FEBRUARY ASSET ALLOCATION NOTE

RAGE AGAINST THE MACHINE

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

GameStop Didn't Give Away the Game

GameStop is a Texas-based midsize specialty retailer. The company sells video games and gaming accessories across its footprint of ~5,000 outlets.

GameStop is also, improbably, at the center of the biggest markets story of the year so far. Last month the company's stock soared from ~$18 to highs of ~$480, propelled by a wave of retail traders hoping to capitalize on its massive short interest at the expense of bearish hedge funds before giving up most of those gains over the first weeks of February. The stock's wild ride, and the Reddit-based trading community that powered it, gripped public attention over the first weeks of 2021.

Pundits and politicians have shoehorned the GameStop story into bigger narratives around populism and social media. We'll refrain from commenting on those points here. However, we do want to push back on one of the prevailing narratives around the GameStop trade: that it signals a coming crash.

While GameStop's run was clearly unsustainable, frothy retail trading doesn't always tell us much about where we sit in the market cycle. Anecdotally, we saw similar stories in 2012 and 2013, as rallies in stocks like Stratasys and 3D Systems inspired comparisons to the dot-com boom. While observers were right to identify those trades as bubbles, they were wrong about their greater significance. The bubbles popped, but equity markets continued to deliver healthy returns, driven by steady economic growth and strong fundamentals.

Given today's early cycle macro backdrop, we believe 2013 is a more comparable period than 1999. So, we'd advise against over-extrapolating from this GameStop story. While we are finding some opportunities to capitalize on growing retail trading at the margins, we think the larger portfolio construction implications of this story are limited.

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Macro Outlook and HDI Update

We remain constructive on the near-term market outlook. This is consistent with our most recent Highland Diffusion Index (HDI) reading and assessment of the economic environment. Speaking to that framework:

- Monetary policy remains supportive, while the U.S. yield curve is steepening, in line with firming growth expectations.
- Credit spreads continue to tighten. Similarly, equity market momentum is positive.
- Our economic indicators remain robust. Employment is slightly softer than other indicators we track. However, this could prove transitory.

Today's positive macro setup and improving vaccination trajectory drive our reflationary growth outlook.

Specifically, we believe the economy will continue to recover toward its pre-COVID activity and inflation trends over 2021. Between 2015 and 2019, real domestic GDP growth averaged out at 2.5%/year while CPI inflation averaged out at 1.6% per year. Pent-up consumer demand could push real growth to >4% and inflation to >2% this year, recapturing much of last year's lost ground. Additional fiscal stimulus could further accelerate this recovery.

This is significant from an asset allocation perspective. It should drive further equity market upside. It could also be significant for equity market leadership across sectors, styles, and regions.

Closing our U.S. Equity Tilt

Our reflationary growth outlook informs our decision to close out our U.S. equity tilt recommendation.

We've recommended favoring U.S. equities over international equities since August '18. That positioning has been additive to portfolios. Over the last two and a half years, the S&P 500 has meaningfully outperformed international benchmarks like the MSCI ACWI Ex U.S.

Today, we're less constructive on U.S. outperformance for a couple of reasons:

- We're increasingly constructive on fundamental drivers outside of the U.S. Fundamental growth expectations are inflecting higher internationally. Yet international markets often trade at steep discounts to the S&P. While valuations are not a useful timing tool, this setup highlights the potential for international outperformance if capital continues to rotate into less loved segments of the markets.
- Overweighting the U.S. carries embedded sector and style bets that aren't geared toward an early cycle growth environment. Relative to international equities, U.S. markets over index to large, fast-growing tech and healthcare companies, and under index to energy, materials, and financials firms. We believe those sector and style tilts could hurt relative performance in a global reflation rotation.
- Momentum increasingly favors international equities.

In light of these views, we're recommending a neutral regional allocation today.

While our regional allocation framework is becoming less constructive toward the U.S., we're still exploring possibilities with more niche domestic managers. For instance, we've identified a couple of U.S.-focused small and mid-cap managers that could benefit from reflationary growth and a sustained rotation into less favored segments of the markets.

We will continue to look for opportunities to position for reflationary growth across equities near term

Positioning for Lower Returns in Non-Core Credit

We're also recommending closing tilts toward non-core credit, i.e., high-yield bonds and bank loans.

We first recommended adding to non-core credit in March 2020. At that time we saw attractive return prospects and a good margin of safety in a severe default cycle scenario across higher yielding corporate debt. Over the ten months since we made that recommendation, non-core credit returns have exceeded expectations. We believe performance could underwhelm going forward for three reasons:

- Credit spreads have recompressed to near pre-crisis levels.
- Both high-yield bonds and bank loans offer historically low yields today.
- Many sub investment grade borrowers are emerging from the COVID crisis with record leverage ratios and poor interest coverage. These weaker fundamentals could impact returns across non-core credit long term.

In light of these headwinds, we no longer see a tactical case for overweighting non-core credit.

Current Tactical Tilts

While we are no longer recommending favoring U.S. equities and non-core credit, we still see avenues for taking active risk today. Within real assets, we're finding opportunities in listed real estate (REITs). Within fixed income, we're finding opportunities in structured credit. Moreover, we've identified some private credit strategies that could deliver strong performance in this environment.

Over the next couple of months, we'll remain focused on areas that could drive performance in a reflationary growth environment.

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