

Asset Allocation Note

Fake Plastic Trees

Summer has arrived, and it isn't just the temperature that's climbing. The latest CPI print shows inflation accelerating at 4.2% year over year, underscoring pressures that refuse to abate. Meanwhile, oil prices remain elevated, even as the Strategic Petroleum Reserve has been drawn down to depths not seen since 1983. Higher energy prices look like *the real thing*, and price pressures have only just begun to seep into the consumer ledger. Overlaying it all, geopolitical tensions continue. Equity markets, however, have remained resilient. With SpaceX in the books and Anthropic and Open AI newly filled, as many as three trillion dollar IPO's could emerge in 2026. Should these venture titans come to market, the effective float of U.S. equities could swell by more than 5% when lockups expire. An overlooked truth is that equity markets are not immune to the oldest law in commerce. Like any market, they generally bend to the forces of supply and demand, and when supply surges, *gravity always wins*. In U.S. dollar terms, a remarkable convergence has unfolded: the MSCI Emerging Markets Index, MSCI EAFE, and both leading U.S. equity indices reached record highs in unison earlier this month, a feat not witnessed since October 2007. Beneath this synchronized ascent, the backdrop may be shifting. A new Federal Reserve chair presides amid firmer inflation, resilient employment, and richly valued asset markets, prompting investors to question the return of rate hikes later this year. Will inflation *blow through the ceiling*? Will the gathering risks beneath the surface make equity markets turn and run, or can the cadre of equity indices continue to perform well for investors *all the time*?

ECONOMIC UPDATE

Economy Remains Resilience but Not Immune

Regions Economic Division

The U.S. economy has proven to be more resilient than many would have anticipated in early March, at the start of the conflict with Iran. Consumer spending has held its own, business investment spending continues to grow at a robust pace, conditions in the manufacturing sector continue to improve, and the labor market seems to be on firmer footing than it was earlier in the year. To be sure, the housing market remains a glaring weakness, particularly with the increase in mortgage interest rates seen since the start of the conflict. Moreover, inflation has reaccelerated, and while the obvious catalyst is the spike in energy prices that have pushed headline inflation meaningfully higher, the reality is that by their own preferred measure, core inflation has been above the FOMC's 2.0 percent target for five straight months.

Perhaps the changes in economic conditions and perceptions of the U.S. economy are best captured in the dramatic change in expectations for the path of the Fed funds rate. Earlier this year, analysts and market participants were debating how many times the FOMC would cut the Fed funds rate as they rode to the rescue of the labor market. By the end of the first week of June, that debate had shifted to how many times the FOMC would hike the Fed funds rate to help quell stubborn inflation pressures. Still, just as we sat out the debate earlier in the year, we're sitting out the

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current debate. We came into this year thinking there was very little room for the FOMC to move, and we think that remains the case despite the world around us looking very different than it did at the start of 2026.

To say the economy has been resilient in the face of jumps in energy prices and interest rates since the start of the conflict is not to say the economy has been immune. In particular, higher prices have weighed on real growth, as we discussed in last month's edition. One way to see this is to trace the path of our baseline forecasts of 2026 GDP growth over the past several months. Since our February forecast of 2.7 percent growth, our forecast of full-year 2026 real GDP growth has come down in each successive month and, as of our June forecast, stands at 2.0 percent. As our forecasts of real GDP growth have been marked down, our forecasts of nominal GDP growth have been marked steadily higher, the divergence reflecting the extent to which our inflation forecasts have been revised higher.

Simply stated, higher prices mean that each additional dollar of spending at current prices translates into a smaller increase in spending after adjusting for prices, i.e., real spending. One way to think of it is having to run faster and faster (nominal spending) just to stay in the same place (real spending). Thus far, consumers have been able to spend at the faster pace dictated by rising prices thanks to a number of supports. One is that aggregate labor earnings, the largest block of personal income, continue to grow at a rate faster than inflation. Consumers have also benefited from meaningfully larger income tax refunds this year than those seen last year, while continued increases in equity prices have helped sustain the wealth effects that are supporting spending amongst upper income households. Additionally, a steadily declining saving rate suggests consumers are dipping into savings to help keep pace with rising prices.

Still, there is cause for concern. The cushion from income tax refunds is being rapidly pared down and consumers could easily reach the point where they're inclined to cut back on spending rather than further deplete savings. At the same time, faster inflation means the gap between growth in labor earnings and inflation is much narrower at present than had been the case, meaning less support for real spending growth. That support would be further weakened by a deterioration in labor market conditions. Concerns over the labor market, however, have abated considerably, in stark contrast to earlier this year. It is striking that while earlier this year many were pointing to the labor market as grounds for the FOMC to make further cuts to the Fed funds rate, in the wake of the May employment report many are

now pointing to the labor market as giving the FOMC the latitude to raise the funds rate to combat stubborn inflation pressures.

Total nonfarm payrolls rose by 172,000 jobs in May, more than double the consensus forecast, with private sector payrolls up by 120,000 jobs and public sector payrolls up by 52,000 jobs. At the same time, prior estimates of job growth in March and April were revised upward by a net 93,000 jobs for the two-month period, and the unemployment rate held at 4.3 percent. In the wake of the release of the report, yields on U.S. Treasuries moved higher across the entire yield curve, and a 25-basis point increase in the Fed funds rate by year-end was more than fully priced into the futures market, a reaction which we find more than a bit baffling. Indeed, our take on the May employment report, and the reaction to it, is that seldom have we seen so much made out of so little.

The details of the data support our take. May's increase in public sector payrolls was driven by payrolls in local government excluding education rising by 43,500 jobs, while the increase in private sector payrolls was driven by payrolls in leisure and hospitality services rising by 70,000 jobs. What the two have in common is that they were largely driven by hiring ahead of the World Cup, with local governments taking on workers to help with things such as security and infrastructure and businesses, particularly restaurants, adding staff in anticipation of higher customer traffic. To the extent this was the case, it follows that once the World Cup is over, payrolls in these segments will go back to where they would have otherwise been. In addition to the outsized increase in payrolls in leisure and hospitality services, healthcare payrolls rose by 47,200 jobs in May, with these two segments almost fully accounting for the increase in private sector payrolls.

All but lost in the hype over the headline job growth numbers over the past few months is that, despite the big headline prints, there has been strikingly little growth in aggregate private sector hours worked, which is what matters for output growth. To that point, despite the gain of 120,000 jobs, aggregate private sector hours were basically flat in May. In part, this is compositional, as job gains were concentrated in leisure and hospitality services and health care, industry groups in which weekly hours are well below the private sector average. That aggregate hours were flat means that the sizable increase in private sector payrolls did little to advance output growth in May while also blunting the increase in aggregate private sector wage and salary earnings.

Gains in household employment over the past several months have lagged gains in payroll employment by a wide margin, and that the unemployment rate has been basically flat is a testament to how tepid growth in the labor force has been. To some extent, this reflects the ongoing decline in the foreign born labor force, which we've been pointing to since late-2024 as a potentially powerful drag on job growth. Additionally, even though the layoff rate remains below pre-pandemic norms, those who do lose a job are having a harder time finding another, which is reflected in the rising duration of unemployment and what, excluding the pandemic period, is now the highest level of long-term unemployment (27 weeks or more) since 2016.

Our view of the labor market has not changed for quite some time. Just as earlier in the year we were pushing back on the dour takes on labor market conditions, we now find ourselves pushing back on the narrative that the labor market is again firing on all cylinders. We've consistently pointed to supply side and demand side factors holding down job growth and have argued that what will be notably slow trend job growth will nonetheless be sufficient to keep the unemployment rate stable if not slightly lower. If and when we have grounds to change our view, we will, but the May employment report doesn't come close to warranting that, let alone providing a rationale for the FOMC to hike the Fed funds rate.

While such a move may come at some point, it won't come at this month's FOMC meeting. As noted above, as measured by the PCE Deflator, core inflation has been at least one hundred basis points above the FOMC's 2.0 percent target rate for five straight months (the May data will make that six straight months). Moreover, indicators of early-stage price pressures, such as the Producer Price Index, show intensifying upward pressures on costs for producing and shipping goods that figure to, at least in part, ultimately show up in measures of core inflation on the consumer level. Clearly, there will be no "easing in" period for new Fed Chair Warsh but, that said, the only "news" likely to come out of this month's FOMC meeting is the Committee dropping the implicit easing bias from their post-meeting policy statement, a move that seems well overdue.

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 followed up April's rally by tacking on sizable gains in May, with the S&P 500 rising 5.2% during the month behind strength out of AI-related names - primarily semiconductor stocks. Impressively, the broader index was higher by 11.2% year-to-date on a total return basis through May after a trough-to-peak move of 19.7% off the late March low. The fundamental underpinning of U.S. stocks, i.e. the earnings outlook, continued to brighten throughout May with earnings season providing market participants with ample reasons to remain allocated to U.S. stocks despite the proverbial 'wall of worry' equity markets continue to climb.

At the end of March, as the U.S./Iran conflict drags on and the potential long-term impacts it could have on the energy market and crude oil prices dominated discussions, while the consensus estimate for full year 2026 earnings per share (EPS) out of the S&P 500 index sat at \$323. But with both trailing results and forward guidance surprising to the upside as quarterly reporting season ramped up in mid-April, the '26 EPS estimate moved to \$333 at the end of April and continued to rise in May, ending last month at \$339. Upward revisions of this magnitude in such a short period of time have historically occurred at the start of economic cycles, not in the middle or toward the end of an economic expansion. But this time around sell-side prognosticators are coming around to the idea that this economic cycle could very well be different due to the mania and frenzy surrounding the buildout of AI-related infrastructure.

With earnings estimates moving markedly higher in recent months, the S&P 500 closed out the month of May trading at 22.5 times projected 2026 earnings, which is lofty by historical standards. However, once we pass the midpoint of this year market participants will begin to shift their focus to the 2027 outlook for profits and this pivot could be a source of further upside for U.S. large cap stocks as the current 2027 EPS estimate of \$390 leaves the S&P 500 trading at 19.5 times next year's estimate. While not part of our base-case scenario, assuming the move lower in crude oil prices in late May is sustained and keeps a lid on interest rates, the S&P 500's current price-to-earnings multiple could even expand modestly from here, in our view.

S&P 500 Profits Grew By Over 12% Y/Y In 1Q26; Looks 'Early Cycle,' Not Late



Source: Bloomberg

U.S. small and mid-cap stocks have also seen earnings estimates move higher in the past couple of months, albeit not to the same degree as the S&P 500, and lower energy costs and falling interest rates will provide tailwinds for smaller companies to varying degrees. However, smaller capitalization stocks could see tougher sledding as the initial public offering (IPO) window opens this month with SpaceX now publicly traded, and given a higher beta cohort of stocks that have done well of late, some high flyers in these indices could see profit taking as investors look to fund allocations to newly public investments. Also worth watching, should U.S. economic growth hit a soft patch as is common in the lead-up to midterm elections, these stocks could experience relative weakness as investors turn to higher quality, dividend paying names in the S&P 500 as they ride out heightened economic and/or political uncertainty.

One blemish that continues to be fodder for market bears is the narrow breadth off the late March lows, as outside of the information technology sector returns at the sector-level have largely been unspectacular. The factor leadership profile also gives us pause as 'momentum,' and high beta names have led while 'quality' factors have lagged materially. While this is a sign of healthy investor risk appetite, it's also potentially worrisome as 'momentum' can be fickle. Just as positive momentum can propel prices higher, a loss of momentum can lead to a sizable and unsettling drawdown in a short period of time as renters of these stocks look to sell early once the trend rolls over and reallocate capital into the next best thing. Another variable worth watching in the next few months is a potential flurry of IPOs to see how orderly markets digest these sizable, high-profile new issues. On balance, we see the earnings outlook and positive

momentum behind AI-beneficiaries offsetting narrow breadth and liquidity concerns surrounding the wave of IPOs, but after such a sizable move off the March lows, a midyear lull and a period of consolidation would likely be healthy and set U.S. equities up on firmer footing for a year-end rally following the midterms in November.

Momentum, High Beta Outshining Quality, Dividend Growth

	YTD Return	1-Year Return	10-Year Return
Beta	28.7%	72.2%	15.6%
Momentum	26.6%	44.4%	23.7%
Quality	14.1%	22.9%	14.6%
Div Growth	7.2%	20.4%	10.6%

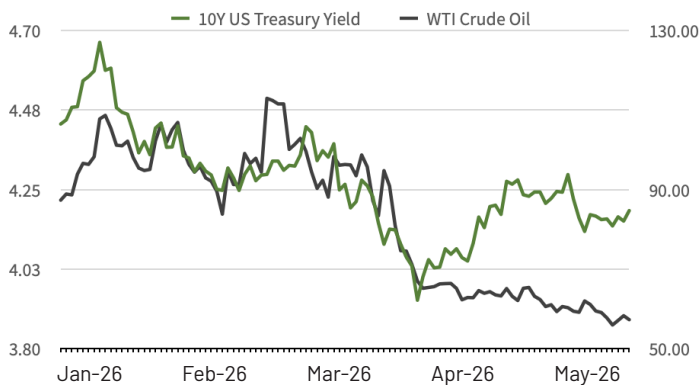
Source: Bloomberg

Bonds are still stuck between a rock and a hard place. Fixed income investors received a welcome reprieve from the relentless rise in rates as hopes for a U.S./Iran deal forced crude oil prices lower late last month, and that rally in the final days of May allowed the Bloomberg U.S. Aggregate (Agg) Bond index to eke out a 0.3% monthly gain. Investors in higher quality bonds have encountered tough sledding ever since yields bottomed in late February as a rapid rise in energy prices has left inflation expectations in-flux and kept sustained upward pressure on longer-term Treasury yields. The benchmark Bloomberg U.S. Aggregate (Agg) Bond index, which is entirely investment-grade, closed out May with a meager 0.4% year-to-date gain, due largely to the fact that the Agg is dominated by U.S. Treasuries and various government-related bonds, which in total account for just over 50% of the index.

Energy prices fell into month-end amid hopes the Strait of Hormuz would reopen and shipping traffic would normalize in the near term, which took some of the upward pressure off the long end of the Treasury curve as market participants inferred that inflation expectations would likely moderate. However, we don't expect yields to fall much from here as even a sustained drop in energy prices and inflation expectations would likely result in an upward bias to expectations for economic growth, both in the U.S. and abroad, thus keeping yields anchored near current levels. Treasuries and higher quality bonds broadly remain valuable components of a diversified fixed income portfolio, but these bonds often carry longer duration profiles and greater interest rate sensitivity. As a result, persistent volatility in prices of energy and other commodities — a reasonable base-case given the ongoing stalemate in the Middle East — could contribute to heightened volatility and potentially

price declines for these bonds. As a result of this view, we currently maintain exposures in-line with our strategic long-term target exposures to higher quality investment grade, U.S. high yield, international developed market sovereigns and emerging market debt as we see upside risks to yields across the board and desire to keep our powder dry as we look for dislocations at the sub-asset class level.

Potential For Energy-Induced Inflation Driving Treasury Yields



Source: Bloomberg

Credit expectations should be tempered. Higher quality corporate bonds have fared a bit better than Treasuries year-to-date, with the Bloomberg U.S. Corporate index rising 0.7% through May as historically tight credit spreads have been offset by the move higher in Treasury yields in the 5-to-10-year portion of the yield curve. Through May, high yield corporate issues had outperformed investment-grade corporates by 1% year-to-date, and the credit spread over the Treasury curve closed out the month at 257-basis points, 72-bps below the widest level seen in late March and just 9-bps above the tightest levels seen this year.

Given the U.S. High Yield index carries a yield-to-worst of almost 7%, and with inflation unlikely to move much lower in the near-term, the asset class is likely to continue garnering interest from investors seeking income in excess of inflation to preserve purchasing power. However, credit spreads are unlikely to move much lower from here with a more uncertain outlook for the U.S. and global economy in place, thus limiting total return potential from this segment of the fixed income market. We don't envision a sizable near-term uptick in defaults, but expectations should be tempered and we are still looking for a coupon-minus return over the balance of this year.




Highland Outlook

We noted the need for fixed income investors to focus on real returns this year with inflation grinding higher, and with year-over-year inflation now above 4%, the returns of investment grade fixed income may end up being sub-1% in 2026. As inflation has climbed market participants have been re-positioning their portfolios and Fed Funds futures are now pricing in at least one quarter-point rate hike by the end of the year as of June 10th. We have a differing view from the market in this respect. While the Fed can combat rising inflation with higher interest rates, this tool is intended to work when the inflation is demand-driven and the economy is hot. The current inflation we find ourselves facing, however, is cost-push inflation and consumers are feeling the pain. In our view, raising interest rates would have little effect on bringing down inflation since the source of rising prices is related to energy costs. As a result, if inflation remains elevated over the balance of the year, we believe consumer demand could soften as households absorb higher costs. While consumers are in a difficult spot, we expect it will have a smaller effect on GDP due to continued large business fixed investment related to artificial intelligence spending. With this backdrop, interest rates are likely to hold around current levels over the next few months.

As we have discussed, for some investors, alternatives such as multi-strategy or macro funds strategies may offer differentiated sources of return and lower sensitivity to traditional bond market duration risk. We continue to favor these strategies over assets like high yield bonds in the current environment due to tight spreads and their high correlation to equity markets. Highland has been allocating to hedge funds for over two decades and it has been encouraging to see more positive sentiment around them after they were shunned in the late 2010's. Throughout the ZIRP (zero interest rate policy) era, hedge funds struggled broadly as the risk-free rate was held near zero and investors lowered their allocations in favor of traditional equity strategies which were experiencing years of double-digit returns. As Fed intervention on interest rates and the yield curve ended, hedge fund strategies have recovered and have been able to provide the returns and diversification to portfolios that investors have typically expected from them. Within our hedge fund allocations, we have recently preferred relative-value and macro strategies given narrower credit spreads and elevated currency/interest rate volatility.

The Highland Investment Working Group will meet later this month and discuss the current overweight allocation to emerging markets equities that has been held since the 4th quarter of last year. While we continue to see areas of opportunity within emerging markets, the exposure is increasingly tied to the artificial intelligence theme and we will discuss bringing our equity allocation back to neutral on a geographic basis.

Highland Associates Cross Asset Views

TIER 1 CALLS	TIER 2 VIEWS			
	-	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	▲		

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