The Early View
Inflation Back in Focus

February 2023

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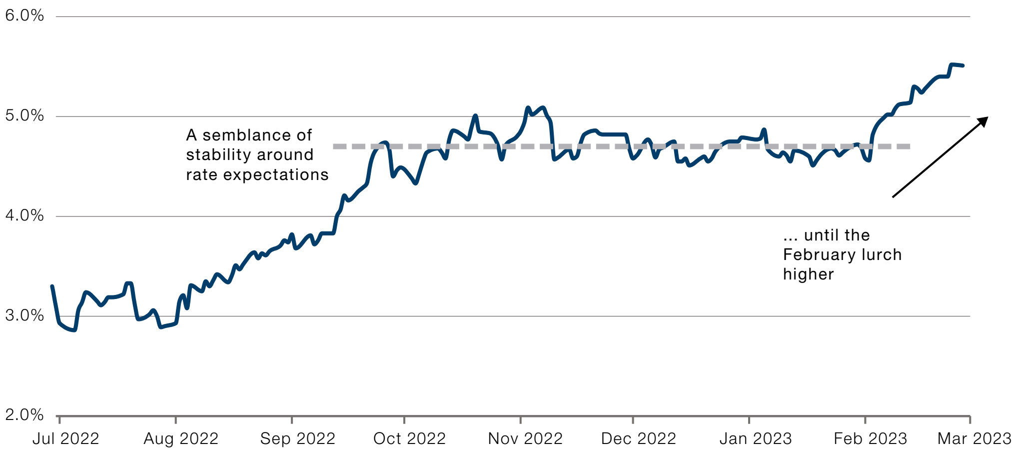
Inflation in February: Less an Opportunity, More Uncertainty

Volatility is a friend to hedge funds: when markets are uncertain, those with a clear eye to determine what really matters and what is just noise can profit accordingly. The growing consensus in hedge fund land at the beginning of 2023 was that investors would look through a short-term earnings dip and focus instead on the downward trend of inflation that started in November.

If only it were that simple.

February caught many off-guard. Indeed, the scenario outlined above proved to be a false dichotomy, with a third route emerging: strong US jobs numbers at the start of the month and the significant upside surprise on the PCE data at the end of the month spooked markets into believing that inflation wasn't tamed after all, and we now had the possibility of weak earnings *and* higher-than-expected inflation. The S&P 500 Index reversed much of the market rally seen in January, government bond yields rose (with the German 2-year above 3% from the first time since 2008) and the Eurodollar curve added 50 basis points to the projection of peak US interest rates (Figure 1).

Figure 1. Implied 3-Month Interest Rate in December 2023 From Eurodollar Contract



Source: Bloomberg; as of 27 February 2023.

And now, rather than being a source of opportunity, hedge funds feel a little caught in the middle of this uncertainty. There's not quite enough fundamental data yet to be scared that inflation is less under control: the PCE prints near the start of the calendar year have become less predictable for the last few years, and lots of input costs to the inflation calculation are still softening quickly. It's probable, therefore, that the Federal Reserve sticks to its plan and inflation does continue to roll over.

However, there is gap risk for the more bullish hedge funds if the Fed rhetoric even slightly veers in a more hawkish direction. Being 'right' on the macro is a hard path to steer, and so hedge funds are typically trying to be nimble, keeping risk low and waiting for the narrative picture to clear.

Key Drivers of Hedge Funds Performance: An Early February Snapshot

Equity Long-Short:

- Negative performance, but generally driven by market beta, with some offset from positive alpha. Worst-performing region appears to have been Asia;
- Overall, positioning remains conservative with long books favouring large caps, defensives, and both quality and profitability characteristics; also, little change in overall leverage levels;
- Despite headlines around an unwind in tech stocks, exposure to the sector remains in the lowest decile and fundamental managers have continued to add to shorts in February.

Credit Long-Short:

- Market backdrop was meaningfully higher yields, some widening in spreads; high yield and investment grade down 2-3%, but leveraged loan exposures held up well;
- Credit managers performed reasonably well given this backdrop and were mostly positive;
- Positive PnL drivers were idiosyncratic credit-sensitive convertible bonds/capital arbitrage (long convertible bonds versus short stock); continued corporate activity (refinancing, managers selling bonds back to companies); SPACs/warrants (driven by yield, some deals closing); floating rate hybrids/preferreds and structured credit (driven by relatively high portfolio yields).

Relative Value:

- Generally flat to small positive month for event arbitrage managers, helped by spread tightening in positions with antitrust risks;
- In early February, negative news from the UK Capital Markets Authority on the $68 billion Activision/Microsoft deal cast significant doubt on the likelihood the deal will close. But as it was already expected to fail the regulatory challenge, and due to the relatively small merger arb market share and tailwinds from strong earnings results, managers were able to exit with little negative impact;
- Special situation managers with exposure to growth stocks were positive for the month. However, Asia-focused strategies experienced some losses.

Systematic Macro:

- Traditional trend-followers enjoyed strong performance trading fixed income markets. Shorts across the US Treasury curve worked best, driven by trend signals with a slower lookback period;
- Alternative trend-followers were also positive in fixed income, adding to paid rates positions in Canada and Asia to good effect, while credit trading was also up. Building into long US dollar positions also helped as the month progressed. In commodities, long carbon emissions and shorts in natural gas and power markets helped offset weakness in metals;

- Systematic macro managers were up. Like traditional trend-followers, shorts in fixed income worked well in the US. Equities added too, with a long Europe/short US setup in equity indices profiting, however commodity markets proved difficult to navigate, particularly in energies and metals where inflation models were bullish.

Discretionary Macro:

- Mixed month, flat-to-slightly-down.
- Positive performance has come from fixed income shorts, as markets priced in further hikes this year from central banks amid upside surprises to US jobs and inflation data. More contrarian strategies outperformed, recovering losses suffered in January as they hold on to their bearish views over the path of disinflation.
- On the flipside, expectations of a more hawkish Fed spurred US dollar strength, to the detriment of short positions versus the Australian dollar and the euro. Long Japanese yen positions also struggled against widening policy rate expectations, and concerns around China's reopening worked against some pro-risk positioning in Asia.

On the Radar:

- The Fed meeting and associated minutes on 21-22 March should give more clarity on whether recent inflation scares have teeth. Discretionary hedge funds are watching for more clarity before taking outright bets on risk assets;
- The Q2 earnings season in April/May is also likely to give much better clarity on the depth of the earnings recession than we learned from the mixed Q1 numbers. Arguably, by the end of May, hedge funds will have a better handle on the balance of macro versus micro opportunities for the rest of 2023…
- … just in time for handwringing around the US debt ceiling. If the old playbook is followed, then the Republican majority in the House of Representatives will use the debt ceiling to score political points and engage in a spot of brinkmanship, leaving a few federal employees unpaid for a few weeks, before a compromise is reached in the nick of time before any real economic damage is wrought. However, there are plenty of less palatable paths that sees inadvertent chaos from an inability to reach political consensus (cf. the difficulty to elect a House speaker earlier in the year). This raises significant questions about potential market reactions and – arguably even more important – the plumbing of financial markets.
- Opportunities for hedge funds in Asia continued to be torn between the China reopening trade and the tail risk of escalation in the China-Taiwan situation. Despite creeping concerns about the latter, managers remain constructive on opportunities in the region for now.

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