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Well, hello and welcome to the Weekly Dividend Cafe. I am very excited. It was kind of some extra work this morning, and putting together our written Dividend Cafe, and I'm excited for the message. I am also going to tell you for those, listening to the podcast, watching the video I think I say this maybe like one every three episodes that you have to go to the written Dividend Cafe but there's 20 charts at dividendcafe.com and I really think that everything I'm about to say is going to have a fuller experience when you can attach it to some of the visual reinforcement, the different charts that are there. So check that out. The other thing I'll say, just to start off so I don't have to say it at the end, but it is really important to us is if you're listening to the podcast on the website, it is a lot better for us and I think it makes it easier for you.

I'm a rather addicted podcast listener and each podcast that I listen to that I love, I subscribe to it through the podcast system that I listen on and then you get it automatically in your feed and then that kind of helps all their algorithms for how they rate and stack and show and display the podcast. And so if you would subscribe to the Dividend Cafe in whatever your podcast listener is, that would be great. And if you are watching on YouTube, we certainly love it If you'd subscribe to the video channel there and those other things about rating and starring and reviewing and ranking or whatever, thumbs up and smiley faces, that's all up to you. If you like it, it's great, it, it's appreciated. If not, whatever, there we go. Okay, we're going to talk today about inflation and you might think, well, you've already talked about this so much and that is very true and I've talked about it an awful lot more than you might even know about if all you do is listen to Dividend Cafe.

There's a lot of different forums and context in which the inflation discussion has been alive and well in my economic orbit for quite some time. But today I think it is helpful for a little refresher because the fed's action this week very expected that we are going to get a 50 basis point rate hike. And then you go, well, it doesn't seem like it was that expected because the market dropped 750 points the day after. And as I'm recording here on Friday, it's down over another 500 points. Now, it had been up over 500 points earlier in the week and at one point, and when the CPI number came out, and it was much better than expected, meaning indicating lower inflation than expected, the market went up another 800 points, but it gave almost all of that back and then has since then gone down another, let's call it 1200 points.

So there was this real strong euphoria and then now there's been this greater pessimism all within the last few days all related to the subject I'm talking about. But if it was 2, 3, 4 days of market action or 2, 3, 4 weeks of market action, I would not even be talking about it. I wouldn't care and I wouldn't want anyone else to care. But it's because all I bring up in the last 2, 3, 4 days is a microcosm of what is a bigger theme in a more macro context. That's why I want to address it. I believe I, I've written at length in recent Dividend Cafes that the Fed is given a very overly elevated role in our economy and I believe that there's a lot of downside to that. And that did not happen beginning when we got high inflation readings a year and a half or two years ago.

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The Fed has been the media darlings of financial markets and economic administration for 25 years. Alan Greenspan became a magazine cover kind of media celebrity 25 years ago. And at that we were in a period of multi-decade moderation of inflation where if anything, if inflation only came up to talk about how low it was. So the Fed is not all of a sudden in our shall we say Google searches because of inflation being elevated. That right now is the context though in which the vet has become very relevant this year, monetary policy tightening as a result of inflation levels being high. So it forces me as an economist to ask a simple question. First of all, is monetary policy tightening anti inflationary? And second of all is monetary ease or monetary accommodation, monetary looseness the pro inflationary. Do you have to do the one to counter the opposite?

Did the other you follow me? And I think that that is a very logical way to think about it. If those premises were true, and yet the problem is that the premises are not true, can monetary policy become inflationary? Absolutely. Is it even very easy to imagine how overly accommodative monetary policy can become inflationary? No question. In this particular context, I'm going to suggest that we really right now have in the data an overwhelmingly obvious body of evidence pointing to a different primary causation of the 2122 inflation that then calls into question what ought to be happening, which is kind of less relevant to me as an investment manager. And B, what we can expect will be happening. And so I'm going to unpack all that for you here today. Okay, let's kind of review some basics here. I think that monetary policy being overly accommodative can be an absolutely awful thing.

The very last Dividend Cafe I wrote on the Fed unpack this at great length I gotta think it's 50 Dividend Cafes I've written in the last several years referring to some aspect of distortions and trade-offs and challenges and instabilities that overly accommodative therapeutic monetary policy a real reliance on interventionist monetary policy represents. And so when I say that I am firmly convinced that fed monetary policy was not the primary cause of the 2021 through 2022 inflation that is not to say that I am defensive of supportive of fond of that level of monetary policy. I'm actually not. And the analogy I use in Dividend Cafe today that I'll share with you is I can very well say that fast food, excessive eating of fast food does not cause osteoporosis without you having to hear me as saying that I think fast food is healthy or good for you or doesn't do damage to your heart.

But when someone misdiagnoses what a bad thing will do, that doesn't help us anymore than saying that a bad thing is a good thing. And in this particular case, I think that prolonged and excessive accommodated Monterey policy, meaning a 0% interest rate for way too long a period of time and additionally piling on with trillions of dollars of quantit of easing for too long of a time that I think it does a lot of damage, that it creates a lot of instability, it distorts price discovery all the things I talked about just in very recent Dividend Cafes. And yet I am perfectly within the bounds of logic to still say despite those criticisms, I don't think it's the primary cause of the current inflation. Now, two caveats. First of all, that doesn't mean easy, accommodating monetary policy can't be inflationary. I'm just simply saying in this particular context, I don't think it was the primary cause.

Being reckless with the money supply can absolutely be inflationary and the number one underlying tenant of monetarism, I fully agree with one of the greatest economic minds who ever walked Earth, Milton Friedman, that inflation is a monetary phenomena and that effectively definition is too much money chasing too few goods and services and have written a bunch about how velocity was always stable in that period. And it's a declining velocity brought on by the diminishing return of excessive fiscal and monetary policy that has altered the way in which we interpret that quantity theory of money and that formula for monetary inflation. But nevertheless, the basics of there are two people on a desert island, and there are absolutely no products or services on the island. There's just 10 bananas and that's it. And there's 10 units of currency, let's call 'em dollars. There's $10 and 10 bananas and there's no more people.

And then you fast forward a week and there's still nothing but 10 bananas and two people, but now there's $20, we've just dropped 10 extra bucks from the moon, then obviously the price of the bananas expect to go higher. That's a classic isolated, easy to define case of monetary inflation that you devalued the currency and it resulted in the product price going higher. But you're not any, you have no different. You have a unit of account and you have more units, but it buys the same amount of things and so therefore the prices are higher that that's easy and an indisputable. And of course the whole challenge of these desert island analogies, first of all, there're always necessary to do property economics, but second of all, there are more than 10 bananas on planet earth. There are gazillions of other products that aren't bananas. Not to mention just in bananas alone there's more than 10 and there's ability to create more, to yield more, to plant more.

And there is of course the fact that the population has a lot more than just two people. So you add the complexity of numerous people and numerous goods and services and the capacity for making more or less of goods and services. And then you get a much more complicated picture around where money supply fits into the price level. And yet I buy the underlying tenant wholeheartedly and the fed can screw up with the money supply. But I think that the interventionist tools that they use to affect an economic stimulus, low interest rates, quantitative easing, other interventions they do, I think that it has a worse impact than just inflationary because actually it becomes pushing on a string. But then B, in the covid moment and out of the covid moment and in the inflation I'm here to talk to you about today, I simply do not believe that it was the primary cause of the inflation for the reasons I would like to walk through right now.

Why do we believe that excessive monetary policy stimulates inflation, promotes provokes, creates inflation? Well, it's the inverse of why we believe that right now tightening monetary policy is going to bring down inflation. We believe that if excessive monetary policy is stimulating aggregate demand than it is promoting more inflation and that therefore the inverse is if they tighten monetary policy, it brings down demand. And that out of that logic is where you get people saying things like, okay, well you can really bring down demand if you get a bunch of people unemployed. So once we can cool down the economy, meaning people will want less things and so prices will come down and the way we make 'em want

less things is to make 'em poor or make 'em unemployed or something. I mean, dear God, if people could just think through the implications of what they're saying sometimes, and this is people on the left and the right, okay, this is a totally nonpartisan apolitical comment about the economic insanity of believing that a great prescription to high prices is to make people unemployed.

But nevertheless, that doesn't mean you can have people get unemployed in the ebb and flow of a market economy. That doesn't mean, and it can happen because of a policy decision you need to make for another reason. I don't want the cost of capital being allowed to mess with a return on invested capital that therefore stimulates unproductive investment. And so overly accommodative monetary policy can do that and I've been writing about that forever and the Austrian in me deeply disdains that kind of interventionist economic policy. Yet I do not believe that the prescription to inflation is to make people unemployed. However, that's the thinking is that aggregate demand is so high and so hot that we use the fed's policy tool, primarily the interest rate to bring down aggregate demand. So it's at least logically fair enough, you may not believe that you need to bring down aggregate demand by things like targeting jobs and wages.

But if the overall idea is that you want to bring down aggregate demand by making the cost of capital higher, I'm in in favor of it If that aggregate demand has gotten overly heated relative to the health and growth rate of an economy. And here's the problem with the inflation of 2021, there's absolutely no evidence that aggregate demand was out of balance. Consumption levels obviously tanked during covid when everyone was locked down. They did not tank as much as people feared because consumption habits changed. Instead of taking vacations, they were watching Netflix instead of going out to the bars, they were ordering DoorDash that there was different consumption. There wasn't the aggregate decline of consumption, many thought there'd be, but demand certainly dropped and then we reopened. And partially because some states were just really ahead of the fact that lockdowns weren't working wanted to be open.

Others were the efficacy and competence that the vaccine provided for people that to get back out there, they now were less worried about being dead. There was all kinds of factors that were driving reopening, but when reopening happened, demand normalized. And I am perfectly willing to admit that generally out of a traditional recession, consumption habits do not normalize that quickly. But this wasn't a traditional recession, it was a forced recession totally out of bounds from the normal factors with declining profits, declining production, declining wages, declining jobs, declining output, that didn't happen. You just simply added everyone locked down. So you had this huge drop in economic activity and then it came back. So I don't think we should be surprised, especially given the dynamic of the human component, that there was pent up demand that was bringing everybody back to economic activity, that pent up demand allowed things to normalize maybe quicker than normally would our recession, but it wasn't overheated and it wasn't even to this day, consumption is not above pre pandemic levels.

And so I don't think we can look at the data and conclude that all of a sudden some of the economic activity of 20 20 21 forced this kind of inflationary boom. But there is data to look at that is totally off trend line and totally above and beyond what we normally would've expected that provides a much better explanation of inflation and that is a massive decline in investment in plants and equipment and factories and production of supply throughout the lockdowns. So we did two things. We shut down demand or limited demand and during covid and then we shut down production, but then we turned back on demand, but we weren't able to catch up to that with the turning back on of supply. You then couple that to global factors where semiconductors couldn't come in, where trucking costs exploded, shipping costs exploded, ports were backed up, labor was in short supply and you had a plethora, a whole myriad of circumstances.

What do you do when you're not making the same amount of products you were before? You have to import more products. What happens to import prices when chips and energy and shipping costs all go up, import prices flew up. So we're importing more, we're paying more for imports and whoa, low and behold, finished products went higher. The most logical, simple, succinct explanation of price inflation that I think we can see, and I'm not even including some of the other things that obviously are additive in their complexity. The Ukraine war and its impact on food prices and crops, obviously a myriad of things that affected energy prices. That distinction between court and headline inflation is useful in this sense that core inflation can help isolate circumstantial causation where headline inflation that includes food and energy is subject to the volatility of a lot of these geopolitical or idiosyncratic events.

And so I think that no matter how you look at it, you're going to see that there was a supply causation throughout 2020 into 21 that caused that inflation level to skyrocket at the time that the world reopened and commodity prices and so forth went up with it. Now you look for a counterfactual to disrupt it like, well, what if prices were still going higher and yet supply conditions have improved? But see all of these factuals play into the narrative, they're reinforcing or supportive of my thesis that goods inflation has come down in concert with supply circumstances improving.

The reality is that the CPI number when 33% of it is factoring in shelter and there's just a massive disconnect between the way they measure the shelter impact of CPI and the real life on the ground level of what's happening in home prices, home price activity and rents and new rents of new leases relative to what was being done a year ago. So you do have downward pressure on the rate of inflation, it will take a bit more time and yet that is totally consistent with the idea that inflation went up for idiosyncratic supply reasons and then comes back down for idiosyncratic supply improvement reasons. Is some of it going to stay sticky? Is some of it going to go down but not go as down as it was pre covid? Where does housing fit into this? There are other questions as well.

I'm talking generally about what people mean when they use the term aggregate demand factors and aggregate price level. I prefer to always unpack it always be in the weeds. I don't like the term the price level, but I'm dealing with the vocabulary one uses when talking

about these subjects. The housing component, I don't understand why we don't constantly have a separate conversation about that because it is a levered asset class that is highly rate sensitive and therefore highly connected to fed monetary policy. So I can write a four page paper or I think D Cafe is probably today if you were printing it out, 10 or 15 pages, I don't know making the case as I do that the price inflation in many of the things we're experiencing are not federal related and yet I would argue tooth and nail and emphatically that price inflation and housing was federal related, not entirely.

Oh, the limited supply factors in housing that we've dealt with post-crisis are not fed specific and they are a big factor and they're also why there's a certain floor underneath housing that once this bubble we've been in finishes a correction. I think it's in very early innings of that, but once it finishes, there is a floor underneath housing because of those limited supply factors. But the reality is that having interest rates go as low as they did in 2020 took a supply constrained asset like housing and then just threw gasoline on that fire pushing up yet another bubble. The second housing bubble we've had to go through now in less than 20 years that I'm perfectly willing to say has a huge connection to monetary policy, but in the broader as and the Fed by the way could look at it right now and say by getting mortgage rates up to 7%, the Fed funds right now back above 4%.

We've clearly done something that's going to have a big impact in housing and that's going to play out over the next year no doubt. But does the Fed have to continue tightening to bring down overall inflation? Well, the Fed may not see it yet. The Fed may need to continue talking differently. The Fed may for all I know disagree with me. I'm not convinced that's the case. I'm convinced there's a delta between what they have to say and what they believe and I'm convinced there's a delta between what they believe and what the reality on the ground is. But where those two deltas overlap, I don't know. I do know this that the rate of inflation that was so problematic politically and certainly in the impact it was having on what actual people were paying for things, particularly lower income and middle class wage earners were paying for things.

I think that that level of inflation is on its way down and you see that across virtually every category and that it might be idiosyncratic causes to it coming down just like the idiosyncratic causes to it going up from energy to food to housing, but then the core goods and more. You look right now at a disconnect between apparel inflation versus entertainment. There are different elements but at the level we're talking about in terms of aggregated prices I think one of the least efficacious tools to bring down that price level is monetary policy because monetary policy had such a minor role in how those prices went up to begin with. So the fact that it is very convenient and politically opportunistic and any number of other things to paint a simpler narrative on this doesn't change the fact that we really clearly see abundant evidence provided with chart after chart in Dividend Cafe as to why a supply causation does not lead to a monetary remedy.

So what does it mean then for investors? Well, one of the hard parts is that if one is convinced I'm right about the causation, that doesn't necessarily help how they allocate their portfolio If the Fed is not also convinced. I always talk about how we have to invest for

what is and not what we believe it ought to be or should be. And so what the Fed will really do is a whole different story. Now, I'm not at all convinced, and this has been pretty empirically proven this year, I'm not convinced that a lot of the things that an investor ought to be doing are negative in this environment even when they're putting downward pressure on asset prices. That's the least of my concerns. The multiple of the s and p being above 20 was too high and higher interest rates, bringing it back down is a good thing because I don't like overvalued assets.

The longer they're overvalued and the more overvalued they get, the worse the pain and hangover will be. And so avoiding overvaluation is a constant theme, but I don't know the timing of what the Fed will do and when I do know that once you've identified a cause that's different than the alignment of the remedy, right? The cause doesn't line up with the remedy that it's only a matter of time to the remedy has to switch gears. And I think the remedy right now of a voker like rates or even talking about that relative to what we're dealing with in inflation is very unlikely to last. And they have gone higher than I would've expected. They are right now higher than I would I believe they ought to be. By the way 50 to a hundred base points ago. I didn't feel that way. I felt that the reason they were doing it was wrong but not the outcome.

I do not think that developers or leveraged asset investors or let alone the need for wages and job creation in the society should or does require a zero bound interest rate. And to the extent that one's business model requires something lower, I don't think that that's good or healthy zombie. It allows something that probably ought of diet to continue living. However, at this point, the level they're at is not only being done, I think for the wrong reason, I think it's above and beyond what is probably the right level. And I've already talked about how I don't need to solve that because in Dave Land I believe in market forces doing price discovery and borrowers and lenders concluding what the right rate ought to be and you bring the Fed in only in a liquidity crisis that requires a lender of last resort. But we are not living in Dave Land and I am here to inform you that you will never live in Dave Land.

David will not ever live in Dave Land. So in the world that we are living in, where E Central bank has a big role and uses the policy tool of the short-term interest rate to affect that, where they likely to go, and that's the big debate in front of us. Now, I would immunize your portfolio as much as you can from a requirement on guessing what the Fed will do and when try your very best to be exposed rather to assets that are organic in their profit creation and not relying on the Fed to do a certain thing at a certain time. With bonds, it's almost impossible. And because there's such a direct connection and with assets that are really dependent on price, earnings ratio expansion, it's very hard because the interest rate informs the valuation of a risk asset so much. But in terms of a more conservative and more cash flow based portfolio, we talk all the time about how we believe one can remedy some of those things.

It's my view on the Fed, but more importantly, my view on inflation right now and one day I am very convinced the entire narrative will change. And then this leads to a tenure or 20 year, 30 year investment objective conversation is when the current inflationistas go back to

realizing the Japan unification we're in the deflationary forces, were forced to reckon with then what makes the most sense for one's portfolio long term. I think about these things in different time horizons every single day. I think we act upon 'em in a wise way, but this is the subject of the D Cafe to understand why things are happening with inflation and with disinflation, and then what the Fed is doing and ought to be doing and we'll be doing so we can formulate actionable investment thesis around that. I hope it's been helpful. I've covered a lot of ground.

I gotta get back to my desk at this point and I would encourage you to reach out with any questions anytime. Have a wonderful weekend. And just by quick recap, there will be no podcast or video for DC today, next Monday through Thursday. But I will be doing the written every day. Mondays will be a long written and Tuesday through Thursday we'll have the normal written market summary with an Ask David section and all that, but not a podcast video as we're dealing with all of our holiday stuff and so forth. Then on Friday there will be a special Dividend Cafe. I'll leave you in suspense on that and we'll go into the Christmas weekend and then in the final week of the year it will basically be shut down that Monday is the holiday anyways, and I'll be writing my annual white paper getting ready for the first Dividend Cafe of 2023 to be a really, really special comprehensive review of 2022 and forecast to 2023. So that's our plan and schedule for the next couple weeks. Thanks for listening to watching and reading the Dividend Cafe.

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