MRP CAPITAL INVESTMENTS, LLC

2nd Quarter 2024 Client Newsletter

Capital Market Update

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After a -5.6% drawdown to begin the 2nd quarter, the market rallied with only one more significant pullback in Q2. For the entire quarter, the market tallied a 3.92% price change. Adding that to the record breaking 1st quarter's return, the total price change for the S&P 500 at the end of the 2nd quarter was 14.49%.

S&P 500 2024 Chart Supplied by Trading View

Looking forward to the 3rd quarter, we expect the election to come more clearly into focus. After the first Trump/Biden debate, there are plenty of rumors Biden will be replaced as the Democratic nominee. If this materializes, it is sure to add some spice to the market as it creates uncertainty. And the market hates uncertainty.

Furthermore, the probability for interest rate cuts has been increasing as the data concerning inflation and the job market appear to be cooling. Nevertheless, the economy does seem strong and this leads to an interesting dichotomy in terms of market views. Classic economists are leaning towards the concept that rate cuts, with a strong economy, can lead to longer term inflationary pressures.

Time will tell, but, as always, we will be watching very closely.

The Situation

As we move forward in 2024, the election will become more and more a focal point for investors attention. However, in addition to this short-term milestone, a longer term market altering set of circumstances is forming as well.

In the short-term, the election will become the only thing on investor's minds. As we have written about in the past 2 newsletters, historically in September/October the market pulls back by a little less than 10%. This is a signal that investors are taking some of their "chips off the table" in terms of equity allocation and they, normally, sit in cash until the winners of the election become clearer.

And once the election becomes settled in the market's mind, a rally normally starts a little before actual election day. This rally normally lasts into the next year and averages a little more than 20%.

We will be mindful of this historical precedence. However, the first quarter went against the grain and bucked the nearly 80% historical precedence of a pullback to begin the year and then a grinding higher of the market until the pre-election pullback.

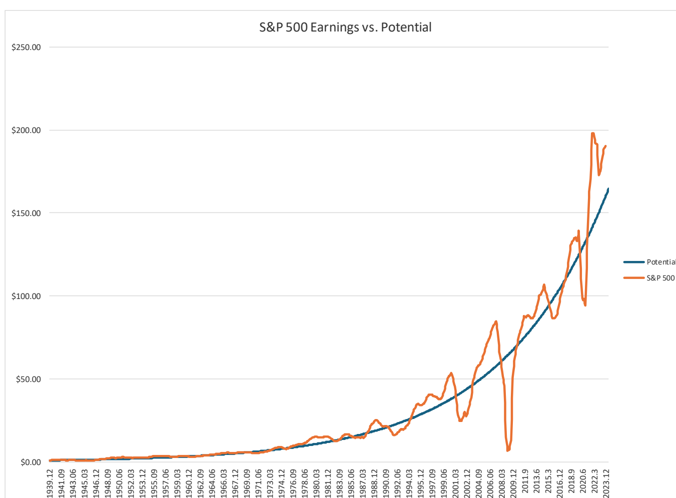
The 20% of markets, since 1950, that bucked the beginning of the year sell-off trend, tended to show less gains throughout the rest of the year as compared to an "average" election year's market. With this, we expected to see a sell off in the 2nd quarter, but not one that brings with it chaos. And, indeed, April saw the markets pullback 5.6% to begin the quarter. As expected, the market didn't enter a chaotic decline after that and, in fact, rallied to post a solid 3.96% return for the quarter.

S&P 500 Q2 2024 chart provided by Trading View

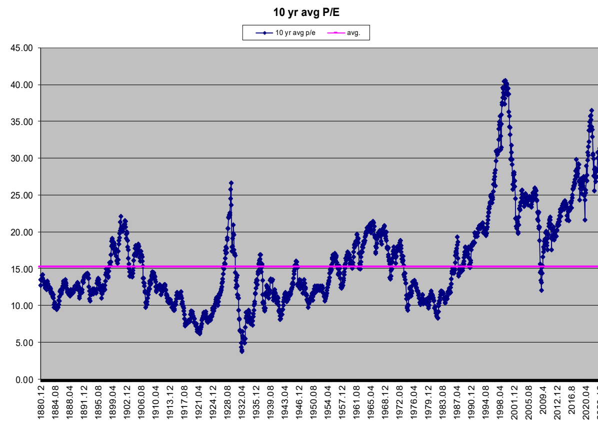
As we noted in the last few paragraphs, normally in a Presidential election year the market sells off about 10% prior to the election in September and then rallies 20% into the new year once the election is settled. We also noted that in years where the market bucks the 1st quarter selloff trend, the post-election rally is historically less robust than "normal."

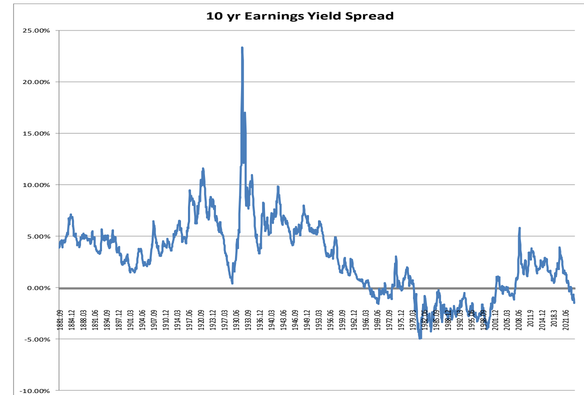
Time will tell us exactly what happens, but we feel pretty good about ending the year with a nice Holiday Season/New Year's Rally. But that does bring us face-to-face with the longer term issue that is forming within the fundamental framework of the stock market.

Years ago, we laid out in great detail our money management process. Included in this process is how we assess market conditions and identify what stage of the market cycle we are in: Boom, Bust, or Consolidation Phase. Since early 2009, we have been in the Boom Phase. Boom Phases normally end with a euphoric blow off top and then the Bust Phase sets in. When earnings are far enough above potential, valuations are high enough, sentiment is too optimistic, and the market is complacent on risk, then the Bust begins.

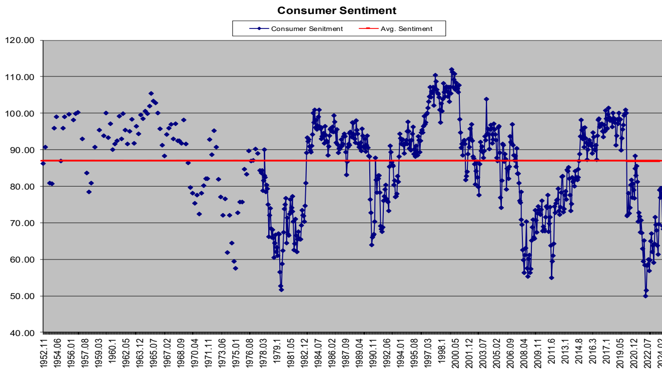


The chart to the left is a proprietary metric that we use to see how earnings compare to what should be a feasible level of earnings based on GDP growth and company efficiencies. As you can see, we are well above potential and very near levels in which earnings declines have historically started.





Above are two more proprietary MRPCI charts that give us a sense of the valuation levels for U.S. based stocks. The left is a Ten Year average P/E ratio for the S&P 500 stocks and you will note the current reading is very high. The chart on the right compares S&P 500 stock valuations to the Ten Year U.S. Treasury to see which one is a better value. If the reading is below 0%, then bonds are a better value at that moment in time than stocks are. And, as you can see, we are below that 0% reading now.



These last two charts show how people are feeling about this market. Boom Phases typically end with that euphoric feeling permeating nearly every investors mind frame. The chart on the left shows Consumer Sentiment is below average. The chart on the right shows a VIX index that does pop substantially higher when negative market events occur. That shows that the market participants are not complacent about the risks in the market.

Wrapping these latter few paragraphs together, the only thing we can really count on for continued market gains is improvement in investors outlook for the market's ability to go higher. This could end the Bull market when this improvement in mood leads to the onset of complacency about the risks in the market and we end up having a negative market event occur that everyone ignores.

This is what we are currently tracking, but haven't seen signs that suggest it is here now.

Bull Market Peak Behaviors

As we've mentioned in previous newsletters and research reports, we believe that we are approaching the end of a Bull Market run. We do not mean that this Bull Market will be over next week. However, we think now is the time to begin to consider how this process takes place and what to be on guard for.

Historically before a market completes the transition from a Bull to a Bear, there is a euphoric phase which sends the prices of stocks into the stratosphere. In the last article, we reviewed the indicators we use to track the market and its location in the cycle. To summarize those findings, we can say that at the end of the 2nd quarter:

-Earnings Relative to Potential were well above potential, which indicates earnings don't have a lot of room for further gains.

-Stock Market Valuations were high on a historical basis and when compared to fixed income alternatives. This means without a substantial drop in rates, stocks are expensive.

-Consumer Sentiment was a little low but is fast approaching mid-level. This is a bullish sign regarding future market gains.

-Investors were not totally complacent regarding the risks to the market.

This tells us that **moves higher in the market need to be driven by improving Consumer Sentiment.** The more confident consumers/investors feel, the more money they are willing to spend and invest. This simple fact, combined with the laws of supply and demand, paints a picture of a rising market in tandem with rising consumer sentiment. However, once Consumer Sentiment hits the historical level which indicates exuberance, then we have no drivers left to push the market higher (assuming the other reading remain in a similar set of circumstances as they are in now).

Those quantitative metrics are good for modeling into spreadsheets and analyzing market data. But very few people run financial and economic models when they think about investing. Instead they simply behave like human beings instinctively behave. This can lead investors down the wrong path from time to time.

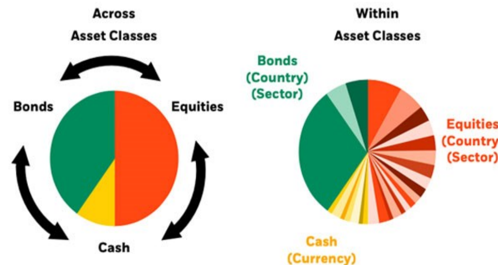
I'd like to highlight some things I've seen over the years that I think can help us avoid some of those missteps.

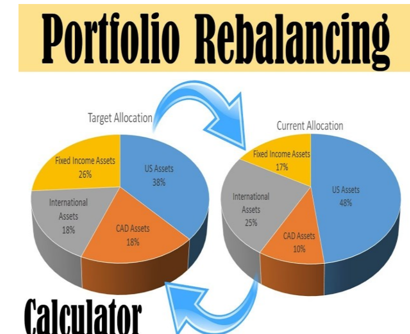
The first thing centers on the **performance of their portfolios**. During bad markets, most people have no interest in their returns relative to market indices. They don't want to hear, "The S&P was down 25%, but you were only down 20%." They don't necessarily view this as a good thing. Interestingly enough, they DO care about relative performance the longer a Bull Market runs. If the market is up 35%, they want to be up 38%. This leads to aggressive risk taking at Bull Market tops, which leaves them over-exposed to stocks (and other risky investments) at exactly the wrong time.

This dovetails into another signal that a Bull run might be getting close to the euphoric top. That "indicator" flashes a warning sign when **performance of an investor's portfolio far exceeds the return required to achieve their financial goals but it still isn't good enough for them.** For example, an investor who needs to earn 8.5% to make their life's financial goals a reality is unhappy they only made 20% in the market because their friend made 23%

Another one concerns **how investors view risk**. As stocks move higher and higher, their returns will dwarf the returns put up by defensive assets, like bonds. As we near Bull Market tops, questions like, “why do we even have bonds?” get asked. The booming returns posted by equities can cause investors to disregard the diversification benefits provided by other asset classes because over the short/medium term the returns of “risk assets”, like stocks, have outperformed. Once again, this will leave investors over exposed to risk assets as the market peaks and begins to fall.

These types of thoughts can cause investors to disregard long term financial planning and prudent asset allocation strategies in their pursuit of quick gains. Rest assured, we are aware of these psychological phenomena and we will always strive to stay appropriately allocated given your goals and risk tolerance. When we see these risk-taking behaviors pop up with clients, we will discuss them and attempt to put things in context of obtaining long term success. And we never forget that it is a mathematical fact that risk control is the key ingredient to compounding capital and obtaining financial success over the long haul.





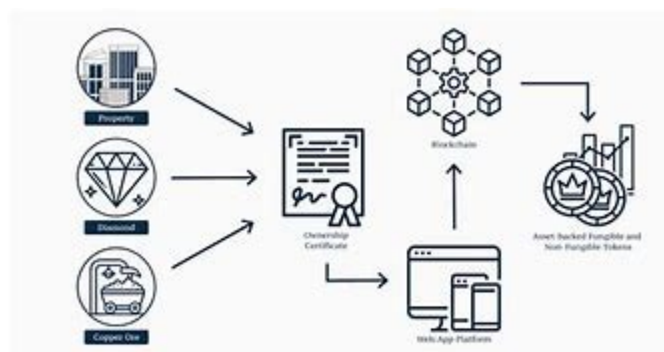
Cryptocurrency Update

This quarter we are adding in a new topic to our crypto discussions: **tokenization**. As powerful as the move upward in bitcoin, and some other cryptocurrencies, has been, the concept of tokenization is probably more powerful. Power players, like Blackrock and JP Morgan, are moving as fast as they can to capitalize on this burgeoning technological breakthrough. The simple truth is that tokenization will soon impact all of our lives. Given that fact, I feel now is the time to ensure everyone is educated on this revolutionary new foundation for asset custody and transactions.

Understanding Asset Tokenization

At its core, asset tokenization involves converting the ownership of a physical or digital asset into a digital token on a blockchain. These tokens are essentially digital representations of ownership rights and can be bought, sold, or traded much like stocks or cryptocurrencies. Each token is uniquely identifiable, providing transparency and traceability that traditional asset ownership often lacks.

The process typically begins with the selection of an asset to be tokenized, followed by its valuation and the creation of tokens that represent fractions or whole units of that asset. These tokens are then issued on a blockchain platform, where they can be traded peer-to-peer or on digital exchanges.



Benefits of Asset Tokenization

1. Liquidity:

Asset tokenization enhances liquidity by enabling fractional ownership. Investors can buy and sell smaller units of high-value assets, such as real estate or artwork, which were previously illiquid due to high entry barriers.

2. Accessibility:

It democratizes access to investments traditionally reserved for institutional or wealthy investors. Retail investors can now participate in asset classes that were once out of reach, thereby diversifying their portfolios and potentially increasing their returns.

3. Efficiency:

By leveraging blockchain technology, asset tokenization reduces the administrative complexities and costs associated with traditional asset transfer processes. Smart contracts automate compliance, distribution of dividends, and other administrative functions, streamlining operations and reducing friction.

4. Transparency and Security:

Blockchain's inherent transparency ensures that ownership records are immutable and easily verifiable. This reduces the risk of fraud and enhances trust among stakeholders. Additionally, smart contracts enforce predefined rules, ensuring that transactions occur only when specified conditions are met, thereby increasing security.

5. Fractional Ownership:

Tokenization allows for the fractional ownership of assets, meaning multiple investors can own small portions of a single asset. This democratizes investment opportunities and spreads risk across a broader base of investors.

Applications Across Industries

1. Real Estate:

Real estate tokenization enables property owners to divide assets into tokens, allowing investors to buy and sell fractions of properties. This opens up real estate investment to a wider audience and reduces the barriers to entry.

2. Art and Collectibles:

Tokenizing art and collectibles enables fractional ownership, making these investments more liquid. It also enhances provenance tracking, reducing the risk of counterfeit items entering the market.

3. Financial Instruments:

Traditional financial instruments such as stocks, bonds, and commodities can also be tokenized, enabling more efficient trading and settlement processes.

4. Intellectual Property:

Tokenization of intellectual property rights allows creators to tokenize their work, ensuring they receive royalties directly and transparently whenever their creations are used or sold.

Challenges and Considerations

While the potential benefits of asset tokenization are significant, several challenges remain:

- Regulatory Compliance: Regulatory frameworks vary across jurisdictions, and navigating compliance requirements can be complex.

- Market Acceptance: Adoption of asset tokenization requires trust and acceptance from both investors and traditional financial institutions.

- Technology Risks: Blockchain technology is still evolving, and issues such as scalability, interoperability, and security must be adequately addressed.

Future Outlook

The future of asset tokenization appears promising, with growing interest from investors, financial institutions, and regulators. As blockchain technology matures and regulatory frameworks evolve, we can expect to see broader adoption across various asset classes. Innovations in decentralized finance (DeFi) and the emergence of tokenization platforms are likely to drive further growth in this space.

Conclusion

Asset tokenization represents a paradigm shift in the way we perceive and trade assets, offering enhanced liquidity, accessibility, and transparency. By digitizing ownership rights and leveraging blockchain technology, asset tokenization has the potential to democratize finance, unlock trillions of dollars in currently illiquid assets, and reshape global markets. As we move forward, overcoming regulatory hurdles and technological challenges will be crucial in realizing the full transformative potential of asset tokenization.

FORBES › FORBES DIGITAL ASSETS

BlackRock's $10 Trillion Tokenization Vision: The Future Of Real World Assets

J.P. Morgan's Onyx Has Tokenized $300B of US T-Bonds So Far

How Tokenization Can Fuel a $400 Billion Opportunity in Distributing Alternative Investments to Individuals

Non-Financial Events occurring this quarter

Iran and Israel engaged in a number of attacks against each other.

UN offered Palestine a seat as Permanent Observer.

Joseg Newgarden won the Indy 500.

Mystik Dan won the Kentucky Derby.

US, and allies, launched a number of retaliatory strikes versus Houthi rebels.

President Trump and Hunter Biden were found guilty on all charges.

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