Memo to: Oaktree Clients Only

From: Howard Marks

Re: Latest Update

I'm going to do all I can to provide information and views throughout this crisis, albeit perhaps without the kind of narrative or literary flourish I usually try for.

Flattening the Curve

The spread of the virus has been described as "exponential." Most people use this word without understanding precisely what it means. In short, exponential growth is the real-world version of what people in our business refer to as compounding. In other words, there's a growth percentage, and the parameter in question increases by that percentage every period. Thus **the rate of growth is constant, but the magnitude of the increase grows in each period**. For years, we've talked about things on the Internet "going viral." This is what exponential growth means.

If the number of daily new cases grows at a constant 10% (almost certainly a substantial understatement in the current case), and we start with 100 new cases on day 1, there will be 110 new cases on day 2; 121 on day 3; 133 on day 4; and 146 on day 5. The ultimate potential number of daily new cases is ugly. If the number of new cases continues to grow at 10% per day, there will be 1,745 new cases on day 31. (I'm very sorry to have to write about a number like that.)

Short-term success in fighting the virus isn't described in terms of eliminating the disease but rather "flattening the curve." In other words, (a) reducing the growth rate will result in a smaller increase in new cases each day (but still an increase), and (b) making the growth rate negative means there will be fewer new cases each day than the day before (but still new cases).

Observers seem to be working under the assumption that, sooner or later, "the curve will be flattened and then bent downward," meaning the disease will be controlled and perhaps disappear in three to six months. The reasons for optimism in this regard are as follows:

- People will isolate increasingly. The closures of schools, businesses and gathering places will help in this regard.
- Testing will allow us to identify those with the disease and separate them from the healthy population.
- The disease will fade when warm weather sets in (other epidemics that have appeared in recent decades have proved seasonal in this way).
- A preventive vaccine or therapeutic medication will be developed and approved.

Of course, no one knows whether or when these things will happen. But we can hope that the combination will limit the disease to the next three to six months as described above.

Short-Term Response

It's clear that strong actions are essential in order to halt or reverse the rising trend in the number of new coronavirus cases. Things we've seen in other countries include:

- Not suggesting, but ordering people to desist from going out, gathering and socializing.
- Imposing punishment for stepping over the threshold of their homes.
- Prohibiting movement on the part of people who have been diagnosed, and tracking their movement through cell phones.

There seems to be no doubt about the fact that success in flattening the curve comes best from identifying the people who have the disease and preventing them from passing it on to others. Thus the battle against the virus may bring public health considerations into conflict with civil liberties. It's "un-American" to restrict people's movements, but so far the American spirit of independence seems to be allowing some people to justify maintaining their usual behavior. **Rules may be required, not just warnings, suggestions and encouragement.** Restrictions will increase our chances of winning the war. People should not be surprised to see them, although their promulgation may come as a shock.

Likewise, people coming together to do business would prolong and exacerbate the epidemic. The more businesses that close, the more success we're likely to have against the disease. In addition, the fact that closings reduce the spread should alleviate the flow of patients to doctors and hospitals, improving the health system's ability to help sufferers. But, of course, the impact on individuals and the economy will be painful.

Unavoidable Pain

The news in the near term is unlikely to be good; instead it'll probably include:

- Business closures
- Job losses
- Supply-chain disruption
- Shortages of life's necessities, stemming from reduced production and distribution difficulties
- Challenges to the health system

Many businesses have been ordered to close (e.g., restaurants and bars). Some have seen their revenues evaporate (e.g., airlines, hotels and theaters). All of these things will cause job losses, with a particularly heavy impact on lower-income workers.

On March 17, Treasury Secretary Mnuchin warned that failure of the government to take appropriate action could take the U.S. unemployment rate to nearly 20% (by way of comparison, it reached 25% in 1933, during the Great Depression, and hit 10% as a result of the Global Financial Crisis). Regardless of the action taken, it seems sure to rise substantially from the 50-year low of 3.5%.

In recent years observers have made a big thing out of the fact that a large percentage of Americans would be unable to respond to a $400 emergency. There's some disagreement as to whether it's true, but clearly many people don't have much money in the bank. Where will they get money to buy essentials if they lose their jobs? The government is highly likely to distribute cash, but the speed and adequacy remain to be seen.

In coming weeks we are likely to see over-taxed hospitals; shortages of beds, ventilators and supplies; triage of care based on patients' age and health; infection among health professionals; and rising numbers of fatalities. There's no question that the health system is underprepared; the question is how much preparedness can be improved. I find it hard to believe the short-term news will be good.

In all these ways and more, the early news is bound to be bad. I think that's indisputable. The only good news in this regard would be if it doesn't reach the levels people expect and fear.

Fiscal and Monetary Actions

- The Fed has cut the short-term interest rate to zero – including a record emergency cut of 100 basis points on Sunday, March 15 – but unfortunately the total reduction has been only 150 basis points, whereas past rate-cut programs have amounted to roughly 500 basis points.

- The Fed and Treasury have taken other extraordinary actions to aid market functioning and financial system liquidity. The commercial paper market will be supported. Tax holidays and asset purchases are possible.

- Banks are likely to be hard-hit as a result of borrowers' defaults or moratoria on customers' payments. Thus we're highly likely to see steps designed to bolster the solvency of financial institutions and the availability of credit. Since banks need equity, dividends could be prohibited/discouraged.

Economists and forecasters are still plentiful – the challenging environment hasn't created a shortage there – and each one has an opinion. I never know which ones are right, but I find myself drawn to the views of Conrad DeQuadros of Brean Capital:

> In addition to Sunday's actions [cutting rates and initiating asset purchases], the alphabet soup of liquidity facilities is back with the relaunch of the Commercial Paper Funding Facility and the Primary Dealer Credit Facility yesterday. With the PDCF, dealers can even pledge equities to the Fed, with only a 16% haircut, and receive a 90-day loan at 0.25%. Non-investment grade corporate debt gets a 20% haircut.
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> We also have continued actions by the Fed to encourage discount window loans. A key difference between now and 2008 is the speed with which the Fed is launching these facilities. In 2008, the PDCF was rolled out in March, the CPFF in October, and the first round of Large-Scale Asset Purchases in November. In this episode, we have rates slashed to the zero-lower bound, massive asset purchases, discount window actions (including regulatory guidance), the CPFF, the PDCF—all in a

matter of days. The speed with which COVID-19 events are unfolding is astonishing, but so is the speed of the Fed's response to financial strains.

The Fed is in "whatever it takes" mode. Fiscal authorities will likely follow suit (especially when next week's unemployment claims reading is a multiple of the highest reading we have ever seen in the past). The ECB joined the parade tonight.

All these are appropriate actions. Hopefully we'll see benefits from them and more. The Fed and Treasury will do everything they think might help. Clearly there's little interest in abstaining simply because expenditures will add to the national deficit and debt.

However, it's unfortunate that there was no appetite for refraining from stimulus and restocking the tool kit during the period of prosperity that prevailed in recent years. No one knows whether that failure will inhibit the monetary and fiscal response. But I wish (for example) that we were cutting short rates from 5.0%, not 1.5%.

<u>Market Behavior</u>

A few observations regarding the markets:

It's easy to say that something approaching panic is present in the markets. We've seen record percentage declines several times within the last month (exceeded since 1940 only by Black Monday – October 19, 1987 – when the S&P 500 declined by 20.4% in a day). This week and last included down days as follows: -7.6%, -9.5%, -12.0% and -5.2% yesterday. These are enormous losses.

However, it's worth noting that every one of those declines was followed by similar gains: +4.9%, +9.3% and +6.0% (before a small gain today). Given that almost all of the biggest down days in the last 80 years were followed by up days, so far the strategy of "buy the dips" has continued to be in favor. That's fine as far as it goes, but it has nothing to do with fundamental improvement. **What this tells me is that optimism still hasn't been entirely eradicated and replaced by capitulation. Typically, the bottom is reached only when optimism is nowhere to be found.**

On the other hand, there has been a rush to cash. Both long positions and short positions have been closed out – a sure sign of chaos and uncertainty. Cash in money market funds has increased substantially. This doesn't tell us anything about fundamentals, but the outlook for eventual market performance is improved:

- the more people have sold,
- the less they have left to sell, and
- the more cash they have with which to buy when they turn less pessimistic.

This is a good time to point out that, thus far in this episode, there's additional evidence that there's no such thing in the investment world as a sure thing, magic potion or silver bullet:

- I find it interesting that the price of gold – historically considered the greatest source of protection again tough times – has declined several percent over the last month. Here's the headline of a story from a gold site: “Gold prices sharply down as dread pervasive in marketplace.” It wasn’t supposed to work that way.

- Bitcoin, which partisans had said would serve as a safe harbor in times of crisis, may be down more than any other “asset class.” (I apply that term to Bitcoin advisedly.) It’s lost 47.6% over the last month, from $10,188 to $5,337.
- Risk-parity funds, which were designed to do well in most environments, experienced double-digit losses in February.
- Even the world’s greatest algorithmic fund – which sports a fabulous long-term record – is reported to have suffered a loss of several percent last month.

Of course this is a short, chaotic period, but we can say that so far, the evidence of a miracle investment is lacking. Nothing new here.

To wrap up, I’ll share some color from Justin Quaglia, one of our debt traders:

> After two days of a basically stalled, but stressed market, we “finally had the rubber band snap.” Forced sellers (needing to sell for immediate cash flow needs) brought the market lower in a hurry. We opened 3-5 points lower, and the Street was again hesitant to take risk (from their couch/kitchen table/living room/weekend house) so risk only transferred into a bid from another market participant. Clearing levels quickly became 6-8 points lower.
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> One of the brokers said it was flat-out mayhem . . . and he was working from home! Imagine what an actual trading floor would have been like. It basically became “duck and cover” if you were a market maker, as their risk-taking abilities are being hindered by the C-suite. Beside immediate needs, investors sold to prepare for quarter-end redemptions, FX movements, and to fund margin calls. Short settlements were rampant, and larger blocks cleared in high-quality BB credits. Most people don’t even want to guess what the mark is on CCC risk. This ultimately ended up being the first real day of panic we have seen in a long time.

We’re never happy to have the events that bring on chaos, and especially not the ones that are underway today. But it’s sentiment like Justin describes above that fuels the emotional selling that allows us to access the greatest bargains.

<u>Oaktree Asset Classes</u>

To give you an indication of what has happened to date in U.S. credit, I’m going to provide data on prices, yields and performance as of yesterday’s close. This information will be to be out of date by the time it reaches you, but hopefully it will still be useful.

(As of the close, March 18)	Average Price	Average Yield	Average Yield Spread	Performance Feb 19-Mar 18
High Yield Bonds ex-energy	88.42	8.9%	787 bps	(13.9)%
High Yield Bonds with energy	83.06	10.0	901	(17.2)
Senior Loans	81.57	9.6	874	(15.1)
BB CLOs	74.24	12.4	1,135	(20.7)

Yields and yield spreads have increased significantly (which is another way of saying there's been a lot of damage done). The price declines have been substantial, but the increase in yield for each point of price decline tends to put on the brakes. A yield of 9%, 10% or 12% is impressive in a world of 1% Treasurys, and thus tends to slow the fall. Declines to date of 15-20% for the bond and loan indices have brought substantial losses to holders, but also vastly improved opportunities for new investment.

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What do we know? Not much other than the fact that asset prices are well down, asset holders' ability to hold coolly is evaporating, and motivated selling is picking up. I'll sum up my views simply – since there's nothing sophisticated to say:

- **"The bottom" is the day before the recovery begins. Thus it's absolutely impossible to know when the bottom has been reached . . . ever. Oaktree explicitly rejects the notion of waiting for the bottom; we buy when we can access value cheap.**

- **Even though there's no way to say the bottom is at hand, the conditions that make bargains available certainly are materializing.**

- **Given the price drops and selling we've seen so far, I believe this is a good time to invest, although of course it may prove not have been the best time.**

- **No one can argue that you should spend all your money today . . . but equally, no one can argue that you shouldn't spend any.**

- **The more you want to garner potential gains and don't mind mark-to-market losses, the more you should invest here. On the other hand, the more you care about protecting against interim markdowns and are able to live with missing opportunities for profit, the less you should invest.**

But is there really an argument for not investing at all? In my opinion, the fact that we're not necessarily at "the bottom" isn't such an argument.

March 19, 2020

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