DIVIDENDCAFE | PODCAST TRANSCRIPTION

FRIDAY, JUNE 23, 2022

Well, hello and welcome to this week's Dividend Cafe being recorded here from beautiful Grand Rapids, Michigan. I've been attending economic symposium all week and I actually gave a speech and I decided to turn that speech into the subject of the Dividend Cafe. The interesting thing for those of you who do listen to or watch or read the Dividend Cafe a lot is that all of these topics I cover quite frequently, not necessarily always conflated into one addition like we're going to do today, but I think that there is a lot of overlap of topics I talk about a lot. And the reason is that that overlap is essentially the various components and ingredients of our economic worldview. And what I mean by that are not the first principles that drive how I think about economics at large, but what I mean is that our contemporary economic worldview in terms of what we think we're living through, what we think we're the moment in time that we're in now.

And so I'm more interested in using the Dividend Cafe for things like that than I am using it for issues that might be more granular, more specific, but we're always going to cover a whole host of different issues. But it just occurred to me that the speech I gave this week happened to be kind of perfect in terms of what I want the Dividend Cafe to be about. And that is summarizing for you the big picture of this moment that we're going through. And of course, one of the cornerstones of the moment we're going through right now is the indebtedness that the world economy is in and particular the moment that the United States is going through, that's what is of most relevance to us, is the impact of a very high level of absolute debt and a very high level of debt relative to the size of our economy that the US is currently going through.

And so of course, those of you listen to a cafe or read it frequently, know my term, Japanfication and what it sort of references, but that's kind of what we're getting at here this week is a discussion on what I'm calling a Tale of two Nations where there is a lot of overlap between what one can learn from what Japan has gone through pre-financial crisis, pre the 2008 US-centric GFC, "great financial crisis" and what the US has been going through post GFC, the post-financial crisis reality, the American economy that really in so many ways mirrors many of the things that Japan began going through in 1990. And I refer to stuff beyond just the debt, but even the demographics, the proposed remedies, and then kind of the results that have come out of this whole picture. So to make it rather simple, I'll start by with the conclusion, a sort of restatement of the case and then go on to provide various charts and information that I think help establish it.

I think the sequence of events that we're talking about with Japan, and it is true in the US is more or less the point at which an asset bubble is fully formed that is systemic. Not a bunch of risk takers saw something go up in value and crash because it wasn't worth what they paid for it, and then there was big losses. For the risk takers, I refer to an asset bubble that gets far outside of a rational valuation. There could be policy errors that cause that there could be monetary priming of the pump that helps facilitate it. There could be general euphoria, there could be a business cycle issue that bids something up and then caused it to come down. Generally over the course of human history, central banks have fingerprints on such events because they're usually associated with periods of easy credit followed by periods of tightening credit, and yet not all asset bubbles fall into this category.

A great example was the crypto crash of last year where it was a significant amount of dollars that were more or less set on fire, but there was really not anything systemic that came of it. There were just people who lost money, but what I mean by systemic is a contagious effect whereby the process of an asset bubble bursting leads to a drop in other corporate profits in wages and in overall jobs. That's basically the definition of recession is some combination of a decline in wages, jobs and corporate profits. And when an asset bubble burst that leads to a systemic decline in those three. Those are the types of events that generally get politicians to intervene and they intervene when there is a recessionary collapse of these types of things. Usually is a Keynesian tool of government spending using what we call fiscal stimulus to try to offset the impact of a decline in aggregate demand as a means of trying to, on the other side of things, prime up events that will keep wages from dropping, keep jobs from going away and bring back corporate profits which themselves bring back jobs and wages, et cetera.

The real severe cases of this are when you get into a debt deflation cycle. This is a concept that Irving Fisher explained quite thoroughly nearly a hundred years ago, but it is a horrific experience whereby as one is paying down debt, their situation is worsening because they are selling off assets at dropping prices and those prices of the assets are dropping faster than they can pay down the debt, meaning that you may reduce debt, but by the time you're done doing so, the assets have dropped even more and therefore your asset to debt ratio has worsened even as you paid down debt. That deflationary spiral is the stuff great depressions are made of. It's the stuff Japan was going through early nineties that we went through a miniature version of societally in the great financial crisis. So in a way of staving off a real severe death deflation cycle or in a way of just staving off the cyclical impacts of severe recessions, job losses and wage decreases, that's where interventions come.

And I think that you start generally with a fiscal intervention, government spending, you end up with a monetary stimulus lowering the cost of capital to try to incentivize more. Borrowing that additional borrowing become puts more of a drag on growth for a number of reasons in both the public and private sector. And then of course, if there's more borrowing by definition, that means that there is less savings, more borrowing and spending means less savings and less savings means less investment. And all of those things work together to put downward pressure on growth. So what has been the situation here in the United States? I refer to ours being really a moment around the great financial crisis and us coming out of that period, our debt to GDP. And I mean right now, public debt. So the debt that the Treasury Department, the United States of America owes other people, not that it owes itself.

So I'm excluding, I think of our 31.8 trillion national debt. There's something in the range of six or 7 trillion of it that is the right pocket of the government owing the left pocket. And to be just totally intellectually honest, I'm excluding that amount from these percentages. And before the financial crisis in 2006, our federal debt is a percentage of GDP was 36% at on the other side of the financial crisis in 2011, it had gone up to 66%, almost doubled, and it almost doubled for two reasons. Both of them bad, the numerator, the debt had gone way up, tons of Keynesian spending through the financial crisis, that medicine the policymakers believed in giving. And then number two was the denominator had dropped, and I'm referring to GDP or the whole point of a recession is that economic output declines. So you ended up a higher debt, lower gGDP, you got a worse ratio.

We went from 36% to 66% from 2006 to 2011. Then there's the period for which we are as a nation without excuse, which is 2011 2019, our debt to GDP went from 66% to 79%. So how did debt to GDP go higher? When we were well past the financial crisis, there was not a recession and there was no war. You basically had eight, nine years of economic expansion and peace time. You had a Democrat president for half of it, a Republican president for half of it, and yet somehow we blew the debt to G D P out even higher. Then you go to the covid moment, and of course we know the trillions of dollars that were spent in the aftermath of them shutting down the economy and we ended up at 108% debt to G D P. That was all from what was 36% in 2006.

So more or less in 15 years, we have tripled our debt to GDP P ratio in our country. Now you can see that federal debt as a percentage of GDP getting up to that 110% range. And look, if you were to count the money that the government owes itself, it's actually 120% plus change. So we have seen a very significant amount of increase in debt in our country, and a lot of this is directly correlated to policy decisions made out of our asset bubble bursting of the 2008 moment and policy convictions, both in terms of trying to treat the economic distress and then expansion of our kind of social democratic commitments. You have a massive increase in entitlement spending, massive increase in healthcare spending and various transfer payments, the social safety net that we provide as a society, and people could think it's a good use of money, they could think it's a bad use of money.

I have a lot of things I could say about the sort of philosophy behind these things, but right now, economically, I'm just simply referring to the reality that the net interest we spend on our annual debt service as a percentage of total expenditures is very low. Our issue is basically we bring in about 5 trillion of revenue. We don't really seem to have a revenue problem, but we spend about 6 trillion and almost all of it is highly controversial if one were to try to touch it because you have mandatory spending in healthcare programs, in food stamps and transfer payments, you have Medicare, Medicaid, social security, there's not a big appetite to change a lot of that. Social security and Medicare spending alone, just as a pure percentage of GDP has become about 10%. And you know, were talking about just when I graduated high school some period of time ago, in all seriousness, it was about 35 years ago.

It was maybe 2% of G D P two and a half it's it's gone up somewhere between four and five times. The amount it represents as a percentage of the economy. The economy has grown a whole lot too. So we're not only talking about a real explosion of the absolute dollar expenditure, but the percentage it represents. And what has all this done, this increased spending and increased indebtedness to cover the spending in this moment of time has really made growth to sacrificial lamb. I think that the data speaks for itself. Our economy grew at 3.1% for real G D P, that's net of inflation from World War II up until the financial crisis and we've been sitting here at about 1.6% ever since. And when you see what that looks like per capita, take the real G D P trend line per member of the population and look at how we've gone off trendline ever since the financial crisis.

You really get a feel for it. It represents something just to give you real dollars, something in the range of $12,851 per capita that it's a meaningful amount of money that we should have been growing in terms of overall gross output, you're talking about that dollar amount times the population of 330 million people. It's a big, big deal and that's what the impact of less growth is. Well, why are we getting less growth first and foremost to back it up enough, as I said before, you have less savings when you have more debt and more spending by definition and less savings by definition means less investment because invested dollars are first saved dollars. And so that decline of national savings has put downward pressure on investment to a point where 50 years ago, this is a long time ago, we were spending close to 12% of G D P on net domestic investment that was broken up by different categories.

That was intellectual property products, that was structures like factories and buildings, that was equipment that was machinery and stuff involved in industrial production. There was a number of different categories, inventory that would be a part of our production and what that represents is a percentage of our gross output, and we're right now barely at 4% of G D P. And so you have such a decline of investment that you obviously end up with a decline of productivity, which leads to a decline of growth, and that's the basic algebra that I talk about all the time. You really have to have investment equal your national saving and when you have less aggregate saving, you're going to get less investment and that's going to put downward pressure on growth because of the downward pressure on productivity. So the bond market helps us measure this, right? What is the impact?

Well, we can look at excessive indebt in the us, but I'm always conscious of not wanting to cherry pick a particular nation, and it's why one of my favorite charts shows UK, Japan, the European Union and the United States, and basically just says those charts are kind of indistinguishable from one another. All of them saw their net indebtedness, net spending skyrocket, and all of 'em saw bond yields collapsed. And why would bond yields collapse like that? They were measuring the negative expectation of forward growth that the success of spending and deadness represents. The United States treasure right now at 10 years sits between 3 6, 3 0.7%. That's coming out of a period where everyone's been talking about very high inflation from this post covid surge of an inflation that we had for all the things I've talked about a million times, and yet still the 10 has not been able to hold at even a 4% bond yield still sitting in the high threes and I strongly suspect going lower from here as a reflection of expected growth.

So all of these fiscal things put their drag on spending, excuse me, on growth and productivity, but then you add the monetary side and that's kind of where plan B comes in like, okay, Japan, the United States through the kitchen sink with fiscal, they ran up debt to GDP. Great. Now let's talk about the monetary side. They want to use the monetary policy to facilitate the fiscal to help the government monetize that debt, capitalize the debt with low cost to capital borrowed monies and use general setting of rates and other liquidity conditions and credit conditions as a policy tool in their own right. What happens here, you get downward pressure on loan demand. You say, why would that be? More people would want to borrow money with lower rates. The problem of course is an economic law that is a mystery to no one. The theory, a marginal utility, there is a diminishing return initially.

There's great borrowers initially there's credit worthy borrowers going into great and productive projects, but over time you lose that level of stimulus and that level of impact because inevitably as you go down the food chain, you find less credit worthy borrowers or less attractive things to be lending money to. This crowding out effect of more government spending of excessive amounts of borrowing into less attractive propositions over time puts downward pressure on velocity. And that's been the whole story of velocity for the last 15 to 20 years. A real downward push on how much money is turning over in the economy, which is offset the inflationary impact of greater money supply. And the correlation between money velocity and the general loan demand has been unbelievably consistent that as there's lower loan demand, there's lower velocity and that refers to stagnant conditions in the economy and less opportunity for productive use of capital.

These diminishing returns I'm talking about. So I think it's where the sin of monetary intervention, the sin of excessive monetary stimulus and accommodation becomes very important to properly identify. I think it is mal investment. I think it leads to people making poor decisions, how we invest as a society, how we invest with sovereign money, how we invest with corporate, this corporate sector, and oftentimes even individual households. The feds distortion of the cost of capital distorts the use of funds and generates what we call mal investment. That distortion affects price discovery, it affects our ability to do rational economic calculation and also that distort out of that distortion can come speculative decisions, speculative frenzy, a euphoric mentality that leads people to, shall we say, do very questionable things because of their weight, the scale they're using to measure risk and reward cost and benefits is so highly distorted.

I think that much more so than inflation that's proven to be the legacy of excessive monetary accommodation is distortion effect. A great example of that is in housing, you saw this spike higher out of the covid moment, far above trendline, all of a sudden a declining stock of housing at the same time that interest rates went much lower, distortedly pushed prices much higher and the market's still trying to find equilibrium out of that moment. Interest rates when they are unnaturally high slow economic growth and when they're unnaturally low, they lead to this mal investment to this distortion that I'm talking about, the natural rate where it is neither slowing or accelerating economic activity. In other words, it's in line with what the growth rate of nominal GDP is. I don't know that a bunch of people around a conference room table can find that natural rate, but I do know that when they purposely try to go above the natural rate now or for most of the last 15 years to be well below, it leads to financial instability.

That's the issue that Japan struggled with and that's the issue that United States is struggling with. Now, what I think we learn from Japan all this is that it's very hard to attract capital over time. Japan has struggled with it far more than us for very good reasons and we're very blessed that a lot of capital still wants to come into the US despite this, but we're making that argument harder on ourselves in Japan. They've made it virtually and once you get to a point where you can't attract capital, it's very hard to attract to generate the growth you need because you have less productive investment. And when you're getting less productive investment and therefore declining growth, you then need to borrow more money as a government, as a country. And that more borrowing means you really need rates to stay low because you can't afford to borrow more to deal with the thing that you're borrowing because of that, this cyclical feeding on itself condition, that is where I came up with this concept of Japan pacification.

It's led to Japan. I just wrote Dividend Cafe about this three weeks ago. It's led to them using their central bank to basically buy 50% of their bond market. The Fed is a little less than 20% of our bond market. It's not as bad, but it's rapidly been increasing and that looks to me to be a future tool of where they would go. And so I think it's important for us to understand that we have had over the years, a lot of domestic savings and bank investment in our treasury market that came lower over the years, but there was a lot of foreign interest. Right now, the foreign interest has come down a bit, but domestic interest has come higher yet. Nevertheless, we went from 4%, yeah, probably it was that low. I think it was about 10% went up to 20% of our bond market owned by a central bank, not as bad as Japan.

But again, moving in that same trajectory, our inflation rate right now has definitely dropped. I talk about that a lot. The tips market, which is trillions of dollars of inflation protected treasuries pricing in as a real market signal inflation expectations over five years is pricing at about a 2.1% inflation rate. That's around what the fed's target would be. Their issue is not an economy that will be overheating. We know that housing is substantially slower and rents and so forth, and the data has been pricing in. I don't expect people are going to be complaining about the economy being too hot. I think that the economy not growing and enough not creating the productive opportunities people have had will be the complaint. And yet one of the things that really accelerated Japan's demise was their collapsing fertility rate. They did Economic growth is equal to population growth plus productivity growth.

That's a set algebraic formula. And the problem when you have very low productivity growth is you need great immigration and great fertility. And Japan had neither United States clearly has slowed substantially on immigration growth and our fertility rate has dropped from 2.1 down to 1.7, which as I've written before, invites not only the economic issue I'm bringing up now, but it also invites cultural concerns and considerations as well. How well will that rate go? And you could even look at our number of births per death, per death deaths because that ratio speaks to total population size and there's a lot in the demographics of this that matter into the future, including just a couple decades out. What will are the size of our prime working age population pool be? I do think it's a mess. I don't think it is apocalyptic. I think there's a great opportunity for people to selectively outperform the economy in which they live in.

Yet I think that social cohesion and cultural satisfaction are far easier to come by when the overall economy is lifting a lot more opportunities for a lot more people than I expect it will do going forward. There is, I don't know exactly how we get out of it. I know that excessive indebtedness leads to policy actions that I think put downward pressure on growth and downward pressure on growth leads to more policy actions that put further, that generate more debt and therefore lower growth expectations. That cyclicality of dysfunction is what has brought us here and what I expect more of what will be done, I just think it's going to be Japan. I think we are going to borrow from the Japanese playbook of kicking the can down the road as long as we can. And people say, how long is that? I have no idea Neither.

Neither is anyone you read. Neither is anyone who tells you they know. The people who most profoundly say that they know what will happen are the people who have been most wrong for my whole entire adult lifetime with their various predictions. So I'm sitting here predicting something that is not good, but I'm not attaching a particular gravity or timeline to it because I'm too humble to do so. I'm going to be wrong if I do, and I don't think it's necessary to the point I'm making. The point I'm making is that we have a period of stability, instability and that there needs to be action taken around that. Now, people ask me all the time, what can be done? And I've answered it. First of all, I always think changing the course you're on is a good idea when you're on a bad course. I would be worried about 31.7 trillion in national debt if we stopped tomorrow.

But really far more concerning than 31 trillion in national debt is where it's going to go too, because there's no intent to stop that number. We want to add one to 2 trillion more every year and you put a recession on top of that, it would get even worse. And so living within our means and acting some sort of balanced budget, Elise would stop the digging in the ditch. I've talked a lot about central bank reform and the Fed going back to just being a lender of last resort, not trying to doctor us through business cycles. All of this, both fed reform and greater fiscal constraints is the job of Congress. Congress has not been willing to do its job for a long time. I say that about both political parties and of course even that really comes down to a lack of self-government within the populace.

I think you will need a more, shall we say, dignified approach to self-government on the other side of what has really been a multi-decade crisis of responsibility for the American people that I think has to be fixed as well. It's more of a cultural observation with profound economic implications. So to me, this entire message comes down to a forecast that Japanification is what will be done. And Japan unification hasn't even finished in Japan, let alone in the States. And writing the final chapter of that book is impossible to do. Underestimating the creativity policymakers could use to do really quite crazy things both on the fiscal and monetary side, I think is a bad idea. But recognizing that that heightened level vulnerability exists and accommodating an economic action plan, a worldview, and certainly a portfolio strategy around all of that is basically what the Bonds group exists for.

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So I don't know how long I just took to go through it all. I know a lot of it you've heard before, but maybe not all pieced together that way. You more or less got to hear the speech I gave this week. I probably attached a little more theology and philosophy to it when I gave the speech here in Grand Rapids. But for our purposes here in the Dividend Cafe, I hope I scratched a few itches. I'm very, very open to answering any questions. You have questions@thebahnsengroup.com. Do not hesitate to reach out if you're not a client of the Bahnsen Group. I do recommend that you talk to your advisor to see what their plan of attack is about Japanification. Now that conversation goes as poorly as I think it will, that I recommend you consider a conversation with us. Thanks for listening. Thanks for watching, and most of all, I really hope that I can thank you for reading the Dividend Cafe. Thanks so much.
