ITERAM

THE ALTERNATIVE CAUSERIE
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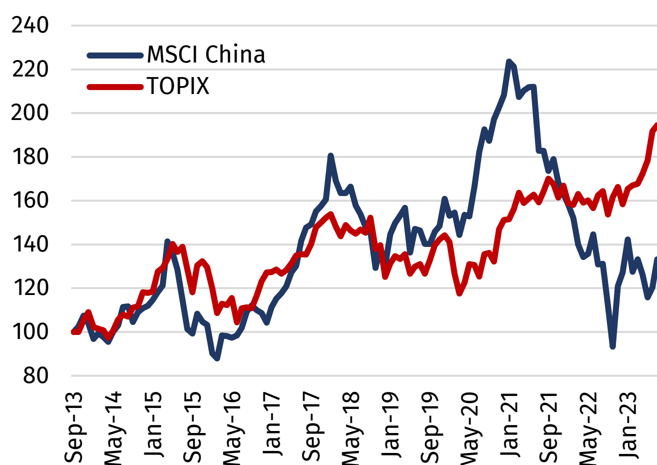
THE UNCORRELATED APPROACH IN BETA-DRIVEN MARKETS

Very few analysts, economists or market experts had anticipated such a good start to the year for risk assets. At some point during the fourth quarter 2022, the consensus expectation was that most Western economies would enter a recession in 2023 as a result of the most aggressive coordinated rate hiking cycle in decades. Fast forward two quarters later, GDPs are still growing, labor markets are stubbornly tight and corporate earnings have been surprisingly resilient. Among the factors behind this unexpected "goldilocks" environment, strong consumer balance sheet and marginally expansionary fiscal policies have supported spending and economic activity in the aftermath of the pandemic.

Looking at broad hedge fund indices, performance has been modestly positive so far in 2023 with directional equity strategies outperforming as the environment has thus far provided a beta tailwind to their long books. However, the relative performance of hedge funds compared to traditional asset classes has been disappointing. First, the S&P 500 index gained a breathtaking +19.5% in the first seven months of the year but under the hood this extreme equity rally has been mostly driven by the stellar performance of the seven largest US technology companies (this group is now dubbed the Magnificent Seven, namely Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta Platforms and Tesla) and investors' frenzy for artificial intelligence. This narrow market breadth has been an additional headwind for stock pickers who typically rely on a wide universe of opportunities. Second, the subsequent suppression of volatility has been detrimental to non-directional managers and other strategies with a "long volatility" profile. This specific set of market conditions is generally the worst environment for uncorrelated strategies which are unable to compete with the unabated appetite for risk assets.

The one major area of weakness in equity markets has been China. Following the initial rally supported by the unexpected COVID reopening announcement, Chinese shares have consistently underperformed on the back of persistent lackluster economic data. Geopolitical tensions and policy uncertainty have also eroded valuations which are now among the most attractive in the equity landscape. This backdrop has led hedge funds to progressively reduce their long holdings in China across A-shares, H-shares, and ADRs. The situation is quite the opposite in Japan as the country is experiencing one of the most exciting periods in the past three decades. The recent corporate governance reform has attracted investor interest by encouraging management teams to implement shareholder-friendly improvements, namely buybacks, spin-offs, and board changes. As a consequence, we have observed steady inflows into Japanese equities since 2022, some of which has been driven by reallocation away from China. However, the number of stand-alone Japan-focused long/short funds shrank over the years due to poor returns and limited investor appetite. Instead, multi-strategy platforms and pan-Asian funds have been progressively expanding their bets in the region.

Chart 1 – Japan has widely outperformed China over the past two years

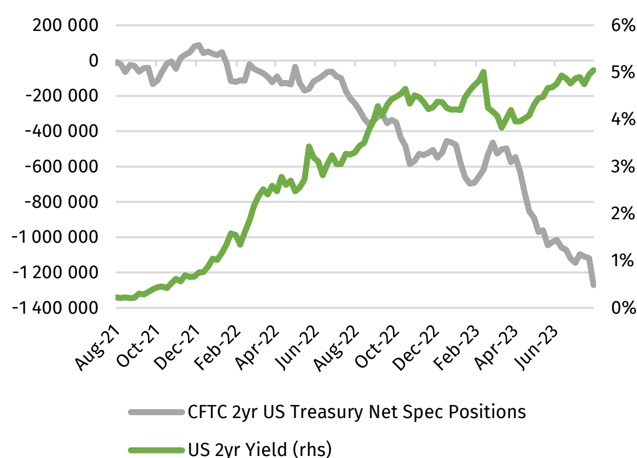


Source: Bloomberg, as of August 31, 2023

By contrast, the strategies that outperformed in 2022 have struggled so far this year due to challenging trading conditions, most notably CTAs and discretionary global macro. Fixed income trading has been particularly detrimental as rates anticipations have been erratic throughout the year. In March, the

crowded short positions in US front-end rates were put under pressure by the US regional banks crisis and resulted in heavy losses for global macro and managed futures programs as market participants priced in an imminent Fed pivot. Positioning and leverage have been trimmed down after the Silicon Valley Bank bankruptcy but the "higher for longer" theme remains consensual among these managers which have doubled down on the trade (see chart 2). Elsewhere, a bearish view in Japanese rates (10-year primarily) is increasingly becoming a core theme in global macro portfolios as traders expect the Bank of Japan to abandon its Yield Curve Control policy on the back of accelerating inflation. This trade has already started to pay off in July when the BoJ decided to widen the band around its 10-year JGB target. Needless to say, this underperformance has triggered outflows from these strategies as investors reallocated capital to opportunities in equity and fixed income. From our perspective, we remain constructive on global macro investing as the opportunity set should improve with the normalization of monetary policies and increased regional dispersion.

Chart 2 – Short positions in US 2-year Treasuries have increased dramatically since April



Source: Bloomberg, as of August 31, 2023

All eyes have been on credit of late, which is becoming a key area of interest for hedge fund allocators. We expect dispersion and volatility to keep increasing in the credit markets as higher rates should eventually take a toll on companies with poor balance sheets. The approaching maturity wall (maturing debt which will need to be refinanced) and a rise in defaults should act as catalysts. While credit spreads are marginally higher compared to previous years, the lower rated parts of the bond and loan markets are showing early signs of stress driven by pre-emptive selling ahead of a potential economic deterioration and weakening fundamentals. At the same time, this indiscriminate selling has resulted in some quality issues trading currently at attractive levels. This environment typically bodes well for credit long/short specialists who can capture alpha from both relative value and directional trades. On the stressed and distressed front, most managers continue to believe that it is still too early to deploy significant capital into these strategies since they don't see enough interesting opportunities for the time being.

While navigating through a sustained bullish market, hedge funds tend to lag the market on a beta-adjusted basis as their short books suffer. But focusing only on the past six months' performance doesn't reflect the real benefit of uncorrelated strategies over the long-term. In the context of a diversified portfolio, the protection brought by an allocation to hedge funds in large equity sell-offs outweighs the marginal opportunity cost experienced during episodes of strong rallies. This asymmetric profile and the potential convexity offered by these strategies look even more appealing when considering the rising number of indicators pointing to a potential economic slowdown in addition to the latest extreme price action across several markets.

We have been humbled by the latest short-term headwinds for our investment approach and have reacted accordingly to minimize the impact on performance. Nonetheless, we remain very excited about the opportunity set and believe that the current complex macro backdrop will prove highly profitable to uncorrelated hedge fund strategies.

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