

Crossroads

Entering 2018, pundits were cautiously optimistic in their outlook, as 2017 had been a banner year for markets and economic growth. Economic and earnings growth remained solid, yet increasing risks appeared, mainly in the form of trade tensions. After an early correction in the U.S., the S&P 500 looked to be back on track for a positive, single-digit-return kind of year.

Meanwhile, uncertainty around trade and global growth expectations heated up, causing a steady move lower in international markets. This synchronized decline in markets happened despite the strongest earnings growth rate since 2011 which averaged 20% for 2018. Additionally, GDP growth year-over-year was the strongest we have seen since 2015 coming in at 3% for the third quarter of 2018. Not to mention consumer confidence reached the highest levels since the last recession, and capital spending was the highest since 2015. The volatility we experienced in global markets was not adding up. Since Christmas, markets have started to recover from a U.S. correction (-19.8%) and bear markets in international developed (-23.1%) and emerging markets (-26.6%). It is easy to feel a bit lost after market moves like this. So, what do we make of the latest market moves, and where does that leave us for 2019? (Source: Highland Associates; Data: FactSet)

Shifting Market Backdrop

In order to assess whether these market moves are the start to a prolonged bear market or simply a bull market correction, we turn to our framework to analyze the current market environment. Although we agree the fourth quarter of 2018 disappointed, especially given the strong backdrop of earnings growth and economic fundamentals, FSA & Highland do not make observations or portfolio changes based solely on sentiment.



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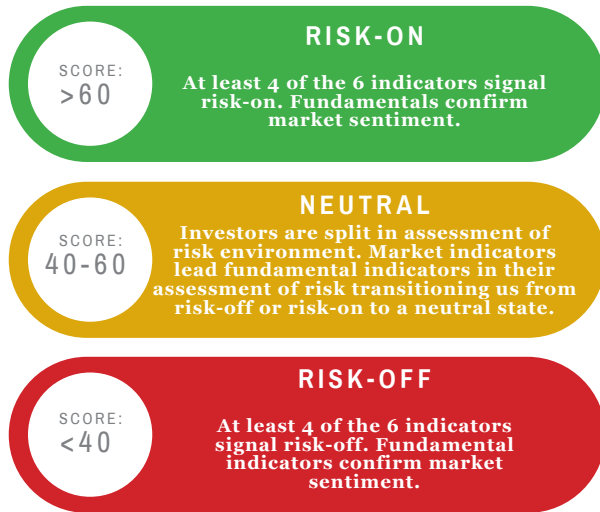
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FSA INVESTMENT GROUP
308 SOUTH ALCANIZ STREET
PENSACOLA, FLORIDA 32502

Telephone: 850.696.1550
Fax: 251.459.6918
Email: info@fsa-ig.com

As seen in Figure 1, we rely on our framework, which examines market and fundamental indicators that make up the Highland Diffusion Index to survey the surroundings and determine whether we are in a risk-on, neutral, or risk-off environment.

Figure 1



Source: Highland Associates

The ultimate objective of the framework is to keep our clients invested in order to meet the returns needed to support their mission. To maintain those returns, we must look to transition portfolios when both market and fundamental indicators confirm a shift from risk-on market environments. Our goal is to avoid deep bear market drawdowns. These are different from normal bear markets with price declines of -20% to -30% that hurt in the short-run but tend to bounce back in a year's time. The deep bear market drawdowns result in greater losses and longer recovery times. Deep bear markets are marked by prolonged declines of -30% or greater and have historically coincided with economic recessions in the U.S. as well as many other developed nations. Instances include the Global Financial Crisis and the Dot-Com Bubble. Global Equities in each of these instances declined more than 50% over the course of 1-2.5 years. A full recovery of losses from the prior market peak took 4-5 years (see Figure 2).

The effects of compounding investment returns mean that a 50% loss requires a 100% gain to recover an initial investment, while a 20% loss requires just a 25% gain to recover. By reducing risk in response to weak market and economic data, losses are mitigated. By being disciplined in reintroducing risk, recovery times can be lessened. This is the goal of Highland's Diffusion Index.

Figure 2

EVENT	PEAK TO TROUGH DATES	MSCI ACWI - PRICE RETURN (USD) - BEAR MARKETS	LENGTH OF BEAR MARKET (MONTHS)	LENGTH TO RECOVERY (MONTHS)	MSCI ACWI - PRICE RETURN (USD) - RECOVERY
Black Monday	8/31/1987 - 11/30/1987	-20.5%	3	3	28.1%
Gulf War Oil Shock & German Re-Unification.	1/4/1990 - 9/28/1990	-25.8%	9	32	36.4% *
Russian Financial Crisis	7/20/1998 - 10/5/1998	-21.1%	3	3	27.1% *
Dot-Com Bubble	3/27/2000 - 10/9/2002	-51.4%	30	49	106.7%
Global Financial Crisis	10/31/2007 - 3/9/2009	-59.6%	16	63	148.9%
European Sovereign Debt Crisis	2/8/2011 - 10/4/2011	-23.9%	5	16	31.5% *
Greek Debt Default & Chinese Currency Devaluation/ Growth Slowdown	5/21/2015 - 2/11/2016	-20.2%	9	12	25.6% *
Global Trade Tensions & Chinese Slowdown	1/26/2018 - 12/25/2018	-20.5%	11		25.6% *

Source: FactSet; MSCI,

*U.S. only a correction; Highlighted cells denote prolonged bear markets; Monthly data from 12/31/1985 - 12/31/1987; Daily data from 1/4/1988-present. Bear markets are defined by returns < -20% and corrections are < -10% but > -20%;

At this point in the market cycle, it can be hard to see the forest from the trees. Late cycle brings mixed data and heightened volatility, but it can also bring substantial returns. Recall from our [Quarterly Market Commentary 3Q18](#), roughly 20% of returns in a bull market occur in the last year on average.

And so we weigh our options based on the data at hand in order to ensure we capture as much of the return as is prudent to meet long-term portfolio objectives.

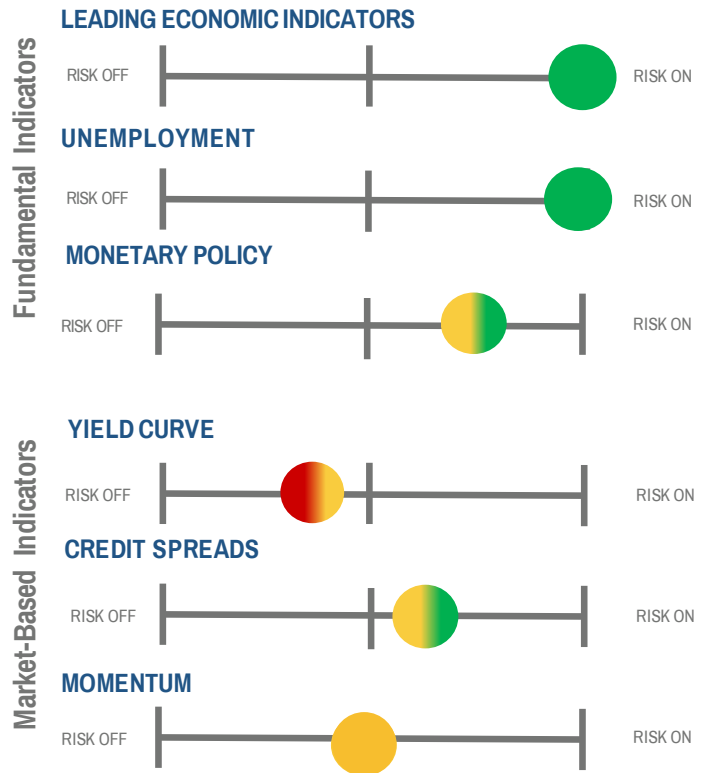
Currently, the index indicates a risk-on environment in favor of risk assets but could very likely move to a neutral position (see Figure 3). Economic data in the form of unemployment, leading economic indicators, and still somewhat accommodative monetary policy are strong. Though we continue to evaluate for late cycle signs, unemployment remains at the lowest rate since 1969, year-over-year changes in U.S. leading economic indicators remain strongly positive, and the Federal Reserve still has some runway for raising rates before hitting a rate that would be restrictive to the economy though they may not use it.

As for the market, we saw widening credit spreads and sluggish equity price momentum in the fourth quarter. Since then, credit spreads have tightened and markets rallied through February. Our eye remains keenly placed on the yield curve. The spread between the 10-year Treasury and 3-month Treasury flattened by just over 80 basis points over the course of 2018. Equity market returns have historically still been positive even in the midst of a flat yield curve. In fact, the yield curve typically inverts then steepens before a recession ensues, making the yield curve a leading indicator.

A move lower in all three market indicators to risk-off would lead us to a neutral reading. From neutral, if conditions reverse and equity market momentum strengthens and/or credit spreads tighten (just as we saw in January), a return to a risk-on positioning could be the result. This has happened three other times in the index's 33-year back-tested history. Alternatively, economic fundamentals could confirm the negative sentiment being expressed by the markets. In that case, the Diffusion Index would signal a risk-off environment. The swift move in markets as witnessed in January is why Highland waits for two months of Diffusion Index data before making a change.

Figure 3

Highland Diffusion Index



Source: Highland Associates; as of 1/31/2019.

As a rule of thumb, market indicators take the index to a neutral reading and fundamental economic indicators take the index to a risk-off position (see Figure 4). The reverse is also true: market indicators lead the index from risk-off to neutral, while fundamental economic indicators bring the index to risk-on. Think of market indicators as the smoke detector and fundamental indicators as the confirmation of a fire. Currently, our market indicators have alerted us to our surroundings, but no alarms have been sounded.

Figure 4

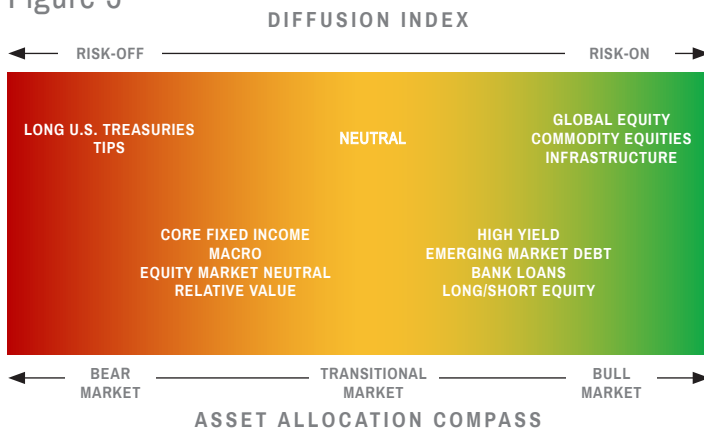
MARKET INDICATORS	FUNDAMENTAL INDICATORS
Yield Curve (U.S.)	Leading Economic Indicators (U.S.)
Credit Spreads (Global)	Unemployment Rate (U.S.)
Equity Market Momentum (Global)	Monetary Policy (U.S.)

Sources: Highland Associates

Navigating the Wilderness

Knowing where you are isn't enough—it's knowing how to get to your destination that makes the difference. Once the environment (i.e., risk-on, neutral, risk-off) is identified, positioning to make the most out of the market is key. We evaluated assets across a multitude of different market environments that we then distilled to three broad market phases—bear, transitional, and bull. These three market phases comprise our Asset Allocation Compass, which guides our portfolio positioning (see Figure 5).

Figure 5



Source: Highland Associates

Bear markets, bull markets, and transitional markets describe equity market return environments in a way that mere calendar quarters or years cannot. Cycles don't fit a calendar year. With rolling annual returns positive 77% of the time and negative 23% of the time, portfolio allocators should most often be positioned for return; however, as the statistics cited above show, the few but mighty deep bear market drawdowns can sideline portfolio goals for 4-5 years of recovery if not allocated appropriately. Therefore, it is important to be dynamic in changing allocations, and the compass helps guide us where to add or remove risk in portfolios. The compass keeps us focused on the path ahead when markets make us feel uncertain. That is why we start by identifying the risk environment using the Diffusion Index and then turn to our compass to help guide our next move by adding assets that protect in uncertain times.

We feel most uncertain in the outlier environments—bears and bulls—which only occur 5% and 25% of the time, respectively. But given the magnitude of these moves, we want to be nimble and assertive in directing portfolios during these pivotal market transitions. In these moments, direct market exposure and liquidity are key, as markets tend to move swiftly.

This means in bear markets heavily allocating to bonds (i.e., long U.S. Treasuries, TIPS) and in bull markets focusing on equities. But 70% of the time we're moving in between these two market states, which is when the compass guides us to introduce a multitude of assets to capitalize on these different market environments. Transitional markets tend to have increased volatility whether returns are flat, positive, or negative. Based on the specific market environment, we believe diversifying into different strategies to complement a traditional stock/bond allocation adds value.

For example, in a market characterized by higher volatility, heightened uncertainty, and/or desynchronization in trends, we would dial back the equity exposure and introduce strategies that benefit from increased volatility but also do well when the economy is growing, albeit at a slower pace. In this type of transitional market, we would favor long/short equity and alternative credit (i.e., high yield, bank loans, and emerging market debt). In the heart of a transitional market, market momentum has softened, credit spreads are wider than average, and economic fundamentals start to show signs of weakness. Coming out of a bear market, the market shows some signs of a recovery. Fundamentals are beginning to improve, but not all signs are positive. We would begin to transition portfolios away from the extreme safety of long government bonds and TIPS to more core fixed income (i.e., intermediate duration Treasuries, investment grade credit, mortgage and asset backed securities). Other strategies that are less directional and provide downside protection, such as equity market neutral and relative

value, could be additive in this recovering growth yet higher volatility environment. This distillation of long-term asset class performance into a guide keeps us focused on the path ahead and allows us to transition portfolio allocations in anticipation of changes in the Diffusion Index.

Recession or Rally?

We have been in a bull market phase, but now we find ourselves at a crossroads. Our risk-on positioning may be waning, and we have two paths from here: maintain our positioning or pull back our exposure to risk assets and increase exposure to other assets that could benefit in an environment of greater market risks and moderating economic conditions. Market indicators are starting to show signs of weakness, as mentioned above. If credit spreads continue to widen, equity momentum remains soft, and the yield curve continues to flatten, our market indicators would have us move to a more neutral stance. In light of this environment, Highland's compass would guide us away from our overweight to equities with an eye toward core fixed income assets if the environment deteriorates further. Hedge fund strategies do exceedingly well in this muddle-along environment typically marked by higher volatility, especially strategies such as macro, equity market neutral, and relative value whose non-directional nature prepares portfolios well for a dial down in risk.

Alternatively, the Diffusion Index could remain risk-on if credit spreads tighten and/or equity market momentum picks up for a late stage rally. We are already seeing movements in this direction, as credit spreads have tightened and global equity markets rebounded in February. Since the December 24th low, the S&P 500 was up 15% and MSCI ACWI up 3% through January 31st (Source: Highland Associates; Data: FactSet). Catalysts for a market rally include a de-escalation of trade tensions

and announcement of a halt to new tariffs on China a better than expected economic growth in the U.S., international developed, or emerging markets; or a market-friendly Brexit plan. A resurgence in markets would be well-supported by earnings and lower valuations post-2018 correction and would likely be the last leg of a long bull market. This would reaffirm current positioning. Current strategic positioning reflects an overweight to equity and hedge funds. Meanwhile, we favor an underweight to core and short duration fixed income, as these assets are historically the least additive to portfolios during this time.

Each market cycle is like an expedition: It's never a smooth ride and hardly a straight path to the destination. That is why asset allocators should be armed with the necessary tools to stay convicted through the dips and turns of the market. We start by identifying the type of market environment we are in by using the Diffusion Index. We then look to the Asset Allocation Compass to dial in on the specifics of the market environment to begin adjusting portfolio allocations. This gives us the direction we need to navigate our environment.

Using these tools to reflect our assessment of current markets, FSA & Highland continues to have portfolios positioned in a risk-on manner. However, current conditions are shifting, which leads us to a crossroads for future allocations. Whether we maintain positioning in light of strengthening market data or transition portfolios to dial down risk, FSA & Highland will continue to patiently observe market trends and respond accordingly.

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Authors:

R. Scott Graham, CFA, Chief Investment Officer, Highland Associates

J. Andrew Webb, CFA, CPA Director, Highland Associates

Lauren B. Hyde, CFA, Vice President, Highland Associates

FSA INVESTMENT GROUP
308 SOUTH ALCANIZ STREET
PENSACOLA, FLORIDA 32502

Telephone: 850.696.1550
Fax: 251.459.6918
Email: info@fsa-ig.com