ASSET ALLOCATION UPDATE
January 2022

Same As It Ever Was

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

Economic Update

It may be a new year, but it doesn't feel much different from the last one. After all, 2021 started with consumers, businesses, and governments responding to a surge in COVID cases, and that is again the case as 2022 gets underway. Clearly, the pandemic, its impacts on consumers and businesses, and the policy responses to it were the main storylines of the U.S. and global economies in both 2020 and 2021 and, at this point, there seems little reason to believe 2022 will prove any different. Still, whether it feels that way or not, the calendar says it's a new year, which means it's time for us to look ahead at how we see the economy faring in 2022—though, admittedly, our outlook comes shrouded in a thick layer of uncertainty.

The Supply/Demand Landscape Supports Continued Growth

- Global supply chain and logistics bottlenecks are beginning to ease.
- Restocking of non-farm business inventories, which experienced a meaningful draw-down in 2021, provide a tailwind for growth.
- Sizable backlogs of unfilled orders on the manufacturers and homebuilders front also paint a picture for continued growth.
- Fiscal policy and monetary policy will remain accommodative in 2022, although to a lesser degree than previous years.
- We anticipate continued growth in consumer spending supported by robust growth in labor earnings, a significant pool of excess saving, and healthy household balance sheets.

If we are correct in expecting further easing of supply chain and logistics bottlenecks, that would contribute to a sharp deceleration in goods price inflation, if not outright goods price deflation. While that would act as a drag on overall inflation, we nonetheless expect faster growth in services prices, including rent and medical care, and continued robust growth in labor costs to keep inflation easily above the FOMC's 2.0 percent target rate through 2022. While we believe the FOMC will begin raising the Fed funds rate by mid-year, we also believe that the changing composition of the FOMC, including three new members of the Board of Governors, will act as a brake on the extent to which the funds rate rises during this cycle. It also seems likely that the FOMC will allow the Fed's balance sheet to begin winding down not too long after their monthly asset purchases come to an end in March. This would be a significant departure from the FOMC's playbook during the prior cycle, when the Fed's balance sheet was held steady for nearly three years after the asset purchases ended.

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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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To be sure, the outlook we've outlined above seems too nice and neat in a world that, in case anyone still hasn't caught on, is seldom so. That raises the question of what could go wrong. At the risk of stating the obvious, the primary risk to the U.S. and global economies in 2022 remains the COVID-19 pandemic. To the extent global manufacturing and shipping hubs are subject to further spikes in case counts, any progress made in clearing supply chain/logistics bottlenecks could be quickly reversed, weighing on economic growth and keeping upward pressure on goods prices. It would seem foolish to presume that there won't be additional variants of the virus in the months (years?) ahead, meaning that how consumers, businesses, and governments respond is critical in determining the extent to which economic activity is disrupted.

While it seems clear that COVID-19 remains the biggest downside risk to our outlook, that doesn't mean it is the only downside risk. For instance, we and most others expect inventory restocking to contribute to real GDP growth in 2022. At the same time, we also respect how quickly inventories can swing, to the point that what begins as a restocking of depleted inventories turns into an inventory overhang, particularly when, as at present, businesses are unsure of the true level of demand. It is reasonable to wonder whether demand for goods is due for a "correction," given the extent to which pandemic-related transfer payments coupled with restrictions on many segments of the services sector juiced consumer spending on goods. Not knowing the true level of demand makes it difficult for firms to correctly gauge the appropriate level of inventories. If inventories become too swollen, that could quickly lead to sharp cuts in output and employment which, if of sufficient magnitude, could trigger a recession.

Additionally, should inflation prove to be more persistent than our baseline forecast anticipates, that could trigger a sharp decline in discretionary consumer spending, and could also trigger a sharp increase in market interest rates that would weigh on activity in interest-sensitive segments of the economy. We also worry that with the high level of debt in the non-financial corporate sector, particularly among companies at the lowest "investment grade" rating level, sharply higher interest rates and slowing economic activity could trigger payment stresses that could weigh heavily on business investment spending. Finally, the combination of elevated inflation and the FOMC moving to lessen the degree of monetary accommodation opens the door for a policy mistake, real or perceived, triggering swings in market interest rates that would impact the broader economy.

Sources: Regions Economic Division; BEA; BLS; Federal Reserve; Institute for Supply Management

HDI Update

The Highland Investment Working Group remains constructive on equity and equity-like assets and less sanguine on traditional fixed income investments. Our Highland Diffusion Index (HDI) continues to support this view. The HDI shows the following:

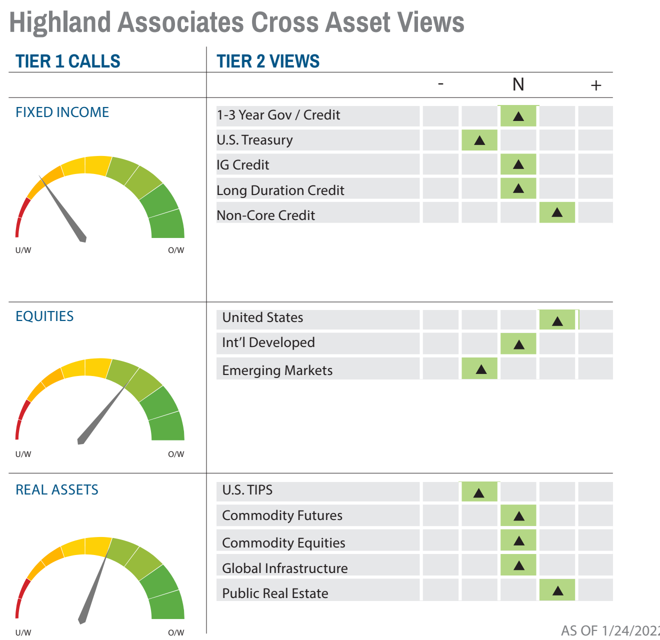
- Financial condition indicators are mixed, with equity market momentum fading but credit spreads behaving overall, albeit trending higher.
- Monetary policy remains accommodative, although to a lesser extent.
- The economic and employment pillars of our HDI framework continue to point toward growth.

Within equity allocations, the team continues to favor U.S. over emerging markets, and specifically U.S. small-cap value. Emerging markets have historically struggled during periods of Fed tightening, which could be a headwind as the FOMC begins unwinding their balance sheet and raising interest rates as expected later in the year. Small-cap value has historically outperformed in periods of higher growth and higher inflation because of their overweight to cyclical sectors such as banks, energy companies, and industrial manufacturers, which tend to benefit from higher interest rates and continued economic expansion. Moreover, attractive relative valuations could create a sustained runway for small-cap value stocks.

Outside of equity allocations, the team continues to favor noncore fixed income investments over traditional fixed income, and specifically structured credit. Higher inflation has had positive impacts on segments of the structured credit market like nonagency mortgages. Supply chain challenges have constrained single-family housing construction, contributing to today's hot housing market.

That has bolstered collateral value for non-agency residential mortgage-backed security investors. Persistent supply side challenges could continue to benefit structured credit allocators from here. Additionally, structured credit carries less duration than core fixed income markets, which helps insulate allocators from inflation-driven interest rate volatility.

Lastly, with inflation expected to remain elevated in 2022, we continue to believe the case for allocating to real assets is strong. We've long advocated clients strategically allocate to sectors like private real estate, listed real estate (REIT), commodities, and natural-resource equities. Today, REIT allocators are benefiting from healthy fundamentals, attractive inflation-hedging characteristics, upside from tight rental markets, and exposure to non-core property types like data centers, life science real estate, and single-family housing. While we saw significant performance from REITS in 2021, we believe there is more runway and continue to favor an overweight to these strategies.



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