

FRM EARLY VIEW

JULY 2014



MARKETS

We believe that we are now in a waiting game – waiting for data, waiting for direction, waiting to see when and by how much markets will react to the known path of Fed tapering. Markets are still sustained by the drip of Central Bank liquidity but the liquidity flow is slowing in the US which is what matters most. And the data is not yet signalling that we should be alarmed although there are plenty of sceptics who believe that the Fed risks falling behind the curve. We do not yet see any evidence that supports conclusively the notion that the day of reckoning has drawn much closer. Fed Chair Janet Yellen has lost no opportunity, either in the June FOMC minutes released on the 9th July or in her testimony on the 15th July and again in the 30th July statement, to reiterate the message that steady economic growth is supporting gradual improvement in the labour market, and that inflation is moving somewhat closer to the Committee's longer-run objective. From the Committee's perspective, economic reality and the Fed's forecasts are converging satisfactorily. Crucially payrolls are growing at a steady and healthy pace without any adverse inflationary impact on wage growth, and the labour force participation rate is only increasing marginally, certainly nowhere yet near to the point which we believe will satisfy the Fed's employment objective. But old style bond vigilantes still number themselves among the unemployed and may likely continue so for some appreciable time to come. Despite the rebound in US Q2 GDP, real GDP and Final Sales are still firmly stuck in the narrow range that has oscillated around 2% for the last 4 years. As yet there seems no obvious economic catalyst for a major market correction, although there are plenty of ongoing geopolitical risks which could at any time erupt into more serious crises. So in illiquid August trading we believe there is scope for market setbacks but we still do not foresee an imminent major correction.

Outside the US the picture is quite mixed. Against all expectations Europe has succeeded in agreeing a tough sanctions regime against Russia, joining with the US in moves against the Russian financial system. This will be painful for continental Europe and the UK financial sector, including the bank of Mayfair property, but much more so for Russia. Assumptions that German economic self-interest would take precedence over confronting Russia for its alleged complicity in downing the Malaysian airliner over Ukraine have been confounded. Recent company results have served to reinforce the understanding and acceptance in Europe that in dealing with Russia there is no gain without pain. Poor company results, inflation numbers printing well below expectation and renewed signs that the financial sector is still selectively experiencing stress all point to a sluggish period ahead. So in Europe we can be confident that the ECB has no alternative but to continue to provide a plentiful supply of liquidity. In Asia the story is apparently simpler: China up, Japan marking time for the moment. China's PMI has just printed a two year high, responding in part to the recent let up in monetary tightening. In Japan Q1 Industrial output fell 3.3%, more than twice median forecasts, reaffirming fears that higher consumption taxes are proving more damaging than even the most pessimistic expectations. So further easing from the Bank of Japan remains

anticipated at some point in the autumn. China is also benefiting from the A/H trade which is another marker in the liberalisation of the market which anticipates greater foreign participation in the future.

Globally the Central Bank liquidity environment remains intact and will continue to be the basis for a positive bias for risk assets.

One place where liquidity is notable for its absence is Argentina. The latest developments in the defaulted bonds story make lurid headlines in the financial news but the Argentina story is something of a sideshow compared to the bigger market concern about how the Fed will transition from the end of QE to a more normal interest rate environment. What is happening in Argentina is entirely consistent with our expectation of regime change next year and a positive outcome for Argentinian assets in the future. A worse situation now probably hastens a better outcome later. The price action is not what might be expected from a defaulting sovereign – prices moved up in response to positive expectations prior to the default announcement, but have not retreated as much afterwards as might be expected, which reaffirms our positive expectations.

Compared to the monetary factors driving markets, the geopolitical backdrop is far from benign. The sanctions regime against Russia does not permit an obvious face saving exit route for President Putin, so it is probably prudent to expect East West tension to increase before it diminishes. And the Middle East continues its relentless cycle of serial turmoil – Syria, Iraq, now Gaza. It is remarkable that markets continue apparently to be impervious to the kind of events that historically would have caused much greater concern. All of these geopolitical flashpoints have the possibility of erupting into something more serious.

In summary, we believe that Central Bank support remains key to maintaining elevated asset prices, and prices may yet become more elevated despite month end jitters. Market support also comes from M&A activity and the buyback calendar. But we are mindful of the fact that liquidity is poor in many markets, volatility is low despite the month-end spike and geopolitical risks have the potential dramatically to destabilise the status quo. But the current stable or falling longer term rates do not imply that global economic growth is set to accelerate, and in the US, inflation and consumption expenditure appear unlikely to force the Fed's hand earlier than current market expectations. So our mantra "Follow the money" remains unchanged but now carries a health warning. As the Fed withdraws support, so we in turn become more cautious.

HEDGE FUNDS

The global hedge fund industry had small negative returns in July. Both Global Macro and Relative Value strategies worked well producing positive returns, but equity and credit based strategies had a more difficult month.

Credit managers had a mixed month in July with dispersion between different strategy returns, but all in a contained range. In general long biased credit managers underperformed, Credit Long-Short managers ended the month with flat returns, while managers running less liquid portfolios outperformed. US ten year treasury yields ended the month marginally higher, but experienced some volatility along the way, and high yield credit spreads widened. The market was not helped by Janet Yellen's comment that valuations of high yield bonds "appear stretched". Following this comment outflows from the high yield market accelerated, with EPFR data indicating that cumulative flows are now negative year to date. The underperformance of longer biased managers in such an environment is not a surprise. Credit Long-Short managers were less affected and ended the month roughly flat. In the CMS market, the setback from the continued weakness of the European banking sector was exaggerated by the low liquidity in the market. However, this presented an opportunity for a number of managers who realised the extent of the selloff was overblown and used this as an entry point. For a long time our message has been that we feel the risk return profile for long biased credit investing is unfavourable. In current conditions it is also very difficult to see how Credit Long-Short managers will generate strong returns, and we are becoming less positive on the opportunity set across credit managers.

Equity Long-Short performance was mixed across regions. In the US, there has been an improvement in the environment for managers. Earnings season and higher corporate activity helped shift the focus from macro factors to company fundamentals. As a result, despite the lingering geopolitical risk, and continued nervousness in markets around data releases (and the Fed's reaction), company earnings announcements were the major driver of equity moves. Accordingly manager returns were a function of stock picking. Overall the region will have generated small positive returns.

The story was different in Europe, which remains a difficult region for Equity Long-Short managers. The situation in Ukraine, and the sanctions imposed on Russia, is affecting Europe, and the fact that indices in the region have lagged on a global basis is not surprising. This was not helped by the continued weakness in European banks following the final week of June. Banco Espirito Santo experienced losses much bigger than the market expected, and is in need of immediate recapitalisation. While this is an idiosyncratic event, it has provided a reminder to the market of the upcoming AQR, and, combined with weak earnings releases in the sector, contributed to a poor month for bank stocks. Managers had a negative month in the region, with both beta and single stock selection working against managers.

Statistical Arbitrage managers had a strong month in July, but as with Equity Long-Short managers this varied by region. Asia in particular was a strong region, with value and quality factors generating strong returns. The US was weaker, and European strategies produced mixed performance, though interestingly outperformed US based strategies; the opposite of Equity Long-Short.

One of the intriguing aspects of hedge fund index returns in July is the negative performance of the HFRX Event Driven Index (-0.96%). A number of the larger trades in the space did well in July, deal spreads generally tightened, and US equity markets posted only small losses. The funds that we actively monitor did well across positions, with the only large position to result in losses the Covidien-

Medtronic deal spread. The environment remains positive for managers. Deal activity is still very high, in line with recent months, and as a result the capacity of merger arbitrage trades has increased, and deal spreads have widened. Given the possibility that the US may attempt to alter tax rules to halt the current rush to implement tax inversion deals there is a chance that some companies push forward with merger activity in the near future.

Discretionary Macro managers had a positive month of performance in July, with a number of managers generating large returns. There has been a clear trend over the last few months of increasing exposure to emerging market assets within Discretionary Macro portfolios. This was a positive in July as both emerging market equities and rates rallied. The other theme that worked for a number of managers was the increase in short interest rate exposure at the front end of the US curve. Equity exposure was mixed, with Japanese exposure a positive, while long positions in European equities were a detractor.

Emerging Market managers continue to generate positive returns. Longer biased managers who have maintained a high net exposure once again outperformed over the month as equities and rates rallied in the majority of emerging markets. Long equity positions in Brazil, China, and India were all positive contributors to performance. There was some volatility on the 31st as US GDP strength caused volatility in interest rate markets, which seemed to feed through to emerging markets. The largest event in emerging markets however, was clearly the situation in Argentina. The impact in prices is perhaps not as would be expected in such a scenario however, with a large move up in prices the day before the default. The current liquidity induced calm could continue for some time, in which case the longer biased managers in emerging markets would continue to generate profits. We are concerned however, that there is a particularly fragile balance in emerging markets, and do not think that this late stage in the liquidity cycle is a good time to increase general long exposure. As we have said before, we believe opportunities are in select areas.

Commodity manager performance was positive across the majority of strategies. The USDA report on the final day of June was the driver for the moves in Agricultural markets. The report confirmed managers' bearish view of all three main crops - Corn, Wheat and Soy. Corn prices in particular were affected, dropping 13.7% through July. Agricultural managers were positioned well for these moves, and generated profits from both directional and relative value positions. The result was the most profitable month for the strategy this year. Base metals managers continued to generate profits, primarily from long exposure. The continued strength of Chinese manufacturing data helped prices to move higher. Energy managers with a focus on Natural Gas profited from a large drop in price (-13.5%). A slowly increasing production rate, and perhaps more importantly, a drop in demand due to mild weather in North America, has resulted in increased storage levels.

Managed Futures managers generated mixed performance, with the strategy overall generating small losses. The long standing long developed market equity exposure worked well in the US for most of the month, but the selloff in the final two days was a large detractor from performance. European equity market exposure was also a detractor, and exposure was reduced by a number of managers. Performance in interest rates was mostly a function of the relative exposure to US and European interest rates. Managers have long exposure across the board, so those with greater exposure in Europe generated profits while those with greatest exposure in the US made small losses. Given that we continue to move closer to future interest rate rises and possible equity market reversals, we remain cautious of the strategy for now.

STRATEGY SUMMARY FOR JULY 2014

Strategy type	Estimated return for July*	Comments
Global Macro	+	<p>Managed Futures generated small losses at strategy level. There was no large contributor by asset class to either profits or losses, with the majority either flat or generating small losses. Equity exposure worked well in the US for the majority of the month, but the selloff in the last two days was a strong detractor. European equities were a detractor and exposure was reduced. Long bond exposure was a detractor in the US, but recorded gains in Europe. In commodities, long exposure to soy resulted in losses, but short corn and wheat positions offset this.</p> <p>Discretionary Macro managers had a positive month. Short exposure at the front end of the US treasury yield curve was a positive driver of performance with stronger growth numbers in the US triggering debate on the timing of rates rises. Exposure to emerging market assets was also a positive driver of performance. Unsurprisingly then Emerging Market managers had a positive month. Those with large net long exposure to both equities and bonds were the best performing.</p> <p>Commodities managers' performance was positive again in July. Agricultural managers' generated strong profits as a result of the USDA report on the final day of June. Base metals managers generated profits from long positions which were helped by strong Chinese manufacturing data.</p>
Equity Long-Short	+/-	<p>Equity Long-Short manager performance varied by region in July, with European managers continuing to underperform their US peers. Geopolitical tensions weighed more heavily on European indices given the close ties (in some instances) to Russia. The financial sector, and more specifically banks also hurt manager returns, as several idiosyncratic issues combined to drag down the index; the Eurostoxx Banks Index ended the month down 3% and had a 7.6% peak to trough drawdown. In the US managers look to have ended the month with small profits, mostly as a result of stock picking. Aside from the final two days, the month was characterised by fundamentals dominating Macro concerns to drive stock prices. Those managers focussed on large caps outperformed those focussed on mid or small caps due to beta; Russell 2000 -6.1%, S&P 500 -1.5%.</p>
Credit	+/-	<p>Credit markets were negative in July, with credit spreads widening over the month and benchmark yields marginally higher. Performance varied by strategy in July, though there were very few outliers from a small range: longer biased credit managers' underperformed, Credit Long-Short managers were roughly flat overall, while those managers focussing on less liquid product recorded small gains.</p> <p>The high yield market was not helped by Janet Yellen's comments regarding valuations. This triggered outflows from the market as investors evaluated portfolios. In some areas the moves were exaggerated by the lack of liquidity. While this gives us a further indication of the risk in some areas when the cycle does turn, it gave a number of managers attractive entry points to trades. Fannie Mae and Freddie Mac preferred shares both popped up in value mid-month and benefitted a number of Credit Long-short managers. This was a result of a new bill seeking to wind down current activities, but allow the sale of the entities; an improvement of a sale from which 100% of the proceeds pass to the treasury.</p>
Relative Value	+	<p>Statistical Arbitrage managers look to have ended the month with positive returns. The performance was generated across a range of strategies, with developing markets once again appearing to outperform more developed markets, with positive flows into developing equity markets supporting a number of factors. At the margin, earnings season was a positive in the US, but value factors still struggled. In contrast to Equity Long-Short managers, European exposure looks to have outperformed US exposure.</p> <p>All the signals that we monitor suggest that Event Driven managers should have had a reasonable month, but the HFRX Index suggests losses. Deal spreads generally tightened (aside a minor widening in the Covidien-Medtronic deal), and equity markets were only marginally negative over the month. The environment remains supportive for managers with deal activity remaining high, and IPO volumes increasing.</p> <p>Convertible bond valuations remain very rich, particularly in investment grade liquid issues. The one area where managers are starting to express an interest is in Japanese converts. The market was very quiet in July, with very few issues following a busy June. This had the impact of muting volumes. Volatility Arbitrage managers are also likely to have found little opportunity in July. A further steepening of volatility surfaces will not have helped, though arguably does present an interesting environment for managers.</p>

*Note: estimated return reflects our opinion of the probable outcome across each strategy in the wider market, based on a variety of sources including partial month estimates from managers we track, index data, and conversations with managers. Double plus (++) represents a strongly positive estimation of returns whilst double minus (--) represents a strongly negative estimation of returns in our opinion at the time of publishing. Opinions are as of the end of each month, and actual hedge fund strategy returns for the month may differ. Past performance is not necessarily indicative of future performance and our opinions should not be used as a basis for any investment decision.

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