THE DRIVE YOU DEMAND

U ACCESS (IRL) TREND MACRO

Quarterly Comment | Q2 2019

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Markets

- Global equity markets were up +3.23% during the second quarter of 2019 and stand at +15.90% YTD, as measured by the MSCI AC World Daily TR Net Index. After a very strong first quarter, Q2 was more volatile with two main elements influencing markets: trade war rhetoric, which initially escalated and then dampened further to the G20 meeting, and central banks, which have been intensifying their dovish stance, signalling possible rate cuts. In short, the market has been willing to ignore the weaker economic data in the hope that central bank stimulus will help avoid a recession.
- Developed Markets (DM) performed strongly in Q2, outperforming global markets on aggregate, with the notable exception of Japan. The S&P 500 TR ended the quarter up +4.30%, while the MSCI Europe gained +4.48%. In terms of styles, growth was once again the winner during Q2, while value and small cap underperformed global markets. Looking at sectors, Financials and IT were the strongest contributors. On the other hand, Energy was the laggard.
- Emerging Market (EM) equities were flattish during this second quarter of the year, with the MSCI EM TR Index being up +0.12%. As US interest rates decrease, a better environment for this asset class could emerge.
- Volatility increased slightly during Q2 but remained at a low level as of June-end (15.08) compared to the last nine months. It briefly topped the 20 mark during the month of May but came back down in June as markets rallied.
- After a very strong Q1, oil contracted somewhat between April and June (-2.78%). Q2 saw a revival in the price of Gold, as weak economic data increased fears of an economic downturn and demand for safe haven assets.
- Markets have been pricing in Fed rate cuts and the potential for further ECB quantitative easing (QE), all of which should be supportive of DM government bonds. However, and although global equities rebounded sharply in June and are off a very good start YTD, there are still a few headwinds that seem to be overlooked by markets so far, among which: (i) the on-going US-China geopolitical tension, (ii) slowing manufacturing data, (iii) early signs of a faltering American consumer, and (iv) a “whatever it takes” monetary policy easing that might not be sufficient to reverse the on-going global slowdown, all this leaving investors overly cautious at this juncture.
- In that context, we believe expanding asymmetric exposure through alternative solutions ahead of rising volatility prospects is a smart asset allocation move today. Indeed, an increased market uncertainty and volatility should provide a fertile ground for our U Access (IRL) Trend Macro fund, which offers access to diversifying risk drivers and exposures by seizing long and short investment opportunities across mainly interest rates, credit and currencies. It has historically shown a limited correlation to traditional assets.

Performance Review

- U Access (IRL) Trend Macro gained +0.70% during Q2, bringing the YTD performance to +1.83% (Class B USD, net to investors). Despite another quarter of continued (and somewhat illogical) appreciation across both risky and riskless assets, the portfolio's emphasis on non-correlated idea generation resulted in another quarter of gains.
- What pleased us most was how the strategy has performed in different market conditions. It made solid positive returns in May when markets sold off globally and modest returns in June, when markets rallied sharply. This is the intended design of the U Access (IRL) Trend Macro portfolio. If one can visualise three states of global beta, (i) one with rapid asset appreciation, (ii) one where risk assets stay flat, and (iii) one where risk assets sell off, we believe this portfolio is well positioned to do extremely well in the second and third states and modestly well in the first state.
- In terms of contribution by asset class, the most profitable part of the portfolio was the interest rates book (+240bps). Long positions in Egypt (+180bps) where duration was added in recent months, and in Nigeria (+80bps) despite what was a volatile quarter for oil, were the largest contributors to performance. A small exposure to Argentina floating rates instruments cost the portfolio 10bps over the quarter.
- Other asset classes detracted to the overall performance, with credit, equities and currencies giving up -90bps, -20bps and -20bps respectively. Losses in the credit book were largely concentrated in short-dated debt in Argentina (-150bps). Corporate credit – where allocation is limited to a maximum of 10% of AUM – was relatively stable over the quarter, contributing a modest +20bps. Sovereign debt in Ukraine also contributed to gains (+30bps). Elsewhere, Equity hedges cost the portfolio -20bps during the quarter.
- On the long side, the positioning of the portfolio worked well in Egypt, Nigeria, Ukraine and corporate credit, as just mentioned. On Argentina and following a visit in March, the investment team anticipated further political uncertainty and made a decision to first hedge and then cut the Argentina exposure. This move helped mitigate losses and provided the team a longer window to reduce that exposure over the remainder of the quarter.
- On the short side, the hedges in US HY and equities were flat to modestly negative, while a short position in front-end rates in the U.S. cost the portfolio, as bond markets rallied aggressively and futures markets began to imply a full cycle of cuts from the Fed.

Portfolio Activity

- There was no material shift in the portfolio's exposure during the quarter, meaning that the core of U Access (IRL) Trend Macro remained a relative value book combining a long positioning in select EM credits and a short exposure to DM rates, high yield and U.S. equities.
- Given the impossibility to predict the exact timing of a resolution to the U.S. - China trade dispute, the investment team has chosen to continue to seek idiosyncratic assets on the long side and market hedges on the short side during this second quarter. This was reflected in a positioning in select EMs (both credit and local fixed income) where both carry and capital gains had the potential to generate substantial upside via fundamental improvements and an easier policy stance from the Fed. Over Q2, this positioning has played out to the plan.

- Over the quarter, the exposure in Ukraine has been increased in both sovereign and quasi-sovereign credit and local rates, as inflation has been decelerating and following the election of Volodymyr Zelenskiy in April. Given the uncertainty around the election outcome, the investment team had a reduced level of exposure, in purely short dated credit prior to the election. However, since the election the new President has appointed a credible economic team and has reaffirmed his commitment to the IMF reforms, which has added to Trend Capital team’s confidence in policy continuity, as Ukraine negotiates its fourth IMF package since the 2014 revolution.
- One important aspect and learning from last year, the team’s research trips to Argentina and Ghana led to timely exit from these markets, avoiding material losses in the portfolio. Indeed, the decision to eschew political risk led avoiding shorting Italian bonds, even though the Italian budget deficit was exactly what the investment team forecast at the beginning of the year. The team was also quick to exit a short position in U.S. rates, as they were cognizant of the momentum on the other side of the trade.

Outlook & Positioning

- Given the uncertainty associated with the timing of a trade deal, and the extremely tight valuations of risk assets in the developed world, Trend Capital’s team continues to focus on idiosyncratic sources of alpha while offsetting or managing risk with market hedges in DM. These idiosyncratic ideas just happen to be in EM today, but even here the team remains very cautious, as they do not want straightforward EM beta given how correlated risk assets are around the world. The team is then explicitly seeking less crowded fixed income markets where real rates are high, inflation is declining and policy rates are coming down. This provides a large margin of safety and substantial potential for capital appreciation.
- For its base case, the investment team expects the Fed to cut interest rates by 25bps in July and another 25bps in September, with the rationale of economic uncertainty and inflation-targeting. The current environment – i.e. a truce on trade with insurance cuts by the Fed – would be helpful for risk assets and particularly bullish for EM. These are the conditions the portfolio operates in today, bearing in mind that, obviously, the process of trades negotiation will go through periods of uncertainty.
- Looking precisely at the portfolio positioning of U Access (IRL) Trend Macro today, the key trades are as follows:
  - Three main themes represent the “risk-on” component of the portfolio, namely (i) Fed rate cuts & IMF driven prudent policy, (ii) EM credit select opportunities, and (iii) Stable oil prices. The first one is played through local rates positions in Egypt, Ukraine and Kenya. The second one is implemented through corporate positions in Ukraine and China. The third one is made of partially hedged Nigeria T-Bills.
  - Two main themes represent the “risk-off” component of the portfolio, namely (i) China trade tariffs and (ii) Market sell-off. The first one is being played through long China rates & short Taiwan Dollar. The second one is implemented through shorts in high yield credit and U.S. equity.

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