FRIDAY, SEPTEMBER 8, 2023

Well, hello and welcome to this week's Dividend Cafe. I am really excited about this week's because not only did I just get done writing it, and sometimes I enjoy, I recording the podcast in this video when I am, you know, fresh off of the writing more than when I'm recording a few hours later because you know, some of the mental inspiration and so forth can get distracted or diverted.

But it's also a topic that I love a lot. I mean, first of all, the whole concept of doing Dividend Cafe around evergreen principles is always hard because there's topical things that come up, and I have a strong desire to bring it back to first principles. If I'm gonna talk about something going on in the world in China, something going on in the world with energy policy, something that just got done happening with bank failures.

These are macro topics. That come from some event that I like to write about Dividend Cafe. And yet really what I mostly want for Dividend Cafe is reinforcement of permanent principles. So to apply various things week by week in and pull into that the first principles that we care about.

Sometimes it's a challenge. Sometimes I think I execute it well. Sometimes I don't think I execute it well, but this week I'm just simply . Talking about first principles. I'm doing an entire Dividend Cafe that starts and finishes with, Hey we have right in front of us a beautiful reminder of something that I want you remember today.

And I want you to remember in a year, and I want you to remember in 10 years, and I'm gonna use the last five years to make a point. If you look at from 2018 to 2022, and then we're coming now into 2023 in this kind of setup here, 2018 was the first of this five year period, and the market was down that year.

2022 was the last of this five year period, and the market was down that year. And you know what's interesting is it bookends three other years in the middle that were up that were actually up quite a lot. But it also, those two years that bookend, this five-year period, they're the only two negative years that we've had in the stock market since the financial crisis.

And 2018, it was down 4.3%. I mean, it barely even counts. 2022 was more substantial, but you come out of that massive period of wealth, evaporation of market, drawdown of credit, contagion of economic pain in a deep recession. That was the great financial crisis. 20 2008. And now in the 14 years since 2023 will be the 15th year.

You had a grand total of two years that were negative and those represented represent the front and back bookends of this five year period. I wanna walk us through, so keep in mind as you go into 2018, what the context was that we had nine years, so positive stock market returns, and in 2017 the market was not just up, it was up a lot over 25%, and it was up 25%.

With no volatility. You have a lot of good up years in the market, but along the way there's, you know, volatility, there's the normal things. Risk takers sign up for equity investors and public markets in particular sign up for, which is drawdowns headline risk, downside volatility that comes with it.

I've said this many times. You average in any given year at some point in the year from a high level to a low level, a drop, . That will take place in the course of that, and in one calendar year, some point there will be a drawdown of over 10% on average, even on really good years every year. And in 2017 the market was up over 25 and the worst draw down you had all year was 2.9%.

You didn't e ironically, if you look back, by the way, I just remember it 'cause I was at a hedge fund conference when it happened. That was part of like a . Two day drop or something when they announced the Russia investigation and the special counsel being appointed James Comey had been fired.

You know, that like that little news event was, got the market to drop a whopping 2.9% and that was the lowest volatility that we had. It kind of tied 1995's. If I remember correctly and you just had a massive year in 2017. So you go into 2018 and basically here's what you are saying. As you enter the first year of this five year period, we're studying corporate profits are picking up immensely.

2018, we didn't know this at the time, but 2018 was gonna be the biggest year for real economic growth that we had since before the financial crisis. We'd been stuck in one and a half percent-ish GDP growth, and we were gonna get to three percent-ish GDP growth in 2018. They had just got done passing at the end of 2017, massive tax reform, which resulted in huge reduction of corporate tax profits and was gonna result in huge repatriation of foreign profits coming back on shore.

You, there were all sorts of reasons to be highly optimistic and what all of a sudden happened was the Fed . Began tightening and by tightening, it doesn't even count then relative to what we are living in now. But they brought the Fed Funds Rate from 0% all the way up to 1.16% 2017. And then in 2018, they doubled that.

And they began doing, you know, hundreds of billions over the course of the whole year of quantitative tightening, reversal of the balance sheet, and the Trump administration embarked upon a trade war. Largely with China, but also inviting, at least rhetorically a lot of tensions even in our trade relationships with Canada and Mexico with Europe.

So 2018 ended up look, it was only down 4.3%, but it at one point it drawn down almost 20% in the fourth quarter, erasing what had been prior gains. And things were not good and you get ready to enter 2019 and you say this trade war's not even close to resolved. The Fed is saying they're gonna raise rates

another four to five times and they're doing this Quantitative tightening.

Companies like General Electric are having trouble rolling over their debt. How Bond spreads had widened five, 600 basis points. And how could anyone feel good about going into 2019? So what felt good entering 2018 became a bad year, and what felt bad entering 2019 lasted about five minutes. The Fed reverses course.

They have some sort of cosmetic improvement in the trade deal with China, what they call it, a phase one trade deal that settled the idea of tariffs worsening. And the stock market had one of its biggest years ever. Basically, let's just call it 30% gains. I, again, completely outside of what people could have predicted, the yield curve had inverted in 2018.

Everyone loves to tell you how that obviously means that economy's gonna recession. Forgetting the constant false alarms that can come about. And false alarms could be two ways. By the way. You can have a recession without a yield curve inversion, and you can have yield curve inversion that doesn't lead to recession has happened.

And I admit it is the exception, not the rule, but exceptions mean. That they're not gospel. So 2019 ends up being a robust year for risk takers. It it ends up being very contrary to what would've been headline predictability at the beginning of the year. And the same, exact same thing. The same exact thing

was true at the beginning of 2018, only in, in inverse around circumstances.

Then you get to 2020 and I mean, I wish I could do this quickly 'cause I think everyone knows what I'm about to say, but there are a few little nuances in the mid middle of it that I gotta point out. But I mean, obviously no one entered 2020 saying there's gonna be a global pandemic this year. Nobody entered 2020, understanding that the pandemic was only gonna be as deep and wide as it would be, but that the po, that the societal response would be the incredible severity of lockdowns and shutdowns and compression of economic activity and social activity for that matter.

Nobody could have predicted the policy response was gonna be so, violent with CARES Act, spending, transfer payments, direct payments, the P, the monetary response, $5 trillion of quantitative easing, holding us at the zero bound and interest rates going all the way back down to 0% and holding that what would end up being two years.

So, you within 2020 had a totally unpredictable event with totally unpredictable response, with totally unpredictable circumstances. And then you say, okay, well, yeah. I mean, I guess the market would go down if that happened, which it did for 36 days. Then the market ended up having a violent rally as the news was getting worse, as the things were not getting better as you know, a whole slew of circumstances socially, culturally, the unrest that was existing in the society as the

pandemic that Was believed to be one thing at one point, and then it changed to kind of another, and then we saw that the inevitability that this thing was gonna be spreading markets moving higher and still ending up 2020 with very positive return.

Then you go into 2021 and you say, okay, well not being political here, but President Biden just won the election. He says he is doing huge multi-trillion dollar tax increases. He's gonna repeal the Trump corporate tax cuts. He's going to cut off a lot of these energy things have been done. He cancels Keystone Pipeline.

You from a social standpoint, you had those just disgusting riots at the Capitol building on January 6th. So, things are not looking really good. And by the way, I'll add, not only is Covid not done for a lot of people, but there's gonna be two new variants that are gonna come Delta in the spring and Omicron in the fall.

And they're gonna, cause like the entire country will get Covid, right. And so 2021 is going to be a disaster. And if I also will add that the economic growth in recovery will not be what it was predicted to be, it's gonna underwhelm expectations for a rebound out of, in the reopening that what we had out of the 2020 closures and economic contraction.

So everything I just said was true there. That is who got elected, that was the campaign promises or intentions and

whatnot. That was the Covid dynamic in 2021, and then the stock market was up huge. I think it was 26.89% on the SS&P. So you again have a series of circumstances. That are negative, that were unforeseen.

Nobody knew you weren't gonna be able to get restaurant workers to come back to work. By the end of the year, you had significant price increases starting to form. The inflation narrative picked up bigger the first half of 2022, but it was alive and well in the second half of 21 as well and very positive market environment.

Then we go into 22 and people say, okay, well, Now e covid is done. And even if it's not, people are just, it is done. They're sick of it at this point. Even those that were relishing in the perpetuity of Covid dynamics, we're kind of ready to, you know, go get, pick up a coffee or something. So the fact of matter is that in 2022, the Fed started off the year saying We're gonna raise rates one to 1.5% by the end of the year.

Everyone thought the same thing. I most certainly thought the same. I didn't know if they'd make it there. I didn't. I most certainly didn't think they'd go higher and didn't even know if they'd get to their stated place. And they raised rates 500 basis points. So not only did the Fed surprise all of us, the Fed surprised themselves with interest rates.

Housing prices had been up 40% in a two year period. All housing activity completely stops, and there's a national

debate about if we're in a recession or not. We weren't, we aren't still now. But nevertheless, 2022, you got the Nasdaq walloped as a lot of its excess got De Frothed down, I think 34% peak to trough.

And you had the SS&P. Down 25%, peak the trough, and down 20 on the year. So, not exactly a great year. And you can say, well, yeah, but people are predicting it except for, we obviously know they weren't. There were no outflows out of the NASDAQ until the NASDAQ's drop was going on. And on the bond yield side, which is where the most carnage took place for 2022.

There was no one predicting that level on the long end or short end of the curve of that kind of rate increase and that kind of inversion in the yield curve. And so really you have to look at it and say, okay, it's 2022. There was this fear of recession coming, but now the Fed's tightened over 500 basis points.

We know a recession's coming now and you enter 2023. And if I say to you, you're gonna have three significant bank failures. Fourth, if you count one of the largest banks outside the US in the world with over a hundred year old Credit Suisse in Switzerland. But you're gonna have ma major bank failures.

You're, you are gonna have the Fed tighten further still. And the corporate profit, you know, decline will continue. Now I'm going to say more than that in a second. The idea that we'd be sitting here now in the fall of 23, the S&P was at 3,600 in October of 2022, and a month ago it was at 4,600.

Now it's down a hundred points or something since then. But my point is same up a thousand points when all of the news. Was bad, and maybe in a lot of cases worse than expected. Now, it wasn't all worse than expected, and that's where this corporate profits point comes because most certainly people were thinking a 20% decline in profits is very much on the table.

I don't think many people thought it'd be a 4%, 5% decline year over year in corporate profits. And that's a lot of the reason markets have done better than expected, but there's. Plenty of other reasons too. You had a, with a, let's call it 4%, 10 year yield and with a 5% short term yield, you had multiple in the S&P go back up from 18 to over 20.

So multiple expansion better than expected earnings environment while there continues to be the economic ambiguity. Big double digit returns in market indices. It just simply wasn't in the cards for 23. Now it's only September. Who knows what happens to you now in the end of the year, but I don't know that you need more than the five year window to make the point that if I go at the beginning of each of those years and tell you what's gonna happen in the year, first of all, no one could have would've or did do that.

And if someone had time and time again, the investment . Outlook, they would've attached to that economic macro world outlook would've also been wrong. You're either gonna get the

prediction of what's gonna happen in the world wrong, or if somehow you get that right. The way in which you invest around it is very often I.

Going to be wrong. And there is a general sense in which markets exist to humble us to confound people, but this is not because of irrationality. This is because of complexity. This is because markets are trillions of activities being coordinated invisibly every second of every day. What I just said was not hyperbole, by the way.

It's not irrational, but it is unpredictable. And so are the macro events people are trying to price in. You say, well then what am I supposed to do as an investor? I have real needs that require real financial solutions, and you're telling me the future's unpredictable, and you're telling me the way in which we attach an investment solution to that unpredictable future is unpredictable, unknowable.

Yes, I am. I am saying all of that. What I'm saying is that it is not necessary. I. To predict these year by year activities in the marketplace when one has an economically coherent investment plan that centers around what can be controlled, analyzing, studying, looking into company fundamentals, what have you, while recognizing that there will be interruptions, there will be disruptions, there will be distress moments, and that you can try to

Time and predict and forecast and use the internet and Twitter and social media and newspapers and cable news to get yourself in and out of these things. Or you can ride through them. I. Believing the statistical odds are exponentially better of a good result, not trying to predict the future and not trying to attach a solution to the future in a short-term period around a particular event, as opposed to the long-term discipline fundamentals that allow you to capture risk premia with an acceptance of

The unknowable being part of that. There's a humility in it. There's a logic to it. There's testimony of history reiterating it, and there's a beautiful result that comes for those who do it. So this is my reiteration. Reaffirmation of a long time principle that has to be understood. It just illustrated within its own five-year window.

And I'm happy to take any feedback and questions you have, but I hope you, you get the point. There's two charts, by the way, at Dividend Cafe.com that I'd love for you to look at if you're not reading online and just simply listening to the podcast or watching the video, a chart of the Federal Funds Rate over time.

And you, so you can look at what the Federal Funds Rate was from 2009 to 2018, to understand the accompaniment that went with that market period where everything seemed so easy and multiple expansion came you know, so, liberally. But then the chart of the day also shows. The GDP growth and the

stock market performance over the last 30 years in Mexico, in China, and the United States.

Now, I want, don't you, to look at those things and see multi-decade reaffirmation of what I'm getting at here. So check out those charts if you can. Thanks for listening. Thanks for watching, and thank you for reading the Dividend Cafe. We'll be back with you again next week. Still here in New York City.

Have a wonderful weekend. Take care.

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