

Asset Allocation Note

Zombie

This March has delivered its own brand of madness—less bracket busting, more world shaking. Volatility has swept back into equity and commodity markets as the conflict between the U.S. and Iran escalates, bringing geopolitical risk ever closer to home. As attacks enter a third week, the Middle East remains in turmoil. Oil prices surged past \$100 a barrel more than once, each time retreating just enough to remind us that stability remains elusive. Even the world of sport felt the tremors, as Formula 1 decided to cancel April races in Bahrain and Saudi Arabia. Meanwhile, in his final appearance as Fed Chair, Jerome Powell held rates steady standing firm as the specter of inflation once again enters our collective consciousness.

The first quarter has been this decade's weak link (2020 onward), posting negative returns on average, and as the curtain begins to fall on this quarter, it appears likely to follow tradition. Momentum in the S&P 500 has stalled, lurching like a zombie trapped in a narrow range, with investors questioning what comes next. Historically, buying the dip after a conflict driven oil shock has been accretive, but will that prove true now... or may we be *mistaken*?

ECONOMIC UPDATE

A Wider Range of Outcomes

Regions Economic Division

It is obviously too soon to know how events in the Middle East will play out and the timeline on which they will do so. It is also too soon to know how lasting of an impact there will be on energy prices and on the broader economy. All we can say for certain at this point is that the longer this persists, the higher the toll on the U.S. economy and on the global economy. Were the conflict with Iran to conclude fairly quickly, the effects on energy prices seen thus far would likely reverse quickly as would the effects seen thus far in the financial markets. The risk, however, is that this turns into a protracted conflict triggering a large and persistent energy price shock that filters throughout the economy, adversely impacting household income and spending, employment, business investment, asset prices, and credit performance.

As we write this, there are already effects in the economy and the financial markets. In conjunction with what to this point has been a better than thirty dollars per barrel increase in crude oil prices, retail gasoline prices have risen sharply, up by more than sixty cents per gallon at this point in some parts of the U.S. This will add to the financial stress already being experienced by many lower-to-middle income households.

One offset, however, will come in the form of income tax refunds, larger than a year ago due to changes in the tax code enacted into law last summer, making their way into household deposit accounts. To be sure, we have for some time.

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been pointing to a substantial boost, on the order of \$150 billion on an annualized basis by our estimates, in after-tax household income in Q1 2026 that would be a support for growth in consumer spending. While the size of that boost is not impacted, the disposition of it is, and to the extent these funds are diverted to spending on gasoline and other energy goods and services to simply keep pace with rising prices, that means either less growth in other forms of spending, less saving, or less debt paydown than would otherwise have been the case. One risk is that a sharp and persistent energy price spike filters through to prices of food and finished goods – via production and shipping costs – and thus takes an even greater toll on spending.

Another impact already observed is that, in contrast to the “safe haven” effects that in times of geopolitical tensions/ conflicts typically push down yields on U.S. Treasury securities, yields rose meaningfully over the first week of the conflict with Iran. It seems that, at least thus far, market participants have been more focused on the potential inflationary impacts as opposed to the potential growth impacts. This could, of course, change and do so quickly, but it was striking that the shockingly weak headline print on the February employment did not elicit more of a pullback in yields on longer-term U.S. Treasury securities. One implication is that the bump up in yields arrested the decline in mortgage interest rates seen in the weeks prior to the start of the conflict with Iran, throwing yet another hurdle in the path of an already challenged housing market just as the spring sales season is set to kick off.

While at this point there may not be much of a basis for businesses to make decisions on employment and capital expenditures, the higher energy prices go and the longer they stay elevated, the greater the chances that firms do begin to make cuts, particularly should they come to expect a protracted period of weak demand. The absence of widespread layoffs has been the saving grace of a labor market already characterized by tepid hiring. There is, after all, a difference between firms not wanting more labor and firms wanting less labor, and a shift from the former to the latter would have significant adverse impacts for the broader economy. At the same time, we’ve been pointing to the strong positive momentum in business capital spending over the past several months and have expected this to be a meaningful support for real GDP growth in 2026. Should business confidence waver and/or higher costs make firms reconsider planned capital outlays, what at this point looks like the early phases of a promising run of growth in capital spending could be, if not stopped in its tracks, at least deferred. Additionally, though the U.S. is somewhat insulated by virtue of being a net exporter of oil, weakness in foreign economies brought

on by higher energy prices, physical shortages of energy, and commodity costs pushed higher by a stronger U.S. dollar would result in weaker foreign demand for U.S. goods and services.

Another risk from a protracted conflict that would trigger a large and persistent energy shock would be the possibility of a steep decline in equity prices. Dimmer growth prospects and higher costs would obviously pressure corporate earnings which, in turn, would push equity prices lower. To the extent that impressive equity returns over the past few years have sparked wealth effects that have supported spending amongst higher-income households, particularly discretionary services spending, a sharp reversal in equity prices could trigger the opposite reaction, opening another channel through which aggregate spending weakens.

This is not intended as a complete rundown of the channels through which a persistent energy price shock could impact the economy, nor is this to say that any, let alone all, of these effects will come to pass. Our aim is to lay out some of the main risks in what would amount to a worse case scenario even if at this point how this will play out remains highly uncertain. As for where this might leave the FOMC, we think for now it leaves them on the sideline, even if more uncomfortably. The effects seen to date are far more on the inflation front than on the growth front. To the extent that remains the case, with inflation already stubbornly above the FOMC’s two percent target rate and, as evidenced by the minutes of the January FOMC meeting, a sharply divided Committee, it’s difficult to envision further cuts in the Fed funds rate at this point, especially at this month’s meeting. That said, should the conflict with Iran persist and pose an increasing threat to growth, that could make the Committee more willing to set aside concerns over inflation and cut the funds rate.

In the wake of the February employment report, some were quick to argue that the time for the FOMC to make that pivot is now, i.e., at this month’s meeting. Total nonfarm payrolls fell by 92,000 jobs in February, with private sector payrolls down by 86,000 jobs. Additionally, prior estimates of job growth in December and January were revised down by a net 69,000 jobs, with most of that hit coming from December. We can point to a number of factors, such as a strike that knocked around 30,000 jobs off health care payrolls, unusually harsh winter weather, previously announced layoffs in delivery services, and yet another notably low establishment survey response rate, that weighed on nonfarm payrolls in February. In other words, we think it highly unlikely the labor market suddenly disintegrated in February, particularly as there has yet to be a pickup in the layoff rate.

More broadly, what we think has happened is that with the trend rate of job growth having been pushed so low in a “low hire, low fire” labor market, the usual degree of month-to-month volatility in estimates of the change in nonfarm payrolls is more frequently resulting in negative headline prints. For instance, over the past six months the average monthly increase in private sector payrolls has been 34,000 jobs, or, right in line with where we see the pace of monthly job gains required to keep the unemployment rate steady. Over that span, however, the monthly change in private sector payrolls has ranged from minus 86,000 jobs to plus 146,000 jobs. Our sense is that this could be the “new normal” for nonfarm payrolls, i.e., fluctuations around a mean so low that monthly declines in nonfarm payrolls are more frequent than has historically been the case.

To be sure, a significant and widespread increase in layoffs remains a primary downside risk to the labor market and the broader economy. For now, though, the economy continues to grow at a healthy rate, thanks in part to an ongoing acceleration in the rate of labor productivity growth. Growth in business investment in equipment and machinery continues to accelerate and become more broadly based, household and corporate balance sheets remain, on the whole, notably healthy, and fiscal policy will be a meaningful support for growth. As discussed above, however, the conflict with Iran has the potential to significantly disrupt the economy, but it is simply too soon to know whether, or to what extent, that will prove to be the case.

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

Investment Strategy Update

Regions Multi-Asset Solutions & Highland Associates

February frustrated bulls and bears alike as the S&P 500 traded in a narrow 3% band over the balance of the month, stuck between 6,800 and resistance around 7,000. The S&P 500 fell just 0.7% on the month, but that masked sizable moves at the sector level. Communication services and consumer discretionary sectors fell more than 5% on the month, while the financials and information technology sectors closed lower by 3.7% and 3.9%, respectively. On the other side of the ledger, utilities jumped 10.3% on a total return basis as the fall in Treasury yields and geopolitical unease boosted demand for stable, higher yielding stocks that behave more like bonds. The energy sector advanced 9.4% during February and continued to garner interest into

March as tensions with Iran flared, while materials posted an 8.3% gain as prices of precious metals rose amid safe haven demand. To round things out, consumer staples and industrials were also up, rising 7.9% and 7.1%, respectively, and healthcare gained 3.5% on the month.

We saw persistent rotation between sectors throughout February as the S&P 500 remained range bound, with ‘defensive’ and economically sensitive sectors benefiting at the expense of secular growth areas tied to AI. However, that dynamic has shifted thus far in March as the Middle East conflict has forced energy prices sharply higher, leading to fears of inflation reaccelerating and potential stagflation for the U.S. economy. This has spurred a reversal of fortune for communication services and information technology stocks, as both sectors have sizable ‘Mag 7’ representation and have caught bids as capital has moved out of some of January and February’s biggest gainers tied to rising commodity prices. Some resolution or clarity regarding the potential duration of the conflict with Iran may be required for the broader index to find its footing and avoid back-to-back down months, but we ultimately see U.S. stocks as relatively well positioned, particularly compared to the Eurozone, U.K. and select EM countries.

Sentiment and risk appetite will likely remain subdued until energy prices stabilize or roll over, with market participants likely looking to sell into rallies so long as the conflict persists. Uncertainty surrounding energy prices may keep upward pressure on inflation expectations and potentially spur downward revisions to expectations for U.S. and global economic growth the longer the conflict drags on. However, once the dust settles, we expect a focus on fundamentals, i.e., profits, to pull investors back into U.S. equities, particularly large-caps. Small caps could remain challenged by elevated energy prices and their inflationary impact, while the recent widening in credit spreads could also pose a headwind to smaller companies, prompting us to prefer larger market capitalization and quality in the near-term.

S&P 500 Returns After Energy Supply Shocks

Conflict	Crude Oil Price Per Barrel	After 6-Months	After 1-Year	After 2-Years
Gulf War I	\$30.20	23%	37%	47%
Gulf War II	\$25.50	20%	29%	41%
Arab Spring	\$111.36	-10%	7%	21%
Invasion of Ukraine	\$99.08	-1%	-6%	23%

Source: Bloomberg

Past performance is not representative of future results.

Energy price spikes pose headwinds for developed economies abroad. The conflict in Iran at the start of March drove Brent Crude oil prices from \$72.48 per barrel at the end of February to as high as \$118 intraday in early March. The rapid rise in prices of crude oil and liquefied natural gas (LNG), among other energy-related commodities, has pressured international equities as market participants were reminded that major developed economies in Europe and Asia import virtually all their energy from overseas. As a result, the MSCI EAFE Developed index was off by 8.2% in the first ten days of March while the MSCI Emerging Markets index was modestly worse off, falling 9.7%. Last month's leaders at the country level quickly became laggards as cyclical exposures that have been pushing developed market indices higher such as Japan, Germany and Spain were some of the hardest hit equity markets, each falling by over 7% in the first two weeks of March. While the rapid rise in oil prices and ensuing market volatility are unsettling, should there be a quicker resolution to the Iran conflict this pullback could prove healthy and extend the rally as froth has been removed and positions re-sized in developed markets abroad that have been flirting with overbought conditions for some time. However, should the conflict drag on, production cuts out of the Middle East could have a more lasting impact and limit near-term upside for developed countries abroad that will have to adjust to drastically higher input costs.

To make matters worse, geopolitical uncertainty has prompted traders and institutions to buy U.S. dollars as a port in the storm, pulling the DXY US Dollar Index up by 1.6%, from \$97.61 to \$99.18. We have interpreted the dollar's recent ascent as primarily a safe haven trade, but should the conflict persist or escalate further the greenback could break above the \$100 level. A close above this ceiling of resistance could spur short covering in the dollar and bring about new year-to-date highs given bearish dollar positioning has been a popular trade, particularly for trend following strategies. Higher energy prices and a stronger U.S. dollar present headwinds for developed markets abroad, and as a result we remain comfortable with a modest underweight to this cohort of stocks at the present time.

After a 14.9% advance in the first two months of the year, the MSCI Emerging Equity index was primed for profit taking with the unfolding situation in Iran proving to be the downside catalyst in early March. Crowded trades in high momentum countries including South Korea and Taiwan were the first to see selling pressure, with the former off by 11.6% in early March and Taiwan holding up a bit better, falling 6.5%. Trading was especially troublesome in South Korea where the country's KOSPI index, according to market

data, registered five trading days with the benchmark either up or down by more than 5% in the first ten days of March. That level of volatility is a hallmark of leveraged positioning, as many traders have been using futures and other derivatives to get outsized exposure to the upside momentum in South Korean stocks. Despite the correction, emerging markets continue to outperform year-to-date.

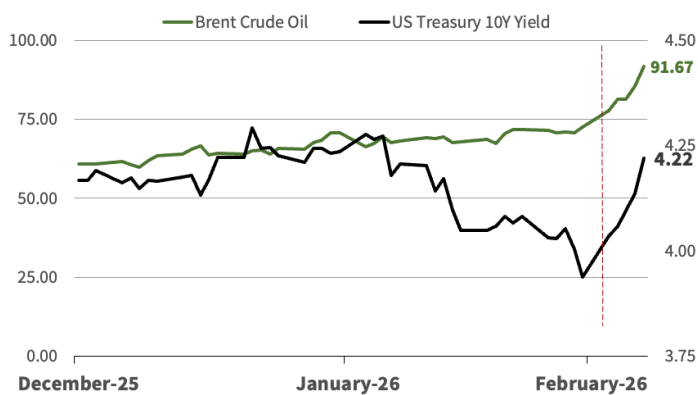
Tech hardware names in Asia including Samsung, SK Hynix and Taiwan Semiconductor were beneficiaries of the recent sell-off in software and were attractive long exposures for trend followers and systematic strategies that use derivative contracts. We still see runway in the memory cycle that could continue to buoy South Korean equities, specifically, but the index had simply gone too far too fast, trading over 20% above its 50-day moving average at the peak, making it ripe for a corrective move. After a bout of repositioning and deleveraging in early March, positioning in emerging market stocks, broadly speaking, has been reset and we believe sentiment now poses less of a risk. Country selection remains of the utmost importance, but we still see reasons to be constructive on emerging market stocks throughout the balance of 2026.

Long-term U.S. Treasuries garnered inflows to close out February with prices rallying/yields falling as investors sought safety in the face of geopolitical turmoil following military action in Iran. But safe haven bids for Treasuries quickly evaporated in early March as rising crude oil prices stoked inflation fears and led market participants to ratchet rate cut probabilities lower over the balance of this year. It's notable that Treasury yields have risen in the wake of the turmoil in the Middle East, with market participants choosing to key on inflation expectations as opposed to buying bonds for safety due to U.S. economic uncertainty. This is somewhat counterintuitive and flies in the face of the historical geopolitical playbook, but could prove to be valuable information, nonetheless. If yields on longer dated U.S. Treasuries fall and crude oil prices continue to climb, then those developments could signal a shift in what market participants are most worried about with an economic slowdown or recession moving to the forefront, but so far that has not been the case.

Energy prices rising sharply on the heels of ongoing military operations in Iran have forced inflation expectations and Treasury yields higher across the curve. The longer energy prices remain elevated, the less likely it will be that the FOMC will have room to cut the funds rate anytime soon. A combination of higher/rising energy prices and softness in the labor market could weigh on the outlook for economic growth should Middle East tensions persist and have already led to a bull market in utterances of the dreaded "s-word:"

stagflation. This sets up one of the more challenging backdrops in which the FOMC tries to navigate achievement of its dual mandate of price stability and full employment as the two appear to be increasingly at odds with one another. We have been in the camp that the FOMC was unlikely to cut the funds rate as drastically as the market consensus appeared to expect this year, and following the recent jump in energy prices, the Committee is likely poised to stand pat on rates into the June-July time frame, at a minimum.

Upward Move In Energy Prices Forcing Sovereign Yields Higher



Source: Bloomberg

Past performance is not indicative of future results.

Coming into this year, we expected Treasury yields to be more volatile and highlighted the importance of diversification and flexibility as we anticipated dislocations to present opportunities to tactically reallocate. The rise in Treasury yields in March has coincided with a commensurate upward move in sovereign yields abroad as inflation expectations have jumped globally. However, given our view that economic growth stateside should hold up given the U.S.'s position as a net exporter of energy, while inflation ticks higher, yields on longer dated U.S. Treasuries appear to have minimal downside from here, limiting total return potential. As Treasury yields have risen, credit spreads on investment grade and high yield corporate bonds have widened, albeit only modestly up to this point, and it would take a more meaningful dislocation for us to consider raising exposure to credit. As a result, we remain underweight high yield and see relative value hedge funds as an attractive overweight today.

Credit may get cheaper still. The recent bout of volatility in commodities and equities has so far failed to drastically impact demand for and prices of lower quality corporate bonds where bids are prone to dry up as equity volatility ramps up.

The lack of a steeper price dislocation across high yield corporates is encouraging as geopolitical uncertainty and private credit concerns have moved to the forefront. Private credit adjacent securities like the Business Development Companies (BDCs) have been some of the hardest hit, exhibited by the MVIS US Business Development Index registering a 9.1% decline in February while the Bloomberg U.S. Corporate High Yield Index was up 0.2%. Relative strength in high yield corporates comes even as credit spreads have continued to widen as uncertainty surrounding the downstream impact of elevated energy prices on the economic growth outlook have built. This backdrop could provide attractive opportunities for investors that have been balking at low yields/tight credit spreads in recent quarters, but patience is still warranted.

Nearing the halfway point in March, the Bloomberg U.S. Corporate High Yield index has fallen by 0.2% month-to-date, a modest setback as coupon payments have offset measured price declines thus far. That is the positive spin on a gradual move higher for credit spreads as long-term investors have seen roughly flat performance, but prices are getting cheaper, allowing coupon payments to be reinvested at lower prices which should modestly increase return expectations over time. The current option-adjusted spread (OAS) on the Bloomberg U.S. Corporate High Yield index of around 292-basis points over like Treasuries isn't exactly a major markdown but does bring the index closer to fair value. The current yield-to-worst on the corporate high yield index of 6.9% is interesting, but amid a backdrop of heightened geopolitical and economic uncertainty liquidity becomes even more valuable as it allows investors to take advantage of extreme dislocations should de-risking and/or forced selling create an opportunity for asymmetric upside in the asset class.

Highland Outlook

The Highland Investment Working Group held a special meeting in early March to discuss the conflict in Iran and the potential ramifications on investment portfolios. While U.S. equity markets seemed surprisingly resilient during the initial days, the team recognized that this resilience could begin to falter the longer the conflict dragged on. Highland believes the length of the conflict is the most meaningful variable when considering portfolio asset allocations. As the duration lengthens, the potential for additional escalation rises and will likely lead to more damages to critical infrastructure in the region. Highland remains in a risk-neutral stance broadly and will continue to assess new developments that could change this positioning.

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205

205.933.8664 PHONE
205.933.7688 FAX

BIRMINGHAM
ST. LOUIS

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