ASSET ALLOCATION UPDATE

April 2020

Social Distancing Leading to Economic Distress...

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

The COVID-19 pandemic has been an unprecedented event in global markets and economy. Economic activity has ground to a halt across large portions of the globe over the last three weeks as the virus has spread. This crisis has roiled financial markets, triggering the fastest 25% drawdown for U.S. stocks in a century, while sending us into what will become a global recession.

Many of the economic and employment data points we follow are published monthly. The unprecedented speed with which large parts of the U.S. economy have decelerated in response to COVID-19 has rendered these metrics less useful during the public health portion of this crisis. However, they should be invaluable as we plot the course of the subsequent recovery.

The Fed's response to this crisis has been encouraging. The central bank was quick to dust off its 2008 playbook, cutting interest rates back to the zero-lower bound and reintroducing an alphabet soup of liquidity measures, including a Commercial Paper Funding Facility (CPFF), a Primary Dealer Credit Facility (PDCF), and quantitative easing (QE). Moreover, it supplemented these measures with new facilities like its Primary Market Corporate Credit Facility (PMCCF), which allows it to purchase investment-grade corporate bonds, and its Main Street Lending Program, which will allow it to direct credit to small businesses.

This rapid monetary easing, paired with robust fiscal stimulus in the form of Washington's $2 trillion coronavirus package, should go a long way toward blunting the immediate impact to growth. The Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 was the largest bill signed into law in U.S. history and has the following features:

- Direct payments to individuals
- Expanded unemployment insurance
- Loan programs of $500 billion, including $117 billion for healthcare institutions
- Food assistance

Even with this response, the number of cases continues to rise and social distancing/mandatory shelter-in-place orders still remain. These actions are wreaking havoc on the global economy, as we are seeing some of the sharpest downward moves in economic data since World War II. That is why Congress began negotiating another stimulus bill before the ink dried on CARES.

In the face of all of these unprecedented moves, we continue to monitor our Diffusion Index closely. We believe the length of this crisis is the most important point on which to focus. If social distancing doesn't flatten the infection curve and the pandemic carries on through the summer, we will likely see a more severe recession and we will react with a risk-off posture. However, if we continue to see evidence of a shorter 6- to 9-month disruption, we will maintain our current positioning. Right now, we see signs of the latter, so we are staying on our current path.

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FSA Investment Group does this with the highest levels of trust, integrity and respect while always collaborating using a team approach. We are dedicated to professionally supporting, educating, and providing informed direction to each and every client.

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We have also re-examined our capital market expectations due to the severe movements in markets. As a result, expected returns for government bonds, cash, and other defensive assets have come down as investors have bid up the price of those assets. Conversely, our estimate for future returns for risk assets, like non-core credit and equities, have increased due to the recent sell-offs. We are now seeing compelling valuations and appealing trade opportunities in the non-core credit sectors. For example, our return expectation for high yield increased 300 basis points per year to 8.5% over the next 10 years.

Over the short term, the path forward for both the economy and financial markets will largely be determined by the duration and severity of this pandemic. Therefore, we expect to experience elevated volatility in markets until we see the number of coronavirus cases level out (or decline).

Risk On/Risk Off Diffusion Index

Maintaining Long-Term Risk-On Stance...Yet Cautious Near-Term

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