FRIDAY, APRIL 21, 2023

Hello and welcome to this week's Dividend Cafe. I'm sitting in the Newport Beach office. Very excited to be in a position to be at our home base and talking to you about the subject of inflation. Yet again, everybody's favorite topic. It's a little different than the way I normally discuss it. Today's topic is not really just about inflation, but more about some particular elements as to what we've been going through the last few years. And I want to give you a little context as to why I'm talking about it and where we're going with this.

I am going to start with kind of a personal anecdote. I had dinner last week with a longtime friend of mine by the name of John Malden. John is one of the best known newsletter writers in our industry, is written a piece called Thoughts from the Frontline for 23 years. I've been reading it every single week without exception for 23 years. And at some point, I do believe it was about 10 years ago now, may have been a little longer. John and I were on CNBC together and struck up a friendship and then came to find out that John actually knew my late father back in the early 80s and in fact published some of my dad's writings. And so just kind of small world stuff that we connected. And then over the years have evolved our own relationship and we really do love talking markets together. John's an economist as well who cares a lot about insights perspective. He's very intellectually curious. And so we do these dinners where we just are bouncing things off each other, talking about the market, about the economy, about the political spectrum, and we can go on and on for hours. And last week John brought something up on me that inspired me to make it the subject of today's Dividend Cafe. I, by way of just quick review, over the last couple years, I've been real consistently in the school of thought that there was a level of inflation that was reached that has been coming down rapidly on the headline inflation level. We got up to about 9.1% last June, and we're now sitting at 5% headline. So you've had really significant disinflation. The Core Inflation right now I believe got up into the mid sixes and is sitting in the fives, it's come down as well. Core goods inflation has come all the way down to 1 to to 2%, but that what is continued to even keep the headline number higher is shelter. And the fact that, let's call it 34% of the Consumer Price Index is made up of what they call a category of Shelter, and of that 34, about 24% is something called Owner's Equivalent Rent, where they ask what people in the survey could rent their house out for and then that number goes up or down. And then there is about seven and a half percent in current rents where they're just asking people what you're paying right now in rent. And so if you just took a new lease, it may be a certain number where if you are in one from a year ago, it could be different. You know what I mean? As leases adjust and there's different starting end dates and there's a couple percent of miscellaneous other things I don't want to complicate it with. Those are the two major ingredients that form the Shelter component. And it's 34% of headline inflation, but it's over 40% of Core Inflation, Core being headline inflation minus Food and Energy.

And so one of the comments I want to make about the inflation escapade, I've said this before and I'm always aware of the fact when I talk that there's people who might be on the right politically listening. There's people who might be on the left, people in the center, there's people that are more movement oriented conservatives on the right, which is the camp I most consider myself to be in. There's other people that are more populist right that are maybe kind of more MAGA friendly where I don't really fit as much, but I understand there's a energy level there. So I don't know how many people on the far left listen to Dividend Cafe. I don't imagine it's a lot, but there's all sorts of different people listening. And I work very hard to not only be civil, cordial, respectful, intelligent, but also honest and call balls and strikes and never go out of my way to cause offense, but never allow the possibility of causing offense to sway me one way or the other the way I share things.

I don't believe that either side, the right or left has really handled themselves great as it pertains to the coverage of the inflation story the last couple years. I think a lot of people on the right have viewed it totally, understandably, and perhaps rightly in the political context as an opportunity to really pour onto the Biden administration. And a lot of that I think is illegitimate. Now a lot I've written, I think that the bill passed in April of 2021, shortly after the inauguration, I think was a really bad bill. Really, really wasteful, very ineffective, unnecessary. And I also think it did add to the inflation problem to some degree, but not so much just by the mere spending of it or the mere indebtedness of it, but more because of the incentives it provided for laborers to stay out of the workforce. And I think the labor shortage became a huge exacerbation of supply problems that were at the heart of the inflation we were experiencing in 2021 going into '22. So I'm perfectly willing to provide some political blame there. But the notion that like in and of itself, excessive government spending once it became the party that a lot of people on the right didn't like that was inflationary. I had a very hard time with that. A very Republican president exploded the debt in the first decade of the 2000s, and then the Democrat president exploded it even more for the next eight years. And then President Trump over the four years that followed, really exploded it. And the, I've been critical of all the above. It's a totally nonpartisan or bipartisan thing for me because I don't think that excessive government indebtedness is good for economic growth. And I do think it ultimately puts deflationary stagnation challenges into the economy and people say, I don't get it. Why do you say it's creating stagnation instead of inflation? And again, my reasons are just empirical testimony history, 30 years of Japan, 20 years of the United States, 20 years of Europe, 20 years of the UK, that the entire witness of the bond market, that more or less the data is just completely undeniable on this front. And yet I certainly understand that a bunch of stimulus checks and excessive spending going out the door with new money creation before it is coupled to the velocity dropping that brings the price impact down. I think that it certainly could be subject to a sugar high. I don't doubt that that happened and could happen, but that ultimately my focus through the Covid moment post Covid moment inflation was on the just easier solution, the easier explanation, the simpler explanation that supply was way too low for demand with a economy that reopened and a lot of people wanting to get their lives back and spend money and do things first, goods then services, and that the lockdowns had impacted at a longer period of time, the production of goods and services, access to labor, the supply chain, the global dynamics, all those things I thought were at the heart of the inflation story.

So I don't think that politicization of it all has been very helpful. And I don't think that the Biden administration, whenever headline inflation was higher, calling it Putin's inflation, and whenever it dropped saying, oh see, there's no inflation, because that energy component had that volatility. So you switch back and forth based on what oil prices are doing. It's one of the defenses I would offer of why we do have a classification called headline inflation that includes food and energy and a classification called Core that excludes it is, I think that they have different causation and they certainly have different volatility dynamics that make it a bit more intellectually honest to separate those things, how we analyze 'em and so forth. But people jumping around to use headliner Core based on his energy prices, providing tailwind or headwind and doing so with political motive or what have you, I think it speaks to an agenda. And I don't think it's really all that honest.

My agenda would be to give cogen economic analysis. And John Malden and I had dinner where he said, David, you've made the point that you think the way shelter is being measured in both headline and Core Inflation is substantially overstating the present inflation because of the lag. And John's exactly right. That's what I believe. That's what I've said over and over. And in fact right now the shelter is reflecting 8.2% inflation in the CPI methodology that is subject to the big lag we've talked about that could include leases signed over a year ago and all that kind of stuff. And therefore, at a 34% waiting at 8.2%, it's adding 2.8% to inflation. So you take away from the 5% we have, you'd be in the twos. Now, maybe there is still some inflation in shelter, maybe it's 2%. There's some studies, Zillow and Redfin and National Realtors, it could be negative, it could be deflation. But anywhere from minus two to positive two is I think by any reasonable metric, a more current state accuracy. And that would put the inflation level somewhere when the twos, low twos or high twos are in between. Okay.

But John said, what about when we were showing low inflation in 2020, the end of 2020 throughout '21, and when the lag effect had been the same thing, then only the other direction. In other words, was the Fed looking at antiquated inflation data then too, that in fact housing prices and rent prices and multi-family and these things were all going way higher, but it wasn't in the data and the Fed was using it then to justify being lower for longer. And that now I'm saying it's the opposite, that they're justifying the higher level to be tighter for longer. And I think John's implication, is there any consistency here? What sauced for the goose is sauced for the gander? If it's overstating it in a lag effect right now, and in fact, it's on its way down as an inflation input. Didn't it do the opposite before? And the answer to that is yes, absolutely, a hundred percent true. Totally agree.

So am I calling balls and strikes now? And I neglected to do it earlier. I never wanted the Fed to be staying at 0% after that immediate Covid emergency moment. I said they're going to, and that's where did I get that from? I don't know when they did it from 2008 all the way to about, give or take, 2017, there was one quarter point hike at the end of '15, but more or less zero bound for nine years. Did I have a pretty good reason to believe that the Fed would stay low? Yes. But over and over and over again, I have talked about excessive interventions lower for longer exacerbating booms, and now the tighter for longer exacerbating bust. And my critique of the Fed is not that they create a bust, and my critique of the Fed is not that they create a boom. My critique of the Fed is when they're doing things that create boom and bust, it's both sides of it. And John is exactly right that the same lag effect I'm talking about in shelter as it pertains to inflation data, now that that lag effect existed a couple years ago the other way, and therefore the Fed did not have intellectual basis to say, Hey, there's no inflation. Look at the data, and really we can stay at the zero bound here.

Now, my biggest critique of them being at the zero bound was not overall the inflation. I do think that the housing price inflation, well, and I've said this over and over and over and over and over again, I do think that that was pretty Fed centric, that the Fed has a much bigger impact by the nature of housing being such a leveraged asset class, the cost of capital created a massive, totally unhelpful, totally unnecessary boom blow off top that now has to get corrected out in the second half of 2020 all the way through 2021, even into early 2022, very rate sensitive with housing. You can go back and check the tape, how many times I talked about that. But the general symmetry here of mistakes on the low side of rate policy and mistakes on the high side, and them creating booms and busts, zig and zigzag, and that they exacerbate that cycle. That's at the Core of my thesis. This is at the Core of my belief about Japanification, about the excessive intervention in the market from the Central Bank leading to mal-investment, poor decision making, and then ultimately an excessively tight contraction of credit, and then the need to whip it back the other way as medicine for that credit contraction that then rinses and repeats the same cycle.

John and I had a great conversation about it. I wanted you to be privy to that perspective, to understand the symmetry of the mistake, boom and bust. That's what the world we're living in is about. That's what the critique is with Central Bank that I have to be cognizant of when we invest client capital. That's our story this week in the Dividend Cafe. Thanks for listening, reading, watching. We look forward to come back to you soon

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