Macro Outlook and HDI Update

Last spring, crude oil futures traded at negative $35/barrel. Today, they're trading above $80/barrel, with some analysts forecasting they could surpass $100 by year-end. What a long, strange trip it's been.

While today's tight energy markets could compound labor and logistics bottlenecks, squeezing growth, our market outlook remains constructive. Our Highland Diffusion Index (HDI) shows the following:

- Equity market momentum remains supportive. Moreover, financial condition indicators like credit spreads continue to point toward a favorable market regime.
- The economic and employment pillars of our HDI framework are consistent with sustained growth.
- Despite recent moves toward tapering and flattening at the long end of the yield curve, our monetary policy and yield curve indicators remain favorable.

So, while supply-side challenges are starting to impact our framework, our Diffusion Index continues to point toward a favorable macro and market regime.

Positioning for More Sustained Inflation

Our reflationary growth regime outlook has put us on the right side of inflationary pressures like tight labor markets and strained supply chains:

- Listed real estate (REIT) allocations continue to deliver strong performance. Investors are gravitating to the asset class due to healthy fundamentals, attractive inflation hedging characteristics, and upside from tight rental markets. Moreover, REIT allocators are benefiting from end-market diversification, as returns across non-core sectors like data centers, life science real estate, and single family housing remain competitive.
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- [illegible]

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Transitioning Away from Transitory

The Fed is responding to sustained inflationary pressures by hedging its bet on dovish policy. Earlier this month, Fed Chair Jerome Powell announced plans to begin tapering bond purchases at a $15B/month pace later this November. That tapering announcement put the Federal Open Market Committee (FOMC) on track to wind down its $120B/month bond purchase program by June 2022, freeing it up to hike rates next summer. That's now reflected in the Fed Funds Futures market, which is pricing in a first 25 bps rate hike by next July, within 2 years of first cutting rates to zero last March.

Putting that timeline in context, it took the Fed more than seven years to hike after they cut rates to zero in 2008. That underscores how today's strong demand environment and supply-side challenges could lead this cycle to burn hotter and faster than the 2008–2020 economic cycle.

The Fed may not keep to this timeline. The Bank of England's decision to abandon a planned rate hike earlier this month highlighted how global central banks could struggle to wind down monetary policy accommodations in the face of more sustained inflation. Nonetheless, here in the U.S., tapering could put upward pressure on rates. That supports our less constructive view toward core fixed income. Lastly, the way we've recommended expressing this tilt, it carries less duration than core fixed income markets. That de facto duration underweight could boost active returns if inflation remains elevated and rates climb. Given structured credit's attractive fundamentals, leverage to key macro themes, and strong relative value, we continue to favor that asset class today.

Regional Tilting Update

We are recommending clients shift their regional equity exposure to favor U.S. stocks over emerging market (EM) stocks. We're recommending that shift for three reasons:

- Our Relative Strength Indicator, a momentum model we use to position around turns in regional equity market leadership, favors U.S. equities over emerging market equities.
- Emerging markets have historically struggled during periods of Fed tightening. That could be a headwind for more fragile EMs like Brazil and South Africa as the Fed begins tapering bond purchases later this month.
- Favoring U.S. equities over EM equities should reduce allocators' exposure to Chinese energy crisis and regulatory policy risks.

However, this is a tactical view, not a strategic outlook. We continue to believe emerging markets offer attractive longterm return prospects. Moreover, we think structural emerging market bear cases, like arguments that recent regulatory interventions prove China isn't investable, are overblown.

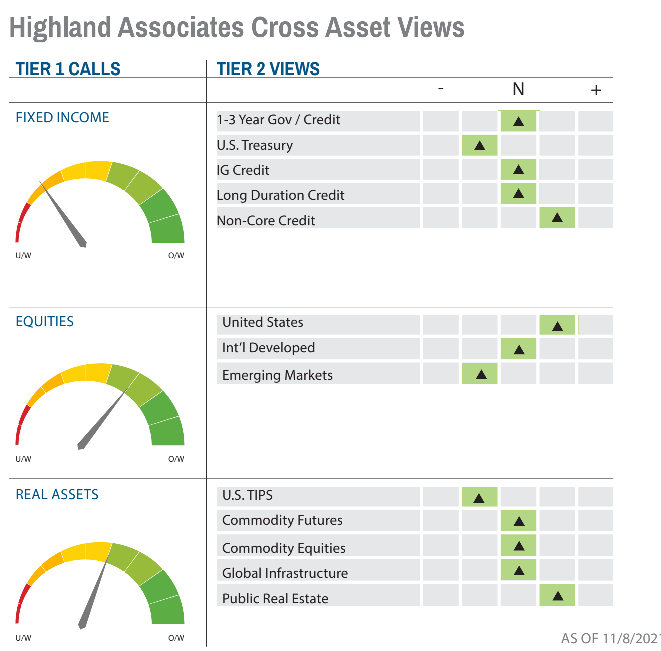
Recent conversations with Chinese asset managers have underscored that Beijing's regulatory tightening should remain targeted, impacting housing, healthcare, consumer internet, and fintech players. Meanwhile, we could see offsetting fiscal stimulus flow to favored sectors like renewable energy infrastructure. On net, those interventions could drive growth, as Xi Jinping works to solidify support ahead of the Chinese Party Congress selection next year. So, we don't want to overstate the structural challenges confronting China or the broader emerging market universe today.

Within U.S. equities, we're recommending maintaining a tilt toward small-cap value stocks to capitalize on favorable macro conditions today.

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 today.

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



Tier 2 Views	-		N		+
1-3 Year Gov / Credit			▲		
U.S. Treasury		▲			
IG Credit			▲		
Long Duration Credit			▲		
Non-Core Credit				▲	
United States				▲	
Int'l Developed			▲		
Emerging Markets		▲			
U.S. TIPS		▲			
Commodity Futures			▲		
Commodity Equities			▲		
Global Infrastructure			▲		
Public Real Estate				▲	

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