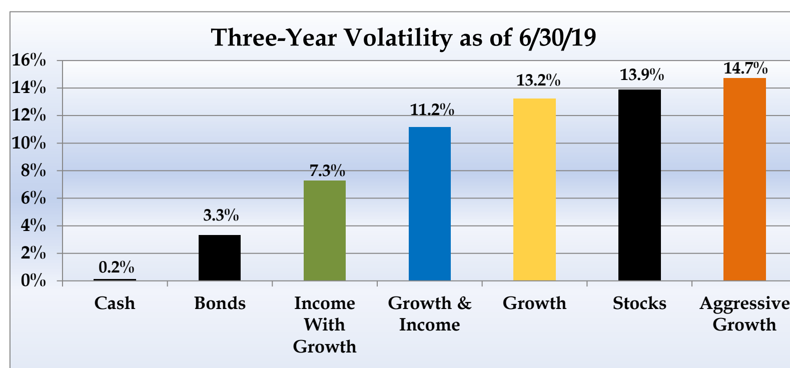
Asset Allocation Quarterly
Third Quarter 2019

The Confluence asset allocation process is centered upon risk management. Our asset allocation strategies offer a broad spectrum of risk profiles, ranging from a relatively conservative posture in Income with Growth (green) to a more risk-tolerant profile in Aggressive Growth (orange). The primary asset classes of cash, bonds, and stocks are illustrated by the black bars for reference in the accompanying chart.



Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index.*

We recognize that risk levels and return potential rise and fall over market and economic cycles. Therefore, we apply an adaptive process, one that evaluates the economy, monetary and fiscal policies, interest rates, regulation, valuations, and other investment variables in a forward-looking context. Although we seek return opportunities, we do so with a consideration for the amount of risk taken to pursue these returns.

The asset allocation strategies are structured across an array of risk profiles, where the more conservative lean against potential volatility and accept more muted, though steadier, returns, while the more aggressive accept inherent volatility in the pursuit of potentially higher returns.

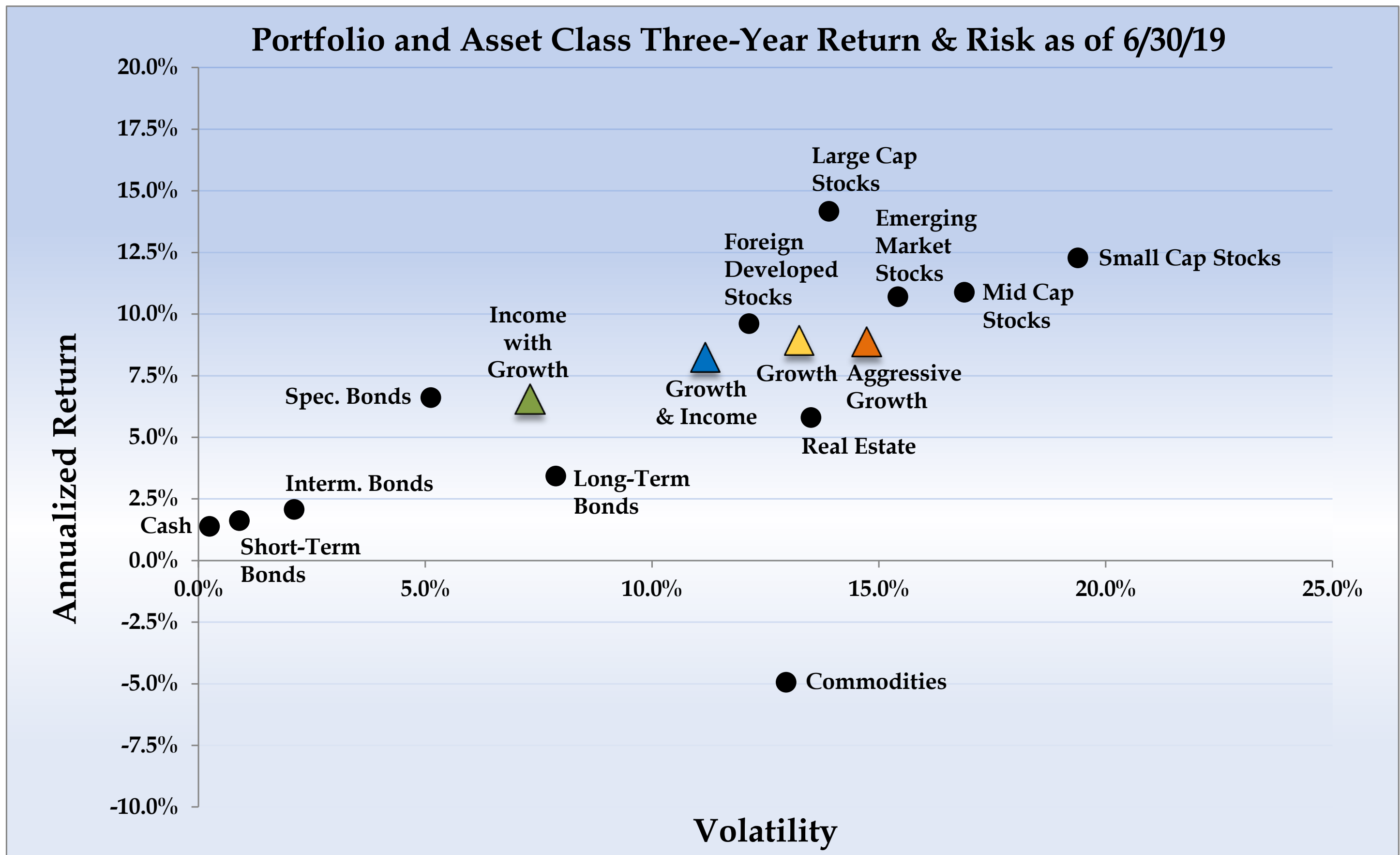
As the following table exhibits, return variance among asset classes from quarter-to-quarter can change dramatically. Over the past three years, we have witnessed healthy gains from U.S. equities, punctuated by a sizable retreat in the fourth quarter of last year. Similarly, bonds have generally enjoyed solid returns, particularly in the first half of this year. Although long-term bonds recorded a substantial loss in late 2016 and struggled through the early part of last year, they have generated outsized returns thus far this year. Non-U.S. developed and emerging market equities were propelled by favorable valuations and a weaker U.S. dollar in 2017, but the strengthening dollar over the past 18 months has been a headwind.

Quarterly Asset Class Returns as of 6/30/19

	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019
Cash	0.10%	0.09%	0.10%	0.20%	0.26%	0.28%	0.35%	0.45%	0.49%	0.56%	0.60%	0.64%
U.S. Short-Term Bonds	0.03%	-0.38%	0.39%	0.30%	0.34%	-0.18%	-0.19%	0.29%	0.35%	1.17%	1.22%	1.49%
U.S. Intermediate-Term Bonds	0.46%	-3.91%	1.26%	1.67%	0.94%	0.03%	-1.86%	-0.38%	0.21%	1.97%	3.79%	3.94%
U.S. Long-Term Bonds	0.90%	-8.37%	1.76%	4.17%	1.46%	2.66%	-3.46%	-1.23%	-0.67%	1.25%	6.17%	6.45%
Speculative Grade Bonds	5.49%	1.88%	2.71%	2.14%	2.04%	0.41%	-0.91%	1.00%	2.44%	-4.67%	7.40%	2.57%
REITs	-1.43%	-2.89%	1.16%	1.52%	0.94%	1.51%	-8.20%	10.04%	1.23%	-6.73%	16.33%	1.24%
U.S. Large Cap Stocks	3.85%	3.82%	6.07%	3.09%	4.48%	6.64%	-0.76%	3.43%	7.71%	-13.52%	13.65%	4.30%
U.S. Mid-Cap Stocks	4.14%	7.42%	3.94%	1.97%	3.22%	6.25%	-0.77%	4.29%	3.86%	-17.28%	14.49%	3.05%
U.S. Small Cap Stocks	9.05%	8.83%	2.47%	2.46%	5.67%	3.34%	-0.08%	7.75%	3.58%	-20.20%	14.58%	2.10%
Non-U.S. Developed Stocks	6.43%	-0.71%	7.25%	6.12%	5.40%	4.23%	-1.53%	-1.24%	1.35%	-12.54%	9.98%	3.68%
Emerging Market Stocks	9.03%	-4.16%	11.45%	6.27%	7.89%	7.44%	1.42%	-7.96%	-1.09%	-7.46%	9.91%	0.61%
Gold	-0.74%	-12.70%	8.22%	-0.77%	3.09%	1.87%	0.95%	-5.49%	-5.00%	7.24%	0.91%	9.01%

Source: Morningstar Direct, CIM.*

*This information is presented as supplemental information to the disclosures required by GIPS® standards.
See page 6 for asset class composition/benchmark details and other important disclosures.



Source: Bloomberg, CIM, using monthly data and gross returns.*

Portfolio and Asset Class Commentary

The chart above depicts the risk, as measured by the volatility of returns, and the annualized total return for 12 asset classes as well as the composite performance (gross-of-fees) for our asset allocation strategies over the rolling three-year period ending June 30, 2019. While positive returns have been generated by almost all of the primary asset classes over the course of the full 36 months, with the exception of Commodities, the annualized returns mask quarter-to-quarter volatilities. Volatility, as measured by standard deviation, has been much higher for equities than bonds.

The returns and risk of the Confluence strategies, represented by the colored triangles, were predominantly influenced by their respective exposures to the major asset classes of bonds and stocks. Given the advances of the stock market over the past three years, the Confluence Income with Growth strategy, which had the largest exposure to bonds, exhibited the lowest level of return, yet with a lesser degree of volatility. The Growth and Aggressive Growth strategies were allocated almost exclusively to stocks over the past three years and, consequently, both returns and risk were elevated in these strategies.

Beyond the allocations to bonds and stocks, a significant influence on the relative returns and risk for each strategy was the allocation to sub-asset classes. As an example, Large Cap Stocks and Real Estate had roughly equivalent volatility yet a wide differential of return. Exposure to Real Estate in lieu of Large Cap Stocks would have yielded a lower return over the past three years, but with a similar level of volatility. The aggregation of the stock/bond mix and the shifting exposures to sub-asset classes within the respective mix led to the location of each strategy along the return/risk continuum. Over the past three years, the four Confluence asset allocation strategies all conformed to the expectation of higher volatility with the greater assumption of risk.

Our three-year cyclical forecast calls for a continuation of a positive economic environment, albeit with more subdued growth, which should reward risk assets. We regularly reassess and review data that can affect our macroeconomic outlook and should we find a shift in market sentiment, an increase in the potential for a policy mistake by the Fed, a higher probability for a recessionary environment, a pronounced disruption to global trade, and/or magnified geopolitical risk then we will naturally adopt a more risk-averse posture for all of the strategies.

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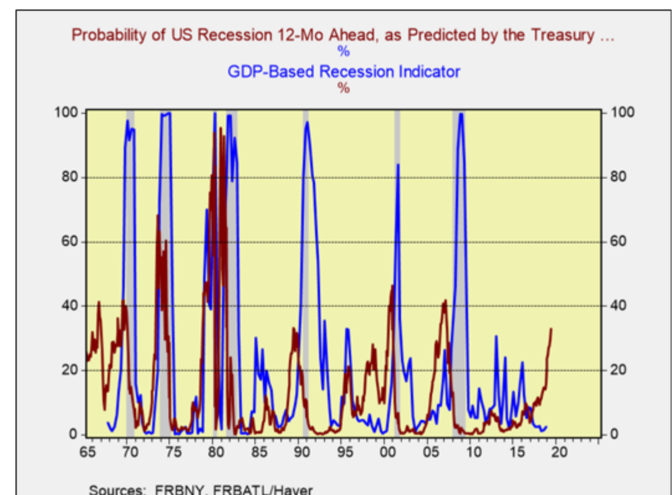
Third Quarter 2019 Asset Allocation Outlook

- **We maintain our sanguine view of the economy and markets, though it is more guarded than last quarter.**
- **We expect the Federal Reserve to implement easier policy in the third quarter, marking its first rate reduction since 2008.**
- **In the absence of a recession, which is not in our forecast, the rate reduction should lead to a healthy environment for U.S. equities.**
- **Although economic weakness abroad is forecast to persist in the near-term, such weakness will only modestly impact the U.S. economy.**
- **The Fed's accommodation and our expectations for continued, albeit muted, U.S. growth encourages our decision to maintain historically high allocations to U.S. equities in the strategies.**

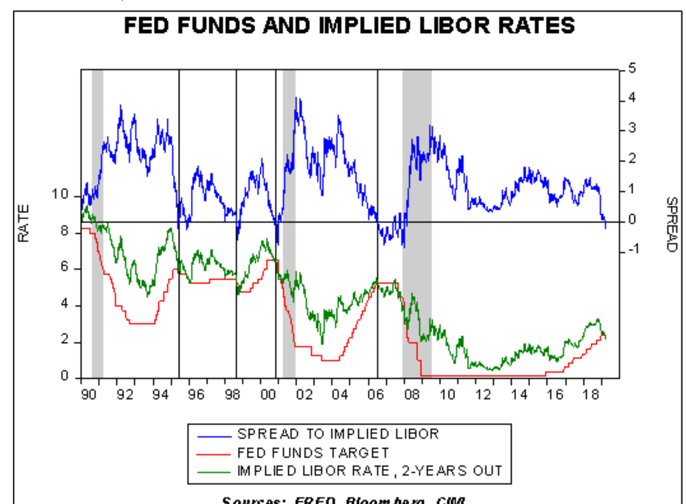
Economic Viewpoints

Although several indicators show increased potential for a recession and several metrics have softened, our consensus forecast is that recession in the U.S. is not imminent, and the economic expansion, already in record territory,[1] may continue beyond our three-year forecast period. While some factors, such as the inverted yield curve, the two-year forward LIBOR rate lower than fed funds, and softening in the composite index of 10 leading indicators, have led to an increase in the probability of a recession, this rise is from a level that was close to zero several months ago. Our expectation is that the Fed will be successful in engineering a soft landing, or at least forestalling a recession. One of the principal arguments for our anticipation of continued, albeit muted, growth is the lack of excesses that exist in the economy. Credit creation, housing values, and equity valuations are certainly elevated relative to the depth of the Great Financial Crisis a little over 10 years ago, yet are far from being stretched. Moreover, the Fed retains some room for maneuvering that can assist in its efforts to maintain the expansion, inclusive of further rate cuts and curtailment of its balance sheet reduction.



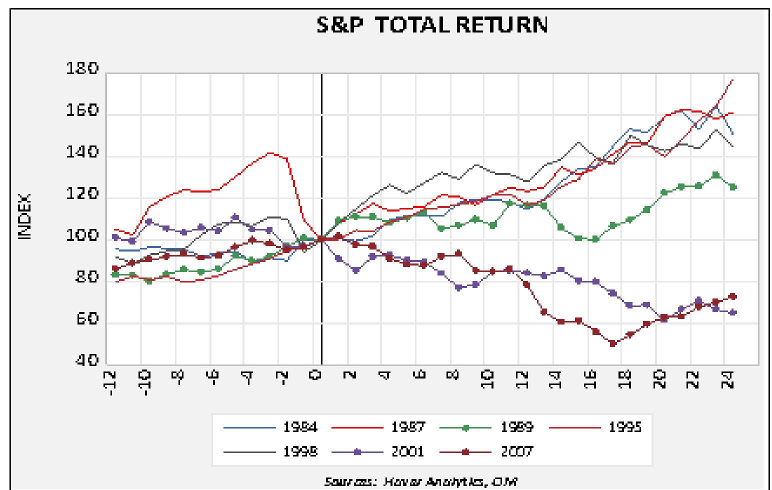
Beyond the U.S., significant leadership and economic uncertainties remain unresolved for the balance of the year. These include the probability of a hard Brexit, Christine Lagarde's ability to steer the European Central Bank, Italy's flirtation with broaching the EU's fiscal rules, the new German chancellor, the replacement of Mark Carney as governor of the Bank of England, the potential for a large reduction in the Bank of Japan's quantitative easing, and the ability of the People's Bank of China to continue stimulus measures. Though difficulties beyond our shores can impact the U.S. economy, as the global hegemon it is unlikely that a global slowdown, or even a recession in certain jurisdictions, would cause a recession in the U.S.

The U.S. economy continues to grow, albeit at a muted pace relative to its long-term average. Given the absence of overt inflationary pressures, the Fed is likely to lower the fed funds rate at its meeting in the third quarter, marking its first reduction since 2008. The elevated level of fed funds relative to the implied LIBOR rate, two years deferred, is supportive of a rate reduction as the Fed attempts to engineer a soft-landing in a fashion similar to 1997.



[1] Assuming this is confirmed by the National Bureau of Economic Research, Inc.

Stock Market Outlook



In every instance following an initial reduction in the fed funds rate that was not accompanied by a recession, equity investors were rewarded. However, as the accompanying chart indicates, each business cycle has its own unique characteristics. Those cycles where the initial reduction in fed funds were concurrent with a recession are indicated by dots on the associated lines.

Our position is that the accommodative posture of the Fed will continue to propel the economy and risk-based assets through the end of this year and into next year's election cycle. In addition, our estimates for S&P 500 earnings are $157.30 in 2019, increasing to $161.32 for 2020.[2] Obviously, a 2.5% increase is far from a cause for celebration, but it does represent an improvement from year-over-year declines recorded over the first half of 2019. Additionally, such growth corresponds with our consensus forecast for positive, though muted, GDP growth. Nevertheless, the potential for a policy mistake, intensifying trade impediments, or building inflationary pressures necessitate vigilance and the willingness to trim equity exposure should conditions warrant.

All risk assets within the strategies remain in the U.S. As noted in the **Economic Viewpoints** section on the previous page, we remain cautious on non-U.S. exposure over the near-term. Although relative valuations are promising, the range of uncertainties encourage our purely domestic exposure. Within investing styles, we maintain our neutral posture between value and growth. Among sectors, Industrials, Technology, and Materials continue to be overweight. While the allocations to equities remain at historically high levels in the strategies, with an overweight to lower capitalization stocks, we trimmed a portion of the small cap position in three of the strategies in favor of increasing the exposure to mid-caps in all strategies. The rationale for this change is due to our view that the latter stages of an economic cycle coupled with pronounced M&A activity is normally favorable for mid-cap stocks.

[2] Using Standard and Poor's method of calculating operating earnings

Bond Market Outlook

The prospect for an increasingly accommodative Fed going into the election season guides our view that the yield curve will return to its traditional slope over the course of the year, principally through a reduction in short-term rates. Through our full three-year forecast period, we are positive on longer term rates as long Treasuries have significantly attractive yields relative to those from other developed countries. Though we have some concerns regarding the nearly $5 trillion in corporate debt maturing before 2023, this concern is offset by the $12 trillion of bonds outstanding globally with negative yields, representing 24% of the global bond market. This fact supports the notion of an adequate appetite for the maturing investment grade corporate credits. In the speculative bond space, however, we expect spread widening over the full forecast period owing to a slower economy being less supportive of lesser rated bonds.

The duration of bond holdings in the strategies with income objectives has been extended slightly accruing from our forecast for an accommodative Fed, a slowing economy, lack of inflationary pressure, and global demand for bonds. We retain the laddered structure as a nucleus beyond the short-term segment in these strategies.

Other Markets

Although REITs have enjoyed outsized returns thus far this year, our forecast for rates combined with a lack of excesses in the commercial real estate segment leads to our sanguine view on REITs. Thus, the small exposure remains in the Income with Growth strategy due to the diversified income stream that REITs provide.

Gold is retained at a modest allocation given its ability to offer a hedge against geopolitical risks combined with the safe haven it can afford during an uncertain climate for the U.S. dollar.

Third Quarter 2019

	Income With Growth		Growth & Income		Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Cash	2%	-	2%	-	2%	-	2%	-
Short Term Bonds	-	-	-	-	-	-	-	-
Intermediate Term Bonds	7%	(5%)	5%	-	-	-	-	-
Long Term Bonds	25%	5%	10%	-	-	-	-	-
Speculative Grade Bonds	-	-	-	-	-	-	-	-
Real Estate	5%	-	-	-	-	-	-	-
U.S. Large Cap Stocks	33%	-	35%	-	45%	-	20%	-
U.S. Mid Cap Stocks	25%	-	35%	5%	35%	10%	53%	15%
U.S. Small Cap Stocks	-	-	10%	(5%)	13%	(10%)	20%	(15%)
Foreign Developed Country Stocks	-	-	-	-	-	-	-	-
Emerging Market Stocks	-	-	-	-	-	-	-	-
Commodities	3%	-	3%	-	5%	-	5%	-
Total	*100%*		*100%*		*100%*		*100%*	

See page 6 for disclosures and important details regarding portfolio allocations.

Income with Growth

The sole change in the Income with Growth strategy was a 5% reduction in intermediate-term bonds in favor of increasing long-term bonds to 25%. We retain the laddered structure in the remaining intermediate-term bond exposure and an emphasis on long-term Treasuries occupies the longer end. Speculative grade bonds continue to be absent and we maintain the 5% allocation to REITs for their diversified income stream. The strategy's historically high equity allocation persists with an outsized weight to mid-cap stocks, where we find valuations attractive relative to large caps and believe mid-caps offer advantages in the latter stages of an economic cycle. We maintain the modest 3% weighting to gold for its potential to reduce overall risk accruing from geopolitical uncertainty and its attractiveness in the event of a decline in the U.S. dollar.

Growth & Income

The only change in the Growth & Income strategy was a 5% reduction in small cap stocks, which was used to increase mid-cap stocks to 35%. Although we retain a position in small caps, we find the advantages offered by mid-caps in the latter stages of an economic cycle to warrant the increased exposure. Within the bond segment, the bond ladder still serves as the intermediate exposure and the long-term allocation has a decided tilt to longer dated Treasuries. The overall duration remains lengthened owing to our expectations for a return to a normally sloped yield curve with rate compression across maturities. We retain the historically high allocation to stocks, resulting from our forecast for an accommodative Fed and continued earnings growth, albeit at more muted levels. We maintain the modest 3% weighting to gold as a hedge against geopolitical risks and due to the opportunity it affords against a potentially weaker U.S. dollar.

Growth

We reduced exposure to small cap stocks in the Growth strategy in favor of mid-caps, which now sit at a historically high level of 35%. This change was enacted due to our view that the latter stages of an economic cycle, coupled with expectations for continued elevated levels of M&A activity, produce an advantage for mid-cap stocks. The neutral split between growth and value remains, and the Industrials, Technology, and Materials sectors continue to be overweight within the large cap allocation. The Industrials overweight underscores our thesis for an advancing equity market caused by a docile Fed and continued corporate profitability, while we favor Technology due to its potential in the latter stages of the economic cycle. We find Materials attractive based upon valuations and expectations for normalization in natural gas prices, which have substantial influence on the Materials sector. Mid-cap and small cap stocks now represent 35% and 13% of the strategy, respectively. We retain the 5% gold allocation as a hedge against geopolitical risks and due to its attractiveness should the U.S. dollar experience weakness.

Aggressive Growth

The Aggressive Growth strategy retains its maximum exposure to U.S. stocks given our forecast for a dovish Fed and continued improvement in corporate profitability for the balance of this year and through 2020. The one change was a reduction in small cap exposure by 15%, which we redeployed in mid-caps. The heightened allocation to mid-caps stems from our expectations for continued high levels of M&A activity coupled with attractive valuations relative to large caps. The growth and value style bias remains neutral across all three market capitalizations. Among large cap sectors, the overweight to Industrials, Technology, and Materials is unchanged. The Industrials overweight underscores our thesis for an advancing equity market, while we find Technology to be a benefit in the latter stages of an economic cycle. The Materials overweight stems from attractive valuations and expectations for normalization in natural gas prices, which have an outsized effect on the Materials sector. We retain the 5% gold allocation as a hedge against geopolitical risks and for its return potential should the U.S. dollar decline in value.

Performance & Disclosures

as of 6/30/19

Strategy	ITD	10 - Year	5 - Year	3 - Year	1 - Year	YTD	Quarter
Income Taxable with Growth - Gross of Fees	9.7%	9.2%	6.3%	6.5%	10.2%	13.1%	3.8%
Income Taxable with Growth - Net of Fees[1]	6.5%	6.0%	3.2%	3.4%	7.0%	11.4%	3.0%
Benchmark - 40% S&P 500 and 60% ML Bond Index	8.4%	8.3%	6.2%	7.1%	9.5%	11.3%	3.8%
Growth and Income Taxable - Gross of Fees	7.1%	10.2%	7.1%	8.3%	4.7%	14.9%	3.7%
Growth and Income Taxable - Net of Fees[1]	4.0%	6.9%	3.9%	5.1%	1.6%	13.1%	2.9%
Benchmark - 70% S&P 500 and 30% ML Bond Index	8.7%	11.6%	8.5%	10.7%	10.1%	14.9%	4.1%
Growth - Gross of Fees	7.0%	10.8%	7.3%	9.0%	3.8%	15.5%	3.3%
Growth - Net of Fees[1]	3.8%	7.5%	4.1%	5.7%	0.7%	13.8%	2.6%
Benchmark - S&P 500	10.3%	14.7%	10.7%	14.2%	10.4%	18.5%	4.3%
Aggressive Growth - Gross of Fees	6.8%	10.5%	6.4%	8.9%	1.3%	15.2%	2.9%
Aggressive Growth - Net of Fees[1]	3.7%	7.2%	3.2%	5.7%	-1.7%	13.4%	2.2%
Benchmark - S&P 500	10.4%	14.7%	10.7%	14.2%	10.4%	18.5%	4.3%

ITD: Inception-to-Date. Inception: Income with Growth (12/1/08), Growth & Income (9/1/08), Growth (9/1/08), Aggressive Growth (8/1/08).

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.

[1]Net of fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly. This fee includes brokerage commissions, portfolio management, consulting services and custodial services. The Confluence fee schedule for this composite is as follows: 0.40% on the first $500,000; 0.35% on the next $500,000; and 0.30% over $1,000,000. There are no incentive fees. Clients pay an all-inclusive fee based on a percentage of assets under management. The collection of fees produces a compounding effect on the total rate of return net of fees. Bundled fee accounts make up 100% of the composite for all periods. Actual investment advisory fees incurred by clients may vary. Wrap fee schedules are provided by independent wrap sponsors and are available upon request from the respective wrap sponsor.

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 7/17/2019 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.

*Benchmark return and volatility calculations utilize monthly data thru 6/30/19. Investors cannot invest directly in an index. Past performance does not guarantee future performance. Asset class and benchmark index representation: cash (ML T-Bill); short-term bonds (ML 0-3 Year C/G); intermediate bonds (ML 3-5 Year C/G); long-term bonds (ML 10+ C/G); speculative grade or high-yield bonds (ML High Yield Master); real estate (FTSE NAREIT Equity); large cap (S&P 500); mid-cap (S&P MidCap 400); small cap (Russell 2000); foreign developed country (MSCI EAFE); emerging markets (MSCI Emerging Market); commodities (S&P GSCI Total Return).

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