Investment Policy

August 2024

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Our market view in a nutshell – August 2024

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- Over the past weeks, **markets have reminded us of their inherent volatility**. As the Fed convened towards the end of the month, concerns about an imminent recession seemed minimal. Employment and confidence indicators pointed to a slowdown, yet the prevailing "soft landing" narrative remained intact. However, market sentiment shifted sharply within days, revealing the fragility beneath the surface.

- The **increase in risk aversion was caused by combination of factors**. Stock indices were already under pressure, dragged down by **disappointing earnings reports from major tech companies** – Meta being the notable exception. These earnings reports cast doubt on the profitability of large-scale AI investments. Shortly after the Fed's meeting, **disappointing employment data** was released, with unemployment trends breaching a technical level historically linked to accelerated job losses, further unsettling investors.

- Beyond economic concerns, **technical and liquidity factors** exacerbated the market downturn. On the same day the labor report was published, the **Bank of Japan unexpectedly raised interest rates** to support the Yen and combat inflation. This move triggered a wave of liquidations, particularly given the Yen's role as a popular funding currency, resulting in a more than 12% drop in the Nikkei in a single session. **Volatility spiked** across major indices, and **credit spreads widened** significantly.

- Despite the turmoil, **the Fed remained notably silent**, likely because financial conditions had not deteriorated to a critical level. However, **markets dramatically revised their expectations for the Fed Funds rate trajectory**. While it is too early to determine if the economy will require urgent support through significant rate cuts or if rates will be phased out gradually, the **beginning of a cutting cycle seems set for September**, especially following the positive inflation report for July.

- Although volatility has decreased significantly, **markets are likely to remain choppy** for some time. The U.S. **Presidential Elections have become more contested**, particularly after changes to the Democratic ticket. On the macroeconomic front, **weaknesses in consumer spending** will be closely monitored, especially as the earnings season has highlighted slowdowns in sectors such as travel, restaurants, and luxury goods. Additionally, the **conflicts in Ukraine and the Middle East** remain at risk of escalation. With valuations still elevated, any negative news could further unsettle the markets. However, the Fed retains the flexibility to provide monetary support as needed.

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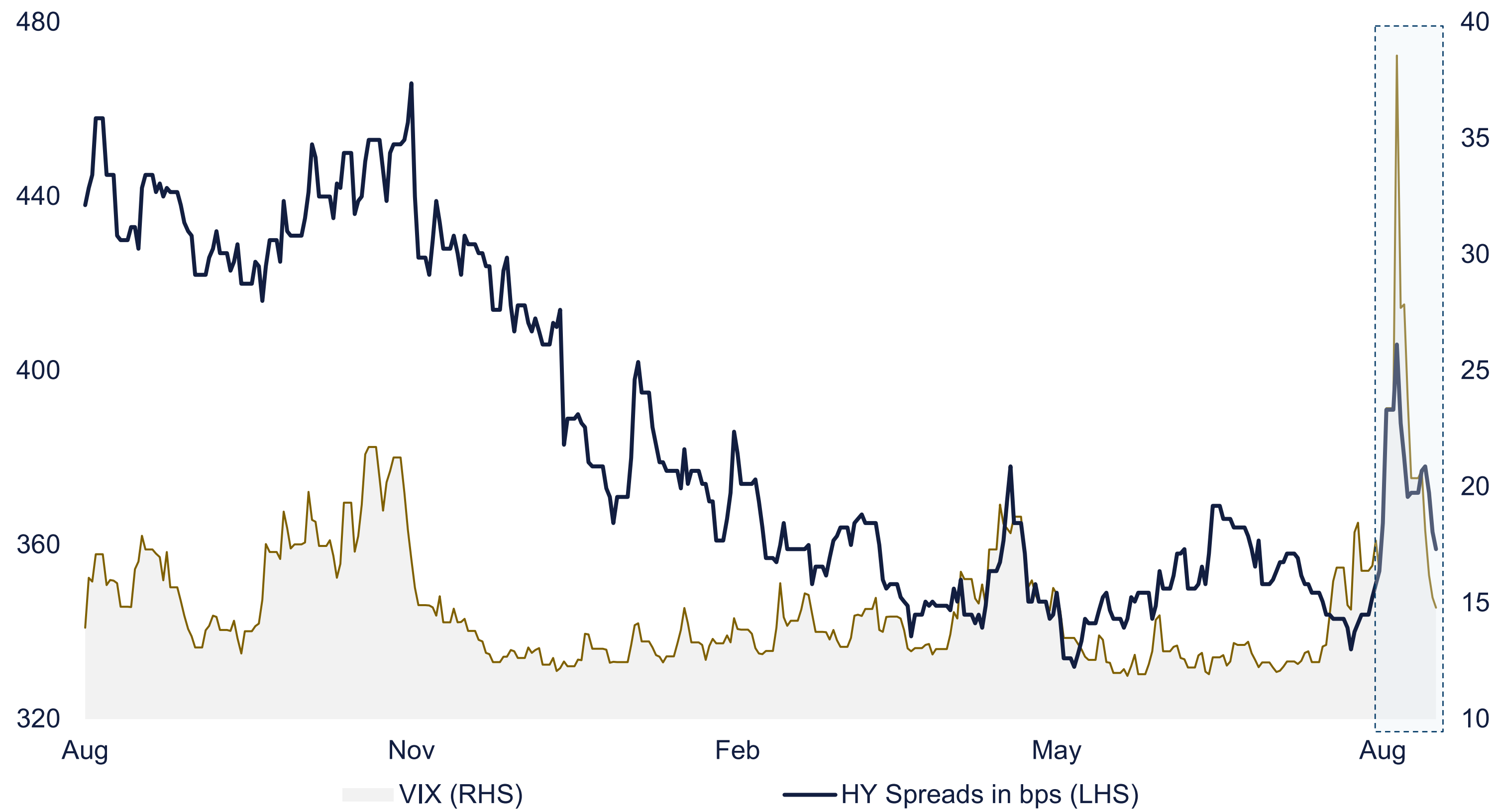
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	+	The Fed's recent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

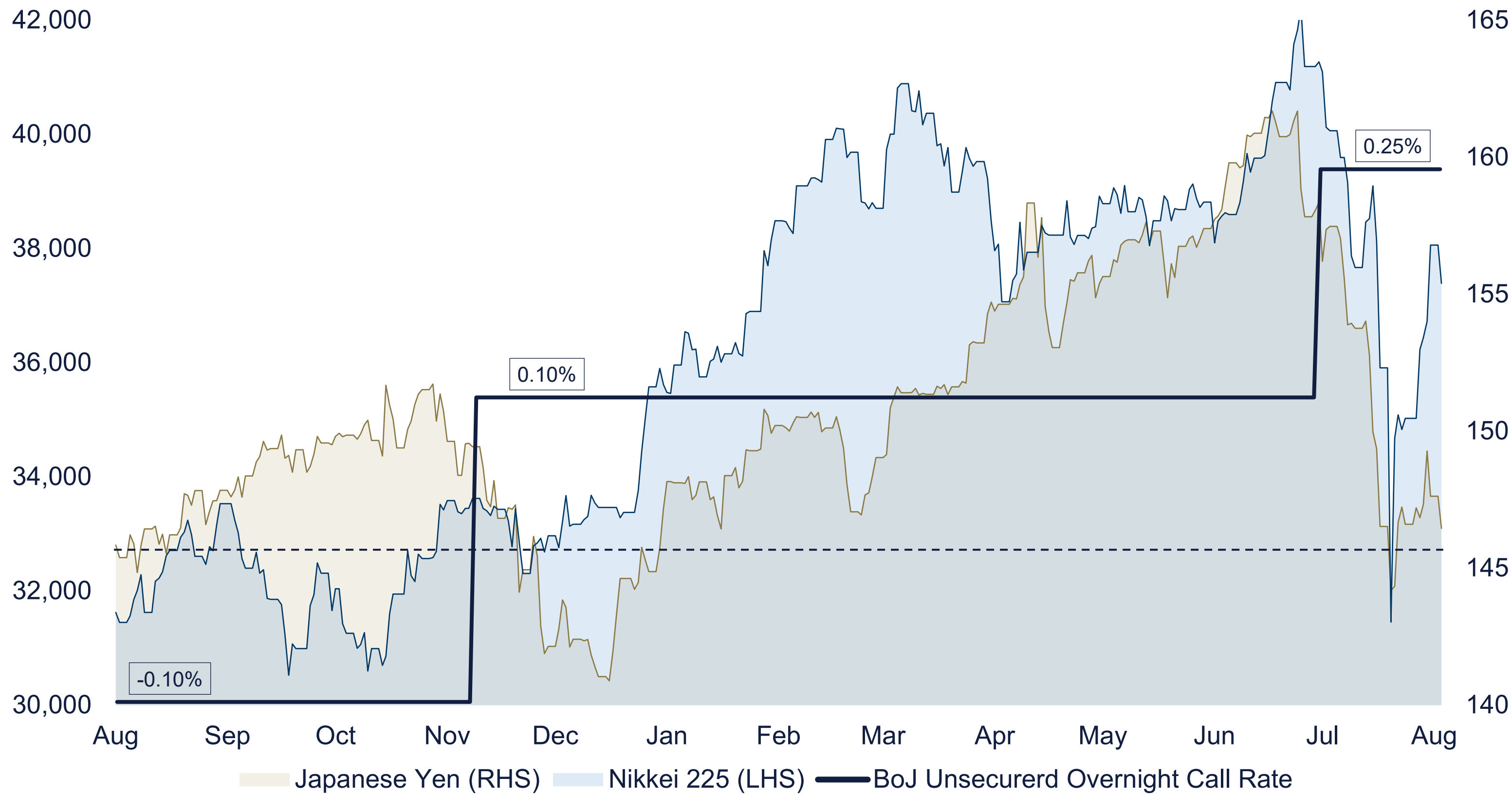
Stark reminder



- **Financial conditions deteriorated rapidly** at the beginning of August, with a spike in volatility underscoring the inherent unpredictability of markets.
- While fundamentals contributed to the downturn, **the correction was largely technical**. Credit spreads widened in response to labor market data and weakening PMIs, though they stopped short of reflecting a significant increase in recession risks.

Source: Bloomberg

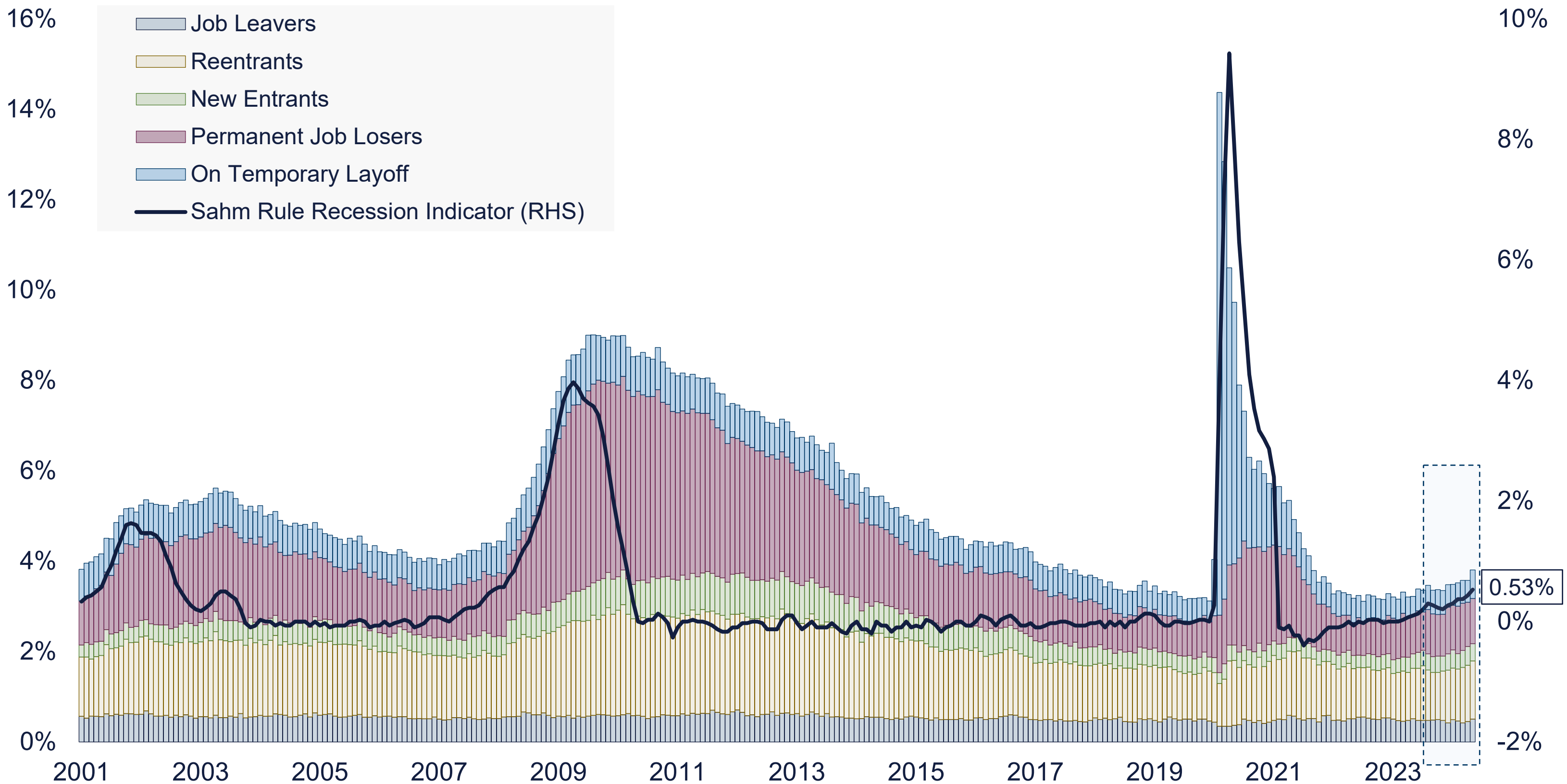
End of cheap money



- The Bank of Japan, the **last major central bank maintaining a zero-interest rate policy** raised rates again in July. Driven by a depreciating yen and rising inflation, the unexpected rate hike signaled the end of the last source of cheap funding.
- This shift is likely to lead to a stronger yen, posing additional **challenges for professional investors engaged in "carry trades"** that rely on low-cost borrowing in a currency that does not appreciate.

Source: Bloomberg

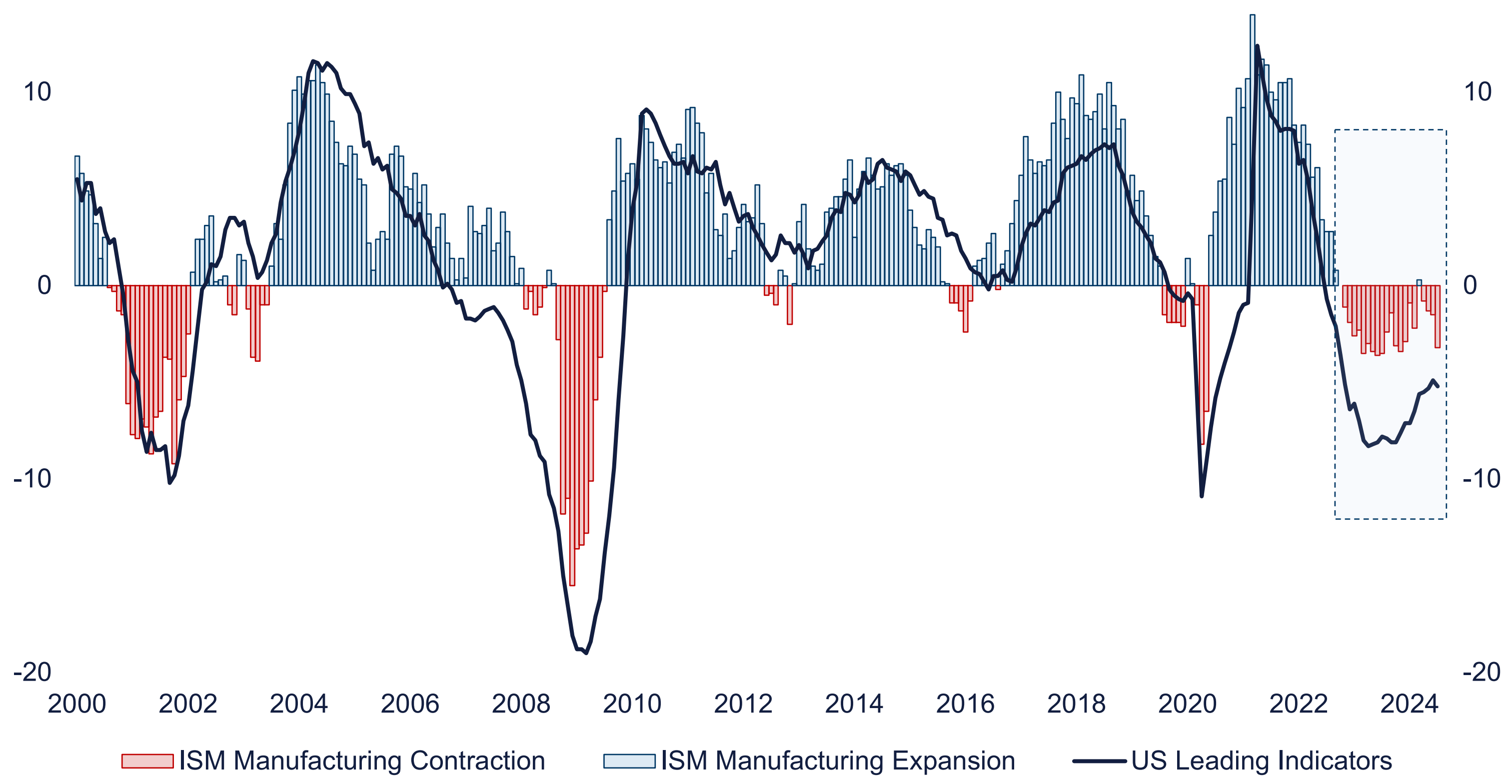
Is the job market cooling too fast?



- July's unemployment rate ticked up to 4.3% from 4.1%, a small rise that signals a **potentially troubling trend**. While the level remains low, it is the upward trajectory that raises concerns, especially as nonfarm payrolls fell short of expectations.
- This could be an **early warning under the Sahm rule**, which links rising unemployment to the onset of recessions.

Source: Bloomberg

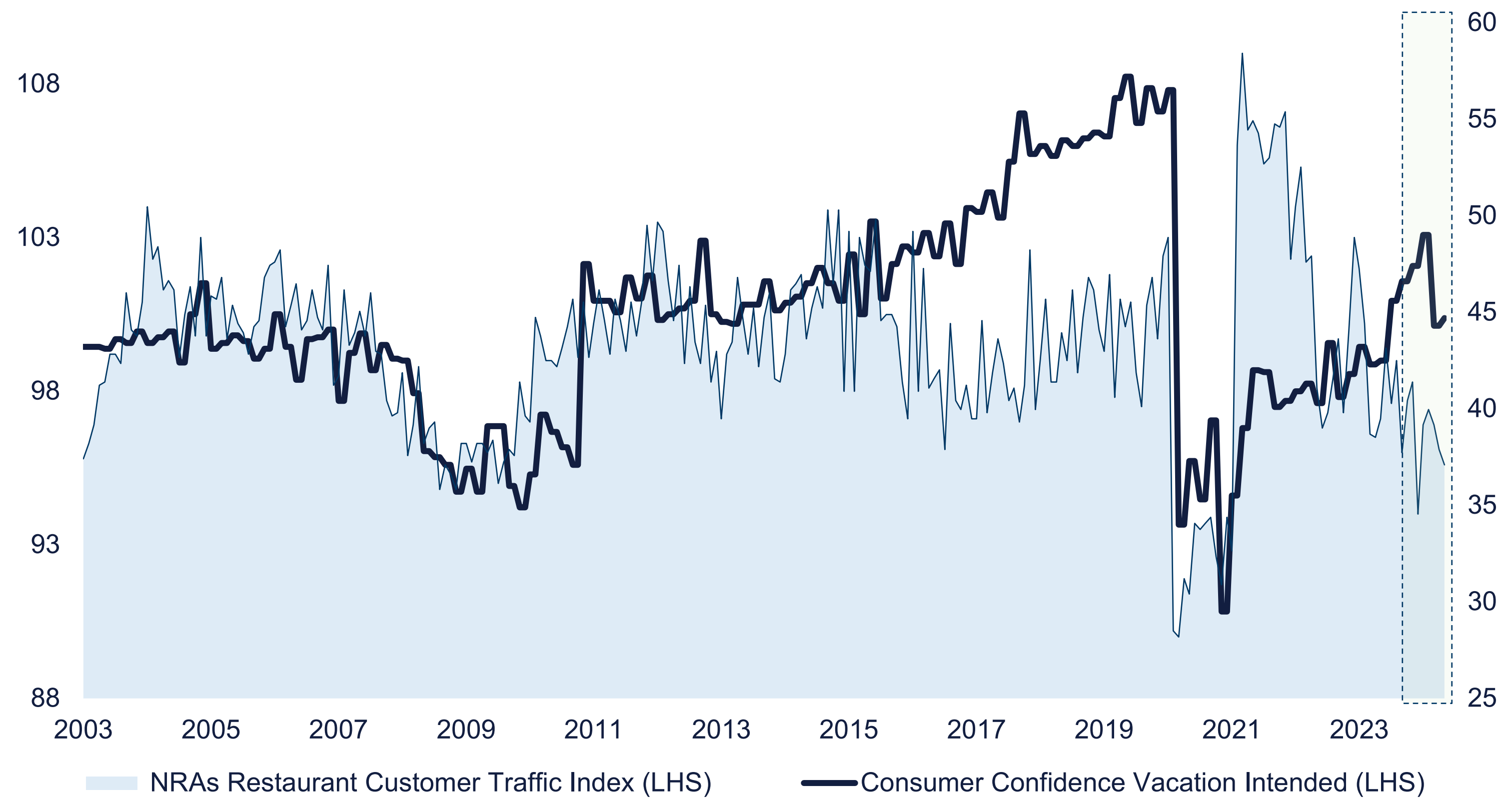
Crying wolf



- Markets were shaken not only by the July unemployment report but also by a **continued contraction in manufacturing** PMIs released the day before.
- This contraction is now **one of the longest on record**, yet, contrary to expectations, the economy has not slipped into a recession.

Source: Bloomberg

Cracks in consumer spending



- **Q2 earnings revealed emerging weaknesses in consumer-driven sectors**, with airlines, restaurants, luxury, and home improvement stocks largely disappointing, signaling a potential slowdown in consumer spending.
- However, **there are some positive signs** – recent consumer confidence surveys, retail sales, and the services PMI have all shown improvement.

Source: Bloomberg

Fed gains greater latitude

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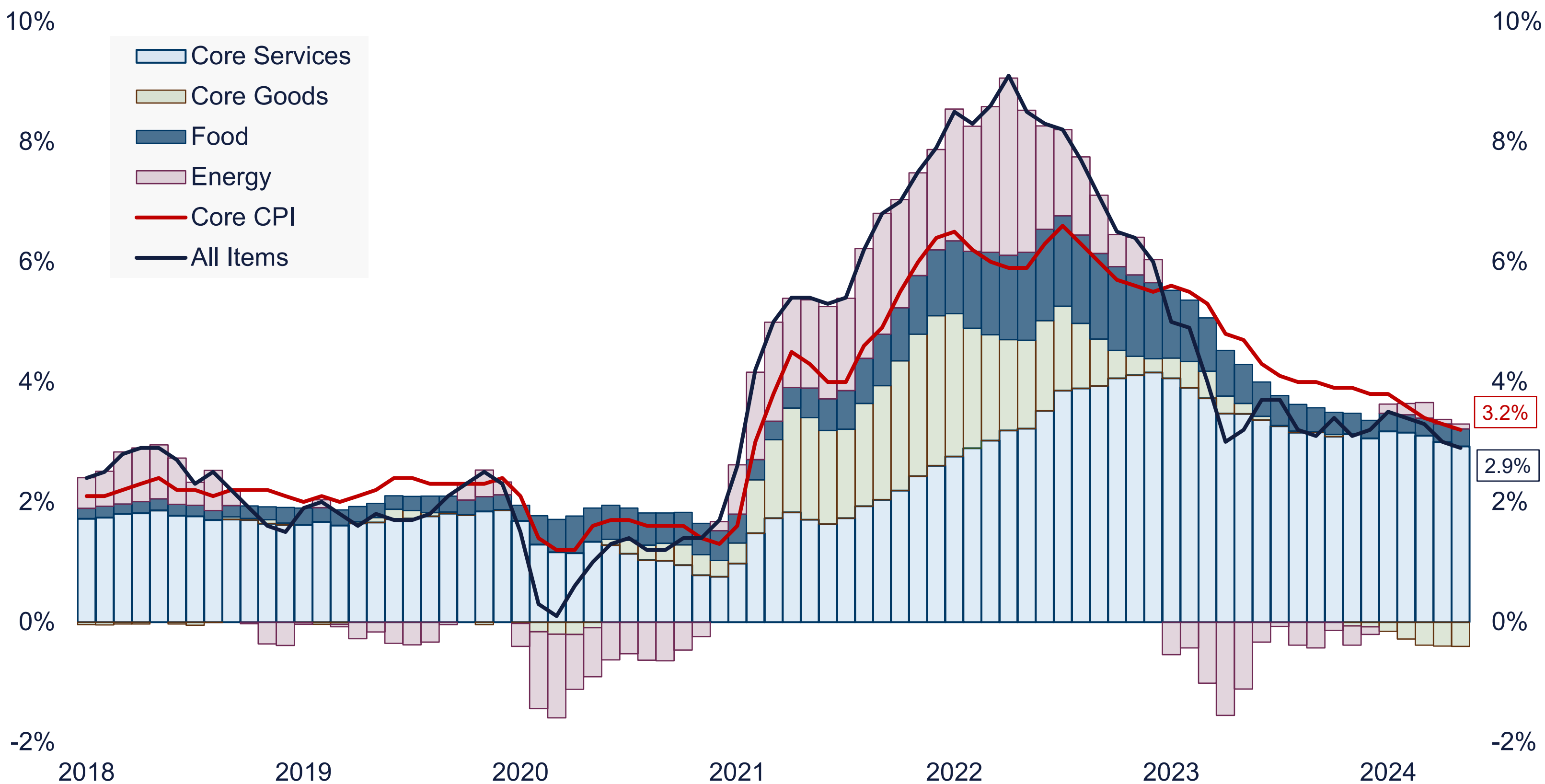
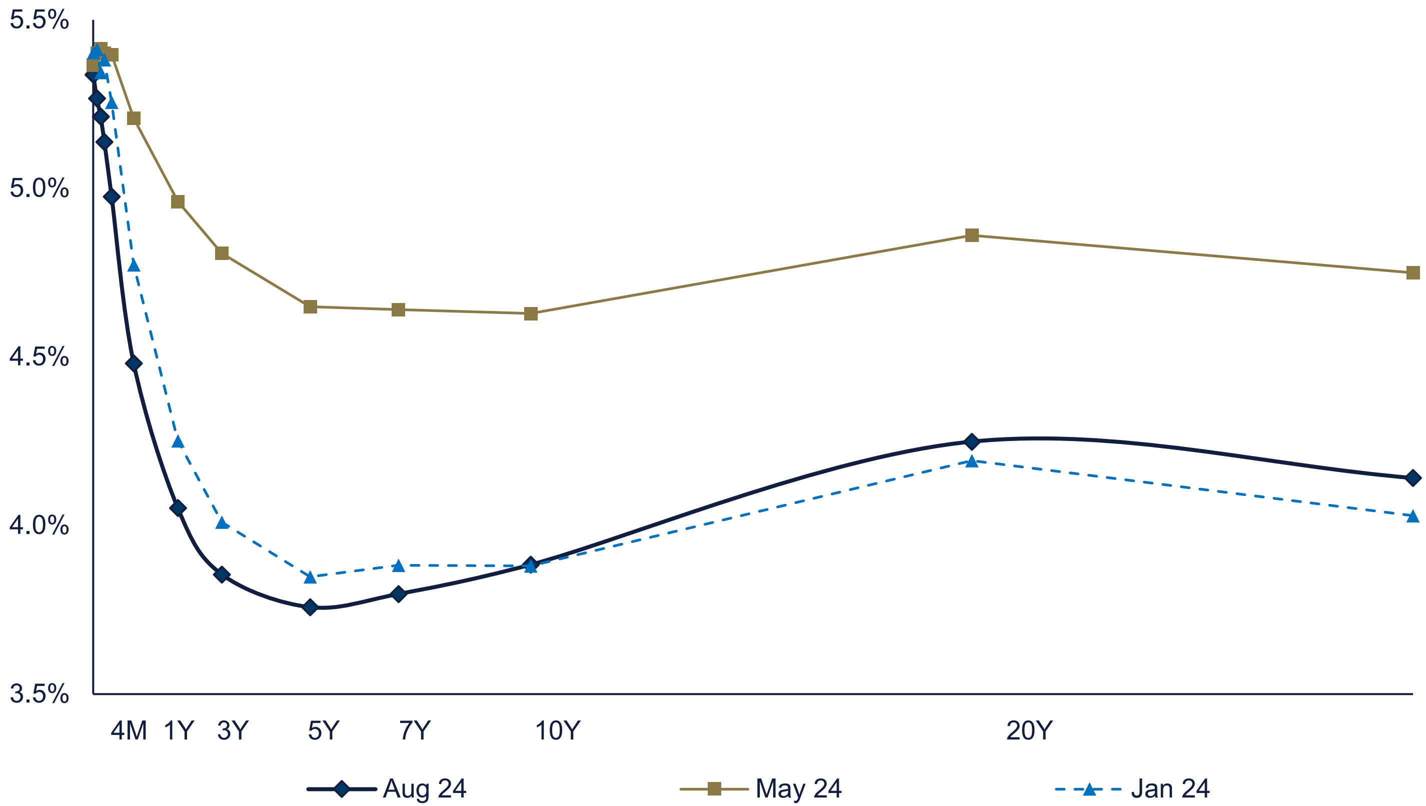


- The positive inflation data for July was **crucial in calming financial markets**, confirming that the disinflationary trend has fully resumed after a brief pause earlier in the year.
- This development provides the Fed with greater flexibility in steering monetary policy, enabling it to **shift focus more towards employment and economic growth**. As a result, the rate-cutting cycle is expected to begin in September.

Source: Bloomberg

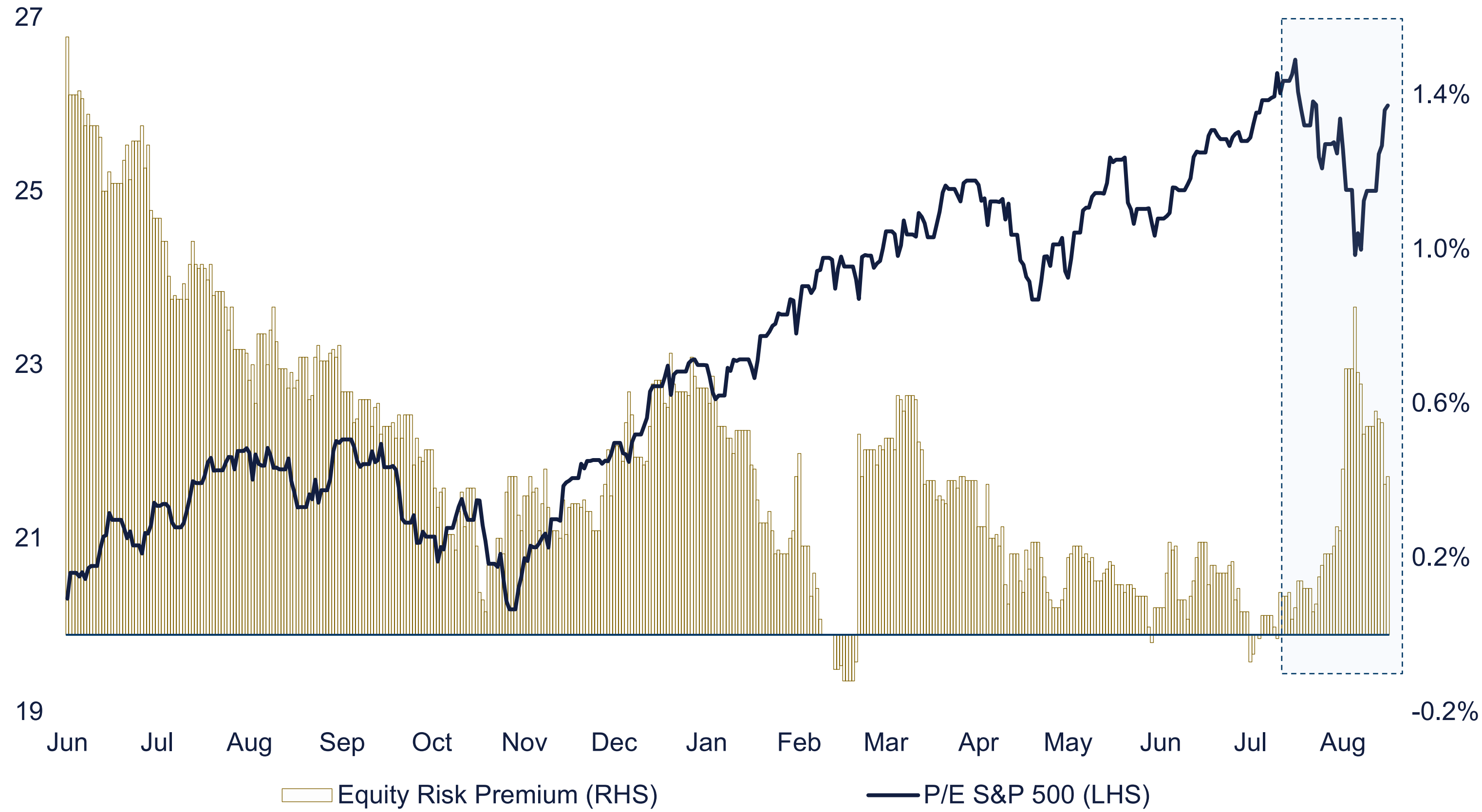
Markets take notice



- Markets have responded to the dual impact of growth concerns and reduced inflation risks with a significant adjustment in interest rate expectations. Currently, they are pricing in **two full percentage points of rate cuts** over the next year.
- Additionally, the **yield on the 10-Year US Treasury has dropped 50 basis points**, and its is now below its starting level for the year.

Source: Bloomberg

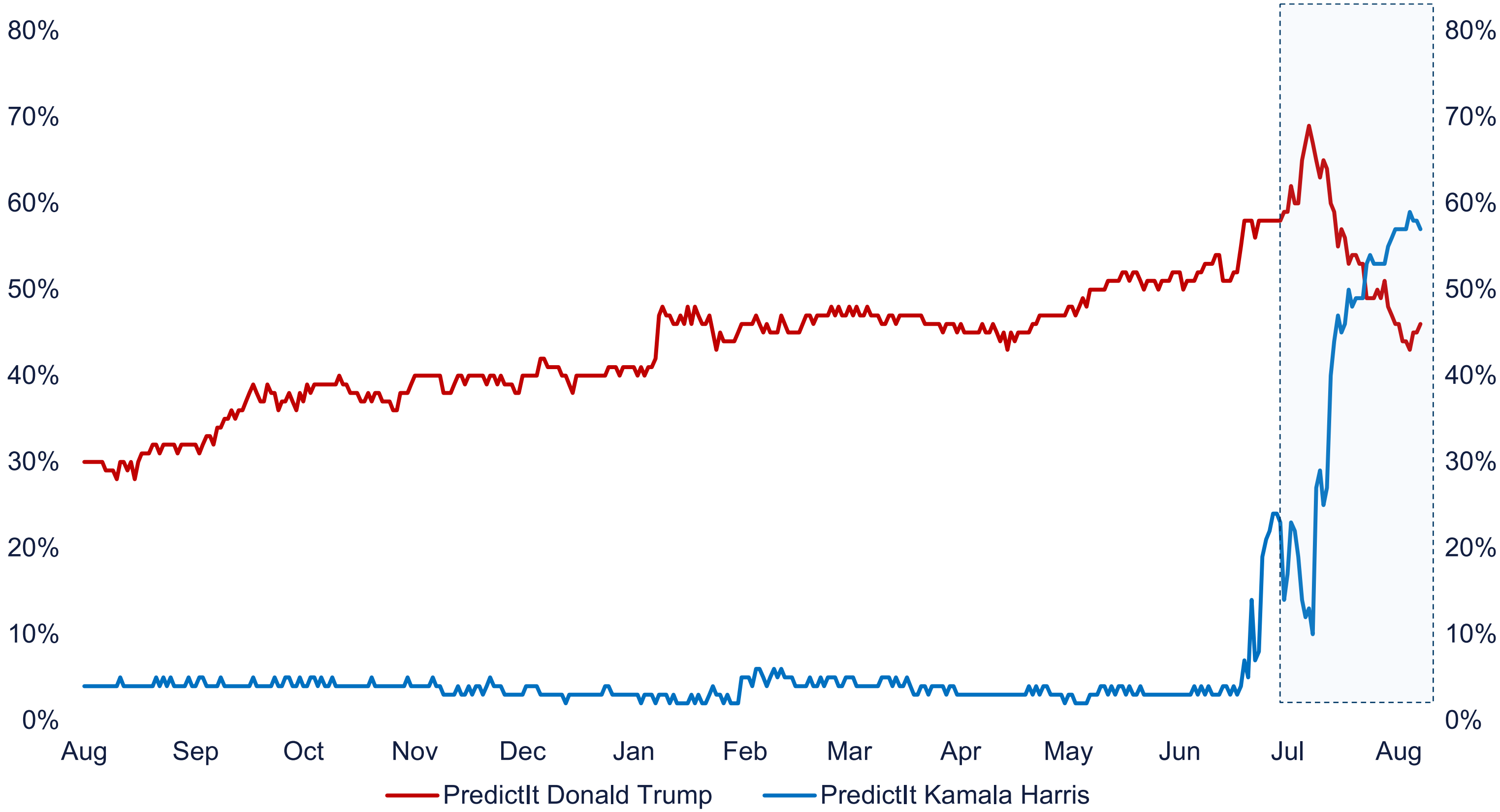
Valuations improved only marginally



- The correction in equity markets, along with the decline in interest rates, brought valuations **closer to their long-term averages.** However, with a swift rebound in prices, valuations have deteriorated once more and remain elevated.
- As the Q2 reporting season concludes, S&P 500 companies have reported an **11% year-over-year increase in earnings**, the largest growth since Q4 2021.

Source: Bloomberg

Back in the race



- President Joe Biden has finally succumbed to pressure from his party and donors and decided not to seek a second term. The new Democratic presidential ticket suggests again a **tightly contested election**.
- **Economic and taxation policies are likely to take center stage**, with increased volatility anticipated as the November election approaches.

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 keep interest rates elevated for longer than anticipated • 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	10% (-5%)	35% (+5%)	55% (+5%)

Short-term catalyzers

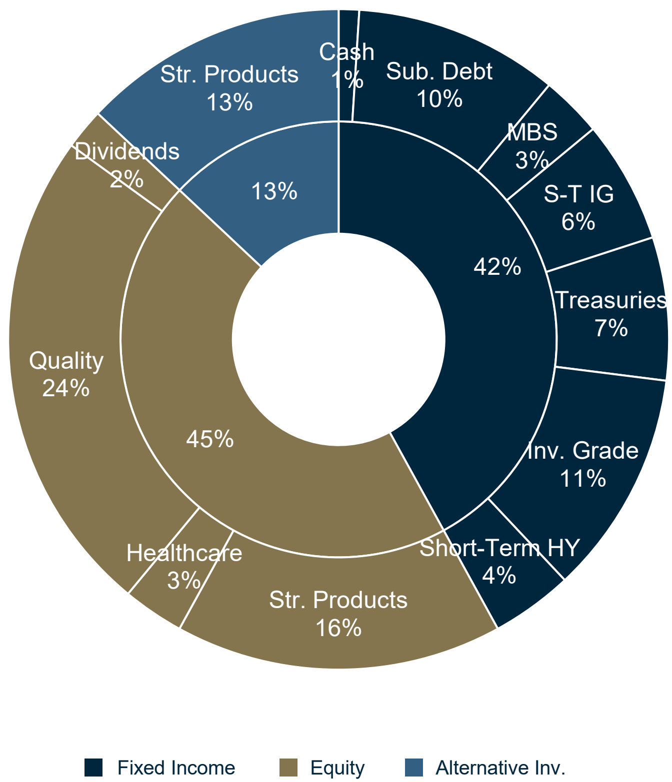
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems continue to ease

Other risks

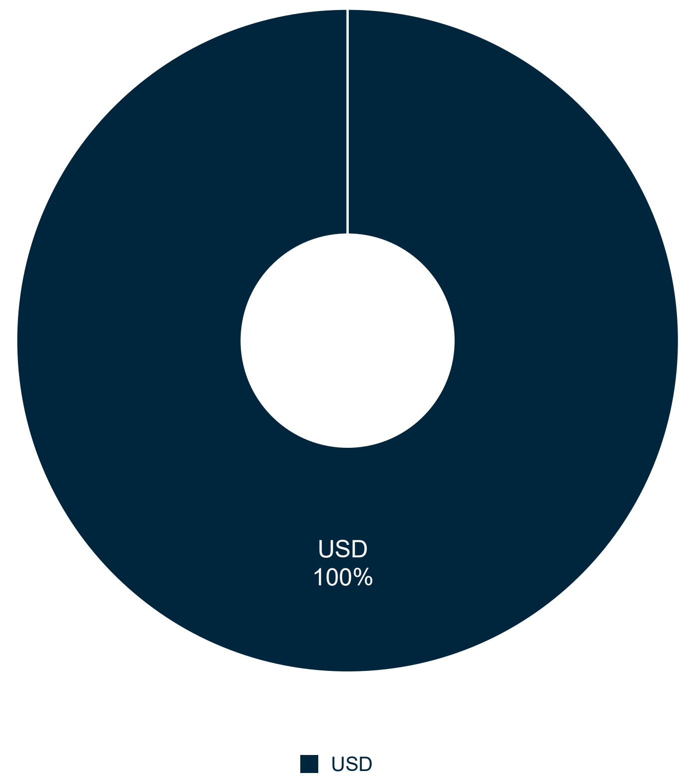
US Presidential Election, Debt ceiling, Escalation of geopolitical tensions, China slowdown, Housing market correction

Boreal Balanced Portfolio USD

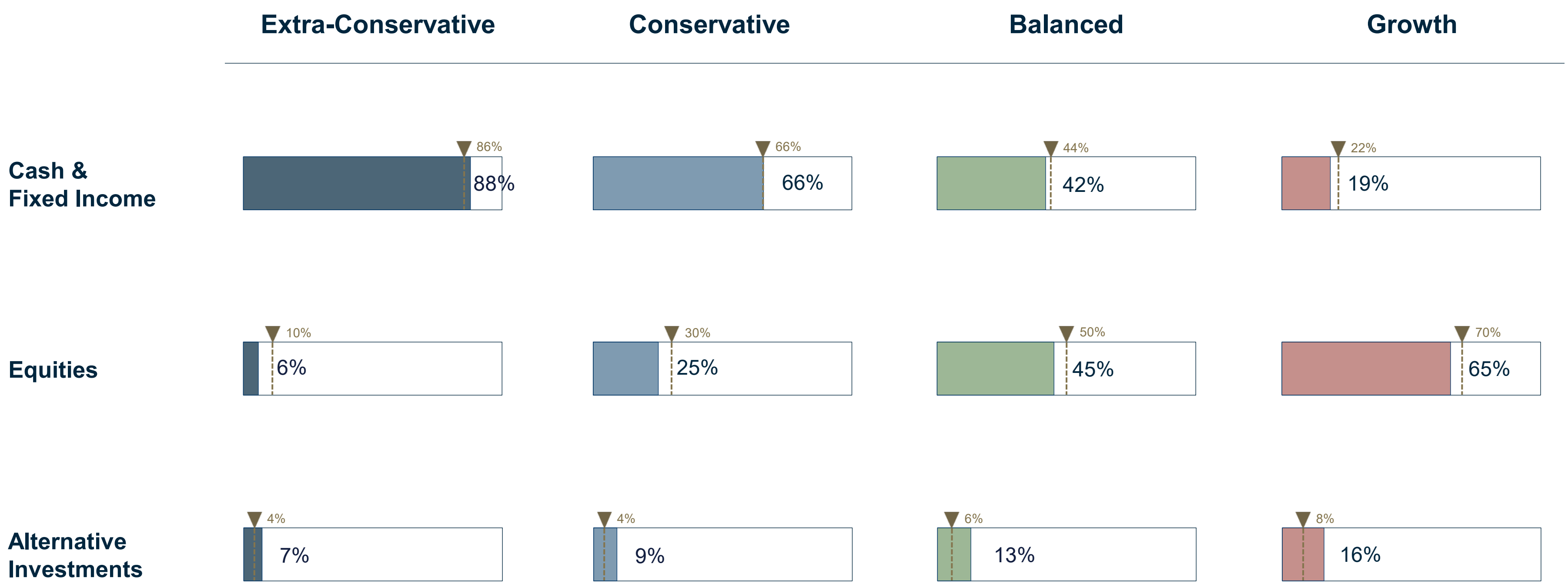
Asset Allocation



Currency Allocation

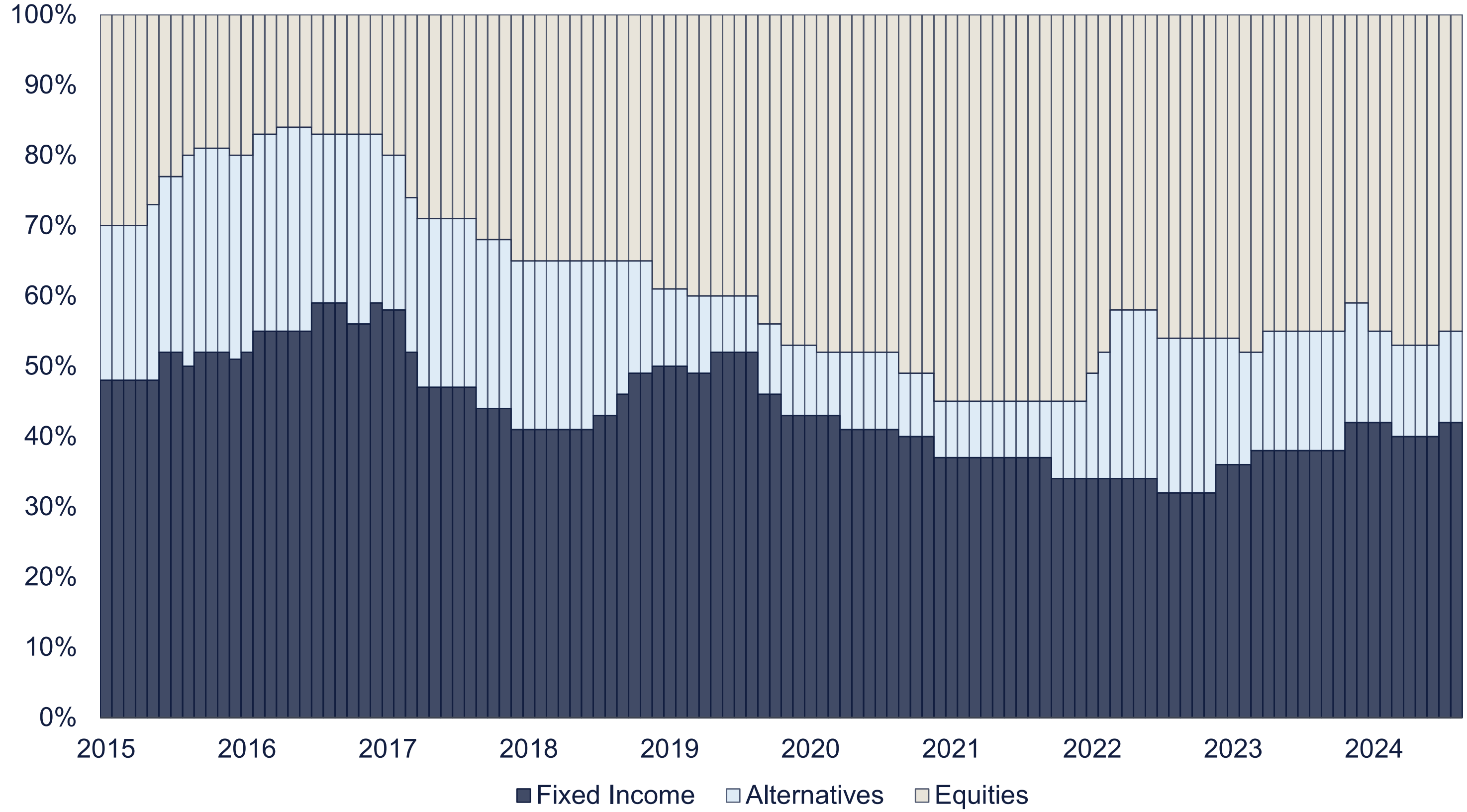


Boreal Investment Profiles



▼ Strategic Asset Allocation

Boreal Balanced Portfolio – Asset Allocation evolution



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