

FRIDAY, JUNE 2, 2023

Well, hello and welcome to the Dividend Cafe brought to you this week from our studio here in Newport Beach. We've kicked off the month of June and we're getting ready to call the first half of the year complete. In the meantime, I want to talk today about the Land of the Rising Sun, the country that is Japan, and sort of make a case for where the US has been playing catch up with some of their policies, and there's a reason why we're doing the second, not first, why they were ahead of the game across the world. And some of these things I'm going to be talking about and talk about what it looks like for US risk, US opportunity going forward.

The 1990s were fascinating decade because essentially as you got into the late eighties and early nineties, there really was only one country on earth. And then this extended all through the decade. One developed country in particular that was struggling with an asset bubble that had burst and it was a massive bubble. Their stock market is still, to this day, not back to its high of December, 1989, a real estate bubble that is one in the history books. And that the byproduct of that bubble bursting was essentially a really radical debt deflation spiral that was happening in Japan. And yet at the same time, the US was at several years in the nineties running balanced budgets. I mean, their debt to GDP ratio was very low. You had really high real GDP growth in the us. There was good enough growth, certainly real growth with lower inflation in the European countries. And so Japan was unique and they embarked upon an experiment of growing debt to GDP in kind of a Keynesian response to their woes and what was hurting

FRIDAY, JUNE 2, 2023

them in terms of the aftermath of their asset bubble bursting. And at the same time, they then began a real radical period of monetary experimentation. And it was not until the US had its financial crisis, Europe was dragged into that. There was a significant buildup of sovereign debt in Europe, particularly at the time in Portugal, Italy, Greece, and Spain. It has certainly worsened in many other countries in the continent as well. But at the time it was sort of a bifurcated thing between Germany and a lot of the periphery. So post '08, you ended up with kind of a shared economic diagnosis with England, with Europe, and with the United States joining Japan and struggling through the hangover of excessive indebtedness and treating it with various forms of fiscal and monetary medicine.

The result of which I've made the argument over and over and over again was downward pressure on bond yields. And there's a chart I want to put up right now showing the 10 year bond yield in Japan over the last five years, it's essentially been at 0%. There's actually a period where it was negative for a little over a year. And what does that mean, a negative yield? It does mean what it sounds. It literally means that lenders people were loaning money at a loss for the right to lend money to Japan. The negative yield world has sort of ended, but it was many trillions of dollars between Japan and other economies in the 2015 to 2021 period. So Japan's tenure yield, as you saw on the screen, was got as high right now, about 0.4%, 0.4%, and had been as low as 0.5 negative, but it stayed right at that 0% range for a long time.

FRIDAY, JUNE 2, 2023

Now, by comparison, I want you to look at the chart here of the United States Treasury Yield. This is going back basically since I think I was in kindergarten, maybe first or second grade, about 42 years. And obviously we just had a huge downward moving bond yields that then continued all the way through the post-financial crisis period. Now our tenure has come up all the way to 3.6%. It had been roughly right around 2% for many, many years post-crisis, give or take a little range around there. And yet that move from two to three six, you can barely even see in the chart because in the grand scheme of how much bond yields have come down, it's barely noticeable. Well, I am fond of reminiscing of James Carville's powerful, profound and insightful line many years ago that if he could ever be reincarnated, he wanted to come back as the bond market and that the bond market had all this power and leverage and influence. And there's just no question that the bond market is sort of one of the most important signifiers of economic reality. But a lot of people believe that when you owe someone a lot of money, they have a lot of leverage over you. And yet, if you just think about it for a second and ignore one fact, which is about to be the only fact that matters, but if you ignore one fact, which is the need to borrow more money, if you're just simply talking about a borrower and a lender and one person has all the money, they've borrowed it and the other person has lent all the money and they don't have recourse or recovery, who really has the leverage? The person who owes the money has the leverage because the person who has owed the money, there's very little they can do. So why do I say the bond market has all the power?

FRIDAY, JUNE 2, 2023

Well, this is the operative most profound thing I will say in Dividend Cafe today, the bond market is this powerful global entity because of the need to be borrowing more money, whether it's municipal finance with states and counties and cities locally in the United States, whether it's sovereign countries and even a lot of corporate borrowers, what have you. It's the fact that the bond holders have the leverage because the borrowers need to borrow more money. And so therefore you have to pay back, or you're not going to get to go back and borrow more. The cycle will break or your cost of capital, your cost of borrowing will skyrocket if you become a bad borrower. And this dependency, this global dependency, this multi-channel dependency on borrowing is what gives the bond market so much power, not the present balance sheet state of who has the assets and who has the liabilities. If it were just that fixed in time with no future borrowing need, the leverage would completely inverse. So what the bond market tells us is very important. Where that power lies is very important. But I want to point out that with the US having about a three and a half percent tenure year right now, it's been largely around 2%.

Japan's was down around zero. There is another factor at play here. A really radically used, widely used and effectively used metric that the Bank of Japan has used called yield curve of control. And I was definitely anticipating that the United States Federal Reserve would go there out of the Covid moment. Their quantitative easing got to be so high, their desire to keep

FRIDAY, JUNE 2, 2023

downward pressure on borrowing costs was so significant as they were shutting down our economy that I recall writing in my covid and markets.com missives of the day, an expectation that yield curve control could happen. And it didn't end up technically happening, although one could argue that it was largely avoided because they sort of threatened to do it. They used forward guidance and certainly the quantitative easing itself had a kind of latent nod to yield curve control. Definitely back in 2013, '14 with QE 3, that was quantitative easing. That was done to push down. It wasn't full yield curve control. There wasn't a policy statement across each maturity in the term spectrum, but it definitely was pushing downward pressure by design on the longer end of the yield curve.

Okay. And so Japan has used yield curve control for quite some time. Japan has really become their bond market. There is two charts that we're going to put up that basically show you first that Japan's central bank is about 50%, and you can see who the other players are there from insurance companies, other private investors, a little bit of foreign investors. There are other actors that are there, but Japan's become about 50% or so of their sovereign bond market. And then the second chart's quite extraordinary. You can just sort of see that there is this massive amount of debt issuance that is held by the Bank of Japan. So these bonds that come due in the future really are held by the Bank of Japan. And I think that the wider, much wider, almost triple percentage of ownership that Jap Japanese debt, which has been bought by their own central bank relatively to the amount our own Fed is bought, where they represent about

FRIDAY, JUNE 2, 2023

20% is a major difference at this time. And yield curve control is a major difference at this time, yet both represent policy tools, the ability to expand the balance sheet much further of the central bank and the ability to manipulate the cost of capital much further. Both represent policy tools that Japan has already done that the United States has. Not that any number of circumstances I think could very well force the United States to go down that path. You look at a chart right now of the foreign investors and see that foreign holders, non-Japanese borrowers are, excuse me, lenders are less half, excuse me, I've gone are net sellers of Japanese bonds.

United States has tremendous foreign interest in its treasury market. So there are differences and there are positive differences. But again, there is sort of a cyclical problem here where a government that borrows too much money needs very low rates on their debt, very low rates on those bonds keeps foreign investors and even some domestic savers from wanting to borrow it, that lack of foreign investors, lack of domestic savers to fund your bond market makes the central bank have to do more. And the more the central bank does, the more interest rates are kept near zero. And a lack of capital flows means a lack of investment, a lack of growth, lack of productivity in the economy. That lack of growth then means you're going to need more government spending and your Kinsey and formula and more borrowing to fund the spending. And that more government spending and more government borrowing exacerbates all the problems they just talked about,

FRIDAY, JUNE 2, 2023

needs them to keep rates even lower still, which means rinse and repeat everything I just said.

That's the issue the government is in the United States of America, that there is this sort of vicious cycle at play, a negative feedback loop that can go even crazier there can kick a can down even further. As we've seen in Japan. Now, the most optimistic, this will be the last chart I put up, the most optimistic thing to say is that thus far, there's still a very healthy appetite for US treasuries. And some of my friends that have thought that appetite was a byproduct of the Central Bank, I think we're wrong. Our central bank definitely took a much larger, they moved from about 10% of the bond market to 20, a little less than 20. But whether it be over different periods of time, domestic savers, banks, investors, foreign investors, all of these different actors have come and gone, and yet there's always been an appetite for US treasuries.

So can that end? Will that end? What will cause it to end? Will they go to yield curve control? If it does, will they do some MAGA, no pun intended, mega quantitative easing? Oh, I think they will. I think they will. I think that they've put themselves in a position where the only thing they can do to afford to avoid a massive hangover is stay very, very intoxicated. And I don't know exactly how it plays out timing or anything like that, but Japan has given us an awful lot to learn from. By the grace of God, the US has not had to go down that exact path yet. Our demography and a lot of our economic circumstances are much different, have been different. But there's a trajectory here that

DIVIDENDCAFE | PODCAST TRANSCRIPTION

FRIDAY, JUNE 2, 2023

matters. Excessive indebtedness is the one common ground from Japan to European Union to the United States. That's a thing that we have to continue watching and understand in a modern, historical and economic context. Thank you as always for listening to and watching the Dividend Cafe. Please read the Dividend Cafe. The charts will be up there, and we'll look forward to seeing you again next week. Take care.

Due to the publishing time constraints for us to produce our daily missive, podcast, and video, the best we can offer at this time is a machine-generated transcription which contains errors. We will continue to work to improve this service and appreciate your patience with us.