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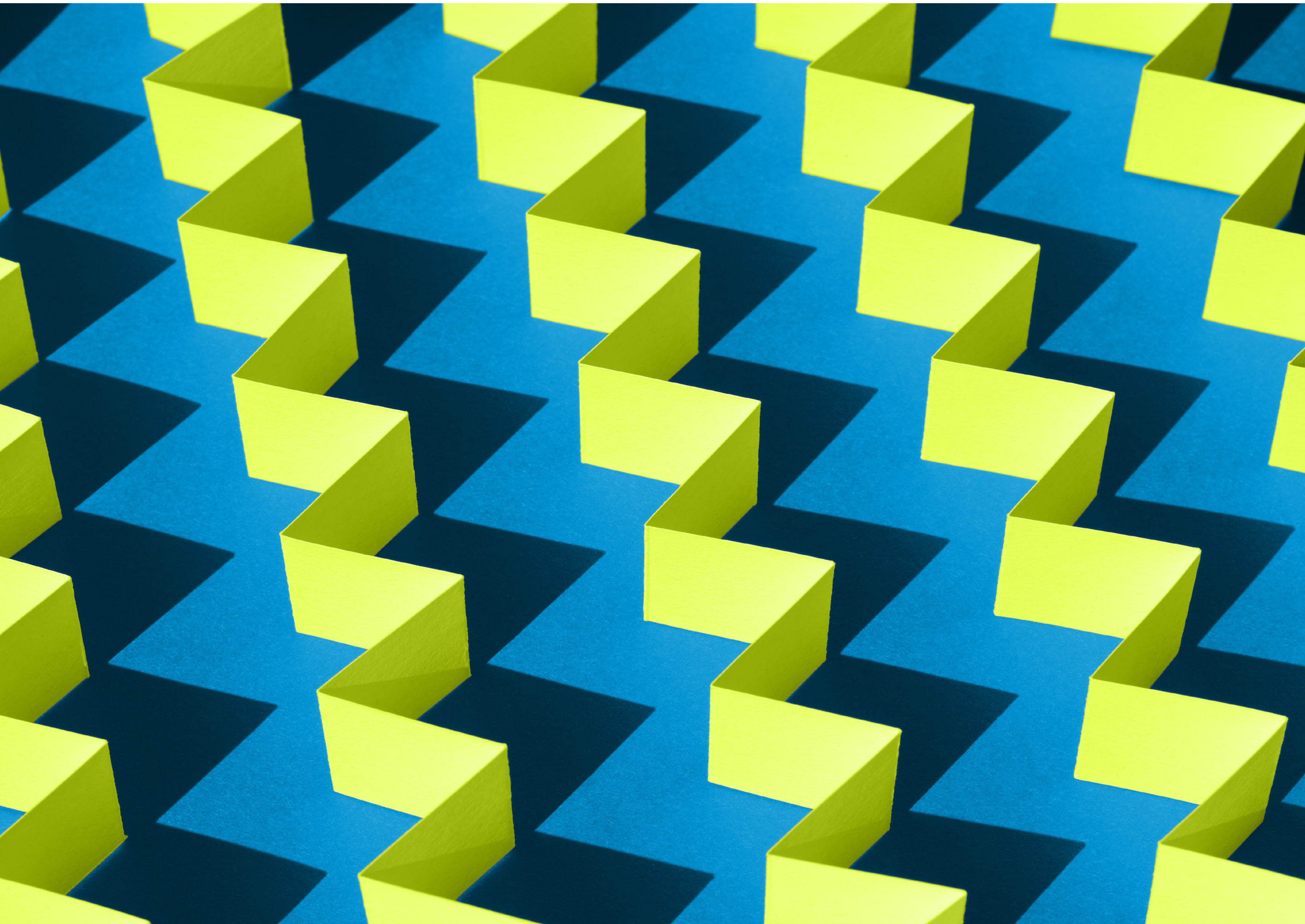
Macro Hedge Funds: Zigging When the Markets Zag

October 2023



Macro investing, executed on a discretionary or systematic basis, has historically performed best when interest rates are higher, when volatility is elevated, and often when traditional asset-only portfolios suffer.

Financial pundits love a good catchphrase, and one that has gained traction of late is "higher for longer." In an effort to curb inflation, the Federal Reserve has hiked rates 11 times since March of 2022, raising the fed funds rate 525 basis points.[1] In the EU, the European Central Bank (ECB) deposit rate reached a record high of 4% in September 2023, a stark contrast from 0% in July of 2022.[2] Yet despite central banks' efforts, inflation remains problematic for consumers and may force policymakers to maintain interest rates at current or potentially higher levels in order to combat elevated prices across the global economy.

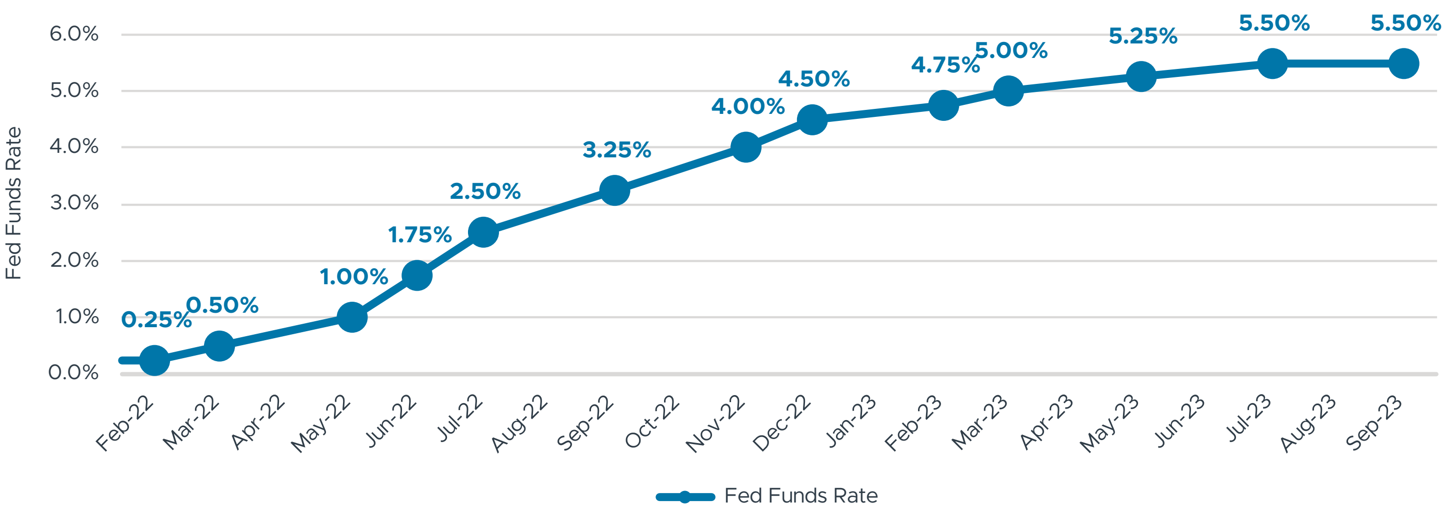
Higher interest rates have an impact on all major asset classes. In equities, over time it widens the dispersion of stocks, differentiating between companies that can effectively handle their capital needs versus those that struggle without the free money lifeline. Shareholders are less willing to invest in highly speculative, longer-dated equities and instead look to companies with a more defined path towards sustained earnings growth.

In credit, companies face higher borrowing costs and tighter loan standards, creating a difficult environment to service and refinance debt, leading to dislocations and heightened volatility globally. According to Goldman Sachs, U.S. companies are expected to see a 7.5% increase in their interest expense over the next two years, which will have a dramatic impact on sub-investment grade issuers with looming debt maturities.[3]

Similarly, in developed and emerging currencies and across the commodities asset classes, the level of interest rates in different countries influences numerous macroeconomic indicators that were largely irrelevant in a world of zero rates. With interest rates higher across the globe, currency

Exhibit 1: Fed Funds Rate Expected to Stay Higher for Longer

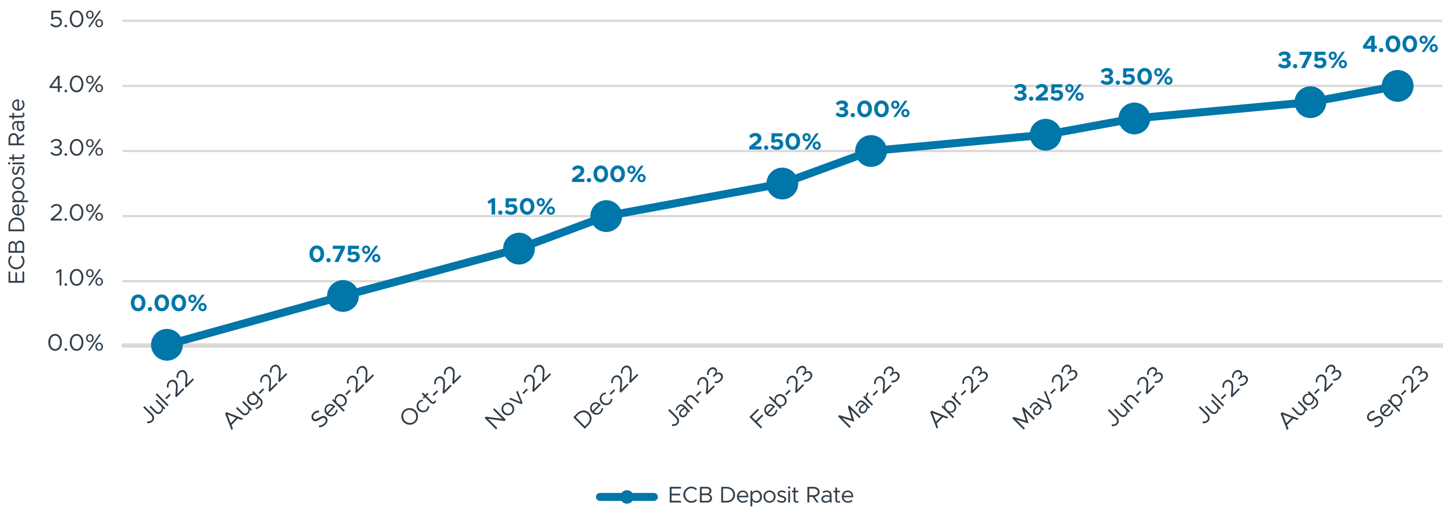
Fed Funds Rate since Feb. 2022



Source: Federal Reserve, as of Oct. 6, 2023. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

Exhibit 2: ECB Deposit Rate reaches record high of 4%

ECB Deposit Rate since July 2022



Source: European Central Bank, Key ECB Interest Rates, as of Oct. 6, 2023. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

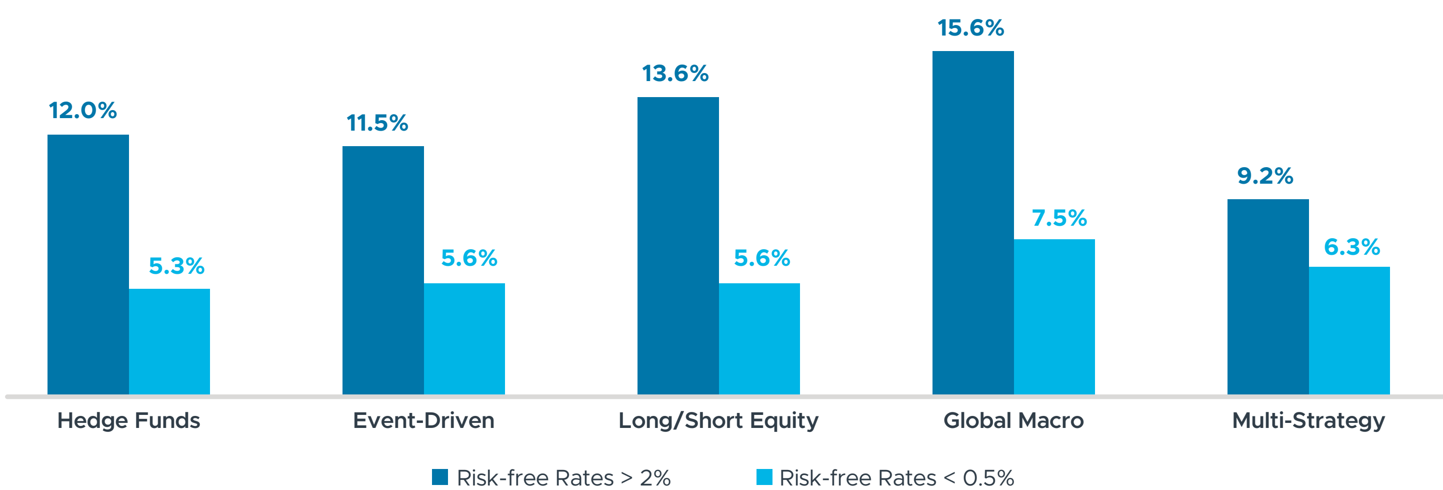
volatility – and by extension, investment opportunities – is likely to remain robust as central banks address their own country's "fight inflation vs. sustain growth" dilemma in a less synchronized manner as compared to the prior decade. One recent case in point – the Japanese yen is trading again at 30-year lows against the U.S. dollar amidst calls for government intervention.[4]

Attractive Environment for Macro

So, if interest rates are likely to stay higher for longer, which strategies are poised to benefit? Macro investing, executed on a discretionary or systematic basis, has historically performed best when interest rates are higher, when volatility is elevated, and often when traditional asset-only portfolios suffer.

Exhibit 3: Hedge Funds Performed Better in Higher Rate Environments

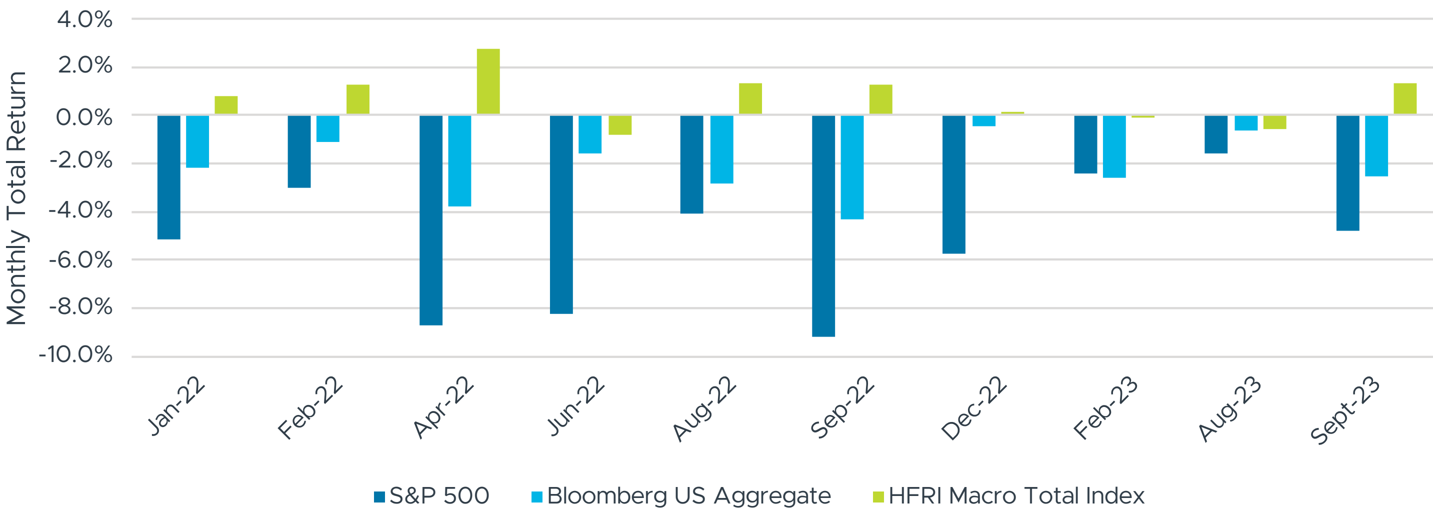
Hedge fund strategy performance in different risk-free rate environments



Source: Blackrock, Hedge Fund Opportunities in a Rising Rates and Uncertain Market Environment, August 2023. Data from Morningstar, median index returns from Jan. 1, 1994 to June 30, 2023. Hedge Funds are represented by the Credit Suisse Hedge Fund Index, Event-Driven by the Credit Suisse Event-Driven Index, Long/Short Equity by the Credit Suisse Long/Short Equity Index, Global Macro by the Credit Suisse Global Macro Index, and Multi-Strategy by the Credit Suisse Multi Strategy Index. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

Exhibit 4: Macro Hedge Funds Have Outperformed in Down Months for Stocks and Bonds

Since January 2022, equities have fallen 10 times, with bonds falling in tandem while macro hedge funds have outperformed



Source: eVestment, as of Oct. 17, 2023. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed. Macro hedge funds represented by the HFRI Macro Total Index, which includes investment managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency, and commodity markets. These managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods.

The fiscal strain and widening dispersion in stock performance, as well as shifting fixed income yields/pricing and volatility in global currencies, provide macro hedge fund managers an opportunity to outperform. Returns for macro hedge fund managers are primarily driven by large market and price movements in either direction, providing macro investors the opportunity to generate uncorrelated returns, regardless of the direction of risk assets. This further demonstrates the benefit of macro hedge funds – in addition to their significant liquidity and multi-asset class diversification, they tend to outperform not only when only stocks and bonds falter, but more typically when volatility and uncertainty are heightened.

Diversification in Traditional-Asset Portfolios

One of the most significant benefits from non-correlated hedge fund strategies like macro is diversification, particularly when equities and bonds in traditional asset-only portfolios are moving in tandem. When the 60 and 40 are positively correlated (particularly on the downside), this portfolio benefit increases dramatically.

September is historically the worst month of the year for stocks, and thus far 2023 has been no exception, with the S&P 500 Index, Russell 2000 Index, Nasdaq Composite Index, and MSCI World Index all down more than 4%.[5] September was also the worst month of the year for bonds, with the Bloomberg U.S. Aggregate Bond Index and Bloomberg Global Aggregate Bond Index down -2.54% and -2.92%, respectively.[6]

Since January of 2022, the S&P 500 Index has declined 10 times, and every time equities have declined, bonds have fallen.[7] While traditional long-only investors were negatively impacted by the positive correlation between stocks and bonds, macro hedge funds delivered positive returns 7 out of the 10 months equities and bonds fell in tandem, and provided meaningful downside protection in the 3 other periods.[8]

Conclusion

From our vantage point, while we may be nearing the end of rising interest rates, investors are still assessing the implications of a sustained period of higher rates, one that may last longer than many have anticipated. In this environment, higher interest rates will impact stocks and bonds, currencies, and commodities very differently, providing strategic and tactical investment opportunities for skilled portfolio managers to drive returns in an uncorrelated manner. By capturing those return-generating opportunities, we believe macro hedge funds should continue to drive value in client portfolios.

ENDNOTES

1. Federal Reserve, as of Oct. 6, 2023.
2. European Central Bank, Key ECB Interest Rates, as of Oct. 6, 2023.
3. Goldman Sachs Global Investment Research, The Corporate Debt Maturity Wall: Implications for Capex and Employment, Aug. 6, 2023.
4. Reuters, Japan Keeps Markets Guessing on Yen Intervention, Warns Against Sharp Falls, Oct. 4, 2023.
5. Bloomberg, as of Oct. 9, 2023. S&P 500 Index down -4.87%, Russell 2000 Index down -6.03%, Nasdaq Composite Index down -5.81%, and MSCI World Index down -4.45%.
6. Bloomberg, as of Oct. 9, 2023.
7. eVestment, as of Oct. 10, 2023.
8. eVestment, as of Oct. 10, 2023. Macro hedge funds represented by the HFRI Macro Total Index.

INDEX DEFINITIONS

Credit Suisse Event-Driven Index: A subset of the Credit Suisse Hedge Fund Index that measures the aggregate performance of Event-Driven funds. Event-Driven funds typically invest in various asset classes and seek to profit from potential mispricing of securities related to a specific corporate or market event. Such events can include: mergers, bankruptcies, financial or operational stress, restructurings, asset sales, recapitalizations, spin-offs, litigation, regulatory and legislative changes as well as other types of corporate events. Event-Driven funds can invest in equities, fixed income instruments (investment grade, high yield, bank debt, convertible debt and distressed), options and various other derivatives. Many Event-Driven fund managers use a combination of strategies and adjust exposures based on the opportunity sets in each subsector.

Credit Suisse Global Macro Index: A subset of the Credit Suisse Hedge Fund Index that measures the aggregate performance of global macro funds. Global macro funds typically focus on identifying extreme price valuations and leverage is often applied on the anticipated price movements in equity, currency, interest rate and commodity markets. Managers typically employ a top-down global approach to concentrate on forecasting how political trends and global macroeconomic events affect the valuation of financial instruments. Profits can be made by correctly anticipating price movements in global markets and having the flexibility to use a broad investment mandate, with the ability to hold positions in practically any market with any instrument. These approaches may be systematic trend following models, or discretionary.

Credit Suisse Hedge Fund Index: An asset-weighted hedge fund index that includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 9,000 funds and consists only of funds with a minimum of US$50 million under management, a 12-month track record, and audited financial statements. The index is calculated and rebalanced on a monthly basis, and reflects performance net of all hedge fund component performance fees and expenses.

Credit Suisse Long/Short Equity Index: A subset of the Credit Suisse Hedge Fund Index that measures the aggregate performance of long/short equity funds. Long/short equity funds typically invest in both long and short sides of equity markets, generally focusing on diversifying or hedging across particular sectors, regions, or market capitalizations. Managers typically have the flexibility to shift from value to growth; small to medium to large capitalization stocks; and net long to net short. Managers can also trade equity futures and options as well as equity related securities and debt or build portfolios that are more concentrated than traditional long-only equity funds.

Credit Suisse Multi Strategy Index: A subset of the Credit Suisse Hedge Fund Index that measures the aggregate performance of multi-strategy funds. Multi-strategy funds typically are characterized by their ability to allocate capital based on perceived opportunities among several hedge fund strategies. Through the diversification of capital, managers seek to deliver consistently positive returns regardless of the directional movement in equity, interest rate or currency markets. The added diversification benefits may reduce the risk profile and help to smooth returns, reduce volatility, and decrease asset-class and single-strategy risks. Strategies adopted in a multi-strategy fund may include, but are not limited to, convertible bond arbitrage, equity long/short, statistical arbitrage, and merger arbitrage.

HFRI Macro Total Index: Includes investment managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency, and commodity markets. These managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods.

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