ASSET ALLOCATION UPDATE
September 2022

The Adults Are Talking (The Fed)

Market Update

Chairman Powell of the Federal Reserve ("Fed") has been very clear in his message this summer, the Fed's primary goal is to bring inflation down. For the first time in years there's a unified message from all of the voting members of the Fed. In fact, there seems to be a weekly contest by each member to determine who can sound the most hawkish regarding monetary policy. With core inflation still showing no signs of slowing down, the Fed will continue to talk about restricting growth through its setting of interest rate policy. While the Fed has stated it will be data dependent in how it sets policy, we do caution that just looking at inflation, which is a lagging indicator, does not provide the most up-to-date data. For instance, shipping container prices are down over 40% since May, used car prices are down close to 15% year-to-date, and food prices have declined six consecutive months and are down 12% since June. All of these measures take time to filter into the reported inflation numbers. Nevertheless, a resolute Fed has enacted one of the fastest rate hiking cycles in the post-World War II era, with rates moving from 0% to 3% since the beginning of the year and expected to hit 4-4.25% by the end of the year. Furthermore, the Fed is continuing to reduce its balance sheet in what is being called quantitative tightening at a time that bond liquidity is approaching levels experienced during the initial COVID shock in March 2020.

This type of move has caused all kinds of problems in the financial markets, with both bonds and equities selling off. According to Bespoke Research, the dollar decline in US equities and bonds has totaled $16 trillion year-to-date through September, well surpassing both the COVID and 2008 dollar declines (in percentage terms, losses were larger in 2008). Meanwhile with U.S. interest yields moving higher and global growth slowing down, we have seen substantial strength in the U.S. dollar. Year-to-date the U.K. sterling, euro and yen are down by more than 18%, 14% and 26%, respectively against the dollar. All of this has caused investors to ask how much further is the Fed willing to go to bring inflation and growth down. Do we have to see a bonafide recession for the Fed to meet its current goal?

One common element in the recession calls we've seen thus far is the Fed being more aggressive than is priced into the market. At some point, the Committee will have to choose between continuing to hike in the face of slowing economic growth or pausing despite headline inflation remaining above its target range. Against this backdrop, the Highland Diffusion

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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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Index is now signaling Risk Off. While we remain cautious and are constantly looking at ways to protect client portfolios, we worry about selling assets after experiencing a large drawdown. We continue to be underweight duration in fixed income and maintain an overweight to U.S. equities over international equities. Both tactical trades position portfolios defensively in protection against more equity volatility and rising interest rates.

Our Highland Diffusion Index (HDI) framework is central to how we manage risk in client portfolios. The framework tracks 27 data points across six primary areas: Economic, Employment, Monetary Policy, Credit Spreads, Yield Curve, and Market Momentum. It helps to cut through market noise and assess the likelihood markets are in a risk-on, neutral, or risk-off environment. The framework helped us successfully navigate periods like the Global Financial Crisis in 2008/2009 and the Dot-com Bubble in the early 2000s.

Date	HDI Reading	Prior 6m Equity Return*	Next 6m Equity Return*	Next 12m Equity Return*	Peak to Trough Return*
September 1973	Risk Off	-0.8%	-11.9%	-47.2%	-47.2%
January 1982	Risk Off	-5.1%	-8.3%	26.3%	-13.3%
September 2000	Risk Off	-3.2%	-19.7%	-29.0%	-55.4%

** S&P 500 Index*

Source: Bloomberg

Importantly, the framework is not a financial model we follow blindly. We always ask ourselves what is not being picked up in the data, and what is different this time? This helped us navigate the 2020 Covid market sell-off as monetary and fiscal stimulus measures were being implemented by the time our HDI indicators signaled Risk-Off. We did not adopt a defensive stance at that time. No such monetary and fiscal stimulus measures are planned in the current environment. Today, five of the six indicators – Economic, Yield Curve, Monetary Policy, Credit Spread, and Momentum – are all signaling Risk-Off. Market-based indicators like Credit Spreads and Momentum turned negative earlier in the year as spreads on investment grade and high yield bonds increased and equity markets waned. In recent months, the frameworks Economic, Yield Curve, and Monetary Policy indicators have shifted negative as portions of the yield curve have inverted and the Federal Reserve continues to adopt a more restrictive strategy. Employment remains a bright spot. The last three times these five indicators were all pointing risk-off at the same time was in September 2000, January 1982, and September 1973.

What is potentially different this time? While there are similarities, few market participants are predicting an oil crisis like we witnessed in the early 1970s or double-digit interest rates we experienced in the early 1980s when Fed Chair Paul Volker was trying to break the back of inflation. At the same time, while investors are still questioning the earnings potential of many tech-related companies, few market participants are likening the current environment to the Dot-com Bubble burst of the early 2000s. Household and business balance sheets remain healthy, and employment is strong. Those investors positioning for a recession are doing so with the expectation that it will be a "shallow" one.

How does a Risk-Off stance potentially go against us? If we see a quick end to the War in Ukraine or China dramatically lessens its no-Covid policies, we will likely see a rebound in equity markets. Geopolitics is unpredictable, and the odds of either happening in the near term is not low. In either case, pressure on the Fed to fight inflation with the "hammer" of interest rate policy lessens, which will be welcomed by both bond and equity investors.

Sources: Bloomberg; Baltic Dry Index, Food and Agriculture Organization of the United Nations, Manheim Used Vehicle Value Index, and Highland Associates

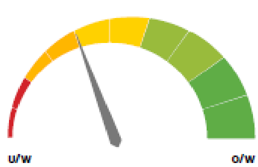
Highland Associates Cross Asset Views

TIER 1 CALLS | **TIER 2 VIEWS**

FIXED INCOME

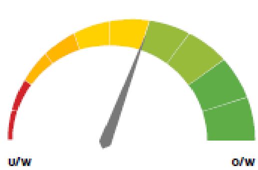
	-		N		+
1-3 Year Gov / Credit				▲	
U.S. Treasury			▲		
IG Credit		▲			
Long Duration Credit		▲			
Non-Core Credit				▲	

EQUITIES



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

REAL ASSETS



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

AS OF 9/21/2022

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