Investment Policy

December 2024

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CAPITAL MANAGEMENT

Our market view in a nutshell – December 2024

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- 2024 started on a promising note following the Fed's pivot late last December. While the initial **focus remained on taming inflation**, delays in the first interest rate cuts **gradually shifted attention to employment**. Despite rates climbing to 5.5%—a stark contrast to a decade of ultra-low rates and quantitative easing—the economy has defied expectations, avoiding a recession so far.

- President **Trump's election victory marked a turning point**, with his promises of deregulation and tax cuts pushing inflation and employment concerns into the background. Confidence indicators and a post-election stock market rally reflect **growing optimism among consumers, businesses, and investors** alike. However, the administration's America-first policies **risk exacerbating global vulnerabilities**. History reminds us that even the U.S., with its relative economic independence, cannot fully shield itself from global shocks, as demonstrated by the European sovereign debt crisis in and China's growth scare in 2015.

- A key risk of the new administration's policies lies in the **potential inflationary impact of curbing immigration and imposing tariffs**, though these effects are unlikely to materialize in the short term. **The Fed, cannot speculate too much on the long-term implications of these policies, and must continue normalizing interest rates**, recognizing that consumer spending alone cannot sustain economic growth indefinitely. Meanwhile, other central banks are aggressively easing to address weaknesses in their economies, which is strengthening the U.S. dollar. This **growing policy divergence** risks creating tension between the new administration and the central bank.

- The combination of a more accommodative Fed, resilient consumption, low unemployment, controlled inflation, and pro-growth policies has **significantly reduced the risk of a recession**. This environment provides crucial **support for risk assets, even as valuations remain stretched**. Historically, large market corrections have been driven by compromised economic growth rather than elevated valuations. However, today's high valuations raise the earnings growth needed to sustain market prices, heightening the risk of potential disappointments

- After two years of extraordinary returns for risk assets—partly driven by rising consumer prices—**a normalization of returns should now be expected**. While this does not suggest an imminent downturn, it underscores the importance of balancing optimism with caution as we navigate a market shaped by both opportunity and risks.

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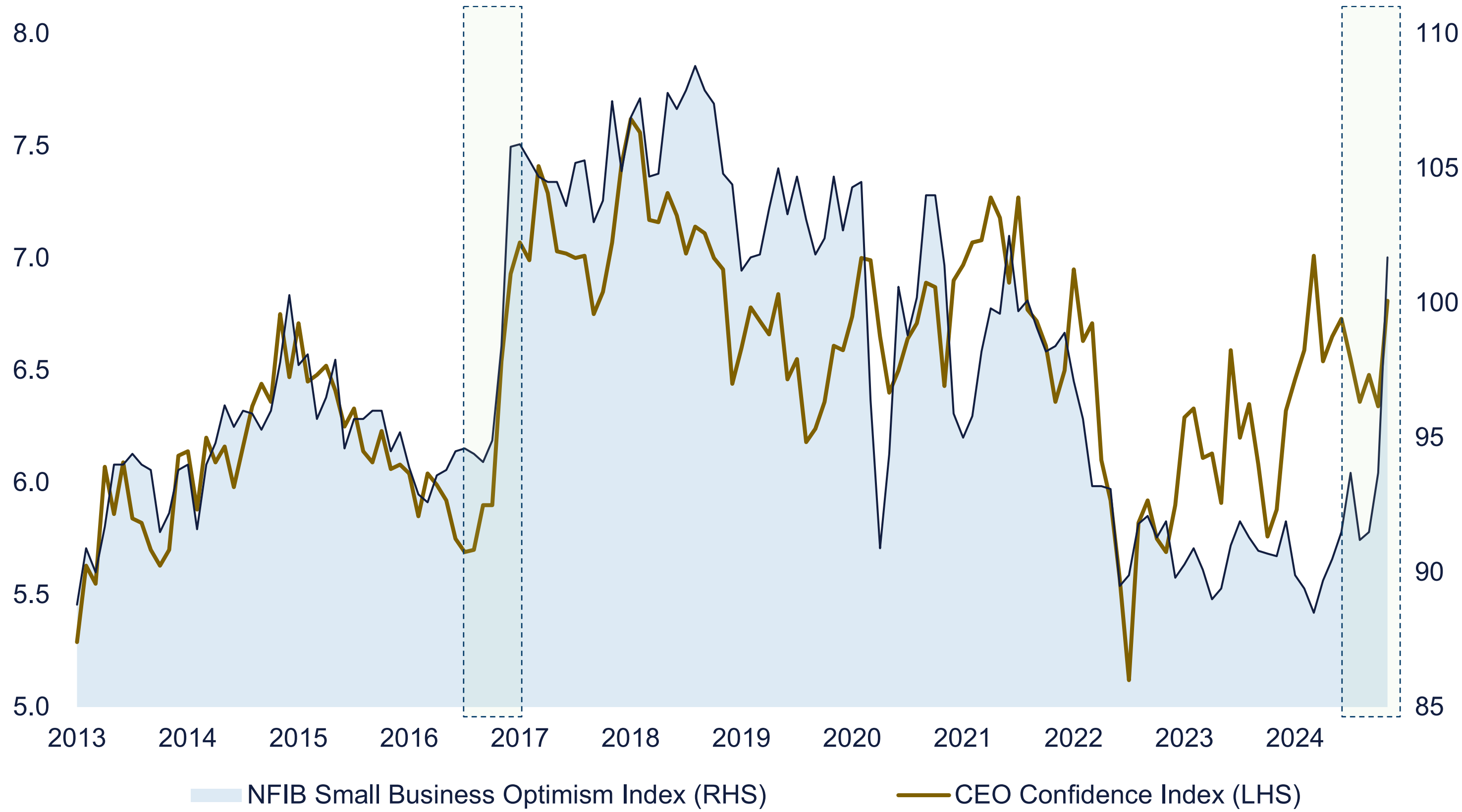
Asset Class		View	Rationale
Fixed Income	US Investment Grade	+	Treasury bonds offer protection against an economic slowdown and / or increased risk aversion. We favor short to medium maturities
	US Credit	+	Interest rate cuts, controlled inflation, and resilient consumption have reduced the likelihood of a recession. While credit spreads have narrowed, investment-grade bonds remain attractive, as the default rate is expected to stay low
	EU Investment Grade	+	The economy is showing greater signs of weakness, and inflation has fallen faster within the target range, providing the ECB with ample room for cutting rates. We prefer government bonds and high-quality corporates
	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	+	Valuations have kept worsening since stock prices have been rising faster than earnings. With interest rates expected to remain higher for longer, we renew our preference for stocks that can reliably grow their earnings.
	Europe	=	The European economy is showing an unexpected resilience despite the slump in manufacturing. With the core economies barely growing and the risk that tariffs pose to the important export sector, we see less upside
	Asia	=	We recommend investing selectively in the region. Despite low valuations, China remains an area of concern
	Emerging Markets	–	Emerging market stocks tend to be more cyclical, and there are fewer high-quality stocks. The risk of tariffs and a stronger US dollar diminish their appeal in the short term
	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

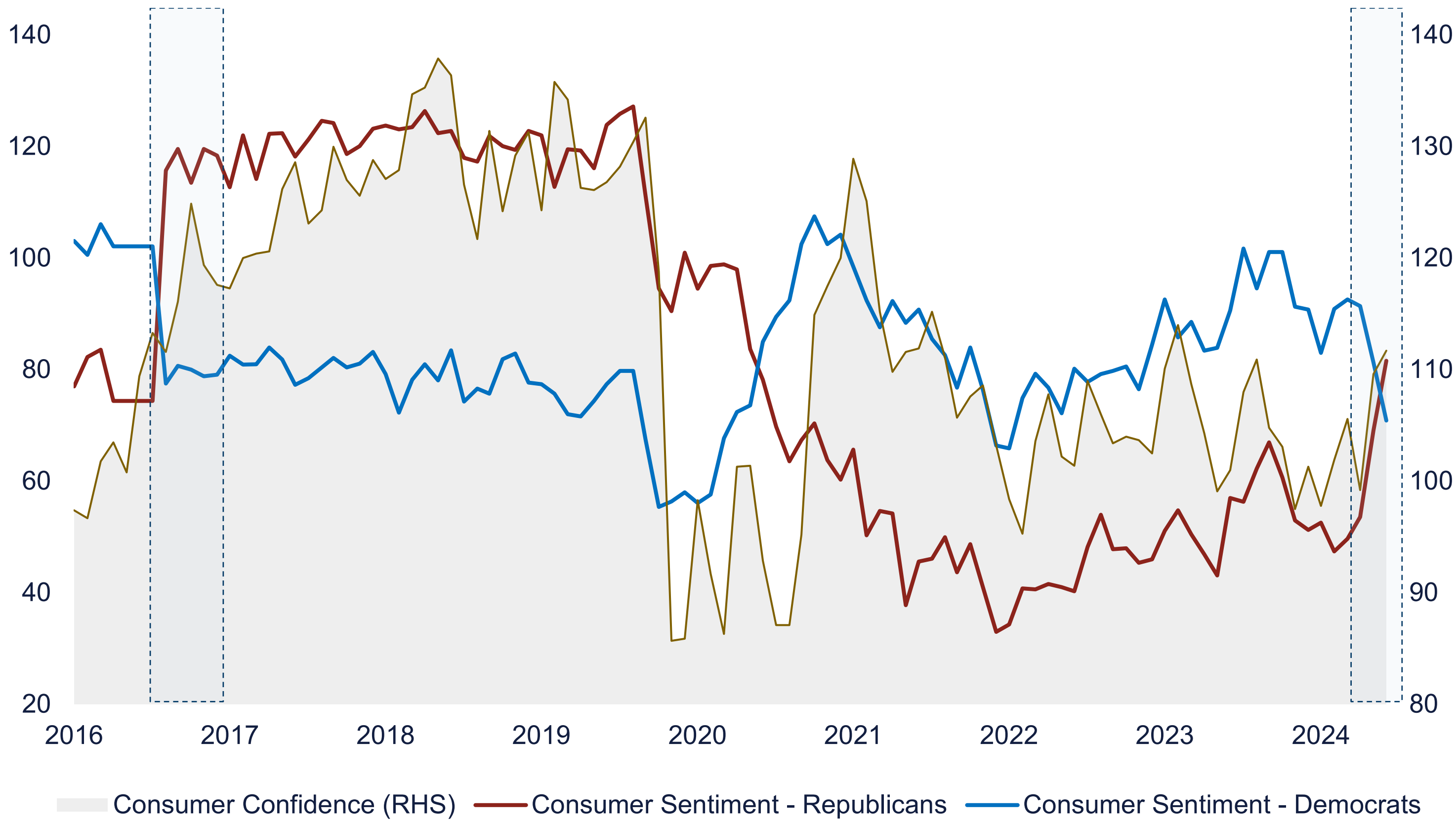
A much-needed relay



- Trump's pro-growth agenda is already **boosting business confidence**, potentially driving an increase in corporate investments.
- This could create an **additional engine of economic growth beyond consumption**, particularly at a time when government spending may need to be scaled back to control the deficit.

Source: Bloomberg

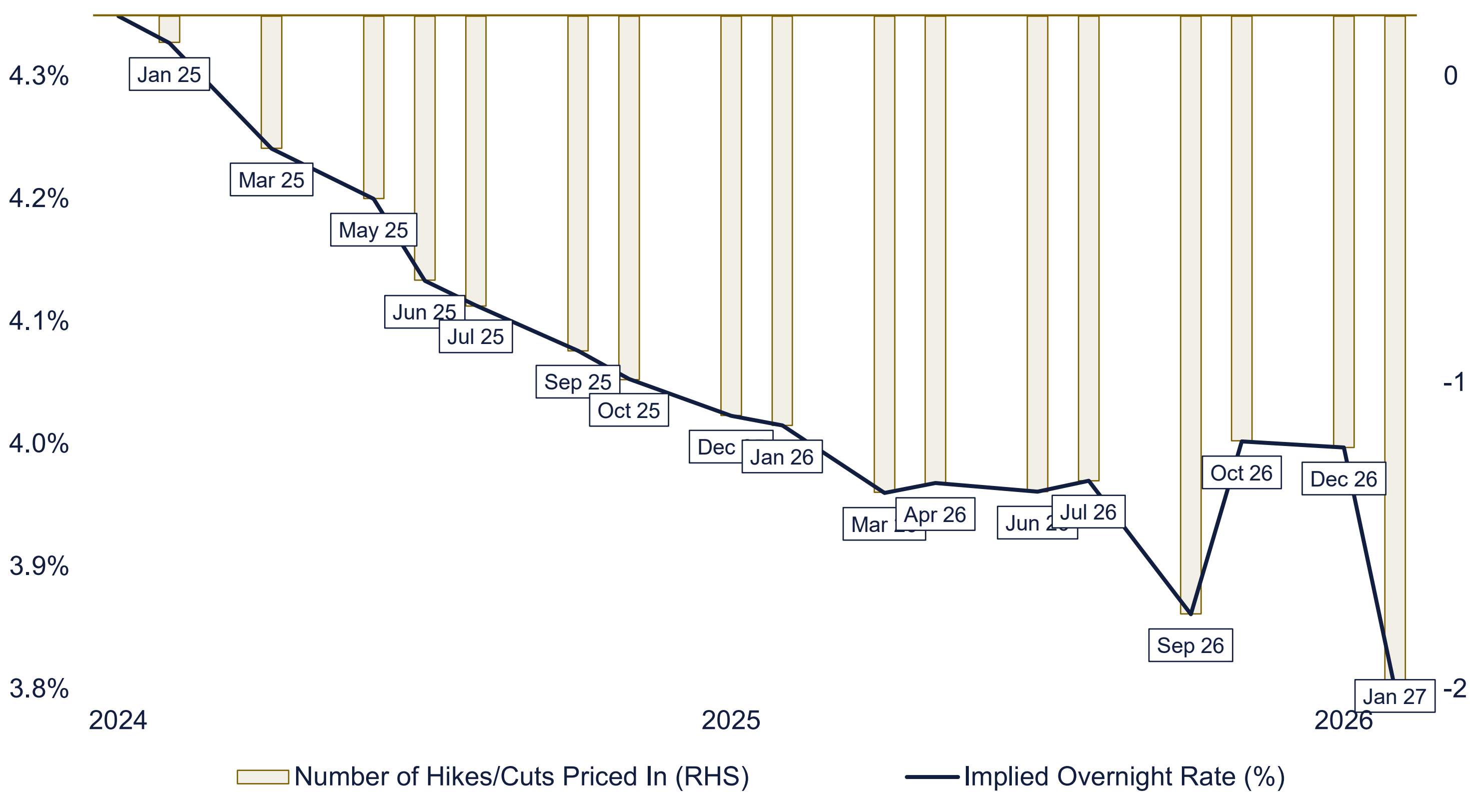
No signs of weakness



- Macro data, including personal consumption and retail sales, continues to point to **remarkably robust consumption** despite high interest rates. Households' balance sheets are in strong shape, with many having locked in low mortgage rates, and the labor market remains resilient.
- **The extension of TCJA provisions**, including personal tax deductions, estate tax exemptions, and lower marginal rates, alongside potential SALT deduction increases, would likely **boost consumer spending**.

Source: Bloomberg

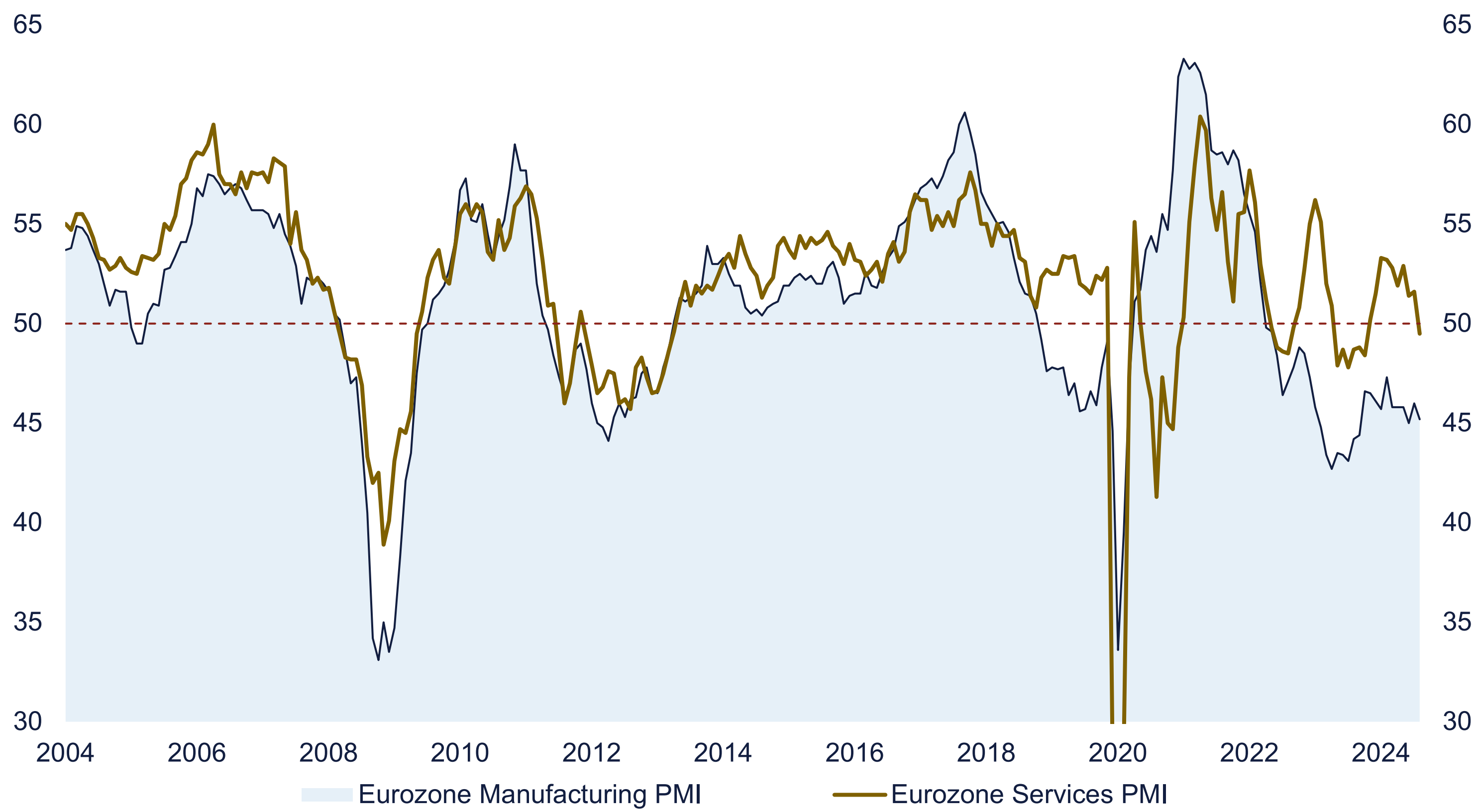
The Fed in no hurry



- With the economy on solid ground and the prospect of reflationary policies, **the Fed is in no rush to cut interest rates**. However, they are acutely aware of the **need to normalize monetary policy once inflation has significantly subsided**.
- The **"terminal rate" at which they will stop is a moving target**, dependent on how the macroeconomic landscape evolves.

Source: Bloomberg

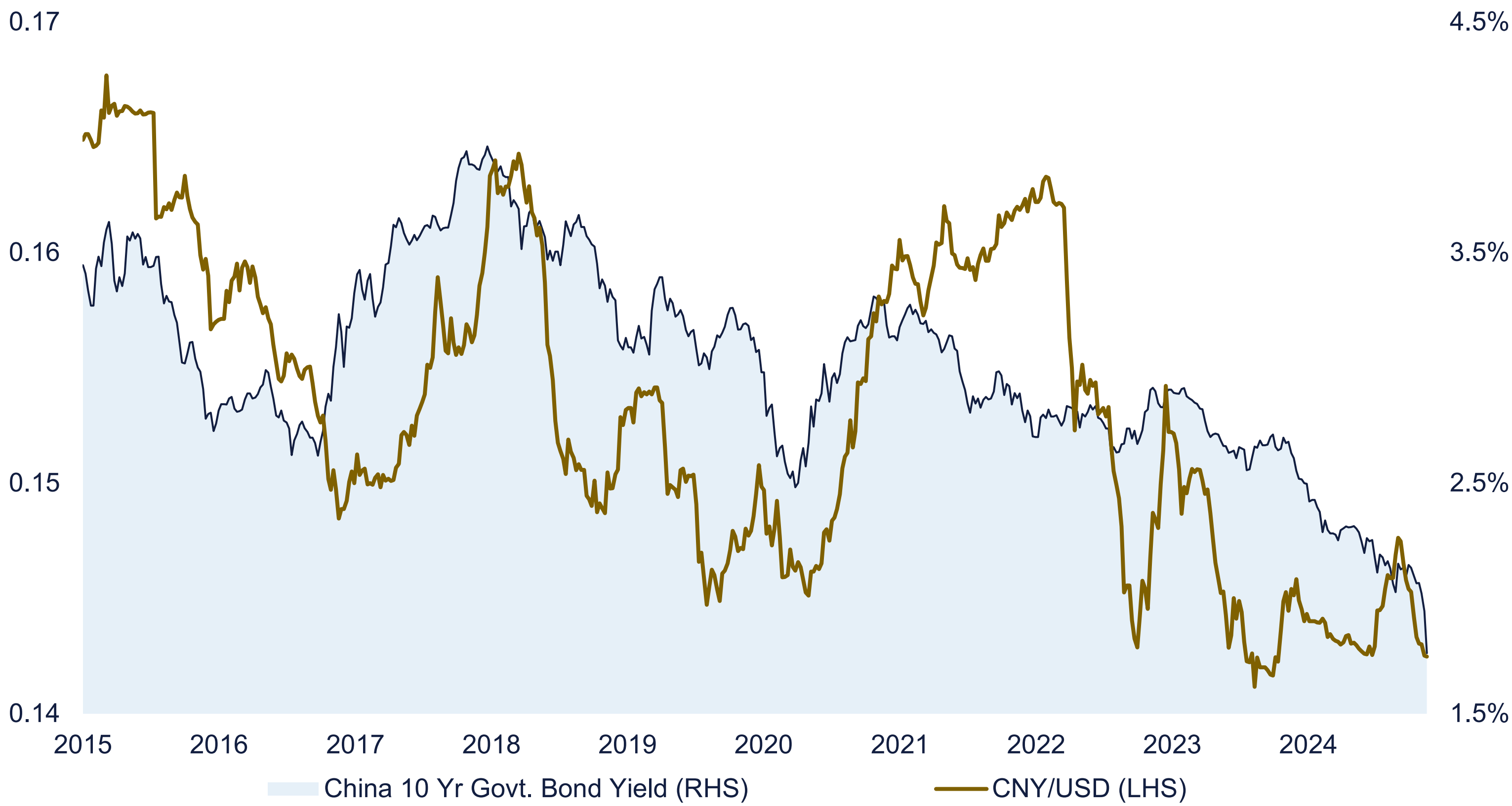
Problems at the core means trouble for the periphery



- **Europe is at a delicate balance**, flirting with recession in its core economies, **weighed down by a slump in manufacturing**. However, it remains supported by record-low unemployment and **strong performance in peripheral economies**, which are more reliant on services and bolstered by the EU recovery funds.
- This makes the **contraction in services indicated by surveys particularly concerning**, especially as manufacturing may face further setbacks due to tariffs on European exports.

Source: Bloomberg

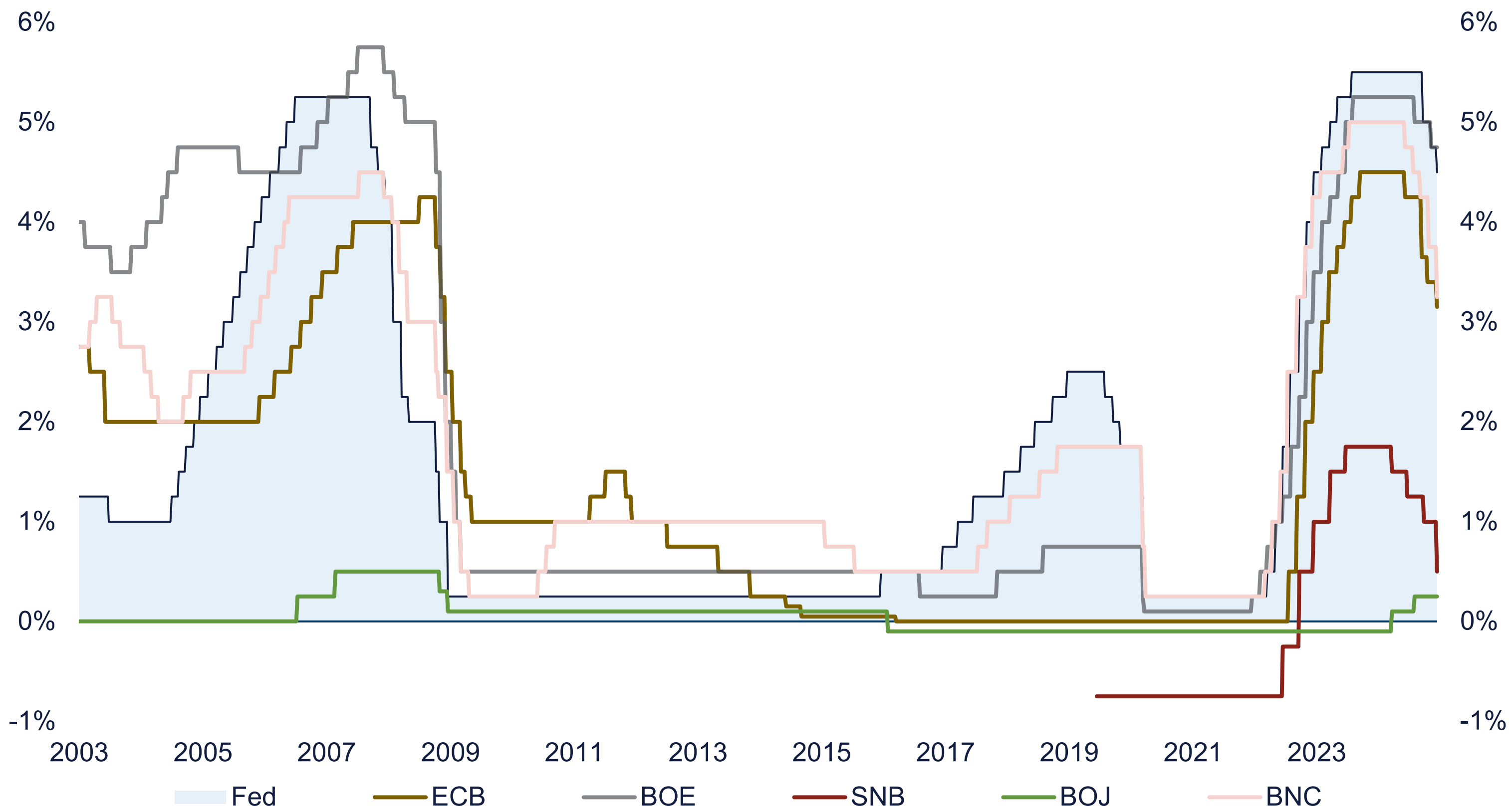
China's main export of late is deflation



- The **Chinese economy continues to send worrying signals**. Consumption remains subdued, and the government's efforts to stabilize the economy are falling short of reigniting growth.
- **Monetary policy has taken over from debt-fueled, investment-driven growth**, putting pressure on the Yuan. This could quickly become a contentious issue with the new U.S. administration, much like it was in 2017.

Source: Bloomberg

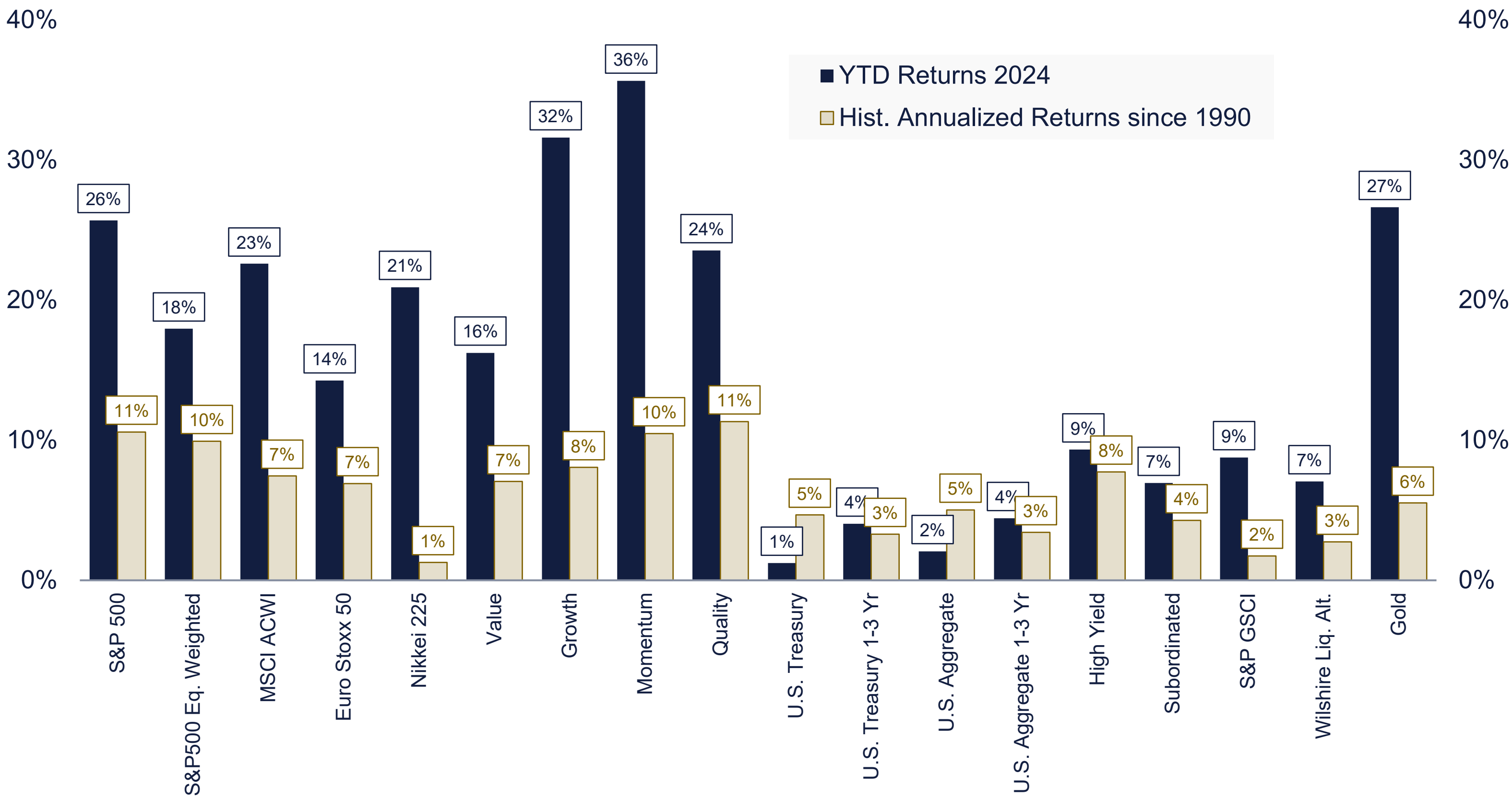
Is the Fed is falling behind?



- The **Fed is taking a more measured approach than its peers**, driven by a stronger macroeconomic picture, as it seeks to avoid a policy mistake.
- However, there is a **risk of acting too late**, and the decoupling of policies could lead to **further appreciation of the U.S. dollar**, potentially creating tension between the new administration and the central bank's objectives.

Source: Bloomberg

Normalization in sight?



- For a second consecutive year, **risk asset returns have been well above their historical averages**. Some normalization should be expected, particularly given that valuations are stretched, and inflation is now under control.
- In contrast, **fixed income returns have been mixed**, with long-term bonds delivering only modest performance, while short- and medium-term bonds have provided above-average returns.

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%	25%	65%

Short-term catalyzers

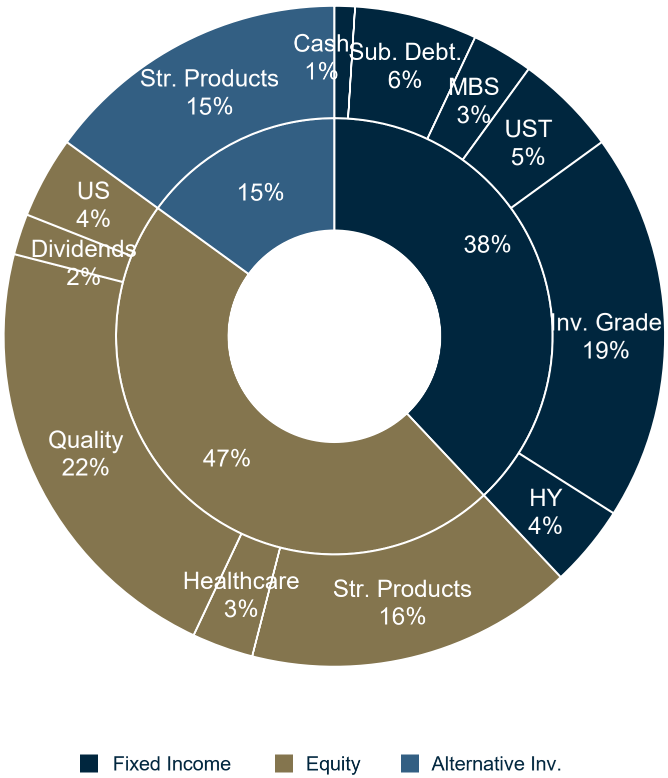
Peace agreement in Ukraine, Slowdown in inflation, Supply chain problems continue to ease

Other risks

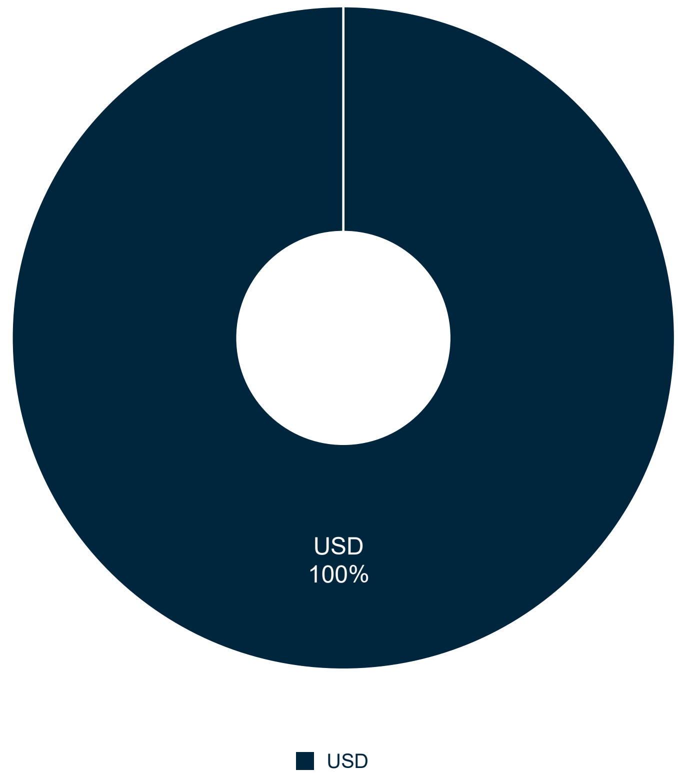
US Presidential Election, Debt ceiling, Escalation of geopolitical tensions, China slowdown, Housing market correction

Boreal Balanced Portfolio USD

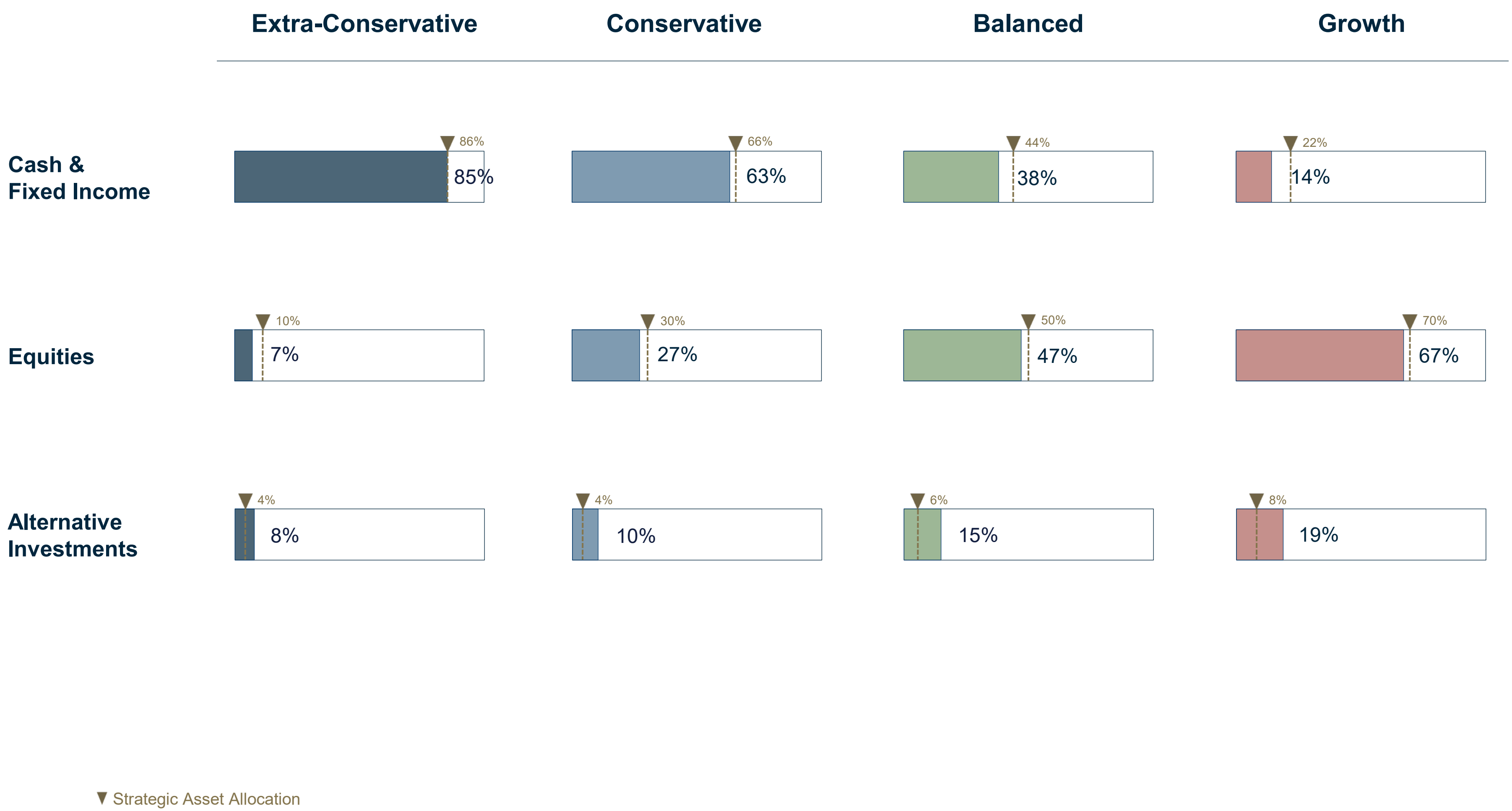
Asset Allocation



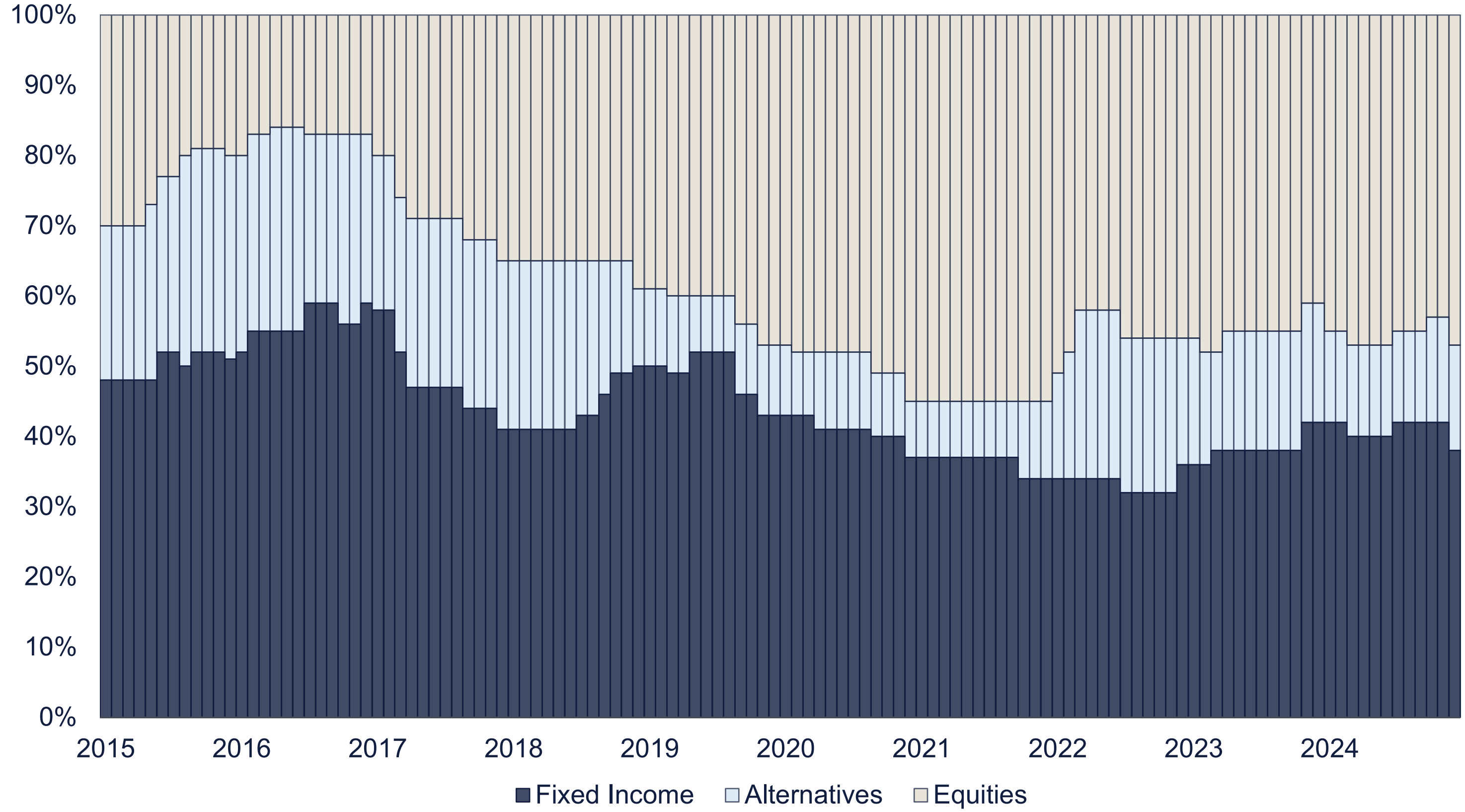
Currency Allocation



Boreal Investment Profiles



Boreal Balanced Portfolio – Asset Allocation evolution



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