Man FRM Early View

February 2022
Time to read: 7 minutes

Writing market commentary in reaction to President Putin's invasion of Ukraine is a futile task. Those of us who have pretended to be epidemiologists for the last two years are being asked to turn our hand to geopolitics, while deep down accepting that we know precious little about either. Events, and the market reactions to them, are unfolding so fast that any attempt to make sense of it all is hostage to being seriously out-of-date within a few hours (or at least by the time you get to read this). And on a human level, who really cares what commentators think about markets right now?

The most striking observation is that for all the seismic changes in the political sphere, markets finished February in more muted terms than one might have expected. Outside of the ruble, most financial assets finished the month well within the bounds of the trading range seen during the month. Volatility has increased, but if one only looked at the June '22 VIX future (which ended February at around 27), one would not suspect that we were in the middle of a land war in Europe. The S&P 500 Index finished the month higher than the level seen before the invasion was announced on 24 February, and even Germany's DAX Index finished the month close to the closing price on 23 February.

This feels either complacent, or at least symptomatic of a dangerous binary outcome, for which investors are grappling with finding the balance of imprecise probabilities of tolerable and very bad outcomes to the current situation. Such 'modelling' of the possible paths in situations as fluid as this is inevitably fragile. Unthinkable steps, such as cutting Russian banks out of the SWIFT payments system or Germany committing to a massive increase in defence spending, can become quickly thinkable and then reality in a matter of hours. Therefore, the lack of an additional uncertainty premium priced into equities at the end of February remains a bit of a puzzle from our perspective.

Assuming that there is no short-term resolution to the crisis, we feel the longer-term implications to markets are likely to stem from the commodity sector. Russian exports span most of the commodity complex, particularly energy and agricultural products, and therefore continued sanctions could weigh on global growth and increase supply-side inflation. This stagflationary risk comes on top of the prevailing climate of post-pandemic inflationary pressures. If there is global financial fall-out from the war in Ukraine, it may be the first time in decades that central banks are less able to react with looser monetary policy as the first reply.

How markets digest these pressures is, however, difficult to forecast. The risk-off backdrop has seen a reversal in the appetite of central banks to raise rates quite as quickly as investors expected a few months ago, with Eurodollar futures erasing a couple of rate rises from the expectations seen in the middle of the month. On the other hand, breakeven inflation rates remain elevated, so a prolonged conflict in Ukraine may lead to a choppy year in government bonds pricing, and this could feed through into the credit landscape and other market phenomena, such as equity factor rotations. It feels like a good time to stay nimble and reactive. Most of the hedge fund managers that we work with are cutting risk rather than trying to be opportunistic and take a view right now.

That said, the most lasting market impact of the war in Ukraine may arise from the political clarity that the crisis has engendered. International bodies such as the UN, the EU and NATO are more aligned in their support for sanctions than they have been for decades. The actions of companies such as BP, Total and Shell in freezing their Russian assets even at enormous cost to their balance sheets, show that there is still a moral imperative that trumps even the most pragmatic of corporate objectives. The biggest existential threat to markets (and therefore to investors, employees, and pensioners) would be the collapse or failure of the rules-based international order. If there is a silver-lining to this desperate situation, it is found in the renewed vigour with which much of the world has pulled together to defend it.

Hedge Funds

Hedge fund returns were mixed in February, as strategies reacted to first the build-up of tensions around the Ukraine situation and then, following the invasion, the market volatility in the last three trading days of the month. Long exposure to risk assets, both equity and credit, weighed on hedge fund returns throughout the month, with most losses seen from market declines before the invasion. The impact on hedge fund's ability to generate bottom-up alpha (both from security selection and arbitrage strategies) remains to be seen. Returns to this kind of alpha were noisier in the last few trading days, which is unsurprising given the higher degree of correlation within markets and general 'de-risking' activity seen across the space. Directional macro strategies generally did well throughout the month, with prolonged trends helping, particularly in commodities, but again these strategies began to reduce risk in the last few days of the month due to heightened volatility.

For equity long-short managers, the biggest pain was felt by long-biased managers due to the broad-based decline in equity markets over the course of the month. However, the factor rotations that markets experienced in December and January have been less pronounced in February, and several managers now believe that uncertainty from Ukraine may lead the Federal Reserve to slow their pace of rate hikes. This has led to some respite from the underperformance of crowded technology names. Outside of the geopolitical pressures, the earnings season has been a significant contributor to idiosyncratic stock price moves, with earnings misses punished more than in previous seasons. Through the market noise at the end of the month, many equity managers were actively managing risk, particularly through their net exposure, although relatively few were seeking to take a directional view.

Credit strategies saw weakness through the first three weeks of the month due to the general risk-off appetite, leading to wider credit spreads on top of already higher rates across government bond yield curves. Credit issuance also appears to have slowed in 2022, leading to less primary market activity for hedge funds. Despite the more negative backdrop, credit hedge funds were not disproportionately affected by the market developments. We believe some of the more esoteric areas of the market are seeing weakness, such as financial preferreds, whereas others such as SPACs, convertible bonds and structured credit have held up reasonably well.

Event strategies saw merger spreads start to widen during February, although there does not appear to be any panic selling of arbitrage positions, and therefore returns to hedge fund managers in the space were mixed, but not necessarily poor. Pre-announced situations suffered more, as the general risk-off backdrop impacted the appetite for M&A activity. European volumes were particularly affected by the situation in Ukraine, whereas US deals continued to be announced during the month. Existing situations continued to close during the month, therefore managers benefited from the relative lack of deal breaks. In other arbitrage news, the China A/H spreads widened by about 5% this month as the Hong Kong market underperformed China on regulatory headlines.

Quantitative equity strategies generally held up well throughout the month and through the period of market volatility in the last few days. Some factor driven strategies saw losses on the 24 February as the invasion was announced, due to increased single stock volatility, but these were generally contained and softened through the final two trading days of the month.

Trend following macro strategies did through the first part of the month, with their pro-inflation positioning benefitting from falls in both equity and bonds, and from the rally in commodities. The flight-to-quality that accompanied the situation at the end of the month was more mixed, but those managers with a larger allocation to commodity signals generally performed better, as the continued rally in oil and gas offset losses from short bond positioning. Also, faster trend strategies have turned materially short equities, which further helped to protect their strategies in the more volatile environment. The whipsawing effect seen in most asset classes across 24, 25 and 28 of February led to several managers reducing exposure.

Discretionary macro managers were also largely positioned with a pro-inflation stance, and their performance in February was therefore also driven by the extent that they expressed this view through short bonds or through long commodities. A number of managers have been wary of higher market risks in the post-Covid normalisation period, and therefore portfolio hedges have been a positive contributor to returns, albeit for a different reason than that for which they were initiated.

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 an investment company as defined in section 833 of the Companies Act 2006. MSL is registered in England and Wales under number 3385362 and has its registered office at Riverbank House, 2 Swan Lane, London, EC4R 3AD, United Kingdom. MSL is authorised and regulated by the UK Financial Conduct Authority (the 'FCA') under number 185637.

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, 452 Fifth Avenue, 27th fl., New York, NY 10018.

MKT003344/ST/GL/1-1/31082022