OSTERWEIS
CAPITAL MANAGEMENT

Is It Safe Yet?
Total Return Market Outlook
July 2020

The second quarter played host to a fierce recovery across risk asset markets as fiscal and monetary stimulus took hold. While it appears we have averted the worst pandemic outcomes so far, a resurgence in recently reopened states shows that we are not yet out of the woods. Nevertheless, equities are at or near all-time highs, and spreads in fixed income have broadly narrowed to pre-shutdown levels. The table below highlights the dramatic recovery across the markets.

Index	3/31/2020	6/30/2020	Change
Fed Funds Target Rate (upper bound)	0.25	0.25	-
Investment Grade Corporate Option-Adjusted Spread	272	150	-122
2-Year Treasury Yield	0.23	0.15	-0.07
5-Year Treasury Yield	0.38	0.29	-0.09
10-Year Treasury Yield	0.70	0.65	-0.04
30-Year Treasury Yield	1.35	1.41	0.06
MOVE (Volatility) Index	83.9	54.1	-29.7
MBS Nominal Spread	126.2	109.6	-16.6
Crude Oil (NY Mercantile)	20.48	39.27	18.79
VIX	53.54	30.43	-23.11

In addition to the countless stimulus programs introduced in March, the Federal Reserve (Fed) has committed to a low target fed funds rate for at least a couple of years. There has been discussion of yield curve targeting, akin to what Japan has done in anchoring their own interest rates near zero for years. The primary question is how far out the maturity spectrum does the market expect to see support from the Fed, whether it’s through explicit yield curve controls or simply through anchoring market expectations of its fed funds target rate at zero. Setting inflation targets at or slightly above 2% – and then waiting for the economy to consistently deliver on this target – will likely take many months to achieve. The only real evidence of inflation we have seen recently has come from temporary supply chain disruptions related to shutdowns due to virus spread; it is not a result of robust consumer demand.

While market levels have changed dramatically, and our outlook for viral spread has probably improved at the margin, very little has fundamentally changed in our longer-term outlook. We do not expect the economy will fully recover until there is a solution to the virus. It can manifest as a widely adopted vaccine, or it can be a new treatment regimen that dramatically reduces the risk of severe illness or death. Absent one of these developments, we will remain in a period of fits and starts with openings and shutdowns and continued virus spread, with the economy running at some suboptimal percentage of its peak. We continue to play headline ping-pong with markets responding to news of medical advances, promises of continued stimulus, and regional outbreaks. While VIX has fallen from its March peaks, a level above 30 reflects continued volatility despite lofty market valuations.

With Treasury yields firmly below 1% for all maturities except for the 30-year, the primary function of the Treasury asset in a fixed income portfolio remains as a place to hide and wait for conditions to improve. Corporate bonds and mortgages offer significantly more value, albeit at richer valuations than three months ago. It remains more important than ever to be judicious about which securities we select – as it is important to identify sectors and individual companies within those sectors that will outperform in a challenging macroeconomic backdrop.

The explicit support for the mortgage market has also buoyed valuations, following a playbook from previous quantitative easing programs. We continue to favor lower coupon passthroughs that have less prepayment exposure for the bulk of our mortgage investment, while keeping our structured investments in very seasoned, higher coupon MBS that exhibit much less prepayment sensitivity than recently issued loans.

Finally, we have a somewhat longer duration profile than is typically our norm. When we see more compelling evidence of normalization of the economy, we will begin to reduce our duration exposure. In particular, we would look to reduce our footprint in maturities greater than 7 years. Shorter maturity rates are low and will stay low for now. But rates will not stay below 1% forever, and we remain skeptical that Treasuries will join government bonds in Germany and Japan and carry negative yields.

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

Best regards,

Eddy Vataru   John Sheehan   Daniel Oh

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A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages.

The Chicago Board Options Exchange (CBOE) Volatility Index, or VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility

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.

Merrill Lynch Option Volatility Estimate (MOVE) Index – USD – is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options.

A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

Spread is the difference in yield between a risk-free asset such as a U.S. Treasury bond and another security with the same maturity but of lesser quality. Option-Adjusted Spread is a spread calculation for securities with embedded options and takes into account that expected cash flows will fluctuate as interest rates change.

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 Total Return Fund or Osterweis Capital Management.

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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.

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