DIVIDEND CAFE | PODCAST TRANSCRIPTION

FRIDAY, OCTOBER 6, 2023

Well, hello and welcome to this week's Dividend Cafe. It has been quite a wild ride in markets, and I wanted to spend just a few minutes with you today to talk about why that has been what's going on and just a few thoughts around it. You know, you look at, I want to set up a little context here to explain the tension that I'm very purposely holding as a wealth advisor.

The Dow closed at the beginning of August at 35,630. When I began writing the Dividend Cafe this morning, it had gone below 33,000. It ended up going from down a few hundred to up a few hundred and we're, as I'm recording right now, that we're up like 250 points on the day. And so, who knows where we'll end up closing on the day. You've already had a five or six-hundred-point swing intraday. But the percentages don't move that much. You're, you're talking about roughly a 2,500 point net drop in the Dow in the last two months, and that's about 7. 5%, but 6 percent of that is in the last three weeks, and all at once, this is a No big deal, status quo, historically far, far, far more common than not.

In fact, kind of muted if the total downside within the year of the market were to only end up being around this level, 6, 7, 8%. It's generally even more. That is all true and warrants some comment. At the same time, after three weeks of a down 6%, NASDAQ even a little bit more vulnerability in the overall economic story; questions about what oil prices and bond yields could do are clearly more than a headline, more than just a little hype.

In fact, it really serves, I think, to highlight how silly some of the things the financial media does to draw hype and clicks and sensationalism around other stories. Because here you're talking about things that are obviously more economically complex have more potential significance.

And it's almost like the media doesn't know what to do with it compared to the normal things that occupy some of the scare tactics and clickbait and whatnot. But I want to unpack exactly why this is happening, what I think it means, and what I think investors can and can't do about it. So no, a three week period of markets down 5 percent or something like that, that shouldn't warrant a Dividend Cafe.

But there are things happening right now that are in our vein of interest when it is so connected to monetary policy. And this macroeconomic focus, when it dovetails into monetary, is kind of my area, of interest. And then it does allow us. To do what we're supposed to be doing with Dividend Cafe, which is provide those behavioral reminders about what is really the best thing for an investor to do and not do in some of these various situations like the one we're in now, and certainly will be in others in the future.

I did say this already in DC Today, last Monday. And, and so I'm repeating it on purpose because sometimes I think just pure redundancy, I try not to do that whole, say something 10, 12, 15 times to get someone to remember it thing. But I think three times is probably enough. And I'm not even good at doing that,

you know, I don't like to hear myself repeat things enough that it makes me keep. myself from repeating things for you, and probably I should be repeating more. But in this case, why are bond yields going higher? Why are bond yields going higher? That's the question. Why is the long end of the bond curve yield curve going higher?

It doesn't make sense to say it's because the Fed funds rate has gone higher. The Fed funds rate has stayed flat for the last two meetings. They have not raised the target, and yet the long end has gone higher and higher. And you could say, well, because expectations are going to keep it higher longer that could play in.

But why are the expectations that they're going to keep it higher longer? That's one of the six reasons. So the six reasons without me getting real elaborate with this right now is number one, I believe the impact of quantitative tightening is really starting to have a big impact it's taking away a marginal buyer of bonds, replacing a non economic buyer, a non yield sensitive buyer with a very economic buyer, a very yield sensitive buyer. Mainly individuals, households, banks, you know, companies that are buying treasuries, regular investors. They want yield. Central banks don't care about yield. A lot of foreign governments don't care about yield.

It's a currency reserve. But when you're talking about regular people, they want higher yield, it's pushed yields higher with the Fed being now a trillion dollars removed from the long end

of the bond curve quantitative tightening, the surprise additions to the budget deficit, repricing the fact that the U.S. has not gone into a recession, in fact the jobs report today, another 336,000 jobs created in the month of September Japan's yield curve changes, having a global impact around global bond yields declining Chinese exports, this is a big deal, less dollars that are being paid to foreign governments that then have to be replaced into treasuries the, thereby taking away, like the quantitative tightening does with the Fed.

Declining Chinese exports leads to less foreign ownership or foreign. purchase of treasury issuance. And then finally the basis trade, which is a more technical thing having to do with the repo market and having to do with hedge funds, getting a little funky between cash market and futures market of treasuries.

Six different things. Primarily, I think it's the repricing about recession and quantitative tightening. Those two things at the top of the list, but there is the rate and then there is the rate and I don't think That we're really dealing with a five and a quarter Fed funds rate. That's the policy rate.

They've left it there. That's what is in our society, the primary benchmark around policies to influence or target monetary conditions. The Fed themselves commissioned the creation of something called the proxy funds rate. It's managed, overseen out of the San Francisco Fed. They put it right up on the website.

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I have a chart in Dividend Cafe today, straight from the Fed. Okay, this is not me interpreting the data, creating the data, or getting all my economic friends together for us to put our theoretical stuff around it. This is their model, and models always can be imperfect, but the point being, their data says that the effective rate, what they call the proxy funds rate, if you were to really see what is the impact into the current Fed funds and, and around economic applications from treasury rates to mortgage rates to bond spreads, credit spreads, and a nber of other factors.

There's 12 variables that go into this all together the proxy funds rate is at 7%. That means you're getting 150 basis points of tightening above the target rate. I am not giving you inside information. I don't think it's talked about a lot. The media would cause their viewers to lose their eyeballs if they tried to get into this, but this is not between David Bahnsen and Dividend Cafe listeners.

The Fed knows this, too. So you have all at once. An ambiguity around the fact that, A, bad, the real monetary tightening is 150 basis points worse than the already severe monetary tightening of 525, 550, the current Fed Funds target. That's the bad. But then the other side is, well, is that 150 basis points spread in the proxy rate doing that tightening for the Fed and actually accelerating the point to which the Fed ends up reversing this period, certainly allowing the rationale for not hiking further. And then eventually allowing the Fed to, to

reverse out of current conditions there, who's supposed to answer that question?

It's not me. It's not them. It's not anyone else. No one knows. But that really is a, a, a, a two headed question right now. That what is the impact of the actual higher monetary tightening than we're really seeing in the Fed Funds rate? This proxy rate delta. of, of tighter monetary conditions that is real life.

What is the difficulty that gets created from that versus what accelerates some form of unexpected future monetary capitulation? I think that has to be on the table in the way we analyze this. I wrote about this in a summer Dividend Cafe. One of the challenges to the Fed, who wanted to create some economic slowdown, as they believe that being part of their anti inflation mandate, was that there was a significant amount of the tightening wasn't really hurting the corporate sector.

There wasn't defaults at any problematic pace. There wasn't a big source of illiquidity. because they more or less had a large maturity wall. The levered loan market, so the bond market, obviously in the residential mortgage market, a lot of people, we've talked about this, had fixed mortgages, or had borrowed at least 5, 7, 10 years at much lower rates.

So that created up until 2024-25, a period where people were still kind of living off of the prior, more accommodative monetary regime. Yet, even without defaults and even with a

lot of credit, without a lot of credit impairment, we're certainly stopping activity of new borrowing at the higher rates.

We've seen this the kind of freeze that's taking place in the residential real estate market. And for new project construction, new project development in commercial real estate, it's pretty much come to a total standstill private credit can do an awful lot of capital project investment, put permanent financing, but does very, very little in terms of brand new ground up development.

So you have a lack of activity in both residential and commercial. And then you have forward looking concern about the default cycle. Does the Fed stay so tight that then you do get massive credit impairment into 24, 25 and, and that train coming at you? The problem with predicting a train coming at you and saying, Look, I think all this stuff's going to happen in a year.

I want, I want to make an action now. is that train could stop tomorrow. That train could go the other way tomorrow. And as I joke in Dividend Cafe, that train could get out and ask you to jump on and give you a first class ticket and some free food and beverage. Okay? There is so many bad things that could happen and so many good things that could happen and it is all rooted in this instability of the monetary and fiscal insanity that has been beget us.

That has begotten us. I'm saying that wrong. I'm not going to correct it. All of this is happening with one of the wild cards I want to throw out there. Oil prices, in addition to bond yields, become not a tradable thing, not a speculative thing, not a short-term thing. I don't care about any of that. Oil prices on speculators, when it goes from 80 to 90 in a month, or when it goes from 90 to 70 in a month, and that stuff is not what I'm referring to.

I'm talking about price levels that go and hold at a place. They have a huge economic impact. And that, you have, if you were to go and hold below 60, you probably are in a recession. And if you were to go and hold below 75 but above 60, you probably have a real sweet environment of benefit to conser, benefit to economic margins, and without indicating some significant demand erosion.

If you were to hold right here around the 80s to 90s, it's more questionable. If you hold above 100. You're, you're very likely going to usher in a significant recession, create massive inflationary pressures, so forth and so on. But I mean, a hold isn't a month, okay? And that's the problem, is right now we have a set of circumstances that makes this utterly impossible.

And I'm befuddled by people, befuddled by people who think they can predict when you have a literal war going on. You have the a country, I'm talking about ours, that has the ability to be the marginal producer of oil that is chosen not to be around cultural pressures. You have a question OPEC Plus,

who is the marginal producer that essentially has grown tired of settling accounts with the marginal buyer that gets to denominate in their currency.

You, you, there are a number of factors, cross currents, that could very well put and hold lasting upward pressure on oil. And yet, any kind of recessionary indications could put lasting pressure downward on oil. And how those things are supposed to be priced in is, is beyond me. So, the un, instability. In bond yields and what to expect, where exactly that train is coming at us about higher yields and where it goes.

Can you have three months, four months, one year very limited new activity in housing or very limited new project development, commercial real estate? Yes, you can. Can it go on for a year and a half, two years? No. At some point, you know, this thing is facing a fork in the road. And I believe that investors who are trying to guess those things, what insanity in fiscal and monetary will come from the other insanity of fiscal and monetary is a fool's errand.

And it's not just that I don't think investors can predict it, I don't think the people in charge of it can predict it. I don't think they have any idea. And, and I believe that the best possible path towards portfolio success with this current regime is to as much as possible be insulated from those moments, recognizing the upside and downside risks that exist.

, that, that bond yields could reverse and totally reprice risk assets. Things could get worse before they get better. But all within a month, you've had utility stocks get hammered. You, you've had the bond, the long end of the bond curve fly higher with yields, pushing bond prices down. So, holders of bonds have gotten hit, but buyers of new bonds now really like the yields.

You get enough of that; it's a self-fulfilling prophecy. We'll start pushing yields down, prices higher, there, there is just simply no way to be able to guess in the coming weeks or months what, where this will shake out. But there is a very profitable, productive, rewarding agnosticism around that which ought, we ought to be agnostic about found in dividend growth.

And I think that with discounting mechanisms like markets, the trains that everyone knows about generally do not run over you. And that is the good news. The bad news is, there are always trains no one sees. And my view is that dividend growth is your ticket to the optimal destination. Thanks for listening, yhanks for watching, thanks for reading the Dividend Cafe. I will be in New York next week, bringing you another Dividend Cafe, and I look forward to whatever questions you may have from this episode. Take care and have a wonderful weekend.

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