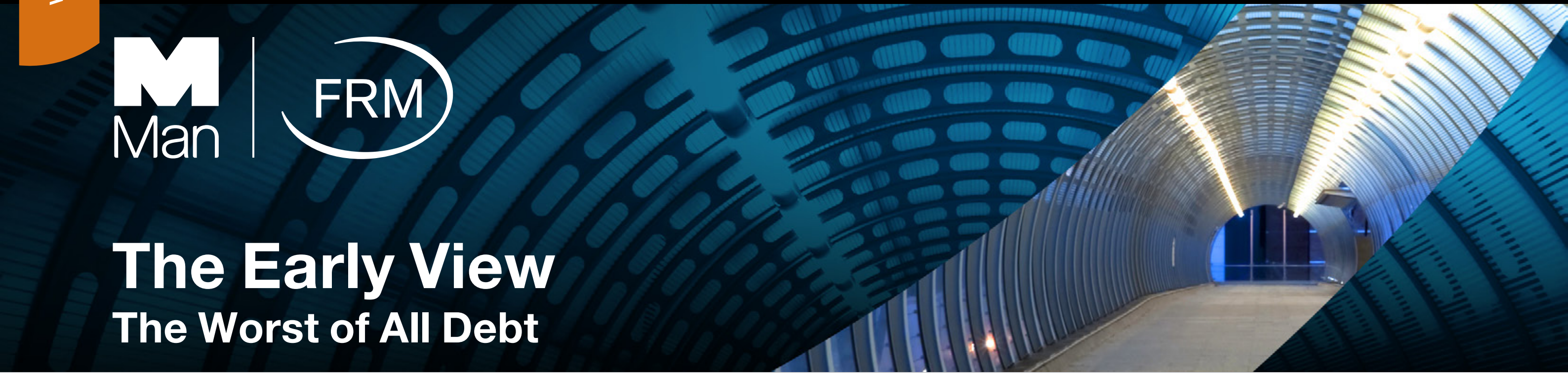

Man FRM

The Early View

The Worst of All Debt

June 2023

Time to read: 7 minutes

Markets in May: A Focus on the US Debt Ceiling

'Junk bond king' Michael Milken recently summarised the lessons he learned in investing in credit markets during the last five decades. One of those was that sovereign bonds are the "worst of all debt". That summarises our emotions during the second half of May well, when we watched how the political class in the US dealt with the debt ceiling. A sovereign default of the US became a real possibility. US Treasuries are considered the safest debt, issued by the most powerful nation with a mighty economic engine and near unlimited ability to 'print' its currency to repay creditors.

Anything can happen when the political system of a nation is borderline dysfunctional. We believe that it has been wrong to discount this saga as show for commercial news channels and to rally up the fringes of the political spectrum. Frustratingly, we saw a fair amount of complacency amongst investment managers taking the view that it's a fabricated crisis which can, and will, be 'solved' once the market pressure is high enough. But where is that pressure point and what can break in the meantime? The willingness to 'blow up the system' is high amongst many representatives that the people have asked to govern us. To ignore (extremely?) low-probability, high-impact events isn't a risk-management strategy.

With a tentative deal agreed, the worst has for now been prevented for the safest of the "worst of all debt". Some damage has been done though (as the rating outlook changes of two agencies have shown). And the long-term issue of an unsustainable stack of debt remains unsolved. But that's a story for another day (when the market forces the issue as neither of the two parties is willing and able to tackle it when in power).

Another headache for hedge funds in May was that regulators once again put their hand on a corporate transaction. The same country that was musing whether or not to pay its debt felt it needed to interfere in the merger between two private corporations, Horizon Pharma and Amgen. The Federal Trade Commission ('FTC') has an important role in securing the functioning of capitalism and the heavy hand by anti-trust bureaucrats isn't a phenomenon we only observe in the US (the UK CMA's Activision Blizzard/ Microsoft intervention last month comes to mind). Merger arbitrageurs were caught off-guard by this, and the market noise was that the FTC doesn't have a strong case. We shall see. Today, we only state that the case for the M&A strategy hasn't been strong – May's return will pull them into the negative (again).

Judging by equity market volatility, equity markets ignored most of this, with the VIX staying in somewhat narrow range. But that's like claiming there are no currents just because the surface of the ocean is calm. The market didn't like Value and low Beta stocks; but it liked speculative companies with the AI frenzy doing its part.

Who's to 'blame' for the low equity volatility? When no other narrative is available, 'the quants', of course! As if this class of systematic investors is a monolithic, homogenous group that **trades in concert**!

Another lesson that Mr. Milken shared was that ratings aren't research. Whether it's sovereign bonds, money market exposures or merger agreements – in-depth research is often not glamorous; but it can make a difference. We are betting on it.

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

Equity Long-Short:

- Performance for equity long-short managers was muted in May as the market awaits the outcome of the US debt ceiling negotiations;
- Sector TMT funds – especially those with exposure to the AI 'theme' – outperformed in May alongside a somewhat narrow rally in the Nasdaq composite;
- Asia-based long-short managers tended to underperform but results were mixed: China-focused funds struggled while Japan-focused funds advanced in May, with Beta a driving factor of returns.

Credit:

- Corporate credit managers generally enjoyed another month of modest positive returns against a backdrop of mostly negative total and muted excess returns for credit markets;
- Managers saw small gains across cap structure arb, convertible bonds arb and credit long-short strategies, with few meaningful single-name P&L drivers, similar to last month; rates hedges contributed positively while other portfolio hedges were modest detractors;.
- Managers with exposure to US financial preferreds had a challenging month after the failure of another regional bank and speculation about others;
- Structured credit managers were up small driven by carry and modest spread tightening.

Event-Driven:

- A very challenging month for event-driven, particularly in merger arbitrage where losses were led by the First Horizon/Toronto Dominion deal break early in the month and the FTC decision to sue to block the Horizon Pharma/Amgen merger, as well as several other smaller deal set-backs;
- Merger spreads widened across the board, potentially overshooting in some cases, which saw some managers entering or adding to positions opportunistically. Deal activity was decent, with several new transactions announced in the $5-15 billion range;
- Special situations generally detracted as equity markets struggled and mid-cap index multiples traded down;
- Asian-focused strategies also struggled in volatile markets amidst selling pressure. China offshore positions saw risk reductions post-earnings, and relative value spreads widened. Japan has been a positive offset, benefiting from multiple tailwinds.

Macro:

- It was another month of muted returns in discretionary macro. While managers are generally not trading around their views on the debt ceiling negotiations, the uncertainty it brings has encouraged them to maintain lower risk levels and continue with a more cautious trading approach. However, we saw positive returns from emerging-market themes, including Turkey and Tunisia, while long euro positions caused losses.

Quantitative:

- Trend-following strategies were positive in May. Short fixed-income positions worked well in developed markets as investors priced in a sustained period of higher policy rates, while Japanese yen shorts also added. Alternative trend strategies were also up, helped by a continuation of trends in credit and alternative energies;
- Quant macro performance was more mixed. Fixed income trading has generally produced gains from net short positioning. However, currencies have proved difficult, with macro models struggling due to reversals in the euro and Australian dollar. Energy trading continues to frustrate with crude oil longs detracting;
- In quant equity, some managers complained about de-leveraging in the first weeks of May. Value was a detractor, with only modest support from Momentum. Quant credit strategies gave back some of their year-to-date gains.

On the Radar:

- Now that a debt deal has been passed, we are watching the impact of the Treasury replenishing its accounts. There are concerns that the flood of issuance may lead to rates volatility; however, the issue has been widely discussed and our view is that its impact may be more muted than some feared.
- The loan market experienced a number of defaults in recent weeks. None of them came as a surprise, judging by how issuers' debt was priced. We are keeping an eye on signs of more distressed in corporate credit.
- If 'AI' is unleashing a lot of imagination (of which little will play out as the hype suggests today, of course), **commercial real estate** ('CRE') is feeding the doomsday scenarios. Many players are talking about the **risks for offices and downtown retail**; and some are betting against it. What is going to be critical in defining how the downturn is going to play out depends on the time frame. Ideally, it will be spread out and a few more regional banks – who hold concentrated exposures in CRE – may have the chance to earn enough to offset write-downs.

Author

Jens Foehrenbach, CFA
CIO, Man FRM

Jens Foehrenbach is the Chief Investment Officer at Man FRM and chairs Man FRM's Investment Committee. He is responsible for the investment policy and oversight of Man FRM portfolios.
He also serves on Man Group's Executive and Responsible Investment Committees. Previously, Jens managed a range of Man FRM portfolios and has served in several capacities for Man FRM and the Man Group multi-manager businesses, including Head of Equity and Credit strategies. Prior to joining Man Group in 2008, Jens spent four years at Harcourt Investment Consulting AG, where he was style head of relative value equity strategies. Before that, he was employed by UBS AG, where he worked on the bank's fixed income derivatives trading desk in Switzerland and London. Jens holds a Master's degree in Business Economics from the University of Basel, Switzerland (lic. rer. pol.). He is also a CFA charterholder.

Important Information

This information is communicated and/or distributed by the relevant Man entity identified below (collectively the 'Company') subject to the following conditions and restriction in their respective jurisdictions.

Opinions expressed are those of the author and may not be shared by all personnel of Man Group plc ('Man'). These opinions are subject to change without notice, are for information purposes only and do not constitute an offer or invitation to make an investment in any financial instrument or in any product to which the Company and/or its affiliates provides investment advisory or any other financial services. Any organisations, financial instrument or products described in this material are mentioned for reference purposes only which should not be considered a recommendation for their purchase or sale. Neither the Company nor the authors shall be liable to any person for any action taken on the basis of the information provided. Some statements contained in this material concerning goals, strategies, outlook or other non-historical matters may be forward-looking statements and are based on current indicators and expectations. These forward-looking statements speak only as of the date on which they are made, and the Company undertakes no obligation to update or revise any forward-looking statements. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those contained in the statements. The Company and/or its affiliates may or may not have a position in any financial instrument mentioned and may or may not be actively trading in any such securities. Past performance is not indicative of future results.

Unless stated otherwise this information is communicated by the relevant entity listed below.

Australia: To the extent this material is distributed in Australia it is communicated by Man Investments Australia Limited ABN 47 002 747 480 AFSL 240581, which is regulated by the Australian Securities & Investments Commission (ASIC). This information has been prepared without taking into account anyone's objectives, financial situation or needs.

Austria/Germany/Liechtenstein: To the extent this material is distributed in Austria, Germany and/or Liechtenstein it is communicated by Man (Europe) AG, which is authorised and regulated by the Liechtenstein Financial Market Authority (FMA). Man (Europe) AG is registered in the Principality of Liechtenstein no. FL-0002.420.371-2. Man (Europe) AG is an associated participant in the investor compensation scheme, which is operated by the Deposit Guarantee and Investor Compensation Foundation PCC (FL-0002.039.614-1) and corresponds with EU law. Further information is available on the Foundation's website under www.eas-liechtenstein.li. This material is of a promotional nature.

European Economic Area: Unless indicated otherwise this material is communicated in the European Economic Area by Man Asset Management (Ireland) Limited ('MAMIL') which is registered in Ireland under company number 250493 and has its registered office at 70 Sir John Rogerson's Quay, Grand Canal Dock, Dublin 2, Ireland. MAMIL is authorised and regulated by the Central Bank of Ireland under number C22513.

Hong Kong SAR: To the extent this material is distributed in Hong Kong SAR, this material is communicated by Man Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission in Hong Kong. This material can only be communicated to intermediaries, and professional clients who are within one of the professional investors exemptions contained in the Securities and Futures Ordinance and must not be relied upon by any other person(s).

Japan: To the extent this material is distributed in Japan it is communicated by Man Group Japan Limited, Financial Instruments Business Operator, Director of Kanto Local Finance Bureau (Financial instruments firms) No. 624 for the purpose of providing information on investment strategies, investment services, etc. provided by Man Group, and is not a disclosure document based on laws and regulations. This material can only be communicated only to professional investors (i.e. specific investors or institutional investors as defined under Financial Instruments Exchange Law) who may have sufficient knowledge and experience of related risks.

Switzerland: To the extent the material is distributed in Switzerland the communicating entity is: To the extent the material is made available in Switzerland the communicating entity is:

- For Clients (as such term is defined in the Swiss Financial Services Act): Man Investments (CH) AG, Huobstrasse 3, 8808 Pfäffikon SZ, Switzerland. Man Investment (CH) AG is regulated by the Swiss Financial Market Supervisory Authority ('FINMA'); and
- For Financial Service Providers (as defined in Art. 3 d. of FINSA, which are not Clients): Man Investments AG, Huobstrasse 3, 8808 Pfäffikon SZ, Switzerland, which is regulated by FINMA.

United Kingdom: Unless indicated otherwise this material is communicated in the United Kingdom by Man Solutions Limited ('MSL') which is a private limited company registered in England and Wales under number 3385362. MSL is authorised and regulated by the UK Financial Conduct Authority (the 'FCA') under number 185637 and has its registered office at Riverbank House, 2 Swan Lane, London, EC4R 3AD, United Kingdom.

United States: To the extent this material is distributed in the United States, it is communicated and distributed by Man Investments, Inc. 'Man Investments'). Man Investments is registered as a broker-dealer with the SEC and is a member of the Financial Industry Regulatory Authority ('FINRA'). Man Investments is also a member of the Securities Investor Protection Corporation ('SIPC'). Man Investments is a wholly owned subsidiary of Man Group plc. The registration and memberships described above in no way imply a certain level of skill or expertise or that the SEC, FINRA or the SIPC have endorsed Man Investments. Man Investments, 1345 Avenue of the Americas, 21st floor, New York, NY 10105.

MKT008162/NS/GL/W