



# Investment Policy

August 2023
















## Our market view in a nutshell – August 2023

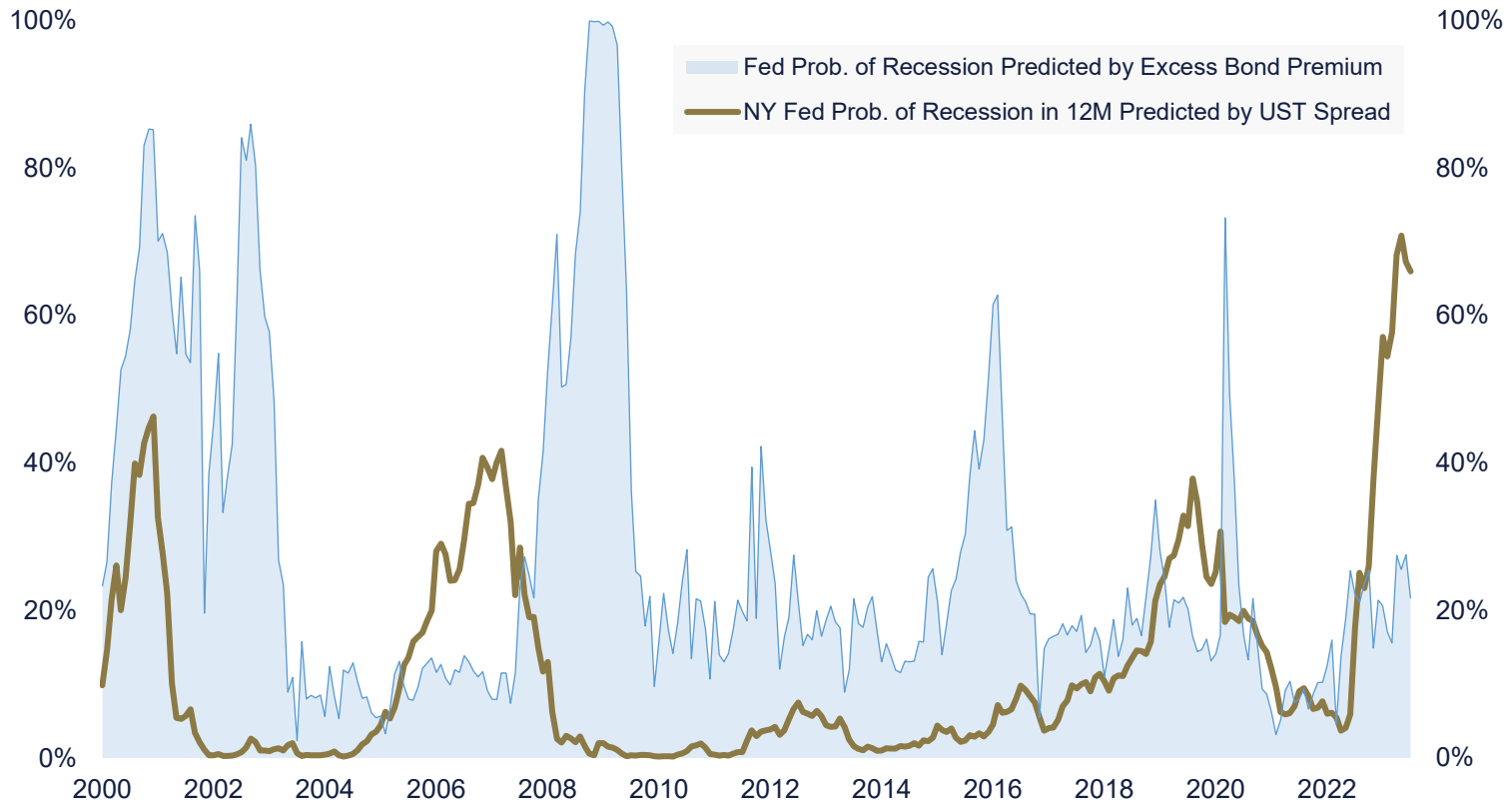
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- The **US economy continues to perform better than expected**, thanks to strong consumer spending. With inflation finally starting to abate, households are seeing their **disposable income increase in real terms** for the first time since the end of the stimulus packages. However, the **manufacturing sector** continues to contract, and the **banking sector** is also not completely out of the woods. Regional banks are still relying on hundreds of billions of dollars in government financing, and loan losses are starting to dent profits
- The presence of a multitude of feedback loops in financial markets makes them notoriously difficult to forecast their direction. The fact that investors have been cheering the resilience of the economy in the face of rising interest rates has **increased the chances of further interest rate hikes**. Now, not only are Fed funds at a 22-year high, but **10-year US Treasury yields have climbed to levels not seen since 2007**
- A number of factors have contributed to the increase in Treasury yields. The first was the **Fed's warning** of potential additional rate hikes if inflation does not decline quickly enough. This was compounded by the **high issuance of US Treasuries** over the summer, which met with lower demand due to the ongoing “Quantitative Tightening” program. Lastly, markets have been **testing the resolve of the new governor of the Bank of Japan**, the last major central bank that is still providing monetary stimulus in developed economies
- In contrast to the optimism about the US economy, **China continues to send alarming signals**. Consumption, industrial production, exports, and employment have all disappointed, prompting the central bank to unexpectedly cut interest rates. At the same time, Country Garden, China's **largest real estate developer**, reported a large loss and missed interest payments on some dollar bonds. This has led investors to fear that the company could default on billions of dollars in loans. To compound the problems, a subsidiary of Zhongzhi, one of the biggest players in the \$3 trillion **shadow banking industry**, defaulted on some of its wealth management products
- Financial markets, which had discounted all the positive news, sold off on rising interest rates and growth concerns in China and Europe. However, **equity valuations remain elevated both in absolute terms and relative to bonds**. The latter fell in price as they had to absorb yet another increase in interest rates, pushing the **year-to-date total return of Investment Grade bonds into negative territory**

# Boreal Investment Policy

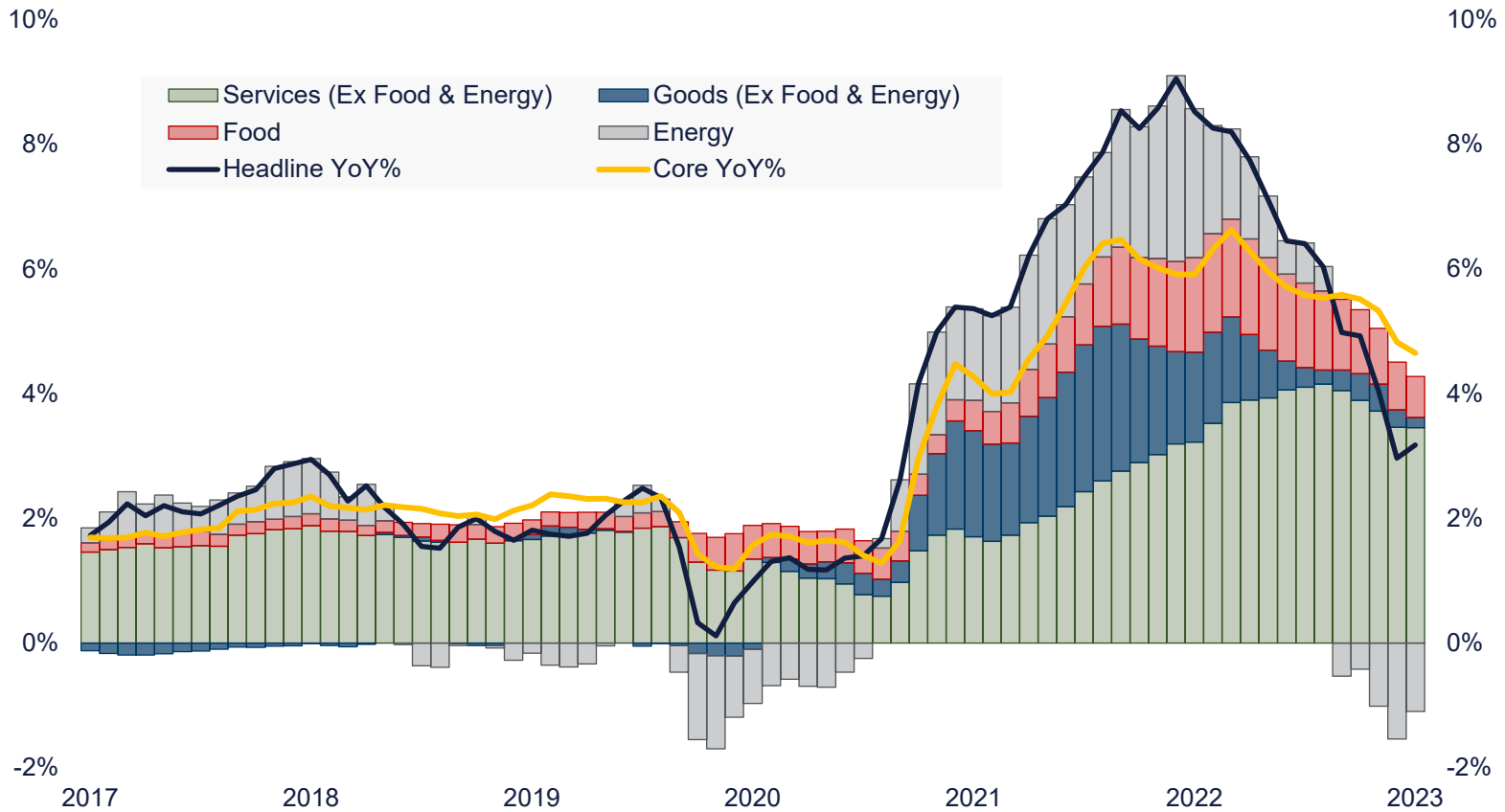
	Asset Class	View	Rationale
<b>Fixed Income</b>	US Investment Grade		Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit		Higher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

# An elusive recession



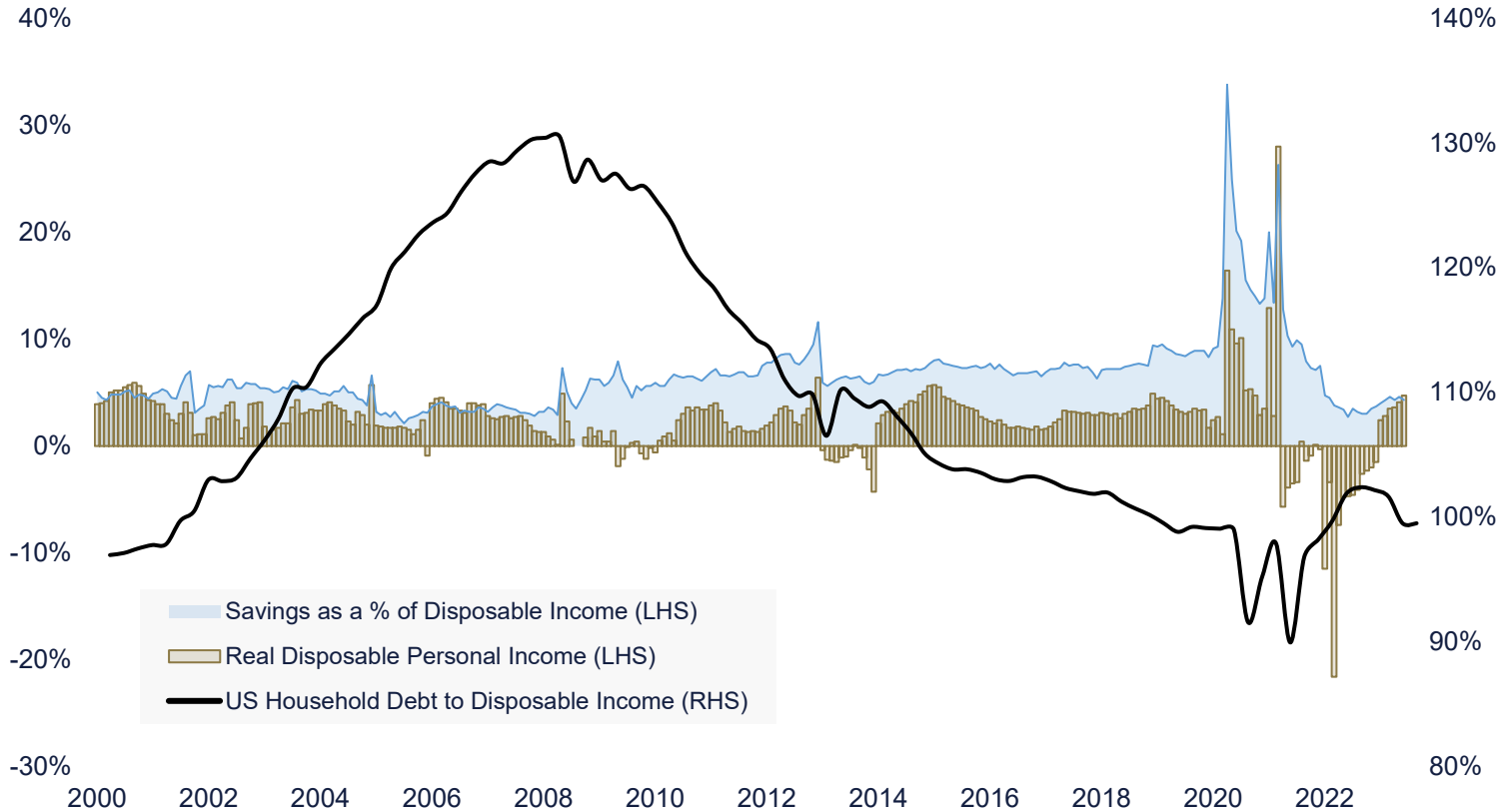
- Month after month, the economy has managed to avoid the much-anticipated recession. The **GDP print for Q2 was significantly better than expected** (2.4% vs. 1.8%), mostly driven by personal consumption
- As a result, the **odds of a “Soft Landing” have increased**, positively impacting asset prices across the board

# On the right track



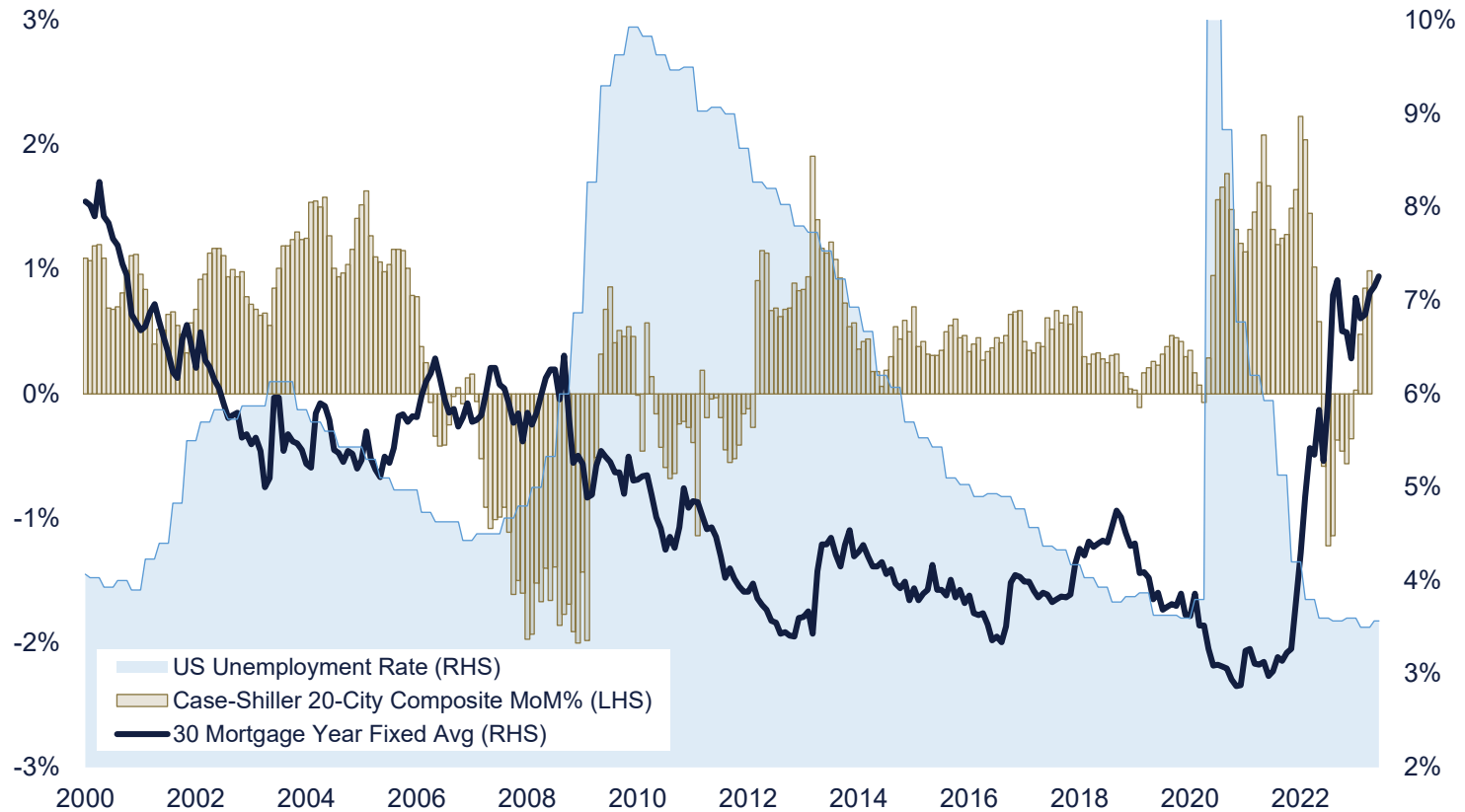
- **Inflation** for the month of July was **in line with expectations**. Headline inflation increased slightly year-over-year due to base effects from the most volatile components, but core inflation decreased more than expected
- On a month-over-month basis, both headline and core inflation increased by 0.2%, bringing the **annual inflation rate closer to the Fed's 2% target**

# No longer drawing down savings



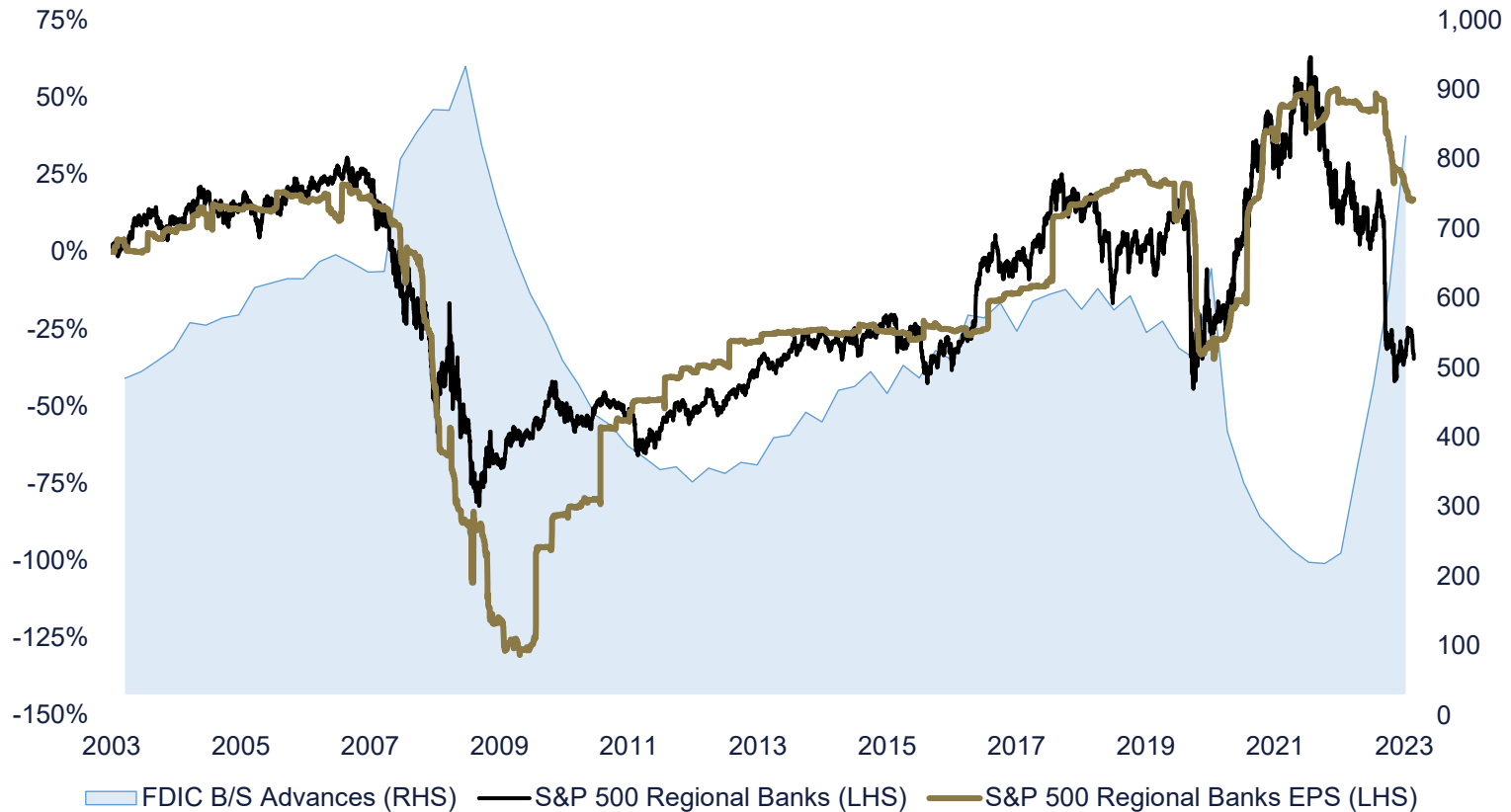
- **Consumers have been drawing down excess savings** accumulated during the pandemic, as wages have been lagging inflation
- However, inflation is now falling faster than wage growth is moderating, resulting in an **increase in disposable income in real terms** for the first time since the end of the stimulus packages

# House prices are holding up well



- The **resilience of home prices** despite **mortgage rates reaching levels not seen since 2000** may seem surprising at first. Demand has declined along with the number of transactions, but prices have held firm due to a shortage of inventory
- **Homeowners are reluctant to move** and give up their low mortgage rates, and there are **few forced sellers** in the current strong labor market

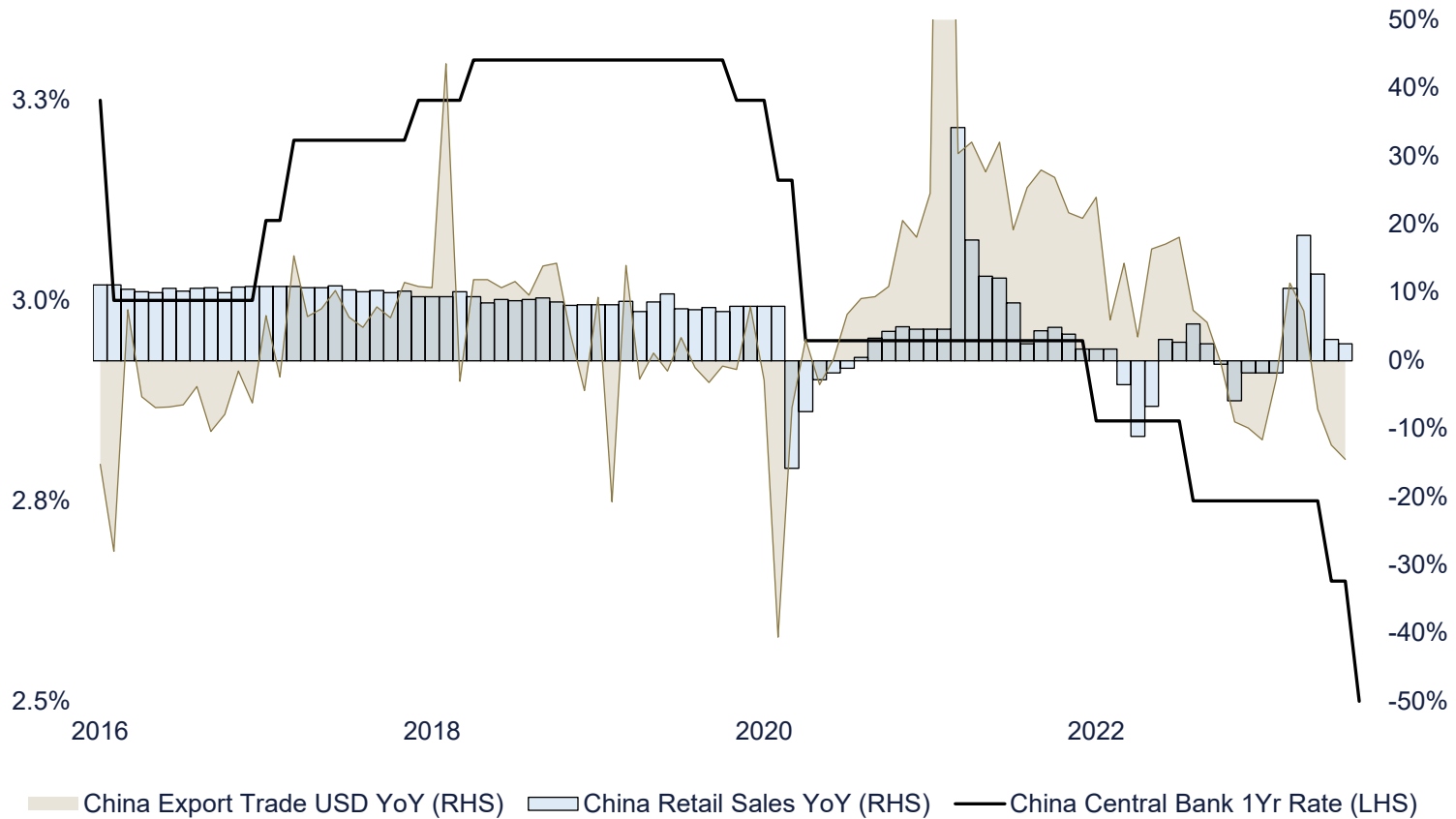
# Commercial real estate is different



- Banks are seeing an **increase in “charge-offs”** (losses on unrecoverable loans), many of them in commercial real estate. This trend has accelerated since the banking crisis began, with losses in Q2 75% higher than the same period last year
- **Regional banks remain under pressure**, heavily relying on government financing, which is a sign that they are still struggling to attract back deposits

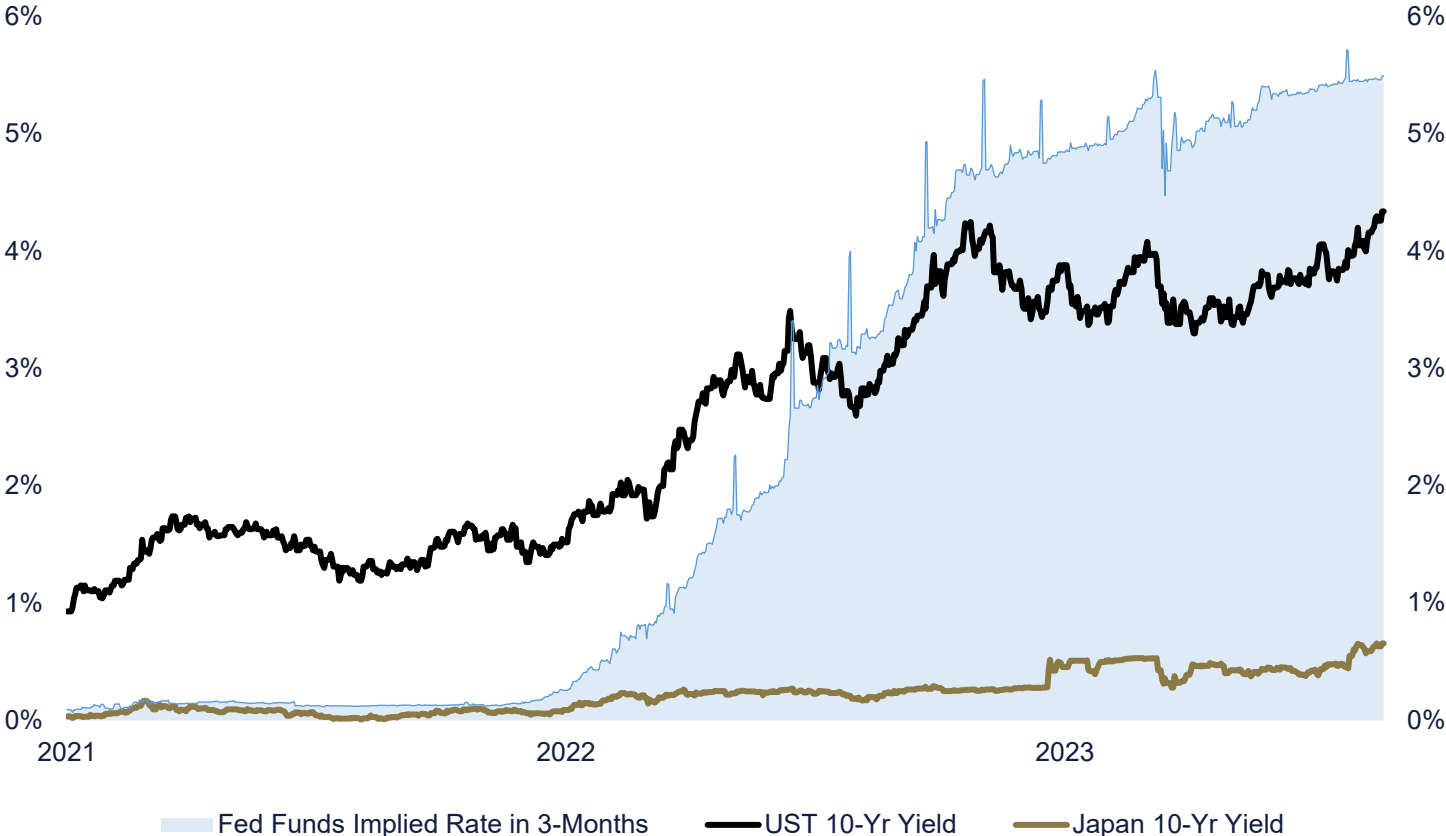


# More worrying signs coming from China



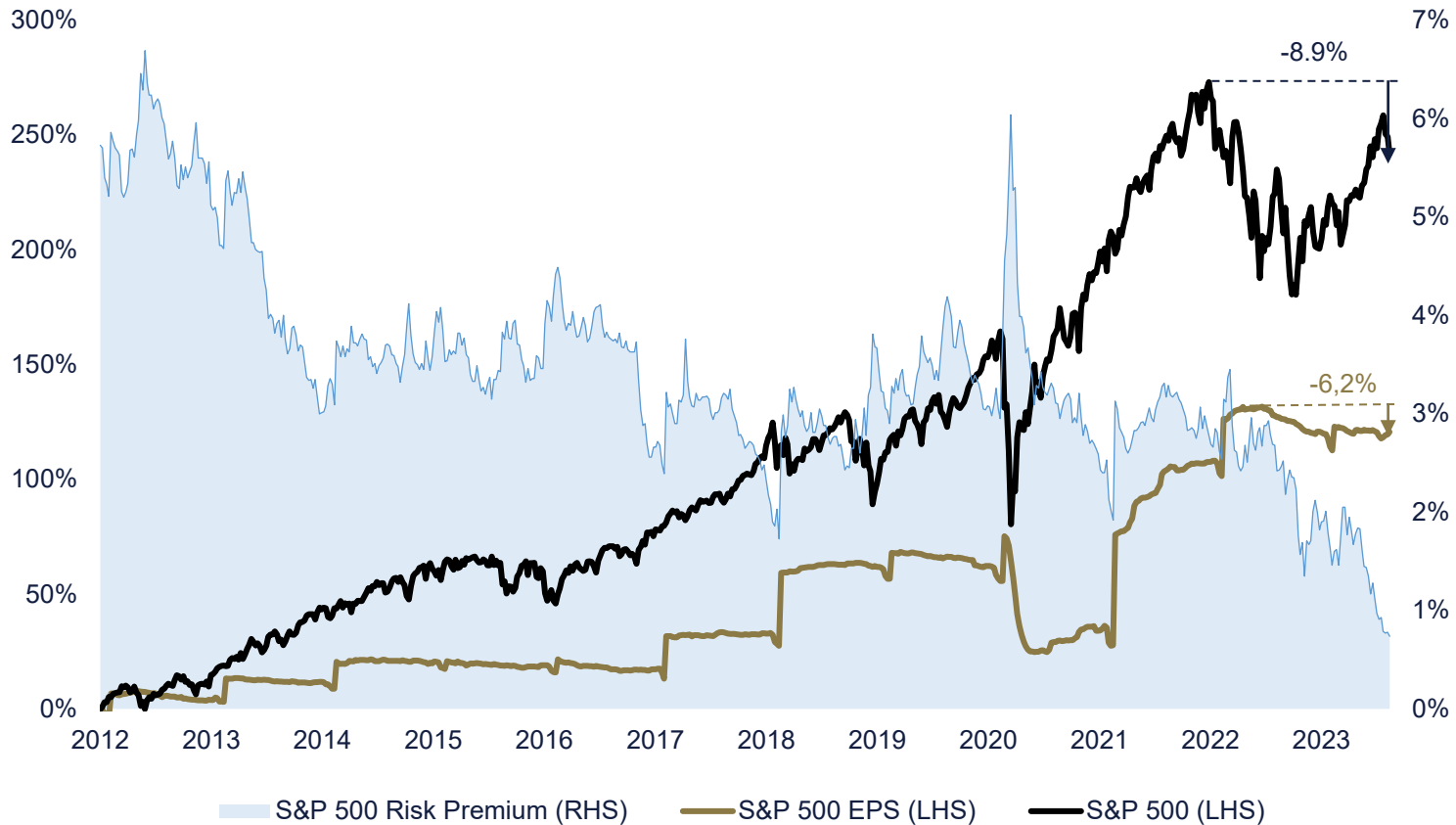
- **Weak economic data**, including disappointing consumption, industrial production, exports, and employment, triggered a **surprise interest rate cut** by the People's Bank of China (PBOC)
- At the same time, the country's **largest real estate developer missed interest payments** on some dollar bonds, and one of the biggest players in the \$3 trillion shadow banking industry defaulted on some of its “wealth management products”

# 15-year highs



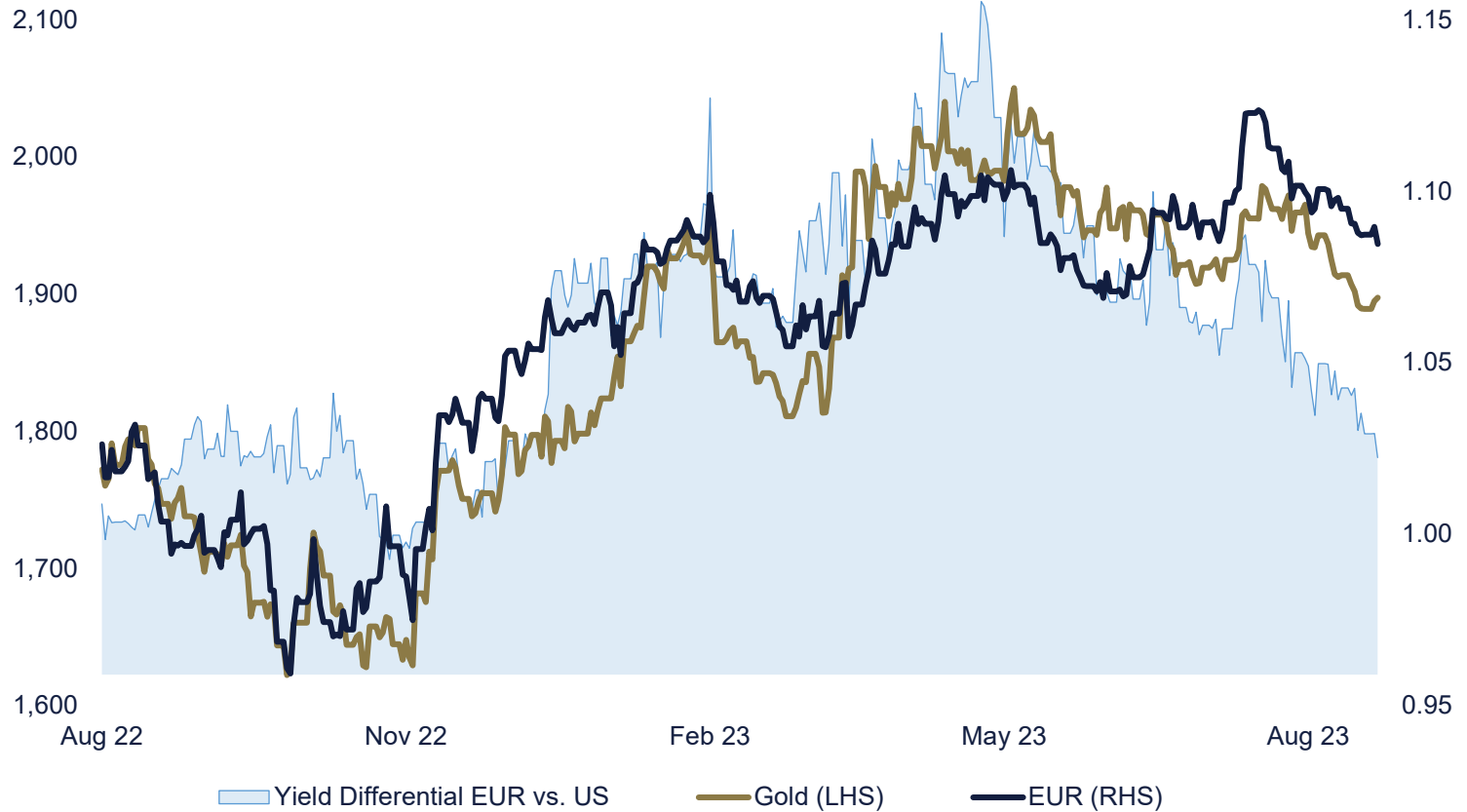
- Long-term interest rates have sharply increased in recent weeks, with the **10-year US Treasury yield climbing to levels not seen since 2007**
- This increase has been driven by several factors, including: (1) Potential **new interest rate hikes**, (2) High volume of **US Treasury issuance** and (3) Markets testing the resolve of the **new governor of the BoJ** to maintain the yield curve control

# Valuations are unsustainably high



- **Corporate earnings continued to slide**, with S&P 500 companies reporting a year-over-year decline of -5.2% in Q2
- However, equity markets have rallied despite higher interest rates. As a result, **valuations are very stretched**, and can only be justified if earnings growth picks up significantly and/or interest rates decline materially in the near future

# Currency markets continue to be driven by rates



• Interest rates are the only game in town for FX markets. As interest rates have risen, **the dollar has been regaining ground** against major currencies and gold

# Investment scenarios

	Scenario 1 Stagflation	Scenario 2 “Hard landing”	Scenario 3 “Soft landing”
<b>Drivers</b>	<ul style="list-style-type: none"> <li>• Inflation remains sticky as labor shortages do not improve, and commodity prices remain elevated due to the war in Ukraine</li> <li>• The Fed needs to tighten further and, worse, keep interest rates elevated for longer</li> <li>• As a result, long-term inflation expectations remain elevated, as do long-term interest rates</li> </ul>	<ul style="list-style-type: none"> <li>• Consumption slows down given that, despite the rise in wages, high inflation translates into lower real disposable income</li> <li>• 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</li> <li>• The economy falls into recession, slowing down inflation and lowering interest rates</li> </ul>	<ul style="list-style-type: none"> <li>• Fiscal policy remains highly accommodative, and the economy continues to grow with strong momentum</li> <li>• The Fed raises interest rates progressively. Inflation begins to normalize without the economy slowing down significantly</li> <li>• The yield curve flattens, and long-term interest rates rise only moderately</li> </ul>
<b>Market impact</b>	<ul style="list-style-type: none"> <li>• Corporate profits somewhat rise with inflation, but higher interest rates have a negative impact on equity valuations</li> <li>• High-quality and sovereign bonds fall due to rising interest rates</li> <li>• Credit performs relatively better despite higher rates, as the risk of corporate defaults remains low</li> <li>• The US dollar depreciates against safe-haven currencies as well as against gold</li> </ul>	<ul style="list-style-type: none"> <li>• Equity markets fall, and cyclicals underperform quality and defensive stocks</li> <li>• Credit spreads widen sharply as the prospect of corporate defaults increases</li> <li>• Sovereign debt and the US dollar appreciates due to “flight to quality”</li> <li>• 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)</li> </ul>	<ul style="list-style-type: none"> <li>• Equities appreciate, as the economy returns to the “Goldilocks”, and valuation multiples widen</li> <li>• Credit spreads tighten moderately as investors chase yield again</li> <li>• High-quality and sovereign debt trade range-bound</li> <li>• Commodity prices stabilize and the US dollar appreciates due to higher real interest rate differentials</li> </ul>
<b>Probability</b>	15% (-5%)	45%	40% (+5%)

### Short-term catalyzers

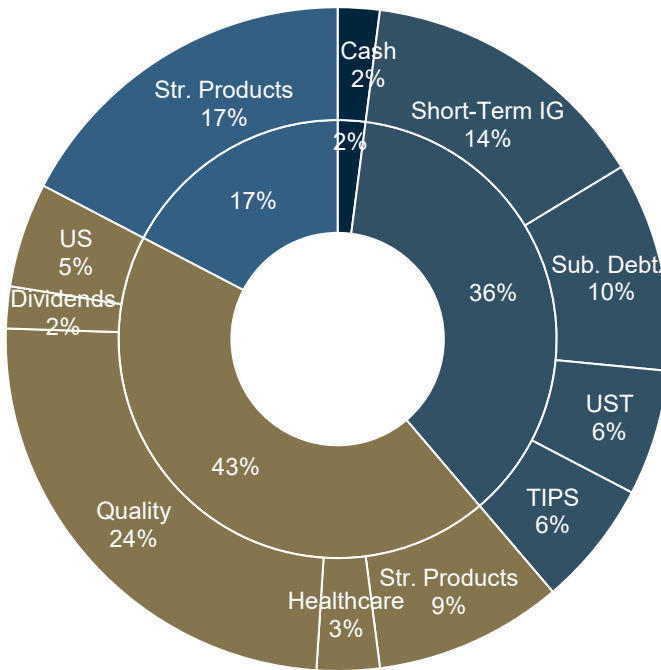
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

### Other risks

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

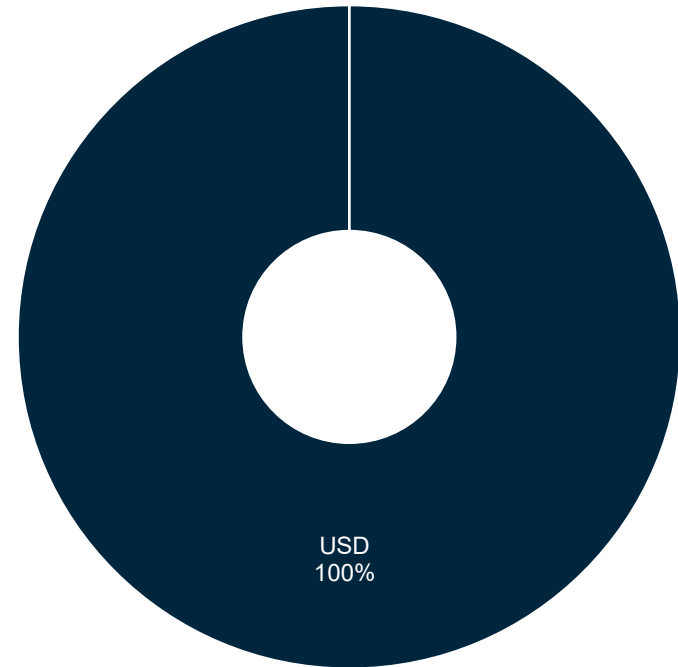
# Boreal Balanced Portfolio USD

## Asset Allocation



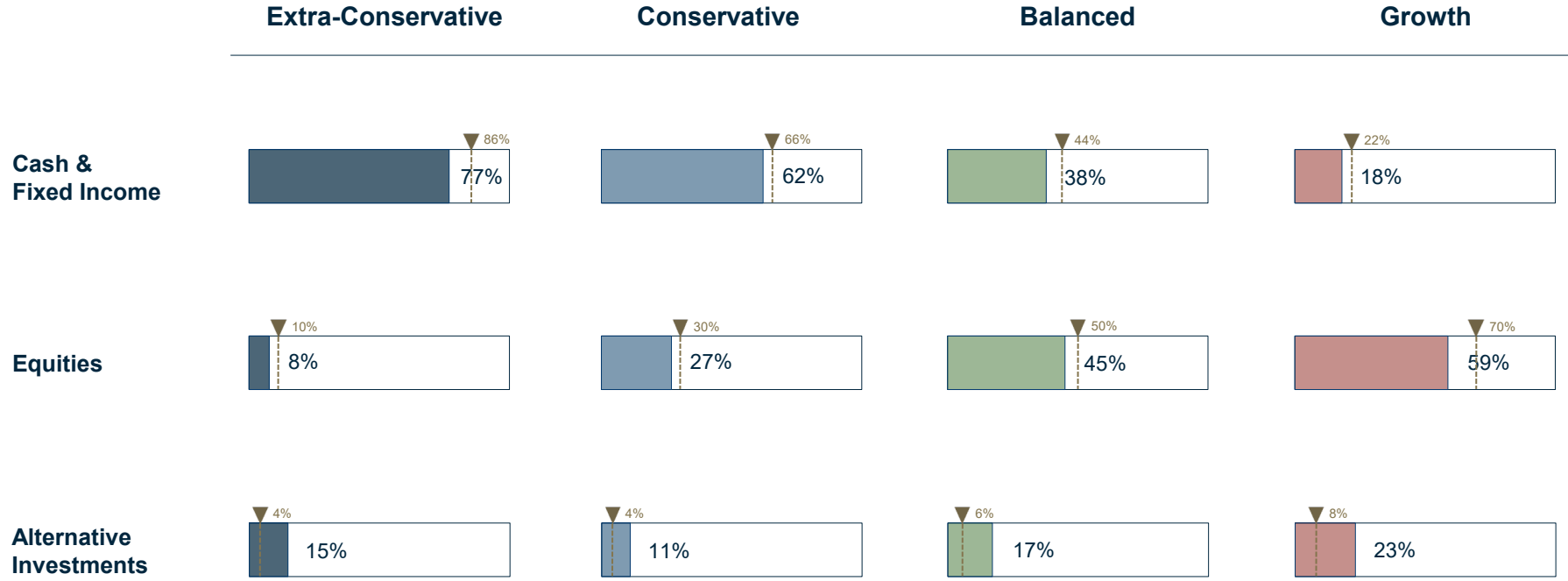
■ Cash 
 ■ Fixed Income 
 ■ Equity 
 ■ Alternative Inv.

## Currency Allocation



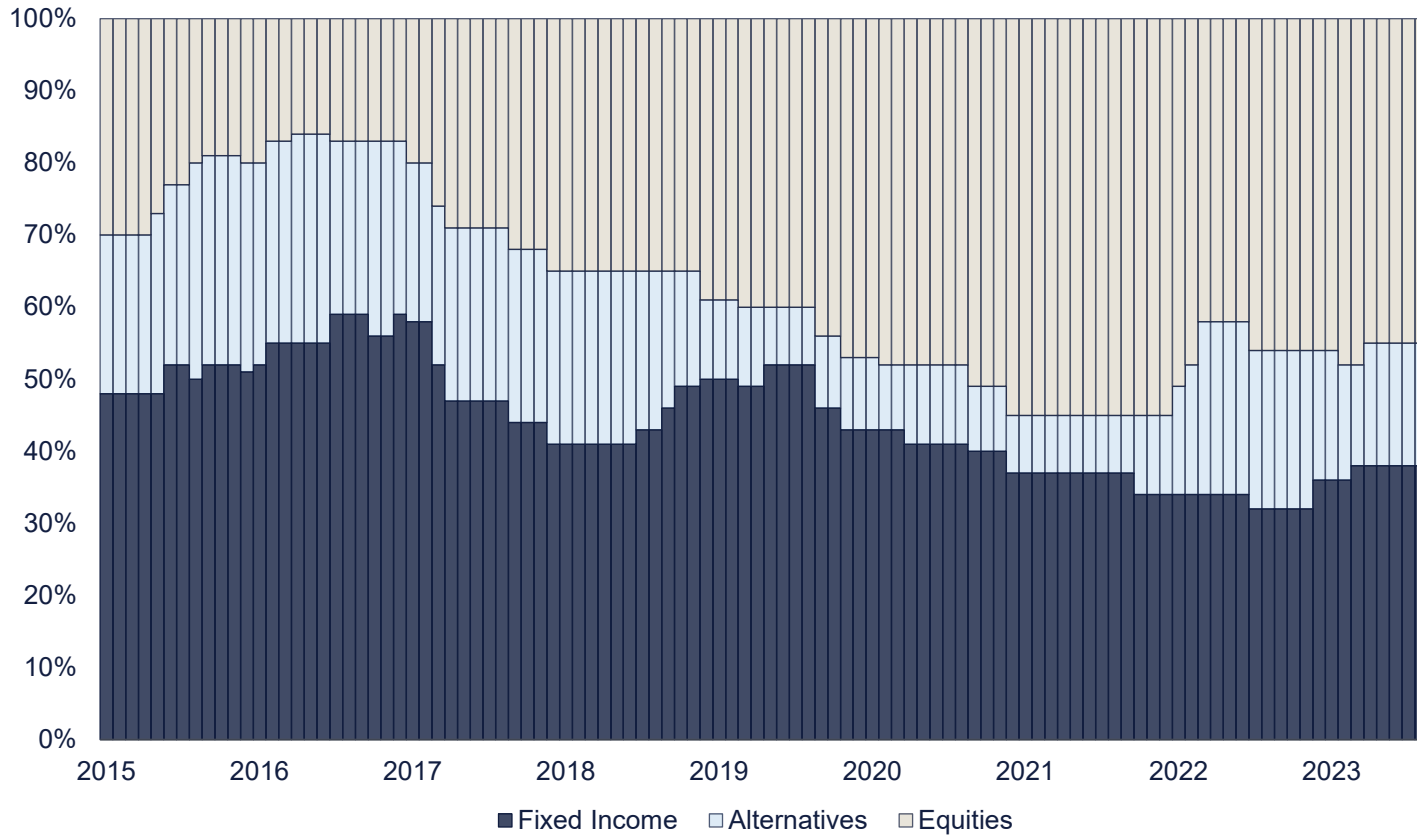
■ USD

# Boreal Investment Profiles



▼ Strategic Asset Allocation

# Boreal Balanced Portfolio – Asset Allocation evolution





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