EAGLE RIDGE
INVESTMENT MANAGEMENT, LLC

Investment Commentary

March 31, 2022

HIGHLIGHTS

- Volatility in oil prices is nothing new and over the long-term, “The solution to high oil prices is high oil prices.”
- The level of investment in the stock market is much higher- e.g., more people have 401(k)s than historically - increasing the importance of the market.
- Everyone needs basic estate planning documents such as a power of attorney, will, healthcare proxy and living will.

1st Quarter Commentary

The first quarter has been marked by market turbulence due to the continued rise in inflation and the war in Ukraine. The war in Ukraine is clearly the more important story, given loss of life and freedom involved and the potential global impact of any escalation by Russia. The geopolitical impact is also important as Russia and China are politically aligned, and any success by Russia may embolden China to attempt to spread its authoritarian policies. On the other hand, a strong response by the U.S. and the EU sends a signal about the importance of defending democracies.

The economic impact is not as important. The International Monetary Fund puts the world’s gross domestic product (GDP) over $90 trillion with the U.S. the largest at over $20 trillion and China over $15 trillion. Russia sits at about $1.7 trillion, less than Canada and South Korea. Ukraine’s GDP is about $150B. Russia plays a larger role in the commodities market, specifically natural gas and oil. Russia is the 2nd largest producer of natural gas with an 18% share. Only the U.S. is larger at about 23%. Russia is the 3rd largest producer of oil with an 11% share. Only the U.S. (20%) and Saudi Arabia (12%) produce more. Russia consumes less gas and oil than it produces and is therefore a large exporter. As a result, the war has caused energy prices to increase. For example, the price of oil spiked from just over $90 a barrel (WTI Crude) to over $100 with a peak of $124 on March 8th. Volatility in oil prices is nothing new and over the long-term, “The solution to high oil prices is high oil prices.”

World’s Largest Oil Producers (2020)

Country	Share
U.S.	20%
Saudi Arabia	12%
Russia	11%
Canada	6%
China	5%

World’s Largest Oil Consumers (2019)

Country	Share
U.S.	20%
China	14%
India	5%
Japan	4%
Russia	4%

Source: International Engery Statistics
Oil includes crude oil, all other petroleum liquids, and biofuels

1st Quarter Commentary continued

Higher oil prices exacerbate pre-existing inflation pressures. February's CPI release showed overall inflation of 7.9%, up from 7.5% in January. Additionally, all subsegments were up more than in January, ironically except for energy (of course, oil prices spiked at the end of February and those played a small role in the report). The increases include shelter, the largest segment in the report, and where prices tend to be more stable and stickier. In other words, increasing costs in shelter is a good indication that inflation is not transitory.

The Federal Reserve has now acknowledged there are "broader price pressures." This statement in March by Chairman Jerome Powell came as the Fed increased rates for the first time since cutting the lower bound to 0% in March 2020. Powell also telegraphed rates are likely to increase at each of the remaining 6 meetings this year, including the possibility of a 50-basis point (0.50%) increase in May. Quantitative tightening, i.e. the Fed reducing its almost $9 Trillion balance sheet, is expected to start soon. This will mark the second attempt by the Fed to reverse the quantitative easing (large scale bond purchases by the Fed) policy initiated during the housing crisis starting in 2007.

Powell's Evaluation

One question to be asked is has Powell done a good job as Fed Chairman? Eagle Ridge discussed this topic at a recent investment committee meeting. The consensus was that he did his job. If we were asked for a Pass/Fail verdict, he passed. If we were to give him a letter grade? Not an A or D, but somewhere in the C or B range.

Powell was nominated in November 2017 and confirmed in January 2018. He took over for Janet Yellen, who had already started raising rates and trimming the Fed's balance sheet. Powell continued that process, with rates reaching a neutral status of 2.25% (lower bound) at the end of 2018. The end of 2018 featured an escalating trade war between the U.S. and China and expectations of a slowing global economy. Perhaps being too reactive to the stock market and political pressures, Powell began to cut rates, ending 2019 at 1.5%.

The pandemic started in early 2020 and Powell reacted swiftly, first cutting rates to 1% on March 4th and then to 0% on March 16th. Quantitative easing accelerated which eventually led to a more than doubling in size of the balance sheet from an initial ~$4 trillion. In addition, the Fed backed corporate bonds and products such as exchange traded funds that held these bonds, which greatly stabilized markets.

This set the stage for 2021 and the decision of when to raise rates and end quantitative easing. He's been late on both counts, but that's not a failure. Inflation was probably inevitable. The supply chain disruptions coming out of the pandemic were going to drive inflation upward no matter what. While necessary to prevent economic distress, the trillions of dollars the government sent to large segments of the population disrupted during the pandemic was likely to have an inflationary impact. Obviously, the war in Ukraine was an unexpected factor.

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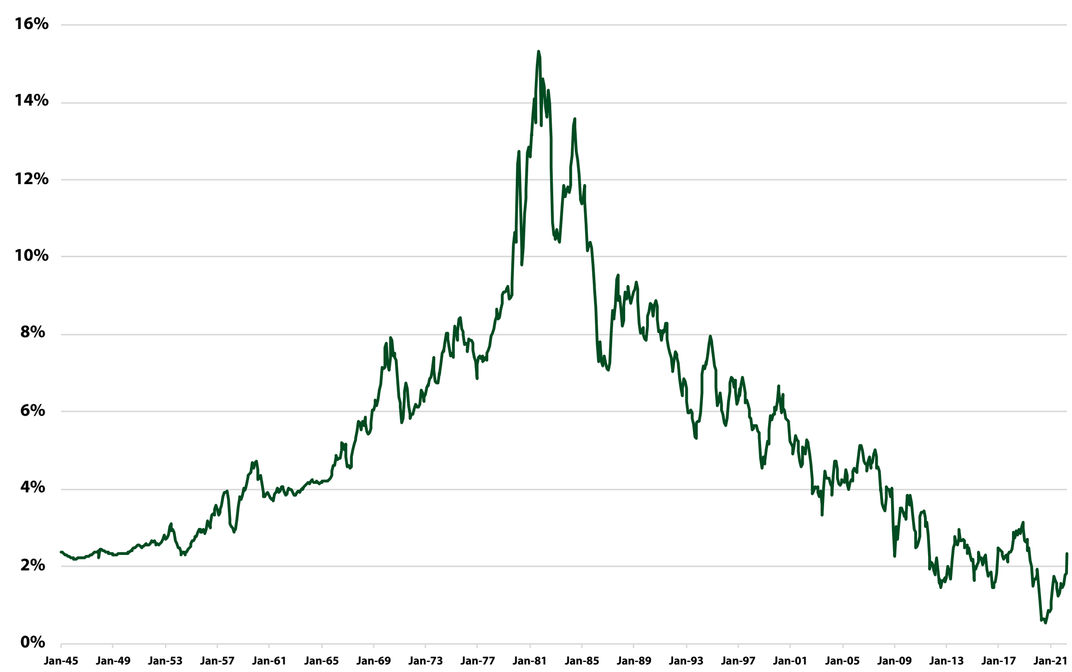
Powell's Evaluation continued

We also believe it's better to be late than early. Raising rates prematurely to cut off inflation can send the economy into recession, and jump starting the economy is not easy. We can look to Japan and its slow growing economy with rates near 0% since the 1990s. No amount of easy monetary policy has sparked the Japanese economy. On the other hand, we know how to combat inflation- Paul Volcker was successful in the early 1980s pushing rates as high as 20%.

The Fed is now more political than ever. As mentioned, Powell was possibly reactive in 2019 when cutting rates. Going into 2021, Powell and the Fed did not want to disrupt the economic and stock market recovery just as we emerged from the first global pandemic of our lifetimes. Eagle Ridge believes the gridlock in Washington increases the pressure on the Fed to help shepherd the economy. The level of investment in the stock market is much higher- e.g., more people have 401(k)s than historically - increasing the importance of the market. Powell also did not want to message expectations of higher inflation. Inflation expectations are as important as actual inflation. If consumers believe prices will be higher tomorrow, they're more likely to buy today, which allows for more inflation and an upward cycle.

10 Yr US Treasury Yield Since 1945



Powell's Evaluation continued

If our conclusion that Powell's lateness to raise rates is justifiable, why not a better grade? It ties back to changes in the Fed since the Volker days, specifically the balance sheet. As noted above, the Fed doubled the balance sheet during the pandemic, but the prior $4 trillion balance sheet was not standard. It was already at a larger than normal level from fighting the Great Financial Crisis in 2008. It was being trimmed heading into the pandemic because a Fed balance sheet of that magnitude should not be standard operating procedure or part of a healthy economy. The balance sheet enables the Fed to manage both the short-term and long-term rates. Keeping long-term rates artificially low, that is creating artificial demand by buying treasuries and mortgage bonds, is good for the stock market. Low rates make fixed income investing less appealing and future earnings more valuable, and both factors drive up equity valuations. It's also good for other parts of life, like keeping mortgage rates low and housing values high. It's bad for investors looking for returns from low volatility assets, i.e. fixed income.

The Fed's navigation out of the inflated balance sheet was the most debated point when we were assessing Powell, probably because it has the least historical precedent. As the balance sheet is reduced, rates will rise. It's a distant memory, or not a memory at all, to many but coming out of World War II we faced a rising interest rate environment. The 10-Year Treasury climbed from 2% in the 1940s to 10% by the 1980s. The U.S. was able to grow and thrive for long stretches during that time. A key part of that growth was due to the growth in the working population, i.e. women entered the workforce. This increased the economy's ability to grow while the added supply of labor kept wages from spiraling upward. The U.S. also dampened inflation by shifting manufacturing offshore to developing countries with lower labor costs.

Today's environment is much different. We don't have a similarly large segment of the population not working in a 9-5 capacity that can easily enter the workforce. Immigration can drive population and economic growth but probably not at the scale experienced post WWII. Japan's slow growth can be partially explained by its closed borders preventing the economy from benefiting from immigration. The current political environment is increasing domestic manufacturing. In addition, as manufacturing moved overseas, the standards of living increased in those countries, increasing labor costs and reducing the savings from offshore manufacturing.

Powell did his job and executed the Fed's playbook for fighting a recession - cut rates and quantitative easing. He now must execute a gameplan for fighting inflation - raising rates. The problem is the field has changed due to the historic level of quantitative easing. We are entering new territory and the path back to normalcy may be bumpy and winding, but there are multiple factors to keep in mind. On the equity side, we strive to invest in companies which can thrive in any market environment. Our valuations are based on the next 3 to 5 years, not the current potentially inflated valuation. In other words, the market is paying X times earnings now, but we normalize to what it will pay in 3 to 5 years. This should help us avoid high multiples purely driven by the current artificially low rates. On the fixed income side, rising rates decrease the value of the current bond investments, but provide an opportunity to re-invest at the new higher rates. Equity should continue to provide the greatest return given the higher risk. Fixed income should continue to dampen the volatility of a balanced portfolio while now providing a higher level of income.

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Estate Planning: Many Choices, no Perfect Solutions

Everyone needs basic estate planning documents such as a power of attorney, will, healthcare proxy and living will. A durable power of attorney allows a trusted confidant to step into your shoes in case of incapacity and helps avoid expensive guardianship proceedings. The will direct an executor to settle your estate and pass your assets according to your wishes. After these foundational documents, there are an infinite number of options available when creating one's estate plan. However, for each of these choices, there is a basic tradeoff between addressing contingencies that could arise and simplicity.

Most parents, who are financially able, want to support their children to make their lives easier. The simplest way to accomplish this goal is to give them the maximum excludable gift each year. A married couple can now give each child $32,000 per year without reducing their estate tax exemption. However, many parents do not want to provide unfettered access to these funds. To restrict their children's access, one solution is to create an Irrevocable Trust for the benefit of each child and then gift funds to that trust. A trust could limit access to capital and also have the benefit of bypassing that child's estate. Trusts allow greater control and tax efficiency yet are more expensive to create and time consuming to administer. For example, each Irrevocable Trust may require its own tax identification number and necessitate a separate tax return annually.

Similarly, a family may own a second home in a desirable location that it wants to pass to the children. The simple solution is to include the house in the will as part of the estate and pass it to the next generation when the parents pass away. The downside of this approach is that the property will then be included in the older generations' estate and produce estate taxes. To avoid this scenario, a Qualified Personal Residence Trust (QPRT) could be established to remove future appreciation of the residence from the older generation's estate. QPRTs are complicated trusts which involve tax tradeoffs. For instance, formalities such as the requirement that grantors pay market rent, after the applicable term, to the next generation need to be observed. If not, the house could be included in the estate. Additionally, transferring the house to a QPRT prevents a step-up in basis at death.

The current estate tax exemption is expected to sunset in 2026 and revert to $5 million (adjusted for inflation from 2018). While the current Congress has not made any significant tax law changes, the sunset occurs without any legislative action so it may be more likely in a gridlocked legislature. This change would more than halve the exempt amount and subject many more estates to taxation. Also, while the votes were not there to make changes last year, the politics and likelihood of new estate taxes could change.

Given the large potential change in the exemption, it may make sense to revisit your estate planning. Since everyone's circumstances are different, there is no one estate plan that works for every family. Similarly, there is not a perfect solution for one individual or family since every plan involves tradeoffs. One of the biggest tradeoffs is between a simple plan which is easy to administer and a complex one that may be more tax efficient (providing more asset protection) but take more time and money to manage.

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Eagle Ridge has Moved!

As noted in our email blast, we moved to a new building within our office park in Stamford. The new space is sunnier and better laid out. The process went smoothly, and everyone has been up and running without downtime. The only remaining task is hanging our pictures. Please visit us if you are in the neighborhood.

The new mailing address is:

4 High Ridge Park, 3rd Floor
Stamford, CT 06905

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**.