ITERAM

THE ALTERNATIVE CAUSERIE
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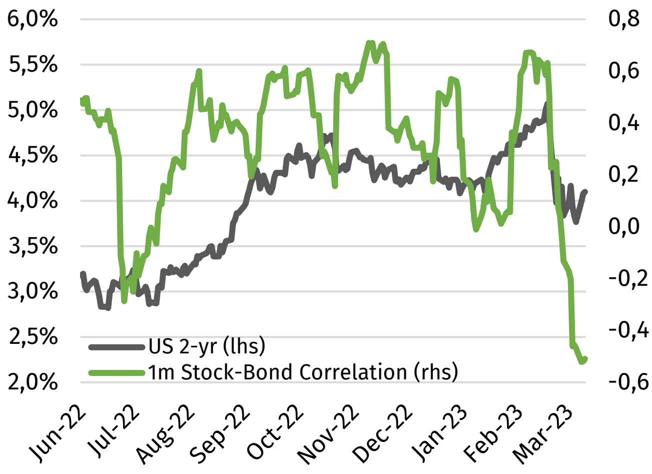
HEDGE FUNDS FACE THEIR FIRST RESILIENCE TEST IN 2023

While stock and bond markets were hit hard by one of the worst corrections since the great financial crisis, hedge funds managed to come out ahead in 2022 after a decade of waning interest from investors in favor of directional investments in growth stocks and private markets. Global Macro, CTAs, and Multi-Strategy managers notably posted remarkable returns thanks to an unprecedented confluence of macroeconomic factors: rising rates, record inflation, and geopolitical conflicts. Positions in interest rates and currencies contributed greatly to this success, thanks to a bearish view on US and European short-term rates on the one hand and benefiting from the appreciation of the US dollar against several developed markets currencies (euro, sterling, and yen in particular) on the other hand.

However, the music abruptly stopped last month as hedge fund managers were still betting on a rise in US short-term rates after a recent hawkish message from the Federal Reserve's chairman Jerome Powell. Net speculative positions on futures contracts on US 2-year sovereign bonds stood at -708,168 as of February 14, 2023 (CFTC data), the largest aggregate net short position and the most bearish reading since the first publication of this data in 1993! Consequently, rising stress around systemic risks with the failure of Silicon Valley Bank, the sixteenth-largest bank in the United States, accelerated capital flows towards safe-haven assets and forced managers to cover their positions swiftly to pay margin calls. The coordinated response from hedge fund managers intensified the upward movement on these contracts which triggered an unprecedented short squeeze in these markets and serves as another illustration of the risk associated with holding highly consensual views. All in all, the US 2-year rate dropped by 0.75% in one week which is equivalent to a 7 standard deviations variation. The MOVE index was close to the 200 level on March 15, 2023, a level like that of the peak of the 2008 crisis, signaling record volatility in this market.

Furthermore, the swift change in correlations was also another detrimental parameter for these strategies, which construct their portfolios based on orthogonal themes to minimize concentration risk. In the wake of the aforementioned developments, the correlation between stocks and bonds has shifted into negative territory within a few days after having been positive for several months (see chart 1). This type of reversal led to allocation shifts and these flows contributed to strengthening extreme price actions. A vicious feedback loop is therefore created, due to an increasing number of players pursuing the same opportunities who can sometimes increase their footprint in the market through leverage to maximize gains. In this context, the HFRI Macro Total Index and SG CTA index lost -3.20% and -6.43% respectively in March mainly driven by weak trading in short-dated rates.

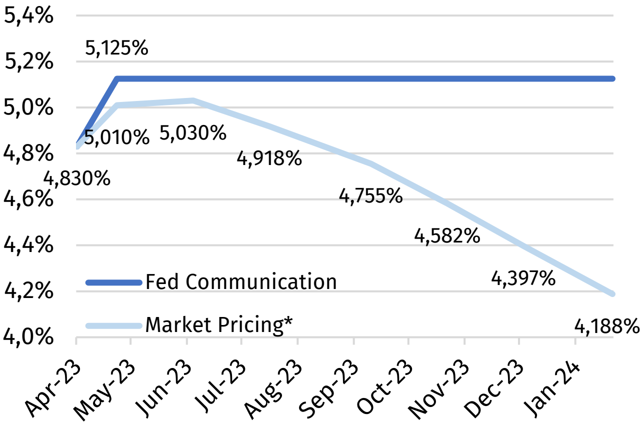
Chart 1 - Stock-bond correlation fell in negative territory in March as yields dropped



Source: Bloomberg, as of March 29, 2023

After being accustomed to forward guidance for more than a decade, investors are now questioning the credibility of central bankers and appear to be signaling an imminent revision of global monetary policies towards a less restrictive stance. In the United States, although the Federal Reserve remains committed to bring inflation back to its medium-term target of 2%, the divergence between market expectations and the Fed's projection of the policy rate for the end of 2023 is such that the gap is now close to 100bps (see chart 2). Similarly, the European Central Bank continues to display its determination to combat rising prices by assuming its policy of monetary tightening. Market participants have been addicted to abundant liquidity and the overall market structure now seems unfit for higher rates and higher inflation.

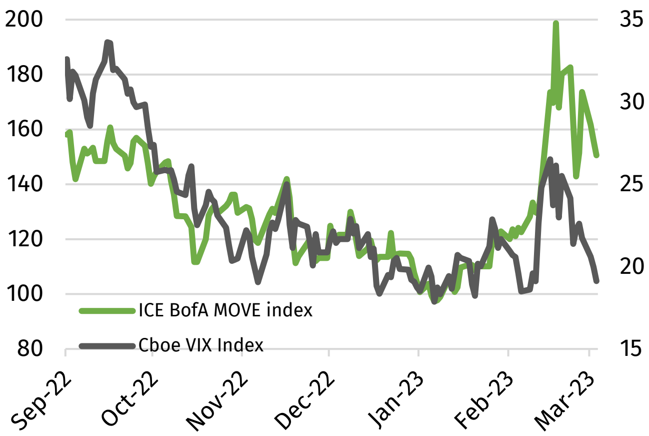
Chart 2 - Fed communication vs. market pricing of policy rates



Source: Bloomberg, as of April 11th, 2023
**Pricing based on Fed Funds futures as of April 11th, 2023*

The uncertainty around the medium-term path of inflation remains the main driver of this divergence. The US consumer price index slowed down to a 6.0% YoY growth compared to a peak of 9.1% last June, a trend that reassured most investors and helped support the appreciation of risk assets between October 2022 and January 2023. However, the dynamics of certain items such as rents and the strength of the labor market continue to put pressure on central bankers. Within fundamental hedge fund managers, we are observing a growing dichotomy in the interpretation of different macroeconomic data between inflationary and deflationary camps. Given the magnitude of the divergence, one side must be wrong …

Chart 3 – Growing disconnect between pricing of risk in US equities and Treasuries



Source: Bloomberg, as of March 29, 2023

As the banking crisis unfolded, volatility spread to other asset classes but remained relatively contained to US Treasuries which suggests that March wild price swings were primarily driven by position unwinds. In equities, the VIX index initially surged to 26 on March 13th but swiftly reversed course to decline back below 20 (see chart 3). While financial and real estate stocks sold off heavily, equity markets did well overall driven by last year's laggards, namely large caps in the information technology and communication services sectors. This resilience was illustrated by the strength in the likes of Google, Amazon, Microsoft, Meta Platforms and similar. Subsequently, major equity indices across the US and Europe advanced in March and seemed unaffected by rising underlying economic stress. Such pricing discrepancy between the equity and fixed income markets is raising questions since one market must be wrong. On the one hand, stocks shall benefit from some kind of relief as rates fell but on the other hand rates expectations are going down as market participants anticipate a hard landing scenario which is unquestionably an alarming sign for future business activity and corporate margins. Most equity long/short managers benefited from such a backdrop with returns being driven by short alpha while long positions were hurt by style factors. According to Morgan Stanley Prime Brokerage, hedge funds rotated out of small and mid-caps into large caps in technology and healthcare while selling energy and financials. Region-wise, equity long/short funds were buyers of China to increase exposure to the re-opening theme while reducing their footprint in Europe (primarily by selling banks).

In the past three years, we have witnessed so many different market environments and a myriad of rare probability events. Although we have probably gone through a full business cycle in fast-track mode, our portfolios have continuously delivered steady returns thanks to our dynamic portfolio management approach and rigorous manager selection process. In such uncertain times, our playbook is to keep optimal diversification and hedge our bets across different strategies, styles, and geographies to minimize the impact of unforeseen events as capital protection is a prerequisite for surviving in the investment management business.