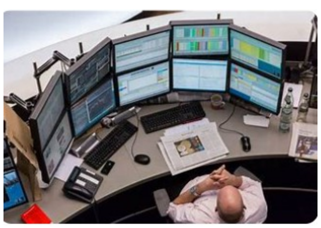
MRP CAPTIAL INVESTMENTS, LLC

2024 Market Fundamentals

2/21/2024

Introduction

Inside this report:



Day to day the pricing levels within the capital markets fluctuate constantly. Many investors try to use short term metrics, charts, and trading patterns in an effort to predict what the next tick of a stock's price will be. Will this $25 stock become a $24.78 stock on the next trade or will it become a $25.05 stock?

My personal opinion is that trying to make those kind of short term predictions is a fool's errand. From time to time, an investor may guess the right chart pattern a stock is following for a brief amount of time. However when the next batch of news hits the Street, the stock's path will change and the stock trader is back at the guessing game.

Rather than focusing on short term price movements, I think its vital to understand the market's underlying fundamentals which foretell the path the market will take in the longer term.

Anyone who follows my work knows that I believe the market has 3 distinct locations within its long term cycle. Those locations are the Boom phase, the Bust phase, and the Consolidation phase.

Each location within the longer term cycle has a direct impact on what investment style is the most appropriate one for investor's to embrace. Knowing this makes handling those short term market gyrations much easier. In fact, that feeling serves as the foundation for my firm's investment mantra:

"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."

Within this report, I will discuss our current market's fundamental positioning and what those fundamentals mean for investors.

Current Market

In February 2009, I wrote a report titled "The Beginning of the Bull." In that report, I detailed how the metrics I track were pointing to the fact that a major Bull Market was about to begin. That market saw the S&P 500 bottom out at 666 and as I write this the S&P is a 5,029.72. So far, that Bull Market that my model saw forming in early 2009 has appreciated 655%.

However, what is important now is to understand what the data says about our current market. And because of that, let's walk through those metrics and their current readings.

The first metric I use/track is Earnings Relative to Potential*. The key point in tracking this metric in our attempt to see when our current 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.

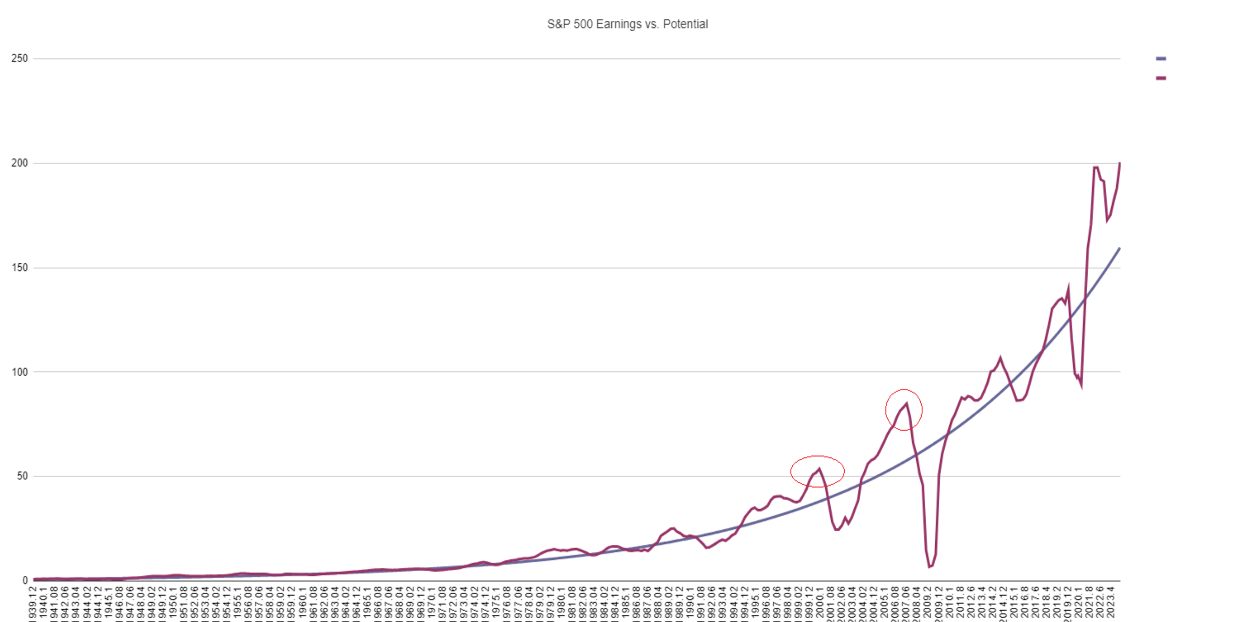


Chart of Earnings vs. Potential from 1880-2024 provided by MRPCI

As you can see from the chart, Actual Reported Earnings have risen above Potential earnings fairly substantially in the last few quarters. Later in the report, we will detail what impact that should have on the market as time marches on. For now, it is sufficient to realized earnings are high.

*I have discussed these metrics many times over the years and have detailed/explained them in many reports. However if you'd like a refresher on the details of each one, on our website (www.mrpci.com) the "Holy Grail" research report outlines the entire process in extreme detail.

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 shows the 10 yr. Price to Earnings Ratio.

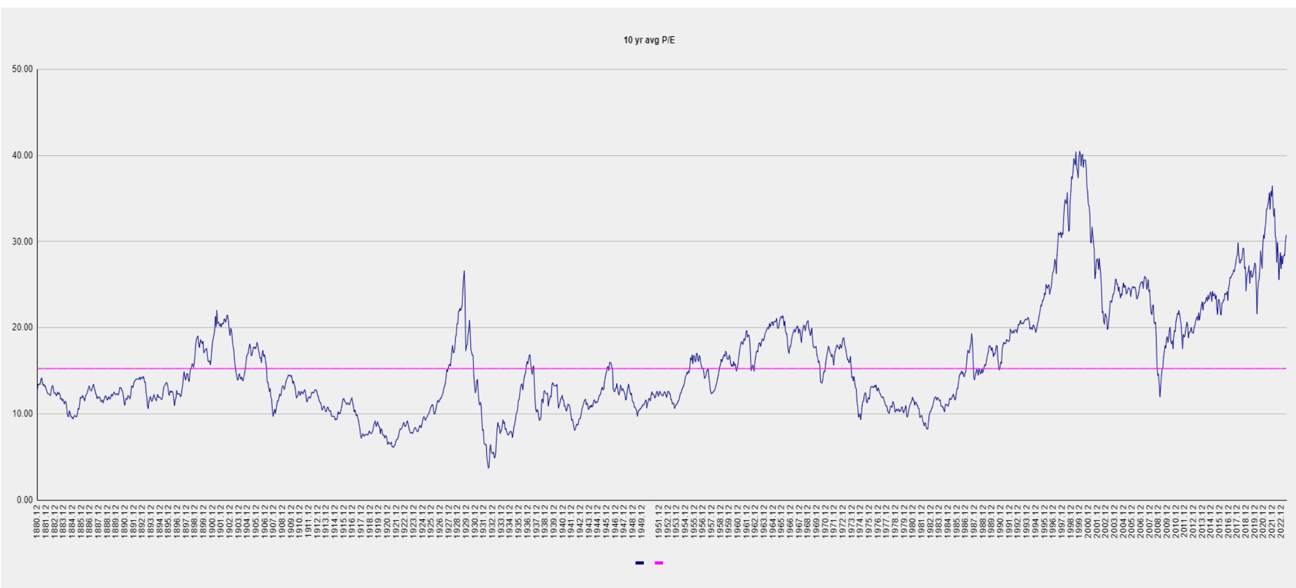


Chart of 10 yr average P/E of the S&P 500 from 1880-2024 provided by MRPCI

For reference, the pink line is the average P/E going back to the 1880s and its value is 15.26. While the Blue line represents the P/E level on the corresponding date as shown on the X-axis. Our current reading is 31.34.

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

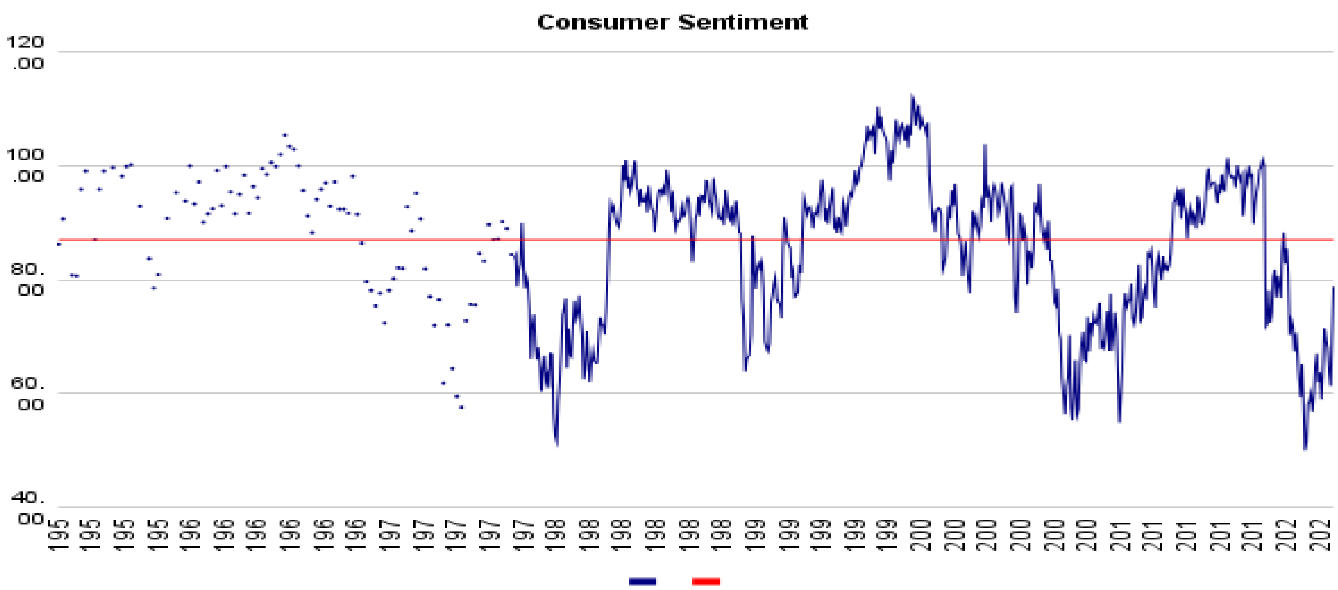
The next valuation chart we want to look at is Stock Valuations in relation to Bond Alternatives. The Bond Alternative we use in the this chart is the U.S. 10 year Treasury.

10 Year S&P 500 Earnings Spread provided by MRPCI

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.

With the historic rise in interest rates over the last couple of years, <u>the current level of bond yields make bonds, just barely, more attractive than stocks.</u>

The next metric I track very closely is Consumer Sentiment. I use the University of Michigan Consumer Sentiment Index to track this data point. I 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 2024, of the chart which plots the Consumer Sentiment Index's readings.



University of Michigan Consumer Sentiment Survey from 1954 to 2024 provided by MRPCI

The Redline is the level at which consumers/investors are in an "average mood." The numerical value of that average mood is 86.99.

In the summer of 2022, the Sentiment index actually registered an all-time low reading. Consumers/investors were in a worse mood than they were when going through the Great Financial Crisis, COVID, September 11th attacks, or anything else. It was at an ALL-TIME low.

It remained at fairly low levels until December of 2023 when it sky-rocketed 13% in one month. And then again in January of 2024, it popped 12% higher.

We remain below average in terms of Consumer Sentiment readings. However, the last two months have shown extra-ordinary levels of improvement in the readings. So, it is beginning to feel like some semblance of hope is brewing.

The final metric I 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.

I 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 showing data from 2011 until 2/2024.

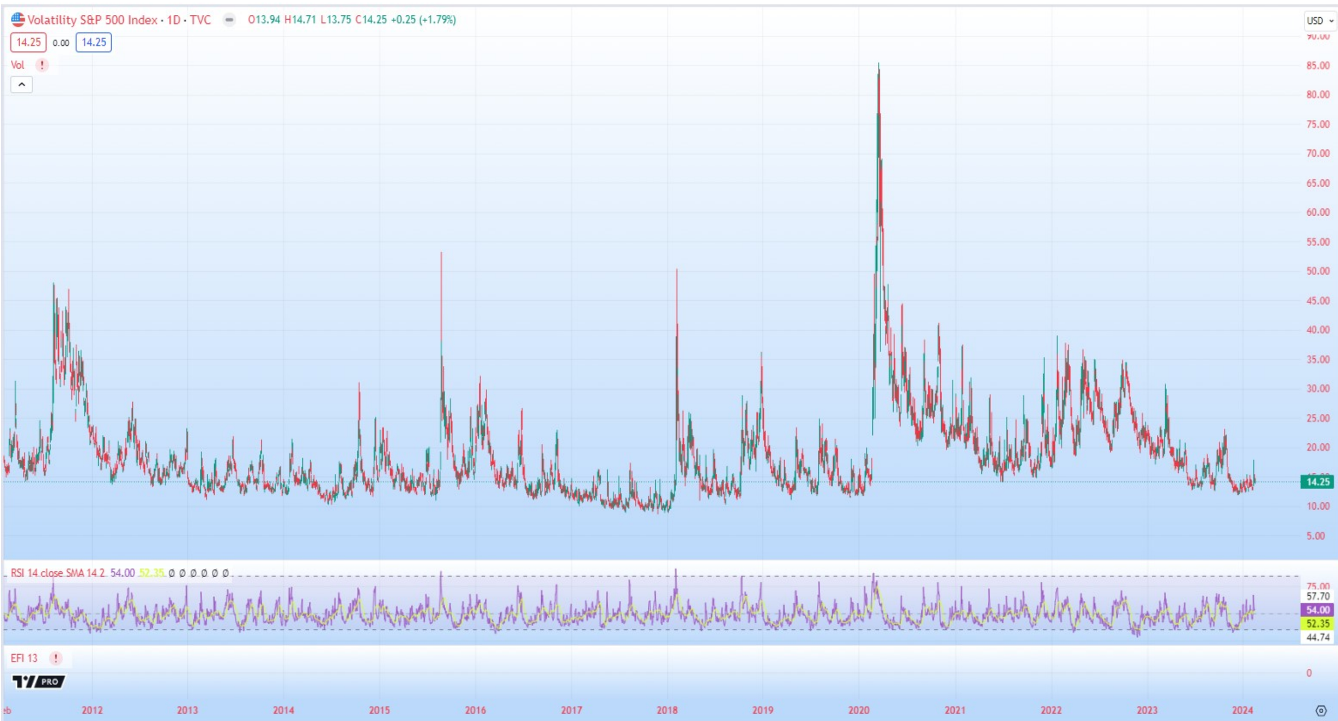


Chart of the VIX index 2012-2024 provided by Trading View

You can see the wild up and down swings. For reference, the biggest upswing on the page is COVID. Not surprising to see a massive spike in fear when a global pandemic breaks out and markets fall 40%.

As of right now, we have a low reading (14.25). However, it isn't even as low as it was during the bulk of the Trump Presidency. Furthermore, just prior to the Great Financial Crisis the VIX was about 9.5. In the late 90s, it also posted some readings under 10.

I think it is fair to say that the market isn't complacent about the risks in the market place. We can say that because of the raw reading of the VIX **and** the fact that it jumps to much higher readings on a frequent basis. These frequent bumps higher demonstrate the jitters market participants have in regards to the risks in the market. And that is a very healthy thing for the markets.

Summarizing the current readings of the metrics we follow, we have:

-Earnings that are well above potential/trend

-Valuations that are high

-Below average, but rising, Consumer Sentiment and

-A pool of investors that are not complacent about the risks in the market place.

At this point, a reader who is new to our work might ask, “Ok. What the heck does any of that mean for my investments?”

Well, the reason we track all of this is because there sure seems to be a high correlation between the readings of those indicators and the transition of markets from Bull to Bear, or Boom to Bust (with a period of Consolidation) to put in the terminology we use in our writings.

When a market transitions into a Boom Phase (or long-term Bull Market) like we saw in early 2009, we have historically seen:

-Earnings below potential/trend

-Valuations that are low

-Consumer Sentiment that is low

-And a High VIX reading, suggesting a market running on Fear.

When that Boom Phase turns into a Bust (or secular Bear Market), historically we have seen:

-Earnings that are above potential/trend

-Valuations that are high

-Consumer Sentiment that has been high for a decent amount of time

-And a low VIX reading, suggesting a market that is complacent about risk.

As we've mentioned, our work showed that our current Boom Phase started in 2009. Historically, Boom Phases last 18 years, they appreciate 1,014% (average compounded return of 14.33%), and experience 5 cyclical Bear Markets that average –15.4%.

In comparison, our current Boom is in its 16th year. It has a compound annual return rate of 14.42% (655% cumulative price return). And it has experienced 6 pullbacks (or cyclical Bear Markets).

Chart of S&P 500 from 2002-2024 provided by Trading View

You can see that the data on our current Bull run is comparable to the historical data on completed Boom cycles. However, that isn't what you track to see when this run will be over. You track those four metrics we were previously discussing. I just think it is important to understand how close we are to fulfilling historic criteria in regards to prior Boom Phases. And, in my book, we are close enough to a complete cycle's averages to begin to closely monitor when this Bull run might Bust.

Bust Phase

The next phase in the market's long-term cycle is the Bust Phase. The main reason we want to be aware of when this phase might begin is that historically the market falls about 50% in a 2-3 year period with very few significant cyclical Bull Markets to offer respite from the sell off.

Another layer of danger to the Bust Phase, in addition to the average return of –50%, is the fact that investors are trained to "buy the dip" during the Boom Phase. Investors are reward during the Boom when they buy any dip, no matter how big the dip, because, by its very nature, the Boom Phase always sees the market recover fairly quickly. But that is not the case in the Bust Phase.

Chart of S&P 500 from 2000-2002 provided by Trading View

If you buy a pullback in the Bust Phase, there is an almost certain chance that the market will keep falling and you will keep loosing money. Why? Because it isn't a dip. Rather it is a long-term secular Bear Market that is correcting overly optimistic market distortions that crept into the market during the prior Boom Phase.

For these reasons, and the simple mathematical fact that losses are more painful to an investor's portfolio than gains are joyful*, we believe it is extremely important to understand where we are in the market's cycle and to protect downside risk in portfolios.

* An investor who's portfolio loses 50% in one year, will have earn 100% to get back to even (that is 2x the loss percentage). While an investor who loses 10%, will only have to make back 11.11% to get back to break even (that is just 11% more than the loss percentage).

As we've mentioned a few times, 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, my research shows that ALL FOUR of there metrics must be triggered before the Boom ends.

Data Update

Let's take a detailed dive into each metric in an effort to completely understand how our current market is positioned in regards to each one.

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.

From the chart on page 2, we see that Earnings are well above Potential/Trend. When you run the numbers, you see that we are currently 20.24% above Potential.

Can Earnings drive this market higher? Hmmm. I suppose that answer is factually, yes, by 1.8%. But, essentially, not really. Any earnings gains from here would be smoke and mirrors in my mind and would be due to reverse in fairly short order.

Valuations—There is no question that normalized P/E ratios are high. And that is, without question, a negative. Furthermore, the valuation of stocks as compared to bonds slightly favors bonds. See the charts on page 3 and 4 for illustrations of these facts.

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

<u>Consumer Sentiment</u>—This is the most important metric for the markets. Historically, you need to see Consumer Sentiment at very high levels for a 3-5 years before the Bust begins. We are not even up to an average reading!

I am of the belief that COVID shutting the global economy down distorted sentiment readings but I am also of the belief that consumer have a lot of money and have yet to feel "normal" since the pandemic. Therefore, there can be a lot of juice coming from rising sentiment that can drive the markets in a significant manner.

All in all, it appears that **<u>continued rising Consumer Sentiment can provide a meaningful boost to the markets</u>**.

<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; Hamas attacking Israel, Fed seeming to push back interest rate cuts, and our Treasury Secretary insinuating we will borrow money to fund every crisis the world experiences. 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 is responding to bad news appropriately.

Chart of US Treasury 10 year Yield provided by Trading View

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 areabove potential and have just about reached historical peak levels.

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

Consumer Sentiment is close to an average reading. December and January saw massive upwards moves which shows the gloom and doom of COVID and the cyclical Bear Market of 2022 is fading.

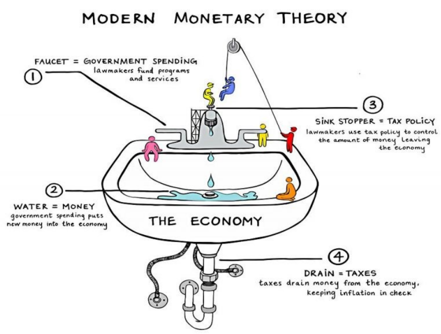
Investors are not **complacent**. They are reacting rationally to shocks in the markets.

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 16 years old.

Boom Phases, on average, generate gains of 14.33% annually and our current Boom's gains have been averaging 14.42% annually.

I had written a few years ago that I thought our current Boom Phase would be below average. This was due to the exhaustion of government's potential to stimulate the economy, given all the debt they had acquired. However, I am changing my tune on that prior opinion. We have seen countries utilize negative interest rates, multiple rounds of Quantitative Easing, and have even embraced Modern Monetary Theory and its concept that debt isn't debt if you can print your own currency and/or you are the World's reserve currency.



Long story short, these Central Bankers will do whatever they can get away with to keep the status quo in the world. And since the Congress, Presidents, and other officials and world leaders seem to be onboard with this or too concerned with re-election to fight against it, I don't see it stopping until the final straw completely erodes that last shred of confidence in our debt-based fiat currency economic system. And I have no idea what that last straw will be, given all that we've let them get away with so far.

Nevertheless, I need to stop the aside and get back on track.

To reach an average level in terms of length of time for this Boom Phase, we need 2 more years. Furthermore, to check all the boxes that the Boom is over, we need to see a high level of Consumer Sentiment and a high level of complacency in the market. Given that earnings and valuations are already high, it makes sense to me that we will ring in the Bust Phase with a euphoric blow off top with the Capital Markets running on irrationality rather than on solid fundamentals.

Truth be told, we could see an S&P 500 level around 7,800 before this thing implodes. That would simply be 2 more years of upside averaging 25% gains per year. Do my fundamentally driven models predict that price? No! They say 5,800 is the max that a rational market could see based on the data that we have available at this moment.

But almost all Boom Phases end in this kind of euphoric stupor. So, why shouldn't we get prepped and ready for it? For those hedge fund managers who want to push portfolios for the maximum amount of gains, it'll be like surfing the raddest and baddest wave they've ever seen and trying to make it back to land and not get killed when the wave breaks. We have very, very few clients who want that kind of portfolio. For almost all of you, we will be trying to maximize gains within a framework that focuses on risk-control at a level that is appropriate for you and your family given your goals and objectives.

As always, we will continue to track the market and adjust portfolios as needed. Although we seem to be in the later stages on a Boom Phase, profits from these phases are some of the biggest of the entire bull market run. So, we are investing to make clients money, but we are aware to the risks. It doesn't seem like the market will begin falling tomorrow and never stop. But risk monitoring needs to be top priority from now until the wave breaks.

Along with risk monitoring, you can rest assured that we are "amped to be carving it up the in the tube of sickest bomb we can find, bro"

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