

The Top 50 gained 6.3% during the first half of 2024, led by credit and fixed income, equity and macro, well behind the market’s remarkable start. Ten funds delivered double-digit returns. But the strategy that continued to surprise was emerging markets with six EM funds having outpaced all other strategies. And one EM credit fund outperformed the market during the first six months of the year.

by Eric Uhlfelder
21 August 2024

PLUS ÇA CHANGE, PLUS C'EST LA MÊME CHOSE¹

Several key themes that emerged from 2024 global hedge fund survey remain front and center.

Tech shares continued to drive the market, helping it to outpace hedge funds. S&P 500 gained 15.3% through June. BarclayHedge Index was up 5.4% while the Top 50 rose 6.3%.

Emerging market funds continued to thrive. It was the best performing strategy within the Top 50, having gained 9.5% on the back of strong credit returns. (See sidebar on p. iii to see how various strategies have done so far.)

Geopolitical risks not only have remained significant but have risen, with Ukraine having invaded Russia and Israel having assassinated a Hamas leader in Iran, not to mention the outcome of the US presidential election now

a horse race, whose implications will be discussed later in this update.

And market sentiment continued to be driven by the prospect of rate cuts. Because it is, rather than what the broader outlook portends, market sentiment continues to spin on a dime. As we saw in May and again in August, small provocations can create lots of noise, keeping investors and analysts wondering what’s ahead. And this uncertainty will continue to feed market volatility.

In early August, *The Economist* put it well:

“How quickly the mood turns. Barely a fortnight ago stock markets were on a seemingly

unstoppable bull run, after months of hitting (consecutive) new all-time highs. Now they are in free fall . . . panic is sweeping through markets. Wall Street’s “fear gauge”, the VIX index, which measures expected volatility through the prices traders pay to protect themselves from it, has rocketed to its highest since America’s regional-banking crisis last year.”

Listening to some analysts and pundits about the recent brief sell-off reminds me of Claude Rains in Casablanca, who was shocked when he learned gambling was going on in Rick’s Café as he accepted his winnings.

Rising rates are supposed to slow the economy to help

ratchet back inflation. Perhaps it surprised some folks that the economy didn’t miss much of a beat for more than a year after the Fed boosted rates.

It certainly felt the US was continuing its exceptionalism, thriving when all other major economies were trying to avoid contraction.

But it takes time for rates to filter through a \$27 trillion economy. GDP growth is slowing, unemployment is inching up, and consumer price inflation just broke below 3%.

Not bad for a bunch of central bankers who many had thought couldn’t shoot straight.

Still, investors were clamoring about how the Fed, in holding back rate cuts, continues to be behind the curve and will be forced to play catch up, again.

Well, maybe not.

The Financial Times saw the recent market whipsaw as, “saying more about the

psychology and structure of modern markets than they do about any fundamental shift in the economic or financial outlook.”

Unwinding of a good chunk of the Yen carry trade, which was adding fuel to US tech shares, shouldn’t have surprised given how weak the Japanese currency had become and how it would induce much needed inflation.

The real surprise was how a mere 15 basis point rate rise, which pushed the overnight rate to just 25 bps, strengthened the Yen by 5%.

Justin Young, director of investments at MEMCO, a pool of university endowments, said the Japanese central bank had signaled it will combat nascent inflation with rate hikes.

“The sharp moves that followed,” explains Young, “were more about crowded short yen positioning, extremely cheap valuation, and the narrowing of expected future real interest rates between the BOJ and the Fed.”

As US growth softens with falling rates and Japan nudging rates incrementally higher, Young expects the Yen will continue to rally.

Words Matter

Popular diction also hasn’t helped investors navigate the turbulence.

Despite claims of the US being in a high-interest

rate environment, we’re at a historically average level. We’ve just been conditioned to expect money to be free, which probably isn’t a good thing for all sorts of reasons.

The second misconception involves the continued discussion of soft or hard landings.

Seems that we’ve passed that glide slope related to Covid, inflation, and rate hikes where there has been no landing at all and that investors should be thinking instead of the next phase of the economic cycle that we’ve entered.

Even if the market sold off by another 10 percent, that wouldn’t necessarily be a bad thing considering how highly priced the market has become, especially with the steady decline in the risk-free rate potentially fueling equities.

A sell-off by itself wouldn’t portend growing systemic risks including recession. Slowing earnings growth, however, might.

But economist Ed Yardeni just reported that, “Q2 S&P 500 operating earnings per share rose 10.9% year over year during the quarter to a record high.” And he found the consensus earnings estimate for next year is up 15% from the 2024 estimate.

Still the recent bout of volatility has revived recession fears.



CONSOLIDATED TOP 50 HEDGE FUND PERFORMANCE BY STRATEGY

No. of Funds	Strategy*	1H24 Net Returns	5-Year Annualized Returns thru 2023
11	Equity	6.96	18.63
5	Macro	6.08	15.90
10	Multistrategy	5.24	12.69
2	Event Driven	2.67	12.58
6	Emerging Markets	9.51	12.49
2	Volatility Arbitrage	4.84	12.33
7	Credit and Fixed Income	7.15	10.26
2	Municipal Credit	3.81	9.28
Top 50 Averages		6.32	13.66
BarclayHedge Index		5.42	6.30
S&P 500 Total Return		15.29	15.69

* Five other funds in the Top 50 involved different strategies
Source: BarclayHedge and proprietary sources

JP Morgan said that despite solid gains in the service sector, sustained profit margins, and limited credit stress, the prospects of a

US recession in 2024 have increased from 25% to 35%. “Important elements of our growth forecast are being challenged,” says Bruce Kas-

¹This somewhat familiar expression felt appropriate: “The more things change, the more they stay the same.”

Top-Performing First-Half Strategies

Six emerging market funds in the Top 50, including four EM credit focused funds, generated average gains of more than 9.5% during the first half of the year. That was 3.5 percentage points higher than the BarclayHedge Emerging Market Index returns.

Key drivers of returns included sovereign debt restructuring, resurgence of local currency bonds, and declining Euro and US interest rates.

This group was led by London-based Sandglass, which delivered the best first-half returns in the survey, even topping the market. According to BarclayHedge, the fund soared 18.4%. A significant contributor to the 33rd-ranked fund's gains was exposure to distressed sovereign credit positions in Argentina, Ukraine, Egypt, and select African nations, along with corporate exposure mostly in Latin America.

London-based Enko African Debt fund (18th) delivered the second-best performance, climbing 15.4% as local currencies and related debt rallied with rising oil prices along with debt restructuring.

Singapore-based FengHe equity fund (31st) rose 11.3%. PM Matt Hu explains his "diversified returns were generated across almost all core markets both on the long and short sides." Shorting has been improved with stricter focus on timing and execution, including the use of tighter stop-losses. And limiting gross exposure to around 100% has improved control of downside volatility.

Seven credit and fixed-income funds were the second-best performing strategy, gaining more than 7%, which was 5 percentage points higher than the BarclayHedge Credit and Fixed Income Indices.

Magnetar Constellation (45th), based in Evanston, Illinois, led the group, having soared more than 11% followed by New York-based CRC Bond Trading (42nd), which returned 9.5%. Kansas-based Palmer Square Opportunistic Credit (35th) delivered gains of 7.9%.

Hedged equity was the third-best performing strategy, rising nearly 7%. That was only marginally better than the BH Equity Long-Short Index which was up 6.4%. BH Equity Long Bias climbed 9.4%

Leading the group was Miami-based quant fund Citadel Tactical, the 7th-ranked fund, which gained 13.7%. It was followed by the survey's top-ranked fund, Peconic Grenadier, which rallied 11.8%. Fourth-ranked Cooper Creek Partners, based in New York, added more than 11%.

man, the bank's chief global economist, "with sharper-than-expected weakening in labor demand and early signs of labor shedding. The latest business surveys also suggest a loss of momentum in global manufacturing." This is especially true in the Euro area where economic sluggishness continues.

He adds that easing labor market conditions suggests the Fed's current policy stance is restrictive.

Accordingly, Kassman thinks the Fed should jettison its penchant for gradual moves and cut at least 100 basis points by year's end.

David Kelly, the firm's chief global strategist, agrees arguing the Fed should initially cut rates by 50 basis points in September to message, "the economy is fine, inflation is under control, and we need to get back to more normal rates."

He feels the Fed's belated response to inflation was overdone, with inflation having peaked in June 2022 when rates were still under 2%. Kelly thinks overnight rates should be brought down to 3.5% to 4% as soon as possible.

"If the Fed makes a bold move in September," cautions Kelly, "it must not be perceived as panicking. That will scare people and delay investment decisions by those who may decide to wait until rates drop even further before acting."

On the other side, Brian

Moynihan of Bank of America sees no recession in 2024, believing the Fed will continue to tap down on inflation while keeping the economy afloat.

"We see two rate cuts this year and four next year," says Moynihan, "with rates normalizing between 3% to 3.5%."

He worries if the Fed doesn't, "start bringing down rates soon, you could dispirit the American consumer. And once the consumer starts turning very negative, then it's hard to get them back."

But that trend hasn't shown up yet. The Census Bureau reported a 1 percent increase in US July retail sales, well beyond economists' forecasts of 0.3% and the largest increase over the past 18 months.

So what does all this mean to hedge fund allocators?

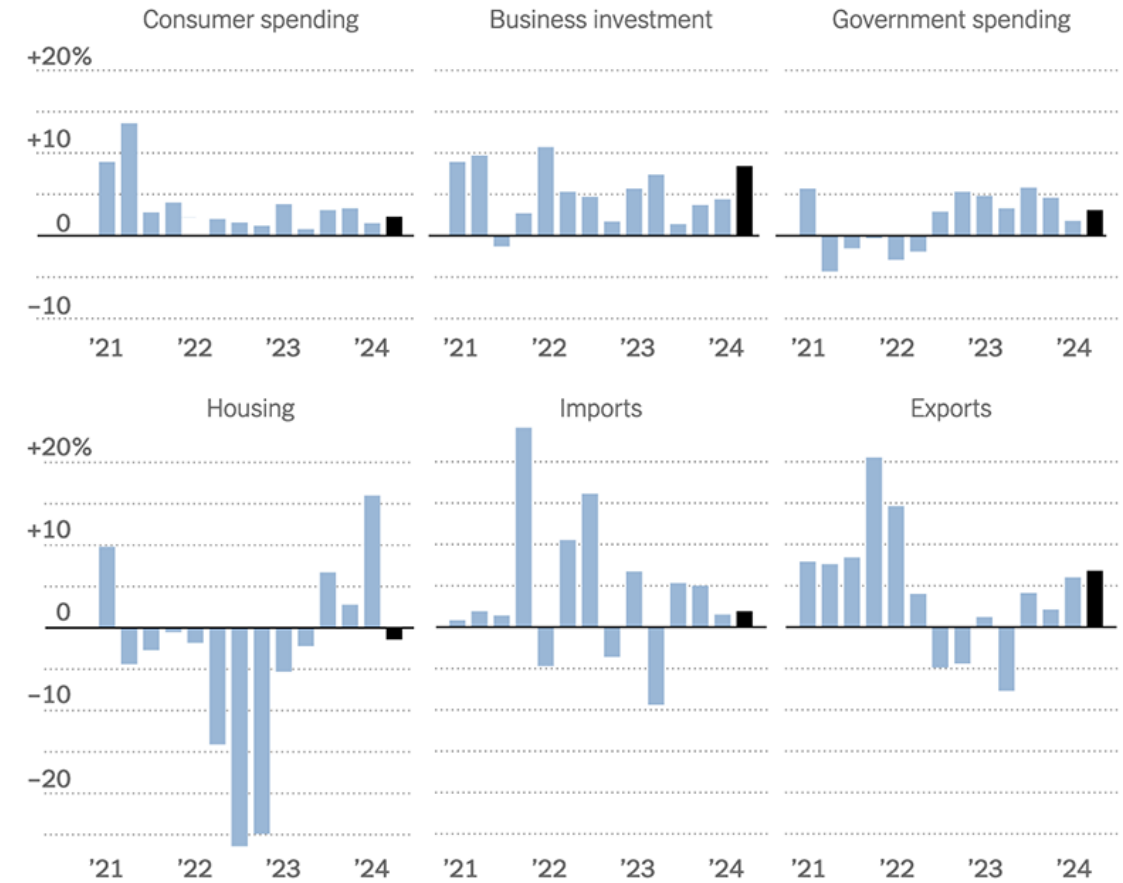
Not much, despite the switch in focus from inflation to growth concerns, the slow rise in Japanese rates, and the resurgence of the democratic party that may augur well for Vice President Harris this fall.

November and Beyond

The presidential race has tightened. But many still believe it's Trump's to lose.

Eurasia Group's CEO Maziar Minovi believes that while President Biden's departure from the race has stabilized Democratic prospects down ballot, he still gives Trump the edge.

Quarterly change in real gross domestic product, by category



Note: Data is the seasonally adjusted annual rate, adjusted for inflation. Source: Bureau of Economic Analysis • By Andrew Park, NY Times

He explains, "what happens at the top of the ticket will have significant repercussions for investors." In a recent Q&A, which appeared in the annual survey in June, Minovi argued the most under-appreciated geopolitical risk is a second Trump presidency. (See full interview on pp. 17-18.)

At the same time, he thinks, "divided government would provide the most stable outlook for investors as compromise will be needed

to pass legislation, especially on fiscal matters."

Anthony Novara, partner and research director at the \$309 billion Fiducient Advisors, sees inflation likely remaining a sticky problem regardless of who occupies the White House. He believes discretionary government spending is unlikely to be slowed significantly by either party.

(Note: Many believe US inflation surged due to Biden's large spending programs.

But that doesn't square with inflation having been a global phenomenon and that US CPI has dropped sharply nearing the Fed's target rate even as the administration's big-ticket CHIPs, infrastructure and clean energy programs are just ramping up.) Either way, Novara believes this will limit interest rate cuts, likely leaving overnight rates between 3% to 4%.

This may boost the prospect of distressed managers, thinks Novara, as

Inflation Is Moving Toward the Fed's 2% Target

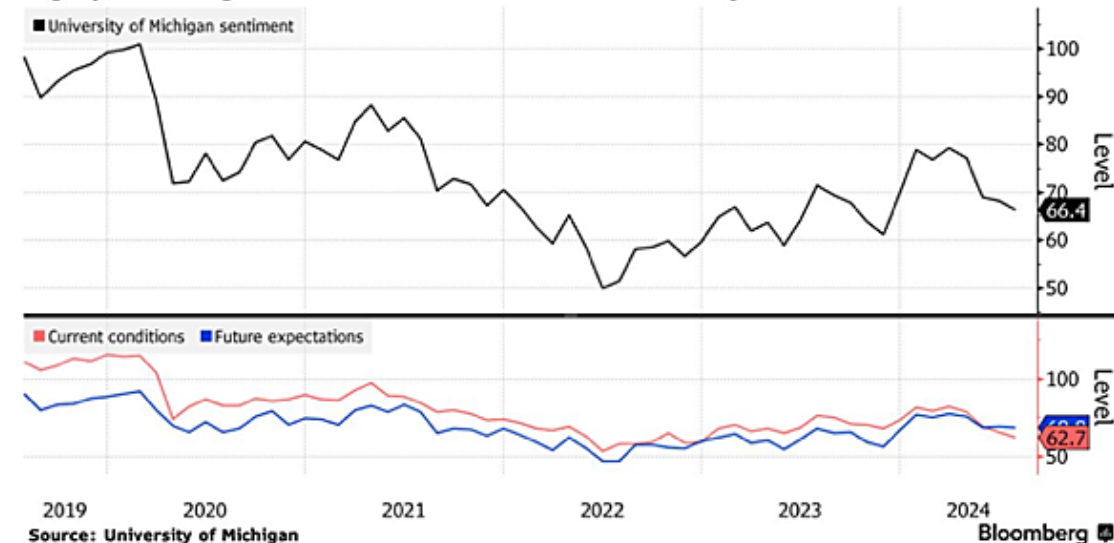
Powell will probably stress progress made without declaring victory



Source: US Bureau of Economic Analysis

US Consumer Sentiment Falls to Eight-Month Low

High prices weighed on current and future views in July



Source: University of Michigan

made any significant investment changes in the light of recent volatility.

“We leaned into reinsurance last year and are making sure all of our strategies have a clear passthrough of cash rates (less true for things like distressed debt),” noted Young. “Outside of Japan, the valuation moves in our book have been modest and haven’t been large enough to cause us to shift our portfolio.”

CIO of London-based Sussex Partners, Jim Neumann, sees the return of volatility as a good thing, reflecting a return to normalcy. This can fuel helpful corrections and create opportunities. “Since Covid struck and government fiscal spigots were turned on full to quell uncertainty,” explains Neumann, “there hasn’t been any sustained volatility.”

Accordingly, Neumann thinks this shift will hit low volatility and high leverage strategies, including relative value and some multistrategy trades, which he recommends avoiding.

In this environment, he sees “several emerging sources of alpha, including economies with diverging post-pandemic stimuli, central banks on the move (and making mistakes), liquidity challenges in even the most liquid markets (US Treasuries), and asset price inflation.”

Accordingly, Sussex Partners continues to favor strategies that have been

historically uncorrelated during periods of dislocation, including geographically and stylistically diverse global macro and fixed income involving relative value and directional trades.

In spite of recent volatility that shocked the Yen and Japanese equities, he says his firm remains very pro-Japan as a source of alpha driven returns.

“The rise in Japanese inflation, interest, and exchange rate volatility has refocused attention on the country,” explains Neumann. But he sees, “its equity market largely under invested and less analyzed than other major financial centers. This creates fundamental idiosyncratic corporate long and short investment opportunities.”

Final Thoughts Before the Election

It’s likely that interest rates will remain a key driver of markets for the rest of the year. And with Jay Powell remaining at the helm of the Fed, its cautious monetary policies are not likely to change.

But the much greater uncertainty is handicapping the impact on the economy and markets of a Democratic versus a Republican win in November and how much support either leader will have from Congress.

The Democratic National Convention explicitly avoided saying Kamala Harris would continue Biden’s

policies, even though it celebrated the president’s accomplishments.

Still, if she’s elected, Harris is expected to closely track Biden’s domestic and international policies. She would not likely renew the 2017 tax cuts for high income earners.

It’s unclear how much success Harris can realize from a divided Congress. But if she delivers on an aggressive fiscal agenda, this could affect the pace in which the Fed loosens interest rates.

Trump 2.0 would likely scale back a number of Biden’s initiatives and reduce regulations. This may help certain businesses. But his proposed across-the-board tariffs would sting importers and trigger more inflation.

This inward tilt, however, reflects a potential threat to multilateral trade and military alliances critical to making a global marketplace efficient. It would introduce more division amongst our allies.

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- Global Investment Report

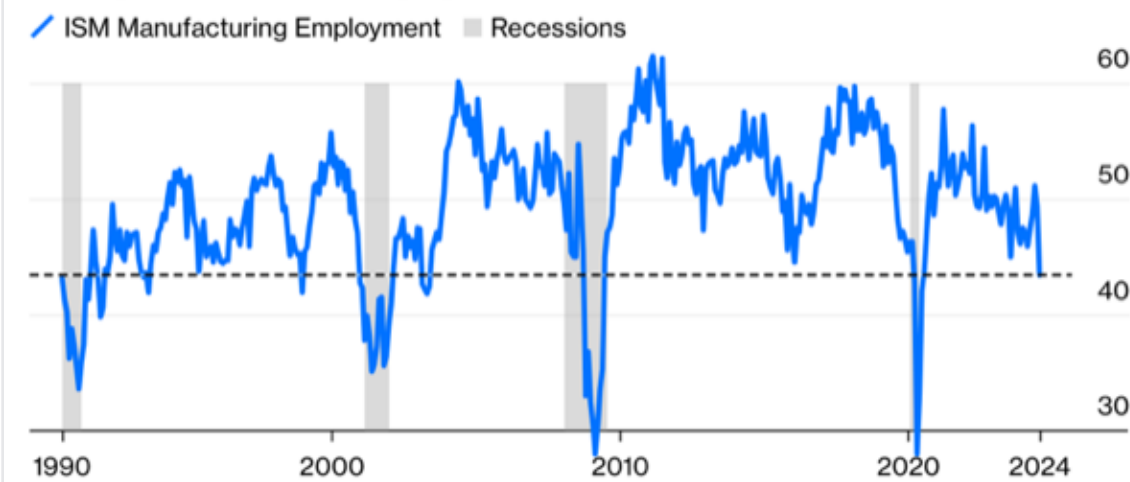
Corporate America is increasingly planning for greater climate-related disruptions which will likely only get worse and grow more costly, especially if Trump continues to dismiss the issue.

This will happen if Trump

relies even less on non-partisan experts guiding him than he had during his first term. His governance, policies, and penchant for chaos may bring greater unpredictability, which institutional investors and markets are not supposed to like. ■

Recession Indicator?

It’s 21 years since ISM Employment was this low outside recessions



Source: Bloomberg

huge refinancing demands ramp up over the next two years. Companies that are struggling will see their debt repriced and may become attractive restructuring plays.

This also feeds into Novara’s penchant for convertible

arbitrage. He believes, “refinancing high-cash burn of tech and health-care companies may fuel a rise in the issuance of convertibles to keep borrowing costs down.”

Novara also thinks equity market neutral funds may help reduce risks related to

a slowing economy while capturing some of the upside from companies that continue to thrive.

MEMCO’s Young (who was the former director of investments of the \$40 billion South Carolina Retirement System), says he hasn’t