By AMUNDI INVESTMENT INSTITUTE

HEDGE FUND OUTLOOK H1 2024 (POST FOMC)

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Jean-Baptiste Berthon
Senior Strategist
amundi.institute@amundi.com

Frederic Hevras
Hedge Fund Research Analyst

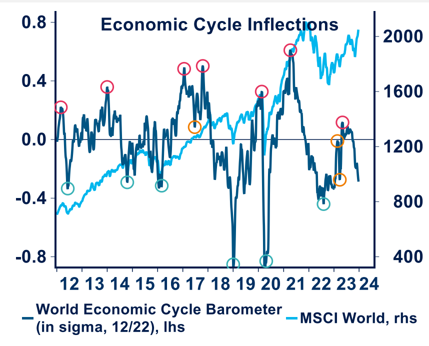
Hedge funds (HF) returns are up +4.4% year-to-date (as of November). Fixed Income Macro, Special Situations, Directional L/S Equity and EM managers led on the upside, whereas CTAs, Merger Arbitrage and Multi-strategy managers lagged. Overall, HF alpha has been mediocre in H1 (unsettled by a series of macro inflections), but surged in H2. Greatest alpha generation was recorded in L/S Equity Neutral, L/S Credit, and Fixed Income Macro, with a contribution above 2% y/y YTD.

Mediocre alpha in H1 is the main reason why HF did not beat cash more decisively YTD. Contrary to common perception, **high cash rates are a blessing not a curse for HF**. As they structurally maintain market exposures well below-par, HF are directly and/or synthetically long cash. When cash rate rise, HF thus compare well with main assets’ declining excess-yield, especially when alpha conditions are supportive. Some market segments still deliver attractive net-carry, but are generally riskier, including high yield or EM debt. HF may provide appealing access to these segments at affordable risk.

At its last meeting, the Fed switched to an easing bias earlier than most investors were expecting, given the expansion of global liquidity and bold rate cut expectations. While data justify a less restrictive policy, some wondered whether US elections might also have had a say. **A nearby rate pivot validated investors’ goldilocks scenario,** i.e. weak growth but no recession and inflation returning to normal, both providing room for monetary easing and resulting in lower tail risks for rate and credit sensitive assets. A faster pivot is good news for risky assets and bonds, but rich valuations suggest the upside repricing will not be linear. These tectonics might have brought forward the sequence we had in mind for HF by a quarter or so.

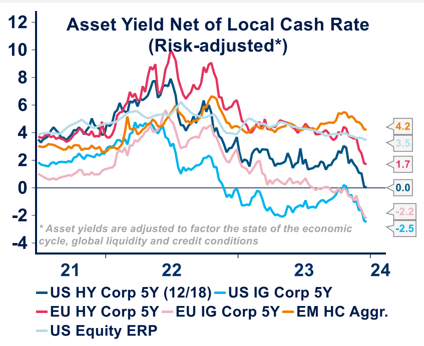
Nine key implications for HF. 1) As past rate hikes continue to feed through, slowing economies will foster greater asset differentiation, with a focus on traditional growth drivers. 2) Yet, expanding global liquidity, with its lot of valuation anomalies, will partially erode the alpha potential. 3) Cross-asset correlations would gradually decline, as growth takes over inflation uncertainty, providing some room for thematic allocation – rates remain in the driving seat for now though. 4) Equity and bond volatility regimes would both be lower than in 2023, resulting in lower alpha from market timing. 5) Diverging central banks will likely provide multiple relative trades for top-down styles. 6) Bonds, HY, EM will be key 2024 themes. HF in these fields, which favor relative arbitrage, will be appealing as flows intensify. 7) Corporate activity will bottom out once economies near their trough, with more focus on event driven, except for distressed likely to remain soft. 8) Cash rates will stay above-par in

Macro inflections



Data are as of the date indicated in the legend
Sources: Bloomberg, Macrobond, Amundi II

Declining main assets’ excess yield, risk adj.



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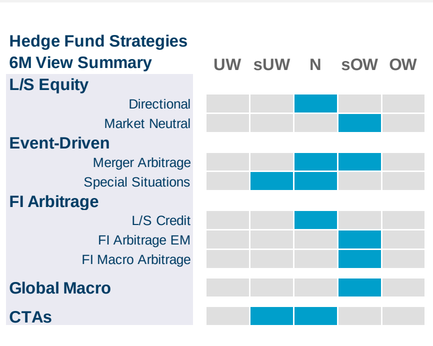
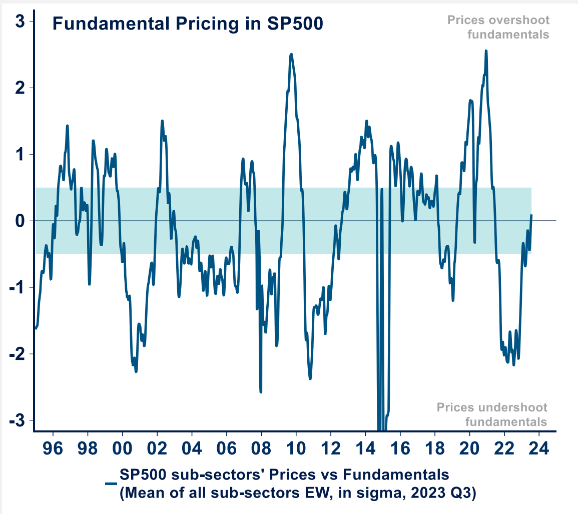
HF Strategy views



Stance as of Dec 20
Sources: Bloomberg, Macrobond, Amundi II

Strong Stock fundamental pricing



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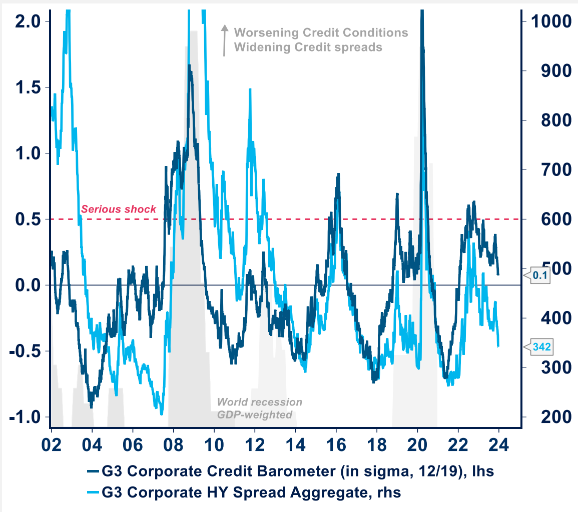
Credit conditions are decreasingly adverse but tight spreads



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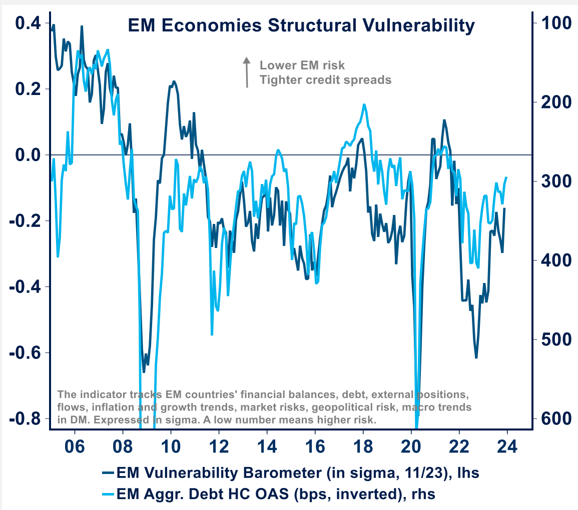
Lower hurdle to allocate to EM Fixed Income styles



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Sources: Bloomberg, Macrobond, Amundi Investment Institute

2024 albeit down from highs, providing 1-2% extra return for HF. 9) Geopolitics will still matter, less from Middle-East and Ukraine, more from US/China/Taiwan and US elections.

For H1 2024, we favor L/S Equity Neutral, Fixed Income Macro and Global Macro, and EM Fixed Income strategies.

After the FOMC, momentum, defensive and large caps strongly lagged cyclicals and small caps, but the impact was milder in other factors. The drag on alpha was manageable for **L/S Equity Directional (N)**, stemming from their cautious exposures and their shorts. Going forward, alpha generation will be supported by stock differentiation (as pressure on top-line and margins deepens) and by strong fundamental pricing. Range-trading could be the main hurdle given rich valuations. Thematic diversification might also be limited, as rates remain the key driver and due to a lack of hard catalysts, for now.

Factor volatility surged in December, but **L/S Equity Neutral (sOW)** were already positioned for lower yields, in particular via financials. Position crowdedness and fewer short opportunities might temporarily hurt. Yet, alpha conditions look fine, with enough stock dispersion albeit selectively, strong fundamental pricing, and rising stock arbitrage potential within quant factors.

M&A activity is bottoming. Despite less support from private equity, the pipe of complex/hostile deals is healthy, with limited breakups. While regulation is a key risk for **Merger Arbitrage (N+)**, at 8%, deal spreads are attractive again. Elevated deal volatility and prospect of bidding wars provide alpha potential.

L/S Credit (N) had gradually raised their exposure and added duration and rating risk since October, which positively contributed in December. The alpha backdrop has become more mixed. Dispersion is selectively returning, with greater focus on issuers' fundamentals, and more short opportunities. However, reversal risk is intensifying given the tug of war between less adverse credit conditions but rich valuations. A lack of catalysts and soft issuance are also limiting the alpha potential. Until valuation improve, we see softer excess return.

Abating macro vulnerability, lower rates, and a manageable China slowdown lower the bar to allocate in EM markets. We see a higher beta contribution for **EM Fixed Income (sOW)**. Alpha remains mediocre, albeit improving. Flows are primarily channeled through indices, limiting dispersion, while our fair-value models spot few compelling country arbitrage. High EM credit correlation is also limiting diversification. Yet, dispersion is returning in EM FX and economic fragmentation is on the rise, along with a number of idiosyncratic developments.

Fixed Income Macro and Global Macro (both sOW) will benefit from relative trades from the uneven paces of monetary easing and inflation normalization. Lower rates and a manageable economic slowdown in DM will also help explore riskier segments. Bond volatility would stay above-par in H1, providing market timing windows, as the magnitude of easing, the impact from quantitative tightening, and loser fiscal efforts further fuel uncertainties. Global Macro will be constrained by expanding global liquidity, still high cross-asset correlation, and a poorer opportunity set outside fixed income.

The shift in the rate paradigm might unsettle market directionality, with episodes of trials and errors. Fresh sets of trends will be needed for **CTAs (N-)**.

Hedge Fund Indices Performance

Hedge Fund Indices HFRI (%)	Q3	2022	Q1	Q2	Q3	YTD
HFRI FoF Composite Index	-0.4	-5.3	0.7	1.5	0.5	4.4
L/S Equity	**-2.3**	**-10.1**	**2.5**	**3.1**	**-1.0**	**6.7**
Equity Multi-Strategy	-0.1	-13.5	3.4	2.5	-2.2	5.1
Quantitative Directional	-3.7	-6.8	2.9	3.3	-0.9	10.1
Market Neutral	0.7	1.2	0.8	0.6	2.7	4.9
Other (Sector, Factor bias)	-1.3	-10.5	2.1	3.8	-1.7	5.1
Event-Driven	**-0.4**	**-4.8**	**1.4**	**1.1**	**2.2**	**6.3**
Merger Arbitrage	2.3	2.8	-1.8	-1.0	4.3	2.5
Special Situations	-0.4	-5.2	1.8	1.3	3.0	8.5
Activist	-1.9	-16.4	6.2	3.8	-2.8	9.6
Credit Arbitrage	-0.5	-1.9	2.8	1.3	2.3	8.4
Distressed/Restructuring	-1.4	-4.3	0.9	1.4	1.1	4.4
Multi-Strategy	-1.7	-9.4	1.4	0.7	2.8	6.2
Relative Value	**0.0**	**-0.7**	**1.3**	**1.2**	**1.7**	**5.6**
Fixed Income-Corporate	-0.4	-4.5	1.9	1.2	2.0	6.3
Yield Alternatives	-0.3	5.5	0.3	1.3	2.4	5.3
Fixed Income-Sovereign	0.4	-0.5	1.0	1.9	0.4	8.2
Multi-Strategy	0.0	-0.7	1.7	0.1	1.7	5.6
Other (CB, Vol, Structured)	0.7	1.2	0.9	1.3	1.3	4.0
Global Macro & CTAs	**1.8**	**9.0**	**-2.4**	**1.7**	**1.3**	**-1.1**
Discretionary Thematic	0.5	2.0	-0.1	0.1	1.1	3.4
Multi-Strategy	0.3	5.0	-1.7	1.1	1.1	1.2
Macro Other	2.3	9.8	-0.1	0.0	2.5	1.8
CTAs	3.1	12.1	-4.3	3.9	1.0	-3.5
EM Multistrategy	**-2.0**	**-6.7**	**1.1**	**3.1**	**0.9**	**8.0**
China	-12.3	-19.3	3.5	-3.9	-2.9	-3.9
Global Benchmarks (net fees)						
40% Equity / 60% Bond Basket	-6.6	-16.7	4.9	1.8	-3.5	8.0
Global Allocation Basket	-6.9	-12.0	3.8	1.5	-1.2	7.4

Data as of Nov 2023. Source: HFR Inc., www.hfr.com, © 2023 HFR, All rights reserved, Amundi Investment Institute

Index Disclosure

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Index Description

Other L/S Equity: equally weighted performance of HFRI Equity Hedge: Sector - Energy/Basic Materials, Technology/Healthcare

Other Relative Value: equally weighted performance of HFRI Relative Value: Fixed Income-Asset Backed, Convertible Arbitrage, Volatility

Other Macro: equally weighted performance of HFRI, Macro: Active Trading, Commodity, Currency

HFRI indices: for a comprehensive description of the HFRI indices used in the above table, please refer to the index description on HFR website: https://www.hfr.com/hfrx-indices-index-descriptions

Global Benchmark Description

40% Equity/60% Bond Basket: Combines the MSCI World and the Barclays Global Bond Aggregate

Global Allocation Basket: Combines the MSCI World, the Barclays Global Bond Aggregate, Global FX Carry in USD, and the S&P GSCI Commodity index.

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