JULY / AUGUST ASSET ALLOCATION NOTE

HALFTIME

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

First Half Market and Macro Trends

Equity markets delivered strong returns over the second quarter. The MSCI All Country World Index returned 7.5% over Q2, bringing year-to-date returns to 12.5%. Market internals, however, were more mixed, as the rotation into cyclical sectors and value stocks that propelled markets higher over Q1 started to ebb late in Q2. Rates, similarly, reversed course over the quarter. Ten-year treasury yields fell from 1.74% to 1.47% over Q2. Those developments reflect the ongoing moderation in growth and inflation trends.

Over the last 12 months, we've taken the view that markets could respond to persistent upside surprises in growth and inflation by favoring reflation beneficiaries including procyclical equities and listed real estate (REITs) while penalizing longer-duration fixed income. That reflation rotation scenario has played out. Here in the U.S., robust fiscal stimulus, pent-up consumer demand, and supply chain bottlenecks have propelled growth and inflation higher. Markets have responded by rewarding many of our cross-asset tilts, including favoring REITs, high-yield bonds, and structured credit. However, today, as growth and inflation slow, we're experiencing a lull in those tailwinds.

Resurgent COVID case counts have also contributed to this shift, as concerns about Delta variant outbreaks drive macro uncertainty and market volatility.

Despite these challenges, we don't believe the reflation rotation has stalled out. However, it could be downshifting. We speak to how we see markets navigating local peaks in growth and inflation below.

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Macro Outlook and HDI Update

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

- Financial condition drivers, including credit spreads and equity market returns, are supportive.
- Despite recent yield curve flattening due to falling inflation expectations and declining 10-year yields, the yield curve remains upward sloping.
- Labor markets and economic fundamentals continue to heal.
- Monetary policy in the U.S. and abroad is increasingly neutral.

This tracks with real-time data around robust private sector investment and resurgent consumer demand.

Navigating Peak Reflation

We believe the U.S. is navigating peak growth and inflation today. On the growth front, looser public health guidelines have unlocked a consumer-powered economic recovery over recent months. The Bureau of Economic Analysis' initial estimates show the U.S. economy grew at a 6.5% annualized rate over Q2. However, this growth rate isn't sustainable. Plateauing consumer spending and labor market challenges suggest growth could slow this summer.

On the inflation front, Consumer Price Index (CPI) inflation climbed to 5.4% in June. That marked the hottest U.S. inflation print since 2008, when oil reached nearly $150 per barrel. Despite these macro indicators showing such extremes, most economists expect inflation to cool by this fall as base rate effects from comparing prices to last year's lockdown-impacted levels become less pronounced.

This peak growth and inflation theme is consistent with market trends, including falling rates and the recent rotation out of procyclical styles within equities.

However, we believe this represents a downshift, not a stall out, for broader reflation rotation themes. We're still constructive on risk assets generally, and reflation beneficiaries like REITs and structured credit more narrowly, for a couple reasons:

- Earnings growth is historically strong today. S&P 500 earnings, for instance, are projected to grow more than 30% Y/Y over 2022. That fundamental growth trajectory should put equity valuations on steadier footing later this year, even as economic growth reverts toward a more sustainable rate.
- While we expect growth and inflation will moderate near term, this economic cycle could still deliver faster growth and hotter inflation than we saw over the last decade.
- Reopening linked growth across Europe and other global laggards could drive more sustained global reflationary trends.
- U.S. fiscal stimulus could prove a tailwind for domestic reflation beneficiaries.

In light of these drivers, we believe reflation will remain a key theme for allocators near term.

Connecting the Dots on Fed Policy

Recent Fed policy announcements have contributed to declining growth and inflation expectations. On June 16, Federal Open Market Committee (FOMC) members increased their median year-end 2023 rate projection from 0.125% to 0.625%. That moderation to the Fed's dovish tone paradoxically triggered a decline in long-end rates as market expectations around the Fed's willingness to let the economy run hot shifted.

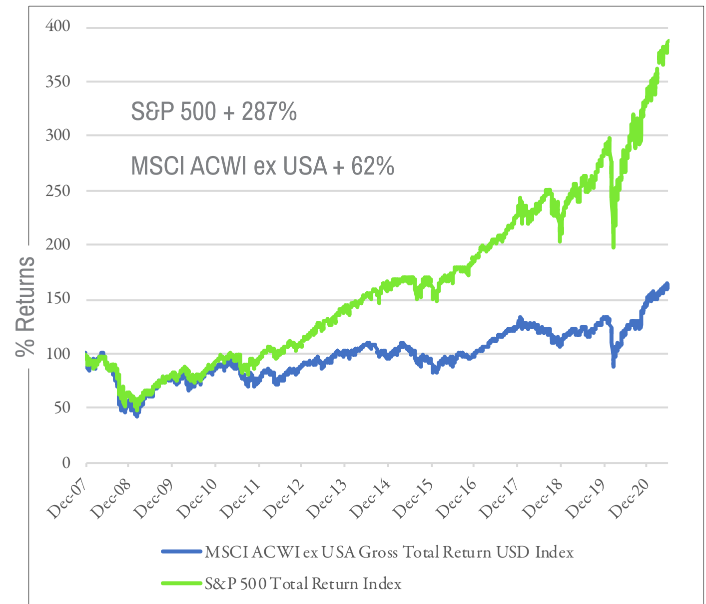
We don't think that June announcement necessarily signals a break from the Fed's structurally looser average inflation targeting framework. FOMC dot plots have a mixed track record as a predictor of future Fed policy. That's especially true today, as we could see significant changes to the composition of the FOMC before the end of 2023. So we would caution against overextrapolating from that June announcement.

The Changing of the Guard

The world economy has experienced an uneven recovery from its COVID trough. China was the first world power to enter lockdowns, and the first major economy to rebound. The U.S. is recovering ahead of most other developed markets due to vaccination progress and robust fiscal stimulus. Europe, meanwhile, has been slower to recover. However, vaccination progress could unlock economic growth across the continent near term. This vaccination rate convergence is especially key today, as Delta variant outbreaks grow. We could see a changing of the guard as U.S. and Chinese growth crests, while Europe and other countries accelerate, later this year.

That decoupling in global growth has contributed to divergences in regional equity market leadership. Today, as developed market vaccination rates converge, European markets and other international laggards could benefit from reopening-linked tailwinds. Additionally, international markets could benefit from drivers including firming fundamentals, attractive valuations, and healthy relative momentum. Those forces could help international equities recapture relative ground over the next cycle.

International stocks have meaningfully lagged U.S. equities since the start of the Global Financial Crisis. The MSCI All Country World ex US Index returned 62% between 12/31/07 and 6/30/21 in USD terms. That paled in comparison to the S&P 500's 287% returns over that period:



Source: Bloomberg; data from December 31, 2007 through June 31, 2021

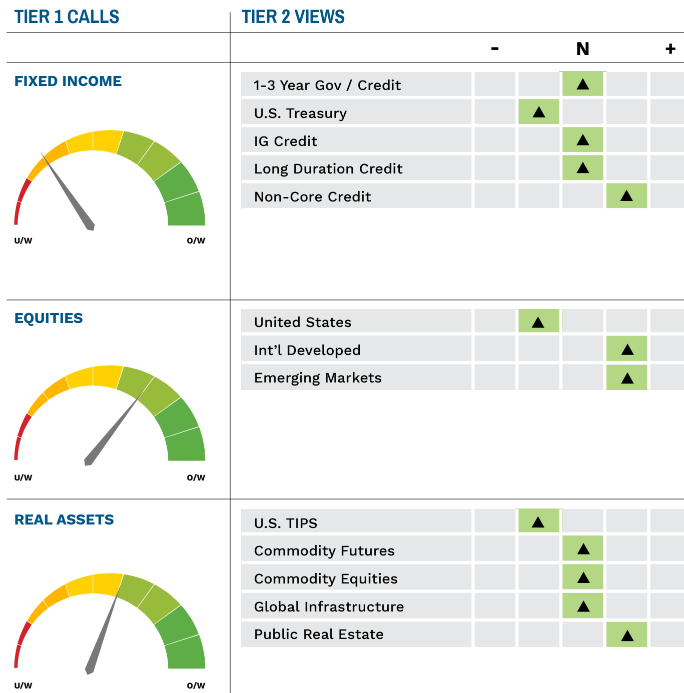
We believe reopening tailwinds, firming fundamentals, attractive relative value, and momentum could set the stage for a convergence in those performance trends. That belief informs our favorable view toward international equities today.

Reviewing Our Open Calls

The Highland Investment Working Group remains constructive on cross-asset tilts exposed to recovery and reflation regime themes. Specifically, we're recommending favoring structured credit over core fixed income, REITs over TIPS, and international equities over U.S. equities today.

You can see a brief synopsis of our cross-asset views below, on the following page:

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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