Investment Policy

May 2024

BOREAL
CAPITAL MANAGEMENT

Our market view in a nutshell – May 2024

- **Macroeconomic data remains noisy**, clouding the economic picture. The disinflation process has been stalling, while economic momentum has weakened. This **creates a dilemma for the Fed**, as they must choose between prioritizing controlling inflation or supporting the economy.

- The **positive impact of the Fed's December pivot on consumer and corporate confidence has largely faded**. A "soft landing" remains our primary expectation. However, keeping interest rates elevated for an extended period raises **concerns about a potential slowdown**, further amplified by the weaker-than-expected GDP growth in the first quarter.

- There are some encouraging developments. April's better-than-expected inflation data suggests **inflation may be resuming its downward path**. Additionally, Jay Powell's dovish tone after the latest FOMC meeting reaffirmed the Fed's dual **commitment to both price stability and full employment**. The labor market remains a key focus area, with wage growth posing inflationary risks, while strong job security continues to underpin consumer spending.

- Given the mixed bag of economic data – weak growth alongside persistent services inflation – **markets have experienced significant volatility**. Interest rates initially rose with the disappointing Core PCE Price Index, only to retreat with weaker growth and employment data. The recent positive CPI data has further brought down rates. This volatility, compounded by a flat yield curve, **reinforces our preference for short-maturity bonds**.

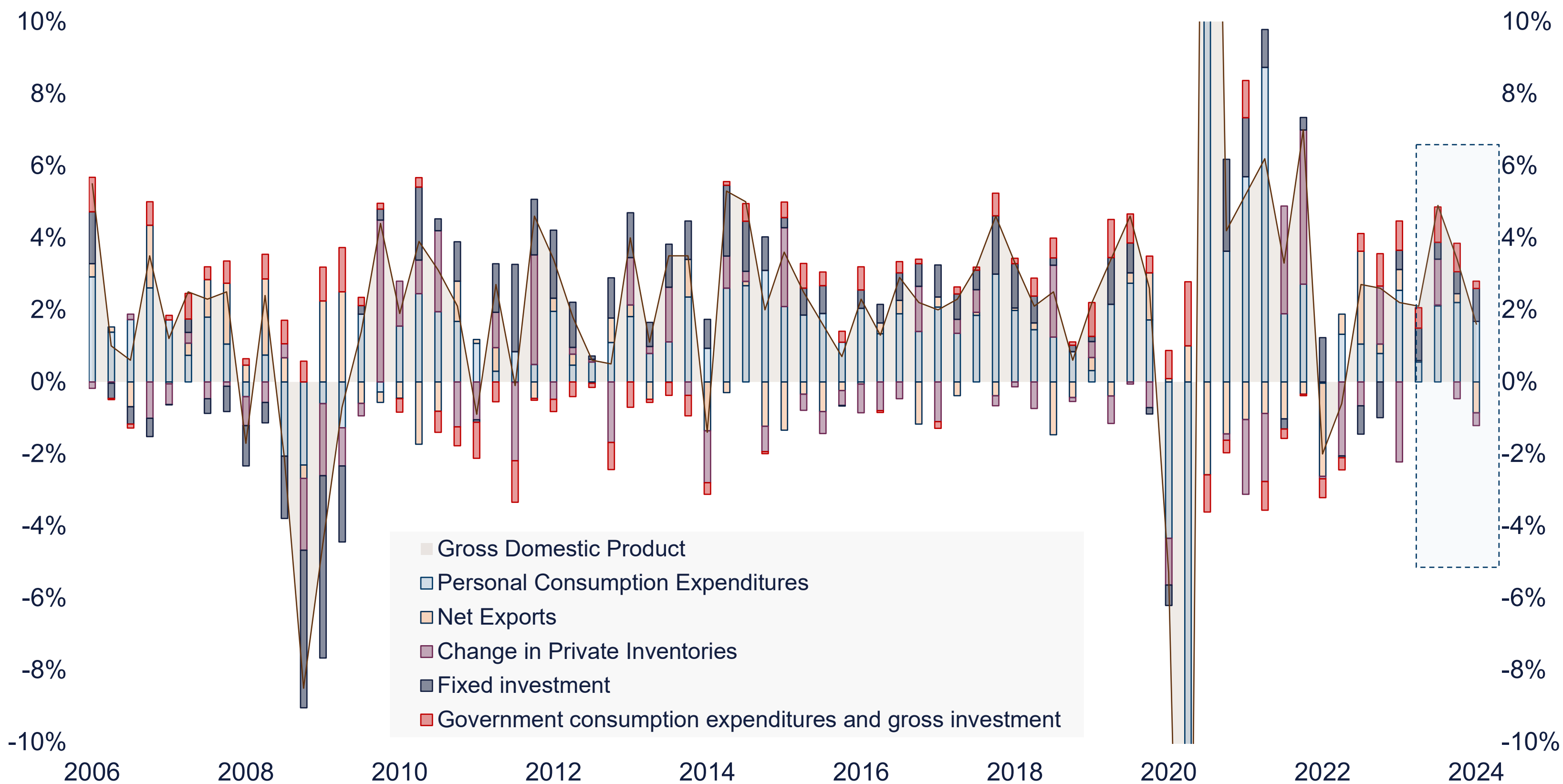
- The ongoing earnings season tell us a **tale of two markets**. Large technology companies, fueled by the AI-driven demand for computing power, are experiencing strong earnings growth. However, the rest of the market is struggling. Despite a modest +5.4% overall earnings growth for the S&P 500 in Q1, excluding the tech giants (Alphabet, Amazon, Meta, Microsoft, and Nvidia), earnings would be down by -2.4%. This **combination of low market breadth, high (but concentrated) opportunity costs, and generally high valuations, justifies our neutral stance on equities**.

Boreal Investment Policy

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

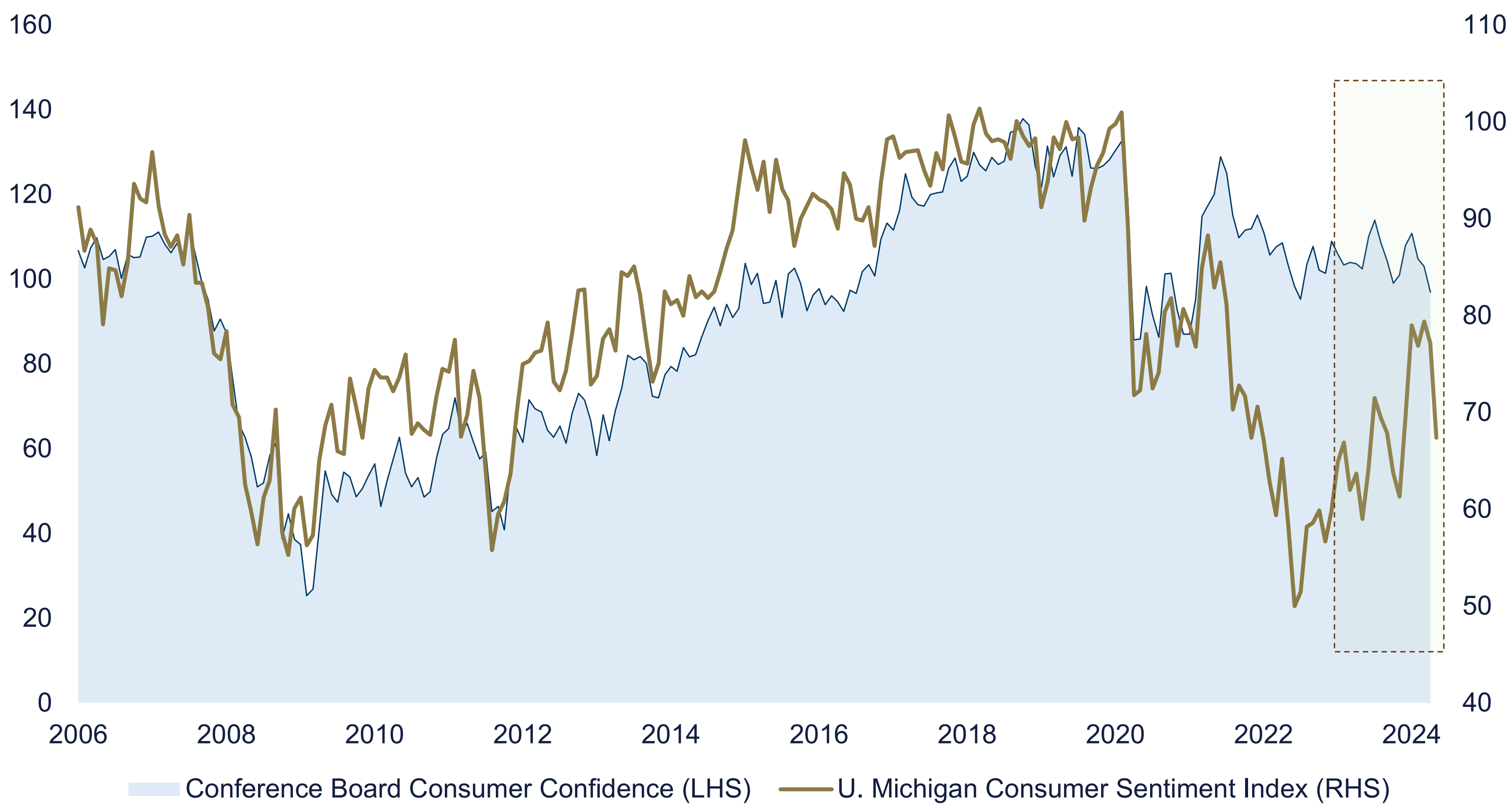
Softer than expected



- **The economy lost momentum in the first quarter**. GDP growth came in much softer than expected, at +1.6% compared to the forecasted +2.5%, sliding to a two-year low.
- Personal **consumption**, though positive, was weaker than anticipated. The **trade deficit** also subtracted from growth again, a consequence of the strong dollar.

Source: Bloomberg

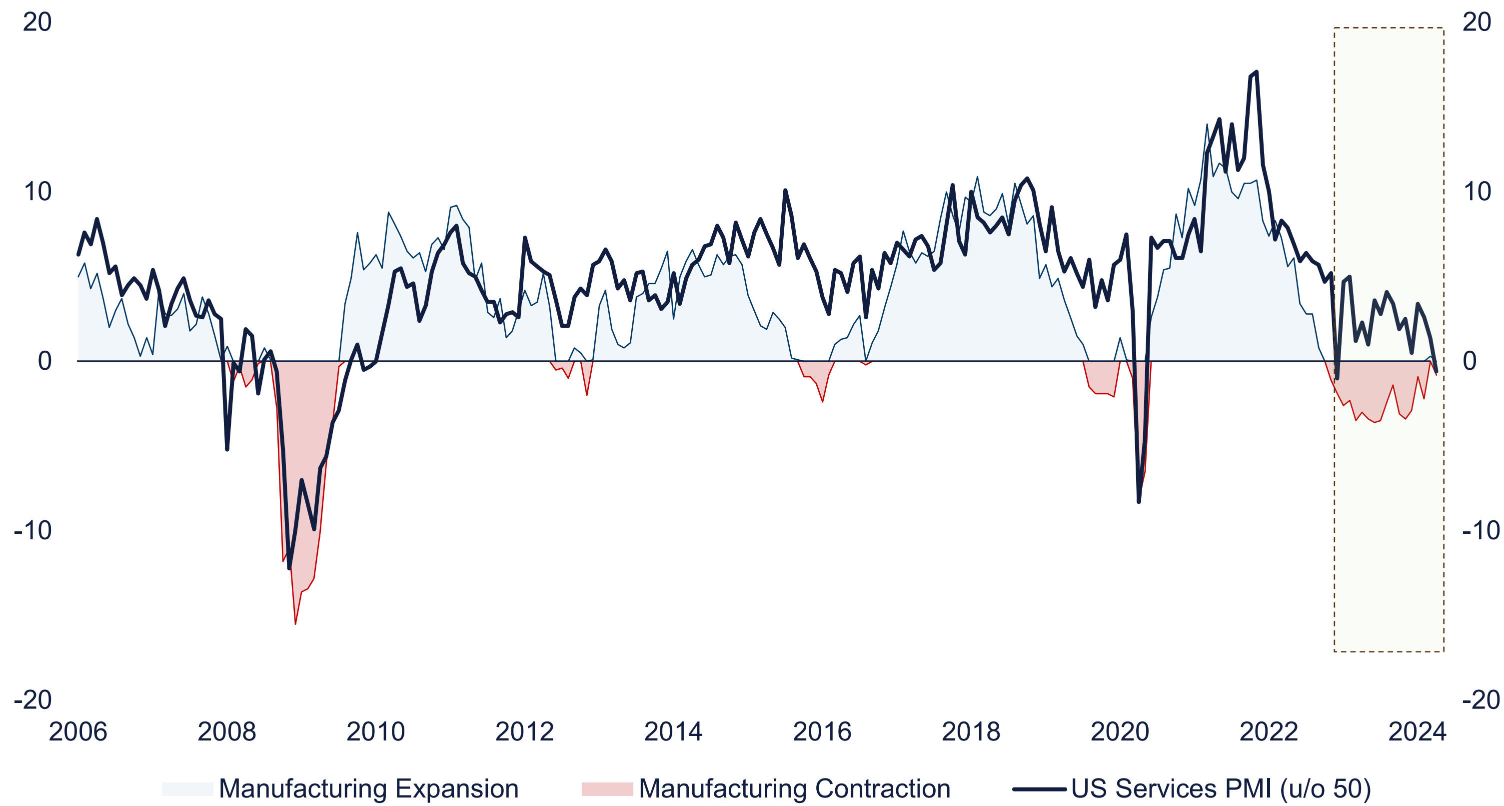
Fed Pivot fades



- The initial **optimism surrounding the Fed's policy shift has begun to wane**. Disappointing inflation data has dampened hopes of near-term interest rate cuts, pushing those prospects further out on the horizon.
- This has **impacted consumer confidence**, which has fallen back to pre-pivot levels.

Source: Bloomberg

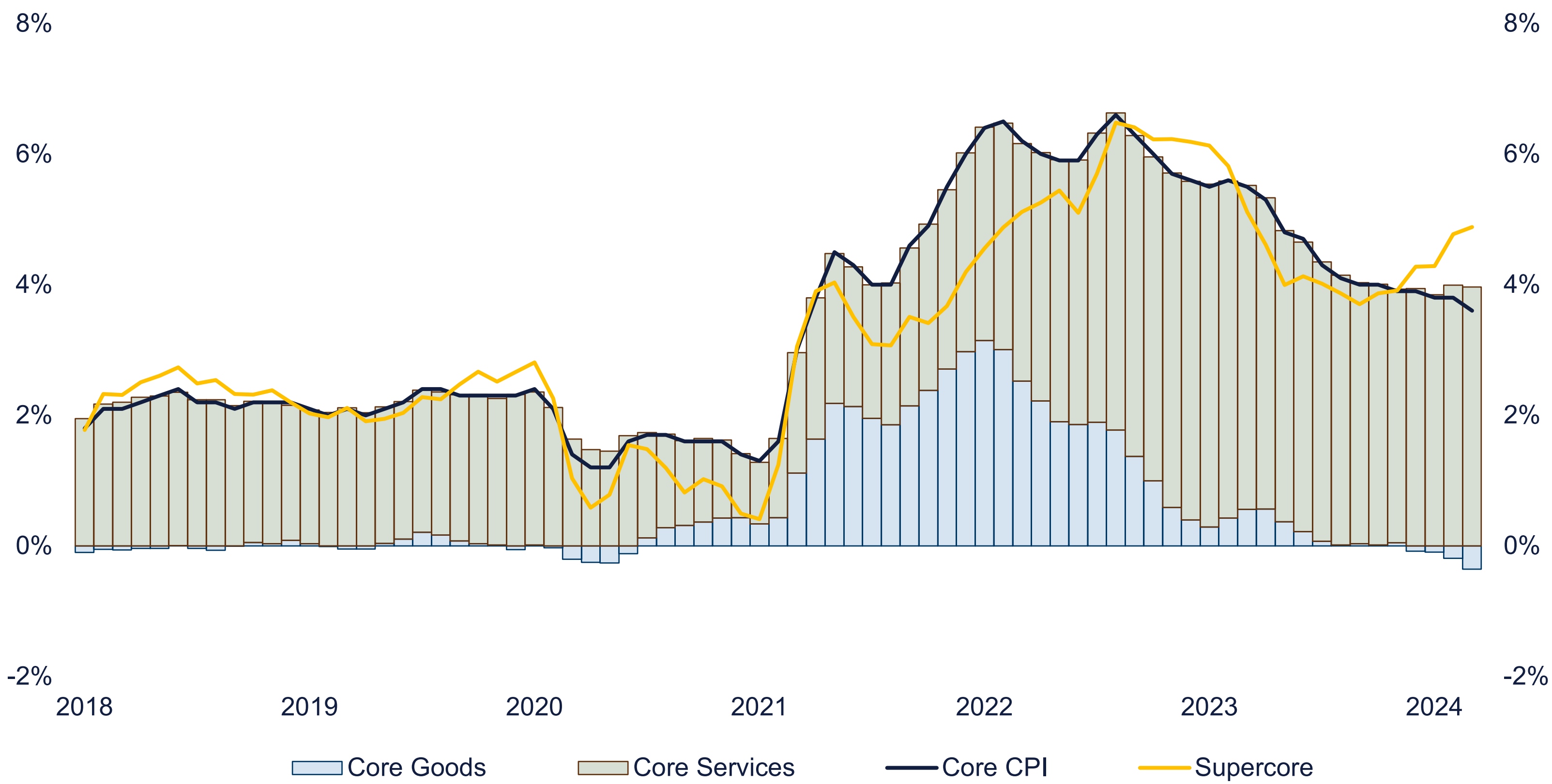
Unexpected twin contraction



- The latest PMI data paints a concerning picture, reflecting a **deterioration in business confidence**. **Manufacturing**, which had just shown signs of recovery by entering expansion territory last month, **has fallen back into contraction**.
- Even more worryingly, services sector **PMIs have contracted unexpectedly**, marking the first time since December 2022, a period when the economy teetered on the brink of recession.

Source: Bloomberg

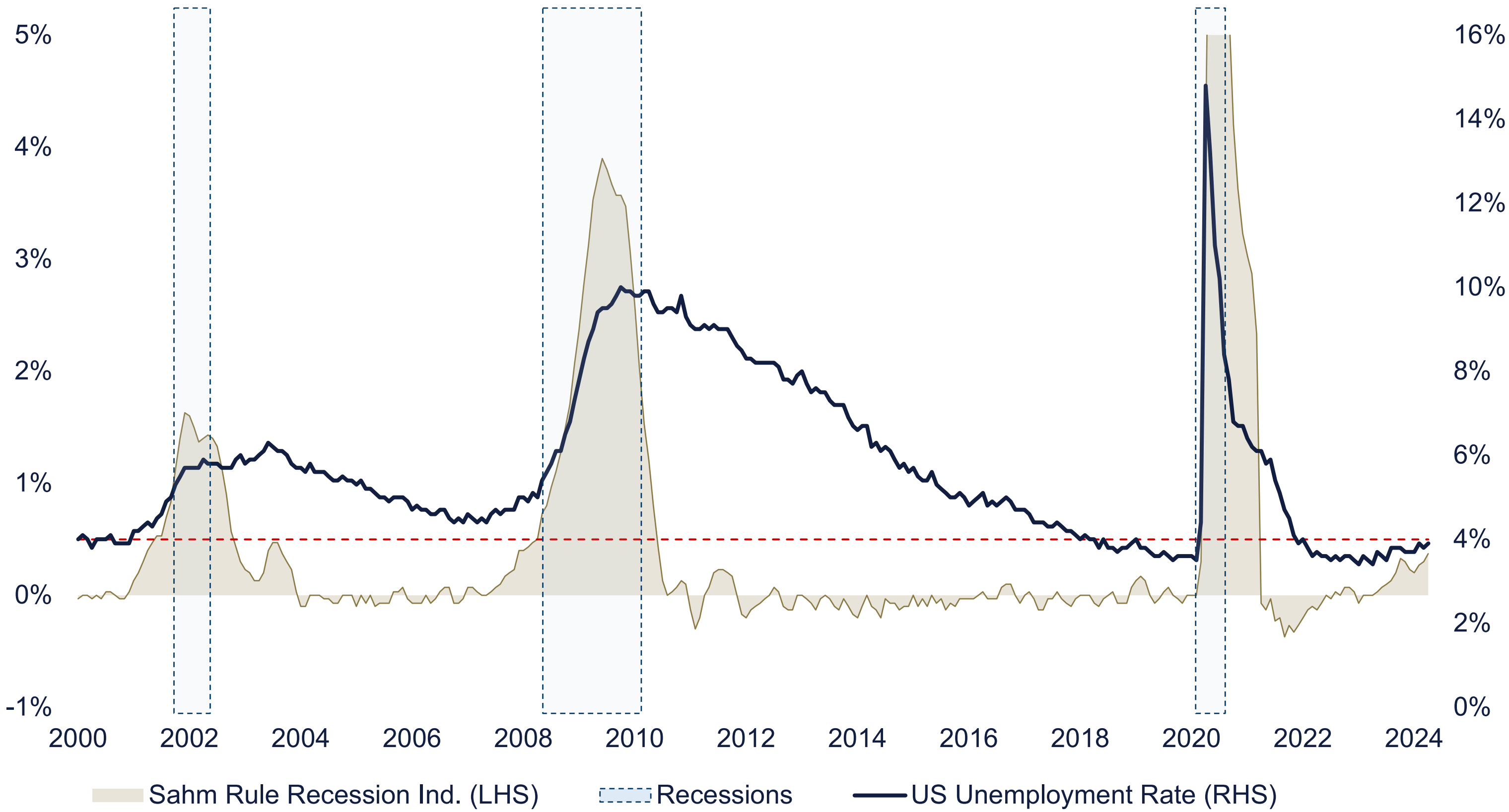
Inflation reprieve



- April's **inflation data provided a temporary reprieve**, suggesting inflation might be resuming its downward path. Core inflation surprised on the positive side for the first time in four months, assuaging concerns that inflation could become entrenched.
- However, **inflation excluding shelter remained sticky**, highlighting the persistence of service sector inflation.

Source: Bloomberg

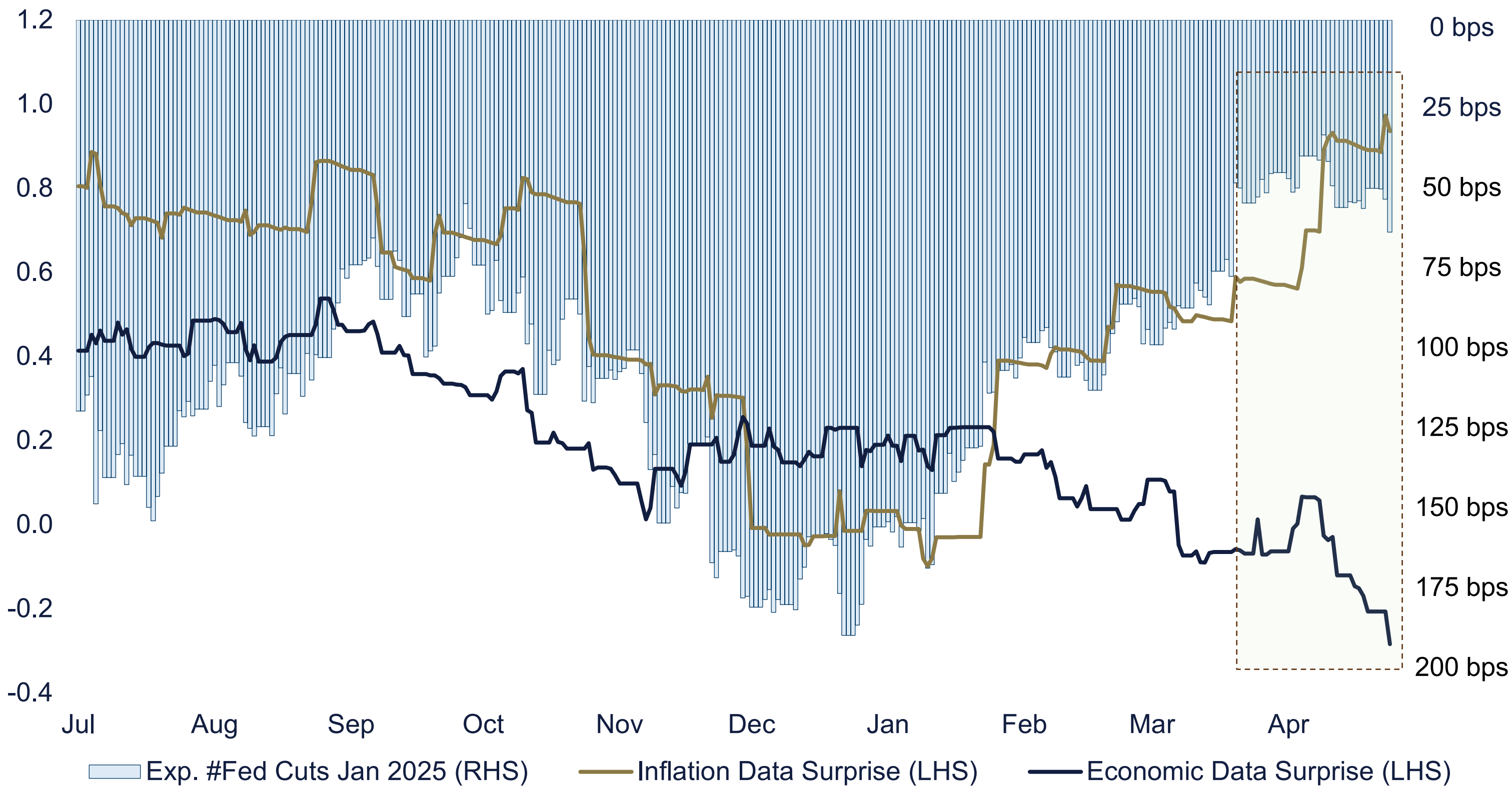
Labor market increasingly in focus



- The **labor market continues to cool gradually**. Job openings continue to decline, reaching close to pre-pandemic levels.
- The **unemployment** rate increased more than expected in April (3.9% vs. 3.8%), and **non-farm payrolls** came in much weaker than expected.

Source: Bloomberg

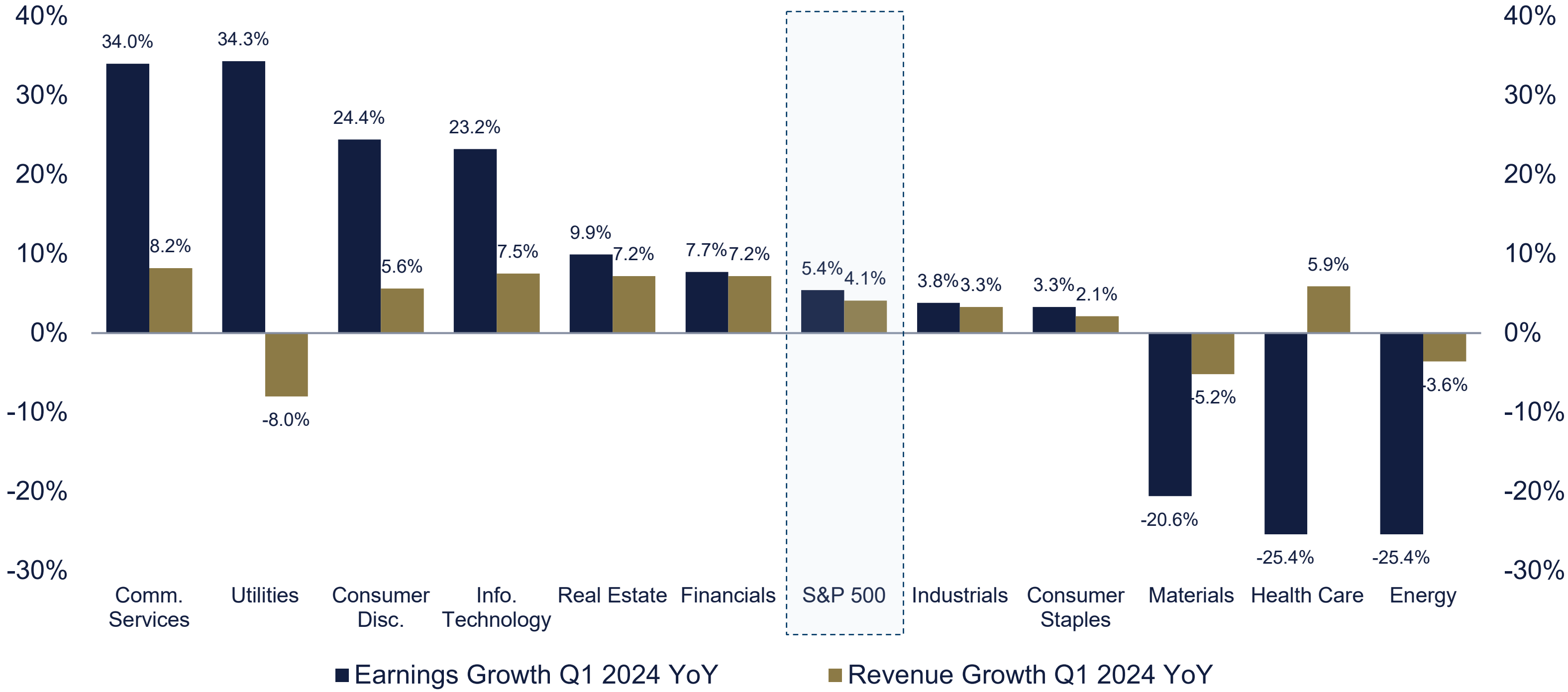
Fed in a bind



- At the same time that inflation has been disappointing, **economic data has been worsening**. This creates a **dilemma for the Fed**, since they must choose between prioritizing controlling inflation or supporting the economy.
- As a result, the **market has started to price in some rate cuts again**.

Source: Bloomberg

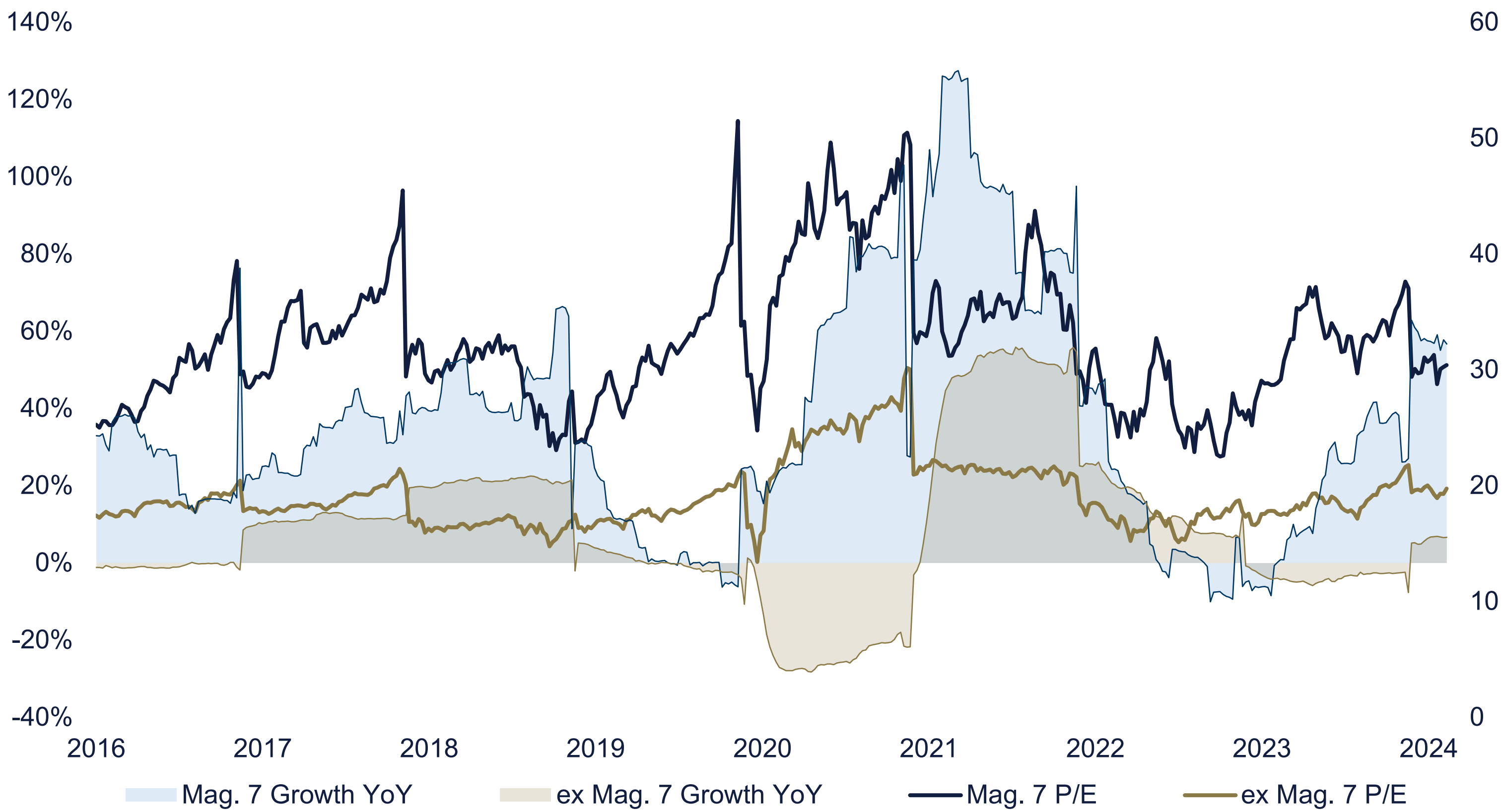
Strong sector divergence



- **Earnings for the first quarter grew at +5.4%.** However, **excluding five stocks**, Alphabet, Amazon, Meta, Microsoft, and Nvidia, earnings would be **down by -2.4%.**
- This highlights the **ongoing decoupling** trend between the performance of AI-driven companies and the broader market.

Source: Bloomberg

A tale of two markets



- Judging by earnings growth, **valuations look more reasonable for the tech behemoths than for the market as a whole**.
- This outlines how the **risk of a low market breadth needs to be weighed by the opportunity cost** of missing out on these stocks.

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%	25%	55%

Short-term catalyzers

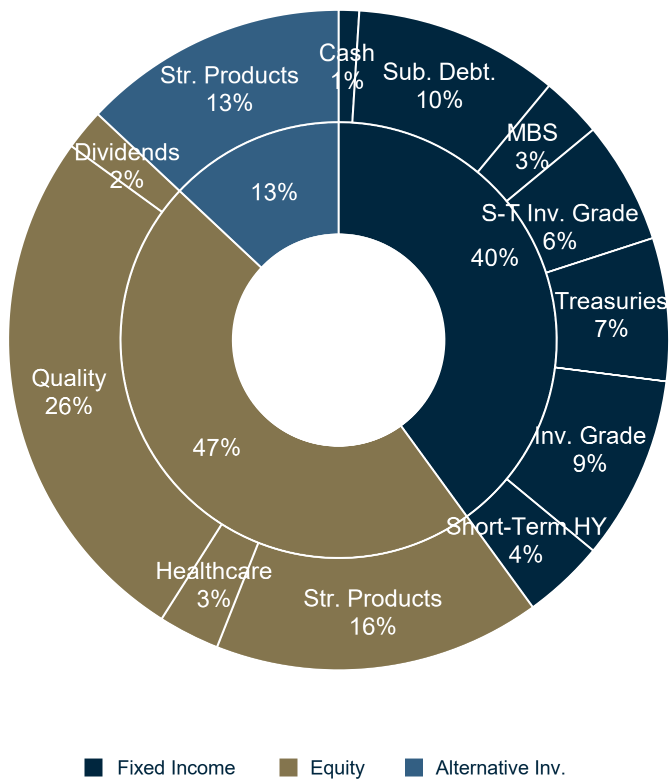
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems continue to ease

Other risks

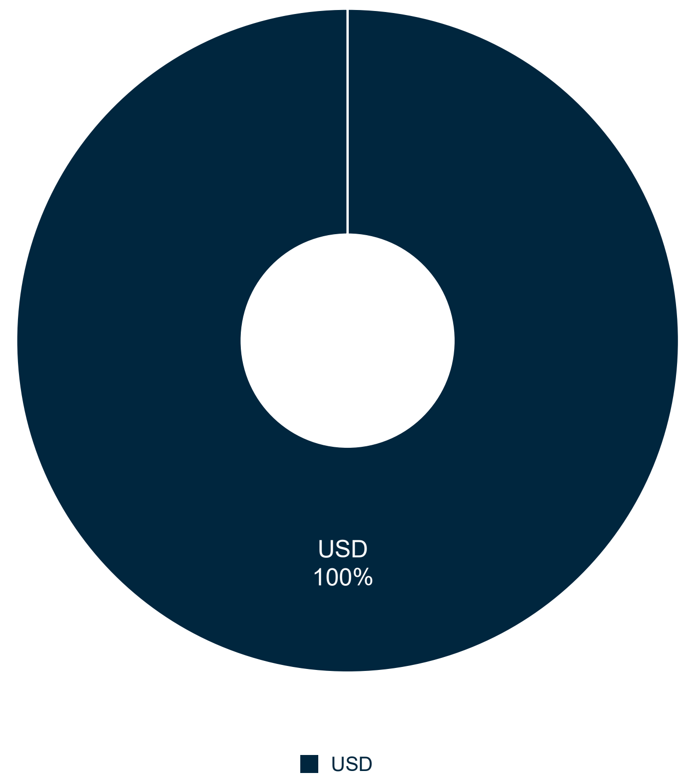
US Presidential Election, Debt ceiling, Banking crisis, Escalation of geopolitical tensions, China slowdown, Housing market correction

Boreal Balanced Portfolio USD

Asset Allocation



Currency Allocation



Boreal Investment Profiles

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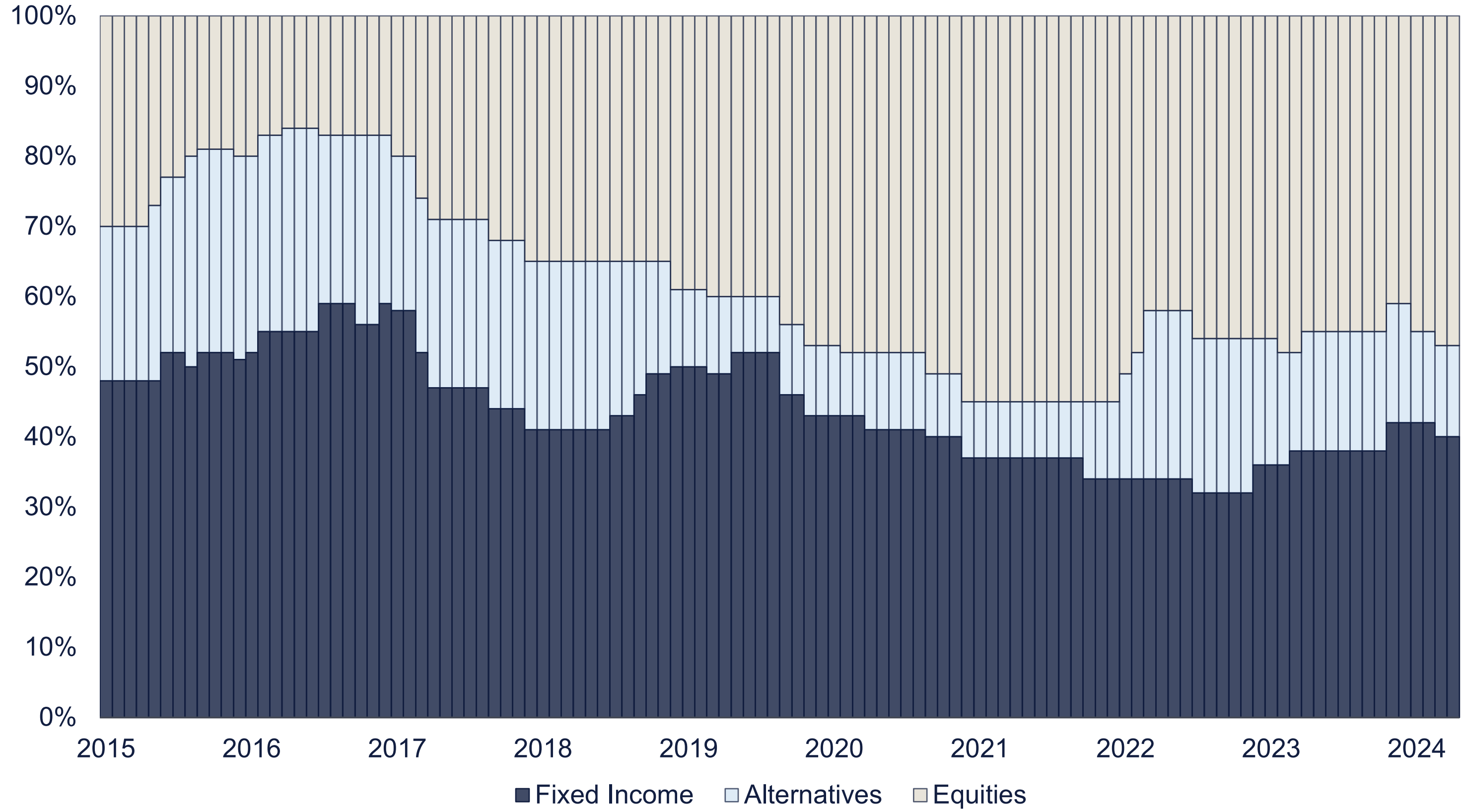
	Extra-Conservative	Conservative	Balanced	Growth
Cash & Fixed Income	84% (▼ 86%)	63% (▼ 66%)	40% (▼ 44%)	18% (▼ 22%)
Equities	9% (▼ 10%)	28% (▼ 30%)	47% (▼ 50%)	66% (▼ 70%)
Alternative Investments	7% (▼ 4%)	9% (▼ 4%)	13% (▼ 6%)	16% (▼ 8%)

▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution



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