Investment Policy

September 2022

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Our market view in a nutshell – September 2022

- **Inflation keeps dominating market dynamics**. Every month that inflation shows no signs of abating, the **pressure on central banks mounts**. And a faster pace of interest rate hikes **increases the chances of a recession**. After the respite in July, the inflation reading for August was very disappointing. Headline inflation barely fell, while core inflation rose significantly

- A breakdown of the components of the price index shows that we are currently **experiencing second-round effects**. These occur when economic agents transfer the direct and indirect effects of the first wave of price increases (caused on this occasion by restrictions on the supply side due to the pandemic) to **wages and services**

- The **problems in the supply chain are progressively being resolved and commodity prices are falling**. To this must be added a more than probable slowdown in the economy due to the cooling of demand. Therefore, a **wage-price spiral seems very unlikely**. Inflation is now primarily a **demand-side problem**, something **central banks can control more effectively**. The sharp rise in financing costs depresses consumption and investment. All of this affects business profitability, often leading to restructurings and job losses

- Investors are witnessing a **trainwreck in slow motion**, the consequences of which are hard to predict. **Public markets have adjusted their valuations** to the new reality, while **private markets show a clear lag**. Most prominently the **housing market**, which exhibited parabolic behavior during the pandemic. A crash similar to that of 2008 seems unlikely, as **households are now much less indebted** this time. By contrast, **companies and governments have borrowed heavily** over the past decade and their balance sheets appear more vulnerable

- Stocks and corporate bonds have corrected sharply, even though corporate profitability has continued to rise. Therefore, current **low valuations** necessarily **reflect not only higher interest rates, but also lower future earnings** as the economy slows down. In this context, we recommend continuing to **avoid cyclical and highly leveraged businesses, and instead focus on low-debt, defensive companies**

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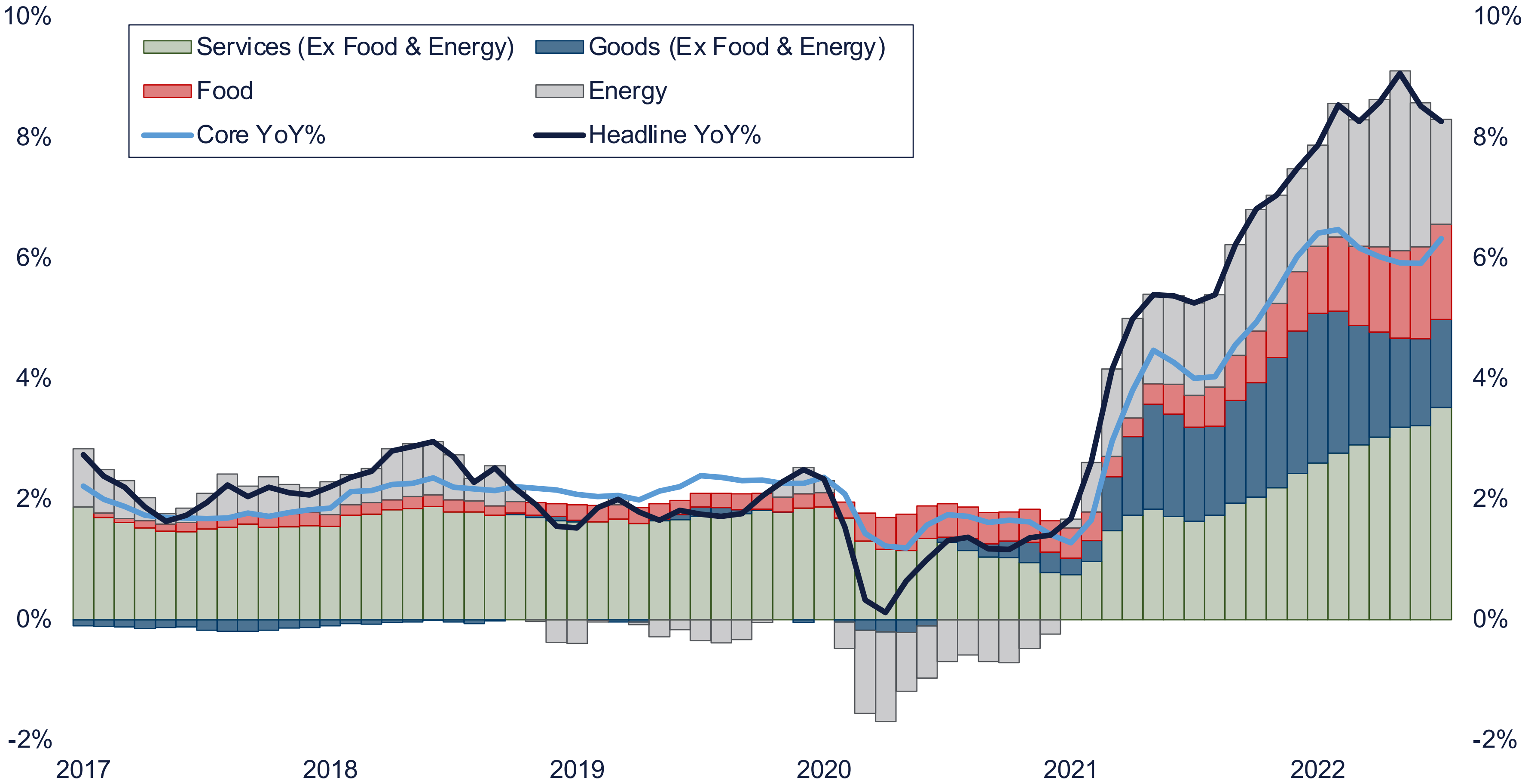
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	=	Higher probability of an economic slowdown caused by rising interest rates and inflation have pushed up credit spreads, so returns are beginning to compensate for the risks taken
	EU Investment Grade	–	High quality debt in Euros presents a very unattractive combination of risk and return as current yields still offer very little cushion to weather potential interest rates increases
	European Credit	=	As with US credit, but from a lower base, higher credit spreads make European credit investable again
	Emerging Markets	–	Emerging market debt attractiveness has improved, but tends to underperform in a strong dollar environment
Equities	US	+	After the sharp sell-off, valuations have improved. We maintain our exposure to US equities, mostly through quality and growth oriented companies
	Europe	=	The European economy has emerged from the pandemic faster and stronger than many expected. However, the continent is more exposed to the falling out with Russia
	Asia	=	We recommend investing selectively in the region
	Emerging Markets	–	Emerging market stocks tend to be more cyclical, and there are fewer quality stocks. Russian sanctions and regulatory pressure on China have increased the risk premium
	Sectors & Themes	+	To complement our core allocation, we favor Healthcare and companies that pay sustainable dividends
Alternative Investments	Multi-Strategy Hedge Funds	–	Multi-strategy / multi-manager hedge funds with daily liquidity are having a disappointing performance, particularly when compared with other less risky alternatives, like short-term corporate bonds
	Commodities	=	Commodity prices have been driven up by (and not caused by) inflation, as well as the war in Ukraine. We do not expect these levels to be sustainable in the long term
	Private Equity	=	Investing in late-stage private equity provides access to the asset class with liquidity provision up to a certain degree

\+ Overweight – Underweight = Neutral

Second-round effects



- August inflation figures were very disappointing as **headline inflation fell less than expected while core inflation (excluding Food and Energy) rose**
- This happened because **inflation has become widespread** and is now present in the most stable components of the price basket, while the most volatile are beginning to fall

Source: Bloomberg

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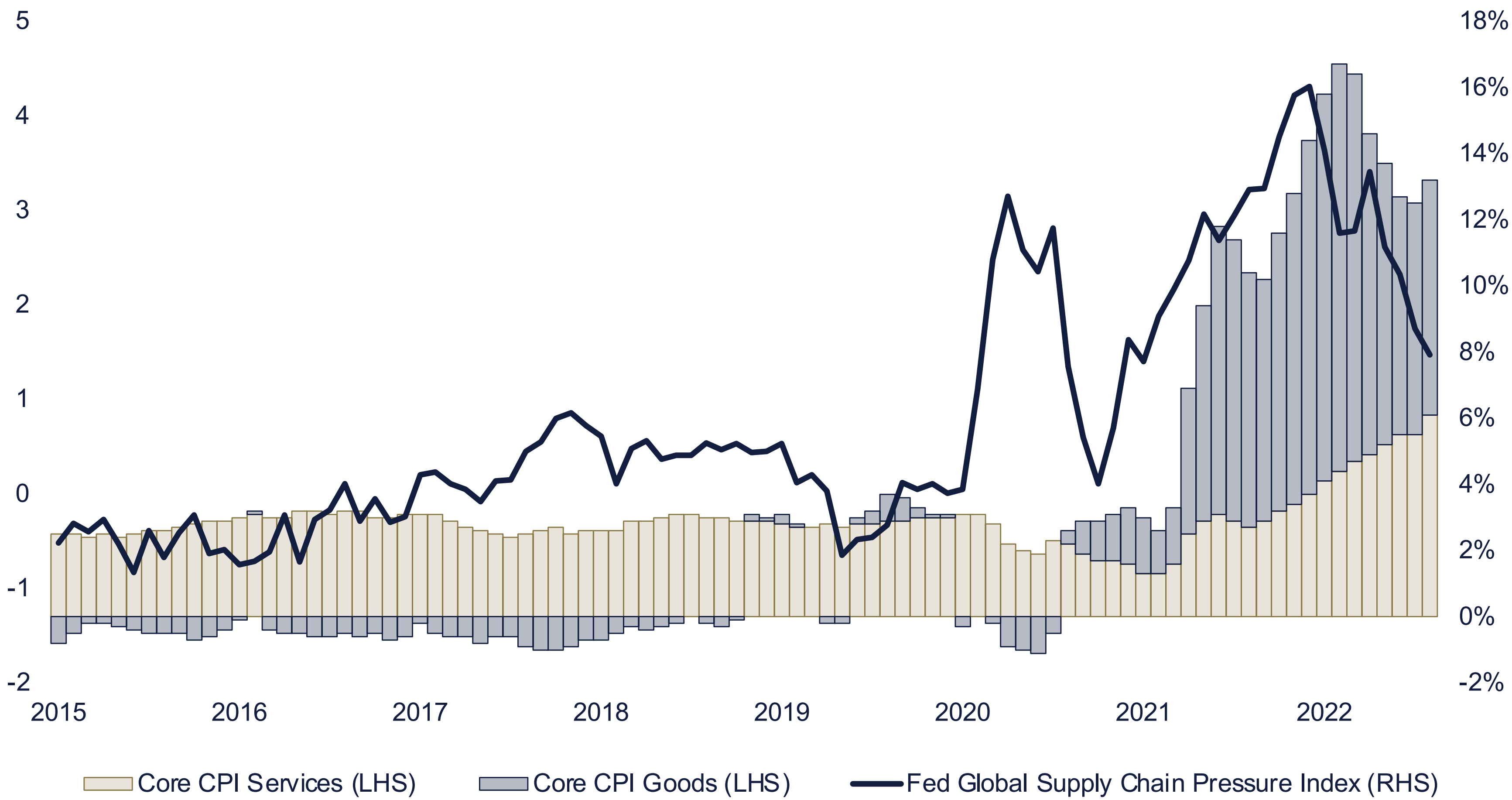
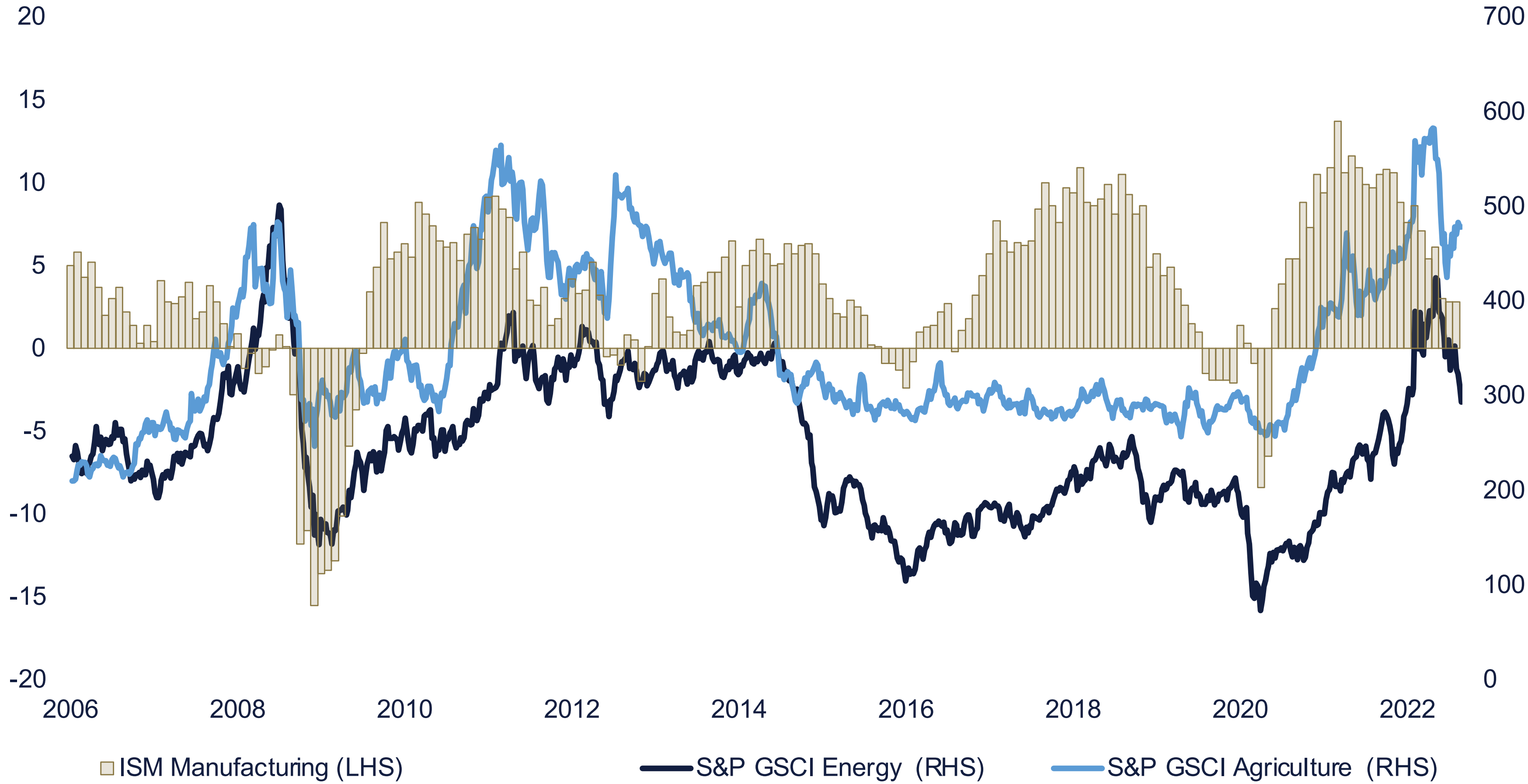
A shift from goods to services



- Inflation originated as a result of the economy emerging from the pandemic stronger than expected, with robust **demand (due to accumulated savings) outstripping a limited supply**
- As supply chain constraints are progressively resolved, the **shift from consumption of goods to consumption of services** has also moved the epicenter of inflation

Source: Bloomberg

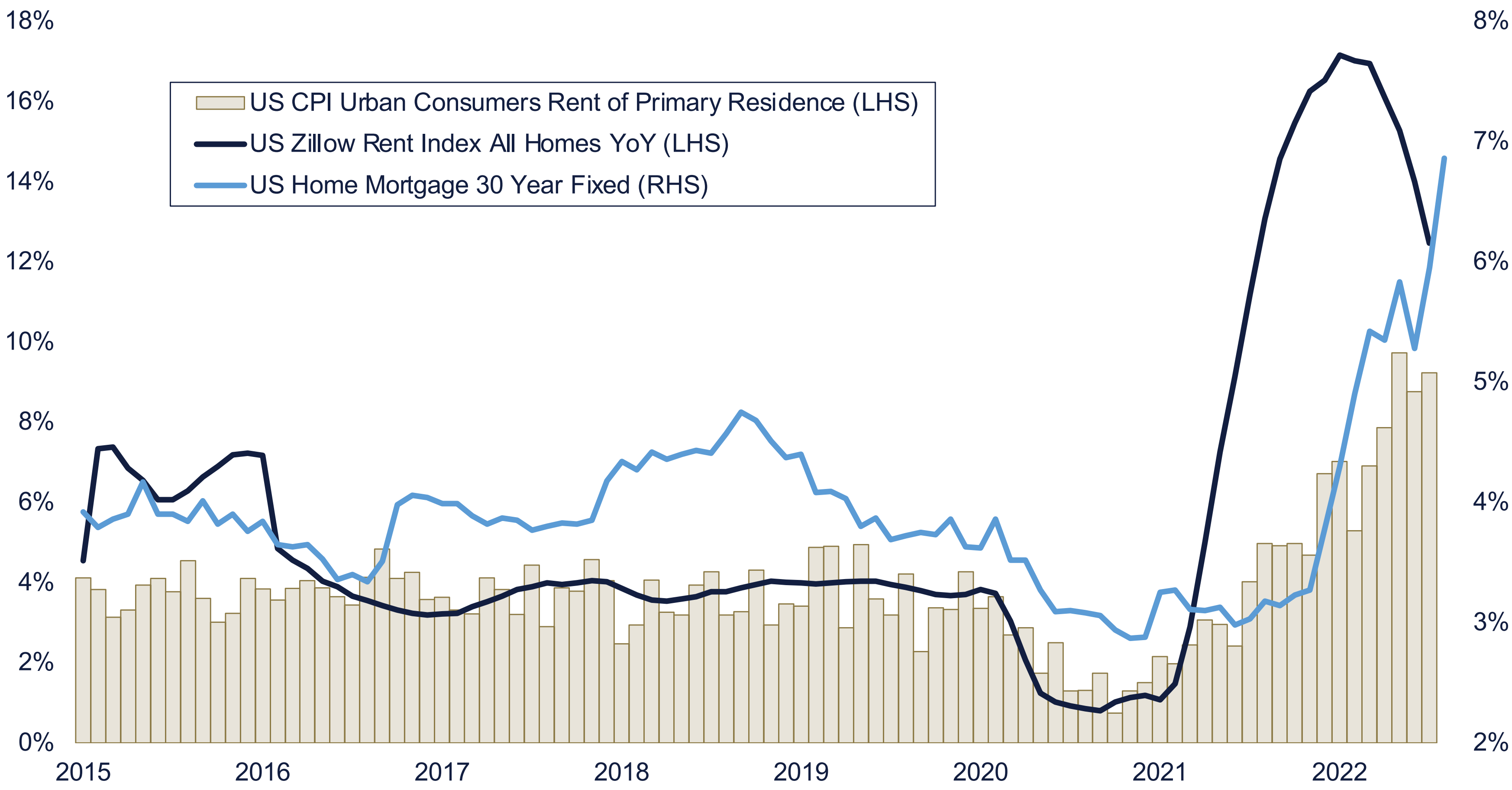
No commodity super-cycle



- Commodity markets, which have soared since the start of the war in Ukraine, are **starting to correct in anticipation of an in economic slowdown**

Source: Bloomberg

Housing market at the brink of a reversal



- **Shelter** (rent and owner's equivalent rent) accounts for approximately **one third of the CPI basket**
- Contrary to supply-side inflation, by raising interest rates, **the Fed can cool the housing market**. There are already some visible signs of a slowdown with falling rents, housing starts, and (for the first time in a decade) house prices

Source: Bloomberg

Early signs of labor market normalization

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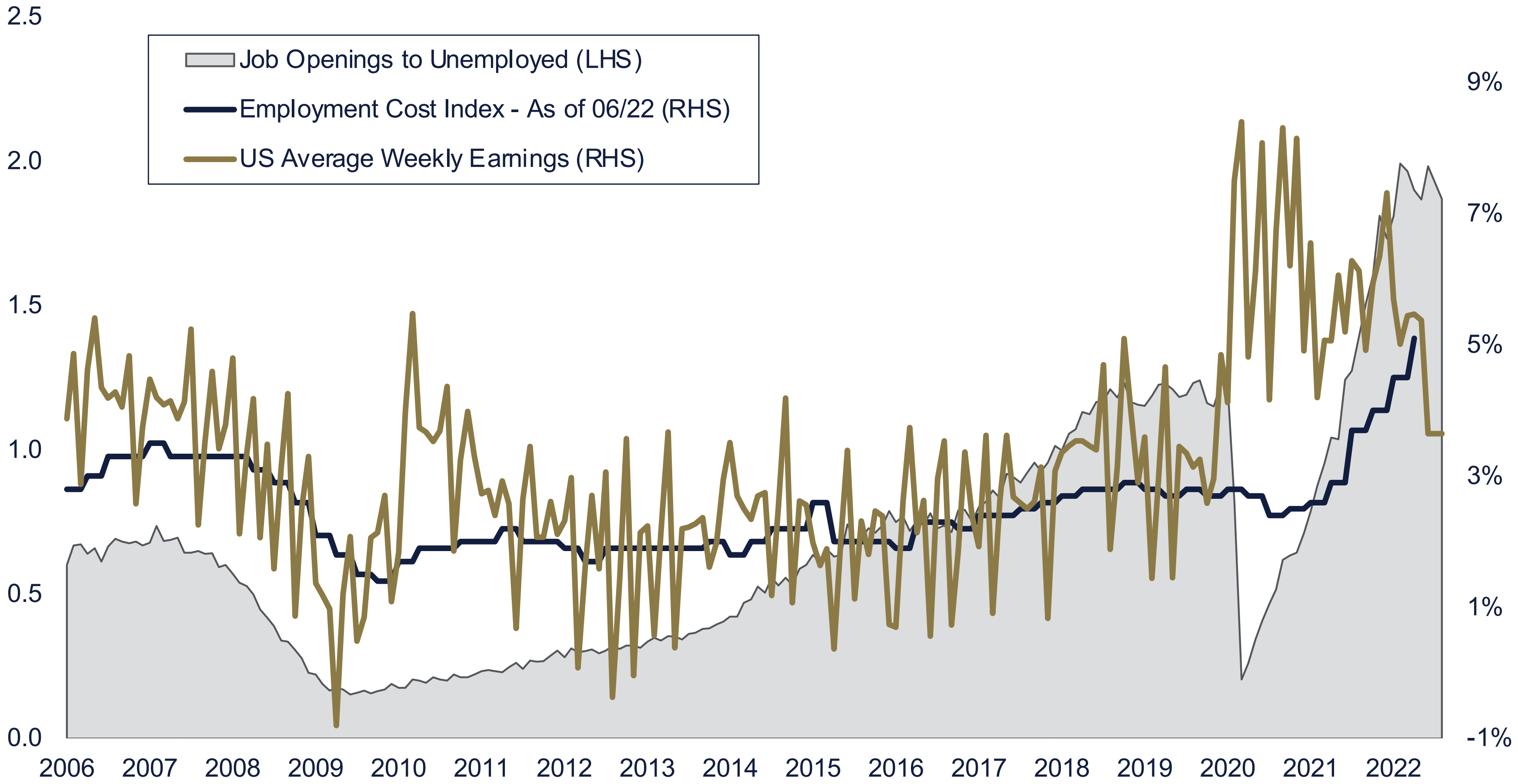
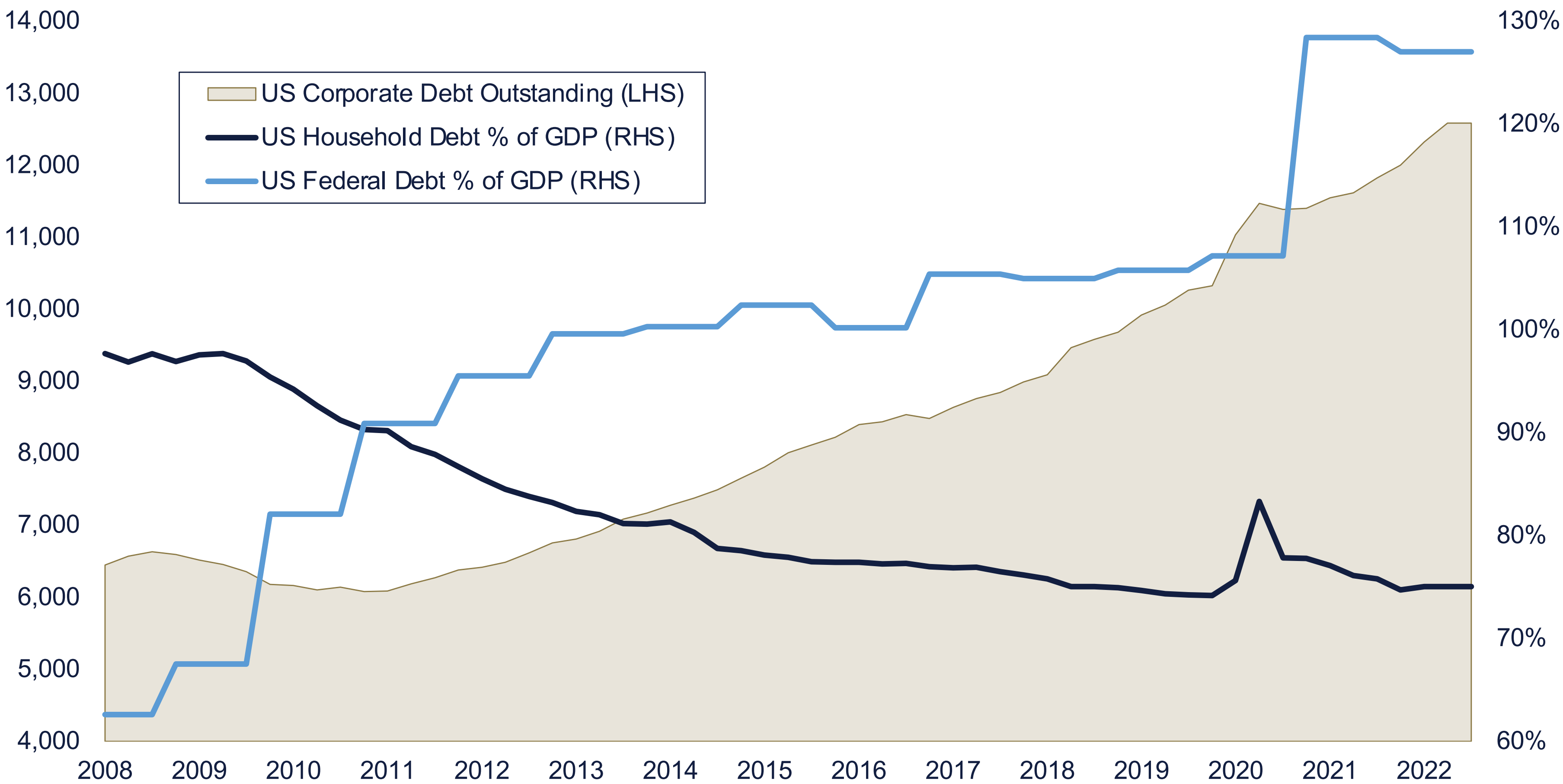


- Second-round effects can be clearly seen in the labor market. Given the shortage of workers, **wages have been able to increase in response to rising prices**
- In addition to rising labor costs, higher interest rates lead to higher financing costs. **If demand cools, this should translate into corporate restructurings, layoffs and rising unemployment**. The latter is beginning to be seen in some sectors such as technology (Tesla, Netflix, Snap, Meta, etc.)

Source: Bloomberg

Brace for impact



- The economy is almost certainly going to slow down. This makes **investors wonder what kind of recession we could face**
- **Households have massively deleveraged** since the Financial Crisis and the **banking system is much more capitalized**. On the contrary, **corporations and governments are more indebted**

Source: Bloomberg

Recession vs. stagflation

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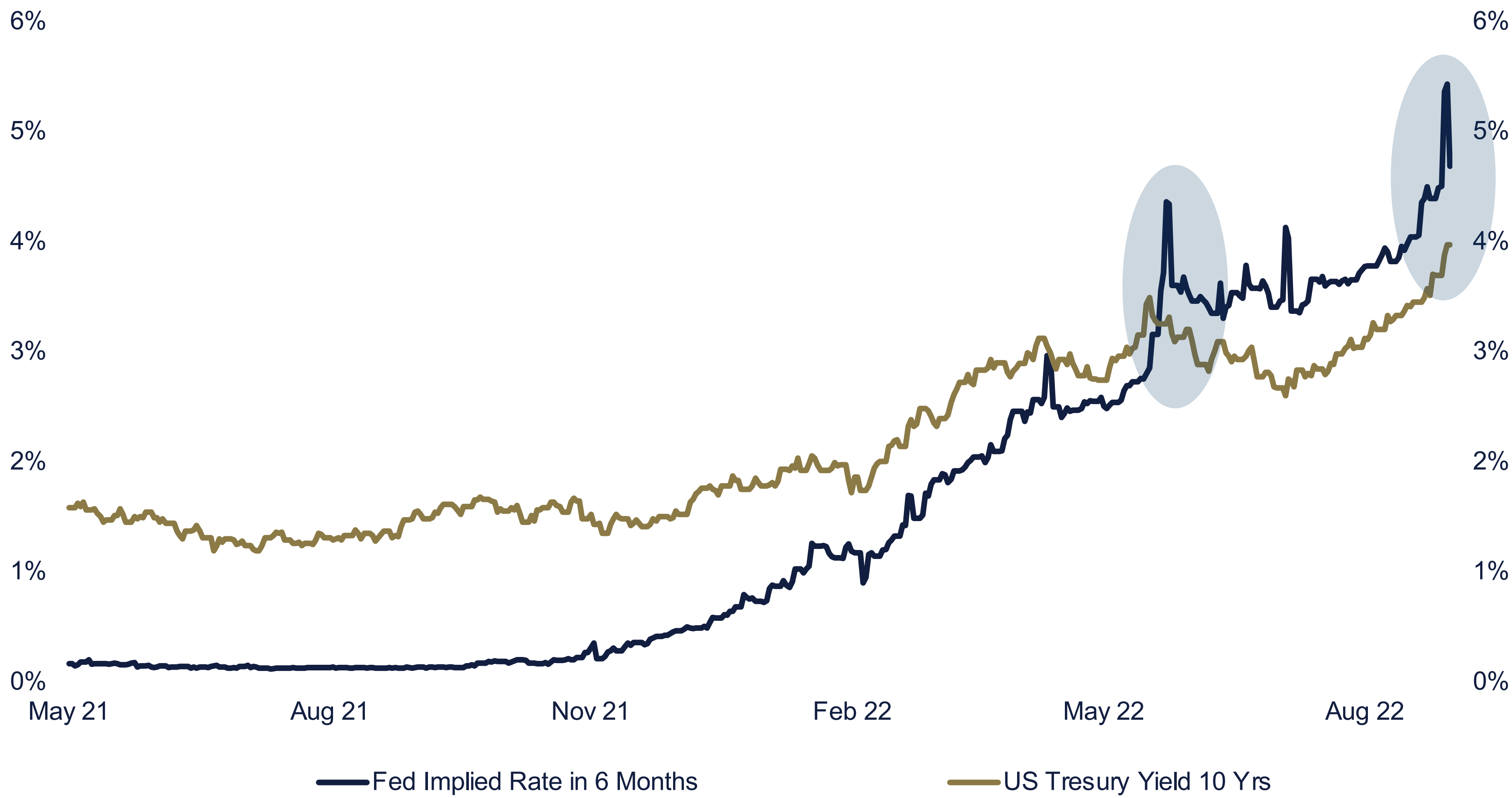
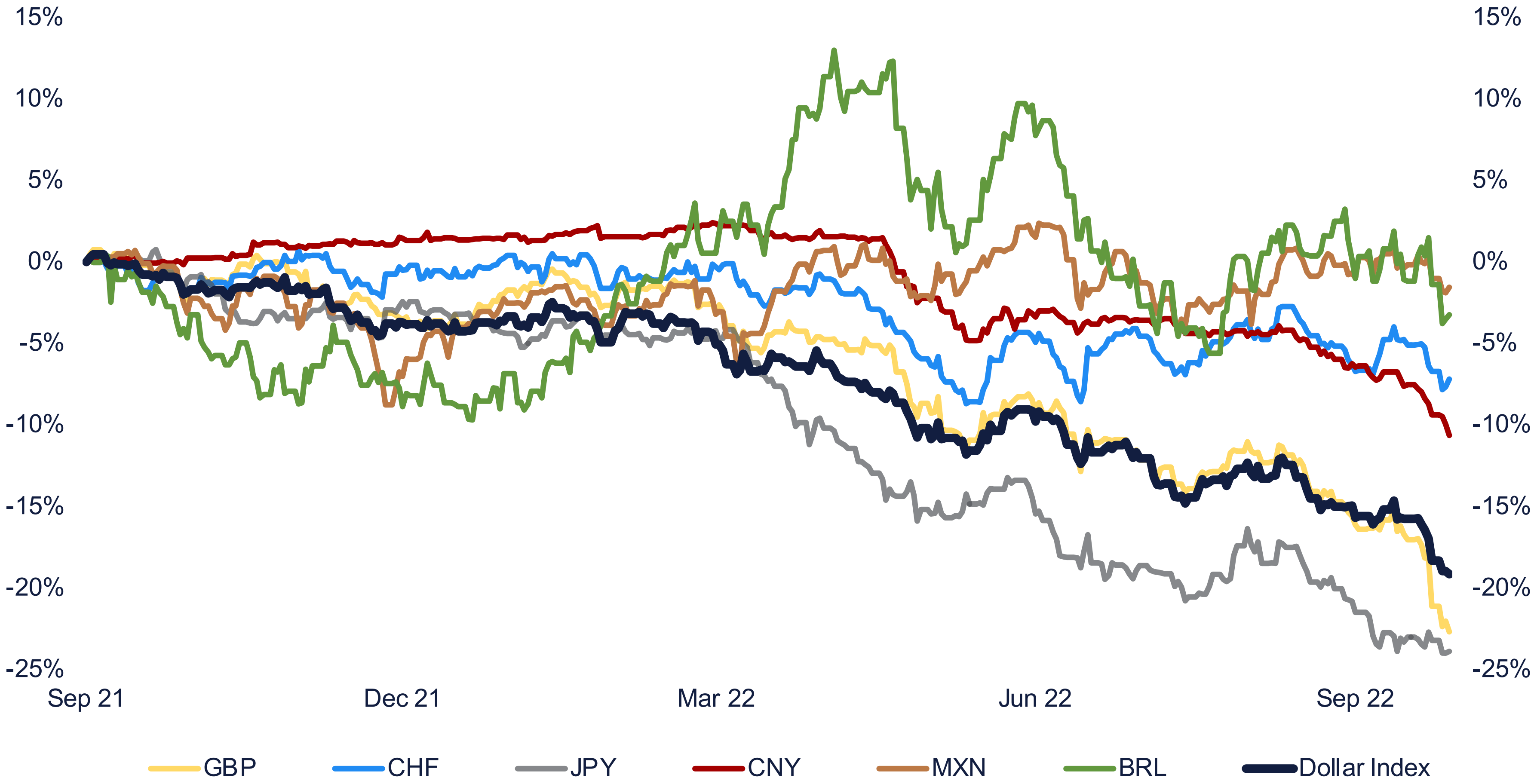


- Every disappointing inflation figure forces the Fed to rachet up interest rates and thereby raises the specter of a recession
- However, **recent movements in the yield curve seem to indicate that the market is becoming increasingly skeptical** that the Fed can win the battle against inflation; even in the event of a slowdown in the economy

Source: Bloomberg

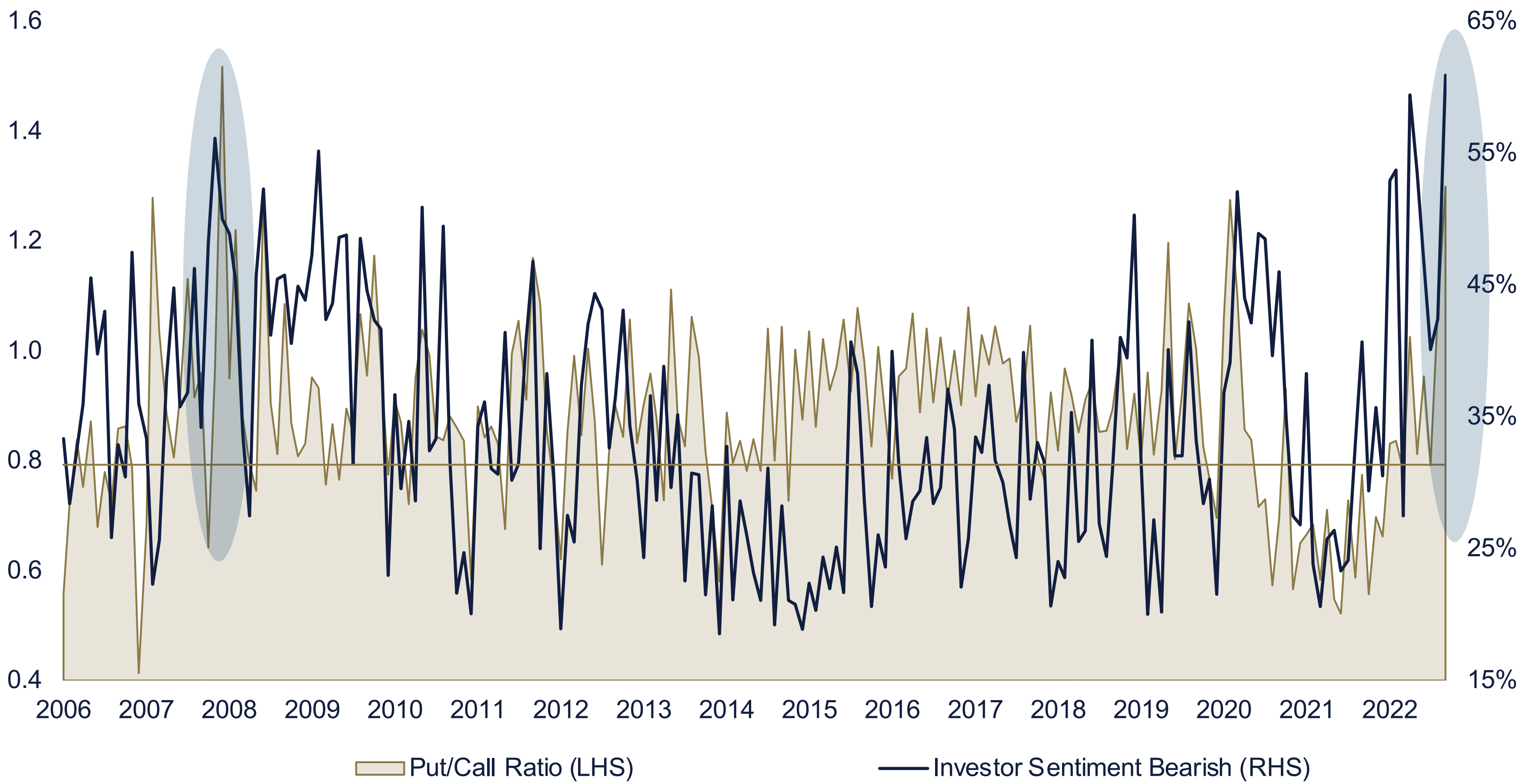
Currency tumult



- Dollar strength has intensified. The appreciation has been particularly intense against those **currencies that maintain divergent monetary policies to those of the US**
- Since some central banks are being **forced to defend their currencies, they need to sell their dollar reserves**. The latter are generally invested in US Treasury bonds, which, when sold, cause a rise in their yields

Source: Bloomberg

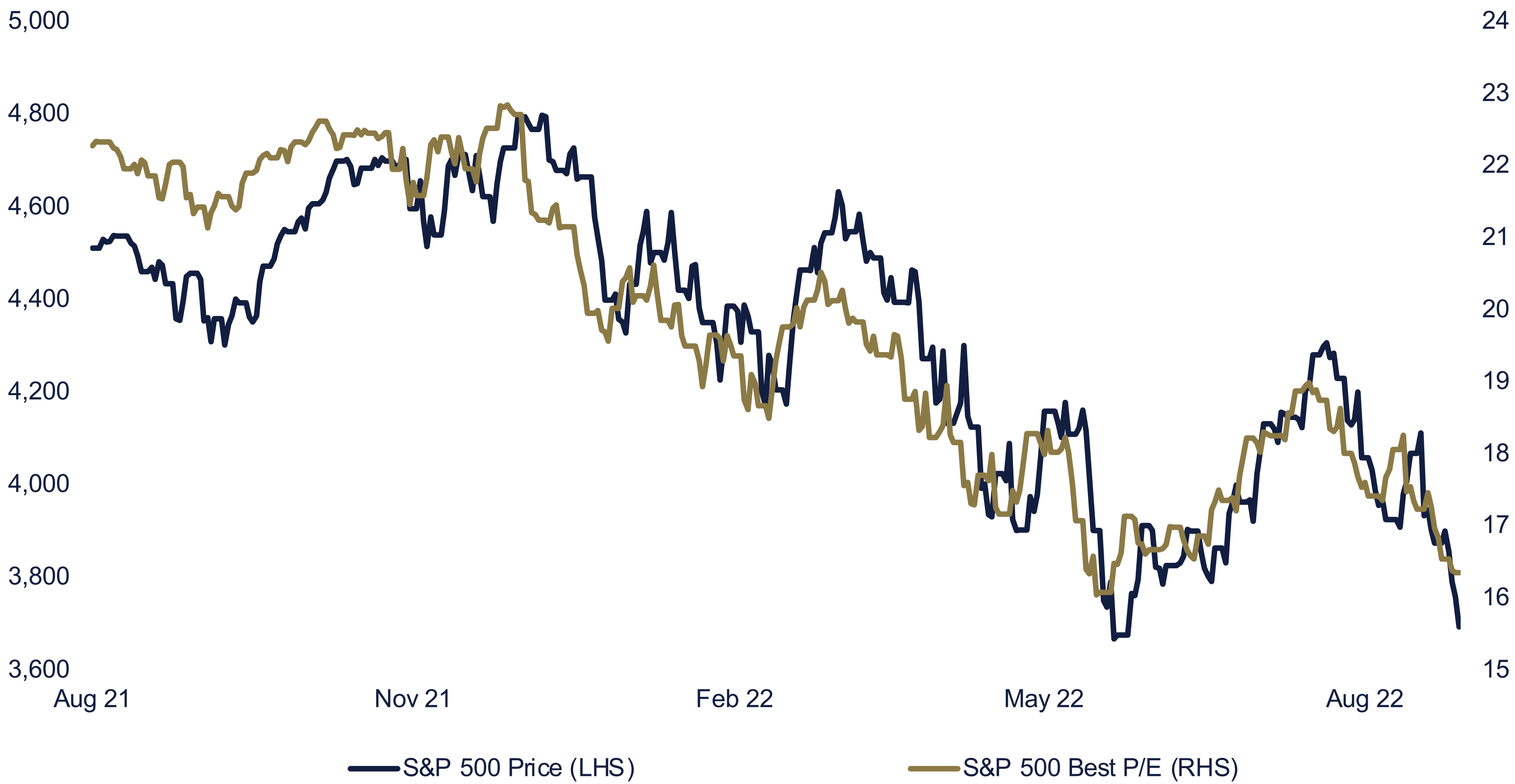
Poor investor sentiment



- We are facing an **unprecedented macroeconomic environment**, with a sudden bout of inflation accompanied by a forceful monetary response
- A recession is almost certain at this point, but **investors cannot compare to similar episodes in the past** to gauge the potential impact on corporate earnings. As a result, the degree of **uncertainty is very high**

Source: Bloomberg and American Association of Individual Investors

How much is already priced in?



- Equity **valuations have massively compressed**. From an all-time high of 28 times P/E in 2020, to 16.4 times today, which is below the historical average of 17.6 times
- Such a movement cannot be explained exclusively by an increase in interest rates, but **must necessarily price in a future slowdown in corporate earnings**

Source: Bloomberg

Investment scenarios

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	Scenario 1 Stagflation	Scenario 2 "Hard landing"	Scenario 3 "Soft landing"
Drivers	• Inflation remains high due to labor shortages, supply chain bottlenecks, and rising commodity prices due to war sanctions on Russia • The Fed tightens its monetary policy at an accommodating pace, which fails to control inflation, but does not slow down the economy either • As a result, long-term inflation expectations rise, as do long-term interest rates	• Consumption slows down given that, despite the rise in wages, high inflation translates into lower real disposable income • In order to bring inflation down, the Fed is forced to raise interest rates aggressively, causing a drop in consumption as well as corporate investment • The economy falls into recession, slowing down inflation and lowering interest rates	• Fiscal policy remains highly accommodative, and the economy continues to grow with strong momentum • The Fed raises interest rates progressively. Inflation begins to normalize without the economy slowing down significantly • The yield curve flattens, and long-term interest rates rise only moderately
Market impact	• Corporate profits rise with inflation, but higher interest rates have a negative impact on equity valuations • High-quality and sovereign bonds fall due to rising interest rates • Credit performs relatively better despite higher rates, as the risk of corporate defaults remains low • The US dollar depreciates against safe-haven currencies as well as against gold	• Equity markets fall, and cyclicals underperform quality and defensive stocks • Credit spreads widen sharply as the prospect of corporate defaults increases • Sovereign debt and the US dollar appreciates due to "flight to quality" • The economic recovery will be greatly influenced by the fiscal policy response (a repeat of the emergency measures tried during the pandemic, or a more orthodox approach)	• Equities appreciate, as the economy returns to the "Goldilocks", and valuation multiples widen • Credit spreads tighten moderately as investors chase yield again • High-quality and sovereign debt trade range-bound • Commodity prices stabilize and the US dollar appreciates due to higher real interest rate differentials
Probability	30% (+5%)	55% (+5%)	15% (-10%)

Short-term catalyzers

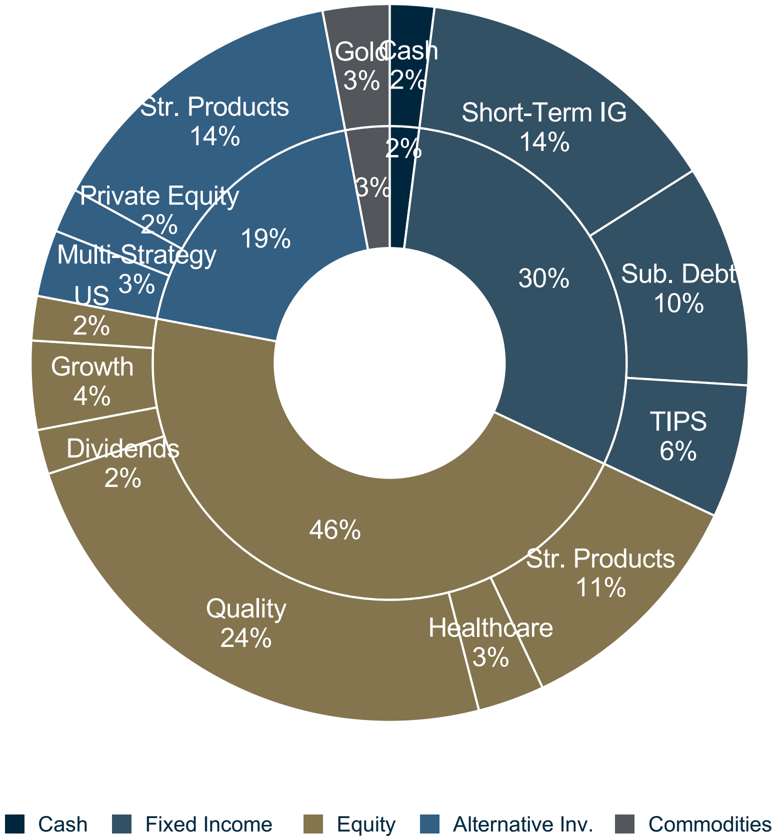
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

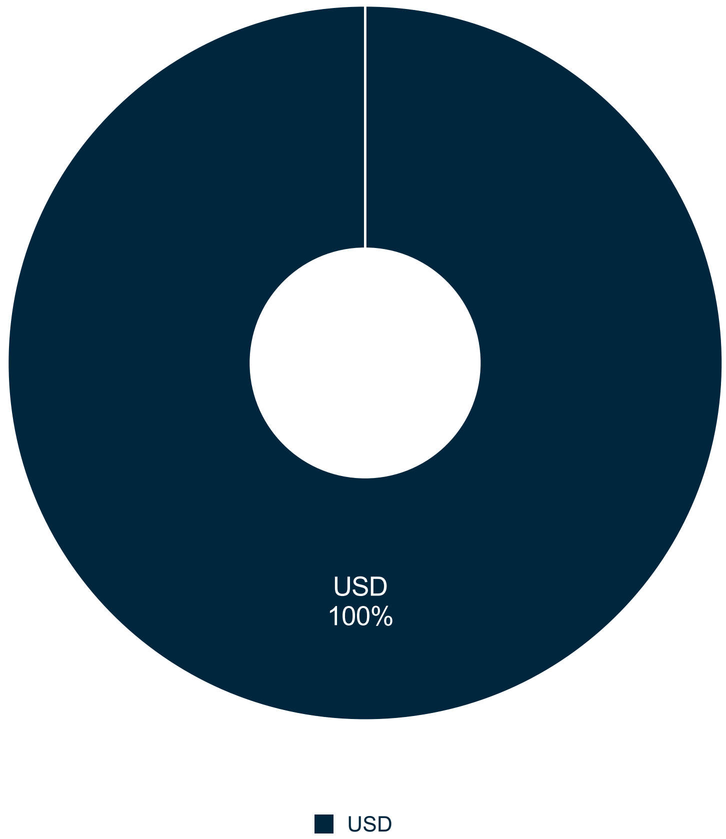
Escalation of the war in Ukraine, China slowdown, Housing market correction, Crypto bubble crash

Boreal Balanced Portfolio USD

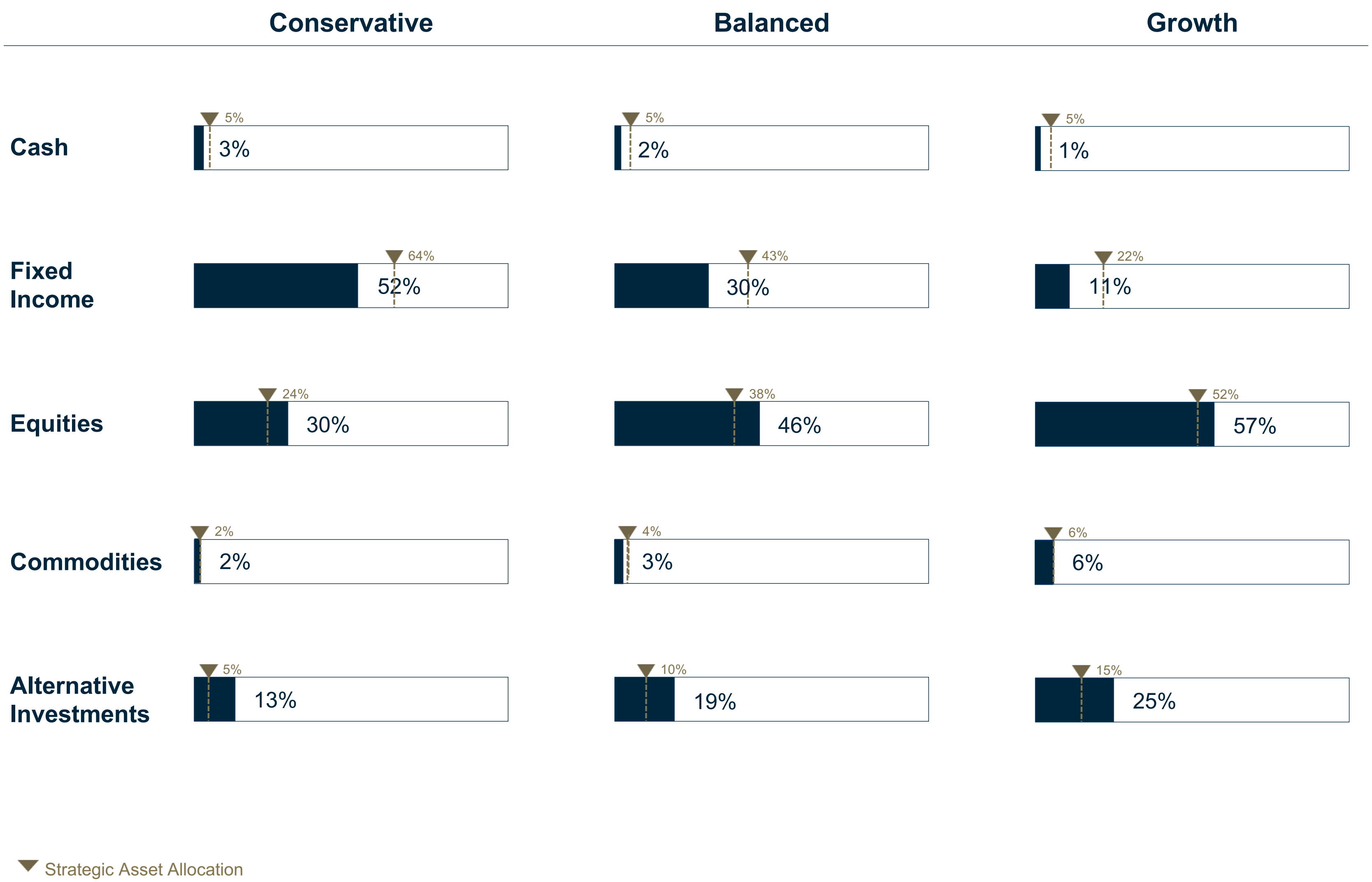
Asset Allocation



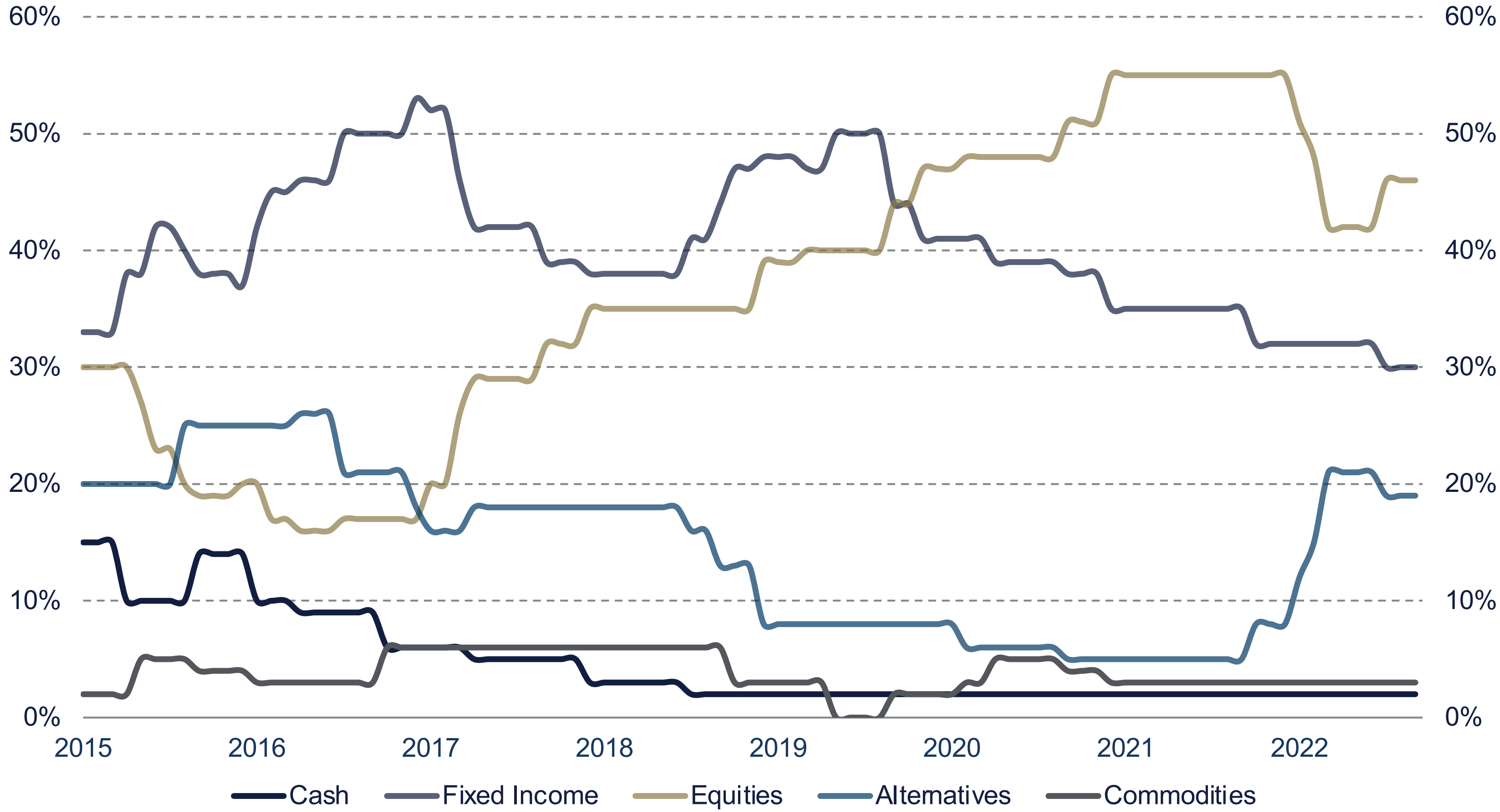
Currency Allocation



Boreal Investment Profiles



Boreal Balanced Portfolio – Asset Allocation evolution



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