HIGHLAND

DECEMBER ASSET ALLOCATION NOTE:

PLENTY OF POTHOLES ON THE ROAD TO RECOVERY

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

The Highland Investment Working Group is increasingly constructive on the intermediate term growth outlook. This is consistent with our most recent Highland Diffusion Index (HDI) reading, which signals a favorable backdrop for assets like core equities, high yield bonds, and listed real estate (REITs). Speaking to that framework:

- Our economic indicators remain favorable, due to healthy manufacturing and building permits activity.
- Equity market momentum is increasingly supportive. Stock market internals are also improving. This reflects the outperformance of procyclical recovery-leveraged stocks like hotel and brick-and-mortar retail names over these last couple weeks.
- Our employment indicator has inflected lower due to a declining Job Openings and Labor Turnover Survey (JOLTS) rate. However, this doesn't necessarily signal longer term labor market challenges.

In light of our improving outlook for the economy and the markets, we feel investors should be rewarded for taking on risk. We also recognize that it may be a bumpy ride near-term. With that in mind, we are gradually adding return-oriented positions to portfolios, building around our current U.S. equity and non-core credit allocations by adding equity exposure and investing in other total return drivers like REITs.

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Our approach to the current market environment is informed by the tension between positive vaccine developments and worsening outbreaks.

Recent vaccine news has been very encouraging. Here in the U.S., our vaccine supply pipeline could get us to effective herd immunity by next summer. That could lead to a supportive early cycle market and economic environment later next year. However, the shorter-term picture is less positive.

Case counts, hospitalizations, and deaths continue to climb across the U.S. State and local governments are responding to this worsening crisis by reintroducing restrictions to slow the virus's spread. Current economic activity indicators show these outbreaks and associated restrictions are weighing on the recovery. Moreover, the upcoming expiration of CARES Act provisions like extended unemployment benefits and rent relief programs could compound these headwinds.

While we don't think these challenges will derail the recovery, and we're optimistic markets will continue to look past short-term pain over these next couple months, these potholes could certainly contribute to market volatility, penalizing allocators who take on too much risk today.

We're increasingly constructive on equity markets. Despite elevated index valuation multiples and frothy signals like high-octane IPOs, intermediate and longer-term equity market return prospects appear healthy. Supportive early cycle economic conditions should be positive near term. Moreover, while headline valuations are high, equity risk premiums, which measure the expected excess return investors demand above the risk-free rate to hold risky stocks, are more in line with their 20-year median, signaling competitive relative value.

Speaking to our regional equity tilts, we have been overweight to U.S. since mid-2018. That position has been a meaningful contributor to performance, as U.S. equities have outperformed international equities by almost 20% over the relevant period. However, it could be in its late innings today.

Over a strategic (~10 year) time horizon, we believe international equities will offer better total returns than U.S. equities. High dividend yields, competitive valuations, the prospects for a healthy post-COVID earnings recovery, and the possibility that the currency headwinds that penalized international markets over the last decade could be fading all bode well for international stocks. So, while our tactical models and market research still point toward healthy near-term U.S. return prospects, we're looking for an inflection point that could favor a shift toward international markets today.

Within fixed income, we remain constructive on the near-term outlook for risk assets like high yield bonds and leveraged loans. Stabilizing default rates represent a supportive fundamental backdrop for those asset classes. Moreover, the supply/demand picture for credit is bullish. High yield issuance should fall dramatically from 2020's record levels, while low returns in the investment grade bond market should continue to support demand for sub investment grade credits next year.

We're closing this final Asset Allocation Note of 2020 by taking off our markets hats and reflecting on the last twelve months.

Due to the COVID-19 crisis, 2020 has been a uniquely challenging year. Hundreds of thousands have lost loved ones. Tens of millions have experienced economic hardship. However, one

bright spot amidst this otherwise difficult period has been watching the mission-based organizations we work with rally to help their communities.

From the hospitals on the front lines of providing care during this pandemic to the local foundations confronting the economic fallout from this crisis, we applaud you. And we look forward to continuing to support you and your missions in 2021.

Happy holidays! And all the best for the new year!

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