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In my last letter I wrote of the tendency of investors to think of the economy and the markets as linear phenomena, rather than cyclical phenomena. In other words, an inclination to think that a good economy will continue its upward path forever unless some villain intercedes and causes a recession. However, at Confluence we believe that both the economy and markets are cyclical because they are the products of human behavior, which always tend toward extremes, extremes which sow the seeds of their own reversals. This quarter I'd like to call your attention to another fallacy of thought that many investors fall prey to: "fighting the last war."

If you left the gate to your backyard open and your dog ran away, it's natural for you to fear that that might happen again. Thus, you'll worry greatly about it and be extraordinarily vigilant about locking the gate ever after, such that it's most unlikely your dog walks out of your open gate again. It is more likely, however, that he gets out of the yard some other way that you haven't thought of.

Investors are unusually well attuned to how the last bear market unfolded, and take measures to make sure they are not injured in that manner again. Usually, however, the next bear market unfolds in an entirely different fashion and catches most investors unaware. Citizens and politicians also take measures to "cure the ills that led to the last recession," which unfortunately often leaves them unprepared for the next recession that unfolds quite differently.

As investors, it's important to study the history of the economy and markets, not just that of the last ten or twenty years, but of the last several centuries. There are many ways that recessions can unfold and there are many types of bear markets. The same type of recession rarely strikes twice in a row and two identical bear markets usually don't occur back-to-back. One must be vigilant to *all* the possible ways the economy can get into trouble and look for *all* kinds of impending trouble.

I mention these things because in my recent travels visiting many clients in all parts of the country, I've been hearing a constant theme: fear of a return to the travails of 2008-09, when the economy hit a major recession and stock indices fell more than 50% over 18 months. While I believe it's inevitable that we'll have a recession again in the next several years, I'm fairly certain it won't look anything like 2008-09. Why? The last recession was driven by a liquidity crisis of the highest order, i.e., almost nobody, individuals or businesses, had any cash. The real estate bubble of the preceding decade had led everyone to believe that property prices would never decline, thus, "Why hold cash? Put all that money to work!" In fact, legions borrowed lots of money to buy all the property they could. When real estate prices finally fell, everyone (well, almost everyone) was cash poor. People scrambled to sell assets (stocks, bonds, property, you

name it!), raise cash, and pay down debt. This led to a recession as people stopped buying other stuff all at the same time. And, debt reduction has continued for most of the last eight years, which has led to very slow growth since.

Today, even though both real estate and stock prices have recovered, few investors are cash poor. In fact, both data and anecdotal evidence show that investors and institutions (especially banks) are still sitting on “big piles” of cash (that’s not a technical term). In other words, people are not going to let 2008 happen to them again. They have padlocked the backyard gate. Whatever sort of recession occurs next, it’s most unlikely to be similar to the last one.

In fact, fears by so many that a recession and bear market are just around the corner is good evidence that they are not. Recessions and bear markets are usually the product of complacency, not fear. Our economic analysis leads us to conclude that the precursors of recession are not yet visible. And while this bull market is getting old, it doesn’t appear to us to be ready to reverse course. Of course, bad things can go bump in the night and unsettle the world, and we watch for those. But inasmuch as everyone seems to be ready to fight the last war, that last enemy is not likely to show up.

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.*