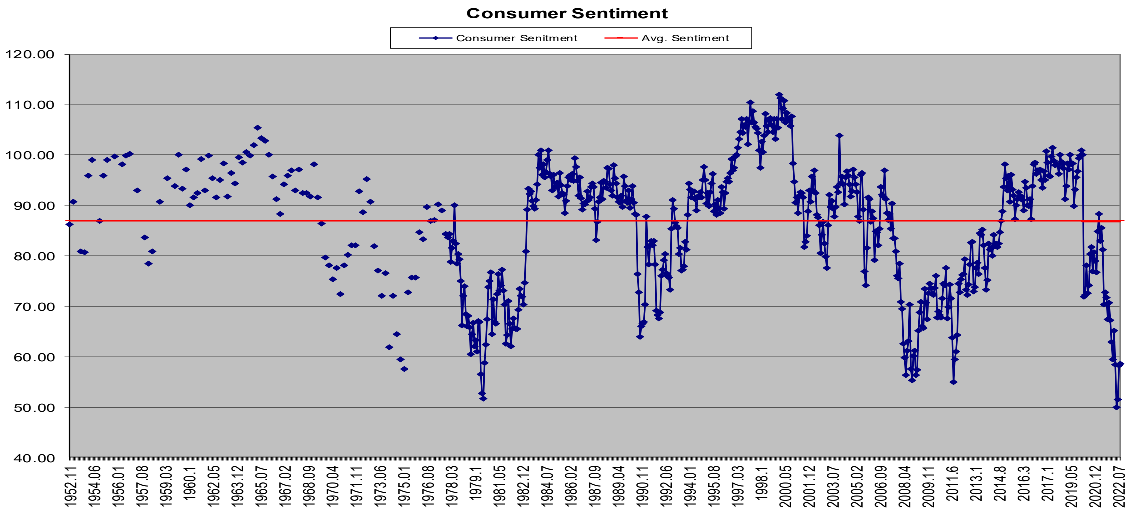
At that time, the S&P 500 was 3,585.62, forecasted 2022 earnings had dropped to $190, the P/E was 18.87, and the 10 year Treasury's yield was 3.80%.

—stock market's implied interest rate calculation..............(1/18.87)-1.06%)=4.23%

—bond market's implied P/E calculation...........................((1/(3.8%+1.06%))=20.57

—bond market's implied earnings calculation...................(3,585.3/20.57)=$174.29

**<u>By using these numbers, and only these numbers, we can lay out several market scenarios</u>.*** I stress that we are only using market supplied data because sentiment in the market is so bad. In fact, as the chart below illustrates, Consumer Sentiment is at an all-time low. It is worse than when COVID hit and the entire economy was shut down. It is worse than the bottom of the 2008 Financial Crisis. It is the worst consumers/investors have EVER felt. Therefore, by using only market supplied/derived data, we see the signals the market is telling us and avoid using inputs that are driven by emotion and feelings.




University of Michigan Consumer Sentiment Index provided by MRPCI

The most **<u>Bearish</u>** of those paths takes the S&P 500 down 8.27%, to **<u>3,288.85.</u>** While, the most **<u>Bullish</u>** of those paths takes the S&P 500 up 39%, to **<u>4,998.9.</u>**

What actually will occur, no one knows. But having an idea of where the market could possibly go in the future, allows us to prudently allocate assets and prepare sound portfolios. Who knows? We might just make some investments that turn out as good as the one we mentioned in the beginning of this article!

*Calculations for these scenarios are provided in the appendix.

# War Update

As we've written about several times, the biggest reason to asset allocate is geo-political uncertainty. Global conflict eruptions are simply too difficult to predict with any sense of timing. Therefore, a prudent investor should always have their investments allocated across a variety of asset classes that differ in their risk/return spectrum. This way when one of these countless regional skirmishes erupts into a globally impactful conflict, you have some defensive positions in your portfolio to combat these unpredictable geo-political eruptions.


Our latest geo-political eruption is taking place in Ukraine right now. Russia invaded and successfully annexed Crimea in 2014. Now, in 2022, Russia is at it again; this time they are seeking more territory in Eastern Ukraine.

The Ukraine forces mounted successful counterattacks against Russian forces in September, reclaiming significant territory.

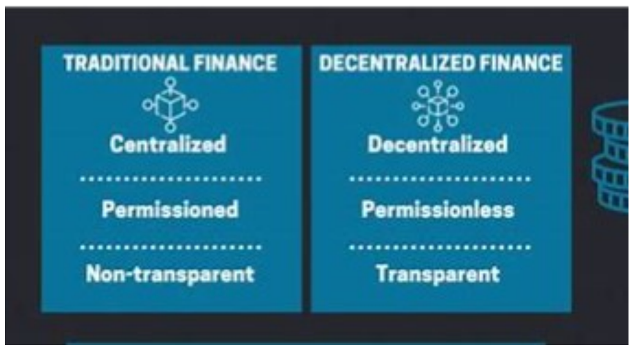
President Putin responded with a series of major escalations, including a troop mobilization of 300,000, threats to use tactical nuclear weapons and outright war with NATO. Putin also called for elections to annex four regions in Ukraine under Russian control in what the Ukraine and others called a sham.

Further inflaming an already tense situation, in September, the two Nord Stream gas pipelines to Europe were both rendered inoperable due to suspected acts of sabotage. The economic fallout of this could be massive because gas exports to the EU from Russia since the start of the war have already dropped dramatically, from 40% to 9%.


Obviously, Europe is in a dangerous place. They must manage through the upcoming winter with gas supplies extremely tight. Furthermore, early indications for November and December point towards colder weather and less wind and rain in Europe, which will have a significant negative impact on hydro and wind power on the continent.

# Crypto Milestones

Every newsletter we include an article on cryptocurrencies. This is because we feel that the technologies underlying crypto have wide reaching ramifications for business and will integrate greatly into our way of life. However, not too many people are actively following these technologies, therefore, **we write these articles in the hopes of providing information and education to our clients.**



One of the most fascinating things that happened this quarter was the fact that there was a distinct **lack of volatility** in bitcoin's price, especially compared to traditional asset classes. Bitcoin began the quarter at $19,245 and ended the quarter at $19,316. That is a gain of 0.36%. Meanwhile, the S&P 500 fell 5.8% and the Bond Index fell 4.73%,

Much like last quarter, we don't feel the price changes tell the whole story inside the crypto world. The big BIG story is we have a **proof of concept** playing out right before our eyes. The Russia/Ukraine crisis flat out proves the usefulness of crypto. Financial aid was able to be delivered to the Ukrainians much faster using the decentralized financial networks instead of the traditional routes. And Russia was able to run their financial system using crypto despite economic sanctions severely restricting their access to global banking systems. Some may view this as a good thing and a bad thing, regardless, the central idea behind the formation of Bitcoin has just been proven on a global stage.


Furthermore, Mike McGlone, of Bloomberg, said 'history may consider 2022 the year that bitcoin joined gold and U.S. Treasuries as a store of value.' Perhaps this can be supported by the fact that this quarter:

-the White House released their framework for crypto regulation,

-several countries have approved, or are in the process of approving, crypto for cross border payments,

-Blackrock (the world's largest money manager) struck a deal with Coinbase to offer crypto trading to their clients,

-Singapore's largest bank opened up crypto operations for their clients,

-Norway is using crypto infrastructure for the issuance and distribution of its national currency,

-the International Monetary Fund reported that 97 countries, or more than half of global central banks, were exploring or developing CBDCs,

-The European Central Bank (ECB) is exploring the possibility of issuing a CBDC, the digital euro,

-Bitcoin saw the number of digital wallets on its network rise to 84.7 million.

-The number of transactions of the Bitcoin network rose to 768 million.

-And the hash rate, which is a gauge of computing power of the network and also serves as a gauge of network of security, hit 226.2 million th/s.

It appears to us that the rising global level of crypto adoption has pushed the 'powers that be' to get their regulations regarding it in order. We believe that once these regulations are official, the cryptocurrency space will see a flood of money entering it on a scale that would have been unimaginable to the early pioneers of crypto.

# Non-Financial Events occurring this quarter

Queen Elizabeth passed away on September 8th


Hurricane Ian devastated communities in late September

Liz Truss was elected PM of the UK on September 5th

World Health Organization

On July 23rd, the W.H.O. declared Monkey Pox an international concern

Former Japanese PM Abe was assassinated on July 8th

The United Nations released a report on September 1st stating that China's internment camps might constitute war crimes

# Appendix

Below you will see the data used for the “Market's Potential” article and the corresponding calculations.

## Data

End of 3rd quarter 2022, the S&P 500 was 3,585.62, forecasted 2022 earnings had dropped to $190, the P/E was 18.87, and the 10 year Treasury's yield was 3.80%.

—stock market's implied interest rate calculation…………..(1/18.87)-1.06%)=4.23%

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—bond market's implied earnings calculation………………..(3,585.3/20.57)=$174.29

## Calculations

Substitute Bond Market Implied P/E……………………………..20.57*190=3,908.3

Substitute Bond Market's Implied earnings……………………..18.87*174.29=3,288.85

Remove Risk Premium……………………………………………...190*(1/.038)=4998.9

Remove Risk Premium with bond market's implied earnings..174.29*(1/0.038)=4,586.59

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