Alternatives

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Hedge funds after the Trump trade

Full house or house of cards? For hedge funds, U.S. politics could matter quite a bit. Even if financial markets remain surprisingly sanguine for now.

The U.S. president, it seems, can barely catch a break. Many of the recent twists and turns would appear far-fetched, if they were taking place in the fictional TV series House of Cards. Firing the director of the Federal Bureau of Investigation (FBI) falls squarely into that category. So does the appointment of said director's predecessor as special prosecutor to look into possible ties between Russia and the Trump campaign. Has Donald Trump, as he put it, been subject to a witch hunt? Or did he "obstruct justice," as a recent headline in a New York Times editorial asked?

Either way, our view is: Calm down, at least as far as short-term investment implications are concerned. As Frank Kelly, Deutsche Bank's Head of Public Affairs in the Americas, points out: "Unless there is hard evidence of a serious crime, there is little chance of impeachment. Any impeachment process would have to start in the House of Representatives. If they vote to impeach, and only then, the matter moves on to the Senate. Basically the House acts like the prosecutor; the Senate is the jury." With Republicans controlling both the Senate and the House, impeachment is still a very remote prospect.

While Washington twiddles…

Recent revelations have certainly dampened the mood on Wall Street. Investors are understandably asking themselves the long overdue question whether the so-called Trump trade is finally over. We would argue that the very term “"Trump trade” " is rather imprecise.

The Trump trade actually started well before the elections. The older term for it is also more accurate. We have been dealing not so much with a Trump trade as with a reflation trade – just look at the rise not just in global equities, but also in interest rates and inflation expectations since the middle of 2016. The U.S. elections merely provided an additional boost. That was not so much due to Trump alone. As my colleagues across our investment platform repeatedly argued at the time, it was more a matter of winning control of both the United States Congress and the White House. Back at the start of 2017, it looked fairly plausible that the newly elected president would have more legislative accomplishments to his credit. Given the setbacks on healthcare reform, those hopes have since receded on some fronts – from increased infrastructure spending to tax cuts. From a market perspective, deregulation stands out as the main bright spot. This might not make up for the disappointment if Trump fails to deliver. Indeed, our previous concerns that it is getting harder to see meaningful corporate-tax reform passed soon look increasingly justified. While we still expect a corporate-tax reform

Expectations in a nutshell

- At least from a financial-market perspective, it is too early to lose your calm.
- The stock-picking environment is clearly improving.
- Our outlook for discretionary macro and CTA strategies remains positive.

to be passed until the end of 2017, we see the uncertainty around this base-case scenario increasing.

… markets are still looking for a new direction

However, blaming Trump for the recent equity-market weakness is just as misleading as the credit he got for the Trump trade. Once again, Trump only provided the trigger. This has less to do with the daily headlines about the president than with a backdrop of reflation hopes already deflating. It is worth remembering that since December, interest rates have been moving sideways and the U.S. dollar lower. Moreover, the rally in equities we saw in the first quarter arguably had plenty of other triggers, beyond seemingly solid U.S. fundamentals following a strong January jobs report. In particular, we had a strong U.S. corporate-earnings season. Significantly, European earnings also showed positive momentum with upwards earnings revisions at a 5-year high and perceived political risk has shrunk following the French and Dutch elections. Moreover, the stronger global macro data in general, and China in particular, continue to provide a supportive backdrop for most risky assets.

What it all means for hedge funds

Against this backdrop, the environment has clearly improved for stock picking; in particular pair-wise correlation (such as correlation of one company's stock with another's) has been falling and dispersion has been rising. That has led us to upgrade the outlook for equity-market-neutral investing strategies to positive. Long/short equity strategies were upgraded too, but only to neutral, as we felt the need to temper our marginally negative outlook for market direction.

Meanwhile, merger arbitrage is getting harder, as merger spreads on announced takeovers have compressed to relatively tight levels. Deal counts and, to a lesser extent, deal volumes have also shrunk. Given the somewhat more limited opportunity set, we have had to adjust one of the drivers we are using to assess event-driven investing strategies. As a result our outlook for these is neutral.

Which takes us to the elephant in the room: volatility. Of course, this shows up in our assessment of several of the trading strategies we are watching. For example, the tighter levels of merger spreads may reflect some complacency from investors as evidenced by lower volatility levels.

However, we are sticking to our positive outlook for discretionary macro strategies. This is because we believe that market volatility should recover sooner rather than later from current, unusually low levels across equity markets. Commodity trading advisor (CTA) strategies should also benefit from any bounce back in volatility, as well as from the possibility of persistent trends across asset markets. Of course, the timing and immediate causes of a rise in volatility are anyone's guess. While troubles for Trump and Brexit-related setbacks may be plausible potential causes, continuing low volatility cannot be ruled out.

Glossary

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

Commodity trading advisor (CTA)

A commodity trading advisor (CTA) is an individual or organization providing advice and services related to trading in futures contracts, commodity options and/or swaps.

Correlation

Correlation is a measure of how closely two variables move together over time.

Discretionary macro strategy

Discretionary macro strategies are investment strategies that aim at exploiting macroeconomic, policy or political changes.

Equity-market-neutral investing strategies

Equity-market-neutral investing strategies aim to deliver superior returns by balancing stock picks as to avoid market-risk exposure.

Event-driven investing strategies

Event-driven investing strategies seek to exploit pricing inefficiencies that may occur before or after a corporate event, such as an earnings call, bankruptcy, merger, acquisition or spinoff.

House of Representatives

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state’s representation is based on population as measured in the previous Census.

Long/short equity strategies

Long/short equity strategies are investment strategies that take a long position in individual equities or sectors that are expected to gain in value and a short position in those that are expected to fall in value.

Merger arbitrage

Merger arbitrage is a type of hedge-fund strategy where the investor tries to gain from the difference in the price a buyer of a firm agrees to pay, and the stock price after the announcement of the acquisition.

Merger spread

The merger spread is the difference between the price a buyer of a firm agrees to pay and the stock price after the announcement of the acquisition.

Reflation

The term reflation refers to rising prices after periods of severe economic weakness.

Trump trade/rally

The terms "Trump trade" or "Trump rally" describe the strong movements in various asset prices in the weeks and months following the U.S. elections of November 2016.

United States Congress

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representative, consisting of 435 Representatives and 100 Senators.

United States Senate

The United States Senate is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

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