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HIGHLAND CAPITAL MANAGEMENT

Q3, 2016

POST-ELECTION OUTLOOK

SIGNAL OR NOISE?

Insights from Mark Okada

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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.

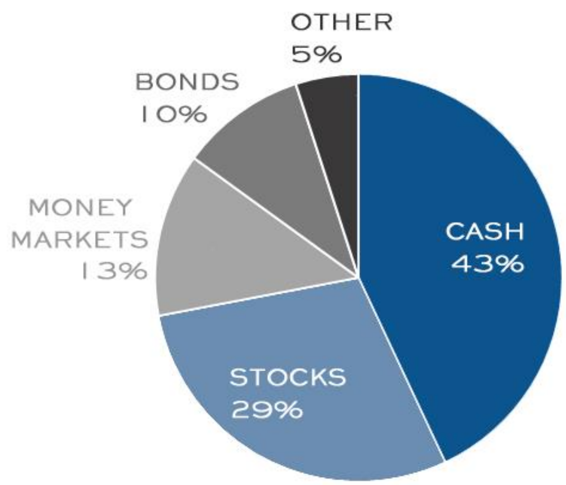
PLANNING FOR AN UNCERTAIN FUTURE

SIGNAL: AAII SENTIMENT SURVEY

"Uncertainty" has become a market buzzword today. The word's pervasiveness may be partly attributed to its use as a hedge—a way for fund managers and prominent investors to make bold calls, knowing they can easily walk them back by going through the laundry list of unpredictable factors that could change their view. At times the use of "uncertainty" seems like a copout, but in today's environment it is quite sincere; rather than citing "uncertainty" as a way to save face, investors are increasingly using it as an answer in itself (read: "I don't know what to do.").

That answer has clearly informed investment strategies this year, with many investors, skeptical or confused (or both), going to cash and hoping that some clarity will come. This is evident in both individual investors, who have increased allocations to cash more than any other asset this year (Fig. 1), as well as in fund managers, whose cash levels are at 15-year highs (Fig. 2).

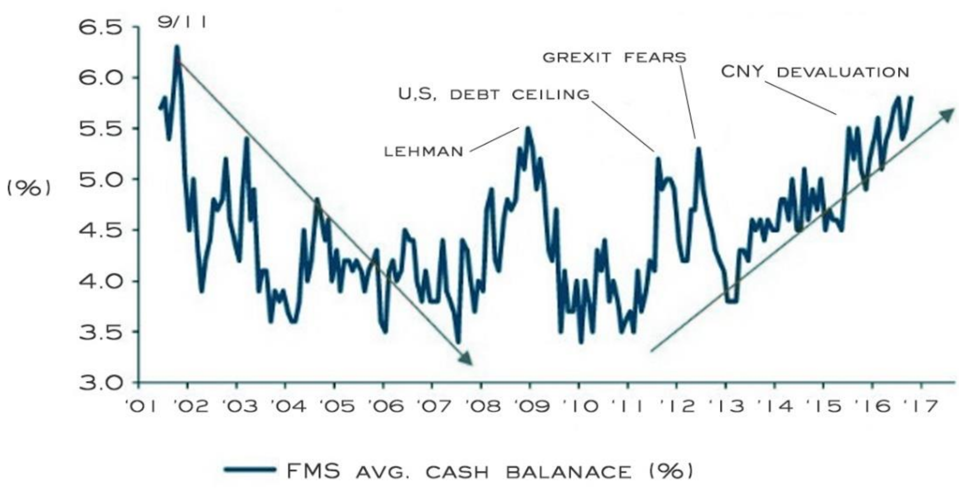
FIGURE 1 INVESTOR ALLOCATIONS IN 2016



Source: Wells Fargo/Gallup Investor and Retirement Optimism Index Q3 2016

FIGURE 2

GLOBAL FUND MANAGER SURVEY (FMS) AVERAGE CASH BALANCE (%)



Source: Bank of America Merrill Lynch Global Fund Manager Survey

In addition to the moves to cash, there has been a lot of rally-chasing activity, as those who missed parts of the rallies in stocks and bonds have since tried to catch up into the end of the year, despite the overshoot that has taken place in both markets.

That behavior underscores why it is better to plan for an uncertain future than to take what could be a never-ending wait-and-see approach. For this reason, we are embracing the heightened market uncertainty and using it as a signal to inform our 2017 outlook.

UNCERTAIN INVESTORS: A PRODUCT OF THEIR ENVIRONMENT

Investor uncertainty, measured by the percentage of neutral readings from the American Association of Individual Investors (AAII) Investor Sentiment Survey, is above 41% to start November, more than 10% above the historical average of 31% (Fig. 3). Earlier this year readings reached an all-time high of 52%.

FIGURE 3

U.S. INVESTOR SENTIMENT SURVEY, % NEUTRAL, LAST 5 YEARS

Source: AAII INVESTOR SENTIMENT SURVEY, WEEK OF OCTOBER 31, 2016

However, given the unusual economic and investment environment, these unusually high levels of uncertainty are not surprising.

Contributing to today's unusual environment is:

- **The aging bull market**:

  We are 91 months into a post-crisis bull market that is now the second longest in history, and while the stock market continues to rise, investors are having a hard time feeling bullish.

- **The contentious election season:**

  We are at the end of the most unconventional U.S. presidential election season where we face candidates with remarkably opposing policies.

- **The rise of populism:**

  In June, unlike many in our industry, we were prepared for a "leave" vote from the U.K. Our prediction was based on our observations of the populist movement—not polls—and populism's power was made known when it upended what everyone believed to be trusted sources of information in the Brexit decision. For this reason, a Trump victory should still not be ruled out, and even with a Clinton win, the populist sentiment is not going away.

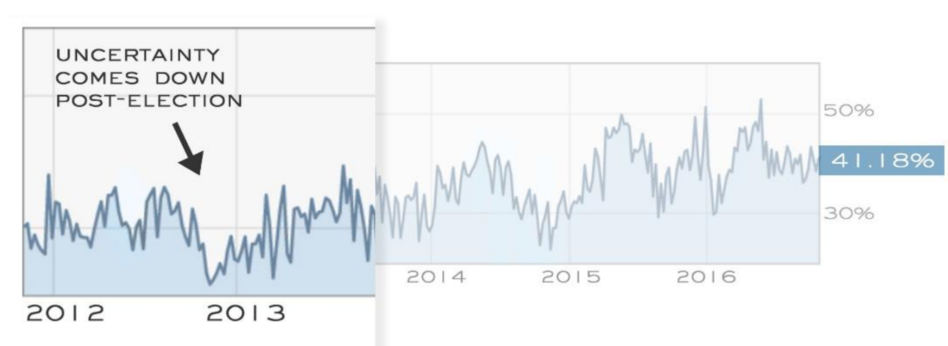
- **Central banking policy and the global search for yield:**

  Around the world there are central banks with negative interest rates, and countries where, thanks to negative bond yields, investors *pay* for the ability to lend the government money.

With such major unknowns in the picture, it is no surprise investors don't know what to do. The good news is we have a catalyst for relief coming November 8th. So amid the negative aspects of this election, one positive it brings is relief from high investor uncertainty. And it doesn't matter who gets elected; the mere fact that we *know* the next president is enough to materially reduce uncertainty (Fig. 4).

When that happens, the cash-heavy investors who have been waiting for clarity will begin to look for ways to put capital to work for 2017. And with the amount of cash on the

FIGURE 4



Source: AAII INVESTOR SENTIMENT SURVEY

NOISE: THE PROMISE OF INFRASTRUCTURE SPENDING

Many investors are holding onto the hope that regardless of the election outcome, the next president will bring a new wave of government spending that is just the stimulus the U.S. economy needs to return to an era of prolific growth. And infrastructure has been the beacon of this hope, as both candidates have touted plans to boost spending in that area, in particular.

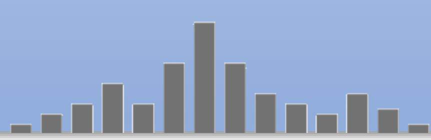
While we hate to dismiss a rare instance of optimism this election season, we think any bets on upcoming fiscal stimulus in the form of infrastructure spending are likely to disappoint. Instead, we see the infrastructure superhero story as no more than a narrative people have latched onto given few alternatives when it comes to concrete policy discussion.

In reality, considering how partisanship affects budget proposals, an infrastructure spending plan could easily fall victim to divided government. And if the next president *does* get a spending plan passed (or if we have a one-party sweep scenario), there is still the question of how effective it would actually be in inciting growth.

With the economy at full employment, the idea of infrastructure spending as a productivity enhancer is far-fetched, and the result is more likely to be increased wage pressure than true economic growth.

Further, any short-term benefits from such fiscal stimulus would likely be at the cost of long-term growth—a phenomenon that is currently evident in the U.S., as we see the post-crisis government spending that helped the initial recovery now acting as a major drag on the economy today. If short-term stimulus were the key to long-term economic growth today, the last few decades in Japan would have gone a lot differently.

In other words, don't hold your breath for the next New Deal. All the anticipation for the savior that is infrastructure spending can be ignored as noise at this point. For now, it looks like we'll have to live with our "third-world" airports…



sidelines right now, this reduction in uncertainty presents opportunities for investors who can get ahead of forthcoming capital flows. So the multi-billion-dollar question right now is: where does all that cash go?

MACRO FORCES DRIVING TODAY'S MARKETS

To answer that question, we look to the most significant macro forces at play, as they are driving today's markets more so than traditional fundamentals:

- **The U.S. economy and the Fed:**

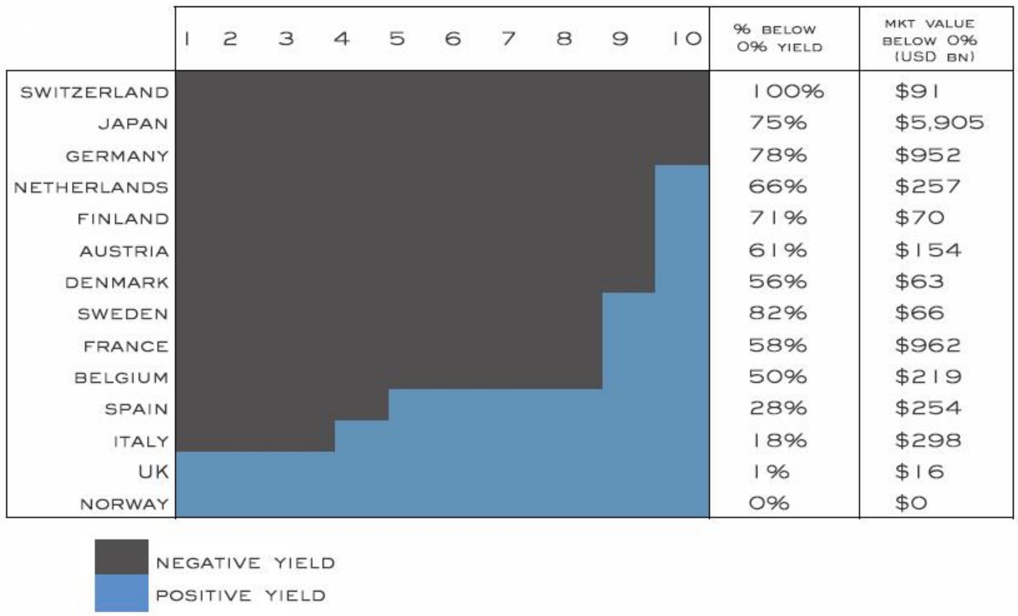
While we still have crisis-like monetary policy in place, the U.S. economy is in decent shape. For that reason, a 2017 recession is not our base case; however, given the factors listed earlier contributing to uncertainty, the risk for a recession is higher. That said, employment and inflation data strongly suggest the Fed has indeed met its dual mandate, making a December rate hike justified.

- **Global growth and monetary policy:**

Compared to the rest of the world, the U.S. appears especially attractive. Looking at the number of countries with negative government bond yields (Fig. 5), even with the U.S. seeing steady declines in the 10-year Treasury, being in positive territory alone is a strength.

FIGURE 5

GOVERNMENT BOND YIELDS



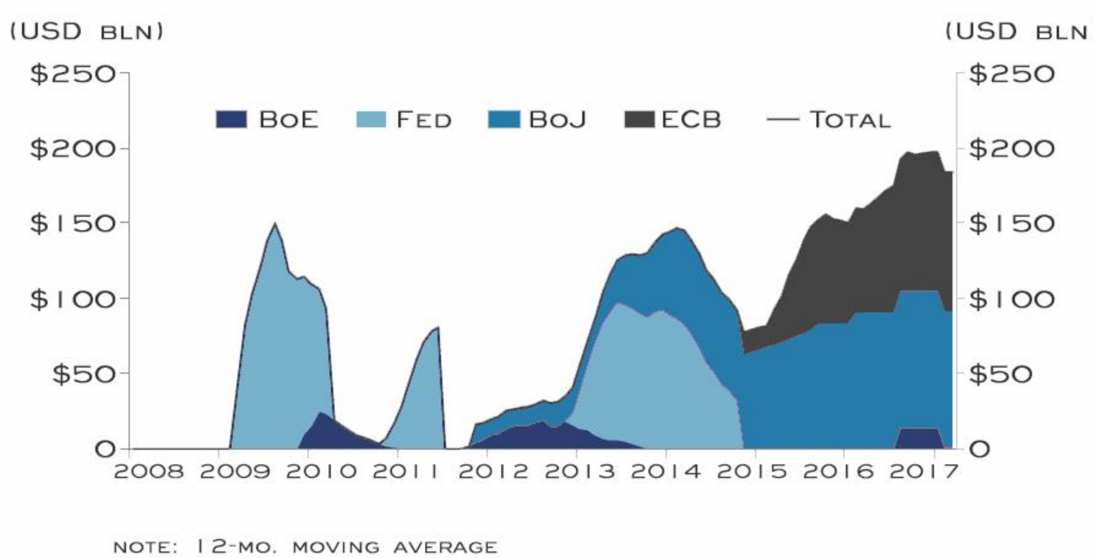
	% BELOW 0% YIELD	MKT VALUE BELOW 0% (USD BN)
SWITZERLAND	100%	$91
JAPAN	75%	$5,905
GERMANY	78%	$952
NETHERLANDS	66%	$257
FINLAND	71%	$70
AUSTRIA	61%	$154
DENMARK	56%	$63
SWEDEN	82%	$66
FRANCE	58%	$962
BELGIUM	50%	$219
SPAIN	28%	$254
ITALY	18%	$298
UK	1%	$16
NORWAY	0%	$0

Source: Bloomberg Finance LP, DB Global Markets Research

This goes hand-in-hand with foreign central banks trying to incite growth at all costs, which can be seen in the amounts of capital those institutions are pouring into markets (Fig. 6). But despite the widespread stimulus efforts, global growth has been declining and the outlook remains challenged.

FIGURE 6

MONTHLY FED, ECB, BoE & BOJ ASSET PURCHASES

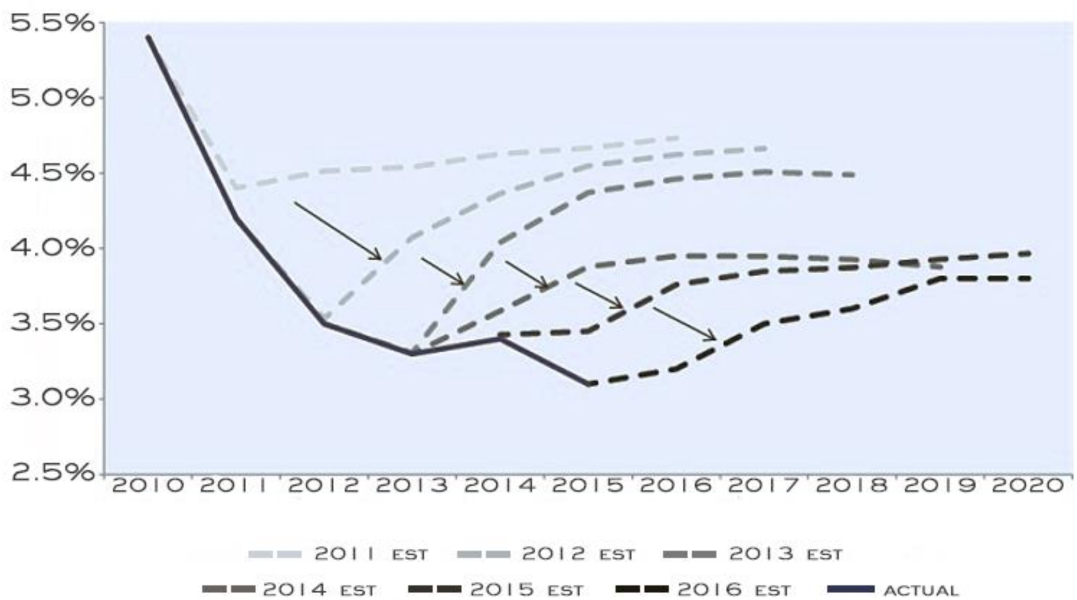


Source: DB Global Markets Research

This has been a trend for some time now, as the IMF has revised its global growth outlook down each year for the last five years. (Fig. 7)

FIGURE 7

IMF GLOBAL GROWTH OUTLOOK



Source: International Monetary Fund World Economic Outlook

- **The election outcome and candidates' downside risks:**

The election results obviously have a macro impact, but rather than trying to call the outcome, we consider it a more productive exercise to consider and prepare for the downside risks presented by both candidates:

Under Clinton, financial regulation is a threat; however, the bigger issue is the mounting unintended consequences of that regulation, which could reach a tipping point without much warning. Further, given the outlook for Congress, Clinton would struggle to pass legislation, meaning there is little hope for fiscal policy to augment monetary policy in stimulating economic growth. Finally, we believe Clinton's trade policies pose a threat to the near-term growth of the U.S. economy.

Trump's trade war—or even the perceived threat of one—would be a huge detriment to the economy in the U.S., raising recession concerns. Beyond trade, Trump's immigration policies pose a demographic threat to the U.S. economy from a shrinking workforce and insufficient working-age population. And more broadly, Trump's deficit spending would thwart long-term economic growth, which is already challenged.

Looking at these macro forces, we see:

- a relatively strong U.S. economy;
- the Fed meeting its mandates and a strong case for a December rate hike;
- the battle other central banks are facing globally against negative interest rates; and
- the downside risks presented by both U.S. presidential candidates.

Given that macro picture, we predict a return to the search for yield in 2017 and see high-quality credit as an attractive destination for capital.

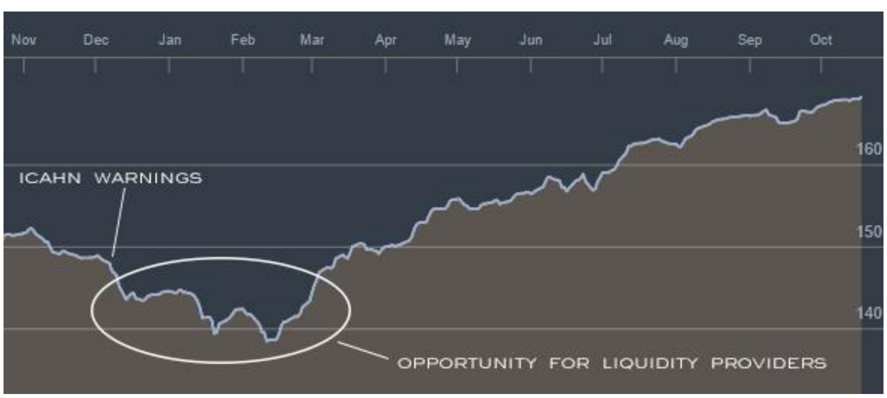
THE CASE FOR HIGH-QUALITY CREDIT

Last December Carl Icahn was outspoken about the looming demise of the high-yield bond market, calling it a "keg of dynamite that sooner or later will blow up." While he was instilling panic in junk bond investors, we were making every attempt to be the voice of reason. In the end, Icahn's voice was louder, and high yield experienced a major selloff at the end of 2015 into Q1 of 2016.

When Icahn warned "there's no liquidity" behind high-yield bonds, he failed to explain that the liquidity dynamic presents opportunities for long-term investors who can step in and be liquidity providers.

FIGURE 8

HIGH YIELD PERFORMANCE, 1-YEAR



Source: Bloomberg USD Corporate High Yield Bond Index

This liquidity premium is evident when you look at the high-yield bond market this year. If you became the liquidity provider amid the chaos earlier this year, you would be up double digits at this point thanks to the nice recovery. (Fig. 8)

That said, we think there's already been an overshoot and have been taking gains in high yield throughout the end of this melt-up. But even if the high-yield market no longer looks attractive to us, the same liquidity dynamic in high yield translates to higher-quality credit and will present opportunities in other credit markets similar to what we saw this year in junk bonds.

WAYS TO PLAY IT: ROTATE UP IN QUALITY

To prepare for uncertainty coming down following the election, we are moving up in quality in credit (Fig. 9, Fig. 10). For example, that means continuing to take gains in junk and shifting that capital toward loans, moving up from CCCs to BBs, or rotating out of emerging markets and into the U.S. These moves up in quality and structure are our preferred way to prepare for not only the drop in uncertainty and subsequent capital allocation, but also for whatever 2017 brings as far as global growth, central banking policies and other factors that may sway markets next year.

Bank loans offer limited duration risk, base coupons that reset if short-term rates increase and a senior secured claim on assets. Loans are therefore an attractive asset in the face of a forthcoming rate increase from the Fed, and relative to high-yield bonds, offer downside protection in the event of a default scenario. When you look at the election, a Clinton victory increases the chances that the Fed hikes in December, while a Trump victory increases the 2017 recession risk. Considering those scenarios, loans appear well-positioned either way.

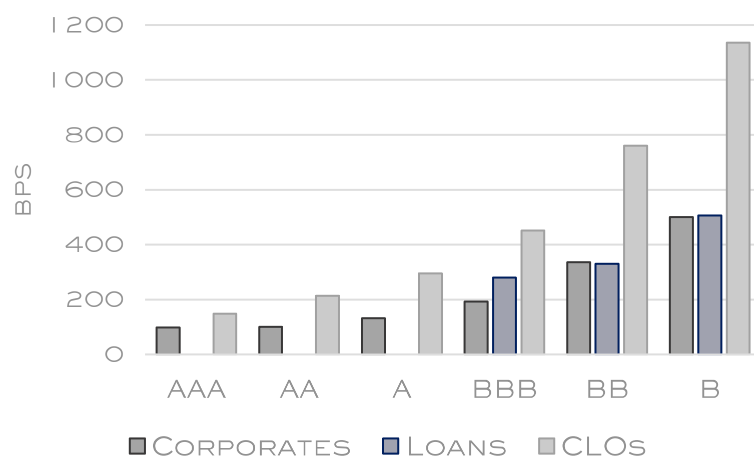
FIGURE 9

THE CASE FOR HIGHER-QUALITY CREDIT

Rating	Corporates	Loans	CLOs
AAA	98 bps	-	148 bps
AA	101 bps	-	213 bps
A	132 bps	-	295 bps
BBB	192 bps	280 bps	451 bps
BB	336 bps	330 bps	760 bps
B	500 bps	506 bps	1136 bps
Claim	Unsecured	Secured	Structured
Coupon	Fixed	Float	Float

FIGURE 10

CREDIT YIELD COMPARISON



Source: J.P. Morgan Indices, as of 10/13/2016

Additionally, floating-rate, structured credit can offer attractive yields and has shown an ability to insulate against losses from defaults. The same election-outcome logic applies to CLO tranches, which offer resilience in credit quality, as well as floating rates.

CONCLUSION: INVESTING ON WHAT WILL BE

It is our view that trading is based on "what is", while true investing is based on "what will be." Uncertainty will fall post-election as investors either become more bullish or more bearish in response to the outcome. Either way, the global growth challenges will remain and we are therefore positioning our portfolios to benefit from a renewed search for yield in higher-quality credit.

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