The Early View

Markets in September: Are we Heading for a New Normal in Monetary Policy?

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October 2023
Time to read: 7 minutes

The inflation endgame continues to evolve. The largest component of US inflation measures is shelter, which has a long lag effect and has been falling precipitously for the last 18 months. All else being equal, this would imply that we see US inflation quickly reduce below target over the next few months. But all else is not equal, and more recent increases to input costs, such as oil, and to wage inflation has muddied the picture. Over the short term, inflation risks have increased as has the chance of rates staying higher for longer, hence the continued sell-off in government bonds that occurred in September.

But the tug-of-war over the minutiae of the inflation print tends to obscure the bigger picture. The accommodative policy stance taken to protect economies from the Covid pandemic may be directly responsible for the inflation problem of the last two years, but 15 years of easy monetary policy has fuelled record private and public debt balances across the developed world. The spectre of financing such debt levels puts additional pressure on central banks not to raise rates too much and lends a sympathetic lens to a forward path of moderately high inflation for the foreseeable future to shrink the debt pile in real terms.

Of course, the Federal Reserve can't just come out and say they are now targeting, say, 3% inflation instead of 2% (not least because the bond shock would materially reduce the value of the bonds on their balance sheet that they are in the process of trying to sell). Remember that there is nothing magical about the 2% level; it is a woolly compromise between consumer comfort and economic growth.

So, we are left with a government bond yield curve that is trying to find the level of inflation with which the Fed will be comfortable, and the future path of rate decisions may lift the veil on their true intentions. There is a clear discrepancy between expectations of inflation from breakeven rates and commentator surveys (normalising north of 2% for the next year), and the Eurodollar curve and median analyst estimates of interest rates at the end of 2024 (expecting 4-5 rate cuts in the next 12-18 months).

The most common explanation for this discrepancy is that medians of expectations do not accurately reflect the distribution of possible outcomes. A central expectation of four rate cuts might be reflecting an equal probability of a benign economic landscape with no rate cuts, and a hard-landing recession which necessitates eight or more cuts. But while future economic paths are generally more chaotically distributed that our smooth Gaussian brains tend to allow, they are not as binary as the previous sentence suggests, and there is a plausible path down the middle.

This path sees inflation reduce to the 2-3% range predicted over the next 12 months, and the Fed looking to cut rates to steepen the yield curve and stimulate growth, implicitly abandoning the 2% target. With similar debt piles across the developed world, one can be confident that If the Fed raises its tolerance for higher inflation,

other central banks will likely follow suit. The market repercussions of such a small but seismic shift in policy are too multifaceted to warrant much discussion from such a premature viewpoint, but one would be wise to remain open to the possibilities of a new normal for monetary policy emerging over the next 12 months.

Key Drivers of Hedge Funds' Performance: An Early September Snapshot

Equity Long-Short:

- Global equities were again challenged in September and for the second month in a row, Equity Long-Short funds posted monthly beta-driven losses against this backdrop.
- Short portfolios generally posted strong returns and equity market-neutral funds ended September in neutral to slightly positive territory. Regionally, Europe-focused funds outperformed peers focused on other regions (i.e., posted more muted losses) with smaller declines in regional indices.
- Notably, shorting of global equities – both single names and indices/ETFs – has picked up and has been concentrated in the US relative to other regions. We expect part of this is seasonality, while some reflects overall unease in the market.

Credit Long-Short:

- Mostly muted returns for Corporate Credit managers during September as risk aversion increased and duration proved to be a headwind.
- Positive contributors included short-dated convertible bonds on refinancing expectations and certain credit-sensitive names driven by exchange activity.
- Specific cap structure arb (long credit vs short equity) positions were also a source of gains as were some idiosyncratic financial preferreds despite weakness in broad markets driven by higher treasury yields.
- It was another month of relatively steady returns for Structured Credit managers, mostly driven by carry, with mixed mark-to-market performance across sectors.

Relative Value:

- Another positive month for Event Driven, driven by both Merger Arbitrage and Event Credit. The broader sell-off in equity markets resulted in offsetting losses for directional long Special Situations positions across regions, including Japan.
- An important development was the announcement by the UK Competition and Markets Authority (CMA) that they had accepted the remedies agreed by Activision and Microsoft (divestiture of streaming rights), which should allow the deal to close by mid-October. The US Federal Trade Commission (FTC) is reinstating certain investigation proceedings, but this is not expected to delay the transaction close.
- There was similarly positive news around the Horizon Pharma and Amgen deal, where a settlement was reached with the FTC. Progress in other large deals, e.g. VMWare/Broadcom or Seagen/Pfizer, led to spread tightening.
- Deal activity picked up notably, both in the US as well as EU/cross-border. The largest new announcement is the acquisition of Splunk by Cisco in a $28bn equity valuation, making this the first sizeable software deal since the Microsoft antitrust victory. Westrock/Smurfit Kappa is a new large ($11bn) cross-border deal in the packaging space, but the deal is seeing some shareholder resistance.

Systematic Macro:

- Traditional trend-followers have also enjoyed strong returns in fixed income, while commodity performance has been boosted by longs in oil as supply concerns have been priced in.
- Stocks have been the main pain point with strategies mostly stuck in net long positions, with the most pain in the US. Alternative trend-followers are trailing their more traditional counterparts slightly, owing to challenges in the agriculturals sector and bullish positions in EM fixed income and FX. Credit longs have also detracted.
- Outside of trend following, performance in other quant macro models has continued positively in September.

Discretionary Macro:

- A positive month for Discretionary Macro managers, with gains coming from short bond positions after the rise in yields on the back of hawkish central bank commentary and expectations of elevated bond supply amid widening government deficits.
- There has been meaningful repositioning in short US Treasury trades, while Japan themes continue to benefit managers via short Japanese yen and Japanese government bonds. However, EM themes have proven more difficult, with long bond and FX exposures coming under pressure from higher real yields and a stronger US dollar.

On-the-radar:

- As noted above, the interplay between the detail and the big picture on inflation and policy responses is keeping Macro funds interested given the apparent discrepancy between inflation expectations and the speed of rate cuts priced in for 2024.
- For equity managers, the more nervous trading behaviour in September suggesting that downside risks to equities remain, particularly given the high valuation of some equity indices. Managers are looking to rebuild short alpha conviction.
- In Credit, managers are watching the default rate increases, particularly in areas such as leveraged loans, where current spreads do not appear sufficient to compensate for higher defaults and weaker recovery rates.

Unless otherwise stated, all market data is sourced from Bloomberg.

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MKT009354/ST/GL/W/301223