THE WEEKLY BRIEF

By LYXOR CROSS ASSET RESEARCH

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WHAT A DIFFERENCE A MONTH MAKES

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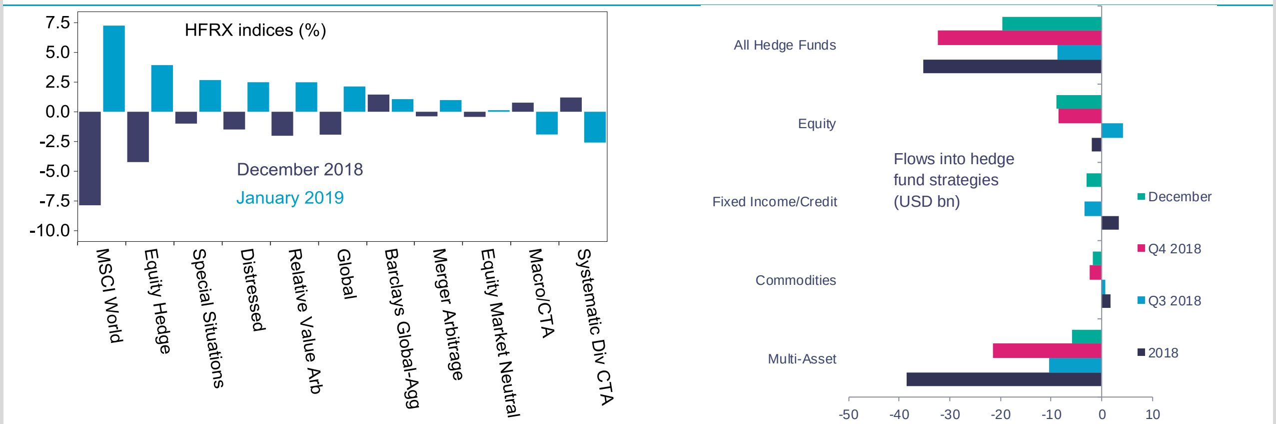
In recent weeks, market conditions switched swiftly from panic mode to exuberance mode. Active investors are scratching their heads as markets no longer seem to be discounting a U.S. recession and any Fed rate hike in 2019. In our view, the January rally is a good reason to gradually reduce risk in portfolios, especially in Europe where the probability of a hard Brexit has increased. Concurrently, the U.S. equity market rebound was led by value stocks, which seems unsustainable. Yet, any aggressive de-risking seems premature as a U.S. recession risk is contained.

In the meantime, hedge fund strategies experienced a symmetric move. The strategies that suffered in December rebounded last month (L/S Equity, Relative Value Arbitrage), while those resilient at the end of 2018 (CTAs) lagged behind. Looking at performance over the past two months, Event-Driven stands out as the outperforming strategy and Macro/ CTAs as the underperforming one, according to broad benchmarks. CTAs suffered from the trend reversal in equities at the turn of the year, down 2.6% in January after a dismal year in 2018. Their long positioning on bonds is now at risk if improved economic expectations eventually translate into higher bond yields, as we expect.

What does this mean in terms of strategic allocation? First, we still prefer strategies that were resilient in recent downturns and didn't suffer during the rebound. This includes Merger Arbitrage and Fixed Income Arbitrage and to a lesser extent L/S Equity Market Neutral and Global Macro. Second, we stay cautious on L/S Equity strategies with an elevated net market exposure and prefer flexible L/S Equity strategies that can adjust their beta according to market conditions. Third, the outlook on Emerging Market ("EM") assets has improved since the Fed has turned less hawkish. EM-focused Global Macro strategies could benefit from it. We thus have a bias in favour of Global Macro vs. CTAs. The latter tends to suffer when markets experience such gyrations, but CTAs should protect portfolios if things go wrong and a persistent downward trend in risk assets eventually takes shape.

Overall, we continue to believe that alternative strategies are attractive relative to traditional assets at this stage of the business cycle. However, caution is required on strategies with a long equity market bias and selectivity is key from both a top-down and bottom-up perspective.

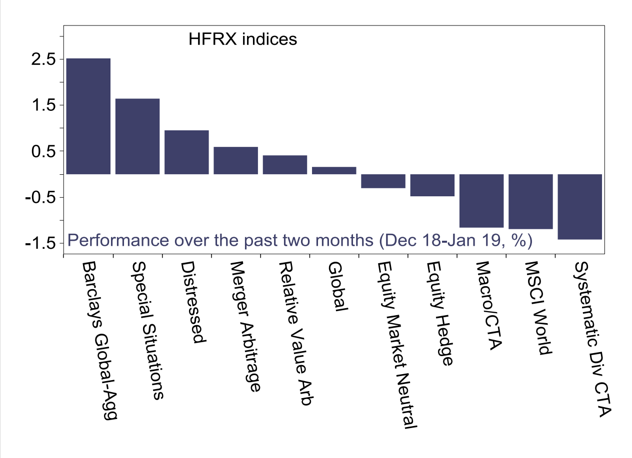
Hedge Fund performance: a mirror effect amid strong outflows



Flows are as of end-2018. Sources: HFR, eVestment, Macrobond, Lyxor AM

PERFORMANCE & POSITIONING

Bonds outperformed massively over the last two months

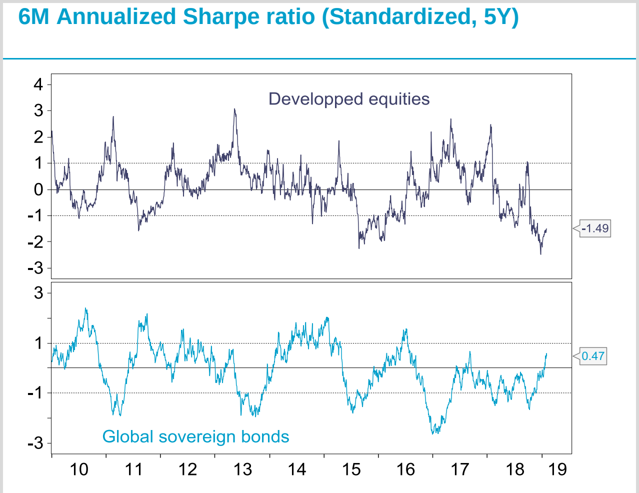


Source: HFR, Macrobond, Lyxor AM.

The past two months provide additional evidence that some strategies, such as Merger Arbitrage, are very resilient during a turmoil. It is also interesting to note that Merger Arbitrage managed to partially capture the market rebound in January.

From an active management perspective, it is extremely hard to determine the timing of such gyrations. Over the past two-months, we note that: i) Bonds outperformed massively and; ii) From a hedge fund strategy perspective, Event-Driven stands out as the outperformer while CTAs underperformed during the rollercoaster, unsurprisingly.

Mid-term momentum signals and what it means for CTAs



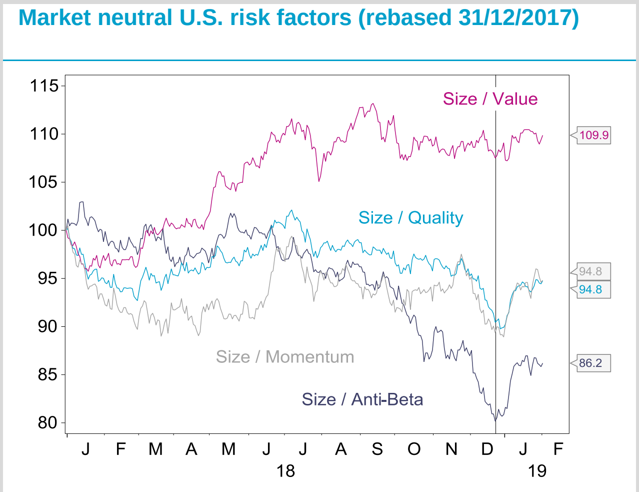
MSCI World; Barclays Global Aggregate Bond Index. Source: Macrobond, Lyxor AM

Bonds rallied during the equity market sell-off, as usual when risk aversion rises. But the upward trend in bond returns remained strong during the January rebound. This is probably related to the Fed changing its stance towards less hawkishness.

The strong upward momentum in fixed income has led CTAs to increase significantly their bond holdings. Yet, the robust pace of job creation in the U.S. could put the bond market rally, and by extension CTAs performance, at risk.

Meanwhile, the momentum in equities remains negative despite the recent rebound. This explains why CTAs maintained short equity positions in early 2019 and underperformed.

Equity style investing and what it means for L/S Equity strategies



Source: Dow Jones, Macrobond, Lyxor AM

The equity market rebound since end-2018 was fueled in the U.S. by two market segments: i) value stocks and; ii) smaller capitalizations (the “size” factor). Meanwhile, momentum, quality, and low beta factors lagged.

L/S Equity strategies, which suffered in Q4-18, outperformed in early 2019. They benefitted from the rebound in the “size” factor. The underperformance of quality and low beta factors was also supportive, due to their short positioning according to our estimates.

We maintain a defensive positioning on L/S Equity strategies. The rebound in the value and size factors looks unsustainable at this stage of the economic cycle. Although we do not expect a U.S. recession in the near term, we are not at the beginning of an expansion cycle, when conditions historically fall in place for value and size factors.

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