HIGHLAND

ASSET ALLOCATION

NOVEMBER 2020

NOVEMBER ASSET ALLOCATION NOTE:

WINTER WORRIES AND A WIDE RANGE OF OUTCOMES

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

Our most recent Highland Diffusion Index (HDI) reading signals a favorable backdrop for risk assets.

- Our monetary policy indicator remains in risk-on territory. We expect it will stay favorable near term. Recent changes to the Fed's decision-making framework, including its embrace of average inflation targeting, which we discussed in our August Asset Allocation note, should lead to structurally looser monetary policy through the next cycle.
- Our economic indicators point toward a supportive business cycle. Notably, however, these indicators reflect the uneven nature of this recovery. Components related to manufacturing orders are positive, while consumer expectations are less encouraging. This is consistent with the two-track recovery we're seeing in the real economy, as the goods sector rebounds while the services sector remains challenged.
- Employment indicators remain favorable. However, the labor market recovery is slowing. We believe it could be several years before we return to full employment.
- Market indicators, including credit spreads and equity market momentum, are still positive despite recent market volatility.

While domestic market and fundamental indicators are constructive, recent COVID outbreaks could signal trouble on the horizon.

COVID cases and deaths are climbing across Europe, driving France, Germany, and Italy to impose new restrictions. The UK is also introducing limited lockdowns in a bid to fight the virus's spread. While the current round of European lockdowns should be less disruptive than the continent's March and April stay-at-home orders, they're still expected to push the EU back into a recession.

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We're worried about outbreaks closer to home as well. U.S. new confirmed case counts have climbed to new highs of over 100,000 a day. If this growth continues unabated, hospitals could be overwhelmed and new restrictions could be introduced. We're already seeing signs of this in California and Massachusetts, which have adjusted their COVID policies in response to recent outbreaks.

Pfizer/BioNTech's provisional COVID-19 vaccine trial results are encouraging. Recent data from Pfizer's phase-three study shows their vaccine candidate reduces symptomatic COVID-19 infections by over 90%, well ahead of expectations.

While this study is ongoing, Pfizer appears on track to file for an FDA emergency use authorization as soon as the third week of November. Moreover, this result bodes well for competing vaccines from Moderna, AstraZeneca, and Johnson & Johnson, which use the same spike protein. While research on side effects is ongoing, and distribution issues could represent a hurdle, this promising vaccine news could represent a real light at the end of the tunnel as Europe and the U.S. confront severe COVID outbreaks.

This is already propelling risk assets higher. Equities have rallied on the Pfizer vaccine trial news, with procyclical and out-of-favor styles and sectors like small-cap value and financials leading the market.

We're recommending clients stay close to their policy allocation targets despite our positive HDI signal and this encouraging vaccine result for two reasons:

- Our HDI model was designed to identify business cycle and market inflections. However, it wasn't built to capture exogenous shocks like COVID.
- We have seen firsthand the impact this pandemic can have on the global economy and the markets. Given how much of what we're seeing right now falls outside the scope of our HDI framework, we're trying to be thoughtful about that tool's limitations and exercising our judgment before positioning around its signals.
- We worry today's high-volatility regime could continue through year-end. Staying close to policy allocation targets should help clients manage this risk.

While we're not pivoting to risk-on and initiating an equities overweight at the tier 1 asset class level, we're still finding opportunities to generate returns at the sub-asset class and strategy level. Positions like our overweight to non-core credit within fixed income, our tilt toward U.S. equities within equities, our overweight to REITs within inflation hedges, and our overweight to structured credit within fixed income have all contributed to positive absolute and relative returns over 2020. We will continue to look for opportunities to reposition at this sub-asset level. Getting that positioning right could be key to meeting clients' return goals this year.

While politics is not central to our decision-making framework, we are following the ongoing vote-tallying process, runoffs, and litigation around the U.S. election closely.

Our base case is that this will end in a Biden presidency and a divided Congress, with Republicans controlling the Senate and Democrats controlling the House. That could limit Biden's ability to enact stimulus, while reducing tax hike risk, relative to the blue wave scenario many analysts were focused on prior to the election.

This scenario could further cement today's low interest rate environment. This underscores the fact

that low bond yields could be here to stay, requiring allocators to rethink cash and core fixed income allocations in order to meet their goals.

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