Memo to: Oaktree Clients

From: Howard Marks

Re: The Anatomy of a Rally

The background is well known to all.

- On February 19, the U.S. stock market hit a new all-time high, with the S&P 500 reaching 3,386.
- Then investors began to price in the novel coronavirus, causing the market to make its fastest trip ever into bear territory, with the S&P 500 down 34% in five weeks to a low of 2,237.
- That low was reached on March 23, the day the Fed announced a major expansion of its response to the Covid-19-induced shutdown of the U.S. economy.
- Following that, the stock market – along with the credit markets – began a recovery of massive proportions.

The advance started off with a bang – a 17.6% gain for the S&P 500 on March 24-26, the biggest three-day advance in more than 80 years – and by June 8 it had lifted stocks from the low by almost 45%. The market rose on 33 of the 53 trading days between March 24 and June 8, and on 24 of those 33 up days (including the first nine in a row), it gained more than one percent. By June 8, the S&P 500 was down only 4.5% from the February peak and even for the year to date.

I'm writing to take a closer look at the market's rise and where it leaves us. The goal as usual isn't to predict the future but rather to put the rally into perspective.

The questions I get are always indicative of what's going on in investors' minds at the time. Around the early-June high and in the time since, the most frequent ones have been, "How can stocks be doing so well during a severe pandemic and recession?" "Have the securities markets decoupled from reality?" and "Is this irrational exuberance?"

The process of answering these questions gives me an opportunity to dissect the breathtaking market rise. **The world is combatting the greatest pandemic in a century and the worst economic contraction of the last 80+ years. And yet the stock market – supposedly a gauge of current conditions and a barometer regarding the future – was able to compile a record advance and nearly recapture an all-time high that had been achieved at a time when the economy was humming, the outlook was rosy, and the risk of a pandemic hadn't registered. How could that be?**

The possible reasons for the markets' recovery are many and, as I write this memo, the list is growing as people find more things to take positively. (As usual, the higher the market goes, the easier it becomes for investors to find rationalizations for a further rise.) I'll survey the apparent reasons below:

- **Investors placed great credence in the ability of the Fed and Treasury to bring about an economic recovery.** Investors were cheered by the steps taken to support the economy during the shutdown, reopen it, put people back to work and begin the return to normalcy. Everyone understands that the recovery will be gradual and perhaps even bumpy – few people are talking about a powerful V-shaped recovery these days – but a broad consensus developed that recovery is a sure thing.
- As the market recovery took hold, the total number of Covid-19 cases and deaths, and the statistics in states like New York that had experienced the earliest and worst outbreaks, were going in the right direction. Daily new cases declined to very low levels in many places, and the signs of a second-wave rebound were limited. **The curve in most locations clearly had been flattened.**
- In short, the worst fears – things like massive shortages of hospital beds and PPE, and an immediate "second wave" as soon as reopening began – weren't realized. This was cause for relief.
- Rising optimism with regard to vaccines, tests and treatments added to investors' willingness to write off the present episode.
- People became comfortable looking past the pandemic, considering it one-of-a-kind and thus not fundamental. In other words, for some it seemed easy to say, "I'm glad that's over (or soon will be)."
- Positive economic announcements reinforced this conclusion. And the unprecedented extent of the economic carnage in the current quarter made it highly likely that we'll see substantial quarter-over-quarter gains in the next three quarters and dramatic year-over-year comparisons in mid-2021.
- **Thus, overall, investors were glad to "look across the valley" at better times ahead. There will be a substantial dip this year in GDP and corporate earnings, but investors became willing to anticipate a time – perhaps in 2022 – when full-year earnings for the S&P 500 would exceed what they were in 2019 and had been expected to be in 2020.**
- With the outlook now positive, investors likely concluded that they no longer needed to insist on the generous risk premiums afforded by low entry prices, meaning purchase prices could rise.
- **In other words, with regard to economic and corporate developments, investors concluded that it was "all good" or at least heading in the right direction.**

Monetary and fiscal actions made an enormous contribution to the market rebound:

- **The chant went up during the week of March 23: "You can't fight the Fed."** Certainly the evidence convinced investors that interest rates will be what the Fed wants them to be, and the markets will do what the Fed wants them to do. **The higher the market went, the more people believed that it was the goal of the Fed to keep it going up, and that it would be able to.**
- The Fed and Treasury demonstrated their dedication to doing absolutely everything they could think of. Fed Chairman Jay Powell and Treasury Secretary Steve Mnuchin acted

early and dramatically, and Powell's assurances that "we will not run out of ammunition" had a very positive effect.

- The Fed said it would continue buying securities "for as long as it takes," and since its actions suggested it was unconcerned about the ballooning deficits and debt, there was no apparent reason why its ability to keep buying had to have a limit.
- When the Fed buys securities, it puts money into the hands of the sellers, and that money has to be reinvested. The reinvestment process, in turn, drives up the prices of assets while driving down interest rates and prospective returns.
- There's been a related expectation that the Fed's buying might be less than discriminating. That is, there's no reason to believe the Fed insists on good value, high prospective returns, strong creditworthiness to protect it from possible defaults, or adequate risk premiums. Rather, its goal seems to be to keep the markets liquid and capital flowing freely to companies that need it. **This orientation suggests it has no aversion to prices that overstate financial reality.**
- Everyone is convinced that interest rates will be lower for longer. (On June 10, the Fed strongly indicated that there will be no rate increases through 2021 and possibly 2022.)
- Low interest rates engineered by the Fed have a multifaceted, positive impact:

    - The lower the fed funds rate, the lower the discount rate used by investors and, as a result, the higher the discounted present value of future cash flows. This is one of the ways in which declining interest rates increase asset values.
    - **The risk-free rate represents the origin of the yield curve and the capital market line. Thus a low risk-free rate brings down demanded returns all along these continua.** All *a priori* returns on potential investments are viewed in relation to the risk-free rate, and when it's low, even low returns seem attractive.
    - The pricing of all assets is interconnected through these relative considerations. Even if the Fed is buying asset A but not asset B, the rising price and falling expected return on A mean that B doesn't have to appear likely to return as much as it used to, so its price can rise, too. Thus if buying on the part of the Fed raises the price of investment grade debt, the price of non-investment grade debt is likely to follow suit. And if the Fed buys "fallen angels" that have gone from BBB to BB, that's likely to lift the price of B-rated bonds.
    - **Lower yields on bonds means they offer less competition to stocks, etc.** This is yet another way of saying relative considerations dominate. Fewer people refuse to buy just because prospective returns are low in the absolute.

- In all, the Fed created capital market conditions that gave rise to readily available financing, bond issuance at record levels, and deals that were heavily oversubscribed. **As long as money-losing companies are enabled to refinance their debt and borrow more, they're likely to stay alive and out of bankruptcy, regardless of how bad their business models might be.** Zombie companies (debt service > EBITDA) and moral hazard don't appear to trouble the Fed.

Obviously, behavioral factors also had a significant impact:

- Although suspended from February 19 until March 23, the ever-hopeful "buy the dips" mentality and belief in momentum quickly came back to life. **The large percentage of trading in today's markets accounted for by index funds, ETFs and other entities that don't make value judgments probably contributes to the perpetuation of trends like these once they're set in motion.**
- Investors have been cheered by the fact that today's Fed seems to be offering a "Powell put," a successor to the Greenspan put of the late 1990s/early 2000s and the Bernanke put induced by the Global Financial Crisis. The belief in the Powell put stems from the view that the Fed has no choice but to keep the markets levitated to reassure financial market participants and keep the credit markets wide open for borrowers.
- **Thus FOMO – fear of missing out – seemed to take over from the prior fear of losing money, a transition that's always pivotal in determining the mood of the market.**
- Retail investors are said to have contributed substantially to the stock market's rise, and certainly to its most irrational aspects, like the huge gains in the stock prices of some bankrupt companies. In the exceptional case of Hertz, it seemed for a while that the buoyant stock price might enable the company to sell large amounts of new equity, even though the equity would probably end up worthless. (Equity capital raised by a company in bankruptcy is extremely likely to end up going straight to the creditors, whose improbability of otherwise being paid gave rise to the bankruptcy filing in the first place.) Large numbers of call options have been bought in recent days, and it was reported that small investors accounted for much of the volume. Developments like these suggest the influence of speculative fever and the absence of careful analysis.
- There's a widely held theory that government benefit checks have been behind some of the retail investors' purchases. And that makes sense: in the last three months, there've been no games for sports bettors to wager on, and the stock market was the only casino that was open.
- **Importantly, fundamentals and valuations appeared to be of limited relevance.** The stock prices of beneficiaries of the virus – such as digital service providers and on-line merchants – approached "no-price-too-high" proportions. And the stocks of companies in negatively affected industries like travel, restaurants, time-sharing and casinos saw massive recoveries, even though their businesses remained shut down or barely functioning. Investors were likely attracted to the former by their positive stories and to the latter by their huge percentage declines and the resulting low absolute dollar prices.

In all these ways, optimistic possibilities were given the benefit of the doubt, making the terms "melt-up" and "buying panic" seem applicable. We saw numerous records smashed in the 11-week recovery of the stock market from its March 23 low.

To sum up and over-simplify, as my partner Bruce Karsh asks in his role as devil's advocate: can the Fed keep buying debt forever, and can its doing so keep asset prices up forever? **In short, many investors appeared to conclude that it could.**

And on the Other Hand . . .

I'm not going to go to the same lengths in cataloging the negatives that exist today. Especially given their appeal to my cautious bias, I've done so plenty in recent memos. But they certainly have been and are out there:

- The likelihood that, since the U.S. engaged in a more voluntary and less sweeping shutdown than the countries that were most successful in suppressing Covid-19, the reopening of the economy would trigger a second wave of the disease.
- The simultaneous likelihood that, due to fatigue and because many consider "the cure to have been worse than the disease," there won't be the same enthusiasm for a new shutdown, meaning there may be significant stress on the health care system and/or large numbers of fatalities.
- **The possibility that we won't have a vaccine as soon as hoped,** or that it will be limited in its duration or its effectiveness with various strains of the disease.
- The reporting of actual GDP declines on the order of 20-30% for the second quarter and 5-10% for the full year, and of an unemployment rate around 10% in late 2020 and into 2021.
- **The impact on the economic recovery if the return to work is slow, large numbers of small businesses never reopen, and millions of jobs turn out to be permanently lost.** In particular, the slow return of customers and the regulations that limit the scale of operation may prevent newly opened public-facing businesses from being much more profitable than they were when they were fully closed.
- Worry that political or financial considerations will keep the Fed and/or Treasury from renewing their monetary and fiscal tools to combat the economic slowdown.
- The significant long-term damage done to state and city finances.
- The likelihood that there'll be widespread defaults and bankruptcies despite the Fed and Treasury machinations.
- **The impact of potentially permanent changes to business models in industries like retail and travel, and on office buildings and high-density urban centers.**
- The possibility of increased inflation (or, some say, deflation), long-term damage to the reserve status of the dollar, a downgrade of the U.S. credit rating, or an increase in the cost to finance our vastly expanded deficits.

There are always positives and negatives, and we can list them, consider their validity and try to assess what they boil down to. But what matters most at a given point in time in determining market behavior is which ones investors weight most heavily. Following the March 23 low, the emphasis certainly was on the positives.

Does It Make Sense?

Yes, there had been something approaching a selling panic between mid-February and late March in response to the pandemic, with the S&P 500 collapsing and the yields on high yield bonds tripling in just four and a half weeks. And yes, the Fed and the Treasury seem to have averted a depression and put us on the path to recovery. **But was there justification for the stock market's 45% gain from the low and the halving of high yield bond yields from their high? And were the resulting security prices appropriate?** In other words, some recovery was not unreasonable, but was the magnitude of the one that occurred justified?

Of course, the answers to these questions lie in the eye of the beholder. If there were a straightforward, reliable and universally accepted way to arrive at appropriate security prices, (a) securities would likely sell at or near those prices and (b) over-optimistic highs and over-pessimistic lows wouldn't be reached. But the most optimistic psychology is always applied when things are thought to be going well, compounding and exaggerating the positives, and the most depressed psychology is applied when things are going poorly, compounding the negatives. This guarantees that extreme highs and lows will always be the eventual result in cycles, not the exception. (For a few hundred pages more on this subject, see my 2018 book, *Mastering the Market Cycle: Getting the Odds on Your Side*.)

Maybe it's the increased availability of information and opinion; maybe it's the popularization of investing; and maybe it's the vastly increased emphasis on short-term performance. But for whatever reason, things seem to happen faster in the markets these days. That certainly has been true in the last four months. In the current episode, the 34% decline from the all-time high to the crisis low took less than five weeks, and the 45% recovery to the June 8 high took only 11 weeks. These fluctuations were incredibly swift and powerful.

In my memo, *On the Couch* (January 2016), I wrote that:

> That's one of the crazy things: in the real world, things generally fluctuate between "pretty good" and "not so hot." But in the world of investing, perception often swings from "flawless" to "hopeless."

Thus far in 2020, the swing from flawless to hopeless and back has taken place in record time. The challenge is to figure out what was justified and what was aberration.

The Bottom Line

I tend to return to a select few investment adages to make my points, for the simple reason that these time-honored standards contain so much wisdom. And I've written often about the first one shared with me by an experienced investor in the mid-1970s: the three stages of a bull market. There's a usual progression in market advances according to this beauty, and as far as I'm concerned, it's absolutely accurate and fully captures the reality:

- the first stage, when only a few unusually perceptive people believe improvement is possible;
- the second stage, when most investors realize that improvement is actually taking place; and

- the third stage, when everyone concludes everything will get better forever.

Looking back (which is the main way we know these things), the first stage began in mid-March and culminated on March 23. Certainly very few people were thinking about economic improvement or stock market gains around that time. Then we passed briefly through stage two and went straight to stage three.

Certainly by the time the interim high was reached on June 8, it felt like the market was being valued in a way that focused on the positives, swallowed them whole, and overlooked the negatives. That's nothing but a value judgment on my part. It's just my opinion that the imbalance of attention to – and blanket acceptance of – the positives was overdone.

I had good company in being skeptical of the May/June gains. On May 12, with the S&P 500 up a startling 28% from the March 23 low, Stan Druckenmiller, one of the greatest investors of all time, said, "The risk-reward for equity is maybe as bad as I've seen in my career." The next day, David Tepper, another investing great, said it was "maybe the second-most overvalued stock market I've ever seen. I would say '99 was more overvalued."

On the days those two spoke, both the plain vanilla forward-looking p/e ratio and the Shiller cyclically adjusted price-to-earnings ratio were well above normal levels, disregarding all the uncertainties present and the big declines that lie ahead for GDP and earnings.

And yet, over the next four weeks leading up to the June 8 high, the S&P 500 rose an additional 13%. What this proves is that either (a) "overpriced" isn't synonymous with "sure to decline soon" or (b) Druckenmiller and Tepper were wrong. I'll go with (a). On June 8, Druckenmiller described himself as "humbled." (In this line of work, if you never feel humbled, it just means you haven't realistically appraised your performance.) All I know is that a lot of smart, experienced investors concluded that asset prices had become too high for the fundamentals. Time will tell.

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There's no way to determine for sure whether an advance has been appropriate or irrational, and whether markets are too high or too low. But there are questions to ask:

- Are investors weighing both the positives and the negatives dispassionately?
- What's the probability the positive factors driving the market will prove valid (or that the negatives will gain in strength instead)?
- Are the positives fundamental (value-based) or largely technical, relating to inflows of liquidity (i.e., cash-driven)? If the latter, is their salutary influence likely to prove temporary or permanent?
- Is the market being lifted by rampant optimism?

- Is that optimism causing investors to ignore valid counter-arguments?
- How do valuations based on things like earnings, sales and asset values stack up against historical norms?

Questions like these can't tell us for a fact whether an advance has been reasonable and current asset prices are justified. But they can assist in that assessment. **They lead me to conclude that the powerful rally we've seen has been built on optimism; has incorporated positive expectations and overlooked potential negatives; and has been driven largely by the Fed's injections of liquidity and the Treasury's stimulus payments, which investors assume will bridge to a fundamental recovery and be free from highly negative second-order consequences.**

A bounce from the depressed levels of late March was warranted at some point, but it came surprisingly early and quickly went incredibly far. The S&P 500 closed last night at 3,113, down only 8% from an all-time high struck in trouble-free times. As such, it seems to me that the potential for further gains from things turning out better than expected or valuations continuing to expand doesn't fully compensate for the risk of decline from events disappointing or multiples contracting.

In other words, the fundamental outlook may be positive on balance, but with listed security prices where they are, the odds aren't in investors' favor.

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