ASSET ALLOCATION UPDATE

May 2021

Born to Run

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

Picking Up Speed

COVID case counts are once again climbing globally. However, here in the U.S., the pandemic is increasingly in check, and the economic recovery is picking up speed.

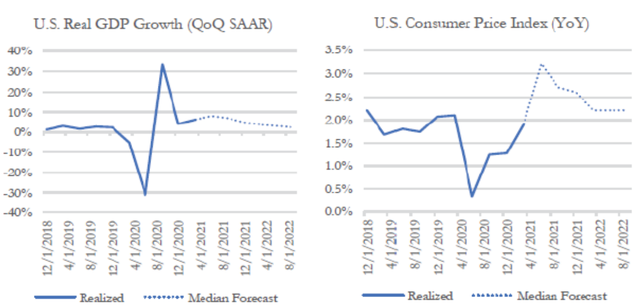
Industrial activity and consumer spending indicators are firming. Widespread vaccinations, looser public health guidelines, and ~$2T in excess U.S. household savings could further fuel this consumer-powered recovery this summer, pushing domestic real economic growth above 6% for 2021 (Figure 1). That would represent the strongest calendar year growth since 1984!

While April jobs growth fell short of lofty expectations, we don't believe that recent payrolls report invalidates broader growth trends. We will continue to monitor updates on that front.

Strong growth is coming hand in hand with higher inflation. The most recent Consumer Price Index (CPI) report showed inflation reaching 4.2% year-over-year in April. Inflation could remain hot into this summer (Figure 1).

Some of that inflation is attributable to base rate effects as we compare prices to lockdown-impacted levels. Some of it could prove short lived, as firms that cut production last year in anticipation of a slower recovery bring capacity back online, resolving supply chain bottlenecks. However, other inflation drivers could prove less transitory. Semiconductor shortages, for instance, could take years to resolve, given the long lead times and multi-billion-dollar investments needed to expand industry manufacturing capacity.

Figure 1



Sources: BEA, BLS, Bloomberg, all data as of 5/7/21

While headline growth and inflation could peak this summer, we think broader trends toward healthy early cycle growth and higher inflation could have staying power. That reflationary rotation outlook supports our constructive view on risk assets like equities and structured credit. Moreover, it informs our favorable calls around economically sensitive reflation beneficiaries like listed real estate (REITs).

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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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Macro Outlook and HDI Update

Our market outlook remains favorable. Our Highland Diffusion Index shows:

- Financial condition indicators like credit spreads and equity market momentum are supportive.
- Monetary policy is accommodative.
- Yield curve indicators point toward healthy early-cycle conditions.
- Economic indicators and labor market conditions are improving after an early winter soft patch.

This is consistent with real-time data around mobility, consumer spending, and industrial activity. It also dovetails with our views on the consumer-powered economic recovery.

Passing the Baton

Unprecedented fiscal and monetary interventions played key roles in setting the stage for this recovery:

- The Fed cut rates to zero, backstopped liquidity providers, and supported credit markets. In one sign of the scale of those interventions, the Fed's balance sheet grew by more than $3T over the six months following the start of this recession. Putting that number in context, it took almost six years for the Fed's balance sheet to grow by the same amount following the '07 recession.
- Congress provided for over $5T in incremental spending and tax relief over the last 15 months. That represented more stimulus than we saw over the last five U.S. recessions combined.

Today, we believe this convergence of fiscal and monetary support could be in its late innings. We anticipate a passing of the baton, as monetary policymakers' attention turns to tightening, while Congress continues to pursue spending priorities.

On the monetary policy side, Fed Chair Jerome Powell has reiterated his commitment to keeping financial conditions accommodative until labor markets heal. However, bond markets show investors pricing in Fed rate hikes by 2023. If inflationary pressures prove less transitory, that timeline could be condensed.

Meanwhile, on the fiscal side, Congress could continue to flex its muscles. The Biden administration's $2.25T American Jobs Plan (AJP) and $1.8T American Families Plan (AFP) proposals show Washington's growing comfort with big spending programs. If key elements of those packages are passed, that could lead to faster growth, higher inflation, and tighter labor markets, coinciding with tapering and rate hikes over these next couple years.

That convergence of monetary tightening and fiscal easing could set the stage for a second act in this reflation rotation trade.

Fiscal Policy and Cross-Asset Strategy

Biden's American Jobs Plan and American Families Plan proposals could impact markets in a couple key ways:

- Infrastructure spending could absorb labor market slack while pushing inflation expectations higher. That could put the Fed on a trajectory to hike interest rates sooner, penalizing duration exposure.
- Tax hikes could be negative for U.S. equities. American Jobs Plan corporate tax hike proposals could detract ~5%–10% from S&P earnings over 2022, before accounting for offsetting revenue contributions from infrastructure spending.

Drilling down a layer deeper, these proposals could also drive a continued rotation within U.S. equities.

Conversations with managers have highlighted how American Jobs Plan tax code proposals like Global Intangible Low-Taxed Income (GILTI) reform could have an outsize impact on large tech companies, which currently benefit from low effective tax rates. Those same companies will likely see limited upside from stronger U.S. economic growth. Meanwhile, more cyclical, U.S.-focused stocks in the industrial and financial sectors could see more muted tax headwinds, and more upside from a stronger economy and rising rates.

At the same time, capital gains tax hike provisions in the American Families Plan proposal could pressure long-term tech winners like Facebook, Apple, and Amazon by incentivizing taxable investors to sell appreciated positions in those names, crystalizing their gains before tax code changes take effect. Market returns around previous capital gains tax hikes show that pre-tax-hike selling pressure can have an outsize impact on better returning stocks, due to investors' large embedded gains in those positions.

Developments in Washington are not, and have never been, a big part of our investment process. However, we are monitoring these AJP and AFP proposals. If key elements of those packages are passed into law, we believe open calls like our REITs tilt, our structured credit tilt, and our emerging market equities tilt should put us on the right side of their market impact.

Moreover, we remain focused on the rotation into procyclical and value styles within U.S. equities. Additionally our outlook for developed international markets is improving as growth prospects materialize. Finding opportunities to capitalize on cyclical trends will be front of mind this quarter.

More Thoughts on Emerging Markets

We've favored emerging market equities over developed market equities for roughly two months. That view is informed by our research around cyclical tailwinds, healthy momentum, and attractive long-term fundamentals.

Elements of that thesis are playing out. For instance, we're seeing strong economic growth and healthy earnings prospects across China, Korea, and Taiwan. Meanwhile, the bull market in commodities has benefited exporters of everything from corn to copper.

However, some cross currents are weighing on emerging market equities' relative performance. For instance, COVID outbreaks in India and Brazil are hurting investor sentiment. Meanwhile, climbing commodity prices are proving a doubleedged sword, as they lead some EM central banks to hike rates to combat inflation.

Despite these cross currents, we're optimistic vaccination progress, reopening optimism, and healthy long-term growth prospects will ultimately win out. Moreover, tilting toward EMs should insulate allocators from U.S. tax legislation risks. So we're recommending maintaining a moderate tilt toward emerging market equities.

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