Investment Policy

June 2023

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Our market view in a nutshell – June 2023

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- We continue to witness the **economy lose momentum in slow motion**, as a result of the **most aggressive interest rate hike cycle** in decades. However, it is still **far from entering a recession**. Leading economic indicators (mostly based on consumer and business surveys) point to a recession, while real data (consumption, employment, industrial production, housing prices) speak of an economy with tepid but stable growth

- **The service sector continues to be the main engine** of economic growth, while the **manufacturing** sector (which entered into contraction months ago) **has moderated its decline**. Globally, the situation is not very different. Europe is the best example of the current "impasse" in the business cycle. The **Eurozone economy has contracted by -0.1% for two consecutive quarters**, but unemployment remains at all-time lows. **China** on the other hand, despite reopening and enjoying low interest rates, is **not contributing to global growth** like it used to

- This **apparent contradiction between "hard" and "soft" data** should come as no surprise, as **monetary policy has long and variable lags**. However, the longer interest rates remain elevated, the greater the probability that the economy will eventually enter a recession

- To achieve a **"soft landing"**, the consumer should remain unaffected by the gloomier outlook. Additionally, inflation should continue to fall for the Fed to start easing its monetary policy (or at least point in that direction). The **Fed pivot seems to be further away than initially anticipated by the market**, but the evolution of **inflation and the labor market** allow us to still give **some probability to this scenario**

- Equity markets have remained upbeat as the **Debt Ceiling** and **US Regional Banking** crises have **receded into the background**. Also due to **investor flows into stocks related to the AI boom**. Looking beyond the surface, overall market gains have been modest. **Valuations remain highly dependent on the path followed by interest rates and corporate earnings**. As for **fixed income, it is not the asset class that is shining the most**, contrary to the initial consensus. Returns have come mainly from interest income, since capital appreciation has been minimal (interest rates and corporate spreads are at levels close to those of the beginning of the year)

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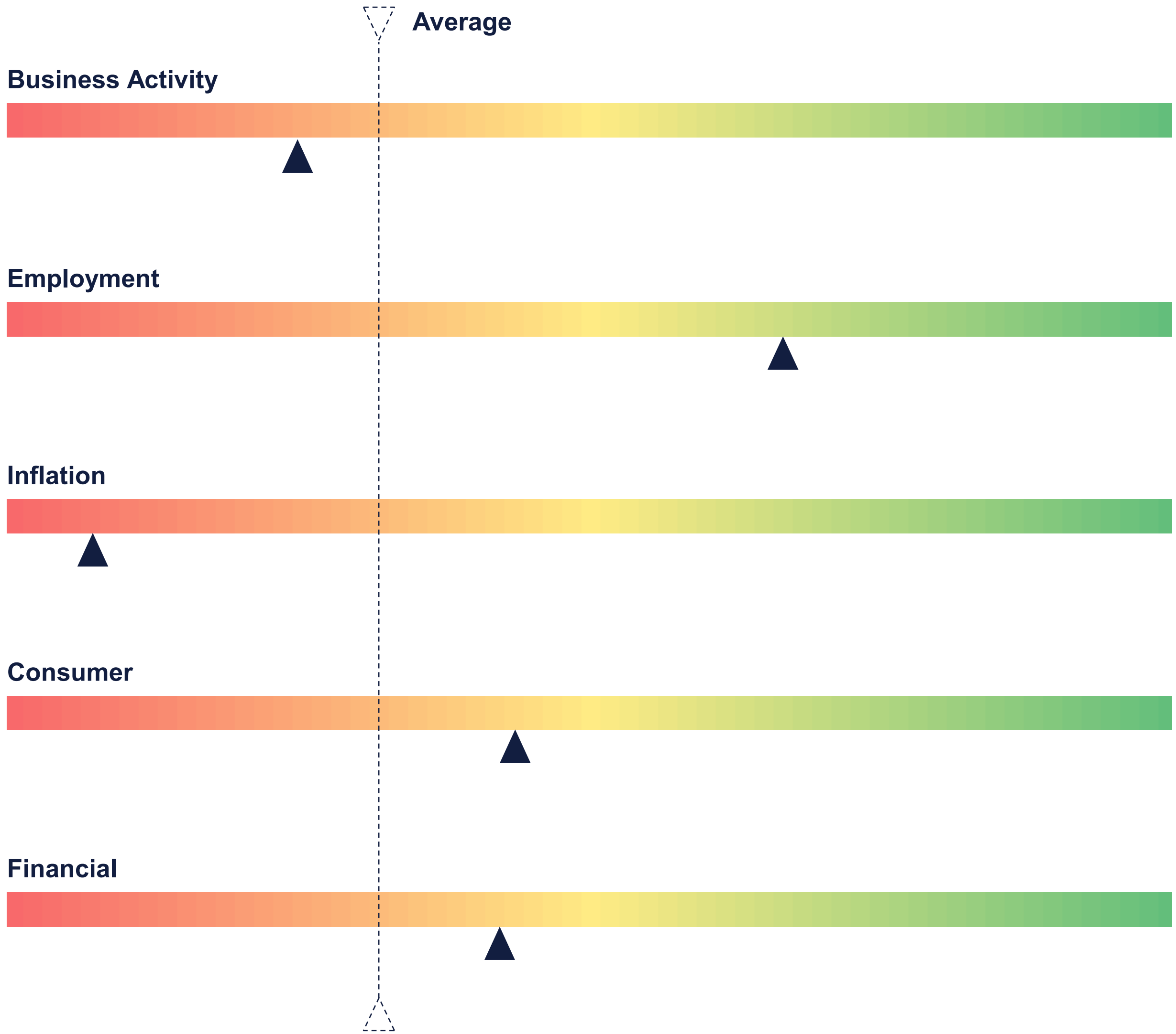
	Asset Class	View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	=	Higher probability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

How close to a recession?



Business Activity
- PMI Manufacturing
- PMI Services
- Durable Goods New Orders
- GDP

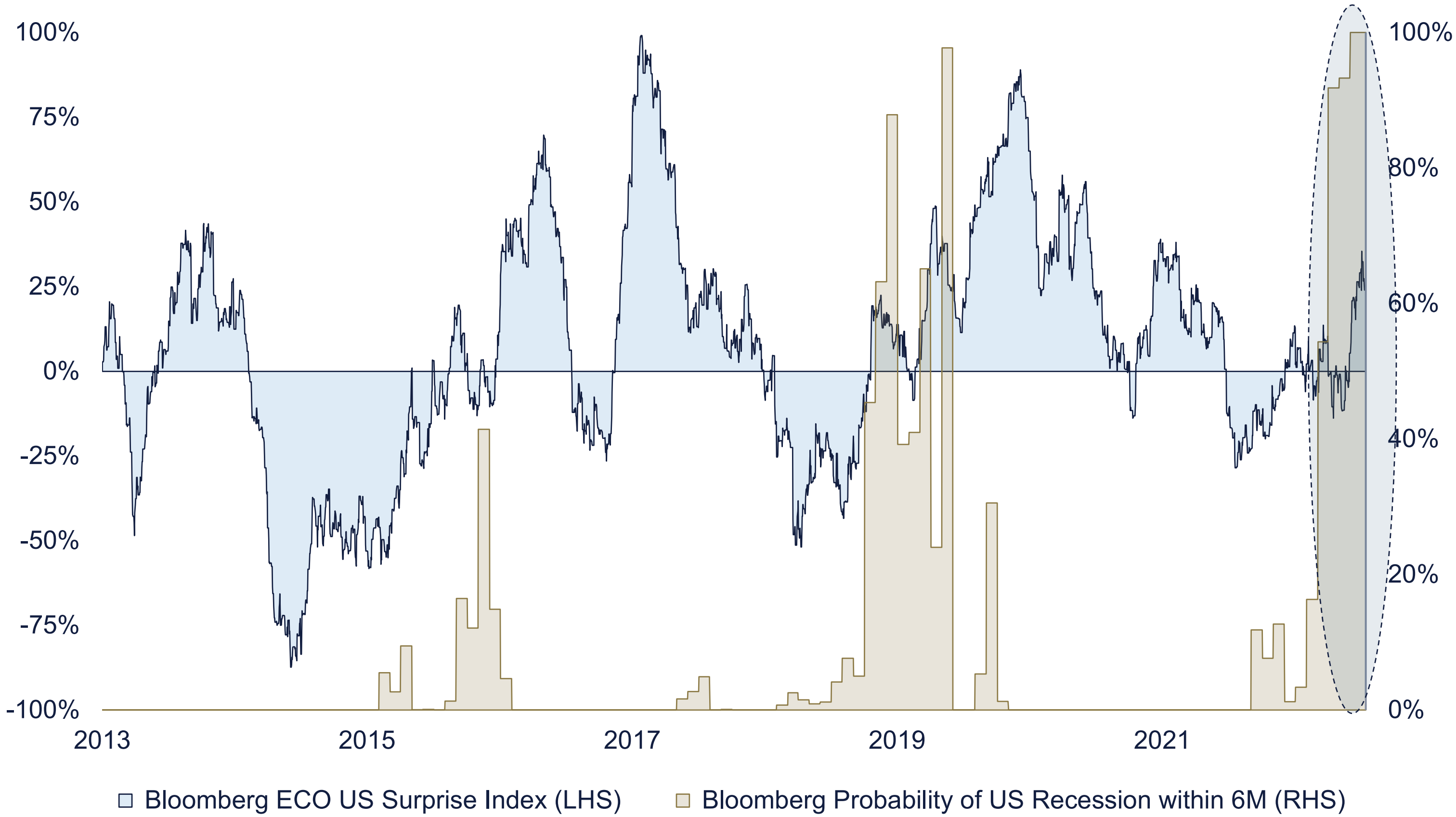
Employment
- Manufacturing Report on Business Employment
- ADP National Employment Report
- US Employees on Nonfarm Payrolls
- Labor Productivity
- Unemployment Rate
- Job Openings

Inflation
- ISM Manufacturing Report on Business Prices
- CPI
- Core CPI
- PPI

Consumer
- Personal Consumption Expenditure
- Consumer Sentiment
- Retail Sales
- Housing Unites Started
- MBA US Mortgage Market Index
- Personal Income
- Personal Consumption

Financial
- Financial Conditions
- HY Spreads
- IG Spreads
- Fed Funds over *r**
- Equity Risk Premium

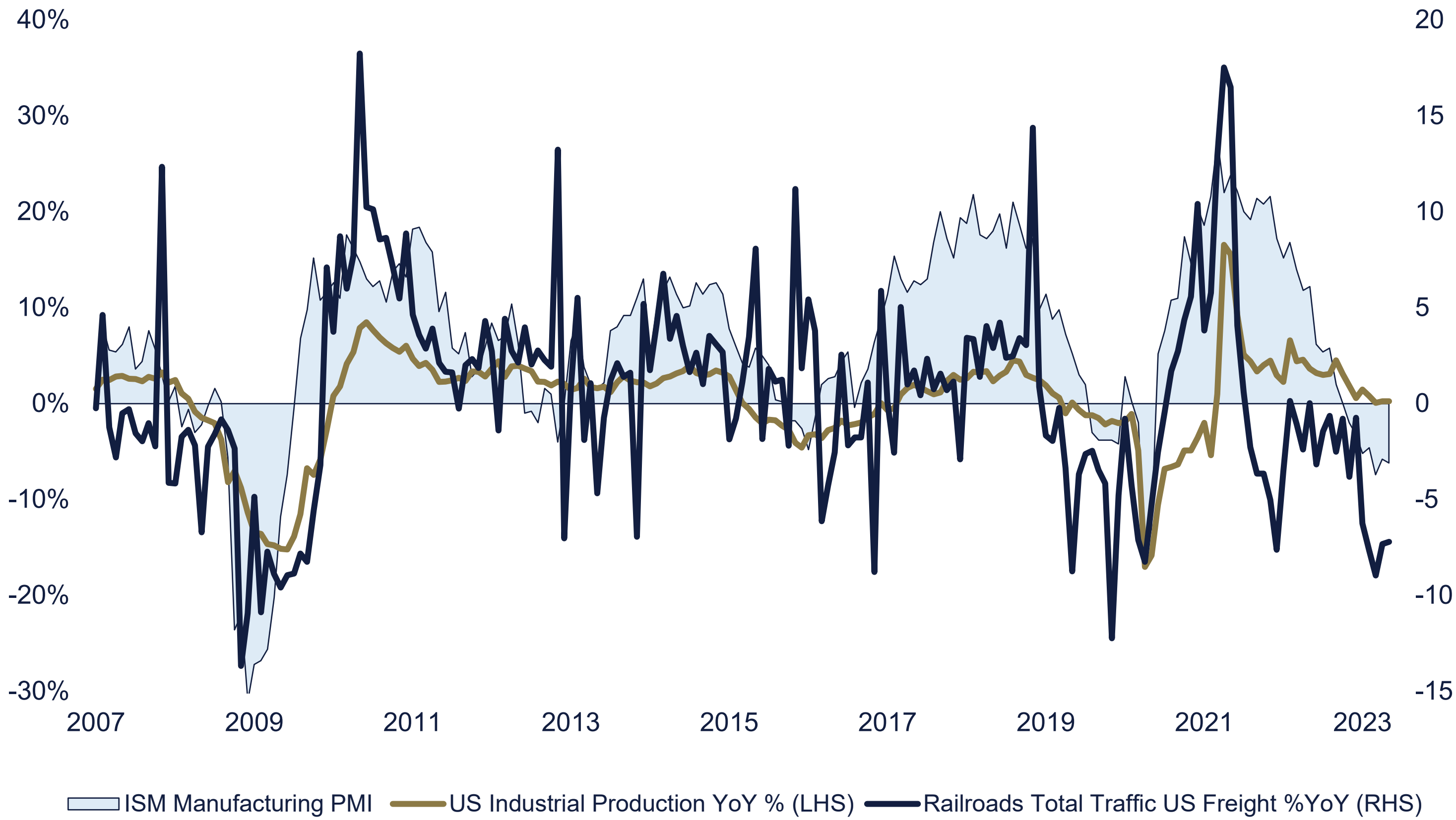
Improvement, but hard landing remains base case



- A robust yet cooling job market, coupled with another month of falling inflation, **raises hopes of a “soft landing”**
- However, the **full impact of the steep change in interest rates is only beginning to be seen**, and a "hard landing" remains the baseline scenario

Source: Bloomberg

A manufacturing recession



- The **deterioration in the manufacturing** sector anticipated by leading indicators is **already visible in real activity data**

Source: Bloomberg

Service sector approaching a critical point

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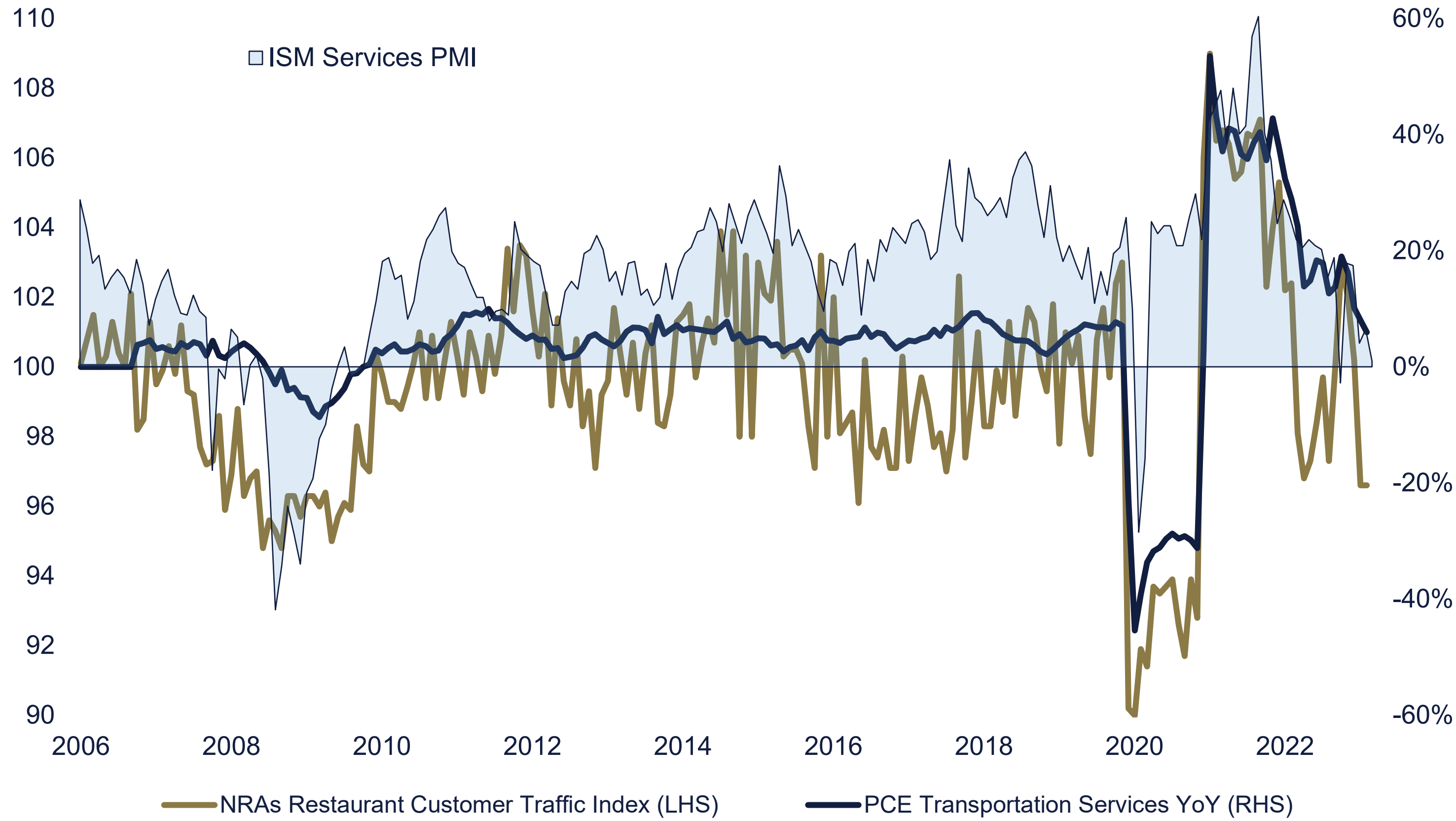
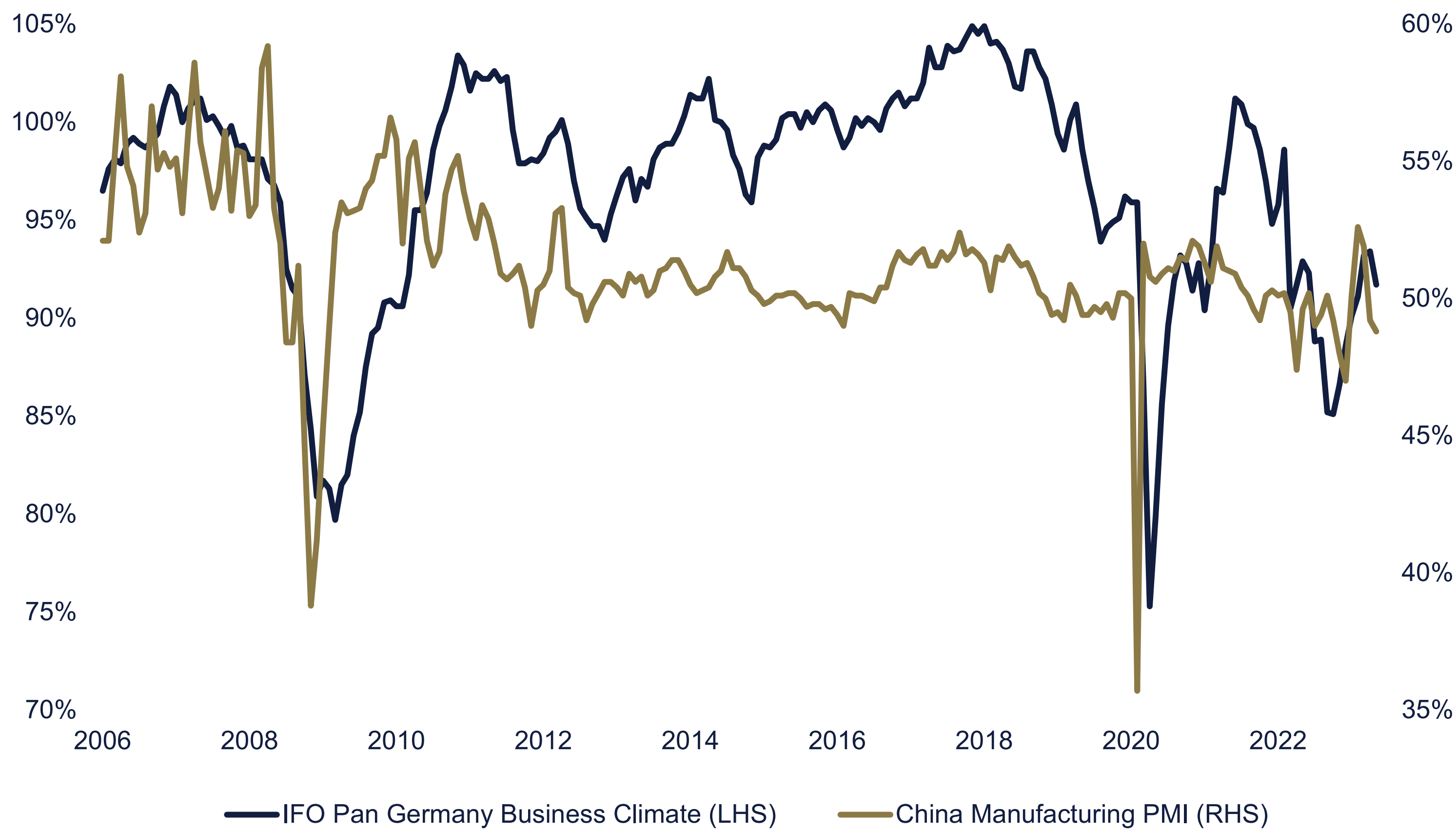


- The **service sector is also beginning to cool**, although there is **still some pent-up demand** in the transportation and hospitality sectors

Source: Bloomberg

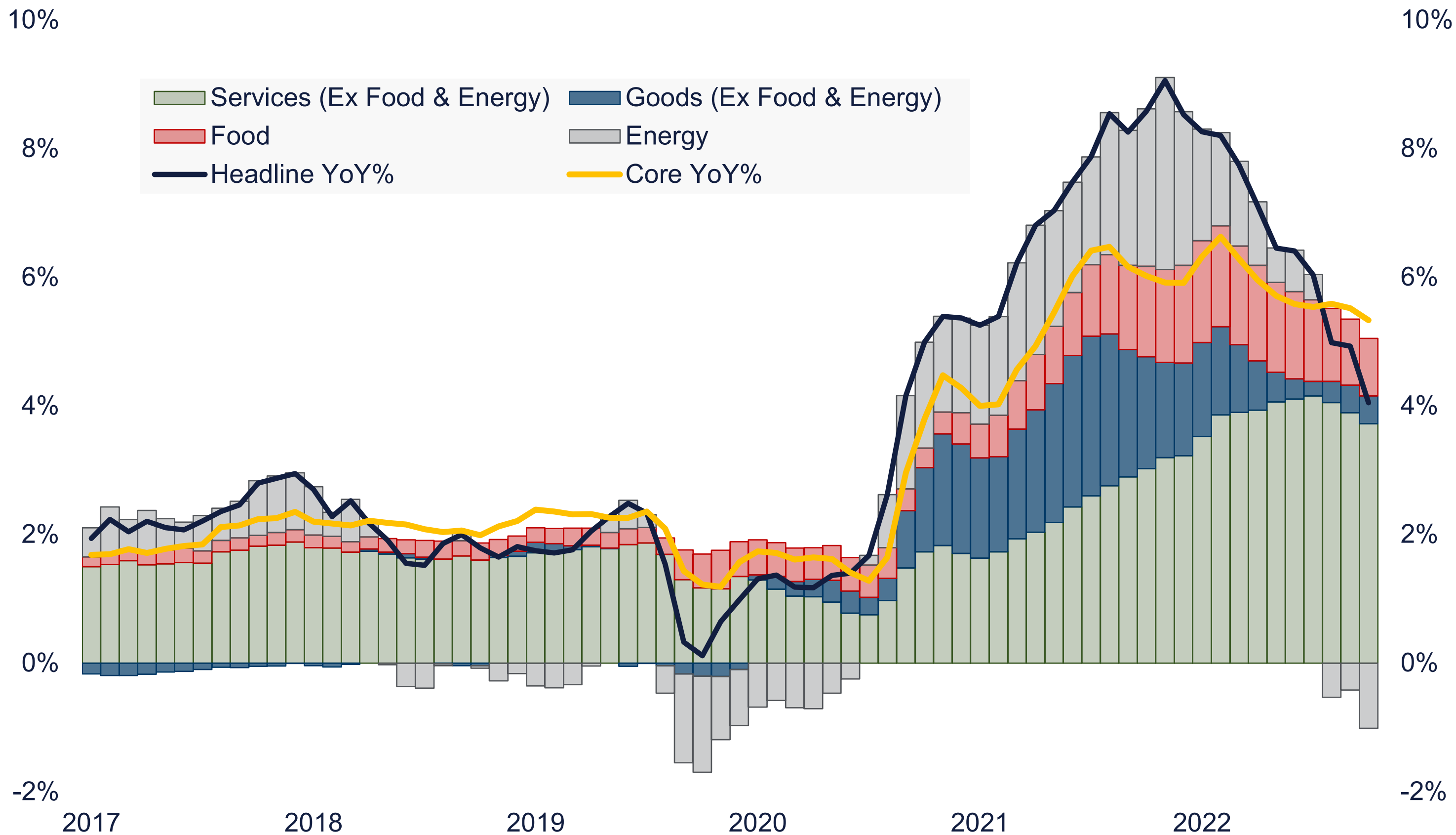
Weak growth is a global problem



- **Outside the US, growth remains tepid**. The central banks of most developed economies (except for Japan) have followed the Fed by aggressively raising interest rates
- The **slowdown in manufacturing** is especially affecting economies such as **China** and **Germany**, which are more dependent on exports

Source: Bloomberg

Following the script



- Headline **inflation continues its downward trend**. And since September of last year, only once (February) has the data came above analysts' expectations
- **Core inflation, by contrast, is taking longer to come down**. But we know that there is a time lag. This can be seen in services inflation, which has peaked eight months after headline inflation

Source: Bloomberg

Is it really so sticky?

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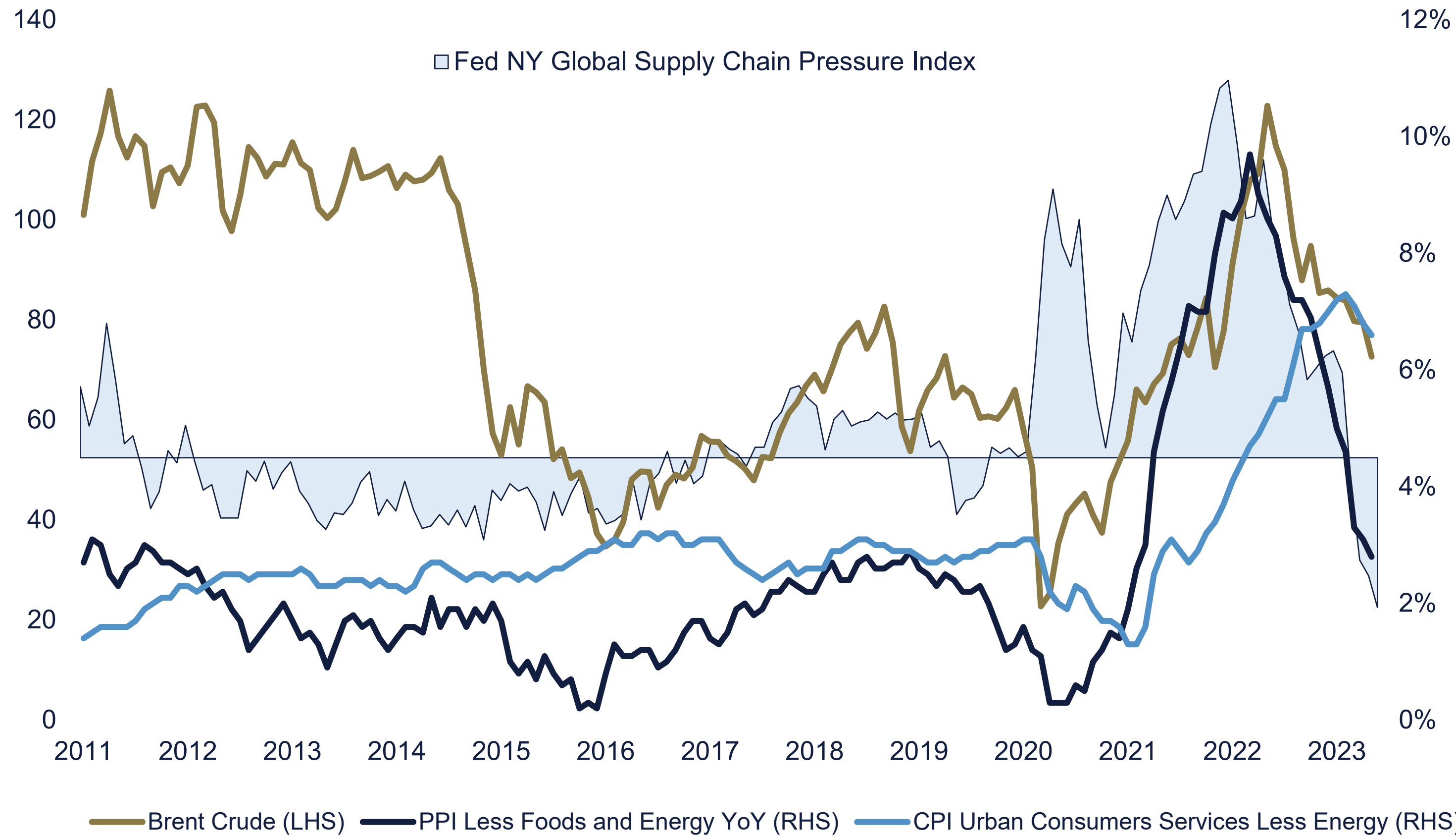


- The two drivers behind last year's exceptional bout of inflation are well known: (1) **Supply-side constraints** when the economy reopened after the pandemic and (2) the impact of the **war in Ukraine** on commodity markets
- With both factors normalizing and the economy slowing down as a result of higher interest rates, it is **only a matter of time until inflation in the services sector begins to normalize** as well

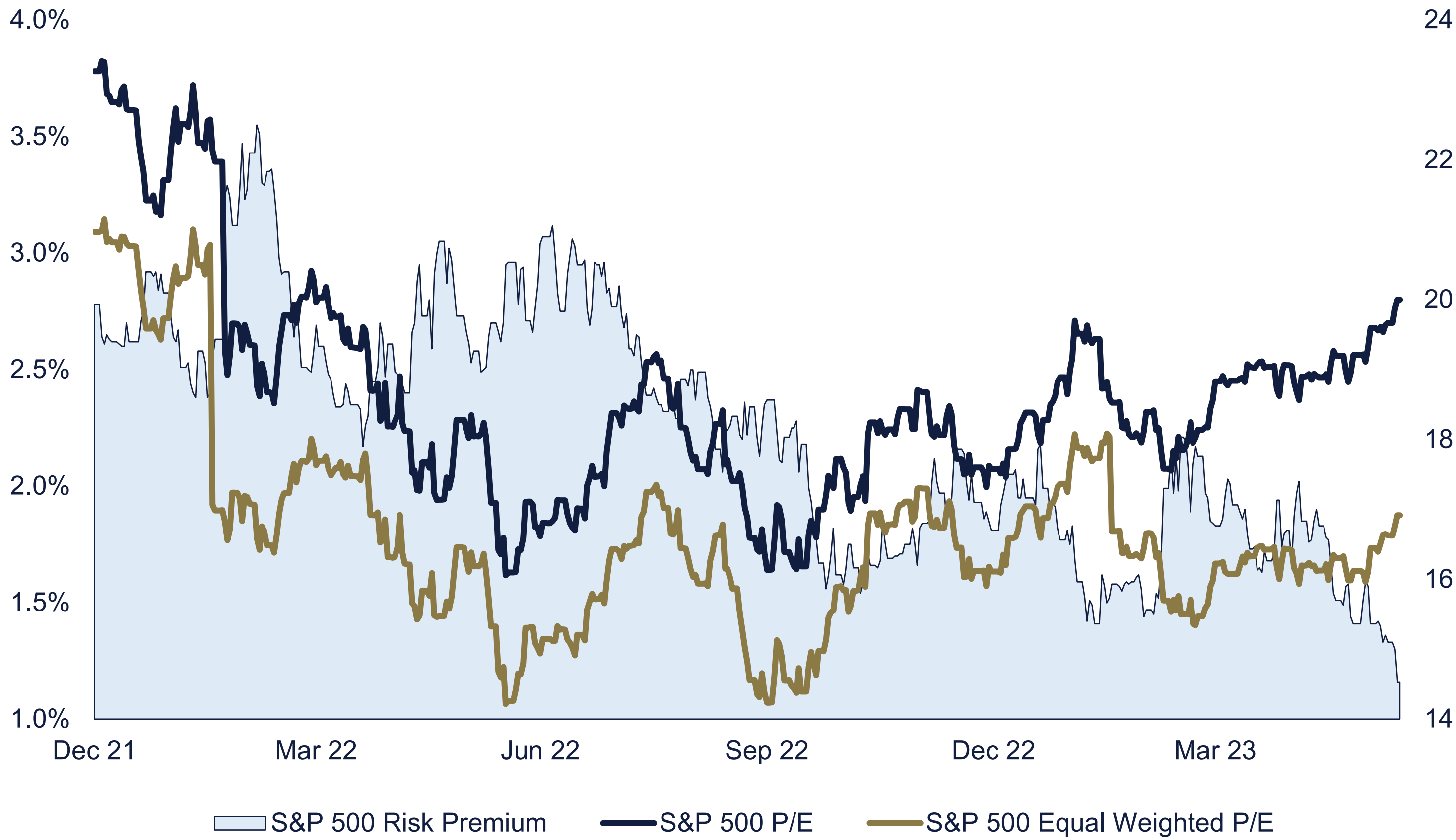
Source: Bloomberg

AI-driven market momentum

- In recent months there has been a **great divergence** between those tech stocks seen as best positioned to ride the **AI wave**, and the broader market
- The rise in Big Tech stocks is also **partly a reversal of the excessive correction they suffered last year**. Now that interest rates are peaking and the economy could enter a recession, they are **considered safe havens**

Source: Bloomberg

Equity valuations have slightly deteriorated



- With interest rates rising (reflecting that the Fed is unlikely to pivot this year) and corporate profits declining, the latest rally in equity markets has **turned stocks more expensive relative to bonds**
- However, **absolute valuations** based on Price/Earnings ratios remain **close to their long-term historical average**

Source: Bloomberg

Investment scenarios

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	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

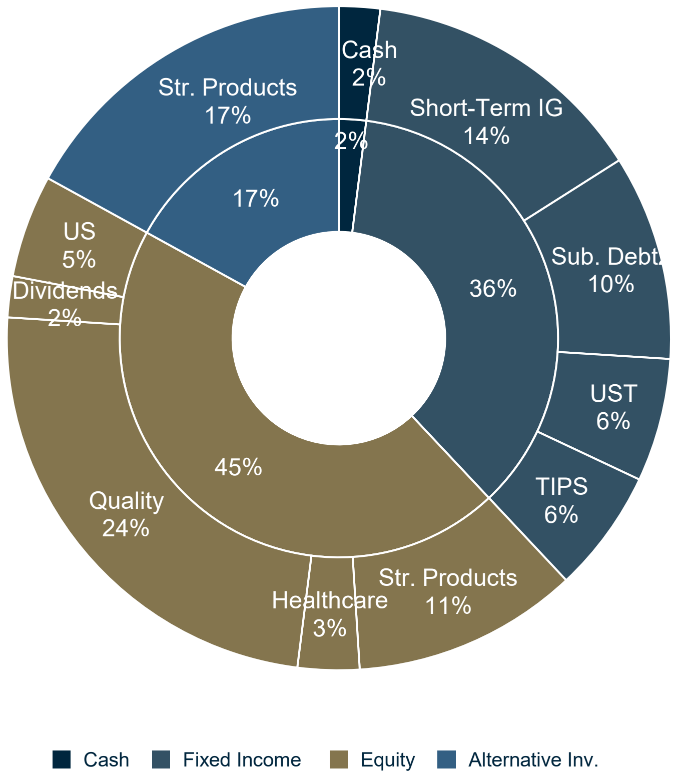
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

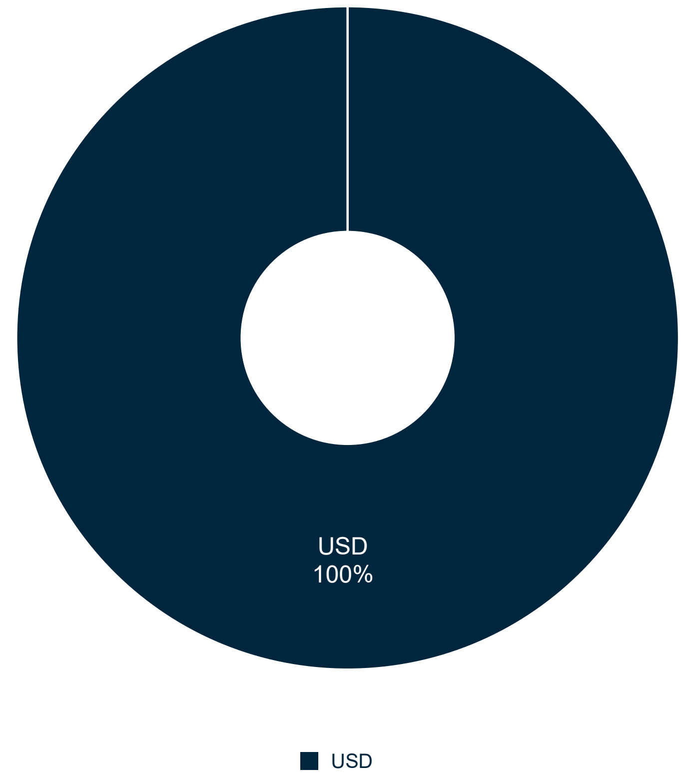
Debt ceiling, Banking crisis, Escalation of the war in Ukraine, China slowdown, Housing market correction, Crypto bubble crash

Boreal Balanced Portfolio USD

Asset Allocation



Currency Allocation



Boreal Investment Profiles

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

▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution

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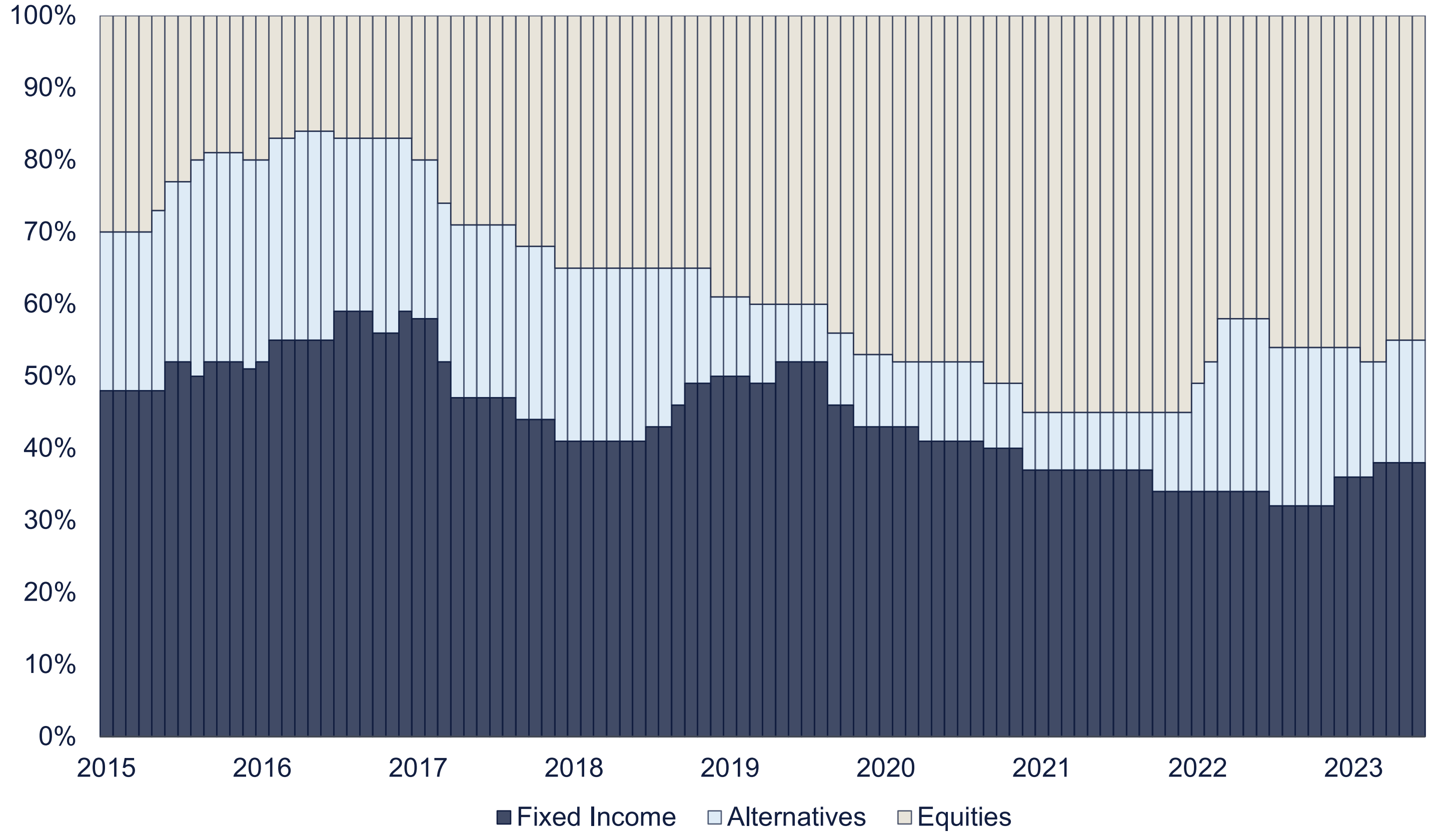

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