HIGHLAND

ASSET ALLOCATION

FEBURARY 2020

FUNDAMENTALS, MOMENTUM AND A VIRUS...

After reviewing the economic and market environment, Highland's Investment Committee offers the following comments on the current landscape:

- Highland's Risk-On/Risk-Off Diffusion Index, which incorporates both fundamental and market-based indicators, continues to favor risk-seeking assets. Economic indicators rebounded from the mid-year slowdown but still are on a low trajectory. Market-based indicators remain firmly in positive territory.
- On the fundamental front, U.S. and German manufacturing survey data firmed over the first month of the year in response to easing trade tensions. These data points, and others we track, are pointing toward sustained growth. Even some of the weaker data points incorporated in the Diffusion Index, the ISM New Orders Index and the Consumer Expectations Index, appear to be stabilizing or inflecting higher. These green shoots may struggle to withstand the latest freeze in Chinese demand as the impact of the current coronavirus outbreak begins to spread.
- On a more conservative note, the most recent JOLTS job openings report points toward a slowdown in new job growth. While the JOLTS component of our diffusion index is still in positive territory, we're monitoring the deterioration in this data closely.

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Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. As of August 31, 2018, we serve as investment consultant on approximately $26 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

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- On the coronavirus, China's economic output is threatened over the short-term. More worryingly, virus-linked disruptions to China's industrial sector threaten growth for trading partners. Regional partners, including Australia and South Korea, are likely to be most affected. As the virus ages, we expect to see more negative effects for the global economy, possibly costing 2020 global growth 0.5%-1.0% over the full year. Most of this effect will come from the global supply chain as component parts become scarce. We expect more companies to follow Apple's lead and make announcements about the impact of the virus on their short-term earnings. As the impact of the virus wanes in the long run, we expect global GDP to rebound sharply as pent-up demand surges back into the system.
- Concerning the U.S. election, market reactions to the Democratic primary have been muted thus far. As the general election approaches, sectors like healthcare and energy could once again become sensitive to changes in election odds. While we think investors would be wise to discount candidates' most extreme campaign pledges, the link between polling and market sentiment will likely become more relevant as we approach November.
- Monetary policy remains accommodative. While the FOMC left the Fed Funds Rate unchanged at 150-175 bps at its January meeting, Chairman Powell conveyed a continued willingness to keep policy rates low in the face of subdued inflation.
- The U.S. yield curve has returned to a more normalized slope across all maturities, suggesting that recession risk has fallen.
- Credit markets, similarly, point toward a risk on environment. U.S. credit spreads remain below their long-term averages, which continues to support a risk-on environment.

- Equity market momentum remains supportive, but we have witnessed increased volatility due to concerns over the coronavirus. The VIX index, a proxy for S&P volatility expectations, climbed from 13.78 to 18.84 in January. While the volatility has been elevated, risk asset performance has been resilient over the month of January and into February.

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