OSTERWEIS
CAPITAL MANAGEMENT

Strategic Investment Outlook
First Quarter, 2021

An increasing number of pundits are raising the possibility that the current Covid-induced recession will be followed by a boom period reminiscent of the Roaring ’20s, which followed the Spanish Flu pandemic of 1918-19. We are somewhat sympathetic to this view but would note two caveats. First, the Roaring ’20s followed not just the flu pandemic but also World War I. So the level of pent-up demand back then probably exceeded the level today following just Covid. Another hallmark of that time – revolutionary innovation such as radio, movies, and autos – reshaped society. Today we see plenty of disruption, but it appears more evolutionary than revolutionary. Second, many of today’s consumers have been badly hurt by their Covid experiences and may choose to rebuild their frayed balance sheets rather than go on a spending binge. Others, of course, will gladly go back to restaurants, theaters, etc. once it is safe to do so. In short, it is reasonable to expect that as vaccination proliferates and people feel safe to move about, the overall level of economic activity will accelerate – especially in the hardest hit sectors: restaurants, travel and leisure, and perhaps even some brick-and-mortar shopping.

One other important caveat is that the strong stock market returns experienced in the Roaring ’20s started from single digit valuation levels and a 5% yield on government 10-year bonds. These metrics were significantly more supportive of future returns than those of today, where the S&P 500 trades at just under 20x 2022 earnings per share, and 10-year government debt yields hover near 1%. So even if the economy enjoys a strong recovery over the next decade, there appears to be less oxygen in the form of multiple expansion to fuel the market’s move to higher levels. Put another way, while the low interest rate environment certainly creates the possibility of further multiple expansion (as we have written numerous times), we think investors should key on earnings growth as the primary driver of equity market advances over the next few years.

As the economy does re-open, there are likely to be bottlenecks in the supply chain as many businesses had to shutter during the pandemic. This could produce a temporary blip in inflation. There are already some signs of this in the copper and steel markets. We would also expect that airlines and hotels will begin restoring prices back toward pre-Covid levels. We do not expect the Fed to raise interest rates aggressively to counteract a short-term rise in inflation. The Fed has very clearly stated that it would like to see inflation rise to at least 2.0% and possibly higher for a while.

But any increase in inflation will raise the question of whether it is temporary or something more pernicious. Over the last two decades or so, there have been a few strong deflationary trends that have kept inflation in check. First is globalization, which opened China and Eastern Europe, thereby creating a vast untapped pool of cheap labor. This allowed U.S. manufacturers to hold down wages domestically by having the ability to move production to low-cost labor markets overseas. There is some concern that this ability is waning as populations age in China and elsewhere, reversing the long-term trend of abundantly cheap labor. How soon and how significant this shift will be is hard to say, but it clearly deserves watching.

From a social and political point of view, higher U.S. manufacturing wages may actually be a good thing as long as they don't trigger a classic wage/price spiral. And that leads us to the second deflationary trend, namely technology. Unlike the effect of globalization, which may be waning, the effect of technology may be getting stronger. We are still in the early innings of the digitization of the economy. Technology is becoming an even larger part of the economy, so it is reasonable to expect its impact to increase. All of this points to a long runway of efficiency and productivity improvements in the years ahead.

A third important deflationary trend is demographics, namely the aging populations in the U.S., Japan, Europe, and China. The percentage of Americans older than 65 has been steadily growing for the past two decades, particularly since the first Baby Boomers reached that milestone in 2011, and the pace is accelerating. According to a study by the Population Reference Bureau, the number of older adults in the U.S. is projected to increase by 69% between 2020 and 2060, from 56 million to 95 million. For a variety of reasons, older people tend to spend less and save more than younger people, so the continued growth of that demographic will be an ongoing drag on aggregate demand, which will likely inhibit pricing power in many sectors, particularly for manufactured goods.

As we study companies, we see numerous efforts to replace labor with automation. Perhaps the starkest example is the ride-hailing industry's investment in driver-less car technology, so far not successful, but still a goal. Another example is agriculture. U.C. Davis is one of the leading ag schools in the country. They write extensively about a looming shortage of ag workers and the need to automate farming. Next, we think about traditional manufacturing and the increasing use of robots. And where robots are irrelevant, we think about what artificial intelligence might one day do to white collar labor.

All this is important because if inflation remains tame, interest rates will stay relatively low. If interest rates stay low, equity valuations can remain elevated for years. We have written extensively in prior Outlooks about the importance of interest rates to equity valuations. To reiterate, low-interest rates drive equity values higher, and this is especially true for rapidly growing companies. One has only to look at the stock market in 2020 to see this dynamic at work.

This past year has been quite dramatic as high growth companies saw their stock prices soar, while companies in struggling industries suffered earnings declines and sagging stock prices. We expect this dynamic to continue. The key will be to identify companies with accelerating fundamentals and avoid those with decelerating earnings and cash flow. We remain focused on dominant firms riding long-term secular tailwinds, but we also feel that 2021 should be a good year for cyclical companies. We anticipate the economic recovery will continue in the new year, and we think "real economy" stocks (e.g., banks, industrials, energy, and commodities) could particularly benefit.

We are taking a similar approach in fixed income. We feel there are pockets of value in the bond market where one can garner reasonable income from companies whose earnings are rising and whose balance sheets are improving. At the same time, we feel it makes sense to de-risk portfolios a bit now and wait for better entry points, as yields are near their pre-pandemic lows. Likewise, we are paring down our convertible bond holdings as they have had a great year on balance, and we feel it is prudent to take some money off the table there and look for better buying opportunities.

We want to thank all of our clients for your loyalty and trust. We wish you a very happy, healthy (Covid-free), and prosperous New Year.

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Sincerely,

John Osterweis　　　　Carl Kaufman

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