

“Life is pain, Highness. Anyone who says differently is selling something.” ~Man in Black: The Princess Bride.

Pain was inflicted upon investors in one of the most memorable weeks money managers have ever experienced. There was pain from Monday's opening trade that saw the Dow Jones down 1,000 points on confusion over China's Yuan devaluation. There was the pain from Tuesday's 1,000-point reversal (largest 1-day reversal since October 2008) when the market went from up 600 points to down 400 points. Lastly, imagine the pain of those who sold in the midst of the panic and missed the massive 2-day rally that caused the market to finish the week higher.

Was the spike in volatility a shot across the bow and precursor to a 2008/2009-style bear market? Or was the ensuing late week rally a sign that all is well and the markets are poised to move higher?

We have long read that Wall Street climbs a Wall of Worry and this year's wall looks more like Mt. Everest. The surge in the U.S. dollar hurting corporate profits, the crash in oil and commodity prices, Grexit, weak GDP in Q1 (though initial negative), a profit recession, Fed liftoff, and now the Yuan devaluation and Chinese bubble bursting. There has been plenty for the markets to worry about.

We are not, however, convinced that the next bear market is imminent or that a market crash is likely. The 2008/2009 crash was caused by the bursting of the sub-prime lending bubble and the ensuing Great Recession. The financial world grind to a halt because ratings agencies had provided AAA ratings to paper that probably should have been BB or lower. The sub-prime debt was widely held and institutions and investors scrambled to try and determine what their exposure was. Even some money market funds were unable to maintain their \$1 share price.

China's economy and stock market deflating, at the core of the latest market panic, is a very different

story. We do not doubt the importance of China to global economic growth but exports to China from the U.S. represent only 0.7% of our GDP. The next true bear market, and drop of 40% or more in the stock market, is far more likely to come when the U.S. enters its next recession; something we do not see on the horizon for the next 2 quarters.

We are not suggesting the path for investors is going to be smooth. The ride for equities and fixed income

“...Wall Street climbs a Wall of Worry and this year's wall looks more like Mt. Everest.”

is likely to be very bumpy. Comparisons to 2008 are inevitable when stocks fall 3% or more on back-to-back days for only the 9th time in 30 years (5 of

the 9 occurred in 2008). The market can handle a default in Greece or Puerto Rico but what about default in Spain, Italy, France or Brazil?

It has long been said that when the U.S. sneezes the world catches a cold. Can the same be said for China in today's global economy? China suffers a credibility gap in how they implement economic policy. They announce that market forces will dictate trading on the Shanghai exchange then clearly intervene with government buying of stocks. The same type of inconsistencies occurred with their poorly communicated decision to devalue the Yuan. China does have the power of its Central Bank (PBOC) and will use that just as the rest of the world has. The Fed provided a model for supporting markets with intervention (QE) and we are seeing the ECB under Mario Draghi's leadership follow in those footsteps. Japan has been intervening through Abenomics and China will surely follow suit as demonstrated by last weeks interest rate cut by the PBOC.

The question for investors today becomes do they “buy on weakness” or “sell into strength”? We favor the latter and will continue to reduce equity exposure in the short-term anticipating valuations to fall further on heightened uncertainty. If stocks retreat in September and valuations become compelling, it could set up a strong 4th quarter for equities in our view.

China

Cut-Rate Cash

China's central bank cut interest rates after days of market turmoil.

One-year benchmark lending rate



Source: People's Bank of China
THE WALL STREET JOURNAL.

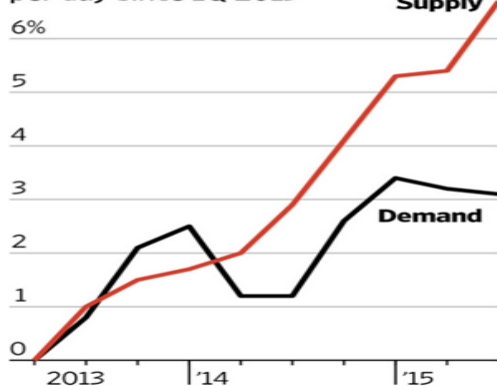
News out of China continued to rattle global financial markets in late August. The worldwide selloff stemmed in part from growing uncertainty regarding economic growth in China and what that might mean for the global economy and risk assets. The People's Bank of China (PBOC) continues to make moves in an attempt to support Chinese equity markets and spur economic growth, adding currency devaluation to its string of interest rate cuts and loosening of lending restrictions. Emerging markets continue to suffer amid China's economic malaise, if you can call 5-7% real economic growth a malaise.

- The economic picture in China remains suspect. Manufacturing in China has contracted for six straight months, its real estate market has overheated and large amounts of debt could pose a problem to the stability and health of China's banking system.
- The latest moves by the PBOC may have delayed the much-needed structural reforms back a few years.
- We expect to see more volatility in China and other emerging markets as well as the potential for the "tail" to continue to wag the "dog."

Digging in Your Heels

Outstripping Demand

Change in millions of barrels of oil per day since 1Q 2013

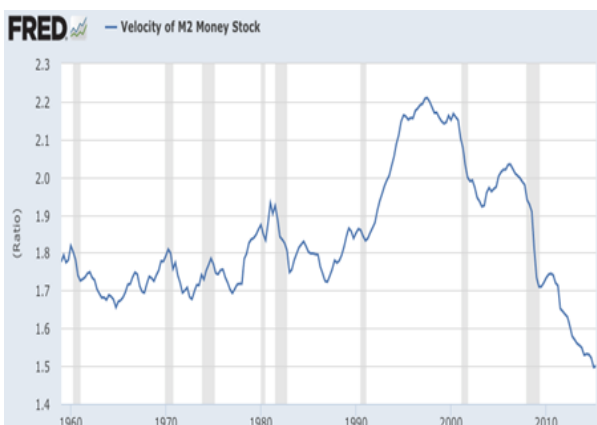


Source: International Energy Agency
THE WALL STREET JOURNAL.

Oil producing nations have not given indication of dramatically reducing production in the midst of collapsing oil prices. This creates uncertainty around where the supply/demand equilibrium price should be in our view. Trends in supply would indicate further downward pressure on prices below the \$40 a barrel price cited as this report was written. The chart demonstrates the dramatic increase in supply since 2013. Demand began to move in to a downtrend going in to 2015.

- OPEC and other oil producing nations, including Russia, Iraq and the U.S. are committed to not constraining production.
- YTD, West Texas Intermediate has fallen over 34%, as of 08-24-15 (Bloomberg).
- Supply of oil in millions of barrels has increased by over 6% since 2013.
- Chinese manufacturing, a large consumer of commodities, has shown significant weakness.

Terminal Velocity of Money



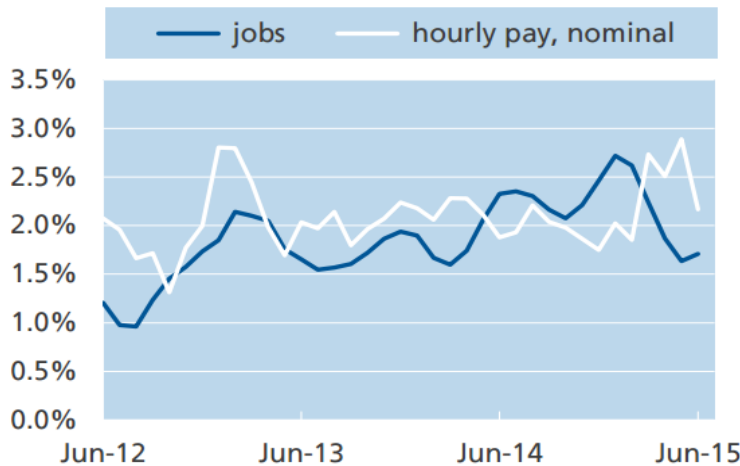
The velocity of money measures how quickly money moves from person to person throughout the economy. When money velocity is high (1990's) people are spending freely and the economy grows without the Fed worrying about increasing the supply of money. When velocity is falling, it is a sign that economic activity is low and the Fed intervenes (QE) to try and stimulate demand. There are many signs that suggest economic growth is accelerating but until the velocity of money turns higher growth is likely to remain erratic.

- It is now estimated that the Fed needs to increase the money supply by \$8 for every \$1 increase in GDP.
- Falling velocity of money is deflationary for an economy as consumers and businesses feel no rush to spend income or savings.
- It is unprecedented that the unemployment rate has been cut in half without a turn around in velocity and puts the Fed in a quandary about tightening monetary policy.
- Negligible gains in wages have exacerbated the falling velocity of M2 and results in a greater share of the economy going underground.

Macro View— Jobs Strength and Weakness

The jobs market continues to show strength. The economy added 215,000 jobs in July while the unemployment rate was unchanged at 5.3 percent. There are areas of weakness, however, namely the low participation rate and sluggish wage growth. Over the past twelve months, wages have risen at an annual rate of 2.1 percent. Also of interest is the reduction in hourly pay. Going into July, hourly pay began a sharp decline while the percent change in jobs began to tick up.

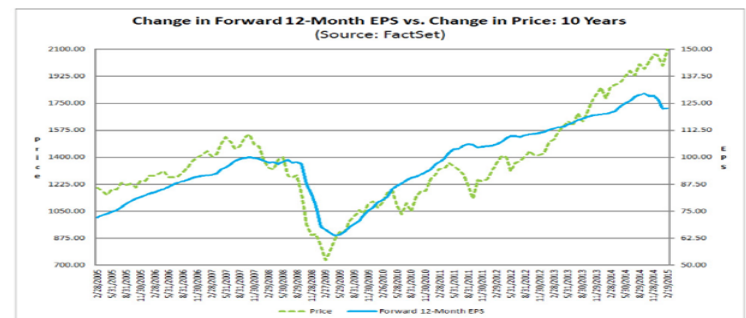
3-mth/3-mth % change, saar



Source: US BLS, Macrobond, LSR

Taking Stock— Continued Dislocation

August demonstrated a dramatic dislocation between company fundamentals and equity market prices. Volatility spiked as we saw repeated and dramatic pullbacks. In some cases we saw different segments of the market enter correction territory (>10%). Much of the volatility was attributed to severe correction in China, leaving many wondering how the Chinese economy could drive such fierce price movement in the U.S. The chart to the right demonstrates the dislocation between earnings growth and market prices in our view. The green line represents price appreciation of the S&P while the blue line represents forward 12-month EPS. Forward 12 month EPS begins to slow its ascent in 2014 and decline over the first 2 quarters of 2015 while the market continued to march upward. With the August pullback, the disparity has somewhat corrected, but still remains something to watch going forward.



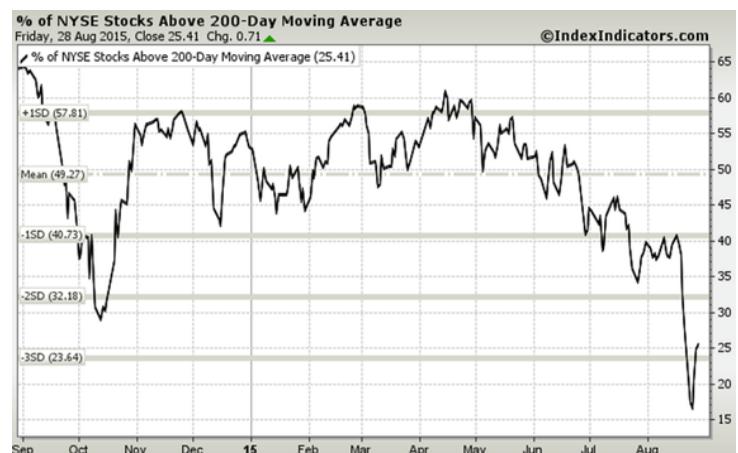
Fixed Income— Look Out Below

High yield bonds have lost over 8% in the last year and are likely to remain under pressure in the foreseeable future. Energy exposure in high yield is around 14% of the index and the recent fall in oil below \$40 suggests defaults could rise to much higher levels than analysts have forecasted. It is estimated that nearly \$5 trillion in debt was created as companies used expensive fracking techniques to drill for oil. Many of these companies are experiencing a liquidity death spiral as access to borrowing is gone and they require \$60 oil in order to break even.



Technical— A Falling Knife

Technical alarms have been ringing since early August and the markets continue to face mounting technical headwinds. This chart shows the number of NYSE stocks trading below their 200-day moving average. The total recently exceeded 3 standard deviations from normal at only 16%. About 3 out of 4 stocks currently demonstrate technical weakness. August also experienced a technical death cross as the 50-day moving average moved below the 200-day and the 13-week dropped under the 34-week average on the S&P 500. Conditions remain oversold at the moment but do not suggest new highs are likely soon.



2008 Revisited?

The latest turmoil across financial markets has investors wondering if another 2008 is in the offing. Given this, we thought it would be worthwhile to compare today to both 2008 and 2011 as there are some eerie similarities.

In the 2008 financial crisis, the U.S. housing market was in a free fall after having risen to unprecedented levels. Its sharp reversal was taking down the U.S. economy with it. The bursting of the housing bubble brought into question the health of many U.S. banks and investment firms exposed to the real estate market. News of Lehman Brothers filing bankruptcy shook markets and subsequently led to U.S. credit markets freezing up. This brought havoc on an already weakening U.S. economy. A collapse of the U.S. banking system was a real possibility and a major concern for both investors and policymakers, prompting the Federal Reserve to respond quickly by providing liquidity to the U.S. financial system. Bear Stearns and AIG were bailed out and thus began the alphabet soup of government

programs to help troubled banks repair their balance sheets and stay in business. In addition to the various programs initiated, the Fed lowered its benchmark interest rate and began expanding its balance sheet to unprecedented levels in an attempt to avert a collapse of the U.S. financial system. The liquidity troubles and turmoil made its way abroad as many developed-market financial institutions and investors had exposure to the U.S. real estate market. Equity market volatility and weakness quickly spread to most developed markets as a result. Meanwhile, emerging markets like China somewhat escaped the turmoil plaguing the developed world in 2008.

In 2011, a couple of things happened. One, the U.S. credit rating was downgraded a notch from AAA to AA+ by Standard and Poor's. The company cited political posturing as a reason to doubt the stability and predictability of the U.S. government's ability to manage its finances. At the time, the U.S. annual budget deficit was still expanding, which helped to propel gold prices to near historic heights. The second thing to occur was the continuation of the European debt crisis, which began to wreak havoc on financial markets in 2010. Over-indebted nations of Greece, Ireland, Italy, Portugal and Spain led the way and the dissolution of the Eurozone was a growing possibility. The "PIIGS" as they were called struggled with some of the same issues the U.S. did in 2008, namely real estate bubbles and government-funded bank bailouts. Greece was notorious for overspending and cooking its books while Spain and Italy saw real estate prices rise to unprecedented levels before subsequently declining. In March of 2011, European leaders

Brett Lapierre, CFA, *Director of Research*

put together a bailout package for these troubled Eurozone countries and it was accompanied by strict austerity requirements and structural reforms, which continue to plague countries like Greece today. Equity markets worldwide saw higher volatility during the summer months, but when the dust settled U.S. equity prices managed to recover from the summer swoon.

Déjà vu

Today, it is China's turn and it seems to be déjà vu all over again for global financial markets. China's challenges are largely similar to the woes the U.S. experienced in 2008 and Europe's problems in 2011 – a real-estate related bubble and a threat to the financial

system. Like 2008, the sharp rise in U.S. real estate prices and a potential for a crash was not unforeseen. The rate of increase in housing prices was simply unsustainable. China's over investment on infrastructure and property development and the potential for a reversal has been discussed in many

venues, so it too is not surprising to see a similar pattern unfolding. China's banks are vulnerable to a credit crisis just as U.S. banks were. The advantage China has this time around is that it has a playbook to go by courtesy of the U.S. Fed and the European Central Bank. And the People's Bank of China (PBOC) is executing on that with their latest, relatively aggressive moves. In mid-to-late August, the PBOC devalued the yuan, cut its benchmark interest rate, lowered reserve requirements and injected liquidity into the banking system. While the PBOC seems to be pulling out all of the stops, investors remain unconvinced such actions will improve China's economic outlook over the near term.

While we see risk that China's woes could help prolong the downturn for equity markets, it's hard to see a similar 50%-plus decline in U.S. equity prices. The U.S. economy is in better shape today than it was in 2008 and 2011 and investors have been anticipating the first Fed rate hike for some time. U.S. exposure to China is relatively small, so we see little risk of contagion beyond emerging markets. Today looks more like 2011 than 2008 and we see the potential for a similar 20% drawdown as possible. As August came to a close, we were roughly halfway there, despite a strong rebound over the last few days. Whether or not U.S. markets enter bear-market territory or brush up against it, we continue to see higher equity-market volatility likely until more certainty around the Fed and global growth materialize.



Should the Fed hike in September?



Brian Lockhart, CFP
PCM Founder & Chief
Investment Officer

To me, the obvious answer is yes because I believe the economy has been suffering under the unintended consequences of 6 years of ZIRP (zero interest rate policy) and QE for sometime. I agreed with the Fed's quick and decisive action in the wake of the financial crisis in 2008 and ensuing Great Recession. They became the backstop that gave market participants confidence that sufficient liquidity would be provided for the sub-prime debacle to be sorted out.

Leaving interest rates at essentially 0% while unemployment has fallen from over 10% to almost 5% and GDP has increased by 2%-plus per year has become counter-productive and created a trap for the Fed. We showed a chart of how the velocity of money is at historic lows, a fact I attribute to Fed policy. The ISM Service Sector (representing two-thirds of GDP) is back near 2004 levels and the JOLTS survey shows job openings at 15-year highs. The only rationale for keeping real rates negative is the risk to asset prices (housing and stocks) and the squeeze it creates in emerging markets where debt is predominately priced in USD.

The Fed appears to be waiting for the perfect time to hike rates and that window closed a long time ago. There are always going to be risks to raising rates when growth is uneven but I believe the risks of not normalizing interest rate policy is greater at this point. Since the Fed ended their latest round of QE the global monetary base, priced in USD, has been declining. A declining monetary base increases the likelihood of recession so the Fed may need the ability to cut rates in the not too distant future to counter a slowing economy.

Do I expect the Fed to raise rates in September? The answer to that question is a resounding NO. The Fed has no inflationary pressure to act in 2015 and with uncertainty created by the Chinese devaluation, the stock market volatility, and the tenuous place emerging markets find themselves in, the path of least resistance would be to leave rates alone until 1Q of 2016. The Fed is supposed to operate outside of "politics" but it is clear that they do not want the next recession blamed on their actions. The fear that the Fed gets too far ahead of the curve is growing, particularly among equity analysts.



Brett Lapierre, CFA
PCM Director of
Research & Chief Equity
Strategist

This is a good question in my view. With the latest market turmoil, I could see them easily postponing that decision until December or later. Recent commentary from the Fed heads has been mixed and hard to get a read on as well, which I think has added to the market consternation this past month. In addition to the mixed commentary, key metrics used by the Fed in determining appropriate monetary policy are unclear. The unemployment rate is hovering near "full" employment, but inflation is still below the key 2.0% level and its trend is relatively flat to down. Economic growth remains uneven and fragile in my view, which is causing the Fed to hesitate.

I believe a rate increase sooner rather than later would give the Fed time to see how it would impact sentiment and economic growth. That way, Committee members may receive further insight into the pace at which the economy can withstand a move towards policy normalization while the economic data is still largely positive. It would also allow the Fed to maintain its credibility in my opinion as markets have largely been expecting a September move for some time. Though uneven, economic data suggests a gradual move towards policy normalization is reasonable. If they wait, I think they may miss the opportunity and the market may not react kindly to a further delay on the rate-hike front. The risk that the Fed falls behind the curve and damages its credibility rises in my view the longer it waits. Some have argued that the Fed should have raised rates before now and that before the recent market turmoil the higher 2-year Treasury yield had reflected this thinking somewhat. I would say the economy could have digested a 0.25% to 0.50% fed funds rate by now. This is by no means a tight monetary policy even with uneven economic growth. In fact, the Fed has already tightened its monetary policy by reducing quantitative easing and allowing its balance sheet to shrink a little. I think it's time to adjust the interest rates.



John Lunt, President of
Lunt Capital, Inc.

The investment world is transfixed by the question of whether the Federal Reserve will raise interest rates in September. Janet Yellen and the Fed's intentions are well known—they want to begin the long process of normalizing monetary policy.

The arguments against raising rates are plentiful. Global growth remains sluggish, disinflationary forces are washing across the global economy, and the "Great Fall of China" has contributed to increased equity market volatility and continued downside pressure in commodity markets. A Fed hike may push the U.S. Dollar higher, squeeze U.S. exports, cap already low U.S. inflation, and create financial stress in the developing world. Former Treasury Secretary Larry Summers recently stated that "raising rates in the near future would be a serious error."

While we are sympathetic to arguments against a rate hike, we believe that it is time to end the unnatural state of a zero interest rate policy. Maintaining a "crisis" policy long after the crisis has passed is creating dangerous distortions and the risk of unintended consequences. Extraordinary monetary policy has been effective in treating the symptoms of sluggish growth, but it cannot cure the diseases of debt, regulation, and structural inefficiencies that create friction for U.S. and global growth. The Fed's policy was important during the crisis and its aftermath, but its continuation has proven a clumsy transmission mechanism to spur the real economy. Rates anchored at zero have resulted in a massive policy of redistribution from savers to borrowers.

We can almost be persuaded against raising rates with the argument that the Federal Reserve is not only the central bank of the United States, but it is also the central bank of the world. However, long-term growth will depend on reducing the world's perceived dependence on perpetual stimulus from central banks. A zero interest rate policy may be appropriate during a generational crisis, but not as a permanent feature used to combat "below potential" economic growth.

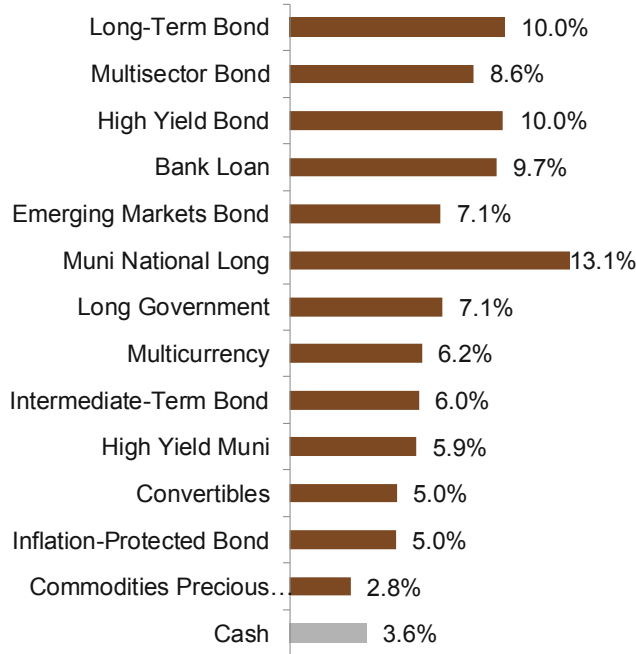
The Fed's desire and intent is clear, and the Fed's credibility is on the line. A deepening crisis in China or in financial markets may delay the timing, and the Fed is right to adapt to new information. Developing events may require the Fed to pause or even reverse policy. However, raising rates may actually bring certainty and relief to global markets. We think it is appropriate for the Fed to raise rates and to signal to markets its intent to proceed cautiously and slowly.

*John Lunt serves as the President at
Lunt Capital Management, Inc.*

To learn more please visit www.luntcapital.com.

Fixed Income

Segment Exposures

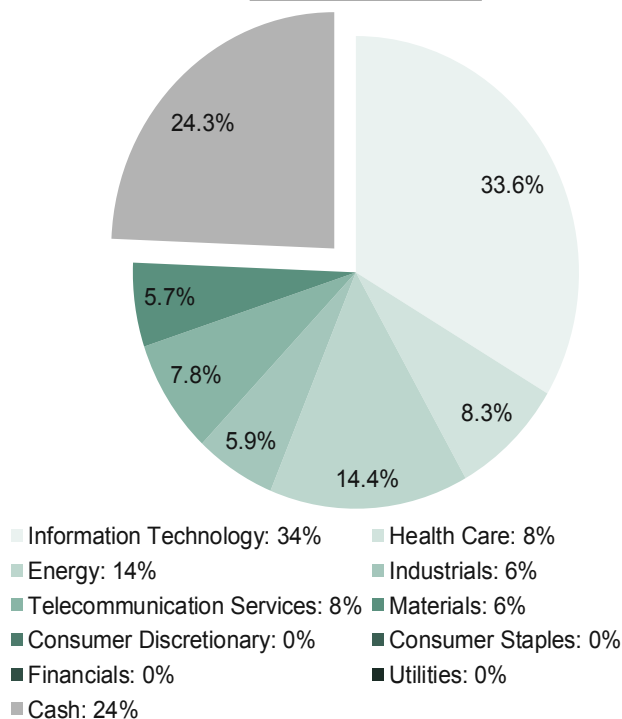


As of 07/31/2015

- The futures market currently price in no fed rate hike until the first quarter of 2016 assuming the economic data remains strong between now and then.
- We are trimming exposure to high yield bonds in light of the collapsing oil prices and the risk posed by energy in the non-investment grade bond sector.
- The current yield on the fixed income portfolio remains at 4.25% with an average duration just above 6.5 years.
- Spreads on investment grade revenue municipal bonds remain one of the most compelling valuations in fixed income in our view.

Equity

Sector Exposures



As of 07/31/2015

- We remain committed to increasing our cash position in our equity portfolio expecting volatility to remain high throughout September and likely October.
- The slowdown in the Chinese economy impacts global GDP growth figures much more than U.S. GDP estimates as exports to china only represent 0.7% of U.S. GDP.
- Oil companies and the energy sector in general have very uncertain outlooks as oil and gas prices remain under pressure. We are avoiding trying to catch a falling knife at this point.
- We anticipate healthcare and technology to be the leading sectors when valuations get to compelling levels.

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