HIGHLAND

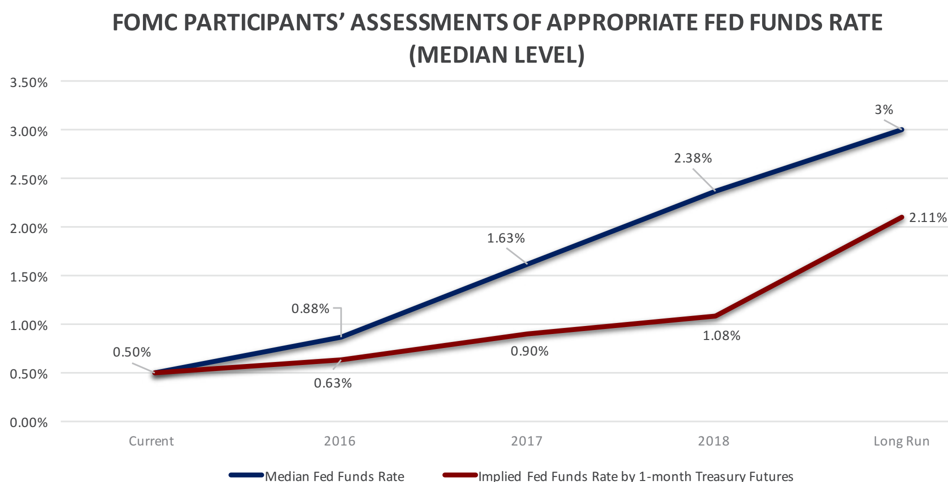
MARKET BRIEF
JUNE 2016

FED'S STATEMENT CONFIRMS LOWER FOR LONGER OUTLOOK

The Federal Operating Market Committee ("FOMC") kept interest rates unchanged at 0.25%-0.50% at its June meeting. The "hold stance" was not surprising, with the market pricing in less than a 5% probability of a rate increase. In the announcement, the Federal Reserve ("Fed") noted that economic growth accelerated even as the labor market slowed. Specifically, in 2015, nonfarm payroll gains averaged 228,000 per month, whereas April and May only saw gains of 80,000 on average. Despite this recent weakness, the Atlanta Fed believes that economic growth is on pace to rally from less than 1% in the 1st quarter to 2.8% in the 2nd quarter. Additionally, lower commodity prices have continued to buoy U.S. consumer spending, which accounts for 70% of the overall economy. In her press conference, Chairperson Yellen estimated that since mid-2014, U.S. households have seen the equivalent of a $1,400 benefit from lower oil prices. Yellen further noted that global economic and political considerations also impacted the Fed's decision to leave rates unchanged. Specifically, she noted that global uncertainty, including the June 23rd referendum vote on the United Kingdom leaving the European Union (i.e. Brexit), compelled the committee to maintain rates at their current level.

The median expectation of the FOMC's 17 participants indicates that the Fed as a whole is now signaling just one or two interest rate increases in 2016. As recently as December 2015, the FOMC's participants indicated an expectation of four rate rises this year. Furthermore, in December 2015, 13 of the 17 voting members expected a Fed Funds rate above 1% by the end of 2016, whereas only two members now believe that the rate will be above 1% by the end of this year. The market believes the Fed is even less likely to raise rates. Figure 1 illustrates that the implied Fed Funds rate remains materially below the median Fed funds rate for the near to intermediate term.

FIGURE 1



SOURCES: FEDERAL RESERVE; FACTSET; HIGHLAND ASSOCIATES

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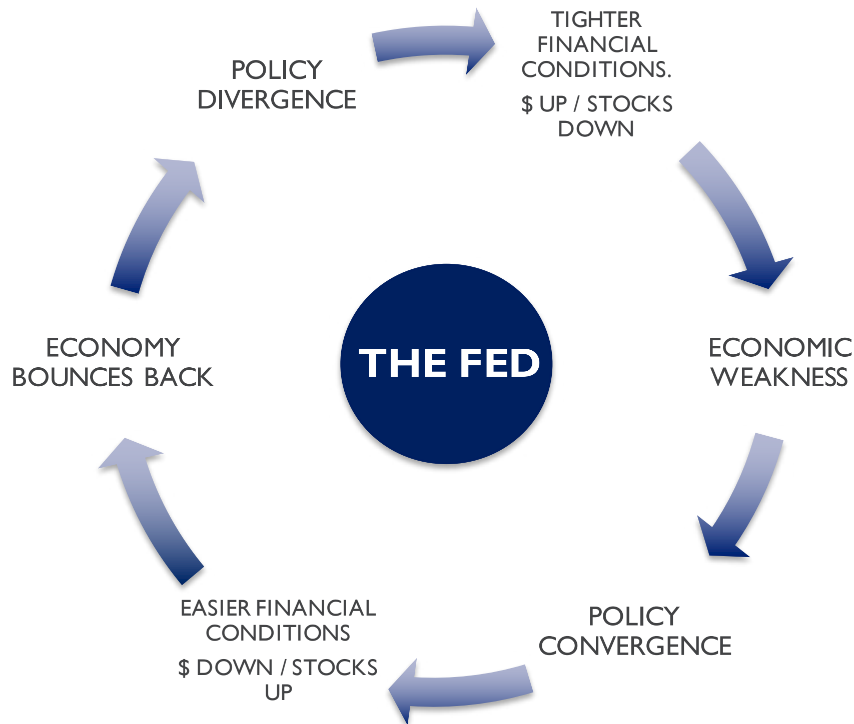
HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 OR (205) 933-8664
F. (205) 933-7688

Why has the Fed become more dovish in its stance? Since the December meeting, we have seen Japan embark on negative interest policy, Europe cut its negative rates even further, increased fears of the United Kingdom leaving the European Union, and constant downgrades of global growth. The uncertainty associated with these developments conspired to drive a peak-to-trough drawdown of 15% in global equity markets earlier in the year. In addition, since the Fed's last rate increase in December, U.S. implied breakeven inflation expectations have declined 25 basis points, while the 10 -year U.S. Treasury yield has dropped 71 basis points. The current 10-year yield is only 15 basis points from its historical low. Although the U.S. economy has remained somewhat buoyant during all of this global turmoil, there remains a lot of uncertainty in both financial markets and the economy as a whole.

The Fed's next meeting is in July, and the market is pricing in only a 10% probability of a rate rise during that meeting. The next meeting with a scheduled press conference is in September, which Highland believes is likely too close to the U.S. Presidential election to compel a change in Fed policy. To the extent that the Fed remains on hold, the dollar is unlikely to strengthen further. This should benefit emerging markets, commodities and other risk assets. As illustrated in Figure 2, the Fed remains stuck in its feedback loop.

As the Fed tries to appease everyone from equity market investors to emerging market consumers, they have made it very difficult for them to raise interest rates without getting negative feedback. It is because of this dynamic that Highland maintains our "**Triple L**" market outlook of **low** growth, **low** yields, for a **long** time.

FIGURE 2



SOURCES: J.P. MORGAN; HIGHLAND ASSOCIATES

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