

Memo to: Oaktree Clients

From: Howard Marks

Re: A Fresh Start (Hopefully)

For years I kept these memos away from anything related to politics. But more recently I began to discuss issues facing the United States, and this has required some mention of policy and thus of politics. I've tried very hard to be non-partisan, with a goal of not having readers know my leanings. I hope I've succeeded; at least no one has complained. (But lots of people deceive themselves regarding how unbiased they are, and I may be one of them.)

Because I found America's recent presidential election – and especially the results – so fascinating, I'm going to move explicitly to the field of politics, but with the same goal of non-partisan expression.

The Votes Are In

To me, the most interesting statistics are these:

- Obama beat Romney by less than three percentage points. That's more than most people projected, but still a modest edge. It's a narrow win relative to the long-term history of our elections, but five of the last thirteen were closer.
- Four years ago, Obama beat his Republican rival by 9.5 million votes.
- This year, he got 6.8 million fewer votes and won by only 3.5 million votes (meaning Romney pulled in 0.8 million fewer votes than McCain did in 2008).
- 7.6 million fewer votes were cast in total this year, even though there must now be several million more eligible voters in the U.S. than there were four years ago.

What do these things mean?

- For months I've been asking people, "Among those who voted for Obama last time, how many are disappointed?" Clearly the answer turned out to be, "A lot." (Note that many of the people who did vote for Obama may also have been disappointed, but not enough to not back him.)
- Despite that disappointment – and the persistent high level of unemployment – Obama still won. Many voters apparently saw him as the better choice between two unexciting candidates.

Behind the Numbers

On November 9, *The Wall Street Journal* ran an interesting article entitled "U.S. Voting Numbers Show Changing Nation." It suggested a number of observations relating to voting trends.

- While Obama and Romney received similar numbers of total votes, few sub-sectors of the electorate were closely divided. The *Journal* listed a number of voting groups where Romney had commanding leads: white, male, older, working-class, and rural and small-town. In contrast, Obama owes his victory to strong, sometimes overwhelming majorities among other groups: Latino, African-American and Asian-American, female, younger, college-educated, unmarried,

and urban and suburban. **Clearly, at the margin, the two candidates' constituencies were very different demographically.**

- When I think of the Romney-leaning groups listed above, I'm reminded of a 1930 painting by Grant Wood titled "American Gothic." It shows an older white couple standing in front of their obviously Midwestern farmhouse, with the husband holding a pitchfork. I think the typical Republican voter of this last election is nostalgic for that era and wants that America back. The problem the Republican Party faced in this election is that America is moving away from that demographic, not toward it.
- Immigration is an important aspect of life in America and a significant political issue. Our immigrant populations are large and are growing faster than our non-immigrant populations (note, however, that almost every "non-immigrant" is descended from someone who wasn't born in the U.S.). Immigrants who have become U.S. citizens and thus are eligible to vote have a hard time with candidates who adopt a punitive stance toward illegal (today's politically correct term is "undocumented") immigrants. But a strong stand on illegal immigration is among the things demanded by a vocal and significant segment of the voters who choose the candidates in Republican primaries. **Immigrants tend to be more religious and conservative (in the everyday sense of the word), and thus they might be expected to vote Republican. But right now the Republican Party is denied a huge percentage of their votes.**
- There are significant ironies in some other groups' voting patterns. I usually expect people to "vote their pocketbooks" and support the candidate most likely to enhance their financial well-being. But this year's results show that's not always the case.
 - Voters over 40 years of age supported the Republican ticket, which placed great emphasis on curtailing retirement and healthcare benefits (although avowedly not for today's senior citizens).
 - Voters under 40 came out more for the Democrats, even though the young pay a lot today for the entitlement programs Democrats are protecting for older citizens, and the day when they'll benefit from them is far off.
 - Lower-income, less-educated voters – who are unlikely to progress far up the economic ladder – gave majorities to the Republican candidate, with his promise to protect the wealthy from tax increases.
 - College graduates and higher-income whites – with their greater probability of achieving big incomes – came out for the Democratic candidate, who considers it essential to raise tax rates at the top.
- The *Journal* makes the point that "Republicans enjoy historically high levels of control over governorships and state legislatures, which they say shows the party's potential if it can improve its message to minorities." What I think it shows is that, unsurprisingly, traditional Republicans can win state and local elections in traditional states, and highly conservative Republicans can win elections in highly conservative states. **The challenge the party faces lies in uniting behind a single candidate for nationwide office who can win in both.** As long as the two Republican factions are unable to agree on a candidate who appeals to the huge number of independents in the middle of the political spectrum, the Republicans will be swimming upstream.

When you put it all together, you see challenges and conundrums. Right now, the voting trends and demographics make it seem as though the Republicans will be out of power for a long time to come. But

I've seen many pendulum-like swings in politics in my life, and I'm sure we'll see many more in the battle between the left and the right for the middle-of-the-roaders who decide American elections.

It's the Weather, Stupid!

In a curious aside, consider these facts:

- According to CBS, 41% of voters said in an exit poll that Hurricane Sandy had played a significant role in their choice between the two candidates. 26% said it was “an important factor” and 15% said it was “the most important factor.”
- Presumably most of the people who said they were influenced by Sandy were expressing a positive view on Obama's handling of it. (It's hard to imagine the logic under which Sandy would have caused someone to vote for Romney.)

If you believe the exit polls, people who were positively influenced by the handling of Sandy could have made up all or more of Obama's 2.8% margin of victory. If it's true that Sandy was the deciding factor for 15% of the electorate, and if it caused just a fifth of those people to switch to Obama, that means without Sandy, Romney would have won. I find it shocking that the choice of a president for four years could turn on something as fickle as the weather.

College Daze

How did the “too close to call” headlines of the days just before the election turn into a resounding victory, which the Democrats will argue has given them a mandate to lead? How did Obama's small edge in the popular vote turn into a 62%-38% margin in terms of the electoral votes that determine the winner? The answer lies in the peculiarities of our electoral college.

I was traveling in Asia and the Middle East at election time, and I found myself having to explain a system in which:

- In all but a few states, 100% of the electoral votes go to whoever wins the popular vote there, regardless of the margin.
- Most of the 50 states – this year it was roughly 43 – are considered “uncompetitive,” meaning one party or the other enjoys a substantial, dependable majority. For that reason, a vote for a Republican is totally meaningless in a Democratic state like California, as is a vote for a Democrat in Republican Utah.
- On the other hand, the electoral system gives voters in a few states disproportionate influence. Since the uncompetitive states' electoral votes are not in play, elections are determined by only the few so-called “swing” or “battleground” states. In fact, this year many people thought the election might be determined largely by who won in just one state: Ohio.
- Perhaps most glaringly, a candidate can be elected president with a majority of electoral votes despite having received fewer popular votes than another.

Our system was designed in the eighteenth century to centralize the job of choosing a president in the hands of a few wise leaders and avoid the uncertainties associated with a widespread and uninformed populace with which it was hard to communicate.

But in the twenty-first century, with the impediments to a meaningful popular election much reduced, it's time to reassess the benefits of the electoral college – it's hard to say what they are – versus the costs in terms of potentially weird outcomes. **In the days just before the election, it seemed that for the second time in twelve years we could have a president who'd lost the popular vote. That tells me it's time to reassess our system of voting.**

The First Order of Business

What do you think of when you hear the word “Greece”?

- An uncompetitive, low-growth economy,
- for years, a higher credit rating than it deserved,
- the resultant ability to borrow money it shouldn't have been able to, at interest rates that were unjustifiably low,
- excessive public spending,
- generous benefit promises that it can't fulfill given the realities and, as a result,
- soaring debt and deficits.
- Consequently, the need to cut spending and increase taxes, and
- mandated austerity and delevering, with very negative implications for economic growth.

Now ask yourself what you think of when you hear the words “United States.” Certainly the facts aren't the same: our economy is the world's greatest (although not what it used to be), and we can print the world's reserve currency, which Greece certainly can't. But there are similarities. The situation in the U.S. isn't a repeat of Greece's but, as Mark Twain would have said, “it does rhyme.”

The truth is that the U.S. has pressing fiscal problems, stretching as far as the eye can see:

- in the short term, the “fiscal cliff,” in which already-mandated tax increases and spending cuts have the potential to take 4% off of GDP if nothing is done about them within the next six weeks,
- in the medium term, trillion-dollar deficits unless there's radical improvement, and
- in the long term, entitlement promises that absolutely cannot be met. (With millions of Baby Boomers entering their senior years and living longer, we cannot afford the pensions and healthcare benefits that have been promised. The math is inescapable. If these programs are left unchanged, Social Security benefits will grow inexorably, and spending on healthcare has the potential to escalate without limitation.)

The bottom line is that if we don't want to be Greece, we can't act like Greece. Something has to be done . . . and soon. Every year in which we add another trillion dollars to the national debt (and tens of billions to the annual interest bill) – and every year the excessive entitlement promises are allowed to compound – makes it harder to solve the problem.

Vote “No” on Gridlock

Political conservatism is associated with a desire for a small federal government, and that often leads to a preference for a divided government and the gridlock that goes with it. The argument is that since government doesn't do much well, we're better off if gridlock prevents government from doing much.

People are entitled to a preference for inaction if they view things that way, but I'd venture that inaction is desirable only when conditions are benign. I wouldn't want to see the government paralyzed by gridlock if we were attacked militarily, or if an epidemic needed fighting, or if we were on the edge of a depression, as I think we were in 2008. And I believe strongly that the fiscal problems outlined above need solving; they won't go away by themselves.

Our debt and deficits will recede only if we do some or all of the following:

- cut spending
- reduce waste
- reform Social Security, Medicare and Medicaid
- raise taxes
- speed up economic growth

In theory, even a gridlocked government can take action against waste, but I think the idea of big savings from doing so is largely an impossible dream. And conservatives would eagerly argue that the best way to foster growth isn't for government to take action, but for it to get out of the way of the free enterprise system (I don't fully disagree). But, especially to solve the shorter-term problems, I think we need progress on the other elements, and that will require constructive decision making in Washington.

The opposite of gridlock is compromise. That's what we need today. **Compromise, however, doesn't mean one party saying "We get all we want and you get none of what you want."** Deals like that can only be inked if one party holds all the cards: either the White House plus majorities in both the Senate (and preferably the 60 votes required to stop a filibuster) and the House of Representatives or, at minimum, majorities in both houses of Congress and enough votes to override a presidential veto. Both parties are far from that today, and that may remain the case for a long time.

No, compromise means, "We get some of what we want and you get some of what you want." In practice, it means elected officials have to vote for things they promised to fight and give up on things they swore to deliver. Unless you do that, the other guy doesn't get any of what he wants – meaning he has no reason to go along. This is a reality that our political leaders have failed to confront and accept.

While compromise comes at a cost, gridlock can cost more. Last year, some long-term U.S. debt was downgraded after a particularly unseemly battle over the federal debt ceiling. This occurred not so much because of our fiscal situation, but because our dysfunctional government showed itself to be unable to rise to the occasion and solve problems.

Help Wanted

In past big-picture memos, I have discussed some of the threats to American industrial performance in the years ahead, the dim job prospects of those not suited to work in the Information Age, and my belief that Americans will have to get used to declining relative standards of living.

On November 7, *The New York Times* carried an excellent article by Thomas L. Friedman entitled "Hope and Change, Part II." In it, Friedman did a great job of outlining some of the things Washington will have to do in order for the outlook to improve.

The next generation is going to need immigration of high-I.Q. risk-takers from India, China and Latin America if the United States is going to remain at the cutting edge of the Information Technology revolution and be able to afford the government we want. . . .

. . . my prediction is that the biggest domestic issue in the next four years will be how we respond to changes in technology, globalization and markets that have, in a very short space of time, made the decent-wage, middle-skilled job – the backbone of the middle class – increasingly obsolete. The only decent-wage jobs will be high-skilled ones.

The answer to that challenge will require a new level of political imagination – a combination of educational reforms and unprecedented collaboration between business, schools, universities and government to change how workers are trained and empowered to keep learning. It will require tax reforms and immigration reforms. America today desperately needs a center-right Republican party offering merit-based, market-based approaches to all these issues – and a willingness to meet the other side halfway. The country is starved for practical, bipartisan cooperation, and it will reward politicians who deliver it and punish those who don't. . . .

I'm frustrated when I see Americans of both parties failing to punish – or even encouraging – behavior on the part of their elected officials that is fractious, partisan, ideological and non-compromising. Gridlock and inaction won't solve our problems. Cooperation, adaptability and Friedman's "imagination" must be the watchwords for the years ahead.

We need constructive action to solve the many problems we face, and there's only one way for it to materialize: bipartisanship.

Signs of Spring

While I was on my recent travels, several people asked me to suggest a potential catalyst for better markets. There isn't any mystery. **I felt (and feel) the clearest answer lies in bipartisan action to resolve our fiscal crises, starting with the fiscal cliff.** In that connection, John Boehner, Speaker of the House of Representatives, gave a noteworthy speech the day after the election. I'm going to quote some of the encouraging statements here (highlighting my very favorites).

The American people have spoken. They have re-elected President Obama. And they have again elected a Republican majority in the House of Representatives. **If there is a mandate in yesterday's results, it is a mandate for us to find a way to work together on solutions to the challenges we face together as a nation.**

My message today is not one of confrontation, but of conviction. In the weeks and months ahead, we face a series of tremendous challenges – and a great opportunity. . . .

The American people this week didn't give us a mandate to do the "simple" thing. They elected us to lead. They gave us a mandate to work together to do the best thing for our country.

We know what the best thing would be. It would be an agreement that sends the signal to our economy, and to the world, that after years of punting on the major fiscal challenges we face, 2013 is going to be different. It would be an agreement that begins to pave the

way for the long-term growth that is essential if we want to lift the cloud of debt hanging over our country. . . .

. . . the American people . . . expect us to solve the problem. And for that reason, in order to garner Republican support for new revenues, the president must be willing to reduce spending and shore up the entitlement programs that are the primary drivers of our debt. . . . For purposes of forging a bipartisan agreement that begins to solve the problem, we're willing to accept new revenue, under the right conditions. . . .

The president has signaled a willingness to do tax reform with lower rates. Republicans have signaled a willingness to accept new revenue if it comes from growth and reform. Let's start the discussion there.

I'm not suggesting we compromise on our principles. But I am suggesting we commit ourselves to creating an atmosphere where we can see common ground when it exists, and seize it. . . .

Mr. President, this is your moment. We're ready to be led, not as Democrats or Republicans, but as Americans. We want you to lead -- not as a liberal or a conservative, but as the President of the United States of America. We want you to succeed.

Let's challenge ourselves to find the common ground that has eluded us. Let's rise above the dysfunction, and do the right thing together for our country in a bipartisan way.

"We want you to succeed." Wow!

As a point of contrast, two years ago, another Republican leader said, "The single most important thing we want to achieve is for President Obama to be a one-term president." That was full-contact politics at its worst, with a goal not of solving the nation's problems, but of winning the next election. Speaker Boehner's remarks are 180 degrees from that . . . and all we could ask for at this point.

I'm not a cynic. I want to believe Speaker Boehner means what he says. The important thing is that a spirit of cooperation exists. Hopefully the details can be worked out (although the two parties are at absolute loggerheads on the subject of raising taxes on big earners, and no one should underestimate the difficulty this presents). I am encouraged for now, and I'm going to stay that way until given reason not to be.

President Obama's Reply

I'm proud to share the news that on the strength of my memos, I have been asked to craft a response for President Obama on this subject. I include my first draft below. (Actually, there was no such request, but I've done it anyway.)

Ladies and gentlemen: I am speaking to you tonight, not to revel in victory, but to chart a course for progress. Not to assert just the goals of my administration and my supporters, but to describe what we're going to get done for all the American people, and how.

In our first term, we took stimulative actions that rescued our country from the threat of depression, and we fought to enact a controversial program that will make healthcare more readily available. There's far more we didn't get done, and much of that was because of a lack of bipartisanship in Washington.

A lot has to be dealt with in the next four years. The list starts with handling the fiscal cliff looming ahead and goes on to include a large number of economic, social and international issues. The basic facts in Washington are unchanged by the election. Democrats occupy the White House and possess a slender majority in the Senate, but we're in the minority in the House and our numbers in the Senate aren't sufficient to cut off debate. Thus control of government continues to be divided. That means progress will be grudging and limited unless we can resurrect a genuine spirit of compromise.

For me to succeed in my job under these circumstances, I must recognize that almost as many people voted for my opponent as voted for me, and that there are almost as many Republicans in the Senate as there are Democrats (and more in the House).

Thus I promise not to act as if only our ideas have merit, or as if only our principles are valid. In order to win support for the things we think are most important, we will make room to the greatest degree possible for the things our colleagues across the aisle deem important, as long as the overall result moves our country in the right direction.

What matters most isn't winning elections, it's doing right for America. I believe the party that does more of that will win most elections anyway. The end will be won if the means are right. You have my pledge that they will be.

That's the best I can do. The rest is up to our elected officials. As my British friends say, "fingers crossed."

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