DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
greg@growmydollar.com
www.growmydollar.com

Apr. 20, 2020

OBSERVATIONS ON THE MARKET

No. 346 pt2

By Greg Denewiler, CFA

Yeah, but... what if this or that happens! There are plenty of reasons to put that statement in a sentence today. Markets have had a significant rebound in April. It is very easy to say; what did you think was going to happen when the Fed throws $4 trillion at the problem? It was not just a case of throwing money at the problem, they bought the problem. This is an excellent reason as to why it is so dangerous to sell when things are looking bad. You just do not know what is going to happen that changes the trajectory of events. Sometimes this can literary happen overnight. The timeline was swift.

First, the Fed entered the mortgage debt market. Interest rates on Treasury's declined to record lows, while simultaneously mortgage rates increased by as much as 1%. The Fed's purchase of mortgage portfolios immediately started to drive mortgage rates back down. They next went into the corporate debt market. Corporate debt that was rated BBB, which is investment grade, declined by 20% as the debt markets panicked. Bonds of investment grade corporations are now almost back to pre-crisis levels. The Fed wanted corporate America to be able to raise capital at reasonable rates, and now they can. Finally, they bought high yield debt. If a company was rated investment grade at the beginning of March but was downgraded to junk because of the economic shut down, they bought that debt as well. These are known as fallen angles. These are not companies that were originally considered higher risk, but just recently became riskier. In this segment of the market, financing costs doubled or more with just one downgrade of their credit rating in a matter of days. The Fed's goal was to stabilize the debt markets, and they achieved it. They not only acted, but also suggested that they would continue to do whatever it takes to keep the mortgage and corporate debt markets stable.

Normal investors, or people who may think that someday we might have to pay back all this money might be inclined to say: 'Yeah, but', the Fed cannot sustain this forever! With interest rates at .6% for 10-year Treasury's, the annual cost of $1 trillion of debt is 'only' $6 billion. For now, you could argue that they can. Assuming interest rates will stay at .6% indefinitely is an entirely different matter, and it is one of the 'Yeah, but…' comments that has a lot of scenarios attached to it. There are more.

Bond valuations are simple, they either pay interest and principle at maturity, or they default. You know exactly what your bond is worth at maturity. If a company issues more debt, that may increase the ability of your bond getting paid at maturity. The stock market is not binary. If a company issues more debt like many are currently doing, it increases the company's costs and lowers their profits without any increase in business. We have a lot of 'Yeah, buts…' in the investing world currently, more than is usually the case. Since some companies are impacted while others are not, it is easy to get lost in the forest. A look at the top holdings that account for about 25% of the S&P 500's value is one reason the market has rebounded so rapidly. Microsoft, Apple, Amazon, Facebook, Berkshire Hathaway, Alphabet (Google), Johnson & Johnson, JP Morgan Chase, and Visa, are all companies that will survive. Some of them may benefit from more online activity. This should be a little comforting knowing that the largest contributors to our economy are stable. However, there are many 'Yeah, buts…'.

There are a lot of small businesses that may not survive. No one knows how the restart of our economy will go, whether new startups will replace all or just part of what was lost, and just how far will our economy ultimately fall. We are fortunate that our economy had enough technology built into it that it could function at some level remotely. However, 20 years ago shutting down the economy may not have been an option. Would we have had a disastrous health care crisis then if it did not close? Did we overreact now? The 'Yeah, but…' list can get very long very fast. Be very thankful that interest rates are low enough that the Fed can provide almost unlimited capital to support our economy for now. It appears we have some time before we must worry about just what the consequences may be of all of this. Yes, there is a 'Yeah, but…' in that statement too, but the Fed has more money than any of us.