FRIDAY, APRIL 26, 2024

Due to the publishing time constraints for us to produce our daily missive, podcast, and video, the best we can offer at this time is a machine-generated transcription which contains errors. We will continue to work to improve this service and appreciate your patience with us.

Well, hello and welcome to another episode of Dividend Cafe, I'm recording from beautiful Rancho Mirage, California where we are awaiting the end of the month of April. It has been an up week in markets. After every other week in April so far being a down week but we'll have a couple of days to go next week to finish up the month of April and go into the glorious month of May.

We're going to cover a number of different topics here this week. First, I just want to give you a quick update for those who receive the daily email that our subscribers to Dividend Cafe, we're going to, by popular demand, put back in the Tuesday, Wednesday, and Thursday email the What's On David's Mind section where I'll add my daily commentary on whatever is most pertinent that day.

If Brian is doing it, it'll be at What's On Brian's Mind. And we'll just try to beef up the content we're adding into the Tuesday, Wednesday, Thursday email, but still delivering that long form. Dividend Cafe on Mondays. And then of course the very Dividend Cafe you're listening to and watching right now we'll continue going on Fridays.

The first thing I want to talk about this week has to do with capital return to investors.  And we believe and advocate and

talk about a lot, why dividends represent the most beneficial way that a company can reward its owners for taking risk in investing in the company. Via the dividend payment, a portion of profits actually being paid back to investors.

It is real money that they really get, that they get to put in their real account and buy real things with. And one of the other more popular ways that companies can return capital to shareholders is what's called stock buybacks, where in theory they're adding value to the investment of the company.

Oftentimes they're not because the buybacks that are authorized don't often happen and oftentimes they're not because one end of the pool is being filled up by stock buybacks, but the other end is being depleted by new stock issuance for employee and executive compensation. And of course, even apart from that, where there really just is net payment via a stock buyback, there still isn't any money received.

In order to go buy groceries with it, the investor has to sell, and then that opens up all different levels of risk. So we talk about it a lot, and one of the issues that is brought up a lot when we say, You know, the dividend yield of the S and P for many years was four to 5%. And right now it's barely 1%.

And people go, yeah, but if you add back in the net effect of stock buybacks, well, then you're really, you know, kind of in the same point is the return to have capital to shareholder yield. In

other words, stock buyback plus dividends divided by the. Share price, then you have a yield that's more historical.

And not only does that not factor in the real net impact of stock buybacks being very different due to new stock issuance, but it also is just not true, even on its own merit.  The S and P yield today is 1. 25. And if you were to add back in the actual stock buyback level, it gets you somewhere around 3 percent where the historical yield for the S&P was closer to 5%.

And so you have something between a hundred and 200 basis points of shortcoming these days in terms of capital being returned to shareholders. Even if you pretend that you're getting almost 2 percent of value out of stock buybacks, which is very lumpy, very cyclical, and very immaterial. Other than that, how was the play?

Oh, okay. Let's move on. You get the idea. I want to talk about drawdowns. You know, when I started writing this earlier in the week, the S&P had drawn down 5.5% since the peak, which happened, the all time high happens to have been the very last day of March. So we closed the month and we closed the quarter all time high.

And then in the month of April, we were down five and a half. It looks like we're going to end up being up 2% to 3% this week. So that's kind of gotten cut in half already. I guess you could argue that this is making my point, not diluting my point, but my point is first of all, the index is still up about 7% on the year.

It's still above its 2021 closing high. This drawdown is, has been child's play thus far, but there's a chart at divinitycafe. com where we're trying to make the point that, you know, you could put aside real drawdowns. Like I'm saying.  1974 bear market that my birth was connected to the com collapse, the great financial crisis the COVID moment, things where you have 30 to 50% drawdowns, which have happened in my lifetime.

1,2,3,4,5 times the other. The other one being in the late 1980s for a very brief period of time, I think many of you might remember black Monday. My invest, my investment sophistication in high school was not quite what it is now, but nevertheless, I was alive for it. So there's these five periods of super drawdowns and I'm taking all those out.

We're not talking about them. The chart is really meant to show every other year and basically only showing the negative, not showing the fact that most of those years were positive at the end of the year, but just what portion of the year was negative. At some point, you have a frequent amount of times that it was down between 10% and 20%and every single year with like two exceptions in 50 years the chart actually goes back 60 years that it was down somewhere between five and 10%.

And so this is the norm. And the more we realize. That drawdowns and that downside volatility is part of being an equity holder, the more prepared we are for the upside of equities and the more temperamentally, I think disciplined one

may be. Now, what is the upside look like? That's a separate subject because I don't think right now the overall index is a very good way to capture equity upside.

I want it from dividend yield. I want it from capital return. I want it from organic growth and not requiring the components that I think are necessary for index return. But regardless Drawdowns in any form of risk assets particularly public equities are a historical norm that should be totally, completely immunized in your system.

That it's just what you're signing up for a lot of talk lately about commodities. And on one hand, there's people who trade commodities for a living. They're engaged in the purchase of commodities that have a real consistent habit of saying this time, you know, whoa. We're about to go on a tear.

You know, this is all the makings of a commodity bull market. And sometimes when you're a hammer, everything looks like a nail. But the fact of the matter is that I don't disagree that the early 2000s proved to be a very fertile time for a commodity investors, a golden era, if you will, but that would be true too, for those who are bearish on the dollar.

Those who are long emerging markets, especially by the way, those who are long value stocks too. These things have a funny way of being kind of correlated with one another. But then, you know, we've had more or less from 2011 to 2020. A it was slow, but it was nonstop reversal in that commodity rally as

things move down and to the right throughout the whole last decade.

And then, you know, we had inflationary period and now things have kind of paused and commodity bulls are screaming. No, now's the time. There is geographical, excuse me, geopolitical volatility. There is better than expected U.S. growth, although that growth expectation for at least Q1 GDP took a little hit this week.

We'll see where things go. It's been better for the last several quarters than anticipated. I could definitely see a possibility of a softening dollar, a bid in emerging markets and a bid in commodities. But the problem we have is that unless there are no more operating businesses in the world, which by the way, if that ever happens, and there's no need for commodities I'd rather be invested in operating businesses.

Then in the raw materials of the world that the raw materials of the world gain their value and operating businesses, put them to work in some capacity. It's the use of raw materials added to a business enterprise, a business function, ideas, and ingenuity. Creativity. That's what extracts value from commodities and to invest purely in the price up and down movement is speculative to attach a commodity thesis to an operating business is what I would consider to be a creational normative.

I get asked a lot about debt to GDP. It's a very fair question. I just want to make a quick point. I'll try not to go too quickly phrasing

it as, will they raise taxes one day? Or will we default on the debt is a false dilemma.  When one like me, you, and most people say this is unsustainable. That does not mean the unsustainability can be reduced to two scenarios.

One of which I dismiss out of hand because I don't believe there's evidence. It's the raising taxes would in fact raise the revenue necessary to solve for a debt to GDP ratio, because I think it would reduce GDP even if extra funds raised was trying to be used to reduce debt. I think it would trigger a deflationary spiral.

There also is the political problem that the only real room there is. To raise taxes with and still collect more revenue would be in the middle class, which both parties have ruled out politically. There's no traction at all for a middle class tax increase and raising taxes on the higher end.

It, there is a Laffer's curve point where I strongly believe it would not raise revenue. It certainly wouldn't raise much. And it would come at an economic cost. And so. I don't accept the second option is on the table, but even the first, I don't think it's true that unsustainability means default.

This is a lack of imagination on our part. I do not say this as a compliment. Debt monetization from the central bank, quasi monetization from the central bank, amend and extend can kicking use of policy tools, both fiscal and monetary. There's so

many things that could be done that I just think it doesn't help us to, reductionist or binary terms.

I would be very surprised if the end run is default. And nevertheless, the end run that I think will play out not over years, but decades is not something I consider a positive either. Speaking of these deficits, there's a chart at dividend cafe that ought to blow your mind that shows the percentage of the deficit it's expressed negatively because that's what deficit is divided by the total GDP.

So in other words, the amount, the budget is imbalanced, okay. The net budget deficit divided by GDP, and you can just see since World War II, how much that has exploded in the last two presidencies really in the last three post financial crisis, but then the last two kicked it up a notch. Just look at the chart and you draw your own conclusions, but I think it, it makes sense when you look at the chart to understand why apparently bipartisanship is not dead.

There's a section divinity cafe dot com this week about a whole asset class. We no longer invest in emerging markets debt. We had been invested in for many years in our credit sleeve, and I just want to briefly make a comment. I've had a few people wonder about it.  We did at one point feel it was attractive yield spreads, attractive coupons, and in theory, you could find good fundamentals that could provide some price appreciation, but we came to believe it was a very asymmetrical risk reward asset class, meaning a higher risk than reward.

Good coupons, but then coupons the cost you pay includes a geopolitical risk, a currency risk a certain volatility. For out of trade dynamics that you could end up having drawdowns of 20 to 30%. There's been several all the while you're trying to get 5 to 9 percent return. And we just decided we didn't like this, the lack of symmetry of that risk and reward. So we're no longer invested there. It's actually an asset class that we have to follow a lot, not for its investability, but for its information. There is a lot of macroeconomics. There is a lot of monetary theory. There's obviously a lot of Forex the currency foreign exchange embedded in it.

So there's a lot of reading and research. to be done in EM debt, but I don't think it's an investable to explain why. What are they going to do in China? GDP percent year over year. It was 5.2% in Q4. Exports have remained strong. They're trying to cheat a little bit to prop up the property sector.

But government attempts to prompt up one sector at the cost of another come at a cost. And I think that we're about to find out if their fiscal policy tools to go stimulate a property when other sectors, particularly their manufacturing and export, because of the strength of trading partners is doing pretty well.

Whether or not that's a good trade off for them as they deal with this slow down, quick fact, us energy, the whole energy sector, the S&P 500  right now trades at 70% of Apple's market cap. All the publicly traded energy companies in the S&P 500

are about two thirds of Apple's market cap, yet they generate 120% of the free cash flow that apple does it's not a statement about apple. It's anecdotal It is a statement about the energy sector. Okay, i'm going to close with a quick comment the GDP number came out this week lower than expected for real GDP Q1 I got a comment from someone saying they were shocked because it's a presidential election year. Wouldn't the president be doing everything he can to goose the numbers?

What is going on and I and it occurred to me? This is worthy of a comment. What is it that people think the president can do to goose the numbers? I'm saying in terms of GDP numbers now, so like last year, could he have passed a big, huge tax cut that would be having an impact on GDP this year? Of course, but I think everyone knows that is not politically or ideologically on the table, and that's a big policy that would take place over a period of time and have a big impact.

But like right now, today, you say, we're going to announce this, announce that. Okay, well, there's things you can do to play politics, and if you, and maybe you believe. As I do that, there's some political component to some of the student debt issues going on political component in 2022 to some of the release of oil from the strategic petroleum reserves.

But I'm talking about a hand on the lever of moving GDP, you know, for giving the student debt things hurts economic growth in the end. You know, it isn't like that debt didn't go away. It just got moved to taxpayers. So no one's getting any richer from it.

Okay. It's zero sum and it's just a reallocation or transfer payment.

My question is why do we have this pre excuse me, presupposition that presidents can pull a lever and just immediately grow or shrink the economy. Well, part of it is we just have this sort of imperial view of the presidency. It's very bipartisan. It has to stop. The president has so much less control over the economy than we think for good and for bad.

But then, you know, the cynical side of it, I understand, but I think the problem there is, leads to number two, which is a misunderstanding of how an economy works, you know, the forces of capital deployment, of risk taking, of entrepreneurialism, of production that, that lead to production of goods and services, that output becomes a consequence.

Those inputs lead to an output. Gross output, which is a production of goods and services. They're growing the wealth of the economy.  The president has almost nothing to do with that. So I don't mind the cynicism that thinks a lot of presidents would like. Economic data to look better when they're running for reelection, Republican, Democrat, Congress, Senate, house, Senate president.

I mean, I get why everyone would like that, but I just want us to remember The conspiratorial idea that they can just cook the numbers that way. They not only can't but the fact of the matter

is that the whole economy doesn't work that way. And it is what it is. And I hope that's helpful to hear. Okay.

I'm going to leave it there. Wonderful chart of the week, reiterating the cycles that play out over time between growth and value.  Please don't forget Ian Morley. If it sounds too good to be true, you can bet your bottom dollar that it probably is. Thanks for listening. Thanks for watching. Thank you for reading the Dividend Cafe. Look forward to being back with you next week and have a wonderful weekend.