Investment Policy

March 2023

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CAPITAL MANAGEMENT

Our market view in a nutshell – March 2023

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- The **collapse of SVB** has come to show that the fastest, most pronounced, and from a lowest starting point interest rate cycle in history, could not be exempt from negative consequences. The same **seismic shift in interest rates** that was felt last year in portfolio valuations has also **left a hole in bank balance sheets**

- With the new **Fed liquidity facility**, local banks will be able to meet the liquidity demands of their depositors, avoiding having to realize losses in their treasury bond portfolios; thus, **preventing similar bank runs to take place**. However, avoiding a banking crisis does not imply that what happened will not have **consequences for both the economy and financial markets**

- **Financial conditions have tightened** significantly over the past year, making it difficult for companies to raise capital. Now that **banks have to compete for deposits and repair their balance sheets**, credit standards will rise. Therefore, we will **expect a contraction in credit**. In a way, the banking system will now begin in earnest to act as a **transmission mechanism for monetary policy**

- A new battlefront has just opened up for the Fed. Now they not only have to **keep inflation under control but must also ensure financial stability**. Furthermore, the **contraction in credit will slow growth**, further complicating their room for maneuver. In their favor is the fact that the **data for the month of February continued to point to a drop in inflation**, an incipient loosening in the labor market, as well as a slight slowdown in consumption

- Market **expectations for future interest rate hikes have come down sharply**, with the market now expecting a 1% rate cut (cumulative) by the end of the year. This is **supportive of both equity and fixed income valuations** and is therefore cushioning the increase in risk aversion on the back of fears about the banking sector

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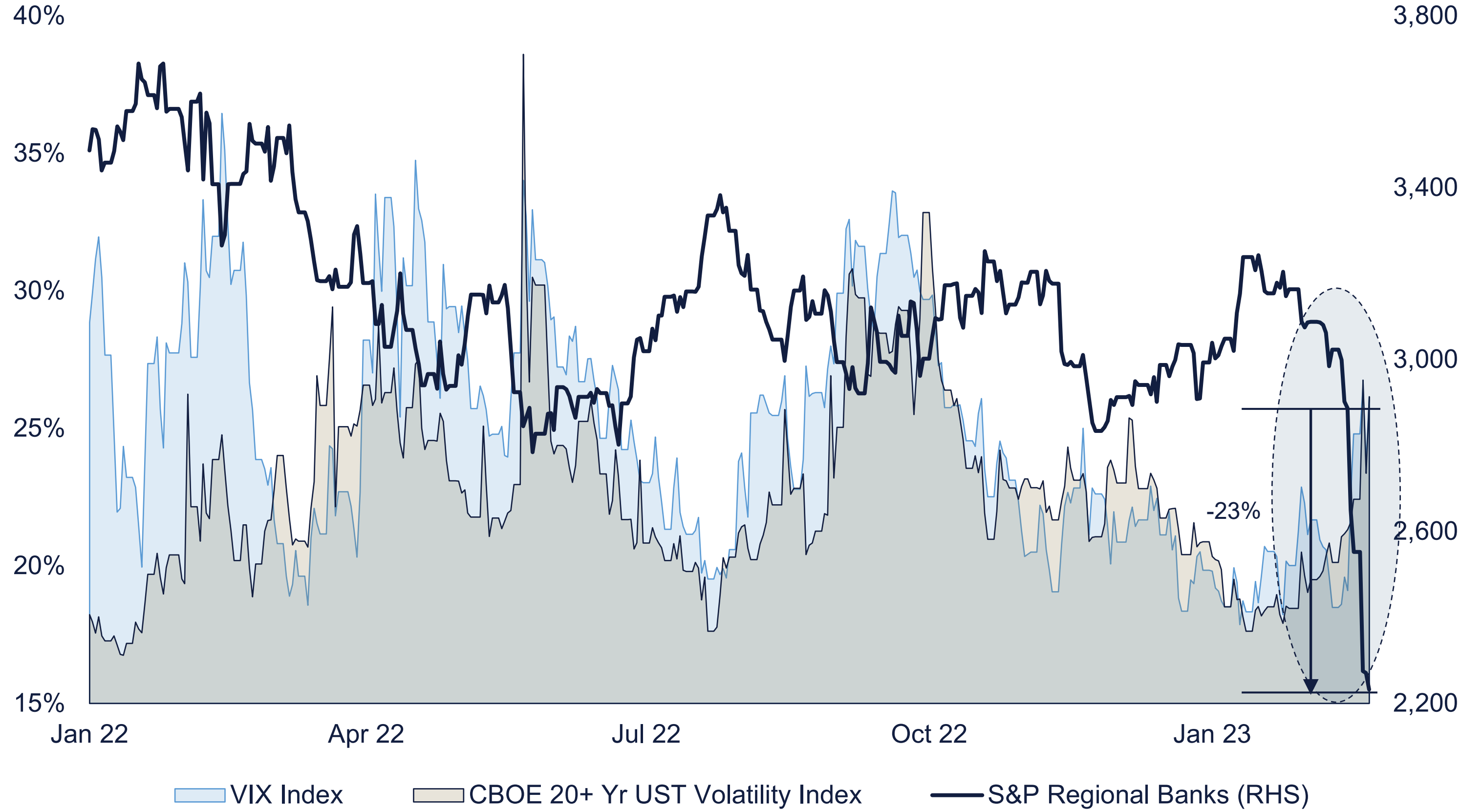
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	=	Higher probability 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	=	The decisive action of the ECB and the widening of corporate spreads has caused high-quality euro-denominated debt to begin to offer an acceptable risk-adjusted return
	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

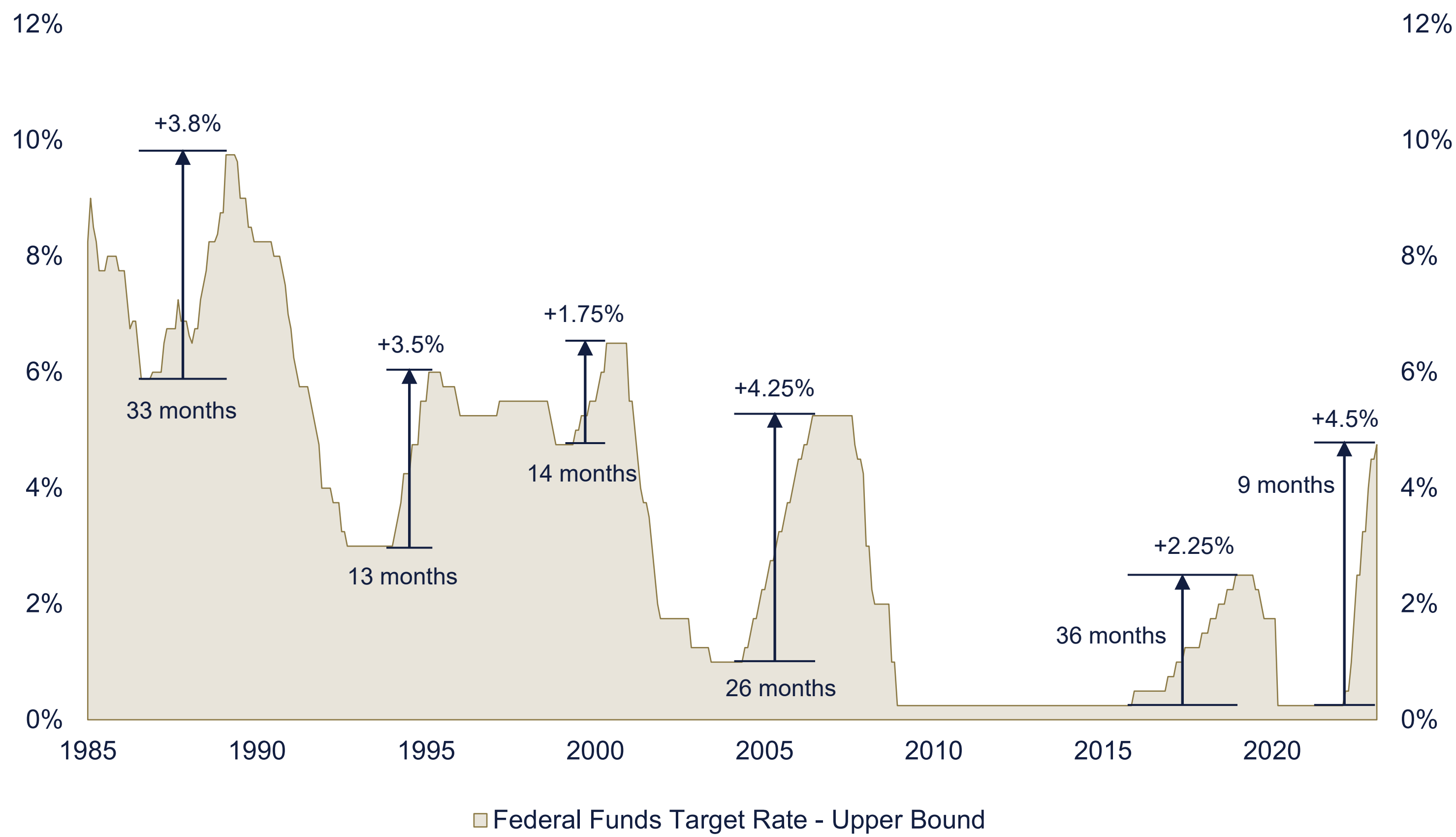
And finally, the Fed broke something



- Bond loses are not limited to individual portfolios. **Bank balance sheets** have also been affected by the **sharp rise in interest rates**
- These **vulnerabilities have been exposed by the collapse of SVB** and the crisis that, despite decisive action by the Fed and the Treasury, has subsequently engulfed the banking sector

Source: Bloomberg

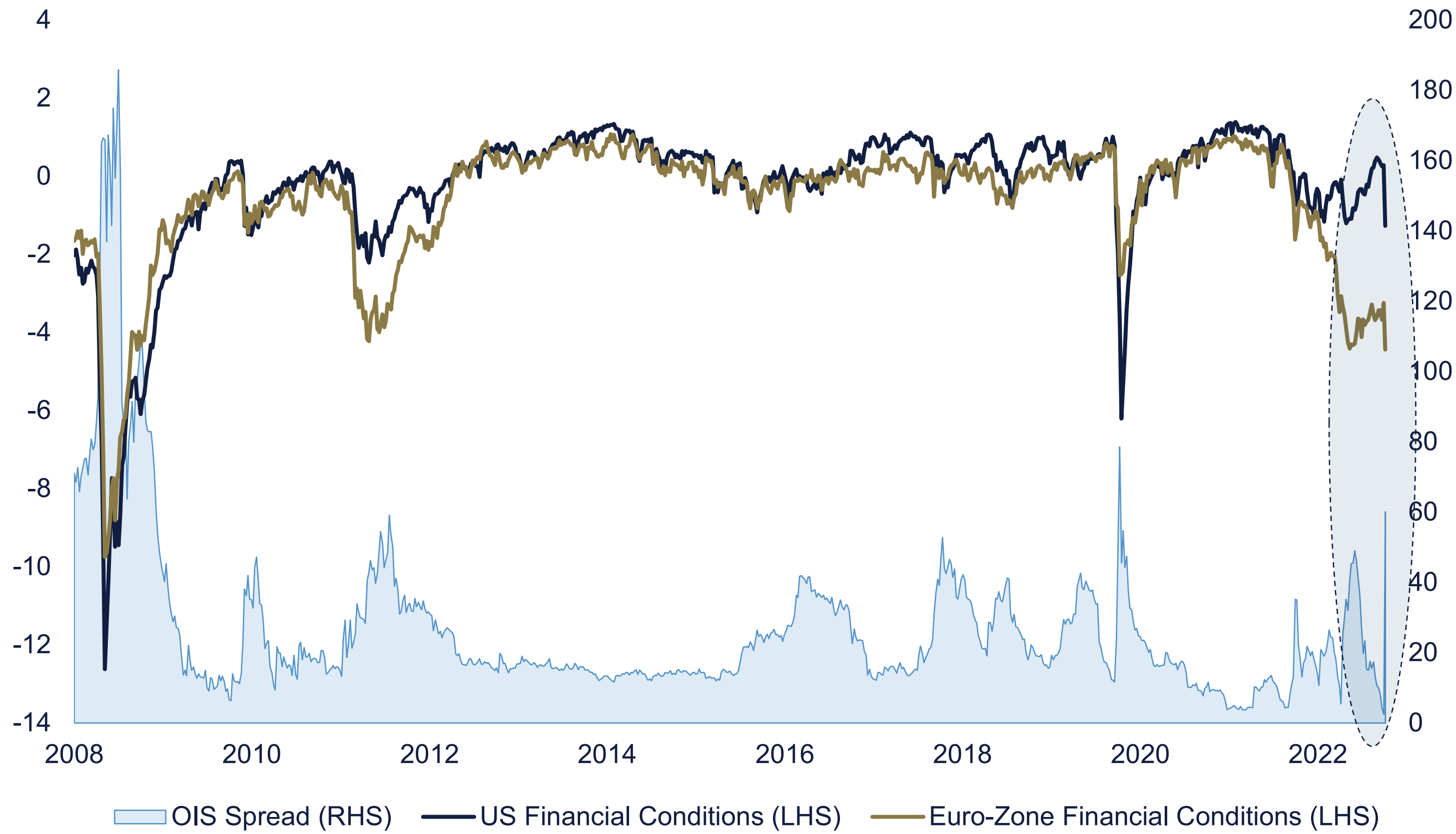
Too much, too fast, from too low



- As a result of the unusual bout of inflation experienced, the **current rate hike cycle is unprecedented in its speed and breadth**. Complicated further because it **started from the lowest possible point**
- In the **previous cycle, the Fed was very careful about raising rates**. It took many years to prepare the market before exiting the zero interest-rate policy, and three more years to rise them just above 2%

Source: Bloomberg

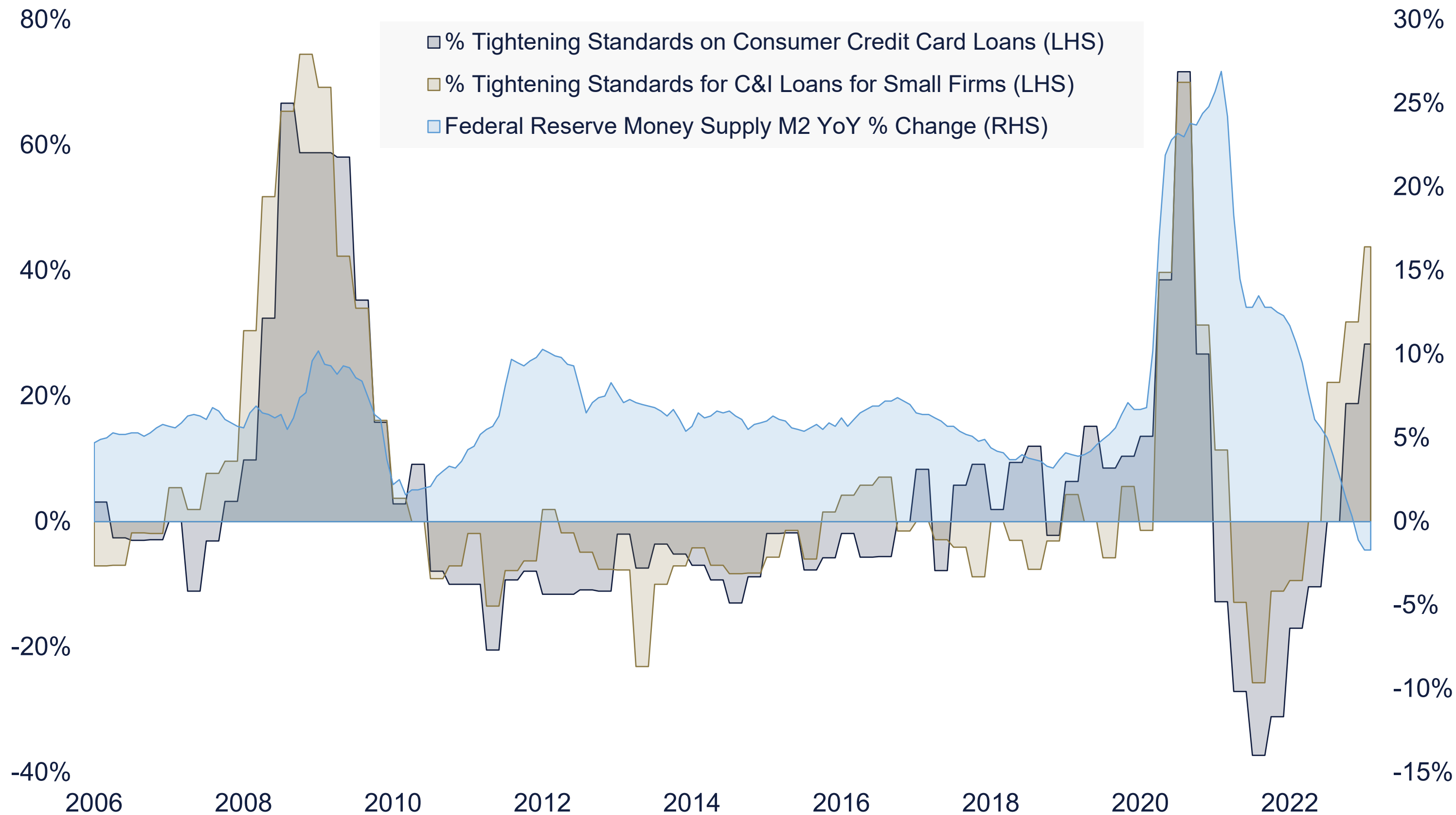
Financial conditions are deteriorating



- Companies are facing **increasing difficulties to access capital markets**. Rising rates and widening credit spreads make it difficult to issue new bonds, while the market for IPOs is completely dry
- The **stress in the interbank market will only contribute to a further tightening** of financial conditions

Source: Bloomberg

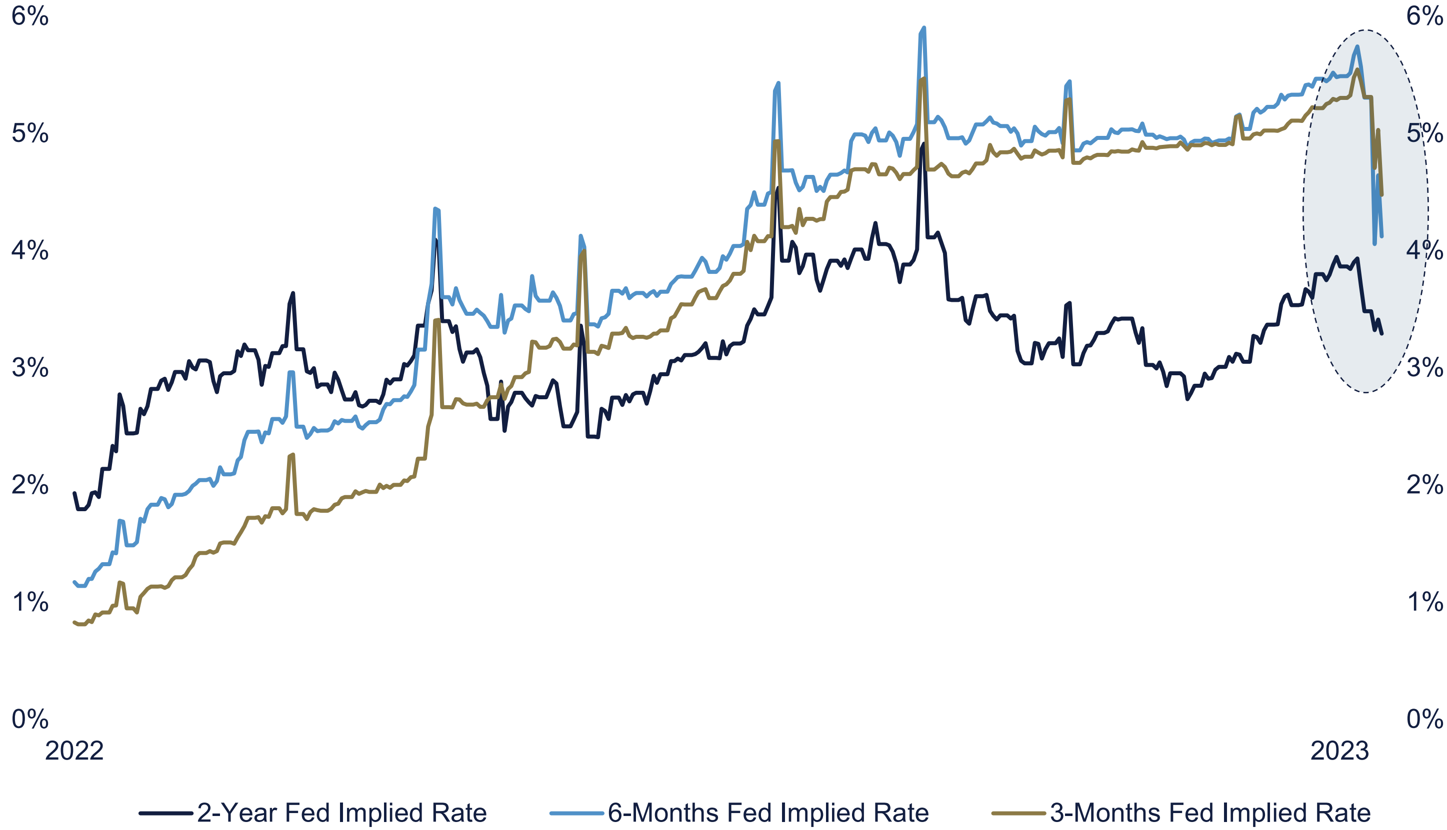
Banks play a transmission role



- A **contraction in credit was already under way,** as the Fed had begun withdrawing the huge amount of liquidity injected after the pandemic
- With **banks now focused on balance sheet repair, and with their profitability eroded** by having to attract depositors by paying higher deposit rates, credit is expected to contract further

Source: Bloomberg

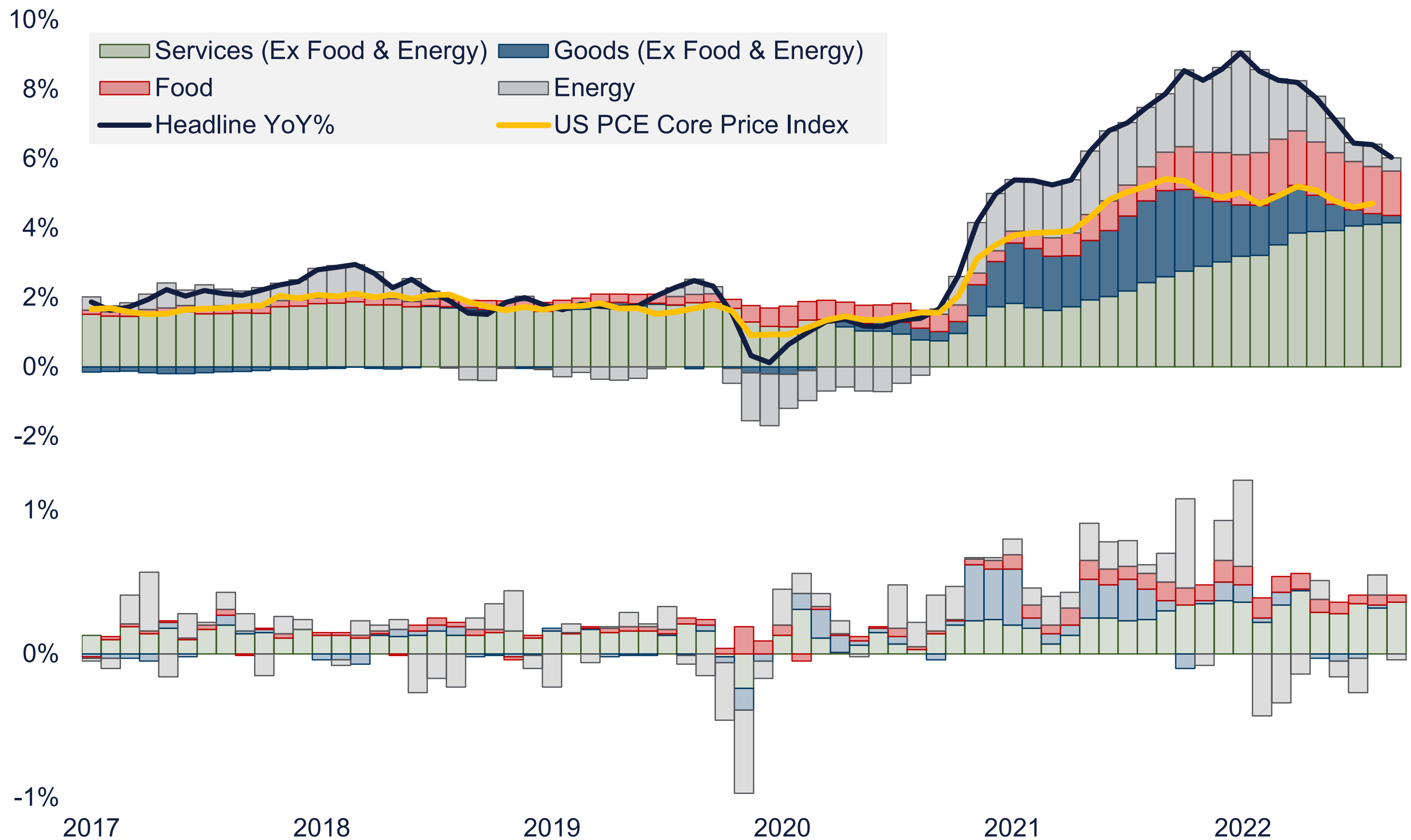
Rates have peaked



- A new battlefront has just opened up for the Fed. Now they not only have **to keep inflation under control but must also ensure financial stability.** Furthermore, the credit crunch will slow growth, further complicating their room for maneuver
- As a result, **it is very likely that we have already hit the ceiling in interest rates**. With the market now expecting a 1% cut by the end of the year

Source: Bloomberg

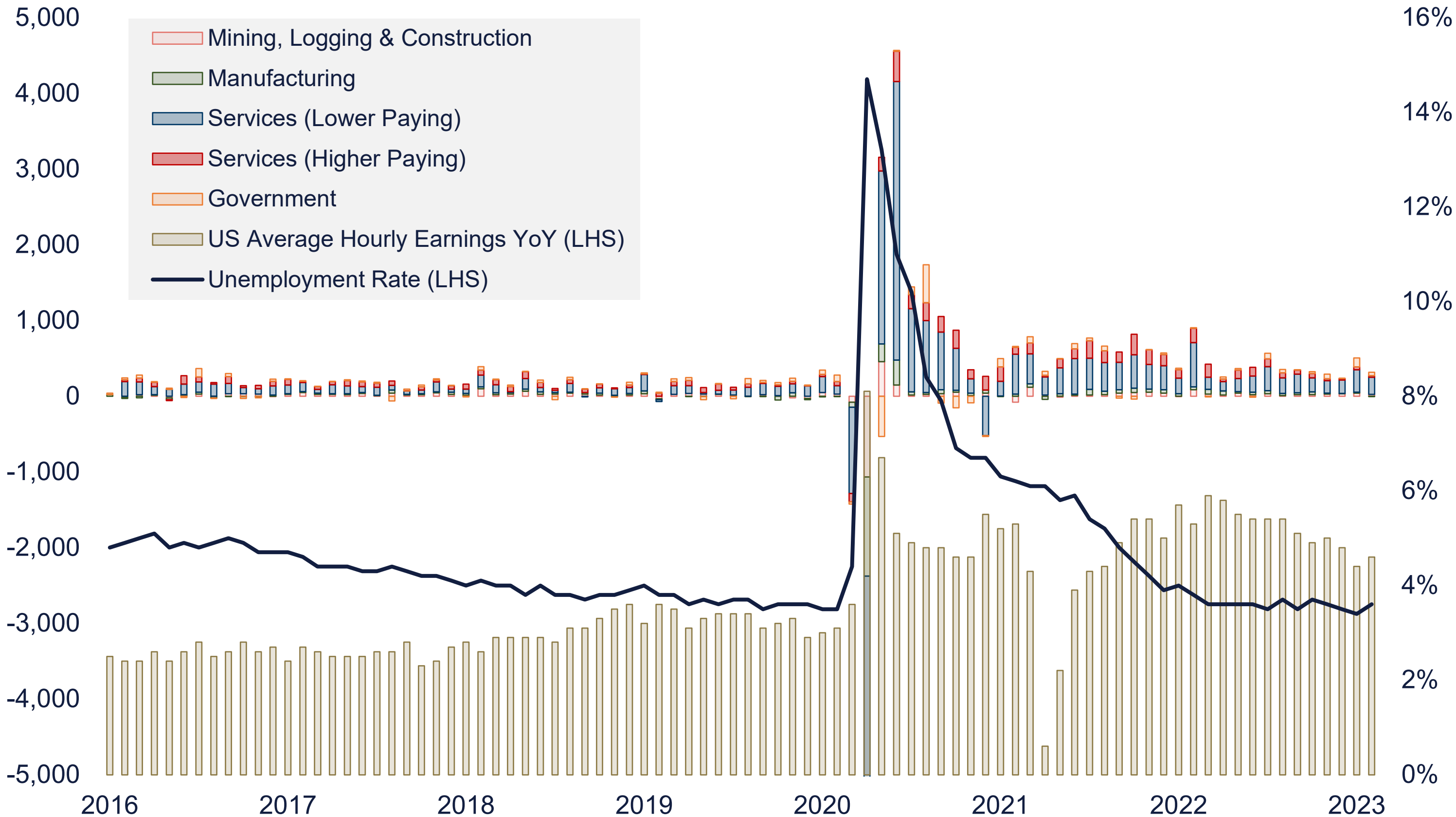
Inflation provides a timely respite



- **Inflation data for the month of February came out in line with expectations**, showing a year-on-year drop of -0.4%. Core inflation (as expected) is proving stickier, but at least it has plateaued
- Breaking down by component, manufacturing prices have slowed down completely, something confirmed by the **latest PPI, which unexpectedly fell to 4.6% from 6%**

Source: Bloomberg

Labor market shows some signs of easing



- **Unemployment picked up** slightly in February and **labor costs continued to moderate**
- However, the labor market is **still far from showing a deterioration that could affect consumption and, ultimately, inflation**

Source: Bloomberg

Bad timing for a banking crisis

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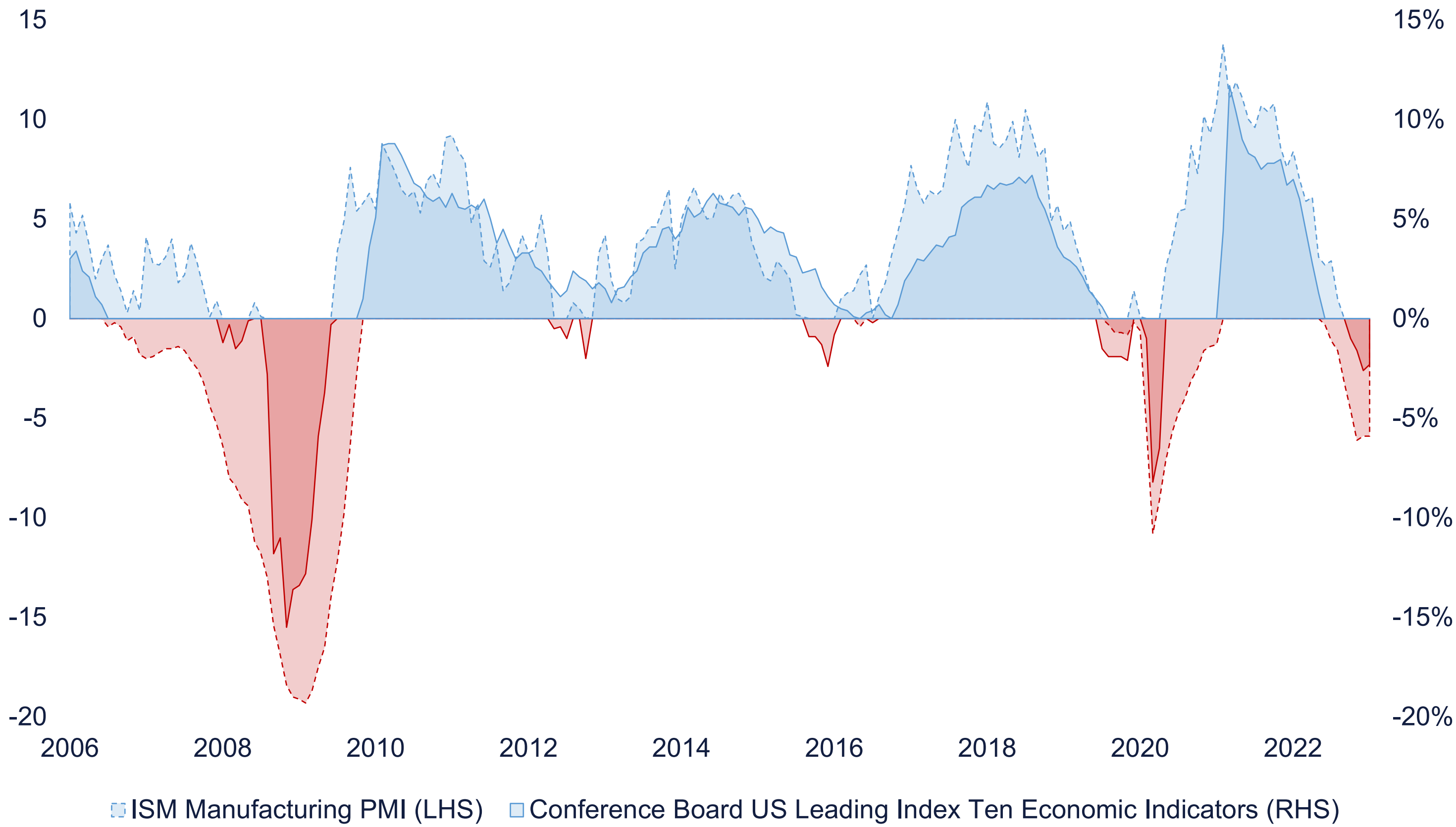


- The economy was going through a **soft patch before the problems in the banking sector** began to manifest themselves
- Leading indicators were already pointing to a clear slowdown, with the economy supported solely by the **resilience of the consumers. It remains to be seen how the latter is affected by the banking crisis**

Source: Bloomberg

Fight to quality

- Although the crisis that has engulfed the banking sector originated in the US, the **flight to quality has strengthened not only safe haven currencies, such as the Swiss franc or the yen, but also the US dollar**
- With the potential interest rates trajectory of the different currency blocks now put into question, **market sentiment will prevail in the short term over fundamentals**

Source: Bloomberg

Investment scenarios

	Scenario 1 Stagflation	Scenario 2 “Hard landing”	Scenario 3 “Soft landing”
Drivers	• Inflation remains sticky as labor shortages do not improve, and commodity prices remain elevated due to the war in Ukraine • The Fed needs to tighten further and, worse, keep interest rates elevated for longer • As a result, long-term inflation expectations remain elevated, 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 somewhat 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	20%	50% (+5%)	30% (-5%)

Short-term catalyzers

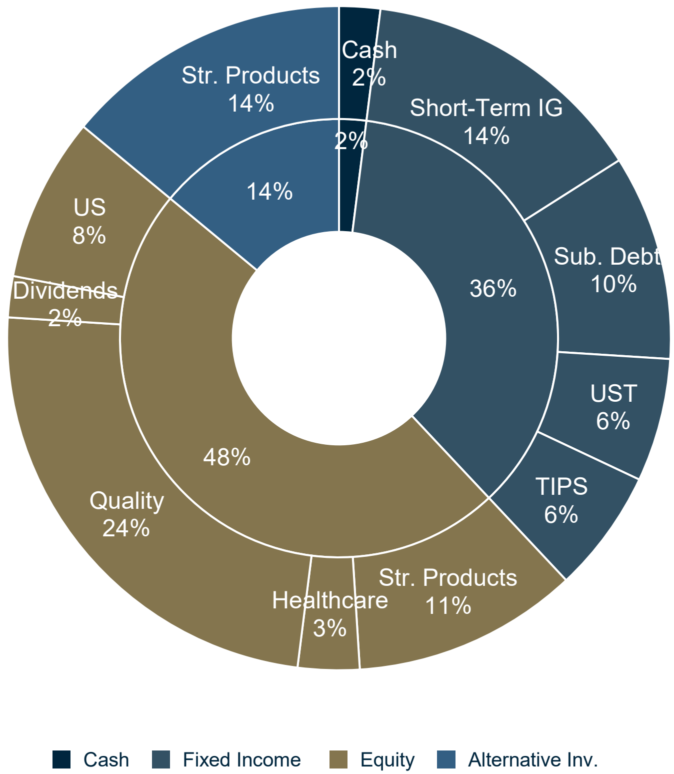
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

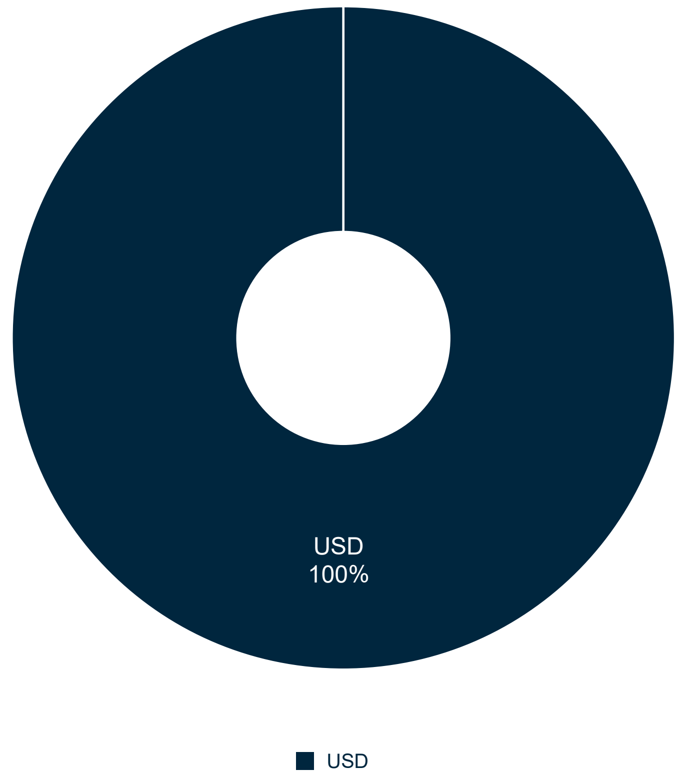
Escalation of the war in Ukraine, China slowdown, Housing market correction, Crypto bubble crash

Boreal Balanced Portfolio USD

Asset Allocation



Currency Allocation



Boreal Investment Profiles

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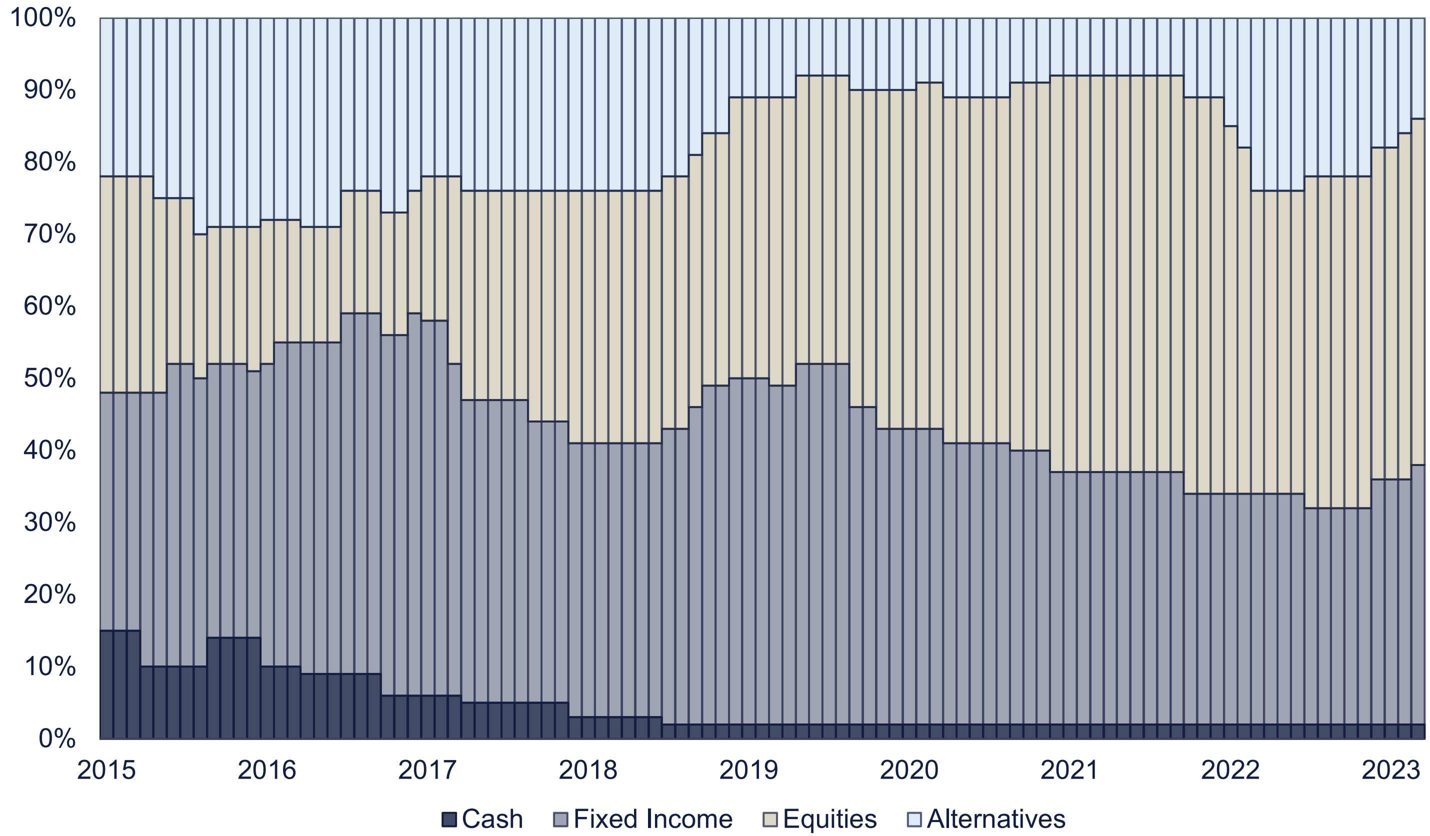
	Conservative	Balanced	Growth
Cash & Fixed Income	62% (▼ 66%)	38% (▼ 44%)	18% (▼ 22%)
Equities	29% (▼ 30%)	48% (▼ 50%)	64% (▼ 70%)
Alternative Investments	9% (▼ 4%)	14% (▼ 6%)	18% (▼ 8%)

▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution



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