December 2019

As we look toward what might drive hedge fund returns in 2020, a key consideration for us is staying on top of sector and regional rotations in equity and fixed income markets. We see evidence of improving clarity regarding disparate corporate fundamentals, which should help markets revert from the recent environment of alternating fear and complacency.

We see several areas of opportunity as this shift takes place. For example, complacent and widespread investor pessimism for European equities overlooks one of the opportunities most attractive to us. With headline fatigue plaguing the region, European equities have trailed their peers in other developed markets, particularly the United States. Uncertainty has surrounded Brexit, and weakness in European economies has been widely broadcasted, particularly for Germany and the United Kingdom. Might this bad news be more than priced into the region’s bourses?

Regional Pessimism Obscures the Potential from Tailwinds

It is often at the apex of pessimism that the greatest potential presents itself. Given a well-telegraphed cautious backdrop, we see a compelling risk/reward profile for European equities for several reasons. Our analysis indicates European earnings estimates have a strong likelihood of improving dramatically in the fourth quarter of 2019 and in 2020. The European Central Bank has also initiated a new round of stimulus. And any relief of macro uncertainty would provide a further meaningful tailwind.

Insurance-linked securities (ILS) is another area where we see the potential for competitive performance with low volatility. Moderating inflows and loss “creep” from prior years’ events have recently weighed on performance for the broader industry, and a record level of insured losses for the industry were incurred over 2017 and 2018. Largely as a result of investor pessimism, the market yield for ILS has adjusted to a higher level and stood at a premium relative to many other fixed income investment choices as of early November. These higher yields across ILS instruments provide support for higher return potential during 2020 for ILS strategies, in our opinion. Furthermore, we find catastrophe bond pricing at the most attractive level since 2013.

Volatility arbitrage is another market where see the potential for meaningful performance. The generally benign environment for
risk assets has been masking the significant underlying fragility of the financial markets, in our opinion. This fragility can best be measured by the suddenness and severity of occasional volatility spikes—both in equities and, more recently, in fixed income and commodities. In our experience, directional and relative value opportunities typically accompany higher market volatility. Given this dynamic, we maintain a favorable outlook for volatility arbitrage strategies due to their predisposition to benefit from such unexpected market moves, and potential for attractive diversification benefits.

Do Not Forget About the Potential for Inflation
Conversely, we see headwinds signaling caution in other areas. Global government bonds have sharply rallied for a good part of 2019, resulting in crowded long positioning, what we view as some fear-driven pricing, and pervasive negative yields in many countries. Negative yields accounted for nearly one quarter of the Bloomberg Barclays Global Aggregate Bond Index as of November 1, 2019. Investors have widely adopted consensus expectations for weak inflation to persist. However, several potential developments in 2020 could resuscitate inflation: more clarity on trade agreements, continued wage growth, resolution on Brexit and companies resuming capital investments that have been on hold amid geopolitical uncertainty. This list of catalysts is by no means exhaustive; however, it supports our view that investor complacency toward inflation could come back to bite government bond prices. As we have witnessed in 2019, yields can move rapidly and dramatically over short time frames.

As we look toward 2020, a key consideration for us is staying on top of sector and regional rotations. In summary, we see fundamentals returning as a primary investment factor, and investors may well experience a reversion-to-the-mean environment. Hedge fund managers who attentively shift both their long and short positioning alongside these rotations could enjoy a compelling opportunity for performance potential.

Endnotes

1. Source: Bloomberg, as of 11/1/19. Indexes are unmanaged and one cannot invest in an index. They do not include fees, expenses or sales charges.
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