INSIGHTS

JULY 2023

HEDGE FUNDS IN H1

REVIEWING AN UNEVEN AND DRAMATIC START TO 2023

EXECUTIVE SUMMARY

It was an awkward opening to 2023 for many hedge fund strategies, with new crises, unexpected rallies, and evolving macro challenges leading to talk of sparse alpha and investor disappointment. Despite this, and as equity market volatility diminished through Q2, hedge funds finished the first half in positive territory, leaving many managers – and investors – having a little less cause for concern and a little more cautious optimism.

How did this happen? Hedgeweek's 'Hedge funds in H1' Insights report offers a data-led snapshot of the hedge fund industry at the year's halfway mark and analysis of the wider trading environment heading into H2.

Section one looks at industry performance. Alpha was in short supply, but many funds were able to generate some impressive numbers as the half wore on – notably those with a focus on the technology sector, where the hype around AI provided a lift for fintech stocks 'new' and 'old'.

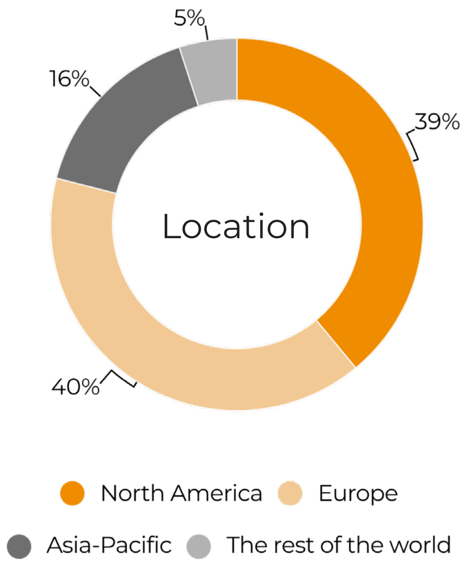
Section two steps inwards, focusing on the banking crisis – arguably the half's most significant theme – with a review of the key events and analysis of the ramifications.

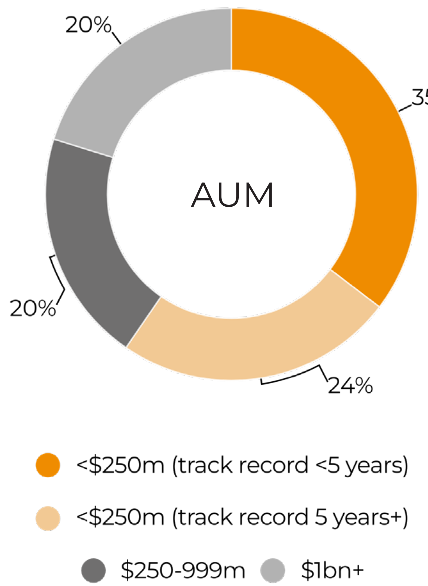
The final section then widens the lens again, taking in the macro view. Here, we speak to macro specialists, who assess a difficult and unpredictable six months for the strategy and set the scene for an intriguing – and pivotal – second half of the year for all hedge fund strategies.

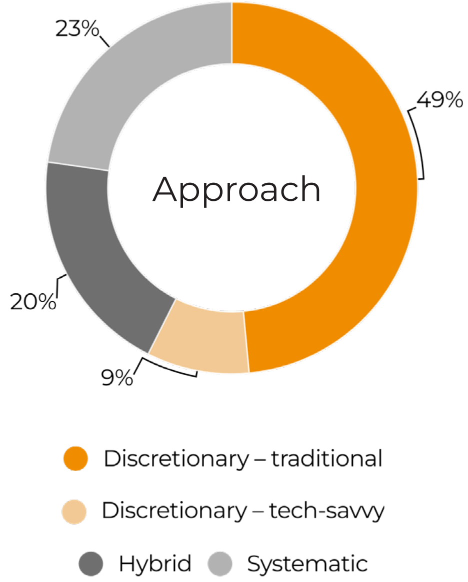
TONY GRIFFITHS
HEAD OF RESEARCH & INSIGHT

CONTENTS

Breakdown of respondents to Hedgeweek's Q2 Hedge Fund Manager Survey by firm location, size, and approach:







METHODOLOGY

A key source of data in this report is the results of Hedgeweek's Q2 Hedge Fund Manager Survey conducted in May 2023. Of the 80 hedge fund firms that participated in the survey, 20% had AUM of $1bn or more, 20% had AUM between $1bn and $250m, and around 60% had AUM under $250m. By firm location, around 40% were based in North America and 40% in Europe. Further insights were gathered during interviews in June and July with named and unnamed hedge fund sources, and additional third-party research and intel.

KEY FINDINGS

1

Lukewarm returns and sparse alpha made for a disappointing H1

Despite returning to positive territory this year, with many strategies clawing back March's losses, hedge funds' performance during the first six months of 2023 carries an air of disappointment, particularly amid a soaring stock market. Alpha in H1 was sparse and confidence among managers is falling, but there are still pockets of opportunities to be exploited in H2 through active management.

2

For hedge funds, the banking crisis had a 'bark worse than its bite'

Initial flows data indicates investors are keeping faith with hedge funds after short sellers profited from the banking turmoil. Prime brokerage activities emerged largely unscathed from the crisis, but with further volatility and dispersion widely anticipated, financial stocks remain in many managers' crosshairs. For hedge funds at least, it looks as if the 2023 banking crisis had a bark that was worse than its bite.

3

Hype around AI and 'new tech' benefited investors in the 'old guard'

Some of H1's top-performing hedge funds included specialists in the technology sector and funds focused on growth stocks, who capitalised on the tech surge to gain around 8% and 6%, respectively. Much of this was on the back of the hype around AI, although as one manager notes, this interest in 'new tech' centred, ironically, around the 'old guard' FAANG stocks of Facebook, Apple et al, ultimately providing comfort to the market.

4

Macro managers have a 'wait and see' approach as turbulence looms

After a fruitful 2022 for macro managers, 2023 is proving more complex. Few investors expected the equities comeback from the heavy declines of last year to be so quick against such a difficult economic and central banking background. But many question what this rally is built on and whether it will last. For now, many managers are advocating a 'wait and see' approach, with further turbulence expected in H2.

A MARKET MINEFIELD

Hedge funds weathered an eventful six months to end H1 in positive territory, but managers' modest gains have left the industry playing catch-up with other asset classes.

Hedge funds finished a tumultuous first half of the year in positive territory (see Fig. 1.1), but H1 has proven difficult for hedge funds overall, industry practitioners say.

Following a torrid 2022 in which they lost more than 10%, long/short equity funds – often seen as the cornerstone strategy of the hedge fund industry – advanced in the first half, averaging 5.5% (see Fig. 1.2). But with the AI-fuelled tech-stock rally driving the S&P 500 to around 16% in H1, and the Nasdaq surging to its best first half in 40 years with 31.7%, long/short equity managers' gains proved comparatively muted.

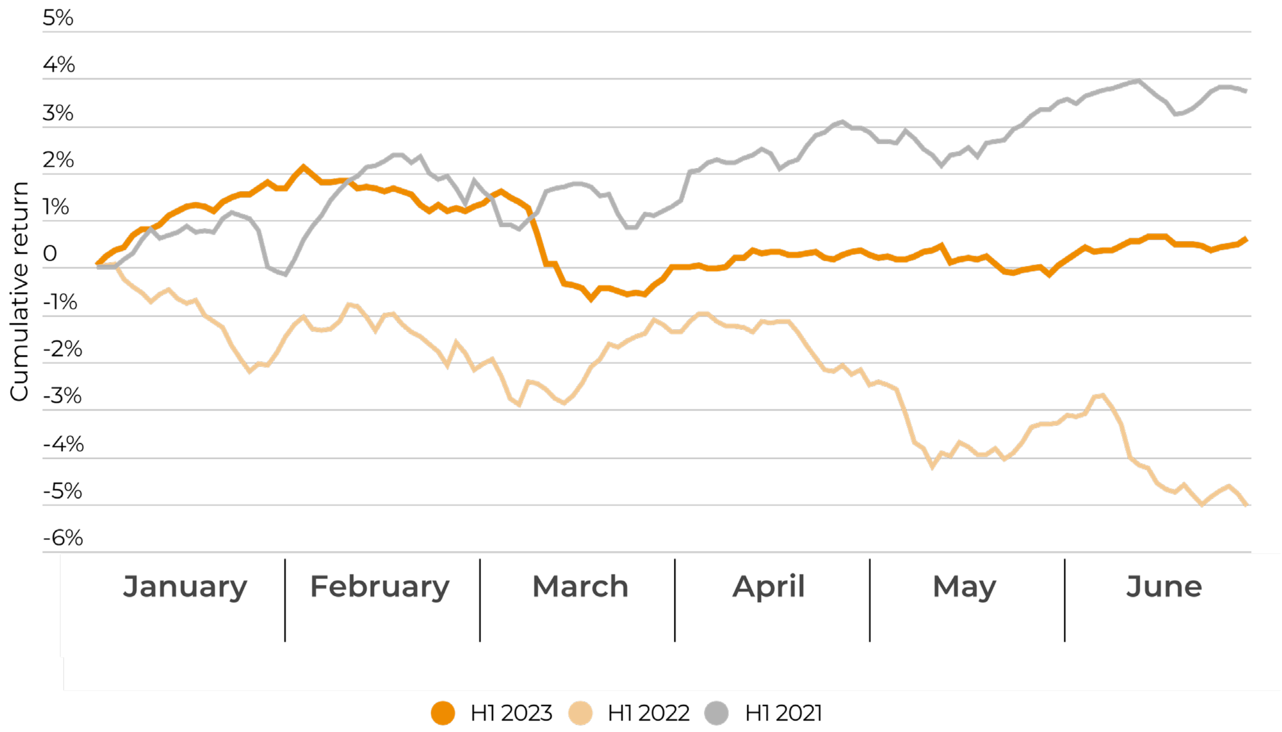
"It's fair to say H1 has been disappointing – very little alpha seems to have been harvested in this period," says Donald Pepper, co-CEO, Trium Capital.

"A lot of the top talent in the whole asset management industry is not beating cash. Many were only up 1-2% – that is disappointing; it's below the risk-free rate, below inflation," Pepper says of equity long/short funds' performance. "Investors are paying top-rate fees – they expect better results than that."

Specialist technology-focused equity managers fared better, pouncing on the tech surge to gain more than 8% during H1, as growth-focused equity hedge funds rose by 6%.

"The real story of the first half, if you were to sum it up in just one word, is AI," says Alyx Wood, Chief Investment Officer of UK-focused long/short equity manager Kernow Asset Management. Wood notes that much of the interest in burgeoning new technologies has

Fig. 1.1 HFRX Global Hedge Fund Index performance, H1 2023 versus H1 2022 and H1 2021



Source: Hedgeweek Q2 Manager Survey, May 2023

centred, ironically, around the 'old guard' FAANG stocks, which proved comforting to the market.

UNEVEN CTAS

Other hedge fund strategies endured an equally uneven six months. CTAs and trend-following managers may have generated stellar annual returns averaging more than 20% in 2022 – their best since 2014 – but H1 could not have been more different.

Societe Generale's main CTA Index – a key benchmark measuring the daily returns of 20 of the largest managed futures names – dropped about 6% in March as Silicon Valley Bank's collapse and the UBS-Credit Suisse shotgun merger upended momentum trends, particularly in bonds. Brand-name managers including Man Group (-19.8%), Aspect Capital (-13.1%), and Systematica (-7.6%) were reportedly left nursing sharp monthly losses.

Nevertheless, trend-followers have since staged an impressive fightback, recouping almost 5% as volatility has receded, though overall SocGen's CTA Index was flat for H1 (see Fig. 1.3).

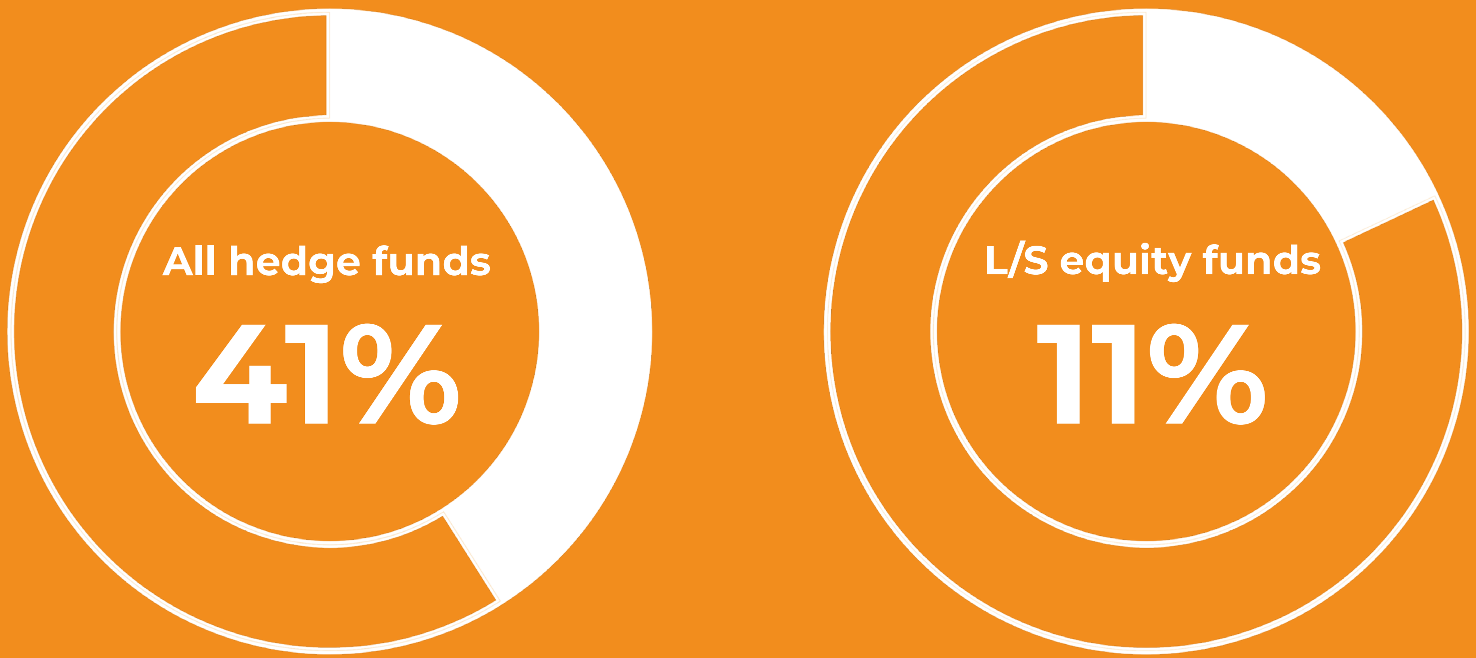
Andrew Beer, Managing Member at Dynamic Beta Investments, believes CTAs remain "invaluable diversifiers" for investors, pointing to their strong returns last year as other assets fell by the wayside.

"The question for allocators today should be not whether to own the asset class, but how

KEY FINDING

Less than half of hedge funds were at their high-water mark in April 2023

Proportion of hedge fund firms surveyed whose flagship fund was at its high-water mark at the end of Q1 2023.



INSIGHTS

much to add," Beer says. "CTAs should be triple the current allocation. The hurdle is that many allocators wrongly assume they can time the space and struggle with messaging."

Performances elsewhere remained patchy. Activist managers posted double-digit gains, advancing almost 11%, but the broader event driven space, which includes merger arbitrage funds and distressed strategies, is lagging, at 2.7%, with merger arb managers funds losing 2.8%.

As a result, hedge funds' confidence has been dented.

The latest Hedge Fund Confidence Index, published by the Alternative Investment Management Association, Seward & Kissel, and Simmons & Simmons, shows manager optimism for the coming 12 months has fallen to its second lowest level since late 2020.

The index – in which 408 hedge funds managing $3.34tn score their confidence levels on a sliding scale of between +50 and -50 with 0 indicating a neutral level of confidence – stood at 14.2 on average at the end of Q2 2023 (see Fig. 1.4)

It noted sustained inflation and interest rate concerns, particularly among UK hedge funds, whose confidence level dropped from +18 to +14.5 and who now lag North American managers (+16.7) (see Fig. 1.5).

However, confidence among Japanese hedge funds has soared to +18. More hedge funds and

Fig. 1.2 Hedge fund strategy performance, H1 2023 versus H1 2022

	H1 2023	H1 2022
HFRI Fund Weighted Composite Index	3.36%	-5.64%
HFRI Equity Hedge (Total) Index	5.45%	-11.75%
HFRI Event-Driven (Total) Index	2.68%	-7.36%
HFRI Macro (Total) Index	-0.59%	8.52%
HFRI Relative Value (Total) Index	2.57%	-2.19%

Source: HFR

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It’s fair to say H1 has been disappointing – very little alpha seems to have been harvested

Donald Pepper
Co-CEO, Trium Capital

CTAs are piling into Japanese equities (see box-out) with the country showing stronger economic fundamentals than both the US and Europe.

FRAGMENTED OPPORTUNITIES IN H2

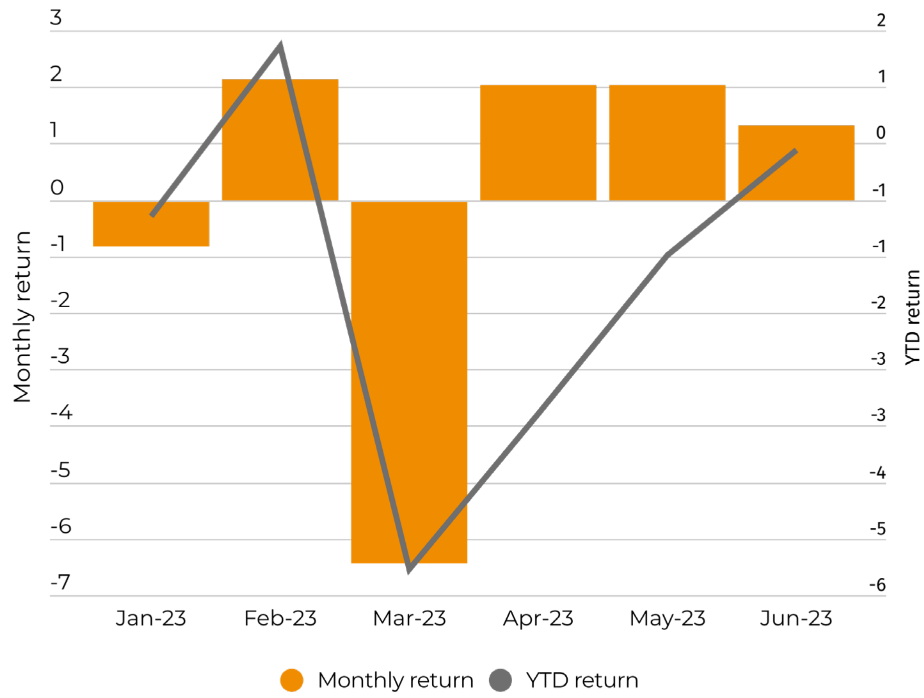
Industry practitioners now predict investment opportunities will become increasingly fragmented and idiosyncratic, and potentially more unpredictable, in H2.

"Most hedge funds have been bracing for a series of rolling crises. Unwinding a decade of market distortions, they believe, will break something big. And yet the economy and markets have sidestepped any major landmines," says Andrew Beer. "The challenge will be: how do we know when the minefield is behind us?"

Recent Man Group analysis noted how first-half stock market gains were driven by half a dozen tech behemoths, masking underlying challenges in equities, and making things tricky for stock pickers, while Goldman Sachs prime brokerage data shows hedge funds are now positioning for downside risk in US equities.

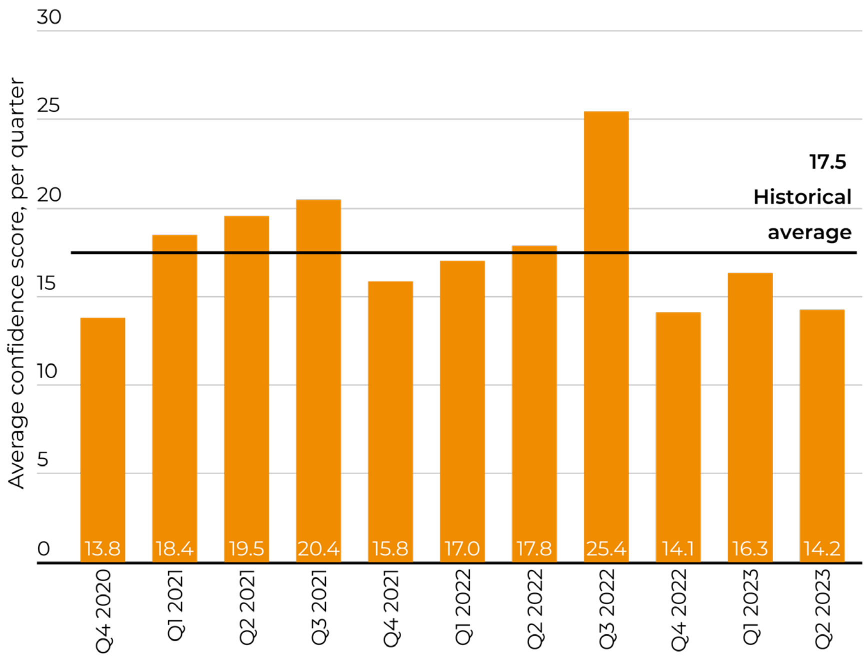
"I think shorting has potentially become a little bit harder," says Kernow's Wood. "In the UK, there may be a few debt-related trades emerging, but even though interest rates are near 6%, and a lot of companies are over-indebted, none of these companies are going bust yet, or they're getting zombied, so that short doesn't work."

Fig. 1.3 Societe Generale SG CTA Index monthly and YTD performance in H1 2023



Source: Hedgeweek Q2 Manager Survey, May 2023

Fig. 1.4 Hedge fund confidence, Q4 2020 to Q2 2023



Source: Hedge Fund Confidence Index (HFCI), AIMA, Seward & Kissel, and Simmons & Simmons

Big in Japan

This year's rally in Japanese equities is fuelling a resurgence in hedge fund interest in the country, with managers across a range of strategies taking an increasingly bullish stance after the Nikkei 225 climbed 27% in H1, its strongest first-half showing in a decade.

JP Morgan market data shows CTAs and trend-following strategies rotated into Japanese and US stocks in late May, exiting European equities positions, amid the Nikkei's sustained rise, which was aided by ongoing corporate reforms and looser central bank policies by the Bank of Japan.

Hedge Fund Research's Japan Index – which tracks the performance of Japan-based hedge funds – advanced 6.72% in H1, comfortably outflanking its 2022 annual return of 1.41%.

Citadel is reportedly preparing to reopen its Tokyo office this year, with founder and CEO Ken Griffin recently quoted as saying that now "is an exciting time to be involved in Japan." The US multi-strategy giant – which shuttered its Tokyo base in 2008 amid the Global Financial Crisis, but continued to invest in the country from overseas – is now understood to be building its Japanese focus by hiring equities-focused portfolio managers for the newly reformed unit.

Patrick Ghali, co-founder of hedge fund advisory Sussex Partners, says that as Asia continues to grow, Japan is an increasingly important component of that expansion story: "It's still a great alpha market – you don't have as many people chasing ideas."

He continues: "The gap between quality and junk stocks is one of the most interesting things. In the US, which is highly efficient, that gap is relatively tight, but in the UK, it's one of the highest dispersion rates in the developed market. So, if you are a high-touch, fundamentally driven, research-driven investor, theoretically if you can move between the two, for the same amount of work you can get a bigger price move."

Meanwhile, despite merger arbitrage funds ending H1 in the red, attributed largely to increased regulatory scrutiny from the US Federal Trade Commission and UK Competition and Markets Authority negatively impacting deals and pushing spreads out, opportunities are growing in the M&A space.

"Merger arb and event driven is one of the big contributors to multi-strategy funds, and we see a very positive outlook for that strategy," Trium's Pepper observes.

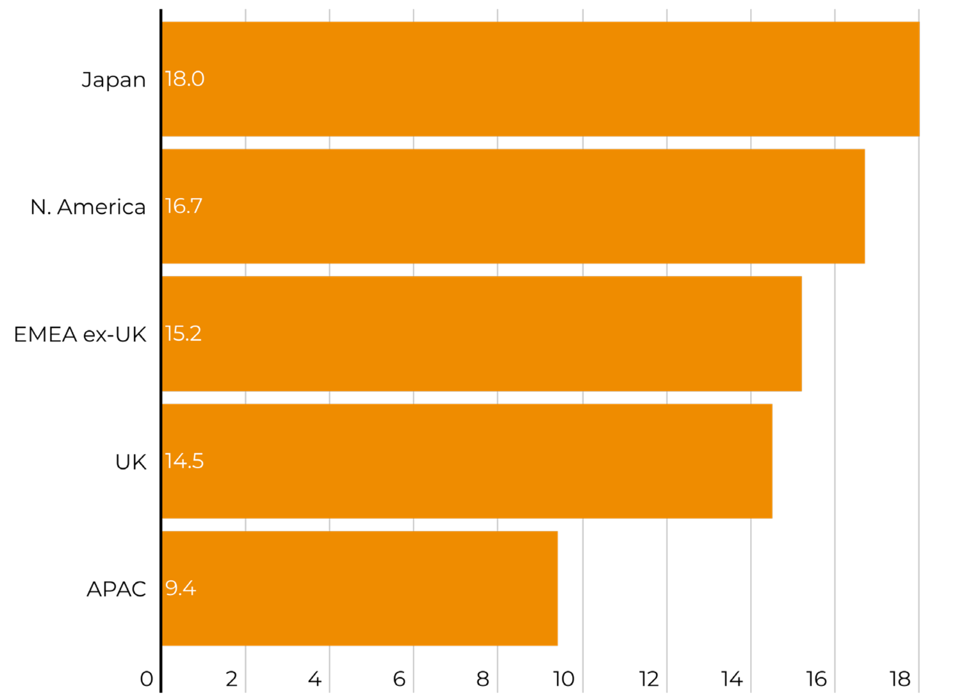
"We see spreads now really wide, and so the risk premium is now built into that, as people are concerned about regulators' views. But if you're selecting deals carefully and finding deals that do actually close despite having the attention of regulators, then you're looking at double-digit returns in what is a very low beta strategy."

Dynamic Beta's Beer says: "The first half was a grind: two steps forward and nearly two steps back. Given the macro headwinds in early 2023, caution was warranted. In that context, modest gains should be considered a success, even if the returns look paltry relative to soaring equities."

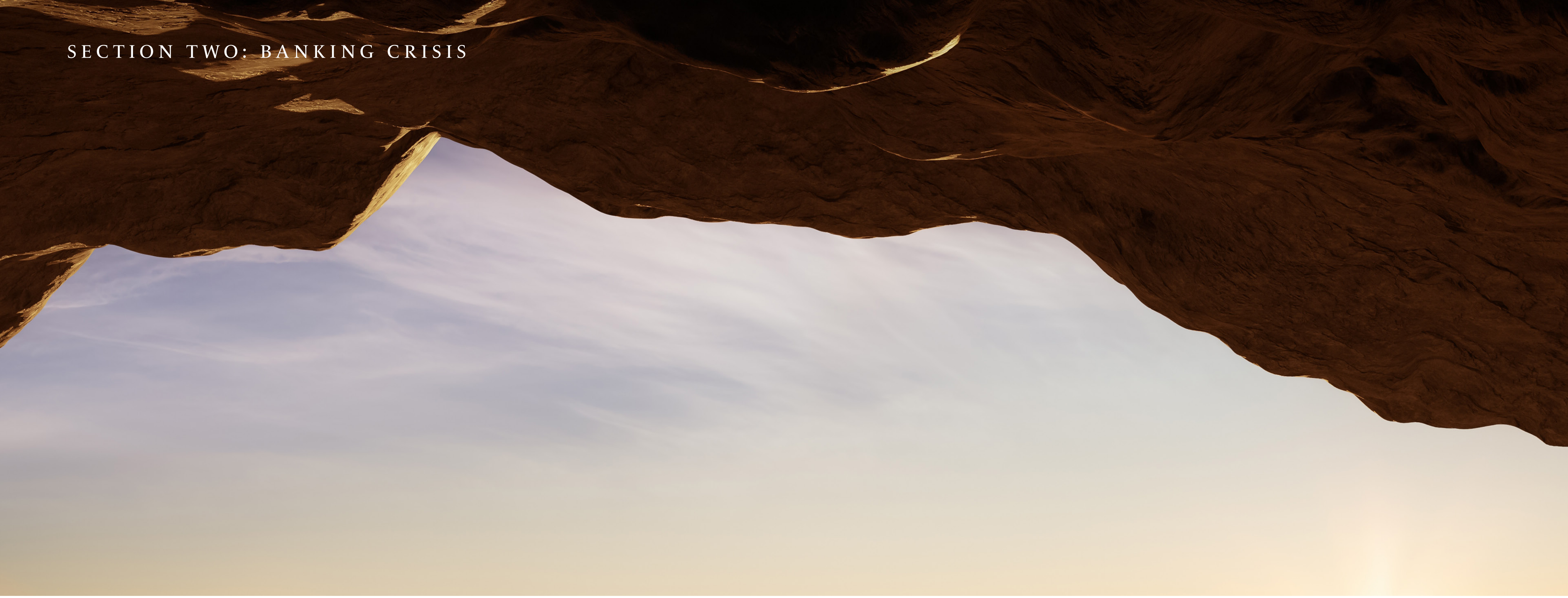
KEY TAKEAWAY

Despite returning to positive territory this year, with many strategies clawing back March's losses, hedge funds' H1 performance carries an air of disappointment, particularly amid a soaring stock market. Confidence among managers is falling, but there are still pockets of opportunities to be exploited in H2 through active management.

Fig. 1.5 Hedge fund confidence in Q2 2023, by manager region



Source: Hedge Fund Confidence Index (HFCI), AIMA, Seward & Kissel, and Simmons & Simmons



THE NEW FEAR

From the sudden demise of Silicon Valley Bank in the US to the abrupt takeover of Credit Suisse by rival UBS, March 2023 was a month of lasting significance.

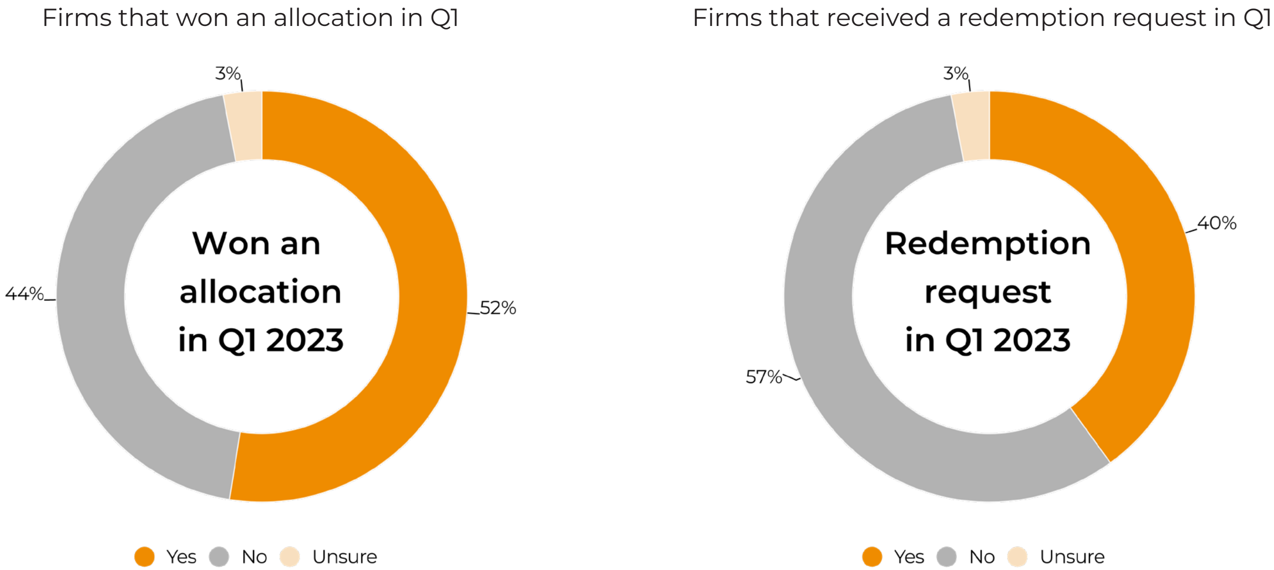
March's global banking crisis upended markets just as investors were getting to grips with interest rate concerns.

The maelstrom rapidly reverberated across markets, including the hedge fund industry. Equity short sellers made more than $7bn as banking stocks sunk, but many macro and CTA strategies were hit hard by the ensuing turmoil, with some brand-name managers registering double-digit losses.

"The banking crisis gave markets something new to worry about," recalls Alyx Wood, Chief Investment Officer of UK-focused long/short equity manager Kernow Asset Management. "The interest rate-inflation wall had become so long in the tooth that the market had pretty much priced it in and had started to move on, and the market had been doing well. But the banking crisis was a new fear story that initially appeared temporary, yet all of a sudden it had legs, and had started to spread. That fear hit people in different ways."

Specifically, short positions in Silicon Valley Bank netted $1.3bn in gains for bearish managers, according to analysis by London-based equity and short interest data provider Ortex. Bets against Credit Suisse – whose share

Fig. 2.1 Hedge funds that received an allocation or a redemption request during Q1 2023



Analyst note: *Survey respondents were asked in Q2, 'During the previous calendar quarter, did your firm a) receive an allocation from a hedge fund investor or b) a redemption request from a hedge fund investor?'*

Source: Hedgeweek Q2 2023 Hedge Fund Manager Survey

price plummeted more than 70% as it was sold to UBS – generated an estimated $684m.

Elsewhere, negative wagers in San Francisco-based First Republic Bank – which tumbled 89% and ultimately required a $30bn multi-bank bailout from almost a dozen lenders including JP Morgan, Citigroup and Wells Fargo – yielded $848m in gains for short-sellers.

Such successes appear, for now, to have assuaged investor concerns. Hedgeweek research suggests little evidence of allocators rushing for the exits in the aftermath of the meltdown.

More than half (52%) of all managers surveyed received an investor allocation during Q1, compared to 44% who did not (see Fig. 2.1). While investor withdrawals in Q1 were not insignificant, with some 40% of managers reporting that clients pulled money, a comfortable majority of 57% say allocators did not move to redeem.

Further analysis shows investors are seeking safety in larger shops: a majority of $1bn+ firms (54%), and managers running between $250-$999m (75%) indicated they received allocations in Q1, while fewer than half (45%) of smaller names received allocations (see Fig. 2.2).

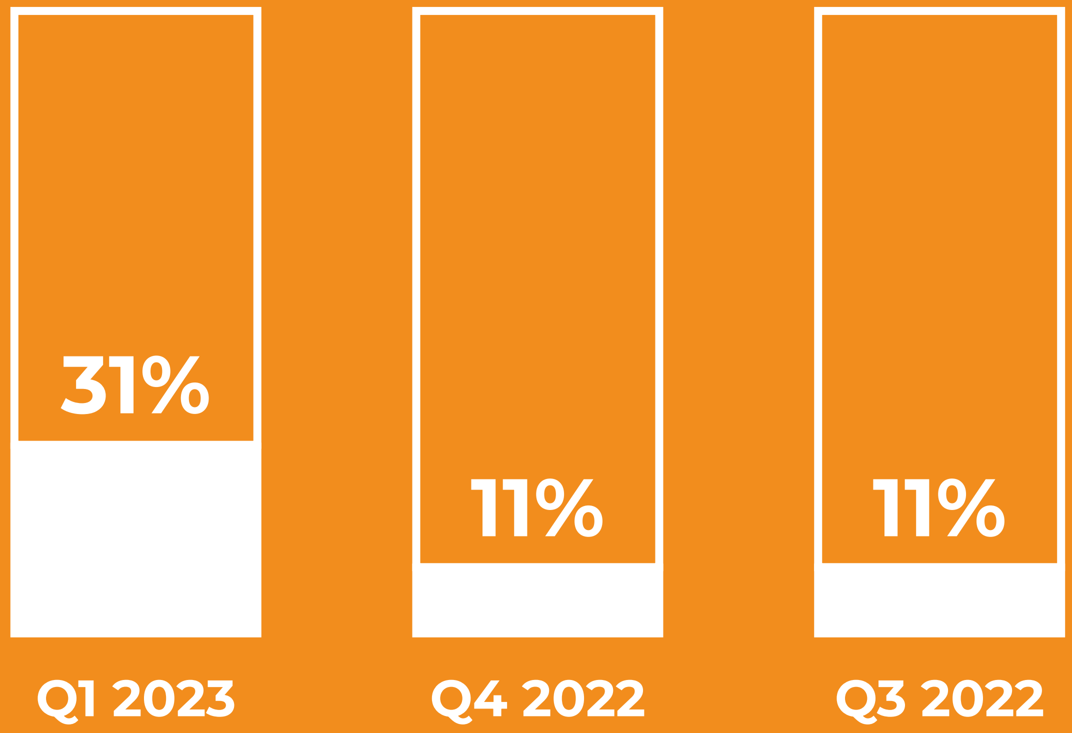
SAGGING HIGH-WATER MARKS

That said, the data indicates that most hedge funds' flagship strategies have remained below their all-time high-water mark in Q1. Some 60% of all hedge fund managers surveyed by Hedgeweek said their main flagship strategy was not at its all-time high-water mark at the end

KEY FINDING

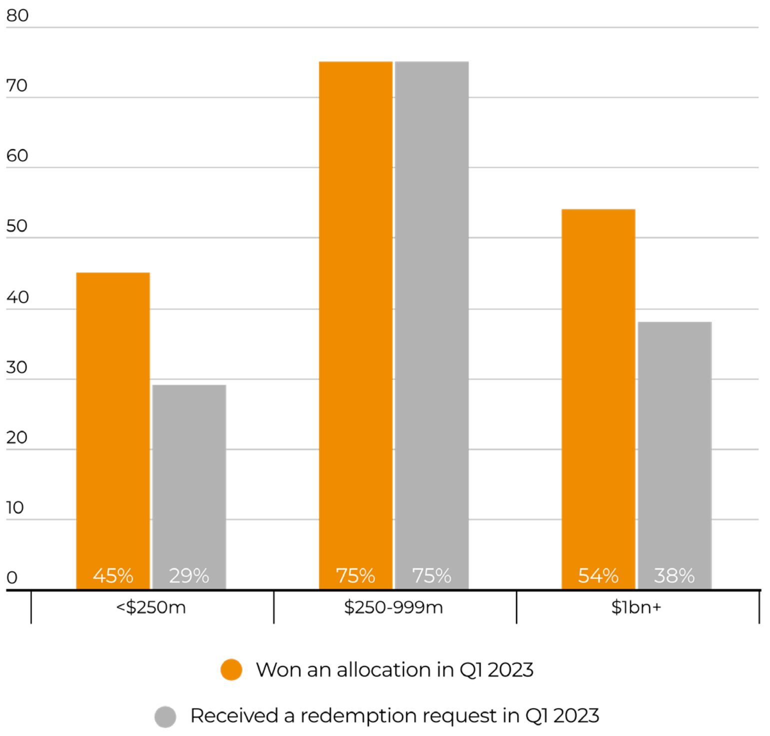
More than twice as many hedge funds moved or considered moving assets in Q1 2023 versus Q4 2022

Proportion of hedge fund firms surveyed that moved or considered moving client assets by quarter – with the banking crisis in Q1 having a notable impact:



INSIGHTS

Fig. 2.2 Hedge funds that received an allocation or a redemption request during Q1 2023, by firm AUM



Analyst note: *Survey respondents were asked in Q2, 'During the previous calendar quarter, did your firm a) receive an allocation from a hedge fund investor or b) a redemption request from a hedge fund investor?'*

Source: Hedgeweek Q2 2023 Hedge Fund Manager Survey

of Q1 (see Fig. 2.3). Here, research suggests a split between systematic and discretionary funds: a majority of systematic funds (53%) said their flagship was at its all-time high-water mark at the end of Q1, compared to around 30% discretionary managers, with that number falling below 20% among long/short equity managers.

Against this unfolding backdrop, industry professionals believe that the fallout from the banking turmoil heralds various opportunities across the investment spectrum for hedge funds to build upon during the second half of the year.

While equities rebounded during H1, banking stocks have remained de-rated. Barry Norris, CEO and CIO of Argonaut Capital, whose long/short Argonaut Absolute Return equity strategy gained from a six-month short position in SVB, continues to be negative on US regional banks. Norris recently noted how the prevailing interest rate environment and attendant pressure means some banks ultimately "now risk going bust not suddenly but gradually".

Man Group research observes how SVB had been increasing leverage by late 2022, when its bonds were still considering investment grade and trading at around 85 cents on the dollar, which in turn led to elevated levels of short interest as its technology-focused customers came under pressure.

Pointing to the ways in which 'network'-based alternative data analysis of customer behaviour is used is more in equities strategies than credit, Man analysts said: "At a time when single-name dispersion in credit is elevated and could still

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The banking crisis upended the great macro call of 2023: that inflation would prove sticky

Andrew Beer
Managing member, Dynamic Beta Investments

rise higher to former peaks given the ongoing uncertainty, we expect such analysis to benefit strategies that seek idiosyncratic opportunities."

With Credit Suisse's prime brokerage business having been sunk by the implosion of Archegos in 2021 – an event explored in depth in the March 2022 Hedgeweek Insights report – hedge funds' prime brokerage activity emerged largely unscathed.

MOVING ASSETS

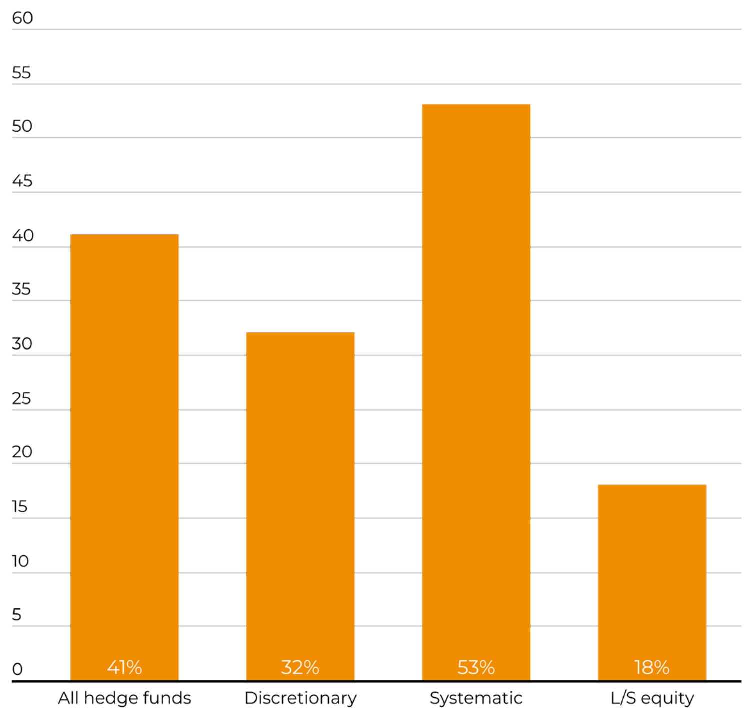
The number of hedge funds moving client assets to a different prime broker, custodian or bank account trended up during the first three months of 2023, from 11% in Q4 2022 to 31% in Q1 2023 (see Fig. 2.4). Overall, though, almost two-thirds say activity here remained unchanged.

"Prime brokers have maintained very robust margin models," says Trium Capital co-CEO Donald Pepper. "As a prime broker Credit Suisse was already out of the market because of Archegos, but there had still been some question marks about whether it may lead to margin requirements increasing. We really haven't seen that at all – there are plenty of strong prime brokers providing plenty of financing."

Looking ahead, the fact that the banking crisis happened relatively recently has heightened risk awareness, Pepper says.

"While it may likely end up being more of an idiosyncratic situation, you don't know when

Fig. 2.3 Hedge funds at their all-time high-water mark at the end of Q1 2023



Analyst note: *Survey respondents were asked in Q2, 'At the end of the previous calendar quarter, was your firm's flagship hedge fund strategy at its all-time high-water mark?'*

Source: Hedgeweek Q2 2023 Hedge Fund Manager Survey

March Madness – Timeline

Mar. 8: Crypto-focused bank Silvergate Capital shutters operations after customer withdrawals soar. Silicon Valley Bank (SVB) announces a $1.8bn loss after offloading $21bn of securities to ease the impact of withdrawals from its mostly tech and VC client base.

Mar. 9: SVB's share price collapses, losing 60% at one point, as clients withdraw more money. Shares in JP Morgan, Bank of America, Wells Fargo and Citigroup also fall sharply, with a total of $52bn wiped off their market value.

Mar. 10: Trading of SVB shares is halted as US regulators take control and shut the bank down.

Mar. 12: US regulators shut down New York-based Signature Bank, after customers withdraw $10bn amid contagion fears.

Mar. 13: SVB reopens as Silicon Valley Bridge Bank in the US. HSBC buys SVB's UK arm for £1.

Mar. 15: Credit Suisse plummets 30% after its majority shareholder Saudi National Bank refuses to offer more support, citing regulatory constraints. Credit Suisse borrows CHF50bn from the Swiss National Bank to shore up liquidity.

Mar. 16: First Republic Bank receives a $30bn rescue package, involving 11 lenders including JP Morgan, Bank of America and Goldman Sachs.

Mar. 17: SVB Financial files for Chapter 11 bankruptcy protection.

Mar. 19: UBS agrees a $3bn takeover of Credit Suisse in a move brokered by Swiss authorities.

Mar. 21: Shares in US regional banks rally after US treasury secretary Janet Yellen says the federal government will guarantee deposits in the event of a banking run.

Mar. 24: Deutsche Bank shares drop 14%, with Barclays and Societe Generale down 6%, as panic selling resumes in Europe.

Mar. 27: First Citizens Bank agrees to purchase the bulk of Silicon Valley Bridge Bank assets, including $119bn in deposits and loans.

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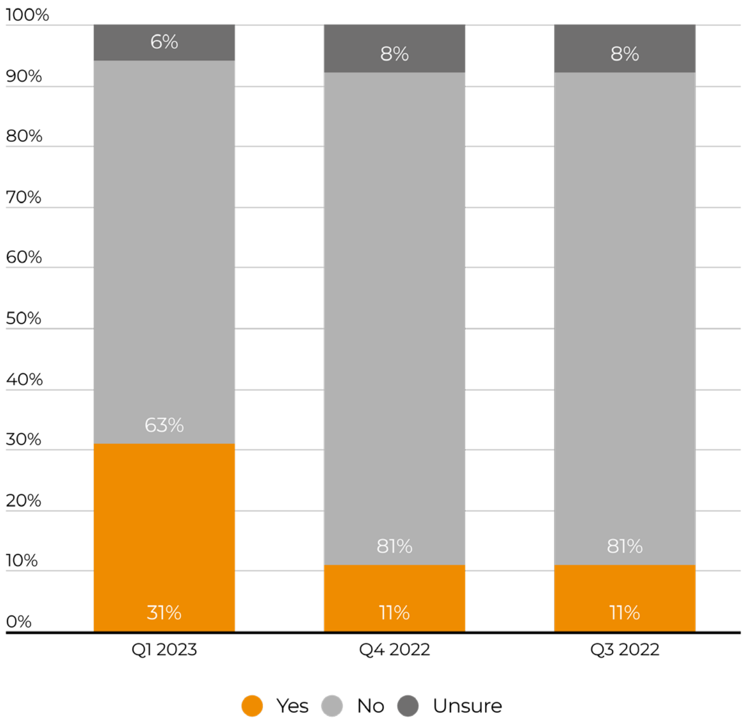
The fact that the banking crisis happened relatively recently has heightened risk awareness

Fig. 2.4 Hedge fund firms that moved or considered moving client assets, by quarter



Analyst note: *Survey respondents were asked in Q2, 'Did your firm move or consider moving client assets to a different prime broker, custodian, or bank account during the following quarters?'*

Source: Hedgeweek Q2 2023 Hedge Fund Manager Survey

the next one will be - it's clear another situation will happen again at some point, creating great opportunities across the whole macro-equity landscape."

He continues: "Volatility and dispersion of prices is good for stock pickers, and good for macro managers, and even in areas like merger arbitrage where more risk is priced in and you're getting paid more for effectively underwriting the risk that the deal closes. It has meant that you're more likely to get paid more for taking views when you successfully realise the strategy.

"The fact that it has happened fairly recently makes people aware these things are likely to happen again. That's so much better for us compared to the QE period where volatility was low, and it seemed like you didn't get paid the same for taking risk and taking views. We feel the opportunities will be better going forward now."

Reflecting on the fall-out of the "overnight banking crisis", Andrew Beer, Managing Member, Dynamic Beta Investments describes the episode as a "world-class head fake".

"The banking crisis upended the great macro call of 2023: that inflation would prove sticky. The massive unwinds in the Treasury markets forced widespread de-risking, which limited gains in subsequent months.

"In a matter of weeks, we went from sticky inflation to expectations of a hard recession by June and right back to sticky inflation. Still, it reinforced the idea that unwinding a decade of monetary profligacy will expose deep cracks in the system – and hedge funds are waiting for the ice to break." ■

KEY TAKEAWAY

Initial flows data indicates investors are keeping faith with hedge funds after short sellers profited from the banking turmoil. Prime brokerage activities emerged largely unscathed from the crisis, but with further volatility and dispersion widely anticipated, financial stocks remain in many managers' crosshairs.

WAIT AND SEE

It was a "half of two halves" for macro managers in H1 and few expect the uncertainty to end any time soon.

Major banking crises, rate hikes, a debt-ceiling standoff – and a stock market rally. The first half of 2023 has been a perplexing mix of bearish and bullish, providing an uncertain environment for funds trading on macroeconomic themes.

Global macro ended H1 with a 0.5% average loss, according to the HFRI Macro (Total) Index. That marks a contrast with last year, when clear winning trades – many built around the inflation surge and rate hikes – gave many macro managers a year of double-digit gains.

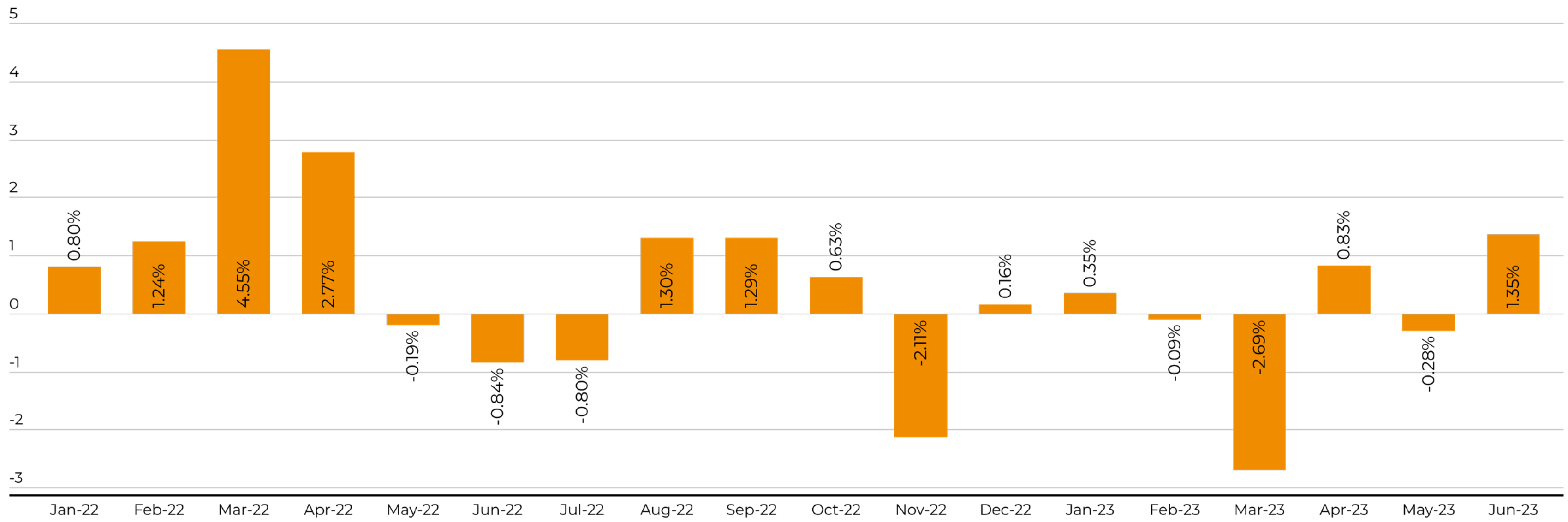
But some of the key themes of last year persist, notably outbreaks of bond market volatility as central banks raise rates to combat sticky inflation.

MORE MACRO VOLATILITY

A rush into US government bonds in March after the collapse of Silicon Valley Bank and government action to backstop the banking system sent Treasury yields tumbling, with the two-year having its biggest three-day decline since 1987.

Macro managers lost an average 2.7% in March, according to HFR (see Fig. 3.1), their worst month in more than five years. It contributed to a 'half of two halves' for macro managers such as Rokos Capital Management, the $14bn London-based firm.

Fig. 3.1 Monthly returns of the HFRI Macro (Total) Index



Source: HFR

It incurred losses as the bond market volatility of March recast expectations over interest rates, and was not alone. Brevan Howard even grounded some of its traders, while Said Haidar's fund was down about 32% at one point during the mayhem.

But Rokos then made about 5% in May and again in June, according to Bloomberg reporting, putting it near flat for the year so far.

The uncertainty has fed into a trend towards risk-off within macro as mid-year passes. For systematic macro managers trading on models, it is particularly difficult.

"The data is telling us markets should be risk-off but, in reality, the markets are happily risk-on," observed Adam Singleton, Head of Investment Solutions at Man FRM, in a research note.

"Such incongruity is a worry, not least for those hedge funds struggling to navigate these markets thanks to the low predictive power of traditional models." [see box out]

'WAIT AND SEE' MODE

Discretionary macro managers are also feeling their way through the uncertainty.

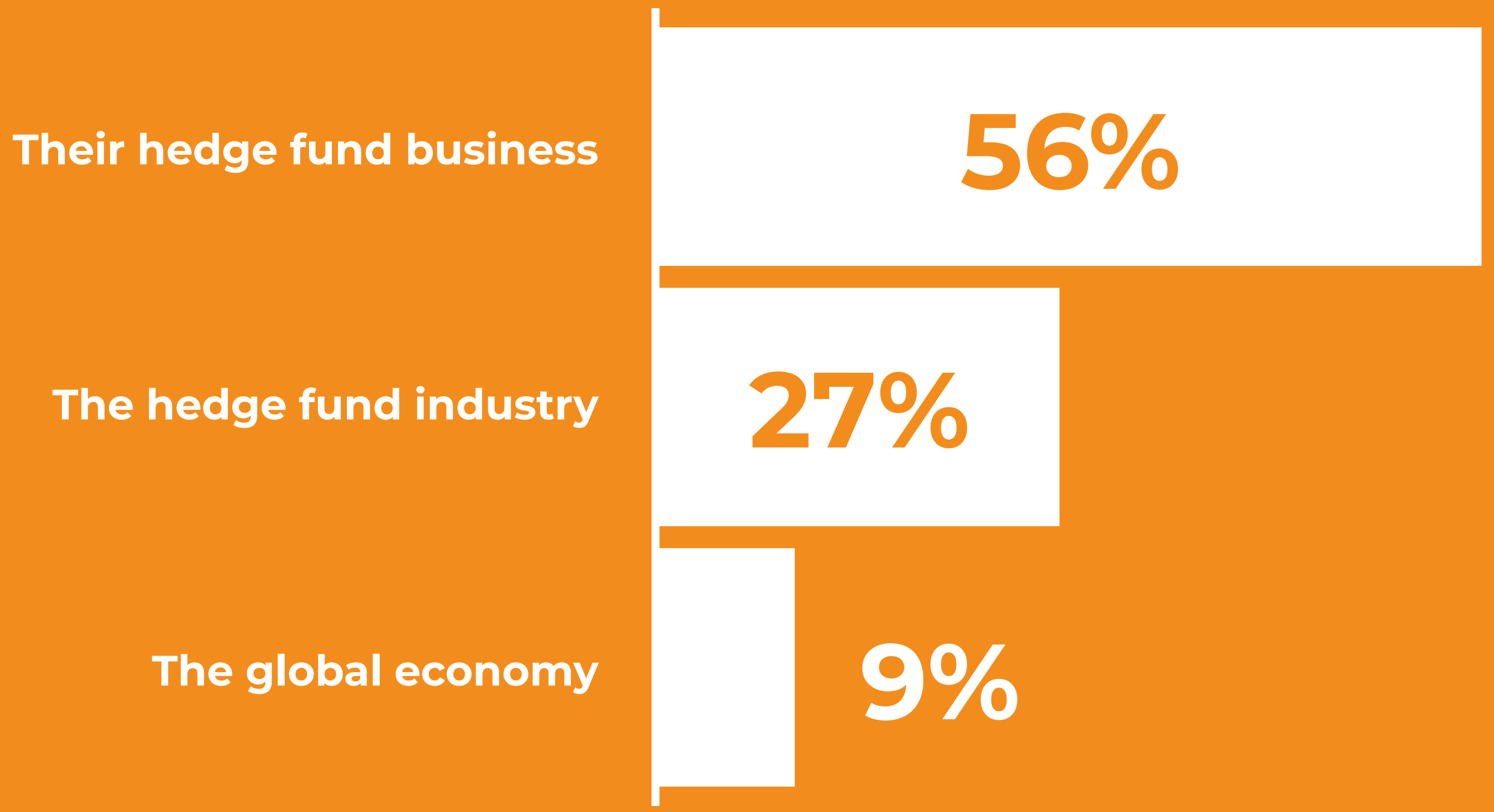
Just 13% of respondents to a Hedgeweek survey said their firm was using more leverage across its hedge fund products compared to 12 months ago, compared to 84% which were not (see Fig. 3.2).

Dave Fishwick, Head of Macro Investing at M&G Investments, who runs the $4bn Episode strategy, was one of many managers to gain from short bond positions early last year on the

KEY FINDING

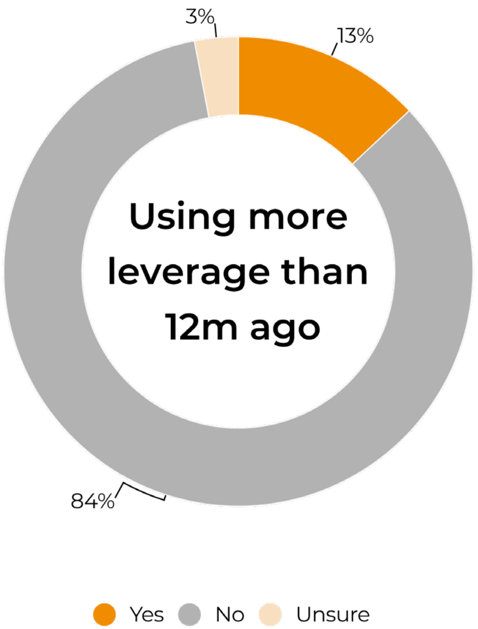
Hedge funds have confidence in their business – but not the global economy

Proportion of hedge fund firms surveyed that were 'very confident' in the 12-month growth prospects of their business, the hedge fund industry, and the global economy:



INSIGHTS

Fig. 3.2 Proportion of hedge fund firms using more leverage in than 12 months ago



Analyst note: *Survey respondents were asked in Q2, 'Is your firm using more leverage across its hedge fund products today than it was 12 months ago?'*

Source: Hedgeweek Q2 2023 Hedge Fund Manager Survey

premise that the probability of persistent inflation was underpriced.

Rising prices have proved anything but "transitory" as central bankers forecast – and Fishwick's fund made 17% last year.

This year is more complex. It has been a rip-roaring first half for equities, with buzz around artificial intelligence breakthroughs fueling a 32% rise by the tech-heavy Nasdaq, its best H1 in 40 years, and the S&P 500 rose 16%.

Few investors expected the comeback from the heavy declines of last year to be so quick against such a difficult economic and central banking background.

But many question what this rally is built on – and whether it will last. Singleton says much of the rally to date may be explained by a change of sentiment from low levels. "Just how much slack there is in sentiment remains a key variable of how much further the equity market can extend to the upside."

Fishwick, who trades across all major asset classes except commodities, thinks it could go either way, and the same is true for the direction of interest rates and economic growth.

"At the moment it is 'sit tight and see which way the market goes' – but the whole [interest rate] policy debate, without a benign resolution, will cause turbulence," he said.

"We try to wait for markets to go definitively one way or another. At the moment they are sitting

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There are more fireworks to come… It’s difficult to position for that today because valuations have adjusted a lot

Dave Fishwick
Head of Macro Investing, M&G Investments

Systematic performance

It was also a 'half of two halves' in the systematic world of managed futures/CTAs.

After losses in Q1, trend-followers and other CTAs posted a third straight month of gains in June to end the first half of 2023 broadly flat for the year.

Winton said financials sector profits helped many managers claw back first-quarter losses and were the main source of trend-following profits in June.

The London-based quant firm, which runs about $10bn, added that trend-followers are heading into July with long exposure to stocks, growing fixed income shorts and mixed positioning in commodities, depending on strategy speed.

New York-based AlphaQuest Original is down 11.1% at the mid-year mark but is hopeful on the outlook.

"While the environment continues to be more challenging for short-term trading strategies, especially for those that utilise momentum as opposed to mean reversion, the price action of markets appears to be exhibiting more favorable characteristics due to implied and realised volatilities nearing their long-term lower bounds," the firm told investors.

Paris-based Lyxor Epsilon Global Trend Fund, up 2.7% for the year, said long equity positions were the biggest driver of its June gain. It has also turned net short on the US dollar, a familiar macro theme going into H2 as the greenback continues to soften.

> "
> the price action of markets appears to be exhibiting more favorable characteristics due to implied and realised volatilities nearing their long-term lower bounds

in the middle, so we are not sure which way we want to price it."

A SOFT LANDING?

A clear divide emerged in H1 between the US economy, which has all but defied recession fears and given the Federal Reserve space to combat inflation effectively without major side-effects, and the UK and eurozone.

Inflation, particularly in the UK, has remained stubbornly high across the Atlantic and anaemic growth will be hit further by the continuing course of rate hikes required by the Bank of England.

More divergence in central bank policy in the second half of the year could increase opportunities for macro managers, according to Jeffrey B Klein, a Managing Director at Goldman Sachs External Investing Group.

He told Reuters there is likely to be less coordinated action in the second half of the year due to the different strategies now being used to combat inflation.

Much of the policy debate over inflation has related to the pace at which central banks can hike rates without causing a recession.

Gavyn Davies, chairman of macro firm Fulcrum Asset Management in London, thinks the

US economy could be hit by a demand-side slowdown as pandemic-era savings run out and rate hikes have a delayed impact in H2.

"Interesting new research by the Fed suggests that the combined effects of these two demand-side factors will begin to fade by the end of 2023, making the economy more vulnerable to a demand-side slowdown," he wrote in a note.

However, it is all relative. "Overall, a clash between a slowing economy and hostile monetary policy seems far more probable in the EU than in the US, at least for now."

RISK/REWARD EQUATION

Though Fishwick is sitting tight, he does see an opportunity on the horizon in the persistent forecasts for next year and beyond that inflation will return to somewhere in the region of 2%.

"There is a degree still embedded in markets, particularly after the recent rallies in equities – but also [given] what's happened on the long end of the curve – of hope and wishful thinking," he said.

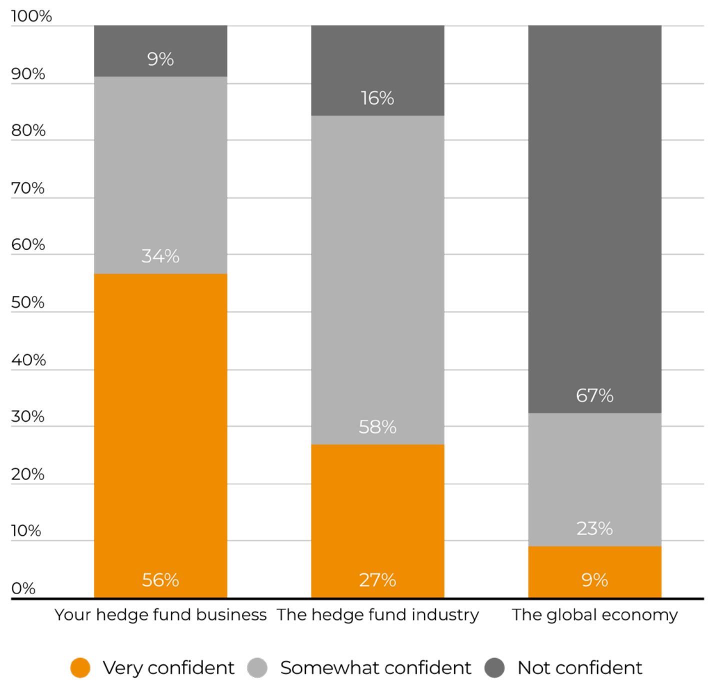
"There are more fireworks to come in my view. It's difficult to position for that today because valuations have adjusted a lot." But the decline in bond prices may not last.

"If you ask me over a glass of wine to say where the inflation rate will be, I'll probably tell you it's going to be a [two point something] as well. But in terms of thinking are you being paid for the risk that it's not, the answer is no, not really." ■

KEY TAKEAWAY

The strong comeback in equities in H1 caught many hedge fund investors – and managers – off guard. But with questions around the foundations and longevity of the rally, and interest rates expected to cause further turbulence, it is not uncommon to find macro managers adopting a 'wait and see' approach in H2.

Fig. 3.3 Hedge fund firms' confidence of the 12-month growth prospects of their business, the industry, and the economy



Analyst note: *Survey respondents were asked in Q2, 'How confident are you in the 12-month growth prospects of the following?'*

Source: Hedgeweek Q2 2023 Hedge Fund Manager Survey

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