

Memo to: Oaktree Clients
From: Howard Marks
Re: The Folly of Certainty

The impetus for my memos can come from a wide variety of sources. This one was inspired by an article in *The New York Times* on Saturday, July 9. What caught my eye were a few words in the sub-headline: **“She doesn’t have any doubt.”** The speaker was Ron Klain, a former Biden chief of staff. The subject was whether President Biden should continue to run for reelection. And the “she” was Jen O’Malley Dillon, Biden’s campaign chair. The article went on to quote her as saying, “Joe Biden is going to win, period,” in the days just before his June 27 debate against former President Donald Trump.

And, with that, I had the subject of this memo: not whether Biden will continue campaigning or drop out – or whether he’ll win if he continues – but rather how anyone can be without doubt. It’ll be another of my “shortie” memos given the potentially limited shelf life of the Biden campaign.

This choice of subject calls to mind another time I heard a highly credentialed person express absolute certainty. In that case, an acknowledged expert in foreign affairs told a meeting I attended that there was “a 100% probability that the Israelis would ‘take out’ Iran’s nuclear capability before year-end.” He seemed like a genuine insider, and I had no reason to doubt his word. Yet, that was 2015 or ’16, and I’m still waiting for “before year-end” to come around (in his defense, he didn’t say which year).

As I indicated in my memo [*The Illusion of Knowledge*](#) (September 2022), there’s no way a macro-forecaster can produce a forecast that correctly incorporates all the many variables that we know will affect the future as well as the random influences about which little or nothing can be known. It’s for this reason, as I’ve written in the past, that investors and others who are subject to the vagaries of the macro-future should avoid using terms such as “will,” “won’t,” “has to,” “can’t,” “always,” and “never.”

Politics

When the 2016 presidential election rolled around, there were two things about which almost everyone was certain: (a) Hillary Clinton would win but (b) if by some quirk of fate Donald Trump were to win, the stock market would collapse. The least certain pundits said Clinton was 80% likely to win, and the estimates of her probability of victory ranged upward from there.

And yet, Trump won, and the stock market rose more than 30% over the next 14 months. The response of most forecasters was to tweak their models and promise to do better next time. Mine was to say, “if that’s not enough to convince you that (a) we don’t know what’s going to happen and (b) we don’t know how the markets will react to what actually does happen, I don’t know what is.”

Even before the much-discussed presidential debate of three weeks ago, no one I know expressed much confidence regarding the outcome of the coming election. Today, Ms. O’Malley Dillon would likely soften her position regarding the certainty of a Biden victory, explaining that she was blindsided by the debate result. But that’s the point! We don’t know what’s going to happen. Randomness exists.

Sometimes things go as people expected, and they conclude that they knew what was going to happen. And sometimes events diverge from people’s expectations, and they say they would have

been right if only some unexpected event hadn't transpired. But, in either case, the chance for the unexpected – and thus for forecasting error – was present. In the latter instance, the unexpected materialized, and in the former, it didn't. But that doesn't say anything about the likelihood of the unexpected taking place.

Macro Economics

In 2021, the U.S. Federal Reserve held tenaciously to the view that inflation would prove to be “transitory,” and I think the Fed might have been proved right. Inflation might have retreated of its own accord in three or four years, after (a) the Covid-19 relief funds that caused the surge in consumer spending were spent down and (b) the global supply chain returned to its normal operations. But because the Fed's view wasn't borne out in 2021 and waiting longer was untenable, the Fed was forced to embark on one of the fastest programs of interest rate increases in history, with profound implications.

In mid-2022, there was near certainty that the Fed's rate increases would precipitate a recession. It made sense that the dramatic increase in interest rates would shock the economy. Further, history clearly showed that major central bank tightening has almost always led to economic contraction rather than a “soft landing.” And yet, no recession has materialized.

Instead, late in 2022, the consensus among market observers shifted to the view that (a) inflation was easing, and this would permit the Fed to start cutting interest rates, and (b) rate cuts would enable the economy to avoid recession or ensure that any contraction would be mild and short-lived. This optimism ignited a stock market rally in late 2022 that persists today.

And yet, the anticipated rate reductions in 2023 that undergirded the rally didn't transpire. Then, in December 2023, when the “dot plot” of Fed officials' views called for three interest rate cuts in 2024, the optimists driving the market doubled down, pricing in an expectation of six. Inflation's stubbornness has precluded any rate cuts thus far, with 2024 more than half over. Now the consensus has coalesced around the idea of a first cut in September. And the stock market keeps hitting new highs.

The optimists today would likely say, “We were right. Look at those gains!” But, regarding interest rate cuts, they were simply wrong. For me, all this does is serve as another reminder that we don't know what's going to happen or how markets will react to what does happen.

Conrad DeQuadros of Brean Capital, my favorite economist (how's that for an oxymoron?), has supplied an interesting tidbit for this memo on the subject of economists' conclusions:

I use the Philly Fed's Anxious Index (the probability of a decline in real GDP in the upcoming quarter) as an indicator that a recession has ended. **By the time more than 50% of the economists in the survey project a decline in real GDP in the coming quarter, the recession is over or close to being over.** (Emphasis added)

In other words, the only thing worthy of certainty is the conclusion that economists shouldn't be expressing any of it.

Markets

The rare person who in October 2022 correctly predicted that the Fed wouldn't cut interest rates over the next 20 months was absolutely right . . . and if that prediction kept them out of the market, they've missed

out on a gain of roughly 50% in the Standard & Poor's 500 index. The rate-cut optimist, on the other hand, was absolutely wrong about rates but is likely much richer today. So, yes, market behavior is very tough to gauge correctly. But I'm not going to take time here to catalog the errors of market savants.

Instead, I'd like to focus on *why* so many market forecasts fail. The performance of economies and companies might tend toward predictability given that the forces governing them are somewhat . . . shall I say . . . mechanical. In these areas, one might say "if A, then B" with some degree of confidence. Predictions here might, therefore, have some chance of being correct, albeit that's mostly the case when trends continue unabated and extrapolation works.

But markets swing more than economies and companies. Why? Because of the importance and unpredictability of market participants' psyches or emotions. Thanks to further help from Conrad DeQuadros, I can illustrate the greater variability of markets, as follows:

40-Year Standard Deviation of Annual Percentage Changes

GDP	1.8%
Corporate profits	9.4
S&P 500 price	13.1

Why is it that stock prices rise and fall so much more than the economies and companies that underlie them? And why is it that market behavior is so hard to predict and often seems unconnected to economic events and company fundamentals? **The financial "sciences" – economics and finance – assume that each market participant is a homo economicus: someone who makes rational decisions designed to maximize their financial self-interest. But the crucial role played by psychology and emotion often causes this assumption to be mistaken.** Investor sentiment swings a great deal, swamping the short-run influence of fundamentals. It's for this reason that relatively few market forecasts prove correct, and fewer still are "right for the right reason."

* * *

Today, pundits are making all sorts of predictions about the upcoming presidential election. Many of their conclusions seem well-reasoned and even persuasive. We hear and read statements from those who believe Biden should and shouldn't drop out; those who think he will and won't; those who think he can win if he stays in the race; and those who think he's sure to lose. **Obviously, intelligence, education, access to data, and powers of analysis can't be sufficient to produce correct forecasts. Many of these commentators possess these attributes, but clearly, they won't all be right.**

Over the years, I've often cited the wisdom of John Kenneth Galbraith. It's he who said, "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." I find myself using this quote all the time. Another of my favorite Galbraith quotes is from his book *A Short History of Financial Euphoria*. In describing the reasons for "speculative euphoria and programmed collapse," he discusses two factors "little noted in our time or in past times. One is the extreme brevity of the financial memory." I often cite this factor, too.

But I don't remember ever writing about his second factor, which Galbraith says is "the specious association of money and intelligence." When people get rich, others take that to mean they're smart. And when investors succeed, it's often assumed their intelligence can lead to similarly good results in

other fields. Further, successful investors often come to believe in the strength of their own intellect and opine about fields with no connection to investing.

But investors' success can be the result of a string of lucky breaks or a propitious environment, rather than any special talents. They may or may not be intelligent, but often they don't know any more than most others about subjects outside of investing. Nevertheless, many are unsparing with their opinions, and those opinions often are highly valued by the general populace. That's the specious part. And today we find some of them speaking with conviction on all sides of the issues related to the election.

A lot has been said about those who express certainty. We all know people we'd describe as "often wrong but never in doubt." This reminds me of another of my favorite quotes, one that's attributed (perhaps tenuously) to Mark Twain: "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

Back in mid-2020, when the pandemic seemed to have become a more or less understood phenomenon, I slowed the pace of my memo writing from the one-a-week pattern of March and April. In May, I took the opportunity for two non-Covid-related memos titled [*Uncertainty*](#) and [*Uncertainty II*](#), in which I devoted a significant amount of space to the subject of intellectual humility. While these memos were on one of my favorite topics, they generated little response. So, I'll quote a bit from *Uncertainty* and hopefully give you reason to look back at them.

Here's part of the article that first brought the subject of intellectual humility to my attention:

As defined by the authors, intellectual humility is the opposite of intellectual arrogance or conceit. In common parlance, it resembles open-mindedness. Intellectually humble people can have strong beliefs, but recognize their fallibility and are willing to be proven wrong on matters large and small. (Alison Jones, *Duke Today*, March 17, 2017)

... To put it simply, intellectual humility means saying "I'm not sure," "The other person could be right," or even "I might be wrong." I think it's an essential trait for investors; I know it is in the people I like to associate with. ...

No statement that starts with "I don't know but ..." or "I could be wrong but ..." ever got anyone into big trouble. If we admit to uncertainty, we'll investigate before we invest, double-check our conclusions and proceed with caution. We may sub-optimize when times are good, but we're unlikely to flame out or melt down. **On the other hand, people who are sure may dispense with those things, and if they're sure and wrong, as the Twain quote suggests, the outcome can be catastrophic. ...**

... maybe Voltaire said it best 250 years ago: Doubt is not a pleasant condition, but certainty is absurd.

There simply is no place for certainty in fields that are influenced by psychological fluctuations, irrationality, and randomness. Politics and economics are two such fields, and investing is another. No one can predict reliably what the future holds in these fields, but many people overrate their ability and attempt to do so nevertheless. **Eschewing certainty can keep you out of trouble. I strongly recommend doing so.**

P.S.: Last summer's Grand Slam tennis tournaments provided the inspiration for my memo [*Fewer Losers, or More Winners?*](#) Similarly, this past Saturday's women's final match at Wimbledon has provided a snippet for this memo. Barbora Krejčíková prevailed over Jasmine Paolini to win the women's title. Before the tournament, Krejčíková was rated a 100-to-1 shot, meaning the bettors were quite sure she wouldn't win. They may have been right to doubt her potential, but it seems they shouldn't have been quite so certain in making their predictions.

And speaking of unpredictable events, I can't fail to mention the recent attempt on Donald Trump's life, an unforeseeable event that could well have had a more grave and impactful result. Even now that it has happened and President Trump has escaped serious injury, no one can state with certainty how it will impact the election (though at present it appears to have bolstered Trump's prospects). So, if anything, it reinforces my bottom line: making predictions is largely a loser's game.

July 16, 2024

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