FRIDAY, JANUARY 26, 2024

Well hello and welcome to this week's Dividend Cafe. Live from New York City. It's been one heck of a week. I was in Washington D.C. Wednesday and Thursday. I came back in at the end of the day, so it was a pretty short trip but a really really productive one and I'm actually looking forward to sharing some of the takeaways more next week because there most certainly were takeaways but you know what you want to use this Dividend Cafe time today?

To delve a little bit into various topics that are floating around the globe, economic, you know a little bit political/market oriented and so I did this week's Dividend Cafe, I did, I did enjoy writing it. It was a bit of a stream of consciousness. I kind of just, throughout the week, took different little topics that came to mind for my morning research and I don't know every now and then I just like explaining the process you know, I am using the very very early morning hours every day of my life for my research and I and I read a lot of research and most of the writing I do ends up being between hours of 3:30 and 7:30 in the morning as well.

But certainly the vast majority of the reading does and so what I did this week is just kind of as I was going through different white papers bulletins, macro reports, you know the from the normal process of research digestion, I would just sort of earmark certain things or highlight things to come back to for the writing and Just wanted to plug in a couple of sentences. I used to read Kiplinger's a lot and I always loved that their format used to be kind of like a paragraph at a time. There'd be a topic and there would just be a little bite-sized deal even in my kind of political reading as a National Review subscriber for many years the first few pages after the table of contents and and letters to the editor section. Since I was in kindergarten National Review had this little section of just kind of bite-sized bullets that were kind of random musings and so I did that and then it ends up covering a number of different topics. And so that's the format here today. It's really easy to do in the written version as I speak through it right now, you know, there's a kind of embedded continuity because I'm jumping from topic to topic, but that's just what it is and I'd be curious for your feedback.

You know, one of the first things I want to jump through is about quantitative tightening I think some people have been curious why I'm so convinced the feds gonna end up needing to chicken out and it occurs to me that's saying things like well the liquidity in financial markets that they are taking out. Eventually there will be a response and they'll have to stop extracting liquidity from the banking system that sentence probably makes sense, but it may not really explain like “What that has to do a quantitative tightening and why and what the different mechanical?” Functions are and I think that it's useful to explain the last year as they removed over trillion dollars. It was a little over a year. They were doing about 80 billion a month But but from the time of which they started they've gotten 1.2 trillion off of their balance sheet in this process called quantitative tightening where they do not roll over bonds that mature so they allow that level of assets to be removed from the system and that and what that really effectively means is less reserves in the banking system and In this particular case it can lead to lower money supply. There's other factors leading to lower money supply as well, but one of the things I asked you I think is unique is it was very much consistent for them to be doing that with their other policy objectives, which were to raise rates. They wanted tightening so to the extent that there was less money in the banking system It all worked out well, but why didn't it get more out of hand? We have to remember that they ran the federal government ran a two trillion dollar budget deficit and and so the the Fed didn't need to be buying any of that and in fact was able to be selling or rolling off even while this much new issuance was coming to market to fund the government deficits because there were buyers for it because of rates being real high. It was an attractive purchase in the private market and I think this year the Fed is going to want as a policy objective lower rates less tightening and the Fed hopefully, excuse me, the federal government, hopefully will be running lower levels of deficits than last year. So I don't know how the policy objectives will lie up line up with also then tightening and that's why I think the quantitative tightening ends up hitting ahead and coming to a point of tension where where they end up by having to kind of wave the the white flag. I hope that makes sense.

The economy in '23, we got the number this week, that the fourth quarter report looks like it's gonna come in a real GDP growth of 3.1 annualized let's assume they revised that down a little bit. We know it was around 5%, they did revise that down already from Q3 But basically that the year you're gonna come in at this 3.1 for the whole year real GDP growth, which is very strong and it'd be the exact opposite of a recession instead of being what our post financial crisis trendline has been about 1.6. You came in almost double that There's some of it, you know that is still attributable to post COVID normalization, but not really I mean, I think at the end of the day, it is a good strong economic number and I am more and more convinced that the economic outperformance of ‘23 and as we get started here into ’24, people mystified in the midst of a Fed tightening cycle why economies done so well. I really do believe that it speaks to probably where the economy was and was going to be in a continuation of normalcy had COVID not happened and that COVID from mid, you know spring of 2020 until whenever you think normalization Started happening. Let's say some point in 2022. I think that that represents this footnote in history this kind of like total timeout from everything normal and yet the ‘23 and ‘24 strength speaks to some of the things that were improving in business confidence it to a very small degree I wish it was much more but in the business sentiment that leads to capital expenditures. Certainly an ongoing consumer who is enjoying and I think there was a policy portfolio around all this from deregulation the repatriation foreign profits that came back and got invested onshore obviously reduced corporate income rate and incentives whether it was from opportunity zones or or instant expensing R&D, though there was this kind of healthy environment I think that it created a pretty fertile soil and I think that's continued and then what's interesting is the thing I'm saying right now, how I believe it upsets people because am I saying the policies during 2017, 2019 helped create a pretty reasonably decent economic environment. Some people like that because they who was president then and then am I saying that right now the economy ‘23 and ‘24 in this aspect of economic growth and what we call output is pretty good, and there's other people like it because of who's president now, so I can't help either of those people Where I'm clearly not saving anything partisan because I'm saying something about two different areas of different presidents But I also don't know objectively anyone could include anything different. I'm gonna move on now because I'm getting bored with that topic.

China slow down ‘23 that was supposed to be a China warm-up of ‘23 It's been talked about a lot in my white paper and the the failed prediction about the China COVID reopening boosting economic growth in China last year. My friend Louie Gave is a economist at Gavekal Capital research and brilliant guy, he had a he had an explanation of some of it this week that I found very compelling that essentially Western governments shutdown and courage workers to stay home and not work and then they paid them not to work or to barely work and then we reopened and there was a good size a minority. But a good-sized minority that were like we like this not working thing, so they continue to not work then that created a shortage of laborers that then shot wages up, that wages going higher means more more spending and so there was this kind of instant response function reaction function in the markets in the economy and it explains a quick economic response in the COVID reopening. But see China didn't pay people not to work and so then all of a sudden, they go back and there's all these migrants returning to cities for work and wages dropped and and so I think it was a kind of opposite response. And it happened of course in concert with their distress in the construction sector. You know, obviously the oil demand did not boost way higher because there was less industrial activity in China And that all worked together to put downward pressure. Look, there's a lot of factors you could play in but as far as explanations go that seek to touch all corners, I think Louie this explanation is as good as one you'll hear now there is a growth story playing out in China by the way, we talked so much about declining trade declining exports and yet there's one sector one industry that's indisputably growing their boosting market share their domestic demand and sales are up they're exports both to the US but especially even neighboring and trading partner countries is huge and that is the electric vehicle market a large growth sector and yet their electric vehicle sector got killed in terms of stock prices. Why? Why are they all these fundamental things seem to be going so well? Well with rising sales with rising exports with with rising market share and how do you end up with declining stock prices? Well, the batteries become obsolete have to be replaced it stunts people wanting to Invest knowing a new batteries coming a few years. There's very limited parking supply in the cities of China and almost no parking supply that has adequate charging, it's just a very complicated space and then you add to it the shipping costs that are owed margins If you're going to be an export of electric vehicles in some cases their electric vehicles are quite cheap and shipping costs are quite high. And so as a percentage of the total price it becomes a really big obstacle and in hindrance and margin and I just think sometimes an investable thesis requires more than just the shiny part.

Okay, so a little sneak preview about some of my takeaways from Washington D.C. This week before I went I had breakfast on Monday with the gentleman I believe for over 35 years has been the most astute political observer pundit commentator in the United States and I am a shall we say I pay a great deal for the for his subscription research commentary now and hold him in high regard even though we are of some different political beliefs, but he's a very astute observer. I had a lunch in D.C. Wednesday that brought all this stuff up with a staffer one of the presidential campaigns a senior advisor and then attended a symposium Thursday that had Barack Obama's campaign manager Donald Trump's campaign manager from 2016 and the head of a third-party advocacy group. So he had like a lot of really significant input this week and It would be easy to come out of all this with all this inspiration and ideas and information and make a prediction But I don't think I have any better prediction on what's gonna happen in November right now I did before the week began although I might have a little more perspective on what I think some of the causative factors one way or the other will end up being but here's the prediction I will make in my crystal ball that has nothing to do with who ends up winning what election? After the 2024 election my prediction is that deficits are not coming down That spending is not coming down that austerity is not on the horizon The entitlement reform and reduction national debt is not coming and that accommodative monetary policy into the future will be needed to support the fiscal policy I believe is coming regardless of who wins the election. You are welcome to write that prediction down.

Back to China we have not been big investors in China throughout my career even our emerging markets exposure, which has always been a somewhat minimal aspect of our portfolio allocation, but nevertheless one we've had a high growth aspiration in but it's been decidedly underweight in China for a long time based on our desire to feed domestic demand where China is of course more of an export-oriented economy, but I think that right now, US investors continue to steer clear of China even for different reasons than what our perspective has always been I think it centers more around fear of what the CCP may do next the overall seeming negative attitude towards their private sector, towards public equities the internet sector high-profile CEOs fear of policy regulations coming out of nowhere.

Obviously economic analysis about China's own economic strength and the disinflation. Well, excuse me deflationary mess, I think they find themselves in and then the geopolitical risks, you know the Taiwan stuff the their support of Russia the US's own growing adversarialness. These are things I think have just kept the sentiment rather low and I think it all makes sense I want to briefly cover the definition the definition of the risk-free rate I talked about it a lot where it's a very important concept in Investment finance that there is something called a risk-free asset that is used as a benchmark or a baseline to measure other assets against it's the opportunity cost I could get X Risk-free so anything I do that is not X I have to weigh the return outlook and the risk outlook against this risk-free rate and if an asset was risk-free and getting generate 4% and another asset was risk-free but gonna generate 5 you would say okay. Well, this is a great deal, but it wouldn't happen But if you say okay, well, it's gonna generate 7 but it has a little more risk, that's where this the whole entire calculation of risk reward that we do for a living at the Bahnsen Group. That's what it's all about and I want to be clear that I just believe a 90-day T bill ultra short-term government bond instrument is. What I mean by a risk-free rate and you could look at a money market fund You can look at a 90-day T bill is my preference But when people start talking about 10-year Treasury, it is risk-free in terms of par value maturity. But it's obviously not risk-free in duration risk as interest rates go up and down. There's price fluctuation and there's interest rate risk of of it going one way or the other that affects the value and the reinvestment value. And then there's currency risk even though those of us buying something short-term. If we're buying in dollars getting back dollars, you don't have that over 10 years, there's any number of things with a longer timeline that happened to the currency. But I think a better way of putting it is that it just gives 10 years for a central bank to do all kinds of things in intervening with monetary policy and that the number one thing I fear is that distortions from a central bank into the price of money and can create a certain economic benefit short-term, but they cannot do so without a less visible economic problem they alter the risk-free measurement. They alter our ability to Measure the risk and reward and I think that's an important concept understand You know at the end of the day people that love an artificially low rate I just will always want to remind them.

And this is the final tidbit I'll share here and let you go to Dividend Cafe.com for a couple others because I didn't get to all of them and I'm up against a timeline. The artificially low rates crush savings they disincentivize savings what over time a road savings means that it roads investments because s equals I savings equals investing investment because investing can never come before there are saved dollars, so less saved dollars means less invested dollars and Investment is where of course you get the productivity that leads to economic growth Ergo artificially low rates a rate of interest below the structural growth rate of the economy erode savings which are roads investment which erodes economic growth So it feels in the short term visible like it's boosting economic growth in the long term Invisibles eroding economic growth that's an economic lesson that nobody could ever ever ever enderstand enough what it would want you think you've mastered it, reread it, teach it to your kids and grandkids and pets because it's we're living in it, and it's an incredibly important idea.

Those are my musings through Wall Street this week. I appreciate you bearing with me and I appreciate you being a listener and a viewer of the Dividend Cafe, and we hope you will be back with us next week. Please share this far and wide Thanks for listening and watching and reading the Dividend Cafe.

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