

FRM Early View January 2016

Global financial markets recorded steep losses in January, reflecting a sharp decline in investor risk tolerance amid big falls in energy prices and heightened concerns about China's economy. All of this pushed down the HFRX Global Hedge Fund Index -2.76% for the first month of 2016. The January fall reflected large declines in global equity markets led by falls in Chinese stocks, while oil slid below \$27 for the first time since 2003.

Of the four main strategy buckets, only the HFRX Macro/CTA Index recorded positive performance in January. Trend following models captured the decline in Energy and interest rates as the USD gained against the RMB, GBP and CHF. In contrast, Equity Long-Short saw the biggest performance losses with widespread declines across regions and sectors. Event Driven fell as credit spreads widened, while distressed issues declined again from exposure to Energy and Basic Materials. In Relative Value, performance losses were generated as high yield credit and arbitrage deals-spreads widened, although some of the declines in specific, concentrated sectors were partially offset by gains in implied volatility. The following comments on hedge fund strategies are based on provisional data and analysis which may be revised as new information becomes available.

Macro strategies had mixed performance amid an overall risk-off environment. Several macro managers exhibited losses in fixed income and equities despite cutting risk levels early in the New Year, while others recorded gains from the continued USD strength. Against this backdrop, central bank policy action looked inconclusive. At its January meeting, the ECB hinted at further accommodation, while at the FOMC, the Fed pared its outlook for growth and inflation. This potential deflationary risk detracted from some macro managers' performance, particularly those long inflation break-evens. Then, on 31 January, the BoJ surprised markets by moving to negative interest rates. The subsequent currency depreciation supported the consensus trades of short JPY and long Nikkei.

Against this backdrop, Emerging Markets strategies were mixed. Managers positioned short BRL benefited from Brazil's continued political turmoil and subpar growth prospects. But managers with significant Asia equity exposure suffered on the big move down in Chinese equities and Japan's descent into a bear market. Meanwhile, several discretionary macro and Emerging Market managers enjoyed good gains after scaling back into short Asia FX trades, featuring the SGD, KRW and THB.

The chief source of performance for Managed Futures strategies was gains in Fixed Income. Commodities and FX also contributed, although equities were a minor detractor. In commodities, gains were again led by shorts in the energy sector, although the rebound in crude oil at month-end reversed some of the earlier gains. Perhaps the toughest trend to get right featured the JPY as managers lost performance initially in January when it appreciated against the dollar; but by the time many had turned long JPY-USD, the BoJ shocked the market with its move to negative interest rates, sending the JPY down 2% in a day.

In Equity Long-Short, most US managers couldn't overcome the hefty -5.1% fall in the S&P 500 and the -8.9% plunge in the Russell 2000. With short books unable to offset the fall in long books, most managers ended the month with low single digit percentage losses. Given that many managers entered the month with low gross and net exposure, the performance represents negative alpha. Much of this is due to the size effect in January given the large underperformance of small and mid-cap stocks, as well as a lack of dispersion between sectors (all but three were negative). Value outperformed Growth, helping a number of managers that struggled in 2015 to post good

performance. Overall, however, managers remain bearish.

European ELS managers also found January difficult as the -6.4% fall in the Eurostoxx 600 Index meant there was substantial negative beta. Unlike the bigger drawdown months in 2015 (such as August and December), managers struggled to make up for the beta losses from alpha. Managers generally weathered the first half of the month quite well, when the index experienced its biggest declines, but then struggled to add value as the index rallied. One explanation of this phenomenon is that the drivers of the sell-off were consistent with the winning themes from last year (namely, short energy and materials, long consumer). The bounce was something of a factor reversal as oil rallied, which led to losses from unrealised P&L across our managers' portfolios. European managers, too, are increasingly bearish and mindful of rising systemic uncertainty in markets.

Early indications are that Statistical Arbitrage managers enjoyed a reasonable start to the year. Technical models look positive amid the heightened market volatility, while fundamental factor models were broadly positive across regions, with the pattern of positive momentum performance and Value models a detractor continuing

in January. Meanwhile, managers that run futures strategies will have had a boost in performance following the strong returns recorded by Managed Futures during the month.

Deal activity has generally been resilient to macro headwinds, but market volatility in January upset that trend with announced transactions falling to \$220bn. Still, two substantial deals did get unveiled – Baxalta/Shire and Tyco/Johnson Controls. As both involved tax reduction strategies, they highlight how regulatory and political risk must be part of any transaction analysis. Elsewhere, foreign acquisitions by Chinese corporates began the year strongly (the \$12.5bn in deals unveiled is the highest ever for January) and then accelerated in early February with ChemChina's \$43bn bid for Syngenta. Event Driven managers recorded a wide dispersion in returns with most producing negative performance (-1% to -4%), though pure merger arb managers outperformed and were up on the month. Tighter spreads were profitable in several deals (Precision Castparts/Berkshire Hathaway, BG/Shell, and Broadcom/Avago) where closure was imminent. Managers continue to like the wide merger spreads (right up until closing) in large, liquid, strategic deals, and those with flexible mandates are generally leaning towards hard catalyst situations.

In Credit, as with other asset classes, the first week of January set the risk-off tone for the month with a global flight to quality and a corresponding rally in government bonds. US HY saw higher quality outperform but total returns were still negative even though around half of the intra-month losses were recovered after dovish central bank comments spurred a rally in stocks and oil. There was also a positive turn in retail flows after heavy outflows earlier in the month.

For the most part, January reflected what we saw in 2015 as US HY underperformed EU HY, while leveraged loans as well as US and EU investment grade markets outperformed in the rush to quality. Performance among Credit Long-Short and Credit Value managers was mostly negative except for those who were either underinvested or had a significant short bias. In Structured Credit, widening spreads meant returns were flat to negative, while in Convertible Arbitrage returns suffered on the underperformance of the underlying equities.