# The Insight: Conversations – Volatility Ahead? Featuring Howard Marks, Armen Panossian, and David Rosenberg

### Anna

Hello, and welcome to the *Insight by Oaktree Capital*. I'm Anna Szymanski, Oaktree's senior financial writer, and today I'm in Los Angeles at Oaktree's client conference, where I'll be having three discussions with Oaktree leaders: co-chairman Howard Marks, co-CEO Armen Panossian, and head of liquid performing credit, David Rosenberg. We'll consider why markets performed so well in recent months despite all of the uncertainty, and we'll dig into some important trends in liquid credit. Please note that we're recording this in mid-April, 2024.

For my first conversation, I'm thrilled to be joined once again by Oaktree co-chairman Howard Marks. Howard, thanks so much for joining me.

### Howard

It's a pleasure to be here, Anna.

### Anna

So, Howard, as we try to make sense of this current moment in markets, I am struck by something that you said in a recent note to clients. You mentioned that people keep telling you that they're unusually uncertain today. So I was hoping that you could just explain why you highlighted this and why you think that this uncertainty may actually be healthy.

### Howard

Well, I think that people are uncertain. First of all, we have an incredible number of things happening in the general environment. We have Ukraine, Gaza, climate change, presidential election that the polls say the majority of Americans want a different choice, incredibly large number of macro-exogenous uncertainties. Then we have the navigating of the environment vis-a-vis inflation, rates, Fed, economic growth. People are so preoccupied now with the Fed and its machinations and guessing at what's next and when, that I think that that preoccupation introduces a great deal of uncertainty, kind of almost separate and apart from the questions of economic growth, inflation and employment.

So people who don't accept that the future is unknowable, people who want to be able to know the future, feel that they're on shaky ground. My view is we're always on shaky ground in that regard. And I said in my review of 2023, which went to the clients of Oaktree only, that we have two kinds of climates. The times when the people think they know what's going to happen and the times when they think the future is uncertain.

Now, as you know, I think that when they think they know what's going to happen, they're wrong. And when they are uncertain, they're right. So I think it's the conviction that they know the future, that's the more dangerous of the two. Now, I didn't invent that concept. It was Mark Twain who said, "It ain't what you don't know that gets you into trouble. It's what you know for certain that just ain't."

Right. So I think it's healthy when people say, I'm worried. I think the future is uncertain. It's much more dangerous when people say, I'm convinced if large numbers, if a large plurality says, I'm convinced that I know what's going to happen, and they bet on it heavily, and the bets all run in one direction, that's how you get bubbles and crashes. I think that doubt is much more likely to produce outcomes closer to the middle.

### Anna

This makes me think of something that you said that I thought was really interesting in this client note. You said that it's obviously always difficult to figure out exactly where we are in a cycle, but that it's important even if we don't know where we're going to know where we are. But that currently determining where we are really depends on what people think about what happened in twenty-twenty in terms of the economic events of 2020, whether people think it was actually recession or not really a recession. So I was hoping that you could unpack this idea.

### Howard

We had all these events essentially in 2020, which affected the economy, but which were not economic. So first, we had the pandemic, then we had the shutdown, then we had the vaccine, and then we had the relief program. So none of those four things was endogenous to the economy. They're all a function of actions that affected the economy, but were not coming from within the economy. So I would say that those events were non-economic.

We normally say that we have an up-and-down cycle of the economy, largely driven by what I would call economic events, mostly taking the form of participants in the economy and the markets getting too optimistic and then correcting in the direction of the happy medium, but continuing toward the other extreme at which they're too negative and vice versa.

That's the character of the normal cyclical fluctuation in my opinion. But we didn't have that. We had those exogenous events. So it's hard to put what has been going on and what is going on into what we think of as the normal cyclical framework. We normally say, well, we have these excesses and corrections, and the normal period between one, let's say top in the economic cycle, and the next top in the economic cycle is about eight-ish years. That's what people quote as the norm. Where are we now? Well, the answer is, it depends, is what I said in that memo. And the key question is, did we have a recession in 2020? You may recall that the Fed announced the GDP in the second quarter of 2020 was down 34%, and it turns out that nothing was down 34%.

The Fed statistics on GDP are annualized. So if things had continued at the same rate of deterioration, it would've been down 34% in a year, but they didn't. And the next quarter, GDP was up 32%. Also annualized. So for the two quarters together, it was down a little, down 34, up 32, leaves you still down a little because of the math. Now the first question was that a recession, the Fed named it a recession, but A, exogenous. B, one quarter. All my life, if people said to me, "What is a recession?" I would say two consecutive quarters of negative growth in GDP. We only had one.

The next quarter was a barn burner on the upside. And since it wasn't a typical economic development that second quarter "recession," what does it do to our normal view of cycles if it was a recession? Well, now we're only four years later, so we're early. This is a youthful recession. Nothing to worry about time-wise. Time is not the only thing that matters, but time-wise, nothing to worry about. On the other hand, if it wasn't a recession, that means the last recession was in '09. We're in the 15th year of recovery, and back in the 20 teens, we set a new record at 10-plus. That was the longest recovery in history. Now, if you don't count 2020 as a recession, we're at 15-plus.

So I returned the question, was 2020 a recession, and what does the so-called recession of 2020 due to our view of normal cyclicality? I don't have an answer. And of course, all cycles are different. The timing of all cycles is different. We generalize to make life easier, but certainly, we can't be too convinced about the chronological age of this recovery. That's my whole point.

### Anna

Yeah, I think this is just, once again, a really excellent example of how challenging it is to understand, let alone forecast macroeconomic trends.

### Howard

Right. And Anna, you know that rather than struggle with it and try to derive the significance of what's going on in the macroeconomy, we just kind of leave it alone for the most part when it's in mid-range, which it's in mid-range 90% of the time.

And it calls to mind what Warren Buffett said to me of nine years ago that he's not interested in macro forecasting. Not because it's not important, but because it's not knowable. And all of these uncertainties that I've just given time to discussing, render it in my opinion, not knowable. Where are we in the cycle? My answer, no idea.

### Anna

To finish up, any final thoughts on where we are now and what we might watch for in the coming quarters?

### Howard

I continue to think the economy is doing pretty well. I'm not smart enough to know if it's a head fake or not, or what's going to go wrong. I continue to think that the next move in rates is probably down, but certainly not 100%. I think there'll be a few rate cuts, but probably not six right away. I think that the Fed funds rate will end this year in the mid-fours, not four, which is what people thought in December. We're going in a pretty good direction.

This is not a stirring economic picture, but it's quite positive, and I think our economic outlook is basically good, but priced in, because at the end, you have to come back to the fact that the PE ratio on the S&P 500 is above average by a significant but not crazy amount. And credit spreads on credit instruments are, I would say certainly not lavish. So a generally good outlook priced in. No bargains, but no crazy bubble.

**Anna**

For my next conversation, I'll be discussing the current state of credit markets with Oaktree co-CEO and Head of Performing Credit, Armen Panossian. Armen, thanks so much for joining me.

**Armen**

Thank you for having me.

**Anna**

The most recent PCQ explores some of the forces that helped to boost markets in previous months. And in an earlier conversation I had with Howard, he was talking about how people keep telling him that there's so much uncertainty right now, it's just an unusually uncertain moment. I'm curious how we can square all of this uncertainty with this market strength.

**Armen**

It's a great question. I think the answer lies in a lot of technical forces that are supporting the market, despite some of the uncertainty around fundamentals and the uncertainty around how companies may be able to withstand refinancing into a higher rate environment going forward. I think companies are going to soon have to grapple with this high rate environment even if they had fixed rate liabilities that were set in place years ago. That's kind of the nature of the uncertainty. I think in terms of what created a very strong market backdrop against that uncertainty are a few technicals. One is just stimulus dollars that were provided during COVID.

When you sprinkle economies globally with trillions of dollars, eventually that spending becomes multiplied through the money multiplier and makes it into the hands of wealthy individuals, billionaires, pension funds, insurance companies, savings accounts of a variety of types, investment accounts of a variety of types. And then following that stimulus that occurred during COVID, there's actually been continued stimulus in the form of infrastructure bills, green energy bills and other spending by the government. Those two types of stimulus have really helped to support the markets.

The other thing is in terms of investor psychology, investors late last year decided that they really cannot time when rates might decline and the cash had been accumulating over years and years and they said, "Might as well just come off the sidelines now." The total return in credit is so strong that the combination of spreads plus rate is more attractive than it's been in a really long time. And even though rates at some point may decline, I just think that now is the time to start going, because I'm not going to be able to all of a sudden deploy all of my cash exactly at the bottom.

And finally, I would just say the market has become so large. The below investment grade credit markets have increased three or four times since the global financial crisis, so the sheer number of issuers and the dollars or euros or other currencies out there that people could deploy into are so massive that investment managers could put together well diversified portfolios that are lost remote and default remote and express a certain perspective on risk tolerance.

Some people are risk loving and loading up on triple C's and others are pretty risk averse, but they still are able to deploy a lot of capital and risk reverse below investment grade instruments. So there's something for everybody because that market has gotten so big. I think it's really a combination of those technical factors that helps to offset some of that fundamental uncertainty and the rate uncertainty around refinancing. It's hard to see the technical tailwind weaken other than if for some reason investors sentiment changes. If investors say, "I got it all wrong, I thought that the Powell fed was going to reduce rates, and it's clear that the Powell fed doesn't want to reduce rates because it doesn't really need to, the data doesn't support it." I think investor sentiment would have to change for that technical tailwind to shift. But the reality is when you have so much in stimulus dollars that have been printed and sprinkled across the economy, that cash is there.

I think the other thing is a lot of investors also say, "look, the Fed has a loaded gun." If there is even a modicum of weakness in the economy, boom, 100 to 200 basis point decline in rates overnight to stop that. And I think that that fed put is still sort of in the back of people's minds, or maybe it's in the front of their minds. If for some reason there is cause for concern or cause for doubting that Fed put, then I think there could be a meaningful shift in investor sentiment and that technical tailwind could have a period of time of volatility.

**Anna**

Let's go and spend a little time on some of this fundamental uncertainty, because one of the other things that you noted in the Performing Credit Quarterly essay where some of the cracks that we are seeing in issuer fundamentals, and one issue related to the French telecom company, Altis, that recently had some issues. I was hoping that you could just explain a little bit about what happened here and why it's creating some concern among credit investors.

**Armen**

Yeah. So Altis, just stepping back, if you think about what that company is. Very hard asset rich business, widely held term loan across both US and European investors, a very large business and not sponsor owned, so it's a large strategic asset. Now, what's happened with Altis is that even though performance is okay, it isn't falling off a cliff, it's on the weakish side, but not on its own a reason to worry about a restructuring.

However, when you couple the company's performance, which has been tepid with its significant near-term maturities, and with this higher rate environment, Altis' management has had to rethink what is the right leverage profile for this business in the near term. And so, they revised that leverage target lower because the cost of borrowing is so much higher today. And as they look at their maturity profile and they say, "Well, I need to refinance now, I can't have five and a half turns of leverage." Initially they said, "I would need it to get to four and a half turns," and then they revised it recently and they said, "I need to get it to four turns." And in trying to navigate that decline in leverage profile, there were options that they had.

One option is to sell assets. I think they're finding that a lot of their great assets that they have sold and I've gotten good prints for, you're not really able to get the high multiple on every one of their assets. So I think at some point the company will or has seen a decline in the appetite in terms of enterprise valuation multiples for its assets that are available to sell. And then the other option is liability management exercises. So this involves going to existing creditors and essentially offering to exchange them into superior instruments at discounts to par.

And that I think is what shocked a lot of people. Again, this is a widely held hard asset rich term loan or capital structure, not just term loans, but term loans and bonds. And the perception around liability management exercises has been that it's mainly a US phenomenon, and it is mainly a sponsor driven phenomenon in essence that private equity sponsors and the companies that they own are the most likely to take on liability management exercises.

But in this case, a company that's based in Europe that is not sponsor owned is now considering liability management exercises, which is a surprise to a lot of investors. So it kind of exposes the tail risk that there are these types of situations where companies that no one would've thought would be at risk like this, are engaging in what some would characterize as desperate measures to manage their leverage profile against this backdrop of high rates coming upon us.

**Anna**

So again, that's going to make a lot of credit investors that thought that they were in safer parts of the market start to rethink that.

**Armen**

Yeah, credit picking matters and in a high rate environment when refinancing has to come at a few hundred basis points higher in terms of total cost, versus what it was when the capital structure was put in place in 2018, 19, 2021, I think that's going to be a day of reckoning for some borrowers that will shock a lot of investors over the course of the next couple of years.

**Anna**

Jumping off of something you said there too, this importance of it being a credit picker's market. I'm curious with everything you're saying here and all the uncertainty that you and earlier Howard talked about, what are the opportunities that this is also creating for investors?

### Armen

Well, I think patient investors that are able to dig deep into companies and understand both their operating structure and how they make money, but also their capital structure and how they're organized may find opportunities to either buy publicly traded securities that sell off without justification. But I think more readily, what I think is going to be very interesting for those types of investors are private credit opportunities involving rescue loans to companies that are highly structured and help the ownership of the company bridge a challenging period, managing cash flows over a short period of time so that the company doesn't default, but really predicated on the belief that the business is a very strong business and can actually grow through this period that is coming upon us. So you got to look at the business separately from its capital structure, underwrite it separately, determine that it is a good business, that it will grow, that it does have an important place in its value chain in terms of the market that it serves.

So when you select that good business and you find that it has a bad balance sheet and you're able to fix that balance sheet with some flexible capital, I think you could potentially make some pretty outsized returns with risk under control. And that's I think, the most exciting part of the risk profile that is apparent in the market today, I think the exciting part are these types of rescue loans that will become available to those investors that understand legal structure and also understand operating businesses very well.

### Anna

The essay you just wrote was on the first quarter, but as we look forward to the second quarter, we're recording this at the beginning of the second quarter. What are some of the things that you're currently most focused on or that you think investors should really be focused on?

### Armen

Well, I think that the markets have rallied in a big way in anticipation of some rate cuts this year. If you look at November 2023, December 2023, and since it's been a very strong period in the markets, both the equity markets and the credit markets, we've seen some meaningful spread tightening in the credit markets in particular. And I think a lot of that is driven by this belief that rates are going to decline, let me take my money and deploy it now and get exposure at these higher rates and spreads, especially rates. But I think that the market has gotten ahead of itself. The expectation that rates would decline is probably overblown given some of the economic indicators in the last month or two are relatively stable to one would argue even on the strong side of stable, that would indicate that rates are probably going to stay around where they're at for the better part of this year.

And then when you overlay the fact that we're in an election year, it makes it less and less likely that there would be a meaningful rate decline in advance of that election. So, if the markets do or if the participants of the markets do realize that maybe they overshot, there probably is going to be a sell-off, there probably is going to be some fits and starts in the credit markets, it will reverberate into the equity markets or vice versa.

So I think there's some possible volatility ahead when the rhetoric switches from three or four rate cuts in 2024 to zero to one rate cuts in 2024, I think there's going to be an air pocket there that's probably going to hurt. We're watching out for that and ready to invest if that does occur. And also staying patient with our capital.

**Anna**

For my final conversation, I'll be digging in a bit more to liquid credit markets with David Rosenberg, Oaktree's Head of Liquid Performing Credit. David, thanks so much for joining me.

**David**

Thanks for having me.

**Anna**

So David, let's dive into liquid credit markets a bit. In the recent performing credit quarterly, we argue that leveraged credit investors no longer need to focus solely on total return. I'd like you to just explain the idea here and why you think it's so significant.

**David**

When I talk to people about credit these days and it very quickly goes to the conversation of, okay, you've got spread that's not so exciting and yet yield is exciting and is that good value or is it not? And I joke with people, I say it's in the name fixed income, but yet people have not been talking about income for years. And so finally we're talking about the income part of fixed income. So what I tell people is you need spread when you need total return, because that's what total return comes from the spread compression.

If you want to see a total return, you have to have a wide enough spread to justify that. And a couple of years ago when yields were four or 5% and below investment grade, you needed a total return to justify taking the risk. So spread was really important. But today you don't really need total return. Quite frankly, the income alone is sufficient for most investors. If I can be getting 8, 9% out of credit, that's very attractive in its own. And so that means that spreads could stay where they are. The market doesn't need to total return, it just needs to deliver income.

**Anna**

One of the other things that this essay highlights is how low the equity risk premium currently is. Can you explain why this is such a key data point and related to what you were just talking about?

**David**

Yeah, I think this is really important when you think about equity risk premium, so basically we're talking about the earnings yield on the S&P, minus the yield on the ten year. So think of it like spread for equities. You've gotten to the point where the equity risk premium is near zero and it hasn't been this low in quite some time. Again, when you start to think about the value proposition of equities, which by definition needs total return and you compare it now to debt with a solid income, in my opinion, with an equity risk premium so low, you basically have a market that's saying that the value proposition between debt and equities favors debt, which is quite rare.

I mean, I've been doing this a long time. You can't normally say the value proposition favors equity debt is structurally disadvantaged equity. Equity is supposed to be better, but we're in a period right now in my opinion, where money is expensive. And when money is expensive, you can borrow less. And if you can borrow less, you have less money to fund growth and you should expect to see less growth. And that's a big problem for equities, but not so much for debt because like we said before, I don't need a total return, I just need to pick companies that can pay the coupon and not default, and I'm going to end up with an income that's quite attractive.

**Anna**

Something else that's changed for credit investors in recent years that we highlight in the piece is patience. Can you explain the main idea here?

**David**

Yeah. I have this conversation with a lot of people where I always say, "Look, generally in investing, patience is rewarded. It's always prudent to be patient."

And the truth of the matter is, while I can always try and be patient as an investor, people are often not patient with me. So when you have an investment that's offering 4% or 5% income and you're trying to be patient, you have a lot of investors that can understandably get impatient with that because it's just insufficient in yield and it doesn't deliver what they need.

But today, if I go into high quality investments in credit, look at loans in high yield in particular, I can get 8%, 9%. That makes it very easy for me to be patient. So think of this in the confines of a multi-strategy portfolio where you have all sorts of different things you can do. The riskier ends of the menu of what you can choose from, you don't need to rush into them today.

I can sit and be patient in credit that is delivering a good, steady income with good quality and wait for things to dislocate before I jump into them, because if there is no dislocation I'm still earning a very good yield, so being patient is easy. And there are some markets where it's very hard, but I think that allows you to be a lot more thoughtful about the risk you take, and it makes this environment quite attractive as an investor.

**Anna**

Yeah. And also potentially gives you, as you say, that opportunity to actually be more opportunistic because you're not taking on so much risk all the time so that then, at those moments when it makes sense to take on a bit more reasoned risk, you can.

**David**

Exactly. It's the difference between talking about being opportunistic and being opportunistic. Everyone in theory will talk about it, and it always sounds like a good idea. But when you're licking your wounds and dealing with losses in the periods of opportunity, it's difficult to go take more opportunity. But if you were in safer things, they were earning a very good income. Then the prospect of jumping into things when they dislocate is much, much easier, and so you'll actually do it.

**Anna**

Now, as we start to look forward, what would you say are some of the trends that are impacting credit markets that maybe should be getting more attention than they currently are?

**David**

The one trend I think is the biggest, and it does get a lot of attention but I think not every aspect of it is captured, is the impact of private debt. Private debt has changed the landscape of investing. I think it's here to stay, for good reason. It's a good asset category with some interesting opportunities, but it also changes the way things behave within the public markets. And one of the things that we talked about a lot in previous discussions, you take the loan market.

There was an expectation for a large pickup in defaults in the loan market because that's where most of the leveraged buyouts were financed, and the leveraged buyouts tend to be the riskier deals. And they were all with floating rate debt that has now effectively doubled in its cost, and that creates some stress. And so most strategists if you talked to a year ago would expect that if there was, call it a 3% to 4% default rate in bonds, there would be a 4% to 5% default rate in loans. That was the general consensus.

And if you talk to the same people today, the expectation for defaults in loans has come down fairly dramatically to probably be roughly in line with what you expect to see from bonds, despite more risk. And the reason being a lot of these riskier deals that were the kind of fodder, if you will, for defaults have moved to the private market and they've found a way to get refinanced in that market. And so it changes the impact on risk and defaults in the low market, which changes the impact on how you see the CLO market performing. And so it really ripples through all of credit in a very powerful way.

**Anna**

So just to end, as we're recording this at the beginning of the second quarter, what do you think are some of the main things that investors should be focused on?

**David**

For me, it comes back to credit. In my opinion, going into 2024 it's going to be more idiosyncratic and less thematic. If you look back over the past couple years, a lot of the changes and impacts on the markets have been thematic, rates being the biggest theme. Rates going up, rates going down had a big impact on risk. In my opinion, as you get into the middle to the end of '24 it's going to be more specific to individual credits and what's happening in their business and whether they have cushion to withstand any unexpected bumps in the road. That's going to be the big driver and what I think people really need to start thinking more about.

**Anna**

Great. Well, an excellent point to end on. So thanks so much for joining me.

**David**

Thanks for having me.