INVESTCORP

INVESTCORP ENVIRONMENT REPORT

3Q 2019

INVESTMENT PROFESSIONALS

Lionel Erdely	Head and Chief Investment Officer of Absolute Return Investments
Gregory Berman, CFA	Head of Equity and Credit Strategies
Jonathan Feeney	Head of Macro and Relative Value Strategies
Gayan Wijesinha, CFA	Macro and Relative Value Strategies Analyst
Vincent Berthelemy	Cross-Asset Research
Christopher Teixeira	Cross-Asset Research
Michael Malvarosa	Macro and Relative Value Strategies Analyst
David Endler, CFA	Portfolio Manager, Credit Management
David Nadeau	Portfolio Manager / Trader Credit Management
David Fewtrell	Portfolio Manager / Trader, Credit Management
Andrew Strong	Portfolio Manager, Credit Management

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OVERVIEW

We are delighted to introduce the 3Q 2019 edition of the Investcorp Environment Report, where we share selected insights from our proprietary research and internal models. As noted previously, our investment framework combines "cycle-aware" analyses of the macroeconomic drivers of traditional and alternative risk premia with more traditional valuation, technical and flow-driven investment approaches. We also model the cyclical outlook for alpha generation for each major hedge fund strategy. Our report begins in Section II with an overview of the major themes in the global macroeconomic environment: we evaluate where we are in the business cycle and draw out the implications for traditional beta markets.

Global Macro Environment

Global growth momentum stabilized in recent weeks, thanks to supportive monetary policies and fading geopolitical headwinds – notably on the trade front. Still, the growth outlook appears mixed with continued weakness in the manufacturing sector for example. The inflation outlook remains relatively benign despite greater evidence of tighter labor markets and lower output gaps.

Still, much of the uncertainty that crippled markets last year has not disappeared. The trade issues have not been settled yet and we doubt any resolution would fully alleviate the risk premium as enforcement questions would continue to cloud investments decisions longer-term. And the impact of stimulative monetary & fiscal policies is also subject to potential lags and/or lower multiplier effect than currently discounted by markets.

In that environment, we opt for patience and prudence. This translates into lower risk budgets, greater appetite for liquidity, positive carry and a balance between upside capture and downside protection.

Alternative Risk Premia

In Section III, we discuss the cyclical outlook for alternative risk premia. In **cash equities, we are downgrading our outlook for Quality to neutral, taking profit on our overweight position**. We retain our overweight in value as signs emerge of a yield curve steepening, extreme valuations and positioning signals. In Fixed Income, we are staying underweight in Rates Carry and Value strategies but prefer an allocation to Front-Rate-Bias strategies in Emerging Markets. In credit, we also opt for Emerging Markets hard currency debt, on an absolute and relative basis – against high-yield corporate debt. Our constructive stance on emerging markets is also expressed in foreign exchange with a preference for carry. We stay constructive on mean reversion as the strategy should be in a strong position to monetize higher realized volatility in foreign exchange.

Hedge Funds

In Section IV, we synthesize our perspectives on traditional and alternative risk premia into forward-looking views for major hedge fund strategies. We downgrade beta-heavy strategies to an underweight as we see limited tailwinds from equity markets going forward. **We maintain our greater appetite for liquidity at this stage of the business cycle.**

Finally, we **remain constructive on the broad Global Macro opportunity set, directional and relative value players**. Volatility arbitrage could also benefit from a higher volatility environment with strong regional and asset class dispersion offering attractive relative value trades.

U.S. and European Broadly Syndicated Leveraged Loans

In this section, our credit teams across the Atlantic share insights over recent performance drivers for the asset class and their outlook for the coming quarters.

GLOBAL MACRO ENVIRONMENT AND TRADITIONAL BETA MARKETS

Strategy	Negative	Neutral	Positive	Comments
Equity	□□■	□	□□□	Underweight exposure to global equities on decelerating earnings, demanding valuations and stretched expectations of greater monetary easing while macro remains weak
US	□□■	□	□□□	US, a growth play with allocation to Tech. Poor earnings momentum and elevated valuations leave little room for error. Positioning can continue to fuel upside, if "FOMO" behavior re-appears but we prefer to take profit and re-build dry powder here
Euro area	□□■	□	□□□	A value play, but with limited catalysts ahead and growing risks of falling in the "secular stagnation" trap. Risks of disorderly Brexit and autos tariffs still concerning medium-term. Needs Chinese growth re-acceleration to stand out.
Japan	□□■	□	□□□	Another value play, with lower tail risks attached. Monetary policy remains supportive and the earnings outlook decent, mind the impact of the consumption tax hike
Emerging Markets	□□■	□	□□□	Play on a successful Chinese stimulus and potential move lower in the dollar, supporting the global liquidity environment
Duration	□□■	□	□□□	
US	□□□	■	□□□	Negative Equity/Rates correlation re-asserting itself as inflation fears fade and growth concerns take center stage. Rates have disconnected (a bit) from equities, pricing in a worse growth outcome, for now
Europe	□■■	□	□□□	Limited value for diversification at current levels, a pure carry play with negative asymmetry if growth were to surprise to the upside
Japan	□■■	□	□□□	Limited value for diversification at current levels, a pure carry play with negative asymmetry if growth were to surprise to the upside
Credit	□□■	□	□□□	
Dev. High Yield	□□■	□	□□□	Spreads have tightened sharply, leaving little value & cushion if growth continues to decelerate. Typically underperforms later cycle although corporate deleveraging trends could be a positive medium term
EM	□□□	□	■□□	Attractive carry and better valuations from an historical perspective.
FX	□□□	■	□□□	
USD	□□■	□	□□□	Challenged longer-term on growing twin deficits and elevated valuations. Decent relative economic momentum a plus and supported by high interest rate diff. vs G3
EUR	□□□	■	□□□	Near-term outlook neutral on poor growth momentum but value and flow dynamics could be supportive longer-term
JPY	□□□	□	■□□	Narrowing interest rate differential and strong valuation make the yen an attractive hedge in diversified multi-asset portfolios

GLOBAL MACRO AND MARKETS OUTLOOK

Global Macro

We begin our discussion of the outlook ahead by detailing our perspectives on the global economy's current momentum with respect to growth and inflation dynamics. Absent major contra-cyclical forces, we find that momentum generally offers the best forecast of the near-term evolution of the economic system. We then study the nature and strength of identified and potential negative feedback loops, the catalysts and tipping points lying ahead that could meaningfully alter the economic system direction of travel. Next, we evaluate flow and positioning signals to determine what is priced in and to identify pockets of entrenched investor expectations. Finally, we conclude with an update of our asset allocation playbook.

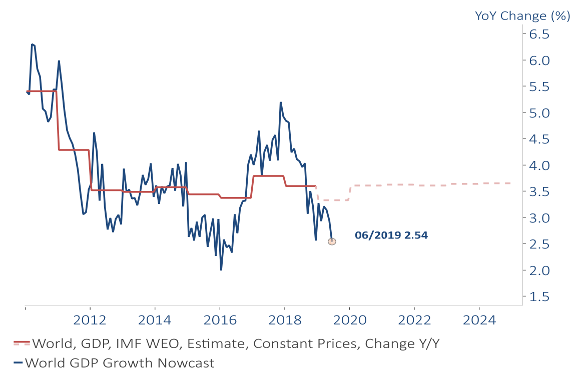
Fundamentals

Assessing Global Economic Momentum

Our approach to macro analysis originates with an assessment of global economic momentum along two primary vectors: growth and inflation. We seek to understand direction and speed of travel across a large set of macro variables in an effort to identify the path of least resistance for the economic system. After that, we consider contracyclical forces and their potential tipping points, any factor that could bring about a change in regime.

As usual, we kick things off with an update of our Global Aggregate GDP Nowcast indicator. As can be seen in the following chart, measures of global economic activity have continued to decelerate since the end of the first quarter. Global growth is now expected to be slightly above 2.5%, significantly below IMF forecasts for the year. The slowdown has been particularly acute in the manufacturing and traded sectors, where the lagged effect of heightened policy uncertainty, last year's Chinese deleveraging, and higher US interest rates is taking its toll on sentiment and business investment decision-making.

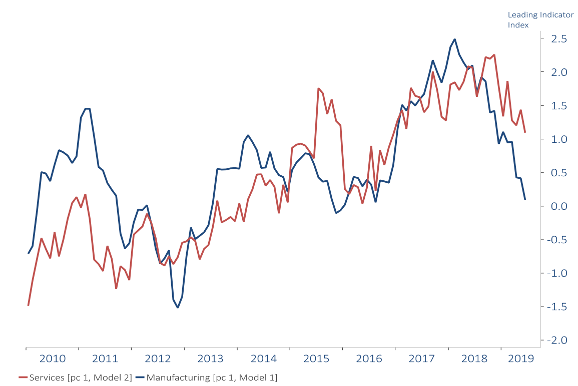
Global GDP Aggregate Nowcast



Source: Goldman Sachs, Morgan Stanley, Investcorp, Macrobond

The services sector, in contrast, has been somewhat buoyant, bolstered by the resilient US consumer, as indicated by the two charts below. Low unemployment, decent real wage growth, and a high savings ratio remain tailwinds for the segment. Still, a sustained downtrend in manufacturing could have a more far-reaching effect, which may already be evident in the recent services gauge decline. That said, this year's policy shifts by the Federal Reserve and the Chinese leadership may well brighten the outlook for manufacturing, assuming the Damocles' sword of rising US trade frictions doesn't tip the sector into outright recession first. Should this happen, we believe the rest of the economy would likely fall into line and hopes for a further extension of the current cycle could quickly evaporate.

US Leading Economic Indicators – Manufacturing vs. Services



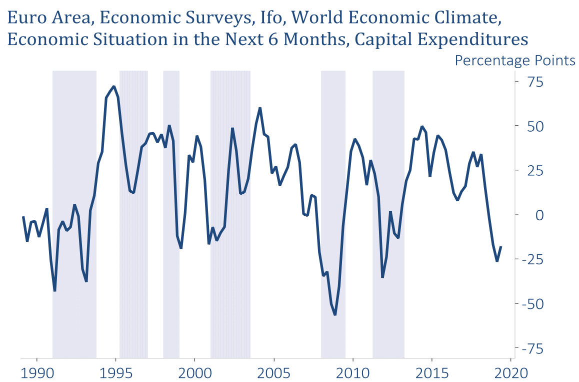
Source: Investcorp

US Economic Leading Indicators – Consumer vs. Corporate

Source: Investcorp

In Europe, the ongoing slide in macroeconomic momentum is showing tentative signs of reaching its nadir; as can be seen in the following chart, capital spending expectations have recently staged a slight rebound. Nevertheless, the situation remains fragile and the calendar going forward is laden with potential negative catalysts. Among other things, the likely ratification of Boris Johnson as the UK's next Prime Minister has raised the risk of a disorderly "no deal" Brexit, while in Italy, the summer lull could prove short-lived when the government begins negotiations in the fall regarding its 2020 budget.

Europe Capex Expectations

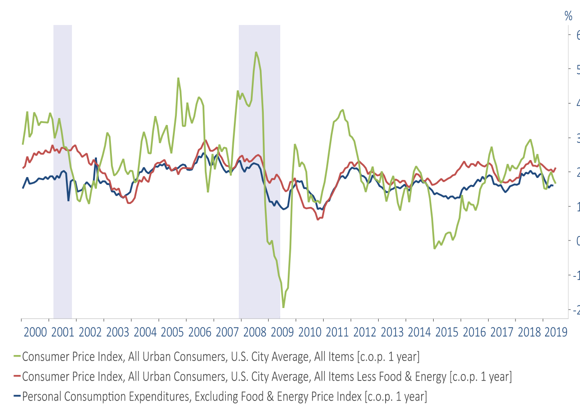


Source: Investcorp

Finally, the risks of further trade-related woes have not disappeared. President Donald Trump has kept his options open regarding the previously announced Section 232 investigation into Europe's automobile sector, while measures aimed at retaliating against increased European taxation and regulation of large US tech firms are also on the table.

With respect to global inflation dynamics – the US gauge is featured in the following chart – we anticipate that expectations will stabilize and gradually firm from where they are now. As evidenced by communications from the Fed and other central banks, policymakers are committed to engineering, through whatever means are necessary, a reflationary process that will alleviate some of the risks associated with rates being pegged near the zero-lower bound.

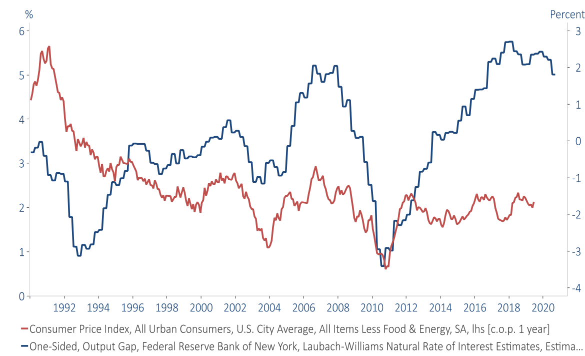
US Inflation Measures



Source: Investcorp

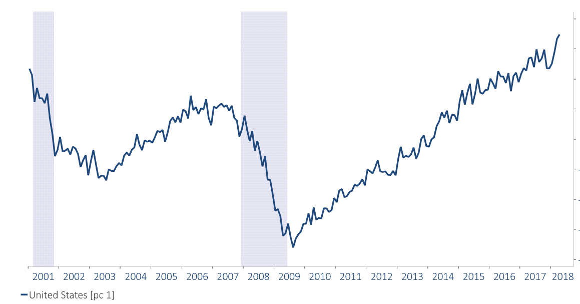
Lending further weight, output gaps in the US, highlighted in the next chart, as well as globally remain in or near positive territory, and industry surveys continue to point to limited slack in the economy. The American job market, in particular, is nearing historically high levels of tightness, as can be seen in the second chart. Even assuming that the Philip's curve becomes flatter, these factors will likely spur, in the medium term, a normalization of inflation toward the central bank's target. Moreover, the suggestion in recent policymaker communications of a willingness to run the economy "hot" and allow for an overshoot of targets to compensate for persistent undershooting in the past suggests that central bankers are more sanguine than normal about the risks to the upside, at least in the near term. Against this backdrop, it appears that central banks will seek to target an average inflation rate throughout the cycle, allowing for periodic over-shoots following downturns.

US CPI and Output Gap



Source: Investcorp

US Labor Market Tightness Indicator



Source: Investcorp

Despite the more dovish stance, it is yet to be seen whether the new framework will spur a reorientation of long-term inflation expectations. Inflation still faces structural headwinds that are difficult to quantify, including the effects of technological innovation and globalization. Taken together, however, we believe the various dynamics will engender a slightly higher path for inflation in coming quarters. Such an outcome will likely be welcomed by developed market central banks and governments alike, especially in Europe, where social disturbances in France and Italy continue to suggest a need to ease the pressures through higher nominal wages. These should feed into higher prices down the line.

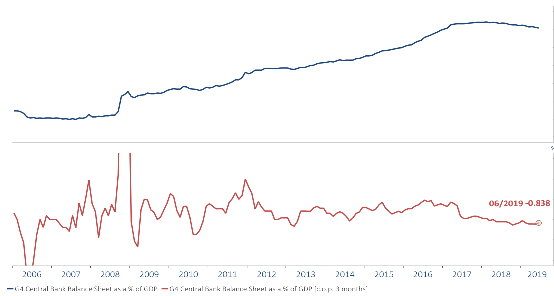
It is worth bearing in mind that any outlook for inflation needs to account for the uncertainties associated with econometric models. Most are heavy with assumptions, including economic system stationarity. By the same token, output gap calculations remain conditioned on future productivity growth assessments, which are something of a challenge given the technology transformations that are currently underway.

Indeed, we could well imagine a scenario where innovation finally feeds through to productivity, allowing for a sustained higher growth rate accompanied by subdued inflationary pressures. On a related note, the ongoing cyclical uplift in inflation should also take account of longer-term structural forces that could limit the extent of a rapid rise in prices. Regardless, each of these developments is difficult to estimate and, as a practical matter, tracking momentum may well prove to be the best playbook for gauging where inflationary tipping points may lie.

What could swing the economic pendulum the other way?

Our review of potential countercyclical factors begins with an update on global liquidity. As shown in the chart following, the pace of growth in G4-region central bank balance sheets – computed as a percentage of GDP on a three-month lookback basis – has continued to contract. The deceleration so far has largely been driven by the Fed, which has not been reinvesting the full notional value of the redemptions in its System Open Market Account portfolio. That said, the speed of redemptions has eased from the fall, when the balance sheet reduction program reached its peak $50 billion per month.

G4 Central Banks Balance Sheet (as a % of GDP), 3-Month Rate of Change

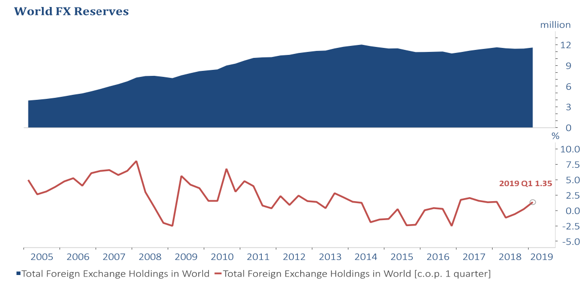


Source: Bloomberg, Investcorp

Since then, however, the Fed has shifted gears. In May, the pace of monthly redemptions fell from $30 billion to $15 billion, where it is expected to stay until the program ends in September. At the same time, the ECB has been tapering its quantitative easing program; it plans to reduce monthly asset purchases from 30 billion to 15 billion euros in September, and to zero after December. Consequently, the next few months should see aggregate balance sheet holdings stabilize – and potentially turn positive amid continued accommodation by the Bank of Japan and China's PBoC – transforming what had been a headwind into a potential tailwind for the remainder of the year.

Helping matters further, liquidity is also being bolstered by the EM central bank foreign exchange reserve accumulation that has been occurring following a period of contraction in last year's second half. The US central bank's dovish posture has helped alleviate upside pressure on the dollar, affording developing market authorities a renewed opportunity to boost foreign currency war chests, as can be seen in the following chart.

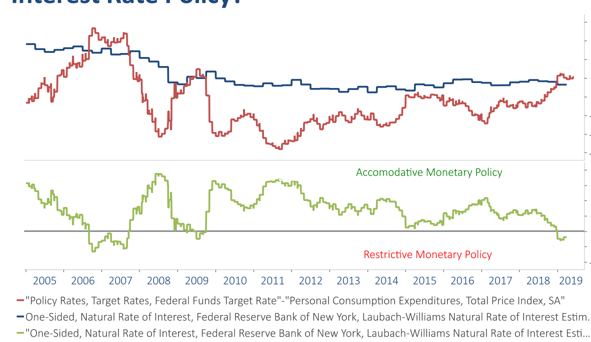
World Foreign Exchange Reserves (in $ Millions), 3-Month Rate of Change



Source: IMF, Investcorp

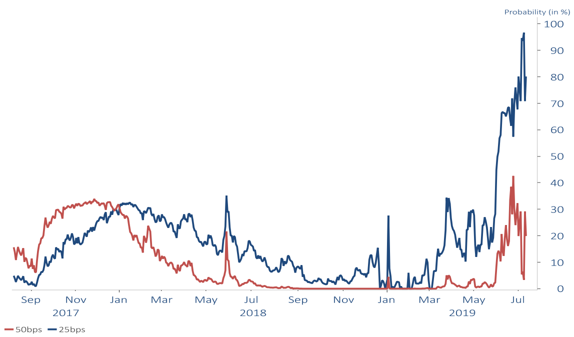
In terms of monetary policy more broadly, our model had moved into restrictive territory following the Fed's last rate hike in December, as shown in the first chart below, though the situation has changed since then. As noted earlier, Chairman Jerome Powell and the FOMC have been communicating their intentions to be more accommodative in an effort to aid the economy and alleviate contractionary pressures building in the manufacturing sector. As the second chart suggests, investors were quick to get the message.

How Accommodative Is the Federal Reserve's Interest Rate Policy?



Source: Macrobond, Investcorp

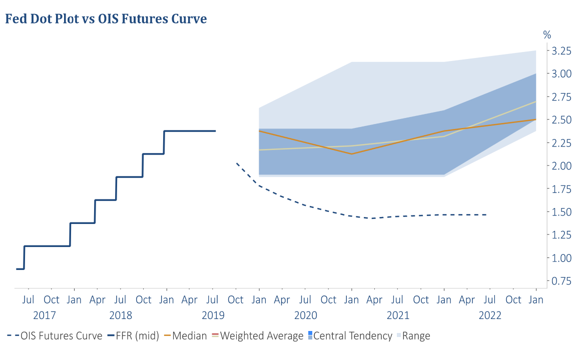
Investors Have Responded to the Fed's pivot



Source: Macrobond, Investcorp

Indeed, expectations have become more dovish as the summer has unfolded. Based on the OIS futures curve illustrated below, investors are looking for interest rates to fall by as much as 75 basis points over the next 12 months. This is despite the fact that the US central bank has only a limited history of providing "insurance cuts" – lowering rates in spite of fairly loose financial conditions. However, investors are focusing more on what policymakers are saying now than on what their predecessors did previously.

What are markets discounting?

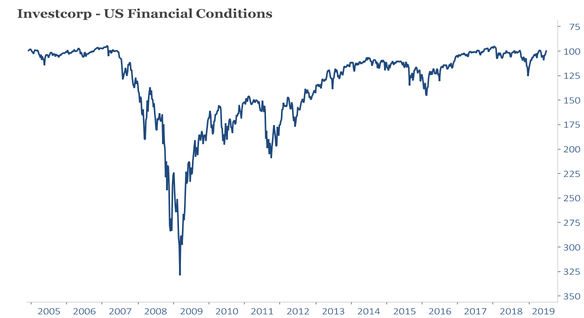


Source: Macrobond, Investcorp

Lending further weight, the ECB has reopened the door to further interest rate cuts and new stimulative measures with its latest targeted longer-term refinancing operations (TLTRO). However, unlike before, we believe the central bank will need to consider the heavy toll that negative rates are taking on the region's lenders should they be pushed still lower. The importance of the European banking sector in channeling credit to the local economies cannot be overstated, an issue that has become more pressing given the adverse impact that ultra-accommodative policies have already had on the group's profitability.

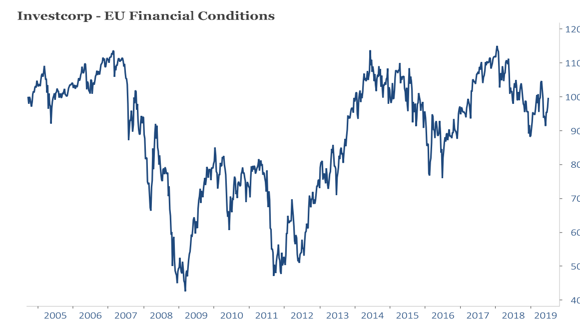
Regardless, it is not just monetary policy that has seen a turnabout. As evidenced by the three charts following, financial conditions have also improved markedly across geographies. It appears that the dovish pivot by central bankers was enough to bolster confidence and fuel a renewed search for yield, leading to tighter credit spreads and an upward re-rating of equity valuations. As it happens, history suggests that improving financial condition are a reliable indicator of future growth, which should go some way toward stabilizing the downward momentum seen more recently. That said, the measure has proved to be volatile, with concomitantly increased tail-risk prospects.

Financial Conditions in the US



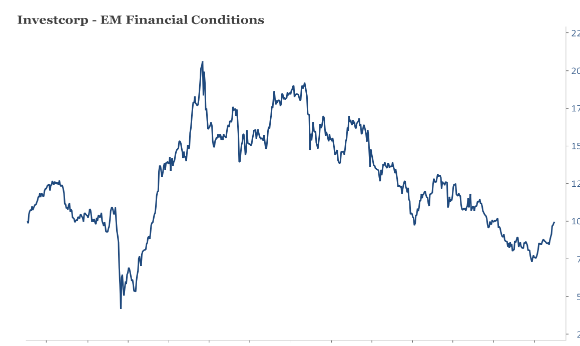
Source: Investcorp

Financial Conditions in Europe



Source: Investcorp

Financial Conditions in Emerging Markets



Source: Investcorp

China

In China, fiscal and monetary authorities have mobilized to address the ongoing slowdown. They have provided incremental stimulus that included front-loaded issuance of local government bonds, January's 100 basis point reduction in reserve requirements, and the announcement during the National People's Congress of a fiscal package that included cuts in VAT. Authorities are attempting to strike a balance by stimulating growth enough to avoid a hard landing but not so much that it jeopardizes prior credit-related structural reforms.

However, at least some of these efforts, including their focus on state-owned enterprises (SOEs), appear to be counterproductive. According to research from the Peterson Institute, prioritizing SOEs has likely proved costly to Chinese productivity, especially when taking into account the detrimental impact that a restructuring of the shadow banking credit channel has had on small- and medium-sized private companies, which are typically not well served by the large domestic banks.

Moreover, as was eloquently discussed in Angel Ubide's Paradox of Risk, incremental approaches tend to have greater calibration risks than the "shock & awe" variety. Nevertheless, Chinese authorities persist in their preference for preserving past policies and longer-term financial stability, including lowering the country's growth objective to the 6-6.5% range. While we are guardedly optimistic that recent efforts will be enough to stem the falloff in activity, we would want to see more of a sustained upturn in credit creation and business activity than is evident in the two subsequent charts to bolster our conviction about the eventual outcome.

China Credit Impulse – Minor Uptick So Far

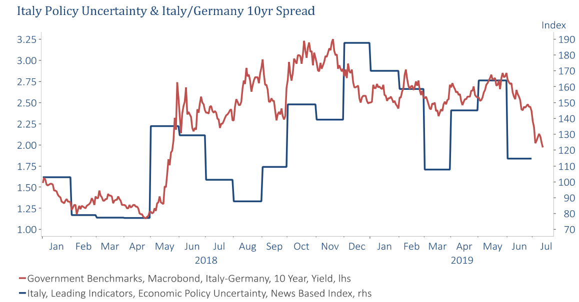
Source: Macrobond, Bloomberg

Government Policy

Government policy and geopolitical risks have been major forces behind market movements in recent months although often difficult to fully anticipate. Europe has so far been the major source of concern for investors, with the Italian political volatility and budget issues and the ongoing Brexit negotiations.

In Italy, we expect the summer lull – already somewhat apparent in the chart following – to continue amid limited headlines from political leaders and a European Commission focused on its leadership transition. Volatility could return to the fore in the autumn, however, once negotiations surrounding the country's 2020 budget begin in earnest. With that, it would not be surprising to see another round of aggressive rhetoric from Deputy Prime Minister Matteo Salvini, putting the already fragile coalition between Lega and Five Star at risk. Should the alliance fall apart, we would anticipate seeing a technocratic government overseeing day-to-day affairs as the country gears up for new elections.

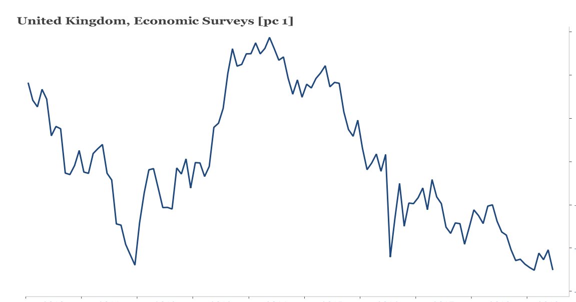
Italy Economic Uncertainty Index and Italian Debt Spread vs. Germany (10-year)



Source: Macrobond, Investcorp

Over in the UK, meanwhile, we expect Boris Johnson to win the Conservative leadership election with a mandate to deliver Brexit following the failure of Theresa May's Chequers plan. With limited time remaining until the October 31 deadline, this has significantly increased the risk of a disorderly "no deal" exit, adding to already depressed sentiment, illustrated in the chart below. In our view, the odds of a fresh agreement and concessions from the Continent within that timeframe are extremely remote; the only alternative is to put the question to UK voters once again, either through a new referendum or general elections.

UK Economic Sentiment

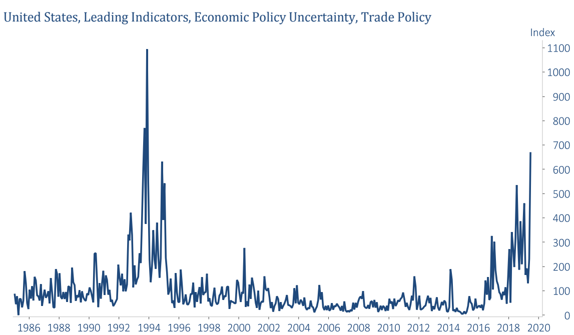


Source: Macrobond, Investcorp

From a Continent-wide perspective, the risks associated with continuing trade uncertainty, illustrated in the chart below, will likely remain elevated amid President Trump's insistence on keeping his options open. As noted earlier, this could mean extending the deadline for imposing Section 232 tariffs on the European automobile sector, along with a fresh push for retaliation in response to French-sponsored proposals to tax and regulate large technology players. Under the circumstances, transatlantic trade relationships could easily become ensnared in tit for tat protectionism.

In sum, then, geopolitical risks are likely to remain a significant source of uncertainty for the region's economic outlook in the period ahead. Despite a few hopeful signs that the worst may be behind us, investors should continue to tread lightly until matters become clear.

US Trade Policy Uncertainty Index



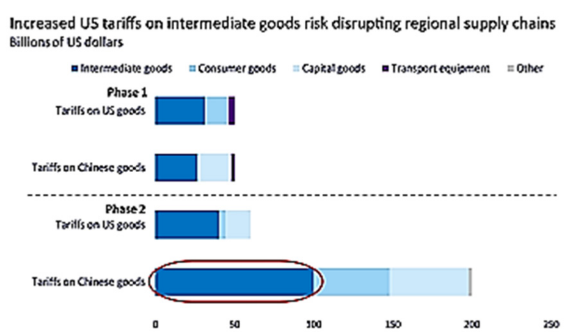
Source: Macrobond, Investcorp

Finally, in regard to tariff policy more broadly, we believe the status quo will continue in the short run. The odds what we will see a "grand bargain" seem low in the wake of the latest breakdown in US-China negotiations; we see limited prospects for a compromise given the gap that exists between the two sides. With this in mind, tariff-related uncertainty – already a major source of concern, as can be seen below – will likely remain a meaningful headwind to corporate investment and could further weigh on the manufacturing sector. If so, hopes for a further extension of the current cycle may prove illusory.

Tariffs – Greatest Source of Worry for US Corporates

Source: JPMorgan

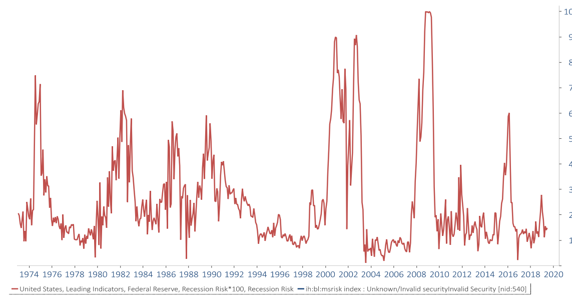
Nature of Chinese Goods Being Targeted Heightens the Risk of Distribution



Source: The Peterson Institute, Eurasia

Finally, we conclude with 12-months ahead US recession risk forecasts, which are based on models from the Federal Reserve and Morgan Stanley, illustrated below, continue to paint a benign picture of the economy. Both models are below the unconditioned probability of 20%. That said, the relentless flattening of the yield curve has been signaling some level of concern over the medium-term growth outlook. Taken alone, we would not seek to read too much of this indicator as its timing horizon has been variable and changes in market structure could well have distorted its informational value.

Recession Risk Models



Source: Morgan Stanley, Federal Reserve, Investcorp

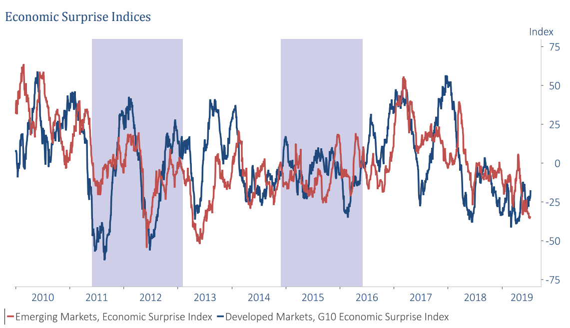
What's priced in?

There is more to our outlook than economic, political and geopolitical themes and dynamics. As usual, we also incorporate data on sentiment and positioning across different markets and investor segments into our analysis. This helps us to identify areas where our views diverge meaningfully from market assumptions, potentially shedding light on opportunities for tactical asset allocation. The following paragraphs provide a brief overview of our thoughts in this regard.

We begin our review with an assessment of economic surprise indices, which, as evidenced by the first chart below, reveal that activity has generally been outpacing expectations in developed markets but has come up short in emerging markets. In contrast, inflation data has continued to surprise to the downside in both regions, as evidenced by the second chart, a trend that appears headed for a test of its historical lows.

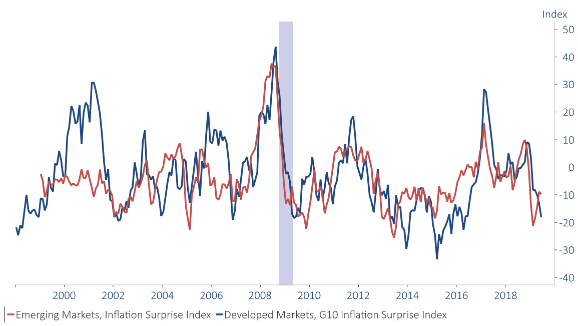
Surveys

Economic Surprise Index – G10 and EM Universe



Source: Citi, Investcorp

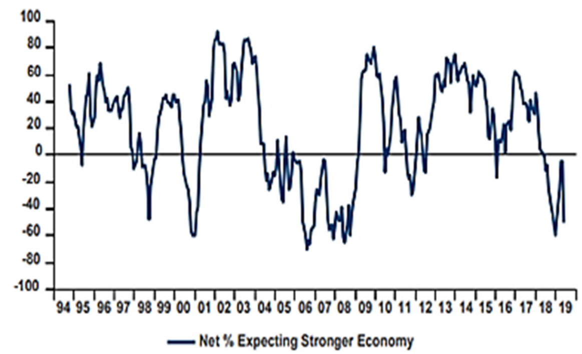
Inflation Surprise Index – G10 and EM Universe



Source: Citi, Investcorp

The somewhat mixed picture in the economic surprise indices appears at odds with what some other measures are suggesting. As can be seen in the following chart, sourced from the Global Fund Manager Survey overseen by Bank of America Merrill Lynch's Michael Hartnett, investors have recently turned quite bearish again on the outlook for growth. In fact, the gauge has fallen back near its December lows, suggesting the investment community sees things differently than economic analysts do. Based on this, it appears that a slow-down is the consensus call for the period ahead.

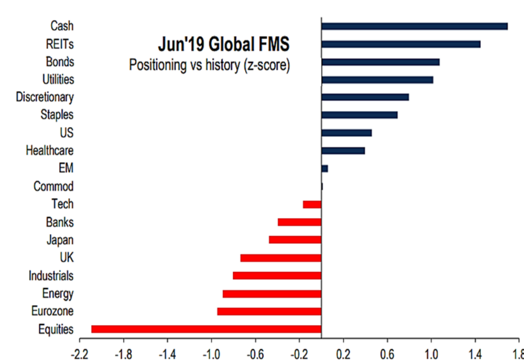
Net % of Investors Expecting a Stronger Economy Over the Next 12 Months



Source: BAML

That cautious outlook is also apparent in positioning data, as can be seen in another chart from the Global Fund Manager Survey included below. Cash, bonds and defensive equity plays, including fixed-income proxies such as real estate and utilities, are among the most overweighted assets in institutional portfolios. At the other end of the spectrum, exposure to cyclical assets such as European equities and the industrial and energy sectors remains fairly light.

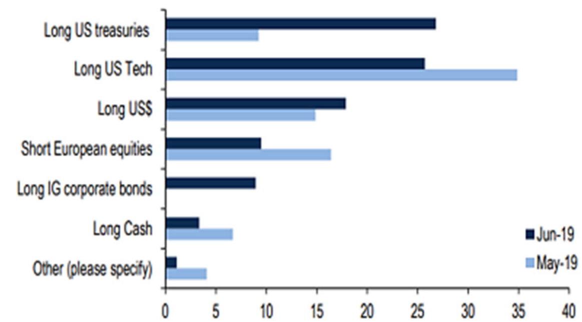
Global Fund Manager Survey



Source: BAML

Institutional investors appear to acknowledge that defensive positioning is near an extreme. According to the Survey, long fixed-income and long equity growth are among the most crowded trades, as evidenced by the chart below. This is consistent with an entrenched conviction that secular stagnation, accompanied by lower interest rates and limited prospects for earnings growth, will prevail.

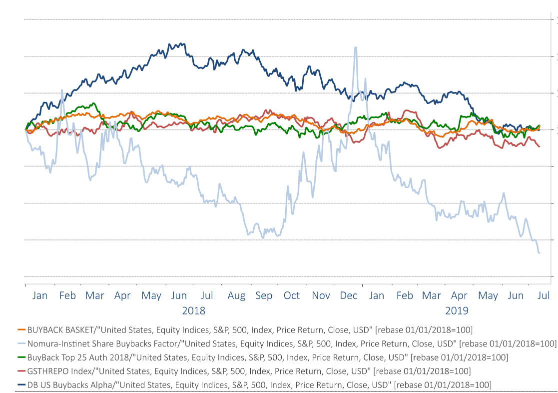
What are the most crowded trades?



Source: BAML

Separately, buybacks have not been playing much of a role in recent equity market activity, as the following chart suggests.

Buybacks – Diminishing Impact?

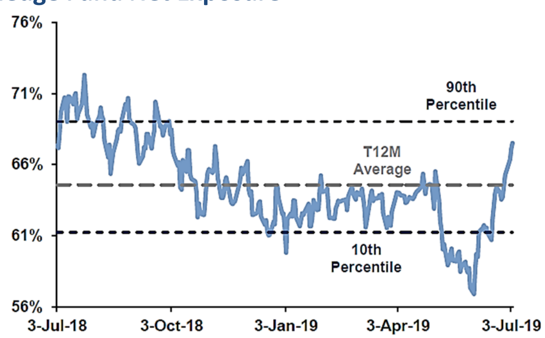


Source: Investcorp

Positioning

Still, as is often the case, matters are not as straight-forward as they might appear. Based on data from prime brokerage platforms, hedge funds have, as shown in the first chart below, significantly scaled up net equity exposure in recent weeks, signaling, perhaps, a more optimistic outlook. That said, the deployment of cash and shift in positioning toward historical averages also suggests a reduced tailwind for markets going forward. Additionally, equity skew steepened only slightly, as detailed in the second chart, indicating a lack of investor interest in downside protection despite higher equity exposure levels.

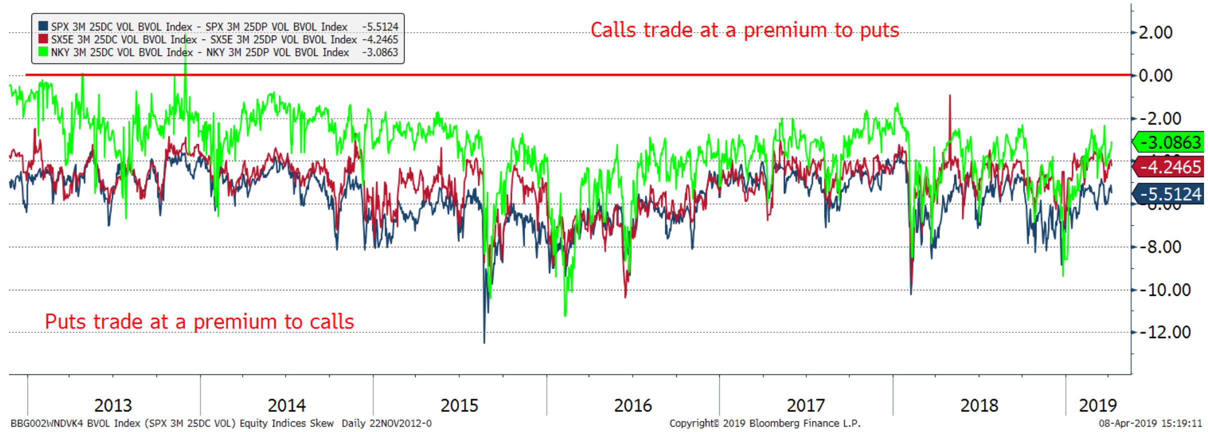
Hedge Fund Net Exposure



Source: Goldman Sachs

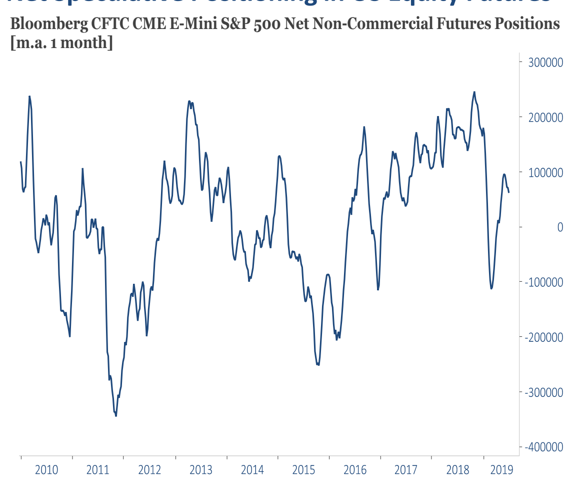
Other segments of the investment community have also boosted equity allocations. Lower realized volatility and strong upside momentum have promulgated fresh inflows from systematic and volatility-targeting managers. By our estimates, this cohort is now close to having fully-levered net-long equity exposure, as indicated below. This sets the stage for a potential downside acceleration should volatility pick up in the months ahead.

Equity Index Skew



Source: Bloomberg, Investcorp

Net Speculative Positioning in US Equity Futures

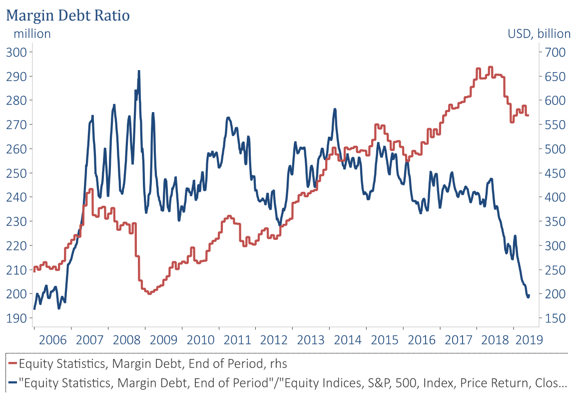


Source: Investcorp

Multi-Asset Portfolios Realized Volatility

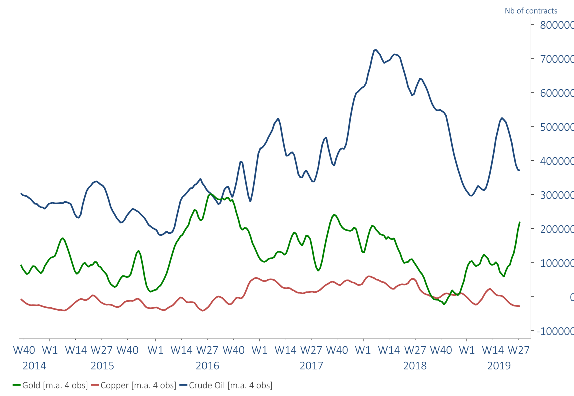
Source: Investcorp

Margin Debt Ratio Multi-Year Low



Source: Investcorp

Net Speculative Positioning in Key Commodities

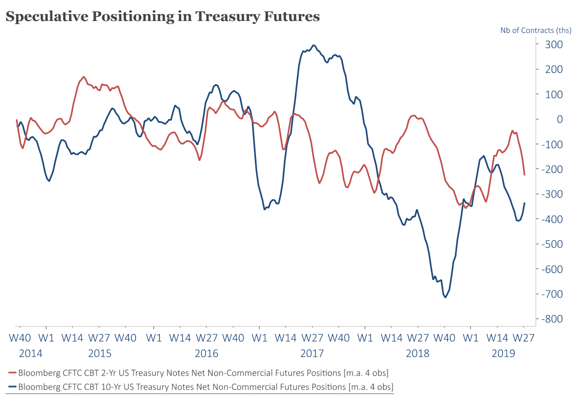


Source: Investcorp

Liquidity in US E-mini S&P500 Futures

Source: JPMorgan

Net Speculative Positioning in US 2- and 10-Year Treasury Futures



Source: Bloomberg, Investcorp

In commodities, speculative demand for long gold exposure rose sharply while net-long positioning in crude oil and the broader energy complex declined, as evidenced by the following chart.

One post-scriptum on market liquidity, it is important to take note of the challenged liquidity environment this year, with multiple signs across Italian bonds, emerging market bonds and currencies and even recently manifesting itself in S&P500 futures. The following chart highlights the drop in top-of-the-book liquidity in this historically very liquid market. It helps explain the high intra-day volatility we have observed recently, with the market showing large "travels" during the open session. Lower liquidity is likely here to stay in periods of stress as market micro-structure may have been structurally affected by recent technology and regulations.

Asset Allocation Playbook

We believe the current environment calls for patience and prudence. In light of the fragilities still emerging within the global economic system, we prefer to adopt a lower risk profile, building dry powder to seize future opportunities when they present themselves. As we have learned again in 2018, cash not only offers a decent carry but also preserves the optionality to invest at better valuations. Structurally lower liquidity across markets means severe dislocations are likely to be back in the not-too-distant future.

Equity and credit markets have seen sharp reversals, erasing much of the valuation cushion that had been built over the last quarter of 2018. In the meantime, we believe uncertainty remains over many of the major market drivers including the nature of a potential US/China trade deal and its eventual impact on corporate CapEx, the efficacy of the ongoing concerted monetary & fiscal stimulus (primarily driven by China) and other tail risks (US populism coming into 2020, Brexit, Auto tariffs, …). This leads us to seek balanced exposure between limited upside capture, in certain value sectors & geographies, carry strategies that should deliver I our muddle through base case while protecting on the downside through trade structuring as well as smart hedging strategies. We emphasized emerging markets as an attractive source of carry, with greater valuation support and the headwinds faced by the dollar, considering the Federal Reserve recent policy shift.

Finally, at this stage of the cycle, we prefer to keep a higher liquidity profile, to maintain optionality, unless the idiosyncratic liquidity premium/profile endogenously creates a decent margin of safety.

Asset Class	Strategy	Negative	Neutral	Positive	Comments
Equities					
	Low Beta	□■■	□	□□□	Extreme valuations and elevated positioning leave us guarded here; at risk of a sharp reversal if Fed ahead of the curve & steepening of the yield curve
	Momentum	□□■	□	□□□	Momentum has turned very defensive, aligned with low risk. Turning point for the economy with major catalysts ahead (trade) suggest caution.
	Quality	□□□	■	□□□	Neutral allocation on higher positioning, offset by positive signals from macro
	Value	□□□	□	■□□	Greater value in value today, fears of turn in cycle overdone and resteepening of the yield curve could make an attractive play, barbell with quality exposure.
	Carry	□□□	■	□□□	Neutral outlook on mixed signals.
	Mean Reversion	□□□	□	■□□	Shift lower in realized volatility is a headwind but out positive outlook on volatility in the coming months leaves us moderately overweight.
Fixed Income					
	Carry	□■■	□	□□□	Stay underweight at current carry levels across developed markets, opportunities remain in more niche developing or municipal bond markets. Opportunities in EM carry and EM FRB.
	Momentum	□□□	■	□□□	At strategic.
	Value	□□■	□	□□□	Meaningful divergence across value signals (absolute rates, real rates …) suggests caution for this universe.
Commodities					
	Carry	□□□	■	□□□	Neutral as carry/seasonal patterns no longer supportive.
	Curve	□□□	■	□□□	Neutral allocation on mixed signals.
	Momentum	□□□	■	□□□	Positive fundamentals in late-stage business cycle but crowding risks have risen with stretched positioning in the energy complex for example.
FX					
	Carry	□□□	□	■■□	EM Carry offers attractive opportunities at current levels of valuations and carry. Retain underweight on G10 carry and prefer EM expressions instead.
	Momentum	□□□	■	□□□	Strategy well positioned to monetize ongoing trends in DM and EM FX.
	Value	□□□	■	□□□	Risky period for GBP given new PM lack of strategy and tight deadline, consider hedging. Look for entry points in JPY, EUR as defensive play.
	Mean Reversion	□□□	□	■□□	Higher volatility should help the strategy harvest gamma; factor has historically done well in high volatility environments and periods of volatility compression.

Outlook for Alternative Risk Premia Strategies

Equity

Our outlook for 2019 includes a low expected return for low beta, on elevated valuations and continued risks from higher interest rates globally. The strategy has been a recipient of large inflows on the back of last quarter market volatility and move lower in interest rates. We still prefer to fade the recent strength, at current levels. Similarly, we are underweight momentum on large binary catalysts ahead that risk catching the factor by surprise. The ongoing US/China trade negotiations could well lead to an upside surprise for cyclicals; the ensuing short covering in cyclicals would prove costly to momentum shorts. We prefer a barbell approach of quality & value for the year which should offer a balanced factor allocation for both upside and downside scenarios. Quality could well continue to benefit from stress in corporate credit markets should the growth momentum continue to deteriorate while value should be a strong benefactor of a revival in cyclical sectors, with historically cheap valuations a major tailwind. Finally, we marginally reduce our allocation to mean reversion strategies on lower realized volatility. That said, we remain confident in the strategy's outlook as realized volatility could again turn higher, on negative growth surprises.

Fixed Income

In Fixed Income we remain underweight Carry and Value strategies. Interest rate differentials have compressed again over the past quarter leaving meager pickings for naïve carry implementations. In contrast, the divergence across value signals – e.g. real vs. nominal rates – suggests caution for this universe for the coming months. We stay neutral for momentum where the universe seems best positioned to capture a change in market direction.

Commodity

In Commodities we stay neutral on plain-vanilla Carry strategies, where carry and seasonal signals have turned less supportive. We retain neutral outlooks for both Curve and Momentum.

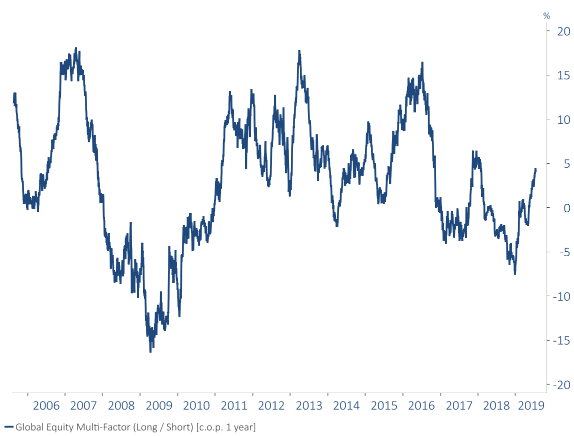
FX

In Foreign Exchange, we remain excited by the performance potential available in carry strategies, particularly within emerging markets. Elevated carry, relatively attractive valuations and headwinds to further dollar upside give us strong conviction. We stay overweight Mean Reversion as higher volatility should help support gamma harvesting algorithms. Mean Reversion has historically done well in both turbulent times and periods of volatility compression. Finally, we downgrade the outlook for Value on higher Brexit risk in the coming months.

Equity

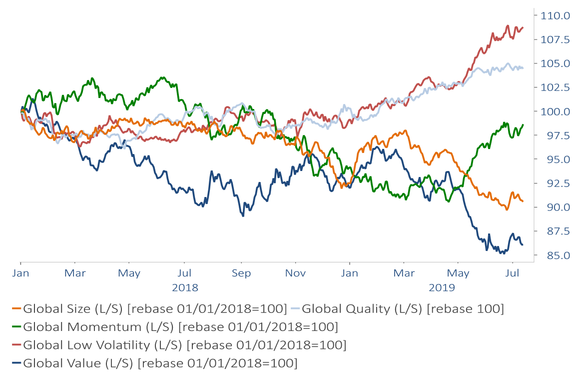
Following a tepid 2018, the performance of a multi-factor equity risk premia portfolio – invested across low beta, quality, momentum, size and value – has rebounded sharply this year, as can be seen in the first chart below. As the second chart suggests, the strong showing has largely been driven by strength in the first three factors, while size and value have continued to struggle. In fact, the latter has slid toward new lows since its fleeting recovery in the first quarter.

Global Equity Multi-Factor L/S Rolling One-Year Performance



Source: Investcorp, JP Morgan

Global Equity Factors (L/S) Performance since January 2018



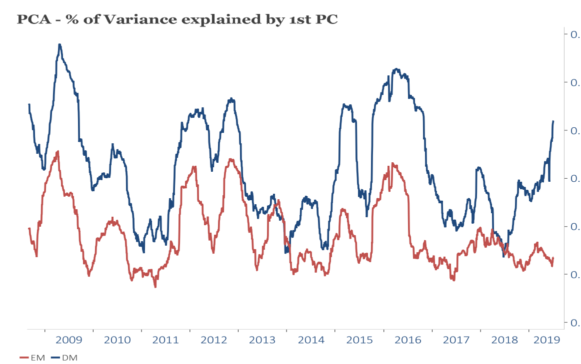
Source: Investcorp, JP Morgan

As we begin our review, we are introducing a measure that has shown great promise for quantifying the diversification potential available across equity factors. In the past, this measure has been fairly well correlated with equity market neutral hedge fund alpha. As with other assets classes we evaluate, we use a principal component analysis, or PCA, to gauge the share of variance that is explained by the first principal component, based on one-year rolling windows. The higher the number, the more a single factor accounts for cross-sectional variance, and consequently, the lower the level of diversification.

In conducting our analysis, we divide the equity universe into two parts: developed and emerging markets. Interestingly, there has been a notable divergence between the two. The percentage of variance explained by the first principal component in developed market equity factor portfolios, represented by the blue line in the chart below, has moved up meaning equity factor portfolios have recently exhibited lower diversification benefits, while the same has not been true in emerging markets.

Based on our analysis – discussed in greater detail later on – we believe the state of the former comes down to a heightened alignment in more advanced economies of momentum, on the one hand, and low beta and quality, on the other, in contrast to what is taking place in the developing world.

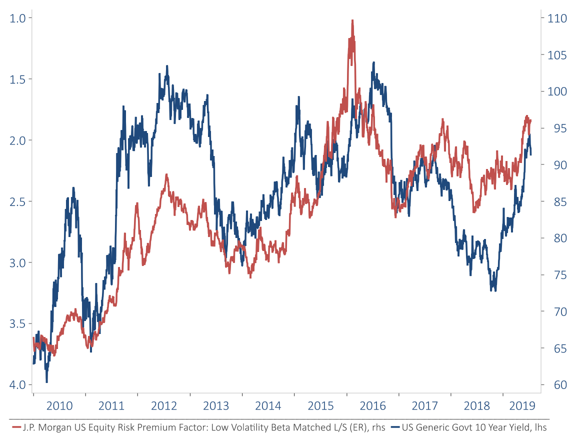
Diversification Available in Equity Factor Universe (Developed and Emerging Markets)



Source: Bloomberg, Investcorp

Be that as it may, we begin our review of individual factors with a discussion of the outlook for low beta. As the following chart indicates, the performance of this strategy has closely tracked movements in government bond yields. This is not surprising given that low beta equities are often seen as fixed-income "proxies" owing to their subdued volatility and high carry attributes. As rates move lower, investors tend to bid-up this group's valuations in their search for "safe" carry.

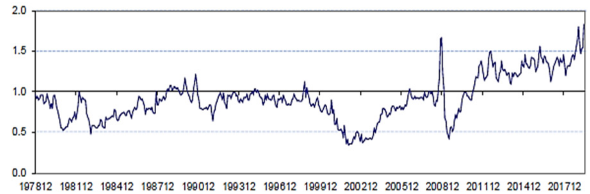
US Low Beta Factor Performance vs. US 10-Year Yield (inverted)



Source: Bloomberg, Investcorp

It is also not surprising that low beta has, in recent months, been the prime beneficiary of dovish central bank messaging. At this point, however, valuations are near historical extremes, as the following chart suggests. To be sure, this may well reflect a so-called Japanification of US and other fixed-income markets, where the aggregate stock of negative yielding government bonds has hit a record high $13 trillion.

US Low Beta Factor – Relative Forward P/E Ratio of High vs Low Quintiles

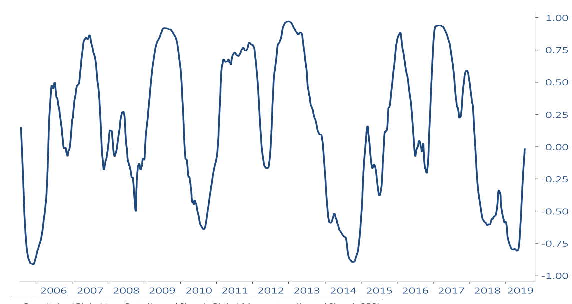


Source: Citi

Even so, we believe the risks to the downside far outweigh those to the upside, and we are sticking with our underweight stance. Further reinforcing our cautious outlook, we note that positioning in long-duration trades is now approaching stretched levels and any hint of a recovery in the beaten-down manufacturing sector could be just the catalyst for a massive unwind of this crowded trade.

But the challenges we see in low beta do not stand in isolation. As we alluded to earlier in our discussion of the diversification benefits available within different strategies, the correlation between low beta and momentum has been rising rapidly, and has now reached the point where there is a notable overlap between the two factors, as shown below.

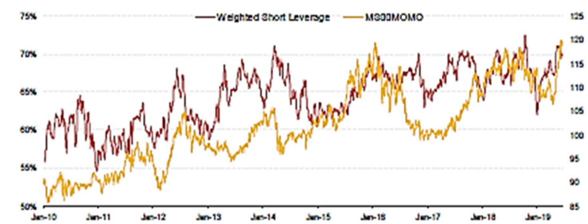
Rolling Correlation between Momentum and Low Beta Factors



Source: Investcorp

Another development also suggests that the risks are growing for momentum. For a start, evidence of extended positioning is emerging again. As the following chart from Morgan Stanley Prime Brokerage indicates, gross short exposures have risen toward extremes. This has potentially set the stage for future deleveraging, which would likely have an adverse effect on momentum strategies.

Momentum Exposure and Hedge Fund Gross Short Exposure



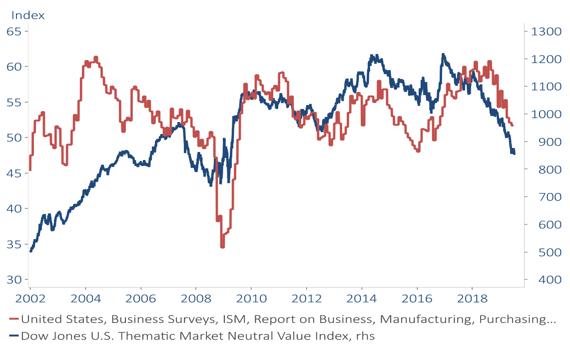
Source: Bloomberg, Morgan Stanley

Turning to value, the underperformance we have seen recently has been consistent with our top-down signals; ISM manufacturing and other macroeconomic leading indicators have been losing steam and the yield curve has continued its seemingly relentless flattening. That said, we believe we may be close to a reversal of fortunes. Among other things, a Federal Reserve that is striving to be ahead of the curve and the lagged effects of increased stimulus from fiscal and monetary authorities in China and Europe could bolster the outlook for manufacturing.

Additionally, downside momentum in the yield curve flattening trend has waned somewhat, with signs of potential steepening beginning to emerge. With respect to the strategy itself, valuations have slid toward negative extremes, as suggested by the following three charts, while bearish positioning also appears to be stretched.

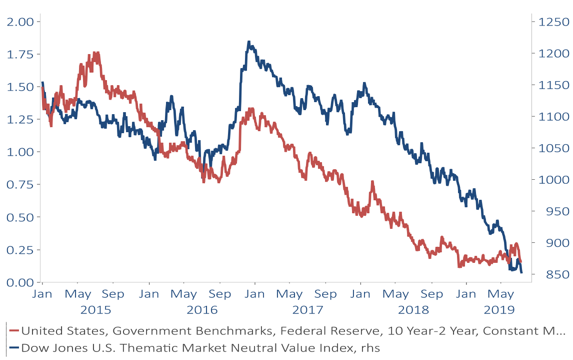
In our view, these various developments have laid the groundwork for a sharp rally if a decisive Fed takes investors by surprise; indeed, the next FOMC meeting could prove a key milestone. With this in mind, we believe that a tactical overweight position in value has an attractive risk-reward profile, though we would not be surprised if some would prefer to wait for a more sustained steepening of the yield curve before adjusting allocations to value.

US Equity Value Performance Relative to ISM Manufacturing



Source: Investcorp, Macrobond, Bloomberg

Equity Value Factor Performance vs. US Yield Curve (2-Year vs. 10-Year)



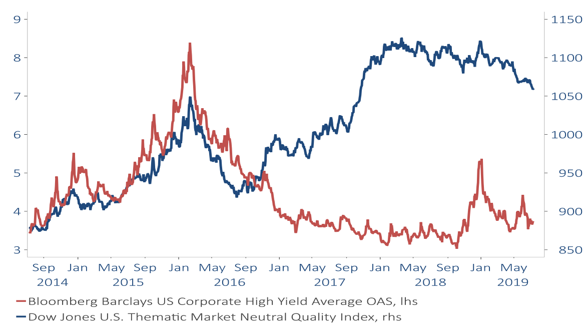
Source: Investcorp, Macrobond, Bloomberg

Relative Value Differential Between Long and Short Legs of US Value Factor (Based on P/E Ratio)

Source: Citi

In closing, we offer a few words on quality. We have been constructive on the factor in recent months, but at this stage, we are turning neutral. Quality has very much become a consensus play, as the following three charts suggest; we doubt it will continue to afford the same level of portfolio protection as in the past should heightened volatility reappear. Moreover, stretched positioning and elevated valuations have increased the downside risks, especially if we see a rotation into value. Under the circumstances, we prefer to wait for more clarity regarding the impact of future monetary stimulus on manufacturing and equity factors overall before reconsidering our outlook.

US Equity Quality Performance Versus US High Yield Credit Spread

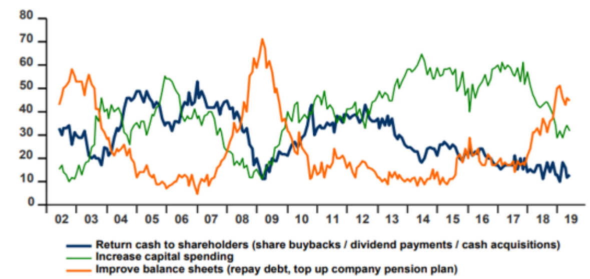


Source: Investcorp, Macrobond, Bloomberg

BAML Global Fund Manager Survey: Balance Sheet (Over)leverage Sentiment at Its Highs

Source: BAML

Investor Preferences for Companies' Use of Cash Flow (Survey)

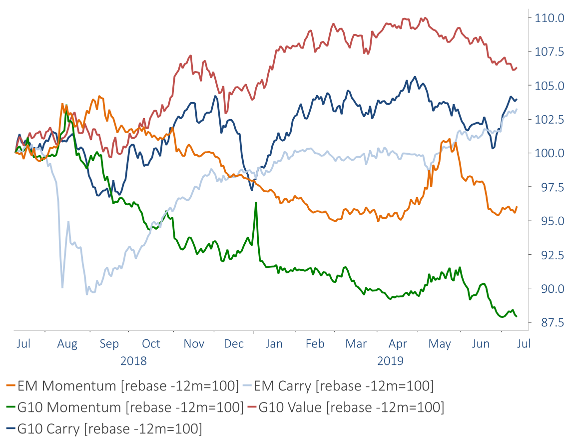


Source: BAML

Foreign Exchange

Over the past year, performance across foreign exchange risk premia has been mixed, as the chart below indicates; while carry and value delivered positive returns, trend-following algorithms lagged noticeably. More recently, emerging market carry strategies have led the pack as the broader universe underperformed.

Performance of Foreign Exchange Risk Premia Over the Last 12 Months

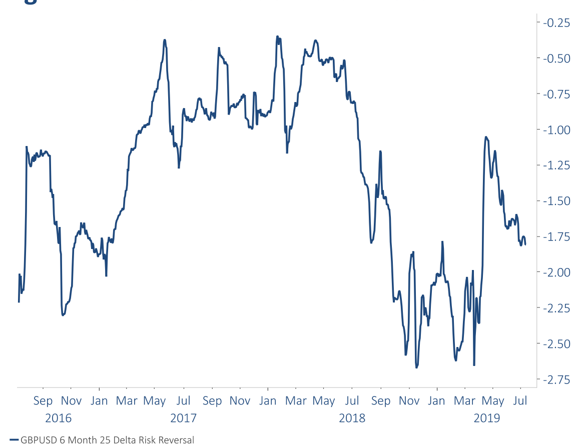


Source: Investcorp

For the most part, the recent poor showing of value in developed market foreign exchange stems from weakness in the British pound. This owes much to the failure of Theresa May's Chequers plan following its numerous rejections in the House of Commons, which eventually spurred calls for new Conservative Party leadership. At this juncture, Boris Johnson appears to be significantly ahead of rival Jeremy Hunt in the race for election, rekindling fears about a disorderly "no deal" Brexit.

Indeed, those concerns are apparent in cable's risk premium, where the skew has recently widened to 1.75, as shown below. In our view, uncertainty surrounding the incoming leadership's approach to discussions with the European negotiating team will likely keep volatility in the British currency elevated in coming months. It has also heightened the exchange-related risks of investing in the UK ahead of the October 31 deadline.

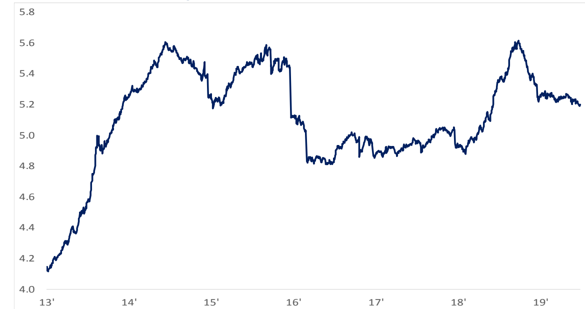
GBPUSD 6-Month 25-Delta Risk Reversal Signaling Increased Downside Risks Ahead



Source: Investcorp, Macrobond

In terms of valuation, there is little to say. As can be seen in the following two charts, which illustrate valuation differentials between long and short foreign exchange pairs based on a quintile approach, spreads have remained fairly stable and close to historical averages, though differentials in the G10 segment have rebounded somewhat from their late-spring lows.

Historical Valuations – Emerging Markets Currencies (Top 20%)

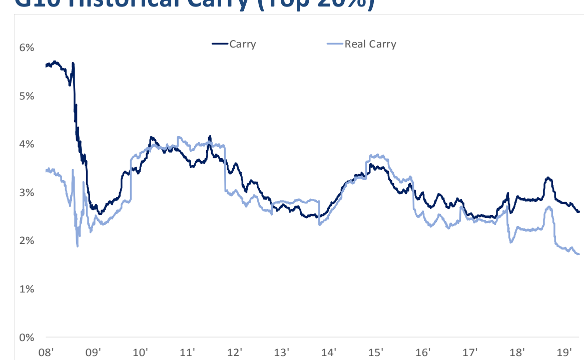


Source: Investcorp

Historical Valuations – G10 Currencies (Top20%)

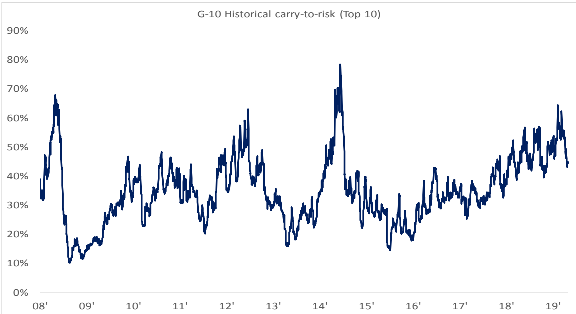
Source: Investcorp

G10 Historical Carry (Top 20%)



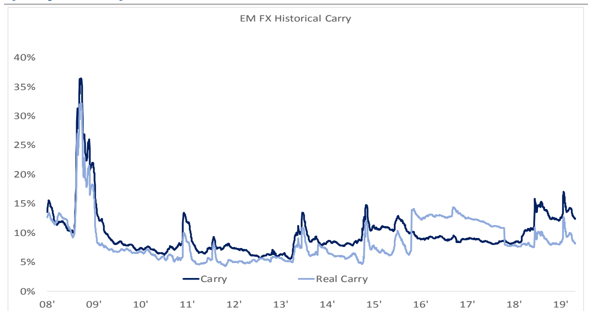
Source: Investcorp

G10 Historical Carry to Risk (Top 20%)



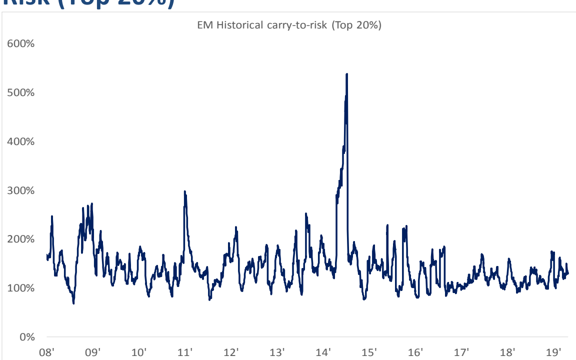
Source: Investcorp

Emerging Market Currencies – Historical Carry (Top 20%)



Source: Investcorp

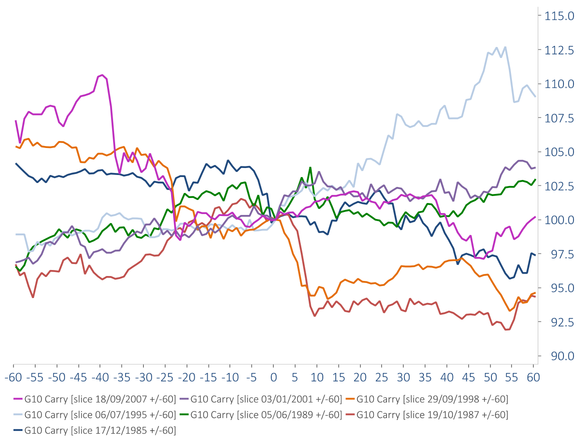
Emerging Market Currencies Historical Carry to Risk (Top 20%)



Source: Investcorp

To be sure, carry strategies could be adversely impacted by the dovish pivots we have seen from both the Federal Reserve and the ECB As the following chart reveals, their performance has generally been mixed in the month leading up to the beginning of a Fed easing cycle and somewhat poor afterwards, with the exception of the episodes that took place in 1995 and 2001.

Performance of G10 Carry Strategy Around the Initial Federal Reserve Cut

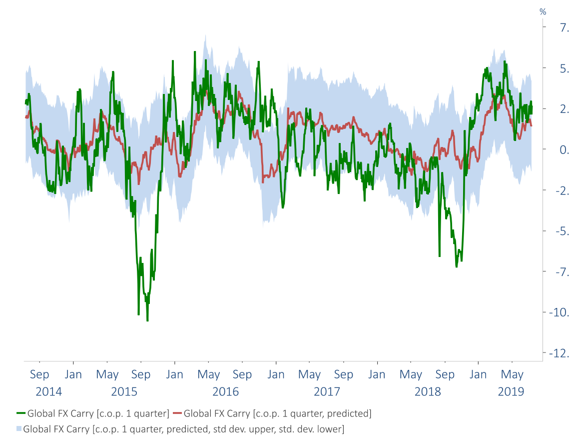


Source: Investcorp, Macrobond

Regardless, history suggests that a global foreign exchange carry strategy will exhibit a natural bias toward holding high-beta emerging market currencies versus funding counterparts, which are typically the units of account of developed countries. As such, this approach has exhibited a sensitivity to the performance of emerging market economies.

One question worth considering is how this model compares, in terms of performance, with asset classes having identical risk-factor exposures, notably emerging market equities and EM hard-currency credit. As it happens, they tell a similar tale. Based on a regression analysis aimed at gauging the linkage between the global FX strategy and the two targeted counterparts, illustrated below, the latter have performed largely in line with what was anticipated by the former.

Cross-Asset Value Model: Performance of Global Foreign Exchange Strategy Relative to Emerging Market Equities and Credit

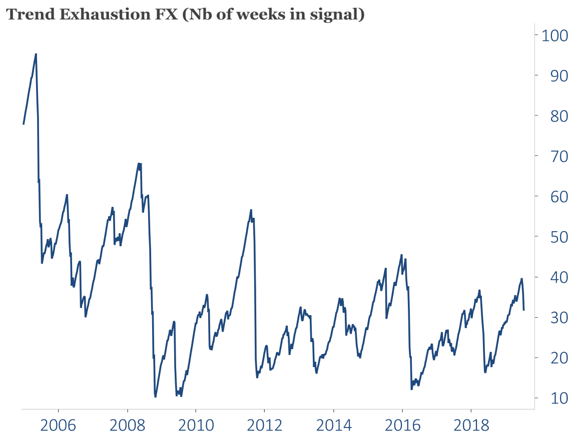


Source: Investcorp, Macrobond

Trend Following

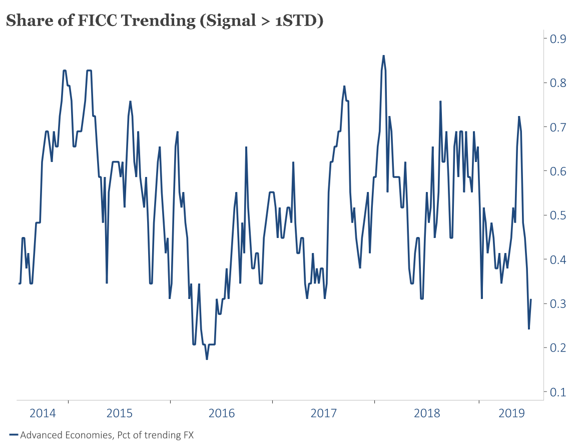
One gauge that has proved useful in assessing the outlook for this segment is our trend exhaustion indicator for currencies, highlighted in the following chart. This time series reflects the average number of weeks that a typical trend-following strategy has remained in the same position – either long or short – across the global foreign exchange universe. Having peaked a few months ago at 40, the current reading of 32 represents a decent pullback. This is consistent with the near-record low reading of 30% for the share of foreign exchange trend signals that are above one standard deviation, detailed in the second chart.

Trend Exhaustion Indicator Foreign Exchange



Source: Investcorp

Foreign Exchange Trend Signals Above One Standard Deviation



Source: Investcorp

Taken together, these indicators leave us feeling more constructive on the outlook for trend-following strategies in the foreign exchange arena, especially in light of the shifts we are seeing in the fundamental backdrop. A softening in stance by the Federal Reserve, along with a prospective interest cut at the July FOMC meeting that seems to be fully priced in, may well have set the stage for a tradeable move lower in the US dollar, especially if the easing engenders a positive reaction in the world manufacturing cycle.

Average Momentum Scores Across FX Pairs

EM	**0.89**
BRL	0.33
CLP	-0.30
COP	-0.40
CZK	-0.27
EGP	9.58
HKD	0.38
HUF	-0.76
IDR	1.93
ILS	0.23
INR	2.12
KRW	-0.96
MXN	0.88
PHP	2.41
PLN	-0.08
RUB	1.17
SAR	0.83
SGD	0.34
TRY	1.36
TWD	-1.33
ZAR	0.36
G10	**-0.47**
AUD	-0.66
CAD	0.22
CHF	-0.26
EUR	-1.16
GBP	-1.38
JPY	0.67
NOK	-0.65
NZD	-0.12
SEK	-0.91
Grand Total	**0.47**

Source: Investcorp, Macrobond

Fixed Income

In fixed-income, momentum strategies have been carrying the day, with all models benefitting from a strong and broad rally across the space, as evidenced by the chart below. Front-rate bias strategies have also been resilient amid interest-rate cuts being increasingly priced in following dovish messaging from the Federal Reserve and, to a lesser extent, the European Central Bank. Performance has been mixed elsewhere, however; value and carry algorithms, in particular, have failed to gain much traction.

Fixed-Income Risk Premia Performance Since January 2018

Source: Investcorp, Macrobond

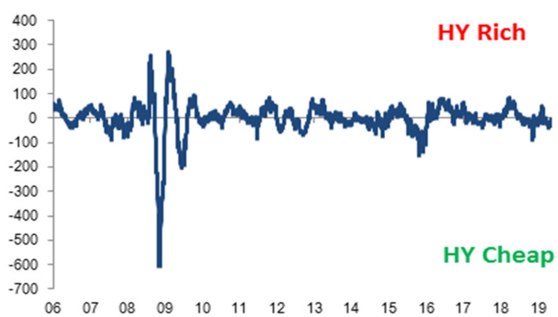
We begin our review of this segment with an update on credit strategies. Not surprisingly, corporate credit-oriented compression plays have been the beneficiaries of a tightening in the spread between investment grade and high yield issues – illustrated in the following chart – which has been driven by a renewed "hunt for yield."

Investment Grade – High Yield Credit Spread

Source: JP Morgan, Investcorp

As it happens, we had previously become more constructive on the space based on our short-term reversion models, which suggested that the widening that had occurred in prior periods had reached an extreme. At this point, however, we believe the pendulum has probably swung too far the other way, and we are downgrading our rating from overweight to neutral. While we believe credit can continue to perform well in the absence of any major negative catalysts and amid continued support from monetary authorities, valuations have gotten a bit ahead of themselves, as suggested by the chart below.

High Yield Valuation Model



Source: Investcorp, JP Morgan

US High Yield Credit Curves

Source: Investcorp, JP Morgan

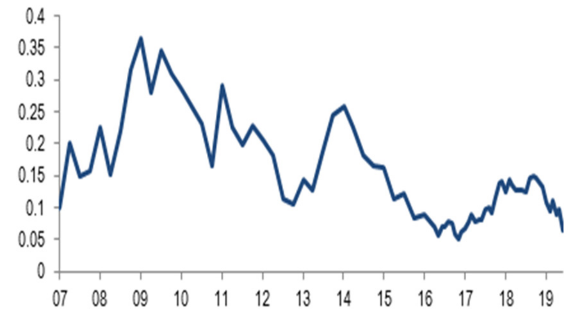
Looking beyond credit, we remain underweight the cross-sectional carry strategy in the G10 fixed-income space. A historically low level of carry, highlighted in the chart below, continues to point to heightened downside risks going forward and limited benefits from hedging.

DM Fixed-Income Carry Strategy – Historical Carry

Source: JP Morgan, Investcorp

Our earlier call for a larger allocation to the front-rate bias strategy has paid off, but at this point, we would continue to take profits in both developed and emerging markets. With investors seeming to have grown overly confident about the extent of future rate cuts, we prefer a "wait and see" approach at this point rather than remaining invested in pursuit of carry that is near its historical lows, as evidenced by the two charts below.

Emerging Markets Front Rate Bias Strategy – Historical Carry



Source: JP Morgan, Investcorp

Developed Marked Fixed-Income Carry Strategy Historical Carry

Source: JP Morgan, Investcorp

Commodity

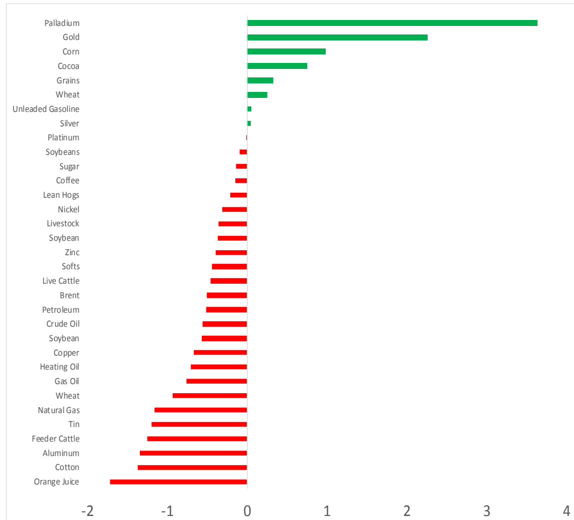
In the commodity complex, congestion and curve carry strategies have been the best performers this year, though returns have been fairly modest, as indicated below. The latter strategy, in particular, has continued to benefit from especially steep curves in various commodities, most notably energy. In contrast, cross-sectional momentum and trend-following strategies are, so far at least, having a difficult 2019. Both groups have been weighed down by mean-reversion-driven movements across most of the space.

Commodity Risk Premia Performance

Source: Investcorp

With respect to current positioning, our models indicate that commodity exposure continues to be tilted toward the downside, especially in agriculturals, as can be seen in the following chart. Speculators have also turned bearish on energy again. In contrast, net positioning in precious metals, notably gold and palladium, remains long.

Net Positioning in Commodity Futures



Source: Investcorp

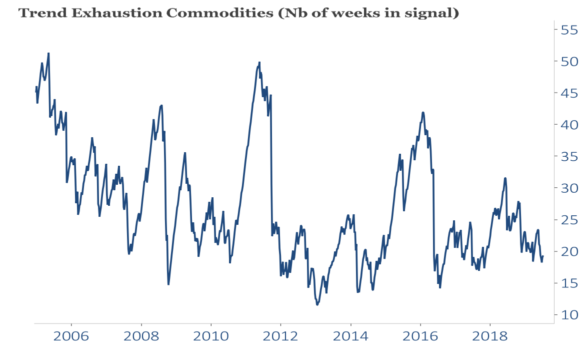
Broadly speaking, our proprietary indicator, featured below, indicates that speculative positioning has turned neutral by historical standards, lowering the risk of an upside squeeze like we saw at the beginning of the year.

Aggregate Commodity Speculative Investor Positioning Indicator

Source: Investcorp

From where we sit, the shift toward more neutral positioning suggests that many markets are going nowhere fast. Our trend exhaustion indicator for commodities, highlighted below, appears to bear this out.

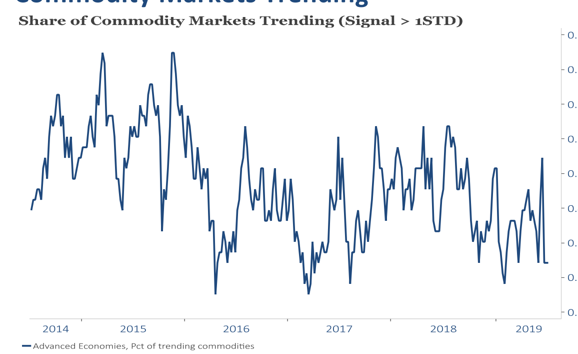
Trend Exhaustion Commodities



Source: Bloomberg, Investcorp

Along the same lines, the share of commodity markets that are in trending mode has recently fallen, as the following chart illustrates, implying that reversals and mean-reverting action are playing a notable role in current trading. Needless to say, momentum and trend-following strategies tend to fare poorly in this sort of environment.

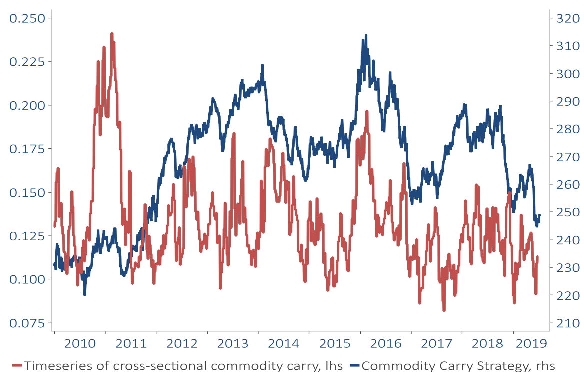
Commodity Markets Trending



Source: Bloomberg, Investcorp

When it comes to assessing the available opportunity set for the cross-sectional commodity carry strategy, a historical analysis of the underlying carry generated by our long/short algorithm can offer clues about its forward-looking performance. Counterintuitively, our research has shown that it makes sense to acquire cross-sectional carry when carry is low, as periods when the opposite holds true are often followed by violent curve reversals that wreak havoc across the space. The fact that the measure is currently near the bottom of its historical range, as evidenced by the red line in the chart below, suggests this an opportune time to allocate to the strategy, which is likely exposed to only modest tail risks based on history.

Long/Short Cross-Sectional Carry Strategy Historical Carry vs. the Strategy's Historical Performance

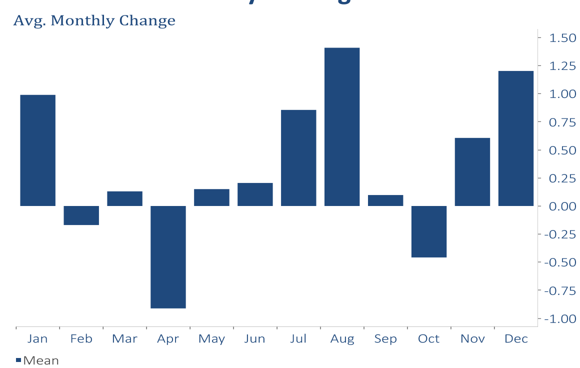


Source: Bloomberg, Investcorp

Indeed, we remain positive on this strategy for the period ahead: the time structure continues to be in strong backwardation in energy and sharp contango in the agricultural complex. Typically, the futures curve reflects expectations about mainstream supply-and-demand fundamentals, which, in the former segment, includes a US overproduction policy that is supported by the current administration and a lack of strategic coordination between OPEC members.

In terms of seasonality and average monthly performance, the third quarter tends to be a favorable period for commodity carry strategies. This reflect the fact that the summer months generally see strong demand for refined products in energy markets (e.g., gasoline) and for certain agricultural goods (e.g., wheat). Because these dynamics directly affect near-term supply and demand, they have a corresponding influence on the shape of the curves in those markets.

Average Historical Monthly Performance for Cross-Sectional Carry Strategies

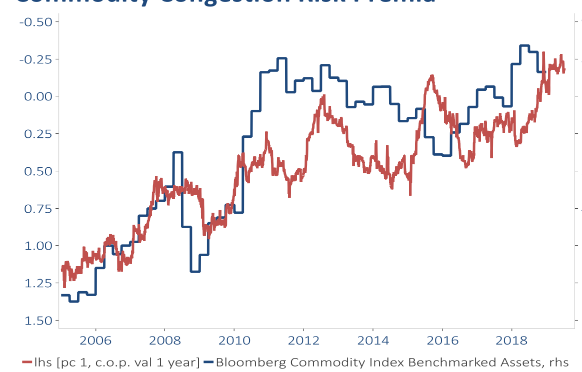


Source: Bloomberg, Investcorp

Before continuing with our regular update on the diversification available in the commodity universe, we thought it would be interesting to highlight data that reveals a warming, of sorts, for the space as a whole, and which is also a potential positive for congestion strategies. As readers may already be aware, these approaches aim to front-run investment flows that follow a predictable, calendar-based pattern of rolling futures contracts. All things being equal, we would expect the risk premia related to such strategies to be positively correlated to the volume of assets linked to commodity indices.

Indeed, after a few dull years, investors have clearly been boosting their allocations to commodities again. With aggregate assets benchmarked to the BCOM Index up more than 30% since the 2016 lows, it is no surprise to see congestion algorithms staging a healthy comeback in performance, as evidenced by the chart below.

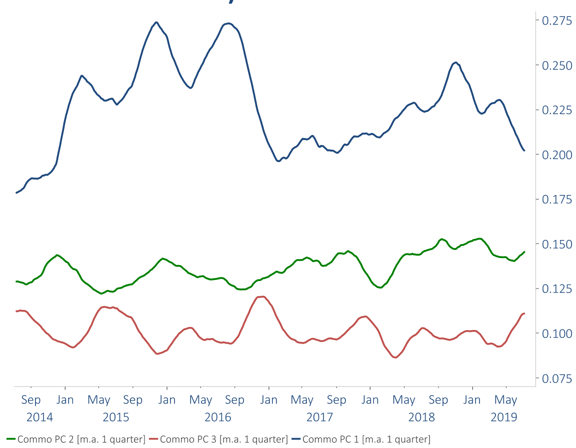
Bloomberg Commodity Index Total Benchmarked Assets vs. the Performance of Commodity Congestion Risk Premia



Source: Bloomberg, Investcorp

Finally, as we have noted in prior Environment Reports, we employ a one-year rolling principal component analysis, or PCA, to quantify the diversification potential available in a particular group of assets. This statistical technique yields insights into how much of the variance among the individual constituents can be explained by a set of unidentified, orthogonal factors. In the case of commodities, recent data continues to point to the large diversification potential that exists in the space; specifically, the first three factors explain less than half of the covariance. This is consistent with a fundamental understanding of the asset class, whereby supply and demand effects may vary widely across individual commodities, oftentimes without being affected by the broader macroeconomic cycle.

Commodity Universe Internal Diversification Properties (% of Variance Explained by the First Three Principal Components, Based on Rolling One-Year Windows)



Source: Investcorp

HEDGE FUNDS

Strategy	Negative	Neutral	Positive	Comments
Hedged Equities	□□■	□	□□□	Muted to slightly down equity moves anticipated, play managers with trading skills and be mindful of factor exposures to provide balanced exposure.
US	□□■	□	□□□	Prefer alpha or trading oriented managers, balance factor expo.
Euro area ex UK	□□■	□	□□□	Monetary policy support has limits in an environment of decelerating earnings and weak macro momentum. Some value exposure could be attractive in a portfolio context
Japan	□□■	□	□□□	Value play but limited catalysts ahead and FX risk
Emerging Markets	□□■	□	□□□	Sector has re-rated, limited valuations support from here
Event-Driven	□□□	■	□□□	Tactical overweight in Merger Arbitrage as spreads widened in excess of fundamentals; stay neutral Special Situations
Special Situations	□□□	■	□□□	Potential for diversifying value exposure relative to fundamental L/S funds. Seek diversification from momentum/growth plays
Merger Arbitrage	□□□	□	■□□	Greater opportunity as higher volatility & spreads opened up M&A spreads. Stay tactical
Equity Market Neutral	□□□	□	■□□	Limited beta and diversifying features attractive in late-cycle environment, neutral on factor strategies
Macro Discretionary	□□□	□	■■□	Greater volatility should offer opportunities for RV/Trading managers but uncertainty over macro trends may limit upside potential near term. EM still has a place in a diversified portfolio
Macro Systematic	□□□	■	□□□	Trend following at risk in range bound environment: lower potential in rates with crowded longs, maybe better in FX/alternative markets
FI Relative Value	□□□	□	■■□	Strategy has adapted well to a changing environment: it is less sensitive to balance sheet scarcity and well positioned to profit from funding dislocations.
Corporate Credit	□□■	□	□□□	Limited carry and asymmetric liquidity profile leave us underweight. Few dislocations to capture; prefer niche plays or wait for even better entry points
Corporate Distressed	□□□	■	□□□	Stay out of traditional corporate distressed plays as tight spreads leave limited risk premium in distressed assets. Look for idiosyncratic themes & opportunities.
Structured Credit	□□□	■	□□□	Traditional structured credit offers limited carry and upside optionality, however idiosyncratic opportunities across near CLO refi's and resets, callable RMBS, and near-maturity CMBS offer potentially attractive risk-adjusted reward.
Convertible Arbitrage	□□□	■	□□□	Relatively cheap valuations should offer support. Tepid new issuance and liquidity remain a concern
Vol Arb	□□□	□	■□□	Higher volatility environment here to stay, cross-asset & cross regions opportunities

Hedge Fund Strategy Outlook

We downgrade our outlook for **Hedged Equities** as we see limited tailwinds from beta, at current market levels. We believe volatility will return to equity markets and open better entry points in the coming month. Looming tail risks remain and create a large downside asymmetry to returns, in our view.

We remain neutral on **Special Situation** managers given the high consumption of equity beta budget. In **Merger Arbitrage**, we are staying tactical, seeking to increase exposure in periods when spreads widen in excess of their cross-asset anchors, i.e. equity volatility and investment grade credit spreads.

We continue to hold a constructive view on the **Macro Discretionary** investment style. Global macro managers are best equipped to monetize higher volatility and offer a valuable source of diversification in hedge fund portfolios, at this stage of the business cycle.

Fixed Income Relative Value remains a high conviction as greater velocity of flows and lower balance sheet capabilities from broker/dealers continue to support alpha generation. We continue to slightly underweight **Corporate Credit** managers. Credit relationships remain fairly tight and offer limited potential for alpha generation.

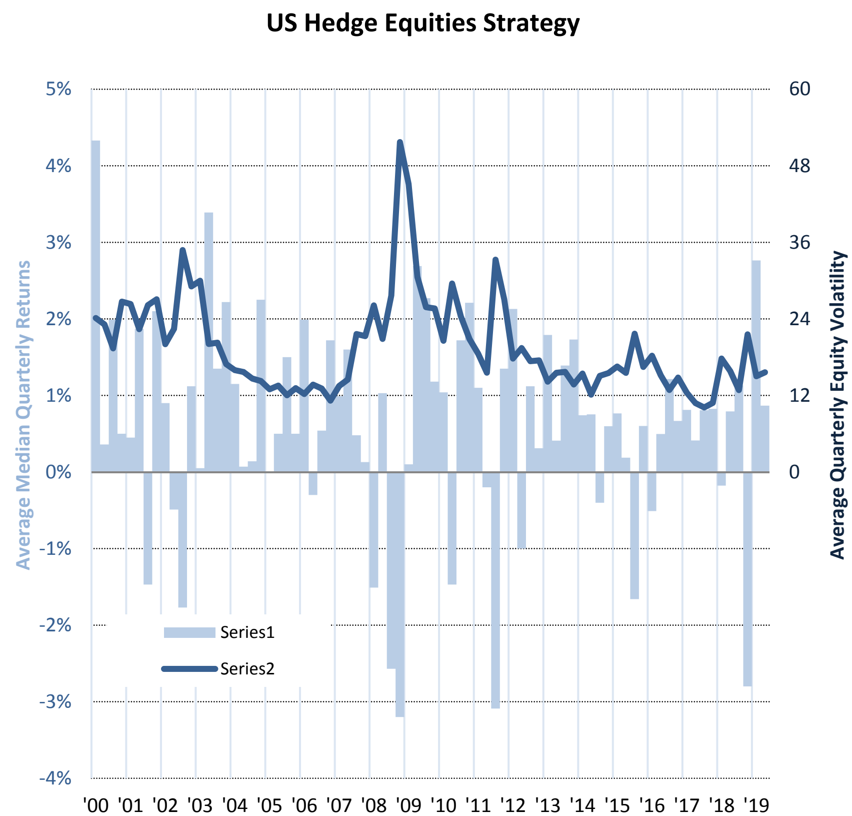
In **Distressed**, we maintain our neutral stance with an opportunity set bifurcated between tepid return expectations in traditional corporate distressed on the basis of compressed credit spreads relative to various risk measures and a greater performance potential in non-corporate idiosyncratic themes.

In **Convertible Arbitrage**, we hold our neutral outlook. We continue to see pockets of value and catalysts for managers to deliver on mild expectations. The same rational anchors our perspective for **Structured Credit** hedge funds.

Finally, we retain our overweight in **Volatility Arbitrage**. The dislocation in equity volatility has opened up a range of attractive relative value trading opportunities, across products, geographies and asset classes.

Equity Long/Short

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation	□□■	□	□□□	Valuations have reset higher and leave little room for error if the macro momentum fails to re-accelerate from current depressed levels.
Earnings	□□□	□	■□□	Earnings growth has peaked and is likely to settle in the 0-5% in the United States. Consensus numbers will likely continue to be revised down.
Stock Selection	□□□	□	■□□	Equities pair-wise correlation has remained well behaved despite risk off environment, supported by large factor & sector rotation. At risk if the environment deteriorates further from current levels.
Momentum / Sentiment	□□□	□	■□□	Positioning has been reset materially lower, with large de-risking visible in both net and gross market exposures for equity hedge funds.
Macro Fundamentals	□□□	■	□□□	Recent disappointments in macro data likely transitory; reflationary environment consistent with positive returns for equities, albeit at a higher level of volatility as financial conditions tighten and excess liquidity is being withdrawn.
Liquidity & Financing	□□■	□	□□□	Not an issue for large and mid-cap names in developed markets; prime brokers are raising financing costs.



Median returns are those of Investcorp's strategy peer group. Strategy peer groups are created by Investcorp and are comprised of funds that Investcorp has judged to be relevant for each strategy.

Source: PerTrac, Investcorp

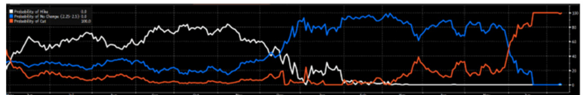
Equity Long/Short

The first half of 2019 was nothing but beneficial for global equity markets. The MSCI Word Index is up 16.3% year-to-date, while the S&P 500 index's 18.5% rally over the same span represents its strongest showing since 1997. According to Eurekahedge, global equity L/S hedge funds have done quite well so far; the group posted gains of 6.71% through June, while returns have been positive in five out of the last six months.

That said, the factors that powered the performance – an easing of financial conditions and the expectation that the Fed will cut rates later in the year – are not enough for us to change our neutral stance on the strategy. In our view, elevated valuations, late-cycle concerns, heightened geopolitical risks, and crowded positioning limit the upside, even with the support of an accommodative Fed policy.

The upside reversal in equity markets that began in late-December has thus far carried well into this year. Needless to say, the Fed's early-January shift in forward-looking guidance from plans for more rate hikes to an indefinite pause in the tightening cycle has played a key role. So, too, has subsequent messaging that not only affirmed this view but also stoked expectations for future cuts. At this point, the market is pricing in a 100% probability that the next move will be lower, and an 87.5% probability that it will take place in July.

Fed Interest Rate Hike Probability



Meeting	Hike Prob	Cut Prob	1-1.25	1.25-1.5	1.5-1.75	1.75-2	2-2.25	Fwd Rate
07/31/2019	0.0%	100.0%	0.0%	0.0%	0.0%	12.5%	87.5%	2.11
09/18/2019	0.0%	100.0%	0.0%	0.0%	8.8%	65.3%	25.9%	1.94
10/30/2019	0.0%	100.0%	0.0%	3.3%	30.0%	50.5%	16.2%	1.84
12/11/2019	0.0%	100.0%	1.6%	16.0%	39.7%	34.2%	8.5%	1.72
01/29/2020	0.0%	100.0%	5.7%	22.8%	38.2%	26.9%	6.1%	1.65
03/18/2020	0.0%	100.0%	9.0%	25.7%	36.0%	22.8%	4.9%	1.60
04/29/2020	0.0%	100.0%	11.1%	27.0%	34.3%	20.6%	4.3%	1.57
06/10/2020	0.0%	100.0%	14.1%	28.4%	31.7%	17.5%	3.5%	1.53
07/29/2020	0.0%	100.0%	15.7%	28.8%	30.1%	15.9%	3.1%	1.50

Historical Analysis for Meeting 07/31/2019 | Add/Remove Series

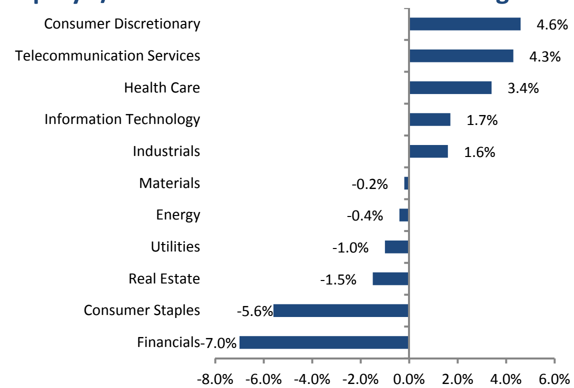
Source: Morgan Stanley

Together with the ongoing rally in share prices, sector and factor rotations have also reversed markedly from what we saw toward the end of 2018, with growth rebounding sharply versus quality. In the US, that shift is evident in the S&P 500 Growth index, which has rallied 21.2% in the first six months, outpacing its value-oriented counterpart by 499 basis points over the span.

Midcaps have done particularly well, with the Russell 2000 up 18.0% year-to-date. That said, this segment has shed 2.5% over the last 12 months, in contrast to the S&P 500's 10.3% rally, amid fears that supply chain inefficiencies would be exacerbated by trade policy uncertainty. At the sector level, information technology, financials and consumer discretionary, up 26.1%, 21.7% and 20.1%, respectively have been at the forefront, while consumer staples, energy and healthcare, up 13.5%, 13.3% and 9.0%, respectively, have trailed.

In terms of positioning, exposures remain heavily skewed toward growth and momentum, as indicated by the following chart. Financials and consumer staples, meanwhile, continue to be the sectors where managers are most underweight, even though valuations in the former, in particular, are fairly benign, with a forward P/E multiple of 11.68 versus 16.24 for the S&P 500. Still, with exposure to value near multi-year lows, it seems a good bet that with any sort of Fed stimulus that leads to a steepening curve – which value has closely tracked, as can be seen in the second chart – we could see an abrupt rotation out of growth, which would likely be positive for financials as well.

Equity L/S Funds Relative Sector Positioning



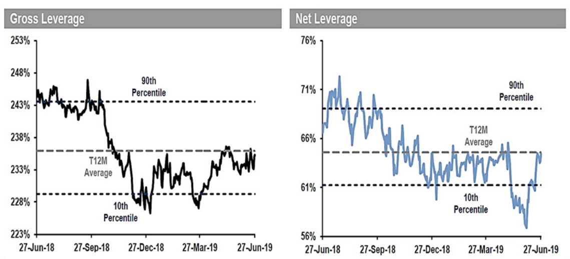
Source: Goldman Sachs

Global Equity Value Performance

Source: Bloomberg

From a broader perspective, we find that at least some of the imbalances that had contributed to the run-up that began late last year have dissipated. Over the past three weeks, there has been a major turnabout in positioning; specifically, equity L/S funds have increased their net exposure by 20% from the May lows. As evidenced by the following two charts, the group's gross and net positioning is now in line with respective 12-month averages.

Equity L/S Funds Gross and Net Exposures

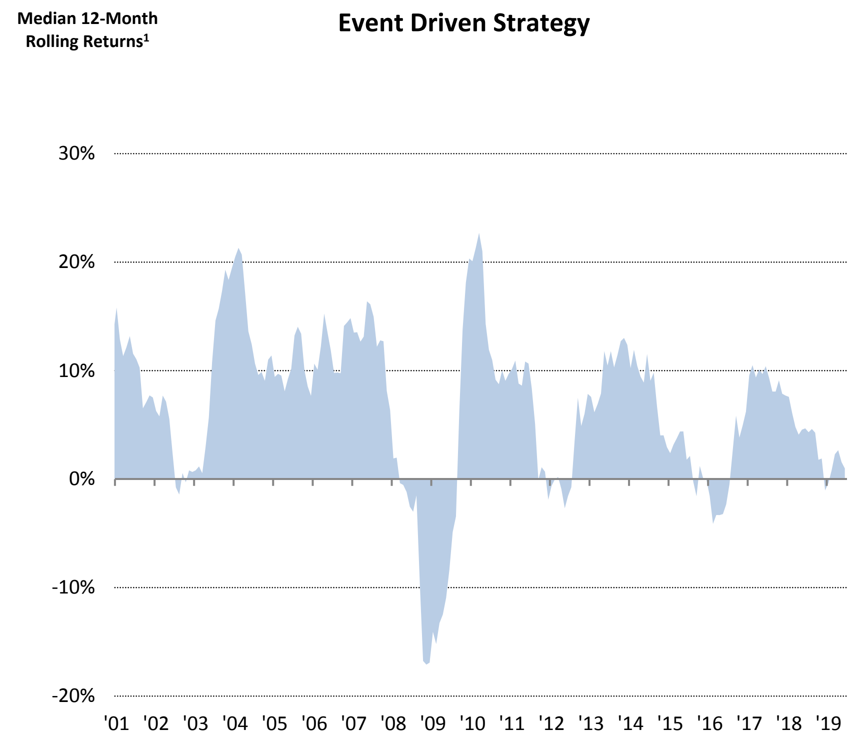


Source: Goldman Sachs

Overall, given our view that markets will remain range-bound and geopolitical risks will stay elevated, we are maintaining our neutral stance on equity L/S across all regions. Generally speaking, we favor managers with solid trading skills, and believe that factor exposures should be monitored closely in an environment that is best suited to those who pursue a balanced approach.

Special Situations / Event-Driven

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Market Beta		■		Neutral outlook for equities.
M&A Spreads			■	Spreads have widened meaningfully and now trade above what equity volatility and investment grade credit spreads would suggest.
Corporate Activity		■		Greater political uncertainty and higher cost of capital likely to dampen large corporate activity.
Activism			■	Activism continues to benefit from their sector and factor positioning, with also increasing security selection alpha in a less crowded market environment.
Tax		■		Limited catalysts.
Crowdedness			■	Lower levels of crowding in special situations portfolios.



Median returns are those of Investcorp's strategy peer group. Strategy peer groups are created by Investcorp and are comprised of funds that Investcorp has judged to be relevant for each strategy.

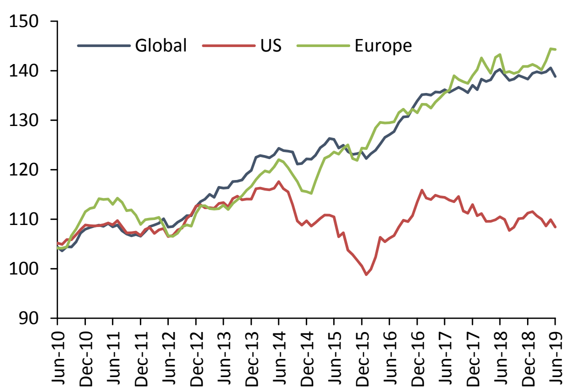
Source: PerTrac, S&P Capital IQ, Investcorp

Special Situations / Event-Driven

Global event-driven hedge funds posted a net return of 0.75% last quarter, according to Eurekahedge; special situation strategies were at the forefront, based on HFRI indices. In regional terms, Europe- and emerging-market-focused managers fared best, gaining 3.53% and 2.10%, respectively, while US-oriented counterparts trailed with a 0.76% rise, according to Eurekahedge.

Interestingly, despite the jump in volatility that took place during May, the group held its own during the first half, bolstered by beta exposure to special situations. In fact, many managers, notably those targeting Europe, appear to have generated increased alpha, as suggested by the chart below.

Event-Driven Funds – Alpha by Region



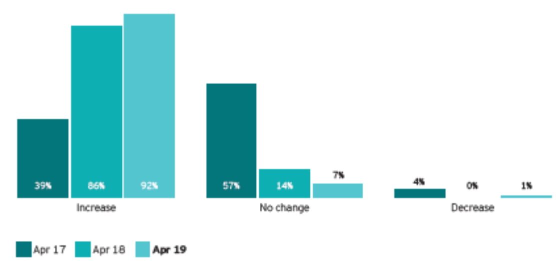
Source: Bloomberg, Investcorp

Outlook on Event-Driven Opportunity Set

There is little doubt that the sharp rally in share prices has aided the group, but given our view that the economic recovery is in its late stages, we are hesitant about prospects for another big leg up. Moreover, we believe that geopolitical threats, including heightened trade frictions and rising populist sentiment, have not gone away. Under the circumstances, we are maintaining our neutral stance on the strategy.

That said, we acknowledge that there has been a modest pickup in corporate activity since the year began. Based on an Ernst and Young survey of more than 2,900 executives in 47 countries, 92% expect the M&A market to see increased activity over the next 12 months, their most upbeat assessment in the past three years. In fact, 59% expect the firms they work for to pursue some type of transaction in the period ahead.

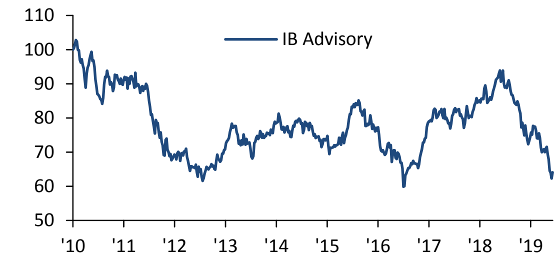
Executive Expectations of M&A Market Over the Next 12 Months



Source: Ernst and Young Global Capital Confidence Barometer

And yet, despite the optimism among corporate insiders, investment banking shares are suggesting something altogether different. As evidenced by the following chart, the performance of the sector relative to the broader market – a proxy for corporate activity – has been pitiful since the end of 2018, with few signs of stabilization. Based on our broader assessment of the fundamental backdrop, we believe this latter measure is closer to the mark, leaving us with little choice but to remain on the sidelines until we have increased clarity.

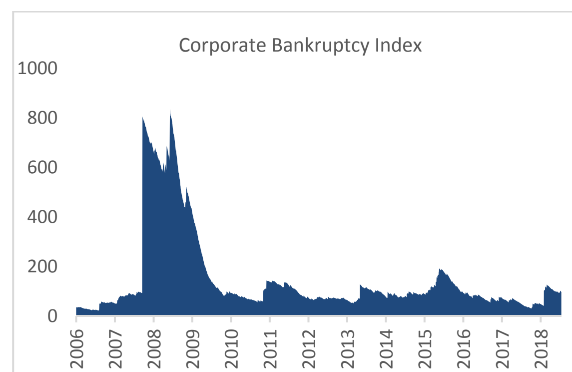
Average Performance of Rothschild, Lazard, Moelis and Evercore Shares vs. S&P 500



Source: Bloomberg, Investcorp

For now, at least, there is not much evidence that prospects are improving. For one thing, corporate debt has risen sharply, bolstered by a burgeoning leveraged loan market and subdued US bankruptcies, highlighted in the chart below. However, while the latter measure is near its lowest level in more than a decade, we are mindful that a late-cycle deterioration in fundamentals and a follow-on rise in defaults could weigh heavily on the segment's beta-driven returns.

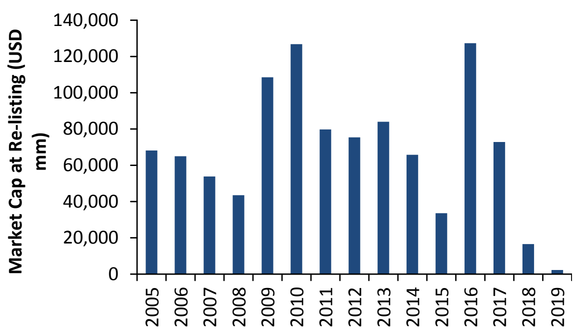
US Bankruptcies Historical Volume



Source: Bloomberg

In fairness, it is not all bad news. A pick-up in credit-related turbulence could expand and enhance the strategy's forward-looking opportunity-set, owing mainly to increases in reorganization- and inorganic-growth-driven corporate activity. Given the drop-off to all-time lows we have seen in post re-organization equity turnover, illustrated below, some might argue there is no way for this measure to go but up as the economic cycle matures.

Post Reorganization Equity Volumes



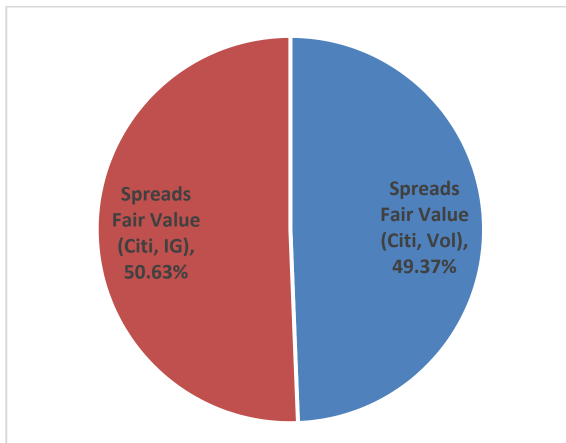
Source: CapitalIQ, Investcorp

Merger arbitrage hedge funds gained a net 3.26% in the first half, according to HFRI, adding to last year's 3.29% increase. That said, merger arbitrage has been a relatively poor performer, falling short of the 5.61% rise in the Event-Driven (Total) Index. Overall, conditions have been less-than-supportive amid rising nationalism and protectionism, heightened trade frictions, and geopolitical uncertainty, including ongoing concerns about a "no deal" Brexit.

In addition, global cross-border corporate transactions involving the technology and infrastructure sectors have faced increased scrutiny, especially when they require both US and Chinese approvals to reach fruition. In our view, the headwinds facing such deals will likely not go away in the near term. We recommend taking a highly selective and cautious approach when it comes to cross-border M&A investing.

As far as constituent drivers go, things are somewhat different than they were before. In the first quarter, cheapness in merger spreads owed much to equity volatility; more recently, this factor has shared almost equal billing with credit spread tightening, as can be seen in the chart below.

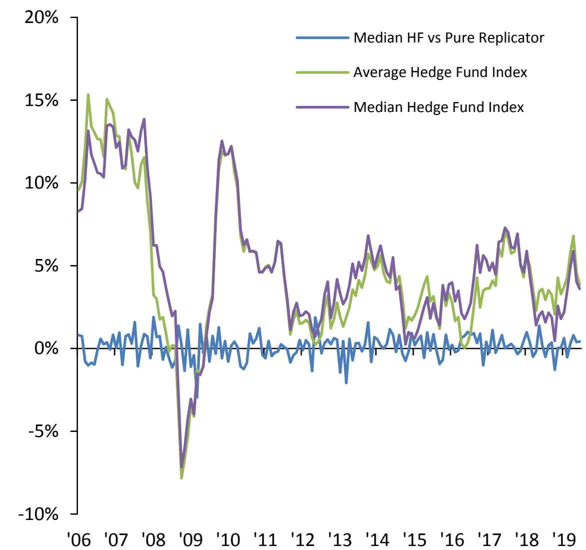
Breaking Down the Value Metric by Component



Source: Bloomberg, Investcorp

Finally, in assessing our outlook for the strategy, we also take account of how it is implemented. Late last year, the performance of hedge funds in the space lagged that of pure replicators on a 12-month rolling basis. Since then, however, the former has moved back out in front. Regardless, absolute returns remain limited, largely because the opportunities deemed relatively "safe" have meager spreads, while those that have more to offer tend to be cross-border deals that are often fraught with regulatory or other risks.

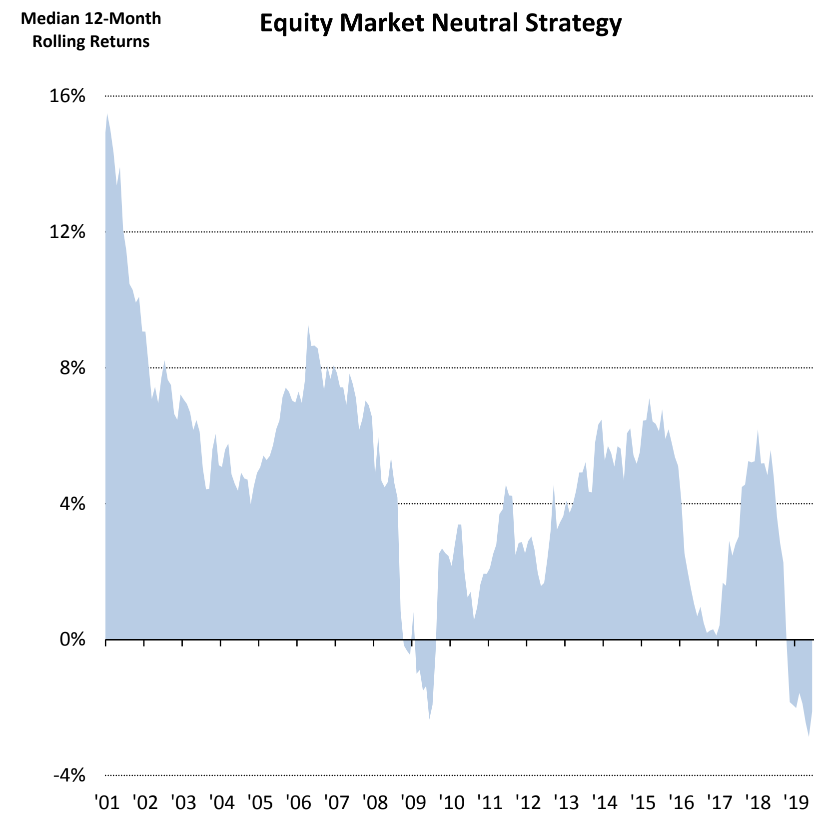
12-months Rolling Performance: HFs vs Replicators



Source: Bloomberg, Investcorp

Equity Market Neutral

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Dispersion	□□□	□	■■□	Volatility-neutralized dispersion trading remains significant. Sector rotation is the primary driver amid equity market bifurcation stemming from new macro trends and changing government policies.
Valuations	□□□	■	□□□	Defensive factor valuations are unattractive, though they are not at historical extremes.
Capital	□□□	□	■□□	Capital allocated to the strategy has declined; returns have not kept pace with long-biased equity counterparts and prop trading desks have exited.
Liquidity	□□□	■	□□□	Liquidity is not an issue with respect to large and midcap developed market names. In small-cap and emerging markets, however, turnover constraints remain key to exploiting attractive alpha opportunities.
Financing	□□■	□	□□□	Higher short-term deposit rates enhance the attractiveness of cash collateral, but it is offset by higher prime broker financing costs.



Median returns are those of Investcorp's strategy peer group. Strategy peer groups are created by Investcorp and are comprised of funds that Investcorp has judged to be relevant for each strategy.

Source: PerTrac, Investcorp

Equity Market Neutral

Equity market neutral hedge fund returns were flat to slightly negative last quarter, with the HFRI EMN Index drifting 0.03% lower and the HFRX EMN index falling 0.5%. The subpar performance occurred against a volatile backdrop for equity markets; in May, the VIX jumped to 20 and S&P lost 6.4%, with the latter recovering to end the period up 4.7%. Despite the mixed showing by the peer group we track, conditions seemed to improve marginally relative to the prior two quarters. In the earlier periods, managers reported that levered-quant portfolio liquidations appeared to have an indiscriminately negative effect on the quant factor opportunity set and statistical arbitrage trading.

In more granular terms, defensive stocks outpaced cyclicals and quality and low-beta names outperformed the lowest rated junk names during the May upheaval, though EMN funds as a group were relatively unscathed and stat arb strategies staged a partial recovery. In June, we saw positive contributions across a broad range of factors and regions, an interesting development. In the past, we have tended to see disproportionate losses being inflicted on the short books of quant managers during sharp, V-shaped rallies. This time around, however, the increasing alignment of momentum with defensive factors promulgated a somewhat different outcome.

The market's late-quarter bullish reversal owed much to a dovish Federal Reserve and a distinctly more accommodative ECB, both of which have become increasingly concerned and more vocal about disappointing growth and falling inflation. Given that, it was not surprising to see low beta and bond proxy stocks perform well and value and earnings growth factors outpace momentum and quality counterparts during June.

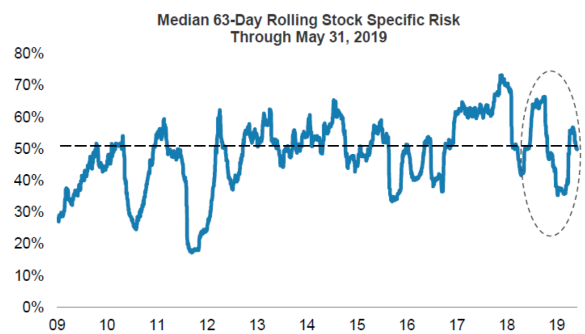
In earlier updates, we discussed the headwinds that weighed on EMN funds for most of last year and into the first quarter, which were exacerbated by an influx of capital into the space. While under-performance during the first three months was dominated by a short squeeze in the lowest quality stocks and weakness in US exposures, the latter fared better in the latest period.

At this point, however, we believe markets are at an interesting juncture with respect to quant equity funds. Even with share prices hitting all-time highs, there are large divergences in interquartile valuation spreads, suggesting that opportunities are there to be taken. Amid the wide divergence between the value and quality factors, it would be intriguing to see if rotations into the former can occur in both rising and falling markets.

In evaluating the year-to-date performance of the peer group we track, we see few standout winners, making it difficult to draw any broad conclusions about what has worked and what has not. While a few funds with nonlinear alpha models have navigated the recent choppiness well, it has been more of a mixed bag for fundamental factor-based players. Regionally speaking, Europe and Asia-oriented managers have outpaced US-oriented counterparts, which is not that surprising given the underperformance of US exposures in the first quarter.

Although not particularly useful for forecasting purposes, one indicator that helps quantify the environment that quant managers are having to contend with is the degree of idiosyncratic, or stock-specific, risk, which is not accounted for in a generic factor risk model. According to Morgan Stanley, idiosyncratic risk has been falling since last year's fourth quarter and is now hovering near its post-financial-crisis median, as can be seen below. Notably, stock-specific risk reportedly fell across all industry groups in May. Correlation is not causation, of course, but it is worth keeping in mind that this measure was closer to 70% for most of 2017, when the strategy generally performed well.

Top 500: Stock-Specific Risk, Rolling 63-Day Windows (Through May 31, 2019)



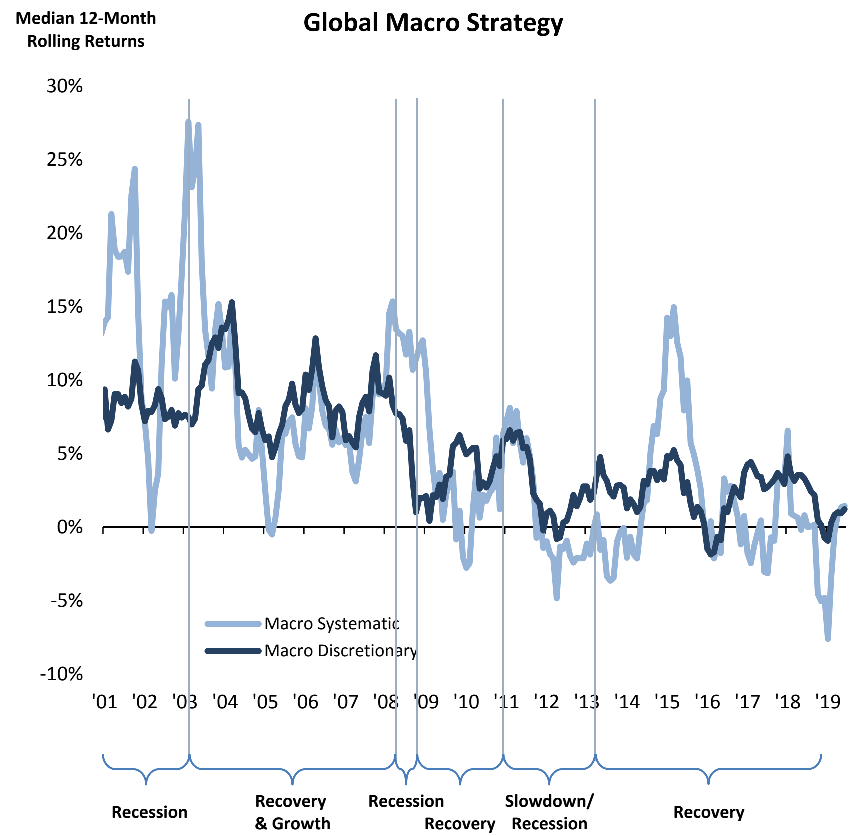
Source: Morgan Stanley, FactSet

From a top-down perspective, the fact that equity and fixed-income prices have rallied on the notion that bad news for the economy is good news for financial assets, owing largely to prospects for further monetary accommodation, could test the mettle of some managers. In particular, market neutral quant equity funds that tend to do well during moderately volatile downtrends may need to rethink their game. More broadly, a fall-off in the fund liquidation pressures we saw from 2018's final quarter through this year's first three months suggests the untenable crowding we noted previously has cleared.

Looking ahead, we believe the next six months could continue to see macro risk dominating the headlines. US-China trade negotiations will likely remain a source of uncertainty in the run-up to next year's US elections, while there is also the potential for a US debt ceiling-related flare up in the fourth quarter and a messy Brexit once we reach the agreement deadline in October. Consequently, we continue to favor regionally diversified multi-strategy quant funds operating over multiple alpha investment horizons. Generally speaking, managers employing this approach have proved adept at navigating varying combinations of heightened market volatility, turbulent macro headwinds, and sharp factor reversals over the last 18 months.

Global Macro

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Fundamentals			■■■	Growth and inflation upturns proceeding at different speeds across regions, offers opportunities for differentiations across interest rate and foreign exchange markets.
Trends		■		Potential for trends in interest rates and foreign exchange.
Correlation			■	Slightly lower diversification in rates but foreign exchange and commodities still offer a good playing field.
Volatility			■	Higher market volatility is opening up opportunities for trading and rewarding smart use of option structures.
Crowding		■		Limited risk of crowding in macro themes today (outside of perhaps long oil).



Median returns are those of Investcorp's strategy peer group.
Strategy peer groups are created by Investcorp and are comprised of funds that Investcorp has judged to be relevant for each strategy.
Source: PerTrac, Investcorp

Global Macro

Macro Discretionary

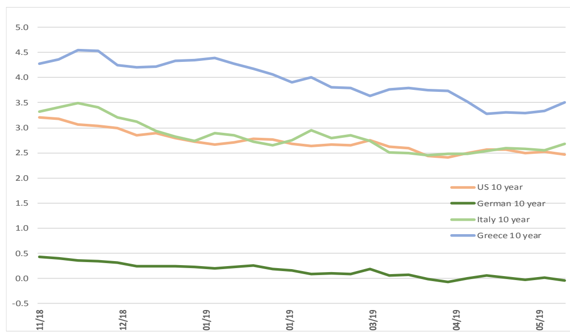
Discretionary global macro funds gained a net 2.9% last quarter and are up 5.2%, according to HFRI indices. While not exactly a poor showing, the group's performance trailed that of the broader HFRI Fund Weighted Composite Index, which rose 6.3%. Nevertheless, we remain overweight the strategy, which continues to be one of our most preferred hedge fund strategies for a variety of reasons, including the risk that the current economic cycle is nearing an end, high valuations in certain sectors and asset classes, and increased prospects for a pick-up in realized volatility, which tends to benefit a group that has historically had a long-volatility bias.

Specifically, we favor allocating to a diverse array of macro managers with exposure to a broad range of policy divergence themes, through with an increasing tilt toward those with a more traditional fixed-income, rates and foreign-exchange orientation. We also believe there are significant opportunities in the emerging markets complex, but would target managers that can be tactical, trade relative value opportunities, and avoid the more illiquid areas of the financial arena, including individual corporate credit names, at this stage of the cycle. As always, manager selection is key as the performance dispersion within our sub-strategy groupings is significant.

With respect to the broader picture, we would characterize the current macro discretionary trading opportunity set as strong. Following last year's second half, which proved challenging for traditional asset classes and across most hedge fund styles, the environment this year has been much more accommodating. The most successful macro players were those that were able to fully capitalize on the movements that occurred in risk assets during the period – overall, it paid to be long equities, credit, and duration.

Indeed, we saw standout performance from some managers, including EM specialists that managed to sidestep the fourth quarter carnage and reengage with markets after the turn of the year, as well as directional and relative value rates players. As alluded to earlier, long duration has been the key trade this year as bond prices have rallied worldwide – highlighted by the chart below – leaving longer-term yields in many leading markets, including Germany, France, Switzerland and Japan, in the red zone once again.

Global Bond Yields Have Rallied Significantly in 2019



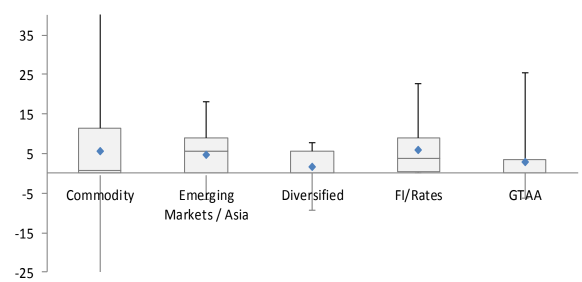
Source: Bloomberg

As of the end of last quarter, the yields on German bunds, for example, were negative for maturities going out as far as 20 years. The Greek 10-year currently trades at a spread of only 10 basis points over its US Treasury counterpart, which saw its yield fall 70 basis points from New Year's Day through the end of June. Across the world, there are, at present, approximately $13.4 trillion of outstanding debt obligations where investors are, in a sense, penalized to own them.

But fixed-income was not the only trading arena that paid dividends to macro discretionary managers. Although this group tends to favor using equities as a hedge or relative value play, those who waded in on an outright basis following the October-December drawdown were well rewarded. Some also capitalized on opportunities in commodities, including gasoline and WTI crude oil, the latter of which rose 64% from December through April; gold, which tested $1,400 after breaking out of a trading range; and soft commodities, including soybeans, which were impacted by tariffs, and corn, where bad weather led to the slowest planting progress since records began.

In dissecting the top-level performance data, we have found some interesting variations among the top 50 global macro discretionary hedge funds over the last 12 months. Typically, we segment the universe into five sub-strategies: FI/rates/FX, commodity, emerging markets/Asia, diversified and GTAA. As the following chart shows, the performance of the emerging markets/Asia and fixed-income segments has been the most consistent and had the least dispersion – based on inter-quartile ranges – which is in line with where we would want to tactically allocate to the macro discretionary strategy.

Investcorp Macro Discretionary Select Universe



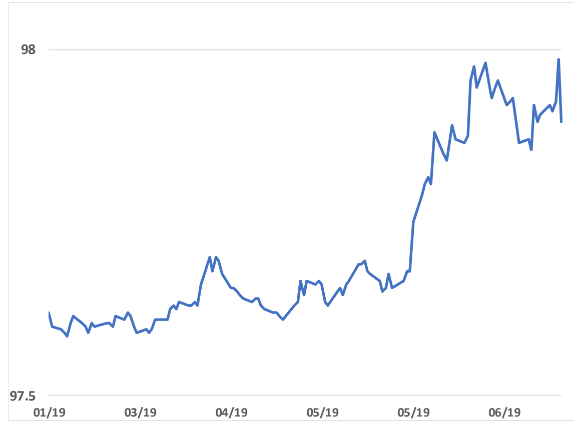
Source: Investcorp

Overall, the key point to keep in mind is that the significant dispersion we witnessed last quarter – and have also seen in prior periods – only serves to reinforce our earlier assertion that the most important investment decision in this space is choosing the right managers.

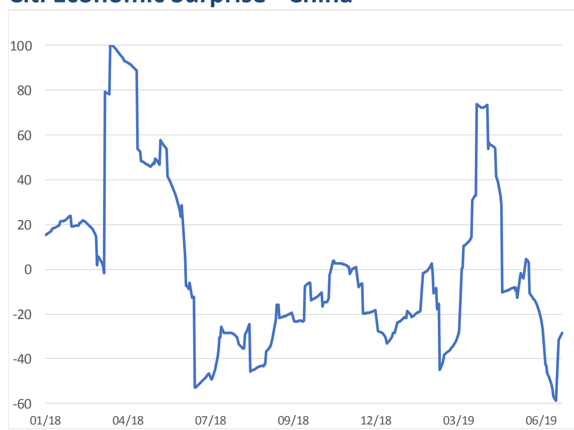
That said, handicapping the outlook can provide helpful context. In this case, absent significant policy mistakes by the Trump administration and a disorderly Brexit, we believe the macroenvironment over the next six months will be predicated on the actions of the Federal Reserve and China. As the last several years have shown, meaningful sell-offs in risk assets – equities, in particular – have tended to be instigated either by the Fed and/or concerns about Chinese growth and stimulus policy reactions.

With that in mind, the fact that fed fund futures rapidly priced in from May a 100% probability of a 25-basis point cut in July – as can be seen in the following chart– naturally raises questions about how events will unfold at the next FOMC meeting. Will we see, for instance, a "pre-emptive" cut of greater than 25 basis points, even though financial conditions are still broadly supportive and improving? Or will policymakers kick the can down the road in the hope of gaining greater clarity? Either way, it is not hard to imagine scenarios where investors respond with something other than sanguinity.

Fed Fund 30-Day August 2019 Future



Citi Economic Surprise - China



Source: Bloomberg

Regardless, we believe the optimal macro discretionary playbook for 2019 centers on the following managers, sectors and trades:

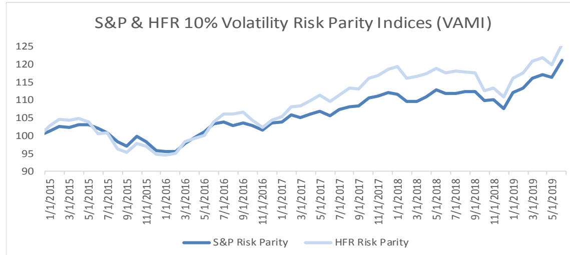
- Managers with cross-asset expertise that can successfully navigate equity and credit indices in addition to pure FX and interest rate exposure.
- Emerging markets specialists that have been able to play, inter alia, Latin America and EMEA, and which have also demonstrated an ability to tactically hedge during periodic sell-offs in carry-based strategies.
- Managers that can readily switch into relative value rate trading strategies, including the classic cash-futures basis.
- Managers that can play both relative value and directional plays in delta one and volatility across the commodity complex – which has been difficult to trade in recent years – where sectors such as metals are beginning to look potentially interesting.
- Idiosyncratic trades such as option structures that are designed to play mispriced event risk and central bank policy missteps.

Macro Systematic

Macro systematic strategies gained +4.4% last quarter and have returned +6.5% year-to-date, according to the HFRI Macro Systematic index; over the same spans, they were up 2.8% and +6.5%, respectively, according to the Société Générale CTA index. Despite the solid showing –first-half returns are the best since 2008 – we remain neutral on the group for reasons discussed in the following paragraphs. We favor allocating to a diversified cluster of multi-quant, short-term and medium-term CTAs, though with a reduced weighting for the latter owing to current range-bound trends, diminished upside potential in rates, and periodic crowded short positioning.

In more granular terms, "pure trend" managers fared especially well, as evidenced by the SG Trend Index, which is up 7.4% in the first six months. This group performed especially well in March and June; many were aided by the sharp rally in government bonds, while some also benefitted from outsized exposure to buoyant global equity share markets. Risk parity strategies have also been on a tear, producing their best first half performance in over a decade. With hefty rallies in equities and fixed-income serving as the perfect backdrop, the HFR 10% Volatility Index is up 13.3% through June, its strongest year ever.

S&P & HFR Risk Parity Indices (VAMI)



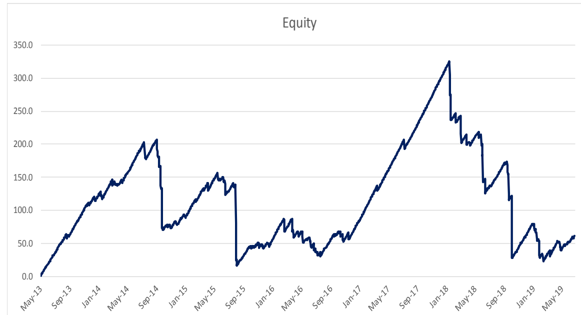
Source: Bloomberg

It is worth bearing in mind, however, that macro systematic manager performance covers the gamut, especially when looked at in terms of the varying approaches being used. To gain more insight into what is working and what is not, we segment the top 50 global macro systematic managers into five subcategories: alternative trend, diversified, pure trend, quantitative macro, and short term. Below is an overview of how each has fared over the past 12 months:

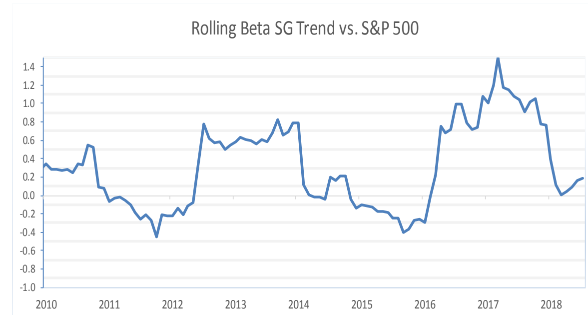
- **Alternative Trend** – This group, which includes managers trading instruments – ETFs, OTC credit, interest-rate swaps, and cash equities – that are more esoteric than the liquid futures contracts employed in standard trend models, has been among the best performers, posting an aggregate return of 15%. Interestingly, we saw some pockets of weakness within this subcategory in November, largely due to credit-related exposures.
- **Diversified** – Comprised of managers operating with a mix of short and medium-term trend and countertrend models, this cohort generated a gain of 16%.
- **Pure trend** – Managers in this group generated returns that were clustered around a 4-7% average, roughly in line with the benchmark index.
- **Quantitative Macro** – Funds in this subcategory, which have exposure to multiple quantitative alpha streams across cash equity style factors, volatility, trend, cross asset and GTAA-type models, among others, picked up around 3%.
- **Short Term** – This group, which tends to have the lowest Sharpe ratios, witnessed the highest level of dispersion; while the overall average was a loss of 2%, individual managers generated returns ranging from a high of +40% to a low of -30%.

When evaluating managers' forward-looking opportunity set, one set of measures we monitor are our internal "trend exhaustion" indicators, which are derived from three separate short-to-medium-term look-back periods across asset classes. In the case of global equities, the latest reading – highlighted in the first chart – suggests that the environment remains challenging for trend-followers, with periodic V-shaped moves making it difficult for models to gain traction. The rolling beta of the SG Trend index versus the S&P 500, illustrated in the second chart, tells a similar tale.

Investcorp Trend Exhaustion Indicator – Global Equity Indices



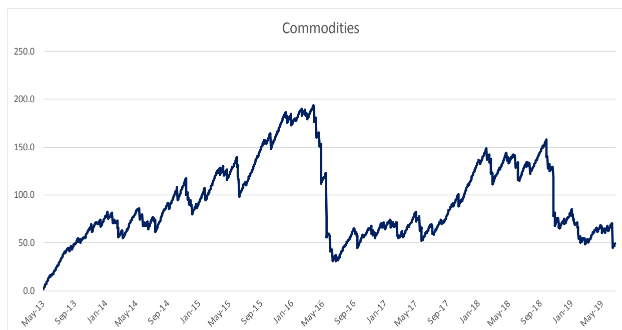
Rolling Beta SG Trend vs S&P500



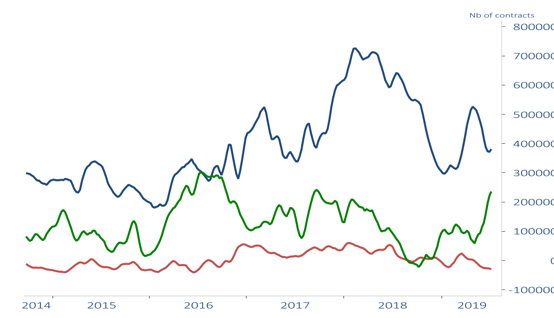
Source: Investcorp, Bloomberg

The picture in commodity markets as a whole looks somewhat similar, as the first chart shows, but the same does not hold true below the surface, where we have seen tradable trends in energy, softs and precious metals. WTI oil, for instance, rallied steadily from its $42 December low to above $65 in late-April, while gold broke out of a trading range in June and subsequently breached $1,400 – accompanied by a jump in speculative exposure – as the opportunity costs associated with holding non-yield-bearing assets fell. We also saw idiosyncratic moves in agricultural futures owing to tariffs (e.g., soybeans) and weather conditions – corn, for example, witnessed its slowest planting progress since records began.

Investcorp Trend Exhaustion Indicator – Commodities



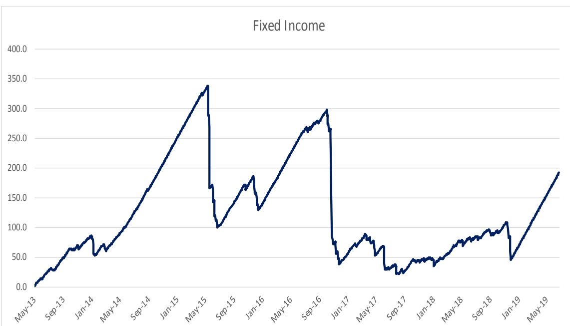
Net Speculative Positioning in Commodity



Source: Investcorp

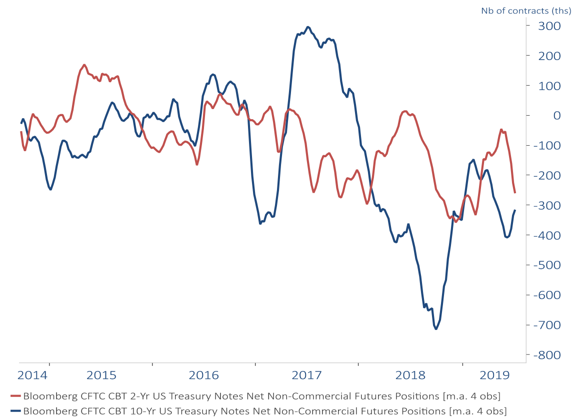
With global bond markets rallying on the heels of dovish policy pivots by both the Federal Reserve and ECB, it is not surprising that the signal emanating from our fixed-income trend exhaustion indicator – illustrated in the first chart below – is the strongest in the series, or that speculative positioning has been keeping pace, as the second chart shows. Indeed, evidence indicates that the move has been captured by many medium-term trend managers.

Investcorp Trend Exhaustion Indicator – Fixed Income



Source: Investcorp

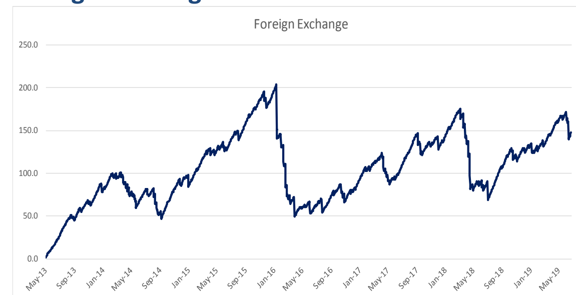
Net Speculative Positioning in Fixed-Income



Source: Investcorp

Finally, while the measure for foreign exchange has lost some steam recently, as can be seen in the following chart, it has largely remained on an upward path since the beginning of 2018, reflecting the strength in the US dollar we have seen over the span.

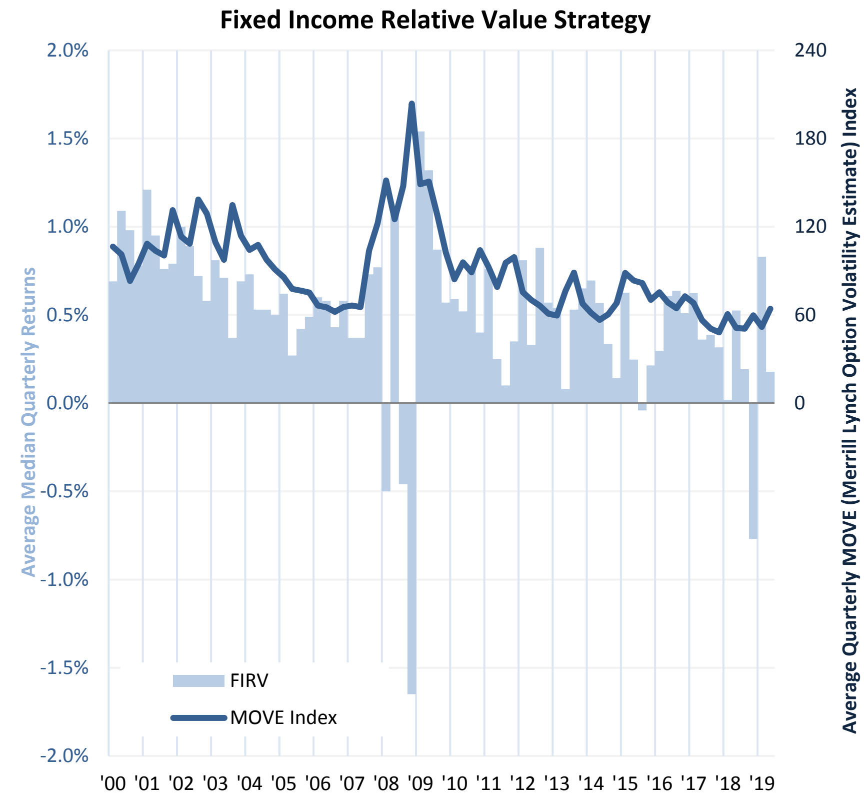
Investcorp Trend Exhaustion Indicator – Foreign Exchange



Source: Investcorp

Fixed Income Relative Value

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Opportunity Set	□□□	□	■■□	Heightened volatility in rates and flows sets the stage for curve micro-dislocations that relative value managers can capitalize on.
Macro Fundamentals	□□□	□	■□□	Macro trends continue to be supportive; event risks can instigate capital flows that lead to RV opportunities.
Capital	□□□	□	■□□	Capital pursuing the strategy remains limited in comparison to history amid an absence of proprietary trading and significantly lower leverage ratios.
Liquidity	□□■	□	□□□	In the Dodd-Frank regulatory era, liquidity can prove ephemeral, even in markets where such risk has historically been seen as negligible – as we learned during the October 2014 sell-off.
Financing	□□■	□	□□□	Balance sheet scarcity is limiting funds' ability to deploy the full range of strategies.



Median returns are those of Investcorp's strategy peer group. Strategy peer groups are created by Investcorp and are comprised of funds that Investcorp has judged to be relevant for each strategy.

Source: Investcorp, Bloomberg

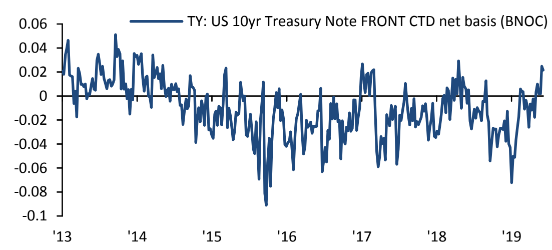
Fixed Income Relative Value

Fixed-income relative value funds gained 0.3% quarter-to-date through June, according to the Morningstar MSCI Fixed Income Arbitrage Hedge Fund Index. Within the peer group we track, balance-sheet-focused managers continued to generate strong gains, with several posting mid-single-digit returns through the half-year mark. Generally speaking, those playing the cash-futures basis and US and European government bond relative value strategies fared best, while those trading interest-rate volatility and swap box trades lagged.

Among macro-discretionary and systemic funds, the dovish tilt by global central banks proved to be the impetus for a ramp-up of duration exposure, mainly through the use of futures and swaps. This afforded managers with balance sheets that were large enough to capitalize on trading in cash bonds versus futures and quarterly futures rolls some-thing of an advantage.

Further out the maturity spectrum, the ECB's downgraded growth expectations and British Prime Minister Theresa May's resignation in June, which boosted prospects of a "no deal" Brexit, sparked a broad rally in fixed income led by UK gilts and German bunds. As suggested by the chart be-low, one result was the repricing of the US 10-year Treasury basis, as measured by the differential be-tween the cheapest-to-deliver bond and the front-month future.

US Cash-Futures Basis



Source: JPMorgan, Investcorp

In regard to yield curve trades, there were several opportunities to capitalize on the interplay be-tween seesawing economic data – such as April's strong payroll number and subsequent weak manufacturing data – and central bank dovishness.

Technical factors have also instigated potential trade set-ups. This includes the balance sheet-driven fall-off in demand for Treasuries around quarter-end as Libor and OIS markets repriced lower, which spurred Treasury underperformance, a steepening in spot and forward 2-year/10-year swaps, and tighter swap spreads. The latter had a particular impact on funds that had put on asset swap box trades in their portfolios.

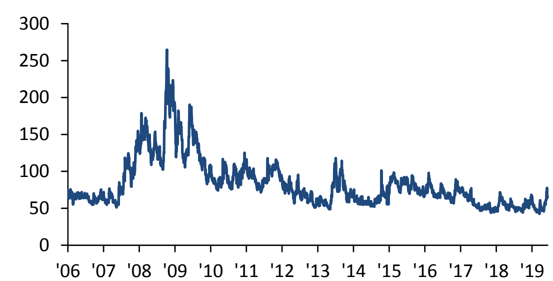
Otherwise, the absence of any real signs of up-ward price pressures in inflation reports caused Treasuries to underperform TIPS and break-evens to skid lower, as can be seen in the following chart, though TIPS asset swaps held up relatively well. Regardless, we can expect increased activity in swaps and futures trading as we transition into a monetary easing cycle, which will likely see, among other things, mortgage-holders beginning to hedge pre-payment risk.

TIPS Break-Evens Close to Lows

Source: Bloomberg, Barclays Research

In broader terms, the shift away from discounting divergent global economic policy responses toward a growing consensus anticipating more central bank accommodation could mean reduced volatility in fixed-income markets, potentially putting a halt to the nascent upswing in the MOVE index, illustrated below. Indeed, it appears that some FIRV managers already see a new paradigm and are responding accordingly. They are adjusting exposures in favor of structures under 10-years so that they can remain focused on monetary policy and be less exposed to a possible vega collapse in longer-dated fixed-income derivatives.

Fixed-Income Implied Volatility Index (MOVE)



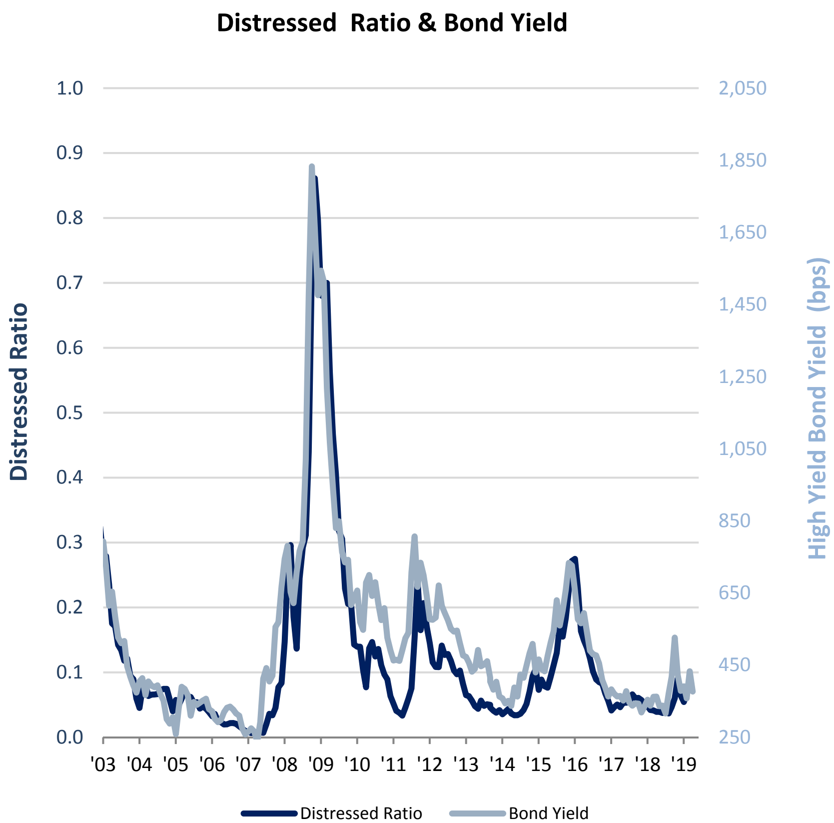
Source: Bloomberg, Investcorp

For those who might wonder about the potential for another easing cycle, it is worth keeping in mind that ECB President Mario Draghi, in his speech at the recent ECB Forum in Sintra, Portugal, laid out the potential for a return to QE. Together with the nomination of Christine Lagarde as his predecessor, this would appear to solidify prospects for a continuation of his dovish legacy.

Against this backdrop, the existence of considerable dealer balance sheet capacity and developments such as the SEC's approval of a plan to expand sponsored repo facilities that include additional market participants, which should further free up major bank balance sheets as they inter-mediate Treasury repos between speculators and money market funds, could create fresh opportunities in government and mortgage relative value trades. That said, we would be cautious if we begin to see an uptick in participation by noneconomic central bank players as a result of QE.

Corporate Credit

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation	■ (red, 3rd)			Credit spreads offer limited room for tightening at current levels
Carry	■ (red, 3rd)			Carry is back on line with pre-sell-off levels.
Credit Spreads		■		Credit spreads should remain stable or widen slightly from current levels.
Duration		■		US yields likely to stay range-bound – little impact for credit.
Dispersion			■ (green, 1st)	There is some dispersion, but it is difficult for managers to capture under current liquidity conditions.
Defaults			■ (green, 1st)	Defaults should remain low, though there will likely be some pick-up in energy-related sectors.
Liquidity	■ (red, 3rd)			Liquidity is challenged: broker-dealers hold structurally lower inventories following regulatory curbs on proprietary trading.



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Source: Investcorp, Bloomberg

Corporate Credit and Distressed

High yield credit gained 2.5% in the second quarter, according to the Barclays High Yield Index. Over the span, HY option-adjusted spreads declined by 14 basis points, from 391 basis points at the end of March to 377 at the end of June, as illustrated below. Hedge funds targeting the segment, meanwhile, returned +3.01%, based on the HFRI RV: Fixed Income-Corporate Index.

Historical Credit Spread – CCC-rated Corporate Debt

Source: JP Morgan

Over the last 12 months, the Barclays benchmark climbed 7.48%, while the HFRI gauge rose 5.72%, owing largely to unaggressive positioning among managers. As has been the case previously, they have maintained average net exposures ranging from 30% to 60%, making it difficult for them to fully capitalize on the snapback rally that kicked off the year.

Given the above, it is apparent that the group did not generate any real alpha net of fees, a recurring issue to which we have long made reference. For one thing, the long/short high yield strategy remains challenged by generally low yields – the average was 5.87% at the end of June – that have left little room for further spread compression. At the same time, a relative paucity of defaults has limited the scope for spread-widening, which would benefit short positions.

Indeed, the U.S. leveraged loan default rate was unchanged at a slim 1% in May, only slightly above the seven-year low of 0.93% seen at the end of March, according to the S&P/LSTA Loan Index.

Power producer Empire Generating Co. accounted for the sole loan default last month. Its impact on the index was largely offset by the rolling off of Proserv Group's default from the trailing 12-month calculation. Citing rising natural gas prices, Empire Generating filed for Chapter 11 protection in New York bankruptcy court on May 20 after triggering a technical default stemming from a covenant breach.

During the proceedings, it is expected that asset managers Black Diamond Capital Management and MJX Asset Management will seek to leverage their 55% stake in the company's secured debt to force an asset sale via a credit bid, a move that is opposed by minority-share debt-holders led by Ares Capital Management. Ares has already made a rival bid for the assets and has signaled in filings that it intends to litigate against credit bidding for the assets.

More broadly, the default rate remains well below its 2.93% historical average, while the number of distressed issuers continues to be limited, as can be seen in the following chart.

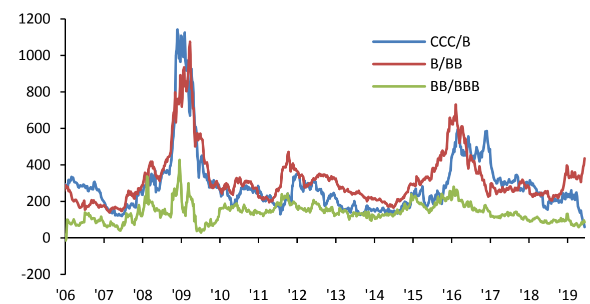
Number of Distressed Issuers

Source: TRACE, Bloomberg

As always, when we evaluate market conditions and prospects for the period ahead, we typically focus on three key metrics: compression trades, liquidity premium, and CDS basis. The following paragraphs provide an overview of where they stand.

Compression trades. Mean reversion is a powerful source of return-generation for long/short credit hedge funds: they tend to outperform benchmarks when credit spreads tighten across segments with different ratings. As illustrated below, spreads have been narrowing since they jumped higher at the tail end of last year.

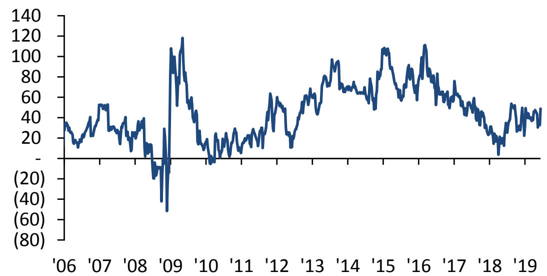
Relative Credit Spread Differentials Across Ratings



Source: JPMorgan, Investcorp

Liquidity premium. Our research has shown that performance in this segment tends to be positively associated with the presence of a liquidity premium, which can be assessed by measuring the difference between global high yield spread indices and their liquid high yield counterparts. As the following chart indicates, this measure has been largely range-bound, fluctuating between 20 and 40 over the past several months.

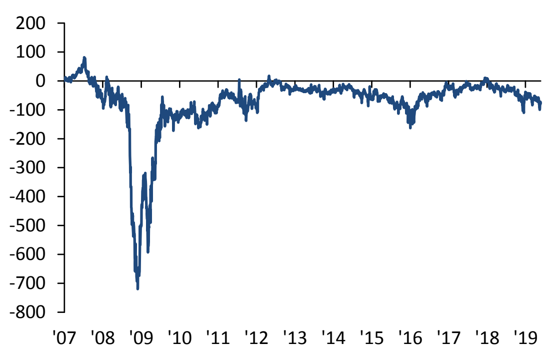
Historical Corporate High Yield Liquidity Premium



Source: Investcorp

CDS basis. One metric that has proved useful as a contrarian indicator is the CDS basis, which can serve as a proxy for gauging stress within hedge fund portfolios. Because most managers go long through cash bonds and short by way of CDS, this measure often falls to new interim lows during periods of violent de-risking. In recent months, it has been hovering near its historical average, as indicated below, suggesting that the strategy's opportunity set remains somewhat lacking.

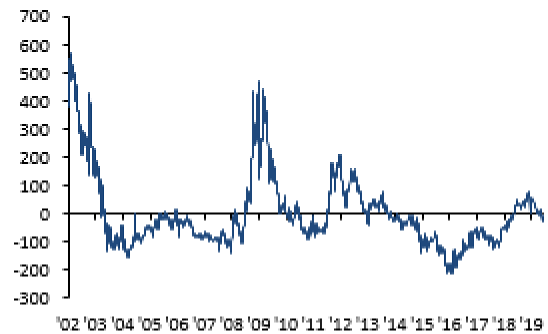
CDS High Yield Basis



Source: JPMorgan, Investcorp

Beyond our shores, developments have been a tad more interesting. Over the past few months, spreads between European and US credit have narrowed, as can be seen in the following chart.

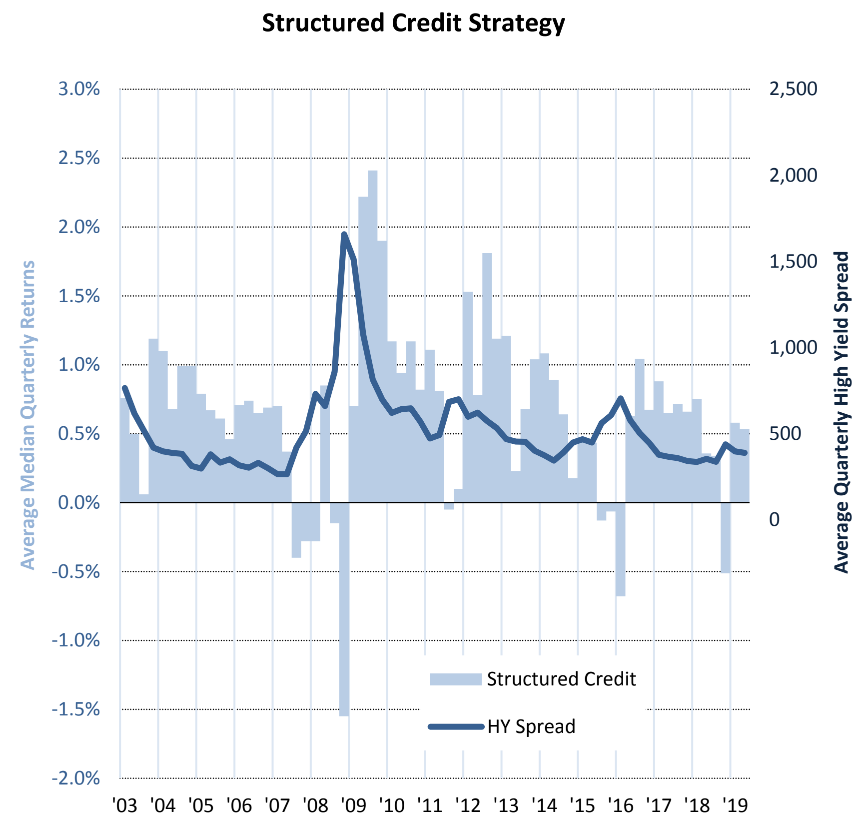
EUR-US High Yield Spread



Source: Bloomberg, Investcorp

Structured Credit

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation		■		Recoveries in most structured credit segments have lagged those seen in more liquid corporate credit counterparts, indicating a relative value opportunity.
Flows			■	Hunt for yield ongoing
Carry		■		Net-of-fees carry is too low to be an attractive driver of returns.
Idiosyncratic Legal & Structural			■	Put-backs and monoline wrappers are creating optionality in selected issues as well as CLO refinancings and resets.
Liquidity	■			With broker-dealers scaling back their market-making activities, the liquidity environment remains unsupportive; strong demand from real money investors has helped, but how they will behave in a severely stressed market environment remains a wild card.
Financing		■		Financing capability continues to be some-what challenged by balance sheet scarcity.



Median returns are those of Investcorp's strategy peer group. Strategy peer groups are created by Investcorp and are comprised of funds that Investcorp has judged to be relevant for each strategy.

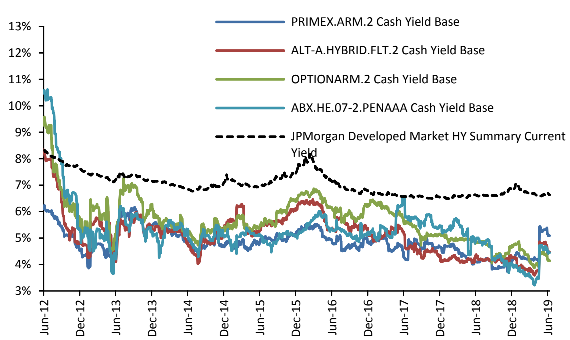
Source: PerTrac, Bloomberg, Investcorp

Structured Credit

Structured credit has largely failed to keep pace with the risk-on rally that began the year, owing largely to inherent structural elements. This asset class exhibits far less beta with respect to broader market movements than other fundamentally driven strategies, which can be an advantage when they are under pressure. Nevertheless, the HFRI RV: FI-Asset Backed Index rose only 1.60% in the second quarter and is up a modest 3.28% through June. HY credit, on the other hand, gained 2.57% in the April-June period and has returned 9.89% so far this year, based on the Merrill Lynch High Yield Index.

This aspect aside, the strategy has often failed to deliver an attractive combination of carry and capital preservation; at best, one is typically substituted for the other. Unfortunately, the broader trend of low-carry opportunities has largely worsened over the last 12 months, with RMBS – which rep-resents a sizable slice of the structured credit space – seeing cash yields fall over the span, as shown below.

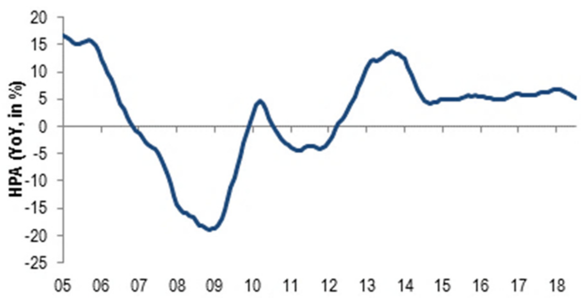
Historical Non-Agency RMBS Cash Yield



Source: JPMorgan

Making matters worse, the housing market has continued to falter. While broader economic fundamentals still paint an encouraging picture for real estate, home sales have been slowing and prices have remained under pressure, as can be seen in the following chart.

S&P Case Shiller Home Prices Appreciation Index

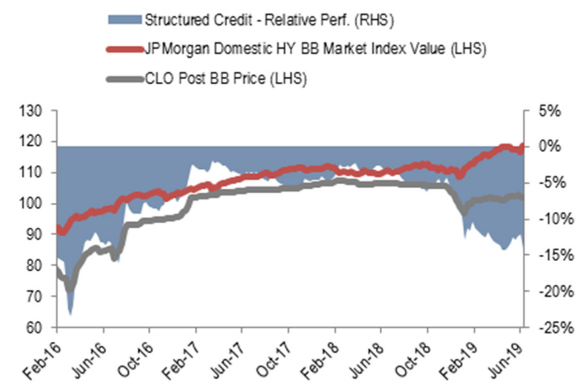


Source: Bloomberg

In the CMBS space, while trading activity and new issuance have picked up and spreads have continued to recover, all eyes remain focused on developments in the retail sector. In fact, the rebound we have witnessed since 2019 began has encouraged many managers to look more closely at positioning on the short side of the CMBX index.

Collateralized loan obligations, meanwhile, have seen prices recover amid improvement in underlying loan indices, though both remain slightly below last year's highs, as evidenced by the chart following. With spread arbitrage remaining under pressure, new issuance will likely continue to be constrained.

Relative Performance between CLOs and Corporate Credit



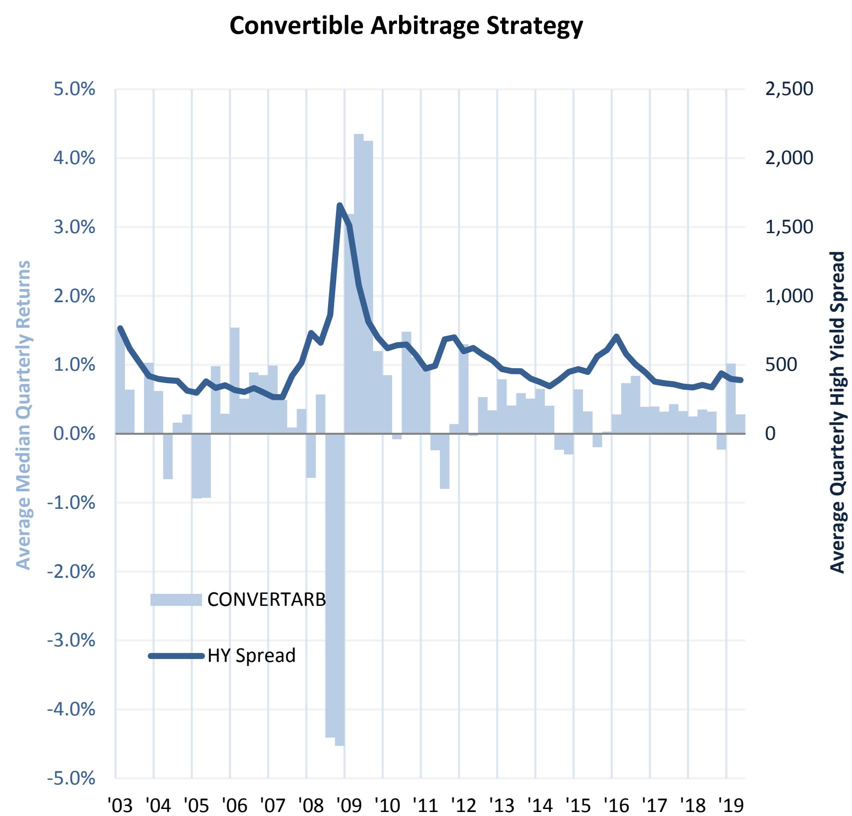
Source: JPMorgan, Investcorp

More broadly, while optionality is somewhat limited amid the recovery in legacy positions, idiosyncratic opportunities remain, including such relatively safe plays as callable RMBS and TRUPS CDOs. As an aside, near-maturity CMBS have continued to trade at a steep discount, even though most have been maturing with sharp recoveries.

Non-qualified and non-prime mortgages are still generating outsized returns; in addition, they offer attractive cushions against downside risk and enhanced liquidity stemming from greater market acceptance and the increased pace and scope of securitization. Finally, formerly attractive strategies such as legacy RMBS put-back litigation, which has suffered in the wake of adverse settlements, have continued to lose favor.

Convertible Arbitrage

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation		■		Valuations have continued to come in limiting the strategy's upside potential in future quarters.
Issuance		■		New issuance has come down in recent months, reducing the alpha tailwinds of new issue trading generally available to hedge fund managers.
Capital		■		Long-only buyers have become an important part of the market, diffusing returns to the long-short risk premium.
Liquidity	■			Liquidity remains a concern as broker-dealers scale back market-making activities.



Median returns are those of Investcorp's strategy peer group. Strategy peer groups are created by Investcorp and are comprised of funds that Investcorp has judged to be relevant for each strategy.

Source: Investcorp, Bloomberg

Convertible Arbitrage

Convertible bond arbitrage hedge funds posted a net gain of 1.5% last quarter and are up 6.7% year-to-date, according to HFRI indices. The Barclays US Convertible index also fared well; aided by strong performance in January and June – which saw positive returns of 7.9% and 4.5%, respectively – the benchmark is up 14.8% through the first six months, though it has lagged the 18.5% run-up in the S&P 500 index. The global convertible market has also turned in a decent showing; the BAML 300 is 9.4% higher for the year-to-date, driven primarily by strength in US and emerging markets.

For the most part, convertibles have been bolstered by the broad rally in risk assets and compression in credit spreads; the midcap space and the technology, communications and industrials sectors, in particular, have been the standout performers. Nonetheless, we retain our neutral outlook on the convertible arbitrage strategy, even though returns have outpaced the broader HFRI Composite index, up 6.3% year-to-date. As we have noted in previous commentaries and discuss later on, there are various headwinds afoot that could undercut future returns.

Tactically speaking, we prefer to steer positioning toward shorter-duration and volatility-focused strategies, and away from explicit credit-oriented plays. We also see increased opportunities in gamma trading through "synthetic put" exposure. In general, we would avoid excessive leverage unless utilized in the aforementioned structures.

As before, we continue to believe that liquidity is a key consideration at this stage of the cycle. Aggregate convertible bond volumes has been declining for a number of years, concomitant with the decline in the value of outstanding issues – at present, the US market is valued at $214 billion and has average daily volume on the order of $1-1.5 billion. While the overall trend has improved somewhat from 2015, things have deteriorated over the last 12 months.

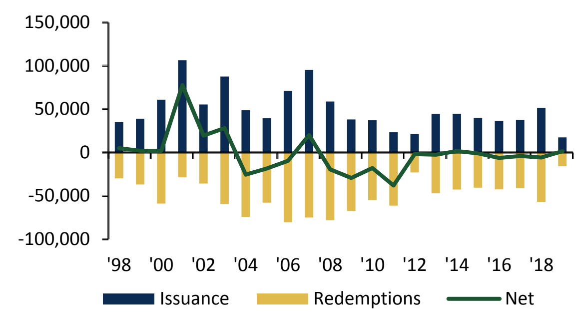
That said, robust new issuance remains a positive for some managers. Those who are active in the primary markets and who can selectively purchase theoretically 'cheap' new issues and flip them quickly, as well as those who can acquire secondary market issues that are being offloaded at big discounts by outright and index buyers, can undoubtedly benefit. Indeed, such strategies can add meaningfully to overall performance.

Volume-wise, global new issuance of $40 billion so far this year is on a par with 2018 –the strongest 12-month period since 2014 – though the risks that the final tally will fall short will likely increase if policymakers press interest rates sharply lower. Overall, volumes this year have been bolstered by a number of jumbo deals, including $1.8 billion for Tesla (i.e., TSLA 2% 2024) and $1 billion for an Avantor mandatory preferred issue (AVTR 6 ¼ 2022), and in Europe, two $2.3 billion tranches for Vodafone (VOD 1% 2021/2022).

The primary drivers behind recent US issuance, in particular, have been, in descending order, demand for growth capital, refinancing, M&A (with secondary uses for exchanges), buybacks, and capital expenditures. Another tailwind has come from the Tax Reform Act of 2017, a driver we first spotlighted when the measure was introduced, which limited the deductibility of interest and substantially improved the attractiveness of convertibles relative to high yield debt. Flexible convertible structures have also provided something of a lift. Separately, it is interesting to note that many of this year's offerings are coming from first-time issuers.

In terms of geography, year-to-date US issuance of $22.4 billion is solid, but it is significantly below the $34.7 billion level seen at the same point in 2018. As alluded to earlier, year-to-date issuance in Europe has been skewed higher by the Vodafone deal. In Asia and Japan, the run-rate has lagged, with support mainly coming from offerings by US-listed Chinese technology companies. US net issuance, highlighted below, is currently positive at $4.3 billion, which, for now at least, stands in contrast to the negative annual totals seen in the past four years.

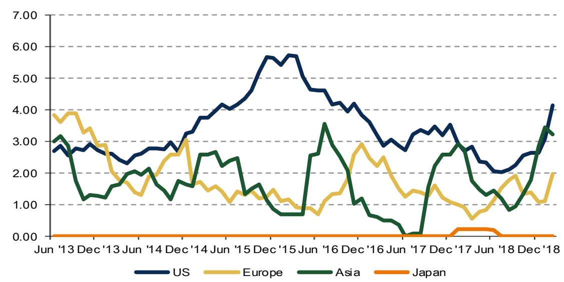
Convertible Arbitrage US Net Issuance Trends



Source: Bank of America Merrill Lynch

Along with the diminished pace of issuance this year, US new offering terms have gotten more generous, as can be seen in the following chart; the current six-month average coupon is at a multi-year high 3.6% (versus 2-3% last year), and the six-month average conversion premium is 25.8% (versus roughly 28-30% last year). US issuance in 2018 was dominated by technology and healthcare, which accounted for 43% and 17%, respectively, of the total. So far this year, healthcare, with a 31% share, is leading the way, followed by the consumer discretionary and technology sectors, with 18% and 13%, respectively.

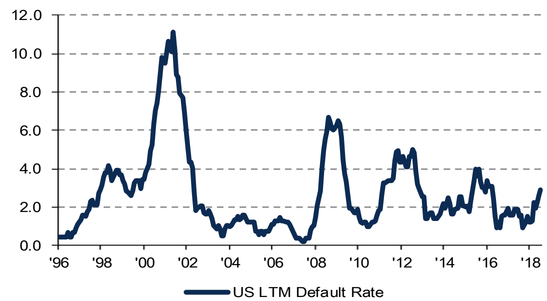
New issue trends – Coupon



Source: Bank of America Merrill Lynch

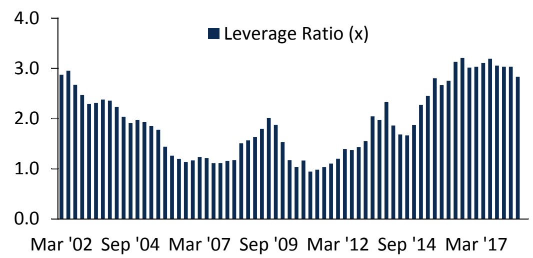
It has not helped that there continues to be questions about the fundamentals going forward. Despite low default rates at present, we continue to see early signs of deterioration – albeit based on a small sample size – as indicated by the first chart. In fairness, some would note that recent year-on-year earnings growth has been strong, while leverage ratios – featured in the second chart – have plateaued over the last 18 months, potentially offsetting the negatives.

US Convertible Bonds LTM Default Rate



Source: Bank of America Merrill Lynch

US Convertible Bonds Issuers Historical Leverage Ratio



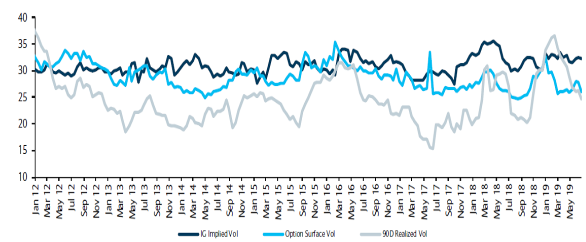
Source: Bank of America Merrill Lynch

That said, many market-watchers nonetheless anticipate a deterioration in credit quality and associated spread widening as an already lengthy upswing ages further and the threat of a downturn increases accordingly. Aside from the fact that liquidity should be a key concern at this stage of the cycle, it is also worth bearing in mind the outsized role that technology has played in buoying convertible performance.

Should worries in the sector about elevated valuations or regulatory curtailments prove justified, things could turn difficult. For investors, one way to potentially ameliorate such concerns is to acquire "synthetic puts" on select names as a hedge.

Finally should quantitative tightening become the policy of choice in the US (or elsewhere), we would expect market turbulence to increase concomitantly. Capitalizing on this is not as easy as it might appear; implied volatility in converts has not eased in lockstep with the fall-off in realized volatility, as suggested below, leaving less to go for in the space overall. With this in mind, the best approach may be to target idiosyncratic single-name volatility driven by company-specific catalysts.

IG US Convertible Bonds Implied Volatility Relative to Option Surface and Realized Volatility



Source: Barclays

Loan Markets

The Credit Suisse Leveraged Loan Index rose 0.47, or 1.58%, to 96.78 last quarter, with most of the gains coming in April.[1] The mixed performance over the May-June span can largely be attributed to ongoing concerns about a potential trade war and the Federal Reserve's pivot toward a dovish stance. Additionally, technical conditions deteriorated as retail investors continued to head for the exits. Loan mutual funds have now seen redemptions for 32 straight weeks; a total of $7.5 billion was withdrawn in the latest three-month period.

That said, other factors served to make up the difference, leaving supply and demand roughly in balance.[2] One key driver was CLO issuance; $36.9 billion in new issues were priced last quarter, which is on a par with last year's record pace. Additional support came from $17.1 billion in loan repayments, much of which emanated from high yield bond refinancings and IPOs. The supply of new loans, meanwhile, remained tepid; net priced volume was $48.6 billion, significantly below the $86.1 billion seen in the year-ago quarter. Generally speaking, issuance owed much to LBO and M&A financing, refinancing, and opportunistic dividend deals, which accounted for 45%, 20% and 10% of the total, respectively.

In terms of the market's fundamentals, conditions remained sound. While the trailing 12-month default rate rose to 1.34% at the end of June from 0.93% in the first quarter, it remained below the 1.63% level that prevailed at the end of December.[3] The discount margin tightened by seven basis points to 460 basis points.

Sector-wise, only one group posted negative returns last quarter – metals and minerals, down 1.62% – though other economically-sensitive segments also disappointed, including energy, which was flat, and consumer durables, which drifted 0.21% higher. In contrast, defensive issues, including utilities and food and drug names – up 2.13% and 2.05%, respectively – more than held their own. Interestingly, the housing segment also fared well, gaining 2.08% on positive sector-specific data. As was the case in the first quarter, higher-rated credits led the pack: BB-rated and B-rate loans were up 1.66% and 1.57%, respectively, while CCC-rated counterparts rose just 0.58%.[4]

Across the Atlantic, the Credit Suisse Western European Leveraged Loan Index rallied 1.87% last quarter.[5] While all three months witnessed positive returns, the bulk of the gain came in April, when the market rose 1.23%. Overall, the average loan price increased from 97.69 to 98.01, which was off its early-quarter peak of 98.38 and well below the September 2018 high of 99.07. Despite more favorable conditions in the region than elsewhere, the European loan market could not fully shake off the US-led decline in global risk sentiment that occurred during May and June.

In terms of supply and demand, the latter continued to outweigh the former. Despite sustained interest from investors, European loan issuance faltered; at EUR 34.9 billion for the year to date, the total was down 30% from the year-ago period.[6]

At the same time, CLO formation has been robust, with EUR 14.7 billion of new issues coming to market during the first six months, 6% more than in last year's first half. Since 2019 began, five new managers have entered the CLO space, with a further handful expected to debut new issues in coming months, even with a more nervous tone in credit markets overall on the heels of continuing macro uncertainty, CLO demand has helped to keep things buoyant. Separately, the European discount margin tightened by 10 basis points to 420 basis points last quarter.

Amid strong demand for European loan assets, especially from CLO rampers, the best values continue to be found in the primary market, where issues have traded up strongly on the break because investors have been unable to get the allocations they want. In contrast, the secondary market remains a fairly expensive source of supply. Given that, primary market access and the ability to secure sufficient allocations remain the key to good performance.

Similar to what occurred in the US, cyclical and other industries that are susceptible to macro headwinds came up short last quarter; shipping and aerospace fell 3.55% and 2.95%, respectively. Interestingly, consumer durables turned out to be the best performing group, with a gain of 3.92%, followed by utilities and housing, which rose 3.00% and 2.49%, respectively. Traditionally defensive sectors such as food and healthcare also fared well; both groups posted returns in excess of 2% for the period.

[1] Credit Suisse US Leveraged Loan Index Monthly data, June 28, 2019.
[2] LevFin Insights, LFI Quarterly Insights 2Q2019, July 2, 2019.
[3] LCD, an offering of S&P Global Market Intelligence, July 1, 2019.
[4] Credit Suisse US Leveraged Loan Index Monthly data, June 28, 2019.
[5] Credit Suisse Western Europe Leveraged Loan Index Monthly data, June 28, 2019.
[6] LCD, an offering of S&P Global Market Intelligence, July 1, 2019

Credit-wise, riskier CCC-rated obligations generated subpar performance, with a gain of 1.18% over the April-June span, in contrast to BB-rated and B-rated loans, which rose 1.88% and 1.93%, respectively.

More broadly, underlying credit fundamentals in Europe have remained robust; the S&P European Leveraged Loan Index (ELLI) posted a 0% trailing 12-month default rate in the first half.[7] That said, the number of issues moving into stressed pricing territory has been rising, though as we noted in the last Environment Report, this has generally been for company-specific reasons, rather than because of market or industry concerns. We continue to expect idiosyncratic mishaps to occur and will be quick to exit positions that we feel may encounter stress.

Loan Market Outlook

In the loan market – and in other asset classes, for that matter – the stance of central banks, most notably the Federal Reserve, is the primary focus. Since last year's fourth quarter, investors have shifted from expecting further Fed interest-rate hikes to anticipating multiple cuts, with the first such move in July. More recently, mixed economic data and the strength of the latest US jobs report have served to muddy the waters regarding the trajectory and timing of prospective rate cuts. That said, Fed dovishness could nonetheless help to prolong the current expansion and provide an earnings tailwind for the companies we invest in.

On the other side of the Atlantic, the ECB also looks increasingly likely to become more accommodative following its acknowledgement of the downside risks to the growth outlook.

Typically, retail investors tend to flee the floating-rate loan segment when rates are expected to decline, creating a technical headwind. However, we agree with a Credit Suisse strategist who notes that "while the prospect of Fed rate cuts certainly remains a challenge for the loan market, low all-in loan yields already factor in this negative outcome."[8] We also expect persistent demand from CLOs – which have already issued $65 billion and EUR 14.7 billion of securities this year in US and European markets, respectively[9] – to remain a supporting factor.

In terms of our outlook for the loan market going forward, we anticipate coupon-like returns that will, following the strong first quarter rally, lead to full-year performance in excess of 8%. In our view, however, the path higher is unlikely to be a smooth. We expect to see bouts of volatility as investors react to changes in perceived risks surrounding the economy, trade policies, and central bank policymaking.

[7] LCD, an offering of S&P Global Market Intelligence, July 1, 2019.

[8] Credit Suisse Credit Strategy Daily Comment, July 3, 2019.

[9] LCD, an offering of S&P Global Market Intelligence, July 1, 2019.

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INVESTCORP

280 Park Avenue, 39th Floor
New York, NY 10017
(212)-599-4700
NYIR@Investcorp.com