Preparing for Recession - How to be a Full Cycle Entrepreneur - Alastair Macdonald: Ep #435

Full Episode Transcript

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Dr. David Phelps

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Welcome to the Dentist Freedom Blueprint, a podcast about freedom—freedom from expectations of society and the traditional path to success that has been ingrained in us from our early years, I'm joined by mavericks, renegades, and non-conformers to discuss an anti-traditional path to financial freedom, freedom of time, relationships, health, and ultimately freedom of purpose. My name is Dr. David Phelps. Let's get started.

Alastair MacDonald: The difference is really in an expansionary economy, capital flows toward the reckless and the impatient, and in a contractionary environment, capital flows to the studious and patient.

David Phelps: Hi, all David here. Let me preface this week's podcast conversation by giving you a little insight into the person with whom I'm having the conversation.

I've had him on before, his name is Alastair MacDonald MacDonald. He is originally from Zimbabwe, fourth generation Zimbabwean. And he's been here in the U.S. for some 20 plus years. Not a lot about his story that I'm going to tell you right now but just realized that he has a full background in the market cycles.

He came to the U.S. after being a very successful National Geographic guide in the jungles and Waterways of Zimbabwe as a teenager. Came to the U.S., and got involved on Wall Street, found that not to be his liking.

But he studied, understands the market cycle and we want to get into a discussion today regarding positioning and being prepared for a deeper recession which I believe we are definitely at the forefront of. And how are we prepared to be what we call full cycle entrepreneurs.

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Most people have not gone through a full cycle successfully, maybe a half cycle but on the other side, what lies there is really what makes people come out as winners or maybe not losers but not doing as well as they should.

This conversation really talks about some of the leading indicators that we can look at regarding how a recession comes about, how we can stress-test our businesses, some of the dangerous conversations that we really have to have, that we have to go against really what I call the group think or the herd mentality.

We have to be able to be contrarian in looking at what everybody else is going forward on, we have to also not go against but learn how to circumvent what the group think is talking about.

Looking at interest rates, the rapid rise of interest rates over this last 12, 13, 14 months, the higher cost of capital, it's changing the dynamics like we haven't seen in 40 years, and this is a major, major change.

So, enjoy the conversation with Alastair MacDonald, and next week I'll bring Alastair back for a second conversation which also ties into a recessionary environment. And we'll be talking more about what I call culture wars, how do we engage the disengaged.

This has been a big problem for anybody within business and a labor force since COVID three years ago, and we're still reeling on a back end of a culture, where people were given a lot of money and feel like they didn't have to go to work.

So, catch you next week, leave some comments, give us a rating if you would.

Well, good day everyone, this is David along with our good friend Alastair MacDonald. Alastair, you need no introduction to our tribe but maybe to a few people, you may be a new face, they haven't met you yet. They'll get to do so in the coming months at our next member meeting.

I try to really be very careful and concise in my introductions, and so I always go back out to the source of all things out, the internet, Google. And I thought, the easy thing for me do is, I can go to a person's website and go to the about tab and draw down what they put in.

So, I went to your website and well, I'm not so sure, I think they need some work. I'll just say it needs a little work. And I thought, well, LinkedIn, everybody uses LinkedIn. So, I went to LinkedIn and yeah, again, sir, I'm going to say it probably needs some updating.

So, I went to the one that everybody goes to and it's Facebook. And so, nice picture there, you doing a Ted Talk. And I went to, of course, there's an about. So, I went to the about in Facebook and here's what it said: "Details about Alastair: no additional details to show." Nothing on name pronunciation, no other names to show, no favorite.

Oh yeah, she did have one thing; a favorite quote. So, let me give this piece, so this will be my intro. Your favorite quote is, "The longer you wait for the future, the shorter it will be."

So, that's all I got on you, sir, I'm just going to have to leave it as an open target here.

Alastair MacDonald: Well, you can't get anything wrong, let's put it that way. I don't even remember putting that quote there, which shows how outdated my bio is, and the closest that anybody's come … someone came up to me once and said, "I've done some work on you, I've been researching you," which is always a little creepy.

And he said, "I know everything about you, I know where you went to school, who you worked for, what your salary was." And this was a little haunting for me because I don't really have any such history. My education is unlikely to show up on the internet. Likewise, I was fascinated to find out that I had a parent who previously had a job, which was also new to me.

And so, I was so surprised by his studious research, I asked to see who it was. Needless to say, this was a bearded 60-something-year-old Scotsman named Alastair MacDonald, who I think was an ichthyologist, needless to say, not at all connected to me.

So, I've been accused of much worse than having no bio, which is being a mid-60-year-old ichthyologist in the **[inaudible00:03:05]**.

David Phelps: You can be like Walter Mitty, you can be whoever you want to be at any given day, any time.

Alastair MacDonald: A flaw in my thinking, I definitely need to at some point, stop behaving like a functioning professional. And I'll take this as a call to arms, and I'll put in at the top of my list of things I probably won't get.

David Phelps: I wouldn't worry about it, I'd keep posting, all good.

Alright, wanted to get a little bit of a conversation regarding what people feel like is the pending recession, and maybe let's just — and we're going to focus on how that may affect business owners, small business owners, people that are in our tribe, dentists, some of the docs. We even have some outside fantastic business owners who are not even affiliated with healthcare, but businesses, businesses, business.

And looking at impending recession, there are certainly some signals, some signs, some attention grabbers that I think small business owners should have. Let's just start by, maybe, could we define a little bit what this word recession that has just been tossed around everywhere in the — what does recession really mean or what could it mean?

And again, it's going to be different for various different people and different business owners. It's not all the same, recession's not a universal thing that happens to everybody at the same time, the same way.

Can we just start there a little bit? What are your thoughts? You've seen a few, you've been through a few, we've talked about those. What are your thoughts as we look forward now in the next several quarters?

Alastair MacDonald: Well, technically, the NBER is the one who decides what a recession means. Typically, two quarters of contracting GDP or because economics is very much like politics and they like to destroy the language or use it in a whatever format they need. We call it negative growth which I think is quite funny.

So, two quarters of negative growth, and if you own a business, needless to say, we don't call it negative growth, we call it a loss or declining revenues or what have you. But then anecdotally and socially, there's that odd saying, recession is when your friend loses his job and her job, and the depression is when you lose yours. Of course, the same is true for our businesses. So, really, just a period of general economic contraction.

Socially, I think of it really as capital being reallocated from boom times to bust times, or from expansion to contraction. And the difference is really in the expansionary economy, certainly, late cycle expansion, capital flows toward the reckless and impatient, and in a contractionary environment, capital flows to the studious and patient, and so it's very much time for that.

This is a time for us to be patient. There's a lot here that we can go down in terms of timing; good idea, bad time equals bad idea — bad idea, good time, good idea. That seems to be how it works out.

Example of that is certain sectors of the economy or of the world that are extremely attractive right now that nobody wants to own. And then there are parts of the world that everybody had to own, like NFTs.

So, beautiful example of the psychology that attends both poles of an expansion and contraction. And we get too and should, because of course, we are part of the averages, we are represented in the data, we do what everyone else is doing.

So, we can use these simple lenses to ask ourself how close we are to one pole versus the other. The beauty of dentistry and medicine in general, is it's extremely resilient to recessions. As a function of supply demand being very much equilibrated to protect us.

Then this means that we can be afforded a privilege really of greater protection. Individuals still have to seek medical help, but at the same time, we can't afford to get lazy or rest on our laurels because every business is tested in a recession, just some are tested more than others.

David Phelps: Since COVID, three years ago, Alastair, all of the credit expansion and the helicopter money that was pushed out to business owners and employees alike really stoked up the economy and pin up demand and all of a sudden, people had a lot of money, in some regards, a lot of free time, maybe not having to go back to work in an office, so remote, flexible hours.

A lot of people enjoyed a lot of those benefits of the last several years. That seems to be coming to an end. I'm going to say that coming to an end, well, people are having to go back to work, more and more companies are bringing people back to the office. So, some of that flexibility is going away.

So, I'm talking about our consumers, in this case our patients. What's changing in their lives from having seemingly a lot of additional capital to deploy in whatever the way they wanted to, to now this last quarter household debt is at a record high across $17 trillion.

Mortgage debt has gone up another $120 billion in the last quarter, now at $12 trillion. Auto loans, looking at some of the notes I have here, up another $10 billion to over one and a half trillion dollars. The average interest rate for a used car today, used car 14%, Alastair. 14%, if you want to go finance a used car, I mean, that's ridiculous.

New car average is 9%, so a new car you've got, I guess good credit, 9% is what you pay. The big one that people have not been talking about very much, but it's coming very, very soon, student loan debt.

All the people who have the big long pause … hasn't been three years now that it's been on pause approximately? Student loan debt is at $1.6 trillion set to resume in August.

Credit card debt just under a trillion dollars; average interest rate (I didn't know this), 25%. I thought I thought 18, 19, but 25%, and that debt is going up. So, we have debt levels going to all-time highs, tack on property taxes. I mean, across the nation, property taxes and insurance, both are adding to the mortgage payments that people took on.

And even if they have low interest rates today, maybe they got under sub four, the escrow for insurance and property taxes and insurance is going up tremendously there. General cost of living, essentially consumers are running out of money and now they're having to use debt to finance the lifestyle that they thought they should have or deserve.

I just saw the report from Home Depot yesterday, so I'm just now looking at retailers — reported their worst revenue in 20 years down, 4.2% year over year, largest drop since the great financial crisis. Retailers appear to be in trouble.

And then just within our own tribe, just pulse on some of the folks that I've been talking about in Freedom Founders has been, they're noticing a decrease in patient treatment acceptance.

So, there's some overriding stats, let's dig in a little bit here and talk about some of the issues that you see from your past experience and also working with some of the many clients that you have the privilege to do so today.

How are you helping prepare them looking forward and what things could they be doing today? What should they be monitoring to or against what maybe coming down the road a few quarters?

Alastair MacDonald: I know you and I have spoken in the past, my good friend Jay Conway, the three of us have spoken. As a general rule of thumb, I run scenarios for any business over 20% decline in revenue, and just see what that does. It's very easy when individuals hear that to think it's a forecast. That's not a forecast, it's a scenario to run.

And I use 20% because I come to dentistry from many other industries. And other industries, that's not uncommon at all. In dentistry, it's almost unheard of unless you're really on the tail end of the discretionary work of say, purely cosmetic or something like that.

And so, that's sort of a contraction, scenario should be run. And what does that do to your hard deck of break-even? What does it do specifically to the difference between your fixed and variable expenses? What changes do you see there?

The first thing to go in any contractionary period is the same thing, we just have to ask ourselves what we would do and what we have done. I would wish that everybody has had an experience of struggling at some point in their life financially, what a gift that can be if we are patient and studious enough to actually splice it apart, how did we get there? What did we do?

What we do inevitably is eliminate discretionary purchases, those things that don't matter. And this cascades all the way through consumer appetites from maybe we don't need the newest iPhone, to maybe I don't need this aspect of my treatment plan yet.

So, I use that 20% as a general risk assessment rule of thumb, but then within that, it's worth it I believe for practice owners to do an equivalent level of scenario running of what if we saw that type of a contraction within our most discretionary aspects of our work, even 100% elimination, what does it look like.

Now, why aren't we doing this? Most people avoid this because it makes them upset. I would rather do this work, so that lowers the probability of it happening. We think analyzing it is upsetting, wait until you live through it.

I would so much sooner do the work and be prepared for it, knowing where we would cut, where, when, and how. These are really beautiful and worthwhile exercises in the comfort of a very protective garden that dentistry is, I think these are sensible things to do.

One of the things I've always appreciated about watching you and how you lead your tribe and look out for those you serve, is not being afraid to talk about these things.

And there's periods of time that we go through where certain things are considered almost dangerous conversations and they shouldn't be, and I think that that's where we need to be courageous enough to spend our time.

Most individuals who are afraid to do that, certainly those of any position of influence that are afraid to do it, and consequently their service contribution to the marketplace tends to wax and wane with the broader economy because they're not staying relevant.

You've been relevant to this full cycle phenomenon for as long as I've known you, and part of it came up goodness, over a year, I remember at your event where we spoke about three critical pieces about interest rate changes, there are three crucial elements.

The first is the easiest to overlook to the untrained eye, and that is the power of small numbers. As you and I were I think really early on anticipating the larger trend and interest rates having turned up in July, August of 2020, we can now confidently say that that low in interest rates was the low, and it will remain so until we get new lows. So, we have to consider they were inside of a larger secular upspring in interest rates.

Now, at the time people say, “Well, what's going to happen then? So, what? Mortgages go from 2.6 to 4 or 2.6 to 4.6, this is not a big deal.” The power of small numbers is critical, that's essentially 100% increase in the cost of cap. Why is it? Because we're lazy, we haven't seen such radical increase.

What we saw happen from January of ‘21 through today, if we look at, say the two-year note, the two-year note was at $0.10, it sure enough hit 4.8, 4.9 and in excess of a 40x increase in the cost of capital. That has never happened in the history of the American backings.

Now, have we seen 4% interest? Sure, but that's what lulls … so that's the first thing, is the power of small numbers. The second is rate of change.

The speed at which things change is a huge fact because again, we enjoy privileges in the medical space that a restauranteur, a biotech company, a real estate, speculator does not enjoy, which is the volatility of interest rates have a meaningful immediate impact on their bound changing cash flow. So, the rate of change is huge.

The last is that relative change, which I kind of alluded to, is the relative change between 0.1% on the two-year and 4.8. The relative change is huge. Again, it is without precedent. I would encourage any of our friends out there to go to the St. Louis Federal Reserve site.

They've got impeccable charts, excellent data, and just look at the history of interest rates there. And you'll see in the 1970s and early ‘80s, we saw double digit interest rates. We've never seen a 5x, a 40x increase in that power. Small numbers rate of change and the relative change is so huge.

David Phelps: I think it's interesting that you say that because what I hear in much of the real estate circles that I'm privileged to be a part of in hearing the conversations, keeping my ear to the ground is what you just said: “Well, David, the 40-year average mortgage interest rate 30 years is 7.88%, we're not even there yet.”

My friend, yes, but we've had 40 years of declining interest rates and gotten used to the hot cheap money and to have a rise, as you said, from mortgage rates from, let's call it, 2.6 a year and a half ago, all the way up to 6.5 to 7% today. Again, that relative change is what people don’t understand.

Yes, interest rates may be an average, but the relative timing of when this happens in the market cycle is what's so critical. And I think we're just at the beginning of what these interest changes are going to be causing downstream as we go into the next quarter, the next quarter, into this year, the next year.

Things are just starting to unravel right now as we look at it, and those who don't understand the flow of funds and the cost of capital, and the fact that everything's been built on the low interest rates and that you could just essentially buy, acquire, expand, do anything because the cost of capital was close to zero.

And that left a lot of room to speculate without really being focused on, “What am I really building here? What value am I building? Oh, it doesn't matter. You don't need value, you only need profit. You can just sell it to the next person down the road and they'll pick it up from wherever you left off.”

Those kind of discussions are what I'm hearing, and that's kind of scary to me, to see people that are I guess, oblivious to what's really happening in the market.

Alastair MacDonald: Yeah, I think this brings up two critical points. The first is, if you hear that type of casual confidence, it's almost borders on swagger. Certainly what I've heard, this is a major red flag. This is evidence that somebody that doesn't understand this rate of relative change and our small numbers.

It also immediately reveals a critical thing, you and I have beat this drum as long as we've known each other, is how dangerous it is to take advice from half cycle experts. When I hear that, I hear somebody that has never truly seen difficult times and they've certainly never seen steep rising interest rates or even consistently rising.

And to be honest, of course, we've got to be fair, in the United States, we haven't really seen consistently rising interest rates since 1968 through ‘81. So, very few people were in business at that time.

But it points to the critical value of seeking inputs from those that have a full cycle history to the point of being able to this kind of hot potato greater fool thinking of investing.

Well, sure we might be overpaying, but there’s a greater fool than I who will pay even more. Which of course, is the whole premise of the vast bulk of private equity DSO offers today. As an aside, I can't help myself, could I bring that up? Just because there's a lot of good people that will be messing.

But besides that, another critical distinction here is when we are talking about assets, that we will find somebody else to buy it from us at these new historic average interest rates — you're talking about somebody who owns an asset that had costed them 2.6% to borrow, to buy, and now, they're trying to sell it to somebody who's paying 7%. What do you think happens?

Well, the very first thing that happens is a reticence to sell, and we're ready seeing the first quarter of this year all the evidence we need, those that have those voices are hesitant to sell. There is some kind of bastion of scoundrels out there right now that are saying, “See, that's going to put a floor under the money.”

Overlooking the fact that death, disruption, disease, divorce, with forced sales, that that alone is going to account for a large percentage. So, we're right in that spot in the auction system that the real estate market is of where bids are not coming in at the rate people want, and so they pull them from the auction, so to speak.

There's less things going to market because they don't like the price. At the end of the day, Warren Buffet point in the south beautifully 10 days ago, individuals that have borrowed to buy some 2.6 have to sell it to someone who's having to borrow 7 to buy it. Very, very difficult.

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