



Overview

During the month of August, the US equity markets declined an average of 6%. The S&P's 500 Total Return Index and the Russell 2000 dropped each by 6.25%. Bonds did not provide much of a support with the US long bond down about -1.83% while the corporate sector fared a little better at -1.20%.

The unexpected devaluation of the Yuan in China gave an additional reason to market participants, already in a state of alert with commodity prices in a nasty decline, to lighten up on equities across the globe. As usual, emerging market equities were most affected with some indices and their tracking ETF (VWO) down close to 10% over the month.

Given our prudent posture of the past few months, we managed to limit the damage to our portfolios to losses ranging from -1.80% to -3.50% depending on the risk profile of the portfolio. On a YTD basis, this puts our performance across portfolios between 0% and -.75%. This compares to a -1.40% YTD performance for a portfolio consisting of 50% S&P's 500 and 50% US bond aggregate.

Market developments

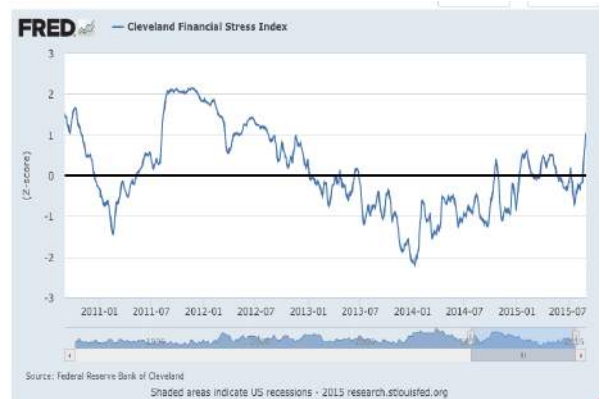
The build up in market tensions has been long in the making. The Chinese devaluation, and the ensuing fear of a global economic slow down, finally triggered a worldwide market correction in equities and a sharp rise in volatility across markets.

The Federal Reserve Bank of Cleveland has developed a "Market Stress Index" that encapsulates those market tensions. Below is a chart that illustrates the part played by equities in this measure.



On an historical basis, the late August equity market volatility has not been seen since October 2011 when serious doubts about the sustainability of the common European currency experiment came first into focus. The Cleveland Financial Stress Index for equities is now at one of its highest levels.

However, the equity component (above chart) is only one of six components of the total stress index. The other components include measures of stress for currencies, credit, interbank, real estate and securitization markets. Below is a chart of the evolution of the Complete Cleveland Financial Stress Index through August 31:



This financial market stress indicator was at about 1.05 on 8/31. A reading from .54 to 1.82 indicates a moderate stress level. Beyond 1.82, the index enters the "High Stress" zone.

Clearly, we are not there. Somehow, the high stress level in equities has been compensated by lower levels of stress in the other markets, resulting in a "moderate rise" for the overall Financial Stress Index.

This measure gives some objective confirmation that the volatile price action in August has not translated into unbearable market stress "à la 2008". We are not there and probably won't be, given the relative strength of the US economy.

At the end of the day, this correction may not be more than a healthy market adjustment after close to six years of uninterrupted market ascent.

Tilts and Allocations

At the beginning of August we reduced our emerging markets exposures by about 30%. In retrospect this was a good move. This reduction together with our higher levels of cash allowed us to mitigate the effects of this market correction. We did not make any other changes to our overall asset and sectorial allocations.

Going forward, our desire to increase our equity allocation, post-correction, is tempered by two main considerations: 1) Market technicals and, 2) Market fundamentals. Here is a "market technical" that is giving us pause:



Viewed with a little more perspective...



This is a very clean and unequivocal breach of the S&P's 500 200 day moving average, a significant technical indicator.

More fundamentally, the Federal Reserve interest rate decision of September 16 and 17 is looming large in the minds of most investors. If the Fed does not hike, it may lose credibility. Since there are plenty of data points that indicate that the US economy is sufficiently robust to manage a .25% interest rate increase, declining to raise the Fed Fund rate will come at a cost.

On the other hand, if the Fed hikes rates, the markets might react somewhat violently, the way an addict reacts to a lower dose of the deadly elixir they have made a part of their lives. This economy is more than a bit addicted to zero interest rates. Now that it has stabilized the Fed is trying to get it into rehab, not an easy task.

Concluding Remarks

Portfolio-wise, the consequence of all of this is that we have decided to stay put for now, keeping our powder dry. In our estimate, now is not yet the time to redeploy. Market volatility needs to subside a bit before we do so.

One last comment: when markets correct, the way equities have in August, they offer a very real opportunity for investors to measure the adequacy of their portfolio allocations and investment choices in general. Is your portfolio exposed to too much equity risk? Did it adjust as you would have expected given the 6% drop on US markets? Did it go down more? If so, is that explained by other factors that you are comfortable with?

Human psychology is such that underperforming when markets drop tends to hurt us a bit more than when they rise. In both situations though, the problem is the same: The portfolio is not properly positioned and/or your investment selection is a bit underwhelming. In both cases it is time to adjust things.

As usual, please feel free to provide your feedback.

All the best,