Volatility Increased, But Not Much Changed

Despite a significant increase in financial market volatility in August, from a fundamental economic perspective, little changed. The U.S. economy continues to grow, the European recovery continues to strengthen, the Chinese economy appears to be slowing, and many commodity based economies (Canada, Brazil, Australia, etc.) continue to struggle amidst slower global growth.

Q2 GDP Revised Upward

The Commerce Department’s second revision of Q2 GDP showed the U.S. economy growing at 3.7% rather than the previous estimate of 2.3%.

Inflation Remains Low

Consumer price inflation has remained low in recent months. The Consumer Price Index rose 0.2% in the 12 months ending in July. Lower energy prices have played a key role. Gasoline prices were down 22.3% year-over-year, and are poised to decline further. Prices of consumer goods have generally been falling and lower commodity prices could push them even lower in the coming months.

Employment Market

The August employment report included 173,000 new jobs versus a consensus forecast of about 200,000. The trend remains very robust with an average of over 200,000 jobs added per month year-to-date. This has pushed the unemployment rate to 5.1%, which is within the range that the Federal Reserve would consider full employment.

Consumer Confidence Rebounds

The Conference Board Consumer Confidence Index, which had declined in July, rebounded in August. The Present Situation Index and the Expectations Index both increased. “Consumer confidence rebounded in August, following a sharp decline in July. Consumers’ assessment of current conditions was considerably more upbeat, primarily due to a more favorable appraisal of the labor market. The uncertainty expressed last month about the short-term outlook has dissipated and consumers are once again feeling optimistic about the near future. Income expectations, however, were little improved.”

Small Businesses Optimistic

U.S. small business confidence also rose modestly in August. The National Federation of Independent Business reported its Small Business Optimism Index gained half a point to 95.9 last month. Small business owners were slightly optimistic about sales, but did not believe it was a good time to expand. Owners were pessimistic about business conditions over the next six months and were noncommittal regarding capital and inventory investment.

Update from the ECB

At the most recent meeting of the ECB, President Mario Draghi highlighted “downside risks” to the Eurozone economic recovery. His fear is that lagging world growth will, in turn, result in widespread turmoil in financial markets, causing investors to avoid risky assets and truncate the forecasted Eurozone recovery. He emphasized the ECB’s willingness and ability to act by using “all instruments available within its mandate.”

Surprise Devaluation from China

China devalued its currency on August 11, raising fears about the health of the world’s second-largest economy. China’s central bank said the surprise devaluation was intended to make the yuan more market-oriented, but the move aroused suspicions that the government was trying to revive an economy that is expanding much slower than the official 7.0% growth target for this year.

Commodity Economies Suffer

Canada and Australia appear to be casualties of the collapse in commodity prices. GDP in Canada shrank 0.5% in Q2. GDP has contracted for two consecutive quarters so it appears that Canada has slipped into a mild recession. Although Australia has more exposure to exports of raw materials, Q2 GDP inched up just 0.2%, which was below expectations.
CHINA TRIGGERS U.S. CORRECTION

U.S. stocks fell sharply in August as worries about a Chinese economic slowdown sparked global market volatility. The S&P 500 Index fell 6%, its largest monthly decline in over three years. The Dow Jones Industrial Average fell the most since May 2010, the month of the so-called flash crash. All of the major benchmarks entered correction territory—commonly defined as a drop of at least 10% from the recent peak—and the Nasdaq Composite was the only one that managed to end August with a gain for the year-to-date period.

NOWHERE TO HIDE

Developed international and emerging markets equities plunged, in many cases erasing all of their year-to-date gains. Rather than a steady decline, stocks continually rallied and tumbled amidst the increased volatility. The rallies could not overcome the selling pressure, and by month’s end the MSCI EAFE Index was down 7.4% and the MSCI Emerging Markets Index was down 9%.
FIXED INCOME: Yields Unchanged Despite Volatility

**TREASURY VOLATILITY REMAINS**
The yield on the 10-year U.S. Treasury note finished August at 2.21%, nearly unchanged from where it started. However, Treasury yields experienced significant volatility within the month. Concerns over China’s currency devaluation, slowing economic growth, and continued pressure within its equity markets, pushed many investors to the safe haven of U.S. Treasuries. During the worst of the selling in equities, Treasuries enjoyed strong demand that pushed the yield on the 10-year Treasury down to 1.90%.

**FLIGHT TO QUALITY**
Investment-grade debt held up better than the high yield investments as investors shied away from risk. Credit spreads increased in August as the Barclays U.S. High Yield Corporate Bond Index fell 1.7%. Similarly, the high yield leveraged loan market fell 0.7% for the month.

**SMALL GAINS FOR MUNI’S**
Municipal bonds generated small, yet positive, returns as they are generally insulated from the global economy. Puerto Rico missed most of a $58 million bond payment at the beginning of the month in a default that was widely expected and had little effect on the overall municipal market. Detroit sold new municipal debt for the first time since exiting bankruptcy protection, issuing $245 million of bonds backed by income tax revenue. The city offered the new bonds at an attractive yield premium relative to similarly rated municipal debt.
**ALTERNATIVES: Gold Rallies**

**HEDGE FUNDS POST MIXED RESULTS**
Hedge funds posted mixed performance for August with gains in market neutral strategies, with the HFRX Absolute Return Index posting a gain of 0.13%, while the HFRX Global Hedge Fund Index posted a decline of 2.21% for the month.

**COMMODITIES HOLD TIGHT**
The Bloomberg Commodity Index (BCOM) ended August down only 0.9%, while 19 out of 22 commodities in the BCOM saw increased volatility in August. The precious meals sector returned 2.16% as investors piled into gold hoping for refuge from the turmoil that swept the global financial markets. Gold closed the month up 4.2%.