Memo to: Oaktree Clients

From: Howard Marks

Re: Quo Vadis?

Leon Uris turned the question "Quo Vadis?" into a book title. Everyone wants to know. **Where do we go from here?** What's in store for the market?

> . . . for all the drama, yesterday's seesaw trading failed again to give investors the one thing they needed most: a clear picture of where the stock market is headed. Many on Wall Street had been hoping for some kind of resolution yesterday – either a significant drop that would wash out the selling, or a significant recovery. Instead, stocks bounced in both directions, as optimists battled the pessimists. (Wall Street Journal, July 24, 2002)

I include this paragraph because it communicates a great deal in just a few words. It makes clear how much investors hunger for an indication of what lies ahead. It shows how inconclusive anyone day's evidence can be. And, most importantly, to me it hints at the sheer folly of this quest for an omen. **There's no such thing as a conclusive sign, and there never will be. The future will always remain a mystery – and this is even more true for short-term fluctuations than for long-term trends. Nothing in the market's movement one day tells us anything about what it'll do the next. Most of the time people will conclude that they have no idea what lies ahead. And once in a while they'll feel they do (as in 1999) and likely be wrong.**

I know my views on the market's direction aren't worth betting on. But while I can't tell you what lies ahead, perhaps I can be of service in my usual way, by marshalling the arguments on both sides and giving you my take on them.

<u>Starting Point</u>

This attempt to provide insight into the market's future course should be understood in light of a few caveats. The most important are these:

First, we are living through the most extreme boom-bust episode of my 33-year investment career and, I think, the most extreme since the Roaring Twenties and subsequent market crash. The magnitude and craziness of the bull market and tech-media-telecom bubble of the 1990s dwarfed every up-leg I've seen, and the correction that started 28 months ago already ranks with the greatest down-legs. Thus all bets for "normalcy" are off. A huge decline like we've had doesn't necessarily create bargains if preceded by a huge advance.

Second, no one knows what the future holds, especially in the short term. **The movements of markets are primarily determined not by physical laws, but by the reaction of emotional humans to developments in their environment. These reactions are well beyond accurate prediction**. The fraternity of would-be forecasters consists of people who've been right once or twice, giving them credibility, and people who've never been right. None of them has a high probability of being right this time.

Third, the market's "observable historic patterns" (a) are very inconsistent and (b) have been derived from a small number of observations over a period of just a century or so under widely varying circumstances. Thus these historic patterns are of very limited relevance in predicting this market's next move.

Last, I want to admit that, as usual, my analysis is likely to overweight the negatives and the rebuttals to the positives. I've been cautious for a long time – in fact, I don't remember ever having written a bullish piece on stocks – and this memo is unlikely to be any different. There are "horses for courses," and I admit it: I'm usually going to cost you money on the upside.

Taken together these caveats mean that very little trust, if any, should be put in any market prediction – especially mine.

<u>Positive Arguments</u>

One of the strongest arguments for buying now cites the market's departure from one of those historic patterns referred to above. The New York Times stated it clearly on July 21:

> Using history as a guide, the stock market should be higher now than it was a year ago. Since 1948, six months after a recession's trough, stocks have jumped an average of 24 percent from the previous year. But at the end of June, six months from the recession's probable end, stocks were down 18% from last year. **That means the market has underperformed its typical post-recessionary move by 40 percentage points**. [Emphasis added]

Supporting this is the widespread and not unreasonable belief that the economy is no longer in decline and a modest recovery is underway. While it is difficult to identify many pockets of great strength in the economy, there is no evidence that the aggregates are still trending down.

Buttressing the economic outlook are recent movements in currency exchange rates. The dollar has stopped appreciating relative to other currencies and in fact has moved 10% lower. This means, for example, that it now takes fewer euros to buy a dollar and more dollars to buy a euro. Thus, everything being equal, U.S. goods are now cheaper than foreign goods. This should serve to increase U.S. manufacturers' sales to Americans and foreigners alike.

The improving environment seems to have taken the downward pressure off profits and slowed the flow of earnings disappointments. As reported by the Wall Street Journal on July 22, "Nobody wants to hear it, but companies are beating their numbers again . . . Of the 208 companies from the S&P 500 that have reported [midyear results] so far, 58%, or 120 companies, earned more per share than analysts had estimated . . . Only 14%, or 29 companies, have missed estimates." (Bear in mind, however, that "earnings ahead of estimates" is not necessarily the same thing as "earnings ahead of last year." This data could simply mean that the comparisons are against estimates that had become too pessimistic.)

I see technical indicators that are encouraging. There are a number of signs that optimism is being wrung out of the market and fear is replacing greed. For example, when the Dow fell 390 points on Friday, July 19, the NYSE saw:

- new lows outnumber new highs by almost fourteen to one (386 vs. 28),
- more than three times as many stocks decline as advance (2,467 vs. 766),
- all of the 30 Dow Industrial stocks decline, and
- an all-time record number of shares change hands (2.63 billion shares, only to be exceeded in the rally of July 24).

In addition, there have been several days this year when 80% or 90% of the trading volume took place on downticks, and cash outflows from equity mutual funds have been substantial.

Certainly investor behavior has turned bearish. Selling sometimes seems indiscriminate. Every better performing group gets its turn in the barrel. The value stocks that outperformed for the last two years are sharing the pain of the growth stocks. It seems there's no place to hide. Investors complain that they can't take it and have started to throw in the towel. **Maximum panic usually coincides with minimum prices**. Thus these may be signs that capitulation, the exhaustion of selling, and a bottom are near.

Negative Arguments

On the other hand – as any good politician would say – there are counter-arguments to many of the above, and a large number of additional negatives to be considered.

In my opinion, just as the strongest positive is seen in the failure of the market to reflect the ending of the recession, I think the counter to that – and the strongest negative – lies in the matter of valuation. **In short, the fact that stocks are down since the end of the recession, and down a great deal from their peak, doesn't mean they're cheap**. In fact, most rumination on the market's future direction touches on the correction, investor psychology and the economy, but not whether stocks are rich or cheap, always a difficult subject to plumb.

The impact of a decline must be gauged in light of its starting point. Stocks ended up cheap after the S&P's 1973-74 decline of 48%, but that's because the average P/E ratio started in the high teens and ended in single digits. Thus this correction's 45% decline doesn't necessarily have equal import, given that it started **and ended** with an average P/E ratio above 20!

Of course, a case continues to be made that stock valuations are attractive (or, more typically, "are not unattractive") because of the low level of interest rates. Low rates raise the discounted present value of a given stream of future cash flows, and they reduce the competition that stocks face from bonds. **As I see it, much of the case for the fairness of valuations today rests on the view that low prospective returns on stocks are reasonable given the low prospective returns on fixed income instruments. Maybe this makes stocks cheap at today's P/E ratios, but I don't consider it much of a positive.** Further, in order for interest rates to continue to render stocks attractive, they must stay low. But low rates presuppose low levels of economic growth, demand for capital, and inflation. Are these the arguments on which to build a bullish case?

There's also a strong counter-argument regarding economic recovery. As stated by Jan Hatzius, the senior economist at Goldman Sachs, it goes as follows:

> Unfortunately, the effect [on the economy] of the stock market's sorry performance has yet to be felt. . . Normally, when you get a big stock market setback, consumers have a harder time getting credit. But there are more alternative sources of credit for consumers now and the Fed is very eager to keep access to credit good. . . Once consumers realize that the stock market will no longer bolster their savings, they will rein in spending and start setting aside more income. That will be a big negative for consumer spending, the only area of the economy that has been strong. (NY Times, July 21, 2002)

Certainly with about $7 trillion of equity value having been erased since the market's peak in March 2000, investors are sure to be feeling a lot poorer, and thus there is reason to question the longevity of strong consumer spending. Bulls often touted the "wealth effect" in 1998-99, but we hear much less about it these days. Yet concern that consumers will cut spending is one of the reasons there is fear of a double-dip recession.

And the negative ramifications aren't likely to be limited to consumers. Corporations will feel their share of pain from the market's decline. First, they may have to come up with cash for contributions to pension funds, and there may come a time when they will no longer be able to augment income with "actuarially assumed" investment returns that aren't occurring. Second, lower asset values may shed doubt on the billions of dollars of acquisition goodwill now present on balance sheets. Third, the prevalence of out-of-the-money options – and the negative recent experience with them – may make employees clamor for cash compensation, with negative implications for net income and cash flow. In this environment, corporations may have a lower propensity toward capital spending.

Governments at all levels also are likely to see their revenues decline. The Federal government will run deficits, (the end of which was one of the factors lifting the market in the late 1990s), and the states and cities will cut back on spending, with a retarding effect on the economy.

If both individuals and institutions have less cash to invest and less willingness to part with it, our reliance on foreign capital is likely to become clearer. But with foreign investors no longer feeling they can count on the dollar to be worth ever-increasing amounts of yen or euros, inflows of those currencies for dollar investments are less dependable. The implications for security prices and capital formation are obviously negative. And questions about our system's integrity and transparency can't help.

Beyond the fundamentals of economy and valuation, there are a vast number of psychological factors to be considered:

- Of course, cynicism prompted by corporate misdeeds tops the list. Who'll invest in the face of the corruption at "all these companies"? How many investors realize that the dishonest acts have been limited to a handful of firms? Or that there is a difference between aggressive accounting and fraud? Who'll believe even the simplest of management's statements about cash in the bank or the next quarter's earnings? (By the way, I think the recent exposure itself can be counted on to produce better corporate behavior. Already companies are scrambling to show they're clean in terms of accounting, governance, and executive compensation.)

- Certainly the belief in the inevitability of stock market profits has been dispelled. Who still believes that "stocks can be counted on to beat bonds and cash"? (Okay, nothing has changed regarding the long run, but investors have learned that living through a negative short run isn't that much fun.) And who still believes that the "efficient market" can be relied on to price stocks right? For these reasons, I think millions who were suckered into investing without the necessary expertise or awareness of risk will drop out for a while.

- Likewise, the 1999 mantra of buying on dips has been laid to rest. Those who tried it in the last 28 months have paid a high price for investing on autopilot, and they are unlikely to rise up and counter the bears' selling any time soon. Sure, stocks will rise again, but few of the burned investors are worried about missing the first ten percent.

- The leaders that people counted on to make them rich in 1998-99 are gone from the scene, and no one's likely to win investors' confidence anytime soon. Alan Greenspan's words no longer have the same soothing effect; now he's blamed for fostering too much liquidity, too great a market bubble, and then too-high interest rates. Likewise, investors have learned painfully that bullish statements from analysts and strategists precede up markets <u>and</u> down markets alike. Without "trusted advisers" they can count on, investors won't be as quick to jump aboard the next bandwagon.

- Macro fears still loom in the background, and they gain more credence when people feel less good about things. The threat of further terrorism, unending violence in the Middle East, nuclear and biological weapons in the hands of rogue states, and even Japanese-style deflation – none of these fears can be put to rest conclusively.

Of course, like almost everything else, these psychological factors have two sides. They're negatives to the extent they contribute to fear and skepticism and thus discourage buyers. But they're positives if they induce panic selling and take prices low enough to form a bottom.

Lastly, I think we all should worry about Washington. Where's the political payoff today? It lies in decrying corruption and calling for extreme reforms. The backlash against corporate malfeasance I cited in "Learning From Enron" certainly threatens to become a witch-hunt, raising great risk of tampering with a system that's essentially sound. Regardless of whether properly motivated or not, the government should not be in the business of codifying rules in areas such as accounting and compensation.

Foreseeing second-order consequences is difficult, and particularly so for politicians and regulators. Not only are they often unknowable, but also they exist in the long term, whereas people in politics are governed by short-term considerations – like getting re-elected. Capping the price of natural gas was popular, but we saw too late that it keeps people from drilling. Controlling rents seemed desirable, but no one foresaw that it would discourage landlords from building housing and renters from moving out. There's little I'm sure of, but I do believe that if the government establishes rules and procedures in areas that should be the province of the market, (a) there will be unintended consequences, and (b) the rules will be much harder to correct than they were to enact.

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I believe strongly that things will not get worse forever. We'll muddle through. Given the retarding effects of lobbyists and competing political interests, the government probably won't do anything terribly destructive. The economy will come back. Most companies will be shown to make real profits, and their securities will turn out to have value. **In other words, the financial world won't come to an end**.

As for short-term direction, no one knows which way the market's going to go, or whether the declines to date are enough to offset the negatives and make this a bottom. Do the declines to date and the economic recovery that's underway mean we're at the bottom? Or do the abject disillusionment that investors have suffered and the still-high P/E ratios mean it won't be reached for a while? The answer rests on the actions of investors in the coming weeks and months, and that truly defies prediction.

When I think about whether the brouhaha over corporate misdeeds will soon die down, I worry about the following:

- When the replacement auditors show up at each former Arthur Andersen client, they'll be bringing their fine-tooth combs. They'll have every incentive to find something wrong in the previous accounting and absolutely no incentive to say, "Everything was just fine."

- With or without suggestions from new auditors, every management team will be motivated to amend its accounting. First, they'll want to join the holier-than-thou parade. Second, they know choosing a more aggressive accounting treatment will leave them open to criticism or worse. Last, they are likely to engage in the usual deck clearing to put costs and restatements behind them, prodded, in particular, by the requirement that they certify financial statements starting in mid-August. The sum of this may result in months of additional disclosures and restatements.

- More virtuous accounting practices, including specifics like the expensing of option grants, are sure to mean lower reported profits than otherwise would have been reported. You might say investors will look beyond these numbers and perceive the lower quantity of earnings to be offset by the higher quality. I doubt it. I think the first-year shift to this new regime could make companies seem generally less profitable.

- Politicians will keep battling to show who's less tolerant of corruption. Democrats will pick on Republicans for their closeness to business, and Republicans will strive to show they're just as tough as Democrats. I think this is overwhelmingly likely to last through the November elections.

- The media will throw gasoline on the fire as always, rising up in indignation whenever they detect a sensational story. The stories are too good, the targets are too rich and attractive, and the rewards for resisting sensationalism are few and far between. Reporters who were pro-investment and pro-free market just a few years ago now see the greatest gains in calling for scalps. And I can just hear the talking heads on CNN and MSNBC saying, "I never liked the stock market anyway."

When I put it all together, I come down, as usual, on the cautious side. I'm not confident that the excesses of the bull market of 1982-1999 and the enormous tech bubble could have been corrected in just 28 months. Stocks' current swoon need not go on without end, but I see fundamental, valuation and psychological problems that will take time to fix. Maybe there'll be some lackluster years rather than a continuous collapse. It's said the investors who were burned in the excesses of the 1920s didn't return to the market until 1955 – or was it their kids?

I doubt there'll be a massive revival of the popularity of stocks any time soon, and thus I wouldn't count on a quick return to performance in line with history. **More than ever, I think non-market-derived, skill-based value added – that is, alpha, not beta – will**

hold the key to investment performance. Because owners of capital may not be able to count on a tailwind like we enjoyed in the 1980s and 1990s, managers with great skill remain the strongest hope. And in this climate, I'd rather bet on risk control than risk bearing as the route to superior results.

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