Sticking with the Winners
Equity Investment Outlook
July 2020

We often characterize markets as a struggle between bulls and bears, but in the current Covid-19 environment, markets are better seen as a struggle between extended shutdowns and optimistic re-openings – or said another way, between pandemic-induced recession on the one hand and economic recovery on the other. This is certainly what we experienced in the second quarter. As the economy started to recover, investors piled into the most cyclical companies such as airlines, which had been battered by the shutdowns. Then as Covid cases started to rise again – the second wave – the market briefly sold off.

The negative sentiment didn't last long, however, and the stock market has resumed its upward climb. We believe this reflects two things: first, the tidal wave of fiscal and monetary stimulus, and second, investors' faith that the pandemic will ultimately prove transitory. We see no reason for the Fed to adopt a more restrictive monetary policy anytime soon. There is a need for both additional fiscal stimulus and direct support for people adversely affected by the current slowdown, so there is some risk that the economy could suffer if Congress fails to enact additional aid.

Until we are able to develop the right combination of cure, vaccine, and herd immunity, which would enable us to contain the pandemic, the markets will likely remain volatile. We suspect that it will take 12-18 months for drug companies to develop an effective vaccine. Meanwhile, the economy is likely to recover, but with occasional setbacks, leading to somewhat manic/depressive market swings.

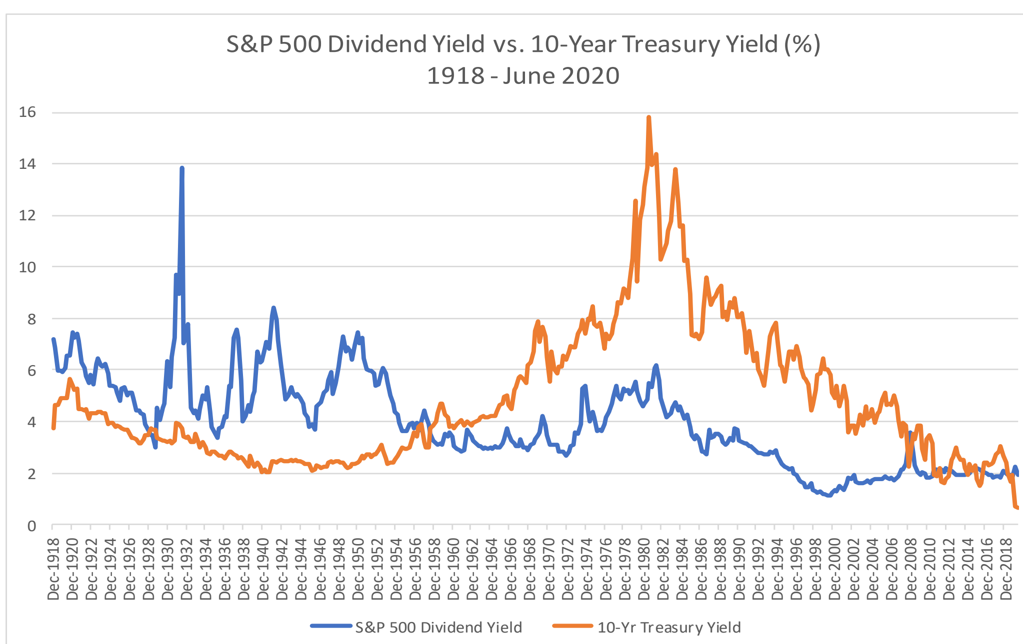
Given the near-term uncertainty, what should investors do? We believe that the wisest course is to focus on the highest quality companies – those able to grow during this time of stress, and those able to gain market share as weaker competitors fall by the wayside or are absorbed by these stronger rivals. Second is to focus on companies and industries that benefit from current trends. For example, as sheltering in place increases the need for companies and consumers to accelerate digital transformation, the demand for data centers and the technology that supports them grows, while demand for brick-and-mortar retail space declines.

Of course, there is always room for a contrarian bet, but such bets need to be made with great caution, because a Covid flare-up, or a longer period of pandemic, could easily turn a variant view into a wipeout. This is especially true of industries where spending is discretionary, and the underlying companies carry significant debt. At this point, we think it's better to stick with the winners, not the laggards.

The next big question is around the implications of low interest rates. The Fed has clearly stated that in the current pandemic-induced recessionary environment, it will keep interest rates at these historic low levels. Inflation is MIA, so there is no incentive for the Fed to raise rates any time soon. It is possible that as the economy reopens, a rush of consumer spending could cause a surge in

demand, which in turn causes inflation to spike. But it is more likely that a gradual reopening will leave consumers in a much more sober mood and that businesses such as airlines and hotels will have to offer discounted rates as incentive for consumers to fly and book rooms. It is also possible that the accelerated "digitization" of the economy will have a lasting and profound deflationary impact. For instance, now that businesses are more comfortable with workers at home, why hire more high-priced engineers in high-priced areas such as the Bay Area/Silicon Valley? Why not hire lower-priced engineers in lower-priced cities such as Cleveland, Detroit, or Pittsburgh? This might prove deflationary or at least dis-inflationary.

We assume that interest rates will remain low for some time. This has several potential implications for investors. First, low interest rates will support higher equity valuations. Second, in this environment, growth will command a real premium. Third, because bonds yield so little, investors seeking income should shift their focus to high quality companies paying growing dividends. We expand upon each of these conclusions below. To set the stage, we illustrate the relationship between 10-year Treasury yields and the dividend yield for the S&P 500 over the past 100 years.

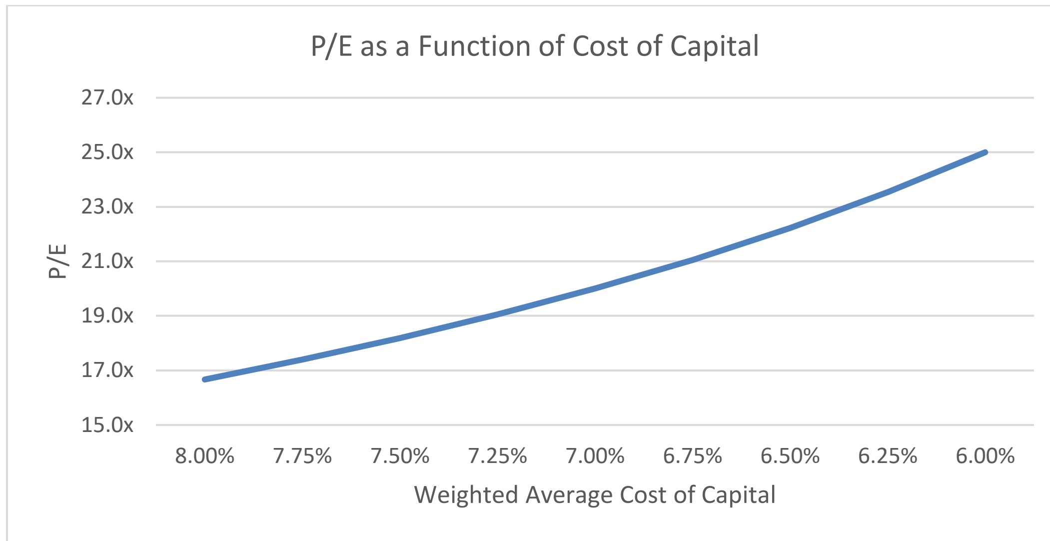


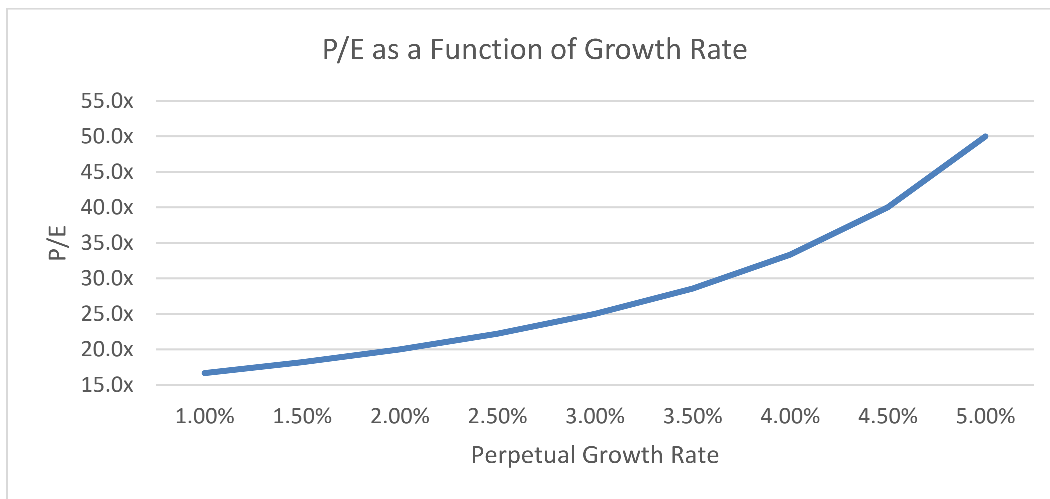
Source: Trading Economics and Multpl

As we all know, stock valuations typically vary positively with growth and negatively with interest rates. Therefore, if we can identify companies with stable and persistent growth prospects, such stocks should command very high valuations in a low interest rate environment. This is beginning to happen, but theoretically could go a lot further, especially if a select group of companies proves themselves to have much more durable businesses than their competitors. We demonstrate this below. The key will be to focus more on the quality of these companies and less on valuation, recognizing that markets typically go to extremes, and so eventually valuation may become over-extended and, therefore, a source of risk. We are a long way from that point today.

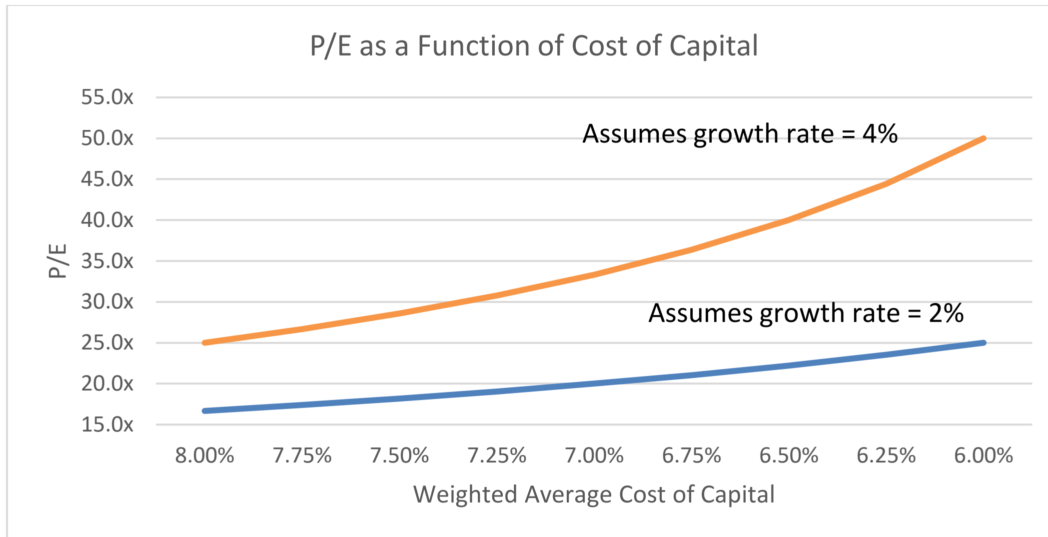
The graph below demonstrates the impact of interest rates (i.e., cost of capital) on equity valuations (i.e., P/E ratios). You can see that as the cost of capital falls (moving to the right along the

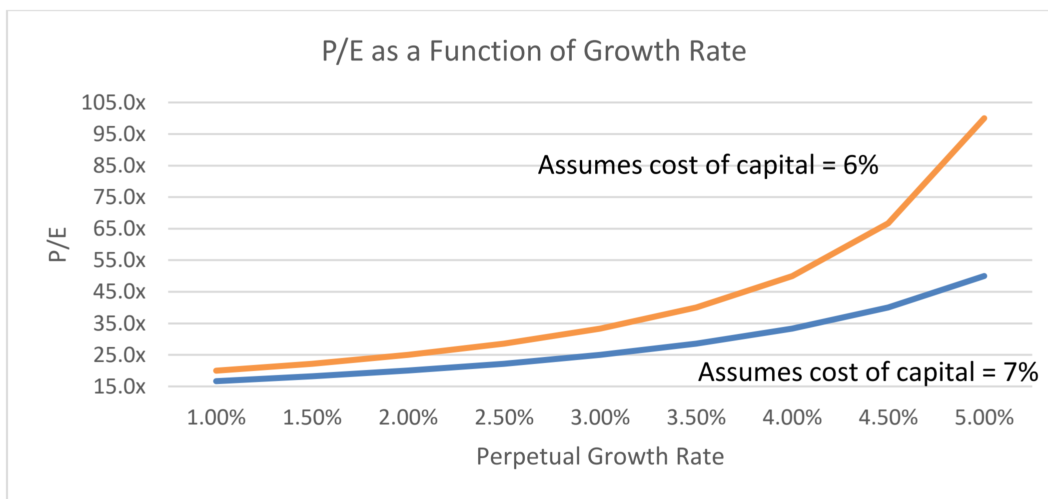
x-axis), valuations rise. The second graph tells a similar story – as growth rates rise (again, moving to the right along the x-axis), P/E ratios rise, too.





The next two graphs demonstrate the explosive effect of lower interest rates and higher growth rates simultaneously. As you can see, if lower interest rates persist and companies continue to exhibit high growth, the resulting P/Es could go a lot higher – theoretically – than they are today. Hence, our counsel to stay invested in high-quality companies with above-average growth. In this environment, we need to be alert to acceleration or deceleration in growth rates.





Because interest rates are so low, it is hard to earn returns from bonds. On the other hand, for investors focused on income, it is possible to build a portfolio of top-notch, industry-leading companies that pay growing dividends that can, over time, provide yields in excess of investment-grade bonds. This suggests that an income portfolio in today's world should be anchored by equities of strong, well-capitalized, market-leading companies demonstrating sustainable growth and, therefore, paying growing dividends. We will have more to say on this subject in the coming months.

In conclusion, the world is a very uncertain place these days, but some companies will do well for very clear and understandable reasons. Our counsel is to stick with these companies and, as my father used to say, not try to get cute.

We thank all of our clients for your patience and loyalty. Please let us know if you have questions.

Sincerely,

John Osterweis Larry Cordisco

Past performance is no guarantee of future results. Index performance is not indicative of fund performance. To obtain fund performance call (866) 236-0050 or visit osterweis.com.

The charts in this outlook are hypothetical and for illustrative purposes only. They are not indicative of fund performance.

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Price-to-Earnings (P/E) ratio is the ratio of the stock price to the trailing 12 months diluted earnings per share (EPS).

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.

Earnings growth is not a measure of the Fund's future performance.

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 Fund or Osterweis Capital Management.

The 10-Year Treasury Yield is the rate of return anticipated on a 10-Year Treasury if it is held until the maturity date.

Perpetual growth rate is the projected long-term growth rate.

Cost of capital is the discount rate, which is the minimum required return. The risk-free rate (i.e., the yield on the 10-year) helps set the discount rate.

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