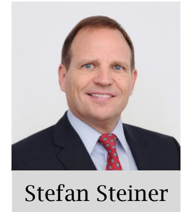
Outlook 2023

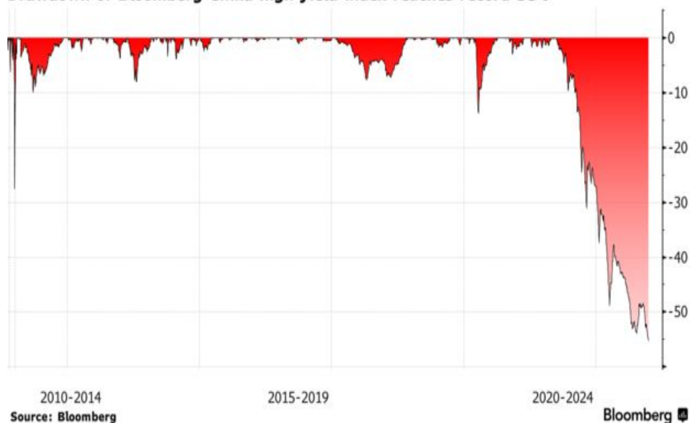
The sentiment has brightened because the labor markets and thus consumption are holding up well. In addition, China is suddenly opening up completely after a long and painful zero-Covid policy, which should trigger a considerable backlog that will be noticeable in Asia and worldwide. This significantly reduces the risk of a severe recession in 2023, which is now expected to be mild.

In our view, this should keep core inflation elevated for longer and central banks will not be able to cut rates as expected by the markets later in 2023. Rates of 3.5% in Europe and 5% in the US will lead to a bounce back into fixed income and will weigh on equity markets. In addition, persistent inflation increases the risk that wages and other costs will rise more sharply, which will have a negative impact on company margins. We expect that the still high earnings expectations in the US of +10% per annum over the next three years cannot be achieved, which will put pressure on the stock markets in the USA.

The bond markets are looking more attractive because the general interest rate level has risen and higher default risk expectations are slowing. Some of the equity and high yield markets collapsed massively in 2022 and have potential for recovery in the next few years. We see good opportunities in Asia and specifically in China, which experienced its real estate and financial crisis in 2022 (see chart). We therefore propose to allocate more to L/S equity in Greater China and to global high yield bonds that promise double-digit returns over the next few years. Further information can be found in the following articles of this newsletter.



Stefan Steiner



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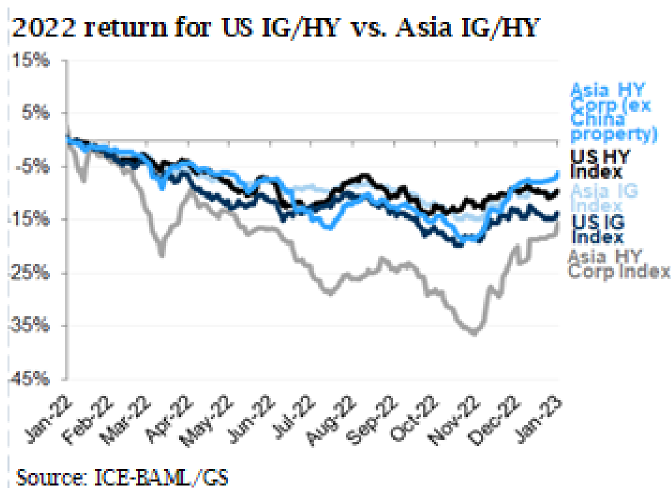
In the limelight

Global High Yield Credit had one of the worst years in 2022. We see attractive potential in the recovery of the high yield markets, especially in Asia. In the US and Europe we will add exposure to specialist of stressed and distressed investments who have a much bigger opportunity set after 2022. Our global high yield strategy recommends allocations across several managers who are investing in long and short opportunities and therefore are partly hedged against a market correction. The liquidity of the strategy is quarterly with 45 days' notice.

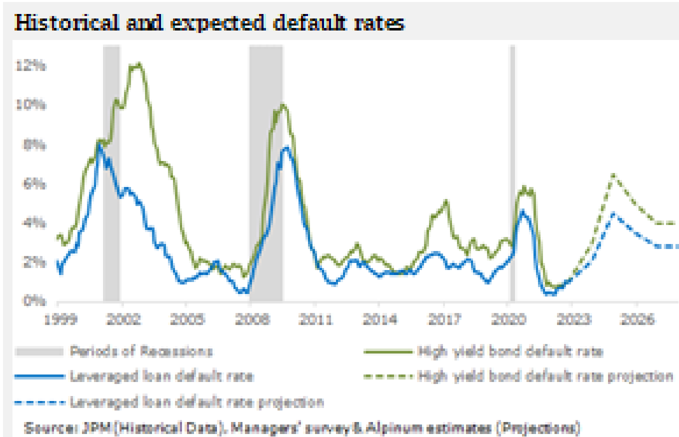
Greater China L/S Equity is looking attractive after China completely dropped all Covid restrictions. Chinese citizen could not travel for three years and often could not even leave their apartments for weeks. This restricted their ability to spend money which will lead to some pent-up demand over the course of 2023. We expect that neighbors like Japan, Korea, Taiwan will benefit first, but also Europe and the US will see many Chinese tourists in 2023. The liquidity of the strategy is monthly with 35 days' notice.

Opportunities in Credit Markets

A combination of rising government bond yields and widening credit spreads created a perfect storm for credit investors for 2022. The US High Yield Indices finished the year down approx. -12%, the second worst annual performance on record, with 2008 being the worst. Losses in Europe were of a similar magnitude, while in Asia they were much larger mainly due to the real estate crisis in China.



Going back to 1984, the US HY Index has only posted eight annual losses. But more importantly, it has never posted back-to-back annual losses. The average recovery of the high yield index after a period of drawdown is +27% average return, or +22% average return with 2008. This came however hand-in-hand with a more benign interest rate environment which is questionable in the next couple of years given the current rates of inflation.



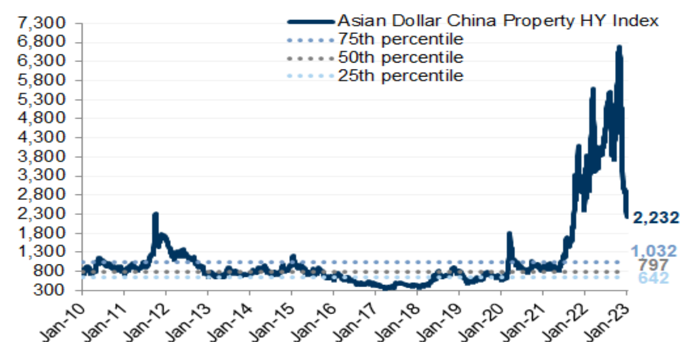
The above chart suggests that default rates will rise in 2023/2024, although from extremely low levels. Companies are facing pressures from higher interest rates and from compressing margins if they can not pass on cost increases. However, many borrowers built up enough buffers during the long stretch of favorable financing conditions to ride out a rough patch which should be supporting credit quality in many sectors.

Ivo Felder

Update on China / Asia HY

2021 and 2022 has seen by far the highest amount of defaults/bond exchanges and maturity extensions in Asian HY, which was mostly due to the collapse of private Chinese real estate companies. A flurry of bad news and defaults of what were seen as financially sound property companies culminated in capitulation selling as markets hit a low in October.

Exhibit 3 : China property HY performance
OAS and historical percentiles from Jan 2010 (bps)



Source: ICE-BAML, Goldman Sachs Global Investment Research

The complete abandonment of Covid restrictions in China as well as the further support of the real estate sector via multi-pronged credit enhancement led to a material bounce in distressed asset prices. It is unlikely that real estate will normalize to its old proportion of GDP but the liquidity and confidence cycle is being reversed from an extremely low base.

Conclusion

The recalibration of credit markets in 2022 means that they are now offering more attractive returns compared to the period where credit spreads were (too) tight as investors were chasing returns in a low interest rate environment. Higher absolute yields, increasing dispersion as markets assess potentially higher default rates and increased risk premia are a great environment for fundamental credit pickers who now find a more attractive opportunity set both for long and short investments. Mispriced yield opportunities across the globe offer a very attractive risk/reward. Despite some expected volatility, we would prefer long-biased managers to maximize returns in this next cycle for credit markets.

For more information please contact Ivo Felder at if@cb-partners.com.

2023 Trends for the Hedge Fund industry

The Agecroft Partners' 14th annual predictions for the biggest trends in the hedge fund industry for 2023 was published. The predictions are based on dialogue with more than 2000 institutional investors and hedge fund organizations.

1. Increase in expected returns for a diversified hedge fund portfolio. With the risk free rate projected to rise above 4%, from close to 0% last year, investor return expectations for a diversified hedge fund portfolio will also increase from the mid-single digits to 7-9% during a period of continued headwinds for the capital markets.

2. Increase in demand for strategies with excess collateral, as for example CTA's, Reinsurance and Market Neutral Long Short Equity. These strategies can benefit from a positive effect of rising short-term rates, as they hold large cash/short-term fixed income positions.

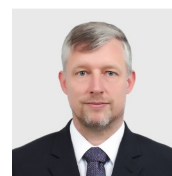
3. Redefining risk. With interest rates expected to continue rising coupled with a moderate recession in 2023, the probability of performance tail risk increases. This will cause many investors to redefine how they view and measure risk. Short volatility and less liquid strategies tend to have the greatest tail risk. These strategies also typically have low volatility and high Sharpe ratios simply because they do not mark-to-market their portfolio.

4. Greater alpha due to higher volatility. The capital markets experienced a large increase in volatility in 2022 due to economic and political uncertainty, which Agecroft expects to continue throughout 2023. This should make it easier for managers to outperform passive benchmarks as larger price movements help skilled hedge fund managers add value through security selection.

5. Continued high concentration of net flows going to a small percentage of managers with the strongest brands. Competition within the hedge fund industry increases each year, with an estimated 15,000 hedge funds in the marketplace.

6. Smaller managers will outperform. One of the biggest issues within the hedge fund industry is the high concentration of flows to the largest managers with the strongest brands. This has caused many of these managers' assets to inflate well past the optimal asset level at which they can maximize returns for their investors. Small and mid-sized managers have a competitive advantage in being nimble and are able to generate meaningful alpha from less efficiently priced areas of the marketplace.

7. Decline in the number of hedge fund organizations. Managers with less than USD 250 million in assets, which represent a majority of hedge funds, are being squeezed from both the expense and revenue sides of their businesses. As a result, the closure rate should continue to rise for small and mid-sized hedge funds.


Armin Vogel

8. Blockchain technology. Agecroft expects modest, if any, asset flows to this sector in 2023, but remain bullish long term. The industry is still in its infancy and will continue to experience tremendous innovation, evolution, and exponential growth over the next decade. Hedge funds will play a much larger role in the industry once security and operational issues improve, correlations between cryptocurrencies and other asset classes decouple, and as future markets are expanded to other blockchain opportunities.

Management Structure and Hedge Funds

Yuhao Chen (Minnesota State University), Huan Kuang (Bryant University) and Bing Liang (University of Massachusetts Amherst) provide the first study on how the management structure of hedge funds affects their performance and risk. They show that hedge funds managed by a solo manager (SMHs) earn higher abnormal returns compared to those managed by a team of managers (TMHs), even though SMHs have higher idiosyncratic and tail risks. Managers of SMHs show better market timing skills than managers of TMHs. Moreover, SMHs survive longer and are less likely to be liquidated, consistent with SMHs flows being less sensitive to fund performance. Finally, a small sample of funds that switch their management structure confirms our findings.

Cyclical dependence in Market Neutral Hedge Funds

Julio Crego (Tilburg University) and Julio Galvez (Banco de España) examine linear correlation and tail dependence between market neutral hedge funds and the market portfolio conditional on the financial cycle. They document that the low correlation between these funds and the S&P 500 consists of a negative correlation during bear periods and a positive one during bull periods. In contrast, the remaining styles present a positive correlation across cycles. They also find that these funds present tail dependence only during bull periods. They study their implications for market timing and risk management, and its consequences on fund flows and survival.

If you wish the above mentioned paper, please contact Armin Vogel at av@cb-partners.com.