MRP CAPTIAL INVESTMENTS, LLC

Earnings Recession

6/6/2016

Introduction

Inside this report:

As readers of my research know, I track actual earnings versus potential earnings of the S&P 500 with the potential earnings being derived from the nominal GDP figures. I put this data into chart form in an attempt to see how likely it is earnings will appreciate or depreciate in the future.

Back in the first quarter of 2015, I began talking about earnings being unsustainably high. Due to this, I moved from an over-weight position regarding equities to an under-weight position.

Now my work shows that earnings appear to be bottoming out. Throughout this report, I will talk about the potential market ramifications of earning's moves like this and discuss my previous market comments.

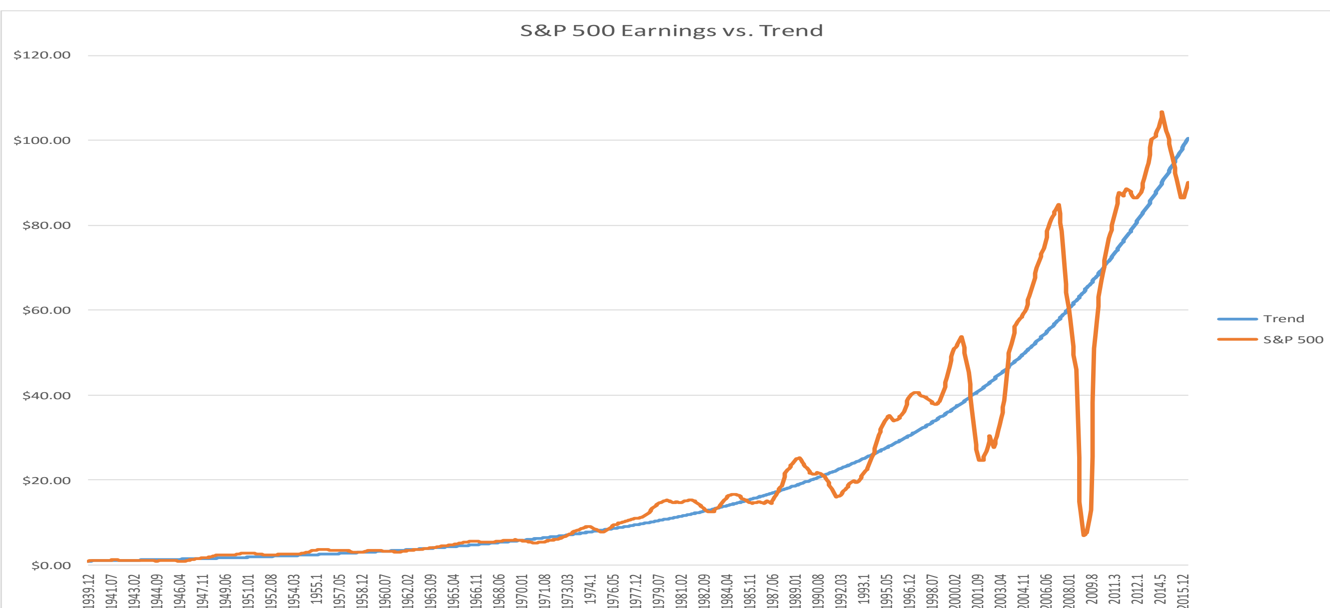


Chart Supplied by the MRPCI database

Previous Market Comments

As we go through this report, I will talk about how the potential for hitting a bottom in this earning's cycle can impact market prices. But before I get into that, I'd like to rewind and talk about something I wrote in last quarter's newsletter. I think they both paint a similar picture and if you can get to the same answer from multiple angles, I think the validity of the conclusion is enhanced.

In the "Economic Reality" article in the last newsletter, I looked at the impact a booming economy could have on stock market pricing. Here are some excerpts of that article:

I took the historical data on employment and the economy and applied it to the market in an effort to truly capture what a really hot economy and market would look like.

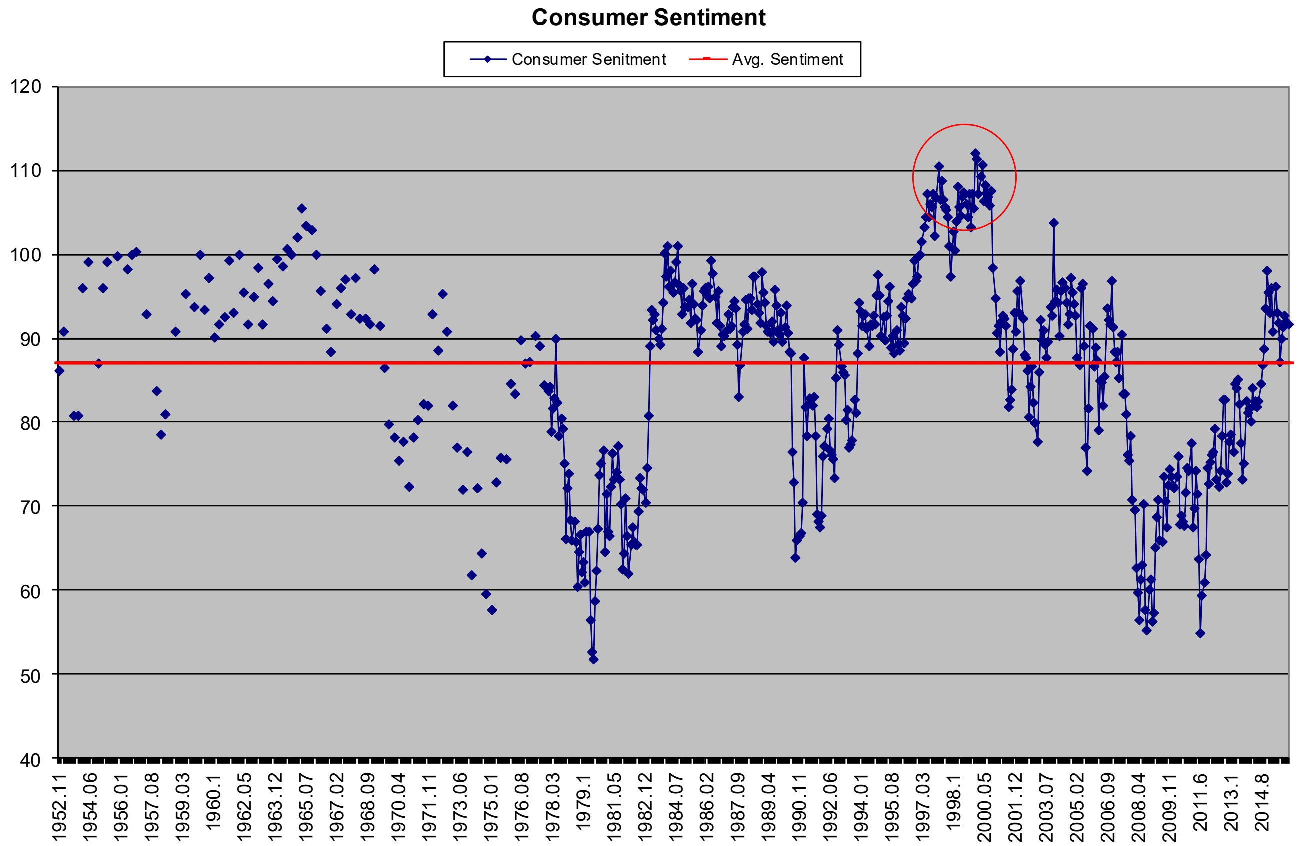
To do this, I first wanted to come up with an employment number that would give everyone a job who wanted to work. To do, this I took our current population number (250 million) and used the lowest unemployment number in recorded history (which was 2.9% in 1952) combined with the largest percentage participation in the Labor Force in recorded history (67.1% in 1997) to derive our Nirvana Labor Force; 163.407 million.

As a side note, this implies that, even at historically high Labor Force participation levels and historically low unemployment levels, there would still be 83.5 million people not in the labor force. Which would most likely be centered around the retirees, students, and homemakers. Put another way; there are over 11 million people who would work right now, if they could find a job.

Ok...back on track...with this Labor Force of 163.407 million people and using the current GDP per employee ratio, this Nirvana Economy could produce GDP of $19.6998 trillion ($1.76 trillion more than our current level).

Taking the ratio of S&P 500 earnings to GDP, implies an S&P 500 earnings level of $106. To find out the market's upside in this Nirvana economy, we need to find out the appropriate P/E level to apply to these earnings.

But here is the kicker, take a look at the Consumer Sentiment chart again. Specifically focus in on the late 1990s readings, which I've circled.



Those readings are historic highs and, of course, the economic activity of the late 1990s was historically good. If we had record high employment, record high Labor Force participation, and surging S&P 500 earnings (as is modeled in the Nirvana Economy Scenario), I would venture an educated guess that Consumer Sentiment would be back to those levels. And, if you remember, the P/E on the S&P 500 hit 37.1 during those boom times.

When you apply that P/E to the implied earnings from this type of economic boom, you get an S&P 500 level of 3,604 and this represents about a 50% gain from our current levels.

Do I think the market will do this/go there anytime soon? No. This analysis was done to simply see where the economy (and market) could go if things started to click. However, over the long-term, this is exactly the kind of thing the market should do as we near the end of the Bull Market.

I wanted to include those previous comments to show that when you look at the market from a historical economic standpoint, the case can be made for pretty significant gains from where we are now. The key to that forecast becoming reality is for the "powers that be" to institute policies that spur growth and/or do away with policies that are curtailing growth.

Another interesting thing to re-look at is the historical work I did on markets a long time ago in the "Holy Grail" report. In this model I call Bull Markets "Booms" and I've quoted the data many times, but I think doing it again makes a lot of sense. Booms, on average, last 18 years and during that time the market appreciates 1014%. The trick is that during that 18 year run, on average, there are 5 cyclical bear markets, or pullbacks, that average a little over 15% each.

For context of where we are now, this Bull Market has been running since 2009. So, this puts us 8 years into the Boom Cycle. The S&P 500 bottomed out at right around 666. And with our cycle high of 2,120, that puts our trough to peak gain at 218%. And we've seen 4 pullbacks during this run.

As you can see, per this historical market perspective, we have more upside to run. Which is what the economic model says as well.

Historical Study of Earning's Moves

The latest batch of research I've done focuses on the Earnings Recession we've been in for the last couple of years. In fact, September 2014 saw the peak of this cycle's earnings when the S&P 500 reported "actual earnings" of $106.75. Since then earnings have fallen pretty consistently and stood at $86.5 at the end of March 2016. However, S&P forecasts earnings of $90.13 at the end of the 2nd quarter with consistently increasing earnings over time.

So the question is, "Will these forecasts be correct?" I have a hunch they will be accurate enough to show that we are at the trough of the Earnings Recession and we could see a nice increase in earnings in the near future. When we take another peak at the chart on the first page of this report, we can see that current earnings are below potential, or trend, earnings. If we were to simply get back to trend that would put S&P 500 earnings at, essentially, $100. But what gets really interesting is when you look at historical Earnings Recession bottoms and see how earnings have moved from these troughs to their next peak.

When I began to look at this data, I went back to the 1970s and analyzed all the major earnings troughs. I looked at what the earnings level of the market was when earnings bottomed, what level the market was at during the earnings bottom, how long it took for earnings to peak from that point, and what level the S&P 500 reached when earnings hit their next peak.

What the data showed was that there were 5 major earnings recessions from the 1970s through now. And during those times, earnings gained, on average, 390.27% from trough to peak. However the fall, and subsequent rise, in earnings during the 2008 cycle was so severe that I felt it skewed the data. So, excluding the 2008 earnings rebound, S&P 500 earnings appreciated, on average, 123.81% from trough to peak following Earning's Recessions.

Furthermore, the length of time of the upside run in earnings from the trough averages just a bit under 4 years. And the market, on average, jumps 31.86% (excluding the market jump after the 2008 trough).

Application to our Current Market

The next step we need to take in this process is to apply the historical data to our current market. This will allow us to see what the historical averages say our current market could do if this, indeed, is the trough in earnings.

To review:

-Current low reading on S&P 500 earnings is $86.75

-Date of low reading on S&P 500 earnings is 3/31/2016

-Average earnings gain for historical trough to peak run is 123.81%

-Average time of the historical trough to peak earnings run is about 4 years

Ok...let's apply the math…

If we have bottomed on earnings and the historical averages hold true, we will see the earnings on the S&P 500 go from $86.75 to $194.16 (86.75+86.75*1.2381=194.16). And this appreciation in earnings will reach its peak in early 2020.

The next step that I believe always needs to be done is to analyze whether this kind of move is feasible.

When looking at my macro-economic model, projected trend earnings in early 2020 is $126.64. And, as we know, during the peak of Boom time earnings, earnings always over shoot projected earnings. The question is how much do they over shoot by?

Of the 5 trough to peak earning's run we've been studying in this report, I found the average "over shoot" of earnings at the cycles peak was 33.05%. When you apply a 33.05% over shoot to our projected 2020 earnings of $126.64, you get $168.49 (126.64*1.3305=168.49).

Based on this, I would say the $194.16 is too high of an earnings estimate. Is it possible? Of course, but I can't plug that number into my model given how far above historical precedent that would be. I have to use the $168.49 figure for peak earnings in my projections for feasibility purposes.

Now we have a peak earnings figure that makes rational sense based on the market's history. And that figure is $168.49. This implies that our rebound in earnings can still be substantial, but, nevertheless, below average.

Regardless, an S&P 500 that produces earnings of $168.49 should trade at a higher price than we are currently at.

To see where the market could be with these kind of earnings, let's apply a basic valuation methodology to the data. For this, let's just take the average market P/E ratio and apply it to those earnings. The average Price to Earnings ratio on S&P 500 stocks since 1970 until now is 19.18. So, the implied Fair Value of the S&P with earnings of $168.49 is 3,231.64 (168.49*19.18=3231.64).

To summarize this analysis:

If the S&P 500 earnings have, in fact, bottomed and appreciate at a below average pace, they could feasibly reach $168.49 by early 2020.

This implies a potential climb in the S&P 500 to 3,231.64 over that time frame. This would equate to an approximate gain of 50% over 4 years.

As an interesting side note, the economic model I mentioned in the beginning of this report suggested the S&P 500 could get to 3,604, if the economy were to start clicking on all cylinders. Both are very similar in their findings, but come at the valuation level from different angles.

Current Challenges

As I read through the data I just presented one thought keeps pulsing in my brain, "Those numbers and historical averages are great, but our world is ripping apart at the seams!!!" And to take that thought a step further: if the world falls apart at the seams, historical average won't hold water.

And, to be frank, those thoughts have validity and we are facing real challenges. These challenges are significant and create fear among investors. It is this fear that has been making the market's so volatile over the last several months.

Make no mistake, I am not immune from human emotion and I get fearful too. The fact that we all are emotional is exactly why I use mathematical models based on historical market precedents. I believe in Behavioral Finance and that our emotions do, indeed, impact our buying decisions. If we are scared, we sell...even if we logically know we shouldn't. If we are euphoric, we buy...even if we know we are paying too much. However when you use cold and sterile math and logic based on historical market precedents, you can limit the negative impact emotional knee-jerk reactions can have on portfolios.

And, if you are being really wise, you can act counter-intuitively to the emotional vibe of the market. There is a great Warren Buffett quote related to this concept, "Be greedy when markets are fearful and be fearful when markets are greedy." In a nutshell, that encapsulated Behavioral Finance.

But, I think everyone who studies markets, even a little bit, knows this. It is just hard to fight fear when the stimulus gets overwhelming. And let's take a look at what the stimulus is:

First, and foremost, we've got the continuing War on Terror and the rise of ISIS.

But now, this terrorism threat seems to be hitting developed countries, including the U.S. on a consistent basis.

And to go along with these continuing Terror Wars and attacks, you have a flood of refugees coming into these developed countries.

You also add to the emotional tidal wave with the huge political divide among the people in these developed countries.

And all of that is just the geo-political stuff, not direct market issues. When you add in that China is trying to transition its economy to a consumer based economy,

Europe is in the midst of some major economic issues,

Oil has been showing crazy pricing moves for over a year,

And Yellen has been factoring all this global stuff into her policy regarding what's appropriate for the U.S. economy,

You get uncertainty and fear. At any moment you feel that China will implode, Europe will disintegrate, or Yellen will make a major policy error.

So, like I mentioned earlier, the fear is real because these challenges are real and real scary. But, let's not forget that the market always faces challenges. My long-term economic model goes back to the 20s and includes a market that had to deal with Hitler, WWII, The Great Depression, the start of the Cold War and the Bay of Pigs.

While all the models used in this report's analysis include time frames that dealt with the stagflation of the 70s, oil embargos, hostage crisis', multiple Wars, and Terror attacks.

And even when all of that stuff is included, the cold and sterile math shows that the market has more long term upside. But, yes, there are downside risks. In fact, we've seen the S&P 500 hit the 1,850-ish level on more than one occasion recently. We need to be prepped and ready for that, while being aware that once this Earnings Recession is over there is a real chance for significant upside to the market.

Conclusion

At the end of 2015, I put out a research report detailing my thoughts on what 2016 would look like. The main theme of that report was "volatility" and I think we can all agree that we've had that in spades so far this year. However I noted in that report that if we could work through the core issues related to that volatility, then the stage could be set for the resumption of the Bull Market. I still believe that is the case.

The main issue that needs to be resolved is earnings. Earnings need to rise because in the end there are two things, and only two things, that drive market prices; earnings and the multiple applied to those earnings. If we are at the trough in the earnings cycle, the odds favor a rising market.

I believe that once we get our Presidential election behind us, then we can focus on a specific President's policies rather than taking the worst of all the candidate's policies and worrying about them. Furthermore, this will let us know what strategy we will be using to deal with ISIS and the global terror threat in general. Both of these things should reduce uncertainty and boost the multiples applied to earnings.

Additionally, and perhaps most importantly for the market's sake, we need to get economic policies in place that foster growth. If we can reduce the strain that is being placed on the business world's bottom line, then we should see a burst of earnings momentum.

If all of these thing begin to unfold, we could see the massive appreciation in earnings that I've detailed in the last several pages. However, we need to be aware of the challenges facing the market and have portfolios prepped and ready for pullbacks and stumbles until then. The coast is not all clear, but the fog should lift in due time.

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