2ND QUARTER ▪ 2019

HEDGE FUND UPDATE

Second quarter 2019 saw most major global equity markets continue their recovery from the sharp fourth quarter 2018 market correction, with the S&P 500 Index reaching record highs in late June. In May, the US unemployment hit a 50-year low, and as of July, the US economy is now officially experiencing its longest expansion in recorded history. Along with record US stock buybacks and M&A activity, all signs point to late-cycle dynamics. In addition, major central banks appear to be attempting to eliminate the business cycle and any potential for losses in equity markets, with the US Federal Reserve recently signaling its willingness to respond aggressively to any further economic weakness or capital markets volatility with rate cuts. While such a move could certainly achieve its objective of extending the current economic cycle in the short run, it would risk exacerbating the next downturn, whenever it eventually comes. Equity markets also seem to be dismissing elevated geopolitical risk between the United States and its rivals. Any further escalation in trade tensions between the United States and China would dampen global economic growth at best and could eventually lead to far worse outcomes. Hostility between the US and Iranian governments has also grown, with the latter now openly touting its uranium enrichment program achievements, in apparent violation of the 2015 Iran nuclear deal.

The S&P 500 Index returned 4.3% for the quarter. All major market sectors were positive with the exception of energy (-2.8%). Interestingly, the communications services (4.5%), consumer discretionary (5.3%), and information technology (6.1%) sectors all outperformed the broader S&P 500 Index even with heightened regulatory scrutiny of the mega-cap technology names that feature prominently in these sectors; the US government announced it is investigating whether Alphabet (Google), Amazon, Apple, and Facebook violated antitrust laws, raising questions about whether these companies are too powerful and should be dismantled. Consequently, large caps marginally outperformed small caps, while growth similarly outpaced value.

Emerging markets equities once again underperformed developed markets stocks (in USD terms) in second quarter. The MSCI Emerging Markets Index returned just 0.6%, compared to gains of 3.6% and 4.5% for the MSCI All Country World Index and the Stoxx 600 Index, respectively.

Hedge funds also fared well in second quarter, with the Hedge Fund Research Composite Index appreciating 1.9%. At the individual strategy level, the HFR Macro (Total) Index gained 2.7%, the HFR Equity Hedge (Total) Index increased 1.8%, and the HFR Event-Driven (Total) Index appreciated 1.4%. As a result, hedge funds are on pace for their best-performing calendar year since 2009.

Many hedge fund strategies have produced disappointing returns over the last several years, leaving investors jaded. In general, investor frustration has led to a reduction in hedge fund exposures, with some investors even eliminating hedge fund allocations altogether. While we sympathize with their frustration, the reduction in hedge fund exposure comes at a time when the economy appears in the later stages of an expansion and with markets beginning to exhibit late-cycle behaviors. Portfolio hedges and diversification now seem underappreciated. Maybe this time it's different, but extrapolating uninterrupted economic expansion and equity market appreciation could prove imprudent. ■

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