FINDING THE BIG PICTURE

The mind has a powerful ability to make connections. This is evident from closely observing the famous painting *A Sunday on La Grande Jatte* (see Figure 1). If you look closely at the painting, you see a multitude of colored dots. However, as you slowly back away from the work, an expansive scene emerges. This technique, called pointillism, was pioneered by Georges Seurat.

Figure 1

Source: https://www.artic.edu/artworks/27992/a-sunday-on-la-grande-jatte-1884

To get a sense of what economic picture Highland observes with data, we run through the multitude of economic "dots" of business, consumer, general economic, and market activity that are making headlines and relate them to our key indicators that make up the Highland Diffusion Index, which guides our risk positioning (see Figure 2).

TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

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Highland Diffusion Index

Figure 2

	INDICATORS	DESCRIPTION
FUNDAMENTAL INDICATORS	UNEMPLOYMENT	Unemployment is a good indicator of the underlying strength of consumers and businesses. When the unemployment rate is declining, then this is a harbinger of economic strength.
FUNDAMENTAL INDICATORS	LEADING ECONOMIC INDICATORS (LEI)	These ten leading indicators, which incorporate business outlook, economic activity, consumer expectations and market sentiment, signal strength or weakness of the economy on a forward-looking basis.
FUNDAMENTAL INDICATORS	MONETARY POLICY	This measure considers how accommodative or restrictive current monetary policy is compared to history.
MARKET INDICATORS	CREDIT SPREADS	Credit spreads are a barometer of risk sentiment in the market. It measures the yield premium required by investors over risk-free treasuries. Typically, spread tightening occurs in periods of economic growth and spread widening in periods of economic weakness.
MARKET INDICATORS	YIELD CURVE	Yield curve positioning is measured by the spread between longer and shorter dated treasuries. The spread indicates forward market and inflation expectations. It is important for understanding where we are in the market environment.
MARKET INDICATORS	MOMENTUM	Equity market momentum indicates investor sentiment and risk appetite. For example, a taper in momentum would signal weary markets and a reduction in risk assets.

Today, Highland sees market and economic data points that are mixed but positive on balance. Market pundits have ascribed a more negative, bearish picture to the data, as they are convinced that the length of the market cycle will force it to an end. Highland perceives a slightly different, albeit evolving, scene. At the end of the first quarter of 2019, we discern that not much in our slowing but growing view of the markets has changed.

Business Activity

Investors worry about business activity because the business cycle has historically been the driver behind the booms and busts of the economy. With trade tensions impacting global commerce, the expectation is that business activity will be hurt. While data revealed this sentiment in the fourth quarter, there are recent positive developments worth noting.

Global Manufacturing PMI

TREND (↘)

INDICATORS AFFECTED

LEADING ECONOMIC INDICATORS (LEI) — measured by new order activity components, which have picked up, positively contributing to the LEI

UNEMPLOYMENT — employment conditions are surveyed as part of the PMI—hiring in manufacturing has slowed down, which could eventually affect the overall employment picture

The Purchasing Managers Index of Manufacturing Activity for the top five largest economies (the U.S., eurozone, China, Japan, and the U.K.) was mixed in March, with the eurozone contracting and a pickup in activity observed in the U.K. and China. The overall trend of the indices has been declining, meaning that the rate of change in activity is slowing but remains positive in all areas except Japan and the eurozone. However, data out of China showed manufacturing growing again, which was a nice upside surprise after three months of declining activity in the world's second-largest economy. The future picture for manufacturing looks rosier if resolutions to Brexit and global trade are reached, thereby providing certainty for businesses.

Global Services PMI

TREND (→)

INDICATORS AFFECTED

LEADING ECONOMIC INDICATORS (LEI) —
measured by consumer expectations for business conditions, which have improved recently, positively contributing to the LEI

UNEMPLOYMENT —
employment conditions are surveyed as part of the PMI—hiring in manufacturing has slowed down, which could eventually affect the overall employment picture

The Purchasing Managers Index of Service Sector Activity has been mixed. U.S., China, and Japan have remained on a relatively constant trend with recent acceleration in activity in March. The eurozone and U.K. have been on a downtrend since 2018, with the eurozone regaining momentum in March and the U.K. falling into contractionary territory. In more developed economies like the U.S. and U.K., the strength in the services sector is more important than the deceleration in manufacturing activity to overall economic growth, which leaves us with a stable U.S. economy and a U.K. economy at risk. Similar to manufacturing, the U.K. services sector would benefit from a Brexit resolution, whereas weakness witnessed in the U.K. spreading to other regions like the U.S. and China would reinforce the global growth slowdown.

Global Trade

TREND (↘)

INDICATORS AFFECTED

LEADING ECONOMIC INDICATORS (LEI) —
measured by new order activity components, which have picked up, positively contributing to the LEI

Global trade volume dipped over the fourth quarter of 2018, picking up modestly in January only to decline again in February. Trade levels remain at all-time highs, but if declines in trade volume were to persist, this could be an indication of a hastened economic slowdown. In fact, the only significant contractions in trade volume came during a recession. The Baltic Dry Index, a measure of changes in the cost of transporting raw materials, e.g., coal and steel, has shown signs of a pickup in activity, which could foreshadow improvements in global trade volume. Progress toward a trade deal between the U.S. and China would be a boost to global trade activity; however, tensions stepped up in early May as Trump threatened new tariffs making the outcome even more uncertain.

Consumer Activity

Consumer activity has grown in relative importance in recent years as developed nations like the U.S. have shifted toward a consumption-driven economy. Consumer spending makes up the majority of U.S. GDP growth. Headlines have cautioned investors about a slowdown in consumer spending, which would be to the detriment of economic growth. However, the data paints a picture of a healthy consumer supported by easier financial conditions than at the end of 2018.

Retail Sales

TREND (↗)

INDICATORS AFFECTED

LEADING ECONOMIC INDICATORS (LEI) —
measured by consumer expectations for business conditions, which have improved recently, positively contributing to the LEI

Retail sales growth year-over-year had been declining since the summer of 2018 but increased in the first quarter of 2019. The downtrend had many concerned about the dependability of consumer spending going forward, as it makes up 70% of GDP in the U.S. Contractions in retail sales have only happened during or right after a recession. The picture for consumers could dull if financial conditions tighten again.

Housing

TREND (↗)

INDICATORS AFFECTED

LEADING ECONOMIC INDICATORS (LEI) —
measured by consumer expectations for business conditions, which have improved recently, positively contributing to the LEI

MONETARY POLICY
measure of financial tightening; based on the Fed's pause of any additional rate hikes, housing activity should benefit

YIELD CURVE
measure of financial tightening; based on low long-term interest rates, housing activity should benefit

Housing (continued...)

TREND (↗)

There has been concern over the slowdown in housing sales and moderation in housing starts as an early indicator to a housing slowdown. The declining data has improved somewhat early in 2019 as interest rates have declined, resulting in cheaper financing. Measures of housing supply also reveal that an expansion in housing can continue much longer before exceeding demand because of the protracted decline in housing starts from 2006–2009. Looking more granularly, home price appreciation is still strong, notably in the West and Southeast, which are home to many low-tax states. We see a change in trend ahead if there were a marked increase in interest rates and pickup in unemployment, which would negatively impact the housing picture.

Unemployment

TREND (↗)

INDICATORS AFFECTED

UNEMPLOYMENT —
top-line and broader measures of unemployment show that hiring trends remain strong and make this indicator a positive contributor to the Highland Diffusion Index

The unemployment rate is at its lowest level since April 2000 at 3.6%. You have to go back to the 1970s to find a lower unemployment rate. Remarkably, this trend extends to the broadest measure of unemployment including all marginally attached and part-time workers, which is at its lowest level since March 2001. The economy also continues to add new jobs—on average 218,000 workers per month over the last 12 months. As a fundamental indicator in the Highland Diffusion Index, rising unemployment usually leads us into a risk-off posture, confirming the weakness reflected in our market indicators. While the trend has been overwhelmingly positive for employment in the U.S., we remain vigilant, watching for a pickup in the 3-month moving average of unemployment for a sign that the economy is slowing. If profits start to come under pressure and/or demand for goods and services slows, we could see hiring slow and layoffs increase, changing the unemployment picture for the worse.

Economic Activity

General economic activity summarizes expectations for businesses and consumers going forward. A slowdown in economic activity would necessitate weaker return on investment as businesses and consumers are hurt by a decline in economic growth or unstable pricing. Economic expectations lean less positive due to the unusually long economic expansion in the U.S. Currently, global economic growth is still positive but growing at a slower pace.

Inflation

TREND (→)

INDICATORS AFFECTED

MONETARY POLICY —
one of the Fed's dual mandates is stabilizing prices, and it has paused additional rate increases as they patiently observe inflation trends

YIELD CURVE —
inflation expectations are one determinant of rates, and the long end of the curve is not reflecting an increase in inflation

Core inflation has slowly declined since mid-2018, hovering at the Federal Reserve's 2% target. Including food and energy, headline inflation also declined over the past several months until March's reading surprised to the upside. Could this be a trend reversal and renewed pickup in inflation? Achieving normal, but not excessive, price appreciation is a reflection of strong consumer demand and a steadily growing economy. Too much inflation or too little inflation threatens long-term economic prospects. We capture this "Goldilocks-like" inflation in our monetary policy indicator of the Diffusion Index. The Fed raises rates based on inflation and GDP growth, so a pickup or drop-off in inflation will necessarily flow through to the monetary policy decisions affecting the market cycle.

Chinese Gross Domestic Product — TREND (↘)

INDICATORS AFFECTED

MOMENTUM —
MSCI Emerging Markets has shown a rebound in momentum in 2019, positively affecting this indicator

LEADING ECONOMIC INDICATORS —
manufacturing new order data reflected the slowdown in Chinese economic activity in 4Q 2018, but a pickup in new order activity in Q1 2019 positively contributed to LEIs

China's Gross Domestic Product (GDP) ended the fourth quarter of 2018 lower than market expectations (6.4% vs. 6.5% measured as the year-over-year, not seasonally adjusted change in GDP) and is at the lowest measure since the first quarter of 2009. As the largest contributor to global GDP growth, the deceleration in China's GDP growth is indicative of a broader trend in slowing global growth. While the magnitude of growth is slowing, GDP growth is still positive. If growth levels sustain or modestly improve, this could be an indication that China's fiscal policy helped the economy achieve a soft landing and would improve the global economic picture. However, keep in mind that China's growth impacts Europe, Japan, and emerging market countries more than the U.S., which is one of the reasons we favor U.S. markets over international markets in the near term.

U.S. Gross Domestic Product — TREND (→)

INDICATORS AFFECTED

LEADING ECONOMIC INDICATORS —
manufacturing new order data reflected the slowdown in Chinese economic activity in 4Q 2018, but a pickup in new order activity in Q1 2019 positively contributed to LEIs

YIELD CURVE —
inversion signals a slowdown in economic activity prior to a recession, and a renewed and sustained inversion would indicate expectations for GDP growth to have substantially weakened

U.S. Gross Domestic Product (GDP) finished the first quarter of 2019 ahead of the prior quarter and consensus expectations (3.2% vs. 2.8% measured as the year-over-year seasonally adjusted change in GDP). This was a strong start to 2019 despite lower expectations for GDP growth for the year. Government spending is no longer expected to be a boost

U.S. Gross Domestic Product (continued...) — TREND (→)

going forward as the benefits of late 2017's fiscal stimulus fades. Net exports are likely to be a detractor as well until global trade disagreements are reconciled. There is room for more private investment, but with the uncertainty the Trump administration has caused over global trade, businesses may hold back on future capex intentions. Finally, personal consumption is the largest contributor to GDP growth and will be the biggest determinant going forward. If consumer sentiment holds steady and wages continue to grow, personal consumption could continue to support GDP growth at a positive, albeit slower, rate. If growth levels sustain or modestly improve, perhaps in response to a trade policy resolution or a continuation of easy financial conditions, this would further extend the current business cycle in the U.S.

Market Activity

Investors tend to be forward looking, incorporating expectations for the economy in their investment decisions. Therefore, we look to market indicators to show the first signs of potential economic trouble—or "the smoke before the fire." We then use the fundamental economic indicators to confirm the need for a positioning change. The markets reveal whether the majority of investors are seeking or avoiding risk as a reflection of their economic outlook, and currently, most investors are risk-seeking.

Yield Curve — TREND (↘)

INDICATORS AFFECTED

YIELD CURVE
specifically 10-year minus 3-month Treasury rates inverted briefly, putting us on watch and negatively contributing to the Highland Diffusion Index

The yield curve gave everyone quite a scare at the end of March with the 5-day inversion (as defined by the 3-month Treasury rate being higher than the 10-year Treasury rate). We are back in positive territory again, but the very flat nature of the yield curve keeps us on watch. The yield curve

Yield Curve (continued...)

TREND (↘)

inversion is significant because it's usually a harbinger of an economic slowdown and impending recession. The trouble is it can be early, and it can give false positive readings. There are two reasons we remain cautious but not yet concerned by the latest inversion: (1) the yield curve did not establish a meaningfully negative trend (i.e., 90 days or more) and (2) the curve inverted without the Fed raising rates (the Fed paused on additional rate hikes starting in December). A rising short end of the curve is more dangerous to economic activity than a falling long end of the curve. This is because short rates tighten financial conditions by raising the cost of borrowing, slowing consumer and business activity. The picture changes for the better in our mind if the 10-year rate increases on improved expectations of growth or increased inflation expectations, but we believe there are structural forces like low global yields that make this unlikely.

High Yield Spreads

TREND (↗)

INDICATORS AFFECTED

CREDIT SPREADS —
option-adjusted spreads for the Bloomberg Barclays Global Aggregate Index have tightened, positively contributing to the Highland Diffusion Index

Global credit spreads declined over the first quarter of 2019. This is a stark reversal from the increase in credit spreads during 2018 that reflected a more risk-off sentiment. Prior to 2018, the last run-up in high yield credit spreads happened in reaction to falling oil prices in 2016 and resulting high yield bond defaults from the energy sector. This indicator is helpful in sensing investors' shifting impressions of market risk. If we saw another swift and sustained pickup in credit spreads combined with a slowdown in global equity momentum and/or yield curve inversion, this would necessitate a remarkably more negative market picture.

Equity Markets

TREND (↗)

INDICATORS AFFECTED

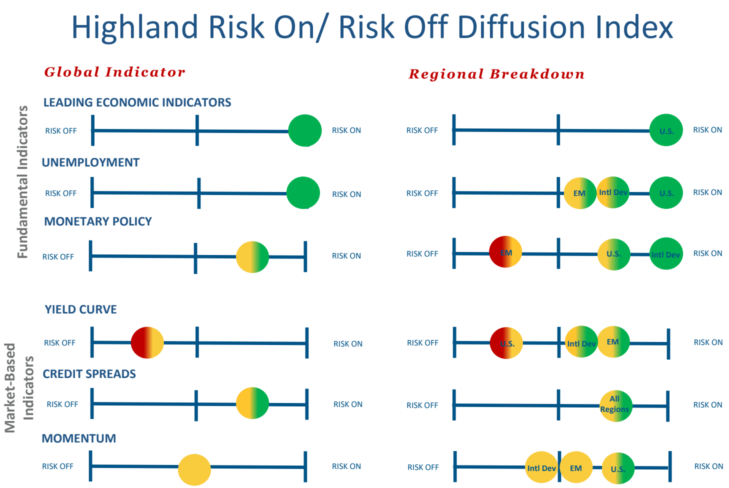
MOMENTUM —
S&P 500, MSCI World ex US, and MSCI EM indices exhibit strengthening momentum, positively contributing to the Highland Diffusion Index

Global equity market momentum was negative at the end of 2018 before rebounding in 2019. The current trend is still positive. Despite the decline in U.S. markets in the fourth quarter and the bear market in international developed and emerging markets, equities seem to have found their footing. However, earnings season will be a test to whether equities can maintain their uptrend. Equity market momentum is a good measure of investor sentiment and risk appetite. For example, a taper in momentum would signal weary markets and a reduction in risk assets. The picture could change for the worse if geopolitical tensions heat up or vast earnings misses spook markets, but looser financial conditions in the wake of the Fed's decision to pause on additional rate hikes will continue to support markets in the absence of other shocks.

Viewpoint

Markets do not die of old age. Nor are their long-term prospects determined by major news headlines. As asset allocators, we are the observers, not the creators, of the market picture; therefore, we must remain objective in our analysis of the data and open to new information. We cautiously observe the transformation of the big picture as additional data points are added. We continue to be objective in our assessment of the current picture, remaining risk-on in client portfolios as supported by our market and fundamental indicators that make up the Highland Diffusion Index (see Figure 3). Pulling the dots together, we currently observe that five out of the six are positive or netural.

Figure 3



Source: Highland Associates as of 3/31/2019; subject to change
Diffusion Index is a method of summarizing measures of the individual indicators listed above to indicate the proportion of indicators that reflect positively or negatively for risk assets.

Highland constantly refines the way we look at the world and updates our Diffusion Index to reflect the complex, dynamic nature of the global economy and markets. The economy is still growing but at a slower pace. While our Diffusion Index objectively reveals a rosier picture today than headlines may suggest, this is not to say that next quarter—or even next month—the balance of data points does not shift, resulting in a very different picture than what is painted today. We do not profess to know the future direction of any of these data points with certainty. Rather we are constant students of the economy and markets, studying changes in the data and responding with necessary adjustments. As the picture evolves, we will evolve with it.

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