HIGHLAND

AUGUST 2026

# Asset Allocation Note

## Stuck in a Moment You Can't Get Out Of

The unrelenting heat of August seems inescapable. As we search for relief from what may ultimately be remembered as one of the hottest summers of the century, the weather is not the only force that is inescapable. The war with Iran grinds on, while disruptions in the Strait of Hormuz keep upward pressure on energy prices and inflation concerns. Against this backdrop, the second order effects of higher inflation, like higher interest rates, are becoming more evident, leaving investors to contemplate whether these pressures will pass, or whether *we can't get out of it*. Compounding concerns, the Federal Reserve has entered a new era under fresh leadership. Conversations that months ago centered on rate cuts have shifted toward the possibility of additional tightening. For borrowers hoping that today's elevated financing costs are merely a passing phase, the belief *later will be better* may soon prove to be wishful thinking. Despite higher inflation and interest rates, the U.S. economy continues to demonstrate resilience. Real GDP growth remains positive, while private domestic demand expanding even faster, suggesting underlying economic momentum is more robust than headline figures would imply.

Corporate profits and equity markets have remained strong, despite the increasing reliance on AI investment and leadership. Markets broadened in July as some defensive sectors outperformed, but without the leadership of technology and AI related sectors markets may be *stuck in a moment* waiting for a catalyst to propel equities upward. For fixed income investors, the terrain has only grown steeper. With Treasury yields at multi-decade highs and concerns over inflation, deficits, and Fed policy lingering, the path ahead is anything but clear. Can markets continue upward along *this stony path*, or will mounting risks remind investors there is *a long way down*?

ECONOMIC UPDATE

## Running to Stay in Place

*Regions Economic Division*

The initial estimate from the Bureau of Economic Analysis (BEA) shows real GDP grew at an annual rate of 1.5 percent in Q2. There is, however, more to Q2 growth than meets the eye. A wider trade deficit than that seen in Q1 knocked a full percentage point off top-line real GDP growth, while a much larger drawdown in nonfarm business inventories than that seen in Q1 knocked another seven-tenths of a percentage point off top-line growth. At the same time, real private domestic demand – combined business fixed investment, residential fixed investment, and consumer spending – grew at an annual rate of 3.9 percent in Q2 after adjusting for price changes, the fastest quarterly growth rate since Q1 2023. This suggests a far more robust pace of economic activity than implied by the headline real GDP growth print. Of the two measures, we routinely point to changes in real private domestic demand as a far more useful guide to the health of the U.S. economy.

Real consumer spending grew at an annual rate of 3.2 percent, a nice bounce back from the tepid 0.5 percent pace logged in Q1. Real business fixed investment grew at an annual rate of 8.4 percent in Q2 after having grown at a 10.6 percent rate in Q1, with real business outlays on equipment and machinery growing at a 15.2 percent rate and real spending on intellectual property products, the vast majority of which consists of computer software and R&D outlays, growing at an annual rate of 8.8 percent. Spending on intellectual property products is an early indicator of trends in labor productivity growth, and much of the spending on equipment and machinery is also setting the stage for faster productivity growth down the road. There are, however, lingering soft spots in real private domestic demand. For instance, real business spending on structures contracted at an annual rate of 5.0 percent in Q2, the tenth consecutive quarterly contraction. And, while real residential fixed investment grew at a 1.5 percent rate in Q2 after five straight quarterly contractions, that growth was more than accounted for by a faster pace of single-family construction which seems highly unlikely to be sustained over the back half of 2026.

At the same time, we'd argue that even what were interpreted as drags on Q2 real GDP growth are to some degree setting the stage for faster growth over coming quarters. Recall that imports of goods and services into the U.S. are treated as drags on GDP growth, but this is somewhat misleading as a sizable share of goods imports are either raw materials or intermediate goods used in the production of final consumer or capital goods. Historically, that share has hovered around fifty percent, but over the past two quarters that share was fifty-nine percent. Though treated as drags on current quarter GDP growth upon reaching the U.S., these imports are actually contributing to growth down the road, particularly to the extent that imported capital goods ultimately contribute to faster labor productivity growth.

Additionally, though to some extent simply reversing the spike seen in early 2025 in response to sweeping changes in U.S. trade policy, the steady drawdown in nonfarm business inventories can also be sending a signal about underlying economic growth. We think this is particularly the case in the manufacturing sector, with a steady and sizable drawdown in inventories coinciding with strengthening business investment spending and the improvement in conditions in the manufacturing sector. With manufacturers seeing steady growth in new orders and rising backlogs of unfilled orders, it is reasonable to expect growth in employment and output in the manufacturing sector in the months ahead.

So, while the top-line growth print was not all that inspiring, the details of the Q2 GDP data paint a picture of a more vigorous pace of economic activity. There is, however, one element of the Q2 GDP data that has not gotten much attention, which is what remains a wide gap between growth in real, i.e., adjusted for price changes, and nominal, i.e., measured in current prices, GDP. In a sense, this seems like old news as it is simply another way to illustrate the extent to which faster inflation has been impacting the economy. Whether to consumers paying higher prices for final goods and services or to businesses paying higher prices for inputs and services, this has for some time been a source of considerable frustration.

To that point, while real GDP grew at an annual rate of 1.5 percent in Q2, nominal GDP grew at a 7.9 percent rate, with the gap between the two reflecting the rate at which prices rose during the quarter. Though not to the extent seen in Q2, the spread between real and nominal growth has been considerably wider in the post-pandemic years than had been the case prior to the pandemic. For instance, the average spread between growth in nominal and real GDP over the fifteen years prior to the pandemic was 1.84 percent, never larger than 3.90 percent. Since 2021, however, the average spread is 4.43 percent, with a high of 9.41 percent in Q2 2022. Again, to the extent that it reflects the pace at which prices have risen, the yawning gap between nominal and real growth over the past five-plus years is not at all consistent with the FOMC's 2.0 percent inflation target.

At the same time, however, the sustained rapid growth in nominal GDP helps account for what has been exceptional growth in corporate profits over recent years, which to some is hard to square with real GDP growth having fallen back into the pre-pandemic trend rate of around two percent. Growth in nominal GDP is generally seen as a proxy for growth in business revenue, but keep in mind that GDP includes business inventories, making it a less than perfect proxy for top-line business revenue. Stripping inventories out of GDP yields the metric known as final sales of domestic product (final sales), a truer reflection of total business revenue. The point remains the same, though, as real final sales grew at an annual rate of 2.2 percent in Q2 while nominal final sales grew at an 8.7 percent rate.

To our point about the gap between real and nominal growth being significantly wider in the post-pandemic years than had previously been the case, as of Q2 real final sales were just over fifteen percent higher than in Q4 2019 while nominal final sales were forty-nine percent higher. Think of the growing gap between nominal and real final sales as the cumulative increase in prices over recent years. Still, while final sales illustrate rapid growth in total revenue, that is only half the story when it comes to growth in profits, and just as consumers have faced rapidly rising prices over recent years, businesses have contended with rapidly rising input prices, with the absorption of tariffs and higher energy prices adding fuel to an already burning fire. The data on corporate profits, however, show that even in the face of rapidly rising input prices, corporate profits have continued to grow at a notably rapid pace. Growth in both before-tax and after-tax profits, as measured in the GDP data, accelerated sharply over the back half of 2025, and each grew at a double-digit pace in Q1 2026 (the BEA's Q2 profit data will not be released until later this month).

Note that the measure of profits in the GDP data covers a much wider universe of firms than the more commonly followed S&P 500 measure of profits. Though obviously the rate of growth varies across industry groups, profit growth has nonetheless been broadly based which, in turn, has been reflected in equity valuations. Keep in mind, however, that the flip side of inflation moving back to, or at least closer to, the FOMC's 2.0 percent target rate is slower revenue growth. To that point, in the fifteen years prior to the pandemic average annual growth in (nominal) final sales of domestic product was 3.9 percent, compared with average annual growth of 7.5 percent from 2021 through 2025, with growth set to top that pace in 2026.

One reason investors are so focused on corporate guidance on revenue and costs is that almost no one sees recent rates of revenue growth as being sustainable for much longer, making cost control a more critical driver of profit growth. Still, even with effective cost controls profit growth is likely to be slower, perhaps meaningfully so, going forward than has been the case over recent years. To be sure, whether, to what extent, and how inflation slows – consumers no longer being able/willing to accept further price increases, a downturn in the broader economy, significant efficiency gains brought about by AI and faster labor productivity growth – will be a key determinant of how profits fare. To follow up on an earlier point, the only way that more rapid growth in nominal GDP/nominal final sales is consistent with the FOMC's 2.0 percent inflation target is if there is a meaningful and sustained increase in the trend rate of real growth, which still seems trapped at around a two percent pace. This is the promise offered by AI and faster labor productivity growth, but we're not there yet, and at this point no one knows how close we'll get and when we'll get there. Barring that, however, the rapid growth in top-line revenue seen over recent years will at some point give way to more measured growth.

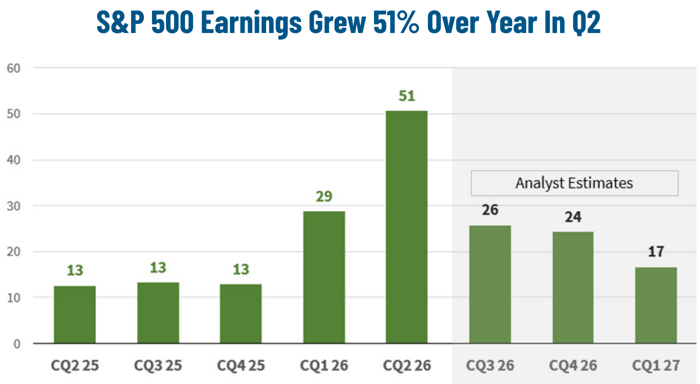
*Source: Bureau of Economic Analysis*

## Investment Strategy Update

*Regions Multi-Asset Solutions & Highland Associates*

July failed to live up to its historical billing as a positive month for stocks as U.S. equity indices struggled amid flaring tensions in the Middle East, monetary policy uncertainty stemming from the FOMC's more hawkish tone in June, and fears of increased AI competition coming from China. The S&P 500 fell by less than 0.1% on a total return basis during the month as weakness in the information technology sector weighed on the index, with the sector posting a -3.4% monthly return as semiconductor and memory stocks fell sharply as capital rotated into relative value plays. Encouragingly, the equally weighted S&P 500 gained 1% in July and beneath the surface we view breadth as constructive. At the sector level, consumer staples, energy, financials, health care, and real estate all finished the month with gains of 2% or more. This transition highlights the importance of diversification and the potential pitfalls of concentrating portfolios in one sector and/or crowding into recent winners as lost momentum can lead to heightened volatility and unsettling drawdowns if risk isn't managed appropriately.

With approximately 89% of the S&P 500 having posted quarterly results at the time of this writing, year-over-year earnings growth was tracking at a jaw-dropping 51% - more than double the 21.9% growth expected at the end of June. However, the S&P 500's reaction to this awe-inspiring growth has left much to be desired, evidenced by the index ending July effectively unchanged. This is largely a function of just how ridiculously high the bar for companies closely associated with the AI buildout was set coming into this earnings season, but market participants also appear increasingly skeptical that sales growth and/or profit margins can improve from here. Much of the weakness in many of the high-flying stocks associated with the buildout and adoption of AI during July appears to have been a byproduct of overcrowding and poor risk management/usage of leverage, which resulted in forced selling both stateside and in Korea. The July shakeout will likely prove to be a healthy event as it removes 'froth' and resets sentiment and positioning. To us, there are minimal signposts to suggest this is a burst of any perceived 'AI bubble.'




*Source: Bloomberg*

The S&P 500 has historically struggled to make gains in the August- September timeframe in the 'average' year, and in midterm election years, such as 2026, lackluster performance from the back-half of August through mid-October has become the norm, with classically defensive sectors such as consumer staples, health care, and utilities often leading an otherwise unimpressive tape. Following midterms, we tend to see portfolio re-risking and a rally into year-end as market participants digest the new balance of power in Washington D.C. While U.S. equity indices have certainly acquitted themselves quite well thus far in August, we expect geopolitical and monetary policy uncertainty to remain elevated as market participants digest Middle East headlines and a more uncertain path forward for both Fed communications and monetary policy, and with earnings season winding down and the calendar turning less kind for stocks later this month, risk appetite could remain subdued for a bit longer. However, impressive earnings results and signs that hyperscalers are already generating an ROI on AI investments leave us constructive on the outlook for capex spending. We are of the view that material downside for the S&P 500 is unlikely to materialize so long as the Mag 7 is garnering inflows and acting as a stabilizing force for U.S. indices.

Developed markets are quietly building momentum as cyclical exposure helps diversify AI. Weak price action in July held back the tech-centric NASDAQ and the adjacent semiconductor stocks in emerging markets, but the foreign-developed MSCI EAFE index played valuable defense last month, rising by 2.0% while broader equities struggled. The resurgence in international equities brought the index back to all-time highs after nearly 6-months of consolidation with the prior peak coming in February just before the Iran conflict kicked off. Investors seem more focused on valuations after shakeouts in more volatile growth and AI-related segments of the global equity market increased the demand for stability. That preference in investor positioning suggests that should a broader sell-off in thematic stocks tethered to artificial intelligence crop up again, the haven trade could be in foreign equities known for their consistent cashflows. From a technical perspective, new highs are an overt positive, especially when taking that price action alongside improving breadth and above-average fundamentals. Developed international equites still appear primed to serve as a worthwhile stabilizer in portfolios, even if they don't carry the same earnings growth power evident in AI-related technology companies.

Emerging market rotation and currency strength are a positive signal, but momentum may not immediately return. Technology tailwinds turned against global equities last month and leaders became laggards as emerging market equities were some of the hardest hit in July, with the MSCI Korea index declining by 23.7%, finishing the month in a 29.3% drawdown. Tech hardware struggled broadly as concerns surfaced around AI Cap-Ex and how more efficient models might dampen semiconductor company profits, but this was exasperated by the rampant leverage in South Korea that unwound in July. That deleveraging was tough on concentrated investors, but the broader MSCI EM index was only lower by 3%, as the old guard carried the mantle with China, Brazil, and India partially offsetting substantial losses in Korea and Taiwan. The MSCI China index specifically had its best month since September, as recent AI model developments reminded investors that Chinese companies are going to push for market share by launching lower cost alternatives to the domestic frontier AI models. Technically speaking, the recent momentum in China hasn't been enough to turn around its declining primary trend, as the MSCI China index remains 2.8% below its 200-day moving average. Emerging equities got cleared out last month, but this does not guarantee a V-shaped recovery, as momentum traders may be slow to rush back into high-flying semiconductors as the toll of leverage is fresh in investor psyche.

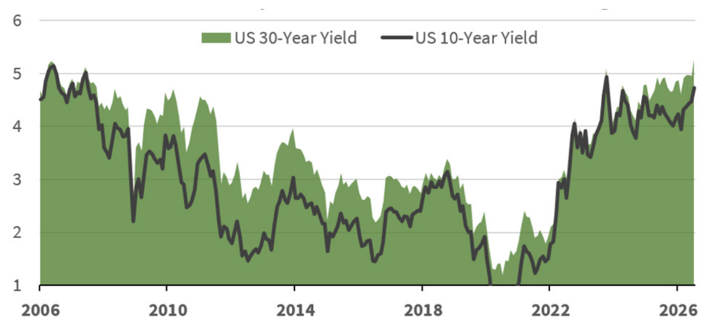
The new 'Bond Vigilantes' could test the FOMC's inflation fighting resolve. In the early 1980's, famed strategist Ed Yardeni coined the phrase "bond vigilantes" to describe a prominent and vocal cadre of fixed income market participants selling U.S. government bonds in response to what they viewed as inflationary and/or fiscally irresponsible policies. Selling from the 'vigilantes' led to a sharp move higher in Treasury yields and a commensurate selloff in bond prices, with the 30-year U.S. Treasury yield jumping from around 10.4% at the end of 1982 to 13.6% by June of 1984 as investors pushed back on fiscal spending plans. The selloff in longer maturity bonds increased borrowing costs and forced Congress to pass deficit-reduction legislation later that year and the 30-year bond yield retraced the entirety of the move higher by June of '85.

Fast forward 40-plus years, and while the absolute level of Treasury yields is a far cry from the absolute levels seen in the early 80's, the U.S. government's annual budget deficit is projected to be over 10X greater this year than it was in 1984. The U.S. government's debt is now just shy of $40 trillion and with rumblings of downgrades to its credit rating growing louder, fixed income investors both at home and abroad are requiring greater compensation in the form of higher yields to buy U.S. government bonds. Deep pocketed investors with long-dated liabilities will at some point find it difficult to ignore higher yields, but until the recent bout of volatility in the Treasury market subsides and prices start to stabilize, they may drag their feet.

Treasury yields could remain volatile with an upward bias in the lead-up to midterm elections in early November, particularly if the FOMC fails to back up its tough talk on inflation with action when it meets next month. Market participants initially took FOMC Chair Kevin Warsh's comments following the Committee's June meeting as 'hawkish,' which led to a flattening of the yield curve as short-term rates rose sharply. But nearly two months after that meeting, market participants, i.e. "the new vigilantes," appear more willing to press their bets and challenge the new Chair's resolve when it comes to fighting inflation. In the lead-up to the FOMC's late-July meeting, the Fed funds futures market placed the odds of a rate hike prior to September at 100%, but following Warsh's post-meeting press conference those odds fell to around 60% as he noted that the bond market had done some of the FOMC's work for it by pushing short-term rates higher and tightening financial conditions. Historically, it has been the equity market that has often challenged new Fed chairs, but this time around, U.S. equity indices are at all-time highs, and it is the bond market and rising yields that could force the Committee's hand.

In early August, the U.S. and Japan took steps to backstop the Japanese yen, easing concerns surrounding Japan potentially needing to sell U.S. government bonds to prop up its currency. The move spurred a rally in long-term Treasuries, but Japan will need to take steps to adjust both fiscal and monetary policies to prevent the yen from weakening relative to the U.S. dollar again, with a rate hike out of the Bank of Japan (BOJ) a likely first step in the months to come. Japan no longer being a forced seller of Treasuries in the near-term, combined with energy prices moving lower amid hopes of de-escalation in the Middle East, could take some pressure off Treasury yields. However, the rally in long bonds to kick off August could prove to be little more than an oversold bounce, and we remain of the opinion that downside for yields will be limited as both variables could easily reverse course and take a less constructive turn for higher quality, longer duration bonds.

**30-Year Treasury Yield Breaks Out To Two Decade High**




*Source: Bloomberg*

The grind higher in U.S. treasury yields for the better part of the year thus far has left many fixed income investors underwater in 2026, but diversification has dulled that pain for investors willing to go beyond core fixed income. Of the bond indices we track, only the high yield index and emerging market debt index have been able to generate a positive total return year to date through July. These segments may not be cheaper than where they started the year from a valuation standpoint, but both subsets offer meaningfully higher income, a powerful driver of total return. The Bloomberg U.S. High Yield Corporate Index which now offers a 7.4% yield-to-worst, higher than the 6.5% yield it carried at the start of the year. The uptick in yield improves expected total return and is likely to create a ceiling on how high valuations can get as buyers will be more willing to step in at higher yields. Any hints of cheapness could present a buying opportunity, but for now we remain underweight for a chance to increase exposure should dislocations occur.

# Highland Outlook

Overall, the economy continues to grow, and the labor market remains steady. This has been supportive of risk assets and domestic equity markets are on pace for another year of double-digit returns. Bonds, on the other hand, have struggled with higher yields and nominal returns are relatively flat through the first seven months of 2026. However, this doesn't account for the loss of purchasing power, so in reality, core fixed income portfolios are around 2% lower than when they began the year.

As inflation readings tick lower, the moves are marginally improving the expected real returns of domestic fixed income. Spread risk remains the primary concern within credit due to their tight levels relative to recent years. Duration risk is a secondary concern and very evident at the end of July as yields moved higher in response to selling pressure from the BOJ. We do think that there may come a time that Treasuries look attractive, specifically if we see a resolution to the conflict in Iran that results in falling inflationary pressure. That being said, other troubles are on the horizon due to the rising cost of interest on outstanding Treasury debt. The U.S. government continues to run a steep budget deficit, with 2026's numbers on pace to hit -$2 trillion. This deficit is being funded by debt, which has grown approximately $2.4 trillion annually over the past three years. The interest cost on that outstanding debt is on pace to reach $1.4 trillion by the end of 2026. So, while we would expect Treasuries to remain a preferred asset in risk-off environments, fiscal policy is creating additional risks that will have to be addressed at some point.

Positive earnings continue to drive tech names higher into August, and these earnings support the growing valuations. Beneath the surface, however, we do have a growing concern surrounding the amount of circular financing apparent in the sector. There have been a number of high-profile announcements of chipmakers and hyperscalers investing in the funding rounds of AI developers, those companies then turn around and spend the raised capital by purchasing GPU's and cloud computing services from those same investors. This creates a feedback loop that pushes further investments and purchase orders, ultimately driving up valuations and revenues. Capital expenditures related to the buildout of AI infrastructure have been tremendous, with hyperscalers projected to spend over $1 trillion over the next twelve months. This has been eating into company free cash flows, and many will need to increasingly rely on equity and debt financing to keep up pace with peers. As projects come online, the returns on those investments need to meet expectations and prove that these projects are worth the capital and deserve the continued investment.

Equities and inflation-sensitive assets should continue to benefit from higher earnings and elevated inflationary pressures. While fixed income struggled early in the year, the space may see incremental benefits from higher nominal rates if we see CPI readings make additional moves lower. Given this backdrop we remain comfortable with our neutral allocations across the board, but will continue to monitor new developments and tactically adjust our portfolios to changing conditions.

## 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 | | ▲ | | | |

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