OCTOBER ASSET ALLOCATION NOTE

POLITICS AS USUAL

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

All Is Not Quiet on the Potomac

Ten years ago, in 2011, the U.S. economy was emerging from the depths of the 2008 recession. However, that building economic momentum was briefly jeopardized by a debt ceiling crisis. While that crisis didn't derail the recovery, the political impasse and ensuing downgrades to the U.S.'s credit ratings precipitated an equity market correction.

Today, history threatens to repeat itself. Conflicts around the debt limit, U.S. fiscal stimulus, and monetary policy are driving macro and market uncertainty today.

While Congress raised the debt ceiling by $480B this October, that represented a stopgap compromise. The debt ceiling fight will once again come to a head this December. If tensions in Congress continue to build, that could threaten markets later this quarter.

Infrastructure bill negotiations are similarly contributing to market uncertainty. Democrats are divided over Biden's >$3T in proposed stimulus, with key Senate moderates like Joe Manchin working to cut spending to ~$1.5T and pare back proposed tax hikes. As negotiations around that legislation drag on, the fate of Biden's economic agenda looks increasingly uncertain.

Monetary policy uncertainty could represent an additional market risk. Jerome Powell's term as Fed Chair expires in February 2022. We don't yet know whether Biden will re-nominate Powell. Any meaningful shifts to the Fed's composition could come at a key time, as inflation remains elevated and the central bank prepares to taper bond purchases later this year.

We're still constructive on the macro and market outlook. However, that comes with a caveat: Policy uncertainty could drive volatility through year end.

TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

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Is China Investable?

Washington isn't the only political power rattling markets today. International markets have been shaken by three significant challenges out of China over recent months:

- Beijing ramped up its regulatory crackdown against big tech. Moves to outlaw for-profit tutoring companies, discourage international listings, and break up the consumer fintech juggernaut Alipay have undermined investor confidence in Chinese equities.
- Evergrande, one of China's largest real estate developers, missed bond payments last month. The company has ~$300B USD in outstanding liabilities. A messy Evergrande restructuring could stress global credit markets or even trigger a Chinese property market slump. We are watching to see if this is a contained problem or if other developers will begin missing payments (à la Fantasia).
- Chinese authorities are closing factories and ports in response to COVID outbreaks and power supply challenges. Those disruptions are impacting Chinese growth while further stressing global supply chains.

These problems have prompted investors to ask whether China is no longer investable.

We think claims China isn't investable are overblown. We don't see the Xi administration's recent regulatory crackdowns as an indiscriminate attack on the private sector. Instead, we believe "common prosperity" interventions will remain contained, targeting real estate, healthcare, and tech businesses, which work at cross purposes to the regime's social agenda. However, we're not advising adding China exposure today.

While we remain constructive on emerging markets' long-term return prospects, Chinese political risks don't easily fit into our macro and market framework. So, despite this strategic outlook for emerging market equities, we're recommending allocators take in their sails while navigating today's crosscurrents.

HDI Update

Our market outlook remains favorable. Our Highland Diffusion Index (HDI) shows the following:

- Financial conditions indicators like credit spreads and equity market momentum remain constructive. Notably, those indicators remained positive despite recent bouts of market volatility, as procyclical equities gained ground relative to defensive equities through turbulent markets.
- The economic and employment pillars of our HDI framework continue to reflect a strong growth outlook. While payrolls growth has slowed over recent months, we anticipate economic growth will continue to exceed its pre-crisis trend near term.
- Our monetary policy and yield curve indicators are favorable. The yield curve remains upward sloping across its term structure. Moreover, while the Fed is setting the stage for tightening, monetary policy remains extremely accommodative today.

While the domestic growth and inflation mix has deteriorated over recent months due to persistent supply side challenges, our diffusion index still tracks to broadly favorable macro and market trends.

Reflation Trade Update

While economic growth has ebbed from this summer's peak, we don't believe that inflection marked the end of the reflation rotation. We still expect the next couple years will deliver faster growth and hotter inflation than we saw over the last decade. That outlook informs our favorable views on asset classes like real estate investment trusts (REITs), structured credit, and domestic small-cap value stocks.

Those views were largely rewarded in U.S. equity markets last month, as investors responded to climbing inflation and rate expectations by rotating out of large-cap growth stocks into small-cap value stocks. We're recommending maintaining a modest tilt toward U.S. small-cap value stocks to capitalize on those links, and the favorable macro regime, today.

Structured Credit Update

Our structured credit call is similarly informed by our macro outlook. Big trends like supply chain bottlenecks and tight labor markets are pushing inflation higher, hurting core fixed income investors. However, they've had some offsetting positive impacts on segments of the structured credit markets. For instance, supply chain challenges have constrained single-family housing construction, contributing to today's hot housing market. That has bolstered collateral value for non-agency residential mortgage-backed security investors. Persistent supply side challenges could continue to benefit structured credit allocators from here.

Additionally, the relative value case for structured credit remains strong. Today, corporate bond spreads are approaching their tightest levels in the last twenty years. Consumer credit spreads have also tightened since we first recommended adding to the asset class a little over a year ago. However, they offer better relative value compared to their long-term history.

Lastly, the way we've recommended expressing this tilt, it carries less duration than core fixed income markets. That de facto duration underweight could boost active returns if inflation remains elevated and rates climb.

Given structured credit's attractive fundamentals, leverage to key macro themes, and strong relative value, we continue to favor that asset class today.

Reviewing Our Open Calls

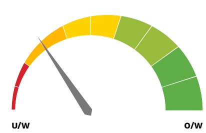
The Highland Investment Working Group remains constructive on cross-asset tilts exposed to recovery and reflation regime themes. We continue to recommend favoring structured credit over core fixed income and REITs over TIPS. Meanwhile, we're expressing a neutral view toward all regional equity markets while favoring domestic small-cap value stocks today.

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

Highland Associates Cross Asset Views

TIER 1 CALLS

FIXED INCOME



EQUITIES

REAL ASSETS

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				▲	

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