Investment Policy

October 2023

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Our market view in a nutshell – October 2023

- The sharp rise in long-term interest rates, which has **shifted the yield curve by a full percentage point** since the summer, has eclipsed macroeconomic data. A move of this magnitude in a mere three months, without any major surprise in the economic data releases, is highly unusual and has left many **scrambling for explanations**.

- One take is that movements in the long end of the yield curve reflect a **more hawkish Fed** talk since the summer. However, this does not fully explain the magnitude of the move in long-term rates. Another interpretation is that investors have come to terms with a new reality of "higher for longer" interest rates, as a result of **higher expected trend growth and inflation**. However, it is unclear why growth should accelerate now. In other words, what has changed since the period of "secular stagnation" that followed the Great Financial Crisis?"

- The most mundane but also most plausible explanation for the rise is **supply/demand considerations**. The US government is running **a large fiscal deficit** that needs to be financed, and some of the regular buyers (the Fed, Japan, and China) are scaling back their holdings of US Treasuries.

- The **economic repercussions of this new interest rates regime are inextricably linked to its causes**. If rates are high because we are entering a new era of more robust economic growth, the risk of recession is not so high. This is what credit markets and equity markets seem to be discounting. However, if rates are higher because of government profligacy, a recession is more likely, and would be more severe since fiscal policy would be more constrained.

- The **implications for asset prices also vary widely depending on the cause of the rise**. If corporate earnings are set to accelerate due to a stronger economy, credit spreads and equity risk premiums are reasonable. However, if the economy stalls, earnings will fall. And when the Fed inevitably lowers interest rates, there is no guarantee that long-term interest rates will follow. A similar disjuncture threatens the real estate market, as mortgage rates have reached 8%, bringing homebuyer affordability to its lowest reading on record. Any meaningful increase in unemployment could set in motion a large correction in house prices, with knock-on effects on the economy.

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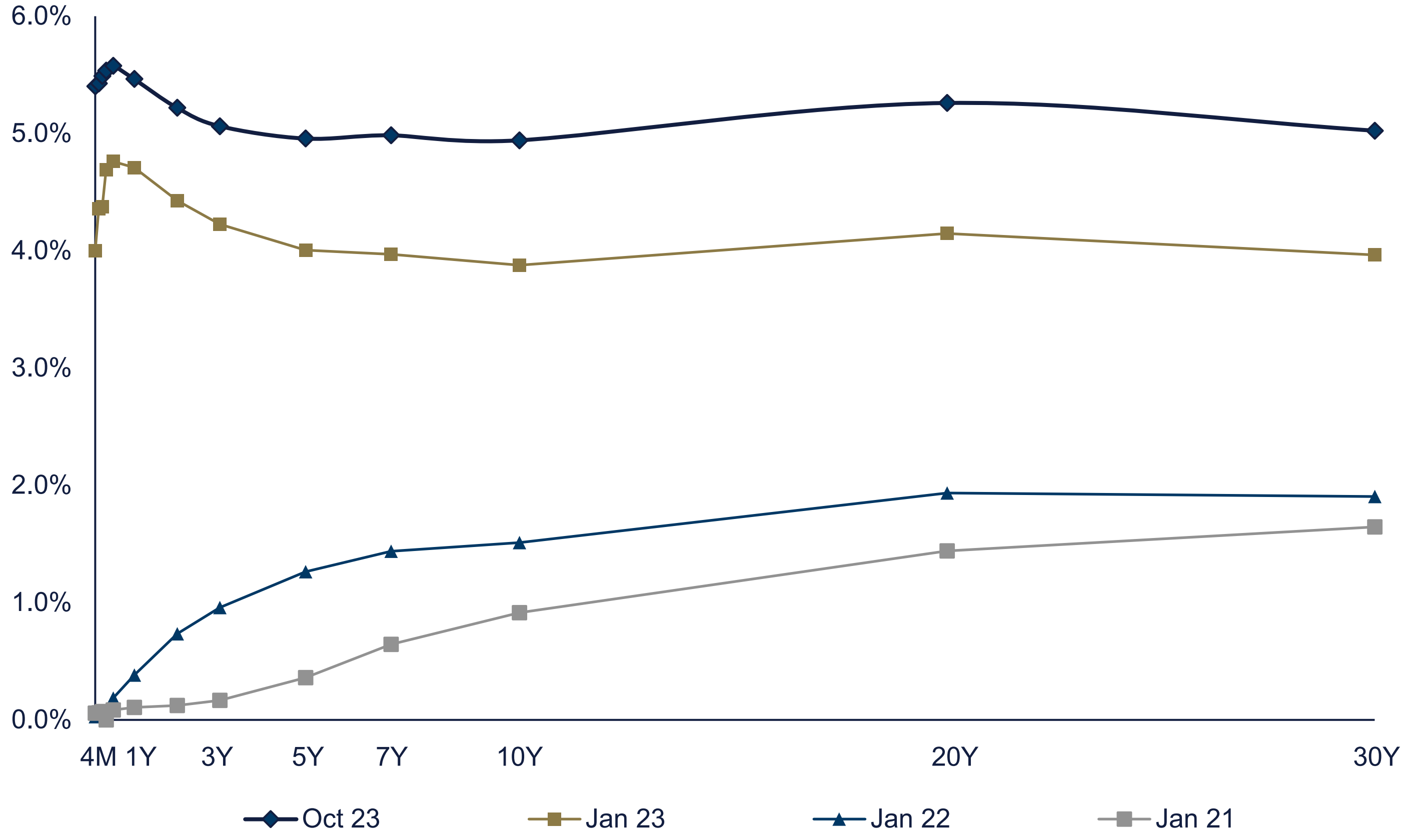
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	=	Higher probability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

Tectonic shift



- The **volatility in the US Treasury market** has overshadowed macroeconomic data.
- Long-term interest rates have reached **levels not seen since 2007**, prior to the Great Financial Crisis. While some factors contributing to this rise are known, the full explanation remains elusive.

Source: Bloomberg

First Hypothesis: Inflation and the Fed

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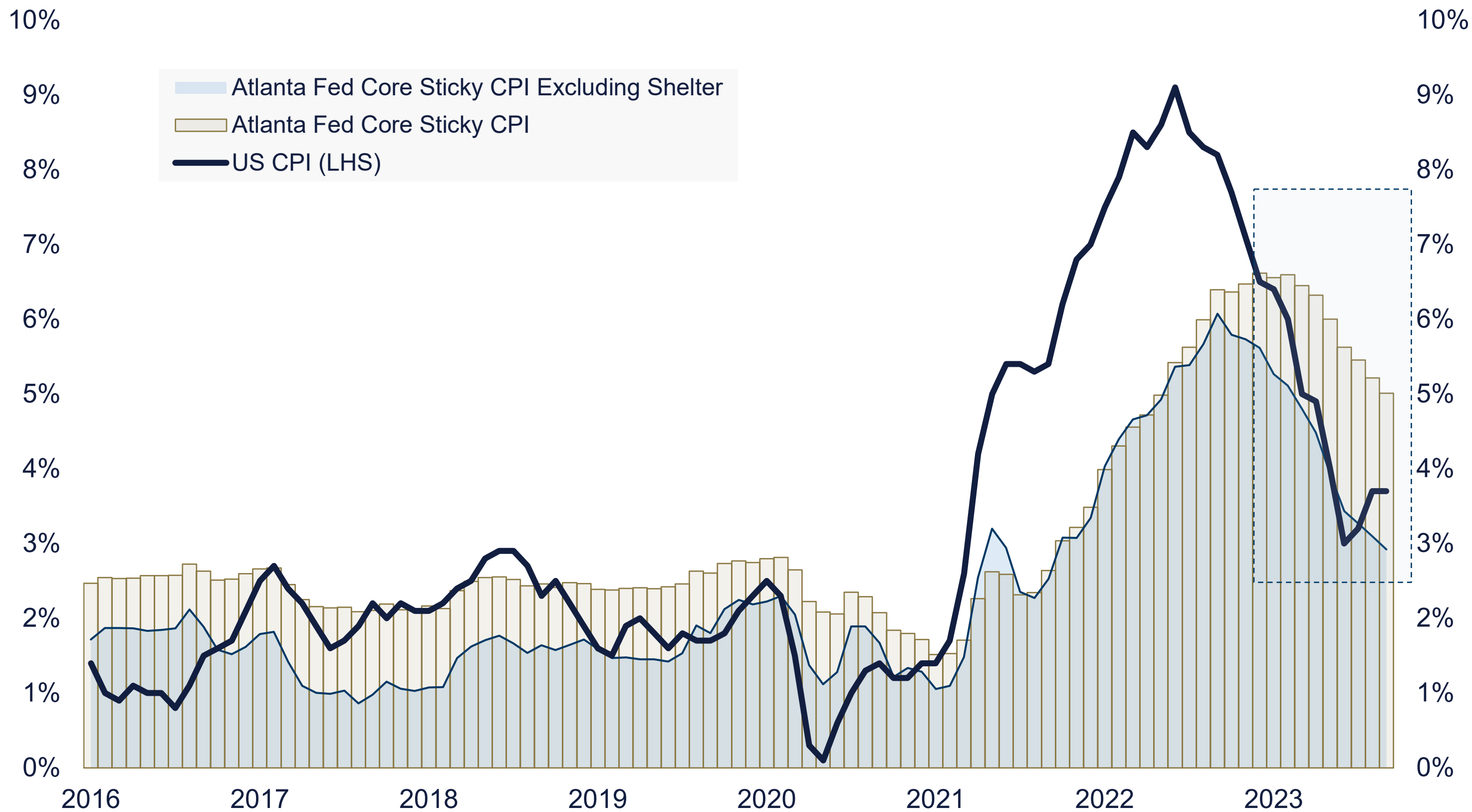
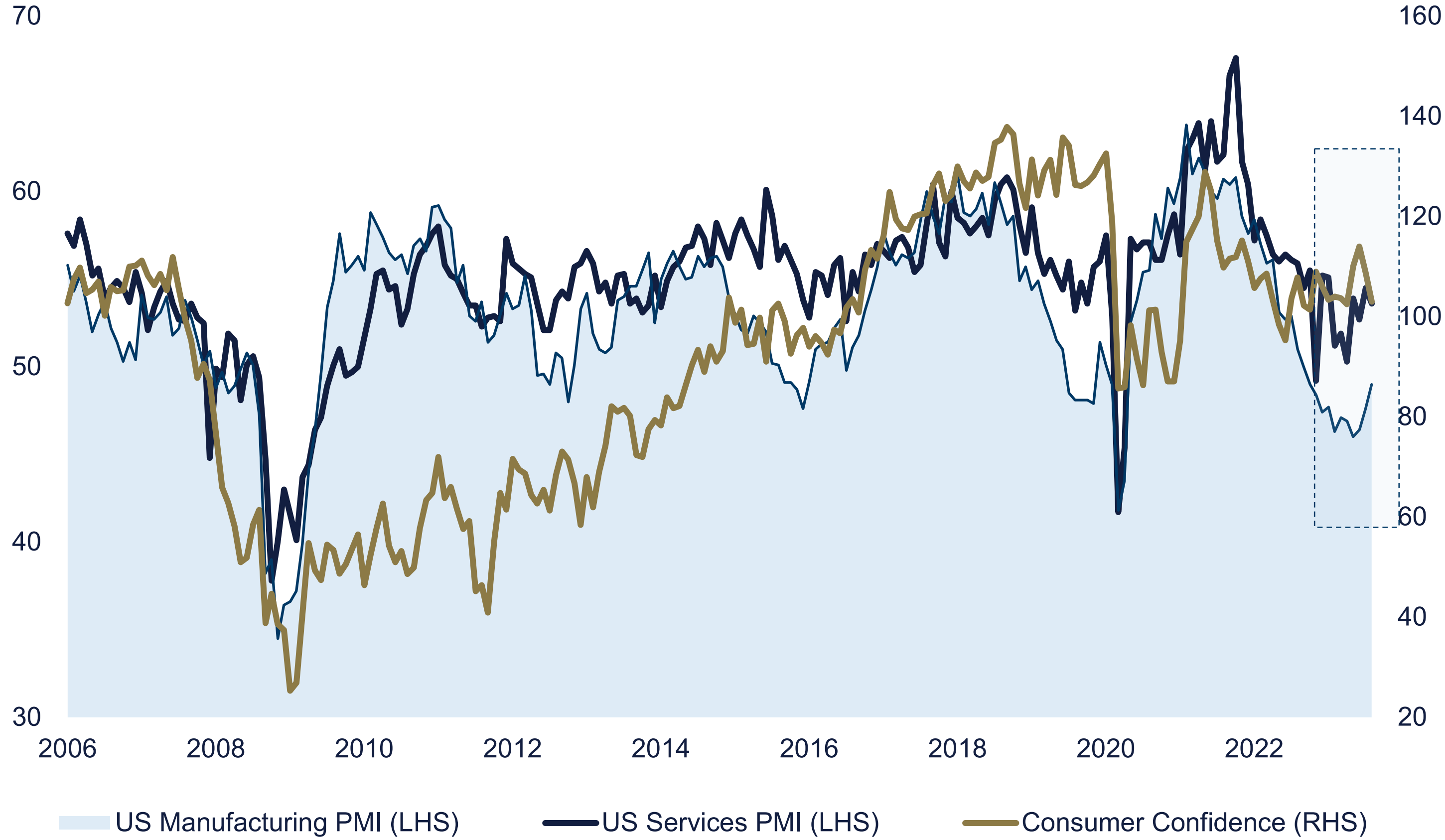


- While **inflation for September was slightly above expectations**, core inflation (excluding food and energy components) remained on a downward trend. The services sector is the primary driver of inflation, with **shelter inflation** being a particularly significant contributor
- The **resilience of the housing market** is likely a key **factor in the Fed's hawkish** stance.

Source: Bloomberg

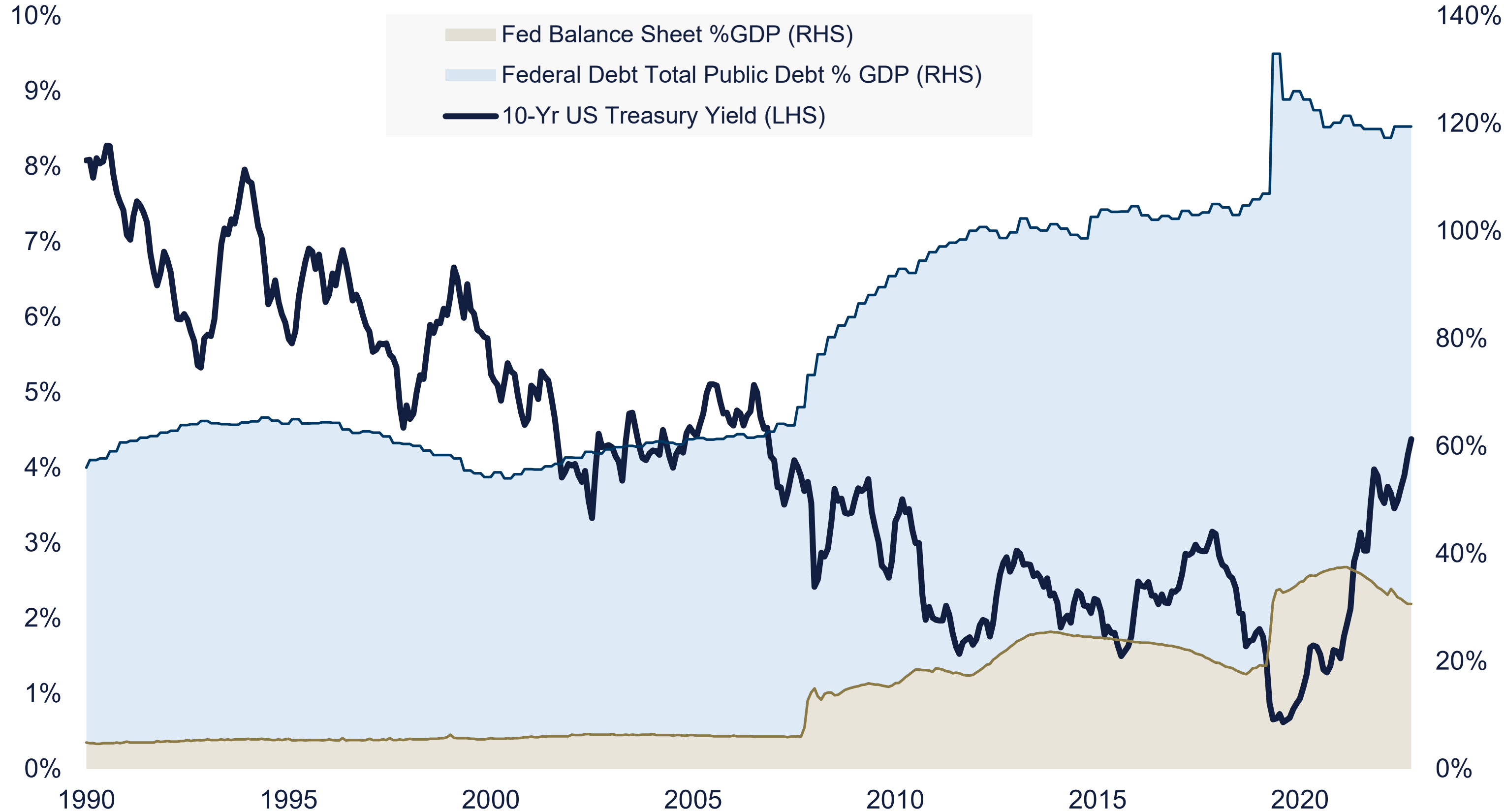
Second Hypothesis: A resilient economy



- The **resilience of the economy** in the face of tight monetary conditions has certainly surprised most analysts. Consumers have remained largely unaffected, continuing to support the service economy. Manufacturing is also now emerging from contraction territory.
- However, this resilience is **consistent with a "Soft Landing" scenario**, rather than a period of strong economic growth that would drive the natural (neutral) interest rate higher.

Source: Bloomberg

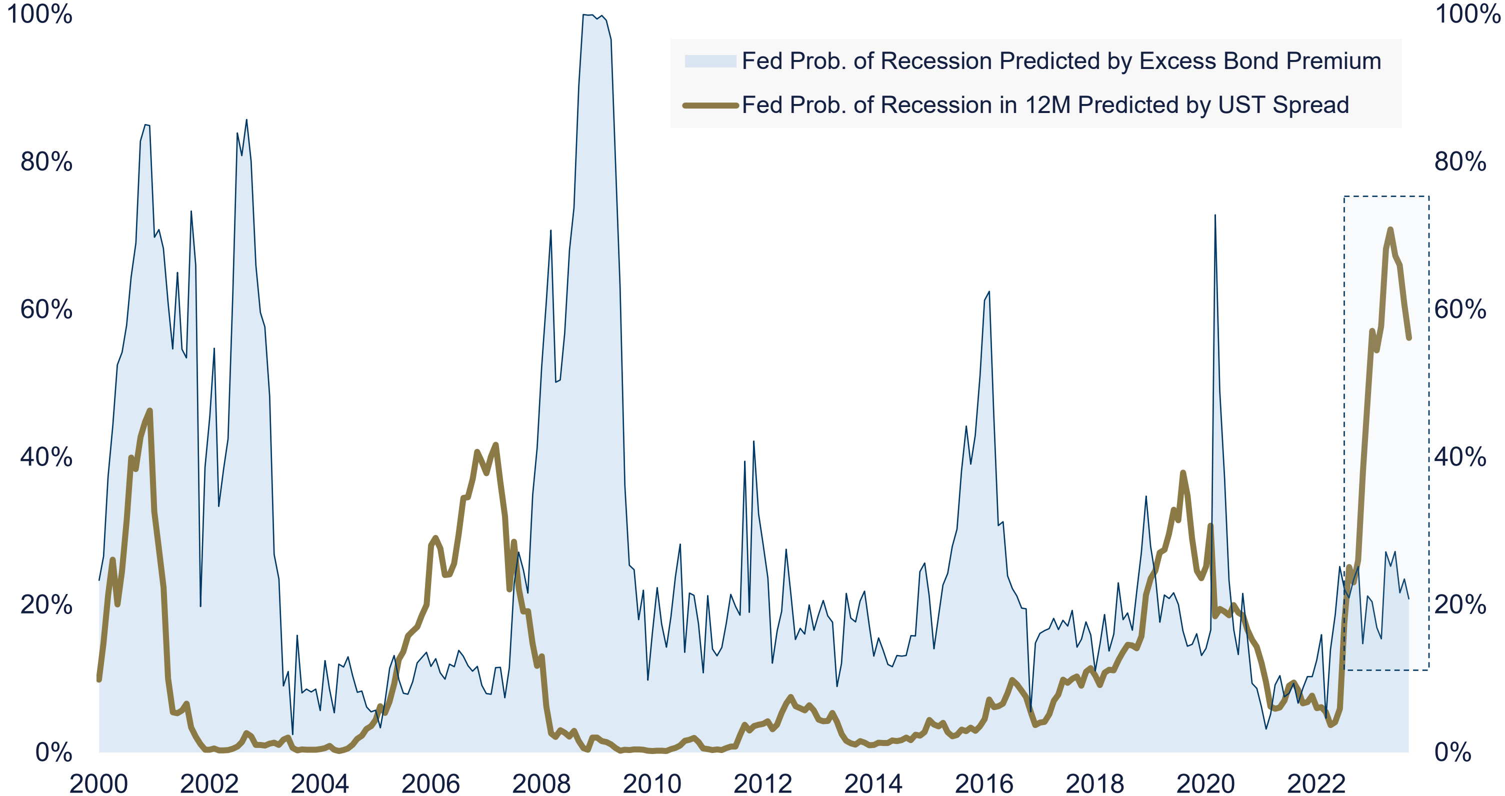
Third Hypothesis: Supply, Demand, and the Marginal Buyer



- The US government is running a **large fiscal deficit that needs to be financed**, and some regular buyers (**The Fed, Japan, China) are scaling back their holdings**.
- Besides economic logic, there is some evidence supporting this thesis since some of the **volatility in the Treasury market has happened around auction days**.

Source: Bloomberg

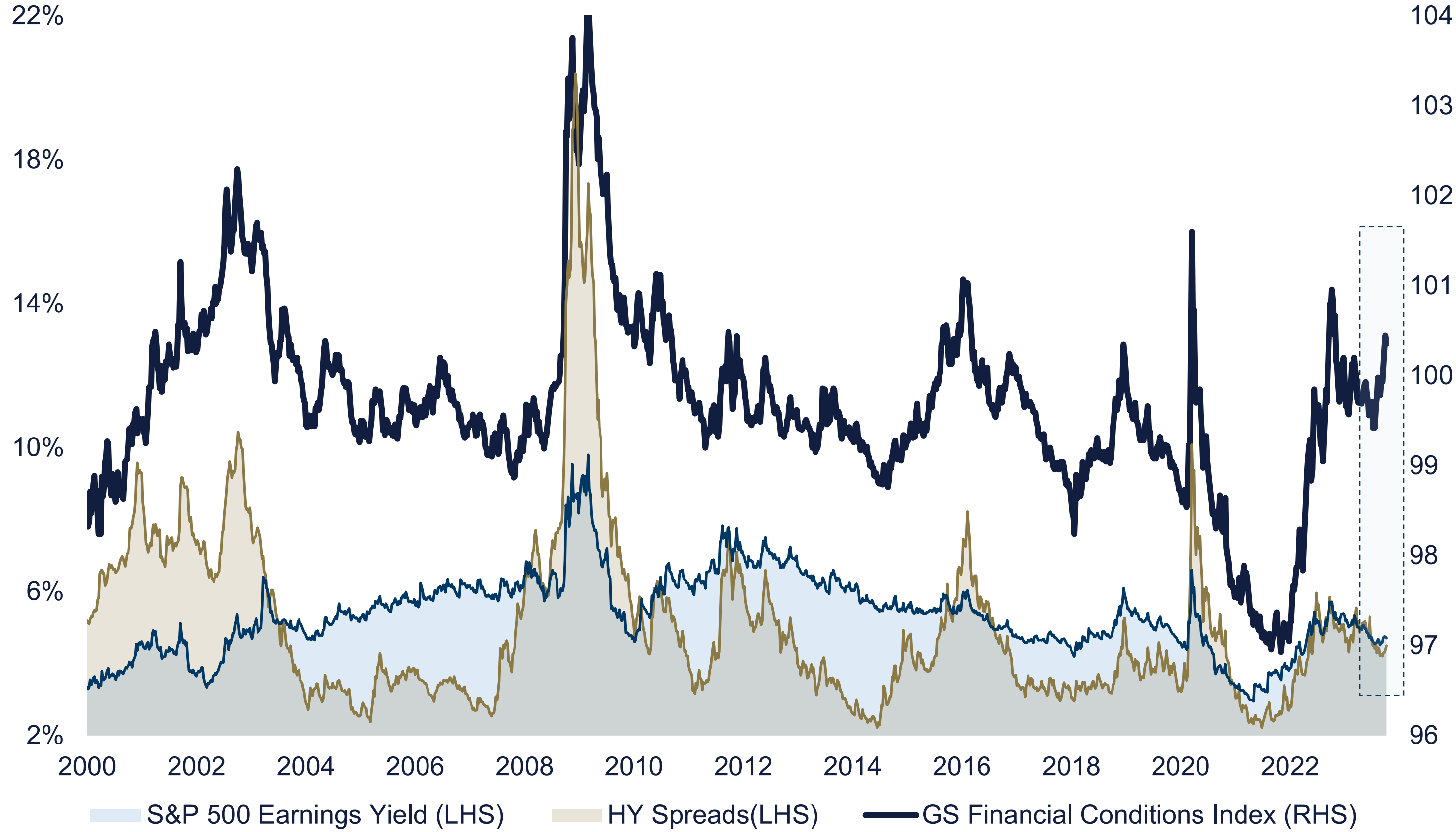
Pick your explanation



- **If rates are high because of a stronger economy, the risk of a recession should not be that elevated**. This is what credit markets seem to be pricing. The **yield curve is also now less inverted**, suggesting a lower probability of recession.
- However, if rates are driven by **"bond vigilantes"** demanding higher yields to finance the government deficit, we may be heading for a more precarious outcome. In this scenario, **a contraction in economic activity could occur without much room for maneuver for fiscal policy** to stimulate the economy.

Source: Bloomberg

Expectations impact outcomes



- Even though the yield curve has experienced a massive shift, **financial conditions have tightened only to a limited degree**.
- This is because **equity and bond risk premiums remain relatively low**, partially offsetting the increase in interest rates. Additionally, the **US dollar has appreciated only moderately**, as most central banks have followed the Fed's lead in raising interest rates.

Source: Bloomberg

Or are we living on borrowed time?

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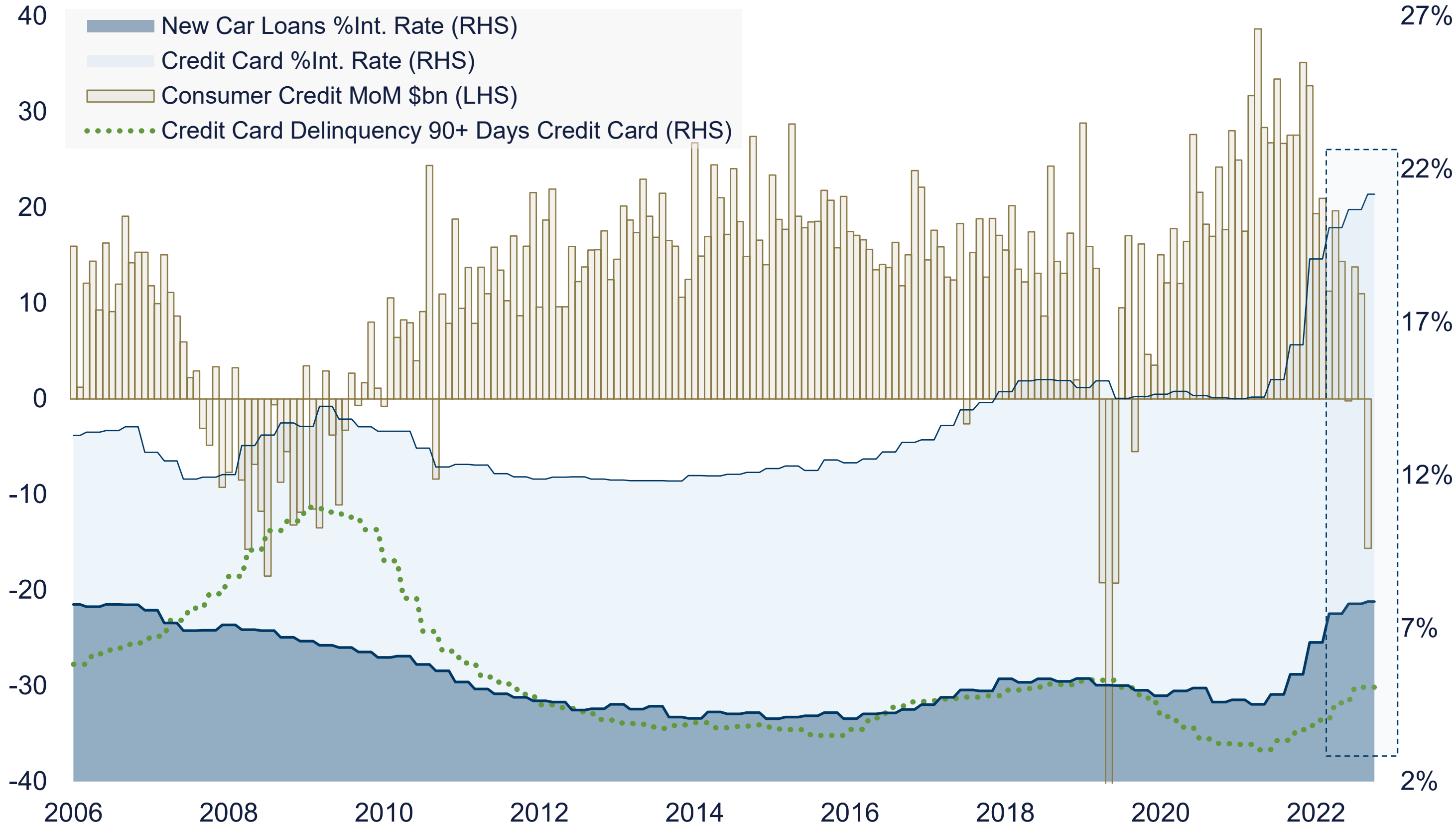
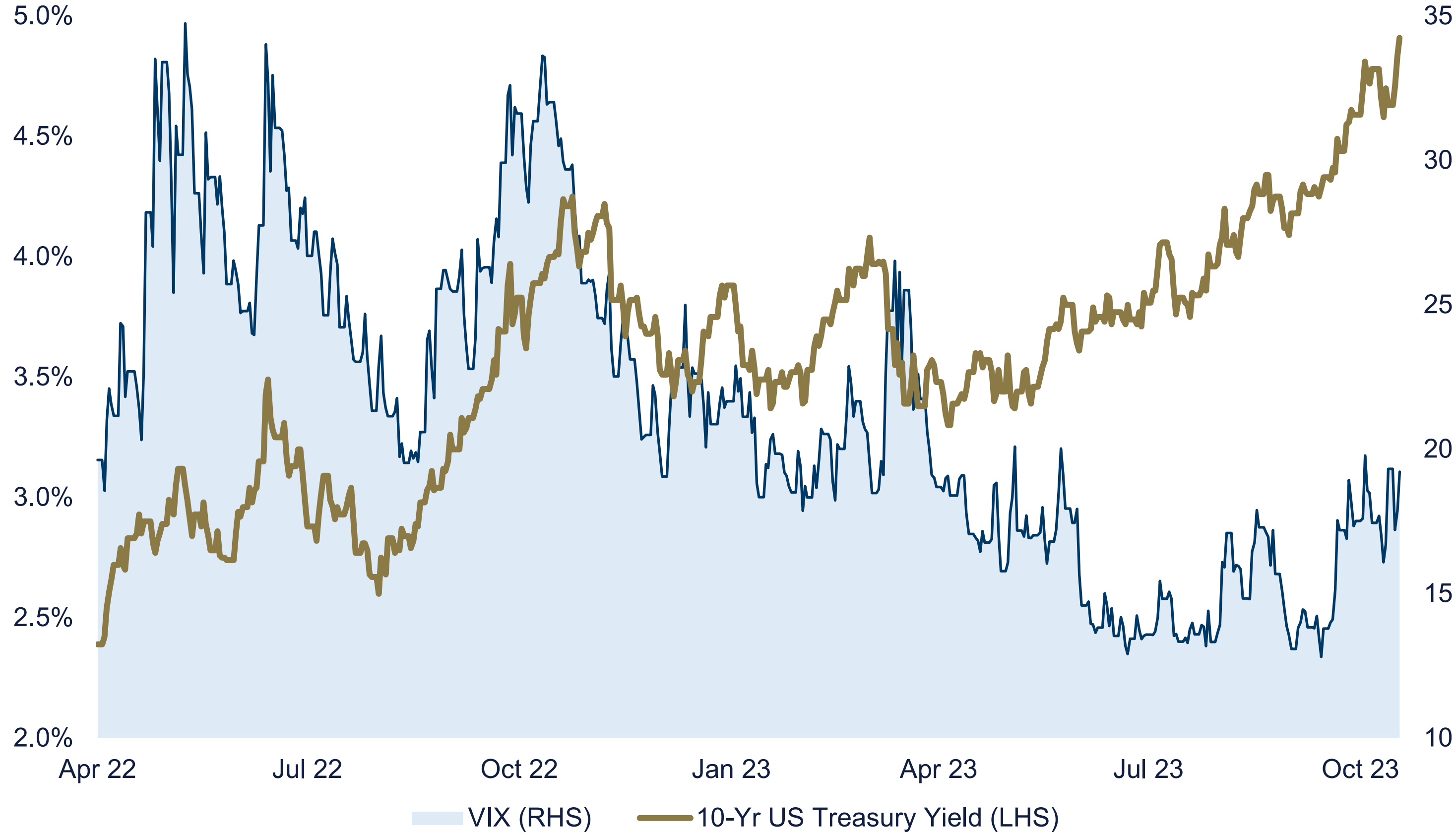


- Rates for mortgages and auto loans are approaching 8%. Savings rates remain very low. **Consumer credit is showing the first signs of contraction**, and delinquencies are starting to rise
- Furthermore, **financing costs are increasing for corporations** as they need to refinance debt issued at much lower interest rates.

Source: Bloomberg

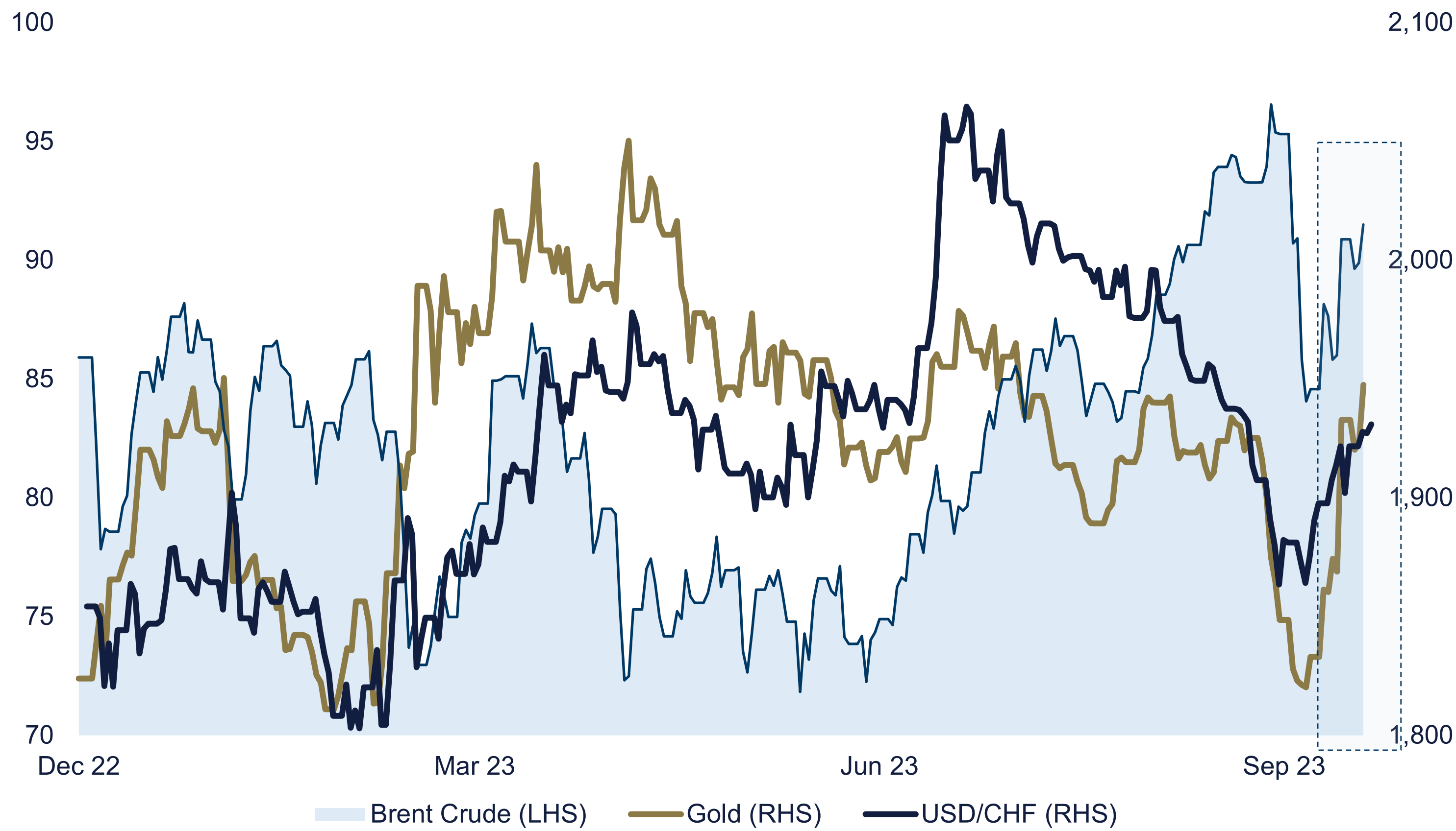
Equity markets remain surprisingly calm



- Equity markets have been **resilient in the face of a barrage of challenges**, including Fed hikes, geopolitical turmoil, and worsening valuations. However, as interest rates continue to rise, **the risk of a larger correction increases**, particularly if earnings disappoint

Source: Bloomberg

Geopolitical risks on the rise, but contained



- The **conflict in the Middle East adds to geopolitical tensions** already heightened by the ongoing war in Ukraine. In both cases, there is a risk of escalation that could disrupt financial markets, particularly through energy markets. However, **containment currently appears to be the most likely scenario**.

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	15%	45%	40%

Short-term catalyzers

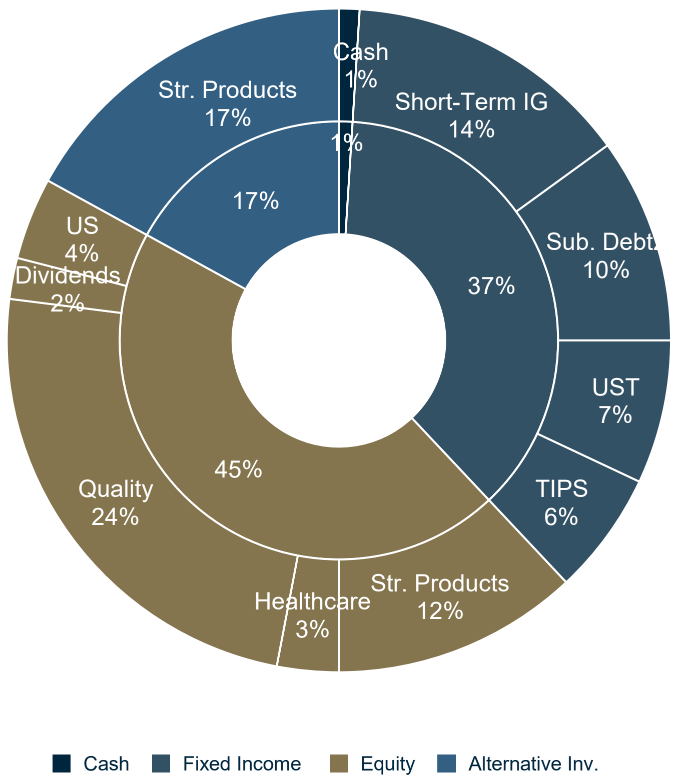
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems ease

Other risks

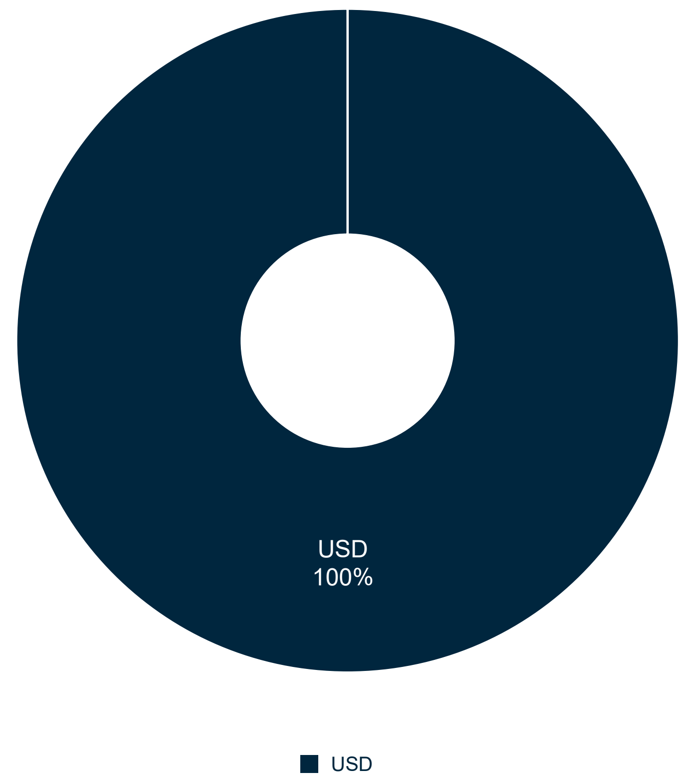
Debt ceiling, Banking crisis, Escalation of geopolitical tensions, China slowdown, Housing market correction

Boreal Balanced Portfolio USD

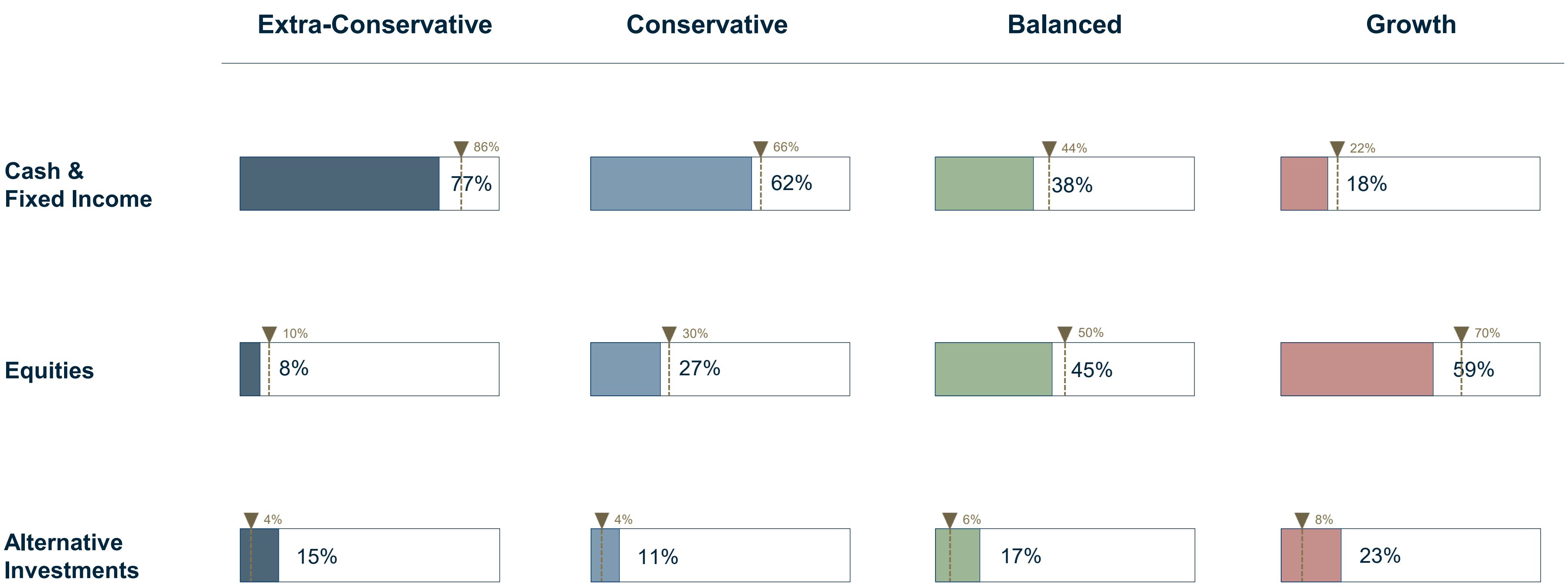
Asset Allocation



Currency Allocation

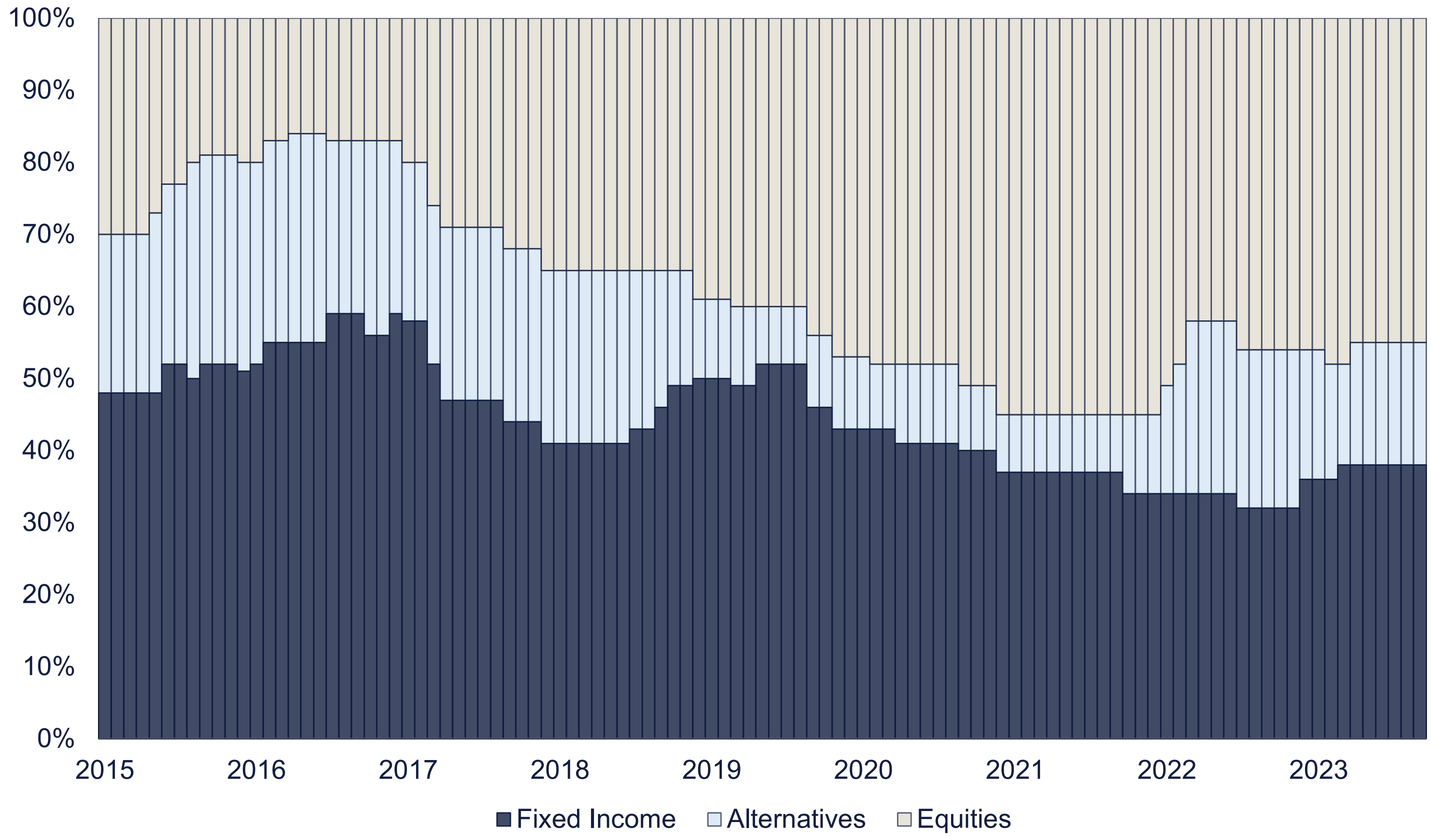


Boreal Investment Profiles



▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution



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