Crossbow Partners
Experience & Discipline

New York Trip Report

June 2023

Executive Summary

For the past months the clash between "Goldilocks" macro outcomes with Fed hawkishness has driven global dispersion. In Q3 2023 the net effect for equities assets has been negative. Fixed income has fare slightly better than equities and the USD has re-strengthened.

Another result of the Fed's hawkishness and the (surprising) resilience of US macro has been a widening international divergence. Even as the US showed resilience, euro area PMIs continued to fall and German business confidence indices continued to decline.

The international divergence was most evident in the 2.5% appreciation of the trade-weighted index of the USD. The British pound (GBP) and the Japanese yen (JPY) were particularly hard hit in September. The latter is down 12% year-to-date and has also been hurt by confusing messaging from the Japanese authorities that they want to prevent the yen from depreciating but also do not want to bring forward the normalization of ultra-accommodative monetary policy.

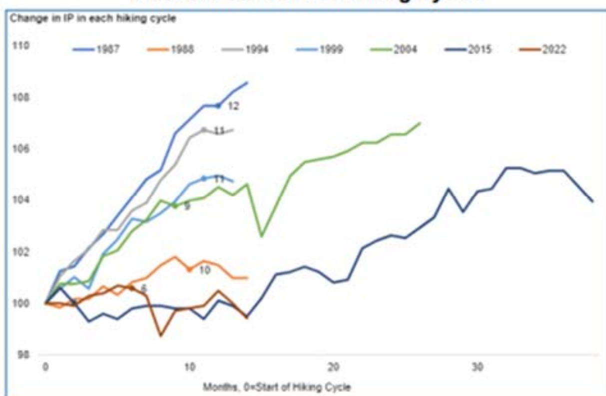
Macro divergence could be reduced if there is a stronger rebound in China. So far, there have been some signs of tentative stabilization in China in September. But it is not strong or broad-based enough to offset the US macro exceptionalism. The drag from China's real estate sector is likely to remain problematic through 2024, and possibly longer.

Goldilocks versus Fed hawkishness

Headline inflation has been on the decline for several months, and recent monthly data provided fresh evidence of the underlying resilience of the US economy, with retail sales and manufacturing PMIs surprising on the upside. Jobs continued to be added at a healthy pace, even as vacancies declined somewhat, and real wage growth held firm.

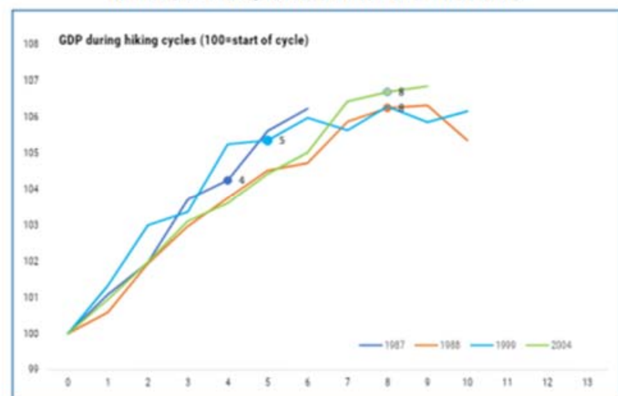
But as US inflation is decelerating and the real economy is proving resilient, there is a debate on whether more tightening is needed or not. There is a growing school of thought that monetary policy lags might be shorter this cycle and that, therefore, policy may not be restrictive.

US IP Typically Starts Decelerating 2–4 Quarters After the Start of Fed Hiking Cycles



Source: Federal Reserve, Morgan Stanley Research

In Fed Hiking Cycles When GDP Decelerated, It Did So 4–8 Quarters After the First Hike



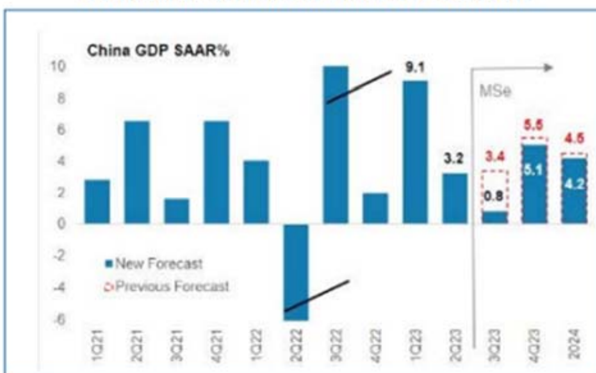
Source: BEA, Morgan Stanley Research

But US economists do not find clear evidence that the Fed's faster hikes have shortened lags, and they continue to argue that policy is in sufficiently restrictive territory and that a large part of the economic slowdown is yet to come.

The Fed's policy response to all this was cautious, dampening market hopes for a dovish policy pivot. Initially it seemed that markets had finally gotten the message that the U.S. Federal Reserve is planning to keep rates higher for longer. Since 2021, the Fed has cautioned investors that inflation could prove sticky and that the central bank will steadfastly keep interest rates higher as needed to bring inflation to a heel.

One caveat to this discussion is the prospect of China exporting disinflation with Chinese inflation turning negative. For China to export meaningful disinflation, it will likely have to come through one of three channels: reduced Chinese demand for commodities that leads to a retreat in global commodities prices; currency depreciation; or exporters cutting their prices.

Downward Revisions in China GDP Forecast



Source: CEIC, Morgan Stanley Research (e) estimates

Deflation in China is Evident

Source: Haver, Morgan Stanley Research

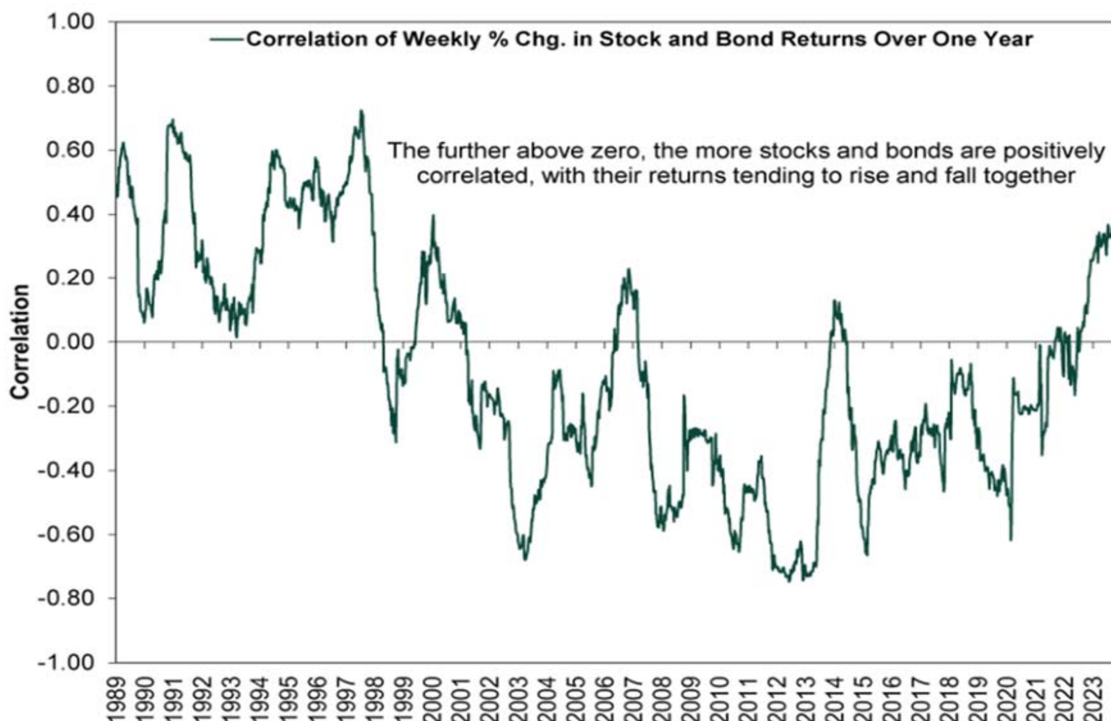
After recently tumbling into “correction” territory, U.S. equities staged a strong rebound. The S&P 500 Index advanced 5.9% in a week, its best weekly performance of the year, accompanied by a pullback in bond yields as the 10-year Treasury yield fell 26 basis points to 4.57%. Investors, it seems, may be looking forward to continued gains from here on, hoping to end the year with a “Santa Claus rally.”

But what’s behind this latest bounce-back in stocks? It looks like the market zeroed in on the fact that the Federal Reserve left interest rates unchanged in its November meeting, keeping the target federal funds rate between 5.25% and 5.50%. With that, pundits and bullish investors were quick to return to the narrative that the rate-hiking cycle is now over, the inflation fight is won and growth in corporate profits lies ahead.

What has this meant for hedge funds?

This Goldilock scenario of soft landing stands in contrast to many of the views taken by hedge fund managers this year. On average the hedge funds has believed the inverted yield curve and persistent inflation would weigh on equity markets.

One important effect of this has been the change in the correlation between bonds and equities, which after many years of negative correlation, has moved into positive territory.

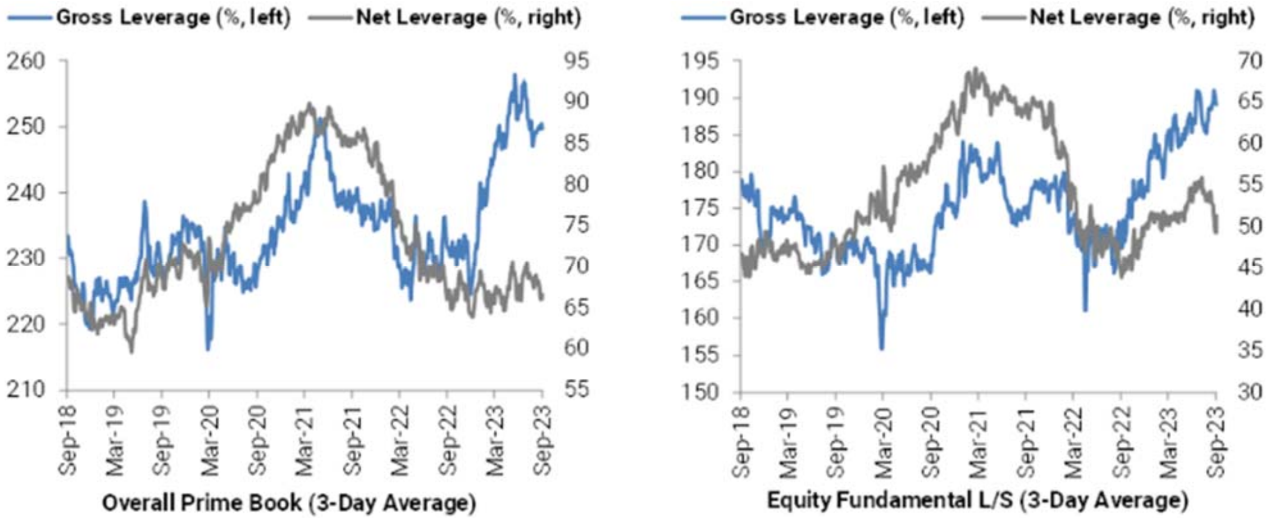


Source: FactSet, as of 9/18/2023. S&P 500 and ICE BofA 7 – 10-Year US Treasury Index total returns, 1/8/1989 – 9/15/2023.

With positive correlation between the two most important assets classes, investors no longer benefit from the diversification effect in their portfolios. The forces them to look for diversification in other strategies, which is where hedge funds with lower net exposures and active strategies can add to the diversification to traditional assets.

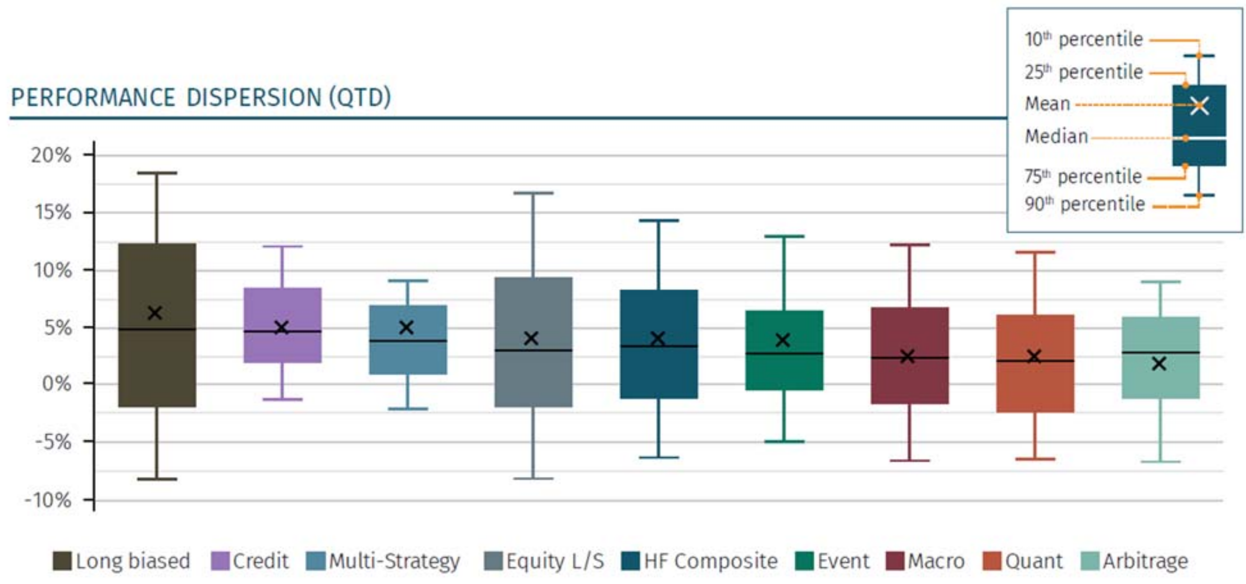
The fact that hedge funds focus on capital preservation can provide a hedge in the case of a market correction while still allowing for upside capture in a rebound. To protect on the downside hedge funds will dynamically manage their exposures.

This is evident in the exposure reports of the hedge fund industry. As inflation concerns became more prominent, hedge funds brought down net exposure by increasing their hedges. The fact that gross exposure in blue is at a multi-year high is because to the increase in short exposure.



Source: Goldman Sachs

As a result, hedge funds are less exposed to market directionality. In Q3 2023, the majority of hedge funds were able to deliver positive performance compared to markets which were down during the quarter.



Source: Aurum Hedge Fund Data Q3 2023

Noticable is the positive performance from long biased hedge funds thanks to their strong security selection skills. Dispersion of manager performance within the same strategy is expected and an opportunity for manager selection.