HIGHLAND

ASSET ALLOCATION

JULY 2020

JULY ASSET ALLOCATION NOTE:

WHAT A LONG, STRANGE TRIP IT'S BEEN (AND WILL BE) . . .

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

The Highland Investment Working Group (IWG) met in late July and affirmed our neutral stance. The IWG believes this positioning allows us to act once we see coordinated movement in the underlying components of our HDI.

Today, there are a wide range of outcomes, including both upside and downside scenarios.

- Risks to the upside include robust fiscal stimulus and progress on vaccine development. On the public health front, The Milken Institute tracker shows 24 vaccine candidates are already undergoing clinical trials globally.[1] Progress on any of these candidates could push markets higher. Most significantly, Moderna, Pfizer/BioNTech, and Oxford/AstraZeneca's vaccines have recently begun Phase 3 or combined Phase 2/3 trials after encouraging early results. Industry observers anticipate we will see strong indications of these candidates' effectiveness by November. This could lead to wide distribution of these vaccines by 1Q21 or earlier.
- Downside cautions include a faltering recovery as new outbreaks develop. Weekly data sets show that the rebound in consumer spending has stalled in severely impacted states like Arizona, Texas, and Florida as COVID cases climbed over June and July. If these outbreaks continue unchecked, activity could decline, leading to more layoffs and business closures. However, slowing infection rates across the sunbelt may alleviate these concerns.

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Many have asked whether this V-shaped recovery in the stock market means that investors are pricing in a V-shaped recovery in the real economy. Investors in risk markets have been looking for evidence of an improving environment. Whether it's optimism over vaccine trials or positive economic data surprises, these events have been fueling risk markets higher. Our base case is that it will take a while for the environment to fully recover and we will likely see many episodes of optimism and disappointment before it's all over.

- When looking at the stock market, it has definitely been a tale of two different periods. Fear dominated the first three months of the year, as COVID-19 spread around the globe. Large-cap growth stocks (i.e., FAANG stocks) performed best, as the Russell 1000 Growth Index (large-cap growth stocks) outperformed the broader market (i.e., Russell 3000) by 6.5%. Since the market bottom, we have seen more optimism in the markets combined with broader participation, as large-cap (+49.2% as measured by the Russell 1000 Index) have performed in line with small-cap (+48.4% as measured by the Russell 2000 Index).
- As for the bond market, Treasury yields suggest the Fed will not increase interest rates above the zero-lower bound until 2023 or 2024. This implies that it will take at least three or four years to return to full employment and above-target inflation. Similarly, while credit spreads have recompressed from their March wides, they remain above pre-crisis levels, reflecting elevated default and downgrade risks.

This low interest rate backdrop poses some unique challenges for fixed income investors. Today, over 80% of the bonds in the Bloomberg Barclays U.S. Aggregate Index, a barometer for the U.S. investment grade bond market, yield less than 2%. Putting this number in context, this time last year only 35% of the index's constituents yielded less than 2%. Moreover, fixed income investors may have to get used to these lower yields. The Fed's framework review, which should conclude this September, could result in a more predictably dovish monetary policy, anchoring interest rates close to zero until we regain full employment. This type of environment will make it difficult for investors to reach their respective return targets. Asset allocation decisions will need to look to alternative asset classes to fill the potential return void for fixed income. Moving to higher-return assets may prove difficult due to increased risk profile, so investors may need to look to fixed income alternatives such as structured credit and high yield for an added source of future returns.

Over the short term, a fiscal stimulus deal could also represent a significant catalyst for equities. The CARES act's supplemental unemployment insurance program, which provided $600/week in federal unemployment benefits, expired on July 31st. Banks' ability to grant new Paycheck Protection Program loans expired a week later, on August 8th. Negotiations for a major CARES act extension package, which would have pushed out those deadlines, fizzled before legislators left Washington D.C. on August 9th.

Trump has responded to this breakdown by signing executive orders extending supplemental unemployment benefits, and introducing payroll tax, eviction and student loan relief. However, we view these as stop gap measures. FEMA funding constraints mean the White House does not have the resources to enact meaningful fiscal stimulus without Congress. So, we're looking for negotiations to resume later this August.

These negotiations are drawing out the stakes of the upcoming election cycle. Most of the discussion about that election has been focused on whether a Democratic sweep would lead to tax hikes. However,

the story is more nuanced.

- Investors are right to worry about corporate tax hikes. The Biden campaign has proposed reversing half of Trump's Tax Cuts and Jobs Act (TCJA) corporate tax cuts, taking the statutory corporate tax rate from 21% to 28%. This could shave $10-$15 (6%-9%) off the S&P's '21 EPS. Most analysts believe that plan would pass in a Democrat sweep scenario.
- There could be some offsetting benefits to a sweep scenario. History shows united governments tend to be more expansionary than divided governments. Research from Matthew Mitchell of the Mercatus Center, for instance, finds that between the Eisenhower and the Obama administration, united governments grew real spending by an average of 4.7%, while divided governments grew real spending by an average of 2.5%.
- This will be relevant in 2021. If Biden wins the White House, a Democrat-led Senate would likely be more amenable to fiscal stimulus than a Republican-led Senate. So, a sweep could accelerate the recovery even if it's negative for corporate tax rates.
- With the recent polling shift in favor of Democrats, and fiscal stimulus front of mind, we anticipate these conversations will take on more urgency between now and November.

We expect market volatility will be elevated over the fourth quarter, as vaccine trials progress and the election heat up.

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1. COVID-19 Vaccine Tracker, Milken Institute FasterCures Center, 31 July 2020, www.covid-19vaccinetracker.org/.