The Bottom Line - Q1 2024

THE BOTTOM LINE

FIRST QUARTER : 2024

EXPECTATIONS

BY JEREMY I. BECK

As you may know, I'm an avid reader and just finished "The Bee Sting" by Paul Murray. The story is based on an Irish family and the aftermath of the economic collapse resulting from the sub-prime crisis of 2008. Although I was woefully disappointed in this "acclaimed" novel, my mind would wander while reading to the current post-crisis U.S. Equity markets.

In the wake of the pandemic, investors have faced an extremely difficult terrain. Central banks, notably the Federal Reserve, were initially unprepared for the rapid increase in inflation rates. As a result, the Federal Reserve implemented unprecedented rate hikes, further complicated by weakened corporate earnings and growing concerns about economic slowdown and rising unemployment.

BUFFALO FINANCIAL QUARTERLY NEWSLETTER

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Despite these challenges, the S&P 500 index achieved a remarkable total return in 2023. Amidst this blend of economic uncertainty and optimism regarding the declining rate of inflation, we present our investment themes for 2024:

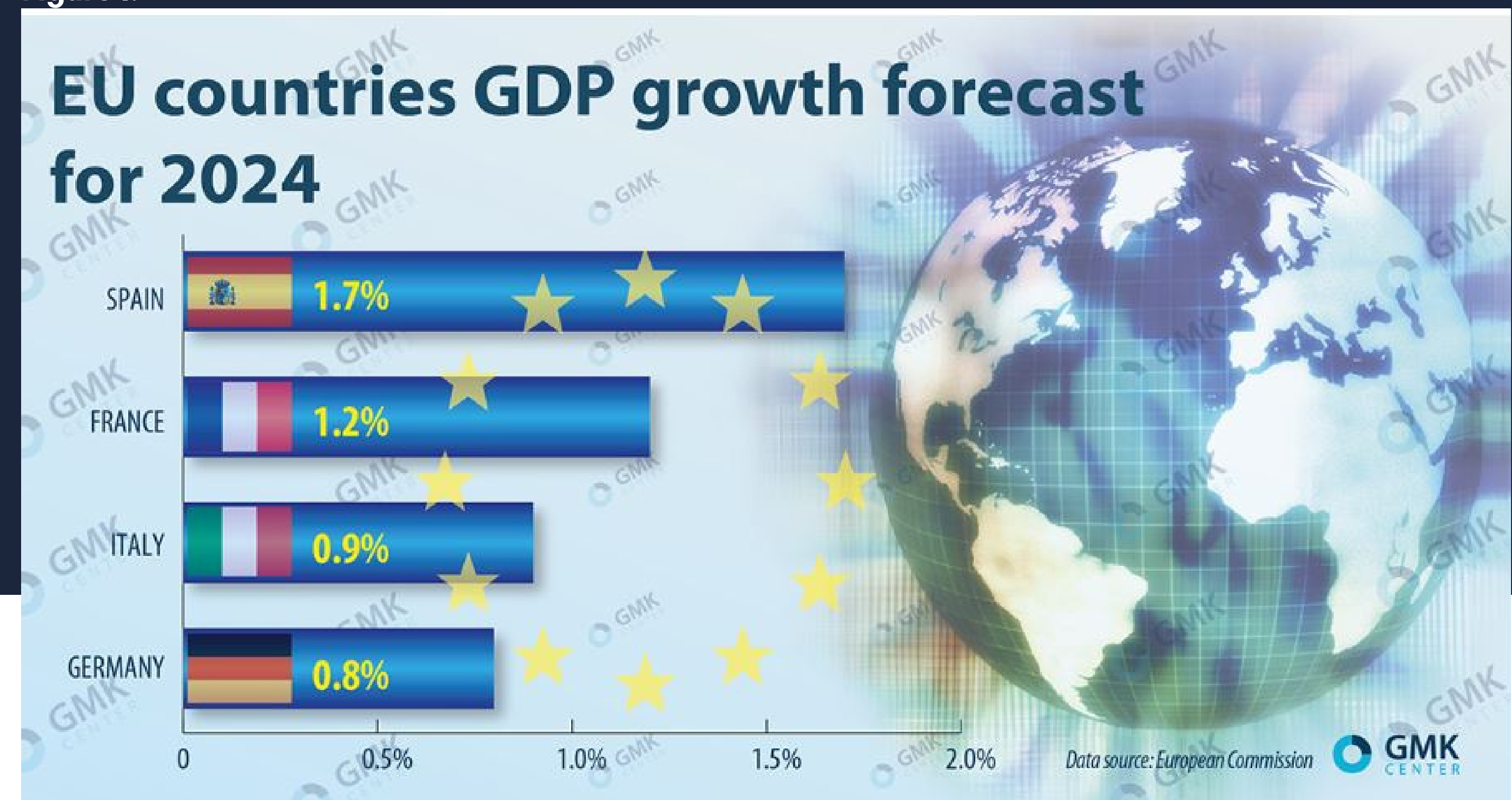
Federal Reserve's Monetary Policy and Interest Rate Implications
The declining rate of inflation, coupled with a slowdown in real wage growth and consumer spending, suggests a potential easing of interest rates by the Federal Reserve in mid-2024. Following a peak inflation rate of 9.1% in June 2021, inflation has reduced to a 3.2% annual pace as of October 2023. The Federal Reserve's significant rate hikes over the past 18 months have inverted the yield curve and made fixed income assets increasingly attractive for 2024.

Moderation of Economic Growth and Consumer Spending
The resilience of domestic economic growth in 2023 was notable, despite aggressive monetary policy tightening. For 2024, we anticipate a more modest economic growth trajectory, with real GDP growth expected to fall below 3%. Consumer spending, a key driver of 2023's economic strength, is likely to moderate in the coming year as consumers face higher debt service.

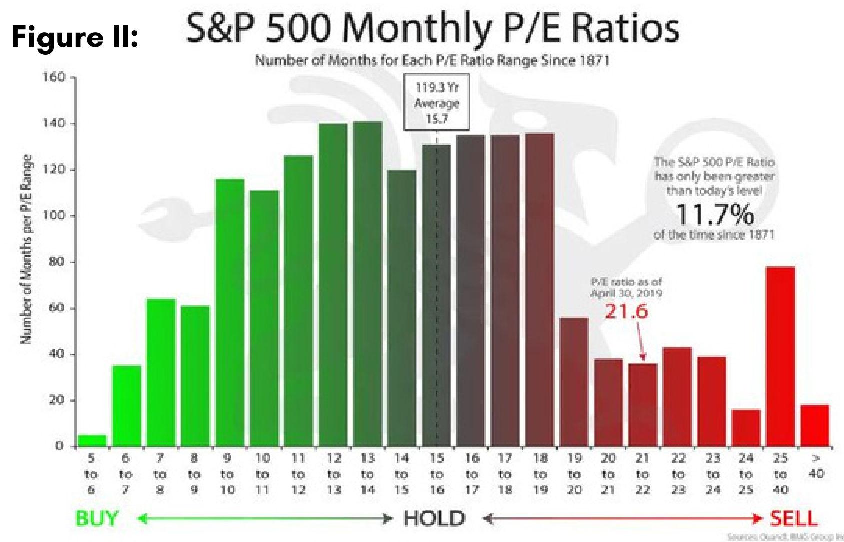
Outperformance of US Equities and Potential in Chinese Markets
US equities are expected to outperform those of developed countries, but Chinese equities, despite recent declines, show signs of undervaluation and potential. The easing of regulatory pressures and geopolitical tensions could make Chinese equities an attractive opportunity. With that being said, we feel there are far safer places in the world to invest and are avoiding Chinese equities.

Gradual Economic Improvement in Europe
We anticipate slight growth improvement in Europe, with a projection of 1.7% growth in 2024 (Figure I below). However, ongoing conflicts and geopolitical issues will continue to impact the European economy for many years to come. As with Chinese equities, we are not looking to build a position in most European equities.

Figure I:



EXPECTATIONS - CONT.



Source: Quandl; BMG Group Inc.

Prospects for Corporate Profit Growth in 2024

After a period of weak corporate earnings growth, we anticipate a recovery in 2024. This expectation is underpinned by corporate cost-saving measures, including layoffs and expense reductions, especially companies that need to service debt. We forecast an 10.5% growth in S&P earnings, with healthcare and information technology sectors leading the way.

Large Cap Technology Stocks and Market Dynamics

The significant weight of technology stocks in the S&P 500 index, including mega-cap firms, suggests a potential underperformance compared to the broader market. The current Price to Earnings ratio of Large Cap growth is currently 34.4% over the historical average, which is simply too high. We advocate focusing on Large Cap Value stocks over Large Cap Growth large cap growth has become extremely overheated.

Promising Sectors for 2024

Banks are poised for recovery as interest rates potentially ease, specifically regional banks. The healthcare sector shows promise with the explosion of GLP-1 agonists (glucagon-like peptide-1) weight loss drugs, as well as the potential for merger and acquisition activities. The AI and cybersecurity sector, driven by the increasing threat of cyberwarfare, is expected to experience robust growth.

Our View: Lower Expected Returns for Risk Assets

Despite the S&P 500's impressive performance in 2023, stretched equity valuations suggest more modest returns in the foreseeable future. Investors should prepare for lower expected returns in the equity markets as valuations are simply higher than historical averages. I found a great point of reference in my files from April, 2019 (Figure II above). When analyzing this chart, keep in mind that as of January 23, 2024, the Price to Earnings (P/E) ratio for the equity market is currently 23.2. The market was overvalued in April of 2019 @ 21.6 times earnings, but is even more inflated today at 23.2!

As we have said many times before, temper your expectations and focus on the names you know at attractive prices.

Stay Safe - Jeremy I. Beck

"Every once in a while, the market does something so stupid it takes your breath away." - Jim Cramer

FIXED INCOME: A FEW BUMPS ALONG THE WAY

BY MATTHEW J. PITROLA

The bond markets have been far from straightforward over the past year. The Ten-year Treasury yield specifically has exhibited significant fluctuations, ranging from a low of 3.25% in April during the banking crisis to a high of 5.02% in October amid unexpectedly robust third-quarter economic growth.

In 2024, we do anticipate lower yields but predict intermittent volatility along the way. Market dynamics will likely be influenced by ongoing efforts to attempt to anticipate changes in Federal Reserve policy. If the Fed falls behind market expectations for rate cuts, heightened sensitivity to every data point may lead to wide-ranging fluctuations in yields.

FIGURE 1: 10 YEAR TREASURY YIELD

Data as of: 01/24/24

However, we do maintain the view that both short and long term yields have likely reached their highest point for this economic cycle and are poised to decline further, assuming inflation subsides in 2024.

We believe that much of the inflation triggered by early-cycle supply shortages has been addressed, but the full impact of major central banks tightening their monetary policies is still unfolding globally. This is expected to result in slower growth and reduced inflationary pressures.

Even though intermediate to long term yields have already decreased from the peak observed last October, we anticipate additional room for decline. The key questions revolve around the extent of this decline and the shape of the yield curve, both of which will be driven by central bank policies.

FIXED INCOME: A FEW BUMPS ALONG THE WAY CONTINUED

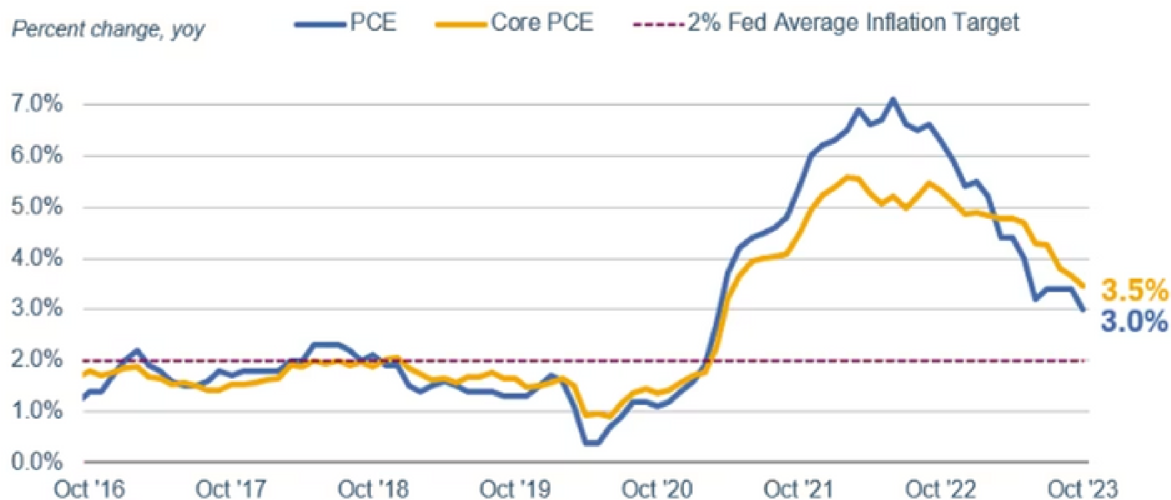
Declining interest rates:

The Federal Reserve's strategies to curb inflation include increasing interest rates and indicating a commitment to maintaining elevated rates until inflation moves closer to its 2% target.

Additionally, they employed quantitative tightening, which involves reducing the size of their balance sheet. Thus far, this approach seems effective, as inflation has decreased by half from its peak levels.

FIGURE 2: INFLATION HAS FALLEN FROM ITS PEAK

Inflation has fallen from its peak levels



Source: Bloomberg, monthly data as of 10/31/2023.

The personal consumption expenditures (PCE) index measures the changing prices of goods and services. "Core" PCE excludes food and energy prices, which tend to be volatile. For PCE: Personal Consumption Expenditures Price Index (PCE DEFY Index), For core PCE: Personal Consumption Expenditures: All Items Less Food & Energy (PCE CYOY Index), percent change, year over year.

The rapid increase in interest rates, coupled with the Federal Reserves mandate to keep rates high while inflation recedes, has led to a substantial surge in "real" rates. That is referring to, yields adjusted for inflation expectations.

At present levels, real yields are appear to be sufficiently elevated to exert a dampening effect on the economy. Elevated real interest rates create a scenario where saving becomes more appealing than spending for consumers and poses challenges for businesses in terms of borrowing, hiring, and investing.

While consumer spending has displayed resilience over the past year, the upswing in interest rates has curtailed demand for durable goods, contributing to a downturn in the manufacturing sector. Recent data indicates a moderation in the pace of growth in the service sector as well.

FIXED INCOME: A FEW BUMPS ALONG THE WAY

FIGURE 3: REAL INTEREST RATES ARE AT THE HIGHEST LEVEL SINCE 2008

Real interest rates are at the highest level since 2008

Source: Bloomberg, daily data as of 12/04/2023.

US Generic Govt TII 2 Yr (USGGT02Y INDEX), US Generic Govt TII 5 Yr (USGGT5Y Index), US Generic Govt TII 10 Yr (USGGT10Y Index), US Generic Govt TII 30 Yr (USGGT30Y Index). **Past performance is no guarantee of future results.**

3 Scenarios for 2024:

I would like to briefly examine 3 hypothetical scenarios for the bond markets in 2024. While I believe that all 3 are possible, the first "Baseline" is our expectation. Then followed by two hypotheticals, the first involving a sudden surge in inflation. The second attempting to simulate a U.S. recession.

Baseline (expectation) - Growth and Inflation Slow:

In our expected view, we anticipate three rate cuts in 2024. Each being .25% in magnitude beginning in the middle of 2024. This would bring the upper limit of the target range for fed funds to 4.75%. This outlook is grounded in the Federal Reserve's hesitancy to proactively reduce rates in this economic cycle and aligns closely with the current market expectations. While this scenario suggests a deceleration in the economy's growth rate, there is a likelihood that we outright avoid a recession.

Scenario 2 - Inflation rises:

While we believe that this is an unlikely scenario. Lets assume that inflation flares up and In response to rising inflation and the Federal Reserves response is to raise the Effective Federal Funds rate by .25% this year and has to maintain higher than normal interest rates over the course of 2024.

Scenario 3 - Recession:

In this scenario lets assume the Fed cuts rates by up to 1.50% in the next 12 months in response to a recession.

FIXED INCOME: A FEW BUMPS ALONG THE WAY

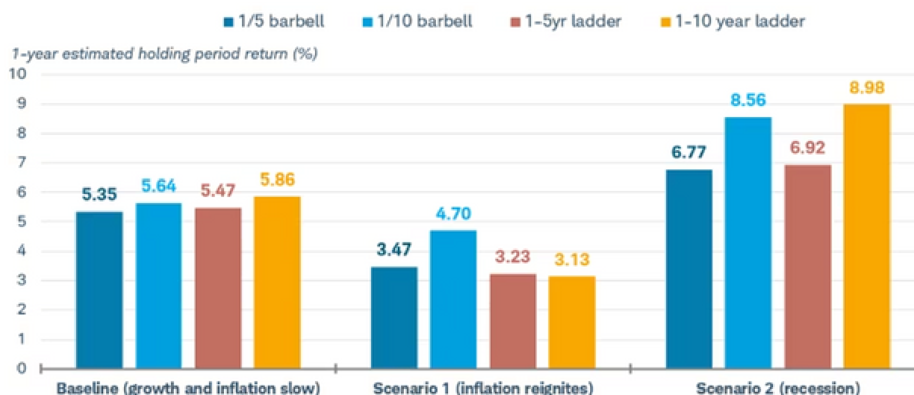
Scenario outline

Scenario description	Fed Funds in 1 year	2yr Treasury in 1year	10yr Treasury in 1year
Baseline (growth and inflation slow) Fed eases moderately in 2024.	4.75%	3.75%	4.00%
Scenario 1 (inflation reignites) Fed has to stay higher for longer or even hike again.	6.00%	5.25%	4.25%
Scenario 2 (recession) Inflation falls more than expected and recession hits early next year and is longer than expected.	3.50%	3.00%	3.25%

The good news for fixed income:

For fixed income investors, the good news is that the range of hypothetical potential outcomes for some commonly used strategies suggests positive returns. The chart shows the hypothetical returns for bond ladders and barbells with different maturities. We looked at one- to five-year and one- to 10-year ladders and barbells using Treasuries.

Estimated return based on each hypothetical scenario and strategy



Source: Schwab Center for Financial Research, as of 12/04/2023.

This hypothetical example is only for illustrative purposes. The chart shows the hypothetical 1-year holding period for 4 different strategies, a 1-year and 5-year barbell, a 1-year and 10-year barbell, a 1- to 5-year ladder, and a 1- to 10-year ladder. All strategies are equally weighted. The baseline scenario assumes a 4.0% 2-year Treasury and a 4.25% 10-year Treasury in 1-year. The "inflation reignites" scenario assumes a 5.25% 2-year Treasury and a 4.25% 10-year Treasury in 1-year. The "recession" scenario assumes a 3.0% 2-year Treasury and a 3.50% 10-year Treasury in 1-year. The "inflation reignites, and the Fed is late to act" scenario assumes a 5.75% 2-year Treasury and a 5.75% 10-year Treasury in 1-year. All other yields are linearly interpolated based on a 2- and 10-year yield. In each of the strategies, the hypothetical examples assume the investor receives the coupon income but does not reinvest it. Basis points (BPS) represent one-hundredth of one percent. Hypothetical total returns assume price appreciation or depreciation. **Probability analysis results are theoretical in nature, not guaranteed, and do not reflect any degree of certainty of an event occurring. Outcomes are not guaranteed.**

No matter what the scenario in the fixed income markets in 2024, it's likely to come with volatility. This cycle has been different in many ways from previous cycles and the road from high inflation to low and stable inflation likely won't be smooth. Every economic data report and Federal Reserve meeting or comment could cause an outsized reaction in the markets. However, in the long run, the trend in inflation is the biggest factor driving interest rates, and that is currently headed in the right direction. With the peak in rates likely behind us and high starting nominal and real yields, we look for lower yields and positive returns for investors.

THE CASE FOR ROLLING YOUR 401(K) INTO AN IRA

BY JACOB B. WOOD

In the ever-changing landscape of personal finance, the 401(k) retirement plan has been a staple for American's retirement savings plans, yet changing circumstances call for strategic adjustments. Rolling over your 401(k) plan has become a financial maneuver that is increasingly relevant. Whether facing a career transition or contemplating retirement, 401(k) rollover offers enhanced flexibility, potential cost savings, simplified management, and improved legacy planning. Financial advisors and assist you in navigating the evolving financial terrain with insights that may redefine your approach to retirement, ensuring a more secure financial future.

Control & Flexibility

When it comes to investment choices, 401(k) plans often come with limitations. However, transitioning to an IRA can broaden your horizons, offering a more diverse array of options such as stocks, bonds, and various funds. This expanded selection brings several advantages like customizable risk exposure, adaptability to market trends and alignment with specific financial goals.

Fees

Excessive fees can eat into your retirement savings over time. Many 401(k) plans involve higher administrative and plan level fees when compared to IRAs. By making the switch, you stand to benefit from potential cost savings, ultimately maximizing your returns and keeping more of your hard earned money in your pocket as you build your nest egg.

Communication

If you choose to maintain your account with a previous employer, you might inadvertently find yourself on the sidelines. Access to plan communications may become challenging as updates flow primarily through company emails, impeding communication with advisors or administrators. Maintaining a connection with your former employer's retirement plan may unintentionally relegate you to a secondary status, hindering communication and accessibility to essential resources. The distribution of news and updates via company communication lines may impede your ability to stay informed, while reaching out to advisors or administrators might prove more cumbersome, potentially limiting the support and guidance available to you. This unintentional sidelining may impact your overall experience with the retirement plan.

Consolidation

Juggling numerous retirement accounts can be a hassle. Consolidating your funds into a single IRA not only simplifies monitoring but also enhances strategic planning. Consolidation offers your financial advisor a clearer view of your financial landscape and invested asset classes. This approach ensures no two investments are conflicticting and keeps you on course toward achieving your retirement goals. Simplifying your financial structure through consolidation fosters a more cohesive and effective path to securing your financial future.

In summary, the advantages of a 401(k) rollover, including increased flexibility, streamlined management, and larger investment options. I todays day and age it is of upmost importance to adapt to the dynamic changes personal finance. As always, consult a financial advisor before deciding if rolling over your 401(k) is the right decision for you.

If you are considering rolling over money from an employer-sponsored plan, you often have the following options: leave the money in the current employer-sponsored plan, move it into a new employer-sponsored plan, roll it over to an IRA, or cash out the account value. Leaving money in a plan may provide special benefits including access to lower-cost investment options; educational services; potential for penalty-free withdrawals; protection from creditors and legal judgments; and the ability to postpone required minimum distributions. If your plan account holds appreciated employer stock, there may be negative tax implications of transferring the stock to an IRA. Whether to roll over your plan account should be discussed with your financial advisor and your tax professional.

BRAD MCMILLAN MARKET COMMENTARY

Looking Back at the Markets in December and Ahead to January 2024

Markets rose last month, continuing November's rally as interest rates pulled back even more on expectations of Fed rate cuts in 2024. Markets in the U.S. were up by mid-single digits, finishing a solid quarter and a very strong year. International markets were also up substantially for the month, quarter, and year. And while stocks were hot, even fixed income posted enough gains to close out the year in the black. 2023 ended with a bang.

Looking Back

Interest rates. The rally was, once again, due mainly to interest rates, which kept dropping in December. Better inflation numbers raised hopes the Fed would start cutting rates this year, and signs of slower but continued economic growth supported that idea. Between job growth moving closer to pre-pandemic levels, healthy consumer confidence and spending, and continued weakness in manufacturing, the economy seemed to be settling into a soft landing, which could keep pulling inflation downward. In response, the 10-year U.S. Treasury yield dropped back to levels last seen in August, driving markets higher.

Looking Ahead

Changing expectations. Looking forward, we may see a change in expectations in the new year. Markets have been choppy so far this month, and there is commentary suggesting that they may have gotten ahead of themselves. After a strong year-end, the seasonal factors can be less positive at the start of the year, which could be a headwind. In addition, the Fed may start pushing back on rate cut expectations, which would be another negative. Overall, in my view, conditions should remain positive in January, but perhaps somewhat less so than last month.

BRAD MCMILLAN MARKET COMMENTARY CONT.

Looking Back at the Markets in December and Ahead to January 2024

Current risks. While overall conditions remain positive, there are still risks. The Fed is concerned that inflation may return in some sectors, which must be watched for its effect on rates. The ongoing war in the Middle East shows signs of expanding and affecting trade routes and supply lines. And domestic politics remain a concern as the election gets closer. But with the fundamentals reasonably healthy and the macro picture stabilizing, many of the economic fears that pulled markets back last year may subside.

The markets and inflation. As we start the year, the key issues will be whether growth continues at a slower rate and inflation moves downward. Market expectations on rates have changed rapidly. If the Fed continues to act in a dovish manner, that positive reaction could continue. That said, there is a mismatch between what the market expects (six or more rate cuts) and what the Fed says (only three rate cuts). That mismatch in the past has given rise to volatility, so this is a risk to watch, even if conditions otherwise remain favorable.

Monitoring the Risks

That is the bottom line here—while conditions are good, volatility looks likely. The last two months were great for markets as rates pulled back, but conditions could change. Looking forward to the new year, we are still not out of the woods with inflation or growth. And while the trends remain positive, risks may pick up again over the next couple of months.

As of this morning's jobs report, job growth is still healthy. The things to watch going forward will be consumer confidence and consumer spending. If they remain at pre-pandemic levels, then a soft landing looks increasingly likely, and the Fed should continue to send dovish signals. If not, we could see more volatility. Even in the case of volatility, the solid fundamentals should limit the damage and help set us up for more growth later this year. I believe this is something to watch for, but not to worry about too much.

Members of Commonwealth's Investment Management and Research team from left to right: Brian Price, Chris Fasciano, **Brad McMillan**, Brian Price, Peter Essele and Sam Millette.

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

BUFFALO FINANCIAL UPDATE

Jacob Wood, Wealth Manager at Buffalo Financial has been nominated to be a candidate in the 2024 Leukemia & Lymphoma Society's Visionary of the Year Campaign. Jacob will be hosting a number of events including raffles, a cheers for charity event, Walking challenges and more! The campaign will run from February 22nd through May 3rd.

Keep an eye out for our upcoming emails, where we'll provide you with information on Jacob's campaign fundraising events along with their respective dates.

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