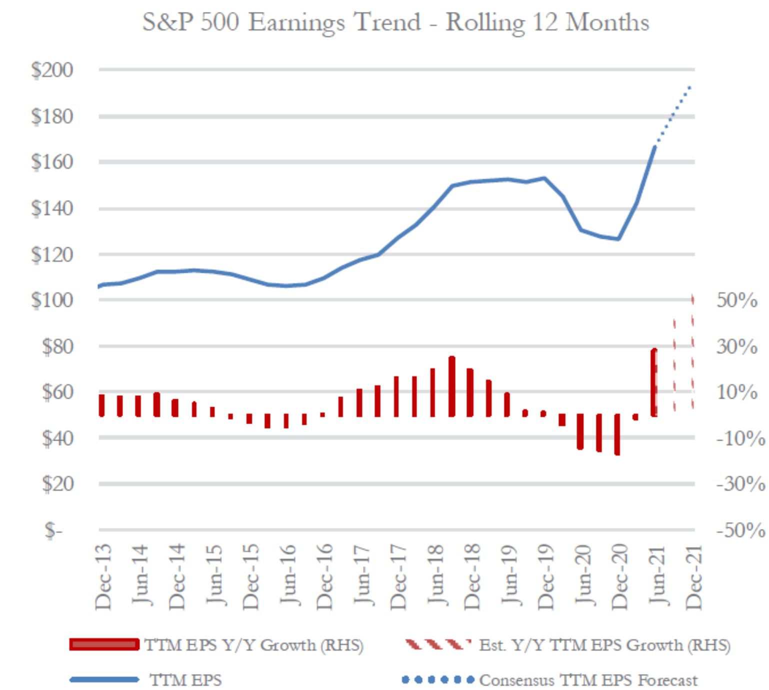
ASSET ALLOCATION UPDATE
September 2021

After the Gold Rush

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

Navigating Peak Earnings Growth

Today, with 2Q21 earnings season in the rear-view mirror, trailing 12-month (6/30/20-6/30/21) S&P 500 index earnings have officially surpassed their pre-crisis peak. Moreover, analysts forecast S&P earnings should continue to grow through the back half of this year. Street consesus holds S&P earnings will climb by 53% over 2021, to end the year more than 25% above 2019 levels:



Source: Bloomberg. As of 9/7/21

If second-half earnings meet these lofty expectations, that will go a long way toward helping U.S. markets grow into their valuations. These short term growth forecasts appear credible. If anything, recent sell-side earnings forecasts have been too conservative. However, this growth rate is not sustainable longer term.

Year-over-year earnings comparisons should get tougher through the back half of this year, as we've already lapped the most severely pandemic-impacted quarter of the COVID crisis. Meanwhile, increasingly endemic COVID outbreaks, sequential declines in fiscal stimulus, building wage pressures, and proposed tax hikes could all weigh on earnings growth longer term. So, we believe investors are navigating peak earnings growth today. This tracks with the peak economic growth and peak inflation themes we've discussed in previous Asset Allocation Notes. Strategists at PIMCO have dubbed this the "peak everything" environment.

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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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Over a strategic horizon, we see S&P earnings growth reverting to its high single digits long-term average. That assumption, alongside today's low dividend yields and high valuations, drives our mid-single digit long term U.S. equity market return forecasts. So, while we remain constructive on risk assets, including U.S. equities, our strategic return forecasts suggest performance will become more muted long term. Positioning for that lower return environment will be increasingly key as economic growth, inflation, and earnings growth retreat from today's highs.

Macro Outlook and HDI Update

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

- Financial conditions indicators like credit spreads and equity market momentum are constructive.
- The economic and employment pillars of the HDI framework continue to reflect a favorable backdrop. Labor markets and economic fundamentals continue to heal.
- Our monetary policy pillar is neutral. We're approaching the beginning of the end for some of this extraordinary monetary support we've seen over the last 18 months. However, monetary policy remains dovish by historic standards.

While growth momentum has slowed over recent months, the diffusion index still tracks to broadly favorable macro and market trends.

Delta Blues

While we remain constructive on risk assets, Delta-variant COVID outbreaks pose a risk to the reopening and recovery trends that inform that outlook.

That's occurring on a global scale, as pandemic-driven factory and port closures in Asia stress fragile global supply chains. It's also a narrow U.S. story. Domestic leisure and hospitality employment growth stalled out due to Delta-linked uncertainty over August. Moreover, school reopening challenges could make it difficult for parents to return to work, exacerbating labor market tightness this fall.

Some signs suggest the current Delta variant wave has already peaked across much of the U.S. So we're optimistic current outbreaks won't permanently derail broadly favorable early-cycle trends. However, short term, Delta could certainly lead to more supply constraints and hotter inflation. That could make the prospects of a soft landing from today's "peak everything" environment harder to achieve.

Equity Market Positioning

We're recommending closing out tilts favoring international equities and adding to U.S. small-cap value stocks.

Our research shows inflationary growth regimes map to strong small cap value performance. While Delta-variant outbreaks have muddied the economic waters, we anticipate inflation and growth will remain elevated near term. We believe expressing a modest tilt toward small-cap value can help clients capitalize on those tailwinds.

Meanwhile, we still favor international equities over a strategic horizon. However, uncertainty around the cadence of regional reopening trends and Beijing's regulatory crackdown are complicating that picture, leading to volatile regional leadership today. That backdrop could make our decision to diversify our risk bets by adding a U.S.-style tilting dimension to our equity tilting framework timely.

The Changing of the Guard

This August, for the second year in a row, the Kansas City Fed held their annual economic policy symposium virtually. However, that hasn't detracted from the Jackson Hole symposium's prominence as the premier economic policy event among Fed decision makers.

Last year, Fed Chair Jerome Powell introduced the Fed's new Flexible Average Inflation Targeting (FAIT) policy at the conference, establishing a policy of allowing inflation to run hot to compensate for periods of low inflation. This August, Powell began to hedge that bet on dovish policy. While Powell still struck a dovish tone, he opened the door to tapering the Fed's asset purchases later this year. Specifically, he suggested that if the economy continues to heal, the Fed will begin tapering their $120B/month bond purchase program this November or December.

We still see uncertainty around future Fed policy. That uncertainty could grow if Biden opts not to nominate Powell for a second term as Fed Chair. However, moves toward tapering and shifts higher in the Fed dot plots suggest tighter monetary policy will represent a headwind for core fixed income near term. That informs our modest underweight to the asset class.

Reviewing Our Open Calls

The Highland Investment Working Group remains constructive on cross-asset tilts exposed to recovery and reflation regime themes. Specifically, we're recommending favoring structured credit over core fixed income and REITs over TIPS. Meanwhile, we're expressing a neutral view toward regional equity markets while favoring small-cap value stocks today.

You can find a brief synopsis of our cross-asset views below.

We have a few notes on how to read this graphic:

- We've limited this graphic to asset classes where allocators have the flexibility to express tactical views. So illiquid allocations like private equity, for instance, are not included in the table.

- We've organized our asset class views into three tier 1 asset classes - fixed income, equities, and real assets - and 13 tier 2 sub-asset class tilts. We've defined most of those asset classes pretty broadly. For instance, non-core credit encompasses structured credit, high-yield bonds, bank loans, and emerging market debt. Today, we are recommending tilts towards non-core credit be expressed via structured credit strategies.

Please reach out if you have any questions about this graphic or our asset allocation reviews.

Highland Associates Cross Asset Views

TIER 1 CALLS / TIER 2 VIEWS

FIXED INCOME

TIER 2 VIEWS	-		N		+
1-3 Year Gov / Credit			▲		
U.S. Treasury		▲			
IG Credit			▲		
Long Duration Credit			▲		
Non-Core Credit				▲	

EQUITIES

TIER 2 VIEWS	-		N		+
United States			▲		
Int'l Developed			▲		
Emerging Markets			▲		

REAL ASSETS

TIER 2 VIEWS	-		N		+
U.S. TIPS		▲			
Commodity Futures			▲		
Commodity Equities			▲		
Global Infrastructure			▲		
Public Real Estate				▲	

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