Investment Policy

December 2022

BOREAL
CAPITAL MANAGEMENT

Our market view in a nutshell – December 2022

- With most **inflation-related indicators surprising on the downside** for the second month in a row, the **odds of a soft landing for the economy have increased**. For the latter to happen, economic activity must continue to slow gently, while inflation must fall as a result of prices of consumer goods and the housing market cooling down. If events play out this way, the Fed will have some leeway to cut interest rates before the economy enters a recession

- Several factors provide support for this scenario. On the inflation front, the shelter component of the CPI is a lagging indicator (by approximately 12 months). The **rise in rents has reached its peak at the beginning of the year**. However, its contribution to the CPI continues to grow. This trend should start to reverse soon. In addition, **supply-side restrictions are easing** (even more so if China finally abandons its Zero-Covid policy)

- On the demand side, **consumption remains surprisingly stable, despite fears of a potential recession**. Under similar circumstances in the past, consumers would have already begun to dial down consumption. It is not yet clear whether this change in consumer behavior is temporary, as a result of excess savings accumulated during the pandemic, or a more lasting change in households' propensity to save

- Against this favorable scenario, **an adverse scenario could materialize in which the economy slows faster than inflation, and in which consumers become more cautious as unemployment begins to rise**. Further inflationary shocks (the war in Ukraine being the most obvious risk) could aggravate the situation. If so, the Fed would be forced to prioritize inflation over economic growth, deepening the recession

- The current macroeconomic environment (sudden halt of the economy, followed by its overheating in record time) is unprecedented. Therefore, it is impossible to predict how events will unfold. This implies that volatility will remain elevated. But if, as we expect, **interest rates are approaching their ceiling**, next year portfolios should enjoy a **powerful tailwind from their fixed income allocation**. As for **stocks, valuations have become much more attractive in absolute terms**, but will remain very sensitive to how corporate earnings evolve in a context of economic weakness

Boreal Investment Policy

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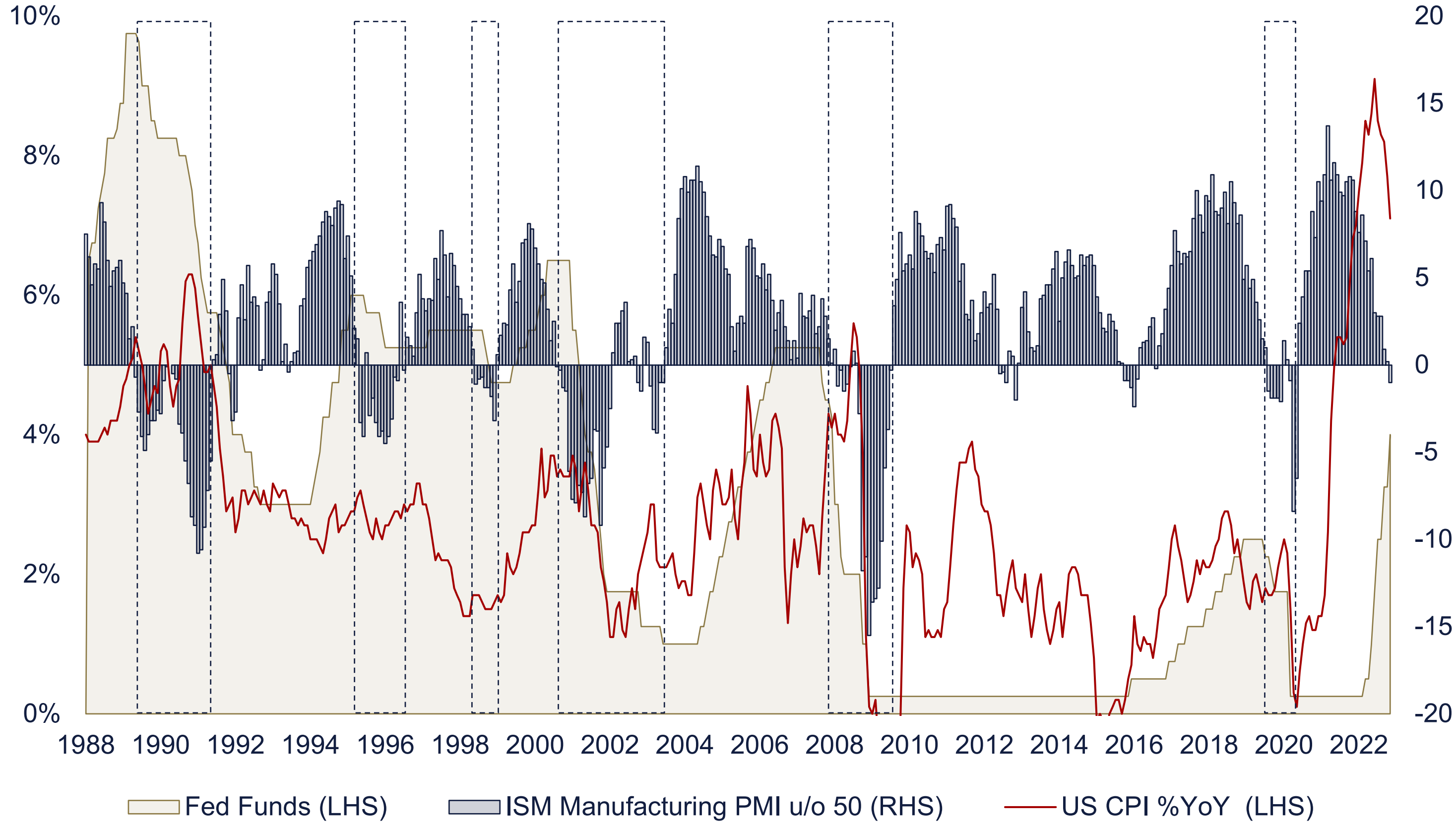
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	=	Higher probability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

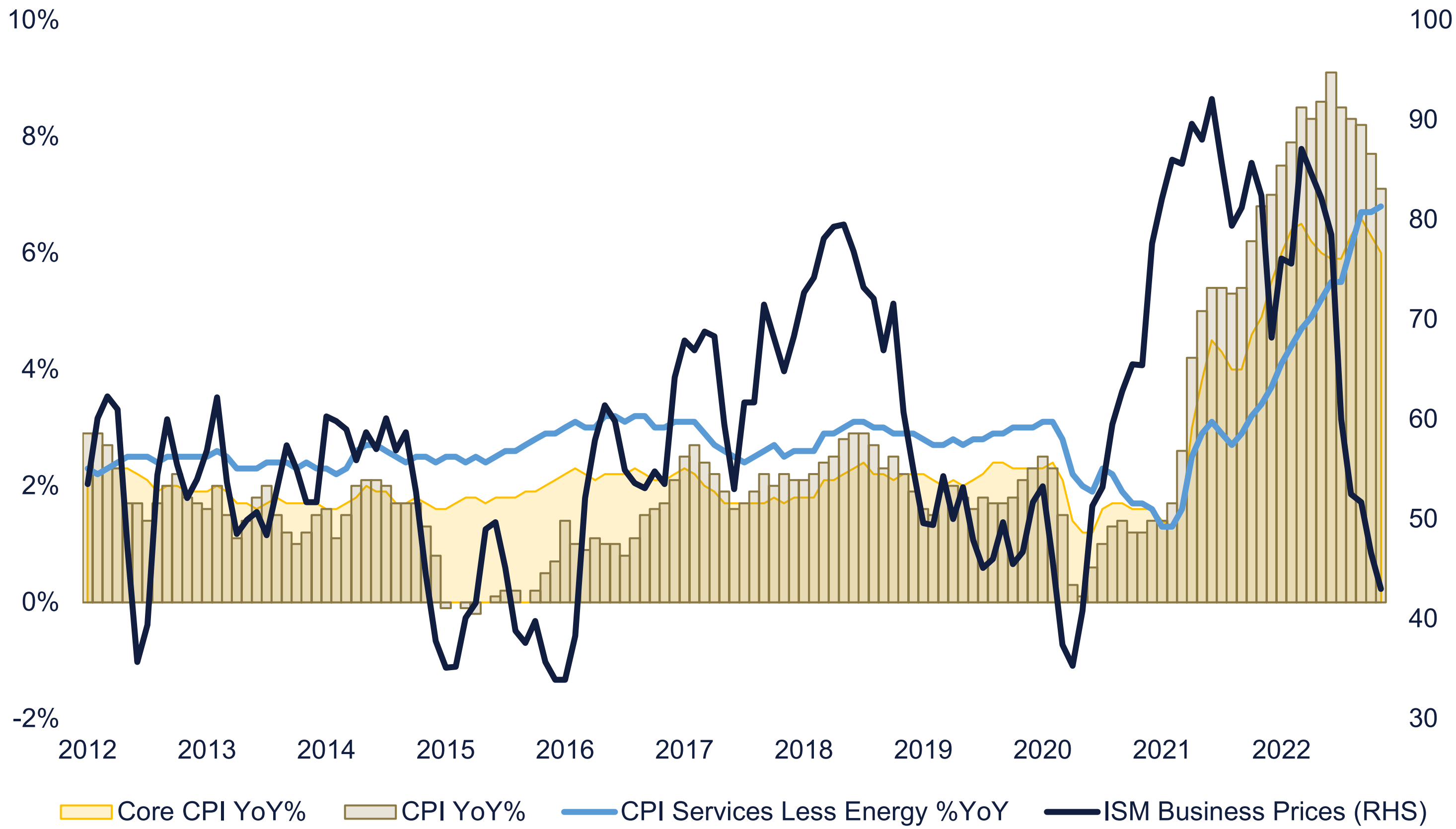
Maximum uncertainty



- In 2023 we are facing a **macroeconomic situation that we have never experienced before**. For the first time in more than four decades, **the economy is on the verge of contracting without the Fed coming to the rescue**
- **If inflation falls faster than the economy slows, the Fed may start cutting interest rates** to support growth. But if the opposite happens, the economy may enter a protracted recession

Source: Bloomberg

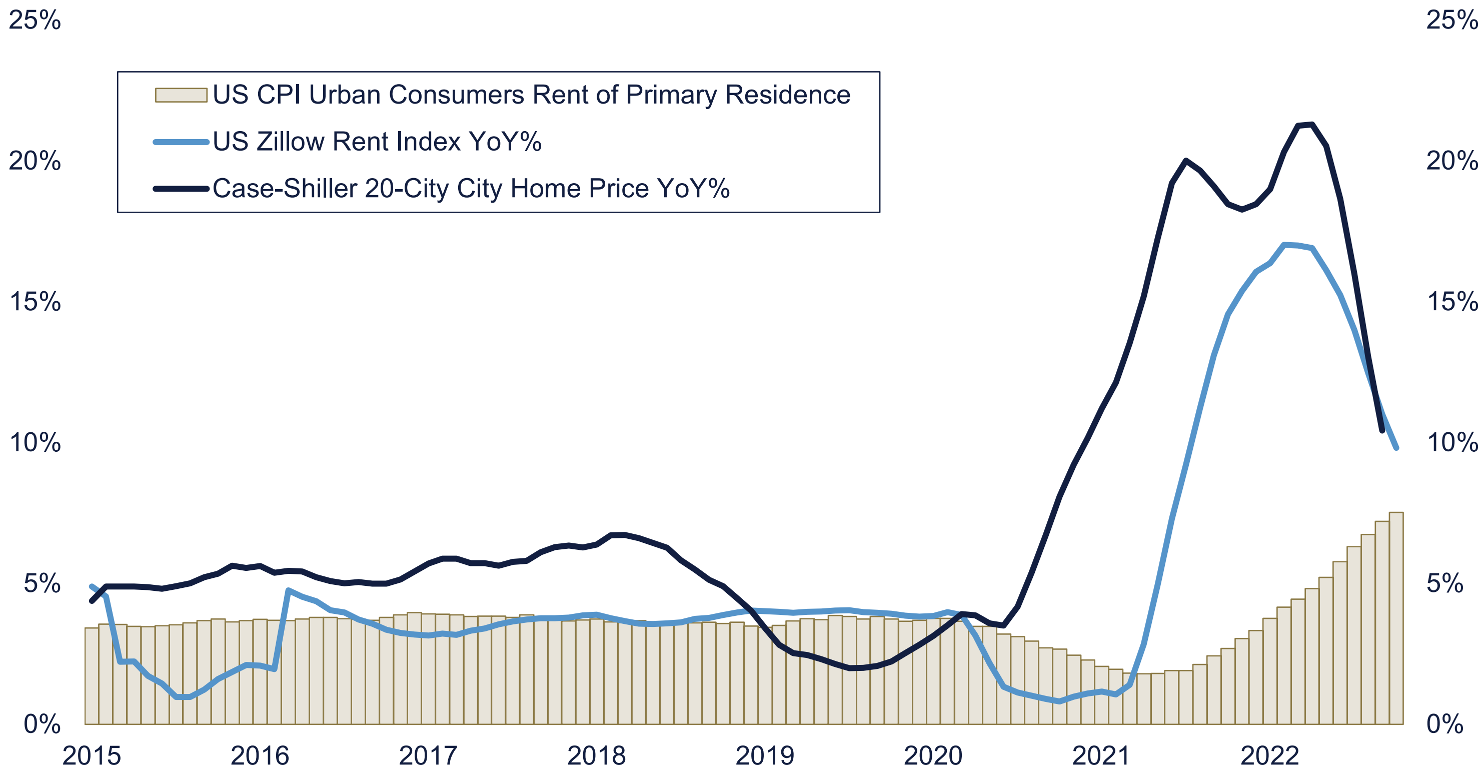
Soft landing still possible



- The latest series of inflation-related indicators give us **reason to remain optimistic**
- Both **headline and core inflation are falling**, driven by a decline in the prices of consumer goods and energy. Inflation in services has moderated its rate of increase and may be close to its peak

Source: Bloomberg

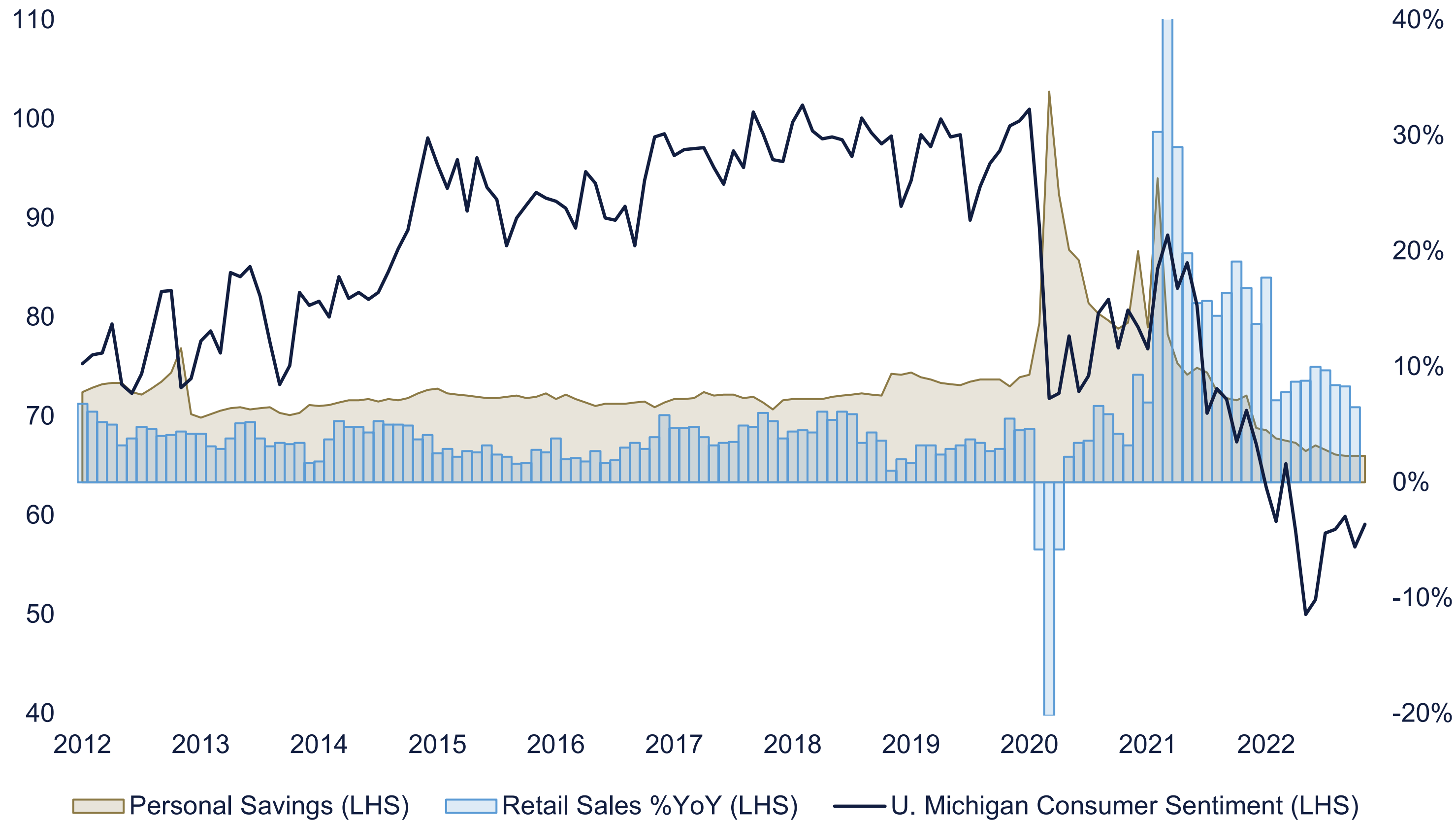
CPI is a lagging indicator



- By construction, the **CPI is a lagging indicator that does not provide a real-time view of price pressures in the economy**. The shelter component (its largest) follows the evolution of prices in the rental market with a lag of around 12 months
- **The housing market has peaked at the beginning of the year**, and we will soon begin to see it reflected in the price statistics

Source: Bloomberg

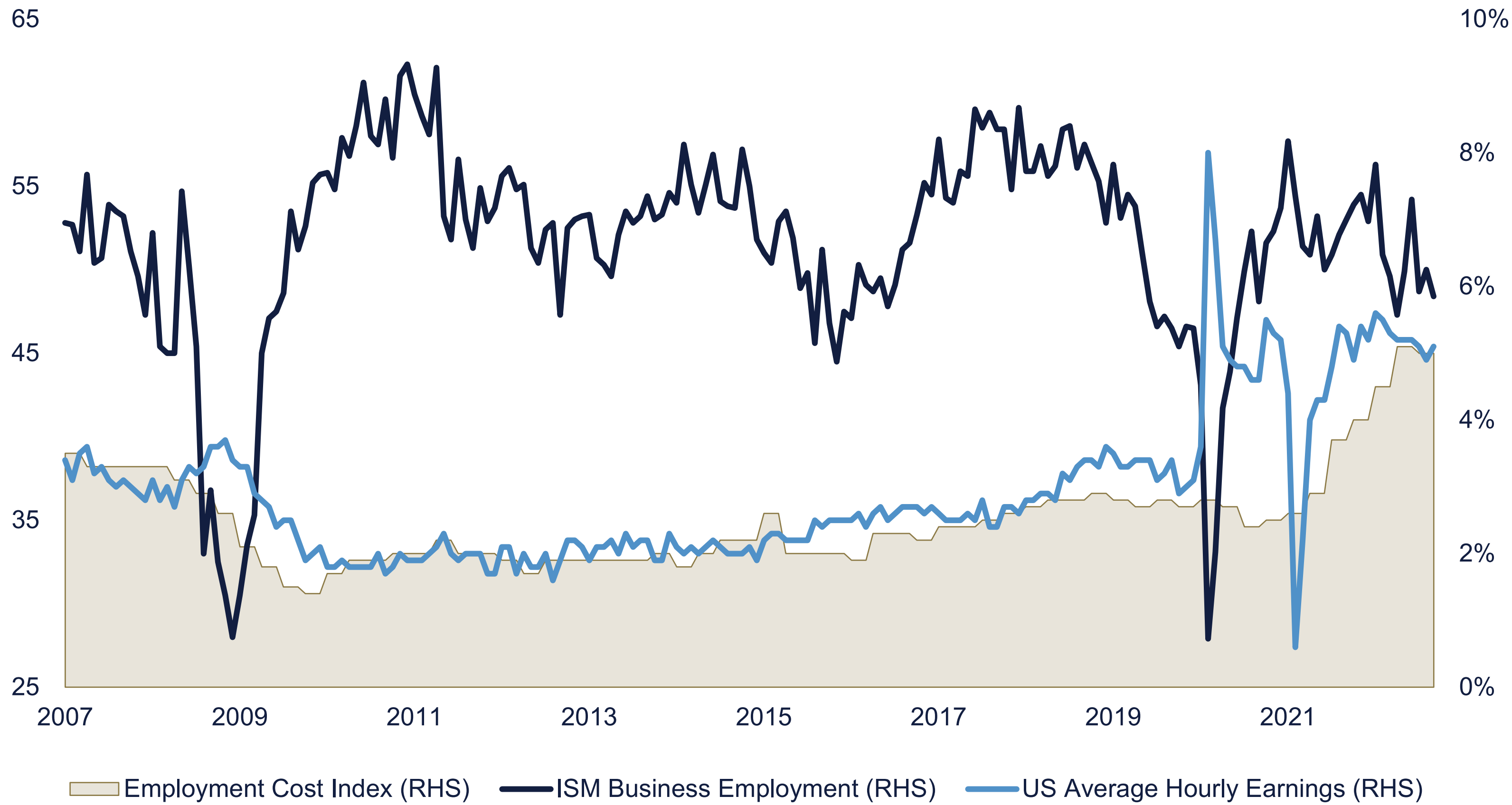
Resilient consumers



- **Consumers are behaving differently** this time. Despite mounting economic problems, they are not preemptively scaling back consumption as is usually the case
- A **strong labor market and accumulated savings** are two factors that help explain this apparent change in behavior. However, it cannot be ruled out that the psychological impact of the **pandemic has altered their propensity to save**

Source: Bloomberg

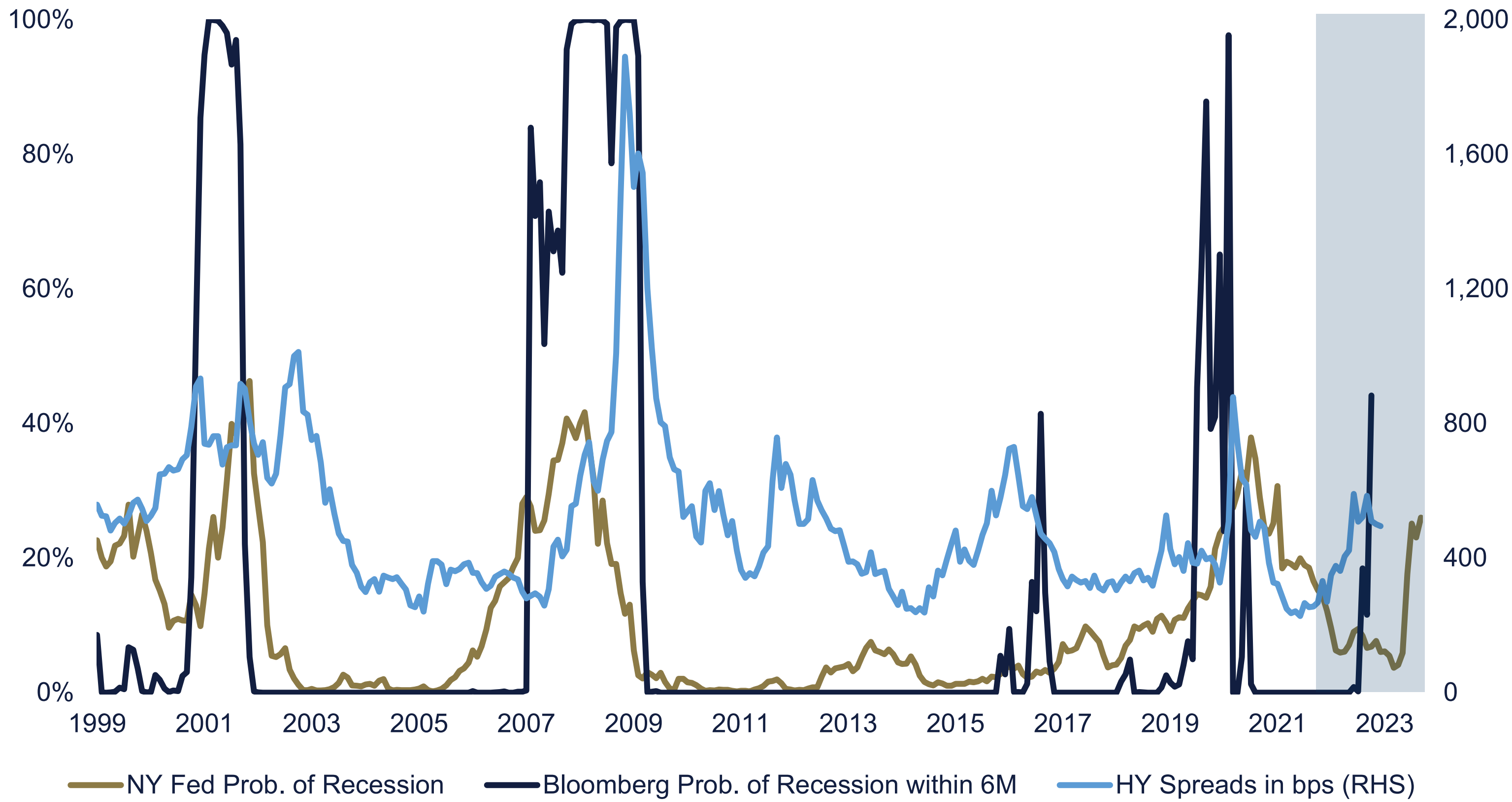
When will the first cracks emerge?



- **A tight labor market has helped inflationary pressures spill over into the broader economy**. However, as manufacturing slows down, we are going to start to see the first increases in unemployment, and a reduction in labor costs
- If wages fall faster than unemployment rises, the Fed will be in a much better place than if the opposite is the case

Source: Bloomberg

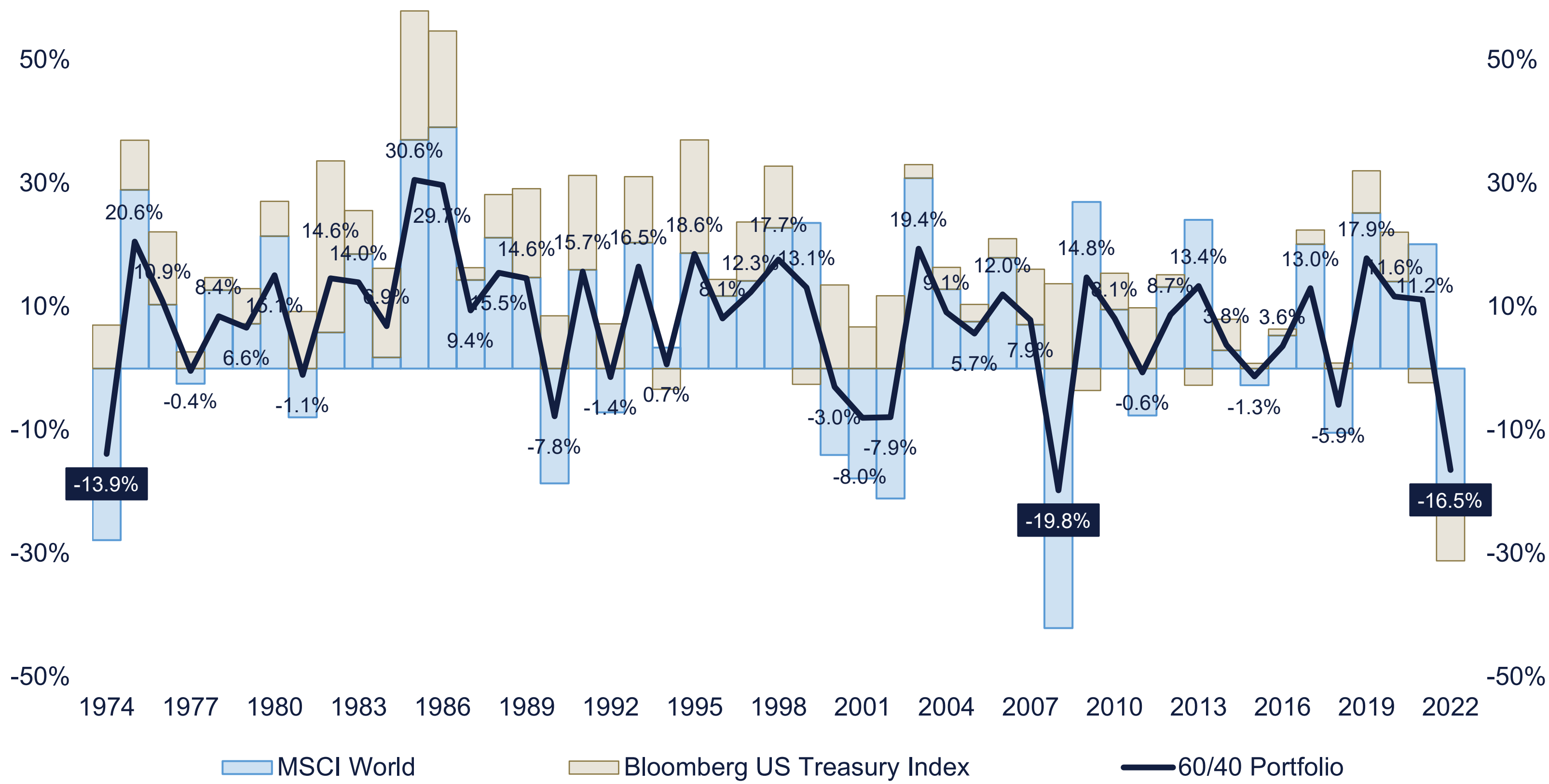
A mild recession is the baseline scenario



- The fact that the economy has been operating for more than a decade in an environment of extremely low interest rates makes it **highly unlikely that it can withstand a hike in interest rates of the magnitude experienced**
- But the **transmission of monetary policy takes time**, and if inflation allows the Fed to pivot early enough, **a recession may still be averted**

Source: Bloomberg

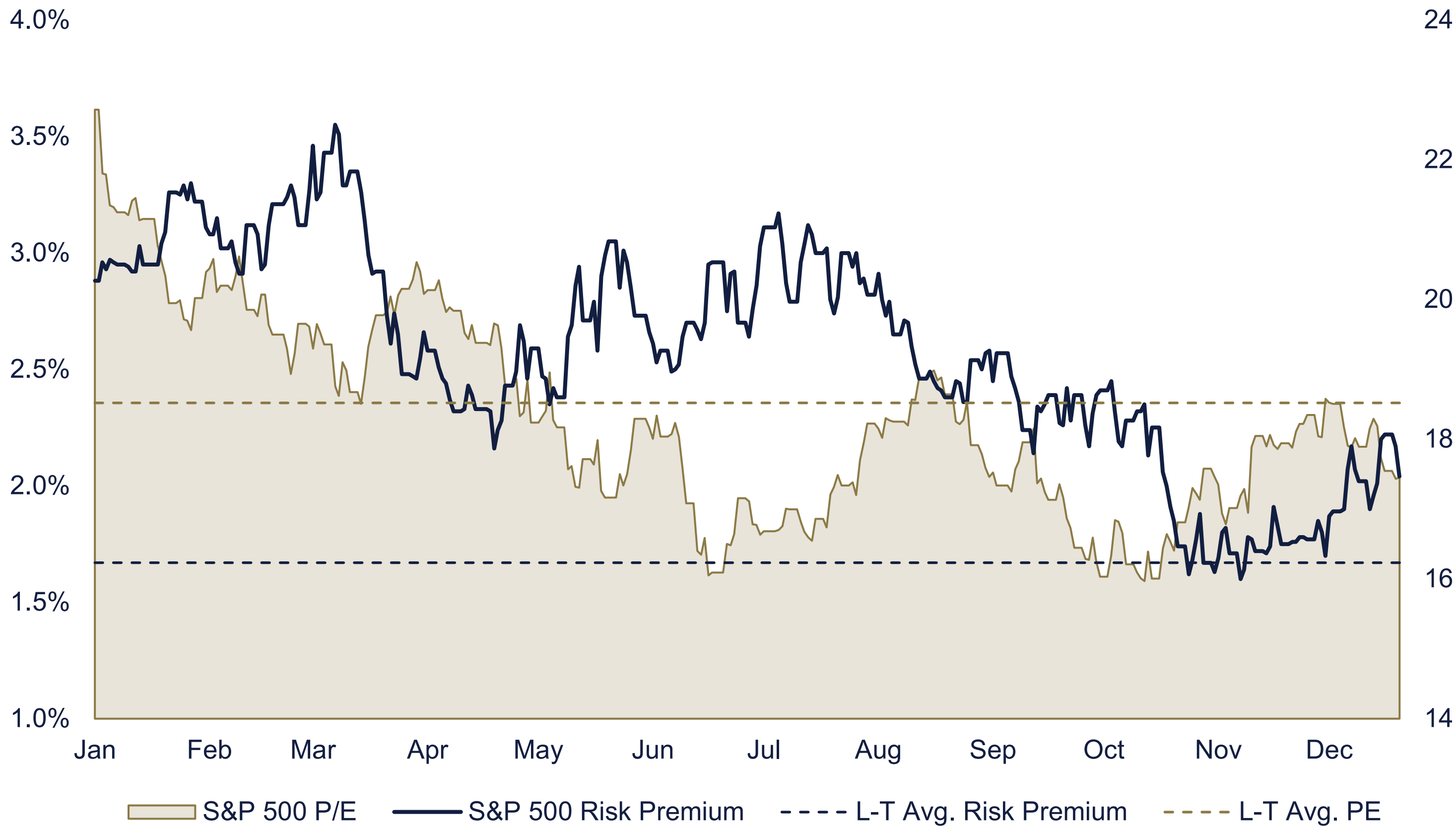
An unprecedented (fixed income) year



- **Bond markets have had the worst year in their recent history**, not only because of the magnitude of the interest rate hike, but also because of the very low starting point
- The rise in interest rates has also been the trigger for the great correction experienced in equity markets, even though corporate profits have continued to increase. Therefore, it has **also been an unusual year for stocks**

Source: Bloomberg

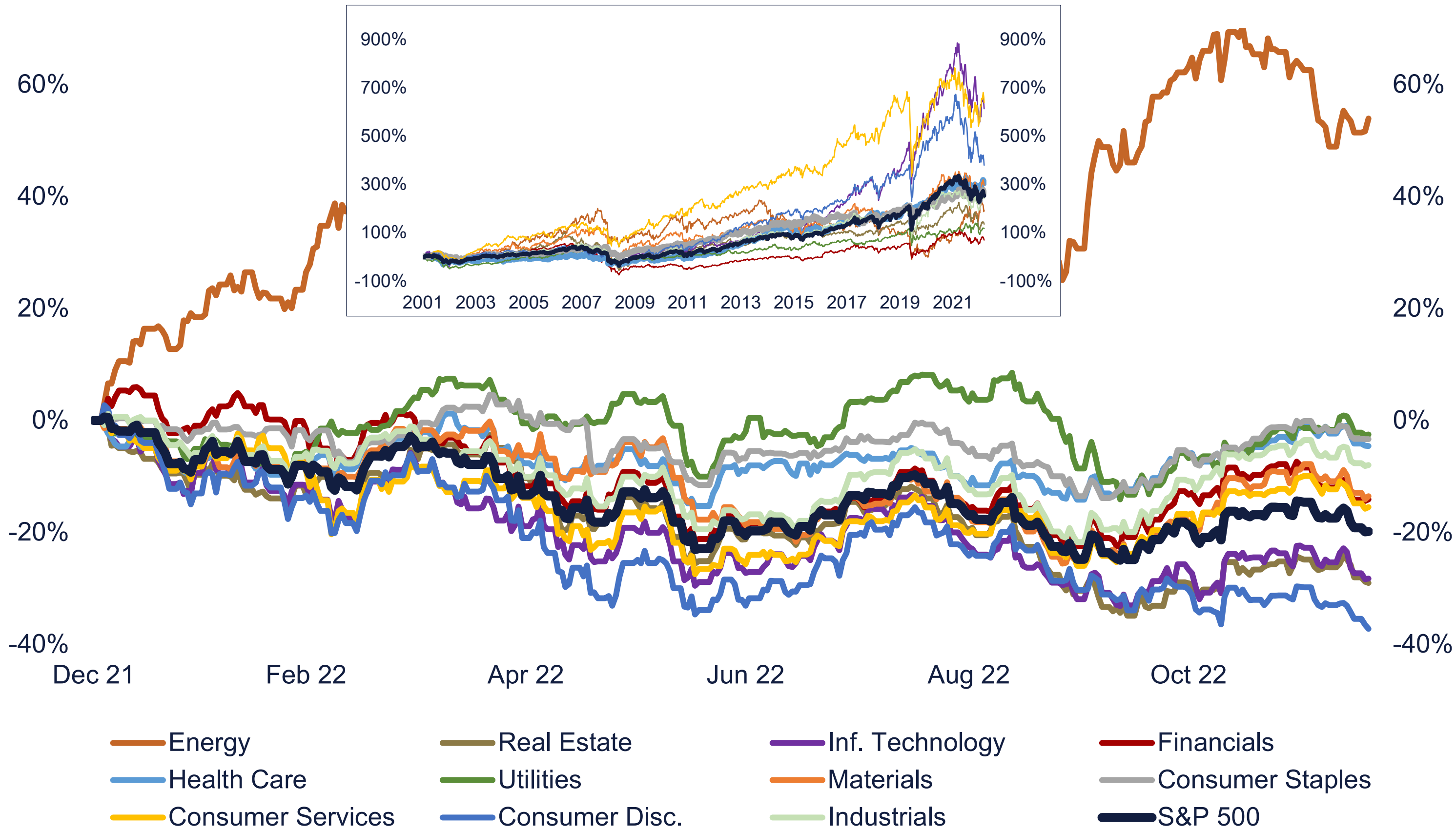
Volatile, but attractive valuations



- At the beginning of the year, **stocks looked attractive from a relative valuation perspective (compared to bonds), but expensive from an absolute valuation** (Price/Earnings) basis
- Ending the year, **the tables have been reversed**. However, both absolute and relative valuation metrics remain **attractive compared to their long-term averages**

Source: Bloomberg

Sector performance also driven by interest rates



- Not only bonds and the stock market in general have been **influenced by the rise in interest rates**, but also the **relative performance between sectors**
- With **interest rates seemingly approaching their ceiling, we may see a reversal next year**. In addition, investors should not forget that, **in the long run, equity performance is mainly determined by earnings growth**

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%	50% (-5%)	20% (+5%)

Short-term catalyzers

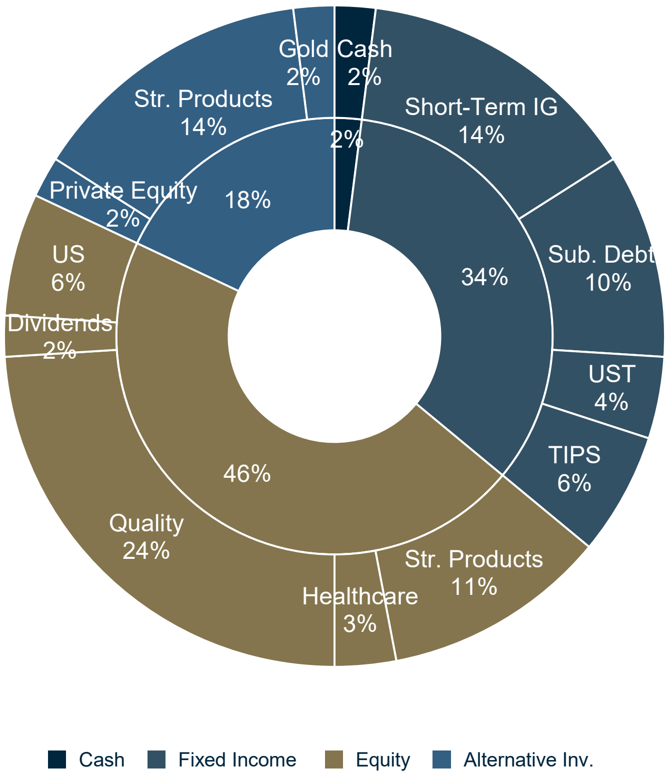
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

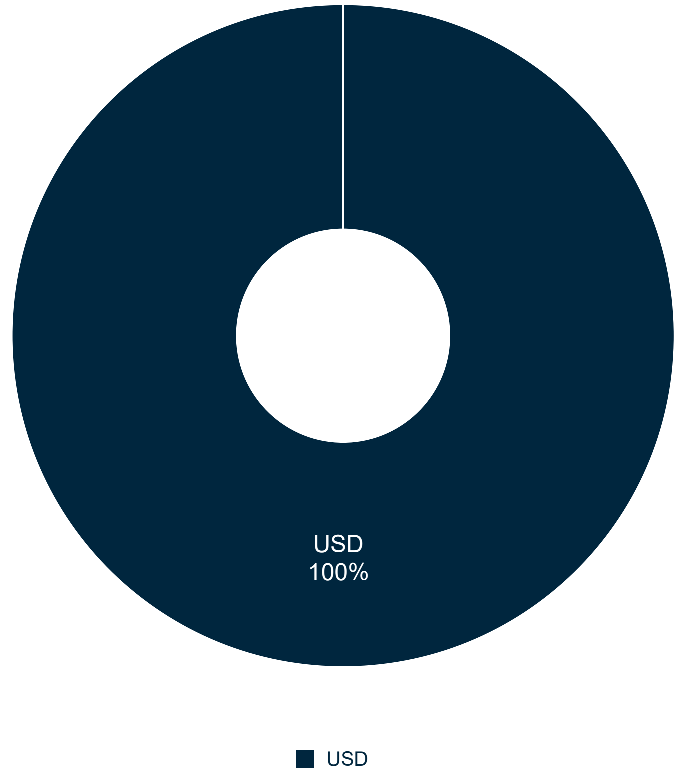
Escalation of the war in Ukraine, China slowdown, Housing market correction, Crypto bubble crash

Boreal Balanced Portfolio USD

Asset Allocation

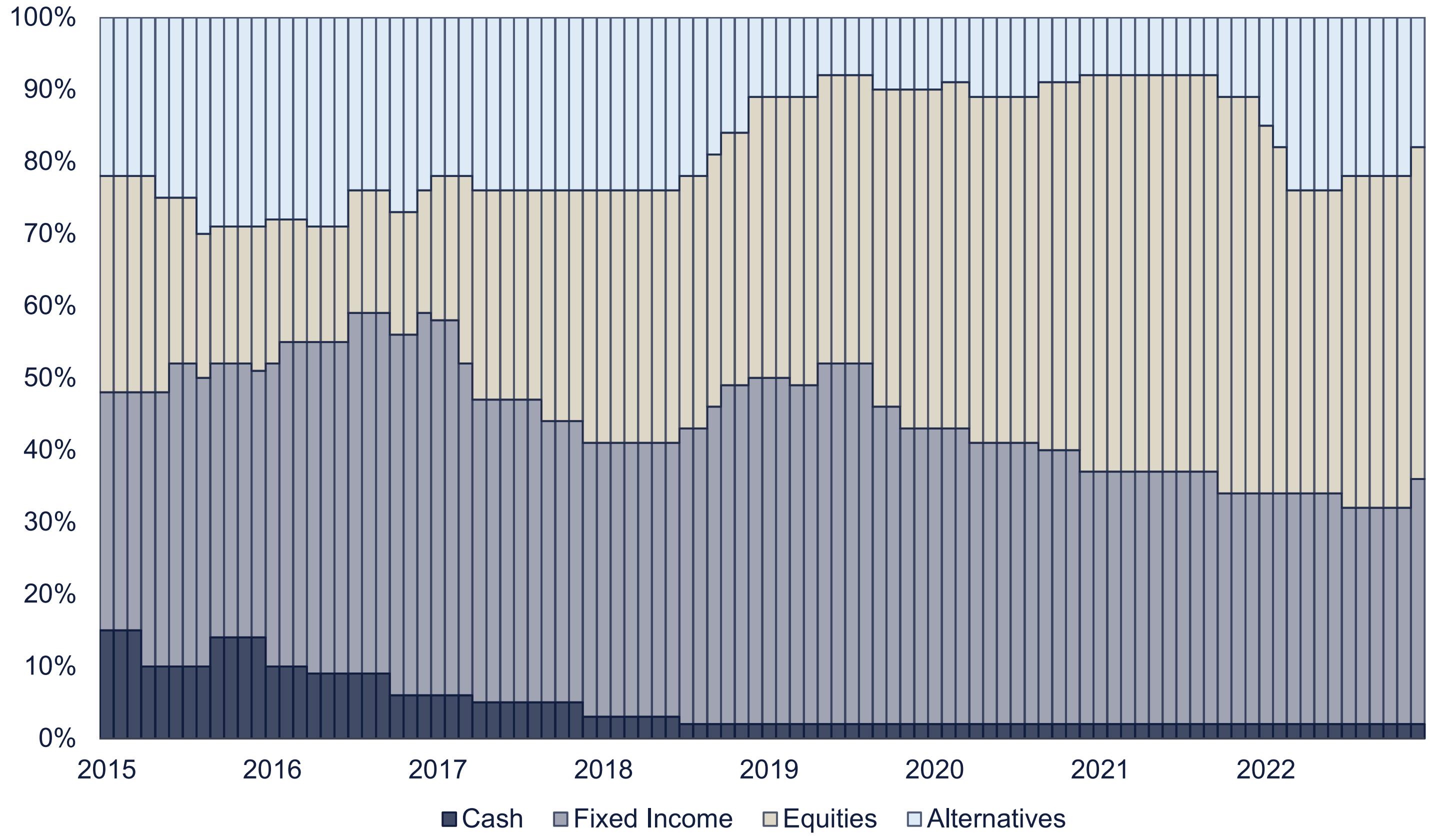


Currency Allocation



Boreal Investment Profiles

Boreal Balanced Portfolio – Asset Allocation evolution



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