Building Wealth and Teaching Financial Wisdom to the Next Generation (Part 2) - Anna Kelley: Ep #476

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Dr. David Phelps

Dentist Freedom Blueprint with 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.

David Phelps: Hi all, David here. Today, I'm having my second session with Anna Kelley. If you missed last week, you'll definitely want to go back and catch it because it'll tell you more about who Anna Kelley is and how she and her husband grew their wealth to financial freedom in a little over a decade. Today, we're going to dive into really the current market, the economy, real estate, where we're at, what we're looking for in the likelihood of a recession and a correction ahead and where the opportunities will lie for those who are positioned well. I know you'll enjoy this conversation. Here it is.

I tell people you have to take what the market gives you. And to your point, I think we're moving from the value added to quick turns, which as you said, was there, the market provided for that for a number of years and we're at what now where it's really the strength of the operators, exactly what you're talking about, the strength of the operators with the right asset and particularly the right long term financing that, yes, a good operator can ride through whatever kind of downturn. Yes, probably values may go down, but if you're not a seller, you're not forced to sell, it doesn't matter.

And we both know that anytime there's a big upsurge in the economy, as we've seen for all the reasons that, well, we didn't talk about the reasons, but the bad manipulation of the economy, the fiscal monetary policies that are in place today, I've allowed for this, and there's always, at times like that, a lot of new people, new kids on the block, let's just call it that way, who rushed to the market, right?

It's like, you know, your Uber driver is flipping houses on the side. When you start to hear that, you go, “Okay, probably a time when things were topping out here a little bit.” And you know those who have not gone through a full cycle, a full market cycle make us don't understand the discipline and kind of the rules of the game and understand that when things do peak or we go through a major shift like we're going through right now, that the dominoes can fall very quickly and that's happening, happening right and left out there today.

What's your sense of the banking system because, again, we're talking about debt. We're talking about syndicators are in trouble primarily for the debt that they have. All right. What's your feel of the banking system today? I've got my thoughts, but again, I'm not super plugged in. I don't, I can't call people on the phone and know, but what do you see there? Is the banking system healthy or do you think it's still rocky right now?

Anna Kelley: I really think that it's rocky and I'll say this, I do podcasts and I do a weekly show and I talk about the economy and I've been called a doomer a few times, which I find really funny because any of us that create wealth through challenging times, we do it because we're optimistic and we find opportunity in every problem.

So if there's a problem in the economy, I want to see it. I want to name it. I want to understand it. I want to understand the risks and the challenges. And then I want to say, “Okay, how can I find the opportunity in it and continue to go?” Right? So I'm very opportunistic, but I'm not real positive on where we are in banking and the next couple of years in the economy.

I really think that there are going to be a lot of challenges ahead that are just starting to really show the cracks in the system. And so for the banks, I think part of the issue, and I studied quite a bit the 1970s because in many ways the rapid inflation, even though it was for very different reasons, the inflation and the fed raising rates to get it down, really, the fallout was that after that was in the 80s, we had the savings and loan crisis, and a lot of why that happened really is because most of the debt that was cheap money for a long time, there was a period of economic growth, and basically, asset values go up. So when money is cheap and easy to get, so both the rate and bank's willingness to lend, asset values go up because people say, “Hey, I can borrow a lot more that money than what I have. I can borrow it at cheap rates. I'm going to go buy an asset.”

And then there's this demand for assets that you can create value with. Well, a lot of loans were done based upon land, oil, leases, commercial real estate. I'll just put it in kind of those three categories. And when rates went up, because these types of assets, what a lot of people don't know that only look at single-family houses is that these assets are very, the value itself is very dependent on what the U.S. Treasury rate is and what the lending going rate of return is. And that's because anyone that's looking for an investment, whether you invest in real estate or stocks or whatever, is always looking to get a fair risk premium, basically a reward commensurate with the extra risk you're taking to invest in something that's going to pay you better than the U.S. Treasury is going to pay you. So when the U.S. Treasury rate goes up, suddenly the demand for a better return for everything else goes way up. Well, if you're going to demand a higher rate of return, what has to happen? You have to pay less for that asset in order to generate that same return.

So commercial real estate, loosely, land, oil, etc. basically, the values significantly came down. Well, what people don't understand is that my liability or my debt on my properties is an asset to the bank. So just like we saw last year, we saw three banks start to fail. They essentially fail primarily because they owned bond that suddenly were worth 50% of what they were when they bought them. They were typically considered very safe assets. Banks wanna own bonds, but when the coupon at two goes to four, no one's gonna buy the coupon at two when they can get one that pays four. So essentially they take a 50% haircut. Well, what happened with these banks, for those that don't understand just very, very quickly, is that the value of those bonds went down.

So they had to write them down to the new asset value and suddenly they became insolvent. Their assets were no longer worth more than their liabilities. Well, the same risk is inherent in commercial real estate today. And so we have a lot of commercial loans that were done by regional bank. So not your Chase bank, not your city, not your Wells Fargo, but regional banks do the vast majority of lending or things like commercial real estate.

And so those banks, just like the banks that fail because of bonds are going to have to start taking big write-downs in their assets. They haven't had to realize the reduction in commercial real estate values yet, in many cases, because they've been trying to work with their borrower to some extent. But commercial real estate, generally speaking, has fallen, values have fallen just on paper just because of interest rates going up about 30%, and you add to that vacancies in such as the office space where your income is down at the same time that cap rate is up, and some properties have lost 40 to 50 percent of value.

Well, once these loans come up for renewal, David, the bank is going to have to write them down, and they're going to have to take a big haircut in their asset. And the question is, how many banks are going to go insolvent because their liabilities are higher than the value of their written-down assets?

And so what I know from just being in the commercial real estate space, and although I operate multifamily, I invest passively in a lot of different types of commercial real estate and private placements as well, is that most of the deals done since 2021 and 2022 were bridge debt, and so they had these two-year loan terms, some three, and often they would have one-year extensions.

So if you invested in a property, if a bank did a loan on a property in 2021, their loan is coming up for renewal in 2023. I'm saying bank, financial institutions in general, and they might have a one-year extension to go into 2024 this year. We're just starting to kind of see that fallout. But a lot of these regional banks on smaller properties or large developments did loans where they might not even have bridge debt, but they might have gotten 2 years of interest-only payments.

And then their rate starts resetting annually. Well, as those loans mature, or they're up for refinancing, or just the rate going up from, you know, double what it was before. Essentially, these properties, their loan-to-value no longer makes sense. There were, they reanalyze the value of the property when they get reset.

The values are down. You can't cover the debt service with the cash flow and meet their minimums anymore. And therefore, because of the terms of the loan, they have to basically, the owners are defaulting. They're turning in their keys because they can't refinance somewhere else. And so banks loan covenants, especially those that end up being sold as securities, don't allow them to make modifications oftentimes.

So people think, “Oh, the banks will just modify the loans.” They can't always do that. And there's regulations that keep them from doing that. So I think that there's going to be a lot more commercial properties default unless rates drastically come down, which they could. If we have a banking crisis, the federal quickly cut rates, and that will fix a lot of the value issues, but I think there's a lot of pain still ahead in both commercial real estate and the banking system that without Fed and Treasury intervention could be a major financial crisis in commercial. Not unlike what we saw in 2008 with residential.

David Phelps: Well, you gave us a lot of great information there and I'm tracking with you and it's very, very helpful to see through your lens and what you're anticipating. We know that how in the fed, December, basically held steady and really gave the markets anticipation that somewhere in the first or second quarter, they would start cutting rates. And then we see the CPI is staying too strong. No surprise, I think, for you and I just see that happening, but that's where it is.

And so they're going from being Dovish to Hawkish and I'm trying to ride that fence rail both sides. I mean, that's just what how the fed has to do it. It's not easy. It's not, I wouldn't want to be in that position, but here's my question for you. I know you studied this a lot. So the fed essentially controls the short-term rates, right? I mean, that's really what they have control over, but mortgage lending rates really are based on the 10-year. So this is just my thinking. You just tell me what you think. To me, the 10-year and on out to the 30, that's the bond market. And that's not the fed. It's the bond markets.

There's gotta be buyers for these bonds, right? And the bond market, I think, if I'm a bond investor and I do, I mean, I hold treasuries, but not long-term short-term treasuries. I've got a long-term bond investor, but if I was, if someone said here, “David, buy this 10-year right now, it's at a good rate.”

What's it 4% now, I lose tracks. You want me to block in at 4% for 10 years? I'm not doing that. I don't think we're gonna get back down to 2% inflation anytime soon. I can't do that. If you're going to sell me a 10-year receivable, a bond, then personally, I demand a lot more for that. So where are the bond investors and why do you think that they're still allowing that to occur?

Anna Kelley: Yeah. I've asked myself this question and I've kind of played out what if games, you know, what if this happens in the economy versus what if this happens in the economy? And a lesson that I learned during the GFC was the economy is extensively more complex and intertwined than I ever really realized, and it's even more so today. And so there's so many things that impact rates, both long-term rates and short-term rates, outside of just what we think of as U.S. Investments. Obviously, wars that we're helping fund and defend, pandemics, all these kind of things that happen on the global front really have a big impact on our growth as a nation, our GDP and inflation. And there's so many things that could make things go one way or another. But my kind of thesis that I'm operating on, and I'm hedging in case I'm wrong, but my thesis is in the short term, I'd almost bet money, although I don't bet money, but I'd almost bet money that it will be declared, the NBER will declare us in a recession already this year or the end of last year.

David Phelps: The National Bureau of Economic Research, just so–

Anna Kelley: Absolutely. So they're the ones that date recessions, but generally they only, they call it about six months after, and then they say, “Oh, we're going to backdate it to this date.”

So when I look at economic data, yes, we had a higher inflation print than what some people expected by, you know, 0.25 or something like that, higher than what they thought. And inflation is harder to get the last leg out than it was to get it to come down so far with big rate increases. And so I think there's parts of the economy where inflation is going to be sticky and higher than it would be.

But if you look, I watched the leading economic indicators that the NBER uses to date recession. We have been in recessionary territory in 8 or 9 out of 10 for over a year. The yield curves and, you know, inverted for 82 to 84 weeks, and it's starting to de-invert jobs. If you look at the underlying data, not just the national data that we see on the news, but you dig into those reports.

You'll see that jobs are actually very weighted to being government jobs, so then they are private-income jobs. And anytime, you know, I follow Lacey Hunt and Danielle DiMartino Booth and some of these other economists, but you know, what they're showing is that if you look at state-by-state unemployment data, 88% say employment has gone down, unemployment's rising.

So underneath all of these national levers, these reports that keep being adjusted downward, we see a lot of cracks where I really believe that we are already in a recession. I think Powell knows that, but they don't want to come out and say it just yet because they want to kind of get rid of this idea of the fed put, and they don't want to have to go back to zero bound interest rates and stay there, right?

So I think that they're kind of walking this dance where I believe that we're in a recession, that the economy is going to continue to get worse. And if we have this banking crisis on top of it, it'll give fed a chance at that point to say, “Okay, now we're cutting rates and we're shifting from fighting inflation to saving the economic system and getting us out of a recession.”

I think rates will drop significantly and very quickly when that happens and is declared, but I think to your point, that'll be short-lived. So the short-term rates will drop and initially, everybody's going to be excited and they're going to think, “Oh, the economy's not quite that bad, but the feds just cutting rates to make sure we don't go into a recession.”

I think at that time, your rates do fall quite a bit, and I'm looking forward to relocking in really long-term debt at really low rates while the economy is suffering. But the other issue that you raised is that if you look out over the long term, I think we're in for a lot more inflation than what we've had.

And I don't think inflation is really tackled for good. I think it's tackled temporarily. But if you look at our national debt, to your point, our national debt has grown so large. We've been downgraded and there's no stopping in path. There were heavy into fiscal dominance and the government just continues to spend money.

And as our debt grows, really, governments only really have three choices that have worked historically to get rid of national debt when it–astronomical like it is today. Our debt payments are more than what we spend on defense. I think it's about a trillion dollars a year now. They either raise taxes significantly or a combination of these things, which I think is coming.

They create austerity so they start cutting programs like social security. That's been in the news. Or they inflate away the debt. They create inflation.

And if they create inflation enough that they hope that they can get GDP to be similarly aligned. I think the inflation numbers are manipulated. I know they are based on data that I've looked at, and inflation is higher than what the government says it is.

But if they can get us to buy inflation and print more money, they can make the value of the debt that they owe less in future terms than it is today. And so I think that they will continue to have to inflate away the debt. What do they need to do? They need to issue more treasuries because they need to be able to borrow more money.

So you and I are going to say, “Why would we block our money up for 10 years for 4% if we think that inflation is going to be worse in the future?” You look at deglobalization and reshoring, energy, and production, those things cost a lot of money and take a lot of debt to do, which leads to more inflation.

I, like you, would never invest in a U.S. Treasury 10 years out when I think inflation's going to go much higher over time. To get control of the debt, then you have to issue treasuries that are at a high enough interest rate to lure us into saying, “Okay, now it's six or seven. Okay, maybe now I play ball and I lock it up.”

So that is going to affect commercial real estate and residential real estate because those longer-term loans really are tracking to that 10-year treasury. So in some ways I think the Fed has lost some control because of the fiscal dominance because of the fiscal policies that have grown our national debt so high that I don't think they can really fix it with just their standard tools that there exists today.

David Phelps: Well, that was a great economics lesson right there. Well done. Well done. I see Pal is trying to use interest rates. What he has in his hand, it's just like a big hammer. That's all he's got, just pound. And you got the administration and congress that are just peeling the other way and just shoving more money.

And he's just trying to pound it down interest rates and they keep spending more money. He's just in that quicksand place, right? I think inflation is out of the bottle. It's the genie out of the bottle. I think stuffing it back in, as you said, it's going to be very, very hard. I think it's going to be very, very volatile over the next years. Yeah. They'll play games with the interest rates, see what they could do. But I think as soon as they lower interest rates, better watch out for more inflation and they got to come back and hammer it down again. It's just going to be up and down, but I think we'll land on this and we can keep doing this for hours.

This is so much fun. I appreciate the time. We got to come back and do more because we scratched the surface.

Anna Kelley: I’d love to.

David Phelps: But that's okay because we hit some good stuff. But I think you made a great point that debt can be an asset to us, and we typically think is when we borrow money. Well, that's a liability, but debt on a producing capital asset, this case, real estate, long-term fixed, can be your friend.

So when do you put that debt on? What kind of debt and what's the asset have to look like? And who's operating and managing it, right? You put those things together, you got a game plan for the future. I think we have to come back and tackle this one, probably on the next one, and dive into that. That'd be a lot of fun.

Anna Kelley: That would be a lot of fun. I love that because debt is a horrible master and a wonderful tool. That's how I kind of look at it. I want debt when inflation is going to be high and I can shift that inflation burden onto the banks rather than myself, but it has to be cash flow producing, and that's kind of a lesson that I learned in ‘07 is you start a debt to start a business.

You better make sure that business is sustainable and create a bunch of cash. But I love debt, but I have learned even more so through what we're going through now, that debt needs to be fixed as long as you can fix that debt. Next time, David, I will pay a higher interest rate to lock my commercial loans and even longer instead of taking the three or five-year option. If you're at the bottom at a recession, you're going to have probably a decade of expansion. Maybe you do some shorter-term debt and go back to value-add stuff. But I think generally speaking, right now, debt is really unwise unless you can lock it in at low rates and keep it there for a while.

David Phelps: Great advice. Well, Ana Kelley, it's been a pleasure. We'll definitely have you back again. I appreciate all the insights and wisdom, starting with how you lived your life and, built, the freedom for you and your husband and your family. And now what you're doing in the economy, this is where I think financial acumen, and you said it well, early is not taught.

It's not taught in the schools, not taught anywhere. It's not even taught in schools where people go and really, I mean, get finance degrees. My wife has one. She goes, “I've learned so much more in real estate than my finance degree ever.” So there's got to be some of both. You've got to have some of the institutional academic acumen, but also you got to put that with boots on the ground and understand how this plays in the marketplace.

You put those two together and I think you've got a winning formula for resiliency going forward. And what I think is going to be volatile times, but opportunistic times for those who are in the know.

Anna Kelley: Absolutely.

David Phelps: All right. Ana, Thank you so much.

Anna Kelley: Thank you, David.

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