DECEMBER ASSET ALLOCATION NOTE

CROSSROADS

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

Omicron Outlook

Over the last couple weeks the discovery of a new COVID variant, Omicron, has reignited public health fears and roiled markets. Today, we think those fears are premature.

We're still learning about this new variant. While Omicron could be more contagious than Delta, early estimates of the virus's transmissibility are unreliable. Similarly, while scientists worry Omicron's mutations could help it evade antibodies, we don't yet know whether it will prove meaningfully more immunity resistant than other COVID variants. Most importantly, while early studies by Pfizer suggest a third booster could neutralize the variant, it's too early to gauge Omicron's severity or the effectiveness of current vaccines.

Early reports suggest Omicron carries milder symptoms than Delta. That would rhyme with history. Previous pandemics have petered out as more contagious but less severe virus variants have outcompeted their more deadly but less transmissible cousins. If COVID follows a similar trajectory, Omicron could paradoxically speed the end of the pandemic. However, we're not yet comfortable assuming Omicron will follow that path.

While we're still learning about this COVID variant, we're optimistic it will prove less disruptive than media accounts suggest for a couple reasons: Firstly, medical advances have given us a powerful tool kit to combat COVID. Virologists believe that, despite spike protein mutations, Merck and Pfizer's oral antivirals will be effective against Omicron. Moreover, drug makers are optimistic that, if existing vaccines are less effective against Omicron, they can quickly adjust their formulas to develop variant-targeting vaccines. Secondly, our non-pharmaceutical playbook for handling COVID outbreaks is increasingly sophisticated. For instance, here in the U.S., investments in digital infrastructure should make the economy more robust to future COVID waves.

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That said, Omicron could still represent a macro and market crossroads in a few significant ways:

- It could lead to regional macro decoupling. Political leaders in China and Germany appear ready to reintroduce lockdowns in response to COVID outbreaks, constraining international growth. Meanwhile, significant new domestic restrictions seem very unlikely, although that could differ state-to-state. Omicron could exacerbate those divergences in countries' approaches to the pandemic: learning to live with endemic COVID, as the U.S. has, or committing to a "zero-COVID" policy, as China has.
- It could contribute to U.S. inflation in two key ways: First of all, factory and port shutdowns abroad could compound supply-side challenges at home. Also, Omicron could exacerbate today's tight labor markets if it discourages people from reentering the workforce.

We believe our cross-asset positioning should help if those headwinds materialize. For instance, our current equity regional positioning—we are overweight U.S. equities and underweight emerging market stocks—could insulate us from international growth challenges. Meanwhile, our real asset exposure could help in a hotter inflation scenario. So, while we are monitoring the potential macro and market fallout from Omicron, we are not changing our capital markets views today.

HDI Update

Our macro and market outlooks remain constructive. Our Highland Diffusion Index (HDI) shows the following:

- Financial conditions indicators such as equity market momentum and credit spreads remain favorable.
- The economic and employment pillars of our HDI framework continue to point toward growth.
- Our monetary policy and yield curve indicators remain favorable, although we have seen the yield curve flatten lately.

However, Omicron outbreaks and monetary tightening could complicate this picture.

Powell Perseveres

On November 22, Biden announced plans to renominate Jerome Powell for a second term as Fed Chairman. Powell didn't take long to capitalize on that newfound job security. Just eight days later, on November 30, Powell testified before Congress that the Fed was looking at winding down its bond purchase program ahead of schedule.

Today, it seems likely the Fed will follow through on that by announcing plans to increase the pace of its bond purchase taper from $15B/month to $30B/month later this December. That would put the bank on track to wind down asset purchases by March. That date is significant because Fed decision-makers have implied they could raise rates shortly after ending asset purchases if inflation remains hot.

Markets have responded to that signal over recent months. Fed funds futures markets now imply a >50% chance of a Fed rate hike by next May.

This move toward tighter monetary policy could be negative for equities. However, even if the Fed accelerates its rate hike timeline, related financial conditions drivers like real rates will likely remain very loose relative to their long-term history. So we're not recommending any cross-asset shifts in response to recent Fed policy announcements.

Real World

While COVID concerns and monetary policy shifts have rattled markets over recent weeks, we believe inflation is still the biggest risk confronting allocators today. Over November, consumer price inflation climbed to a new high of 6.8%. That marked the hottest inflation we've seen since 1982!

We've long advocated clients strategically allocate to real assets to protect against inflation risk. This year, as inflation soared, that approach was tested. Our real asset allocations passed that test. Specifically, real assets including private real estate, listed real estate (REITs), commodities, commodity producer stocks, and treasury inflation-protected securities (TIPS) delivered strong absolute and relative returns.

We believe this real asset rally could have more runway, as sustained inflationary pressures like wage hikes and tight housing markets take the baton from potentially transitory inflation drivers like used car prices. We're looking at ways to capitalize on those tailwinds. However, we also want to avoid being whipsawed by more volatile real assets like commodities and commodity equities, which tend to be mean reverting over longer horizons. Investors were reminded of that whipsaw risk recently, as commodities and commodity-linked stocks sold off over the last couple weeks due to geopolitical and COVID-restriction-linked concerns. While that volatility could make tactically adjusting real asset weights challenging, at a minimum, we believe recent market trends have validated our strategic case for allocating to real assets.

Reviewing Our Open Calls

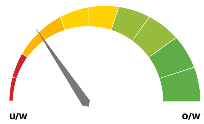
The Highland Investment Working Group remains constructive on cross-asset tilts exposed to recovery and reflation regime themes. We continue to recommend favoring structured credit over core fixed income and REITs over TIPS. Meanwhile, we're recommending favoring U.S. equities over emerging market equities, and favoring domestic small-cap value stocks coming into the new year.

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

Highland Associates Cross Asset Views

TIER 1 CALLS | TIER 2 VIEWS

FIXED INCOME



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Long Duration Credit			▲		
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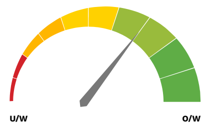
EQUITIES



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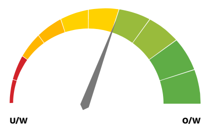
REAL ASSETS



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U.S. TIPS		▲			
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Commodity Equities			▲		
Global Infrastructure			▲		
Public Real Estate				▲	

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