The Bottom Line - Q1 2022

THE BOTTOM LINE

FIRST QUARTER : 2022

BUFFALO FINANCIAL QUARTERLY NEWSLETTER

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TAPER TANTRUM

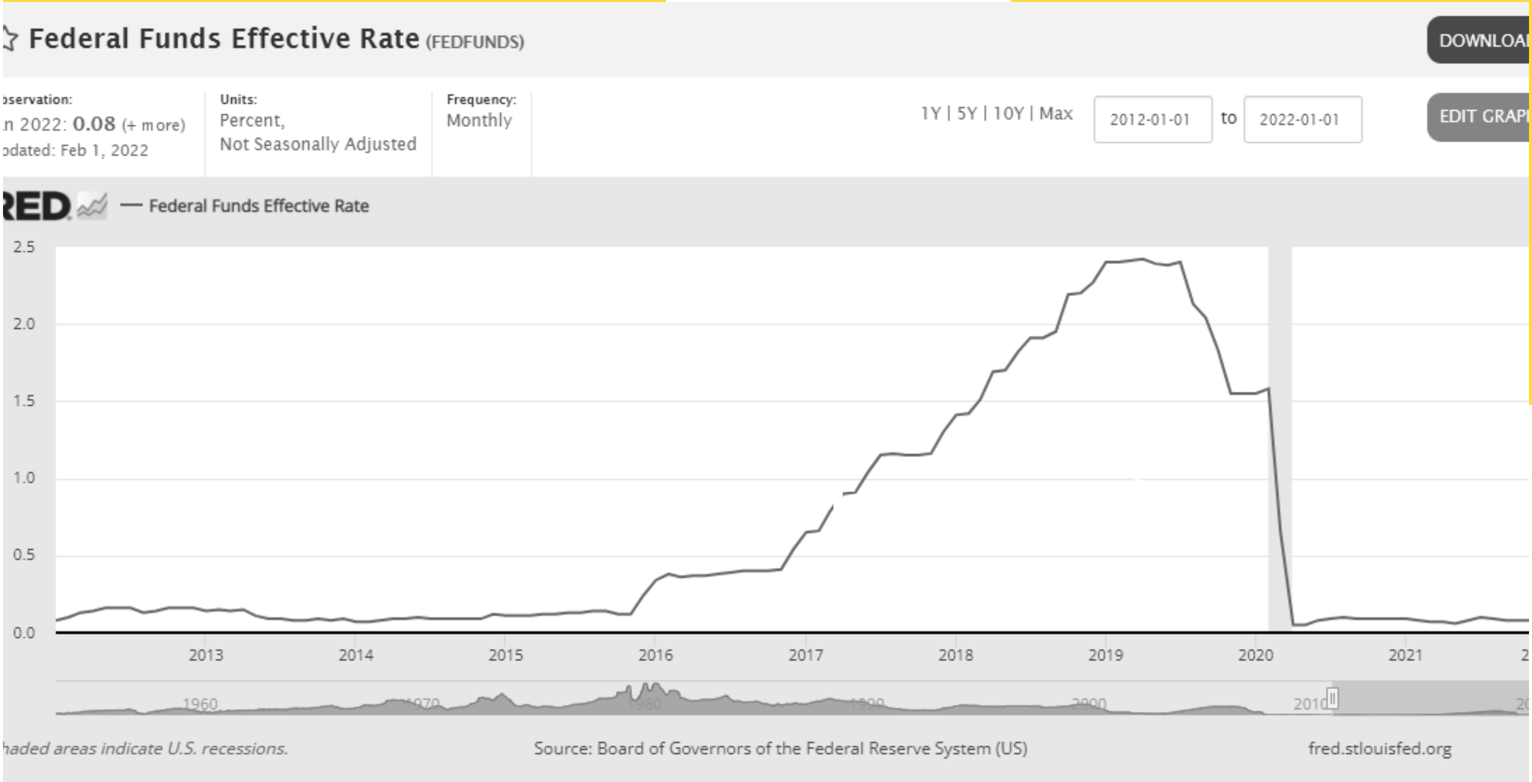
BY JEREMY I. BECK

The only way to describe the equity markets over the past year and a half is that market participants have become spoiled, similar to a child that throws a temper tantrum when it doesn't get their way. These emotional outbursts are clearly on display in the equity markets as we begin 2022. The term "taper tantrum" was coined in 2013 when a combination of reduced asset purchases by the Federal Reserve and the likelihood of rising interest rates led to a period of increased volatility. Beginning in January of 2022, the Federal Open Market Committee (FOMC) will reduce its monthly purchase of assets to $40 billion in U.S. (continued)

TAPER TANTRUM - CONT'D

Treasury securities and $20 billion in mortgage-backed securities (MBS). In conjunction with tapering, which is expected to be completed by mid-year, the markets are projecting five to six rate hikes in 2022 as the Fed begin to shrink its balance sheet. This is a direct response to the loose monetary policy created by the Fed as it combated the effects of the Covid-19 pandemic, dating back to March, 2020. According to the CME FedWatch Tool, the probability of a Federal Funds Rate increase on March 16, May 4, June 15, July 27, September 21 and November 2 are...100%! As you can see from Figure 1 (below), the current Federal Funds Rate has a target of 0.08% and six 0.25% rate hikes would bring the Fed Funds Rate to a target of 1.50% by the end of the year. Federal Reserve Chairman Jerome Powell is on record stating, “This is going to be a year in which we move steadily away from the very highly accommodative monetary policy put in place to deal with the economic effects of the pandemic”.

Figure 1: Federal Funds Effective Rate



The Federal Reserve has two jobs: keep inflation under control and maximize employment. In mid-2021, the FOMC viewed higher inflation as a passing phenomenon, but quickly changed course in January of this year, calling “high inflation a severe threat to the achievement of maximum employment”. The main question is, how will the fed shrinking their balance sheet and increasing the Federal Funds rate affect investors?

The answer is identical for equity and fixed income investors: expect volatility to increase in both the fixed income and equity markets as we move through 2022. A good measure of volatility is the CBOE Volatility Index, also known as “VIX”. The Volatility Index represents the market’s expectations of the relative strength of near-term price changes of the S&P 500 Index. This is a very important index in the world of investing as it provides a quantifiable measure of market risk and investor’s sentiment. Since we know we will have per-

iods of increased volatility throughout the year, how can we take advantage of these periods of uncertainty? Maybe the saying “When the VIX is high, it’s time to buy. When the VIX is low, it’s time to go” will help solve this riddle. As you look at the chart of the VIX below (Figure 2 - next page), the ideal time to deploy capital is when the VIX is high. The best time to raise cash and protect your investments is when the VIX is low.
(continued)

TAPER TANTRUM - CONT'D

As the Federal Reserve reduces its quantitative easing, equity markets will continue to respond as a child that is not allowed to have another candy bar. Use the "taper tantrum" to your advantage throughout the year to maximize gains and reduce losses in what should be a year of volatility.

Stay safe - Jeremy I. Beck

Figure 1: CBOE Volatility Index

FIXED INCOME OUTLOOK 2022: FLATTER YIELD CURVES AHEAD

BY MATTHEW PITROLA

With the expectation of 5 to 6 interest rate hikes in 2022 and a high estimate of 7 rate hikes, the stage is set for this to be a climactic year for fixed-income investors.

As the Federal Reserve and central banks around the world begin to pivot towards tighter monetary policy in an effort to cool inflation, we should expect the yield curve to flatten in 2022. Short-term rates are rallying on the news of the aggressive Federal Reserve, while long-term rates lag with the thought of slower future growth of the U.S. economy. The flattening of the yield curve is in full display in Figure 3 (next page):

How to approach Fixed income in 2022:
First and foremost, investors should continue to diversify their fixed-income holdings as the headwinds we are seeing today do not affect all fixed income in the same manner. I would evaluate credit, interest rate and inflation risks for all your bond holdings when looking at your fixed income allocation.

Second, duration is of utmost importance as this is a general gauge of how your fixed income (cont'd)

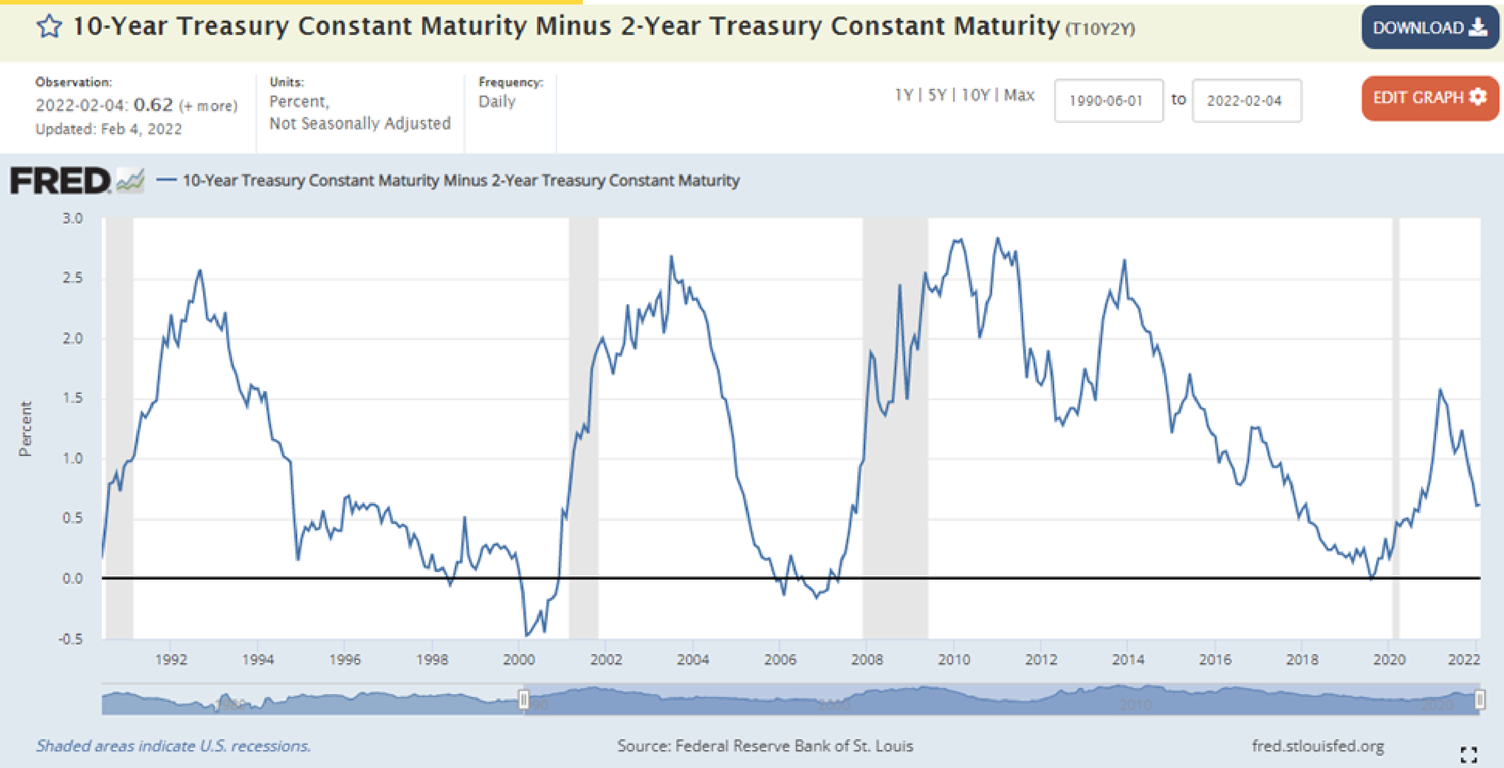
FIXED INCOME OUTLOOK - CONT'D

holdings will respond to movement in the yield curve. We ask you to focus on shorter duration bonds in your portfolio. Shorter duration bonds will react less to a move higher in interest rates while long duration bonds will react more to the same interest rate increase.

FIGURE 3: 10-YEAR TREASURY MINUS 2-YEAR

Third, I do not feel this is the time to slash credit exposure. The Federal Reserve raising interest rates is a direct result of strength in the economy. Corporate balance sheets are strong and high yield debt has outperformed in previous rising interest rate environments.

Finally, I would like to note that everyone should be keeping an eye out for a yield curve Inversion. Over the last 30 years, this has become a self-fulfilling prophecy for the equity markets. If we enter a period of yield curve inversion (Figure 4 below), the likelihood of the U.S. entering a recession within the next 12 months increases substantially.



LOOKING BACK AT JANUARY AND AHEAD TO 2022

Brad McMillan, CFA, CAIA, MAI, Commonwealth Financial Network

January was a terrible month. Worries about economic damage from the Omicron wave were combined with the Fed's perceived decision to start raising interest rates based on inflation levels at a 40-year high. Stocks were knocked down around the world. Tech stocks got hit especially hard, but even fixed income was down. It really was a terrible month.

Looking Back

Case growth spike. One of the major concerns was fear that the Omicron wave would derail the economy. Slowing job growth into the end of 2021 had already hit both confidence and consumer spending. The massive spike in new cases in January seemed to suggest the damage would only get worse.

Other reasons to worry. The other big worry was that inflation was still rising and had hit the highest level recorded since 1982. The Fed, already under fire for being behind the curve, signaled strongly that it would begin tightening monetary policy to get inflation under control—starting in March. With a combination of fears about slowing growth and the promise of higher interest rates, the significant market declines made sense.

Positive trends. In good news, the end of January also saw significant changes from the negative trends that knocked the markets earlier in the month. The Omicron wave peaked in mid-month and then started to drop sharply. Case growth ended the month down 40 percent from its peak two weeks earlier.

In February, so far, case growth has dropped another 20 percent from its January peak and looks to be on a steady and steep downward trajectory. If this trend holds, we should be back to the much-lower November 2021 infection levels by the end of this month. By the end of March, case growth should be close to its lows from last year, at or below the levels seen in the last Delta wave. So, January saw both the peak in medical risks—and the start of the turnaround. (continued)

LOOKING BACK AT JANUARY AND AHEAD TO 2022 - CONT'D

Looking Ahead

Economy picking up. There is more good news. The other major concern, that the economy was weakening, was substantially reduced by the latest jobs report in early February. This release showed substantial job gains—much larger than had been previously reported—in November and December, along with much-larger-than-expected growth in January.

Not only did the economy not weaken during the Delta and Omicron waves, it actually picked up momentum. Looking forward, as that momentum combines with normalizing infection rates, we can reasonably expect economic growth to accelerate even further. In addition, confidence and spending should increase with employment. Again, January saw both a peak in worries about the labor market—and a turnaround.

Signals from the Fed. Where are we with the Fed? High inflation and the central bank's plans to raise rates were a major worry in January, and there we have not seen a turnaround. High inflation rates are still very much with us. And the fact that employment is doing very well raises the chances the Fed will raise rates substantially. Still, looking forward, there are signs that inflation may be peaking. In several of the sectors with the highest price increases, such as used vehicles, the pressure is starting to moderate. There are also signs the Fed is trying to tamp down expectations for rate increases. So, although worries are still high, we might well see them pull back a bit in February.

Cushioned Volatility Likely Ahead

And that is the big picture. Looking back, our worries regarding medical, economic, inflation, and policy risks may have seen a peak in January. Since then, there have been clear signs that several of these risks have come down. Other, preliminary signs indicate the other risks will decline as well. In February, the markets will be sorting out these indicators and trying to figure out whether the risks are truly dropping and, if so, by how much. In other words, we can expect more volatility—but also more cushion under the markets and even the chance of a bounce.

January was a tough month, for good reason. February looks to be, if not a good month, at least one that is less bad. Despite the risks that are still out there, the potential for a good month is very real. In any event, we should see better news overall.

- Brad McMillan

BUFFALO FINANCIAL: REBRANDING

We are extremely excited to announce the rebranding of our company to Buffalo Financial!

We chose a name that resonates with our clients and the community we love. The new logo was just installed on the sign at our office at 4990 Transit Road. Our new website, www.buffalofinancial.com, will be released shortly.

Thank you all for the continued trust you have instilled in our firm!

BUFFALO
FINANCIAL

UPCOMING SEMINARS AND EVENTS

RSVP TO OUR EVENTS!

INVESTING DURING UNCERTAIN TIMES
Presented by Matthew Pitrola

- Wednesday, March 9th, 8:30 AM
  - Complimentary bagels and coffee
- Wednesday, March 16th, 12:00 PM
  - Lunch will be provided
- Wednesday, March 23rd, 4:30 PM
  - Snacks and Refreshments
- Wednesday, March 30th, 12:00 PM
  - Lunch will be provided

All presentations will be held at our office - 4990 Transit Road, Depew, NY. Please RSVP by calling Brooke or Matthew @ 716-771-1888 or email Brooke or Matthew directly: brooke@beckwny.com or matthew@beckwny.com!