FRIDAY, DECEMBER 2, 2022

Well, hello and welcome to the Dividend Cafe. I am recording from my house in Newport Beach because I am running to the airport when I am done. We'll be meeting with some clients this afternoon and then speaking at a conference in San Francisco tomorrow. And so in the meantime, I just got done taping for Varney on Fox Business, and I'm going to be taping when I'm done with this for 'Wall Street Week with Maria Bartiromo', which tapes, which airs on Friday night and I think they air it over the weekend. So I'm wrapping these things up and then heading to the airport. And yet I really have enjoyed what Dividend Cafe is going to be about here today. The writing and message around the Fed is hardly something new for those who listen to or read, watch, Dividend Cafe frequently, my beliefs are well known about the fact that Central Banking and monetary policy are a significant element of what is now happening in macroeconomics. And I don't say that as a good thing. I say it as a concerning thing. And yet I wanted to just give a kind of high level understanding as to what I think is the heart of the matter with the Fed, and then of course what that means and ought to mean and needs to mean for investors.

So I go back to a certain kind of Economics 101 with this, that I do believe in certain key understandings or first principles being elemental to how one will understand economics. And among those, I think there is a sort of antithesis between, and this is really a 20th century economic fight that is most certainly continued here in the first 20+ years of this 21st century between risk takers and central planners. There was the classical school of economics developed out of the late 18th and early 19th century that we called laissez faire that had more of a focus on hands off freedom, liberty free exchange, private property, mutual cooperation, all of these types of things. And then as the population grew and economic complexity grew, there was more of a fondness through the 20th century, especially post depression for something more central planning oriented. And that could take on more extreme forms such as a totalitarian communism or it could take on a softer form sort of a faculty lounge keynesianism that was much more benign compared to the militaristic forms essential planning that we saw in the 20th century. And yet I would argue still is cut from the same cloth of a belief in the need for and the benefits of central planning around an economy. And so far and away that camp ha is the predominant group of policy makers and institutional leadership in the country, the commanding heights of power, whether it be think tanks, government, and the focus of my talk today, Central Bank. The Central Banking largely believes that you can soften the edges of markets with some well intentioned, thoughtful, elite form of central planning. And I'm trying not to even, I don't actually like that word 'elite'. And it's possible that even that was more loaded than I intended it to be. But I'm trying to avoid loaded language here because I think that's often where the conversation goes and it just turns into kind of a gunfight of vocabulary where people substitute verbiage for a real argument. And so when we say you just want the elites and the powerful to run the economy and others say, we're just trying to soften greed and excess, and there's a lot of rhetoric there that obviously is meant to kind of make a point, but it doesn't make a point. And I want to make a point. I do come from the Hayekian camp that believes that there's a 'Fatal Conceit' in those devoted to central planning of an economy. And that language that Hayek used was rooted in this notion that we may believe we can centrally plan the affairs of economy, but we cannot. And then he really devoted an intellectual career to establish an academic career to establishing why we could not.

And so I could go down this path forever. I lecture on this topic to high school students and I've created an economic curriculum around a lot of these ideas just to stick to first principles. But right now I'm taking these things and applying them into Central Banking. I don't believe that the central planning mantra applied to Central Banking has gone very well. And the reason I believe it hasn't gone well is because I don't think it can go well. I fundamentally believe in the critique of central planning, even before it's applied to monetary policy, which is that there lacks the knowledge and incentives for central planners to effectively do what they have set out to do. So there's a certain hubris and arrogance in the basic idea that one can go about stewarding the affairs of mankind better than those involved in transactions. Can those individuals who are going to be feeling the reward or the pain. But what I want to do is now convert past the philosophical and the macro. These are topics that I'm not trying to give an exhaustive argument about right now. We've been fighting them for a hundred years and I don't think I'm going to solve it for you in 10 minutes but I can solve it for you in a whole semester. But I digress.

What do I mean when we're talking about the 'Fatal Conceit' of central planning applied to Central Banking? Well, first of all, let's talk about the whole basis for having a Central Bank to begin with. See, this is where I, and I've said this so many times over the course of the years that I've talked about this subject, I am not against having a Central Bank and many people who feel as I do about the 'Fatal Conceit' essential planning do oppose the whole notion of having a Central Bank. But I think that if you were talking about having a lender of last resort and that was holding to that famous 19th Century dictum of lending to solvent financial institutions with posted collateral for at high and punitive rates to keep people from excessively borrowing, but nevertheless making liquidity available so that liquidity traps do not turn into solvency crises. We were suffering through these periods in the late 19th Century and early 20th Century, and that's what I think a Central Bank should be intended to do to provide liquidity when you fall into liquidity trap, when in fact there is solvency. So when there are assets higher than liabilities, you're talking about a solvent institution. And I've said many times, I believe the Fed existing to provide liquidity in those moments so that liquidity problems don't undermine solvency is different when an institutions insolvent, that there is actually more liabilities and assets and so forth, that becomes a very different story. But all of that would require a whole other

Dividend Cafe and a whole other book, and other people have written those whole other books.

So my point is only to say this, my critique of what the Fed is now doing is not related to an existential critique of the concept of a lender of last resort. It is related to the notion that interest rate planning, as a step number one, is a good idea for an entity like the Fed. And so let's first just ask ourselves, "What are we talking about with interest rate planning?" and, "What are we talking about with interest rates?" Well, we know interest rates are the price you pay to borrow money, but what they are further than that is a couple other things that I need to make clear. It's the price of time. Why does somebody want to receive money to be separated from their money? It's the price that they're charging for the time period at which they will not have access to that money. And then of course there can be a risk premium factored in as well for the risk that they won't get their money back. Now we're not talking about that element right now. We've talked about how that works when it comes to pricing risk assets, the amount of return you expect to get because of the risk that you might lose money. But we're right now theoretically in the reference of money, good lending. And so then the interest rate when you're going to get paid back on the other side is purely to compensate you for the time you're separated from the money. And so this is an area which for some reason that I've never understood, people treat it as if it is a different economic concept than any other buying and selling. What I mean by that is, we like high interest rates when we're lending money, and we like low interest rates when we're borrowing. And that is exactly analogous to how we like selling a house at a high price and we like buying a house at a low price. And to the extent that we already have a mechanism in place in our economy for how a home price gets determined and it is called 'free exchange' and that there is price discovery, the buyer says, "I want to pay this". The seller says, "I won't sell it for that, but I will for this," and then they say," Let's make a deal." They, 'let's make a deal' their way to selling a home or they don't. And then that gives you more price information. Hey, this house was listed for a million dollars for a year and it never sold. So you have some sort of information embedded in that price. The exact same thing applies to interest rates. Now we know this when it comes to you borrowing money from me that we're going to do a private transaction. And when it comes to you borrowing money from your bank we know what the bank might charge and what you say, "Okay, well I'm going to go to another bank or I'm not going to buy this thing and borrow money to do it because I don't like that rate." There's individual decision making that goes around it, but for some reason we act like that doesn't apply when it comes to what banks will charge each other to lend money. The fact of the matter is that the interest rate in the economy, whether we're talking about a 10 Year Bond Yield, an overnight lending rate for banks or you and I borrowing or lending money with houses and cars, it is still ultimately the byproduct of two competing forces coming together. And so my friend, Jim Gran,t talks about how prices are to be discovered, not imposed. We discover a price when a buyer and seller reach an agreement of buying a home. We discover a price of capital when you say I want to borrow money and I say, I'm going to lend it to you at this amount, this is discovery. What when the Fed is imposing an interest rate, you lose price discovery. And what else do you lose when you lose price discovery, you lose the information that price discovery provides. So this is a very Hayekian notion that prices are signals, the prices are packets of information in an economy that help us to deal with the knowledge problem. That there is such a wide dispersion of knowledge. We can't possibly know everything, but prices can signal to us a lot of information that helps us in our own economic affairs to make decisions and to steward resources and to manage the challenges of scarcity. The fact of the matter is that imposing a price on capital that's become a primary given tool for Central Banking in the modern era and it is distortive to price discovery. So you go, "Okay, yeah, academically, David, philosophically that I think this all makes sense. You're highlighting doing something that is probably unnatural to those who advocate a more open free economy and a more efficient system. But really at the end of the day has been that bad?" Now I think that's a reasonable point. See, I've never believed that every time at which they are imposing an interest rate that they're necessarily imposing one that would be that different from what would be freely discovered if we were using a more natural and open process for a rate discovery. But the fact of the matter, is that the Central Bank is incapable of allowing that natural process to unfold when they have the burden that we have given them of full employment, maximum employment and price stability. So they end up having this sort of political mandate to do something that then requires them to use a tool that I think they ought not have. The setting of prices of capital, the setting of prices of time. These are two pretty big things, wouldn't you say? Capital and time And you're, you're going to give a few people around a conference room the power over those things. It, it's a big deal, right? Over time, what we have seen is the natural and expected excesses that such power would come with that one would go too high with rate setting at certain points and overly tighten access to capital in an economy and tighten financial conditions which leads to economic slowdown greater than would be otherwise the case. And then of course the opposite, the boom part of the cycle where they're overly easy, overly accommodated and it ends up creating excesses that later have to be purged.

I don't know historically anyone could argue that this has been anything but that anything but that has been the story. I do believe that we are really looking at a boom bust cycle Fed that is not going to go anywhere anytime soon. Okay? And so at the end of the day, this is a byproduct of a 'Fatal Conceit'. I don't think that our Central Bankers are bad people. I think they're well intentioned. I think they're intelligent, but I think they've taken on a task that is above and beyond the call of anybody. And so I cannot say that there will be a perfect resolution when we have entitled or given someone this kind of power. But let's look at the actual case of what's gone on. You literally have seen silly excesses develop in financial markets that I don't think would've ever developed a part from low cost of capital, distorted price of capital, distorted price of time.

The 'Fatal Conceit' of the Fed did not create human nature. Human nature wants to believe stupid things. Human nature wants to believe that one can get rich buying a digital token or a Beanie baby, the latter of which I think might be more valuable by the way. Human nature wants to believe that abc.com in 1999 with a celebrity doing a commercial in the Super Bowl is going to be a new company that now I can buy and it will make 10 times their money quickly all the time. Human nature wants to believe in the ability to get rich quickly that there is not risk in investing. There is not volatility, that there are not normal processes by which risk premium is extracted. I talk about those things all the time because that's the process by which I'm trying to get a return on capital by which I'm trying to empower clients to get from their capital, the returns they need for their own financial goals out of both income and growth and so forth.

I'm trying to deal within the laws of economics, the laws of reality, the laws of nature and human nature wants to believe we can exceed those things. And what does the Fed have to do with that? See, the Fed didn't create human nature and yet the Fed provides kerosene on top of human nature when they distort the price of time and the price or cost of capital that allows people to then now have incentives and excess liquidity and an accommodative environment to go be silly, tokens, '.com', Florida condos in 2005, the things like that. When you're borrowing money in a leverage sense, you then have all of the motivation in the world to leverage up excesses, which then of course exacerbates the bust on the way down the boom-bust cycle is the ultimate child of the 'Fatal Conceit' of Central Banking. Once you have asked the Central Banker to do something that is so overwhelmingly outside of their natural ability to do, the byproduct you get is going to be a boom bust cycle. And then of course to treat the boom bust cycle, you're going to get a kind of reinvented hubris to account for the initial arrogance. First, we dared to believe we could properly set the price of time and find this smooth equilibrium around a natural rate in the economy. And then when it got out of control, we thought we would have the tools to kind of go treat it and provide the medicine necessary around it. And you see things like in Japan where somehow they are dealing with a given month's issuance of Ten Year Treasuries and you see that there is more Treasury Bonds on the books than exist. And yet how could that happen? Because they are trying to now counteract the fact that there's people short selling and they can't have that and they're creating more bonds out of thin air. And so it gets this silly whole notion, all of which started, you could argue that it's a good thing to do or a bad thing to do given that immediate ad hoc moment they're in. But my point is, it came about because they first dared to intervene to begin with. So the 'Fatal Conceit' never really ends. It always leads to more overreach, more excess, all to try to do what was fundamentally impossible to do to begin with. And not just impossible, but unnecessary because a buyer and seller were always going to come to an agreement as to what the price of time, price of capital needed to be to begin with.

So when it comes to the present state of the Fed, I do not believe this is going away. I do not believe that J Powell, or back in the day, Ben Bernanke, Janet Yell, and Allen Greenspan were begging for more power and authority and that they somehow tricked Congress into giving to them or tricked the media into deifying them. I believe that over time that the notion that we became very, very dependent on central planners to try to treat these things has evolved into a very elevated position, to a point where one day they give a speech that kind of sounds a certain way and the market goes up a thousand points and another day people start worrying that, "Oh, jobs number looks a little good. I bet they're going to do this." And the market drops hundreds of points. It is, it is now led to this silliness in financial markets that we can't unwind ourselves from. And so I do have all kinds of beliefs and theories about what we ought to do and how to go about right sizing and downsizing, an unreasonable vision of monetary policy in our society. But that is not how I'm going to invest client capital as if those things are about to happen. because I don't think we're anywhere near to those things happening. So therefore, I want to try to immunize us from the reality of a boom bust cycle as much as possible. It can't be done entirely. Even dividend growth stocks have a PE ratio. I don't want to rely on the PE ratio or rely on expansion to get my return, but they're going to have a PE ratio no matter what. And if PEs are going to be going higher or lower based on different actions and reactions and so forth, then we're going to be somewhat exposed to these realities in financial markets, job holders, job seekers, wage earners are totally exposed to the Fed. And in fact, the Fed has kind of said that there's the enemy, that the reason we have inflation is that the economy's too hot and we need to go take away jobs and damen wages as a way of getting prices lower. This is literally the governing belief of the kind of central planning oriented vision of our economy right now.

So we're dealing with different beliefs that are sometimes I think right, sometimes wrong, even when wrong, often rightly intended, but nevertheless require me to have an operating paradigm for how I want to steward client capital. And this is going to, I suspect lasts for the rest of my career, the rest of your investing lifetimes. And that's the type of stuff we talk about all the time as to what that means, what we want to do about it, how we adjudicate, make risk, reward decisions in that paradigm.

So those are a few thoughts on the Fed. I could do a 10 part series on this. I could write a huge book on it. My library is filled with significant contributions to a truly intelligent understanding of the Fed. Some of the books I hate, some of them I love. I'm not trying to become articulate spokesman for what monetary policy ought to look like with Dividend Cafe. I'm never going to stop studying it, caring about it. What I want to do at Dividend Cafe is give you guys a better understanding as to why exactly the media narratives around a lot of these things may not be right. The kind of knee jerk thought of what's the Fed going to do is not really the way you want to think about economic life. And yet give you a little backdrop as to how I think we got it to this point in what these consequences have been.

So I'm going to leave it there, run and get catch my plane, and I do hope you have gotten something out of this message. Please reach out with any questions while I'm on the subject. As you read Dividend Cafe, as you watch the video or listen to the podcast, I hope that you will subscribe to the way in which you take it in as that really does help us and that you would even rate and review if you're watching the video or listen to the podcast. Those things mean a great deal to us for reasons I won't bore you with now, thanks for listening to you watching Reading the Dividend Cafe.
