Crossbow Partners
Experience & Discipline

London Trip Report

May, June 2022

Executive Summary

London is back to normal and almost all Corona restrictions have been lifted

We visited London-based managers across several strategies including Long/Short Equity, Merger Arbitrage, Volatility and Discretionary Macro

The big question is whether the US Fed will achieve a soft landing with its monetary policy targeted to fight a rampant inflation

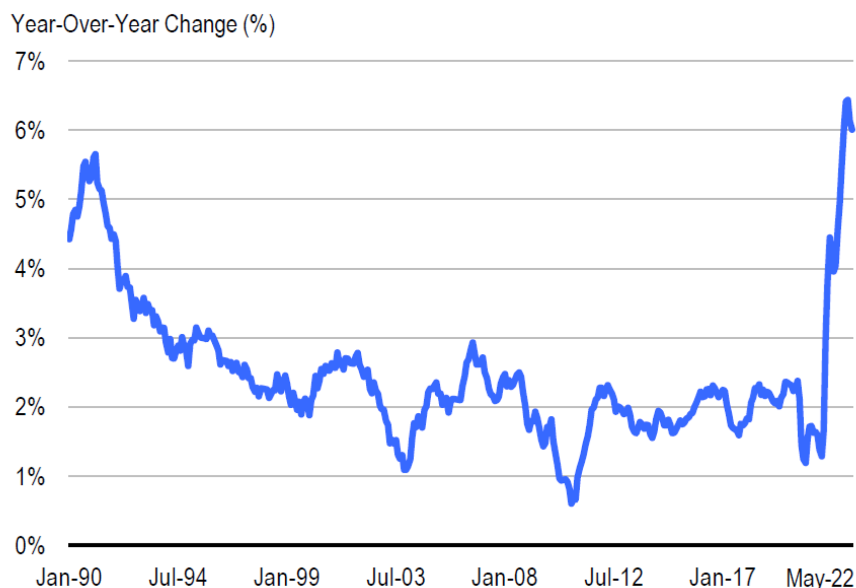
Volatility will likely remain elevated in the coming months as the market digests the coming inflation numbers

Macro strategies in particular are benefiting from a richer opportunity set

We favor diversifying strategies that are expected to benefit from rising rates and inflation

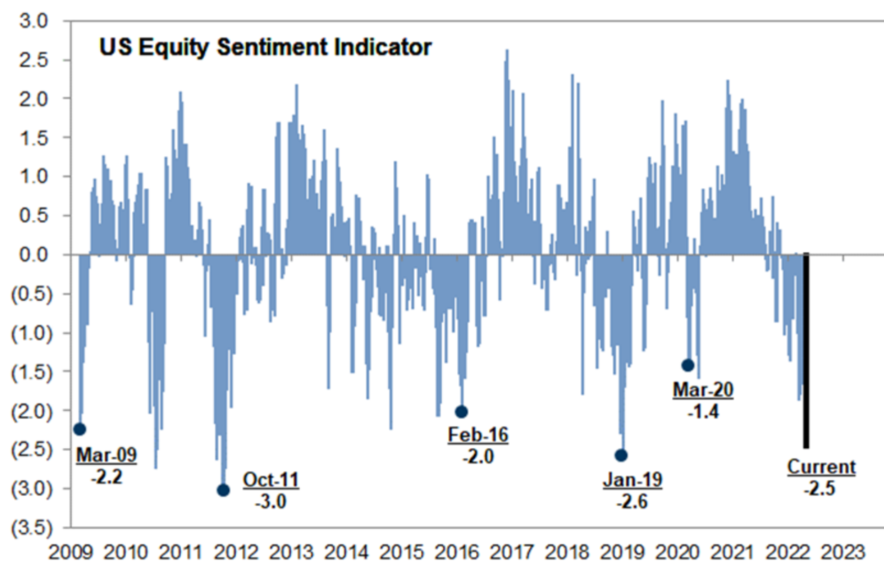
Market Observations

Inflation and economic growth are the key factors driving the macro policy mix and market direction. With significant moves in major asset classes over the last several months, managers are now focusing on the incremental data for suggestions of where policy may shift next. Many central banks have clearly stated their intentions to bring inflation back down to policy targets. Fed Chairman Powell has stated that his commitment to bringing down inflation is “unconditional”, meaning that the monetary tightening will continue until inflation is tamed. This will likely require a cooling of the very hot labour market to slow wage growth and therefore price growth as well. The consequence could be sub-par growth for an extended period, or even a recession. Currently, inflation remains well above the central bank’s target:



Source: FRED Database

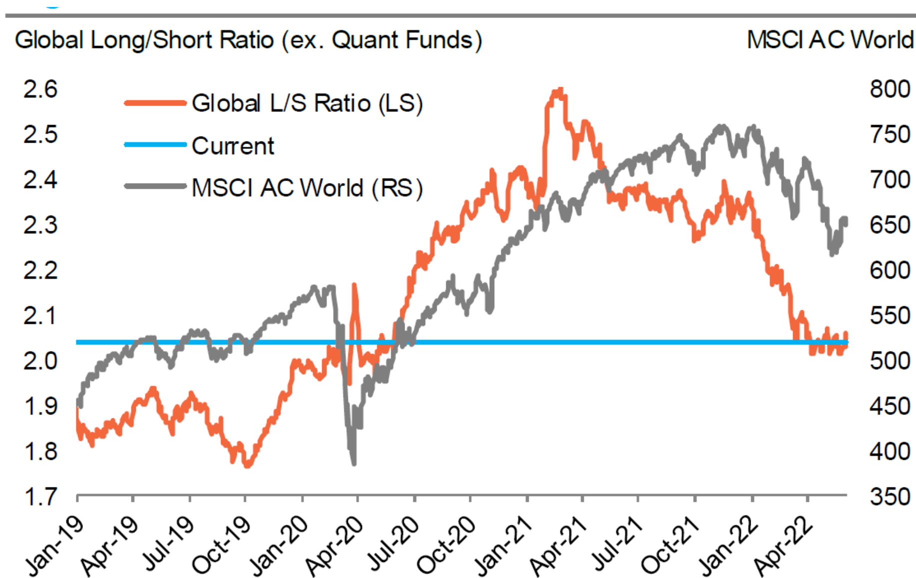
The S&P Total Return Index is down 13% YTD per the end of May and many portfolio managers are expecting an equity market bounce within the next couple of weeks and months. Equities seem to be oversold on a short term basis and sentiment is particularly bearish. According to Bank of America, fund managers are holding relatively high cash balances while the Goldman Sachs Sentiment Indicator is now at the third lowest reading since 2009. In each of the past instances, equity markets have staged some strong rallies subsequently.



Source: Goldman Sachs Research

Looking further ahead, it is difficult to envisage how equity markets will continue to rally to new all-time-highs. The consensus estimates still show S&P EPS at 230 in 2022, expecting a growth of +20% vs 2021, which was a year where profit margins were at an all-time high. Historically, margins have always come down late cycle even absent a recession, due to high wage-growth, high input prices, and higher interest rates. For comparisons, during the last two recessions (and bear markets) in 2000-2002 and 2007-2009, not only did aggregate S&P EPS come down significantly (-23% and -37% respectively), but sales came down too (ca. -10% in each case). Assuming a modest earnings contraction of -15%, flat sales and a P/E of 18, would result in an S&P 500 of 3,000.

Hedge funds have continued to sell global equities for a sixth month in a row according to Morgan Stanley prime brokerage data. The selling can he attributed to equity long/short (long selling) and stat arb/quant managers (adding shorts) in North America, Asia ex-Japan and LatAM. Interestingly, they were net buyers of equities in Europe and Japan. The global long/short ratio (excluding quants) ended just above 2.0x at the end of May. Looking at the chart below, one can argue that there is still room for the ratio to fall further to levels prior to April 2020. This could happen if the funds were to further reduce their long or gross exposures in a de-risking event.



Source: Morgan Stanley Research

Looking at the performance of the various hedge fund strategies this year, it is unsurprising that long biased equity long/short funds have struggled the most. Event-driven managers are slightly down for the year, driven by increased spreads in the space, while relative value managers are flat. Equity markets are down, but volatility reaction has been muted, which has been a challenging environment for long-biased volatility managers. Macro and particularly commodity managers were able to profit from the strong trends in the underlying asset classes that they trade. We expect the second half of 2022 to continue to be fruitful for macro and commodity PMs with a tactical approach, as markets continue to digest inflation and other major economic data points.