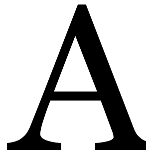
JUNE ASSET ALLOCATION NOTE

HEAT WAVES



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

Transitory Inflation? Sustained Inflation? Or a Bit of Both?

The May consumer price index (CPI) report showed CPI inflation rising to 5% last month! That marked the hottest inflation print since 2008.

This heat wave could break soon, as base rate effects from comparing prices to last year's lockdown-impacted levels become less pronounced by this fall. Moreover, inflationary pressures from supply chain bottlenecks could ease later this year.

Widespread shortages are pushing prices higher. From diapers to cardboard boxes to microchips, global manufacturers are struggling to keep up with resurgent demand. However, order backlogs could become less disruptive by 2022 as firms that cut production in anticipation of softer demand rebuild inventory, while consumer spending shifts from goods to services.

While this heat wave could pass by next year, allocators should remain mindful of sustained inflationary pressures for a couple reasons:

- Looser monetary policy could contribute to inflation. The Fed's embrace of average inflation targeting, for instance, has shifted monetary policy in a more dovish direction.
- Looser fiscal policy could prove inflationary. Congress has passed a record >$5T in fiscal stimulus since the end of 2019. That could mark a sea change in how Washington approaches spending. Moreover, this isn't just a U.S. phenomenon. Recent progress on the EU recovery fund shows attitudes toward ambitious fiscal policy are shifting on both sides of the Atlantic.

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- Evolving consumer expectations could compound these fiscal and monetary pressures. While economists and market participants expect inflation will return to more normal <2.5% levels by 2022, American households are less sanguine.

  The May University of Michigan Survey of Consumers showed Americans' intermediate-term inflation expectations are climbing. That could become a self-fulfilling prophecy, if inflationary psychology makes it easier for businesses to pass along price hikes.

This confluence of dovish monetary policy, expansive fiscal policy, and climbing inflation expectations might not have as dramatic an impact on today's prices as current widespread shortages. But, over a longer horizon, it could make for a hotter inflationary climate. That trend toward hotter inflation could represent a key theme for allocators over the next cycle.

Macro Outlook and HDI Update

Our market outlook remains favorable. Our Highland Diffusion Index shows:

- Financial conditions indicators like credit spreads and equity market momentum are supportive.
- Yield curve and monetary policy indicators point toward healthy early cycle conditions.
- Despite April's underwhelming payrolls data, economic indicators and labor market conditions are generally trending in the right direction.

This tracks with real-time data around consumer spending and climbing private sector investment. It also dovetails with our views on reopening, recovery, and reflation themes.

Rethinking Real Assets

Real assets—i.e., commodities, treasury inflation-protected securities (TIPS), private real estate, and listed real assets—play two overlapping roles in portfolios: protecting investors from inflation shocks and preserving purchasing power through sustained inflationary regimes.

- Inflation shock protection is important because inflation surprises are associated with negative returns across core portfolio building blocks like equity and fixed income.

  Commodities have historically protected allocators from that macro risk factor. However, that protection has come at the expense of lower through-cycle returns. Even in sustained inflationary environments, commodities can deliver underwhelming performance.

- Preserving purchasing power is important because sustained inflationary regimes can meaningfully erode the value of allocators' other portfolio building blocks. It can be especially important for not-for-profit healthcare allocators because inflation impacts both their portfolios and their operating costs, and healthcare inflation has historically outpaced the overall level of inflation.

  Private real estate and listed real assets have historically done a good job of preserving purchasing power over sustained inflationary regimes. However, they have a mixed track record during inflation shocks like the 2008 commodities boom.

Both of these roles are significant. However, emphasizing total returns over sustained inflationary regimes could be more timely today.

Our current positioning within real assets is informed by that view. Right now, we favor listed real estate (REITs) within real assets. While REITs haven't historically offered as much inflation shock protection as commodities, they should offer more upside in sustained inflationary environments.

Meanwhile, we're taking a more balanced approach to commodities. While we still see a strategic role for the asset class within client portfolios, we worry some of commodities' recent appreciation could represent pulled-forward returns as realized inflation and inflation expectations have climbed. So we don't view commodity futures as a timely portfolio addition today.

More generally, we're looking for ways to express our view that the next cycle could burn hotter than the last cycle across client portfolios. That theme informs our approach to procyclical and value styles within U.S. equities, and our approach to non-core credit within fixed income. Finding opportunities to capitalize on this trend will remain front of mind for our team.

Reviewing Our Open Calls

The Highland Investment Working Group is recommending clients position for the current recovery and reflation regime. Specifically, we're recommending tilts favoring structured credit over core fixed income, REITs over TIPS, and emerging market (EM) equities within equities today. Calls like favoring structured credit over core fixed income and favoring REITs could continue to drive performance if inflation proves more sustained. Moreover, our EM equities tilt could be rewarded in a weaker dollar regime while benefiting from higher commodity prices. So, we should be well positioned for a hotter cycle.

Speaking to that emerging markets call in more detail, attractive valuations and healthy fundamental growth drivers could bode well for long-term EM equity performance. That confluence of secular tailwinds and cyclical drivers linked to inflation and rebounding global risk appetites is central to our investment thesis.

So far, that tilt has generated mixed results, as COVID outbreaks in India and Brazil have weighed on EM sentiment, while Chinese regulatory concerns have hurt large benchmark positions like Alibaba and Baidu. However, EM equities regained ground over May. We're monitoring a couple drivers like improving EM reopening outlooks and U.S. tax code changes, which could continue to contribute to EM relative performance near term.

We also see opportunities to generate returns by favoring hedge funds over core fixed income.

You can see a brief synopsis of our cross-asset views below:

Highland Associates Cross Asset Views

TIER 1 CALLS	TIER 2 VIEWS	-		N		+
FIXED INCOME	1-3 Year Gov / Credit			▲		
	U.S. Treasury		▲			
	IG Credit			▲		
	Long Duration Credit			▲		
	Non-Core Credit				▲	
EQUITIES	United States		▲			
	Int'l Developed			▲		
	Emerging Markets				▲	
REAL ASSETS	U.S. TIPS		▲			
	Commodity Futures			▲		
	Commodity Equities			▲		
	Global Infrastructure			▲		
	Public Real Estate				▲	

We have a few notes on how to read this graphic:

- We've limited this graphic to asset classes where allocators have the flexibility to express tactical views. So illiquid allocations like private equity, for instance, are not included in the table.
- We've organized our asset class views into three tier 1 asset classes—fixed income, equities, and real assets—and 13 tier 2 sub-asset class tilts. We've defined most of those asset classes pretty broadly. For instance, non-core credit encompasses structured credit, high-yield bonds, bank loans, and emerging market debt. Today, we are recommending tilts toward non-core credit be expressed via structured credit strategies.

Please reach out if you have any questions about this graphic or our asset allocation views.

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