CAPITAL MARKETS QUARTERLY
1Q16

TAKING THE ALTERNATE ROUTE

Today's economic landscape is ripe with challenges resulting from diverging monetary policies and growth trajectories. We continue to grapple with ***low*** growth and ***low*** rates for a ***long*** time. This "Triple L" environment puts strain on investors as they try to navigate a multifaceted and changing world, all with an eye towards meeting their objectives. Changing times often call for a change in perspective. It is a lot like taking a road trip and trying to determine the best route. Most of the time, the freeway is the favored choice because of its speed and efficiency. What happens though when the freeway is overwhelmed with traffic or is shut down? Travelers are forced to take an alternate route to their destination, utilizing back roads. The new unfamiliar route may pose a few twists and turns and perhaps a few speed bumps. This creates stress due to the uncertainty of your whereabouts and the change from the norm, often leading to second guessing by passengers. The road trippers still arrive at the destination, but the path traveled is a little unconventional.

Recent stock market performance has been this tale of two markets. In March of this year, investors celebrated the seven year anniversary of the bull market in U.S. equities. At seven years, this makes this the third longest bull market on record. On March 9, 2009, the S&P 500 bottomed as equity valuations touched generational lows. Since that time, the S&P 500 has been in a strong up trending market. As of the end of the first quarter 2015, the S&P index had risen 209% since the bottom. Returns were good and we were traveling unencumbered down the freeway.

Last year, the market environment changed dramatically. From March 2015 through March 2016, the S&P 500 produced zero returns for investors. In fact, since last year, the market experienced four separate instances when the index level either rose or fell 12%. In addition, international markets experienced bear market drawdowns, or greater than 20% declines. Why have we seen this change in risk sentiment from investors? We believe that central bank activity has been the root cause. There was coordinated global cooperation from central banks as rates were kept low and liquidity was pumped into the markets. The mantra of investors during this period was "don't fight the Fed". Risk sentiment was low, equity valuations rose and bond yields fell. The outlook for a positive market environment appeared certain - at least for the short term.

DIVERGING MONETARY POLICIES

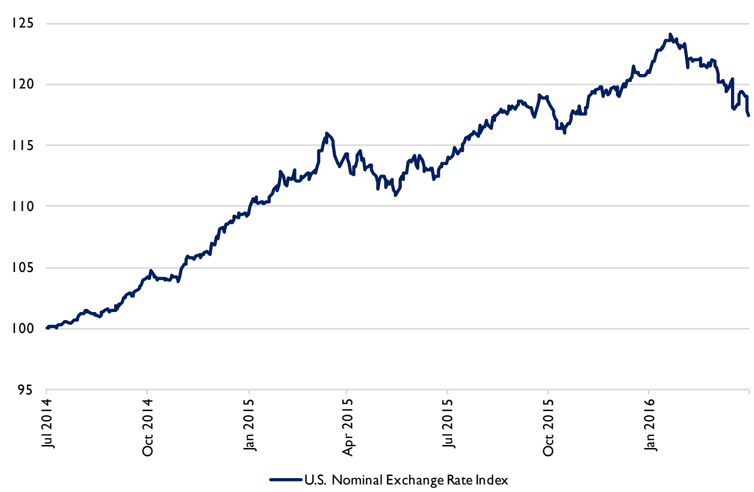
The summer of 2013 marked the beginning of a divergence of U.S. monetary policy from the rest of the world, when the Fed signaled to markets that they would begin tapering, or reducing, asset purchases. In October 2014, the Quantitative Easing program in the U.S. ended. By executing this action, the Fed was removing some of the liquidity that had buoyed the market. Since that time frame we have seen a

much more uneven market. Reducing extremely accommodative monetary policy meant that the Fed was not cooperating with other central banks.

As the dollar strengthened, this placed pressure on emerging markets which had borrowed heavily in U.S. dollars.

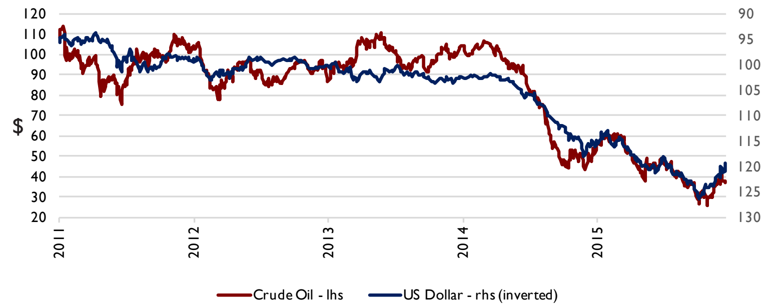
This action had many consequences and implications, but the most important was that it resulted in a rise in the U.S. dollar (see Figure 1). As the dollar strengthened, this placed pressure on emerging markets which had borrowed heavily in U.S. dollars. With many of these countries' currencies now depreciating versus the dollar, this made it more expensive for them to repay these dollar denominated debts. As emerging market growth slowed down, commodity prices fell reflecting this reduction in demand. Although demand for commodities had begun to wane, energy production continued to rise, creating excess supply. These two forces drove commodity and oil prices further down, in almost lockstep with the U.S. dollar (see Figure 2, US $ inverted). Lastly, dollar strength placed stress on U.S. manufacturing, as a stronger dollar made U.S. goods more expensive compared to their counterparts. All of these actions resulted in a fall in global trade as companies and countries grappled with lower revenues. Since the global trade pie was shrinking, countries devalued their currencies in hopes of increasing their share of world trade. This type of a beggar thy neighbor policy was instituted in order to increase exports to other countries. However, all of these devaluations did not result in countries increasing their share. In fact, merchandise exports as a % of GDP fell from 24% in 2012 to 21% in 2015.

FIGURE 1



SOURCE: FEDERAL RESERVE; HIGHLAND ASSOCIATES, INDEXED TO 100

FIGURE 2



SOURCE: FEDERAL RESERVE; BAKER HUGHES; FACTSETSET; HIGHLAND ASSOCIATES

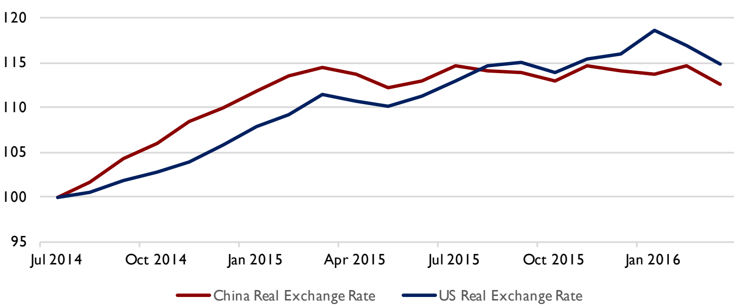
CHINA'S PURSUIT OF THE INCOMPATIBLE TRINITY

The trinity is a country's ability to achieve free flowing capital, a fixed exchange rate, and independent monetary policy.

The other after-effect from the divergence of U.S. policy was the impact that the rise in the U.S. dollar had on the 2nd largest economy in the world. China's economy has been slowing as it attempts to transition away from its historical investment driven model to one that is based on internal consumption and service-based economy. Not only is China attempting something that is rarely accomplished, they are also attempting it through very unconventional means. They are seeking to conquer the incompatible trinity, which is a concept introduced by Nobel Laureate Robert Mundell. The trinity is a country's ability to achieve free flowing capital, a fixed exchange rate, and independent monetary policy. It has never been accomplished over the long-run, and the best one could hope for is attaining two of the three. This is because in order to achieve it, a country must use its reserves as a buffer. That is what makes it incompatible, as reserves are finite and will eventually run out.

Since the Chinese renminbi is effectively pegged to the U.S. dollar, as the dollar rose, so did China's currency (see Figure 3). China's growth is slowing due to its aforementioned economic transformation. In fact, since 2011 the real, or inflation-adjusted, economic growth rate in China had dropped 31%. However, there was an even starker decline in the nominal economic growth rate, which includes inflation. During this same time period, the economic growth rate had declined 71%. A drop of this magnitude is a significant impediment, especially considering that China's total government and private debt to GDP amounts to 282%.

FIGURE 3



SOURCE: BIS; FEDERAL RESERVE; HIGHLAND ASSOCIATES; INDEXED TO 100

As China's goods became more expensive, their economy began to feel pressure. In order to alleviate some of this weakness, China encouraged retail investors to invest in its stock market, thus boosting stock prices. Eventually prices ran too far and the Shanghai market fell 40%. In August 2015, China announced that they would allow its currency to float more freely and increased the band around its peg to the U.S. dollar, signifying its first waiver from the trinity. With this announcement, China's currency depreciated versus the U.S. dollar and the country faced a substantial outflow of capital, which is the second leg of the trinity. In order to protect their currency from experiencing further depreciation, they used their reserves to buy the renminbi and defend their currency (see Figure 4). By reducing their reserves and buying their currency, this is effectively a tightening in its monetary policy, which is the final leg of the trinity.

FIGURE 4

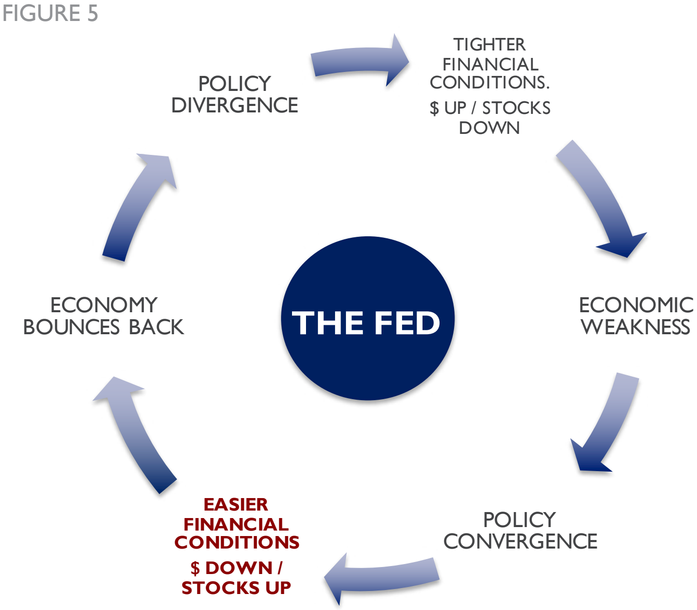
SOURCE: BIS; FEDERAL RESERVE; HIGHLAND ASSOCIATES

THE FED'S FEEDBACK DILEMMA

Investors continue to be fixated on central bank monetary policy, and in particular the Fed's move. In December of last year, the Fed raised interest rates a quarter of a percent. However, what caught investors off guard was its signal to the markets they expected to raise interest rates four times in 2016. This volatility in the markets trickled down to the economy and caused a slowdown in economic growth. The Fed officials therefore backed off its estimate to only two rate hikes this year. However, it is this constant feedback loop that will make it difficult for the Fed to normalize interest rates. As the chart below from JP Morgan illustrates, the Fed's divergence has them in the middle of a feedback loop. Whenever they signal tighter financial conditions, the dollar rallies and the equity market falls, resulting in a slowdown in the broader economy. Therefore, this causes the Fed to back off their expectations, resulting in a lower dollar, financial conditions easing and equities rising, driving economic growth higher. As the economy strengthens and inflation begins to rise, the Fed signals divergence which leads us back into this feedback loop. With the Bank of Japan and the European Central Bank signaling extremely easy monetary policy for the near future, it is difficult to see how the Fed can break from this feedback loop.

> *As the economy strengthens and inflation begins to rise, the Fed signals divergence which leads us back into this feedback loop.*

FIGURE 5



SOURCE: JP MORGAN; HIGHLAND ASSOCIATES

CONCLUSION

Previously coordinated central bank policy has led to a historic low interest rate environment. The average yield of G-7 countries is the lowest it has ever been. According to Bloomberg, there have been over 600 interest rate cuts and $12 Trillion of asset purchases by central banks globally, yet growth has been stuck in a rut and inflation has barely moved. Because of these factors, we continue to remain in this "Triple L Environment" with ***low*** growth, ***low*** yields for a ***long*** time. The more time it takes for economic growth to move closer to its pre-Global Financial Crisis levels, the more apparent it becomes that structural forces, such as aging demographics and highly indebted societies, will place a weight on economic growth.

These factors are why we expect the Fed to move very gradually with any subsequent rate increases. Thus, we are underweight fixed income. We continue to favor a target weighting for equities. However, in December 2015, we moved back to neutral regional positioning (we had been underweight U.S. and overweight International Developed ex U.S.). We continue to favor markets outside of the U.S. over the long-term, but in the short-term we believe the risks outside the U.S. are higher, especially with Europe and Japan employing negative interest rates. In addition, in an environment more prone to financial and economic shocks, we favor a higher allocation to hedged equity, which we expect to generate equity-like returns with less volatility. Real assets, which include private real estate, commodities and inflation-linked bonds, performed very well in the first quarter of 2016, but we remain target weight due to the uncertainty around longer term inflation expectations.

Most likely the remaining years of this bull market are going to be more like this last year and less like the previous 6 years. We are now in the point of the cycle, where investing may warrant following an alternate route, as opposed to the freeway. We believe this bull market has more room to go, but the drive is going to be much more volatile as global economic growth is much lower than what investors have come to expect. It is this uncommon perspective that will aid us in allocating capital in a constantly evolving landscape, where central banks are attempting policies that were thought to be impossible before the Global Financial Crisis. We fully expect to still reach our destination, but the ride may be full of some twists and turns. Our goal is to help our clients navigate these unchartered and untraveled roads so they can reach their destination safe and sound.

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