OSTERWEIS
CAPITAL MANAGEMENT

Whooaaaa DeChambeau!
Strategic Income Outlook
Fourth Quarter, 2020

For those of you who don't follow professional golf, Bryson DeChambeau recently won the United States Open Golf Championship at the famed Winged Foot Golf Club. Although played before only volunteers and officials, it was unusual for other reasons. The U.S. Open in its 118 prior editions has always placed a premium on precision, restraint, and control. Bryson is an iconoclast, choosing to develop his own swing based on the application of physics, his college major, and he has developed a swing that can best be described as unorthodox. When the PGA tour was on hold at the start of the pandemic, Bryson decided to throw caution to the wind and gained 40 pounds (mostly muscle) in an effort to maximize the distance of each shot. While this all-in, take-no-prisoners approach works well at some tournaments, it has not been the traditional recipe for success at the U.S. Open. His unlikely win has pundits questioning their assumptions about professional golf and wondering aloud if this "new" aggressive approach might permanently change the way the game is played.

We are hearing similar musings today about the equity and fixed income markets and whether we should think about the markets differently. Has the investment landscape permanently changed? Do valuations even matter anymore in a seemingly inflation-free "near-zero" interest rate environment? Will value ever recover? Can active management beat passive? To the surprise of many experts, a similar "pedal to the metal" strategy, which ignores traditional valuation metrics, worked very well following the pandemic-induced selloff we experienced in February and March. No one expected the Federal Reserve ("the Fed") to act with such largesse, stocks to recover so rapidly, or the capital markets to reopen so quickly and forcibly. Does it make sense to expect this approach to continue to outperform, or should we perhaps consider dialing back our risk-taking a bit and take a more conservative approach?

The S&P 500 has rallied 8.93% and the Bloomberg Barclays U.S. Corporate High Yield Bond Index returned 4.60% in the quarter as investors recovered most, if not all, of the markdowns they endured during the severe first quarter correction. While most are comforted by seeing some positive year-to-date returns on their financial statements, the question remains: Will this good performance continue, and where can we expect to find positive returns in the next few quarters? The support provided by the Fed has clearly been very effective in assuaging investor concerns and stabilizing markets. It has pumped trillions into the markets through purchases of Treasury bonds, mortgages, corporate bonds, and even exchange traded funds (ETFs). This support has been crucial to the speedy recovery we saw in the second quarter. It is likely that this may have pulled forward some of 2021's equity and fixed income returns into 2020. However, while the Fed is expected to remain steadfast in its support of the markets—as evidenced by Chairman Powell's recent comments that he expects to keep rates near zero through 2023—we think it's likely that the bulk of the quantitative easing (QE) measures are now behind us. Future advances in the credit and equity markets will need continued fundamental improvement and not merely a blank check from the Fed.

The second quarter was likely the nadir for corporate profits, as regions and industries have started to reopen, unemployment has fallen, and corporate profits have improved. What we don't know, however, is when and to what extent businesses hurt most by the pandemic, such as travel and leisure will recover. They employ many people and we will need to see them rebound strongly before the economy can reach its full capacity and truly be healthy again. While some sectors, such as grocers, eCommerce, and technology firms that support telecommuting, are doing much better than expected, these are not enough to get us out of the deep rough and onto the green. The future remains uncertain, and we worry that the no-holds-barred approach by the Fed could backfire if we see more than a whiff of inflation. If yield curves steepen meaningfully, this could hurt asset prices across the board – growth stocks, longer maturity Treasuries, and medium-to-long maturity investment grade bonds would all see their values decline. Consequently, given the low yields and elevated valuations, we need to ask ourselves if investors are being adequately compensated for long-duration risk?

As we have posited many times in the past, markets hate uncertainty. Currently, we have two great unknowns facing us. First, it appears that a material second wave of Covid-19 is happening in Europe. Second, it is anyone's guess how our election will turn out and what the subsequent near-term market impact will be. We should have clarity on both soon and hopefully regarding the first, we have learned how better to treat the disease, which will dampen the economic fallout and prevent kneejerk government responses. Regarding the election, we expect the next several weeks to be a crescendo of mudslinging and hyperbole. It will be difficult for the markets to latch onto a kernel of certainty and we would not be surprised to see increased volatility ahead. If we have a contested election, we worry that the rancor and additional uncertainty could be destabilizing until there is greater clarity. Longer term, however, we feel that the economy and markets can do well under either party, as they have done in the past.

What should a thoughtful investor be doing right now? Should we ignore the news and continue unbridled risk taking, essentially, pulling out the driver and trying to knock the ball over the trees and onto the green? While that worked well when the markets were in disarray earlier this year (buying when others were fearful and valuations were under pressure), today we have much higher security prices, moderating Fed support in the form of curtailed bond purchases, record low Treasury yields, the continuing uncertainty around a renewed Covid upsurge, and a tense Presidential election. At the very least, these could cause more of a headwind and make further meaningful near-term appreciation of financial assets more labored. Perhaps it is wise to put the driver back in the bag and safely play away from trouble. Consequently, we have been scaling back our exposure to equity-sensitive convertibles and bonds where we see either continued fundamental weakness or where higher leverage is beginning to erode measures of safety. Cash, short-duration, better quality high yield bonds, and a smattering of convertibles seem best suited for the current market environment. To change analogies for a moment, we feel it is better to hit a lot of singles right now and be patient while we wait for fat pitches that we can knock out of the park.

We thank you for the continued confidence in our management and look forward to continuing our relationship. We welcome any questions or comments that you have.

Sincerely,

Carl Kaufman   Bradley Kane   Craig Manchuck

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