HIGHLAND

MARKET BRIEF

JUNE 2015

FED BRIEF

On Wednesday, June 17th, Federal Reserve Chairwoman Janet Yellen and the Federal Open Market Committee voted to keep the Federal Funds interest rates at its current rate of 0-0.25%. In the release, the Federal Reserve ("Fed") noted that labor slack in the job market has diminished somewhat, while the economy has seen some improvement lately. The decision to not raise interest rates was expected, but the interesting part was during Yellen's opening speech during the Fed's press conference. In her speech, Yellen began by informing investors they should not overstate the importance of an initial rate increase, and that too much attention is being placed on the timing of the first rate hike. She then qualified her statement by stating that policy will continue to remain highly accommodative and any policy decisions will be data dependent. By Highland's calculation, these words from Yellen were meant as a sign to investors that the Fed is positioning to enact its first rate hike since 2006. However, Yellen is also stating that the Fed will not follow any kind of "mechanical" approach to raising rates and that most likely rates will be lower for longer.

There is still some disagreement between investors as to when the Fed will raise interest rates. Of the 65 economists that were surveyed when the first rate hike is coming, 51 or 78%, of the economists expect the Fed to raise rates in September. However, the Fed funds futures markets are telling a different story and are placing only a 19% probability of a rate hike in September and have pushed the first rate hike into 2016. Why are the futures market less confident of a rate hike? Most likely this is because the market sees Greece continuing to agonize the European Union, China's economic growth is decelerating and the United States registered negative real GDP growth in the first quarter. What does this mean to investors? When you have little consensus from investors and then add in a decline in liquidity during the summer months, this usually fosters an environment of heightened volatility.

We expect, barring some unforeseen incident, the Fed is likely to raise rates in September. The U.S. economy has added 3.1 million jobs the last 12 months, on par with the type of growth experienced in the 1990's, and slack in the labor market has declined. The Fed badly wants to move away from zero interest rate policy and even a 0.25% increase would be a big step. However, Yellen understands that most of the global economy is easing monetary policy, inflation is running below 2% and a stronger dollar would be a dampener to inflation. Because of these reasons, Yellen and the Fed will be much slower in their pace of raising interest rates and will be less likely to raise interest rates every meeting. The Fed recently downgraded their estimates for GDP growth in 2015 from 2.5% growth to 1.9%. Historically, the Fed has been more optimistic in its growth forecasts than what has been experienced, so we expect the Fed to be more cautious when it begins its rate hiking cycle and gradual in its pace of hikes.

HIGHLAND'S VIEWPOINT

For Highland, the pace of the rate hikes is most important to us. This is what we are closely monitoring, not the timing of the first rate hike. A gradual rise in rates should be supportive of risky assets, such as equities and real estate, although we expect volatility in both the fixed income and equities markets to rise. We continue to feel comfortable with our current positioning in our clients' portfolios and see no reason for any changes.

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