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The Early View

Bond Valuations Looking Attractive - August 2023

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In mid-August the US 10-year government bond yield touched 4.3%, the highest level since 2007. Despite US Federal Reserve (Fed) chairman Jerome Powell's exhortation at the annual central banker gathering at Jackson Hole that rates would likely stay higher for longer, it seems clear to us that we are approaching a point where the risk/reward trade-off from holding bonds becomes skewed to the upside.

Government bonds look cheap relative to their history, both in absolute and relative terms. Historically, US government bonds trade at a significant discount to a 'fair value' rate (calculated as a sum of real growth plus inflation expectations plus a term premium). This discount is often explained by the fact that US bonds have the privilege of being denominated in the world's reserve currency, but this discount has disappeared over the last 12 months, with US government bonds now offering a real yield comparable to long-term US trend growth.

At the same time, the relative value of US government bond yield versus equity dividend yields is materially stretched, beyond any local minima seen since before 2008. Furthermore, any 'black swan'-type economic event could (and should) see a significant flight-to-quality and cause a large rally in bonds.

The bear case for government bonds is easy to identify but limited in severity. If the Fed maintains a higher rate for longer – and one can easily build a narrative where the market expectations of an initial rate cut are far too premature – then there is a case for a continued small increase in longer-term yields as the market starts to price a structural change in the term premium. But without an inflationary disaster it is very hard to see long-term US rates rising much above 5%, and any materially negative path would be at least as painful for equities as it would be for bonds. So, we have market pricing suggesting an objectively cheap asset, which is caught between a probable path of getting slightly cheaper in the short term and an improbable path of rallying strongly, hence the skewed risk-reward pay-off.

This matters for the hedge fund industry for two reasons: first, the Systematic Macro universe currently holds significant short exposure to government bonds, following the downward trend that has developed over the last three years. Second, hedge funds are typically seen as diversifiers to equities and other risk assets; there is a stronger argument that government bonds can once again fill that role from today's starting point, especially if inflation does come under control.

Managing the situation is tricky. Government bond volatility is elevated, and so hedging any short bond exposure through out-of-the-money calls feels expensive. And owning bonds outright through a static long exposure isn't typically what hedge fund investors are looking for from their managers. It's better to be nimble; after all, the Systematic short bond exposure will quickly reverse if market direction changes, and so it is more about managing inflection points in bonds than long-term positioning. If the main fear from short bond positioning is a flight-to-quality crisis, then one can arguably hedge the inflection point more effectively through equity options, given the current relative cheapness of the VIX curve.

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

Equity Long-Short:

- Equity Long-Short funds were able to limit losses compared with global equity indices in August, but still generally incurred losses that were beta-driven.
- Equity market-neutral funds were able to mitigate more of the losses amid stronger performance from crowded short positions. Conversely, funds with a growth orientation and/or heavy positioning in technology, media and telecommunications (TMT) industries were challenged alongside a heavier sell-off of the Nasdaq Index. China exposure remains a pain point too, and Asia-focused funds generally underperformed.
- Trading activity suggested funds were back on the offensive after de-risking in the prior two months, as both short selling and long buying picked up, though not to any significant degree.

Credit Long-Short:

- There were modest but largely positive returns for Credit Long-Short managers, with few positive outliers.
- Equity markets were lower but realised volatility remained subdued, resulting in the underperformance of traditional volatility-sensitive convertible arbitrage positions; certain idiosyncratic credit-sensitive convertible bonds continued to perform well, driven by positive issuer-specific news and events, including M&A and exchanges.
- Capital structure arbitrage and high yield long/short positions were positive contributors, as they had been in the previous few months.
- Portfolio hedges were modest positive contributors, as were certain equity Relative Value (RV) (split-off, share class arbitrage) positions for some managers.
- It was another month of modest positive returns for Structured Credit managers driven by carry, with mixed spread performance across sectors.

Relative Value:

- Across Event strategies, Merger Arbitrage performed strongly thanks to positive regulatory developments in several large transactions that had been trading with elevated perceived regulatory risk.
- The Federal Trade Commission paused their legal challenge of the $28 billion Horizon Therapeutics/Amgen Inc. deal, opening a path to a potential settlement with the parties. The spread tightened, but remains interesting at 3% and managers have continued to add to this position. The Seagen/Pfizer deal spread also tightened in sympathy as the acquisition is still expected to close later this year or early next year.
- Other deals with positive developments include Nuvasive/Globus Medical, VMware/Broadcom, Black Knight/ICE and ForgeRock/Thoma Bravo. The latter has been seen as an important bellwether for whether regulators might challenge private equity portfolios' accumulation of competing firms.
- Activision/Microsoft filed a revised approval in the UK, which now excludes cloud assets from the combination. This is believed to significantly boost the likelihood of receiving approval.
- A settlement reached between AMC Entertainment and investors on the conversion of preferred equity units into common stock has concluded a long-running share class arbitrage trade.
- Approximately 30 new deals were announced during the month across the US and Europe, a decent level considering the summer period. But these were mostly fairly small in size. Capri Holdings/Tapestry, a merger in the fashion industry, was the most notable at $8.5 billion. United Steel is reportedly running a strategic review after receiving several unsolicited approaches.

- Special Situations in Europe suffered from general market retreats, as well as mixed earnings. In Asia, choppy markets were challenging to navigate, especially volatile Greater China sentiment, but idiosyncratic catalyst trades remained available, e.g. in Korea.
- Event managers have generally increased exposures in August, also benefiting from platform de-risking at the end of July.

Systematic Macro:

- Traditional trend-followers are modestly down, having also struggled with longs across equity markets, though we have seen offsetting gains through fixed income and currency trading.
- Alternative trend-followers look to have had a slightly tougher time, with credit longs and a long bias in EM FX adding to losses.
- Systematic Macro strategies are positive, with strong performance coming from USD positions, while a mixed, somewhat defensive, stance in equities offered some protection from the sell-off.

Discretionary Macro:

- Discretionary Macro managers are broadly positive, with gains primarily coming from hawkish themes in fixed income.
- However, carry trades in currencies have been challenged by the risk-off tone in markets, as have bullish positions in equities.

On-the-radar:

- If one believes that rate rises are all but done in the US, then we are approaching something of a limbo period for fundamental economic data. How do the lag effects on things like housing costs and corporate debt restructuring feed through into growth and inflation? And if inflation approaches the Fed's target, does this give the central bank any reason to cut rates rather than hold steady?
- Risk emerging from the short-term political landscape is arguably underpriced by the market. Elections in Taiwan in January of next year could reignite concerns of possible conflict with China and developments in the Russia/Ukraine situation remain chaotic. And before long we will be well into the primary season for the 2024 US presidential election.

Unless otherwise stated, all market data is sourced from Bloomberg.

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