OSTERWEIS
CAPITAL MANAGEMENT

Who Will Win?
Total Return Market Outlook
Fourth Quarter 2020

The third quarter saw a continuation of the theme of normalization in markets, as equities hit new highs, corporate and mortgage bond spreads edged lower, and Treasury yields were little changed. The narrative in the markets began to switch from mostly pandemic headlines in July and August to more election headlines in September, a trend that we expect to continue in October. Based on the outcome of the election, the markets will need to reassess their collective view on fiscal stimulus and economic policies more broadly.

The table below highlights the dramatic recovery across the markets.

Index	6/30/2020	9/30/2020	Change
Fed Funds Target Rate (upper bound)	0.25	0.25	-
Investment Grade Corporate Option-Adjusted Spread	150	136	-14
2-Year Treasury Yield	0.15	0.12	-0.03
5-Year Treasury Yield	0.29	0.27	-0.02
10-Year Treasury Yield	0.65	0.68	0.02
30-Year Treasury Yield	1.41	1.45	0.04
MOVE (Volatility) Index	54.1	39.2	-14.9
MBS Nominal Spread	109.6	93.1	-16.5
Crude Oil (NY Mercantile)	39.27	40.22	0.95
VIX	30.43	26.37	-4.06

The biggest news out of the Federal Reserve (the Fed) in the third quarter was a change in its inflation targeting scheme, announced in late August. In short, the Fed's new view is that it will now seek a 2% inflation target *over time,* which means that following a period of sub-2% inflation (as we've experienced for the last decade), it is appropriate to aim for inflation above 2% for some time. Our interpretation of this is that the fed funds target rate will stay lower, for longer, and that the Fed will not blink when inflation, by any measure, reaches or surpasses 2% unless they deem this change to be persistent. Of course, inflation has historically proven to be a slow-moving phenomenon with a lot of inertia, so we believe there is some potential of an inflation overshoot in the intermediate-to-long term following this policy – if the Fed is actually able to stoke inflation. So far, we've seen four bouts of quantitative easing and none has demonstrably generated inflation. In our minds, inflation will manifest only if one or more of these conditions are met:

- Persistent dollar weakness (or commodity strength), increasing the cost of imports
- Significant fiscal stimulus, which would put money in people's pockets and ultimately encourage them to spend, increasing the velocity of money and thus inflation
- Supply chain onshoring, which could increase the cost of goods to the consumer

It is interesting to note that in July and August, we saw upside surprises in the CPI. Whether this is temporary – or the start of a trend – remains to be seen.

The real wildcard for the fourth quarter is the U.S. election. A Democratic sweep, which has appeared increasingly likely in recent weeks, would probably bring a large fiscal stimulus package, which could put pressure on Treasuries – we would expect yields to rise most in this scenario. A scenario with a split Congress and/or Donald Trump winning reelection, would appear to be somewhat better for Treasury investors. We are not going to forecast election outcomes, but we will use the outcome to instruct our portfolio positioning. With Treasury rates near generational lows and the general direction of the economy decidedly positive, it is difficult to envision interest rates falling or even staying at current levels for very long in any election outcome. The other primary driver – Covid – has seen a slew of regional outbreaks mostly related to school campuses reopening, offset by many headlines around vaccine and therapeutic developments. It should be noted that these spikes in positive tests have not been accompanied by widescale hospitalizations or deaths. We expect the economy to inch toward fully reopening at an irregular pace, and the election to be the primary driver of market volatility in the coming weeks.

Diving into the investment grade market, corporate credit performance in the third quarter moderated as the recovery continued from the previous quarter. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Aggregate corporate sector tightened from 150 basis point (bps) to 136 bps. Heavy new issue supply continued despite expectations for a slowdown in the second half of the year. During the period, total new issue volume reached $350 billion, led by record issuance in the usually slow month of August. By comparison, there was $302 billion in the third quarter in 2019. Sectors most adversely affected by the pandemic outperformed, with the finance company cohort (which includes aircraft lessors) tightening by 63 bps. Notably, the banking group underperformed other corporate sectors as it only tightened by 10 basis points, as it was hit by accusations and fines over poor risk controls. Despite the pandemic, all corporate sectors tightened over the quarter. A notable trend in investment grade credit has been an uptick in the amount of debt being retired early by companies with strong cash positions and those extending their maturity profile. This dynamic is worth watching and will likely continue to support the performance of short and intermediate maturity bonds. We are maintaining our overweight in the investment grade corporate sector but will remain vigilant on credit selection.

The explicit support for the mortgage market has also buoyed valuations, following a playbook from previous quantitative easing programs. We continue to favor lower coupon passthroughs that have less prepayment exposure for the bulk of our mortgage investment, while keeping our structured investments in very seasoned, higher coupon MBS that exhibit much less prepayment sensitivity than recently issued loans. We anticipate little change in this allocation so long as the Fed maintains its significant purchase program in agency MBS.

Reiterating a point we made last quarter - with Treasury yields this low, the primary function of the Treasury asset in a fixed income portfolio remains as a place to hide and wait for conditions to improve. Corporate bonds and mortgages continue to offer significantly more value. It remains more important than ever to be judicious about which securities we select, as it is important to identify subsectors and individual companies within those sectors that will outperform in this macroeconomic backdrop. We have shortened our duration profile and are back to our longer-term norms. If the Fed has any success in stoking inflation, we would look to reduce our duration profile further, perhaps to zero. We have reduced our holdings in bonds with greater than seven years to maturity and will continue to be defensive in our interest rate exposure. Recall in 2013, 10-year Treasury yields rose over 100 basis points while the Fed was carrying out QE3 – the infamous "Taper Tantrum." It is entirely possible to see a repeat of this performance given a narrative of a recovering economy, resolution of uncertainties around the election, and a potential curtailment of the impact of the pandemic.

We thank you for your confidence in us and welcome any questions or comments you may have.

Best regards,

Eddy Vataru John Sheehan Daniel Oh

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A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages.

The Chicago Board Options Exchange (CBOE) Volatility Index, or VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility

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.

Merrill Lynch Option Volatility Estimate (MOVE) Index – USD – is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options.

A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

Spread is the difference in yield between a risk-free asset such as a U.S. Treasury bond and another security with the same maturity but of lesser quality. Option-Adjusted Spread is a spread calculation for securities with embedded options and takes into account that expected cash flows will fluctuate as interest rates change.

Holdings and sector allocations may change at any time due to ongoing portfolio management. References to specific investments should not be construed as a recommendation to buy or sell the securities by the Osterweis Total Return Fund or Osterweis Capital Management.

Coupon is the interest rate stated on a bond when it's issued. The coupon is typically paid semiannually.

A basis point is a unit that is equal to 1/100th of 1%.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

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