

OVERVIEW

Modest improvement in several economic indicators during the second quarter fostered optimism that the worst may have passed for the US economy. Investors regained their appetite for risky assets amid hope that the pace of contraction is slowing and that the US economy may soon emerge from the grip of a severe recession that began in December 2007. Advanced estimates of second quarter GDP growth came in at -1.0% versus consensus estimates of -1.5%; a sharp improvement from the first quarter's steep decline. Other measures of economic health also exhibited improvement. The Conference Board's Index of Leading Economic Indicators posted three consecutive months of improvement after falling since June of 2007 with 7 of 10 indicators positive in June. The Index of Coincident Indicators, however, continued to fall, led by further deterioration in June employment figures. Manufacturing data from the Institute of Supply Management and an unexpected drop (albeit slight) in the July unemployment rate also offered some encouragement. Against this backdrop of economic data and the widespread belief that the financial system has been stabilized, equity markets and non-Treasury fixed income sectors staged impressive rallies. For the quarter the S&P 500 rose 15.9%, its biggest quarterly gain since the fourth quarter of 1998. Since its March 9th low, the S&P has risen 44.5% through July 31, reaching levels not seen since last November. Corporate bonds across the credit quality spectrum also rallied sharply as yield spreads versus Treasuries raced tighter. As the Barclay's Government index fell 2.2% during the quarter, investment grade and high yield indices rose 8.8% and 23.1%, respectively. From their highs last year, investment grade spreads have tightened over 350 basis points, while high yield spreads have tightened nearly 1300 bps.

Despite somewhat encouraging developments on economic and investment market fronts, investor optimism should be tempered by three distinct realities: 1) the methodology utilized to derive economic statistics must be closely examined to gain a true sense of their effectiveness in measuring what they purport to measure, 2) economic statistics may not reflect economic reality, and 3) short term market moves are generally more indicative of investor sentiment than fundamental value.

"I believe we will need to see a much stronger upturn in savings and investment, and a fall in debt loads before we see a strong sustainable economic expansion. I say to our clients - we are probably starting an economic expansion, but we should be careful what we wish for. For stocks, anticipation is often much better than the event itself."

- Ned Davis, Ned Davis Research, Inc. July 31, 2009.

Index	2Q09	2009 YTD
Barclays Aggregate Index	1.8%	1.9%
S&P 500 Index	15.9%	3.2%
MSCI EAFE Index	24.4%	5.6%
MSCI Emerging Markets	34.7%	36.2%
HFRI Fund of Funds Composite Index	4.9%	5.2%
NCRIEF Index	-5.2%	-12.1%

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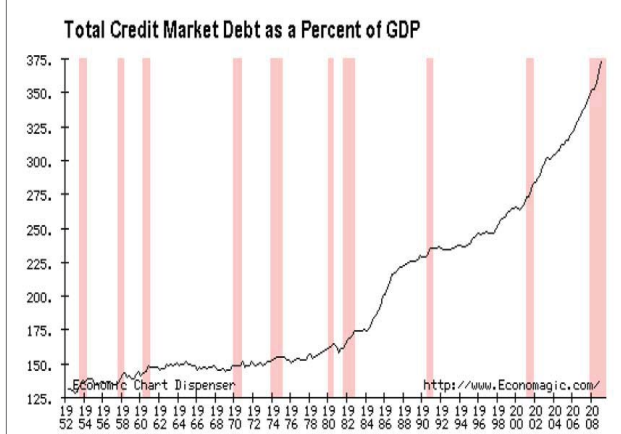
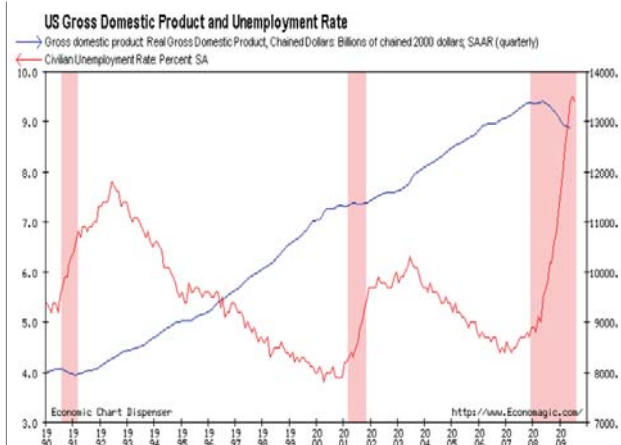
While a “statistical” recovery may very well have begun, slow job and income growth, personal, corporate, and governmental debt burdens, and an era of higher personal savings and lower consumption are likely to remain a drag on economic expansion for the foreseeable future.

GROSS DOMESTIC PRODUCT

As with many economic statistics, US gross domestic product is frequently estimated and subject to revision. The US Commerce Department’s Bureau of Economic Analysis releases quarterly advance, preliminary, and final GDP estimates. While the advance estimate of second quarter 2009 GDP was better than expected (-1.0% versus consensus expectations of -1.5%), first quarter was revised downward to -6.4% from -5.5%. From the fourth quarter of 2007 to the first quarter of 2009, the economy shrank at a -2.8% rate, worse than the -1.8% originally reported. Despite the revisions, many economists are now forecasting a return to growth by the end of 2009 and some have boldly proclaimed that the recession ended in June 2009. While a “statistical” recovery may very well have begun, slow job and income growth, personal, corporate, and governmental debt burdens, higher personal savings, and lower consumption are likely to remain a drag on economic expansion for the foreseeable future.

GDP METHODOLOGY

Upon closer examination of the methodology employed to calculate US GDP, several idiosyncrasies emerge. First, GDP is a measure of output, not sales or consumption. When an automobile rolls off the assembly line in Detroit, it has a contributory effect to GDP as an addition to inventory, even if it is then shipped to a dealership where it sits unsold for months. For this reason, inventory adjustments can have a significant impact on growth estimates and revisions. For example, as production fell in the first quarter, automobile output detracted -1.7% from GDP growth. Production resumed (at a much slower pace) and actually was a slightly positive contributor (+0.2%) in the second quarter.

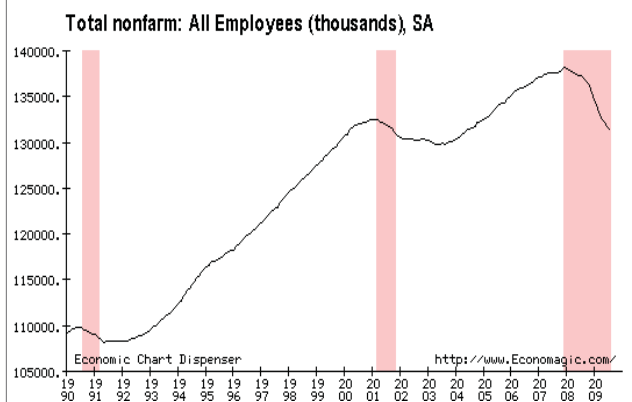
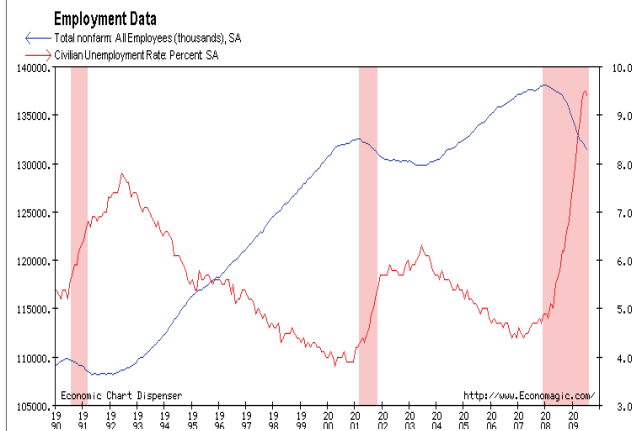


in fact, non farm payrolls, a widely followed measure of employment and overall economic health, have fallen back to early 2000 levels, reflecting the loss of nearly all the jobs created this decade.

Secondly, increasing government spending is additive in the GDP calculation, but represents a tax on private capital and perhaps less than optimal re-deployment of that capital towards non-economically productive projects and programs. Third, imports are subtracted from the GDP equation, so a decrease in imports perversely contributes positively to GDP (as in the 2nd quarter). Declining imports however, are likely indicative of declines in consumption driven by consumers' reluctance or inability to spend. (Source: "Why Investors Should Ignore GDP", John Tamny, www.realclearmarkets.com) Given these considerations, an increase in business inventories from depressed levels, the current Administration's aggressive budget assumptions and spending plans, and lower personal consumption could actually contribute to a statistical recovery over the next several quarters.

UNEMPLOYMENT

Given the importance of consumer spending to the US economy and current levels of consumer debt, any sustainable economic growth must be accompanied by improvement in the US labor market. The Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) is charged with officially assigning the beginning and end dates for US business cycles. Recognizing the significance of employment and income to economic health, the Committee focuses on key indicators including labor market measures, non farm payrolls and personal income less transfer payments (like Social Security), in addition to GDP. While recent data has indicated that the pace of job losses is slowing, the overall employment picture in the US is still daunting. Over 6.5 million jobs have been lost since December 2007. In fact, non farm payrolls have fallen back to early 2000 levels, reflecting the loss of nearly all the jobs created this decade. The pace of job loss appears to be declining, but the economy still lost 247,000 jobs in July, and has lost an average of 331,000 jobs per month in the last three months compared with 645,000 from November to April. One in three unemployed workers has been unemployed for more than 27 weeks. More and more workers are relying upon benefit extensions, and the exhaustion rate of unemployment benefits is at a 27 year high.



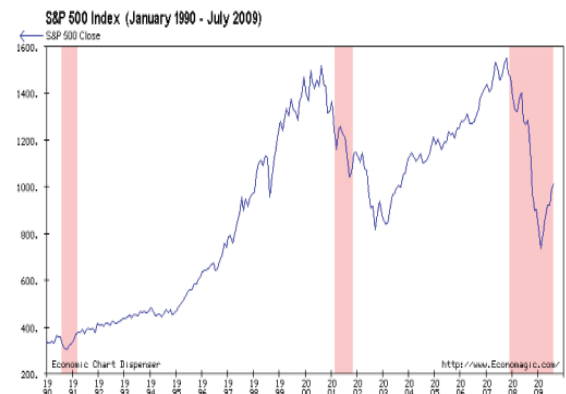
In July the unemployment rate improved to 9.4% (or 14.5 million people) from 9.5%, not because of higher employment, but a reduction in layoffs and workers leaving the labor force. Another 2.3 million were not counted as unemployed because they hadn't looked for a job in the prior four weeks either because they became discouraged or other reasons including family responsibilities, school attendance, etc.). If these workers were counted, the unemployment rate would be approaching 11%. Recently the Fed revised its unemployment rate outlook upwards from 9.8% to 10.1% by the end of 2009, and from 9.5% to 9.8% by year end 2010. If the Fed's forecast is correct, a quick turnaround in labor markets appears unlikely.

The anomalies in these headline economic statistics may partially explain some of the periodic divergence between economic health as perceived on Main Street, and well publicized economic statistics.

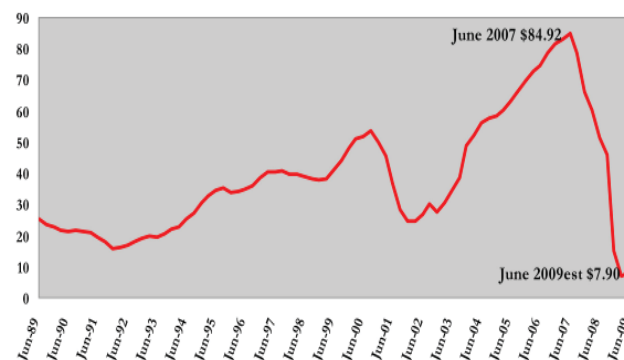
EQUITY MARKETS

The S&P 500 staged an impressive rally in the second quarter gaining 15.9%. With a total economic meltdown seemingly averted and stability somewhat restored to the banking system, financials (+35.7%) led the market's advance. Many institutions announced better than expected earnings, fostering increased investor optimism in the sector and propelling share prices higher.

Future earnings prospects, however, are still questionable. Between 1973 and 1985, the financial sector accounted for 16% of US domestic profits. In the '90's, the range was 16-30%, and this decade the sector's share of earnings peaked at 41%. (Source: Epoch Investment Partners) Massive write-downs, global deleveraging, heightened regulation, and a reduction in financial engineered profits will likely limit future earnings potential well below pre-crisis levels. For 2009, financials are expected to account for only 8.4% of S&P 500 earnings after detracting nearly 30% in 2008. Across sectors the near term earnings picture remains bleak. With nearly 90% of the total market value of the S&P 500 reporting, late season misses by several large index components including Exxon Mobil pulled second quarter earnings 5.9% below estimates and 36.0% below last year. For the quarter, 44% of companies beat current estimates with 31.5% beating last year's earnings, and 17.4% beating both. Overall, operating earnings are expected to decline 18.8% from last year. Although bottom line earnings have offered some encouragement, top line revenues have been dreadful. 77% of companies reported lower sales in the second quarter and index sales are expected to be nearly



S&P 500 Earnings Per Share
Trailing 12 month
June 1989 - June 2009 (est)



"...But getting less worse is different than getting better, and significantly different than being good."

-Howard Silverblatt S&P Senior Index Analyst on corporate earnings

20% below last year's levels. While companies in general have been somewhat successful in managing costs to partially shield their bottom line, at some point revenues must increase to support any sustainable recovery in corporate profits

FIXED INCOME

Bond markets also benefited from increased investor appetite for risk as spread sectors outperformed Treasuries by a wide margin with riskier sectors producing outsized gains. The corporate bond sector has seen massive inflows in the first half of 2009 absorbing considerable new issuance and driving spreads tighter. High yield was the best performer, up 23.1%, followed by emerging market debt (+12.4%), investment grade credit (+8.8%), and asset backed securities (+7.6%). Investors should remain cautious however, as default rates on high yield bonds continue to rise and recovery rates have trended lower.

Agency mortgage backed securities continued to outperform duration adjusted Treasuries during the second quarter. The Fed has managed to keep mortgage rates low by purchasing \$622 billion of MBS in the first half of 2009. Expectations of escalating prepayment speeds amid lower rates, however, have failed to materialize as re-financings remain subdued. Non-agency mortgages also rallied during the period on hopes that the government's PPIP program would provide support and liquidity to the market. According to Blackrock, by quarter end prices on non-agency residential mortgage backed securities (RMBS) were 30% above their March lows, and expected loss adjusted yields range from 9-13%.

Finally, TIPS rose 0.66% during the quarter outperforming nominal Treasuries by a wide margin. Breakeven spreads (the level of inflation that represents the breakeven rate between TIPS and nominal Treasury yields) generally rose, reflecting market expectations of higher inflation and a potential glut of nominal Treasuries (Source: PIMCO). At the end of July, breakeven inflation rates stood at approximately 1.3% for 5 year, and 1.8% for 10 year maturities

CONCLUSION

A jobless recovery is not likely to support sustainable economic growth considering the US economy's reliance on personal consumption. A period of lower consumption and higher savings amid higher unemployment going forward will present a significant headwind to sustained economic expansion. Similarly, a revenue-less recovery in corporate profits is not likely to support a return to earnings anywhere near pre-crisis levels. Without sustained earnings growth, fundamental valuations could suffer and future return prospects for equity investors could be disappointing. The turning point for the US economy will be evident when consumers are encouraged by prospects for job creation and wage growth, and corporations exhibit both top line growth and bottom line expansion. A turning point may be reflected in the data, but more importantly will be apparent in consumer and corporate behavior and perception. Sustainably higher levels for assets prices could then follow.

Additional Sources:

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US Department of the Treasury
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Wall Street Journal
Standard and Poor's
NAREIT
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