FRIDAY, AUGUST 25, 2023

Hello and welcome to this Friday's Dividend Cafe. Recording the day before USC football starts, and unfortunately not providing a dividend cafe this year, as I did last year when the USC football season was starting where I actually talk about the correlation between SC football and markets, it was by far the greatest dividend cafe ever written.

I decided very early this morning to not do a repeat of last year's masterpiece. But instead, , actually address a new current relevant topic. And that topic this week is gonna have to do with the fed, , tightening cycle that we're in and what some of the aftermath of that may be. . Has been so far and could, could be into the future. From the time I started writing Dividend Cafe very early this morning to the time I'm recording right now, Jay Powell's speech at Jackson Hole has already happened. And so it really was sort of a nothing burger and, and the markets. We're, we're not down or up a lot right away. And then now they've kind of gone higher, but it's still so early in the morning that anything can happen in next few hours.

And so I don't want to predict where the market will close today, but whatever it does, it wasn't a a, a big market moving speech that Powell gave and it was kind of a repeat of where we've been for a little while of, you know, Oh, we could still have to go higher, but maybe we won't. And we're data dependent and you know, we really wanna beat inflation.

But on the other hand, we wanna take a look at how things are going and all that kind of stuff. So we'll update what market expectations are on Monday in the DC today in terms of fed futures. But yeah, as far as just the, the broader narrative, it wasn't like something happened in the last few hours that makes this dividend cafe already obsolete.

What, where we are is where we are, which is that the Fed in the last 15 months plus change has tightened the Fed funds rate by over 5%. And that, that was from basically the zero bound up to a five and a quarter to 5.50 Fed funds range right now. And that in a normalized environment that that would be, utterly, surreal for financial markets to digest. And I think that outside of financial markets, just in terms of the economic impact, if you had asked a hundred out of a hundred economists at the beginning of 2022, if the Fed were to raise rates over 5%, would the economy go into recession? That first you would've had a hundred say They're not gonna do that, and they have.

Second you have said, and of course it would put the economy into recession and it has not. And so one of the things that I am most interested by right now is the difference between the immediate impact from what the Fed has done in tightening. I've talked about credit a few times that we've talked about China recently.

There's a lot of stuff that has, we know and things that have happened in the last year. I wanna review some of those things. But then there's this idea of kind of going back to Milton Friedman's notion of a lag in monetary policy that sometimes the action happens and the reaction can take place much later.

So I read a piece for my friend Louis Gave this week. Lewis is the Chief Macro Economist at Gov Cal Research. I read their material every single day of my life. Louis in particular is, is a very proficient, , economist, writer, thinker. I really enjoy what I learned from him. And he had a piece that had an analogy in it that I don't totally understand, not being a man of the sea, if you will, but it makes sense to me as it pertains to the analogy and the financial markets. We talked about the idea of a whale coming up to surface that if there was a bunch of dynamite that you put underwater, you'd almost immediately see a lot of dead fishes. A lot of the smaller creatures of the sea immediately come up to the top from an explosion underneath the surface, but that it would take a while.

From the underwater explosion for some of the bigger things to come up and that it might be a couple of weeks or what have you until some of the whales surface, so that the event has an immediate impact to the smaller things, but that the longer impact might take. The larger impact might take longer.

To surface. And so what all that means in terms of marine life? I, I have no idea, but, but it generally makes sense to me and it, , make, I think there's a good analogy in there into financial markets. And you say, okay, well what are the fishes here? What are the small things in this analogy? And I think that that's really what 2022 was, that there was a sense in which there's shiny objects that I've talked about so many times, and I believe that if the Fed hadn't tightened, If the Fed never tightened these things were still gonna get their comeuppance.

They were still gonna get rerated. They were still gonna get walloped because they were just simply beanie baby valuations and in some cases beanie baby value, that that needed to be corrected. And so there was a significant correction that was quickened. By the Fed re risk repricing risk assets. And so a lot of unprofitable technology companies, a lot of SPACs, a lot of faddish investments from plant-based meat to work from home to electric vehicle or solar.

I mean there's all these different categories of it and we've gone through it on different phases quite a bit. So you had a lot of these things get decimated and, and I think that they were to the fishes, it wasn't systemic. It wasn't contagious. Risk takers got hit, no one else really did. It didn't spread to other aspects of the economy.

Why is, am I not mentioning crypto in that list right now? Well, that's a little tougher in the sense that I definitely think the Fed repricing. And then crypto getting walled exposed, crypto, that it was actually correlated with traditional risk like NASDAQ and tech, and not reverse correlated or contrarian as a lot of crypto investors may have wanted to believe that they were sort of outside the vein of what many traditional investors were doing, when in fact it was very correlated, in fact, levered. It wasn't just, it had a high beta to that space. It had a higher than one beta to that space. But first of all, I don't wanna call it a fish. Because there was a thought last year, it could have been a whale. It was over a trillion dollars of losses. And yet we do now know that as bad as the losses were, they weren't contagious because they didn't leak into the banking system.

They didn't cut off credit into the economy. A lot of money got lost by a lot of people who took speculative risk, but there was not, a contagion effect. And also it clearly was not merely a byproduct last year of fed activity. There was other grift and corruption and, and NFTs and that had to get kinda wiped out.

And then, of course the issues with some of these crypto exchanges and scams and things that are right now under indictment and arrest and SEC and DOJ and whatever. So that kind of invites other issues as well. There were a lot of fishes that immediately when the Fed raised rates, it just kind of said, okay, well this didn't go, so what are these whales?

What are the bigger issues that we're still maybe waiting for that could be, consequential as a result of what is obviously a very dramatic and significant federal reserve tightening. I think the biggest false alarm we got, Was the regional banks that you legitimately had an issue that could have become very contagious.

That looked in fact like it might be, and that wasn't small ball stuff. You were talking about good sized banks. Silicon Valley was large but very niche signature was less large and also very niche. More crypto, Silicon Valley, more vc. Then you had, First Republic, which was much more traditional, a lot of real estate, residential and whatnot, and various problems there.

But see, in each case it was contained and people could agree or disagree with some things that happened. But I think the FDIC, backstop, And the JP Morgan rescue of First Republic. Not rescuing it, but taking it on after it was left or dead. And then even though it's a separate subject, let's not forget, Credit Suisse was major global financial player going down in March and UBS orchestrated by the Swiss National Bank taking on the Credit Suisse deal.

So like a number of different things could have spread and just didn't, maybe for different reasons. Idiosyncratically in each case. And, and so when the fear of, , freeze up of regional banks sort of subsided, then that, I think disqualified that as the likely whale in this whole mess. , one of the elements I alluded to last week, Some of the things happening in China right now, and you go, what does US rate policy have to with problems in China?

And I don't, I think that there's a fair argument to to say not much that I don't think China's property sector problems are related to the Fed tightening rates, but I do believe that the limits to what the Chinese policy policymakers can do about it is related to the Fed's rate policy. As I talked about last week, they have a currency that's depreciated 15% already and their sort of logical aspiration to loosen monetary policy to help in this property sector.

Weakening is less possible because they cannot see their currency weaken much more, and yet, if they intervene, to, to strengthen it has the effect of tightening monetary policy. And so they need the fed to do it forum effectively, let the fed, by, by tightening, excuse me, by weakening, , loosening monetary policy, weakening the dollar.

Would help the one, strengthen and give them more leeway on their monetary side, policy side, I'm not sure I worded that as articulate as I want, but I think you get the idea the Fed could help China, but they're not. And that is leaving China in a precarious position. I don't, I'm not suggesting the Fed should in that sense.

I do believe the Fed is overly tight, but my concern here is not how it's impacting China. I'm just pointing out the way that interconnectedness of monetary policy and the global economy works is that there is other side effects and other things under the ocean water that could cause certain whales to surface.

And, unforeseen and unintended impact to China's property sector and thereby the rest of China's economy, and thereby the global economy is certainly a candidate here. Now, Louis mentioned the possibility, this, the, the selloff in treasury bonds as a possible whale, and I wanna explain why I don't agree, anyone holding bonds that they bought when, at 10 years when the yields were one and a half percent has these bonds priced lower right now, but you're still talking about something that is not bought with borrowed money that is fully principled, protected at maturity, just gonna be a lower rate of return than other people who bought bonds later would get, and that whatever mark to market price impairment exists now could be rectified in a moment because just by definition, what we call a tautology, if they, if they loosen rates right now, they if they lower rates, some of the damage done to other things isn't gonna be reversed. It's, it's already done.

But if they loosen, have lower rates, treasury bonds, by definition, move higher. And by the way, it's also true that with the quantitative tightening that they could stop tightening and thereby allow. For downward pressure on yields at the low, at the, longer end of the curve. So I don't agree that that becomes a whale there.

I just think that, I'm not really sure what the consequences are on a mark to market basis. People holding on dated bonds, show statement prices that are lower, but I don't think that's a contagious thing. Now you could say, what about Silicon Valley Bank? Well, that's right. The regional bank thing could be, but that's not a problem in and of itself with treasury bonds is treasury bonds potentially.

Causing a problem in the balance sheet of banks, which we've already talked about, how that's been rectified, allowing them to hold those in their balance sheet and receive liquidity from the Fed at full par pricing for these money. Good assets in the balance sheet to deal with the hold to maturity value versus the mark to market value.

So the banks have that issue. Recently we rectified, and I think from an investor standpoint, it's just not a levered asset class that has that contagious risk. Other things like alternative energy. You know, it's down 50% basically globally from 2020, but again, I think that's a more shiny object. About half of that drop took place before the Fed started tightening, and those were things that just as a non-profitable asset class, I think it was gonna go down whether or not the Fed had tightened rates.

So, I really believe the most likely candidate is the one everyone's talking about, which makes it least likely to really be what everyone's talking about. 'cause in my entire life as a professional investor, I've never seen everyone talking about something be right, never once. And what is effectively going on right now is a lot of people talk about commercial real estate as if it's a foregone conclusion that the Fed tightening is blowing it all up and that it's all one big thing.

And not only do I wanna make the argument that there's a difference between self storage and data center and industrial and office and retail, and.

There's between high quality office in Manhattan and in Manhattan, so some would say, from from home, and first of all, that whole thesis has formed to smithereens as company, after company, after company has brought people back to work. And the notion of businesses not having folks in the office anymore proven to be comical other than a couple isolated cities struggling from other political and social epidemics.

But then even in a market like Manhattan, which is very overbuilt for office and has a lot of vacancy, You're paying the highest rents ever for high quality office space. It's just that there's a lot of old and lower quality office space. And so you could have things like, , hotels in San Francisco, the two largest hotels in San Francisco give their keys back to the bank.

And yet by and large record levels of revenue and occupancy for the hotel industry around the country. So, All that means is we're saying, well, bad stuff is doing bad and good stuff is doing good. Well, that's not a statement about a com, a monolithic asset class. That's a statement you could say any day, any year about anything.

The good is doing well and bad is doing poorly, so I believe that what we're really talking about is new development. There is a freeze up of credit that private lenders are, are available. Private credit is available when we're talking about, , when we're talking about incumbent assets. But from a development standpoint or a build.

That's where there's risk, that there's not the credit available to roll when there were short-term financing that is needing to convert and even just getting the financing needed from the build, and that if this were to go on longer, I think this becomes your whale, and I'm not sure that people fully appreciate those distinctions.

Even then, I think it's solvable by a simple correction in a flawed policy. I do not think they have to go from five and a quarter fed funds to two, one or zero, but just merely getting a downward trajectory in the coming months, headed to four, headed to three and a half, something in that range could very well stabilize even new development in commercial real estate.

But maybe they've already gone on too long, too much dynamite is already blown up under the surface, and we're gonna see some whales come up. To the water. Thank you, Louis, for your analogy, and hopefully you, listeners, readers, viewers, understand where I'm going with this. That's kind of where we are. A lot of the immediate damage from fed tightening we saw last year.

In the meantime, talking about financial markets and investors, the, the, these are some of the things that are on the table, and I think potential risks that come, this is different than the conversation about the impact . Into jobs, wages, and corporate profits. I've talked about that plenty. Today we're talking about the impact for investors in various aspect of financial market.

Okay? Real quickly, by way of housekeeping, you'll see me live Dividend Cafe next Friday because I will return on Thursday from being out of the country with my wife, but I'll not be doing the DC today. , Monday through we Monday through Thursday and will not be checking email. , for the first time in my adult life, first time my marriage, we are going to go away and I get over a thousand emails a day and I cannot do an out of office and just check 'em all when I go back and have three, 4,000 emails waiting.

So I will be dark and then you can resend me anything upon my return. I wanted to let clients know about this ahead of time. , but I am committed for the first time in my vacationing travel, my wife ever, to unplugging for a couple of days outta country. But I will be bringing you dividend cafe. We have at this point a lot of questions that are built up, and I wanna do another ask David version of Dividend Cafe next Friday to get up to speed with some very thoughtful questions that have come in.

In the meantime, USC will start their football season tomorrow. Next week, I will be gone a few days and we will be back with you next Friday going into Labor Day weekend as we get ready for the greatest time of year, fall football season, back to school, all the fun things. I hope all you parents are excited and I hope this dividend cafe was helpful in understanding the lay of the land we're in and this unprecedented period of fed tightening. Thanks for listening. Thanks for watching, and thank you for reading the Dividend Cafe.
