The Bottom Line - Q1 2023

THE BOTTOM LINE

FIRST QUARTER : 2023

BUFFALO FINANCIAL QUARTERLY NEWSLETTER

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RECOVERY

BY JEREMY I. BECK

We are pleased to announce that signs of recovery are beginning to take hold. Equity markets showed signs of life in January, following a 2022 that saw it register its worst annual performance in 14 years. Background data on inflation point to the Federal Reserve's policy actions beginning to moderate off sharp price increases, but readings on the gross domestic product and labor market indicate that the U.S. economy is still on firm ground for the time being. In February, which traditionally has been one of the worst months of the year for the S&P 500, investors are hopeful that the market can maintain its early 2023 pace.

RECOVERY - CONT'D

Inflation and interest rates continue to be the two main market drivers that affected stock values throughout 2022. In December, the consumer price index (CPI) increased by 6.5% year over year, down from a peak reading of 9.1% in June but still much higher than the Fed's long-term goal rate of 2%.

At the December meeting, the Federal Open Market Committee (FOMC) slowed the rate at which it raised interest rates by raising the benchmark by only 0.25%. Economists anticipate that the FOMC will continue to raise interest rates twice this year, pausing after the March 22nd meeting. Based on our research, we feel there will actually be three increases in the Federal Funds rate this year with the pause officially happening after the May 2nd meeting.

With that being said, the equity markets still face an uphill battle in 2023. According to Richard Saperstein, chief investment officer at Treasury Partners, "Markets have been reacting favorably to moderating inflation and expectations of a reduced pace of Fed tightening, but the lag effects of the Fed's tightening so far will slow the economy in the second half of 2023 and cause analysts to slash earnings estimates, which ultimately is a headwind for stocks".

Recession Watch

The Fed is at a turning point in its fight against inflation, and the next few months may determine whether it can steer the U.S. economy through a so-called "soft landing" without sending it into a recession. The American housing market has drastically weakened recently, and manufacturing output has decreased. A popular indicator of the state of the economy, the Conference Board's Leading Economic Index, has also declined for 10 straight months.

The resiliency of the U.S. job market has been the most convincing indication to date that a soft landing may still be feasible. In December, the U.S. economy added 223,000 jobs, more than the 200,000 jobs predicted by economists, according to the Labor Department. However, since the economy has consistently added more than 500,000 jobs each month in the early months of 2022, the rate of job growth has drastically decreased.

The Q4 U.S. GDP growth rate of 2.9% was somewhat higher than the 2.8% level experts had predicted. But, according to Bill Adams, chief economist at Comerica Bank, the economy will face too many challenges in 2023. According to Adams, "Comerica expects real GDP to decline to roughly zero in 2023 due to headwinds from high interest rates, the housing market correction, and consumers bundling up to deal with the high cost of living."

RECOVERY - CONT'D

A famous quote on the US stock market is by Peter Lynch, a renowned investor and former manager of the Fidelity Magellan Fund. He said, "The stock market is filled with individuals who know the price of everything, but the value of nothing."

Michael Gapen, an economist from Bank of America, predicts a U.S. recession for 2023. However, Gapen predicted that the process would take a little longer and result in a lower peak unemployment rate (at 5.1% in Q1 2024, down from 5.5% previously). "We still expect headwinds to the economy to lead households to reduce spending and push the saving rate higher, leading to a mild recession this year," he said.

Our View

We fully anticipate that the Federal Funds rate will increase three times in 2023, then remain unchanged for the rest of the year. If there is a recession, it should be short-lived, priming the pump for future gains in the U.S. Equity Markets.

Stay Safe - Jeremy I. Beck

FIXED INCOME OUTLOOK 2023

BY MATTHEW J. PITROLA

2022 marked an unprecedented event in the fixed income markets. The Bloomberg Barclay's U.S. Aggregate Bond Index, a comprehensive benchmark for U.S. bonds, experienced a decline in value for the second consecutive year, the first time in U.S. history.

FIGURE 1: Bloomberg Barclay's US Aggregate Bond Index 2 Year Chart:

Source: TC2000

In 2022, the Federal Reserve began to raise interest rates at a pace we have not seen in more than three decades, driven by the need to counter inflation.

The sharp drop in fixed income values during the year was indeed a painful experience. Nevertheless, this setback served as a reset for the fixed income markets. Bonds have regained their role as a critical component in constructing portfolios. For the first time in many years, bond yields have increased to a level where retirees seeking income can utilize them to sustain a 4% withdrawal rate from their portfolios. The impact of the 2022 fixed income market declines will not be forgotten, but the event created opportunities for investors to rethink their investment strategies.

FIXED INCOME OUTLOOK - CONT'D

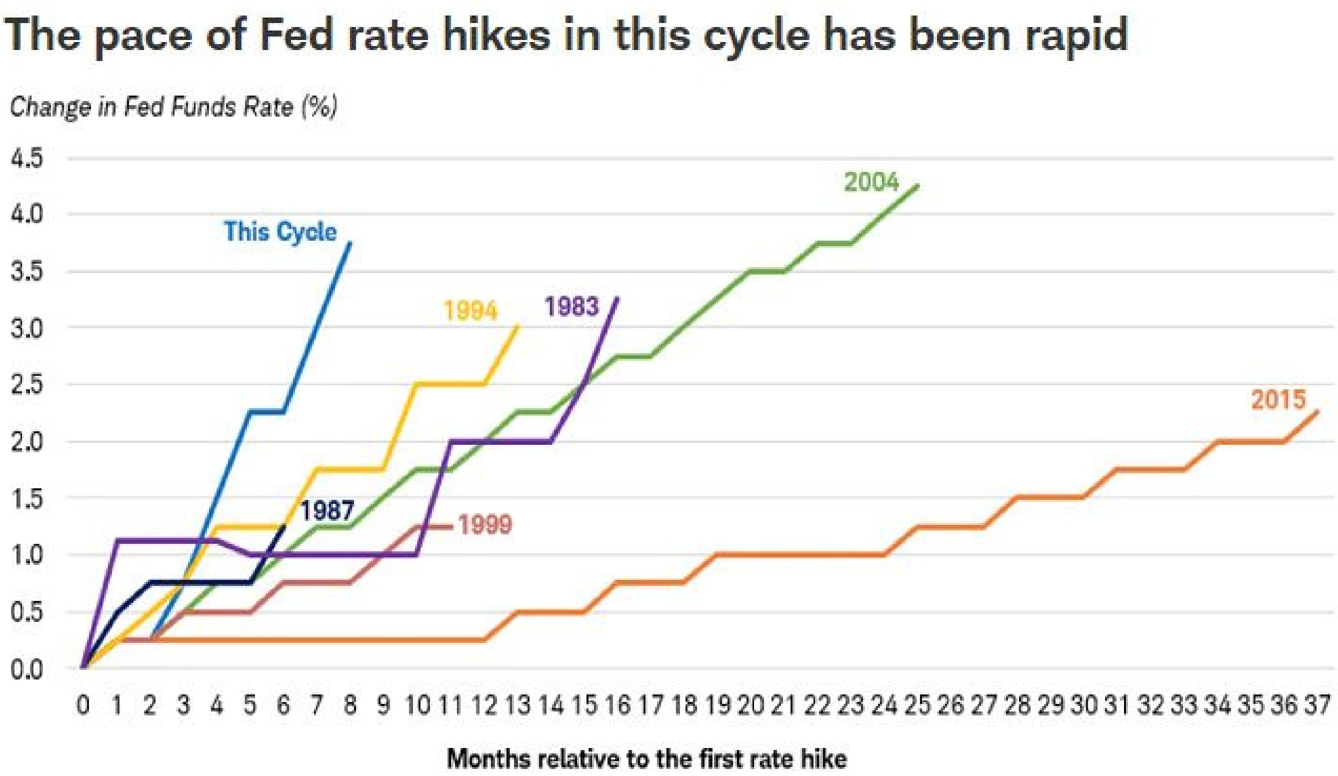
What to expect from the Federal Reserve in 2023:

While reflecting on the start of 2022, it is apparent that the Federal Reserve realized that inflation was not going to be a transitory issue around the same time that Russia initiated their invasion of Ukraine. This event triggered a rapid increase in commodity prices, causing public anxiety to surge.

To counter inflation, the Federal Reserve adopted a more restrictive policy than anyone had anticipated, resulting in the Effective Federal Funds rate rising from 0% at the start of 2022 to 4.50% by year-end. This marked the most rapid pace of tightening witnessed in over three decades.

Figure 2 below showcases the rapid rise in interest rates throughout 2022, as compared to previous interest rate hiking cycles over the last 30 years.

FIGURE 2: THE PACE OF FED TIGHTENING IN THE CURRENT CYCLE



Source: Bloomberg.

Following the significant increase in interest rates in 2022, a question that I am frequently asked is "What is the outlook for interest rates in 2023?" This can be solved by asking another question: "Why did the Federal Reserve begin to raise interest rates in 2022?"

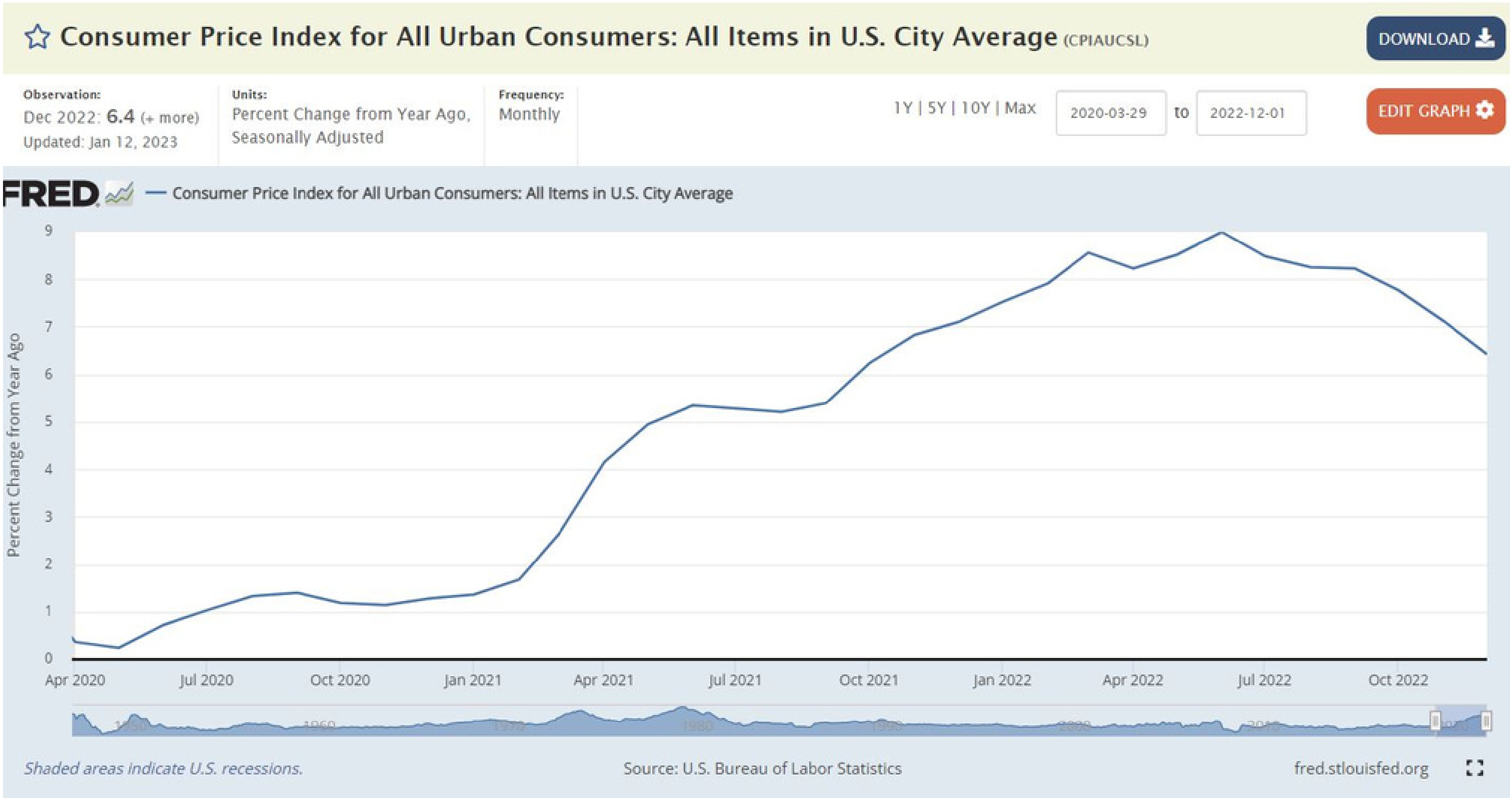
The answer to this question is clear by now - the interest rate hikes were implemented to counter inflation. To anticipate what we can expect from interest rates in 2023, the first step is to analyze the hard inflation data. For this purpose, I have included a chart displaying the Consumer Price Index (CPI) dating back to April 2020. CPI is a metric that tracks the average price change of a fixed basket of consumer goods and services over time, serving as a general gauge for the rate at which prices are rising for consumers.

FIXED INCOME OUTLOOK - CONT'D

When you examine Figure 3 below, you can see the parabolic growth in inflation numbers throughout 2021 and 2022 that caused much of the chaos throughout last year.

When analyzing the last six months of inflation data, it becomes apparent that inflation has started to ease. If this trend continues, it is probable that interest rate volatility will also diminish as the uncertainty related to inflation has been the primary factor behind the swift increase in interest rates.

FIGURE 3: CONSUMER PRICE INDEX (CPI)



Source: Federal Reserve Economic Database

Looking forward to the next FOMC meeting on March 22nd, the FOMC Fed Watch Tool is currently predicting a 81.19% chance of a .25% rate hike. This would take the Effective Federal Funds rate to a target range of 4.75% - 5.00%.

There is much debate surrounding the FOMC meeting on May 3rd. Most economist expect the Fed to keep rates unchanged, whereas others expect another .25% hike, taking the Effective Federal Funds rate to a range of 5.00% - 5.25%.

The months of June and July are where we will likely see a pause by the Federal Reserve.

We do not believe the months of June and July will be the point where we see the "pivot" that many Wall Street investors are anticipating, which is a transition from a rising interest rate environment to a falling interest rate environment. Our expectation is that the final rate hike of the cycle will be at the May 3rd meeting, followed by an extended period of keeping rates unchanged. Nevertheless, the dramatic departure from the current rising interest rate environment to a pausing period will put fixed income in a unique position.

FIXED INCOME OUTLOOK - CONT'D

THE TREND IS CHANGING

Coming off the worst year for fixed income since 1931, we feel that the opportunity in fixed income for individuals that have a time horizon of 3 years or more is very appealing.

In fact, in the last 45 years, bonds have only had an annual decline in value six times. Two of those declines happened in 2021 and 2022. With interest rates approaching the 5.00% level in the Effective Federal Funds rate, there is a clear opportunity for income of over 4.00% the next 12 months with the possibility of price appreciation if the Federal Reserve does have to pivot away from higher interest rates into 2024. The reason for the possible price appreciation would be the inverse correlation between bond prices and interest rates in the economy. As bond prices declined throughout 2021 and 2022, interest rates rose, the exact opposite could happen in 2024. As the prospect of a U.S. recession increases, the Federal Reserve grapples with a slowing economy.

SUMMARY:

The years 2021 and 2022 exemplified the worst-case scenario for fixed income investors. Fortunately, there appears to be a glimmer of hope on the horizon. With interest rates hovering near 5.00%, signs of inflation abating, and indications of a shift in monetary policy from the Federal Reserve, we anticipate that 2023 and 2024 will be significantly better for investors seeking income and portfolio protection.

However, it is essential to remain vigilant while monitoring both inflation data and Federal Reserve comments, as both factors could lead to volatility in the fixed income markets in the first half of this year.

THE SECURE 2.0 LAW

BY JACOB B. WOOD

On December 29th, 2022, President Biden signed the Consolidated Appropriations Act of 2023. This act included the SECURE 2.0 measure, or the Securing a Strong Retirement Act 2.0. This piece of legislation aims to enhance the retirement security of Americans by facilitating the process of saving for retirement, increasing the availability of workplace retirement plans, and ensuring a more secure retirement for both workers and retirees. Below, I have listed some of the key provisions of this act.

Key Provisions of SECURE 2.0 Relating to Individuals

- Delays required minimum distributions from age 72 to 73, eventually increasing to age 75 by 2033.
- Employers can match employees' student loan payments.
- Taxpayers can create SIMPLE Roth IRAs and SEP Roth IRAs.
- IRA catch-up contributions and qualified charitable distributions are indexed for inflation.
- RMDs for Roth accounts in employer-sponsored plans are eliminated.
- Unused funds from 529 college savings plans can be rolled into Roth IRAs, *subject to restrictions*.
- New post-death beneficiary withdrawal options for surviving spouses of retirement plan owners.
- Exceptions to the 10% penalty for early retirement account withdrawals, including domestic violence victims and qualified long-term care expenses.
- More blind and disabled individuals can access 529 ABLE accounts.

SECURE 2.0 Provisions Affecting Retirement Plans
Effective Immediately (2023)

- Increased tax credit for eligible startup expenses of retirement plans for employers with 50 or fewer employees.
- Employer contribution tax credit available for eligible employers for up to 5 years.
- Matching Roth contributions allowed in 401(k), 403(b), and 457(b) plans.
- Emergency expense distributions up to $1,000 per year without penalty.

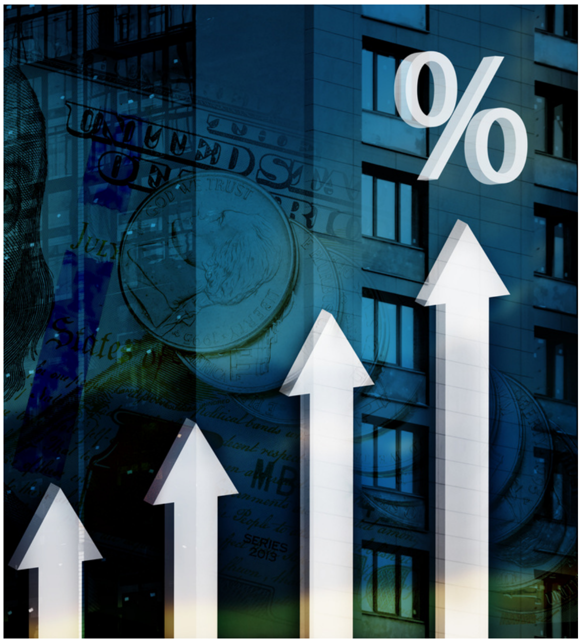
Effective in 2024

- Catch-up contributions required to be directed to a Roth account for individuals earning more than $145,000.
- Student loan repayment match allowed in retirement plans.
- Starter 401(k) plan option for small businesses without employer matching contributions.
- Roth RMDs no longer required for Roth 401(k)s.
- Auto-enrollment requirement for plans adopted after December 31, 2024.
- Escalated catch-up deferrals for individuals ages 60-63.
- Saver's Match for low- and moderate-income individuals contributing to a qualified retirement account starting in 2027.

SECURE 2.0 offers provisions that promote retirement saving and provide individuals with more time for tax-deferred saving and growth. Unlike previous bills, SECURE 2.0 does not aim to limit taxpayers' ability to engage in Roth conversions and Backdoor Roth conversions, therefore making these strategies still viable. As more information on the interpretation of SECURE 2.0 becomes available, it is crucial to review your financial plan and tax strategies to understand any impacts on you and your family.

BRAD MCMILLAN MARKET COMMENTARY

Looking Back at the Markets in January and Ahead to February 2023



After a tough December, the markets rallied in January. Fears about inflation faded, and hopes that the Fed would hike rates more slowly—or even start cutting them—dominated markets as signs of economic weakness appeared. But this bad economic news was good news, as long-term rates pulled back, supporting financial markets.

Looking Back

Stock markets. For the actual numbers, U.S. stock markets gained substantially for the month, ranging between a 2.93 percent gain for the Dow and a 10.72 percent gain for the Nasdaq, with the S&P 500 in the middle with a gain of 6.28 percent. International markets also did well, with both developed and emerging markets up around 8 percent. Even fixed income had a strong start to the year, with the Bloomberg U.S. Aggregate Bond Index up 3.08 percent.

Interest rates. The reason for the universal gains was a pullback in interest rates. With inflation starting to pull back, and with the headline CPI figure coming in negative for the month, markets started to price in slower rate increases from the Fed. This took the yield on the 10-year U.S. Treasury note from 3.88 percent to 3.52 percent during January—a significant drop. Lower interest rates typically mean higher stock and bond values, and that is just what we saw. Looking back, lower rates appeared reasonable. In fact, the Fed increased rates only 25 bps, instead of the recent, typical level of 50 bps, at its last meeting.

The economy. While financial markets did well last month, the economy continued to show signs of weakness. Consumer spending slowed for the second month in a row at the end of last year. Business sentiment ticked down to recessionary levels, even as housing continued to suffer from higher mortgage rates. Looking back, it appeared that the Fed's rate increases were indeed slowing the economy, and a recession looked likely in the next couple of months.

LOOKING BACK AT THE MARKETS IN JANUARY AND AHEAD TO FEBRUARY 2023-CONT'D

Looking Ahead

Job growth. February's data, however, changed the outlook that supported markets last month. Job growth came in well above expectations, and business sentiment bounced back into positive territory for the service sector. Any recession looks less likely now, especially in the short term, which is good news for the economy. But it will be a headwind for financial markets.

While it appears that inflation will keep dropping, the shockingly strong jobs report at the start of February put the Fed back on edge, and it will likely push rates higher than we thought. This will be a headwind for markets this month, as the decline in rates may pause or even reverse.

Earnings and valuations. Even if rates reverse, there may be some good news. With the economy looking somewhat less weak, earnings may do better than expected. While the current data shows that they are beating expectations, it is by much less than usual. With a stronger economy, those beats may increase.
While earnings are likely to do better against expectations, valuations are likely to adjust down if rates rise again. We should get more color on this as Fed officials continue to comment and as the inflation data evolves. Looking forward, markets may face more headwinds and will likely not do as well as they did in January.

In the short term, the economy appears to be improving, but markets may struggle as the Fed continues to prioritize bringing inflation down. February is likely to be tougher for markets than January was. At the same time, as we look a bit further forward, a strong January has historically been a positive sign for the year as a whole. We can reasonably expect more volatility in the short term, but the longer-term picture remains more positive.

Political and international risks. Beyond the economic and policy angles, February faces challenges from politics. The federal debt ceiling was hit again in January, and the Treasury is now using extraordinary measures to pay the bills. While this will be resolved, it will likely be at the last minute (as it has been before). Until then, the rising uncertainty will also weigh on markets. With the Ukraine war underway and China's Covid-19 reopening still uncertain, there are multiple risks that will also act as market headwinds this month.

The Bottom Line

Looking back, January had bad economic news but good market results. February may well be the reverse. Even if it is, the prospects for the rest of the year continue to look good. And that is the bottom line here. While we do have headwinds, the strong January reflected real improvements in multiple areas. Looking forward, we should see the same kind of economic resilience over time as those improvements continue.

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

BUFFALO FINANCIAL UPDATE

Welcome to the Team, Jacob Wood!
Jacob is Buffalo Financial's newest wealth manager. He is a University at Buffalo graduate and was born and raised in West Seneca, NY. Jacob specializes in business retirement plans. This includes, but is not limited to SEP, SIMPLE, 401(k), and 403(b) plans. Join us in giving a warm welcome to Jacob!

BUFFALO FINANCIAL

4990 TRANSIT ROAD
DEPEW, NEW YORK 14043

716-771-1888

OPERATIONS:
TRISH@BUFFALOFINANCIAL.COM

SEMINARS:
TYLER@BUFFALOFINANCIAL.COM

www.buffalofinancial.com

SPRING IS ON IT'S WAY!!!