The Early View
A Goldilocks Path for the Rest of 2023?

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Markets in April: An Uneasy Calm

Talk to hedge fund managers and most will tell you that they are uncomfortable with risks in markets. Concerns range from the stability of the banking system to the debt ceiling negotiations, from a slowly deteriorating geopolitical landscape to a weaker corporate earnings picture. But there isn't enough in any of these narratives yet to set a definitive course for markets. So, in April, equities ground slightly higher on thinner volumes, the VIX index fell as low as 16 in mid-month, and bond markets have settled from the extreme levels of volatility seen earlier in the year. Even the concerns around the health of First Republic Bank in the last week of the month were digested with relatively little panic. Everywhere one looks, there is an uneasy calm.

And while there's a sense that things should be worse given the fundamentals, there's also a degree of mistrust in the data. The Covid period played havoc with much of data used for leading indicators used by macro specialists, with two things standing out. Firstly, seasonal adjustment of data is noisier now, given the size of the economic demand crash and then explosion through 2020 and 2021. Secondly, employees' approach to the jobs market appears to have materially and structurally changed post-Covid, so relationships such as that between the paucity of job openings and (usually) a pick-up in unemployment feels broken. It's as if we sit at a crossroads of possible economic paths and our usual maps and compasses are malfunctioning.

At times like these, it's often best to react to the shape of the problem rather than try to accurately predict the answer. It feels likely to us that when uncertainty is high, we should expect short, sharp periods of higher volatility (regardless of source), and therefore remaining liquid and nimble enough to capitalise on opportunities as they arise seems like a sensible position. Indeed, we've seen an increasing number of 'dislocation' funds launching across the hedge fund industry, lining up investors' capital ahead of these possible opportunities. Similarly, investors' appetite for credit-focused hedge funds has also risen despite the tightening of credit spreads over the last year, which again feels driven by an opportunistic bet on increased activity later in the year.

With most participants primed for something to go wrong, the worst path for active managers might be one where the banking crises remain contained and manageable; the debt ceiling issue gets resolved after a bit of inconsequential sabre-rattling; there are no materially negative developments in the Russia-Ukraine or China-Taiwan situations; inflation falls back close to target levels; and the perspective on corporate earnings shifts to more sunny pastures of 2024 and 2025 which supports equity levels. So therefore, while not exactly a 'pain trade', the slightly uncomfortable trade for some of the hedge fund industry might be this Goldilocks path through the rest of 2023.

Key Drivers of Hedge Funds Performance: An Early April Snapshot

Equity Long-Short:

- Performance for equity long-short managers was muted in April. Regionally, Asia-based managers underperformed due to China equity exposure, caused partially by a rotation of long-only holders out of Chinese equities and into Japanese equities;
- Equity sector performance reversed from March, favouring more value-oriented managers;
- Funds were net sellers of TMT and Communications Services stocks, ahead of the first-quarter earnings season, which challenged TMT specialists.

Credit Long-Short:

- It was also a quieter month for credit hedge funds. The market backdrop saw a marginally positive month across corporate and structured credit, with (1) spreads modestly tighter as bank earnings (with a few exceptions) were generally positive; (2) relatively stable trends on deposits, again with some exceptions. Financial preferred securities saw a continued small rebound since intra-month lows in March;
- There were few meaningful single-name profit and loss drivers with managers mentioning gains in capital structure arbitrage trades, high yield long-short and idiosyncratic credit stories in convertible bonds;
- Declining volatility in rates and equity markets, coupled with tighter spreads, has been a tailwind for long positions. As such, portfolio hedges were generally a detractor.

Relative Value:

- The biggest story of the month in event arbitrage was the UK Competition and Markets Authority ('CMA') blocking the $69 billion acquisition of Activision Blizzard;
- Until this deal break, merger spreads of some higher-profile deals had tightened during April;
- There continues to be relatively rich deal activity in April (including several that were unsolicited), even in Europe which is particularly noteworthy. However, these were mostly mid-sized new deals; indeed, only one was more than $10 billion.

Systematic Macro:

- Trend-followers were positive in April after the extremely difficult March. Currencies produced strong returns via euro longs and Korean won shorts, while peers in the alternative trend space continued to profit from longs in Latin American commodity producers;
- Commodities also stood out, with sugar longs and wheat shorts working well in traditional markets, while shorts in crude oil earlier in the month were challenged by the announcement of OPEC+ production cuts. In the more esoteric markets, shorts in the European gas and power complex added, though longs in EU carbon emissions lost money;
- Quant macro managers enjoyed the continuation of price trends in agricultural commodities, and struggled with short oil positions at the start of April. Equities were positive, with longs in UK and European indices adding. Residual short exposure to fixed income markets, led by a bias towards short-term interest rate shorts, produced modest gains.

Discretionary Macro:

- April was a more muted month for discretionary macro managers. After the bond market volatility in March, managers entered April running lower levels of risk;
- Most of the risk-cutting was focused on neutralising directional fixed income exposure, particularly in the US. However, we did see some gains in euro rates this month as markets priced in further rate hikes from the European Central Bank;
- FX positioning has become a more meaningful portion of portfolio risk over the past month. Trading in Latin American pairs produced mixed returns;
- Macro developments in Japan remain a focal point for managers, given possible difficulties in exiting yield curve control and any possible policy shift under Governor Ueda.

On the Radar:

- The US debt ceiling negotiations have started in earnest, with the US House of Representatives approving a bill on raising the debt ceiling with meaningful spending reductions. This bill is likely to be dead-on-arrival in the Senate, but sets the stage for further wrangling in May and June, ahead of a possible default deadline in July or August;
- Hedge funds seem less concerned about the actual likelihood of a US default, but more concerned about the impact on market liquidity and second-order effects in short-term interest rate markets. The market paths around a 'technical default' or other such language are unclear – for example, what happens to regulated funds, such as UCITS funds' restrictions on holding B-rated securities or securities in default, and the possible associated capital flight from Treasuries;
- The political landscape is equally risky, mainly from unintended consequences. For example, Kevin McCarthy conceded a lot of ground to win the speaker nomination at the start of the year. What if house members force a vote to remove him at the same time as trying to resolve the debt ceiling? This could be a very chaotic situation under time pressure.
- Beyond the debt ceiling, the usual focus remains on fundamental data, inflation and central bank reactions to the data. And while everyone with a basic grasp of mathematics knows how the annual calculation for inflation works, the optical impact of seeing the data for May and June of 2022 (at 0.9% and 1.2% month-on-month US CPI, respectively) falling out of the annual calculation could give less observant market participants further confidence that the inflation problem is coming under control.

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