DIVIDENDCAFE | PODCAST TRANSCRIPTION

FRIDAY, JUNE 30, 2023

Well, hello and welcome to the Dividend Cafe. I am very excited as we get ready to go into a kind of longer weekend. We have Independence Day next week, and yet we are here at the halfway point of 2023. And so, I'm recording on Friday, June 30th. The market's up a decent amount here this morning. Anything could change between now and the end of the day, but I can't give you the exact number as to where markets close. So, we'll have a kind of follow on real comprehensive first half with all the final numbers. But I wrote the dividend cafe yesterday and Thursday. I'm recording right now on Friday, and that always leaves you with just a little bit of tracking error as to where things can come. But what I am going to do is just thematically use our dividend cafe today to talk about the kind of surprises in the first half of the year, expectations going into the second half of the year and all that kind of stuff.

So hopefully, this little midway point is sort of halftime update will be useful. The surprises of the year are a little different than some of the things that I'm going to be talking about as big stories of the year because I think that was surprises. I'm specifically referring to things that either did happen but didn't have the response we would've expected or didn't happen when we thought they would've, that type of a thing. And I don't just mean we surprises for my idiosyncratic or contrarian predictions, but I mean across the market the sort of consensus things that were still somewhat of a surprise, but I'm going to start that list here. There'll be three things I just want to quickly kind of say. I consider to be pretty surprising. The first half of the year was the incredibly underwhelming economic output from China's reopening that many myself included, had expected the removal of lockdowns from the just insane and ridiculous and scientifically and medically naive and preposterous extensions of China Covid lockdowns, the removal of those many expected, we would see a demand surge that like we saw when Europe reopened, when America reopened, that there would be this pent up demand that would lead to, if nothing else, a big increase in energy consumption as travel reopened both within the large nation of China and particularly international towers going in and out and so forth.

And there are certainly some aspects that I think it's just simply a not yet not at all, that some of those metrics will end up coming, but I've become more convinced. Initially, I thought the issue was that after the lockdowns then they actually had to go through and have happened to their country, which should have happened a year and a half ago, which was let everyone get covid so they can then get on to normal. So it wouldn't be like the day they reopened all of a sudden activity surged because there would still probably be a little sick period and so forth. And that may or may not have been a factor in the early days. But what I have become convinced is the economist Louis gov, who I follow closely and consider a good friend, he has sort of convinced me that a lot of it is related to the construction slowdown in China, that even on a reopening post covid, there is such distress in their construction sector, but that unlike the United States where that could affect one area of our economy and it may lead to lower supply of new homes being built, but it isn't necessarily the same macroeconomic impact in the US that a construction slowdown or freeze or distress is in China where there's capital that has to be expended into areas that have never been built out.

So there's sort of this massive need for infrastructure coming from construction CapEx from capital flowing in, and when that slows off, it not only means less houses built, but it really leads to a much bigger trickle down effect into jobs, into wages, into profits, into just the expansion of an infrastructure and their macroeconomic situation. And so I think that China's really struggling with that and that explains some of the surprise of their low economic output. And then now I think the big question is will they take the steps to try to export their deflation the way that we certainly have seen Japan and the

United States do? Will they effectively lower their cost of capital and get into that kind of downward spiral of what I always refer to as Japan pacification by using monetary policy to try to goose things a bit. The second surprise I'll get to is the failure of some of these major regional banks that not necessarily being the surprise, although you could argue that was too, but that's not really my point.

It's more the response to the failure of Silicon Valley Bank, Signature Bank New York, and then First Republic being almost nil, that there doesn't seem to have been any kind of contagion. Now I think part of that is the FDIC jumping in and covering all those uninsured depositors signaling to the market that if did go down, they would cover that too, which enabled less depositors to flee. And so it may have put in a little bit of a backstop at least on the deposit withdrawal side, but just macroeconomically even as credit conditions tightened at the as, there's clearly far less lending, almost no ending going on our regional banks particularly into commercial real estate and it just hasn't had some of that effect that has infected across the whole economy that I think many would've expected. The third surprise is the idea that the strategic Petroleum Reserve has been such a non-actor in the energy sector that after having taken down 180 million barrels of oil and getting oil prices into the high sixties, mid sixties, low seventies has not acted and taking advantage of these lower prices.

So you've ended up oil prices staying right around $70, a couple bucks less at a few bucks more at one point 10 bucks more, but really right around the low seventies all year. And that's with OPEC plus really curtailing production a great deal. And so SPR r not taking advantage of that to re-engage on the demand side is just a shock and I'm sure some would consider it myself included, a policy error. So those are I think the three big surprises that are a bit more granular, but let's just sort of talk about the major theme of the market on the year. I think you have to say it's the top heaviness of the way equities have gone that right now five companies in the S&P 500, for those of you that were a little slow in math, five out of 500 means 1% of the S&P 500 is 24% of its total capitalization that 1% of the companies equal 24% of the value of the index five companies.

It's the highest weighting that five companies. It's the most top heavy the market's ever been. And then the other data point that I think correlates to this is that the return of 10 companies out of 500 now by the way, to really impress you with my math, we're talking about 2%, the return of just 2% of the companies is equal to 85% of the return the index has gotten. So, and obviously that's been largely segregated inside not just tech but even particularly tech with a more artificial intelligence angle to it one way or the other. So this is 85% coming from Top 10 companies is the highest ever. You've had a very significant percentage of the return of the top 10 companies come in 2007, in 2021 in 2000 in 1999. And so when you look at the four biggest years, four or five biggest years ever of the percentage of return coming from 10 companies, all of them were followed with pretty significant drops.

Now there's other years where it kind of lingered on a little longer. I wouldn't throw this out there as a timing mechanism, but I don't think that there's much question that fundamentally what it does in indicate is a pretty meager amount of breadth across the whole market and yet bubbles forming in certain aspects of the high end and especially in that tech side and AI side. While we're there I'll say that, yeah, I think you can argue shiny objects of return. It isn't the work from home silliness from 2020 and the hot tech that was really largely software and cloud driven, that that had total separation for any kind of profits or fundamentals back in 2020. And a lot of those arc type things getting hammered. It's not the crypto story of 22, I think it's a AI and yet of course there's a caveat here because there's no question artificial intelligence is real and that there's going to be some real utility.

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I think a lot of what we're talking about will prove not to be real. A lot of it will be and there will be all sorts of ways in which stuff gets implemented into the economics of our society, but along the way, a company's trading at 200 times earnings companies that don't even have anything close to earnings or even revenues running up 200%, 300%. These are the things bubbles are made of. And so I think you see celebrities pouring in and starting their own funds to go into unprofitable sides of AI. This stuff it, it's happened a long time. We saw it with NFTs and crypto, we saw it with.com back in the day, and these things have a tendency to not end very well. So that's been another part of the first half of this year and along the way, things like dividend growers, you go, well, they're up.

It's been positive but they're not up as much as AI and whatnot. And I always say, look, these dividend growing companies better be not the top leader year after year because then they would form a particular bubble. It's one of the things about being a dividend growth investor that you not just get used to you cherish is that you're not going for trying to be the hot dot and your investment strategy and your success is not dependent on being the hot dot and then timing your exit from being the hot dot and then timing your reentry into the hot dot. You follow me. As a matter of fact, if you look at just since this new millennium began and the.com moment out of 2000 is 12 out of 23 years that the dividend growers outperformed the whole market, it's 52.5% of months that they've had a better month.

So it's right at half, it's a little bit more than half as far as the frequency. So having a year like last year where dividend growers smoked the index and a year like this year where the index is up higher but dividend growers are still up, this stuff doesn't matter an iota to me, to our team, to our investment committee, to our advisors shouldn't matter to our clients. And yet I will point out that the dividend growers in the S&P are up 853% since the new century began and the S&P itself is up 305% that on a per year basis, the different growers are up over 10 and the index is up six and a half or so. So you there look in an extended period of time that has bad market and good market and flat market and booms and bust by the way, not only better returns but with lower volatility, a lower standard deviation and during the three periods that markets really dropped a lot.

You had significantly less downside with the dividend growers as well, which is when people most care about volatility to be down 10 or 20% less than the overall market in a period of a large market drawdown is a big deal too. So I think that having a six month period where some artificial intelligence companies go up 200% is completely immaterial to what you ought to be thinking about dividend growth. You look at it with a 20 year lens and the big picture of what it is intended to do over time. It's just simply irrefutable that the consistency is the bigger story. Okay, what else do I want to cover here? The Fed obviously has been kind of what most people have looked to this year and I would like to say I think the second half of the year will be a year in which we can talk more about earnings, less about the Fed, but I know for sure I'm saying that only because I want it to be true.

I don't have any idea if that will actually happen. I think the Fed has become a real pop culture celebrity in our society and in our economy and that rather than embed them as a lender of last resort, we have embedded them with some sort of a celebrity status that I think is unhealthy and a sort of savior or messiah complex to smooth out different things. Now will they continue to go until they break something that's a big question. I don't know the answer. I know that's what they've stated. That's what it's looked like. I think the fact that they haven't begun to cut or that they actually a better way to put it's that they did hike the last two or three hikes on top of what they'd already done. I think it seems that they're a little bit mad at the moment, but then I also hear the Biden administration getting ready to launch a presidential campaign around this theme of bidens and really wanting to tout an economic performance as a major election issue and that's a risky thing to do if you believe the Fed is going to break credit into a point of a recession, and I don't have a conspiracy theory on this.

I don't say anything sinister. I'm just simply talking kind of intuitively, look, if the Fed does do what they could do there and really put us in a recession break, something that will be really challenging politically. And so part of me just doesn't believe it will happen for that kind of nexus between the politics and the central bank side of things.

I personally think a recession is difficult because obviously we already know the unemployment number is the sort of counterfactual with three and a half percent unemployment. It's hard to be talking about recession, but you could also say that unemployment is always low until you go into recession. Then it picks up and so it may not be very predictive and that's fair. It's just that people have been saying that unemployment number get worse for 18 months now it's been a year and a half of saying, okay, well now that low unemployment's done and we're about to really, it hasn't played out for me though, I'm looking at something that I think is more predictive, not backward looking but forward, which is high yield credit spreads. I became a big student of credit spreads as a market indicator back in 2007 when you saw spreads getting to 250, some of real poor credit quality bonds trading at only two and a half percent more yield than a United States Treasury.

That was an indication I think of a very low regard for risk and of course during recessions they frequently will grow out to 800 or a thousand basis points spread. You're going to demand eight to 10% more yield largely because you're going to have a lot of defaults, failures, bankruptcies and things of that nature and that economic distress really forces spreads a lot wider. Well, we're sitting here right now at 415 wide, the spread between high yield, which are junk bonds, low rated credits is 4.15% more than treasuries of the same maturity. So that is not real tight and real indication indicative of no regard for risk. It's kind of healthy and normal, but it isn't real wide where people are saying, okay, there's a lot of defaults coming, there's a lot of foreclosures. It's a very happy medium spot and that to me is an indicator that look, if spreads start widening, I think then recession becomes more likely.

But at this level, I think corporate bond spreads have really been an indicator that we may very well hit a soft landing. The issue is whether or not the Fed will keep going until they kind of break something the that the Fed pausing would be stimulative I think is also misnomer. They could break something even at pausing, but to continue hiking is what I'm referring to the analogy. I may have shared this already in a DC today, but I wrote about it in dividend cafe today and if I want to share just for those who may not have heard it before, I came up with this analogy when I was running at the, I was working out the hotel gym and at a conference I was at in Michigan last week and listening as I'm working out at CNBC and they're talking about this idea of, oh, well the fed pause, give the time markets to breathe.

A little while I was on the treadmill with my heart rate up and I realized that that's a pretty good analogy that nobody considers it rest. When your heart rate stops going up at one 70, like when you're in a peak speed on the treadmill or outside running or whatever you do, your heart rate does stop going up at a point and it just is real elevated and that's because you're actually in a peak cardiovascular workout. You're not in a pause, you're not resting, it's not stimulative, it's in. When you stop, go, then the heart rate starts to come down, but that period at which it is staying in a high ex level, that's still tightening, that's still exercise. Back to the monetary analogy, it's still tightening and I think if they're going to tighten at five and a half federal funds rate that if they're going to pause there, that would be tightening.

There are a lot of people who borrowed money at 2%, then now have it reset at 5%. That's tightening and so use that heart rate analogy, how you see fit. I think it works, but I also confess that about half of my analog is usually don't, so that's something I've learned to live with. Okay, lemme move on here. I'll give you six quick summary items and we'll call it a day here. Number one for the second half of the year, the soft landing versus hard landing in terms of the Fed recession, it's going to come down to if they break something or not within credit. That to me is the issue. I'm pulled a little bit away from my belief that they will, but that's going to be the issue about softwares hard landing. Number two, commercial real estate. I think the fears are overdone.

There's definitely going to be defaults and foreclosures and certain vintages, certain geographies, certain asset classes, whether it is some of the overbuilt office or multifamily or low quality product, but as a general rule of thumb, there's a demand for more high quality, good multifamily. There's still more industrial capacity. The Fed is maybe keeping us from being able to build more with the pressure they're putting in credit markets. I don't think you come out of this period without there being various pockets of damage, but systemically do I think certain challenges in commercial real estate are going to become the big Black swan event? I don't, and part of it is what I just said, black swans are things you're not talking about. Everyone's talking about commercial real estate. Number three, emerging markets. I just very much agree with the report, a k, a QR just put out that you may be looking at the greatest disconnect of value in EM versus developed markets in history right now, and if the Latin American economies are kind of in a healthier position to go forward, which I think they are, and based on the valuations both relative and absolute and with the dollar very unlikely to be surging anytime soon, but rather the opposite.

If anything, I think you may finally have the backdrop for a sustainable rally in emerging markets. I would not be chasing momentum number four. Those things that have gotten way too expensive, they can get even more expensive. In fact, many would say they will. I just don't think that's the way you want to be investing money in the second half of this year. I talked about number one being the recession talk soft versus hard landing. Number five is related to it. It's adjacent, but it's a separate point, which is specifically will the Fed end up breaking something because that is a risk that may be unpriced into markets. If there is actual significant, let's say a wave of 10 more regional banks that go down or something like that, I wouldn't be predicting it, but I would not assume it can't happen, and that's that issue of tail risk out of the Fed breakage needs to be factored in, and the number six is housing.

I don't think you're ready in the second half of this year to see things really improve, get transactions back up running. Plenty of sellers are willing to wait to rates come down to be able to ask for the price they want. Plenty of buyers are wanting to wait till rates come down. There are also plenty of buyers that al that need to be sellers and they can't become buyers because they don't want to sell what they already have with a low rate locked in. So there's just sort of a wait and see pause period. Right now, I think we'll stay on the table with housing, but I think that we could be close to that level where it kind of finds equilibrium by the end of the year. We'll see. And then I think a lot of what I predicted will come true that prices may have dropped 10, 15, 20% and barely anyone feels it or cares because you're not getting a huge amount of sales activity out of that moment.

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There's my thoughts, my six thoughts neatly encapsulated for you as we get ready to go in the second half of the year. A lot of other commentary provided on the first half of the year reach out with questions. Next week I really want to do a big Ask David version of Dividend Cafe and devote the whole time to questions that come in. We're not going to have a DC Today, Monday or Tuesday because of the 4th of July holiday. Brian Szytel will bring you DC Today, Wednesday. I'll bring it to you Thursday and then Friday at Dividend Cafe from yours truly. But we'll have a lot of questions built up. Feel free to send your questions to questions@thebahnsengroup.com, and it may very well be in the dividend cafe next Friday. With that said, have a wonderful Independence Day weekend, very few holidays. The special is 4th of July where we celebrate the life, liberty, and pursuit of happiness that is at the cornerstone of this Grand American experiment. Thanks for listening. Thanks for watching, and thanks for reading the Dividend Cafe.
