

Memo to: Oaktree Clients
From: Howard Marks
Re: Nobody Knows II

I wrote most of this memo over this past weekend, on the heels of the tumultuous seven-day correction. But I couldn't get it out on Monday, and that day the S&P 500 rallied by 4.5%, or 135 points, for the biggest point gain in its history. I just can't update it daily to take into account every rise or fall (or rate cut). And my real goal – as usual – is to suggest how to think about developments, not to say “buy” or “sell.” **So please read this memo as of Sunday afternoon – whatever the markets have done since – and let me show how I assess the recent events.**

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I last used this memo title on September 19, 2008, two days after Lehman Brothers' bankruptcy filing. This is certainly an appropriate time to recycle it.

Over the last few weeks, I've been asked repeatedly for my view of the coronavirus and its implications for the markets. I've had a ready answer, thanks to something from my January memo, [You Bet!](#) As you may remember, I drew heavily on quotations from Annie Duke's book on decision making, *Thinking in Bets*. The one that stayed with me most – and that I've used a lot since the memo was published on January 13 – is this one:

An expert in any field will have an advantage over a rookie. But neither the veteran nor the rookie can be sure what the next flip will look like. **The veteran will just have a better guess.** (Emphasis added)

In other words, if I said anything about the coronavirus, it would be nothing but a guess.

I've written in the past about my reaction when people in China ask for my view of their country's future. “You live there,” I say. “I don't. Why are you asking me?” Not only am I not an expert on China, but I firmly believe the future of a country isn't subject to prediction, especially one that operates under a system that's unique. I furnish my opinion of China's future, but I hasten to point out that it's nothing but a hunch. **People may ask me for my opinion because they think I'm intelligent, think I've been a successful investor, or know I've lived through a lot of history. But none of that should be confused with expertise on subjects of every kind.**

And that leads me back to the coronavirus. No one knows much about it, since this is its first appearance. As Harvard epidemiologist Marc Lipsitch said on a podcast on the subject, there are (a) facts, (b) informed extrapolations from analogies to other viruses and (c) opinion or speculation. **The scientists are trying to make informed inferences. Thus far, I don't think there's enough data regarding the coronavirus to enable them to turn those inferences into facts. And anything a non-scientist says is highly likely to be a guess.**

So, overall, there are facts, inferences and guesses. It's always essential to know which you're dealing with. As for the virus, I don't think anybody knows the answers to the following questions:

- **How does the virus travel from person to person and community to community?** – People have tested positive who had no known contact with other people who had it or who were in countries in which there are known outbreaks.
- **How many people will contract it?** – On February 28, the head of the World Health Organization said it had “increased our assessment of the risk of spread and the risk of impact of COVID-19 to very high at a global level.” According to Dr. Lipsitch, it will affect 40% to 70% of all adult Americans. (I only provide this as an example. I don't assert that it's correct, or that his is the opinion to accept.)
- **Will it recede?** – According to the reported data, the number of new cases in China has declined substantially, from 9 out of 13 days with more than 3,000 the first half of February, to 8 out of 9 with less than 500 at the end of the month. How much of this is a function of the restriction of people's freedom of movement? To what extent can this downtrend be extrapolated to the rest of the world? Some say the virus will recede when the weather turns warm, as happens with other flus. Will that apply in this case?
- **What will its effect be?** – To date, only 20% of those contracting the virus have experienced something described as more than “mild,” and the fatality rate has been only 2-3% of those infected. Will these percentages hold? Will the fatalities continue to be primarily among people who are elderly and/or compromised? 2% of Dr. Lipsitch's 40-70% suggests **a million deaths** in the U.S. On the other hand, according to Dean Jamison, a global health economist and professor emeritus at University of California, San Francisco:

... the U.S. has a superior health system to China, where the outbreak is centered, and months of warning. ... “I think we're unlikely to see a really large outbreak in the U.S. — meaning **thousands of deaths**,” he said. (*The Wall Street Journal*, March 2)

- **What countermeasures will be taken?** – Will schools and offices be closed? Will people be told to stay in their homes? Will food be delivered to homes as in China? Will large public events be canceled? Will a vaccine be invented, and when?
- **What will be the effect on the economy?** – If people are shut in at home and unable to go to work, shop, eat out or travel as usual, how will GDP be impacted? How will a negative wealth effect impact people's propensity to spend? “Zero GDP growth” means the same thing as “same as last year” – is that an optimistic expectation or a realistic one?
- **How will the markets react?** – Since the markets' reaction ultimately will be a function of both economics and emotion, it seems impossible to quantify how far it'll go.

I want to stress that the purpose of the above discussion isn't to give answers or to appear to be complete or authoritative. If anything, it's to indicate the degree of uncertainty. If it's true, as I think, that these things are currently unknown and unknowable, then clearly there can be no such thing as a reliable statement regarding the implications of the virus.

The Economic Impact

In the early days of the disease, when the coronavirus was something that was happening “over there,” the effects likewise were mostly second-hand:

- obviously, a major contraction of the Chinese economy due to factory closures,
- the decline in retail spending in Asia,
- the curtailment of travel to and from Asia, and
- the important impact of shutting down an essential part of the world supply chain.

The supply-chain effects are particularly important. The unavailability of a small Chinese component can cripple the production of a large piece of equipment. And it only takes one, unless there are alternative sources. Relocating sourcing will be a challenge: it’ll take time, and there’s no assurance that the new locations won’t become engulfed in the disease.

More recently, the repercussions have moved beyond Asia and closer to the U.S., and they have grown in scale for the non-Asia world:

Nestlé SA told more than 290,000 employees to suspend international business travel until March 15. Several U.S. airlines are canceling flights to China and waiving change fees for passengers traveling to other affected destinations. U.S. apparel and footwear companies are facing supply-chain delays, which could result in a shortage of spring goods. Toy aisles may be bare as production of Barbies and Nerf guns in China flattened. And containership operators have canceled 40 sailings at the Port of Los Angeles through April 1, mostly for vessels coming from China. (*The Wall Street Journal*, March 2)

The reasons for the economic impact are understandable, but their collective impact can’t be quantified any more than most economic phenomena, and probably less given how much the elements in this situation are in flux. **There are as many forecasts as there are forecasters:**

S&P Global is forecasting the U.S. economy to slow to a 1% annual growth rate in the first quarter from 2.1% pace in the fourth quarter of 2019, with a half-percentage point attributable to the coronavirus. For the full year, the effect would be modest, shaving one or two tenths of a percentage point off growth. But that forecast assumes the impact is mainly overseas. (*The Wall Street Journal*, March 2)

Mr. Jamison [the UCSF emeritus professor introduced above] said such a scenario could still cause U.S. businesses and schools to close, grind transportation networks to a halt, and trim a half percentage point from economic growth for the year. That is enough to slow the economy but not cause a recession, or two straight quarters of economic contraction. He expects any event wouldn’t last longer than several months and be followed by a sharp increase in economic activity. (Ibid.)

“You have all the ingredients for an interruption of economic activity here,” said Carl Tannenbaum, chief economist for Northern Trust. “The impact of what’s going on is being underappreciated,” he added. “I don’t think the presumption of a month ago, that this will blow over, is an appropriate posture at this point.” (Ibid.)

Self-Fulfilling Expectations Pose Real Economic Risks: Consumers increasingly expect the economy to get worse. Morning Consult's Index of Consumer Expectations (ICE) fell 2.5 points since Feb. 24 and currently stands at 112.9. The fear for policymakers is that the slide in consumers' future expectations becomes a self-fulfilling prophecy: As more consumers expect the economy to contract in the coming months, they become more likely to delay discretionary purchases, which in turn drives down aggregate U.S. demand. (Morning Consult, March 1)

Investor Reaction

The markets' decline in the seven trading days February 20-28 certainly represents a very strong negative reaction. The S&P 500, for example, declined by 432 points, or 12.8%. Here are a couple of indications of its magnitude:

The market crash in the past two weeks has been truly historic: its probability of occurrence is ~0.1% since 1896; the velocity of the plunge and of the VIX surge is the fastest on record; and the 10-year [Treasury yield] is at all-time low. (Hao Hong, BOCOM International, a subsidiary of Bank of Communications, March 1)

While we are merely days into it, this stress episode is already among the most substantial of the last 25 years, joining an elite group that includes Asian Contagion (1997), LTCM (1998), the WTC attack (2001), the Accounting Scandals (2002), the Big One (2008-2009), the Flash Crash (2010), the Eurozone Crisis (2011), the China "re-peg" (2015) and the VIX event (2018). (Dean Curnutt, Macro Risk Advisors, March 1)

There's no doubt about the fact that the coronavirus represents a major problem, or that the reaction so far has been severe. **What really matters is whether the price change is proportional to the worsening of fundamentals.**

For most people, the easy thing is to say that (a) the disease is dangerous, (b) it will have a negative impact on business, (c) it has kicked off a major reaction to date, and (d) we have no way of knowing how far the decline will go, so (e) we should sell to avoid further carnage. But none of the above means selling is necessarily the right thing to do.

All these statements reflect a measure of pessimism. However, there's no way to tell whether that pessimism is appropriate, inadequate or excessive. I wrote in [On the Couch](#), (January 2016) that **"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.'"** What I can say is that a month ago, most people thought the macro outlook was uniformly favorable, and they had trouble thinking of a possible negative catalyst with a serious likelihood of materializing. And now the unimaginable catalyst is here and terrifying.

(There are a few important lessons here. First, the catalyst for a recession or correction isn't always foreseeable. Second, it can seemingly appear out of thin air, as this virus seems to have done. And

third, the negative effect of an unforeseeable catalyst is likely greater when it collides with a market that reflects so much optimism that it is “priced for perfection.”)

Before leaving this subject, I want to make mention of some illogicalities that mark the current market reaction, telling me that the market can’t be relied on to reflect reason:

- Some people are comparing the coronavirus and its market reaction to the events of 9/11. But that was a one-day event, and there’s no reason to consider that an appropriate model for this instance.
- It can be argued that the carnage to date has been indiscriminate. The shares of Amazon and Alphabet (Google) experienced declines in line with that of the overall market. But certainly since they don’t rely on visits from customers, they might be expected to be more immune to the effect of the virus than most. And Amazon – featuring e-tail orders and at-home deliveries – could actually find advantages in the current situation.
- Not only were stocks hit over the last week, but so was gold. Since gold is supposed to be the ultimate source of protection in times of dislocation, I can’t imagine any reason why it should decline in sympathy with stocks in a market correction.
- In a flight to safety, people have flocked to the 10-year Treasury note, bidding up its price and dropping its yield to 1.1%. If you think about it, this isn’t very different from the negative interest rates I complained about in October. How can it be anything but a manifestation of extreme fear to make an investment that guarantees a return of 1.1% a year for the next ten years? And consider that question in the light of the 2% dividend yield on the S&P 500, or perhaps its earnings yield of almost 6% (based on prior earnings forecasts). I’m not a dyed-in-the-wool devotee of equities, but how can buying the 10-year at these yields make better sense.

Finally I want to call your attention to the “elite group of stress episodes” of the last 25 years enumerated just above by Dean Curnutt. Every one of them was gut-wrenching. And they were followed by recoveries that produced significant gains for stalwart investors.

Most investors seem to think in terms of a very simple relationship: bad news → price declines. And certainly we’ve seen some of that over the last week or so. But I’ve argued in the past that there’s more to the story. The real process is: bad news + decline in psychology → price declines. We’ve had bad news, and we’ve had price declines. **But if psychology has declined too much, it might be argued that the price declines have been excessive given the news, as bad as it is.**

Monetary and Fiscal Policy

The good news is that many market participants are counting on the world’s central banks and treasuries to help pull us out of any economic slowdown. Here’s one example:

[On February 28,] Fed Chairman Powell released a short statement saying, “The fundamentals of the U.S. economy remain strong. However, the coronavirus poses evolving risks to economic activity. The Federal Reserve is closely monitoring developments and their implications for the economic outlook. We will use our tools and act as appropriate to support the economy.” Following Powell’s statement,

futures markets moved to fully price in a 50-basis-point rate cut on March 18. (RDQ Economics, February 28)

Market participants seem to think that (a) rate cuts and other stimulus are always a good thing and (b) they'll work. Yet, given that the economic impact of the disease is unknowable, how can investors be sanguine about the ability of the Fed (plus other central banks and treasuries) to counteract it?

Fifty basis points this month may or may not be enough to stem the tide. But investors probably infer from Powell's "we will use our tools and act as appropriate" language that the Fed will "do what it takes." But we must be mindful of the limitations on "ammunition" that exist. In [*On the Other Hand*](#) (August 2019), I supplied a list of "ways in which low rates are undesirable and potentially harmful." The last one was this:

Finally, but very importantly, when interest rates are low, central banks don't have at their disposal as much of their best tool for stimulating economies: the ability to cut rates.

The normal program of rate cuts covers roughly 500 basis points. That's not a very encouraging thought when we think about the fact that the short rate already stands at a mere 150 bps. So the one thing we know is that the Fed doesn't have room for a normal regime of rate-cutting (there's uniform insistence that it won't cut into negative territory).

Further, we have to wonder about the desirability of using 50 bps of the 150 bps the Fed does have at its disposal. Will it be enough? **And what will the Fed be able to do when the economic impact of the virus has been muted but we only have 100 bps or less left with which to fight any recession that appears?**

The facts regarding monetary and fiscal policy are these:

- In 2009, to fight the Global Financial Crisis, the Fed cut short-term rates to zero for the first time.
- Not wanting to derail the subsequent recovery, it hesitated to raise rates before Chair Yellen enacted a series of rate increases in 2015-18 that took the Fed funds rate to 2.25-2.50%.
- When around the end of 2018 interest rates reached levels that investors feared would jeopardize the economic expansion, Chair Powell's Fed reversed course and embarked on a series of three rate cuts.
- Thus today we have the 150 bps I mentioned above – "limited ammunition."
- In addition to rate cuts, the Fed has the ability to pump liquidity into the economy by engaging in quantitative easing through purchases of government securities. But we can't know the long-term impact of expansion of the Fed's balance sheet.
- Finally, looking away from the Fed, we can think about fiscal policy (i.e., increased deficit spending). But this will add even more to our national debt.

Normally, fiscal and monetary stimulus is applied in times of economic weakness. (Even Lord Keynes, whom many people consider the father of deficit spending, advocated running deficits and accumulating debt when the economy grows too slow to create jobs, and then repaying the debt when the stimulus produces surpluses.) Now we have near-zero interest rates and trillion-dollar deficits in

times of prosperity. No one wants a recession, but using up our ammunition preemptively may not have been smart.

The Fed/government's tool for fighting the economic impact of coronavirus are very limited. Thus I believe it's undesirable to be highly sanguine about their powers at this juncture.

What to Do?

These days, people have been asking me whether this is *the time* to buy. My answer is more nuanced: it's probably *a time* to buy. There can be no unique time to buy that we can identify. The only thing we can be sure of today is that stock prices, for example, are a lot lower in the absolute than they were two weeks ago.

Will stocks decline in the coming days, weeks and months? This is the wrong question to ask . . . primarily because it is entirely unanswerable. Since we don't have answers to the questions about the virus listed on page two, there's no way to decide intelligently what the markets will do. We know the market declined by 13% in seven trading days. There can be absolutely no basis on which to conclude that they'll lose another 13% in the weeks ahead – or that they'll rise by a like amount – since the answer will be determined largely by changes in investor psychology. (I say “largely” because it will also be influenced by developments regarding the virus . . . but likewise we have no basis on which to judge how actual developments will compare against the expectations investors already have factored into asset prices.)

Instead, intelligent investing has to be based – as always – on the relationship between price and value. In other words, not “will the collapse go further?” But rather “has the collapse to date caused securities to be priced right; or are they overpriced given the fundamentals; or have they become cheap?” I have no doubt that assessing price relative to value remains the most reliable way to invest for the long term. (It is the thrust of the whole discussion just above that there's nothing that provides reliable help in the short term.)

I want to acknowledge up front that ascertaining intrinsic value is never a simple, cut-and-dried thing. Now – given the possibility that the virus will cause the world of the future to be very different from the world we knew – is value too unascertainable to be relied upon? In short, I don't think so. What I think we do know is that the coronavirus is not a rerun of the Spanish flu pandemic of 1918, “which infected an estimated 500 million people worldwide – about one-third of the planet's population – and killed an estimated 20 million to 50 million victims, including some 675,000 Americans.” (history.com) Rather, it's one more seasonal disease like the flu, something we've had for years, have developed vaccines for, and have learned to deal with. The flu kills about 30,000-60,000 Americans each year, and that's terrible, but it's very different from an unmanageable scourge.

So, especially after we've learned more about the coronavirus and developed a vaccine, **it seems to me that it is unlikely to fundamentally and permanently change life as we know it, make the world of the future unrecognizable, and decimate business or make valuing it impossible.** (Yes, this is a guess: we have to make some of them.)

The U.S. stock market's down about 13% from the top. That's a big decline. It would be a lot to accept that the U.S. business world – and the cash flows it will produce in the future – are worth 13% less today than they were on February 19. That sentence may make it sound like I think the market's undervalued. But that's not the proper interpretation. If it was overvalued on the 19th, rather than being undervalued today, after the decline, it could just be less overvalued. Or it could be fairly valued, or even undervalued, but it isn't necessarily.

I think the stock market was overvalued two weeks ago . . . somewhat. That means I think that today, even with the short-term prospects of business somewhat diminished, it's closer to fairly valued, but not necessarily a giveaway. In the starkest numerical terms, before the rout, the p/e ratio on the S&P 500 was 19 or so, roughly 20% above the post-World War II average (and there are arguments on both sides regarding the current applicability of that average). Thus, after a 13% decline, you'd have to say the p/e ratio is pretty close to fair (unless earnings for the year will be very different from what they previously had been expected to be).

Buy, sell or hold? I think it's okay to do some buying, because things are cheaper. But there's no logical argument for spending all your cash, given that we have no idea how negative future events will be. What I would do is figure out how much you'll want to have invested by the time the bottom is reached – whenever that is – and spend part of it today. **Stocks may turn around and head north, and you'll be glad you bought some. Or they may continue down, in which case you'll have money left (and hopefully the nerve) to buy more. That's life for people who accept that they don't know what the future holds.**

But no one can tell you this is *the* time to buy. Nobody knows.

March 3, 2020