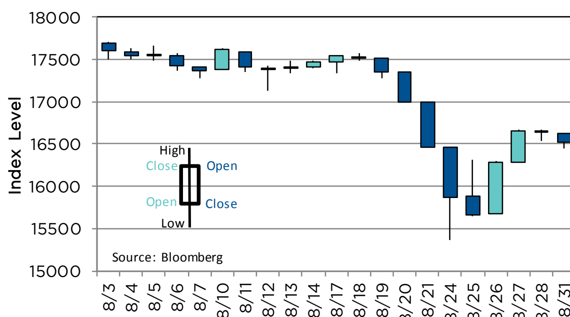
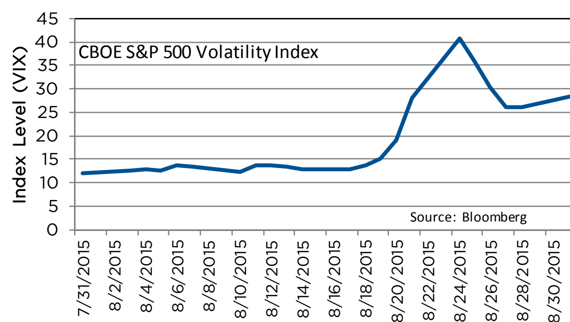
ECONOMIC REVIEW AUGUST 2015

The slowing of the Chinese economic engine and its repercussions spooked global equity markets during August to a degree not seen in years. The Chinese government surprised markets on August 11 by devaluing the yuan nearly 2%. Investors believed the adjustment to be a one-off shift, but when the yuan dropped a further 1% the following day, nerves showed signs of fraying. China's economy has grown at a 7%+ rate for such a long period, driven by central planning, and forecasts had expected only modestly slower growth. Owing to the reliance on centralized allocation of resources and banking controls, the Chinese government took drastic steps to shore up the economy and, when it did, foreign investors recognized the depth of China's underlying economic problems. For years, China has built infrastructure and factories for which it did not have an impending need. Commodities had been stockpiled in anticipation of shortages caused by the torrid construction pace in China. Because so much economic activity was brought forward, the current demand for construction and manufacturing is not enough to sustain a 7% growth rate. The yuan devaluation was an attempt to reprice Chinese goods in foreign markets and increase exports, as domestic growth prospects weakened. China's stock market fell an additional 12% during August. As European countries claw their way toward growth, they also have taken on substantially more debt. The global drop in equities is a reminder that organic growth is important and that sustainable growth cannot be forced onto an economy by central bank asset purchases and a massive expansion of government debt.

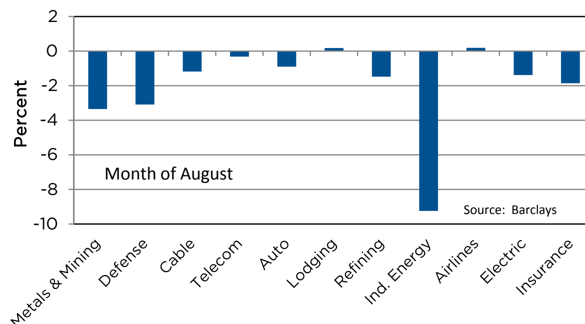
Dow Jones Industrial Average



Equity Volatility Spikes



High Yield Bond Returns



Market Returns

As of August 31, 2015

	August	3 Months	YTD
S&P 500	-6.0%	-5.9%	-2.9%
Russell 1000 Value	-6.0%	-7.4%	-6.1%
Russell 1000 Growth	-6.1%	-4.6%	1.0%
Russell 2000	-6.3%	-6.7%	-3.0%
MSCI EAFE	-7.4%	-8.1%	-0.2%
Emerging Markets	-9.0%	-17.6%	-12.9%
Barclays Agg	-0.1%	-0.5%	0.4%
3-Month T-Bills	0.0%	0.0%	0.0%

U.S. GDP for Q2 was revised higher to 3.7%, with consumer spending growth a highlight. Canada entered a recession as Q2 GDP was -0.5%, following a 0.8% contraction in Q1. Ongoing weakness in energy and commodities took its toll on the Canadian economy. Interest rate cuts, combined with limited supply, have shored up Canada's real estate market and limited price declines in the western provinces. Canada's federal elections in October will determine if the Conservative government retains power. An expansion of the House of Parliament and a wearying Senate spending scandal may overshadow economic worries in determining the outcome.

U.S. equity volatility spiked to a level last seen in August 2011 after the Shanghai stock market turned negative year-to-date. The opening bell on Monday, August 24, brought a torrent of selling, plunging the Dow Jones (DJIA) 1,089 points lower within minutes. The drop in points was larger than the May 6, 2010 crash. The following Tuesday saw record, single-day outflows from mutual funds and ETFs. Wednesday and Thursday combined for the strongest two-day gain for the index. In the end, the DJIA lost 6.6% in August. Many emerging market country indices fell by over 10% during the month.

Debt concerns faded into the background after stock market losses grabbed headlines, although repayment of debts acquired over the past decade remains an important issue for corporations and sovereignties. Puerto Rico defaulted on a $58 million payment. Creditors have called for the territory to sell assets and state-owned utilities, as well as cut payrolls at its largest employer, government. Eurozone members agreed to an €86 billion loan package for Greece, in return for Greek spending cuts and economic reforms. After the ruling Syriza party in Greece denounced the agreement, Prime Minister Tsipras submitted his resignation. The Syriza party swept into power only months ago on a platform opposing austerity and economic reforms.

U.S. Treasury bond yields edged up slightly during August, in spite of increased stock volatility. While the likelihood of a Federal Reserve interest rate hike in September appeared imminent to some investors, the upheaval in equity markets lowered expectations for a September move. Several Fed governors voiced concerns about the timing of a rate hike, given uncertainties in the market. The opposing view has wanted rate hikes to commence in order to give the Fed an option for action in the event of an economic downturn. Investors' and consumers' sentiments appear to hold the key to the Fed's timing. A rate increase in the current environment, when other countries are lowering rates, may hobble a stock market rebound. On the other hand, the economy has grown at a historically weak rate during the recovery, despite record-low interest rates. Eventually, a normalization of interest rates is needed; the timing of it remains sensitive, given the current environment.

High-yield bond interest rates rose with concerns over falling oil prices and an easing away from higher-risk bonds. Municipal defaults are an ongoing concern, and high debt loads are becoming more pronounced as the Fed's interest rate hike looms larger on the horizon.

Pavilion Advisory Group is a registered trademark of Pavilion Financial Corporation used under license by Pavilion Advisory Group Inc. in the United States and Pavilion Advisory Group Ltd. in Canada. The opinions contained within this document are those of Pavilion Advisory Group Inc.