FRIDAY, AUGUST 9, 2024

Please note that this podcast transcript was machine generated. As a result, it may not always read smoothly, as it reflects unedited spoken content. For the clearest understanding of the podcast's content, we recommend listening to the podcast itself. For complete clarity on the topics addressed, we encourage you to always read the related Dividend Cafe missive and related communications at dividendcafe.com.

Well, hello and welcome to the Dividend Cafe. It has been an amazing week. I am David Bahnsen, Chief Investment Officer, managing partner at The Bahnsen Group. Many of you know that for those who don't know, I just always want to make the introduction. So you know who you're talking to. And today you're talking to someone who was really blessed, privileged, thrilled, honored, to ring the bell on the opening of the New York Stock Exchange this morning, along with Brian Szytel, my co Chief Investment Officer, and Kenny Molina, our director of Investment Solutions, Mina and Joleen from our Client Experience team and Teddy and Liping, our research equity analyst. We all together were on the floor of the exchange ringing the bell. And I joke in Dividend Cafe that if all you did this week was look at the market where it closed last Friday, and then look at the market where it is here and keep in mind as I'm recording, there's a couple hours to go so who knows, but markets just down a couple hundred points on the whole week, literally like 0.4%. And so you might think, Oh, the biggest story of the market this week was Bahnsen and his team getting to ring the bell on the floor of the exchange. But actually it was a pretty significant week in markets.

It just round tripped. And what I mean by that is there'd been a sell off late last week, especially in the big tech things. And then going into the weekend there was some questions as to where things were in markets. And on Sunday night as American futures opened up, they were down quite a bit.

And across the world as Japanese markets were opening in Tokyo. They were getting hammered and it quickly became apparent that Japan, the Nikkei. Was not down as a follow on to what had happened in American markets Thursday and Friday, but rather American markets were pointing down as a follow on to what was happening in Japan.

And what happened was that day, it was Monday in Japan, Sunday night for us in America. The Nikkei dropped 12 and a half percent in one day, the worst day since Black Monday, 1987. And there was a lot to talk about, which I already did in the Monday Dividend Cafe of, a few days ago about this Yen carry trade. Which really was at the crux of the drama on Monday. But as I pointed out Monday and we'll still point out today, it's coupled with other stories like the tech sector overvaluation concerns, as well as economic strength and concerns about economic slowing. And so there was, more than enough fear or rationale for fear or ability to let our, your one's mind get carried away with it all.

So the media had its normal fun with it and so forth. But when all said and done, that Yen carry trade issue was a big deal. It obviously stopped. The Nikkei had its biggest up day in the

history of the Nikkei the very next day. And then, as I mentioned, U. S. markets just basically came back around to barely being down on the week when all was said and done.

So, I believe that there's a few things to be said today. And I could just talk about the uncarried trade, why it matters, what happened, and I'm going to do that real quickly, but it's not what the Dividend Cafe is going to be about. It's wonkish. It's boring to some, and I want a Dividend Cafe to be really fun for everybody.

But also there's a much bigger point than just simply this Yen carry trade idea. So first let's get this out of the way. What do we mean by it? What, why this weird terminology? The Yen, for a lot of reasons I've talked about in other context as a byproduct of various policy objectives in Japan, particularly out of the Bank of Japan, has weakened against the dollar this year It is a very low yielding currency basically zero percent Although it went for a long period of time where it was a negative yielding currency And this was all by design in terms of their policy objectives with a very high debt to gdp And a very high need of monetary intervention based on their debt deflation issues that they've been fighting through.

And I've written about all this stuff a lot, but what it also has done when you have a currency that is at a low price and you have a currency with a very low yield. In this case, it was a 0 percent yield and yet a currency that is not exactly a third world country. And in fact, as a developed currency of a reasonable

size economy, it's been a reasonably anti fragile currency. It's done well when there's been moments of big distress, 9/11, 2008 financial crisis, things like that. So it was a good candidate for a lot of speculators, borrowers, investors people who wanted to use leverage. To borrow Yen and use that to buy Chinese one U. S. dollar and then from their assets denominated in those currencies. So it's called a Yen carry trade. You're getting a carry in your investment, you're leveraged, and you're doing so but with Yen, That you borrowedand you're borrowing it because it doesn't cost you anything to borrow it. And you think it's a reasonably safe asset and it's already down a lot. And then last week the Bank of Japan raises rates a quarter point.

It's unsurprising the Yen rallies five or six percent and billions of dollars of margin calls begin and so forth. So an unwind of that Yen carry trade has to happen. I've tried my best to give you a number on what the total nominal exposure is to borrowed Yen and other financial assets that may be bought with borrowed Yen, and it's very hard to do there's 350 billion dollars of short term loans out from japanese banks to international borrowers I would think most of that it probably is in the n carry trade, but we don't know that all of it is And but then on the other hand, we also don't know You How much has been done with in Japan and that wouldn't be showing up in loans short term loans like this to, to non Japanese economic actors.

So it's hundreds of billions and could be more, but that it's a big number that unwind played out this week in a day. The next one may take longer, but my point today is the Dividend Cafe.

Now we'll get to what I'm here to talk to you about is first of all, we'll just get the easy part out of the way. If you were uncomfortable with the Dow being down 6.4 percent over the, from the high point to the low point in this recent market cycle the S&P down eight and a half. The the Nasdaq down 13 and a half, even those of you that are all in, in Nvidia, and the 26.7% it dropped. You can't be in the, you can't be in the market if you can't handle 6%, 8% drop.

You certainly, I'm not a big fan of someone being all in on one stock anyways, but down 26% for a company trading that kind of valuation counts your blessings. And so my point is. If that experience made you uncomfortable, your temperament may be different than you said it was, because markets go down 6, 8, 10, 13 percent all the time, and they don't need economic slowing to do it, they don't need a tech overvaluation to do it, they don't need a Yen carry trade on wine to do it.

As I joked with Larry Kudlow on his show yesterday, markets can go down like that because he and I sneezed. And so, just use this opportunity to check yourself, to talk with your advisor, whoever gives you, if you're a client of ours, your advisor at The Bahnsen Group, if you're not a client of ours, vo have a conversation with whoever your advisor is, or you may want to be, about what your real comfort level is and make sure you have a reality check about how risk assets work because this was child's play and things like this can and will happen again. And even this itself, if you look to reason number two, number three. And meaning the tech overvaluation and economic

slowing, and then even reason number one with the Yen carry, we don't know if that's done.

So I just think people need to really make sure that they have evaluated realistically their own temperament. But what I also want to do is now parlay this conversation and the lessons from Yen carry into a much broader one, which is the nature of leveraged finance. The nature of how a lot of risk assets exist in investor form on planet earth. People find an asset they like, and then they start buying it and then they start paying more for it and then they will borrow money to buy it. And because other people liked it, there's probably a lot of other people that liked it too. And when other people are borrowing money to like it, it's making the price go up. And then that makes other people want to buy it because they're missing out. On what other people are now benefiting from with borrowed money. And when you get a bunch of momentum into something like this, it creates a very high price when prices go up and down. But if there's a lot of borrowed money that went into boosting the price and a lot of borrowed money at risk because of how much people like an investment.

You have debt that doesn't go down when asset prices do go down when that's risky and people can start selling the asset they bought that they borrowed money to buy. When that asset starts dropping 10, 20, 25%, they say, okay, I don't really want to borrow more excuse me, to sell more of what I borrowed to buy.

So then, and I don't actually think I put this line in the written Dividend Cafe this week, but I used to utter it all the time around COVID. And it's just something that's in my normal financial lexicon as a portfolio manager. When you have to sell. You sell what you can sell, not what you want to sell. This is where you and I come into this, that there are people out there that then can't sell the thing that got them into trouble or don't want to. So they start selling the good stuff, the higher quality stuff, the stuff that didn't get them in trouble, but it isn't down 25%. So they'd rather sell stuff down two or 3%, or maybe it's up whatever, and it's liquid.

But then that other stuff is probably owned by a whole lot of other people that are also in a forced selling position, trying to avoid selling further the things that have taken a big drawdown. You follow what I'm saying? Portfolio insurance in 1987 around black Monday was a derivative version of this.

There has been, the, during all through COVID, what I referred to as the national margin call that took place in the middle of March 2020. There was a lot of this that was going on around a blow up of a low volatility trade 2018 and early 2015 with various implosions in China. And the Chinese currency markets and carry trades getting unwound. I can go on and on throughout history of how many times borrowed money, having to be unwound by forced sellers has bled into certain good things for a day, two days, three days, maybe a bit longer, usually not, but it can be, I want to reiterate our philosophy as dividend growth investors who are never forced sellers. We

don't care. You can choose to ignore it, stay back, let these little silly things play out. And in the case of risk parity blowing up in March of 2020, it resulted in about 400 billion. Various assets across fixed income equity currency that had to be liquidated. I've told you the size of the Yen carry trade.

There's, there's a lot of money out there that gets levered up around these things. And it's worse than it's ever been in the sense that so many hedge funds are so crowded in the same trades and usually with a little leverage. Sometimes with a lot of leverage. If you don't have leverage, if you've paid for what you own, then why do you care?

Well, one reason to care is if you plan to make money on the deal, you can be the buyer on their forced selling. And this is something I've become very attracted to, identifying moments of forced selling and saying, this is selling off because someone doesn't want to sell any more of something else.

And so they have now turned to a high quality part of their book and they have to raise money because they're over levered and it happens all the time. And when it happens, you can panic out and Joel and B and kind of join the madness. So we're going to go ahead and say, we don't recommend that one. You can also just ignore it and say, look, I own my stocks.

I paid for them. I have all these good dividend growers. I have a well constructed portfolio. I'm going to let this ride out. I don't care. That's a very good approach too. And you also could just

be. opportunistic and say, well, there's four sellers out there and then thank God. I'm not a four seller, but I'm going to try to be a buyer from the four sellers.

And I think that's a wonderful approach to take too, but I said, thank God in there somewhere. And I want to reiterate, this is really what I would do. Is I would have gratitude because in moments where there are panic selling, force selling, leverage selling, and even those moments affect things besides crypto and bad NASDAQ stocks and over levered tech stocks and weird derivative trades and what, and, international investment themes.

When they start impacting prices of high quality stuff they do not impact the cash flows. They do not impact the fundamentals. They impact the price. Value doesn't go down. Price does go down. That's what you should always want as an investor. And so be prepared that it's going to happen again and why it's happening.

These hedge funds have very smart people, but there are a lot of smart people thinking the same things. So there's a group think. The hedge funds also. Have become liquidity providers to the street. Todd Frank took out a lot of the investment banks, the prop desks that used to play this role are out of this game.

So the hedge funds are even more crowded or monolithic with one another, the big ginormous ones than they've ever been. And what I think that has done is leave certain sides of a boat.

Very crowded at times to when those trades get unwound, it forces people to then start unwinding other things. We may be in some of that position.

And I really want you to be grateful for that. Why would it be grateful? There's a time when prices are dropping a bit because you are not a for seller, so it just doesn't matter. And that's our position is avoid for selling position yourself to be a buyer from for sellers, if you're so inclined and be grateful for high quality companies, high quality portfolio, well positioned takes you out of this madness, that's my thought.

In this time don't know what next week holds in the market. I do know I'm very grateful for markets being on the floor of the exchange i'll share some more next week. Hopefully monday if I organize my thoughts a little better, but yeah, our team had a real wonderful experience there today and I am Renewed in my appreciation of American financial markets.

I'm not appreciative merely because I make my living in financial markets. I've devoted my career to trying to understand and cultivate and steward and manage within financial markets to the betterment of my clients, to the betterment of myself and my family. All those things are huge blessings, but that's not what I mean. American financial markets create opportunities for real human flourishing. They produce goods and services. They facilitate a higher standard of living for everyone. And I think it's beautiful. I was grateful to be a part of that this morning.

I'm gonna leave it there, thanks for listening, thank you for watching, thank you for reading the Dividend Cafe. I'll be back with you again from New York next week. Thanks so much!