SPECIAL REPORT: THE CORONAVIRUS AND THE EQUITY MARKETS

Back in the early days of the Financial News Network, they had an exceptional credit market analyst named Ed Hart who would talk about periods "where the demand for certainty far exceeds the available supply". If he were alive today, he would surely consider this to be one of those times.

That said, even during periods of extraordinary uncertainty, there are certain things that seem to remain forever constant. These include human nature, crowd psychology, and how we, as human beings, process the emotions of fear and greed. These characteristics tend to be so remarkably consistent, and also measurable, that almost the entire science of behavioral economics (and much of technical analysis) is/are based upon them. We hope to use the opportunity of this report to put the current decline into context, by viewing it through the lens of human nature and investor psychology.

At present, the consensus opinion is that it will take good news related to the coronavirus pandemic to put in place a sustainable bottom in the stock market. If true, then equity markets are likely to get much worse before they get better, as we don't think that we are near the end of the bad news related to the coronavirus, despite the fact that the spread of the virus in China itself is showing signs of abatement. To the contrary, the World Health Organization has just categorized the risk of global coronavirus spread as "very high".

However, we believe that the aforementioned premise ignores some of the important lessons of history, including the fact that, when faced with great uncertainty (like now), markets tend to almost immediately try to price-in the worst-case scenario, instead of waiting to determine just how bad things are realistically likely to get before reacting.

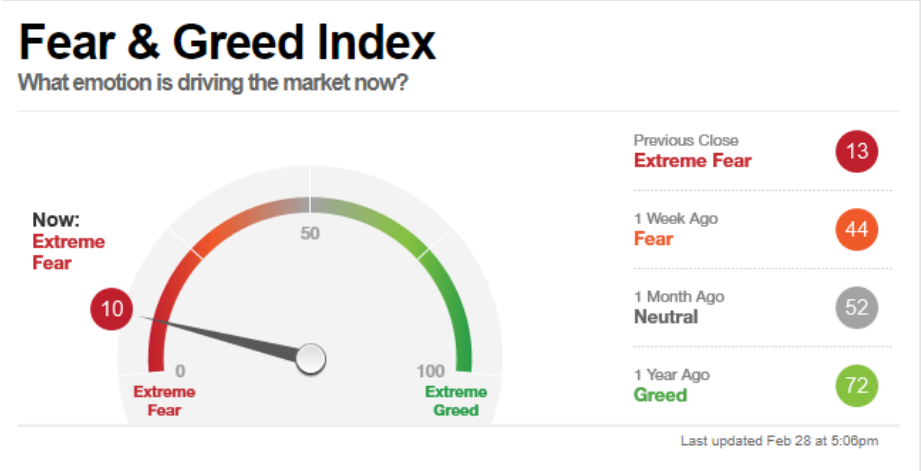
Normally, the selling continues until investor sentiment reaches the "point of maximum pessimism", when the market essentially runs out of potential sellers, and a bottom is put in place. Historically, the greater the level of uncertainty, the more likely investors are to try to price in the worst-case scenario immediately, rather than react to information as it comes in.

There are a number of reasons why we suspect that the equity markets are rapidly approaching that point of maximum pessimism, at which point markets usually become fairly indifferent to bad news, because it is already priced in. Importantly, that is also what often allows markets to rally even on bad news, just as long as the news is less bad than what had previously been priced in by the markets.

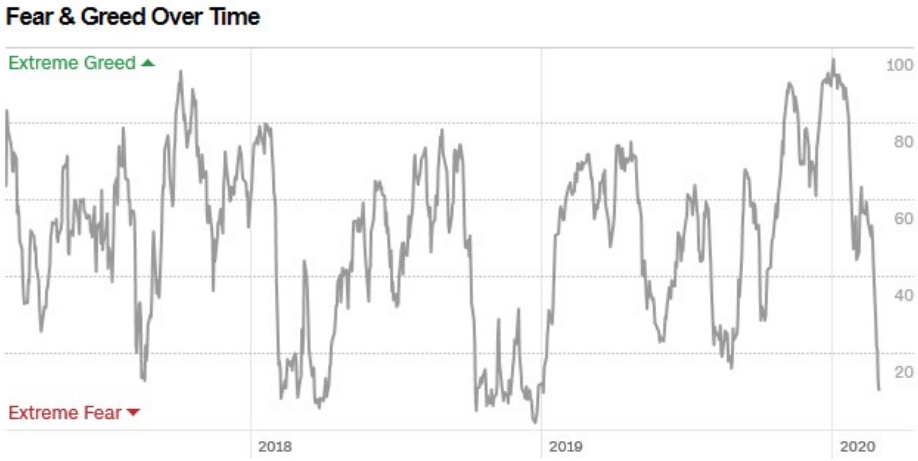
If markets react as they often have in the past, then, rather than looking for an improvement in the outlook for the coronavirus, investors should instead be looking for evidence of a selling climax in stocks (when investors engage in panic-selling, no matter what the price). The most obvious, albeit anecdotal, evidence of the markets having approached this point is found in the sheer immensity of the current decline, with the markets suffering their fastest 10% fall from a new high in history, and the worst weekly decline since the financial crisis.

However, there are also statistically-based models that can be very useful in identifying inflection points in the markets.

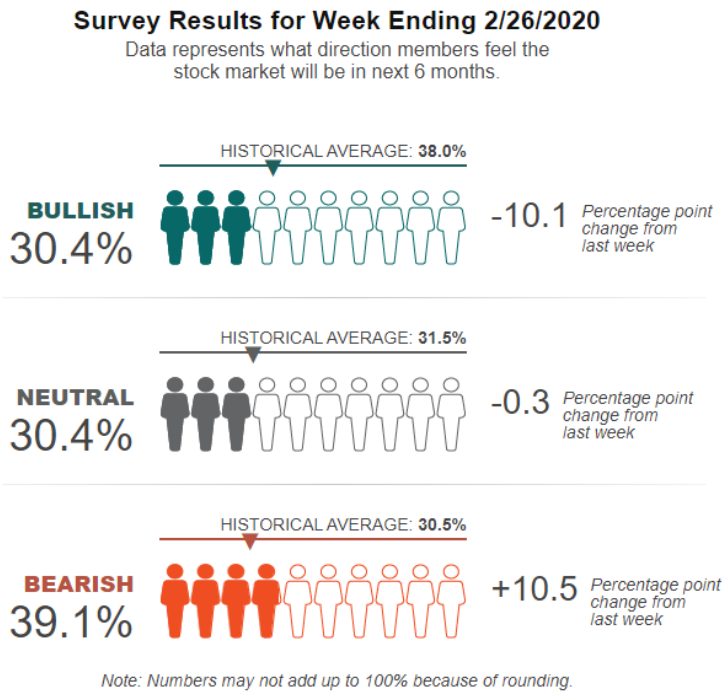
Historically, one of the best tools for identifying such "capitulation bottoms" is the VIX "fear index" (above), which essentially measures what investors are willing to pay for defensive hedges, and which surged as high as 49.5 on Friday, before closing at just over 40. In the past, readings of 40 and above have frequently coincided with both peak levels of fear and capitulation bottoms in the equity markets.



There are numerous other market and sentiment-based measures that are affirming the extreme levels of fear that oftentimes accompany a market bottom. One indicator that does a nice job of combining an array of such measures of investor sentiment is the CNN Fear and Greed Index, which has gone from readings of extreme greed earlier in the year to a level of only 10, which is approaching the extreme levels of fear reached during the Q4, 2018 bear market, and which provides a fairly compelling indication of the potential for a near-term selling climax. After all, if investors are already that bearish, it is very likely that they have already sold about as much as they are inclined to sell.



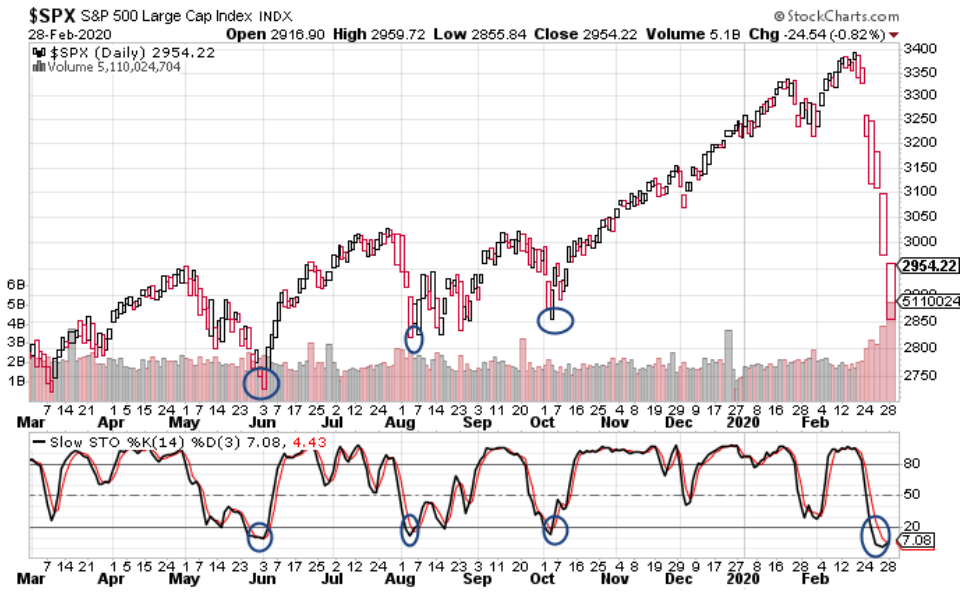
The extreme level of bearish sentiment is also very evident in the American Association of Individual Investors survey, which suggests that only 30.4% of individual investors believe that the stock market will be higher six months from now. Logic would suggest therefore that most individual investors who are inclined to sell have also already done so.



Another chart that we would like to highlight is one that employs a variety of mathematical and statistics-based technical indicators of capitulation and sentiment.

One of the first things that you are likely to notice (below) is that trading days are represented by boxes of varying widths (i.e., equivolume), with the heaviest volume days having the widest boxes. Periods of extraordinary volume, such as the present, tend to be quite significant, as "volume equals validity". Historically, important tops and bottoms almost always occur on extraordinary trading volume, and we believe that this further supports the premise that we may be rapidly approaching a capitulation bottom in domestic equities.

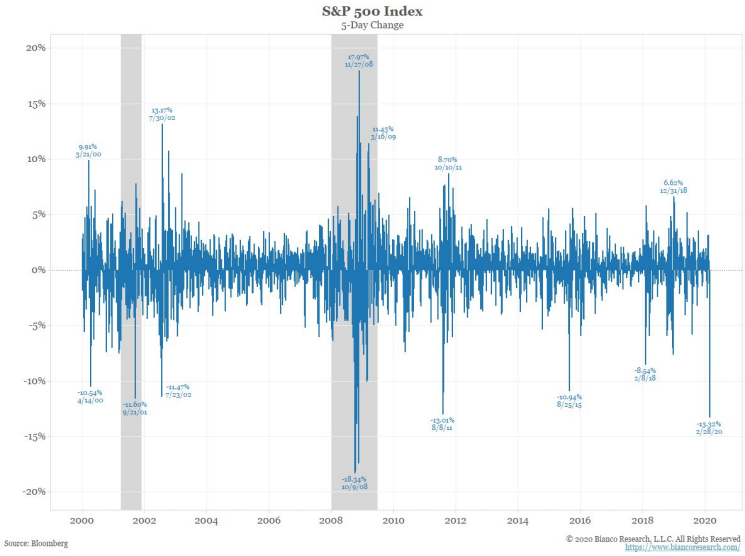
Further suggesting that the markets are approaching at least a near-term bottom is the fact that last week included two 90% down days and two 80% down days (i.e., days when 80% and 90% of the trading volume was in declining stocks). These numbers also suggest capitulation.



Yet another noteworthy indicator is the red and black stochastic oscillator at the bottom of the chart. Readings below 20 (circled), as we are seeing today, normally indicate that the stock market is very technically oversold (i.e., it has gone down too far, too fast), which could lead to a powerful rally. While the past is not necessarily prelude, you can see how previous drops below the 20 level have coincided with lows in the equity markets.

Importantly, there are a few things that have likely contributed to both the depth and breadth of the current decline. Among them are headline-reading computer algorithms, that generate trades based upon news headlines, at least initially without the benefit of human input, and which now account for a significant majority of trading volume on most days.

The second has been the massive shift to passive strategies like index funds (where investors invest in a whole index (like the S&P 500) or sector (like healthcare, technology, financials, etc.), without differentiating between individual companies) that has taken place over recent years, and which is causing the indiscriminate selling of stocks, largely without regard to underlying company fundamentals, as index investors end up selling the entire market or sector, when they make a tactical decision to get defensive and raise cash.



We should emphasize that markets tend to overshoot in both directions, **so it is certainly possible that a sustainable bottom is not as close as these indicators suggest, particularly if the pandemic becomes even worse than worst-case market expectations.** It is further possible (even probable), that even a powerful rally will require an eventual retest of the lows, as "W-shaped" bottoms are historically much more common than are "V-shaped" bottoms.

That said, regardless of whether or not a sustainable bottom is imminent, we do strongly believe that anyone buying quality stocks at these levels is likely to be well-rewarded on both an intermediate and longer-term basis, particularly in light of what we consider to be a high probability that we are about to see a wave of fiscal and monetary stimulus introduced by central banks and governments across the globe.

To paraphrase legendary investor Sir John Templeton: Bull markets begin in despair, grow on pessimism, mature on optimism and die in euphoria. We have been warning about investor euphoria over recent months. However, one of the direct casualties of the coronavirus pandemic has been that bullish ebullience, and we would argue that sentiment is now much closer to irrational pessimism (despair) than irrational exuberance (euphoria).

While there are few absolute rules in investing, "buy low and sell high" has worked for a lot of investors for a lot of years and, as Mark Twain noted, "history does not repeat itself, but it oftentimes rhymes".

If you have any questions about this report, please do not hesitate to reach out to your financial advisor. We would be pleased to have you share this perspective with anyone who you believe might find it beneficial.

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Neither Asset Allocation nor Diversification guarantee a profit or protect against a loss in a declining market. They are methods used to help manage investment risk.

The VIX Index is based on real-time prices of options on the S&P 500® Index (SPX) and is designed to reflect investors' consensus view of future (30-day) expected stock market volatility. The VIX Index is often referred to as the market's "fear gauge".

The CNN fear and greed index (FGI) was developed by CNNMoney to measure two of the primary emotions that influence how much investors are willing to pay for stocks. It is based on the premise that excessive fear can result in stocks trading well below their intrinsic values, and that unbridled greed can result in stocks being bid up far above what they should be worth. CNN examines seven different factors to establish how much fear and greed there is in the market, scoring investor sentiment on a scale of 0 to 100.

The Standard & Poor's 500 (S&P 500®) is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

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