The Early View November 2023

Price of Risk Hinges on Clear Interest Rate Cutting Path

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In November government bonds staged their biggest rally since 2008, with the US 10-year bond yield falling by more than 50bps, wiping out most of the losses incurred by bond holders since the start of the year. On what? A small undershoot on the November inflation print by 0.1% and a growing consensus that the Federal Reserve maybe done with rate hikes. It doesn't feel like enough of a seismic shift to justify such a large move in the back end of the curve. But perhaps therein lies the message; the size of the shifts in bond yields (both higher through September and October, and lower in November) show how uncertain the forward path for monetary policy is right now. Much is made of the curve being inverted, but pretty much all the inversion is in the first three years. Indeed, the US 3-year bond yield dropped below 4.3% on 1st December suggesting something like eight rate cuts over the next 36 months, depending on the speed of tightening.

This massive bond rally has quickly changed the risk dynamic in markets. Not only were yields more attractive a month ago, most of the fast money (i.e. trend followers) were materially short bonds, setting up a nice tailwind from position unwind into any rally – which we saw last month.

Now the case for bonds is much harder to make. Not only has the overweight short positioning largely unwound, but to make any further decent gains from long-dated bonds from here would require either an even more inverted curve or a significant enough deterioration in the economic landscape to necessitate faster and larger rate cuts than currently priced. The former feels unsustainable, while the latter is essentially a bear call on equities.

Which brings us onto the second big move of November, the equity rally, with the S&P 500 Index adding nearly 9%. There is something jarring about this move which doesn't quite fit with the bond story. The economy is so healthy that equities can retest recent highs, but the bond market is fearful enough to be pricing rate cuts. The narrative tightrope being walked here says that inflation comes under control, but the economy stays buoyant, central banks cut rates a little (because – erm - why not?), and despite historically exhibiting negative correlation when inflation is lower, we see equities and bonds both gliding serenely higher from here. No alarms and no surprises, please.

Large moves such as those seen in bond markets over the last three months are a good illustration of the opportunity set for hedge funds in the short term. It's hard to argue that higher rates in themselves are good for hedge fund performance (not least because many funds charge absolute performance fees), but uncertainty of paths around near-term rates means that it is harder to accurately price the risk premium in arbitrage trades. This leads to more noise, more volatility, but potentially more alpha for skilled market participants.

We may, therefore, be talking our own book (or at least that of our industry), but this all feels a little too convenient. There is clearly a quiet path through 2024 but given the political landscape (not least the number of significant elections next year), the current parlous state of government debt balances, and the growing corporate debt default rates, it seems sensible to conclude that the moves seen across traditional assets in November were a little too much too soon.

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

Equity Long-Short:

- Strong performance of crowded longs relative to shorts meant that alpha generation held up in November, but beta was the largest contributor to positive equity long-short returns given the especially strong rally in global equities; as such, more directional strategies outperformed their lower-net counterparts.
- Both sector-focused and generalist funds benefitted from the rally, though energy specialists lagged as the sector did not participate in the broader market rebound.
- An early active and pretty sizeable de-grossing – via short covering – was offset by the outsized price appreciation of long positions. Gross exposures across U.S.- and European-focused funds continue to sit in top quartile levels (over a one-year period).
- However, towards the end of November we started to see funds taking down long positioning, perhaps signalling funds are approaching this market exuberance with some caution.

Credit:

- The risk-on month for the credit and equity markets led to mostly positive returns for Corporate Credit managers.
- With few idiosyncratic exceptions, convertibles became richer during the month as rates were lower and credit spreads were generally tighter. Financial preferreds reversed October losses and saw strong gains. Regional banks and longer duration securities outperformed.
- High yield long-short and capital structure arb strategies also benefitted from the supportive market backdrop as did reorg equities and stressed/distressed credits. Portfolio level hedges though were a meaningful detractor for some managers.
- November was a good month for Structured Credit managers with modest MTM gains across most sectors and strong portfolio carry driving returns. Portfolio hedges again were a detractor.

Event Driven:

- After a soft start, November was a month of positive returns for Event Driven funds largely driven by the successful closing of the widely held VMware/Broadcom transaction after receiving Chinese regulatory approval. The position was one of the largest holdings for most Event funds and the spread had widened in October on concerns the deal might not close.
- The return of capital was recycled into remaining deals, which resulted in spread tightening, helped also by constructive sentiment and several regulatory approvals in the US. Seagen/Pfizer is the largest M&A transaction in the market at present.
- Deal activity in November was disappointing after a strong October, however a large ($15bn) European LBO with Adevinta ASA is an encouraging reminder of the potential for Private Equity money to be put to work.
- Some idiosyncratic winners in Event Credit, e.g. Banca Monte dei Paschi after strong Q3 results were followed by rating upgrades.

Discretionary Macro:

- Discretionary Macro returns were a small positive in November. Improving risk sentiment in markets has helped long positions in EM rates, which we have seen macro managers add exposure to recently on weakness. Tactical trades in US rates around key data releases have added, as have shorts in EU carbon credits.
- However, given positioning across the peer group coming into the month in DM steepeners and hawkish themes in Japan, both of which struggled this month, we expect final returns to come in weaker once all funds have reported numbers.
- We continue to see macro managers take a more cautious approach in markets. Shorter trading horizons are preferred in rates as uncertainty in the soft-v-hard landing debate and above-target inflation in many economies is deterring strong directional views in the asset class. Japan is an exception though – we have seen positioning shift towards the front-end of the yield curve as the BoJ's exit from negative interest rates comes in to focus ahead of the Shunto wage negotiations next year.

Systematic Macro:

- It was a tough month for Trend Following strategies amid strong reversals in fixed income and currencies. Short positioning in US Treasuries struggled as markets reacted to more benign economic data releases, which in turn weighed on the US dollar against Trend's long position. Equity index shorts were painful at the beginning of the month, though performance stabilised somewhat as models moved towards a net-long position in the sector. Commodity trading has been profitable thanks to shorts in natural gas and corn, and longs in gold.
- Alternative Trend Followers have found November similarly challenging, particularly in DM interest rate swaps where paid positions have detracted. Reversals in EM Asia have also been difficult to navigate, though offsetting gains have come from long credit index exposure and shorts in EU energies.
- Quant Macro strategies are down, with bullish USD views hampering performance. DM crosses have been most painful, while shorts in US equities have also struggled. Like Trend Followers, commodities have been a bright spot from trading in natural gas and gold.

On-the-radar:

- Short term positioning from the discretionary parts of the hedge fund industry has turned contrarian, with fewer risk-on trades than seen at the start of November. We are watching whether these managers maintain this slightly more bearish stance if markets continue to rally.
- 2024 is being talked of as the 'year of elections.' We are watching for any significant shift in the voting dynamics of the major developed economies, although we remain wary that (as in 2016), the market's initial reaction to political uncertainty can be wrong.
- Longer term, everything seems to hinge on the timing and path of rate cuts. The tug-o-war between market expectation (largely dovish) and central bank rhetoric (largely hawkish) has to resolve soon which should set a clearer picture for the price of risk over the next few years.

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