FRIDAY, DECEMBER 8, 2023

Well hello and welcome to another Dividend Cafe. We have made it to the end of the week. And really, I think so far, people have to be kind of happy how things are going in December. The big monstrous rally in November has not continued, but things haven't fallen off. They're kind of all hanging in there. Market's not responding to different news much. And I personally would love it if we had a very boring December to end the rest of the month. But sometimes I don't always get what I want this time of year. I will say that this week's Dividend Cafe is a tiny bit different than the way I've been doing it for some time. And I kind of set this whole thing up in the dividendcafe.com. You know, historically, I would write every week, throughout the week, on just different things that would come up. I would read an economic bulletin and add some commentary. And then when all was said and done by Friday, you'd have kind of this whole potpourri of various subjects always related to the market or the economy or whatnot. I did that as this weekly email distribution for many, many years back at Morgan Stanley. And then we started it under the brand of Dividend Cafe, but continued that same kind of methodology of how we created it. It was just sort of various multi-subject contributions, largely written throughout the week and then whatever was needed to complete it all, written usually Friday mornings. And I think it's been two years, but it could even be three years. I honestly don't remember now that I switched to more or less a single topic approach to the Dividend Cafe every week. So one particular week I may say I'm inspired to write about monetary policy this week or about oil or about the history of geopolitical risk. There's all these different topics and they're generally something that might inspire me to pick that topic, but that's kind of what we've done. And I think people like it better that way. I will say just candidly that our readership has certainly exploded since I began doing it that way versus the other. So it just kind of works and it also keeps me really focused on a given topic. And plus we're doing DC Today every Monday through Thursday and that's always inherently covering a lot of different topics.

And so this, the one caveat by the way for those who are going to email and say, "Hey, what about those Q&A ones?" You are right that I think we've done it three times this year. It's either been two or three times. But yeah, I would like to keep that going about once a quarter where we end up getting kind of an excess of Ask David questions that have come in and the DC Today can only tackle one of them a day. Every now and then we might do two. But if we get an excess of 8 to 10 to 12 of these, we'll put them on to one Dividend Cafe and cover it all that way. But as far as my own writing, I generally sit down and write the Dividend Cafe all at once. And both mentally for me as the writer and then I think hopefully your reader experience, it comes off as something more cohesive and certainly it's a singular subject that I think is a little more organized and has that clarity. Well all that to say this week, I'm doing it different, kind of more old school, but not like 12 different topics or eight different topics. But three kind of major things that didn't warrant an entire Dividend Cafe, but all three I wanted to address. And so we just kind of thought we'd go back a little more old school.

And the first of those is this subject right now about the market valuations and how valuations work for risk assets in the context of bond yields. Now this is something I wrote Dividend Cafe about last year using an analogy of a lemonade stand, but to really unpack something that's the most important thing for any basic investment knowledge that all an investment price is in the present tense is essentially what one is projecting about future cash flows and then discounting that into the present.

And to discount it, you have to use what's called a discount rate or a risk free rate. Some cost of capital, you can call it a hurdle rate. All these things are synonymous with their capturing what you want to value.

The sum of these earnings at like you can't just say 10 plus 10 plus 10. I'm going to get $10 for four years in a row. So it's worth $40 because there is some value to being disconnected from that money. And there is a level you'd want to achieve just for the inconvenience, just for the risk, just for the illiquidity. There's some cost to being separated from your money. And so we use the risk free rate as the basic level. Like, hey, if I didn't do this and I just sat there doing nothing, I'm going to get 1%. I'm going to get 4%, whatever it is. By attaching that in the way we value and discount future cash flows to a net present value, the higher that rate, then the lower the valuation may be. And the lower that rate, the higher the valuation. Okay, this part's all very basic and I hope you follow that. It's okay if you don't, but it's kind of like ABCs for professional investment management, but it's also, frankly, I think a concept that most laymen can understand in terms of thinking about investment markets. Now, obviously it gets a lot more complicated because people have to project what future cash flows are going to be. That's not exactly easy to do. And the things that dictate what future cash flows will be are often going to require some conjecture of an assumption about how a technology is going to perform or what a consumer appetite is going to be. There's all, or not to mention macroeconomic circumstances. But the one variable that we also don't know how it'll play out, but we do know that it is a key factor, is the discount rate. In other words, interest rates. And so bond yields become a big part of that. So I've talked a lot lately about how clearly equity valuations have been higher as the ten-year bond yields come down over the last, I think it's about six weeks now.

And when the Fed funds rate goes down, the markets are projecting in futures market terms, that that will start happening in the spring of next year.

There's conjecture that, hey, will equity valuations be able to go higher because the Fed funds rate came lower.

And I think it's entirely possible.

And you can point historical charts and say, look, the market was valued here, rates went higher and the valuation came to here, but then rates went lower and it came back up to here. And those historical precedents are all true. They're all pretty consistent in their messaging, the lesson you can extract. However, the actual numbers, generally, if the market average valuation is when something in between 16, 17 times earnings, generally declining rates have pushed valuations above that median, excuse me, that mean, that average. And then when rates have gone higher, it's pushed it lower. So it may be 12, 13, 14, no problem. This is the difference though.

In 2022, markets dropped as valuations went, not from 16 to 12, but from 22 to 19. This year, the market was up a bit as valuations went from about 19 back to 2021, particularly with five, six, seven big companies. So if interest rates were to drop, let's say the Fed funds rate were to go from 5% to 2% to 4% to 3%. Do we believe the market multiple starting off at 19 or 20 is going to go to 22, 23?

Historically, it might've gone up a couple points from where it was when bond yields dropped, when the discount rate, the risk-free rate, the Fed funds rate dropped, but it was doing so from a lower starting point. So the ahistorical possibility of floating is not theoretical because half of it's already the case. It's ahistorical that in a time of the Fed funds rate going from zero to five, the market valuation stuck at around 19.

Therefore, can I say with certainty that market valuations will go up when rates go down in the future, when they didn't cooperate on the first half of the historical analogy? I'm not saying they won't. And in fact, I read a research paper this week from my friends at GovCal Research that I thought was quite intuitive around the history of PE ratios with oil prices. They think oil prices are a bigger factor than bond yields, being able to see where valuations might go. But just like bond yields, I would argue that what that paper was missing is it isn't enough to look at historical correlations between oil prices and market valuations, or bond yields and market valuations. You have to look at the reasoning behind why interest rates did what they did or why oil prices did what they did. And some form of geopolitical tension that pushes oil prices higher could very well push equity valuations lower. Some form of oil prices higher that's just inflationary and representing a higher input cost throughout the economy and therefore pushes equity valuations lower, that has strong precedent and logic.

But oil prices that go lower because of demand erosion or a weakening economy, that doesn't necessarily push equity valuations higher.

So the reasons behind what oil prices do, what bond yields do matter as well. My basic point here to move on to the next topic is that I don't think the historical correlation between a declining risk-free rate necessarily means an S&P already trading at 19 times forward earnings, 21 times trailing earnings is going to go up to 23, 24, 25 times.

I don't know that that won't play out but I would not be putting my investment philosophy or investment execution around the idea that that will play out. Okay, totally separate topic but something that's getting a ton of press right now. There's your normal hand ring errors and I think you could also call them bedwetters. People tend to find something to be afraid of in everything and sometimes there's things that are very logical, very understandable to be afraid of and other times I think it's a bit of a stretch. But right now there's a prima facie case to be made saying there is systemic risk building up in private credit, it's trillions of dollars been added into this space in various forms of private credit. And I wrote a Dividend Cafe earlier this year.

There was actually a two-part series I think and one was called credit or credits due and the next week was called extra credit and it was in the second week's one on extra credit that talked to the different categories of private credit because they're not all exactly the same and I wanted people to have an idea of what we mean when we talk about middle markets, direct lending, when we talk about structured credit, when we talk about private credit, bank loans, these all have different kind of usages. But what we're referring to is basically non-bank lenders that are lending out money to borrowers and it has different category types of borrowers, different size, different uses, different structure in the financial arrangement.

But throughout history of time systemic risk builds up or just bubbles build and then you end up with a big problem and this is kind of how these things go. Is there some good thing out there? There's something that like people like, it becomes popular, it becomes useful, it's a thing. And then people invest in it and the people already invested in the thing before it became a thing, they made a lot of money and nobody wants to see someone else make money they're not making so then they put money in, maybe it gets even better and then people start borrowing money to buy the thing and if someone's borrowing money to buy the thing, I mean someone else is lending money to get the thing. So now you got lenders into the thing and you got borrowers into the thing and that's going to boost it further because now you have leveraged finance coming in to create more demand and then the thing does what it does and if the thing's really dumb, it might just kind of collapse quickly but if the thing could be really great, it may have a ways to go but ultimately the leverage, the excess, the euphoria, the stupidity, the evaluation and mania kind of falls down and then there's lenders, borrowers, people that were into the thing that all have kind of lost money and then the government comes and goes geez, what in the world, we got to do something about this so then they do something to try to keep people from buying the thing but it doesn't ever work and it ends up, you know, I think creating more collateral damage than anything else. But that's sort of the rinse and repeat of this whole topic. Well, is private credit one of these things right now? Well here's the thing, no pun intended, there's deals out there that people need to borrow money for and when the banks lend them money, let's use something really safe and easy, a high quality residential home that a family's going to live in and they're going to put 25% down and they have tons of income and credit to service the monthly payment.

That bank has a pretty good loan out there and so they can do that with depositor funds.

Pretty vanilla, they could do 100 of them and 99 of them will pay. If one does go bad, they can always foreclose on the home. There just isn't a lot of loss absorption. But then if they start doing riskier loans, worse borrowers, things go wrong, maybe the whole town loses a big employer, there's things that can go wrong even with first-lean residential lending but they also might do second-lean residential lending, you know like home equity lines of credit, they might be doing small business loans, banks can have losses obviously.

And so there's a risk and whose capital is it? Well it's depositor money. You know grandma put her money in the bank and then it gets lent out and they lend out 6, 7, 8, 9 dollars for every one they have on deposit and they have their kind of math and then they have to have capital. So there's a pretty inherent safety of the banking system. Sometimes things go a little off and one of the reasons they don't go off more is because the banks can very quickly get real conservative. You go, well that's good, you don't want the banks to lose money. Exactly.

Conservative bank lending is a good thing, you don't want banks to lose money, you certainly don't want depositors to lose money, you don't want bank failures that result in depositors not losing money but the FDIC losing money. You don't want to have to use a government backstop. So then does that mean we don't want money being lent out, well there might be a good new lemonade stand coming to the market and it needs to get lent so private credit is going to do the lending. At the end of the day I am mystified by why we're talking about private credit is having systemic risk versus 70 years of leverage finance of depositor money that is always going to bring about taxpayer support. Depositor money, I don't want depositors losing money. Taxpayer support, I don't want taxpayers losing money. That's the whole system we have.

Along comes private credit, we take a pool of capital that's going to lend money for this new lemonade stand and yet the investors are risk takers. They're well healed, they are investing into a pool, they have to be accredited investors, they have to be qualified to make the investment and then it's going to pay more and so they get a higher reward but they take a bigger risk to do it. What is systemic about it? Well the argument would be, well it used to be a certain amount of money and now it's grown five times so quickly. There's people out there that think it's safe, they're getting 10, 11 percent and they think it's safe but then there could be failures and defaults and all of a sudden they're going to have losses, they don't know about it. No, I'm quite certain that's possible.

Investors should know what they're investing in but advisors and intermediaries should most certainly only be doing suitable investments. Everyone is investing in something that pays 11 percent when the risk free rate is 5 percent. There is an intellectual deficit if you don't know that the risk could be higher when the return is much higher but there's also a moral deficit if an intermediary is telling the person you have no risk here. So there is risk but I think the risk is good. That risk is how you get a premium return and that risk is not owned by taxpayers or depositors, it's owned by risk takers. What a beautiful system, right? I don't think it's systemic. I don't understand the need for greater regulation. These funds are already regulated by SEC. The asset managers are most certainly regulated by SEC. A lot of times the institutional investors are highly sophisticated. They have their own regulation around what they do.

Many times insurance companies that have a lot of reporting and regulatory oversight and their own insurance apparatus, different states get involved with different asset managers at different levels. There is an abundance of regulation here. This is not new. I don't think there is an absence of regulation. I do believe, now here is what I do fear. I do fear that there will be some losses. There will be too much money that comes in that then results in a deterioration of quality and there is more money chasing less deals and therefore there ends up being some sacrifice of quality and then when people lose money someone starts screaming for some kind of a bailout or whatnot.

The whole system works like a charm as long as no such thing is forthcoming.

Buyer beware, let the pool of capital that is investing in this advent of a beautiful new system called private credit that takes risk off of taxpayers, takes risk off of depositors and has created this whole new capital markets innovation that's resulting in higher yield to investors, great access to more deal flow, funding more businesses that can find it in banking channel all by de-risking other conventional aspects of our financial system and you have to allow for losses.

That's my regulatory advice but do I think a systemic risk is building up as long as the risk is born and held and isolated to the risk taker? I do not.

Category number three in this multi-category, multi-topic Dividend Cafe, I'll close out with a discussion about something kind of fascinating regarding PE ratios. We talked about it before about how they may or may not be impacted. Valuations of stocks might be impacted by changes up or down in the risk free rate and bond yields.

I would argue right now totally off the subject of bond yields and their impact on the equities that index investors have something else going on that I think most of them are totally unaware of. I've argued for many years that the fundamental appeal of index investing post-crisis was that almost everything in the risk asset universe went up together because of earnings being reflated post-crisis, valuations being significantly reflated post-crisis with a lot of liquidity being reflated around Fed action of QE and zero interest rate policy.

All those things were a great perfect storm. Some volatility on the way but it was just very difficult to not make money as an equity investor from 2009 to 2021.

Right now when I say to you that S&P is trading at 21 times trailing earnings, 19 times forward earnings, I'm taking the entire basket of equities and this is the valuation that we can see.

But there's a link in dividendcafe.com to a paper that Hamilton Lane put out this week that I think is fascinating. I mean it's fascinating in big cap. It's fascinating with S&P 500, the Russell 1000, but in other market indices it's really even more profound. But let's say you have two companies in an index. Dave's Lemonade Stand that makes money and then Bill's Lemonade Stand that loses money and they take my earnings of $10 and Bill's earnings of negative five and then they create a PE ratio out of what what it's trading at. They do the math. Are they taking 10 and the negative five and doing five divided by the value?

No.

Any negative earnings are at zero. They're just eliminated.

And so the total earnings are treated as just those with positive earnings divided by the value of the overall index.

And negative earnings, which admittedly are much more rare with big cap, it isn't like there's a ton of big cap companies in the Russell 1000, S&P 500 are losing money. But nevertheless, the data is all there in this article. If you were to take the companies that are losing money and factor that into the denominator and the way you do this, the S&P is trading at over 25 times earnings. Might be useful to know some of that. But there's such it's only I think 15% of the companies in Russell 1000, which is a big cap index that are negative earnings. What about the Russell 2000, which is the small cap index?

Over 40% of companies losing money.

So you put a much bigger strain on the companies that are earning money to carry because in order to actually get what we're going to call 20 times earnings and not factor in the companies that are losing, they have to be earning greater than that. They have to have a greater valuation to get there. And that's, I think, very distorted to the way people are thinking about the valuation of what they own.

When you own the index, you do own those companies with negative earnings. Therefore, your aggregated PE ratio ought to be understood that way, in my opinion. A little food for thought and check out that link if you're interested in the topic more. I'm going to leave it there. We've been off quite a bit across these three topics. As I'm sitting here now, I actually don't have any idea what I'm going to write about next week. I will be back in New York City next week. After a couple of days in Michigan where I have a number of meetings and speaking engagements, and then we'll finish out next week in New York.

And Dividend Cafe will come to you next Friday on one single topic, TBD. Thanks for listening. Thank you for watching. And of course, thank you for reading the Dividend Cafe. I'll see you next Friday from New York City. Enjoy your weekend.
