SEPTEMBER / OCTOBER ASSET ALLOCATION NOTE:

DOLDRUMS AFTER THE STORM

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

The Highland Investment Working Group reaffirmed our neutral stance in early October. Our Highland Diffusion Index (HDI) framework is increasingly constructive on the outlook for risk assets. However, drivers beyond the scope of that framework, including overlapping election and vaccine trial timelines, could lead to elevated volatility near term. In light of these risks, we're recommending staying close to policy allocation targets for now.

Our most recent HDI reading confirmed the improving environment for risk assets.

- Employment indicators remained positive as the labor market continued to heal. The employment picture still leaves much to be desired. According to the September payrolls report, even after several months of seven-figure jobs gains, U.S. payrolls have declined by almost 10 million year over year. Moreover, much of the recovery in payrolls has come from furloughed workers returning to work. Meanwhile, the number of Americans telling surveyors they have permanently lost their jobs continues to grow. We believe the labor market recovery may be slowing with unemployment around 8%. However, it shows no signs of reversing.
- A few of our leading economic indicators shifted into positive territory. Most notably, manufacturing orders and building permits climbed above their three-year trends. Moreover, weekly indicators like Redbook same store sales, federal tax withholdings, and railroad traffic, which tend to anticipate shifts in these more traditional economic series, showed strong momentum into October. Based on that momentum, we anticipate the economic strength indicators we follow for our HDI could continue to improve from here.
- Market indicators, including credit spreads and equity market momentum, remained in positive territory

Meanwhile, our monetary policy and yield curve indicators remained constructive.

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One of our higher conviction calls is our overweight to the U.S. within clients' equity portfolios. We moved to that tactical overweight in 2018. That positioning has been a material contributor to returns since inception. The case for that domestic tilt remains strong today:

- Our U.S. vs. International relative strength indicator continues to favor a U.S. tilt. We use that tool to capture shifts in regional leadership. It has done a good job of helping us position for multiyear performance trends.
- The U.S. economic recovery is outpacing the recovery across most G7 nations. Much of this comes down to the eurozone's underwhelming response to this crisis. We saw a lot of optimism earlier this year that Europe was moving past the fiscal and monetary coordination problems that hamstrung growth on the continent over the last decade. However, as elements of the EU recovery fund are tied up in Brussels, that optimism is waning.
- A second wave of COVID infections is driving new restrictions across Europe. This could weigh on international developed markets, which are largely made up of EU and UK issuers.

Our relative strength indicator, recent macro fundamentals, and growth prospects all favor the U.S. over international equities. Therefore, we continue to see additional upside from that regional tilt.

The market dislocation earlier this year presented investors with tactical opportunities to add exposure to structured credit, high yield bonds, and REITs. While those are still priorities today, we're increasingly looking beyond the tactical opportunity set to re-underwrite the assumptions that drive our longer-term strategic portfolio allocations.

Today, allocators confront a challenging environment. High equity valuations and low bond yields imply underwhelming long-term return prospects for those core portfolio building blocks. This outlook could require allocators to think outside the box, adding new strategic allocations, reexamining the returns they're earning in illiquid investments, and repositioning within existing asset classes in order to meet portfolio goals.

As we flagged in our July Asset Allocation Note, we believe real assets could be part of that solution. They should generate healthy total returns while insulating investors from inflation risk. Moreover, we have identified a couple themes, including diversifying into non-core property types, which we believe will be key for real asset investors over the next cycle.

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