Investment Policy

October 2022

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Our market view in a nutshell – October 2022

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- The “macroeconomic drama" in which we are immersed has continued for another month. **September's inflation figures disappointed once again**, offering no sign of an immediate improvement. And despite the Fed's aggressive series of rate hikes, **the economy hardly seems to be slowing down**

- Sooner or later, we will find out which one breaks first. With supply chain problems that constrained economic activity largely resolved, the **manufacturing sector is about to start contracting**. The other side of the coin is that prices are expected to fall as demand cools and inventories rise. By contrast, the **services sector remains strong** once the economy has fully reopened (but is also the main source of inflation today)

- Although, on the surface, the **sharp increase in interest rates** has barely dented economic growth, its impact has been **strongly felt in public markets**. Next in line is the housing market, which for the second month in a row has seen prices fall as mortgage rates hit levels not seen in 20 years. So far, **negative wealth effects have been negligible**, as consumers continue to sit on savings accumulated during the pandemic. But a **contraction in house prices, where most of personal wealth is accumulated**, seems more difficult to digest

- Given the amount of **macroeconomic uncertainty** that financial markets are having to absorb, it is not surprising that volatility is so high. **Financial stability is starting to be a concern** for policymakers as some cracks have started to appear (in Treasury and currency markets). Markets, like tectonic plates, observe a “stick-slip” behavior. Tension can build up under the crust without any apparent manifestation, until the energy is suddenly released in the form of an earthquake. That may be the trigger for the long-awaited Fed pivot

- **Analysts have started to revise down corporate earnings**, but these still do not reflect a dramatic slowdown. Similarly, **credit spreads have widened to levels experienced in other turning points for the economy**, but they seem to be pricing in only a mild recession. Attempting to time the bottom of the market, with valuations so dependent on the path the economy and interest rates will follow, is a daunting task. Instead, we recommend **focusing on improving the resilience of the portfolio**, so that it can weather the different recessive scenarios that may arise

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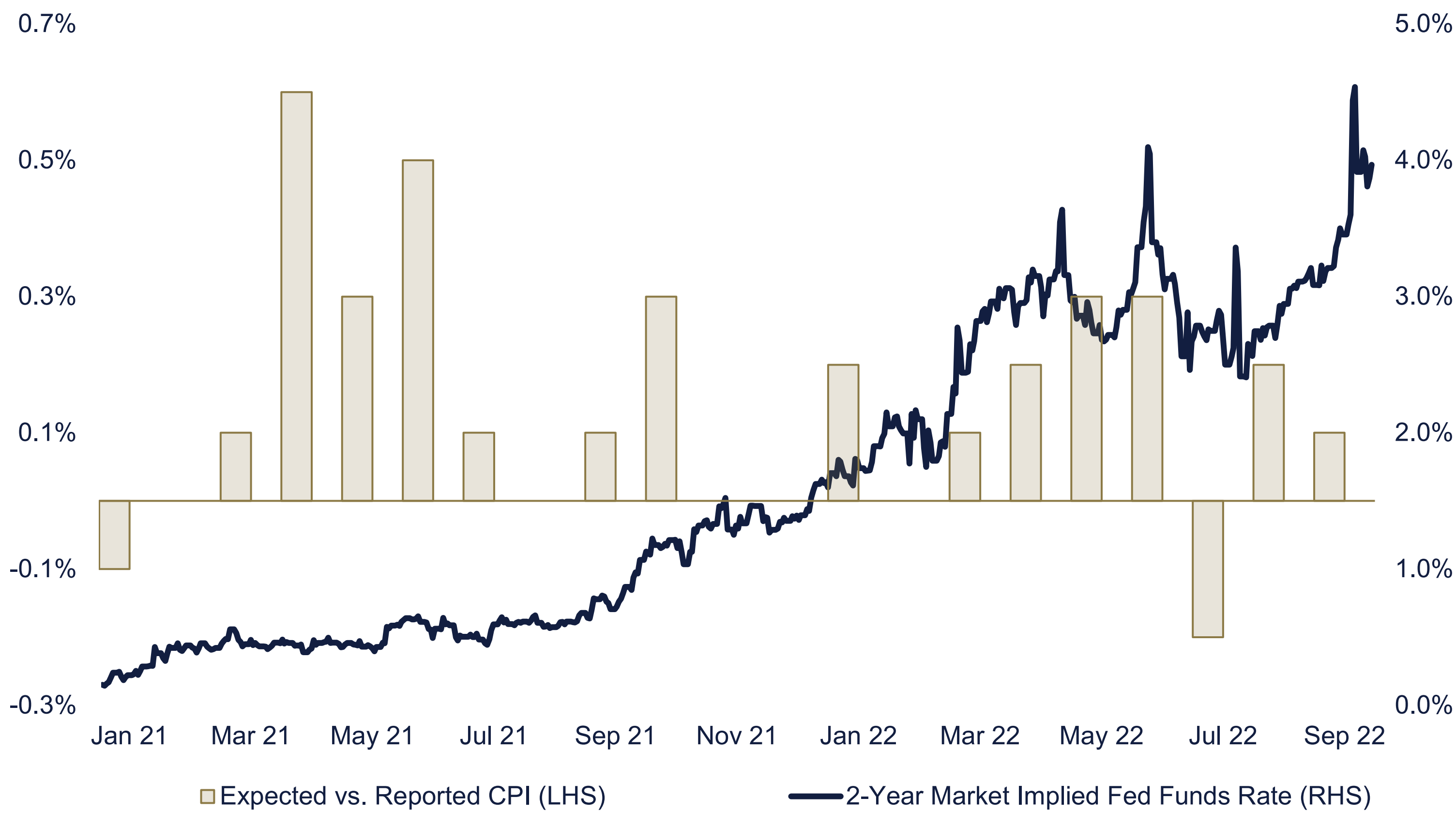
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	=	Higher probability 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

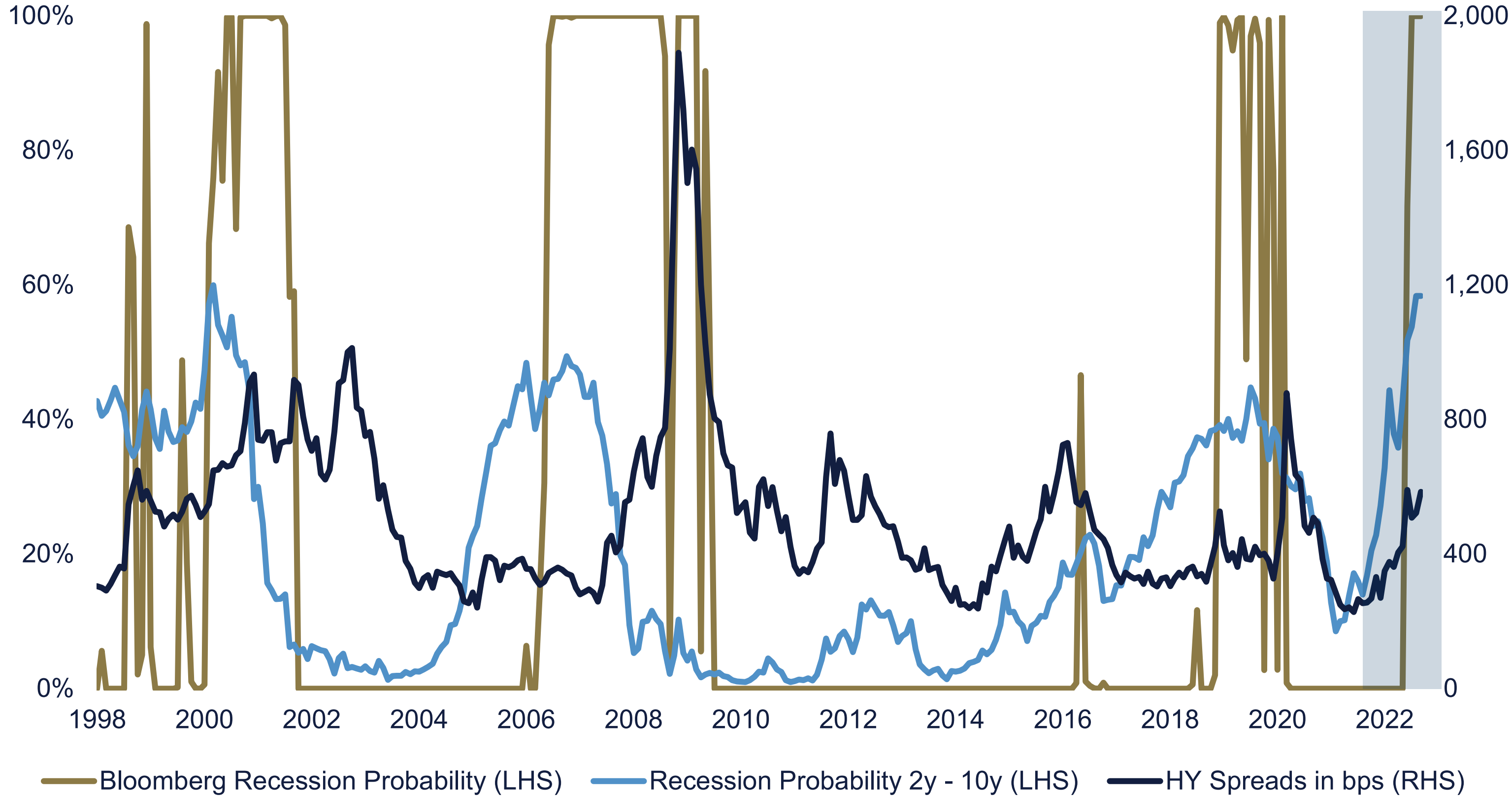
It is all about inflation



- Disappointing inflation data is forcing the Fed to **accelerate the pace of interest rate hikes**
- This is reverberating throughout financial markets, as **long-term interest rates have risen sharply** in response

Source: Bloomberg

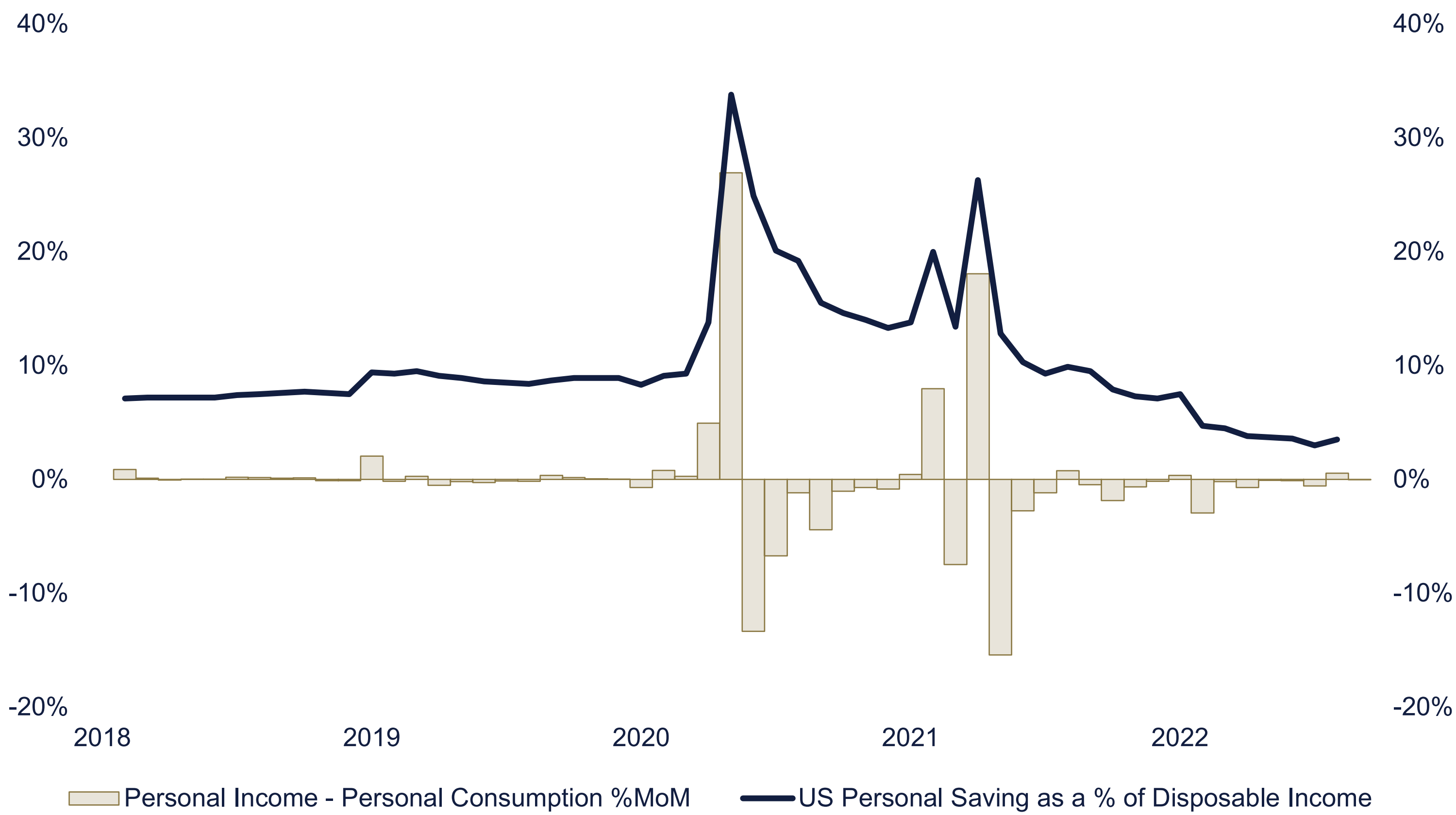
Avoiding a recession seems unlikely



- Although the economy appears to be running at a normal pace, it is very unlikely that it will be able to assimilate such a sharp **tightening of monetary conditions** without suffering a significant slowdown
- Several leading **indicators point to a recession in 2023**. However, they give us no clues as to how deep and long the latter could be

Source: Bloomberg

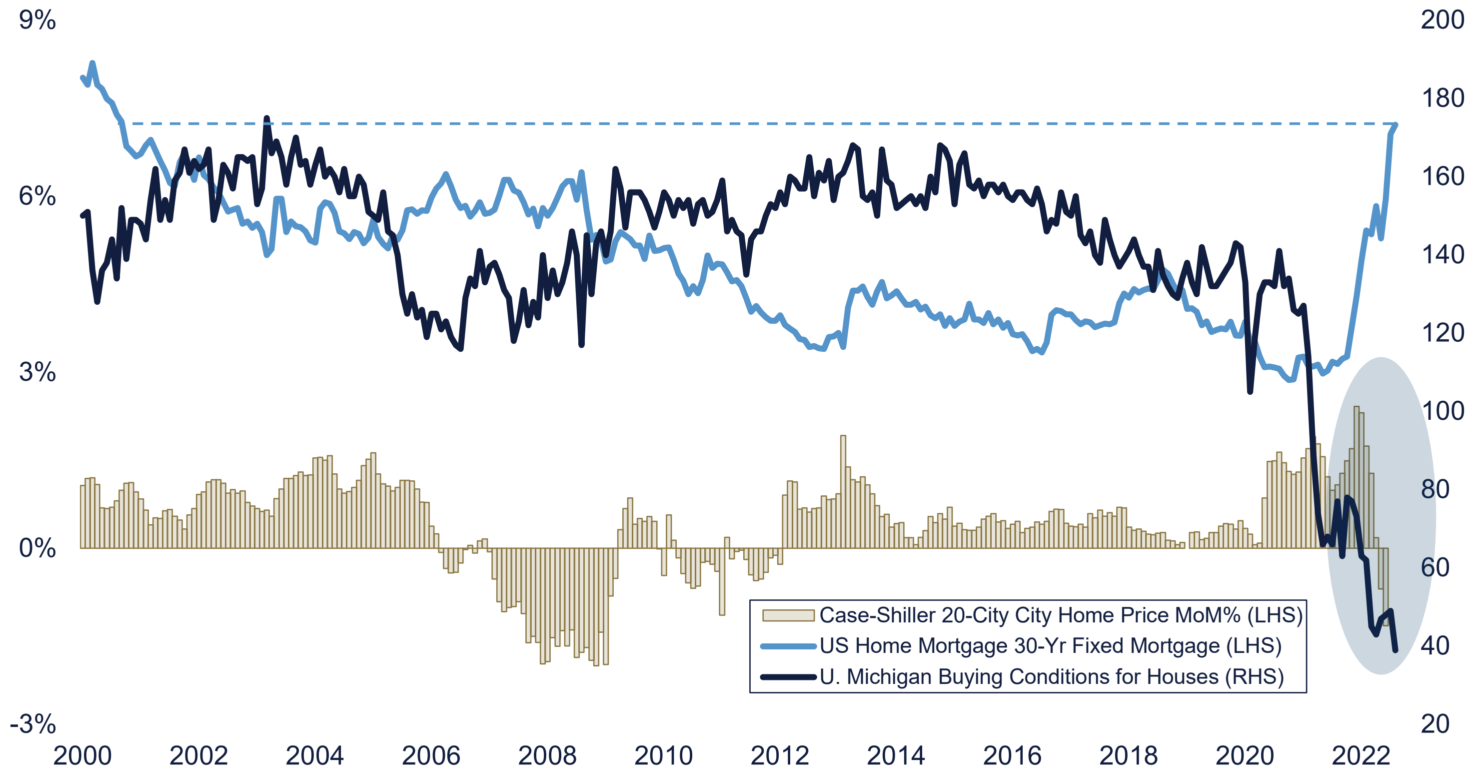
A resilient consumer, but for how long?



- It would be difficult to understand the **gap between declining consumer confidence and the resilience of retail sales**, were it not for the large savings accumulated during the pandemic
- The other factor underpinning consumption is a very **tight labor market** that shows no signs of easing anytime soon

Source: Bloomberg

Housing market flashing red



- **The next to adjust will be the housing market.** House prices and rents are starting to decline, and this has a much larger impact on perceived wealth than a correction in stock markets
- The **extent of the correction will depend both on how much unemployment rises** and how long mortgage rates remain elevated

Source: Bloomberg

Manufacturing closer to contraction

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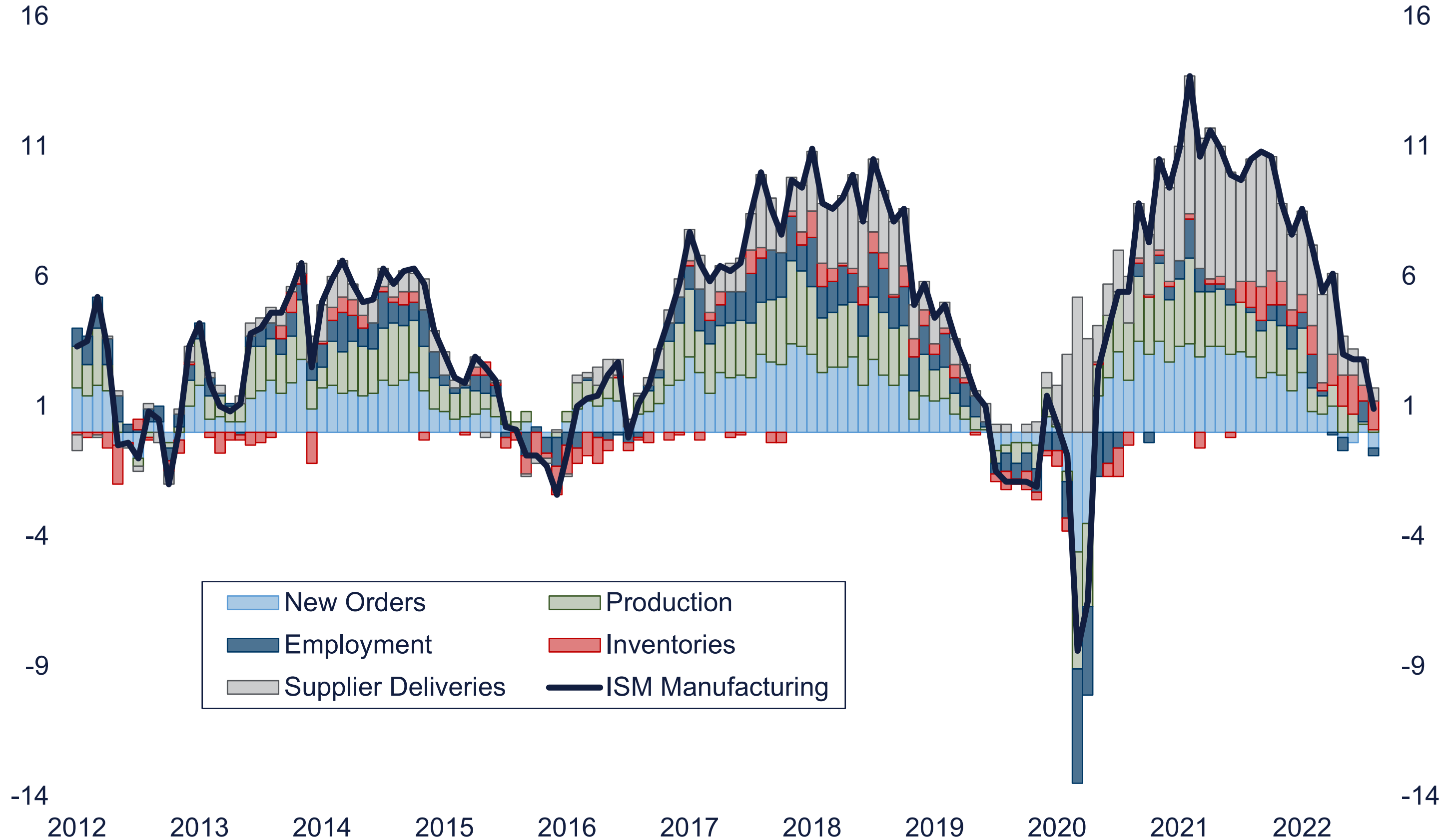
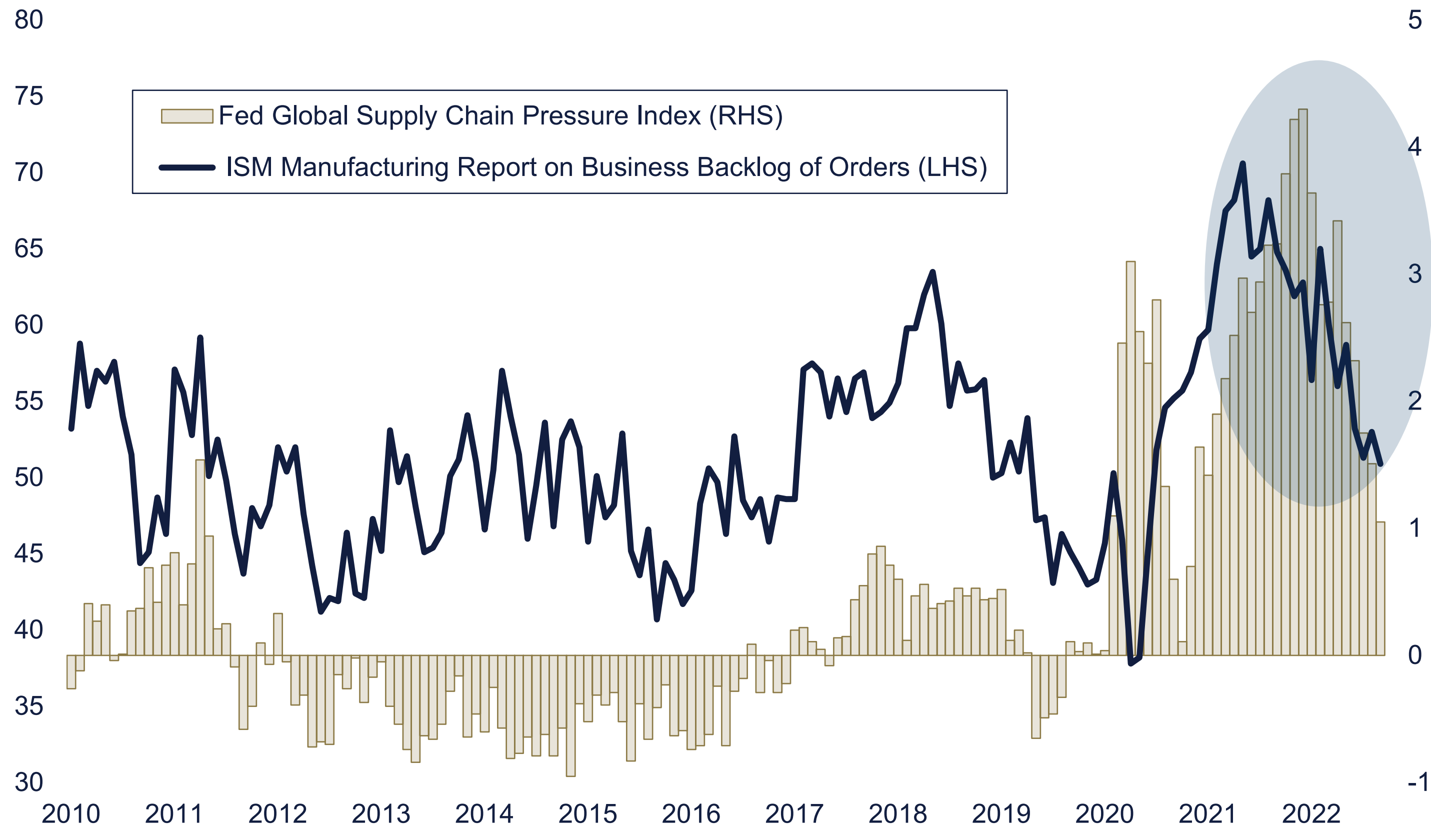


• **Manufacturing activity** continues to slow down and is already **close to contraction territory**. Particularly considering the decrease in new orders and the increase in inventories

Source: Bloomberg

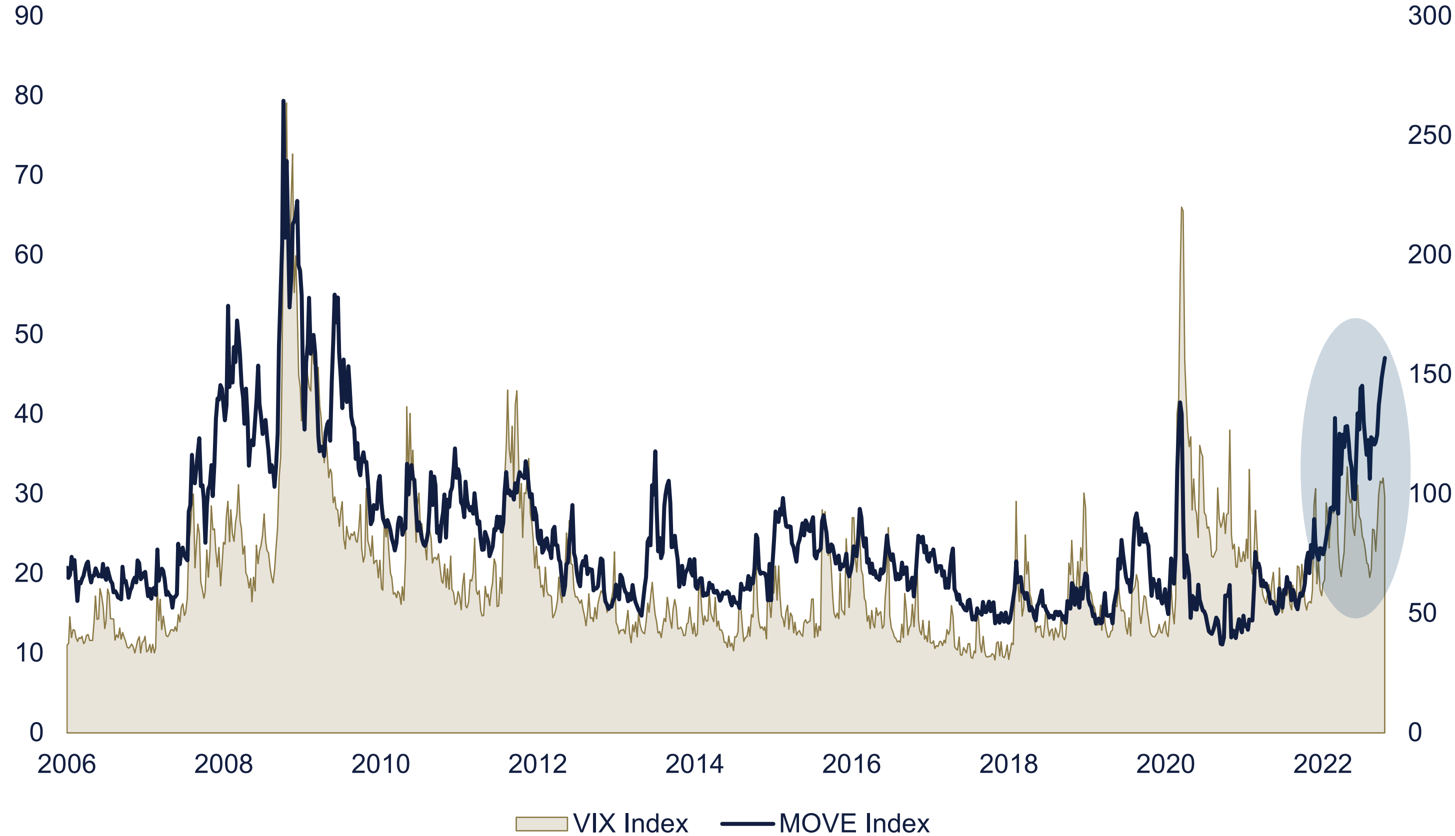
Supply chain woes are over



- The slowdown in manufacturing coincides with a **marked improvement in global suplply chains**
- The **combination of lower demand and a build-up of supplies** as a result of double-ordering may translate into excess inventories, ultimately helping to bring down inflation

Source: Bloomberg

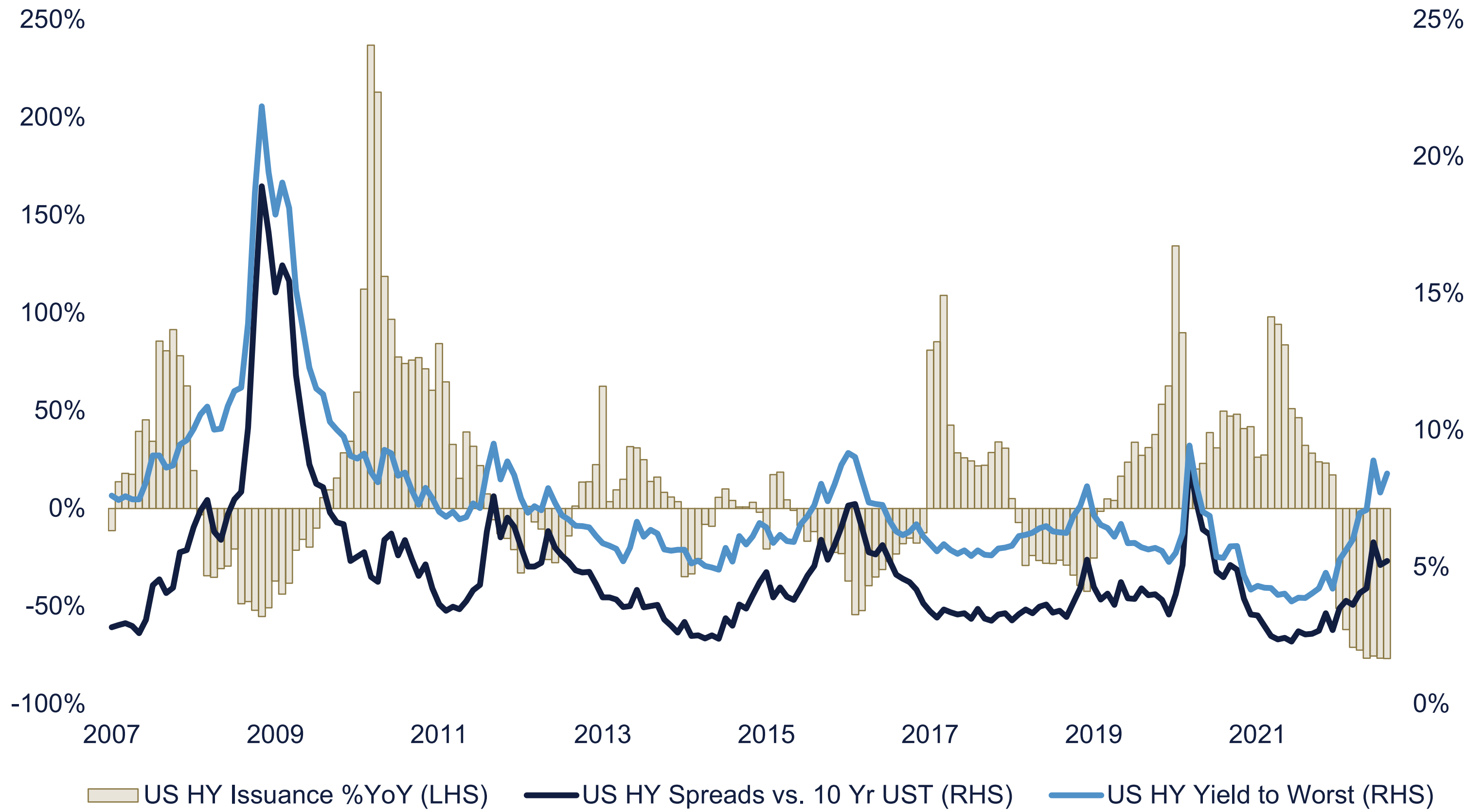
Public markets show signs of stress



- The anxious wait about how the economy will evolve is causing tremors in financial markets. **US Treasuries are experiencing a level of volatility matched only by other episodes of high stress**
- The Fed is watching closely but, for the time being, **financial stability appears not to be compromised**

Source: Bloomberg

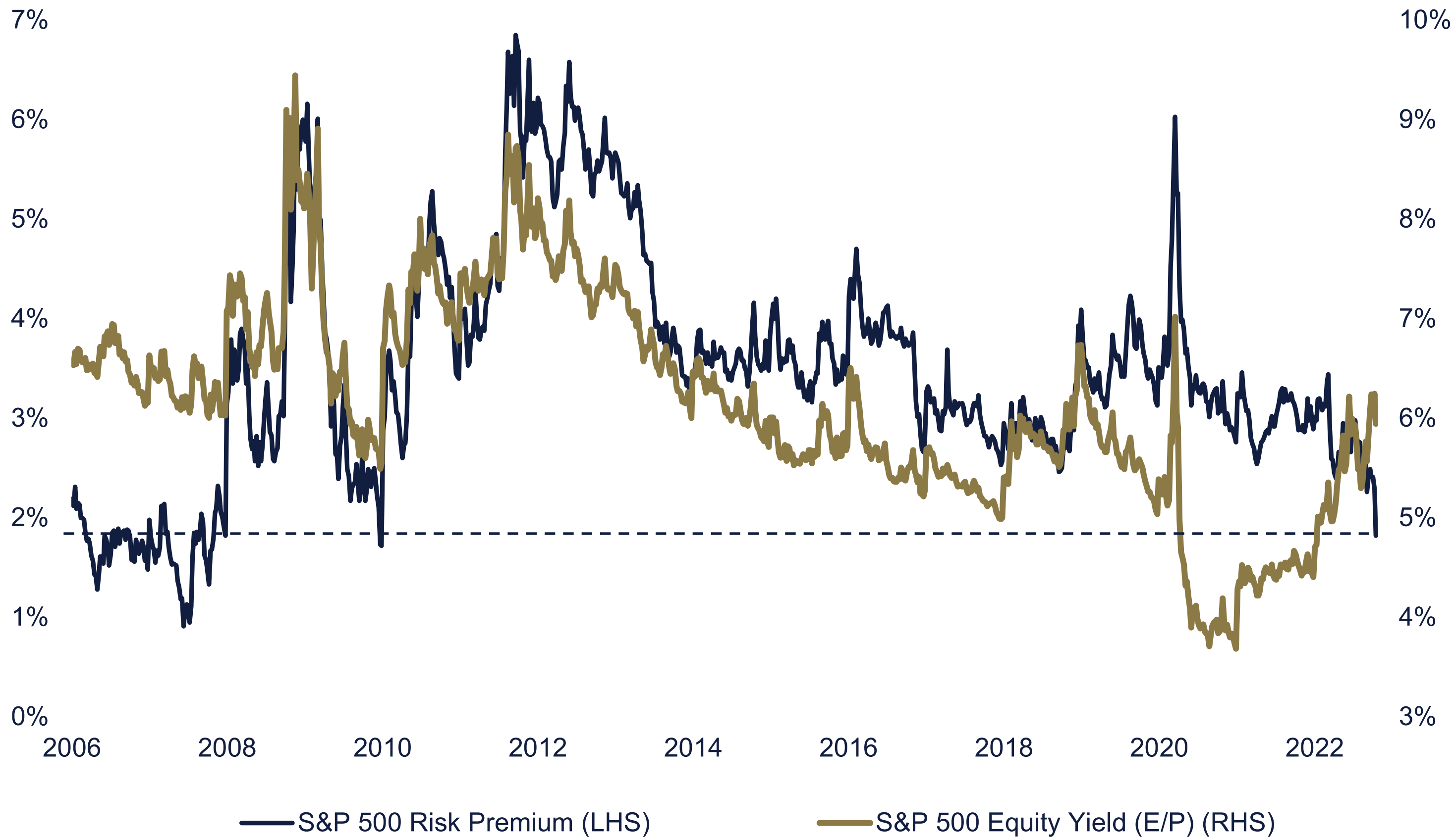
Credit markets are pricing a mild recession



- Credit **spreads are one of the most reliable indicators** of the probability of a recession
- Current **levels are consistent with previous periods of low economic growth**, but which did not end in a recession

Source: Bloomberg

Stocks lose appeal compared to bonds



- Stock **valuations are deteriorating** due to a combination of lower expected earnings and rising interest rates
- With so much uncertainty about the evolution of both factors, looking at valuations can be misleading. Instead, we recommend **positioning the portfolio so that it can withstand different recession scenarios** without suffering a permanent loss of capital

Source: Bloomberg

Investment scenarios

	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%	60% (+5%)	10% (-5%)

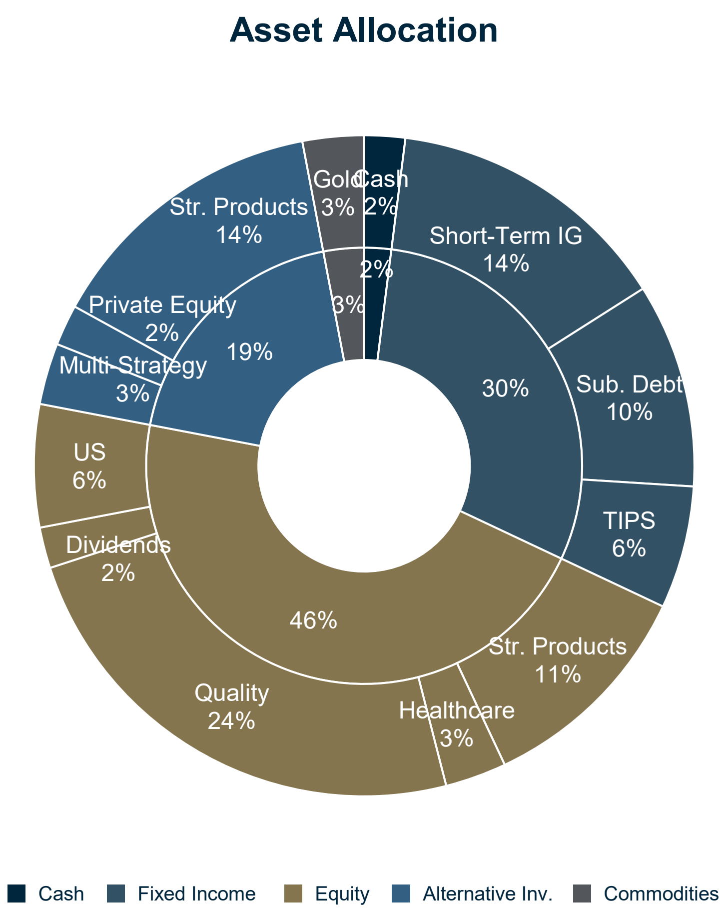
Short-term catalyzers

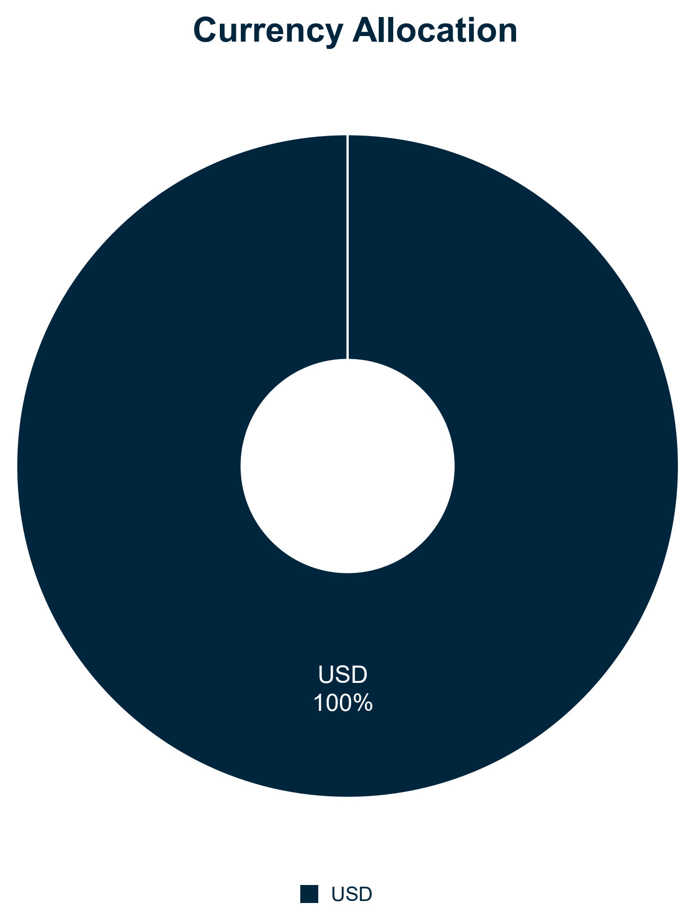
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

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

Boreal Balanced Portfolio USD





Boreal Investment Profiles

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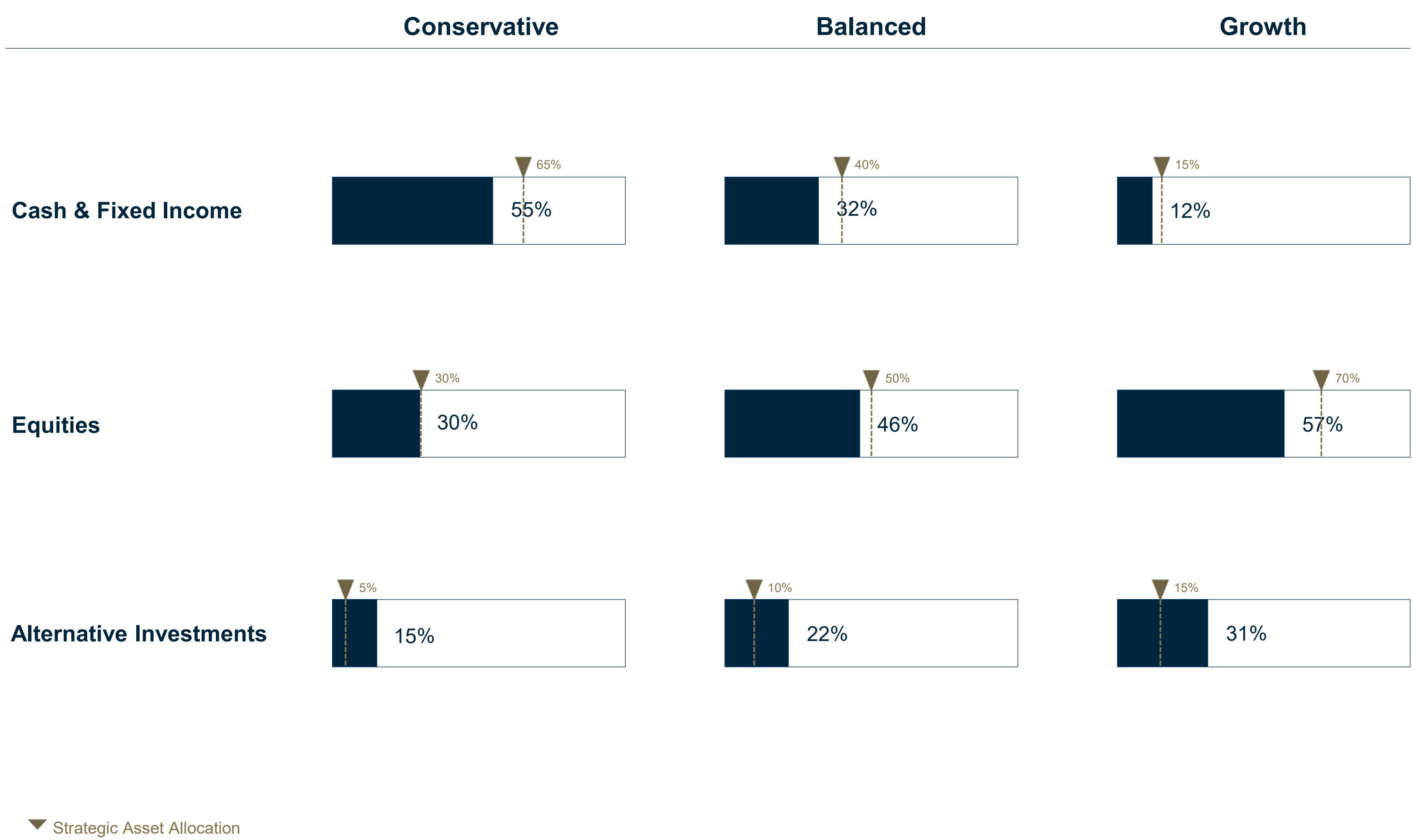
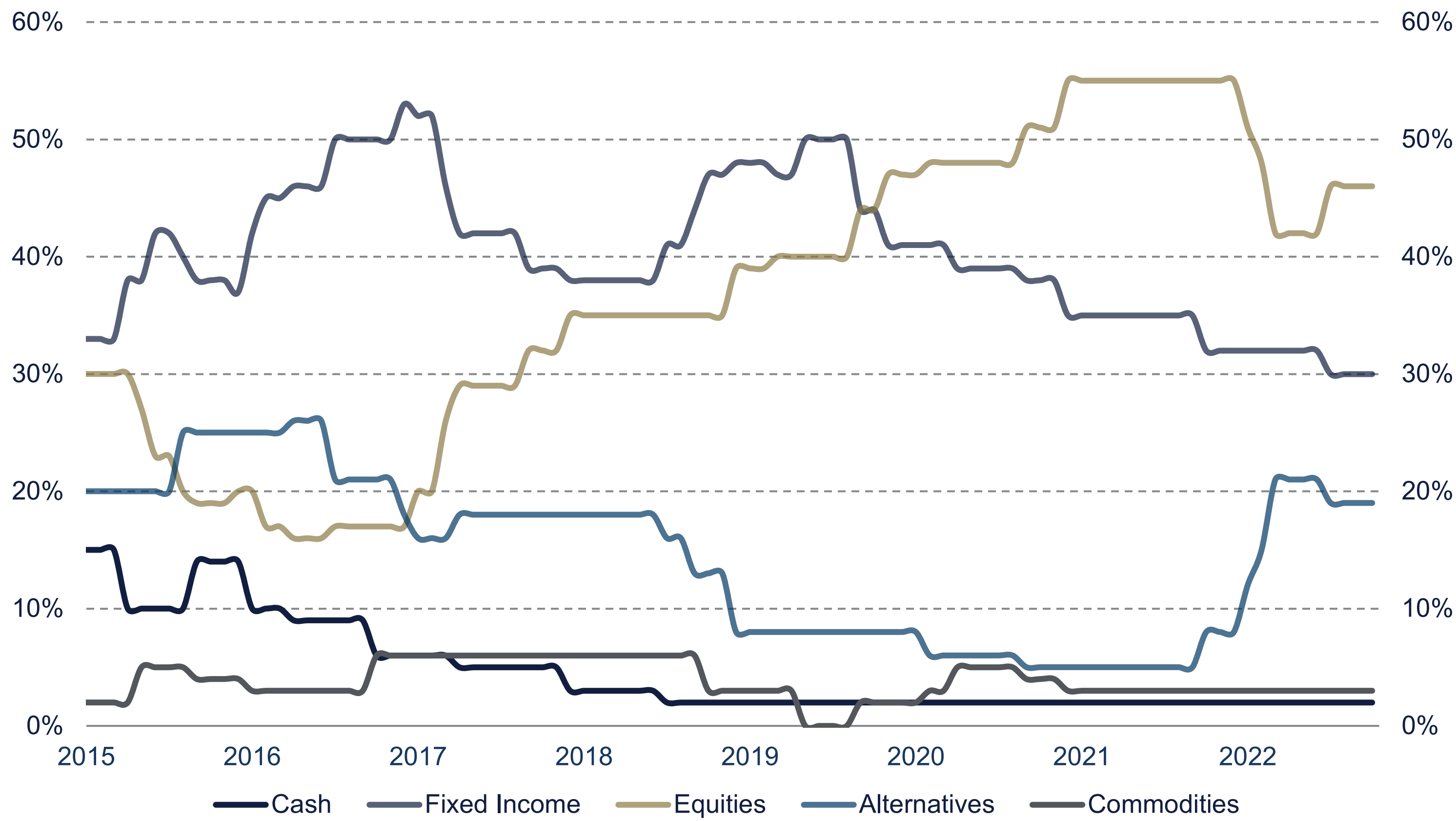


Boreal Balanced Portfolio – Asset Allocation evolution



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