DIVIDEND CAFE | PODCAST TRANSCRIPTION

FRIDAY, NOVEMBER 10, 2023

Well, hello and welcome to this week's Dividend Cafe.

I am David Bahnsen. I am sitting at my desk in New York because our studios had a mechanical failure. I think we had one of these with DC Today one other time, but it's kind of a rare deal. And yet we sort of have to get to the recording and I don't really think most of you care where I'm sitting while I do it. So we are recording in a slightly different backdrop and yet nonetheless recording all the same with, I think a really interesting message for you this week. One of the issues, one of the phrases, the sayings that is so commonly used in my business and for the investing community is this time it's different and saying it as a sort of pejorative, like mockery.

t comes from Sir John Templeton in 1933 in a letter he wrote to investors saying that this time it's different could be the foremost expensive words in investing. And it refers to a concept that I talk about all the time. The most common way that people in financial services in the field of wealth management use it is to reiterate to people that are tempted to panic when the stock market's down that the stock market will come back and whether it's in one month or three months or three years, that long term this time is not different, markets tend to recover.

Now there's a lot more wisdom in the expression than just that, but I think most people have a simplistic, appropriate reductionist view that just simply says, this time is different is a way of reinforcing buy and hold.

That's fair enough, but there's so much more that can go into it. And yet there's also a need, I think, even for Templeton disciples like myself who agree completely with him that this time it's different are four very expensive words in investing, there is not a belief that nothing ever changes. There is not a belief that pivots are not necessary sometimes. The difference is the thing that screams out for wisdom is being able to unpack what things are different versus those things that don't change.

I hope listeners of the Dividend Cafe and readers of the Dividend Cafe understand that I don't believe eternal principles change. And one of the ways you can confirm that is I just used the word eternal. Okay, so this is a tautology that timeless principles do not change through time.

But the challenge in saying something like that is being able to differentiate what is a timeless principle versus what is descriptive of a cycle. Like right now interest rates are low is not the same thing as saying interest rates will always be low or what have you. I could come up with any number of examples.

And so there is a really important need for people engaged in applied economics which is my life's work to have principles, to defend them and to seek to know the difference between permanent principles and matters that do adjust or change. And in that case, are subject to a principle that hasn't changed having an application of the principle that might change. And so I'm gonna get into some of those things. There's one particular that I sort of wrote about a little last week around long bond yields that we're gonna use as a good example. But it speaks to where we are right now. There's a number of things going on in the world that some can say, okay, well, this time it's different. And I wanna walk through those things and see is it different or not. And I think you're gonna be surprised at the responses. And it's not because everything I'm gonna say today is that 100% of all circumstances are going back to the way they once were here or here or whatnot. There's all kinds of change, but there is a permanence in change. That is itself a reality of the world. It's a reality of nature. It's a reality of creation, if I may.

And out of the permanence and change, investors have a lot of work to do. And most particularly fiduciary investment managers that are tasked with doing that work on behalf of the investing public. And so let's get into it and figure out where this time is not different, where maybe some things might be. I mentioned bond yields. We talked about in Divening Cafe last week, how to think about the long bond yield. And I do believe that essentially, the long bond is just almost sort of as a mathematical construct, a combination of the risk-free rate and expectations for nominal GDP growth. And there's cyclicality around that, and there's volatility around it, and there's tracking error around it. But more or less, that's what the sum of parts will be. And yet, unpacking the sum of parts, instead of saying risk-free plus nominal GDP, saying risk-free plus inflation expectation plus real GDP growth, even though those latter two equal nominal GDP, it's a different way of saying it because the composition of nominal GDP between inflation and real growth is important. It being four and one or one and four makes a big difference in how we think about the economic cycle.

But let me give you an example of something that would not count as a timeless principle. From 2008 to 2022, we were in a zero interest rate environment with like five minutes where it got all the way up to one and a half percent. You know, I mean, literally 14.4 out of 15 years, you were at the zero bound.

Now, was that different? Like we always had these higher rates, and now it's different. And then now that interest rates are back up at 5%, is this time different? Well, those are most certainly true descriptively, but see, there was never anything that said rates were gonna permanently be above five or permanently be below one.

There was a cyclicality that was a long-term era of a certain thing with rates, but what was driving those things were the same. It's just the things, the application of those drivers changed.

So when there were higher inflation expectations, you had higher rates in the 70s. When there were higher growth expectations in the 80s and 90s, you had higher rates. When there were lower growth and lower inflation expectations post GFC, you had lower rates. And when the zero bound saw the Fed get out of the way, inflation expectations move, and now we sit here wondering where growth goes, but the risk-free rate has moved so much, you have higher rates. The principles never changed. I talked about like four different set of circumstances in the last 25, 30 years.

The principles were the same in all of them, but the application as the math was filled in as those variables took hold led to a different result.

Are we in a period of higher for longer? Well, I answered that question last week by saying that we have right now a higher long bond that is not holding a lot of high inflation expectation in its term premium.

So if investors are gonna demand a higher term premium to give 10-year money versus three-month money, then it's very likely going to have to be because they expect higher growth. And I'm not really in that camp. If you expect nominal GDP growth of five to 6%, you're very likely gonna get a little bit higher bond yields. And that would be a good thing because you're getting higher nominal GDP growth. If you think you're gonna get nominal GDP growth of three to 4%, inflation of one to two and real GDP of one to two, I think bond yields are going lower. But my point being that what people get out of inflation and out of growth can be right or wrong compared to their expectation, but what has not changed is how the bond yield takes hold. The thing that's in front of us now though is that risk-free rate.

That's what's holding the rate up higher. And then when the Fed drops the risk-free rate, what will the term premium do? I don't know the answer.

I believe that there'll be downward pressure on inflation and growth expectations and therefore downward expectations of bond yields. But that part is in the timeless principle. That's a projection.

That's a view, an opinion out of interpretation of data and outlook. But the principle is the ingredients, what those ingredients end up being will depend on certain circumstances.

So this time is not different. Bond rates are gonna still be made up of a general formula. It's just what those inputs end up being.

That's really the arrow we're in right now. Now, one of the other things, I almost spent a lot of time on this one is I did a whole dividend cafe near the end of September, celebrating, recognizing, remembering, whatever is the appropriate verb, celebrating the 25 year anniversary of long-term capital management.

And where I believe in the fall of 1998, the Fed put was born. It was called the Greenspan put at the time. But the notion that the Fed has more or less been there to kind of provide a backstop at certain levels of pain for risk assets, primarily real estate and the stock market, to a lesser degree credit, maybe more esoteric asset classes like commercial, mortgage-backed, levered loans, there is a sense in which some of those things are true that the Fed has been there to backstop a number of these risk assets. Is the Fed put going away? My view is very clear.

I don't believe so.

All we know about Chairman Powell so far are three kind of experiences. One was at the end of 2018. The second was the COVID moment. The third has been these last 18 months. And a lot of people are looking at the last 18 months saying, "This guy is a cowboy. The Fed put is gone. He doesn't care at all about risk assets. He is here to tighten." And then they call him the new Volcker and all this other stuff. It would be comical if it wasn't so odd. I don't even think, it's not just like, "You think it's wrong." It's just very odd.

The first event was when the stock market dropped 20% in less than three months, 19.8% in the fall of 2018. And credit spreads blew out over 500 basis points. General Electric Commercial Paper was not really trading. And Chairman Powell not only stopped raising rates and stopped quantitative tightening, he reversed and was cutting rates and going back to quantitative easing early in 2019.

So there was an extraordinary use of the Fed put there. But then there was basically the mother of all Fed puts in the COVID moment, even more than GFC in the sense that the quantitative easing was $5 trillion.

Even in the GFC, it was only 4 trillion. Now in fairness, the economy was a lot smaller than. So actually, relative to GDP, the QE bomb of Bernanke was bigger than the QE bomb of Powell. But the absolute size of the quantitative easing bomb, 5 trillion was bigger under Powell.

And it's true, he cut rates to zero for two years where the post GFC, they kept them there for seven years, which was one of the mistakes I had made in believing that they'd hold rates longer at the zero bound because of what I learned out of the financial crisis. There were different circumstances that were unforeseeable that changed that. But also the alphabet soup of things he did with facility creation, with the Fed getting incredibly creative with use of emergency special circumstances to provide backstops to municipal bonds, to high yield corporate bonds, to mortgage backed structured credit, all kinds of things. I mean, that was the Fed put at like basically the second or first most aggressive level ever. And then now there's this third era where yeah, it's no question Powell has been tighter, higher, longer than anybody, including David Bahnsen expected.

However, the counterfactual hasn't been there. If my view is he'll go tight, but once markets panic him, he'll go the other way, the Fed put, I don't believe what happened last year counts even in Iota. I think that the bulk of the stuff that got hammered was shiny object froth. And then the kind of just regular broad markets, 20% in the S&P, which by the way, came pretty much right back in 2023. That's not enough to trigger a Fed put. The Fed, the S&P is kind of flat. It's trading at 20 times earnings. It might've gotten as low one point at 18 and a half. It never even came down to its median average evaluation. It never even got close to it. So why have a Fed put at 19 times earnings? It's just absurd.

Do I think if the S&P is trading at 14 times earnings and was down another 25%, then you'd see a Fed put? Yeah, I do.

So is it different? Well, I don't think so. But does anyone know that it is different? Absolutely not. It hasn't happened. And is the empirical evidence more likely than not that it is still there? I would say so.

Another thing right now, people are saying is very different. I think they're right about it is different. And that is something that is different from the way it's been the last 30 years. And the way it had been the last 30 years was different from the way it had been before that. And it has to do with the globalized nature of the world economy. A lot of it has to do just simply with China's emergence as an economic superpower. The West's extraordinary enthusiasm to buy stuff cheaper for China. Greater economic efficiency is created out of the lower cost structure of using Chinese manufacturing.

So there was a lot of globalization, not just in manufacturing and production, but in trade.

And explosively higher amount of total trade imports and exports. And so that dynamic of globalization that was such a significant force in the 90s and in the first part of the 2000s, the first decade of 2000s. And then now as you look at some point in 2015, 2016, was there a kind of populist and nationalist movement in the United States culturally, politically, economically in Europe that leads one to believe that this stuff was being looked at with skeptical eyes. And then out of the COVID moment, did that skepticism move into actionability where concerns about semiconductor manufacturing, concerns about national security, concerns about global supply chains, that all of a sudden focus move to reshoring, to onshoring, to nearshoring, friendshoring, an adjustment in the way that the global supply chains work. I think we're living in an alteration of the last 30 years. Now, I don't know if it's gonna move the knob from 98.6 degrees to 96 degrees, or if it's gonna move it down into 60 degree temperatures.

I don't know if it's gonna happen over six months to a year, or if it's gonna happen over six years to 10 years. I find it very unlikely that any of this happens without pain, and I find it unlikely that any of this happens without opportunity, both.

But do I think that there is a greater form of nationalism than globalism now versus the 30 year era that began in the early 90s? Of course I do. Now, is that the biggest question to me? What's gonna happen when we nearshore or reshore? Is there gonna be a CapEx explosion? Is there gonna be a really significant higher cost to doing this versus, I mean, why did we do it to begin with? It cost less. So by undoing, it is gonna cost more. I think all those things are out there. I may have just said over the last 45 seconds, my second, third, and fourth biggest questions around a lot of this. But my first is are we going to build a bunch of factories, prepare new widget manufacturing, get ready to generate orders out of the United States, and not have anyone show up to work? That's the biggest question. So yeah, there is something different afoot. The principles didn't change, but the cyclicality of nature of global trade and manufacturing and productivity has changed a lot. And now it might be changing to something different. And there's questions and ambiguity and uncertainty around what those changes look like. And some of them pertain upside risks and some pertain downside risks. And one of the big cultural questions for me is whether or not we are in a position to meet the labor demand that such a paradigm shift would entail.

So I need to move along through this a little more quickly.

Peace in our lifetimes has this gone away? Was there a peace dividend that came for investors after the Cold War ended and the Berlin Wall fell? And so this is sort of like at the point at the beginning of my adult life in the late 1980s, did I sort of graduate high school into this period where all of a sudden we had a very safe world for the last 30 years of my adult life and now we have an unsafe world?

My God, is that ever a stupid idea? Inexplicably stupid.

One major global threat that was in existence throughout the childhoods and young adult lives of baby boomers, the Cold War did drastically change at the late 80s, early 90s. The fall of the Soviet empire and the fall of the Berlin Wall and a reshaping of Eastern Europe block and a largely global rejection of a communist block.

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Major change in the international order, a major change for the better from my vantage point and any of you that are also anti-communist. For those who are not, please accept my apology.

The idea that at the point of the fall of the Cold War ending that the world became a totally safe place is untrue. And it's untrue because of a better understanding of human nature. I wrote about this, I think about a month ago, maybe three weeks ago in Dividend Cafe after the horrific Hamas attack on Israel. But the 9-11 moment, the Arab Spring, the decade later, the issues that with ISIS, the issues that were almost explosive with Syria, civil war, all sorts of different conflicts in Africa, South America, the Russian movement on Crimea 10 years ago.

And then, okay, yes, now in the last 18 months, the Russian invasion of Ukraine and the Hamas invasion of Israel, these are two new escalations that are horrific in their own right. But they do not represent at this time it's different. They represent at this time it's the same. We have not had something like a peace dividend ever. Now on a relative basis, is the world safer when we're not in World War II than when we are? Of course, but has there been the threat of various geopolitical, military, foreign entanglements throughout investing history? There most certainly has, and there is now. And when one of these things gets cleared up a bit, another one will come up. That is something unfortunate, I believe, will last until kingdom come.

And so this time is not different.

Same as it ever was. So banks, there's some differences in how banks played out. I think they have less earning power if you're a regional bank. I think some of the larger banks, the largest one in America is exponentially larger than it was 15 years ago, not smaller. Dodd-Frank didn't make the too big to fail banks smaller. It made them bigger.

Regulation has been a subsidy for big banks, a problem for regionals. So these things are true all at once. Some banks have benefited in the moment, but you had a big period higher in the last 10 years for regional banks, and it gave most of that back. It's kind of flat over the last 10 years, and it gave a lot of that back as the Fed began tightening 18 months ago, and a couple of large regional banks failed. Do I expect that the way in which credit is extended in our economy will look the same the next 10 years as the last? I don't. I think you will. I write about this all the time. I think it's a new macro theme, that there will be different ways in which credit is extended into the free economy, and that could be a loss for some areas of investing. It could be a benefit to others, but it is part of our view. What else has changed? We'll bring up artificial intelligence. I'm gonna dedicate next week's dividend cafe to talking more about it all. Do I think that artificial intelligence is a game changer, or do I think it's gonna create a bubble that a lot of people just lose tons of money on? My answer to both questions is yes. Obviously, I think there will be technological advantages that will change the way certain things get done and executed and administered. There will be certain efficiencies. There will be certain problems. There will be jobs lost. There'll be jobs created. It's faster moving than the Industrial Revolution. The whole Digital Revolution has moved very fast. There's a whole lot about the world throughout the Industrial Revolution that has not changed. I think teenagers looking at their stupid Instagram reels is different in terms of the specific cultural fad of it, but the fact that teenagers are doing something stupid was the same before, television, radio, internet, social media, that's all the same thing in the end, teenagers are teenagers. So again, there's a permanence and change.

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This isn't that complicated. Artificial intelligence is a technological innovation. I'm gonna write about more next week. And investors buying into bubbles is a permanent thing I'm gonna talk about next week. But do I think the entire world is changing always and forever as a result of it, that this time it's different? I do not. So that there are lines to rub, my friends. There are just various things that you have to accept attention around. That there are principles that don't change and applications that do, and that creates attention. It creates a challenge. It also creates a wonderful opportunity.

One of my favorite things in the world is that opportunity to navigate within these beautiful global macro markets that God has created as venues for human flourishing and to try to utilize these things to achieve genuine financial solutions in our ongoing objective of cultural stewardship, economic growth, producing goods and services that enhance quality of life. This is a fun thing. It's a good thing. And this time is not different. Thanks for listening. Thanks for watching. Thank you for reading the Dividend Cafe. Please rate this episode. Please subscribe.

And if you're listening on our podcast, we would love for you to put it into your player feed. And in the meantime, I look forward to being back with you next week in the Dividend Cafe. I think next Friday, I will be recording from California. All right, thanks so much. Take care.

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