Highland Capital Management

Q4, 2016

2016 Review & 2017 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.

2016 REVIEW & 2017 OUTLOOK

SIGNAL: REVISITING 2016'S SIGNALS AND WHAT THEY MEAN FOR THE YEAR AHEAD

From the Brexit vote to the U.S. election, the rise of populism was a disruptive force in 2016. Fueling the populist movement in the U.S. was the one-sided recovery from the financial crisis, which consisted of monetary policy from the Fed delivered in the absence of fiscal support. That dynamic created a dismal environment for savers, while those with assets that did more than just sit there without gain – i.e. the wealthy – enjoyed a recovery and then some.

FIGURE 1

2016's Signals

SIGNAL	OVERVIEW
Q1 PMIS	o Weak PMI data in 4Q15/1Q16 caused recession concerns, creating overly sensitive markets, especially in areas like below investment grade credit o Since we believed a recession was NOT imminent, we looked for buying opportunities where we could capture liquidity premiums in credit
Q2 USD	o DXY was at the bottom of its 18-mo. range, a key signal for risk assets o Expecting DXY to remain range-bound, we advocated areas like bank loans, which remained cheap and provided low risk asset correlation
Q3 INVESTOR SENTIMENT	o Investor uncertainty was high in Q3; we expected this to drop dramatically post-election causing cash to come off the sidelines o We advocated rotating up in quality on a broad basis (from high yield to loans, from CCCs to BBs, from emerging markets to the U.S., etc.)

We took note of the populist movement and were among the few in our industry prepared for both Brexit and the Trump victory. The Republican sweep of Congress, on the other hand, took us by surprise, and to us, that's the real game changer.

Thanks to the prospects for growth in this political landscape, we begin 2017 in an unusual, unexpected environment where we see both opportunity and volatility ahead. To fully capture this unique outlook, we revisit the key signals we identified in 2016 (Fig. 1) and explore their investment implications for the year ahead.

Revisiting PMIs: PMIs in Q1 2016

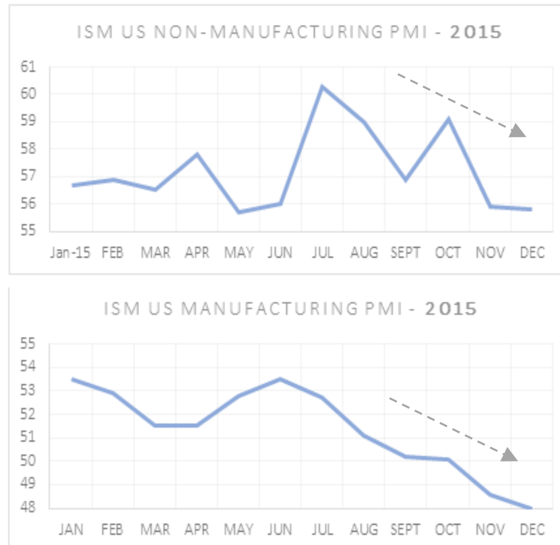
In the first quarter of 2016, we were looking at purchasing managers' indices (PMIs) as a signal of the strength of the U.S. economy. While hard to fathom now, at the time there were plenty of people predicting an imminent recession.

Looking at the U.S. PMIs in 2015 (Fig. 2), it is clear why those concerns were top of mind. And given the way 2016 started for risk assets, with stocks and commodity prices in apparent freefall, recession fears only intensified in the first quarter of 2016.

While that PMI data was troubling, we viewed it as an indication of a slowdown in global growth rather than an imminent recession. As such, we considered early 2016 as a buying opportunity in areas like below investment grade credit. There investors could capture liquidity premiums by acting as the liquidity provider when forced sellers overwhelmed fundamentals.

FIGURE 2

Fueling Recession Fears: ISM PMIs in 2015



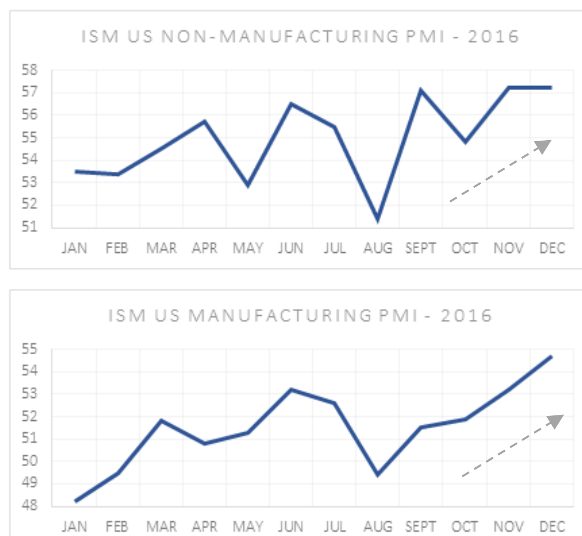
Source: Institute for Supply Management

PMIs today

PMI data looks much different as we start 2017 compared to where we were a year ago (Fig. 3). We believe this upward trend is partly responsible for the market rally that many are attributing solely to Trump. In our opinion, this positive economic data, along with the Republican sweep, deserves much more credit for the recent optimism.

FIGURE 3

Inspiring Confidence: ISM PMIs in 2016



Source: Institute for Supply Management

Revisiting the dollar: DXY in Q2 2016

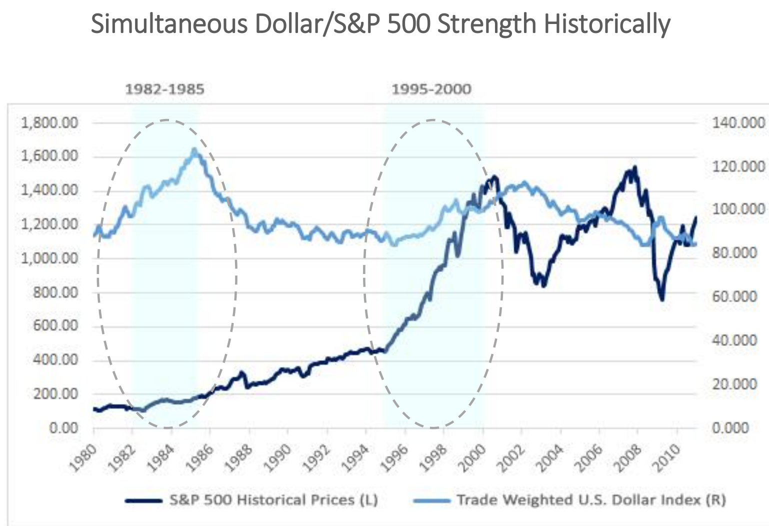
In Q2 of 2016, the dollar was near the low end of its 18-month range. Because of this movement, we believed the dollar index (DXY) was a key signal to watch to determine the fate of risk assets. Our view then was that if the dollar broke out below that band of 93-100, it would be bullish for risk assets, and conversely, if it reflated and rose above the band, risk assets would struggle.

DXY TODAY

While our Q2 prediction was not accurate on the surface, a closer look shows that the nature of the dollar's strength changed in a meaningful way starting in the last quarter of 2016, altering its relationship with risk assets.

While a strong dollar is typically a headwind for stocks, there have been anomalous periods of dollar strength that accompanied economic strength in the U.S. (Fig. 4), and in these instances, the equity market benefitted, showing that all dollar strength is not necessarily created equal.

FIGURE 4



Source: Federal Reserve Bank of St. Louis, Standard & Poor's

Before the election, the dollar was strengthening not because investors were excited about what was happening in the U.S., but because things were simply worse elsewhere. Now it appears the dollar has strengthened because the U.S. economy, on an absolute basis, has improved, and that can actually be accretive to risk assets.

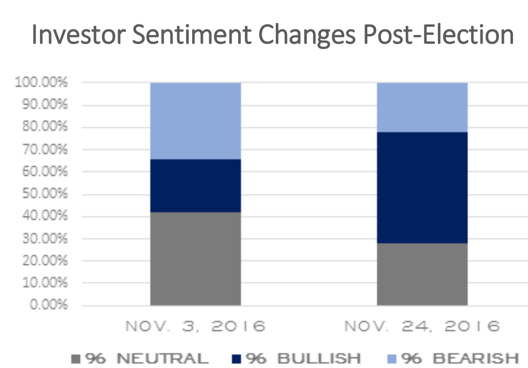
REVISITING INVESTOR SENTIMENT: AAII INVESTOR SENTIMENT SURVEY IN Q3 2016

In Q3 2016, investor uncertainty, measured by neutral ratings on the American Association of Individual Investors (AAII) Investor Sentiment Survey, was at notably high levels, in large part due to the upcoming U.S. election.

As such, we expected uncertainty to drop significantly post-election, consequently bringing down cash levels, which were also unusually high at that time, as investors put capital to work.

That sequence of events unfolded as we expected, with investor uncertainty dropping from above 42% before the election, to below 28% in the weeks following (Fig. 5). We also saw fund managers' cash levels move from 5.8% ahead of the election to 4.8% in December according to the Bank of America Merrill Lynch Global Fund Manager Survey.

FIGURE 5



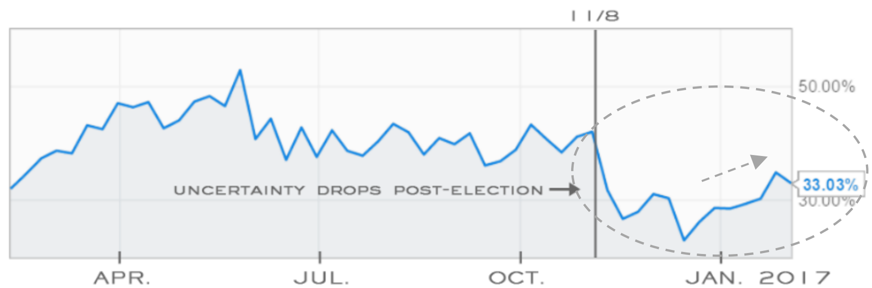
Source: AAII Investor Sentiment Survey

Investor Sentiment Today

Today, uncertainty is creeping back up after hitting two-year lows in mid-December (Fig. 6). While markets are holding onto much of the post-election enthusiasm, we believe the many unknowns that still exist under Trump are now back in focus, renewing a sense of uncertainty among investors despite the general optimism about the Republican sweep.

FIGURE 6

U.S. Investor Sentiment Survey, % Neutral



Source: AAII Investor Sentiment Survey (as of 2/2/2017)

WAYS TO PLAY 2016's SIGNALS in 2017: "Make volatility great again"

The economic strength we've seen recently in positive PMI data, along with other indicators like elevated consumer confidence and job creation, is a product of the stimulus that was deployed in response to weakness in Q4 2015 and Q1 2016 finally playing out.

That trending economic strength, along with the GOP sweep of Congress, is in our view the driver of the post-election rally more so than Trump's win alone. We see Trump as a source of volatility, and expect 2017 to be marked by volatility-inducing actions and communications coming out of the Oval Office.

That said, the combination of strong economic data and the high likelihood of fiscal stimulus inspires confidence, so our overall outlook is constructive for the U.S. corporate economy. And considering the significant opportunities in deregulation, relief there can provide enough benefit on the margin to justify this optimism.

With this expectation about both the volatility and opportunity ahead of us, we will be looking to buy any dips in the market created by Trump and the policy uncertainty he brings. And if his executive order spree is any indication of what's to come, there will be plenty of buying opportunities in 2017.

NOISE:

THE CALL TO FEAR THE UNKNOWN

In this section of our newsletter, we typically highlight signals that investors should ignore. However, in light of the state of unrest regarding immigration politics, we feel the need to reorient our message for this edition. Today's noise is the call to fear the unknown. This divisive and destructive emotion should be resisted at all costs. Our society and markets are based on the bedrock of freedom, respect and honesty. The obligation we have to protect our country, our families and the capital entrusted to us should be informed by these principals. Therefore we urge you to reject the noise of fear.

OUR CURRENT INVESTMENT RECOMMENDATIONS

In this risk-on environment, we favor higher quality assets as a cash source rather than sitting on cash itself. If a buying opportunity arises, those assets are easy to sell to generate capital.

MANAGE INTEREST-RATE RISK

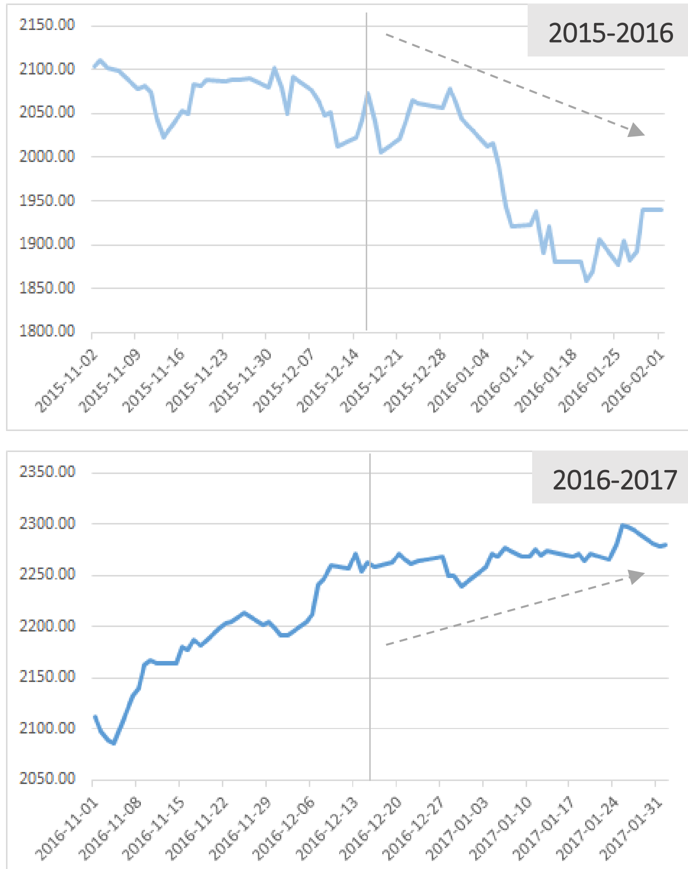
The aftermath of the recent December Fed decision further highlights the contrast between our outlook today compared to 12 months ago. When the Fed finally moved forward with a rate hike in December of 2015, the new year began with a steady plunge in risk assets that lasted until mid-February. Conversely, when the Fed elected to raise rates again in December of *2016*, the new year brought Dow 20,000, as well as new highs for the S&P 500 and the Nasdaq. Looking at the contrasting stock market activity following these two decisions (Fig. 7), it is clear that the Fed is in much more of a position now to carry out the multiple hikes outlined in their guidance than they were at this time last year. That, combined with the latest string of positive economic data, is a recipe for rising rates.

Demand for floating-rate credit has already increased in recent months, and loan funds saw $6.8 billion in inflows in December alone. Rising Libor into Q4 of 2016 rewarded those flows, and as of early January, three-month Libor rose above the 1% level of the floor cap that's in place for most loans, meaning those loans are now truly floating rate. With much of the loan market trading around par, there is not necessarily a broad-based opportunity for price appreciation; however, the value of

FIGURE 7

| = FOMC raises federal funds rate

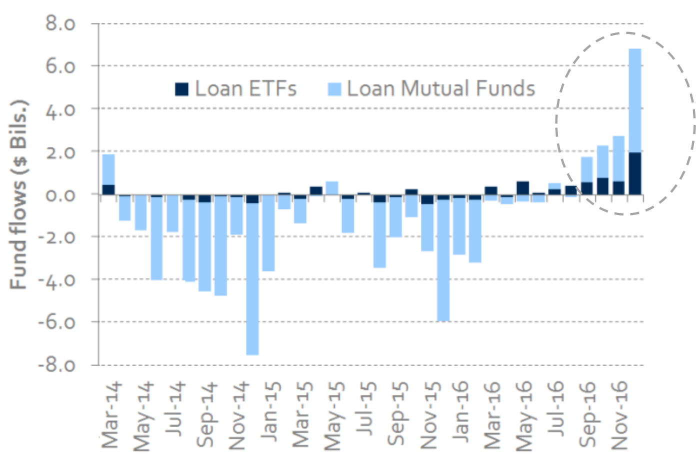
S&P 500 Post-Fed Decisions: The Difference a Year Makes



Source: S&P Dow Jones Indices LLC

FIGURE 8

Demand for Loans: Loan Mutual Fund & ETF Flows



Source: Lipper Leveraged Loan Monthly (December 2016) investing in loans today is the protection from the downside of rate increases that occurs in other fixed income strategies.

The volatility we expect in 2017 will create winners and losers, which presents trading opportunities with the prospect of price swings. Investors who position capital to benefit from volatility should thrive in 2017.

Get active

We have been outspoken in our defense of the value of active management, which many have questioned amid the underperformance from active managers in recent years. But between the post-crisis regulatory environment and the effect of the overreliance on monetary policy, markets over the last several years were artificially inflated and momentum driven. Now we are finally in an environment where active managers can truly prove their value, and the 2016 credit market provided a glimpse of what that can mean for investors.

In credit, disciplined security selection and nimble active management produced outsized returns in 2016. Further, any regulatory easing bodes well for the function of credit markets, meaning this fundamental allocation approach should continue to be rewarded. At the end of 2016 we saw the beginning of meaningful rotations in sectors and asset classes, and those kinds of movements create valuable opportunities for active management. At the same time, correlation is dropping broadly across equity markets, as well as within sectors, meaning there is more idiosyncratic risk in stocks. All these market forces, from sector rotation to declining correlations both on a sector and security basis, present the ability to generate real alpha.

Central to our outlook for 2017 is that there will be winners and losers that emerge as markets react to and digest changes in this new environment. You can't capitalize on this dynamic in an index fund, and while we don't see the popularity of passive strategies going away, we do expect many critics of active management to be silenced in 2017. Trump will continue to create uncertainty, but one thing we are certain of is that he will "make volatility great again."

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