[Posted: August 7, 2017—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index up 0.7%. U.S. equity index futures are signaling a higher open. With 419 companies having reported, the S&P 500 Q2 earnings stand at $32.60, higher than the $31.42 forecast for the quarter. The forecast reflects a 6.5% increase from Q2 2016 earnings. Thus far this quarter, 72.1% of the companies reported earnings above forecast, while 18.6% reported earnings below forecast.

It's a quiet Monday morning in August. Washington is mostly on recess and families are squeezing out the last few days of summer before school begins. Here are the notable news items.

Sanctions on North Korea: The UNSC voted unanimously to apply further sanctions on North Korea. If fully implemented, they would cut the Hermit Kingdom's trade by about a third. The real surprises were the "yes" votes from China and Russia. We note that China's foreign minister, Wang Yi, had intensive talks with his North Korean counterpart at the ASEAN meetings in Manila over the weekend, calling on North Korea and the U.S. to ratchet down tensions. The Chinese media pressed the U.S. to ease off North Korea as well. Despite these comments from Chinese sources, getting UNSC sanctions approved on North Korea is a major diplomatic win for the Trump administration. We suspect part of China's compliance involved hopes to delay trade tensions with the U.S. Vetoing sanctions would have certainly triggered a U.S. reaction on trade. We also suspect Russia went along because China voted in favor of sanctions. Still, it's a win for the administration; now we will be watching to see if the sanctions are implemented.

Iran's widening reach: The *NYT* carried a report over the weekend that Iran is expanding its influence in Afghanistan by working with the Taliban.[1] Iran has already widened its influence in Iraq as well. Essentially, in areas where the U.S. has fought two wars since 2003 America has failed to build replacement governments for the Hussein regime and the Taliban. Iran is rapidly filling this void. On the surface, Taliban and Iranian cooperation appears odd. The former, a hardline Sunni group, would generally view Shiites as an anathema. However, the key point that is often missed is that Iranians should probably be thought of as Persians first and Shiites second. As Persians, the Iranians are working to expand their influence and are less concerned with religious issues. There is no easy solution to this issue in the Middle East. The Obama administration appeared to have concluded that Iran was going to run the region and thus was

[1] https://www.nytimes.com/2017/08/05/world/asia/iran-afghanistan-taliban.html

willing to cooperate with them; the Trump administration is not comfortable with that position but doesn't really have an alternative to containing Iranian influence.

A coup in Venezuela? Turmoil in Venezuela remains extremely elevated. The newly "elected" body to rewrite the constitution appears to be taking power and opposition leaders are being arrested again. Over the weekend, there were reports of a military uprising. This looks rather suspicious to us; if there was an uprising, it was in the lower officer ranks and this is little evidence of success. Instead, we suspect this was a "false flag" operation of sorts. If the Maduro regime can convince its internal opposition that it faces a potential coup it will tend to solidify support. Thus, it wouldn't surprise us if this was staged. So far, there is no evidence that oil supplies have been affected by the problems in Venezuela.

OPEC meets: The oil cartel is meeting with selected non-OPEC members to monitor quota compliance. As summer comes to a close, we are about five weeks away from the usual seasonal trough in inventories. Although we have seen a drop in U.S. commercial crude oil stockpiles, current levels are not low enough to support prices much higher than current levels. Thus, there are hopes that OPEC can engineer some sort of cuts in output at this meeting. We doubt we will see much other than promises to improve compliance.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Consumer Credit	m/m	jun	$15.25 bn	$18.41 bn	**
	Mortgage Delinquencies	m/m	2q		4.7%	**
	MBA Mortgage Foreclosures	m/m	2q		1.4%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:45	James Bullard Speaks in Washington	President of the Federal Reserve Bank of St. Louis				
13:25	Neel Kashkari speaks at Minneapolis	President of the Federal Reserve Bank of Minneapolis				

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Foreign Reserves	m/m	jul	$3.081 tn	$3.057 tn	$3.075 tn	**	Equity and bond neutral
	BoP Current Account Balance	m/m	2q	$52.9 bn	$18.4 tn		**	Equity and bond neutral
Japan	Leading Index CI	m/m	jun	106.3	104.6	106.2	**	Equity and bond neutral
	Coincident Index	m/m	jun	117.2	115.8	117.2	**	Equity and bond neutral
Australia	AiG Perf of Construction Index	m/m	jul	60.5	56.0		**	Equity and bond neutral
	ANZ Job Advertisements	m/m	jul	1.5%	2.7%		**	Equity and bond neutral
New Zealand	2 Yr Inflation Expectation	m/m	3q	2.1%	2.2%		**	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	jul	27.7	28.3	27.6	**	Equity and bond neutral
Germany	Industrial Production	m/m	jun	2.4%	5.0%	3.7%	***	Equity and bond neutral
UK	Halifax House Prices	m/m	jul	0.4%	-1.0%	0.3%	**	Equity bullish, bond bearish
Switzerland	Foreign Currency Reserves	m/m	jul	714.3 bn	693.5 bn		**	Equity and bond neutral
	CPI	m/m	jul	-0.3%	-0.1%	-0.3%	***	Equity bearish, bond bullish
	Total Sight Deposits	m/m	aug	578.6 bn	579.1 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	aug	479.9 bn	478.9 bn		*	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	131	131	0	Up
3-mo T-bill yield (bps)	105	106	-1	Neutral
TED spread (bps)	26	25	1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.27	2.26	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	25	25	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	down			Neutral
pound	up			Down
franc	down			Down

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$51.84	$52.42	-1.11%	Long Liquidation
WTI	$49.04	$49.58	-1.09%	
Natural Gas	$2.78	$2.77	0.32%	
Crack Spread	$19.19	$19.49	-1.54%	
12-mo strip crack	$17.27	$17.48	-1.20%	
Ethanol rack	$1.71	$1.71	0.38%	
Metals				
Gold	$1,256.64	$1,258.88	-0.18%	
Silver	$16.15	$16.27	-0.73%	
Copper contract	$288.65	$288.50	0.05%	
Grains				
Corn contract	$ 384.50	$ 381.00	0.92%	
Wheat contract	$ 458.50	$ 454.75	0.82%	
Soybeans contract	$ 966.75	$ 956.75	1.05%	
Shipping				
Baltic Dry Freight	1032	1023	9	

Weather

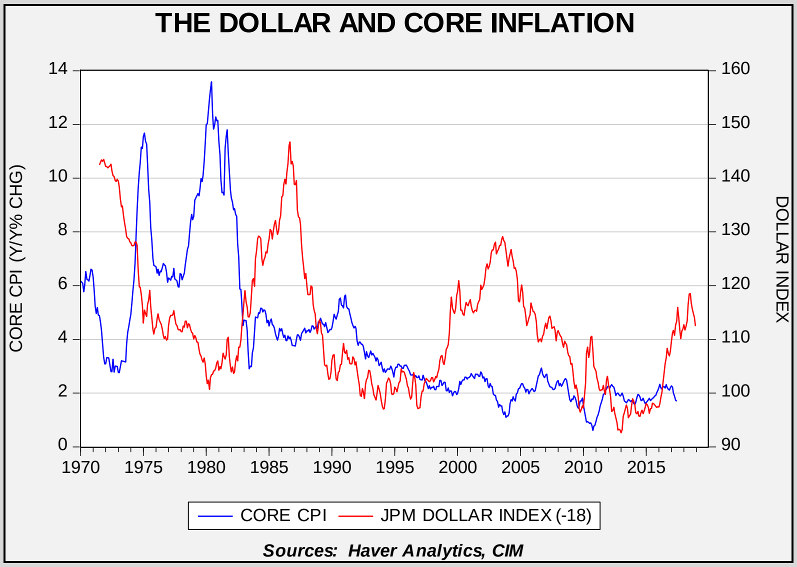
The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, with warmer temperatures expected for the western region. Precipitation is expected for most of the country. TS Franklin is expected to enter the Gulf of Mexico on Tuesday and dissipate by Thursday. Its path will take it across the Yucatan Peninsula tomorrow which will almost certainly affect Mexican oil production. Mexico is the fourth largest supplier of crude oil to the U.S.; it sends around 0.6 mbpd of crude to American shores. Thus, TS Franklin could depress imports and reduce inventories when the inventory data is released next week.

Asset Allocation Weekly Comment

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

August 4, 2017

Two weeks ago, we detailed our expectations for a weaker dollar. If we are correct, one of the potential effects could be inflation. A weaker dollar has two price effects. First, it directly raises import prices. Second, it gives pricing power to domestic firms competing with imports as price pressures should dissipate as import prices rise. The Federal Reserve has struggled with continued low inflation rates as the Phillips Curve models have consistently overestimated inflation. Perhaps dollar weakness will come to the FOMC's rescue and lift price levels, allowing the Fed to raise its policy rate.

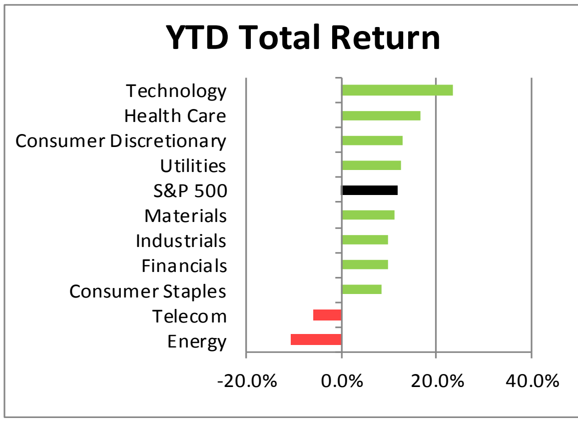


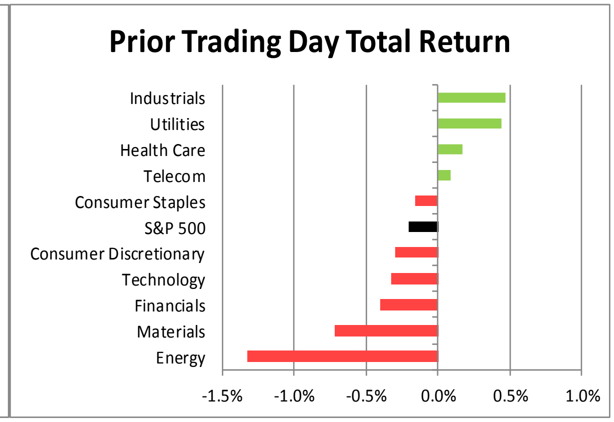
This chart shows the yearly change in core CPI with the JP Morgan dollar index, which is advanced 18 months. A cursory view of the chart does suggest that a rising dollar seems to depress inflation, while a falling dollar seems to have the opposite effect. And, the idea that the dollar's impact takes place over time is consistent with theory. This is because foreign firms will initially try to maintain market share by holding prices steady and face margin compression in a weak dollar period and will only move prices higher over time. The opposite tends to occur during periods of dollar strength as domestic firms attempt to maintain their market share.

However, as much as our eyes see the above pattern, the statistical impact is actually rather weak. The correlation is only a mere 5%. There are clearly other factors that are keeping core inflation low; we believe the long-term effects of deregulation and globalization play a much more important role. Thus, as we discussed two weeks ago, the dollar should have an important impact on foreign equity performance but probably only a modest effect on core inflation.

Data Section

U.S. Equity Markets – (as of 8/4/2017 close)

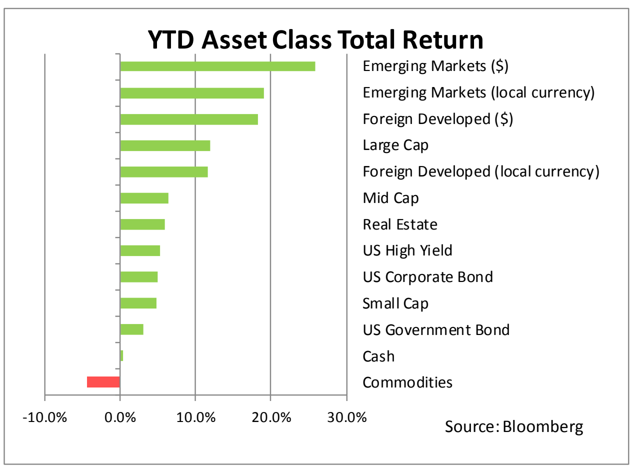




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 8/4/2017 close)

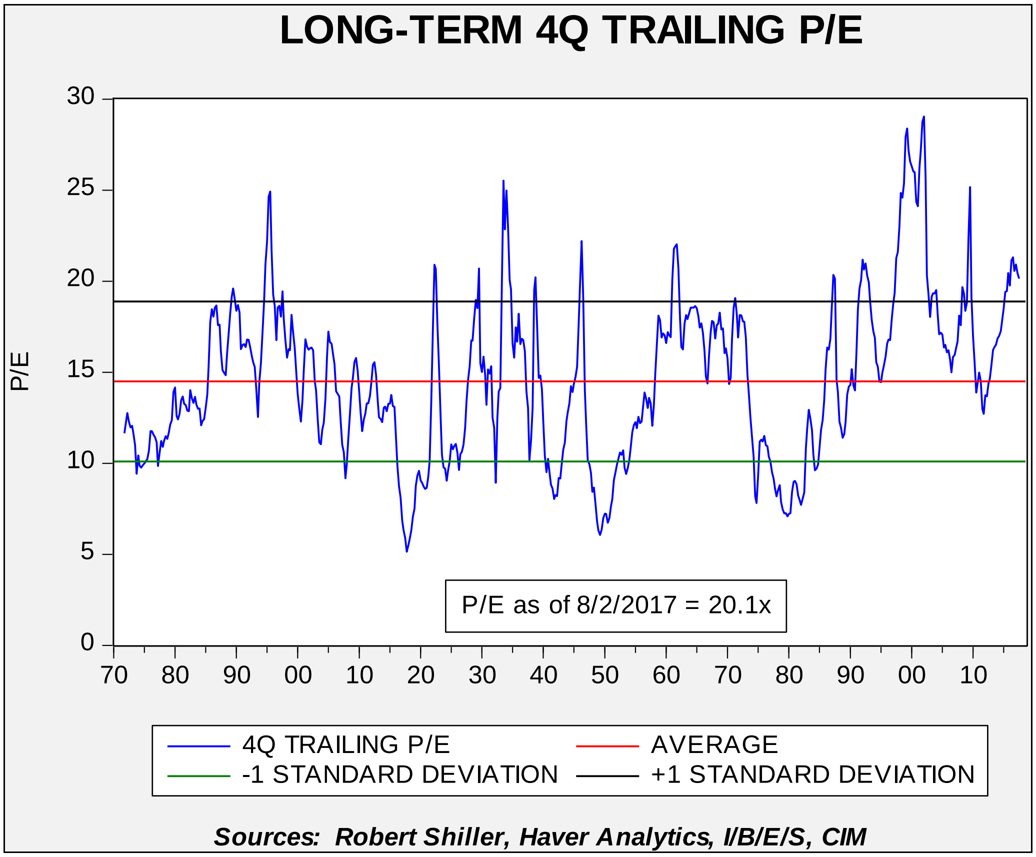


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index).

P/E Update

August 3, 2017



Based on our methodology,[2] the current P/E is 20.1x, unchanged from last week.

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

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[2] The above chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q4, Q1) and two estimates (Q2, Q3). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a very long-term dataset for P/E ratios.