

# Asset Allocation Note

## Waiting on the World to Change

As the air warms, so does the sense that something is shifting. Late May signals the end of school and beginning of summer, yet beneath the surface, something larger may be taking place. A fragile truce holds between the U.S. and Iran even as shots are fired, and the world waits to see if we can *bring our neighbors home from war*. A rare Andean hantavirus has surfaced among cruise ship passengers, reviving the long shadow of pandemic memory. Epidemiologists and virologists alike have assured this time is different, but memory remains from when a *virus ruled the population*. These threats have not slowed markets. Stocks are nearly 20% off the March lows, led once again by the Magnificent Seven. Their earnings made one thing unmistakably clear—the engine of growth for both corporations and the U.S. economy alike has become increasingly intertwined by the unrelenting appetite for data infrastructure. Data center spending expectations are surging towards a trillion dollars in 2027, and at over 3% of GDP, the US economy could contract without it. Progress, especially when accompanied by supply chain issues, comes at a price. Inflation is stirring again as oil, fertilizer, metals, and agricultural commodities have all begun to surge in price. Even a sudden end to conflict or supply chain snarls, many warn, would not fully cool the pressure. As a new Fed Chair readies to join the fight between growth and price stability, investors have learned that *the fight ain't fair*. Can this growth endure rising inflation or potentially higher rates? Should investors press forward with the same playbook, or should we be *waiting on the world to change*?

## ECONOMIC UPDATE

### Economic Resilience with Downside Risks

*Regions Economic Division*

The first estimate from the Bureau of Economic Analysis (BEA) pegs Q1 real GDP growth at an annual rate of 2.0 percent, shy of what our forecast anticipated but it helps to recall that in any given quarter BEA's initial estimate of GDP is based on highly incomplete source data and, as such, prone to sizable revision. As the data now stand, real private domestic demand (combined business and household spending) is shown to have grown at an annual rate of 2.5 percent in Q1. We consistently point to real private domestic demand as the more reliable gauge of the underlying health of the U.S. economy, as what tend to be sharp swings in net exports and business inventories often sway the headline GDP growth print. While it is not surprising that growth in real private domestic demand outpaced real GDP growth, what does stand out is the extent to which business fixed investment drove growth in private domestic demand in Q1.

Real business fixed investment grew at an annual rate of 10.4 percent in Q1, a pace made even more impressive in light of real business spending on structures contracting at a 6.7 percent rate. Real business outlays on equipment and machinery grew at a 17.2 percent rate in Q1 while real outlays on intellectual property products, the bulk of which consists of computer software and R&D outlays, grew at a 13.0 percent rate, with the former adding 0.88 percentage

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points to top-line real GDP growth and the latter adding 0.70 percentage points. Investment related to AI was a powerful support for the growth in business investment seen in the GDP data, but we've routinely noted that growth in business investment in equipment and machinery has become more broadly based over recent months, in part thanks to the more favorable tax treatment resulting from last summer's changes to the tax code.

Growth in real consumer spending slowed in Q1, with annualized growth of 1.6 percent more than accounted for by spending on services, as real spending on goods contracted despite growth in nominal spending (i.e., measured at current prices) on goods having accelerated sharply. Nominal goods spending rose at an annual rate of 5.2 percent in Q1 after having risen at a 2.3 percent rate in Q4 2025. That real goods spending contracted while growth in nominal goods spending accelerated so sharply reflects the pace at which goods prices rose during Q1. While this in part reflects the steep increases in energy prices during March, it also reflects further tariff pass-through pushing prices for core (non-food, non-energy) consumer goods higher, with the core PCE Price Deflator rising at an annual rate of 4.4 percent after having risen at a 4.6 percent rate in Q4 2025. Moreover, the PCE Deflator's measure of core goods prices rose at an annual rate of 4.9 percent in Q1.

The combination of faster goods price inflation and sharply higher energy prices poses downside risk to growth in consumer spending going forward. One offset in Q1 was a sharp acceleration in disposable (after-tax) personal income growth, fueled by meaningfully larger income tax refunds than seen in 2025, another byproduct of last summer's changes to the tax code. We and most others expected this tax refund windfall to be a strong support for growth in consumer spending over 1H 2026, but the strength of that support has been eroded by steeper than expected price increases. One way to think about it is that higher prices mean consumers have to spend more just to keep pace, leaving less room for growth in real spending. The longer energy prices remain elevated, the less support for growth in real spending to be had from larger income tax refunds, particularly in light of accelerating core goods price inflation.

It seems likely that, should they remain elevated, higher energy prices will ultimately spill over into core inflation in the form of higher costs of producing and shipping goods. That the Strait of Hormuz is not only a shipping channel for energy but also for industrial and consumer goods opens additional avenues through which the conflict in the Middle East can intensify upward pressure on goods prices. To that point, the New York Fed's index measuring supply chain

stresses shows significantly more stress on global supply chains in April, with the index jumping to a level last seen in mid-2022 when pandemic related supply chain disruptions were fueling inflation price pressures. Note that prices of core consumer goods had turned higher, reflecting the effects of higher tariffs, well before supply chains came under renewed pressures.

To the extent they persist, these supply chain pressures could be reflected in further acceleration in core goods price inflation, and it is possible that we're already seeing the early stages of such a transition. For instance, the prices paid index, a gauge of changes in input prices, in the ISM Manufacturing Index jumped to 78.3 percent in March before rising further still to 84.6 percent in April, the highest reading since April 2022, and has risen by over twenty-five percentage points over the past three months. In ISM's April survey 70.3 percent of firms reported paying higher input prices, up from 59.4 percent in March. Keep in mind, though, that the prices paid index had been signaling persistent and broadly based upward pressures on input prices long before the start of the conflict in the Middle East, meaning that the conflict has intensified what were already well-entrenched price pressures. The ISM's survey of the broad services sector tells a similar story, i.e., firmly entrenched price pressures kicking into a higher gear as a result of the conflict in the Middle East.

Thus far, however, supply chain disruptions and higher prices for energy and other inputs have not derailed the nascent rebound in the manufacturing sector. The ISM Manufacturing Index held at 52.7 percent in April, the fourth straight month in which the headline index was above the 50.0 percent break between contraction and expansion, though as we've noted the turnabout in the ISM's index lagged other indicators which had already been signaling better conditions in the manufacturing sector. The conflict in the Middle East, however, poses new hurdles for the manufacturing sector, but the ISM's April survey shows no signs of deterioration in order books, while at the same time firms again reported larger backlogs of unfilled orders. While this would suggest support for employment and output in the factory sector in the months ahead, the longer the conflict in the Middle East persists the greater the danger that supply chain disruptions and higher input prices bring an abrupt end to the rebound in manufacturing.

That job growth exceeded expectations in both March and April has many wondering if the narrative around the labor market has changed. We think not and can point to factors such as atypically harsh winter weather, seasonal adjustment issues, and Easter having fallen so early in

April this year, which have impacted the past few monthly employment reports. Such twists and turns in the data, however, are standard fare, which is why it's more useful to look at longer-term patterns. For instance, over the past six months total nonfarm payrolls have risen by an average of 55,000 jobs per month, and while that may not seem all that impressive, it is above what we consider to be sufficient to keep the unemployment rate steady given what we expect will remain anemic labor force growth.

To us, this is simply the new labor market normal; there is considerably less turnover in the labor market than has historically been the case, and we continue to point to labor supply constraints as a drag on job growth. We'll repeat a point we've been making over the past few months, which is that with such a low trend rate of job growth the typical variability in the estimates of the change in nonfarm payrolls will likely yield negative headline prints more often than has historically been the case. This puts us at odds with those for whom the narrative of the labor market changes with each headline print on the monthly employment reports.

In light of the series of shocks that have hit the economy over recent years, it is striking that real GDP growth is nonetheless right back in line with the trend rate, just over two percent, that has prevailed for many years now. At the same time, however, that nominal GDP growth remains far above what had been the pre-pandemic norm reflects how intense and persistent inflation pressures have been, with inflation likely to accelerate further in the near term. At present, solid growth in business investment, a labor market that while not firing on all cylinders has at least stabilized, and consumers still willing and able to spend are supporting real GDP growth. The risk, however, is that elevated energy prices and global supply chain disruptions lead firms to pull in the reins on capital spending and pare job counts, while unrelenting price pressures cause consumers to pull back. That combination could easily sink the economy, and while not our base case, we're certainly mindful of the downside risks.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; U.S. Census Bureau; Institute for Supply Management; Federal Reserve Bank of New York

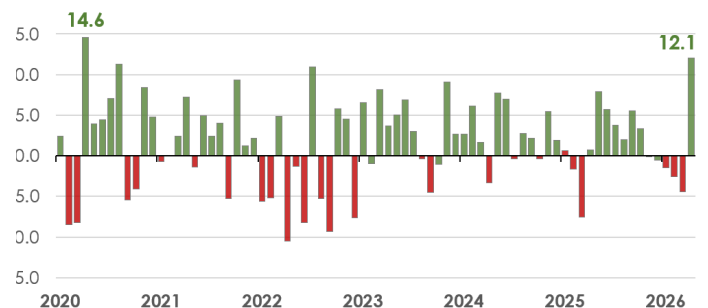
## Investment Strategy Update

*Regions Multi-Asset Solutions & Highland Associates*

U.S. equity indices rallied sharply in April, with the S&P 500 and S&P Small Cap 600 indices each rising over 10%, while the S&P Midcap 400 tacked on a respectable 7.8%. While stocks across the market cap spectrum turned out

gains last month, the 'top of the market' was particularly strong, with an equally weighted basket of the largest 20 S&P 500 companies by market capitalization rising 12.1% during April - the best month for mega caps since April of 2020. At the sector level, information technology was far and away the biggest winner in the S&P 500, rising 17.4% as semiconductor stocks led the charge, evidenced by the Philadelphia Semiconductor index jumping 38.4% during the month. Smaller technology stocks also performed well, with the S&P 600 information technology sector rising 23.7% during the month, with semiconductor names leading the charge there as well. This performance is evidence that investors are seeking exposure to what remains a robust AI spending backdrop outside of just the prominent hyperscalers in the 'Magnificent 7' cohort. April's narrow breadth, however, could prove problematic for indices should semiconductors and other AI adjacent plays succumb to profit taking.

**Best Month For Mega Caps Since COVID Reopening  
(Performance Of Largest 20 S&P 500 Names By Market Cap)**



Source: Bloomberg

Some digestion may be required for the information technology sector at large and for semiconductor stocks specifically after the April rally, but the fundamental underpinning for stocks, i.e. the earnings outlook, is reason enough to remain constructive on U.S. equities. The consensus estimate for 2026 S&P 500 earnings per share (EPS) rose to \$332 at the end of April, up from \$310 at the end of last year and implying just shy of 20% growth versus the S&P 500's 2025 EPS. To be sure, the breadth behind these revisions was quite narrow with the energy and information technology sectors driving the lion's share of the upside, but with manufacturing data improving in recent months and the U.S. economy so far remaining resilient in the face of higher energy prices, positive revisions for more economically sensitive sectors such as financials, industrials, and materials could follow, potentially forcing estimates higher while boosting investor sentiment and risk appetite in the process.

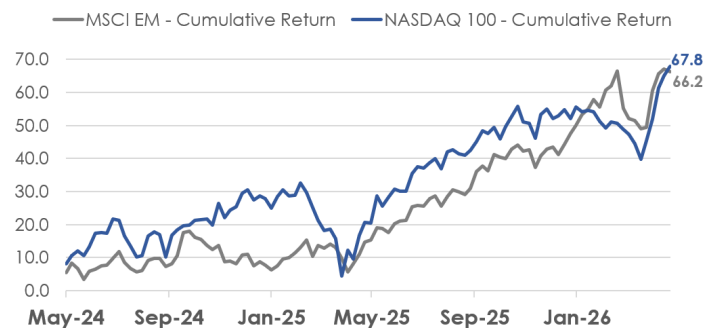
Among other market guideposts, at the sector level, the relative performance of consumer discretionary stocks versus the more defensive consumer staples sector is worth monitoring as a lens into what could lie ahead for energy prices at the U.S. economy. By that measure, market participants aren't yet overly concerned about a potential downturn in consumer spending on more discretionary items due to higher gas prices as the S&P 500 consumer discretionary sector rallied 11.7% in April and outperformed the consumer staples sector's relatively paltry 3.1% return. The performance gap between these two sectors in April is encouraging, but this relationship is worth watching into the summer months for signs that elevated gas prices are weighing more heavily on spending as consumers exhaust tax refunds.

Emerging Market U.S. equity gains have been highly correlated with U.S. Technology stocks. The MSCI Emerging Markets (EM) index generated a 14.6% year-to-date total return through April, easily outperforming the S&P 500 and the MSCI World indices which posted gains of 5.6% and 5.8%, respectively. However, the bulk of the MSCI EM's gains this year have been driven by just two countries - South Korea and Taiwan, with the former rising 61% and the latter gaining 39%. While those return figures are impressive, it's even more awe inspiring when one looks back to the end of 2024 as the MSCI South Korea and MSCI Taiwan indices are higher by 225% and 91% since then. Much of the enthusiasm surrounding these two countries has been directly related to their outsized exposure to technology stocks, specifically, dynamic random-access memory (DRAM) semiconductor manufacturing via national champions Samsung, SK Hynix, and Taiwan Semiconductor, with those names mirroring, and in some cases outperforming U.S.-based semiconductor stocks. Whether the memory cycle proves to be more durable and secular in nature rather than cyclical as it has been historically remains to be seen, but relationships between asset classes and indices are more dynamic than is commonly believed, and this shift has broader implications for equity portfolios that shouldn't be ignored.

Market participants likely don't think about allocating capital to emerging market stocks as a means to increase exposure to the technology sector and to semiconductor stocks, specifically, but from the start of 2024 through April the MSCI EM index generated an almost identical return to that of the tech-heavy Nasdaq 100 index. Of course, the paths taken by each index to produce those returns have differed, but the end result is largely the same. The correlation between those two indices over the trailing 2 years and 4 months has been just short of 0.85, indicating that approximately 85% of the time the EM index has moved

in the same direction as the Nasdaq 100. This correlation is well above what it has been historically, highlighting how the sector makeup of the MSCI EM index and the underlying country components within the index have shifted over time. The information technology sector now constitutes 37% of the MSCI EM index, up from around 27% at the end of 2024, while South Korea and Taiwan accounted for around 30% of the MSCI EM at the end of 2024, they now combine to make up over 43% of the index. Most investors would likely be surprised by how correlated these two indices have been, and this must be considered when deciding to allocate capital to developing markets. We remain constructive on emerging market stocks, but from an asset allocation perspective a neutral position versus our strategic target to this cohort of stocks is warranted after the run-up in the asset class over the prior 16 months. On the other side of that argument, we're cognizant of the fact the MSCI EM index has built out a multi-year base against the S&P 500, that could be setting up for an extended period of relative outperformance. Disciplined active management in EM will likely prove beneficial from a diversification perspective as these strategies look and act differently than the MSCI EM, and the Nasdaq 100, for that matter.

NASDAQ Strength Mirrored By Emerging Markets



Source: Bloomberg

The 10-year U.S. Treasury yield made a year-to-date closing high in early May at 4.44% as energy prices continued to climb, serving to put upward pressure on sovereign bond yields abroad and necessitating intervention in the currency market by the Bank of Japan to support the yen. Brent crude oil, the global benchmark, made an intra-day high above \$126 per barrel on April 30 as the ceasefire between the U.S. and Iran appeared to be on shaky footing, but has since backed off a bit and was oscillating between \$100 and \$110 per barrel at the time of this writing. However, even with energy prices coming off the boil somewhat, yields across the Treasury curve were higher in early May than they were at the end of April. This is largely a function of the longer energy prices

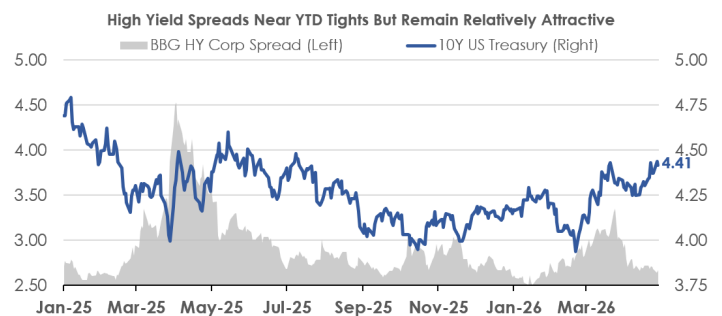
remain elevated, the greater the likelihood that long-term inflation expectations become unanchored and recalibrate higher, which has led investors to require higher yields to compensate them for the risk of this potential outcome.

Yields on the short end of the Treasury curve have drifted higher alongside probabilities for rate hikes amongst foreign central banks in the past month, prompting fears that the FOMC would need to follow suit in response to elevated energy prices. In early May, the 2-year Treasury yield moved above the top-end of the Fed funds target range, trading to a year-to-date high of 3.96%, indicating that market participants believe the FOMC's next move – whenever that may be – will be a hike, not a cut. But we don't expect that to occur this year as the FOMC will be patient and maintain the status quo for as long as it can as it waits to see how the energy supply shock plays out. The FOMC's wait and see approach appears justified at this juncture given positive readings on the state of the labor market, including the strong May employment report, which suggests the economy may not need further accommodation.

The backup in yields during April and into May leave U.S. Treasuries modestly more appealing relative to our 'coupon-minus' return view coming into this year. But with still little clarity regarding a potential timeline for a full reopening of the Strait of Hormuz, crude oil prices are likely to remain elevated and we would look to maintain a duration profile in line with that of the Bloomberg Aggregate Bond index as upward pressure on the long end of the Treasury curve could persist into the summer if not beyond. Compensation for taking credit risk remains paltry relative to historical standards but given our view that the U.S. economy is on relatively firm footing with corporate profits surprisingly strong, we see little reason to expect a meaningful uptick in near-term defaults. Exposure to credit sectors and non-U.S. bonds continue to warrant investor attention due to higher carry/yields and for diversification benefits, but allocations must be sized appropriately.

A decent backdrop remains for credit, but total return upside is limited by tight spreads. Below investment grade credit participated in the global risk rally in April, as the Bloomberg U.S. Corporate High Yield index more than recovered price declines incurred in the wake of the conflict between the U.S. and Iran as the index rallied 1.7% after its March drop of 1.2%. Option-adjusted spreads (OAS) finished April at 268-bps over comparable Treasuries, the lowest level for the index since mid-February. After the snapback last month, valuations are now just 18-bps off the 10-year lows, leaving little room for further price appreciation, but investors shouldn't lose sight of the primary driver of return from

bonds – income. Higher sustained rates in the Treasury market left benchmark yields for low-grade credit hovering around 6.9% at the start of May, roughly 50-bps above where they began the year. From an absolute return perspective, that's a competitive expected return given the lower duration profile of the sub-asset class, suggesting it should be more insulated from inflationary shocks that could crop up as the conflict in the Middle East drags on. The case for credit exposure at this point in cycle is not substantial upside to total return driven by further credit spread compression because that appears limited, but high yield corporate bonds can be a valuable diversification component within a broader portfolio that provides a higher level of carry/yield than we're currently seeing in higher quality assets.



Source: Bloomberg

## Highland Outlook

We believe bond investors should be focused on real returns as inflation continues to rise and threaten purchasing power. The yield-to-worst of the Bloomberg US Aggregate sat at approximately 4.63% at the time of this writing and a headline CPI reading of 3.8% for April implies that bond portfolios may be looking at real returns closer to 0.8%. While additional credit risk may help to boost expected returns, the potential for spread widening poses additional risks to portfolios and increases the already positive correlation seen between fixed income and equity portfolios in 2026. One potential allocation to hedge against higher inflation may be the addition of Treasury Inflation Protected Securities ("TIPS") within nominal bond portfolios. Highland has long held an allocation to TIPS within the Public Inflation Hedges sleeve, but investors without dedicated inflation-sensitive portfolios may want to evaluate such an addition to their fixed income portfolios. One important consideration in the current market environment should be the duration of TIPS portfolios. In 2022, as inflation averaged approximately 8%, the Bloomberg US TIPS Index fell ~11.8% and failed to protect against the higher-than-expected

inflation due to rising rates. To mitigate the rising rate risk, Highland has been evaluating the use of shorter-duration TIPS. The bear case to such an allocation is that it could underperform in an environment where the middle east conflict was resolved and interest rates on US Treasuries fell as inflation fears dissipated. While making duration calls has empirically not been a value-adding endeavor, the current market environment and dynamics may warrant a different approach than we have historically taken.




On the equity front, investors who held their portfolios steady throughout the March and April volatility have generally benefitted from new record highs. The Price-to-Earnings multiple on the S&P 500 has risen to 29.0x, roughly two standard deviations above its two-year average of 26.3x. While such a valuation may appear stretched, analysts are projecting earnings growth of approximately 20% over the next twelve months which could bring the forward P/E ratio to a more digestible 21.9x if equity prices were to remain level. Technology, which accounts for more than one-third of the S&P 500 Index, is carrying the lion's share of this optimism with sector earnings growth projected over 47%. Energy is also a notable contributor with analysts projecting 68.5% earnings growth over the next year. Outside of those two sectors, growth expectations moderate considerably, and we believe the market's continued ascent could hinge heavily on tech earnings delivery in the quarters ahead. Emerging Markets returns are likely to be heavily dependent on these earnings too considering the concentration within the South Korean and Taiwanese companies mentioned earlier. Highland continues to maintain an overweight allocation to emerging markets relative to developed markets and we continue to rebalance back to our target weights on a regular basis to take incremental gains on the positioning.

On a final note, we continue to see commodity prices rise. While Energy has been the primary driver, other areas such as agriculture, grains, and industrial metals are all up over 12% in 2026 at the time of this writing. As the growth outlook globally continues to point upward we could see continued demand for industrial metals, especially as the data center buildout remains robust. Agricultural commodities may also see continued demand as the conflict in the middle east disrupts the production of fertilizer globally. The Public Inflation Hedges sleeve holds a dedicated

allocation to commodity futures, which has benefitted from these increases, but we are mindful of the volatility of the asset class. While commodity futures are often strong performers during inflationary shocks, they can turn quickly and experience sharp revisions. As such, we hold a higher allocation to commodity-sensitive equities to balance out some of the volatility from these futures contracts.

May holds several meaningful events that we are watching closely. A key Senate vote early in the month moved Kevin Warsh closer to succeeding Jerome Powell as the next Chairman of the central bank, and clarity regarding the Fed's leadership and policy path may calm investors with regard to monetary policy. Additionally, as the US-China Summit draws closer there are high hopes that the meeting will remove some uncertainty regarding Iran and tariffs. The Highland Investment Working Group is slated to meet in the coming weeks to discuss these developments and the impacts they may have on asset allocations broadly.

### Highland Associates Cross Asset Views

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

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