Investment Policy

January 2024

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Our market view in a nutshell – January 2024

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- The Fed often achieves more by talking than by doing. **By signaling potential rate cuts, it has significantly brightened the macroeconomic outlook**. The economy avoided a recession last year, in part thanks to the continued strength of the consumer. Additionally, businesses, despite sluggish profit growth, have been hesitant to lay off staff, wary of not being able to quickly replace them in an upswing. The Fed's pivot towards a more accommodative stance reinforces this positive feedback loop, further shoring up consumer and business confidence.

- Though the Fed's pivot towards a more accommodative policy bolstered markets at year-end, the new year immediately delivered a **reality check. December inflation data was higher than expected**, highlighting the ongoing struggle against rising prices. Housing costs, a key component of services inflation, remain stubbornly above the Fed's target. Further complicating matters, **wage growth, though moderating, remains elevated**, posing a risk of renewed inflationary pressures.

- The "soft landing" scenario hinges on a **crucial element: timing**. The full impact of recent interest rate hikes is yet to be fully realized, particularly considering the anticipated rise in refinancing activity. **Real interest rates have reached highly restrictive levels**, compounding the **prolonged weakness already evident in many economic sectors**. Even if the Fed acted sooner than expected to support growth, the ability to implement rate cuts will ultimately depend on the trajectory of inflation. If the latter proves persistent, any rate cuts may arrive too late to avert a downturn.

- **Equity markets also share the improved outlook**. While valuations remain elevated, declining interest rates are likely to drive **multiple expansion**. More significantly, a business cycle reacceleration could create a visible **path for corporate earnings growth**, extending beyond the recent focus on big tech and the potential of AI. **For bonds, the new environment is unequivocally positive**. Yield levels are very attractive, and potential rate cuts offer the additional benefit of capital gains.

- With the pandemic's macroeconomic volatility receding, a long-term perspective necessitates a **less defensive investment approach,** prompting us to **gradually adjust equity and credit allocations closer to neutral levels**. However, ongoing **geopolitical tensions** and the upcoming **US presidential elections** present near-term challenges that could derail markets.

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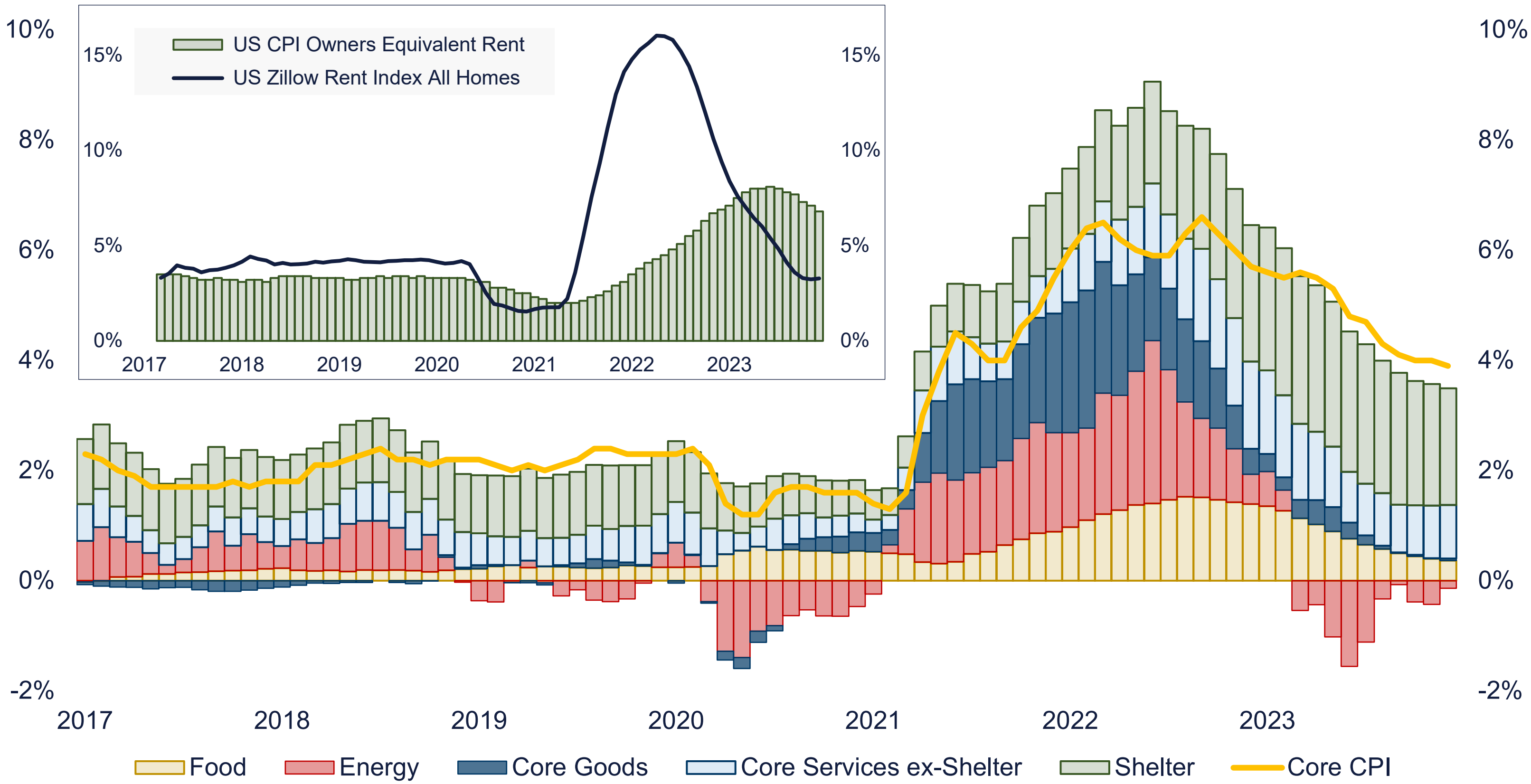
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	+	The Fed's recent shift in policy has reduced the likelihood of a recession. While credit spreads have narrowed, they remain attractive as the default rate is anticipated to stay low
	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	=	Prospects for European credit have improved since it is expected that the ECB will follow the Fed in lowering rates. However, the European economy remains more vulnerable to a downturn
	Emerging Markets	=	The prospect of a weaker dollar spurred by the Fed's interest rate cuts has marginally enhanced the appeal of emerging market debt
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

Reality check



- Following the Fed's unexpected dovish shift, **disappointing inflation figures** served as a stark reminder to investors that the final leg of the normalization process could be more arduous than anticipated, hampered by **sticky services inflation**.
- Housing cost adjustments are expected to eventually contribute to curbing inflation. However, this process could be disrupted if the **prospect of lower interest rates fuels a still overheated housing market**.

Source: Bloomberg

Risk of “third-round” effects

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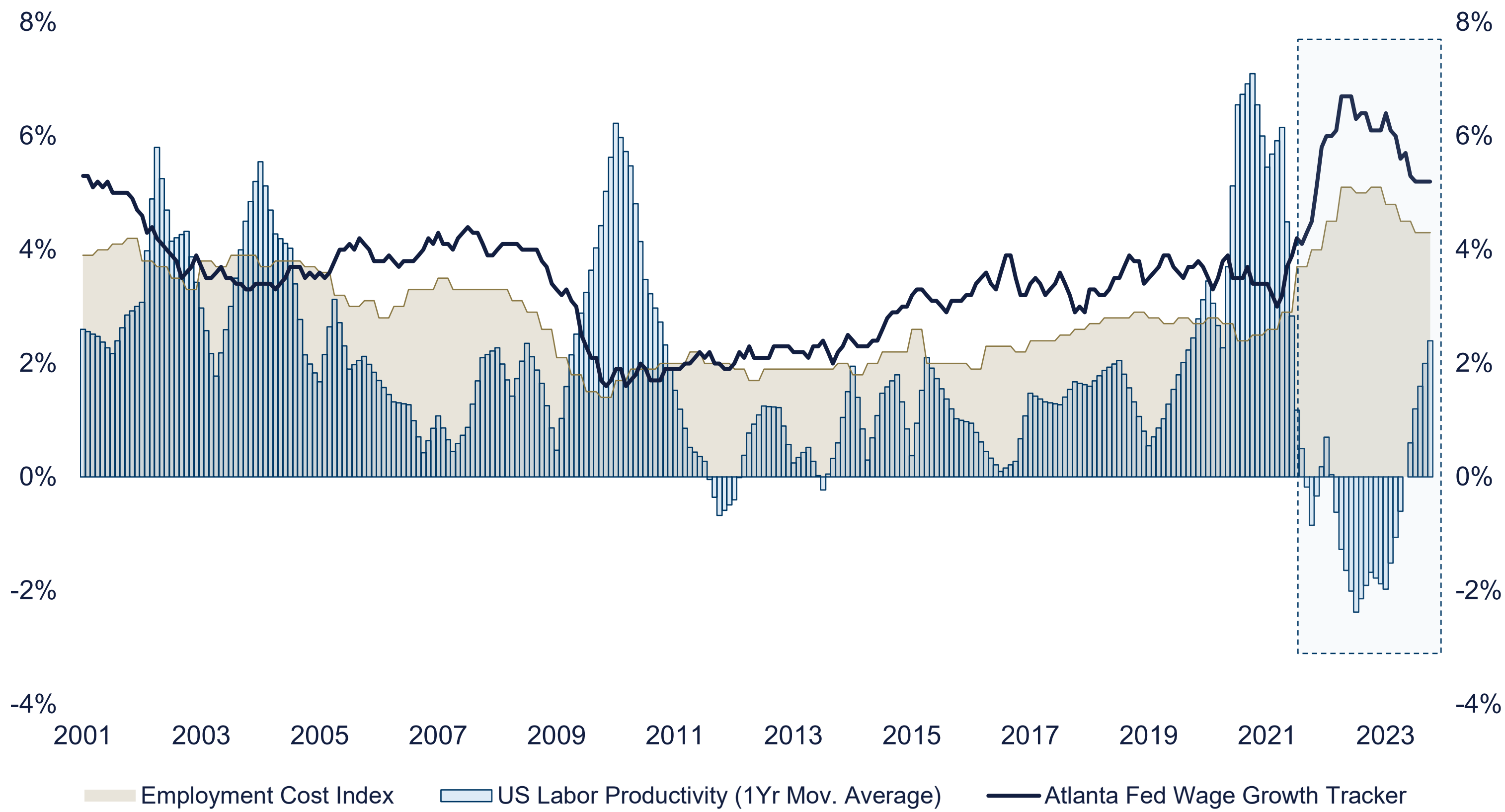
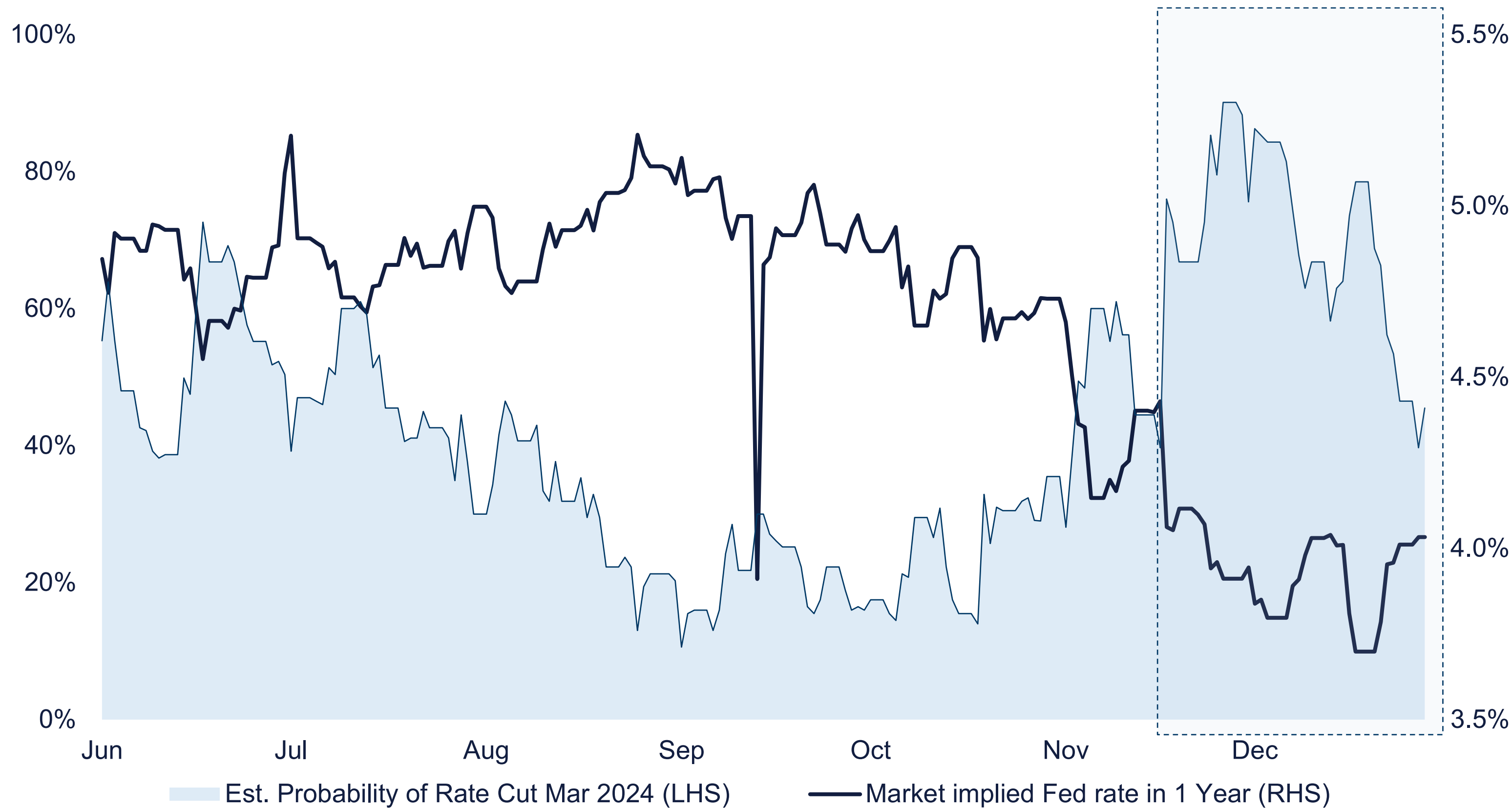


- Inflation became entrenched when it persisted long enough to translate into wage increases, triggering what economists call **"second-round effects“**.
- The Fed's decisive action prevented inflation from spiraling out of control. However, **the early pivot,** combined with wage inflation significantly exceeding productivity gains and an unemployment rate near historic lows, **risks a "third round“**.

Source: Bloomberg

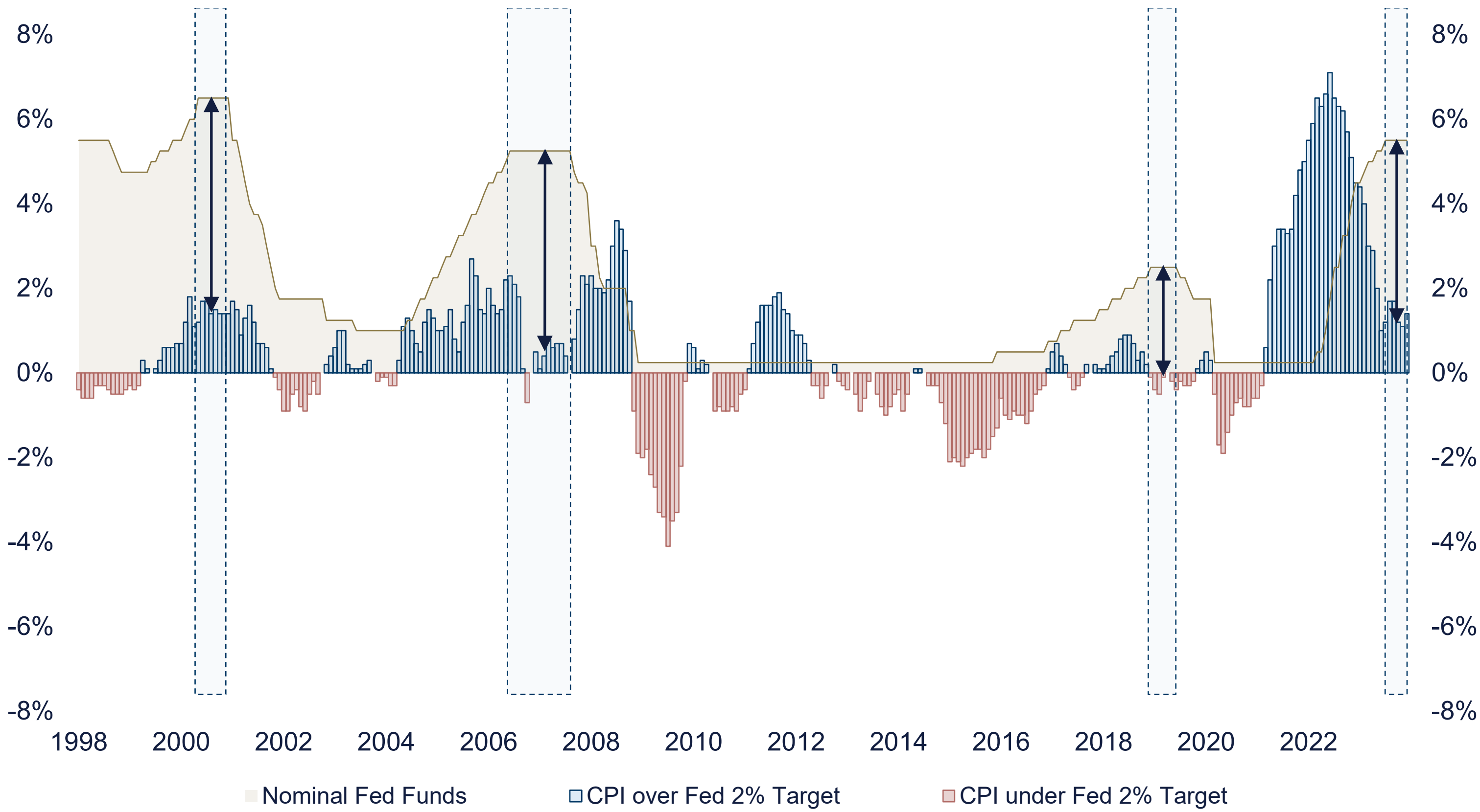
The genie is out of the bottle



- Following the December FOMC meeting, **nearly all Fed members have sought to modulate the message**, attempting to rein in market expectations that may have gotten ahead of themselves.
- However, the market has already reacted. While initial expectations for the first interest rate cut have been tempered, **markets still anticipate more than four cuts by the end of the year**.

Source: Bloomberg

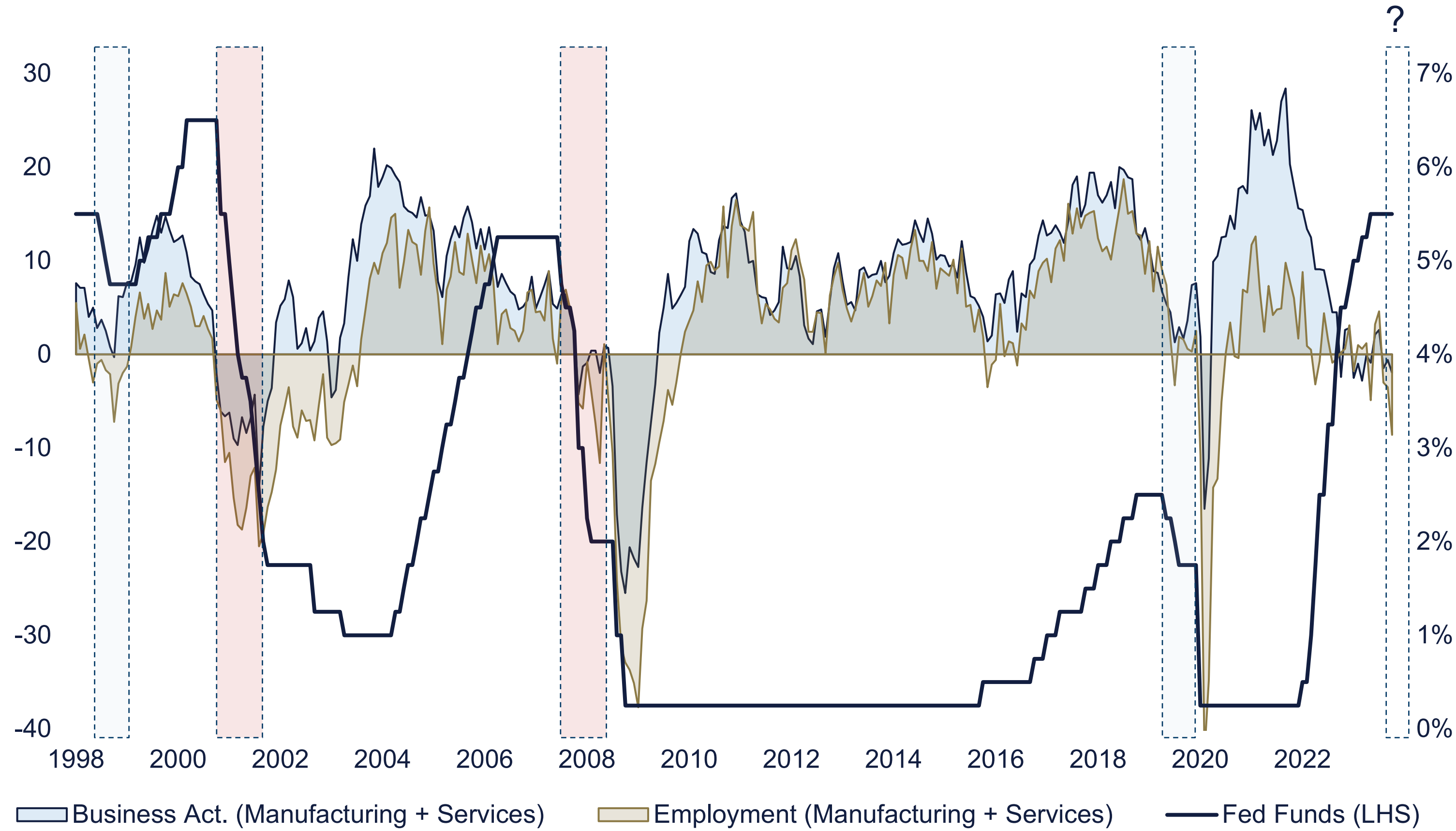
Risk of tightening in excess



- The primary argument for initiating rate cuts before inflation reaches the 2% target hinges on the current, **highly restrictive real interest rates**.
- With inflation having declined significantly, maintaining current rates effectively translates to a form of **"passive tightening“**, which could unnecessarily stifle economic growth.

Source: Bloomberg

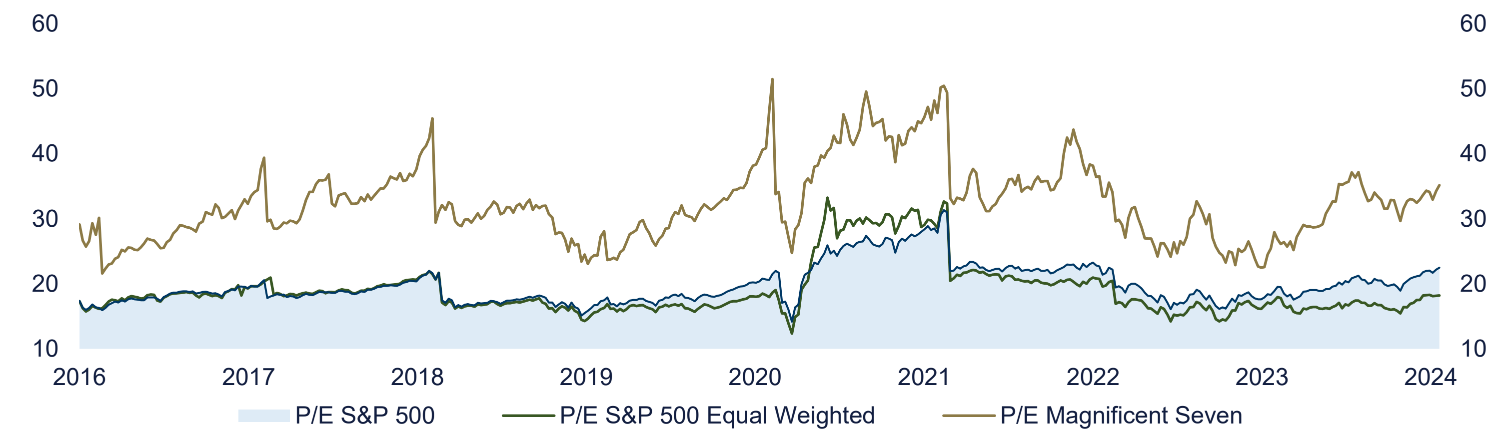
Will the trend reverse?

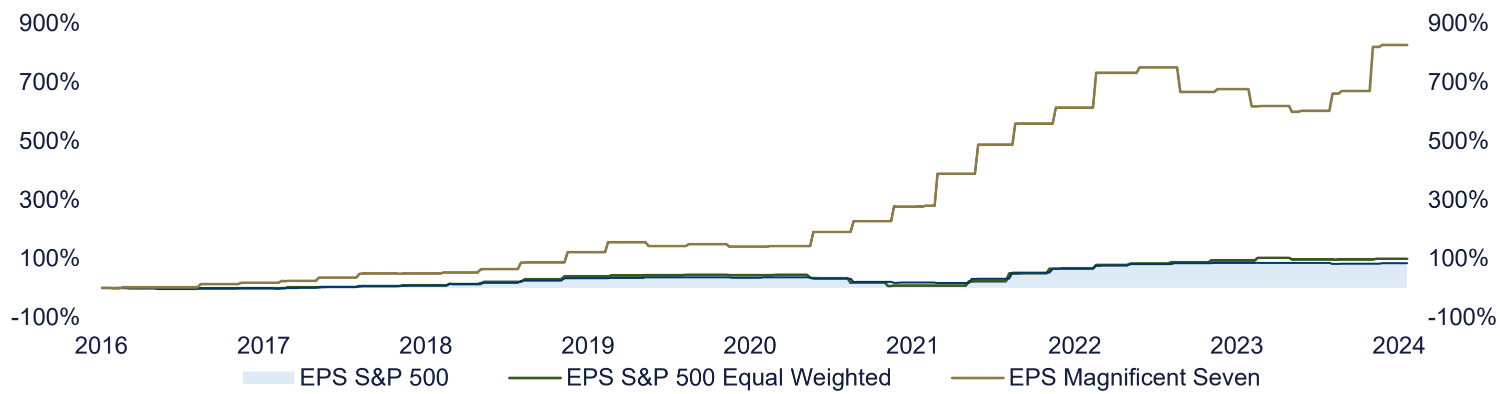


- For months, **leading indicators have signaled a slowdown in business activity**, which is now evident in the manufacturing sector. Service sector prospects are also deteriorating, particularly in terms of employment.
- However, it's **premature to gauge the full effect of the Fed's policy shift on sentiment surveys**. Turnarounds similar to those observed in 1998 and 2018 remain distinct possibilities.

Source: Bloomberg

A new look to valuations

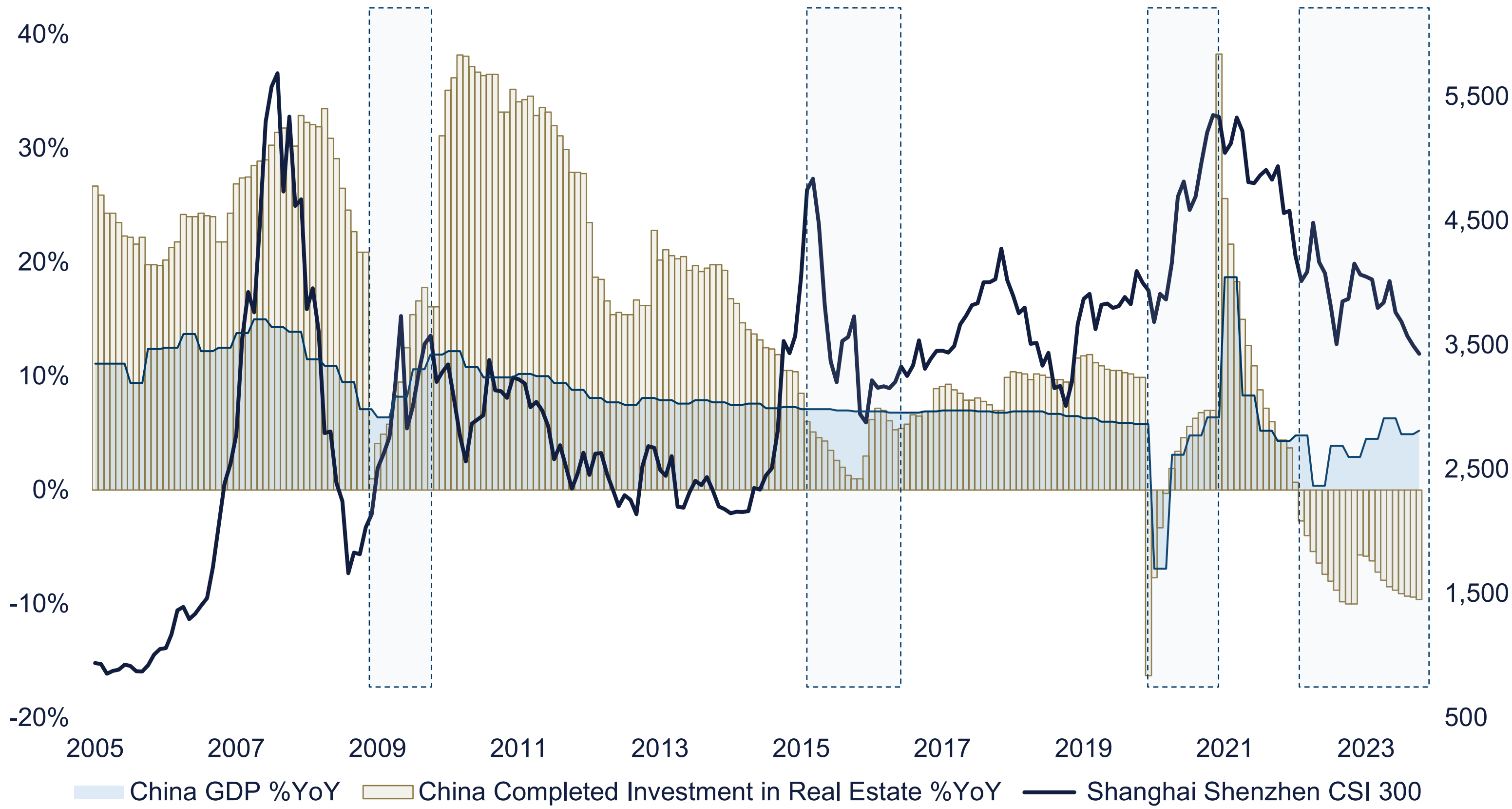




- **Equity valuations require reassessment** given the brighter macroeconomic outlook. Although current valuations remain high, declining interest rates are likely to fuel **multiple expansion**.
- Furthermore, a pick-up in economic activity should translate into **corporate earnings growth**, potentially broadening the market's focus beyond the recent dominance of big tech and the potential of AI.

Source: Bloomberg

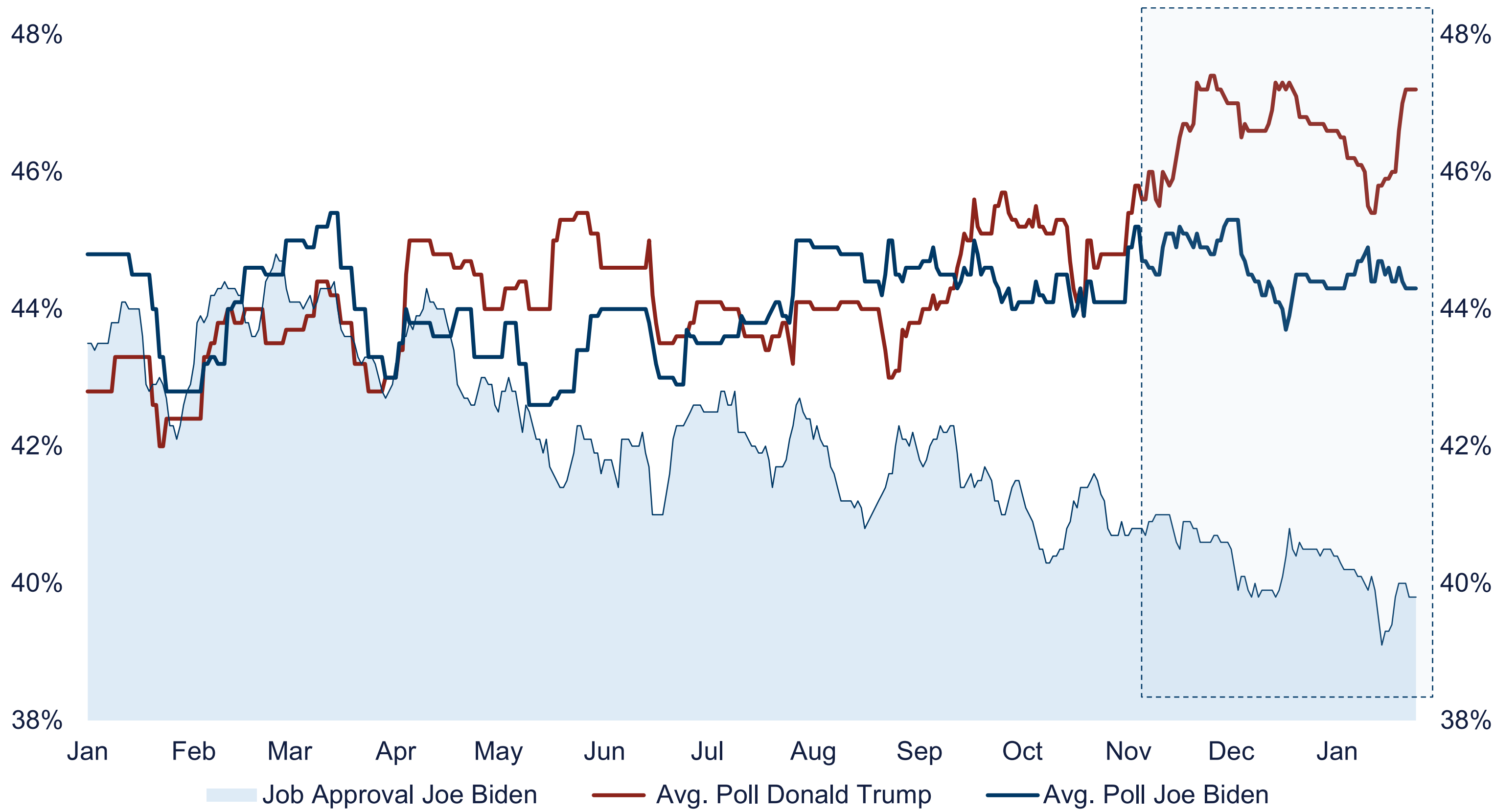
Lagging behind



- The **optimistic outlook for the US economy is not mirrored globally**. While Europe is expected to follow a similar trajectory, with central banks likely cutting rates in line with the Fed, China is experiencing a more challenging path to economic recovery after the pandemic.
- **The real estate sector remains a significant drag on the Chinese economy**, impacting consumer spending and posing potential risks of contagion to the banking sector.

Source: Bloomberg

"Known quantity"



- The US presidential election has the **potential to be a major source of volatility**. It is still too early for markets to react to them given that already at the beginning of the process it is becoming clear who the two candidates will be.
- If there is a Biden-Trump rematch, both candidates will be a **"known quantity" from an economic policy perspective**, with foreign policy being the issue that could prove most contentious.

Source: Bloomberg

Investment scenarios

	Scenario 1 Policy Mistake	**Scenario 2** “Boiling Frog”	**Scenario 3** “Soft landing”
Drivers	• Sticky inflation persists amid a hot labor market and resilient housing prices, with core services inflation defying the Fed´s 2% target • The Fed must reverse course and implement further tightening, keeping interest rates elevated for longer • Macroeconomic uncertainty and market volatility increase. Long-term interest rates pick up again along with inflation expectations	• Consumption, which has barely budged despite the sharp increase in borrowing costs, finally adjusts • Firms, which in the face of a tight labor market have been reluctant to lay off workers despite higher costs and sluggish profitability, begin to restructure • In order to help the economy, the Fed is forced to loosen monetary policy aggressively, but it is too late to prevent the economy falling into recession	• Fiscal policy remains accommodative, and the economy continues to grow, avoiding a recession • The Fed pauses rate hikes and eases policy. Inflation continues normalizing without the economy slowing down significantly • The yield curve steepens, credit spreads narrow further, and corporate earnings resume growth. It is the beginning of a new economic cycle
Market impact	• Corporate profits rise if inflation is caused by strong economic growth, 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 appreciates against safe-haven currencies as long as the economy remains strong. Gold gains as inflation expectations get de-anchored	• Equity markets fall, and cyclicals underperform quality and defensive stocks • Credit spreads widen sharply as the prospect of corporate defaults looms • Sovereign debt appreciates due to "flight to quality“ and lower interest rates. Commodity prices will fall. • The US dollar will depreciate if the Fed leads the way cutting interest rates and / or if the economic slowdown is not a global phenomenon. Otherwise, "flight to quality“ will support the US dollar	• Equity markets rally, as the economy returns to the “Goldilocks”, and valuation multiples widen • Credit spreads tighten further as investors chase yield again • High-quality and sovereign debt trade range-bound • Commodity prices stabilize. The fate of the US dollar is determined by growth differentials and real interest rate differentials
Probability	20%	30%	50%

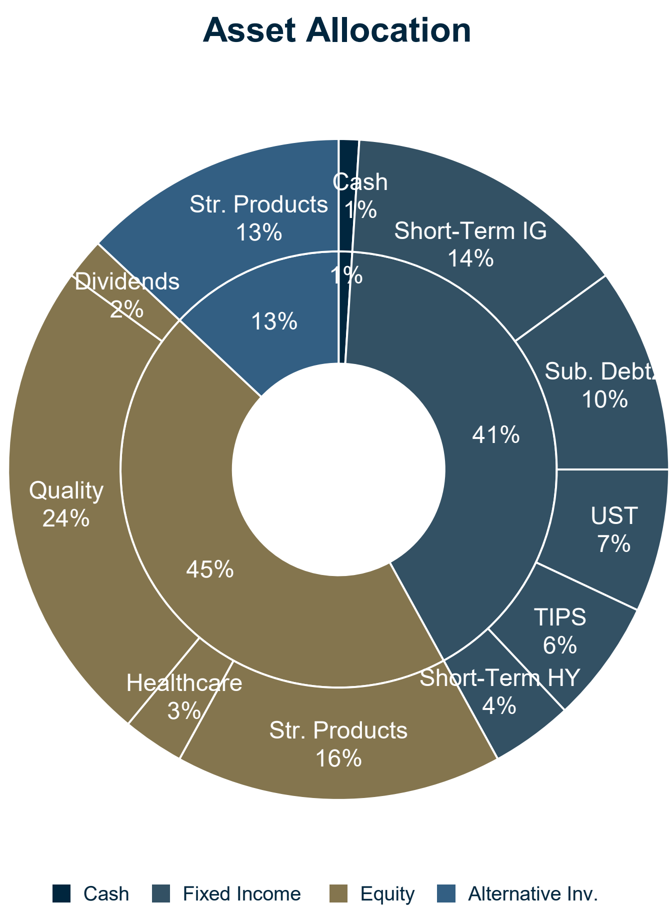
Short-term catalyzers

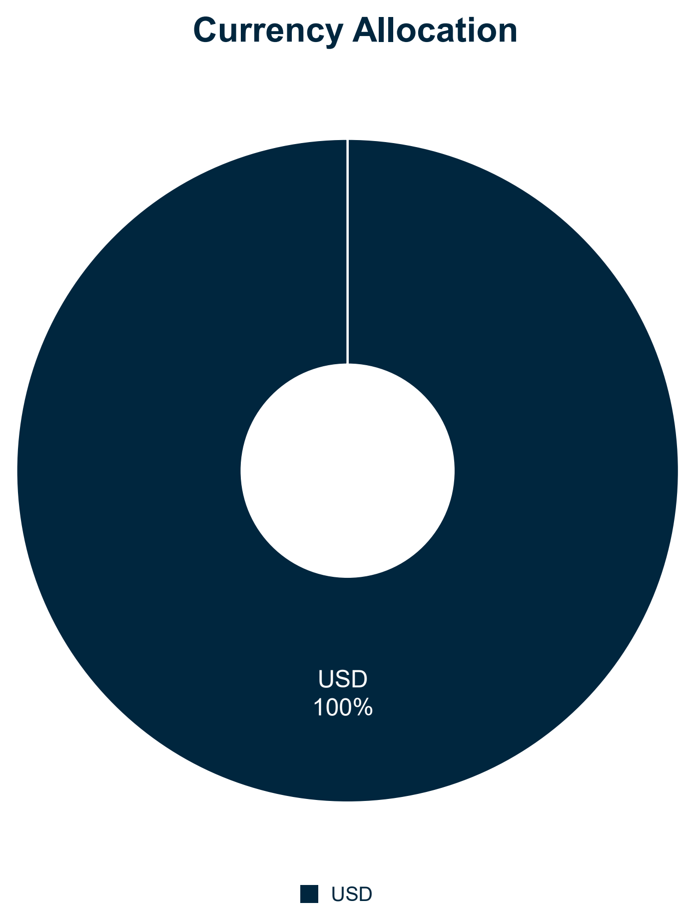
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems continue to ease

Other risks

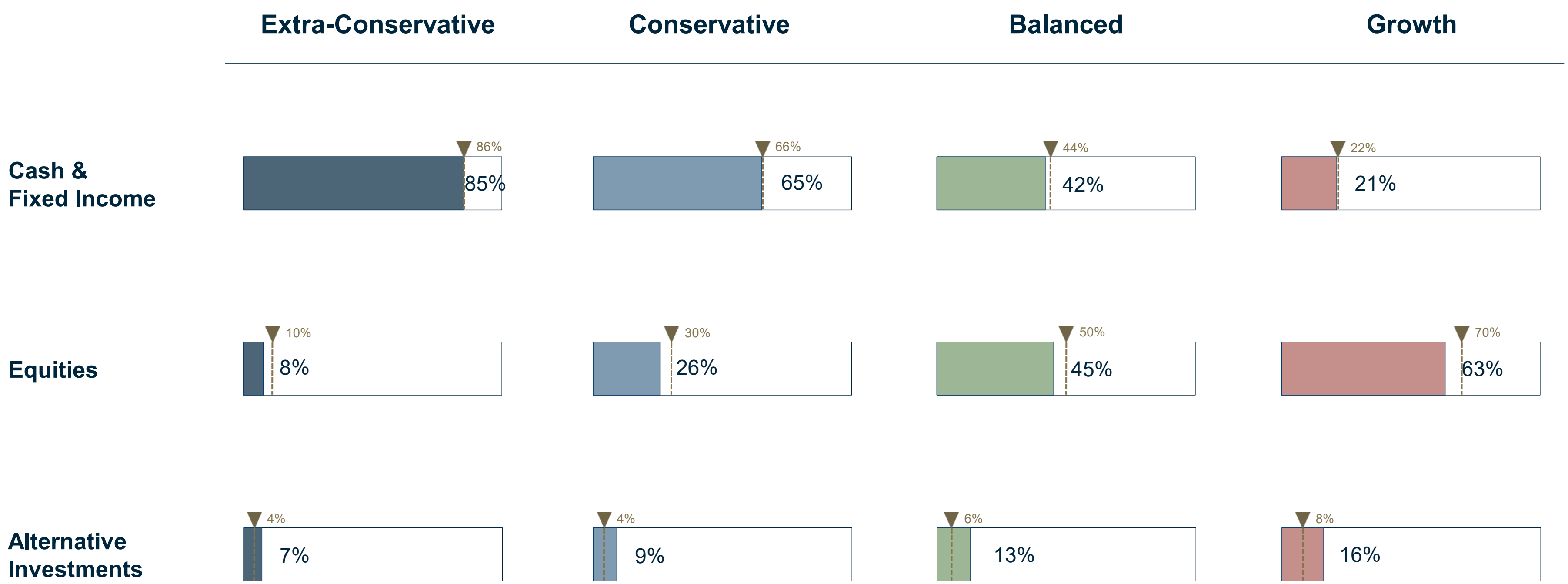
US Presidential Election, Debt ceiling, Banking crisis, Escalation of geopolitical tensions, China slowdown, Housing market correction

Boreal Balanced Portfolio USD



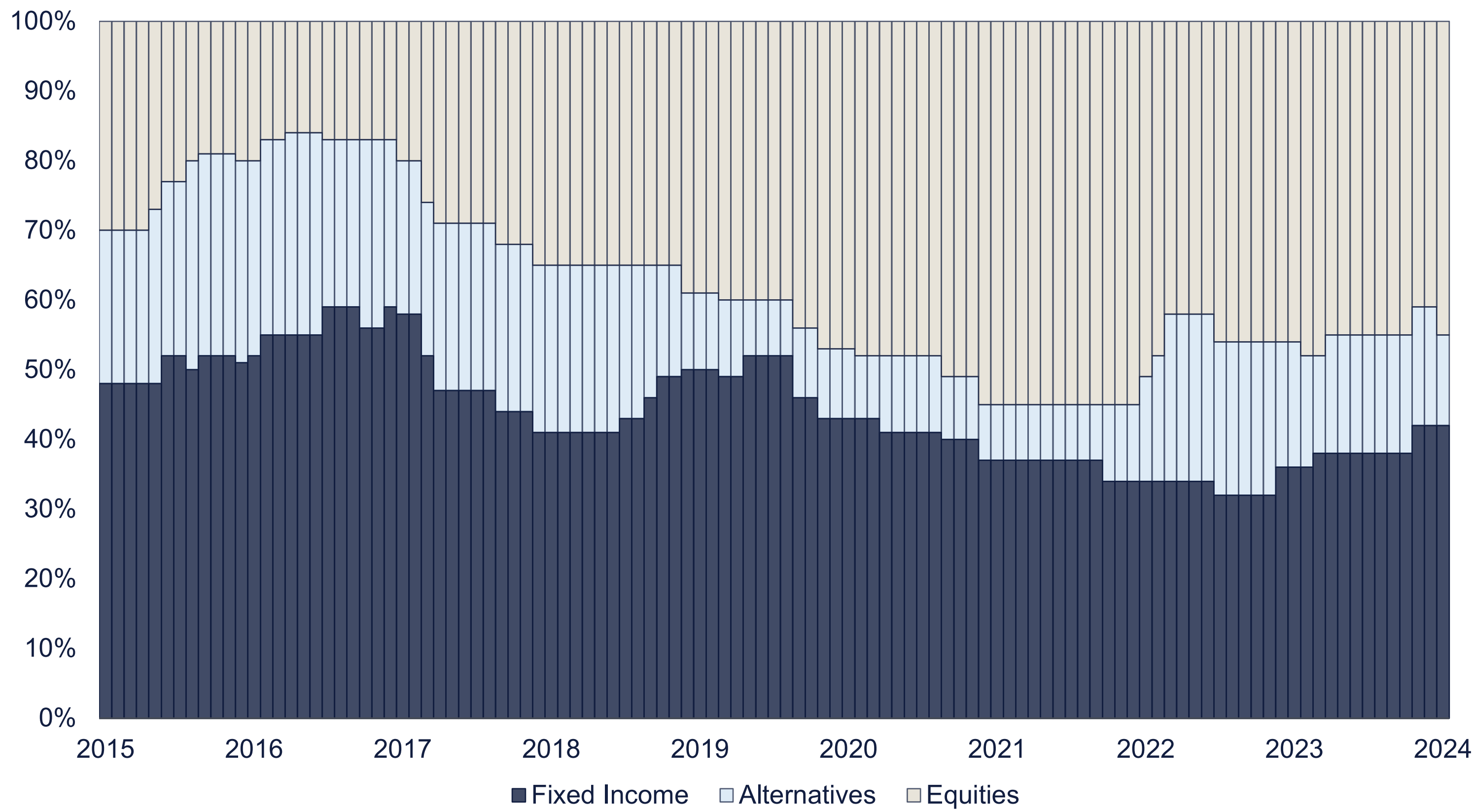


Boreal Investment Profiles



▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution



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