Man FRM Early View

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Equity markets are more confusing than ever. We are in the midst of the largest ground war in Europe since 1945; US CPI hitting the highest level in 40 years at 7.9%; hawkish Federal Reserve rhetoric leading to a steepness of the 1-year Eurodollar curve hardly seen since the 1970s; and a re-emergence of Covid-19 cases in China so severe that Shanghai has been forced to lock down again leading to possible global supply chain issues. One would imagine that any of these alone should be enough to cause at least a modest uptick in risk aversion, but here we sit, finishing March with the S&P 500 Index **up** 5% on the month and not far from all-time highs.

There are multiple angles from which this seems to make little sense. From a probabilistic perspective the level of equities is troubling. *Maybe* Vladimir Putin accepts a limited loss of face and doesn't escalate the current conflict beyond the tragic mess already unfolding within the borders of Ukraine, and *maybe* Jerome Powell really believes he can deliver a soft-landing and control inflation without crashing the US economy, and *maybe* the recent spike of Covid cases around the globe represents a benign transformation to an endemic, less serious viral threat. But all these maybes have embedded downside risks that we feel are more-or-less catastrophic for the corporate landscape. There seems no desire for equity investors to consider these paths and bake in a higher level of risk premium to the current market pricing.

From a volatility perspective, implied risk is close to 99th percentile levels in all asset classes, except equities, where the VIX finished the month around 20 – high, but not extreme. Indeed, the dispersion between the big jump higher in the MOVE index of bond volatility and normalisation of the VIX feels relatively unprecedented in the history of those measures. Are bonds *really* riskier than equities now?

And what of the much-analysed relationship between bond yields and the Value-Growth dynamic in equity markets? The recent popular narrative dictates that growth stocks are priced from longer-dated earnings, therefore a rise in bond yields significantly depletes the discounted present value of these earnings – that seemed to explain their outperformance then underperformance in 2020 and 2021 respectively. But in March, as we watched the US 10-year yield spike

(intraday) from 1.66% early in the month to 2.55% late in the month, we saw a host of well-loved tech stocks trading on sky-high multiples of earnings also rallying back towards their all-time highs. Market-neutral expressions of Value (typically big winners when bond yield rise significantly), only finished the month in marginally positive territory.

The overriding impetus for investors is, clearly, still to buy equities. Extreme concerns, such as the start of the war or a scary data print, can push a chunk of fast money out of their positions. But as soon as those concerns ease slightly, then the money pours back in. At times like these equities feel disconnected from the other asset classes. Bonds are anchored to the dry mathematics of interest rates, coupons, maturity dates and arbitrage pricing that ensures a logical explanation for the current value of, say, a 7-year government bond. You may disagree with some of the inputs to the equation, but the valuation method is beyond reproach. Similarly commodities, with their tangible connection to actual *things*, being delivered a proscribed date in the future, subject to the supply and demand dynamics of various industries; they have a rational underpinning of value. But equities? Right now equity valuation feels like it is driven by more of a collective belief system than any kind of financial maths. When the 'Fed put' stops being the reason to invest, maybe a long-term hedge against inflation can become the reason?

The relative serenity of equity markets against a backdrop of emergency is also apparent in recent hedge fund performance. From our perspective as hedge fund allocators, we arguably worry most about the withdrawal of liquidity from markets, which tends to coincide with periods of heightened volatility. It is these moves that can lead to dislocations in common trades, particularly arbitrage trades, which then leads to risk managers cutting exposure and starting a dangerous deleveraging spiral. For all the market gyrations during the first quarter, capital markets functioned well with small dislocations ameliorating quickly rather than expanding into bigger issues. Somewhere within both equity market pricing and hedge fund performance there is the sense that, despite the chaos unfolding across the globe, this isn't quite a proper crisis yet.

Hedge Funds

Hedge fund managers enjoyed a strong month in March, with gains coming from several strategies. Equity managers generally did well, through both beta exposure to bouncing markets and from positive returns to most blends of equity factors, which helped both discretionary and quantitative low net managers in the space. Systemic macro strategies did particularly well during the month, mainly from long commodity exposure and short fixed income. The one area of notable weakness was Asian-focused funds, which suffered from the withdrawal of foreign capital from Chinese markets around geopolitical concerns.

Equity long-short managers generally had a difficult start to the month, with the increased market volatility coming from the Ukraine conflict, but managers generally improved performance as the month progressed, not least because markets rallied, and volatility normalised. Managers continue to hold a more cautious stance, with lower net and gross exposures, although there was some short covering following the FOMC meeting on 16 March. Asset flows from global managers have generally been towards the US/North America and away from Asia, particularly Japan and China. From a sector perspective, managers continue to be a net-buyer of energy related names given the current elevated commodity pricing.

In credit, it was another volatile month given the macroeconomic backdrop, but credit spreads broadly finished tighter on the month, with outright losses in credit driven by rate moves. Loans outperformed high yield, which outperformed investment grade, continuing the theme for the quarter with higher risk securities outperforming lower risk as bond yields rise. As expected, credits in the energy sector were the best performers. Issuance in high yield remains anaemic, although there was continued strong retail flows into loan funds.

For hedge fund managers in credit, it was a muted month, with mixed returns for managers. Higher quality exposures were hurt by higher rates, as were financial preferred strategies. Traditional credit long-short benefitted from the outperformance of lower rated credits, while SPACs and convertible bonds benefitted from the positive performance of their equity sensitivities. Managers with rates hedges generally benefited from tighter credit spreads. Structured credit saw wider spreads, but managers still posted positive returns on the month due to positive carry.

Merger arbitrage was weak early in the month due to Russia's invasion of Ukraine. Spreads reached almost 10% annualized before firming up later in the month. There was robust new deal flow, somewhat contrary to expectations given the uncertain macroeconomic backdrop. Particularly in the US and Asia, but even European activity picked up somewhat in the second half of March, albeit still slow, with a small pick-up in pre-announced deals in Europe. Generally, managers profited from an accumulation of small winners, but some

managers were hurt by the surprising UK regulatory set-back and delay for an apparently far-advanced technology deal, which was widely held in the arbitrage community.

Discretionary macro managers enjoyed a strong month as the market's attention shifted back to inflation, rates, and central banks, as traders became comfortable with the idea that the ongoing conflict between Russia and Ukraine would not cause significant delays to policy tightening. In fact, markets have priced in more tightening this year than what was priced before the invasion. Hawkish commentary in the back half of March from Fed officials has led to growing expectations of a hike at every Fed meeting this year, with at least one 50bp hike required at one or more of the remaining meetings to align with current pricing. Short STIRs, front-end US and European rates, and shorts further out in the US curve have worked well, the latter benefitting from Fed official's support for policy to reach 'restrictive' territory in the US. In FX, positioning for the long 'commodity producers', short 'commodity importers' theme has worked in March given the selling pressure in JPY, GBP, EUR alongside rallies in BRL and AUD.

Quantitative strategies added value across the board in March. On the equity side, managers benefited from a positive equity factor backdrop as well as generally well-functioning markets despite higher ambient volatility. On the macro side, trendfollowing strategies saw significant gains in commodities (mostly long gas and crude oil), and fixed income (shorts across US Treasuries, Eurodollar and Euribor). After a slow start, FX trading pick up in the second half of the month, with most trend-followers enjoying the USDJPY rally, and shorts in EUR and GBP also performed well. Equities were mixed for trend followers, with faster signals cutting their net short position early in the month to limit the damage. There was some pain earlier in the month for quant commodity managers, who were hurt by the closure of the LME nickel market. And although spreads have tightened from their earlier dislocations, we have heard of losses in wheat calendar spreads on volatility from the Ukraine invasion.

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