The Bottom Line - Q4 2022

THE BOTTOM LINE

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FOURTH QUARTER : 2022

BUFFALO FINANCIAL QUARTERLY NEWSLETTER

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SEVENTH INNING STRETCH

BY JEREMY I. BECK

My grandfather absolutely loved baseball. When I say loved, he LOVED baseball and we would watch games together quite frequently. I fondly remember him sitting on his Barcalounger, cigar firmly planted between his fingers and then placed in his pedestal ash tray. I always loved the seventh inning stretch (middle of the seventh inning), because that's when we would grab a snack from the pantry. I used the seventh inning stretch as the title for this newsletter as I feel this is exactly where we are in the current bull market. I can't wait to send news that this bear market has finally been relegated to dates in history, but sadly, we aren't there yet.

SEVENTH INNING STRETCH - CONT'D

When will it be over?

The equity markets should bottom in the first quarter of next year, but the chefs in the Federal Reserve kitchen still need to finish making their sauce. They will need to add another interest rate increase at the December 14th FOMC meeting, raising the Federal Funds rate by 50 basis points from a target 3.75 - 4.00% to a new target of 4.25% to 4.75% (I can already hear the cheers from CD investors). As we have stated all year, the Federal Reserve must continue to raise rates to reduce inflation to their target rate. We expected 6 to 7 Interest rates hikes when the year began, and December 14th would mark their seventh increase.

Massive game of tug of war

Many clients have asked why the stock market is so fixated on what the Federal Reserve is doing. The explanation is very simple: money goes where money grows. When analyzing the stock market, the average annual return for the S&P 500 over the past 30 years is 9.89%. As we all know, this 9.89% comes with a steep price, in the form of extreme volatility. In 2008, the S&P 500 finished 38.5% lower and down 23.4% in 2002. The best years (in the past 30) were up 34.1% in 1995 followed by an increase of 31.0% in 1997.

Now let's take a look at the fixed income markets. The expectation is that by the end of the first quarter 2023, the Federal Funds Rate (overnight lending rate) should reach the 5.00% range. If the Federal Funds rate is 5.00%, there will be many conservative fixed income investment yielding much higher. For example, the current Federal Funds rate is 3.75 to 4.00%, yet our one year CDs are yielding 4.75% and two year CDs are nearly 5.00%. When the Fed Funds Rate reaches 5.00%, we can reasonably expect one and two years CDs to be 6.00% (or higher)!

Every investor in the world will need to make a decision:

- Will I invest heavily in the stock market, looking for the longer term average return of 9.89%, but accept the volatility associated with stocks?
  OR
- Do I purchase FDIC insured CDs at 6.00% and not worry about my portfolio?

The rope in our theoretical tug of war will "break" if interest rates move even higher than expectations. At the end of November, St. Louis Fed President James Bullard stated that the Federal Funds rate would need to move much further to put a damper on inflation. Without forecasting a specific number, Bullard stated that the Fed Funds rate would need to be between 5 and 7% to be "sufficiently restrictive". I believe a 7% Fed Funds rate would break our rope, making the decision easy for investors to pile into 8 - 9% CDs, nearly matching the long term return of the S&P 500 without taking any risk.

SEVENTH INNING STRETCH - CONT'D

Did you know? According to the Wells Fargo Investment Institute study, the average 12-month return after the end of a bear market is 43.4%.

With the being said, I feel we are in the seventh inning stretch. The "game" isn't over yet, but it's getting close. I fully expect a 50 basis point increase on December 14th, followed by another hike of 25 to 50 basis points at both the February 1 and March 22, 2023 meetings. If inflation in the form of Producer Prices, Consumer Prices and Wage Growth trend lower, the Fed will be able to pivot from raising rates to a "wait and see" approach. The stock market would cheer this news, similar to L.A. Dodgers Fans in 1988 when Kirk Gibson blasted one of the most famous home runs in the bottom of the 9th inning in Game 1 of the World Series.

We wish you and yours the very best this Holiday Season!

- Jeremy I. Beck

FIXED INCOME OUTLOOK - THE WORST IS BEHIND US

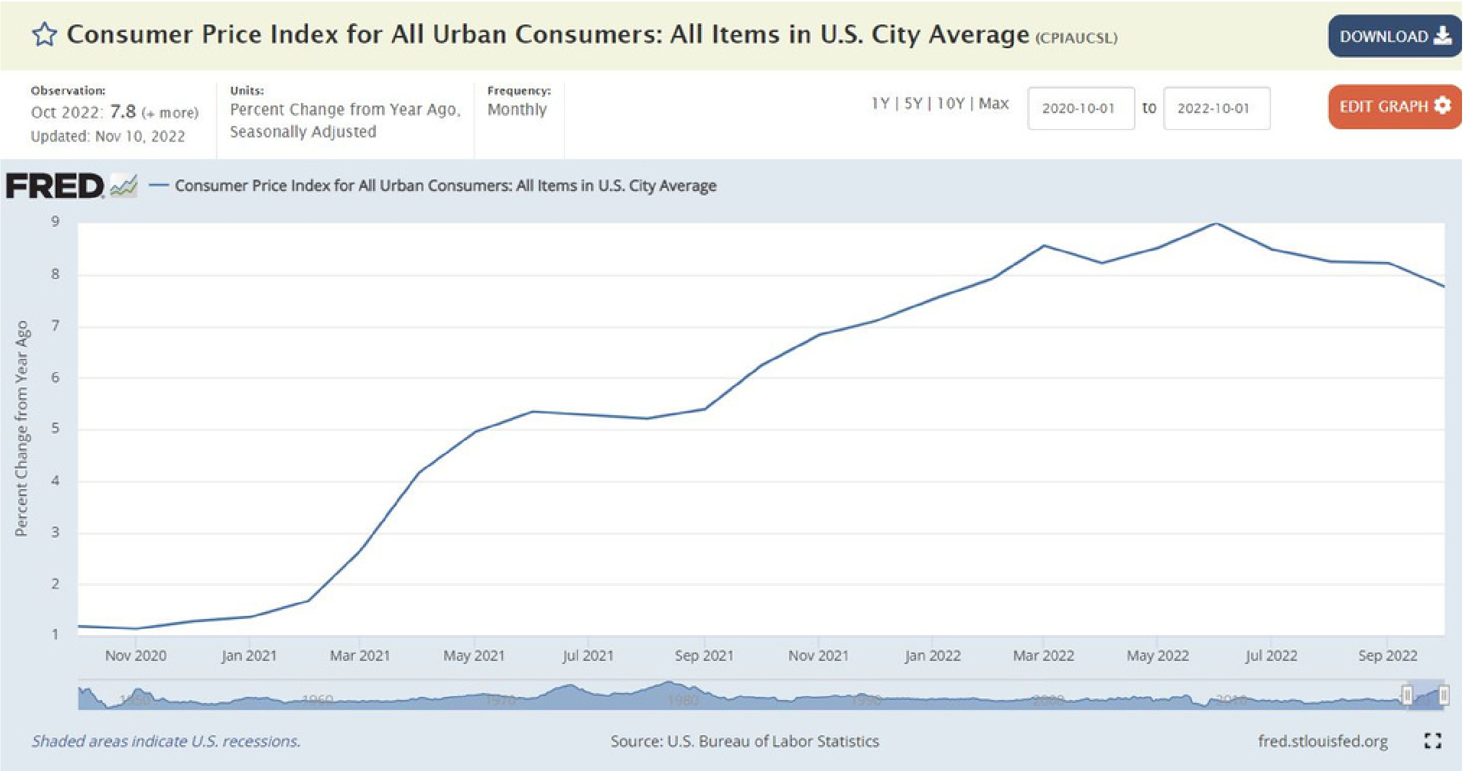
BY MATTHEW J. PITROLA

Over the course of 2022, policymakers have made it abundantly clear that nothing else matters until price stability is attained. In short, the Federal Reserve will do everything in their power to tame inflation. This means that volatility in the fixed income market is likely to continue in the short term as the Federal Reserve continues the ongoing fight against inflation.

While inflation has proved that it is not "transitory" like Federal Reserve predicted in 2021, we are beginning to see the initial signs that the worst of the inflationary situation is now behind us. I would like to focus on the 2-year chart of the U.S. Consumer Price Index (Figure 1 below), which highlights the year over year change in consumer prices.

By analyzing Figure 1, the Consumer Price Index (CPI) peaked in June 2022. There has been a relatively modest decline in the CPI over each of the past four months. The Federal Reserve analysis the CPI, as well as the Producer Price Index (PPI), the Personal Consumption Expenditures Index (PCE) as well as Wage Growth in the U.S. Labor Market. Although each index has remained persistently high, inflation has begun trending lower.

FIGURE 1: 2-year chart of United States CPI



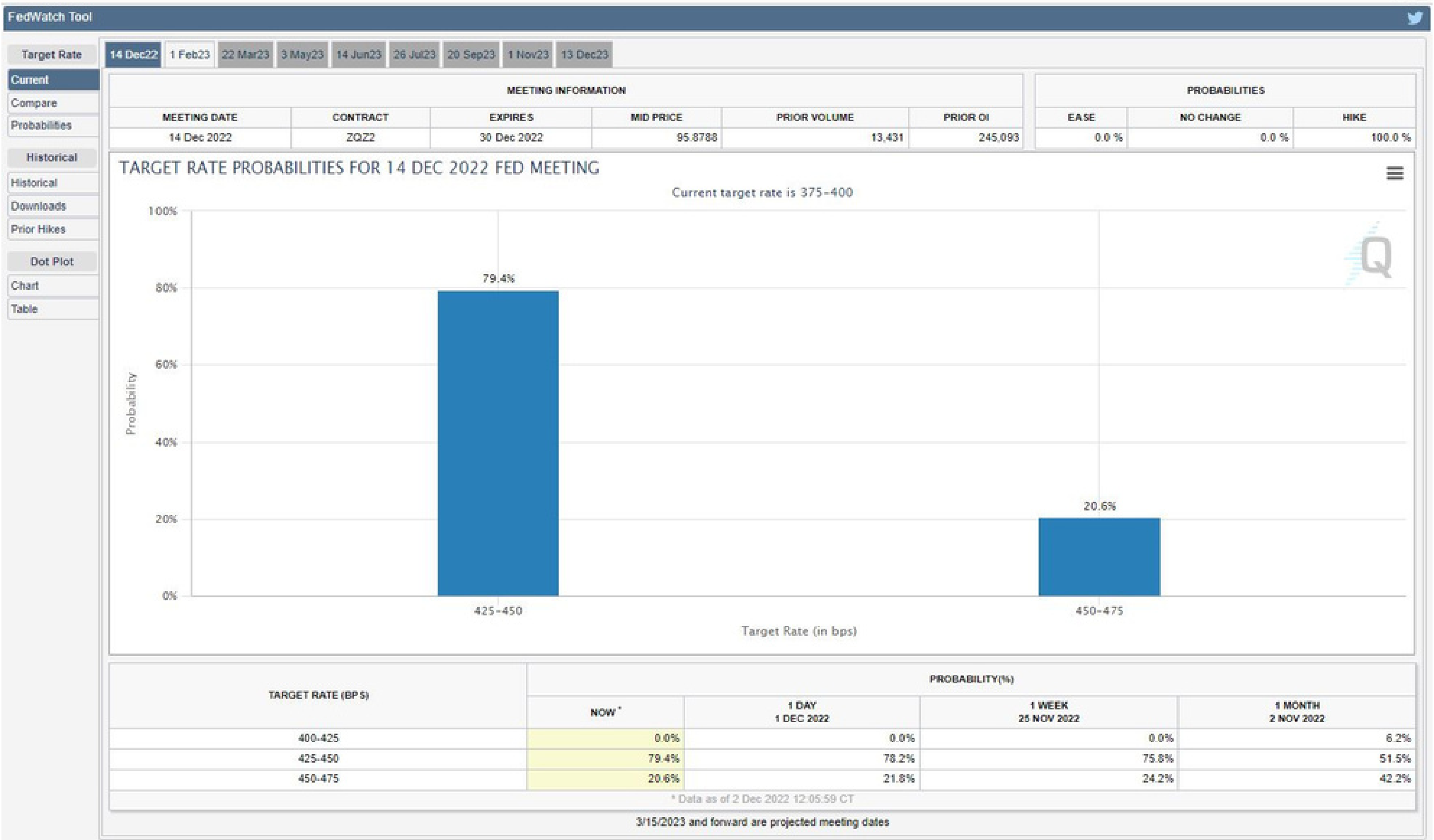
FIXED INCOME OUTLOOK - CONT'D

What does declining inflation mean for interest rates?

We have highlighted previously that inflation is the ultimate enemy in 2022 and has been the main force driving the Federal Reserve's tight monetary policy. Now that we are seeing inflation begin to cool in the United States, investors should wonder what is next for interest rates.

On Wednesday, November 30th, Jerome Powell surprised investors by saying that "smaller interest rate increases are likely ahead and could start as soon as the December 14th meeting." This comment immediately moved the likelihood of a .75% interest rate hike at the next meeting, down from a 50% likelihood to a 20% likelihood. Figure 2 (below) shows the current interest rate probabilities for the December 14th meeting, with a 79% probability of 0.50% increase and a 21% chance of a 0.75% increase.

FIGURE 2: INTEREST RATE PROBABILITIES FOR THE 12/14/22 FOMC MEETING:



MEETING INFORMATION						PROBABILITIES		
MEETING DATE	CONTRACT	EXPIRES	MID PRICE	PRIOR VOLUME	PRIOR OI	EASE	NO CHANGE	HIKE
14 Dec 2022	ZQZ2	30 Dec 2022	95.8788	13,431	245,093	0.0 %	0.0 %	100.0 %

TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 1 DEC 2022	1 WEEK 25 NOV 2022	1 MONTH 2 NOV 2022
400-425	0.0%	0.0%	0.0%	6.2%
425-450	79.4%	78.2%	75.8%	51.5%
450-475	20.6%	21.8%	24.2%	42.2%

* Data as of 2 Dec 2022 12:05:59 CT

3/15/2023 and forward are projected meeting dates

The fear of the Federal Reserve is subsiding:

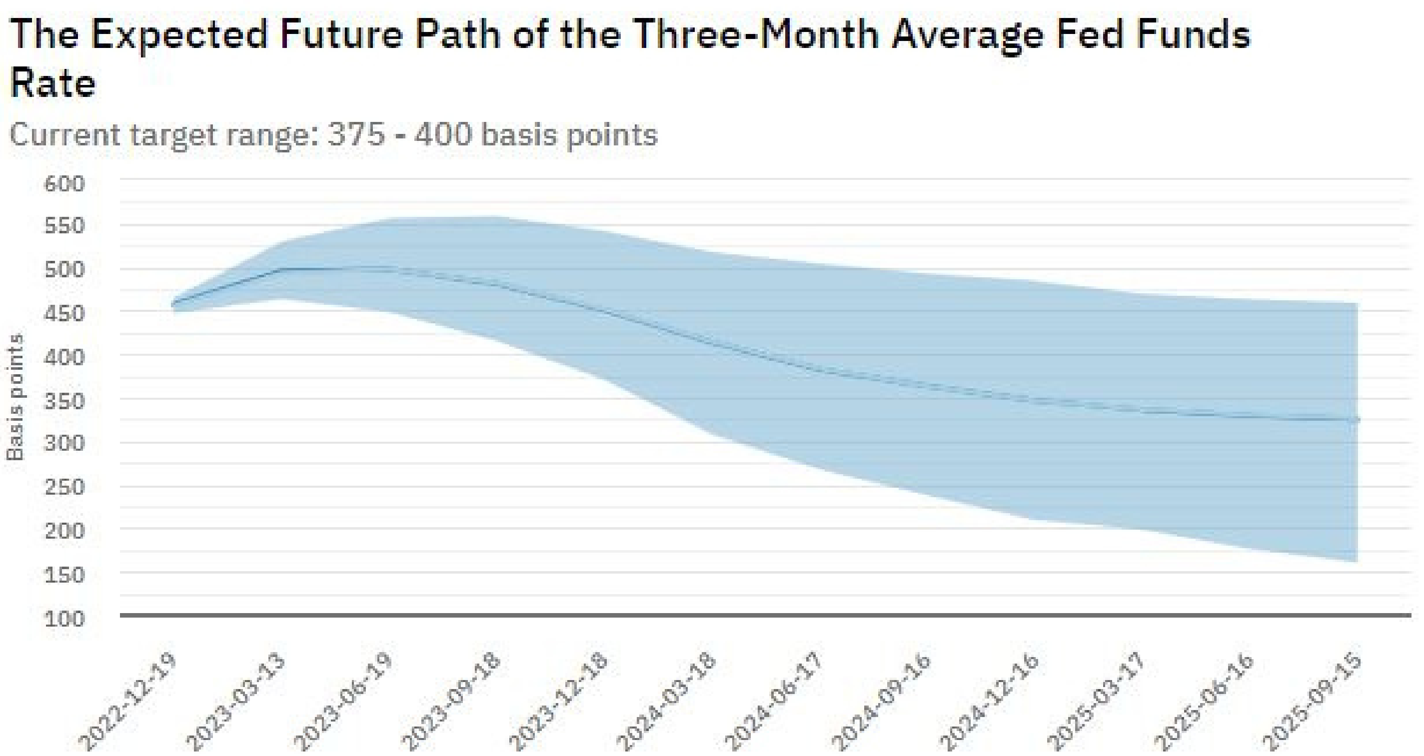
Fixed income investors tend to lean on guaranteed rates of return for two main reasons: The first being protection from market volatility and the second being the steady streams of income provided from their investment. As Jeremy stated above, if an investor is faced with the dilemma of a 6.00% guaranteed rate of return or a highly volatile 9.00% rate of return, many investors will favor the former over the latter.

Over the course of 2022, the Federal Reserve's Effective Fed Funds rate has increased from 0% - 0.25% target at the beginning of this year, to 3.75% - 4.00% as of December 8, 2022. This increase in interest rates has put pressure on fixed income holdings causing bond prices to decline as there is an inverse correlation between price and yield. If bond yields were to decline, we would reasonably expect an increase in bond prices. This has understandably made investors fear the Federal Reserve.

FIXED INCOME OUTLOOK - CONT'D

Now that inflation is beginning to show signs of deterioration, we believe that interest rates will reach their peak near the first half of 2023. Many Institutional Investors expect a "pivot" in March through May of 2023. The term pivot refers to the Federal Reserve moving from an increasing interest rate policy to flat or declining interest rates. Yields will ultimately decline by the end of 2023, with the prospect of a U.S. recession being front and center. Figure 3 (below) from the Atlanta Federal Reserve displays interest rate possibilities from 2023 to 2025.

FIGURE 3: EXPECTED FUTURE PATH OF THE FED FUNDS RATE



Source: Federal Reserve Bank of Atlanta

Navigating fixed income into 2023:

Plenty of valuable opportunities have been created in the traditional bond and Certificate of Deposit (CD) markets, with interest rates rising throughout this year.

2022 has been a banner year for CD Investors, as we have been able to transition from various bond mutual funds and ETFs to more traditional, fixed rate investments. One year CD rates began the year at roughly 1.00%, yet have ballooned to 4.85% as of December 8, 2022. I fully expect interest rates will peak in the middle of 2023 and this will present an opportunity for fixed income investors to take advantage of what is sure to be higher interest rates.

I know we have discussed CDs quite a bit in our last few newsletters, but the increase in interest rates have allowed "all ships to rise with the tide". Meaning, not only are CD rates higher, but a number of tax-free municipal bonds have showed signs of life. Not only are municipal bonds starting to become more attractive, but a number of high quality, investment grade corporate bonds have begun to bloom. We expect plenty of opportunities in 2023, in both the bond and equity markets.

Have a Merry Christmas and a Happy New Year!

Matthew J. Pitrola

BRAD MCMILLAN MARKET COMMENTARY

Inflation: Shocks vs. Trends

Inflationary Trends

This morning I spent quite a bit of time looking at long-term inflationary trends over the past 70 years. The data gets iffy beyond about 1955, but there were some really interesting observations that will feed into my discussion. First, general inflation trends tend to last between 10 and 20 years, sometimes longer. Second, the period from 1970 to about 1990 was an anomaly, compared to the decades before and after. Inflation was quite high during that time, but it has been contained both before and after. Third, when you look at overall price levels—not the annual change in prices, but the price index itself—there have been only two episodes when price changes really accelerated: from about 1970 through 1980 and from 2021 to the present.

Over those time periods, high inflation has really been an anomaly. You can argue that, over time, lower levels of inflation add up, and that is certainly true. But to get the kind of massive year-on-year price increases we have seen recently simply is not that common. So, the question we have to answer is why those two periods had such high inflation—and do we see those conditions now?

Shocks to the System

This takes us to shocks versus changes in trend. In both of those cases, there were enormous shocks to the system. In the 1970s, it was the oil price spike, which then fed through into more general price inflation, through wages and everything else. Because of that pass-through, inflation got entrenched into a wage price spiral and just proceeded to get worse until the Fed put the economy through two recessions to get rid of it. The shock was certain. But what made it worse was that the shock was allowed to turn into a change in trend over time.

When we look at today, we certainly have our share of shocks. The pandemic, the Ukraine war, the ongoing deglobalization of the world economy, and the U.S. labor shortage come to mind immediately. The question is whether those will lead to a change in trend, leaving inflation higher permanently for years to come.

INFLATION: SHOCKS VS. TRENDS-CONT'D

A Change in Trend?

Thus far, the answer seems to be no. Most of the inflation here in the U.S. has been driven by three things: energy costs, food costs, and shelter costs. All three of these are running well above other components and have pulled the overall inflation rate up. All three of these are, however, also starting to correct and, as they correct, will pull inflation back down. Like other spikes we have seen, they appear to be fading and, as they do, will pull inflation back down.

Another factor that should help push inflation down, and prevent a change in trend, is that the Fed is now taking preemptive action, which will help prevent a wage price spiral based on expectations.
That said, we will likely see inflation at higher levels than we have seen in the past decade. Oil will likely be more expensive, and wages will grow faster. A less efficient global economy will keep supplies tighter and prices higher. But that doesn't mean we are back to the 1970s. Rather, it's more that we are back to the 1950s, where we saw a steady range of inflation, or, for that matter, back to the 1990s.

Will Inflation Subside Sooner Than We Think?

There are some good arguments against this conclusion, which I am still thinking through. But for the moment, the data suggests that this bout of inflation is due to shocks and not a change in trend. That the Fed is doing the right thing, and it is working. And that this inflation will subside—perhaps sooner than we think.

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

BUFFALO FINANCIAL UPDATE

Matthew Pitrola and Jacob Wood will be hosting a series of seminars in the Spring of 2023. There will be a number of "Lunch and Learn" presentations at our office, as well a two financial seminars in March and April of 2023.

Topics include:

- Positioning portfolios for the end of the bear market
- Fixed Income Opportunities
- Strategies for Successful Business Owners

Please email matthew@buffalofinancial.com to be added to the invitation list!

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HAPPY HOLIDAYS TO YOU AND YOUR FMAILY!!