ARIA | CAPITAL

Investment Insight

Friday, 24 April 2015

Concentrating on concentration: *Hedge funds have reported a strong start to 2015 with Discretionary Macro and CTA managers proving most successful. Hedge fund managers have been able to take advantage of relative value opportunities in fixed income and FX, as well as long positions in US European and Japanese equities.*

However, this success has resulted in some crowded hedge fund trades as multi-strategy funds desperately seek liquidity in the liquid portions of their portfolios and exit those more liquid equity positions. While such scenarios often prove to be short-lived, they can be quite unexpected and volatile while they are unfolding.

In in this week's ***Inside Track*** *we hear from the team at Ivory Investment Management who closely monitor the hedge fund industry when making investment decisions in their long only and long/short strategies, and who are particularly sensitive at present to the crowded names.*

Baby Bulls. *China's stock market has experienced remarkable growth recently. However, it's not just share prices that are soaring, it's investor headcount. A surge in novice investors, eager to spend their newly accumulated wealth in a rising stock market, is further fuelling a market rally stoked by anticipation of the latest economic stimulus package. In* ***Pic of the Week*** *we examine the scale of the issue.*

The Inside Track

Ivory Investment Management, L.P. is a research-intensive, fundamental value-based investment firm founded by Curtis Macnguyen in 1998. Their recent review of the first quarter of 2015 including the following comments on their Long/Short Equity strategy.

Oil Price Volatility - We anticipate higher oil price volatility to remain for the next few quarters. Besides the obvious factor exposure of oil-sensitive equities (both positive and negative), we may also see some impact of oil price trends on U.S. economic growth and inflation, which could impact value and growth styles, interest rate sensitive names, as well as concerns over financial leverage and credit spreads since energy-related companies make up a disproportionate amount of high yield credits.

China Slowdown - The outlook on China continues to be concerning to us in light of the lack of real economic response to recent stimulus measures. While Chinese equities currently appear to be in their own bubble-like universe as they discount a fairytale-like reaction to stimulus, the fundamentals are a different matter. We anticipate that further and increasingly aggressive stimulus efforts, both monetary and fiscal, over the next few months from the Chinese authorities are quite likely. We believe these efforts to re-stimulate could have a disproportionate impact on materials stocks, commodities and emerging markets. If such additional measures fail to produce any noticeable re-acceleration in growth, we could in turn see a potentially negative tail event in China and related emerging market plays. This downside scenario could easily lead to a global de-risking scenario and rotation into long-term Treasuries, the U.S. dollar, defensive sectors, and higher quality stocks.

U.S. Interest Rates - After yet another slow seasonal start to the year from one-time and temporary headwinds such as energy sector cap ex cuts, the West Coast port strike, drop in auto production, and heavy snowfalls, we anticipate that U.S. macro data will improve noticeably during Q2. We believe that in particular employment data will remain strong in the U.S., driving down the unemployment rate into and throughout the summer. Add in the growing risk of accelerating wage growth, and we see a higher probability of Fed policy moving soon.

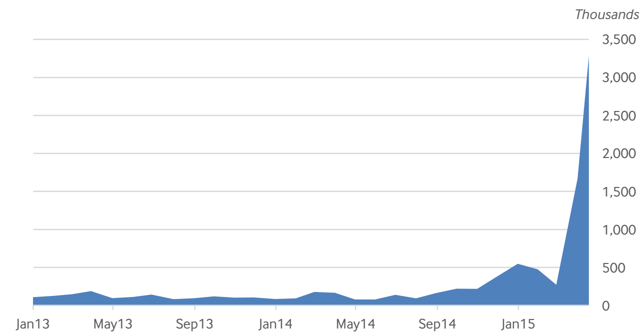
Emerging Market Risks/U.S. Dollar - We see rising risk from several emerging markets where there is a high propensity for a funding crisis and/or currency crisis. Several large emerging markets that rode the benefits of the commodity super-cycle also have issued a substantial amount of foreign-currency denominated (particularly U.S. dollar) debt. As these countries' currencies continue to weaken, this move increases the debt service obligation and worsens the financial position of these countries. So far, these asset markets have remained relatively well behaved, but we cannot help but worry what will happen as the Fed initiates its long path to rate normalization.

Hedge Fund Concentration - With some of these highlighted risks above creating heightened volatility around interest rates, currencies, and oil prices, we estimate there is above-average risk for a major deleveraging event among hedge funds, especially those in concentrated and illiquid positions.

Pic of the Week

The Shanghai Composite index is up over 120% since the beginning of 2014. This is way ahead of the growth rates being reported by the companies that make up the index, meaning that the market has become a whole lot more expensive. One of the remarkable factors in this growth, whether cause or effect (but probably both), is the huge increase in market participation by retail investors. As the chart shows, the growth in participants is so staggering that it is quite likely the Chinese authorities will introduce controls to cool the jets. When that happens, a whole new generation of "investors" could experience falling prices for the first time in their short investment careers which could certainly lead to a very large wobble for the market.

Newly added accounts on the Shanghai Stock Exchange



Market View

	Last 7 days	YTD	5Y Ann.
Global equities	+0.1%	+7.4%	+8.4%
US equities	+0.4%	+2.6%	+11.7%
European equities	-1.0%	+18.7%	+8.4%
Emerging market equities	+1.1%	+10.2%	+0.6%
Irish equities	-1.2%	+19.9%	+12.6%
Commodities	-0.4%	-2.8%	-5.7%
Hedge funds	-0.5%	+2.9%	+1.1%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+0.7%	-0.6%	+4.1%
Germany	+0.2%	+0.3%	+1.4%
USA	+2.0%	-0.1%	+2.4%
China	+3.4%	+1.4%	+7.0%

Currencies	*Current*	*YTD Δ*
EUR:USD	1.08	-10.6%
EUR:GBP	0.72	-7.5%
EUR:CNY	6.70	-11.2%
GBP:USD	1.51	-3.4%
Bitcoin	231.74	-27.0%

Week ahead: Key events

27/04 Dallas Fed Manufacturing Activity
28/04 Japan Retail Sales & UK GDP
28/04 Ireland Property Prices & Retail Sales
28/04 US Consumer Confidence
29/04 EU Confidence Indicators
29/04 Ireland Unemployment & US GDP
30/04 EU Unemployment & CPI
30/04 US Initial Jobless Claims
01/05 China Manufacturing & Non-Manufacturing PMIs
01/05 US Manufacturing & University of Michigan Sentiment

Commodities	*Current*	*YTD Δ*
Gold	1,192.57	+0.7%
Copper	5,943.00	-6.7%
Oil	64.60	+5.5%
Wheat	500.50	-16.2%

Central Bank rates	*Current*
Eurozone	0.05%
USA	0.25%
UK	0.50%

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