HIGHLAND CAPITAL MANAGEMENT

Q2, 2016

SIGNAL OR NOISE?

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CUTTING THROUGH THE CLUTTER

MOTIVATION | The world is vastly more interconnected and interdependent than it has ever been—and the exchange of information only continues to grow in volume and speed each day. In this environment, being able to cut through the clutter to identify the signals while ignoring the noise is critical to successful investing.

VISION | As a tenured, independent-minded firm, Highland's perspective can help you sift through the vast amount of information available, tune out the noise and zero in on what matters most. With this newsletter we set out to highlight the critical signals and, more importantly, explain how smart investors can act on them.

Watch the dollar

SIGNAL: the dollar (DXY)

At this midway point in the year, we've been reflecting on 2016 and trying to make sense of what's happened to determine our outlook going forward. What we've found is that it's a lot easier to identify what *hasn't* made sense this year.

The downturn that kicked off 2016 caught many by surprise. Investors seemed to be waiting throughout January for a rally that never came. And when it finally did arrive nearly six weeks into Q1, it provided relief, yet little certainty.

With all the incongruities we've seen in markets since then—where the price of oil rises while supply and demand remain divergent, where currencies rise in countries where the economy weakens, and so on—it's no wonder that many investors are having a hard time believing this rally.

That skepticism is warranted; operating in an environment where markets move in ways completely contradictory to fundamentals, it seems almost futile to attempt any kind of forecast, let alone make any high conviction calls. You can't trust many tried and true market signals, especially those coming from areas that are subject to manipulation by central banks. However, it's even less productive to just throw up your hands when nothing makes sense and wait for things to normalize. (Those who went to cash in early 2009 understand this lesson well.)

Our strategy in this environment is to identify a signal we *do* trust and then watch it closely to determine our outlook. For us, that signal right now is the dollar, and we are looking at its subsequent movement as an indication of how risk assets will perform for the remainder of the year.

Why the dollar is key

One reason the dollar is a reliable signal to us is because it represents a big, liquid market that is less likely than most to be manipulated.

Additionally, when you look at the dollar's relationship to stocks, oil and high-yield bonds, (*Exhibit 1)* it's clear why the movement of the dollar is meaningful for risk assets.

Finally, the dollar's behavior in recent years makes a strong case for its value as a signal. The dollar index (DXY), which measures the dollar against a basket of other currencies, rose more than 18% from the middle of 2014 to early 2015. That prodigious rise created huge headwinds for equities in 2015 as it weakened earnings and commodities. Adding to the strength of those headwinds is the fact that the dollar stayed at the level of its highs throughout 2015, and remains there today.

The Dollar (DXY) vs. Risk Assets (S&P 500 (SPX), High Yield (HYG), Oil (WTI)) - 2016

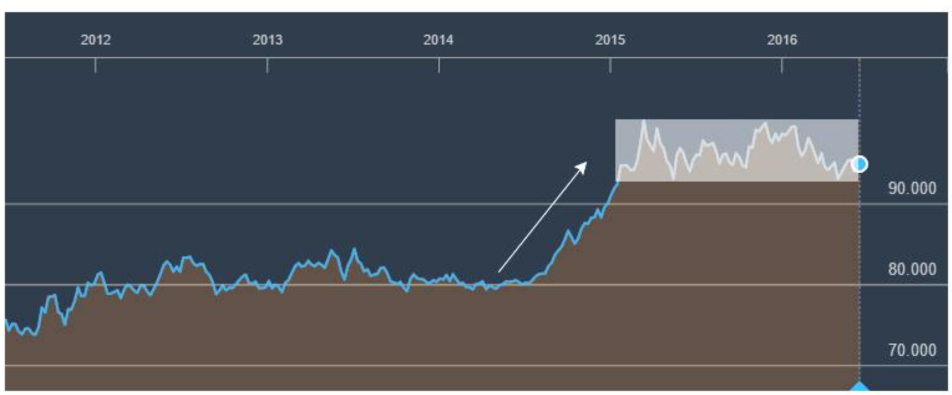
(EXHIBIT 1)

Source: Bloomberg

Since DXY's surge from the low 80s in 2014 to close to 100 in 2015, the dollar index has been stuck in a tight band between 93 and 100. *(Exhibit 2)* This band is key to the dollar as a signal. If DXY can break out of the band in either direction—dropping below 93 or breaking out above 100—it would bring major clarity about the fate of risk assets.

DXY: Past 5 Years

(EXHIBIT 2)



Source: Bloomberg

NOISE: The condemnation of smart money

There has been a lot of criticism of the “smart money” this year. And given the underperformance among many well-known hedge funds and active managers, it’s not totally surprising to see these fund obituary stories dominating the news. But while some of the criticism is valid, our view is that the “end of hedge funds” headlines should be ignored as noise.

The focus period of the recent criticism has had episodes where correlations were pushed towards one. In that environment it’s a beta game and beta strategies have the inherent advantage. But that’s not the environment we’re heading into today.

There’s enormous beta risk building in the market while dispersion is on the rise and correlation is falling—the ideal conditions for active management.

This is evident in the performance of our Global Allocation Fund, a ’40 Act fund designed to generate alpha by bringing in the best ideas from portfolio managers across the Highland platform to create an opportunistic portfolio. The fund finished 2015 with double-digit losses and, to add insult to injury, outflows; now the fund is outperforming 99% of its Morningstar category and is up more than 20% in the past six months alone.*

The turnaround can be easily explained: when you allow experienced, capable managers to capitalize on assets, sectors, themes and factors that move in opposition, that’s when you have the opportunity to generate real alpha. We believe that’s the environment ahead of us.

We’d caution investors of the noise out there questioning the future of active management. Smart, patient investors understand that the value of a good active manager comes from trusting them to outperform when given the opportunity. If you have the patience and discipline to maintain faith in a proven, experienced manager during times of negative performance, you stand to benefit the most when their convictions play out and performance goes the other way.

**As of 6/17/16*

What to look for in the dollar’s movements

At the end of April, the dollar touched down to the low end of the band, even breaking 93 at one point. Around that time, we saw hedge funds and other speculative investors the most bearish on the dollar that they’ve been since February 2013, according to data from the CFTC and Scotiabank. Then the month of May brought mostly bad news for those dollar bears, as the dollar not only bounced off the 93 level but also continued to rise throughout the month. However, as we saw with the May jobs report, that situation can quickly change.

The report rattled markets with only 38,000 jobs added in the month—a big letdown from the 158,000 forecast. That headline alone brought DXY down 1.6% in a single day. Expectations of a June rate hike fell along with it, but while the Fed lived up to market expectations and left rates unchanged, they continue to indicate their desire to finally go forward with the next hike in the near future.

At the same time, in addition to uncertainty around monetary policy from the Bank of Japan and the European Central Bank, there remains the question of the Brexit vote, scheduled for June 23. A vote in favor of Brexit would boost the dollar, which would quickly assume its role as a safe haven trade in the wake of such news.

> “*The question is: will any upcoming event be enough to push the dollar out of its recent trading range?*”

In other words, anything could happen. Though the real question is: will anything will be enough to push the dollar out of its recent trading range?

WAYS TO PLAY IT:

If the dollar goes down...

Strong evidence of a rebound in global growth, a resounding "remain" Brexit vote and more dovishness from the Fed in July are among the factors that could push the dollar back down.

If the dollar begins to fall, it's important to watch the 93 level of the dollar index. If DXY breaks through the low end of that band it would be a very bullish signal.

> "*DXY breaking out below 93 would give way to a major risk-on environment and be a compelling reason to shift capital toward risk assets.*"

A much weaker dollar would indicate that global growth outside the US is recovering and therefore multinational profits, in particular, would be stronger.

Overall, breaking out below that 93-level low would give way to a major risk-on environment and be a compelling reason to shift capital toward risk assets.

A less dramatic drop would still be reason to consider some opportunities in risk assets; however, in this case, it's important to be wary of the sensitivity of these assets in today's environment and their tendency to overshoot on both ends, which we've already witnessed this year.

If the dollar goes up...

If the dollar continues to rise, be it from a more hawkish Fed, diverging US vs. global economic data alone, or any of the other factors that could boost the currency, risk assets stand to suffer.

In the event of a rise similar to the 2014-2015 trend, we would expect to see a 2015 scenario return and even intensify for stocks, oil and emerging markets, among other susceptible risk assets.

Again, the 93-100 DXY band is key here. If the dollar shows signs of breaking out above the band, that would be a much stronger statement than if it experiences a range-bound rise.

Range-bound bets

If the dollar index stays in the 93-100 band, risk assets would remain volatile and represent a risk-without-reward proposition for buy-and-hold investors.

Stocks look unattractive without a major move in the dollar. Earnings are challenged as it is, and with slow growth and wage pressure in the picture, the outlook is bleak.

There are certainly investment opportunities in this status quo scenario, but active management has the edge when it comes to identifying and maximizing them, as they often deploy nimble, bottom-up analysis and close monitoring.

For stocks, this is an environment where long/short strategies provide extra value as they specifically avoid reliance on rising markets for returns. Long/short strategies are designed to operate independent of market performance and can offer downside protection amid increased volatility.

"There are investment opportunities in this status quo scenario, but active management has the edge when it comes to identifying and maximizing them, as they deploy nimble, bottom-up analysis and close monitoring."

There are also bright spots in credit in this scenario for long-term investors. As credit markets normalized during the second half of Q1, high yield reflated dramatically but we feel ended up overshooting the rally and now looks overpriced. Bank loans and CLO securities, however, remain attractive to us and are our preferred credit investments in this environment.

Looking at loans, in addition to their relative value compared to high yield, they have significantly less energy exposure. And while oil has started to reach the $50 level, we don't feel we're out of the woods in the energy sector by any means yet.

Bank loans have also demonstrated low correlation to other risk assets, adding to their appeal in this range-bound scenario. However, the advantage again goes to those who can select the right names in the loan space and hold them with steady hands. As active credit managers we're looking for undervalued names where the fundamentals remain sound.

The bottom line

Watch the dollar in the coming months to develop a stance on risk assets. Central banks and economic data have deprived those markets of any real guidance this year, leaving the dollar as one of the few forces that's been able to provide rational direction. Though at this point, we feel any significant dollar depreciation is unlikely. We are therefore preparing for a high-volatility, low-return environment where nimble active managers and good stock pickers will prove their worth.

- MARK OKADA
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