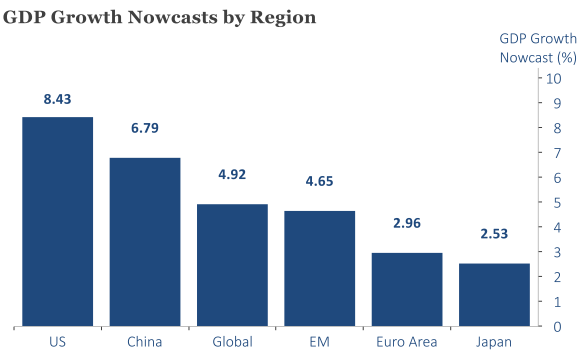
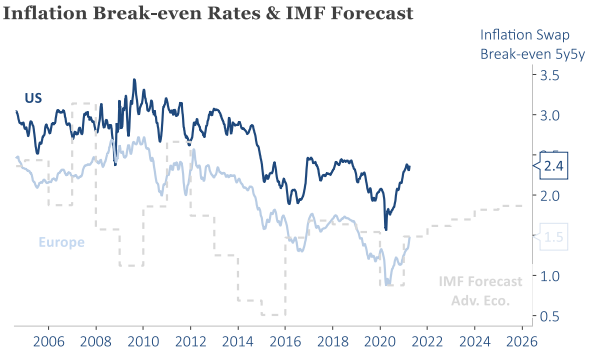
Investcorp-Tages Hedge Fund Strategy Outlook

May 2021

Macro-economic Environment

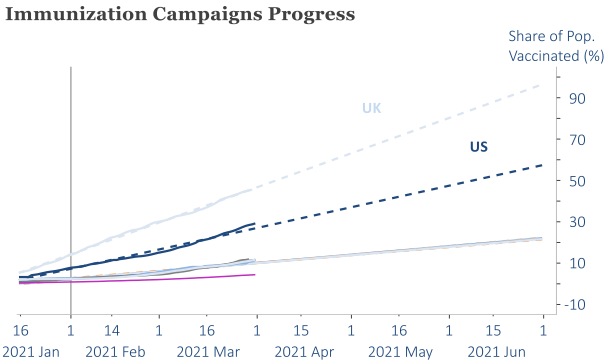
Global growth re-accelerated modestly over the first quarter. But economic fortunes varied widely, with the United States recovering much faster thanks to continued extraordinary policy support. The new Democratic administration wasted little time in passing a $1.9 trillion support package, beating expectations for a more modest stimulus. And President Biden recently presented yet another fiscal plan with his infrastructure and tax reform bill that would likely add another four trillion dollars of spending in the next few years. Meanwhile, the United States and United Kingdom reaped the benefits of well-organized immunization campaigns, allowing them to gradually reopen their economies while Europe lags by a couple of weeks.

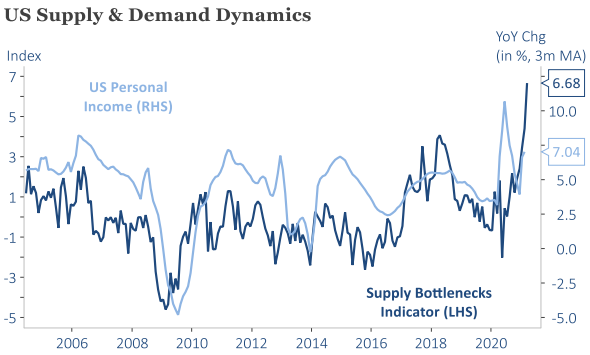




Source: Macrobond, Bloomberg, Investcorp-Tages

Unleashed fiscal power supported by loose monetary policy can be a potent growth cocktail. But it also naturally brings forward questions over the inflation outlook. Near-term, a surge in demand fuelled by excess savings and robust income growth will meet a supply side still scarred by the effects of the pandemic. This imbalance will be compounded by base effects that will likely push the inflation rate in the United States above 3%, if only for a brief period. Longer-term, a Bayesian prior would strongly suggest that price pressures will remain muted, held down by successfully anchored expectations, demographic trends, or technology. But our confidence level should certainly be revised downward. In Europe, a larger output gap and tighter policy mix point to a more timid reflationary impulse.

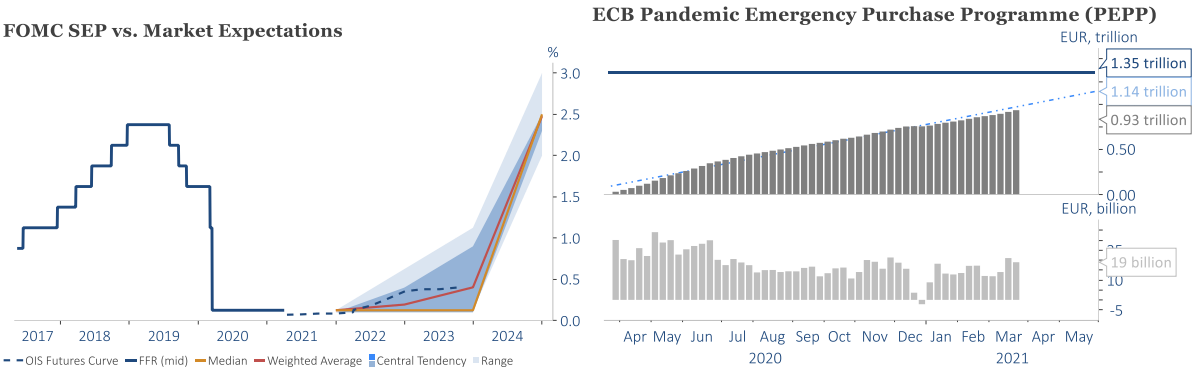




Source: Macrobond, Bloomberg, Investcorp-Tages

Diverging economic conditions in recent months are creating greater dispersion in monetary policy too. In China, policy is likely to turn less accommodative as signalled by the NPC's deliberations. Financial stability concerns and the leadership's long-term objective to

rebalance economic growth away from debt-financed fixed asset investments and towards domestic consumption will take priority again. In Europe, the ECB is leading the response by pushing back against steeper yield curves through their communication and more rapid purchases under the PEPP. The fiscal outlook beyond the European Recovery Fund remains uncertain however as old habits die hard, and institutional constraints limit individual government's spending ability. All eyes will really be on the Federal Reserve for the coming months as pressure is building from investors to clarify their exit plans. Jerome Powell and the FOMC have pushed back against expectations of an earlier tightening with their outcome-based forward guidance but market participants remain unconvinced – pricing in initial rate hikes in 2023, one year ahead of the median path communicated in the FOMC's Summary of Economic Projections. The coming quarters will bring an opportunity to test the Fed's response function and how their recent Average Inflation Targeting framework will drive policy actions.



Source: Macrobond, Investcorp-Tages

In this environment, we have marginally upgraded our probabilities towards both the Reflation and Goldilocks scenarios while the Long Slog Back and Depression scenarios seem more distant, at the very least in the next twelve months.

<u>Macro-economic Scenarios Overview</u>

Reflation 40%

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 40%

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.

Long Slog Back 10%

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.

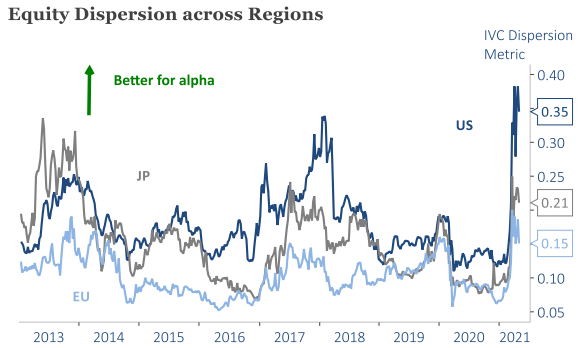
Deflationary Bust 10%

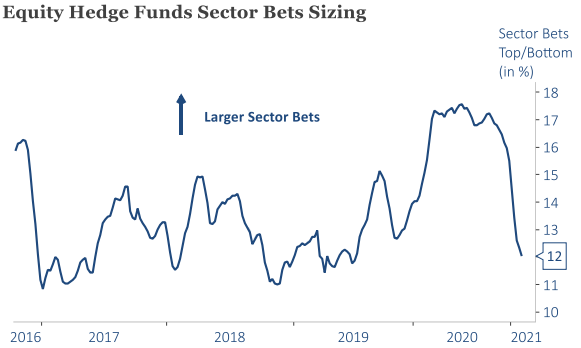
Uncertainty, de-leveraging pressures and scarring effects cripple the economy and force the system into a deflationary loop. It is a scenario where new or lingering exogenous shocks (no vaccine) meet inadequate fiscal policy response. The contraction in private demand is self-sustaining. Active monetary policy may limit the speed of the downfall and lead to slow-motion crash.

Hedge Fund Strategies Outlook

As we look forward to the next twelve months, we only expect minimal returns from pure beta exposure but the outlook for alpha looks bright across a wide group of strategies.

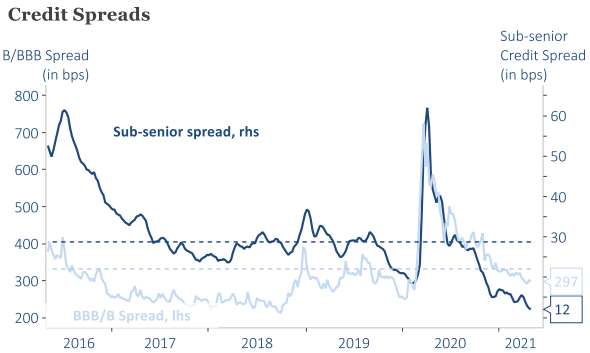
Within the **equity** universe, we are excited about the opportunities in stock selection alpha that the recent dramatic rise in dispersion is likely to bring about. We consider here a volatility-neutralized measure of dispersion that we have found to have the most robust explanatory power over present and future stock selection alpha. We came into the year somewhat concerned about the level of macro risks undertaken by equity long/short funds through sizeable, long growth/short value styles and their associated sector biases. The ongoing rotation has triggered a significant de-risking in these exposures, with funds now running much lower sector bets relative to a year ago – as one can see on the right-hand chart below. All in, we remain conservative in our beta budget, with a slight preference for ex-US market, primarily driven by our conviction for the continued re-rating of value. But we see abounding opportunities in funds able to select the winners & losers within the respective sectors and factors thanks to fundamentals divergences finally showing up in equity dispersion.

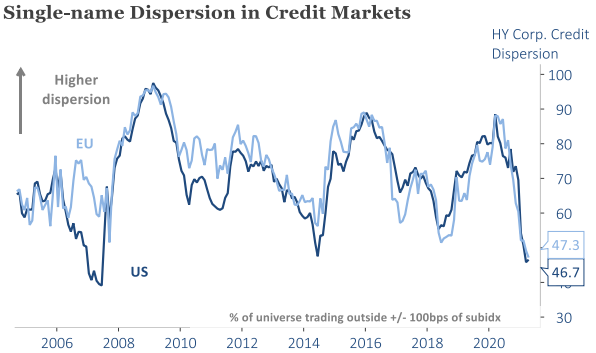


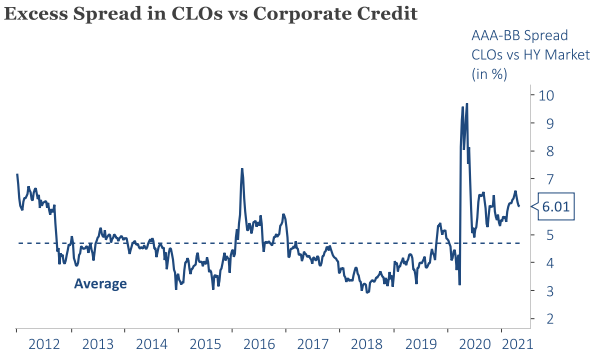


Source: Macrobond, Bloomberg, Goldman Sachs, Investcorp-Tages

In **credit**, we are gradually taking profit as last year's dislocations have all but evaporated. In addition, dispersion in single-name credit has narrowed to multi-year lows as the reflationary wave lifted all distressed and poorly rated firms. This leaves a narrower opportunity set for both directional and relative value strategies in corporate credit. Similarly, the outlook for distressed investing looks more challenging, at current spread levels. Many distressed funds are opportunistically sizing up their equity exposure and performance has been strong thanks to the large rally seen in value and cyclical sectors as economies re-opened. But greater selectivity will be key going forward as these tailwinds fade. In structured credit, dislocations are taking more time to heal as the liquidity windfall takes time to trickle down to the least liquid segments of the market. We remain constructive on this strategy as excess carry screens attractive, relative to history and other credit markets.

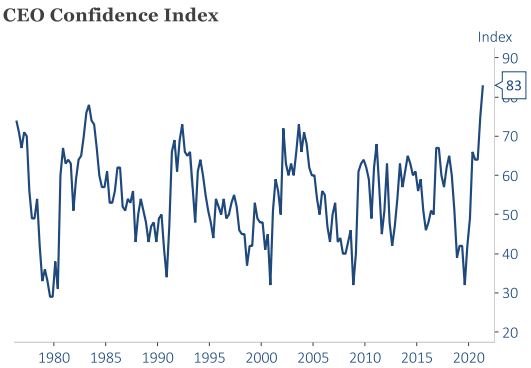


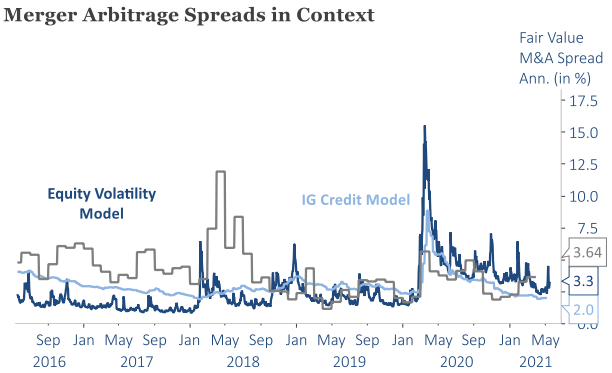




Source: Macrobond, Bloomberg, JPMorgan, BAML, Investcorp-Tages

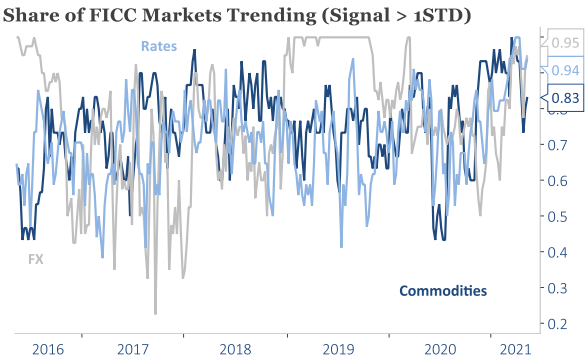
Event driven funds have ranked among our favourite ideas to deploy capital in recent months as corporate activity heats up and managers benefit from greater exposure to the value rotation. Similarly, merger arbitrage offers today an attractive liquid alpha stream with spreads running in excess of their cross-asset valuation anchors.

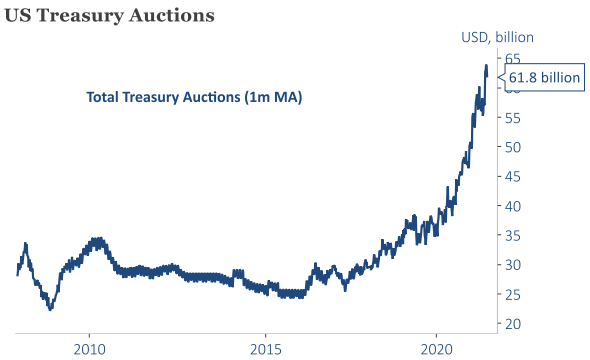




Source: Macrobond, Bloomberg, JPMorgan, Investcorp-Tages

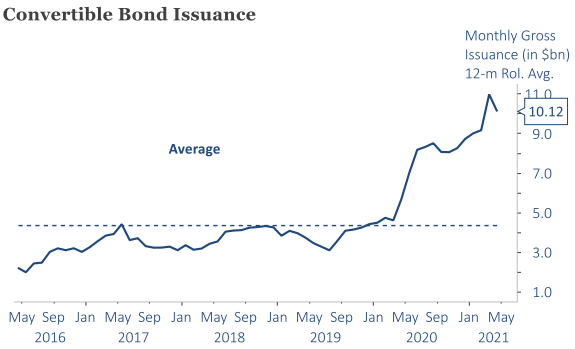
Across **macro** strategies, both discretionary and systematic funds have benefited from trending markets across asset classes. The left-hand chart below shows that virtually all instruments in rates, foreign exchange or commodities have strong trend signals currently. While the initial reflationary trade required being directional, the recovery going forward may proceed at varying speed across regions triggering greater divergences in the policy responses on the fiscal and monetary sides. Global macro funds are generally best positioned to capture these opportunities and we remain confident the environment will offer a good trading ground for these funds. For CTAs, medium-term trend followers are running much greater portfolio risk today and could be at risk of reversals, after the sharp moves we have observed in recent months.





Source: Macrobond, Bloomberg, Investcorp-Tages

Finally, the outlook for **relative value** funds remains broadly positive. Within **convertible arbitrage**, issuance is running at elevated levels, allowing funds to capture the "new issue" premium. Also, dislocations in the SPAC universe should afford new trading opportunities. Valuations have certainly run a long way from the March lows, but single-name volatility could stay elevated as the greater presence of retail investors takes hold. We have upgraded **fixed income relative value** to a neutral stance as a larger CTA footprint in fixed income markets and the Fed's decision to let the SLR elapse could bring new opportunities in futures basis trades. Meanwhile auction strategies are likely to continue to do well thanks to a busy issuance calendar.



Source: Macrobond, Bloomberg, JPMorgan, BAML, Investcorp-Tages

Strategy Outlook Summary

Strategy	Negative	Neutral	Positive	Rationale
Hedged Equities		■		Recent de-grossing reduces risks for alpha ahead, remain careful about crowded factor exposures. Neutral equity outlook as valuations/positionings risks offset cyclical upswing – prefer value style to capture economic rebound
US		■		Recent de-grossing has reduced risks for alpha; but mind factor positioning or too rapid re-risking
Euro area ex UK		■		Europe could benefit from value bias in sector mix; positioning and valuation signals less stretched than in the US
Japan		■		Japan could benefit from value bias in sector mix; positioning and valuation signals less stretched than in the US. Yen weakness and BoJ support help
Emerging Markets			■	Ahead in economic recovery on better pandemic management, continued policy support and constructive flow dynamics
Event Driven			■	Capture value and opportunities from greater corporate activity
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			■	Upgrading on higher spreads, even considering IG credit spreads. Eq vol still dislocated
Equity Market Neutral			■	Better opportunity set for market neutral funds, greater dispersion and larger diversification for quant factor portfolios
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.
Fixed Income Relative Value		■		Higher fixed income volatility, greater CTA footprint, SLR exemption elapsing, large auctions suggest a greater performance potential for the strategy.
Corporate Credit	■			Turning negative on lower carry potential and lesser tailwinds from liquidity, size premium.
Corporate Distressed		■		Spreads have compressed quickly but default cycle is ongoing, post reorg equity can be attractive but pure credit exposure offers lower value
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
Volatility Arbitrage			■	High volatility environment and limited competition after March debacle are positive for the medium-term environment

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