July 2020

The Capstone Quarterly

We hope this letter still finds you and your family safe and well. Another holiday is upon us that might be celebrated a little differently than last year. However you celebrate this Independence Day, may it be an enjoyable and relaxing weekend. In this newsletter, Bryce discusses the performance and positioning of our client accounts and Casey gives a market update.

Bryce's Point of View

-By Bryce Pease, CFP®, Chief Investment Officer

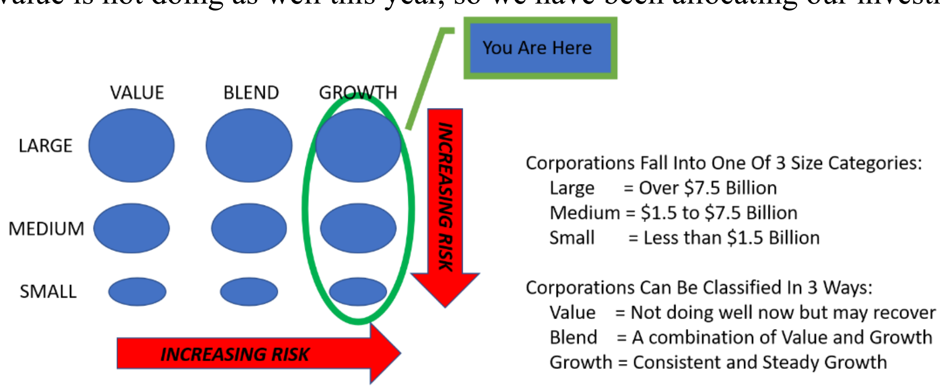
It is okay to look at your account!

Many of our clients have said during this pandemic that they were scared to look at their accounts online or their monthly statement that comes in the mail. I'm here to tell you that it is okay to open up that browser or that piece of mail.

We have been working hard to take advantage of the swings in the markets and we are happy to say that there have been strong gains in your account. As of this writing, the Dow Jones and S&P 500 are still in negative territory[2] but the majority of our clients are positive for the year – some even hitting double digit returns!

One question I've gotten quite a bit through all this is whether or not I am personally investing my money in the stock market right now. Both Casey and I invest right alongside our clients with our own personal money. Meaning, we are in the same models and have the same investments in our own accounts at TD Ameritrade that you have in yours. We have always done this, and plan to always continue to do so.

As far as the investments are concerned, this year we have been mostly on the Growth side of the stock market which has been outperforming the Blend and Value categories. For example, small value is not doing as well this year, so we have been allocating our investments more towards the growth investments. As always, we will make changes as the markets change. It is also important to know we do not have any funds in the international markets right now. At the



moment we believe there is too much risk for the potential return. Always remember that you have a team in place who are constantly monitoring the markets and trying to choose the best investments for all of us.

Casey's Corner

-By Casey Morris, CFP®

Coronavirus Market Update

You're on the highway, drumming your fingers along the steering wheel and humming to the music on your radio when suddenly you look at the speedometer. Woah! You are driving 83 miles per hour – and the speed limit is 65. Hoping the highway patrol is not around to see, you immediately press the brakes. Has that ever happened to you? (Yeah, me neither. Wink-wink.)

Well, on Thursday, June 11, that's exactly what happened to the markets.

The Dow plunged over 1800 points. The S&P 500 fell by almost 6%.[1] It was the largest selloff since April. It is also a sign that investors have realized the markets may have been climbing too fast – well beyond the speed limit the economy has set.

Here's what I mean. Remember the brief-but-brutal bear market in March? Thanks to the coronavirus, the S&P fell from 3,386 points on February 19 to 2,237 just over a month later.[2] What started as anxiety over disrupted supply lines morphed into full-blown terror over the prospect of skyrocketing infections, bankruptcies, and unemployment. It was one of the fastest bear markets in history.

But in its wake came one of the fastest bull markets in history. From March 23 to April 8, the S&P rose roughly 22%.[2] And for the most part, the markets have kept climbing. By June 8, the S&P had climbed 44% in only two-and-a-half months![2] It was an absolutely stunning turnaround.

But was the turnaround real? That's the question our clients have all been asking us. Because as the markets climbed, the economy fell.

As you know, we're in a historic recession right now. Since March, over 44 million people have filed unemployment claims.[3] The jobless rate currently sits at 11.1%.[4] (Although the Department of Labor has admitted that the real numbers are even worse than that. Thanks to a "misclassification error", previous months' rates should have been several points higher.[4]) And yet, the markets surged ahead. What gives?

What gives is that the rally was largely driven by two things: hope and fear. If that seems contradictory, bear with me. It will make sense in a moment.

The "hope" part of the equation was simple: After weeks of scary headlines, investors began to acclimatize to the coronavirus. When that happened, hope took over. Hope that government stimulus would work. Hope that jobs would return. Hopes that "the curve" would flatten and the pandemic brought under control. Hope that a vaccine would be discovered in record time. Hope that the economy would recover in a classic "V-shape", meaning it would be rebound out of a recession as quickly as it fell into one.

Once hope established itself, fear quickly followed – the fear of missing out. FOMO, as it's popularly known, is a completely normal emotion, but it's also the bane of many a rational investor. The more the markets climbed, the more investors feared missing out on a historic rally, and all the on-paper profits that come with it. Even some companies that recently declared bankruptcy have seen their stock price rise nearly 50%![5]

To be clear, a market rally was not really a surprise. History tells us that the stock market usually recovers fairly quickly after a pandemic.[6] Furthermore, because the markets move largely on what investors expect will happen in the future – as opposed to what's only happening right now – the bad economic data we saw in April and May was already priced in. If investors know we are in a recession but expect that recession to end quickly, a market rally is a natural result.

But now we return to my "speeding" analogy from the beginning of this letter. A rally is all well and good, but the higher stock prices go, the further they get from their underlying **fundamentals**. In investing, fundamentals are what you use to value a company or security. Earnings, revenue, assets, liabilities – the stronger these are, the more highly a company is likely to be valued. The economy has its own fundamentals, too. (Think unemployment, GDP growth rate, inflation, etc.) Right now, our economy's fundamentals are not particularly strong. By extension, many companies' fundamentals aren't particularly strong right now, either. While we at Capstone Pacific don't just rely on fundamental analysis to choose investments – we use *technical* analysis instead – when the markets get so far ahead of their fundamentals, it's like a driver who suddenly realizes he's speeding way beyond the limit.

So, what prompted investors to look at their speedometer? Several things. First is the simple realization that, despite the warmer weather and the easing of quarantine restrictions, COVID-19 is not going away anytime soon. I know – you're probably as sick of hearing about the pandemic as I am. But the fact remains that several states are seeing a dramatic increase in cases. In fact, fourteen states "have recorded their worst week yet for new coronavirus infections." [7] Hospitalizations are also on the rise.

Second is a sobering report from the Federal Reserve. Ever since the financial crisis, our nation's central bank has taken an increasingly important role in propping up the economy. So, when the Federal Reserve speaks, people listen. Chairman Jerome Powell warned that interest rates would probably be kept near zero for years to come – and that by the end of the year, the unemployment rate would still be around 10%.[8] On the heels of this statement came the news that, while the May job report was better than expected, and that jobless claims have dropped 10 weeks in a row, 1.5 million more Americans filed claims in the last week alone.[3]

A v-shaped recovery is not guaranteed. The story is not over. Investors looked at their dashboard and realized they were speeding.

So, what does this all mean for us? Is another market correction due? Or will the markets simply take a breather, and then keep climbing?

You can probably guess my answer: There's no way to know for certain. You see, trying to predict what the markets will do means we have to predict exactly what the virus will do. And no one – not even the most experienced epidemiologist or grizzled virologist – can do that. So, as investors, it doesn't make any sense to try. It just doesn't work! That's why we don't invest using economic predictions, or companies' fundamentals, or just holding onto everything we own and hoping our portfolio will eventually go up.

The fact of the matter is that the markets are going to leap ahead and fall behind like they always do. As your financial advisor, I don't want you to participate in that kind of rollercoaster ride. Rollercoasters always end where they started. Buy-and-hold investing tends to leave you where you started, too! (Remember, after all was said and done, the S&P 500 finished 2013 almost exactly where it finished in 2000.[2] That's thirteen years of bull markets and bear markets, just to go around in circles.) That's why we're not going to invest based on hope for a vaccine or hope for a swift recovery. Instead, we'll continue to use indicators like relative strength, supply and demand, and trendlines. We'll continue to follow the rules we've put in place: Getting in the markets when they trend above a certain point and getting out when they trend below a certain point.

It helped us avoid the worst of March's market crash. It will help us in the future, too.

We cannot predict exactly whether the drop was the start of a market correction or just a blip. That's why we must remain prepared for more periods of volatility over the coming months. More good weeks and bad days. We should be prepared to speed up or hit the brakes depending on the road conditions. The good news is that, with our investment strategy, we have planned ahead.

We continue to live in an uncertain time. Investing during times of uncertainty can be stressful. But we made it through the market crash in March. If extreme volatility returns, we'll make it through that, too.

Did you know?

We have a Facebook page! Well, we've had it for quite a few years now but have begun to post again more regularly. Find us on Facebook: @capstonepacific. Invite your friends.

Want to review your account but not comfortable coming to our office? No problem. We can review client accounts over the phone and virtually. We've been doing this for years with our clients located all across the country but of course now it has become very popular amongst those local to our office as well.

Finally…

We released our new eBook a couple weeks ago detailing the various possibilities of an economic recovery, please let us know if you would like another copy.

Don't forget - deadlines to contribute to IRAs for tax year 2019 have been extended to July 15, 2020. If you would like to contribute to your IRA or Roth IRA for last year, you have a few more days to do so. Contact us for the information on how to make that contribution.

As always, if you have any questions about the markets, or about your portfolio, please let us know. We welcome your calls and emails. Also, feel free to share this report with others that may be interested.

Sincerely,

The Team at Capstone Pacific

P.S. If you ever run across anyone who could use our services or is unhappy with their current adviser's performance, we always appreciate it when you pass on our name.

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