Industry Perspectives - Q4 2020

A New Year and a New Outlook for the Country

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Overview

The impact of the COVID-19 virus has been seen throughout all sectors of the economy and government.

During the post-vaccination period this year, pent-up demand for virtually everything outside of home will provide a springboard for a dramatic economic recovery.

We believe the mainstay of a healthy stock market in 2021 will be profits, not lower interest rates and their accompanying higher price-to-earnings ratios.

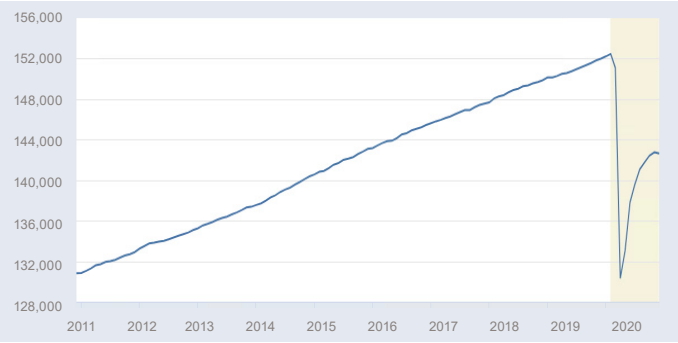
We see robust U.S. economic growth starting the second half of 2021, with the stock market producing a positive, but more modest return this year.

To start off the new year, we want to thank our shareholders and advisors for having the courage to stick with their investments during the pandemic. COVID-19 has been a very personal and very serious health epidemic. Much like the outbreak of the Spanish Flu of 1918, no one had immunity to COVID-19, and it has proven highly infectious. Community spread has been rampant, and, amazingly, the wearing of masks has remained the main line of defense (pre-vaccine). In the early stages most of us barely knew anyone who had caught the virus. Today, with a death total that exceeds U.S. combat deaths in World War II, knowledge of loss of life due to COVID-19 is commonplace. Our thoughts and prayers go out to their families.

The impact of the virus has also been seen in job losses, the closure of small businesses, Real GDP (Gross Domestic Product), consumer spending, corporate spending, and corporate profits (see figures 1-3). The impact on states, local governments, and schools has been severe as well. There will also be medium-term ramifications of trillions of relief dollars handed out by the Federal government, with potentially more to come. Government debt is simply exploding to the upside.

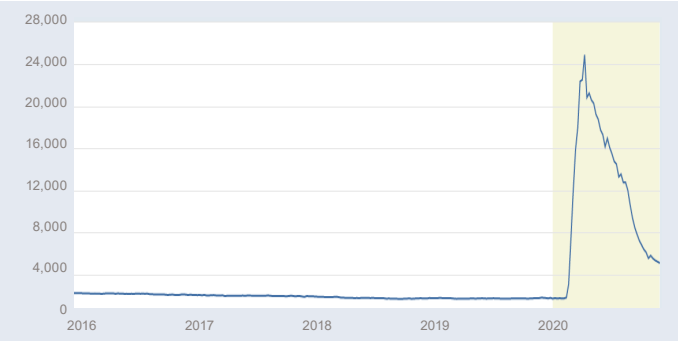
While most of the above is quite concerning and in some cases tragic, there are bright lights on the horizon. First, despite the plunge in economic activity, the stock market has soared to record highs. Why did such bad news produce positive returns? With FDA approval of two vaccines (and possibly more on the way), the market sees a "back to normal" world relatively soon. It will take time to get the majority of America vaccinated, and the death toll, job loss, and economic activity will likely worsen in the interim. However, during the post vaccination period, (hopefully this summer if all goes well), pent-up demand for virtually everything outside the home will provide a springboard for a dramatic economic recovery in the 2nd half of 2021. Under this scenario, payrolls, personal income and spending, GDP, and corporate profits should all return to or exceed pre-COVID levels.

Figure 1 – **U.S. Non-Farm Payrolls**



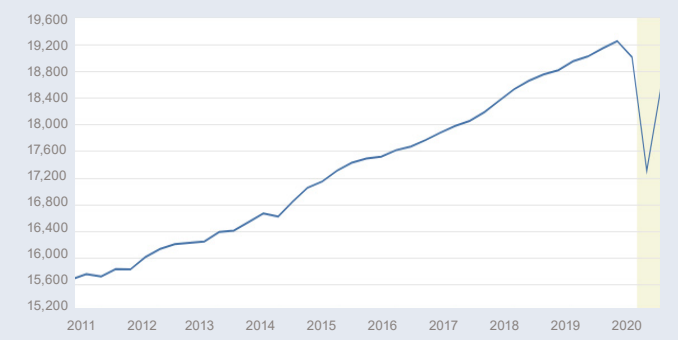
Numbers in Thousands of Persons; Source: U.S. Bureau of Labor Statistics

Figure 2 – **Unemployed Workers in the U.S.**



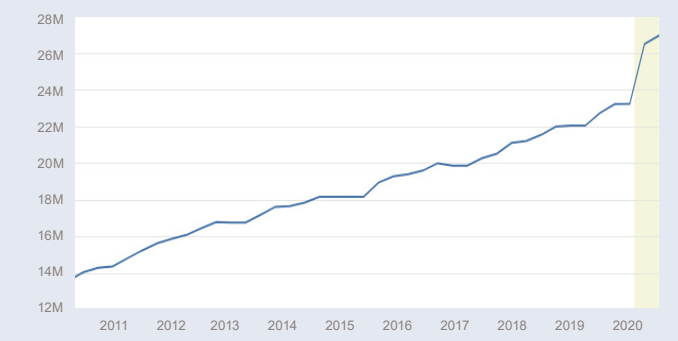
Numbers in Thousands of Persons; Source: U.S. Employment & Training Administration

Figure 3 – **U.S. Real GDP**



Billions of Chained 2012 Dollars; Source: U.S. Bureau of Economic Analysis

Figure 4 – **Outstanding U.S. Government Debt**



Millions of Dollars; Source: U.S. Department of the Treasury, Fiscal Service

In more detail it will be certain industries and sectors of the economy that are likely to see dramatic recoveries starting in Q3 2021. These include leisure airline traffic, hotel occupancy, oil demand, concerts, movies and sports attendance, business conferences, health club attendance, restaurant same store sales, cruise line occupancies, elective surgical procedures and mall traffic, among many others. These areas could very well go from recession/depression conditions to boom times.

We believe the mainstay of a healthy stock market in 2021 will be profits, not lower interest rates and their accompanying higher price-to-earnings ratios. Nor will it be lower tax rates. We believe a big improvement in corporate profits is likely, due to a possible secular decline in certain costs. The most obvious savings would be much lower business travel and entertainment expense, lower occupancy / rent expense (due to stay-at-home workers) and lower payrolls as businesses are careful to rehire.

Regarding interest rates, we believe they will rise in 2021. However, we are not yet convinced bond rates will rise enough to compete with stocks. A rise in the 10 year Treasury to 2-2.5% is likely in our view and would be a big move from 1%. However it would still be historically low. This is our base case on rates at present. However, strong arguments could be made that long term Treasury rates will rise much more than our base case. The most common sense argument is that investors will start to demand a real return on bonds.

> **"During the post-vaccination period, pent-up demand for virtually everything outside the home will provide a springboard for a dramatic economic recovery."**

Sometime this year COVID-19 risk will fade, relations with our allies and rivals will improve, global GDP growth will rise sharply, and a pickup in inflation could become a possibility. In other words, the dollar (and Treasury bonds) may no longer be viewed or needed as a safe haven as global risk subsides. To attract future capital, Treasury rates may again have to follow some semblance of a 2% real return plus inflation (the historical pricing model for bonds). This would put the 10 year Treasury rate at 4.5%, a far cry from the current 1.10%.

Another strong argument for higher long-term Treasury rates is the shocking rise (see graph 4) in U.S. government debt outstanding. If we get another stimulus package, debt could rise by trillions more. New records have been set in several popular measures of U.S. credit worthiness, which continue to worsen. These include the ratio of government debt/GDP and in government debt per U.S. household. While these numbers alone do not guarantee higher rates, when combined with a changed psychology as described above, the chances get higher. Finally, there is also the possibility that the ratings services could look to downgrade U.S. treasury debt, if there is no plan to lessen the country's debt burden.

To summarize our thoughts, we see robust U.S. economic growth starting the second half of 2021. We believe the stock market will produce a positive, but more modest return this year. It will be profit driven with no help from P/E expansion, lower interest rates, or lower tax rates. Historically, interest rates need to rise some 300 basis points before stock returns are negatively impacted. We believe long-term (10-year) Treasury rates will rise to 2.5% from around 1.1% currently. The rise will be investor-driven, not Federal Reserve driven as they control short term rates. As global risks subside, U.S. Treasury bonds will no longer trade at large premiums to their intrinsic value. Their demand as safe havens will fade and they will be priced accordingly.

We want to again thank all our shareholders and advisors for trusting the Buffalo Funds to successfully navigate the fund portfolios through this difficult period.

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?

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