DIVIDENDCAFE | PODCAST TRANSCRIPTION

FRIDAY, APRIL 12, 2024

Well, hello and welcome to the first ever Dividend Cafe being recorded from Bend, Oregon. I am up in our office here, in Bend, Oregon. We opened a Pacific Northwest location two years ago. I've spent the last three days here with Joleen. We've had a wonderful time with many clients doing dinner events, two different nights, and really enjoyed our time with John and Jill and Drew and Nick the two advisors and financial planning professional and operations professional that make up the team here at our Pacific Northwest location.

Bend is a beautiful city. And I very much enjoyed the time in the clean mountain air and we'll be heading out here shortly but not before bringing you the Dividend Cafe. I began reading a handful of different research papers I was sort of behind on very early this morning and became quickly inspired with a couple of different topics I wanted to go around the horn with today the lay of the land and markets is fascinating, but it allowed me To kind of tee up a theme, which is that the markets were at 39,800 in the Dow, which was an all time high on the last day of March at the closing of March all time high 39,800.

And I'm sitting and recording in the middle of the market day on Friday. We're down a few hundred points, but since that closing high in what is almost 10 trading days, nine and a half trading days, the market has gone down about 1600 points well. The interesting thing is that from March 15th to March 30th, or I think it was March 29th was the final day of the month markets were up maybe something over a thousand points.

So two weeks, the markets moved up that quickly, two weeks, the markets moved down that quickly. And you ended up just kind of in a round trip, more or less back to where you began just literally three or four weeks ago. This is the byproduct of markets right now. They're very trigger happy, both to the upside and downside.

What was going on in that first 10 day period of markets had already been up quite a bit in the first quarter and had that additional rally. You did, you, I think it's important for me to address what one of the theories is, why I disagree with it is the resurgence of the so called Tina trade. The, there is no alternative.

Yeah. I don't believe it applies in this moment because I kind of think there are actually plenty of alternatives. The bonds are paying over four and a half percent. And when the TINA acronym was created, the interest rates were at zero percent, one percent. The reality is that Emerging markets are doing well.

A lot of developed international markets are doing much better. Japan not all of Europe, but some. They're, you know, private credit is doing very well. High single, low double digit returns. There's alternatives. I don't think it's a matter of a TINA issue. I think it's that we're dealing with a backdrop of pretty healthy corporate.

Fundamentals that they have essentially been strong earnings have outperformed margins have been good and yet there's been a concern of higher interest rates and that concern has slowly but surely been getting mitigated into capital market pricing. Because the higher rates have not been impacting big cap companies.

They haven't needed to tap the bond market. They're not borrowers. They have a lot of cash on their balance sheet already, which is in fact earning them additional interest income. The ways in which they prefunded borrowing needs during the zero interest rate moments of COVID and a couple of years thereafter really kind of alleviated some of that impact.

Look, when bond yields are moderating declining pausing the high valuations then get coupled to a hope that maybe those high valuations are going to work out and that again, it is hope, but you're attaching a hope for high valuations that might become validated, attaching it to healthy corporate fundamentals and again, corporate balance sheets.

Good cash generation that it was feeding stock price appreciation. Now, that's all the good news it's just my view of course is that's being coupled to the challenge of lower excuse me, of high valuations that put downward pressure on stock prices eventually. Now what's going on in the last 10 days to just take everything I just said and look at the situation now, bond yields have moved higher.

You're talking about going from, let's call it 4.2 to 4.5 percent on the 10 year. It's not dramatic, but it's a modest repricing. around modest differences in expectations for bond yields, different expectations for the Fed, et cetera. And as totally expected and talked about in my annual white paper a few months ago it's added to noise in the markets.

It's added to exacerbated volatility. In a perfect world, the bond yield going from 4.2 to 4.5 percent is a good thing to the extent that it would be indicating higher expectations of growth. That's not what it represents now in a market that has already gotten frothy. It really just becomes a catalyst for punishing the froth and it causing some sort of repricing.

So, you know, where does it go from here? I talked last week about the total futility and absurdity of making those kinds of short term predictions. What I would say is that fundamentally the return on invested capital has been quite good. The last couple of years, despite the fact that the cost of capital has increased.

And yet, because of the higher cost of capital, the delta between the two has narrowed. And in fact, at times gone negative. And when you get a spread that is negative between the return on invested capital, the cost of capital, those things can often become recessionary when companies slow down. On corporate spending, when they slow down on growth, when they slow down on hiring, when they slow down all the things that make them good and productive companies.

And then that slowdown causes the economy to contract. Companies haven't slowed down. No one's going to argue that CapEx is super robust. It is nowhere near where I want it to be business investment, but it's hung in there. And capital spending hanging in there despite the fact that spread has evaporated between the return and cost of capital has been kind of the major story here.

I think any fundamental analysis right now about where markets are going, that is focused on anything other than those dynamics that return on invested capital and the byproducts of this to company spending, productive endeavors, productive investments. This is the fundamental story. And when we get sidetracked by some of these other issues that are much more short term in nature, unknowable, and sometimes Frankly not merely tangential, but actually irrelevant.

I think that's where our analysis goes astray. There were quite a bit of inflation headlines out this week. The CPI came in 0.1 percent higher than expected. The PPI producer price index came in 0.1 percent lower than expected. We have a chart and Dividend Cafe.com today, showing, you know, a handful of things with above trend inflation and a handful of things below several things in deflation from electronics to new vehicles to hotel rooms to school supplies to furniture.

Do appliances to airfare, to toys, to rental cars, all in deflation. And then you have plenty of things that are, you know, above desired inflation, primarily on the way they measure shelter and then certain transportation costs. But the really big one that jumps out was auto insurance of 22 percent year over year, skewing all of those numbers.

The one thing I would say as one who is, you know, really deeply been studying the disinflation. Embedded in the data for some time, especially as it pertains to core goods and trying to wrap my arms around the disconnect and services inflation between the shelter price lag and reality is oil. I think if there's anything that it represents upside risk to inflation at a headline level, cause obviously core strips out energy prices, but on a headline level oil has come up to the high eighties, 86, 87 lately.

It relaxed in the mid seventies for quite some time. And now is recently kind of reset itself around the mid eighties. Does that get into the nineties? Does that get to a hundred? OPEC+ is not restoring the normal production levels. They're still furious at the United States for 2022 flooding from the strategic petroleum reserve and then not filling it back up as promised.

It's hard to predict these supply dynamics. Many said, You're not going to get enough supply to clear the market because U. S. rig count dropped so much. But U. S. production has been far higher than expected, even with reduced rig count. And a lot of it is related to far better efficiency and productivity out of the wells that are open.

Getting a greater yield out of those wells because of improved technology and fracking improved high, you know, horizontal drilling and other things like that, that maybe you can get more production with less rigs. That's applied debate is not something I can settle. And obviously the geopolitical complexities are not predictable by anybody.

But if I were to. Predict what could create upside pressure and inflation in the next several months or quarters. It would be oil prices, and at least that would allow for some intelligent conversation on the subject, which otherwise seems to be quite lacking. So 2022, 2022. What was the general story?

Fed tightens more than expected, valuations come down, froth gets hammered value kills growth, energy does well, commodity prices moved higher. 2023, what was the story? Oh, people are ready for the Fed to reverse, recession didn't come, valuations come back up, bond yields peak and then retreat, growth over value.

Now the question is, well, is 2024 going to be like 22 or 23? And you've had two weeks where it was like 22. And before that you had two weeks. It was like 23. This. You look it's entirely possible 2024 ends up being like one of those two years and we'll end up finding out which one, but you know, the far more likely scenario is that 2024 is going to end up being like 2024 where there will be some similarities to one of these past years, but there will be other nuances and other conditions that are just simply different.

As a result of the fact that it's a different year or different circumstances. Those binary reductions are often, I think, very unhelpful and sometimes dangerous. There's a chart at divinitycafe. com this week about the cost of interest on the debt. It's a topic that's come up quite a bit lately. It came up at one of my client dinner events this week.

And I just want to point out that right now, the percentage of total debt our interest expense is a percentage of total debt. Is just barely gotten back to over half of what it has been for 25, 30 years. So there is. A couple of different ways one can look at it when someone says the interest rates going higher are going to lead To the interest expense that the government has to pay blowing out the federal deficit busting the budget You could look at and say so because the interest rates are going higher that's going to happen to the budget Or you can say because that's going to happen to budget interest rates aren't going to go higher and i'm really pretty blown away by the fact that just intuitively Blown away Most people fall into one of these two totally contradictory camps, and I don't, and I do think it's a byproduct of a certain intuition one brings to it.

My, my view is most certainly in the camp of if something can't happen, it won't, and I don't believe that the Federal Reserve is unaware at all. of the fact that they've been asked to be an accomplice, even if a silent accomplice, to treasury spending, and that there is a point where the cost of borrowing and the service of that debt blows out the budget, and the Fed then has to use the interest rate as a manipulative tool to keep that from happening.

That's what we're I'm more in the latter camp, not that because rates are going higher, the they will blow out that part of the budget, but rather they will not blow out that part of the budget because they will not let rates go higher. I don't say it as a good thing. I say it as more the chicken or egg as I see it in this.

Process of how monetary and fiscal policy interact. All right. I'm going to leave it there. I really hope you'll go to DividendCafe.com because there's an additional section about China and their economy surprising to the upside a little bit this year when they surprised to the downside last year and how the reasons for the upside surprise in Q1 Are really more related to the neighbors and trading partners of China emerging markets, improved manufacturing, improved demand and appetite for the exports that China sends out.

And there's also a chart of the week that is one of my favorites where you get a chance to look at the P E ratio, not of the whole S&P 500, but the isolated large cap growth index, the Russell 1000. And see how that has blown out. But then a dividend index where it's dividend excuse me, PE ratio has stayed relatively flat and the Delta between the two is exploded in just recent years.

I don't say in Dividend Cafe, therefore this speaks to the relative attractiveness of the dividend side of things. But even though I didn't say it, hopefully you know what I'm thinking. Thanks for listening. Thanks for watching. Thanks for reading Dividend Cafe. And I look forward to being with you yet again next week, this time back in Southern California.

Have a wonderful weekend and please do take a little time to watch some golf. Take care.