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OBSERVATIONS ON THE MARKET No. 346

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It's back to basics. Everyone knew that it was going to be a challenge, we were told it was going to be bad, and the peak of the virus spread is still in front of us. Now, we sit at home and wait, or some version of that. Waiting is always the hardest part. James Bullard, President of the Federal Reserve Bank of St. Louis, was interviewed last week for a podcast. Here is a few of his comments.

Bullard predicts that unemployment will reach 30% and that the economy will contract by 50% (an annualized rate). Bullard believes that it is temporary, and that every virus in history has been a temporary phenomenon. His view is that the economy was solid, it was just shut down to keep people healthy. He thinks the second quarter will be the bad one, and that production, factories, and stores will be brought back online once the virus passes. Most of his belief in the economy restarting again comes from the Fed and Congress's focus on maintaining the economy's capacity. The actions of the Fed and Congress are not to stimulate or bailout the economy, but to build a bridge to when the economy restarts. His assumptions are based on his belief that the direct lending to small business will have some success. Has the stock market over-reacted? Bullard suggests that 90% of the value of a company comes from the cash flow it earns after 2021, and arguably the market has become too pessimistic. Hopefully he's right, however, it is one person's opinion. Here is another way to look at it.

If you own a rental house, the value of that house is determined by the future rental income that you or other investors expect the house to earn over time. If you have a tenant move out, and the house sits vacant for three months, is the house suddenly worth 50% less because it has no current income? No one believes that. If you decide to sell the house

before it is rented out again, you, and investors, will focus on the rent the property is capable of producing in the future, not what one month indicates. There will always be distressed situations created from overleveraged owners, but long-term value doesn't change from three months missed rental income.

The stock market has seen a very dramatic sell off. It also has seen some dramatic recoveries. The Dow reached a low of 18,213 on March 23rd. In three days, it was back up to 22,552, or a 23% gain. How many headlines did you see stating that a new bull market had begun? A 20% move from a market low is the definition of a bull market. The value of a rental house may not change much month to month. However, it is still stressful if you as the owner have a mortgage payment due and you are at the end of the first month with no rental income. You have no guarantee of when the next renter is going to show up. That is probably a good definition of stress. Here are a few more points to consider.

Airline traffic has almost ceased. Is America ever going to fly again? If anything, commercial traffic may temporarily surge as businesses and individuals are free to once again move around. There is another disease that is already building - cabin fever. The best remedy for cabin fever is the opposite of Coronavirus. The Fed's goal is to keep the airline industry alive for a few months, at least until we can move again. There is always a cost, but a brief look at long-term GDP shows it always recovers. "Whoever watches the wind will not plant; whoever looks at the clouds will not reap... Sow your seed in the morning, and at evening let not your hands be idle, for you do not know which will succeed, whether this or that, or whether both will do equally well. (Author available upon request)