Investment Policy

July 2024

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Our market view in a nutshell – July 2024

- **The Fed faces a delicate balancing act: managing inflation while avoiding an economic downturn**. Recent data provides crucial insights into their path forward. Since the Fed's December shift in monetary policy, inflation has shown a disappointing decline, hindering potential interest rate cuts. However, June marked the **third consecutive month of stronger-than-anticipated inflation decreases, potentially signaling the beginning of a rate-cutting cycle**.

- This potential shift is further supported by **weakening economic projections**. Consumer spending, particularly in the crucial **service sector, is decelerating**. This coincides with a **cooling labor market**, which may further dampen consumption. The Fed recognizes that even with unchanged nominal rates, real interest rates are rising as inflation falls. As such, an adjustment in monetary policy appears warranted. Markets currently anticipate **three consecutive 25-basis-point rate cuts between September and December**.

- **Equity and credit markets appear less concerned about the potential economic slowdown**, as evidenced by the S&P 500 reaching 37 new highs so far this year. Despite recent declines in long-term interest rates, equity prices have surged at an even faster pace, **stretching valuations even further**. The ongoing **second-quarter earnings season** will offer additional insights into the opposite side of the valuation equation: earnings growth.

- **Market volatility remains subdued**, despite ongoing political uncertainty and geopolitical risks. **Investors appear to have largely priced in a potential second term for former President Trump**, with **tax hikes seemingly off the table**. This removes a significant source of market concern. While **potential inflationary pressures** from increased tariffs and stricter immigration policies remain on the horizon, these are unlikely to impact the Fed's near-term policy decisions in the absence of concrete data. The most pressing short-term risk likely lies in a **potential escalation of the trade war** with China, especially considering their current economic vulnerabilities.

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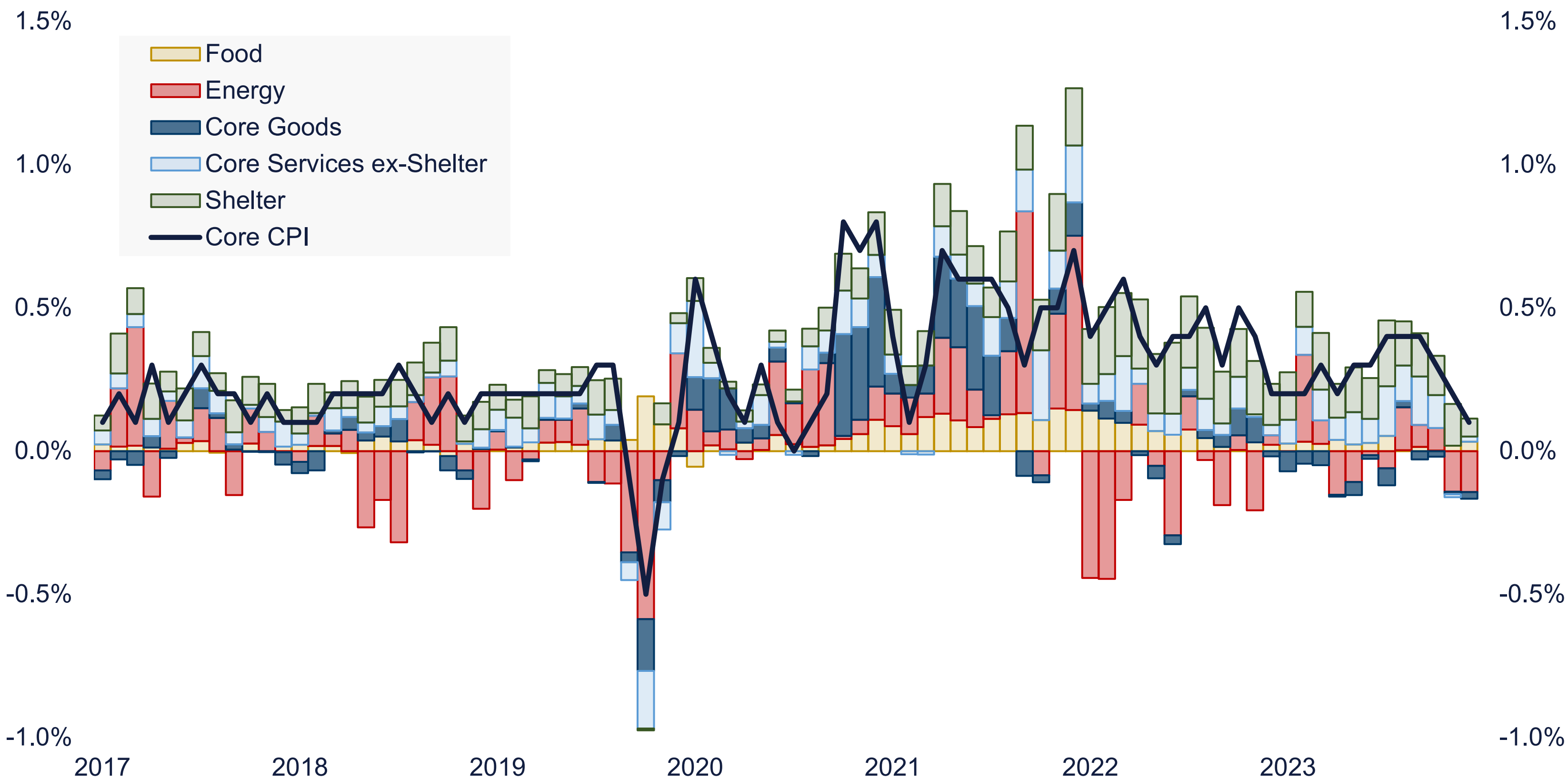
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. Given the binary macroeconomic risks we are facing (stagflation vs. recession), we favor TIPS and short-duration bonds
	US Credit	+	The Fed's recent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

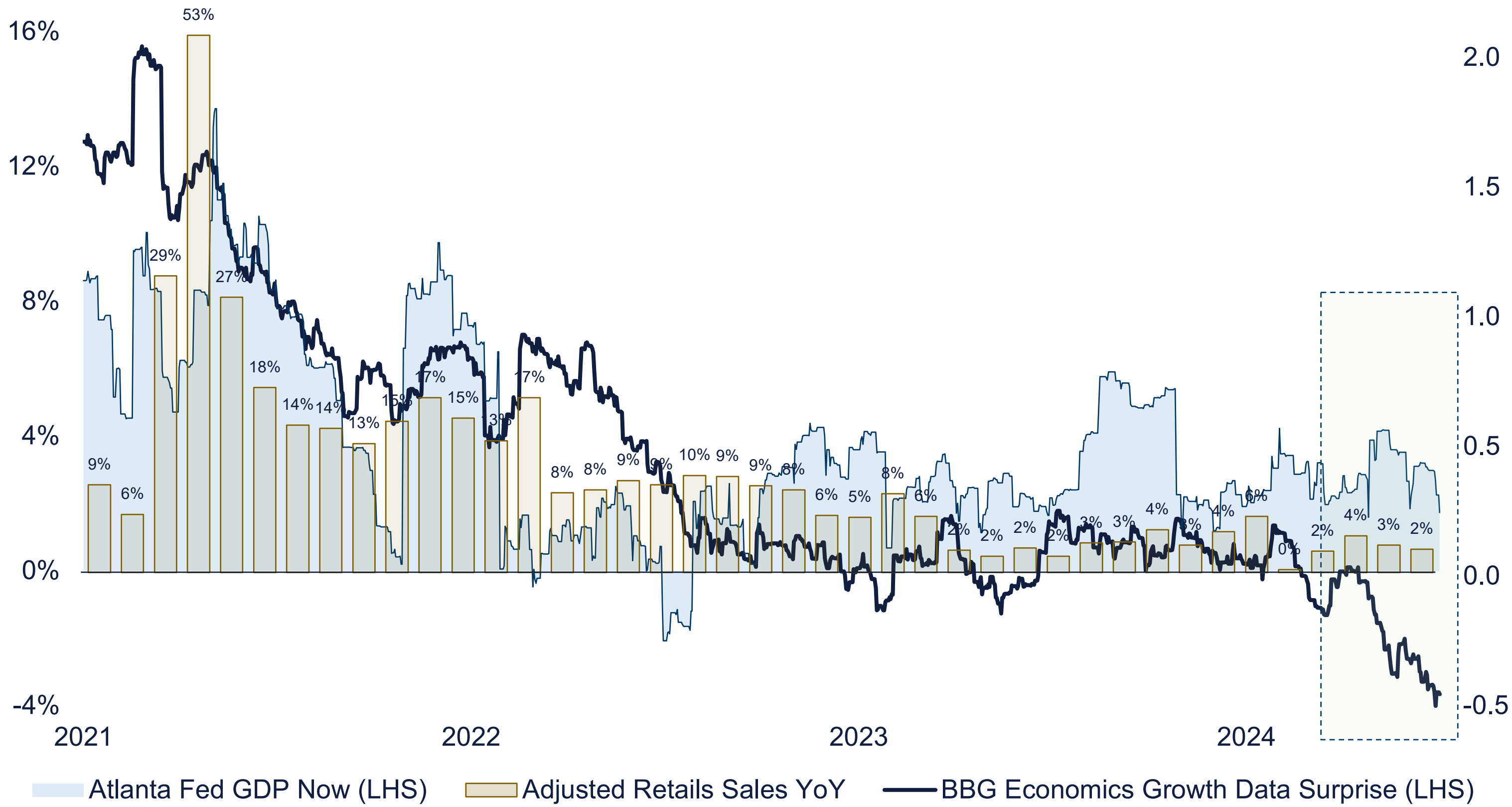
Back on track



- **Inflation has exceeded expectations for the third month** running, decelerating at a faster pace than analysts predicted. This suggests a renewed disinflationary trend.
- Both **services and housing costs have contributed to the decline**. Notably, owner's equivalent rent, the largest factor in the Consumer Price Index (CPI), saw its smallest increase in three years.

Source: Bloomberg

Time for Fed support



- The possibility of imminent Fed cuts has been reinforced by a growing number of **economic indicators suggesting the economy is entering a soft patch**.
- The Fed is aware that as inflation decreases, real interest rates are rising, effectively tightening monetary policy further. This carries the risk of **being overly restrictive and potentially compromising a soft landing for the economy**.

Source: Bloomberg

Growing concerns in the service sector

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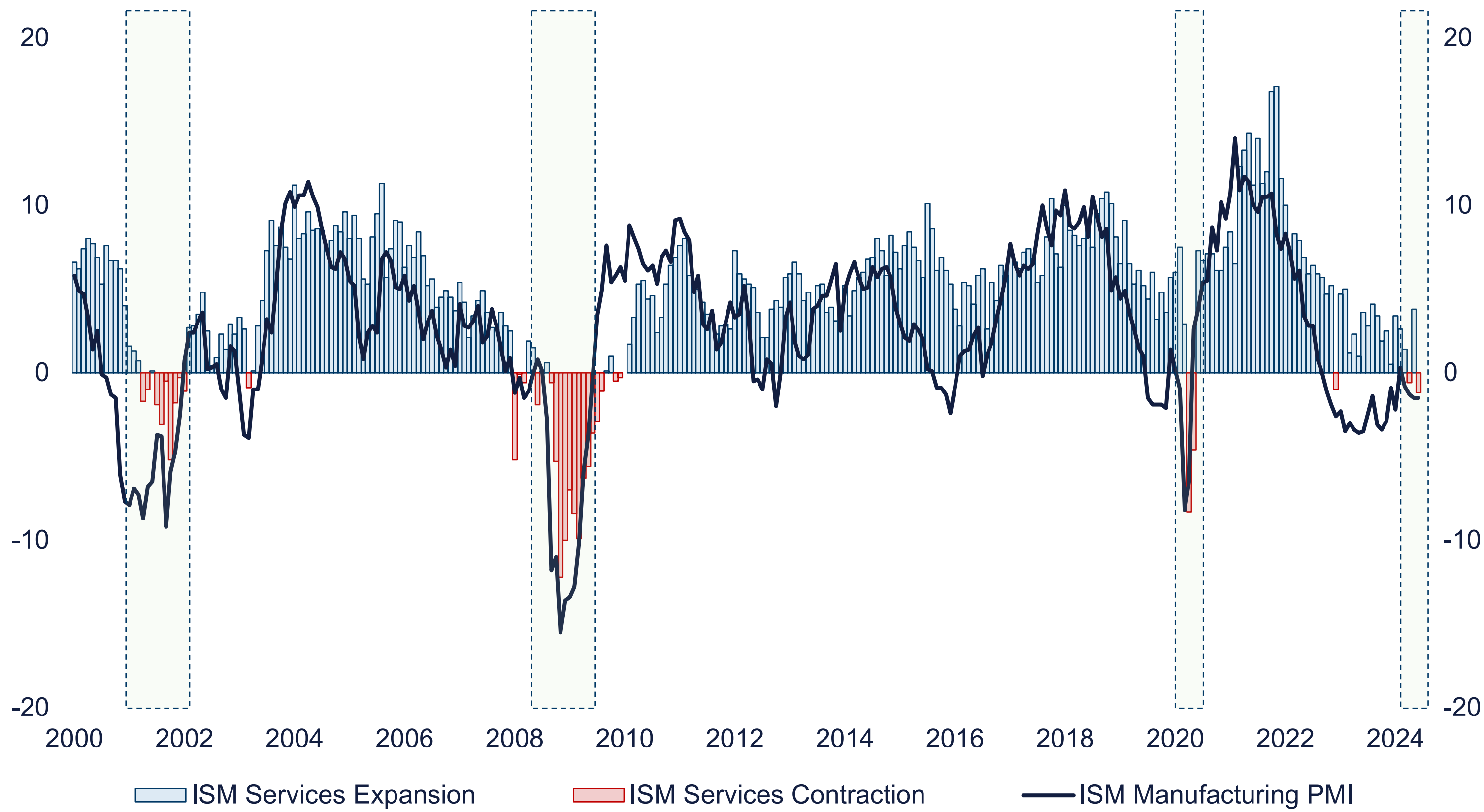
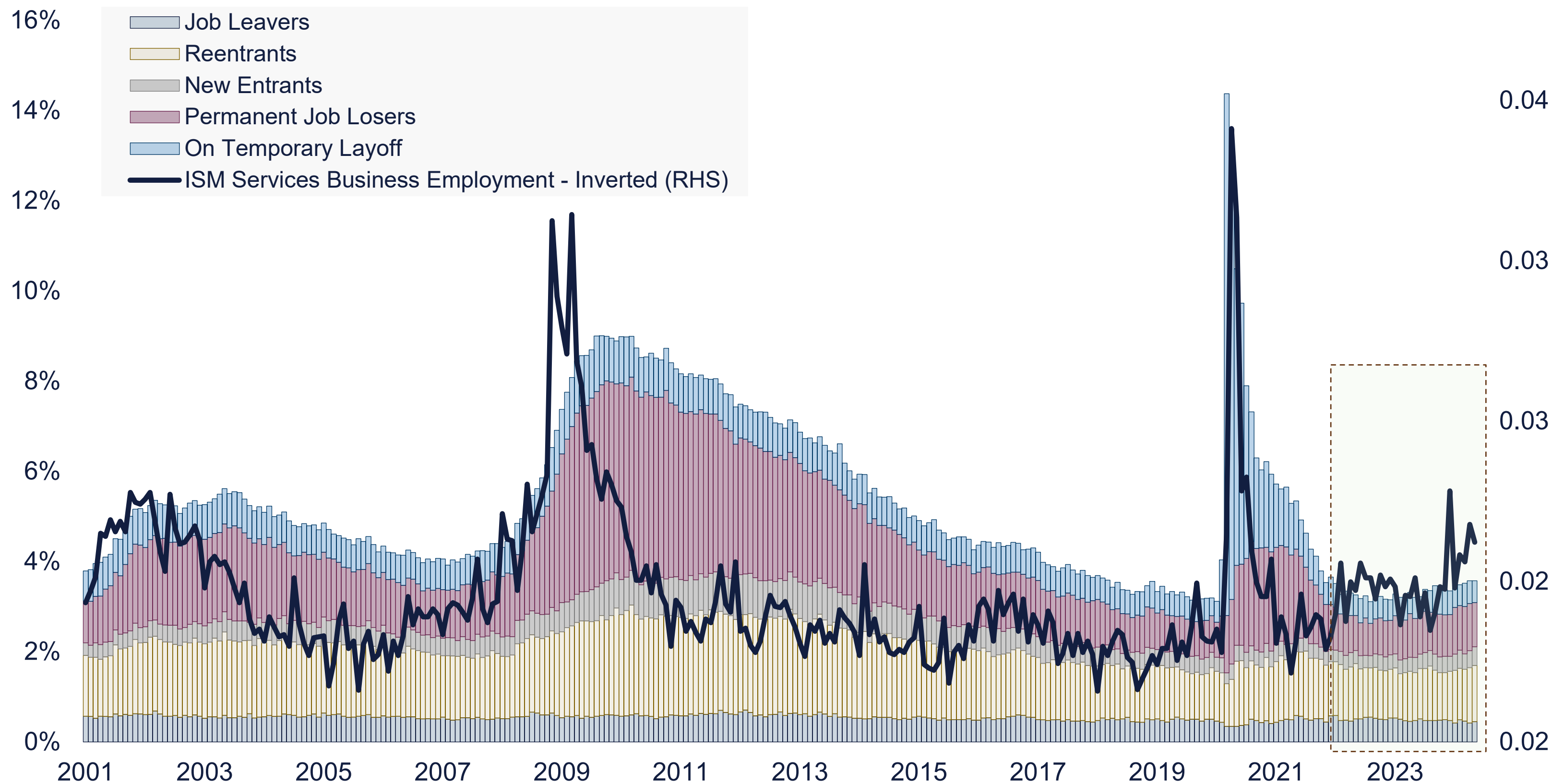


- Survey indicators for the **service sector continue to send worrying signals**. A contraction in services PMIs is something that typically occurs only when the economy has entered a recession.
- The fact that the **manufacturing PMIs**, which are much more sensitive to economic conditions, **have been in contraction for nearly two years** adds to the concerns that the economy may be slowing down dangerously.

Source: Bloomberg

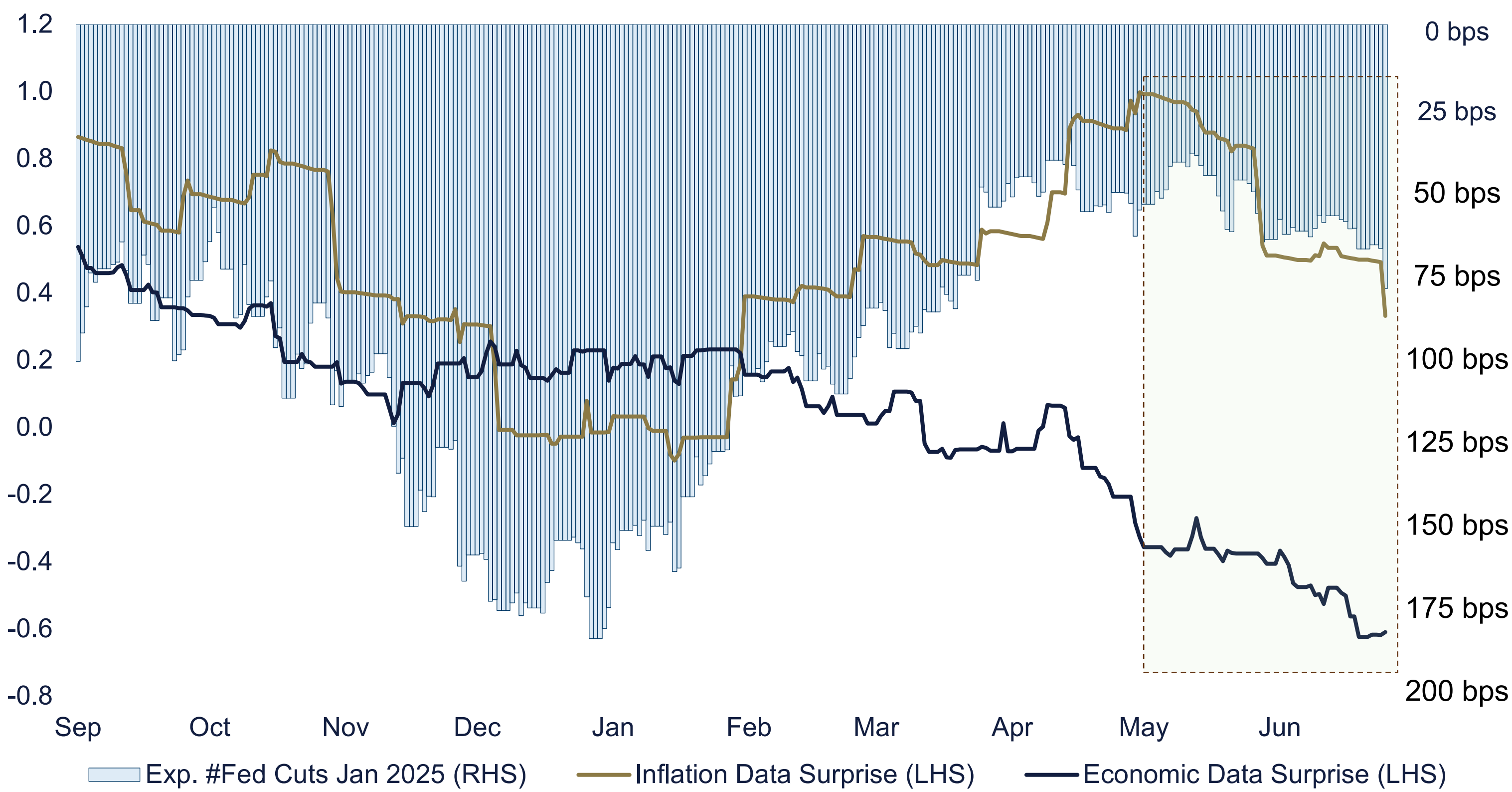
Labor market increasingly in focus



- Looking at absolute levels, the labor market can be considered very strong. However, when examining it more closely, there are **clear signs of it starting to cool off**.
- Any further increase in unemployment poses the **risk of triggering a long-delayed adjustment in consumption**.

Source: Bloomberg

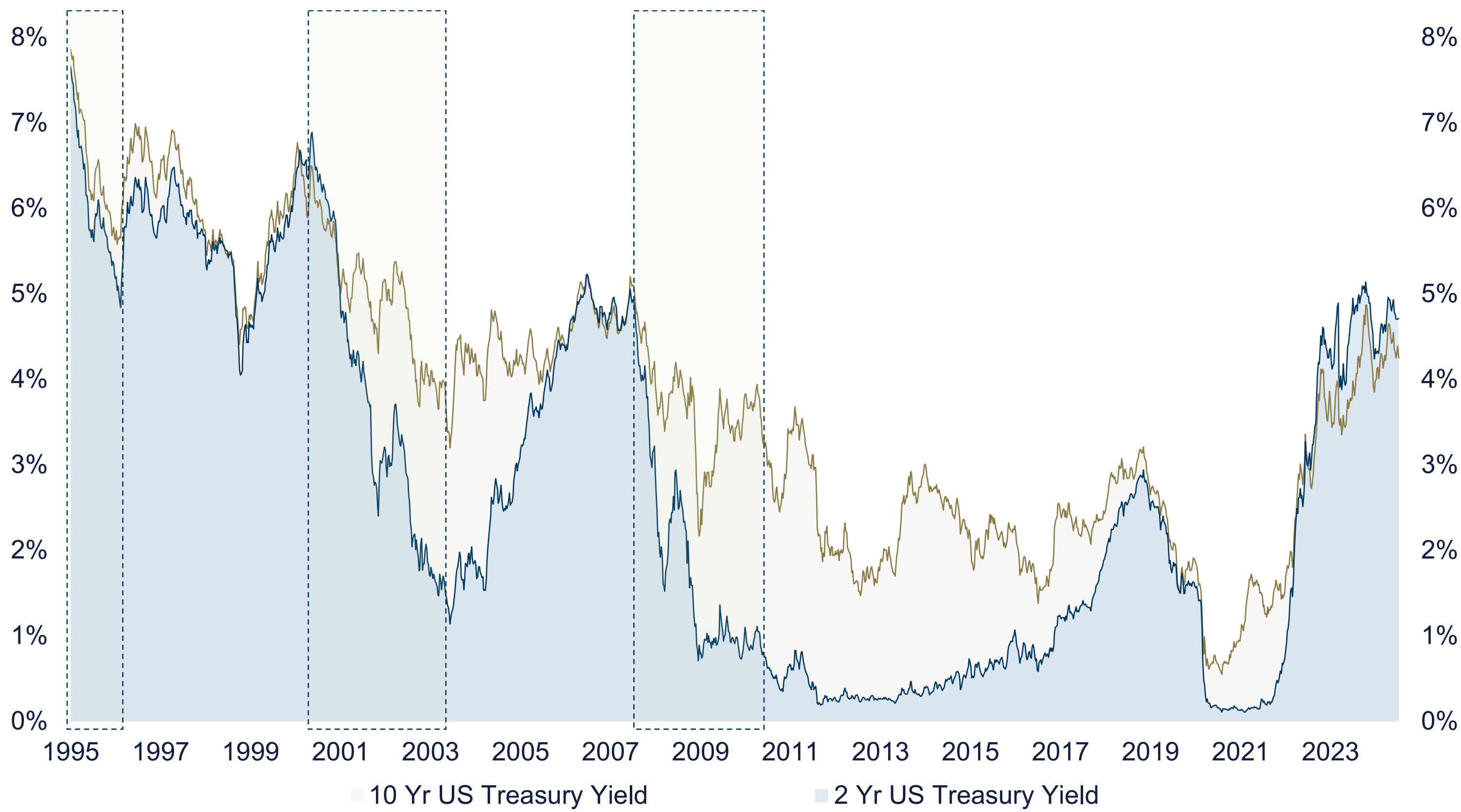
The path is now clear



- With the resumption of the deflationary trend and the worsening of economic growth, **the Fed now has a clear path to start cutting interest rates**.
- The market is predicting the **first 25bps cut in September, followed by successive cuts in the coming months**. However, a continuation of the above-mentioned inflation and growth dynamics could prompt the Fed to act more decisively.

Source: Bloomberg

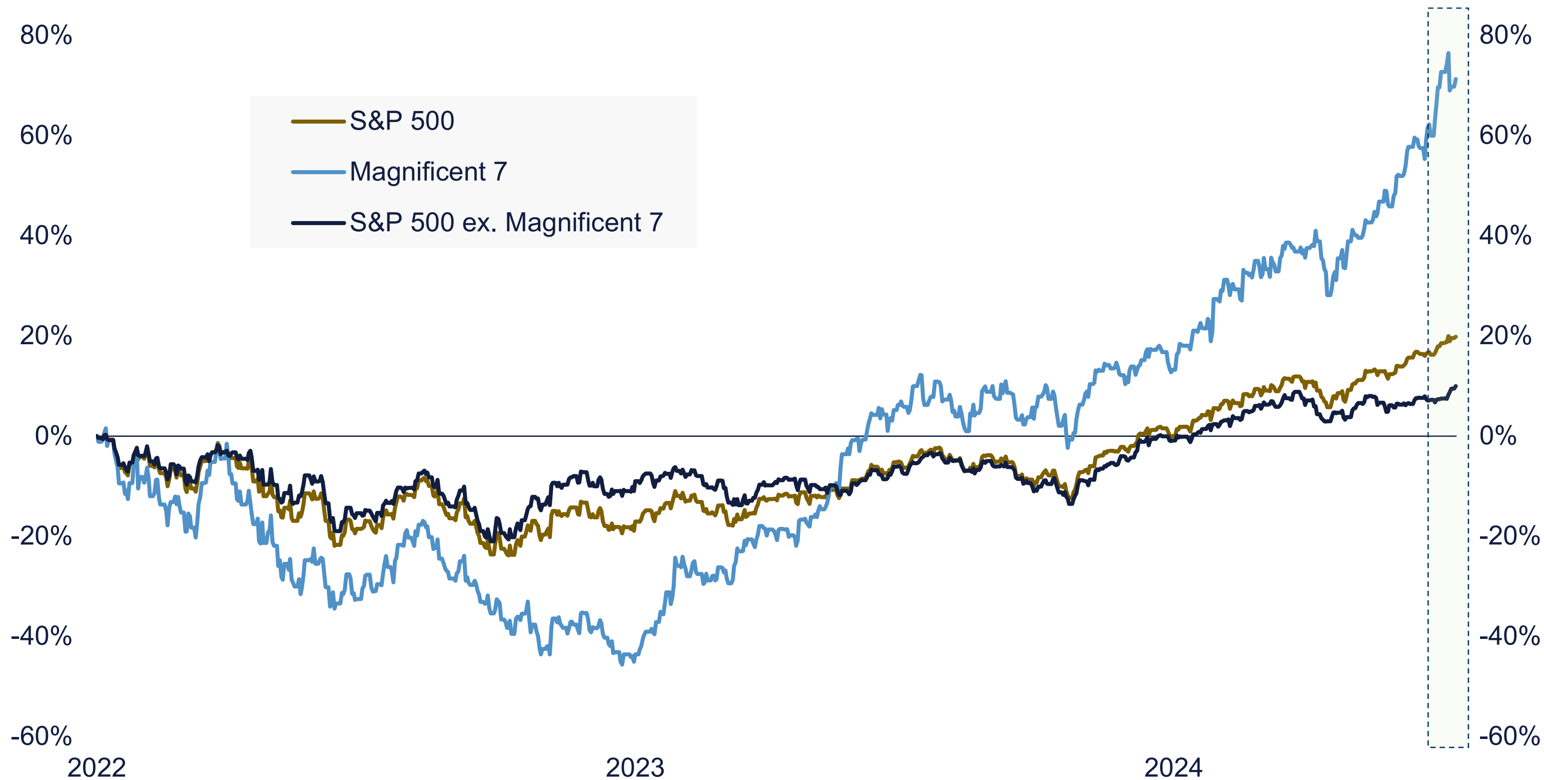
Long-term rates face more uncertainty



- While the direction for short-term interest rates appears clear, investors should be **cautious about expecting corresponding declines at the long end of the yield curve**.
- One pressing issue for investors is the **sustainability of the fiscal deficit**. Another uncertainty is whether the **natural rate of interest** has increased due to changes in global value chains after the pandemic and the rise of protectionism.

Source: Bloomberg

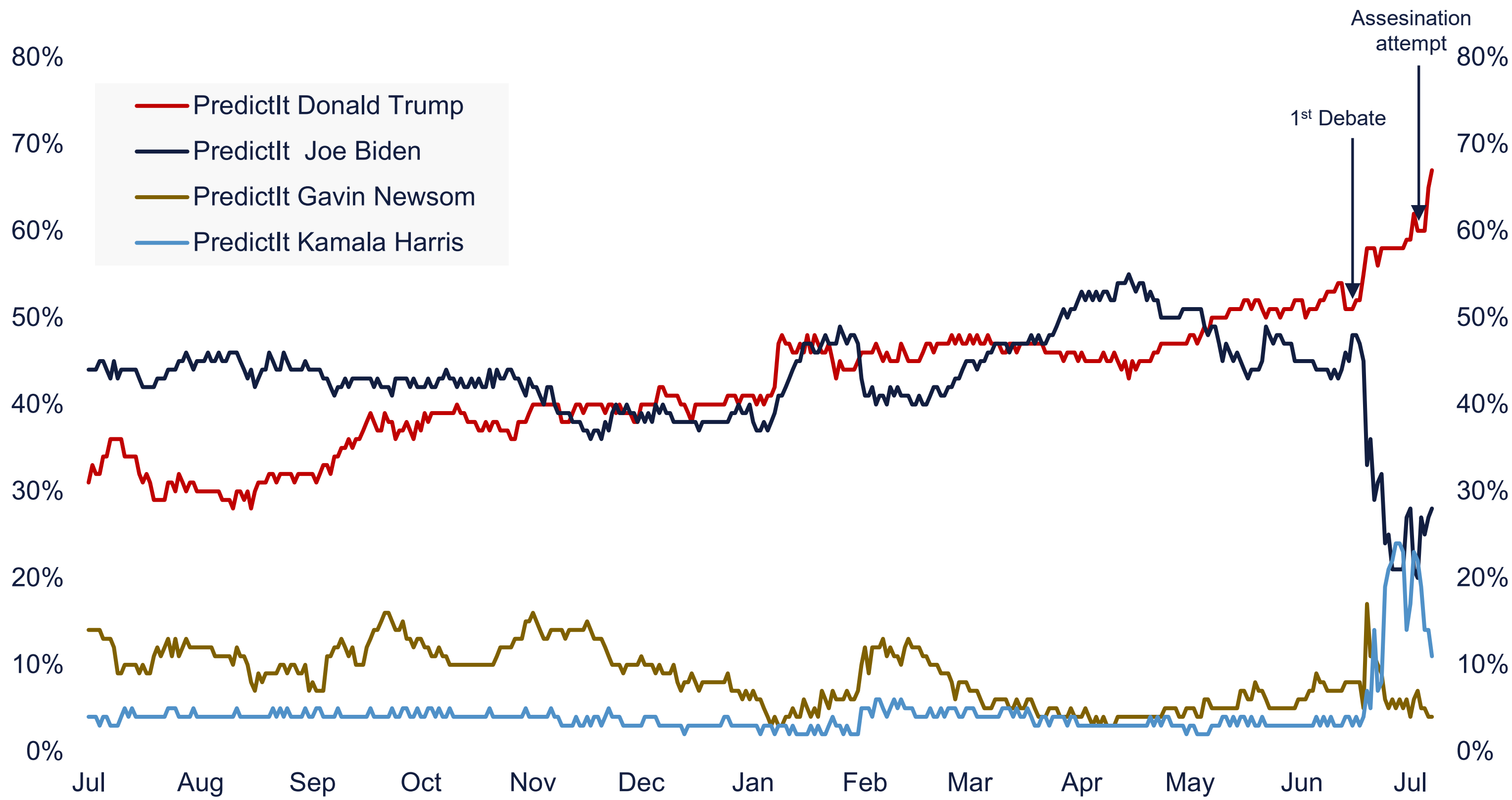
From strength to strength – At the expense of valuations



- Equity markets continue to rally despite lofty valuations, growing economic strain, and geopolitical and political unrest. **While high valuations alone rarely trigger corrections, stretched valuations offer diminished support** when corrections do occur.
- Cyclical **sectors that have been lagging could benefit most if the Fed starts cutting rates**. However, it is still too early to say there will be a sector rotation.

Source: Bloomberg

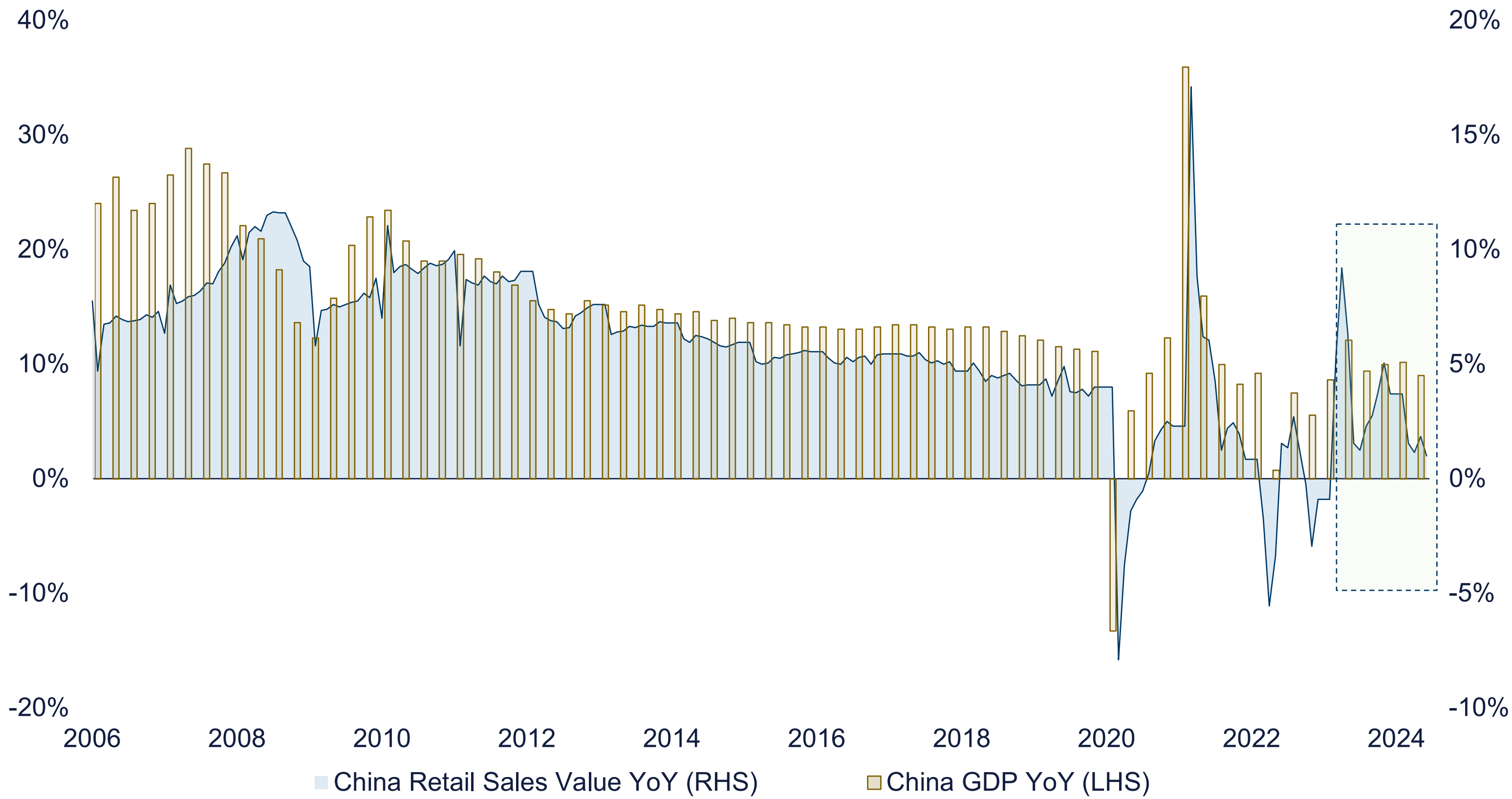
Markets have settled for a second Trump term



- After the **debate** between Joe Biden and Donald Trump, and following Trump's recent **assassination attempt**, a victory for the latter now seems almost guaranteed.
- **Equity markets have smoothly digested the news**, with only a handful of sectors perceived as directly benefiting or being impacted showing significant movement post-events.

Source: Bloomberg

China's growth back on the spotlight



- A new term for Trump may lead to **more tariffs and protectionist rhetoric against China**. This poses a significant danger to its economy. **China is grappling with maintaining growth, hampered by a property crisis** that continues to heavily impact consumers.
- The **market's thesis is that the Chinese government will be able to bolster the economy and avoid a recession**. However, the experiences of 2015 and 2018 serve as reminders of how swiftly the market can revisit this thesis.

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%	30% (+5%)	50% (-5%)

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

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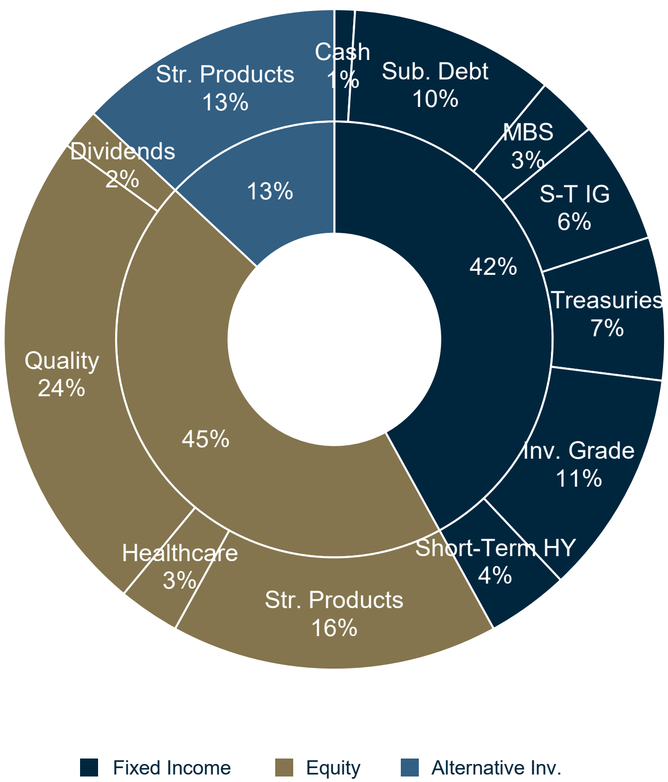
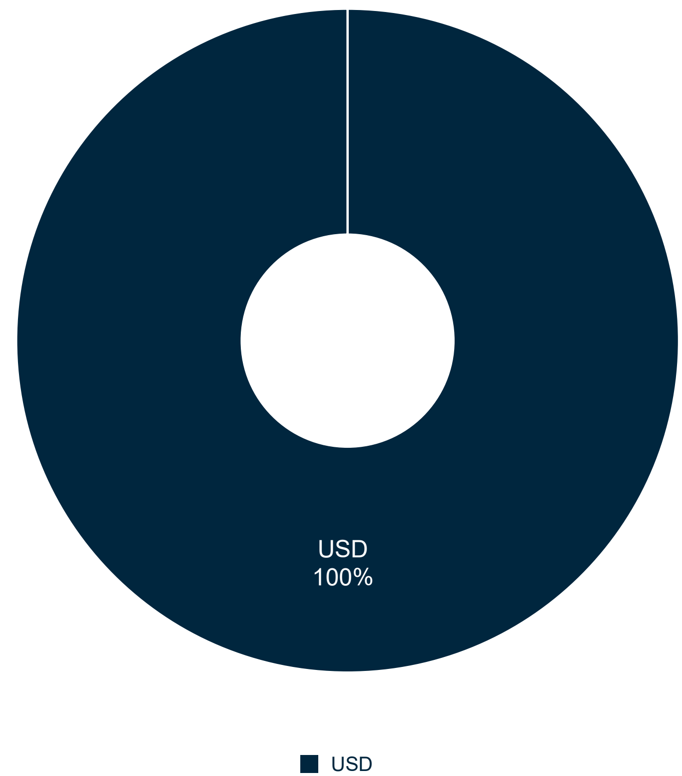
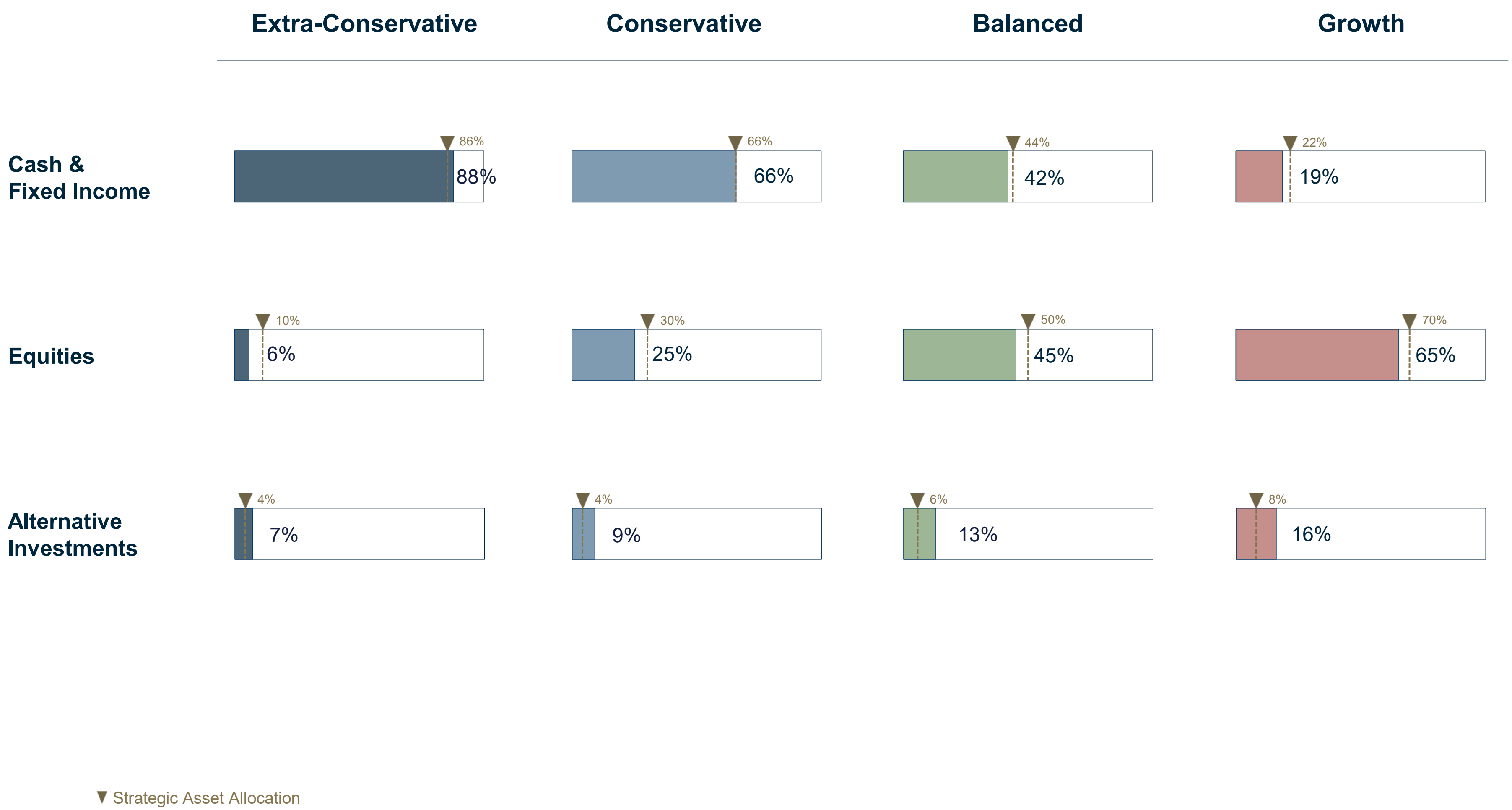
Asset Allocation



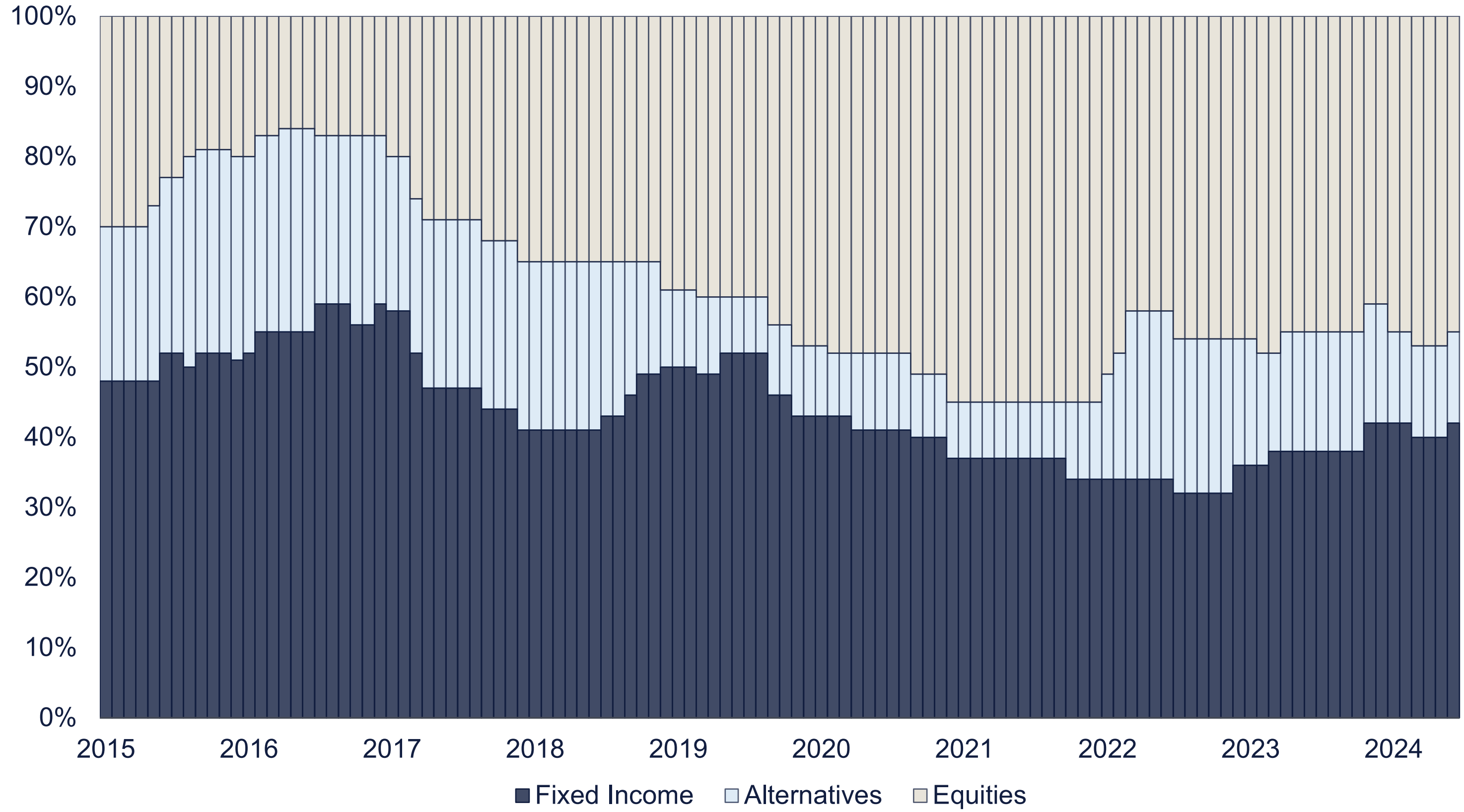
Currency Allocation



Boreal Investment Profiles



Boreal Balanced Portfolio – Asset Allocation evolution



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