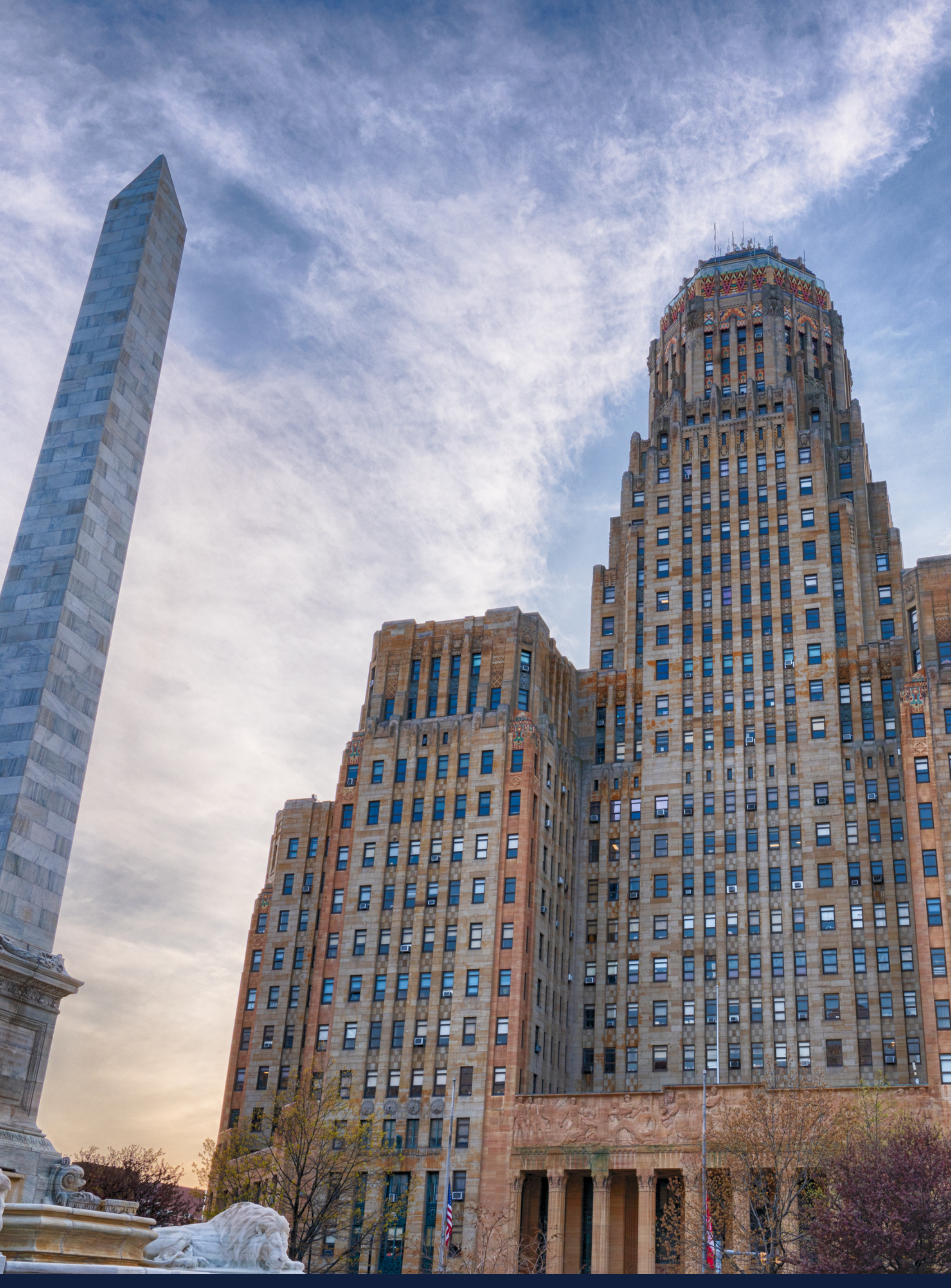
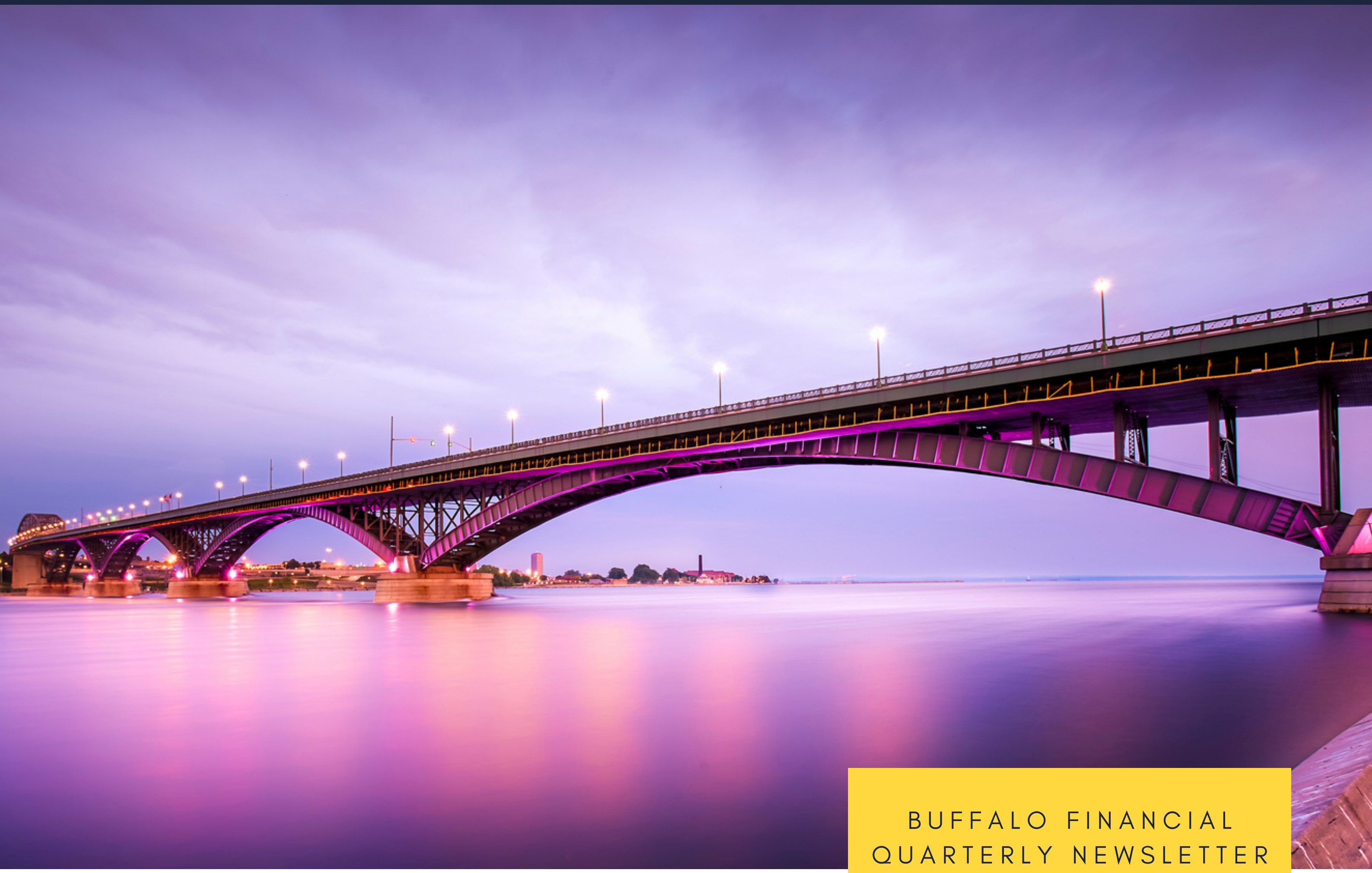


The Bottom Line - Q2 2022

THE BOTTOM LINE

SECOND QUARTER : 2022



BUFFALO FINANCIAL QUARTERLY NEWSLETTER

NO PLACE TO HIDE

BY JEREMY I. BECK

We ended our first quarter 2022 newsletter with the statement "in what should be a year of volatility". Well, volatility is exactly what we have experienced in the first five months of 2022! The dominos were lined up in precise order, beginning with inflation rearing it's ugly head in the physical and digital assets. The next domino was the expectation of the Federal Reserve attempting to combat with a series of interest rates hikes. Sadly, this was followed by the invasion of Ukraine and the bloodshed which does not appear to have an end in sight. The, China's top leader Xi Jinping pledged to "unswervingly"

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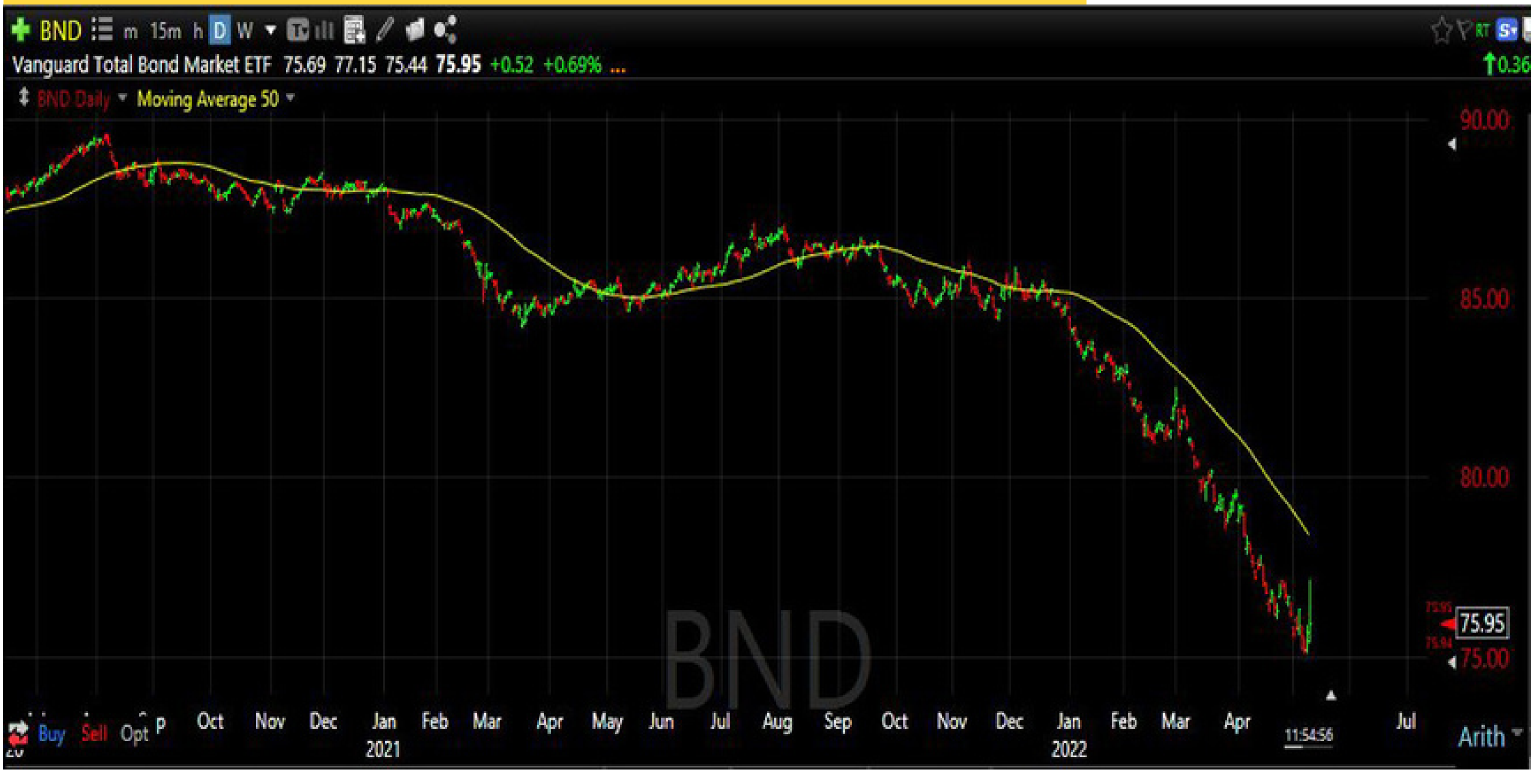
NO PLACE TO HIDE - CONT'D

double down on the country's controversial zero-Covid policy, leaving millions confined to their homes with no end in sight. Among Chinese businesses, monthly surveys released in the first week of May showed sentiment among manufacturers feel to the lowest level since the initial shock of the pandemic in February, 2020. As these dominos continue to fall, the damage to the Global Equity and Bond Markets have been dire. As of May 9th, the S&P 500 is down ~16% from the highs reached on January 3, 2022, whereas the Nasdaq Composite Index has reached bear market territory, down over 26% year to date.

One of the historically best hiding places for stock markets investors has been to move assets into high quality bonds. Unfortunately, this has not proven to be the case this year, with the Bloomberg U.S. 10+ Year Corporate Bond Index down a whopping 20% in 2022!!! (Figure 1 below) Very few investments have been able to withstand the onslaught of bad news that has been the first half of the year 2022. The question is, where do we go from here?

Figure 1: Vanguard Total Bond Index (BND) - October 2021 to May 2022



When analyzing the equity markets, I've always followed the philosophy of using fundamental and technical analysis. Fundamental analysis involves the study of a company's assets, liabilities, earnings, debt, reserves and other financial metrics to evaluate the real value of a stock. Once all of these factors are considered, investors can determine an appropriate price of the stock.

Technical analysis is the study of historical market data, usually focusing on price and volume. Using insights from quantitative analysis, behavioral economics and market psychology, technical analysts use past performance to predict future market behavior. The most common forms of technical analysis are an array of chart patterns and statistical indicators.

On a fundamental basis, the market is fairly to slightly undervalued, trading at a Forward P/E ratio of 17. The labor markets are incredibly resilient and a majority of the companies in the S&P 500 have healthy corporate balance sheets. Housing Permits are on the rise, truck shipments are improving, profit margins are expanding and the ISM New Orders Index is higher. Looking at technical analysis, we are keeping a very close eye on the full 20% correction level for the S&P 500, which would be the 3,840 range. If we are able to maintain this key support level, this would bode very well for the entire stock market.

NO PLACE TO HIDE - CONT'D

As painful as the recent declines in the equity and fixed income markets have been, tremendous opportunities are beginning to appear. If the economy remains on track and the S&P 500 holds the important 3,840 levels, I believe this will end up being the market bottom. In other words, get your shopping lists ready to deploy in undervalued securities.

Stay safe - Jeremy I. Beck

Figure 2: S&P 500 Index - 2022 Year to Date w/ Support and Resistance Line

FIXED INCOME OUTLOOK

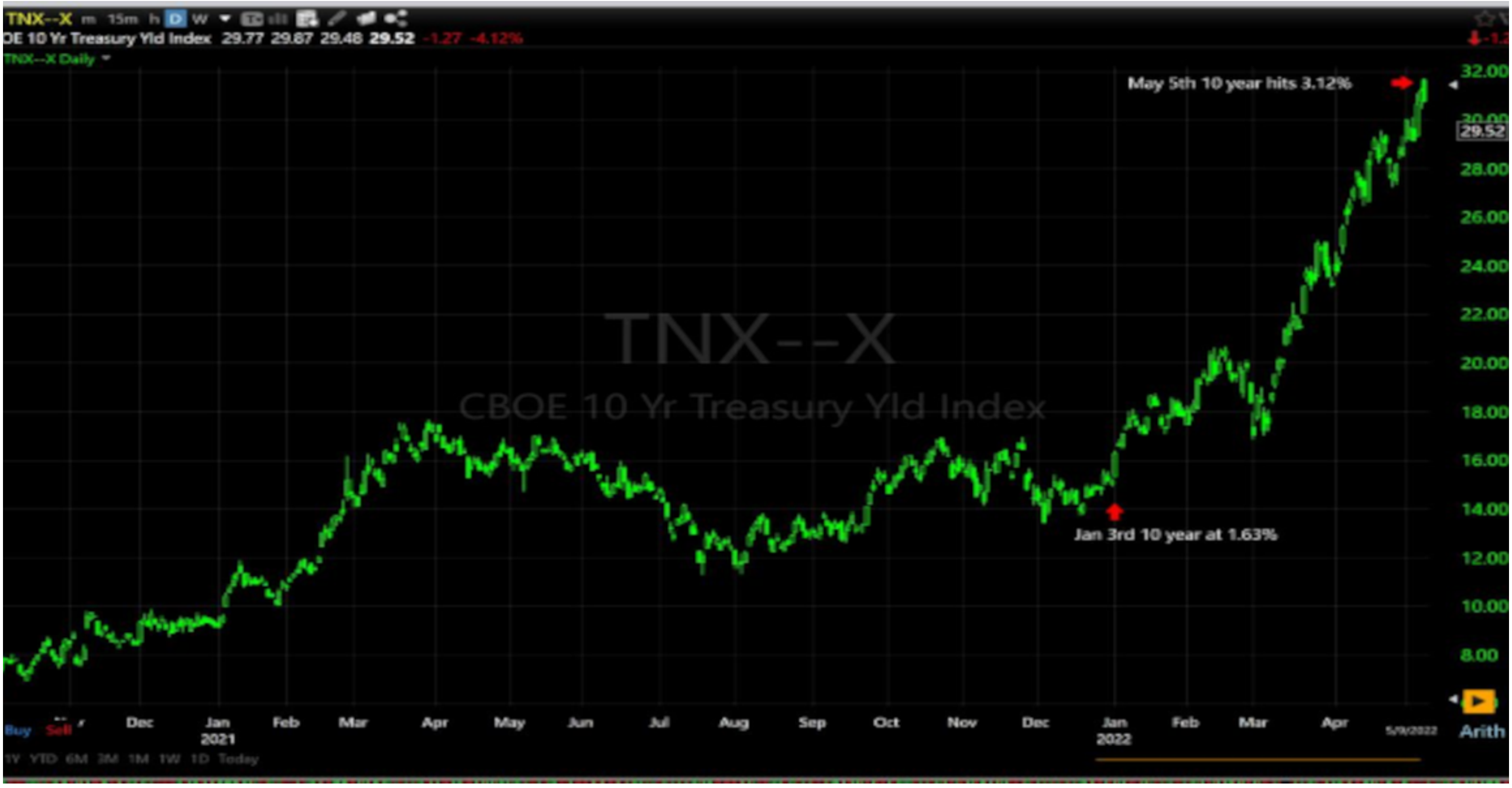
BY MATTHEW PITROLA

In the first quarter of 2022, we have witnessed bond yields increase dramatically. One January 1st, 2022, the 10-Year U.S. Treasury opened the year at 1.53% and has soared to a high of 3.16% on Monday, May 9th. Yields on the 10-Year U.S. Treasury hit a three-year high last week due in part to the highest inflation readings that we have seen since the 1980s and hawkish remarks from the Federal Reserve. The Federal Reserve plans to raise the Federal Funds rate four to five more times this year along with reducing their overall balance sheet by a projected 1.1 Trillion Dollars per year for the foreseeable future.

High quality bonds are typically considered a safe haven investment, especially in times when the equity markets are volatile or decline. However, this has not been the case in the first half of 2022. As of May 9th, 2022, the S&P 500 has declined by 15.85%, while the Bloomberg U.S. Aggregate Bond Index has dropped 10.11%. This is the largest simultaneous drop in both Indices since 1976! The only time both indexes dropped for the year was in 1994, when the bond index dropped by 2.9% and the S&P 500 fell 1.5%

FIXED INCOME OUTLOOK - CONT'D

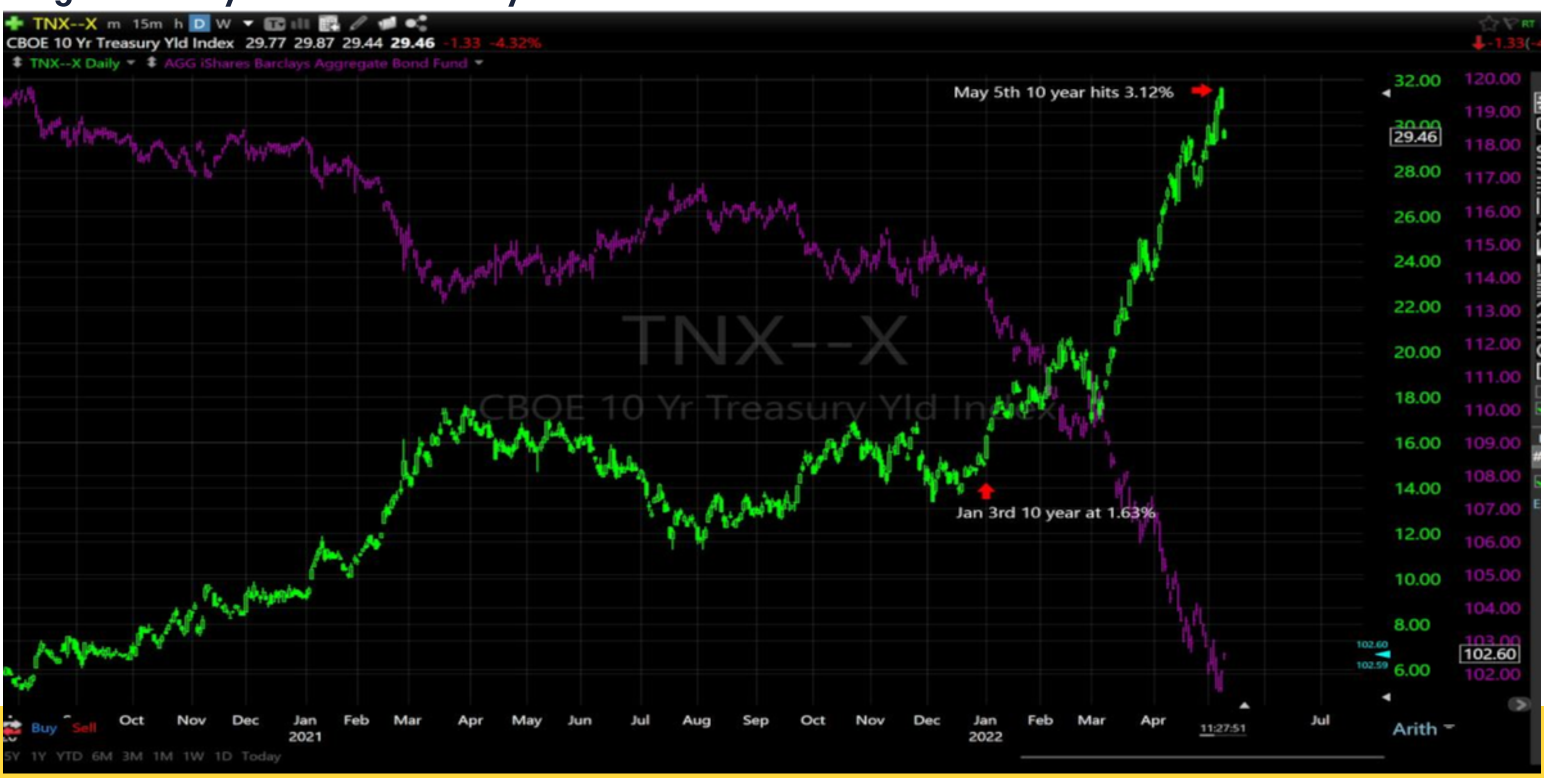
FIGURE ONE: 10-YEAR TREASURY YIELD



What has caused the increase in U.S. Treasury Yields?

The massive increase in U.S. Treasury yields has led to short term declines in bond holdings given the inverse relationship between bond yields and bond prices. This inverse relationship can seem a little complex, but I love to use a simple example. Let's say you were driving past a local bank and saw a great rate on a short-term CD (3 years @ 3.00%). You decide to purchase this CD but a few weeks later, you drive past the same bank and see a short-term CD (3 years @ 5.00%). Most investors would automatically go back to the bank, close the 3% CD and purchase the 5% CD. This is exactly what is happening now, i.e. everyone is selling their lower yielding bonds, putting downside pressure on these securities.

Figure 2: 10-year U.S. Treasury Yield vs. Bond Index Prices

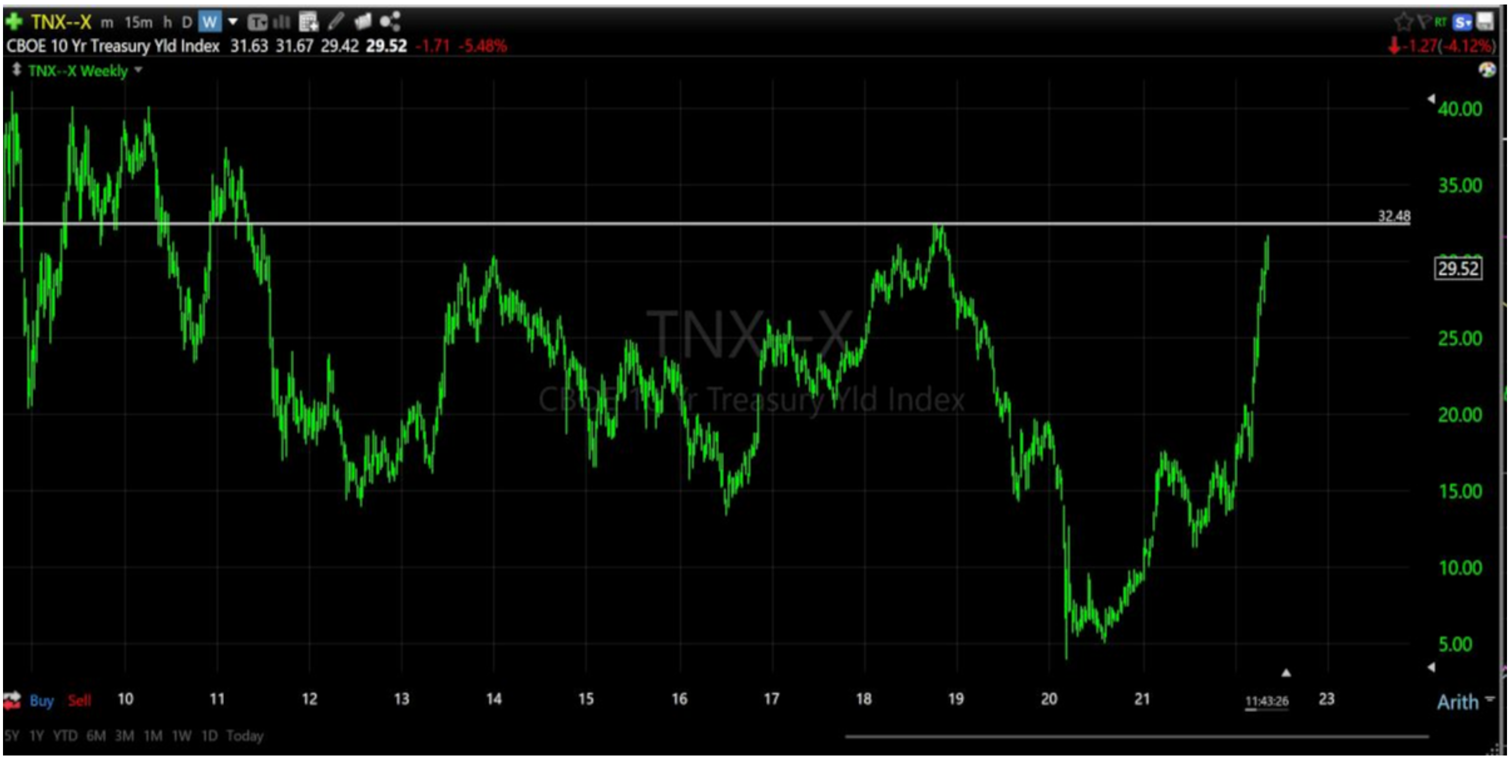


FIXED INCOME OUTLOOK - CONT'D

WHERE DO WE GO FROM HERE?

Although the increase in U.S Treasury Yields to begin 2022 has been a painful time for fixed income investors, I would like to leave you with an optimistic mindset for the remainder of the year. Yields doubling in a 5-month time is a very rare phenomenon. This is due in part to the Federal Reserve being late to the game when it comes to cooling down our economy. What we are witnessing is the bond market playing a game of "Catch Up" similar to what we are seeing the Federal Reserve do with the Fed Funds Rate. Even with 4 to 5 more interest rate hikes remaining on the table, I do not expect the Yield on 10 Year U.S. Treasuries to exceed 3.25% in 2022. There has been an immense amount of resistance at this level from a technical view dating back to the Great Financial Crisis as you can see from the chart below:

FIGURE 3: 10 YEAR TREASURY YEILD DATING BACK TO GREAT FINANCIAL CRISIS



FINAL THOUGHTS

I would like to leave you all with a final note on inflation. As we discussed in our first quarter 2022 newsletter, one of the primary jobs of the Federal Reserve is control inflation. When inflation is too high, the Federal Reserve will raise interest rates to slow the economy and bring price down. Over the next few months, a number of reports will be released that will play a pivotal role in the direction of the fixed income markets for the remainder of the year. If the Consumer Price Index (C.P.I) numbers begin to track lower over the next few months, I would expect the 10-Year Yield declining modestly and ending the year in the 2.50 to 2.75% range.

If the inflation numbers prove to be higher than expected, it would force the Federal Reserve to be more aggressive. The main tools the Federal Reserve would use to continue fighting inflation are increasing interest rates and reducing the Federal Reserve's Balance sheet. This is a very slippery slope that the Federal Reserve must ascend because raising interest rates too quickly could propel our economy into a recession. If they don't raise interest rates fast enough, we could see inflation numbers similar to the 1980's.

BRAD MCMILLAN MARKET COMMENTARY

Stock Market Continues to Slide

Yesterday saw another significant drop in stock markets, more than reversing the bounce we saw the prior day. Up, down, up, down, but largely down—it looks like the market is headed down indefinitely.

Yet, if you look at the S&P 500, we are about where we were a year ago. That is not great, but it's certainly not the end of the world. If you look at recent highs, we are down about 14 percent from the peak. Again, this is nothing to cheer about, but it's not especially bad in the historical context.

Is There an End in Sight?

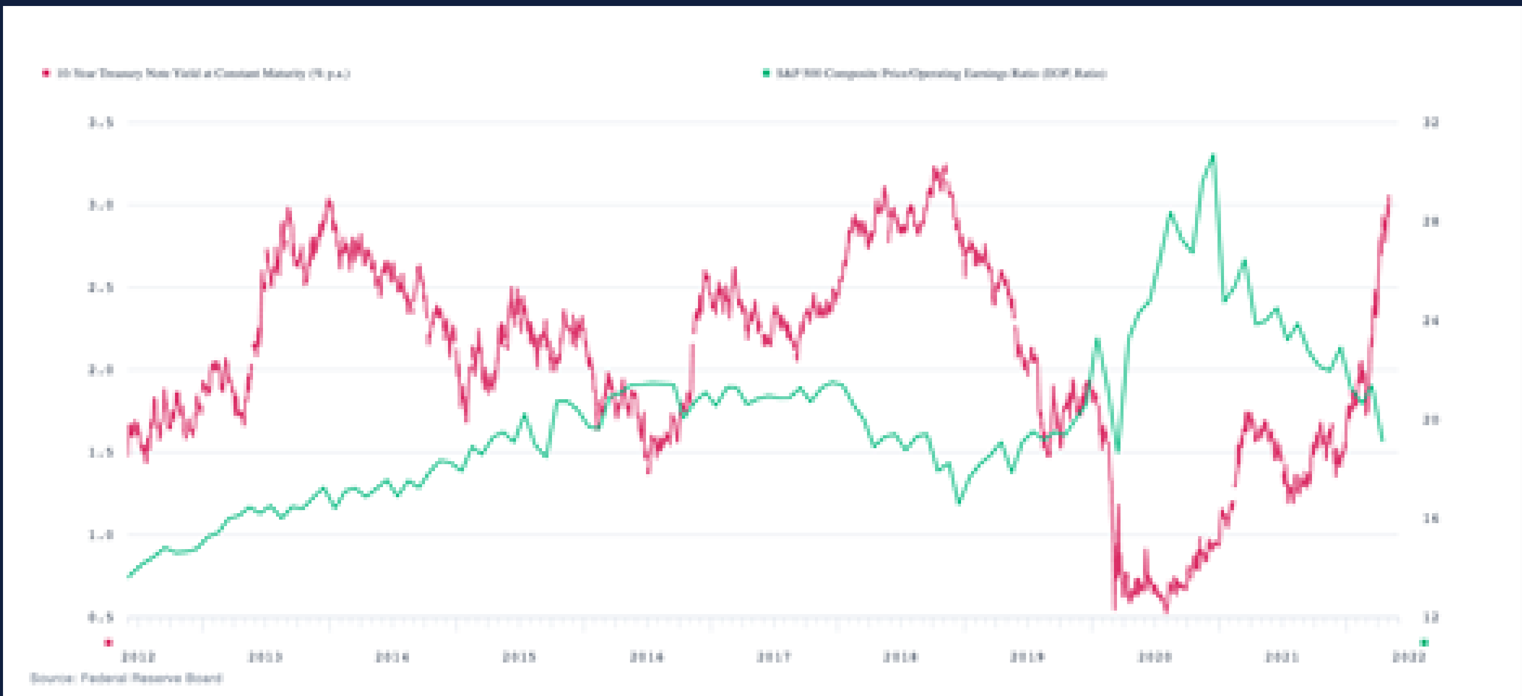
Markets bounce around. No one minds the up bounces, but the down bounces hurt (a lot). And reminders to focus on the long term often don't really help. So, let's look at the question in another way: what should the market be worth? If we believe that stock prices are determined by fundamentals, which over time can be demonstrated, then there should be a central value that stocks trade around. If we can estimate that, then we can watch the downswings (and the upswings) with a bit more equanimity. That is the question I want to look at: what should the S&P 500 be worth—and is there a bottom in sight?

You can really go down the rabbit hole here. For today, I want to do a simple analysis based on three factors: interest rates, stock valuation multiples (also known as P/E ratios), and earnings. If we look at these three things, we can get some insight into where stock prices should be and, therefore, where they are likely to end up.

Interest Rates and Valuations

Let's start with interest rates and valuations. This chart looks at the interest rate on the 10-year U.S. Treasury note and compares that with the price-to-operating earnings ratio for the S&P 500, based on the last 12 months of earnings. You can see that, generally, higher interest rates mean lower valuations. With interest rates rising, we should see the market going down. So, where will valuations end up?

STOCK MARKET CONTINUES TO SLIDE-CONT'D



For simplicity's sake, let's just look at the last two times interest rates were at current levels, in 2013–2014 and the end of 2018. In both cases, the S&P traded at around 18 times trailing operating earnings. If the relationship holds (and it should), we should see it bottom out around that level this time as well.

Earnings

Let's look at the data. For the four quarters of 2021, the total operating earnings were $208.21. So far, for the first quarter of this year, earnings are up by about $5.00 from the first quarter of last year, which is not final but pretty close. If we use that, then the trailing 12-month earnings for the S&P 500 would be about $213, which means the S&P 500 should, on this basis, be worth around 3,850. Based on the past results, that is where the index should bottom, if the decline continues. In other words, we may have another 7 percent or so to go.

Note, though, that in both cases valuations then rebounded. If history holds, that would be a bottom. Also note that we might well not get that low; other metrics suggest higher support levels. Finally, note that as earnings increase over time, even at lower valuation levels, the market can and will rise. The actual number, of course, is an estimate. But the real message here is that we are approaching a solid value foundation—and that will limit any further declines.

Back to Normal?

The other reason not to panic is that the reason this is happening is positive, not negative. Economic conditions are normalizing, which is what we have been working toward for years. As part of that, so are interest rates. Finally, as interest rates normalize, so are market valuations. All necessary and ultimately positive.

STOCK MARKET CONTINUES TO SLIDE-CONT'D

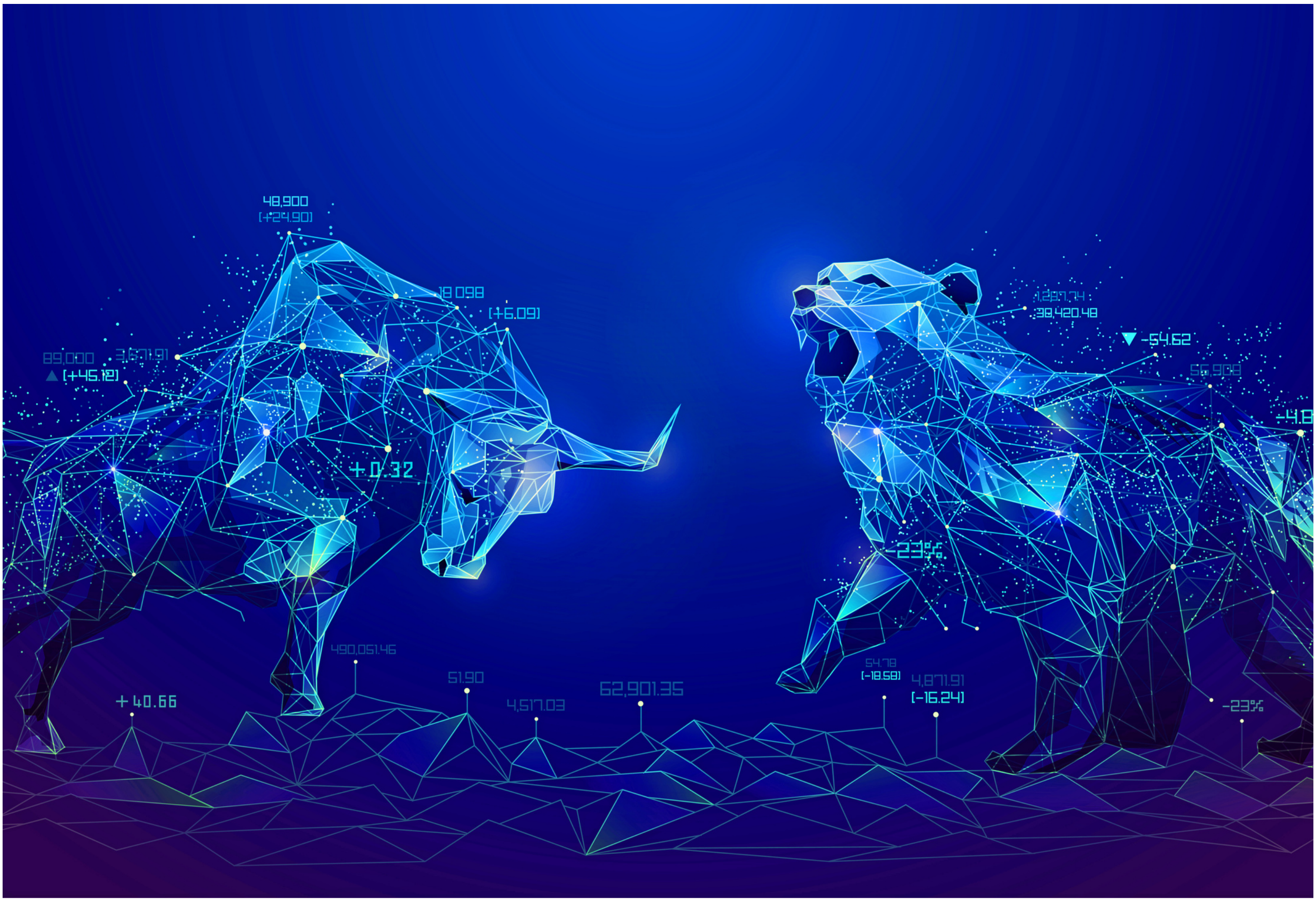
Per the chart above, valuations have been at very high levels and are now moving back to normal. Per the chart above, interest rates are doing the same thing. This is painful in the short term, but it will set the stage for future growth.

It also provides us with the assurance that the market is not irrational and is not on an unending downward slide. We may (I repeat may) have more of a decline ahead of us, but it will be limited. More, it will still be well within the adjustments we see almost every year. Like most medical procedures, this is no fun but will ultimately end and leave us in a better place.

Detour Ahead

If you understand where you are going, you know what it takes to get there. This analysis is intended to show us both. This is part of the healing process. We will get back to growth—we just have to take a bit of a detour first.

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



BUFFALO FINANCIAL: UPDATE

We are extremely excited to announce the launch of our new website: www.buffalofinancial.com

Our firm partnered with the fantastic design team at Parkway Digital in Lancaster, NY. They have built websites for Martin House, Buffalo Museum of Science, Rich Entertainment Group, Villa Maria College and many more. Please visit our new site, we would love to hear your feedback!

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

BUFFALO
FINANCIAL

UPCOMING SEMINARS AND EVENTS

RSVP TO OUR SEMINARS!

INVESTING DURING UNCERTAIN TIMES
Presented by Matthew Pitrola

- **Thursday, June 16th, 12:00 PM @ 4990 Transit Road.**
  - **Lunch will be provided**
- **Tuesday, June 21st, 12:00 PM @ 4990 Transit Road.**
  - **Lunch will be provided**

CHARITY EVENTS

- **Leukemia & Lymphoma Society Golf Tournament - Friday May 20th.**
- **Leukemia & Lymphoma Society Pub Crawl: East Aurora Saturday June 4th.**

Seminars will be held at our office - 4990 Transit Road, Depew. Please RSVP for seminars or events by calling Brooke or Matthew @ 716-771-1888 or email Brooke/Matthew directly: brooke@buffalofinancial.com or matthew@buffalofinancial.com!