

Memo to: Oaktree Clients  
From: Howard Marks  
Re: Down to the Wire

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Here are the ingredients in the plot: A problem everyone's aware of. If it isn't resolved, a shutdown with unspecified but possibly disastrous consequences. A deadline which seems indispensable, since in its absence it appears nothing would be done. And despite the presence of the oncoming freight train, movement toward a solution is deterred by highly entrenched positions. It's truly white-knuckle time, and if the progress toward a solution continues to lag, the things that must happen won't.

I'm not talking about the nearly concluded drama at the National Football League, where failure to reach a labor settlement for just a few more days would have caused significant changes in the schedule for the coming year, upsetting the flow of wealth to owners and players and depriving fans of the game they love. I'm talking about the down-to-the-wire battle over the U.S. debt ceiling. I've decided to devote a memo to the debt issue and its significance. I especially hope it'll be helpful to our non-U.S. clients, for whom the lack of progress to date must be absolutely incomprehensible.

Interestingly, the immediate debt crisis is somewhat artificial. It is occasioned now only because of our debt ceiling, which currently limits the net debt of the United States to \$14.29 trillion. Such ceilings are far from the norm worldwide. Many other nations seem to function no worse without them.

But the U.S. has the historical accident of a ceiling, and we must deal with it. Because the limitation is set in terms of absolute dollars and not indexed for inflation or growth, we would run into it every few years even if our debt only grew apace with the economy. "In fact, it's been raised nearly 100 times over the decades." (*Financial Times*, July 16) But thanks to the especially rapid growth of our debt relative to GDP in recent years – exacerbated by the Afghan and Iraq wars and the financial crisis – the ceiling has the potential to provide some real excitement every once in a while.

### The Relentless Growth of Debt

Greece, Ireland, Portugal, Spain, Italy, Iceland, the U.S., California . . . the list of governments with debt problems is long and grows longer. The issue has flared up in the last fifteen months and is often in the headlines nowadays.

And yet, the general conditions causing the concern are nothing new. The deficits and debt that worry people today have existed for a good while: similar in kind albeit perhaps

not in degree. This merely shows that in the economic/investment world, what matters most in the short run isn't necessarily what's true but, rather, what's on people's minds.

Serious attention began to be paid to government debt in April 2010, when the Greek crisis burst into the news. Prior to that, no one seemed to worry about the way Greece – like many other countries – increased its budget deficit and national debt each year relative to its GDP. Banks and investors around the world were perfectly willing to extend credit without limitation based on Greece's strong EU-backed credit rating, and without thought as to whether there was any prospect for Greece ever paying down the debt, or even slowing its growth or growing out of it.

If you ask me, one of the most pronounced trends in the global economy over the course of my 42-year career has been the growth in the use of credit. And it's not just governments that have vastly expanded their use of credit over this period.

If I wanted to buy something upon my arrival at college in 1963, I had two choices: I could spend money I had in my pocket, or I could write a check against money I had in the bank. The one thing I couldn't do – now here's a radical concept – is spend money I didn't have. As a result, I had no way to buy things I couldn't afford.

But then, around 1967, Bank of America came out with the first credit card, the BankAmericard, and First National City Bank countered with The Everything Card. (When I was hired into FNCB that year for my first summer job, it was to go door-to-door trying to convince merchants to accept the card. But then volume on the New York Stock Exchange spiked to 25 million shares a day and banks like FNCB couldn't keep up with the related paperwork; thus I was assigned instead to a task force whose job it was to eliminate bottlenecks in the back office. But that's another story.)

Before the BankAmericard and The Everything Card, the only plastic in circulation consisted of T&E (“travel and entertainment”) cards – American Express, Diners Club and Carte Blanche – which generally were limited to people in the upper economic strata and had to be paid off each month. It was only in the last forty years that we've seen the morphing of BankAmericard into Visa and The Everything Card into MasterCard. With them came the ability of consumers to maintain an outstanding balance. Now it was easy for people to buy things they couldn't afford. And so they did.

When I was a boy, as I recall, owing money was considered undesirable and debts were generally expected to be paid off. When people bought homes, they put down 30% and took out thirty-year mortgages to finance the rest. They made level payments that included a substantial principal component that grew over time, eventually extinguished their debt, invited their friends over for mortgage-burning parties, and owned their homes free and clear in time for retirement.

But attitudes toward debt underwent significant change, and in the last forty years we've seen the following:

- Vast expansion of the use of credit cards, the balances on which are never expected to be paid off.
- Innovative mortgages requiring little or no principal amortization; reverse mortgages, where you owe more at the end than the beginning; declining down payment requirements; and eventually the availability of mortgage loans exceeding purchase prices.
- Home equity loans enabling owners to drain off any equity in their homes. Fifty years ago these were called second mortgages, and people who had them were considered by their neighbors to be in financial trouble.
- Growth in corporate debt, and the extension of borrowing power to companies with “speculative” credit ratings.
- The development of the commercial paper market, where companies could access “permanent” capital with maturities measured in days, on the assumption that the paper could always be rolled over.
- Creation of highly levered investment entities.
- Vastly increased steady-state borrowing on the part of nations, whereas, previously, deficit spending had been limited to occasional efforts to fight recession through stimulus.

What's the upshot of all of this? For the last several years, as I've visited with clients around the world, I've described the typical American as follows (exaggerating for effect, of course): He has \$1,000 in the bank, owes \$10,000 on his credit card, makes \$20,000 a year after tax, and spends \$22,000. And what do lenders do about this? They mail him additional credit cards.

Most people laugh – perhaps uncomfortably – when they hear this. But no one says it's inaccurate or benign. The bottom line is that consumer credit has been extended without any thought for how the full balance might ever be paid off. As long as the borrower is able to make monthly payments covering the interest and a tiny bit of principal, the situation is considered acceptable. But that's not my version of fiscal health.

So now let's jump from the top of the above list of developments to the bottom. In much the same way, credit has been available to governments deemed creditworthy without limit and without concern for the fact that:

- Countries were constantly spending more than they were taking in.
- Their deficits were growing non-stop relative to GDP.
- Their national debts likewise were expanding relative to GDP.
- In other words, repayment of principal was absolutely unimaginable.

**One of the most striking aspects of debt in the modern era is that little if any attention is paid to repayment of principal. No one pays off their debt. They merely roll it over . . . and add to it.** Thus credit ratings are highly deficient (shocker!) in a way that few people talk about. What ratings describe isn't the borrower's ability to repay principal, but its ability to make interest payments and refinance principal. But the assessment of their ability to roll their debt – likewise – isn't based on an ability to repay, but rather to refinance again. So ultimately the security of capital providers stems not from the borrower, but from the continued willingness of other capital providers to roll debts in the future. (It was their occasional refusal in 2007-08 that caused the worst moments of the financial crisis.)

**With no one asking how debt could be repaid, nations were allowed for decades to increase their deficits and debt non-stop relative to their GDP. And then, in the first quarter of 2010, the little boy stepped out from the crowd, took note of the emperor's non-existent new clothes, and said "Hey, wait a minute: Greece will never be able to repay even the debt it has, forgetting that it takes on more all the time. Its economy is non-competitive and stagnant, and tax compliance is non-existent. They shouldn't be able to borrow."**

That's all it took. Greece was denied further credit. And then people took a look around peripheral Europe and saw more of the same. Today, although the situation is nowhere as dire, they're also looking at the U.S. and some of its states.

### It's Not the Ceiling

In June, the debt of the U.S. reached the ceiling, meaning no more could be issued. That's bad news for a country that continuously spends more than it takes in. Thus the deadline imposed by the debt ceiling has brought the issue to the forefront. (If the debt limit was reached in June and we've continued to spend more than our revenues, how have we financed the shortfall? The federal government has borrowed from federal retirement funds; the courts ruled in the past that when we do this, it's not an expansion of our net debt, since America is borrowing "from itself." The well-known deadline of August 2 is the date on which the capacity for borrowing in this way is projected to be exhausted.)

**The problem isn't the ceiling, it's our behavior.** The debt ceiling merely imposes a discipline that our national leaders should provide but generally haven't. On this note, in his press conference on July 15, when asked about conservatives' insistence on a balanced-budget amendment to the Constitution, President Obama replied, "We don't need a constitutional amendment to do that [balance the budget]; what we need to do is to do our jobs." **But clearly we do need some enforced discipline, because the years in which we haven't run a deficit have been by far the exception of late, not the rule.**

The U.S. has run deficits almost every year since World War II, with prominent surpluses only in 1998-2001.

Go back a few decades, and the characterizations of the two political parties were fairly well established. The Democrats stood for progressive taxation (meaning a higher percentage burden on top earners) and more government spending, especially in aid of those in need. The Republicans were the party of strong defense, small government, fiscal responsibility and balanced budgets.

More recently, neither party has shown resolute fiscal discipline. Both have added unfunded programs. Tax reduction has been discovered as a growth stimulant. The upward march of our deficit and debt has been nearly uninterrupted.

We've seen the enactment of spending programs without providing for increased revenues to pay for them, and cuts in taxes without corresponding reductions in spending. As President Obama put it on July 15:

. . . we cut taxes without paying for them over the last decade; we ended up instituting new programs like a prescription drug program for seniors that was not paid for; we fought two wars, we didn't pay for them; we had a bad recession that required a Recovery Act and stimulus spending and helping states . . .

The blame isn't limited to one party. The increases in deficits and debt took place when both Democrats and Republicans were in power, and while control of government was both divided and in the hands of a single party.

**It seems apparent that in recent decades, politics has become more partisan, and solving the nation's problems has taken a back seat to adhering to ideology and getting re-elected. And what gets people elected? Promises of more: more benefits without increased taxation, and more take-home pay without reduced largesse. Only recently have large numbers of politicians begun to face the music, admitting that the government has to either do less or charge people more or both.**

### Obstacles to a Solution

From my point of view, so much that's illogical is going on regarding these issues that I sometimes find it hard to get my head around the current "debate" (if we can call it that when so few people are conversing). Here's what I think is the logic of the situation (with data from *FactCheck*, July 15):

- Expenditures have risen relative to the economy even as revenues have declined.

Washington's spending has recently been higher as a percentage of the nation's economic output than at any time since World War II. But by the same measure, Washington's revenues are the lowest in more than 60 years.

- The government is spending far more than it brings in. The current deficit is in excess of \$1 trillion, and "the U.S. is borrowing about 36 cents of every dollar spent so far this year. It borrowed 37 cents on the dollar last year, and 40 cents in 2009."

- **There's no way to change these facts in the short run.** In particular:

The largest components of federal spending are Social Security and Medicare programs for the elderly (33.5 percent of total outlays in 2010) and national defense (20.1 percent). Interest payments on federal debt . . . accounted for 5.7 percent of all federal spending.

Thus revenues (which equate to 64% of spending) just slightly more than cover the 59.3% of the budget that went for these inescapable expenditures. What about cutting programs that are unpopular and more discretionary? That wouldn't accomplish much:

Foreign aid . . . amounts to less than 1 percent of the entire budget. . . . All agriculture programs – including farm subsidies – make up just over one-half of 1 percent.

- When deficit spending is unavoidable, we have to borrow.
- Since we're at the current debt ceiling, continuing to borrow requires that the ceiling be raised.
- If the ceiling isn't raised and we can't borrow, we won't be able to make good on all of our obligations. Someone will have to go unpaid: employees, creditors, soldiers, retirees, vendors, etc. I don't think anyone believes we can make good on all of our obligations without borrowing.
- Thus we have to solve this immediate problem. We can enact spending cuts and/or tax increases, but invariably these things will only take effect over the long run. **In the short run we have no choice but to raise the debt ceiling and keep borrowing.**

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- **When the House of Representatives is under the control of one party and the other party is in charge of the Senate and the White House, solving gritty problems requires compromise.**
- A compromise is defined as a solution in which both sides make sacrifices, giving up some of what they want and making concessions to the other side that they find distasteful. On July 14 *The New York Times* cited Sen. Alan Simpson on President Ronald Reagan's pragmatic attitude toward compromise:

He had a rule: If you can agree on 80 percent, take it. He raised taxes 11 times in eight years. He did it to make the country run.

- **But compromise runs directly against ideology and is incompatible with lines drawn in the sand.** Some of today's elected officials have pledged not to permit any increases in taxes. Others have vowed to resist any cuts in entitlement programs such as Social Security and Medicaid. **Some even campaigned on explicit promises not to compromise and not to raise the debt ceiling; for people like these, reaching agreement would be a problem, not a solution.**
- Even among Republicans, it seems that some put the highest priority on balancing the budget while others insist on shrinking the government. This creates a fundamental intra-party conflict, since increasing government revenues represents a way to accomplish the former but is in direct contravention of the latter. (See "Anarchists and Tassel Loafers," *The New York Times*, July 14.)
- There's another important difference of opinion; which is more important, adherence to avowed principles or action to address the short-term problem? Many politicians have made public pronouncements that render the two mutually exclusive.
- **Thus to date enough people have refused to accord first priority to solving the debt problem in the short term that a compromise solution has been rendered unreachable.**

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- The picture is complicated by the fact that any action to reduce the deficit and related borrowing – be it through reduced spending or increased revenues – would have a depressing impact on an economy that is already anemic.
- Thus many people want to maintain or increase spending or cut taxes to stimulate the economy, even though doing so would exacerbate the problems of deficit and debt in the short run.
- There is considerable disagreement over which would be worse for the economy: a \$1 reduction in government spending or a \$1 dollar increase in taxes? Economics is too imprecise to produce a definitive conclusion. And economists have ideologies, too; Republican economists tend to describe revenue increases as more harmful, while Democratic economists are more likely to resist spending cuts.

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- If the debt ceiling isn't raised, as I said, some people will have to go unpaid. Among the candidates are our nation's creditors. Failure to pay creditors is called default.
- Some lawmakers believe that, even if the ceiling isn't raised, we'll manage to pay creditors and avoid default.
- At least until recently, and perhaps still, some of those involved have been unconvinced that failure to act would have grave consequences.

At a closed-door meeting Friday morning [July 15], GOP leaders turned to their most trusted budget expert, Rep. Paul D. Ryan of Wisconsin, to explain to rank-and-file members what many others have come to understand: A fiscal meltdown could occur if Congress fails to raise the debt ceiling. House Speaker John A. Boehner of Ohio underscored the point to dispel the notion that failure to allow more borrowing is an option. "He said if we pass Aug. 2, it would be like 'Star Wars,'" said Rep. Scott DesJarlais, a freshman from Tennessee. "I don't think the people who are railing against raising the debt ceiling fully understand that." (*Los Angeles Times*, July 16)

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- If the U.S. defaults on its debt, our credit rating will likely be cut from triple-A. But there may be people who don't believe this, while others seem unconvinced that it would be a serious development.
- I believe, however, that (a) our rating will be cut if there's a default, (b) this would have serious repercussions for our cost of borrowing, and (c) even if we were able to avoid default and/or downgrade, the feeling that our political leaders had engaged in irresponsible action could reduce lenders' view of our credit and increase our cost of borrowing anyway. **I strongly doubt the dollar can remain the world's reserve currency, of which unlimited amounts are accepted, without unflinching adherence to the associated responsibilities.**
- **Another thing I'm most sure of is that no one knows what the repercussions of default and downgrade would be.** They don't call economics "the dismal science" for nothing. When some people warn of Armageddon, others feel they're exaggerating for effect. There's no way to prove anything on this subject other than by letting it happen.
- Finally, I'm convinced that while it's not certain exactly what will happen if a solution isn't reached, some of the possible results could be very negative.

**This situation is incredibly complex and serious. I feel we need a compromise solution, because I'm just not willing to conduct an experiment with consequences that are unforeseeable and could be grave.** But the events to date show us that compromise solutions are assured only when there's a broad consensus that an agreement is desirable, and that the consequences of not reaching one are worse than the disadvantages of the compromise. Nothing tells me that such a consensus is prevalent enough to guarantee that the underlying problem of deficit spending will be solved.

#### The Most Likely Outcome

If you want to get re-elected and suspect that failure to raise the ceiling might hurt your chances – or if you just believe raising the ceiling would be good for the country – you might agree to a compromise in the end. But, given the ideological divide, lawmakers will be more likely to accept a compromise if there's less substance and less teeth in it.

**Thus I think a solution will be reached.** But given the complexity and difficulty of the issue and the short time remaining before the deadline, it's unlikely to be either detailed or iron-clad. **The most likely outcome here is a short-term, stopgap solution.** It probably won't require the balanced-budget amendment desired by conservatives, the broad spending cuts Republicans want, or the tax increases Democrats insist should be part of any deal . . . some or all of which we clearly need.

**In other words, the “solution” is unlikely to represent much fundamental progress; for the most part it’ll just kick the can down the road.** It may call for a new commission to study the problem, but:

- the last commission came up with a plan that was hailed by the commission members who were former elected officials, rejected by many of those still in office (who have to face voters), and quickly forgotten, and
- it’s hard to believe that the likelihood of a plan being adopted will be greater without the presence of a deadline for raising the debt ceiling, as opposed to lower.

Progress will be touted, but much of it will be illusory. In that regard, I’m reminded of the recently announced solution in the Minnesota budget stalemate. A good part of the financial shortfall was bridged with an agreement to securitize and sell off payments scheduled to be received in the future as a result of the tobacco settlement. But raising money by selling assets doesn’t permanently fix an excess of expenses over revenues. That’s like selling off manufacturing equipment to save a company that’s operating in the red. (Note that one of the things that keeps government from taking a “businesslike” approach to fiscal issues is the fact that government accounting treats spending on capital assets the same as expenses, and the proceeds from asset sales the same as revenues. No business would join in these mistakes.)

Regardless of the exact methodology, I believe that any “solution” announced this month will (a) fail to make fundamental improvement, and thus in the words of Rahm Emanuel will let the current crisis – with its potential to compel real change – go to waste, (b) delay any real action and (c) fail to reduce the likelihood of recurrence of the debt ceiling problem.

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What we need is this:

- government expenditures that are limited to revenues, with the exception of isolated instances of deficit spending designed to fight recession, where after the deficits are promptly reversed by amassing surpluses, and
- encouragement for economic growth that enables the pie to grow and government to pay for its activities on a current basis.

Anything else would be a short-term palliative . . . or a continued exercise in imprudence. **Spending that grows no faster than GDP should be an imperative. Shrinking government's share of the economy seems highly desirable. National debt that is stable or declining as a percentage of GDP sounds compelling.**

(In addition to balancing the budget and growing the economy, I think we have to accept that the coming decades are likely to see U.S. standards of living decline relative to the rest of the world. Unless our goods offer a better cost/benefit bargain, there's no reason why American workers should continue to enjoy the same lifestyle advantage over workers in other countries. I just don't expect to hear many politicians own up to this reality on the stump.)

To close, I'm going to borrow some quotations and data from Michael Cembalest, Chief Investment Officer of J.P. Morgan Private Bank (*Eye on the Market*, July 18):

The long-term threat:

. . . there are serious questions, most immediately about the sustainability of our commitment to growing entitlement programs . . . the time we have is growing short. (Paul Volcker, *The New York Review of Books*, June 24, 2010)

According to the CBO alternative case (tax cuts do not sunset as planned; AMT keeps getting indexed to inflation; no Medicare cuts take place, etc.), by the year 2024, entitlements plus interest spending will be equal to total government revenue. Just 12 years ago, in 1999, the CBO estimated that this would not happen until 2060. The crossing point has moved in by 36 years.

In 1967, the government estimated that Medicare expenses would grow by 7x by 1990 (unadjusted for inflation); they grew by 61x instead. In addition to the lack of cost controls on entitlements, demographic changes are a problem as well: the ratio of workers to Social Security recipients has declined from 17-to-1 in 1950 to 3-to-1 today.

The short-term threat:

As the largest buyer and holder of U.S. Treasury bonds, we need to seriously assess the risks. We hope that the U.S. government adopts a serious policy to ensure the interests of the investors. (China Cabinet Development Research Center, and the Chinese Foreign Ministry, after the Moody's downgrade watch was announced and S&P reportedly told lawmakers it might downgrade U.S. debt if payments were missed.)

The essential element in any real solution:

The country is so thoroughly given up to the spirit of the party, that not to follow blindfolded the one or the other is an inexcusable offense. Between both, I see the impossibility of pursuing the dictates of my own conscience without sacrificing every prospect, not merely of advancement, but even of retaining that character and reputation that I have enjoyed. Yet my choice is made; I am at least determined to have the approbation of my own reflections. (John Quincy Adams in his diary, on sticking to his principles and supporting the British embargo, knowing that it would harm his home state of Massachusetts and get him thrown out of the Federalist party)

**The world has awakened to the undesirability of ever-growing government debt. Repairing the situation will require difficult decisions and great sacrifices, especially on the part of lawmakers required to vote for unpopular solutions. This would be a great time to start taking positive steps.**

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