Memo to: Oaktree Clients

From: Howard Marks

Re: Knowledge of the Future

As I showed by using it again in last week's memo, I was impressed by the observation of Marc Lipsitch, Harvard epidemiologist, that there are (a) facts, (b) informed extrapolations from analogies to other viruses and (c) opinion or speculation. He said it in connection with the novel coronavirus, but I've been thinking about its relevance to investing.

In the past, I've defined investing as the act of positioning capital so as to profit from future developments. I've also mentioned the challenge presented by the fact that there's no such thing as knowing what future developments will be. This is the paradox we must deal with.

To follow Lipsitch's analysis, in our world of investing:

- there are few if any facts regarding the future,
- the vast majority of our theorizing about the future consists of extrapolating from past patterns, and
- a lot of that extrapolation – and just about all the rest of our conclusions – consists of what Lipsitch calls opinion or speculation and what I call guesswork. (George Bernard Shaw said, "All professions are conspiracies against the laity." Thus the rules of the investment profession seem to require that its members describe their views about the future using high-sounding terms like "analysis," "assessment," "projection," "prediction" and "forecast." Rarely do we see the word "guess.")

Last week, in *Calibrating*, I mentioned having written to an Oaktree colleague that, "These days everyone has the same data regarding the present and the same ignorance regarding the future." I chose the title of this memo because it's such an oxymoron: there's practically no such thing as meaningful knowledge regarding the future investment environment. Thus, this memo will be about some things people think they know but may not.

Extrapolating from the Past

We use extrapolation from the past as the best way to deal with the future. If not for the ability to research past patterns and apply them to decisions regarding the future, we'd have to reach a new conclusion every day about every future possibility. So, for example, in investing we study typical past cycles, the exceptions from the norm, and details like the up-and-down pattern that's part of most rallies, as described last week in *Calibrating*.

But blind faith in the relevance of past patterns makes no more sense than completely ignoring them. There has to be good reason to believe the past can be extrapolated to the future; as Lipsitch says, it has to be informed extrapolation. And that brings me to the current episode.

What does the U.S. see today?

- one of the greatest pandemics to reach us since the Spanish Flu of 102 years ago,
- the greatest economic contraction since the Great Depression, which ended 80 years ago,
- the greatest oil-price decline in the OPEC era (and, probably, ever), and
- the greatest central bank/government intervention of all time.

The future for all these things is clearly unknowable. We have no reason to think we know how they'll operate in the period ahead, how they'll interact with each other, and what the consequences will be for everything else. **In short, it's my view that if you're experiencing something that has never been seen before, you simply can't say you know how it'll turn out.**

In my last two memos, I stressed my conviction that there's no "informed" way to choose between the positive and negative scenarios we face today, and that most people decide in a way that reflects their biases. While searching the Internet for the source of the quote above about professions, I came across something that I think supports my view that most people reach conclusions for reasons that are questionable:

> An ignorant mind is precisely not a spotless, empty vessel, but one that's filled with the clutter of irrelevant or misleading life experiences, theories, facts, intuitions, strategies, algorithms, heuristics, metaphors, and hunches that regrettably have the look and feel of useful and accurate knowledge. This clutter is an unfortunate by-product of one of our greatest strengths as a species. We are unbridled pattern recognizers and profligate theorizers. Often, our theories are good enough to get us through the day, or at least to an age when we can procreate. But our genius for creative storytelling, combined with our inability to detect our own ignorance, can sometimes lead to situations that are embarrassing, unfortunate, or downright dangerous – especially in a technologically advanced, complex democratic society that occasionally invests mistaken popular beliefs with immense destructive power (See: crisis, financial; war, Iraq). ("We Are All Confident Idiots," David Dunning, Professor of Psychology, University of Michigan, *Pacific Standard* magazine, October 27, 2014)

In other words, we may not be able to know the future, but that doesn't keep us from reaching conclusions about it and holding them firmly.

<u>Getting Back to Normal</u>

One of the greatest uncertainties we face today surrounds the outlook for the economy. The optimists expect a V-shaped recovery, and a great deal is riding on the question of whether it'll materialize. It depends on when America will go back to work, and that, in turn, depends to a great extent on the trend in infections.

Early on, we were told the growth of the disease would be "exponential." We learned what that meant – the number of new cases would grow from one day to the next by a constant percentage – and about the idea of "flattening the curve." Thus, in the language of investing, the number of cases would "compound." Because new cases would rise each day by a constant percentage, their number would increase as the fixed growth rate was applied to an expanding base.

In order to get the disease under control, the following progression has to take place:

- The growth in the number of daily new cases has to come in below expectations, meaning the rate of growth has to decline rather than remain constant.
- Then the number of daily new cases has to stabilize, meaning the rate of growth is declining.
- Then the number of daily new cases has to decline, meaning the rate of growth is negative.
- Then the number of daily new cases has to go to zero, meaning the disease has been stopped.

Different places around the world and in the U.S. are at different stages in this progression. There are places where the number of daily new cases is continuing to rise; places where the curve is flattening and the new cases are declining (e.g., trends are positive in U.S. cities that were beset early); and places that had good results early but are seeing rebounds as rules are relaxed and people start to return to their normal behavior. Here are a few of the questions that bear on the outlook for the curve:

- Will testing and contact mapping facilitate keeping infected people out of circulation?
- Will large numbers of asymptomatic infections impede the effort to isolate carriers?
- Will it be possible to test people to learn whether they've had the disease and developed antibodies, such that they can go out in public without fear of reinfection?
- Will herd immunity develop? Will it be permanent?
- Will the arrival of warm weather be helpful?
- Will a cure be developed?
- Will the virus morph into other forms, requiring new cures?
- Will a vaccine be developed, and when?

One of the thorniest questions remains how society and its leaders will make the trade-off between minimizing deaths from the virus and restarting the economy. In other words, at which step in the progression at the top of this page will the back-to-work message be delivered? The longer people stay at home and the economy remains shut down, the further the progression will be allowed to go, and the closer we'll get to containing the disease. Simultaneously, however, the more damage will be done to the economy and the harder it'll be to restart.

A decision to end the stay-at-home orders on May 1 rather than May 31 will be better for the economy in the short run, but it'll also send people into society while there are still infected people around, and thus it's likely to result in a "rebound" or "echo," as Hong Kong and Singapore have seen; in a re-steepening of the curve; and in further infections and deaths. **How will we make that trade-off? There's no algorithm for deciding whether to favor life for a few (or for thousands) versus economic improvement for millions.** On one hand, choosing the economy seems hard-hearted. On the other, we permit or even encourage many activities that result in large numbers of deaths, such as driving. Here's how renowned investor Edward Lampert put it in *The New York Sun* on April 6:

> Driving an automobile is risky. In 2018, the number of auto-related fatalities in the United States was 36,560, according to the National Highway Traffic Safety Administration. Yet we don't ban automobiles, nor do we impose a 10 mile an hour speed limit. Doing so would eliminate most of those deaths and injuries, but it would also adversely affect economic activity enabled by faster transportation of people and products.
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> Overall, the benefits of automobiles exceed the costs. Individuals knowingly assume the risks. Businesses compete to make money by reducing those risks. To deal with market failures and externalities, and to provide a certain minimum floor, we have regulatory mechanisms imposed by government to mitigate risks and compensate for losses.
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> These same approaches can be useful in guiding the public policy response to the coronavirus, showing the way to a middle ground that minimizes harm without excessive costs to either the economy or individual freedom. . . .
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> We need to get America back to work quickly. Businesses and individuals can adapt dynamically to intelligently guard their interests, seek opportunities, and make trade-offs. The government can provide the traffic signals and the safety standards. That approach to public health is consistent with a free and economically vibrant country, rather than in conflict with it. It's tested on our highways every day.

The last issue I want to raise on this subject surrounds the decisions each individual will have to make regarding the point in the progression of control at which they and their loved ones will cease practicing social distancing. Oaktree debt traders Justin Quaglia (who's been showing up in these memos a lot) and Sam Rotondo came up with a few questions on this subject:

Assuming the quarantine is lifted:

- when will you take your first flight? How will you react when the person next to you starts coughing?
- what has to happen to make you feel it's safe to send your child back to school?
- what will happen when everyone returns to work, allergy season begins, and a few of your colleagues begin to sound nasally and cough persistently?
- when you go out to dinner with your wife/husband/friend/family, do you want to be served by a waiter/waitress wearing a mask and gloves?

I'll add two more: If a test says you have immunity, will you stop social distancing and go back into public spaces while new infections are still being reported? And for us New Yorkers, when will you get back on the subway?

Questions like these suggest that a mere message from government is unlikely to get everyone to return to their former habits, including their jobs (if they have a choice). **Instead, the reopening of the economy is likely to be gradual and, until a vaccine is perfected or herd immunity is reached, subject to alternating periods of progress and retreat.**

Washington Goes to Battle

Over the last few weeks, the Fed, SEC and Treasury have announced an unprecedented program of stimulus, support, rescue and regulatory relief. They continue to bring new actions forward and expand the size and scope of existing ones. There's no reason to believe there's anything they won't do or any magnitude they won't exceed. I was among many who were worried a month ago about the limited scope of the Fed arsenal, given that the federal funds rate stood at only 1½% and most past rate-cutting programs ran to about 500 basis points. Now we see the vast extent of the Fed's potential toolkit.

On March 15, in announcing the second of two rate cuts totaling 150 basis points that took the short-term federal funds rate to nearly zero, Fed Chairman Jay Powell said the following: "We really are going to use our tools to do what we need to do here." (*Reuters*, March 16). Two weeks later, he elaborated on the Fed's intentions (emphasis added):

> Mr. Powell has made clear that **even with interest rates at zero, the Fed's firepower is limitless**. "When it comes to lending, we are not going to run out of ammunition," he said Thursday [March 26] in an interview on NBC's "Today" show. "That doesn't happen." (*The Wall Street Journal*, March 30)

Here are some excerpts from *Bulletin Intelligence's* April 10 recap regarding the Fed's actions (emphasis added):

> CNBC reports that the Federal Reserve has "dramatically expanded its efforts to save the economy, even adding junk bonds to the list of assets it can buy, as a wave of businesses are anticipated to have trouble surviving the expected recession." According to CNBC, "Stocks jumped, Treasury yields rose and the dollar sagged after the Fed said it would provide $2.3 trillion in programs that expand its operations to reach small and midsized businesses and U.S. cities and states." CNBC says **the Fed "expanded its corporate lending programs to take it into an entirely new area, including ETFs of companies that are rated below investment grade.** It had previously announced a program to buy investment-grade corporate debt and ETFs. It also will now accept triple-A-rated commercial mortgage-backed securities and collateralized loan obligations."
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> Bloomberg reports that "investors quickly bid up prices on corporate bonds and stocks after the announcement. High-yield debt was among the biggest gainers, with some of the largest ETFs tracking those bonds surging the most in a decade." According to Bloomberg, **"The nature of the Fed's actions pass the traditional boundaries of the central bank to purchase lower-rated debt and the credit of municipalities, raising questions about its future role."**
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> The Washington Post editorializes, **"The Fed is putting its balance sheet at the service of the private sector** for what we must hope is the shortest period absolutely necessary," but "it will be up to Congress to provide whatever needed funding – for health care, state budget relief and individual income support – lies beyond the Fed's ambit."

> **An editorial in the Wall Street Journal views the Fed's move as a misstep** that increases the Fed's exposure to risky assets [see page 8], and overlooks Main Street in favor of Wall Street. **The decision also poses a threat to the traditional concept of American capitalism, as the Fed and Treasury become the leading lenders to US businesses.**

There's no doubt in anyone's mind that there was a pressing need for a swift and pronounced response to the economic impact of the effort to combat the pandemic. Less than a month ago, Bruce Karsh and I were pondering the possibility of a global depression. We never hear about that topic anymore, and much of the discussion centers around whether 2019 GDP will be exceeded in 2021 or whether it'll take until 2022.

Now, instead of discussing depression, we wonder about the propriety and long-term impact of the various government actions. I don't intend to dissect the program emanating from Washington in detail, but I do want to raise some questions:

"Limitless" is an interesting word (see previous page). **Is the program really limitless? And is that okay?** The stimulus, loans, bailouts, benefits and bond buying that have been announced thus far add up to several trillion dollars. What are the implications of the resultant additions to the federal deficit and the Fed's balance sheet? To be facetious, the government could send every American a check for $1 million, at a cost of $330 trillion. **Would there be negative consequences from doing this, such as burgeoning inflation, a downgrade of U.S. creditworthiness or the dollar losing its status as the world's reserve currency?** If the answer is yes, is there a point below $330 trillion at which those ramifications might kick in? And if so, where? Could we be there already?

Obviously, what these government entities are doing is cushioning the financial impact of the economic deepfreeze. And as I mentioned on March 31 in *Which Way Now?*, they clearly have the ability to distribute enough money to make up for businesses' lost revenues and workers' lost wages. **But what'll be the impact on America of the loss of a substantial portion of the second quarter's production of goods and services? How will the economy rebound, and at what speed? If we have stops and starts, and if workers return gradually as suggested on page 4, is a V-shaped recovery still likely?** What'll be the effect if some unemployed workers who used to earn less than $1,200 per week can receive more than that in benefits?

Finally, I want to talk about the Fed's role and the impact of its behavior. Just two months ago, I attended a dinner with the president of one of the 12 Federal Reserve Banks. I asked him whether the Fed might adopt the tactic of buying corporate bonds, given the limited room for rate cuts. No, he said, it would only buy government and agency obligations. As mentioned above, a few weeks ago the Fed added investment grade corporates to its buying list, and last week it dropped down to include some high yield securities (BBBs downgraded to BB and some high yield ETFs).

It also gave regulatory relief to business developments companies, or BDCs, which buy or make loans to mid-size businesses. In order to help them avoid tripping limits on their activities, the Fed said they can value the loans on their books at December 31 prices. "The SEC is primarily trying to address the issue that a temporary markdown in the fair value of BDC portfolio companies could increase leverage above the regulatory maximum, thus limiting further lending by a BDC. As such, the SEC is allowing BDCs to use an adjusted portfolio value when calculating their asset coverage (leverage) ratio." (Keefe, Bruyette & Woods, April 9) **In other words, we're in a regulatory wonderland where there's no pretense that financial statements have to be accurate or current.**

I was particularly surprised by these latter actions. **What's the Fed's purpose in buying non-investment grade debt?** Does it want to make sure all companies are able to borrow, regardless of their fundamentals? Does it want to protect bondholders from losses, and even mark-to-market declines? Who'll do the buying for the government and make sure the purchase prices aren't too high and defaulting issuers are avoided (or doesn't anyone care)?

And why should the SEC provide relief to leveraged investment vehicles? If such an entity proves to be over-leveraged and sees its collateral marked down such that it's constricted or even liquidated, what's the loss to society? Why should leveraged investors – ostensibly not systemically important – be protected from pain?

In the aftermath of the Global Financial Crisis, the Fed and Treasury undertook a number of actions to encourage price discovery, rekindle risk-bearing and reopen markets. They worked well, their goals were accomplished, and the U.S. recovery from the GFC was swift and strong. (Of course, we can debate whether the willingness to bear risk snapped back too fast and too far.) But some of these things were done through encouraging the operation of market mechanisms, not direct action. Now bonds are being bought and rules waived. **Is there a point at which these things become undesirable?**

Most of us believe in the free-market system as the best allocator of resources. Now it seems the government is happy to step in and take the place of private actors. We have a buyer and lender of last resort, cushioning pain but taking over the role of the free market. When people get the feeling that the government will protect them from unpleasant financial consequences of their actions, it's called "moral hazard." People and institutions are protected from pain, but bad lessons are learned.

A company uses its cash and perhaps borrows more to repurchase its shares. A corporate acquiror chooses to use more leverage rather than less. Or the organizer of a REIT or CLO takes on more debt in order to amplify its returns. In each case, the chosen tactic will magnify profits if things go well, but it'll also magnify losses if things go poorly **and reduce the probability of surviving tough times**. If these parties get to enjoy the fruits of their actions when they're successful but are protected from loss when they fail, risk-taking is encouraged and risk aversion is suppressed.

There's an old saying – variously attributed – to the effect that "capitalism without bankruptcy is like Catholicism without hell." It appeals to me strongly. **Markets work best when participants have a healthy fear of loss. It shouldn't be the role of the Fed or the government to eradicate it.**

Some people argue these days that there's no way those who took on leverage that turned out to be excessive could have been expected to anticipate a pandemic and the resultant damage to the economy. Thus, the argument goes, the jam the government is rescuing them from "isn't their fault," meaning the bailout isn't unreasonable. As I wrote in *Which Way Now?*, I understand they aren't guilty of having ignored a likely risk. But unlikely (and even unforeseeable) things happen from time to time, and investors and businesspeople have to allow for that possibility **and expect to**

bear the consequences. In other words, they have to think like the six-foot-tall man hoping to get across the stream that's five feet deep *on average*. **I see no reason why financiers should be bailed out simply because the event they're being harmed by was unpredictable.**

Here's the reaction of *The Wall Street Journal* to last week's Fed actions (April 9; emphasis added):

> The big winners included non-investment grade corporate bonds and real-estate investment trusts that will now qualify for Fed programs despite their credit risk. High-yield and municipal bond prices also rose. Growth companies like Amazon, Intel and Nvidia fell or were flat, and the overall market reaction was underwhelming.
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> This reflects the priorities of the Fed's new lending facilities, and how far out on the risk curve it is going. Take the Term Asset-Backed Securities Loan Facility that the Fed first used in 2008 and that it revised last month. In 2008 TALF accepted only triple-A-rated securities and it made money on the loans. On Thursday the Fed said it will now accept much riskier credits including commercial mortgage securities and collateralized loan obligations.
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> **These are loan pools packaged into securities by Wall Street, which lobbied the Fed and Treasury hard for the TALF expansion. This means the Fed will in effect buy the worst shopping malls in the country and some of the most indebted companies. The opportunities for losses will be that much greater.** Treasury is backstopping losses, but the taxpayer risks here are greater than what the Fed took on in 2008-2009.
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> The Fed may feel all of this is essential to protect the financial system's plumbing and reduce systemic risk until the virus crisis passes, but make no mistake that the Fed is protecting Wall Street first. The goal seems to be to lift asset prices, as the Fed did after the financial panic, and hope that the wealth effect filters down to the rest of the economy.

The bank bailout of 2008 has been roundly cited as a case of the government putting Wall Street ahead of Main Street, and it contributed significantly to the populism that has riven American politics ever since. This recent step to rescue leveraged lenders may add further fuel to that fire.

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The market seems to have passed judgment with regard to the future. U.S. deaths have reached 23,000 and continue to rise. Weekly unemployment claims are running at 10 times the all-time record. The GDP decline in the current quarter is likely to be the worst in history. But people are cheered by the outlook for therapies and vaccines, and investors have concluded that the Fed/Treasury will reduce the pain and bring on a V-shaped recovery. There's an old saying that "you can't fight the Fed" – that is, the Fed can accomplish whatever it wants – and investors are buying it. Thus, the S&P 500 has risen 23% since its bottom on March 23, and there's little concern about the retrenchments that typically have been part of past market rallies.

But Justin Beal, my artist son-in-law, is mystified. "I don't get it," he told me on Saturday. "The virus is rampant, business is frozen, and the government's throwing money all over the place, even though tax revenues have to be down. How can the market be rising so strongly?" We'll find out as the future unfolds.

April 14, 2020

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