OSTERWEIS
CAPITAL MANAGEMENT

Who You Callin' an Idiom?
Fixed Income Outlook
April 2017

"Not see the forest for the trees" is an idiom derived from British English that describes someone who is so focused on the minutiae that they miss the larger picture. The financial media and many investors have been so focused on news headlines that they are missing the fact that economic growth is continuing to improve around the world. While Brexit, populist elections in Europe and our own Presidential election make for good news stories and may contribute to market swings in the short term, the headlines only tell part of the story. We are seeing economic surveys that portend good growth for current and future "hard" economic results. It seems that we may finally be seeing the green shoots (and even flower buds) that former Federal Reserve (Fed) chair Ben Bernanke spoke about in 2009. And that is the rub; statistics sometimes take a lot longer to show that which we see with our eyes. If you take a step back and focus more on the forest and less on the trees, you can see that growth is beginning to accelerate.

While the populist Brexit vote was in mid-2016, England only recently triggered Article 50, which officially begins the countdown to negotiate the terms of exit. Since the vote, the British pound has declined 16% versus the U.S. dollar as concerns regarding the future relationship with European Union (EU) trading partners and economic stagnation roiled the markets. The euro has also weakened as a result of economic and trade uncertainty, so the upcoming bartering about exit terms could cause more volatility in the markets. While no one can truly know exactly how these negotiations will turn out, the UK is still an important market for EU trade and the lower currency will make UK exports much more competitive, especially to trading partners outside the eurozone. Lombard Street Research estimates that UK exports will more than double between 2016 and 2018, along with a decline in the unemployment rate over the same time period. This is on top of the growth in household consumption that the UK has seen over the last several years. It seems that all of these positive results are why the Bank of England raised its 2017 growth forecast. The forest is growing but one cannot see that when looking only at the tree trunks.

The nationalist wave that swept through Britain has also been seen rolling across the EU The two largest economies in continental Europe, France and Germany, have candidates running for political office with nationalistic/"leave the EU" mindsets. Political rhetoric will continue to dominate the headlines for most of 2017. French elections are in April with both a centrist, Emmanuel Macron, and a right-wing nationalist, Marine Le Pen, neck and neck in the polls. German elections are in the fall and Angela Merkel, the incumbent, continues to lead in the polls, although her coalition is under pressure to bring in alternative ideas and voters. Once again, the real story here is not the election, but the economic revival that is taking place in Europe. According to IHS Markit, the Markit Flash Eurozone Purchasing Managers' Index (PMI) hit a 71 month high of 56.7 in March. This also included data that showed the fastest employment growth in almost 10 years. New business orders have been increasing steadily since 2013. And while input costs (read inflation) have been increasing for manufacturers, output prices (read sales prices and profits) have been more than keeping pace. Additionally, Germany's PMI growth, led by output and order books, was the highest since May 2011. France, led by its service sector, also hit its highest growth since May 2011. Spain is also expected to grow nearly 3% in 2017. UBS reports that German wage growth has been strong and running at more than twice the eurozone average. Coupled with a high employment rate, this could lead to faster consumer spending and inflation. In addition, European Banks have increased their borrowing from the European Central Bank (ECB) under the targeted longer-term refinancing operations (TLTRO). The TLTRO is a program whereby banks borrow for four years mostly at a 0% interest rate, and sometimes even at a negative interest rate. Recent loans totaled 233.5 billion euros compared to analyst forecasts of approximately 110 billion euros. While increased borrowing might typically be a worry, in this case it seems banks think there is enough growth and inflation for the ECB to curtail its accommodative lending policy and likely wanted to increase their funding while these ridiculously low rates remain available. Keep your eyes on the forest of bank lending going forward, not the trees of political headlines.

We are seeing similar growth across Asia. In Japan, fourth quarter Gross Domestic Product rose at a 1.2% annualized rate. Estimates from several investment banks are for growth to increase further over the next two years. If this happens, 2018 will be the seventh year of expansion for the Japanese economy. In addition, fourth quarter Japanese business spending grew at an annualized rate of 8% and capital expenditures grew at the fastest pace in three years. While core Consumer Price Index seems to be rising, general inflation has not yet picked up to the point where government stimulus would be reined in, so we should expect continued accommodation. There is always a risk, however that inflation accelerates quickly and stimulus will need to be ended sooner than their central bankers may have planned. Along with increasing domestic consumption, Japan's foreign exports have been growing rapidly as well. South Korea, an export driven economy, posted export growth in February of 20%. Not to be outdone, manufacturers in Taiwan showed consecutive growth over the past 12 months and Taiwanese exports were up 28% year-over-year in February alone. While we may be distracted by headlines from China and a South Sea power grab, these trees mask the forest of growth happening in the region.

We are happy to finally see above-trend growth in Europe and Asia. In the U.S., the Fed's actions over the last nine years have stabilized the economy and created a floor from which to grow. While the price of the S&P 500 Index (as a proxy for the U.S. stock market) has risen by 250% in the eight years following its nadir on March 9, 2009, it has only been in the last 15 months that the Fed has seen enough economic growth to begin to raise the federal funds target rate and to begin normalizing Fed policy rates. So what does the Fed see? The labor force participation rate has been increasing lately, which shows that more employees are entering the workforce with jobs. The St. Louis Federal Reserve Bank reported that household debt is at its lowest level when compared to disposable income since 2002. In addition, Average Hourly Earnings have continued to rise. With improved balance sheets, consumers are able to accelerate spending. This increased confidence is showing up in home sales. Existing home sales for January 2017 rose 3.3% year-over-year — a very strong pace — and new home sales were also strong. The other, not so minor, fact worth mentioning is that all of this has been showing up post President Trump's populist election. While his administration is not responsible for past economic growth, politics being what it is, we are certain to hear them take full credit for any future growth. Love it or hate it, we are likely to see much self-congratulatory rhetoric coming from our leaders in the coming quarters. It's not clear which policies will eventually become law, but one needs to avoid getting too distracted by the partisan wrangling in Washington D.C. and remember to focus on the big picture or risk missing the best part of the show! Consumer sentiment is rising, proof of which is seen in the Consumer Confidence Index wherein the net share of households indicating "jobs are plentiful" leapt to its strongest level in 16 years. We still need to see pro-business policies enacted, but as consumers and investors grow more positive, they begin to act and spend in ways that should further propel the economy. A positive outlook is sometimes all it takes to create a virtuous cycle of spending and reinvesting.

While we would like to be long-term bulls post the European elections, we must keep an eye out for developing risks. Delinquencies in subprime auto loans and continued increases in student loan debt balances could restrain consumer spending. In addition, if the majority party is successful in lowering taxes, cutting regulations and accelerating growth, inflation might rear its ugly head. This could cause interest rates to rise faster and possibly pose a risk to the longevity of the recovery. While this is a possibility, we feel it is still years away. According to Goldman Sachs, the bull market cycle generally has four phases: Despair, Hope, Growth and Optimism. Looking back over this cycle, Despair can be defined as the period from 2007-2009 where we suffered through the worst part of the great financial crisis. Hope can be defined as 2009-2010 where the Fed amped up its policies to stimulate the economy. Growth, albeit sub-par, can be defined as 2010-2015 where we saw the economy continue to recover from the depths of despair. Both the equity and credit markets as well as household balance sheets improved dramatically during this phase. Since 2016 we have been in the final phase, Optimism. This last leg of the bull market, as explained by Goldman Sachs, can last for several years and can show additional positive stock market returns as prices rise and valuations get pushed higher. With further price-to-earnings expansion and Fed interest rate increases comes worries about earnings quality and inflation. At some point Optimism might be better characterized as "exuberance" (to steal a term used so eloquently by former Fed Chairman Alan Greenspan), which can get the best of investors' mindsets and may eventually lead to a market top followed by a painful correction. This is what we are keenly watching for, and we have tried to position ourselves defensively for it.

Along with a rising stock market, we have seen sustained improvement in the high yield market. Companies have continued to feed the equity market with debt-financed buybacks and increased dividends. Investment bankers, never a shy lot, have pitched debt deal after deal this year as investors, flush with cash, have continued to accommodate heavy issuance. This type of frenzied refinancing can lead to protective covenants getting looser, maturities extending out and coupon rates declining as investors temporarily forget they need to be paid a fair rate of return for the risk they are taking. This is usually what precedes corrections. On the other hand, issuing companies are benefitting from very low rates, and this should help lower interest cost burdens in the next downturn, which could lead to lower default rates. While we don't see any industry bubbles currently, we do see some excesses brewing in the market. One interesting fact is that approximately 37% of bonds in the high yield market now have coupons below 6% with maturities longer than five years. As you would expect in this environment, we have become extremely selective about what terms we will accept; and when we are not receiving them we prefer to allow cash to build. While many benchmark-oriented investors have been focused on staying fully invested, they seem to be okay with the rising duration in these lower yielding, longer maturity issues. If the next correction comes with higher interest rates, we believe that this recent crop of bonds could provide us with many investment opportunities as prices adjust lower. In the meantime, headlines have caused increased volatility in some equity names, which has allowed us to add more convertible securities at very attractive yields. We continue to have a healthy cash balance and plan to take advantage of bouts of market weakness to acquire both convertible and high yield bonds at attractive yields.

On another note, you have likely read in our SEC filings that Simon Lee is retiring after over nine years with Osterweis and nearly four decades in the investment industry. Craig Manchuck, who joined our team in February and has settled in quite nicely, will be replacing Mr. Lee. Carl and Simon have known Craig for over two decades and are pleased to have him join Osterweis Capital Management. We hope you get a chance to meet Craig in the near future and welcome him to the team as we have. As always, we thank you for your continued trust and welcome any questions and comments you may have.

Sincerely,

Carl Kaufman | Simon Lee | Bradley Kane | Craig Manchuck

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The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The core Consumer Price Index excludes goods with high price volatility, such as food and energy. This measure of core inflation systematically excludes food and energy prices because, historically, they have been highly volatile and non-systemic.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

Gross Domestic Product (GDP) is *the monetary value of all the finished goods and services produced within a country's borders in a specific time period.*

Price-to-Earnings (P/E) ratio is the ratio of the stock price to the trailing 12 months diluted EPS.

Yield is the income return on an investment.

Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.
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