EAGLE RIDGE
INVESTMENT MANAGEMENT, LLC

Investment Commentary

June 30, 2022

HIGHLIGHTS

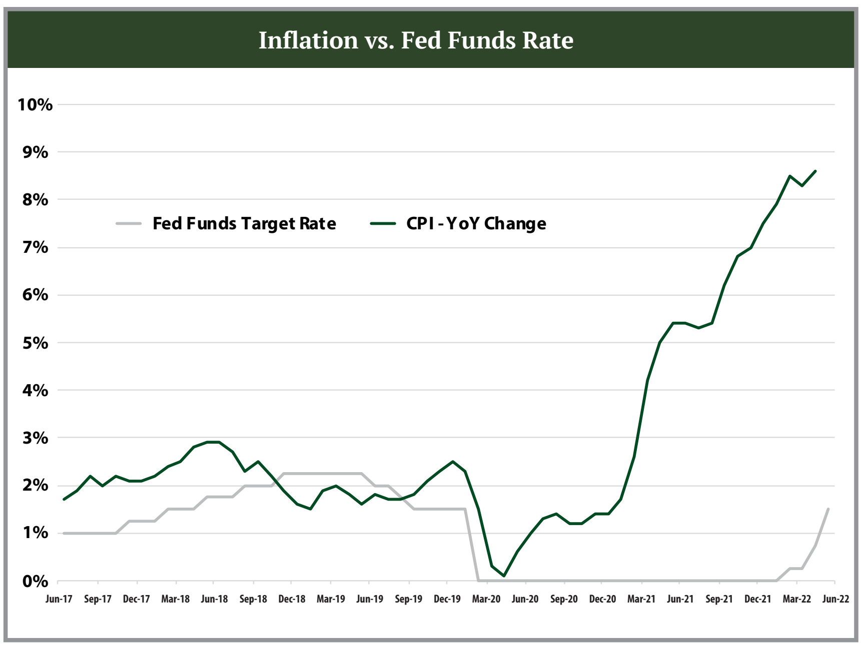
- We believe that a soft landing for the economy is unlikely. Higher rates and less money in the system will most likely cause a recession. If the Fed is committed to controlling inflation, it will most likely overshoot its rate increases.
- Despite recent losses, fixed income is still an important part of a balanced portfolio. Interest rates are resetting due to the Fed's inflation fight, but once stabilized, there won't be such a negative trend.
- For individuals who may be approaching retirement after 2025 and who have accumulated significant sums in 401(k) plans and IRA Rollover accounts, now may be the time to consider partial or full Roth conversions of these retirement arrangements.

2nd Quarter 2022 Investment Commentary

Leaner Times

Looking back to the Great Financial Crisis of 2007-2009 provides important context for the current market volatility. At that time, the Federal Reserve (Fed) acted aggressively to restore credit throughout the financial system since many of the country's financial institutions were on the brink of collapse. The Fed lowered interest rates and increased the money supply through quantitative easing. Lower interest rates increased economic demand as borrowing became cheaper. Accommodative monetary policy also increased the value of all assets including stocks, bonds, and real estate. Higher asset prices led to a "wealth effect" where individuals and institutions increased spending because they felt richer. Since the economic and credit recovery was slow, inflation didn't become a problem.

In response to the dramatic slowdown from the pandemic, the government and Fed doubled down on the prior strategy that worked to bring the country out of the Financial Crisis. The government provided numerous support programs while the Fed lowered rates and increased the money supply again to avert a deep economic decline. This coordinated response explains the dramatically quick recovery from the economic shock caused by the pandemic.



However, unlike during the recovery from the Financial Crisis, the banks and financing mechanisms were healthy and functioning going into the pandemic economy. Therefore, the abundant fiscal and monetary stimulus fueled an incredible spending spree that sparked the first sustained inflation in the US in over 40 years. Supply chain restrictions also contributed to inflation.

Leaner Times continued

As is well documented, prices for everything have increased dramatically recently. The Consumer Price Index increased by 8.6% year over year. Gas sells for a national average of $4.87/gallon, with the highest prices in California, touching over $7 in Southern California last month. Housing prices have also increased in excess of 20% over the past 12 months according to the latest Case-Shiller figures.

The tools to combat inflation are well known: raise interest rates and slow (or reverse) monetary expansion. The Federal Reserve started this process in March of this year, but the market didn't get the message until the Fed raised interest rates 0.5% in May and then another 0.75% at its June meeting. These moves caused the sharp stock selloff late in the quarter.

The process to slow inflation has begun, but the Fed needs to keep increasing interest rates since the current levels are still stimulative. As an oversimplified example, picture a home buyer who has seen housing prices increase 20% a year for the last couple of years. If appreciation slows to 10% per year, a buyer will still come out ahead even if he or she pays 6% per year in interest. Therefore, the only way to slow the economy is to keep raising interest rates until the point where demand for housing and other goods slows dramatically.

We believe that a soft landing for the economy is unlikely. Higher rates and less money in the system will most likely cause a recession. If the Fed is committed to controlling inflation, it will most likely overshoot its rate increases. Economic responses to higher rates tend to lag the interest changes by months so that it is impossible for the Fed to know the exact point to stop tightening economic conditions.

Even though we may experience a recession in the coming quarters, a slowdown is not a reason to avoid investment in the market now. Markets are always discounting future events and we believe that a recession is largely priced into the indices. Markets and economies move through various cycles of expansion and contraction. In response to high inflation, we are now in a contraction. While we are not there yet, prices will stabilize to the point where the Fed can stop raising rates and a foundation is established for the next expansion.

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Fixed-Income and Interest Rates

Volatility in the equity markets is expected. Investing in equity means taking an ownership interest in a dynamic company which must react to economic conditions. And those conditions can negatively or positively affect the stock price. Volatility in the fixed income market is less expected as the investor is guaranteed a series of payments, regardless of economic conditions. Fixed income is usually a hedge against the volatility in the equity markets, providing a "safe" asset when equity markets fall.

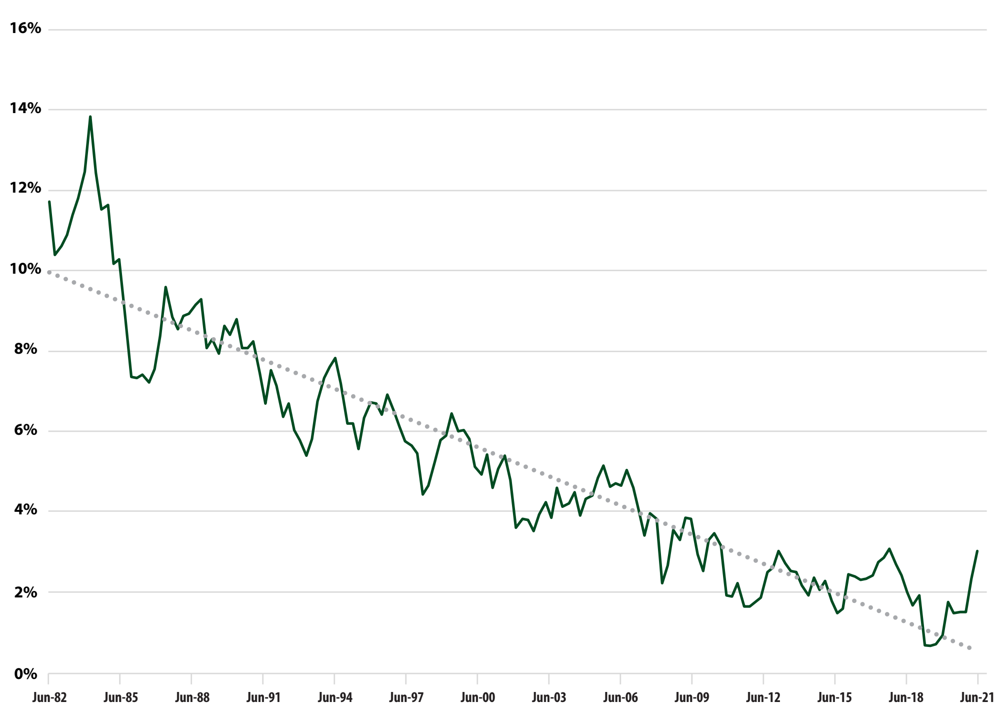
Fixed-Income and Interest Rates continued

Fixed income has been both relatively volatile and not much of a hedge in 2022. Interest rates have been quite volatile really since the start of the pandemic in 2020 – the 10-year treasury rate has ranged from about 0.5% to 3%. The absolute change of 2.5% might not seem like much, but the rate increasing 6X over the last two years is a dramatic move. This volatility means the underlying performance of one's fixed income investment can vary dramatically depending on when one initially invested.

Fixed income has not performed well year to date. The Bloomberg Aggregate Index is down about 10% through the 2nd quarter, as increasing rates mean lower bond prices. In balanced accounts, Eagle Ridge has actively emphasized very high quality, short maturity fixed income securities. This has helped to greatly blunt the price deterioration experienced in broader bond market averages.

Negative fixed income returns stand out even more in 2022 for a couple of reasons. First, we've been in a 40-year fixed income bull market driven by declining interest rates.

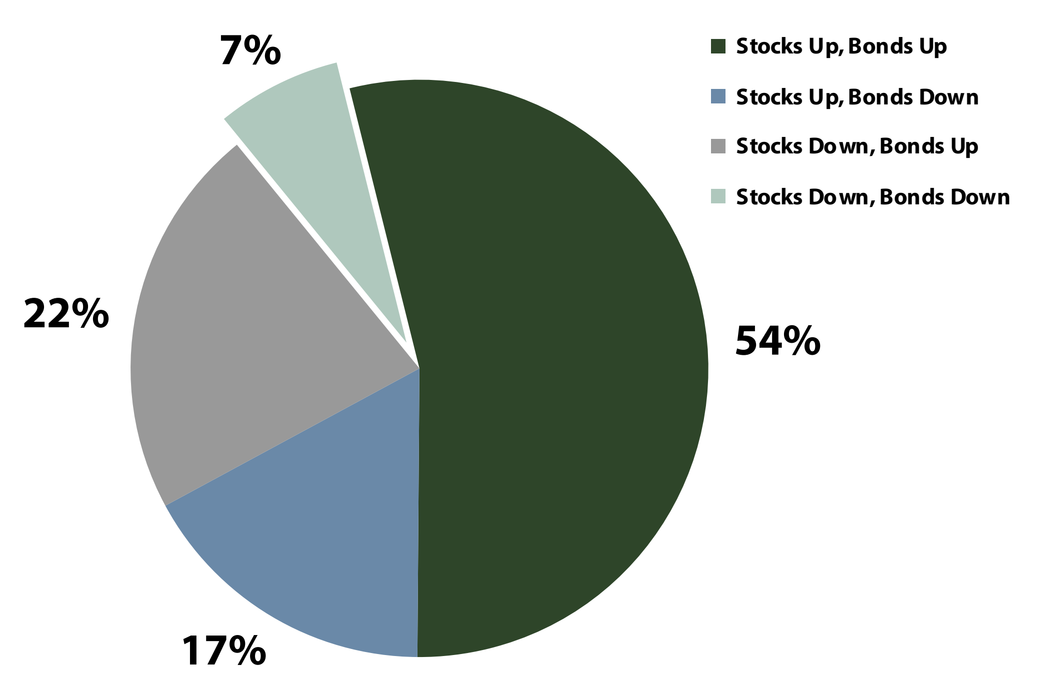
10 Year Treasury Rate



Fixed-Income and Interest Rates continued

This means investors not only collected their income payments, but also saw the value of their principal increase. The second reason is that, in 2022, fixed income has not provided a hedge against the falling equity markets. Over the last 25 years, fixed income and equity markets have been simultaneously down for only 7 quarters, and 2 of those are the first 2 quarters of 2022.

Breakdown of Stock and Bond Returns



And for the 5 other quarters, the average decline was only about 1% for fixed income and 3% for equity. This is very different than the 5% and 6% decline in fixed income during the first 2 quarters combined with the 5% and 16% decline in the stock market.

Despite recent losses, fixed income is still an important part of a balanced portfolio. Interest rates are resetting due to the Fed's inflation fight, but once stabilized, there won't be such a negative trend. Additionally, the increased rates will allow bond investors to collect significantly higher yields going forward which will augment portfolio returns.

The Future of Social Security: Behind the Headlines

Social Security payments play a significant role in retirement planning for most people. It is one of the few government programs that 90% of American adults support, according to recent surveys. It is a separate, self-funded program, which invests its excess cash in U.S. Treasury bonds. There were a lot of sensational headlines about the system's health recently, and we'd like to present a clearer picture of the current status and outlook for Social Security. Social Security is funded by payroll taxes, so it's a pay-as-you-go system. About 80% of benefits paid out are covered by these payroll taxes. There is a Trust Fund that can be tapped when benefits exceed taxes. This draw has been the case in recent years due to a confluence of events, principally demographic shifts:

- **A huge increase in retirees from the baby boom generation**
- **An increase in disability claims and longer general life expectancy**
- **A dramatic and sustained drop in birth rates since the 1970s [where we once had 3 workers contributing to the system per beneficiary, we now have only two]**

These have all affected the system at the same time creating a deficit that has eroded the Trust Fund, which pays an estimated 20% of benefits. It is estimated that at current rates, the Trust Fund will disappear by 2035, leaving those benefits it now pays for in doubt. We have 13 years left to figure out how to restore balance to the system.

Headlines about the demise of social security are good click-bait, but bad reporting. Social Security has faced funding issues before. In the 1980s, Congress responded to a shortfall by raising the full retirement age, increasing payroll taxes, and instituting an income tax on benefits. In all probability, we're facing similar choices to restore the system's financial health. The system is not teetering on bankruptcy, but it does have financial challenges ahead that our legislators need to address as soon as possible.

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Bear Market Planning Strategies

During periods of market volatility, it is common for many to allow the emotional side of investing to seize control of our financial planning thought processes, oftentimes resulting in paralysis. For those who may have been contemplating some strategic maneuvers only weeks ago, now can be an opportune time to take advantage of lower market values to "leverage" some of these strategic maneuvers.

Bear Market Planning Strategies continued

Specifically, transfers of assets in kind to lower generation family members or to trusts for the benefit of family members can be accomplished at a lower transfer tax cost than would have been the case at the start of 2022. For example, if one had been planning to transfer a specific number of shares of stock in January that would have been equivalent to the $16,000 per recipient annual exclusion amount, more shares may be transferred today at a lower per share price to equate to the $16,000 dollar value. As the stock market and economy rebound, less property will remain in the donor's estate, and more wealth will have been transferred. This principle also works very well where clients may be contemplating more substantial transfers of wealth using popular planning vehicles, such as Charitable Remainder Trusts, Grantor Retained Annuity Trusts, Donor Advised Funds and 529 Plans.

For individuals who may be approaching retirement after 2025 and who have accumulated significant sums in 401(k) plans and IRA Rollover accounts, now may be the time to consider partial or full Roth conversions of these retirement arrangements. While the thought of paying income taxes today on the conversion of tax deferred retirement accounts may be somewhat distasteful, the prospect of higher income taxes in the not-too-distant future may help to shake us out of this funk. Sound retirement planning begins well in advance of one's actual scheduled retirement date.

It was only five years ago that the Tax Cuts and Jobs Act (2017) was enacted, reducing income, gift and estate taxes. Many of these provisions are scheduled to sunset after December 31, 2025, unless extended by Congress, prospectively resulting in the return of higher rates and lower exemptions.

If you would like to explore some of these strategic planning opportunities, please contact your Eagle Ridge Portfolio Manager. We will be happy to work through some ideas and projections, tailored to your specific short- and long-term objectives on a complimentary basis.

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**.