January 2016

The turning of the annual calendar occasions all sorts of prognostications in our profession. We prefer not to think in terms of forecasts, but rather in terms of probable scenarios. All sorts of things are *possible* in 2016, but not all scenarios are equally *probable*. For example, a great many purveyors of gloom and doom are forecasting that the U.S. dollar will cease to be the world's primary reserve currency in the near future. These prognosticators speak of it as an inevitability and trouble the souls of many with the supposed dire results (although I believe they misinterpret the implications of such an event). The issue is not that this event is not *possible* (it is), but that it is of very low *probability*. In fact, we regard the probability of that occurrence as extremely low, not just within the next year, but within the next several decades.

There are a great many negative scenarios one may construct for the coming year, but those we need to be on guard for are those that have some real probability attached to them. In October I wrote to you that there were three problems that really matter to investment portfolios: 1) high levels of consumer debt, 2) decelerating growth in China and the emerging markets, and 3) Federal Reserve (Fed) intentions to raise short-term interest rates. Since then, the third concern has shot to the top of the list.

In December the Fed raised the fed funds rate by 0.25% and indicated it has plans to raise it further. The U.S. economy is growing slowly and foreign economies are struggling due largely to the first two problems listed above. With growth sluggish and inflation very low, we are concerned that the Fed is committing an unforced error. Unlike the hand-wringing we see about the dollar's reserve status, this is a potential problem that has real probability. A single quarter-point increase won't slow the economy dramatically all by itself, but markets have a way of compressing into the present what they think will happen in the future. If longer term interest rates, which are set by the market, not the Fed, rise too quickly, the economy could stagger. Thus, what is important is not that the Fed raised rates a little, but what the market thinks their intentions are for the future. Here the Fed may be able to moderate the effects of its error by being very slow to raise rates in the future, or maybe by stopping the tightening process altogether. We still regard the likelihood of recession in the next year or two as small, but we are vigilant in our reconnaissance.

How does an investor protect his or her portfolio from such risks? There is no such thing as portfolio insurance, but it is possible to soften exposure to business cycle risk and interest rate risk in the construction of portfolios. Our job as investment managers is not to "bury your money in a coffee can in the back yard," but to take the steps we believe promote reasonable returns for your portfolio in the light of the negative scenarios that may have a measure of *probability*.

Each year starts with both promise and trepidation. But, as we've noted before, "*Worrying* is a major part of the job."

As always, we appreciate your confidence.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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