HIGHLAND

MARKET BRIEF
DECEMBER 2015

THE BEGINNING OF A NEW ERA?

Throughout 2015, the market has been fixated on when the Federal Reserve ("Fed") would raise short-term interest rates. Finally, we can put this behind us as the Fed announced a 25 basis point increase in the Fed Funds rate on December 16th. This is the U.S.'s first rate hike since 2006. Although this move is another signal that the Fed is moving towards a normal rate environment, its monetary policy stance remains accommodative. The reality is that by historical standards rates are extremely low and likely to remain depressed for some time.

In Chairperson Yellen's speech, she noted that the rate increase was appropriate because the U.S. economy has shown considerable strength and labor markets have improved. Despite the recent turmoil in the markets, her speech had an upbeat tone with respect to the economic outlook. She noted that domestic spending, which accounts for 85 percent of aggregate spending in the U.S. economy, has continued to increase. Yellen also expressed conviction that global risks have lessened since the summer.

The initial rate hike was an important signaling tool, but it is the path of future rate movements that matters the most. In past cycles, the Fed has increased the level at a "measured" pace. This meant that each meeting the Fed would raise the target rate by 25 basis points. For this current cycle, Yellen noted the Fed is going to hike rates at a "gradual" pace. This implies that future rate decisions are not on a predetermined schedule and each action will be data dependent. By not having a preset schedule, the Fed has allowed itself more latitude. However, this also adds uncertainty, as investors focus on each piece of data more closely in the absence of more explicit guidance from the Fed.

The Fed's Dot Plot, which illustrates the projections from each member, shows interest rates rising 100 basis points in 2016 and another 100 basis points in 2017. In the 1994 and 2004 hiking cycle, rates rose 275 basis points and 200 basis points, respectively, in the first 12 months following the initial rate increase. The current projection is much lower than history and reiterates the Fed's desire to be very gradual in increasing the level of rates.

However, the market does not believe that future rate hikes will occur as aggressively as current Fed projections indicate. Fed funds futures are pricing in a 50 basis point increase in 2016 and another 50 basis point increase in 2017. Because of this dichotomy, we expect there to be increased volatility in the fixed income market until Fed and market projections converge to a consensus level.

Despite inflation running below its stated goal of 2 percent, the Fed decided that it was time to change policy. Yellen noted that many of the factors holding down inflation are transitory, including energy prices. She remarked that once energy prices stabilize then these aspects should subside, thus moving inflation closer to its goal. Interestingly, the chairperson's statement does not reconcile with the Fed's own projections, which indicate inflation running below 2 percent until 2018.

HIGHLAND'S VIEWPOINT

The Fed's tightening marks the beginning of a period in which the world's central banks are moving in different directions. While the Bank of England is closer to tightening than loosening, the European Central Bank and the Bank of Japan are both committed to quantitative easing programs, and the People's Bank of China looks content to let the yuan continue to depreciate against the dollar. Although the dollar is not likely to appreciate rapidly from current levels (it has risen strongly for 18 months already in anticipation of this move), the potential is there for further dollar gains. An appreciating

ANDY WEBB, CFA, CPA
VICE PRESIDENT

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 September 30, 2015, we serve as investment consultant on approximately $17 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

dollar, as it has for much of this year, will continue to impact investments in widely held asset classes like domestic large cap multinational equities, non-U.S. stocks and bonds, and commodities.

Since 2009, more than a dozen central banks have tried to raise interest rates, only to have to admit defeat and reset them lower. The U.S. is looking to buck this trend with its latest move. By raising rates and diverging from other central banks, the Fed has indicated the U.S. economy is resilient and healthy enough to cope with higher borrowing costs. While the first rate hike is now behind us, we believe what the Fed does from here is more important. Can they maintain a gradual pace or will they fall victim to raising too quickly? Answers to these questions are difficult to predict, but real time economic data will provide helpful feedback. If broad economic data such as GDP growth decelerates or contracts following rate hikes, the Fed will likely scale back the timing and magnitude of future rate hikes. Conversely, if GDP and other economic data continue to thrive amid higher rates, the Fed may raise more aggressively than currently anticipated. Only time will tell and we will continue to monitor the situation closely.

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 OR (205) 933-8664
F. (205) 933-7688

HIGHLANDASSOC.COM