Investment Policy

March 2024

BOREAL
CAPITAL MANAGEMENT

Our market view in a nutshell – March 2024

- The past month witnessed a significant **divergence between stocks and bonds**. Risk assets, such as equities, rallied strongly, while treasuries experienced price declines, pushing their year-to-date performance into negative territory. This has occurred amid ongoing **uncertainty surrounding the Federal Reserve's monetary policy timeline**. Notably, volatility remained surprisingly subdued.

- Several market segments exhibited **signs of speculative activity**, with momentum stocks leading gains and cryptocurrencies reaching new highs. This exuberance contrasted with **mixed macroeconomic data**. While consumer confidence ticked up, business activity indicators showed some pullback. Inflation remained a key concern, with core and headline figures coming in below expectations. However, core service inflation (notably housing costs) moderated, suggesting a continuation of the disinflationary trend.

- Economic data influenced market expectations for future interest rates. **Market-implied rates now anticipate two rate cuts by mid-year, followed by another one before year-end**. This reflects a more hawkish outlook compared to earlier projections. More importantly for asset valuations, long-term interest rates also mirrored this pullback.

- Despite a less favorable interest rate outlook, the rally in **equity markets continues largely unabated**. With the earnings reporting season concluded, **analysts are revising earnings estimates upwards**. This is to be expected as the probability of a "soft landing" scenario rises, and with it a potential pick-up in economic activity. While this supports current valuations, it also **increases the risk of a correction** if earnings disappoint.

- Prudent investors face a **tough dilemma**. A continuing economic expansion could lead to **missing out** if they stay on the sidelines. However, current **valuations seem to fully reflect this favorable environment**, leaving the market vulnerable to a correction. Fortunately, bond returns are now offering some cushion to mitigate equity market swings.

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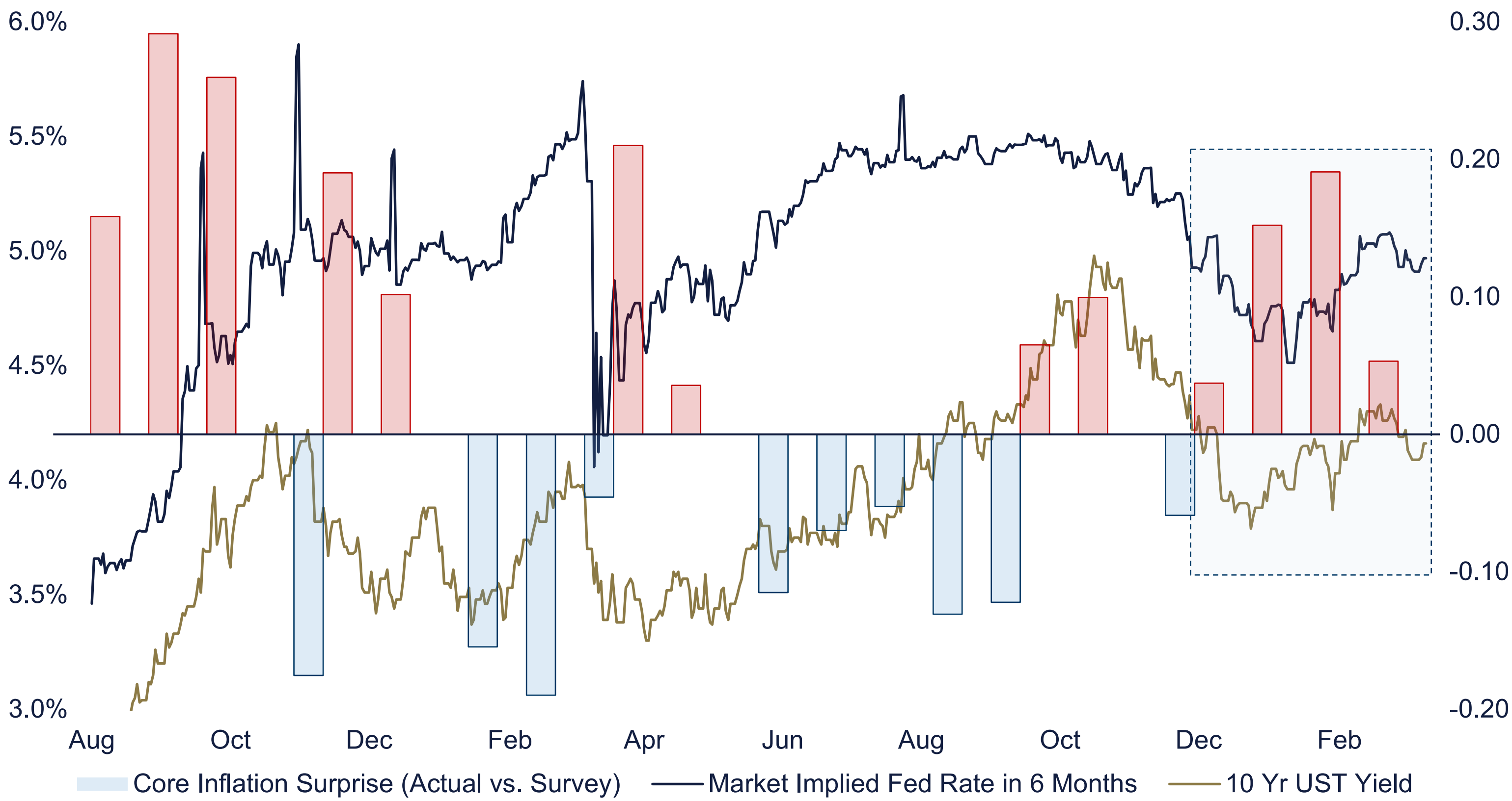
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	+	The Fed's recent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

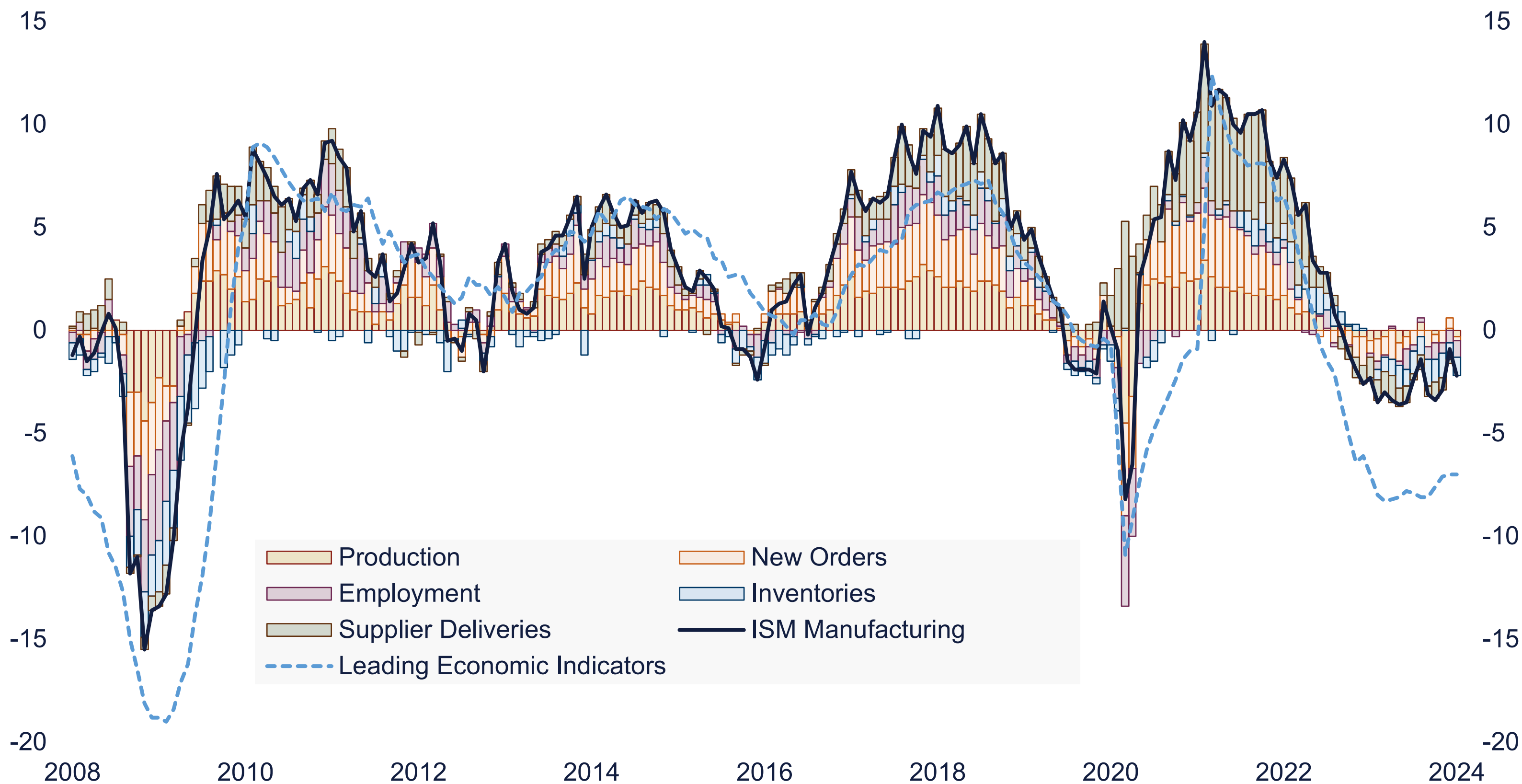
Negative surprises delay rate cuts



- The disinflationary trend has continued, although **inflation has come in above analysts' expectations**. This has led the Fed to **postpone the first rate cuts**, as they seek more confirmation that inflation is approaching their target level.
- **Long-term interest rates have also mirrored this pullback**, impacting the valuations of financial assets.

Source: Bloomberg

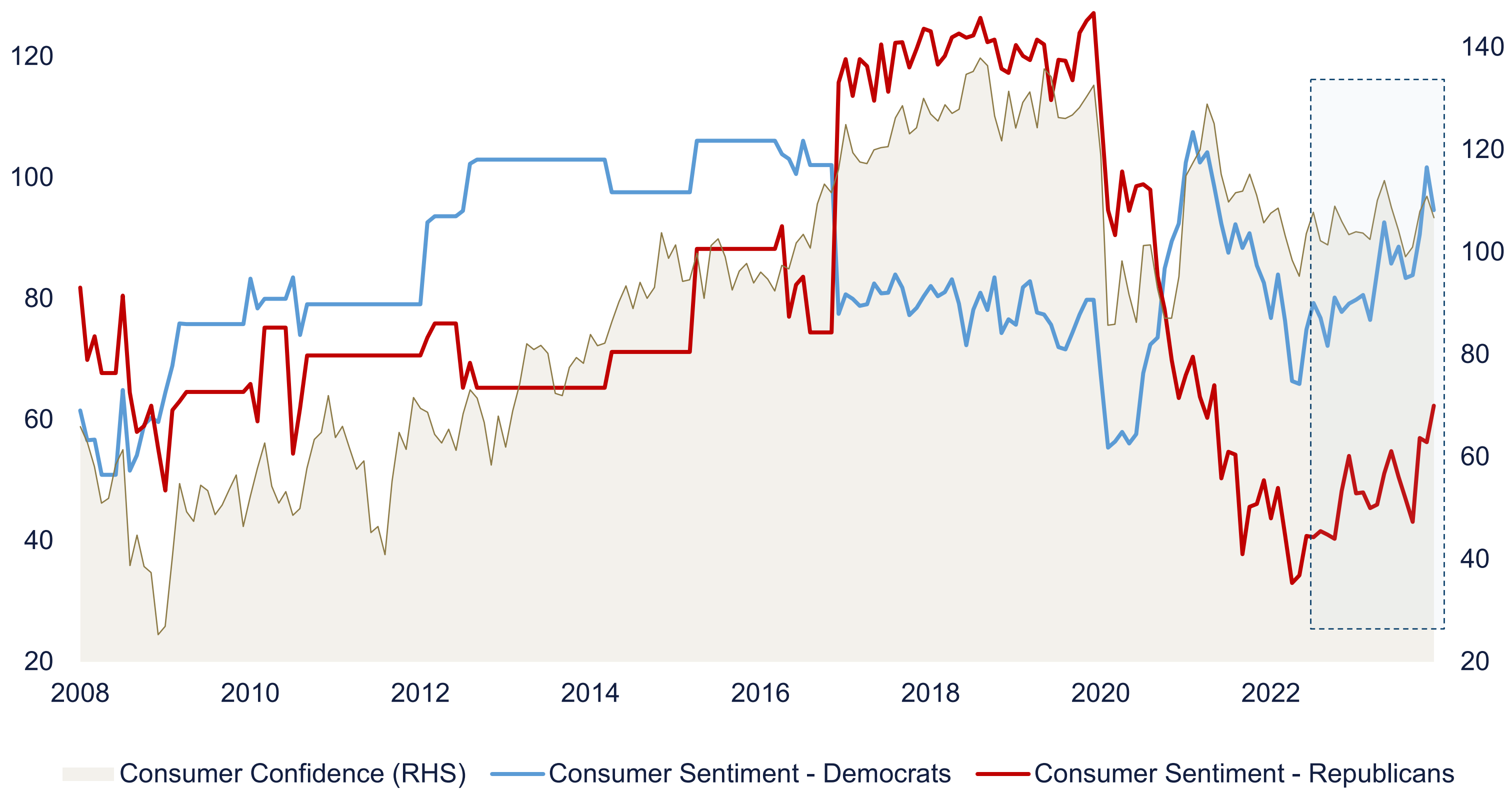
Delayed rate cuts, delayed recovery



- As the prospect of rate cuts fades, **the recent uptick in leading indicators of business activity has stalled**.
- While the current contraction in manufacturing activity **mirrors the length of the financial crisis period**, the depth of the decline is significantly less severe.

Source: Bloomberg

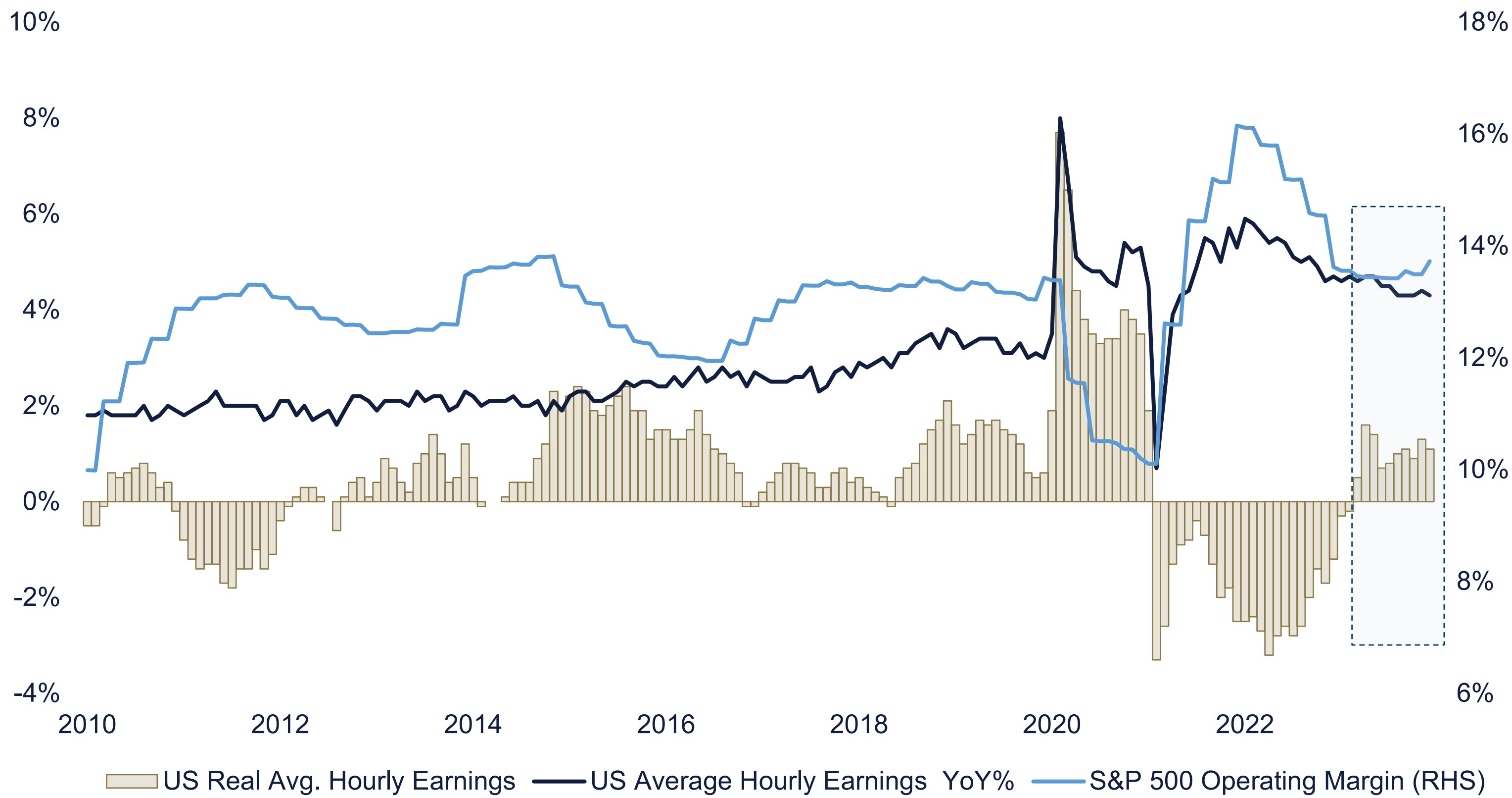
Consumers shrug off rate cuts delay



- Contrary to business sentiment, **consumer sentiment keeps improving**, **unaffected by the timing of interest rate cuts**.
- **Strong fundamentals** like low household debt, very low locked-in mortgage rates, and a robust labor market are underpinning consumers.

Source: Bloomberg

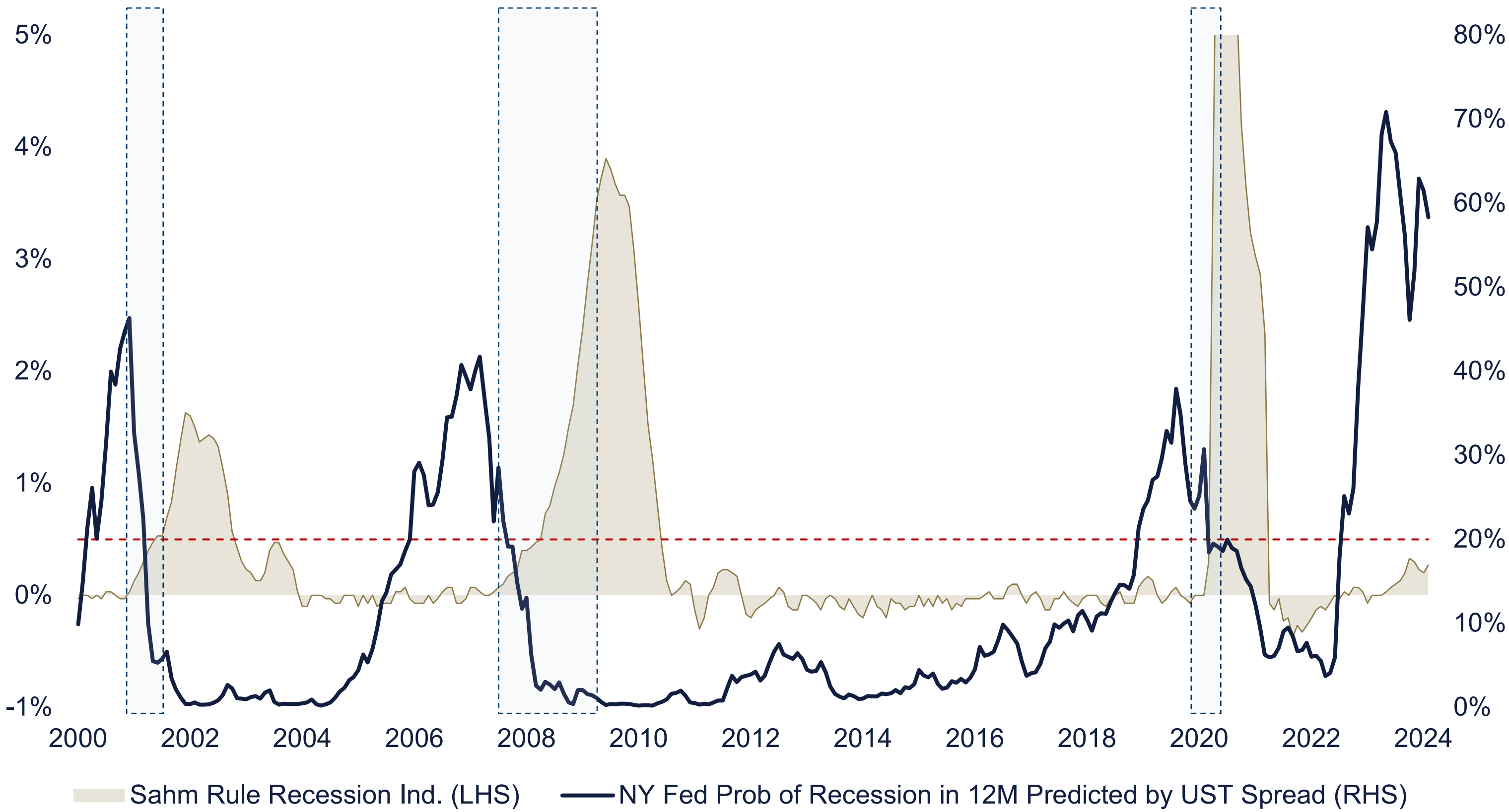
Wages threaten inflation and employment



- **Wage growth and housing costs remain the biggest hurdles** for the Fed in achieving its 2% inflation target. While both are showing signs of moderation, the pace of decline is slow.
- This presents a **double-edged sword for the Fed**. High wages can keep inflationary pressures elevated as businesses potentially pass on higher costs to consumers. Additionally, to manage these costs, companies may resort to reducing headcount, dampening economic growth.

Source: Bloomberg

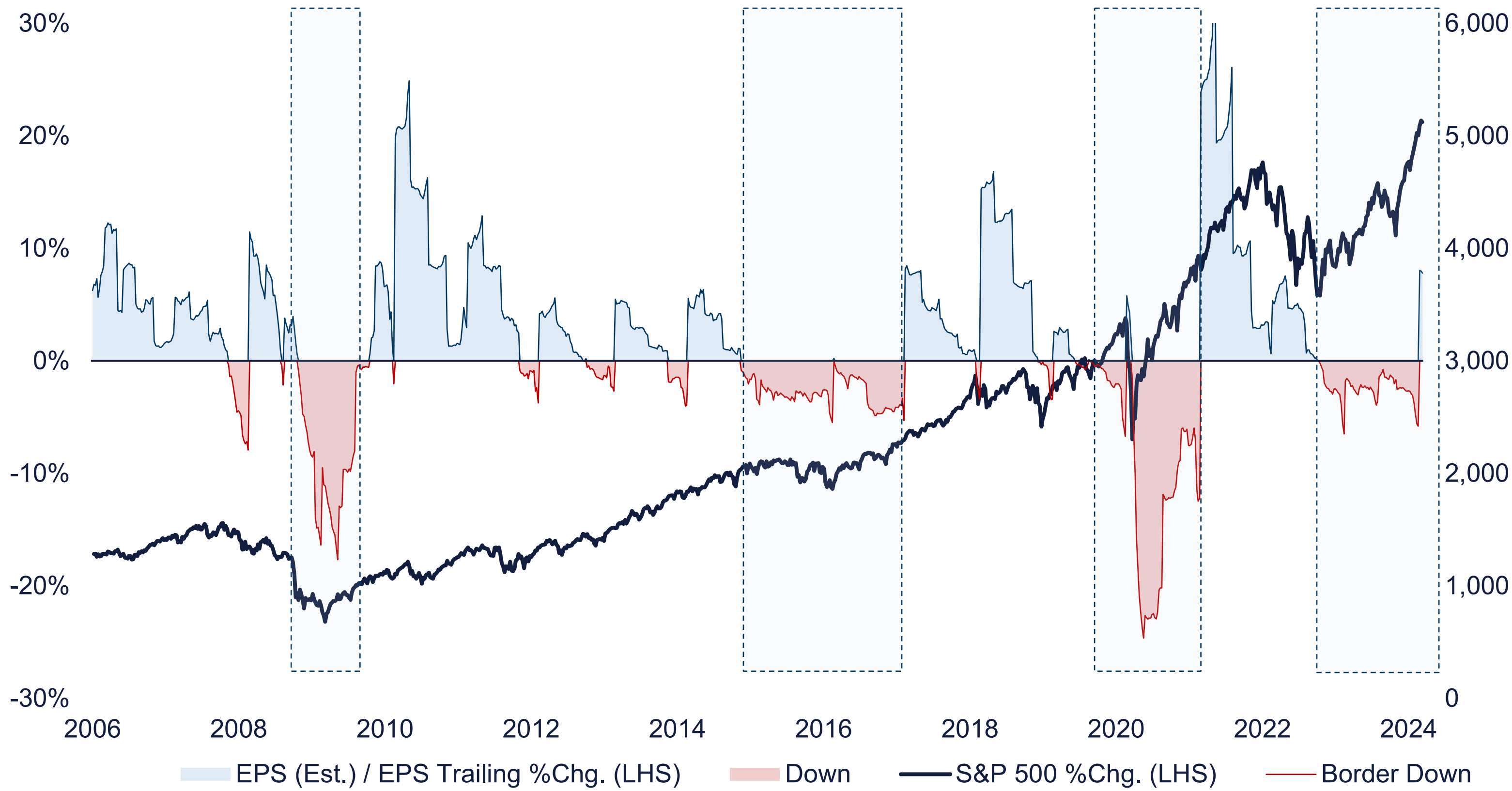
Recession risk is not over



- **Leading indicators and the yield curve suggest a potential recession on the horizon**. However, credit spreads and consumer behavior paint a different picture, indicating the economic cycle may have more room to run.
- The **labor market also sends mixed signals**. While data on actual job creation remains strong, survey-based unemployment measures are ticking up, albeit from historically low levels.

Source: Bloomberg

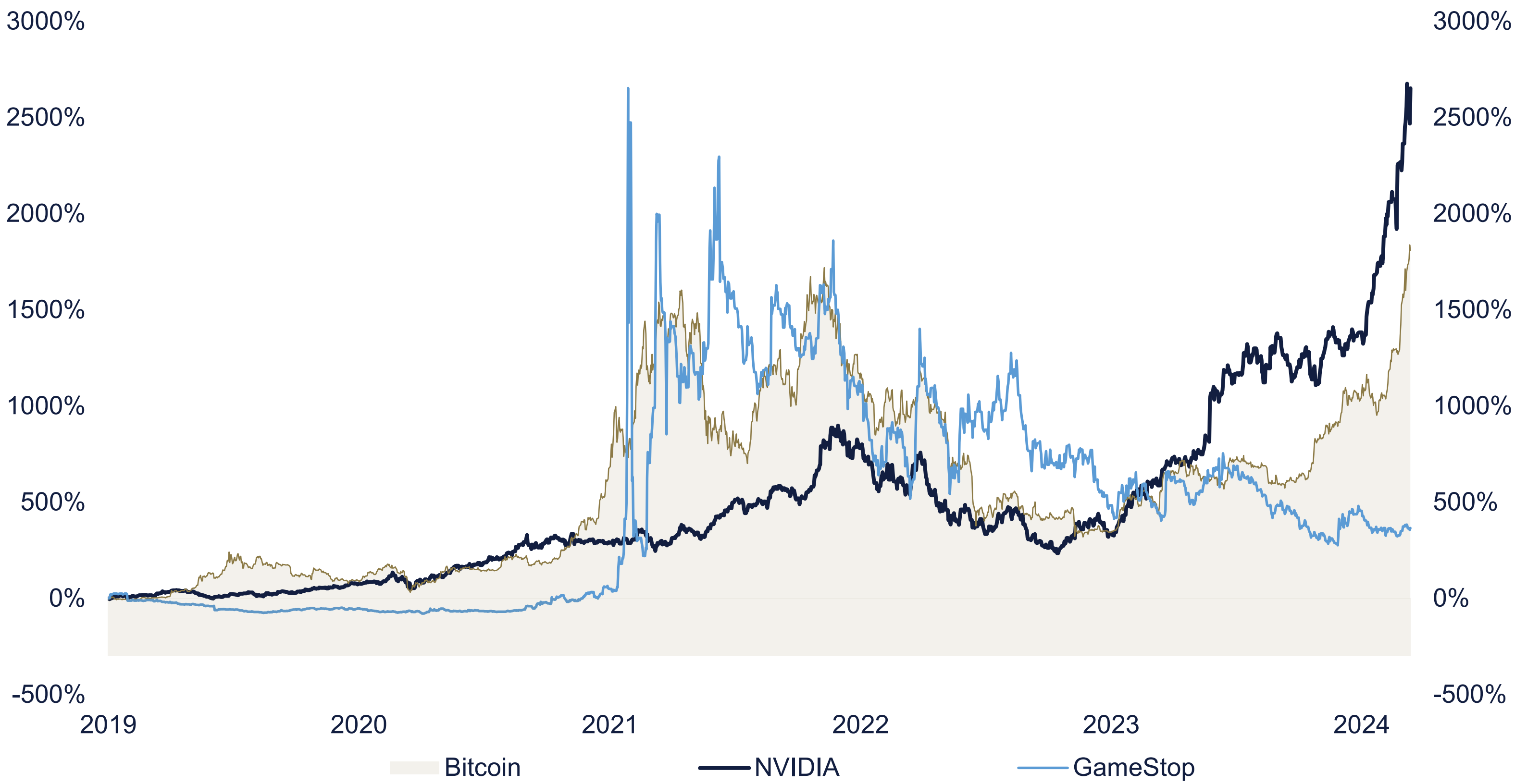
Gap risk



- With the earnings reporting season concluded, analysts are adjusting their forecasts. **Earnings estimates are being revised upwards**, reflecting expectations of a potential pick-up in economic activity.
- While this upward revision **supports current stock valuations**, it also **increases the already elevated gap risk**. This risk stems from the market's prior expectation of lower interest rates, and any disappointment in earnings could trigger a sharper-than-anticipated market correction.

Source: Bloomberg

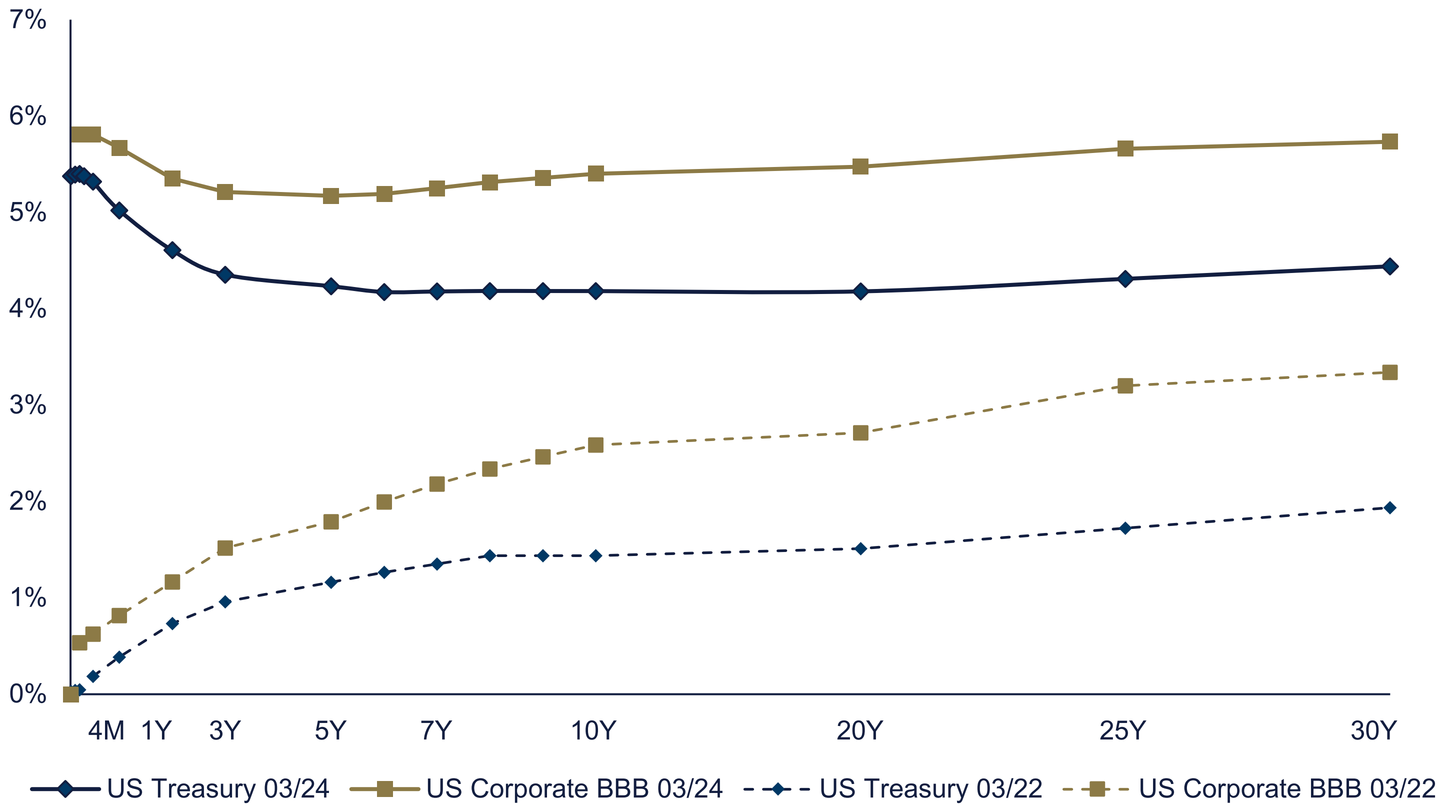
Momentum works both ways



- The market is exhibiting **signs of increased speculative activity**, reminiscent of 2021. However, this time it is occurring in a higher interest rate environment.
- While strong fundamentals can justify momentum in certain stocks, **we recommend maintaining a core allocation to quality-growth** companies.

Source: Bloomberg

Flat curve, focus on safety



- With current yields offering attractive returns, **bonds can provide much-needed protection against stock market volatility**. However, a **flat yield curve** reduces the potential benefits (and added risks) of extending maturities.
- Additionally, **wider credit spreads in the short end** of the curve reinforce our recommendation of investing in high-quality, short-duration bonds.

Source: Bloomberg

Investment scenarios

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	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%	25%	55%

Short-term catalyzers

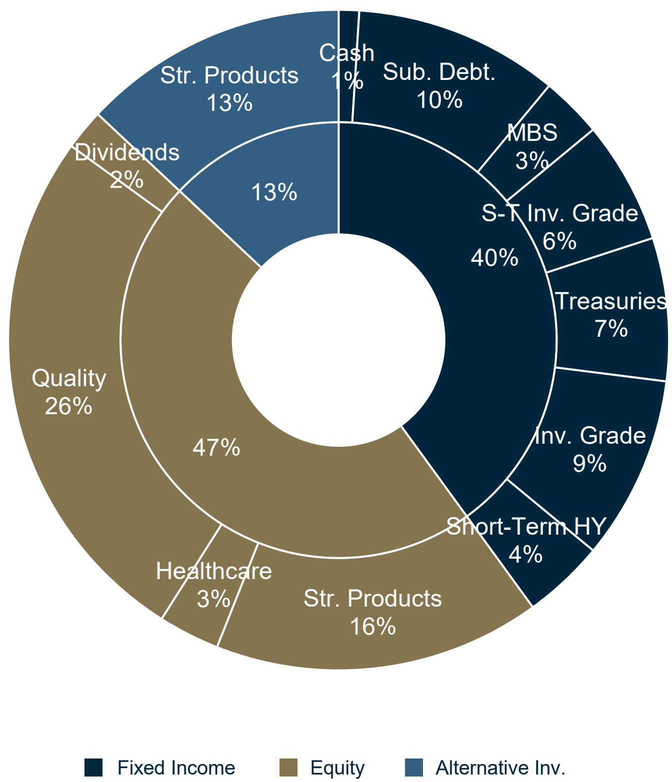
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems continue to ease

Other risks

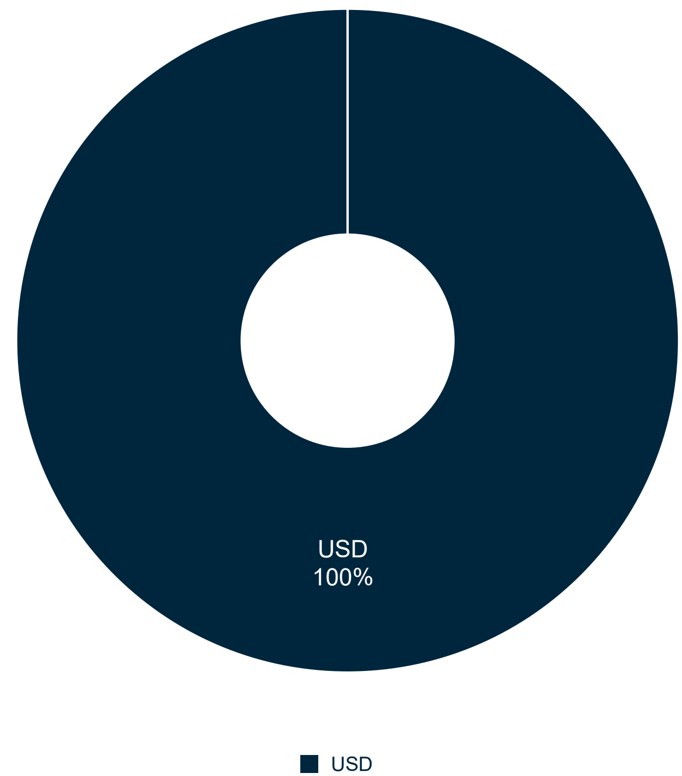
US Presidential Election, Debt ceiling, Banking crisis, Escalation of geopolitical tensions, China slowdown, Housing market correction

Boreal Balanced Portfolio USD

Asset Allocation



Currency Allocation

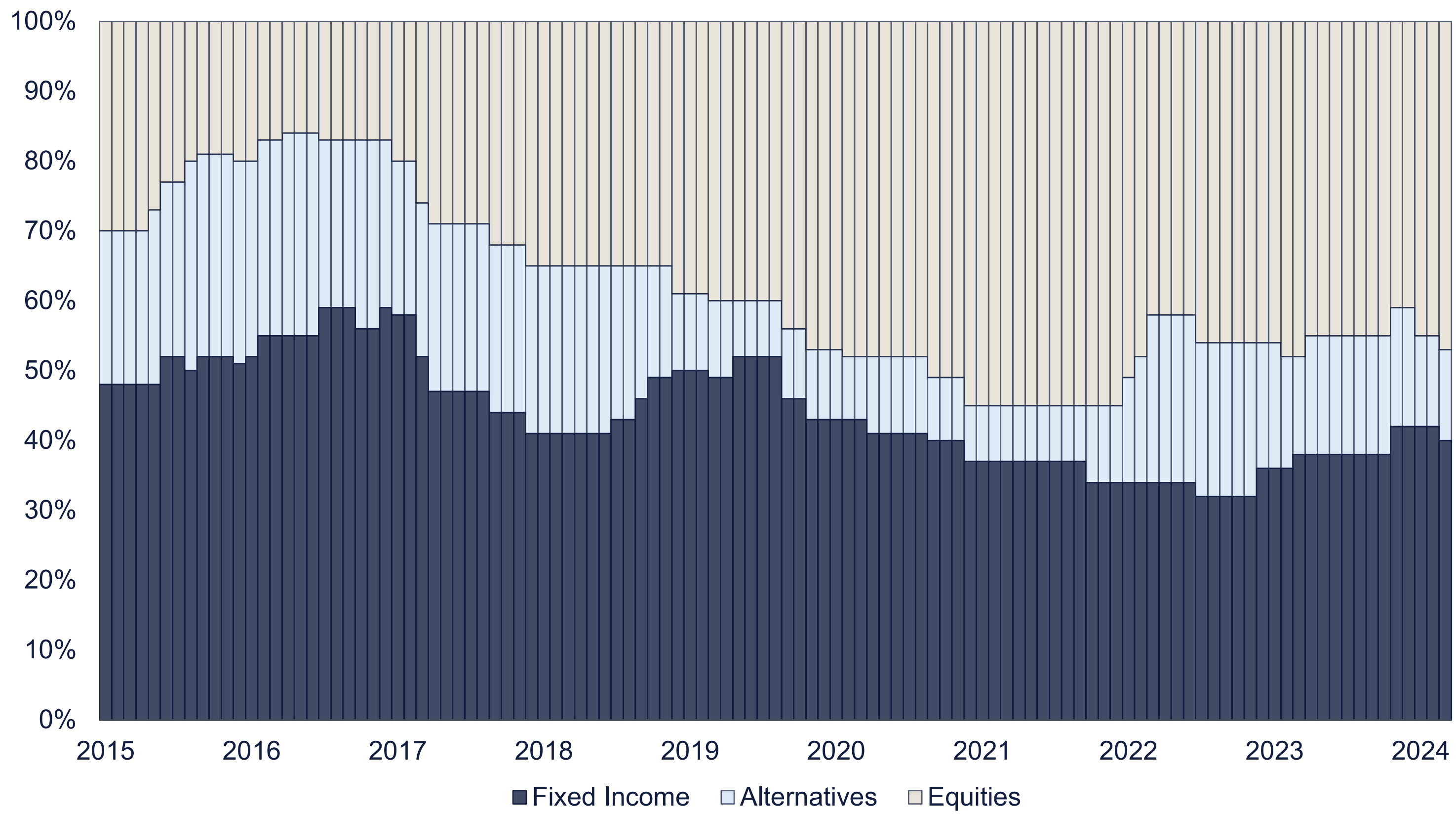


Boreal Investment Profiles

	Extra-Conservative	Conservative	Balanced	Growth
Cash & Fixed Income	84% (▼ 86%)	63% (▼ 66%)	40% (▼ 44%)	18% (▼ 22%)
Equities	9% (▼ 10%)	28% (▼ 30%)	47% (▼ 50%)	66% (▼ 70%)
Alternative Investments	7% (▼ 4%)	9% (▼ 4%)	13% (▼ 6%)	16% (▼ 8%)

▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution



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