Q2 2024 Hedge Fund Strategy Outlook

Opportunities Persist Across Hedge Funds after a Strong Start to 2024

Please note that the opinions discussed below are those of the individual authors and do not reflect a Man Group house view. All market data referenced below sourced from Bloomberg unless otherwise specified.

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1. Introduction

The first quarter of 2024 has been unusually strong for hedge fund performance, with gains across many strategies, not least in those exposed to momentum in either time-series or cross-sectional form. Equity markets have ground higher as economic data continues to suggest a more benign backdrop than expected. In reaction, central bank watchers have reduced the number of interest rate cuts forecast for this year, given the stronger economy and the risks of fuelling further inflation through overly loose monetary policy. This has led to an interesting 'game of two halves' for equity markets over the last six months. The Q4 rally was supported by the idea of large rate cuts in 2024, whereas the Q1 rally has been driven by economic strength that removes the need for large rate cuts. Somehow both narratives have been market positive.

We broadly believe that the higher rate environment of the last few years has led to a varied landscape across many financial assets, with greater opportunities for identifying winners and losers at both a corporate and a security level.

2. Our Outlook

One should always be wary of overenthusiasm. In the table below we offer our most positive outlook on record for the breadth of strategies on which we are optimistic about alpha generation over the next 6-12 months. We have upgraded our outlook for **Structured Credit, Merger Arbitrage** and for **Equity Long/Short** (both Long Biased and Market Neutral). We broadly believe that the higher rate environment of the last few years has led to a varied landscape across many financial assets, with greater opportunities for identifying winners and losers at both a corporate and a security level. Furthermore, as we move into a period of potentially looser monetary policy, the impetus is there for market dislocations to close on a supply of easier financing.

We have spent a long time as a team discussing the outlook table as it is unusual to be positive across such a wide range of strategies. However, we remain steadfast in our strategy outlook as it is grounded in a what we believe is a compelling market backdrop for hedge fund alpha generation.

Figure 1 summarises our stance on different hedge fund strategies for Q2 2024.

Figure 1. Q2 2024 Outlook versus Q1 2024 Outlook

	Strategy	Q1 2024	Q2 2024	Change
Credit	Credit Long/Short	Positive	Positive	–
	Distressed	Neutral	Neutral	–
	Convertible Arbitrage	Positive	Positive	–
	Structured Credit	Neutral	Positive	Upgrade
Quantitative	Macro Quantitative	Neutral	Neutral	–
	Micro Quantitative	Positive	Positive	–
Macro	Global Macro	Positive	Positive	–
Event Driven	Merger Arbitrage	Neutral	Positive	Upgrade
	Special Situations	Neutral	Neutral	–
Equity Long/Short	Long Biased	Negative	Neutral	Upgrade
	Market Neutral	Neutral	Positive	Upgrade

3. The Details

3.1 Credit

We retain our positive view on **Credit Long/Short** and remain favourable on managers with a focus on idiosyncratic credit selection. After strong credit market performance over the past few months on increasing expectations of a soft landing, US high yield spreads are now only modestly wider since year-end 2021 and remain below historical median levels. However, lower-rated credits (i.e., CCCs) have lagged, credit spread dispersion remains elevated, there is still reasonable distress, and all-in yields are attractive. This backdrop should be favorable for High Yield Long/Short and Capital Structure Arbitrage strategies as different issuers continue to see varying impacts from higher funding/refinancing costs, and in some instances (particularly lower-quality names) still face challenges in accessing capital markets. Overall tight credit spreads also present managers with opportunities to reset asymmetric single-name credit shorts as well as portfolio hedges (index shorts). As previously discussed, performing stressed credits with mispriced market expectations of issuers' ability to address upcoming maturities, as well as liability-management trades, also remain areas of focus. We remain neutral on **Distressed**. 2023 saw elevated levels of defaults and distressed exchanges, which are expected to persist in the near- to medium-term, but expectations have moderated as the economy remains on a solid footing, the universe of distressed bonds/loans is smaller, and capital market access has eased with the exception of lower-rated names.

While broad markets trade around estimates of fair value and credit-sensitive names have performed well over the past few months, spreads for non-investment grade convertible bonds remain at wide levels relative to the US high yield market.

We remain favourable on **Convertible Arbitrage**, particularly managers focused on the idiosyncratic opportunity set in credit-sensitive convertible bonds. While broad markets trade around estimates of fair value and credit-sensitive names have performed well over the past few months, spreads for non-investment grade convertible bonds remain at wide levels relative to the US high yield market. This should continue to present opportunities for skilled managers with appropriate scale and relationships to extract alpha from credit selection, as well as engaging with issuers around liability management transactions (buybacks, exchanges, etc.) Primary markets are expected to remain active as issuers seek to address 2025/2026 maturities resulting in opportunities from new issues/flow as well as refinancing trades, and also for sourcing attractive volatility-oriented/balanced convertible bonds, which can potentially benefit from a pickup in market volatility on any renewed stress.

We are upgrading our outlook for **Structured Credit** to positive (from neutral) as many securitised products sectors have lagged the recovery of the broader equity and corporate credit markets. Spreads/loss-adjusted yields remain attractive despite recovering from recent wides while aggregate consumer performance remains strong, driven by a robust

economy and solid labour market. Mortgages have continued to perform well, driven by favourable supply/demand technicals driving strong home-price appreciation (HPA) while auto/credit card delinquencies for subprime borrowers have been increasing, though from low levels. Our concern remains a significant, broad-based increase in residential/consumer asset-backed security (ABS) delinquencies/defaults if tighter monetary policy more meaningfully impacts consumer/residential credit and/or unemployment increases significantly. However, we believe weighing risks versus potential opportunities merits a more positive outlook.

There are signs that equity market dispersion has picked up which should benefit quantitative equity market neutral managers.

3.2 Quantitative Strategies

Our positive outlook for **Micro Quantitative** strategies remains unchanged. There are signs that equity market dispersion has picked up which should benefit quantitative equity market neutral managers, including those operating with statistical arbitrage/machine learning and alternative data driven approaches that we continue to favour. Encouragingly, research enhancements made by some of the highest-quality managers have enabled us to increase exposure in this usually highly capacity constrained space. One cautionary note is that while the most sophisticated strategies have performed well so far this year, they have done so in lockstep with more simplistic equity factor driven approaches. We hope much of this short-term correlation in returns is coincidental and if we see any reversal in performance of the latter strategy type, we do not see a commensurate period of negative returns for the former.

We keep our neutral outlook for **Macro Quantitative** strategies. We remain weighted more towards alternative trend over simple trend strategies. We hope this will partially guard us against the potential for a reversion in pricing of quite concentrated bullish positions currently prevalent in the latter. Some signs of dispersion across regions from a monetary policy perspective support the case for opportunities for non-trend systematic macro strategies and it has been pleasing to see a rebound in performance in Q1 following a difficult 2023. We have retained our exposure to commodity specialists and have identified some interesting and esoteric market segments here that we believe could provide diversification in portfolios going forward.

We are entering a new macro environment characterised by an unusual backdrop for global economic policymaking, which many of today's market participants have not faced before in their lifetime.

3.3 Macro

We maintain our positive outlook for **Global Macro** strategies, expecting higher volatility, greater dispersion, changing market relationships and more frequent market dislocations to produce an attractive environment for macro risk-taking.

We are entering a new macro environment characterised by an unusual backdrop for global economic policymaking, which many of today's market participants have not faced before in their lifetime. Investors are faced with significant uncertainty compared to the old regime and they must consider a wider range of possible outcomes in their forecasts. Such forecasts are being governed by different combinations of factors, reflecting the increased importance of factors that were previously an insignificant component of price discovery. As investors reposition according to their new expectations and preferences, new relationships are forming between markets. With that in mind, we are more positive on discretionary strategies to delineate between structural shifts in correlations and volatility versus those that are more spurious and/or short-lived.

We see potential for continued macro uncertainty and price dispersion to generate alpha opportunities for managers. So far this year we have seen a pickup in dispersion across markets due to differences in economic cycles and policy reaction functions. The Bank of Japan finally raised interest rates and ended yield curve control. Meanwhile, many emerging markets have initiated cutting cycles with their developed counterparts projected to follow suit in the coming months. We expect dispersion to persist against a backdrop

of heightened policy error risk, particularly around policymakers' assessment of neutral rates which appears at odds with the recent trend of economic robustness broadening out beyond the US. Activity on the fiscal side should also play a role, with higher volatility into elections anticipated as price action across markets becomes increasingly sensitive to expected election outcomes, while investors must also discount the possible impact of leadership changes on longer-term themes such as fiscal sustainability, supply-chain recalibration, and the move towards a greener economy. We anticipate greater opportunity for discretionary macro managers in reacting to price dislocations, rather than aggressively positioning ahead of elections, policy decisions and key data releases.

We have upgraded our outlook on Merger Arbitrage to positive, mainly to reflect a significant expansion in deal activity in both the US and Europe.

3.4 Event Driven

We have upgraded our outlook on **Merger Arbitrage** to positive, mainly to reflect a significant expansion in deal activity in both the US and Europe. This rebound is dominated by strategic acquisitions, across a broad range of sectors, and is notable also for an increase in mega-deals. There are encouraging indicators that the M&A rebound will be sustainable, as rising valuations help bridge bid-ask spreads, pending M&A financing is meeting robust demand from capital markets, CEO forecast confidence has been picking up, and a growth in activism may become a driver of M&A campaigns.

Merger spreads also remain attractive, particularly for more complex transactions. Spreads have recently incorporated more antitrust risk, which remains a key challenge to navigate, despite several notable regulator 'defeats' in H2 2023. Specifically in Europe scrutiny on mergers may increase due to populist demand for more robust enforcement. Nonetheless, more complex completion paths generally enable skilled managers to generate alpha with active trading. Spread volatility is often integral to more binary situations, however, and duration increases can also dilute returns.

We remain more neutral on **Special Situations** more broadly, but see encouraging potential in idiosyncratic opportunities. Certain Asian Relative Value strategies are well positioned to benefit from dislocations between fundamental and more sentiment- and flow-driven factors, like China A/H, ADR versus local lines, and HoldCo versus OpCo discount trading. And corporate governance tailwinds continue to support catalyst trades in Japan and newly also in Taiwan.

Non-merger hard catalysts, like spin-offs and asset sales, are often beneficiaries from increased activism and M&A influences. Soft catalyst trades, however, will likely remain difficult to hedge in rallying markets and may introduce unwanted market beta. Pre-event investing similarly carries higher downside risk but can be lucrative in sectors such as biotech with large acquisition premia. Event Credit should benefit from idiosyncratic stress dislocations in capital structures, even in the absence of a more pronounced distressed environment. Catalysts related to litigations continue to be sources of alpha for specialised managers.

3.5 Equity Long/Short

We have a more positive outlook for the Equity Long/Short (ELS) strategy and have made upgrades in both sub-strategies: to a positive rating (from neutral) for **Market Neutral** Equity Long/Short and to a neutral rating (from negative) for **Long Biased** Equity Long/ Short. These upgrades have not been made on the heels of the recent strength in global equity markets, as what has remained consistent versus the past few quarters is our continued preference for low-beta ELS managers. Aside from the fact that we would prefer not to pay for beta, we believe that elevated yields and lows in equity risk premium may be headwinds to market beta. However, the environment for true, dual-sided stockpickers looks more encouraging for a couple of reasons.

While narrowness in market leadership has been a big story over the preceding months, the data shows that dispersion among the blue-chip market leaders has picked up.

There appears to be a clearer path for interest rates and the managers we speak to are citing fewer macro risks. In the context of Long/Short Equity, this has been a welcome respite as the relationship between company fundamentals and stock prices has improved.

A prolonged higher cost of capital and tougher economic climate should continue to create separation between winners and losers, furthering the opportunity for alpha generation on both sides of a portfolio. Given inflation and higher wages, discipline in cost management and/or a focus on driving operational efficiencies (perhaps through the adoption of AI) are other ways for companies to differentiate themselves. There is also a lot of chatter about a resurgence in equity capital markets, but not all companies will be able to secure capital on favourable terms. The market has surely learned from the SPAC 'boom-and-bust' of a few years back.

To further support our more bullish outlook, we note that single-stock dispersion has picked up while correlations have decreased. While narrowness in market leadership (i.e., the 'Magnificent 7' stocks) has been a big story over the preceding months, the data shows that dispersion among the blue-chip market leaders has picked up. Managers focusing their efforts away from the market leaders have a greater shot at being rewarded in pair or relative value-style trades.

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