FRIDAY, JANUARY 31, 2025

Hello and welcome to this week's Dividend Cafe. The final day of January is here. As always, there are two schools of thought; did January fly by, or did it take forever, or was it both? That's my view. We're through a really interesting month. And this week itself probably packed over a month's worth of excitement. And it forced me into a kind of difficult position about what to write in this week's Dividend Cafe. I do receive, comments and emails and correspondence quite a bit. And I pretty much think they're almost always intended to be compliments. I certainly take them that way of people banking me for doing the time and work and sacrifice to write Dividend Cafe each week.

And I always feel a little bit guilty because I don't view it as particularly onerous to write Dividend Cafe because, as I've said before, I love writing Dividend Cafe. I love the reading and research that go into it. I love the exercise of the writing and it is, of everything. That I absolutely love about my job as the managing partner at The Bahnsen Group, creating this content and trying my best to be a diligent thought leader around the world of economics and markets is not something that I have to sacrifice to do. I just love it. The sacrifice comes in sometimes in having to pick what to write about. In The Dividend Cafe, because there are weeks where it's very difficult and I have a strong bias against writing on the events of the week, if you will. I have right now a higher level, just topical set of things I want to get to. I've been wanting for some time to write a longer treatise as to where my question headed towards me. Looking forward to meeting you upload the next several days.

Taxing imports whether it's selectively or universally. And there's certainly a lot to say at a high level about China and where their, the state of their economy is and what that means as we go forward into the next iteration of U.S. China relations and negotiations. Which is a shorter term episode in what is a longer term saga with the U. S. and China most certainly being the two preeminent world superpowers. So those are, significant, big topics and I want to get to some of them in the weeks ahead. But then there was this week where, You could argue what may be one of the larger stories of the year came to be on Sunday evening and played out on Monday in markets as the Nasdaq got just hammered.

The largest company in the world. What there's links to covering some of this stuff that happened with NVIDIA and DividendCafe. com was down, 15 percent in one day and was down quite a bit some other days as well. And it brought about this larger story around artificial intelligence in China and then just the overall vulnerabilities that existed in the NASDAQ versus what's going on in the Dow.

And so that, that was a big story and I was able to cover it in the Monday Dividend Cafe, but there's other things to be said. But in the meantime. If that wasn't happening, just the Fed having its, big FOMC meeting and the comments and press conference and issues that went around where they are on things was a big story.

And you had President Trump's more controversial Nominees, whether you like them or not certainly there's a little bit closer outcome expected regarding some of the nominees. They had their hearings this week. I speak of Robert Kennedy Jr. at Health and Human Services, Tulsi Gabbard at DNI and Kash Patel at FBI.

And then what's the other one that I'm missing here? I'm sorry that you there were a couple of non controversial ones that got through Lee Zeldin at EPA, Marco Rubio at State, which was last week Scott Bessent through at Treasury but, I'm missing I guess that covers it. Oh, totally, I said Tulsi Gabbard, DNI as well.

So anyways, all that to say the nominations have been a subject we've covered quite a bit in Dividend Cafe and that whole saga continues. Then of course, just this unspeakable tragedy the commercial airline colliding with a military helicopter over Washington DC waters dozens of people dead.

Just an awful story and that may not necessarily seem to be a big market story but it speaks to some broader issues of policy and obviously captured the news stories for a couple days for very good reason. All of that was just packed in the last four or five days. I want to focus on where the probably biggest market story is.

I'll first just quickly cover on the Fed side, my, I just think as a brief summary, like the Fed did not raise rates this week and they did not cut rates. And that was basically priced in for quite some time. The 10 year treasury, by the way, was at 4.8 percent a couple of weeks ago. It's at 4.5 percent now. And that's without any change in Fed policy and any change in Fed expectations. However. As I've pointed out over and over, the Fed really, what they're doing with short term rates and what they're expected to do with short term rates is going to have a big impact on short term rates.

And there are other issues around both inflation and real growth expectations that drive the longer end of the curve. And so the 10 year and the Fed are not nearly as connected as people want to think. Where we are on the short end is that there's an 82 percent chance right now in the futures market that again in the March meeting, the FOMC doesn't meet in February, in the March meeting, they will again neither cut nor hike rates, leave it as it is, and we're actually at a 57 percent chance of them doing the same in May, so again, the odds start going higher that they will cut a little bit in May, it's up to 43%, but Still a greater than half chance right now.

And that can change around employment data, inflation data, and Fed comments between here and there. You got a much better outcome predictability in a month than you do in four months for obvious reasons. But then when you look further out. At December at this point, we're now about a 60 percent chance that there will be two to three rate cuts by the end of the year.

It's almost certain that there'll be at least one and then a much better chance of two and a little lesser chance of three. The market seems to me, that it's a little bit agnostic at this point about the next four to five to six months and certainly four to five to six weeks and much more interested in where things are going to be in eight months, nine months, 12 months.

And that's how I think it should be. And my own view is that the Fed will cut two to three times between now and the end of the year, quarter point at a time. And they will be ignoring trolling and tweeting from the white house. They will be ignoring various pressure that they may receive from any number of different places, but they will be speaking to the labor data as they always do and speaking to the price data as they always do, but that fundamentally the primary driver of what they're really going to be doing is a going to be focused on liquidity in the financial system with quantitative tightening as they look to probably slow that and that at some point this year.

As we talked about in our year ahead forecast for 2025 and the Fed is very likely to be internally focused on where they need to avoid some form of disruption to the economy with sustained dysfunction and housing that would trickle out into the real economy and most certainly has not done that yet.

So with the large resetting of rates in commercial real estate, levered loans, and then where things are with housing, where they, the market is essentially frozen, 30 year low in existing sale activity the Fed, I think, realizes that. That's fine as it is. It's not breaking in pricing yet, but there is a trickle down effect in other parts of the economy and when you have such a large percentage of people with low rates that would have to sell to go buy at higher rates, they're frozen, and I think that there is some point at which the Fed wants to thaw that to allow prices to set.

I do not really think the Fed cares if house prices go higher or lower. All things being equal, I think they'd prefer they go a little bit lower, but not too much lower. And that's most certainly what I expect would be the case. The supply demand imbalance is significant. That puts a four under prices.

But the affordability issue is a significant problem. That puts a ceiling at prices. And in the meantime, there are no prices to be found when there's such little activity. And there's such a little activity because of the rate issue. And I think that's really driving a lot of what the Fed has to think about, but just can't really be what they talk about.

And I've said all this before, but I'm repeating where we were. I want to get to the big subject of the week, which is about AI in China. And, you get opportunities all the time to see what we call people's priors, the prior Presuppositions, prior biases, prior emphases that they have around given topics.

Sometimes they can be rational, sometimes they can be irrational, but people have certain prior perspectives that they bring into almost any subject. And that's okay. It's a little heavier right now than normal in this political and tribal and I think polarized climate in which we find ourselves.

But when it comes to things like China and technology, there are a lot of strong opinions people have, and some of them, are coherent. Some are not but they're all rooted to something. And what happened earlier in the week, this idea that the AI tool that is meant to compete with chat, GPT and open AI in China called Deep Seek, that they essentially announced a very successful launch of a new version of That they claim is being powered by a very cheap NVIDIA chip and that the export controls that were keeping the more complex and higher end NVIDIA out didn't get in the way of them being able to do a better AI tool that Americans were able to do with a more expensive product.

And so then, of course, you get people saying, see, look, China's eating our lunch. They're ahead in 5G, which I think is fairly true. They're ahead in electric vehicles, which obviously people believe is true because the Biden administration, the Trump administration, the European Union, all, have tried to do significant trade barriers around EV because of China's ascendancy in that space.

They're ahead in batteries and drones, which again, I think as best I'm able to detect is true, and that they graduate a lot more science, technology, engineering students, math students, than not just the U. S., but like every other country on earth combined. And again, that to best of my knowledge is empirically indisputable, whether or not it's relevant is another story.

So then there are people saying, see, this is the issue. China is eating us up because of all these other things. And there's some truth to all those things that are said, and people bring those priors into the way they evaluate this deep seek AI type story. But then, other things are true too.

China is in a very deflationary spiral in their economy. There's a property bubble. It's having significant impact in the economy and requiring a lot of fiscal impositions by the CCP. They don't have a great rule of law. They don't have the free flight of people. mobility of people, free flight and mobility of capital.

That is very hard for economic market innovations to fertilize and grow apart from freedom of movement both people in human capital and financial capital. And of course, China's communist. The lack of free speech, the lack of free press, those things you would think are a pretty big impediment to the adaptation, to broader adaptation of a language learning tool or generative AI when information is filtered by the government.

Both, I think all of these statements I've just said are true and with all due respect, the debate between China being a formidable competitor to the U. S. And where they are a kind of, uninvestable disaster because of the oppressive communist regime. That debate will continue and that debate was not settled this week and I'm not even sure it's particularly advanced.

There's a tension there with uncertain outcomes and we've already spoken to our point of view in the past that we just generally consider much of the equity side of China uninvestable. not because there aren't great companies that are going to grow profits that probably could be bought at good values, but because there's a lot about the system we just don't trust, and on a risk reward basis choose not to engage in.

And they have behaved in their bond market and currency more than most countries on earth, but as a general rule we think that our position on China investability is rather clear. This is more a subject as to whether or not it needs to impact policy. Is there a need here? To intervene around China's competitiveness with U.S. and A.I. My view is that you might think that DeepSeek and China have revealed a big vulnerability in the U.S. A.I. story, and you might believe the whole thing is a fake, and you might believe something in between those two theories. That's probably a safe place to land but regardless, my view is that the stories of this week do not shine a light per se on U.S. China competitiveness in AI, but the overall vulnerability about the U.S. AI story, where in permanent ascendancy of U.S. AI capability, the, that, that's a vulnerable theory, it is not a disproven one, but it is vulnerable. It is subject to change. The belief that high cost artificial intelligence, CapEx, which is certainly priced in that is going to continue, I think that is vulnerable.

The assumption that mass adaptation of AI, a mass acceptance of AI in American society that's certainly priced in, and I think that assumption is vulnerable. The assumption that there will be little or no competition to the current leaders in the space is certainly priced in, and I think that's vulnerable.

No, I don't believe China's going to eat the US's lunch in a country with no rule of law. A country with little rule of law, a country with questionable freedom, unless the U.S. decides it wants to be more like China. So my big picture long term view is always to be voting for, from a predictive standpoint where there is greater freedom in rule of law than where there is less.

That's just a permanent belief system that's tracked pretty well throughout history, if you don't mind me saying so. But this issue is not really about China. It's this broader AI story that I would suggest is revealing certain vulnerabilities that have to be considered. And it leads to a kind of question, is it possible that this AI spending in the last couple years, which is just hundreds of billions of dollars, is going to prove to be like the metaverse of 2022, which I think limited itself to tens of billions of money set on fire.

And much less than that with other more embarrassing stories, like the apple. Electric vehicle or the Google glasses. Those things just ended up being bad, darts thrown at the wall. The metaverse thing was massive and then just totally went away. All of that has links, in Dividend Cafe about what I'm referring to, but here's the thing.

I have tons of confidence in the ability of big tech to set money on fire. I have no belief whatsoever that they are immune from capital misallocation. I don't, I would not say that I think the AI capex is going to prove to be the metaverse. What I would say is that there's a heck of a lot of money being spent without a real clarity as to what it's being spent for.

And a lot of things are probably going to play out differently in the end than people think. And I don't think that's a very controversial theory. I don't, I think there's questions about the utility of artificial intelligence, the economic usefulness, the cost benefits analysis, and then the question of who will benefit.

But when we talk about CapEx, always in forever, not just digital capital expenditures, not just technological, all capital expenditures. are one company's expense and somebody else's revenue. In this case, the revenue that is coming in from some company's CapEx in AI if that CapEx is deemed to be overdone, overwrought with a questionable ROI, the growth assumptions about that CapEx, which is other company's revenue, get called into question.

And I think that a declining revenue to the recipient of the CapEx because the spenders of the CapEx. Find better pricing power, find competitors, find different utility, rethink strategy.

There's all kinds of things that could happen. I'm not sure that stuff has ever been fully thought about, and it needs to be thought about more.

So there will be more to say on this subject going forward. But that's what I believe was the great vulnerability of this moment, was that there was a real question. That has been put upon us about the utility of AI spending. And I do not believe it'll prove to be a big waste, but I do not believe there's plenty of clarity on what the opportunity is, hence the vulnerability.

I'm going to leave it there for the week. There are a couple more things in the dividendcafe. com that I think are really worth looking at. Just getting your arms around valuations in the S&P, a market trading at 22 times earnings, but where the median PE is only 18 times. But that's because five names in the s and p have a 31 times multiple, and they are bringing up the blended multiple, the blended valuation of the market so much.

There's a chart about government spending on pensions around the world. what that means to economic growth a couple of the, and then the chart of the week. So a few other things at dividendcafe.com if you get a chance to visit over there please feel free to share Dividend Cafe anytime with anyone you want.

It's a free tool made available to the world so that we have a venue for truth telling. That's what Dividend Cafe exists for. Truth telling in the matters of markets and the economy. And I really love doing it and will plan to continue doing more of the same. Okay, I need to go speak at a conference here in Atlanta this afternoon and then get right on a plane to New York and I will be in New York all of next week and look forward to being back with you in New York City and the Dividend Cafe next week, both Monday and Friday.

And in the meantime, thank you for watching, thank you for listening, thank you for reading The Dividend Cafe.
