FRIDAY, SEPTEMBER 20, 2024



Well, hello and welcome to a very fun Dividend Cafe. And by fun, I mean, we're talking about monetary policy and that's pretty much about as much fun as I have. And we are doing something a little unique in that I'm recording after the market is closed on Thursday. And I think I've done it once or twice before, if that. But it's very rare that I am recording the Dividend Cafe for you podcast listeners and video watchers. And the written Dividend Cafe is not even done yet because there's a few things that I'm going to be adding to it early Friday morning. But I have the whole Just of what I'm doing. I don't need the written to accompany me producing this podcast and video and it may sound like I'm showing off a little bit because you know the way people try to show off these days is by talking about their knowledge of monetary policy. And, you know, let's just say it's a good thing I'm married, but what I'm I wouldn't be able to do this actually, if it weren't for the fact that it's a topic that I am very familiar with and it all joking aside there's something broken enough in me that I kind of don't need to go to the dates and the written and the notes and work through my whole, you know, sort of sequence of what point I'm going to be making in the written Dividend Cafe to do this. I really can sit down and talk to you the way I'm doing right now.

And then, and so this is just a topic that facilitates it because the role of monetary policy in what has happened in financial markets throughout my adult life and this period of time in which I have this overwhelming fiduciary duty to manage client capital towards different objectives.

A long time ago, and it really was a kind of byproduct of what took place out of the global financial crisis that forever changed my life. I learned that one who is not paying attention to monetary policy is not serious about managing money, period. That does not mean that there should, that a serious money manager should be trading every day around monetary policy.

I mock that even more. I'm about to mock it. In a second, when I do a little rewind of what took place this week, but what I mean is having a macroeconomic outlook that allows for a strategic asset allocation on behalf of a client to not be done without understanding ways in which the world has changed.

And that has to do with monetary policy, how it is being used, why it is being used that way, and various expectations and whatnot going forward. Not quarter by quarter rate levels, but the big picture of what monetary policy represents in macroeconomics.  And because of that obsession I want to sit here with you and just sort of from memory.

Give you a little very quick history as to how we got to this point. And then I'm going to talk about this week and what has happened this week. And then I'm going to talk about going forward and that's what you want to hang around for. And I, if I do everything right, you'll get a really hot trade out of this.

No, I'm just kidding. There's no reason for compliance to strike that line because I am joking and I am making fun of people who would think that there is a hot trade to be found out of any of it. There is no hot trade to be found out of anything that comes out of my mouth ever not the least of which includes sober discussion about monetary policy.

Now, when I say it's worth waiting around to the end, I don't refer to hot trade. I refer to hopefully an understanding of where I think we find ourselves in a cycle and what my views on this going forward may be as it pertains to. Real estate, bond investing, stock investing, the whole kit and caboodle.

This is a big deal. So yes, the history lesson, see, whenever I say it's going to be short, I usually don't do it short. So I gotta be okay. I'm holding myself accountable here. I'm going to go real quickly through roughly 15 years of history in something that various times in my life, I've gone to do this and taken like an hour and a half.

So I'm going to try to do this in 90 seconds. 2008, the world is ending, financial crisis, Lehman, AIG, Fannie, Freddie, dogs and cats, and the Fed goes to 0%. The Fed funds rate, which had been coming lower in the final years of Greenspan into Bernanke, as economic conditions weren't looking good but then went to zero, literally in October of 2008, and it stayed there for basically eight years. The very end of 2015, they raised rates a quarter point in December of 15. They said they were going to raise rates four times in 2016, and they didn't at all. Kept it there, basically at zero, a quarter point for another year, the eighth year. in a row and then at the end of 2016 raised rates a quarter point and throughout 2017 now they raised it a whopping 75 basis points. 2018 a whopping one percent. So we end up through 2018 at the end of the year, being at a two and a quarter fed funds rate, very low historically 2 percent plus change off of the zero we had been at for eight years and the fed saying, we really have to get rates normal. Okay. So now I did it. I got us up to 2019 and then the fed chickens out and begins cutting rates. And I'm going to talk about a important component and compliment to this story. with monetary policy outside of interest rates in just a second. So in 2019, the Fed actually cuts were a couple of times that we go into 2020 before COVID has hit our shores, before there's any discussion about shutting down the country and spending trillions of dollars and everybody watching Michael Jordan's documentary on Netflix, like before any of that all we were dealing with was a one and a half percent. Okay, Fed funds rate, and then it went to zero in March of 20, zero percent, and it stayed there then for two full years, and zero, you fast forward to March of 2022, they raised it a whopping quarter point, May of 22, a whopping half a point, then they get serious. And they raised it all the way up to five and a half percent. From zero to five and a half, they added 550 basis points in what was essentially about 15 months. From the spring of 22 through the end of summer of 23. Yeah, within that period of getting from zero to five and a half percent, There was three hikes in a row at one point of 75 basis points each. So they went at a pretty fast pace, very consistent.

Every fed meeting from the spring of 22 to July of 23 did have a rate hike in it. And then they paused. That's where we've been now for the last, let's call it 14 months. So it has been 54 months since the fed cut rates. The last cut being in the COVID moment of March, 2020. I think I'm doing my math there, right?

Four years is 48 months and then six months from March to September, 54 months since the Fed has last cut until this week. And then it has been 14 months since they last moved at all. And that was a hike in July of 2023. Okay. So now 14 months of a pause, still high rates, but no cuts, no hikes. Then we get to this week and on Wednesday, the federal open market committee did announce a 50 basis point rate cut.

So they brought it from five and a half at the high end of their target to 5%. And basically stated intention to get it down another 50 to 75 basis points by the end of the year. The futures market is pricing in a minimum of another 50 basis points between whatever they do in November and December. But pretty high likelihood of actually 75, meaning they're expecting perhaps another quarter point and then a half or another half then a quarter.

We'll see what ends up happening there. All right, so that is where things stand. Here is the issue I need to bring into the conversation. Quantitative tightening is continuing. What is this? Quantitative easing is where the Fed is buying bonds with money that doesn't exist, putting it onto their balance sheet, essentially injecting liquidity into the financial system.

It is a means of adding liquidity in excess bank reserves. And giving the Fed a tool to control some form of rate policy to essentially a tool to use for monetary policy, either tightening or easing financial conditions.  The Fed had been heightening that with quantitative tightening, meaning bonds that they own that were maturing, they were getting proceeds back from the Treasury Department, and they were just letting it roll off.

They were not reinvesting. Okay. So it was a way of taking this money out of the financial system. They had been doing about 80 billion a month and they slowed that pace down to 20, 25 billion.  But Chairman Powell announced Wednesday, they're going to continue with ROLA and this is the point I want to make that I don't believe anyone's talking about and I don't think I'm some genius and I think there are plenty of people at hedge funds.

And other Wall Street actors that are internally discussing it. But in the mainstream press, the relationship between interest rate policy and either quantitative easing or tightening has been perfectly aligned. All of the post-crisis era, the Fed went to zero rates and a lot of quantitative easing.

From 2008 to 2014, the Fed went to, a little bit of tightening with higher rates and a little bit of tightening with selling bonds off their balance sheet From that 2016 to 2018 era, slow pace, but both things were in the same direction, the quantitative tightening in 2018 eventually  caused credit markets to revolt credit spreads, widened commercial paper was not rolling over.

Stocks had dropped, financial conditions were terrible. That's really what caused the Fed to chicken out in January of 2019. Then in 2019, and obviously fast forwarded and accelerated a great deal with the COVID moment. Again, rates were going down and quantitative easing was taking place together.  And then in 2022 in the spring through current high rates with quantitative tightening.

So there's four different periods and in all four of them, eat one policy tool fed of rates and the other policy tool of the fed balance sheet, their bond buying or selling were aligned. They were either easing with two policy tools at once, or they were tightening with two policy tools at once.

And there's no exception to that from 2008 to this week.  Now, what the Fed is saying, and you're about to find out that I don't believe this, we'll ask. The Fed is saying, oh yeah, we're easing monetary policy. We're concerned about a slowdown in jobs. We believe in the inflation issue is dealt with as much as they can control it.

And yet we want to now be providing monetary accommodation with a lower Fed funds rate.  But we're still tightening with the balance sheet. We're still doing roll off of, you know, 20, 25 billion dollars a month. Quantitative tightening with one hand, lower rates on another.  This is the first time that the two policy tools that they primarily use to affect monetary policy are diverging.

Now, what does this mean? Why am I bringing this up? And first of all, before I answer that, why are they doing that? And I think this is a very important piece. I wrote a Dividend Cafe sometime back explaining what the Fed actually controls when we talk about interest rates, because they don't literally control the 10 year treasury.

They don't control the two year treasury. They control the overnight lending rate, the banks loan to one another, and then serves as a reference rate. That ends up impacting people can charge for other rates as well with mortgages, with business lending, with credit cards, with auto loans, with real economy rates, they get referenced to a fed funds rate, which is really what banks are being charged to, to borrow overnight.

And so when the ultra short term rate that the fed does control is a certain level, other rates feed off of that. And in a perfect world, a normal world, it doesn't have to be perfect. A just regular world, it cost you, you were going to charge more in interest to loan your money for 10 years than you are in two years.

And that reflects normalcy, it reflects some optimism about the future because the only reason that you would want more money for a short loan than you would for a long loan is if you believe something negative into the future. about growth or you right now in the short term, that's what the market rate is, which the Fed controls.

That's what we're doing with now. The 90 day T bill is 4. 7%. The 10 year Treasury is 3. 6. But the Fed can control the 90 day T bill rate. They can bring the Fed funds rate down, but they don't want to do it all at once. But yet we have this messed up yield curve. And so my view is that still continuing to do quantitative tightening is a way.

It's not a perfect way. It's not even necessarily a great way, but it's a way for them to try to, you know, keep the yields higher on the long end of the curve while they can take their time bringing the yields lower on the short end. We will end up at a normal yield curve once the Fed has normalized rate.

Problem is that normal is different when growth expectations are so low. The 10 year should not be at 3. 6 percent. Most of us believe, even someone who has been very contrarian about the inflation outlook versus a lot of my friends, believe that there's still going to be one to two percent inflation, best case, could very well be a little bit higher.

And if you add the real growth expectations, if you're at 3. 6, then that means you're expecting something like one to one and a half percent of real growth. This is the theme I've been writing about, talking about for so long, but see the, maybe the 10 year, it should be a three and a half. Maybe it should be higher.

I don't think so. Maybe it should be even lower. The point is that I think the Fed's keeping a hand on the quantitative tightening while they're cutting rates because it is distorted between the short end and the long end and the only way to fix it is to rapidly drop the short end, which they simply can't do.

And you say, why can't they do that? Well, it would be pretty reckless. It would destroy credibility. It would facilitate a lot of speculation. It would slosh around a lot of money supply it, it incentivize now they're going to do it slowly anyways, but they don't want to do it all at once and to their credit they shouldn't, but this is what we're dealing with is the long end of the curve already acting normal.

And because what that normal expectation is not good. The fed stuck now where they still have. Even though the two 10s are pretty flat, what I mean by that is the two year is about 3. 5, 3. 6, and the 10 year is about 7, so it's not inverted anymore, it's been inverted for two years. It's just flat, which is not normal either, it's not positively sloped like you would expect, but then the short end is still higher and the Fed needs time to bring that down.

So all of this to say credit markets in 2019 and 2018 revolted and they just haven't revolted the last two years. And a lot of my bearish friends and a lot of people that love to talk about this stuff expected it would.  But, look, obviously stock prices have done well corporate credit's done fine, default rates have not gotten crazy, liquidity is hung in there.

There's definitely been challenges, particularly in certain real estate areas, or being able to roll over debt, but they have been able to continue tightening longer this time. 9 trillion, they've got it down to 7 trillion. So it's still two and a half trillion higher than it was, but they got two trillion off the balance sheet and they haven't had a hangover.

They're pretty happy about that.  They want to try to keep that going. And then my view is as soon as credit markets say, nope, we're done too much liquidity coming out, rate policy rates diverging too much. There will be some moment at which the quantitative tightening will end and that either Leave it alone or go back to quantitative easing.

And so that's really the outlook I'd have.  There's just no question what they're trying to do at the Fed funds rate is as long as the economy is not going in recession, they want to slowly lower it.  If the economy slows down substantially, they'll accelerate lowering it in their Goldilocks scenario of soft landing and nothing acting crazy.

They'd like to get to two and a half percent.  They'll probably say three, but they'd like to get to two and a half on fed funds rate. And they don't want to have to go lower because they'd like the economy to hang in there. And they don't want to stay much higher because this is not normal to have the short end so close to the long end and the long end is being too rational.

Pension company, pension funds, insurance companies, sovereign wealth funds, widows and retirees and. And investors and banks and corporations and savers, their yield levels reflect expectations of growth and inflation. And it's low. They're taking 3. 6 percent tenure. They may end up taking 2. 6 percent tenure.

And yet what that does is put pressure on the Fed to lower even more so on the short end, and they're trying to resist that. So I'm watching the balance sheet of the Fed, I'm watching the Fed's language about the balance sheet, and we're watching what housing will do in terms of unfreezing if mortgage rates can come lower.

But they're not going to go lower. Buy enough to unfreeze the market at 50 basis points. So they need another 100, another 150, another 200 basis points out of the Fed funds rate to move mortgage rates so that people that have a 2 or 3 percent mortgage that want to sell their house and buy one don't have to pick a 6 or 7 mortgage in the replacement.

They'll buy, they'll sell their house. If they can replace a 3 percent mortgage with a 4. 5%, but they will not do it if they replace a 3 percent with a 7%. That's the issue. That froze the market. I've talked about it a lot. So we're watching what that does to housing. You say, well, is it going to raise prices though?

If mortgage rates come down, doesn't that push house prices up? I do think it's possible. There's a little immediate reaction, particularly in high demand areas. But ultimately, my reason for believing it can't, is because they're already just too high. Prices just didn't drop.  Interest rates went to six, seven percent and prices marginally dropped, but mostly volume dropped.

The froze the market and affordability being what it is, there just isn't a lot of room for price appreciation. And so I think that more likely than not, you'll unfreeze sellers and you'll start to hopefully see some thawing in prices to normalize the market and address this affordability crisis.

What about stocks?  Gotta watch quantitative easing.  You're 21 times next year's earnings in the S& P right now. Is there a lot of room to go higher if the Fed does cut rates, 50 more basis points, 100 more basis points? Is there really a lot of room to go if earnings expectations aren't moving substantially higher?

They've already moved to 15 percent expected next year over year. I think you know how I feel about that. I just don't see it. With bonds, I think yields are going lower and I think this has been a good time to when rates were higher to have bought more of the bonds. People didn't want to buy them.

After 22, because rates went up so much, they took a hit in pricing. That's when they became a good buy. And right now they're quite attractively priced. I'll have more to say after my meeting with our bond managers and various portfolio talent that I'm meeting with Kenny and Brian from our investment committee the first week of October.

But my view of this would be that duration is probably the right place. The short end comes down. And then credit quality will end up mattering more if spreads are going to widen by a persistent QT that becomes a QE the quantitative tightening, quantitative easing thing. But I need a little time to work on that thesis more.

That's my view of what the Fed's done. My view of what the outlook for it is. Is it bringing inflation back? No. Is it political? Absolutely not. That's absurd to believe that the Fed could help the incumbent party 60 days before the election and have done and been so incredibly tight for the two years before the election.

I can like what the Fed does or not like it. People can like one party or the other party. That's not my point. My point is, if the belief was that the Fed was trying to put their thumb on the scale for the Democratic Party, this would be a really bad way to do it. To have tightened monetary policy 550 basis points for two years up until two months before the election.

There's no time for 50 basis points out of 550. To accrue to any political benefit of anyone. So no, it's not a political issue. No, it's not a needle mover in the economy. The traders and speculators, I said, I was going to come back to this whip sod all around up 200 down 200, five times in 90 minutes on Wednesday afternoon, and then markets go to sleep for the night, woke up and rallied big on Thursday.

And so as we're sitting here now with the market, having closed Thursday, Dow was up over 500 points. All time high Dow, all time high S& P. Very interesting.  NASDAQ is 700 points away from an all time high.  What does the NASDAQ want to make a new high other than the Fed announcing all those rate cuts?

Earnings are already priced in at very high levels.  I suspect that there's more downside risk than upside risk for the NASDAQ. But I don't care about the technical side of it, I'm just sharing. That it's interesting to note a more conventional market, like the Dow making a new high and the Nasdaq is still not back to its July levels and that just speaks to valuation.

But that can change and I freely admit that. We'll continue watching.  So, I don't know, a little history, a little projection, a little economic commentary and analysis.  Like I said, this has been a lot of fun. I hope it's been somewhat fun or at least informative for you to listen to it. I know it's been fun for me to do it.

As always, check out the Written Dividend Cafe, feel free to send this to anyone. If you're watching the video and you're not subscribing, hit the subscribe button or a thumbs up, even better, there on YouTube, it helps us a lot. And if you're listening to the podcast, we'd love it if you'd subscribe in your streamer of choice.

It helps us quite a bit with the algorithms. And a rating and some kind of star rating with a review, those things help as well. But in the meantime have a wonderful weekend. USC does play Michigan at Michigan. And if you think the Fed has a tough job managing the balance sheet, Imagine what it'd be like for my beloved Trojans going into the big house to play the national champion, Michigan Wolverines.

Can't wait for this weekend. Can't wait to be back with you again next week, where I really will be delivering the special election issue, Dividend Cafe next Friday, September 27. Thanks for listening. Thanks for watching. Thank you for reading the Dividend Cafe.