CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

April 16, 2020

Financial Markets Commentary 1st Quarter 2020

Summary

It probably comes as a surprise to no one, but the first quarter of 2020 was the worst first quarter in modern market history. The stock market lost 19.6% during the quarter, but even that fact masks the truly awful stretch between February 20th and March 23rd in which the S&P gave up more than a third of its value. That kind of drop from an all-time high (February 19th) is also unprecedented. It was as if the stock market was cruising and then suddenly hit a brick wall! The decline in international stocks was worse at 22.8% and downright terrifying in the small cap arena (30.6%). We all know why stocks went down but the speed of the decline was augmented by computer trading programs. These trading systems had spent years over-investing in stocks because stock volatility continued to trend lower. As volatility suddenly soared in March, stocks became an increasingly risky asset to hold, meaning more stocks needed to be sold in order to hit target volatility. This vicious feedback loop led to -6%, -7%, -9%, and -12% days. It was very hard to make a "good sale" on a very bad day, and this extreme market action spilled over into the Bond Market as well.

Bonds theoretically do not need the issuing company to thrive, as stocks do. They just need the issuing company to remain solvent. The price of bonds should be impacted by only two factors: is the company able to service the debt (default risk) and does the interest I'm getting compensate me fairly for the risk to my purchasing power (inflation risk)? Last month, however, we saw bonds plummet in value that had no risk of default in an environment where inflation was of no immediate concern whatsoever. The reason was liquidity. In other words, owners of Treasuries, mortgages, corporate bonds, and municipal bonds were dumping them because they needed the cash to meet other obligations. Foreign governments sold off Treasuries because they needed to push down the value of the soaring dollar versus their own currency to avoid a crisis. Insurance companies and other financial firms sold all types of bonds in order to raise cash because they expected a surge in claims. From March 9th to March 22nd there just weren't enough buyers for all the motivated sellers!

In time, there are enough buyers and then some, but bonds don't trade like stocks in the way that you always know where the market is and can expect execution at that price. They don't flash bond CUSIPs across the screen on CNBC for a reason. That said, massive government intervention into the credit (bond) markets did start to stabilize prices on the 23rd. Treasuries and agency regulated mortgages had largely recovered

by the end of March. After another huge government intervention on the 8th of April to help bring the corporate and municipal sectors of the bond market more into line with actual default risk.

Activity

While we can't say we saw the Coronavirus coming, we can take pride in having moved decisively once the impact became foreseeable. We slashed positions on February 27th, raising cash levels in portfolios from 8% to over 20% above where they were the previous day. This enabled us to lose much less throughout the most chaotic two weeks of the March. We trimmed or replaced positions where funds were not holding up as well as we would have expected, but we could also buy if we thought prices had fallen too far too fast. On the 23rd of March we felt we had to take a little extra insurance against an outright collapse, so we started using short ETFs as a hedge against some of our positions. This has, in the short run, meant that our portfolios have not bounced back quite as fast. It is our belief that the economic damage done by the virus will be measured in months and years instead of days and weeks, so while we are happy government moves have sparked a rebound in both equity and bond prices, we are playing the long game. We believe that it will be extremely difficult for the government to get needed funds to all the sectors and sub-sectors of the economy quickly enough to avoid a very deep recession[1].

Outlook

We don't believe anybody has a playbook for where we are now. The rally in stocks so far this month seems ridiculous given what we think we know about the difficulties of fully restarting the economy. That said, the stock market has its own logic. If participants believe that there are profits to be made in buying remote communications stocks and/or squeezing those that are short or underweight stocks, the market can move higher for a while. That just isn't a bet we want to make because at heart we are not traders. We are far more comfortable in bonds because we know that the government is actively purchasing them. This has the effect of putting a floor underneath prices. You can't make money nearly as fast but you can be much more confident that you will make money any given day, week, or month.

Commentary

When we wrote the commentary last quarter, there were a few points we really wanted to make. We obviously didn't expect the market to sell-off immediately, but we knew both valuation and sentiment were extremely high and we knew that combination was traditionally associated with market peaks not bottoms. The first

[1] Note: If it were possible for any government to get all the money and resources necessary to all of the sectors that need them, then capitalism is probably not the best economic system.

chart showed the market being 130% above its long-term regression line, which was the highest in history. The second chart showed the CNN Fear and Greed Index flashing extreme greed[2]. Both of these measures have come down considerably, but stocks are still higher than their long-term averages. This is not what the bottom of a bear market looks like. At generational market bottoms, like we saw in the 1930s and 1970s, investors are not thinking about how much they can make in the darlings of the moment (today Amazon, Zoom Video, Netflix, etc); they aren't thinking about the stock market at all. They have been burned by false rallies so much that they have given up.

With lower stock prices today, we can think in terms of stocks providing high single digit returns going forward. This is an improvement from the mid-to-low single digit return expectations that we started the year with. Again, we are currently more attracted to bonds because of the higher probability of (modest) success. It is our continuing aim to provide reasonable risk-adjusted returns to all our clients. When it is not possible to accurately measure risk, as it is today, you can expect us to err on the side of caution.

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[2] We also asked, at the end of the last commentary, "in an environment where most investors are fully committed, who does the buying if there is a mad rush to get out?" Unfortunately, we got our answer. The old adage that markets take the stairs up and the elevator down was proven once again.