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Welcome to the **Dividend Cafe** *Weekly Market* commentary focused on dividends in your portfolio and dividends in your understanding of economic life.

Well, hello and welcome to yet another episode of the Dividend Cafe. We get to that end of the week, that is Friday. And I have a topic today that I wasn't really sure as I began writing how excited I was about it. I think it's important and, and I had a kind of vision for what I wanted to do, but I got to say, as I was writing and writing, I got real into it. And I enjoyed writing this week's Dividend Cafe a lot. And I think the outcome and the message I want to give to you here today is exactly what I wanted. And then some, I think it's important, but more than that, I do think there's a certain clarity that can come for investors who properly grasp a few of the things that we're talking about. I titled it something to the effect of, you may not care about the bond market, but the bond market cares about you.

There's this sense in which when you start talking about bonds, and I've been doing this for a long time and served as the Chief Investment Officer at the Bahnsen Group, which entails more than just oversight of our equity management on the portfolio manager, on our core dividend portfolio. But as the Chair of our investment committee, there's decision making across all asset classes and due diligence and manager selection and point of view in bonds, not merely in equities. And so, there's a sense of which I've been inside the fixed income world for my whole career and more intensely in the last seven years. And I do find the asset class very boring. I don't think that people are wrong to feel that stocks are more exciting and bonds are less so. But because of the nature of capital markets, the nature of capital asset pricing, bonds matter to everything else.

And, so I want to talk today about why the bond yields and, and what is happening with interest rates is essentially this bad thing in 2022, and a good thing after that. And, I have a lot of reasons for that and what that kind of expectation may be.

So, I'll just sort of start from the beginning and, and, and go from there.

You know, first and foremost when we, The most basic thing I've already written about, talked about spoken about in the past, the bond yields affect the valuation of equities because all risk assets are priced up against a risk free rate. The basic common sense of the fact that an investor, when they invest in something, wants to be compensated for two things, One, is the time that they'll be away from their money. So, that applies to a hyper safe bond and also applies to an equity or real estate or something else.

The time separation from one's money, what we call the time value of money, is one factor. And then there is the risk, the, the greater risk, whether you're looking at the up and down movement, the volatility headache, or the actual risk of loss those things require a greater commiserate return to justify a rationalize and warrant to certain degree of risk and headache. And when you talk about something like treasury bonds and particular 90-day T bill, you have the lowest possible time issue. You don't need that much time value on your money when it's 90 days, and you have no risk. These are 100% secured by the largest government country, military power in the world with 0% default rate over what is becoming close to 250 years. So, you have textbook definition of a risk free asset. And so you price risk assets against that comparison.

And we've talked about it a lot, and I already spent I think just two minutes, which is about a minute and a half longer than I want to do, rehashing that point. But I think that when we look right now at the bond market we are getting a little reminder in how these things work in how bond yields impact the valuation of equities. And so, what I did with a chart that you're going to have to look at, it's too historically important. what earnings in the S&P 500 did and what the price return was. And what you see is a, because I'm, I'm holding onto this concept that as earnings go, so goes the market. It's an accurate presupposition. My friend Larry Kudlow codified the term that “profits are the mother's milk of the stock market.”

But you look at a decade, like the 40’s the 2010’s for that matter, the ‘60’s, you had really good earnings growth and really good stock market growth. And you have a decade like the ‘30’s and the 2000’s , and you had bad earnings growth and bad stock market. Those are all pretty easy. But then there's three other decades I want to hold onto. And then one particular, okay, the three are the ‘50’s, the ‘80’s and the ‘90’s. The eighties and nineties being where a lot of people that are alive today and investing today kind of set their expectation for how this stuff works. And in those decades, you had good earnings growth but you had unbelievable stock market growth. So, why did the proportion of stock market growth so far out pay earnings growth? Our principles align directionally, but the proportionality was above and beyond.

And that's where not only did earnings go in lift markets, but valuations went up more as a result of lower bond yields. The eighties and nineties in particular, you went through the bull market rally of a lifetime as bonds did, admittedly, just from the coincidence of timing started brutally high levels, came far lower. And then that kind of reverse impact bond yields were just really, really dropping, dropping, dropping. And it brought equity evaluations up. So, instead of getting a slightly higher stock market return than earnings growth, you got something like five times or 10 times that, that, because over the decade compounded because of the evaluation. But then I mentioned, and, and the same dynamic was going on in the fifties as well, coming out of the big war, a lot of economic growth things were good, and then investors were bidding up the valuations around risk assets for those reasons.

But I mentioned that the same principle applying into another decade, but the math was in the opposite. And that was the seventies where you basically had, okay profit growth, but worst stock market return. And why is that the case? Because the bond yields and the valuation of the opposite. Profits were giving to stock market return. They were pretty good, but valuations were dropping as bond yields were coming up, so that even though equity profits were doing better than they did in some other decades, the valuation we'd pay for them was being compressed, and being compressed substantially really meaningful. PE contraction, valuation contraction, what we call the multiple. And, and that was a byproduct of bond yields going higher. So, we know that there is this reality in investing that bond yields are going to impact equity returns and that you have decades where things can get a little out of distortion.

But the problem is that we got in the eighties and nineties, great profit growth, but tremendous valuation growth from declining bond yields, and you get a diminishing return on that bond yields going from 10 to 1 . It's really hard to get the same kind of multiple expansion when you're already at the zero bound. And so, yes, I'm about to make the argument that, hey, at least now we're not at the zero bound bond yields have come up, but the story doesn't end there. Effectively, it's one thing to explain the mechanics that, that a stock price equals its earnings growth, plus its valuation. And I'll throw in, because this is our whole, you know, investment religion, the dividend then becomes another factor too. And I'm trying not to get sidetracked by my life's obsession, but you know, it technically the investor returned, can be a byproduct of the equities the earnings of the stock. The multiple put on it, and then the dividend that's paid back to 'em. And you could get growing earnings, but a reduced dividend that would hurt equity return. You could get you know, muted earnings growth, but increased dividend returns, and it could help. And so, the dividend adds another variable to the mix of how investor can expect a return. And generally speaking, in periods where earnings growth and especially multiple expansion or more muted, the dividend becomes much more valuable. And, you know, my belief we're very, very much in a period like that, and I expect to be so for quite some time.

But I guess this is the point I want to make about the bond - saying that a component of the equity return is going to come from that valuation, which is influenced by a bond yield is incontestable and it's quantitative, it's measurable. But the qualitative thesis, what's driving those bond yields?

Is it economic growth? Is it inflation? Is there macroeconomic expectations? What are these other pieces that make all this much harder? And the answer's all the above. It is very qualitative, but I think as a general rule of thumb, I've never found a better back of hand metric than to say that let's take like the 10-year bond yield and it's got to be a treasury bond. And why is that? Because when you go to a corporate bond, even like a triple A corporate like Apple or J&J, which are two of the only companies that have a triple A credit rating, you basically still have some degree of investors maybe pricing in an unknown credit event. And certainly when you start going down, there's going to be spreads that exist in the corporate world that adds another dimension of return for good or for bad to what happens at bonds.

But their treasuries are the product being spread against. So, you, you, you, you get purity. You, you eliminate, first of all, currency risk as we're dollar denominated people buying and selling in dollars and you, and you just isolate outside of a credit component to the interest rate. And why do we buy bonds? Why do we lend our money United States government, whether it's for three months, three years or 10 years because we want a safety of assets and a return and then there's some time value we put on it along the way. And how do you price would that yield ought to be? And by the way, that's why we might buy a treasury or, or an investor, institutional investor in the United States, something like that. China has a different reason why they do. They get a bunch of dollars when they sell stuff to America and then they don't use, use the dollar in their country. So, they have to turn around and hold those in foreign exchange reserves and put it somewhere safe. And the treasury market becomes a place to do that.

When the Feds buy treasury bonds, they're doing it to try to influence, it's a policy tool. They're trying to influence the interest rate. They're trying to influence liquidity or reserves in the banking system. And so there's different objectives, but for a regular investor saver like us, that's why you buy a treasury bond. And so you don't have to worry about a default concern. So, you write into the yield you need in order to lend the government your money, the time value of the money, and more or less the Fed funds rate, the Federal funds rate, which is the rate banks will charge to loan overnight to borrow money overnight, it's the rate the Fed is charging plus the expectations for nominal GDP growth inflation plus real growth.

And I know that there will be periods of time where the bond market longer out is going to have ups and downs because you're going to have flights to safety and bad times. You're going to have recession events get priced in, you're going to have exogenous shocks in the financial system, you're going to have geopolitical disruptions. So, there is a thing called bond market volatility, just like their stock market volatility. But as a general economic principle, when you pull back a bit, I think that it's a pretty solid formula. Fed funds rate, which by the way has been at zero most of the last 15 years that all of a sudden is not to be technical it's 14 years. So Fed funds rate plus nominal GDP growth expectations, well, where are we right now? The two year, the very short term bonds, six months one year, they're right in line with the Fed funds.

People think the Fed funds rate's get into, it's, it's over 3% now. It's going to get to 4%. They've priced it around the four, the 10 year is around the four. So, whether you're now again, the Fed funds rate will be coming down is what obviously the 10 year market is telling you. So, I don't want to say that the 10 is pricing in 0% nominal GDP growth which would mean negative real GDP growth. But do I think that the longer end of the curve is saying even as the Fed funds rate comes down, let's say it comes back down to 2%, we go, don't go back to zero bound, we don't go meaningfully higher than four, whatever it ends up being, but whether it's inflation or real growth or that or some combination that I've put together nominal GDP growth pricing in 1 -2% soaking wet, and I believe the downward pressure on inflation expectations and downward pressure on real GDP growth, which unfortunately is my macroeconomic outlook based on excessive indebtedness that I've talked about in the Dividend Cafe for years.

And we'll be talking about for years that you have a situation now where bonds come back in with a value, they provide an opportunity for hedging, they provide an opportunity for diversification, they provide an opportunity for what they're not giving right now, which is reverse correlation to equities. Why are they not giving it now? Because we're still in a rising rate cycle and historically, and certainly in the present tense, rising rates with fear of economic slowdown and then the actual mathematical impact of rising rates, hurting stock valuations and obviously pushing bond prices. Rising rates are, are generally going to be positively correlated between stocks and bonds and not in a good way. Where rising rates can create reverse correlation is when they're in the midst of economic growth. So, it's causing bonds to go down because you're pricing in greater growth expectations. And yet equities are not being repriced because of the fact that equities are excited about more revenue growth, more sales growth, and indeed more profits.

Well, that's not the environment right now. So, this is where it's more than just quantitative. The math of rising rates, it's qualitative, the reason for rising rates, and we know what those reasons are now. It's the Fed funds rate itself coming up, but it's not the terminal rate, It's not long dated expectations of higher inflation or optimism of higher growth. There's nobody thinking, talking, acting that way that we're getting this great decade of high growth ahead. And so, while the tenure has had to reprice around higher Fed funds, it is not repriced around higher nominal GDP expectations. So, it leaves us with my equity outlook has already been there that I think we're in a period a monetary instability. We're in a macro environment that will struggle for headwinds, excuse me, for tailwinds to growth, forcing us to buy quality and stability and balance sheets and solid business models.

We're in a period where instead of 70 or 80% of companies having a higher dividend yield than the short-term bond market has had, which has been the case for 14 years, we now have less than 10% of companies offering a higher dividend yield. So, selectivity has to matter. Sustainability of dividend growth, the alignment of management with shareholders, the impressiveness of a business model to repeat this, all of those things matter a great deal on the equity side of what we're doing. But the reality is that you don't have an advantage and in fact have a disadvantage from a starting point of a zero bound bond yield, which is where we were a year ago. Now we're in a position where I don't know if the 10 year peaks 1% higher than now. I don't think it's going to, but I don't know. But I do know that I expect going forward, downward pressure on bond yields, whether that downward pressure starts in three weeks or three years, and that along the way that it presents competition between stocks and bonds that is healthy for an asset allocator that could help reduce overall portfolio volatility and provides non-correlation and a bit of hedging.

Where alternatives become so vital as a diversifier to bonds is when you're at the zero bound and you are getting effectively very little non correlation benefit from bonds to stocks. Now we're in a period in which I think the motivation for our use of alternatives is different, reducing equity beta, finding idiosyncratic alpha oriented opportunities. And then bonds have a different role in the portfolio, but the bond market is not the cause of economic distress. It reflects different things.

And how do you become pessimistic about bond yields going higher? You have to believe that these expectations for nominal GDP growth, you can be agnostic if you think it's coming from real growth or from inflation, but you have to believe nominal GDP growth is going higher, not staying high. Okay? It's come up, but the question, on the inflation side, but do you believe the rate of inflation is going to be growing still?

I simply don't. I'll make that case all day long. And so even if it remains elevated level relative to past periods, at some point the Fed funds rate comes down. That's component in how he priced 10 year treasure yields. Some point nominal GDP growth expectations come down. And the one savior to all of this that would keep bond yields elevated, but for a good reason is if we've had this great period of real economic growth coming. I don't see it on the supply side. I’m not a Keynesian, but I most certainly don't see it on the demand side. And I don't believe that the excessive indebtedness of the countries of earth are going to allow it to come back. Ergo, I think that one is in a position where bond yields are likely to come lower and that provides portfolio benefit if we properly understand this.

So, there's some benefit to the fact that what's happened in 22 facilitates this going forward eighties and nineties era is over. The 2000’s era was quite unique, but the post GFC era was a story all of its own. We know what has happened here in 21 and 22, they reopen the economy and we had shut it down and cut off our ability to supply goods and services. But when we reopened, demand didn't just stay low in concert with supply, it, it didn't go higher, it just got normal. People were normal. Most untalked about story last two years is how bad Covid policy screwed up, what we're dealing with. Now when it comes to inflation, labor shortages from a political standpoint, a lot of my Republican friends want to talk about how they printed a bunch of money or the Biden administration gave out money or the Trump administration gave out money too.

You know that that's all out there. But the real factor that when you get into the cogs of inflation and basic quantity theory of money is we force to substantial inadequacy in our production of goods and services. And that explains the era we've been in. When I look out, I'm saying that to start in the next period of higher bond yields, I think produces that benefit. It properly understood. There's a little macroeconomic education in there, there's a portfolio application. And coming into this weekend, there's an opportunity for USC to beat a great Utah team on the road and for the Dallas Cowboys to go on Sunday night into a road game in Philadelphia and beat the evil Eagles. So, there is today's dividend cafe. Thanks for listening. Thank you for watching. Reach out with questions you email questions@thebahnsengroup.com. I try to publish a response to most of them in the DC Today, but I certainly write back personally to all of them.

And I do ask for your support with Dividend Cafe and forwarding it, subscribing to it, whether it's on video right now, if you just hit that little up thumb button or subscribe button same on your podcast, a little review, all those things help us. I'll leave that pitch for next week. In the meantime, I'm off to New York with our investment committee. We have over 20 meetings, the money managers next week. And suffice it to say we have a lot to talk about. Thank you so much for watching and listening to the Dividend Cafe.
