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The Early View

Markets in July: Wiser to Observe than to Forecast

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When discussing markets, it is wiser to observe than to forecast, since even the best forecasters are wrong close to half of the time. It is therefore in the spirit of observation that we note the S&P 500 Index has just recorded the strongest first seven months of the year since 1997, and the Nasdaq 100 Index has recorded the strongest first seven months since the index began in 1985. And that the top 10 largest publicly listed companies now make up over 30% of the value of the S&P 500.

One might also observe that investors' appetite for taking risk seems to be much more correlated to the expected change in economic conditions rather than the absolute values of these conditions. In short, they care more that inflation is coming down and rates are likely to be close to peaking, rather than worrying that inflation is still significantly higher than the 2% target and that the headwind from higher absolute rates is yet to be fully realised.

A further observation is just how difficult it has been to generate alpha in the hedge fund community this year. If we ignore those strategies that sit with a long bias to traditional assets, then managers have mostly struggled to outperform cash so far in 2023. Macro strategies came into the year with a bearish mindset and were caught off-guard by the speed of the risk-on move, while micro strategies (both quantitative and qualitative) look for fundamental reasons to hold positions, so a world where expensive stocks get more expensive isn't conducive to alpha generation. The market isn't behaving the way the (allegedly) smart market participants think it should.

Finally, observers of the balance sheets of active market participants would note that while many investors started the year defensively, we now see that positioning in US equity futures by asset managers is close to the longest levels seen in the last 10 years (source: JPM). A forecaster might be tempted to conclude that frothy markets, narrow leadership, stretched valuations, wider spreads in fundamental factors, a challenging economic backdrop, and overbought equity sentiment means that equity markets are prone for a correction, but we'll stick to observations for now.

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

Equity Long-Short:

- More directional Equity Long-Short strategies were able to post modest returns in July, while market neutral strategies were challenged and incurred small losses. Short portfolios were challenged by a squeeze during the month.
- July was marked by de-grossing activity – concentrated first in European equities and then accelerating in US equities. The unwinding started with the covering of crowded short names but had spread across sectors and into indices/ETFs by month-end.

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- At a regional level, European Long-Short managers seemed to be most challenged by the above dynamics and upside capture (performance versus Euro Stoxx 600 Index) was weak. Asian Long-Short managers, however, saw more success after having been challenged through most of 2023; this was partly driven by China beta.

Credit Long-Short:

- Returns were mostly positive for Corporate Credit managers in July. Event driven, primarily credit-sensitive, outright and cap structure arb-oriented convertibles positions did well, driven by idiosyncratic news and issuer-led activity (e.g. stock sales), as well as a strong overall market backdrop; vol-oriented traditional convertible arbitrage positions underperformed.
- Stressed/distressed credits and reorganisation equities were generally positive contributors for managers, offset by losses from portfolio-level hedges given continued spread tightening.
- July saw a strong rebound for US financial preferreds as stress test results were better than expected and earnings were generally better than feared; one of the weakest remaining regional banks was also acquired, boosting confidence in the sector.
- Modest positive returns for Structured Credit managers in July were largely driven by carry, with slightly tighter spreads across most sectors.

Relative Value:

- July has been an active month for Event Driven, with mostly positive deal developments and related headlines. Both global and Asia-focused funds were generally up for the month.
- The outlook for the $69 billion Activision/Microsoft merger was significantly boosted by a US court's rejection of the Federal Trade Commission's attempt to block the deal, as well as by renegotiations with the UK's Competition and Markets Authority (CMA). In anticipation of the path to closure, the parties extended the merger termination date to mid-October.
- The $61 billion VMWare/Broadcom transaction was approved by the European Commission and provisionally approved by the CMA. And L3Harris's acquisition of Aerojet Rocketdyne neared completion upon regulatory approval.
- The Silicon Motion/MaxLinear merger saw massive volatility at the end of the month after first spiking on the news that the deal had finally received Chinese SAMR approval, just to be rocked hours later as MaxLinear announced the termination of the deal, a decision that Silicon Motion intends to contest.
- Merger spreads continue to be volatile, and while deal flow has been slower, as is often the case over summer, some notable mid-sized transactions were announced, including Denbury/Exxon and American Equity Investments/Brookfield.

Systematic Macro:

- Traditional trend-followers lost money in July. A change in the monetary policy outlook for Japan saw the Japanese yen reverse recent weakness while also stunting the rally in Japanese equities, to the detriment of Trend's positioning. A rally in the South African rand was also lossmaking for the space, while growing doubts that most developed market central banks would continue their tightening efforts later in the year worked against short positions in STIRs. However, better returns have come from Alternative Trend-followers, thanks to long positioning in US and European credit indices and more esoteric energy markets.
- Systematic macro managers have posted losses, though with typical dispersion among peer group returns. Like trend, FX trading has proved difficult, with losses arising from shorting safe havens such as the Swiss franc and Japanese yen. More defensive positioning in equities has been challenged by improving sentiment. However, longs in energies and agriculturals have provided some offset.

Discretionary Macro:

- Performance among discretionary macro managers was generally positive in July. Better-than-expected economic data and a downside US CPI surprise boosted hopes of a soft landing, benefiting carry trades in currencies and risk-on themes in equities.
- Broader US dollar weakness generally worked in favour of short exposure, though longs against Japanese yen detracted as markets took the loosening of yield curve control as a more dovish signal than they were expecting.

On-the-radar:

- Market pricing has the Fed reducing rates early next year, even though inflation is still projected to be above target. The incongruity of these two statements is likely to come under increased scrutiny over the next few months, with a risk that rates stay higher for longer than current pricing would suggest.
- Hedge funds are waiting for some more rational pricing, particularly in equity markets, following a difficult Q2 earnings season. We are watching how much risk active managers are willing to take into the Q3 earnings season.
- The hesitation of the BoJ in defining exactly how they plan to exit yield curve control, despite higher inflation and negative rates, is leading to growing concerns over the prolonged volatility in the yen and Japanese financial assets.

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