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With the federal funds futures market now pricing a peak rate of above 5%, fears about future inflation and monetary policy are set to remain in the driver's seat. (ddp)

Hedge funds to remain relevant in uncertain environment

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Global equities started 2023 strongly, with the MSCI All Country World index recording a 7.1% gain in January. Hedge funds, however, failed to capture much of the upside despite a positive performance.

The HFRI Fund Weighted Composite Index rose 2.8% last month, and macro funds—which led the outperformance last year—gained just 0.3%.

However, such moves should be viewed in a broader context—global equities fell 19.8% last year, while hedge funds overall declined just 4.2%. Macro strategies delivered a return of 9%.

While market moves have reflected optimism on China's reopening, the likely end in sight of the Federal Reserve's hiking cycle, and a better growth outlook in Europe, we believe hedge funds will continue to play an important role as a diversifier for portfolios this year.

Inflation risks remain amid tight labor market. Recent inflation data indicate that price pressures have moderated, but the still-tight US labor market, evidenced by the nonfarm payrolls released last week, remains a concern for policymakers. Fed Chair Jerome Powell this week said the central bank has a "significant road ahead" to cool inflation, while some other Fed officials had a hawkish tilt in their recent remarks. With the federal funds futures market now pricing a peak rate of above 5%, fears about future inflation and monetary policy are set to remain in the driver's seat.

Risks around earnings are skewed to the downside. The US reporting season is nearing the finish line, with aggregate earnings missing forecasts by 0.5% and earnings per share on track to decline by 5.2%. The effect of the Fed's 425 basis points of rate hikes last year, along with the 25bps increase earlier this month, will continue to feed through to the economy and corporate earnings, in our view. Globally, we expect earnings growth to turn negative this year and equity markets to be volatile.

Divergence in growth outlook underscores importance of active strategies. The US ISM manufacturing PMI in January fell further to its lowest reading since May 2020. With the activity indicator registering the fifth monthly decline in a row, we expect the growth outlook in the US to remain below trend amid macroeconomic headwinds. Meanwhile, China's rapid reopening and a mild winter in Europe should create opportunities within those respective markets. Being selective and quickly shifting allocation to the best-performing areas of the wider market will therefore be key to benefiting from the inflection points in growth.

As one of the most flexible and actively managed financial investments, hedge funds can help investors generate alpha, diversify portfolios, and reduce drawdown risks. We continue to like the ability of macro managers to take long/short positions across a range of asset classes, regions, and financial instruments; equity market neutral funds and their uncorrelated returns; and the diversified approach and versatility of multi-strategy funds.

Investors, however, need to consider the risks involved, including partial illiquidity, leverage, complexity, and high return dispersion among managers.

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