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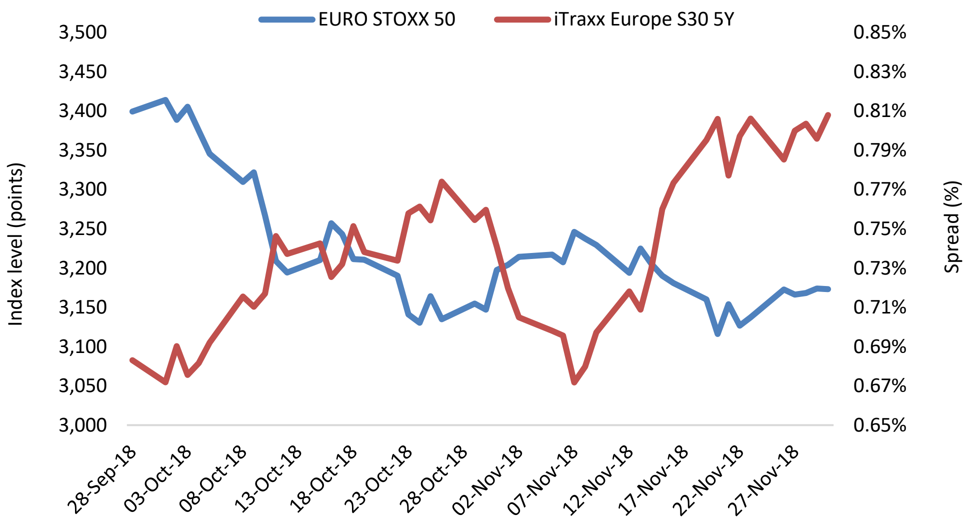
Market commentary on October/November

The months of October and November were a period to forget for many asset classes and investment strategies. However, a nimble long/short strategy could still protect year-to-date performance, making it possible to take advantage of newly available opportunities.

After a period of relative calm during the summer, volatility suddenly returned at the beginning of October. In Europe, the EURO STOXX 50 was already down 6% for the year and lost a further c.9% over October and November. The Financials sector was equally affected, as the EURO STOXX Banks index also declined by c.9% during this time. As for credit markets, iTraxx Europe (S30) 5Y spreads widened by 12bps (over 18%), and iTraxx Crossover (S30) 5Y spreads increased by 76bps, or nearly 28%.

Chart 1: European equity and credit markets in October and November



Source: Bloomberg, Markit

As chart 2 highlights, the performance of the HFRX Global Hedge Fund Index also shows significant pressure during this two-month period, losing 3.1% over October and another 0.6% in November, leaving the index down c.4.9% between January and November, and down 6.3% YTD as we write this letter.

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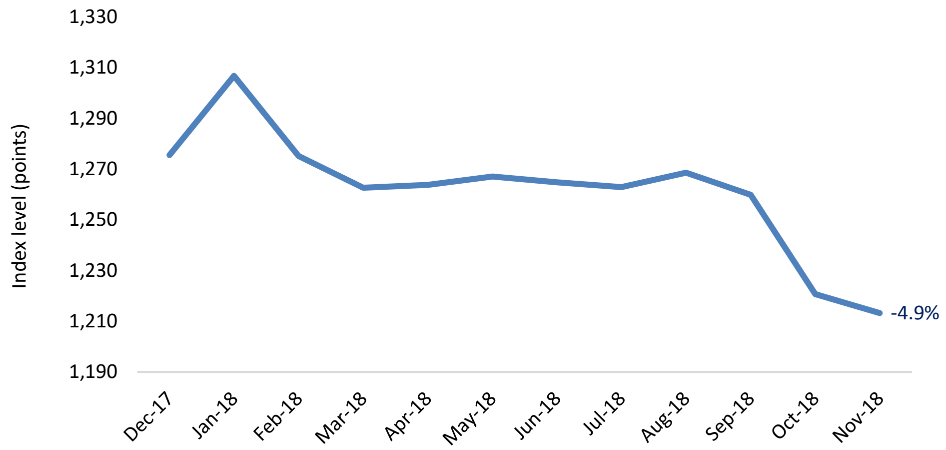
Chart 2: Performance of the HFRX Global Hedge Fund Index



Source: Bloomberg

In Europe, specific factors weighed on investor sentiment at the beginning of this period. The European Commission stated that Italy's draft budget for 2019 "presents a particularly serious deviation"[1] from expectations and requested submission of a revised budgetary plan – the first time it had made such a request. In Spain, the Supreme Court surprised markets with a ruling that banks should be responsible for paying a mortgage tax instead of their clients – a decision that could potentially have led to large costs for the banks, if applied retrospectively[2].

Around this time, the ECB also reiterated their intention to end net purchases under their asset purchase programme, at the end of December. While this had been well-flagged in advance, the additional prospect of a future interest rate hike caused some trepidation, with markets expecting such a move by the central bank in Q4 2019 or Q1 2020. Finally, continuing fears of a global trade war also continued to weigh on investor sentiment, ahead of a meeting between the US and China at the G20 meeting in Argentina at the end of November.

Protecting fund performance was a key priority during the October/November period, where for example the BoAML EUR HY index returned -3.2%, and the BoAML CoCo index -2.7%[3]. Funds were severely impacted. For example, the HFRX Fixed income – Credit Index returned an estimated -1.6% over the two months, and the HFRX Global Hedge Fund Index was down 3.7%[3].

For the same period, the Lyxor Chenavari Credit Fund was down 82bps[4] (Class SI USD), below our own expectations but still outperforming the above points of reference. We believe this contributes to

[1] European Commission Press Release, 23 October 2018
[2] Following a reversal ruling by the court, the government subsequently ensured that banks would indeed pay this tax going forward
[3] Source: Bloomberg
[4] Source: Lyxor

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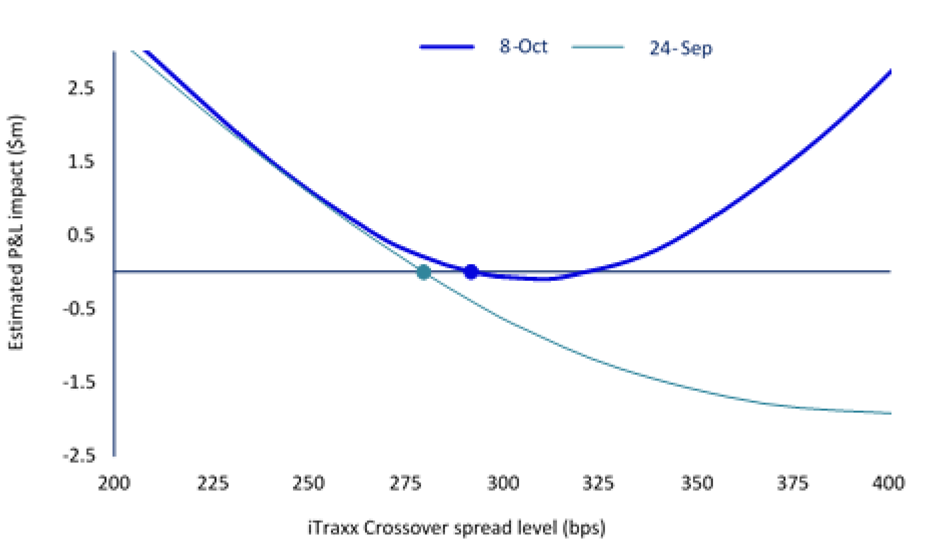
demonstrate that our long/short strategy, with an intense focus on managing volatility and limiting drawdowns, is the appropriate way to invest in credit.

In this context, the ability to dynamically adjust exposures was key to protecting the portfolio. For example, the portfolio managers reduced exposure to Financials bonds and took portfolio exposure to CoCo AT1s from net long to net short during November. The ability to utilise a variety of instruments was also demonstrated during this time - credit index options provided gamma as volatility increased at the beginning of the period, and a greater proportion of single name CDS shorts in the portfolio, in place of index hedges, benefitted as dispersion increased.

The flexibility of the strategy during these periods is evident at the overall fund level. Chart 3 shows the estimated P&L impact for the Lyxor Chenavari Credit Fund as spreads of the iTraxx Crossover index are instantaneously moved from prevailing levels. This shows how the fund P&L could react to a scenario of either tightening or widening of credit spreads.

At the beginning of October, the portfolio managers rapidly adjusted the portfolio to create a distinct, positively convex risk profile which helped protect the Fund’s profile to the downside.

Chart 3: Credit spread stress impact on P&L



Source: Chenavari

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The fruits of these efforts are reflected in the most recent report on top-performing credit funds from Kepler, for example:

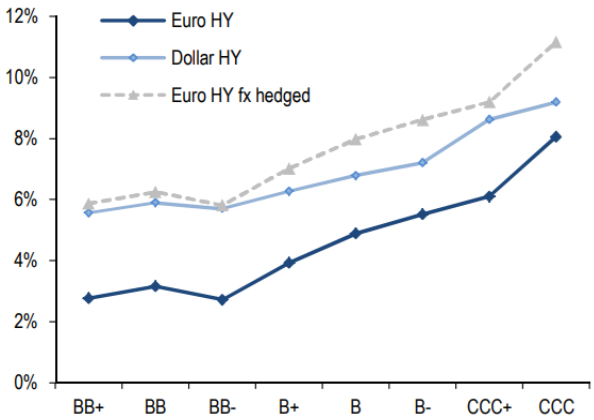
Table 1: Kepler report, Top 10 Credit funds, 2018 YTD performance (%)

TOP 10		
	Schroder GAIA Cat Bond	2.14
	LO Funds - CAT Bonds	1.92
	GAM Star Cat Bond	1.30
	Advent Global Partners UCITS	0.79
	Lyxor Chenavari Credit Strategy	0.51
	Janus Henderson Credit Alpha	0.48
	Aberdeen Absolute Return Bond Fund	0.25
	HI Numen Credit Fund	0.19
	Robeco Flex-O-Rente	0.07
	Kames Absolute Return Bond	-0.03

Source: Kepler, Alternative UCITS monthly performance report, November 2018

Sharp market corrections are uncomfortably painful for most investors. However, they also create new opportunities for those that can be proactive, having protected the downside, and are sufficiently agile. The yield available from the iBoxx EUR Liquid HY index increased from 3.8% to over 4.7% by the end of November. European credit also bears comparison with US markets, as the cost of hedging against USD currency exposure has increased recently, and results in a yield pick-up available in Europe at most rating levels.

Chart 4: Europe and USA, YTW by rating



Source: J.P.Morgan. EUR HY hedged using one month FX forward.

In European credit, increased dispersion has already become a feature of the markets and this factor has only been amplified by the recent volatility. The interactions of political and corporate

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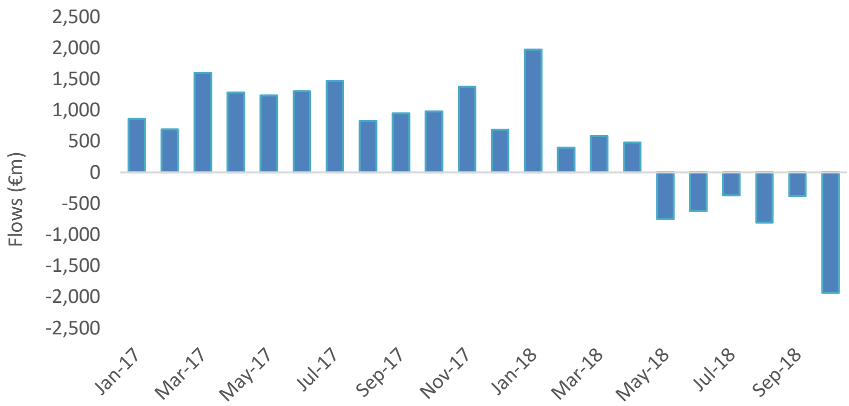
developments have seen large moves for some individual instruments, including Italian infrastructure firm Atlantia and French retail group Casino. Such idiosyncratic risks can provide fertile ground for long/short strategies, particularly when pursued in a broad approach that encompasses cash and derivatives markets across bonds, CDS, indices and options.

For European Financials markets, dispersion has been less influential compared to broader market factors such as the significant strengthening of bank balance sheets, the regulatory cycle potentially peaking, and the maturation and growth of the market for subordinated debt. In the year to date, AT1 bond spreads started widening after the last bout of market volatility in February and were further impacted by the Spanish court ruling described above. Now, yield levels could be considered attractive again as a result, when compared to peer assets such as European High Yield bonds or US preferred instruments. Specific factors such as extension risk can then be used for long/short positioning, anticipating divergent performance between names. The technical picture is weak for the market however; funds offering short-notice liquidity have amassed large holdings in such bonds and have started to see outflows from their investors.

Chart 5: Credit Financials funds, flows



Source: Chenavari, Bloomberg

The volatile markets of October and November proved to be a challenging environment for many investors. However, the underlying factors of dispersion and changing macroeconomic drivers are also providing significant opportunities. Long/short strategies have the flexibility to take advantage of the opportunities that have arisen, with the ability to rapidly change a portfolio's risk profile in response to changing conditions.

We believe European credit markets offer a combination of attractive yields in select locations, as well as rising dispersion that provides an even better environment for generating real alpha through fundamental, long/short trading. We look forward to the exciting potential of 2019.

Chenavari, December 2018

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