FRIDAY, SEPTEMBER 29, 2023

Well, hello and welcome to this week's Dividend Cafe. I can promise you, this is the first time I've recorded a Dividend Cafe from Moscow, Idaho. But I am in Moscow for just a couple of days where I have a few speaking engagements. I'm seeing some clients have a meeting Saturday morning, and then I'll be back at the Newport beach office all of next week. So in the meantime, I get to record this week's Dividend Cafe from this beautiful town and I am really fond of this week's Dividend Cafe. It's a weird thing for the author to say it's probably sounding different than I intended to because it's not an arrogant thing I do say this every now and then so it isn't like it never happens But there's just some that I really enjoy writing and I enjoy writing all of them, but this week's was one I had a lot of fun writing. It was I think this is a very important message. I think that there's some fun history involved in it. I am an obsessively nostalgic person and there's a lot of modern history in this week's Dividend Cafe, but I think it captures some of the most important investment realities of the last 25 years and highlights a very big fork in the road at which I think we find ourselves now.

What is it I'm referring to? Well, on this actual Friday that this Dividend Cafe is being released, we are literally at September 29th, 2023, the exact 25 year anniversary of a Federal Reserve rate cut that took place September 29th, 1998. You say, why in the world is there an anniversary of a Fed rate cut? But it really isn't about the rate cut. It is what was happening 25 years ago. That is going to be in the history books and I think it'll be in college history books, literal college history books. I don't think it'll be in elementary school history books. And it's already absolutely required understanding and reading in financial markets history.

And what I'm referring to is the implosion of a hedge fund in September 1998 called Long Term Capital Management and there was a bond trader. He was the head of bond trading the arbitrage desk at Solomon Brothers By the name of John Merryweather who started his own fund in 1994 brought on some of the biggest most elite Bond trading and bond arbitrage talent on Wall Street couple Nobel Prize winners. This was the A team and they raised gazillions of dollars and went out and basically were promising highly leveraged returns around a thesis that they felt couldn't go wrong, mispricing of bonds that converged in their relationship to one another over time.

And they were up 60 percent their first year, 40 percent their second, 27 their third, and compounded at something around 40 percent a year. And then in the summer of 1998, things started going really badly. And you say what who cares this is some hedge fund it's been gone for 25 years. Why would it matter?

The reason is that they were making very big returns. They had entered the month of September with 100 to 1 leverage and really, excuse me, 50 to one. It went to a hundred, and then it closed at 250 to one. That is the equity value dropped from 2.7 billion down to 400 million, and yet they had a hundred billion of borrowed money, and that a hundred billion was in a trading book.

And you could blow up those positions, because now. this thing is imploding and you have way more liabilities than assets and some form of panic selling could take place. So there'd be an awful lot of money left lost. There wouldn't be a lot left. There'd be some. And yet what happened was systemic because the amount of the money extended was, where do you think, who do you think had a hundred billion dollars to extend that kind of credit to a hedge fund?

It was your Merrill Lynch's and Lehman Brothers and Morgan Stanley's and Goldman Sachs's and some international banks. It was the big 10 to 12 financial institution players of the globe. And what happened in September 1998 was that the Fed, recognizing this thing could turn systemic, And recognizing that it was getting bad even though Long Term Capital management wasn't yet having to sell they had certainly had to sell some But there were a million copycat players out there who were trying to mimic their pair trades they then forget caught up in what had unwound these trades unwound, this portfolio management, the Russian Ruble Crisis took place in August, you had the stock market drop almost 20%, and less than two months and there was a lot of anxiety in financial markets And bond spreads were moving and trades that weren't supposed to go one way did but did so with a hundred to one leverage effectively.

Well, what really happened was that the Fed got everyone together and this now gets called a bailout, but there wasn't a dollar of Fed money and I say in Dividend Cafe, the written, maybe they bought the coffee and the pastries.

And I've always said this was the first thing ever to be called a bailout because they gave them use of their conference room. 10 years later, it was 2008 and then you had like real monies backing trading books with the Bear Stearns movement to JP Morgan. And you had the Fed significantly involved in what had happened.

And of course, treasury through TARP injecting actual equity You can call those things bailouts. Even then, I think people have never been willing to call it the creditor bond bailout. It really was, but I don't want to get on a tangent. The Fed got all these financial institutions to set up their own syndicate that would basically take over the positions and avoid the inject enough equity.

They 300 million a piece. Some put up 100, 125. One financial firm refused to participate. That was Bear Stearns. So the bank of karma, there you go. All that to say, they put in a certain amount of money that then meant the no panic selling had to happen. And over time, these positions were allowed to roll off, mature, converge.

There were still losses, but the Long Term Capital people wiped out. And then the systemic risk of significant capital losses that could then lead to weakness in the counterparty. All of that leveraged finance contagion risk was contained as all these banks got together, but for a period it really didn't look like it would be.

So what was September 29th in all this? It was the Fed in a period of incredibly strong jobs, wages, consumer spending incomes were rising, corporate profits were very healthy. There had certainly been financial market shock in Russia. Currency, stock market had dropped. I believe it was down at one point from its high in July to its low in October.

It was down about 22 or 23%. And the Fed cut rates three times in six weeks. One in an expected meeting at the beginning, one unexpected meeting at the end that I'm going to get to and a surprise rate cut in the middle. And then the market rallied over 20 percent and the Fed cut rates again in November.

And so apart from what happened in this historical moment of Long Term Capital and the implosion, apart from a sort of anecdotal lesson that I write about a little bit more in the written div cafe. Where you can learn that sometimes leveraged finance means that what other people's doing can affect your marks.

And I think an obvious lesson is therefore don't be overly leveraged, but also when people are having to sell because the marks, the mark to market has gotten too bad, it's always better to be a buyer than a seller. You want them selling to you. You don't want to be selling to them or someone else. And that's what happens all the time is company a has positions, but company B has similar positions and they're having to panic sell, which is then hurting company.

A company thinks they'll be okay and not have to sell. But because company B keeps selling, it's bringing the marks down for company a, and eventually they ended up having to sell rinse and repeat. You follow me? That's a classic case. of leveraged finance that we've been dealing with as a financial system for quite some time.

And that was a very big part of this Long Term Capital failure. But what really, I think, represents this 25 year anniversary is the beginning of the Fed put. The Greenspan put is what my old neighbor, I was in the same building with Paul McCauley at PIMCO when I worked at Morgan Stanley. And I believe Paul McCauley did make the term up.

If someone else wants to claim it, then I'll apologize. But that's always been my understanding. And so over time, you can call it the Greenspan put. And then of course you had Bernanke and we had Yellen and we had Powell, but the Fed put this idea that when things get bad enough and risk assets, the Feds are going to come in and provide some backstop.

And there's a lot of people out there that believe. That the Fed does this and I'm one of them and there's a lot of people out there that believe the Fed does it because they have some sort of a crush on Wall Street or it's some sort of conspiratorial thing. And I will tell you and I've put links in and support and a written div cafe, I think they're all dead wrong.

I think it's one of the worst economic heresies of the last hundred years. But they believe in something sincerely called the wealth effect, whereby they believe that asset prices do not reflect economic conditions, but they create economic conditions. And I fundamentally disagree. I believe asset prices price discovery tells us about conditions and to use asset prices to confuse the chicken or egg in this way leads to all sorts of distortions. But if you believe as a central banker and there's 112 page white paper they bring to the FOMC meeting and fall in ‘98, I've read every word of it. And they say that they believe it added 1 percent to consumer spending in 1997 because of the big move that was going on at the time in the stock market, if you believe that, and then you see the stock market dropping, then you believe you ought to keep it up, otherwise you'll see prices drop, consumer prices drop, which then will lead to decline in wages.

And corporate profits. So the wealth effect became a huge element of monetary philosophy. And we saw it then again, after. com tank, they 6 percent to three and a half percent in like eight months, cut after cut. Then 9/11 happened and they brought it down another 50 percent from three and a half to 1.

75 and then throughout 2002-2003 they brought it down another 75 base points. You got down to 1 percent and then what do you think happened? You had a Fed funds rate that are basically from late 2001 All the way until 2004 been in between one and two percent and you had the housing bubble and there's a lot of other factors with the housing bubble too.

I've talked about that plenty, but the Fed in trying to put a put in on stocks, backstop risk assets, drive higher housing. I think absolutely created one of the great distortions of human history. The Fed put didn't stop after dot com. It didn't stop after housing. We know all the draconian measures that were really dramatic stuff that did took place after financial crisis and the really dramatic stuff that took place after COVID and I give him a pass on that in the sense that I disagree with almost all of it, but that's not really the Fed put, that's a little different category when it was in concert with the treasury and there was significant balance sheet expansion and they were attempting to very purposely reflate The government sector and the corporate sector while they knew that the household sector was deflating so severely again, there's a lot of distortions to get involved there, but it's different than a typical Fed put now Leaving it at zero for seven years.

That's Fed put 101 Janet Yellen saying we're going to raise rates four times in 2016. Then January, the stock market dropped 7 percent and they don't raise rates at all the whole year. J. Powell got the rate all the way up to 2 percent in 2018.

Then credit markets widened 400 basis points. The stock market dropped 19 percent in Q4 and all of a sudden then.

They stop the Fed put has been there So right now I think people say dave this history is interesting 25 years ago. It really started out of the Long Term Capital management implosion and it was a sort of mentality that came out of a genuine ideology of the Of the wealth effect of belief that you needed rising asset prices to create improving economic conditions.

And it was lived out from, for a long time with a lot of different illustrations and different conditions that manifested it. What I mean by this is interest rates are so high policy, so tight, they've removed a trillion dollars off their balance sheet. I have no doubt that's true, but excuse me.

The S&P is trading at over 20 times earnings, so I am not of the opinion that the Fed put has gone away. I'm of the opinion that right now the Fed put has, in their estimation, not been needed. Is that going to change? I don't know. Are there folks in commercial real estate right now that thinks the Fed put should come back in their case?

Of course. But systemically. Right now, credit spreads another 200, another 300 basis points, perhaps it changes. But what got taken to the woodshed since the Fed tightening? We know Bitcoin and crypto, and we know really unprofitable speculative tech. But more or less, we haven't had conditions that would have brought about the Fed put.

And unemployment, and all the other labor conditions, wages, we've talked about all of this stuff. So when people say well, this is different now the Fed no longer wants to coddle risk assets I'm, sorry, you have an S&P at 20 times earnings. Do you think if it dropped 25? Do you think then that the Fed would coddle risk assets?

Maybe they wouldn't I'm asking the question I know my answer is I would say the probability is that the Fed put would be back in a second But I don't know that for sure But do I think that things are that different in the last 18 months versus last 25 years? No, I do not I think the things that got violently hammered in the last 18 months, the Fed couldn't care less about.

Candidly, I couldn't care less about. As we now go into a period of a lack of liquidity, a lack of access to capital, if debt is to begin getting rolled over, I think eventually in commercial real estate they're going to be dealing with a real problem. I happen to think the Fed will reverse course by then.

That is not my opinion based on what I want, what I hope happens, it's just my prediction. And much of my, well, my entire adult investing life professionally has been through a period of the Fed put. That's true. So I'm very open to the unique view that would say, Nope, that puts gone. But I do know this.

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Historically, September 29th, 1998, 25 years ago today, we entered a period where there began a real implementation of monetary policy of utilizing the Fed funds rate to drive the wealth effect and protect the wealth effect as a means to the end of greater economic activity around rising asset prices.

And that we have not really tested that when the overall behavior of asset prices has not become distressed in the level, which a put would normally be used to dot com implosion, the aftermath of 9/11, the Russian ruble crisis concerns, those moments, that would be my view.

That would be the history of it. This would be the paradigm in which we live. And if there's a tension right now, I guess it is on those who wonder. Has 25 years of Fed put gone away and are we now in a new environment is this time different? So you probably you know, I think you understand where I'm going with this A lot of history a lot of information a lot of perspective and I really enjoyed this discussion I hope that you listen the podcast watching the video have got something out of it.

The Reading of Div Cafe this week will be fun if you get a chance to do it. And in the meantime, I hope you have a wonderful weekend and I hope that USC will go into Colorado and beat the Buffaloes. Thanks for listening. Thanks for watching. And thanks for reading the Dividend Cafe.

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