Investment Policy

January 2023

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Our market view in a nutshell – January 2023

- The marked **tightening of monetary policy is beginning to be felt in the economy**. After months of trying to spot signs of a looming recession, the latest batch of leading indicators tell us that **consumers are starting to tighten their budgets**. We are probably already approaching the point where demand starts to contract (we are already seeing this in the drop in retail sales) and unemployment to rise. The **economic outlook is not much more encouraging in the other major economic blocs**, especially Europe and China

- Probably the current obsession that investors have with inflation explains why **the very bad data from the Services PMI** in the US (5 points below estimates) went relatively unnoticed. The service sector is the most stable part of the economy. That is why analysts prefer the manufacturing PMI to look for clues as to where the economy is headed. The latter has been pointing to a contraction in activity in recent months. And now comes the contraction in the services sector, something that has always been accompanied by a recession

- Despite this bleak outlook, **investors should not panic. It is no surprise that the economy will slow down**. This has been the main objective behind the aggressive path of interest rate hikes by central banks. What we do not know is whether we will have a **soft or a hard landing**. This will mainly depend on **how consumers react when unemployment starts to rise**, as well as how much and how quickly inflation moderates

- Both consumer and producer prices have been surprising positively in recent months. We see **widespread price declines for those categories that were subject to supply constraints last year**. Also, a **drop in energy prices**. Both core and services inflation seem to be peaking, but there is still a lag in the shelter component, which makes up around a third of the basket. **If the trend continues, the Fed will have more leeway to focus on growth, if necessary**. This is what markets are pricing in as interest rates have been falling **in anticipation of a Fed pivot**

- The shift in the yield curve is behind the rally in stocks and bonds since October. As far as the stock market is concerned, **it is still too early to tell if this is a bear market rally or the start of a new bull market**. The uncertainty stems from the fact that corporate profits (in aggregate) are almost certain to fall. As for **bonds, they continue to be the most attractive asset class** for providing returns while reducing portfolio volatility

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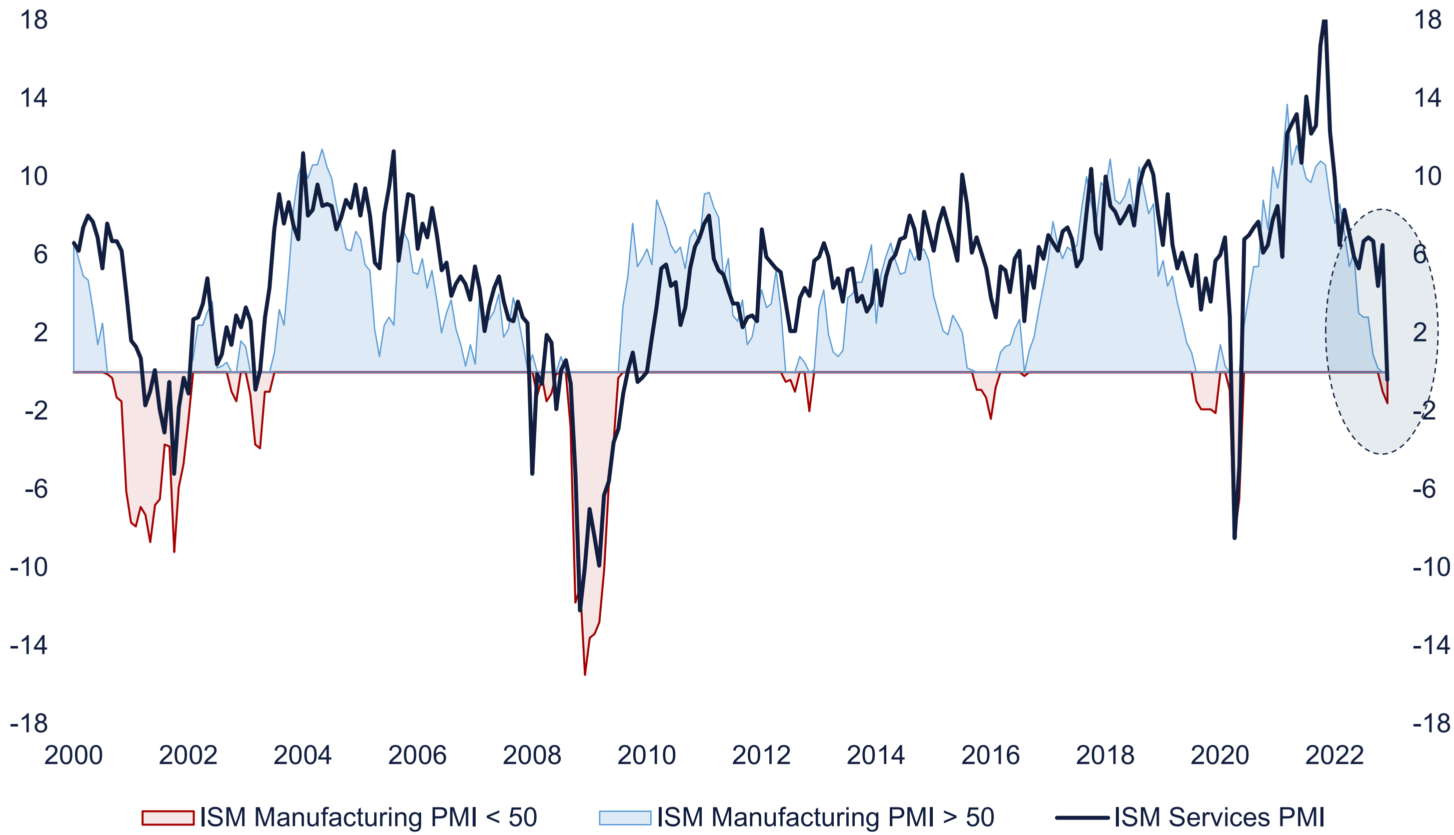
	Asset Class	View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	=	Higher probability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

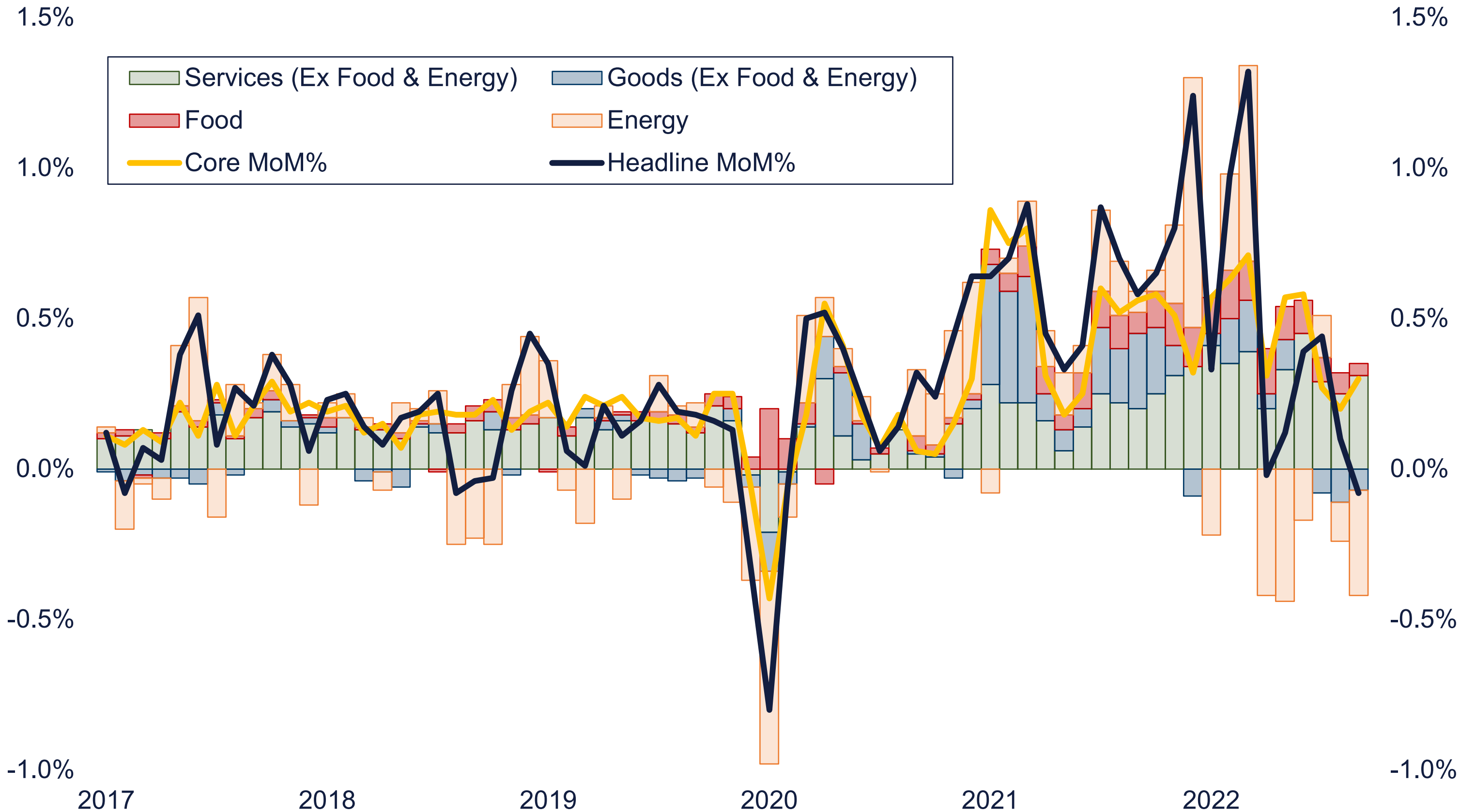
“Big miss”, little attention



- **The Services PMI (a leading indicator) fell more than 5 points below the level expected by analysts**. Not only was the magnitude of the gap between the survey and the actual data very large, but it is also very unusual for this indicator to drop below 50 (indicating a contraction in activity)
- With **both Manufacturing and Services PMIs in contraction territory**, the likelihood of a recession looming in the coming months has risen significantly

Source: Bloomberg

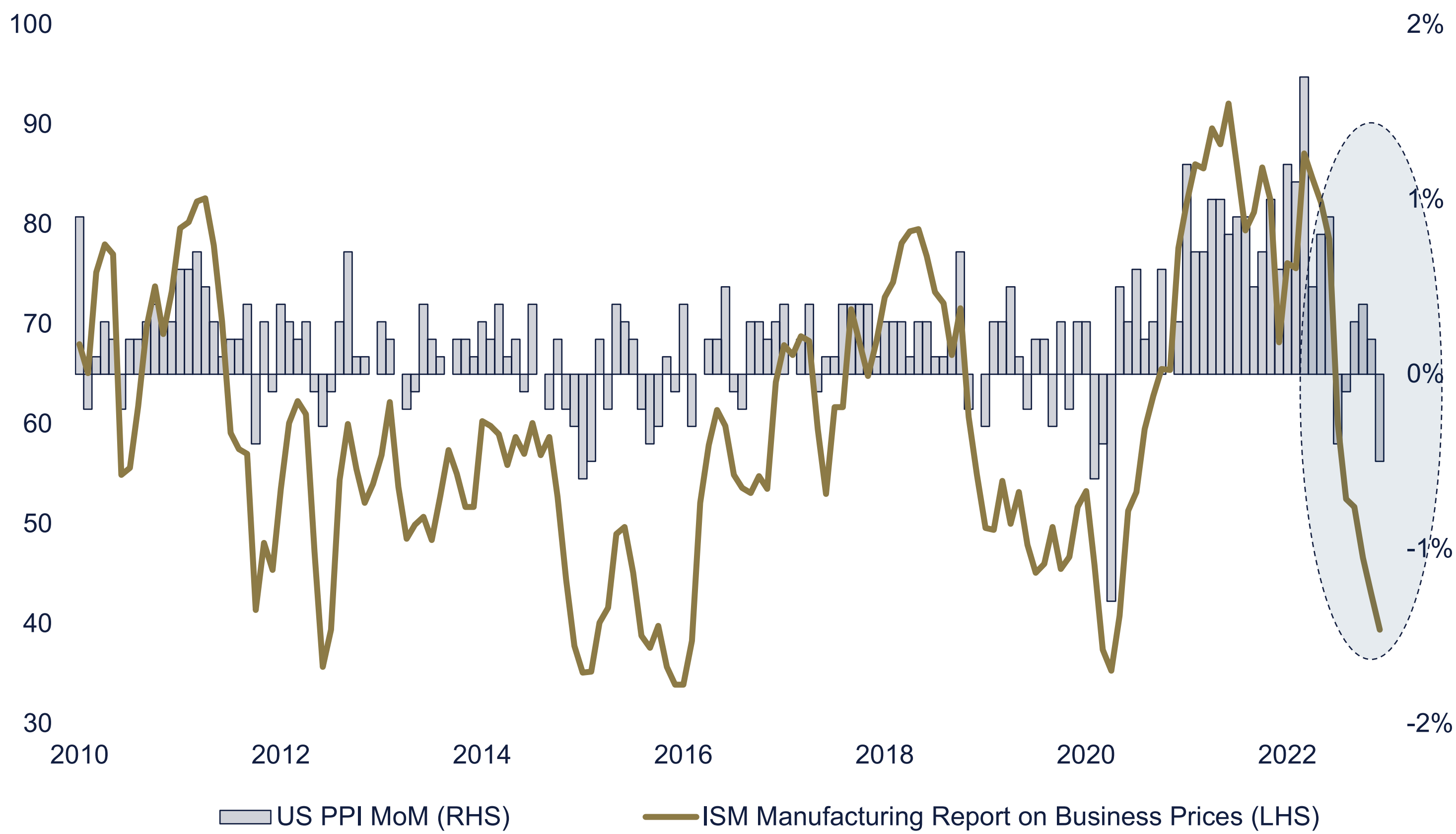
Inflation continues to moderate



- **Inflation** (judging by various indicators such as CPI, PPI or ISM Business Prices) **continues to slow down**
- This is **excellent news for investors**. We should not be surprised that the economy is going to slow down. But the sooner we put the current inflationary episode behind us, the sooner the Fed can start lowering interest rates

Source: Bloomberg

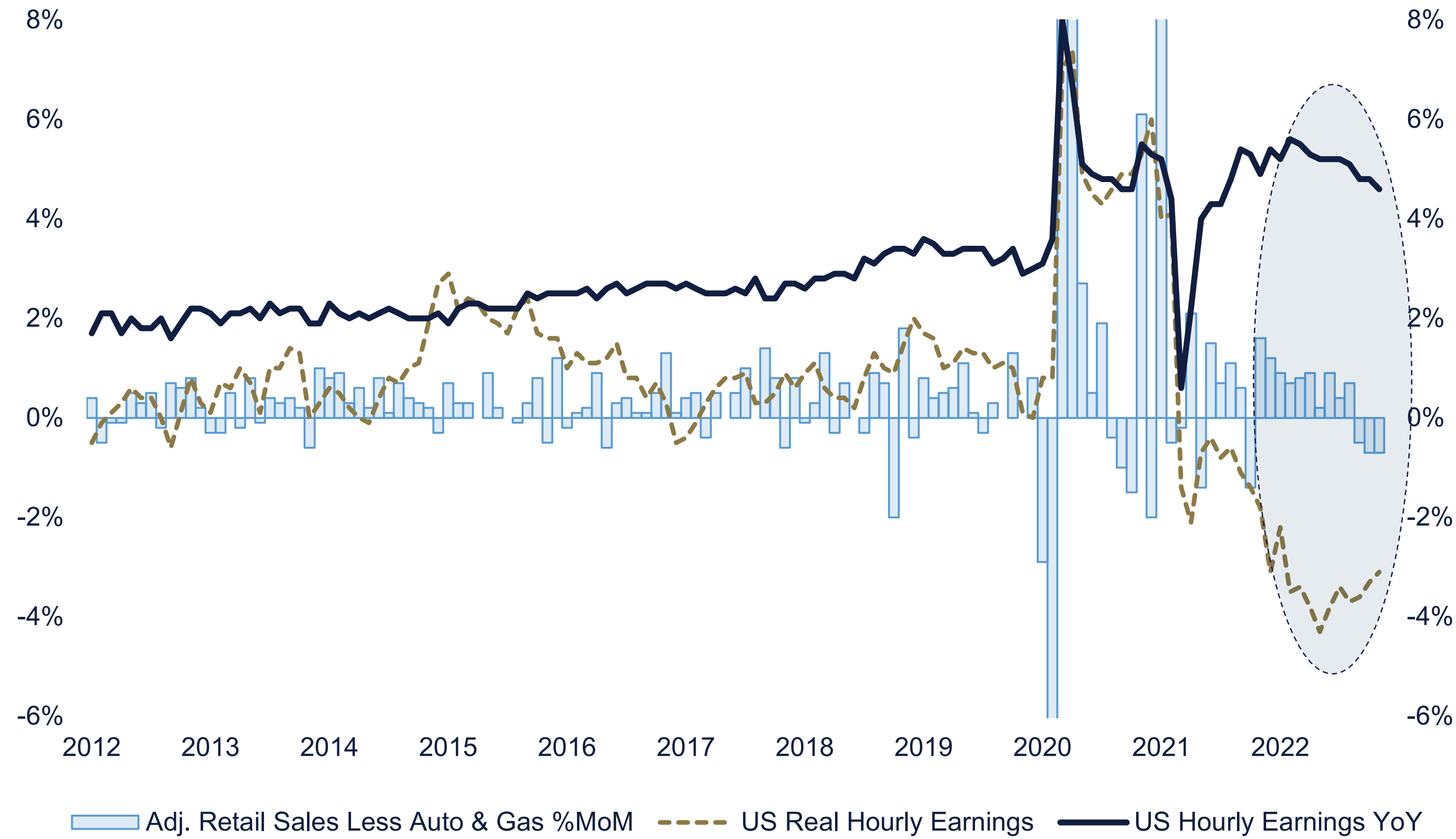
And even falling for supply-constrained items



- The prices of **items that have been affected by the pandemic** are not only slowing down but are **starting to fall**
- **This trend is expected to continue and even intensify** when (sooner or later) consumers start tightening their belts

Source: Bloomberg

Consumers begin to feel the pinch



- **Wages have not kept pace with inflation**, and disposable income in real terms has been eroded as a result. This is **beginning to affect consumers** who, for the past year, have relied on the savings accumulated during the pandemic
- The positive reading of all this is that **wages are beginning to moderate**, thus reducing inflationary pressures

Source: Bloomberg

Europe remains more vulnerable

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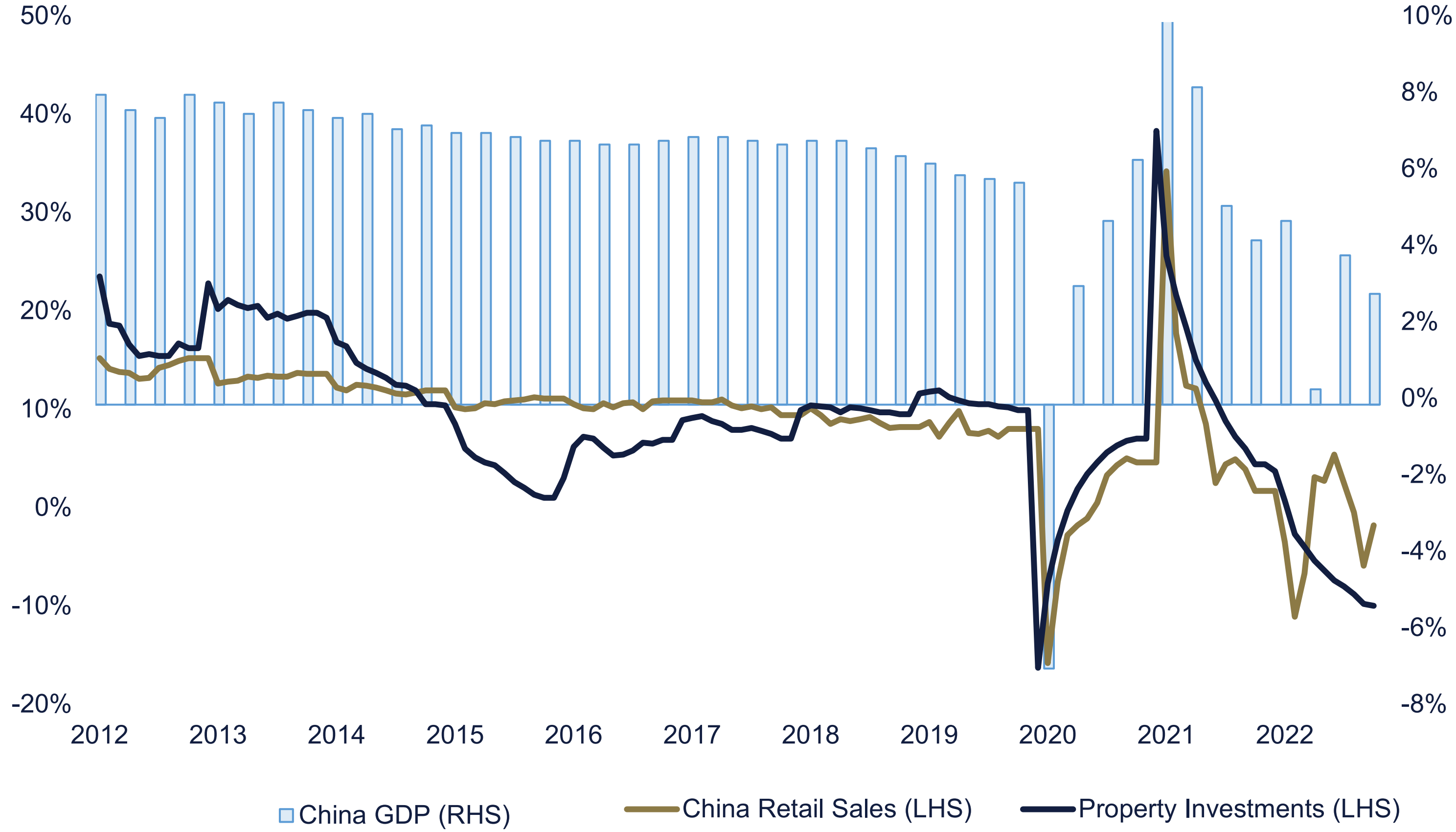
- Despite having weathered the winter better than expected, the **European economy remains much more vulnerable than the US** one
- Not only because of its **energy dependence**, but also because the **tightening of monetary policy is more pronounced** there, after a decade living with zero or negative interest rates

Source: Bloomberg

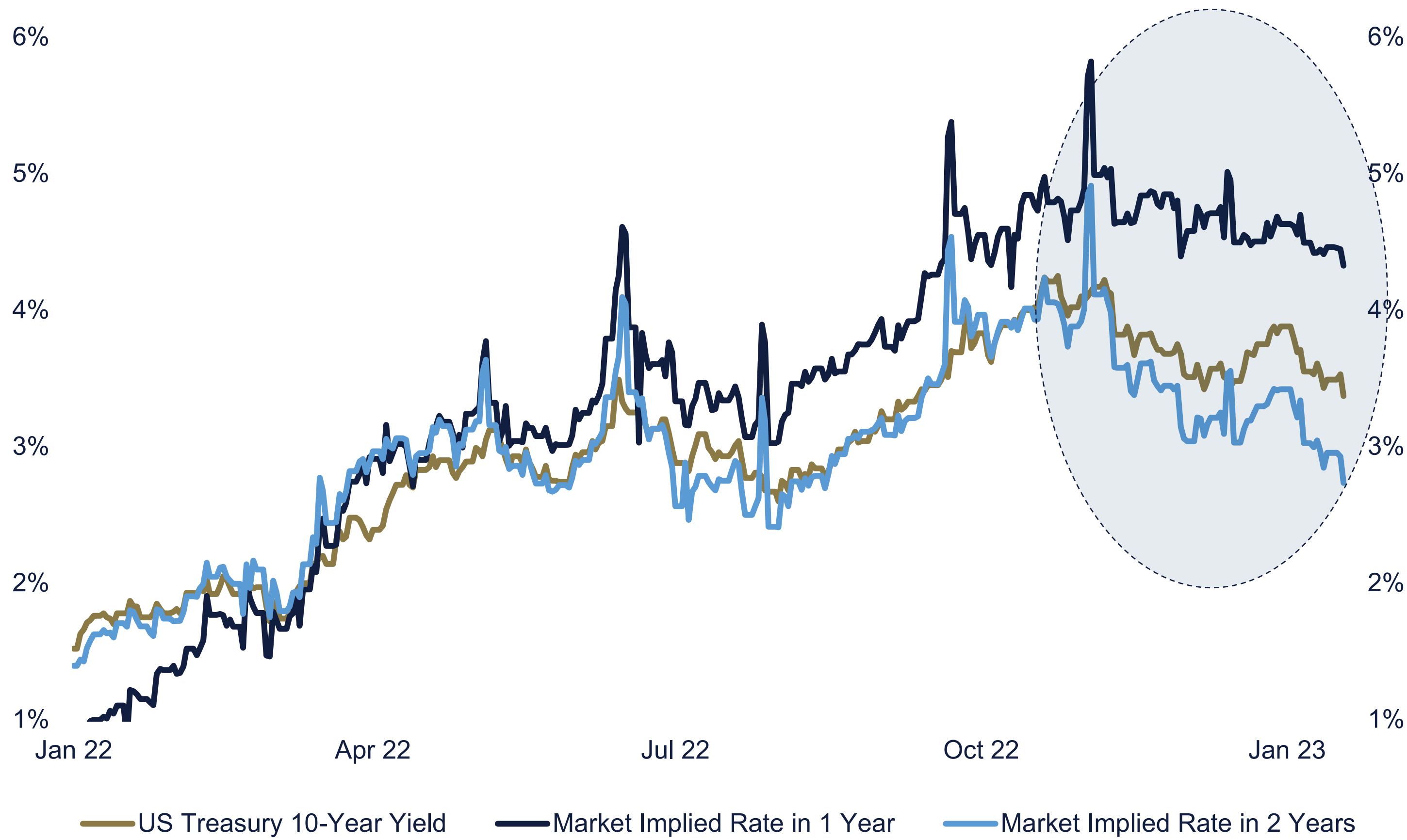
China back in the spotlight?



- **China has been the main engine of growth in the last two decades.** Now that the other big economic blocs are starting to slow down, it is important that their economy regains traction
- The impact that an economic normalization would have on inflation has two sides. On the one hand, it could **put pressure on commodity prices.** But on the other hand, it could help to **further alleviate supply side bottlenecks**

Source: Bloomberg

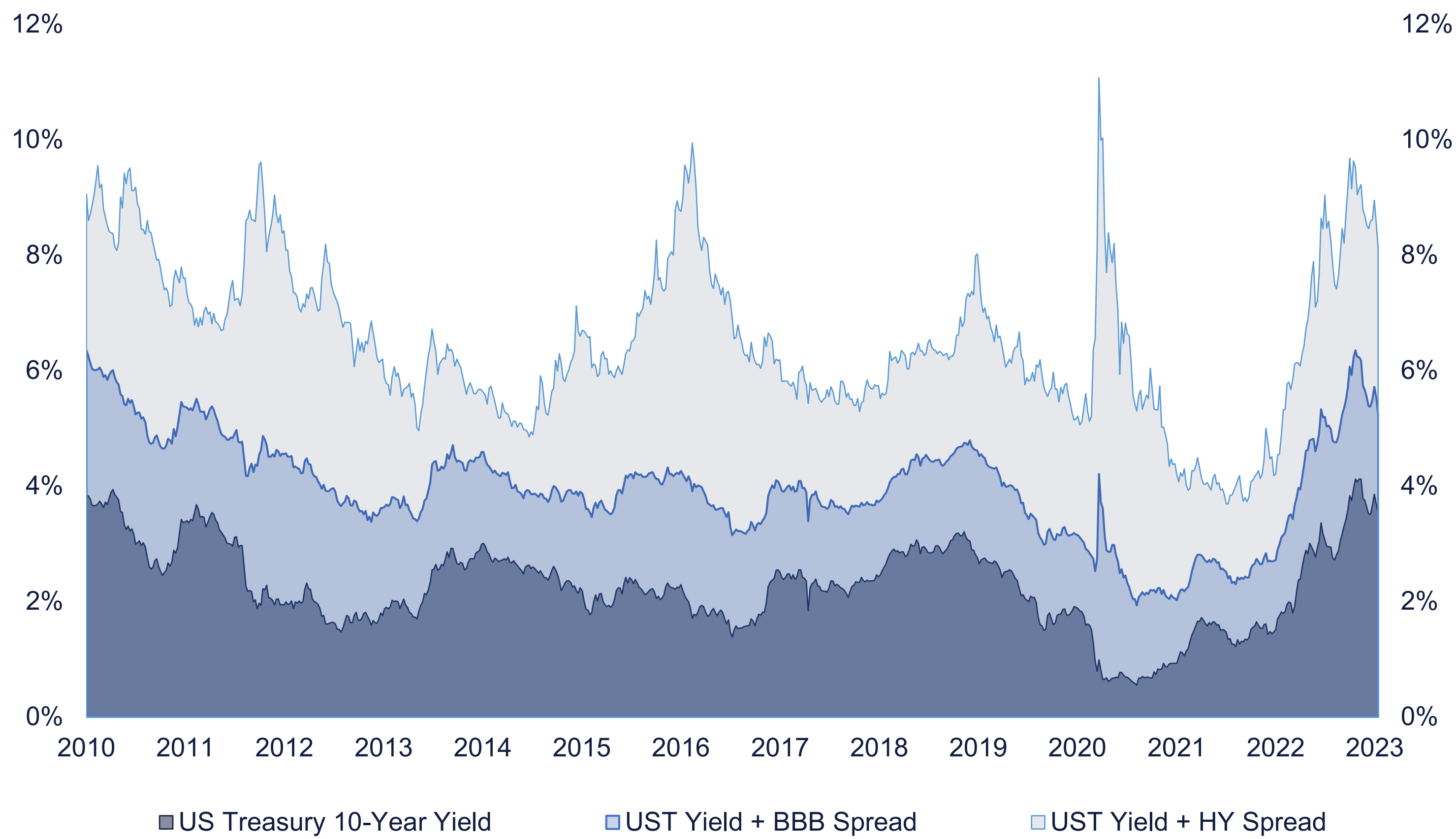
Markets are expecting a Fed pivot



- The good news on the inflation front has caused **interest rate expectations to move lower**, both in the short and long end of the curve (the 10-year US Treasury yield has fallen almost one percent since the peak reached in October)
- This **shift in the yield curve has helped both stocks and bonds**. However, for the former it is still too early to tell if it is a bear market rally or the start of a new bull market, as corporate earnings will have to slow down

Source: Bloomberg

Bonds continue to shine



- Despite the recent decline in yields, bonds continue to offer **returns not seen in more than a decade**
- Considering that there is a risk that the economy will enter a recession, and that in this case corporate spreads would widen, **high-quality bonds stand out as the best alternative to help reduce volatility in portfolios**

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%	45% (-5%)	25% (+5%)

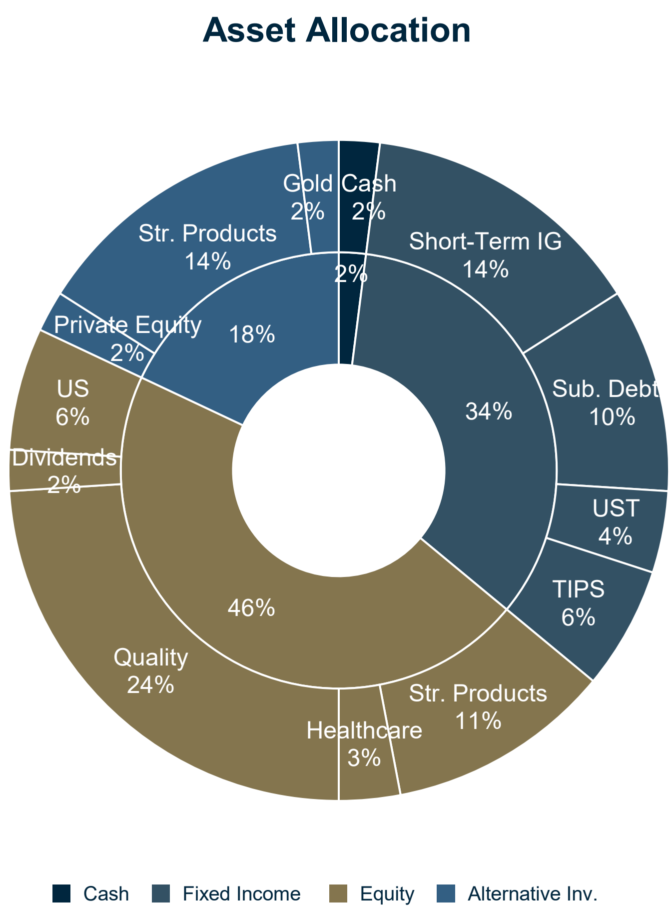
Short-term catalyzers

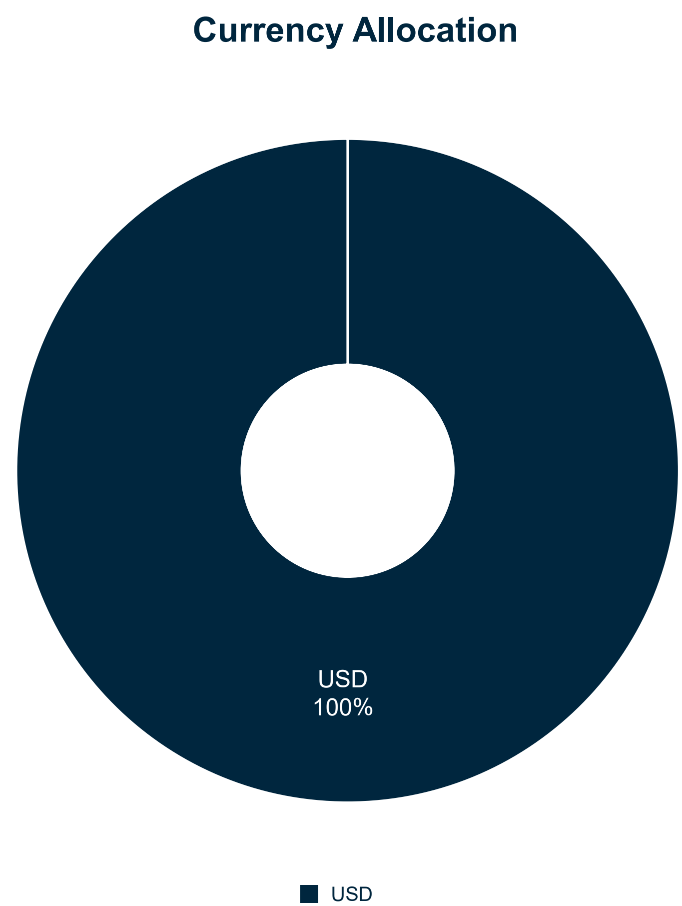
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

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

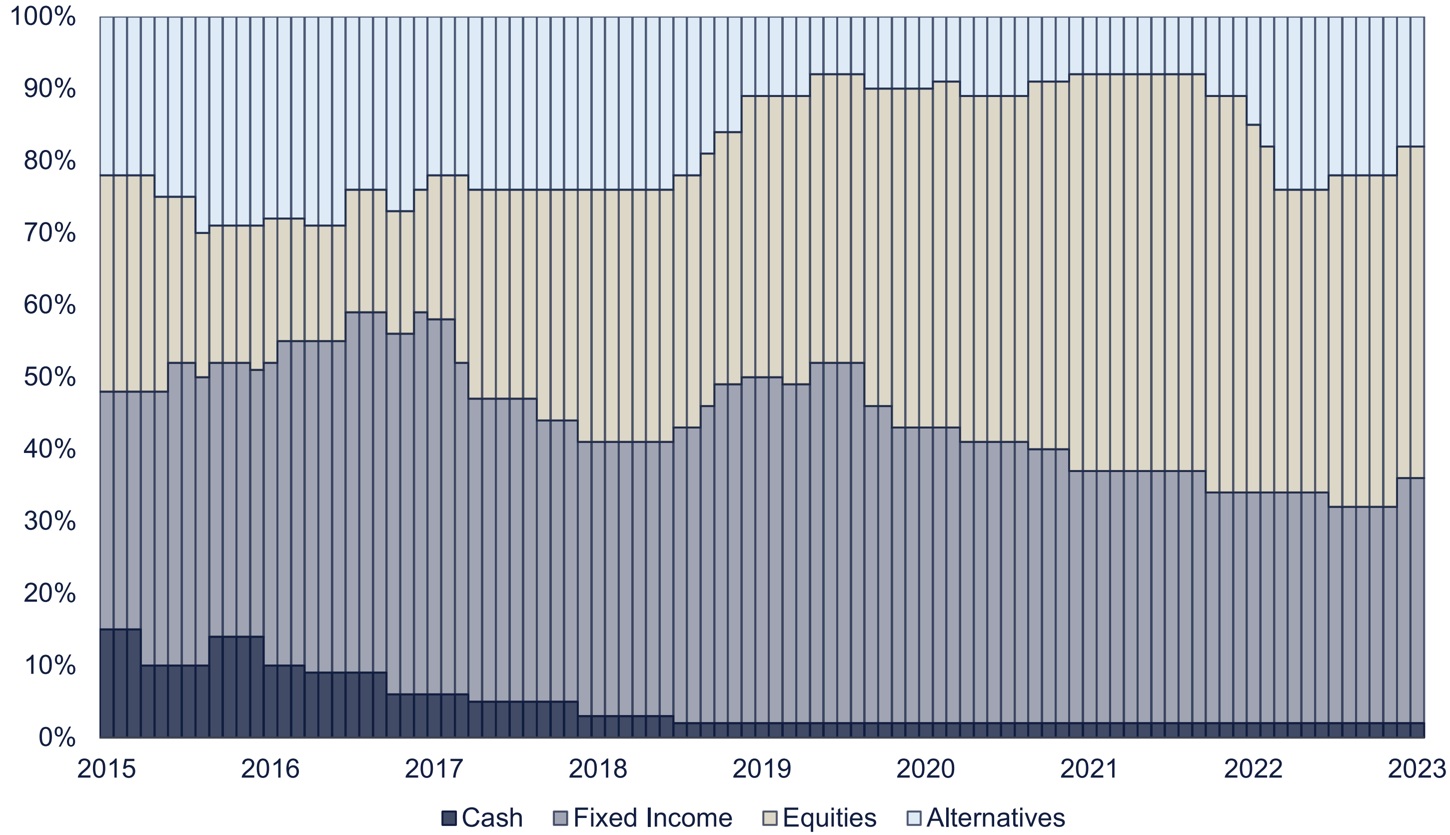
Boreal Balanced Portfolio USD





Boreal Investment Profiles

Boreal Balanced Portfolio – Asset Allocation evolution



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