Investment Policy

April 2023

BOREAL
CAPITAL MANAGEMENT

Our market view in a nutshell – April 2023

- The **banking crisis has subsided significantly** after the decisive intervention of monetary authorities. For now, the contagion effect has been prevented, but the **consequences for the real economy are just beginning to be seen**. Bank profitability will suffer due to higher funding costs (since Credit Suisse convertible bonds were wiped out), and a foreseeable new round of regulations to improve liquidity controls

- The sector will remain **exposed to headline risk for a long time**. This crisis has shown that, despite the time that has elapsed since the financial crisis, both **investors and customers remain highly sensitive to the slightest sign of trouble** at a financial institution. What happened with SVB has also exposed that with the advent of digital banking bank runs can now occur in a matter of days, instead of weeks. Therefore, **banks will become more cautious about extending credit**, further slowing down growth. The biggest risk is that a recession causes bank losses and creates a vicious cycle that leads to a full-blown credit crunch

- **Macro data continues to provide a blurry picture** of the current state of the economy. On the one hand, a slowdown in activity is already visible, especially in the manufacturing sector. On the other hand, **consumption remains stable**, and **unemployment close to a multi-decade low**. There are also some **early signs of loosening in the labor market**, with a moderation in the rate of increase in wages and a reduction in job openings

- **Inflation continues its downward trend** driven by lower energy and consumer goods prices, but **core inflation remains elevated** (higher now than headline inflation). Knowing that there are diffusion effects and that the contraction in credit is moving the economy closer to recession, **the Fed's rational decision would be to pause**. However, beyond their stated mandate of maximum employment and price stability, they are also now trying to restore their credibility

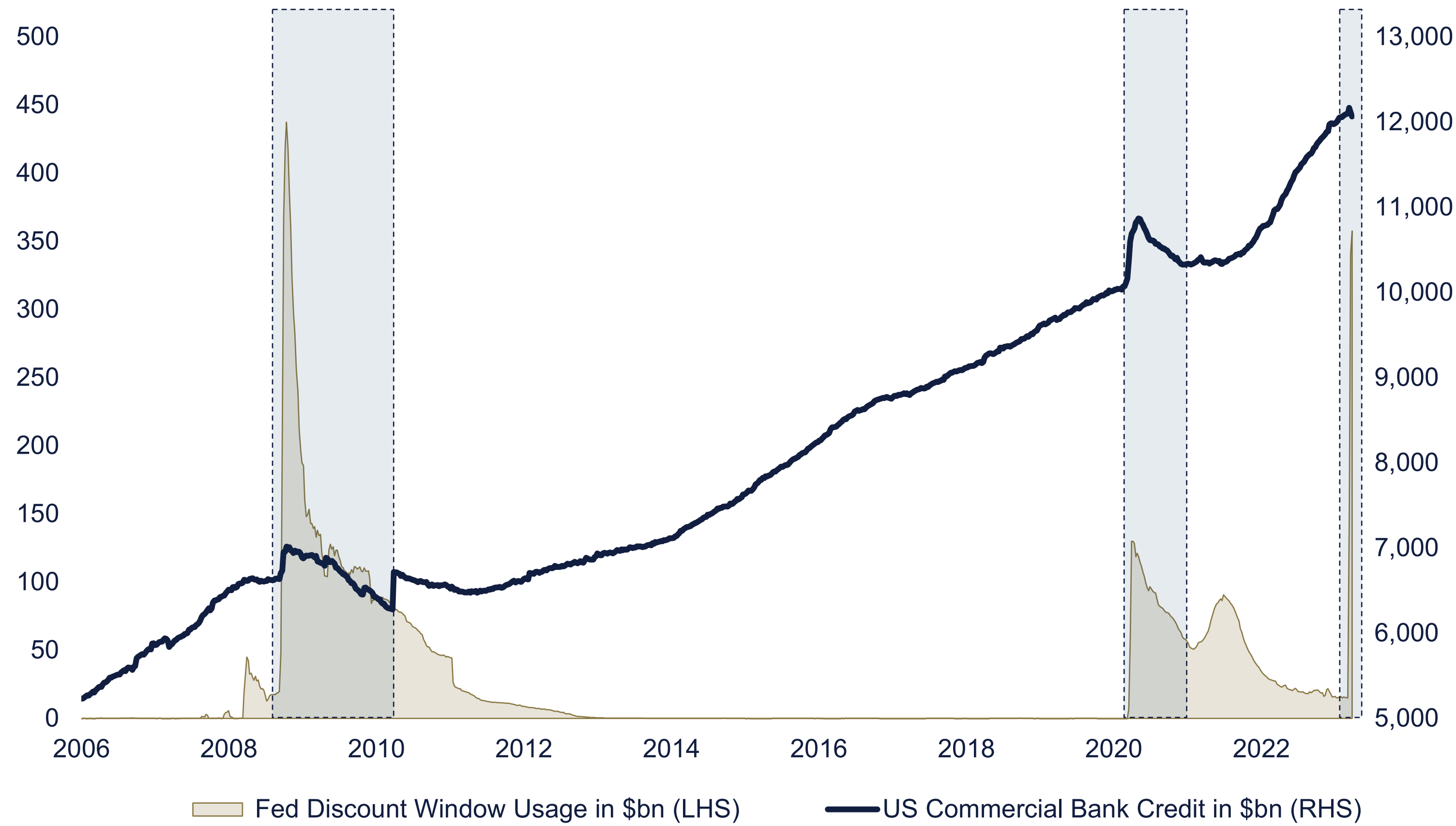
- **Increased uncertainty warrants a more defensive positioning** in portfolios as investors must now assess a broader range of potential outcomes. Interest rates may fall more than initially discounted by the market; but the same can happen with corporate profits. This leads us to **underweight risk assets and continue to favor companies that enjoy secular growth** and are therefore less exposed to the economic cycle. In addition, the latter can benefit more from a further drop in interest rates

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	=	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

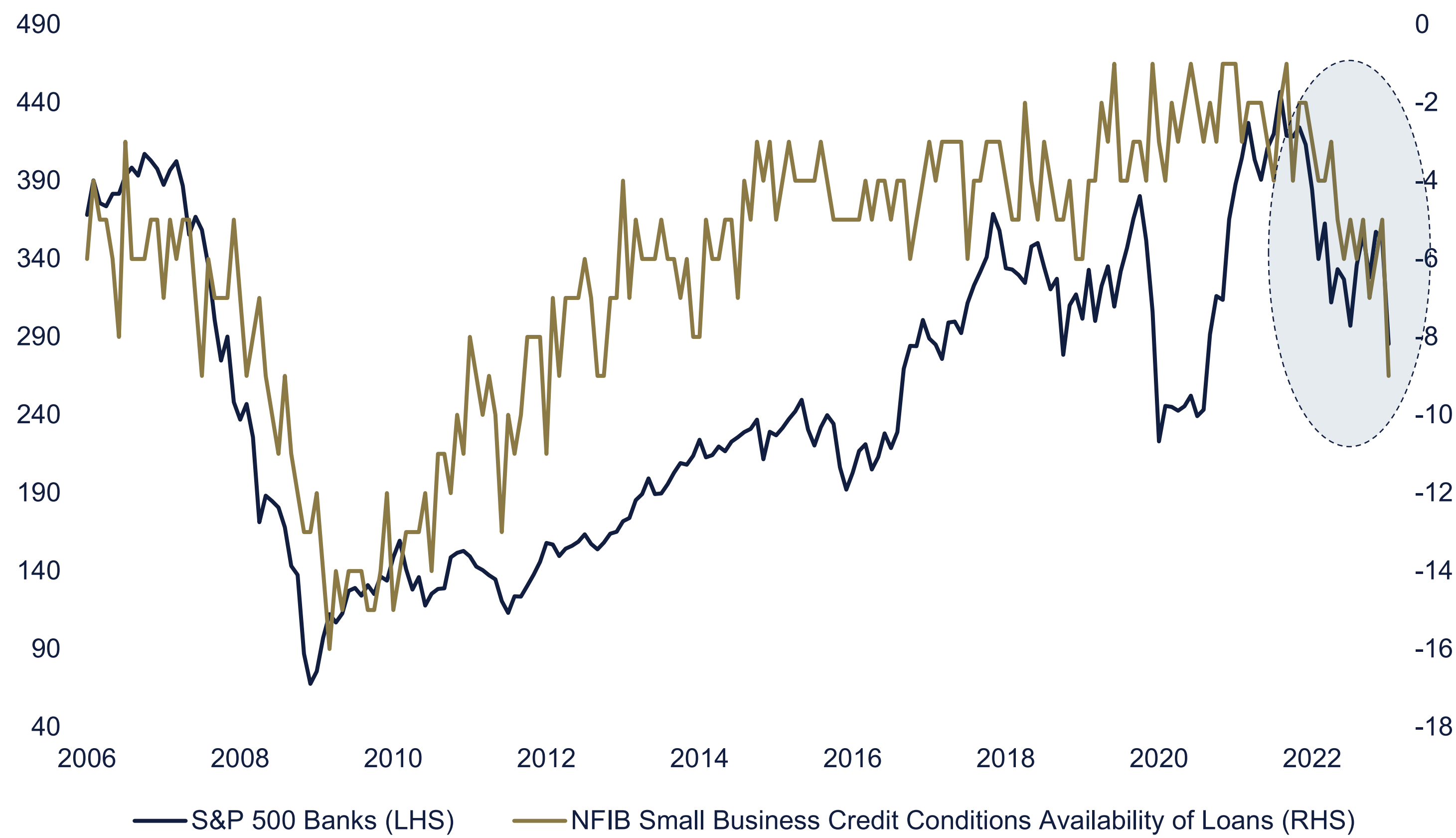
Contagion prevented, but consequences are yet to come



- The **crisis in the banking sector has been contained**, but what has happened in recent weeks will not be without consequences
- The **contraction in credit has already started**, but it is still too early to tell how deep and prolonged the latter will be

Source: Bloomberg

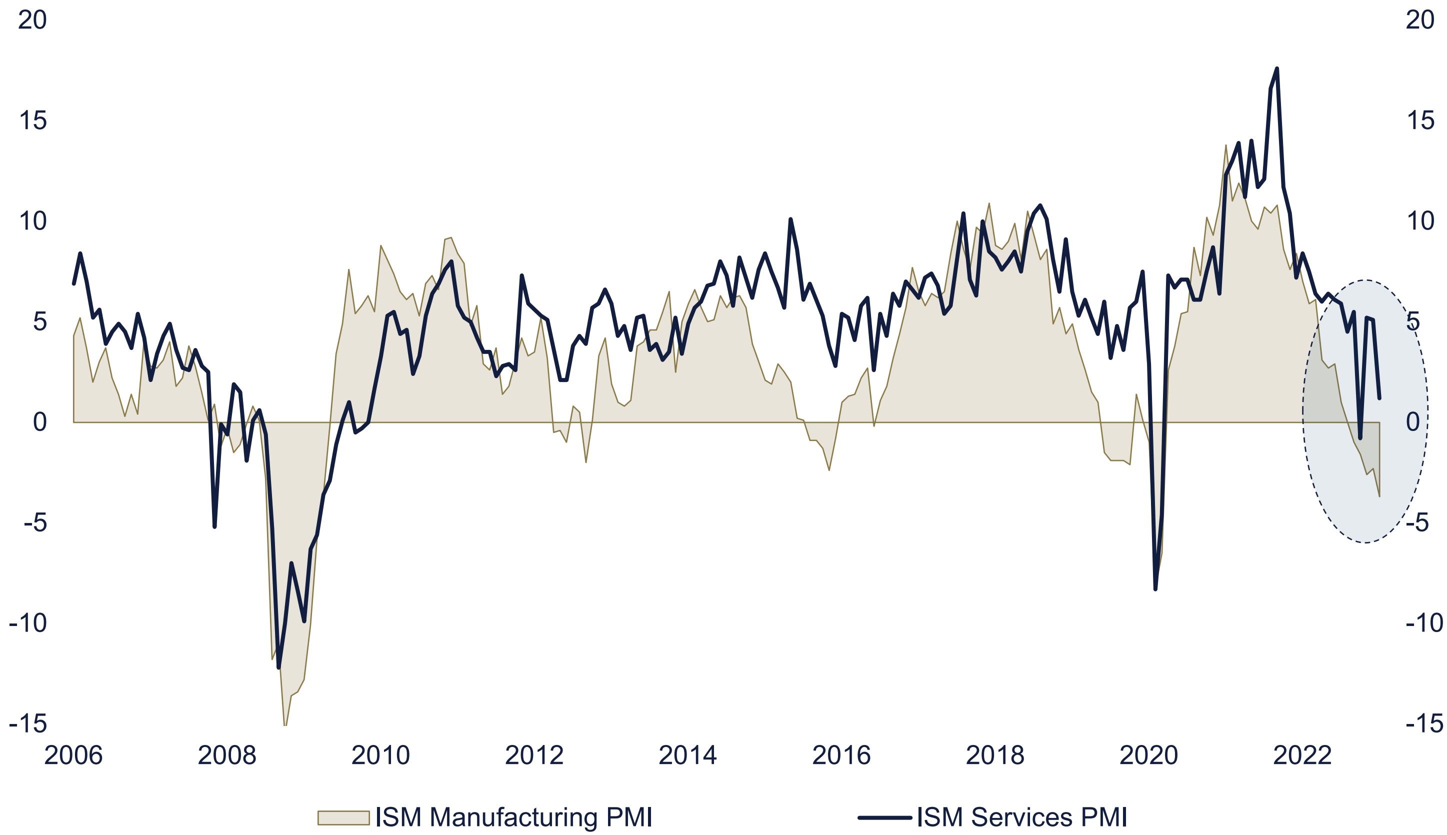
Risk of a negative feedback loop



- Recent **bank runs have shown how sensitive investors and depositors can become** to bad news
- With the economy already slowing down, a contraction in credit can further shrink banking profits, with the **risk of entering a negative feedback loop**

Source: Bloomberg

Drifting closer toward a recession



- Leading indicators of the **manufacturing side** of the economy have **contracted in March for the fifth consecutive month**
- The **services sector**, after a brief recovery, has **reconfirmed its downward trend**

Source: Bloomberg

Labor market begins to loosen

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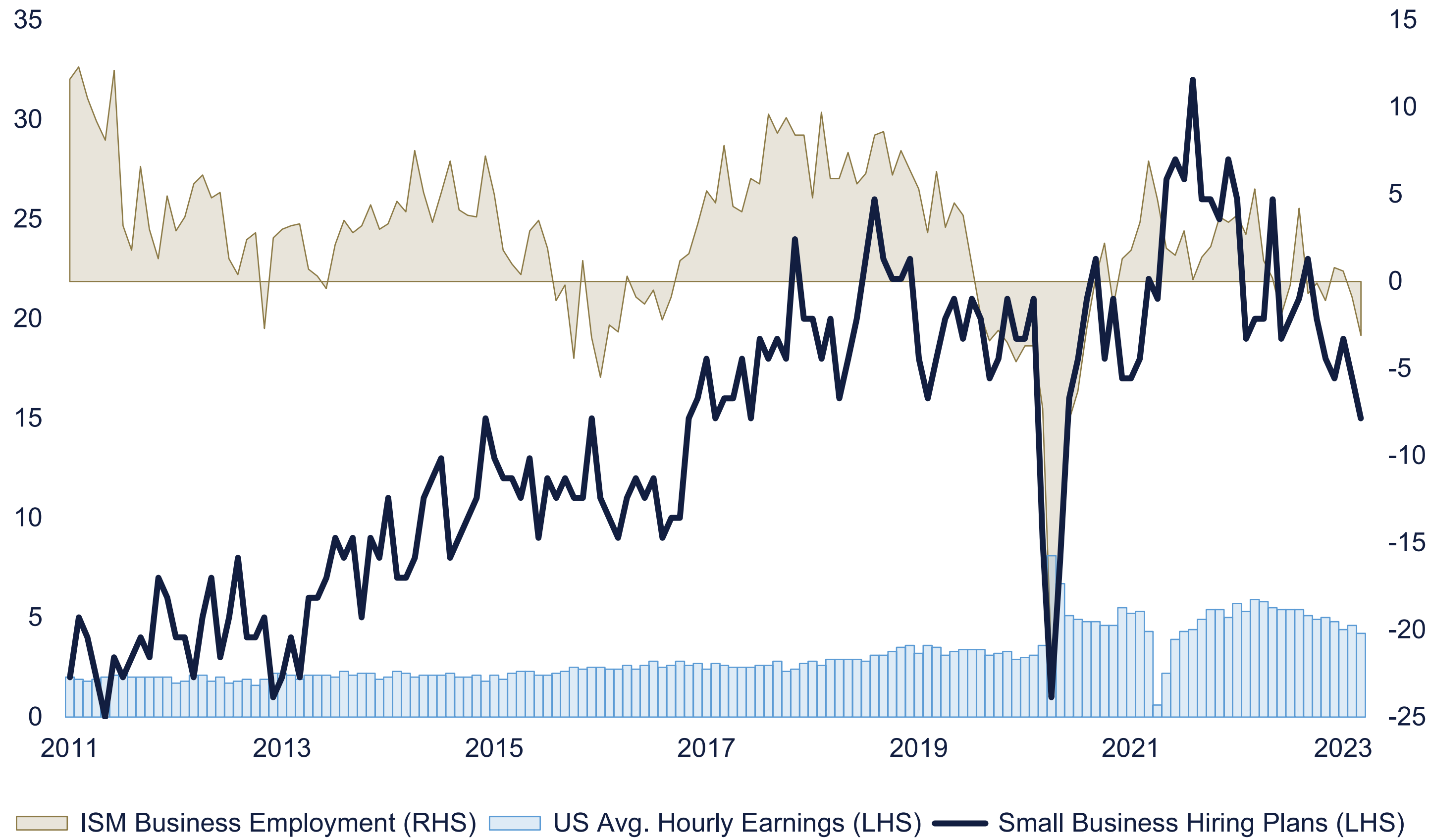
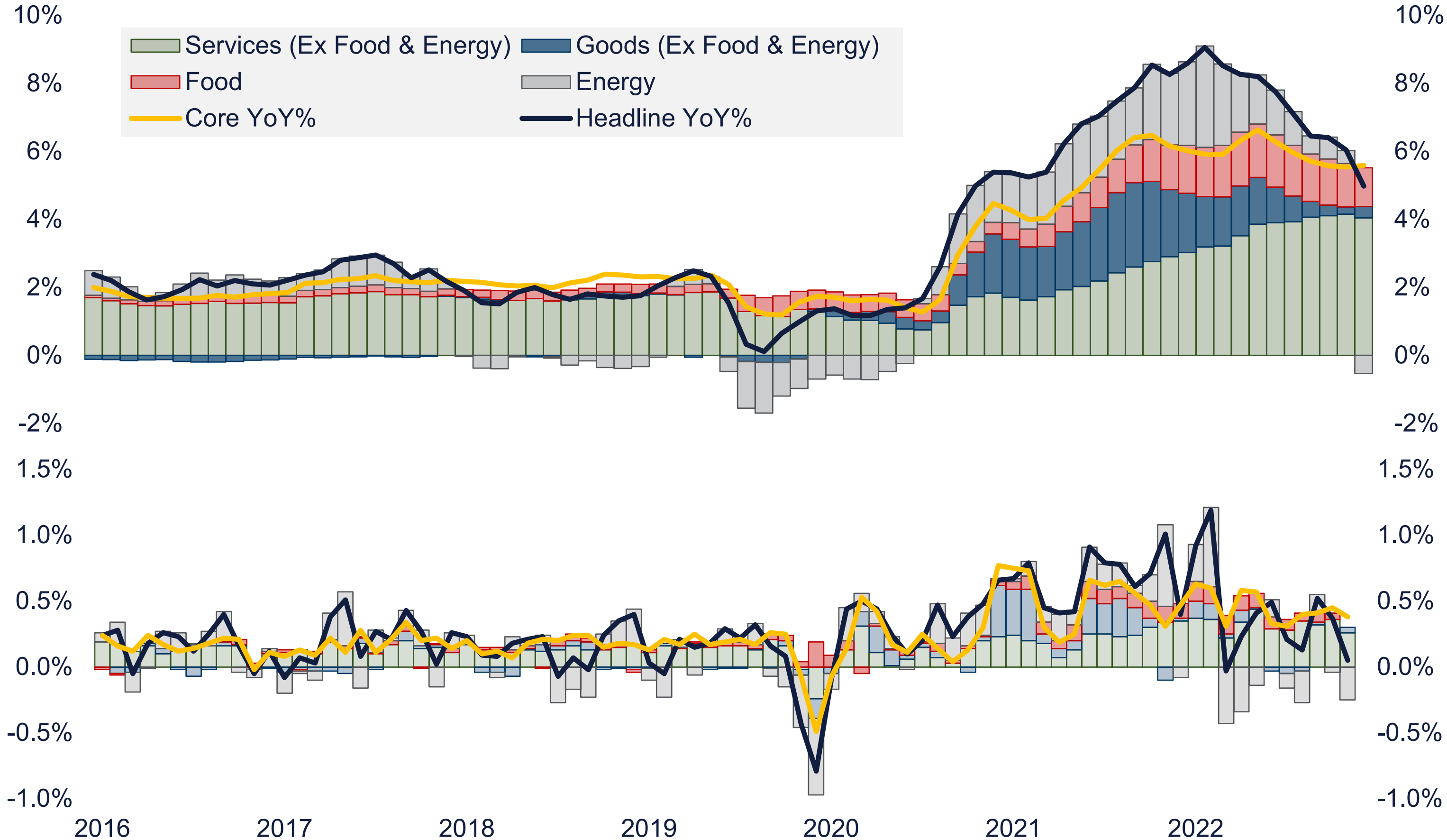


- A **strong labor market** remains the main **pillar that sustains consumption, and hence the whole economy**
- **Labor data for the month of March was mixed**. Unemployment decreased slightly, but so did job openings and the rate of increase in wages

Source: Bloomberg

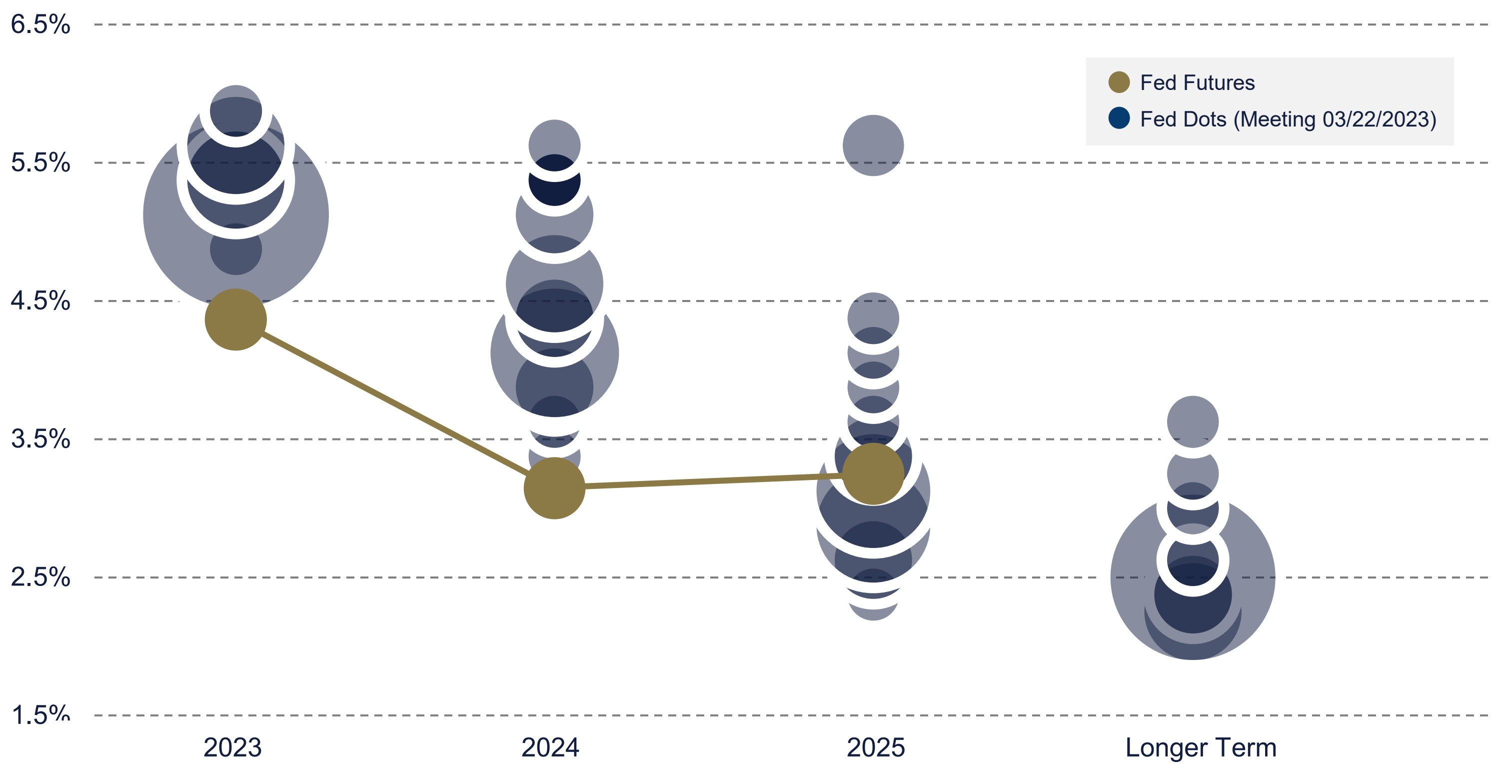
Down to the core



- **Inflation continues to moderate**, driven mainly by the slowdown in the prices of consumer goods and energy
- However, **core inflation remains high**, already exceeding headline inflation. It is essential that the former also decrease so that we can declare victory over inflation

Source: Bloomberg

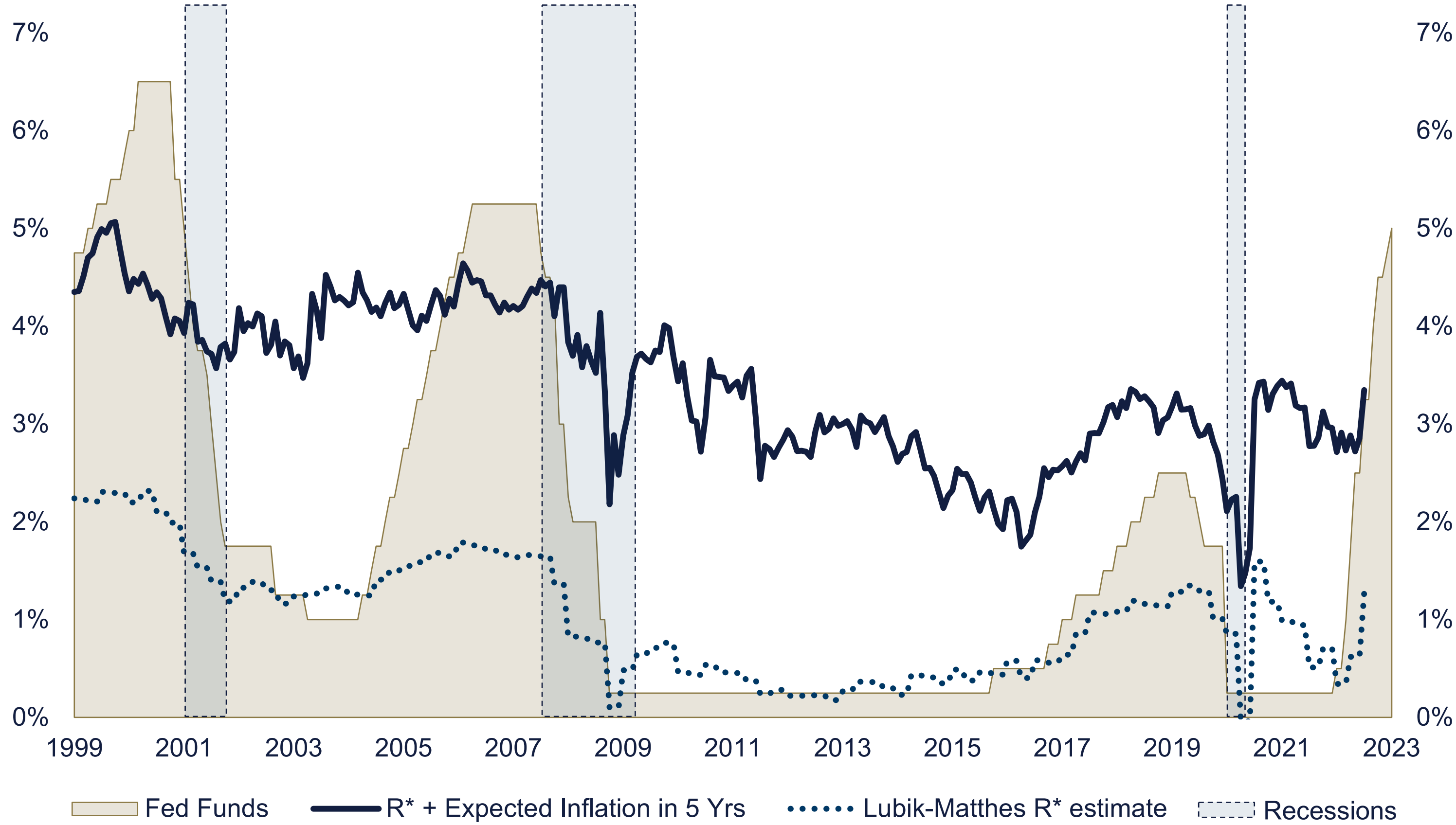
A credibility problem



- Unfortunately, the **Fed lost credibility** by being too patient at the start of the inflation spike, and now they **want to regain it by not easing too soon**
- The risk is that they will now persist in keeping interest rates high for too long, **ignoring the impact on growth**

Source: Bloomberg

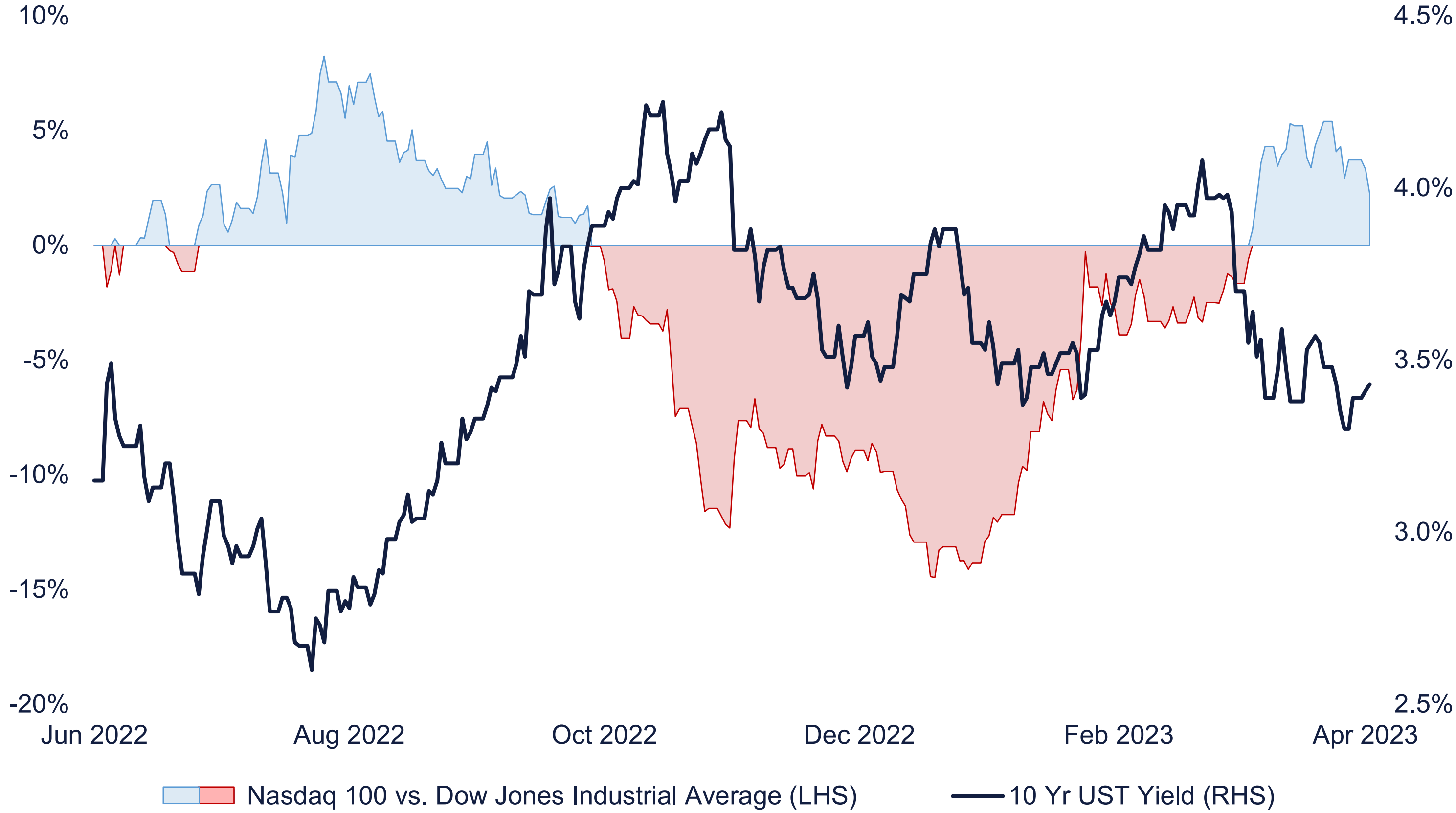
We are already in highly restrictive territory



- Considering where the natural interest rate is assumed to be, the **current level of Fed Funds is highly restrictive** for economic activity
- **Similar overshoots in the past have always ended in a recession**. A risk compounded this time by the steepness of the current tightening cycle

Source: Bloomberg

Position portfolios for low rates and lower growth



- **Movements in interest rates have dictated movements in financial markets** over the past year, but corporate profits are likely to be a more important factor going forward
- Rates may continue to fall, but **earnings may fall more than expected if we head into a deep recession**. This increased uncertainty speaks in favor of **underweighting stocks**, favoring companies enjoying secular growth

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%	55% (+5%)	25% (-5%)

Short-term catalyzers

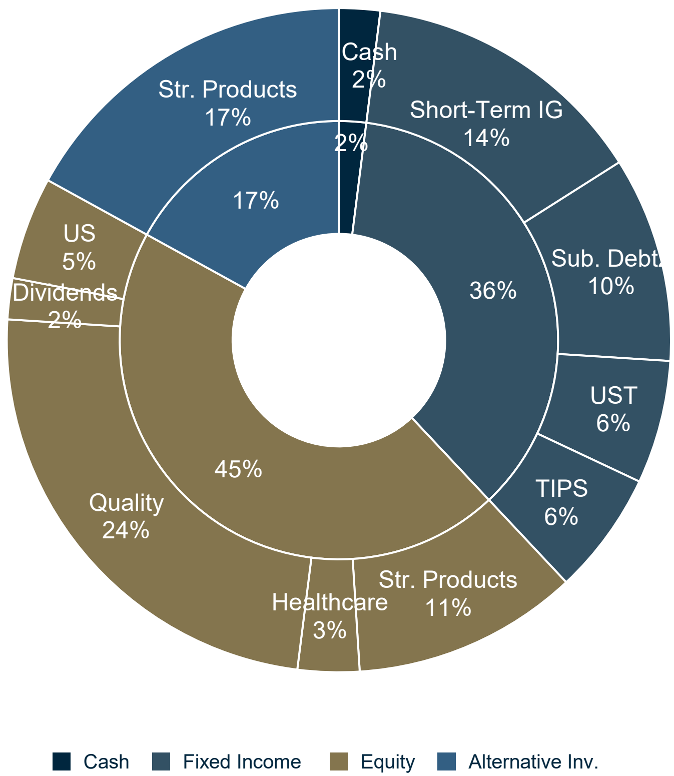
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

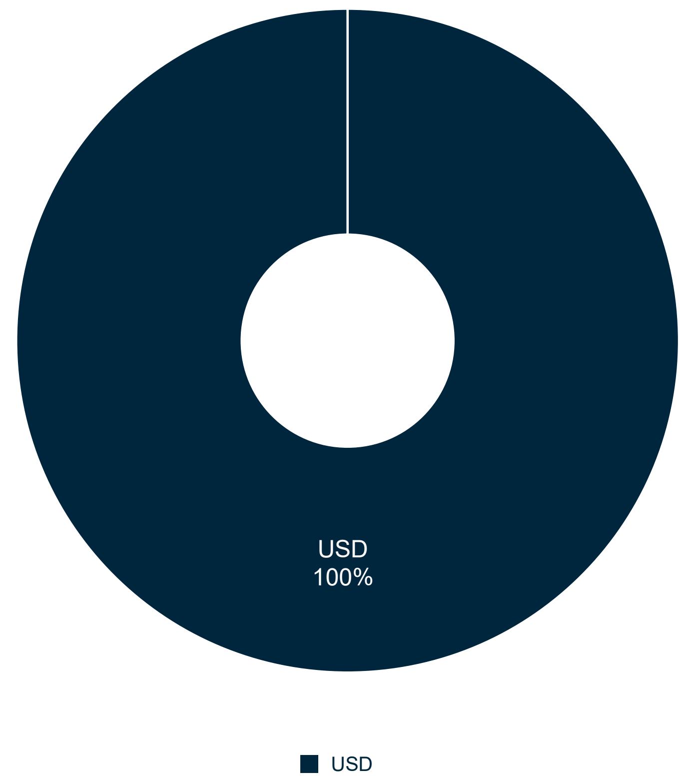
Banking crisis, Escalation of the war in Ukraine, China slowdown, Housing market correction, Crypto bubble crash

Boreal Balanced Portfolio USD

Asset Allocation



Currency Allocation

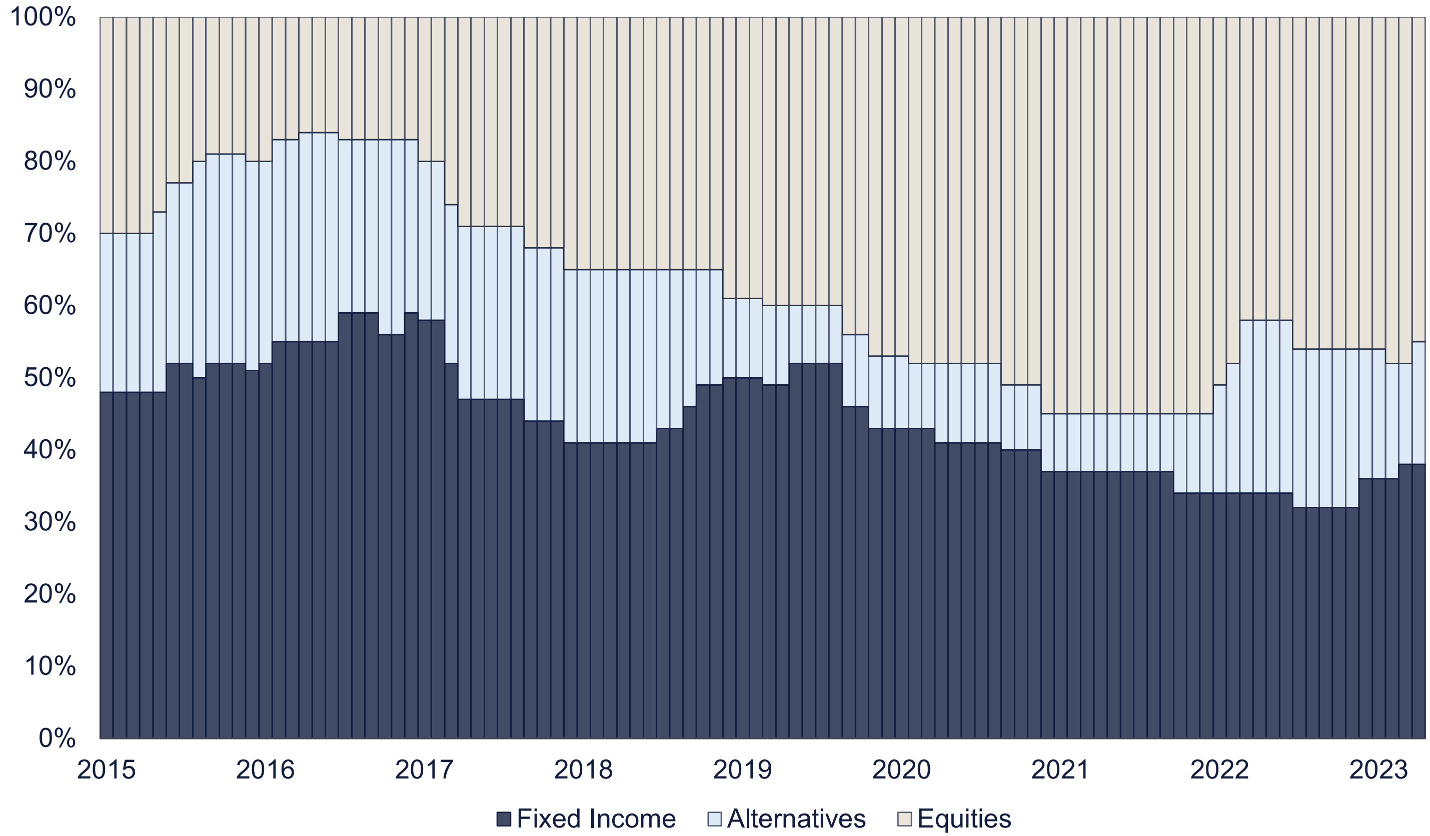


Boreal Investment Profiles

	Conservative	Balanced	Growth
Cash & Fixed Income	▼ 66% 62%	▼ 44% 38%	▼ 22% 18%
Equities	▼ 30% 27%	▼ 50% 45%	▼ 70% 59%
Alternative Investments	▼ 4% 11%	▼ 6% 17%	▼ 8% 23%

▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution



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