OSTERWEIS
CAPITAL MANAGEMENT

MARKET PERSPECTIVES
Third Quarter, 2021

Q2: MORE QUESTIONS THAN ANSWERS

The second quarter was a complicated period for both the economy and the markets. The good news was that the post-pandemic recovery continued to gain strength, as the combination of pent-up demand and significant fiscal and monetary stimulus fueled purchasing by both consumers and businesses. On the downside, the surge in spending created a wide range of supply shortages that triggered substantial price increases in sectors as diverse as commodities, housing, and retail.

The upshot was a market in flux. Investors were befuddled by questions around the transitory nature of inflation, how long the strong rebound will persist, and whether a resurgence of Covid threatens the recovery. As a result, the average stock has traded flat since the first quarter earnings season, with the most recent market advance coming from a flight to safety in large-cap tech stocks as bond yields have fallen.

More interestingly to us, we see high daily volatility between small and large caps, and growth and value. This suggests a lack of market consensus about the next stop for the economy – is our destination a return to low growth and low inflation, which is favorable for higher multiple secular growers, or structurally higher inflation and a long duration cyclical recovery, which favors value and cyclicals?

INFLATION: TRANSITORY OR NOT TRANSITORY?

With apologies to Shakespeare, we believe this is the most important question facing the market today. The ultimate answer is likely several quarters in the future, but different schools of thought are emerging.

One camp foresees persistent labor shortages and long-term upward pressure on wages, reversing trends of the last 20-30 years. Since roughly the mid-1980s, the twin forces of globalization and technology have conspired to keep labor costs down. Globalization allowed the U.S. and other developed countries to tap into nearly limitless Chinese and other developing economies' low-cost labor pools. High-paying U.S. manufacturing jobs were shipped overseas. Union membership declined. Domestic wages stagnated.

Technological advances also worked to reduce labor input and generally to make business processes more efficient. We see no let-up in technology gains but caution that globalization may have run its course. First, we see a trend toward re-shoring (i.e., bringing manufacturing

FEATURED SECURITY

Danaher Corporation (DHR)

The global pandemic hastened the adoption of health care technologies related to virus testing and mRNA vaccines, which teach our immune systems to fight disease by creating new proteins. Danaher, a global conglomerate focused on life sciences and applied industrial technologies, is a clear beneficiary of both trends.

Originally an industrial conglomerate, management has steadily repositioned the company towards higher growth, higher margin businesses that benefit from long-tail secular tailwinds in diagnostics and health sciences. This transition has been powered by a low-cost, high returns model that provides huge sums of capital that management has shrewdly reinvested in these new opportunities.

Cepheid, a subsidiary that develops a point of care platform that can test for a variety of maladies, saw its placements increase by 40% during the pandemic. Positioned as a better, faster, cheaper solution, Cepheid should see long-term benefits of these placements regardless of the trajectory of the pandemic. Another subsidiary, Cytiva, provides the high-performance reagents, raw materials, and filters needed for the next generation bio-processing that is required for many of the Covid-19 vaccines and therapeutics. Made from proteins, biologics drugs could comprise a $400 billion industry by 2025.

The acceleration of these trends helped Danaher more than double its free cash flow during the pandemic. We remain confident that management will continue to put that money to good use to the benefit of shareholders.

back to the U.S.), which would obviously lead to greater demand for domestic workers. Second, China's one-child policy has had a profound impact on its demographics, and it appears the country may be running out of cheap labor. In fact, Chinese authorities recently relaxed the policy as they need more workers to support their aging population.

The other camp points to a drop in Treasury yields from nearly 2% to below 1.5% and a significant drop in the prices of bitcoin and precious metals. While the Fed has been pumping money into the economy, the actual velocity of money has declined. That is, banks have not been lending aggressively, thereby blunting the stimulative effect of loose monetary policy.

Our view that inflation will likely decelerate meaningfully in the back half of 2021, but over the longer-term we see the potential for upward wage pressure that may or may not be offset by technology and automation. Our best guess is that reality will probably fall somewhere in-between, i.e., the economy will again settle into a slower-growth, low-inflation pace where wages keep pace with inflation (which would be a positive change). Given all the monetary stimulus and the potential for marginal improvement in real household income, this could be very good for equity prices.

EITHER WAY, FED POLICY REMAINS UNCHANGED

Throughout the current inflationary spike, the Fed has consistently said that they believe the situation is temporary, and they appear to be committed to keeping rates low for as long as is practical. This, combined with the expectation that growth will inevitably slow from the current torrid pace, will likely keep interest rates from rising excessively over the next few years. Given that finding yield will likely be challenging in this environment, we prefer the non-investment grade sector because of its lower duration, higher yields, and healthy fundamental backdrop. Within the investment grade market, we favor opportunities in MBS and ABS that take advantage of historically high asset values rather than corporate bonds, as spreads are near multi-year tights and seem to present more downside than upside.

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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The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index which is widely regarded as the standard for measuring U.S. investment grade bond market performance. These indices do not incur expenses, are not available for investment and include reinvestment of dividends and/or interest income.