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MARKETS

During the last week of August, the headline writers on financial television channels had little need to update their text. “S&P 500 hits record high” was the seemingly constant message for days on end, extending one of the longest bull runs in history. As the climb continues, it progressively loses fans amongst the investor and analyst community, perhaps adding to its durability. A bearish narrative forms easily from the shifting worries about trade wars, emerging markets crises, US and Italian politics as well as dollar strength and the risks of yield curve inversion. But price action and data suggest that, despite the noise, we are still largely in an environment dominated by US economic supremacy with a combination of high growth and low inflation in a supply side shock context.

It is human nature to worry about the end of the rally. But while timing markets remains a near impossible task, we are more confident that the next market sell-off (whenever it comes) will look different to previous crises. Most market participants will think of bear markets in the shape of the dot-com bubble or the global financial crisis, but we believe there is little in the current data to suggest markets are as overvalued and narrow as in 2000, or that the banking system is as fragile as in 2008. And while the last two sell-offs were globally correlated, we should not rule out a more benign end to this market cycle which is characterized by significantly variable performance of different regions.

Indeed, beyond the impressive absolute performance, the relative performance of US stocks this year is truly remarkable – with the S&P500 outperforming the DAX by more than 12% YTD and the Topix and Hang Seng by 13% and 15% respectively. Combine this equity market performance with tax reforms that have encouraged increased employer contributions to pension plans, and we have quickly reached a healthier pension funding level in the US than for any time since the financial crisis. From our conversations with US clients, fears about the end of the market cycle come from a natural incentive to protect unrealized gains rather than any immediate market concern. For us, this continues to fuel the search for crisis alpha solutions in the alternative investments universe, but more broadly this goes some way to explain the demand for long duration and the flattening of the US yield curve on the back of asset rotation towards fixed income. Far from being a recession predictor, perhaps this time the flattening of the curve is a symptom of the success of US markets, US policy and the improved solvency of US pension schemes.

There are two competing narratives to explain the US outperformance of other regions despite relative tightening of financial conditions. The first says that we are witnessing the market implications of the gradual unwind of globalization. Mainstream economic theory tells us that trade barriers are a losing proposition for all parties involved but in the short to medium term this narrative says that markets are playing out a script of clear winners and losers instead – with the US being the ‘winner.’ US Political decision makers might use this kind of narrative to increase the rhetoric around trade wars. If they are right, this could be just the beginning of a dislocation between the US and the rest of the world, with forecast of an even stronger dollar and US equity markets that continue to rise despite the normalization of monetary policy while the rest of the world struggles with lower growth.

The second narrative says that there are peculiarities about the US equity market that supports higher prices around the end of the economic cycle. Share buybacks are more common in the US than other developed markets and these twinned with the one-off benefit of the Trump tax reform packages may be supporting the US market in the short term. Of course, US corporate data has been unusually strong over the last few quarters, but these effects are not necessarily sustainable through time and would lead us to expect a mean reverting normalization of relative performance in the not too distant future.

The reality is probably a blend of the two. While it is hard to argue that trade barriers should be positive (in absolute terms) for US equities over the longer term, there has been a clear bifurcation in growth between the US and the rest of the developed world for some time now. The rise in US rates and the generally tighter global financial conditions seem to be gradually triggering a repricing across all markets, particularly those that are more dependent on funding conditions and financial engineering while being lesser beneficiaries of growth. This exceptional feature of US equities is not limited to a comparison against other equity markets, as no other asset class seems to be able to keep the pace.

Maybe the divergence between US stocks and the Rest of the World will be resolved by actions outside of the US. China is facing a number of challenges that are not new but have been augmented by the rising trade tensions. Domestic equities and the renminbi have weakened significantly this year while economic growth shows signs of slowing. The change is significant enough that it has made China the first of the larger global economies to turn around its monetary policy from tightening to easing mode. If China’s stimulatory measures are successful, as they have been in the past, it could be a game changer for global markets and particularly for emerging assets.

It is a sobering thought that as China continues to grow in dominance, we may be too focused on the US strength and miss inflections elsewhere in the world. For the ‘next’ cycle, (whatever that means in a decoupled world) we may be underestimating the ability of Chinese policy makers to become the driver of global liquidity expansion. For the next few decades, perhaps the motto for global investors will be - don’t fight the PBoC.

HEDGE FUNDS

The pattern of mixed performance across strategies culminating in overall lackluster hedge fund returns has been quite persistent this year and August was no exception.

Equity Long-Short managers continue to struggle to find any traction on for alpha generation, with mixed returns depending on regional and sector exposures. Following a wobble in June and July, US tech stocks returned to market leadership, and hedge funds with more of a Value bias found it more difficult to make returns through August. One area where this was not as prevalent was Japan, where the recovery to valuation risk factors continued through the first three weeks of August. More broadly, Pan-Asian managers generally had a very difficult month as Chinese stock volatility increased on continued fears around the need for deleveraging and concerns around Turkey leading to contagion in other EM stock markets.

The divergent performance between US and European stocks during the month means that beta was positive for some manager and negative for others, and in particular, two global managers with similar net exposures may have experienced very different performance depending on where their net exposure was concentrated.

Global macro managers were mixed as usual but some patterns were clear, primarily the pressure on emerging markets risk assets which led to the underperformance of those with more constructive positioning in EM and vice versa. Elsewhere, the mid-month reversal in the USD and its temporary bout of weakness generated some P&L volatility for those that maintain a long USD stance. In the managed futures space, long equity positioning was helpful while long USD against other developed market currencies was a detractor.

August was a positive month for Managed Futures managers in aggregate, but there was quite a range of results. By asset class, each of Equity, Commodity and FX trading was positive, while Fixed Income exposure generally detracted. Within commodities, almost all of the main positions that managers held were positive (quite a rare occurrence in a sector that has lower average correlations between sub-sectors). Short Agriculturals (particularly Soy) and short precious metals were positive drivers for most managers. Energy was slightly more mixed, but those who maintained the long position from previous months had the most positive results. In Equities, managers remain long across most regions, which worked in August. There is some dispersion in exposures though, with most managers now short the UK, while European exposure is also mixed. In FX, the net short exposure to currencies remains at very high levels, with few major currencies where managers are long given the strength of the USD this year. Fixed Income was the only negative sector, with the positive performance from long European bonds offset by losses from short US bonds.

In Credit, despite weakness in EM corporates and sovereigns and stress in EM FX, strong technicals (coupons, calls/maturities, muted issuance), resulted in a fairly stable month for US high yield. Investment grade markets (along with higher-rated HY) in the US were also supported by a rally in Treasuries. The one notable exception was the US HY retail sector which repriced lower on earnings from several retailers that showed ongoing challenges in the space. Corporate Credit manager performance was modest and mixed in the month. Puerto Rico muni bonds were a positive contributor on the announcement of an agreement with another group of creditors. Some managers benefitted from longstanding shorts in the retail sector while others saw some losses from longs in the energy sector.

In Structured Credit, legacy MBS spreads continued to be relatively stable on strong residential credit fundamentals while CMBX spreads widened, especially those with concentration in malls exposed to certain retailers. Spreads were also modestly wider in the credit risk transfer sector. Structured Credit manager performance was largely positive in August driven by carry income given the mixed month for spreads across sectors.

During the month Risk Arbitrage had mixed performance. Overall, it was a quiet month with deals progressing toward completion and the pipeline of new deals remains robust in our view. In vertical integrated deals, healthcare related transactions have garnered attention. Shareholders of an insurance company and a prescription benefit plan provider voted to approve the firm's merger. This merger transaction along with a retail pharmacy company's pending acquisition of a managed care company both have outside parties voicing opposition to these mergers and they are currently pending the Justice Department's approval. A computer company's efforts to buy out its tracking stock in its effort to go public also was a focal point during the month. The proposed package faced criticism in August by activist investors and hesitation from shareholders.

In Stat Arb we saw notable results from technical and Machine Learning strategies in equities while challenges continue with weaker results in fundamental strategies, especially in Emerging Markets, with China, Korea & Turkey being some of the more difficult markets this month. There is some excitement in the quant community around expansion of China A shares given progressive MSCI Index inclusion. We've seen new China A market neutral funds pop-up in the last couple of months and expect to see more.

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