EAGLE RIDGE
INVESTMENT MANAGEMENT, LLC

Investment Commentary

December 31, 2021

HIGHLIGHTS

- Paying more for a growing company is normal and logical. What has shifted is the amount investors have been willing to pay for this growth, and the concentration of that payment in fewer and fewer names.
- Short-term interest rates have risen, however, medium- and longer-term rates have barely budged. This difference has produced extremely low real interest rates (real interest rate = nominal rate – inflation).
- Financial professionals have long known that undesirable financial habits and practices exist; what has been elusive is "why" they are happening. Applied behavioral finance research in the personal finance domain has been increasing annually, leading to heightened visibility and publicity among consumers.

4th Quarter Commentary

Inflation and COVID dominated headlines in 2021 as the market plowed ahead to record highs. The two are related – COVID led to shutdowns which slowed both demand and production in 2020. Government reaction to the shutdowns was to stimulate the economy through easy monetary policy (low interest rates) and simply easy money (sending money directly into the pockets of consumers). As economies re-opened, demand surged but supply has taken longer to catch up. Increasing demand without increasing supply means higher prices for what's available and results in inflation.

As inflation went from transitory to possibly permanent, all eyes turned toward the Federal Reserve and its chairman, Jerome Powell. Powell is the first chairman tasked with fighting inflation since Paul Volcker in the early 1980s. For anyone under the age of about 45, inflation has never been an issue. The Fed has reacted at a measured pace, committed to signaling their process as to not disturb the bond and stock markets.

The first step has been to taper its buying of treasuries and mortgage back securities. The Fed started cutting back its purchases in November with the original goal of finishing in June 2022. This has proved too slow given the elevated levels of inflation. The Fed increased its tapering to finish the process by March. This has opened the window to increasing rates starting in June. Expectations now call for 3 Fed Funds rate increases in 2022 and finishing the year at an upper bound of 0.75%.

This is a relatively tighter monetary policy, but we should remember rates were at 1.75% at the start of 2020, which was a cut from the 2.5% in July 2019. This 2.5% level is considered a neutral level and expectations are that we won't reach this until sometime in 2024. In other words, we are still more than 2 years from a neutral monetary policy.

This will most likely keep interest rates low (see the next section for further details), presenting less of a headwind for stocks. Low interest rates provide a tailwind for stocks in a couple of ways. When rates are low, the discount rate applied to future earnings and cash flows is lower, which results in a higher current valuation of those earnings and cash flows. Also, low rates mean investors will accept lower returns from their equity. When a lower return is needed, investors will pay more for the stock, driving up the valuation.

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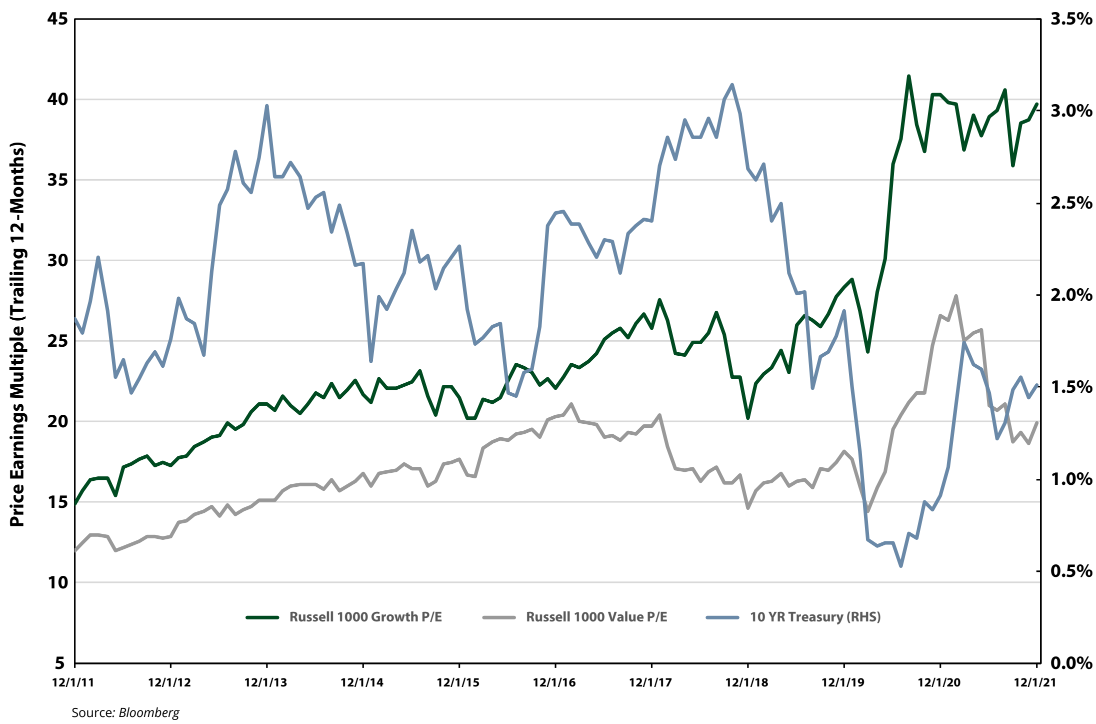
4th Quarter Commentary continued

Of course, that doesn't mean the same market leaders and laggards we've seen over the last 2 years will persist going forward. The market has been driven by growth, i.e. the market has been willing to pay a high multiple relative to earnings for any company growing its earnings. Paying more for a growing company is normal and logical. What has shifted is the amount investors have been willing to pay for this growth, and the concentration of that payment in fewer and fewer names. This has led to a bifurcation in the market.

Interest Rates and Equity Index Valuation



Source: *Bloomberg*

While we are not ignoring the growth sectors of the market, we are only paying for companies that have earned the high multiples. We are also continually searching for the companies which the market has unfairly discounted.

Why Are Interest Rates Still So Low?

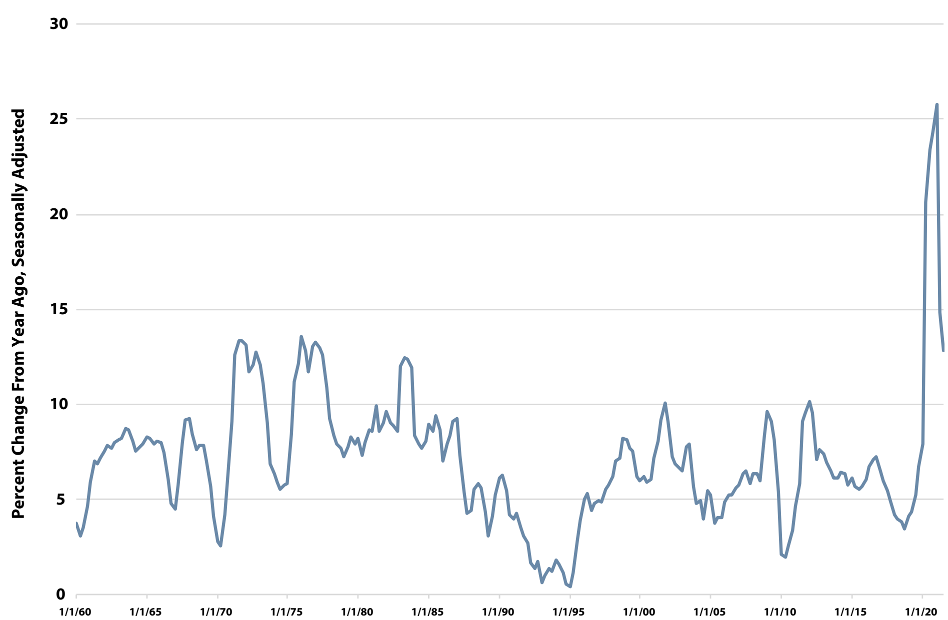
In his recent testimony to Congress, Powell indicated that the adjective “transitory” would no longer be used to describe inflation since price increases have become more persistent. Short-term interest rates have risen, however, medium- and longer-term rates have barely budged. This difference has produced extremely low real interest rates (real interest rate = nominal rate – inflation). The real rate of the 10-year US Treasury is about –5% using year over year CPI as the inflation measure. Following is a list of reasons why interest rates may have remained so low even with rising inflation.

Inflation Really is Transitory: Inflation has spiked recently since the economic demand has rebounded at the same time as supply has been constrained. It may not be unreasonable to expect that demand will moderate due to lower government stimulus and that the supply chain and labor issues will resolve themselves over the next couple of quarters.

Technology: The two factors that have produced disinflation over the past few decades have been technological advances and global trade. Technology allows increased productivity so that fewer workers can produce more goods or provide greater services. Global trade suppresses salaries since companies (especially in the manufacturing sector) can substitute cheaper foreign labor for more expensive domestic labor. While global trade growth has slowed due to supply chain and security issues, technology may continue to keep future prices in check.

Glut of Capital: Another explanation for low interest rates is that there is a tremendous amount of money floating around the world that needs to be put to work. From November 2020 to the same time in 2021, the money supply in the US (M2) increased over 13%. As the nearby chart shows, the growth rate of this measure peaked in the first quarter of 2021 at an astounding 25%. Aside from increasing valuations for stocks, houses and cryptocurrencies, this glut of global capital also buys bonds and suppresses interest rates.

M2 % Change from One Year Ago



Source: *Board of Governors of the Federal Reserve System (US), M2 [M2SL], retrieved from FRED*

Why Are Interest Rates Still So Low? continued

Demand for Safe Assets: Similar to the glut of capital argument, another reason could be that there is a persistently high demand for “safe assets”, such as US Treasuries and mortgage-backed securities. This rationale rests on the premise that valuations are so high for risky assets that there is naturally a high demand for safer assets from less risk averse investors, such as insurance companies and pension funds.

Central Bank Buying: All of the major central banks are still buying lots of government-backed securities. The US Federal Reserve announced that quantitative easing will end in March of 2022. However, the European Central Bank plans to increase its Asset Purchase program to 40 billion Euro per month to ease the transition as another pandemic purchasing program also ends in March. This buying increases prices and keeps rates low regardless of the fundamentals that determine market interest rates.

Recent History: Investors are strongly influenced by recent markets. Two generations of professional and retail investors have only experienced falling interest rates over the last 40 years. Whenever these investors bought short-term bonds in anticipation of higher rates, they have generally performed worse than investors that held long-dated bonds. Therefore, many investors want to avoid getting burned by poor performance by reallocating their portfolios to less interest rate sensitive bonds and wait for rates to rise.

Investors will also demand higher rates from issuers since real yields are historically low. However, we expect future interest rate increases to be gradual since the forces limiting rate rises are strong.

Our view is that these rationales explain, to a greater or lesser degree, why interest rates remain so low even though investors are losing purchasing power by holding most bonds. We believe that long-term rates will increase from these levels since the central banks will raise interest rates to limit inflation. Investors will also demand higher rates from issuers since real yields are historically low. However, we expect future interest rate increases to be gradual since the forces limiting rate rises are strong.

Wealth Accumulation, Behavioral Finance and Keeping Up with The Joneses

The allure of taking extravagant vacations, buying a larger home or new car has admittedly become stronger since the rise of social media and compounded since the start of the Covid-19 Pandemic. Our friends and relatives post never-ending photographs depicting the expense side of their annual income statements, while keeping the revenue and increasing liability aspects of their lives private. True, there will always be individuals within our families and among our sphere of friends who will choose to place their spending on display. Most of us, however, will never know the sacrifices made, increased debt incurred or juggling of cash flows from week-to-week necessary to enjoy such extravagances. Financial professionals have long known that undesirable financial habits and practices exist; what has been elusive is “why” they are happening. Applied behavioral finance research in the personal finance domain has been increasing annually, leading to heightened visibility and publicity among consumers.

Wealth Accumulation, Behavioral Finance and Keeping Up with The Joneses continued

In the mid-1990s, the late Dr. Thomas J. Stanley (Georgia State University) and co-author Dr. William D. Danko (SUNY-Albany) published *The Millionaire Next Door: The Surprising Secrets of America's Wealthy*, sharing the results of several decades-long research into the investing and spending habits of the affluent. Dr. Stanley and Dr. Danko found that affluence can be categorized into *asset affluence* and *income affluence*. In the most condensed terms, *asset affluent* individuals have "money work for them", while *income affluent* individuals work, non-stop, for money to support a profligate lifestyle. The *income affluent* lifestyle is forced to abruptly change the moment one or more sources of income declines or ceases. *Asset affluence* is most often achieved, apart from inheritance or winning the lottery, by (1) allocating one's time, energy and money efficiently and in ways conducive to building wealth, (2) consistently living beneath one's means, and (3) believing that financial independence is more important than displaying high social status (Stanley & Danko, 1996). The investment and compounding of surplus income over time has empirically been shown to lead to wealth accumulation.

One may ask: "Why do some individuals save for a rainy day, while others are more interested in immediate self-gratification?" There is no single answer to this question. The answer does lie within the emerging fields of financial psychology and financial therapy, subsets of behavioral finance.

The root of this question can be found in our *money scripts*, or beliefs about money. Money scripts are most often formed at an early age by observing behaviors, practices and the absence or presence of financial dialogue within our family of origin. Money scripts, unconsciously, drive our financial behaviors as we become adults. Money scripts may have been passed down from generation to generation with little knowledge or understanding of why they exist, may include heuristics, which are outdated or no longer valid, and ultimately become ingrained in our decisions around personal financial matters. Money scripts can function as autonomic behaviors, which is partially why, once formed, scripts become so difficult to change with the passage of time, and a factor limiting the efficacy of financial literacy efforts in middle and in high school education programs.

Further, emotionally-charged traumatic events during one's childhood, such as asset repossessions, bankruptcies and divorce have been associated with destructive financial behaviors. Research has found such events can be highly-resistant to change without professional assistance (Klontz & Klontz, 2009).

Fairly recent research has found that money scripts can be classified into one of four core categories (Taylor, Klontz & Britt, 2015): money status, money vigilance, money avoidance and money worship. Money status behaviors equate self-worth to net worth, money avoidant scripts typify anxiety or fear around money and carry the assumption that rich people are greedy. Worship behaviors are grounded in a belief that more money will solve all their life problems. Money vigilance is associated with privacy surrounding one's net worth as well as a protective or cautious approach in handling one's finances.

Each core money script category in the extreme has been associated with potentially dysfunctional and destructive financial habits, which can be detrimental in the attainment of financial goals. For example, money vigilance scripts (privacy surrounding affairs) can include maintaining secrecy from significant others and spouses with spending and in purchasing large ticket items, a practice known as "financial infidelity".

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Wealth Accumulation, Behavioral Finance and Keeping Up with The Joneses continued

While no single script is absolute in determining the attainment or failure of financial goals and objectives, knowledge of one's predispositions can be the first step in recognizing and addressing financial biases. Wealth management and financial planning professionals are now being routinely educated today in behavioral finance concepts as well as in approaches designed to assist clients in overcoming financial biases. Assessments have been devised, validated, and implemented to assist financial professionals when working with clients.

In 2009, The Financial Therapy Association (fta.org) was formed by a collaboration of family therapists, financial planners, financial coaches and researchers from Kansas State University, Texas Tech University and the University of Georgia. Today, membership nationwide stands at over 300. While financial planning focuses on the future, financial therapy focuses on past experiences and on interior finance topics, which may limit a client's ability to optimize long-term financial well-being if not edited. At times, we must look to our past to enhance our future.

Eagle Ridge Investment Management, LLC personnel are part of this exciting movement integrating behavioral finance principles into our core client offering. Please don't hesitate to let us know if you have questions or if we may be of assistance at any time with your financial concerns.

Enhancement to Quarterly Reporting

Beginning with the year-end Portfolio Review, we have enhanced our quarterly reports by including a new page titled, "Year-to-Date Tax Summary". This report provides the total year-to-date Realized Gains/Losses and Interest & Dividends by account and tax status.

Happy New Year from Eagle Ridge Investment Management, LLC!

About Eagle Ridge

Eagle Ridge Investment Management is an independently owned, SEC-registered investment advisory firm. Our goal is to provide superior investment performance and a high level of service to a select group of clients, unencumbered by the need to sell products or meet corporate goals. We strive to help our clients meet their needs and compound their wealth through a disciplined investment process.

For more information, please contact Alie Hamilton at **a.hamilton@eagleridgeinvestment.com** or **203-227-4515**.