ASSET ALLOCATION UPDATE

August 2020

Caught in the Balance

After reviewing the economic and market environment, FSA & Highland offer the following comments on the current landscape:

The Highland Investment Working Group (IWG) reaffirmed our neutral stance in late August. We believe this is not the time to take outsized active risks. Staying close to policy allocation targets should position clients to benefit from the fast shifting outlook for risk assets, while helping them manage risks associated with political uncertainty, vaccine trial uncertainty, and valuation concerns.

Our Highland Diffusion Index (HDI) has meaningfully improved since our last asset allocation note. As stated in previous notes, we believe we could see many ebbs and flows to our HDI over the course of a longer, more gradual recovery, leading us to reaffirm a risk-neutral stance. For this month's reading, there were three main drivers for an improved outlook: :

- Employment indicators climbed back into positive territory in July as the job market recovery continued to gain traction. This was further affirmed in the U.S. Bureau of Labor Statistics' most recent employment report, which showed the unemployment rate falling to 8.4% in August. While the job market is still far from healthy – even after this rebound, we're still 11 million non-farm payrolls below the February peak – it's clearly on a positive trajectory.
- Credit market indicators surged back into risk-on territory in July, as spreads continued to normalize.
- Momentum indicators continued to improve, as the stock market climbed to all-time highs over August. While this is a bullish signal within our HDI framework, we worry overbought conditions could lead to pullbacks. We're already seeing a version of this in the U.S. tech sector, where extreme momentum and aggressive options positioning have set the stage for elevated volatility.

Meanwhile, our economic strength indicators remained challenged, while our monetary policy and yield curve indicators remained constructive. We believe this momentum will continue to build despite the sequential decline in fiscal stimulus in August. The CARES Act's supplemental Pandemic Unemployment Assistance (PUA) program expired on July 31. While the Trump administration

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has introduced stop gap funding to replace some of that lost stimulus, that money has been slow to go out via state systems. So, we're starting to see how this fiscal cliff is impacting the recovery.

So far, the data suggests the impact of these stopped checks isn't as bad as feared. J.P. Morgan's card tracker data, for instance, has not shown a slowdown in spending since PUA expired in July. Other data points like Redbook same-store sales and tax withholdings, which are captured in the NY Fed's Weekly Economic Index, also show the recovery building through August. While it's too early to say what the longer-term impacts of PUA expiry will look like, this data points to the positive trend reflected in the HDI.

August also saw some significant progress on the monetary policy front, as Fed Chair Jerome Powell previewed dovish changes to the Fed's decision-making framework in advance of the September meeting.

The most significant shift was Powell's embrace of average inflation targeting. This will allow the Fed to let the economy run hot over the late innings of the next cycle in order to compensate for subdued inflation during recessions. Specifically, this policy change gives the Fed the flexibility to defer rate hikes even as inflation climbs above 2%. This should reduce first order market risks if inflation rebounds faster than expected.

The other significant change was new language around employment targeting. This change will allow the Fed to take an asymmetric approach to its full employment mandate, cutting rates when unemployment is elevated and keeping rates low once full employment is reached, barring severe inflation.

These changes should anchor interest rates near zero for the next several years, pressuring fixed income returns while increasing inflation risk. This reflationary bias highlights the importance of less correlated return drivers and inflation risk management in this environment.

Real assets like commercial real estate will play a role in helping investors meet this challenge. While segments of the asset class face significant headwinds – retail properties, for instance, may continue to struggle – we also see attractive opportunities within the space. We have identified a couple themes, including balancing secular growth with stable income, looking beyond superstar cities, and diversifying into non-core property types, which we believe will be key for real asset investors over the next cycle.

We've capitalized on a couple of other opportunities to help investors manage these challenges. Our overweights to non-core credit and U.S. equities, for instance, have helped investors benefit from accommodative monetary policy and the Fed's increasingly reflationary bias.

We anticipate this lower-for-longer interest rate environment will be a critical theme over the next cycle, and we're focused on finding other ways to capitalize on it across asset classes. Our ongoing real asset review is one aspect of that project. We're also discussing the efficacy of core fixed income and other safe haven assets in this environment.

While volatility is already elevated, we anticipate market moves could become even more dramatic through the remainder of the year as investors respond to macro catalysts. As we flagged in our July asset allocation note, we see three big catalysts for U.S. markets over the next several months:

- Progress toward the approval of leading vaccine candidates between now and December;
- Political uncertainty as the November election approaches and as the Trump administration takes a harder line with China; and
- Congressional negotiations to extend some CARES Act provisions.

Developments on any one of these fronts could drive risk assets near term. So, while we'll avoid prognosticating on politics or spike protein prospects here, we do recommend positioning for withstanding elevated volatility.

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