MRP CAPTIAL INVESTMENTS, LLC

A Bear Hunt

Research Report 12/31/2013

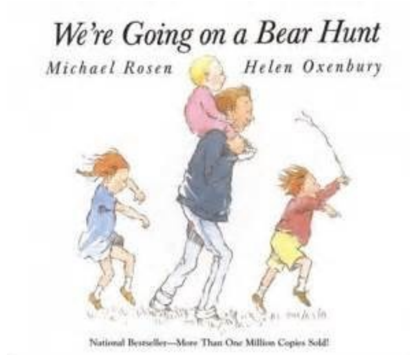
Introduction

Inside this report:

As I noted in my last research report, the stock market has appreciated significantly over the last 5 years. In fact, the S&P 500 is up over 100% since 2009 and the biggest year of this run was the 29.6% appreciation that occurred in 2013. According to my work, we have been in a secular Bull Market since 2009. Obviously, these gains solidify that claim that this is, indeed, a long-term Bull Market. However studying past Bull Markets shows that during times of long-term upwards moves the market does experience short-term pullbacks.

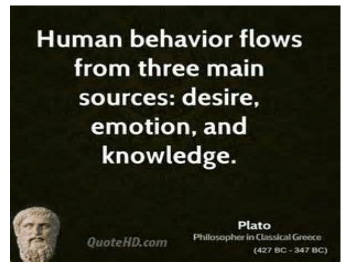
Since all of my client's goals center around long-term asset growth and capital preservation, I must remain ever wary of the next Bear Market; even if it is short-term in nature. With this in mind, I've gone through every market cycle since 1871 and analyzed every Bull Market pull back of 10% or more in an effort to identify the characteristics that have set the table for those pullbacks.

My hope is that by knowing the market conditions that led to previous pullbacks, we can stay a step ahead of this market. I view this as hunting down these Bear Markets and being prepped and ready before they can hurt us.



Historical Review

I always turn to historical data to try to garner clues for what the future might hold. I do this because I believe that markets are a study of human behavior. And if we can study what humans have done previously under similar circumstances, then we are a step ahead of the crowd.



With this, I've looked at all previous cyclical Bear Markets which occurred within secular Bull Markets. I began this analysis right after World War I. From that starting point, there have been 14 market movements that fit the above criteria. The average pullback during these cyclical Bears was –16.92%. Since basic math shows that the key to generating excellent long-term returns is minimizing the damage from market pullbacks, we need to do our best to limit the damage caused by these Bear Markets.

To do this we need to understand what was happening just prior to these previous sell offs, so we can identify when our current market is beginning to morph into cyclical Bear. Key elements I am looking at while performing this analysis are:

-Where were we in the Economic Cycle? Expansion or Recession.

-What did the valuation of the market look like?

-What was the interest rate environment?

-Where were Actual Earnings in relation to Trend Earnings?

-What was the level of Consumer Sentiment?

-And what level of fear, or complacency, was in the market?

After analyzing all of this data, the most obvious conclusion was that as the economy transitions from expansion to recession, the market is primed for a pullback. In fact, during these Secular Bull Market Runs there were 8 times when the economy transitioned from Expansion into Recession. 6 times during that transition, the S&P 500 fell over 10%. And the average selloff during those occurrences was -17.33%.

Another interesting discovery was the damage caused by highly valued markets when they entered cyclical Bear territory. Of the 14 cyclical Bears occurring within a long-term Bull cycle, 4 of them came about when the market was highly valued. [For our purposes, that equates to a P/E ratio greater than 20.] The average drawdown during these cyclical Bear markets was -21.4%

Another common theme among these Bull Market setbacks centered on geo-political events. For instance, in the early and mid 1960s the market saw 2 Bull Market pullbacks. And neither time did the economy turn into Recession. However, there were major geo-political events unfolding. The early 1960s pullback, specifically from December 1961 through June 1962, took place soon after the Bay of Pigs invasion and JFK sending "military advisors" to Vietnam. There is no question in my mind that the fear of the Cold War escalating into WWIII prompted this sell off.

Furthermore, the next cyclical Bear was unleashed when LBJ escalated the Vietnam War. And this resulted in a 17.35% market pullback from January 1966 through October 1966.

Historical Conclusion

As I look through this data and put it into useful form, I have three main takeaways.

#1—We need to be aware of our place and time within the Economic Cycle and be adequately defensive when an expanding economy begins to enter a Recession.

#2—We need to be vigilant regarding the mood of the market in light of geo-political events.

#3—We need to be aware when the market enters a highly valued state, as the damage caused by cyclical Bear Markets during these times are particularly harmful.

Application to our Current Market

As I stated previously, I look at this historical data in an effort to stay a step ahead of our current market and where it could potentially go. With that in mind, let's apply our Historical Conclusions to our current market to see how close we are to the next Bear.

Our first historical conclusion was that:

#1—We need to be aware of our place and time within the Economic Cycle and be adequately defensive when an expanding economy begins to enter a Recession.

According to the National Bureau of Economic Research, we have been in an economic expansion since June of 2009. And, frankly, it is hard for me to see that our economy is headed for a Recession. If you look over recently economic headlines, you see things like:

US Pending Home Sales Rise (12/30/2013)

Jobless Claims Hit Lowest Level in nearly a month (12/26/2013)

Durable Goods Order Surge in November (12/24/2013)

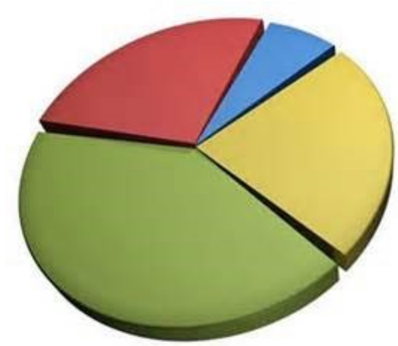
US Consumers Spend Enthusiastically in November (12/23/2013)

These headlines seem to highlight a growing and robust economy. And that seems to give validation for the Fed tapering their bond buying program. Because if the economy is strengthening, why do we need extraordinary levels of economic stimulation? Well, we don't. So, the Fed is taking their foot off the gas, slowly, due to a strengthening economy.

The second historical conclusion was:

#2—We need to be vigilant regarding the mood of the market in light of geo-political events.

Now, this one is tough. We've always had hot beds of potential geo-political disruptions. And, frankly, at any time these things can erupt. BUT, this is why Investment Policy Statements are made and risk-tolerances assessed. We need to have custom tailored portfolios with their own unique asset allocation strategies, in order to protect our portfolios and investments due to unforeseen circumstances and events.



And, when one of these market changing geo-political events unfolds...portfolios need to managed in accordance with the stated goals and objectives within the Investment Policy Statements. This helps takes the emotion out of investing and helps us focus on the long-term goals, while taking advantage of short-term opportunities. And geo-political disruptions generally do create opportunities for savvy investors.

And the final historical conclusions was:

#3—We need to be aware when the market enters a highly valued state, as the damage caused by cyclical Bear Markets during these times are particularly harmful.

If we are not in a highly valued market, then we are darn close to it. The trailing 12 month P/E ratio of the S&P 500 at the end of the year 2013 was: 18.9 And the 10-Yr. Average P/E on the market is 23.03. Historical data shows that a P/E reading greater than 20 should be considered high. So, this is something that bears watching very closely.

Another thing that is vitally important to this statistic is the earnings level of the market. At current earnings levels, the trailing P/E is 18.9. Should the earnings level increase, that number becomes smaller. Should earnings decrease, that number becomes larger...and the highly valued status of this market gets worse. Therefore, we need to keep a keen eye on the upcoming earnings reports.

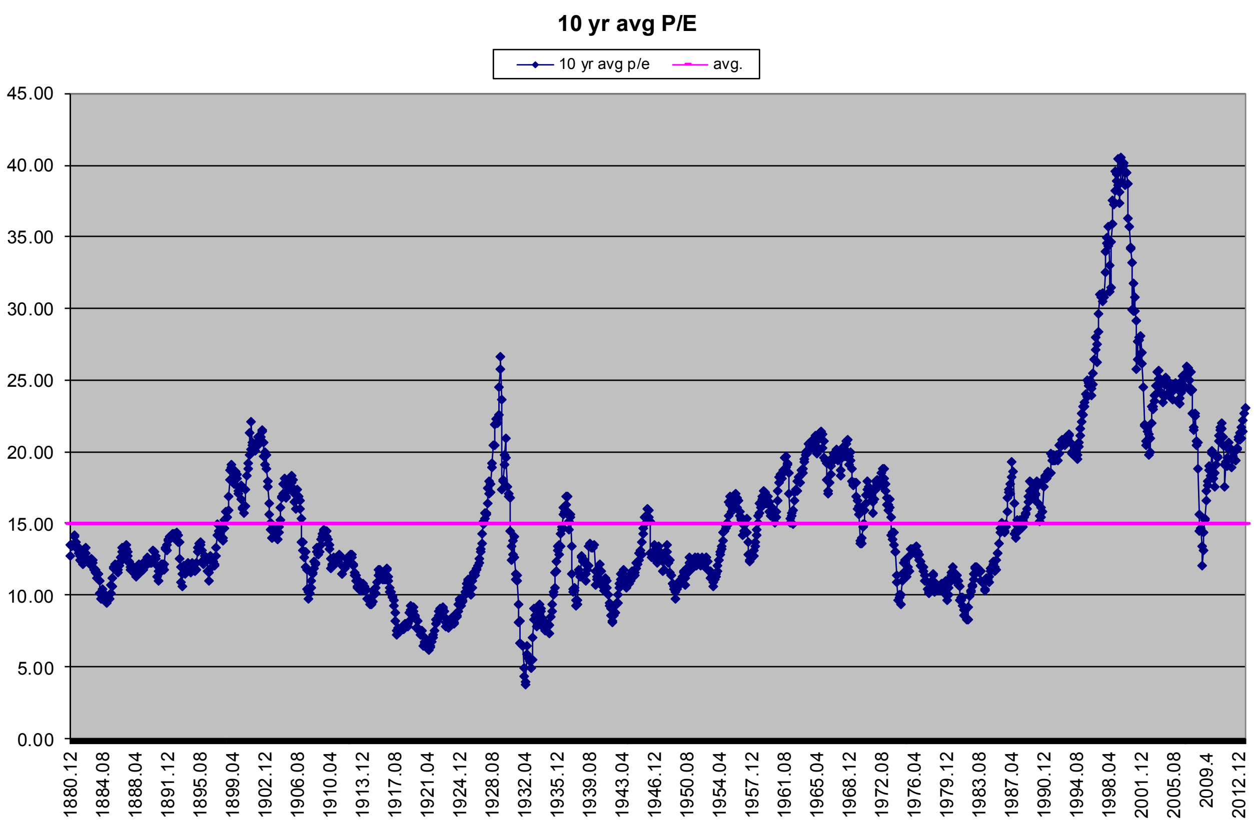


Chart supplied by the MRP Capital Investments, LLC database

Summary

In summary, I think it is vitally important to understand that even though we are in a long-term Bull Market run, the market will still experience shorter-term Bear moves. In fact, on average, secular Bull Market runs experience 5 such Bear Market pullbacks. Within our current Bull, which began in 2009, we have only seen 2 such Bear Markets. I am on the look out for the next one; I'm on a Bear Hunt!

Kenneth Anderson

When looking back at history to study these Bull Market setbacks, I noticed three interesting things. These setbacks seemed to be highly linked to the economic cycle, geo-political events, and the market's valuation level.

In our current market environment, it appears our economy is performing well enough to allow the Fed to begin to remove its extraordinary stimulative measures. But the valuation levels within our current market are beginning to get elevated by historical standards. And even though geo-political events are very important to the markets, it is very hard to predict when these negative events will unleash themselves on the markets.

These findings show that a growing economy will be the key to the continuation of our current Bull Market run. Any economic stagnation could lead our highly valued market into the next cyclical Bear Market. Rest assured, I will remain focused like a laser on all pertinent data releases and potentially market moving announcements. And portfolios will be adjusted as necessary in light of new information and will be managed according to each of your custom tailored Investment Policy Statements.

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