HIGHLAND

CAPITAL MARKETS QUARTERLY
FEBRUARY 2016

WHAT'S CHANGED?

The beginning of a new year is generally full of excitement as the clock resets back to zero. Individuals make resolutions and seek goals with refreshed motivation. Companies begin implementing new plans and the possibility of success is in front of them. New beginnings breed optimism. Unfortunately, this is not the case for capital markets, as 2016 is proving to be very difficult for risk assets. Equity markets are in the midst of a drawdown. Commodities are sliding, continuing the trend that began in 2014. Investors naturally seek answers for drawdowns, and question if these declines are due to a change in the global landscape.

It has been Highland's view that the Global Financial Crisis started the world down a different path. We believe that the world is on a long road to recovery, resulting in:

- Longer periods of low economic growth;
- Longer periods of low interest rates;
- Negative economic shocks;
- Increased volatility in financial markets; and
- Extreme monetary policy.

While we believe this view will hold over the long-term, there always is the possibility that unforeseen events can change our stance. For this reason, we are continuously sifting through news and data releases to determine if a change in our viewpoint is needed.

GLOBAL ECONOMIC ENVIRONMENT

When looking at the global macroeconomic landscape, it's important to focus on the inputs to growth. In our opinion, growth comes from two factors: (1) change in the labor force and (2) change in productivity.

$$Growth = \Delta Labor + \Delta Productivity$$

CHANGE IN LABOR

For the last 60 years, developed economies have benefited from an elevated growth rate in its labor force. An increase in the workforce can drive economic expansion and increase GDP through spending, accumulating wealth and savings. In the coming decades, the labor force is expected to grow at a significantly reduced rate. This is due to lower fertility rates and the aging/retirement of large numbers of people from the post-World War II boom. In 1990, the average annual increase in the working age population in the U.S., Japan and Europe was 1.0%, 0.3% and 0.2%, respectively. In the next five years, the U.N. projects the average workforce growth rates in U.S., Japan and Europe as 0.2%, -0.6% and -0.9%, respectively. This same scenario also runs true in the world's most populous country, China, where the average workforce

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *Business services*

ABOUT OUR FIRM

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. As of December 31, 2015, we serve as investment consultant on approximately $17.2 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

growth rate has gone negative and will be a drag on its growth.

Demographics are not a forecast, but are the future. This will be a headwind to growth and can only be overcome through immigration and improved birth rates. Immigration and migrant activity is expected to be a major topic for both Europe and the U.S. in 2016. Lastly, people are living longer and therefore having to save more for a longer retirement period as the retirement age has not risen along with life expectancy. All of these factors should lead to lower growth rates in the future.

CHANGE IN PRODUCTIVITY

Fiscal policy, monetary policy and overall business financial health are the biggest drivers of productivity growth. Since the Global Financial Crisis, politicians have not implemented enough fiscal and structural reforms to get growth rates back to pre-crisis levels. Because of this void, Central Banks are forced to enact extremely accommodative monetary policies, including unprecedented monetary experiments, such as negative interest rates. Although this has benefited asset prices, these policies are not leading to increasing economic growth.

> *Most of the data we review confirms our thesis of a lower trajectory of growth for the foreseeable future. We are not ruling out that the environment can change for the better, but we are not seeing it right now. Therefore, we see no changes to our long-term macroeconomic view of lower for longer.*

The Global Financial Crisis casts a long shadow on consumption, saving and investment behavior. In order to combat the fall in economic growth, central banks reduced their policy rates to almost zero. As this financial repression penalizes savers, they then must save more to make up for the lower returns. According to the World Bank, domestic savings rates as a percentage of GDP have increased in the U.S., Europe and U.K. since 2009. Due to these factors, the global economy has been suffering from a deficiency of demand, both on the investment and consumption fronts. The longer this persists, the more these factors slow potential growth as weak investment dents the growth of capital. Capacity utilization, which illustrates the amount of industrial output produced versus its potential output, remains below pre-crisis trend for U.S., Europe and Japan. There was hope that the decline in oil prices which is a benefit to most developed economies, would result in increased consumption, but this isn't materializing. Until businesses see more demand from consumers, we expect this trend to continue, thus reducing the growth rate in productivity.

Most of the data we review confirms our thesis of a lower trajectory of growth for the foreseeable future. We are not ruling out that the environment can change for the better, but we are not seeing it right now. Therefore, we see no changes to our long-term macroeconomic view of "lower for longer."

FIXED INCOME

Since the end of the Global Financial Crisis and the precipitous drop in fixed income yields, we have maintained the stance that yields should remain low for a long period of time, much longer than the typical interest rate cycle. This long period of depressed rates would translate to lower than historical returns for fixed income. Combining the low yield forecast with the steepness of the yield curve, we believed that it was best for fixed income investors to avoid the temptation of shortening duration and maintain as long a duration in their bond portfolio as their risk profile allowed.

From April 2014 through June 2015, the unemployment rate dropped 1.4% and U.S. GDP growth averaged 3.1%, yet the Federal Reserve ("Fed") maintained rates at zero. However, in the second half of 2015, as global growth slowed down and credit conditions were weakening, the Fed decided it was time to lift off of zero interest rates, finally raising rates in December by 25 basis points. While this action raised short rates, we maintain that the path the Fed takes on raising rates is far more important. To this point, the Fed projects four rate hikes during 2016, whereas the market is only expecting one rate increase. The divergence between markets and the Fed can cause volatility in rates and make fixed income investing difficult.

The spread of fixed income over treasuries is also important to consider in fixed income investing. From the end of the Global Financial Crisis, spreads steadily declined, bottoming out at 95 basis points in July 2014 as measured by the Barclays Capital U.S. Credit Index ("BC Credit"). At the end of 2015, spreads stood at 155 basis points. Although spread widening makes credit more attractive, most of it occurred in lower rated credits and mostly from energy and mining companies.

While higher yields and increased spreads increase our expectations for fixed income, the probability of higher future yields has declined. This tempers our expectations and confirms our view that fixed income should experience lower returns than historical averages. Therefore, we maintain an underweight and favor intermediate bonds over cash. However, we recognize that bonds remain a central component of any well diversified portfolio and provide protection during volatile markets.

While higher yields and increased spreads increase our expectations for fixed income, the probability of higher future yields has declined. This tempers our expectations and confirms our view that fixed income should experience lower returns than historical averages. Therefore, we maintain an underweight and favor intermediate bonds over cash.

PUBLIC EQUITIES

Coming into 2015, equity markets rebounded from 2009 lows with the U.S. recovering more than international markets. The multiple year divergence between U.S. and international equities caused U.S. equities to become expensive whereas international developed and emerging market equities remained undervalued. U.S. equities (as measured by the S&P 500) continued to outperform in 2015, returning 1.4% versus -5.7% for international equities (as measured by the MSCI All Country World x U.S. Index).

From December through January 2016, each of these markets have corrected, or fallen 10% or more. Declining prices usually leads to lower valuations. In the U.S., the cyclically adjusted Price-to-Earnings ("CAPE") is at levels last experienced in September 2013. However, at the same time U.S. equity valuations were declining, earnings were also rolling over. Therefore, our expectation for U.S. equities did not see a substantial increase.

Meanwhile, developed international market CAPE is at levels last seen in September 2012 and the emerging market CAPE is at an all-time low. Earnings have not been near as strong in these markets, but the fall in price was more than what was experienced in the U.S. Consequently this resulted in us increasing our return expectations for both of these markets.

Even though future expectations are higher overseas, the global economy and trade is experiencing a slowdown that started in the summer of 2015. Therefore, we do not feel now is the time to overweight these markets.

Even though future expectations are higher overseas, the global economy and trade is experiencing a slowdown that started in the summer of 2015. Therefore, we do not feel now is the time to overweight these markets. Risks in Europe include Great Britain exiting the European Union, immigration crisis and higher threats of terrorism. Meanwhile, emerging markets continue to struggle with the drop in commodity prices, currency devaluations and China's economic transformation. This leads us to maintain a neutral weight across major global regions to mitigate short-term risks until these equity markets become more stable.

HEDGED EQUITY

Coming into 2015, we were worried about the complacency in the markets and in particular that investors had become accustomed to lower volatility. It is our belief that lower growth rates make economies more susceptible to recessions and increased volatility in financial markets. Since that time, equity market volatility has increased considerably. Not coincidentally, this coincides with the Fed ending quantitative easing, and the U.S. dollar strengthening versus other currencies. We continue to expect the markets to be choppy and therefore prefer allocating to hedged equity for growth while protecting capital during difficult markets. Therefore we continue to recommend an overweight to hedged equity to navigate these more volatile times.

REAL RETURN ASSETS

The goal of diversification is to allocate to assets that perform well during different types of economic environments. Most investments are financial assets and benefit from declining or stable inflation environments. This means that portfolios could be susceptible to periods of rising inflation. Therefore, the addition of real assets can provide benefits as these investments perform well during rising inflation. We prefer to construct a real return portfolio with the following:

- Real Estate – outperforms when inflation rises and economic growth rises
- Inflation Linked Bonds – outperform when inflations

rises and economic growth stalls
- Commodities – outperform during inflation shocks

In private real estate, we have witnessed capitalization rates decline since last year. However, the spread over fixed income is still attractive. We therefore maintain our return expectation for private real estate.

Inflation-linked bond returns are driven by inflation expectations and real yields. Using the Barclays 1-10 year TIPS breakeven yield as a measure of market inflation expectations, the breakeven has declined 0.46% since last summer. A portion of this is a function of the decline in commodity prices, but this illustrates the market is expecting lower inflation going forward. However, real yields increased 0.65% since that time, making inflation-linked bonds more attractive. Therefore, we have slightly increased our return expectation for inflation-linked bonds.

It is not the level of inflation that impacts real assets, but the rate of change of inflation. If there was a sudden spike in inflation expectations due to a geopolitical crisis, supply shock or a growth surprise, then commodities would be expected to perform well. Further, with the market pricing in such low expectations of future inflation, it is cheaper to buy these assets now. Commodities are at levels last seen in April 2009. Because of this, we have slightly increased our return expectations for commodities.

OPPORTUNISTIC

Private equity and private debt have had our highest expected returns. This is a function of the illiquidity premium, control premium and structure of these investment vehicles. According to JP Morgan, $5.5 trillion of global government debt is trading with a negative yield. In this type of environment, we believe we are being paid an appropriate illiquidity premium by investing in longer dated investment vehicles.

According to Dealogic, mergers and acquisition activity last year was the highest since 2007. However, with equity market volatility increasing last year, we saw private equity valuations come down as strategic investors slowed their purchases. In addition, borrowing costs increased as investors have required a higher spread on lower rated, middle market names. All of these factors resulted in us decreasing our return expectation for private equity. Increasing borrowing costs is a benefit for private debt, especially through strategies that focus on direct lending. However, we also see increased risk with earnings slowing down and concerns within the oil, gas and mining sector. Therefore, we maintained our same return expectation for private debt

We also see prospects in the distressed energy and mining space. Many of these troubled assets are getting to levels in which they are attractive enough to buy at these prices and wait until the oil cycle turns. Companies are shutting down rigs at a rapid pace yet production is still at elevated levels. Many of these companies are able to keep producing due to hedges that had been put in place in the prior year. However, with oil prices remaining low and many of these hedges likely drained, it is probable that bankruptcies will increase in 2016. According to IHS Cambridge Energy, worldwide energy investment declined 20% last year and is expected to fall a further 16% this year. Meanwhile, oil demand continues to increase and the world economy is expected to need an additional 7 million barrels of oil per day more by 2020. The landscape appears promising but we are cautious as we look for specific opportunities/entrance points.

Meanwhile, oil demand continues to increase and the world economy is expected to need an additional 7 million barrels of oil per day more by 2020. The landscape appears promising but we are cautious as we look for specific opportunities/entrance points.

CONCLUSION

Just as a new year brings renewed excitement for individuals, sharp equity market declines bring risk into the light. While the marketplace is pointing to disappointing economic data as a harbinger of poor investment markets, we ask the question: What's changed? The world is still stuck in a low gear due to declining demographics and productivity, translating into low growth and low yields. Capital markets continue to struggle with unprecedented monetary policy and the reality of economic activity, creating heightened volatility. Sir John Templeton once said, "The four most dangerous words in investing are: 'this time it's different.'" For us, it's not different. It's the same path the world has been on since the Global Financial Crisis.

HIGHLAND

IMPORTANT DISCLOSURES: The information provided herein is for informational purposes only. While Highland has tried to provide accurate and timely information, there may be inadvertent technical or factual inaccuracies or typographical errors for which we apologize. The information provided herein does not constitute a solicitation or offer by Highland, or its subsidiaries and affiliates, to buy or sell any securities or other financial instrument, or to provide investment advice or service. Nothing contained herein should be construed as investment advice or a recommendation to purchase or sell a particular security. Investing involves a high degree of risk, and all investors should carefully consider their investment objective and the suitability of any investments. Past performance is not indicative of future results. Investments are subject to loss.

AUTHORS:

SCOTT GRAHAM, CFA
CHIEF INVESTMENT OFFICER

ANDY WEBB, CFA, CPA
VICE PRESIDENT

HIGHLAND

HIGHLAND ASSOCIATES

2545 HIGHLAND AVENUE SOUTH, SUITE 200

BIRMINGHAM, ALABAMA 35205

P. 1-800-405-7729 OR (205) 933-8664 F. (205) 933-7688