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It's terribly hot here in the Midwest. It wouldn't be a normal Missouri summer if it didn't touch 100 degrees for a week or two. As uncomfortable as it is, what makes it tolerable is the knowledge that in a couple of months the brutal heat will have left us and a beautiful autumn will be beginning. We know this will happen because we think *cyclically* about the weather. We know that the weather runs in cycles and that when it reaches extremes, we can rest in the knowledge that it will revert back to the mean again, and then back to the other extreme. We have learned to think cyclically about the weather because: 1) we have learned by *experience* that the seasons run in cycles, and 2) the cycles are regular enough that we know to expect a reversal when the temperatures reach 100.

It's my observation that very few people think that way about the economy or the financial markets. Most people think about the economy and the stock market in a *linear* fashion, that is, they believe that the economy moves in a straight line indefinitely, usually upward sloping. If it goes down substantially, the conventional wisdom is that something very bad has happened, or that something like a financial accident has occurred. Usually, people look for someone on whom to blame this financial disaster. Even more amazing, once a downtrend is in place, many people begin to think of *that* linearly as well. "The market is going down and it will never get better," they think. The possibility that financial ups and downs are cyclical, perhaps not as regular as the seasons, but cyclical nonetheless, rarely enters the mind.

It's not just average people who think linearly about the economy and the financial markets, many professionals, including economists, think this way as well. When the next recession comes along, just watch how many economists are introduced to tell us exactly who is at fault for allowing this terrible thing to happen. Here at Confluence we are big fans of the late economist Hyman Minsky (1919-1996), and not just because he taught at Washington University in St. Louis for 25 years. At a time when many economists thought that the economy could and should be managed for optimal and long-lasting growth, and that recessions could be avoided, Minsky taught what he called the *financial instability hypothesis*. Essentially, he taught that financial instability was inherent in the system, "that the financial system swings between robustness and fragility and these swings are an integral part of the process that generates business cycles." In other words, the swings between strength and fragility in the financial system are normal and cyclical.

The idea is really quite simple: the longer times are good, the more people will begin to think the economy will *always* be good, and the more likely they will make financial decisions that are inherently risky, such as take on additional debt. Eventually all these risky actions accumulate as a great burden on the economy, people can't pay their debts and the economy cycles in the other

direction for a little while. Once excessive debt is liquidated, the economy starts back the other way. Because the economic and market cycles are not as regular as the seasons, people have a hard time recognizing them. Because policy-makers in Washington (such as the Fed) try to ameliorate the cycles and make the good times last longer, people begin to think that economic cycles have been "outlawed."

We think that the cyclical nature of people's behavior and, thus, the economy, is baked into the way the financial world works. Therefore, we analyze the cyclical nature of the economy, and the effect of those cycles on various asset classes and on the stocks of various companies. This doesn't mean we can predict the future, but we believe that approaching the economy and the markets under the correct framework (cyclical versus linear) is essential to mitigating the risk of being wrong.

We appreciate 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.