Asset Allocation Note

Break on Through (To the Other Side)

As the nation commemorates its 250th birthday, the markets may be turning a page to a new era of their own. History reminds us that a *country in* its prime can celebrate, endure conflict, and reinvent itself all at once. A new Fed Chair has swapped his predecessor's carefully crafted messaging for a leaner, albeit sparse, communication style. The recalibration lands just as our short-lived truce with Iran shows real signs of falling apart. The recent volatility surrounding the Iran conflict has revived questions about oil and broader commodity prices. As renewed conflict threatens to keep inflation elevated and monetary policy uncertain, a quieter shift is unfolding beneath the surface: market leadership is rotating.

Leadership, it seems, is changing everywhere. The Magnificent Seven has relaxed its grip on the market, with a broader cast of small domestic companies beginning to take over. Overseas, leadership has shifted from emerging markets toward developed economies. Investors who have long *tried to run and tried to hide* in a handful of dominant names may soon find themselves looking beyond the AI trade. In a summer where little feels settled—rates, inflation, market leadership, or politics—the question is becoming harder to ignore: is the groundwork being laid for a turbulent fall? Markets have been resilient to this uncertainty so far. Will they *break on through*, or will they lose their footing while climbing the wall of worry?

ECONOMIC UPDATE

A New Fed Chair in Town

Regions Economic Division

Well, that didn't take long. Ahead of the June FOMC meeting, it was generally expected that new Fed Chair, Kevin Warsh, would put his stamp on the Committee. What was unexpected, however, was the speed with which he did so and the breadth of the changes he would, and would like to, make, both in how the FOMC conducts monetary policy and in how they communicate with the markets. Given that central banks are, rightly or wrongly, generally perceived to be slow to act and even slower to change, Mr. Warsh's first meeting came as quite a jolt to many analysts and market participants. That, of course, is not necessarily a bad thing.

The most immediate indication that things were different was the Committee's post-meeting policy statement, which was substantially shorter than those issued over the past several years. One factor contributing to the brevity of the post-meeting policy statement is that it offered no forward guidance, save perhaps for the final sentence, which read "The Committee will deliver price stability." Recall that ahead of the meeting it was widely expected that the Committee would strike the implicit easing bias from the forward guidance offered to the markets, but we're not sure anyone was expecting they would dispense with forward guidance altogether. Then again, in light of Mr. Warsh having in the past frequently questioned the value of forward guidance, perhaps doing away with it should not have been all that surprising.

Highland Associates, Inc. is an institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined beneft plans and defined contribution plans. Please visit the website at highlandassoc.com to leam more.

The June FOMC meeting brought the release of an updated Summary of Economic Projections (SEP), which includes members' forecasts of real GDP growth, headline and core inflation, and the unemployment rate, as well as the "dot plot," which shows the path of the Fed funds rate each Committee member sees as being appropriate with their outlook for growth and inflation. One question ahead of the June meeting was whether Chair Warsh would contribute to the SEP, given his well-known disdain for the SEP in general and the dot plot in particular. A quick count of the updated dot plot showed only eighteen dots, meaning that one FOMC member did not submit projections, and there seemed little question that Chair Warsh was the FOMC member in question. As for those who did submit projections, the updated dot plot took a surprisingly hawkish turn from the March edition, with nine of the eighteen Committee members indicating they felt at least one twenty-five basis point hike in the funds rate by year-end 2026 to be consistent with their outlook for growth and inflation, with six members indicating multiple funds rate hikes would be appropriate by year-end.

For market participants busily trying to process these changes, the thirty minutes between the release of the post-meeting statement and updated SEP and the start of Chair Warsh's post-meeting press conference must have seemed more like three minutes, and things didn't exactly slow down once the press conference started. Perhaps the least surprising element of the press conference was Mr. Warsh acknowledging that he indeed was the Committee member who did not contribute to the SEP. Mr. Warsh then announced what will amount to a comprehensive review of the conduct of monetary policy to be conducted by task forces focusing on five areas: 1) Fed communications; 2) the Fed's balance sheet; 3) the Fed's use and reliance on existing sources of economic data; 4) productivity and jobs in an era of transformation (as Mr. Warsh put it); and 5) the Fed's inflation frameworks, or, the drivers of inflation and the Fed's options for achieving price stability in a changing economy. Each task force, consisting of members from within and outside of the Fed, will be charged with examining current practices, asking "hard questions," considering alternative approaches, and ultimately proposing steps for FOMC members to consider. All of this coming just several minutes into the press conference had many analysts, market participants, and likely more than a few of the gathered reporters asking, "wait, what just happened here?"

As noted above, Mr. Warsh did not wait for the task force on Fed communications before doing away with forward guidance. We don't necessarily disagree with Mr. Warsh in questioning the value of forward guidance. After all, a seemingly endless stream of public comments by FOMC members may elicit market reactions but provides little clarity around the path of the Fed funds rate. Many were quick to object to the elimination of forward guidance on the grounds that it would trigger greater volatility in the financial markets. That argument, however, doesn't carry much weight in an environment in which each and every economic data release is seemingly evaluated in terms of what it means for the FOMC on the basis of seemingly nonstop forward guidance, as opposed to what it means for economic growth, inflation, and corporate profits. Given the twists and turns that are inherent in much of the economic data, this approach can be, and often is, a source of considerable market volatility.

Mr. Warsh offered a more forceful defense of doing away with forward guidance, noting that "financial markets perform best when they react to incoming data" but work far less efficiently when the reactions to the data are couched in terms of what it might mean for the Fed. He went on to say that changes in asset prices "are probably the most important source of information to guide central bankers." The signals being sent by changes in asset prices, however, are distorted "when all the financial markets are doing is reflecting back what we've said."

To us, this was the most important and meaningful part of Mr. Warsh's press conference, and anyone who has ever been confused by bad (good) economic data being treated as good (bad) news by the markets would probably agree. Though we do not at all disagree with Mr. Warsh's premise, it does raise a serious concern. Specifically, much of what is now considered the "top tier" economic data is plagued by measurement/collection issues, seasonal adjustment noise, and reporting lags. After all, if the economic data releases are more noise than signal, then changes in asset prices based upon these releases are also more noise than signal, making them far less useful signals to market participants and central bankers alike.

A few recent examples illustrate our concerns. For instance, the Bureau of Economic Analysis (BEA) recently released their third estimate of Q1 GDP, showing real GDP grew at an annual rate of 2.1 percent in Q1, better than the second estimate of 1.6 percent and not too far from the initial estimate of 2.0 percent growth. The details of the revision, however, are not so favorable, as the upward revision to real GDP growth largely reflects a smaller trade deficit and a smaller drawdown in business inventories than previously estimated. At the same time, growth in real consumer spending was revised down to an annual rate of just 0.5 percent from the second estimate of 1.4 percent on slower growth in services spending. That revision, however, was concentrated in two categories – net foreign travel and financial services – and is not indicative of underlying trends in consumer spending. Moreover, the cadence of the GDP data is such that the BEA's third estimate of real GDP growth in any given quarter comes roughly three months after the end of the quarter, the point being that backward looking data is of little value to forward looking market participants and central bankers.

The past two monthly employment reports are prime illustrations of our concerns, as both the May and June employment reports are far more noise than signal (we discussed the May report in last month's edition). Total nonfarm payrolls are reported to have risen by 57,000 jobs in June, far below the consensus forecast, while prior estimates of job growth in April and May were revised down by a net 74,000 jobs. Estimates of changes in payrolls in leisure and hospitality services have been riddled by seasonal adjustment issues over the past several months, which have played a key role in the sharp swings in headline job growth on a seasonally adjusted basis. Additionally, the initial collection rate for the June establishment survey was notably low – the lowest June rate since 1992 – which right off the bat diminishes the reliability of the initial estimates of nonfarm employment, hours, and earnings in June.

At the same time, the household survey data show the unemployment rate falling to 4.2 percent in June, but this reflects what is reported to be a sixty-basis point decline in the labor force participation rate amongst the 25-to-54 year-old age cohort, i.e., the "prime working age population." The not seasonally adjusted data show that the number of prime age adults in the labor force fell by over 1.1 million persons in June which, aside from April 2020, is easily the largest monthly decline on record in data going back to 1948.

To be sure, the issues with the past two monthly employment reports are clear and obvious, yet each report has elicited strong market reactions, though to our earlier point these reactions have mostly been couched in terms of what each report might mean for the path of the Fed funds rate. It's almost as though market participants (and more than a few analysts) have become conditioned to interpret each and every economic data release in these terms. Whether that is due to excessive forward guidance from the FOMC cannot be determined, but in the absence of more timely and more reliable economic data, it's a moot point. Either way, Mr. Warsh seems intent on breaking market participants of this habit by eliminating forward guidance. At the same time, though, Mr. Warsh's task force on sources and uses of economic data clearly has its work cut out for it.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; U.S. Census Bureau

Investment Strategy Update

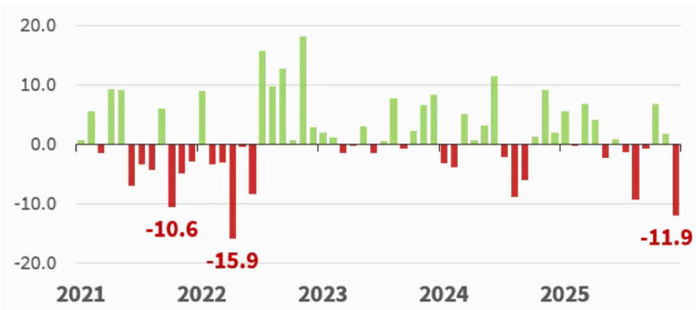
Regions Multi-Asset Solutions & Highland Associates

U.S. equity indices posted mixed results in June, with the S&P 500 falling 1%, while small and mid-cap indices fared much better, with the S&P Midcap 400 and Small Cap 600 rising 3.4% and 7.1%, respectively. Investors had a lot thrown at them during the month with the long-awaited SpaceX IPO, a new FOMC Chair taking the helm, and quarter-end portfolio rebalancing, just to name a few potentially market-moving events. But after cramming quite a bit of 'noise' for market participants into June, earnings season ramping up in mid-July could provide a welcome reprieve and allow investors to again focus on the outlook for corporate profits, which could provide support for risk assets.

S&P 500 earnings are estimated to have grown by 22% year-over-year during the second quarter. While this would be a deceleration from the strong 25.3% year-over-year earnings growth seen in 1Q26, it would likely be enough for U.S. large cap stocks to find their footing and resume rising after taking June off. The focus should continue to be on the outlook for earnings, and with year-over-year growth projected to reaccelerate to 24.6% in the 3rd quarter, it's difficult to get too bearish despite the June swoon and shaky start to July. Monetary policy expectations are also worth watching, and should energy prices remain anchored around pre-conflict levels, inflation expectations could move lower and rate hikes could be priced out, which would likely lead to improved risk appetite and sentiment.

Other than continued strong relative performance out of smaller capitalization stocks, what stood out most in June was the glaring weakness out of the 'Magnificent 7.' An equally weighted basket of those names fell by 8.8% during the month, with Tesla's 3.4% decline the best of the bunch and Microsoft's 17% monthly drop giving it the distinction of worst performer. The Mag 7 selloff coincided with a pronounced rotation out of the communication services and information technology (IT) sectors, which together account for 47.5% of the S&P 500, as investors grew increasingly concerned about the durability of the rally in AI-related area. Mag 7 members, viewed as some of the biggest expected spenders on AI infrastructure, were hit the hardest amid rumors some were weighing issuing stock to finance their spending booms. Aside from potentially dilutive capital raises, the $75B SpaceX IPO also likely contributed to the pullback in the Mag 7 last month, as these are the most liquid names in the market and are an easily accessible source of funds. As these companies begin to post quarterly results, investors will likely focus on commentary surrounding both AI spending guidance as well as clarity on how these companies intend to fund the buildout. If management teams can ease concerns of dilutive equity raises, then this cohort, along with the broader S&P 500, could resume its ascent.

Magnificent 7 Had Its Worst Month Vs. 'The S&P 493' Since October '22



Source: Bloomberg

Smaller capitalization stocks in the U.S. closed out June and the first half of the year on a high note, with the S&P Small Cap 600 index rising 7.1% on the month and 23% year-to-date. The strength of the rally in small caps this year has been surprising, as the rapid and unsettling rise in energy prices over the March through May timeframe led to inflation expectations being in flux and generated concerns that the FOMC could be tightening monetary policy in the back half of this year. All else being equal, a higher Fed funds rate and economic uncertainty would typically raise borrowing costs for these companies and act as a drag on earnings growth and free cash flow generation. But the S&P 600 has shrugged off the prospect of a more hawkish Fed and uncertainty surrounding energy prices and the U.S. economy, despite the fact that the 600 skews heavily toward economically sensitive areas, with the consumer discretionary, financials, and industrials sectors accounting for 49% of the index, compared to 29% in the S&P 500.

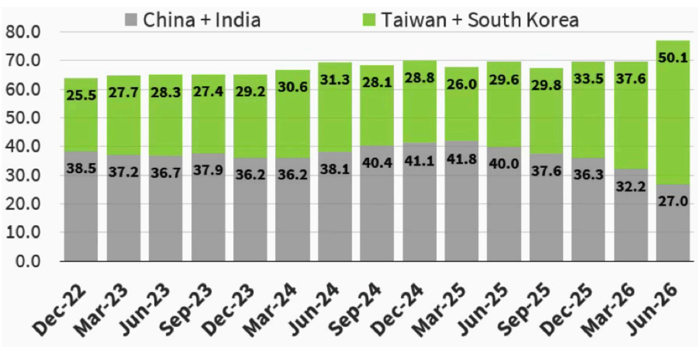
The rally in small caps so far this year has been at least partially a function of offsides positioning as investors crowded into S&P 500 stocks closely tied to the buildout of AI infrastructure last year. But with concerns surrounding AI-related spending and a lack of return on those investments growing louder in recent months, investors have taken profits in mega cap technology and reallocated proceeds into small caps which are relatively less sensitive should AI-related spending ebb. The rebound has likely also been driven by expectations that mergers and acquisitions (M&A) will accelerate this year. The 33.5% rally in the S&P 600 biotechnology industry group year-to-date through last month, with 21% coming in June alone, is evidence that investors are eager to participate in a potential wave of buyout activity and small caps give them a higher beta way to do so. While we have questioned the durability of the improved relative performance out of smaller capitalization stocks in recent months, recent price action warrants attention and we have little choice but to respect the rally, and if capital continues to flow into the U.S. from abroad and the U.S. dollar steadies or strengthens from here, small caps could continue to perform well in the months to come.

Developed foreign markets outpace emerging markets as investors see value in 'Value.' Economically sensitive sectors led stateside and gained traction abroad in June as the MSCI EAFE eked out a 0.1% gain while the now tech-heavy MSCI Emerging Market (EM) index was lower by 1.3%. The divergence between the two was evident early in the month as the VIX rose into the low-20s on June 11, leading to a 5% drawdown in the MSCI EM which tested support at its 50-day moving average. During that timeframe the MSCI EAFE was off by a less drastic 2.6%, exhibiting relative strength that is even more encouraging when considering the index quietly made a series of higher highs in May and June. The EAFE's positive price action coincides with better than anticipated inflation readings out of major European economies last month, causing futures markets to push out the next ECB policy move to March of 2027 instead of September. All told, the near-term trend improvement is intriguing for foreign stocks, but the U.S. Dollar index (DXY) breaking above $100 last month sets up a more difficult backdrop for international stocks over the intermediate term.

The DXY rallied to close June at $101.18, its highest level since May of 2025, throwing cold water on emerging market equities in the process as the MSCI EM currency index finished June lower by 1.1%. The story in emerging markets comes across as more of a bottom-up narrative, as rising index concentration is creating volatile trading in the broader benchmark. At the end of 2Q, Taiwan and South Korea combined account for more than half of the MSCI EM index, a staggering datapoint considering the pair made up roughly 29.6% of the index just four quarters ago. The insatiable demand for South Korea-based AI-related names led memory maker SK Hynix to file for a U.S. IPO to sell roughly $28B in ADR's this month. Increased leverage and heightened volatility have been at the forefront in South Korea, prompting us to take a more cautious view on

South Korea, specifically, and the MSCI EM index broadly as outsized moves are unsettling and likely to weigh on sentiment. If volatility persists and risk appetite wanes, we could see a meaningful deleveraging cycle that could accelerate the sell-off, as history shows leverage unwinds don't end with a whimper. However, once the pullback in South Korea ends and firmer footing can be found, EM may again be an attractive spot to deploy capital.

MSCI EM Index Concentration



Source: Bloomberg

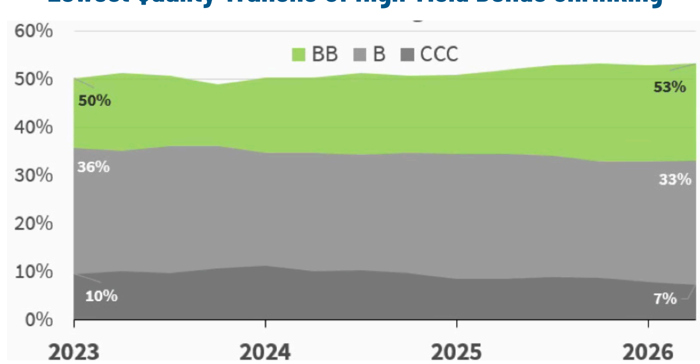
A shift In Fed communications strategy may contribute to a more volatile rate backdrop. Bonds across segments and of varying credit quality benefitted from the drop in yields on longer-dated U.S. Treasuries during June, with the Bloomberg Aggregate, Bloomberg U.S. Corporate, and Bloomberg U.S. Corporate High Yield index all generating gains of around 0.2% during the month. Credit spreads on high-yield corporate bonds finished the month higher by 8-basis points (bps), while investment-grade spreads leaked wider by just 2-basis points. Yields on U.S. Treasuries maturing inside of 5 years rose during the month as market participants bet on rate hikes out of the Federal Open Market Committee (FOMC) before year-end. All told, the 2-year U.S. Treasury yield rose 16-bps over the balance of the month, while the closely watched 10-year yield finished the month lower by 1-bp.

The flattening of the yield curve was driven by a combination of factors, but chief among them were comments made by new Fed Chair Kevin Warsh following the June FOMC meeting that were perceived to be decidedly hawkish, which put upward pressure on short-dated yields, while falling energy prices and inflation expectations served to pull yields on longer-term bonds modestly lower.

Amid this potential backdrop, a broadly diversified fixed-income portfolio remains preferable, with exposures to higher quality Treasuries and investment-grade corporate bonds, high-yield credit, and foreign developed and emerging market bonds all potentially valuable exposures. Bouts of elevated volatility should be expected as market participants are likely to occasionally be caught offside by shifts in Fed policy, which will create dislocations and could cause bond prices to diverge from fundamentals more often than we have grown accustomed to. These divergences may create opportunities for active managers to seek incremental value, but in the near term most fixed income sub-asset classes still appear fairly to fully valued, which leaves us with allocations that fall in line with our strategic long-term target exposures as we kick off the 3rd quarter. High yield credit spreads leak wider as demand can't keep up with supply. Prices of below-investment-grade bonds moved modestly lower in June as the option-adjusted spread for the Bloomberg U.S. Corporate High Yield index went from 257 basis points (bps) over Treasuries to 270 bps by month end. That incremental move wider comes after index spreads tightened in each of the prior two months from their March peak. From our perspective, more interesting than the absolute level of spreads is the intra-month trend which entailed a series of higher highs for spreads as riskier assets encountered pockets of volatility.

Waning risk appetite played a part in the June pullback in high-yield bonds, but so did the technical backdrop as roughly $34.4B of new paper was issued during the month, the second highest month for issuance this year. All while light summer trading volume led to sparse demand and likely had a hand in pushing bond prices lower. The recent dip in demand could improve prospective compensation as underlying credit fundamentals continue to improve with BB-rated exposure climbing to over 53% within the index, while lower quality CCC-rated bonds have declined to roughly 7% at the end of June. All told, the asset class could provide yield to support prices beyond a modest dip but rising tech exposure in this segment is a potential risk worth monitoring.

Lowest Quality Tranche Of High Yield Bonds Shrinking



Source: Bloomberg

Highland Outlook

As we look to the 2nd half of 2026, inflation remains a key factor to watch as it continues to dwell above the Federal Reserve's 2% target. The new FOMC Chairman, Kevin Warsh, has stated that the Committee is committed to restoring price stability and market participants have been positioning for the potential of higher rates. We continue to believe energy prices linked to the conflict in Iran are an important contributor to inflation pressures, although other factors are now at play. Some forecasters have become increasingly concerned about a 'super' El Niño, a phenomenon where warmer waters in the Pacific Ocean alter typical weather patterns around the globe. Such conditions can disrupt crop yields and affect food prices, which are already elevated due to higher oil prices impacting shipping costs. High oil prices combined with a decrease in crop yields would only exacerbate the pain consumers are feeling at the grocery store. While the labor market appears strong, the personal savings rate (as a percentage of disposable income) continues to decline as consumers battle higher prices. While a temporary ceasefire in Iran provided some respite for oil prices, renewed strikes could drive those prices back up in the second half of the year.

Fixed income remains challenging as Treasury yields continue to climb, particularly within the 1- to 3- year portion of the yield curve, and the 30-year Treasury now sits above 5%. Spreads, on the other hand, continue to remain narrow on both investment grade and high yield debt. Highland has been cautious about fixed income due to the lack of real return and higher correlation to equity markets, and this theme is likely to continue through the second half of the year. The additional yield from higher rates helps to alleviate some of the concern of real return, but investors should remain cautious of spread risk given current levels. Core fixed income has historically served as a diversifier during periods of market turmoil, but the threat of inflation could limit that protection that would otherwise be seen from typical risk-havens such as U.S. Treasuries.

Highland Associates Cross Asset Views

TIER 1 CALLS

FIXED INCOME

EQUITIES

REAL ASSETS

TIER 2 VIEWS

Tier 1 Call	Tier 2 View	-		N		+
FIXED INCOME	1-3 Year Gov / Credit			▲		
	U.S. Treasury			▲		
	IG Credit			▲		
	Long Duration Credit			▲		
	Non-Core Credit			▲		
EQUITIES	United States			▲		
	Int'l Developed			▲		
	Emerging Markets			▲		
REAL ASSETS	U.S. TIPS			▲		
	Commodity Futures			▲		
	Commodity Equities			▲		
	Global Infrastructure				▲	
	Public Real Estate		▲			

AS OF 6/16/2026

Equity markets remain near their all-time highs, but momentum has slowed after peaking in late May. Highland's Investment Working Group met in June to discuss the firm's tactical overweight to Emerging Market equities and the trade was unwound after a holding period just shy of seven months. The ultimate decision was made to "lock in the gains" and unwind the tactical overweight and return the portfolio to a neutral geographic allocation given the increased influence that AI names were having on emerging market equity indices. While there may be additional gains to be had within the Tech sector and Artificial Intelligence, the move reduces tracking error within our equity portfolios.

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