OSTERWEIS
CAPITAL MANAGEMENT

Fortuna Redux
Strategic Income Outlook
July 2020

Fortuna Redux was the Roman Goddess of Luck, who oversaw the safe return of travelers from long and perilous journeys. Given the pandemic's societal and economic uncertainty, has Fortuna failed to appear? Hopefully, actions taken by the scientific and medical communities, governments, corporations, and individuals will yield more clarity and positive steps (read: signposts) towards finding our way back.

While we won't rehash the last several months, there are a few points we would highlight that could help illuminate our path forward. By the end of the first quarter, we saw "shelter-in-place" orders widely instituted, which effectively stopped economic activity in its tracks. As we cautioned in our last outlook, the downturn would likely be severe and for the six weeks ending May 7th, over 33 million people filed for unemployment benefits in the U.S. While we were sadly correct in our assessment, the reaction by the Federal Reserve (the Fed), the European Central Bank, and governments across the globe was nothing short of Herculean. Globally, there have been at least 414 stimulus measures announced and/or implemented since early March.

In the U.S. alone, the Fed cut interest rates by 150 basis points to a range of 0% - 0.25%, began a massive lending and asset purchase program, and reduced regulations on banks to free up excess reserve capital for lending. Unlike the limits the Fed placed on itself in 2008, the current program is open-ended and will be "in the amounts needed to support the smooth functioning of markets."[1] The Fed is also once again lending money to primary dealers, to support the money market sector, including commercial paper. In late March, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act, providing $2 trillion of stimulus to individuals, families, workers, hospitals, and businesses large and small. Unlike previous stimulus packages, which were targeted at large corporations and the markets, this one also focused on helping individuals and small businesses weather the storm. Included in the package were direct checks to individuals as well as extended and enhanced unemployment insurance. These cohorts were basically ignored in 2008, when the focus was on saving banks from insolvency and supporting the damaged mortgage market. So far, the Fed's balance sheet has grown from $4.2 trillion in early March to over $7 trillion by the beginning of June. This includes a few additional security purchase programs that might have unintended consequences down the road; more on that later. Needless to say, the steps taken to-date should help to start us on our return journey to recovery.

With employers incentivized by the CARES Act to keep many employees on the payroll, combined with enhanced and extended unemployment for others, incomes were largely maintained and, in some cases, increased by those on the receiving end. Mortgage and student loan servicers,

[1] Federal Reserve Bank of New York, Statement Regarding Repurchase Operations, March 16, 2020

some landlords, and other creditors are also allowing for payment deferments to help maintain incomes for individuals. While home confinement should help slow the pandemic's spread, it is also sowing the seeds for a potentially powerful economic recovery. As reported by the Federal Reserve Bank of St. Louis, personal consumption declined through the first half of the second quarter as individuals shrunk their purchasing to mostly essentials. The flipside is that the personal savings rate, which had been running at about 8%, rose to over 30%. We view this as pent-up demand once the economy reopens in earnest.

Corporations have been enhancing their liquidity by raising massive amounts of capital in both the debt and equity markets to maintain their businesses, refinance pending maturities, and to weather the storm. According to JP Morgan, high yield companies raised over $142 billion in debt during the second quarter, which is the highest quarterly total of all time, and over $215 billion during the first half, which is also among the highest first half totals ever. Investment grade companies have been even more active, raising over $1.15 trillion in debt year-to-date, easily surpassing Barclays full year new issuance estimate of $920 billion. This doesn't include the common and preferred stock or convertible debt that has also been issued.

The one differentiating factor in this recessionary event is that the capital markets reopened with a vengeance rather quickly and trading resumed along with it. The markets are functioning normally and seem to be receptive to almost any worthy company raising capital. What does give us some concern is the recent Fed exuberance in purchasing assets they have not previously bought before – specifically, non-investment grade debt and exchange traded funds (ETFs). ETFs do not have maturities, so they cannot simply be held until maturity or a refinancing event. When the Fed decides to unwind its position, it will need to sell it, which could cause some hiccups in the markets. For example, they are the third largest holder of the iShares iBoxx Investment Grade Corporate Bond ETF (LQD), having recently purchased 13mm shares worth $1.8 billion. At this point, their other ETF purchases have been more modest, so we hope that this is more suasion than swagger. Given the huge cash stockpiles on the sidelines, this intervention is not needed by the markets now.

Speaking of which, the S&P 500 Index, which hit a low of 2,237 on March 23rd, rebounded almost 1,000 points to a high of 3,232 on June 8th. During the same time period, the ICE BofA U.S. High Yield Index (the ICE HY) yield declined from 11.41% to 6.43% and the Barclays U.S. Aggregate U.S. Index (the Agg) yield declined from 1.96% to 1.41%. Alternatively, spreads have tightened in the ICE HY Index from +1,087 to +551 basis points. For the Agg, spreads declined from +123 to +63 basis points. All positive signposts.

With only limited re-openings in the second quarter, we can already see the potential of the U.S. recovery as stir crazy consumers emerge and spend, companies begin to rehire, and supply chains reboot. This is evidenced by the most recent May and June jobs reports. In May the U.S. economy added 2.7 million jobs and the most recent June report shows 4.8 million jobs added. The unemployment rate has fallen from a high of 14.7% to 11.1%. While still elevated, the trend is favorable. Also, new home sales are on the rise, and the University of Michigan's Consumer Sentiment Index increased for two straight months. Evercore ISI's Company Surveys have steadily improved from the lows in early April, and the Evercore ISI Trucking Companies report has continued to improve as the economy reopens. Mobility statistics are showing steady improvement as well. According to the Federal Reserve Bank of Philadelphia, both their Current and Future general activity indexes have been steadily increasing off the lows. This is not just a U.S. restart, but global as well. In China, the first country hit by the pandemic, airline passenger traffic and vehicle sales have been improving, and steel and coal pollution (an unwanted, but reliable indicator of industrial output) has also been rising – in some cases surpassing 2019 levels. All of these are signs of economic recovery.

Companies are not only shoring up their balance sheets but are also re-examining how they do business. They are streamlining operations, rationalizing costs, and revamping supply chains, which hopefully begets more profitable growth in the future. For example, the Wall Street Journal reported that restaurants have been streamlining their menus by removing slow-selling items. PepsiCo's food business has cut a fifth of its product line, and even Harley-Davidson is cutting some motorcycle lines. Companies likely should have taken these actions earlier, but they have spent years trying to please everyone, and now the pandemic has helped them realize that this was inefficient and unnecessary. Initial reactions by consumers may be negative, but do we really need 40 types of toilet paper, 60 varieties of Lay's potato chips, or 400 types of Campbell's soup? Perhaps not. We think people will adapt and markets will allocate capital to attractive areas of the market if more choices are demanded by consumers.

While optimistic over the medium and long term, we are keeping an eye on some possible unintended near-term consequences of the shelter-in-place restrictions and government largesse. The most notable recently is the rise in day trading by small investors. With an absence of live sports (including sports betting) and other outside entertainment/distractions, people have been looking for creative outlets. Spurred perhaps by a very high savings rate, a growing number of retail investors have begun day trading stocks. Fostered by websites such as Robinhood Trading (from which these day traders get their collective name), which offer trading with no transaction fees, coupled with the ability to now purchase a slice of a share of stock, we are witnessing unbridled increases in less-than-fully informed trading activity that gives us some pause. One only needs to look at the trading in Hertz Rent-a-car stock post its filing for bankruptcy as a sign that people need to get back to their regularly scheduled lives. Led by blogs such as Barstool Sports, these "Robinhood" traders drove the bankrupt stock up 525%. Stocks of bankrupt companies are typically wiped out, but these new levels drove bankers to consider raising more bankrupt stock for Hertz, essentially "feeding the ducks while they quacked." Thankfully cooler heads at the SEC prevailed, the sale was shelved, and Hertz's stock price has since receded. Even large pension funds are not immune to seemingly irrational decision making. According to the minutes of a recent CalPERS's Pension Fund board meeting, the Chief Investment Officer mapped out a plan to add leverage and make additional investments into private equity and private credit in order to achieve its return targets. It will remain to be seen if this works out for them or not. We hope, as social activities normalize, this craziness subsides.

We do not expect the recovery to be a straight line. There will be speed bumps and detours ahead, but the trend should be positive. As we have seen recently, following a sunny Memorial Day with many crowded beaches, and weeks of densely populated protests around the country, there has been a resurgence of Covid cases and a commensurate dialing back of reopening plans by many states and cities. This second wave is not a surprise, but its timing is earlier than the September spike originally anticipated by medical experts. Additionally, our healthcare system has learned a lot since the outbreak about treating the disease, and we have made progress in securing protective gear for health care workers. Hopefully this curve flattens without much disruption of the momentum we have seen so far.

In sum, we believe that the dark days of March are behind us, and while the recovery will not be "V" shaped, companies with the ability to raise capital will make it safely to the other side. So far, the signposts for the return journey from our perilous pandemic detour appear to point to recovery. We have taken advantage of the market volatility to find good companies at cheaper valuations across both the bond and convertible markets and continue to retain a fair amount of cash for additional opportunities. We thank you for the continued confidence and look forward to continuing our relationship. We welcome any questions or comments that you have.

Sincerely,

Carl Kaufman Bradley Kane Craig Manchuck

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