Man FRM Early View

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All market data sourced to Bloomberg unless otherwise indicated. All manager data sourced to Man FRM's internal database.

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Right now, when we speak about markets to our (usually more perceptive) colleagues and contacts in the industry, there's an uncommonly high proportion of people feeling stumped. It's clear that the inflation story is underway; CPI prints continue to set levels not seen for decades and central banks are, by and large, finally reacting. But once a straightforward narrative moves from the realm of forecasting to reality, we start to puzzle over the exact nature of the different strands of the plot. Forecasting is hard enough at the best of times, but for the first time in a while the question 'what next?' is now particularly multifarious.

The crux of the matter tends to be the interplay between inflation and growth, how one affects the other, and how exogenous factors might affect both. In its 'World Economic Outlook' published in mid-April, the IMF downgraded global growth expectations for 2022 to 3.6%, from a level of 4.4% in the January report. Cutting almost a percent from growth expectations after only one quarter, at a time of high inflation should give everyone pause for stagflationary thoughts.

And despite some high-profile earnings disappointments during April, particularly from US tech giants such as Amazon and Netflix, the overall earnings season was a mixture of good news and bad. The pullback in growth expectations is therefore being driven more by macro factors, such as the continued lockdowns in Chinese cities and the impact of the war in Ukraine on commodity prices, particularly oil, gas and wheat.

So, the main thread to untangle is how much of the growth impact is coming from the supply side, because of increased raw material prices and disrupted supply chains post-Covid, and how much is coming from the demand side (i.e., a direct feed through of higher rates from most Western central banks). We feel the balance of the two is important. The demand equation is the mainstay of central bank decision making – higher rates choke off growth which reduces demand which reduces inflation. The challenge for central bankers for the rest of this year is how much do you want or need to oversteer on the demand side of the equation to compensate for the supply constraints?

Despite dropping the word from the minutes of last few the Federal Reserve meetings, supply constraints <u>are</u> transitory. It is likely, in our view, that at some point in the next 12 months the Covid lockdowns will cease, the war in Ukraine will end, and supply-chain disruptions will start to normalise. It's the reason why the long ends of government bond yield curves aren't particularly concerned by the

current inflation shock (remember, 10-year US bond yields are still negative in real terms).

There's a persuasive argument that says even if US inflation data may have peaked, we'll still see 5% CPI prints at the end of the year, and that the current dot plot from the Fed is insufficient. But this presupposes that the Fed timeline for getting it under control is aligned to the end of 2022. If inflation is falling, maybe the Fed is happy to see inflation normalise in 2023, or even 2024, rather than risk the policy error of an oversteer right now. The optics of rates going up and inflation coming down (regardless of their absolute levels) may be sufficient to project an image of being in control.

It's easy to see why taking a view in such an environment is a hostage to fortune. Better to perhaps take a breather and get a clearer understanding of how inflation, growth, central bank actions, the war in Ukraine, the Covid situation in China, and the ultimate tightness in commodity markets plays out over the next few months. Equity investors seem to have taken a similar stance, with markets largely range-bound for the last few weeks. Remind me, how does the old maxim about investing in May go again?

Hedge Funds

April was a more mixed month for hedge fund managers, although as an asset class it continued to provide good diversification to traditional assets. Most strategies eked out small gains despite a backdrop of falling equity and bond prices, and defensive strategies such as CTAs and other systematic macro strategies generally enjoyed another positive month.

Equity managers faced market headwinds from high-level macro fears, driven by the continued Covid lockdowns in China, the war in Ukraine and worries that necessary Federal Reserve tightening could tip the US economy into recession. As a result, managers with more net exposure found the month more difficult, although in aggregate the strategy has been running with lighter net exposure levels in recent month which helped to protect returns (for example, Morgan Stanley noted that the average US equity long-short manager was running at around 40% net exposure, the lowest point for over two years).

One area of positive performance for equity long-short managers was the earnings season. Despite mixed results from companies, hedge funds generally benefitted from their positioning around which companies would beat or miss earnings expectations. On a regional basis European managers tended to do a little better during the month, since European markets held up more than US or Asian markets, and that the average European equity long-short manager runs with lower net than their peers in other parts of the world. Asian – particularly China-focused – funds continued to post the worst performance and the latter generally contains more long-biased funds, so downside risk mitigation has not been as strong among this group. Manager sentiment still seems very mixed due to the recessionary risk. Managers were looking forward to earnings season for clarity, but thus far there are no signs of this translating into taking additional risk.

Credit markets also saw a relatively tough month in April due to the pullback in risk-seeking assets. Leveraged loans outperformed credit markets due to light issuance and buyer demand for floating rate risk. Investment grade credit again saw meaningful losses from their duration and interest rate sensitivity, whereas high yield credit outperformed its historical beta vs equities.

Against this backdrop, credit managers did well to post returns that were mostly positive, with several idiosyncratic opportunities bolstering returns against the market softness. We saw the best protection coming from relative value opportunities, with managers who include exposure to convertible bond arbitrage and SPAC trading benefiting the most. Similarly, managers who take a more neutral view on rates by hedging their long book rate risk also helped protected capital well. Structured credit managers gained on the month from carry and hedges, which offset the mark-to-market losses from spread widening, leading to a relatively muted month.

Event arbitrage managers had a relatively stable month in April despite the wider market weakness. There were no noteworthy deal breaks and spread remained largely unchanged. Announced M&A activity in the US remains high, with a similarly high number of pre-announced or rumoured situations right now. Private equity remains very active globally, supported by huge piles of dry powder, as well as

investor pressure on publicly listed PE firms to allocate capital. Despite the benign landscape, there are some continued signs that anti-trust is growing as a risk factor – not only US but increasingly also UK's CMA, as well as national security approvals in Europe as a whole. US FTC commission expected to soon gain a fifth member, removing partisan voting deadlock and freeing up the FTC more to implement regulatory actions.

In the macro strategies, Trend following managers have enjoyed another positive month. Commodity longs broadly worked well, with gains from positioning in natural gas, heating oil, and grains, although there were losses from positioning in metals. Short positioning in bonds helped during the first part of the month, although these gains were tempered during the second half of the month as bonds bounced somewhat. Currency exposures were mixed, though generally positive as a broadly long US dollar stance across the space worked well. Losses generally came from reversals in commodity FX and select EM FX. Alternative trend-followers were more sensitive to these reversals. Return from equity index trading was also mixed, but managers have generally held low exposure given the range-bound markets exhibiting high volatility. Discretionary macro managers appear to have also done well in April as most have a pro-inflation stance and have benefited from positioning in long commodities and short bonds.

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