Flash Notes – Fund Update & Manager comments

March 2020

H2O Adagio – Global Macro

The fund has been hurt since the beginning of the year and more specifically over the last few days. Amongst other things the spread widening between the Bund and the Italian government bonds, the short duration exposure to the US curve and the rise of the CHF and JPY have all been the main detractors. As always, when there is a sudden rise in volatility, the portfolio tends to be subject to drawdowns. But as a value manager, Bruno Crastes view this period as opening to a great set of opportunities.

Portfolio Managers team's latest comments.

Our portfolios were short safe-haven assets, such as US Treasuries, which surged more than 6% following the collapse of long-dated US sovereign yields to record lows, effectively now pricing-in a recession in the US.

Similarly, risk-off currencies such as the Japanese's yen and the Swiss franc, which were already expensive before the crisis, were sent close to their historical highs. These currencies, which exhibit negative carry, were previously sold by market participants in order to finance carry trades on higher-yielding risk-on currencies, such as emerging or commodity-related currencies. The current crisis, and the losses it leaves in its wake, forced investors to cut these arbitrages, buying back their shorts on safe-haven currencies and as a result propelling them higher. A similar phenomenon is at play on the Euro, which surged against the greenback even though nothing fundamental supports it. In this context, our directional long US dollar position was unable to protect the portfolios as its gains against risk-on currencies (Australian dollar, Korean won, Indian rupee) were more than offset by its losses against the risk-off ones.

US Treasuries and dollar aside, another source of underperformance came from the Italian sovereign bonds, which should have naturally benefitted from the rise in risk-aversion but were aggressively sold as Italy became the epicentre of the epidemic in Europe.

Amongst the diversification strategies, on currencies, our long Mexican peso position against US dollar detracted from performance as recession expectations in the US and the oil price plunge weighted heavily on the Mexican currency. The same causes had the same effect on the Norwegian krona.

Finally, on equities, our strategies underperformed as well. Not only did European equities suffer more than their American counterparts, but cyclical sectors – and European banks in particular – fell more than defensive ones. The outperformance of blue chips against US small and midcaps is among the few strategies to come out positive.

In short, it took less than three weeks for assets that were previously considered expensive to become exorbitant, and for those that were previously affordable to become remarkably cheap. In such context, our "value" stance took a significant hit, against which the US dollar could not provide enough protection. While this explains the recent negative performance – the magnitude of which may appear disconcerting at first – it does not reflect a misdiagnosis on the global macroeconomic forces at play today.

What are the next possible steps from a portfolio management standpoint, and what's the opportunity in staying invested in our funds?

PARTNERS

H2O Adagio – Global Macro

The market hysteria over the past few days no longer reflects the health crisis triggered by the virus. If anything, this has improved markedly in China and Korea. Instead, on Monday March 9th, financial news centred exclusively around the oil price drop, and tomorrow it is sure to be about something else. We must therefore extract the market from this anxiety-provoking spiral it has fallen into, which may cause a recession, at least technically.

Only a swift and concerted effort from governments (via targeted fiscal policy measures) and central banks would yield the necessary impact to calm markets. While it is true that, aside from the Fed, the ECB and the BoJ have limited ammunition to cut rates any further, they can easily put into place asset purchasing programmes in order to provide a put for risk assets. This is why we believe that with ECB intervention, the recent widening of Italian government debt and European credit spreads are likely to hit a ceiling. Likewise, with inflationary pressure now in the doldrums following the collapse in oil prices, the Fed is now free to use the one percent it has remaining to possibly offer further cuts, while maintaining its asset purchasing program.

Such a sharp spike in volatility, to levels that are now hardly sustainable, clearly illustrates the disconnect between the current market panic and the underpinning macroeconomic forces at play. Such an environment favours selling short-term volatility (which we have been doing on several currencies, including NOK, SEK and ZAR) while increasing exposure to certain commodity currencies (AUD & NZD) via options as a way to benefit from the gradual recovery in economic activity in Asia as the epidemic recedes.

Overall, the considerable disconnect we see between the current market panic on the one hand, and the transitory nature of the viral epidemic, coupled with sound growth prospects further buoyed by the recent oil counter-shock on the other, highlights the opportunities that may lay ahead for those who remain invested in the funds.