*JANUARY ASSET ALLOCATION NOTE:*

# *BRIDGE OVER TROUBLED WATERS*

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

At times, 2020 tested investors' capacity for cognitive dissonance. There were stretches last year where we struggled to square the circle between buoyant markets and dystopian news cycles.

For better or worse, that dynamic seems to have carried over into the new year. It's often said that markets hate uncertainty. Yet investors have shrugged off news of delayed vaccinations, viral mutations, and political turbulence over the first weeks of 2021.

Despite this dissonance, the Highland Investment Working Group believes allocators should remain positioned for supportive markets and reflationary growth. This is consistent with our Highland Diffusion Index (HDI) reading, which continues to signal a favorable market backdrop for assets like core equities, high yield bonds, and listed real estate (REITs).

Some HDI inputs could falter over the next couple months as COVID outbreaks weigh on economic activity. Recent declines in leisure and hospitality spending, for instance, bode poorly for the employment component of our framework. These headwinds could prove more sustained if slow vaccine distribution and new virus mutations drive additional restrictions. Despite these challenges, we don't anticipate a sustained shift in the market environment.

Our cautiously optimistic near-term outlook is informed by our belief that fiscal stimulus can help bridge the gap between worsening outbreaks today and a rebound in services spending once vaccines are widely distributed later this year.

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The recent news on that front has been positive. The late-December approval of a $900B package—including $600 stimulus checks, small business funding, and extended unemployment benefits—should go a long way toward seeing us through the next several months. Moreover, Warnock and Ossoff's victories in Georgia's Senate runoffs could set the stage for additional stimulus.

Even after Democrats' Georgia sweep, Biden will govern with historically thin majorities: 11 House seats and a tiebreaking Senate vote. This could limit his ability to enact progressive priorities like expanding the ACA. Nonetheless, the Georgia Senate victories should allow Biden to achieve some campaign goals via the reconciliation process.

We expect the new administration will move forward with reconciliation-friendly priorities like additional stimulus checks and state and local aid over the first quarter. If Biden can push a significant package through, this could mute the short-term economic pain associated with today's outbreaks, while fueling an economic rebound later this year.

Over a longer horizon, Biden's Congressional majority could be more of a mixed bag for investors. Legislative analysts anticipate that his administration will turn its focus to a combination of tax hikes and spending programs in 2022, once the acute economic pain from COVID-19 has faded. A partial rollback of the Tax Cuts and Jobs Act (TCJA), increasing corporate tax rates from 21% to ~25%, could be a centerpiece of that reconciliation package. While increased spending could offset some of the effects of tax hikes, on a simple back-of-the-envelope basis this could drive a ~5% decline in S&P earnings in 2022 or 2023, creating a modest headwind for U.S. equities.

Rates markets reflect today's more constructive stimulus outlook. The yield on 10-year treasury bonds climbed to 1.04% in the wake of the Georgia runoffs, surpassing 1% for the first time since March 2020. Meanwhile, 10-year inflation breakevens, a crude barometer of inflation expectations, climbed from 1.7% before the November general election to ~2.1% after the January runoffs, reaching their highest level since 2018. While our reflation view is more of a multiyear outlook than a 2021 call, we expect headline inflation will start to climb on a year-over-year basis this year as these measures are compared to 2020's lockdown lows.

Incidentally we think allocators should reposition within real assets to better capitalize on this reflationary growth outlook. Specifically, we're recommending adding to REITs while reducing TIPS exposure.

REITs have historically delivered strong performance in reflationary regimes. Moreover, the asset class boasts attractive fundamentals today.

Low leverage and sustainable payout ratios should help REITs maintain dividends despite operating challenges. Sector valuation metrics are attractive. Additionally, leverage to growth markets like life sciences and data centers should continue to offset acute pain in COVID-exposed segments like retail and hospitality for REIT allocators. This combination of strong balance sheets, attractive relative value, end market growth, and reflationary tailwinds should drive healthy returns for REITs.

TIPS, alternately, look less appealing today. Negative real yields and climbing inflation breakevens represent a challenge for the asset class. So, while TIPS should continue to outperform nominal treasuries if reflation accelerates, we expect they'll deliver muted total returns from here.

December marked an important milestone in the four-year Brexit odyssey. On Christmas Eve, U.K.

PM Boris Johnson struck a trade deal to establish a framework for the U.K.'s post-Brexit relationship with the EU. That deal averted the uncertainty of a no-deal Brexit.

We are recommending a U.S. equity overweight today. However, over a strategic horizon, regional valuations favor an increased international equity allocation. Moreover, tax hike risk and antitrust risk in the U.S. could drive domestic underperformance over the next couple years, while the removal of the Brexit overhang leaves us marginally more constructive on U.K. and EU markets. Meanwhile, recent executive orders forbidding U.S. investors from holding some Chinese stocks, paired with Beijing's increasingly active role in the management of key Chinese tech companies like Alibaba, has muddied the waters for EM investors. These developments could require judgment as we apply our regional allocation framework. So, while we're not ready to recommend rebalancing into international developed or emerging equities today, opportunities outside the U.S. will be front of mind over 2021.

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