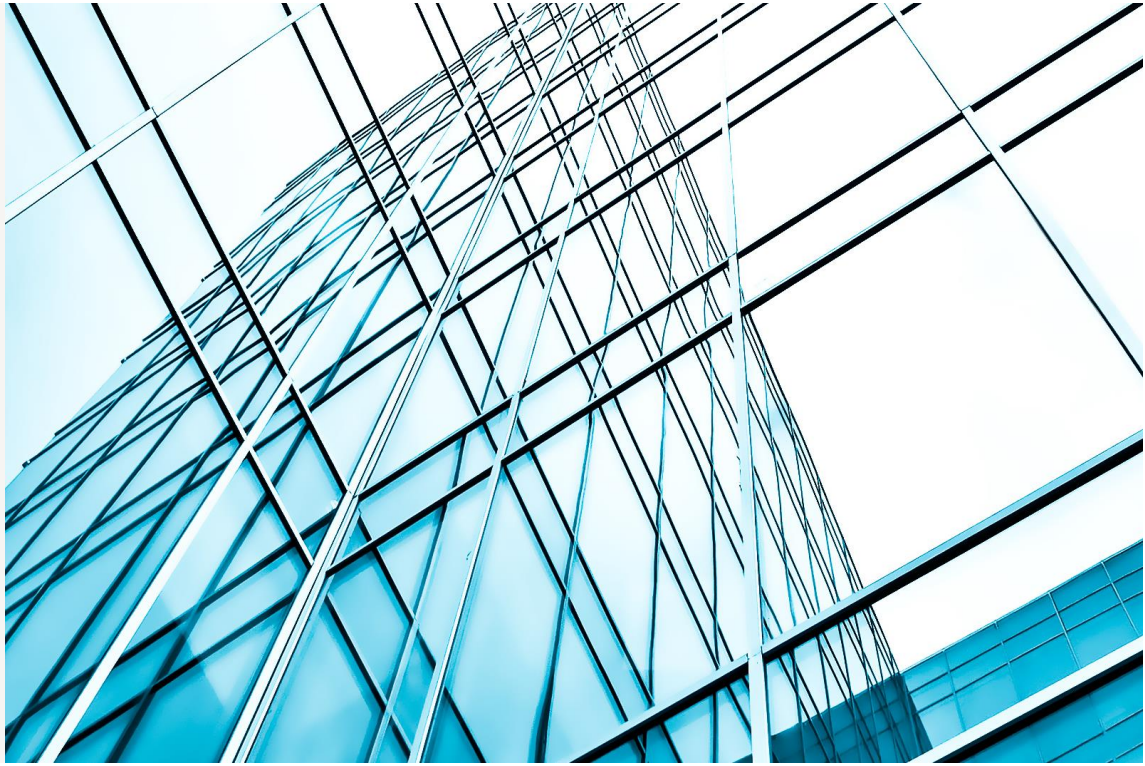
INVESTCORP-TAGES

Investcorp-Tages Market Outlook

Q1 2021



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Dear Clients and Partners,

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

As we enter 2021, we open this quarterly report with a note from author Andrew Zolli, excerpted from his book Resilience: Why Things Bounce Back.

> The journey toward resilience is the great moral quest of our age. It is the lens with which we must necessarily adjust our relationships to one another, to our communities and institutions, and to our planet. Even so, we must remember that there are no finish lines here and no silver bullets. Resilience is always, perhaps maddeningly, provisional, and its insistence toward holism, longer-term thinking, and less-than-peak efficiency represent real political challenges. Many efforts to achieve it will fail, and even a wildly successful effort to boost it will fade, as new forces of change are brought to bear on a system. Resilience must continuously be refreshed and recommitted to. Every effort at resilience buys us not certainty, but another day, another chance. Every day is Day One.

Zolli's words naturally applies to our business of investing capital. The impressive performance we have witnessed in recent months across asset classes risks complacency winning over again. Fear Of Missing Out is a powerful motivator. After all, Charles Kindleberger said it best: "there is nothing so disturbing to one's well-being and judgement as to see a friend get rich". But history has not been kind to those seeking short-cuts and get-rich quick schemes. Investing is difficult, requires constant diligence, process and a healthy dose of critical thinking. Keeping that in mind, we renew our focus on striving for resilience in the New Year.

In the pages that follow, we share snapshots of our current views, 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

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				Stretched valuations and positioning signal fragility to consensus view
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 valuations have moved a lot in recent period.
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

It was only months ago we were all terrified of climbing the wall of worry before us. Now we are almost eagerly awaiting the next speed bump to buy the dip. Notwithstanding the ever-wider gap between asset markets and Main Street, 2020 turned out to be a very decent year for investors. Let us hope central bankers well-meaning efforts to suppress market volatility and speed up an economic recovery through loose financial conditions will prove Paul Volcker wrong when he said in 2018 that:

> The real danger comes from encouraging or inadvertently tolerating rising inflation and its close cousin of extreme speculation and risk-taking, in effect standing by while bubbles and excesses threaten financial markets. Ironically, the "easy money," striving for a "little inflation" as a means of forestalling deflation, could, in the end, be what brings it about.

At this point, the macroeconomic picture is becoming increasingly clear. The consensus has rallied around the base scenario of a one-time shock followed by a quick economic recovery, thanks to the extraordinary relief provided by public sector authorities. With the effects of policy support, especially on the monetary front, likely to be sustained, investors are embracing the return of the "Goldilocks" scenario, where a relatively speedy recovery and "lower for ever" interest rates represent a benign backdrop for risky assets.

Lending further weight, two lingering sources of major macro uncertainty have diminished in recent months. First, positive vaccine developments serve as a beacon in the darkness created by the coronavirus pandemic. To be sure, the path to herd immunity remains littered with obstacles. Aside from the nightmarish logistics of distributing the vaccine on an unprecedentedly large scale, there is also the threat of dangerous new virus mutations, a less-than - anticipated take-up of the vaccine, and a host of other potential issues, some of which may not be on policymakers' radar.

Second, a Biden presidency should be decidedly less chaotic than was the case amid the Trump-tweet-induced volatility investors had grown accustomed to over the last four years. In addition, the victory by the Democrats in Georgia's U.S. Senate run-off races, representing a razor-thin majority that nonetheless gives the party the opportunity to move forward with a fiscally expansive agenda, sets the stage for increased public sector spending in the medium term. This should help to mitigate the risk of sustained economic weakness.

Still, while control of both houses will afford the Biden administration leeway to set a new course in areas where the reconciliation process allows for measures to be passed without a filibuster-proof majority, the odds that we will see a dramatic reorientation are somewhat less. The rise in political polarization in recent years has shown how difficult it is for elected representatives from both sides of the aisle to secure bipartisan agreement on meaningful reforms, making it likely that ambitious new policy initiatives will end up being shelved.

This seemingly leaves investors in the position of having to look through any near-term disappointments — including a likely double-dip recession stemming from the reimposition of lockdowns in Europe — to focus on the emerging — or, some might wonder, the already fully-emerged — consensus scenario referred to earlier. To be sure, valuations and positioning models are signaling complacency, while evidence of exuberance is popping up here and there, suggesting the upside is limited. Nonetheless, the extraordinary momentum we have seen so far dictates that we remain bullish or risk missing out. Party like it's 1998—again?

Google Search Engine in 1998

From where we sit, our analysis of the potential macroeconomic paths ahead leaves us with an expected outcome that is not much different from that of the consensus, though we lean in a more conservative direction. We believe it will

take time to fully identify and assess the fallout from the COVID-19 shock. This seems especially true today, where a rising number of so-called zombie firms serves to obfuscate the true impact of the pandemic. As the extent of the underlying damage becomes clearer, we could see this translating into lower future trend growth — beyond the initial snapback recovery — as the outlook for productivity deteriorates.

Separately, the prospect of the widening wealth gap with respect to both individuals and firms leading to a political backlash is also a concern, though for now, at least, near-term catalysts for such a turn of events appear scarcely evident.

At this juncture, what makes us uncomfortable, in particular, is the extent of the consensus regarding where things are headed, which is fully evident in our positioning indicators. Along with stretched valuations, the lack of diversity with respect to future expectations has led us to maintain a more cautious stance regarding most asset classes, including having a lower exposure to equity markets than might be expected in such a scenario. In our experience, complex systems tend to be a lot more fragile when one response function dominates, which has been especially true in an environment where central banks seem to have done their best to ensure we all buy into a similar heuristic.

Under the circumstances, we favor assets with a pro-cyclical bent that also have unmistakable tailwinds relating to valuation and positioning, as our asset allocation playbook at the end of this section makes clear. Factor-wise, this leaves us more constructive on value in its different expressions across markets and geographies. In fact, we view heightened exposure to a value revival helping to rebuild the upside convexity we no longer get from credit markets, where prior dislocations have almost completely dissipated.

Before getting into the nitty-gritty of our scenarios, we offer a reminder 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.

The scenarios we view as plausible (and their respective probabilities) are summarized in the table below. Our base case is a slow and fragile recovery, where deflationary forces are offset by an extraordinary policy response from monetary and fiscal authorities. The lower economic momentum inherent to this pathway presents risks of reversals and will likely remain uneven across geographies and sectors. It reflects a world where the "winners" keep winning and the "losers" struggle to stay alive.

Macro Scenarios and Associated Narratives

Long Slog Back 40%	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 30%	Sustained extraordinary policy response, from fiscal and monetary allow 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.
Back to Goldilocks 20%	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.

An alternative narrative would see reflationary forces gain pace, though not immediately given that output gaps remain wide open. But increased resiliency in the economic system in the wake of COVID-19 and the continuation of an extraordinarily loose policy mix could gradually undermine the foundation stones of the disinflationary environment we have become so accustomed to. This would represent a sea change for investors, setting the stage for an epic momentum crash; positioning and valuations suggest recent trends have been extrapolated far into the future.

In our minds, the odds of this scenario coming to fruition are less than those of the "Long Slog Back," but we acknowledge the tenable asymmetry it represents and would want to ensure that our portfolios are built to withstand this turn of events should it come to pass. Lastly, we view the final two scenarios as symmetrical tail risks, sitting at opposite ends of a positive-negative spectrum. That said, we currently see greater chances for the "Back to Goldilocks" narrative to unfold in the wake of a post-vaccine recovery.

Looking at the asset allocation implications of the four scenarios, summarized in the following table, it is clear that there is no one-size-fits-all outcome. With the narrative we view as most likely, we would expect to see range-bound markets, where volatility is elevated relative to its longer-term history, together with disappointing earnings growth.

Macro Scenarios and Associated Narratives

Long Slog Back 40%	**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 30%	**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.
Back to Goldilocks 20%	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.

Certainly, valuations could remain supported in this circumstance given the favorable liquidity backstop, but we believe better values would be found in credit markets, where the technical linkage to central bank support is clearer and where deleveraging pressures should serve as a tailwind.

Dispersion could also stage a comeback, with the passage of time providing more clarity on which companies and industries have ended up as the winners or losers, representing a plus for market neutral relative value strategies. Additionally, growth would likely continue to outperform value, though rich valuations and stretched positioning with respect to this theme should be taken into account. Finally, the importance of policy support is likely to preserve the edge that global macro funds have enjoyed in recent years.

Alternatively, if the forces of reflation were to gain traction — our most out-of-consensus outcome — value would likely be the clear beneficiary across asset classes. In fixed income, the curve would steepen violently on a higher term premium. At the same time, the return of nominal growth would serve to deflate the premium that growth stocks have enjoyed over value counterparts, with current lopsided positioning and valuations likely exacerbating the move. In foreign exchange, the US dollar would weaken back toward fair value, potentially overshooting to the downside.

Should the Goldilocks scenario unfold instead, massive outperformance in equities seems easy enough to predict. In contrast, market neutral and long convexity strategies would likely be the only ones to serve as safe havens during a "Deflationary Bust." Finally, we see the absence of the portfolio protection that fixed income has historically provided, reflecting yields and pricing that are rich by virtually any standard, as a notable concern. It means a large cross-section of investors are currently taking more risk than they have over time in what is likely to be a 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.

Starting with an overview of where things stand with the broader economy, our Nowcast models — which provide a real-time read on activity derived from a wide range of macroeconomic data using standard econometric models — show global GDP growth expanding at an annual rate of 4.8%, as of December, as the following chart illustrates. While the bounce-back that followed the pandemic-related lockdowns earlier last year was sharp, it has continued to lose momentum since then.

Global GDP Growth Nowcast

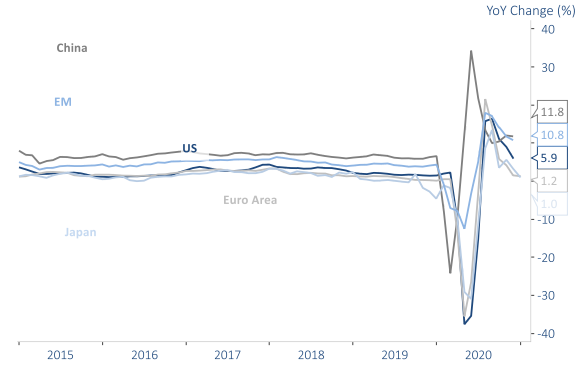
As of: 02-Nov-20, 31-Dec-25

Source: Goldman Sachs, Investcorp-Tages, Macrobond

That said, the recovery overall has been broad-based across geographies, with China at the forefront and the euro area and Japan pulling up the rear, as the first chart below reveals. In recent months, our diffusion index of OECD leading economic indicators, which seeks to measure their general tendency for a wide swath of countries, has tapered off, falling to 82 at the end of December, as the second chart indicates. While the measure remains above 50 — below which would indicate that most countries are experiencing a contraction in their leading economic indicators — it is apparent that the recent economic headwinds originating from the reimposition of lockdowns in many European countries are taking a toll.

GDP Growth Nowcast by Region

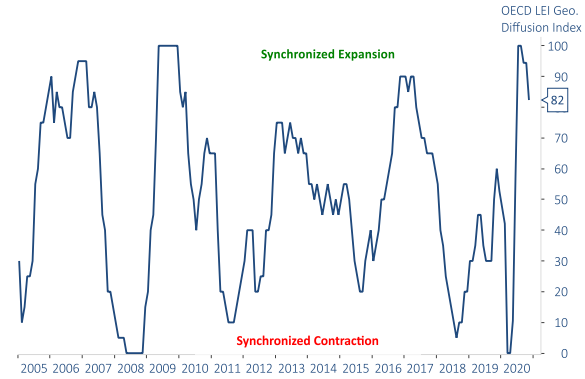
As of: 01-Dec-20, 30-Nov-20, 31-Dec-20, 31-Dec-20, 30-Nov-20



Source: Goldman Sachs, Investcorp-Tages, Macrobond

OECD Leading Indicators Diffusion Index

As of: 01-Nov-20



Source: OECD, Investcorp-Tages, Macrobond

Indeed, the resurgence of the virus in recent months seems to be threatening the nascent recovery. As can be seen below, the Dallas mobility index has been grinding lower since August, suggesting economic activity was under pressure in the fourth quarter. Nevertheless, the late-December passage of a second US stimulus bill providing $900 billion in relief, including an extension of federal unemployment benefits and another

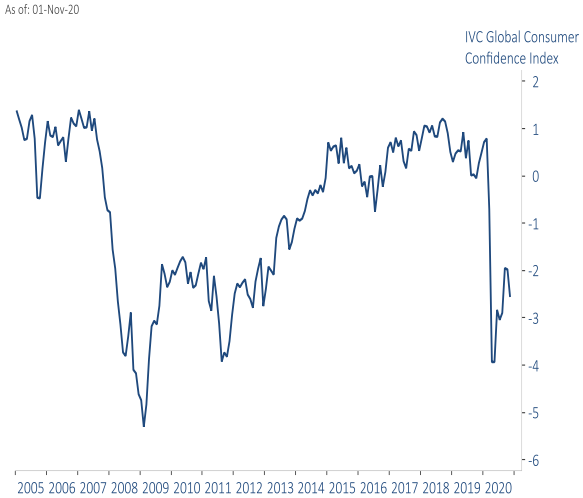
one-time payment to many households, will likely help mitigate the adverse impact on confidence of the renewed lockdowns in various locales. Additionally, the Democratic gains in the Senate suggest more financial support is on the way, particularly for state and local governments.

Dallas Fed Mobility Index and Citi US Economic Surprise Index

Source: Investcorp-Tages, Macrobond

Given this, we may well see a further lift in consumer confidence, which has bounced off its post-crisis lows but remains well shy of its pre-pandemic highs, as the following chart shows. Thanks to the generous relief measures provided by Washington, US personal income surged following the outbreak of COVID-19, but their temporary nature has raised the need for higher savings among the most vulnerable segments of the population. Uncertainty remains high regarding the outlook for employment going forward, further weighing on sentiment.

Investcorp-Tages Global Consumer Confidence Indicator



Source: Investcorp-Tages, Macrobond

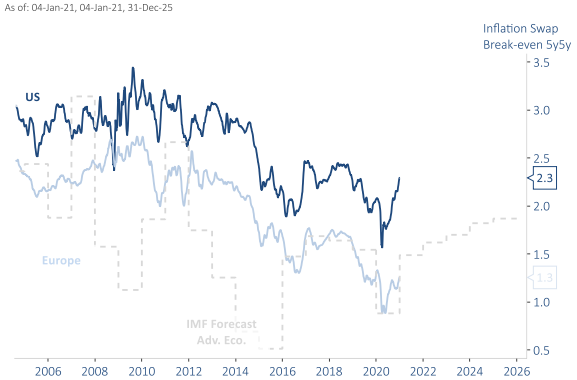
The turnaround in manufacturing has been more pronounced, as illustrated below, with activity less impacted on a sustained basis than has been the case in services. The rapid economic recovery in China, led by fresh investment in fixed assets, remains encouraging for the sector. Prior to the pandemic, manufacturing was mired in a two-year long recession owing to the slowing of the Chinese economy in 2018 and diminishing trade volumes around the world. At this juncture, however, we believe there is more upside, partly as a result of fiscal support shifting further in favor of public sector infrastructure investment in the coming years.

Investcorp-Tages Global Manufacturing Confidence Indicator

Source: Investcorp-Tages, Macrobond

Moving on to inflation-related developments, expectations have staged a convincing rebound in the US but remain fairly muted in Europe, as indicated below, amid the tug-of-war between the disinflationary impact of the pandemic and the consequent extraordinary policy response. That said, a number of long-term headwinds to inflation remain in place, including slowing population growth and the increasing penetration of scalable technologies.

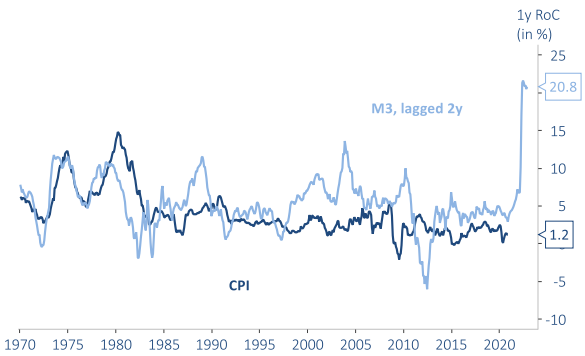
Inflation Break-even & IMF Forecasts



Source: Investcorp-Tages, Macrobond

However, some of the broad trends that have helped to keep a lid on inflation may be on the cusp of an about-face. Globalization, for instance, has played a significant role in depressing the prices of goods around the world since the end of the 1990s, but the post-pandemic push toward re-shoring in the US and Europe could transform this longtime headwind into an inflationary tailwind. Similarly, while we do not believe that the explosion in monetary aggregates highlighted in the chart below will by itself promulgate rising prices, it has been some time since Milton Friedman's theory that "inflation is always and everywhere a monetary phenomenon" has been verified empirically.

Inflation and M3 Monetary Aggregate



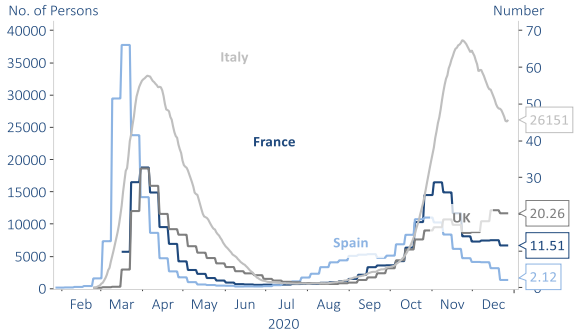
Source: Investcorp-Tages, Macrobond

What could swing the economic pendulum the other way?

After reviewing the trends at play today in the economic system, we turn our focus to a discussion of the forces leaning against the 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.

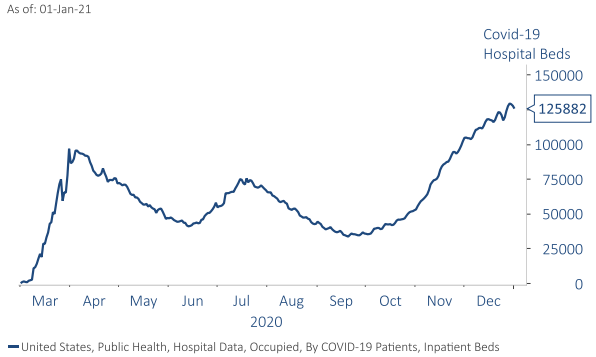
In the current cycle, the primary factor remains the ongoing pandemic-related healthcare emergency. While we have learned a lot about the disease since it first erupted, epidemiological models continue to represent probabilistic exercises; the recent sharp upswing in infections in Europe has challenged many of their underlying assumptions. The emergence of a new variant of the virus in the UK, which appears to spread at an accelerated pace, is again putting healthcare systems to the test, as the first chart below suggests, while the situation in the US is no less challenging, as the second chart indicates.

COVID-19 Hospitalizations in Europe



Source: Investcorp-Tages, Macrobond

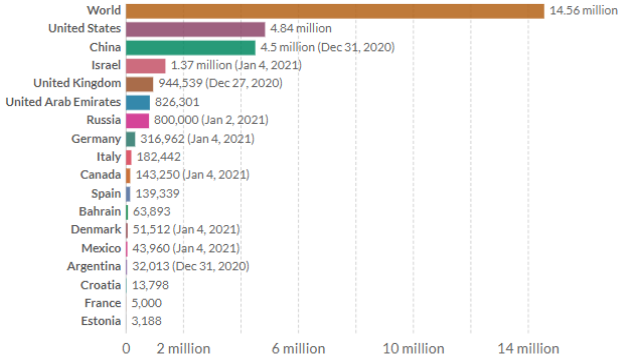
COVID-19 Hospitalizations in the US



Source: Investcorp-Tages, Macrobond

Governments in various locales are responding by enforcing new lockdown measures and going all out in many cases to expand vaccination campaigns, the latest updates of which are detailed below. Even so, the restrictions will likely matter more in the near term, weighing on economic activity as 2021 begins, though the impact should be more muted than what we saw in last year's first quarter. Businesses and other economic agents appear to be adapting more easily and current virus-containment measures are generally more selective, which should afford greater protection to certain sectors of the economy, including manufacturing.

Global COVID-19 Vaccinations



Source: Ourworldindata.org

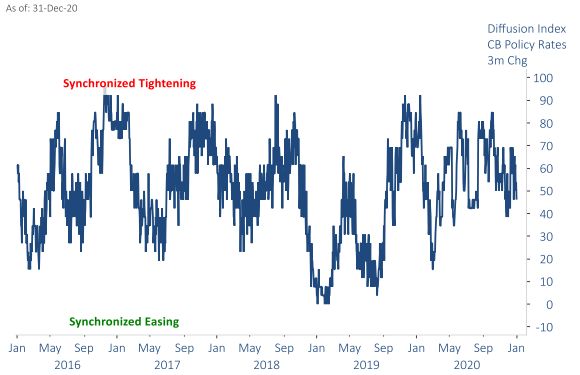
In the first weeks since certain vaccines were approved by regulators, the immunization campaigns have faced logistical problems but progress is being made, nonetheless. So far, almost 15 million people worldwide have been vaccinated. Analysts expect that herd immunity levels could be reached by the end of the first semester in developed countries, though it may take much longer to achieve the same in developing and frontier countries.

Turning to monetary policy, we expect little relief to emanate from 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 remain marginal. In Europe and Japan, meanwhile, concerns about the health of domestic banking systems will probably deter the ECB and BoJ, respectively, from pushing rates deeper into negative territory.

Global Monetary Policy Signal

Source: Investcorp-Tages, Macrobond

Global Monetary Policy Diffusion Indicator



Source: Investcorp-Tages, Macrobond

On this side of the Atlantic, the Federal Reserve has stuck with its position of strategic ambiguity regarding negative interest rates but any final decision is unlikely to dramatically alter the impulse associated with monetary policy. At this point, we are continuing to update and present our global monetary policy signal, as can be seen in the first chart below, but truth be told, this chart — as well as our diffusion indicator, highlighted in the second chart — will likely be quite boring in the immediate years to come.

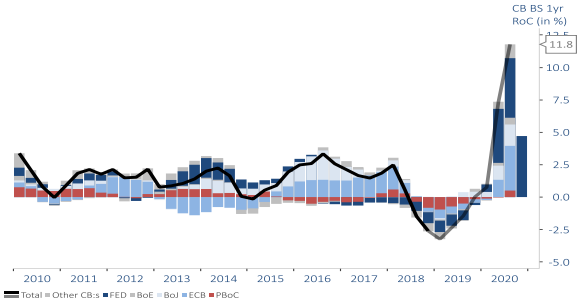
As a consequence, central banks are left playing defense — providing market liquidity when necessary and deploying asset purchases to avoid too sharp a tightening in financial conditions, illustrated in the following chart. That said, we have in the past discussed one of the concerns associated with an overly strong focus on the latter. As Goodhart's law states: "when a measure becomes a target, it ceases to be a good measure." Too much emphasis on dampening asset-price volatility could lead to the return of moral hazard and a build-up of speculative excesses that threaten the long-run stability of the financial system.

US Financial Conditions Index

Source: Investcorp-Tages, Macrobond

Beyond front-end rates, central banks have also reacted by amending policies relating to their balance sheets, where aggregate growth has, as indicated below, remained elevated. This includes the ECB recently extending the timeline for its Pandemic Emergency Purchase Program (PEPP) asset purchase initiative to March 2022 and increasing its envelope size by EUR 500 billion, bringing the program's total to EUR 1.85 trillion. Policymakers also committed to keeping the program from shrinking until at least the end of 2023 by reinvesting the proceeds from maturing issues. The Fed, meanwhile, did not add to its quantitative easing program, but it remains committed to doing so should economic conditions deteriorate.

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



Source: Investcorp-Tages, Macrobond

Regardless, the key transmission mechanism for central banks will be real interest rates, highlighted below. These rates are not fully under their control since they cannot dictate what inflation will be. However, they can keep interest rates anchored, at the front end or across the curve, through yield curve control policies that remain in place while inflation recovers. That said, a return of deflationary pressures would serve to shift things the other way,

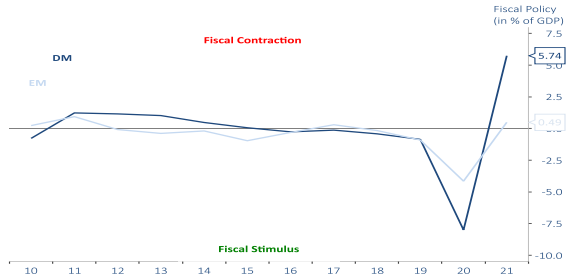
leading to a tightening of monetary conditions and leaving few policy responses for central banks acting on their own.

Global Real Interest Rates (as a % of GDP)

Source: Investcorp-Tages, Macrobond

With central banks stuck playing defense, the only offense, policy-wise, will have to come from fiscal authorities. Fortunately, the news flow in this regard has been more encouraging of late, as the following chart suggests. The Democrats and Republicans finally agreed to a second pandemic relief bill worth $900 billion, securing an important extension to some of the support measures provided for in the CARES Act, including additional federal unemployment benefits. The Democratic gains in the Senate will likely also lead to follow-on assistance, including for states and localities.

Global Fiscal Impulse (as a % of GDP)



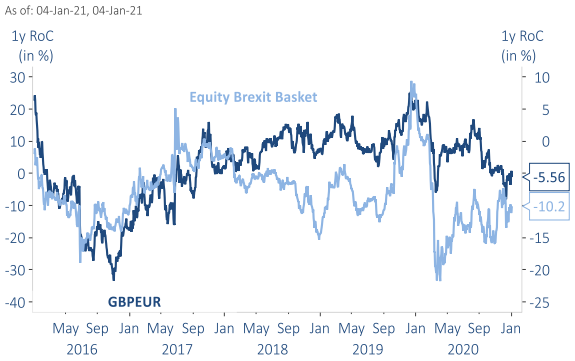
Source: Investcorp-Tages, Macrobond

Taken together, these various efforts will likely serve to mitigate the extent of any fiscal contraction that was on the cards for 2021. They will also make the economy more dependent on its own growth dynamics, especially in a world where the threat represented by COVID-19 is expected to recede.

Lastly, it is worth noting that on the other side the Atlantic, the Brexit saga has finally concluded with what some might describe as a skinny deal, largely focused on goods. However, this is really only the end of the beginning. There is much left to be discussed and negotiated in the coming years, particularly in regard to the dominant services industry in the UK. Perhaps that is one reason why, as the

following chart indicates, markets have remained less-than-enthusiastic about the British currency and various UK asset prices.

British Assets Have Remained Under Pressure



Source: Bloomberg, Investcorp-Tages, Macrobond

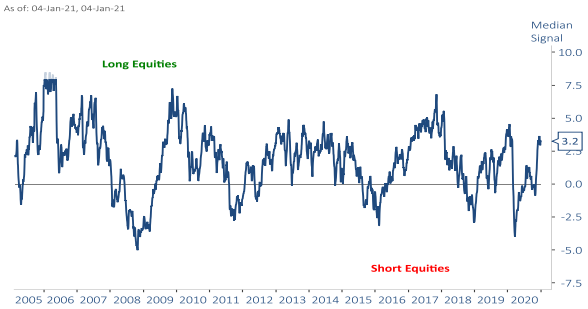
What's priced in?

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 and regions — with look-back windows from one-month to a year — bullish momentum exploded higher again in the wake of the powerful run-up that began in November. At 3.2, the signal now sits comfortably near the upper end of its range over the last 15 years.

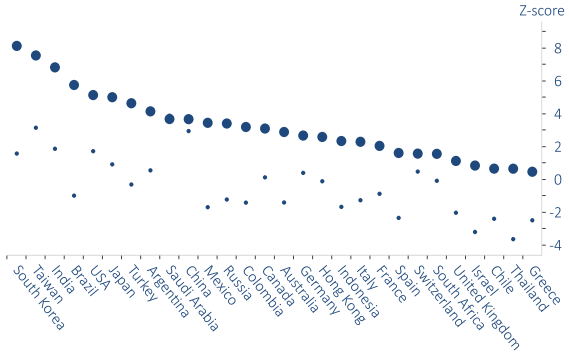
Global Equity Momentum Signal



Source: Investcorp-Tages, Macrobond

Looking at things from a different angle, dispersion across regions has remained fairly wide, as the following chart illustrates, but breadth has improved markedly in terms of geographies and sectors. Amid the value rotation in November, earlier underperformers partly caught up, with hopes for a successful large-scale vaccine rollout driving some of the reallocations implemented by investors.

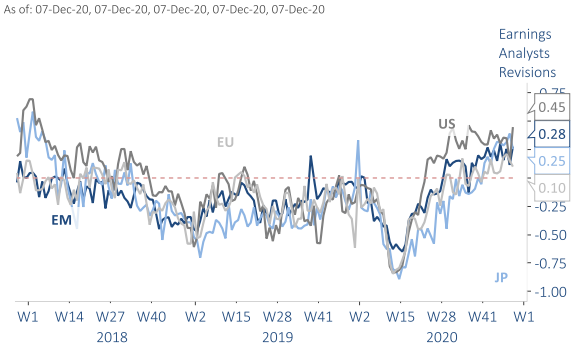
Individual Country Latest Equity Momentum Signal



Source: Investcorp-Tages, Macrobond

Fundamental momentum also showed signs of improvement. As can be seen in the chart below, analysts' earnings revisions are still broadly positive across regions, even accounting for the cautious turn seen in Europe more recently.

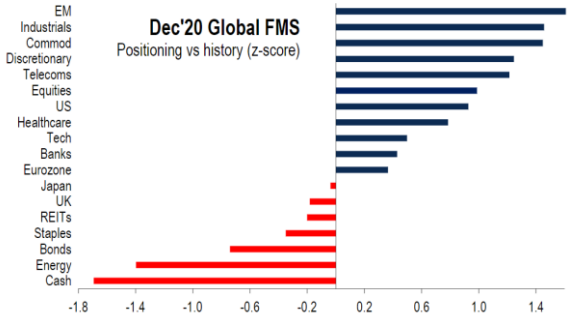
Analysts Earnings Revisions by Region



Source: Citi, Bloomberg, Investcorp-Tages, Macrobond

On the positioning front, aggregate indicators suggest that investors are running with slightly higher equity exposure than is typical, though not by a large margin. Risk appetites among real money investors, in particular, remain in line with their historical average, as data from State Street or Bank of American Merrill Lynch— highlighted in the two charts below — suggests.

Global Fund Manager Survey



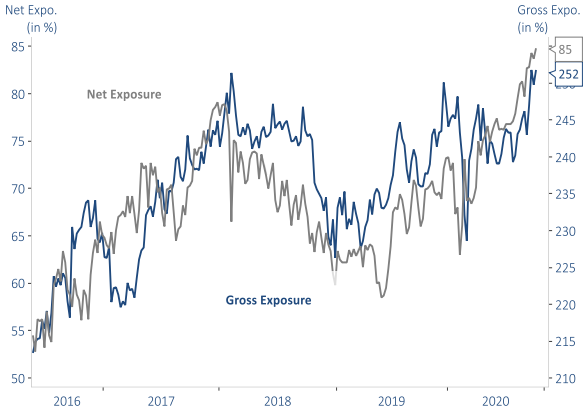
Source: Bank of America Merrill Lynch

Institutional Investors Sentiment

Source: State Street, Investcorp-Tages, Macrobond

That said, the aggregate numbers appear to be hiding pockets of elevated risk taking. This is true within the hedge fund community, where data from prime brokerage platforms has consistently showed net exposure levels at multi-year highs, as indicated by the first chart below. It is also the case within a subset of the retail community, where day trading remains a popular activity, unimpeded by the sharp but short sell-off in September. Retail flows have receded to an extent but remain much larger than in the past decade.

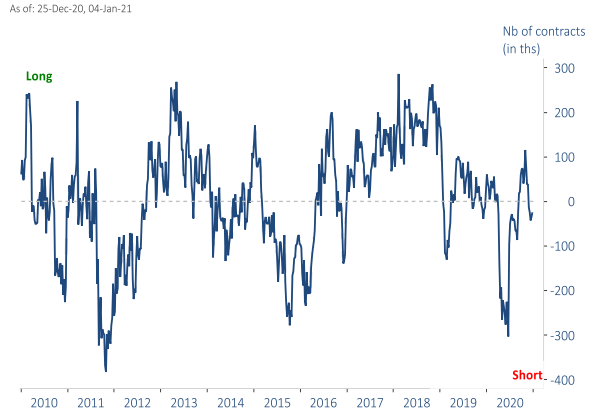
Equity Hedge Funds Net & Gross Equity Exposure



Source: Goldman Sachs, Investcorp-Tages, Macrobond

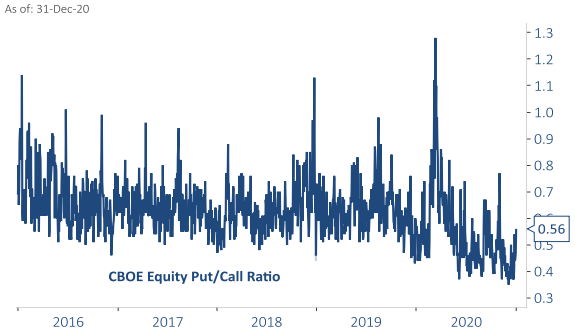
In fairness, we note that some other measures we monitor, including speculative positioning in equity futures and the CBOE put-call ratio, highlighted in the following two charts, paint a less exuberant picture with respect to sentiment.

Speculative Futures Equity Positioning



Source: Bloomberg, Investcorp-Tages, Macrobond

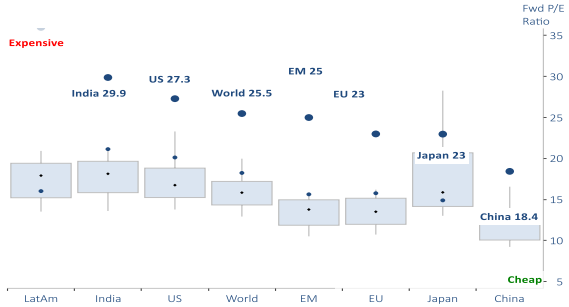
CBOE Equity Put Call Ratio



Source: Bloomberg, Investcorp-Tages, Macrobond

Meanwhile, equity valuations have also turned more demanding, except in Japan. As evidenced by following chart, which details regional forward price-to-earnings ratios in a historical context — where the shaded area represents the 25th to 75th distribution percentiles — most are screening toward the top-end of their valuation ranges. As we have noted previously, much of the debate surrounding valuations has centered on the influence of lower interest rates on valuations, with the primary argument being that the former support the latter, with that premise largely supported by an analysis of equity risk premia.

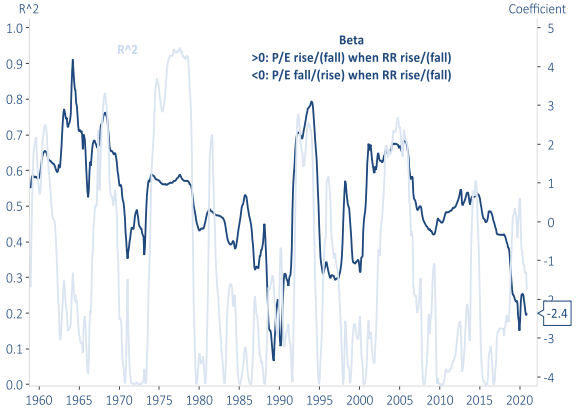
Equity Valuations in Historical Distribution (Forward P/E)



Source: Bloomberg, Investcorp-Tages, Macrobond

This perspective partly ignores the fact that rates are low because future growth potential is seen as tepid, signaling diminished equity earnings potential in the years ahead. Moreover, an analysis of the historical relationship between the two gives reason for caution. As illustrated by the following chart, which details the rolling beta of changes in US equity valuations — based, in this case, on the P-E ratio — to movements in real interest rates, the measure is near its historical lows. While this confirms that the relationship between the two has indeed been strong, investors should be wary of how extreme things are and the prospect of an abrupt reversion to the mean.

Relationship Between Real Interest Rates and Equity Valuations

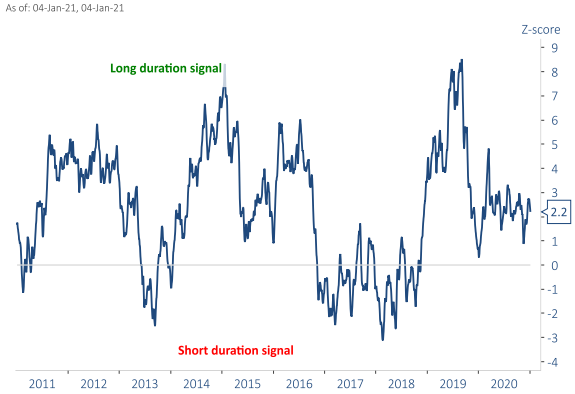


Source: Bloomberg, Investcorp-Tages, Macrobond

Fixed-Income

In fixed income, our momentum signal, highlighted in the following chart, remains long government bonds across curves. Breadth has continued to be elevated, with bullish signals across the board except at the very long end of the US curve.

Global Government Bonds Momentum Signal



Source: Bloomberg, Investcorp-Tages, Macrobond

On a duration-adjusted basis, assets under management in government bond exchange traded funds (ETFs) have remained remarkably stable in recent months, as the following chart shows, despite the strong recovery in risk appetites. While inflows have been on something of a hiatus, we have yet to see evidence of a sustained reallocation away from this asset class.

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

Source: Bloomberg, Investcorp-Tages, Macrobond

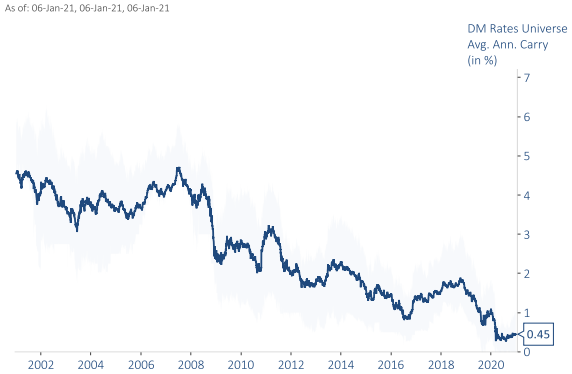
When we consider both value and carry investment signals, the appeal of developed country government bonds is not apparent. The term premium is near its historical lows, as indicated below, while econometric value models suggest yields have dramatically overshot fair value. At current levels, we do not feel investors are being appropriately rewarded for duration risk. Cash and short-duration assets offer only optionality value at this point, while real interest rates are strongly anchored in negative territory. Still, in this context, we believe a cash allocation has merit as we expect to see continued volatility in coming months, potentially offering better entry points into risky assets.

US Term Premium

Source: Investcorp-Tages, Macrobond

As far as carry goes, the situation remains unencouraging. As shown in the following chart, which highlights the average annual carry across maturities in developed countries — including coupons and roll-down— the aggregate annual average is hovering near a new low for the cycle of 45 basis points, which continues to leave government debt deeply unattractive on this basis.

Developed Country Average Annual Carry in Government Bonds

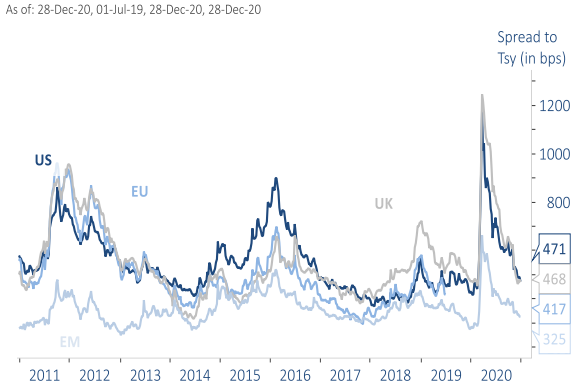


Source: Investcorp-Tages, Macrobond

Credit

Moving on to credit, high yield spreads have continued to narrow and are now roughly around the levels seen prior to the crisis, as illustrated below. Monetary authorities' ultra- accommodative liquidity stance and the quick return of a widespread hunt for yield have lent major support, despite the default cycle picking up steam.

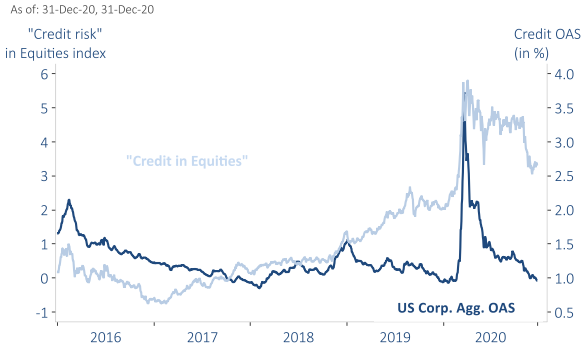
High Yield Credit Spreads by Region



Source: Bloomberg, Investcorp-Tages, Macrobond

One new and notable development has been the convergence between equity-derived credit risk — drawn from long/short equity baskets comprised of the stocks of companies with weak versus strong balance sheets —and tightening credit spreads. The names perceived as more vulnerable outperformed their stronger counterparts in the wake of the value rotation that occurred following last fall's positive vaccine announcements.

Credit Risk Pricing in Equities vs HY OAS



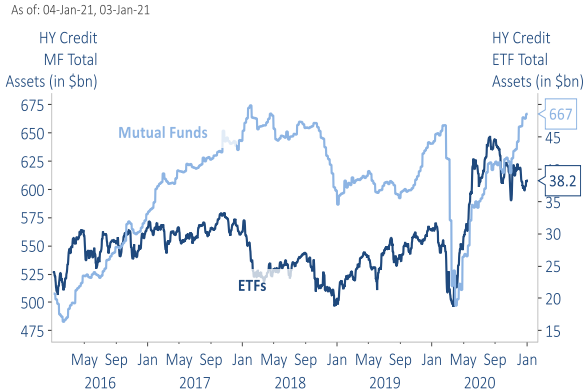
Source: Bloomberg, Investcorp-Tages, Macrobond

At this point, however, credit spreads no longer offer the same upside convexity that we viewed as attractive a few months ago. Consequently, we recommend that investors gradually take profits in the credit space and reinvest the proceeds in value equities, which share many of the same attributes with respect to credit and procyclical exposures, but which stand to benefit from more appealing valuations and positioning starting points.

Looking at capital movements, recent months have witnessed a renewed wave of inflows into credit funds, especially mutual funds, as detailed in the first chart below. In contrast, ETF assets under management have remained fairly stable. This follows the second-quarter surge, which largely

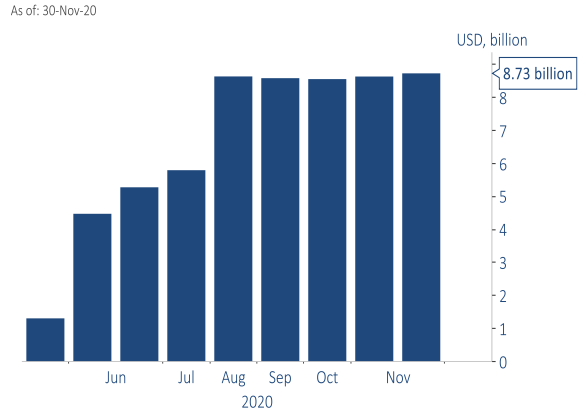
stemmed from the Fed's announced support for credit markets, including building exposure to the traded fund vehicles, which has reached $8.73 billion, as the second chart indicates. Not surprisingly, ETF and total return swap (TRS) premiums are not far from the midpoints of their respective multi-year ranges, as the third chart reveals.

ETF and Mutual Fund Assets under Management



Source: Bloomberg, Investcorp-Tages, Macrobond

Federal Reserve Purchases of Credit ETFs



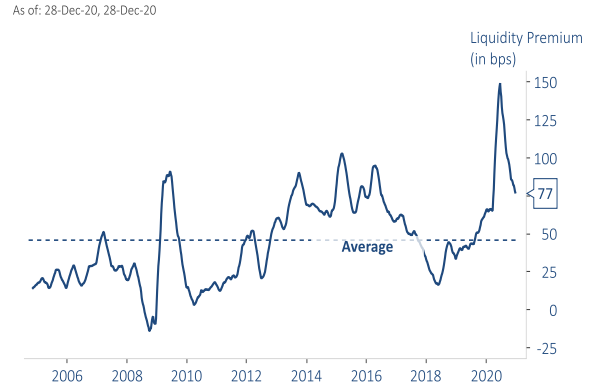
Source: Investcorp-Tages, Macrobond

ETF and TRS Discount/Premium to Net Asset Value

Source: Bloomberg, Investcorp-Tages, Macrobond

With respect to the liquidity premium, things have not yet fully normalized, as the first chart below shows, and this measure remains attractive relative to its history. In contrast, the premium available from buying small-size credit issues has fallen back near its historical average, as the second chart reveals. At 220 basis points, there is room for further declines, but this exposure offers less convexity in comparison to what was available previously.

Corporate Credit Liquidity Premium



Source: Bloomberg, Investcorp-Tages, Macrobond

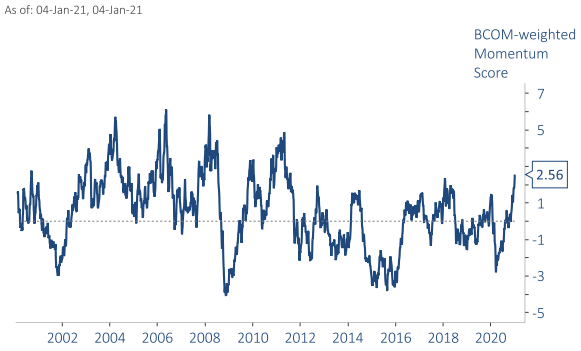
Corporate Credit Size Premium

Source: Bloomberg, Investcorp-Tages, Macrobond

Commodities

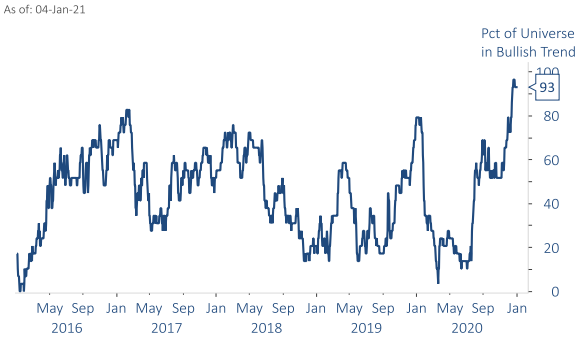
We conclude our review of asset classes with a few remarks on commodities. The first chart below highlights our momentum model for the asset class, with individual signals aggregated using weights from the Bloomberg Commodity Index. To be sure, momentum has witnessed a significant bullish jump. At 2.6, the weighted signal now stands at its highest level since 2011. Interestingly, breadth has risen in tandem; 93% of the individual constituents are currently in uptrends, as the second chart indicates. History suggests this set-up has often set the stage for a sustained upside move.

Commodities Momentum Signal



Source: Investcorp-Tages, Macrobond

Commodities Momentum Signal – Breadth Across Individual Contracts



Source: Investcorp-Tages, Macrobond

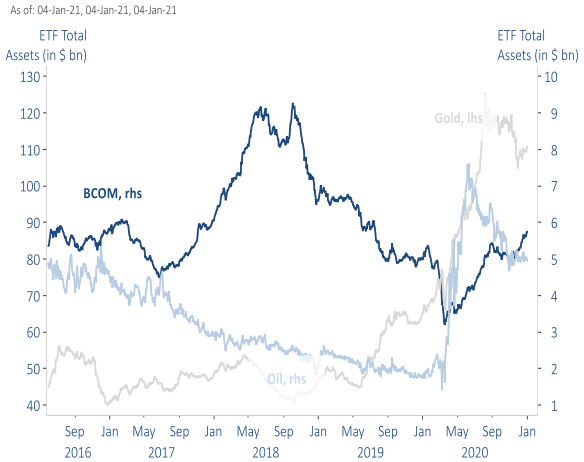
Another factor to consider when investing in commodities is carry, which emanates from the roll yield associated with futures contracts. Using a homogenous measure of carry derived from BCOM-weighted differentials between near-dated contracts and one-year counterparts for various products, we can see that the measure has climbed further into the black and is now hovering the top end of its five-year range, as indicated below. This lends further weight to the bullish case for commodities.

Commodities Carry Signal (BCOM-Weighting)

Source: Investcorp-Tages, Macrobond

In terms of investor activity, we have yet to see the return of risk-on flows in commodities to the same extent as in equities or credit. As can be seen below, ETF assets under management have not changed all that much. With respect to precious metals and oil, in particular, demand seems to have tapered off, though it is hard to read too much into the situation regarding the latter. It appears that a sizable share of energy-related turnover stems from short-covering that has served to pare down bearish exposures.

Commodity ETFs Investment Flows



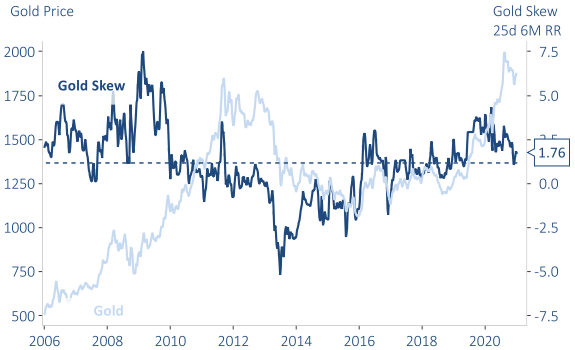
Source: Bloomberg, Investcorp-Tages, Macrobond

In the futures market, the situation is somewhat similar. As evidenced by the first chart below, speculative positioning has only gradually moved to the upside in recent months, representing a sharp divergence from the exuberance we have witnessed in other risky assets. In gold, meanwhile, implied volatility skew has drifted lower, as the second chart reveals, signaling more subdued sentiment than we saw previously.

Speculative Positioning in Futures

Source: Bloomberg, Investcorp-Tages, Macrobond

Gold Skew



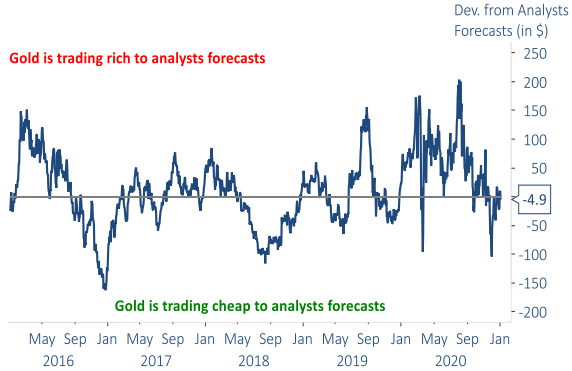
Source: Bloomberg, Investcorp-Tages, Macrobond

We conclude our review with a look at our value models for selected commodities. Starting with gold, the clear overvaluation that was apparent a few months ago has largely dissipated, as the first chart below reveals. This suggests a neutral outlook when the behavior of related assets, including the dollar and real interest rates, is factored in, though many might view it in a more bullish light based on the surge that has occurred in digital currencies. From a more fundamental perspective, gold is near its expected value based on sell-side analysts forecasts, as the second chart indicates.

Gold Value Cross-Asset Model

Source: Bloomberg, Investcorp-Tages, Macrobond

Gold Price Deviation from Analysts' Forecasts



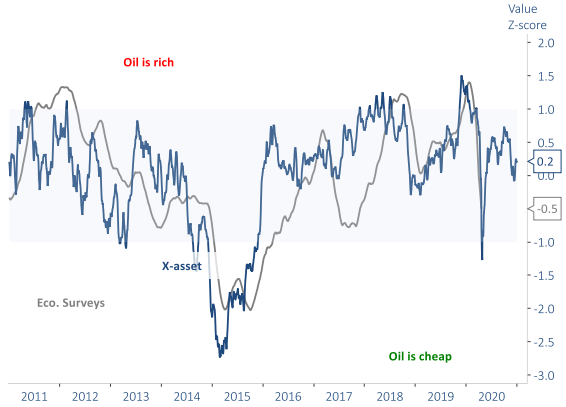
Source: Investcorp-Tages, Macrobond

Turning to energy markets, our models continue to show crude oil as being slightly undervalued relative to both sell-side consensus views, illustrated in the first chart below, and our cross-asset and macro value frameworks, highlighted in the second chart. Along with positive momentum, value and carry signals, and investors' and traders' limited exposure, we believe the current configuration paints a bullish picture for oil markets in the 12 months ahead.

Crude Oil Value Model (Analysts Forecasts)

Source: Investcorp-Tages, Macrobond

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



Source: Investcorp-Tages, Macrobond

Emerging and Frontier Markets

Manuela Cedarmas, ESG and Impact Investments

In emerging market equities, Asia was the winner in 2020; the MSCI Asia ex-Japan index was up 14.87% in the year-to-date through November, outpacing the 8.11% and 9.53% gains, respectively, in the MSCI EM and World indices. Amid the coronavirus pandemic, Asia benefited from what proved to be a defensive orientation and a heavy tech weighting in the region's equity benchmarks.

Asia was also the winner in the frontier space, while the laggard was Sub Saharan Africa. One market that stood out was Argentina, which was super volatile last year. This largely stems from the fact that the MSCI index only includes three stocks, one of which, Globant, is a technology company that has seen its share price double since March.

In our view, EM assets could benefit from several tailwinds going forward, including positive cyclical trends, sizeable exposure to commodities, sensitivity to Chinese growth, and assorted pockets of deep value, especially in Latin America. The headwinds that both EM and frontier markets face relate to the effectiveness of the coronavirus vaccines and how quickly they are distributed, as well as the lasting impact of past and future fiscal and monetary initiatives aimed at mitigating the economic fallout from the pandemic.

To be sure, investor appetites will play a strong role in how both segments fare in coming months. As last year came to a close, the outflows from hard-currency bonds funds that had occurred when the COVID-19 crisis was at its peak were largely reversed, but the same did not hold true for equity and local bond funds.

A number of broader themes will likely also exert a growing influence on stock selection, including post-COVID structural changes, especially in the health care sector; technological disruption and relative regulation, both of which witnessed rapid acceleration last year; climate change and ESG mandates, which have become important themes; and, the consolidation of the shift toward a multipolar world.

In terms of valuation, emerging markets are better placed than they were a year ago. Despite the recovery we have seen since March, EM credit spreads are wider in comparison to US investment grade counterparts than was the case 12 months before. Moreover, real rates (versus the U.S.) and FX are at more attractive levels. In addition, while EM equity valuations relative to the MSCI World are around the midpoint of their historical range, they are well below where they were at the end of 2019.

More broadly, the trajectories for all asset classes have been fairly similar since March. Following the sharp retracement into early summer, we have seen broad-based intermittent rallies and sell offs over subsequent months, suggesting that macro developments have been key in determining EM's relative returns. That said, performance has not been homogenous, as evidenced by the resiliency we have seen in Northern Asian, which also owes much to a more effective policy response to the virus than has been the case elsewhere.

As alluded to earlier, EM countries stand to benefit from their sensitivity to the Chinese economy, which counts as the largest source of external demand for what they produce. Given how well China has been faring in comparison to the US, Europe and elsewhere, we should expect EM to become less dependent on developed market economic activity and more dependent on that of the Asian leader. This will likely lead, in turn, to a divergence from DM business cycles and potentially a growth trend that is less volatile than and less correlated with that of the DM countries.

Sector-wise, the strength of materials relative to energy — specifically, copper relative to oil — has in many ways mirrored the solid performance of Northern Asian emerging markets versus the rest of the group. As the post-crisis recovery in the region continues to gain pace, there is more room for energy stocks to outperform. Normalization could also favor domestic demand sectors such as industrials and financials, which have, even with the rebound we have seen in those groups in the wake of the US elections and positive news about the coronavirus vaccines, lagged tech-like consumer discretionary.

Turning to FX, we note that despite the November rally, some EM FX plays, notably the Mexican peso, South African rand, and Indian rupee, continue to represent attractive combinations of undervaluation, cyclical upside potential, and high carry. Another currency, the Brazilian real, offers a good way to play commodities, China, and the continuing recovery from the worst of the crisis, but fiscal challenges in that country remain severe. In addition, Brazil's policy rate is at a historical low of 2%, which means investors are no longer well compensated for taking on the significant domestic risk.

In EM Credit, the picture is cloudier. Odds are that we will only see marginal spread compression, with

high yield names leading the way, before difficulties arise. That is because rising debt levels in response to the pandemic have left a number of sovereigns at risk of default as 2021 unfolds. Even though some have already been forced to bite the bullet (e.g., Lebanon, Ecuador and Zambia), left-tail risks persist (e.g., Angola, Gabon, Iraq). That said, some HY names (e.g., Egypt, Kenya, Bahrain, Jordan) may well normalize at a relatively rapid pace owing to their energy or tourism exposure.

As far as EM local rates go, the combination of still-easy financial conditions on a global basis, an improving risk appetite, and the prospect of a multi-month period of capital flows into the EM space should prove supportive for the higher-yielders. Markets with attractive real yields, room for policy easing, and fundamentally well-supported currencies, such as Mexico, Russia and Indonesia, have become consensus long positions.

As would be expected, the heightened volatility we witnessed last year created deep pockets of value, especially in Latin American, which was hit the hardest in the first half. So far, at least, its pace of recovery, while noteworthy, has lagged other regions, weighed down both by COVID-19 and assorted fiscal challenges, which constitute the next biggest risk. Nevertheless, we believe the region could benefit from three factors: China decoupling dynamics, a successful vaccine rollout, and an improving outlook for the US.

Needless to say, how and to what extent investors respond to the various developments will be key to the sustainability of any trends we might see. Over the past year or so, the interplay between active and passive flows has created significant market dislocations in the region. Early on in 2020, Latam benefitted from foreign active and passive fund inflows, including strong flows into Brazilian equities, which was positive for both on-index and off-index stocks. However, when COVID-19 erupted, equities got hit across the board. Finally, in the second half, selling by foreign active funds and buying by passive counterparts led to other dislocations.

Still, it is important to note that Latin American FX and equity remain cheap in comparison to history, with the only exception of Brazil.

ESG

In many respects, the 2008-2009 upheaval was a crisis of financial instability whereas the COVID-19 pandemic is a crisis of social needs—more specifically, a need to deal with political issues that can no longer be ignored. This includes various forms of inequality, climate change, and the structural unemployment we see in key sectors and demographics.

Against this backdrop, it is no surprise that sustainable investing has become increasingly mainstream. Not long ago, it was viewed with skepticism and mostly accessible through active managers. Now, however, indexation and its passive replications — ETFs, futures, and swaps via third-party or bespoke indices — have facilitated broad access to environmental, social and corporate governance themes and strategies. Publicly available index methodologies, a better understanding of ESG frameworks, and a wealth of ESG-focused research have further bolstered this growth.

As a result. index assets as a proportion of the overall sustainable funds market grew rapidly in 2020. In the US, $12.0 trillion, or one out of every four dollars invested in the nation's capital markets, includes sustainability as an element of the investment approach. Globally, the figure is approximately $30.0 trillion, or one out of every three dollars, according to Morgan Stanley. As of October, assets in US sustainable ETFs reached $47 billion, up from $22 billion when 2020 began; in Europe, the total increased from $27 billion to $56 billion. Meanwhile, open interest on listed ESG futures hit $3.5 billion in September, notes Goldman Sachs, a seven-fold jump from early-2018. ESG investing is also seeing strong growth in a variety of locales, including China.

Given the accelerating pace and extent of ESG flows we have seen, it is important that investors better understand their impact on valuations, especially on sensitive sectors such as energy and utilities. Moreover, when it comes to evaluating active managers, it is equally necessary to understand their level of engagement, if any, with respect to ESG themes. This includes their methods of approach and implementation (e.g., ESG integration, exclusions, screening and thematic/impact). At Investcorp-Tages, we have been surveying our universe of managers to gain insights into these elements and welcome the opportunity to share the results with readers.

Asset Allocation Playbook

Extraordinary support from both monetary and fiscal policies have managed to revive animal spirits at a dazzling speed. From the Ides of March, the dominant narrative has shifted to one of a V-shaped economic recovery, with no lasting damage from the shock and a “lower forever” interest rate environment. Investors cannot add risk fast enough. This view of “Goldilocks” in perpetuity justifies new highs on valuations and increasingly exuberant sentiment. It is becoming increasingly difficult to safely outbid the marginal buyer. We wonder what the long-term policy implications will be if we indeed are witnessing the third bubble in just twenty years. But this time may be different or just early.

It is frustrating to try to keep up with momentum in this environment. We are not trying to and stick to our tested investment process. That leaves us defensive relative to consensus, with a preference for alpha over beta. Our investment universe affords us this chance of a limited opportunity of pursuing beta relative to alpha strategies. Still, we recognize the chance of a strong recovery in the second semester and seek to express this constructive view of the economy through other pro-cyclical exposures. Ones that screen relatively more attractive on valuations and positioning. The pricing of liquidity is going down and we are gradually rebuilding dry powder to seize future opportunities, at better entry points.

We see limited catalysts for a violent reversal in the coming months, but fragilities are once again building up across markets. Expectations for change are moving lower. And we know it is a fool’s errand to try to predict what the next unwind trigger will be. Stay patient, bide your time and stick with process.

HEDGE FUNDS

Strategy	Negative	Neutral	Positive	Comments
Hedged Equities	■			Low appetite for equity beta in current environment, maintain balance factor exposure between growth and value (legging in further), mind crowded positioning
US	■			Low expected returns on beta, elevated net and gross exposure, stretched factor positioning and greater portfolio crowding leave us underweight
Euro area ex UK		■		Stronger reflationary impulse could help value and promote a reallocation towards Europe; fiscal support in place with ERF and exposure to resilient Chinese growth
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			■	Capture value and opportunities from balance sheet restructuring
Special Situations			■	A place to capture value in portfolios. We remain guarded on beta but alpha potential could return for special sits portfolios
Merger Arbitrage		■		Turning neutral on lower spreads, even when considering moves in equity volatility and IG credit spreads
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		■		Turning neutral on lower carry potential and lesser tailwinds from liquidity, size premium.
Corporate Distressed		■		Spreads have compressed quickly but default cycle is ongoing, watch for entry points in the coming months if volatility picks up again
Structured Credit			■	Carry remain attractive on a relative basis and flows are likely to return as hunt for yield intensifies and technical pressures subside
Convertible Arbitrage			■	Decent valuations, elevated net issuance and trading opportunities should continue to support robust alpha generation for the strategy
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. Across geographies, we hold a preference for non-US markets to diversify away from the expensive and crowded Growth sector. Emerging markets and Asia could continue to do well on better growth dynamics and a weaker dollar environment.

We mitigate this tilt through an upgrade of **Special Situations** funds that could well benefit from a reversal in the performance of Value as reflationary forces take hold in the economy. 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 neutral in the short-term but continue to watch the universe closely as new opportunities could arise in the coming months.

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 stay 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.

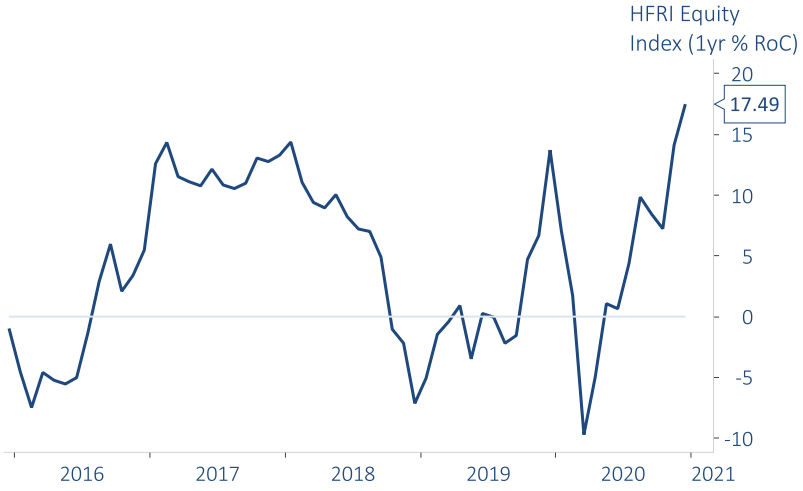
We stay underweight **Fixed Income Relative Value** on low volatility in the asset class. Central banks' asset purchase programs are likely to keep volatility muted in the coming months, reducing the opportunity set for the strategy.

Finally, we turn neutral on **Credit L/S** but stay positive on **Structured Credit**. Carry remains relatively attractive in securitized markets while dislocations have almost fully healed in corporate credit.

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	■ ■ ■	■	■ ■ ■	Earnings should rebound strongly in H2 and have proved more resilient to the shock overall, with dispersion across industries
Stock Selection	■ ■ ■	■	■ ■ ■	Limited dispersion but greater uncertainty over earnings could be an edge for fundamental 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



Source: Bloomberg, Investcorp-Tages, Macrobond

Equity Long/Short

Matteo Meloni, Equity Strategies

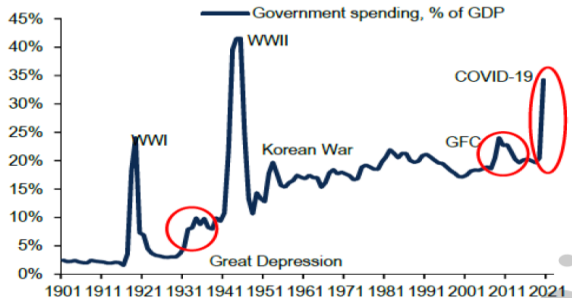
Looking back, the last quarter of 2020, and especially November, proved eventful. Following an unsettling pickup in volatility from September to October amid concerns that a second wave of the global pandemic could undermine the recovery from the crisis-driven lows in March, two developments served to give a fresh boost to risk-on sentiment. The first was the fact that Joe Biden had been elected without a corresponding "blue wave," which eased concerns about a less business-friendly environment going forward. The second was the unexpected news that both the Pfizer-BioNTech and Moderna vaccines were more than 90% effective.

Together, those two factors helped kickstart another leg up and a sharp factor rotation in equity markets around the globe. Over the fourth quarter, the MSCI World and S&P 500 indexes were up 14.0% and 12.1%, respectively. In Europe, meanwhile, stocks fared even better after lagging other markets in each of the first three quarters. Boosted by the shift in favor of cyclicals and industrials on the heels of the vaccine announcements, the Eurostoxx50 Index rose 11.2% over the span.

Interestingly, while the fourth quarter upswing helped to drive implied volatility down in early November, the VIX Index, which was trading around 22 near month-end, was higher than might have been expected given that US benchmarks were hitting new records on virtually a daily basis. Be that as it may, it seems clear based on their performance that hedge fund managers had made the most of the late-2020 trading environment. Over the last three months, the HFRX Equity Hedge Index was up 7.8%.

Overall, the rally since the March lows has allowed global equity markets to recoup nearly all of the losses taken as the COVID-19 crisis first took hold. In fact, the speed of the recovery has been astonishing in comparison to the rebounds that followed other bear markets. There is little doubt that the recent standout performance of equities and other asset classes owes much to the unprecedented degree of pandemic-driven monetary and fiscal support that has been provided, which has helped elevate government spending to its highest level since WWII, as the following chart shows.

US Government Spending (Since 1901)



Source: BAML

At this point, central banks are likely to remain ultra-accommodative and keep rates close to zero, at least in the near term. While it remains to be seen whether this means more of the same with respect to risky asset prices, it is apparent that the current environment is supportive for equity markets, housing, and economic activities more generally. Even with the outperformance we saw in the value segment in November, the ratio of growth to value is still 2.7 standard deviations above its longer-term average, as the following chart illustrates. Put another way, growth stocks are, on a relative performance basis, where they were at the peak of the internet bubble in 1999.

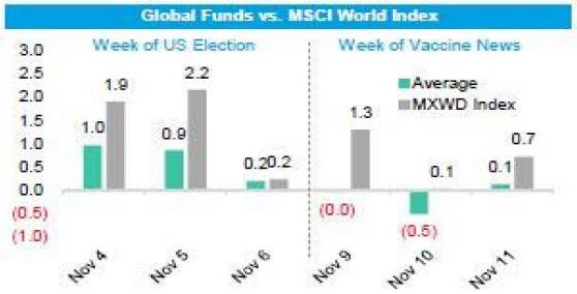
Russell 1000 Growth vs. Russell 1000 Value (Rolling 12-Month Return)

Source: Goldman Sachs Research

In terms of sector performance, we have seen a significant divergence, much of which stems from the impact that the pandemic has had on business activities, supply chains, and consumer behavior. The biggest losers have been real estate, financials and energy, while information technology, consumer discretionary and communication services have generally been positive. Since bottoming in March, cyclical assets, particularly in Europe, have recovered but are still below where they were at the beginning of the year.

For equity hedge fund managers, the two developments that buoyed risk assets more generally had a more mixed effect. While strong beta returns allowed them to offset some of the losses emanating from factor rotation, especially in the wake of the US elections, conditions on the days around vaccine news proved to be tougher on a comparative basis. Short-covering during that the time had a pronounced impact on short-side alpha, while a shortage of value exposure on long books created less of a positive offset than desired, as the following chart suggests.

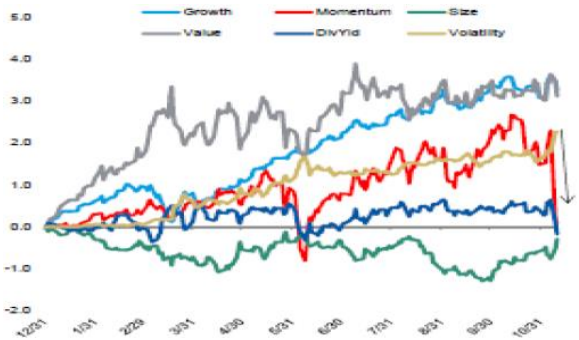
Hedge Fund Managers Caught Off-Guard by Vaccine News



Source: Morgan Stanley

Not surprisingly, heightened style-factor volatility remained a key driver of disparate performance among managers. The theme of being long work-from-home winners and short lockdown losers was a source of decent alpha generation after the first quarter ended, while positioning on the right side of the growth-versus-value play ended up contributing the most to year-to-date returns. In November, fears of a reversal of fortunes on the heels of the positive vaccine news led to abrupt swings in style factors, including a sharp selloff in momentum, highlighted below, as investors rushed to unwind short cyclical exposures.

Momentum Factor Erased Year-to-Date Gains in a Matter of a Few Days



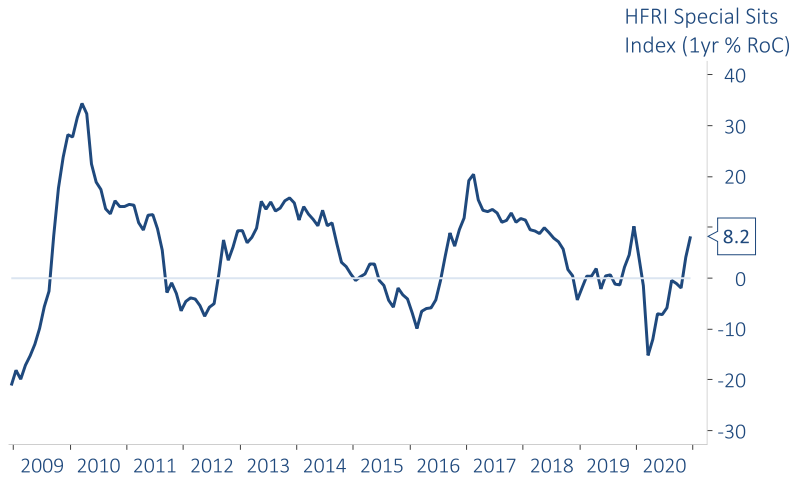
Source: Morgan Stanley Research

More recently, the focus has shifted to Brexit and how an agreement — or lack of one — between the UK and the EU might impact economies on both sides of the English Channel as well as the British pound. Based on the latest reports, the sticking point appears to relate to fishing rights, which suggests that other key issues points have largely been agreed upon. That said, the prospect that further stimulus measures will be introduced to combat the fallout from the pandemic remains an important theme.

Special Situations / Event-Driven

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Market Beta	■			Underweight beta.
M&A Spreads		■		Stay tactical in allocation, spreads have recently compressed back to fair value levels
Corporate Activity			■	Policy uncertainty gradually dissipating, corporate activity could make a strong return in 2021
Activism			■	Getting more constructive on the outlook for value style; activists could benefit once again
Tax		■		A new administration could unfold new opportunities
Crowdedness			■	Lower levels of crowding in special situations portfolios.

Strategy Rolling 1-year Performance



Source: Bloomberg, Investcorp-Tages, Macrobond

Special Situations / Event-Driven

Selim Rekaibi, Hedge Fund Research

Global event-driven hedge funds gained a net 11.8% in the fourth quarter and were up 9.3% year-to-date, according to the HFRI Event Driven Index. Looking at performance by sub-strategy, activist and special situations were at the forefront, up 15.8% and 14.2%, respectively, followed by merger arbitrage which posted returns of 9.1%. The activist sub-strategy was also the winner over the first 11 months with a net 6% increase, followed by distressed/restructuring, merger arbitrage and special situations, up 5.8%, 2.0%, and 1.6%, respectively.
Looking back, it is worth noting that event-driven managers proved to be largely immune to the sell-off that occurred in October. In November, all sub-strategies benefited from strength in global equity and credit markets, which rallied strongly in the wake of the US elections and multiple positive COVID-19 vac-cine announcements. Performance was also bolstered by a rotation into cyclicals and value, which led to a recovery among the previous months' laggards. Many managers had also implemented opportunistic "economy reopening" trades in leisure and travel companies, for example, which proved to be successful.

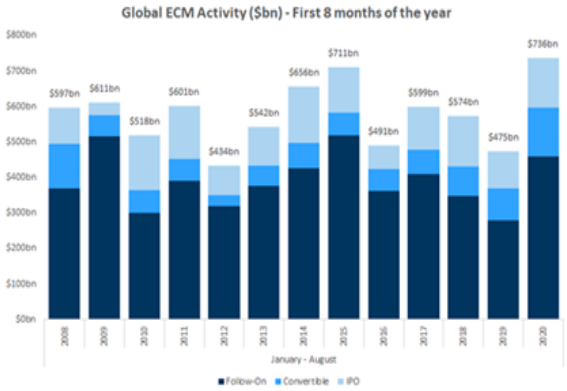
Outlook on Event-Driven Opportunity Set

We recognize that there are pockets of opportunity in the event-driven space, but not enough for us to change our neutral stance on the strategy overall. In more granular terms, we down-grade merger arbitrage to neutral; while we have seen a material acceleration in M&A activity, spreads have come down significantly, limiting the upside. With respect to corporate distressed, we are sticking with our neutral rating. Despite a widening opportunity set, we believe it is still early in the distressed cycle and that we will see good entry points in the period ahead. For special situations, we have become more constructive and upgrade the sub-strategy to one-notch positive. In light of our view that there will be more corporate restructurings in coming months, we believe this approach represents one of the few avenues for capturing value exposure in the portfolio, as evidenced by its performance in November. From our vantage point, a more sustained rotation into value is certainly possible in a post-COVID world. That said, we are not up-grading the sub-strategy further; given our cautious market outlook, we believe it remains handicapped by its higher beta.

Special Situations

As noted, we have become more constructive on special situations, but not just because we see further restructurings ahead. Among other things, we believe that the record levels of equity capital market (ECM) activity we saw last year—illustrated in the following chart — which stemmed from companies being pushed by the fallout from the pan-demic to raise cash to address liquidity issues and fix balance sheets, represented a transfer of value from shareholders to creditors that has been well identified by players in this space. In addition, sustained M&A activity will likely also provide ample pre- and post-merger opportunities for managers to exploit. Finally, we believe this segment has the potential to diversify value exposure with respect to the equity long/short space. That is because the roll-out of effective coronavirus vaccines helps lay out a clearer path for a return to normal that could be just the catalyst for a more sustained rotation into value. At this point, however, our concerns about the broader market make us wary of being too positive.

Global ECM Activity in 2020

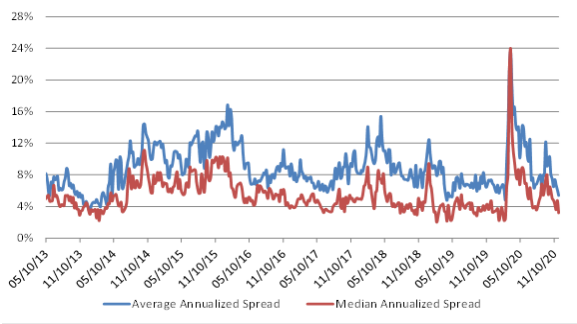


Source: Goldman Sachs

Merger Arbitrage

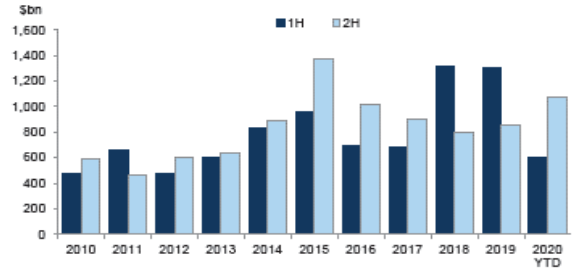
Diving deeper into our more cautious rating on merger arbitrage, we note that the median annualized net spread for US deals — in the 0-30% range —fell from 6% in October to approximately 3% recently, as evidenced by the first chart following. That said, we acknowledge the strong momentum in M&A deal-flow. As the second chart shows, activity in last year's second half was up sharply versus the first six months, representing the highest second-half tally since 2015. Bolstered by transactions in technology and financials, in particular, the market also witnessed a resurgence in megadeals, which should allow managers to deploy capital more easily assuming these trends continue into 2021 as we anticipate. Looking ahead, cheap financing, a shortage of growth, record private equity dry powder, and a booming SPAC market should be the right combination to further boost M&A.

US Merger Arbitrage Spreads



Source: Bloomberg, UBS

M&A Volumes – US and European Acquirers

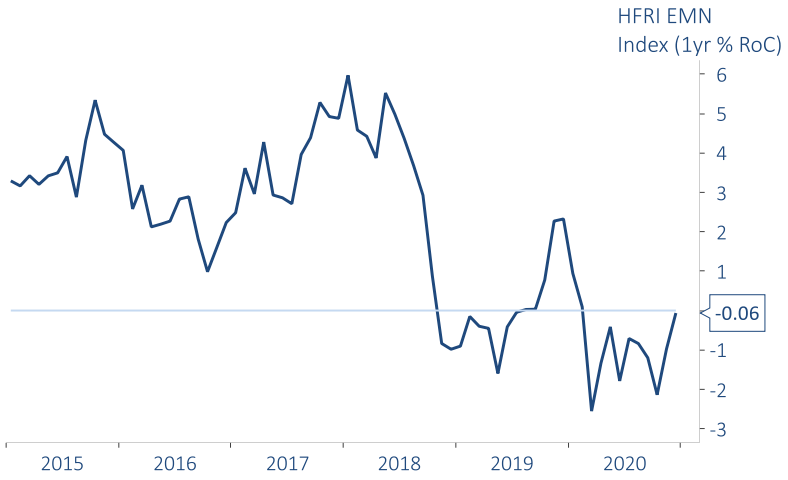


Source: Goldman Sachs

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 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



Source: Bloomberg, Investcorp-Tages, Macrobond

Equity Market Neutral

Gayan Wijesinha, Hedge Fund Research

Equity market neutral hedge funds generated small gains in the fourth quarter period following what appeared to be a flattening out in September of the post-March uptrend. The HFRI EMN index rose 1.5% over the period and was up 0.5% year to date. The S&P 500 index, in contrast, climbed 11.7% over the quarter, drawing in a range of stocks that served to inflict decent losses on short books.

In certain respects, last quarter witnessed a continuation of trends that had been in effect since the peak of the crisis. Despite a brief jump in equity market volatility just prior to the US elections in November, when the Vix index hit 40, conditions have been relatively subdued, leaving that latter measure trading largely in a range be-tween 20 and 25. Meanwhile, gross leverage at both long/short and market neutral funds edged closer to pre-March levels amid falling correlations and rising dispersion, albeit from low levels.

For the funds in the representative universe we monitor, performance continued to be some-what bifurcated last quarter. The more concentrated fundamental managers were at the fore-front, while quant fund counterparts either tread water or moved deeper into drawdown territory, especially in those cases where managers were left wrong-footed by violent growth-value rotations and momentum factor volatility.

In theory, rising dispersion and moderately elevated volatility should favor all equity market neutral funds, with quants also tending to do well amid snapbacks from post liquidation events like we saw in the January-March period. However, other factors have been at play that have impacted the opportunity set. Based on the group we track, which is comprised of both quant and fundamental managers, we found that the worst performers last year were the larger multi-strategy quant managers and funds with US-based exposures. In contrast, those that fared best included funds targeting Europe, Asia and emerging markets.

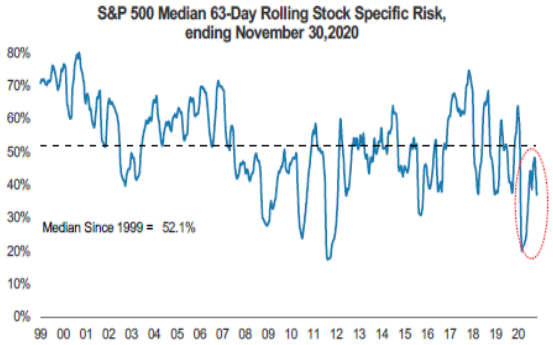
Given how the large funds have performed, it is not surprising that we have seen factor volatility remain elevated relative to that of market over-all, as the following chart shows. With respect to fundamental EMN managers, in particular, the fact that they came into the year with modest leverage and have been willing to add to dislocated opportunities since the peak of the crisis has proved rewarding.

S&P Volatility vs. Fundamental Factor Volatility

Source: Investcorp-Tages, Macrobond, Bloomberg

To provide some context regarding the environment for stock-selection strategies, we typically look at the median stock-specific risk of the S&P 500 constituents, highlighted in the following chart. After dropping to multi-year lows in March, the measure has worked its way higher since then, though it remains well below its 20-year median.

Stock-Specific Risk of S&P 500



Source: ClariFi, Morgan Stanley

Looking at this in conjunction with how popular quant factors have performed, we can see that there was a decline in diversification and a corresponding fall-off in EMN returns last year, as evidenced by the chart below. Along with the disparity between market and factor volatility cited earlier, it is not hard to see that betting on fac-tors has been something of a narrow game, where macro influences have exerted a dominant influence.

Diversification Measure and EMN Performance

Source: Investcorp-Tages, Macrobond, Bloomberg

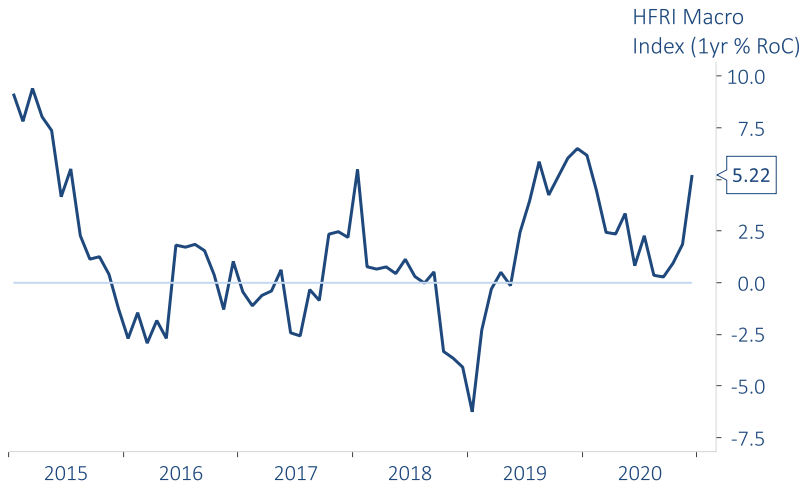
HEDGE FUNDS

Taking everything into account, we continue to be neutral on the strategy, though we are slightly more positive than we were against a backdrop of potentially greater dispersion opportunities in the months ahead. As was the case previously, we favor fundamental EMN managers that can look through to changing fundamentals at a time when quant datasets are having to digest and incorporate information from a very unusual inflexion year

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



Source: Bloomberg, Investcorp-Tages, Macrobond

Global Macro

Macro Discretionary

Jonathan Feeney, Tactical Strategies

Discretionary global macro funds gained a net 4.73% in the fourth quarter, according to the HFRI Macro (Total) index, and was up 5.22% year to date. Over this time span, the benchmark significantly trailed the broader HFRI Fund Weighted Composite index, which posted returns of 11.61%.

That said, the aggregate measure does not tell the whole story. If we look at the more narrowly defined HFRI Macro: Discretionary Thematic index, which is focused on purely thematic discretionary managers — as opposed to currency, commodity and quantitative specialists — it fared significantly better, posting a year-to-date gain of 8.73%, which was more in line with the performance of the broader hedge fund benchmark. Behind the disparity was the poor showing by quantitative managers, which is also reflected in the asset-weighted index. That latter measure declined 7.70% through November, weighed down in particular by the poor performance of the large players employing risk parity strategies. They were hit hard in the first quarter when equity and fixed income correlations — the building blocks of the approach — broke down.

Taking these and other factors into account, including those discussed in more detail later on, we are sticking with our overweight stance on the strategy. Even with the relative underperformance — depending, of course, on the index being tracked — the macro discretionary segment generally provided diversification benefits in last year's first quarter, especially during March. In addition, as is always the case and as we have noted previously, there was significant dispersion within the macro universe this year. Allocators with exposure to the top quartile managers had quite a positive experience in 2020.

Reflation Trade Dominates the Second Half

Looking across common tradeable macro factors and the broader universe of asset classes, it is apparent that assets linked to reflation have been the standout winners this year. As can be seen in the table below, which details the performance of assets viewed as prime beneficiaries of inflation or reflation from May 1 to mid-December — a period that corresponds to just before the Federal Reserve launched their bond buying program but after they had signaled their intentions —returns were firmly in the black. So far, the leader of a pack that includes yield-curve steepeners, precious metals and other commodities, and commodity-sensitive FX pairs, is bitcoin. The cryptocurrency has gone from being a peripheral niche asset to being embraced by many of the biggest names in the macro discretionary space.

Returns for Selected Assets (May 1 - December 18, 2020)

Silver	71%
Bitcoin	206%
Gold	12%
Nasdaq	43%
GSCI	61%
AUDJPY	12%
5's 30's	116%

Source: Bloomberg

2021 Playbook

As alluded to earlier, there are several reasons why we believe macro discretionary has an attractive opportunity set, and why we rate it as a tactical overweight for the year ahead. Below is an overview of three key rationales:

Global Macro Dispersion: as with any hedge fund strategy, the dispersion of the assets being traded tends to be synonymous with the number of alpha-generating opportunities. In addition to fiscal and monetary policies, which are the usual core drivers of variations in growth among countries, one element that will likely play a strong role in 2021 is how well different government policymakers react to the ongoing pandemic and the structural changes emanating from it. Currently, China, in particular, and Asia, more broadly, are handling the crisis better than the US and Europe. In fact, economists are forecasting that Chinese GDP growth in 2021 will be 8-8.5%, a nine-year high.

Broadly speaking, the differing growth profiles come down to three elements. First off, some countries have had more experience than others in dealing with pandemics. In addition, a structural orientation toward manufacturing, which is more commonplace in Asia, makes it less of a challenge to limit human interaction than in more service-based economies. Finally, there have been marked differences in economic responses. The US, for example, has injected more stimulus into its economy than Europe has, including fiscal spending amounting to 12% of GDP and a 1.5 percentage point cut in short-term interest rates.

Taken together, these various elements suggest we will see a significant divergence between the winners and losers as far as growth is concerned, both within and across regions. Under this scenario, the playing field for global macro players that can invest across a broad universe of developed and emerging markets is likely to be chock full of opportunities.

Commodity Complex: we have previously noted that we believe the commodity sector potentially represents an excellent two-to-three-year structural investment opportunity, based in part on trends and relationships that extend back decades. These include the ratio of the Goldman Sachs Commodity index (GSCI) to the Dow Jones Industrial index, which recently tested its lowest level since the 1960s, and the Bloomberg Commodity index (BCOM) index, which hit a 45-year nadir in May. Lending further weight, policymakers around the world have a compelling incentive to keep real yields below zero in a world of abundant debt, because this helps reduce the financial burden on debtors, many of them economically disadvantaged, at creditors' expense.

In addition, we have been in the midst of a radical monetary policy experiment, where money supply has been growing at a parabolic rate, and where it is not out of the question that the next policy move might be to implement yield curve caps. Should this happen, we could end up with significantly negative real yields, which would likely set the stage for significant commodity inflation. So far this year, China has been a major buyer of various resources, which partly represents a pulling forward of demand, but if 2021 growth in that country comes anywhere near expectations, demand will likely be quite robust. Given the dearth of commodity supply-side investment in recent years, upward price pressures will be exacerbated on an above-trend boost in demand.

Finally, investment industry dynamics could also provide a boost to commodity prices. As we have noted on many occasions, the role of fixed-income as an asset class diversifier is increasingly being called into question, leading some institutional investors to consider other options. This includes the Ohio Fire and Police Pension fund, which in August 2020 approved a 5% allocation to gold. Based on past history, including the move toward "crisis risk offset" strategies that occurred several years back, a shift by one thought leader or other has often set the stage for others to follow. It would only take a small change in allocations by institutions looking to diversify away from fixed-income or seeking inflation protection to significantly impact the relatively smaller commodity space.

That said, we are not necessarily advocating a structurally long position in commodities, but are simply noting that should capital flows gain pace, this will likely engender tradable inefficiencies for macro discretionary managers. It is worth keeping in mind as well that the commodity complex has been a difficult trading arena to navigate in recent years, which has resulted in less capital being allocated to the space and an exodus of managers. Consequently, the best approach when it comes to allocating funds to this segment is to target high quality managers that can play both relative value and directional trades in delta one and volatility across the product spectrum.

Emerging Markets: betting against the US currency is becoming something of a consensus position, as current speculative positioning suggests, but it is apparent that the greenback faces severe structural headwinds. These include the fact that US has run a trade deficit every year since 1982 and relies on global savings to finance the shortfall. In addition, China is increasingly challenging America's role as global hegemon and appears intent on recycling global infrastructure project assets and rolling out fintech solutions that bypass US dollar payment system. Additionally, significant monetary and fiscal stimulus combined with a weakening dollar have historically been the recipe for robust returns in emerging market asset classes.

Macro Portfolio Approach

As always, when It comes to investing in the macro discretionary strategy, we favor a diversified risk budgeting approach so as to secure exposure to a broadly diversified array of global risk factors. For the year ahead, we recommend allocating to:

- Managers with cross-asset expertise that can successfully navigate equity and credit indices as well as pure FX/rates exposure, including gaining increasing exposure to FX and, potentially, FX volatility.
- Emerging markets specialists that have been able to play, inter alia, Latin America and EMEA, but can also tactically hedge during periodic selloffs in carry-based strategies rather than being tied to a "deep value" credit orientation.
- Emerging market themes that can also be played systematically by investing in alternative trend managers that have exposure to over-the-counter products, emerging markets, and the broader commodity complex, including resources where China tends to exert a strong influence, such as iron ore, coal and steel.
- Commodity experts, preferably with a relative value orientation, that can trade the whole complex. In our view, they should benefit as rising passive flows into the space open up alpha opportunities, especially in an environment where the number of high-quality commodity players has in recent years shrunk dramatically.

Macro Systematic

Gayan Wijesinha, Hedge Fund Research

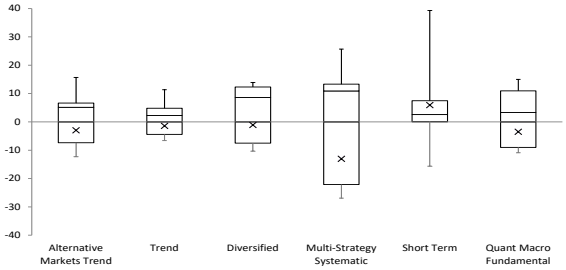
Macro systematic funds gained 5.8% in the fourth quarter and were up 2.6% year-to-date, according to the HFRI Macro Systematic index. Based on the Société Générale CTA Trend index, the momentum subgroup rose 6.8% over the last three months and gained 3.2% for the year. Bearing in mind that this cohort is comprised of a diverse universe of managers, we remain neutral on the strategy overall but can envisage better opportunities ahead for certain segments.

For the most part, short-term traders have not had much success holding onto the strong gains they generated at the start of the year and into the first quarter. It did not help that the fourth quarter has had its share of challenges, including false breakouts in bonds and FX and the fact that some managers were caught off guard by the positive news in November regarding COVID-19 vaccine efficacy. That said, medium-term momentum-oriented funds more than held their own over the first two months of last quarter.

Broadly speaking, it remained a mixed year for alternative market trend funds. Multi-strategy systematic funds investing across both futures and cash equities and fundamental quant macro managers that rely on slower-moving economic data have not found it easy, either. With both the US elections and positive developments on the vaccine front behind us, we now find our-selves at an interesting juncture, where a majority of forecasters are calling for improving growth and higher targets for risk assets. The danger, however, is that markets have fully priced in those expectations. As a result, we want to stay open to the possibility that the coming quarter may contain some surprises. As it stands, medium-horizon momentum managers are currently positioned to benefit from the weaker dollar, broad strength in equities, and a renewed interest into commodities. Alternative market trend funds, in particular, that have greater exposure to areas where there is capturable risk premium — in contrast to what is generally available to traditional CTAs — could fare quite well. Shorter-term CTAs will likely find it difficult to generate gains should volatility remain subdued but serve as a good counterbalance at this point to the positioning of medium horizon systematic funds.

Looking back at how the year unfolded, systematic funds broadly benefited in the first quarter from the sharp rally in government bonds but were in something of a rut since then. They gave back a portion of their gains in fixed-income, traded the reversals in the dollar and oil some-what badly, and until recently, did not materially capture the upside in equities owing to the lack of broader upside momentum outside US markets. In more granular terms, we found less dispersion and diversification than previously across the various subgroups – "Alternative Trend," "Di-versified," "Traditional markets Trend," "Multi-Strategy Systematic CTA," and "Short-Term" – drawn from our universe of top macro systematic managers, as the following chart illustrates.

Investcorp-Tages Macro Discretionary Select Universe



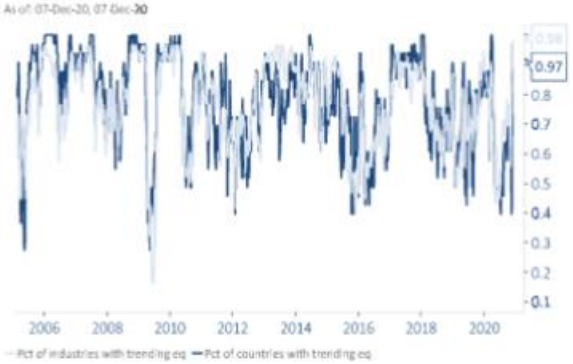
Source: Investcorp-Tages

Below is an overview of how each subgroup fared in the year to date through November:

- **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 return of -2.2%.
- **Traditional Trend:** generally employing a medium-term-oriented strategy – and where flat fees are occasionally a selling point – this segment lost 2.2%.
- **Diversified CTA:** typically operating with a mix of short- and medium-term trend and, occasionally, countertrend models, the median gain for this subgroup was 1.1%.
- **Multi-Strategy Systematic:** made up of managers that have exposure to multiple quantitative alpha streams and that trade both futures and equities, this group was down approximately -11%, with losses being exacerbated by cash equity quant factors.
- **Short Term:** populated by traders operating with short time horizons, this group posted a median gain of 2.6%.
- **Quant macro:** funds that utilize fundamental economic data have found the environment to be particularly challenging. The median return for this group was -5.7%

In terms of the technical picture, 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, suggest that the CTA opportunity set remains attractive, as the following two charts illustrate.

Percentage of Asset Trending – Equities



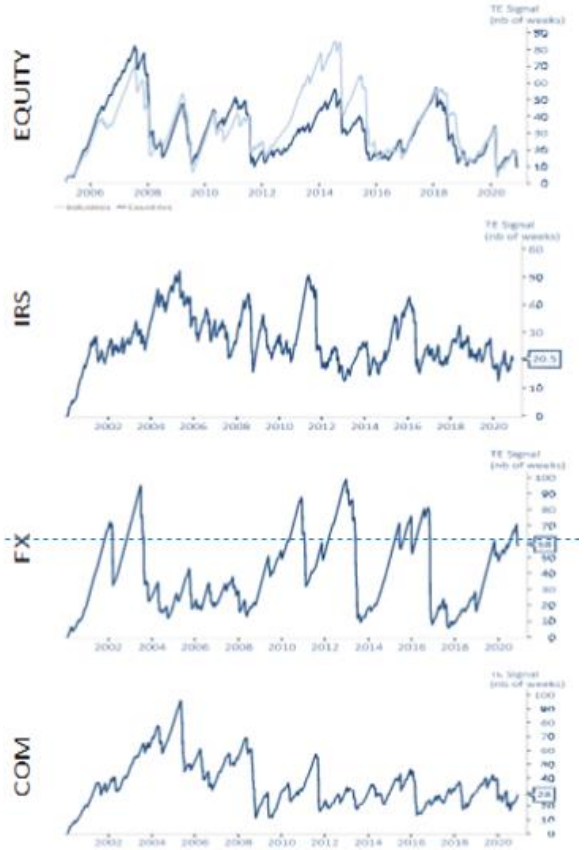
Source: Investcorp-Tages, Macrobond

Percentage of Assets Trending - FICC

Source: Investcorp-Tages, Macrobond

Looking at things 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 more conservative picture. As indicated by the series of charts below, rates have been a clear driver of trend fund performance. However, we see less evidence that in a rising-yield environment trend-followers can capitalize on short bond exposure to the same extent as they did previously.

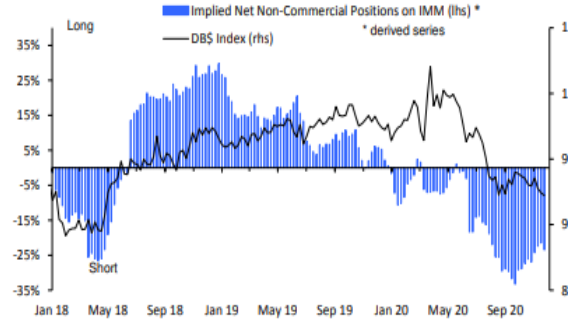
Investcorp-Tages Trend Exhaustion Indicators



Source: Investcorp-Tages, Macrobond

The same may not hold true with respect to FX, where we have seen asset managers and levered funds, based on data from Commitment of Traders Reports, highlighted in the first chart below, return to building short bets against the US dollar following a two-month period of winding them down. It is worth keeping in mind that while this could present some crowding risks, current positioning levels relative to history do not appear to be as extreme as has been seen with long dollar trades in the past. Lending future weight, an analysis of how the greenback has fared in the wake of previous recessions, detailed in the second chart, suggests that the path of least resistance for the US currency may well continue to be down for a while longer.

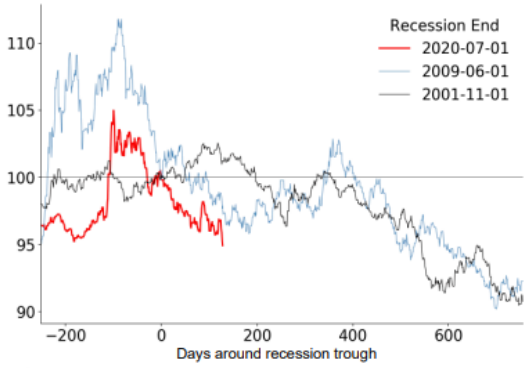
Commitment of Traders Report



Source : Bloomberg Finance LP, Deutsche Bank

The initial USD sell-off after a recession-end typically starts consolidating at this point, before resuming a trend decline in the middle-latter part of the global expansion

USD Index, 100 = recession end



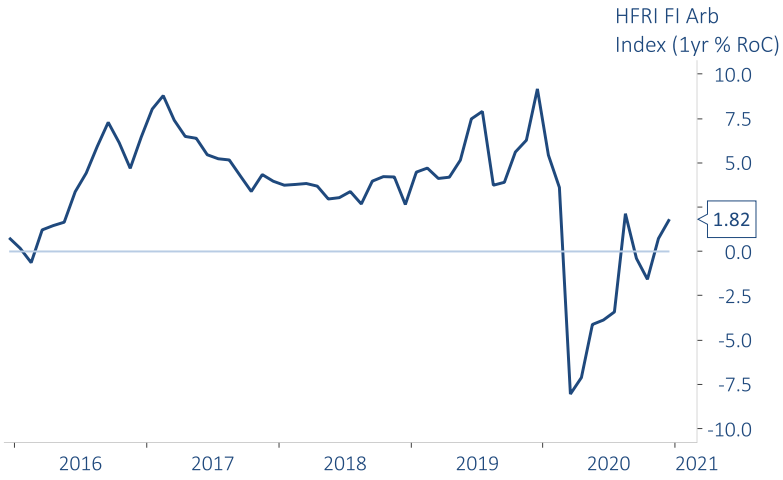
Source: J.P. Morgan

Source: Bloomberg, Deutsche Bank, JP Morgan

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



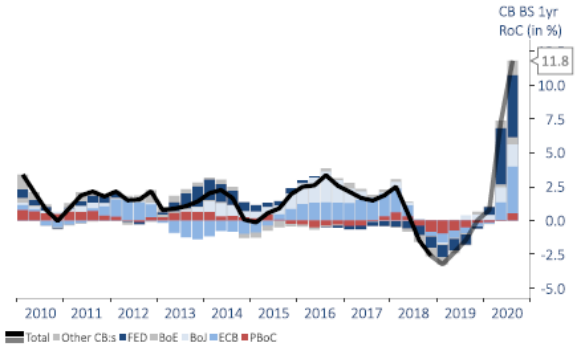
Source: Bloomberg, Investcorp-Tages, Macrobond

Fixed Income Relative Value

Luca Valeri, Relative Value Strategies

Fixed-income relative value funds turned in a solid performance as 2020 wound down, recouping most, if not all, of the losses experienced by the group during the peak of the COVID-19 crisis. Year to date, the HFRI RV Sovereign and Credit Suisse Fixed Income Arbitrage Indices were down 1.02% and up 0.21%, respectively. Helping matters, the Federal Reserve's first-quarter shift to an easier policy stance. one of the fastest and most forceful transitions ever seen, remained in effect during the fourth quarter. As of December, the Fed's balance sheet had grown to $7.24 trillion, more than 60% higher than its $4.17 trillion total when January began. As can be seen in the chart below, all major central banks have followed suit, dramatically expanding their balance sheets in an effort to mitigate the fallout from the pandemic.

Central Bank Balance Sheets (Including FX Reserves)



Source: Investcorp-Tages, Macrobond

Around the globe, interest rates have converged toward zero in tandem with the broad shift toward implicit/explicit yield-curve-control policies, which appears inevitable in light of the massive buildup of sovereign debt and the ensuing need to keep rates low. In the immediate aftermath of the crisis peak, Fed asset purchases were outpacing gross supply levels by more than two to one; quantitative easing has since tapered to "only" $40 billion of mortgage-backed securities and $80 billion of Treasuries per month.

Volatility within the government bond space has fallen dramatically since the February-March spike, as the following chart illustrates. In a zero-interest-rate-policy (ZIRP) environment, this will likely further spur investors to sell or short volatility — once again — in an effort to enhance portfolio returns. That said, while there are reasons to believe that fixed-income markets will be relatively calm going forward, especially amid the prospect of a divided US government and former Fed Chair Janet Yellen being at the helm of Treasury, there is the admittedly unlikely possibility that the results of upcoming Georgia run-off elections could tilt Congress toward the "blue wave" scenario. Should this occur, both real and nominal curves would likely steepen on expectations for a ramp-up in public sector spending and its consequent impact on growth and inflation.

MOVE Index

Source: Bloomberg

In the mortgage market, conditions continue to improve, no doubt bolstered by the Federal Reserve's actions. After dramatically underperforming Treasuries in the first quarter, mortgages significantly outpaced US government bonds through December. The US central bank's aggressive QE4 expansion program has helped push the MBS basis down toward levels that have not been seen since the end of 2017, as the following chart shows. At the same time, the OAS on MBS has fallen from a peak of 132 basis points on March 19 to 16 basis points as of early-December.

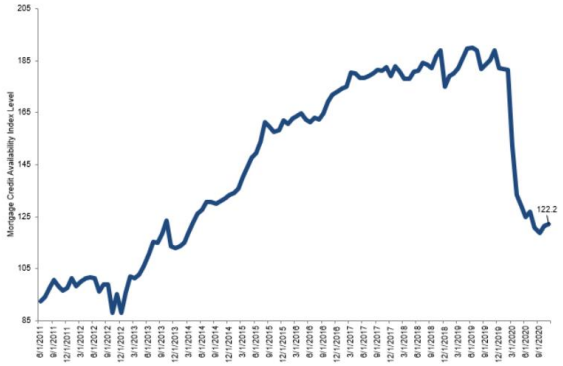
MBS Basis

Source: Investcorp-Tages, Macrobond

Interestingly, interest-only spread levels continue to undervalue the potential for a slowdown in prepayments, which remained fairly stable last quarter amid increasing incentives. While the big uptick in prepayment speeds has been driven by super-prime borrowers, the trajectory will likely ease as the pool of eligible borrowers begins to shrink. The combination of dwindling federal and state benefits, tougher loan standards, and more rigorous employment and income verification will begin to impact refinancings going forward, weighing on prepayments. Indeed, there are

indications that the turnabout has already started. As can be seen in the chart below, the Mortgage Credit Availability Index has dropped in recent months, undermined in part by rising mortgage delinquency rates in the second quarter.

Mortgage Credit Availability Index



Source: Mortgage Bankers Association

Looking ahead, there are several headwinds that could limit upside for the FIRV strategy in the period ahead. These include the prospect of a reacceleration of Fed Treasury purchases, which, together with ZIRP, will help to limit volatility — illustrated by the following chart — narrowing its opportunity set. Add in the likelihood of a divided Congress, which should serve to keep some federal spending in check, and the fact that Yellen will be overseeing Treasury, which increases the odds of a prolonged zero-interest-rate regime, and we see little choice but to maintain our rating of one-notch negative. That said, should the Georgia elections turn out differently or the economic recovery be swifter and stronger than expected, we would look to reconsider our stance.

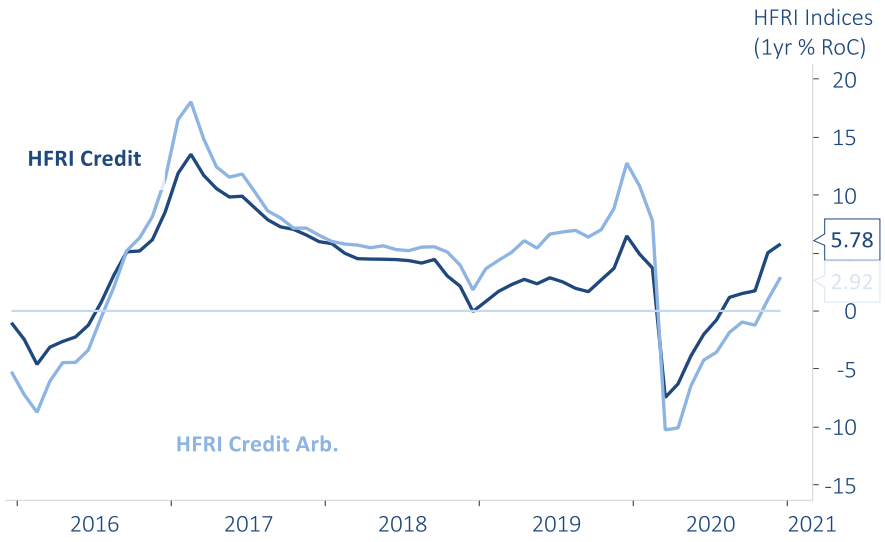
Realized Volatility — Global Futures Basis

Source: InvestcorpTages, Macrobond, JPMorgan

Corporate Credit

Driver of Strategy Returns	Negative	Neutral	Positive	Comments
Valuation		■		Spreads are back to historical average levels
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



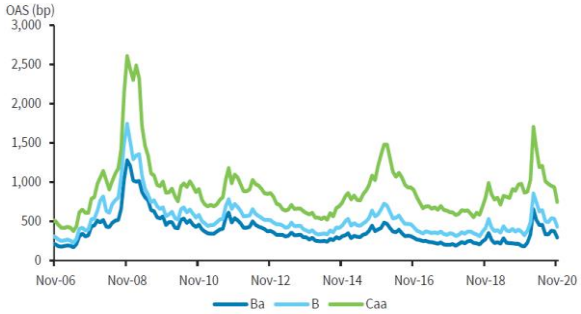
Source: Bloomberg, Investcorp-Tages, Macrobond

Corporate Credit and Distressed

Greg Berman, Credit and Event Strategies

Credit markets remained strong in the first two months of last quarter, continuing their recovery from the sharp losses they experienced earlier in the year, as the following chart shows. Reflecting performance at credit-focused hedge funds, the HFRI-RV: FI-Corporate index and HFRI-ED: Distressed-Restructuring index were up 6.2% and 10.%, respectively, over the quarter, bringing 2020 returns to +7.2% and +11.4%, respectively. The Barclays High Yield Index, meanwhile, rose 6.5% in the October-December period, boosting year-to-date returns to +7.1%.

Credit Spread Differentials Across Ratings

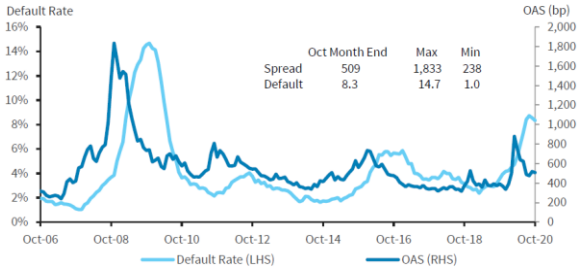


Source: Bloomberg, Barclays Indices

Looking back, we have seen a virtually uninterrupted rally since April, with the exception of a small sell-off in September. In November, the segment posted solid gains; most asset classes moved higher on positive vaccine news and relief over the US elections, which resulted in of what many viewed as a market-friendly mixed government. Hints that a re-opening of economies might not be far away promulgated a surge in many names, especially distressed issues. The latter had been punished by fears of high cash burn rates stemming from their inability to deliver revenues amid lockdowns and other re-strictions designed to contain COVID-19.

At this juncture, we remain cautious on the traditional corporate credit long/short strategy; continuing spread compression has left fewer and fewer opportunities for outsized carry and price appreciation. In fact, spreads have tightened to pre-pandemic levels, with narrowing risk-free rates promulgating even lower yields and premium prices. That said, we continue to see dispersion between the credit spreads of the largest 50 high yield names, which was 3.4% at the end of November, and that of the larger HY index, which was 4.1%, pointing to pockets of opportunity. Meanwhile, short opportunities are become scarcer as rating agencies scale back default forecasts and ease downgrade efforts. As can be seen in the chart below, the gulf between HY spreads and the trailing 12-month default rate remains notable.

High Yield Spread vs. Trailing 12-Month Default Rate

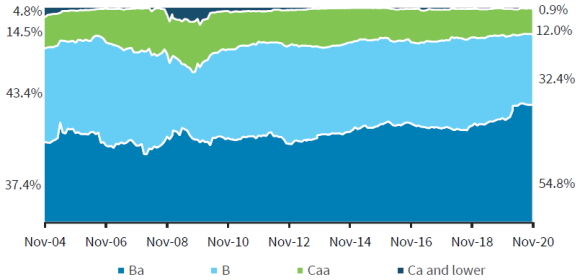


Source: Bloomberg, Barclays Indices

In our view, distressed credit is becoming more interesting. We should soon see whether or not and which companies can effectively access capital markets in the months ahead after finding themselves lumbered with more leverage and suffering through stressed performance throughout the COVID-19 crisis and its associated restrictions. Recurring lockdown risk still looms large, while any delays on rolling out vaccines to the broad population will likely further exacerbate burn rates.

Looking at things from a different perspective, we note that CCC and worse-rated credit spreads remain elevated. At the same time, activity in lower-rated credit continues to climb, both in terms of volumes and as percentage of the over-all high yield market, as the following chart reveals. At a time when only certain industries are even beginning to recover on a fundamental basis, this suggests that any new hiccup in the economy could see an elevated impact across the ratings spectrum.

High Yield Market Quality Breakdown



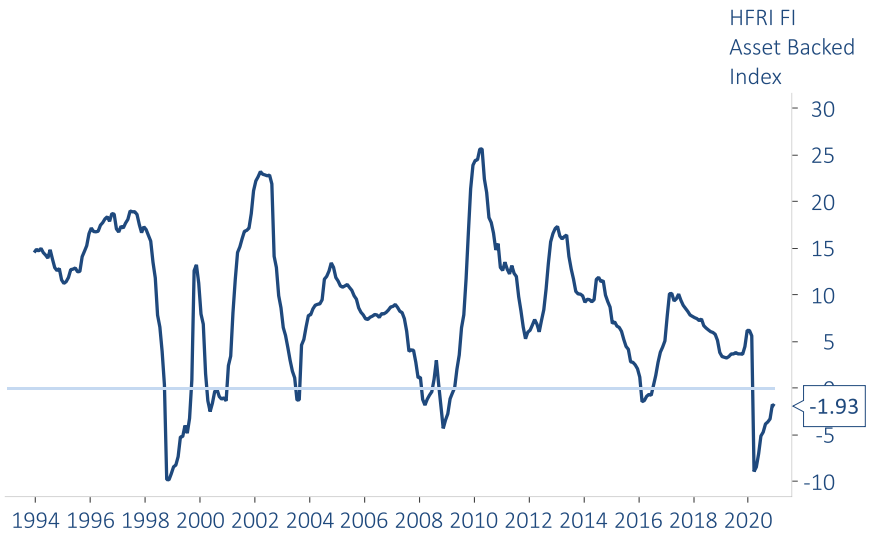
Source: Bloomberg, Barclays Indices

Against this backdrop, it is a good bet that fund managers that have a solid handle on corporate liquidity timetables and cash efficiency, as well as companies' ability to successfully navigate through additional uncertainty, will prove the most successful. Regardless, as the effects of the new vaccines serve to return things to some kind of normalcy, there should be significant room for markets to churn up potential winners and losers, affording investors with sufficient dry powder ample opportunities to step in and take advantage.

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			■	Pressure from fund redemptions should subside while the renewed hunt for yield should be a strong tailwind for the asset class
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



Source: Bloomberg, Investcorp-Tages, Macrobond

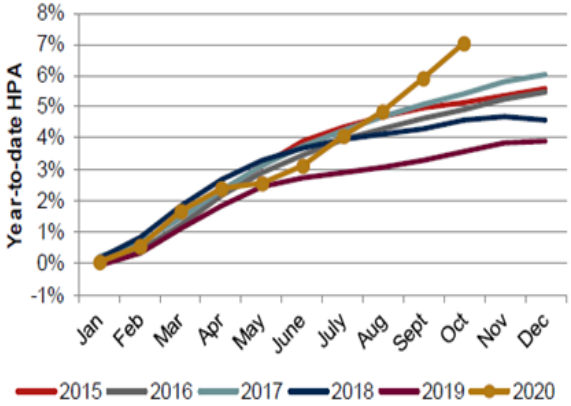
Structured Credit

Greg Berman, Credit and Event Strategies

RMBS

As last year wound down, US housing-related economic data releases continued to surprise to the upside, reflecting ultra-low mortgage rates and a pan-demic-induced shift in housing preferences, which further bolstered demand for credit risk tied to the trend. Thirty-year fixed-rate mortgage rates fell once again to new all-time lows, hitting 2.72% in November, spurring a concomitant jump in applications. Existing home sales, meanwhile, reached their highest level since 2005, with prices up 7% in the year-to-date through October. As can be seen in the following chart, the pace of residential property price appreciation this year has exceeded that which we have seen since 2015, pushing the S&P/Case-Shiller 20-City Home Price Index to record levels.

Year-to-Date HPA by Year



Source: CoreLogic, Census Bureau, NAR, Current Population Survey, Nomura Securities International

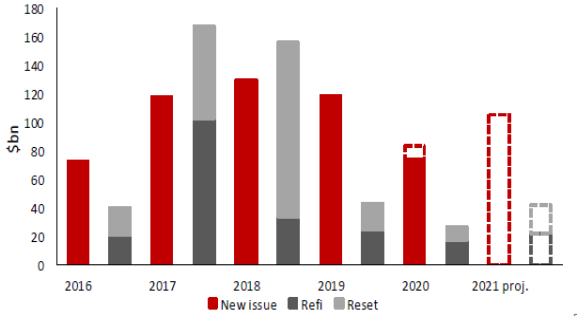
Adding to the impressiveness of the strength we have seen in the residential property market is the fact that home sales collapsed in April before their sub-sequent surge. While some had expected the lockdown-induced jump in unemployment to be a formidable headwind, the fallout from the pandemic has had on outsized impact on lower-income workers, who are less likely to be homeowners. Regardless, aside from cheap financing, one key factor behind the strength in the single-family home segment has been the ongoing exodus from the larger cities to the suburbs, where the risks of exposure to COVID-19 are perceived to be lower.

Across the legacy RMBS segment, we believe that sentiment and underlying assumptions in a number of areas could improve. The latter could include higher forbearance recoveries, increased deal redemptions for discount bonds, gradually declining severities, and more prepays on modified loans. The fall in financing costs since the crisis reached its peak has also been beneficial in other ways. It has helped boost the return profile for bonds retained from securitization and buoyed the value of underlying loan collateral, even when accounting for the prospect of higher delinquencies.

CLOS

In the wake of high-for-the-year issuance in October, the supply of new issues fell sharply in November, as the following chart shows, amounting to a roughly 49% drop and only around $7 billion of pricing across 16 transactions. Yearly issuance now stands at nearly $81 billion, approximately 26% below the same period last year. That said, while activity has lagged that of prior years, it is widely expected that issuance in coming quarters will make up the difference owing to continued favorable market conditions.

CLO New Issue, Refi, and Reset Volumes



Source: LCD, Intex, Nomura, Markit

Year to date through November, the median return for CLO equity was around 2% overall, as the table below suggests, or 6% for deals involving reinvestment. Pricing in this segment has recovered sharply, driven by positive investor sentiment and improved interest-only (IO) valuations following October payments (based on anecdotal reports, prices were 3-5 points higher through November). Approximately $10 billion of CCC loans in CLOs were upgraded to B- or above in recent months, representing 20% of the total CCC downgrade volume that has occurred since February, largely due to better-than-expected performance by certain issuers.

Estimated 2020 Returns for CLO Debt and Equity

AAA	1.2% to 1.6%
AA	1% to 2%
A	0.3% to 1.7%
BBB	-2% to 2%
BB	-5% to 3%
B	-11% to 1%
Equity	-12% to +13%

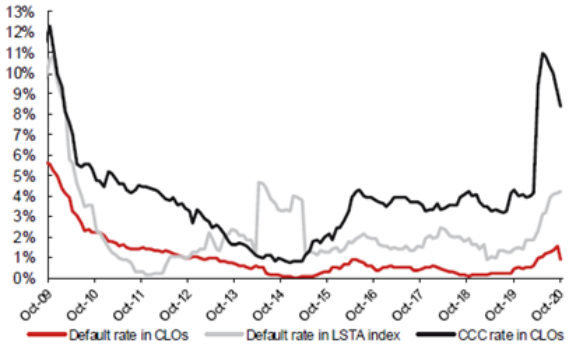
Source: Nomura

In secondary market trading, CLO prices gapped higher and trading volumes jumped, largely as a result of real money investors being active in seniors and hedge funds aggressively adding mezzanine risk. AAAs tightened by 15-20 basis points and now sit at or near their tight, pre-pandemic lows; BBB and BB spreads had concomitantly larger falls, narrowing by approximately 75 basis points and 150 basis points, respectively.

Looking at the broader landscape, CCC loans currently account for a smaller percentage of portfolios than they did earlier in the year, while CLOs have experienced a far lower default rate than overall loans owing to three factors: high levels of diversification, thoughtful selection, and active trading. Separately, BBs have lagged equity in recent months, leaving the former with significantly better downside protection.

In light of these developments, many CLO hedge fund managers have been focusing on mezzanine debt. Adding to its appeal, these obligations offer carry that is significantly higher than that of similarly rated corporate credit assets while also being structurally robust. In addition, we believe that default expectations — alluded to in the following chart — especially constant default rates (CDRs) of 4-5% for life, represent quite a harsh scenario. Across BBs, meanwhile, the upside appears limited with spreads being at the lower end of their historical range. Lastly, single-Bs remain relatively cheap, with double-digit base yields and more DM compression potential based on historical patterns.

Default Share in CLOs vs. Loan Index vs. CCC

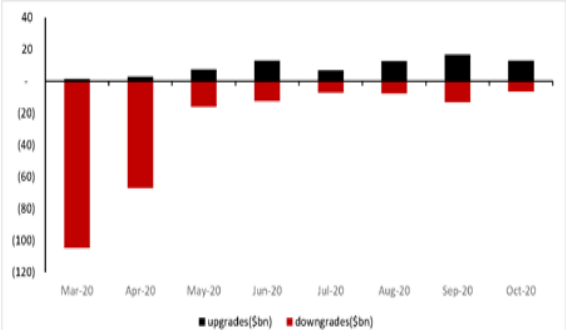


Source: LCD, Intex, Nomura, Markit

Generally speaking, we believe equity offers high potential dividend returns and mostly cured interest diversion tests. Even so, we are cautious for the near term, as the outlook for defaults and equity NAVs is somewhat uncertain in the immediate months ahead should the extent and duration of lockdowns in-crease. Otherwise, we expect spreads to widen as loan issuance picks up and note that while LIBOR floors exist for many credits, CLO liabilities do not have such provisions, which equates to an additional excess spread to equity.

Looking at the pattern of ratings changes since last July, illustrated below, the latest readings indicate that 25% of CLO loans that were previously down-graded by S&P to CCC+ or lower have since been upgraded to B- or higher. The average price difference between upgraded CCC issues and other CCC issues is 15 points. This has led to a sharp improvement in the performance of CLO CCC tests and dampened the impact of any failures that have occurred, which has, as a consequence, seen prices continue to rally.

Overall Upgrade/Downgrade Volumes for CLOs



Source: Intex, Bloomberg, Nomura

CMBS

Amid the emergence of what appears to be a K-shaped rally, the commercial real estate market remains in the eye of the COVID-19 storm, despite the seemingly sanguine picture painted by the chart below. That said, we believe that prices may only fall 10-15%; sizable amounts of dry powder are serving as a supportive safety net. Over time, however, supply should catch up with demand as issuance rises in conjunction with the rising share of the $430 billion of loans outstanding loans set to mature. Other headwinds include September's 62% plunge in transaction volumes, which now stand roughly 40% below what they were in 2019, the 7.2% decline in corporate net operating income (NOI) in the third quarter, and lending conditions that have tightened to global-financial-crisis levels.

CCC CMBS vs. BB HY

Source: ICE Data, LLC, BofA Global Research

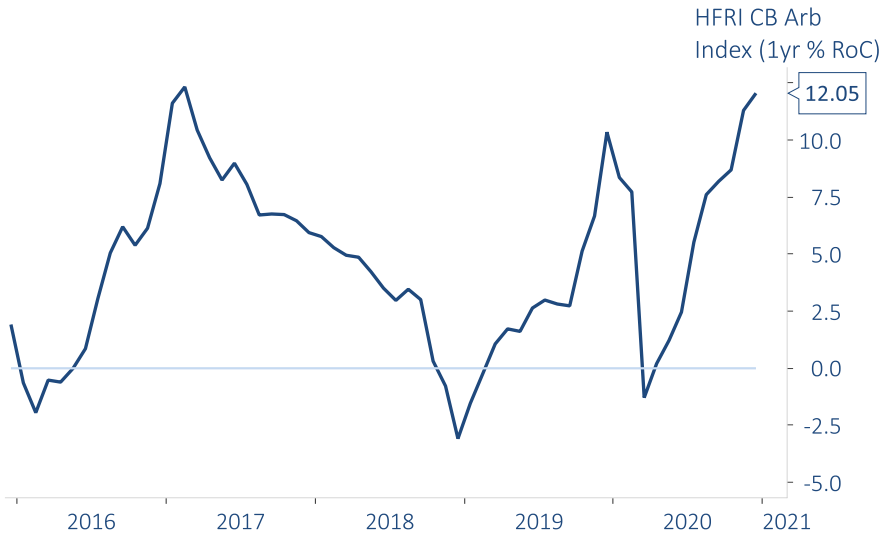
But this does not mean that conditions will be uniform for individual names and sectors. While the broader outlook for CRE is somewhat tenuous — and possibly that much worse if a credit crisis erupts, which we do not expect — there has been significant bifurcation among what many view as the post-pandemic winners and losers. So far, at least, notable beneficiaries include the industrial, storage, single-family rental, and cell tower segments, while the major casualties have been the hotel, retail, and office segments.

To be sure, a great deal rests on how quickly lockdowns and other government restrictions aimed at containing the virus can be wound down. Many remain hopeful that it will not be long at all. In fact, since the announcement of the successful vaccine trials, the CMBS mezzanine sector has recovered much of its earlier decline. From where we sit, this may be overly optimistic, especially with respect to the still-challenged retail, hospitality, and office segments, which account for more than 50% of most CMBS conduit deals.

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			■	After a significant surge in new issuance that support hedge funds alpha generation, we expect a moderation in the next twelve months but new issuance should remain healthy
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



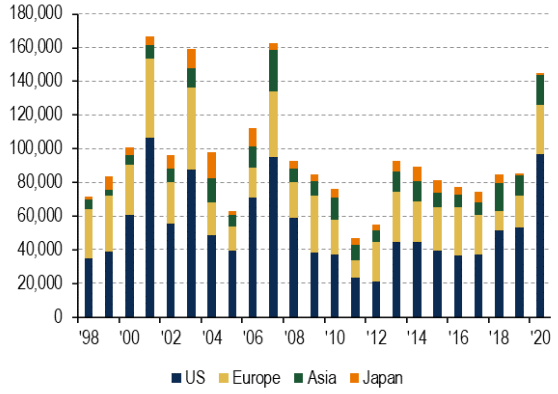
Source: Bloomberg, Investcorp-Tages, Macrobond

Convertible Arbitrage

Luca Valeri, Relative Value Strategies

Convertible arbitrage hedge funds gained approximately 6.0% in the fourth quarter and were up 12.05% year-to-date, according to the HFRI FI Convertible Arbitrage Index. The group no doubt benefited from an underlying market that had been firing on all cylinders throughout the year, bolstered by positive trends in primary issuance — highlighted below — gamma trading, credit spreads, and rescue deals. While the strategy was initially hurt by fallout from the COVID-19 pandemic, the subsequent combination of heightened market volatility and wide credit spreads turned out to be the recipe for a robust convertible market.

Issuance Trends



Source: Bank of America Merrill Lynch

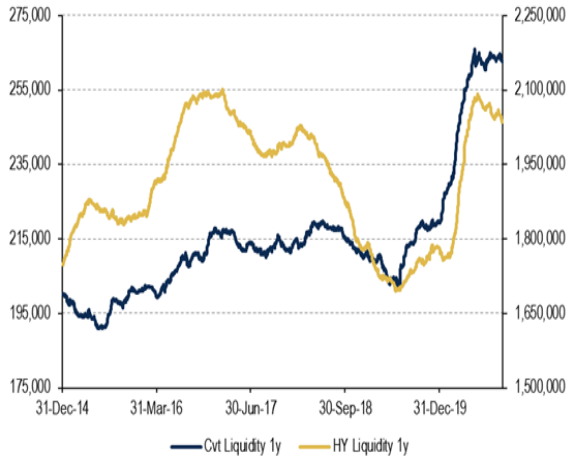
Sector-wise, the biggest drivers of performance last year were high-delta groups such as consumer discretionary, technology, and healthcare, up 101%, 32%, and 15%, respectively, over the 11-month span, followed by media (+26%), materials (+19%), and utilities (+18%), which rose 26%, 19%, and 18%, respectively. At the other end of the spectrum were energy, financials, and consumer staples, which generated more modest returns. That said, if the shift from growth into value carries on, the laggards have a good chance of catching up with the rest.

Looking at how convertibles fared by region, there is little doubt that the resiliency was fairly widespread. At the aggregate level, the BofA G300 Global Convertibles Index returned 27.11% for the year through November. In the US, the market rallied 36.59%, despite experiencing a nearly 27% drawdown around the peak of the crisis. On the other side of the globe, Asian converts posted an impressive 47.88% return in the period, while Japanese counterparts generated a slightly less eye-catching 28.27% return. Based on issuer size, mid-caps were the leader with a gain of 36.38%, while large caps, up 11.76%, and small caps, down 2.4%, pulled up the rear.

In terms of issuance, the primary market has been very active, with approximately $144 billion of offerings brought to market in last year's first 11 months. The US has accounted for the lion's share of activity, with aggregate issuance through November of $96 billion versus $53 billion in the whole of 2019. Many companies with depressed valuations were able to raise capital through "rescue deals" aimed at buying them sufficient time to survive the COVID-19 crisis. For those that were most directly affected by the fallout from pandemic, including airlines and cruise lines, such efforts turned out to be self-fulfilling prophesies that saw their distressed share prices recover sharply.

Secondary market activity has also been robust, with liquidity returning to near normality — or perhaps even better — as the following chart suggests. In a relatively short period of time, banks have readily adjusted to remote working arrangements and have been facilitating flows well, while US convertible TRACE volumes have soared, partly on the heels of record issuance.

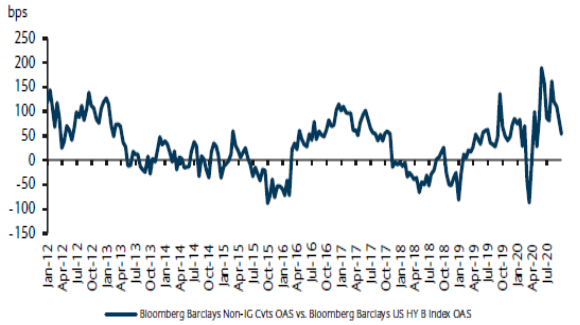
1-Year Market Liquidity in US CBs and HY



Source: Bank of America Merrill Lynch

As far as the segment's relative attractiveness goes, the picture still looks relatively encouraging. Prior to the pandemic, yields on many convertible bond traded in line with straight bond equivalent counterparts for some period of time. However, when COVID-19 erupted in the first quarter, spreads widened out dramatically. While they have come in sharply since then, convertible bonds currently offer a pickup in yield when compared to straight bond issues, as the following chart suggests.

US Non-Investment Grade CB vs HY B Spread

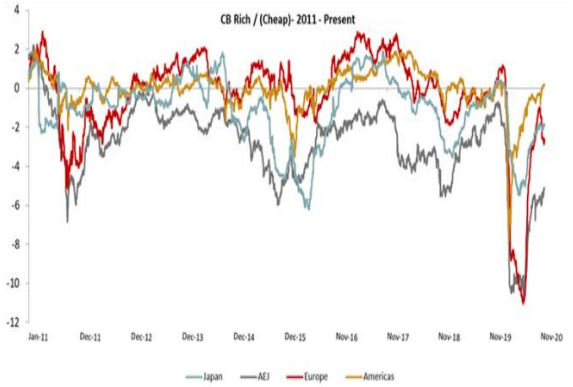


Source: Barclays

As we noted, the stars were fully aligned for the convertible bond market last year, but the picture looks a bit more mixed going forward. This does not necessarily mean it is all downhill from here; we believe the overall line-up of performance drivers remains tilted in a positive direction. Below is a brief overview of where they stand:

- **Primary market:** we expect 2021 issuance to decline significantly from last year's record pace4, offering correspondingly fewer opportunities, but it will likely remain buoyant in comparison to prior history.
- **Put trades**: in the wake of the market rally, a number of converts are trading deep in the money. In this scenario, funds can fully hedge the delta and make money during market corrections while also benefitting from positive carry.
- **Gamma trading**: heightened market volatility and increased dispersion within sectors and single names should continue to facilitate a strong opportunity set.
- **Credit:** although this asset class continues to offer a yield pickup versus HY counterparts, the fact that spreads have narrowed considerably and the market is no longer as cheap as it was, as the chart below illustrates, means that most of the low hanging fruit is no longer available. Under the circumstances, credit is unlikely to be a primary driver of performance in the period ahead.
- **Special situations**: the wave of rescue deals in 2020 enabled this element to serve as a powerful tailwind, but the circumstances that brought it to bear unlikely to repeat themselves in 2021.

Bottom-Up Valuation – Percentage Cheapness



Source: Bank of America Merrill Lynch

Summing up, it seems unlikely that performance of convertible arbitrage hedge funds over the 12 months ahead will be anywhere near as good as it was last year. Even so, we believe the strategy still has a number of things going for it and, consequently, that can continue to outperform other credit market segments.

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INVESTCORP-TAGES

39 St James's Street
London, SW1A 1JD
+44 (0)20 3743 3476
IR-EU@investcorp.com

280 Park Avenue, 35th Floor
New York, NY 10017
(917)-935-6240
IR-NA@Investcorp.com