OSTERWEIS
CAPITAL MANAGEMENT

Strategic Investment Outlook
July 2017

During the second quarter ending June 30, 2017, the stock market continued to inch its way higher. Gaining another 3.09%, the S&P 500 Index (the "S&P 500") is now up 9.34% year-to-date through the first half despite the beginnings of a reversal in monetary policy. With valuations now somewhat above average, and with the Federal Reserve (the "Fed") signaling that it intends to move towards a more neutral monetary policy–as opposed to an ultra-stimulative one–the question facing investors is whether the bull market is topping out or if it has further to run.

For some time we have maintained that from an investment perspective, a rising interest rate cycle should be viewed as having two phases; one favorable to equities and one threatening. In the first or initial phase of the cycle, the Fed raises interest rates in line with inflation and maintains a pro-cyclical or pro-growth bias. This phase is essentially reactive in that the Fed is trying to "keep up" with the economic expansion. During this phase the economy usually continues to expand and corporate profits grow. The stock market is able to move higher as rising corporate profits typically offset any valuation compression caused by higher interest rates.

The second phase of rising interest rates is typically quite different. In this phase the Fed actively tries to choke off the economic recovery in order to control unacceptably high inflation. This phase typically ushers in a recession, lower corporate profits, rising bankruptcies and, of course, a lower stock market.

So the burning question for investors is: Where are we? Phase One or Phase Two? We would answer emphatically, Phase One. Why? Because inflation is quiescent.

The economy has changed significantly in the last twenty or thirty years. Declining unemployment no longer automatically engenders rising wages, and hence inflation, as it did previously. The change was first visible during the long 1990s expansion and is seen again in this cycle. "Today, wage growth has been stuck around 2.5%"[1], and inflation hovers below 2%. At the same time the unemployment rate has dropped from 10.0% in 2009 to 4.3% today. Yet wage pressure is barely visible.

According to Greg Ip in the Wall Street Journal[2], "Minimal corporate pricing power, lackluster productivity growth and an aging workforce have all undercut employers' ability to pay better." He further explains that "…pay is closely tied to what employers can recover by raising prices (inflation) or sales per employee (productivity). Since 2012, U.S. businesses' selling prices have risen by 1.4% and worker productivity by 0.6% a year. At 2%, the sum of those two figures–a proxy for sustainable wage growth–is the lowest in more than 60 years. Worker pay has actually grown faster than that subdued 2% benchmark, because employers have absorbed the excess in their profit margins…"

To us the key to understanding this hinges on why businesses' selling prices have risen by only 1.4%. Why is inflation so persistently low? In the 1990s we, and many others, pointed to the twin causes of globalization and the digital revolution. Today we would say globalization is still a factor, but the digital revolution–the impact of technology on business systems and processes–is the dominant cause. It allows business to produce products and services more cheaply. It allows consumers to price compare like never before. It introduces disruptive competition in industry after industry. As a result, business faces relentless pricing pressure. Here are examples:

Price Comparison Shopping

Almost no matter what you want to buy, whether it is a hotel room for the night, a plane ticket, a car or clothes, you can go online to find the relevant bargain. Brick and mortar retailers are dying like flies as consumers come in, check out the merchandise and then go online or use their mobile phones to buy it for less from a competitor. Simply put, the digital revolution has provided the consumer with unprecedented price discovery powers, thus exerting tremendous pressure on businesses to remain price competitive.

Business Process Evolution

Businesses today must focus maniacally on efficiency and on taking costs out of their systems. The use of digital technology is a key component of this trend. Think 3-D printing, robotics and other forms of computerized machine controls. Think of data analytics, e-mail and artificial intelligence.

These developments make business more efficient and tend to reduce the amount of labor needed to produce goods or provide services. It also changes the type of labor needed for these processes. As an example, think of the computer you talk to when you call Walgreens to refill a prescription. Moreover, in large successful technology firms, the number of employees per dollar of sales is lower than in traditional manufacturing.

Cost of Computing

The cost of computing has come down relentlessly over decades and continues to grind lower, having ripple effects throughout the economy. Lower computing costs keeps pricing for all kinds of goods and services low. Decades ago, companies needed tremendous financial resources to afford computers, which were giant mainframe devices that took up large physical footprints. Today, with cloud computing, datacenters and ever faster internet speeds, an entrepreneurial individual with an idea can afford the same computing power as a multinational company and roll out a competing product or service on a global scale. This ensures a highly competitive global economy where higher computing power at continually lower costs levels the playing field for new competitors who want to offer cheaper and better services.

Labor's Declining Bargaining Power

Union participation is down nationwide to 10.7% at the end of 2016 vs. 20.1% in 1983. Clearly there has been a long-term structural shift in power away from labor in favor of capital. Compounding this structural trend has been the rise of the technology-enabled gig economy. In the gig economy, workers are independent contractors, not union members with collective bargaining power. New business models enabled by technology are dramatically altering the competitive landscape. Airbnb is allowing independent homeowners to compete directly with hotels, thereby dampening hotel chains' pricing power. Uber is doing the same to taxi companies. But the model does not make Uber drivers rich. In fact, as a full time job, driving for Uber is not very lucrative. We have heard anecdotally of Uber drivers who are essentially homeless and sleeping in their cars.

Low Commodity Prices

Look at the price of oil. It is trading at $45 per barrel, down from over $100 per barrel. Why? Because with the new technologies of horizontal drilling and fracking, the U.S. has unleashed a tidal wave of cheap oil. Other commodities are also trading at reduced prices as supplies have outstripped demand, often because of new, better, cheaper production techniques.

Thanks to tech, consumers are smarter, businesses are more competitive, labor less powerful and commodities more plentiful. Ergo minimal inflation. We believe these trends remain durable. There is a counter argument that claims inflation is poised to accelerate because of low unemployment and a high level of unfilled jobs, which will cause employers to start bidding up the price of labor, thereby igniting an inflationary process. One of the problems with this argument is that businesses generally lack pricing power in a highly competitive economy, as do many workers. So we doubt that inflation can suddenly take off.

The one argument that does seem to support higher inflation focuses on the rising cost of certain services such as health care and education. Clearly these services cost more, partly because there are few, if any, productivity gains in them. The same also holds true for the arts. A duet or a "pas de deux" still requires two performers, just as they did 300 years ago. While it is undeniable that certain services cost more, these costs do not have a determinant effect throughout an economy that appears structurally different from the economy 50 years ago and is thus less vulnerable to an old-fashioned wage/price spiral.

In conclusion, we think that lower-for-longer inflation means that the upward trend in interest rates should be moderate, allowing the bull market in equities and high yield bonds to continue. For equities, we are keeping our focus on companies with 1) robust, growing dividends; 2) clear market share gains; 3) turn-arounds with specific catalysts for improving sales and earnings; 4) a few companies facing rapidly improving industry conditions; and 5) companies insulated or benefiting from the technology changes elucidated above. Overall, we favor attractively priced, rock-solid companies that have durable growth trajectories projecting well into the future.

Looking at fixed income, in this slow growth, low inflation environment, we prefer credit or economic sensitivity to interest rate sensitivity. We favor shorter duration and continue to add convertible exposure when we find compelling value, either in busted, bond-like issues or in converts underlying attractive companies where we are getting paid a fair interest rate and have an option to participate in that company's future growth. We still like the absolute yields in the shorter end of the high yield market.

Sincerely,

John

John Osterweis

Carl

Carl Kaufman

[1] Wall Street Journal, Economy: Other Times Unemployment Has Been This Low, It Didn't End Well, Josh Zumbrun, June 4, 2017.
[2] Wall Street Journal, Monetary Policy, Federal Reserve Fed Tightening Timetable: Lousy Pay Raise? That May Be as Good as It Gets, Greg Ip, June 14, 2017.

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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. One cannot invest directly in an index.

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.

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