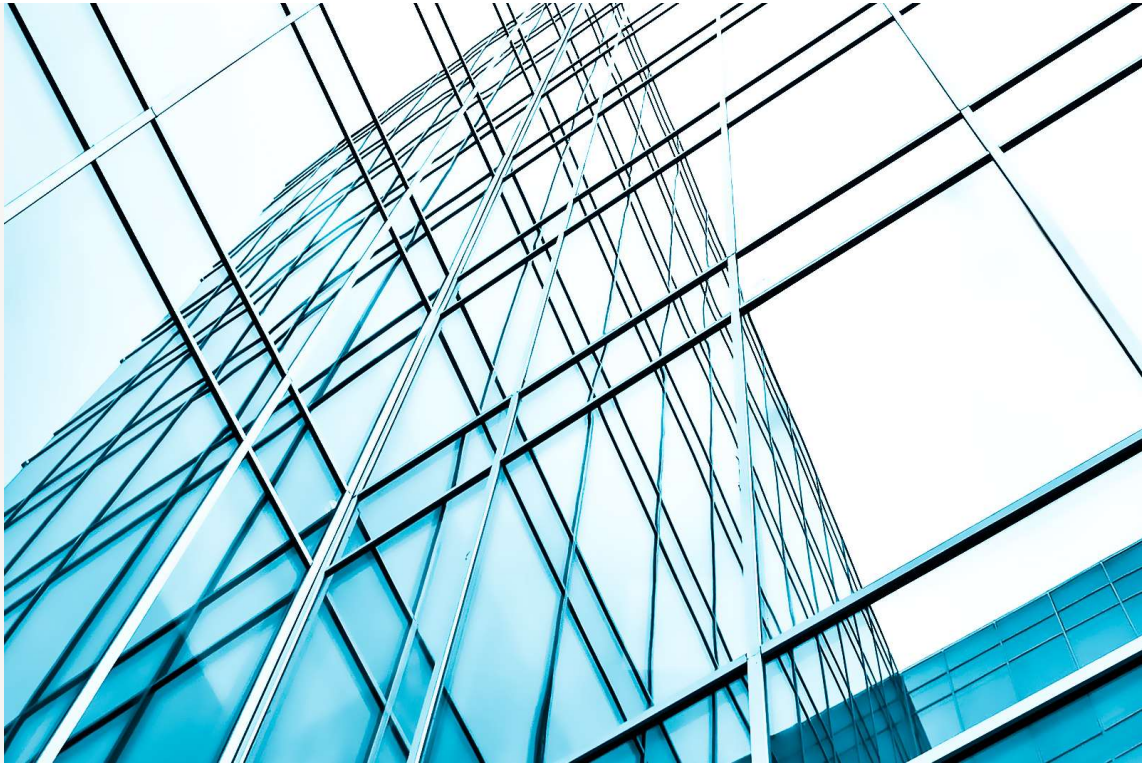
INVESTCORP-TAGES

Investcorp-Tages Market Outlook

Q4 2020



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Dear Clients and Partners,

We hope you and your families are well and staying safe.

We open this quarterly report with a note of humility from historian H.A.L. Fisher, excerpted from his History of Europe.

> "Men wiser and more learned than I have discerned in history a plot, a rhythm, a predetermined pattern. These harmonies are concealed from me. I can see only one emergency following upon another as wave follows upon wave, only one great fact with respect to which, since it is unique, there can be no generalizations; only one safe rule for the historian: that he should recognize in the development of human destinies the play of the contingent and the unforeseen."

Fisher's warning invites greater scrutiny over historical determinism. This idea that a careful study of events should reveal hidden patterns, from the seemingly random course of history. Knowing experts can distill these into elegant theories that help us assert control and make sense of our past. Theories often associate with compelling narratives of why events happened this way and could not have unfolded differently. They deny the importance of chance and serendipity.

As Margaret Heffernan wrote in Unchartered: "When we expect history to guide us, we overweight continuity and narrative, while underweighting change and contingency." This is top of mind for us today, as we face the US election in November and consider the many ripple effects from the continued healthcare emergency.

In the pages that follow, we share snapshots of our current thinking, with the hope that it will help you navigate today's turbulent times. We have revised our macro-economic scenarios this quarter, sketching new potential paths ahead and their likely implications for asset prices. Our research analysts also share their views on the opportunity sets available across hedge fund strategies and the key indicators we are watching.

As always, we welcome the opportunity to engage in longer conversations with you, whether you are interested in learning more, challenging our views, or providing feedback that can help us get better at what we do.

Best regards,

Investcorp-Tages team

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GLOBAL MACRO ENVIRONMENT AND TRADITIONAL BETA MARKETS

Strategy	Negative	Neutral	Positive	Comments
Equity				Poor risk/reward, demanding valuations and signs of exuberance in segments of the market place. Earnings expectations look optimistic amid continued uncertainty over 2nd wave and shape of the policy response
US				Policy uncertainty is largest here but the region exhibits resilience through the tech sector in a muddle-through scenario. Valuations are rich & positioning no longer a tailwind
Euro area				Badly hit by the second wave; fiscal support on the way through ERF but may be difficult to add support incrementally. Valuations also demanding, although less than in the US
Japan				More resilient to virus and long-term positive structural changes but rich valuations and a relatively dim outlook for the global economy leave us underweight still today.
Emerging Markets				Quality Asia offers better value for growth, with strong Chinese policy support, better healthcare governance
Duration				Fixed income no longer offers the diversification potential and carry has compressed since curves remain relative flat. At risk of a reflationary turn
US				US duration can protect (a bit) during a severe sell-off but is at risk of sustained large fiscal deficits/reflationary impulse.
Europe				Dead money for multi-asset portfolios – find better diversifiers
Japan				Dead money for multi-asset portfolios – find better diversifiers
Credit				
Dev. High Yield				An opportunity to play value with carry; spread compression has been rapid so stay neutral & on watch for better entry points
EM				An opportunity to play value with carry; spread compression has been rapid so stay neutral & on watch for better entry points
Foreign Exchange				USD weakness attractive against quality DM&EM

GLOBAL MACRO AND MARKETS OUTLOOK

Global Macro

Vincent Berthelemy, Cross-Asset Solutions

Writing in the fall edition of Foreign Affairs, Gideon Rose reminds us of Dwight Eisenhower's famous quip: "Plans are worthless, but planning is everything." Taking that message to heart, the next section reflects our continuous effort to prepare for what may lie ahead. However, we would add that we view planning as a constant learning process and value receiving your feedback along the way. Over the course of the last quarter, we revised our macroeconomic scenarios for the period ahead. But before getting into the nitty-gritty, we offer a quick word on our use of scenarios. Following in the footsteps of strategic planner Peter Schwartz, we see value in imagining the future through the construction of rich stories that lay out the dynamics at play and potential tipping points into alternative paths. These scenarios are often closely aligned with existing market narratives, which get passed on by investors or the media.

In our case, we strive to take matters further. Our process seeks to expand upon the stories and use this information to estimate the probability that they come to fruition. At any given time, market prices will reflect average investor perspectives on what comes next, and any divergence between those views and the handicapping we have done can potentially point us to tactical asset allocation opportunities.

With the above in mind, the table following and the following paragraphs set out the various macroeconomic scenarios we believe may come to pass and our estimate of the probabilities associated with each. Our base case, "Long Slog Back," is a slow and fragile recovery, where deflationary forces are offset by an extraordinary policy response. At the same time, lower economic momentum heightens the risks of reversals, while activity will likely remain uneven across geographies and sectors. This a world where the "winners" go from strength to strength and the "losers" struggle to stay alive.

Macro Scenarios and Associated Narratives

Long Slog Back 60%	Plentiful liquidity and the continued support of fiscal relief efforts help offset deflationary pressures (elevated leverage, high uncertainty and lower confidence). After the bounce-back from re-openings, the recovery proceeds slowly, in fits & starts, unevenly across industries and regions. Political hurdles & governance issues limit the extent of fiscal support over time, leaving a fragile growth profile at risk of new unexpected shocks. Central banks retain a lower for longer approach, leaving interest rates anchored at the ZLB and curves relatively flat. Dispersion among winners and losers widens further, driven by secular themes & ability/willingness of individual countries to stimulate further in the face of adverse developments.
Reflation 20%	Sustained extraordinary policy response, from fiscal and monetary allows a faster than expected recovery, quickly closing the output gap. New supply restrictions from re-shoring efforts and large public spending on CapEx meet surging consumer demand amid a step-change in monetary aggregates. A weaker dollar fuels further increases in import prices while the Federal Reserve welcomes this overshoot in inflation.
Return of Goldilocks 10%	Lasting policy measures and a vaccine allow for a quick bounce-back in activity above recent trend-growth level. Sustained fiscal support helps fuel investments and greater productivity gains. Globalization & technology remain driving forces, helping keep inflation in check. Central banks remain accommodative, running the economy hot for longer.
Deflationary Bust 10%	Uncertainty, de-leveraging pressures and scarring effects cripple the economy and force the system into a deflationary loop. It is a scenario where new or lingering exogenous shocks (no vaccine) meet inadequate fiscal policy response. The contraction in private demand is self-sustaining. Active monetary policy may limit the speed of the downfall and lead to slow-motion crash.

Another scenario, "Reflation," would see inflationary forces gaining ground—not immediately, but in stages, given that output gaps remain wide today. But should the economic system remain resilient amid a winding down of the COVID-19 crisis and a sustained extraordinarily loose policy mix, it could gradually challenge the underpinnings of the disinflationary environment we have become so accustomed to.

Indeed, it is likely that such an outcome would jar and rattle investors, potentially instigating an epic momentum crash emanating out of positioning and valuation assumptions predicated on recent trends being extrapolated far out into the future. While this scenario is less likely in our minds, we like the asymmetry it offers and want to ensure our portfolio can withstand the fallout should it materialize.

In terms of the last two scenarios, "Return of Goldilocks" and "Deflationary Bust," we label them as tail risks, with one being a positive and the other a negative. From where we sit, we currently see equal chances that either one will occur.

Looking at the asset-allocation implications of each scenario, detailed in the table below, it seems clear that there is no one-size-fits-all strategy. Our base case, for instance, will likely see range-bound markets, with heightened volatility relative to a long history and disappointing earnings growth. Valuations could remain supported by the liquidity backstop, though we would expect the more attractive opportunities to be found in credit markets, where the linkage to central bank support is clearer and widespread deleveraging pressures should serve as a tailwind.

Macro Scenarios and Asset Allocation Implications

Long Slog Back 60%	**Equities:** range-bound markets with greater volatility as earnings growth disappoint lofty expectations and valuations offer little margin for error. Past winners are likely to continue to deliver above-market growth but stretched valuations & positioning could create airpockets & limit further upside. **FICC:** also likely to be somewhat range-bound with potential for mild steepening of curves and lower dollar as the global economy slowly recovers. Carry pays and credit likely to outperform equities, particularly on a Sharpe ratio basis. **Alternatives:** Greater dispersion & volatility may be attractive for alpha generation across classes. Prefer relative value strategies & macro. Carry strategies also deliver.
Reflation 20%	**Equities:** limited headline gains or mild losses but sharp rotation across factors, sectors & regions, with Value outperforming Growth, Low Beta/Quality. RoW outperforming the US **FICC:** curve steepening violently and break-evens outperforming, the dollar is under pressure on valuations, lower real rates and twin deficits while commodities outperform. **Alternatives:** Real assets outperform. Value strategies shine.
Return of Goldilocks 10%	Above-trend growth and below-trend inflation environment spurs a new wave of gains across markets, with equities outperforming strongly credit. Speculative activity fuels an expansion of valuations to bubble-like territory, with limited response from central banks. Limited moves outside of equities.
Deflationary Bust 10%	Risky assets sharply underperform, with the sell-off magnified by elevated starting valuations. Technical support may help certain segments of the market (IG credit, peripherals), widening the gap between losers & winners. Default cycle would pick up, widening losses for lower-rated credit; commodities would tank on higher real rates and a stronger dollar while rates would rally & curves may invert again.

More broadly, dispersion could move higher, providing greater clarity over time regarding the prospective winners and losers and potentially lending support to market neutral relative value strategies. Additionally, growth would likely continue to outperform value, though rich valuations and stretched positioning in this long-running theme should be taken into account. Finally, the importance that policy support has assumed in recent years will likely keep giving global macro funds something of an edge.

Alternatively, if the forces of reflation were to gain greater traction, value would almost certainly be the clear winner across asset classes. In fixed-income, the curve would likely steepen violently on a higher term premium. By the same token, the return of nominal growth would eat away at the premium that growth company equities have enjoyed over value counterparts, with current lopsided positioning and relative valuations exacerbating the move. In foreign exchange, meanwhile, the dollar would likely weaken toward fair value and potentially overshoot to the downside. Although we have assigned only a 20% probability to this scenario, we view it as our most out-of-consensus positioning.

Moving on to the two least likely scenarios, it is not hard to see how the chips could fall in either case. Should Goldilocks prevail, the prospect of massive outperformance of equities in comparison to other asset classes seems easy enough to predict. In contrast, market neutral and long convexity strategies would likely be the only approaches to deliver protection during a deflationary bust. The lack of protection one might typically expect from fixed income owing to current lofty price levels will likely be an issue for most investors. In fact, it suggests a sizable cross-section have taken on more risk than warranted for a prospective lower-return environment.

Global Macro and Markets Outlook

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 contracyclical 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.

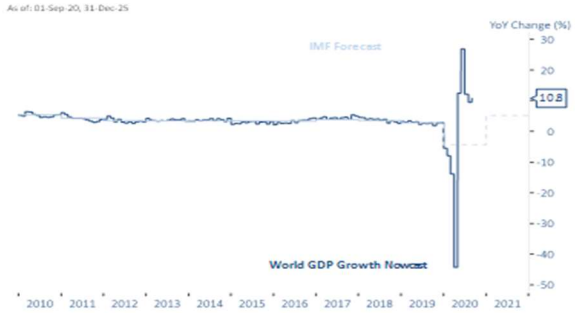
Macro-economic Fundamentals

Gauging 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.

Nowcast models show that the global economy was expanding at a 10.8% rate in October. Derived from a wide range of data drawn from standard econometric models, this indicator provides a real-time read on the economy's dynamic. That said, we would note that while the post-lockdown recovery has been sharp, it has been losing momentum in recent weeks, as the following chart illustrates.

Global GDP Growth Nowcast



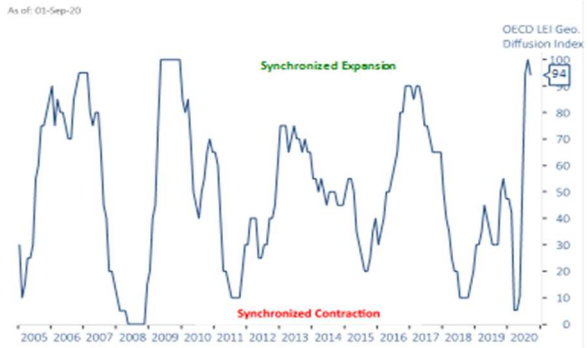
Source: Goldman Sachs, Investcorp-Tages, Macrobond

Across geographies, the rebound has been relatively broad-based, as the first chart below shows, with China leading the way and the euro area and Japan pulling up the rear. As can be seen in the second chart, our diffusion index of OECD leading economic indicators, which gauges the general tendency of leading indicators for a wide range of countries, has spiked to a 100, pointing to a fully synchronized recovery. Readings below 50, meanwhile, would indicate that most are signaling a contraction. Despite the apparent uniformity, we have seen divergence in performance among individual regions, largely driven by varying degrees of exposure to the pandemic and its fallout, as well as differences in the respective policy responses.

GDP Growth Nowcast by Region

Source: Goldman Sachs, Investcorp-Tages, Macrobond

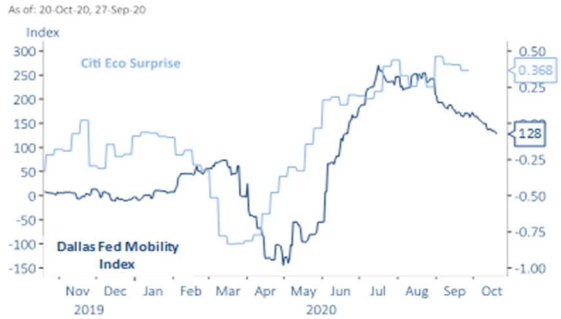
OECD Leading Indicators Diffusion Index



Source: OECD, Investcorp-Tages, Macrobond

Be that as it may, the recent resurgence of the disease appears to be threatening the nascent recovery. As the following chart illustrates, the Dallas Fed Mobility and Engagement Index has been grinding lower since August, suggesting that economic activity slowed down last quarter. One factor that has likely compounded matters is the failure of negotiations between Democrats and Republicans to secure an extension of the extraordinary benefits made available under the CARES Act. In Europe, the surprise reintroduction of partial lockdowns will likely push growth back into negative territory in the fourth quarter.

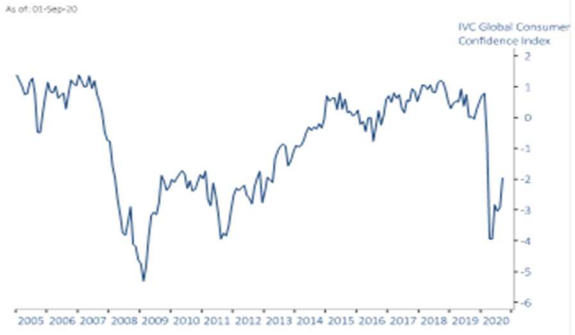
Dallas Fed Mobility Index and Citi US Economic Surprise Index



Source: Investcorp-Tages, Macrobond

Moving on to other measures, consumer sentiment has bounced off the lows, as shown below, but remains well shy of its pre-pandemic highs. Thanks to the generous relief measures Washington enacted, US personal income surged in the wake of the crisis, but its temporary nature has done little to satisfy a pressing need for savings among the population's most vulnerable segments. Meanwhile, concerns about the employment market has kept uncertainty high, weighing further on sentiment.

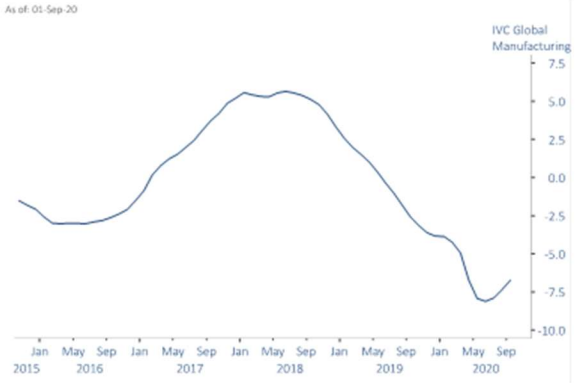
Investcorp-Tages Global Consumer Confidence Indicator



Source: Investcorp-Tages, Macrobond

In manufacturing, the turnaround has been pronounced, as indicated by the following chart, with activity less impacted in a sustainable sense than has been the case with services. China's rapid economic recovery, led by strong fixed asset investment, is encouraging for the sector. Up until the crisis struck, manufacturing had been in a two-year-long downturn owing to the slowing of the Chinese economy in 2018 and diminishing trade volumes. Now, however, it seems that the bottom is in. We are relatively optimistic going forward, partly because of an anticipated shift in fiscal support toward public sector infrastructure investments.

Investcorp-Tages Global Manufacturing Confidence Indicator



Source: Investcorp-Tages, Macrobond

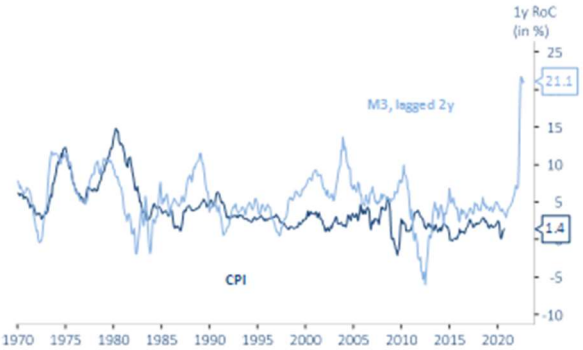
As far as Inflation goes, expectations have largely stabilized in recent months, as the following chart suggests. The tug-of-war between the disinflationary impact of the coronavirus shock and the extraordinary policy responses we have seen so far remains in place. That said, broader forces also remain in play, including long-term demographic headwinds and the growing role played by scalable technologies, which have helped to keep a lid on prices.

Inflation Break-even & IMF Forecasts

Source: Investcorp-Tages, Macrobond

But the benign inflation picture may be set to change. First, given that globalization has played a key role in depressing goods prices since the late-1990s, a growing push in favor of reshoring in the US or Europe could turn a headwind into an inflationary tailwind. Similarly, while we do not believe that the explosion in monetary aggregates—highlighted below—will by itself engender price inflation, we would note that it has been a while since Milton Friedman's theory that "inflation is always and everywhere a monetary phenomenon" has been verified empirically.

Inflation and M3 Monetary Aggregate



Source: Investcorp-Tages, Macrobond

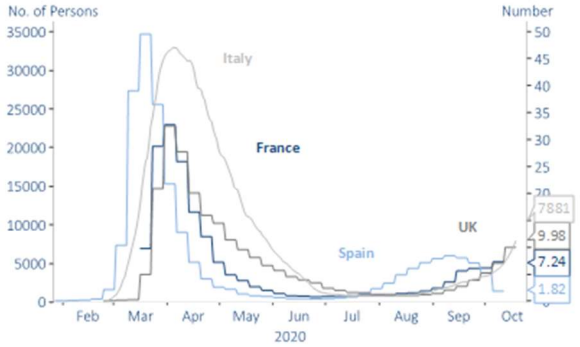
What could swing the economic pendulum the other way?

After reviewing the trends that are currently at play in the economic system, we turn our focus to a discussion of the forces leaning against current momentum. We seek to review the usual contra-cyclical factors, primarily monetary and fiscal impulses, as well as potential sources of exogenous shocks, including geopolitical developments.

For now, the coronavirus crisis continues to be the main event. While we have learned a lot about the

disease since the pandemic first erupted, epidemiologic models remain probabilistic exercises; the sharp acceleration of COVID-19 cases in Europe since September, highlighted in the first chart below, has challenged many of the models' underlying assumptions, though the picture in the US, shown in the second chart, is seemingly less unsettling but still a major source of concern.

COVID-19 Hospitalizations in Europe



Source: Investcorp-Tages, Macrobond

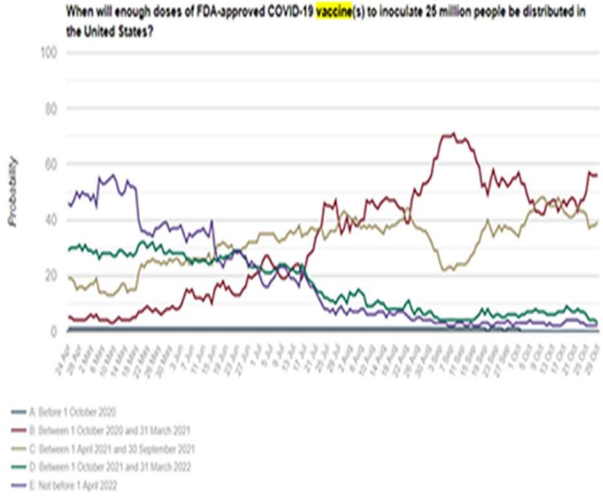
COVID-19 Hospitalizations in Europe

Source: Investcorp-Tages, Macrobond

The resurgence in cases has also led to the reintroduction of partial lockdown measures in various locales, aimed in part at slowing the infection rate ahead of potential super-spreader events such as Thanksgiving and the holiday season. Odds are a sizable second wave of the pandemic and the likely resultant constraints on economic activity will bring about another quarter of contraction through December.

That said, the pharmaceutical industry has made swift progress with respect to developing a vaccine, with multiple candidates currently under-going Phase III trials. Based on a probabilistic assessment from Philip Tetlock's crowd of super forecasters on when we might see large-scale vaccine distribution in the US, the majority expect it to occur sometime between now and March 31, 2021, as the first chart below illustrates. This represents a significant improvement in the forecast timeline from what we saw a couple of months ago, and is consistent with insights from task force experts gathered together by the Goldman Sachs research team, set out in the second chart.

Probability and Timing of COVID-19 Vaccine Distribution in the US



Source: Goodjudgement Project

Expert Opinions Over Vaccine Timing

Forecast for Emergency Use Authorization

"I think the probability starts to increase measurably through November and into December and barring some safety concern that we don't know about ... the probability increases to a reasonable likelihood that we'll have something before the end of the year and that starting to get deployed into frontline workers in a significant way by the beginning of the new year. And then it'll start to expand into larger populations."
- Dr. Peter Marks (Director of Center for Biologics Evaluation and Research (CBER) at the FDA) October 8

"It's extremely unlikely that is achieved in October; it's slightly more likely in November, it's more likely in December, and it's really, really likely in January. Where it's going to be, I don't know; nobody knows.."
-Dr. Moncef Slaoui (Head Operation Warp Speed) October 9

"I think there will be a vaccine that initially be available sometime between November and December, but very limited supply and will have to be prioritized."
- Dr. Robert Redfield (Director of the CDC) September 16

Forecast for Widespread Distribution

"The totality of vaccines that will be produced… will be a total of about 700mn doses by April of 2021. We will have substantial doses, tens of millions and maybe even 100 million by December and then as you get into January it incrementally gets more and more. …in our society it likely will be that many people will not want to get the vaccine right away they will want to wait to see what happens with the first 10-50mn people and that may mean that... by the time you get enough people vaccinated so that you could … start thinking about maybe getting a little bit more towards normality that very likely… would be maybe the third quarter or so of 2021 maybe even up to the fourth quarter."
- Dr. Fauci (Director of NIH Allergy and Infectous Diseases) September 25

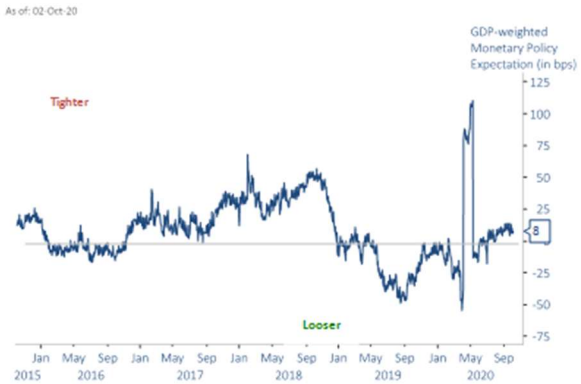
"When is it going to be generally available to the American public, so we can begin to take advantage of vaccine to get back to our regular life? I think we're probably looking at late second quarter, third quarter of 2021."
- Dr. Robert Redfield (Director of the CDC) September 16

"It's going to take four to five years until everyone gets the vaccine on this planet."
- Adar Poonawalla (CEO of the Serum Institute of India) September 14

Source: Goldman Sachs

Turning to monetary policy, we can expect little relief from the central banks' primary lever – front-end interest rates. While the Bank of England recently hinted that it was considering implementing negative rates, the ultimate impact of such a move would likely be marginal. In Europe and Japan, concerns over the health of domestic banking system are likely to deter central bankers from pushing rates deeper into negative territory. Similarly, in the US, the Fed has maintained a position of strategic ambiguity in this regard, but in our view, whatever they decide is unlikely to dramatically alter the impulse from monetary policy. For the sake of completeness, we continue to feature our global monetary policy signal—highlighted below—, but odds are that this measure will be quite boring over the next few years.

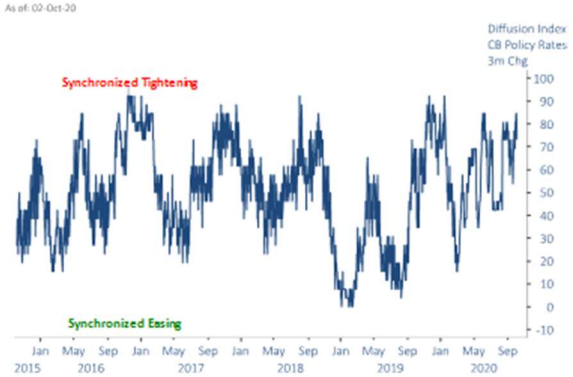
Global Monetary Policy Signal



Source: Investcorp-Tages, Macrobond

In reality, central banks are generally on the same page, as the first chart below suggests, left with the option of playing defense. This includes providing market liquidity when needed and engaging in asset purchases to forestall an acute tightening in financial conditions, illustrated in the second chart. But as we have discussed previously, the latter mechanism has risks of its own. As Goodhart's law states, "when a measure becomes a target, it ceases to be a good measure." Too much emphasis on reducing asset-price volatility could engender a reawakening of moral hazard, encouraging speculative activities that threaten the long-run stability of the financial system.

Global Monetary Policy Diffusion Indicator



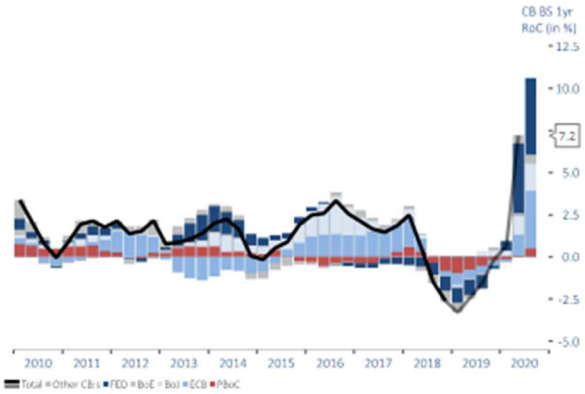
Source: Investcorp-Tages, Macrobond

Global Financial Conditions Index

Source: Investcorp-Tages, Macrobond

Beyond their actions with respect to rates, central banks have also reacted by amending their balance sheet policies, as evidenced by the chart below. In the US, the Fed suspended its quantitative tightening program and may well further expand its balance sheet in coming quarters should greater funding stress reveal the need for more accommodation, including higher levels of bank reserves.

Global Central Bank Balance Sheet Growth (in % of GDP)



Source: Investcorp-Tages, Macrobond

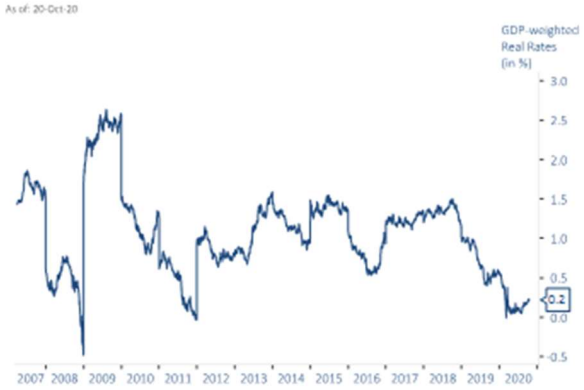
Across the Atlantic, the ECB resumed making asset purchases at a rate of 20 billion euros a month on an open-ended basis. It also initiated a tiered system for interest rates, aiming to alleviate, at least partially, the pressure that negative rates have put on the European banking system. In our view, the central bank's acknowledgment of the side-effects of this historical abnormality is a step in the right direction.

That said, we continue to have doubts that a much greater supply of liquidity is enough to raise the demand for credit. As Mario Draghi hinted, a more decisive fiscal policy at this stage would be a better

tool for boosting investment demand than throwing more monetary firepower at the problem. So far, signs of progress in this area remain few and far between.

Until things move in that direction, the key transmission mechanism for central banks will center on real interest rates, highlighted in the first chart below. However, because they cannot dictate what inflation will be, this element is not fully under their control. Even so, they can keep interest rates anchored, both at the front end or throughout the curve, by engaging in yield curve control policies with the expectation that inflation will eventually recover. But should deflationary pressures gain strength instead, this would serve to heighten real rates, tightening monetary conditions and potentially leaving central banks with limited room to deal with the morass on their own.

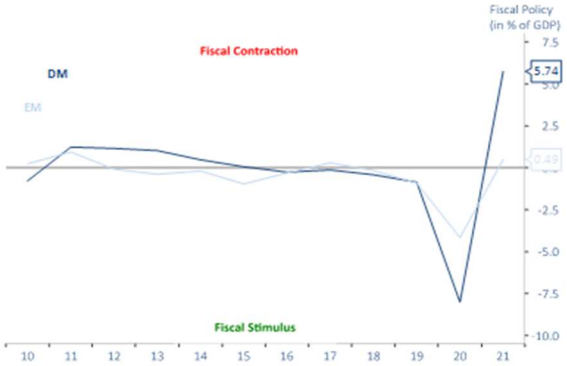
Global Real Interest Rates (in % of GDP)



Source: Investcorp-Tages, Macrobond

Under the circumstances, the only offense, policy-wise, will have to come from the fiscal side. So far, at least, developments have been mixed on that front, though clearly things are different than what we saw before the pandemic, as can be seen below. In the US, pre-election political gridlock has blocked bipartisan agreement with respect to extending CARES Act benefits; with the election only days away, prospects seem fairly binary near term. A blue wave victory, where Democrats win the presidency and Senate and retain the House, would increase the potential for greater fiscal stimulus going into next year.

Global Fiscal Impulse (as a % of GDP)



Source: Investcorp-Tages, Macrobond

At this point, the House has already floated a $3.2 trillion proposal, which does not include additional programs related to Biden's policy platform. His infrastructure plan, for example, would add upward of $2 trillion in public sector spending support in the coming years. But should the second-most likely scenario prevail—the election of a Democratic president along with the party's failure to secure the Senate—this would likely bring things back to square one. Republican Senate majority leader Mitch McConnell has consistently expressed his party's reticence to pass a spending measure over $500 billion, and it is difficult to imagine this might change post-election.

Over in Europe, the Brexit saga is finally drawing to a close. The next few weeks will be critical when it comes to deciding on the relationship between the UK and the EU going forward. As of October, both sides had inched closer to a deal to secure a free trade agreement (FTA), with the primary focus on goods.

Still, experts generally put the odds of securing an agreement between 65% and 75%, which suggests there is a decent risk of a hard Brexit in January—after which, no new extensions can be secured. Additionally, the FTA under consideration remains lighter than what might have been expected last year, potentially serving as a headwind for the British economy, especially the services sector. These various concerns have likely played a role in the recent faltering performance of UK assets, highlighted below

British Assets Have Remained Under Pressure

Source: Bloomberg, Investcorp-Tages, Macrobond

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.

Equities

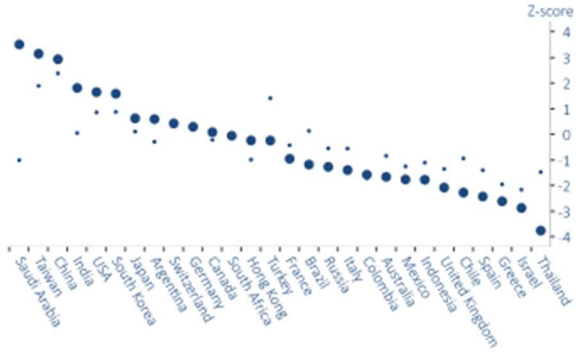
We begin our discussion of equity markets with an update on our price momentum signal. As can be seen in the following chart, which details our median trend signal across more than 30 countries or regions—with look-back windows from one-month to a year—the measure has again turned flat as a second wave of Covid-19 infections pressures European shares lower.

Global Equity Momentum Signal

Source: Investcorp-Tages, Macrobond

Meanwhile, we continue to see significant performance dispersion across regions, as the following chart illustrates. Southeast Asia and the US have been among the leaders, handily outpacing Europe and the emerging market countries.

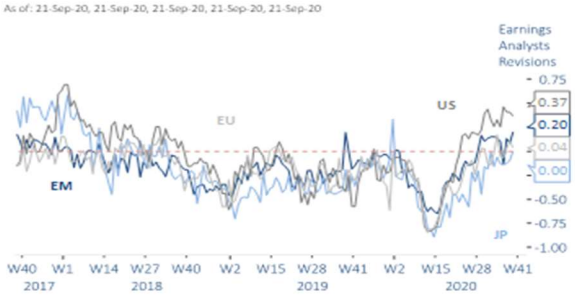
Individual Country Latest Equity Momentum Signal



Source: Investcorp-Tages, Macrobond

Looking at earnings trends, momentum has turned the corner, with companies outperforming admittedly low expectations. The US has outpaced peers, as shown below, thanks to that market's outsized exposure to the technology sector. year.

Analysts Earnings Revisions by Region



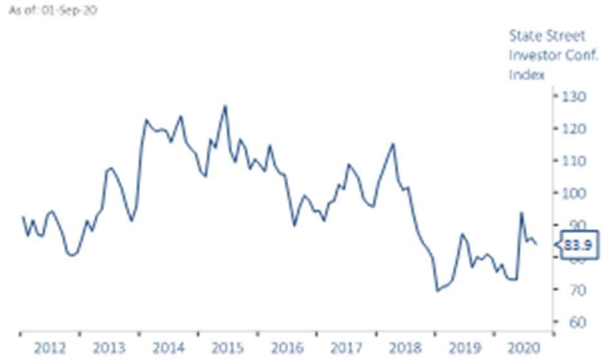
Source: Citi, Bloomberg, Investcorp-Tages, Macrobond

On the positioning front, aggregate indicators suggest that investors have stepped up their equity exposure from more typical levels, though not by a large margin. Risk appetites among real-money investors, in particular, are in line with their historical average, as the two charts following seem to attest.

Global Fund Manager Survey

Source: Bank of America Merrill Lynch

Institutional Investors Sentiment



Source: State Street, Investcorp-Tages, Macrobond

That said, the aggregate measures appear to be hiding pockets of heightened risk taking, which are somewhat evident in the following three charts. For example, data from prime brokerage platforms consistently shows hedge fund net exposure levels to be at multi-year highs. A similar situation exists within a subset of the retail community, where day trading remains a popular activity. While speculative retail flows receded to some extent following the quick but short-lived sell-off in September, they remain well above where they have been for most of the past decade.

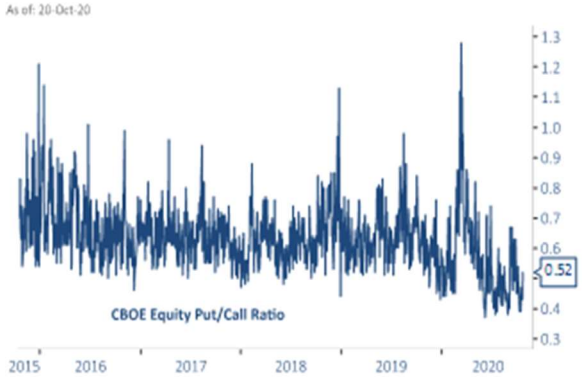
Speculative Futures Equity Positioning

Source: Bloomberg, Investcorp-Tages, Macrobond

Equity Hedge Funds Net & Gross Equity Exposure

Source: Goldman Sachs, Investcorp-Tages, Macrobond

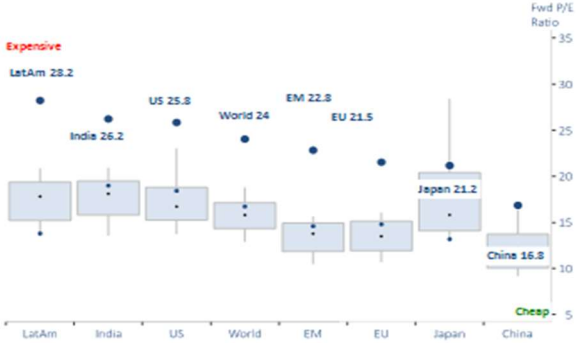
CBOE Put Call Ratio



Source: Bloomberg, Investcorp-Tages, Macrobond

Moving on to the fundamentals, equity valuations have also turned much more demanding, with the exception of Japan. As evidenced by the chart below, regional equity indices' forward price-to-earnings ratios relative to history—where the shaded area represents the 25th to 75th distribution percentiles—indicate that most regions are screening toward the top-end of their historical ranges.

Equity Valuations in Historical Distribution (Forward P/E)

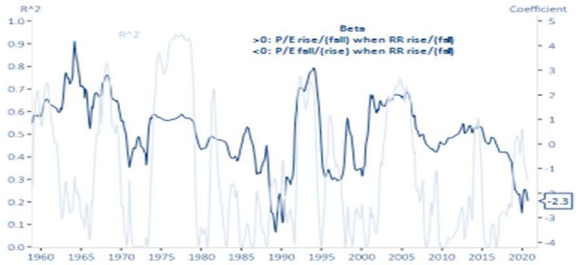


Source: Bloomberg, Investcorp-Tages, Macrobond

As we have discussed previously, much of the debate surrounding valuations centers on the influence of interest rates. Often supported by an analysis of equity risk premia, the argument essentially goes that lower rates support higher equity valuations. However, this partly ignores the fact that the former is where they are because future growth prospects are perceived as weak, which would likely have an adverse impact on aggregate earnings.

Regardless, the following chart— which shows the historical rolling beta of changes in US equity valuations, based on the P/E ratio, to movements in real interest rates—provides some useful context with respect to the linkage. As can be seen, the current beta is near historical lows, indicating that the relationship has in recent times indeed been very strong. But investors should be conscious of just how extreme the latest readings are, and the possibility this may be setting the stage for a reversion to the mean.

Relationship Between Real Interest Rates and Equity Valuations



Source: Bloomberg, Investcorp-Tages, Macrobond

Fixed-Income

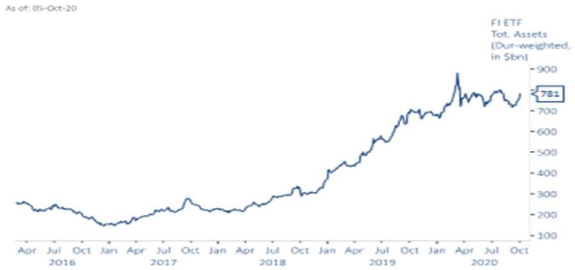
In fixed income, our momentum signal continues to be long government bonds, as the following chart suggests. Breadth has remained elevated, with bullish signals across the board, except for the very long end of the US curve. Recent months have witnessed a mild steepening of the US Treasury curve, and trend systems have added to this trade.

Global Government Bonds Momentum Signal

Source: Bloomberg, Investcorp-Tages, Macrobond

Looking at flows, assets under management in government bond exchange-traded funds (ETFs) have remained remarkably stable on a duration-adjusted basis in recent months, as the following chart illustrates, in spite of the strong recovery in risk appetites. While inflows have no doubt paused, we have yet to see evidence of a sustained reallocation away from this space.

Investment Flows into Fixed Income ETFs (US, Duration-Weighted)



Source: Bloomberg, Investcorp-Tages, Macrobond

But that does not necessarily mean all is well. When we consider both value and carry investment signals, the appeal of developed country government bonds is not apparent. As can be seen in the chart below, the term premium has been pushed down to historical lows; meanwhile, econometric value models suggest yields have dramatically overshot fair value.

US Term Premium

Source: Investcorp-Tages, Macrobond

At current levels, we do not believe that investors are being appropriately rewarded for duration risk. Cash and short-duration assets offer only optionality value at this point, with real interest rates strongly anchored in negative territory. That said, we believe a cash allocation has merit, tactically speaking, since we expect the coming months to remain volatile and offer better entry points into risky assets.

Focusing on carry in particular, it is difficult to see any upside here. As the following chart shows, the average annual carry across maturities in developed countries, including coupons and roll-down, reached a new low for the cycle of 25 basis points, making it clear that government debt is deeply unattractive from this vantage point.

Developed Country Average Annual Carry in Government Bonds

Source: Investcorp-Tages, Macrobond

Credit

Moving on to credit, high yield spreads have recently stabilized, as can be seen in the first chart following, after retracing a large share of the first quarter widening. While increasing defaults will eat into the carry the segment generates, a fragile recovery supported by plentiful liquidity provision should still allow credit markets to deliver a decent performance.

High Yield Credit Spreads by Region

Source: Bloomberg, Investcorp-Tages, Macrobond

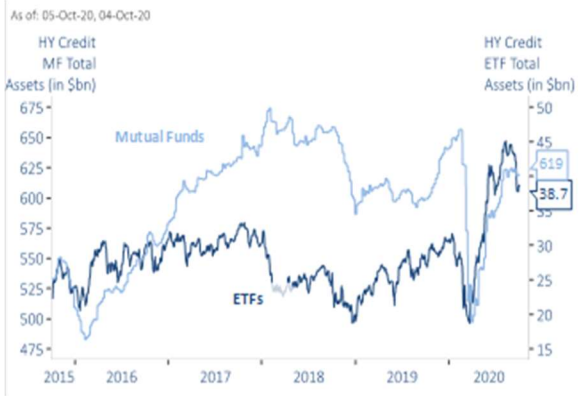
Interestingly, the pricing of credit within equities— as gauged by the performance of companies with strong balance sheets relative to those with weak balance sheets— has diverged from the risk-premia compression we have seen in credit markets, as shown below. This serves to highlight the continuing nervousness of investors in regard to corporate leverage and the associated risks in a weak economic environment.

Credit Risk Pricing in Equities vs HY OAS

Source: Bloomberg, Investcorp-Tages, Macrobond

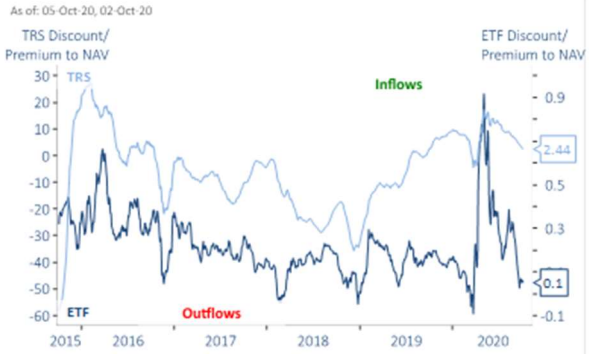
Flow-wise, activity in credit funds has been muted since our last update, as the first two charts below suggest. The September pickup in volatility referred to earlier had triggered only modest outflows out of high yield ETFs. No doubt the market has benefited from the ongoing support of the Federal Reserve backstop, though explicit purchases, highlighted in the third chart, have been limited to date.

HY ETF and Mutual Fund Assets under Management



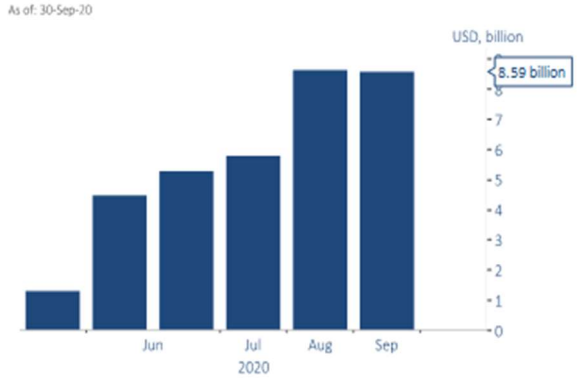
Source: Bloomberg, Investcorp-Tages, Macrobond

ETF and TRS Discount/Premium to Net Asset Value



Source: Bloomberg, Investcorp-Tages, Macrobond

Federal Reserve Purchases of Credit ETFs



Source: Investcorp-Tages, Macrobond

Looking at other elements, the liquidity premium in credit markets has not fully normalized, as the first chart below illustrates, and remains attractive in comparison to its history. In contrast, the premium available from buying small size credit issues has fallen back to its historical average, as the second chart shows. At 220 basis points, there is room for continued narrowing, but at current levels, this exposure offers lower convexity.

Corporate Credit Liquidity Premium

Source: Bloomberg, Investcorp-Tages, Macrobond

Corporate Credit Size Premium

Source: Bloomberg, Investcorp-Tages, Macrobond

Commodities

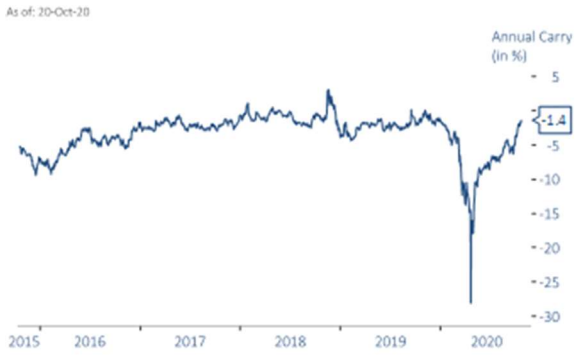
We conclude our review of asset classes with a few remarks on commodities. The first chart highlights our momentum signal for the asset class, with individual signals aggregated using weights from the Bloomberg Commodity Index. Momentum models are still slightly negative on the asset class overall but with large signal dispersion across individual contracts.

Commodities Momentum Signal

Source: Investcorp-Tages, Macrobond

In assessing prospects for this segment, we also consider projected annual carry. Based on BCOM weights, commodities offer a negative carry of 1.4%, as illustrated below, a strong improvement on last quarter's reading. That said, a decent share of commodity curves remain in contango, which has historically proved to be a headwind to performance.

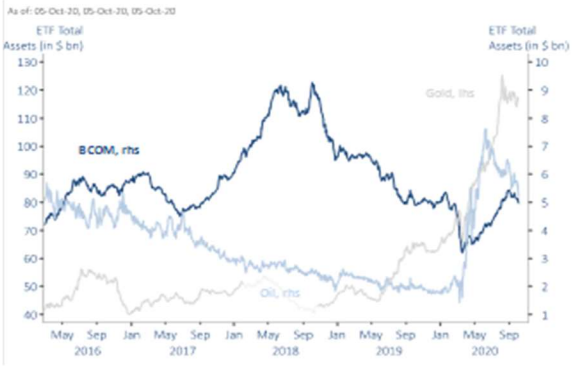
Commodities Carry Signal (BCOM-Weighting)



Source: Investcorp-Tages, Macrobond

On the flow side, investment demand for gold, which has been at the forefront of activity in the commodity space, has tapered off recently, as indicated by the first chart following. This marks a distinct pause following the doubling of gold ETF assets under management to a peak of more than $9 billion in the summer. However, skew has remained positive, as the second chart shows, highlighting a continued preference by option traders for capturing the upside over the next six months.

Commodity ETFs Investment Flows



Source: Bloomberg, Investcorp-Tages, Macrobond

Gold Skew

Source: Bloomberg, Investcorp-Tages, Macrobond

Turning to energy, oil ETFs have also experienced outflows, though the signal here may be less reliable since a significant share was created for the purposes of lending to short-sellers. Speculative long positioning in copper, meanwhile, has continued its surge from the March lows, as the following chart illustrates, bolstered by follow-on buying from the trend-following community. Otherwise, the fortunes of the industrial metals segment have echoed the stepped-up recovery in Chinese manufacturing.

Speculative Positioning in Futures

Source: Bloomberg, Investcorp-Tages, Macrobond

In terms of fundamentals, gold still screens as slightly expensive on our value cross-asset model, though signal strength has halved since June. As can be seen in the first chart below, the yellow metal sits only half a standard deviation away from fair value, which is derived from its historical relationship to the US dollar and real interest rates. In a similar vein, its price has converged toward analysts' average target price, as the second chart indicates. In the current environment, a neutral fair value signal may well represent an attractive entry point amid a scarcity of safe-haven assets and the explicit commitment by central banks to deliver lower real rates.

Gold Value Cross-Asset Model

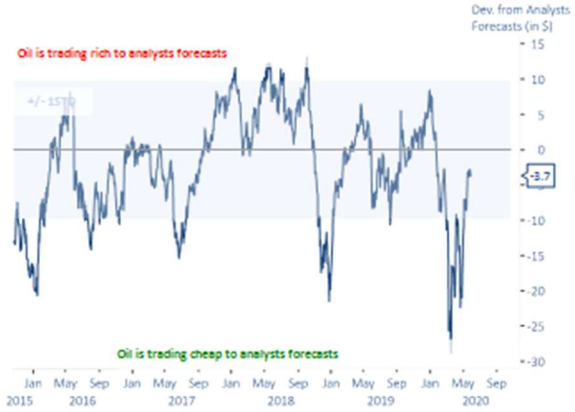
Source: Bloomberg, Investcorp-Tages, Macrobond

Gold Price Deviation from Analysts' Forecasts

Source: Investcorp-Tages, Macrobond

Moving on to the energy sector, our value models suggest that crude oil prices are trading in line with fundamentals and expectations, as the following chart suggests. Even so, we expect that conditions in the future may remain volatile and dominated by COVID-19 developments, though we remain more optimistic longer-term based on the capital expenditure cycle.

Crude Oil Value Model (Analysts Forecasts)



Source: Investcorp-Tages, Macrobond

Finally, we note an interesting divergence between our macro fundamental and cross-asset valuation models, both of which are highlighted in the chart below. One could argue that the faster recovery in manufacturing activity indicates that the risks are to the upside, however the continued underperformance in energy equities, for instance, would seem to be a yellow flag.

Crude Oil Value Model (Manufacturing Surveys, Cross-Asset)

Source: Investcorp-Tages, Macrobond

Emerging and Frontier Markets

Manuela Cedarmas, ESG and Impact Investments

Emerging market economies have rebounded sharply in recent months, though the robust tailwinds stemming from the easing of COVID-19 restrictions and sizable macro policy stimulus will likely fade as the fourth quarter progresses. That said, it is worth keeping in mind that even with the recent strong pickup in growth, the fallout from the crisis may well have a lasting impact on GDP equilibrium levels, in addition to fostering a significant and persistent measure of spare capacity. As far as equity markets go, EM indices exhibited significant dispersion last quarter, with Asia outpacing other regions on the heels of its success in containing the coronavirus as well as heavy index weightings in technology stocks. Among the BRICs, Brazil remains the laggard, both in local currency terms–prices were roughly unchanged last quarter and are down 17.4% year to date–and in US dollar terms– prices fell a hefty 41% over the nine-month span.

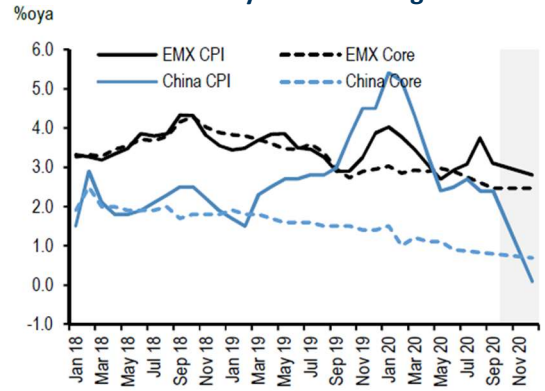
In the Frontier space, the Sub Sahara Africa Index has fared worst this year, while Frontier Asia has been the relative outperformer, with Vietnam giving back 5.6% in US dollar terms through September. Argentina has been super volatile, owing mainly to its limited presence in the MSCI index; the benchmark includes just three of the country's listed stocks, one of which—Globant—is a technology company that has doubled in price since March.

Going forward, we do not anticipate seeing broad convergence in the EM space anytime soon. We expect differences with respect to the following three factors to drive continuing and increasing differentiation among the various locales:

- **Virus control.** China and the richer Asian EM nations have reduced COVID-19 transmission rates to very low levels, in contrast to what has been seen in Latin America, large parts of the Central and Eastern Europe Middle East and Africa (CEEMEA) region, and low-income Asia. Countries that have been unable to implement "test, track and trace" strategies have been forced to resort to more severe lockdowns or tolerate the increased spread of the disease, both of which have had adverse economic consequences.
- **Fiscal policy constraints.** Some countries have been more limited with respect to public sector spending than others owing to already significant debt levels and/or concerns that increased monetary stimulus might undermine external economic stability.
- **Trade exposure.** Nations that are heavily reliant on cross-border trade, especially services–most notably international travel and tourism, which remain at very low levels and are unlikely to recover before next summer—have had less room to maneuver than others.

One element that has not exhibited much of a divergence across the EM space is Inflation, which has thus far been relatively mild, as the following chart shows, especially considering the exchange rate shock that some countries have experienced. Apart from the price-dampening effects of excess capacity, a primary disinflation driver this year has been weak oil prices, which will likely only rebound after next spring, assuming a normalization of worldwide economic activity.

EM CPI Inflation Likely Peaked in August



Source: Goldman Sachs Research

Also playing a role are certain structural factors, which could weigh on goods and services prices for some time to come. First, as with developed markets, there are reasons to believe that EM Phillips curves have become flatter, reflecting the more elastic supply curves associated with intangible-asset scalability, which helps to determine a firm's pricing ability. Globalization is another element that appears responsible for the disinflationary effects relating to increasing economies of scale and heightened competition in a more integrated worldwide marketplace. More broadly, long-term demographic developments also appear be a tailwind.

This is not to say that the picture is the same everywhere. In the few economies where rising prices are a problem, idiosyncratic factors have overshadowed broader trends. These include heightened food inflation in countries such as India, Brazil, and Mexico, and the outsized FX depreciations that have exacerbated imported inflation pressures in some places, including Turkey and Argentina.

In terms of foreign exchange, the consensus is anticipating a weaker US dollar and correspondingly stronger emerging market exchange rates. More predictable trade policy stemming from a change in the US Administration could mean a lower risk premium in EM FX, including the Chinese renminbi. Indeed, that nation's currency could witness even more appreciation than it already has on strict coronavirus controls, a strong rebound in growth, solid export tailwinds, and buoyant portfolio inflows, which largely reflect ongoing index inclusions. Energy-balance savings and the limited recovery in outbound tourism seen so far could generate significant current account savings in 2021 in comparison to 2019 levels, representing a source of substantial net commercial demand for the renminbi going forward.

Among the high-carry EM currencies, the Mexican peso has been a favorite of EM managers and analysts, with the South African rand and the Russian ruble also screening as attractive. The Brazilian real and the Colombian peso, meanwhile, offer high cyclical beta but lower carry. Although EM currencies have been a frustrating play for many investors so far this year, as the following table suggests, there are signs that the winds may be shifting in a more amenable direction.

EM FX (Year to Date)

Source: Bloomberg

Moving on to fixed-income, we expect EM rates to remain low on the front end in the period ahead. In our view, a majority of EM central banks will maintain an exceptionally easy monetary policy stance well into next year; we also anticipate further easing by a few of the high-yielders. On the credit front, we note that EM investment grade spreads have fallen most of the way back to pre-COVID levels, while local rates were quick to reverse their March jumps.

At this point, emerging market high yield credit remains the most attractive segment in the space, especially in light of prospective further dollar weakness. The still-wide spreads reflect higher tail risks among HY sovereigns relative to IG counterparts, particularly with respect to external funding vulnerabilities and idiosyncratic political developments. From where we sit, Egypt, Ukraine, Kenya, Côte d'Ivoire, Senegal, and other Western Africa countries constitute the most attractive fixed-income opportunities, potentially delivering double digit returns over the next 12 months.

In terms of activity, the rebound we saw last quarter served as the impetus for continued strong issuance. At the end of last quarter, 2020 sovereign issuance stood at $172.6 billion, within earshot of the 2017 full-year record of $178.3 billion. Based on current forecasts, gross issuance is expected to hit a new annual record this year. The vast majority of issues that have come to the market so far have been investment grade names. At $129 billion for the first nine months, the IG tally has already set an annual record, and could rise even more on the heels of anticipated new issuance from Kuwait, Saudi Arabia, China, Indonesia, Morocco, Kazakhstan and Russia before year-end.

Looking ahead, the biggest uncertainties for the EM space include the upcoming US presidential election and coronavirus vaccine availability. A Biden win, especially if it turns out to be part of a broader "blue wave" political shift, would likely mean increased fiscal stimulus, heightened cyclical upside, a diminishing of trade policy risk, and the combination of a weaker US dollar and stronger EM FX. An early and widespread rollout of a vaccine against the disease would likely have directionally similar effects.

When it comes to which EM locale has the best prospects going forward, China remains the favorite. Its economy is less dependent on COVID-sensitive services than others, and its exports have benefited significantly from the country's large market share in sectors such as healthcare equipment–especially PPE–and computers, which have experienced positive demand shocks amid the pandemic. In addition, fiscal policy remains quite supportive. Meanwhile, with an economic recovery seemingly well underway, policymakers have been comfortable allowing the Chinese currency to appreciate–slightly on a trade-weighted basis and materially versus the greenback.

Within the China equity space, we continue to favor A-shares for three reasons: the better protections they afford with respect to US-China tensions, their reasonable valuation relative to offshore counterparts (i.e., shares that comprise the MSCI China index) based on history, and capital market reforms that have helped improve accessibility and asset quality over the medium-to-long term. H-shares are also less attractive because of what we view as a disappointing Hang Seng Index rebalancing, which has left the benchmark with larger direct revenue exposure to the local Hong Kong economy than other China-related indices and with a higher correlation to global indices than A-shares, as illustrated below. Indeed, at less than 9%, foreign ownership of the latter segment is significantly lower than their roughly 40% allocation to offshore Chinese equity.

Benchmark Breakdown - China

	Estimated Revenue Exposure to		
	China (ex HK)	HK	Others
MSCI China	92%	2%	6%
MSCI HK	26%	40%	34%
Hang Seng	71%	12%	17%
HSCEI	93%	2%	5%

Source: Morgan Stanley Research

In terms of the bigger geopolitical picture, expectations are that the US and China will increasingly compete directly in multiple spheres, ranging from technology, security, and health policy to financial markets and corporate governance. Other locales, notably Europe and Japan, will likely face a difficult balancing act as they vie for influence and economic opportunity in what could be a challenging post-COVID world.

Finally, it is worth noting that 2021, the 100th anniversary of the founding of the Chinese Communist Party, will almost certainly be an important year for the nation and its top officials. Undoubtedly, the CCP leadership and President Xi, in particular, will be keeping an eye on this major milestone, which may well serve to define the future of the single party governing structure and the emerging superpower's domestic and global ambitions.

Asset Allocation Playbook

The pandemic has laid bare the radical uncertainty that rules economic systems. Given its nature and magnitude, this shock is likely to ripple through our ecosystems, in surprising and unexpected ways for years to come. To a large extent, its immediate impact has been to accelerate long-standing trends. In a few weeks, we have lived through the monetary policy endgame, with all developed markets central banks converging to the zero-lower-bound and resorting to extraordinary unconventional tools. Global technology firms seem to have reached a new "permanently high plateau", asserting world dominance through resilient cash flows and strong balance sheets. But we know better than to call for the "end of history".

We can imagine a wide array of alternative futures, all contingent on how consumers, corporates, governments, societies and nations will choose to adapt in the face of adversity. Keeping an open mind about what lies ahead, we seek to build resilient portfolios that can absorb stress and still deliver on their longer-term objectives.

We entered these turbulent times with a cautious stance expressed through a larger cash allocation than usual, greater appetite for liquidity and a defensive strategy mix. In the wake of the market dislocations seen in the first quarter, we moved to a neutral stance on equities and added to opportunities in less liquid markets, particularly in credit and structured credit. Plentiful liquidity and deleveraging pressures continue to bode well for credit assets. But the sharp bounce-back in risk appetite looks premature, in our view, and we have moved underweight equities again. We are comfortable running a lower beta and resist the powerful fear of missing out. We remain patient, with major catalysts for continued volatility in the coming months as second-round effects start taking hold.

HEDGE FUNDS

Strategy	Negative	Neutral	Positive	Comments
Hedged Equities	■			Low appetite for equity beta in current environment, balance factor exposure between growth and value, mind crowded positioning
US	■			Low expected returns on beta, stretched net/gross exposures and factor positioning leave us underweight.
Euro area ex UK	■			Underweight on equity risk but carefully watching policy response that would signal better outlook on European markets.
Japan	■			Better structural tailwinds and more attractive valuations but we see limited upside potential at current levels
Emerging Markets		■		Quality EM (SE Asia) offers better value, continued policy support & better healthcare governance
Event-Driven				Prefer low volatility, short-duration managers that will be resilient to greater equity volatility
Special Situations	■			One of the few pockets left to capture value exposure in a portfolio. Handicapped by higher beta given our negative market outlook. But watch for entry points on an eventual policy driven sustained value rotation
Merger Arbitrage			■	Positive on the short-term but less enthusiastic about longer-term potential. Capture elevated spreads in the coming months and re-consider. Stay tactical
Equity Market Neutral		■		Underweight quantitative arbitrage on low factor diversification but prefer fundamental managers with limited factor bets
Macro Discretionary			■	Lower alpha potential in riding fixed income trends but attractive opportunity set in pursuing alpha in commodities or foreign exchange, emerging markets
Macro Systematic		■		We prefer alternative trends and short-term trading strategies that could monetize a higher volatility environment.
FI Relative Value	■			Lower fixed income volatility and plentiful liquidity have compressed the opportunity set, lesser CTA positioning pressure. Good potential on auction strategies
Corporate Credit			■	Lower tailwind from carry as spreads have narrowed but we see continued tailwinds on alpha as liquidity premium has stayed dislocated
Corporate Distressed		■		Spreads have compressed quickly but default cycle is early, watch for entry points in the coming months
Structured Credit			■	Q1 dislocations are slowly healing, attractive carry profile but mind leverage & legacy exposures. We prefer consumer to corporate exposure and stay up-in-quality
Convertible Arbitrage			■	Better valuations and gross issuance trends should support alpha generation for the strategy, continued volatility could be well monetized
Vol Arb			■	High volatility environment and limited competition after March debacle are positive for the medium-term environment

Hedge Fund Strategy Outlook

We stay underweight **Hedged Equities** relative to our strategic allocation. The view reflects our guarded outlook on global equities where we see a relatively poor risk/reward balance, at current levels. In recent months, hedge funds have raised net and gross exposures back to multi-year highs despite elevated market volatility, including dramatic factor moves in the later part of the second quarter. On aggregate, the universe remains positioned long Growth and short Value – with greater levels of crowding across funds that bears close watching.

We also reflect our lower appetite for equity risk by an underweight on **Special Situation** managers given their high consumption of equity beta budget. Still, special situation funds can increase portfolio resilience through their selective value investment style. 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 are constructive in the short-term but continue to watch the universe closely as lower deal volumes could be a headwind to the strategy's medium-term performance.

We remain constructive on **Macro Discretionary** funds relative to our strategic asset allocation. We expect lesser opportunities in fixed income but remain constructive on directional and relative value trades in foreign exchange and commodities.

We also move neutral on **Macro Systematic**. We see value in trend following, with funds having adapted to the higher volatility environment and limited "unrealized" P&L. The strategy can offer a cheap way to add convexity in a portfolio when other markets may no longer exhibit the same sensitivity. But we recognize that our base case of the "Long Slog Back" is likely to prove challenging for long-term trend models, with a lot of choppiness around policy/virus catalysts.

We stay constructive on **Volatility Arbitrage**. The extreme dislocations observed in March have decimated the already small universe of players. We see an attractive opportunity set for the surviving funds who should benefit from continued volatility and a better price of risk.

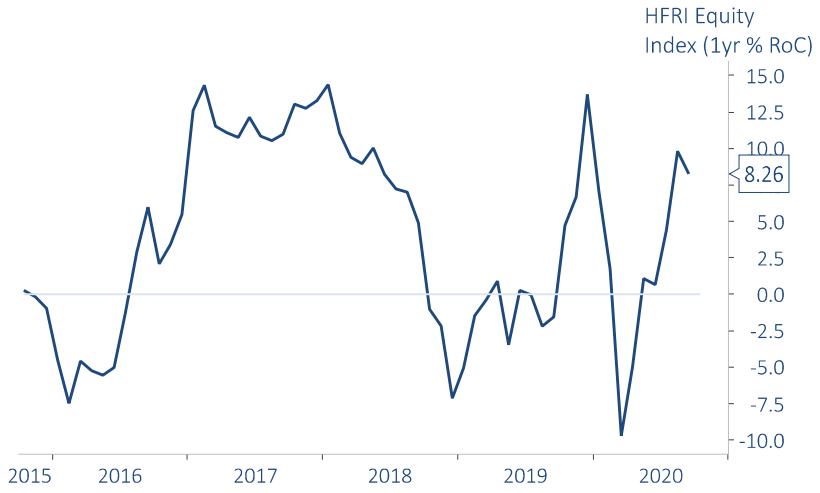
We stay underweight **Fixed Income Relative Value** on low volatility in the asset class. Central banks' asset purchase programs are likely to keep volatility muted in the coming months, reducing the opportunity set for the strategy.

Finally, we stay positive on **Credit L/S** and **Structured Credit**. Carry remains relatively attractive with the liquidity and size premium available in these markets still screening cheap. This should bode well for the opportunity set of those strategies going forward although we recognize the risk of a bumpy road ahead.

Equity Long/Short

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation	■ ■	■	■ ■	Back to the highs, especially in the US and defensive sectors, offers limited margin of safety at these levels considering the greater uncertainty and poor momentum in fundamentals
Earnings	■ ■	■	■ ■	Faster recovery than expected but road ahead remains uncertain
Stock Selection	■ ■	■	■ ■	Limited dispersion but greater uncertainty over earnings could be an edge for funda-mental stock pickers
Momentum / Sentiment	■ ■	■	■ ■	Net and gross exposures have moved back to historical highs, at odds with continued volatility in equities
Macro Fundamentals	■ ■	■	■ ■	Macro factors are playing a large role in driving cross-sectional returns
Liquidity & Financing	■ ■	■	■ ■	

Strategy Rolling 1-year Performance



Equity Long/Short

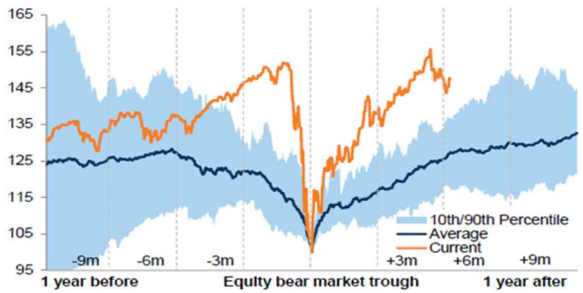
Matteo Meloni, Equity Strategies

In the equity space, last quarter turned out to be largely a continuation of the prior period. Despite a few volatile weeks toward the end of September, share prices remained on the upward trajectory that began during the worst days of March. July and August were particularly buoyant, bolstered by stronger than expected US labor market and retail sales data as well as ongoing speculation about an expedited timeline for the rollout of a coronavirus vaccine. In September, trading conditions became more unsettled, marked by violent rotations out of several growth names with lofty valuations.

Even with that, equity markets ended up comfortably in the black. The MSCI World Index rose 7.5% in the quarter while the S&P500 Index fared even better with a gain of 8.5%. Europe, in contrast, was the laggard; the Eurostoxx50 was down 1.3%, partially owing to a paucity of growth names in that index. Over the first nine months, the three benchmarks posted returns of +0.4%, +4.1%, and -14.7%, respectively. Meanwhile, the VIX Index fell from 30.4 to 26.4 over the span, despite the spike that occurred early in September. Overall, it was a relatively good quarter for alternative equity managers, as gauged by the HFRX Equity Index, which was up +3.6%. For the year to date, the group is down 3.0%.

Broadly speaking, the speed of the rebound in equity prices has been astonishing when compared to other post-bear-market recoveries, as the following chart illustrates. Undoubtedly, the move has been accelerated by unprecedented central bank liquidity injections, which have buoyed asset prices, especially real assets and liquid investments. The improvement in earnings sentiment—based on the number of analyst upgrades and downgrades divided by the total number of estimates over a one-month period—has lent further weight; the measure turned positive in the US and Europe in May and mid-August, respectively.

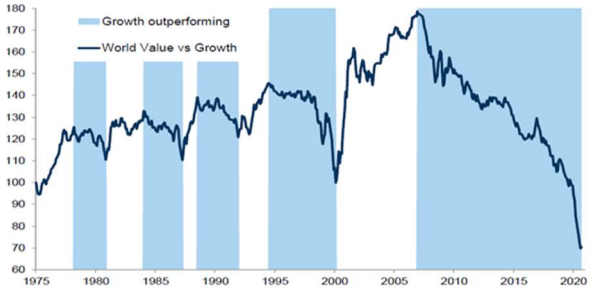
MSCI World Index Performance Around Bear Markets (Since 1970)



Source: Goldman Sachs Research

Sector-wise, there has been a significant dispersion in performance. Unlike the broader measures, three groups in particular—real estate, financials and energy—remain significantly in the red, while information technology, consumer services and consumer discretionary are generally positive across the globe. This disparity looks to be the continuation of a trend that began in the wake of the global financial crisis, whereby growth has persistently outpaced value to a staggering degree, as evidenced by the following chart.

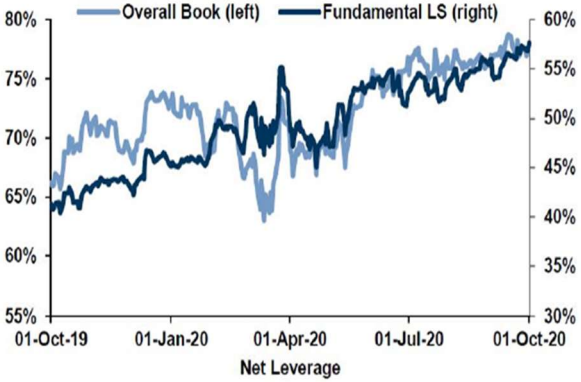
Value vs. Growth



Source: Goldman Sachs Research

In terms of risk appetites, we saw something of a turnabout over the last three months. Chastened by heightened volatility and the losses that were seen in February and March, hedge funds had been hesitant to take on additional risk, even as July began to unfold. Since then, however, managers have been upping the ante. As the following chart shows, over the last few months, net leverage has steadily risen to multi-month highs.

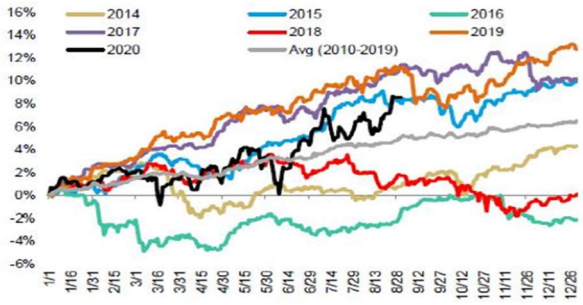
First Quarter Sector Returns in US



Source: Goldman Sachs Research

Against the backdrop of a particularly challenging environment, which saw a sharp selloff seemingly come out of nowhere that was followed by one of the fastest recoveries on record, equity managers have demonstrated a measure of resilience. They not only avoided incurring big losses when the crisis hit its peak, they managed to deliver relatively steady outperformance throughout the year, as the following chart suggests, except for the strong factor-rotation hiccup in the period from late-May to early-June. Bolstered by a positive showing during the summer months, alpha generation through September is consistent with what we have seen in some of the last decade's best years.

Hedge Funds' Relative Performance by Year



Source: Morgan Stanley Research

Hedge Fund Alpha Generation Constituents

Source: Morgan Stanley Research

When it comes to how equity markets have fared, the averages do not really tell the story, however. Beneath the surface, we have seen a sharp bifurcation with respect to style factor performance (a development that is also evident with respect to geographies). One notable catalyst, which has exacerbated what was already a clear trend, has been the mad scramble for technology solutions. This has exacerbated a persistent preference for growth-oriented businesses over cheaper counterparts, pushing the relative performance gap into unchartered territory.

For hedge funds, it is no secret that the level of technology sector exposure has been one of the key drivers of the group's returns over the last few years, and 2020 is no exception. Breaking down what is behind the good performance so far this year, it appears that style factors account for more than 100% of the alpha that has been generated, as the following chart suggests. In essence, this means that managers have been adept at playing the right side of factor movements, but less so with respect to owning the right companies.

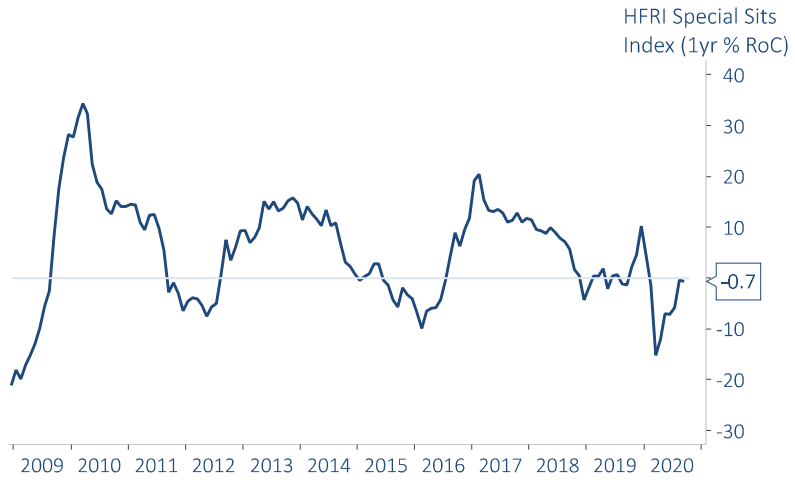
Looking ahead, it seems clear that the near term focus will be on earnings season, though attentions will likely switch toward the US elections as October draws to a close. Along with questions about when a coronavirus vaccine will come to market and concerns about the outsized performance of the shares of the technology behemoths, these various factors will likely foster considerable uncertainty, which may well keep already heightened implied volatility at lofty levels.

To be sure, some market participants might view the prospect of a potential $7 trillion fiscal spending plan on the heels of a broad Biden-led Democratic victory as something of a bullish panacea. However, it is worth keeping in mind that some of the initiatives that have been put forth, including corporate tax reform, may well lead to EPS related shocks and other reverberations that serve to magnify the equity market's downside risks.

Special Situations / Event-Driven

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Market Beta	■			Underweight beta.
M&A Spreads			■	Stay tactical in allocation, short-term opportunity
Corporate Activity	■			Elevated uncertainty will limit corporate activity in the coming quarters. Not only related to Covid-19 but also a polarized UD election and US/China relationship
Activism		■		Value tilt has been a drag and shows little sign of a turn-around. But relative valuations keep cheaper.
Tax		■		A new administration could unfold new opportunities
Crowdedness			■	Lower levels of crowding in special situations portfolios.

Strategy Rolling 1-year Performance



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

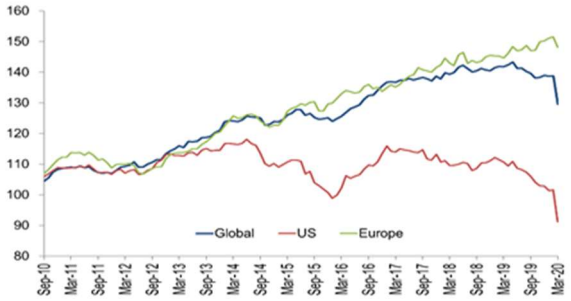
Source: PerTrac, S&P Capital IQ, Investcorp-Tages

Special Situations / Event-Driven

Selim Rekaibi, Hedge Fund Research

Global event-driven hedge funds posted a net +4.3% return last quarter, based on the HFR Event-Driven (Total) index, outpacing the 3.4% gain in the broader HFRI Global Fund Index. Looking at the sub-strategies, activists and special situations, up 8.1% and 5.4%, respectively, were the leaders, while distressed/restructuring and merger arbitrage, up 3% and 2.5%, respectively, were the laggards. Generally speaking, sub-strategies with the highest beta benefited from the continued rally in equity markets, though all remain negative for the year to date. performance in terms of recent alpha production.

Event-Driven Funds – Alpha by Region



Source: Bloomberg, Investcorp-Tages

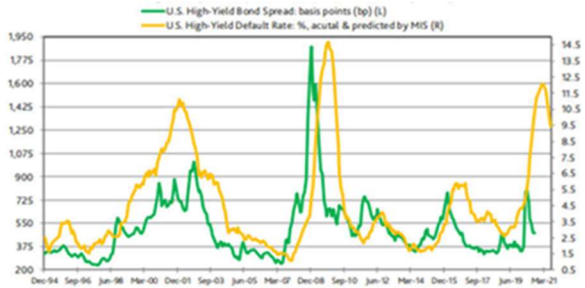
Outlook on Event-Driven Opportunity Set

There are pockets of opportunity in the event-driven space, though we remain neutral on the strategy overall. Specifically, we continue to maintain a one-notch-positive rating on merger arbitrage; spreads remain attractive and M&A activity has picked up. In corporate distressed, we are sticking with our neutral stance. While there are signs that the opportunity set is broadening out, we believe we are still in the early days of the distressed cycle and will see good entry points in the coming months. Special situations, one of the few segments that has man-aged to benefit from value exposure, remains handicapped by its higher beta exposure, in our view, given our negative market outlook. That said, we are keeping tabs on it, and will likely become more interested if we see a value rotation.

Corporate Distressed

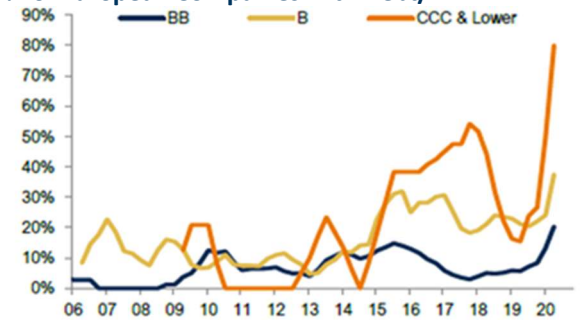
Corporate distressed credit is an area worth monitoring closely, as the pandemic appears to be accelerating thematic trends within the economy that could result in larger distressed opportunities within specific sectors. As market volatility has significantly declined subsequent global central bank actions, spreads have compressed quickly; however, the default cycle is just beginning, and we expect an expanded opportunity over the coming months. Explosive growth in corporate debt levels is a development that should be closely monitored and a risk worth thinking about. US corporate debt has grown from nearly $6 trillion in 2010 to $10.5 trillion in 2020. The US corporate debt market has been buoyed by a burgeoning leveraged loan market and historically low levels of bankruptcy; however, the COVID-19 crisis has thrown the world into an entirely different environment, almost overnight. As of August, the trailing 12-months US HY default rate stood at 5.7% according to Fitch. Looking ahead, Moody's predicts a peak ~12% default rate. The trailing 12-month default rate in Europe is only 2.9%, but elevated and increasing leverage metrics for lower rated issuers point to a rise in defaults in the future. While pockets of value are starting to open within the corporate distressed strategy, this is just the beginning of the distressed cycle and we are looking towards an enhanced opportunity-set over the coming months, as the various government support measures taper off.

Moody's US HY Default Rate Estimates



Source: JP Morgan, Moody's

% of European Companies with Debt/EBITDA >7X

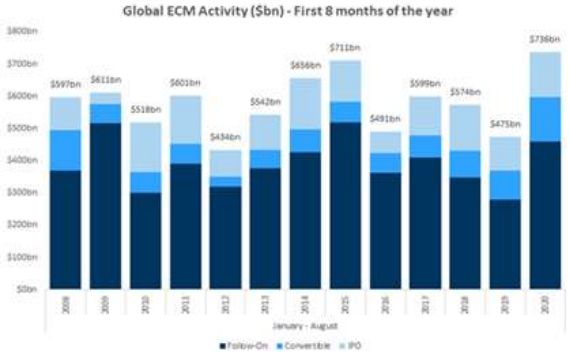


Source: Bank of America Merrill Lynch

Buoyant capital markets activity in 2020 has provided opportunities for special situations managers. We are seeing record levels of ECM activity as COVID-19 pushed companies to raise cash to ad-dress liquidity issues and fix their balance sheets. This transfer of value from shareholders to creditors has been well identified by special situations managers. Within the special situations space, there is potential for diversifying value exposure relative to the L/S space; however, the overall strategy remains handicapped by

higher beta given our negative market outlook. It is worth continuing to watch for entry points on an eventual policy driven sustained value rotation but given the beta sensitivity we remain negative on the strategy.

Global ECM Activity in 2020

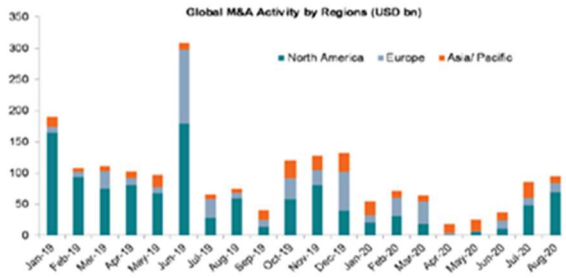


Source: Goldman Sachs

Merger Arbitrage

As noted, we remain upbeat on the merger arbitrage segment based on various factors. For one thing, we see a resurgence in megadeals that had been shelved in the wake of the crisis, which should allow managers to deploy capital more easily. Indeed, following an 81% year-on-year decline in the second quarter, public M&A activity is already nearing pre-crisis run rates, as the following chart shows. While the US is leading the charge, European deal-making is also showing signs of life. Globally, activity in September alone accounted for one-third of the year-to-date tally, and volume over nine months is down only 15% versus the year-ago period

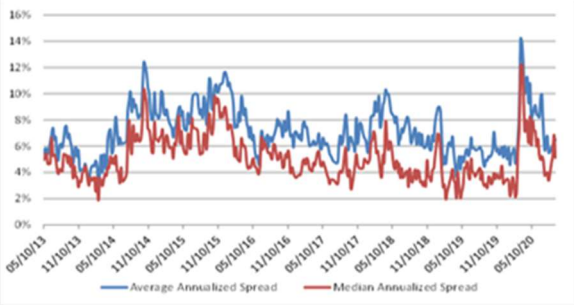
Global M&A Activity



Source: BNP Paribas, Exane

Additionally, while spreads in the sub-strategy have normalized somewhat from the distressed levels seen in March, they are much more attractive than they were when January started. The median annualized net spread for US deals in the 0-30% range is close to 6% currently, as the following chart illustrates, roughly three times higher than the 2% level that prevailed when 2020 began. Looking ahead, cheap financing, a shortage of growth, and record private equity dry powder should lead to further M&A.

US Merger Arbitrage Spreads

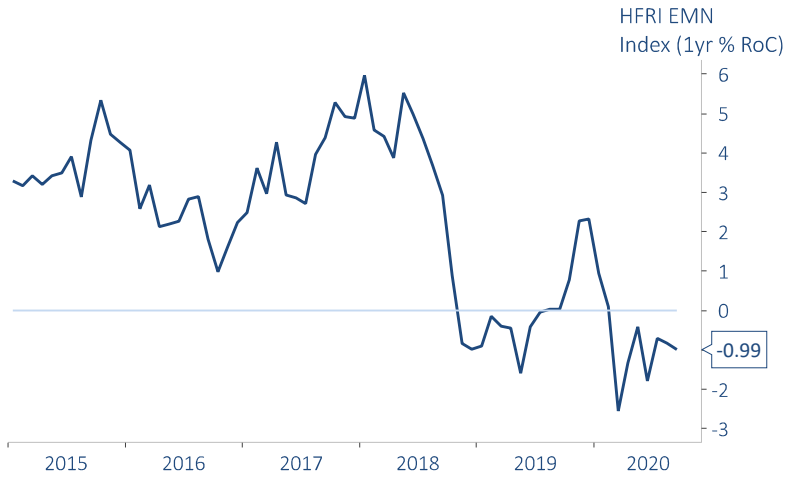


Source: Bloomberg, UBS

Equity Market Neutral

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Dispersion				Limited dispersion across factors so quantitative arbitrage likely challenged in portfolio construction while greater dispersion may offer better opportunity set to fundamental players
Valuations				Valuations for many of the quantitative factors sit close to historical highs, worry about Low Beta & Growth in particular
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.

Strategy Rolling 1-year Performance



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

Equity Market Neutral

Gayan Wijesinha, Hedge Fund Research

Equity market neutral hedge funds continued last quarter to partially claw back losses incurred from January through March, though the recovery seemed to flatline somewhat during September. The HFRI EMN index was up 1.1% in the period and is 1.5% lower year-to-date; the HFRX EMN Index was down 1.9% and 6%, respectively, over the two spans. The S&P 500 index, in contrast, rallied 8.9% last quarter, despite a decline in September, and is up 5.6% in the first nine months.

As noted previously, broad de-risking by multi-strategy quant funds employing high leverage and with tight risk controls played a key role in exacerbating the selloff that took place in the year's first three months , with volatility-based sizing strategies likely making matters worse. Although market volatility—as measured by the VIX index—has trended down since then, it has remained within the range of 21 to 33. Similarly, gross leverage has continued to increase, but it has not returned to the levels that prevailed around the turn of the year. Meanwhile, correlations have fallen and dispersion has increased, albeit from low levels.

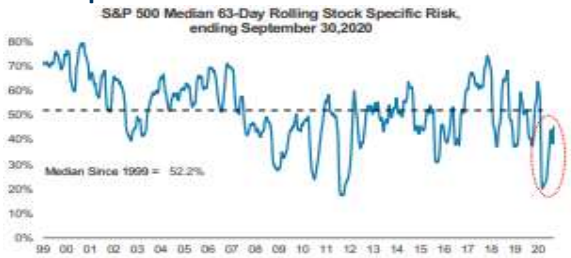
Looking at how EMN managers have fared, we find that the performance of the funds we track has been bifurcated. In the current environment, fundamental-based managers with concentrated exposures have generally fared best, while quant funds have either tread water or fallen deeper into drawdown territory. In theory, increasing dispersion and slightly elevated volatility should favor the entire group. Moreover, quants tend to do well in snapbacks that follow liquidation events like we saw in the period through March.

However, it appears that other factors have had a detrimental impact on the opportunity set. Of the quant and fundamental managers we monitor, the laggards over the first nine months were the larger multi-strategy quant managers and funds with US-based exposures. In contrast, the leaders include funds targeting Europe, Asia and emerging markets. In the wake of this divergence, factor volatilities have remained elevated relative to market volatility.

Whether it stemmed from the nature of the catalysts behind the selloff, differing risk management approaches, or other aspects, fundamental EMN managers came into and out of the first quarter with moderate leverage. Their willingness to step in and take advantage of dislocations and add to positions more quickly than their quant-oriented counterparts paid dividends that have bolstered their relative performance.

To provide some context with respect to the current environment for stock-selection strategies, we look at the median stock specific risk for the S&P 500 constituents, highlighted in the following chart from Morgan Stanley. After dropping to multi-year lows back in March, the measure has since been trending higher, though it remains well below its 20-year median.

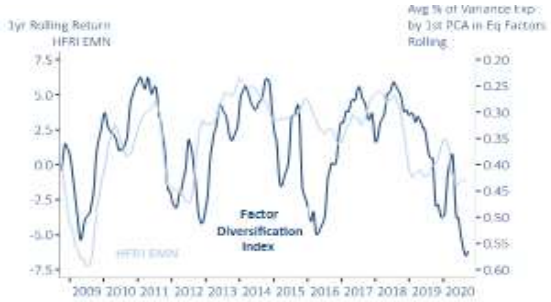
Stock Specific Risk of S&P 500



Source: ClariFi, Morgan Stanley

Looking at popular quant factors, we can see that diversification has fallen this year, with EMN performance tracking lower in tandem, as can be seen in the first chart below. At the same time, factor volatility in the US has remained high, in contrast to the decline in market volatility, as the second chart illustrates. What this potentially indicates is that betting on factors has remained a narrow game offering limited upside so far, suggesting that macro developments may matter more than stock-specific risk, at least for the time being.

Diversification Measure and EMN Performance



Source: Investcorp-Tages, Macrobond, Bloomberg

S&P Volatility vs. Fundamental Factor Volatility

Source: Investcorp-Tages, Macrobond, Bloomberg

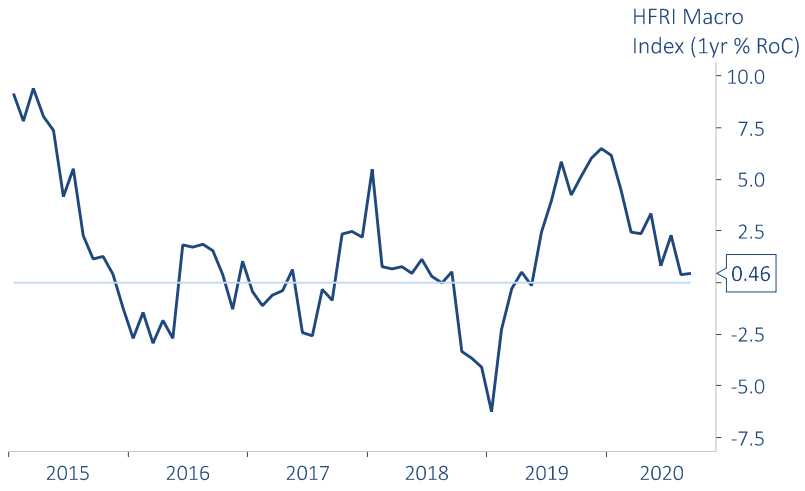
HEDGE FUNDS

Summing up, we continue to favor two EMN sub-groups: fundamental managers that can pinpoint opportunities that may not be evident in back-ward looking data, and the more price-and-behavioral-model-based funds, which have demonstrated an ability to navigate an uncertain macro environment. In contrast, we are more neutral on factor quant funds, which will likely need more time to model economic inflection points to account for the significant impact the coronavirus pandemic is having on corporate fundamentals.

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 foreign exchange markets. Large impact of policy, a positive for discretionary players
Trends				Trend following offers attractive convexity in today's portfolios
Correlation				Correlations normalizing slowly after March dislocations
Volatility				Cheap implied volatility can offer attractive trade structuring opportunities
Crowding				Limited risk of crowding in macro themes today

Strategy Rolling 1-year Performance



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

Global Macro

Macro Discretionary

Jonathan Feeney, Tactical Strategies

Discretionary global macro funds posted a net return of +1.0% in the third quarter 2020, to bring year-to-date returns to +0.30% and to +0.11% over the last 12 months, according to HFRI indices.

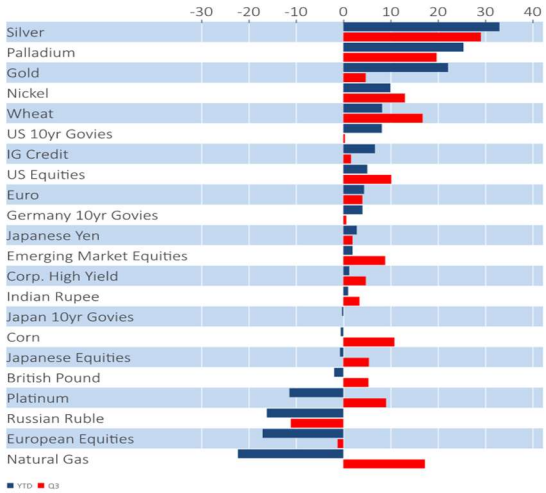
Macro Discretionary managers are slightly behind the broader hedge fund universe on a year-to-date basis versus (+0.3% versus +0.5% for the HFRI Fund Weighted Composite index) and are also trailing on a 12 month basis (+0.1% versus +4.0% for the HFRI Fund Weighted Composite index). While the macro strategy held up well in the first quarter, particularly in March, it has steadily underperformed in the strong risk recovery from April onwards and particularly underperformed in August as the S&P 500 rose +7.2% and hedge funds generally performed well.

Despite the relative underperformance we retain a high conviction on the Macro Discretionary strategy and it remains an overweight ranking. The main rationale for an overweight ranking is that we believe increasingly policy driven markets with plenty of volatility will provide an abundance of opportunities. As we have outlined in recent reports, while the "average" experience of investors in macro may be disappointing there is a significant dispersion of returns both across and within sub-strategies meaning manager selection is key to generate superior returns. In addition, we look to structurally tilt away from fixed income specialists into other asset classes and geographies, namely, FX, emerging markets and increasingly into commodities.

The following chart highlights some of the key macro factors that Macro Discretionary managers could potentially be exposed to through the third quarter. Some winning positions for macro managers in the third quarter included the precious metals complex – particularly gold and silver (before experiencing sharp reversals in August), a dollar weakening trend - particularly long Euro versus USD, long duration and curve steepeners and US versus Europe and EM equities. The most successful managers this year were able to successfully identify the severity of the COVID-19 pandemic and ensuing consequences and negotiate Q1 drawdown by being defensive

positioned in long duration (particularly in the front part of the curve that is most sensitive to policy actions), short credit, long volatility and short equity, long USD positioning then importantly hold onto gains or rotate the book through the sharp recovery into to the third quarter. Other managers (particularly EM focused) that got hit hard in March have recovered well as long as managed to keep a healthy amount of risk on their books.

Key Macro Factor Returns Q3 & YTD 2020



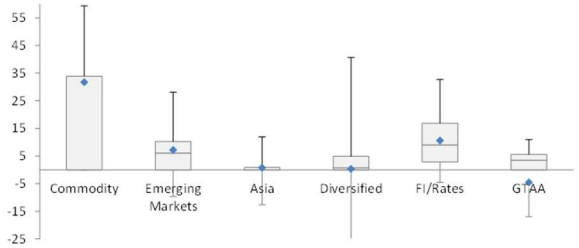
Source: Bloomberg, Macrobond

The relative strength of commodities is somewhat reflected when looking at the returns across a select group of macro managers when looking at the commodity complex. We provide a summary below of the performance of the top 50 global macro discretionary hedge funds over the last 12 months (to September 2020). The universe is disaggregated into six sub-classifications: FI/Rates/FX, Commodity, Emerging Markets, Asia, Diversified and GTAA.

There are several observations to make that have been consistent in recent quarters:

- There is significant dispersion both across and within the Macro Discretionary sub-strategies. There has been some outstanding performance from managers over the last 12 months with top quartile managers generating double digit performance. Conversely, there has been some shocking performance with double digit negative returns
- The commodity sub-strategy is the strongest performer over the last 12 months (albeit with a small sample size).
- Largest dispersion (inter-quartile range) is within the commodities and diversified sub-strategies
- Tightest dispersion (inter-quartile range) in GTAA, also GTAA managers are the most challenged from a performance perspective. This is possibly related to the disparity between economic fundamentals and price action that has been heavily influenced by huge liquidity injections from Central Banks

Investcorp-Tages Macro Discretionary Select Universe



Source: Investcorp-Tages

Playbook: Shift from Fixed income to Commodities and FX

We outlined last quarter the structural challenges facing Macro Discretionary managers that are fixed income specialists. By extension this also applies to strategies such as risk parity that a reliant on relatively equity /fixed income correlation relationships. Term premia have structurally collapsed globally as we reach the lower bound as have annual carry rates, requiring macro investors to turn to emerging markets, sovereign and quasi sovereign credit to squeeze out premia.

US 10-Year Term Premium

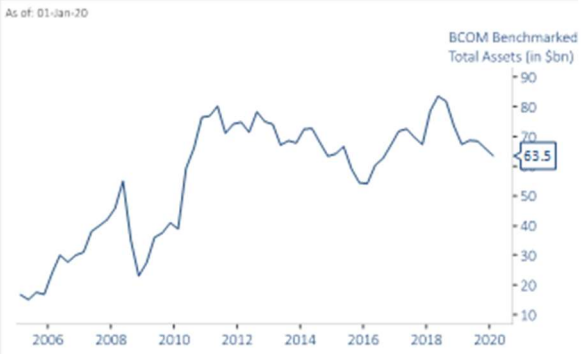
Source: Investcorp-Tages, Macrobond

Average Annual Carry in DM Universe

Source: Investcorp-Tages, Macrobond

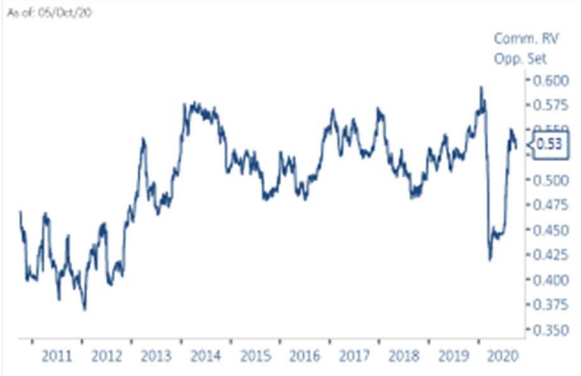
Two very interesting events occurred in the third quarter 2020 to further strengthen the structural case for investing in commodities. The $16 billion Ohio Fire and Pol and Police Pension fund approved a 5% allocation to gold in August 2020 and Berkshire Hathaway made a significant investment in Barrick Gold, despite the huge historical distain Warren Buffet and Charlie Munger have had for gold. These two events have far reaching ramifications in that US pension plans are often influenced by the actions and initiatives of others such as the move in "Crisis Risk Offset" strategies and therefore may lead others to follow. There has been an historically strong relationship between gold and real interest rates i.e. gold has performed well in a negative real yield environment. Policy makers have a compelling reason to keep real yields below zero in order to reduce the real value of the enormous debt stocks that have built up globally. In a world of potential yield curve controls and negative real rates, large allocators are on the look-out for diversifying assets. A total of $18 trillion is invested in public pensions and a small increase or introduction of a gold allocation will have a disproportionate impact on a relatively small investable market. From a corporate perspective Buffet's investment represents a blue-chip stamp of approval for the mining sector and could possibly presage a period of M&A and consolidation in the space.

BCOM AUM



Source: Investcorp-Tages, Macrobond

Commodity Relative Value Opportunity Set



Source: Investcorp-Tages, Macrobond

As outlined above Commodity managers are leading the way over the last 12 months with the median returns of our commodity sub index at +34% (with the caveat of a small sample size). There is currently

a very rich trading opportunity set within the commodity space as the impact of the global pandemic has had a direct impact to the broader commodity complex Furthermore, many of the large commodity hedge funds have left the space over the past 5-10 years leaving only a handful of experienced and capable players. This only adds to the attraction of the sector as potential trades are less picked over. From a purely long-biased perspective, it is possible that experimental monetary policy will trigger a resurgence in hard assets. On a more secular basis, the unprecedented fiscal and monetary stimulus, the potential rebound in economic activity post-COVID and the self-correcting nature of the commodity market offers an interesting contrarian opportunity. Furthermore, two interesting observations that outline the potential secular opportunity is that relative to the Dow Jones index, commodities are currently trading at the lowest valuation level since the mid-1960s. In addition, the "BCOM" (Bloomberg Commodity index) index reached a 45 year low in May. We would favor managers that can trade across the whole commodity complex (metals, agriculture, energy), rather than focus on one area. We also favor managers that can be both directional and relative value rather than taking outright "heroic" directional positioning.

In summary, the Macro Discretionary strategy remains a tactical overweight despite underperforming the wider hedge fund strategies in 2020. The playbook for 2020 is to have exposure to the following components within the Macro Discretionary space:

- The commodity complex has been a difficult area to navigate in recent years resulting in less capital allocated to the space and an exodus of managers therefore, remaining high quality managers that can play both relative value and directional plays in delta one and volatility across the whole commodity complex
- Managers with cross-asset expertise that can successfully navigate equity and credit indices in addition to pure FX/rates exposure with an increasing exposure to FX and potentially FX volatility
- Emerging markets specialists that have been able to play, inter alia, Latin America, EMEA but can also tactically hedge in periodic selloffs to carry based strategies rather the "deep value" credit orientated

Macro Systematic

Gayan Wijesinha, Hedge Fund Research

Macro systematic funds posted a -0.4% return last quarter and are down 2.3% year-to-date, according to the HFRI Macro Systematic index. Based on the Société Générale CTA index, the group lost 1.1% and 2.0%, respectively, over the same spans. For the period ahead, we remain neutral on the strategy as a whole. That said, we note that this cohort is comprised of a diverse group of managers, and believe certain sub-strategies offer more potential upside than others.

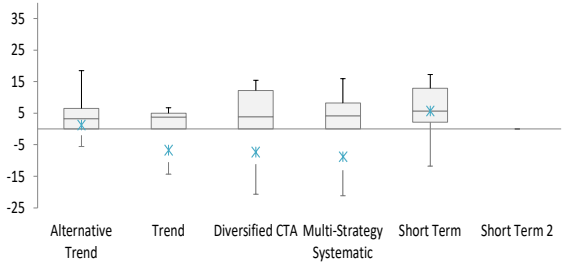
In regard to the standouts so far, it is clear that short-term traders have been particularly successful in holding onto the gains they generated in the first quarter. Alternative trend funds, meanwhile, have proved to be winners over longer lookback periods, owing to the higher capturable risk premiums on offer and barriers to entry that are greater than those faced by man-agers targeting traditional developed market trading vehicles.

Nevertheless, while both cohorts have fared well, odds are that with US elections and a potential conclusion to Brexit looming ahead, the former group of nimble, shorter-term-oriented managers that have navigated the market environment best over the last 12 months will remain a valuable portfolio diversifier should bond and equity valuations stay as rich as they are.

However, if rising public sector spending and easy monetary policy lead to sustained dollar weakness and a broadening out of procyclical trends, it is likely that alternative trend managers would be more exposed to areas offering rich pickings in terms of risk premia than the traditional CTA contingent, which tends to carry proportionally more risk in potentially more problematic developed market bonds and equities. Although our internal trend indicators suggest that the latter group also has access to a decent opportunity set, we believe the current stock rally would need to broaden out across sectors and geographies to give a measurable boost to CTA returns. Moreover, a likely realignment between the market's interest-rate expectations and the Federal Reserve's forecasts suggests that fixed-income players face a more constrained opportunity set in the period ahead.

Looking back at what impacted the macro systematic strategy's fortunes this year, it is clear that the broad lift from the sharp first quarter rally in government bonds has not been enough to overcome subsequent sideways trading in bonds, recent reversals in the US dollar and gold, and a fast and narrow-rally in equities, reflecting a lack of momentum outside the US markets and the technology sector. But as with other strategies, the top-level data does not tell the whole story. Breaking down performance by approach, we found some interesting divergences within and among five key sub-strategies – "Alternative Trend," "Diversified CTA "Traditional Trend," "Multi-Strategy Systematic," and "Short-Term" – drawn from our universe of the top macro systematic managers, as the following chart illustrates.

Investcorp-Tages Macro Discretionary Select Universe



Source: Investcorp-Tages

Not apparent from the chart is the fact that Alternative Trend, the leader in 2019 and over the last five years, has performed largely in line with traditional trend-followers this year. Over the last 12 months, meanwhile, the Short-Term segment has led the pack, edging out the longer term leader we referred to above. Below is an overview of how each subgroup has fared during the same span:

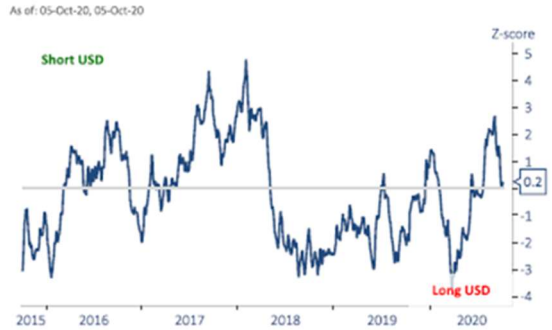
- **Alternative Trend** – Comprised of managers that trade the more esoteric instruments – ETFs, OTC credit, interest-rate swaps, and cash equities – as opposed to the liquid futures contracts utilized by traditional trend-followers, this segment posted a median gain of 1.2%.
- **Traditional Trend** – Generally employing a medium-term-oriented strategy – and where flat fees are occasionally a selling point – this cohort generated a median return of -6.8%.
- **Diversified CTA** – Typically operating with a mix of short- and medium-term trend and, occasionally, countertrend models, this segment is effectively a catch-all group trading multi-horizon futures that can have a high trend correlation; over the period in question, it generated a median loss of 7.4%.
- **Multi-Strategy Systematic** – Comprised of managers that have exposure to multiple quantitative alpha streams and that trade both futures and equities, this subgroup gave back roughly 8.8%, with losses exacerbated in some cases by cash equity quant factors.
- **Short Term** – Populated by traders operating with short time horizons, this group was up 5.7%.

In terms of the broader outlook, there is reason for caution. On the one hand, high-level summaries of the percentage of assets trending – those with momentum-signal z-scores above one – for fixed-income, FX, commodities and, based on a separate but similar approach, equities—some of which are highlighted below—suggest that the CTA opportunity set remains attractive. On the other hand, we are concerned about the pro-cyclical risk of current exposures and equity hedge funds' stretched positioning at a time of challenging valuations. Under the circumstances, we are neutral on the strategy for the period ahead.

Percentage of Asset Trending – Equities

Source: Investcorp-Tages, Macrobond

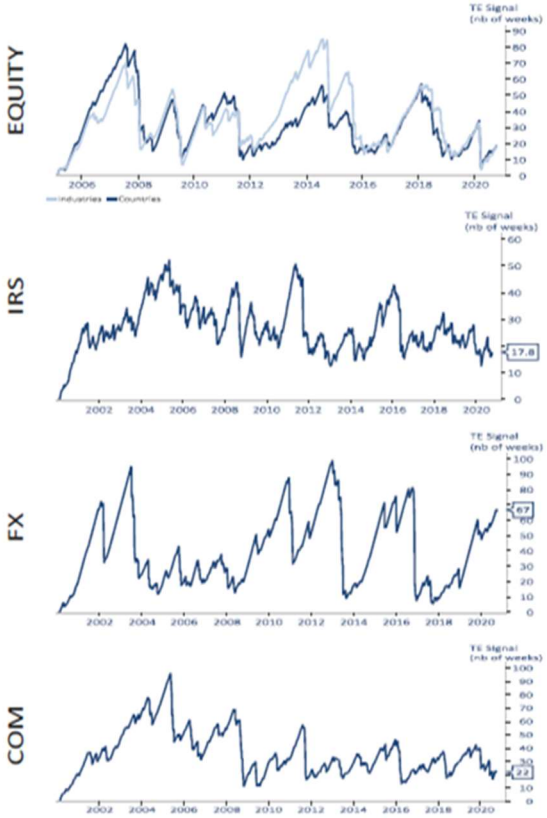
Median Momentum Score in FX USD pairs



Source: Investcorp-Tages, Macrobond

Assessing matters in a different way, our internal "trend exhaustion" indicators–calculated for each asset class using three separate short-to-medium-term look-back windows–paint a fairly mixed picture. As indicated by the following series of charts, rates have been a clear driver of trend fund focus and performance, but this linkage has started to break down. In particular, the dollar has started to weaken and the emergence of tradeable trends in commodities appears long overdue.

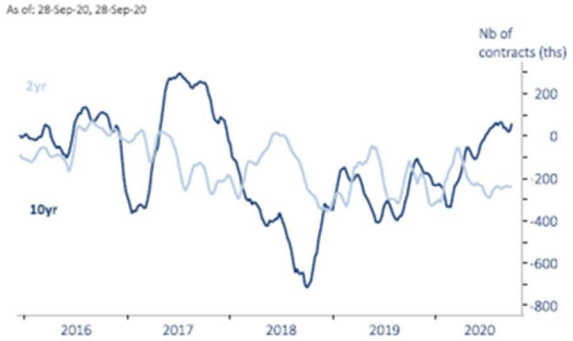
Investcorp-Tages Trend Exhaustion Indicators



Source: Investcorp-Tages, Macrobond

Going forward, we expect that fixed-income will have less to offer for trend-followers than it has so far; those who are positioned to take advantage of heightened interest-rate volatility will likely be better off. Among other things, we note that speculative positioning in longer-dated bond futures has surpassed its 2019 highs, as the following chart shows, at the same time we are seeing a rotation out of speculative positions in shorter maturities in the face of a bounded opportunity set.

Net Speculative Positioning in Fixed-Income

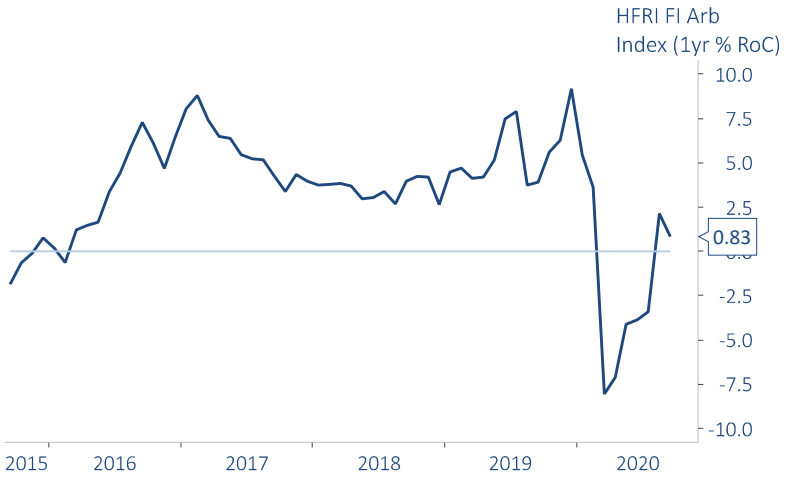


Source: Investcorp-Tages, Macrobond

Fixed Income Relative Value

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Opportunity Set	■			Lower volatility and greater competition from dealers leave us slightly underweight
Macro Fundamentals	■			Volatility compression in fixed income markets on greater involvement from central banks could be a headwind
Capital			■	Smaller number of players and lower leverage relative to history
Liquidity			■	Recent central banks programs have lowered liquidity risk for the strategy, the buyer-of-last-resort should help ensure relative value relationships hold stable
Financing	■			Scale is required to negotiate funding from counterparties for "balance-sheet" heavy trades

Strategy Rolling 1-year Performance



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

Fixed Income Relative Value

Luca Valeri, Relative Value Strategies

Fixed income relative value funds in our tracked peer group ended last quarter solidly in the green, recouping some of the COVID-19-related losses in the prior period; the HFRI RV Sovereign and Morningstar MSCI Fixed Income Arbitrage Indices were up +6.9% and +2.7%, respectively. Amid diminishing volatility in interest-rate markets, the rebound left the two measures down a more palatable -6.1% and -3.2%, respectively, year to date.

Following on from the Federal Reserve's first-quarter shift to an easier policy stance – one of the fastest such transitions ever seen – the Fed's balance sheet grew from $5.8 trillion to nearly $7.0 trillion over the April-June span. As can be seen in the chart below, major central banks have dramatically expanded their balance sheets in an effort to mitigate the fallout from the pandemic.

Central Bank Balance Sheets (Including FX Reserves)

Source: Investcorp-Tages, Macrobond

Across the globe, interest rates have converged toward zero in parallel with the broad shift toward implicit/explicit yield-curve-control policies. In the immediate aftermath of the crisis peak, Fed asset purchases were outpacing gross supply levels by more than two to one; quantitative easing since then has tapered to "just" $80 billion per month.

That said, things will likely be quite different going forward. Bank of America, for instance, is forecasting gross issuance of more than $1.4 trillion–based on 10-year equivalents – significantly above anticipated Fed purchases of roughly $400 billion. This less accommodating dynamic explains why many expect the recent yield curve steepening trend to continue, potentially leading to primary issuance dislocations that prove to be interesting trading opportunities.

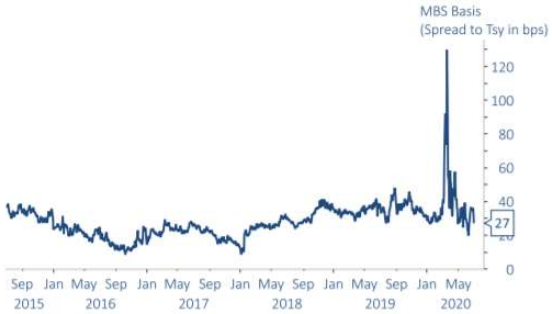
As alluded to earlier, volatility in the government bond space has fallen dramatically since the February-March spike, as the following chart illustrates. In a zero-interest-rate environment, this will likely spur investors to sell or short volatility once again in an effort to enhance portfolio returns.

MOVE Index

Source: Bloomberg

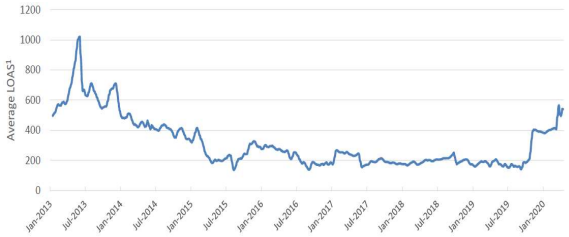
In the mortgage market, conditions were much more amenable last quarter than they were in the prior three months. After dramatically underperforming Treasuries in the January-March period, mortgages significantly outpaced US government bonds in the April-June span. The groundwork for this turnabout was laid in March, when the Fed embarked on its aggressive QE4 expansion program, which culminated with a portfolio holding of $1.9 trillion of MBS and CMBS. As can be seen below, this buying spree helped push the MBS basis down toward more normal levels and drive the OAS on MBS from a peak of 132 basis points on March 19 to 27 basis points by the end of last quarter.

MBS Basis



Source: Investcorp-Tages, Macrobond

Average Interest Only - Inverse Interest Only Libor OAS



Source: Investcorp-Tages, Macrobond

Interestingly, interest-only spread levels continue to undervalue current prospects. In our view, actual prepayments could be much slower than models and the market anticipate, mainly because agency mortgage yields, which have fallen sharply

on the heels of the Fed's large-scale buying of agency MBS, are the primary input for prepayment models. Based on history, these models are predicting higher prepayment rates in future, but given that unemployment has spiked, housing markets have weakened, Federal agencies are offering borrowers mortgage payment forbearance for 6-12 months, and underwriting standards are tightening, we believe prepayments are more likely to slow down.

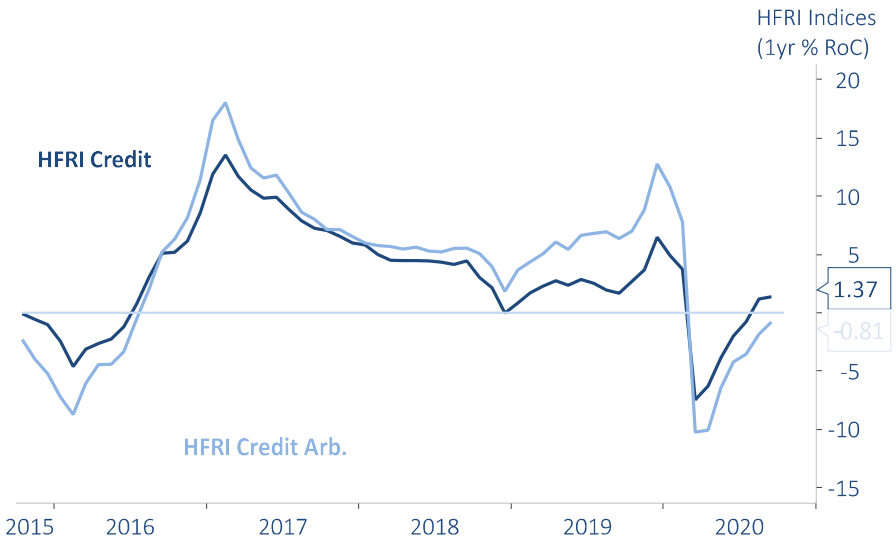
Looking forward, there are a number of developments that could constrain strategy returns. Among the prospective headwinds are the rapid move in rates to the zero lower bound and a reacceleration in Fed Treasury purchases. Both could impact the FIRV opportunity set by extending the time frame for the normalization of price distortions in closely linked securities and curves for longer than arbitrageurs can reasonably endure. Meanwhile, interest-rate volatility continues to move lower; it will likely take a pick-up in inflation expectations for this trend to reverse.

Under the circumstances, we have downgraded our rating on the strategy to one notch negative. That said, with the broader forward-looking opportunity set looking less attractive in the face of a liquidity-driven decline in fixed income volatility, we believe macro cross curve relative value, cross currency basis, and selective mortgage relative value trades will have more room to run than traditional futures basis and bond RV plays.

Corporate Credit

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation				Spreads remain at attractive levels, relative to history and other asset classes
Carry				Attractive carry relative to safe assets and large segments of equities
Duration				Limited duration risk
Dispersion				Large bifurcation across issuers, sectors and ratings tranches should offer trading opportunities
Defaults				Still early in the default cycle, expect a meaningful pick-up to double digits over the coming quarters
Liquidity				Asset class remains exposed liquidity risk but premium has re-priced higher, offering investors greater compensation for the risk

Strategy Rolling 1-year Performance



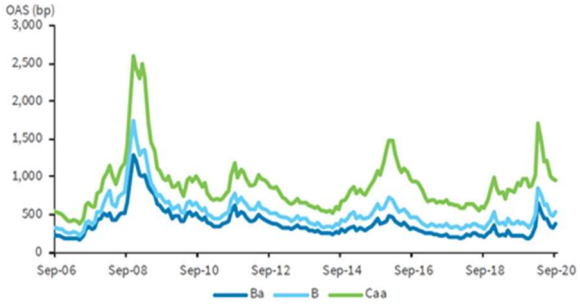
Median returns are those of Investcorp-Tages's strategy peer group. Strategy peer groups are created by Investcorp-Tages and are comprised of funds that Investcorp has judged to be relevant for each strategy. Source: Investcorp-Tages, Bloomberg

Corporate Credit and Distressed

Greg Berman, Credit and Event Strategies

Credit markets continued to recover last quarter from the losses we saw earlier in the year, as the following chart illustrates. The HFRI-Credit index, an aggregate of focused credit-related hedge fund benchmarks, rose 3.39% in the period, out-performing its typical beta-implied forecast. Two sub-indices, the HFRI-RV: FI-Corporate index and the HFRI-ED: Distressed-Restructuring index, were up 3.4% and 3.0%, respectively, leaving both within earshot of being positive on the year. The Barclays High Yield Index, meanwhile, gained 4.6%; year-to-date returns turned positive at the end of July and remain in the black after a small sell-off in September. Buoyed by two quarters of improving conditions, many individual credits and sectors also experienced further catch-up moves.

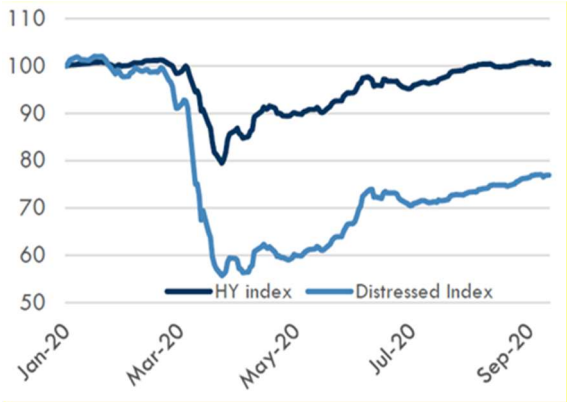
Credit Spread Differentials Across Ratings



Source: Bloomberg, Barclays Indices

At this juncture, our outlook for credit markets remains largely as it was; we continue to be slightly positive on corporate credit and more neutral on distressed credit. Amid the steady rebound in prices, highlighted below, improved responses to the ongoing pandemic by various governments, and the likelihood of further stimulus, we have seen growing stability across the corporate credit landscape. This includes in dis-tressed credit, which was ripe with bargains in the second quarter but which has since seen prices rebound significantly in areas that had sold off indiscriminately. Interest-ingly, high yield option-adjusted spreads, as measured by the Barclays High Yield Index, are only 1.81% wider than they were when the year began.

Performance of HY and Distressed



Source: Bank of America, Bloomberg

This is not to say that markets are out of the woods. Certain sectors, including transportation, leisure, energy, and retail, are still exposed to the risks of a sustained global slowdown as well as changes in consumer preferences and behavior. However, given that many of the larger players have successfully tapped capital markets, including cruise lines and aircraft manufacturers, it seems that the threat of a near-term liquidity crunch is behind us. Even so, distressed opportunities may resurface if current challenges begin to push these companies' burn rates into risky territory. For now, many in the corporate sector have sought to buy time through downsizing, as-set sales, and strategic adjustments.

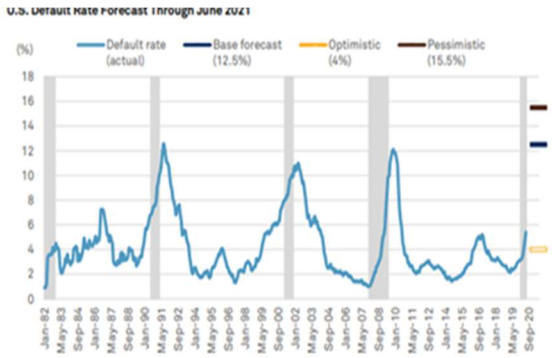
Against this backdrop, we are not inclined to alter our cautious stance. We are also concerned by the fact that the recovery has been buoyed by unprecedented levels of monetary and fiscal policy support, and that corporate earnings and personal consumption remain down on the year. Moreover, just as equity indices have been propelled by a minority of constituents–mostly in big tech–credit market returns have been anything but uniform. For instance, BB issues have outperformed CCCs by approximately 1,100 basis points this year, which largely stems from the fact that government stimulus programs have disproportionately favored the obliga-tions of higher-quality borrowers over those of their overleveraged counterparts.

In addition, as we have seen in the equity space, many of the issues of companies and industries that have been hardest hit by the pandemic are still suffering from the fallout. On average, they are trading 300 basis points wider than when the year started. Even then, this may be understating the true level of spread widening, largely be-cause of the changes in index constituents that have helped to paint a better picture of broader performance. For example, the retail sector credit-spread level is nearly unchanged from January. However, this does not rep-resent the same opportunity set; retailers such as Neiman Marcus and JC Penney have gone bankrupt and been dropped from the index, replaced by stronger operators that have only recently been down-graded to junk.

Even taking this into account, we believe the overall high yield market can hardly be characterized as cheap. In addition, if the pandemic and its adverse ef-fects manage to stretch well into 2022 without the economy receiving significant additional fiscal

stimulus, it is likely that we will see spread widening and a higher default rate, illustrated in the chart below. Indeed, while liquidity has been strong in the wake of the March sell-off– high yield issuance is on track for a record year– helping levered companies to shore up balance sheets, concerns remain. The high levels of cash burn referred to earlier may well leave many companies with elevated debt burdens that will need to be resolved.

US Loan Default Rate



Note: Shaded areas are periods of recession defined by the National Bureau of Economic Research
Source: S&P LSTA

So far, corporate bankruptcies are up materially on the year, and while the pace of downgrades has eased, the outlook is less sanguine. S&P projects that defaults among US high yield issuers will double from current levels to 12.5% by mid-2021, exceeding the peak that was seen during the global financial crisis. With respect to levered loan defaults, the picture is a little brighter. They remain lower, ranging between 4% and 5%, depending on whether the measure is calculated as a percentage of volume or number of issuers.

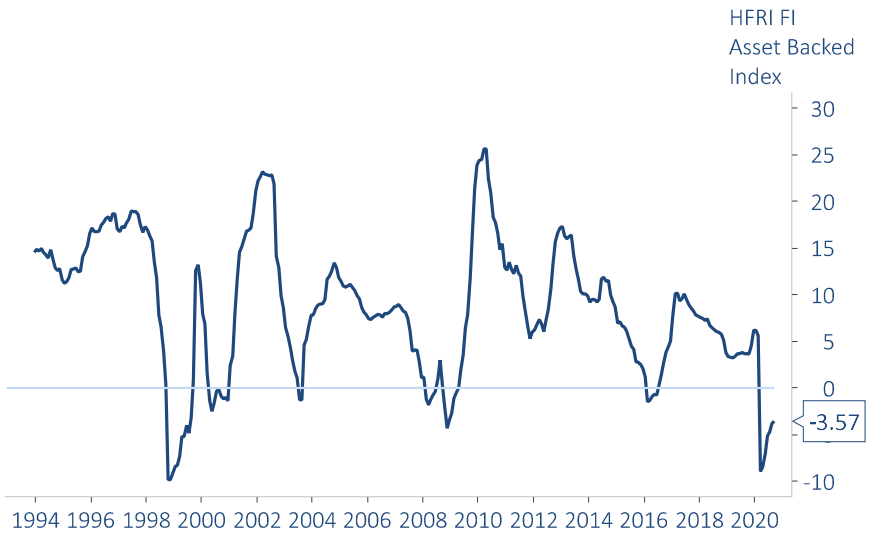
Regardless, we see further stimulus coming no matter of how the US elections turn out, with only the timing and the sizing caught up in the partisan political debate. That said, with recent polls and betting markets pointing toward a possible Democratic sweep of both the White House and Congress, odds are that any accommodation measure that are introduced will lean toward being larger and more sweeping.

These various developments lead us to conclude that while broader markets might be rich overall, there are some disparities worth keeping in mind. That is, certain segments look very rich, others appear quite attractively priced, and when push comes to shove, many CCC-rated companies may well need to restructure. However, things play out near term, at some point managers with the experience and expertise to determine which issuers will be able to steer clear of bankruptcy will have access to a potentially lucrative opportunity set. setting the stage for us to consider upgrading our stance on distressed. In the meantime, we expect opportunities to short the most expensive issues will grow, especially as spreads and default projections begin to dovetail.

Structured Credit

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation			■	Valuations have come in from March levels but remain attractive on a relative basis
Flows	■			Likely technical pressure, potential for investor redemptions and fund's closures
Carry			■	Spreads remain at attractive levels, relative to history and other credit markets
Idiosyncratic Legal & Structural			■	Complex capital structures and waterfalls continue to offer opportunities for alpha generation
Liquidity	■			Liquidity can dry up quickly given lower dealer involvement
Financing		■		

Strategy Rolling 1-year Performance



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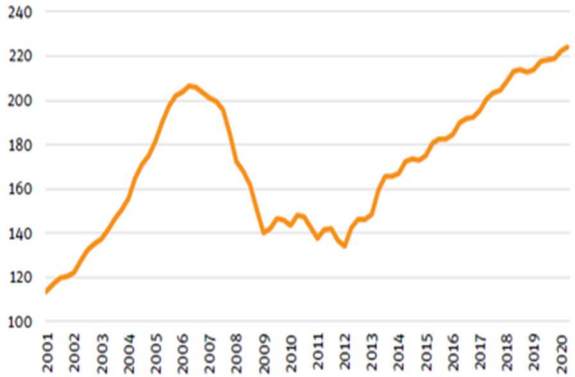
Structured Credit

Greg Berman, Credit and Event Strategies

RMBS

On The residential mortgage-backed securities space has benefited from resiliency in the housing market, where the fundamentals have been buttressed since March by the need for many former commuters to work from home. As can be seen in the first chart below, residential property prices have continued to climb higher, pushing the S&P/Case-Shiller 20-City Home Price Index to record levels.

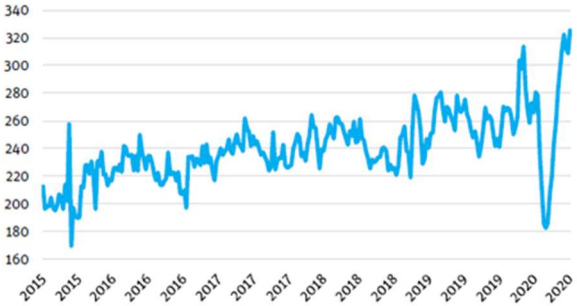
S&P/Case-Shiller 20-City Home Price Index



Source: Bloomberg

Other factors have also contributed to rising demand for homes, including low interest rates and a notable exodus from the larger cities to the suburbs. In July, housing starts jumped by almost 23% and existing-home sales rose a record 24.7%. Mortgage applications have also picked up considerably over the past few months, as the following chart shows.

US Mortgage Purchase Applications



Source: Bloomberg

Meanwhile, the cost of debt for recent non-agency real estate securitizations has fallen significantly. In our view, execution will remain strong in a low rate environment where new-issue supply across the residential credit space has been lacking. Going forward, we expect this trend to continue, bolstered by the ongoing migration to areas where the perceived risk of exposure to COVID-19 is low and where there is extra space for families who are spending more time in the home.

Looking back at developments this year, it is clear that that during March's liquidity crunch, conditions were anything but positive. Non-qualified mortgage (non-QM) AAA bonds were trading at spreads as wide as 300 basis points. Originations effectively came to standstill as loan prices dropped to the low $90s from their pre-March premium levels. Prices have been working their way higher since then, making the prospect of restarting new originations more appealing to mortgage lenders.

The decreasing financing cost since the post COVID-19 crisis peak has also been beneficial in other ways. It has helped boost the return profile for the bonds retained from securitization and increased the value of the underlying loan collateral, even when accounting for the prospect of increased delinquencies.

Assuming that originations eventually pick up, the market will likely only see a limited supply of new securitizations through the end of this year. Consequently, with active issuers facing limited competition in the market and senior bond buyers continuing to hunt for yield, we believe securitization execution has the potential to carry on improving. Currently, volumes this year are estimated to be in the $10-13 billion range.

CLOS

CLO spreads have continued to tighten amid significant increases in primary market activity. Issuance was roughly $11 billion in September, the highest monthly total since April of last year. That said, the nine-month total is $60 billion, 35% below the year-ago period. Meanwhile, secondary market trading in CLO tranches has been quite active in recent months. According to Morgan Stanley research, trading in IG CLO tranches reached $12.8 billion, almost 60% higher than the two-year average of $8.1 billion, while trading in below-IG counterparts was $3.8 billion, only modestly above its $3.3 billion average.

Broadly speaking, the segment's metrics have improved in recent months due to several factors, including higher loan prices, fewer loan downgrades, and trading activity by managers aimed at reducing risk. Even so, these measures remain much weaker than the levels that prevailed prior to the pandemic, as the following table illustrates.

Median US CLO 2.0 Fundamentals

US CLO Metrics	Dec 2019	March 2020	June 2020	Sept 2020
WA Portfolio Spread (bps)	351	345	346	370
WA Moody's Rating Factor	2857	2851	3291	3192
Diversity Score	78	79	79	79
CCC Assets	3.7%	3.6%	9.7%	8.5%
Caa Assets	3.3%	3.3%	7.6%	7.2%
Defaulted Assets	NA	0.30%	0.90%	1.00%
Minimum OC (bps)	410	402	210	235
WA Portfolio Price ($)	$ 97.40	$ 83.30	$ 91.10	$ 94.40
Equity NAV	51.5%	-91.9%	-17.1%	15.4%

Source: Barclays

Below is an overview of selected developments of note:

- **CCC Exposure.** CLOs have significantly reduced their exposure to CCC-rated loans in recent months. That said, current weightings are more than twice as high as they were at the beginning of the year.
- **Minimum OC Cushion.** The minimum overcollateralization test cushion fell below 200 basis points in the second quarter, less than half the more than 400 basis point level at the start of the year. While that cushion has rebounded in recent months, it is still less than 60% of its initial value. A failure of one or more OC tests could not only lead to reduced or eliminated CLO equity distributions for a period of time, it could potentially result in junior CLO debt and equity tranches paying out their coupons in kind ("PIKing") and not paying dividends.
- **Weighted Average Portfolio Price.** At its worst point in March, the leveraged loan index slid into the $70s and its total return was down more than 12% for the month. While the weighted average price of the median CLO loan portfolio has recovered significantly since then, it is still three points below where it was when January started.
- **CLO Equity NAV.** The median CLO equity tranche NAV has fluctuated in line with loan price changes, but the movements have been magnified by the structural leverage inherent in CLOs (the typical equity tranche is levered 9-11x). Regardless, median NAV remains more than 35% below its starting level. This is one reason for the continued softness in CLO equity prices, in addition to uncertainty about the outlook for the economy and loan down-grades and defaults.

As far as loan defaults go, activity in September was subdued in comparison to what we saw during the March- July period. Even so, the current year-to-date total of $123 billion in loan defaults and distressed exchanges is the second highest in history behind the $205 billion registered in 2009.

Under the circumstances, CLO investors will no doubt be keeping a close watch on default risk. However, they should also be tightly focused on post-default recovery prospects. While recoveries on first-lien senior secured loans have averaged 75%, many expect that percentage to be lower going forward due to several important changes in the market.

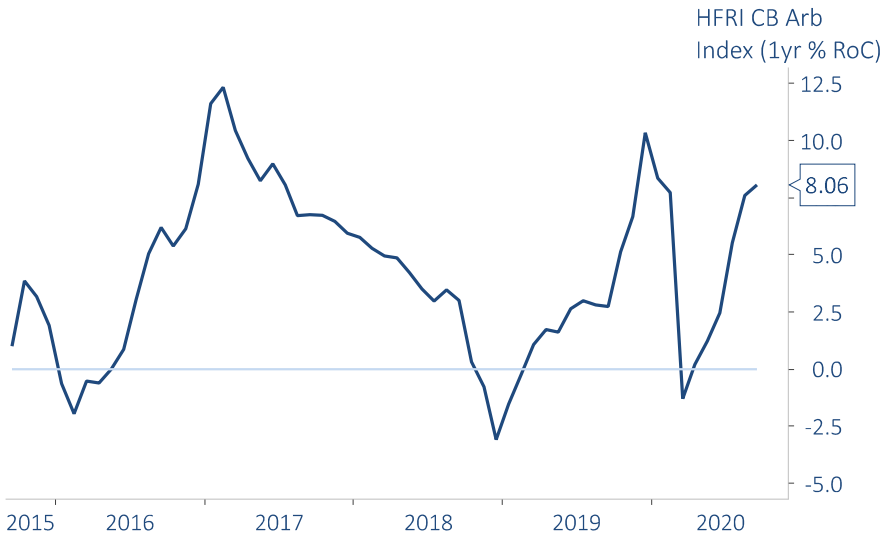
First, most outstanding loans are now structured as Cov-lite obligations—they do not contain financial maintenance covenants. Historically, a borrower would fail such a covenant before committing a payment default or filing bankruptcy, which would force the borrower to negotiate with its lenders. However, without them, borrowers can potentially operate in a stressed or distressed condition for a longer period of time prior to default. This circumstance will likely pressure asset values and reduce the recoveries that are ultimately realized by lenders.

Second, there has been dramatic growth in "loan-only" capital structures in recent years. Traditionally, leveraged loan borrowers had capital structures consisting of a senior secured loan and unsecured bonds. Nowadays, bonds are no longer included in many cases and the loan is concomitantly larger. Based on historically lower historical bond recovery rates, this change will likely feed through and depress overall loan recoveries. Given these changes, while borrower-specific considerations will continue to be a key driver, we would not be surprised to see average recoveries fall to the 50-60% range.

Convertible Arbitrage

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation				Valuations have turned neutral in US but remain attractive in Europe/Japan/Asia
Issuance				New issuance has exploded in recent months as converts offer cheaper way of accessing funding for many businesses
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.

Strategy Rolling 1-year Performance



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

Convertible Arbitrage

Luca Valeri, Relative Value Strategies

Convertible Arbitrage hedge funds gained 6.6% in in the third quarter, continuing the strong trend in effect since March and taking the return of the benchmark HFRI FI Convertible Arbitrage index, highlighted below, to +5.73% year-to-date. Performance was bolstered by the robust recovery in equity markets, tightening credit spreads, a broad-based improvement in valuations, and strong primary market and gamma trading.

Convertible Arbitrage Hedge Funds – 1 Year Rolling Performance

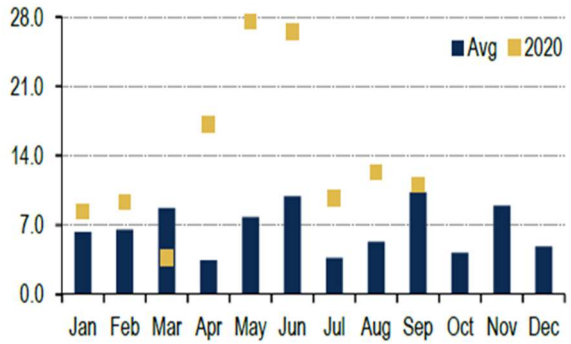
Source: Investcorp-Tages, Macrobond

Regionally speaking, we witnessed a bifurcation of returns. Although the benchmark BofA G300 Global Convertibles Index rose 13.6% during the first nine months, the US measure fared significantly better, gaining 22.2%. In contrast, European and Japanese counterparts were up a meagre 2% and 8%, respectively.

Sector-wise, the biggest winners last quarter were consumer discretionary and communication services, up 42.5% and 15.5%, respectively, and the most notable laggard was energy, which rose just 2.4%. Segregated by profile, equity-sensitive converts led the pack with a gain of 20.6%; while balanced and credit/rate-sensitive converts rose a more modest 7.4% and 5.8%, respectively.

In terms of issuance, $125 billion of new convertible bonds came to the market in the first nine months, the most since 2007's full year total of $162.9 billion. Of this year's tally, the US has accounted for $88.2 billion—again. the most since 2007's $95.1 billion—while Europe, Asia, and Japan have accounted for $22.7 billion, $13.6 billion, and $1.2 billion each. Although the primary market experienced something of a lull during the summer, as the following chart indicates, brokers have recently been reporting a pick-up in activity, suggesting that 2020 global issuance could reach $140 billion.

Average Global Issuance by Month ($ Million)



Source: Bank of America Merrill Lynch

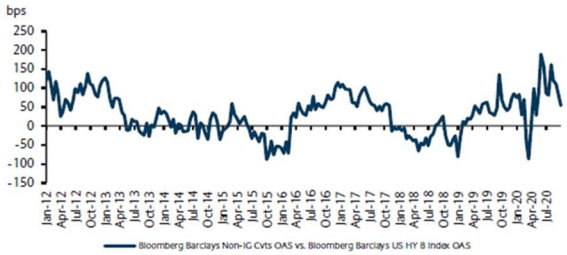
Looking at performance from a broader perspective, US Convertible Bonds have outpaced all other asset classes; in the first nine months, the HFRI FI Convertible Arbitrage Index was up over 5.2%, topping the 4.8% rise in the hedge fund composite benchmark. All of the following elements have made a positive contribution to the strategy's solid showing so far this year:

- **Primary market:** COVID-19 pushed corporates to raise fresh capital to survive the crisis, augmenting the market's appeal as a viable source of funding. But even before the pandemic struck, other developments had served as a tailwind, most notably the Tax Cuts and Jobs Act, signed into law in December 2017. This measure allows companies to take a maximum interest payment deduction of up to 30% of EBITDA, increasing the cost of issuing corporate debt, especially for businesses with limited amounts of EBITDA, most notably growth companies in the information technology and biotechnology industries.
- **Synthetic put trades**: On the heels of the strong market rally, a number of convertible bonds are now trading deep in-the-money, representing an opportunity for hedge funds to benefit from positioning these issues on a fully delta-hedged basis. They can benefit from positive carry and stand to gain if and when the market corrects.
- **Gamma trading**: The increase in issuance and trading volumes has afforded managers increased opportunities to make the most of any spikes of volatility, as well as to capitalize on increased dispersion within sectors and among single-name issues.
- **Credit:** During the first half of the year, the relationship between the aggregate US non-investment-grade convertible yield and the HY-B rated spread hit an extreme, as can be seen in the following chart. While the dislocation has partially dissipated since then, taking away the

low-hanging fruit, convertibles still offer a pickup in yield in comparison to both high yield bonds and CDS.

- **Special situations**: The fallout from COVID-19 and buoyant markets have together helped to churn up attractive opportunities in puttable converts (where the trigger is a change of control), exchanges, and refinancing offers.

US Non-Investment Grade CB vs. HY B Spread



Source: Barclays

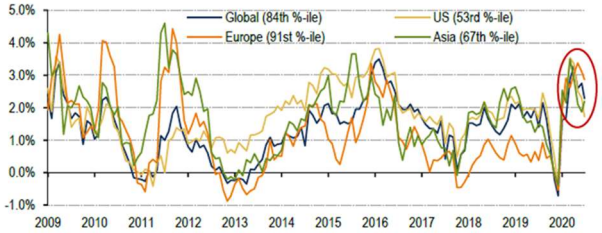
After rebounding to multi-year highs in the second quarter on the heels of strong new issuance, convertible bond market liquidity has since drifted back, as shown below. In recent months, volumes have eased toward more normalized levels, though bid-ask spreads reportedly remain fairly tight.

US Convertible Bonds Average Daily Volume (3-Month Average)

Source: InvestcorpTages, Macrobond

As far as valuations go, convertible bond cheapness has slipped from the extremes reached in the second quarter, as the following chart illustrates. While all regions still trade at a discount to fair value, the retracement seen in the U.S over the last several months has moved the level of undervaluation closer to its historical average. Other regions, meanwhile, continue to be cheaper than they were on most occasions since the global financial crisis ended.

Bottom-Up Valuation – Percentage Cheapness



Source: Bank of America Merrill Lynch

Taking everything into account, we continue to believe that the convertible strategy has further upside. While performance over the last two quarters has been especially strong, our view is that the aforementioned tailwinds remain in place and, thus, we maintain our positive stance.

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