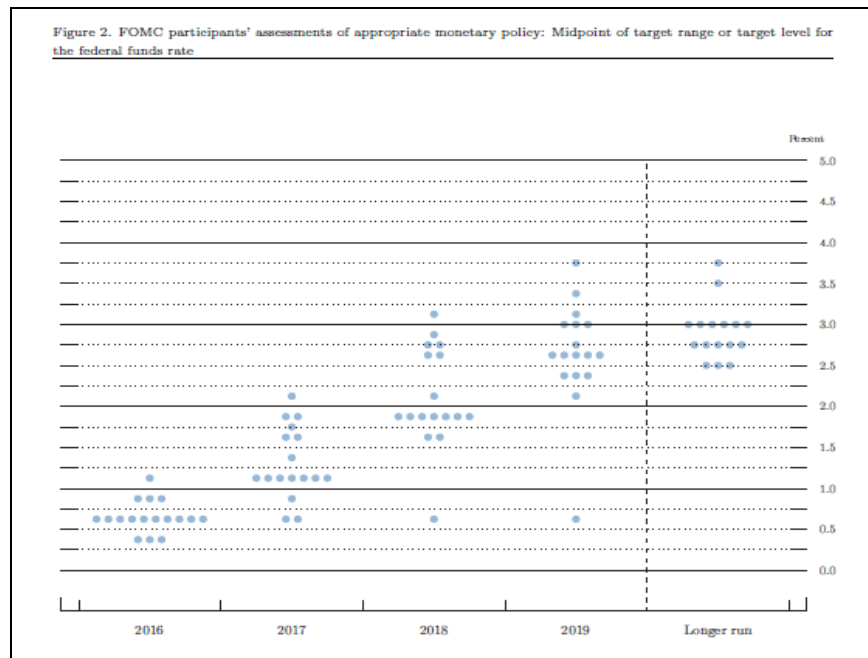


*Confluence Investment Management offers various asset allocation products which are managed using “top down,” or macro, analysis. We publish asset allocation thoughts on a weekly basis in a special section within our Daily Comment report, updating the piece every Friday.*

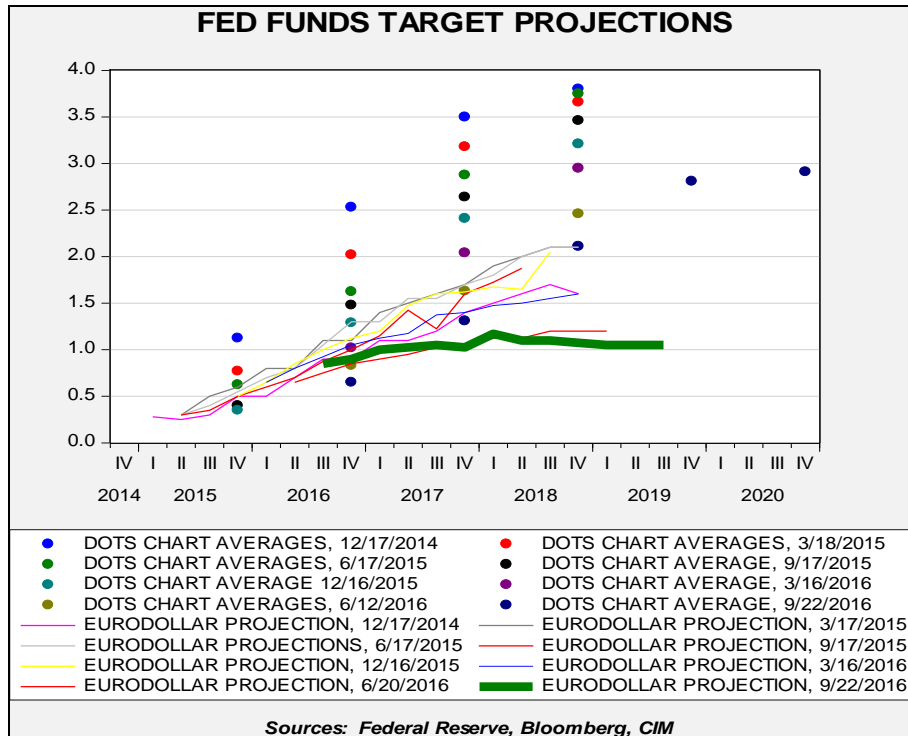
September 30, 2016

Last week, the FOMC left rates unchanged, as expected. The statement was rather hawkish but the accompanying information, such as the “dots” chart, was mostly dovish.



(Source: Federal Reserve)

Note that three of the 17 members of the committee want to stand pat for the rest of the year and two want to raise rates only once next year.



This chart shows the average projected rate from the dots chart along with the projected fed funds rate from the Eurodollar futures market. A couple interesting trends are emerging. As we have seen for some time, the FOMC is steadily lowering its terminal rate, the policy rate where tightening ends. They still hold out hope for a normalization in the long run, around 3%, but this expectation has been in the dots for some time. It never actually seems to occur. For this year, expectations are modest; on average, in fact, there is a chance that no hike will occur, even though the Eurodollar futures have one discounted. However, the Eurodollar futures are also looking for a terminal fed funds rate of around 1.25% at its peak. Simply put, the financial markets expect that the conditions that have led to low rates will continue well into 2019.

What would lead to rate normalization, which appears to be a rise to 3% for fed funds? The most obvious catalyst would be a rise in inflation. As long as the world remains awash in excess capacity, inflation will remain low (assuming trade remains open). That's why the presidential elections are important. We expect Donald Trump to restrict trade, whereas Hillary Clinton will, for the most part, try to maintain the current trade structure. For now, we expect that rates will rise, but expect a terminal rate of 1.25% for fed funds.

*Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.*

*This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.*