Investment Policy

May 2023

BOREAL
CAPITAL MANAGEMENT

Our market view in a nutshell – May 2023

- We are experiencing a sort of **truce between financial markets and a hard-to-read macroeconomic reality**. Contrary to the "Goldilocks" period, **stability this time necessarily must be short-lived**, since the main economic variables are excessively unbalanced. **Monetary policy continues to do its job**, which basically consists of slowing down the economy to curb inflation; now with the **banking sector serving as an accelerator of the process**

- The **crisis in the US regional banking sector continues to claim new victims**. Large banks seem to have managed to remain isolated, and even to be benefiting from the problems of their smaller rivals. But inevitably the entire sector will turn its attention to balance sheet repair, if only preventively. As a result, **credit will contract and become more expensive**

- **Under normal circumstances, the Fed would have cut interest rates in order to prop up financial stability** (and indirectly economic growth). But having initially reacted too late to the surge in inflation, **they now do not want to risk a possible flare-up**. This explains why the Fed hiked interest rates twice, despite the fact that a few days before each meeting, a new bank had to be bailed out. Markets, however, discount that **the Fed will be forced to lower interest rates three times before the end of the year** to shore up the economy

- Fortunately, **inflation continues to cool down along with wages**. Most of the categories that caused the spike in prices after the reopening continue to gradually normalize. But inflation has spread to all components of the economy, and service inflation usually takes longer to come down. It is **very difficult to predict how inflation will behave in the face of an economic slowdown**, and how deep and long-lasting the latter will be. Therefore, the three main scenarios we consider (**soft landing, hard landing** and **stagflation**) remain unaltered

- The same uncertainty that blurs the macroeconomic outlook also affects the valuations of stocks and bonds. Therefore, we **remain underweight in risk assets**. The **equity risk premium is currently below the safety zone** (north of 2%). In addition, the latter is extremely dependent on the future trajectory of both interest rates and corporate profits. As for credit, although the total level of carry is attractive, corporate **spreads seem relatively tight for the implied risk of default in the event of a recession**

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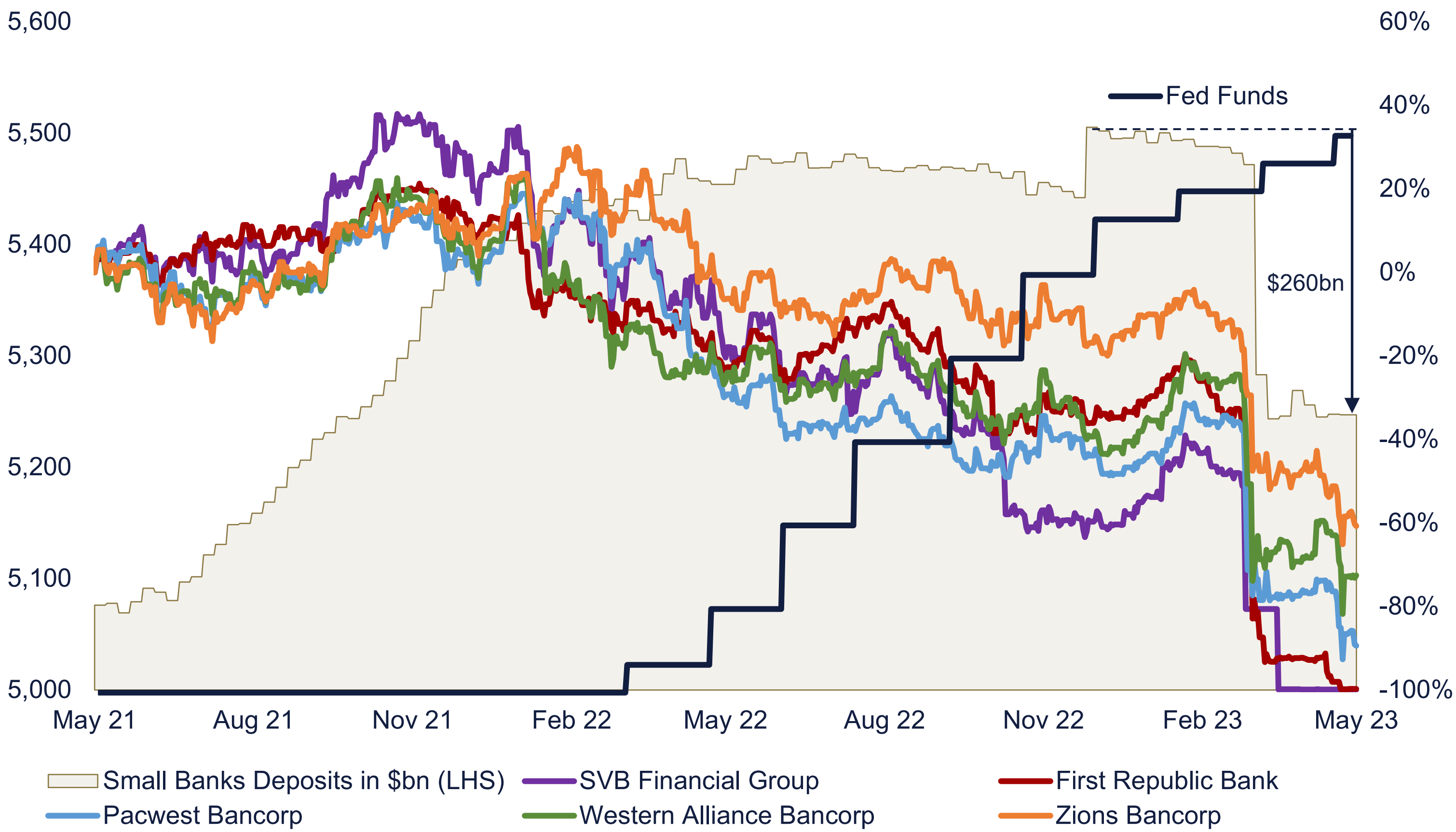
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	=	Higher probability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

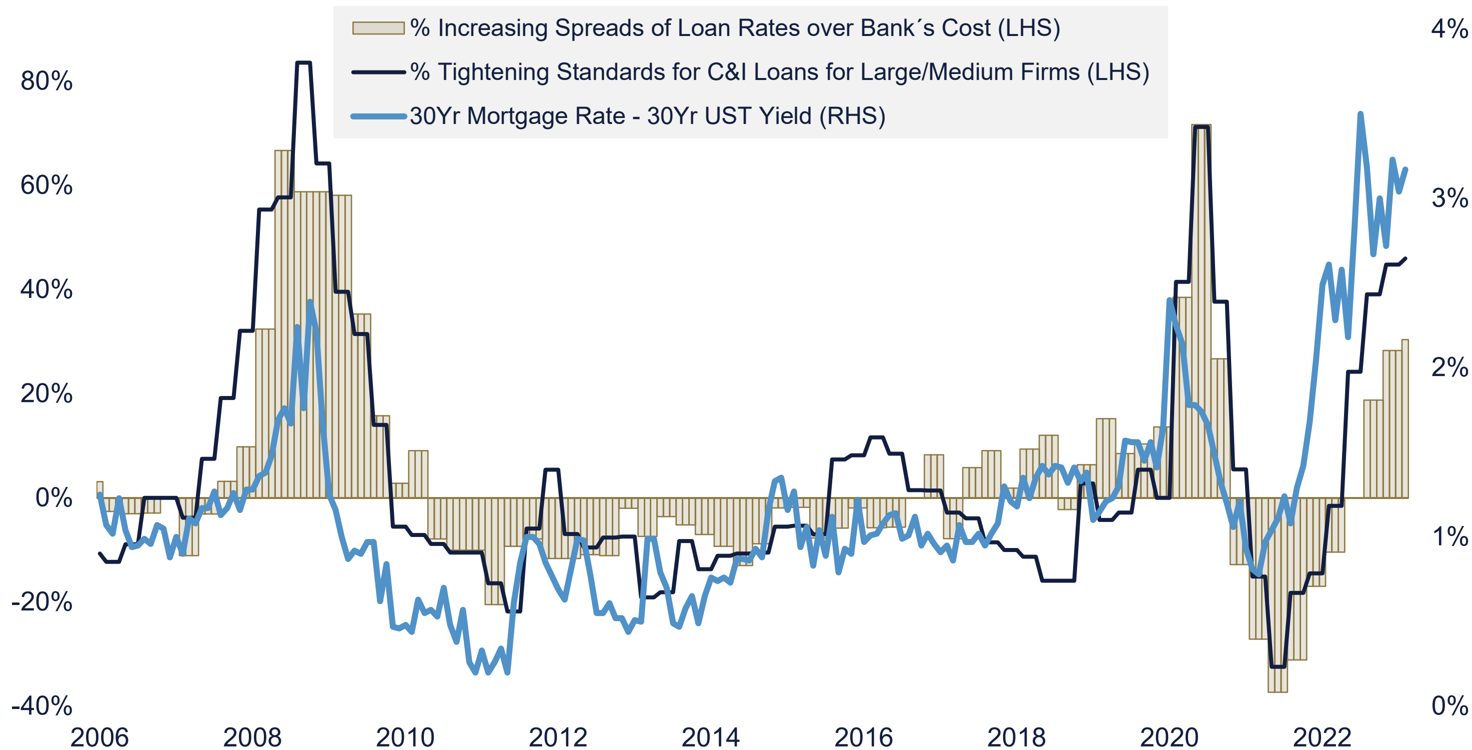
The banking crisis is not over



- US **regional banks appear to be falling like dominoes**. Last month, First Republic Bank was finally seized by the authorities. The side effects of these bankruptcies have been limited (since depositors have been bailed in) but **the crisis of confidence seems to have no end**
- The **Fed has remained seemingly unmoved, raising interest rates despite the sector's woes**. Quite a statement about his resolve to fight inflation

Source: Bloomberg

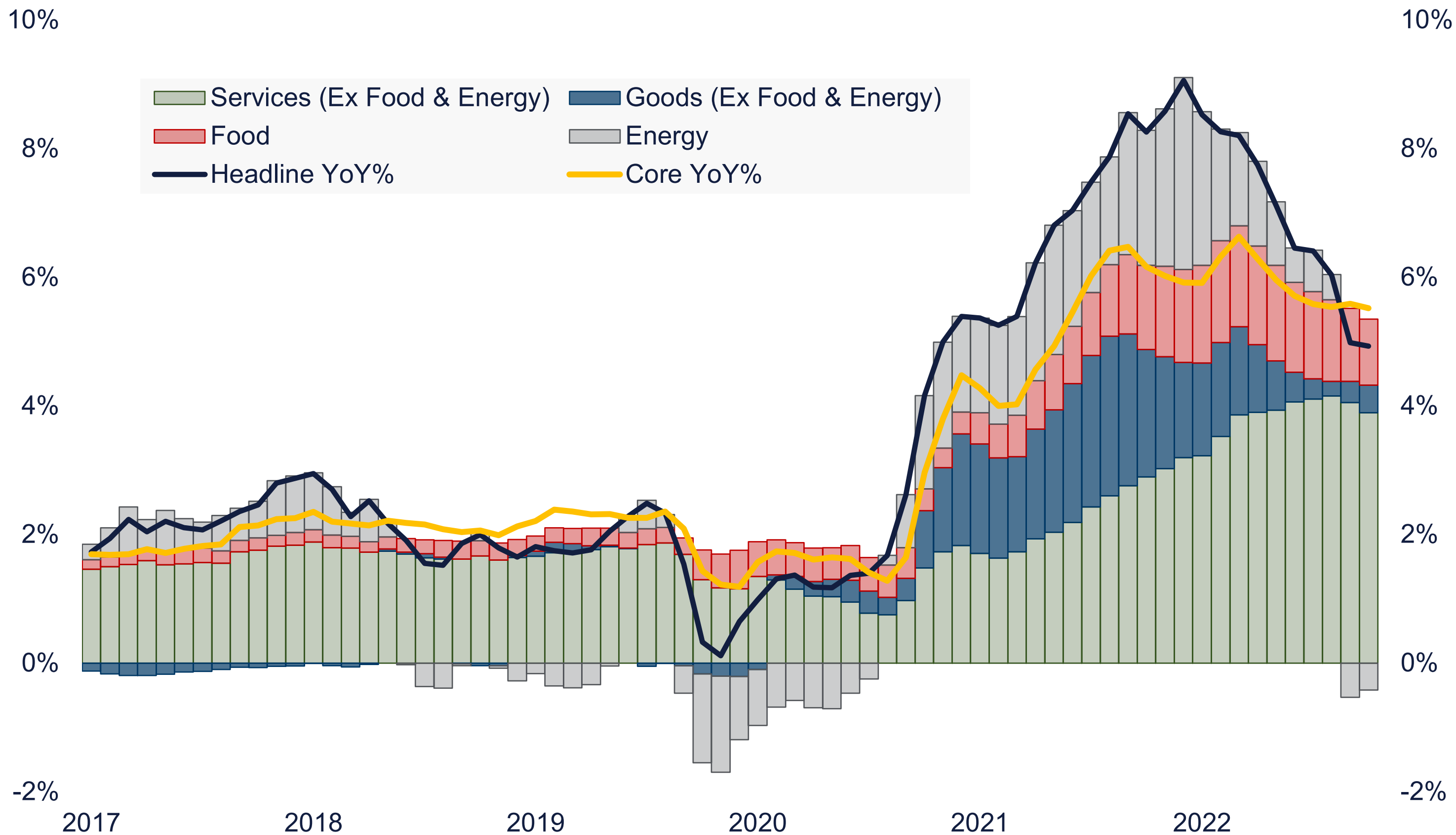
Less credit and more expensive



- Before the crisis broke out, the banking sector was already tightening credit standards and making credit more expensive. This acts as a **second round of monetary policy tightening, magnifying the impact of interest rate hikes by the Fed**

Source: Bloomberg

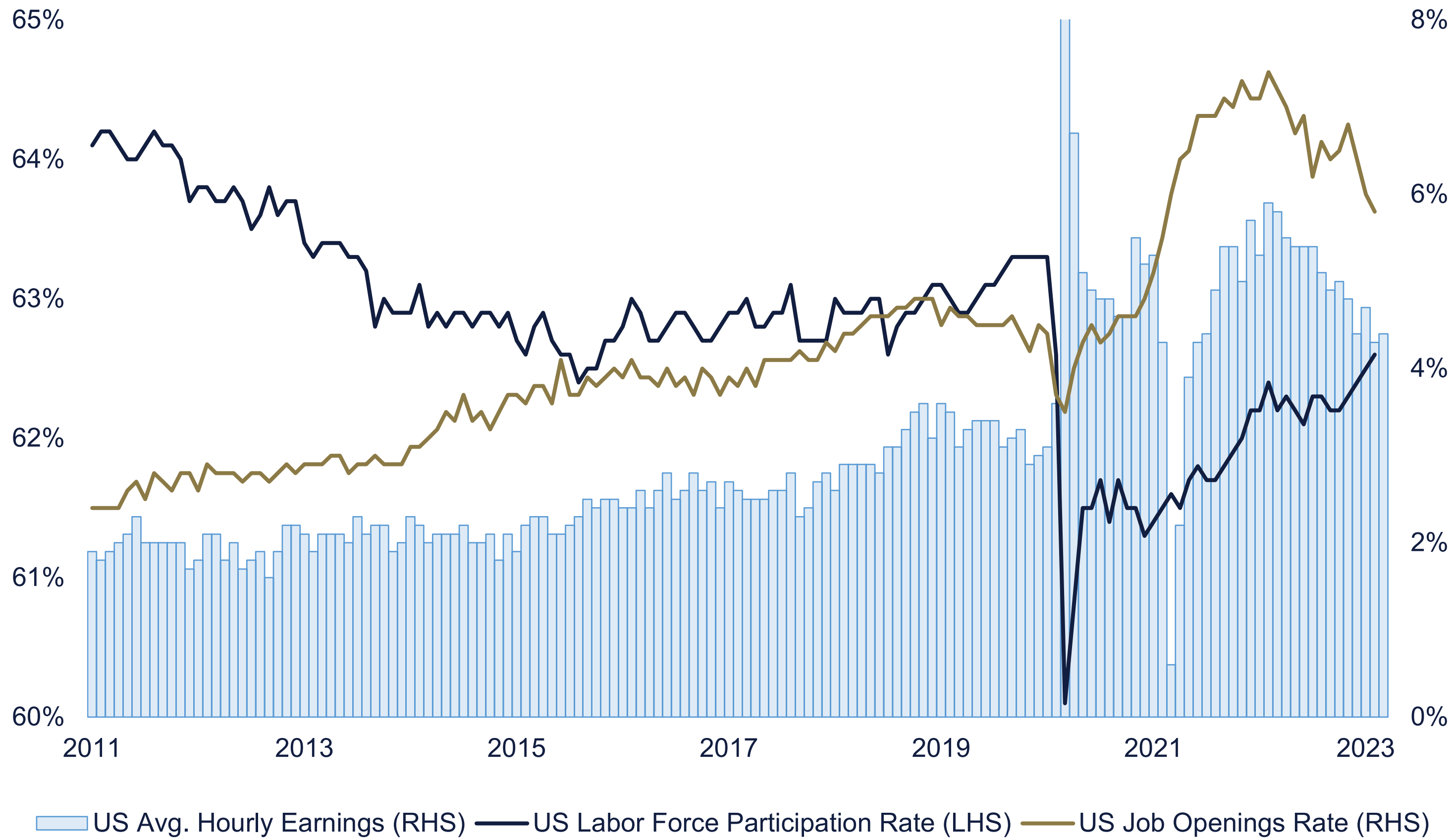
Inflation continues to surprise positively



- During the month of April, **inflation continued to moderate**. In particular, inflation in services seems to have finally peaked and is beginning to decline
- Other inflation indicators such as **producer prices or the PCE deflator point in the same direction**

Source: Bloomberg

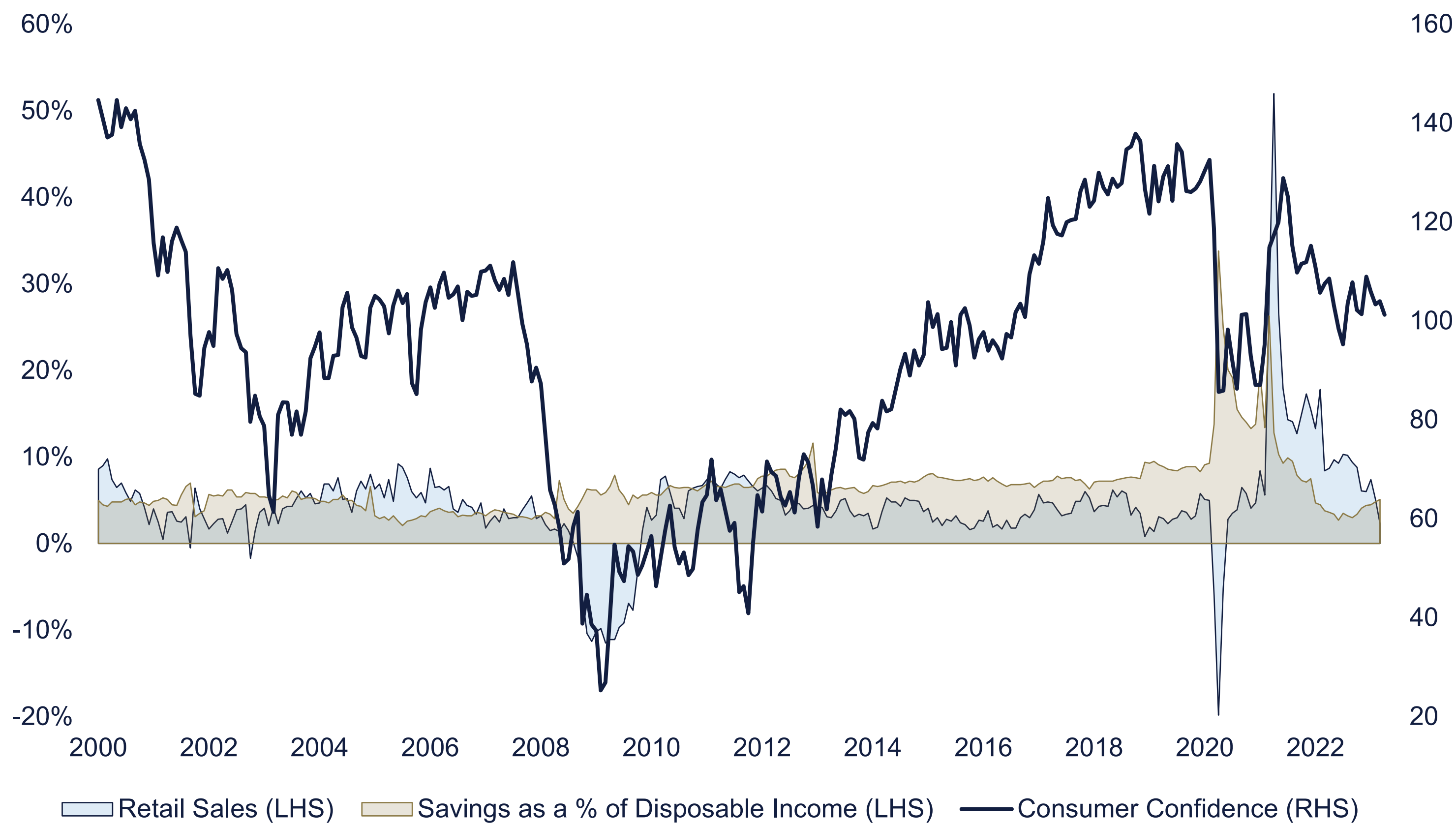
Labor market cooling without job losses



- The **positive evolution of the labor market leaves the door open to a soft landing for the economy**
- Wage growth is moderating, job vacancies are declining, and the participation rate is increasing. All this while job growth remains robust, and the unemployment rate is at a multi-decade low

Source: Bloomberg

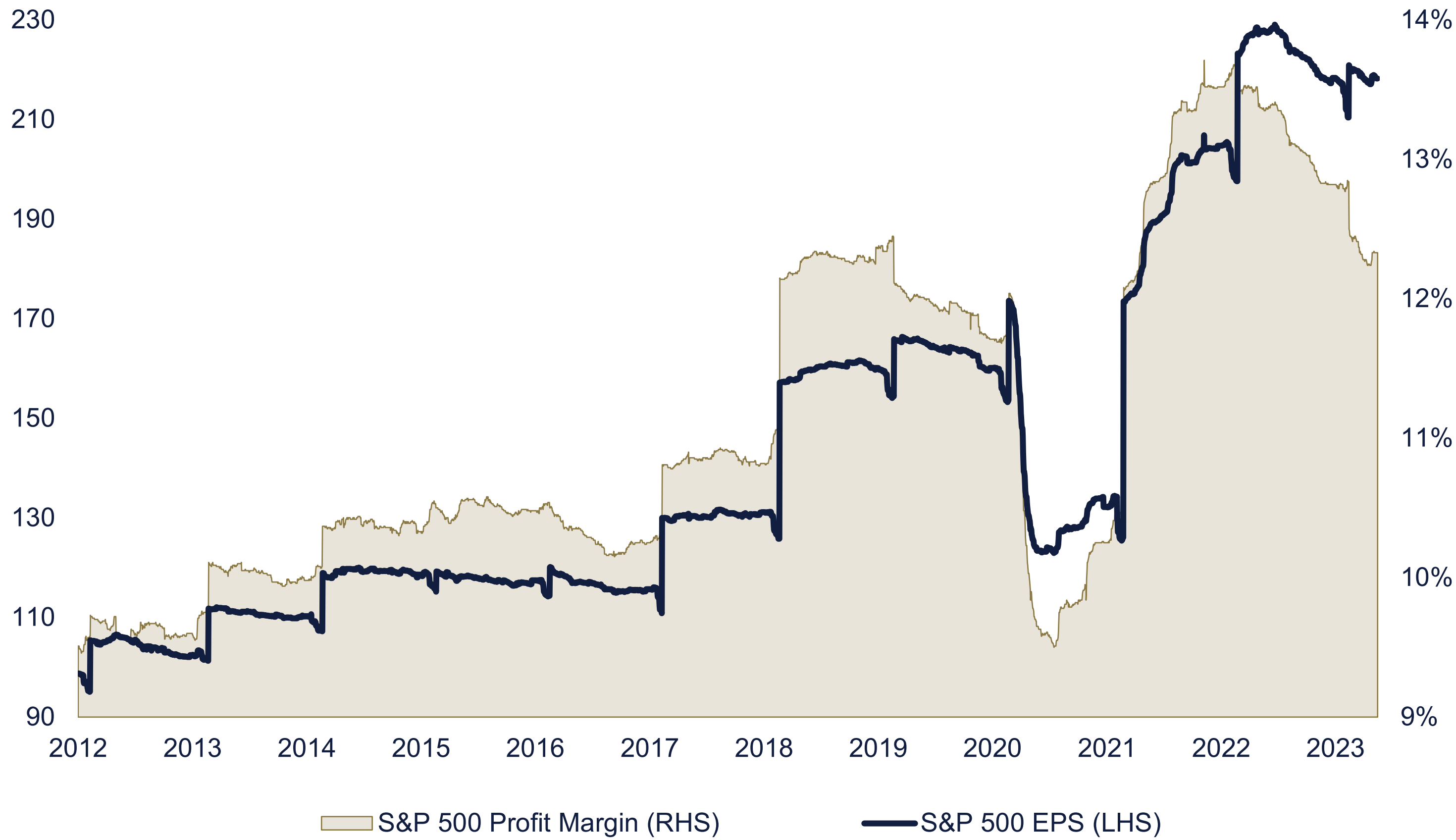
Consumption holds up well



- Despite all the economic uncertainty, **consumers are not cutting back on spending**
- They have **started to save more**, as the savings accumulated during the pandemic have been progressively spent, but the consumption of services remains strong

Source: Bloomberg

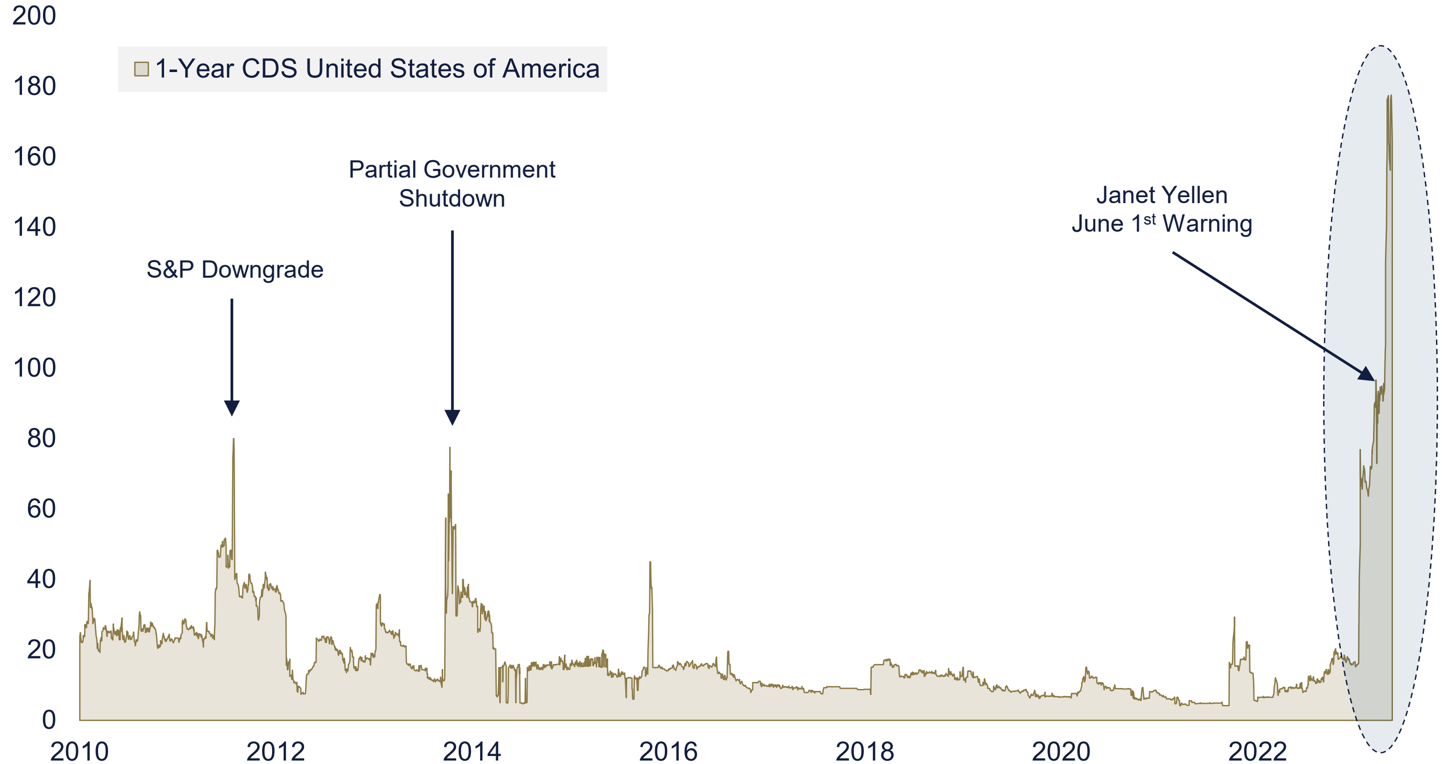
Earnings fall less than expected, margins deteriorate



- During the first quarter, **blended earnings for the S&P 500 fell by -2.5%.** Before the earnings season began, a fall of -6.7% was expected. More than three quarters of the companies reported a **positive EPS surprise, and/or a positive revenue surprise**
- On the downside, **margin erosion continues as a result of rising costs**. However, margins remain elevated compared to their historical average

Source: Bloomberg

Playing chicken, risking the financial system



- The political deadlock around the debt ceiling poses a **new risk for financial markets**. The most likely outcome is that Democrats and Republicans will reach an agreement, since a default would be devastating for both parties
- **An accident (even if immediately remedied) would cause great damage**. Rising the cost of debt for the US government and imperiling the risk-free status of its bonds. Something that would have consequences for the entire financial system

Source: Bloomberg

Low probability event, but just in case

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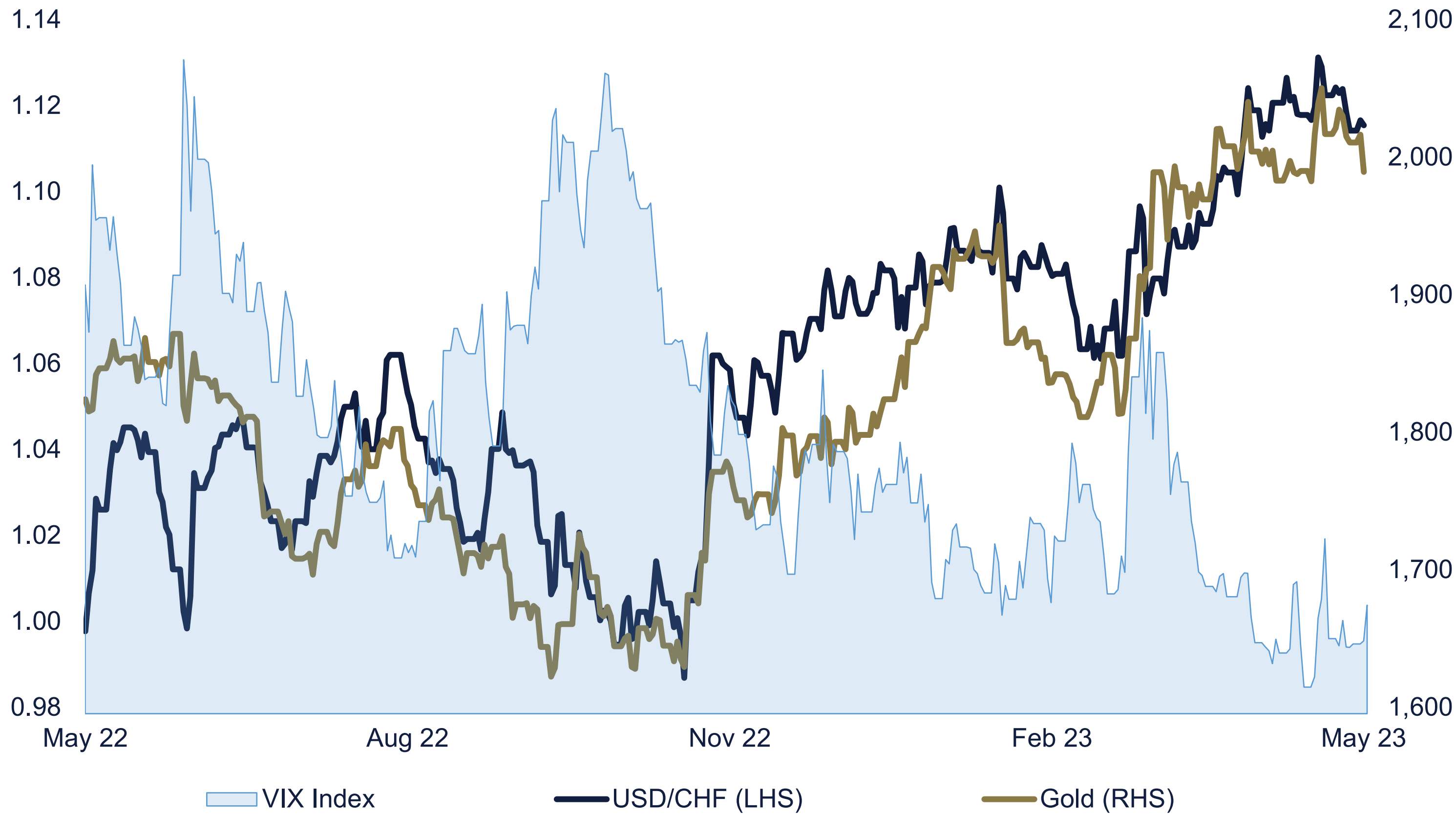


- A **US government default remains a low probability event**, the consequences of which are not easy to anticipate. The entire **financial system would be shaken up** given the indisputable role that Treasuries play as a risk-free asset. In fact, despite being at the epicenter, they would probably still be one of the safest places to be invested in
- Traditional "**safe haven" assets like gold or the Swiss Franc** would likely appreciate but are currently trading at elevated levels. Other alternatives for investors wishing to hedge would be to **short equity indices or to bet on a spike in volatility**

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%	25%

Short-term catalyzers

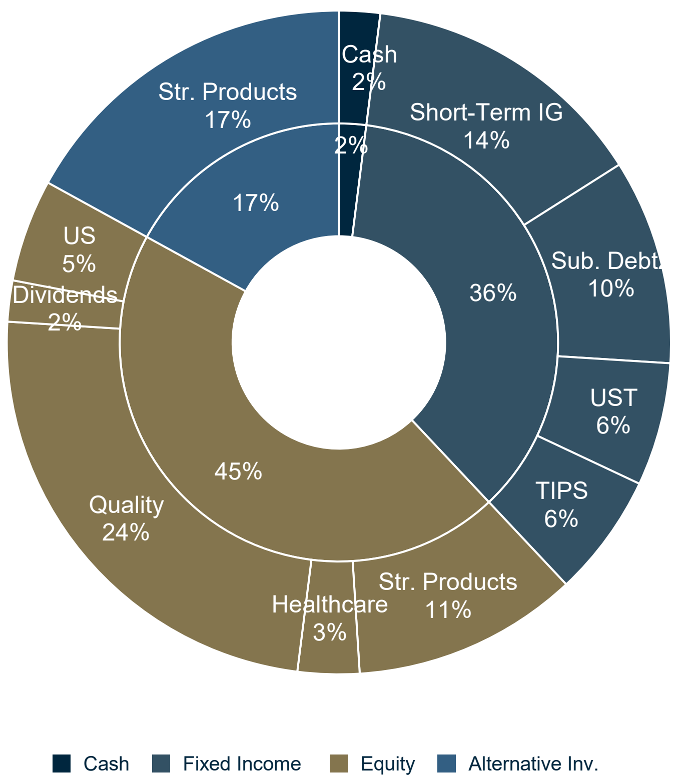
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

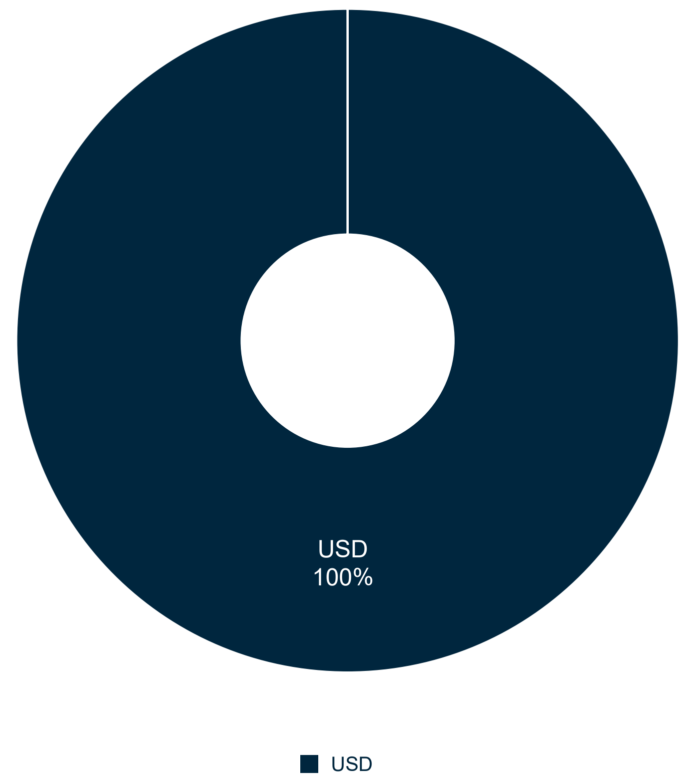
Debt ceiling, Banking crisis, Escalation of the war in Ukraine, China slowdown, Housing market correction, Crypto bubble crash

Boreal Balanced Portfolio USD

Asset Allocation



Currency Allocation

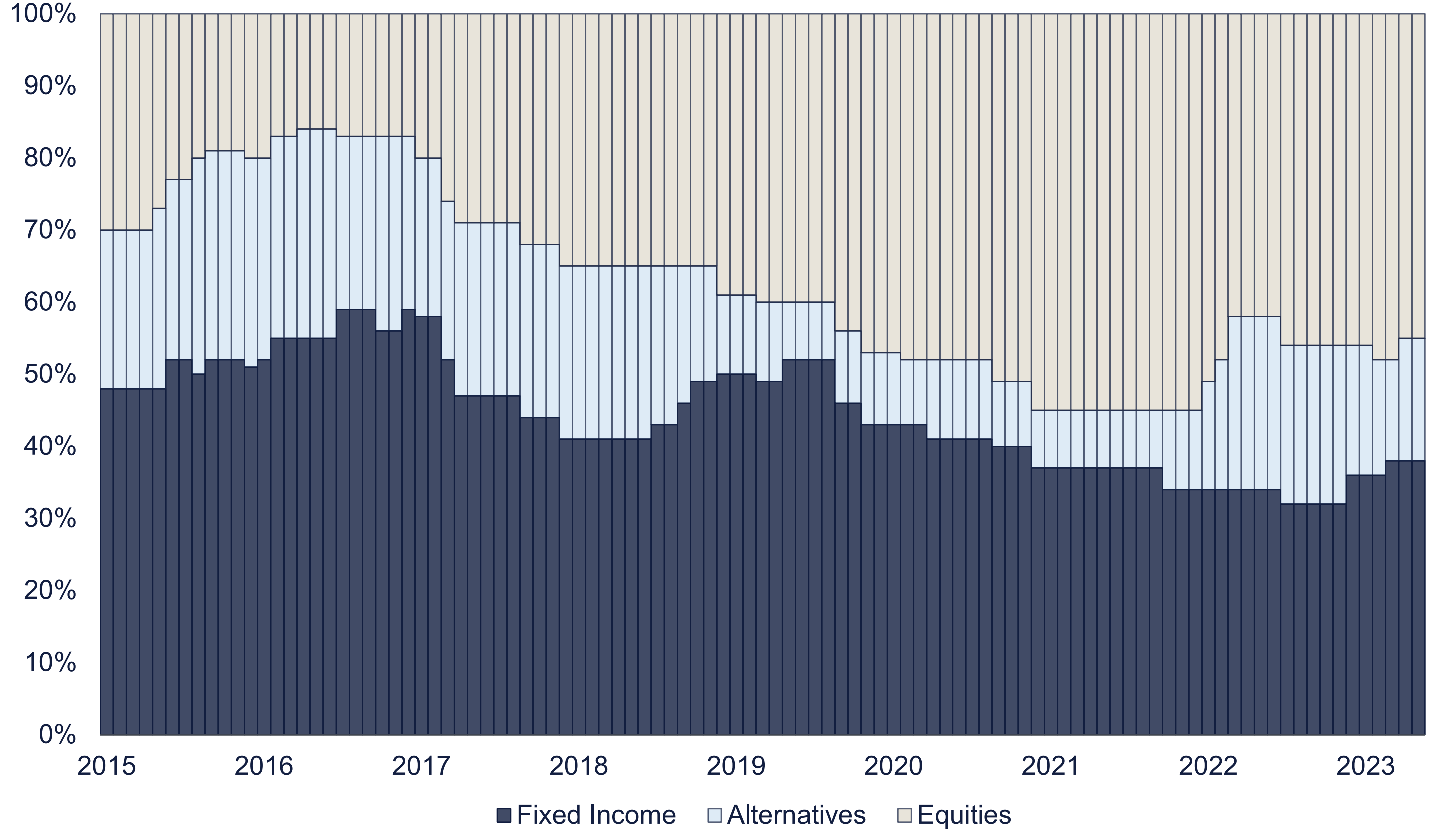


Boreal Investment Profiles

	Extra-Conservative	Conservative	Balanced	Growth
Cash & Fixed Income	▼ 86% 77%	▼ 66% 62%	▼ 44% 38%	▼ 22% 18%
Equities	▼ 10% 8%	▼ 30% 27%	▼ 50% 45%	▼ 70% 59%
Alternative Investments	▼ 4% 15%	▼ 4% 11%	▼ 6% 17%	▼ 8% 23%

▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution



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