July 2018

The "choppiness" of the stock market, of which we wrote last quarter, continues. Even though the U.S. stock market, as represented by the S&P 500, has been working its way upward since early April, it still stands 2.6% below its high for this year (reached on January 26th). As we noted last quarter, this market action is completely normal and even somewhat welcome for a market that had barely paused in its upward climb for almost two years prior to the recent sell-off. Investors who don't "live daily" with the stock market often think in terms of stable rates of returns. Experienced equity investors know that stock prices (and stock returns) are lumpy, even if the earnings and dividends of the underlying companies are relatively stable.

This "lumpiness" is called "volatility" by many analysts, and there is really no way to avoid it once you have decided you want to invest in stocks; it goes with the territory. Yet a wise investor can make use of this volatility. By both recognizing its existence *and* expecting it to occur, an investor can use volatility to gain advantage by targeting stocks to buy when the volatility is downward (when stocks "go on sale") and selling some stocks when the volatility is upward. This same approach is useful in the management of all financial assets and, indeed, *all* asset classes used in our Asset Allocation portfolios.

Recent volatility appears to have derived from a combination of Fed tightening (interest rate increases) and administration trade policy changes. We've recently been receiving lots of questions about rising tariffs and the impact of potential trade wars. This is a topic that requires historical analysis, because no one working in our industry today has direct experience investing during a time of generally rising tariffs and trade barriers. The last such period was the 1920s and 1930s. Rising trade barriers do affect the values of financial assets, but perhaps not in the ways you would expect.

Industries that are the targets of tariffs may be directly affected either positively or negatively, depending on "which side of the knife" they're on. But these direct effects tend to be short term in nature and simply add to the market volatility that we try to take advantage of. The more important effect of trade barriers is longer term, one that eventually appears if the barriers remain in place for years. That effect is *inflation.*

It is not an accident that we have experienced 38 years of declining inflation during 38 years of steeply declining trade barriers. The more global trade is unhindered, the greater the supply of goods to U.S. consumers; and the greater the supply is relative to demand, the lower the prices are. It's as simple as that. Reverse the process, i.e., hinder trade and reduce the supply of goods to U.S. consumers, and prices should rise if demand remains the same. That rise in prices is inflation, and inflation pressures interest rates up and the value of financial assets down.

In light of that, why would anyone want to hinder trade? Because not everyone is an investor. In fact, many more people are workers than are investors, and that increased supply of foreign goods displaces domestically produced goods and the jobs that go with them. After a multi-decade trend in one direction, many people have just presumed that this was the way the world should be. A sense of history, however, tells you that long-term trends usually sow the seeds of long-term trends in the opposite direction. If you've been reading our Daily Comment (www.confluenceinvestment.com/research-news/) for any length of time, you are aware that this is a matter we've been concerned about for years.

I've often described investing in a rising inflation environment as something like running up the down escalator: it can be done, but it's just a lot harder than going up stationary stairs at the same speed. And it's not nearly as easy as simply riding up the up escalator! In all honesty, investing in a declining inflation environment is a little like running up the up escalator: investors do better than they expected to do. We at Confluence are acutely aware of the dangers of inflation and its impact on *all* financial assets, in both our Equity and Asset Allocation portfolios. In fact, we're old enough to remember that kind of world! Since many of us here started our careers during the high-inflation days of the 1970s and early 1980s, our methodologies incorporate a respect for rising inflation. We're not certain that is what lies ahead for investors, but we will be ready if it does.

We don't get to manage investments in the world we wish we had, we must manage them in the world we have.

We appreciate your confidence in us.

Sincerely,

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.