Investment Policy

February 2025

BOREAL
CAPITAL MANAGEMENT

Our market view in a nutshell – February 2025

- **Micro Overshadows Macro** The start of the new U.S. administration is keeping the world on edge. A flurry of tariff announcements and counter-announcements has left markets uncertain about their ultimate impact on the economy. Despite this background noise, the corporate sector continues to thrive. Earnings releases for the fourth quarter of 2024 show a double-digit increase in corporate profits, highlighting resilience amid geopolitical uncertainty.

- **Steady Growth, but at Varying Levels** The global economy remains on a steady growth trajectory, but at different speeds: the U.S. versus the rest of the world. In the latter, GDP for the fourth quarter grew at a healthy pace of 2.3%, bolstered by personal consumption growth exceeding 4%. In contrast, Europe is barely growing but is not showing immediate signs of contraction, while China continues to report figures suspiciously close to its official 5% target. In this delicate equilibrium, tariffs pose a significant destabilization risk. While markets have largely ignored this so far, once the dust settles and tariffs take shape, we may witness sharp market fluctuations, as happened back in 2018.

- **The Fed Stays Cautious as Data Buys Time** Economic activity continues to accelerate, with manufacturing emerging from a more than two-year slump. Retail sales and consumer surveys for January indicate moderation following a strong holiday season, while the labor market continues to cool gently. Inflation remains stubbornly above 3%, and with tariffs and immigration restrictions potentially putting further upward pressure on prices, the Fed is expected to remain on pause for an extended period—unless financial conditions deteriorate sharply.

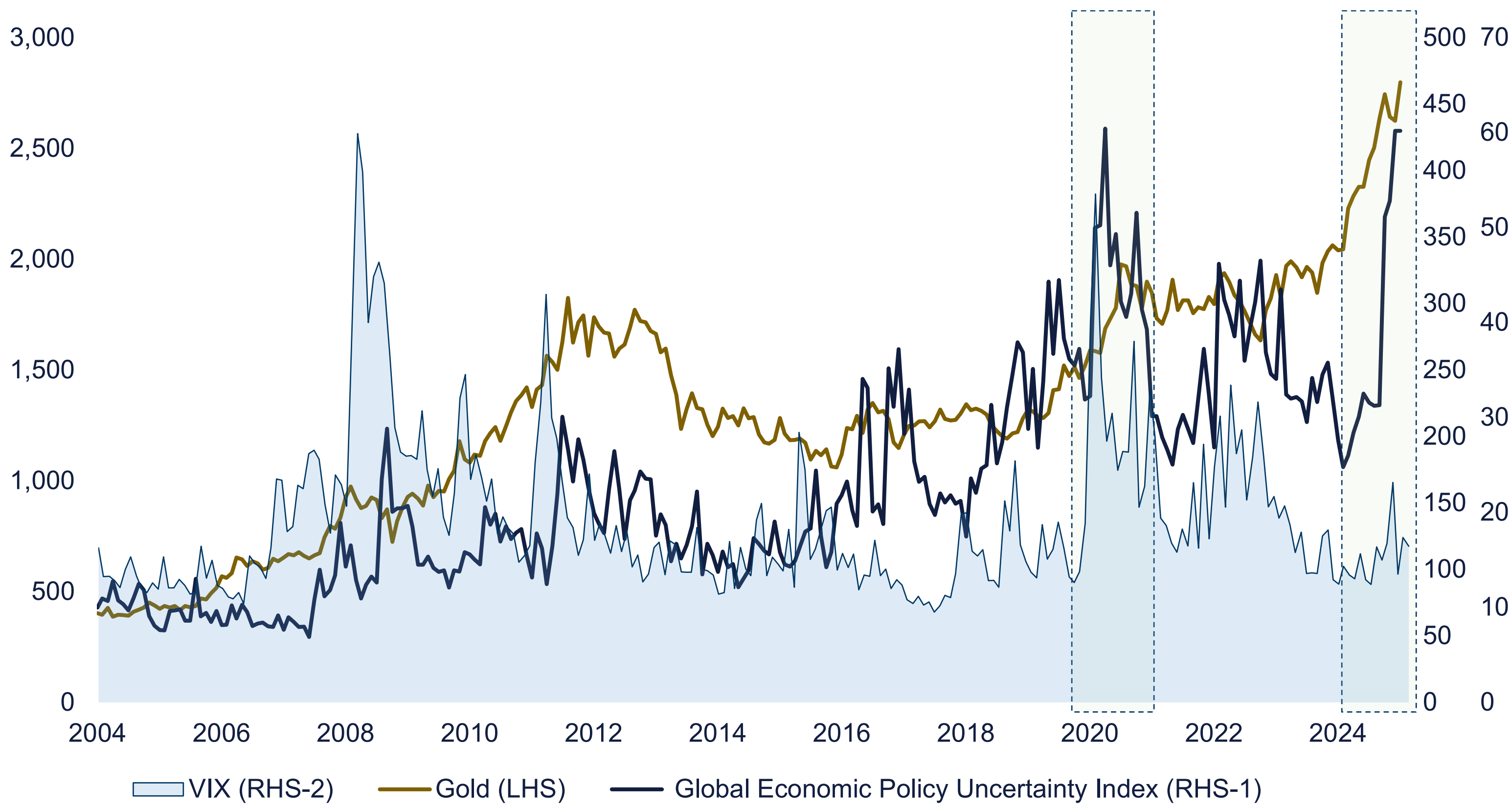
- **Valuations: The Elephant in the Room** All major indices are trading at or near historic highs, supported by record-breaking earnings. Over the past year, European and Japanese markets have finally reached new all-time highs after spending 25 and 34 years underwater, respectively. Meanwhile, the S&P 500 has risen 3.5 times in price since the peak of the dotcom bubble. This "anomaly" can be attributed to the much steeper earnings growth trajectory of U.S. companies. Diverging growth prospects also explain the gap in equity risk premiums. While the U.S. market appears expensive relative to the past two decades, its premium may well be justified by stronger domestic growth and technological leadership. At this stage, investing in equities is a bet on growth rather than valuations, making the outcome more uncertain.

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. 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

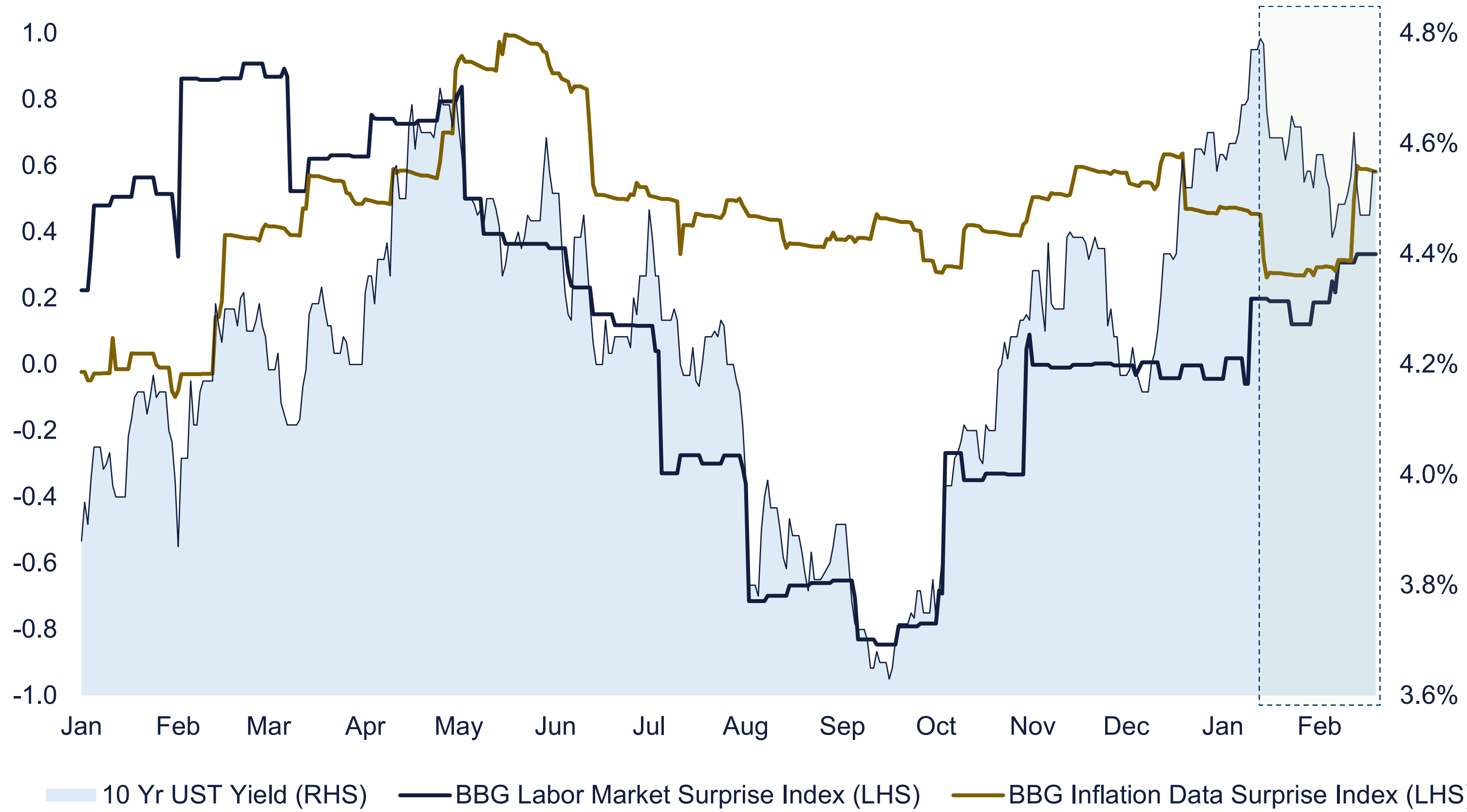
Micro overshadows macro



- The new U.S. administration's **tariff policies are creating uncertaint**y, yet markets remain resilient, **with volatility staying low** and no signs of stress.
- Corporate earnings continue to grow, demonstrating the **strength of the corporate sector** despite ongoing geopolitical and trade-related uncertainties.

Source: Bloomberg

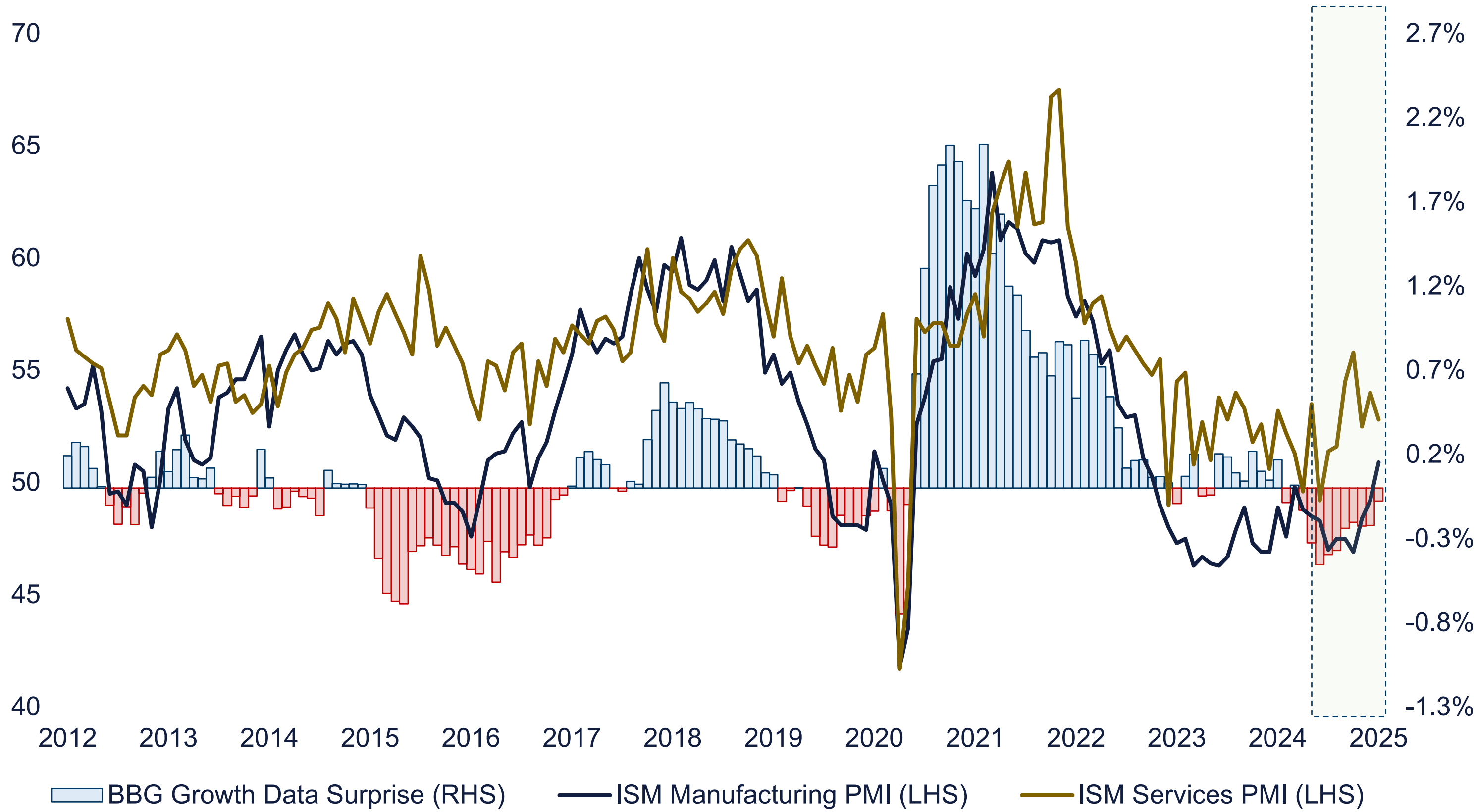
Data buys time for the Fed



- **Inflation** remains above 3%, while the **labor market** continues to cool gradually.
- With tariffs and immigration restrictions potentially adding further pressure, **the Fed is expected to stay on hold unless financial conditions deteriorate significantly**.

Source: Bloomberg

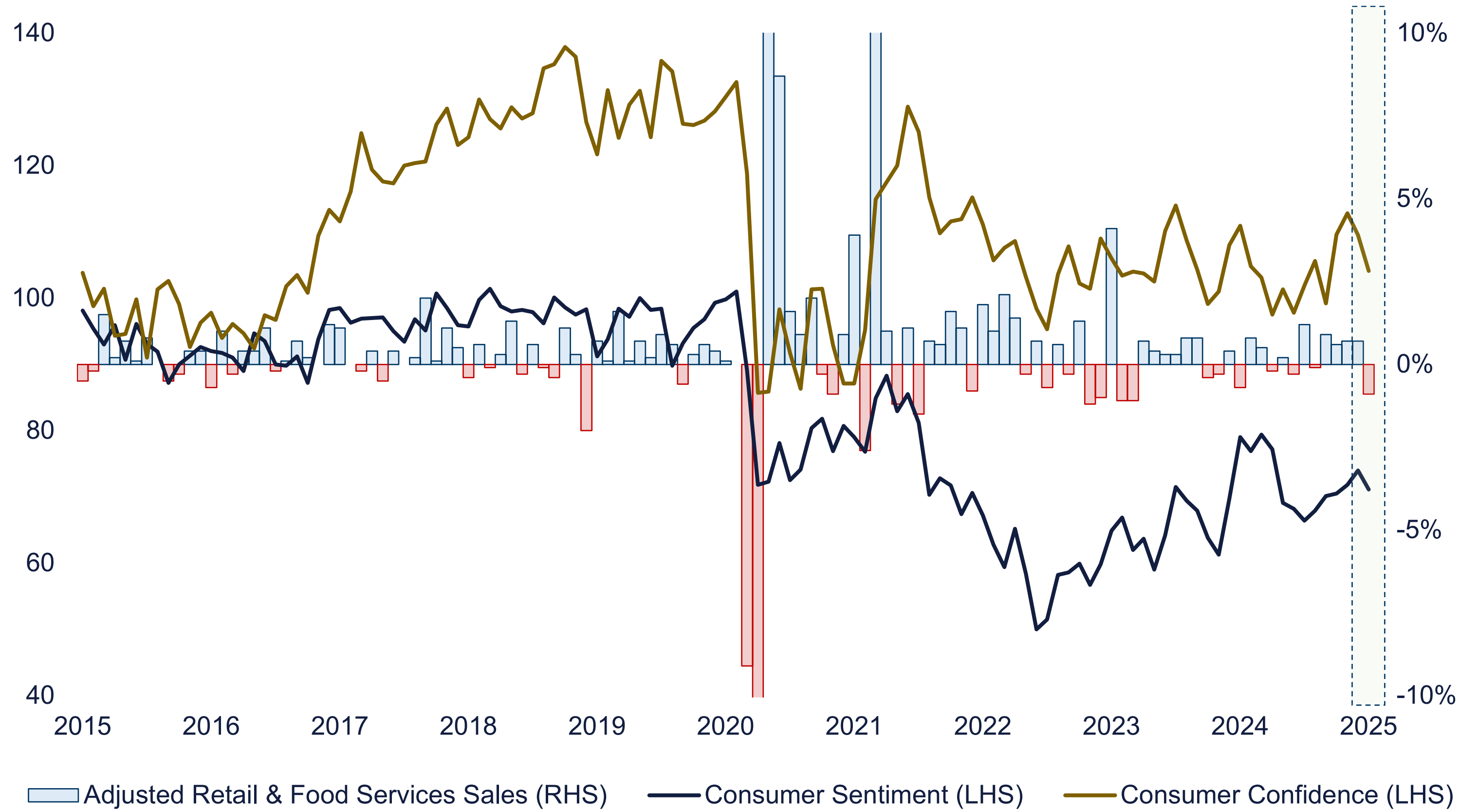
Manufacturing takes the relay



- Surveys indicate that **economic activity is accelerating**, with manufacturing rebounding from a prolonged slump.
- As seen over the past two years, services continue to decouple from manufacturing. However, with both sectors now in expansion territory, this may signal the **start of a new economic cycle**.

Source: Bloomberg

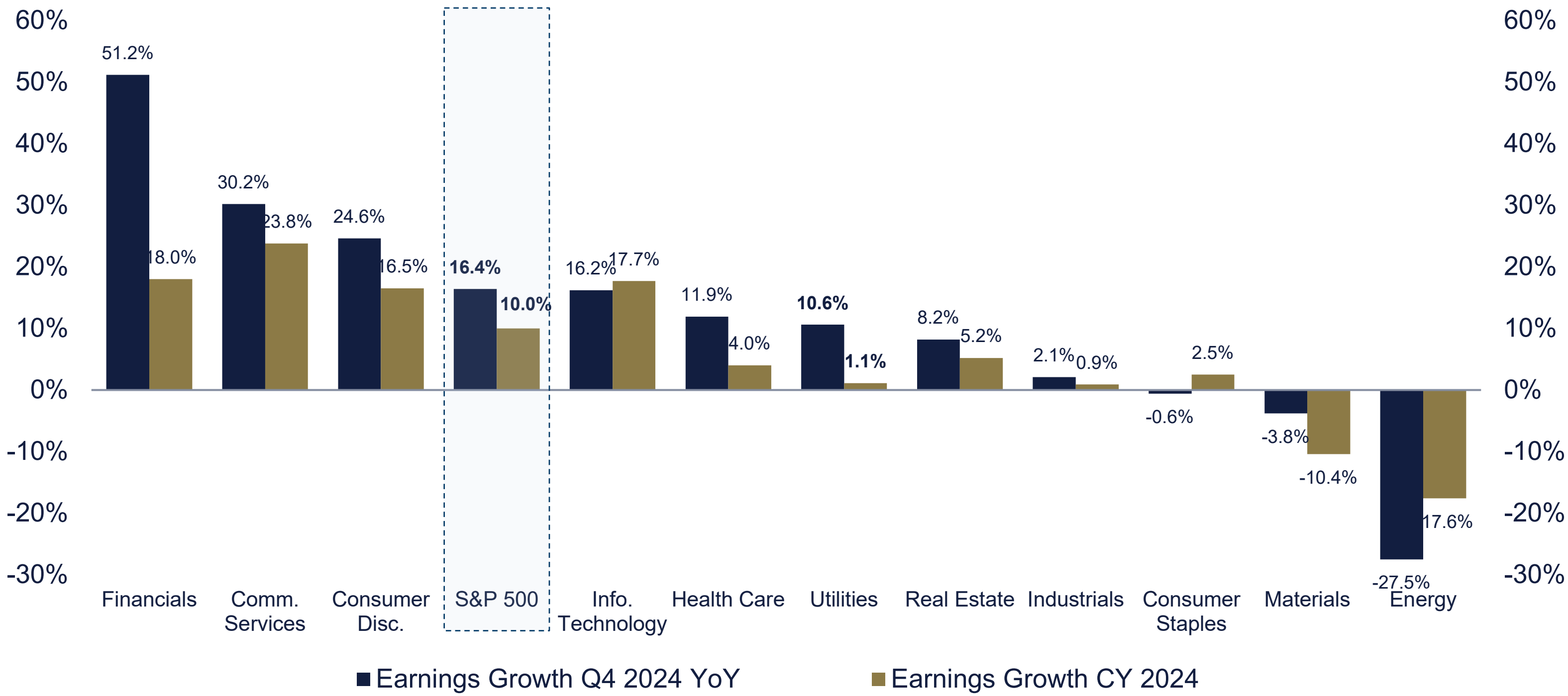
Consumption on auto-pilot



- GDP growth for the fourth quarter remained robust, exceeding 2%, driven by strong **personal consumption**, which expanded by more than 4%.
- While January's retail sales and consumer surveys suggest a **moderation following a strong holiday season**, the resilience of consumer spending—despite multi-decade highs in inflation and interest rates—diminishes concerns of a sudden contraction.

Source: Bloomberg

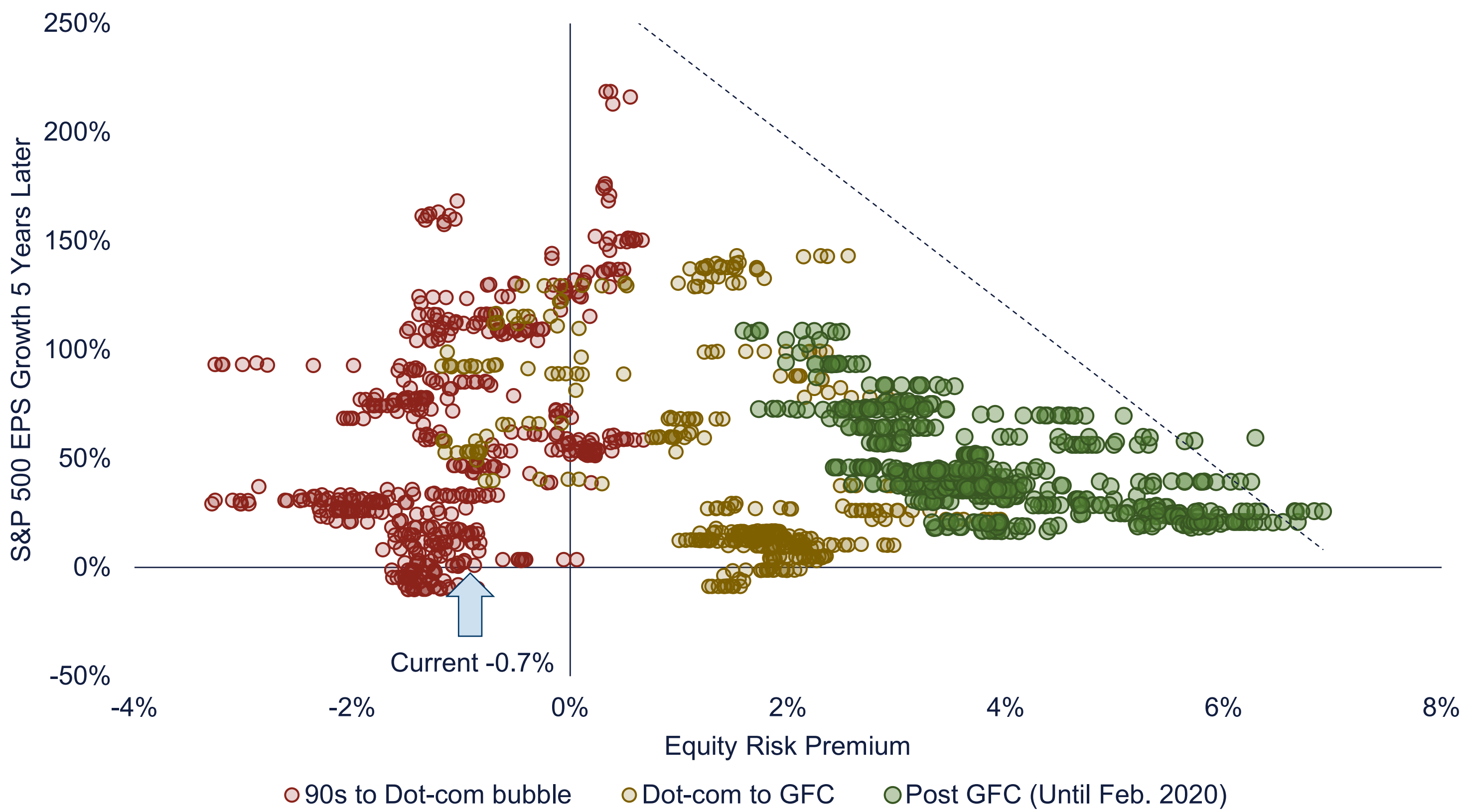
Robust earnings support market valuations



- The corporate sector remains strong, with fourth-quarter 2024 earnings reports revealing a **double-digit increase in corporate profits**.
- The S&P 500 is posting its **highest year-over-year earnings growth rate in three years**, marking the index's sixth consecutive quarter of annual earnings expansion.

Source: Bloomberg

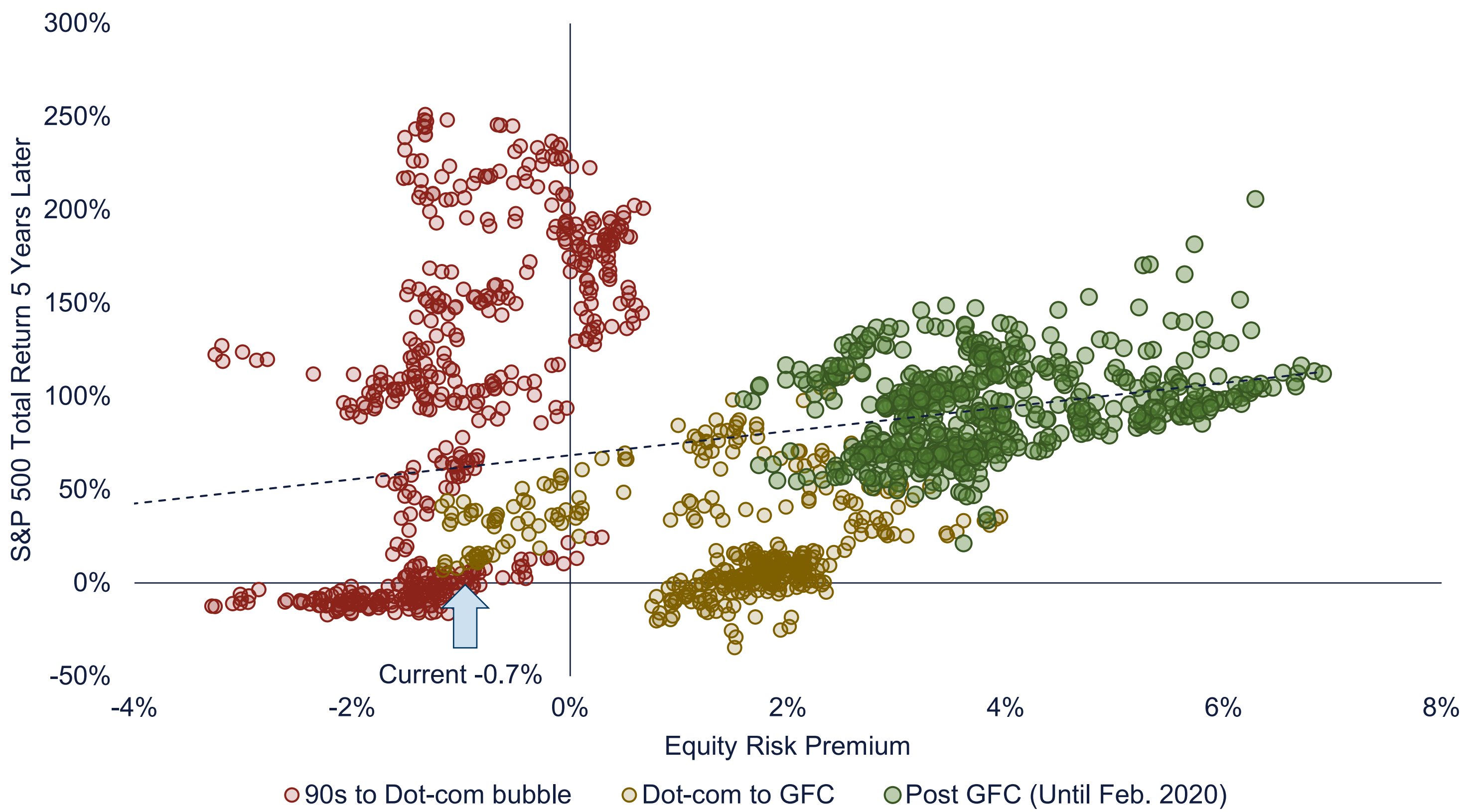
More implicit growth equals more risk



- Valuation metrics such as **Price/Earnings ratios and the Equity Risk Premium are nearing levels last seen during the dot-com** era, sparking concerns that current market valuations may be excessively high.
- However, in efficient markets, these **multiples mirror expected earnings growth**. The issue is that growth assumptions dominate valuations, increasing risk if those expectations are not met.

Source: Bloomberg

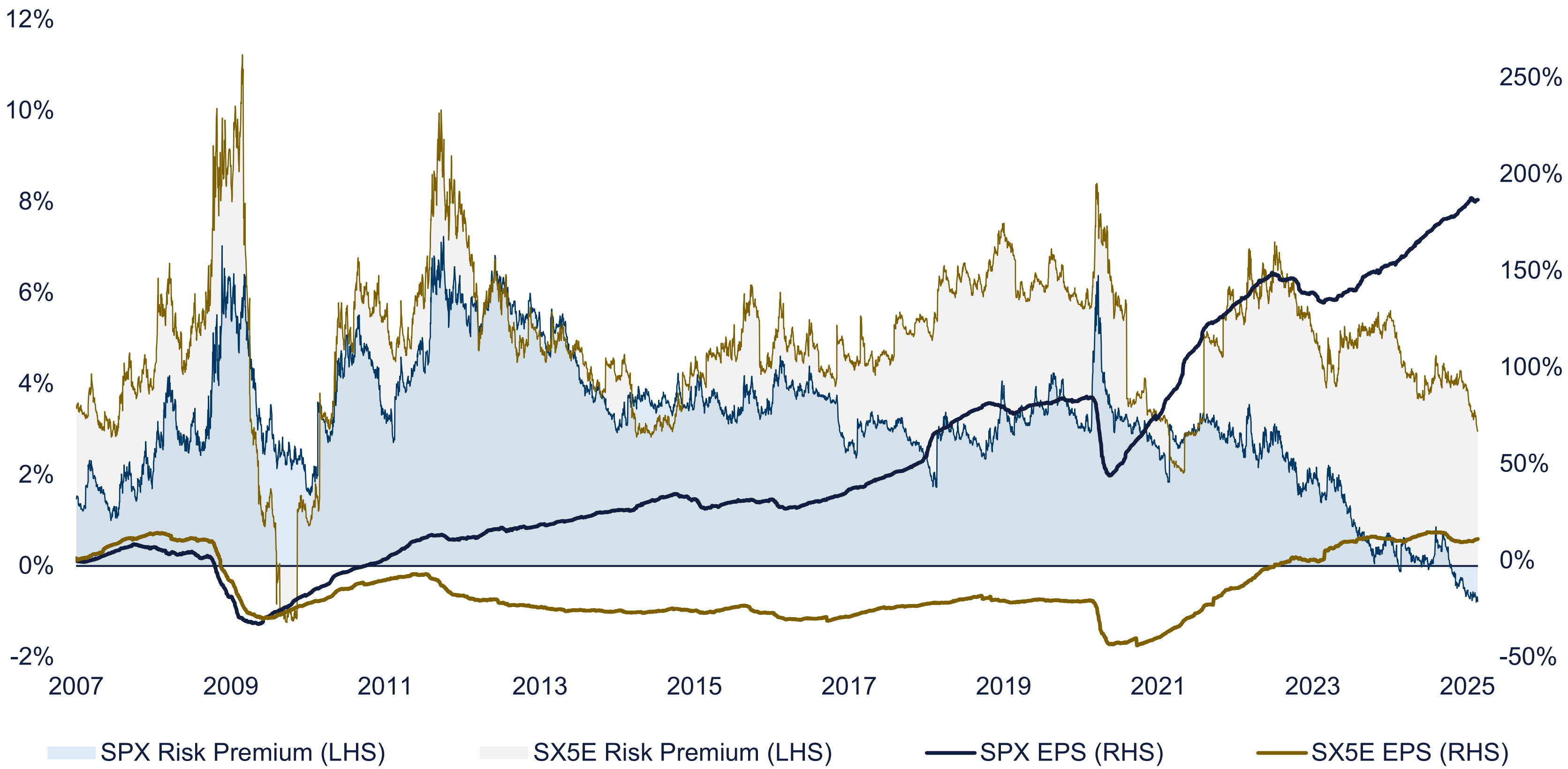
More risk does not always translate to higher returns



- Markets have **moved on from the post-financial crisis era regime characterized by of cheap valuations**. The robust earnings growth of that period is now fully priced into the market.
- While the prospect of a **golden era of AI-driven growth** is enticing, there remains a risk—much like during the dot-com boom—that excessive optimism **could lead to overvaluation**.

Source: Bloomberg

Mind the “value trap”



- Based on valuation metrics, **other markets—most notably Europe—appear as a "cheap" alternative to the U.S.** However, these lower valuations stem from **very different growth prospects**.
- For example, while the EURO STOXX 50 took 17 years to regain its pre–Great Financial Crisis levels in both price and earnings, the S&P 500 has more than tripled its earnings over the same period.

Source: Bloomberg

Investment scenarios

	Scenario 1 Monetary policy mistake	Scenario 2 Outgrowing the problems	Scenario 3 Economic policy mistake
Drivers	• Inflation remains persistently high, driven by a seemingly strong labor market and resilient housing prices. Tariffs and immigration restrictions further exacerbate price pressures. • The Fed overestimates the economy's strength, keeping rates too high for too long or even raising them further, pushing the economy close to recession. It later reverses course with aggressive monetary easing.	• Pro-growth policies, resilient consumption, and corporate dynamism extend the economic cycle. • Inflation normalizes further, prompting the Fed to ease gradually toward a neutral stance. • Robust economic growth narrows the fiscal deficit, while the yield curve steepens slightly, credit spreads stay tight, and corporate earnings grow steadily.	• Tax cuts are not fully offset by new tariffs and decreased government spending, leading to a significant widening of the fiscal deficit. • Tariffs imposed on key trading partners (such as Europe and China) trigger retaliatory measures, negatively impacting global economic growth. • Debt sustainability concerns pressure long-term rates, steepening the yield curve.
Market impact	• Equities decline, but the “Fed Put” limits the extent of the correction as lower interest rates support valuations. • Credit underperforms as spreads widen from historic lows. • Sovereign debt rallies on "flight to quality" and falling rates. Commodity prices drop. • The US dollar depreciates if the Fed cuts rates ahead of others or if the slowdown is U.S.-centric; otherwise, "flight to quality" supports the US dollar.	• Equities gain support from earnings growth and the “Fed Put,” even with high valuation multiples. • Credit performs well as default rates stay low and spreads remain stable. • High-quality and sovereign debt deliver solid returns, with potential upside if long-term rates fall. • Commodity prices rise on economic strength. The USD stays strong, driven by growth and real interest rate differentials.	• Equity markets sell off on valuation and growth concerns. • Credit spreads widen sharply as the prospect of corporate defaults looms. • Turmoil in the Treasury market may force the Fed to intervene, putting the US dollar’s role as a reserve currency at risk. • With US Treasuries in question, the 'flight to quality' will take a new form, with safe-haven currencies like the Swiss Franc and Yen, as well as gold, appreciating.
Probability	30%	50%	20%

Short-term catalyzers

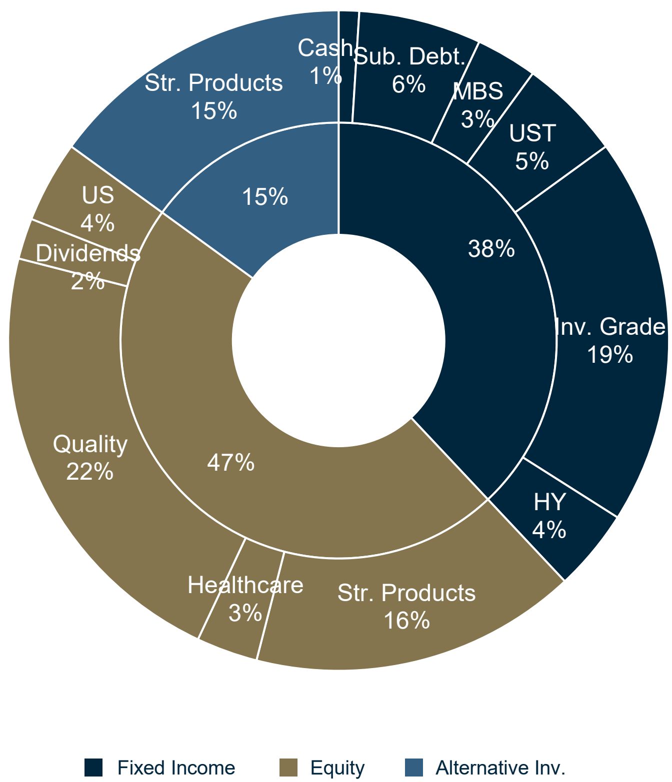
AI-driven productivity boost, De-escalation in Ukraine/Middle East conflicts drives down energy prices, Further slowdown in core inflation

Other risks

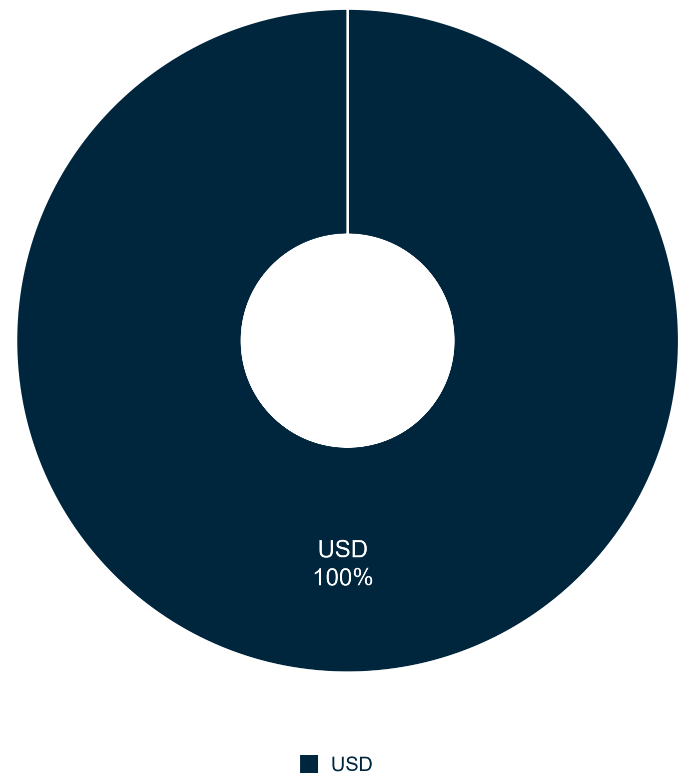
Crypto bubble, Cybersecurity, Debt ceiling, (Geo)Political risks, China/Europe slowdown, Housing market correction

Boreal Balanced Portfolio USD

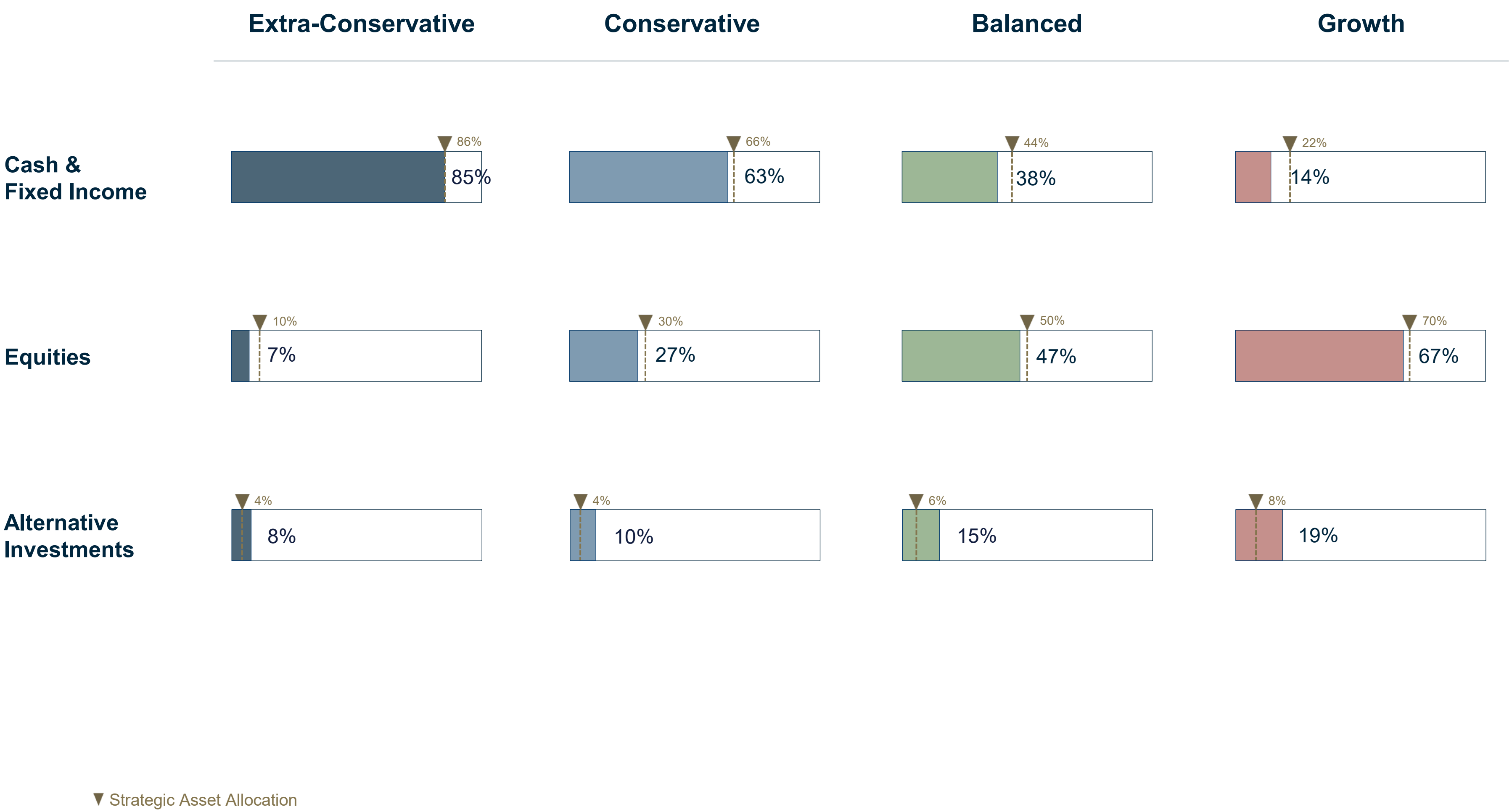
Asset Allocation



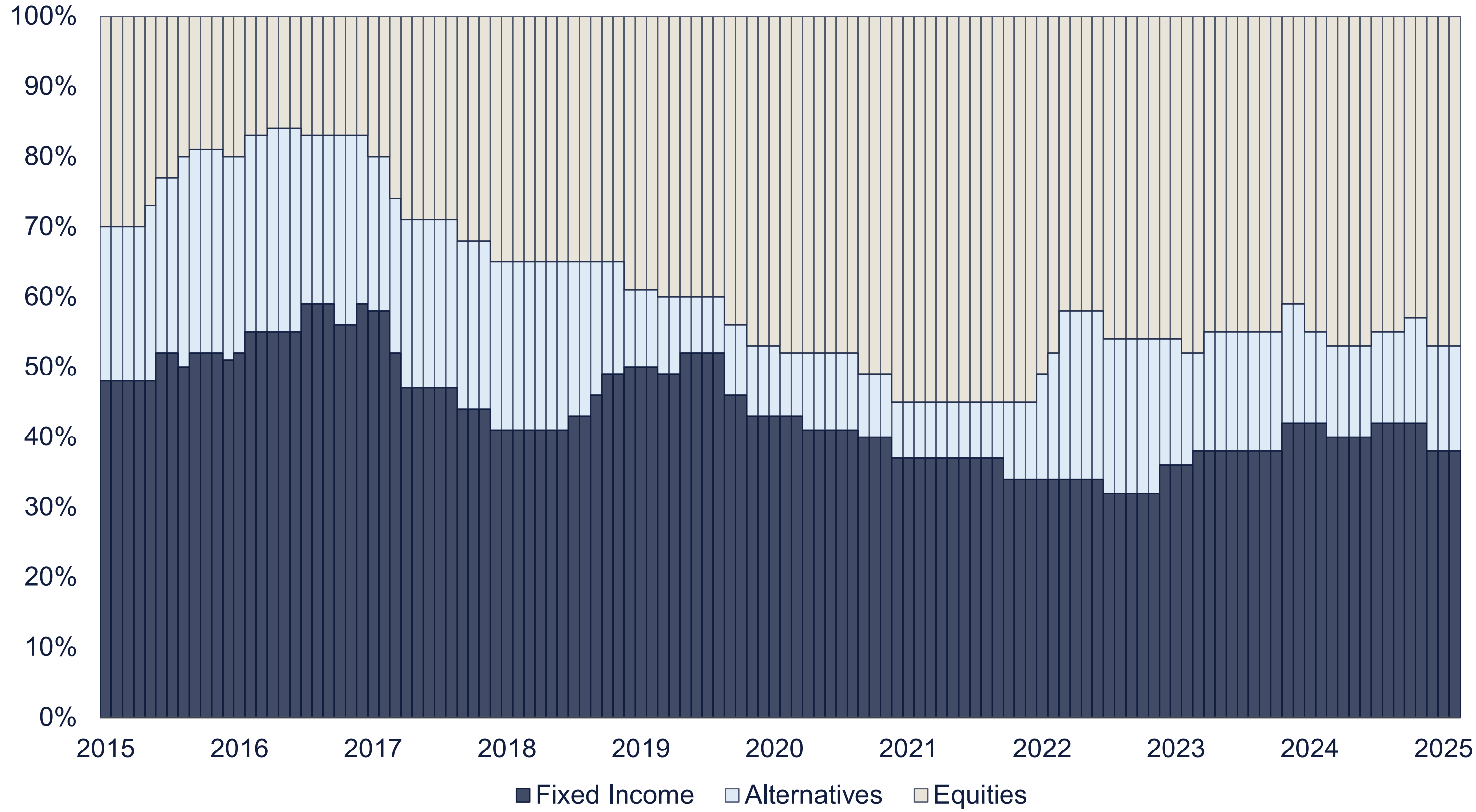
Currency Allocation



Boreal Investment Profiles



Boreal Balanced Portfolio – Asset Allocation evolution



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