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Hello and welcome to the Dividend Cafe. Love recording here from our Newport Beach studio, and I love the topic of this week's Dividend Cafe. We're talking a lot right now in the markets about where we are in the banking system, where the Fed is in their cycle with interest rates and what it means to the overall economy. And I think that when you start talking about financial cycles, it behooves us to review monetary policy but have a better understanding of the way the world works. And this is a passion of mine to apply the sort of behavioral logic of economics to monetary policy. And I think that there is a lot of interesting application to that when you apply it to personal finance when you apply it to individual investment decision making. But I also think on the macro that when we understand it better as it pertains to policymakers, to governments and yes to banks, that we get a clear understanding of the way the world works and maybe just what could be done to make it better in the future. Learning from mistakes that one could argue have been made.

One of the great principles and understanding economics is the notion of trade offs being an inevitable reality. Sort of codified in a famous line that Milton Friedman used in a paper called where he said 'There's no free lunch", and I ended up titling my last book the same thing, There's No Free Lunch. And all that concept is really trying to capture is that there are trade offs and that people do cost benefits analysis and that that's okay. It doesn't mean everything is bad just because there's a cost to it. We voluntarily take on cost all the time, but we do so when we've consciously weighed the cost against what it is that we're trying to achieve, I think that one of the fundamental errors of modern policy, contemporary approach to monetary policy is this notion that we can use easy and overly accommodative policy without a trade off. That there won't be a price to pay for excessively low interest rates for an excessive amount of time, for example. And I will argue that I first of all have spent much of the last several years in the Dividend Cafe talking about what some of those costs are, whether it be distortions of markets or whether it be eventually getting a diminishing return on the effect of monetary stimuli that ends up creating disinflationary and deflationary pressures in an economy ala Japan. But that is not so much my point here today.

I'd rather want to focus on the specifics of how the Feds staying too low, too long and some of the consequences of that are really behind where we are right now at the banking system. And the questions about what exactly we're going to do to have a robust and healthy and stable banking system in our country. Dr. Lacey Hunt, who I think is one of the great monetary economist alive today, has been publishing academic material since the 1970s. He's become a friend and one who I've learned a great deal from, but he lists five things as sort of the major consequences of excessively easy or overly accommodating monetary policy. First of all, how do we know when it's overly accommodating? I mean there is a backward looking component there that might not be very helpful and there is some subjectivity, but I'm really kind of sold on the basic Austrian idea that there is a natural rate at which the rate that is embedded in the cost of capital, the interest rate so to speak, is neither so tight that it is suffocating economic growth or so loose that it is encouraging malinvestment and encouraging excessive leverage. Now of course, quantifying what that natural rate would be is the million dollar question. And I very much believe it is effectively in line with the growth rate of nominal GDP that whatever the economy's growing at represents a pretty good discount rate to apply. And when you get an interest rate far below that or ahead of that, you end up with some very unnatural results. But regardless, we don't really deal with central banks that are generally struggling with being too tight or too loose. They're generally too loose and then they end up getting too tight in response to being too loose, which is what we're dealing with right now. And I assure you it ain't going to last much longer, but I digress.

The excessive accommodation to Dr. Hunt's model is that first of all, it leads to money supply growing too fast for too long and despite the fact that we have been dealing with downward pressure and velocity for other reasons that are not good, excessive growth of money supply is most definitely inflationary when you have stable velocity, this is kind of fisher quantity theory of money 101, something I've never in my life disputed. Our problem now is that we are not generally seeing money supply growth create excessive inflation because velocity's offsetting it, but regardless, excessive money, supply growth and then money supply contraction that is greater pace than would be normal in the ebb and flow of economic activity. It creates distortions and instabilities in the economy.

But Lacey's point number two is that credit being available too long and he calls it too available for too long leads to too much debt. I mean we can use the word credit all we want because the person giving it out is giving out credit. The person taking it is taking on debt. It's the same word just applied to a different actor in the transaction. Okay? And when there is too much credit available for too long, the result is you get too much overall debt. That puts downward pressure on growth because the debt has to be paid back in the future. You've pulled forward future growth in the present. This isn't complicated.

Number three in an overly accommodative monetary system is when you end up with rates that are too low for too long and that missed prices risk. That's happened quite a bit and it's certainly something I think we were dealing with a lot last year. And it can lead to real extreme manias, the Bitcoin stuff and the hot tech non-profitable tech space. We remember the.com boom. We certainly dealt with the real estate housing boom and all that stuff. And these things have interest rates that are too low, too long that enable people to miscalculate the risk and of the leverage you're taking the risk of the underlying asset and miss prices in the economy. I've talked about this one probably the most over the years. It's not complicated either.

Number four would be subpar borrowers and subpar deals. People that maybe shouldn't be the ideal borrower of money are able to get loans when rates are too. Oh two long when monetary policy is too loose. And then they are applying it into deals that are not great deals. Why do we know they're not great deals? Cause the good deals already got done, the debt and equity that went into high quality deals was done and you start going down the food chain and you're going down the food chain and quality of deals with an excessively long, overly accommodated monetary policy. But you're also going down the food chain of the people doing the deals, subpar borrowers.

But then the fifth point that Dr. Hunt makes is forward guidance really becomes gospel that an overly accommodated monetary policy, the markets, financial markets, significant actors begin relying on the expectation of what will be going forward. And this is very much in my opinion, what we're dealing with. Now, really, you could argue that 2022 was much more about points one through three high money supply growth. Credit was too available too long and too much debt built up rates were too low too long and risk was dramatically mispriced. There may be some of those things to still kind of work through, but those were really 2022 lessons. I think so far, 2023 has been more about subpar borrowers. Certainly subpar deals, the quality of some of the loans in commercial real estate, for example, not as good. But then number five, this is kind of the one that I just can't believe is not getting more conversation, which is that you really had every reason in the world to believe 14 months ago, beginning of 2022, that rates were going to start to come up. But very slowly the Fed was telling you that they were going to end the year to one point a half percent Fed Funds Rate. And now here we are over 5% and it looks like they're going to hike again next year. The Fed is given forward guidance and market actors rationally acted on that guidance and yet the Fed has pulled the rug and now you end up with instability in some of the banking system. You go, well, yeah, but all that these big banks had to do is not give bad loans. But see, they didn't give bad loans, they, there's not been credit impairment, the rates are too low. But see, the Fed had rates at 0%. So how's the bank to make money? They were giving low rate loans to depositors who brought over a lot of money and they weren't expecting interest on their deposits. So that gave the bank adequate net interest margin and a higher deposit base to go out and grow and do more business. It's the banking model. And it was predicated on that low rate environment that changed behavior. It changed the behavior of depositors who were willing to take 0% deposits of borrowers who were borrowing at low cost money doing deals and maybe they should or shouldn't have been doing the bank willing to lend on those deals at lower rates. And then even a bank like Silicon Valley Bank we talked about six weeks ago, I've been very critical of a company having a hundred billion bond portfolio and not hedging out the interest rate buying long dated bonds. But if the Feds told you they're going to keep rates low and just kind of increase a quarter point at a time, that's what they've always done in the past. And that forward guidance gets baked in. It is not irrational that people would've taken the Fed at their word, and yet they end up doing four, three quarter point hikes in a row.

And so this Boom Bust cycle is exacerbated in the faulty forward guidance given by a central bank. There Was No Free

Lunch. You were not going to have that period of too low, too long over accommodated monetary policy without a bigger buildup of debt without governmental debt building that that has to get paid back. Part of my Japanification thesis, subpar borrowers and subpar deals, distortion of risk, and then ultimately decisions made by rational humans, and particularly in this example, the banks themselves, that has now led to an instability all brought about by the Fed's effort to bring business cycle stability through monetary policy. It doesn't work. The natural rate is where you want to be at some level, which nominal GDP is growing and some rules-based approach, that approach that takes away on the margin, these more excessive booms and more excessive bust.

So I think humans act, I think economics is the study of human action. I think humans were made by God to be pretty reasonable, rational, incentive driven economic actors, and I think banks are mostly run by humans. And I think that when we put ourselves in a system where the monetary policy is going to distort these principles and we will not get a free lunch out of it, we will not get the wonderfulness of a boom without the byproduct of a bust. However, that takes shape. Whether it is having to reprice risk around the reality of a natural interest rate, whether it's having to reprice debt levels or reset debt levels because of excess of leverage that exists in the system, or even when it means people that have gotten on the wrong side of deposit rates, lending rates, what their loan book looks like and the overall stability within that of the entire banking system. So I don't think we're going to learn from it.

By the way, I don't share this as like now all of you, Dividend Cafe readers and listeners and viewers can go play a role in us not doing it. Again, we're not Federal Reserve governors and there is a rather fatal conceit that believes that they can kind of turn the knobs here and there to make it all work out in the end. But there isn't a free lunch. An overly accommodated monetary policy comes back to bite and forces me as a portfolio manager to make because humans act, and that includes those who run money for a living like I do and my team does. We have to run money with the reality of an instability that if it was not the reality, would enable us to perhaps do things differently, easier, more opportunistic, whatever the case may be. Hope you get the point. Hope you follow what I'm saying. Hope you've learned from it, and I certainly welcome your questions as I try to keep you informed in our view of monetary policy, the basic economic reality that there's no free lunch that includes for central bankers. Thank you for listening and watching and hopefully many of you reading the Dividend Cafe, have a wonderful weekend. We'll see you next week.
