OSTERWEIS CAPITAL MANAGEMENT | MARKET PERSPECTIVES Fourth Quarter, 2021

REASONS FOR OPTIMISM, DESPITE SLOW Q3

The third quarter of 2021 was characterized by a highly volatile equity market and a sluggish bond market, both of which finished the period roughly flat. The post-pandemic rally finally stalled out, as investors grappled with several significant issues simultaneously, including the Delta surge, decelerating GDP growth, continued supply chain issues, labor shortages, rising inflation, and a potential tightening of the Fed's monetary policy.

Given all the uncertainty, it is not surprising that the market sputtered – investors are having trouble figuring out what the economy will look like when things eventually normalize. While there are many possible scenarios, including continued market volatility, we believe the most likely outcome is favorable – an extended cycle of capital investment that should be the impetus for both broadening growth and job creation.

ECONOMY IS PRIMED FOR CAPITAL INVESTMENT

Our bias toward this outlook is based on a few presumptions. The pandemic has laid bare the need for an extended investment cycle. For example, we have witnessed the inherent structural risks associated with global just-in-time supply chains, which are a root cause of the shortages and bottlenecks we are currently facing. We suspect the remedy to this is the reshoring of manufacturing capabilities and supply chains to geographies that are closer to the markets where customers live. The proliferation of omnichannel retail only makes this trend more acute.

We are also seeing signs of energy stress, with demand for energy outstripping supply, resulting in multi-year high prices for crude oil and natural gas. Due to the combination of shareholder demands that traditional energy companies put less money into the ground and return more money to shareholders, along with societal pressures for de-carbonization, we see the potential for the energy shortage to persist. The need to fill the gap between supply and demand will drive investments in alternative sources like wind, hydrogen, and solar.

In addition, everyone in Washington, D.C. seems to agree that infrastructure spending is necessary, which should create a persistent bid for raw materials such as steel, aggregates, and copper. In combination with reshoring of global supply chains to carry more inventory, we will likely see increases in demand for logistics and warehousing.

FEATURED SECURITY

Advanced Micro Devices (AMD)

For decades Advanced Micro Devices (AMD) played a distant second fiddle to Intel. Both make x86 chips, the brains of everything from notebooks to complex data centers, but AMD had historically struggled to match Intel's technology leadership and cost, resulting in 90%+ share for Intel. That history began to change when a fresh management team at AMD designed a new kind of semiconductor chip architecture that is extremely well suited for the needs modern data centers.

This architecture, called "chiplets" because of the use of small, specialized chips to process data, is the underlying driver of AMD's success. The chiplet design lends itself well to customization and a more seamless hand-off of data between different kinds of chips in a data center. The technology positions AMD well to help data center engineers improve performance and reduce power consumption by tailoring their architectures to the unique requirements of different types of computing jobs.

The result has been a tripling of revenue since 2017 and huge market share gains for AMD. With all of this success, AMD still only commands about 15% of the data center market, meaning there is a long runway of opportunity ahead in an industry that should grow at about 20% per year.

REAL WAGES ARE RISING

Another reason we are constructive on the economy is that real wages are rising at a rate we haven't seen in decades. This is likely due to a constellation of factors that have led to near-term labor shortages: a wave of Covid-induced early retirements (2 million above normal), massive labor dislocations created by the pandemic lockdowns, more workers choosing to stay home due to safety concerns and increased government stimulus, and slowing population growth caused by the tragic decline in life expectancy, lower birth rates, and stagnant immigration rates.

Whether these trends become the impetus for long-term structural inflation or whether they are a short-term anomaly is an open and critical question, as we see both temporary and structural forces at play. For example, on the temporary side, many of the supply chain issues should be resolved in the next year or so. On the structural side, as noted above, we think the bottlenecks have laid bare major shortcomings in global supply chains that could lead to permanent changes and a large investment cycle.

ECONOMIC FUNDAMENTALS APPEAR TO BE SOLIDIFYING

It seems to us that the combination of increased capital investment and rising real wages should result in above-trend growth with manageable inflation. Price increases for raw materials should be transitory – there is plenty of capital and technology for supply to catch up to demand. Upward wage pressure may persist, but real wages are still below historical levels, and the recent increase in incomes should be supportive of consumption, which accounts for nearly 70% of U.S. GDP.

In addition, many businesses have done a remarkable job of cutting costs and have positioned themselves to come out of the Covid crisis stronger than they were in 2019. The capital markets have been functioning exceptionally well for the past 18 months, allowing companies to fund growth and easily refinance debt obligations at attractive rates as they come due. Management teams are gaining experience and getting comfortable managing disparate organizations whose employees have been largely working from home for the last six quarters. So, while tight labor markets and supply chains present some near-term challenges, and a Fed taper could trigger some near-term volatility in the markets, corporate balance sheets are generally in excellent shape and companies seem well-positioned for growth as these temporary conditions work themselves out over the coming quarters.

CONTACT US

If you have questions about this commentary or would like more information about our firm, please reach out using the contact details below.

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