The Early View

Plus Ça Change?

November 2023

Time to read: 8 minutes

Over the last few months markets have mangled the French aphorism; now it's *plus c'est la même chose, plus ça change*. The last US rate rise was over three months ago now, and the fundamental data on inflation, jobs, growth etc has been devoid of shocks, but markets continue to display new levels of tolerance for this uncertain regime. US 10-year bond yields popped their heads briefly above 5% in late October, capping a full 1% rise over the last three months, and equity markets continued their recent downward trajectory: the MSCI World Index is down almost 10% in three months.

Single stock behaviour is similarly detached. The Q3 earnings season was broadly in line with expectations, but stock reactions post-earnings were much more often negative than positive. Here, the messaging from companies reporting weak numbers was sufficiently negative to breed broader pessimism throughout risky assets. Lag effects are pernicious; the second- and third-order effects of higher rates are so difficult to model accurately that one can only observe their development in real time. It feels like death by a thousand cuts; with sentiment gradually weakening and US 10-year breakeven inflation creeping up to 2.4%, it is starting to look more like a structural inflation problem. As we noted last month, an 8% inflation print may be transitory, but an equilibrium level above the 2% target may be not.

Of course, there's a fundamental trade-off in the corporate earnings picture, and higher structural inflation should ultimately feed through into the earnings per share of the stock market, so then market pricing becomes a relative play on the earnings multiple of equities versus other asset classes. Long-term investors can buy equities with confidence if earnings per share are growing… unless one fears a prolonged stagflationary episode, of which there is relatively little evidence of material risks yet (markets remain a hostage to fortune).

Outside of the banality of market data and price dynamics, geopolitics remain tragically messy. Risk premia are beginning to reflect the quickly deteriorating panorama across the Middle East, although currently these reflect possible negative future developments rather than a tangible negative impact on financial markets. See the reaction in the price of gold vs oil over the last two weeks as a gauge of this difference. Throw in the apparent stalemate in Ukraine, persistent geopolitical concerns for parts of Asia, and a forthcoming (undoubtedly messy and acrimonious) US election cycle, and the sources of real-world chaos and change appear multifaceted right now.

All of which points to a widening price of risk in markets right now, through real yields on nominal government bonds, credit spreads, and merger spreads. Throughout the investment landscape there is an increased premium for providing capital and liquidity and the challenge for hedge fund managers now is to capitalise on this alpha opportunity without suffering losses if the picture continues to deteriorate.

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

Equity Long-Short:

- Global equities remained under pressure in October and as such, performance for fundamental Equity Long-Short managers looks to have ended the month in the red – largely driven by beta.
- Market neutral managers again outperformed as short books provided strong alpha; however, both crowded longs and crowded shorts underperformed global equity indices, leading to a headwind for managers. US-focused managers seemed particularly challenged in the back half of October, in part due to the underperformance of TMT (Technology, Media &Telecommunications) stocks.
- Net leverage across the fundamental equity space continues to fall, both due to mark-to-market and in part due to increased shorting activity.

Credit:

- With few exceptions, October was a negative month for Corporate Credit managers as equities sold off, credit spreads widened, and rates were higher.
- Convertibles were down on an outright basis and cheapened on a hedged basis, contributing negatively to returns. It was a tough month for financial preferreds as some banks reported increasing credit losses and provisions which led to selling in the sector with little differentiation by credit quality or duration. Certain defensive capital structure arbitrage positions continued to be a source of gains as were portfolio level hedges. Overall, single name profit and loss drivers were relatively muted in either direction.
- Most Structured Credit sectors saw some spread-widening during the month leading to flat to modest returns for managers as mark-to-market losses were offset by carry and portfolio hedges.

Event Driven:

- The negative month for broader equities has also been challenging for Event Driven, with both Merger Arbitrage and Special Situations down. Credit Events are roughly flat.
- In Merger Arbitrage, the widely held VMWare/Broadcom transaction saw a sharp spread widening following speculative articles about a potential delay in receiving China antitrust approval, which was then confirmed by both parties at the end of month. The current end date for the deal is the end of November.
- Positively, the large Horizon Pharma/Amgen and Activision/Microsoft both closed in October as expected.
- In terms of M&A activity, several large deals were announced, particularly in the energy space, e.g. Exxon acquiring Pioneer Natural Resources for around $60bn, and Chevron buying Hess Corp. for around $52bn.
- While Special Situations are generally down across all regions, including Japan, market hedges helped soften the returns. Losses were generally due to market drift, rather than idiosyncratic events or profit warnings. Certain China positions saw positive idiosyncratic events that bucked the down-market trend.

Discretionary Macro:

- It looks to have been another positive month for Discretionary Macro strategies. There was a period of difficulty earlier in October as markets digested an escalation of geopolitical risks and a slight shift in the Fed's rhetoric, however many managers benefited once the bond sell-off resumed via steepeners and outright short bond exposure in developed markets.
- Hawkish themes in Japan have also increased and are now mostly expressed in fixed income given mounting intervention risk in Japanese yen trades, while received rates positions in Mexico and Brazil have struggled.

- Conviction levels are relatively low amid elevated geopolitical and macro uncertainty. This month we've seen some managers use recent weakness to add to received positions in Emerging Market bonds and others enter defensive positions that align more with a hard landing, where they expect the rise in term premium to increase the likelihood of a recession this cycle. However, for the most part we've seen managers approach markets more cautiously, tactically trading and taking profits where available, and expect this to remain the case until there's more clarity regarding in which direction markets go from here.

Systematic Macro:

- Traditional Trend-Followers also faced a challenging start to the month, first through long oil positions and then shorts in fixed income, however performance has rebounded strongly since then with peer group performance positive for the month.
- Bond shorts in developed markets have added strongly in October, while rising US yields has seen US dollar crosses strengthen, notably against the Japanese yen, which has benefitted Trend's long positions. Equities have produced muted results overall, recouping losses earlier in the month after switching to a net-short position. The commodity sector has been lossmaking owing to longs in crude oil and shorts in gold, though we now see more neutral Trend positioning across precious metals.
- Alternative Trend-Followers have found October more difficult than their traditional peers, largely due to a greater risk allocation to alternative energies where shorts in EU gas have struggled against supply-driven price rallies and cattle longs have detracted. A bias towards alternative fixed income markets has further contributed to underperformance, given the more pronounced bond sell-off in traditional markets throughout October, while longs in credit have also lost out.
- Quant Macro programmes are broadly down, having suffered heavy losses in crude oil earlier in the month. FX performance has also been rather muted, as has fixed income due to more concentrated positioning in shorter-term bonds and rates that has resulted in limited exposure to the moves further out on developed markets yield curves. Shorts in US equity indices have been profitable, though these gains have often been outweighed by long positions in European bourses.

On-the-radar:

- Despite the lack of large surprises in fundamental data in recent months, there is a material possibility that economists' estimates are wrong on the path for inflation and rates from here. Any sense that a new inflationary episode is building could be very disruptive to markets, as this would suggest that the recent tightening cycle hasn't moved far enough.
- Similarly, any spillover from the conflict between Israel and Hamas into the wider Middle Eastern region is likely to cause more severe financial impacts, particularly in energy commodities.
- For hedge fund managers, we have seen weak alpha generation in 2023, and managers are looking to capitalise on greater dispersion and possible high volatility to reverse this in 2024.

Author

Adam Singleton, CFA
Head of Investment Solutions, Man FRM

Adam Singleton is Head of Investment Solutions based in London. Adam is responsible for the oversight of the Portfolio Management and Quant Research teams, providing innovative portfolio solutions to the most sophisticated clients of the firm. He is a member of the Man FRM Investment Committee and the Man Solutions Risk and Portfolio Committee. Previously, Adam has held positions in Portfolio Management, as Head of Equity Long-Short manager selection, managing the Investment Risk function within the Risk Management team, as well as fund selection in Relative Value and Specialist Credit strategies. Prior to joining Man FRM in 2005, Adam worked as an analyst within Investment Consulting at Watson Wyatt. Adam holds a BSc in Mathematics from the University of Warwick and is a CFA charterholder.