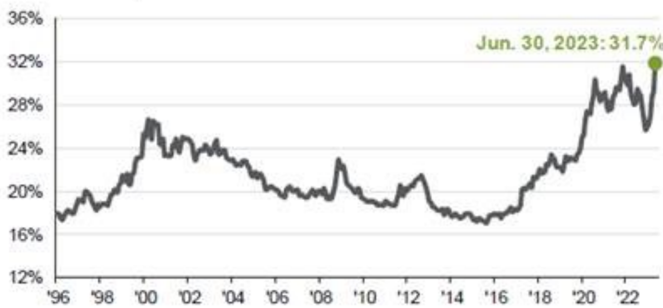
Crossbow Partners
Experience & Discipline

Newsletter July 2023

US Equity Outlook

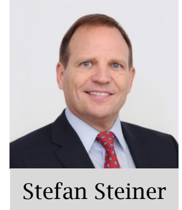
The capital markets have stabilized in 2023 after a weak last year. US equity markets surprised with a stronger-than-expected rebound, although interest rates are still rising and the Fed continues to try to get inflation under control. However, the stock rally of the last few months is mainly driven by large-cap technology stocks. The 10 largest stocks in the S&P500 have thus achieved a weighting of over 30% in the index for the first time. The remaining 490 stocks share 68.3%, as the chart below shows.

Weight of the top 10 stocks in the S&P 500
% of market capitalization of the S&P 500



Quelle: JP Morgan Asset Management

We expect two scenarios for the equity markets and neither of them are promising. Firstly, the high interest rates will lead to a significant economic slowdown in the second half of the year, which will affect corporate earnings and will lead to a correction in the stock markets. Or secondly, the overheating in the USA is continuing, which is causing inflation to sprout again, making even more drastic interest rate hikes necessary and, with a time lag, will also lead to a correction in the stock markets, which would be correspondingly stronger. The US stock market is grossly overvalued relative to interest rates, as illustrated in the chart below. We recommend taking profits and diversifying



Stefan Steiner

Quelle: JP Morgan Asset Management

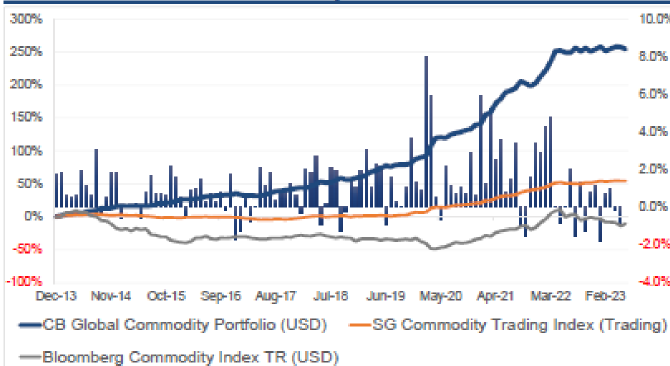
For more information please contact Stefan Steiner at ss@cb-partners.com.

In the limelight

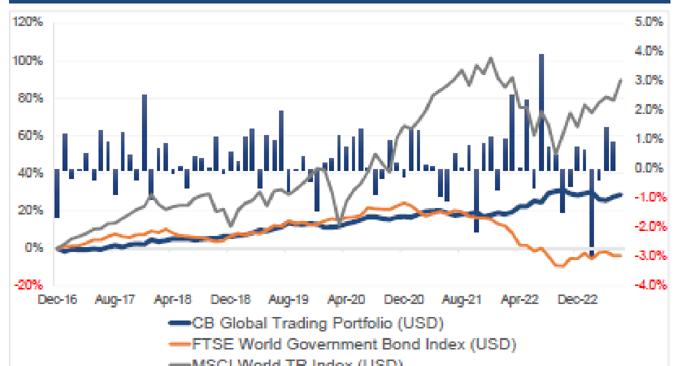
Commodity prices will also come under pressure in a recession, but the managers implement their commodity strategies primarily with very liquid financial futures and can thus quickly and easily profit from negative trends as well. Commodities are a good diversifier because movements tend not to coincide with equity markets and the correlations are therefore low. The CB Global Commodity Portfolio (USD) has already shown in 2022 that it can generate an attractive, positive return even in weak capital markets. The liquidity of the certificate is monthly with a notice period of 45 days.

Global macro managers also have little correlation with the capital markets. The investment strategy relies heavily on financial futures and is fast and agile. Marco managers invest across all asset classes, and commodities are also part of the investment universe, but usually make up less than 10%. Many managers rely primarily on the movements of the interest rate and currency markets. The CB Global Trading Portfolio (USD) is invested in five investment specialists who have a different focus. The certificate generated a positive performance in the difficult 2022. Liquidity is bi-weekly with a notice period of 15 days.

Cumulative returns since January 2014



Cumulative returns since January 2017



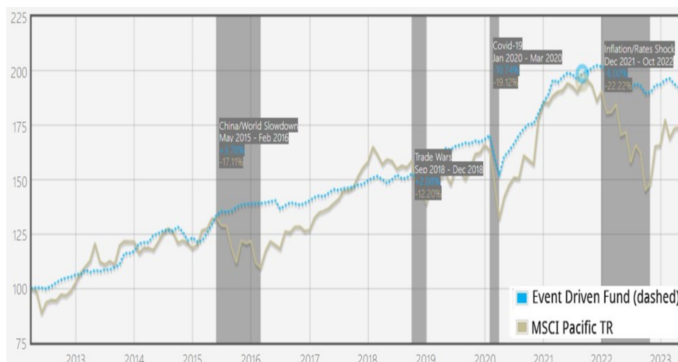
Investment Case Event Driven

Summary

A couple of major deal breaks have led to a sharp widening of merger spreads which has significantly improved forward returns for merger arb strategies. A recent positive ruling by the Court of Appeals in the Cayman Islands has recognized the importance of appraisal rights for protecting minority shareholders. This should materially impact the funds appraisal rights positions in the coming months as the court cases settle. Given the court rulings and the increased merger spreads, the manager expects to deliver double-digit returns over the next 12 months.

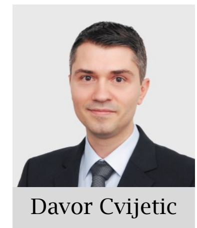
Merger Arbitrage Spreads

The fund has a track record of delivering attractive risk-adjusted returns since its inception, with a compound annual growth rate of +5.8% and a Sharpe ratio above 1. The fund has protected capital during large equity corrections, with its worst drawdown being significantly smaller compared to the broader equity index loss. This demonstrates the fund's ability to manage risk effectively.



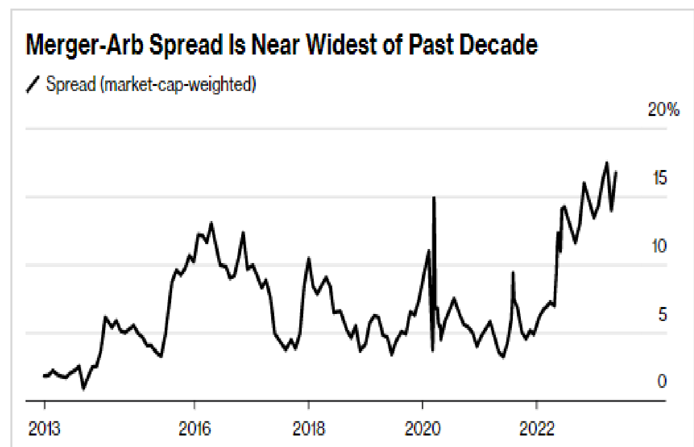
The co-founders of the fund bring extensive experience and expertise to the table. They have a background in portfolio management, M&A banking, M&A law and event-driven investment management. Their combined knowledge and skills position the fund well to identify and capitalize on opportunities in transformative corporate change events.

The fund has still capacity left for investments which presents an opportunity for new investors to participate in the fund's strategies. Additionally, the increase in the number of M&A transactions in Asia and access to onshore China have expanded the capacity for the strategy. The fund can tap into share placements and other spread opportunities, further enhancing its diversification and future return potential.



Davor Cvijetic

Despite recent setbacks in the merger arbitrage space, the manager has avoided significant deal breaks while increasing positions at attractive spreads. The fund's ability to participate in late-stage, unconditional M&A transactions with low deal risk, particularly in the pan-Asian market, provides a unique advantage. The managers are confident that these positions will pay off handsomely once the deals close, and they have been buying spreads at 20% net annualized returns, reflecting a 15% risk premium above the risk-free rate.



Appraisal Rights

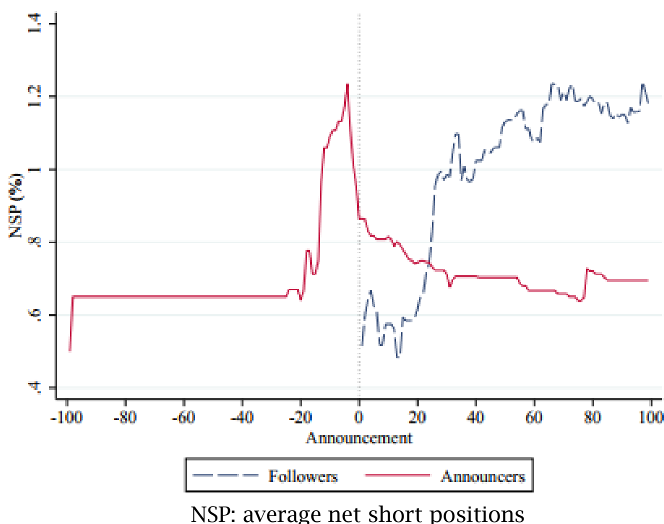
Appraisal rights trades represent a substantial part of the portfolio. The fund, along with other hedge funds, has filed lawsuits in the Cayman Islands and Bermuda to request higher premiums than reflected in the deal prices. Recent developments, including a judgment by the Court of Appeals in the Cayman Islands, have significantly improved their position. The court's recognition of the importance of appraisal rights to protect minority shareholders are expected to unlock substantial value for the fund. The manager anticipates a potential premium of 40-50% above the deal price for some positions, which could result in a significant return contribution over the next 12 months.

Investors can benefit from the fund's unique focus on transformative corporate change events in the Asian market, which provides diversification and potential outperformance compared to capital markets in the current environment.

For more information please contact Davor Cvijetic at dc@cb-partners.com.

See it, Say it, Shorted: Strategic Announcements of Short-Selling Campaigns

Jane Chen from the London School of Economics studied how hedge funds strategically disclose their private information during short-selling campaigns. Using data on hedge funds' voluntary announcements and daily short positions in the EU market, he documents the existence of two groups of funds: Announcers and Followers. Announcers, typically small and young, (1) establish short positions, (2) publish research reports about short targets, and (3) realise profits from the falling price within a short time frame. Followers, usually large, enter at the release of the report and increase their short positions even after announcers exit. To understand strategic interaction among short sellers, he provides a model to explain how size affects a short seller's incentive and behaviour. Small funds benefit more from disclosing when facing binding leverage constraints. In contrast, large funds profit from others' private information by offering capital to price discovery.



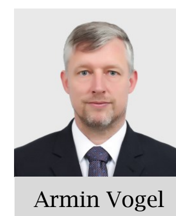
NSP: average net short positions

Moreover, he characterize the effect of such short-selling campaigns on market efficiency.

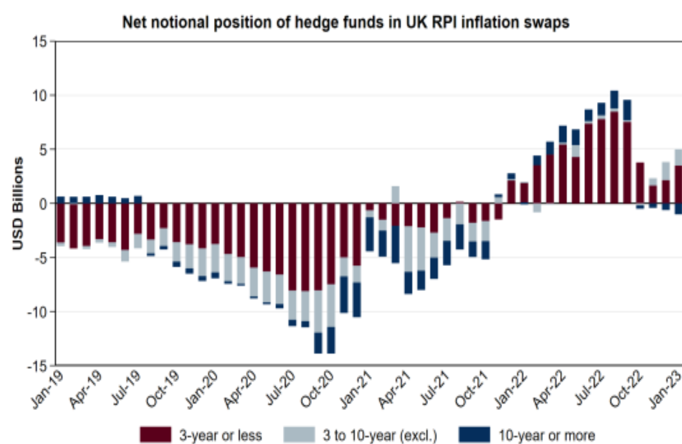
The Market for Inflation Risk

The paper published by Saleem Bahaj, Robert Czech, Sitong Ding and Ricardo Reis (from Bank of England and London School of Economics) uses transaction-level data on the universe of traded UK inflation swaps to characterize who buys and sells inflation risk, when, and with what price elasticity. This provides measures of expected inflation cleaned from liquidity frictions.

They first show that this market is segmented: pension funds trade at long horizons while hedge funds trade at short horizons, with dealer banks as their counterparties in both markets. This segmentation suggests three identification strategies—sign restrictions, granular instrumental variables, and heteroscedasticity—for the demand and supply functions of each investor type. Across the three strategies, they find that (i) prices absorb new information within three days; (ii) the supply of long-horizon inflation protection is very elastic; and (iii) short-horizon price movements are unreliable measures of expected inflation as they primarily reflect liquidity shocks.



Armin Vogel



Their counterfactual measure of long-horizon expected inflation in the absence of these shocks suggests that the risk of a deflation trap during the pandemic and of a persistent rise in inflation following the energy shocks were overstated, while since Autumn of 2022, expected inflation has been lower and falling more rapidly than conventional measures.

Figure 20 FUNDAMENTAL EXPECTED INFLATION

If you wished to receive the above mentioned papers, please contact Armin Vogel at av@cb-partners.com.