FRIDAY, OCTOBER 29, 2022

Well, hello and welcome to the Dividend Cafe. I am very pleasantly back in absolutely beautiful Newport Beach, California. After over a week in New York City and a couple days in Palm Beach and a lot of speaking, a lot of meetings, a lot of note taking. In fact 24 pages of single space typed notes all got finished up and buttoned up and manicured at around 3:30 AM this morning. And I took the major takeaways from the travel, from the notes, from the meetings and have tried to make it the subject of today's Dividend Cafe. Now, the notes, of course, are not edited and cleaned up towards a specific theme and key takeaways. There are lists and whatnot, but there's a lot of just shorthand of sitting in front of credit managers, sitting in front of long short equity managers sitting in front of some of macro economists. One case a Fed governor in one case, the CEO of Federal Express. I mean, there was a lot of real high level meetings. It was an unbelievably stimulating, intellectually, it was very motivating in terms of my work as a portfolio manager. I want to get these things right. I want to exert wisdom into what we do on behalf of our clients. And I think that Brian and Kenny and I formulate the investment committee at the Bahnsen Group. I think we came away from it better at what we do as a result of all these meetings. But there's a lot of action items. There's a lot of things we're doing in recommending and implementing as a result of the meetings. And then there's a lot of things that we're kind of more aware of and thinking about implementation as it affects the macroeconomic environment. And I think that's what you listen to Dividend Cafe for. And I remain a very stubborn advocate of the written Dividend Cafe that I want people to read the written word, where the charts are and where I feel I do my best work in trying to put pen to paper and expressing key thoughts.

But regardless of whether you're a video watcher or podcast listener or a Dividend Cafe reader this week we're going to walk through what I think

are some of the key takeaways from this last week in New York City. And I'm going to start with a line from Jim Grant, for those who aren't familiar with, Jim is an incredible macroeconomic mind. He wrote for Barons back in the 80's and began his own sort of publishing empire out of that, A lot of very, very high level, very expensive institutional research that I've been subscribing to for quite some time and very grateful for. But he also does an annual symposium in New York City. Brian and I attended it last week, and I want to start with a quote from Jim, "Climate is what you expect. Weather is what you get." And I think that this line sticks out because it captures the essence of what's going on. We can talk about bond yields, we can talk about interest rates being higher. We can talk about inflation. We can talk about when the Fed's going to stop or when they're not going to stop or how high they're going to go. We can talk about what the impact of that is to various aspects of credit markets. In fact, we don't talk about that last one enough. We can talk about what it means to PE ratios and stocks. We probably talk about that plenty. We can talk about, and I have talked about over and over and over again, this dynamic of shiny objects and how Fed monetary policy may throw kerosene on a fire of human behavioral tendencies as it pertains to shiny objects.

But what does it mean? The climate is what you expect. Weather is what you get, I believe, and the way I worded it in Dividend Cafe this morning, I believe that, let me read this verbatim. "The Fed is decided to try to make weather with their predictions of the weather," okay? And what I mean by this rate policies can't ever speak to what rates ought to be interest rates, like all prices are meant to be discovered, not imposed. And everything we're dealing with right now fundamentally can be reduced to this. Interest rates are the price of time. My friend John Malden says that a lot of people say that it's not rocket science, but I love that key summary. Interest rates are the price of time. And absent

coherent rates, you make activity in a given time period incoherent. We've gone 14 years with a price of money, not set by a calculus of risk and reward, not set by human action, not set by supply and demand in the marketplace, not set by economic actors or risk takers who are responding to reality.

We've set the price of time by a weather man who's trying to make weather rather than predict it. And I believe that there are noble intentions in some of that, but I think you have to understand the environment we're in created by this dynamic. Climate's what you expect weather's what you get. And the confusion of those two is prominent in monetary policy. Nothing fed the bubble of shiny objects like the zero cost of capital that came out of the COVID moment. And nothing is distorted valuation like a monetary regime that is highly interventionist. And valuations can be distorted in housing. They can be distorted in big tech, but they can also be distorted in things that have no intrinsic value at all. Non fungible tokens, for example, these NFTs that I tend to agree with, my friend Jim Grant, I think NFTs will be the key marker of this era of the real height of the absurdity, because as skeptical as I am of Bitcoin, as a medium of exchange and as something possessing inherent value, I don't think it's going to zero.

All the FAANG stocks that I think were just perversely overpriced, all of them have value. Some of them have huge value. High PE ratio doesn't mean you don't like the company. I've always said that companies like Apple, Google, the earnings power is insane. They just got very expensive. NFTs though they're just worthless. They're the Beanie Babies of the 2020s. And this is a Fed induced phenomena. So here's the thing, some will say, "Okay, well, you're critical of the Fed". And this was a huge subject to conversations with taxable fixed income managers with other economists and with some of the credit guys. But look, right now we have to deal with the fact that now the Fed has started to tighten

and maybe they're going to end up making one mistake by being too easy, too long, and now another mistake by being too tight, too long.

And I think that's entirely possible. I certainly think it's possible if one thinks that the point of tighter policy is to bring down inflation, or that if you need to induce a hyper recession to stop inflation, or if one believes that people having jobs is inflationary all of those things, I think could be wrong motivators. But yeah, I think getting off the zero bound and having some normalization and then trying to create a regime of stability, a monetary policy is all a good thing. But the problem is that's not what I think is going to happen. If I thought we were too easy, now we're going to overshoot. So I'm critical that I'm critical, but then we're going to land in a state of equilibrium where now the Fed says we've got religion, we're done being too easy, we're done being too tight. And we're back to a mode of we're going to let the market set prices.

We're going to let prices be something that are discovered, not that we're going to try to create back to that climate weather distinction, but they're not going to do that. And so I have to invest money with a continually distorted scale. And right now, in the shorter term, there is a belief of okay, what if the Fed's going this whole expression, they go all Volcker on us. What are they going to go do this massive quantitative of tightening, Is that going to create all kinds of tightening of financial conditions? Is it going to weigh on real estate? Is it going to weigh on capital expenditures and commercial real estate? Is it going to weigh on the borrowing capacity in various aspects of what is a levered finance economy? And then I'm dealt dealing with one of the huge takeaways from this week, which is I just simply don't believe that they're going to do quantitative tightening.

Now, they've done it so far, I think 8.9 trillion on their balance sheet has gotten all the way down after four months to like 8.71. Okay? 47 billion

a month. And they weren't able to really do it the first month. They weren't able to do the mortgage backs they wanted at all. So they've had to kind of alter the scale on a little higher on treasuries back in 2018, they got about 9% off. They brought it from, I think 4.4, almost 4.5 trillion down to 4.1. Then that ran back higher. Right now there's roughly 2 trillion in reverse repos, meaning so much liquidity came out of cash reserves that they had to create a reverse repo facility for people to be able to exchange collateral for cash and money markets and so forth. There's a kind of financial functioning there. So see, this is another point I came away with.

I went back and was reading a lot of what was being put out at the time Covid began. And in 2018 and in 2016 and what they're saying now, and there's a very common expression that gets used, it's restore market functioning. What the UK said a couple weeks ago. Now, in fairness, their bond market was seizing up and their pensions were over levered, and it was a complete pandemonium, self-induced, deserved, whatever you want to say. But I'm not trying to get an Old Testament here. I'm just simply pointing out that there was a lack of market functioning. But there always is the ability to say, 'Look, we don't want to intervene, but we're doing it to restore market functioning.' Well, that line gives you a kind of permanent get out of jail free card. You can always have an appeal to some need to restore market functioning. And so I believe a need to restore market functioning will ultimately be the death of quantitative tightening.

And I think probably some restoration of quantitative easing. I don't believe they'll really get off of it. Tom Hoenig spoke to us, he was a Fed governor about 20 years, sat in the FMC meeting, was there when they passed QE 1 and QE 2, was the only one who was against it. But you just need to look at the history of quantitative easing to see why I believe what I believe. And by the way, there's a chart reflecting these increases

in the Fed balance sheets over time. But the fact of the matter is that QE 1 was supposed to be a one and done $600 billion increase to the Fed balance sheet to restore market functioning and housing back in early 2009. And then they realized once it stopped that there was a little bit of liquidity pinch happening in financial conditions, they needed greater easing of financial conditions. So they went and did QE 2. And then they realized that kind of helped things and that did prime some pump and stock and bond credit markets real estate. And they said, 'Well, look, it doesn't seem to have had any implications negatively so far. Let's go ahead and move forward with QE 3'. And then they dropped the bazooka trillions of dollars. So there is this huge, I think, reaffirmation for them that aggressive monetary interventions have not really ever come at a big price. The problem is that they have never gotten off of it, and it's now my belief that they never will, that they just simply are not going to be able to. They have no historical basis, not in Japan, not in Europe, not in England, not in other Asian central banks. South Korea is now reverse course. Australia is reversing course. I think Canada's going to end up reversing course. I think that formulating an investment assumption that quantitative tighetning will happen is naive. I believe that the Fed is in a real pickle as it pertains to QE.

Ultimately, productivity is what has been sacrificed. We had a productivity rate of 2.3% per year, the decade before QE. We've had our productivity rate of 1.1% since. A little bit less than half as despite stock market returns being 16% a year, despite S&P sales being up 50%, S&P profits being up over a 100%. I think that there has been a sacrifice of productivity. So let me sum up the Fed stuff and I'm going to move on to two other points and wrap us up. I don't believe quantitative tightening is really going to happen. I believe quantitative easing is going to come back, whether it's camouflaged at first and then eventually without a disguise at some point, QE comes back. I believe the terminal level for

the Fed funds rate, it will come at the end of 2022. And whether that's 4.25, 4.5, I don't care that there will be a long pause and then actual rate reductions will follow. I believe number four, that Volcker is credited for bringing down inflation back in the early 80's because the inflation they had then was much more monetary oriented than it is now. His actions were coupled with world changing supply side incentives from marginal tax reductions to deregulation and to an energy inflation that was organically turning down because of massive investments that were being made in oil and gas rigs. We're dealing with the opposite now. So I believe comparison's of Powell to Volcker are fallacious, and then not only are the men different, but the circumstances are different. Finally, number five, I'm reading directly from Dividend Cafe. "Our focus on interest rates, meaning the Fed's focus, society's focus on interest rates as a tool to manipulate growth is wrong. And our focus on rates now as a tool to decrease inflation is wrong too. Interest rates above all else, put a price on time and a price on anxiety disrupting that misallocated capital distorts valuations, destroys savings, which in turn erodes investments. It screws up pension funding, it causes yield chasing. It enhances economic fragility, and it alters healthy economic activity by incentivizing financial engineering versus productivity."That's the environment we're dealing with. That is what is going to play out in risk assets and in the economy for some time.

I spoke last week about my belief that indexing is facing a very tough road to hoe, and I've really elaborated this week in Dividend Cafe actually doing, showing you the kind of work on the whiteboard, the sum of parts, on the numbers as to where I think well, where we just see the attribution is very mathematical, where attribution for the S&P has come from over the last decade and what the challenges are going forward. I'm not going to repeat out of it now, I'm going to let you look at those charts. But the bottom line is I think you could have a market

over the next 10 years that's a little down, a little up, flat, we'll have periods moving around, and I also think it could outperform my pretty darn muted expectations. That requires a lot of stars lining up. But ultimately, multiple expansion growth comes and it goes. And what I think is going to prove to be a far superior capital allocation strategy in the years ahead, as we talked about last week, is a cogen philosophy that is more focused on organic cash flow growth than multiple expansion.

One of the downsides to an era in which equity prices were distorted, where they were enhanced, and where all risk assets benefited from. Fed valuations at a time where an entire asset class was exploding in value. The stock market was a big old thing 15 years ago. And then the Fed, you could argue, boosted some valuations. And let's not forget, sales went up too margins, profit margins went up, profits themselves went up. So the Fed did not create the entire stock market but they poured kerosene on some of the frothier parts of it, no doubt. But private credit was barely an asset class. Now, less than a trillion dollars goes to near 5 trillion. There is both the impact on the asset class Fed policy had and the creation of the asset class the Fed facilitated. And I think when you look at high yield bonds, but certainly the levered loan market and direct lending, you're talking about 5 trillion of new corporate credit. And I'm sorry, but some of that's bad money. Now, a lot of it's good and a lot of it went to very good and productive use, but you can't tell what's good or bad always in a period of financial repression rates are low liquidities flowing. It disguises some of the bad actors or some of the bad loans or some of the bad borrowers or some of the bad businesses, some of the bad terms, some of the risk level, some of the excessive leverage. It gets disguised by a favorable scale. And I think this is a huge thing going forward. It's not to be bearish on private credit, it's to say that there are good and bad loans out there, and private credit's a complicated space. It

allowed everyone to look like a genius. Now the tide's coming down and we think we have to be more discriminating than ever.

So a few quick strategies, specific things, I'm going to wrap it up. And our boring bond portfolio, we're getting paid now for quality. You're getting paid for liquidity. Investors don't need to go out the credit curve. There's attractive returns for what a boring bond portfolio is supposed to create in high grade AAA, AA, municipal bonds, corporate bonds, treasuries, et cetera. And the credit portfolio being overweight, floating rate has been a very good idea. As rates were going higher, high yield spreads were widening, it was doing worse. Right now, we think that flips that. The credit quality of high yield is superior to floating rate for a number of reasons I won't get into now. And the benefit of rising rates is kind of washed off. High yield Muni, we think is an incredibly attractive asset class. We're going to be consolidating some of our small cap exposure, but increasing to the left, the consolidator of small cap and our emerging markets and putting more focus there in our growth enhancements, maybe consolidating in structured credit as well. Really, really excited about one of our structured credit partners and just as selective and focused as we've ever been on private equity and private credit and how we want to get exposures there.

So I kind of rush through the end there. We have all of our conclusions in our notes and everything's written out in Dividend Cafe. That's the basic takeaway. It is a really, really fun time to be managing money. I'm very blessed to do what we do, and I hope that you are somehow blessed about what we had to share today in the Dividend Cafe. If so, share it and subscribe it. Reach out to us with questions. And thank you as always from listening to watching and reading the Dividend Cafe.

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