



Industry Perspectives

October 2017

Interest Rates & the Federal Reserve

Overview

- ▶ Signs of inflation continue to remain elusive despite recent moves by the Fed and increases in interest rates.
- ▶ Tax reform has hit stumbling blocks with Congress' inability to pass legislation.
- ▶ A shrinking bond portfolio and potential shake up in Fed leadership could cause the market to move significantly in the 4th quarter.

"If multiple central banks throughout the world embark on drawing down their balance sheet in the same manner as the U.S., interest rates could be pressured to go higher."

Clay Brethour, CFA
President,
Buffalo Funds



The Marriner S. Eccles Federal Reserve Board Building

The equity markets continued their upward trajectory during the 3rd quarter, with most market indices closing the quarter at an all-time high, or close to their record highs. This defies the well-known trading adage of "sell in May and go away" that warns investors to sell their equity holdings in May to avoid the typical volatile Summer months and come back in the Fall.

The Standard and Poor's 500 (S&P 500) rose nearly 4% for the quarter, marking its 8th straight quarter of positive gains. The Russell 2000 was up 5.67%, its 6th consecutive positive quarter. There have been only five other times since 1980 when the Russell 2000 had positive returns in the 1st three quarters of the year.

Not only did the markets continue upward but it was also the least volatile 3rd quarter, as measured by the CBOE Volatility Index (VIX) for the past 20 years, and was the least volatile quarter since the 4th quarter of 2006 (see chart 1). Emerging market stocks had a strong quarter and are on pace for their best year since 2009.

While the Federal Reserve (the "Fed") has raised their benchmark lending rate two times this year so far, with another increase expected in December (for a total increase of 75 basis points for the year), the rise in short term interest rates had minimal impact on long term rates. With 10-year treasuries trading in a narrow range of 2.20 - 2.40% for much of the year, signs of inflation continue to remain elusive.

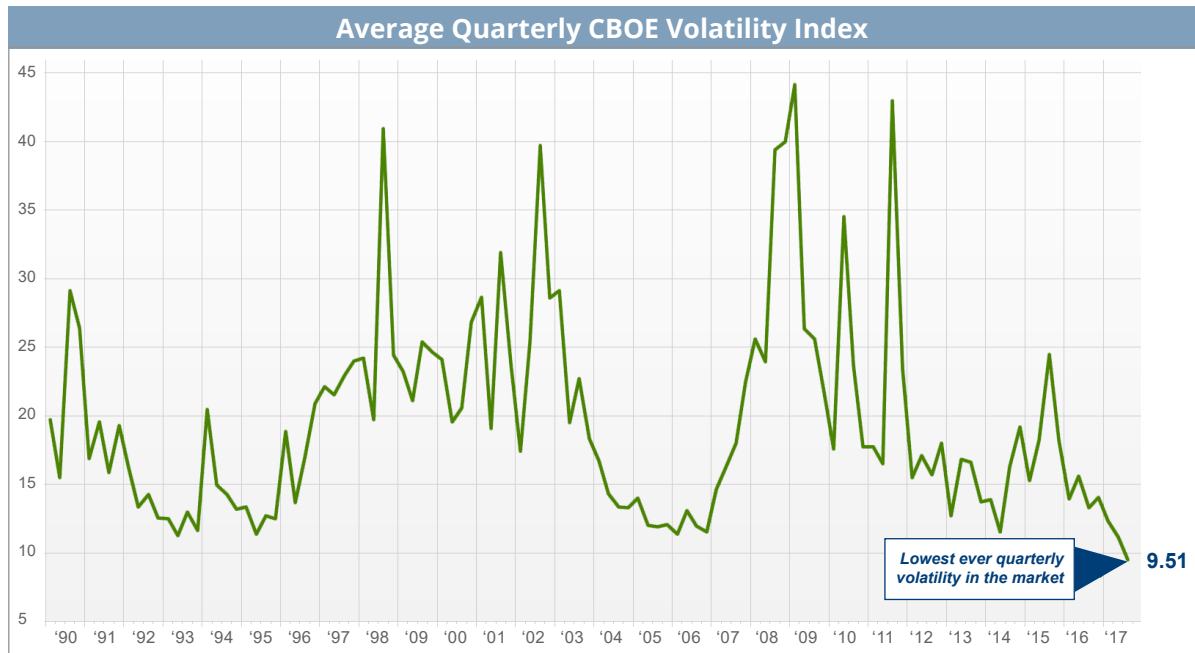
In a recent speech, Federal Reserve Chairwoman Janet Yellen defended the central bank's projection for a gradual path of rate increases over the next few years despite the past few months of unexpectedly low inflation, which under the Fed's preferred measure has undershot the central bank's 2% target for much of the past five years.



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source: FactSet - As of 9/30/17

Although Chairwoman Yellen said she expects inflation to gradually move up to the target, she acknowledged the uncertainty surrounding that prediction and that some members on the central bank committee disagree. Some policy makers are starting to be of the opinion that weaker inflation reflects structural changes in the economy rather than a temporary phenomenon. The sole opposing vote of the central bank's two rate increases this year has been the Federal Reserve Bank of Minneapolis President Neel Kashkari.

Kashkari was closely involved in dampening the initial stages of the financial crisis in early 2008 by working closely with then Secretary of the Treasury Henry Paulson and eventually being appointed to lead the Troubled Asset Relief Program (TARP), the initial Federal asset buying program to purchase \$700 billion of the outstanding mortgages held by financial institutions. He believes the raising of short term rates should be delayed until the inflation rate actually hits the 2% level on a 12-month basis.

Income reliant investors continue to be hopeful that interest rates will rise. Yields did soar into the end of 2016, as investors anticipated President Trump's pro-growth agenda would drive inflation and economic growth higher, giving the Fed a foundation on returning to a more "normalized" interest-rate environment, but since then, there has been minimal

movement of interest rates. The Fed has raised rates four times since 2015, and has penciled in one more rate increase this year (likely December) plus three increases in 2018.

Why is it taking so long for interest rates to increase?

From a monetary policy perspective, moving too quickly could slow growth unnecessarily, but raising rates too gradually could create an inflationary problem down the road that might be difficult to overcome without triggering a recession. Additional global forces are impacting the market. While the U.S. central bank is discussing returning to "normalized" levels, the rest of the world's central banks continue to buy assets. Investors continue to seek yield throughout the world, and U.S. yields continue to be attractive worldwide.

During the September Fed meeting, policy makers dropped their average prediction for long-run interest rates from 3% to 2.8%. The long-run neutral rate of interest, the *natural rate*, has a big influence on how policy makers set rates. It is the rate that should keep inflation steady when the economy is running at full capacity and is key to judging monetary policy. The lower rates are below the natural rate, the more they boost the economy. And once they reach it, monetary stimulus has been fully withdrawn.



Recall that the federal funds rate was 5.25% in August 2007, significantly higher than today's 1% to 1.25% range. In this environment, equities should continue to benefit into the foreseeable future, but there is another force that should be a positive driver of equities and the economy: **the potential of tax reform.**

Given Congress' inability to pass legislation this year, the hit rate of proposed legislation becoming law this year does not inspire confidence. There is time for Congress to deliver on the Republican promise of a simpler tax code with lower rates, but time is vanishing to accomplish it in 2017.

The 1981 tax cut laid the foundation for a quarter-century of strong, noninflationary growth, which, despite three subsequent recessions, averaged 3.4%. The framework of the proposed tax reform would lower taxes on corporate profits, give incentives for business investment, reduce and lower individual income tax brackets, and put an end to estate taxes.

Under the Republican's plan, the corporate tax rate would fall to 20% from 35%, and the top rate on individuals could drop to 35% from 39.6%. As with any proposal in a divided Congress, what is proposed and what actually becomes law will be vastly different.

STUMBLING BLOCKS TO TAX REFORM

The proposed tax reform would eliminate state and local tax deductions, placing high-tax states' citizens at a disadvantage. The elimination of the deduction was to help pay for the tax cuts by generating \$1 trillion over the next 10 years.

While it comes as a surprise, this isn't the first time the elimination of the deduction has been proposed. It was proposed in 1986, the last time that Congress revamped the tax code and failed to gain support from high-taxed states. But if it is removed, there will have to be changes elsewhere to help offset the corporate tax cut.

The most important news is that the plan would make U.S. businesses more competitive around the globe. The corporate rate, which is currently 35% and the highest in the developed world, would fall to 20%. While short of then Presidential candidate Trump's campaign platform of a corporate tax rate of 15%, it is below the industrialized world's 22.5%

average. This will be the first significant fiscal policy that could provide a tailwind to the equities market and the economy since the start of the financial crisis, and, importantly, offset the increase in rising interest rates and the steps that the Fed is taking to reduce its balance sheet.

There are two key events that will take place over the coming year that will likely have an impact on the market.

1) FED BEGINS TO SHRINK BOND PORTFOLIO

In an effort to bring it into alignment with levels prior to the financial crisis, the Fed will begin to shrink its \$4.5 trillion bond portfolio in October. The Fed's balance sheet was less than \$1 trillion before the 2008 financial panic. The central bank will be pulling \$10 billion a month from the financial system and increasing that amount gradually over time. In a year, the anticipated monthly amount will be up to \$50 billion, a level that is more than the Fed bought each month during the first phase of QE3 (quantitative easing policy) in 2013.

The three quantitative easing programs injected capital into the economy and kept rates low, while increasing the central bank's balance sheet. Conversely, when the central bank sells or redeems those securities, the cash it receives is withdrawn from the economy, and in theory increases rates.

We believe the attractiveness of U.S. yields relative to global alternatives will help support lower yields initially. But if multiple central banks throughout the world embark on drawing down their balance sheet in the same manner as the U.S., interest rates could be pressured to go higher. Nonetheless, currently the U.S. is the only central bank with a tightening policy.

It is debatable to quantify succinctly the impact of the QE programs to the economy over the past decade. After spending \$2 trillion on government bonds in an effort to stimulate the economy, there is still uncertainty on how, or even if, it worked. Fed Chairwoman Yellen has admitted that quantitative easing is still poorly understood even by the experts. Therefore, this monetary experiment is far from over and will likely continue to play out over the next several decades, not only in the U.S., but also in the world.



2) SHAKE-UP IN FED LEADERSHIP

The second item facing the Fed is the potential for a leadership shake-up next year. Chairwoman Yellen closes in on the final months of her four-year term as the leader of the U.S. central bank, and while she is a top contender for another term as Fed chair, President Trump has voiced that there are additional candidates he is considering. Chairwoman Yellen has been very transparent with the market on the pace of rate increases and deleveraging of the central bank's balance sheet. Any change in the committee makeup, particularly with the Chair position, could have an impact on the policies currently expected by investors.

OTHER FACTORS TO CONSIDER

Inevitably, there will be geopolitical issues impacting the market, such as North Korea and Spain, but we believe they are transient to the marketplace. Not to downplay the seriousness of those events, because as the news flow ebbs to and fro, it will impact the market. We just do not believe these issues will have a lasting impact on the U.S. economy and market.

So far, the current economic expansion has lasted 101 months (beginning June 2009). The National Bureau of Economic Research shows only two U.S. expansions lasted longer than this one -- the great expansion of the 1960s lasted 106 months, and a 120-month expansion went from 1991 to 2001. To top that longest expansion, the current recovery would have to continue growing past June 2019. The most common cause of U.S. recessions in the postwar era has been monetary tightening by the Federal Reserve as a means to fight inflation, an issue that is non-existent today.

OUR OUTLOOK

Historically, the 4th quarter is the strongest return quarter of the year and has a positive return nearly 75% of the time since 1980¹. With the underlying momentum driving the U.S. economy, the equity market should continue to perform well for the rest of the year. We continue to find value in the marketplace and would advise investors to continue to take advantage of any market pullback and put additional capital to work. ◀

INTERESTED IN MORE INFO?

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¹Source: FactSet. Average quarterly returns: 1st - 2.3%, 2nd - 1.7%, 3rd - 0.4%, 4th - 4.1%.

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The S&P 500 is a capitalization weighted index of 500 large capitalization stocks which is designed to measure broad domestic securities markets. The Russell 2000 is an unmanaged index that consists of the smallest 2,000 securities in the Russell 3000 Index, representing approximately 10% of the Russell 3000 total market capitalization. The CBOE Volatility Index is a measure of the volatility of S&P 500 index, calculated and published by the Chicago Board Options Exchange (CBOE). It is not possible to invest directly in an index.

A basis point (BPS) is one hundredth of a percentage point (0.01%).

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