Selloffs and Uncertainty

March 2 ,2020

Predictions continue to be difficult, especially about the future (Steincke). The future we face today is no exception, especially with respect to financial markets. Our job has been, and remains to be, a guide to navigate uncertainty and not a sage that can foretell. That navigation is difficult for a variety of reasons, not the least of which are the very real emotions each of us experience at the prospect of gain and fear of loss. The most recent selloffs from all-time highs can only serve to exacerbate those emotions and make an unclear future seem murkier. Today the primary question on our minds, as it relates to the assets we're privileged to manage is, **"what do we make of the coronavirus as it relates to financial markets?"**

We will continue to monitor events each day as they unfold and make portfolio adjustments as necessary within the confines of each client's strategy and overall plan. Our objective is to be mindful and responsive to the present while never losing sight of the big picture.

Our research on epidemics, relative to markets, over the last 40 years indicates the market impact has been relatively small and temporary. Of course, there is no guarantee this epidemic couldn't worsen, by spreading before receding and taking a tragic toll on those whose immune systems are very compromised. For the majority of us it would likely be a garden variety, miserable, flu. The U.S. is preparing by alerting the public and advising safe practices, restricting travel to high risk areas, improving testing, and isolating those who are confirmed cases as well as those suspected to be infected. Hopefully these precautions mitigate a substantial stall of U.S. commerce.

However, it has already had a very large impact in China. The coronavirus developed just before the Chinese New Year, the biggest annual celebration for the massive Chinese population that entails a lot of travel to family and holiday getaways. China is not known to be as proactive of, or reactive to, these kinds of situations, as much of the developed world. It has shut down entire industries in China that supply much of the world's manufactured goods. Technology firms, auto makers, airlines, and numerous other companies have already announced they will be impacted by lost business because of the closures.

The soft landing the U.S. economy had achieved is indeed vulnerable to the impact we have already seen from business interruption stemming from overseas economies. There is some intermediate-term risk that even if the virus turns out to be no more serious than previous outbreaks, as we still expect, extreme government responses aimed at containing the virus, while effective, may result in a pandemic of fear; increasing global recession risks and a negative environment for the broader stock market. On the other hand, the Federal Reserve and the current administration may act aggressively to mitigate risks that develop. So, we will continue to diligently monitor the health of the U.S. economy, corporate earnings, and consumer confidence.

SECURITIES OFFERED THROUGH PRIVATE CLIENT SERVICES, MEMBER FINRA/SIPC. ADVISORY PRODUCTS AND SERVICES OFFERED THROUGH CAPSTONE INVESTMENT GROUP, LLC, A REGISTERED INVESTMENT ADVISOR. CAPSTONE INVESTMENT GROUP AND PRIVATE CLIENT SERVICES ARE UNAFFILIATED ENTITIES.

As this is being written, the S&P 500 is down for a 7th straight day. We believe that what came together cumulatively to start this correction were the following:

- **Stocks were expensive**
- **Investors had gotten too optimistic**
- **Coronavirus is having impact on the economy and corporate earnings**
- **Many investors are fearful of what a Sanders presidency would mean for the stock market.** (Fear gets priced in whether what is feared is realized/justified or not)

This correction has been rapid, steep, and more conservative investments have been hit disproportionately hard relative to what we normally expect in relation to the S&P 500. It seems there is inadequate distinction between higher risk and lower risk investments. We don't believe this will persist. In a panicky market environment, many sell first and ask questions later. When things do stabilize, we believe investors will selectively return to buying quality, at depressed prices. Historically, this has been the case with most every major market correction in the past.

The stock market is a discounting mechanism and It attempts to look ahead and price in today what it sees in the future. It sometimes over-reacts to the degree of risk it perceives might be in the future. The stock market is also a huge auction. So, when the market is down a lot, many investors allow fear to inspire selling. When there are too many sellers and not enough buyers/bidders, prices can get very depressed in the short-term.

The volatility index, also known as the fear gauge, has tended to hit extremes when fear is excessive. This tends to have a high correlation with being near stock market lows. The VIX (fear gauge) spends most of the time hovering between low double digits to mid-teens. The VIX hit a very high reading of 36.20 the day after the low in the stock market in December of 2018. Earlier today the VIX hit a high of 49.48. We are not aware of the VIX hitting highs this extreme at any time in the last 30 years, other than during the financial crisis of 2008.

When the fear gauge is at an extreme, like it is today, history suggests that it is a buyers' market and not a sellers' market. Buy fear, sell greed has produced pretty good odds throughout stock market history, but has rarely felt very good when the time to buy fear arrived.

To reiterate, we continue to monitor all the market events as they unfold and make any necessary portfolio adjustments within the borders of each client's strategic plan. Our goal is to remain mindful and responsive to the present while never losing sight of the big picture.

Thank you for the trust you've placed in our team and we welcome any questions or concerns you may have during this time.

Sincerely,

Capstone Investment Group