ASSET ALLOCATION UPDATE

May 2020

And the Beat Goes On...

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

COVID-19 continues to dominate the global investment landscape. How the virus progresses will greatly determine the path to recovery. While there are lots of scenarios being discussed, we believe there are three potential paths for the global economy:

- **V-shaped (low probability)**: Quick turnaround in both economic and health data, leading to a resumption in growth. The economy is fully open, and employment largely rebounds, by summer. There is no second wave of infections in the fall, and markets return to normal by the end of the year.
- **U-shaped (base case):** The economy takes time to reopen. However, the recovery gains traction over Q3, putting U.S. GDP on a trajectory to exceed 2019 levels by 2021. Businesses don't hire back furloughed workers until growth is regained. Any second wave threatens the economy, so businesses stay defensive until effective treatments/vaccines are developed.
- **L-shaped (low probability):** The economy doesn't fully recover and instead sets a new base. Businesses don't actively rehire workers and innovate how to manage work with fewer employees. Virus disruptions become more frequent and shutdowns more prevalent, weighing on growth.

Economic data for April has fallen at a pace never seen before. Whether its retail sales, unemployment, manufacturing, or inflation, the magnitude of the declines is stunning. As the data has been released, the Highland Diffusion Index (HDI) captured the deteriortion.

- **Economic Indicators:** Deterioration began in February and fell into contraction territory during March. In April, our HDI Economic Indicators captured further weakness as the shutdown in the global economy filtered through the data.
- **Employment Indicators:** Data has turned at an unprecedented pace. The U.S. economy shed more than 20 million jobs over a four-week period, raising the unemployment rate from 4.4% to 14.7% in April. How long workers stay out of the workplace will be a big determinant of the shape of the recovery. Of note, approximately ¾ of the unemployed are furloughed; if they are rehired, that should assist with the recovery. However, the longer the duration of the self-imposed lockdowns and the slower the U.S. consumer comes back will be significant factors in whether the workers shift from furloughed to unemployed or back to work.

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- **Credit Indicators:** Credit markets experienced stress across the entire quality spectrum. Liquidity dried up and prices fell at a pace only rivaled by the Global Financial Crisis. Central banks responded by injecting liquidity and creating programs to back-stop credit markets. Since their intervention, liquidity has improved, and spreads have come in, though they remain elevated.

- **Momentum Indicators:** Global stock markets have rebounded off late March lows, giving investors a breather from the fastest bear market in the history of the stock market. While the rebound has been strong, markets are still well off their February highs and the bounce hasn't been even. The U.S. market has led international markets and the strongest performance has been isolated to the technology and healthcare sectors, leaving investors with a wide array of outcomes.

Since March 23rd, global markets have remained strong. Global stocks (as measured by the MSCI All Country World Index) have increased in price by 24.6%, even in the face of disappointing economic data. Either the market vastly overestimated the fall in economic data, or hopes for a quick recovery have the market looking past the initial economic impact. While either could be the case, we see the probability of the latter becoming smaller each day due to the following:

- **Resurgence:** Many are predicting a second wave of infections during the fall. These discussions are premature, as we have yet to get past the first wave. Countries like China, Singapore, and South Korea are experiencing a resurgence of the virus before the impending second wave, which can pose a threat to an economic recovery. With the U.S. beginning to lift restrictions, the risk of a resurgence is increasing.

- **Vaccines:** The work being done on vaccine research is remarkable, as the entire research community is completely engaged in finding a vaccine. Currently there are 86 different vaccines being developed, with three in the human trial phase. This is good news for the world, but getting the vaccine into production and to the world population is still a daunting task and will take time.

- **Cautious Businesses:** While governments are lifting restrictions, the question remains, How quickly will companies bring back furloughed employees? If demand returns quickly, then we may see employment recover. On the other hand, the longer it takes for demand to return, then the more prolonged the path to recovery. Either way, in the face of heightened uncertainty, businesses usually take a cautious approach when ramping up operations.

Markets tend to lead the economy, but we feel they have gotten too far out on point given the current epidemiological path for COVID-19. For this reason, combined with the increasing probability of economic disappointment, Highland decided to shift our positioning to a Risk-Neutral stance. We feel that it is too early to tell which recovery path the world is currently on. Highland's Diffusion Index confirms this view as we are getting mixed signals. If we see improvements in vaccines and a muted v(or no) resurgence, then we will take a more constructive view on risk assets. On the other hand, if we see further deterioration in economic data and a strong second wave, we will become more defensive. In either case, our Risk-Neutral stance puts us in the position to act.

Risk-Neutral Stance During Uncertainty

Reasons for Risk-On

- Central Bank Responses
- Fiscal Responses
- Yield Environment
- Vaccine Development

Reasons for Risk-Off

- Second Wave of COVID-19
- Negative Economic Surprises
- How Long to Fully Re-open
- Length of Layoffs

Dynamic Positioning

- Underweight Fixed Income
  - Adding Non-Core Credit
- Neutral Equities
  - Overweight US Equities
- Overweight Alternatives

Source: Highland Associates; as of 5/18/2020

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