

Asset Allocation Note

Land of Confusion

This October feels like any memorable Halloween party, and it is keeping us guessing what is behind the mask. Somewhere beneath the façade, the U.S. economy is proving more resilient than many market participants expected. Annual revisions revealed that growth, business investment, and productivity were all better than previously reported. Corporations are spending with more enthusiasm than shoppers on the candy aisle in anticipation of trick or treaters. Capital expenditures on data centers, semiconductors, and AI infrastructure continue to feed the U.S. economy's sweet tooth. With analyst expectations and institutional positioning light, recent equity market volatility may simply need earnings season to *put it right*. If you *read the news today*, it is clear the Iran war, higher energy prices, and inflation are not *going away anytime soon*.

Fixed income investors, meanwhile, are playing the *hands they're given*. With inflation still above target and fiscal deficits expanding, bond markets are increasingly *haunted by a thousand screams*. Bearish positioning has grown crowded, and elevated yields may offer investors *a place worth living*. As time passes, it becomes increasingly clear that the post-pandemic recovery era has passed, and the AI investment cycle appears to be in increasingly important contributor to economic growth. As *we look to the future*, the question is whether there is sufficient growth to *go around* and keep equity markets and the economy advancing, or whether fixed income markets, inflation, and uncertainty *made too many problems* to pull both stocks and bonds, which have stumbled in recent weeks, back from the brink?

ECONOMIC UPDATE

A Floor Under Parts of the Economy

Regions Economic Division

The Bureau of Economic Analysis recently released the results of their annual revisions to the data from the National Economic Accounts (NEA). The NEA provide a comprehensive view of U.S. economic activity and are the root source of the BEA's estimates of GDP, personal income, corporate profits, and a host of other national and regional data series. Each year the BEA undertakes revisions to the data from the NEA, which vary in terms of scope and duration; this year's revisions cover the period from Q1 2021 through Q2 2026. On the whole, the revised data show the U.S. economy, at least most of it, on firmer footing heading into 2H 2026 than previously implied.

Real GDP is now shown to have increased by 17.4 percent from Q1 2021 through Q2 2026, as opposed to the 16.7 percent increase previously reported. The larger net increase in real GDP is pretty evenly split between a slightly larger increase in output and a slightly smaller increase in prices over this span. Real GDP is now shown to have grown by 3.0 percent in 2024 and by 2.3 percent in 2025, compared to the prior estimates of 2.8 percent and 2.1 percent, respectively. The upward revisions go hand in hand with the data showing an accelerating trend rate of labor productivity growth in place well before AI came to dominate the discussion.

One element of the revised GDP data we found of particular interest is that an upward revision to business investment spending is the

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primary driver of the upward revision to real GDP growth. Real business fixed investment grew by more from Q1 2021 through Q2 2026 than previously reported, with larger gains in each of the three main components – structures, equipment and machinery, and intellectual property products. One caveat, however, is that the growth in business spending on structures over this period is almost entirely a function of the burst of factory construction from late-2022 through mid-2024 fueled by the “CHIPS and Science Act,” outside of which commercial construction activity has been notably weak. The obvious exception is construction related to data centers, which lent support to the Q2 2026 data, and which will make a bigger impression on structures spending going forward.

The impact of AI related investment is apparent in the data on business investment in equipment and machinery. Business spending on computer equipment and communications equipment has been notably strong over the past several quarters, reflecting surging AI-related investment, but at the same time growth in business spending on equipment and machinery has become much more broadly based. This to some degree reflects the impact of changes in the corporate tax code enacted into law in the summer of 2025, particularly the provision allowing for immediate expensing of such investment. The higher frequency data on core capital goods orders (i.e., non-defense capital goods excluding aircraft and parts), a very early indicator of the GDP measure of business investment, suggest business spending on equipment and machinery will remain a meaningful support for real GDP growth for several quarters to come.

The revised data also show faster growth in real business investment in intellectual property products than previously reported. Intellectual property products mostly consist of outlays on computer software and research & development, and spending in these areas heavily impacts labor productivity growth over time. To that point, growth in spending on intellectual property products has for some time tended to outpace growth in the two other broad components of total business investment. This consistent growth presaged the pickup in the trend rate of labor productivity growth that has for some time been apparent in the data.

Another sign of the strength in business investment spending over recent years is the growth in imports of non-automotive capital goods – goods ultimately used by companies in the U.S. in the production of final goods. The revised data show total imports of goods, adjusted for price changes, grew by 22.7 percent from Q1 2021 through Q2 2026, up from the initial estimate of 21.5 percent, with an upward revision to imports of non-automotive capital goods the primary driver.

One area in which the revisions to the recent historical GDP data were not kind is residential fixed investment, now shown to have contracted by 17.1 percent from Q1 2021 through Q2 2026 rather

than by 16.9 percent as previously reported. The downward revision would have been harsher had it not been for single family residential investment expanding at a faster pace in Q2 2026 than had previously been reported. That, however, won't last for long as single family construction slipped in Q3 2026 and we look for it to slip further over the final quarter of this year, while multi-family activity is flat to slightly lower. We expect residential fixed investment to be a drag on real GDP growth through 2027.

On the whole, the upward revisions to the various components of business fixed investment and imports of non-automotive capital goods suggest a firmer foundation for overall economic growth over coming quarters than had already been implied in the GDP data. To be sure, the ultimate extent of and timing of the payoff from AI-related investment cannot be known, but the strength in business investment spending is benefiting current real GDP growth while laying the groundwork for faster future growth. At present, however, the revised GDP data do not alter the point we made in last month's edition, which is that real GDP growth has settled back into the trend pace seen over the course of the pre-pandemic expansion while nominal GDP growth not only remains well above the pre-pandemic trend rate but has accelerated over recent quarters, a reflection of prices rising at a faster pace.

Though expectations of faster real GDP growth down the line brought about by current business investment spending may be playing a role, the recent run-up in market interest rates seems far more a function of the acceleration in nominal GDP growth amid trend-like real growth. This combination is keeping the FOMC in play even after the twenty-five basis point hike in the Fed funds rate at their September meeting. Though remaining in play, any sense of urgency around subsequent hikes in the funds rate seems to have faded in the wake of recent data releases.

Specifically, the BEA recently introduced methodological changes in the calculation of the PCE Deflator, the FOMC's preferred gauge of inflation. These changes had the net effect of lowering core PCE inflation by twenty-to-thirty basis points over the past several quarters. To be sure, this still leaves core PCE inflation, at 3.0 percent as of August, handily above the FOMC's 2.0 percent target at a time when rising energy prices are pushing headline inflation higher. That said, the revised data show a shallower trajectory of core PCE inflation than had previously been reported, which many market participants see as giving the FOMC some breathing room as they deliberate the appropriate policy path.

The September employment report is also seen as diminishing any sense of urgency around further funds rate hikes. Total nonfarm payrolls rose by 29,000 jobs in September, with private sector payrolls up by 46,000 jobs and public sector payrolls falling by 17,000 jobs. Prior estimates of job growth in July and August were revised sharply lower, with 81,000 fewer private sector jobs added



over the two-month period than previously reported. Average hourly earnings rose by just 0.1 percent, leaving them up 3.0 percent year-on-year, while aggregate private sector wage and salary earnings rose by 0.2 percent, translating into an over-the-year increase of 4.2 percent. Thanks to a second straight monthly increase in the labor force participation rate, the unemployment rate ticked up to 4.2 percent, while the broader U6 measure, which also accounts for underemployment, fell to 7.6 percent.

While many are assessing the September employment report in terms of what it may mean for the FOMC, our assessment revolves around just two numbers. First, the initial response rate for the September establishment survey was just 53.1 percent, well below depressed post-pandemic rates and the lowest September response rate since 1987. A rate this low calls into question the reliability of the initial estimates of nonfarm employment, hours, and earnings in September, and could lead to larger revisions than would have been the case with a higher response rate.

Second, over the twelve months ending with September, not seasonally adjusted private sector payrolls increased by an average of 60,167 jobs per month, right in line with the trend rate that has prevailed since early 2025. This is, to us, the most relevant data point that can be pulled out of the September employment report. While the estimates of monthly job growth on a seasonally adjusted basis have been all over the map, the underlying trend rate of job growth in the not seasonally adjusted data has been notably stable. Though well lower than what we were accustomed to over the years prior to the pandemic, this trend rate is nonetheless more than adequate to keep the unemployment rate in check given what is much weaker labor supply growth.

A stable but not necessarily strong labor market is freeing the FOMC to make inflation their main focus. This, of course, does not mean the FOMC's job is any easier given the high degree of uncertainty around the path of core inflation. We do, however, think the FOMC can be patient. Even if, as we expect, the FOMC remains on hold at their October meeting, the December FOMC meeting remains in play absent clear evidence that core inflation is slowing.

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

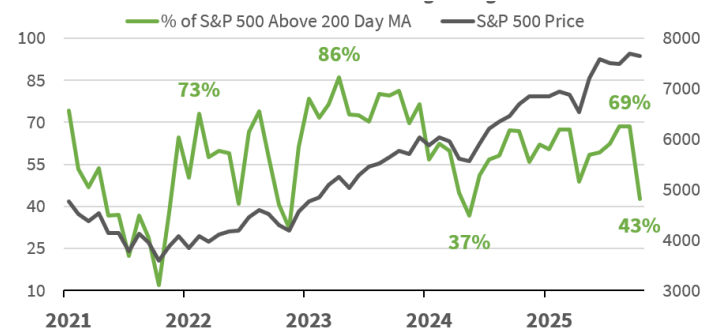
Investment Strategy Update

Regions Multi-Asset Solutions & Highland Associates

Market participants had a lot thrown at them in September, including continued saber rattling in the Middle East sustaining upward pressure on energy prices and the FOMC hiking the Fed funds rate for the first time since 2023, just two of the more market

moving forces in play. Still, the benchmark S&P 500 index fell just 0.4% during the month while the more interest rate sensitive S&P Small Cap 600 index dropped a more meaningful 5.7% as the relentless rise in Treasury yields weighed on sentiment surrounding small cap stocks. The S&P 500 had no shortage of reasons to pull back last month, but the index finished the month less than 2% below its all-time high and rallied to a new high in early October as capital continued to rotate out of economically sensitive sectors and into secular growth due to 'defensive' and 'quality' traits. While the consumer discretionary, energy, financials, and industrials sectors each finished the month with declines of 4.5% or more, the communication services and information technology sectors garnered inflows, with the former rising 4.2% on the month and the latter 4.4% due in large part to strength out of the 'Magnificent 7' and semiconductor stocks. Breadth (or, participation) deteriorated during the month, but that has been a common dynamic during periods of rising interest rates. With information technology stocks again leading the pack and amid renewed investor interest in the 'Mag 7' – an equally weighted basket of those seven stocks rose 4.2% last month, the S&P 500 remains on firm, albeit narrow footing entering 4Q.

Breadth Deteriorating With The Majority Of S&P 500 Stocks Below Their 200D Moving Average



Source: Bloomberg

The start of quarterly reporting season is but one potential tailwind as investors could be eager to shift their focus away from headlines surrounding geopolitics, midterm elections, and monetary policy and back to fundamentals. At the end of September, the consensus estimate called for S&P 500 reported earnings per share (EPS) to grow 26.9% in 3Q compared to the same quarter last year, but it's notable that the quarterly earnings estimate of around \$90.86 is only up from \$88.89 at the end of June. With the estimate for 3Q EPS less than \$2 above where it was at the end of the 2nd quarter, even after a sizable upside earnings surprise last quarter, the analyst community may again be underestimating profit growth, and positive earnings revisions would be supportive of further upside.

While the fundamental backdrop for U.S. large cap stocks remains constructive, we could see additional positive catalysts in the



form of offside positioning/sentiment and an improving seasonal backdrop. The last American Association of Individual Investors (AAII) survey taken in September suggests that investor sentiment is not a risk into 4Q, as 46.5% of survey respondents stated they were 'bearish' on stocks over the next six months, well above the 31% average since the survey began in 1987. Along with investor sentiment far from being overly optimistic, hedge funds entered October carrying equity exposure that fell somewhere between 'underweight' and 'neutral' positioning, and with leverage low, this could provide fuel for any rally as there is room for these deep-pocketed allocators to lever up and chase stocks higher.

Lastly, October has garnered a reputation as being a volatile month for the S&P 500, with notable large drawdowns occurring in 1929, 1987, and 2008. But in midterm election years since 1990, the S&P 500 has posted a gain in October seven times and a loss just twice, and once we turn the page to November, we usher in what has historically been the best three-month stretch in the calendar for U.S. large cap stocks. Based on data from 1928 to the present, the S&P 500 has averaged a greater than 1% monthly return in November, December, and January, and performance has skewed decidedly in the favor of gains in years when the index is higher by a double-digit percentage entering that stretch. Stocks may continue to face headwinds from geopolitical uncertainty, elevated energy prices, and the relentless rise in sovereign bond yields across the globe, but we expect fundamentals to ultimately win-out and provide a lift for U.S. equities, particularly large caps, into year-end.

A stronger dollar continues to be a headwind for foreign stocks, even as fundamentals improve. Foreign stocks were under pressure throughout much of September as the U.S. Dollar index, or DXY, rallied to close the month at 101.45, the highest level since mid-2025. Dollar strength contributed to a 3% monthly decline in the MSCI EAFE international developed markets index, with the bulk of the decline stemming from currency movements as the index was only off 0.6% when hedged back to the euro, specifically. The MSCI EAFE's weaker return profile doesn't align with some of the recent fundamental tailwinds in the broader index as free cash flow growth improved last quarter and once paired with lower prices, valuations improved at the margin last month. Within the MSCI EAFE benchmark, we're seeing substantial bifurcation between the performance of cyclically oriented countries in the Eurozone with the MSCI Eurozone index lower by 4.4% in September and the technology-centric MSCI Japan index rising 1.7% last month. From a technical standpoint, the developed market index has seen selling pressure mount in the last month as downside volume spiked to the highest level since the March drawdown. This may be a sign that volatility could be with us for some time to come unless energy prices stabilize in relatively short order, which isn't our base case given a shortage of diesel fuel into the colder winter months.

The trend in fixed income favors the "Bears", but higher yields could offer some support. September proved to be a challenging month for bonds and thus far October hasn't been much better, regardless of credit quality, issuer, or geography. Persistent inflation pressures spurred central banks in the U.S., Eurozone, and Japan to raise policy rates last month, helping push global sovereign bond yields higher and spurring a selloff in corporate bonds along the way.

The closely watched 10-year U.S. Treasury yield jumped an unsettling 54-basis points during the month to close at 5.29%, the highest yield seen on that bond tenor since May 2002. The sharp rise in the 10-year yield has been attributed to a number of possible root causes: the prospect of persistently elevated energy prices; U.S. economic data surprising to the upside; expectations that the Federal Open Market Committee (FOMC) could be on the cusp of a more aggressive rate hiking cycle; fears that increased AI-related corporate bond issuance could crowd out government borrowing; and hedge funds and/or trend following strategies pressing short positions betting on a continuation of the uptrend in rates, intensifying the move in yields. Each of these reasons may have some merit, which makes it easy to make the bear case for bonds at present, and after a tough month for bonds, it's difficult to get too excited about the asset class. However, with so many logical reasons for yields to rise further, we think it prudent to consider what could go right for bonds.

For starters, meaningful and sustained declines in prices of crude oil, gasoline, and/or diesel fuel could take some of the upward pressure off longer-term yields. Signs of deescalation surrounding the conflict in the Middle East, Russia ending its ban on diesel exports, and/or signs of demand destruction due to diesel prices eclipsing \$6.50 per gallon could all lead to short covering in longer duration bonds. From a competition for capital perspective, higher yields and wider credit spreads on investment grade and high yield corporate bonds could force some corporate issuers to downsize bond offerings or pull them altogether, potentially boosting demand for Treasuries as that capital would need to be reinvested somewhere. Reduced corporate issuance could also serve to lower expectations for economic growth as the U.S. economy has been driven in large part by AI and datacenter-related spending in the past couple of years, and due to how reliant companies have been on tapping the debt market to fund their grandiose plans, decreased capital needs could imply slower growth and decrease the upward pressure on long-term Treasury yields.

On the policy front, after the sharp rise in Treasury yields during September, Treasury Secretary Scott Bessent could be preparing to announce additional actions to improve liquidity in the Treasury market, including stepped-up monthly buybacks above the recent \$6B level and/or shifting issuance into shorter-term issues. By



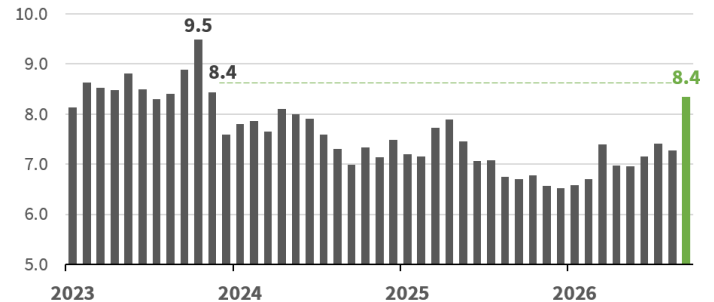
paring back issuance of 20- and 30-year bonds, buyers with longer duration liabilities could effectively be forced to turn to 10-year Treasuries as a substitute. Lastly, with bearish positioning in Treasury bonds stretched and approaching max-short for hedge funds and trend following strategies, a simple absence of bad news might be enough to spur profit taking or short covering and push yields lower. With market participants universally positioned for yields to continue rising, incremental sellers will be harder to find.

To be sure, nowhere in the above did we address the elephant in the room, i.e. the U.S. government's current \$40T debt load and expectations that it will continue to run a fiscal deficit equal to or greater than 6% of U.S. GDP into the foreseeable future, which are certainly longer-term concerns. In the near term, however, a parabolic rise and recalibration in rates along with a widening of credit spreads has likely created opportunities for active managers to tactically adjust portfolios that shouldn't be ignored.

High yield investors are beginning to discount additional risks. The sharp rise in yields across the Treasury curve hampered higher quality, more interest rate sensitive corporate bonds last month. The Bloomberg U.S. Corporate index fell 2.7% in September but, encouragingly, paper losses on high grade corporates weren't accompanied by a drastic move wider in valuations as the index's option-adjusted (OAS), or credit spread over Treasuries, only moved higher by 4-basis points during the month; remaining well below the widest levels seen this year back in March. On the other side of the coin, lower quality higher yielding corporate bonds faced substantially wider credit spreads, with the OAS on the Bloomberg U.S. Corporate High Yield index rising 50-basis points during the month and closing out September at 310-basis points over like-duration Treasuries, a level last seen at the end of March amid the onset of the conflict in the Middle East.

But even after a substantial widening of credit spreads, the High Yield index outpaced its higher quality counterpart, falling by "only" 2.5% due to its shorter duration profile of 3.5 years. That puts the below investment-grade index at roughly half the interest rate risk present in the high-grade index, which carries a duration of 6.6 years, with a current yield-to-worst of 5.5% vs. 8.4% for the below investment-grade index. The relatively attractive yield on lower quality credits blended with modest interest rate risk may present an opportunity for strategic investors to lock in higher yields without taking on excessive price volatility. However, while interest rate risk is lessened in high yield bonds, it is replaced with an elevated credit risk profile and the prospect of a deeper drawdown should the economy deteriorate. Tradeoffs must be well understood before increasing exposure as simply reaching for a higher yield can be a dangerous proposition.

Below Investment Grade Bond Yields Near 3-Year High Yield-To-Worst For Bloomberg U.S. Corporate High Yield Index



Source: Bloomberg

Highland Outlook

Throughout the year we have postulated that real returns in fixed income were unattractive given persistent inflation, continued upward pressure on Treasury yields, and tight spreads on both investment grade and high yield credit. September's significant move in yields led us to reconsider that stance. Rising nominal yields have led to higher real return expectations, and wider spreads on both investment grade and high yield bonds are providing better compensation for credit risk within the market. These developments have made fixed income incrementally more attractive and we are weighing the potential up- and down-side cases that could impact those portfolios over the next few months. As we close out the year, one of the primary risks to yields is likely a large re-escalation of hostilities in the Middle East. In that scenario, oil prices could move higher on the expectation that traffic through the Strait of Hormuz would slow again and infrastructure in the region could sustain further damage. Additionally, the cost of those campaigns would put further pressure on the already high budget deficit. As a result, we would expect yields to rise as investors priced in higher inflation expectations and increased deficit spending. Conversely, we would see a resolution of the conflict leading to much more attractive fixed income returns. The yield-to-worst on the Bloomberg U.S. Aggregate Bond Index is approximately 5.5% at the time of this writing and headline inflation most recently came in at 3.8%, implying a real return of approximately 1.8%. This calculation assumes, however, that yields and credit spreads remain unchanged over a 12-month period. If the conflict were to end, energy prices could fall and the main upward pressure on Treasury yields fade. With a duration of approximately 5.8 years, a 50-basis point shift lower in the yield curve (assuming other inputs remaining unchanged) could increase the expected return by 2.9%. Additionally, any resulting declines headline

inflation would lead to a 1-for-1 increase in expected real returns. The team is considering these scenarios along with many other factors, including the impact of additional Treasury operations and changes in hedge fund positioning discussed earlier in this month's note. Overall, we believe that the forward returns on fixed income are becoming less of a concern and more of an opportunity.

The situation in the Middle East also remains a core determinant of positioning within our inflation-sensitive portfolio. As it stands today, we are neutral across the underlying asset classes relative to our longer-term strategic targets. Elevated oil prices have resulted in strong year-to-date performance for oil and gas names within the natural resource equity sleeve, and their continued strength will remain correlated to the commodity price of crude oil. Inflation-protected bonds, on the other hand, are essentially flat throughout the year as yields rose and negated any benefits of inflation adjustments to the principal amounts. The allocation to these securities has always been viewed as a diversifier to the higher-volatility assets within the portfolio rather than a return-seeking segment. Thus, in risk-off markets where correlations across assets converge, this is the allocation of the portfolio that we would look to tactically increase. Given the continued strength of the U.S. economy and attractive earnings projections for equities over the next twelve months, it is unlikely we would be increasing inflation-linked bond allocation over the foreseeable future.

As mentioned above, the S&P 500 only fell 0.4% in September as it remained supported by Technology and Communications which make up just shy of half of the index constituents. The S&P 500 outperformed the S&P 500 Equal-Weighted Index by 4.2% in the 3rd quarter, but defensive sectors have been on the rise in October. We expect volatility to persist as we enter the earnings season and inch closer to the U.S. midterm elections in November. Analysts will likely be looking for further guidance related to AI-spending now that the additional spend will be increasingly coming from debt markets rather than free-cash flow. The big question on everyone's mind is not only whether or not the return on investment from these projects will justify the capital outlays that have been made, but how long it will take. The U.S. economy has been boosted greatly by these projects and any slow down could have broader ramifications beyond the Technology sector. U.S. equities continue to outperform international developed and emerging markets and that momentum has gained in recent months.

Highland 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		▲		

We currently hold a neutral geographic positioning relative to the MSCI ACWI Index after closing out the Emerging Markets overweight in late June. Our concerns about the index concentration in South Korea appears to be playing out, with Korean equities teetering on the edge of bear market territory. We will be watching closely to see if these struggles remain contained or if some contagion spreads to other countries. At present we remain comfortable with a risk-neutral positioning across our portfolios and eagerly await both earnings and election results to remove some uncertainty from the market for the remainder of the year.

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