DIVIDENDCAFE | PODCAST TRANSCRIPTION

FRIDAY, SEPTEMBER , 2023

Hello and welcome to this week's Dividend Cafe. We are digging into various distress. In the financial system this week. I have a caveat I want to provide as we get started here. I think, let's see, the Dow is down as I'm recording, we're in the middle of the day. Friday, the Dow is down about 600 points on the week. That's 1.7%, that's not exactly the kind of thing that should make me ever go, Hey, we need to change what we wanted to do at Dividend Cafe, 'cause of a 1.7% drawdown over five days. The NASDAQ is down 3.3% on the week. That's a lot worse and it's down seven point a half percent since it's high in July.

So a couple months at seven point a half percent. That's a little more substantial. But you know, we're . This isn't the type of stuff that should ever cause me to say I need to do a special bulletin on. Those things are normal and expected and that's part of the dynamic of being an equity investor, obviously.

But the reason I wanted to kind of, avoid certain evergreen themes and some of the other topics that I had in my potential docket to write about and talk about today and go this direction, is that it to me, there is something behind why certain things are happening that I wanna unpack with you right now, and I do believe it.

Just to kind of set the table a little, we should be really clear about what is happening. It isn't just that there's equity volatility, and it isn't that equity volatility is severe, which it's not. It's not that the equity volatility is. No big deal. It's that we're talking about bond market volatility.

That is, is much more of a story and for reasons I've talked about in the past, the bond market never gets the attention the stock market does. And yet I think right now it's important to understand what, where the chicken is and where the egg is. You had a 10 year yield in April. That had gotten all the way down to 3.3%.

Now in fairness, First of all, that's about five months ago. Second of all, it wasn't at 3.3 for very long. It had come quite a bit down to get there, but I mean, we did stay in the mid threes and the mid high threes for quite some time. And it was where it was, and now we're talking about it as I'm talking.

Being a whisker short, a 4.5%, I mean, that's a dramatic move. And even if over five months, that doesn't grab your attention. It's 38 basis points that have been added to the 10 year yield just this month. And so you have seen upward pressure on the yields of longer term bonds and I think that there's some significance into what's going on here.

And I wanna walk you through it. So of effectively, if I can just kind of review . What has transpired in terms of this particular period of market ishness? I hope I'm well on record. I know I am. I, you know, I have the tape , I have the writing. I do believe we're in the midst of what is very likely to be historically a prolonged period of directionlessness or ishness in market indexes.

And I think that historically has been the case after a really substantial bull market that you generally will have a period after a bear market of not reverting to a big upward trend or continuing a downward trend, but just sort of bouncing and the upward bound and downward and, you know, the floor and the ceiling, if you will, could be where they are.

But my point is that it stays in a reasonably tight range. And you know when something, I'm making up a number, but let's say that range is gonna be plus or minus 8% when things are plus eight. It feels like that's a really good market. When things are plus or non minus eight, it feels really bad.

But my point was from beginning point to end point. So when am I kind of starting this? It's more or less at the end of 2021. Alright, you had that bull market from 2009, 2021. We had the covid interruption for about a month. Market indices resumed an upward trend. And then after the election of 2020 and the vaccine and energy reopening and the market reopen excuse me, the world reopening society.

2021 became this kind of blow off top shiny objects got ridiculously overpriced. The overall market did quite well and you were still in a zero bound for the Fed. You had a lot of earnings recovery, you had a lot of economic recovery and so it was things like energy and value doing well, but also growth and tech doing well.

And then we go into 2022. And so what I'm gonna suggest here is that there's five phases I wanna walk you through real quickly. And I mean that real quickly, more or less. The first phase was markets realizing in early 2022 that the economy was weakening, that it wasn't looking at this robust period of strength and that you know, we needed to first just sort of clean the house a little bit.

And so shiny objects got taken to the woodshed first. And so very early in the cycle you kind of had a mercy killing of shiny objects and that this was . Surrounded by a period of economic skepticism, like, okay, we may be facing some economic challenges. The second phase then is by mid 2022. Now the Fed gets very involved.

It's very clear that the Fed was gonna tighten more than expected. It led to a market sell off. It led to the assumption that the Fed would induce a recession, the likelihood it would induce a recession. Earnings revisions start coming down expectations for growth, start going negative, et cetera.

Perma Bears who had predicted 20 of the last two recessions started calling for recession spades and non perma bears. Also just said, look the odds, the statistical probability here is that you get a recession. And so that had to get priced into markets by late 2022. And interesting thing happened is that markets began to price in the idea that the Fed may be near the end of their tightening.

It was certainly my view at the time market factors were largely positive near the end of 2022 in terms of pricing out a little bit like, okay, on the other side of whatever may happen with the economy, whatever may happen on a rate policy, we see a more positive thing and markets began to try to look forward and be more optimistic on how that may play out.

I think that a lot of it had to do with market actors, investors who have seen it before discounting the next steps sooner than later and trying to get in front of the way it all may unfold. That was sort of the third level of market activity. Then in number four is that into 2023, the recession discussion itself changed.

That now of a sudden, instead of a will we or won't we? It began a we will, but how bad, excuse me, I'm saying it backwards. It became a will we or won't we discussion as if the possibility of not having one was, you know, a necessary option where previously the discussion was largely, we're gonna have one, but how bad will it be?

You follow me? And I think that by mid 2023, just a few months ago , the odds were now more in favor of no recession than even like a mild recession, let alone a more severe one. Okay, and prior to that, your debate was really binary between mild and severe, and then all of a sudden you added this well or not at all, and markets began to price in this kind of scenario or outcome by which a Fed ended up reversing, tightening claiming victory over inflation, which as you know, I most certainly think they should do. Move on past yesterday's battle and also avoiding a recession. Pretty good scenario that was getting priced into both bond and stock markets. But then now this fifth phase is where I think we are now over the last couple months, which is one of which markets have begun to say, wait a second, what if we do avoid recession?

But the Fed just stays tight for a long time. Valuations aren't getting a better boost. Risk-free rates stay high risk assets, valuations have to come down. Liquidity stays tight. Bond markets beat equity markets to starting to price in this scenario, and stock markets have been catching up a little bit.

But that's more or less where we are is a financial market stock and bond financial markets that have gone from fearing recession to being excited that there is right now no recession, to now wondering if we get a market problem in a non-res recessionary scenario. And so this is all within 18 to 24 months.

The, these kind of five steps have sort of played out. You know, this week Chairman Powell, as the Fed, came out and announced they're pausing not raising, you know, they doesn't see them cutting anytime soon. They really want to, you know, make sure that inflation stays in the rear view mirror, that kind of thing.

He talked about how difficult getting to the neutral rate has been, that the neutral rate seems to be higher than it's been before. And the neutral rate is this sort of poorly defined term that has a lot of circularity in it, which is the rate at which if you're above it, your your restricting economic activity.

And if you're below it, you're stimulating economic activity. And I always think it's a difficult thing philosophically to talk about a concept . that you don't know what it is you're going for until you can define it with hindsight, well, and you know, now we know that X was the neutral rate.

'cause it a little bit more than X. This happened and a little below, below x this didn't happen. And it's constantly changing and there you know, I think it's all predicated on a view that I have come to believe is deeply flawed, which is that . Trying to stimulate economic activity or restrict economic activity with the cost of capital is foolishness that most of our significant problems we have come not from the cost of capital, but from just general confidence in insolvency to begin with.

I mean, real severe moments, you know, someone came and said, okay, well, Lehman Brothers seems to have a $80 billion hole in their balance sheet. And we're gonna go ahead and lower the cost of capital. So you can do business with Lehman because at 4% you don't want to, but maybe 2% you will if you believe it to be an insolvent entity.

I mean, it's just absurd. And we've seen this in all significant financial crises over the years, or balance sheet recessions that the cost of capital is somewhat ineffectual. At stimulating activity when the solvency of counterparties is really what might be the issue. And I think when someone loses a job,

They don't say, well, if my credit card rate was a little lower, I would go ahead and take this family vacation, but because the credit card rate's higher, I'm not going to. Their issue is employment, so wages, profits, solvency, net worth, balance sheet asset values, these things are all real. The cost of capital is an input, but it is not the defining input of economic activity, and that's, I think, the flaw.

Of a sort of divine view of monetary interventions. Anyways, to move on with this, the Fed doesn't know what the neutral rate is and the market is now realizing that and they believe they need to alter economic activity with policy tools, but I don't think the Fed has been understanding why markets do not see it that way.

And so you get a sort of confused project, confused objectives. And then certainly a very mixed and essentially confused response. Now I wanna give full credit to my very dear friend who's one of the most brilliant people I know, Renee Corbu, who his theory about what the fire and the ointment is that productivity is either higher now or the Fed sees productivity going higher.

and that leads to it requires us to have a higher neutral rate assumption that you can if you're getting more from less, you're gonna need a higher rate to, to restrict economic activity. And if it's true and if it's sustainable than you need a higher fed funds rate for some time. And that would then lead to more capital coming in the US.

It would lead to a stronger US dollar. And certainly lead to a CapEx boom. There's a virtuous cycle there because it, those, that chain of events leads to a CapEx boom. But a lot of that chain of events is somewhat caused by a CapEx boom. And that's somewhat my view, so I agree entirely with Renee about that.

I think the question is whether or not one believes that we will that the Fed . Will actually allow this higher rate environment to take hold around that set of circumstances. And I can't talk about the higher rate environment, what is happening in the market right now on the long end of the curve without talking about quantitative tightening, which all focus in media discussion and most people you just talk to around the street is on the Fed funds rate.

and I understand it. I think part of it is it's just simpler, it's shorter, it's more definable, it's more understandable. Quantitative easing. Quantitative tightening, A more complicated concepts, but quantitative easing tightening, let's basically call it the policy tool of what the Fed does with their balance sheet and the Fed funds rate the policy tool of what the Fed does with the short term interest rate, the policy rate.

Used to influence the cost of capital. These are two different policy tools. They're obviously intertwined, but they're different levers that the Fed can pull in one direction or the other. And you could say, okay, well look, the Fed right now has a trillion dollars less treasuries on their balance sheet than they did a little over a year ago, and they began quantitative tightening.

and households have more, a little more than a trillion dollars additional on their balance sheets than they did a year and a half ago. So it's kind of, even Steven, all that's happened is a trillion came off the Feds. A little more than a trillion went on households and it's washed. But the difference is that the Fed is a non-economic buyer of treasuries.

They're, they don't, not only do they not care what the yield is, the whole point is the fact that the yield may be lower is to them a good thing. They're not buying for their own accounts so that they can collect good income where households are buying for that reason, their economic buyers. So you didn't do an apples to apples.

Let's trade out a fed position in treasuries with a household position in treasuries. And it could be the private sector, it could be banks, it could be foreign investors for some degree, although that gets more complicated 'cause you have a currency issue. But my point is that the apples to oranges is that you did, you can't get a trillion off the fed and a trillion on to household without the yield being higher.

And that's what's happened on the longer end of the curve is households had no interest in buying. 2%. 10 years, but they apparently do have interest in buying 4% tenures, four and a half percent tenures or what have you. And so I think that what we have to answer is whether or not the fed is to some degree a, some a politicized entity that they are they a totally independent body from the treasury or not?

Or is the accord between the Fed and treasury that's clearly been a part of American economic life for 15 years or longer? I, is that still in play? Because one thing I do know, and I want to get to a bottom line summary of exactly what the tension is so you can really clearly understand. My point of view on this fundamentally is the Fed's role more

To accommodate what its economic policy objectives are, or is it to accommodate governmental policy objectives? And this is the tension especially back to like Renee's thesis about productivity, you know, which I think is very potent stuff. Fiscal policy, 32 trillion of debt requires accommodative monetary policy.

High productivity suggests that the Fed may want . Tighter monetary policy, higher rates.

If the Fed were, what can you do to remedy this fiscal policy, let's say, could raise taxes that then requires less fed accommodation. In theory, the more revenue coming in, less need for borrowing less sensitivity, cost of capital. But then you lose the productivity, higher taxes, lower productivity. I promise you I'm right about that.

So the very thing that could cause the Fed to want to do more restrictive monetary policy reverses if the fiscal changes, but if the fiscal doesn't , Then the Fed is stuck in that pickle. I'm gonna, I'm gonna read from Dividend Cafe so that I state it for the podcast, state it for the video with the clarity that I think my written word afforded it the pickle of our day for the Fed, which is really where markets are sort of jumbled right now.

Fiscal policy needs more accommodative monetary policy, but high productivity calls for less accommodative monetary policy and the fiscal policy is changed. To be in line with less accommodative monetary policy, then lower productivity results and calls for more accommodative monetary policy. It's a tangled web, all started by the doubling down of economic intervention with experimental policy tools.

So right now, do I think markets responding to government shut down threats and so forth? I don't. I put all this in Dividend Cafe today, the average. We've had 20 of them, 20 in my lifetime. I'm only 49 years old, believe it or not. I know you thought I was a lot younger, but of those 20 you, the market has essentially been up the vast majority of times since 1980.

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The market's been up 11 outta 14 times. Of those 20, the average length of one of the shutdowns was eight days. They're not generally market sensitive events, but you know, you also may could argue, haven't had one before that coincided with fed tightening or higher for longer thesis. With a UAW Strike.

There are with Chinese economic slowdown weighing on global growth. There's plenty of macro things that could all factor in together here, but I think really what we're dealing with is markets that are having to deal with the reality of the fed's pickle, that they can talk about being higher for longer.

And my thesis is they can't stay higher for longer because of fiscal policy. And that it, the productivity boom is threatened if fiscal policy gets in line with more accommodative monetary budget cuts, tax increases. And if fiscal doesn't go that way, which most certainly is not, then the fed will not have a choice But to Japan apply itself the other way.

And that is therefore the very tricky thing for both bond yields and ultimately equity valuation. That's a lot to chew on. I very much welcome your questions. I've tried to be as clear as I can. There's somewhat complicated topics, but I hope I pulled off what I intended to by simply laying out this this dilemma.

Generally when, I don't know if I pulled it off on podcast or video, I say, well, I think I do better in the written words to try that, but maybe the written word won't help either. There's a few other nuggets there @divindendcafe.com. Please check it out. And we will come back to you next week, either with more elaboration on this topic or moving on to something different.

But I do welcome your questions@thebahnsengroup.com. I wish you a very good weekend, and I thank you as always for listening, reading, watching the Dividend Cafe.