FRIDAY, AUGUST 23, 2024

Well, hello and welcome to this week's Dividend Cafe. We are getting very close to the end of summer, but we're not quite there yet. We will officially end the summer next week, then go into Labor Day weekend, and what that means, of course, is that the football season will be here, and our lives can recover the joy and meaning that they have been missing.

In the meantime, as I'm sitting here recording in the middle of the day, in the middle of the market day on Friday, it looks like markets are going to end this week right about where they ended last week. There have been some ups and downs along the way, but it's actually been a very flat week for the markets.

I decided to go directionless this week in terms of Dividend Cafe. What I mean is, instead of focusing on one particular big theme, there are a few different things I want to cover. I don't want to shortchange the podcast listeners and video watchers, so I'm going to try to cover all those things that I discuss in the written Dividend Cafe, giving you a kind of potpourri of different elements.

Let's start with where, unfortunately, the media has started and ended, and where much of the financial industry has been focused this week: Jackson Hole, Wyoming. Fed Chair Jay Powell gave a speech. I received a transcript of the speech in advance this morning and then listened to the speech very early. Initially, markets jumped up over 400 points. As

I'm sitting here talking now, they are up about 200. They may give all of that up, or they may stay where they are—I don't know, and I don't care. But I want to read you a quote from Chairman Powell that I think is an appropriate way to understand how the Fed is viewing things and to make a big point about where rate policy is going to matter:

"The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks."

He went on to talk about the balance of risks in the ongoing context of labor markets, which he emphasized about five times more than price stability. A year ago or two years ago, it would have been five times more focused on price stability and less focused on labor markets. This isn't anything more than very specific, explicit, and undeniable purposeful messaging that, when we say we're more focused on labor markets than price stability, it's our way of telling you, yes, we are going to be more accommodative.

The futures market on the Fed Funds Rate is now pricing in a 67 percent chance of a quarter-point rate hike in September and a 33 percent chance of a half-point hike. I do not know what they will do, as there is still a full inflation report and a jobs report to come in September for August that could skew things one way or the other. More or less, we're looking at either a quarter-point or half-point hike, and it means nothing to me which one it ends up being, nor should it mean anything to you.

But if, in three months or six months, the Fed is cutting rates by 100 basis points—a full 1 percent—at a time, I received a note this morning about how we’ll remember that Volcker sometimes raised rates by 400 basis points. But let's remember, in 1981-82, if you're going from 15 percent to 19 percent, the base effect of that is very different than when you're going from 2 percent to 3 percent. The percentage of movement depends on what you're starting with.

I don't expect the Fed to be making big, dramatic, unexpected, high-magnitude rate moves, but if they were, it would be the worst thing for markets. It would mean there was some sort of economic calamity, collapse, or more than expected economic slowdown and contraction that they were responding to. If they are responding to normal economic slowness that has been well telegraphed and discussed, and they are making methodical, measured, periodic cuts—a quarter point here, a half point there—this would be a kind of ongoing Goldilocks narrative. Any market watcher who says interest rate cuts are good and interest rate hikes are bad, and therefore thinks a 1 percent or 2 percent cut would be good, is oversimplifying things in a way that could lead to a caveman-like result.

You do not want the Fed cutting dramatically in response to very significantly negative economic data. I hope that would be obvious. Yet, to the extent that there is no calamitous economic data and the Fed is cutting slowly and methodically, they are not tightening; they are adding liquidity to the system. That becomes the most benign scenario for markets.

Switching gears, behavioral modification is a term I've been using for the majority of my 25 years in financial services. At some point early on, I caught onto the idea of behavioral modification as a very important component of our value proposition—keeping clients from doing dumb things, doing the wrong thing at the wrong time, and maintaining the ability to resist our own human nature is a vital part of our value. That has not waned at all. What is noteworthy to me, and cause for significant gratitude, is that we have done it so long and, I think, so well, that we don't have a lot of clients calling to say, "I saw this billionaire guy on TV; he told me to sell everything. What should I do?" or "I saw this billionaire guy on TV; he told me to buy everything. What should I do?" You get some of those things, and it's our job to talk people through, explain what is going on, and how we think about some of these things. We always have a point of view.

There are cliché mistakes that people make—some very smart people, some very sophisticated people, some not always super smart or sophisticated, but they are human. Everyone is human, and human nature is a failed investor, as my mentor Nick Murray taught me. We have created a business that is trying to guide people around the realities of human nature. I am taken aback by how common some things are in the world of wealth management, investment management, and investment practice that are not common for us.

Now, I also think it's possible that some of them might be a little bit more common than I think, and my advisors in our private wealth advisor group at the Bahnsen Group hide it from me, which would be even greater cause for gratitude. The only thing better than having hundreds of clients who are all doing the right thing at the right time, or who have had an intuition formed over time that is more immunized against human nature, is having 20 advisors who themselves are ambassadors of such value and philosophy.

That is an important way to think about it. We have a worldview, and to work at the Bahnsen Group, you have to believe in this worldview and practice it. Whether it's a client calling and saying, "I can't take it anymore, I have to buy some of this crypto stuff," or someone talking about the hot topics of the day—the panic, the euphoria, "Let's wait it out; let's get on the other side of the election"—that's a common one. I'm not at all suggesting that clients could be immune from that entirely, but we don't have a systemic issue with some of these behavioral problems that have become more common. I do want to give us some credit for it. I think that we communicate frequently and do a pretty good job of trying to provide information and perspective, and I sure would like to believe we've earned clients' trust via our own trustworthiness in messaging why some of these mistakes are so bad: panic and fear at the wrong time and euphoria and greed at the wrong time.

These concepts have been with me my whole career, and I'm grateful that I believe we've achieved a certain success with that. But because human nature is immutable, the need for ongoing practice of it has not gone away, and there's always an opportunity for new mistakes to arise. The major categories of mistakes that exist out there, however, have become very few and far between, and our advisors are highly capable of addressing them when symptoms are evident. I'm grateful for that.

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I read a piece this week by my aforementioned mentor, Nick Murray. The great Howard Marks does a monthly investment commentary, which I generally don't miss. There was some statistical stuff that Howard included this week that I wanted to share with you all. If you were to look at GDP growth—and I think most of you remember from either high school or college statistics classes what standard deviation is, measuring the variability around the mean—high standard deviation doesn't mean that something is high; it doesn't mean it's low. It means there's high volatility around the average result, and a low standard deviation means there's very little variance around the result. If you look at GDP growth, the standard deviation—the volatility around its own average—is 1.8 percent over the last 40 years. That is a very slight amount of volatility around economic growth, up or down. But the volatility around earnings, corporate profits in the stock market, is about 9 percent a year.

Now, there is one school of thought that says ultimately, profits have to revert to whatever economic growth is. That's not necessarily true, by the way, and if it is true, it's pretty unhelpful because the time period and distribution of results change things so much that it becomes a kind of unhelpful fact of life. But whether it's true or not, the variability around profits—that they can go up and down around their own average at a 9 percent standard deviation, with economic growth only 1.8—means something to us. It means that economic growth is much less volatile than the profits that

companies achieve from it. Now, if profits revert to growth, it means that ultimately you're going to get more volatility out of the share of profits going to shareholders.

But then, what is the volatility of the market itself? The standard deviation of GDP growth is 1.8, profits are 9 percent, and the stock market is about 19 percent. What that is saying is that the stock market is roughly twice as volatile as the profits of the companies it is tracking. To some people, that is proof that the market is wrong; it is proof that the market is just emotional, that the market is irrational and inefficient. I don't think any of those things are true. I think it's proof that the market looks forward, and it's always moving and adjusting to what it believes is coming next. So the volatility around market prices is significantly higher than the volatility around corporate profits because there are various times when the market will price in too much exuberance or price in too much pessimism. There are times when the market will price in unexpected tax cuts, when the market will price in unexpected interest rate cuts, when the market will price in unexpected good earnings, and unexpected bad earnings. But either way, the market is always forward-looking. So it's priced at a premium relative to the profits that come from an economy that's much less volatile than corporate profits, which are much less volatile than the stock market that is following those profits.

Those are the three rings in the circus: 1.8 percent GDP, 9 percent earnings, and 19 percent stock prices. That framework is something to always keep in mind, and it is not proof of any one thing or another except to understand the way the system works.

Lastly, I want to make a point about Japan. This week, Japan's GDP was revised higher, and it's creating a kind of reconsideration about the various ways in which people look at Japan's economy, including the way in which they criticize Japan's economy. I was quoted in a financial publication in London this week about Japan's economy, where I said there's a whole lot of criticism about Japan's economy that needs a real reconsideration and that's because Japan's economy, stock market, and bond market are going through some things that have to make people stop and ask whether the model is as unsustainable as the headlines suggest. Japan is the only country I know of that is so widely dismissed and criticized, while at the same time being among the five wealthiest, most successful economies in the world.

When I first started as an investment advisor, I wasn't really able to buy a Japan ETF. We were still talking about ADRs in the 90s. But it was just assumed that Japan was going to be left for dead, and anyone thinking that's a good investment is nuts. Yet now, 25 years later, the reality is that it has significantly outperformed most European markets. The bond market itself, although it has a very unusual yield curve, still produces positive yields in shorter maturities and positive total returns relative to inflation. There are various components of the Japanification thesis that are now being reconsidered.

So that's a thing to keep in mind. It's something I'll probably revisit another time because I want to continue to make the case that people who are afraid of the U.S. becoming Japan (which I think is totally impossible, by the way) should reconsider just what exactly they think Japan is, what they think Japan has done wrong, and how they consider Japan's unique political economy. I don't really know what a Japanification of the U.S. would look like, but I'm certain it wouldn't look like Japan.

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That is your Dividend Cafe for this week. A little random, but I hope there was some helpful stuff in there. We'll see how next week shapes up, but we'll get through it together. There's a lot to unpack for all of us, and I remain convinced that we'll unpack it best together here at the Dividend Cafe. Thanks for listening, and I'll see you next week.

If you need any further edits or additional help, feel free to ask!