FRIDAY, OCTOBER 27, 2023

Well, hello and welcome to this week's Dividend Cafe. We are getting very close to the end of the month of October. We actually have a couple of market days left in October next week, but in the meantime, my team is fresh off of our annual retreat. The entire company, all seven offices of people embarked upon Newport Beach, California the last couple of days. I, myself, am heading back to New York City. And in the meantime, I wanted to devote today's time in the Dividend Cafe to the luncheon I attended last week with Fed Chair Jerome Powell. There were some takeaways and an overall I guess both the basic premises from which he's operating and some of the conclusions that he shared, how that might affect our thinking. I thought the whole A to Z of his talk was worth recapping and building a Dividend Cafe around. I want to start by saying that the food was terrible and that the people who stormed the stage caused security to have to rush the Fed chair out to the back stage and get him out of harm's way while they did their whole little spiel, forcing, a whole bunch of police and guns and security and everything that I don't think that they got a lot done. I thought it was maybe a little ineffective for their cause but nevertheless. It was an experience to be there witnessing it from not all too far away and more than a nuisance to anything else. So if you did catch that on the news it was most certainly true. There's a picture of the whole thing in the Dividend Cafe today.

But yes, myself and Brian Szytel and Kenny Molina, our collaborative investment committee here at the Bahnsen Group, we were all there in person watching the drama. Fed

Chair Powell's an interesting person. I should point out that he's one of the first and only Fed Chairs we've ever had with capital markets experience. He worked at the private equity behemoth, Carlyle, for quite some time. And he was on the Federal Reserve Board At the, in the Federal Open Market Committee in 2012, at the time Chairman the Fed Chair was Ben Bernanke and he had proposed the idea of a third round of quantitative easing, but one that was going to just be substantially larger than both the first and second round put together ended up being over 2 trillion that the Fed added to the balance sheet. It was a little more controversial at the time because this was being proposed three and a half years after the financial crisis had ended. And it would last another two years, the quantitative easing, this additional bond purchases that the Fed was continually doing with money that didn't exist.

It would keep going all the way till October of 2014. So. At the time, Chairman Powell voiced concerns about it and particularly around the exit. What would it look like? How do we undo this when it's time to undo it? And I think it's prescient because even though he clearly reversed and he became a big fan of QE, both then and of course later when he was Fed Chair himself at the time of COVID and he added 5 trillion to the balance sheet himself.

But he is most certainly living through this right now, the very thing he predicted, the challenges of undoing quantitative easing and really more abstractly, the challenges of undoing experimentation of saying that you would. Don't know how something will end, but you feel comfortable going forward.

It's not necessarily how we used to do monetary policy. And the fact that along the way, we like some of the benefits and along the way, some of the short term risks don't materialize. I think people need to be humble enough to admit that's true. Quantitative easing's risks did not materialize in the short term the way some predicted.

And that a lot of things did get better, whether or not QE helped it or not is somewhat non falsifiable, but I will say this, they haven't got off it. And I believe a lot of what we're dealing with now is related to the attempt to get off it, that there seems to be a certain cushion for pain. And then when that gets exhausted it's an unknown.

And that I think is what Powell was talking about himself 11 years ago. So in terms of his talk last week he started off referring, getting into just kind of macroeconomic growth, which I thought was very interesting. He predicted that GDP growth going forward, that we are more comfortable modeling 2 percent real GDP growth.

And you could say, well that's pretty optimistic because we've only been getting 1.6 real GDP growth since the financial crisis. So that's true, he is taking an era when we had 10 trillion of debt as an overhang and now in an era of 25 and 30 and 35 trillion as we go forward assuming a slightly even better rate of growth and yet I was taken by the other side of it, which is it's the first time I've heard someone admit, yeah, we're stuck in 33 percent lower growth environment.

We've grown at 3.1% from the World War II to the Great Financial Crisis. And he is basically conceding that those days aren't coming back. And so the he got into their assessment of hours, worked of productivity. They model this. It's very imperfect. And of course the actual trend line itself is imperfect because the trend line only becomes a trend line through time that, that even when it is a trend line, there was ups and downs on the way, obviously.

I think that what is more interesting than just his prediction about real GDP growth is that he does seem very pleased with the fact that the economy has not revolted against the monetary tightening they've done. And there is the kind of almost cliche at this point reality that Milton Friedman himself predicted that there are various long lags that might exist between the actions they take and it being felt.

But what I am a little confused by is that if they're pleased that they've achieved a fair amount of monetary tightening. They see it in financial conditions. They see really severe disinflation and yet, wouldn't be content to stop that course before it ends up having this economic impact that they're so far happy it hasn't had it, I'm unable to tell you if they are going, if they're insisting on doubling down until they do the pain. Or if they just simply hope that they can get away with pain free tightening a little bit more. We'll talk more about that in the end. When you look back to what Chairman Powell did during 2018, he was trying to tighten the balance sheet and do quantitative tightening at the same time that he was trying to do what his predecessor, Chairwoman Janet Yellen, who's now our Treasury Secretary, would not do. And that is get us off the zero bound, raise interest rates a little bit, for the purpose of normalizing monetary policy. And I think what Powell found out is he was able to get away with doing both at the same time until he wasn't. You add in President Trump's trade war at the time and the markets revolted, credit spreads widened, and not just widened, but frankly, the credit markets seized up. And as we all know, in early 2019, Chairman Powell chickened out entirely. So as we think about the Chair Powell who went through that, trying to normalize in 2018, capitulating in early 2019, throwing a Bernanke bazooka on steroids at the COVID problem in 2020 and then staying hyper easy in monetary policy for two full years all the way to spring summer of 2022 and then now tightening beyond what anybody expected. It's really hard to extract an ideological Identity from Chairman Powell. He's been all over the map a little bit. And I think his talk, one of the things I want to tell you, and I don't actually write about this, I probably should have in the written Dividend Cafe, but while it's on my mind, I'll share with those of you watching the video, listening to the podcast.

I firmly believe that he's a very earnest and sincere person. And where I have areas of disagreement those areas of disagreement have nothing to do with my beliefs about his own sincerity and intentions, I firmly believe that they believe they're doing the right thing. And I believe a lot of my concern is not with him, but with the fatal conceit of thinking that you can do this to begin with, that you can manage the cost of capital in an interventionist, and this non pejoratively, but in a manipulative way.

As if you have the knowledge and ability to see everything that's actually happening in the economy. You can do this better than prices clearing on their own. I just simply don't believe it. But I do believe that Chairman Powell sees a need. to administer monetary policy in line with their legal dual mandates.

And I believe he thinks he's going to work every day trying to do that. And I appreciate that earnestness, that sincerity. It was interesting to hear him talk about the Phillips Curve, which is something I'm extremely critical of. I don't believe that this relationship between low unemployment and high inflation exists.

And he talked about the Phillips Curve as being a model that was really accurate in the 1970s, which I don't think it was, and that the model didn't work at all in the next few decades and that now the model seems to be working again. And I guess I would ask you if you guys created a Microsoft Excel spreadsheet and it gave you numbers that worked in some decades and gave you numbers that didn't work in other decades, what would you think about the spreadsheet? Would you think maybe the model was not totally accurate? Some inputs were off or it wasn't, it didn't quite have the you maybe don't owe that spreadsheet a rigid loyalty, okay? I do not agree that the Phillips curve right now is working, and it's indicative of a low unemployment, creating high inflation. I think we've had significantly lower than normal unemployment with lower than normal inflation for a long period of time, and then when we had higher inflation it was completely supply oriented.

And in fact, the unemployment number got better. And now, of course, we see inflation coming substantially lower, even as unemployment has lowered itself. I don't think the Phillips Curve model is working. And I think that what I heard from Chairman Powell was that he doesn't really believe in it much either.

And so he's acting like, well, it is working now, it worked before, but yeah, it didn't work for a long time. That doesn't sound to me like a Phillips Curver theologian, okay? And so if they really are making decisions off the Phillips Curve, I think it's incredibly unfortunate. And if they're pretending to that's a little different.

I think that's unfortunate too, but I would take that over really doing it. There was a lot of talk about whether or not the Fed owed a Mia culpa from what they did during COVID. Did they implement too much monetary policy and now we know it was not necessary. And there's a hangover effect.

And I think Powell's view is they did what they believed was the right thing at the time, but that, yeah, only with the gift of hindsight, you could conclude that perhaps in the margin, there was more monetary policy interventions than were necessary. I think that's a red herring because I'm not so much interested in Monday morning quarterbacking what they did in March of 2020 and what they knew at the time and what things were like at the time I'm interested.

And how long they stayed there, to the degree they stayed there, a zero percent interest rate for two calendar years. Five trillion, a quantitative easing, continuing to buy, to be buying that massive tens of billions of dollars per month of treasury bonds all the way up until mid 2022. I think that's really the issue that probably warrants Fed criticism as opposed to what they did right in the heat of the moment in the spring of 2020.

The long end of the curve is really the whole issue right now. I like the way I've presented it, that you basically have a buyer problem. Currency driven who are rate agnostic buyers are not really the market makers, that's China, Japan. And those that are actually buying for the purpose of lowering yields.

The Fed, they're not the key buyer and so that leaves you with buyers that are yield focused and that ends up creating higher demand as yields can move higher and that's investors and banks and mutual funds and people like us. But I, another way to say a similar thing, and my friend Louis Gave wrote a piece about this week.

Is that there's a forced seller in the market and we're used to thinking of a forced seller as a hedge fund is blowing up or an overlevered investor but, or a liquidity crisis that it's none of that. It's that the Fed has told you we're reducing our holdings by 80 billion a month. It's a trillion dollars a year.

And so it has enabled. Upward pressure on prices because there are buyers who know that there is a forced seller and they can stop being they're not forced in the sense of they have to do it, but they have announced they're doing it, and therefore people may as well push yields higher, and that's what has been happening.

I think that you will see a that this reversal of this when and if and when they, they reverse QT the quantitative tightening, but his conversation about the long end of the curve was fascinating to me. He doesn't think that there's a lot of defection from foreign buyers and they have that data points as clearly as we do, probably more so.

But he just is really astute about the fact that this is the term premium going higher. Like I mentioned, he knows capital markets. Bonds and stocks are non correlated and bonds have always served as a hedge against stocks. And they are so incredibly correlated right now, as opposed to their historical non correlation.

The bonds are not working as a hedge for stocks, which is causing the term premium to increase. When you get a supply shock, you don't have bonds to rally and yields to drop while stocks go the other way. They're very correlated together. And yet it isn't inflation expectations. And we get to measure this, as I've talked about before, with tip spreads.

That you have 100 basis points of increased yield in the 10 year this year, and only 17 basis points increased in inflation expectations. That means it's real yields that are increasing. And one either believes that's pricing in Years and years ahead of greater economic growth, or it has to do with the factors we've been talking about and to hear pal talk about it.

It was extremely clear to me that he understands as well. So on the practical side of things, he essentially didn't really get into China's weakening economic growth. I was surprised he didn't. If China's going to have two to 3 percent come off of their GDP, then global bond yields are going to come down. And he didn't get into anything to do with China's economic health. He mentioned the regional banks. They think that the regulators are watching with his concentration risk. He doesn't believe there's a broad or systemic. He used the word broad problem with commercial real estate at regional banks.

He knows the home builders are in trouble. I don't know what they can really do about that, but there's sort of collateral damage in this, and he talked about just small companies overall being kind of collateral damage, that small businesses suffer from rising cost of capital a lot more than big businesses do. They know that, but I don't, I didn't get the impression he was drawing a particular conclusion from that. The final thing I'll leave you with just in terms of various takeaways was I definitely got the impression he's at odds with his vice chair of supervision at the Fed, who's really looking to tighten capital standards for the big banks, force them to hold more regulatory capital and hearing pal say our banks are so well capitalized, they're so well capitalized.

And then when he was pushed on this issue well, why are you guys trying to get them to hold more capital then? Saying, well, that's out for comment right now, that's in a review period. So, yeah, I got the impression he doesn't think it should happen. And that could be interesting. So, very simply put, you're really dealing with a kind of almost binary, I don't...

I don't think most things in finance and I don't think most things in life are usually binary. There's usually more nuance and optionality around things. But more or less, and I'll read it to you the way I wrote it in Dividend Cafe. The Fed has all but told you they're not going to raise rates again, but they have also postured themselves as being prepared to stay high, tight, for a long time.

It is, it has not blown out bond spreads yet. It has not impaired jobs yet. It has not impaired real GDP growth yet. The Fed is right about all that. But the question is really simple. Will they be content to take the victories, or will they hold on to a point of destroying them? Powell didn't give us the answer last week.

And that is really, I think, what most people in financial markets are waiting to see. Is the Fed determined to let another boom cycle they created create another bust cycle? I'm going to leave it there. I do appreciate you listening to Dividend Cafe. I sure hope you'll subscribe. And if you're listening to the podcast, put it into your feed. If you'll write us a review of this episode, it helps quite a bit. Thumbs up on YouTube, all that kind of stuff. Those things help drive our traffic. Thanks for listening, thanks for watching, thanks for reading The Dividend Cafe. I'll see you next week from New York City.
