FSA INVESTMENT GROUP

# ASSET ALLOCATION UPDATE

April 2021

## Bulls on Parade

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

### Smooth Sailing Over Choppy Seas

Equity markets delivered a strong start to the year. The MSCI All Country World Index was up ~4.9% over Q1. U.S. equities fared even better. The S&P 500 returned ~6.2% over the quarter, with most of the gains coming in March. Volatility, meanwhile, has been relatively subdued across key indices.

While index-level volatility has been muted, there's been plenty of turbulence below the equity market's surface. Between January's Reddit-driven run-up in heavily shorted names and March's leverage-driven media and tech sector sell-off, markets have been anything but calm. Moreover, we've seen dramatic rotations in market leadership across sectors, styles, and themes.

Reopening beneficiaries like airlines and hotel stocks have outperformed. Cyclical sectors like energy and financials, which lagged in 2020, have led less growth-sensitive sectors like tech and healthcare. Small cap stocks and value stocks have come roaring back. These trends have had one thematic through line: Investors are embracing reopening, recovery, and reflation themes.

We remain focused on finding ways to capitalize on this prevailing market landscape.

### Macro Outlook and HDI Update

Our market outlook remains favorable. This is consistent with the Highland Diffusion Index (HDI) which shows:

- Monetary policy and yield curve indicators are bullish.
- Credit spreads and equity market momentum remain supportive.
- Economic indicators and labor market conditions are improving after an early winter soft patch.

This is consistent with our qualitative analysis around loose financial conditions and the positive impact of vaccinations. It's further supported by real-time economic indicators like flight bookings and credit card spending, which suggest a consumer powered economic recovery is gaining steam.

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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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## Reflation and Rising Rates

In our last asset allocation note we highlighted how economic optimism, inflation concerns, and liquidity factors were pushing interest rates higher.

That bond market correction continued through March. The Bloomberg Barclays U.S. Long Treasury Index returned -13.5% over Q1. That marked the index's worst calendar quarter returns since 1980! Moreover, 10-year treasury yields ended the quarter around 1.7%, up 0.8% year to date.

This move in interest rates is reminiscent of 2013's taper tantrum. However, we don't view it as a threat to broader risk assets for two reasons. Firstly, we view recent bond market moves as a rightsizing of rates. U.S. rates were historically low for much of last year. Even after last quarter's bond market sell-off, interest rates remain below their 10-year average. Secondly, we see a healthy mix of firming inflation expectations and growth optimism driving this move in rates:

- We're looking for robust economic growth. Over the short-term, elevated household savings, pentup consumer demand, and loose financial conditions could drive rapid growth. The Federal Reserve forecast shows the U.S. economy growing by ~6% over 2021. That would mark the strongest real economic growth rate in over 30 years.
- Over a multiyear horizon, 6% growth isn't sustainable. However, we still see reasons to be constructive. Moderate unemployment, loose fiscal policy, and accommodative monetary policy could create the conditions for a robust early cycle growth environment into '22 and beyond.
- We're similarly looking for above-trend inflation. Over the short-term, consumer price index (CPI) inflation could climb to >3%, reaching decade highs due to lockdown-impacted year-over-year comparisons, pentup consumer demand, and rising commodity prices. However, extreme April and May inflation reports could represent a head fake.
- Over a longer-term horizon, we think overheating concerns are premature. We're not worried about sustained >2.5% inflation until the labor market tightens significantly. That likely won't occur until late 2023 at the soonest. That said, looking out to 2024 and beyond, the broadening of the Fed's mandate and growing comfort with fiscal stimulus could contribute to inflation risk.

Moreover, other drivers of financial conditions remain supportive. For instance, tight credit spreads and strong equity market returns are keeping financial conditions accommodative.

## First Thoughts on the American Jobs Plan

On March 31, President Biden proposed a ~$2.25T infrastructure package and an offsetting corporate tax hike. That package could go to the Senate as soon as this July. If passed, that proposal would commit over $300B/year to priorities like transportation infrastructure modernization, manufacturing incentives, and eldercare while pushing U.S. corporate tax rates to 28%.

After the last four years of infrastructure package head fakes and false starts, we're not ready to pencil in this infrastructure package. That said, if Congress enacts the bulk of Biden's plan, it could further fuel ongoing reflation and risk on rotations across equities, rates, and real assets. Calls like our REITs tilt and our emerging markets equities tilt should put us on the right side of these trends.

We'll continue to monitor the progress of that legislation over the next several months.

## Reviewing the Case for Emerging Market Equities

Last month, we introduced a tilt favoring emerging market (EM) equities over developed market (DM) equities. The thesis behind that call centered around healthy momentum, cyclical tailwinds, and attractive long-term return prospects:

- Our Relative Strength Indicator, a momentum model we use to position around shifts in regional equity market leadership, favors emerging markets.
- We believe EM equities should benefit from cyclical tailwinds including climbing global trade volumes, robust commodity demand, and burgeoning risk appetites.
- Valuations and fundamentals suggest healthy EM returns over a strategic (~10 year) horizon.

All three legs of that thesis remain intact. However, we're monitoring a couple cross currents that could impact that allocation near term.

On the positive side, EM equities are insulated from domestic tax hike risks. So, our EM tilt could drive relative performance if tax hikes weigh on U.S. equities.

On the negative side, disparate COVID vaccination trajectories could lead to a decoupling of DM and EM growth. Today, developed markets like the U.S. and the U.K. are much further along in their vaccination campaigns than emerging markets like South Africa, and Brazil. Slower vaccination campaigns could mean a longer road back for services demand in some of those EM countries. While improved vaccine production should put most EMs on the path to herd immunity by the end of next year, less synchronized global growth could pose risks for EM allocators over the interim.

We'll continue to track these more idiosyncratic drivers of regional relative performance.

## Reiterating Our Constructive Real Estate Call

Our expectations around healthy economic growth and abovetrend inflation support our focus on opportunities across listed and private real estate.

Within listed real estate (REITs) we believe strong fundamentals and attractive macro exposures should drive healthy returns. Sector valuations are attractive. Despite recent outperformance, REITs still offer compelling relative value on a dividend yield and price to funds from operations basis. Moreover, improving fundamental prospects across out-of-favor property types like hotels and office space could drive upside, while REITs have a history of delivering strong performance in reflationary regimes.

Private real estate should also benefit from improving growth and above-trend inflation. Moreover, low rates and uneven property level liquidity could create opportunities for managers to add value. Within private real estate we remain focused on themes including balancing secular growth with stable income, looking beyond superstar cities, and diversifying into non-core property types.

Favoring opportunities across listed and private real estate will remain a key part of our reflationary growth playbook.

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