Memo to: Oaktree Clients

From: Howard Marks

Re: Nobody Knows (Yet Again)

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On Monday, September 15, 2008, shortly after the close of the New York Stock Exchange, Lehman Brothers surprised the world by filing for bankruptcy. This came on the heels of rescues/bankruptcies of Bear Stearns and Merrill Lynch and was followed quite soon by more of the same at Wachovia, Washington Mutual, and AIG. Market participants quickly concluded that the U.S. financial sector was likely to melt down. It was now patently obvious (unlike a few days earlier) that financial institutions might fall like dominoes due to the combination of (a) financial deregulation, (b) a manic housing boom, (c) unwise mortgage lending, (d) the structuring of mortgages into thousands of tranched securities that were rated too high, (e) investment in these securities on the part of highly levered banks, and (f) "counterparty risk" resulting from the banks' interconnectedness. This thesis couldn't be refuted, and as a result, the markets embarked on what felt like a downward spiral without end.

I thought I should comment on these developments and the outlook, and the result was a memo called *Nobody Knows*, published four days later. I affirmed my ignorance of the future as usual, but to an even greater degree given that all prior expectations had been upended. Nobody knew – especially me – whether the spiral could be arrested. Nevertheless, I concluded that we had to assume it would, and thus that we should plow money into financial assets at their highly discounted prices.

There was nothing anyone could say they "knew," and that included me. I was limited to gaming out my conclusions, which were as follows:

- we can't confidently predict the end of the world,
- we'd have no idea what to do if we knew the world would end,
- the things we'd do to gird for the end of the world would be disastrous if it didn't end, and
- most of the time the world doesn't end.

Clearly, I didn't base these conclusions on knowledge of the future. But I saw no logical choice other than to start putting money to work, including the $10 billion that was sitting uninvested in Opportunities Fund VIIb. We had formed that fund to prepare for an elevated opportunity in distressed debt. How could we not follow through when one arrived? **And yet, we admittedly had no idea what the future would bring.**

**I can't claim to have analyzed the future.** In fact, I consider the phrase "analyze the future" one of the great oxymorons. The future has not yet been created, and it's subject to millions of complex, unquantifiable, and unknowable factors that will always be in flux. You can ponder the future and speculate about it, but there's nothing to "analyze" and certainly there wasn't in the early days of the Global Financial Crisis.

In March 2020, I reused the title of the 2008 memo for *Nobody Knows II*, my first memo during the Covid-19 pandemic. In it, I cited Harvard epidemiologist Marc Lipsitch, who said we usually make decisions on the basis of (a) facts, (b) informed extrapolations from analogous experiences, and (c) opinion or speculation. But since there were no applicable facts regarding a Covid pandemic and no analogous experiences, we were left with only speculation.

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**I want to say right here about 2008 and the other crises I've invested through – as well as today – that I don't reach my conclusions with confidence or act without trepidation.** There's absolutely no place for certainty in the world of investing, and that's particularly true at turning points and during upheavals. I'm never sure my answers are right, but if I can reason out what's most logical, I feel I have to move in that direction.

## The Uncertain Outlook

In my February memo *2024 in Review*, which went only to clients, I said the word to describe the Trump administration was "uncertainty." President Trump's thinking seems less predictable than that of most presidents, largely because it doesn't necessarily hew to a consistent ideology, and it's very much subject to being applied and revised tactically. It should be noted, however, that Trump has complained about how the U.S. is treated in world trade and argued in support of tariffs since at least 1987. Having said that, and even though we knew he was going to hike tariffs, no one anticipated the magnitude of the increases. Clearly the markets hadn't.

Last week's events remind us of the events of 2008 and the Global Financial Crisis they produced. All norms have been overthrown. The way world trade has operated for the last 80 years may be of little relevance to the future. The impact on economies and the world at large is entirely unpredictable. We're faced with large-scale decisions, yet again there are no facts or prior experiences on which to base those decisions. Truly nobody knows, and a lot of this memo will be about things we can't know for sure. But I hope it'll help you organize and evaluate the issues.

I want to point out that there are no experts on the subject at hand. Economists have analytical tools and theories to apply, but no economist and no tool will produce a conclusion in this instance that we can follow with confidence. There have been no large-scale trade wars in the modern era; thus, the theories are untested. Investors, businesspeople, academics, and government leaders will all give advice, but none of them is much more likely to be right than the average intelligent observer. The things on which everyone will agree are obvious, like the likelihood of higher prices. The less obvious truths will be harder to discern.

One of the things I insist on is that even for someone who deals with the future via forecasts, a forecast isn't enough. **In addition to a forecast, you have to have a good sense for the probability your forecast is correct. In this case, under these circumstances, it must be accepted that forecasts are even less likely to prove correct than usual.**

**Why? Primarily because of the vast number of unprecedented unknowns involved in the current matter, which has the potential to turn into the biggest economic development in our lifetimes.** There's no such thing as foreknowledge here, just complexity and uncertainty, and we must accept that as true. **This means that if we insist on achieving certainty or even confidence as a precondition for action, we'll be frozen into inaction. Or, I dare say, if we conclude we've reached decisions with certainty or confidence, we'll probably be mistaken. We must make our decisions in the absence of those things.**

**But we also have to bear in mind that deciding not to act isn't the opposite of acting; it's an act in itself.** The decision to not act – to leave a portfolio unchanged – should be scrutinized as critically as a decision to make changes. The old saws that are the refuge of terrified investors – "we're not going to try to catch a falling knife" and "we should wait for the dust to settle and the uncertainty to be resolved" – cannot in themselves be allowed to determine our behavior. **I love the title of a book by a market**



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**analyst named Walter Deemer: "When the Time Comes to Buy, You Won't Want To."** The negative developments that make for the greatest price declines are terrifying, and they discourage buying. But, when unfavorable developments are raining down, that's the optimal time to step up.

**Lastly, given Trump's tactical focus, it's important to bear in mind that absolutely everything is subject to change. It shouldn't surprise anyone if he extracts concessions and declares victory . . . or if he responds to other countries' retaliation by escalating further.** Thus, I told a Wharton conference on Friday that if anyone thinks they know what a given tariff rate will be three months from now, I'll bet good money they're wrong – even without knowing what they think the answer is.

Tariffs

What are President Trump's reasons for enacting his tariffs, and are they valid? On the day of the announcement, I heard a TV commentator credit Trump's "impulses" as having some justification. What are his goals? They include some or all of the following:

- support U.S. manufacturing
- encourage exports
- discourage imports
- shrink or eliminate our trade deficit
- make supply chains more secure through onshoring
- deter unfair trade practices aimed at the U.S.
- force other countries to the negotiating table
- generate revenue for the U.S. Treasury

**It must be acknowledged that every one of these things is desirable in itself and a logical result of tariffs.**

If only it were that easy. **The problem is that in the real world, and especially in economics, there are second- and third-order consequences that must be considered.** If there weren't, economics would be dependable like the physical sciences, as in "if you do A, then B happens." As theoretical physicist Richard Feynman said, "imagine how much harder physics would be if electrons had feelings." Well, economies and markets are made up almost entirely of people, and people do have feelings, rendering reactions unpredictable. In economics, others will react to action A, as well as to result B that action A produces, and we have to think about the effect of those reactions. Not only are repercussions often significant, but they're also unpredictable. Further, politics plays a particularly significant and unpredictable role in the matter at hand, with a calculus all its own.

What are some of the likely consequences of Trump's tariffs? The list is long, and many are particularly serious:

- retaliation by other countries
- price increases and rising inflation
- destruction of demand due to price increases and declining consumer confidence
- recession and lost jobs, both in the U.S. and around the world
- supply shortages
- a massive change in the world order


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There are many threads to follow, and if I try to do them all justice, we'll be here forever. I'll just touch on a few.

Some countries will negotiate – after all, in most cases, to borrow Trump's terminology, the U.S. is "holding the best cards." But others won't, perhaps because their leaders will insist on looking strong, leading to escalation. Higher "reciprocal tariffs" are unlikely to accomplish anything positive on balance and will probably make life worse for both parties. It will be of scant satisfaction if the incremental problems we encounter are less bad than those befalling other nations.

There is little doubt that the tariffs will raise prices. Tariffs are taxes on imports, and someone has to pay them. This is true in the case of goods brought in from abroad, as well as goods made in the U.S. that incorporate imported materials or components. This means the effect will be widespread. While it's the importer who pays the tariff at the border, the cost is usually passed on to the ultimate purchaser of the goods, the consumer. In theory, the manufacturer, exporter, exporting country, or importer can choose to absorb the tax to preserve their business, but they won't be eager to cut into their profits to do so, and in many cases their profit margins aren't high enough to allow them to do so.

Note that in my March 2022 memo, *The Pendulum in International Affairs*, I observed that between 1995 and 2020, U.S. consumer durable prices declined by 40% in real terms and total inflation averaged only 1.8% per year. Consumer durables consist mostly of vehicles, appliances, and electronics, and a big percentage of these have been imported. **What would inflation have been if low-cost imports were discouraged or precluded?**

But let's assume the first three goals listed above are actually achieved, causing more of the goods purchased in the U.S. to be made in the U.S.:

- First, in most cases, there isn't sufficient manufacturing capacity that can be switched on. For example, I doubt there's a factory in the U.S. capable of producing flat screens for TVs or computers. It would take years to build enough capacity to satisfy a meaningful percentage of U.S. demand, meaning in the interim there would be shortages and/or selling prices would likely be at the old levels plus the tariffs.
- Second, the new factories designed to bring back manufacturing jobs would take years to permit and build, and the cost of construction would have to be justified by an expectation of profits many years out in the future. Are CEOs likely to commit to those investments based on tariffs that might be subject to renegotiation (or discontinuation when a new administration takes office)? Bear in mind that Trump's 25% tariff on Mexican and Canadian goods replaced the United States-Mexico-Canada Agreement he negotiated during his first term and that went into effect in 2020, which in turn replaced NAFTA, which was enacted in 1994.
- Third, there probably aren't enough skilled workers available in the U.S. to take the place of all those in China and the developing world who presently make goods for us.
- **Fourth, why have Americans been buying imports in the first place? Because they're cheaper.** Why did the U.S. lose the jobs it lost? Because American workers were paid more than workers elsewhere for the same job, but U.S. products weren't good enough to justify higher selling prices. That's why the U.S. went from importing 330 Volkswagens in 1950 to more than 400,000 in 2012. It wasn't that U.S. tariffs were too low. The simple truth is that foreign goods often cost less than comparable goods made in the U.S.

Even if tariffs are set high enough in the future to render U.S.-made goods cheaper than imports-cum-tariffs, the price of the goods will be higher in the absolute than those of a week ago. **Prices are virtually certain to be higher for U.S.-made goods than those of the imports Americans have been buying.**



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Since most Americans have little income left over after paying for necessities, the result of higher prices is likely to be declining standards of living. That's true unless wages rise as fast as prices, but in that unlikely case we're talking about a dangerous inflationary spiral.

Higher prices are likely to result in lower unit sales, and thus in declining profit margins. My favorite economist (there's an oxymoron for you), Conrad DeQuadros of Brean Capital, considers corporate profit margins to be the best leading indicator of recessions. When margins come under pressure, corporations engage in layoffs and other forms of cost-cutting, often leading to economic downturns.

And again, there's the complexity of economic cause and effect. It's widely reported these days (I have no idea how reliably) that when tariffs were imposed on imported steel in 2018, 1,000 jobs were saved in the U.S. steel industry. But 75,000 jobs were lost (or potential new employees weren't hired) in U.S. steel-using industries. Similarly, as I wrote in the memo *Economic Reality* in May 2016:

> How will the interests of the 3.2 million Americans estimated to have lost their manufacturing jobs to China be balanced against the hundreds of millions who would have to pay considerably more for imported goods? Not an easy question.

Economics is the science of choices and is fraught with trade-offs. That's certainly true in the area of trade and tariffs.

## The International Picture

The impact of the developments on tariffs extends importantly to the international arena and goes well beyond economics. Global trade has had an enormous beneficial effect on the entire world since the end of World War II. Along with expenditures to rebuild after the war, technological and managerial progress, improvements in infrastructure, and the expansion of capital markets, **globalization contributed to a rising economic tide that truly lifted all boats**. Some countries and some people did better than others, of course, but virtually everyone was better off. I believe it was because of this, among other things, that we've generally enjoyed peace and prosperity for the last 80 years. **As a result, we've been privileged to live in the best period in history.**

The main benefit from globalization is called "comparative advantage." Every country has some things it produces better and/or cheaper, and others where the reverse is true. If every country makes the former products and sells them to the rest of the world, and buys the latter products from other countries, collective welfare is maximized thanks to increased overall efficiency. As I said on Bloomberg TV on Friday, we're all better off because Italy makes the pasta and Switzerland makes the watches. But if trade barriers were to require Italy to make its own watches and Switzerland to make its own pasta, the citizens in both countries would probably end up paying more for products they used to buy from abroad, or consuming lesser products made locally, or both.

U.S. citizens in particular have benefitted massively from the fact that most things can be made more cheaply in other countries – and especially developing nations – because wages are lower. This has cost the U.S. a few million jobs, but it has also allowed virtually all Americans to live much better than they would have if they had been limited to buying U.S.-made goods. That's the simple reason why most of the non-food merchandise at Walmart is imported.

To cite one more factor that has made the world a better place, **I describe the behavior of the U.S. in the post-World War II period as "generosity toward the rest of the world stemming from enlightened**



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**self-interest."** Under the Marshall Plan, we gave (not loaned) billions of dollars with which Western Europe rebuilt. Likewise, between 1945 and 1952, General Douglas MacArthur oversaw the reconstruction of Japan and the strengthening of its economy. Since then, the U.S. has (a) distributed extensive foreign aid, (b) invested heavily in healthcare in developing nations, (c) created programs that bring foreign students to the U.S. and vice versa, and (d) beamed positive messages to people throughout the world. These are all instances of generosity. In each "transaction," we gave more than we directly got, and a cynic might say we acted like suckers.

Yes, these things can be described as largesse, but as the National Archive puts it, the Marshall Plan "provided markets for American goods, created reliable trading partners, and supported the development of stable democratic governments in Western Europe." That's a pretty good payoff. People in other countries received lots of freebies, but certainly these programs helped the U.S. by restraining communism, bringing nations into defensive alignment with the U.S., and contributing to the U.S.'s position as the world's most prosperous nation.

**Please note that it's not impossible to throw this process into reverse:**

- We can antagonize our trading partners and cause our allies to feel like they're being bullied and extorted.
- We can force countries that have depended on us for capital and other forms of assistance to look to China and Russia for these things instead.
- We can convince the rest of the world to invest less in the U.S. and less in U.S. Treasurys.

The first two points can cost us important allies and cause nations to look less favorably on democracy. As my friend Michael Smith says, "You can't antagonize and influence at the same time." And the third point can dramatically influence the U.S.'s fiscal position.

To date, the world's high opinion of the U.S. economy, rule of law, and fiscal solidity has allowed us to hold a "golden credit card," where there's no credit limit and no bill ever comes. This enabled the U.S. to run fiscal deficits in each of the last 25 years and all but four of the last 45, including trillion-dollar-plus deficits in each of the last five years. **In other words, we've been able to live beyond our means**, with the federal government spending more than it takes in via taxes and fees. This has led to one of the worst things about the U.S.: the $36 trillion national debt and the grossly irresponsible behavior in Washington that caused it.

Since I don't expect Washington to suddenly begin to behave responsibly and live with balanced budgets, I'm left to wonder how much longer we can count on that golden credit card.

- Might other countries become less willing to buy U.S. Treasurys? Might they conclude that our fiscal management is unreliable?
- Even if we remain the world's best credit, might they cut back on purchases out of worry, spite, or political motivation?
- What would happen if a Treasury auction failed? (I imagine the Fed would buy the unsold securities, but I'm uncomfortable about it creating the money to do so by crediting banks with deposits with which to buy. In the end, where does the money come from?)
- Will we remain the world's best credit if the dollar comes to be less accepted as the world's reserve currency?
- What would happen to the deficit – and thus the national debt – if buyers demand higher interest rates on Treasurys?


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Going all the way back to World War II and longer, the U.S. has been "holding the cards." Trump believes in the strength of the U.S. and in cashing in on it. That's what his moves on tariffs amount to: no longer "throwing the party" for the rest of the world. No longer generosity in the hope of long-term benefits, but rather transactions in which we extract fair value.

I've received a lot of kind responses to Friday's appearance on Bloomberg TV, and I'm going to use a comment from a viewer to bring us to a conclusion on this subject:

> In the 1980s, people like [current Trump economic advisor] Peter Navarro decided that Japan pulling ahead of the US in autos threatened the future of the U.S.
>
> Japan did indeed pull ahead and never looked back.
>
> The U.S. economy has more than doubled in size relative to Japan since then. It has doubled even after allowing for population changes and currency strength. It doubled in spite of losing the lead in autos, **or is it that it doubled partly because of it?** The margins on computer software and jet engines are probably a good deal higher than on mass-market automobiles. (Emphasis added)

Japan exploited its advantages in producing autos, and the U.S. moved on to things in which it could achieve an advantage of its own. **Isn't that exactly the way things should work in dynamic economies?** As I asked in a memo in September, is it a good idea for nations to try to repeal or resist the laws of economics in an effort to make it otherwise?

The Bottom Line

**I consider the tariff developments thus far to be what soccer fans call an "own goal"** – a goal scored for the other side when a defender accidentally puts the ball into his own team's net. In this way, they're highly analogous to Brexit, and we know how that turned out. Brexit cost the British mightily in terms of GDP, morale, and alliances, and it harmed their reputation for governance and stability. All of this damage was self-inflicted.

**I like the way things have gone during my lifetime**, which conveniently spans 99% of the post-war period I've been discussing. Some of our government expenditures have certainly been misspent, both at home and abroad, and our national debt is nothing to celebrate. But I've enjoyed living in a peaceful, prosperous, and increasingly healthy world, and I'm not eager to see that change. **Just a couple of months ago, the U.S. economy was performing well, the outlook was positive, the stock market was at an all-time high, and there was much talk about American exceptionalism. Now, if Trump's tariffs are put into effect, the U.S. economy is likely to experience a recession sooner than otherwise would have been the case, higher inflation, and extensive dislocation.** Even if the tariffs are reversed entirely, it's unlikely the other nations will dismiss this incident and conclude that they have nothing to worry about in terms of relations with the U.S.

**No one should rule out the achievement of some of the goals of tariffs listed on page 3.** U.S. manufacturing could increase, bringing new jobs and more dependable supply chains. Our treatment in world trade could become fairer. And the Treasury's take could increase.

**On the other hand, some of the hoped-for benefits are probably beyond reach.** In particular, as for reducing our trade deficit, the U.S. is unlikely to ever buy less from other countries than they buy from us


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as long as the U.S. is bigger and more prosperous and thus has greater buying power. This will be especially true as long as our workers are better paid, meaning most U.S.-made goods cost more than goods produced elsewhere.

The hoped-for results might materialize, or the negative consequences might be felt, or some combination of the two. Importantly, however, it must be noted that **any gains that come are likely to arrive in the long run, following a multi-year period of adjustment, whereas the costs will probably be felt almost immediately.**

And what about the financial markets? In the last few days there's been a massive shift in the economic outlook and a huge stock market decline in reaction. As always, the key question surrounds the appropriateness of the response to date: has it been just right, inadequate, or excessive? It's even harder to answer that question than usual. **On the one hand, if the tariffs remain as announced and retaliation leads to an all-out trade war, the economic consequences could be truly dire. But on the other hand, cooler heads (and highly negative political and stock-market reactions) could prevail, causing the tariffs to be rolled back to less harmful levels, perhaps leading to a win for free trade.**

How is the Fed likely to respond? The threat of recession might call for accelerated rate cuts to bolster economic activity. Or the threat of inflation might cause rates to stay higher, with cuts postponed. Note, however, that inflation-fighting measures such as higher rates are probably less likely to succeed against inflation caused by the addition of tariffs to selling prices than they would be against the more typical demand-driven inflation. Today's title is particularly applicable to the Fed's actions: certainly nobody knows.

In Oaktree's markets, fear of defaults (not unfounded) has caused risk compensation in the form of yield spreads to increase substantially, but a flight to the safety of U.S. Treasurys has caused Treasury prices to increase and thus Treasury yields to decline. The net result has been a fair-sized net increase in the available yields on credit. At the same time, we anticipate a higher incidence of distress and increased demand for bespoke capital solutions, meaning we're likely to invest our latest opportunistic debt fund faster than otherwise would have been the case.

To paraphrase Mark Twain, there are themes that rhyme throughout history. For that reason, just as I recycled the title of my post-Lehman bankruptcy memo for this one, I'll also borrow its closing paragraph:

> Everyone was happy to buy 18-24-36 months ago, when the horizon was cloudless and asset prices were sky-high. Now, with heretofore unimaginable risks on the table and priced in, it's appropriate to sniff around for bargains: the babies that are being thrown out with the bath water. We're on the case.

On a personal note, I was fortunate to visit investors in Montreal on the day of the tariff announcement and in Toronto the day after. What a time for a trip to Canada! I started each meeting by saying I'm one of the hundreds of millions of Americans who respect Canada and consider it a friend and ally. The reception was stirring. **This is a good time for all of us to connect with our fellow citizens of the world.**

April 9, 2025



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