The Early View
Are Markets too Complacent on Inflation?

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All market data sourced to Bloomberg unless otherwise indicated. All manager data sourced to Man FRM's internal database.

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It's always easy to find things that can go wrong for risk assets, but it's seldom easy to find this many. The Chinese economy looks ever more precarious; political tensions in the Middle East are rising and the election cycle in many democratic countries is set to bring uncertainty. Equity markets feel crowded, particularly in AI-hype stocks, which have pushed the S&P 500 up more than 18% over the last three months; corporate default rates are rising with weaker-than-usual recovery rates; and equity markets have surged higher still since the start of the year despite bond markets pricing a more sober route through rate cuts than initially hoped for in the giddy days of December.

From this pessimistic perspective, it feels increasingly hard to make a fundamental case for equities, but we all know that market timing is both near impossible and not often a fundamental exercise anyway. Global capital must go somewhere, and markets can confound expectations for much longer than the average investor's tolerance threshold. Besides, multiple possible threats weigh much less on markets than one tangible actual threat, of which we currently have none. The geopolitical risks from China, the Middle East, and the election cycle (not to mention Ukraine and Taiwan), could each easily destabilise markets – but liquid investors can afford to stay invested until a clear crisis materialises. Similarly, expensive markets and gradually rising default rates have been experienced before, and it often needed a big market event to release the tension rather than a gradual process of rationalisation.

And if we are prepared to ignore the tail risks (at least until they slap us in the face), then the most important driver of markets now, as usual, is the economy. The US non-farm payrolls number was surprisingly strong at the start of February, suggesting that the US economy and the US consumer are weathering this period of higher rates with little fuss. Yes, this means that the Fed might now need to cut less than first expected, but a strong economy that needs less accommodative policy should be positive for equities.

Therein lies the most interesting dynamic for 2024 in our view. If we wind the clock back to the midst of the inflation crisis in 2022, the dominant narrative was that central banks needed to raise rates enough to fully choke off demand, effectively creating a recession to solve the inflation problem. We now have markets that believe they have solved the inflation problem without causing a recession - a fabulously executed tightrope act.

Not so fast. While most eyes have been on the recession part of this equation (or lack thereof), few have been focused on whether inflation has conclusively been tamed. With strong economic growth, a healthy jobs market, rising values of important leading indicators such as costs of shelter and freight pricing, and growing risks of geopolitical supply-side shocks, inflation could again be the biggest risk to markets in 2024. It is feasible, in our view, that we could see inflation continuing to surprise on the upside for the next few months, and that market sentiment gradually shifts towards a narrative of a more persistent and pernicious inflation problem. This is a path that requires no great shock or catalyst to materialise and feels significantly under-priced by markets. After all, who is predicting that the next move from the Fed is a rate rise?

Key Drivers of Hedge Funds' Performance: An Early January Snapshot:

Equity Long-Short:

- Fundamental Equity Long-Short funds started off the year with modest, positive returns.
- While US equities got off to a good start to the year, global equities experienced more modest returns. Beta was a sizeable component of US-focused fund performance, and the US outpaced the other regional peer groups.
- Positively, short alpha rebounded following a weak period in November-December.
- One of the more notable trends in equity exposure in January was the net buying of Chinese equities on news that Chinese authorities were shoring up efforts to stabilize the equity market. This marked a reversal as this area of the market saw continued outflows in the second half of 2023.

Credit:

- In Credit, Investment Grade was modestly negative, driven by higher 5-10-year Treasury yields, while High Yield was modestly positive, and leveraged loans outperformed High Yield.
- Generally, it was a good month for Corporate Credit managers driven by idiosyncratic drivers and lack of meaningful detractors; and unlike the last two months, portfolio hedges were not a meaningful drag on returns.
- It was another strong month for financial preferreds driven in part by some primary issuance at tighter spreads vs. secondary trading levels. There was modest richening in Convertible Bonds overall as well as some event driven (M&A related) contributors.
- High Yield long/short and cap arb strategies also performed well driven by issuers that had lagged the move in broad markets over the previous two months.
- Structured Credit managers also posted positive returns helped by carry as well as modest spread tightening driving MTM gains.

Event Driven:

- January was mixed for Event Driven strategies. A clear positive has been several new deal announcements, dominated by the US and led by the technology and energy sector, the largest of which, the acquisition of Ansys by Synopsis, is expected to be a $33bn transaction.
- While smaller in size, there have also been several new transactions announced in Europe, e.g. FDJ's $3bn bid for Kindred in the gaming sector. Managers are growing their exposures as a result of these new M&A deals.
- Some setbacks include Japan Aviation Electronics, after its parent company, NEC, announced plans to sell a large part of its controlling stake. And several Event funds were caught out by Novartis stepping away from late-stage negotiations to acquire Cytokinetic.
- January also saw two deal breaks, however both terminations were largely expected by Event Driven managers and were sometimes held as short positions: the US Department of Justice (DoJ) successfully blocked JetBlue's takeover of Spirit Airlines, and Amazon dropped its takeover plans for iRobot after an EC regulatory challenge.
- In Japan and Korea, corporate governance themes continue to drive expected Event Driven positioning, e.g. the market is anticipating various actions to be announced by the Korean government, targeting low price-to-book stocks, among others.

Discretionary Macro:

- Discretionary Macro managers are flat-to-down in January. Yen trades (from the long side) have struggled, as have the growing long positions in fixed income as markets have pushed back on the timing of rate cuts across the developed economies.
- There is an interesting divergence again in January between discretionary and quant (diversified) macro – both broadly seeing a reversal of last month's fortunes.

Systematic Macro:

- In Trend Following, January looks set to have been a positive month. By asset class, equities was generally a positive driver as long positioning continued to help managers; commodities was mixed but generally more positive drivers than negative; and fixed income and FX were negative contributors given the shape of trend reversals in these sectors.
- Across other Systematic Macro managers numbers are generally mixed but tend to be a little better than their Trend-focused peers.

Quant Equity Market Neutral:

- We don't usually include a section on Quant Equity market neutral strategies, but January was an extraordinary month for many managers in this space.
- Returns from factor exposures to Value, Quality, Momentum and Low Beta were all positive during the month; a near perfect environment for these strategies, and many managers posted returns for January that would be a good result in alpha terms for a whole year.
- This coincidence of positive drivers was a welcome return to form following a relatively difficult period in November and December.

On-the-radar:

- The earnings season is in full swing in equity markets, and likely to be the biggest short-term driver of market sentiment outside of a material deterioration in any of the geopolitical risks.
- However, over the medium term we are strongly focused on the possible re-emergence of inflation concerns, particularly if this interferes with the narrative of steady rate cuts for the rest of 2024.
- Longer term, the US election cycle will start to generate a lot of noise through the second half of this year. How much of this noise matters for markets is yet to be seen.

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