FRIDAY, MARCH 29, 2024



Well, hello and welcome to a special episode of the Dividend Cafe. It is special because we're recording on Thursday. You're getting it on Friday and it is a very rare market holiday on a Friday. As we celebrate Good Friday and the beginning of the Easter weekend. We also come to the end of Q1 calendar year 2024. First quarter is done. We'll hit up Q2 next year. And it has been a fascinating first quarter to say the least this year. I'm recording from Austin, Texas. We were set to record in our Austin office, but it has been kind of a whirlwind, crazy morning of things moving around. So I'm recording here from the hotel in Austin, heading back to New York city. And I'm going to be providing clients next week, a much deeper summary of what took place in Q1 with markets, particularly with various elements of our portfolio. But my focus today is on a handful of different things have been on my mind around the markets, macroeconomic. And we did kind of one of these multi topic Dividend Cafes.

First I'm just going to jump into it in the interest of time. Not just my time recording, but your time listening, because I got to think you have some March Madness games to watch and Easter weekend to enjoy. Passive investing. It's all the craze. It has seen trillions of dollars go into it. It's benefited over the last 15 years from a bull market. Where virtually every year markets have increased. There's really only been one bad down year and one barely down year. And that happens at the same time. There's been a lot of innovation in the product manufacturing of passive indices.

So it's not a big surprise. Cap weighted indexes have drawn a lot of capital as some of the biggest companies have become even bigger. But there's a couple of things I want to share. I share all the time. A passive indices clearly rely upon multiple expansion and multiples, which is what we call price earnings ratio are already very stretched.

But I also want to point out that right now we have an average median stock across the whole U. S. public stock market of only 17.5 times. It's a little bit higher than normal, but it's not brutal. And yet at the same time, we have a pretty high number it's not an all time high, but it's a very high range of things of 23 percent of companies trading above 30 times earnings.

And we have, obviously, as I've talked about a lot, the highest waiting of the top two, top five, top seven, top 10 companies we've ever had. So it's a very top heavy index. And if you basically have 17 and a half times average median, but you have a high level, of those companies that are above 30 times earnings, it stands to reason that it's a small amount of companies that are extra super duper sized that are bringing that higher valuation.

At the same time, you see a really declining correlation among stocks, a big dispersion of returns. So my friend and frequent

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Dividend Cafe reader, Michael Poulos himself a wonderful analyst and intellect in his own right mentioned to me this week in the email correspondence that this appeared to be an indication of a weakening environment for passive, a better way to say it as the way he put it opportunity for active managers.

I could not possibly agree more. I think that when correlations are dropping. You're going to see a breakdown, a higher dispersion of returns. And a lot of this is driven by, first of all, right now, the easiest trade in the world. You could be wrong in it and lose money. You could be right and make money.

But one way or the other, you're going to be different than the market. It's just a simply own a lot less of the super duper big things and own more of the smaller things. But see right now, when you say that, you're also saying, oh, less of the expensive things and more of the not as expensive things, those two things are synonymous based on where valuations lie.

I think it's worth pointing out that is probably something that bodes very well for active management. And I also think that's an. Inverse way of saying something that doesn't bode well for passive index management. Just for those wondering, high interest rates, tightening credit, spreads had widened, Fed's been tight for a while.

Where are we on the default cycle? High yield bonds, they were financial crisis, I believe at 14 or 15 percent defaults. The dot com crash the total high yield world was over 10 percent defaults during COVID. We got to eight or 9 percent defaults. We've averaged five to 6 percent for 25 years. We had been at about 2 percent as the feds tighten, we've come up to about Four.

So we're still below averages and that's with it increasing from Fed tightening, but well below those periods of actual distress and credit markets. This continues to be one of the major stories of this Fed tightening period of those things that often have happened that haven't. The Fed will end up being the big story of Q1, but it will be the big story for the reasons I said it would be at the beginning of the year, not the reasons many others said.

And the simple reason is. At the beginning of the year we were pricing in six Fed rate hikes for the year. They're now pricing in three, maybe four. We were pricing that they're going to start in March. We're now pricing that they're going to start June, maybe July. And yet, markets are up significantly. In Q1, the markets have said time and time again, other than on the day of or day after other than the noise surrounding a Fed announcement,  they're not buying the noise.

The markets are responding to liquidity. They're responding certainly to valuation expansion. They're responding to sentiment. They're responding to animal spirits. They're also responding to earnings, but whatever the different factors are, the noise of the Fed is not the primary driver and that narrative desperately needs to change. Couple other random things I'm gonna let you go early today. The Fed is well aware that their headline inflation rate remains higher than the two percent. They're well aware it's come down significantly. They're well aware that the shelter number, if it were properly measured, probably does have a two handle in inflation.

If not two, somewhere around two and a half, two point six. And the Fed is not interested in there being a resurgence of inflation. So why would the Fed be talking down rates, talking about rate cuts, if they believe the inflation issue is still lingering? The Fed is well aware that deflationary spirals are why they exist.

That when they happen, they lose control of the ability to put it out. They have policy tools that can do a lot of harm and damage that people don't like, but do put down inflation. They don't have policy tools to put down deflation once it spreads. That's been the story of some of the great contractions and cyclical periods of pain and distress throughout world economic history.

So at a high level in long term, I don't care what anyone says. The central bankers of the world exist to put on an anti deflation uniform. They still care about price stability. I don't think they're very good at creating it. They are somewhat political animals, but at the end of the day they are well aware that there's been massive disinflation.

They take a lot of confidence, as they probably should, in seeing how core goods have basically come down to zero percent inflation, and that the shelter number is not really reflecting reality. So then it looks at the higher services number, tries to put, get its arms around where the difference in core and headline is.

So at the end of the day, I really believe that the Fed is going to prove to not care as much about this optic, this narrative, this conversation that they will be cutting rates later in the year and that they're not as worried that there'll be upside surprise to inflation. I don't happen to agree with what the feds been asked to do.

I don't happen to agree with the way they always do it, but that's why the inflation narrative is not one lingering around fed policy. Read dividendcafe.com for the rest of this week. I do have to run right now to my next meeting, but I do want everyone to have a very happy Easter weekend. There are three or four other topics addressed to Dividend Cafe. Unfortunately, the video and podcast is getting the short end of the stick this week. I'll make it up to you next week as we enter Q2 and go into the month of April. Thank you for listening. Thank you for watching. And thank you for reading the Dividend Cafe.