FRIDAY, FEBRUARY 16, 2024

Well, hello and welcome from beautiful Palm Beach, Florida to this week's Dividend Cafe. I am in my, I think it's a fifth Florida city now, four in the last four days, and ready to head back to New York City shortly, but not before giving you a Dividend Cafe. And I spent quite a bit of time going through a lot of the backlog of questions that we've gotten into the sort of ask David section, and they cover different topics. And I just want to go through all of those and get that kind of updated. It was a good week to do that. And I'm gonna go back to sort of a single topic, Dividend Cafe next week.

I have a couple of things in mind, but I'm gonna jump right into it here regarding the different questions that have come in. And the first one is just sort of a vocabulary review where the person asked, you use the word disinflation. Can you walk through the difference between disinflation, stagflation, and Japanification? And then they ask if these things are synonymous. And it's interesting, because a lot of people ask me the difference between disinflation and deflation. And those things are different. They're not synonymous, but they're easily confused and they are similar or adjacent. But disinflation, stagflation, and Japanification are really three totally different ideas. So the answer is no, they're not synonymous. But let's just get the vocabulary clear. Disinflation refers to a declining rate of inflation. So that's not deflation, which is a negative inflation. So if a price is $100 and then it goes to $99, that's deflation, a 1% drop in price. If a price goes from 100 to 101, that's inflation, a 1% increase in price. But if one year it went to 102, that's 2% inflation. And the next year it goes to 103, that's disinflation. You

go, the price went higher, right. But it had gone up 2%. The next year it only went up 1%. So it's a decline in the rate of inflation, but it's still a positive move in price. But we expect a positive move in price in a market economy or producing more goods and services, wages are growing and so forth. A lot of things will have an increase in price, but a rate of increase in price going higher and higher, that's inflation. Disinflation is what we've had the last year and a half, let's say, where we got up to a 9% increase and it's come down to a right now three or two and a half percent level, okay. So that's what disinflation is. Stagflation is a reference to the combination of inflation, a higher than trend line rate of inflation, along with stagnation, a economy not growing. Really, we haven't had much stagflation in our economy since the 1970s. That's the combination of stagnant growth along with a perpetual increase in prices. Then Japanification is not exactly a real term, okay. I don't wanna say I made it up because I'm positive I didn't, but I use it all the time and I know what it means and I know what I mean by it and I don't think a lot of other people are using the term, even the people, whoever they may be. I do think John Baldwin was one of them, but he doesn't think he made it up either. So regardless, someone else can try to TM the term at some point, but Japanification is a term I'm using to describe a period by which economic growth is stagnated and attempts to create more growth via fiscal and monetary policy, create a diminishing return, whereby you get low, slow or no growth and have to resort to more fiscal and monetary stimulus that then exacerbate your problem of low, slow and no growth. That's what Japanification is. There's a lot of economic concepts inside

of it. I'm gonna talk more about some of this in a few minutes, but that's the vocabulary, okay. So there, one, you got five for the price of one, disinflation, deflation, stagnation, inflation and Japanification. I hope you have some vocabulary 101 today.

Okay, a really, really good question from Chris here. There are obviously lots of market bets around the timing and increments that the Fed will be lowering rates this year, but why should the Fed ease at all if none of the fundamental economic numbers change? GDP growth, employment, inflation, the baking industry, credit stress in general are fine. The Fed should not ease simply because of the passage of time and market expectations, in my opinion, am I wrong? Well, here's the thing that Chris is saying, which in theory could be true, but is missing a certain forward expectation. I first wanna start with the idea that what the Fed is trying to do, I don't believe in, which is find the neutral rate and then either find the right spot to go above the neutral rate to slow economic activity or the right level below the neutral rate to accelerate economic activity. And that first presupposes that the Fed's able to know what that neutral rate is, and second, that they're able to get the right mix of what goes above neutral to tighten and slow, or it goes below neutral to accelerate and stimulate. And my opinion is that the reason the Fed should not be at five and a quarter, five and a half, even though unemployment's low, GDP is good, et cetera, is the other issue brought up, which was credit stress, which is fully, I fully agree, is right now not a problem, but it is the fact that if you believe in the Fed being active in trying to adjudicate this, there is no question, no question, that if the Fed stays tight like this,

they will create that, so quote unquote, hard landing, higher unemployment, lower GDP, higher credit stress, via the maturity wall of debt, whether it be to a certain degree amount of fixed residential mortgages, but far more in commercial mortgages that are gonna reset, and I said fixed residential, I meant variable residential that are gonna reset, but far more with commercial, with the bank loan market, with corporate debt, whether it be investment grade or high yield, whether it be in the bond market or private credit, the Fed is well aware of these data points. The Fed is well aware that you cannot get construction loans right now for new projects. It hasn't hurt GDP for the last 18 months, but you talk about monetary lags, Milton Friedman's concept of the lag effects in this. This is what they're trying, why they need to go back to what I believe is a neutral rate, which is most certainly lower than five and a quarter, five and a half, is because that will end up happening, and then you will end up getting this ping pong back and forth of too loose, then too tight, then too loose again. Now, I already have baked in my expectations since I've lived in my entire adult life that the Fed goes too loose, too long, and then ends up going too tight, rinse and repeat. This is the sort of Austrian viewpoint of boom-bust cycles that a Fed creates. So I freely admit that's what they're gonna do, but I'm talking about, to Chris's question, within the confines of what the Fed is seeking to do, the reason to not just stay status quo at a level that is above the neutral rate is because those things will then become highly problematic, and there's no reason for them to. The price level is dropping, there is disinflation, and in many cases deflation. So it's all about being anticipatory. You say, well, why should the

Fed be anticipatory? I didn't make the system. I would be perfectly fine to have a rules-based system, but if we had a rules-based system, if we were doing this on nominal GDP growth, if we were doing it on nominal GDP targeting, if we were doing it on a commodity price indicator, there's no possible way. The rate would be this high. So it has to do with avoiding stress levels into the banking system, the credit markets, not the fact that right now it hasn't yet fit, okay?

You could argue, by the way, I'm making up this analogy right now, and for those of you who have listened to me for a while, sometimes when I do this, it could be sheer brilliance, sometimes it could be really off, but my viewpoint here would be, why not keep touching infected and dirty things? You're not getting a cold, you're not sick, you may as well just keep doing it, and the reason is at some point you're gonna get sick. All right, that analogy's pretty good, I think, but I haven't thought through it.

All right, next, CapEx. Is business investment growing as GDP has grown the last two quarters? I know you look at that more than consumer activity. Well, it's a great question, and there is actually a couple mixed data points here. CapEx has come up a bit, non-residential fixed investment. But it is disproportionately on the government spending side, so that forces a question of whether or not that matters. On one hand, it is entirely possible to get productive spending from the government sector into the private sector. People could disagree with it politically, there could be problems with it in terms of corporate welfare, other things. Well, let's take the ChIPS Act, for example. If the

government is spending, and yet all of a sudden there's stimulative activity happening with semiconductors, does it matter to the economy that it was the government spending the money versus private sector? And the answer is yes and no. It is very possible to get GDP boost from that. It is very possible to get productivity boost from that. That CapEx can be helpful. But if it's deficit-funded, all we've done is poll growth in the present, we get growth in the present, that we poll from the future. Okay, so that's the issue with the government spending. A lot of it is just simply unproductive, most of it in terms of economic analysis. But some of it can be. CapEx is an example, it can be. It's just that it has a trade-off. And the trade-off is future debt and deficits. I would add too, by the way, construction spending for manufacturing alone was $214 billion last year. And that was up 61% from the year before. I've talked before about factory construction is up 77%. A lot of that's government spending, but not all of it. But the question is, will there be more private sector activity in the constructed facilities that are coming about for manufacturing? Whether it was government spent money or not, I would think it would be. And this is an argument for why I do think we have the possibility of a short-term, short to intermediate-term productivity boost. I certainly hope we do. But to the extent that some of it may be around, stemming from legislation I don't agree with or that produces bigger problems later, that poll from economic growth, Japanification, that has to be factored into a longer-term prognosis.

All right, a really thoughtful question here. Could you explain a bit as to what alternatives you use and what criteria, referring to alternative investments? And it's complicated to answer this at a macro level across a wide audience. Every client, we're addressing their portfolio construction individually and their weighted asset allocation. One client that has 50% in our core dividend portfolio, but 25% alternatives, there might be different reasons going on there. Another client might have 58% in core dividend, 20% in alternatives and other things that fill in the remainder. I'm saying it as a sort of example. And what those things are across the macro construction of the portfolio are related to tolerance for volatility, risk appetite, timeline, current income needs, future income needs, liquidity, tax treatment. There's all of these factors that go in now, a portfolio is constructed and it starts with defining the objectives, the particular personality of the client, particular aims that go there with. And I will say risk tolerance is a very important thing because we have to separate the risk of permanent erosion of capital and the risk of up and down volatility. And then some clients just candidly, we have to know these things in a different way than they may articulate them. Clients that say I can tolerate 20% volatility but get really nervous every time there's 3% volatility. Well, it's up to us to maybe sometimes know the client better and they know themselves, that's our job. Now this question that was limited to within that bucket of alternatives, it's one of our magnified sleeves, the way we construct portfolios with seven broad categories. Alternatives is a very big one. It's a very large part of my own personal portfolio. It's a very large part of what we do at the Bahnsen Group. Within that, the

same questions apply. The liquidity issue. So a lot of alternatives, particularly private equity, have large batch, long stints of illiquidity. Certain private credit, certain private real estate. So some clients have limited ability to be illiquid and that changes the allocation. Then there are regulatory environments, okay? There is what's called a QP, qualified purchaser, there's a credited investor and different net worth requirements that play in terms of rules set by the SEC about what clients are allowed to have and not have. Then beyond that, it depends what we're trying to diversify for the portfolio. If a client has a risk tolerance for more equity, is getting all of the market return and income and cashflow they need from their public equities, let's say dividend growth, and they have a tolerance for additional equity exposure, but we want now to sort of lower the beta and diversify against the market volatility, then we could go more private equity. If we already have a full equity exposure, meaning trying to capture the operational profits of a business, private, public, all that, then we can switch to something that might be more private credit, might be real estate. It's a diversifier against equities. And then there are just idiosyncratic returns that some clients have a tolerance for, understanding the complexity that might be more global macro, might be commodities, it might be trading oriented. Now, a lot of these things, there's different strategies we like, and we can put them into single vehicles and try to get our best ideas captured into one. But where we will go more illiquidity, where we will go less, understanding how private equity is done. And again, that understanding is a key word too, because we may think it's a really good investment, but if a client doesn't understand the

nuances, and it's gonna cause them anxiety, the way private equity might have a call structure, and then other private equity we can do, there isn't a call structure, all the money gets invested day one. We have to customize and tailor that each client. So liquidity, tax treatment, income generation, some alternatives kick off income, others do not. What the rest of the portfolio looks like that we're trying to diversify, those are the various factors that go into alternative construction.

All right, did President Biden make some quiet behind the scenes change in energy policy that nobody noticed? The US was producing 11% of the world's oil when President Trump took office. It went to 15 and a half percent when he, by the time he left office, and is 16% now, so modestly up a bit. I'm surprised no one's talking about this, is a great question. Let's understand the full context here. It had dropped because of COVID trend line, and the US's production of world oil could theoretically have been a bit higher. It did drop then when President Biden took office, but then has come back up. And my own view on it is all at once that there are not a lot of new projects for pipelines to transport oil and gas. There are not a lot of projects on federal lands, but that the US government policy has very little it could do for pre-existing wells and rigs and things on private lands. Those big private oil producers, we don't have a nationalized oil and gas space, so the biggest factor for that production level will be what market forces are causing those companies to do, the Permian Basin, the major players, particularly in shale. But what the US policy is able to do is either grow or limit future expansion of production, and then on

a price level, President Biden used the Strategic Petroleum Reserves by releasing a lot of oil. So a lot of that number is manipulated, and I don't wanna say manipulated, but it's affected, it's impacted. I do, by the way, have a negative opinion of it, but my point here is not my negative opinion. It's a sort of objective analysis. The 16% figure has to factor in that we took 300 million barrels out and put them into circulation and have not replenished them, okay? So at the end of the day, I don't think that President Biden has done any kind of secret deal or whatnot, but to the extent that energy production's up, it's a byproduct of the political desires of his constituency that he is not gonna brag about it or talk about it. I personally would rather we be at 16% of world oil supply than 14%, 13%, 11%, so I would be bragging that it's at 16. I don't expect he's gonna brag about it, but that's simply a byproduct of all these different moving parts. The question ultimately is what it could be. All of economics is about trade-offs. All of economics comes down to marginal economics and opportunity costs. Could we be 18%, could we be 20%, could we be exporting liquefied natural gas, could we be doing more today to be a bigger exporter of LNG in the future? Those are all pretty legitimate questions that I think are probably a more sensible component of how we think about current energy policy. All right, almost ready to wrap this up.

Someone asked what velocity was with respect to money flow. I've talked a lot over the years about velocity, but it's always worth redoing. It's such a huge component of understanding inflation that essentially money supply times velocity equals the price level times the total supply of goods and services in the

economy. This is the Irving Fisher price theory, the quantity price theory of money, and more or less the reason I think that we have gone through, there was that substantial increase in money supply without a substantial increase in inflation for those 25 years, and you had really downward pressure on inflation in countries like Japan, post financial crisis in the US, Europe, UK, was not that money supply stopped, it grew, and yet it was because velocity went the other way, and those two numbers are multiplied together, and that's what a lot of people missed, and certainly I've spoken over and over again about Milton Friedman not really ever living through a period where there was not stable velocity, or even elevated velocity, but what is velocity? It's basically a measurement of how much a dollar turns over in the economy. So if somebody, if there's new dollars created, there's new money supply, then if person A spends it with person B, and then person B goes and spends it and rinse and repeat, it's moving all over, that's a high velocity. It's one dollar turning over a lot in the economy, and that is factored into how we think about what the impact of money supply and velocity will be on prices, but when you have a very low velocity, and we see in the data, and I've studied this significantly, low velocity is highly correlated with low loan demand. Low loan demand comes from low expectations of economic growth, low insignificant amount of new projects to invest in. It puts downward pressure on velocity. So that's a big part of the thesis around Japanification. It's a big part of the explanation around Japan's own low, slow, no growth turmoil, but that's the basic kind of back of napkin definition of velocity.

All right, there are gonna be a couple other questions that I'm gonna leave you to look at at dividendcafe.com because I am limited in time. My very last thing I'm gonna cover, because it's kind of an easy one, is how does the labor participation force, how does the Bureau of Labor Statistics measure people that are so-called creators, YouTube creators? They may be making some money, and yet are the BLS counting them as employed or unemployed? And it could be creators, it could be social media. There's a lot of these sort of gig economy issues that might be newer, off-grid, and are they distorting the data or not? And the best way to answer is to understand that, first of all, if this was being missed, it would be understating employment, not understating unemployment. You follow me? That we'd be talking about people that are technically employed, self-employed, and that would make the very low unemployment we have lower, not higher. However, the BLS does measure self-employed in the statistics, and that's part of the model that they have. Now, are they able to capture all the new gig economy people that are self-identified as self-employed? I don't think we have any way to know that, but I would suspect that we do in the sense that that would be putting lower pressure on the unemployment, not higher. And so this is factored in. We've always had consultants. We've always had, I mean, look, this term influencer is a new word. It's kind of a laughable word, in my opinion. But are there people out there that are making a living that don't have an outside job, don't have a W-2, don't have a K-1, don't have a 1099, and they're self-employed as a influencer? There are. And is that factored into the self-employment capture of the BLS? I imagine it is, and I imagine it

isn't perfectly. But how many people is that, really? Is it enough to move the needle in a labor force of 160 million people with three, four million unemployed with nine million job openings? I don't think so. I don't think these things are needle moving. But these are good questions, stuff to continually think about, challenge ourselves as we analyze the data. I'll leave it there.

There are a few more questions at dividendcafe.com. Thank you so much for listening. Thank you for watching. And thank you for reading Dividend Cafe. And I will see you next week. Where am I recording next week? I will be very likely recording in Nashville, Tennessee, I'll be at our Nashville office next week. But I might even be recording at a special surprise destination we shall see. Thanks so much. Have a good weekend.

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