Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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*I*n Howard Mark's Memo "Sea Change" on 13 December 2022, he described two significant sea changes[1] since his career commenced in 1969 that, in his opinion, had a profound impact on the investing environment. The 1st sea change was the "Risk/Return" mindset that investors began to adopt in the late 1970s. In essence, it was based on the premise that even a good asset can be a bad investment if bought at a price that does not adequately compensate an investor for the risk they are discussing. Due to this mindset of considering both return and risk, the high-yield bond industry grew and subsequently, the private equity industry (which used high-yield debt to fund acquisitions).

*T*he 2nd sea change was the low interest rate, low inflation, and highly leveraged environment post the mid 1980s till 2021, following the Feds taming of the highly inflationary environment preceding this period. The outcome of this period was,

"a rebirth of optimism, the pursuit of profit through aggressive investment vehicles and an incredible four decades for the stock market".

*I*n his opinion, the four factors that resulted in this outcome were, "*strong economic growth, incredible performance of companies, gains in technology, productivity and management techniques and the benefits of globalization*". However, in Mark's own words,

"It seems that a significant portion of all money investors made over this period resulted from the tailwinds generated by the massive drop in interest rates. I consider it nearly impossible to overstate the influence of declining interest rates over the last four decades".

*I*n contrast to the period between 2009 and 2021, he sees the present economic environment as one characterized by, higher risk aversion, lower optimism and less liquidity and tightening credit conditions. While not an advocate of macro forecasting, Mark feels that a recession is highly likely to coincide with a deterioration of corporate earnings and investor psychology, non-accommodative credit conditions, and possibly higher debt default rates, but almost certainly, he does not believe that interest rates will decline (or by a significant amount) from these higher levels at present.

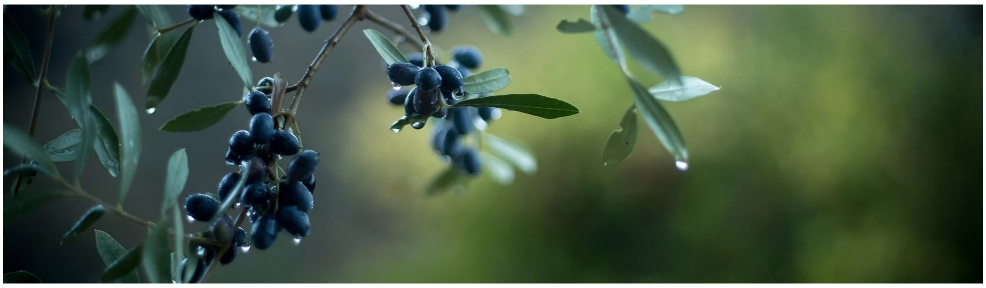
*I*t brings us to the 3rd sea change Mark sees. He believes we have gone from the low-return investing environment of 2009-2021 to a higher-return investing environment.

*I*nvestors can now yield much higher returns through owning credit instruments than they could before and '*by implication*' do not need to venture into the riskier spectrum of assets in the '*chase for yield'*. Taking this thought process further, it is very likely that the macroeconomic environment at present will result in investors that are much more risk averse, overwhelmed by pessimism and face tightening and stricter credit conditions that will result in depressed asset prices, as per Howard Mark's book, 'Mastering the Market Cycle' and his theory derived from this. But it is precisely at this point of the 'Market Cycle' that the risk/reward profile of assets, by and large, will be most favourable to an astute long-term investor. As Warren Buffett has said: (be)

"fearful when others are greedy and greedy when others are fearful".

10 March 2023

[1] *sea change (idiom): a complete transformation, a radical change of direction in attitude, goals . . . (Grammarist)*



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Strong Roots, Sustainable Growth

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