The Bottom Line - Q3 2022

THE BOTTOM LINE

THIRD QUARTER : 2022

BUFFALO FINANCIAL QUARTERLY NEWSLETTER

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TICK....TOCK...

BY JEREMY I. BECK

The clock has officially started. No, we aren't referring to the start of the NFL season, but the ticking of the bear market clock. As we discussed in prior newsletters, a bear market occurs when securities fall 20% or more from recent highs. The day we officially entered a bear market for the S&P 500 was June 13th, 2022. Now that we are officially three months into this bear market, the most common calls and emails we are receiving from clients are:

- How often do bear markets occur?
- How long does a typical bear market last?
- What should I do with my portfolio now?

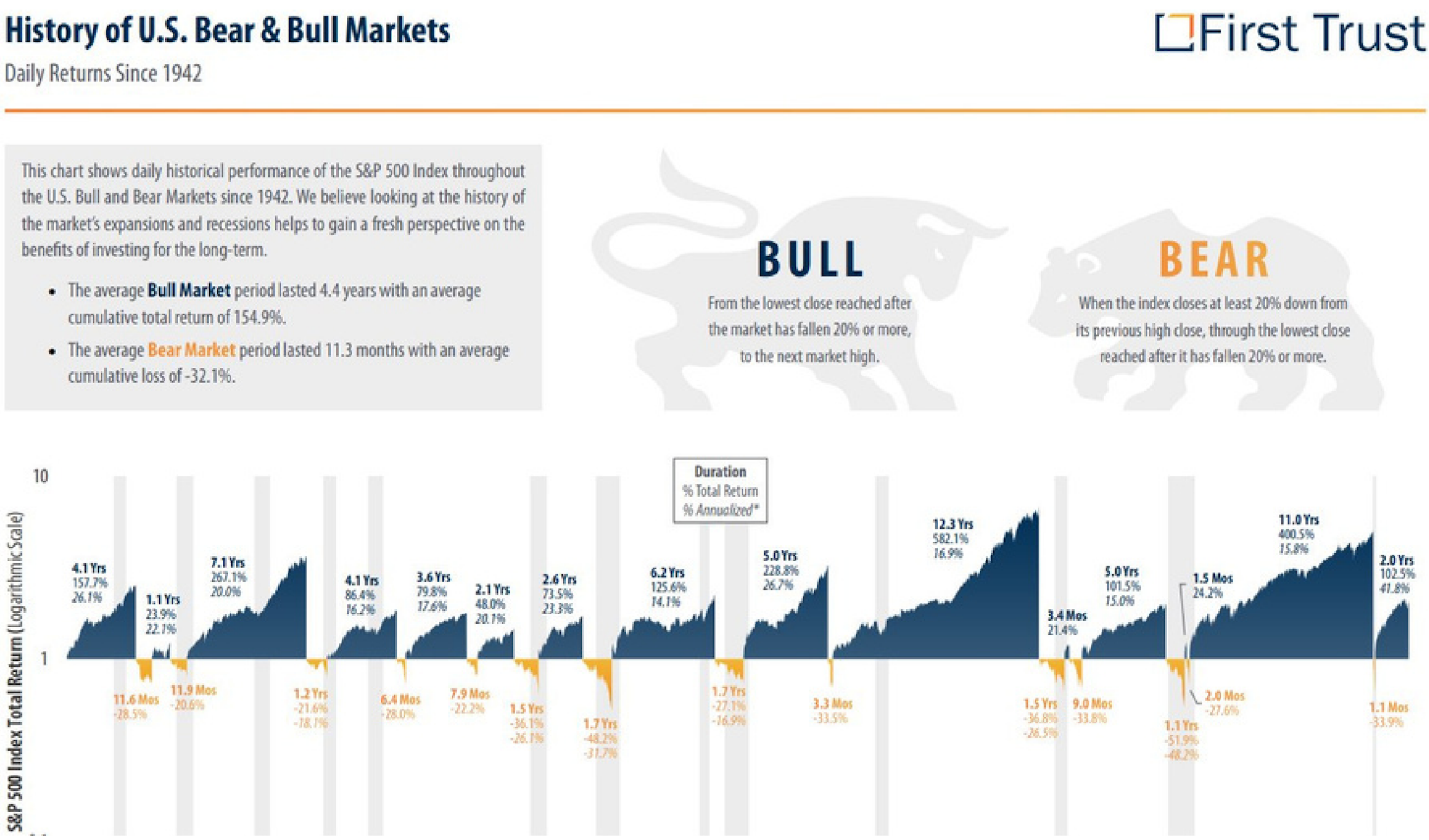
TICK...TOCK... - CONT'D

How often do bear markets occur?

First and foremost, bear markets are a normal occurrence in the equity markets. Since 1928, there have been a total of 26 bear markets (and 27 bull markets). The score would be 27 to 27 if the bears succeeded in 1990, but the S&P 500 only dropped 19.90% and did not qualify as an official bear market. On average, a bear market occurs roughly every three and a half years. Ironically, bear markets have been less frequent since World War II, with a bear market occurring once every five and a half years.

How long does the typical bear market last?

Historically, there has been a high variance in the average length of a bear market. The longest bull market was a whopping 61.8 months between March 6, 1937 and April 29, 1942. The shortest bear market occurred during the Covid-19 pandemic of 2020 and lasted from February 19, 2020 until March 23, 2020, only



slightly over a month in total! I found a fantastic chart published by First Trust (above), which shows the length of each bear and bull market dating back to 1942. The chart is fascinating; especially when looking at the size of each type of market over time. When looking back over the past 80 years, bear markets tend to be dwarfed by the average bull market.

What should I do with my portfolio now?

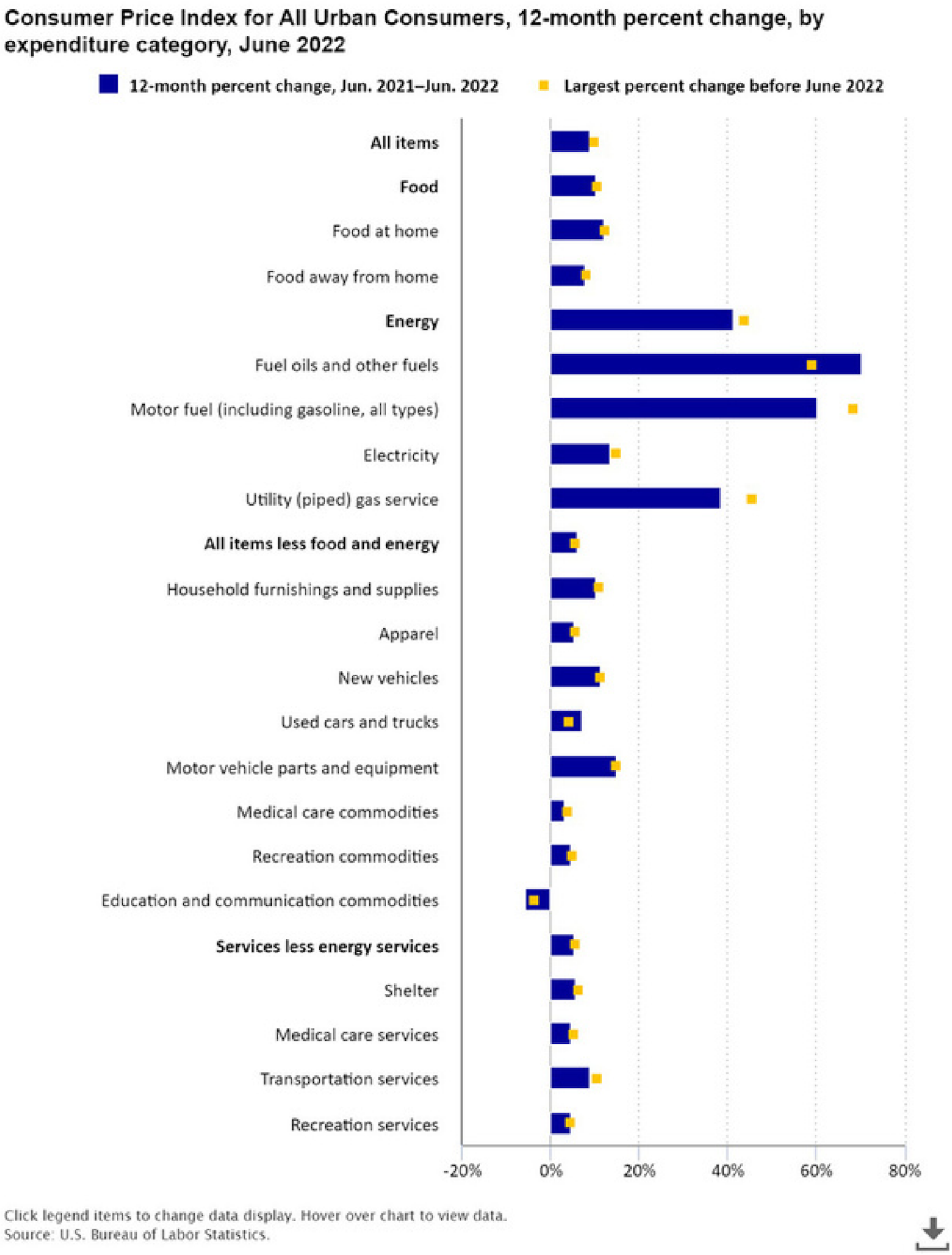
The answer lies in the cause of the current market drop: inflation. As the Federal Reserve Chairman Jerome Powell has stated, “The Fed needs to move forthrightly, strongly against inflation”. Since 1996, the Fed’s long term inflation target is 2.00%. The Federal Reserve is strongly committed to reaching this goal of reducing inflation by using the following tools:

- Reduce the Money Supply / Trim their $9 trillion balance sheet.
- Increase the Federal Funds interest rate.

TICK...TOCK... - CONT'D

FIGURE II - YEAR OVER YEAR CHANGE IN CONSUMER PRICE INDEX

Inflation has been breathtaking over the past 12 months (ending June 2022), with food prices increasing by 10.4%, the largest increase since 1981. Energy prices increased 41.6% over the past year (largely as a result of the Russian invasion of Ukraine), resulting in gasoline price increases of 59.9%. Prices for nearly all materials have increased over the past year as displayed in the table (right), courtesy of the U.S. Bureau of Labor Statistics.



The Federal Reserve is attempting a "soft landing", putting the brakes on the economy by curbing demand to bring prices under control without pushing the economy into a long recession. As interest rates move higher, look to position your fixed income holding into the "sweet spot" of the yield curve, which is currently in the 1 to 3 year time frame. In regards to equity positions, we suggest holding your high quality, Large Cap U.S. Equities with an eye to increase exposure to stocks as we see inflation beginning to subside. We are already seeing signs that the parabolic move in inflation has begun to level off, but we will need more data to suggest the Fed's Policy is indeed working.

In the meantime, stay safe and for all the Buffalo Bills fans, GO BILLS!!!! - Jeremy I. Beck

FIXED INCOME OUTLOOK

BY MATTHEW PITROLA

2022 has been one of the more painful and enduring years for fixed income investors in recent memory, with interest rates rising rapidly throughout the first nine months. The bond markets have been going through a transformational shift away from a period of ultra-low interest rates and accommodative monetary policy, to a period of higher interest rates and tighter monetary policy. While transitions tend to create uncertainty and volatility in the market, they can lead us into new and unique opportunities.

The Federal Reserve

The Federal Reserve and Chairman Jerome Powell have been playing a daring game of catch up throughout all of 2022. This ultimately is because of the lack of action throughout the course of 2021. The Federal Reserve suggested the surge in inflation is transitory and that it will work itself out on its own. After several months of persistently high inflation in early 2022, the Federal Reserve began to face the certainty that inflation is not going to disappear on its own and that they must act.

During the first nine months of 2022, the Federal Reserve has moved the Effective Federal Funds rate from near 0% at the beginning of 2022 to 3.25% as of September, 21st. With interest rates rising rapidly, it has made navigating the fixed income markets throughout the year increasingly difficult.

In the months of July and August, we received our first semblance of hope. Seeing our first month over month decrease in the Consumer Price Index or CPI (United States main inflation metric.) This caused interest rates to decline and gave the market hope that this interest rate hiking cycle would be coming to an end sooner than anticipated.

Unfortunately for investors, this hope was short lived. At the Jackson Hold Symposium, Powell reaffirmed the Federal Reserve's mandate to combat inflation. Signaling that this interest rate hiking cycle is far from over and that one monthly decline in CPI was not enough to take the Federal Reserve off of its current course.

All eyes are currently on the Federal Reserve’s FOMC meeting on September 21st. In this meeting we will get more information on the magnitude of interest rate hikes throughout the remainder of 2022. The market is currently pricing in a 80% chance that the Federal reserve will raise interest rates by .75% at the next FOMC meeting. For year end, the market is currently pricing in a Effective Federal Funds Rate of 3.75% which would mean that rates on the short end of the yield curve could rise another 1.25% through the end of the year.

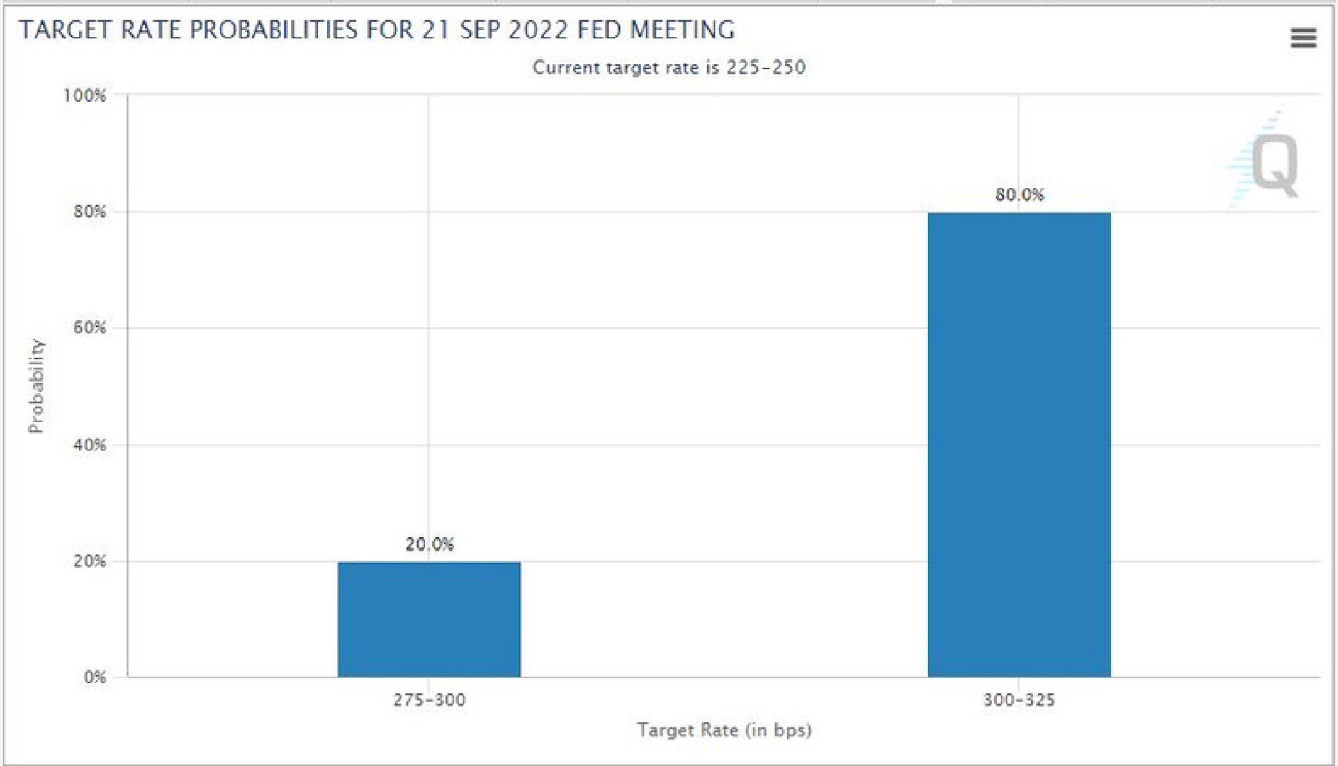
In figure one on the following page, I have included an image directly from the CME Group showing the current interest rate hike probabilities for the September FOMC meeting. We fulling expect the Federal Reserve to increase the Federal Funds rate by 0.75% unless we see a steep decline in headline CPI prior to the meeting (unlikely). All signs point to increased pressure on the fixed income markets throughout the remainder of 2022.

FIXED INCOME OUTLOOK - CONT'D

FIGURE ONE: 80% PROBABILTY OF A .75% INTEREST RATE HIKE ON SEPTEMBER 21ST

21 Sep22 | 2 Nov22 | 14 Dec22 | 1 Feb23 | 15 Mar23 | 3 May23 | 14 Jun23 | 26 Jul23

MEETING INFORMATION						PROBABILITIES		
MEETING DATE	CONTRACT	EXPIRES	MID PRICE	PRIOR VOLUME	PRIOR OI	EASE	NO CHANGE	HIKE
21 Sep 2022	ZQU2	30 Sep 2022	97.4588	13,106	192,882	0.0 %	0.0 %	100.0 %



OPPORTUNITIES IN FIXED INCOME

A rising interest rate environment can be a moment of uncertainty for fixed income investors, but can also lead to new opportunities. One safe haven investment for risk averse individuals that I would like to highlight is the opportunity in the Certificate of Deposit market.

Certificates of Deposit, also known as a CD, are federally insured up to $250,000 meaning that this investment is about as "risk - free" as they come. While rates today are not as attractive as the 10.00% + yields that we saw in the 1980's, yields in 2022 have approached a level where they can meaningfully compound interest for investors. The table below shows the current CD rates from our ICE BondPoint terminal on September 6, 2022.

U.S. Treasury Rates | Municipal Bond Rates | Corporate Bond Rates | CD Rates

CD Rates

Last Updated: 09/06/22 17:00 ET

Maturity	Yield	Yesterday	Last Week	Last Month
3 Month	2.80	2.75	2.55	2.40
6 Month	3.10	3.10	2.90	2.75
9 Month	3.30	3.30	3.30	2.90
1 Year	3.25	3.25	3.15	3.10
2 Year	3.45	3.40	3.40	3.35
3 Year	3.60	3.60	3.60	3.40
5 Year	3.60	3.60	3.60	3.55

Source: ICE BondPoint, Inc.

FIXED INCOME OUTLOOK - CONT'D

OPPORTUNITIES IN FIXED INCOME

When it comes to selecting a desired maturity, individuals will often gravitate towards a CD that has the highest yield. Instinctively, this makes sense. You want to earn the highest rate of return possible for your time horizon. But for investors considering a CD investment during a period of rising interest rates, I would suggest a laddered CD strategy. In a laddered strategy, you invest in several certificates of deposit with staggered maturities to take advantage of higher interest rates on long term CDs, while still keeping funds accessible in the near term if we see rates continue to move higher.

How to build a CD ladder:

For example, if you have $50,000 to invest in CDs, create a CD ladder with five separate $10,000 rungs. Instead of investing all of your funds in the highest yielding CD. You could structure your investment as such:

- $10,000: 3-month CD yielding 2.80%
- $10,000: 6-month CD yielding 3.10%
- $10,000: 12-month CD yielding 3.25%
- $10,000: 24-month CD yielding 3.45%
- $10,000: 36-month CD yielding 3.60%

When your first CD matures after 3 months, you can cash out or continue your ladder by reinvesting the funds into a 48-month CD with a higher yield. The advantage of this strategy is having the ability to take the proceeds from an expiring CD and roll those proceeds into a higher yielding CD's throughout the duration of this current interest rate hiking cycle.

CONCLUSION:

The direction of inflation is the number one issue driving the markets this year. As long as it remains unclear whether or not central bank intervention is succeeding in bringing down inflation, we will continue to see fixed income markets under pressure. While the high inflationary period we are in could be looking more positive by the end of the year, it could also prove to be a more persistent issue.

If inflation does begin to trend lower later this year, will the Federal Reserve alter its course? Will they continue to hike interest rates even if we see inflation begin to come down? Will a soft landing be possible for the United States economy? The uncertainty regarding inflation will continue to drive volatility in the fixed income market throughout the remainder of 2022 and into 2023. In times of uncertainty, the greatest opportunities present themselves.

Enjoy the beautiful fall weather!

Matthew Pitrola

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

Please keep an eye out for an invitation to our client appreciation event. We will also be hosting a series of investment seminars, projected to run from late October through April, 2023. Details to follow!

We are also extremely excited to announce the addition of a very talented young man to the Buffalo Financial Team.

Jake Wood is our newest Wealth Management Analyst after successfully completing his SIE and Series 7 Examinations!

BUFFALO FINANCIAL

UPCOMING SEMINARS AND EVENTS

CLIENT APPRECIATION EVENT!

Please keep an eye out for an invite to our client appreciation event!

- **Date to be finalized (potentially early October)**
- **Will be located at our office - 4990 Transit Road, Depew, NY.**
- **Food, drinks and more!**
- **Come take a look at our completed addition and say hi to our new faces!!!**

CHARITY EVENTS

Jeremy Beck is the Co-Chair for the Leukemia & Lymphoma Society "Visionary of the Year" Campaign for 2023. If you would like to nominate an individual for this prestigious award, please email Jeremy directly: jeremy@buffalofinancial.com.

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