Memo to: Oaktree Clients

From: Howard Marks

Re: 2020 in Review

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The opening lines of Charles Dickens's *A Tale of Two Cities* offer a fitting coda to 2020:

> It was the best of times, it was the worst of times . . . it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair.

We're left to contemplate the jaw-dropping list of extremes compiled during this turbulent year:

- The coronavirus brought on the worst global pandemic in over a century.
- In the U.S., more than 340,000 people died from Covid-19 – 85% of the number who died in battle in the four years of World War II.
- In the second quarter, the U.S. experienced the worst quarterly drop in real GDP in 74 years of recorded quarterly history, an annualized decline of 32.9%.
- But in the third quarter, it saw the biggest annualized gain in history: 33.4%.
- Initial unemployment claims jumped from 251,000 to almost 3 million in a single week in March, crested at 6.2 million two weeks later, and remained above the pre-pandemic record of 695,000 every week for the remainder of the year.
- Through bond buying, the Federal Reserve grew its portfolio by $2.7 trillion, or roughly 55%, and the U.S. Treasury funded roughly $4 trillion in grants and loans.
- After the S&P 500 Index reached an all-time high of 3,386 on February 19, it fell 33.9% in just 32 days to 2,237 on March 23.
- But from that low, the index regained the previous high in less than five months on August 18 (an increase of 51.5%). It ended 2020 up 67.9% from the low and up 18.4% overall for the year.
- Unlike the credit crunches that accompanied many past crises, capital flowed like water. High yield bond issuance for the year was $450 billion, up 57% from 2019 and well above the prior record set in 2013. Investment grade debt issuance totaled $1.9 trillion, up a similar 58% from 2019 and also ahead of the previous record, set in 2017.
- After the Fed cut its federal funds rate target to between zero and 0.25%, bond prices rose as bond yields fell in parallel. At year-end, the average A-rated bond yielded just 1.52%, and the average yield on high yield bonds (ex. energy) was just below 4%.

So we had a health emergency, an ailing economy, the most generous capital market of all time, and strong stock and bond markets. The seemingly anomalous relationship between the pandemic and recession on one hand and the strong capital and stock markets on the other can be explained by the Fed's and the U.S. Treasury's aggressive actions.

As suggested by the above catalog of events, the buying opportunity in 2020 turned out to be very brief, especially with regard to public securities and companies with the ability to access the capital markets. Defaults affected a large dollar amount of high yield debt securities, but default rates came nowhere near the highs that had been predicted and soon began to recede. Highly motivated selling was short-lived – essentially limited to the month of March – and we never saw the full-throated panic (accompanied by margin calls, meltdowns and forced selling) witnessed in prior crises. In just a few months:

- investors grew confident about the inevitability of an economic recovery;
- optimism developed regarding the outlook for a Covid-19 vaccine;
- the near-zero fed funds rate brought down prospective returns all along the capital market line;
- risk tolerance returned, and fear of missing out took over from fear of losing money;
- asset prices rose, and the markets bounced back; and
- the exceptional buying opportunity came to what for our purposes was a premature end.

Last year's extreme, rapid-fire developments – and especially their origin in an exogenous and unforeseeable event, the virus outbreak – created great challenges for investors. To have taken maximum advantage, one would have had to have gone into late February prepared for a significant shock and then turned bullish a month later. Obviously, few investors did both.

<u>Positioning for 2021</u>

Because the market is at a possibly critical juncture and its direction is much debated these days, I'm going to spend an unusual amount of time discussing positioning going forward. Thus, you might end up feeling this memo should have been titled *Preview of 2021* rather than *2020 in Review.*

Investors often imagine there are two distinct macro environments: times when the future is clear and times when it isn't. In reality, though, these periods are all pretty much the same, since perceived clarity regarding the future often turns out to have been illusory. Most macro forecasting consists of extrapolating current levels and recent trends with minor tinkering. While predictions of "no change" are often right – as continuation is the general rule – they give rise to little in terms of profit. Only forecasts of major deviation from trend can be highly profitable. But to be so, they also must be correct, and they rarely are. That's why profitable macro forecasts (and successful forecasters) are few and far between. This negative view on forecasting is a major theme running through Oaktree's culture and the reason we don't base our investments on macro forecasts.

Most investors felt that the beginning of 2020 was a time of clarity: the economy and the stock market were both expected to continue advancing. While everyone knew they wouldn't do so forever, nothing seemed poised to make them stop. And then came the strongest exogenous shock we've ever seen – the novel coronavirus – proving once again that we never know what's going to happen (and that even though we can't predict, we should prepare – more on this later). Today's environment, in contrast, seems to be characterized by a lack of clarity. Experts are expressing highly divergent opinions regarding the outlook for U.S. markets, with strong arguments both bullish and bearish.

**Most important on the positive side of the ledger, we seem highly likely to have a healthy economy for a good while, and the Fed has telegraphed its plan for years of accommodative monetary policy to keep it that way**. The economy continues to reopen and recover from the pandemic, and this process should speed up as the vaccine rollout accelerates. President Biden's administration wants to provide unprecedented levels of financial support and stimulus, and the Democrats probably have enough control of the two houses of Congress to do so.

I'm particularly impressed by the potential for well above average consumer spending. Think about all the things you didn't spend money on in the last 12 months, such as vacations, dinners out, concerts and shows, and clothing for special occasions, and about the millions of Americans of whom the same is true. Now consider the households that made more money last year than they did the year before – starting with those who received support checks but didn't suffer job losses. This caused real personal income to grow at the fastest rate in 20 years. **Harvard economist Jason Furman estimates that the combination**

**of above-trend income and below-trend spending has created roughly $1.8 trillion of extra disposable personal income since the beginning of the pandemic**. Finally, add in the very positive wealth effect from last year's multi-trillion dollar appreciation on stocks and still more on homes.

The combination of this extra disposable income with the ending of a prolonged period of isolation and release of pent-up demand has the potential to add substantially to short-term economic growth. Many economists expect U.S. GDP to rise at a well above average rate this year, and with the early months likely to be slow, that implies big gains later in the year. Morgan Stanley, to pick one source, predicts that 4Q2021 annualized GDP will be 7.6% above 4Q2020. While the lockdown-related recession was painful, it set the stage for some very positive year-over-year comparisons in the period immediately ahead.

**The strong economy will be abetted by a Fed that has promised to keep interest rates low for years and to continue buying bonds**. The Fed will make every effort to keep monetary policy accommodative to support economic growth and job creation. It clearly demonstrated in the last year that its tools are varied and powerful, at least in the short run.

A related positive to consider is that market tops usually occur with the economy several years into the up-leg of the cycle and vulnerable to recession. This time, however, we have strong markets at the beginning of what may prove to be a long economic recovery. **The fact that we already see full asset prices so early in the recovery is a source of risk. But on the other hand, the fact that the economy is likely to grow for several years is very encouraging.**

Finally among the positives, I believe U.S. political uncertainty has declined somewhat, truncating the extreme tails of the distribution of possible events. With a center-left president and tiny Democratic majorities in both houses of Congress, I believe radical legislation is unlikely to be enacted.

Arrayed against the optimistic outlook regarding the two most important things, the economy and the fight against the pandemic, are a number of concerns. The shortest-term risk is the possibility of unimpressive first quarter GDP data. The latest severe wave of the virus, which took daily cases in the U.S. to record levels, may have slowed current economic activity (so far, the economic data are very mixed). But everyone knows this, and investors have been willing to "look across the valley" for the past eleven months and are unlikely to stop now, when strong growth is right around the corner.

**The biggest risk of all is the possibility of rising interest rates**. Rates have declined quite steadily for the last 40 years. This has been a huge tailwind for investors, since a declining-rate environment lowers the demanded returns on assets, making for higher asset prices. The linkage between falling interest rates and rising asset valuations is a good part of the reason why p/e ratios on stocks are above average and bond yields are the lowest we've ever seen (which is the same as saying bond prices are the highest).

But the downtrend in rates is over (if we can believe the Fed's assurance that it won't take nominal rates into negative territory). **Thus, while interest rates can rise from here – implying higher demanded returns on everything and thus lower asset prices – they can't decline. This creates a negatively asymmetrical proposition.**

**So today's high asset prices may be justified at today's interest rates, but that's clearly a source of vulnerability if rates were to rise.** (Note that today's 1.40% yield on the 10-year Treasury note is up from 0.52% at the low in August 2020 and from 0.93% in just the last seven weeks.)

The Fed says rates will be low for years to come, but are there limitations on its ability to make that happen? Can the Fed keep rates artificially low forever? On longer-maturity bonds? **And what about**

**inflation? Can the 10-year Treasury note still yield 1.40% if inflation reaches 3%?** Will people buy it at a negative real yield? Or will the price fall so that it yields more? Where could inflation come from? The price of goods may not rise in dollar terms, but reduced respect for the dollar (or increased quantities of dollars in circulation) could cause it to depreciate relative to the price of goods: same result.

On TV on February 7, Treasury Secretary Janet Yellen responded to a question about inflation risk posed by the proposed Covid-19 relief package with a long discourse on the importance of delivering relief to Americans who are suffering. Few would argue with that premise. She also made clear that she believes it's better to provide too much relief than too little. True as well. **But that doesn't mean (a) the more relief the better or (b) there aren't risks attached.** Experts from both sides of the political aisle have questioned whether the $1.9 trillion relief package under discussion is too much and/or misdirected; Larry Summers, a progressive economist, wrote to that effect in *The Washington Post* on February 4:

> . . . a comparison of the 2009 stimulus and what is now being proposed is instructive. In 2009, the gap between actual and estimated potential output was about $80 billion a month and increasing. The 2009 stimulus measures provided an incremental $30 billion to $40 billion a month during 2009 — an amount equal to about half the output shortfall.
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> In contrast, recent Congressional Budget Office estimates suggest that with the already enacted $900 billion package — but without any new stimulus — the gap between actual and potential output will decline from about $50 billion a month at the beginning of the year to $20 billion a month at its end. The proposed stimulus will total in the neighborhood of $150 billion a month, even before consideration of any follow-on measures. That is at least three times the size of the output shortfall.
>
> In other words, whereas the Obama stimulus was about half as large as the output shortfall, the proposed Biden stimulus is three times as large as the projected shortfall. **Relative to the size of the gap being addressed, it is six times as large. . . .**
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> Another [way of assessing the scale of a fiscal program] is to look at family income losses and compare them to benefit increases and tax credits. Wage and salary incomes are now running about $30 billion a month below pre-Covid-19 forecasts, and this gap will likely decline during 2021. Yet increased benefit payments and tax credits in 2021 with proposed stimulus measures would total about $150 billion — a ratio of 5 to 1. The ratio is likely even greater for low-income individuals and families, given the targeting of stimulus measures. . . .
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> . . . while there are enormous uncertainties, **there is a chance that macroeconomic stimulus on a scale closer to World War II levels than normal recession levels will set off inflationary pressures of a kind we have not seen in a generation, with consequences for the value of the dollar and financial stability**. (Emphasis added)

Normally one would expect such a flood of additional liquidity into the economy to cause inflation to accelerate, but the Fed says no. Of course, although central banks might like to see inflation increase (as it makes it cheaper to repay debt), they have to discourage such talk for fear of fueling inflationary expectations. On the other hand, we've had substantial deficits and accommodative monetary policy ever since 2008 and no serious inflation. We've seen a 50-year-low in the unemployment rate and yet not the inflation the Phillips Curve would have predicted. And Japan and Europe have been trying for 2% inflation for years without success. Is inflation a threat anytime soon? The answer's clear: who knows?

In addition to these major risks, there are others that – although perhaps smaller, less consequential or less imminent – should nevertheless be considered:

- Optimism regarding the economy is based on positive assumptions about vaccines being efficacious, getting into arms, and holding up over time and against new variants. My own guess is that the U.S. will reach herd immunity in the third quarter, with life thereafter moving back in the direction of pre-pandemic norms. Disappointment regarding the speed or efficacy of vaccinations could delay and complicate the rekindling of economic growth.
- The actions of the Fed and U.S. Treasury may be leading investors to aggressively pursue high returns in today's low-return world, replacing risk aversion with risk tolerance. Signs that in the past indicated excessive optimism and complacency in stock and bond markets are present today:

    - the strong performance of speculative securities and "meme" stocks;
    - heavy retail buying of stocks, options buying, and buying on margin;
    - heated bidding for bond deals, low bond yields and weak contractual protections;
    - the Buffett Indicator (the ratio of total equity market capitalization to GDP) far above its previous high; and
    - large numbers of IPOs, including IPOs by unprofitable companies, and first-day share price jumps of tens or hundreds of percent.

- Since many investors have concluded over the last 20 years that they can't achieve the returns they want or need in traditional stocks and bonds, capital has flooded into alternative assets, complicating life for investors there, too.
- The unemployment rate may not soon fall to pre-Covid-19 levels, and the secular growth of the economy could remain unimpressive.
- U.S. relations with China are likely to continue to be thorny, flaring up from time to time, and globalization – with its economic benefits for the world overall – may be weaker than in the past.
- America's social and political divides are unlikely to close anytime soon, and the country may not easily resolve questions of unequal opportunity and treatment.

The above list omits two long-term worries that may seem theoretical and far off but I think are potentially significant:

- Can the Fed really increase its balance sheet by trillions of dollars and the U.S. run annual deficits in the trillions – in 2020 and in coming years – without negative consequences, like a decline in the dollar's value? If the dollar performs poorly, will it remain the world's reserve currency and leave unchanged the U.S.'s ability to borrow unlimited amounts of money to cover deficits? And what happens if the answer to that last question proves to be "no"?
- How will we find jobs for all the people who are displaced by technology and automation and lack the skills required to participate in the information economy? What happens to parts of the country that are left out of the new economy?

**Finally, much of the worry about whether we're in a bubble relates to valuations.** For the S&P 500, for example, the current ratio of price to projected 2021 earnings is roughly 22 (depending on which earnings estimates you use). This seems expensive compared to the historic average in the range of 15-16. But knee-jerk judgments based on the relationship between current valuations and historic averages are too simplistic to be dispositive. Before making a judgment about today's valuation of the S&P 500, one must consider (a) the context in terms of interest rates, (b) the shift in its composition in favor of rapidly growing technology companies, with their higher valuations, (c) the valuations of the index's individual components, including those tech companies, and (d) the outlook for the economy. **With these factors in mind, I don't think most of today's asset valuations are crazy**. Of course, a big correction in speculative stocks could have a negative impact on today's bullish investor psychology.

In particular, as to item (a) above, we can look at the relationship between today's 4.5% earnings yield* on the S&P 500 and the yield on the 10-year Treasury note of 1.4%. The implied "equity risk premium" of 310 basis points is very much in line with the average of 300 bp over the last 20 years. Valuations can also be viewed relative to short-term interest rates. The current p/e ratio on the S&P 500 of 22 is slightly below the reading of 24 in March 2000 (the height of the tech bubble), and the fed funds rate is around zero today versus 6.5% back then. Thus, in 2000, the earning yield on the S&P 500 was 4.2%, or 230 basis points <u>below</u> the fed funds rate, while today it's 450 bp <u>above</u>. In other words, the S&P 500 is much cheaper today relative to short-term rates than it was 21 years ago.

The story is similar in the credit market. For example, the yield spread on high yield bonds versus Treasurys is below the historic range, although probably still more than adequate to offset likely credit losses. Thus, as with most other assets today, the price of high yield bonds is high in the absolute, fair-ish in relative terms, and highly reliant on interest rates staying low.

So where does that leave us? In many ways, we're back to the investment environment we faced in the years immediately prior to 2020: an uncertain world, offering the lowest prospective returns we've ever seen, with asset prices that are at least full to high, and with people engaging in pro-risk behavior in search of better returns. This suggests we should return to Oaktree's pre-Covid-19 mantra: move forward, but with caution. But a year or two ago, we were in an economic recovery that was a decade old – the longest in history. Instead, it now appears we're at the beginning of an economic up-cycle that's likely to run for years.

**Over the course of my career, there have been a handful of times when I felt the logic for calling a top (or bottom) was compelling and the probability of success was high. This isn't one of them**. There's increasing mention of a possible bubble based on concerns about valuations, federal government spending, inflation and interest rates, but I see too many positives for the answer to be black-or-white.

In the interest of moving toward a conclusion, I'm going to briefly recap the pros, cons and counter-arguments:

- The **economic outlook** is positive, although Chairman Powell warns that the recovery remains "uneven and far from complete," with inadequate job creation.
- Thus he says the Fed will keep **interest rates** low for years. But with fiscal and monetary policy extremely accommodative, rates are already on the move up and vulnerable to increased inflation.
- **Inflation** stayed low in the 2010s despite records being set in terms of duration of the economic recovery, deficits and low unemployment. However, inflation's ability to remain so is uncertain.
- The **temperature of the market** is elevated, and there are signs of euphoria and risky behavior.
- **Valuations** are high relative to history, as security prices have run ahead of economic gains. High multiples are justified by today's low interest rates but dependent on continued low rates.
- **Risk compensation** is skimpy, as seen in the premium valuations of favored companies and in historically narrow yield spreads on credit.
- **Washington** poses a risk because of one party's control and the anti-capitalist policies of its most progressive members. My hope is that the narrow majorities render radical legislation less likely.
- As to **exogenous risks**, President Biden will pursue greater harmony, but tension with China and Iran and the racial and social divisions at home continue to cloud the outlook.

* -- The earnings yield on a stock or stock index is the ratio of its earnings to its price. Thus it's the e/p ratio: the inverse of the p/e ratio, or 1 divided by the p/e ratio. A forward-looking p/e ratio of 22 equates to an earnings yield of 1 ÷ 22, or 4.5%.

**With arguments on both sides, I feel the prices of most assets are in a gray area – certainly not low, mostly on the high side of fair, but not so high as to be unreasonable.**

The bottom line is this: given current conditions, should investors be at their usual risk position, more defensive or more aggressive? **While the risk-adjusted returns of most asset classes seem to be at rough equilibrium relative to each other, all absolute returns are ultra-low, commensurate with today's equally low interest rates.** On balance, I think it's appropriate to be in one's normal stance, perhaps with a modest bias toward defense. Since the rewards for moving further out on the risk curve – such as yield spreads – aren't lavish, I have trouble seeing this as a time to aggressively chase high returns. **Moreover, the surer one is that rates will soon rise meaningfully, the more cautious one should be today.**

**Because the primary risk lies in the possibility of rising inflation and the higher interest rates that would bring, I think portfolios have to make allowances: even though we can't predict, we should prepare.** This possibility means (a) bonds with maturities much above ten years are obvious candidates for underweighting and (b) inflation beneficiaries should be considered for overweighting, including floating-rate debt, real estate capable of seeing rent increases, and the stocks of companies with the power to pass on price increases and/or the potential for rapid earnings growth.

When it comes to finding decent returns in this environment, the options are slim. Investors have plowed capital into the mainstream public "beta" markets. As a result, prospective returns have come down – fully reflecting the reduction in interest rates – and markets have become quite efficient. In most cases, price has converged with – if not run ahead of – intrinsic value. That means it's harder than ever to outperform, other than by taking on additional risk and being lucky enough to do so in an environment where such action is rewarded.

Although no markets are starved for capital these days, there may be alternative "alpha" markets where investment skill can add to returns, hopefully without a commensurate increase in overall risk. Some of this additional return is simply a premium for bearing illiquidity, and the pain suffered by some institutions during the 2008-09 crisis shows how important it is to correctly assess one's ability to live with illiquidity. And some of the return increment will come from employing managers with alpha, or the ability to add to return without a corresponding increase in risk. However, relying on positive alpha exposes investors to manager risk, or the possibility of hiring managers who turn out to have negative alpha.

**This past year challenged many preconceived notions about the economy, markets and policy – and even changed the way we live. But the inescapable truth of investing remains unchanged: there is no magic answer, no solution (other than superior skill) that will enable an investor to earn a high return safely and dependably. And that's especially true in today's low-return world.**

March 4, 2021

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