DIVIDENDCAFE | PODCAST TRANSCRIPTION

WEDNESDAY, JULY 3, 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 this very special Dividend Cafe special because it is coming to you on a Wednesday. Tomorrow, of course, is July the 4th. The markets are closed on Thursday, and even though markets will be open on Friday the 5th, we thought it'd be better to get this mid-year report out to you going into the long weekend.

Surely Friday is going to be Pretty muted work activity for a lot of people. So we're giving you a dividend cafe a couple of days early. And to add to the specialness of it, we want to really do a sort of mid-year check in we, we closed out the second quarter at the end of last week. We are now.

Just a couple of days into the second half of 2024, and I don't believe I've ever done this before, but I thought I would take the year ahead projections that we did at the beginning of the year. Those are things we've done every year now for well over 10 years. But provide a kind of check in as to where some of those things stand.

We'll start with just a little bit of an update as to where things are in the markets through the first half of the year. It's not a big surprise that most investment assets are in positive. territory on the year. The Dow was up 4. 7 percent in the first half. Even the Russell 2000, which is the small cap index was technically up about 1%.

And yet the S&P Was up 15 percent the NASDAQ, even a little bit more than that. Close to 17%. So, you can call it a risk on rally if you want, but it was really not one in which those the rally was evenly distributed. And I've talked so much about the kind of top-heavy nature of the market right now, but I'm going to get back to that in a moment.

There's other things that I think are more peculiar and more interesting about the market in which we find ourselves. Generally you wouldn't look at a risk on rally and see small cap basically flat or see an almost thousand basis point difference from one major market index to another. It really does speak to the unique concentration.

Of a couple sectors. For example, technology is the highest performing sector of the year. On the year communication services, which is a cousin to technology is in second place behind it. And the only negative sector is real estate. So, it would almost appear yeah, everything else is really rallied.

But well over half of the returns in the in the index have come from just two sectors, even though in between there are eight sectors in positive territory they're just because of the market cap waiting, not contributing that much mathematically to the returns of the index. International markets are mostly positive.

When I say that international markets are up, emerging markets as an index is up about 9%. Japan was up over 20 percent in the first quarter alone. It was more flat in the second quarter. I don't want to give the wrong impression. Europe is up to some degree. I don't want to say that everything is up though, because that's a blended aggregate for international markets where there are some.

International markets that are down, but across a index of diversified countries, whether it's emerging markets or developed, those are up as well. To really find negative territory in an asset class, you have to get to bonds. And even then you're talking about negative 0. 7 percent through the first half of the year.

That's basically true in both taxables and tax freeze. And really all you have there is something in the range, which Of about two to 3 percent of negative price appreciation, but with about two to 3 percent year to date of coupon income of the interest from the bonds basically offsetting each other.

So, the total return ends up being right around the flat line mark year to date, despite interest rates being higher than they were at the beginning of the year. Oil prices are up 16 percent on the year but that's with a 21 percent rally at the beginning of the year, then a 16 percent drop, and then a 13 percent rally, so there's been bigger up and down moves, and that's just crude oil, natural gas is far more pronounced, it was basically oil.

Down about 50 percent and then basically up about a hundred percent. And so you've had a pretty severe volatility in natural gas prices as well. I've already talked about this in the Monday Dividend Cafe a couple of days ago, but. When you're talking about the oil and gas prices on the year, and we're talking about equity market performance, midstream energy certainly been a standout up, let's call it 18%.

There's a couple of different indexes that have slightly different compositions, but a median level return year to date, 18 percent in midstream and still offering very high yield. The VIX, and I'm going to talk a bit about volatility year to date, The VIX is basically flat on the year, the price that people are paying for protection in the S& P 500.

It's had periods where it's moved up higher, it's had periods where it's dropped, but not a lot of movement there reflecting enhanced volatility, enhanced fear. The cost right now of buying downside protection for stocks remains very low. The S&P 500 has had a max drawdown this year, a five and a half percent.

And all of that was within the month of April. So,VIX from its high level of the year to its low level of the year, you had a five and a half percent, what we call drawdown. More interesting to the point I'm making about the volatility is you've had literally just seven days all year where the market was down 1 percent or more.

You've had 14 days where the market was up 1 percent or more. So if you're going to have a little unevenness between the number of 1 percent up days and 1

percent down days, you'd rather be in the way it is more On the up days than down days, but it's still not very many. There's been a grand total of one day all year where markets were up or down, even 2%, and that was a up day of 2%, but that's very, very moderate day by day volatility.

So, both in the max drawdown, the cost of downside protection, the vix, and the number of up or down 1% type days. It's been very low volatility. The key issue that distorts a lot of how people feel about the market is certainly market breadth. If you had higher participation and more democratized returns within the market, and you had a market that was up 15 percent after being up the way it was up last year, it would feel entirely different.

But it's a very thin, market for those kind of superlative returns. And I think that adds to the feeling and it adds to the feeling of fragility justifiably. I think it makes sense that it feels a lot different in the economy. I think most people are aware of the mixed bag of data, mixed bag of sentiment that the jobs number continues to be reasonably benign and yet seemingly slowing a bit is not really up for debate.

That economic growth has been positive, but it's muting relative to how positive it had been last year. The consumer continues to spend. But there have been an increase in delinquencies. There is an increase in credit card debt on the corporate side. M and a activity has picked up, but nowhere near the level it had been just a few years ago.

I think most elements of the economy have shown a resilience to the impact of higher rates. But there is certainly pockets that are suffering when I talk about commercial real estate, when we talk about regional banks, nobody would call them immune from the impact of higher rates, even as other segments of the economy have proven so far to be reasonably resilient.

Housing prices have not dropped. I'm going to talk about this in a moment, but housing sales have totally collapsed. Inflation is definitely lower, but there's still

components. Whether it's the data on rent growth or auto insurance housing insurance, there's components that are staying stubbornly high.

You don't normally see loan defaults start to pick up when jobs and wages are growing, but that's happening. Not only that, but wages are up and savings levels have come way down. So you have people earning more and saving less. It's definitely been a great time to own assets. It's not been a great time to owe money.

And so. That may seem somewhat ambiguous and unclear, but I put a little link in dividend cafe. com to a short little speech from Vice President Harris and a short speech from former president Trump. Cause I want to be very bipartisan. And I just want to show that sometimes Even very distinguished people in power can be somewhat unclear.

And my intent in providing an economic assessment that seems unclear from all the data points and categories I just went through is on purpose. I'm giving an ambiguous picture of the economy because the picture of the economy is ambiguous. This is not a, on one hand, on the other hand, economic cowardice thing.

This is an economic honesty and an economic humility thing. There is, to a large degree, tension points in the data that make it very difficult to have high conviction as to where exactly some of these things stand in the economy, and that comfort level with the ambiguity is very important from our perspective.

When you look into credit, I will say that because I am one who's always believed credit is a leading indicator. That I don't believe there are very many signs at all of an appetite for corporate credit declining the cost that borrowers are willing to pay has been very tight for both investment grade credit and meaning high quality and high yield riskier corporate credit Companies are just not having To pay a lot more relative to treasuries for some of these corporate borrowings.

There's been a ample demand to meet the supply. I anticipate some of this changing in the second half of the year where corporate debt that is high grade, I think, might stay in high demand and tight to treasuries in terms of correlation, but I could see in high yield debt trading much more like stocks than like investment grade debt.

I think that will see a sort of divergence between. The way investors in credit are treating investment grade and high yield. So, I'm going to quickly go through the eight forecast perspectives, themes that we had for 2024 at the beginning of the year, and just tell you where I think the lay of the land is in some of these things.

The first one is that Fed particulars would be overrated. And this I have said throughout the year already, and including a plethora of media appearances, because they'll ask me in media interviews all the time, Oh, what if the Fed, what will the market do? If the Fed doesn't cut rates here?

What will they do with the Fed? Cuts less than expected. And I say, it's no longer a, what if this has happened, we came into the year. with priced into markets and expectation of six rate cuts. Some indication it could be as much as 200 basis points that would come out of the Fed funds rate this year.

We're now looking at maybe 25 or 50. And the, they were expecting the first rate cut of March. We're now looking at maybe September, but much more likely November, December, if that, and markets are up 15%. So that the fed particulars would be overrated is already been true far more than anyone could have predicted, including the person who was predicting it.

Yours truly don't worry. I'm getting to a point where I. I have a few things not lining up here in a moment. The second theme was the cost of de globalization being in a potential economic tension with the opportunity for enhanced productivity with CapEx, with manufacturing, with on shoring, things like that.

And without getting into the weeds of all of it here, I'll just say that I think that tension persists. I don't think that the first half of the year gave us any clarity as to which side of the tug of war is prevailing. I think the tension continues to exist. I don't know that there's going to be a lot of resolution in the second half of the year.

If deglobalization is real, which I think it is both real but also quite slow if manufacturing continues to be weak, then it doesn't appear to me the productivity boom is going to offset. If you're going to get enhanced manufacturing, enhanced employment at factories, enhanced capex and commitment from business towards a productive business investment, I think that that could end up becoming a boost in economic growth.

There's a lot of different factors that are Sorting themselves out in real time. And that continues to be a big theme of ours. Not one that I think the first half of the year gave a lot of clarity on number three, quantitative tightening would be an underrated story. The fed has gotten 2 trillion off of its balance sheet.

I think they're near the end of the rope as to how much they can get done in Extracting liquidity from the financial system without doing damage. And on May 1st, you had April 30th, the market dropped five and a half percent. May 1st, they say, well, we're slowing the pace of our tightening, still tightening, but instead of 80 billion a month, it went down to 25 billion a month.

That's a very big drop. Lo and behold, markets start rallying immediately. I think there's already been vindication on this, but I am expecting it to be more pronounced. And eventually very possibly getting from a quantitative tightening to a quantitative easing. Scenario, but at the very least a cessation of quantitative tightening as the Fed begins to think they overstayed their welcome.

I love this one. China to split the baby on Japanification. Very much they have leaned into fiscal policy, subsidies, spending, policies, targeting, but very much so leaned away. From Japan and us like monetary policy. So in both cases, the

Chinafication has thus far been a split baby of what Japan's playbook has been the one in which we're so far away from a full year prediction that I continue to believe is still very likely by the end of the year.

But nevertheless, first half of the year didn't do anything to vindicate. That is my forecast of broader market participation in 2024 than we had in 2023. And thus far, of course, has been the exact opposite. So we shall see what happens for the second half of the year. Number six earnings for 2025 forecast for earnings, In 2025, that earnings outlook will dictate 2024 performance.

It's already played in. You were getting about 10 to 11 percent earnings growth expectation for 2025 at the beginning of the year. Now they're expecting as much as 14 percent earnings growth, which would come in at 279 a share of earnings in the S&P. And that earnings growth expectation for right or for wrong is behind much of why the market is up 15 percent on the year.

The second half of the year, if you start seeing earnings growth expectations, revised downward. I would expect that to have a big impact on markets and not a good one in 2024. The election will not be as big of a market story as it is a news story. This was hardly a prediction. It was me just repeating the lesson of history and I will say it continues to be our view as well as the fact that we think it's going to be a reasonably unknown presidential election outcome.

Right now, we don't even know necessarily who the candidate is going to be. And then, of course, the Senate and the House and some of the policy ramifications remain TBD. We're going to write exhaustively about this in September's Special Dividend Cafe on the election. And then finally, number eight, another one that is just thus far not been true at all, is prepare for much more volatility.

And as I mentioned earlier, measured by VIX, by day to day up and down movements, and by drawdown, it's actually been very low volatility on the year. Going forward clarity around 2025 earnings, I think will be the big factor for 2024.

WEDNESDAY, JULY 3, 2024

I think fed actions to begin cutting rates will be discussed, but I I think it's more likely to impact markets.

If they don't do it, then if they do, it'd be very hard for me to believe something, the market is priced in happening could be a further juice to markets, but I do think it not happening could be disruptive or at least create a timing volatility. Number three, the opportunity for valuation to crack.

We know we're very high multiples, and I think that the asymmetry of this is the problem at 25 times. Forward earnings. You could say, well, you know, again, if you want to take the new ordinance revisions and call it 22 times, I don't feel comfortable saying 22 times is going up to 25 or 26, but could 22 times come down to 19 or 18.

Yes, it could very easily. And in fact, it could do so and still be. Well, above historical averages. So the valuation wall is an ongoing story we'll deal with right for the end of the year. And then, of course, the election itself, perhaps a very late year story. It's obviously going to be a lot of discussion, but by the end of the year, getting clarity on where the next couple of years of agenda will be in a number of elements of policy, particularly in health care, health care.

Tax policy and energy. So, to recap, I w I think you're looking at essentially earnings expectations for next year. The fed will, they won't, they, the valuation story. And then the election, these become the kind of four major market themes for the remainder of the year. There is a chart in the divinity cafe today showing over 80 History, I think goes back about 25 years.

The total volume of existing home sales, and you can see the unbelievably low level we are in history, the lowest since we've been doing the charts in a period where corporate profits are growing or wages are growing, where jobs are plentiful. And you can see that it's now lower than the last period where it got real low, where we were in a full blown, severe recession.

WEDNESDAY, JULY 3, 2024

It's surreal. What has happened in terms of volume in housing for all the reasons we talk about a lot. I'm going to leave it there. I'm so grateful to be going into a 4th of July weekend. I'm grateful for our country. And I know many of you are as well. The story of America's independence does transcend.

Some of the ways in which we'll celebrate tomorrow the barbecues and beach parties and hot dogs and sun and all that stuff is fun and necessary and important part of American life and culture all made possible though, by a creator who endowed us with certain unalienable rights amongst those include the life, liberty, and pursuit of happiness.

I hope you're happy this 4th of July weekend. God bless America. Thanks for listening to watching and reading the Dividend Cafe.