HIGHLAND

MARKET BRIEF: SUMMER STORMS
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SUMMER STORMS
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Summer has always been a time characterized by beach trips, fireworks and baseball. However for investors, summer time is also a period of heightened volatility in the markets. In fact, since 2009, the VIX Index (known as the "Volatility" index) is 6% higher on average in summer months than in non-summer months. This year has been no different as volatility has been rising, with the VIX index up 33% since the end of May. The equity markets despise uncertainty and that's currently what is driving this increase in volatility. This nebulousness is coming from Greece, China and the Federal Reserve's plans for hiking interest rates. Lately there have been some outsized swings in the equity markets which has investors wary.

Greece, a country of 11 million people and accounts for 2% of GDP in the European Union ("EU"), continues to act defiantly against its creditors. Last week, Greek citizens voted against the proposed austerity conditions imposed by the EU and the International Monetary Fund ("IMF"). This decision took the market somewhat by surprise as we witnessed elevated volatility, but not the huge sell-off predicted. Eurogroup President Jeroen Dijsselbloem called this result "very regrettable for the future of Greece." Still, the EU has agreed to keep the Greek banking system afloat until July 12th. They have provided an ultimatum to Greece that they must have a bailout deal in place before the EU's lifeline runs out, or else face a banking collapse and likely euro exit. Before the referendum was called, Greece's Prime Minister Tsipras was said to be very close towards striking a bailout deal with its creditors. Since the referendum, the EU has turned cold towards Greece. Any bailout deal would need to include heavy cuts, austerity, fundamental economic/fiscal reforms and full repayment of debt. In other words, the EU does not appear to be giving any ground from the previous talks. The onus is now on Tsipras to close the gap between a citizenry that does not want more austerity and creditors that demand it. This will truly be a delicate balancing act that could run all the way up to the deadline.

Adding to the uncertainty in the markets created by Greece is another looming issue that could have deeper ramifications. We view China as the biggest uncertainty in the markets because of its size. As famed investor Jim O'Neill used to exclaim, China creates a new economy the size of Greece every 12 weeks. This accelerated growth trajectory has dropped from 14% annualized growth in 2007 to 7% growth today. The slowdown in the growth rate is a by-product of China trying to transition to a consumption driven economy.

Due to China's decelerating economy, there has also been a fall in housing prices. For many years, housing has been the citizens' favorite choice to invest their capital, so a decline in housing could cause massive ripple effects in the country. The Chinese government is highly focused on keeping social unrest down, so naturally they found another place for citizens to invest their money: the stock market. Once China made it easier for its citizens to buy mainland shares of Chinese companies, there was a rush to invest. From September 2013 through June 11, 2015, the Shanghai Composite rose 140%. Many of these new investors used margin to buy shares with leverage, thus boosting their returns. However on June 12th, the Chinese government announced new measures which decreased the amount of margin lending stock brokers could provide. As the adage states, leverage is a double-edged sword and once the Chinese market began falling, many

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of these investors were forced to sell to meet margin requirements, thus begetting more selling. Chinese stocks are down 32% since that date. Their government is now doing everything it can to rescue the markets. These measures include cutting interest rates, suspending IPOs and having brokerages commit to buying billions worth of stocks, all to no avail. According to Bespoke Investment Group, China's stock markets have now lost $3.25 trillion. As CNN noted, to put this into perspective, that's more than the size of France's entire stock market and 60% of Japan's market.

From Highland's perspective, we are not as concerned with the fall in the stock market as we are the Chinese economy slowing down. During this same time period, copper and silver have fallen 30% and 47%, respectively, which could signal a further slowdown in China's economy.

HIGHLAND'S VIEWPOINT

Although understanding the risk environment is important, it is also vital to understand how the markets have reacted to these risks this year. As of July 7, 2015, year-to-date returns for global equities are up 2%, U.S. large cap equities have risen 2.2%, developed foreign equities are up 2.0% and emerging market equities are only down 1%. The U.S. economy has mostly recovered from its winter slow down, as economists are expecting second quarter growth of 2.5-3%. According to the latest Federal Reserve employment report, job openings have risen to a record high 5.4 million jobs, indicating the strongest demand since December 2000, while initial claims for unemployment remain near its lowest level since the spring of 2000. Valuations in U.S. equities remain on the higher end historically and have continued to inch higher. As valuations rise, the expectation of future returns decline, thus leading to an increase in volatility. Therefore, we have been more positive on global equities where valuations are lower and expected returns are higher. Volatility is not going away as there remains a lot of uncertainty, but as long-term investors we see these challenges as manageable and remain committed to a global equity orientation.

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