January 2017

2016 was full of surprises, and we expect that 2017 will be just as surprising. As we discussed in last quarter's letter, the job of an investment manager is to navigate the world that *is*, not the world that *we would like to have*. Thus, rather than try to correctly predict what will happen next (an impossible task), we need to think through all the probable outcomes and be ready for whatever happens next. For instance, we have a policy mix in Washington, D.C. that not many predicted just a few months ago: a Republican president *and* Republican control of both houses of Congress. But the Republican president is not your "standard issue" Republican hard money, free-trading supply-sider. He is an apparent populist, who, as such, likely favors easy money, exports over imports, and policies that benefit domestic employment over capital. This is a policy mix we haven't often seen in modern American history. What will be the impact on financial markets if policies move in this direction?

As we have noted in many of our commentaries, policies that roll back trade globalization, even a little bit, will likely result in higher inflation, simply because in this scenario the prices of imported goods would rise. Such higher prices would permit the prices of domestic goods to rise also as foreign competition would be less onerous. If successful, such policies are not all bad: the goal would be for these higher prices to permit more production in the U.S., which means more domestic employment and more sales and earnings for U.S.-based companies. The downside would be higher inflation in the U.S., which would result in higher interest rates on bonds and lower price/earnings ratios for equities. Commodity prices would likely respond well to this policy mix, but foreign producers of goods, especially emerging markets, would suffer.

Will all these things happen? We don't know, but these policy proposals would be quite a break from those of all administrations of the last 40 years, Republican or Democrat. Thus, they have the potential to change financial markets by a little or a lot, depending on how (and by how much) they are implemented. Indeed, the bond market has sold off sharply since the election, resulting in higher interest rates. The stock market has risen during this time, likely on expectations of higher growth ahead (a common post-election reaction).

There is often a trade-off between low inflation and broad-based economic growth. As investors, we interpret the events of the presidential campaigns just concluded (in both parties) to mean that the American public has decided that the benefits of low inflation are not worth the low earnings power that is the experience of most American workers. That is a sea change. We don't say that lightly.

How would we manage our portfolios differently if these changes occur? The leadership of Confluence started their careers in the high-inflation days of the 1970s and early 1980s and, as a result, our methodologies incorporate a respect for rising inflation. Since the guiding principle of our equity investment philosophy is that we target companies with powerful competitive advantages that result in pricing power, the companies we seek to invest in have the ability to raise prices (when necessary) with less push-back from customers than average businesses. This ability to raise prices is an important reason why such businesses are good hedges against inflation. We also seek to invest in companies that possess excellent management talent. Adept managers can respond to changes in the economic and policy climates, which is why well-chosen stocks can generally outpace bonds and other fixed-rate investments in a rising inflation environment. Of course, rising inflation would bring valuation headwinds, and thus we must stay true to our valuation discipline.

In general, on the fixed income side of our portfolios, we would keep our durations shorter than we have in years past. The potential for higher rates in the future would lead us to protect capital by avoiding low-coupon, long-term bonds. We will also tend to favor credit risk in fixed income as inflation will lower the real debt service cost for corporate borrowers. We're not sure how policies might change or how all this will work out, but we are watching it closely and will respond to meaningful changes accordingly.

One thing never changes in the investment business: the world will surprise you, so prepare for it. Our wish for you is a Happy and Healthy New Year!

Thank you for your confidence in us.

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.