FRIDAY, FEBRUARY 3, 2023

Well, hello and welcome to the Dividend Cafe recording for you from Newport Beach. And the month of January is behind us. The latest Fed meeting is behind us. I did get a lot of good feedback about last week's talk on where we're headed with recession. I don't think the recession debate is behind us yet. It was time for me to put back in front of us a discussion around the subject of what I call "Japanification". And even though I titled Dividend Cafe this week, Deflation Debation in Denation, that was really because I was being clever. And there is a sense in which deflationary issues are at the heart of this. But I think that there is a need to constantly refresh what I'm talking about on this subject. It's a macroecqonomic, secular, long-term, historical generational important matter for how we think about investing, how we think about economic life and very possibly what it means in terms of political and cultural life in the United States and elsewhere in the world as well.

So here's what I want to go through today. What do we mean by 'Japanification"? Why this topic has become a bit complicated in the last few weeks. So let's get that out of the way first and not the last few weeks, last couple years. There was, let's just say a rather overwhelming theme playing out on the world stage in the UK, in the EU, in Japan, and in the United States post-financial crisis where central banks were absolutely flabbergasted that there was not more inflation. On paper, they seemed to be doing a lot of things to create inflation, very low interest rates, very high priming of the money supply the buildup of excess reserves at banks with money that was effectively printed though not circulated, and a general explosion of governmental spending. And those things did not seem to be creating inflation. They also did not seem to be creating economic growth. And over the last couple years, it became a different conversation as inflation moved much higher. And as much as any topic I've talked about in recent times, I've tried to explain where I think that came from. And yet the reality is that regardless of the causation of the inflation, people were not super interested in worrying about deflation or being informed about Japanification and these other concepts when it was very clear that housing prices had exploded, used car prices had exploded, et cetera, et cetera. And so I want to talk about why this subject is reverting and some people may find green shoots of good news. I think it's mostly not good news. I'll explain what that means.

So in a way, I am talking about two nations. There's a historical precedent here where the concept of "Japanification" comes from that is you may imagine rooted in a nation called Japan. And as I joke in Dividend Cafe if you didn't know that "Japanification" came from Japan, you may want to also re-study how many companies are in the S&P 500. But yes, obviously the term has to do with the dynamics that have played out over the last generation in Japan. And the historical sequence, there was a massive, and I mean unparalleled asset bubble that took place in the 1980s in Japan. United States, we have certain cultural connections to that asset bubble. Japanese bought Pebble Beach, they bought Rockefeller Center at a just ungodly price in each case. President...many, many decades later, President Trump, then Donald J. Trump, the real estate developer of New York City, penned an ad in the New York Times, bemoaning the fact that Japan was taking over the US economy and achieving supremacy on the world stage, and complaining about some of those conditions that were allowing Japan's new dominance and perhaps most telling of all the movie diehard took place in the late 1980s referring to a Japanese conglomerate in Century City, effectively in West Los Angeles that was representing this new kind of global powerhouse. And of course today, none of these cultural references would make any sense. The asset bubble burst and Japan's real estate market, stock market and position in global credit and global economic prominence has never ever come back or anything close to it. And my belief is that there was a deflationary period that came out of that asset bubble burst that now tells us a lot about certain principles. And I do think there are a lot of economists and a lot of pundits, a lot of analysts that have some talking points that are rooted in truth but are incompletely truthful and therefore distort our understanding of certain things today. So that when one says government spending is inflationary, which it most certainly can be, but when the we retort, well, government, excessive government spending in Japan was the highest in the world and they've had the lowest inflation in the world. Nobody wants to engage the conversation. And when you say, well, central banking money printing and zero interest rates, and all these other types of things are inflationary there's an incredible truth to it. And yet, when one points out the counterfactual of Japan is often crickets. And I think that that has to change. One has to be able to apply the lessons of Japan to the present economic moment in America. And ignoring it or shrugging your shoulders at it is intellectually unacceptable. It is my view that it is a hundred percent true that spending too much money at a governmental level is inflationary until it isn't. And that ridiculous monetary policy from a country central bank is inflationary until it isn't, and that you run into a diminishing return from fiscal government spending or monetary essential bank activities. And that process of diminishing return leading to inadequate growth in an economy or a declining standard of living, is what I mean by "Japanification" in the sense that the only things you can now do to try to treat it are the things that are themselves causing the problem. More fiscal stimulus, more monetary stimulus, rinse and repeat. I've talked about this over and over again.

Japan's path to, "Japanification" is different. In the United States path, Japan had less defense mechanisms against it, primarily in the form of a less productive adult workforce. Their demographics had long since turned upside down, and were having to deal with more elderly that required to take from the economy as opposed to a younger, productive workforce that was giving into the economy. And that was not the case demographically in the United States. There are all sorts of other issues as well that we're going to get into. But what I think needs to be understood before we go further is that when we talk about these central banks are creating inflation, these politicians are creating inflation that we are not insulting them. That is the plan. And it was only when inflation breached a certain level of comfort zone for the American population. Car prices and lumber prices and groceries got too high. Gas prices is always a great case in point there. Over the '21, '22 period that inflation became something that politicians now had to deal with. But that by design countries that spend above their means that run massive deficits, expect to, demand to, pray, to pay those debts back in inflated dollars that effectively they borrow $1, get the benefit of what they want to do in distributing that dollar and then want to pay it back with a dollar that is worth 60 cents. If you could pay back a dollar with 60 cents, everybody would love to do it. But the creditor who gave you the dollar won't allow it. You got to pay back a dollar with a par value of dollar. So that's what inflation is. It enables one to pay a dollar back with 60 cents. That is called a dollar. You follow me? So this is not an accident and this is not a bad thing to the creditors doing it, the excuse me, borrowers doing it, which are primarily sovereign nations, okay?

And so the challenge becomes A) politically when the inflation gets high above that level, two, three, 4% that it's, it doesn't upset the population enough to create uprising. But then the other problem becomes when you are undermining the growth of your economy and the standard of living that your people demand, this is the situation that we got into.

Fundamentally, I want you to just remember this basic paradigm. Politicians exist more or less with an agenda to inflate away debt. And all that means is to spend a lot of money and borrow a lot of money. Essential bankers exist primarily to avoid a debt deflation. That there is the total unwillingness from the testimony history, whether you're Bank of Japan in the last decade couple decades, or the Central Bank out of the Great Depression and out of the great Financial Recession and the Mario Draghi era in European Union, European Central Bank policy in the 2010s. The number one thing the essential bankers are, is my friend John Malden, used to say, they are brought in a room and programmed like robots. Deflation is the great enemy of the soul.

And so we get into a situation where that inflation is undermined because of the velocity of money dropping. The velocity of money drops as a result of the excessive spending hitting the diminishing return. So I want to read a little Milton Friedman to you. Milton said that let the well, oh yeah. So let me start with Milton Friedman. "Let the higher rate of monetary growth unchecked by velocity produce rising prices and let the people come to expect the prices will continue to rise. Borrowers will then be willing to pay. Lenders will demand higher interest rates..." This is Irving Fisher 101, and Milton was a hundred percent right in this cycle of monetarism, but he said unchecked by velocity. And I quote from Lacey Hunt, an economist who I am in constant contact with now, read excessively, have learned a great deal from, who adopts the same beliefs that I have, Milton Friedman has, many people that you know, the champions, not me. People I've learned from tried to stand, tried to and continue to try to stand on the shoulders of that "rising in income will raise the demand for loans. It may also raise prices unless the velocity of money falls sharply." And this is the inverse of the basic point we learned from Milton Friedman, in monetary theory. And so that increase in velocity of money can do a lot to prevent interest rates from dropping when money supply is rising. But inversely a declining velocity allows interest rates or forces interest rates lower and offsets and distorts the impact of that rising money supply.

This could be confusing and it's okay if you haven't really followed it, but I want to just keep it simple. What am I talking about as to why we have declining velocity? A turnover of money that is proven to limit the inflationary impact of high government spending and access and Federal Reserve intervention. It's that we get the growth, the output that we get per dollar of debt has collapsed. The economic output we get per dollar of debt has collapsed. And then the level of loans we have in our banking system, which is where new money creation comes from, has collapsed, has collapsed, loan demand down and GDP from debt dollars has collapsed. This then puts downward pressure on velocity. This is declining velocity.

So there's a chart that I'm want to put up on the screen right now that shows you clear as could be going back 70 years, the correlation between the velocity of money, how much that money is turning over and the correlation between the marginal revenue product of debt and the loan demand and marginal revenue product of debt is a fancy term that just simply means the GDP growth you get for every new debt dollar, you follow me? So new debt dollars, new debt dollars and declining productivity from that and loan demand that is not going higher, but in fact going lower, that means lower velocity and it totally has distorted what we would've expected from inflation. This is where "Japanification" comes in. Of course, government spending is inflationary until it isn't. This is the point where it isn't. Of course, government stimulus Federal stimulus, the central bank level is inflationary until it isn't. And the reason it isn't is it runs against the velocity of money that is declining where that money isn't turning over and it stops the impact of rising prices that you would expect in correlation with money supply. Okay?

So this is the pre-COVID conversation that we have to have that we come out of the financial crisis and as I mentioned, we're getting very, very low economic growth with a lot more debt dollars in the economy. And all of a sudden in the Covid moment, you have obviously immediately a down economy, total collapse of wages, prices, jobs, profits, output, supply consumption, everything from a lockdown. And then as I've talked about a nauseum out of the reopening, you end up getting this big boost of demand and you do not get a corresponding boost to supply because of the lockdowns. Now, supply chains come back online and slowly but surely those inflationary levels have begun to come back down. Not fully restored yet mostly restored on goods inflation, but not yet services. And that's where we are. Okay, so what is the byproduct? If you take out the Covid moment and you go into the post-Covid world, which is what I'm arguing, looks a lot like the pre-COVID world.

And I put another chart up now, which is the real per capita GDP of where we are now, the economic growth per pop member of the population relative to our trend line where the trend line had been going back to the 1990s. And you see that since financial crisis we broke below the trend line and have just not even come close to coming back up. So this is what I mean we, we are living with brutally subpar economic growth compared to what we've been used to as a developed, successful, capable, resourced, and resourceful nation. And that chart tells the story in a very ugly way. Now people can say, but we're different than Japan. I think that's fair. Our debt dynamics, our diminished return reality from fiscal and monetary stimulus are directionally the same. But we have been different structurally, we have been different in terms of our age demographics, our workforce productivity. And that has essentially resulted in us having less economic growth than we've wanted versus no economic growth. These are differences of degree, not of kind. "Japanification" has been uglier than "Amerification", but "Amerification" is trying to become "Japanification". And I think demographics is a big part of the difference. It's not the only one, but I'm trying to keep things a little simple.

What do I refer to now by us trying to go into full-blown "Japanification" around our stagnating growth, stagnating productivity as a result of declining velocity because of hitting a point of diminishing return in our fiscal and monetary endeavors? Well, I'm talking about demographics. There's a chart right now that you'll see on the screen that deals with our median age of our first marriage that you see back in the fifties and sixties and seventies. It was between 20 and 25 years old. Well, it's now up to about age 30. Now people can say culturally, they like it being 10 years more than it used to be, five years more than it was more recently. There can be advantages to that disadvantages, but my only point is to parlay that into a discussion about fertility, that it does lead to less babies in a household when there's less time to have babies. That's just sort of obvious. So you have people getting married later, for better or for worse, no pun intended. And that is resulting in less babies being born. But that age 80 I hope this goes out saying 40 year olds tend to be more economically productive than 80 year olds. Today we have a lot less 40 year olds than we did, and less 40 year olds still coming, and the ones we do have are having less babies going into the future. And so what I put here in Dividend Cafe, I want to reread because I think the clarity is better here in written form. If today's 30 to 40 year olds are having less kids, that means that when today's 40 year old kids are tomorrow's 80 year old kids, we will have less people in the productive zone, age 40 than we do in the less productive zone, age 80, all right? That's what Japan had been dealing with, that our Baby Boomers were all in their work years. And Gen X was reasonably robust in terms of fertility in terms of workforce productivity and population growth. But now the number of births per death, there's a chart you should see on the screen. The Baby Boomers were all familiar with post World War II extraordinary amount of new children born then it kind of stagnated. It did not go down further in the 19, let's call it '70s, '80s , '90s. It flatlined didn't go to up to three, three and a half, but it stayed around 2.1 for a long time. And now all of a sudden we see since guess when the great financial crisis, a new leg down, a number of births, and this is a ratio of births per deaths in the United States and that you should see the chart on your screen. Okay?

Don't think this is just a United States problem as this next chart, which may be the last chart I'm going to put up. I think it is. Yeah. No, no, no, no. Yeah. We'll make it the last chart as though as this next chart shows, this has been a global phenomena, you see a significant decline of the portion of a country's population that is in its primary productivity zone. So we're going to call that age 25 to 54. And you see from Canada, China, France, Germany, United Kingdom, United States a significant move lower in the portion of a population that's in that max productivity zone or lower. Now look, why do I bring up all these demographics? Not all deflation properly understood has to be thought of as negative. We talk about our MP3, MP4 players that can hold 10 million videos and songs and they just cost a few bucks. And that a VCR that was clunky and obnoxious, and it was so hard to get just one video cassette that had one movie on it. And when you did buy that video, it was $25 and poor quality that those things cost 800 bucks an MP3 player cost 40 bucks. Okay? That's deflation that everyone loves. And I love this quote from my friend Louis Gave. Louis, puts it this way, "capitalism is a profoundly deflationary system and narrowly if only because every company boss wakes up each morning wondering how his or her organization can get more efficient, whether by using fewer workers, smaller amounts of material, less capital, it's the impulse to do more with less. That drives a lot of economic progress."

So there's a healthy deflationary component there. But see, that's not what we're referring to. We're referring to a "Japanification" that has to do with stagnation and financial repression. So we had a significant period of inflation in the 1970s, and it significantly came down. Disinflated away and moderated in a wonderfully healthy and productive way in the 1980s, 1990s. And people can debate about how much Paul Volker and the Fed had to do with that when monetary tightening. I think it was absolutely a part of it. The supply side growth, pro-growth incentives of that Reagan Revolution were a huge part. There was the beginning phases of China's globalization. There was a difference in the unionization of the workforce. There was a difference in America's domestic production appetite for oil. A lot of these things were an healthy way, disinflationary.

But what happened when I talk about the advent of "Japanification", I do not talk about lower inflation, lower inflation, stable dollar less negative impact, and on purchasing power, those are good things. Being able to buy more with less is good. But what I'm referring to is stagnating economic growth and downward pressure evidenced and bond yields and elsewhere because of the excessive indebtedness in the economy. And the great financial crisis was a period of significant amounts of excessive leverage in the household sector. And rather than getting into a debt deflation spiral that Irving Fisher wrote about, the Federal government's balance sheet was there to try to offset those pain. And we levered up the Federal government households liquidated a lot of debt and breathed a little better. And yet now we came out of that moment with a massive size of debt to GDP that only got more massive during Covid and that is what I refer to as the diminishing return. That ongoing period of low velocity had been happening since the spark up of debt relative to economic output of the 2000s. And we hit a really significant period of pain in the great financial crisis. We just never got out of that.

And now it is my belief that we face a "Japanification" moment. And I believe that when we're not talking about the price of rising eggs, we will be talking about the challenge of normalizing economic growth, how this plays into standards of living, how this plays in a quality of life for people economic opportunity, growth, innovation, and that all the things we need to do to heal. What is wrong in the economy are the things that create more of the "Japanification", that vicious cycle we're in. This is the macroeconomic challenge I believe we face. I talk a lot about what I do about it as an investor, but I don't want us to lose the sight of the ball. That tells us that "Japanification" is a macro generational theme that the United States is plagued by.

I'm giving you a lot to chew on this week. Some of the things I may not have articulated as smoothly as I want to do. I hope the charts were helpful on the video. I hope those of you listen in the podcast will go to Dividend Cafe.com and look this over, reread it, look at some of the visual aids and reach out with questions. But I believe this is one of the profound, even if it is contrarian understandings of the age that we are in. And I welcome your questions and what we intend to do about it is not take a 2023 view of the economy in the markets, but take a '23 and '33 and '43 and '53 view as well. That's what we're going to do here at The Bahnsen Group. I welcome your feedback, appreciate you bearing with me on this kind of meaty and sometimes tedious topic but I think it's a prominent one. Share it with those you wish. Rate us, subscribe to us and thank you for listening to Dividend Cafe watching the video. Look forward to coming back to you next week.
