HIGHLAND

CAPITAL MARKETS QUARTERLY
FIRST QUARTER 2017

GREAT EXPECTATIONS

HIGHLIGHTS:

- The equity market has benefited from a surge in confidence from businesses due to the expectation of de-regulation and fiscal reform. However, passing legislation is difficult because of the polarization in Congress. Fortunately, even with this policy uncertainty, higher global economic growth and profits should sustain the market's upward trend.

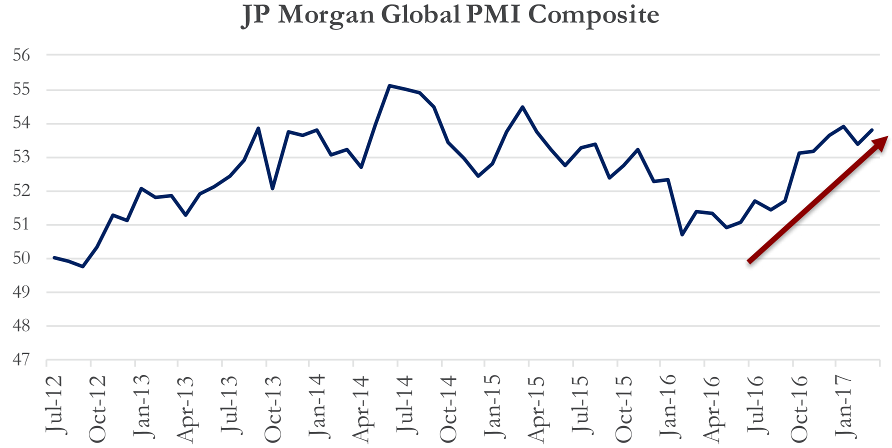
- It is important for investors to focus on the key drivers. Despite the government's inability to pass reforms, the global economy is showing strength. If growth slows and there is no progress on meaningful reform, the market could retrace some of its recent gains.

- Tax reform is difficult due to the many parties involved and their different goals. Congress remains divided as to what is the appropriate marginal tax rate, how to fund tax reform, and how to make it revenue-neutral and not increase the deficit. There are also other global issues that could shift attention away from tax reform.

Spring is a time of great hope as the signs of winter are shed and new growth emerges. Even though we experience warmer weather during the day, the crisp night air reminds us that colder weather isn't quite gone. Much like the seasons, the markets, too, are experiencing change.

Since the presidential election, the equity markets are being buoyed by hopefulness that new policies and changes in regulation will lead to higher economic growth. In fact, this was the best start to the year for global equities since 2012 (global equities ended up 16% that year). Global leaders have come to the realization that monetary policy can only take their economies so far, and there has been a noticeable shift toward employing more fiscal stimulus. Easy monetary policy and a push for more government spending has reverberated in the U.K., Europe, China, and Japan, as well as in the U.S. This is the first time since pre-crisis that all of these countries have been synchronized in trying to stimulate their economies. Consequently, the global economy has experienced an upswing in economic activity since last summer. Global economic surveys are validating this upward trend in economic growth (see *Figures 1 and 2*).

FIGURE 1



SOURCE: FACTSET; HIGHLAND ASSOCIATES

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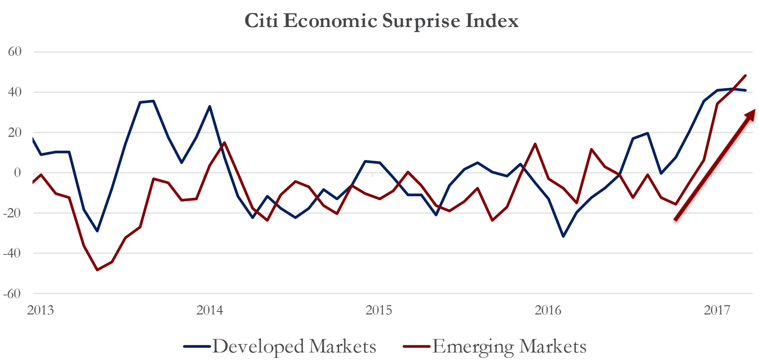
FIGURE 2



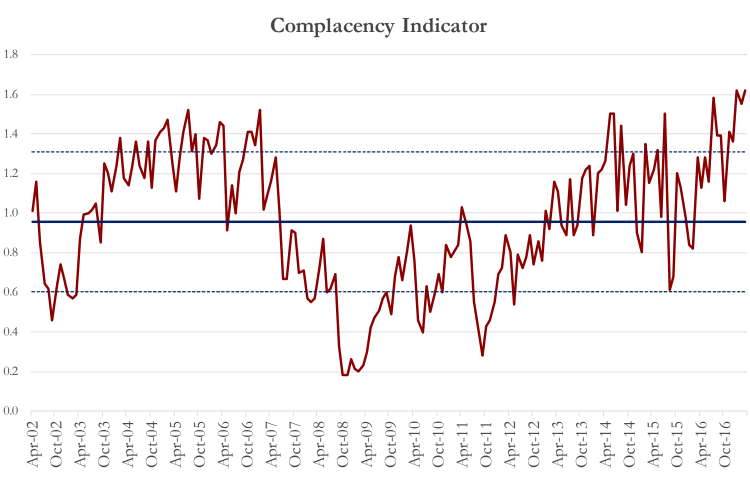
SOURCE: CITIGROUP; FACTSET; HIGHLAND ASSOCIATES

This enthusiasm from investors is based on the hope that, finally, economic growth will get out of this malaise and, with the right reforms, will move back to pre-crisis average. Market sentiment is benefiting from the following notions:

- Tax reform
- Defense and infrastructure spending
- Rollback of regulations

This confidence coming from both investors and business surveys drove a steady increase in global markets amid low volatility. The average closing price for the VIX, an indicator of market uncertainty, in the first quarter was the lowest it has been since 2006. It was almost too quiet, as the rise in the market was driven by expectations of higher earnings, thereby driving valuations higher. The complacency ratio (S&P Price-to-Earnings divided by VIX, *Figure 3*) points toward investors being a bit too optimistic. In other words, the market appears priced for perfection.

FIGURE 3



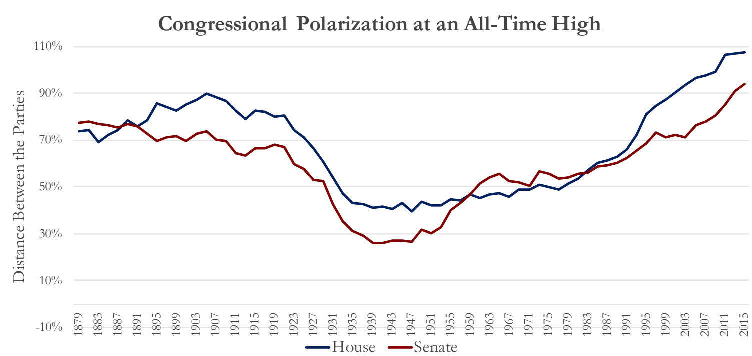
SOURCE: FACTSET; HIGHLAND ASSOCIATES; S&P PRICE-TO-EARNINGS DIVIDED BY VIX

The rally in the U.S. markets was driven by the hope that the new administration was going to bolster business spending by taking a pro-business approach. However, the president is finding it is much easier to mince words than it is to actually get these measures passed. The hope for change in policies and stimulus has buoyed the market, but should these reforms fail to be implemented, it could precipitate the market clawing back some of these gains. President Trump and his allies have discovered quickly that despite having a majority in the House and the Senate, it will be a battle to get sweeping reforms.

POLITICAL UNCERTAINTY

There has been a substantial shift in Congress for members to vote along ideologies and party lines. Using data from 1879 through 2015, University of Georgia professor Keith Poole calculates the degree of partisanship as measured through an analysis of Congressional roll calls. According to this data, polarization in Congress is reaching new record highs (see *Figure 4*).

FIGURE 4



SOURCE: VOTEVIEW; HIGHLAND ASSOCIATES

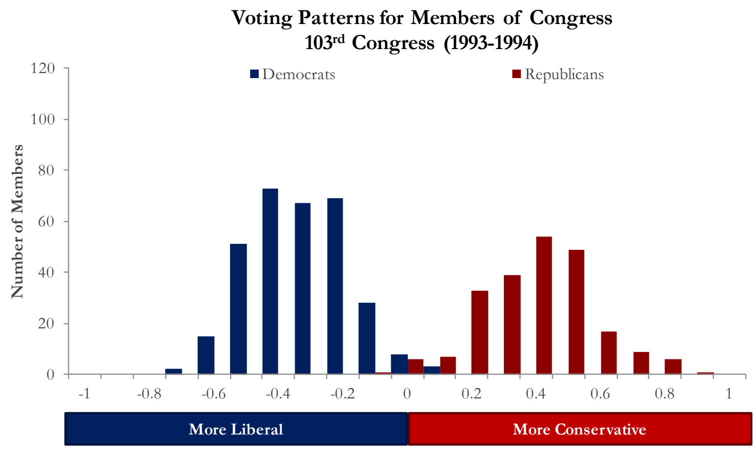
This data signifies there has been a dramatic shift away from moderates and a clear swing toward stronger leaning left and right members. This results in more stalemate and less working across party lines. This can be seen in the recent confirmation process of Supreme Court Justice Gorsuch. Once Republicans realized that Democrats would filibuster the nomination, they enacted an uncommon option that only required a majority vote. Coincidentally, Gorsuch was confirmed with all Republicans voting yes and most Democrats voting no.

The next issue Trump faces is the realization that although there are two parties in Congress, there are multiple "tribes" within those parties, as highlighted in a recent *Wall Street Journal* article.

- Freedom Caucus: group of 40-50 less-tenured House Republicans who are among the most right-wing Conservatives
- Tuesday Group: group of 50 moderate House Republicans who believe it is essential to enact reforms even if it means accepting compromises with Democrats
- Trump Tribe: group consists of President, his advisers, and his wider administration
- Never-Trump Democrats: strong left-leaning liberals who are determined not to cooperate with Trump
- Maybe-Sometimes-Trump Democrats: moderate to conservative Democrats, many from states Trump won, who are willing to work with Trump on select issues

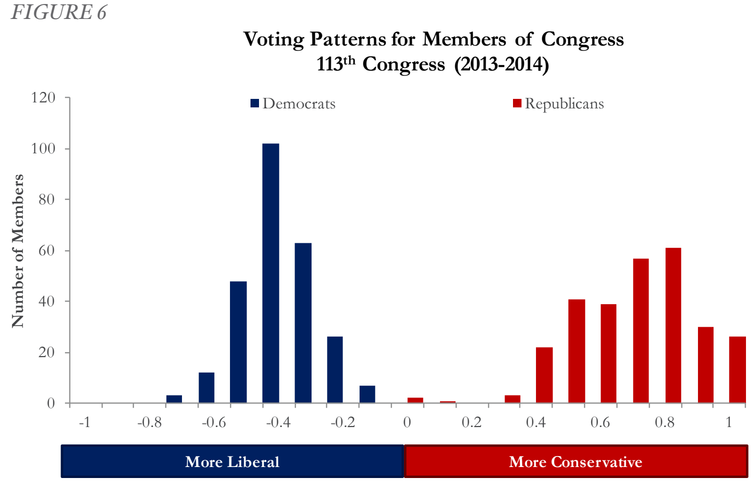
The Freedom Caucus within the Republican party stamped out the new administration's attempt at repealing the Affordable Care Act. This group's dislike of the alternative resulted in there not even being a vote, as it was apparent that without its support it had no chance of passing. The next tribe is the Bernie Sanders–led group that will not cooperate with President Trump on any issue. There are still some on both sides that state they believe a properly functioning government involves working together to create policy that benefits both sides. However, these are becoming the minority as the median Democrat and Republican have moved further from the middle over the last 20 years (see *Figures 5 and 6*). The added difficulty of appeasing the many tribes, some of which will vote against their party, makes it that much more difficult to get cohesive policy enacted.

FIGURE 5



SOURCE: DEPT. OF POLITICAL SCIENCE AT THE UNIVERSITY OF GEORGIA; HIGHLAND ASSOCIATES
NOTE: -1 IS MOST LIBERAL AND +1 IS MOST CONSERVATIVE BASED ON VOTING RECORDS OF ALL THE MEMBERS OF CONGRESS

FIGURE 6



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NOTE: -1 IS MOST LIBERAL AND +1 IS MOST CONSERVATIVE BASED ON VOTING RECORDS OF ALL THE MEMBERS OF CONGRESS

While the equity market initially sold off after Congress determined not to vote to repeal the Affordable Care Act, sentiment swung from negative to positive as investors believed Congress would now focus on tax reform. However, without the offsetting increase in revenue expected from repealing the Affordable Care Act, meaningful reform is going to be difficult.

Tax reform is a massive undertaking that is much more difficult to accomplish than the mainstream public understands. For one thing, there is a big difference between a tax cut and tax reform. Tax reform means a revenue-neutral adjustment of the tax code, which removes some tax deductions and uses that increase in revenue to reduce tax rates. If the goal is to finance a tax rate cut by removing tax deductions, then it results in a zero-sum game where every winner is offset by a loser. The GOP calls for broadening the tax base, which suggests taxes will be lowered for some, but will be raised for others. Because of this, there are many interested parties and lobbyists that are working hard to make sure they are on the winning side with lower taxes.

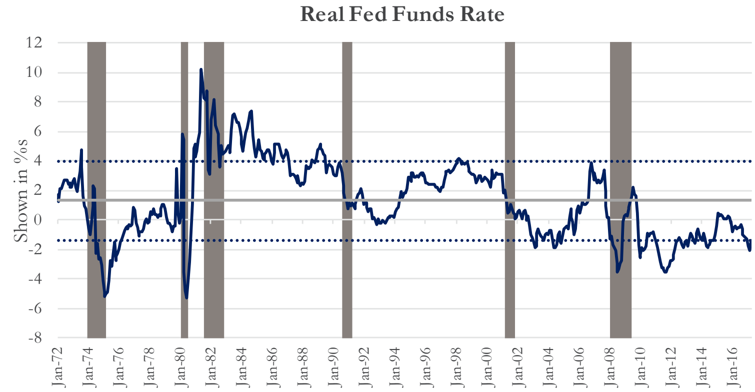
As for the details of tax reform, Congress remains divided as to what is the appropriate marginal tax rate, as well as how it should be funded. There are some in Congress who are vehemently opposed to any tax cuts unless they are revenue neutral. Furthermore, the Border Tax Adjustment that has been discussed is very unpopular with many in Congress, as it is perceived to be too complicated and a boon to exporters while increasing costs for U.S. consumers. Also, the only way to pass tax reform with a simple majority in the Senate, without being filibustered, is through a budget reconciliation bill. To take this path, the rules state the modifications cannot increase the budget deficit after 10 years. If they do, then they must be phased out after 10 years.

Tax reform could take a back seat as there is still the potential government shutdown at the end of April, the need to raise the federal debt ceiling this summer, and the passing of a budget in the fall. Geopolitically, there remain potential problems with Syria and North Korea, as well as terrorism in Europe and the Middle East that could take precedence. In addition, there is still the presidential elections in France and Germany, uncertainty with BREXIT negotiations, and the unpredictable nature of President Trump and his Twitter tirades. If this swing away from tax policy were to occur, investment could slow down as businesses delay capital spending.

MONETARY POLICY

Monetary policy remains accommodative globally as Europe and Japan are still instituting negative interest rates. Even though the U.S. is in the early stages of removing accommodative policy, it remains very loose based on history (see *Figure 7*) as real rates remain negative. The Federal Reserve ("Fed") has now raised interest rates three times in this economic cycle and is expected to raise them two more times this year.

FIGURE 7



SOURCE: FACTSET; HIGHLAND ASSOCIATES; FEDERAL FUNDS TARGET RATE MINUS INFLATION

The last quarter point rate hike in March was interpreted as dovish by both bond and equity investors due to the Fed's Dot Plot not changing its path of future rate hikes. In the press conference, Chairperson Yellen discussed letting the economy and inflation run higher before considering accelerating rate hikes. Yellen noted that the 2% inflation rate the Fed is targeting is not an absolute 2%, but that it should average 2% over a cycle. Because personal consumption expenditure ("PCE") inflation, the Fed's favored metric, has been below 2% for years, there is the possibility that the Fed will allow it to remain elevated before deciding to increase rates more quickly. This type of scenario is not ideal for bonds where yields are low and have been depressed by central banks.

Many are questioning how the Fed voting members could alter the Fed's current path. Currently there are two open seats with the potential for more in 2018 if Yellen and Vice Chairman Stanley Fischer were to resign after their terms. With the news of Richmond Fed President Jeff Lacker resigning for leaking confidential information, there remains a lack of clarity as to what kind of fallout could ensue. Additionally, there's the $4.5 trillion elephant in the room regarding how the Fed plans to reduce its balance sheet. Furthermore, how will the market react once a plan is announced to reduce the Fed's holdings of U.S. treasuries and agency securities? Investors may take this as a full admission that extraordinary accommodative monetary policy is coming to an end.

Due to demographics, high debt loads, and tepid economic growth, we expect the path of rate increases to be gradual, but the Fed's desire to normalize policy could result in faster rate hikes. Not only is the U.S. raising rates, but China has also been increasing its rates to stop outflows of foreign reserves. In light of these issues, uncertainty with monetary policy will continue to be a focal point for investors.

HIGHLAND'S VIEW POINT: FOCUS ON THE KEY DRIVERS

Despite the shortcomings of the government and reservations about its ability to pass reforms, the economy is showing strength. Even with this void of fiscal stimulus in the U.S., other developed and emerging markets point toward healthy growth. The global economy is in a reflationary window, thereby driving stronger sentiment, rising profits, and increasing business and consumer confidence. The latest business surveys signify an increase in growth in both developed and emerging economies. After years of slow growth, there are even signs that world trade volumes are beginning to show strength. According to the J.P. Morgan survey, global manufacturing is stronger than it has been in five years. This is partly attributable to the end of the depression that energy and mining companies experienced since 2014. The other factor boosting manufacturing is the stimulus efforts from China, which has been pumping potential growth into its economy.

In addition, the threat from domestic populist policies appears less likely to materialize in the near term. President Trump has backed off labeling China a currency manipulator, as well as rescinding the NAFTA agreement. Government leaders are coming together to renounce protectionist policies, and voters in European elections appear willing to stay in the EU.

When reviewing the markets, it remains important for investors to take a **3-D** approach: **Decode** and **Deconstruct** to **Deliver** value. Even in this uncertain world, there continue to be opportunities to add value, as well as areas of the market to avoid. Emerging markets are exhibiting a rebound in economies, experiencing double-digit earnings growth, and valuations are cheap compared to history. Although U.S. large-cap stocks have outperformed small-cap stocks to begin the year, smaller stocks will benefit more from less regulation as well as tax reform. Europe is even beginning to show a decline in unemployment and a substantial increase in business confidence. However, it is still grappling with the pro-Euro vs. Euro-skeptic parties. In addition, negative interest rates keep a ceiling on bank loan growth in Europe and Japan. We continue to believe that in this market environment, a rising tide will not lift all boats. It is therefore important to be mindful of potential policies when looking for areas to allocate capital.

The market appears to be waiting and hoping for fiscal and monetary policy to help maintain its upward trend. If policy uncertainty can be reduced through meaningful reform and economic growth continues its upward trend, the market will be set for strong gains. However, if growth slows and there's no progress on this front, then this could cause the market to retrace some of its gains. Charles Dickens once described spring as "summer in the light, and winter in the shade." This seems like a great description for today's landscape, where hope for pro-growth policies point to re-emergence in the near future, while policy uncertainty reminds us of the cold days we are trying to leave behind.

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