



# Quarterly Letter

O'Connor Global Multi-Strategy Alpha | [Third Quarter 2023](#)



In the second quarter fears over the US regional banking system faded quickly and economic data was resilient, resulting in a decline in the probability of a recession this year.

Core inflation remained persistent though and central banks continued to hike interest rates, which weighed on sovereign bonds as the Bloomberg Global Aggregate Treasuries Total Return index was -2.4% in Q2 and +0.6% YTD. In spite of that backdrop, risk assets generally performed well, with the S&P 500 advancing +8.7% in Q2 in total return terms, its best quarterly performance since Q4 2021, putting it at +16.9% YTD. Some of the excitement around generative AI has inevitably helped and has been a prominent theme in recent months.

In Q2, we saw the most positive performance in our Credit strategies. Credit spreads tightened given the better than expected data and having underperformed equities in Q1 due to the banking turmoil. Following JP Morgan's acquisition of First Republic Bank in April, regional banks have been one of the best performing sectors. Similarly, European bank AT1s have been a top performing sector in Q2 following the resolution around Credit Suisse, assurances from regulators on AT1s, bank earnings, and capital-based calls of existing AT1s. The debt ceiling resolution in the US passing without incident further helped spreads tighten and we have seen companies take advantage of this with a wave of issuance.



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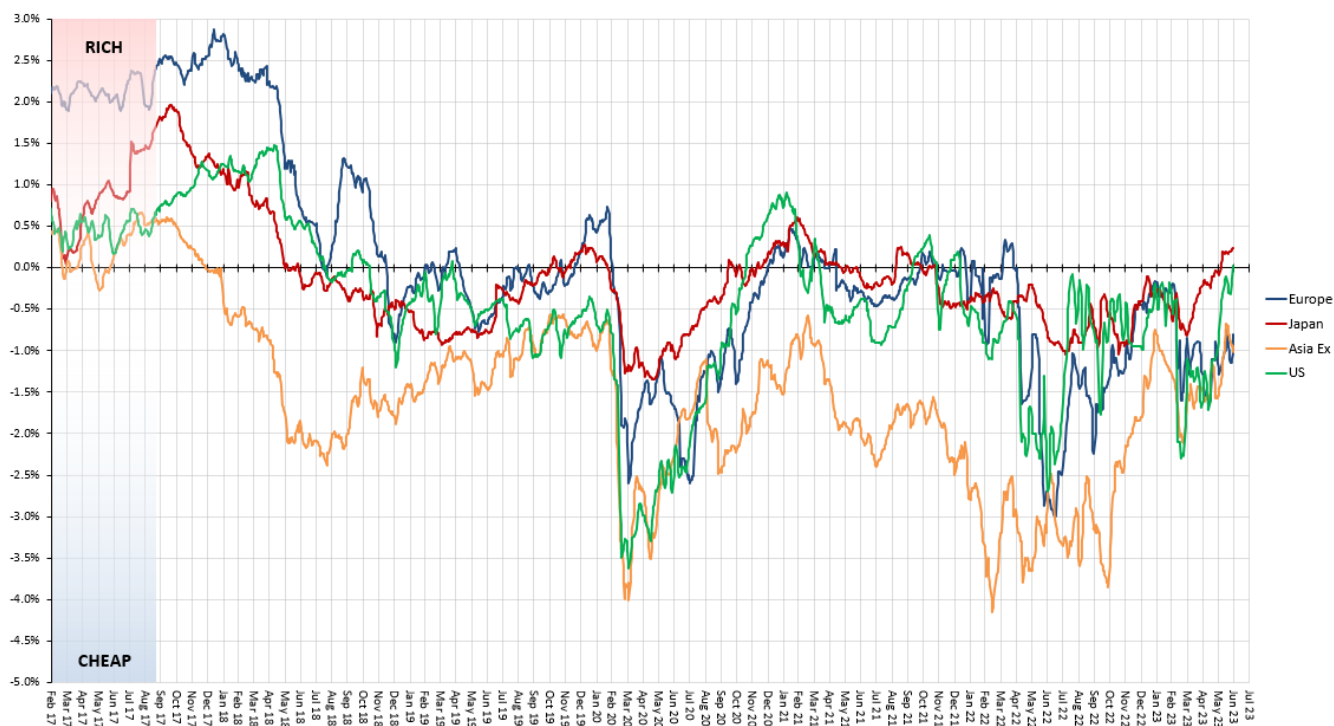
Given current spreads and a daunting maturity wall in the next few years, we expect corporate refinancing issuance will pick up. However, it is worth noting the increasing amount of borrowing taking place in the private credit market. In a similar vein, we have seen companies and private credit capital look to take advantage of loose credit documents to carve out assets to fund liability management exercises – this environment creates both opportunity and risk for investors and reinforces the importance of fundamental and technical analysis. While credit beta has continued to underperform equities, spreads are through their pre-QE non-recessionary averages, and the consensus sentiment and positioning have shifted from bearish to bullish. This makes it more difficult for beta to outperform and we expect increased volatility and earnings-based dispersion through the rest of the year.

Our convertible strategy continued its strong performance in Q2, with the catalyst for the overweight thesis continuing to

materialize. Low coupon/no coupon converts issued in the low-rate regimes of 2020 and 2021 morphed into low dollar/busted converts in late 2022 and 2023 due to either one, or a combination of: an increase in treasury rates, spread-widening, or a decline in formerly high flying fintech and biotech stocks. In our view, bonds trading in the \$30/40/50/60 range provided more protection in an adverse scenario, have positive convexity to any M&A activity due to their par change of control options, and were ripe for liability management exercises.

We have seen companies wisely address their cap stack and buy back low dollar bonds at a premium to market. We have also been the beneficiary of M&A activity that resulted in well discounted bonds being taken out at par. Credit tightening and a lack of convertible supply has also been supportive. Given the strong rally and current spreads, we plan to take advantage of this move to feed the bid and be positioned to add on any pullback.

Figure 1: Jefferies Fair Value Tracker



Source: Jefferies, Kynex, Leversys. Europe, Japan, Asia (excluding Japan) and US indices represent a basket of convertible bonds per region. The Asia (excluding Japan) issuers are convertible bonds where the underlying common equity is listed in a qualifying exchange. Rich and cheap values for convertible bonds are determined through comparison of convertible bond prices against fair values which are calculated and maintained by Jefferies through use of dynamic inputs. . Data as of 31 July, 2023. Reproduced with permission.

It has been an eventful few months in Merger Arbitrage following a challenging Q2 where US Federal Trade Commission (FTC) and UK Competition and Markets Authority (CMA) rulings around key situations weighed on various spreads. Yet in recent weeks we have seen a complete about turn from the CMA and a court ruling go against the FTC; our team has been adamant that anti-trust enforcement is ultimately governed by rule of law and precedent cases, making these reassuring datapoints. We still observe several transactions with potential regulatory risk trading at wide spread levels which we believe presents an attractive opportunity set.

In Long/Short Equity we have seen improved performance from our Asian strategies after a difficult Q1. Markets reacted positively to recent headlines out of the Chinese Politburo July meeting, given more announcements related to easing of the housing market and efforts to promote consumption.

Our China Long/Short team is taking a more conservative view on the growth outlook for the remainder of this year as we see China decoupling from its previous growth engines of real estate investment and infrastructure fixed asset investment. Instead, we are focusing more on alpha opportunities relating to themes such as winners and losers from generative AI, and leaders in the manufacturing sector who could gain global market share given their favorable cost positioning, stronger brand image and improved organizational flexibility. The recent addition of analysts in technology and advanced manufacturing to the team have been timely in this regard.

There were no other changes of note to the investment strategies in the quarter, and we feel our current teams are well positioned to take advantage of a backdrop in H2 where there should be less of a beta component to returns.

As we enter the back half of the year, we believe a few themes and data points will be in focus.

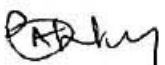
Inflation has declined throughout the year leading to multiple expansion, peak Fed thesis, and the market pricing in an imminent Fed pivot in early 2024. The comparables become more difficult in Q4 and an uptick in inflation data, coupled with historically high valuations, could reset the narrative and pricing. While the Fed will continue to respond to data, given the current employment rate, there is a strong case any pivot is pushed out further in 2024.

So far this year, market returns have been dominated by a few stocks; however, beneath the surface we have seen an increase in stock dispersion. Given the starting point on valuations, earnings will be increasingly important to justify or refute valuations. Historically higher dispersion regimes are ripe picking for equity long/short strategies, providing fertile alpha opportunities.

While it is not certain we have reached peak rates, it is likely we are closer. Rate volatility has remained elevated over the past 17 months, and the rate and equity volatility divergence has been historically wide. We believe this relationship will begin to normalize creating more convex opportunities between equity/debt trades.

Beta was the star performer in the first half of the year. Inevitably as prices and valuations increase, the bar of additional beta performance becomes higher. We believe the second half will be an alpha opportunity, with more long/short opportunities available to capture.

As always, we thank you for your continued support.



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