FRIDAY, SEPTEMBER 1, 2023

Well, hello and welcome to the Dividend Cafe. I am excited to do another edition we've been trying to do about one of these per quarter, where I just go through and answer questions that have come in. Every one of them is real. Everyone has come from an actual person, often a client, sometimes not a client, just a regular reader subscriber, but always, questions in particular this week. I think there's some really thoughtful questions we want to answer. So I'm gonna just go through these one at a time. It covers multiple different subjects and we should be able to scratch a lot of itches here. And of course, you know, if the answers to any of these questions generate follow up questions, so be it.

Fire away. We're going to holiday weekend. What else do I have to do? I want to thank everyone who wished me well on the trip this week. The trip ended up not. Totally really happening. We never did make outta the country with flights canceled around the big hurricane down in Bermuda. Our thoughts and prayers are very sincerely with those.

There's another hurricane that's hitting Florida right now, and then there's the Hurricane Franklin that took out our trip and so I don't really care much about. Are vacations when you're dealing with other people that have more real life consequences. But we got a little bit of time this week, and I'm grateful to Brian.

I mentioned yesterday in the DC Today that he filled in capably for a couple days with DC Today. But here we are, and it was

just one of those things, and it's happened before. I'm sure it'll happen again. But I did appreciate some of the sentiment some of you shared Now In terms of things, people shared a question that I get a lot of questions about the Fed.

I write a lot about the Fed, so I probably provoke some of these questions. But one person asked if in particular the Fed were abolished, would interest rates then be managed by market forces? And you know, there's a sense which I could just say, well, yeah, sure, but you know, there's two things that have to be said on both sides of this hypothetical, which is interest rates could be managed by market forces without a Fed, with a Fed rather.

You don't, in other words, you don't have to have the Fed abolished to have market forces. Guide where interest rates would go because the Fed really in its initial mandate, is created as central Bank as a lender of last resort, not to set the price of capital, not to try to impose a price of capital to affect policy objectives.

That's a more novel and subsequent intervention into the charter of the Fed. So I am one who does believe in rules-based monetary policy, but I also am one who does believe in a Fed. I think that there is a legitimate function for a central bank, particularly in the context of being a lender of last resort to help keep liquidity crises from becoming solvency crises.

And there's rules by which I think those things should play out, and I also freely acknowledge that is. Just not even in the stratosphere of what we look at essential bank to do now. So the market force idea behind interest rates. If you had some sort of rules based monetary policy, then you'd have market forces that are indicating where those rules go.

So if you're looking at what the bond market or looking at commodity prices, you're looking to nominal G D P growth. You're looking to a number, the Taylor rule. There's all kinds of different rules and I think there's plausibility in a lot of different theories. Of course, there's all the old gold standard.

There's different levels by which money supply and the cost of capital could be set and various criteria by which those rules could be set that would be dictated by supply and demand and buyers and sellers and borrowers and lenders. In other words, market forces. I'd be fine with any of that, but I think that could happen with the Fed as well.

And then in terms of whether or not we would get market forces, if there were no fed at all, that I can't actually answer because it would depend what the federals are placed with. And there are some scenarios by which it could get worse and other scenarios where it could get a lot better. I hope that's helpful.

What would reverse the trend of private credit gaining market share, or is private credit here to stay regardless of what

happens in the bond market or the Fed. And so again, there's kind of a theoretical here if a lot of commercial banks took on a risk appetite to lend in into a lot of the things that right now private credit's been lending into and commercial banks had the liquidity.

Had the green light from regulators, and if interest rates came substantially lower where there was the ability to do that at that competitive level on the banks, well then of course that would cut into private credit market share. But none of those things are going to happen. I mean, it's yes, theoretically, but no, not practically.

And the reason being . The advent of private credit really did not just kick off in the last couple of years with this tightening cycle. It kicked off in a period of very loose interest rates, but it was regulatory outta Dodd-Frank where commercial banks were a lot more restricted on what they could do with deposit or cash and loss absorption and and risk weighted capital and other

Metrics outta Basel three and outta Dodd-Frank substantially changed the rules of the game. And so I wrote a different cafe about this few months ago. I think this became a very positive capital markets innovation. The private credit's a better way for some of this to take place. Now marginally. If there was greater lending from regional banks at a lower cost, would that hurt private credit to some degree in terms of the volume of their deal flow?

Well, maybe it would, but as a general trend percentage of the lending needs in the marketplace investor returns because of dealing with wider spreads, you often with floating rate, I think it's very safe to stay private. Private credit as an asset class is here to stay for the foreseeable future, regardless of what happens with interest rates, the bond market, or anything the Fed may do or not do in the next few, you know, months, years, what have you.

A very thoughtful question came in as to why we an investor at the Bahnsen group in particular wanna enhance growth. Outside of the growth objective we have in our dividend growth portfolio. You know, we use things like small cap or emerging markets. Why would we wanna enhance growth relative to what the risk and reward profile is of the dividend growth investor?

And there's absolutely no question. The answer may be that they might not wanna do that. Maybe they shouldn't do that. It is for those who wanna enhance a growth objective with an enhanced volatility. It's not a free return. It's not free. Extra money. Take on more volatility. Without the income, without the same parameters, dividend growth offers and see if there's a greater octane available through higher growth rates out of the organic earnings growth that is expected with other asset classes, such as right now for us, it's all around small cap and emerging markets.

We could put other things in there. We actively manage that model. It's a very small where are we at with that? I think, you know, out of our four and a half billion dollars, I think it's right around 300 million of what we're managing. Not well over 2 billion, two and a half billion, like what we're doing in dividend growth.

Dividend growth has got to be the bread and butter core of the portfolio for all the reasons I talk about. You know, week in, week out. But where we think there's room for companies growing prematurity, pre cashflow maturity to the point where they could return capital shareholders, and yet with a well-managed, attractive bottom up approach, I think small cap could be very attractive with emerging, you deal with geopolitical and currency risk, but again, there are most certainly higher growth rates for some of these companies domiciled in emerging markets with lower valuations.

Where most people are getting large cap growth is chasing expensive growth oriented companies that they hope get more expensive. I've said that many times. It's a line that, I don't mean it to be cutesy, it's very descriptive. It's not the way we wanna try to enhance growth. So we use something more boutique and more appropriate to our philosophy.

Another really interesting question here. If Saudi Arabia comes into the bricks, will they drop the US dollar as the pet? Well, the US dollar as the petro dollar, the currency being used on oil transaction doesn't really matter. Well, it appears that Saudi

Arabia is coming to the bricks. So again, you're Brazil, Russia, India, China, South Africa has now invited Saudi Arabia, Iran.

Ethiopia, Argentina, a number of third world countries. To join in their sort of block of around a currency block around trading various agreements and packs to go there with. And I would suggest that it's very likely with or without this, that marginally the dollar will end up being transacted with less with oil, so far it's incredibly marginal.

I think Qatar and United Arab Emirates have done a couple transactions with China, maybe one with India. Where the dollar was not the transactional currency, but Saudi hasn't yet. They've talked about it with China. I think that's coming with Yuan. But I gotta come back to the most important point here.

That's not gonna change the dollar being the reserve currency. You can trade oil for a different country's currency and then from there, exchange into dollar. Because these countries. Have to hold a currency that they believe has a stability, has a convertibility, has a transactional broad utility.

This idea, what does a currency strength come down to? It? Does it come down to a lot of weaker countries bonding together all saying they wanna use the weaker currency, or does it come from countries themselves being stronger? Does is Ethiopia? Enhancing the attractiveness of a bricks shared currency block.

It's just absurd. And again, that distinction between transactional and reserve currency is very important. I'm all for the arguments as to what the dollar is subject to based on various elements of weakness from monetary and fiscal policy. But when, but not, I'm not for the argument it, once you get to the point of now, you gotta compare it to something or suggest an alternative.

We're suggesting that Saudi would rather have transactions for petro denominated. With a third world currency from another country that's significantly smaller, weaker, and whatnot is just not accurate. So, no, I don't think it matters. I think that reserve versus transactional currency is the more important point, but all things being equal do I think on the margin that Saudi joining this BrickX block will likely lead to less dollar transactions with oil.

I think that's very possible and probably very likely and totally immaterial. Will markets do better? Under a President Trump or a President Biden after the next election? Well, let's first of all make clear, I'm not convinced that either one of those are a s shoe-in to be the person that will be running for president for the respective parties.

I'm certainly not sure that both of them will be. It's very possible, and there's no question right now they're both the significant leads in their respective parties. There's just a lot of things that can happen and a lot of time that could go by. And we won't get into all that. I just hope it's kind of obvious that,

you know, things do happen and that's particularly true in politics.

So perhaps things change, pivot, you know, go a different direction in the next 4, 5, 6, 7 months. That's a lot of time. But my answer about how markets would do is, first of all, the person in the White House is always vastly overrated. As a determinant of market behavior one thing I would say is let's say President Biden wanted $5 trillion in new spending, and two and a half trillion of new taxes on investment, on capital gain, on marginal income, on productivity that was proposed in his build back.

Better legislation, 2021. He could want that, but we have to know what the composition of the Senate is, what the composition of the house is. So knowing who is president tells you one piece, but it doesn't tell you all the pieces. Markets have sometimes done very well with divided government. Markets have done well when all the sides legislatively and executive brancher doing things that might be pro-growth or market friendly, and markets could suffer if everyone is aligned.

Doing something that's market unfriendly, but that's hard to get to in our country, in our form of government. It's possible, but it's hard. It's harder. So I don't know without knowing more variables, you know how market could respond to some of that policy front, and you could have in theory, really unfavorable political.

Color for markets, but then have certain fed activities or economic things going on that really rally markets new technologies, new productivity, new growth, new innovation. You could also have the opposite. Maybe the political environment is supposed to be market friendly, but you have recessionary conditions that are being sorted through.

You have a fed doing this, doing that. Geopolitical issues instabilities. The politics are just so vastly overrated. So I don't really totally care for the question, even though I very much understand where it comes from. I've been being asked this my entire adult life, and I give the honest answer more or less the same answer for quite a long time now.

All things being equal, if there was a sufficient majority do I think that some of the things that President Biden has said he wants to do if he had the House and Senate lead to do so that they'd be negative for markets? I think so. And do I think, you know, president Trump's corporate tax reform, Was really good for markets in 2017.

Of course it was deregulation good for markets, some of the energy policy, but again, we don't know what the agenda would look like. We don't know what the legislative capability would be. So it's very hard to answer. I would rather answer in a longer term perspective, do I think that long term

The biggest challenge we face in economic growth is excessive government indebtedness. Yes, I do. And do I believe that either

President Biden and President Trump have a great track record there? I do not. And would expect any kind of meaningful improvement. In the size of government relative to G D P in current spending, the size of debt relative to G D P or ongoing budget deficits?

I do not. And that, and so on a bipar or nonpartisan basis, I don't really think either one would move the needle on the more important element there. Somebody asked, that was a very thoughtful question, what makes Smart Wall Street people. Embrace flawed ideas like keye and economics and what makes academically trained economists continue to embrace this Phillips curve error about a trade-off between appointment and inflation.

I talk about this a lot, that fed economists believe they need to see more people lose their job, to see inflation come lower. And I think one of the things I wanna say first on the Wall Street front is I don't, that's not been my experience that most Wall Street minds have and act upon. Decidedly and accurate worldview that is more rooted in keynesianism and central planning and in top down command control, economic understanding.

I think they're usually very agnostic very focused on what is and having an investment thesis. The real talented wall Streeters. Might not be very ideological at all. They might be more focused on what is, and if Keynesian policies are, then

they trade and create and strategize around that reality as opposed to what they think maybe ought to be.

That's on the more talented side of Wall Street. When you're sometimes just getting kind of generic macro research from some of the big Wall Street firms and it has kind of a Sian bend or flavor to it, A lot of that is not investment specific. There's no activity out of it. It's not actionable. It's just kind of drl.

It's consensus group think, that is non-controversial. It's regulator friendly. It doesn't separate anyone from the PAC because risk taking is not really what that, that camp is about. So if everyone sort of sounds the same, if they're all rhyming then someone could be wrong. But they'll all be wrong together.

Someone could be right, they'll be right together. But when you get out of consensus, bold calls . That could be rooted in something that has a flawed ideology, or it could not be, but you just don't see it one way or the other. That much in my experience where I think that there are Wall Street folks, whether, you know, traders, deal makers, advisors, portfolio managers who actually have an economic world view I don't again see it very much, but when I do see it,

It's kind of counterintuitive. It's not very common that they may be full blown Keynesian. I think that. You know, the rarity is meeting worldview minded Wall Streeters, but when I don't generally see run into it in that sense. Now the other question

was why the academic class of economists embrace something like Phillips Curve?

Despite so much incredible empirical evidence that it's a flawed theory, I think a lot of that is that there is an agenda. For central planning. If you, if your whole economic worldview is centered around the idea that there's a particular model that real brilliant people could tap into that could do a lot of economic good then you may as well want to advocate, you know, creating that model.

If you don't believe any such thing exists, if there is no Phillips curve metric, then it sort of does eliminate the need for a econometric academic model driven economics. So I don't know that it's always this cynical. I'm not trying to be cynical, like it's, that it's sinister or purposeful, but subconsciously there's no question that believing in something like Philips Curve does imply.

A high regard for central planners, and these are the people who would be the central planners. And so that's a, I think, a fair critique of what Hayek would've called their fatal conceit. I don't mean it to be sarcastic or derogatory, but that's my answer. I do think Philips Curve is largely or operating out of a kind of embedded implicit bias.

Is an investment in high yield municipal bonds about interest rates or credit quality or both? And I would say it's a little bit neither. It's more about the spread. When you're talking about

credit quality, the default rate is historically so low. We're not really looking at defaults. We're more talking about during periods where there's a higher risk appetite more comfort with risk spreads tend to tighten relative to the risk-free rate, and then they tend to widen when there's more concern.

What the interest rate itself is, could be high or low, and that's not the call around high yield muni, whether it's a high or low, it's more a spread relative to a high or low rate. So that's why I say it's not really about the rates, it's about the spreads, and it's not really about credit because we're assuming a very low to default rate historically in the high yield muni section.

Now another question in the Munich bond category was, what's your view of trend in the fiscal soundness of state and local governments is a positive and I guess I would say no. I do not have a positive opinion of the fiscal soundness of many state and local governments, and yet I don't think that has anything to do.

I'm sad to say it has nothing to do with the pay ability of the principal and interest payments on bonds. I think that these states have many avenues by which their fiscal soundness can be skirted for the sake of the bond holders. That's been going on a long time and I have no reason to believe it will change anytime soon.

I'll leave it there. Someone asked me if I'd be willing to define the word deflation. Let me do it kind of quickly because at, in a

mo deflation, just as a vocabulary term it does mean just, you know, dropping of. Aggregate price level, lower prices across the entirety of the price level, just like inflation means an increase in the overall aggregated price level.

So you could argue that deflation when it comes from greater productivity. Greater competitiveness is a good thing. But that generally speaking, when deflation happens, it's from a contraction of money supply, a contraction of credit, and that it is not a great thing for a number of reasons. First of all you could say, okay, well it's good a consumer is able to spend less, but the entrepreneur and the risk taker can't go.

Project and do economic calculation and extend risk capital into a new project when the revenues they anticipate could be deflating by then. But fundamentally, this should make a little sense to you. Deflation is something that anyone who is lending money with love. Because they're gonna get paid back with things that they could buy more of in the future.

But it is something that people who borrow money would hate. They have to borrow a certain amount of money and pay back money that is worth more than the amount they borrowed. And then that really also ends up being bad for the lender because the solvency of the borrower called into question. It doesn't help the lender at all if the borrower can't pay back, whether it's a bank or a company or a household, you know, and generally we're talking about governments too, but

governments have the ability to print money and so forth and so on.

This is very similar to Irving Fisher's idea of a debt deflation cycle, that the problem with deflation is that if the asset values are dropping at a quicker rate than the debts being paid back. You're in a vicious cycle. That's what the Great Depression was about. That's what Japan story's about at a different scale.

That's what our great financial crisis was about. We don't have a lot of outright deflation in American history across a price level, but what we do, it's pretty ugly, but that's just the basic definition of deflation. Borrowers hate it. Lenders love it. . Unless the borrower doesn't stay solvent, then they've and by and in periods of mass deflation, the borrower usually doesn't.

Someone else asked about what fed now is what the repercussions would be. Again, I wanna make clear it's not a currency, it is not a digital currency. It is. Payment mechanism. The Fed, you already had Fed Wire, you've already had Fed Funds Wire, ACH. It's a payment mechanism with banks that is meant to be an improvement.

The Fed is not making payments available to consumers or businesses. The banks may do it, but the Fed's transacting with member banks and it's just a payment mechanism. Do I think the Fed is on the verge of cutting edge technology and payments? I do not. I think they struggle to do what they do well.

I don't think that they should be expanding in things they don't do well, but . Be that as may I still don't buy into this idea that Fed now is itself an existential threat of any noticeable difference to our own privacy and monetary control. Alright, well I'm gonna leave it there. That is all the questions.

So I didn't rip off anyone on the podcast or the video. Relative to the written Dividend Cafe that covered all the questions. The two things that you'll get@dividendcafe.com are the chart of the week and the quote of the week. But as far as all the questions, those covered it, we'll reach out with any more.

I hope this was interesting, and I certainly really do encourage you to write questions@thebahnsengroup.com for any additional info. And thank you so much for listening. Reading and watching Dividend Cafe. I look forward to coming back to you next week from New York City. And in the meantime, enjoy your Labor Day weekend and USC fight on and beat Nevada.

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