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The Early View

Markets in June: Low volatility, high uncertainty

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How should we interpret the VIX index dipping below 13 on the last day of June? Some might say that a high level of the VIX implies that equity pricing is more uncertain, whereas low values imply that pricing is more certain. But this is a dangerous oversimplification. Right now, the VIX marks a low value seemingly due to an *absence* of sufficiently material concerns; recent market pricing has been absent of any large moves, and the near-term calendar is similarly lacking in any major policy events.

Since the debt ceiling resolution at the start of the month, the S&P 500 Index has melted higher, extending its performance for the first half of 2023 to nearly 17% total return, and facing little in the way of resistance despite an increasingly stretched price-to-earnings ratio.[1] The last episode of ratio expansion in 2010-2018 was perhaps justified by the record low interest rate regime (a valuation of 25 times earnings may be the right answer when cash earns nothing), but those excuses ring a little hollow in the current higher rate landscape.

We believe much of the market gain has been built around tech stocks and the potential of AI to improve productivity and revolutionise business practices. Such epoch-defining shifts in the corporate landscape can never be priced accurately, and arguing over the right price for companies exposed to such a nebulous concept is often futile. But in the absence of more immediate market concerns, it is understandable that investors would allow their imaginations to project further into the future to find ways to justify buying equities on speculation.

Of course, multiple market risks do remain, not least those associated with living through a prolonged period of higher rates and its hard-to-model effects on corporate profitability and household spending. Inflation is coming down in most regions, but as seen with the stubbornly high CPI data from the UK in June (which prompted a larger rate rise from the Bank of England just two days later), the path back to a more benign inflation outlook is far from assured. But these downside risks are harder to accurately articulate – we must wait and see what kind of 'landing' the global economy faces in the second half of the year – whereas the bull case for AI is at least tractable, regardless of how persuaded individual investors may or may not be by the hypothesis.

The weird behaviour has spread across all asset classes, with weakness in the US dollar and strength in commodities. As a result, June saw some painful losses for some Macro hedge funds, particularly quantitative strategies. Outside of trend-following (which performed well in June), computer models that take macro views on fundamental data generally had a tough time. If previous experience is a guide, the data is telling us markets should be risk-off but, in reality, the markets are happily risk-on. Such incongruity is a worry, not least for those hedge funds struggling to navigate these markets thanks to the low predictive power of traditional models. In short, this low-volatility episode is one of high unpredictability.

1. Source for market data unless otherwise stated is Bloomberg.

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

Equity Long-Short:

- Performance for fundamental Equity Long-Short was positive – for both market-neutral and directional strategies, as well as across regions;
- Positive returns have predominately been driven by beta as net leverage within Equity Long-Short remains heightened (on a 1-year lookback). Alpha figures for June appear to be mixed thus far;
- After weeks of strong net equity buying, flows reversed and the third week of June was the largest week of net equity selling since September of last year, especially in the US. Ultimately, the activity was driven by short additions of index products and much of the activity came from funds outside the Equity Long-Short sector.

Credit Long-Short:

- June was another month of mostly positive returns for corporate credit managers;
- Idiosyncratic capital structure arbitrage positions (long credit vs short equity) and credit-sensitive convertibles performed positively, benefiting from issuer-driven activity including buybacks and equity raises; equity/convertibles primary and secondary markets remained active, helping drive catalysts for some positions;
- US financial preferreds overall posted negative total and close to flat excess returns, with a rebound in regional bank preferreds after losses last month;
- Structured Credit managers built on year-to-date gains; credit spreads were steady across most sectors, with returns largely driven by carry.

Relative Value:

- June showed some recovery for Event Driven, especially in Merger Arbitrage, in both the most affected trades in May (e.g. spread tightening in Horizon Pharma and Seagen), but also some pre-event positions became binding (Network International and Dechra Pharmaceuticals);
- In the Activision deal, as the termination date approaches, the market is expecting Microsoft to continue strongly pursuing the deal, potentially leading to an improvement in deal terms and/or termination fee. Microsoft and Activision are currently in active US court proceedings in order to prevent the Federal Trade Commission from receiving an injunction;
- Deal financing continues to be supportive, e.g. demand for Univar LBO debt (Apollo being the bidder) was reportedly oversubscribed, leading to tighter pricing;
- In contrast to mixed updates around China outlook, several take-private offers in Asia were announced, e.g. Chindata by Bain in China, and JSR by Japan Investment Corp for $6bn. Expected corporate actions later this year include a potential IPO of the Alibaba subsidiary, Freshippo, as well as JD.com's plans to spin off its groceries business.

Systematic Macro:

- Traditional trend-followers delivered another positive month. Risk-on positioning in equities and bonds earlier in the month produced strong results, outweighing significant losses in commodities that rallied strongly against Trend's short positions. While a more risk-averse market backdrop has proved challenging in the second half of the month, returns broadly remain in positive territory. Alternative Trend strategies followed a similar pattern, though credit trading was an added boost as spreads tightened;
- Quant macro strategies endured a difficult month, on average, driven by both directional and relative-value commodity trading. Carry signals continue to profit broadly in currencies, though some managers struggled with long US dollar exposure. Equities have been more mixed, though predominantly short positions in short-term interest rates and bonds has provided some offset.

Discretionary Macro:

- It looks like a small positive month for discretionary macro managers;
- Fixed income themes benefited from investors pushing back the expected timing and magnitude of rate cuts, while carry trades in FX added performance on the same narrative;
- Late-cycle themes produced mixed results, as US Treasury curve steepeners struggled while equity expressions broadly profited. We continue to see relatively low levels of risk across the space while central bank policy decisions remain highly sensitive to recent economic data releases.

On the Radar:

- Investor positioning is of particular interest as we progress through the next few months. Investment bank surveys of investors suggested that many came into 2023 at peak equity bearishness, and therefore much of the rally to date may be explained by a change of sentiment from these low levels. Just how much slack there is in sentiment remains a key variable of how much further the equity market can extend to the upside.
- Staying with the equity market, over the longer term the important question is whether extended valuations can be justified in 2024 earnings. Signs that stocks can justify a higher multiple by delivering on upside earnings surprises may be necessary to prolong the current cycle.
- From a hedge fund perspective, returns this year have been subdued, particularly relative to returns in other assets. We continue to watch whether more fundamentally justified narratives will emerge, from which hedge funds tend to find it easier to generate alpha than the melt higher in equities seen in the year to date.

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