Nonplussed is how we view market sentiment about some of the excesses cropping up today. When we last wrote to you, our opinion was that many parts of the markets were perhaps fully valued, albeit not yet priced for perfection. Fast forward three months and you wouldn’t be faulted for thinking the pandemic was over, economic growth was booming, and the excessive federal debt had subsided. You would be wrong. We are more constructive today on the economic outlook but would point out that speculative excesses seem to be multiplying. The reversal of some of these could hamper market progress in the future.

It’s been four months since the FDA approved the Pfizer and Moderna vaccines. Over 148mm doses of the vaccine have already been administered here and we have seen a rapid improvement in the trajectory of the pandemic in the U.S. There has been a significant drop in reported infections, hospitalizations, and deaths, which has allowed for regions to reopen a bit more and partly resume some activities, like limited indoor dining. Assuming we stay on this trajectory and avoid a fourth wave, we could see a return of jobs and potentially the unleashing of huge pent up consumer demand for services. The Conference Board Consumer Confidence Index, which hit a low of 85.70 a year ago April, has been steadily increasing and is currently at 109.70. Helping to drive this change in sentiment is the improvement in the job market. While we still have a way to go, after averaging about 812,000 a week since December, initial jobless claims dropped to 684,000 last week. Hopefully we see continued improvement. Healthy employment, coupled with the recently signed stimulus package, should give consumers more money to spend and should continue to propel the economic recovery. Given the Covid case spikes in Europe and renewed government actions to combat them, it is possible that the recovery could stall a bit longer. We will be watching developments there closely.

Of course, a continued recovery assumes that consumers do, in fact, spend their money. During the pandemic there has been a bifurcation of cash uses, as evidenced by the higher-than-average personal savings rate. While the long-term average back to 1980 is 9% of disposable income, last year it reached a high of 26% and is still hovering around 13%. The other subset of the population seems to want a more active use for their cash and appears to be “investing” it in non-traditional ways. This is one of the unintended consequences of the broad brush versus a more targeted approach to the stimulus packages.

One example is the spectacular growth of Robinhood, the retail stock trading platform. From the end of 2019 until today, the number of average weekly users has increased roughly 150%, from four million to over ten million. While the concept of more people trading stocks might be an indication of the democratization of trading, given the decline in overt trading costs to zero, evidence seems to indicate it may be the result of boredom and the search for a creative outlet, especially since professional sports has been limited during the pandemic. Another example we have talked about in the past is the cryptocurrency Bitcoin. It was trading at about $18,000 on the day the Pfizer vaccine was approved and rose to almost $29,000 three weeks later at year-end 2020. Subsequently a number
of public companies, most notably Tesla, have touted their investments in Bitcoin and the price has continued its climb to over $59,000 as of 3/31. That’s more than a 200% increase in less than four months. Remember that this digital currency was created out of thin air by an unknown programmer and has no underlying government backing nor significant uses in commercial transactions. In other words, by limiting supply, it is a perfect speculative vehicle.

We would be remiss if we didn’t also mention the delirium around GameStop and some other speculative stocks favored by small traders at Robinhood. GameStop was a company teetering on the edge of bankruptcy, as most of its business was mall-based and its young user base was migrating to online platforms. As a result, there was a very large short position in the name. Spurred on by internet message boards and clearly some extra disposable income (stimulus checks perhaps?), traders moved en masse to buy the stock, inflicting huge losses in the hedge fund community. GameStop rose from $19.15 at year end 2020 to a high of $483 in less than a month. While many distressed holders were able to sell their stock at prices deemed unimaginable a few months earlier, those who were short had to scramble to cover and suffered huge losses. Congress held hearings to discuss this trading activity and it was discovered that there was more than met the eye with “free” trading offered by platforms like Robinhood, but subsequent increased margin requirements by these platforms has helped quell this unbridled trading frenzy for now. Hopefully this volatility dissipates over time as the Fed’s largesse is withdrawn.

Whenever there is too much money looking for a home, Wall Street bankers find a way to spend it, often to excess. Their latest and greatest use of cash is the SPAC (Special Purpose Acquisition Company). These are public corporate shells set up with the express purpose of finding a private company with which to merge within a specified amount of time, typically two to three years after issuance. They used to be known as blank-check companies and occupied a small niche on Wall Street. According to Deutsche Bank, SPAC IPO volumes were well below $10 billion a year from 2010-2016 and below $20 billion from 2017-2019, representing less than 10% of the IPO market. However, according to Bloomberg, in 2020, over $77.8 billion of SPAC money was raised, and $85.7 billion of SPACs have been priced so far this year, representing 75% of domestic IPO issuance. With the average 2021 SPAC size around $300 million, that’s a lot of entities trying to find suitable companies to buy. While some may find attractive targets to acquire, others may feel the deadline approaching and rush into less than optimal deals, like the SPAC that announced a merger with a flying taxi startup. Celebrities are putting their names on SPACs and are able to raise capital, despite having no demonstrable investing or managerial experience. It seems that the rush to SPACs and hopes of a quick payday could end badly for some. Again, without the distortions to the markets, courtesy of the Fed, there might not be as much unbridled speculation as we are now seeing.

Not to belabor the point, but away from Wall Street, we are seeing speculation run amok in a new concept called Non-Fungible Tokens, or NFTs for short. Like cryptocurrencies, these are one-of-a-kind digital “assets.” Artists have been using them to sell both an electronic copy of their art and art that exists only online. The buyer owns a block-chain certified digital copy of the art but typically not the copyright nor any increase in the original art’s value. Only the demand for their unique digital copy will provide them with any financial return. Additionally, if the artist decides to sell more digital copies, the original buyer essentially gets diluted. The NBA has been using the technology to sell digital copies of game clips. Again, the NBA owns the rights and can sell as many copies as they want and broadcast the video anytime and anywhere they want. The buyer of the NFT only owns a unique digital copy. Now why the big buildup? The NBA has sold $400 million worth of these digital video clips! One video of Lebron James fetched $612,000. In the art world, a graphic designer who goes by the name Beeple
recently sold an NFT of a digital collage for $69mm. Anyone can actually search the internet and see the digital art and even save it on their own computer, but for $69mm only one person gets the bragging rights to owning the digital image. The artist Beeple still actually owns the art and can sell future copies if he chooses. Please let us know if you are interested in purchasing an NFT for some of our past Investment Outlooks!

Thankfully much of this speculation should have little impact on the real economy as it is a zero-sum game. However, when we see massive price spikes in assets that are deemed to have limited supply (or little intrinsic value), we wonder if a broader rise in prices can be far behind. Given the massive stimulus packages and extremely easy monetary policy keeping short term lending rates (and yields on cash) at essentially zero, combined with the pent-up demand from post virus re-openings, inflation becomes a bigger and bigger concern. Our colleagues from our Total Return team have written about inflation in their latest quarterly outlook if you would like to read more on this. In summary, they believe that the situation today is the polar opposite of the post 2008 period regarding the health of the consumer, growth in the economy, and the sheer magnitude of the liquidity infusion by central banks. Also, that various parts of the population experience inflation differently and it is virtually impossible for the Fed to control everyone’s inflation expectations equally. They reiterate points we have written about in the past about how hedonic adjustments can keep reported inflation more subdued.

On that matter, it has been said that technology is deflationary. Clearly, companies’ use of vast computing power to make their operations more efficient is an obvious example. However, technological advancements over time make the value received from a product much greater, which in the Bureau of Labor Statistics (BLS) eyes makes it cheaper, hence deflationary. This holds true even if you pay more dollars to buy the same item such as a computer, a cell phone, or a TV. The current computer chip shortage rolling through the global supply chain and rising prices for chips will be an interesting test for the inflation bean counters at the BLS. A recent article in The New Scientist magazine details the drivers behind the current shortage, which seems to have no short-term solutions. Automakers are mothballing production lines, Samsung is considering delaying its new phone launch, and Microsoft is cutting back on its gaming systems. There will need to be significant investment to increase the production of chips to fix the supply demand imbalance. We will have to wait and see how the BLS deals with this as the prices for both components and finished goods are likely to rise.

Our friend and former Chief Economist for Wells Fargo, John Silvia, brings up an interesting conundrum in a recent piece. “Traditionally, deficit finance rises as a percent of GDP as the economy weakens. But that is not the story from the period of 2016 to 2020 as deficits as a percent of GDP increased even while the economy expanded...rising fiscal deficits, with no budget constraint, in an expanding economy, is an interesting fiscal policy experiment—even more so when combined with expansionary monetary policy.” Even former Treasury Secretary Larry Summers, typically not a balanced budget hawk, has been warning that the massive stimulus, easy monetary policy, and expected surge in consumer spending post lockdowns are all risks for increasing inflation. Tempering this risk is the fact that much of the stimulus package is short term or one time. Monetary policy can also be reversed. Plus, Congress will likely claw it back, in aggregate, through higher taxes, which could cause an economic slowdown that would likely dampen inflation. We shall see.

Longer-term interest rates have been rising recently with the yield on the 10-year U.S. Treasury rising from 0.92% at year-end 2020 to 1.74% on 3/31/21. The Fed is steadfast in anchoring short-term interest rates at essentially zero for at least the next couple of years. While some of this move in interest
rates is certainly based on the expectation of stronger growth and possibly higher inflation driven by the vaccine-induced reopening of the economy, some of it may also have to do with the plumbing in the banking system. Normally, to maintain sufficient capital ratios for stress testing, banks must hold a certain amount of equity capital based on their Treasury and customer deposit balances. This required capital reserve is usually 5% of assets, which are usually classified as deposits and loans. The pandemic threw a monkey wrench into these ratios and restricted the banks’ ability to further lend just as companies demanded significant amounts of “cushion” by drawing down bank lines, thereby increasing banks’ assets. In addition, consumers working from home, or receiving enhanced unemployment benefits and additional stimulus checks increased their deposits at banks, also increasing the denominator. The Fed relaxed the capital ratio (the SLR or “Supplemental Leverage Ratio”) requirement by exempting both Treasury and cash reserves from the ratio until March 31, 2021 to allow for the banks to lend additional capital and handle the increase in deposits, while making some return on the longer term Treasury bonds. The government also benefitted from this as the banks were steady buyers of Treasury bonds, whose issuance jumped to fund the stimulus programs. Recently, under pressure from some in Congress who viewed this as a handout to banks, on March 19th, 2021, the Fed announced that the relaxation of capital ratios would cease. Without the special capital treatment for their Treasury positions, banks began selling these positions, which undoubtedly contributed to driving the 10-year yield to its highest level since January 2020. It’s also possible that with the new stimulus checks that have begun arriving in homes, that bank deposits will again balloon and these ratios will once again be stressed. We have even heard some talk by major banks of refusing new deposits. This may pose a problem for the Fed and bank regulators down the road.

As we highlighted at the end of 2020, we were concerned that yields were low, and duration was high, especially in investment grade, and we considered high yield to be a more attractive alternative. Given the uncertainty surrounding the reopening rebound, we maintained a cautious view. Year-to-date, as of 3/31/21, according to Bank of America, the Investment Grade market has returned 3.58% while the high yield market has returned 0.904%, mostly driven by a 5.208% return for CCC-rated bonds. Energy is the predominate contributor to the CCC return, driven by a 21.5% rise in the price of oil this year. As you know, energy is a sector in which we have a significant underweight, especially in exploration and production. Given our cautious nature, and based on current valuations, we have continued to rotate into what we consider higher-quality yield companies and also into shorter to intermediate maturities. We do not believe that the more distressed parts of the market, which have led performance over the past six months, offer the same protections and future returns as the rest of the high yield market over the balance of the cycle. This will mean accepting a lower yield for a period of time until we see better buying opportunities. We have also seen an accelerated pace of the refinancing of our higher coupon bonds, which has accentuated the move lower in yields for our aggregate holdings. We continue to find opportunities in higher-yielding longer-term paper in good companies, but they have become harder to come by. We also have been taking profits in some convertible positions that have moved markedly higher during the equity rally. As always, we thank you for your continued support and welcome your questions and comments. Here’s to an acceleration of the vaccine rollout and getting back to normal.

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