THE WEEKLY BRIEF

By LYXOR CROSS ASSET RESEARCH

15 APR 2019

STOCK-PICKING ALPHA Q2 OUTLOOK

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The alpha environment is normalizing after months of rollercoasting. From October to December 2018, the economic deceleration led by slumping global trade, was largely amplified by a sudden tightening in global liquidity. The overshoot in asset prices destroyed alpha until year-end. Subsequently, support from world central banks, Chinese stimulus and receding policy uncertainties, improved sentiment and liquidity. The market bounce helped the L/S Equity strategy recoup some of the loss, due to their cyclical and smaller cap exposures in particular.

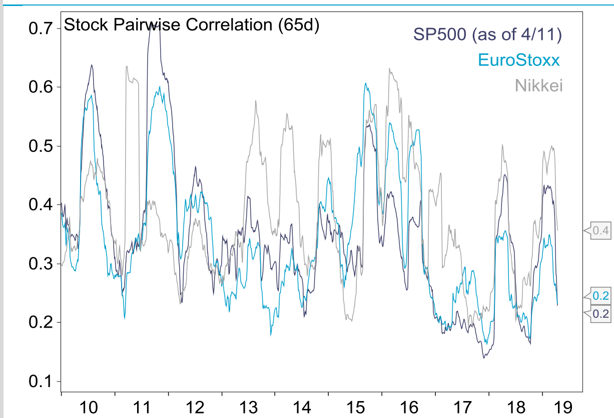
Going forward, on top of a modest beta contribution, we expect less alpha volatility in Q2. The market recovery since year-end lows is not at odds with that of 2016. However, it will be shallower in our view, as each of the driving factors (monetary policies, Chinese stimulus, easing uncertainties) will face limitations and have become partially priced in. As a result, we expect a modest positive beta contribution, with greater upside in Europe and Emerging Markets (EM).

The environment for alpha normalized, however with persisting constraints. Witnessed by a plunge in equity correlations and a weaker share of stock returns attributable to broad market moves, investors are refocusing on company specifics. The earnings season kicked off and will soon confirm whether prices faithfully reflect changes in stock fundamentals, which is a key pattern for managers' alpha. To that regard, the consistency of equity market moves with the quality of incoming economic data bodes well. Managers still enjoy a rich universe of fresh stock opportunities, those that are starting to show momentum but not too mature yet.

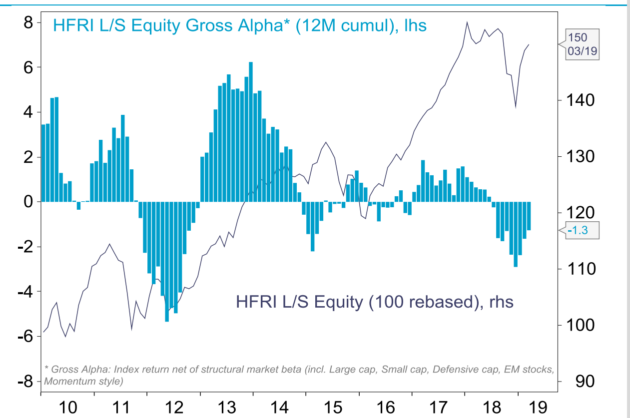
Our key concerns for alpha relate to trends in policy uncertainty and swings in monetary policies, which have both plagued active managers last year. A U.S.-China agreement will ease uncertainty, but only partially given another 6-month Brexit delay and the auto tariffs wildcard. Moreover, the dovish Fed turn and delays in DM monetary normalization might fuel market distortions detrimental for alpha. Price dispersion is rapidly shrinking in mainstream segments, which is curbing stock pickers' arbitrage potential. We note that dispersion is still wide in smaller caps and in several sectors, including consumer, healthcare and financials. Amid fair equity valuation, these factors might explain why a majority of managers are not rushing back to markets with new positions and higher exposures.

The environment for alpha generation improved, but we only expect a modest contribution in Q2, with regional nuances, favoring less efficient segments in smaller caps or sectors.

Refocusing on company specifics



Alpha generation on the mend



Sources: HFR, Macrobond, Lyxor AM

PERFORMANCE

Longest biased strategies lead

Lyxor UCITS Peer Group Performance (%)

	Last Week*	March	YTD 2019**
Global Macro	0.4%	0.2%	3.3%
L/S Equity Directional	0.3%	0.3%	4.3%
L/S Credit	0.3%	0.6%	3.1%
Event-Driven: Special Situations	0.2%	0.9%	4.7%
Global	0.1%	0.7%	2.9%
MSCI World	0.1%	1.7%	14.7%
Event-Driven: Merger Arbitrage	0.0%	0.5%	1.6%
Bloomberg Barclays Global Aggregate Bond Index	0.0%	1.8%	2.8%
L/S Equity Market Neutral	0.0%	-0.3%	0.5%
CTAs	-0.4%	4.2%	3.1%

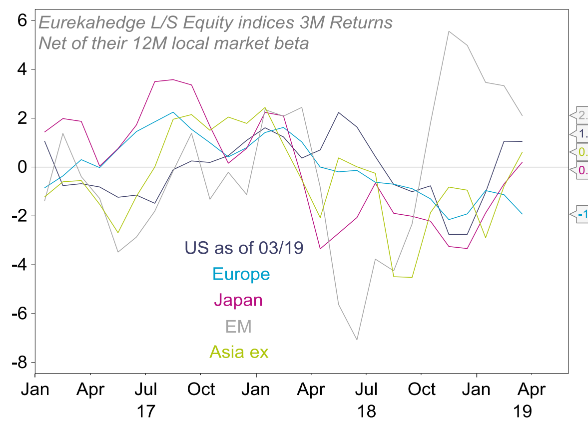
* Last Week as of 04/02/2019 - 04/09/2019; ** YTD as of 04/09/2019

Source: Lyxor AM

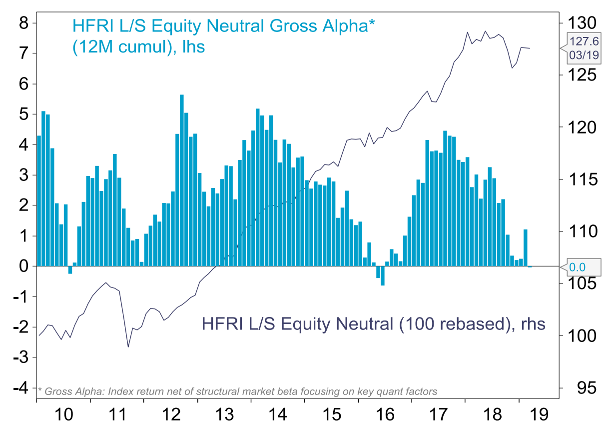
The most recent economic data is not pointing to further deceleration. Chinese data is encouraging (trade balance, money supply and new loans) and European hard data is not reflecting weak and mixed surveys so far. Cyclical assets continued to creep higher and boosted the most directional hedge fund strategies.

In contrast, quant factors unsettled by transversal drivers, remained challenging to arbitrage. CTAs gave back some gains on their long bond and U.S. Dollar positions.

Regional Alpha Q2 Outlook



Source: Eurekahedge, Macrobond, Lyxor AM



Source: HFR, Macrobond, Lyxor AM

In the U.S., more fundamental pricing, wider sector leadership, less crowded funds' positions, and less market-disruptive policies ahead of the 2020 elections would support active strategies. Large-cap stock picking potential would be constrained by fading dispersion, but managers focusing on smaller caps and sectors displaying highest stock differentiation could do well. Meanwhile, quant factors continue to be unsettled by transversal drivers, making them a challenge to arbitrage.

In Europe, the alpha environment could be mixed in Q2. More fundamental stock pricing and low correlation would be supportive, as well as appealing valuation and weak investors' positioning. However, managers could still lack decisive catalysts and sufficient clarity to take bolder stances. While a soft Brexit looks increasingly likely, another 6-month delay could deprive both companies and active managers from better clarity. Auto tariffs also remain a wildcard, along with elections in Spain, which may lead to laborious efforts to form a governing coalition. A positive surprise in the Italian political landscape cannot be ruled out though. We find that the alpha environment **in the UK** is more supportive than in continental Europe.

The same alpha environment applies **in Japan**. Distortions from a dovish BoJ, elevated sensitivity to the JPY and a lack of catalysts ahead of the VAT tax hike would continue to constrain active managers. Those focusing on specific sectors will find limited stock differentiation.

In EM, active managers are likely to generate alpha out of very differentiated country situations. Uneven exposures to changes in supply chains could be decisive in Asia, while the magnitude of sanctions hitting Russia and sensitivity to the European economy could be key catalysts in EMEA. Domestic politics and the implementation of reforms could fuel opportunities in Latam.

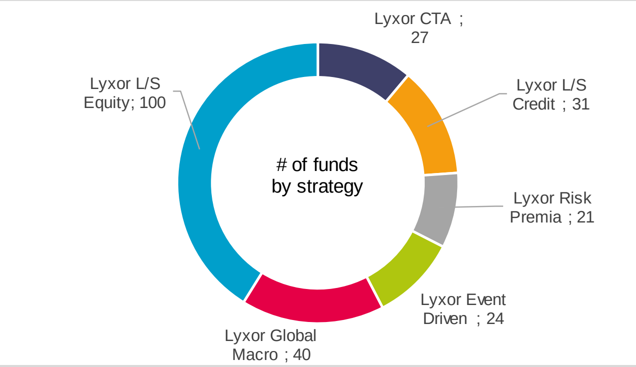
METHODOLOGICAL APPENDIX

The information contained in this report on the performance of onshore hedge funds is based on publicly available information. The universe of underlying funds is relatively stable but varies depending on the criteria of inclusion presented below. It is based on an unbiased selection from our hedge fund analyst team.

Performance is calculated on a weekly basis, as of end-Tuesday, using an arithmetic average (equally weighted average).

Regarding share classes used in these peer groups, we selected the primary share class as referenced in Bloomberg. Non-USD share classes are hedged in USD based on hedging costs available on Bloomberg.

Lyxor Hedge Fund Peer Groups: number of funds by strategy



As of February 2019

- 243 strategies across the main categories in the industry
- USD 245 billion of assets under management

Criteria of inclusion

The criteria of inclusion are fourfold:

i) We only include UCITS strategies;

ii) Strategies are assessed and categorized based on fund prospectuses;

iii) We only include strategies with assets under management of at least USD 50 million; and

iv) We only include strategies with at least a one-year track record.

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