NOVEMBER ASSET ALLOCATION NOTE

TRUCKIN'

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

Logistics, Labor, and Supply-Side Snarls

We've seen a robust recovery in demand since the trough of the COVID crisis. Here in the U.S., consumer spending now exceeds its pre-pandemic trend. Other developed markets are on a similar trajectory. However, that strong demand is running headlong into supply-side challenges.

One key challenge is logistics. The COVID crisis upended global trade patterns, snarling supply chains. Those logistics logjams have compounded over recent months, as shippers have wrestled with surging volumes, packed warehouses, and unpredictable traffic patterns. The 70+ container ship flotilla waiting to unload cargo outside the port of Los Angeles is only the most visible sign of those bottlenecks.

Another key challenge is labor. The U.S. has experienced a historically fast labor market recovery over the last 18 months, with the unemployment rate plummeting from 14.8% last April to 4.6% this October. Moreover, Bureau of Labor Statistics estimates of job openings hit an all-time high of over 11 million this July. However, there are still over four million fewer Americans working today than there were last February, while millions of Americans have pulled back from the labor force since 2020. That tension between record demand and a shrinking workforce is crimping growth.

Trucking sits at the intersection of these two stories. The trucking sector was already struggling with driver shortages before COVID. That strain has grown worse this year, as drivers left the industry while demand reached new highs. Today, the American Trucking Association estimates the industry needs to attract 80,000 new drivers to meet client needs. Meanwhile, truckers working today are struggling with dysfunction in other parts of the supply chain as logjams at loading docks force them to spend uncompensated hours idling in clients' lots.

TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

Highland Associates, Inc. is an institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans and defined contribution plans. Please visit the website at www.highlandassoc.com to learn more.

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

▲ BIRMINGHAM
▲ ST LOUIS
▲ NASHVILLE
▲ PENSACOLA

These challenges are impacting markets in a couple of ways:

- Logistics logjams and tight labor markets are contributing to inflation. That's pushing central bankers to reassess their dovish monetary policy commitments.
- Labor and logistics challenges are impacting corporate earnings. While U.S. corporate fundamentals remained strong through the third quarter, we're seeing more and more corporate leaders cite hiring and logistics bottlenecks as key obstacles to sustained growth.

While we don't think these challenges will derail global growth, and we're not anticipating stagflation or a risk-off market regime, we are monitoring the market implications of these supply-side challenges. We anticipate this mix of supply-side inflationary pressures and resource-constrained muted growth will represent a key theme for allocators near term.

HDI Update

Last spring, crude oil futures traded at negative $35/barrel. Today, they're trading above $80/barrel, with some analysts forecasting they could surpass $100 by year-end. What a long, strange trip it's been.

While today's tight energy markets could compound labor and logistics bottlenecks, squeezing growth, our market outlook remains constructive. Our Highland Diffusion Index (HDI) shows the following:

- Equity market momentum remains supportive. Moreover, financial condition indicators like credit spreads continue to point toward a favorable market regime.
- The economic and employment pillars of our HDI framework are consistent with sustained growth.
- Despite recent moves toward tapering and flattening at the long end of the yield curve, our monetary policy and yield curve indicators remain favorable.

So, while supply-side challenges are starting to impact our framework, our Diffusion Index continues to point toward a favorable macro and market regime.

Positioning for More Sustained Inflation

Our reflationary growth regime outlook has put us on the right side of inflationary pressures like tight labor markets and strained supply chains:

- Listed real estate (REIT) allocations continue to deliver strong performance. Investors are gravitating to the asset class due to healthy fundamentals, attractive inflation-hedging characteristics, and upside from tight rental markets. Moreover, REIT allocators are benefiting from end-market diversification, as returns across non-core sectors like data centers, life science real estate, and single-family housing remain competitive.
- Structured credit allocations like non-agency mortgages are benefiting from tight real estate markets. Moreover, structured credit carries less duration than core fixed income markets. That's insulating allocators from inflation-driven interest rate volatility.
- U.S. small-cap value stocks are once again gaining ground thanks to tailwinds including firming inflation and rate expectations. Our research shows small-cap value indices tend to outperform in reflationary regimes because of factors such as their more procyclical sector composition (i.e., higher weights to cyclical sectors like banks, energy companies, and industrial manufacturers) and domestic focus. Moreover, attractive relative valuations could create a sustained runway for that market segment.

We think these cross-asset tilts could continue to be relative winners if supply-side challenges and associated inflationary pressures prove more sustained.

Transitioning Away from Transitory

The Fed is responding to sustained inflationary pressures by hedging its bet on dovish policy. Earlier this month, Fed Chair Jerome Powell announced plans to begin tapering bond purchases at a $15B/month pace later this November. That tapering announcement put the Federal Open Market Committee (FOMC) on track to wind down its $120B/month bond purchase program by June 2022, freeing it up to hike rates next summer. That's now reflected in the Fed Funds Futures market, which is pricing in a first 25 bps rate hike by next July, within 2 ½ years of first cutting rates to zero last March.

Putting that timeline in context, it took the Fed more than seven years to hike after they cut rates to zero in 2008. That underscores how today's strong demand environment and supply-side challenges could lead this cycle to burn hotter and faster than the 2008–2020 economic cycle.

The Fed may not keep to this timeline. The Bank of England's decision to abandon a planned rate hike earlier this month highlighted how global central banks could struggle to wind down monetary policy accommodations in the face of more sustained inflation. Nonetheless, here in the U.S., tapering could put upward pressure on rates. That supports our less constructive view toward core fixed income.

Regional Tilting Update

We are recommending clients shift their regional equity exposure to favor U.S. stocks over emerging market (EM) stocks. We're recommending that shift for three reasons:

- Our Relative Strength Indicator, a momentum model we use to position around turns in regional equity market leadership, favors U.S. equities over emerging market equities.
- Emerging markets have historically struggled during periods of Fed tightening. That could be a headwind for more fragile EMs like Brazil and South Africa as the Fed begins tapering bond purchases later this month.
- Favoring U.S. equities over EM equities should reduce allocators' exposure to Chinese energy crisis and regulatory policy risks.

However, this is a tactical view, not a strategic outlook. We continue to believe emerging markets offer attractive long-term return prospects. Moreover, we think structural emerging market bear cases, like arguments that recent regulatory interventions prove China isn't investable, are overblown.

Recent conversations with Chinese asset managers have underscored that Beijing's regulatory tightening should remain targeted, impacting housing, healthcare, consumer internet, and fintech players. Meanwhile, we could see offsetting fiscal stimulus flow to favored sectors like renewable energy infrastructure. On net, those interventions could drive growth, as Xi Jinping works to solidify support ahead of the Chinese Party Congress selection next year. So, we don't want to overstate the structural challenges confronting China or the broader emerging market universe today.

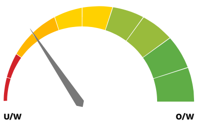
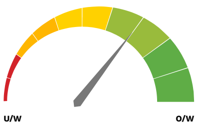
Within U.S. equities, we're recommending maintaining a tilt toward small-cap value stocks to capitalize on favorable macro conditions today.

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 recommending favoring U.S. equities over emerging market equities, and 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	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				▲	

AS OF 11/8/2021

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

▲ BIRMINGHAM

▲ ST LOUIS

▲ NASHVILLE

▲ PENSACOLA

PUB00000036