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June 2020

Hedge Funds

Liquid Alternatives Monthly



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Looking Back

Markets and Hedge Funds in June

Risk assets continued their climb in June. Manufacturing, service, and retail sector activity saw a further recovery above expectations across most regions. Despite a sharp pickup in prices of growth-sensitive assets, the major central banks reiterated their commitment to maintaining an extremely accommodative policy stance. However, investors showed growing concern for a second COVID-19 wave. Renewed US-China tensions and continued uncertainty about the global economic outlook in the face of the pandemic also contributed to the increased nervousness of market participants.

The equity rally slowed in June, with less investor conviction and more turbulence seen in broad equity indices. With valuations in developed markets becoming elevated, emerging markets saw a meaningful outperformance (MSCI World +2.5%, MSCI EM +7.0%). US equities underperformed (S&P 500 +1.8%) on growing COVID-19 infection rates as well as valuation concerns. Expectations of continued fiscal support in Europe and reduced risks of a sovereign crisis propped up European equities. While Eurozone equities had a strong month (Stoxx 600 Europe +2.8%), UK equities underperformed (FTSE All-Shares +1.4%). In Asia, Chinese equities rebounded after a challenging May (CSI 300 +7.7%, Hang Seng +6.4%) as economic activity bounced back to expansionary levels. In contrast, Japanese

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equities closed lower (Topix -0.3%) over concerns about the slower recovery of trade and manufacturing activity in Japan. Within fixed income, credit outperformed government bonds (Bloomberg Barclays Global Corporate +2.1%, Bloomberg Barclays Global Aggregate +0.9%) as credit risk premiums compressed across the board. Near-zero short-term yields and a further consolidation in longer-term yields resulted in subdued returns in government bonds. Commodities had another strong month (S&P GSCI +5.1%) on the back of cyclical segments such as oil (WTI futures +10.7%) and copper (+11.9%), while gold also continued to rise (+2.9%).

Hedge funds registered another positive month, with some dispersion in returns across different strategies. Long/short equity managers fared best. Inter-stock correlations continued to decline from elevated levels, while regional and sector performance dispersion was wide, leading to an even more conducive environment for alpha generation. Among event-driven strategies, the performance of merger arbitrage strategies was muted but generally positive, as deal spreads were nearly unchanged on aggregate. Quant-driven strategies posted mixed results, as the extreme factor volatility challenged long-term-focused managers. In relative value, multi-strategy funds continued to post strong results, bringing them a step closer to recovering the losses suffered in March. In tactical trading, global macro managers delivered a mixed performance. CTA performance was subdued, as most major markets lacked directionality and looked to consolidate after the strong moves seen earlier in Q2 2020.

(Source: Credit Suisse)

Index	June	YTD
HFRI Fund Weighted Composite Index	1.94%	-3.43%
HFRI Equity Hedge Total Index	2.72%	-3.19%
HFRI Event-Driven Total Index	2.63%	-6.68%
HFRI Macro Total Index	-0.19%	-0.87%
HFRI Relative Value Total Index	1.75%	-4.19%

Index	Factor	June	YTD
S&P 500 TR Index	Equities USA	1.99%	-1.74%
MSCI World TR Index	Equities World	2.69%	-0.62%
CS High Yield II	Distressed	0.92%	-2.77%
VIX	Volatility Index	10.61%	120.83%

Source: Credit Suisse, Bloomberg; Data as of June 2020

Looking Forward

Hedge Fund Style Outlook

HF Style Outlook (3–6 months outlook as of January 2020)	
Fundamental	38.00%
Tactical Trading	30.00%
Relative Value	32.00%

World output has risen significantly since the major developed economies started reopening. A further improvement is likely thanks to the current subdued COVID-19 contagion in Europe and Asia, but a resurgence in the Americas has become a major threat. The pandemic's persistent toll on the economy should lead to an uneven and partial recovery in H2 2020, and global GDP will likely contract by 3.8% for the year.

Supportive economic policies have played a vital role and will generally remain supportive. The ECB has extended its asset purchases, and the Fed has committed a floor of its unlimited quantitative easing. Explicit forward guidance or yield curve control from the Fed are possible.

For global equities, we continue to see an attractive return outlook over a six-month horizon, though the risk of a near-term correction has increased. Regional increases of virus infections, a challenging Q2 earnings season and the US presidential election are sources of volatility. In equities, Switzerland, Germany, Australia, Hong Kong and China are the most preferred regions. In emerging markets, Asia is the most preferred.

Government bonds remain unattractive as benchmark yields are low, and issuance activity has picked up significantly in order to finance large fiscal stimulus. We expect attractive returns in both investment grade and high-yield (HY) bonds over the next 3–6 months. However, we reduce our allocation of HY to neutral. The current implied default premium is not sufficient to compensate for macroeconomic uncertainties and deteriorating fundamentals. We maintain a positive stance on emerging market hard currency bonds as carry remains relatively high.

Our Hedge Fund Barometer suggests that market conditions are stabilizing especially for growth and liquidity-reliant strategies. In our H2 2020 outlook, we highlight dislocation opportunities in structured and corporate credit, new corporate issuance and opportunistic equity as well as distressed strategies. Such strategies can exploit sectoral and regional divergences amid more supportive market volatility levels.

The opportunity set for fundamental strategies has improved. Inter-stock correlations have fallen further, while valuation dispersion is likely to persist between most affected sectors (such as travel) and least affected sectors (such as health care, tech) creating a conducive environment for security selection. Opportunistic long/short equity strategies are most preferred. Additionally, the opportunity set for distressed strategies should rise with rising default rates amid the current COVID-19 slowdown as certain sectors (e.g. travel, consumer discretionary) face a prolonged downturn.

In relative value, the outlook is positive on strategies dealing in structured credit/ agency mortgages as well as long/short credit and corporate arbitrage strategies. Fundamentals in residential housing, as well as several parts of consumer loans market, are still healthy, which creates opportunities for structured credit and agency mortgage strategies. After a rally seen in Q2 2020, dispersion may widen among credits as fundamental divergences emerge between fundamentally stronger vs. weaker quality issuers, creating trading opportunities for long/short credit strategies. Convertible arbitrage strategies benefit from better valuations and an above-average equity volatility environment.

In tactical, the outlook is positive on diversified macro as well as EM-focused strategies. Coordinated fiscal and monetary policy easing measures, as well as larger trading ranges, create opportunities for tactical strategies. Besides, a resurgence in infection rates (e.g. second surge in the USA and Latin America) and variance in stimulus measures across regions and countries (e.g. stimulus more pronounced in Europe than Asia) also create opportunities. Moreover, selected EM countries (e.g. China, India) are fundamentally better prepared to face the crisis than others (e.g. Turkey, Brazil).

(Source: Credit Suisse AI Strategy)

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Hedge Fund Barometer: Improving market conditions for growth-reliant strategies

Our Hedge Fund Barometer indicates close to favorable market conditions for growth- and liquidity-sensitive hedge fund strategies. Market conditions for these strategies are now the most benign since mid-2019 due to improvements in global activity levels and liquidity conditions

Global activity levels continue to recover from a sharp drop in late Q1 2020 and early Q2 2020. Historically, hedge funds have delivered a very strong performance when activity levels are recovering from contractionary levels.

Financial market risk levels remain above long-term average, though with greater divergence across asset classes. Volatility is below long-term average in rates, while staying above average levels in equities, commodities and credit. Historically, hedge funds have delivered excess returns compared to risky assets during periods of higher macro uncertainty.

Global liquidity conditions have seen a further rebound driven by extremely accommodative monetary policies as well as improving market liquidity. Besides, central bank asset purchase programs reduce liquidity tail risks, which are particularly detrimental to relative value strategies.

Systemic risks remain moderate. Dispersion among strategy returns is higher, which reduces risk from a portfolio perspective. While fundamental strategies have done well in the recent rebound, tactical ones showed resilience in the downturn earlier in the year, leading to a more balanced performance on aggregate.

(Source: Credit Suisse AI Strategy)

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