OSTERWEIS
CAPITAL MANAGEMENT

A Flat Yield Curve is Not All Bad
Investment Grade Market Outlook
January 2018

2017 was a year characterized by low volatility, a flattening yield curve and narrowing corporate bond spreads. The economy grew modestly and the Federal Reserve (the Fed) began to pull back its monetary accommodation. What has been missing so far is a rise in inflation. For 2018, we believe the biggest challenge in the investment grade space will be finding opportunity while effectively managing interest rate exposure.

In 2017 the yield curve flattened sharply, especially in the second half of the year, while investment grade corporate spreads narrowed and volatility declined. The 10-year Treasury yield traded in a 60 basis point (bp) range for the entire year and ended the year a mere 4 bps lower than a year ago, while the 2-year Treasury yield increased by 70 bps. 2017 also marked the first time in this cycle that investors believed the Fed's forward guidance on rates — also known as "the dot plot" — and short-term interest rates experienced an accelerated upward trajectory (see Figure 1 below). We expect the latter to continue in 2018 as the synchronous global economic recovery continues and the quantitative easing programs that characterized the earlier part of this decade are slowed, halted and, in some cases (including the U.S.), reversed.

Figure 1:

	12/30/2016	12/29/2017	Change
Fed Funds Target Rate	0.75	1.50	0.75
Corporate Option-Adjusted Spread	123	93	-30
MBS Option-Adjusted Spread	15	25	10
2-Year Treasury Yield	1.19	1.89	0.70
5-Year Treasury Yield	1.93	2.21	0.28
10-Year Treasury Yield	2.45	2.41	-0.04
30-Year Treasury Yield	3.07	2.74	-0.33
MOVE (Volatility) Index	71.6	46.6	-25.0

Source: Bloomberg

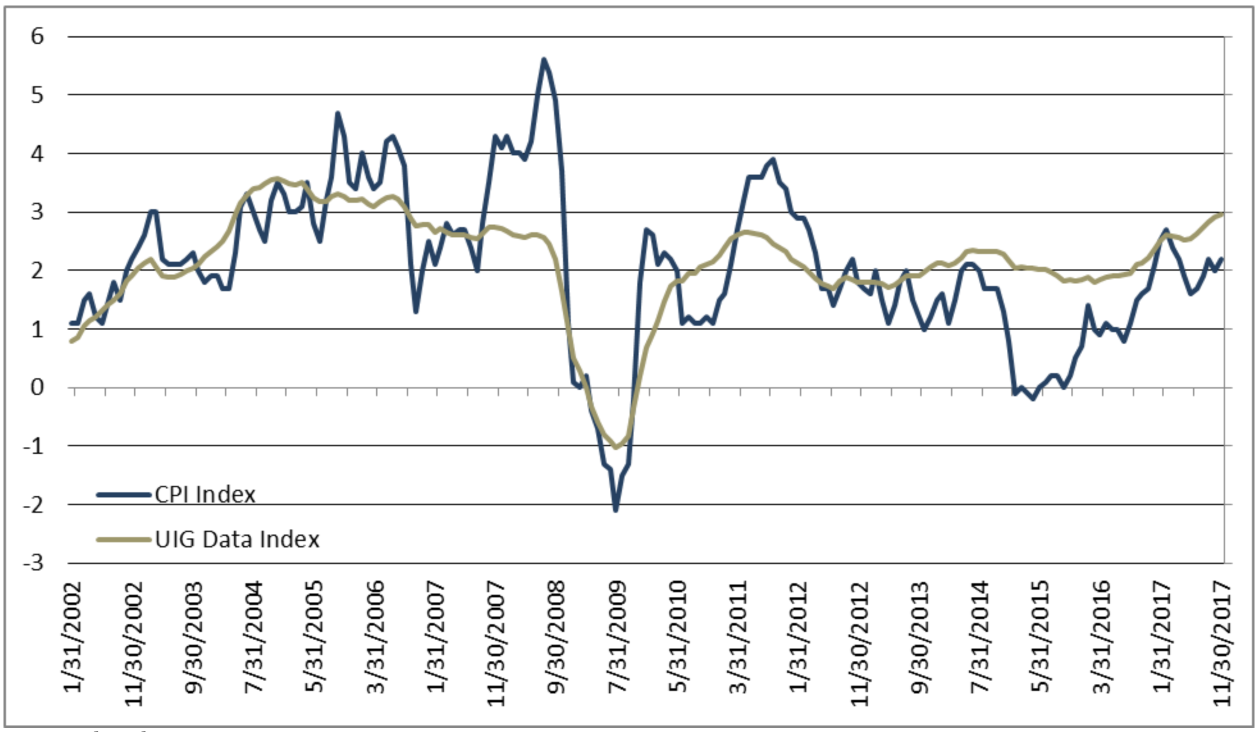
Investors typically look at the yield curve as an indicator of where we are in the interest rate and economic cycle. The last time we embarked on a tightening cycle (2004-2006), the yield curve inverted after about 75% of the rate hikes were completed. Looking ahead we believe that in 2018 we may see 3-4 rate hikes, bringing the fed funds target to 2.25-2.50%. This is around 75% of the way to our expected terminal fed funds target rate of just north of 3.00%. Given that, it stands to reason that the Treasury curve could easily be flat (as measured by the difference between 10-year yields and 2-year yields) by year's end. Historically, flat yield curves have been predictors of recessions, but we do not believe that to be the case in this circumstance, as the *absolute level* of yields remains very low. A flat yield curve at 3%

remains very accommodative from a historical perspective – and with corporate and mortgage spreads at multi-year lows, funding costs should remain relatively low compared to periods where the curve has flattened/inverted in the past.

We believe the greatest risk to the market is a rise in inflation and, therefore, we are keeping a close eye on inflation-related measures. While most investors focus on the Consumer Price Index (CPI), another measure of inflation that was recently released by the Federal Reserve Bank of New York is the Underlying Inflation Gauge (UIG). It was created about nine years ago to provide policy makers with a better way to not only measure inflation but help predict it. The Fed began monthly publication of the index in August this past year. There are two series of note: The UIG Data Index and the UIG Prices Only Index – the former being more predictive, as it includes manufacturing and other economic data. As you can see in Figure 2 below, the UIG indices are less volatile than the headline CPI.

Figure 2:

CPI vs. UIG (%)



Source: Bloomberg

We believe these alternative measures of inflation are important forecasting tools for the Federal Open Market Committee and bear watching. With the UIG Data Index approaching 3% for the first time since 2006, it's easy to understand how the Fed attributed the weakness in headline CPI to transitory factors. Inflation is notoriously slow-moving but momentous, and if economic data/activity (higher prices, near full employment, global economic expansion) point to higher estimates of inflation going forward, it may be difficult for the Fed to hold the terminal federal funds rate at 3%. The biggest risk to markets and possibly to the economic recovery is a spike in inflation, which could lead to higher rates across the yield curve.

Accordingly, we will be very defensive in managing our interest rate exposure. Interest rate futures and swaps are tools we can use to help insulate the fund from advances in interest rates that can negatively impact the value of the bonds we hold. We are likely to maintain a short duration profile compared to that of the Bloomberg Barclays U.S. Aggregate Bond Index, which currently has a duration of around 6, near its all-time high. Investors may not realize that the index duration has risen in recent years due to increased issuance of longer bonds with lower coupons. The composition of the index itself represents a potentially underappreciated risk to the markets. We don't forecast material spread widening in corporate bonds and mortgage securities unless inflation takes center stage – in fact, we believe credit and mortgage spreads may narrow slightly if this orderly repricing of interest rates continues. TIPS may also present a viable hedge for inflation fears, and we will likely continue to include them as part of our Treasury allocation.

We thank you for your confidence in us and welcome any questions or comments you may have.

Best regards,

Eddy Vataru   Scott Ulaszek

Past performance is no guarantee of future results. This commentary contains the current opinions of the authors as of the date above which are subject to change at any time. This commentary has been distributed for informational purposes only and is not a recommendation or offer of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed.

The Osterweis Total Return Fund may invest in fixed income securities which are subject to credit, default, extension, interest rate and prepayment risks. It may also make investments in derivatives that may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. The Fund may invest in in debt securities that are un-rated or rated below investment grade. Lower-rated securities may present an increased possibility of default, price volatility or illiquidity compared to higher-rated securities. Investments in foreign and emerging market securities involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks may increase for emerging markets. Leverage may cause the effect of an increase or decrease in the value of the portfolio securities to be magnified and the Fund to be more volatile than if leverage was not used. Investments in preferred securities have an inverse relationship with changes in the prevailing interest rate. Investments in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. It may also make investments in derivatives that may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. The Fund may invest in municipal securities which are subject to the risk of default.

The Osterweis Funds are available by prospectus only. The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information about the Funds. You may obtain a summary or statutory prospectus by calling toll free at (866) 236-0050, or by visiting osterweis.com. Please read the prospectus carefully before investing to ensure the Fund is appropriate for your goals and risk tolerance.

No part of this article may be reproduced in any form, or referred to in any other publication, without the express written permission of Osterweis Capital Management.
The Bloomberg Barclays U.S. Aggregate Bond Index (BC Agg) is an unmanaged index that is widely regarded as a standard for measuring U.S. investment grade bond market performance.

It is not possible to invest directly in an index.

A basis point (bp) is a unit that is equal to 1/100th of 1%.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

Underlying Inflation Gauge (UIG) is a measure that captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data.

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.

Osterweis Capital Management is the adviser to the Osterweis Funds, which are distributed by Quasar Distributors, LLC.
[30440]