Memo to: Oaktree Clients

From: Howard Marks

Re: Easy Money

The backstory: I began writing these memos in 1990 and continued to do so for ten years despite never receiving a single response. Then, on the first business day of 2000, I published bubble.com, a memo with warnings about excesses in the tech sector that turned out to be timely. The inspiration for the memo came from a book I'd read the preceding autumn: Devil Take the Hindmost: A History of Financial Speculation, by Edward Chancellor, an account of speculative excesses starting with the South Sea Bubble of the early 1700s. The book's description of behavior surrounding the mania for the South Sea Company jibed with what I was seeing in the tech/media/telecom bubble that was underway. I received excellent feedback on the memo from clients – encouragement that prompted the many memos that have followed.

I consider it highly coincidental that 24 years later, I devoted another autumn to reading another Chancellor book, The Price of Time: The Real Story of Interest, his history of interest rates and central bank behavior. I thank Zach Kessler, a regular memo reader, for sending it. The relevance of The Price of Time to the trends I've been discussing for the last year occasions this memo.

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In December 2022, I published *Sea Change*, a memo that primarily discussed the 13-year period from the end of 2008, when the U.S. Federal Reserve cut the fed funds rate to zero to counter the effects of the Global Financial Crisis, to the end of 2021, when the Fed abandoned the idea that inflation was transitory and readied what turned out to be a rapid-fire succession of interest rate increases. The memo concentrated on the impact that this lengthy period of unusually low interest rates had on the economy, the financial markets, and investment outcomes. I followed this up with the memo *Further Thoughts on Sea Change*, which Oaktree released to clients in May 2023 and to the public in October. In the latter memo and subsequent conversations with clients, I've emphasized the significant impact of low interest rates on the behavior of participants in the economy and the markets.

Easy Times

In *Sea Change*, I likened the effect of low interest rates to the moving walkway at the airport. If you walk while on it, you move ahead faster than you would on solid ground. But you mustn't attribute this rapid pace to your physical fitness and overlook the contribution from the walkway.

In much the same way, declining and ultra-low interest rates had a huge but underrated influence on the period in question. They made it:

- easy to run a business, with the stimulated economy growing unabated for more than a decade;
- easy for investors to enjoy asset appreciation;

- easy and cheap to lever investments;
- easy and cheap for businesses to obtain financing; and
- easy to avoid default and bankruptcy.

In short, these were easy times, fueled by easy money. Like travelers on the moving walkway, it was easy for businesspeople and investors to think they were doing a great job all on their own. In particular, market participants got a lot of help in this period as they rode the 10-year-plus bull market, the longest in U.S. history. Many disregarded the benefits that ensued from low interest rates. But as one of the oldest investment adages says, we should never confuse brains with a bull market.

As I've continued to think and talk about the switch from declining and/or ultra-low interest rates to more normal, stable ones, I've emphasized the fact that low rates alter investor behavior, distorting it in ways that have serious consequences.

Thinking about the change in interest rates sensitized me to media mentions of low rates, and I've noticed many. This was particularly true following Silicon Valley Bank's meltdown last March, which many articles attributed to faulty managerial decisions made "during the preceding period of easy money." More recently, there's been much discussion of the less-favorable outlook for private equity, usually related to expectations that interest rates aren't going to return to the low levels of the recent past.

The effects of low interest rates are multi-faceted and ubiquitous, yet frequently overlooked. I became more conscious of them as I read *The Price of Time*, and I want to catalog them here:

i. <u>Low interest rates stimulate the economy</u>

Everyone knows that when central banks want to stimulate their countries' economies, they cut interest rates. Lower rates reduce costs for businesses and put money into the hands of consumers. For example, since most people buy cars on credit or lease them, lower interest rates make cars more affordable, increasing demand. The result is typically good for automakers, their suppliers, and their workers, and thus for the economy in general.

It's important to realize that easy money keeps the economy aloft, at least temporarily. **But low interest rates can make the economy grow too fast, bringing on higher inflation and increasing the probability that rates will have to be raised to fight it, discouraging further economic activity.** This oscillation of interest rates between extremes can have effects and encourage behavior that natural/neutral rates (see p. 13) would be less likely to induce.

ii. <u>Low interest rates reduce perceived opportunity costs</u>

Opportunity cost is a major consideration in most financial decisions. But in low-interest-rate environments, the rate earned on cash balances is minimal. Thus, you don't forgo much interest by withdrawing money from the bank to buy a house or boat (or make an investment), which makes doing so seem painless. For example, if someone's thinking about taking $1 million out of savings for a purchase at a time when savings accounts pay 5% interest, they're likely to understand that doing so will cost them $50,000 per year in forgone income. **But when the rate is zero, there is no opportunity cost. This makes the transaction more likely to occur.**

iii. <u>Low interest rates lift asset prices</u>

In finance theory, the value of an asset is defined as the discounted present value of its future cash flows. We discount future cash flows when calculating present value because we must wait to receive them, so they're less valuable than cash flows received today. The lower the rate at which future cash flows are discounted, the higher the present value, as investors have noted for centuries:

> In the [18th] century, Adam Smith described how the price of land depended on the market rate of interest. In *The Wealth of Nations* (published in 1776) Smith noted that land prices had risen in recent decades, as interest rates declined. (*The Price of Time, or "TPOT"*)
>
> By placing too low a discount on the future earnings of companies, investors [in the 1920s] ended up paying too much. (*TPOT*)

In real life, investments are evaluated primarily on a relative basis. The return demanded on each investment is largely a function of the prospective returns on other investments and differences in these investments' respective levels of risk. **Low interest rates lower the "relative bar," making the higher returns offered on riskier assets appear relatively attractive even if they're low in the absolute.**

In this vein, *The Price of Time* describes the thought process that made "iffy" loans to the government of Argentina acceptable in the low-rate environment of the late 1880s:

> Buenos Aires "took advantage of the low rate of interest and the abundance of money in Europe to contract as many loans as possible, new loans often being made in order to pay the interest on former ones." Some Argentine loans paid as little as 5 percent – **low in absolute terms or relative to their risk but still a couple of points above the measly yield on [consols, or perpetual British government debt]** . . . (*TPOT*, emphasis added)

When bond yields decline, bonds present less competition for riskier assets. Thus, low yields on bonds lead to lower demanded returns – and higher valuations – on other asset classes, such as equities, real estate, and private equity. **For these reasons, low interest rates lead to asset inflation and sometimes asset bubbles like those we saw in late 2020 and throughout 2021.**

iv. <u>Low interest rates encourage risk taking, leading to potentially unwise investments</u>

Low interest rates create a "low-return world" marked by paltry prospective returns on safe investments. At the same time, investors' required returns or desired returns typically don't decline (or they decline by much less), meaning investors face a shortfall. **The ultra-low returns on safe assets cause some investors to take additional risks to access higher returns. Thus, these investors become what my late father-in-law called "handcuff volunteers" – they move further out on the risk curve not because they want to, but because they believe it's the only way to achieve the returns they seek.**

In this way, capital moves out of low-return, safe assets and in the direction of riskier opportunities, resulting in strong demand for the latter and rising asset prices. Riskier investments perform well for a while under these conditions, encouraging further risk taking and speculation:

> In his 1844 book *On the Regulation of Currencies* [banker John Fullarton] observed that at times of low interest, "everything in the nature of value puts on an aspect of bloated magnitude," and every article becomes an object of

> speculation. Long periods of easy money, wrote Fullarton, engender "a wild spirit of speculation and adventure." Fullarton noted that financial euphoria occurred after a period of falling interest rates: "From the Bubble year [i.e., the South Sea Bubble of 1720] downwards, I question much if an instance could be shown of any great or concurrent speculative movement on the part of capitalists, which had not been preceded by a marked decline of the current rate of interest." (*TPOT*)

The risk-free rate is the point of origin, or jumping-off point, for returns and risk premia. When a central bank cuts the risk-free rate:

- the rest of the yield curve usually follows;
- the capital market line governing asset-class returns also shifts downward, especially if the desire for higher returns in the low-return environment causes riskier investments to be aggressively pursued as described above;
- in addition to moving lower, the capital market line also can flatten, reducing risk premia, if investors are paying little heed to fundamental/credit risk; and
- the liquidity premium – the increment in expected return for owning illiquid rather than readily saleable assets – can also shrink, as return-seeking investors embrace illiquid investments.

In all these ways, the return increments associated with longer-term, riskier, or less-liquid assets can become inadequate to fully compensate for the increase in risk. Nevertheless, the low prospective returns on safe securities cause investors to look past these factors and lower their standards, encouraging speculation and causing questionable investments to be made in pursuit of higher returns:

> For [Austrian-school economist Friedrich] Hayek, it was axiomatic, but all too often overlooked, that "all economic activity is carried out through time." When interest rates decline, he said, businesses are inclined to invest in projects with more distant payoffs – in Hayek's terminology, the "structure of production" lengthens. If interest rates are kept below their natural level [see p. 13], misguided investments occur: too much time is used in production, or, put another way, the investment returns don't justify the initial outlay. **"Malinvestment", to use a term popularized by Austrian economists, comes in many shapes and sizes. It might involve some expensive white-elephant project, such as constructing a tunnel under the sea, or a pie-in-the-sky technology scheme with no serious prospect of ever turning a profit.** (*TPOT*, emphasis added; the quotation is from 1928)

I'll provide a few examples of imprudent investments made during the recent easy money period:

- In the low-return environment of 2017, Argentina once again became the poster child for questionable investment opportunities, when it offered 100-year bonds. As I asked at the time in my memo *There They Go Again . . . Again* (July 2017), "Is Argentina, a country that defaulted five times in the last hundred years (and once in the last five), likely to get through the next hundred without a rerun?" Argentina's checkered history as a borrower was ignored in the low-return environment, and the bonds were oversubscribed thanks to their having a yield of 7.85% at a time when 30-year Treasurys offered only 2.77%. It took less than a year for Argentina to request a loan from the International Monetary

Fund and less than three years for it to default on the bonds. When the 100-year bonds were restructured in 2020, holders received new bonds with an expected recovery value of roughly 54.5 cents on the dollar, according to *The Wall Street Journal* of August 31, 2020. Aptly, that same *Journal* article quoted Piotr Matys of Rabobank Group NV, as saying, **"Treasury yields are so low, it's forcing investors into risk. That's why people are buying crazy stuff."**

- In the 2010s, investors eagerly snapped up leveraged buyout loans bearing historically low yields of around 6%. The buyers included CLOs, which are structured to give relatively high yields to the investors in their lower-rated tranches, as well as private credit lenders that levered up the prospective returns to roughly 9%.
- While "zombie" companies that burn cash haven't historically been considered creditworthy, many were able to borrow easily in the pro-risk times through 2021. But as financial conditions have tightened, these companies have seen their cost to borrow rise and/or the amounts they can borrow shrink.
- The craving for good returns in low-return times can enable scams. Theranos (the medical technology company) and FTX (the cryptocurrency exchange) were the most prominent examples in recent years. Such scandals are less likely to happen in times of economic and capital market stringency, when investors are less eager and more careful.

Under easy-money conditions, long-dated bonds may appear particularly desirable; since the yield curve usually slopes upward, they typically offer higher yields. It should be noted, however, that long bonds are more rate-sensitive than short ones, meaning their prices change more in response to a given change in interest rates. As a result, the higher yields on more-volatile long bonds can attract capital in times of low rates, just when the odds usually favor a subsequent increase in yields (and thus a rapid decline in long bond prices).

It seems to me that there's often a similar movement of capital toward "long stocks" when interest rates are low. By this I mean the stocks of companies believed to have many years of rapid growth ahead. For these companies, more of the projected cash flows are, by definition, in the distant future. Yet, investors may become more attracted to these stocks when rates are low because they want the higher returns that such rapid growth would bring, and there's less opportunity cost associated with the long wait for the relevant cash flows. (These sound like Hayek's "projects with more distant payoffs." See the quote on the previous page.) Just as the prices of longer bonds fluctuate more in response to a given change in interest rates, so-called "growth stocks" usually rise more than others in times of easy money and fall more when money dries up. The former was certainly the case in late 2020 and in 2021 . . . and the latter in 2022.

I love Hayek's word "malinvestment," because of the validity of the idea behind it: in low-return times, investments are made that shouldn't be made; buildings are built that shouldn't be built; and risks are borne that shouldn't be borne. People with money feel they must put it to work, since cash yields little or nothing. They drop their risk aversion and, as discussed below, compete spiritedly for lending or investing opportunities with higher potential returns. **The investment process becomes all about flexibility and aggressiveness, rather than thorough diligence, high standards, and appropriate risk aversion.**

Skimpy return prospects on safe assets lead to elevated risk taking – sometimes abetted by widespread optimism and/or the suspension of disbelief – and thus to the approval of investments that would likely be greeted with skepticism in normal times. Many of the risky assets people invest in out of presumed necessity are deemed less palatable and less valuable under tougher market conditions, when they can only be sold at lower prices.

v. Low rates enable deals to be financed readily and cheaply

Related to the above, low rates make people more willing to lend for risky propositions. Providers of capital vie to be the one who gets the deal. To compete for deals, the "winner" must be willing to accept low returns from possibly questionable projects and reduced safety, including weaker documentation. **For this reason, it's often said that "the worst of loans are made at the best of times."**

The availability of capital fluctuates radically. Whereas in times of stringency, capital may not be available even to quality borrowers for valid purposes, in periods of easy money, capital typically becomes available to weaker borrowers, in large amounts, for almost any purpose. Things that couldn't be financed in tighter times are deemed acceptable.

For one example, consider the shifting perception of high-tech companies. Prior to roughly 2005, they were usually considered too undependable to be creditworthy, since outcomes for tech investments are generally asymmetric. If the company succeeds, the equity owners get rich. If it fails, there's little asset value for creditors to recover. But in the years following the tech/media/telecom meltdown of 2000-02, when interest in public equities declined and large sums flooded into private equity funds, tech companies began to be bought out, often with financing from the newly popular field of private credit.

vi. Low interest rates encourage greater use of leverage, increasing fragility

Borrowed money – leverage – is the mother's milk of rapid expansion and speculation. In my memo *It's All Good* (July 2007), I compared leverage to ketchup: "I was a picky eater when I was a kid, but I loved ketchup, and my pickiness could be overcome with ketchup." Ketchup got me to eat food I otherwise would have considered inedible. In much the same way, leverage can make otherwise unattractive investments investible. Let's say you're offered a low-rated loan yielding 6%. "No way," you say, "I'd never buy a security that risky at such a low yield." But what if you're told you can borrow the money to buy it at 4%? "Oh, that's a different story. I'll take all I can get." But it must be noted that cheap leverage doesn't make investments better; it merely amplifies the results.

In times of low interest rates, absolute prospective returns are low and leverage is cheap. Why not use a lot of leverage to increase expected returns? In the late 2010s, money flowed to both private equity, given its emphasis on leveraged returns from company ownership, and private credit, which primarily provides debt capital to private equity deals. These trends complemented each other and led to a significant upswing in levered investing.

But in the last decade, some companies acquired by private equity funds were saddled with capital structures that failed to anticipate the increase in interest rates of 400-500 basis-points. Having to pay interest at higher rates has reduced these companies' cash flows and interest coverage ratios. Thus, companies that took on as much debt as possible – based on their former levels of earnings and the prevailing low interest rates – may now be unable to service their debt or roll it over in a higher-rate environment.

Finally, all else being equal, the more leverage that's piled on a company, the lower the probability it'll be able to survive a rough patch. This is one of the foremost reasons for the adage "never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average." Heavy leverage can render companies fragile and make it hard for them to get through the proverbial low spots in the stream. Take, for example, Signa, a large privately owned property company in Europe, which announced in November of last year that it was beginning insolvency proceedings:

> **The decision to go all-out during the era of cheap money left Signa dangerously exposed to the sharp rise of interest rates this year. . . .** And rising interest rates have hammered commercial property values across the market, reducing the value of the assets used to secure Signa's loans. (*FT Asset Management Newsletter*, December 11, 2023, emphasis added)

vii. <u>Low interest rates can lead to financial mismatches</u>

Easy-money episodes make it particularly attractive to borrow short at low rates in order to make long-term investments or loans with higher prospective returns. This is the other classic reason why, in the investment world, proverbial six-footers often drown. (Investors with liability maturities that match the duration of their assets make it across the river much more regularly.) In tougher times, if lenders demand their money back or decline to roll over existing debt when it comes due, debtors can find themselves holding discounted or illiquid assets – just when cash is needed. This is a familiar theme that frequently marks the turn of the cycle from benign to nasty. Chancellor provides an example from 1866 in connection with the failure of Overend Gurney, a London broker:

> Lending against long dated and illiquid collateral was not a suitable business for Overend, which normally discounted three-month commercial paper financed with daily cash calls on the money market. *The Times* [*of London*] described how Overend had erred:
>
> > A Discount Company which had forsaken the business of discount brokers for that of "financing", which had locked up its assets in securities promising to repay a high rate of interest, but incapable of conversion into cash on an emergency, had found its resources too limited to meet the calls upon them except at a ruinous sacrifice of its property, and had, therefore, suspended payment. (*TPOT*)

viii. <u>Low interest rates give rise to expectations of continued low rates</u>

It's common for people to conclude that the environment they've lived through for a while is "normal," and that the future will entail more of the same. For this reason, people who have gotten used to low interest rates may think rates will always be low and make decisions based on that assumption. **As a result, investor due diligence or corporate planning may assume that the cost of capital will remain low. This can become a source of trouble if rates are higher when financing is actually sought.**

For example, in recent months, I've noted a number of lots in midtown Manhattan that have been cleared for the construction of new buildings. Given the lengthy planning and approval process involved with such projects, these buildings were undoubtedly greenlit in the low-interest-rate environment that preceded 2022. Will they be built if the actual financing costs are higher than those that were assumed? Or will they be abandoned at significant cost?

When the pandemic year of 2020 came to a close, the recovering economy, rallying stock market, and low interest rates put investors in a good mood, and there was widespread belief that the Fed would keep rates "lower for longer," supporting the economy and stock market for years to come.

However, investors learned a lesson that has been repeated throughout financial history: catalysts for interest rate increases inevitably pop up, and thus perpetual prosperity and "the end of cycles" turn out to be nothing but wishful thinking. Consider another example from Chancellor:

> One of the aims of U.S. monetary policy in the 1920s was to dampen the seasonal fluctuations of interest rates caused by the agricultural cycle, which led to money being tight at certain times of the year. The Fed was so successful at this that Treasury Secretary Andrew Mellon went so far as to hail an end to the cycle of boom and bust. "We are no longer the victim of the vagaries of business cycles. . . . As economist Perry Mehring writes [in *The New Lombard Street*]: **"Intervention to stabilize seasonal and cyclical fluctuations produced low and stable money rates of interest, which supported the investment boom that fueled the Roaring Twenties but also produced an unstable asset price bubble."** (*TPOT,* emphasis added)

ix. <u>Low interest rates bestow benefits and penalties, creating winners and losers</u>

Importantly, low interest rates subsidize borrowers at the expense of savers and lenders. Does it make sense to reduce the revenues of lenders so that investors can lever their investments cheaply?

> [In the mid-17th century,] Thomas Manley added that lowering the rate of interest would involve robbing Peter (the creditor) to pay Paul (the borrower). (*TPOT*)

Doing so is a policy decision, or more likely the consequence of a decision to stimulate the economy. But it can have many other effects.

When the rate of interest on savings is 4%, a retiree fortunate enough to have saved up $500,000 will earn $20,000 per year on her bank balance. But when the interest rate on a savings account is near zero, as we saw for much of the last 14 years, she gets essentially nothing. Is it good for society to make her settle for zero? Or would it be better if she put the money into the stock market in an effort to make more?

While discussing the ramifications of policy decisions, let's consider the impact of low rates on the distribution of income and wealth.

> **. . . because assets like stocks and real estate are disproportionately held by the rich, ZIRP [the "zero interest-rate policy" that was introduced in December 2008] helped produce the largest spike in wealth inequality in postwar American history.** From 2007 to 2019, . . . the wealthiest 1 percent of Americans saw their net worth increase by 46 percent, while the bottom half saw only an 8 percent increase. A report from McKinsey Global Institute, not exactly known as a bastion of economic populism, calculated that from 2007 to 2012, the Fed's policies created a benefit for corporate borrowers worth about $310 billion, whereas households that tried to save money were penalized by about $360 billion. (*The Atlantic*, December 11, 2023, emphasis added)

The yawning economic gap is one of the biggest problems the U.S. faces, and it's probably responsible for a fair bit of the extreme divisiveness we see every day in the media and in

politics. A central bank's decision to set rates that subsidize some and penalize others clearly has consequences.

x. Low rates induce optimistic behavior that lays the groundwork for the next crisis

Elevated risk taking, underestimating future financing costs, and increased use of leverage often lie behind investments that fail when tested in subsequent periods of stringency, bringing on the next crisis and perhaps the need for the next rescue. In this way, excesses in one direction typically precede excesses in the other direction.

> In October 1889, the Governor of the Bank of England, William Lidderdale, delivered a stern warning to the City:
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> > The present tendency of finance . . . is distinctly in the direction of danger, too much capital is being forced into industrial developments, financiers are taking larger & larger risks in securities which require prosperity & easy money to carry without becoming a burden, & an increased number of investments have been driven up in price by the combined efforts of a long period of cheap money & depression in trade . . . we have most of the elements of a Crisis. (*TPOT*)

The Never-Ending Story

One of the quotes I return to most frequently is Mark Twain's purported observation that "history doesn't repeat itself, but it often rhymes." **For investors, cycles, along with their causes and effects, are among the influential matters that invariably rhyme from one period to the next.**

Roughly 30 years ago – largely thanks to my involvement with my partner Bruce Karsh and his distressed debt funds – I became much more conscious of the importance of fluctuations in the availability and cost of money. Thus, I wrote as follows in my memo *You Can't Predict. You Can Prepare.* (November 2002):

> The longer I'm involved in investing, the more impressed I am by the power of the credit cycle. It takes only a small fluctuation in the economy to produce a large fluctuation in the availability of credit, with great impact on asset prices and back on the economy itself.

I reused that paragraph in my 2018 book *Mastering the Market Cycle: Getting the Odds on Your Side*, adding this:

> . . . the credit cycle can be easily understood through the metaphor of a window. In short, sometimes it's open and sometimes it's closed. And, in fact, people in the financial world make frequent reference to just that: "the credit window," as in "the place you go to borrow money." When the window is open, financing is plentiful and easily obtained, and when it's closed, financing is scarce and hard to get. . . .

In the book I made three foundational observations about cycles in general:

- **The events that make up each cyclical progression don't merely follow each other. Much more importantly, each event in the progression is caused by those that went before.** This causality must be appreciated if one is to fully understand cycles and navigate them successfully.
- Cyclical oscillation isn't best thought of as consisting merely of "ups and downs," but rather as (a) an excessive departure from the midpoint, secular trend or norm in one direction, and (b) a correction of that excess, which often ends up in (c) an excessive continuation of the correction in the opposite direction. **"Excesses and corrections" is a much more useful way to think about cycles than "ups and downs."**
- Cycles don't have an obvious beginning and end. The only requirement for something to correctly be considered a full cycle is that it must include four components: (1) a movement from a norm to a high, (2) a move away from that high back toward the norm, (3) a move from the norm to a corresponding low, and (4) a movement from that low back toward the norm. **Any of these can be labeled the start of a cycle, providing it goes on to include all four.**

While there's no fixed point that represents the official start or end of a cycle, most economic cycles can be described as follows. Notably, each step in the cycle causes the next.

- **First, stimulative rate cuts bring on easy money and positive market developments;**
- **which reduce prospective returns;**
- **which leads to willingness to bear increased risk;**
- **which results in unwise decisions and, eventually, investment losses;**
- **which bring on a period of fear, stringency, tight money, and economic contraction;**
- **which leads to stimulative rate cuts, easy money, and positive market developments.**

Here's an especially trenchant observation on the cyclical process:

> The Manchester banker John Mills commented perceptively [in 1865] that **"as a rule, panics do not destroy capital; they merely reveal the extent to which it has previously been destroyed by its betrayal into hopelessly unproductive works."** (*TPOT,* emphasis added)

As readers know, I believe investors can gain an advantage by studying cycles, understanding their causes, and watching for excesses in one direction that are likely to lead to corrections in the opposite direction. Walter Bagehot, the editor of *The Economist* in the 1860s, is described as having demonstrated an exceptional understanding of cycles and cycle-related behavior:

> . . . our modern monetary mandarins never stop to consider Bagehot's warnings about the adverse consequences of easy money – how interest rates set at 2 per cent or less fuel speculative manias, drive savers to make risky investments, encourage bad lending and weaken the financial system. (*TPOT*)

What I so enjoy about Chancellor's books is the way they illustrate the tendency of financial history themes to rhyme, as Twain would say, and thus how behavior that took place 200 or 400 years ago is being repeated today and is sure to reappear again and again in the future. What he tells is a never-ending story.

Easy Money Observed

The behavior brought on by low rates takes place in plain sight. Some people take note of it, and a subset of them talk about it rather than let it pass unremarked. Fewer still understand its real implications. **And almost no one alters their investment approach to take them into account.**

The low-rate period that immediately preceded the Global Financial Crisis of 2008-09 was marked by the kind of spirited competition to make investments and provide financing described above. It was in this climate that Chuck Prince, then CEO of Citi, made the statement for which he is remembered:

> When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. (July 14, 2007)

When money is easy, few people opt to sit out the dance, even though the adverse results described above can reasonably be anticipated. When faced with the choice between (a) maintaining high standards and missing deals and (b) making risky investments, most people will choose the latter. Professional investment managers especially may fear the consequences of idiosyncratic behavior that's bound to look wrong for a while. **Abstaining demands uncommon strength when doing so means departing from herd behavior.**

And this gives me a great opportunity to reference one of my favorite quotations from John Kenneth Galbraith's wonderful book on market excesses:

> Contributing to and supporting this euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. . . . There can be few fields of human endeavor in which history counts for so little as in the world of finance. (*A Short History of Financial Euphoria*)

The lessons from past periods of easy money usually fall on deaf ears since they come up against (a) ignorance of history, (b) the dream of profit, (c) the fear of missing out, and (d) the ability of cognitive dissonance to make people dismiss information that is inconsistent with their beliefs or perceived self-interest. These things are invariably enough to discourage prudence in times of low interest rates, despite the likely consequences.

As you no doubt know, Charlie Munger passed away on November 28 at the age of 99. I want to pay a small tribute to Charlie's life and wisdom by sharing something he wrote me in 2001: "Maybe we have a new version of Lord Acton's law: easy money corrupts, and really easy money corrupts absolutely."

Will We Go Back to Easy Money?

Before I turn to the above question, I want to answer the one I'm asked most often these days: "Are you saying interest rates are going to be higher for longer?" My answer is that today's rates aren't high. They're higher than we've seen in 20 years, but they're not high in the absolute or relative to history. Rather, I consider them normal or even on the low side.

- In 1969, the year I started work, the fed funds rate averaged 8.2%.
- Over the next 20 years, it ranged from 4% to 20%. Given this range, I certainly wouldn't describe 5.25-5.50% as high.

- Between 1990 and 2000, which I would consider the last roughly normal period for rates, the fed funds rate ranged from 3% to 8%, suggesting a median equal to today's 5.25-5.50%.

So no, today's interest rates aren't high. Having disposed of that question, I'll move to the subject of this section: the outlook for rates.

Many of my reasons for believing we're not going back to ultra-low rates are rooted in my thoughts on how the Fed should think about the issue. But the Fed could decide to lower rates to stimulate economic growth or reduce the cost of servicing the national debt, even if doing so might be deemed imprudent. Thus, I have no idea what the Fed will do. But I'm sticking with the thinking that follows.

In my original *Sea Change* memo, I listed a number of reasons why we weren't likely to go back to ultra-low interest rates anytime soon. The most salient are these:

- Globalization has been a strong disinflationary influence, and it's likely on the decline. For this reason – and because the bargaining power of labor seems to be on the rise – I believe inflation may tend to be higher in the near future than it was pre-2021. If true, this will, all else being equal, mean interest rates will be kept higher to prevent inflation from accelerating.
- Rather than be in a perpetually stimulative posture, the Fed may want to maintain the neutral rate most of the time. This rate, which is neither stimulative nor restrictive, has most recently been estimated to be 2.5%.
- The Fed might want to get out of the business of controlling rates and let supply and demand set the price of money, which hasn't been the case for a quarter century.
- Having had a taste of inflation for the first time in decades, the Fed might keep the fed funds rate high enough to avoid encouraging another bout. To control inflation, one would think the rate would need to be kept positive in real terms. If inflation will be, say, 2.5%, the fed funds rate would by definition have to be above that.
- **Perhaps most importantly, one of the Fed's essential jobs is to enact stimulative monetary policy if the economy falls into recession, largely by cutting rates. It can't do that effectively if the rate is already zero or 1%.**

To this list, I would add a few more reasons for not returning to ultra-low interest rates, including the tendency of easy money to (a) induce risk taking and "malinvestment"; (b) encourage increased use of leverage; (c) produce asset bubbles; and (d) create economic winners and losers. **Finally, cutting rates to stimulative territory as soon as inflation hits 2% could cause it to reaccelerate. Instead, the plan should be to get inflation to 2% and then keep rates at a level that is neither stimulative nor restrictive.**

After listing the above bulleted arguments against renewed low rates, I went on in *Sea Change* to say the following (despite my strong aversion to predictions):

> **These are the reasons why I believe that the base interest rate over the next several years is more likely to average 2-4% (i.e., not far from where it is now) than 0-2%.** Of course, there are counterarguments. But, for me, the bottom line is that highly stimulative rates are likely not in the cards for the next several years, barring a serious recession from which we need rescuing . . .

Most people – other than lenders and savers – want low interest rates: people (and businesses) with floating-rate mortgages and other debt, consumers in general, homebuilders, car and boat dealers, private equity firms and their LPs, investors using leverage, and the people charged with paying the interest on our national debt. **But when you consider the reasons for not keeping rates permanently low, as enumerated above, I think the economic merits favor setting rates low only as an emergency measure to rescue the economy from prolonged or severe contractions.**

When I attended graduate school at the University of Chicago, the leading intellectual light was economist Milton Friedman, who argued strenuously that the free market is the best allocator of resources. In this same vein, I'm convinced that so-called "natural" interest rates lead to the best overall allocation of capital. **This is why I so like Chancellor's decision to title his book *The Price of Time*. That's what interest rates are: the price borrowers pay to rent lenders' money for a period of time.** Natural rates reflect supply and demand for money, and they're found at the intersection of (a) the price suppliers of money ask for parting with it temporarily and (b) the price borrowers are willing to pay to use it. Like Chancellor, I think it's clearly best when interest rates are naturally occurring.

> A consensus emerged among [17th-century] English practitioners of "political arithmetick" that interest – defined by one writer as "a Reward for forbearing the use of your own Money for a Term of Time agreed upon" – was much like any other price, whose level should be determined by buyers and sellers in the market, rather than government fiat. (*TPOT*)

> Even though it cannot be known with certainty, it is useful to hold in mind how the world would look if the natural rate held sway; . . . a rate that accurately reflects society's time preference; which ensures that we neither borrow too much nor save too little; which ensures capital is used efficiently, and puts an accurate value on land and other assets; a rate which provides savers with a fair return and is not so low as to subsidize bankers and their financial friends, nor so high as to bite borrowers. (*TPOT*)

Or as the central bank head of Germany said in 1927, a time when his counterparts in the U.S. and Great Britain were arguing for easy money, **"Don't give me a low rate, give me a true rate, and then I shall know how to keep my house in order."** (*TPOT*)

Natural rates seem to me to be related to but not quite the same thing as "neutral rates," which are rates that are neither stimulative nor restrictive. Neutral rates are less likely than administered rates to be super-high or super-low, and thus less likely to encourage extreme behavior. As Swedish economist Knut Wicksell said in 1936:

> . . . if the rate of interest was too low, credit would expand rapidly, and inflation would appear. On the other hand, if the rate was kept too high, credit would contract and prices would decline. (*TPOT*)

In my view we haven't had a free market in money since the late 1990s, when I believe the Fed became "activist," eager to head off problems real and imagined by injecting liquidity. Given that activism, investors have become preoccupied with central bank actions and their consequences. For years, that's all investors have talked about.

If I ran the Fed (to be clear, I don't expect to be offered the job), I think I would (a) lower rates to stimulate the economy when it's growing too slowly to produce needed jobs; (b) raise rates to cool off the economy when it's overheating, to head off rising inflation; and (c) keep my hands off rates the rest of time, allowing market forces to determine their level. Under this construct, we certainly wouldn't see rates perpetually near zero, as we did much of the time from 2009 to 2021. (I estimate the fed funds rate averaged roughly 0.5% over that stretch).

Finally, what will we see moving forward? It now appears that sometime in 2024, the Fed will declare victory against inflation and begin to reduce the fed funds rate from today's somewhat restrictive 5.25-5.50%. The current "dot plot," which summarizes the views of Fed officials, shows three 25-bps rate cuts in 2024, bringing the rate to 4.60%, and then more cuts in 2025, taking it to the mid-3s. However, today's consensus thinking among investors seems to be considerably more optimistic than that, anticipating more/earlier/bigger rate cuts.

While on the subject of consensus thinking, I'll point out the following:

- Eighteen months ago, it was near-universally accepted that the Fed's aggressive program of rate increases would result in a recession in 2023. That was wrong.
- Twelve months ago, the optimists who launched the current stock market rally were motivated by their belief that the Fed would pivot to dovishness and start cutting rates in 2023. That was wrong.
- Six months ago, there was a consensus that there would be one more rate increase in late 2023. That was wrong.

I find it interesting that the current stock market rally began as a result of optimism powered by consensus thinking that was generally off target. (See the second bullet point just above.)

At present, I believe the consensus is as follows:

- Inflation is moving in the right direction and will soon reach the Fed's target of roughly 2%.
- As a consequence, additional rate increases won't be necessary.
- As a further consequence, we'll have a soft landing marked by a minor recession or none at all.
- Thus, the Fed will be able to take rates back down.
- This will be good for the economy and the stock market.

Before going further, I want to note that, to me, these five bullet points smack of "Goldilocks thinking": the economy won't be hot enough to raise inflation or cold enough to bring on an economic slowdown. I've seen Goldilocks thinking in play a few times over the course of my career, and it rarely holds for long. Something usually fails to operate as hoped, and the economy moves away from perfection. **One important effect of Goldilocks thinking is that it creates high expectations among investors and thus room for potential disappointment (and losses).** *FT Unhedged* recently expressed a similar view:

> Yesterday's letter suggested that we think the market's current expectation of solid growth and six rate cuts seemed likely to be wrong in one direction or the other: either strong growth will limit the Fed to close to the three rate cuts it currently forecasts, or growth will be weak and there will be as many cuts as the market expects. In this sense, the market does look to be pricing in too much good news. (December 20, 2023)

I don't have an opinion as to whether the consensus described above is correct. However, even granting that it is, I'll still stick with my guess that rates will be around 2-4%, not 0-2%, over the next few years. Do you want more specificity? My guess – and that's all it is – is that the fed funds rate will average between 3.0% and 3.5% over the next 5-10 years. If you think I'm wrong, ask yourself whether you'd put your money on a different half-point range. (Before readers protest my uncharacteristic descent into forecasting, I'll point out that, at Oaktree, we say it's okay to have opinions on the macro; it's just not okay to bet clients' money on them. We invest with an awareness of current macro conditions, but our investment decisions are always based on bottom-up analysis of companies and securities, not macro forecasts.)

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The upshot of my sea change thesis is simple:

1. The period from 1980 through 2021 was generally one of declining and/or ultra-low interest rates.
2. This had profound ramifications in many areas, including determining which investment strategies would be the winners and losers.
3. That changed in 2022, when the Fed was forced to begin raising interest rates to combat inflation.
4. We're unlikely to go back to such easy money conditions, other than temporarily in response to recessions.
5. **Therefore, the investment environment in the coming years will feature higher interest rates than those we saw in 2009-21. Different strategies will outperform in the period ahead, and thus a different asset allocation is called for.**

Bullet points one through three above are statements of fact and not controvertible. Consequently, the conclusion – number five – depends exclusively on whether number four is correct. The question is simple: do you agree with it or don't you? If you agree, we have a host of solutions to propose.

January 9, 2024

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