Industry Perspectives - Q2 2021

Another "Tantrum" in 2021 or 2022?

Kent Gasaway, CFA
President – Buffalo Funds

Overview

The Federal Reserve taper tantrums are typically minor and short-term in nature.

There are definitely parallels between the recent deep COVID-19 led recession and the 2008-2009 version.

At present we would view a meaningful correction in the stock market as a buying opportunity.

Some worry exists if treasury yields were to rise much higher than our current thoughts.

In financial history, the term "tantrum" most often refers to the 2013 "taper tantrum". This period of high volatility occurred when the Federal Reserve (the "Fed") sent an unexpected signal that it would soon begin shrinking its balance sheet. While viewed as a black mark on Fed policy, as we will discuss below, the impact on the market was minor and short-term in nature.

The 2008-09 recession led to a decline in Gross Domestic Product (GDP), high unemployment, lower home prices, a stock market crash, and a near meltdown of the entire financial system. A collapse in market liquidity, near-zero risk taking by banks, and the bankruptcy of Lehman Brothers called for quick action. As mapped out by the U.S. Treasury, the Fed and the heads of leading banks, the integral piece of the short- and long-term recovery plan involved the Fed. They would use their balance sheet to buy treasury bonds, mortgage securities, and corporate bonds, as well as inject equity into vital companies. The plan was to restore liquidity and confidence, improve bank balance sheets, and keep interest rates low.

The Fed expanded its balance sheet from $1 trillion in 2008 to $3 trillion in 2013. Looking back, the plan worked and by 2013 the economy had settled into a period of slow but steady GDP growth. The unemployment rate dropped below 6.5%. However, because the numbers were unspectacular, there was considerable debate among investors as to when the Fed would begin to scale back or "taper" its monthly bond purchases. Thus, the table was set for a "taper tantrum".

Ben Bernanke, the Fed chairman at that time, met with Congressional leaders in May 2013. At that meeting he said U.S. economic growth appeared sustainable and it was time to take a step down in the pace of purchases. Because the market had never gone through a "tapering", much less one that was unexpected, long treasuries were hit hard with the 10-year yield almost doubling.

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U.S. 10-Year U.S. Treasury Yields During 2013 *(in %)*

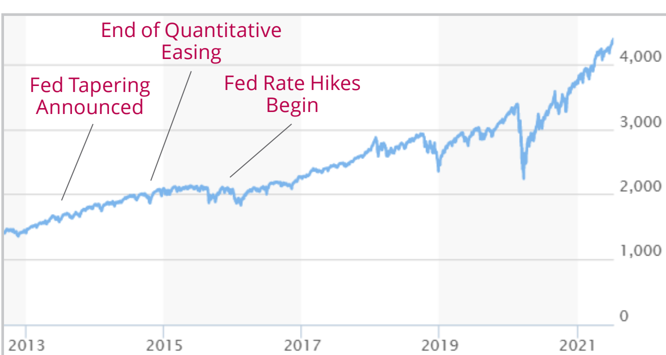
Source: FactSet

Emerging market debt experienced pain as well, with some currencies like the Indian Rupee falling 15% or more. Meanwhile, U.S. stocks experienced greater volatility, but ultimately rose sharply for full year 2013 (S&P 500 +28%). Investors correctly assessed that U.S. GDP would improve in 2014 with lower inflation. This started a multi-year run up in the stock market.

S&P 500 Index *(Calendar Year 2013)*

Source: Federal Reserve Bank of St. Louis

S&P 500 Index *(2013-2021)*



Source: Federal Reserve Bank of St. Louis

Why are we talking about taper tantrum again? There are definitely parallels between the recent deep COVID-19 led recession and the 2008-2009 version. In both cases, central banks and governments pumped money into their economies through various stimulus measures. And in both cases, as the economies recovered, there were concerns about the Fed turning off the tap and the risk of rising inflation.

We saw in 2008/2009 this risk was misplaced as there was a brief down phase followed by new market heights.

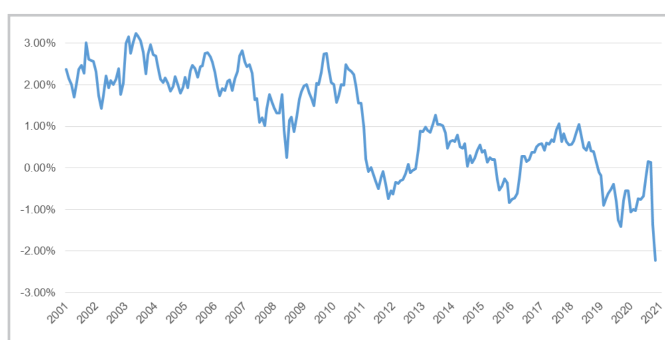
S&P 500 Index

Source: FactSet

We believe the main difference in the COVID-led recovery is the extremely wide difference between the 10-year treasury yield from 2008-2009 and it's intrinsic value.

Inflation is rising and the 10-year treasury actually is trading with an all-time low real rate of return. This valuation risk could begin to be re-evaluated by the market when the Fed stops buying treasuries and true investors must make up the difference in demand.

U.S. 10-Year U.S. Treasury Yields Less Core Consumer Price Index Year-Over-Year Change



Source: FactSet

At present we would view a meaningful correction in the stock market as a buying opportunity. However, some worry exists if treasury yields were to rise much higher than our current thoughts. We will be monitoring the treasury market carefully as 10-year treasury yields much above 2.00% – 2.25% could force us to become more cautious on equities.

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Kent Gasaway, CFA, is the President of the Buffalo Funds and has been an investment professional since 1982. He joined Kornitzer Capital Management, Inc. ("KCM"), the Advisor to the Buffalo Funds, in 1991. During his time with KCM, he has been a portfolio manager and investment analyst for several of the Buffalo Funds, other funds, institutions, and individuals. Kent's current roles with KCM include investment analysis firm wide and portfolio management and relationship management within Kornitzer Private Client Services. Kent received a B.S. from Kansas State University. He also holds the Chartered Financial Analyst designation.

Interested in more info?

For questions or to speak with a relationship manager about adding any of the 10 Buffalo Funds to your portfolio, contact:

Christopher Crawford
ccrawford@buffalofunds.com
(913) 647-2321

Scott Johnson
sjohnson@buffalofunds.com
(913) 754-1537