Solid Fundamentals but Questions Remain
Equity Investment Outlook
Second Quarter 2021

The first quarter of 2021 was challenging, as sentiment gyrated back and forth between hope for re-opening plays, which had lagged in 2020, and faith in long-term secular winners, which had done well last year. Compounding these somewhat schizophrenic mood swings was a worry that inflation was picking up and that interest rates would start to rise, putting downward pressure on elevated equity valuations. Moreover, given the strong stock market performance over the past year, some speculative froth had crept into the market as evidenced by surges in collectible prices, Bitcoin performance, the rash of Special Purpose Acquisition Companies (SPACs), and a surge in biotech company prices. Speculative enthusiasm always leads to greater market volatility and eventual vulnerability.

In order to make sense of all this, it is important to understand what is actually going on fundamentally. As more and more people are vaccinated, the economy is gradually re-opening. Two rounds of robust fiscal stimulus have also helped protect and bolster the consumer despite the negative demand shock of Covid, and the Fed has maintained a highly accommodative monetary policy throughout. We therefore expect very robust GDP numbers in 2021, perhaps growth in the 7-9% range. This will clearly benefit cyclical companies and seems likely to fuel higher inflation, at least over the short term. This will also put upward pressure on interest rates, although the Fed has clearly and emphatically stated that it will not rush to raise short-term interest rates, as it wants to support economic and employment growth and it is not opposed to higher inflation at this time.

There are a few big questions in all this. First, will the most recent $1.9 trillion stimulus and a possible multi-trillion dollar infrastructure plan — partially funded by tax hikes — lead to sustained above-average GDP growth before settling back to the recent norm of 2.0-2.5% growth? Second, will the pick-up in inflation be simply a short-term, transitory blip or are we at some sort of secular inflection point driven by fiscal and central bank-induced liquidity? Third, will interest rates rise from extremely low rates to still low rates or will they move substantially higher? Finally, have stock prices already discounted the recovery, leaving current valuations in a more mature mid-cycle state?

Our best guess is that the economy will enjoy a post-Covid bounce that could last one or possibly two years, but then will settle back to a more normal pace. Likewise, inflation will pick up with this post-Covid bounce, but it too will settle back down as transportation and other bottlenecks open up and the inexorable march of technology re-asserts downward pressure on prices. It is also worth noting that unemployment remains at 6.0%, well above the 3.5% pre-Covid level, indicating significant labor slack. If we are correct in this view of inflation, interest rates are likely to remain lower for longer after a bit of an uptick.

Given these factors, we have been gradually reorienting toward more exposure to leading cyclical businesses likely to benefit from an economic recovery while also maintaining positions in
long-term secular growers that have dominant market positions, enjoy pricing power, and operate in industries with great long-term tailwinds.

In an effort to generate inflation-protected income, we have also focused on companies capable of raising dividends over time. This is especially important in an era of low interest rates, where high-quality bonds are unable to provide robust cash flow.

Looking at the risks going forward, we would point to inflation as probably the most obvious. If the current pickup in inflation turns out to be more virulent and durable than we expect, that would prompt the Fed to tighten monetary policy sooner and more aggressively, causing interest rates to rise and the economy to slow. We regard this as unlikely but not impossible. It is worth noting that the market is highly attuned to inflation risks today, so at least some inflation risk appears to be priced in already.

In general, we remain constructive on the market. The economy is expanding, monetary policy remains very accommodative, another round of fiscal stimulus has just been passed, and a potential massive infrastructure plan is in the offing. With all the stimulus and with rising corporate profits, the market should do well, albeit with a bit of volatility.

Please let us know if you have any questions. Meanwhile, stay healthy.

Sincerely,

John Osterweis

Larry Cordisco

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