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Ditto

His ominous one word, "Ditto", gave me the chills. Legendary investor Howard Marks of Oaktree Capital warned of leverage issues in 2004. He says a similar situation is brewing in the credit market today with a record $810 BB in corporate bonds issued in 2012, 20% more than 2007. Also, investors are scrambling for fixed income products, paying 110, 115 to yield low returns relative to their risk profile. His letter mentions cycles and investor psychology, which summarily says, investors are taking on more risk and are not acting rationally at the moment. One has to wonder whether the spillover from the credit frenzy will affect equities, as corporations have trouble paying off the maturing debt when they come due in 5-10 years. Sure, the corporations are able to finance the annual interest payments because they are cheap, **but more than the interest is the sheer, nominal value of those debt obligations. Who knows what the market will look like in 2015, 2016? Will they be able to rollover their term notes, as investors continue to look for more bonds?**

He also described the stages in a real estate cycle.

<u>The Real Estate Cycle</u>

I'll use the cycle in real estate as an example. In my view it's usually clear, simple and regularly recurring:

- Bad times cause the level of building activity to be low and the availability of capital for building to be constrained.
- In a while the times become less bad, and eventually even good.
- Better economic times cause the demand for premises to rise.
- With few buildings having been started during the soft period and now coming on stream, this additional demand for space causes the supply/demand picture to tighten and thus prices and rents to rise.
- This improves the economics of real estate ownership, reawakening developers' eagerness to build.
- The better times and improved economics also make lenders and investors more optimistic. Their improved state of mind causes financing to become more readily available.
- Cheaper, easier financing raises the pro forma returns on potential projects, adding to their attractiveness and increasing developers' desire to pursue them.
- Higher projected returns, more optimistic developers and more generous providers of capital combine for a ramp-up in building starts.
- The first completed projects encounter strong pent-up demand. They lease up or sell out quickly, giving their developers good returns.
- Those good returns – plus each day's increasingly positive headlines – cause additional buildings to be planned, financed and green-lighted.
- Cranes fill the sky (and additional cranes are ordered from the factory, but that's a different cycle).
- It takes years for the buildings started later to reach completion. In the interim, the first ones to open eat into the unmet demand.
- The period between the start of planning to the opening of a building is often long enough for the economy to transition from boom to bust. Projects started in good times often open in bad, meaning their space adds to vacancies, putting downward pressure on rents and sale prices. Unfilled space hangs over the market.

Where are we in this cycle? I think real estate market is on bullet #4 or #5. Rumors and substantiated talks of a real estate recovery is taking ground. I think real estate/equities will trump fixed income in the next couple years.