Confluence INVESTMENT MANAGEMENT

Asset Allocation Quarterly
Second Quarter 2020

The Confluence Asset Allocation Committee elected to rebalance the investment strategies early this quarter in order to take advantage of market opportunities. Therefore, we are publishing preliminary comments without our usual charts and discussion of performance and volatility. We will republish the complete report once the data becomes available after quarter-end.

Second Quarter 2020 Asset Allocation Outlook

- **The prospect of a recession in the U.S. is nearly a foregone conclusion. The depth will likely be severe, but the duration could be brief.**
- **Actions over the past two weeks by the U.S. Federal Reserve should help mitigate the economic crisis, potentially avoiding problems faced in past downturns.**
- **The stimulus package signed into law on March 27 offers further assistance for lessening the duration of the contraction.**
- **Our three-year forecast is for a recovery and even the potential for expansion toward the end of the forecast period.**
- **Risk assets, especially U.S. equities and even corporate bonds, are at attractive valuations in our view.**
- **Each strategy now has elevated exposure to equities with a tilt toward growth over value.**
- **Though long-term Treasuries have likely run their course, the use of gold as a stabilizer for the strategies remains appropriate.**

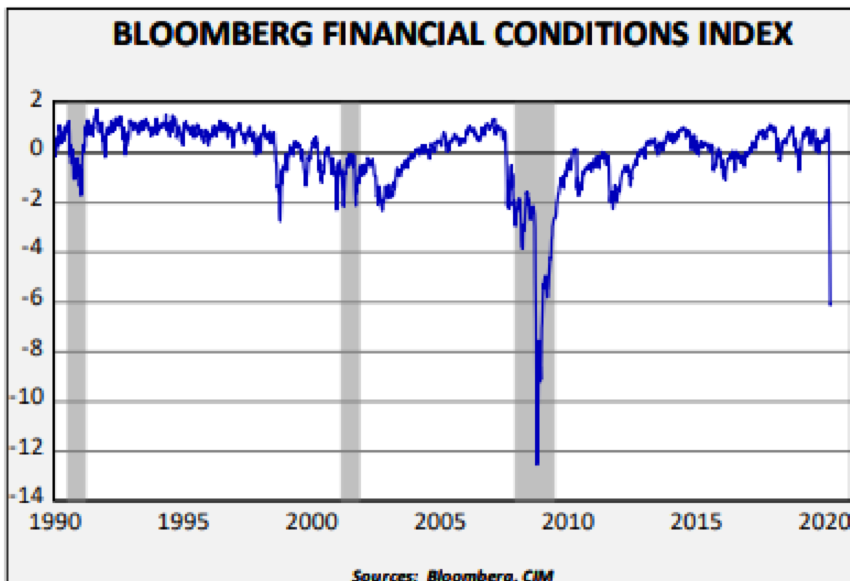
Economic Viewpoints

The COVID-19 virus has plunged the U.S. and global economies into a recession faster and more violently than anyone had forecasted even a month ago. Sheltering at home has ground economic activity to a near-standstill and has resulted in an astounding increase in unemployment claims and consequent business inactivity. Nearly simultaneously, the price of oil has collapsed, owing to the market share battle waged between the Kingdom of Saudi Arabia [KSA] and Russia. A third concern, that of increasing financial stress, has been addressed and potentially allayed by the recent actions of the Fed. Since the beginning of March, the Fed has responded with the following, among other measures:

- Cutting fed funds by 1.50% to 0.00%-0.25%;
- Expanding its repo operations, effectively offering an unlimited amount;
- Resuming Quantitative Easing as open-ended, announcing thee intention to buy $375 billion in Treasuries and $250 billion in mortgage-backed securities for the week of March 23 alone;
- Supporting money market funds through the Money Market Mutual Fund Liquidity Facility, allowing banks to pledge collateral they purchase from prime money market funds.
- Resurrecting the Primary Dealer Credit Facility, offering rates as low as 25 basis points to primary dealers with investment-grade debt, including municipals, and equities being used as collateral;
- Encouraging bank lending by lowering the discount window rate to 25 basis points and extending the term to 90 days from overnight;
- Relaxing regulatory capital requirements and liquidity buffers in an effort to stimulate lending;
- Establishing two new facilities to support high-grade U.S. corporations: the Primary Market Corporate Credit Facility – allowing the Fed to buy new corporate bond issues and extending loans; and the Secondary Market Corporate Credit Facility – allowing purchases of not only existing corporate bonds, but also ETFs holding investment-grade rated bonds.

These historic measures by the Fed have the potential to avoid the issues associated with most prior recessions where the financial system exacerbated the problems.

Despite the Fed's actions, the magnitude of the impact of COVID-19 on the economy remains to be seen. Due to the lag in data reporting, many indicators won't turn decidedly negative until reports are released in April and May. However, we have noted a sudden decline in financial conditions as measured by the Bloomberg Financial Conditions Index for the U.S., which is compiled daily and comprises eight variables.[1] The more negative the reading, the greater the level of financial stress. It clearly indicates a substantial impact from the economic inactivity inflicted by the disease.



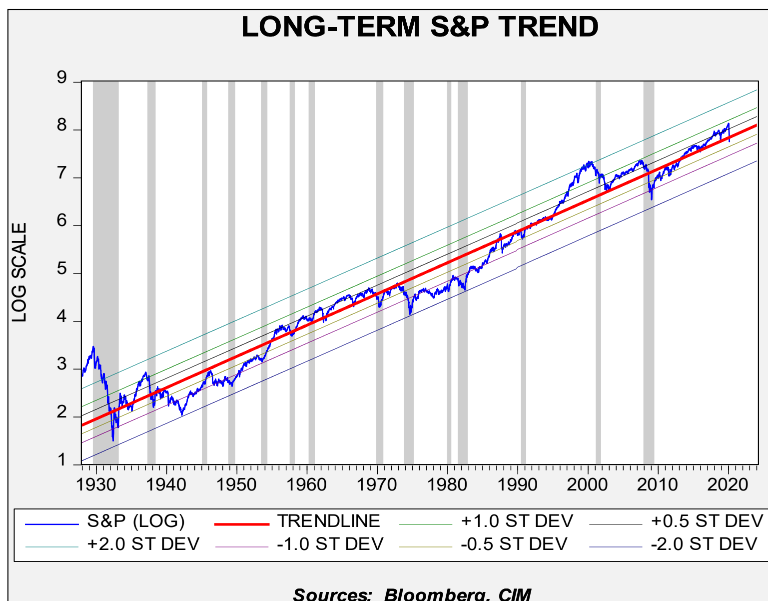
Our forecast is for a dramatic decline in U.S. GDP recorded for the second quarter of this year, with the potential to stretch into the third and fourth quarters should a second wave of the virus assert itself in autumn. However, over the full three-year forecast period, we anticipate that a U-shaped recovery will engage, accompanied by an unleashing of pent-up demand from businesses and households awash in liquidity.

[1] The eight variables contained in the index are the TED spread, LIBOR/OIS spread, commercial paper/T-bill spread, Baa/10-Year T-Note spread, Muni/10-Year T-Note spread, swap volatility, S&P 500 and VIX.

Stock Market Outlook

Although our near-term view is that domestic and overseas equity markets will be in search of new footing, we believe that in the absence of a policy mistake equity markets should recover over the course of our three-year forecast period. That is not to imply that in the interim all will be roses and buttercups for corporations and equity investors. The combination of the pandemic, the "oil war" between Russia and the KSA, and the global recession will naturally cripple corporate earnings. Our updated EPS estimate for the S&P 500 is $127 for 2020. A resurgence of the virus in autumn and/or a policy mistake, such as a failure to follow the $2 trillion stimulus bill with additional legislation in the event of a more severe and durable economic contraction, could plunge equity prices even lower. However, the policy responses thus far have been heartening.

The downturn may provide an opportunity for companies to write down some inflated assets, such as intangibles, and revise compensation structures to appease governance-focused institutional investors. In addition, share repurchase programs are likely to be curtailed, reducing this form of demand for shares, and in the near term, dividends may be suspended by a number of firms as they address the business impact over the next several months. However, over our forecast period, dividends are likely to become the preferred means by which to reward shareholders, thereby replacing share repurchases. Over the course of the next three years we anticipate that pent-up demand, the realignment of supply chains, and builds in corporate inventories will lead to a recovery in equity prices from today's attractive valuations.



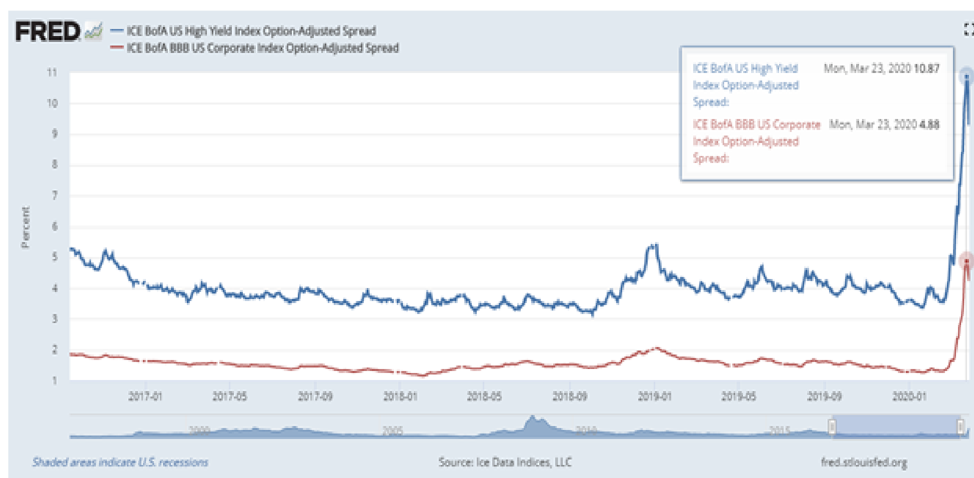
In summary, current pressures associated with COVID-19 and the oil war may continue to build over the next several months, placing more downward pressure on equities. However, we find valuations to be enticing, even factoring in a temporary plunge in EPS for this year. Accordingly, over our forecast period we believe that stocks hold remarkable appeal and will be viewed as such when we look in the rearview mirror in 2023.

Among U.S. equities, a tilt now exists in favor of growth over value and we increase the allocation to the quality factor focusing on profitability, earnings quality, and lower leverage. Within large cap sectors, we establish an overweight to Consumer Discretionary, given expectations for performance once constrained demand from COVID-19 is revived, while maintaining the overweight to Technology and Communication Services.

In contrast, overseas developed markets hold lesser appeal, given the current and anticipated continued strength of the U.S. dollar. Until a durable catalyst for weakening the U.S. dollar becomes evident, the strategies will continue to exclude non-U.S. developed market exposure. For the more aggressive strategies, however, we find that emerging markets have largely discounted the effects of a strong dollar, COVID-19, and the oil war. Emerging markets ex-China are trading one-third lower than they were at the end of last year. Accordingly, we have introduced exposure to emerging markets in the higher risk strategies, Growth and Aggressive Growth.

Bond Market Outlook

The extraordinary measures employed by the Fed have helped to ratchet down yields across the curve and thus far have effectively rescued the commercial paper and investment-grade corporate bond market. While these measures excluded the high-yield bond market, the stimulus package passed by Congress on March 27 provides the potential for remedy. Within the package is a tax carryback provision allowing companies to use losses incurred from 2018-2020 to offset profits from prior years. This may provide continued life support for a number of high-yield entities. As the chart shows, spreads for both investment-grade and high-yield corporate bonds rapidly widened over the course of the past month yet have declined over the past week due to both Fed intervention and anticipated assistance from the stimulus package.



While the Asset Allocation strategies benefited from employing long-term Treasuries as stabilizers through last quarter's equity market turbulence, we find continued upside to be limited as there is a risk that the U.S. encounters a lift in inflation this summer from surging demand, which would pressure the long-end of the curve. The potential for an increase in rates over the full three-year forecast period encourages our substantial reduction of long-term bonds in the income-oriented strategies and their elimination from the Growth and Aggressive Growth strategies.

Other Markets

The combination of our forecast for rates and the significantly attractive pricing caused by the market decline leads to the continued exposure to REITs in the more conservative Income with Growth strategy. Although the office/retail segment will obviously struggle this year, the more diversified pool of REIT enterprises including data storage, cell towers, and timber lessens the impact retail and office formerly held.

We retain the prior elevated allocation to gold given its ability to offer a potential hedge against geopolitical risk. In the more risk-seeking strategies of Growth and Aggressive Growth, gold is complemented by small positions in silver, which we find can magnify the advantages of gold. Another potential advantage of silver is that roughly half of its demand is from industrial uses, which can be supportive of its price during an economic recovery.

Second Quarter 2020	**Income With Growth**		**Growth & Income**		**Growth**		**Aggressive Growth**	
	Current	Change	Current	Change	Current	Change	Current	Change
Cash	2%	-	2%	-	2%	-	2%	-
Short Term Bonds	5%	5%	-	-	-	-	-	-
Intermediate Term Bonds	15%	(2%)	12%	2%	-	(6%)	-	-
Long Term Bonds	10%	(23%)	10%	(8%)	-	(15%)	-	(15%)
Speculative Grade Bonds	5%	5%	-	-	-	-	-	-
Real Estate	5%	-	5%	-	-	(5%)	-	(11%)
U.S. Large Cap Stocks	31%	8%	35%	-	50%	10%	30%	-
U.S. Mid Cap Stocks	17%	7%	20%	-	20%	-	20%	-
U.S. Small Cap Stocks	-	-	6%	6%	11%	11%	24%	14%
Foreign Developed Country Stocks	-	-	-	-	-	-	-	-
Emerging Market Stocks	-	-	-	-	5%	5%	10%	10%
Commodities	10%	-	10%	-	12%	-	14%	2%
Total	*100%*		*100%*		*100%*		*100%*	

See next page for disclosures and important details regarding portfolio allocations.

Income with Growth

Several changes were made to the Income with Growth strategy this quarter. Congruent with our thoughts on long-term bonds and the potential for risk assets over our three-year forecast period, the majority of exposure to long-term bonds was removed in favor of initiating a position in speculative grade bonds and increasing the weight to U.S. large cap and mid-cap equities. In the short and intermediate bond segments, the strategy retains the laddered maturity structure and incorporates maturity-term Treasury ETFs toward the back end of the intermediate maturity segment. U.S. equities now favor growth over value, and large cap sectors are overweight Consumer Discretionary, while maintaining the overweight to both Technology and Communication Services. We increase the formerly neutral weight to mid-cap stocks, further evidence of our risk-accepting posture for the strategy over the three-year forecast. However, we retain the stabilizer of gold owing to its potential to reduce overall strategy risk accruing from geopolitical uncertainty, along with the opportunity it affords in the event of continued global equity market volatility.

Growth & Income

The Growth & Income strategy's former risk-neutral posture with equity stabilizers was changed this quarter. Almost half of the long-term bond exposure was eliminated, with the proceeds assigned to intermediate-term bonds and U.S. small cap equities. In the intermediate bond segment, the strategy retains the laddered maturity structure and incorporates maturity-term Treasury ETFs toward the back end of the intermediate maturity segment. U.S. equities now favor growth over value, and large cap sectors are overweight Consumer Discretionary, Technology, and Communication Services. We initiate a modest position in small cap stocks, further evidence of our risk-tolerance for the strategy over the three-year forecast period. However, we retain the stabilizer of gold owing to its potential to reduce overall strategy risk accruing from geopolitical uncertainty, along with the opportunity it affords in the event of continued global equity market volatility.

Growth

Although the Growth strategy was risk-controlled over the past two quarters and incorporated equity stabilizers of intermediate/ long-term bonds and commodities, only the commodities remain. We removed the former positions in long-term and intermediate-term bonds, with the proceeds funding larger exposure to U.S. large cap equities and a new position in U.S. small cap equities. U.S. equities now favor growth over value, and large cap sectors are overweight Consumer Discretionary, Technology, and Communication Services sectors. We introduce a position in emerging markets to the Growth strategy this quarter due to our view that the sharp sell-off has adequately addressed associated risks and presents an attractive entry point. The strategy retains the stabilizer of gold for its potential to reduce overall strategy risk accruing from geopolitical uncertainty, along with the opportunity it affords in the event of continued global equity market volatility. This position is augmented by a minor position in silver, which complements the gold position and has the potential to magnify the advantages of gold.

Aggressive Growth

Among all the strategies, Aggressive Growth had the largest changes from last quarter. U.S. large cap and mid-cap equity allocations are unchanged, while we increase the U.S. small cap exposure to nearly twice the prior weight. All positions in bonds, including intermediate-term and long-term, were eliminated. U.S. equities now favor of growth over value, and large cap sectors are overweight Consumer Discretionary, Technology, and Communication Services. We introduce a position in emerging markets this quarter due to our view that the sharp sell-off has adequately addressed associated risks and presents an attractive entry point. The strategy retains the stabilizer of gold for its potential to reduce overall strategy risk accruing from geopolitical uncertainty, along with the opportunity it affords in the event of continued global equity market volatility. This position is augmented by a small position in silver, which complements the gold position and has the potential to magnify the advantages of gold.

Disclosures

Confluence claims compliance with the Global Investment Performance Standards (GIPS®). A complete list of composite descriptions and/or a GIPS compliant presentation is available by contacting Marketing@confluenceim.com or calling (314) 743-5090. Confluence Investment Management LLC is an independent registered investment adviser. Past performance is not indicative of future results. The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of all fees and include the reinvestment of all income.

Each strategy is implemented using Exchange Traded Funds (ETFs) and the investment objective is the pursuit of nominal returns (yield and growth) in excess of inflation, subject to the limitations of the risk constraint for each strategy. The targeted risk constraint and appropriate investor risk tolerance for each strategy is as follows; Aggressive Growth (High), Growth (Average), Growth and Income Taxable (Moderate), and Income with Growth (Conservative). ML Bond Index consist of Merrill Lynch US Corporate, Government, and Mortgage Bond Index.

The asset allocations shown represent the individual ETFs used for the asset allocations in the model portfolios as of 3/30/2020 and do not represent the precise allocation of assets in an actual client account. Asset allocation in client accounts may vary based on individual client considerations and market fluctuations. The allocation of assets in the model portfolio may be changed from time to time due to market conditions and economic factors. The investments held by the portfolio are ETFs and are not guaranteed and do carry a risk of loss of principal. There are investment risks in investing in these strategies. Each asset class has specific risks associated with it and no specific asset class can prevent a loss of capital in market downturns. In a rising interest rate environment, the value of fixed income securities generally declines. Speculative grade bonds are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities. Investments in international and emerging market securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. The real estate asset class is a portfolio containing Real Estate Investment Trust (REIT) securities.

Confluence utilizes fixed income ETFs for the bond asset classes to deliver the income and lower volatility traditionally available from a diversified bond portfolio. Fixed income ETFs are not bonds, but are pro-rata interests in publicly traded bond funds. Investors should be aware there are limitations in utilizing fixed income ETFs, which are subject to market risk, including the possible loss of principal. There may be times when an ETF's performance may vary relative to its targeted benchmark. And while ETFs generally trade very close to their net asset values, during times of market disruption they can trade at discounts or premiums, directly affecting performance. Liquidity can vary depending upon market conditions. ETFs trade like a stock but charge internal management fees; there will be brokerage commissions associated with buying and selling exchange traded funds unless trading occurs in a fee-based account. Investors should consider an ETF's investment objective, risks, charges, and expenses carefully before investing.

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.

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Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri, that provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates evaluation of market cycles, macroeconomics and geopolitical analysis with the firm's value-driven approach. The investment team's portfolio management philosophy begins by addressing risk and follows through by positioning clients to achieve income and growth objectives.

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