HIGHLAND

JUNE ASSET ALLOCATION NOTE:

MIXED MESSAGES AND FAST-MOVING MARKETS...

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

As of late June, the Highland Diffusion Index (HDI) is signaling a turn to risk-off. However, in light of the historically swift correction and recovery we've experienced over these last few months, current economic and market conditions could lead to a risk-on reading by the end of the third quarter. Taking this into account, we are maintaining our neutral stance. This should reduce whipsaw risk in these volatile markets, while positioning us to act as the economic and market pictures become clearer.

We've highlighted how the components of our HDI framework are evolving below:

- ***Economic Indicators:*** Our economic indicators have been in contraction territory since March. We anticipate they will remain unfavorable near term, as three-month averages for data points like weekly hours worked and capital goods orders remain below their three-year trends.
- ***Employment:*** On a positive note, the May jobs report showed the unemployment rate unexpectedly declining from 14.7% in April to 13.3% in May. Moreover, three quarters of COVID-period job losers surveyed for that update self-reported as temporarily laid off, creating room for more upside surprises to payroll estimates. However, our employment indicator is still in negative territory and will likely remain there near term, as three-month averages for key series like unemployment and the JOLTS rate remain below their three-year averages.

TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

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HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

ST LOUIS:
8182 MARYLAND AVENUE,
12TH FLOOR
ST. LOUIS, MO 63105
P. (314) 615-3501

- ***Monetary Policy:*** Monetary policy remains supportive, as rate cuts and quantitative easing bolster liquidity.
- ***Yield Curve:*** The yield curve is upward sloping across its term structure, suggesting a favorable market environment.
- ***Credit Spreads:*** Credit markets have largely recovered from their March trough. While the Fed has forestalled a liquidity crisis, pockets of acute distress, paired with general economic uncertainty, may keep spreads elevated near term. Today, the credit component of our HDI is contractionary. However, modest additional tightening could signal more supportive conditions by the end of Q3.
- ***Market Momentum:*** Global equity markets have continued to climb since our last asset allocation note. While our momentum indicator remains negative, it should shift back into positive territory over Q3 barring another sell-off.

We're frequently asked whether the disconnect between the U.S. economy, which is confronting generationally high unemployment, and the stock market, which is trading near its pre-crisis peak, proves that this rally has overshot and is due for a correction. We would caution that stock market performance and current economic conditions can diverge for a lot of valid reasons, not least because markets are forward looking, because they trade off earnings and not GDP growth, and because U.S. stocks are increasingly leveraged to global, not domestic, demand. Moreover, we believe the near-term outlook for U.S. stocks, and risk assets more generally, could remain healthy for the following reasons:

- ***Cyclical Support:*** Real-time indicators like consumer spending data from J.P. Morgan and Affinity Solutions have begun to retrace their recent declines. While this high frequency data is noisy, limiting our confidence in these indicators, history shows that stocks tend to outperform in these transitional and early cycle environments.
- ***Positioning:*** Investor positioning data shows allocators are underweight equities and overweight cash and fixed income. This could set the stage for rising markets as investors rebalance toward their policy exposures. This positioning setup is especially important in the systematic cross-asset strategy space.
- ***Monetary Stimulus:*** The Federal Reserve has met this crisis with a flood of liquidity. Over the first 15 weeks since the start of this recession, the Fed's balance sheet expanded by more than $3T. Putting that number in context, it took almost six years for the Fed's balance sheet to grow by the same amount following the beginning of the '07 recession. Federal Reserve Chairman Jerome Powell's proven willingness to act quickly to combat the economic fallout of this pandemic leaves us more constructive toward risk assets.
- ***Relative Value:*** While the S&P's P/E ratio sits at the high end of its historic range, the stock market's relative value is more compelling. Today, relative value metrics like estimated equity risk premiums and the spread of equity dividend yields above treasuries screen as moderately attractive relative to their long-term histories.

We were able to capitalize on recent market dislocations by recommending a couple of attractive opportunities over March and April. Most notably, on March 26, we recommended an overweight to non-core credit—i.e., high yield bonds and bank loans—where appropriate. We liked the opportunity because spreads had widened to a point where we believed investors could earn healthy returns in even a severe default environment,

and because non-core credit has a history of leading other risk assets during transitional bull markets. That investment has benefited clients as credit spreads have fallen and default rates declined from their April peak. Today, we still like this non-core credit idea. However, we believe the opportunity set may be becoming more attractive in adjacent markets like structured credit, where fundamentals are similarly stabilizing, yet spread tightening has been slower.

We opened our last asset allocation note with a discussion of three possible recovery scenarios: a robust V-shaped recovery, a slower U-shaped recovery, and a disappointing L-shaped recovery. Today, it seems like segments of the economy will experience variations on all three:

- Credit card data shows spending on consumer durables like cars and appliances is on track for a V-shaped recovery. Manufacturing activity may also rebound quickly. We saw this in China, which was first in and first out of virus lockdowns. Recent data suggests the domestic manufacturing sector could follow a similar trajectory.
- S&P earnings may be on track for a U-shaped recovery. While they will not recover to pre-crisis levels overnight, consensus is building that market earnings will rebound toward their pre-crisis trend over the next few years.
- Overleveraged and virus-exposed businesses like movie theaters and oil and gas companies could continue to struggle absent a vaccine. Bankruptcies in those industries may create pockets of economic scarring, leading to acute L-shaped recoveries.

Overall, a U-shaped recovery is still our base case. However, we're increasingly seeing how the pace of the recovery will vary across industries and regions, sometimes to painful effect.

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BIRMINGHAM: 2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
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F. (205) 933-7688

ST. LOUIS: ST LOUIS:
8182 MARYLAND AVENUE,
12TH FLOOR
ST. LOUIS, MO 63105
P. (314) 615-3501

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