Man FRM Early View

January 2023
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It has been a very odd start to the year. We ended 2022 with something of a consensus across parts of the hedge fund landscape that the economic backdrop would turn out worse than expected in 2022,. But, lo and behold, markets refused to play along. With equities strongly higher, and the MSCI World touching levels not seen since pre-Jackson Hole in August, market strategists have been left scratching their heads. Fundamental data on growth and inflation has been broadly in line with expectations, as have corporate earnings (if not even a little weak), and central banks have hardly changed their tone.

The immediate read on the market move in our view is one of fragility. The rally has been led by the least profitable stocks, particularly in the tech sector, with volumes of index and single stock calls traded giving echoes of the retail crowding effect seen in early 2021. This has somewhat hardened the consensus within the hedge fund community that this is a rally to be sold, at least until some fundamental data supports prices.

For quantitative equity managers, this kind of market is a frustration. There are a range of factor-driven investment strategies which perform poorly in periods of narrow market leadership. However, January saw markedly negative returns to both cross-sectional momentum (the stocks that are leading the market are those that sold off the most in 2022) and to low volatility/low beta strategies (the stocks leading the market are generally high vol, high beta names). This latter point is a headache for ‘smart beta’ indices which seek more of a risk parity approach to building equity indices as opposed to market capitalisation. One must go back to the market snap-back in November 2020 around the first Covid vaccine announcement to find a month where high volatility stocks outperformed low volatility stocks by this much.

These unusual markets can also become banana-skins for discretionary stock pickers, but many of them managed to avoid losses in January. The choppy market environment through the fourth quarter of 2022 helped to keep risk levels low, and exposure to the momentum factor (so often the Achilles’ heel of discretionary strategies) has been performing poorly for a while now, and so was less likely to have crept into traders’ portfolios.

The rally in equity markets has led to similar moves elsewhere in markets. Credit spreads have tightened and volatility measures (both the VIX and the MOVE indices) have retreated significantly. These moves force active investors to take view on the playbook for 2023. If one is still committed to the idea of harder landings, more hawkish central banks and weaker corporate earnings, then January may have provided attractive opportunities for portfolio hedging or reducing risk-asset exposure.

However, there is a counterargument that is gaining traction, not least as the market continues to confound expectations, which puts the roll-over in inflation at the heart of macroeconomic positioning. Month-on-month inflation data suggests that we are well past the peak, as does the decline in price of key commodities and input costs to the real economy. If we continue to see a normalisation of inflation, and if central banks take this as a cue that they have 'done enough', we believe then the investor community may look through one or two quarters of disappointing corporate earnings and continue to support asset prices at higher multiples, focused on the longer-term growth dynamics of 2024 and beyond.

Against this narrative, the recovery in higher beta growth stocks seen in January starts to make a little more sense. However, most sensible market analysts would like to see a little more traction to the recovery and, crucially, positive surprises in the fundamental economic data before being too confident that the recessionary bullet has been dodged. Indeed, it would only take one bad data point for that fragility of the market rally to be exposed, in our view.

Hedge Funds

Hedge funds generally did well in January, in our view, with positive returns from equity and credit specialists helped by the rally in risk assets. Quantitative strategies did less well, particularly quantitative equity market neutral, whereas arbitrage strategies were mixed on lower levels of market activity in new issues and other events.

Like equity markets, equity long-short managers made a strong start to January with funds capturing approximately 50% of upside globally, with greater capture for US- and Asia-based funds. While a sizeable portion of gains were driven by beta (both market exposure and market sensitivity), alpha generation was also positive, especially across the most crowded names in equities.

For credit managers, the US high yield and investment grade markets outperformed floating rate leveraged loans. Lower-rated US high yield credits, not surprisingly, meaningfully outperformed higher quality bonds in a strong risk-on month. Corporate credit managers generally performed positively in January. Robust demand, limited supply, lower Treasury bond yields and tighter credit spreads led to a positive month for financial preferreds, after a challenging 2022. Similarly, some beaten down, credit-sensitive, technology sector and crypto-related convertible bonds were up meaningfully during the month. Managers also saw gains from certain cap structure arbitrage and HY long-short positions which were partly offset by losses from portfolio level credit and rate hedges. Additionally, stressed and distressed corporate/sovereign credit longs were a source of gains. SPACs were positive contributors as the discount to trust continued to narrow on a portfolio which now has a relatively short average weighted life. Structured credit managers also enjoyed a month of positive returns driven by ongoing strong portfolio carry coupled with firmer spreads, particularly for higher beta sectors.

Event-driven managers had a mixed month, with special situations outperforming strongly in line with the market rally and idiosyncratic catalysts, e.g. news reports suggesting an imminent sales process of Fujitsu General. Equity arbitrage trading in Asian markets had another positive month. Within the M&A space, however, many funds are down, despite slightly tighter spreads. Positive developments included the decision of the Canadian regulator not to appeal the Shaw/Rogers deal, and DCP and Phillips 66 agreed to a merger agreement after lengthy negotiations. But detractors included negative regulator news for the widely held Microsoft-Activision deal, as well as a significant deal break mid-month when Frontline announced they were discontinuing a combination with Euronav – fortunately some managers were well hedged against this possibility. Activity levels were mediocre – while several new deals were announced, in both North America and Europe, none were particularly large. Some smaller transactions in the health-care industry were announced ahead of the JP Morgan Healthcare Conference.

Macro strategies have broadly started the year on a positive note. Discretionary managers enjoyed gains in themes based around China's reopening, both directly in Chinese equities and in proxies such as the Australian dollar, alongside tactical trades that benefitted from declining inflationary pressures in the US and Europe. The rally across bond markets produced mixed performance. Short positions detracted as markets repriced policy rate expectations lower in the developed markets, while other managers were left disappointed with the rather benign Bank of Japan meeting. Systematic macro strategies were positive, as better-than-expected data coming out of Europe was a tailwind for long equity positions in the region. Positive performance was also seen in Canadian bonds following the Bank of Canada's dovish communications during the month, which helped offset losses from short Australian dollar and British pound positioning. It's been more of a difficult month for trend-followers, as the price action seen across fixed income markets frustrated slower signals, particularly in Europe.

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