# Investment Policy

November 2022

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CAPITAL MANAGEMENT

# Our market view in a nutshell – November 2022

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- With markets laser focused on inflation data, **better-than-expected figures for the month of October triggered a furious rally in equity markets**. Treasury yields also decreased dramatically, with the 10-year falling from 4.2% to 3.8%. At a time when many investors remain on the sidelines waiting for a capitulation that signals the market bottom, this rally acts as a **powerful reminder of how costly not staying invested can be**; particularly when the latter implies having to realize losses

- **Both headline and core inflation fell more than expected, confirming that the peak is behind us**. Prices of consumer goods, which were the main driver of the inflation surge last year, continue to fall. Energy prices appear to have plateaued, and the contribution from shelter to inflation will soon begin to decline reflecting the incipient correction in the housing market

- **The US economy grew 2.6% in the third quarter**, leaving behind two quarters of negative growth. **Consumption remained relatively strong despite deteriorating consumer confidence**. This apparent contradiction can be explained both by the amount of accumulated savings that remains to be spent (close to $1 Tn) and by the strength of the labor market. In general, **companies continue to experience difficulties in finding workers**. Although in some sectors (such as Technology) the tally of companies announcing hiring freezes and job cuts is increasing. **With corporate earnings beginning to fall across the board, mass layoffs may soon spread to other sectors**

- Despite the recent rally, **equity valuations remain attractive in absolute terms, but their relative attractiveness vis-à-vis bonds has declined**. The equity risk premium must in any case be put into context, since long-term interest rate projections may be overly pessimistic. If the current inflationary episode turns out to be short-lived, interest rates may fall significantly from current levels

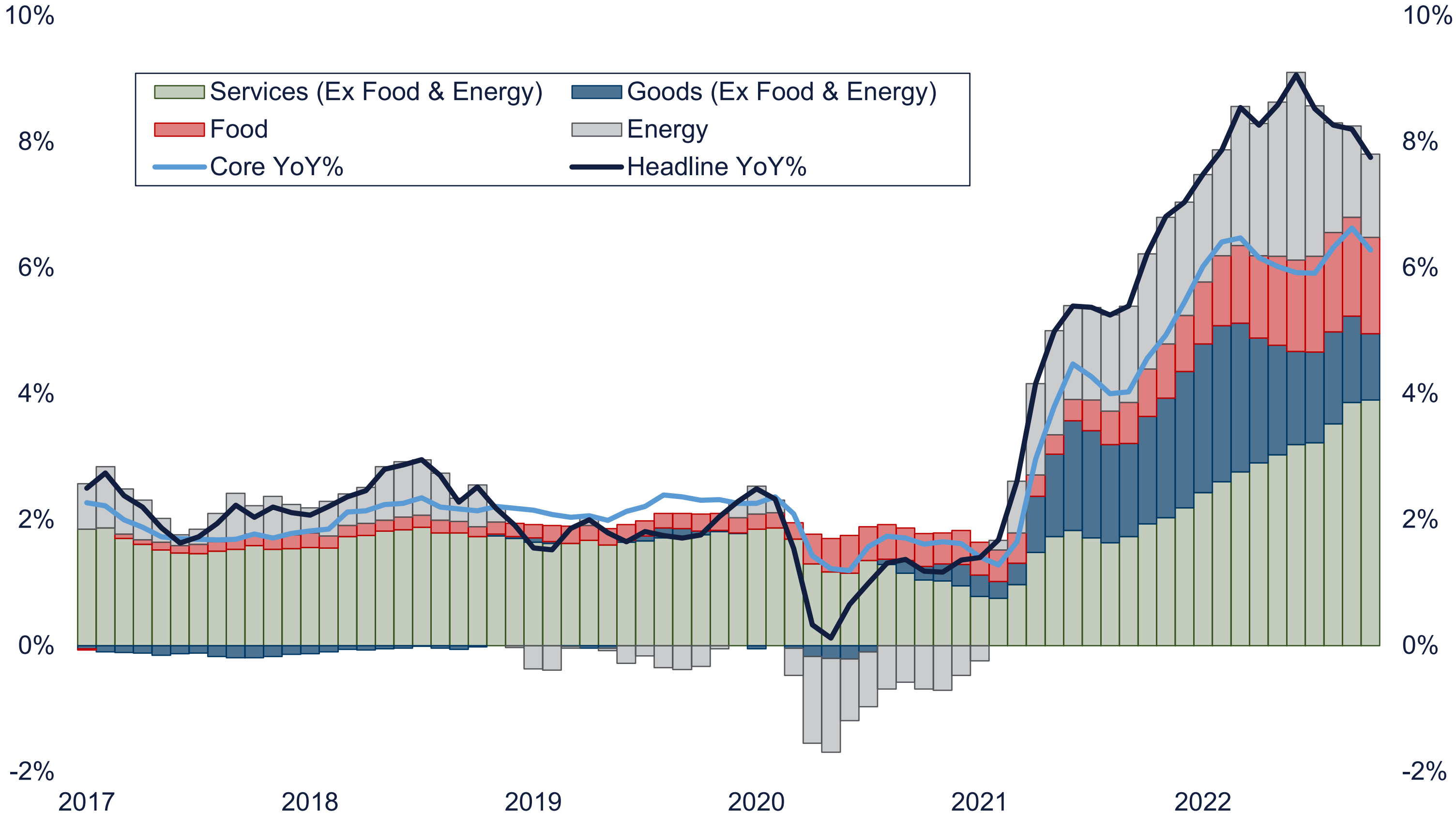
- As central banks progressively withdraw liquidity from the system, volatility increases, **exposing the most fragile areas of the market**. After the tremors felt in the treasury market in the UK, the **crypto ecosystem has been the next to show cracks**. The implosion of FTX follows other notorious collapses in the sector this year. **This should favor gold**, which has seen its status as an alternative reserve currency threatened by Bitcoin and other cryptocurrencies

# Boreal Investment Policy

| 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

# The peak is behind us

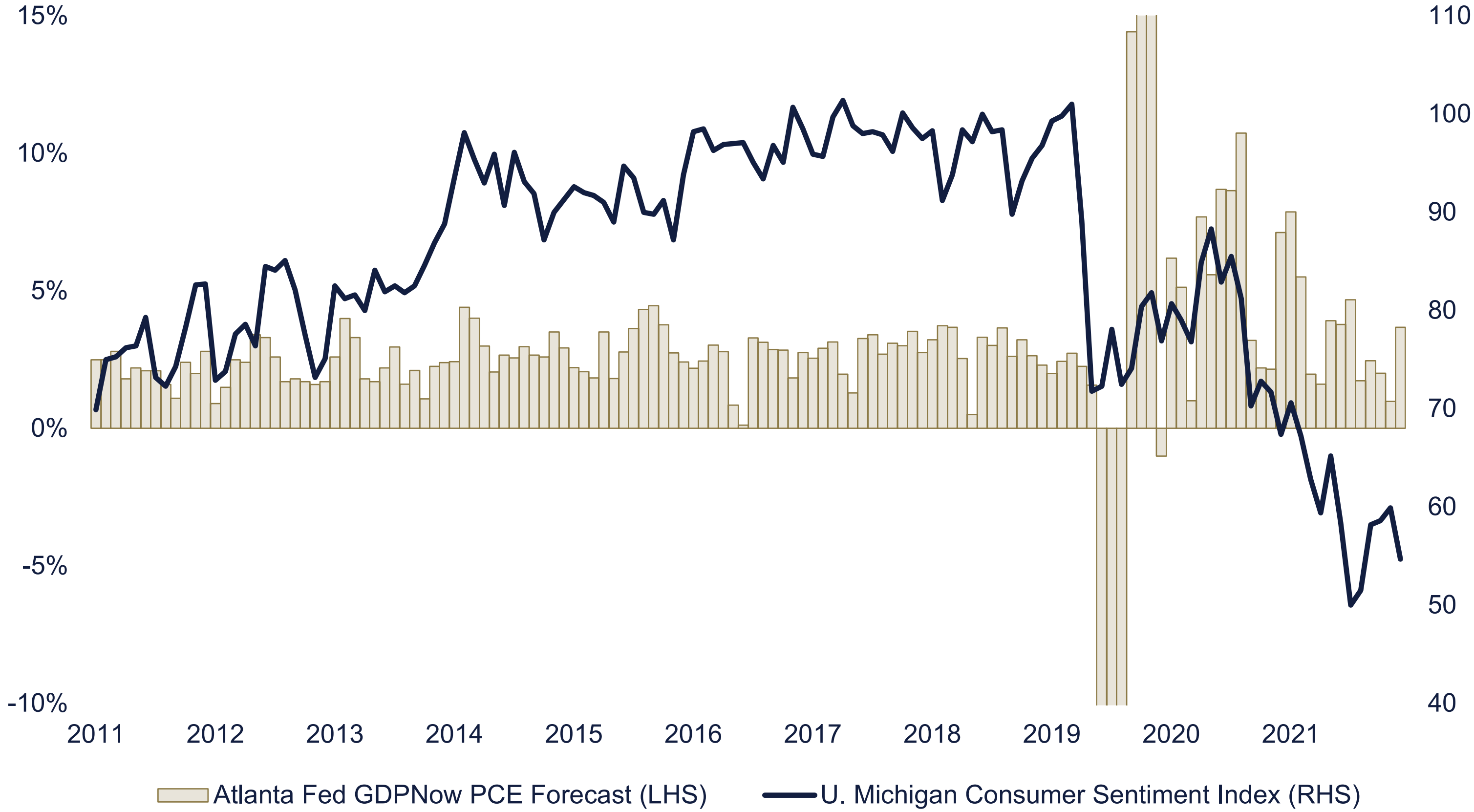



- **Both headline and core inflation in October surprised on the downside**, driven by a steeper-than-expected drop in prices for both consumer goods and energy
- This is a clear sign that supply chain problems are a thing of the past, and **raises hopes that a soft landing of the economy is still possible**

Source: Bloomberg

# Living in the present

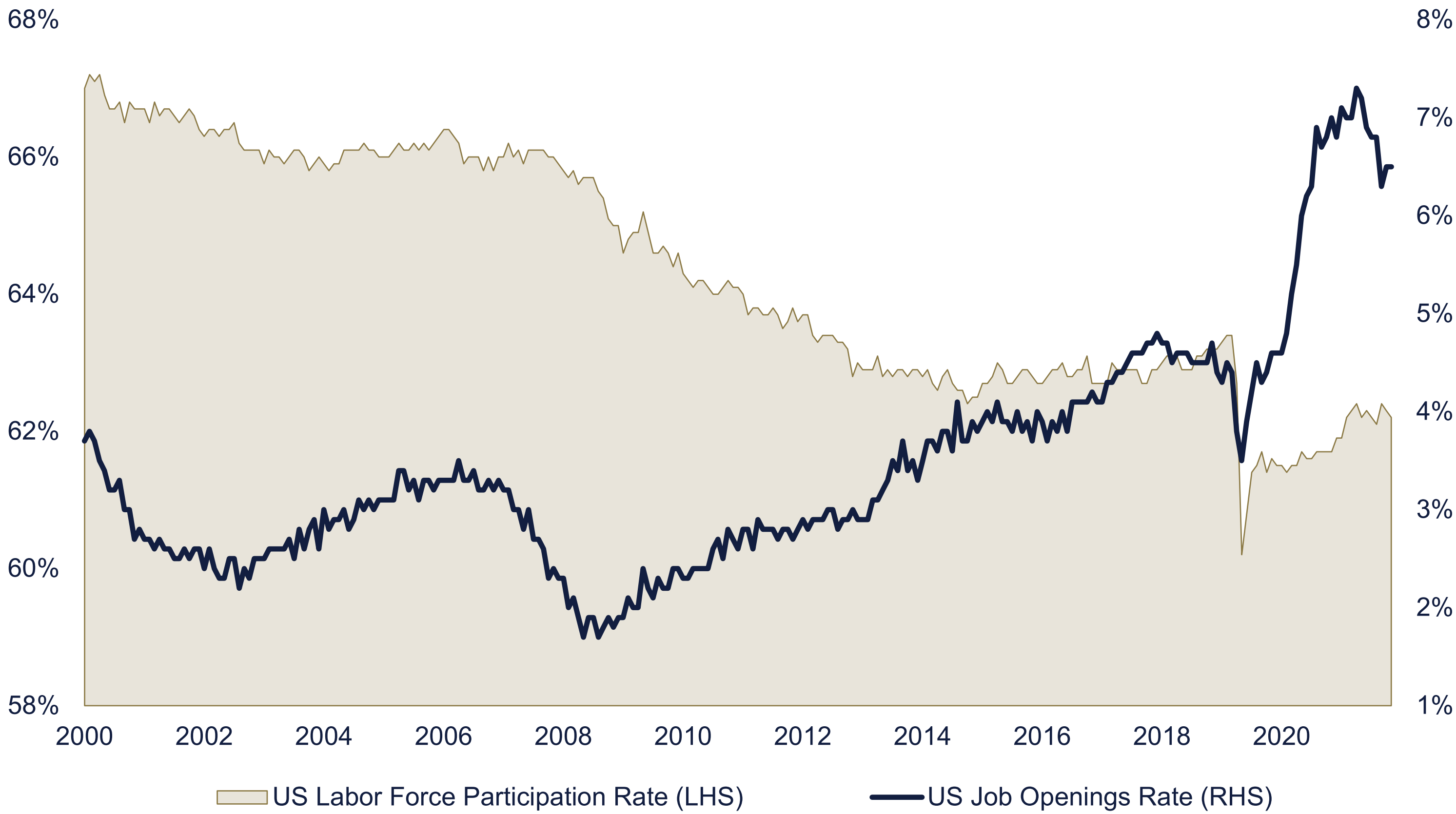





- The **US economy expanded 2.6% in the second quarter**. This confirmed that, despite the contraction experienced in the two previous quarters, it is still premature to say that the economy is in recession
- **Consumption remains surprisingly strong**, defying gloomy projections from consumer surveys

Source: Bloomberg

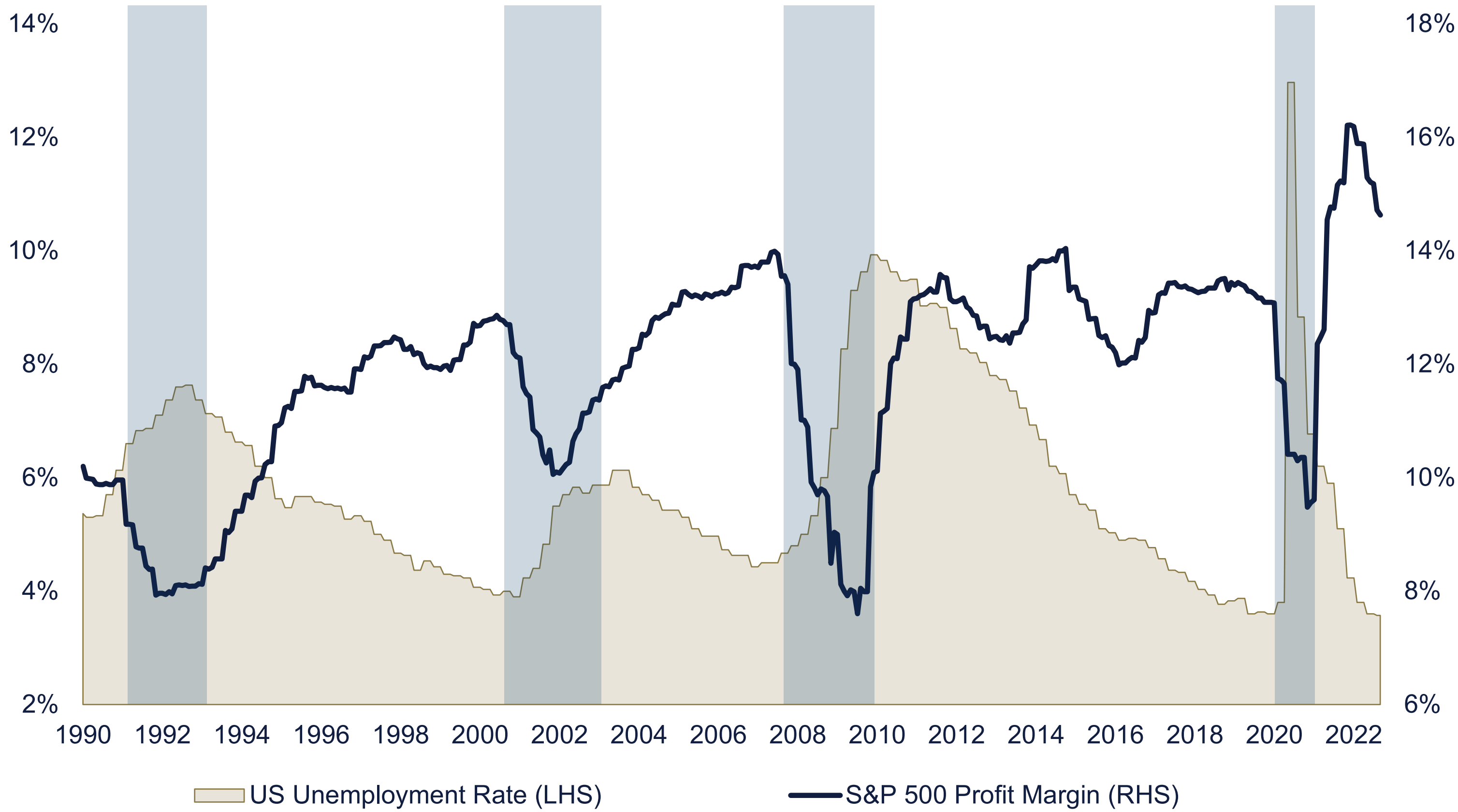
# The labor market is still tight




- The main reason that explains this unusual consumer behavior is the **tightness in the labor market**, where the scars left by the pandemic are still very visible
- The socioeconomic causes of this dislocation are far from clear, but as with the supply-side problems, **sooner or later the labor market should return to equilibrium**

Source: Bloomberg

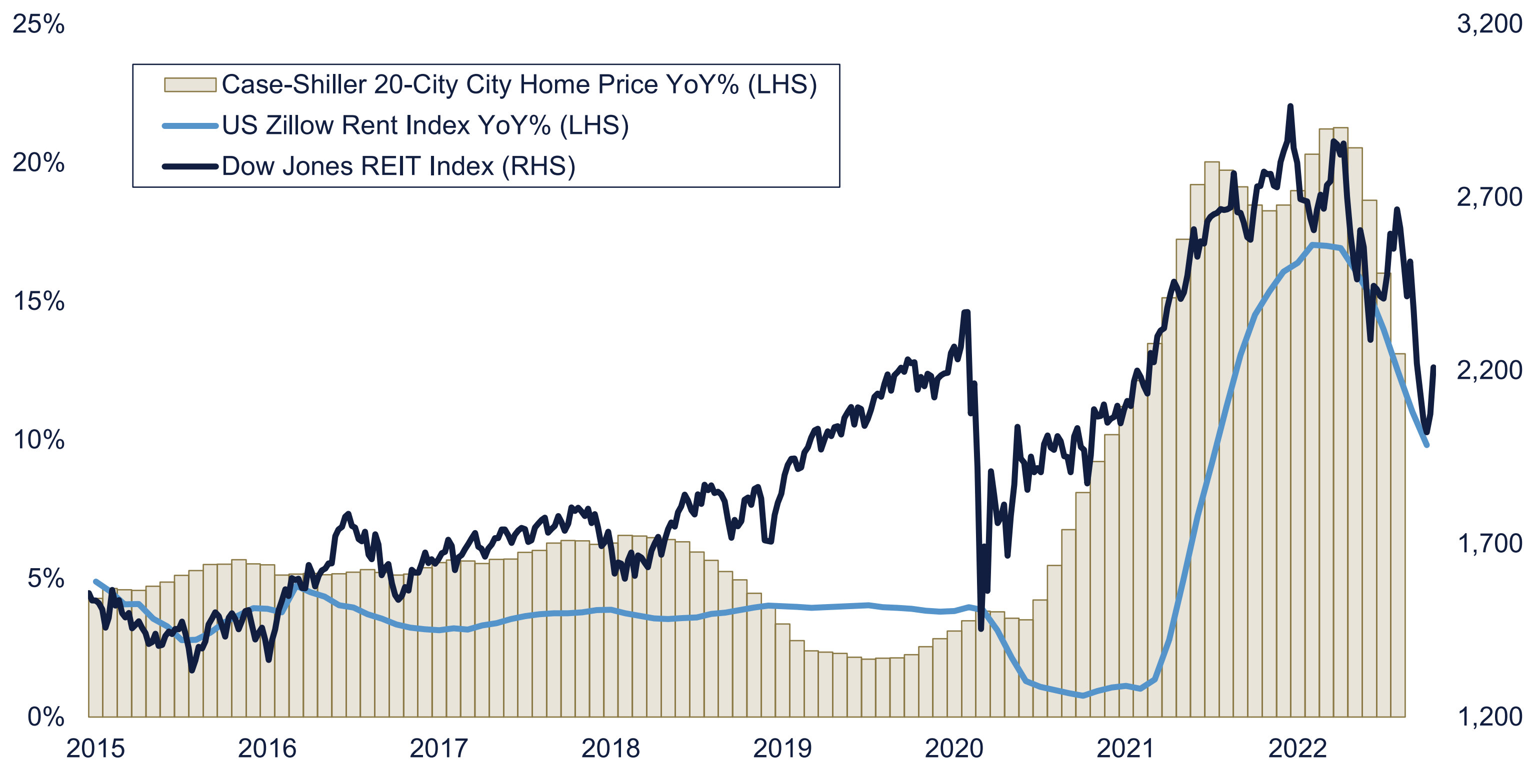
# Jobs can rapidly become scarce




- **Mass layoffs and hiring freezes have been restricted to a handful of sectors**, mainly Tech. However, the increase in interest rates will cause **corporate profitability to decline** as a result of the increase in financing costs and the slowdown in demand
- The past shows us that companies can react very quickly to a change in economic conditions, causing **unemployment to typically rise much faster than it falls**

Source: Bloomberg

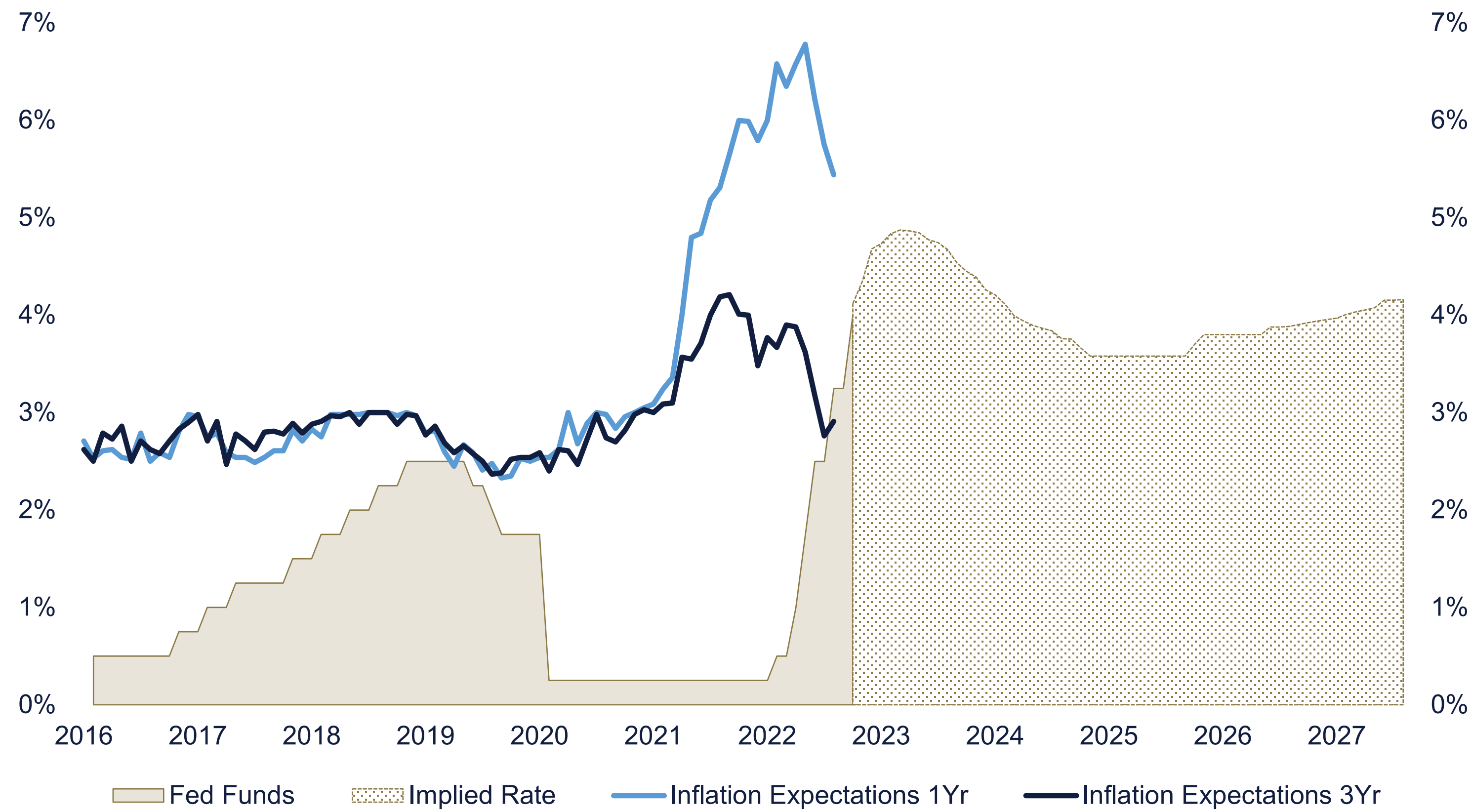
# Housing market headed for a correction




- The **second pillar behind consumer strength** is the appreciation of home prices after the pandemic
- However, with mortgage rates reaching levels not seen since 2006, the housing market is **beginning to cool down**. A negative feedback loop between rising unemployment, falling house prices and lower consumption would push the economy into a recession

Source: Bloomberg

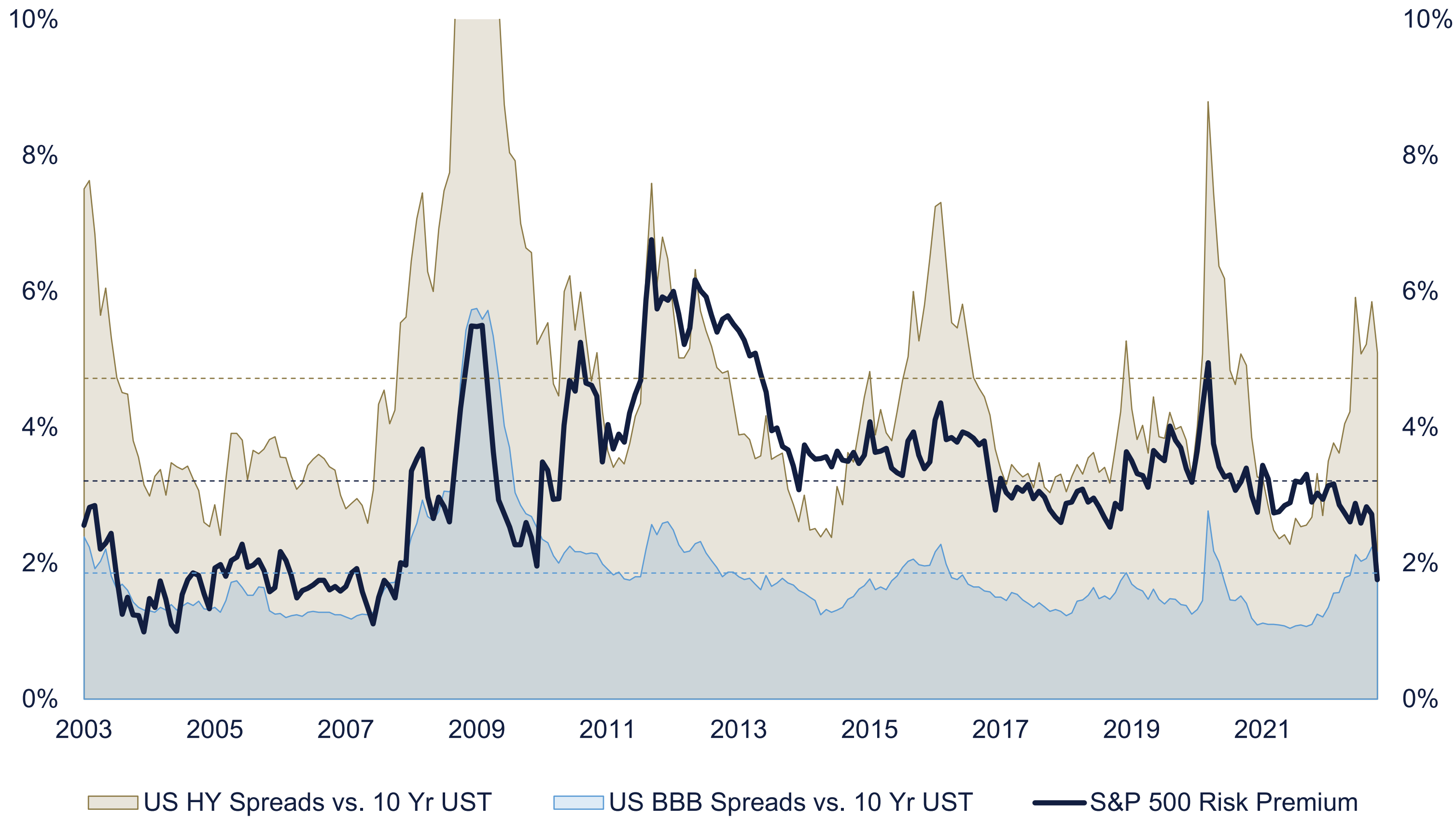
# A new normal?




- **The rise in inflation expectations last year was what prompted the Fed to act**. Their subsequent drop shows that economic agents believe the Fed when they say that they will do everything necessary to bring inflation back to 2%
- However, **forward rates remain elevated**, as if, once inflation is brought under control, interest rates will no longer return to the regime of the previous decade

Source: Bloomberg

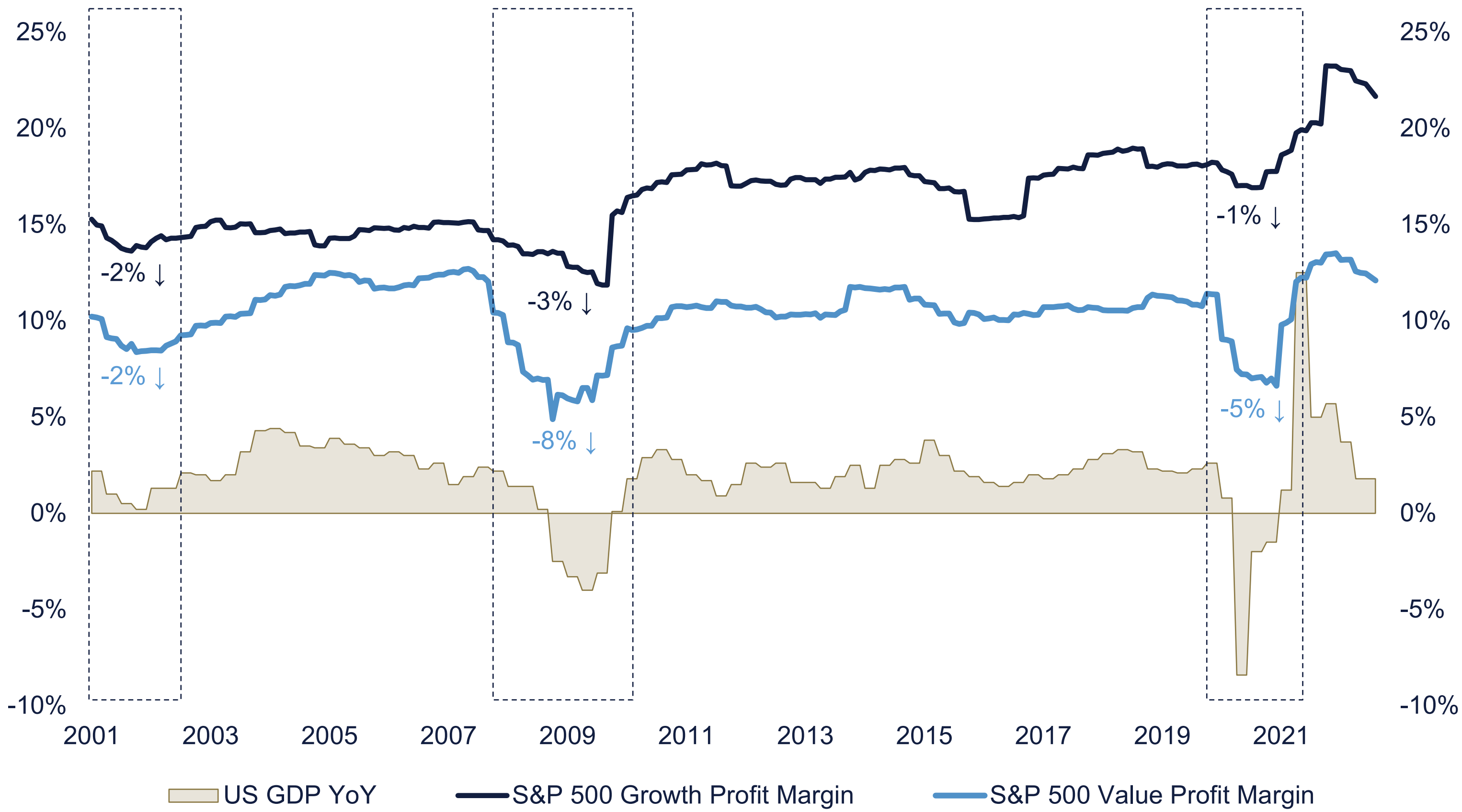
# Relative valuations




- As long-term interest rates rise and corporate profits fall, the **equity risk premium deteriorates**. However, uncertainty around interest rates is very high and **absolute valuations (P/E) look attractive**
- On the contrary, credit spreads are above their long-term averages. Add to this the rise in rates, and **bond yields look very attractive**. Particularly for Investment Grade bonds, which are less affected by a potential slowdown in the economy

Source: Bloomberg

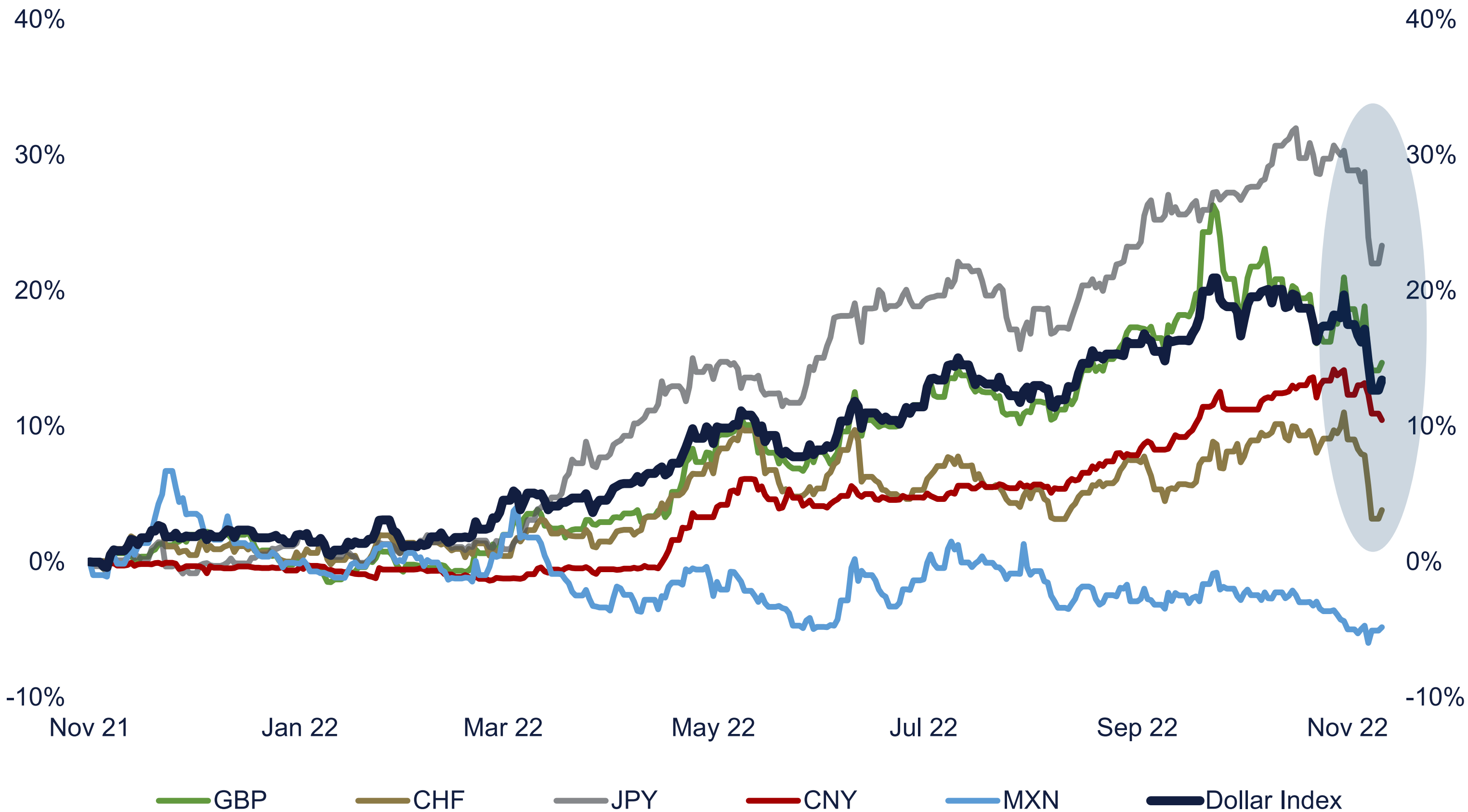
## Time to seek resilience




- Value stocks have been the market darlings this year. However, **with the economy slowing down, growth stocks currently look more attractive.** Not only are they less cyclical, but they should benefit more if interest rates fall as a result of a recession

Source: Bloomberg

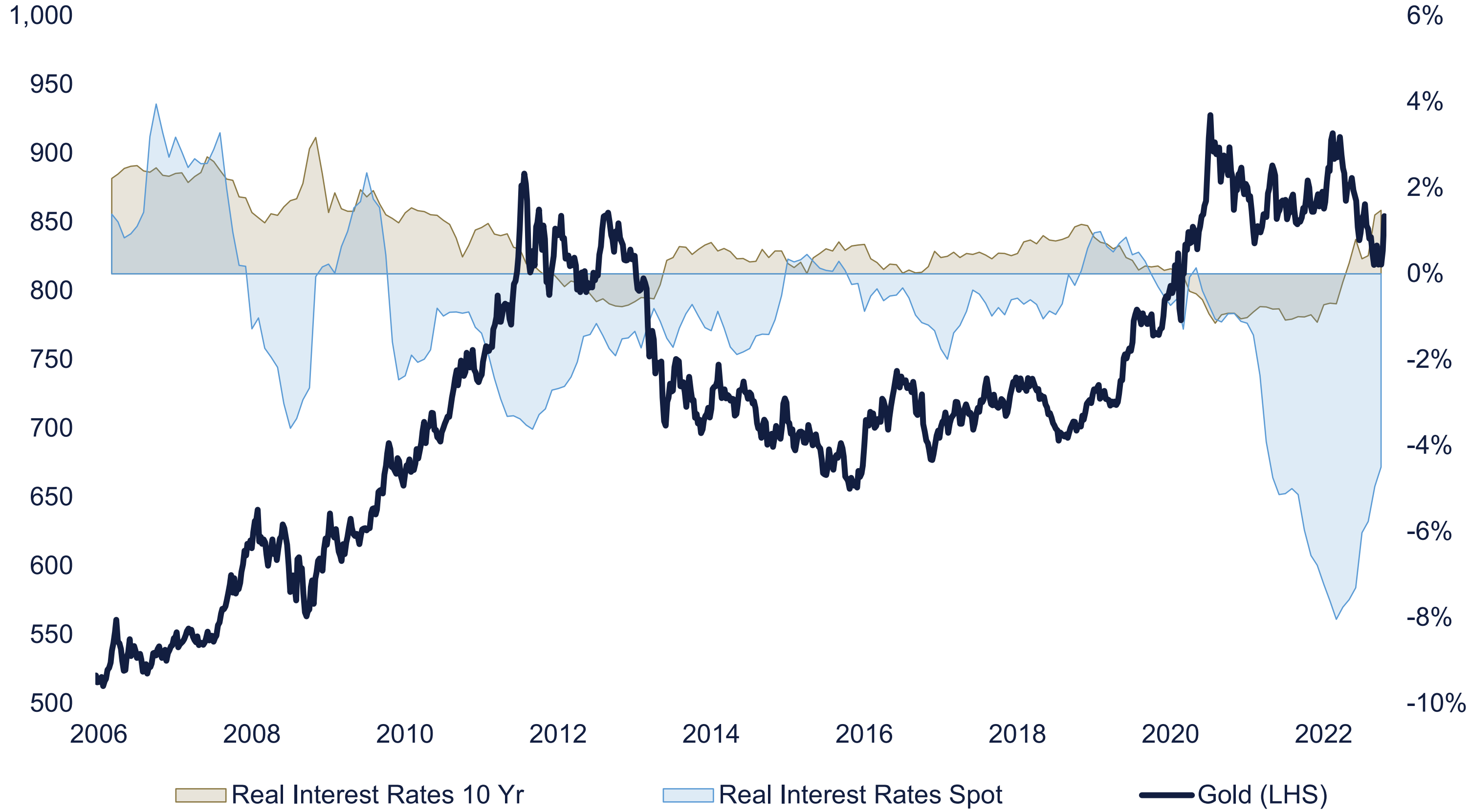
# Dollar reversal




- After the positive inflation data, **the US dollar has halted its unstoppable upward trend**. The reason for this reversal is that the market has started to discount a smaller interest rates differential

Source: Bloomberg

# Gold is back?




- **Gold should have performed better** in an environment of rising inflation and strongly negative real interest rates
- Although the meaning of "real" is very different depending on whether one considers current or expected inflation, gold's poor performance is difficult to explain. The **recent collapse of the crypto-bubble could be the catalyst for gold** in the short term

Source: Bloomberg

# Investment scenarios

| | Scenario 1<br>Stagflation | Scenario 2<br>“Hard landing” | Scenario 3<br>“Soft landing” |
|---|---|---|---|
| **Drivers** | • Inflation remains high due to labor shortages, supply chain bottlenecks, and rising commodity prices due to war sanctions on Russia<br>• The Fed tightens its monetary policy at an accommodating pace, which fails to control inflation, but does not slow down the economy either<br>• 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<br>• 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<br>• 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<br>• The Fed raises interest rates progressively. Inflation begins to normalize without the economy slowing down significantly<br>• 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<br>• High-quality and sovereign bonds fall due to rising interest rates<br>• Credit performs relatively better despite higher rates, as the risk of corporate defaults remains low<br>• The US dollar depreciates against safe-haven currencies as well as against gold | • Equity markets fall, and cyclicals underperform quality and defensive stocks<br>• Credit spreads widen sharply as the prospect of corporate defaults increases<br>• Sovereign debt and the US dollar appreciates due to "flight to quality“<br>• 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<br>• Credit spreads tighten moderately as investors chase yield again<br>• High-quality and sovereign debt trade range-bound<br>• Commodity prices stabilize and the US dollar appreciates due to higher real interest rate differentials |
| **Probability** | 30% | 55% (-5%) | 15% (+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

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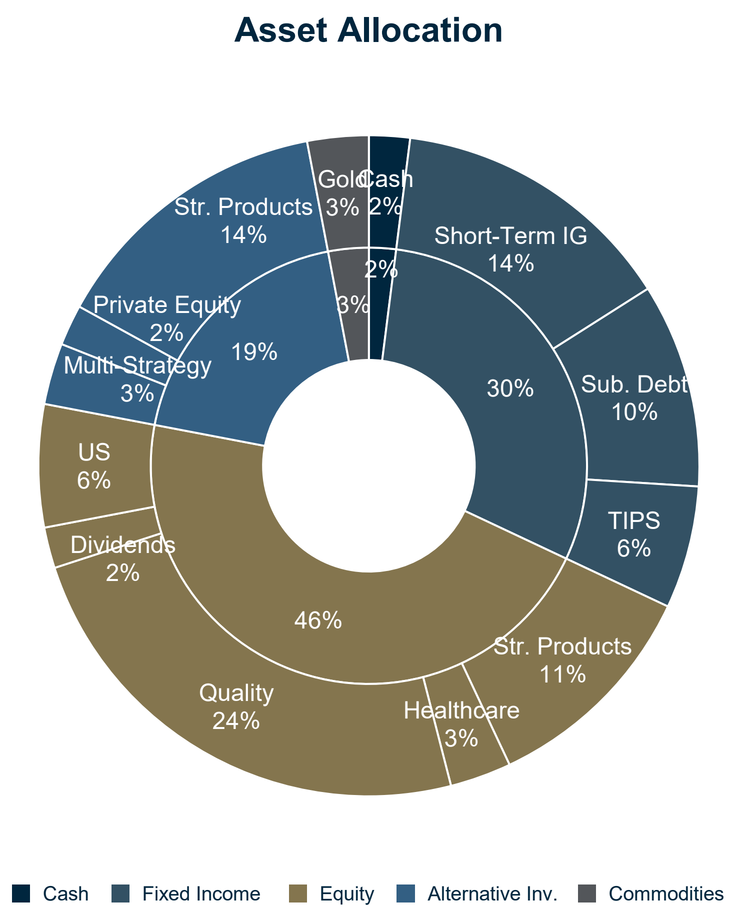
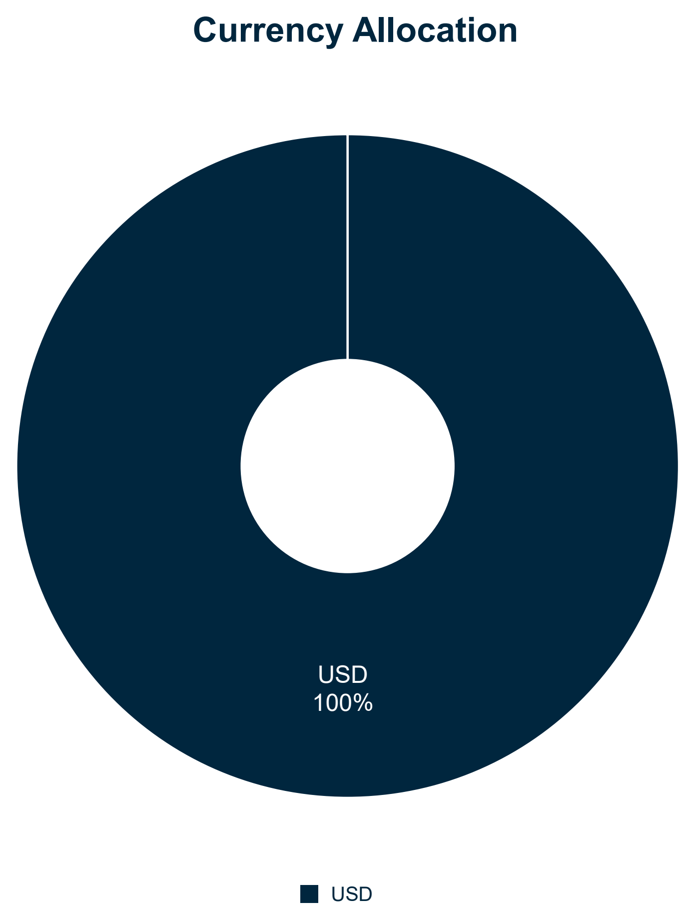
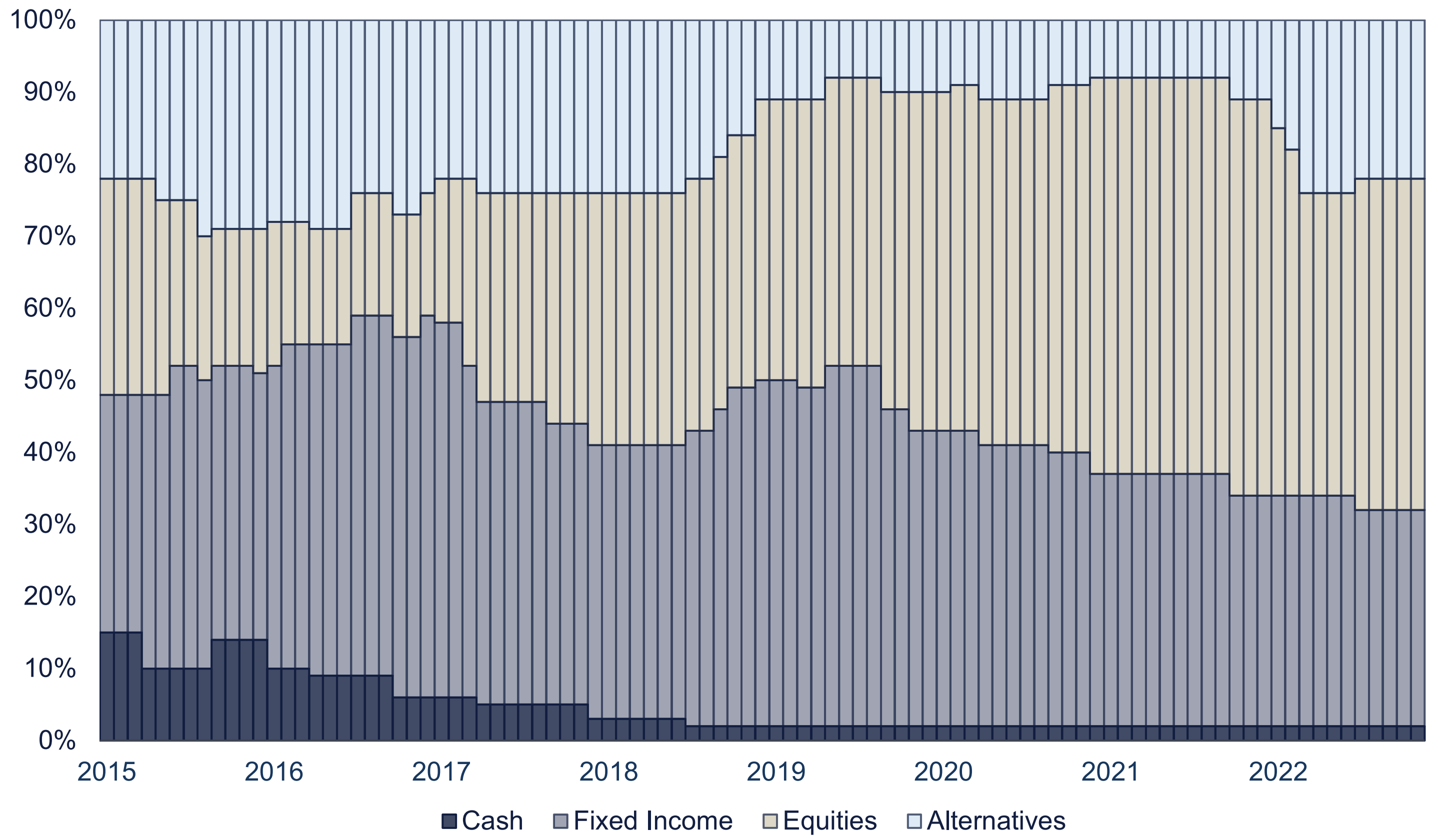


# Boreal Investment Profiles

# Boreal Balanced Portfolio – Asset Allocation evolution



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