FRIDAY, JULY 7, 2023

Well, hello and welcome to the Dividend Cafe, brought to you from beautiful New York City, very hot New York City where I am doing a special Q&A version of Dividend Cafe today. Trying to walk through a lot of questions that have come in covering a whole lot of different topics. So if what you like is multi topic Dividend Cafe covering all the bases, you're in luck. If you prefer a sort of singular concentration of topic, maybe something here we'll grab you. And next Friday I actually plan to do a more elaborate treatment of this subject of onshoring or reshoring or nearshoring, but various elements of American economic activity being removed from some of the globalization of the last 20, 25 years and what that looks like, what it means, what it means for investors. So there'll be a kind of concentrated topic treatment next week and I'll look forward to that.

But today I do think a lot of these questions were quite fruitful and I'm just going to jump right into it and go through them in order. I'm going to try to cover all the ones here for you on the video and the podcast that we do cover at the written dividendcafe.com just so you're not being ripped off at all. The first question was that I've heard further rate hikes end up pouring more fiscal deficits into the economy by raising the treasury's average interest expense, which is ironically stimulatory to a certain degree.

Does the rate rising by the Fed have a short term stimulatory effect on the economy? So I try to be really charitable in the way I answer all questions. First of all, especially in this case

because the person asking the question wasn't making the statement. They were wondering if it were true, what they had heard that someone else had uttered. But it is a depressingly idiotic idea that first of all, the general tenet of Keynesianism, I happen to disagree with this notion that government spending is stimulative when the economy is in kind of the doldrums, the notion that you would want the government to spend to keep wages and profits and jobs from declining and that will all kind of pan out in the end versus as a way of stimulating aggregate demand versus the belief that a more classical economist like myself has that markets are generally self-correcting mechanisms and the interventions into inevitable business cycle challenges, which are themselves unavoidable.

That interventions come at a cost, that there's a trade off that ends up being sometimes worse than what we were trying to avoid itself. But see, this question is not even about Keynesian interventions. It's saying is the mere fact that the deficit would go larger even if the point of deficit increase is only for added interest expense. In other words, we're not even pretending that the additional spending is for some building project or government program or direct payments to people to supplement wages or whatever. The different things that we've done since let's say the new deal. And some of those things have arguably had a higher multiplier effects or return on investment than others. I mean, all of them I sort of disagree with as an economic philosophy, but certainly I can acknowledge some of them have been less bad than others in terms of productivity contribution to the economy, but the

notion that just merely feeding a higher deficit for the sake of feeding a higher deficit and via higher interest expense, so that would be stimulatory is utterly crazy and I think a lot of people might be in need of a good economics primer.

Another question came with all the buzz lately about cryptocurrency, ETFs from BlackRock, et cetera. Are you planning to weigh in on this latest shiny object? I have zero interest in investing in this, but my kids are talking about it. I'm not well versed enough to explain why this is a bad investment opportunity and I don't want to sound like a boomer dad telling them no. What say you at the end of the day though, this question really just addresses whether or not we should own Bitcoin. An ETF that may or may not come out from an asset manager is just simply some version of trying to capture the up or down movements of Bitcoin. The S e C has previously denied all other applicants who have tried to do something like this. This one appears to be moving forward. We don't know what the outcome will be, but let's assume that the ETF is constructed in a way that does provide it a pretty close correlation to the up and down movement of Bitcoin.

First of all, I'd point out that that's going to give a vehicle now for people to short a lot easier. So you know those things and if they run options on the etf, it'll give people the ability to buy both put and call derivatives on the Bitcoin price as well. But you fundamentally, you're just stuck with the same question you had well before this ETF was being discussed is whether or not people think bitcoin's going to go higher. And if someone

says, yes, I do, then my questions are, what is it that would make Bitcoin go sustainably higher? Now maybe there's an answer, but it's a question I think is worthy of being asked. There's no yield, there's no coupon, there's no earning stream. And so things like that that don't have an internal rate of return, you have to have some reason why you believe the price would be going higher apart from the ability to measure that internal rate of return that exist in cashflow, generative investments like an operating business or a debt instrument or a piece of real estate or something like that.

What exactly would cause someone to say, I do believe it's going to sustain we hire? Is it mere speculation? Okay, well if so I'm against that. Is it just confidence that more people want to pay for it? Maybe, but why a view that it's low supply guarantees price appreciation. I certainly wouldn't agree with that if that were the argument. Plenty of things that have low supply don't necessarily see the price go up if there isn't a real tangible benefit need or use a view that it will be a substitute currency in the future. I don't accept that. I don't believe. I think that there are more powerful entities that have the ability to squash that in a second if they so that so desire. So look, I think most people at varying degrees of honesty, self-awareness, understanding if they want to be bullish and make the case, I think Bitcoin price will go higher.

They still have to conclude that their reasoning is rooted to some form of speculation or argument and speculation. They don't have any economic probability or probabilistic argument

to make and maybe it goes higher, maybe it goes lower. It's gone all over the map the last few years up big down huge, I mean very, very volatile. It's obviously not proven to be a reliable store of value and I think that the lack of understanding as to why people own it from the people who own it is probably the most bearish thing I could say. Those things generally don't end well when you have a high degree of kind of uninformed speculators as your ownership base and then those using it as a utility are generally on a certain side of criminality, there is not a very democratic or widespread use. And if there were, that would be an argument against it too because it has dropped so much.

The currency utility argument is really impeded by the high degree of volatility and so you could say it's a Ponzi, you could say it relies on greater fool theory or you could just be nice and say it's speculative hope. I kind of think it's a little bit of all the above, but even if you only think it's speculative hope, I don't think hope is a good investment strategy and that has been my answer and that will continue to be my answer and that has nothing to do. Whether or not it goes higher or lower, it just has to do why we wouldn't touch it because we don't do speculative hope. Next question, how bad isn't commercial real estate? Can you elaborate on your statement from the last Dividend Cafe that hand wringing over commercial real estate is overdone? Why do you believe defaults will be less than expected?

Recoveries will be higher than expected. There's two principles going on driving. My view, first of all is just the kind of evergreen statement that whenever everyone is talking about something, it never plays out the way everyone is talking about that if all people believe something's about to be a disaster, it's really hard for it to be a disaster when the very process of all people believing it sort of preps it and in fact refutes it anyways, that there is a sort of contrarian logic to the idea that when everyone knows something that is going to be the surprise, huge thing that happens, it isn't a surprise and it isn't huge, and that could be whether people are talking about some higher or lower, that when the whole camp is already on board when something's already being discussed that way, it tends not to be the big black swan event the people are anticipating. But there is a second issue I'd bring up which is more specific to commercial real estate and more recent history in the aftermath of the great financial crisis of 2008. It was one of the most consensus views that I heard all the time from both more pedestrian type people and really kind of in the professional investor class and macro economic perspective that in the 2009, 2010 that commercial real estate was the next shoe to drop. I mean I heard it a thousand times from people with varying degrees of experienced pedigree and intelligence and the principle was residential real estate had just gotten shellacked. Commercial real estate had been part of a big credit bubble too. There had been certainly some properties that were defaulted and an increase in the CMBS market, commercial mortgage backed securities just like there had been in the residential mortgage back, and yet the commercial side

had not collapsed the way residential had and led to this sort of systemic risk into the economy and that was what was expected next, and it just simply didn't happen.

You definitely had commercial real estate prices drop. You had people who bought certain assets in 2005, 2006, early 2007 that probably regretted either paying buying them or what they paid for 'em and to the extent that there were a lot of foreclosures of overlevered properties, the macroeconomics for example, let's say in retail or in the hotel space, we are in a real consumer recession, a severe one, so people are spending less so that was causing people to be out of their bank covenants or in some cases default altogether. It happened, but it never became the systemic event people predicted and you never got the wave of defaults. People predicted because the fact of the matter was that banks in that situation want to work. It isn't like homes with commercial assets. There's much more appetite for a bank who's already dealing with a lot of other distressed assets in the balance sheet and perhaps non-performing loans on their own balance sheet to want to work with borrowers to allow them to get through the event.
To the extent that there is some degree of systemic distress like there was in '09, '10, I would argue it would end up being a great buying opportunity. We're not seeing that yet, but I think the bigger critique I'd offer as to why I would reject this sort of broad democratic statement that, oh, commercial real estate's a disaster right now is it lacks any nuance. It lacks any specificity. It lacks any differentiation or any appreciation for the dispersion of commercial real estate assets in our economy

and in our marketplace. Treating San Francisco like New York is ridiculous. They're an entirely different situations right now with their commercial assets, with their population. And treating New York like Nashville is ridiculous. There's just totally different geographical realities in the Sunbelt than there is in the Bay Area than there is in the Midwest, the southeast, what have you. So you not only have geographical differences, but then product categories is a healthcare facility, the same thing as multifamily apartment or data storage or an office building is a class office building that is fully rented the same as a class B or C office building that is not rented.

I mean these particulars matter and they're, and they inundate our understanding of commercial real estate and yet I think when people talk broadly about a wave of defaults coming, it lacks necessary nuance. I think that there's a lot more protective equity in most underlying assets. I think lenders have a lot more incentive to work with borrowers. I think the biggest negativity I freely admit to is the ability to get new commercial real estate assets done when bank lending is largely dried up and some proformas don't work with the new cost of capital that is a negative for the development of new commercial real estate, but not arguing for a wave of distress events and a wave of defaults that ends up bleeding into the broad economy. That would be my argument. This is not really that similar, but there's a little bit of adjacent to this next question about if we have too many banks given regulatory constraints practically guaranteed increase in the US after Silicon Valley,

Signature, First Republic Bank, do you expect bank M&A to increase in the US (mergers and acquisitions)?

I don't see why the US needs literally thousands of banks versus say Canada, where there are six main banks that are practically government sponsored enterprises. And I do think that small community, mid-size regional banks are going to see a really big wave of consolidation and mergers and acquisitions into the future. I think we do have more banks than our marketplace necessarily needs and through market forces, a long period of m and a probably lies ahead, but it will be strategic and sensible consolidations hopefully more than forced or panicked consolidations. I certainly do believe our treasury department and FDIC want to see this, but this notion though of a quasi nationalized banking sector where there's only five or six major banks, many people kind of think we have that defacto anyways because of the too big de fail dynamic of our banks like JP Morgan, Wells Fargo City, Bank of America. They're so large that they kind of have these implicit guarantees, but I don't think latent nationalism is a good idea for a market economy. I think that you want competition in capital stewardship and capital advice in trading capital. You want competition amongst the services offered by financial institutions for the same reason. You want competition, any other field and the delivery of any other good or service is it improves quality, it improves opportunity, it improves pricing. Competition creates incentives for a better result and why people think that is different and banking and financial institutions why they think banking ought to be immune to the

laws of economics is completely beyond me. Banking has the ability to be a growth engine, to serve a growth engine when adequately capitalized. Firms that are well run bring ideation, advice, innovation, human capital to the table. That's the key. I understand generic retail banking is a pretty boring business. I wrote a Dividend Cafe about this a few months back, taking deposits and lending money out at a net interest margin at some sort of a spread that doesn't create a whole lot of opportunity for production for innovation yet there's a relationship banking advantage, there's a time and place circumstance that regional local banking can offer. It can be a huge benefit to the customer base of local banks, so there's a place for it and it may be a more diminished place. The larger banks have a greater portfolio of services they can offer that diversify their revenue base and their business model. But I think there's room for both small banks and big banks and I think there's room for very niche business models along the way. What I don't think serves the country's interest is the DMV becoming a national bank and that's essentially what nationalization would lead to.

It would lead to less investment, less savings, less lending, less capital markets, and ultimately less innovation. And by the way, it would also lead to more embracing of foreign financial institutions to meet the needs of a lot of America's banking and financial services. So we would probably become hindered in the global reality as well. All right. Moving on. Do alternative investments help to provide lower, excuse me, help to provide better returns with lower risk? Because if so, why don't we put

more money into them and if not, why do people invest in them at all? I think this is a really, really important question because many people's advocacy of alternative investments, many people's implementation of alternatives is based on a false premise that you can have market-like returns with lower risk like magic. Our philosophy has never been that alternatives provide the same or better returns with lower risk.

It is that they provide a return environment with a different risk environment that the sources of return and risk, not higher or lower are different than the sources of risk that feed traditional investments, let's call it the stock market or the bond market, a different return driven by a different source of risk, not better or worse, not higher or lower. Why does someone want different sources of return or risk? That comes down to modern portfolio theory and the idea of having non-correlated sources of return and risk in a portfolio. It comes down to where there is illiquidity premium that is so much of what we believe in of alternatives and that is not available in traditional markets. Illiquidity has a different set of circumstances that again, may not be appropriate for all investors if they need all of their assets to maintain a certain liquidity function where some people have a net worth that they can afford an illiquidity bucket, and that's where we think alternatives provide various sources of idiosyncratic risk and reward.

We don't mind having a little less market risk and having more idiosyncratic risk. That's different than saying we're just simply lowering risk and keeping the same return. All right. Both

Britain and the US have significant budget and current account deficits, debt to GDP and both countries is close to a hundred percent of gdp. Britain has raised rates in the last month aggressively Bank of Canada did. Do you think it's predictive of what's coming in the us? Well, look, I don't think anyone could make a good argument that the US is following other central banks. I think you have a lot more central banks trying to follow the Fed, largely based on currency ramifications that if you become too dovish in your own monetary policy, your currency weakens to a point of it becoming problematic and if you become too hawkish, your currency could strengthen and undermine your own competitive positioning, especially if you're a export-oriented economy.

And so I think that there are all sorts of different circumstances driving monetary policy decisions at each central bank and I don't think anyone is that widely divergent from anyone else right now besides Japan, perhaps China, but for the most part, Bank of Canada, Bank of England and Federal Reserve are not really all that far apart. But no, I don't think there's anything predictive in what one Central bank is doing about what another bank will do a month down the line just is not really the way these global central banks work. Alright, what books would you recommend on qualitative stock analysis and also on portfolio management For the dividend growth investor, I'm a big sucker for the late great Benjamin Graham father of value investing. His book The Intelligent Investor is sort of a bible for those of us who do a lot of qualitative and quantitative assessment.

But in terms of dividend growth investing, which is where we want to take our applications of quantitative and qualitative tools and apply it to a methodology of security selection and portfolio construction. I wrote a book, the Case for Dividend Growth investing in a post-crisis world a number of years ago, and it is the book that sort of captures our worldview about dividend growth investing. My old friend Will Miller also wrote a book years ago called The Single Best Investment that is another hard backed book defense of Dividend Growth investing, and it was highly influential for me. I'm more of a, when it comes to month by month ongoing stock research, qualitative assessment, I've read tens of thousands of pages over the years quite literally, and a lot more in journals and symposiums and articles, white papers, things like that. Books are intended for a more pedestrian audience generally if they're going to sell much.

And so those are a couple books I do think has some value. The fact that I wrote one of 'em is neither here nor there Fed. Now, if memory serves me correctly, you have said you don't think the Fed has the no hour capability to create a central bank digital currency, CBDC, but is the Fed Now service that has just come out a new service called Fed Now, is that not a CBDC or is it just a wannabe that will not succeed? It's essentially, Fed Now is essentially a payment service. It's a payments infrastructure that allows banks and whatnot to participate in real time transfer of payments. You've had swift, you have Fed funds wire, you have a CHI, there's clearinghouses that help

transfer monies now, all of which are under the purview of the government that's not new.

And Fed now is a newer one out of the systems of the Fed, but it isn't creating a liability at the Fed. That's what a currency would do is if they're creating their new currency, whoever holds it as an asset and it becomes a liability, whoever issued it, and that's what a cbdc would be fed now, doesn't create an asset of liability. It's a payment movement system which is different than a digital currency. I'm skeptical of our central bank's ability to do either real well and to form a real penetrated market position. But that's the answer. Okay. I'll have this next question and I really love my answer. Since World War II stocks have averaged 12% per year, you regularly warn us that growth moving forward is unlikely to be anywhere near that which would result in returns like that. If you had to hazard a guess, what would you say stocks will average in the next 20 or 30 years?

You'll probably insist you have no idea. You're too humble to make a prediction, but you must have some ballpark figure. Are you expecting meager returns of only 5% due to the ravages of Japanification or something more like seven or 9%? The exhortation of returns? Half of what we've enjoyed in modern times would be nothing short of monumental in terms of planning for retirement. Well, okay, first of all, stocks have returned 11.1%, so little less than 12 since World War II. And unfortunately, the person asking the well-intentioned question is right. I don't have any idea knock and a venture a guess. And

anyone who does try to offer the pretense of an educated guess should be avoided as the charlatan that they are. You're talking about asking an asset class as return for the next 30 years, be utterly irresponsible to try to come up with an answer to that.

And more importantly, it's immaterial to the way we manage money. I purposely want our clients immunized by what the index may do over a particular period of time. And I think Japanificatin will disrupt retirement plans of a lot of index investors and a lot of closet index investors that maybe they don't own the actual index, but they own mutual funds or things that are basically like the index. And I think 30 year equity returns more so than 20 and 20, more so than 10, 10 more so than five have so many variables that make it all impossible to do long-term capital asset pricing over 30 years, the variance of what will take place in inflation and interest rates and growth rates, population growth. Do I think that in a 10 to 20 year period, I hope it doesn't last 30 it has in Japan that you'll have downward pressure on the growth dynamics that are important to macroeconomic growth?

Yes, I do. Do I think that that leads me to want to be more selective in how we manage a portfolio and more growth of cashflow oriented? Yes, it does. Does it cause me to believe you'll have a lower index return than we're used to? I have no opinion about that. Nobody could possibly guess. That sure would make sense to me, but guessing what number it will be is totally impossible. All right. Free trade, fair trade, funny trade

is my headline for the next question. Isn't it unethical or wrong to produce a good somewhere else just because the workers there make less money? Wouldn't it be a free condition, a precondition to free trade to somehow level the playing field? In other words, sometimes a company producing something can do it cheaper somewhere else because workers get paid less and the person's wondering, is that sort of unfair?

You want everyone kind of making the same amount of money so that that's really free trade because it's a level playing field going on. My answer here is again in the form of some questions, much like I did with Bitcoin earlier, what is the criteria for a level playing field and is such a thing remotely possible in a free the real world and in a free society? Number two, who determines what is a level playing field? The buyers and sellers in a transaction or the governments of the country where the buyers and sellers are? Number three, does one import goods from countries or from companies that are in other countries? Is that distinction relevant? It is, by the way. And then number four, if it is unethical to produce a good somewhere just because it's cheaper to make it there due to less health benefits being paid to workers, less compensation, wouldn't it also be unethical to consume such a good, maybe even more so when we consume goods, do we know all the needed information about the economics for workers relative to other potential consumed items?

If the answers we don't and ethics are on the line, do we have an obligation to find out why would that burden stop at the

border? Should I find out wages and benefits information of a place selling me a burger for $8 relative to another place selling it for $6? Even if both burger places are within the states? I think the answers to these questions can be deduced to help get to the point of where we find a law of comparative advantage and then also help honestly work through some of these really valid, fair, genuine considerations. And I hope that the way in which I've answered the question with more questions that are not rhetorical is constructive. Finally, how do companies pull profits out of China with the Chinese government's tight control capital markets? Well, various non-Chinese companies have various agreements with China about capital controls and movement.

Most Chinese companies that are based in China do not move profits made in China out of China. Hence the competitive advantage that companies with a free flow of capital have over countries that do not. So the moral to the story, if you're looking to start your own country, is have capital that you allow to move freely across different borders and you will advance the cause of freedom and economic opportunity in your own country. Alright, we covered a lot of ground this week. I hope you got a lot out of it. I hope that multiple topics scratch different itches. I'm very happy to always receive your questions. We cover 'em in DC Today, day by day. I look forward to coming back to you Monday back in Newport Beach with another Long form version of DC today. And thank you for listening, watching and reading this week's Dividend Cafe.

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