Opening Pandora's Box - Transcript

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Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is episode number 313. Welcome to Detroit, Michigan. I am here joined with Tim Mullooly and Brendan Mullooly. Good afternoon, guys.

Tim Mullooly: Good afternoon.

Brendan M: Ready to roll. What kind of topics are we discussing today?

Tim Mullooly: A good article, as usual, from Morgan Housel.

Tom Mullooly: I just want to say for the record, that guy writes so well.

Tim Mullooly: Yeah, he's for sure one of my top finance thinkers and writers.

Brendan M: I pre-ordered his book, which is coming out in September this year.

Tim Mullooly: There you go. Get it online.

Brendan M: It should be a very good one.

Tim Mullooly: Yep. So his article is titled Never the Same, and he was talking about how the world and the US has changed over the span of the last handful of recessions and downturns in terms of the response that we had seen from the federal government and how it's going to be tricky to see how, or if, things go back to the way they were. He was talking about how, in 2008, we saw a big response from the Fed and there was a lot of debate about how they should step in and to what degree, and at the time it was unprecedented measures. And then that became table stakes for this time around when things turned down again and the Fed and the federal government, Congress, came back with even bigger responses.

So he's asking the question, now that the people know what the government is capable of, what is that going to do moving forward every time we have a downturn again? It's tricky.

Brendan M: This is the point that you were making on a lot of our videos. The level of attention that was being given to the virus and the economic downturn and what the government and the Fed stepped in to do earlier this year. We used the playbook from 2008 and then some, and each time it's just been this build on from the prior edition. So, yeah, does that get baked into people's expectations now? Is this expected every time the economy goes into a downturn now? Are we going to expect all the same measures that we've taken this time to be trotted out again and then some?

Tim Mullooly: Right, like where's my $1,200 check when the next recession comes or $600 extra in unemployment benefits? Are those going to be the table stakes moving forward?

Tom Mullooly: I will say that, as you pointed out, the Fed has gotten a lot smarter with each recession that comes along, or each economic crisis that they have to deal with. They're a learning machine in the sense that they learn what worked and what didn't work, at what pace they need to move.

Brendan M: Yeah. How long did it take them in the last recession to start ... Quantitative easing was a concept then, and then they instituted it. But how long did it take them to get that going?

Tom Mullooly: It wasn't called quantitative easing, but the first bond purchases that they did were in December of 2008. The world had ended in September of '08.

Brendan M: The Fed was doing stuff on the repo market at the end of last year, and we didn't even know any of this was coming-

Tim Mullooly: This was November of last year.

Brendan M: Right. And everything was great then in the economy. Things were going really well, and they were still stepping in to do stuff, which is, I think I'm calling that a direct result of what they did in 2008, because they were still using the playbook from then to say, "Hey, this looks kind of fishy like it did back then. Let's shore things up."

Tom Mullooly: Now they did overnight repurchases and things like that in the '70s and '80s, but nothing, I mean, nothing to the magnitude that they did in 2008 and '09, and certainly nothing like what they did in 2019. There were daily articles on places like Zero Hedge, where they were like, "What is going on? There must be a bank failure going on that we don't know about because what the Fed is doing now in the overnight repurchase market is record setting." So it's eye-popping with the numbers that they're using.

Brendan M: They're doing this stuff really fast. And I don't know, I mean, maybe some credit needs to be given to Mnuchin because the Treasury Secretary needed to approve a lot of these things that the Fed did. So some of the new stuff they did this time, they're out there literally buying ETFs and corporate bonds from people, which we've never seen before now. But they've been given the runway to do this stuff pretty much at will. Maybe that's a result of having somebody like Mnuchin who understands, obviously, the industry, based on coming from Goldman. He knows what these places need and the support they need to get.

Tim Mullooly: I think it's tricky though, because it's hard to critique what they did, because up until this point, like right now, it does seem like it's working, but at the same time, it's what is this going to do to the economy moving forward? And there are going to be unintended consequences that we didn't see. What's the consequence of essentially printing all this money and giving it to the individuals? Same thing with the money for corporations, with the PPP loans and stuff like that. Will the extra unemployment benefits end up backfiring in a sense? It's hard to predict what's going to happen, but there is a dangerous aspect to it.

Tom Mullooly: The slippery slope.

Tim Mullooly: They're changing the game forever in a sense, because now the people know what they can do.

Tom Mullooly: And I've even said this on the phone to a few people lately. What are they going to do the next time there's a slowdown in the economy? So one of the things we said before we turned the microphone on is that recessions in the past, if you open up the textbooks that we all read in college, these recessions used to last a year, 18 months, sometimes even longer than that. I mean the depression, depending on where you draw the line, was seven years, 10 years. It ended in World War II. But each of these recessionary periods, at least in my recent memory, have gotten shorter and shorter and shorter and shorter. I swear, we're going to have a recession that's going to be a week.

Brendan M: Yeah, I get your point, but that could also just be the sign of a more mature economy and one that's also got its currency as a reserve currency for the entire world, which I think backstops a lot of the government spending that's going on.

Tom Mullooly: It helps everything.

Brendan M: If the dollar wasn't the gold standard, so to speak, of currencies, if other countries didn't want our treasury bonds, didn't want our currency, we might run into a different situation. That's where you run into hyper-inflationary environments, if you do this thing, and you don't have the level of credibility that the United States does. But when in history has a country with the level of respect that the United States has now, when has that existed and when have they tried this stuff? It's all new. So, we don't know what the limits are in terms of, is there an end to this? Does there have to be an end to this? I don't know.

Tom Mullooly: So there was a debate in Congress, and I think this ties in, Tim, with the point you're trying to make. Through the end of '08 and into '09, it was like, we have to do something for people who are being laid off from their jobs. And all that debate out of Washington, we didn't wind up with money in people's hands. We wound up with cash for clunkers. That was the best they could do.

Brendan M: And money to corporations, not the people.

Tom Mullooly: Right. They had incentives, tax incentives. But now kind of a different approach.

Tim Mullooly: Yeah. I mean, this time they did that and then Congress was able to pass these extra unemployment benefits and send the stimulus checks out to people, which seems like it has helped, but it's going to be a tough conversation. When they set this out in the beginning, it's like, "Hey, these extra benefits are going to run out at the end of July. And now we're at the end of June and 19, 20 million people are still unemployed and their benefits are going to run out at the end of July." And it's like, "Well, how are we going to go back to life without the extra money every week when we know that the government can afford to just give it to us?" So that's a point that Morgan brought up too. He was like, "I feel like the extra unemployment benefits are going to exist in perpetuity in some extent. It might not be the full $600 a week extra, but they have to raise the stakes at least a little bit from the floor that it was at."

Brendan M: Which elected official with elections upcoming in just a few months is going to be the one to get religion and say, "Hey, we can't do any more of this spending"? That's popular with literally no one.

Tim Mullooly: Because now everybody knows that it's not true to an extent.

Brendan M: And if you're going to be the person to take a stand and say, "Hey, I'm going to hold this up if we need to get it through Congress again for approval to get more money into the hands of the people that need it now. I'm going to be the one to hold it up and get all the bad press for this." I mean, I hope you're not up for reelection in November because regardless of where you are on the political spectrum, that's going to be very unpopular.

Tom Mullooly: So I think it was 2001 or 2002, President Bush sent every family $2,000. And if you just adjust for inflation and fast forward a little bit, if you took that $600 extra per week and wrapped it up into 12 weeks, I mean, you're talking about $7,000 or $8,000. I'm doing this math in my head. But I just look at that and say, "Gosh, I hope people remember that this is a temporary thing." And so I think the revolt is going to happen in the sense that people, when they start to realize that this extra $600 a week may be going away, as unpopular as that may seem, they have to be ready for it. I look at it from a business owner's perspective and say, "Whoa, whoa, whoa, whoa, whoa, extra $600 a week, that's $30,000 a year," if you're annualizing that. That's like paying someone's $16 or $17 an hour, that becomes your new minimum wage.

Tim Mullooly: It's a slippery slope, for sure.

Tom Mullooly: It is.

Brendan M: I think what will cause them to extend stuff like this is if they turn all of it off, if they don't reach a decision before these mandates are supposed to end and the stock market starts going down, or the economy starts to get worse in terms of the data that's coming out, then they will do something because all of the elected officials care about the economy, regardless of their colors. So they may play hard ball beforehand, but if it turns out that ... That'll be the ultimate signal, I think, if this wasn't enough. If they don't extend it and things start to get worse, in stocks especially, they will come back to the table and send more money to people. They care about what the market's doing.

Tim Mullooly: Yeah. I mean, you said it's a temporary thing and people need to be ready for it to go away. And the revolt will come. People will get upset when it does go away. But if I'm one of those people that was getting the extra money and it's temporary, I'm asking why. Why is it temporary? You can afford to continue to send me the money.

Brendan M: Now you're just choosing questions. Beforehand, it wasn't maybe even a possibility that we ...

Tim Mullooly: I didn't know it was a thing.

Brendan M: But now it's there. So it's okay, now you're willingly choosing not to help me when we know that you can, because you have in the past. That's even more unpopular than before.

Tom Mullooly: You're right. It's funny in the sense that 11, 12 years ago in the last recession, people were discussing moral hazard in the sense that they would live in the house and not pay their mortgage. And for a year and a half, they weren't being kicked out of their houses. And so you created this situation where people could choose not to pay their mortgage and there weren't very many repercussions. Now we're talking about doing this on a national level. Let's just give people money because the money that they're handing out doesn't even come close to the taxes that they collect in terms of a total amount of gross receipts that they get from taxpayers. They're handing out more.

Brendan M: I think the difference is that there used to be the people in government who would say that they couldn't do stuff because of deficit spending. But in the last several years, that's just been proven to be a total farce on both sides of the spectrum. Nobody cares about deficit spending. Everything we've done, even before we were doing this stuff to help with the economic situation with the virus, we were doing tax cuts. So there's no political party anymore who cares about the deficit spending because caring about the deficit spending cuts things that are popular with their constituents. And so people are going to do things that the people they're supposed to be representing in the aggregate want them to do. And I just don't know who is going to take the stand and say, "We're not doing this," because they're basically laying their livelihood as a politician on the line.

Tom Mullooly: They're laying down on the railroad tracks.

Brendan M: It could be the end of their political career. And what incentive do they have to do that?

Tim Mullooly: Before we turned the microphone on, we were talking, I think one of you said the quote, "Everyone wants capitalism," or something, until-

Brendan M: Everybody wants help when they need it. And then some people are more indifferent than others when it doesn't directly benefit them. But the saying is like, "There's no atheists in a foxhole." Everybody wants to believe and be a part of the team when it benefits them or when they have something to lose, but not all the other times. So yeah, it's tough. I don't know what the answer is. I don't think there's an easy one. But to just put a bow on everything, Morgan's piece was basically just that when you put these things out there that are so huge, like what we've done this year in terms of stimulus from both the Fed and Congress here, you can't walk that stuff back. It's been done now. Like the saying, you can't put Pandora back into the box. It's out there. It's in the world now. And we'll have to see what they do with it moving forward.

Tom Mullooly: What's the line from Ferris Bueller? I weep for the future. So Brendan, a moment ago, you said that no matter what color politician is, meaning red or blue, they all want the same thing. They all want to get reelected. And we've got a pretty important election coming up in a few months. And you wrote a piece this week that I think we want to talk about.

Brendan M: Yeah. It just seems like every time, especially when we have presidential elections, this one is always the most important one. This is the election to end all the elections. This is the be all, end all. And with that in mind, we get a lot of phone calls from clients and prospects and people who are concerned about what the election is going to do for the markets and for their investments. I wrote a post this week, just taking a look at general consensus going into the last two elections and how it was totally wrong, just to caution people about not getting too tied up in this.

Tim Mullooly: Are we going to talk about President Romney?

Brendan M: No.

Tim Mullooly: Well, the prospect of him.

Brendan M: Yes. So going into the election in 2012, the general narrative was that if Obama were reelected, that it would be not good for stocks. And a year out from his eventual reelection, the market was up 26%, the S&P 500. And so then fast forward to 2016, where everybody was saying, "If Trump wins, the markets are going to tank. It's going to be terrible." And a year out from his election, the market, the S&P 500 is up 23%. both ends of the political spectrum there, both narratives just completely busted. But instead of learning that the narratives that we hear leading up to an election are just not useful, we just believe people again, because I've seen nothing but headlines about how this or that for the upcoming 2020 election means whatever for the markets. If Trump wins, it's going to be good. If Biden wins, it's going to be bad. If Biden wins, it's going to be good. If Trump wins, it's going to be bad. Reverse all the headlines and slap a different news headquarters logo on it. I mean, you see these things everyday now.

Tim Mullooly: Literally yesterday, one of the biggest financial profiles out there, Jim Cramer, said that the market went down a couple percent yesterday because a new poll came out that said Biden was leading or his lead grew, or something about Joe Biden. And that was the reason why the stock market went down yesterday.

Brendan M: It's irresponsible to tell people that kind of nonsense, as if we know why the market moves on a day-to-day basis.

Tom Mullooly: There's so many reasons to come up with to explain away what a market did from one day to day the next, but people get crazy at this time of year, every four years going into these elections. It seems to me, just the first time that I was a broker Reagan was getting reelected. Nobody knew what the true outcome was going to be until the dust settled. But it seems like you're right, every four years, this is the most important election we've ever had as a nation. And I don't know why people get so hung up on this thing, because it's almost like the fever that you hear when people start talking about the Jets or the Giants. They're just wrapped up in their own narrative about what the future's going to hold if my guy loses, or if my guy wins. We find, as you showed in your blog post, and everybody should read it, it doesn't really matter. It doesn't really matter to stocks.

Tim Mullooly: Yeah, to the stock market.

Brendan M: Market data going back ... You know, I had data from all the presidents since 1920, which was basically just, it showed what the returns were over the course of their presidency, which was just squiggles-

Tim Mullooly: It went every which way.

Brendan M: ... heading in different directions. Good luck divining something from that. And I had another piece of data that just showed Republican or Democrat, the market has averaged 11% a year over the very long term. I'd caution people against getting too wrapped up in what's going on because ultimately what happens in the US economy and stock markets is a result of the people in this country and the companies that operate in this country and marketplace wanting to get better and wanting to be more profitable, and it's not necessarily a direct result of who's in charge.

Tom Mullooly: I can't tell you how many times I've heard, "Well, if this candidate wins, we know the taxes are going up." No you don't. You think they might go up, but they may not. I mean, first of all, you have to get a president that's going to push an agenda that's going to get approved by Congress. It's a tall task. Sometimes the market likes offsetting parties because nothing gets done. Not really a win, but nothing really changes.

Brendan M: Maybe it is a win.

Tom Mullooly: And that could be a win.

Brendan M: Yeah. It's just, people get really crazy about it because in today's day and age, political parties tend to be like sports teams, unfortunately. So you take a tribal mentality, but I think over the course of an investing lifetime, if you skew to one party or the other, in general, the way that things have gone, you're going to be unhappy half of the time. But that doesn't mean you're not going to make money half of the time. I mean, just look at what the market has done over the very long term. On a one year basis, you have better than 50% odds of being positive. And the further you go out, especially as you extend into decades, in the US markets, you have 90 plus percent chance of being up on your investment a decade in, if you can have the patience to do that. And that doesn't matter, there's no asterisks in there that says only if XYZ party is in control for that 10 years. That has nothing to do with it.

Tom Mullooly: Tim, you saw another article on MarketWatch this week about expected returns. That ties in nicely with what we've been talking about. Like what to expect if we get Republican win, Democrat win.

Tim Mullooly: I think it's just, yeah, what to expect if this narrative continues or this happens. And the article was talking about interest rates and what it says about the prospect of stock and bond returns over the next five year period. So not even the very long-term. Five years in terms of an investing careers is still relatively short term. The author was making a bearish case in a sense for stocks and bonds, because interest rates are so low. And historically when they're this low, adjusted with inflation, the five year outlook for it is not looking good. It just feels like a narrative that, I know since me and Brendan have been here, we've been hearing that the entire time and it hasn't been true. I mean, just in the article, the last example that they gave was the last time that the inflation adjusted rates were this low was 2013. So, a five year period from 2013 to 2018, I mean-

Tom Mullooly: Pretty damn good.

Tim Mullooly: Yeah. If you took your money out of stocks and bonds from 2013 to 2018, how much money did you miss out on?

Tom Mullooly: A ton.

Tim Mullooly: I don't know.

Brendan M: What the stats in the article we're saying is that the odds are, based on what has happened historically, the odds are with real interest rates where they are right now, that forward returns for five years will be on the lower end of the spectrum. So, do with that what you may. In my opinion, just for planning purposes, planning on lower market returns isn't necessarily a bad thing. But if you're going to use information like this to say, "I'm out of stocks," I think that's unhelpful. There are different ways to use this kind of information.

Tim Mullooly: It felt like that was the point that he was, the author was trying to make. He didn't explicitly say, "You shouldn't have money in stocks and bonds," but I got the feel that that's the point that he was trying to nudge to people, is like, "Well, you're not going to make any money in stocks and bonds over the next five years." But at the same time I was reading the article and I was like, "Okay." So let's say what this guy is predicting comes true, there are lower returns for stocks and bonds. Where should I put my money than elsewhere, if I'm not in stocks and bonds? And he didn't really offer any other alternative or a solution. He just presented a problem and then said, "Here," and ran away. It's like, "Well, present an alternative or something. Give your take on where we should put our money instead then." And there was none of that. So I didn't appreciate that.

Brendan M: Yeah. If you're going to take your money out of stocks and bonds because real returns are going to be low, then definitely don't be putting it in your bank account because they'll be even lower. That's a virtual certitude. I mean, over time, cash has returned lower than stocks, which has returned lower than bonds, which is why there's more risk as you climb up that very same ladder. Just that's how things have worked.

Tom Mullooly: And if we're also saying that real returns are low because interest rate's nominal, interest rates are low, and there's no inflation, I can't really make the claim that real estate would do well. Real estate does well because of inflation. So I think, Brendan, your point made the most sense, in the way that if you use this from a planning perspective, we always want to low ball what the returns are going to be in the future.

Brendan M: Yeah. Everybody's financial plan works great if you just assume 20% annual returns. Great. Your plan's perfect. Stamp it, done.

Tom Mullooly: Yeah.

Brendan M: No, we would never do that. So, you can use it responsibly in that sense and you can use things like the CAPE ratio in a similar way to say, "Hey, we don't know what returns will look like over the next five to 10 years." We never know, but this suggests maybe we should be a little more conservative than we otherwise would.

Tom Mullooly: Right. To use it though, as an in-out-

Brendan M: A timing indicator.

Tom Mullooly: ... kind of play. Bad.

Brendan M: Bad.

Tom Mullooly: Very bad.

Brendan M: I mean, nothing is great as an in-out, but this especially. Yeah, I would say one other thing that's baked into this that I just question the usefulness of moving forward, is just the idea in general, that real interest rates are predictive of expectations for growth moving forward. In the past, basically what that's baking in is the bond market, and if interest rates are low, that means people have piled into things like fixed income, meaning that growth outlooks may be poor moving forward. However-

Tom Mullooly: All right. Wait, wait. Let's just take a moment to explain what you just said. In the past, people would pile into bonds because out of fear, they're a flight to safety. They're looking at the best guaranteed, so to speak, rate that they could get pile into bonds. You're saying there may be a different reason why rates are so low.

Brendan M: There's a different dynamic at work now because we have the Federal Reserve with an unlimited arsenal buying bonds on the market every single day to get cash into the bank so that they can lend to people and stimulate the economy. So, when there's a buyer who is indiscriminate and has bottomless pockets on the marketplace, just vacuuming up fixed income securities, and by the way, also setting the very short term interest rates that all other rates are relatively based off of anyway, I'm not sure that that indicator of where rates are suggest growth. I feel like it may not suggest anything about growth moving forward. It may just suggest that the Fed is in the marketplace and they're holding rates where they want them to be.

Tom Mullooly: So for the listener, think about what Brendan just said in the sense that the Fed is controlling the short term side of the bond market, they're controlling short term rates. They're also out at the longer maturities buying everything in sight. The Fed is buying $5 billion worth of securities every day.

Brendan M: They're buying day LQD. They're buying like an actual ticker symbol in ETF. Like we mentioned earlier in this podcast. Yeah, I don't know. And it certainly looks like based on the evidence that this was useful using a bunch of historical data, but we may find in the future that as the Fed becomes more and more involved in what's going on in the marketplace, that maybe this isn't super predictive of that. And maybe that is why in 2012, '13, when these rates were where they were last time, things weren't so bad on a move forward basis, because what it basically did was stimulate stuff, so the next five years were actually pretty good and rates rose a little bit over that time, but not to such an extent that it strangled the market out. The market was very good.

Tom Mullooly: I think Yellen announced in 2014 that they were going to start raising rates.

Brendan M: Right, and they raised all of '15-

Tom Mullooly: But they didn't start 16 until the end of '15, and through '16.

Brendan M: '15 and then '16 and then '17 and then ...

Tom Mullooly: In '17, the market was up 30%. It's crazy, with rates going up.

Brendan M: Yeah, I don't know what kind of perfect timing indicators are out there. This isn't one. I haven't found one yet either. So if you do, let me know.

Tom Mullooly: We have a Slack channel that we use to gather our thoughts when we start preparing for this podcast, and I know I wrote something, Tim, when you posted this article into the channel. And I wrote, "Lower expected returns is something that I have heard since the 1987 crash. Since 1987, over 30 years, there have been people in our line of work telling people you better get ready. We're going to have lower returns going forward." False. Oh wait, wait. Wrong.

Brendan M: It's fine. It depends on what ... There have been rolling five year periods of low returns. Look at the early 2000s, or rolling decades of lower returns.

Tom Mullooly: 10 years of nothing.

Brendan M: They have existed, but I agree with your point that in general, especially as you stretch out the timeframe, it doesn't matter as much. But I mean, there have been periods of low returns and you just have to define it a little bit more. If you just say a blanket statement like, "Lower returns moving forward," then I don't even know what that means. That's not specific enough. Over what timeframe matters a ton. Lower returns over like 30 years, like my entire retirement, okay that's a problem. If this is right, then we need to address this and really plan for it. Lower returns over a five year stretch of time, I mean, I don't know.

Tim Mullooly: When I'm 35 years old, it doesn't matter.

Brendan M: Or in retirement. You build a plan that's going to ... If you build a plan that won't break because of a five year period of low returns, then if that doesn't materialize, wonderful. You just have extra. And if it does materialize, then you were ready for it.

Tom Mullooly: So, we hope you've enjoyed this podcast, episode number 313, our cruise through Motor City. Thanks for tuning in. We'll catch up with you in St. Louis.