Howard Marks is Cautious

By Robert G. Kahl, CFA, CPA, MBA

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Is This Time Different?

Howard Marks is the Co-Chairman of Oaktree Capital Management, LP and has a reputation for providing some prescient commentary on the financial markets. He is known for his memos to Oaktree clients which are available to the public on his firm's website. Warren Buffett has said, "When I see memos from Howard Marks in my mail, they're the first thing I open and read."

In February 2007, Marks wrote a commentary called "The Race to the Bottom" which highlighted some of the looming financial problems resulting from a lack of prudence. He acknowledges that the real pain of the global financial crisis did not set in until September 2008, so being 19 months early "was indistinguishable from being wrong" for many.

In his latest commentary to Oakmark clients, Marks cites several examples of excess in the current investment environment. He writes that the market is being driven by: 1) optimism, 2) trust in the future, 3) faith in investments and investment managers, 4) a low level of skepticism, and 5) risk tolerance, not risk aversion. He summarizes by writing that "attributes like these don't make for a positive climate for returns and safety."

Debt Levels and Credit Quality

Since the Fed and other central banks started engaging in their "quantitative easing" programs to suppress interest rates, there have been increases in debt levels across the globe. This has been accompanied by lower lending standards. Marks cites many indications of excess in the credit markets in his commentary but here are a few of them below. For the sake of brevity, I have not included the sources that he cites.

- Between 2007 and 2017, the ratio of global debt to GDP increased from 179% to 217%.
- The total amount of dollar-based loans worldwide has jumped from $5.8 trillion in the first quarter of 2009 to $11.4 trillion today. Of that, $3.7 trillion has gone to emerging markets, more than doubling in that period.
- Congress passed a tax cut and spending increases that represent the largest stimulus to the economy outside of a recession since the 1960s. Federal debt, already the highest relative to GDP since the 1940s is on a steep trajectory and stimulates an economy that is already at or above full employment.
- Total leveraged debt outstanding (high yield bonds and leveraged loans) in the US is now $2.5 trillion, double the amount of 2007.

- From 2005 to 2015, the oil fracking industry increased it net debt by 300 percent even though, according to Jim Chanos, from mid-2012 to mid-2017 the 60 biggest fracking firms had negative cash flow of $9 billion per quarter.
- Student debt has more than doubled since the 2008-2009 financial crisis to $1.5 trillion and the delinquency rate has risen from 7.5% to 11%.
- $375 billion of covenant-lite loans were issued in 2017 (75% of total leveraged loan issuance), up from $97 billion in 2007. The purpose of loan covenants is to limit actions by borrowers which are likely to weaken their financial position. Covenant-lite loans have fewer restrictions than more traditional loans or bonds.
- BBB-rated bonds (the lowest investment grade category) now stand at $1.4 trillion in the US and constitute the largest component of the investment grade universe - roughly 47% in both the US and Europe, up from 35% and 19%, respectively, ten years ago.
- BB-rated high yield bonds are now coming to market with loose covenants.
- The amount of CCC-rated debt outstanding currently stands 65% above the record set in the last cycle.

History Rhymes

Howard Marks recycles some of the closing comments that he wrote in February 2007 in "Race to the Bottom," writing that after eleven years, he can't improve on it.

> Today's financial markets are easily summed up: There's a global glut of liquidity, minimal interest in traditional investments, little apparent concern about risk, and skimpy prospective returns everywhere. Thus, as the price for accessing returns that are potentially adequate (but lower than those promised in the past), investors are readily accepting significant risk in the form of heightened leverage, untested derivatives and weak deal structures....
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> This memo can be recapped simply: there's a race to the bottom going on, reflecting a widespread reduction in the level of prudence on the part of investors and capital providers. No one can prove at this point that those who participate will be punished, or that their long-run performance won't exceed that of the naysayers. But that is the usual pattern.

Marks is not a big advocate of cash. He describes Oaktree's current mantra as "move forward, but with caution." His advice at this point is that "investors should favor strategies, managers, and approaches that emphasize limiting losses in declines above ensuring full participation in gains. You simply can't have it both ways."

Client portfolios are currently positioned to minimize credit risk, have low exposure to higher interest rates, limited exposure to equities (due to high valuations, aggressive corporate finance strategies, and rising interest rates), and some exposure to precious metals (that few US investors will own now).

Update on the US Dollar's Status as the Reserve Currency

Investors who believe that the reserve currency status of the US dollar will never change should consider the events of September 24 at the UN General Assembly. Russia, China, the UK, Germany, France, and the European Union agreed to create a special purpose vehicle (SPV), a "financially independent sovereign channel" to bypass US sanctions against Iran. The countries are still working out the technical details, but the SPV will facilitate payments related to Iran's exports and imports.

US sanctions against Iran that could severely reduce oil exports are scheduled to take effect on November 5 and Iran has warned the EU that it should find new ways of trading prior to that date. All payments will be made in currencies other than the US dollar. In August, the EU also passed a blocking statute to empower EU firms to seek compensation from the US Treasury for its attempts to impose extra-territorial sanctions.

Efforts by the US to impose sanctions on other countries have continued to force those countries to develop alternative payment systems and use alternative currencies. This is one of several reasons to hold precious metals at this time.

If you have any questions or comments, please contact me.

Sincerely,
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