MARCH 19, 2020

MARKET COMMENTARY

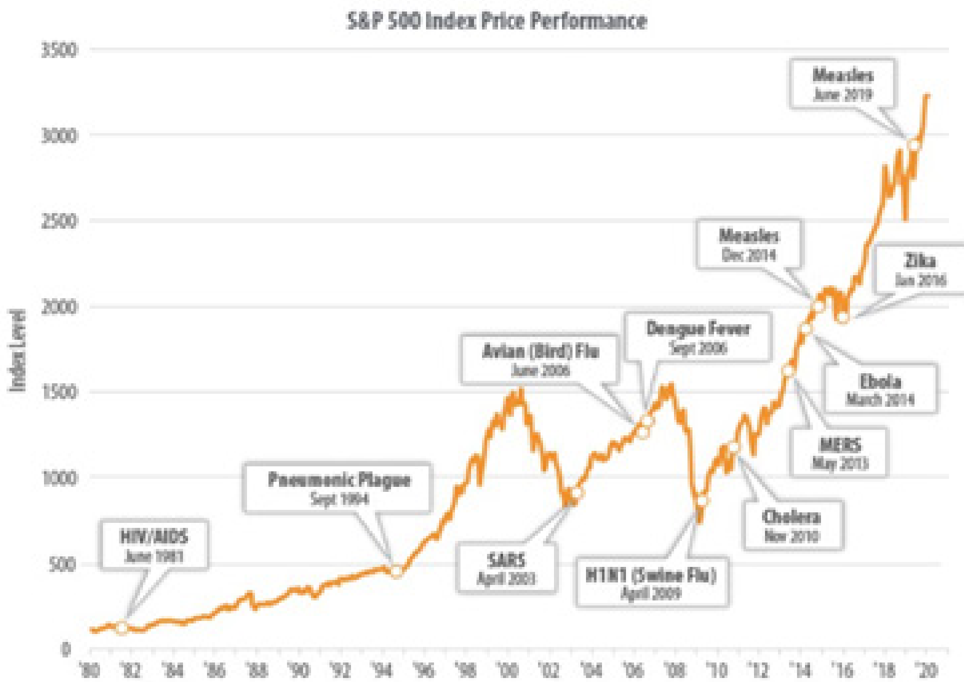
SPECIAL REPORT: THE CORONA VIRUS IMPACT

EXECUTIVE SUMMARY

- ***CORPORATE DEBT MARKET: PAYBACK TIME FOR 10 PLUS YEARS OF EASY MONEY***
- ***EQUITY MARKETS: DRAMATIC CORRECTION HAS HELPED TO DISCOUNT PENDING WEAK DATA, BUT TIME IS NEEDED***

The financial markets have been rattled due to the spread of Coronavirus. As the visual from First Trust below illustrates, this is not the first epidemic to hit the U.S. and its financial markets. While the timing of COVID-19 creates some challenges, we present this visual so investors can step back and take a long-term perspective that markets can recover from epidemics.

A HISTORY OF EPIDEMICS AND THE STOCK MARKET:



Source: Bloomberg, as of 2/24/20. Month-end numbers were used for the 6- and 12-month % change. *12-month data is not available for the June 2019 measles. **Past performance is no guarantee of future results.**

The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Returns are based on price a[nd do] not include dividends. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future.

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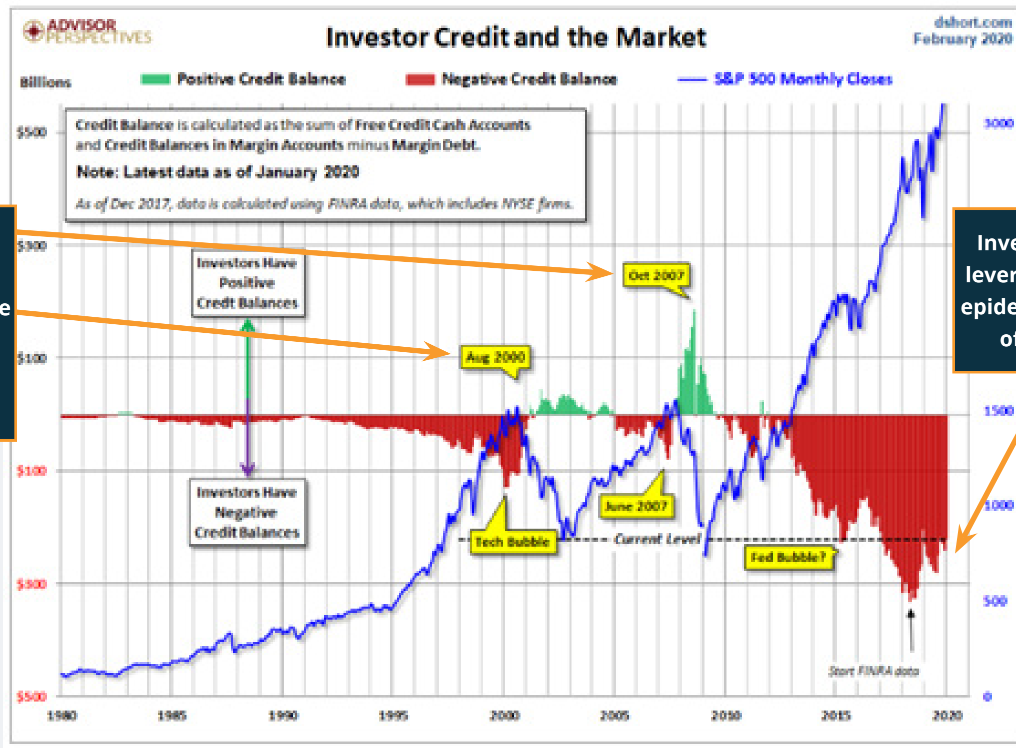
We know, based on today's ratio, COVID-19 as it infects at twice the rate and has a much higher mortality rate (3.5% according to the World Health Organization) of seasonal flu. This attribute is the reason behind strategies of isolation and distancing and is more unique than recent viral outbreaks. The impact to the economy and it's ripple effect into a very saturated and levered corporate bond market is what financial markets are reacting too, in our opinion.

The problem with the timing of COVID-19 is that it is hitting at a time when the system is very levered after years of cheap borrowing rates and quantitative easing. Although the data below is based off brokerage account data ending in January, it is still a good representation of how levered up equity and bond accounts were for the retail investor.

History has shown when investors de-leveraging can create opportunities for those with a long-term horizon

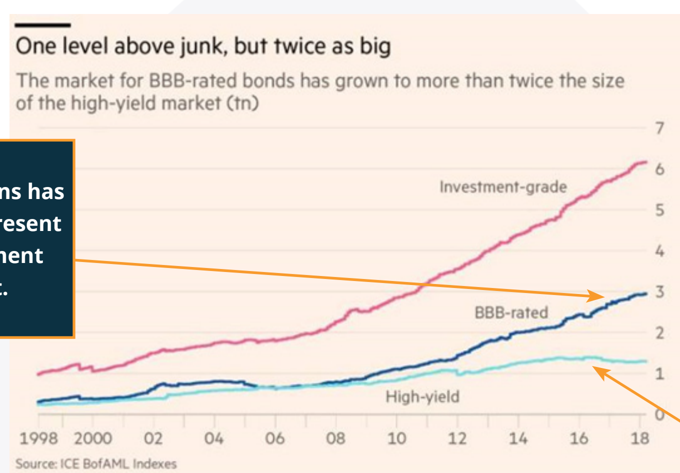


Investors were very levered going into the epidemic – data as end of January 2020

Source: https://www.advisorperspectives.com/dshort/updates/2020/02/25/margin-debt-and-the-market-down-3-in-january

Also, as we presented in our Fall 2019 Star Capital: Debt Series Research Report (ask your financial advisor for a copy), years of cheap money have fueled a corporate borrowing binge. The issue is the BBB tranche (the lowest rating before "junk" classification) which is vulnerable to downgrades. The size of the market is huge and is the reason we have been cautious on fixed income positioning.

The BBB tranche of loans has grown rapidly and represent about 50% of Investment Grade (IG) market.



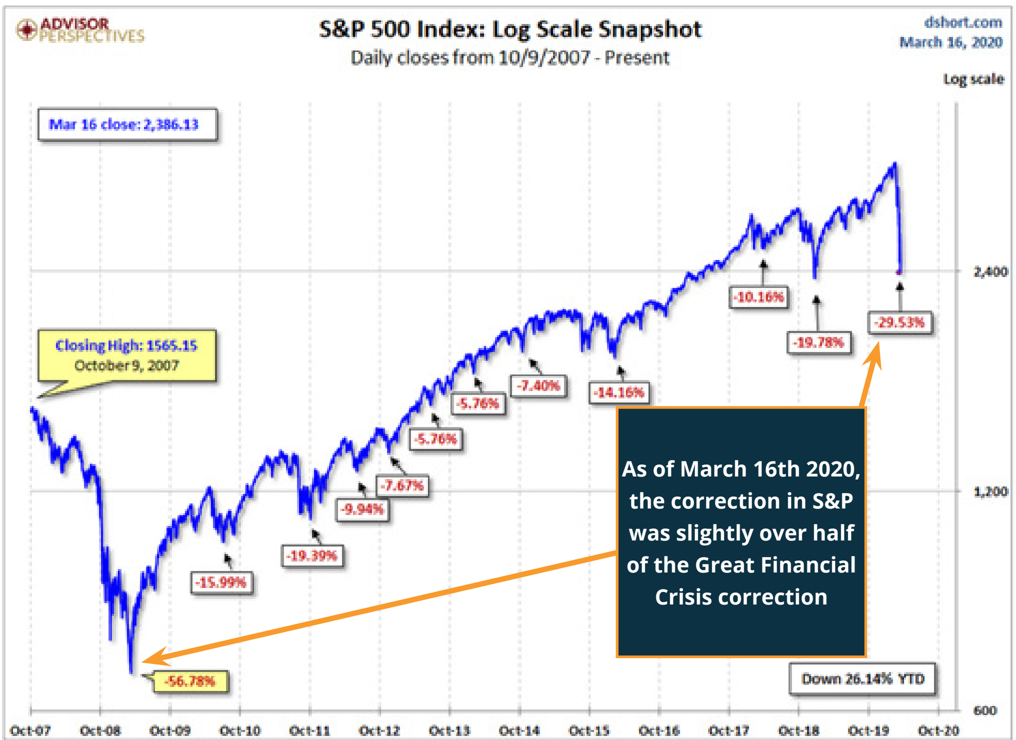
The BBB market is now so large, if a downgrade cycle hits, we are concerned about potential price dislocation in the much smaller high-yield market. The high-yield market would have to absorb this influx of bonds.

Source: Financial Times

The combination of containment strategies potentially triggering a recession when investors and corporations are highly levered is what has initiated the swiftest market correction in history. Computer and algorithmic trading have aided in the decent too.

The big question is what is the stock market anticipating for company earnings for P/E ratio valuation and reasonable pricing? This is an elusive question to answer.

Let's put this drawdown into a broader perspective. As of the market close on March 16th, 2020, the S&P was down just under 30%. The S&P drawdown during the financial crisis was just under 57%. In other words, the S&P is down around 52% of the 2008-2009 financial crisis.



Source: https://www.advisorperspectives.com/dshort/updates/2020/03/16/s-p-500-snapshot-12-loss-bear-market?bt_ee=ekiY4EWfvYYrU%2BGNhGKeKIjHUZsH2Pppi3t8B8AUZcz62YxUwn1dALxqSnfBjjra&bt_ts=1584447864917

Is there more downside? There certainly could be but a lot of damage has been done.

It is our opinion, first, the U.S. banking and financial system, in general, is in better shape than going into the financial crisis. The corporate bond market is at risk to re-rate and will take time to play out.

Second, and more important, the global central banks (including International Monetary Fund) are proactive and aware of the risks this slowdown can inflict. This positioning was not the case in the financial crisis.

The U.S. Federal reserve has broadened the lending base will dramatically increasing the size of loans and injections. The IMF has announced several measures of preparedness. Central Banks across the global are injecting money and/or lowering rates. Germany has even announced it is breaking "austerity" ranks and will do "whatever it takes" to offset economic impact of COVID-19.

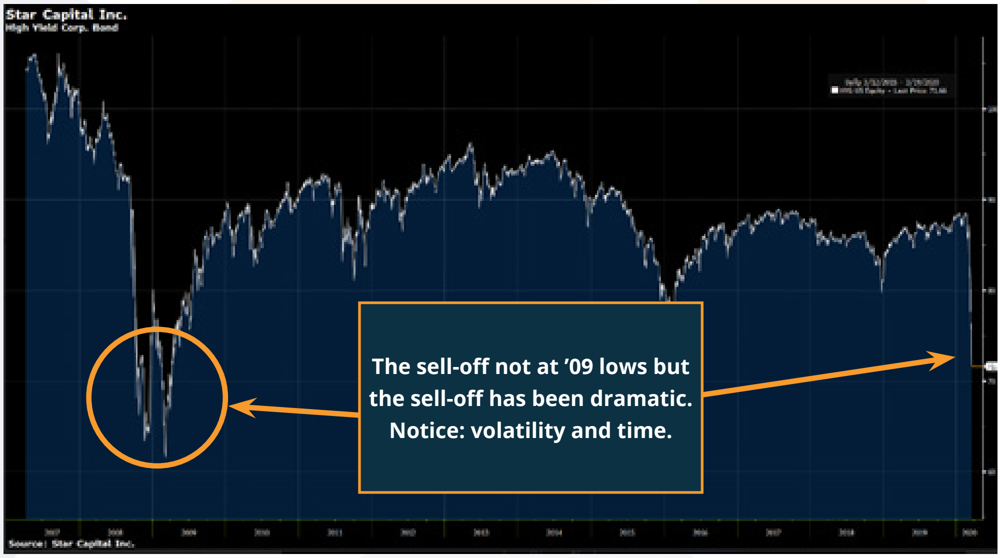
We do suspect and highlight the risk of a large financial institution in Europe or Asia will require a bailout. Europe and Asia financial institutions did not de-lever like our banking system.

We believe bankers worldwide appear willing to pull out all the stops to correct economic weakness. We believe these all-out measures will tilt the world towards inflationary pressures over time from deflationary trends today.

Fiscal stimulus will be another lever that will assist in getting the economy stabilized and eventually thriving. The government will have to step up huge. We do believe the urgency to provide Americans with tax breaks, direct payments and other means for small businesses to stay functioning is of the utmost importance to our representatives and economic leaders. The US has shown in the past that we come together in times of extreme adversity. We expect the same throughout this unprecedented challenge.

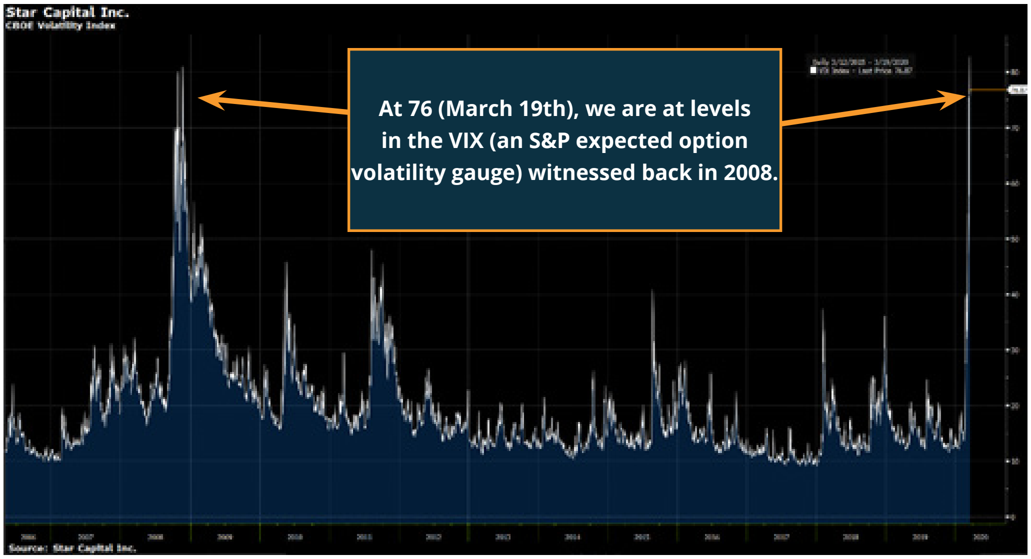
With that said, we urge investors to expect financial market volatility as participants assess and model what economic weakness means to defaults in the corporate bond market. This progression will take time.

The High Yield (HYG) ETF below shows the reaction in the lower rated segment of the bond market. Six months or so of time was needed before the corporate bond market recovered from the financial crisis. We expect the similar circumstances today and remain cautious on high yield. Price action in this market will likely add volatility to equities until resolved.



Source: Star Capital Inc.

Meanwhile, the VIX (volatility index) or “fear gauge” indicates investor pricing significant risks into the S&P equity market.



Source: Star Capital Inc.

In times of uncertainty like we are experiencing, we would urge investors to step back and take a longer-term perspective to restore calm. Hopefully this commentary helps.

Please feel free to call or schedule client calls to discuss our opinions. As always, we appreciate your confidence.

THANK YOU

Star Capital Inc.

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Benchmarks: The performance results shown are compared to the performance of the S&P 500. The index results do not reflect fees and expenses and you typically cannot invest in an index.

Return Comparison: The benchmark gives investors a point of reference they can use to measure how a fund has performed relative to the segment of the market it invests in. It contains the 500 largest companies in the United States.

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