FRIDAY, FEBRUARY 2, 2024

Well, hello and welcome to this week's Dividend Cafe, brought to you from beautiful Miami, Florida, where I assure you the weather is very different than it has been in Midtown Manhattan. I am here just for 24 hours, a speech at the Miami Economic Forum Friday morning, but right now I want to talk to you about the Fed. And I am really excited. I enjoyed riding this week's Dividend Cafe a lot. It was fun.

And that's really how I think everybody believes that the Federal Open Market Committee and the Fed federal funds rate, how they feel about those conversations is that they're fun. And so I'll try my best to prove it right now.

The question is, does it matter what the Fed does? This week, the Fed announced that they were not moving rates higher or lower. That had been 100% priced into markets for, I think, three months.

And the expectation for market activity was going to be what they said or didn't say about March. So they're already kind of looking ahead, but nobody expected any change this week. And the market was down over 300 points on Wednesday, as Fed Chair Jerome Powell gave his kind of press conference.

But the bond market rallied big, and bond rates, yields dropped a lot, causing bond prices to rise. And yet stocks dropped, and that seemed to be a disconnect. And then on Thursday, markets rallied huge, and the Dow was up more than it was down the day before. And you're back where you were. So I've predicted this for some time, elevated volatility around the Fed's short-term pronouncements. But it still kind of leaves the question lingering. Does any of this matter what the Fed does? And I don't mean that. And I think people asking me that don't mean it in the context of the trading day before, day of, day after. I don't think it's about speculating what exactly the Fed will do. I mean, for a lot of people, it is. Those people are called idiots. But in terms of the non-idiots that are trying to make sense of it, it's more substantive. Like, does where the Fed sets the rate matter in terms of the economy, in terms of what to expect as investors? And this forces us to kind of answer a little bit, what is it the Fed really does?

It's one thing to just use the language, oh, the Fed raised rates, or the Fed cut rates. That's fine. And it's accurate enough when there's movement with the Fed on rates. But does that mean that they move your mortgage rate? Does that mean that they tell banks, here's the new credit card rate?

Does it affect a small business? Are they setting the rate that a businessman borrow money at, or that the bond market may charge? Of course not. So what does it mean? Well, the Fed has, the Federal Reserve has a group called the Federal Open Market Committee that is tasked with setting federal open market operations. And all this fancy jargon means they set what is called the federal funds rate.

And they do it as a tool towards policy objectives. But what is the federal funds rate? It's the rate that banks can charge each other for overnight lending, and a bank can only lend to another bank from their excess reserves. So banks have reserve requirements, and they are required by law to hold their reserves on deposit with the Fed. That's why the Fed is a central bank. All banks hold those deposits at the Fed, and then they can hold excess reserves above and beyond what is their minimum reserve requirements, and they're allowed to lend those out. And that is what you call profit-making activity. That's credit being extended in the economy.

But why would a bank lend money to another bank? Because some banks are below their reserve requirements, because they've lent more money out, and others may be above because of just the ebb and flow of operations. So banks lend with one another. And the higher the rate, the either less activity or more expensive activity, and that filters down to the actual borrowers from the banks. Bank A charges Bank B is somewhat immaterial directly, but becomes very material indirectly in that cost and that incentive to extend capital, create new credit, then trickles down into what is generated in terms of new credit in the real economy.

And so the answer to the question, theoretically, of does it matter, is that obviously a lower cost to capital incentivizes more activity and credit extension in the economy. So theoretically, that caveat is important. Most adverbs are.

Theoretically, it's important to the extent that it could marginally be pushing activity up or down. That's the whole point in the policy, right?

However, the reason the Fed does it has got to be understood. People can point out in history, 2001, 2002, the Fed was cutting rates, and it wasn't having a big impact in stocks. Stocks were actually down in both years. That's right.

Now, of course, they could be cutting one day and stocks go up later, but that's not what we're really talking about. Why was it not? Let's not even use 2001, 2002, because frankly, ‘01 had a 9-11 issue that somewhat idiosyncratic in 2002. That recession was so minor. There really was a problem for stocks in those years of just purging out the brutal excess from dot com and the tech boom.

And I think most of the shiny object boom that had to be purged out the last couple of years took place in 2022.

Let's use 2007, 2008 as a great example. The Fed starts cutting rates. Things aren't looking good. We're trying to cut. Then in 2008, they go all the way to zero, and stocks had their worst time since the Great Depression in late 2007 all the way through early 2009. Why did stocks get crushed in this 18-month period when rates were being cut? Because when the economy is bad enough, the cost of the borrowing is irrelevant.

It is when the economy is good and then they're cutting that all of a sudden stocks can really get a jump. And that's the 1998, 1999 example. I've written about that before.

That when you have a decent kind of baseline and then you make it better, that's a really fertile environment for risk assets. An analogy I used in the written dividend cafe this week, and I made it up as I was writing, and I don't want to give myself enough time to think about it because as a writer, I often decide later that what I said I don't like, and this one I'm just going to go with it. I don't want to think about it. But if you have a delicious dessert and you add more to the sauce on top of the dessert, you just sort of make it a little bit better. But if you take a dessert sauce and throw it on top of lima beans, it really doesn't matter. You got to get those lima beans out of the way so you're going to have anything you can enjoy. And for those of you who like lima beans, I apologize for the analogy, but I also would question what's wrong with you. But here's the thing I'm saying.

The economy is so bad in ‘07-‘08 that the cost of capital doesn't matter. There's not going to be credit extended no matter what the borrowing is because you're in a massive liquidation mode. People are selling, they're buttoning down the hatches, all the cliches you can come up with.

And that's really why reducing interest rates is not a very effective thing to do in the short term in a recessionary environment. Now inversely, why the Fed is raising rates can make a difference. If you're raising rates because the economy is so strong and there's so much good activity, it may not hurt stocks a whole lot. And if you're raising rates because there is an inflationary situation, that could be very challenging. So good growth with bad inflation is not good.

What they perceive to be inflation but with good growth can be good. So there's all these different factors that make a difference as to why they're doing what they're doing. But then why did stocks go up in 2023 when the economy was doing pretty well, but then the rates were so high and they were trying to contract economic activity, which is this whole point we're talking about.

Because there's also this issue of markets being discounting mechanisms. They're pricing in ahead of time, what they believe about the future. And the markets became convinced that the Fed would be cutting in 2024 and therefore stocks kind of got in advance of that. So you're never going to be getting a perfect scenario where you can just respond as an investor what the Fed does. Like, oh, they cut rates now I want to buy more stocks because there's going to be price activity ahead of time. And they cut rates or they raised rates, therefore I want to buy or I want to sell. You also have to know the why. And that's really the fundamental issue. Now why did a really severe Fed tightening in 2023, in 2022 and ‘23 not do more damage? I've talked about this a lot.

I think there's a number of reasons. The biggest one being that a lot of the corporate borrowing and business borrowing had already been done ahead of time. There's a huge maturity wall at which some rates have to reset later in ‘24, ‘25, ‘26. And so there was kind of just a free period where there wouldn't need to be a lot of contraction of credit in the corporate economy. Secondly, the same thing is true of mortgages and consumer borrowing. There's a chart at Dividend Cafe this week that shows how much of a consumer's debt, household debt is already fixed. And therefore, somewhat unimpacted, legacy or incumbent debt is not affected by higher rates if it isn't variable. Now new debt is, so there's still a marginal affitation, but it's different than affecting people already have that debt on the books.

So in a nutshell, the answer to the question about does it matter is I don't believe, there's two things I want to say. I don't believe that where they go a quarter point, half a point, March or May, I don't think any of that matters at all. That's all pure noise around trading. And then I don't really think the fact that we're going into a rate cutting cycle matters at this point, other than the downside risk in the sense that if for whatever reason they didn't cut unexpectedly, that is most certainly not my forecast. But my point being, I think you kind of have a scenario where the market's priced in the fact that the Fed is going to be cutting, that's known.

So you need something else that becomes a superlative in the economy, a driver in the economy. You need more productivity.

And really, if you get more productivity, or you get less productivity, that's going to impact the way the Fed positions things out into the future beyond what we're talking about, beyond what I know, beyond what anyone else knows. And right now, beyond what the Fed knows. But the parts that we do know are already on the table, and they're for somewhat basically almost always priced in. And therefore, the answer is no. Now, if you get a big recession, if there's a bigger lag effect of monetary tightening they've already done, that could change the equation. If you get some great productivity for other reasons I've talked about, CAPEX being a big one, and again, various elements that contribute to productivity, then perhaps you even outperform expectations and the Fed responds accordingly. Maybe you have a good economy and good results and good unexpected data, and the Fed continuing to cut more than expected out into the future, 1998, 1999 type stuff. That could become very good. Now, again, they're at this risk, not even a risk, it's an inevitability of boom bust cycles, because they always tend to go too far one way or the other. But my point being that we right now, I think, can look to things more substantive than what the Fed does this year, unless the Fed surprises us. And I don't mean by surprise, but not cutting, they're going to cut. And I don't mean by doing May instead of March, that's a coin flip.

Basically, the stuff that we know, we know, I don't expect to get a big boost from it. I don't mean there's people saying, I want to buy stocks once I see them start cutting. I think for the most part, that's priced.

And then you have to look to where this economy goes on the other side of this Fed tightening, on the other side of the COVID moment, and on the other side of where we were back in ‘18 and ‘19, after the Trump tax cuts, the trade war, we're still in a lot of ways trying to get the other side of the GFC.

What is the productivity that is going to come or not come that represents a new phase in American economics? That's a much bigger issue for investors thinking about 25, 26, 27. Those thinking about January 30th of this week, well, I guess you were either up one day or down one day and all that kind of trading. But as I say in Dividend Cafe, I think a much more interesting thing to bet on one day or the next is stuff like Travis Kelce and Taylor Swift's relationship than what the Fed will do or not do.

So I am going to leave it there. I hope this has been an interesting little tutorial around the Fed policy. I hope I've made it a little more interesting than it often can be. And I doubt I have, but look forward to your feedback on it. And I look forward to seeing you again on Monday in the DC Today. Have a wonderful weekend. And thanks for listening, watching and reading the Dividend Cafe.
