FRIDAY, JULY 19, 2024

Well, hello and welcome to another edition of the Dividend Cafe. I am once again here at my house in East Hampton. I will be recording next week from a very special event in Napa Valley, California. I'll be speaking out at the Napa Institute's annual symposium. And then we'll be in California for about a week.

And so, just moving around, doing the deal. It's been a crazy week in the world. From the assassination attempt, which was last Saturday, I had a dividend cafe, the Monday edition where we've already discussed it, but haven't even had a Friday dividend cafe since then. So just to, I say that to point out, it's only been six days since that event, which came one inch away from being one of the biggest news events in history.

And then since then, having had the whole Republican convention, what looks like may very likely be a change coming in the Democratic party candidate according to a lot of different news reports at this point, which is why I can share it, but has been stewing with sources of mind quite heavily for about 48 hours.

The selection of President Trump's Vice President running mate JD Vance, the Senator from Ohio. It's just been action packed week in politics world events. The. Earning season for markets is well underway. There's actually been a lot of action in markets. So it's, there's a lot going on and I thought that was a perfect time to not talk about any of that stuff whatsoever.

So today I want to go back to the subject of inflation and yet I don't want to do it in the way that a lot of others are talking about it right now, which unbeknownst to them, they're actually not even really Talking about inflation, they're also talking about politics because when you look month by month and see, are we going to be 0.

1 percent lower or 0.1 percent higher? It's a story of interest for a headline purpose that may or may not have some kind of relevance to another narrative that is important to people. The broader macroeconomic story of inflation. Is one that plays out over a long period of time and it's much less exciting to people And it is a subject of a debate of multiple debates actually because There are questions about what causes inflation There are questions about what the cures for inflation may or may not be there are different variables that play in and my very strong contention on Through this period, and of course, Dividend Cafe readers know that I've been writing about this subject.

Candidly, I've been heavily studying this subject. For many years before the inflation outbreak of 2022 the prolonged post financial crisis period of a lot of downward pressure on global inflation but particularly here in the United States really created a subject interest for me that has not waned.

And I don't believe will, and there's a lot of ramifications to it in our investment philosophy and things I've talked about for a long time, but there is in the 2022 inflation moment, there was a school of thought that said, Oh, well, we had high inflation because government spending was so high out of COVID and monetary policy was crazy.

And I was pretty on the record as to why I didn't believe that was the particular. reason at that time, and I do believe I've been somewhat vindicated about that, but that's okay. There's a lot of controversy. around it. And right now, I think that there's a debate where there are people who believe there is upside risk to inflation and an upside expectation for inflation going forward, yet not because they're of monetary or fiscal reasons.

that they would hold to a different rationale for the same conclusion. And that's what I mean by the nuance of this, that it's not always just binary. You would think there will be upward pressure inflationary. I think there'll be downward. You think it was caused by this or you don't think it was caused by that.

There, there are various nuances and pivots and turns that invite a little more complexity. And I think that this warrants a lot of understanding for investors and certainly for investment managers like ourself the school of thought that is concerned about upward pressure and inflation going forward and again, this is on a global context, a global inflationary bias is one that I want to consider even when it is Especially when it is rooted to something that is outside that conventional thesis of, well, it's just because of excessive debt that's inflationary or easy money that's inflationary.

I believe that's been largely disproven. I believe it's been multi decades of disproving going on in multiple domiciles or geographies, not merely the United States, his own context and experience. And that's why I talk about Japanification so much. So it's a long setup, but what I'm getting to is, are there other factors that even someone like myself, who's been so laser focused on studying Japanification, the effects of fiscal and monetary policy, and putting downward pressure on nominal GDP growth, Is are there other factors that I may be missing?

And so I used today an outline from Anatoly Koletsky who is a highly regarded Keynesian, economist and both those things can be true at once. I'm not a Keynesian I have strong philosophical differences But I am also not so arrogant as to say that there are not highly regarded Keynesian economists Some of my favorite economists to read happen to be Keynesian, but I enjoy being able to read them from a vantage point of knowing exactly why I disagree.

And that, that's a matter of having to, throughout my economic studies over my adult life, having to really unpack what the first principles are so that attacking Keynesianism, or someone else attacking Monetarism, or someone else attacking Austrianism, you look at these different economic schools of thought.

And you're not, you should not just be doing it because of a partisanship. Even an economic partisanship that there ought to be a philosophical connectivity to what you agree with and disagree with and why. And when I think of Antoni as a a Keynesian I don't think of that as pejorative.

I think I talked about what was it now, maybe a month ago when I was talking about the Minsky moment. And why I didn't believe this NVIDIA valuation bubble was a Minsky moment per se. And I went on to define what the legacy of Hyman Minsky was. I said a lot of very complimentary things on Minsky because I think there has to be something wrong with somebody to not say positive things about Minsky, but he was essentially a kind of Neo Keynesian.

In the second half of the 20th century and then where I really got turned on to Minsky and unpacked Minsky-ish understanding of the 2008 financial crisis was from Paul McCulley, who's been long retired from PIMCO. And I don't think Paul and I agree on a single thing ever, politically or economically, and I absolutely adore the guy, love reading him.

So, I say this to, to give you a context that with, when I'm using this structure here, I disagree with it. And I'm going to go through why I don't believe these things represent inflationary causation. But I say it from a vantage point of respect in the point of view, I think it is prima facie important to contend with and understand.

But I also respect some of the people from which these arguments are coming, who, by the way, it can come from people of an Austrian vantage point as well, or other schools of thought economically besides Keynes. But because I'm borrowing Anatoly's own outline and he's Keynesian, I'm just setting it up that way.

So, the arguments here more or less are that there's anticipation of upward pressure coming in inflation for years to come. And that one of those reasons is de globalization. that there will be less competition globally, which will mean less downward price pressure. Another way to say this is that globalization aided disinflation and deflation.

And so therefore de globalization removes some of that aid to disinflation. Ergo it inversely. AIDS inflation. Okay. I'm going to come back to this demographics, the idea that there's more baby boomers retiring and that would mean more government spending. We are in a context in which there's a low appetite politically for immigration.

So, you're going to have less workers to fund more retiree expense and that demographic reality. will cause deficits to expand and inflation to rise. I'll get back to it. Politics, in this populist moment, both left and right wing populism, there's a demand for higher wages, especially for middle class, working class earners, and that could create an upward, an upside wage price spiral, more wages than pushing more aggregate demand.

Pushing higher prices, which pushes a demand and a political in context for higher wages, still a spiral to the upside around wages coming from a politically populist moment. Number four is war that there's increased defense spending drives deficits higher. And that quote unquote, everyone knows war is inflationary.

We're going to come back to that. Number five, environmentalism. And this is interesting. But there's a global opposition to fossil fuel. It will limit supply. But demand will continue to grow. And there's energy transition to renewables playing out that requires high capital intensity. So, all of these things represent a classic case for higher prices.

And then number six technology the mag seven, the Fang, the big three, the big four, the big five, the big cap growth, these dominant in most cases, multi trillion dollar plus market cap type names. Are essentially monopolistic. They have unlimited pricing power. The efficiencies that we're told are going to come from artificial intelligence in pricing are overrated.

And so therefore there's a risk of higher costs because of technology, not a lower one. All right, so look from tech, let's recap real quick. Technology, environmentalism, war, politics demographics, and deglobalization. Out of those six factors, the way that they've been articulated, if you believe there's something to those arguments in three, four, five cases, obviously all six, then there's a prima facie reason to believe that you would see nominal GDP expansion fueled by inflationary pressures.

I happen to not agree with a single one of these points. And I want to walk through them quickly. You could think one or two of them have some merit and not necessarily conclude an inflationary thesis. I think it's batting zero for six. First of all, deglobalization does not have to be inerrantly inflationary.

For one thing, the pace of de globalization is highly uncertain. People talk as if there was a 20 year period of globalization at this period, and now there'll be 20 year or a two year period of undoing the same. I don't believe anyone in their right mind thinks that all of globalization is going to be de globalized.

There is a marginal movement to undo some of the globalization, particularly around the supply chain. And I also, by the way, very much agree that it will prove to have a cost to it. I think that increased cost from de globalization. Is uncertain what it will look like. It will be spread out, it will be temporal.

And it's very possible that it could be offset by greater productivity out of regionalization, out of capex renaissance, out of marginal efficiencies. That could very well create a different price outcome. The idea that it's a foregone conclusion that deglobalization will prove inflationary is simply untrue.

The demographics one is, I think, just a matter of getting as a non sequitur, just getting the wrong conclusion from the right premise. I do believe we face population decline around the world. And I do believe that lower fertility lower birth rate and lower population growth over time are deflationary, not inflationary.

I think aggregate demand declines that you get less productivity, less innovation, and then most importantly, you get a higher dependency ratio. So there are more people having to contribute for the output necessary. Excuse me. There are less people available to contribute for more people who are not contributing in terms of, to make it more simple, retirement pensions, for example, being economically supported by the productivity of a lower size workforce Ascent more resources coming from the productive to the unproductive as a percentage of output in the economy.

This is an inherently deflationary component. And again we haven't had a ton of countries that have had significant decline in demographics, but one of the major world countries that has is Japan, and obviously that was extremely deflationary. Then the idea about politics, populist politics.

There's a few things I want to say about this. I don't deny that we are in a period right now, both the right wing and left wing populism in our national politics for what it's worth. I don't happen to like it very much. And I agree it will drive more redistribution, but I don't agree that's inflationary.

Even to the extent it expands deficits, I believe that fuels a Japanification, a negative feedback loop that is actually disinflationary. A poor allocation of resources, especially a poor allocation of capital, always puts downward pressure on nominal growth. I do agree to the extent that the populist politics are seeking some protectionism tariffs and cut off a trade and things like that, which is something I'm going to address more in my election white paper in September.

I agree that protectionism is inflationary. But I don't know that pretend protectionism is. I don't know that bad ideas like protectionism can or will last. So the notion that something being threatened will end up having an inflationary outcome when getting any sustenance of this dynamic.

In this case, I talk about protectionism. I think that's a very big stretch and it's not one I would want to bet on. And then think finally, we want to talk, let's see, what is their final one here? Democrat politics. So we have a couple to go here. So I'm sorry. War is interesting because there isn't much of an argument as to why it's inflationary.

There's just a statement of fact where war we know to be inflationary. But I want to dispute two things in this. First of all, the idea that we're now in a new era of elevated war. That the Russian invasion of Ukraine, the Hamas attack on Israel, Where those conflicts stand still open ended. This is, unprecedented.

A paradigmatic shift. And that's just simply untrue. These things could escalate. I pray they will not. I would like someone to point to what the period is they're referring to where there was not some global conflict that undermined a peace dividend. I think there was a period. A temporary period in between the fall of the Soviet Union and 9 11 that you could argue it, it felt like there was global peace dividend, but the Iraq war, the Afghanistan war, the various Arab spring uprisings, the not, and even apart from Middle East, other Russian agitations and just human nature, which I've written about in Dividend Cafe before.

I don't accept that this is anything new. I consider this to be extremely embedded in human nature priced into markets and not new, therefore allowing for me to formulate a new inflationary thesis around it. Is war inherently inflationary? Look, I would say this defense spending as a percentage of GDP may very well go higher.

I hope it does. But that's also because I hope non defense spending as a percentage of GDP goes lower. But I don't believe that we had, we have enough info to say that this dynamic would prove to be inflationary deflationary either way. The environmentalism argument is quite intriguing because it does presuppose that the zealots will get their way.

That they'd put downward pressure on fossil fuel production and the demand would stay level or demand would keep growing. And it's certainly true that if that were the case, higher supply, excuse me, higher demand or lower supply put upward pressure on prices. But I would say it's quite interesting because the first of all, that is an argument for a higher price in oil.

It is not an argument for a higher aggregate price level. A specific increase in a specific spending category is not how we define inflation. And secondly it presupposes that the environmental zealots that he's referring that this argument is referring to are going to win. I would ask you, do you think ESG is the same momentum now?

It had four or five years ago. I think that they're on their back foot. Look, oil was 10 in the early 1990s. It stayed between 10 and 20 for a decade. It got up to a hundred. It's been, you look at it now. Like anything below 60 is extremely unexpected. It's been a while. The range is been somewhere around 70 to 90.

And yet we had a significant amount of disinflation over the same 20 year period that oil repriced from a 10 to 20 base to a 70 to 80 base. So I just, I don't agree that the environmental dynamic is creating an embedded inflation. There's ample evidence that the opposite is true. And then the opposite truth in technology, this is most fascinating.

First of all, I don't think that the pricing power, when we talk about monopoly, I want to be clear that I would agree that they are effectively a monopoly, that they have a pricing power, That is potent, but I use that as an economic term, not a legal term. Because I would not say that is the same thing in what we're describing here, as far as an actual definition of antitrust, but be that as it may.

Does anyone think that the pricing power Amazon has led to them paying higher prices for e commerce versus lower? It has not played out that way. I consider myself to be as AI skeptical as anyone. I was Interviewed by Bloomberg about that this week. And there, there was a Goldman Sachs analyst that also interviewed and there seems to be more financial media coverage right now of this idea that maybe just maybe some of the efficiencies and applications promised out of AI may not come to fruition.

I'm not trying to sell some rose colored glasses AI brings prices and technology, but I do think there's going to be some efficiency. Some margin enhancement, some reduction in cost as a result of AI. And I just don't think that the monopolistic pricing power of big tech has proven to put upward pressure on prices.

I think it's been one of the most radically deflationary components in economic history. And I also would say that the politics point is a direct odds with this point. You can't argue that left wing and right wing populism is demanding more income redistribution and then also argue that the big tech companies are going to get away with price gouging.

Because the populist politics wouldn't allow for that either. So I just don't see look, there's some, I don't know the magnitude and I don't know the pace of impact but I do know the direction and I think technology would be an argument for anti inflationary forces. The part I want to leave you with is the most important part, and that is the bond market.

We're so used to talking about this time it's different with the stock market, with risk assets, that how dangerous it is that, when people see very overpriced stocks and they go, no, this time it's different. They're going to stay overpriced forever. And I agree. And how dangerous it is when things are really low.

And they go, this time it's different. They're never coming back. And this time is different. And I, I agree that's dangerous, but we talk about it on the stock market a lot, but at the end of the day, a nominal GDP growth of six, 7%, which would be necessary to allow for this four or five or 6 percent inflation worry.

Is just so far away from being reflected in the bond market. Trillions of dollars of bond actors are asset allocators around the globe are of the opinion and I, and they may be optimistic here about growth, about nominal growth. That you may get something around 2 percent real GDP growth, which is well below trend line and 2 percent inflation.

And you end up somewhere around 4 percent for the long haul. The bond market is structurally indicating that. And I'm and my question is. Well, what, how do we explain this tension? The answer is, well, the bond market has it wrong. And I'm a believer in humility in investment markets and all of life for that matter.

I don't think that we should say it lightly. That the entire bond market has gotten this wrong. I think you want a high degree of proof and a high degree of conviction before going there before you bet against the bond market, but structural factors are priced into bonds and this would require a pretty significant.

Shall we say flawed price discovery if indeed the structural upside to inflation were to come to fruition that is being predicted out of some of these other factors. It's a little wonky this week. A lot of nuance in some of these categories. It's just a topic I really wanted to address. The other thing at DividendCafe.

com that you really want to go read is I covered a number of other factors about government spending about productivity, about the percentage of debt in the S& P that interest is covering now. There's a lot of these other little side things. topics that I think you'll find interesting. The relationship between growth and value.

The, all of it just go check out divincafe. com. If you get the chance, reach out with any questions you have about this week's topic. And I look forward to being with you again next week. I will be recording from

Napa Valley, California. In the meantime, I have a wonderful weekend. Thank you as always for watching, listening, and reading the divining cafe.