Highland Capital
MANAGEMENT, LLC

QUARTERLY REVIEW

March 31, 2021

Economic Commentary

After a strong year for the equity market in 2020, the market continued its move higher in the new year by gaining another 6.17% in Q1. The move was primarily driven by improving earnings outlooks (estimates are up 5.7% since 12/31), rising consumer confidence, and building optimism for stronger GDP as the economy re-opens and more Americans receive the Covid 19 vaccines. The roughly 75% gain off the Covid induced market lows of 3/23/2020 caps the best 12-month market rally in 75 years. The economy has entered a better place as evidenced by the 33% GDP growth of Q3 and the 4.3% GDP growth in Q4. With the $1.9 Trillion Covid relief bill being passed in March, and the additional payments hitting most Americans bank accounts, economists have upped their forecasts for 2021 GDP. **The Conference Board consensus forecast is now for growth of 5.5%.** That number could prove to be low as it is not uncommon now to see full year GDP estimates of 8% or better. With infrastructure bills being discussed, the likelihood of even further government stimulus is highly plausible. The jobs picture also continues to show meaningful signs of improvement as the unemployment rate has fallen to 6% as of the March jobs report. There are still approximately 9.5 million jobs that have not been recovered, but the Fed is intent on delivering on their employment mandate. As such, we continue to see the Fed as being very accommodative in their monetary policy, and even while inflation and interest rates are on the rise, the Fed sees those issues as transient. As a result of the Covid crisis the Fed balance sheet has ballooned to $7.7 trillion, and the national debt has risen to $28 trillion, or roughly $224,000 per taxpayer. While the crisis was an unprecedented situation and required unusual actions to combat an economic disaster, we continue to feel that we will look back at this time as a watershed event that changed the secular trend of abnormally depressed interest rates. **It is our view that market returns in 2021 will be a battle between strong earnings growth and potential valuation compression driven by higher interest rates.** The markets have benefited from low rates which increase the present value of cash flows, but that tide is beginning to turn. Inflation expectations influence interest rates, and commodity prices have moved higher in the new year with WTI crude up 25%, copper +13%, and lumber +32%. Supply chains were disrupted by Covid, and we continue to see supply chain pressures as evidenced by semiconductor shortages for the auto business, and the recent container ship blockage of the Suez Canal.

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Q1 2021 Equity Commentary

The first quarter market returns continued to show the cyclical rotation that began in earnest in Q4 of 2020 as Value outperformed Growth, and small cap bested large cap. The Russell 1000 Value index gained 11.2% in Q1 versus the Growth index at 0.94%, and the small cap index returned 12.69% versus the S&P 500 return of 6.17%. The best performing sectors in the quarter were cyclicals with Energy (+29.3%), Financials (+15.4%), and Industrials (+11.0%). The poorest performing sectors were Consumer Staples (+0.5%), Technology (+1.7%), and Utilities (+1.9%). An improving economic outlook and rising rates favors the value and cyclical sectors. The market was in a "risk on" mode in Q1 as defensive sectors such as Staples and Utilities were out of favor. Previously high-flying names such as Apple, Tesla, and Amazon detracted from market returns in Q1, while more pedestrian names like Exxon, JP Morgan, and Bank of America were additive to index returns. Market volatility did pickup somewhat in the quarter and was driven by both retail investors (Robinhood) and institutional hedge funds (Archegos). It's a testament to the markets resiliency that the liquidation of over $30 billion in stocks from an over leveraged Archegos did not result in any major market disruption.

Stock Market Indexes

Market/Index	2020 Close	2020 Change	2021 Q1 Close	2021 Q1 Change
DJIA	30,606.48	7.25%	32,981.55	8.29%
Nasdaq	12,888.28	43.64%	13,246.87	1.76%
S&P 500	3,756.07	16.26%	3,972.89	6.17%
Russell 2000 (Small Cap)	1,974.86	18.36%	2,220.52	12.69%

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What can we expect in the months ahead? It is now consensus thinking that we will see the strongest economy in our generation over the next several months. The pent-up demand after a year of restrictions, income replacement provided by the government, and now the additional stimulus of fiscal spending will result in tremendous demand for goods and services. We are already seeing high frequency indicators such as Open Table seated diners showing strong improvement with late March in person diners just 21% below the comparable period in 2019. Airports are also coming back to life with TSA daily numbers showing travelers at 1.4 million daily versus roughly 810,000 in early January of 2021. Demand will not be lacking but will the supply chain be able to keep up with that demand, and what will be the subsequent impact on inflation and thereby interest rates? Both the rate of increase in Treasury yields as well as the absolute level of rates will matter. The markets would prefer a more orderly rise in interest rates. A sudden jump tends to portend that the Fed is behind the curve and will have to move to catch up. **Where we land on interest rates will determine how well markets do over the remainder of 2021.** We know that supplier deliveries are facing longer lead times, and this historically leads to higher prices. The US trade weighted dollar has declined roughly 6% over the past year. This makes imports more expensive and import prices are up 3% over the past year, the largest 12-month advance since October of 2018. And don't forget the previously mentioned increases in commodity prices. All of this points to at least modestly higher interest rates over the coming months, and the potential that rising interest rates will cap or possibly compress market valuations. We all know that lower inflation rates are associated with higher price earnings multiples for the market. Historically inflation rates of 0-2% have given rise to stock market P/E multiples just over 18X earnings. An inflation rate of 2-4% has led to a slightly lower multiple of 17.4X. Current inflation numbers are still below 2%, but the markets P/E ratio is over 20X. **But it is also possible for rates and the market to rise simultaneously**. Since 1990 there have been 7 periods of rising interest rates with the average rate increase being 1.8% and the current increase so far being 1.17%. We should see rates move higher. However, during those periods of rising rates, the S&P 500 produced positive returns in all periods, ranging from a low of 1.8% to a high of 28.3%, and averaging 17%. **The real risk to financial assets is not the specter of higher inflation itself, but when central banks make it clear they are ready to stop it.** We are far from that with the Fed publicly stating they are willing to allow inflation to run hot for some time, keeping in mind that since the Great Recession the Fed has been ***trying*** to increase inflation unsuccessfully. Higher interest rates do increase the risk in the equity market, but with a market awash in liquidity (M2 growing at 24%) **we still expect the strength of earnings growth in 2021 to trump the impact of higher rates**. As such, we would continue to expect the more cyclical areas of the market such as Energy, Financials, Industrials and Consumer Discretionary to lead, while the more defensive sectors such as Consumer Staples and Utilities should lag. **Where does the Technology sector fit into this?** Higher rates could be a headwind for Tech as their valuations have benefited from values being discounted at near zero rates. But we think this could be similar to 2013 when rates rose and Tech also participated in the market rise, but just not to the same degree as the more cyclical sectors.

Valuation: The market is currently trading at a P/E multiple of 21.6X forward 12-month earnings, above both the 5 and 10 year averages of 17.8X and 15.9X respectively. The current price to cash flow multiple of 15.9X is well above the long-term average of 10.8X. Valuation metrics continue to look stretched, which creates impetus for the market to produce the robust earnings growth that is expected in order to lower those valuation multiples. We expect this to occur. Earnings are now beginning to lap the weak periods of early Covid lockdowns, and Q1 2021 earnings are projected to grow by over 23%. Full year 2021 eps are now expected to increase by 25.4%. This is impressive given that in the early months of the pandemic it was believed that it would take several years for the market to recover to 2019 pre-Pandemic earnings levels. If the 2021 earnings materialize, then we will eclipse 2019 earnings by 7%. The picture should continue to improve into 2022 as well, with earnings growing another 15%. One of the risks to achievement of these earnings could be the new potential tax hikes outlined in the infrastructure plan. This could serve as a drag on growth in 2022 as infrastructure money tends to be spent more slowly over time, whereas new taxes are paid in the year enacted. This will bear careful watching over the next several months as higher corporate tax rates could result in negative earnings revisions, and 2022 earnings that are not as robust as currently projected.

Like most of you, we are encouraged by the improving availability of vaccines for the US population. We are hopeful that we can reach a level of “herd immunity” perhaps by this summer. While it will still take some time for things to return to normal or whatever the new normal might look like, we are nevertheless making progress. We are hopeful that we can return to meeting with many of you in person, and we will begin to reach out to you in the upcoming months.

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Fixed Income Commentary

Treasury yields rose sharply in the first quarter, largely related to the brightening economic outlook due to the improving COVID-19 backdrop and further fiscal stimulus. Since the pandemic hit the markets in 2020, the last concern on investors' minds was the potential of inflation. At various points in 2020, the market was pricing in close to zero inflation for the next five years. After positive developments related to vaccines and increased government stimulus the bond market is finally pricing in the risk of inflation. Between the $935 billion spending bill passed in late December and the $1.9 trillion package in March, the US economy should see a stunning 15% (of GDP) worth of fiscal support. This does not include the multi trillion CARES act passed in 2020. Federal Reserve Chairman Jerome Powell believes prices will rise this year. However, he has played down the risk of inflation getting to unwanted levels. According to Powell, "Our best view is that the effect on inflation will be neither particularly large nor persistent." New York Fed President John Williams has a similar sentiment as Powell. He said, "I see the US economy recovering really nicely over the next couple of years" but "I don't see inflationary pressures really building during that time." The Fed is essentially saying 2021 will be a transitory year for inflation and upcoming years will trend back towards acceptable levels. Even though recent inflation data paints a picture in which investors need to pay close attention going forward. The February Institute for Supply Management (ISM) increased to a very solid reading of 60.8 which was the highest reading in three years. However, the price component was the highest level since July 2008. Indicating that supply chain disruptions and the shortage of many goods has already created pockets of inflation.

The Federal Reserve met on March 17th and kept short term interest rates unchanged along with the Fed's asset purchase program of Treasuries and mortgage-backed securities. Seven of 18 officials predicted higher interest rates by the end of 2023 compared with only five during the last meeting in December of 2020. In the forecasts released, Fed policy makers projected that the economy would grow 6.5% in 2021. That would be the fastest increase since 1983. Additionally, the global economy is expected to grow 6.4% in 2021 after contracting 3.3% in 2020, the worst global recession since World War II. Europe appears to be somewhat of a wild card, as the recovery is slower due to vaccination delays and fiscal stimulus that is less aggressive compared to the United States. Heading into the second quarter of 2021, households have accumulated excess savings of as much as 8-10% of GDP. Some of the excess savings is related to transfer of payments from the US government. However, a large part is related to the widespread lockdowns creating downward pressure on consumption. From the 3rd quarter of 2019 to 3Q 2020, US household net worth increased approximately $5.2 trillion. ***Currency and savings deposits rose $2.3 trillion which was the fastest three-month gain in history.***

The 10-year Treasury ended 2020 yielding only 0.93% and increased 81 basis points during the first three months of the year to reach 1.74%. Front end rates have been anchored close to zero as the Treasury curve continued to steepen. The 2-year Treasury increased only 3 basis points during the quarter ending at 0.16%. Another reason for the increase in rates in 2021 is the amount of supply hitting the markets. According to Bloomberg, global government issuance is up 79% year-to-date as the US has already issued $4.1 trillion this year. Most bond indices generated negative returns in the quarter. The Bloomberg Barclays Aggregate decreased -3.37% during the quarter. The Bloomberg Barclays Intermediate US Gov/Credit index decreased -1.86% during the quarter. The Treasury index was down -1.54% in March and finished the quarter down -4.25%, the largest quarterly decline since 1980. Verizon's $25 billion 9-part deal to purchase spectrum assets was the largest corporate deal of the quarter and tied Boeing for the sixth largest deal on record.

The Biden administration is considering increasing corporate taxes from 21% to 28%. After corporate taxes were recently lowered, banks and some insurance companies decreased exposure to municipal bonds. Higher tax rates will incentivize these investor groups to increase exposure to the space. As Treasury yields have moved up in 2021, the muni market has been very resilient. The Bloomberg Barclays Muni index was only down -0.35% during the quarter outperforming most other bond markets. Historically, tax-exempt bonds outperform when Treasuries are selling off which happened this quarter. Additionally, in light of fiscal support, S&P has upgraded its sector view of the muni market. The rating agency said that "The revision of sector views back to stable from negative reflects a marked improvement in economic conditions as well as the receipt of additional federal stimulus."

Last quarter we wrote about the distinct possibility of negative returns in the Treasury market in 2021. We believe yields are rising for the right reasons, based on an improved economic outlook. Riskier assets in the bond market face a 'Goldilocks' scenario with a combination of strong economic growth and massive policy support (both fiscal and monetary). The US government has a vested interest to keep short term interest rates low for the foreseeable future. Thirty-four percent of US outstanding debt matures every single year and 56% rolls off in three years. The US has shed approximately 9 million jobs since the start of the pandemic and the Federal Reserve will remain highly accommodative until the employment gap has been closed. This leaves longer term inflation expectations as the key unknown variable for fixed income returns in 2021.

We are here to assist you in any way and to answer your questions. We appreciate the opportunity to serve you and value the trust and confidence that you have placed in us. Stay safe and well.

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