Memo to: Oaktree Clients

From: Howard Marks

Re: What's Behind the Downturn?

In May, I observed in "How Quickly They Forget" that investors had returned to pro-risk behavior despite the lingering presence of significant macro worries. And then just three months later, a number of exogenous events caused the markets to undergo a significant decline and one of the greatest paroxysms of volatility ever seen. All of the reasons existed well before. Investors simply hadn't taken them to heart.

I never cease to marvel, and complain, about the way investors flip-flop – focusing on just the positives at one moment and just the negatives at another – and the speed at which they do it. But I learned long ago not to be surprised by this phenomenon or expect it to stop occurring, but instead to look past the market's behavior and assess the underlying realities. Thus I decided to take the occasion of my summer vacation to write a memo parsing the recent events and touching on the outlook.

<u>Confluence</u>

Markets usually do a pretty good job of coping with problems one at a time. When one arises, analysts analyze and investors reach conclusions and calmly adjust their portfolios. But when there's a confluence of negative events, the markets can become overwhelmed and lose their cool. **Things that might be tolerable individually combine into an unfathomable mess whose extent and ramifications seem beyond analysis. Market crises are chaotic, not orderly, and the multiplicity and simultaneity of contributing causes play a big part in making them so.**

That was certainly the case in the three crises we've lived through as investors in credit. In addition to the recession and credit crunch that marked each one, we saw:

- in 1990, the collapse of the most prominent leveraged buyouts of the 1980s; the Gulf War, with Iraq's invasion of Kuwait and the allies' response; and the government's crusade against high yield bonds, Drexel Burnham and Michael Milken;

- in 2002, the aftermath of 9/11, including our invasion of Afghanistan; the unraveling of the overbuilt fiber telecom industry; and the exposure of accounting scandals at Enron, WorldCom and Adelphia and the fall of Arthur Andersen; and

- in 2008, the sub-prime mortgage meltdown; the defrocking of tranching, leverage and derivatives as constructive forces; the outing of credit rating agencies as no more reliable than their models; the banks' major losses in off-balance-sheet investments; and, as a result of all of the above, the collapse or rescue of a number of prominent financial institutions and grave concern about the rest.

It's my sense that it was the simultaneous nature of these occurrences – in addition to, or perhaps rather than, their force individually – that rendered the markets so incapable of maintaining their equanimity.

Certainly that was the case in early August. For the first time in history, the Dow Industrials either rose or fell by at least 400 points four days in a row. What was it that sent the markets on that wild ride? I can think of a number of factors:

- rising awareness of the import of the U.S.'s fiscal deficit, and the bitterly disappointing display that played out in Washington as we approached the date on which the debt ceiling would bind,
- Standard & Poor's downgrading of U.S. government debt,
- increasing worry about Europe's ability to deal with the excessive debts of its peripheral countries, and thus about the health of European banks holding them,
- concern over the possibility of a double-dip recession, and
- mounting evidence that China and the rest of the emerging world are something less than unstoppable economic miracles.

Importantly, we saw the onset of one of those negative feedback loops where intelligence is imputed to market developments. We're told the falling prices reflect problems lying ahead, and thus investors sell in response to the message being provided by . . . investors who're selling.

Again, I think it was the collective force of these things that convinced people the world was a scary place. **What could be worse than the convergence of a number of major worries whose extent, interaction and solution seem beyond comprehension?**

Washington Debt Follies

Where can I start on this sorry subject? As described in "Down to the Wire" in late July, America and the world contemplated the collision of an irresistible force (the U.S. government's need to borrow due to its habit of spending more than it brings in) with an immovable object (the debt ceiling and Washington's seeming inability to reach a constructive solution to it).

With control of the government divided and many legislators committed to preventing either tax increases or cuts in social programs, it was obvious to most level-headed observers that any solution would require compromise. But while it could have been a negotiating stance, several of the participants in the debate seemed not to attach much importance to reaching a solution if it required compromising on their positions. In the process, a disappointing number gave the impression that they didn't understand or care much about the significance of deficits, defaults and downgrades.

On July 27, *The New York Times* ran an article on political negotiating. Its mention of the game of chicken reflected what was going on in Washington: "two players [drive] toward each other, each wanting the other to swerve. The one who does, loses. The trick to winning is for one player to convince the other that under no circumstances will he or she veer off course." One way to do that, *The Times* suggested, is to unscrew your car's steering wheel and toss it out the window. I must say I found that an accurate metaphor for what we were watching. **While that may have been an effective tactic for winning the political game, however, it didn't do much to reassure onlookers hoping for a reasonable solution. Instead, it gave the strong impression that reason couldn't be counted on to prevail.**

Nevertheless, the situation played out as expected. We saw the short-term problem papered over; little movement toward meaningful spending cuts or revenue increases; and the formation of a bipartisan commission to come up with a solution to the long-term problems. But if the plan formulated a year ago by another panel including some of our most eminent former legislators couldn't gain traction, what's the likelihood a new one will fare any better?

Anyhow, the markets breathed a collective sigh of relief and went back to normal when the can was kicked down the road. Investors were hungry for reassurance that Washington was up to solving the problem of deficits and debt and alleviating the uncertainty, but I don't think they got it. **All decisions to invest – whether in factories, new employees or securities – require confidence that there'll be a salutary, stable and predictable environment. Our leaders' response to the debt crisis did nothing to foster one.**

Confidence was further eroded when, a few days later, Standard & Poor's announced that it had downgraded long-term U.S. debt from AAA to AA+, and all hell broke out. Was the downgrade appropriate? What did it mean? And how many of those who reacted in the markets really understood its significance?

According to S&P, a triple-A debt issue means "Extremely strong ability to meet financial commitments. Highest rating." **Certainly the U.S.'s ability to meet financial commitments remains "extremely strong." But is it the "highest"? And is it as high as it used to be, or do recent events suggest it is diminished? I find the issue hard to wrestle with:**

- Given that the U.S. has the power to print the world's reserve currency, it doesn't make sense to think it will fail to pay its obligations. (Of course, if it runs the printing presses to pay its debts, the dollars with which it does so will likely have diminished purchasing power.)

- The truth is that an AA+ rating is far from meaning "default-prone." Since only a few percent of single-B bonds default each year on average, at worst AA+ must imply a probability of default of a small fraction of a percent. In fact, many potential triple-As opt for AA+ instead in order to be able to carry more debt. That's one reason S&P rates only four companies triple-A.

- Getting a little more esoteric, what does it mean for a debtor to "meet financial commitments"? As I mentioned in "Down to the Wire," debtors generally aren't expected to pay off their debts; rather, it's the normal expectation that interest will be paid and principal will be refinanced. **Interesting, then: even triple-A doesn't necessarily connote an ability to extinguish one's debts.**

- While credit ratings are explicitly defined as relative, relating primarily to the likelihood of payment, **I've always thought triple-A has a connotation for most people that absolutely nothing can go wrong. For that matter, U.S. Treasurys have traditionally been described as "riskless," which sounds pretty absolute to me. If that's a fair description, it doesn't seem to fit the political process we've witnessed in the last few months.**

- The events of July suggest some of those currently in control in Washington don't think failing to meet commitments would be a big deal. Certainly it seemed possible on July 31 that some of the people to whom the U.S. owed money might go unpaid within a few days. So, is the risk on Treasurys really non-existent?

- If the U.S. was triple-A in 2000, when it was running a surplus, its national debt was far smaller, and Washington functioned much more constructively, mightn't it deserve a lower rating today?

- Our deficits are far bigger than ever, and the commitment to do what it takes to reduce them seems quite weak. As I wrote in "I'd Rather be Wrong" (March 2010), "Everyone wants to see the deficit narrowed, but today's circumstances seem to prohibit both expenditure reduction and revenue increases. Everything else is on the table." The process of governing seems to be running less well than ever.

- The long-term outlook is particularly bleak. In "Down to the Wire" I described how entitlement programs endanger our fiscal future. I failed, however, to mention that the present value of our future unfunded obligations is estimated at $64 to $99 trillion depending on the source (per J.P. Morgan), a burden that dwarfs our current national debt of $14.3 trillion.

So S&P and Egan-Jones downgraded U.S. debt (while Moody's and Fitch didn't). There was one main moving part on August 5: that's the day S&P labeled U.S. debt less safe. What was the upshot? A buying panic in U.S. Treasury securities, with the yield on the 10-year note falling below 2%.

As an aside, let's spend a minute thinking about that reaction. If there had been near unanimity about anything, it was that a downgrade would raise the yield demanded on U.S. debt. **Certainly the fact that so many people could be wrong about this supposedly simple linkage should disabuse investors of the notion that they know how markets work.** The expected reaction was much more logical than the one that actually played out: after it was labeled less safe, the yield demanded on U.S. debt declined markedly. **I find the explanation fully worthy of Yogi Berra: the downgrade of Treasurys made people so worried about the elevated risk in the world that they ran to Treasurys for safety. So much for the supposed rationality of markets.**

The bottom line for me in all the above is that, while on an emotional basis I find the debt situation depressing, intellectually I believe U.S. Treasury obligations will prove money good. At bottom I agree with former Treasury secretary Hank Paulson:

> While the players in Washington certainly haven't performed at AAA level, I would certainly take U.S. Treasuries over other AAA sovereigns any day." (*The New York Times*, August 9)

<u>The European Version</u>

The problem in Europe isn't overwhelmingly different, just manifested differently. **In the credit boom of the last forty years, debtors all around the world – nations as well as states and cities, consumers, home buyers and buyout companies – borrowed amounts that they couldn't repay now if required to do so. The key questions are whether the loans will be renewed, or who'll pay them off, or how they'll otherwise be discharged.** Only the details vary from instance to instance.

As I described in "It's Greek to Me" (July 2010), for years, especially thanks to their membership in the European Union, peripheral nations with weak economies and little fiscal discipline were able to borrow sums disproportionate to their incomes. Thus Greece, Portugal, Spain and others could run continuous deficits to support excessively generous programs with features such as retirement ages in the fifties and a thirteenth month of pay each year. Lenders were unconcerned about the impossibility of repayment, it seemed, until early 2010. But then they awoke.

Economically stronger nations such as Germany and France, on the other hand, applied much greater prudence. They and their citizens and financial institutions didn't participate as much in the trend toward over-borrowing, and thus don't share the particular problems of the peripherals. But they have problems of their own, since they took the capital piled up by their strong economies and lent it to the profligate borrowers. **Thus the direct problems in the strong nations relate not to unpayable debts, but to questionable receivables**: their banks and other providers of capital are owed large sums lent to the governments and institutions of the peripheral nations.

All member countries are impacted by the general uncertainty present. As in the U.S., the divided, fractious nature of Europe's governing bodies will complicate the process of problem solving. Will the governance structure of the European Union permit a solution to be reached? What can be done about the weaker members? How much of the relief will the strong nations be expected to provide? Will the untested, loose confederation of the monetary union hold together or, alternatively, have to provide for the exit of the weaker links? Will voters in the strong nations allow their elected officials to use resources to support the weak ones?

The basic problems are similar to those in the U.S. in terms of scale, novelty, and the difficulty of identifying solutions. How will the transition be handled from the easy-money environment of the past to the more restrictive one of today? Who will bear the burdens of excessive debt and shoulder the losses? How will the banks' bad-debt problem be solved and their capital rebuilt? Will the political system produce the needed solutions? Are the leaders up to the task? Here's how the *Financial Times* put it on August 20:

> There is no magic medicine and the best solution would be a combination of [several] policies, wrapped up in a show of political will that restored confidence to the global economy. But political will is in short supply, and that may be the most worrying economic sign of all.

If markets abhor uncertainty – as we know they do – then these issues imply little in the way of tranquility. And when multiple problems of this nature coincide, as they did in early August, the result is chaos, at least until the markets become inured to the uncertainty and the gyrations themselves run out of energy.

<u>Possibility of a Double Dip</u>

In 2010 and early 2011, the economic reports suggested a healthy recovery. They contributed to confidence that things were going in the right direction, and thus to investors' feeling of wellbeing and willingness to bear risk. In fact, I expressed in "How Quickly They Forget" my belief that risk tolerance had become excessive relative to the fundamental outlook.

Even when the economic reports were positive, I didn't feel they were as dynamic as in past recoveries. And this one was from the worst recession I've seen, which should have made for a strong rebound. In particular, job growth was slow and unemployment remained at stubbornly high levels.

But then, concurrent with the explosion of uncertainty over debt in the U.S. and Europe, slower growth was reported for the second quarter and the gains of the first quarter and late 2010 were revised downward. All of a sudden, another contributor to the sense that "it's all good" had turned negative instead.

I always hasten to point out that I am not an economist (and Oaktree doesn't have one). **Thus I don't have a strong opinion as to whether the U.S. will relapse into a double dip. (I also have no idea how people reach firm conclusions on such things, other than as expressions of their biases and hunches.) For our purposes, it suffices that we have operated since the financial crisis under the assumption that the recovery would be sluggish, rather than V-shaped. We still feel that way.** And that feeling is inconsistent with moving out on the risk curve or down in credit quality, investing more in cyclicals or taking on leverage.

Our enthusiasm regarding the macro economy has been muted for a number of reasons, including:

- conviction that it was largely the growing use of credit that enabled consumption to grow faster than sluggish incomes over the last 20-30 years, and that in the future credit will not be equally available or equally employed,

- the potentially counter-stimulative effect of austerity as government spending shrinks and taxes rise relative to GDP, and of delevering in general on the part of over-indebted governments, businesses and individuals,

- concern (thus far unfounded) over the potential for rising interest rates and their depressant effect on the economy,

- continuing challenges regarding manufacturing competitiveness due to our status as a high-cost location, and

- belief that unemployment will remain a persistent problem due to the above-mentioned decline in manufacturing, our problems in education, and the shift to an information-based and more productive economy (read: fewer hours of labor per dollar of output).

In addition, we mustn't ignore the part played by confidence. I think confidence is everything in determining the economic future. If participants in the economy believe things will be good in the future, they'll spend and invest and things will be good, and vice versa. **Economic expectations are self-reinforcing in many ways, and right now**

that bodes ill. When people see nothing on TV but news of how bad things are, they tend to pull in their horns. Certainly the recent events haven't been helpful in this regard.

Finally, there's no longer much confidence in the efficacy of the Fed, its chairman and its arsenal. Clearly confidence in Alan Greenspan and his Fed was overdone in his last decade (and thus contributed to the moral hazard of the period). Today the reverse seems to be true, but at least that means we're not burdened with unrealistically high expectations in this area.

On the positive side, many companies are reporting healthy orders and profits. Further, I believe the likelihood or potential severity of another recession is reduced by the fact that economic comparisons now and in the coming months will be against non-dynamic prior periods, and thus relatively easy. In short, without a boom, it's harder to have a bust.

My overall vision continues to be of an airplane rising weakly, perhaps overloaded or with an engine sputtering and thus having difficulty getting above "stall speed." Its sluggishness constitutes a drag and introduces risk, but predicting deceleration is going too far . . . and not necessary to convince us to remain cautious in deciding on our course of action.

Emerging Markets Play Their Part

The emerging markets' contribution to the unsettled environment is of a very different nature. Their economies are growing strongly and generally not over-indebted. Rather, here the issues stem from the juxtaposition – as often seen – of investors' high expectations with a new, less rosy reality.

I've written in the past (e.g., in "Hemlines," September 2010) about the propensity of markets to become captivated by simple themes, like "the Internet will change the world," "equities are good" or "who needs bonds?" One such easy-to-swallow story line that prevailed over the past decade has been with regard to the "emerging market miracle" and, especially, the inevitability of China.

I don't mean in the least to suggest that the outlook for China, India and the rest of the emerging markets is less than bright. In fact, I'm sure they'll out-grow the developed world over the remainder of the century. **The problem, however, is that simplistic, mania-following investors elevated emerging markets to the pedestal of the "sure thing" where nothing can go wrong. And when prices incorporate unlimited virtue, the eventual result is bound to be disappointment, disillusionment and depreciation. Even favorable developments can lead to losses when they fail to measure up to expectations. That's been the case in the emerging markets.**

So now we see:

- concern that the emerging market economies have been over-stimulated,
- the rising inflation that occurs as a consequence,
- uncertainty over whether the monetary tightening which is taking place will result in a soft landing or something worse,
- questions about corruption, fraud, non-transparency and inefficiency, and
- realization – again – that their economic success isn't independent of that of the developed world.

The fundamental outlook in the emerging markets is still excellent. It's just that at times in recent years, when problems arose in the U.S., Europe and Japan, investors turned to the emerging markets for investment solutions, and the view that their future would be "superior" morphed into "flawless." When their securities became priced for that perfection, the realization that they actually had feet of clay – at a time when investor confidence was weakened by the other things I've mentioned – took a toll on investor equanimity and security prices.

<u>Taken Together</u>

None of the issues described above is illusory. The U.S. is a fiscal and political mess, and its leaders inspire little confidence regarding their ability to effect a solution. The outlook in Europe is similarly murky, and the emerging markets have turned out not to be as foolproof as had been believed. However:

- none of these is a new development; they all existed three or six months ago, when the markets were sanguine,
- their scariness is due to the fact that many are relatively unprecedented, and thus the solutions aren't obvious or time-tested, and
- this uncertainty is among the greatest contributors to the markets' unease.

So, as is often the case, the swing we've had is more in psychology than in fundamentals. The positives of June are diminished, forgotten or eclipsed, and now investors are preoccupied with the negatives. As usual, the truth probably lies in between.

We face a new world nowadays in terms of the speed of media coverage, the vast number of outlets competing for people's attention, and in many cases their seeming lack of concern over their own partiality, volatility and non-objectivity. I have no doubt that the media contribute significantly to the manic swing from "it's all good" to "it's all bad," with its highly unsettling effect on the markets. Emotion takes over from reason.

Hysteria rules the day. Nobody knows what the developments mean or what to do about them. But that doesn't prevent investors from acting in response.

With the strong flight to the perceived safety of Treasurys and the pronounced cheapening of everything else, the dearth of bargains that I bemoaned a few months ago is much eased. In U.S. high yield bonds, for example, the yield to worst and spread on the Citi High Yield Market Index went from 6.8% and 526 basis points on May 31 to 8.3% and 719 b.p. on August 31, just three months later. As for European issuers, the yield and spread on the BofA Merrill Lynch Global High Yield ex. Russia Index went from 7.7% and 545 b.p. to 10.0% and 840 b.p. in the same period. Not only are the current spreads well above the historic averages, but the yields are actually quite reasonable in the absolute (and suitable for institutions with 8-ish actuarial assumptions or required returns). And what's been the response? Massive redemptions from high yield bond mutual funds.

So the pattern of the last few weeks hews to the norm:

- There's a period in which the news is good, reaction is favorable, psychology is positive, willingness to bear risk grows, and assets move to higher prices, attracting additional buyers into the markets.

- Then something takes a turn for the worse and, in the most serious downturns, there is a confluence of negative events.

- The worrisome elements gain sway over investor psychology, and the positives are forgotten.

- Disillusionment replaces sanguineness: "How could I ever have put so much trust in the markets?"

- Money flows out of the markets rather than in; it's sellers who influence prices rather than buyers; and securities eventually move from dear toward cheap.

Certainly some of these developments have taken place. **Nobody waves a banner when assets have gotten cheap enough, but it's incumbent on investors to recognize things like these and react appropriately, rather than follow the herd. Thus right now I would be a better buyer, albeit in moderation since fundamentals still pose threats.**

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Rather than end there, as I originally thought I would, I want to add a little about the longer-term future. I could prepare the way by repeating my standard confession that I'm given more to worrying than to enthusing, but you already know that.

What I want to say is this: the worries concerning the U.S. economic outlook enumerated on page seven are not limited to the current short-term cycle. I touched on most of them in "What Worries Me" (August 2008), "The Long View" (January 2009) and "Tell Me I'm Wrong" (January 2010), and my view of their importance hasn't changed. I think they're likely to influence the environment for years.

I feel today's distribution of possible futures is shifted to the left – that is, generally less attractive – relative to the distribution that governed the late twentieth century. The picture in the U.S. is less positive today in terms of consumer-led growth and the supercharging impact of increased credit use, competitiveness and job creation, and the government's fiscal situation (and thus its ability to stimulate the economy).

I think we benefited greatly in that earlier period from the luck of the draw. Things went about as well as they could have for the economy (despite sluggish income growth). Inflation was very much under control, and we benefited from steadily declining interest rates. We were even lucky enough to see the collapse of our great enemy, the USSR, and to live in a world that was generally at peace.

It was a period in which the markets benefited from positive developments and overwhelmingly bullish attitudes. As my partner David Kirchheimer points out, the favorable underlying trends constituted a rising tide in the Buffett sense, meaning for a long time we didn't get a chance to see which borrowers, risk takers and financial innovators were swimming unclothed. The picture has become less alluring with the tides less favorable, and I expect only moderate improvement in that regard.

David adds that "it took many years, trillions of dollars in credit extension, and countless well-intentioned but misguided policies to get us into this mess, so it's likely that under the best of circumstances it will take many years for the economy – and standards of living – to reach a new equilibrium, and for the financial markets to acclimate to a 'new normal' of possibly lower returns without the artificial effect of record government stimulus."

I feel the prosperity we enjoyed in the final decades of the twentieth century was considerably better than "normal," and better than we're likely to see up ahead. I'm not implying a world without growth or otherwise permanently negative. Just one without the prosperity, dynamism or positive feelings of past decades. In addition, the newness of the macro picture and some of the problems – and the opacity of the solutions – certainly make it less clear in which direction we'll go.

It’s my belief that things went better in the late twentieth century than we have reason to expect in the years ahead. We could get lucky again, of course, but it would be downright imprudent to make investments predicated on that assumption. **Thus at Oaktree we’re making allowance for things that may go less well than they did in past periods. Cheapness provides a margin of safety today, but only so much. We’re moving forward, but cautiously.**

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