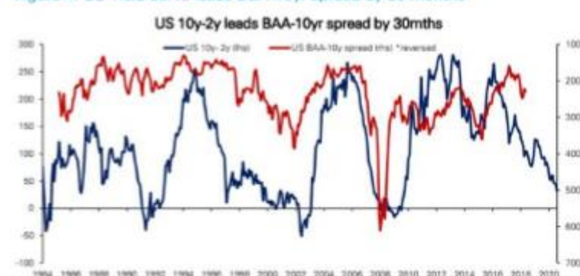
Ayaltis Funds – March 2019 Commentary

Market Commentary

Our flagship fund, Areca Value Discovery, delivered a strong positive performance of +1.31% in March. From an economic standpoint, we have definitely seen a deceleration in economic activity. The reaction of fixed income instruments to the warning signals of the real economy were swift. The 2m10y Treasury spread went negative: seven of the eight US yield curve inversions of the last 50 years were followed by a recession. Markets are anticipating that Central Banks will cut rates in the near future. The change of scenery sent investors running towards long-term government paper to be protected if a recession unfolds. 10y Treasuries fell sharply from 2.75% to 2.41% and 10y break-even inflation levels narrowed by 10bps on the month. The U-Turn in the Fed’s narrative created a huge support for long-bias asset allocators.

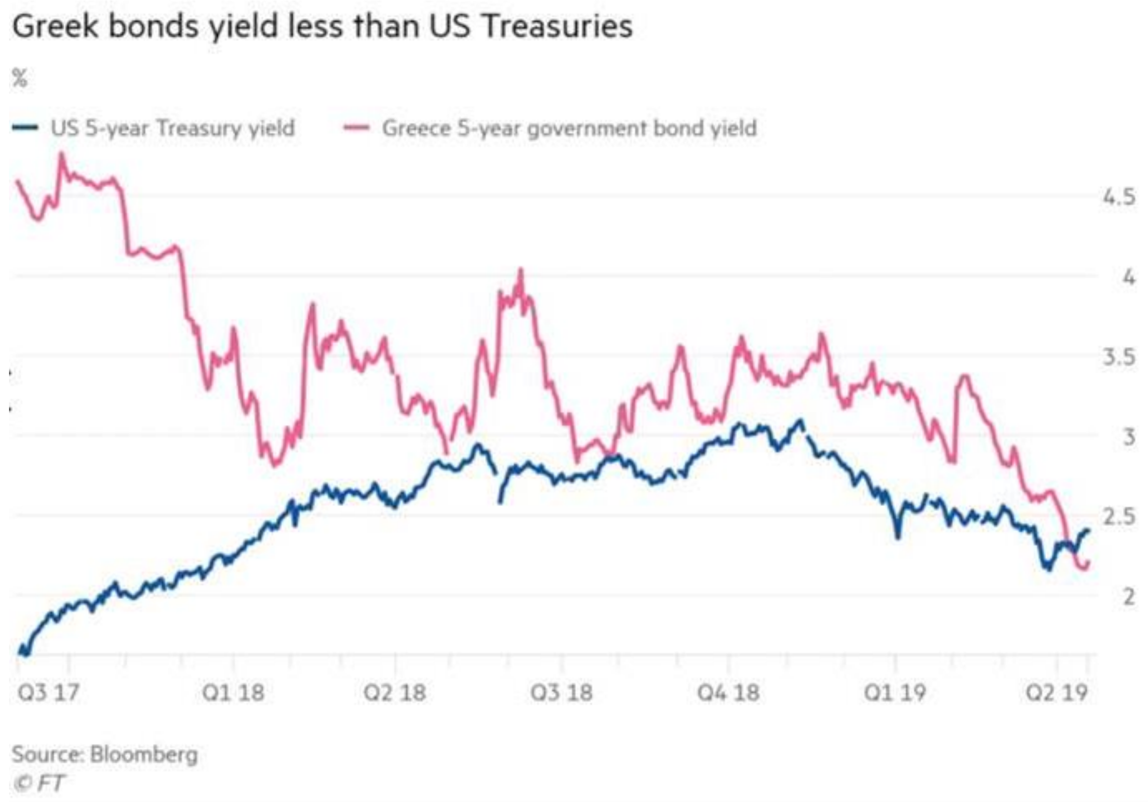
Graph 1. The Yield Curve as a Leading Indicator



Source: Deutsche Bank March 2019

All equity markets continued their relentless rally, albeit at a slower pace with the S&P500 up more than 20% from the beginning of Christmas eve. Investors now perceive the goodwill of Central Banks will be fully behind them to provide a floor market without a shred of doubt. Interestingly the Swiss National Bank now owns CHF 141 Bn of equities for a total of CHF 20,142.86 per Swiss citizen, without considering the major bank’s balance sheets. The aggressive set of stimulus policies implemented by Chinese authorities further supports a pickup in growth. The contradiction between the risk-asset rally and the recession forecasting pessimism of the yield curve, requires net-exposure caution.

Graph 2. Greek Bonds Yield less than US Treasuries



Source: Bloomberg, April 2019

On the last day of March, Chinese PMI figures instilled a measure of optimism in the economy. Bank credit is picking-up speed, with a record amount of new loans issued in the first quarter of the year. After the great fear of Q4 2018, the global monetary stimulus seems to be alive and in good health. Following Donald Trump's attempts to influence the Federal Reserve, under the premise that inflation is well under control, Draghi recently expressed his concern about Central Bank independence, with a surprising remark to the US. The perception that Central Bank independence may be relaxed going forward is a side-effect of their own success: inflation is tamed, financial assets are printing highs almost every week and the riskiest government paper in the developed markets (Greece) is selling at lower yields than US. We believe inflation is likely to remain tame for an extended period as baby-boomers retire in ever bigger numbers, thereby providing for a stealth pressure escape against inflation as they dynamically relax the output gap. As such, Central bankers may be able to extend the risk-asset Goldilocks rally for longer without triggering dangerous inflation. The Goldilocks effect is influencing all markets. While wage inflation does not send any sign of overheating, financial and real assets are booming, creating a social world that runs at two very different speeds: workers vs capital owners. In a recent report from Eurostat, we can see how the European property market is benefitting from the aggressively loose monetary policy of the ECB: the last quarter of 2018 has seen prices going up at levels not seen since the financial crisis. The first fragility cracks in the developing market structure are coming from private equity. Private equity managers are piling more and more "dry-powder" and are borrowing record sums to support deals that would be unattractive

without supportive high leverage multiples and optimistic projected savings. Investors, particularly, institutional (pension funds, sovereign wealth managers), are participating in the rally, afraid of missing the band-wagon.

Portfolio Commentary – Areca Value Discovery

In our portfolio, all asset classes delivered positive returns. Global Macro, Event Driven, Systematic Relative Value and Fixed Income Relative Value were strong contributors. Credit, notwithstanding its slightly net-short bias on corporate debt, combined with Structured Relative Value added to the overall good number, stopping the negative trend of the first two months. It took the usual longer time for Structured RMBS to show the signs of a recovering market. Although the hedging strategy on credit costs us almost 1% in a quarter dominated by aggressive buyers, we continue to prefer our prudent balance of risks than being swung violently up and down by the erratic expectations on Central Banks.

Fixed income trading accounted for a strong part of the gains last month. The main sources were tactical trading around bond issuance, long duration in US and Europe and the reversal from US flattener to steepener. Essentially, the pessimistic forward expectations of the real economy began moving the yield curves in the expected downward direction of our managers: Debt markets remain sceptical of the “Goldilocks” true lifespan.

Equity was nonetheless a positive and strong contributor. Our focus on idiosyncratic short-term events makes the overall direction of the markets not playing a big role in explaining our final performance. Our portfolio made substantial money in March, while the market was slightly positive, and much less during the first months of the year, when the equity rally created the mother of all V-shaped moves. Our portfolio was designed to avoid such a massive and unexpected move, but we managed to deliver positive performance throughout the period, with a fraction of market volatility. The fund displayed very limited exposure to the eventual corrections we expect to periodically return, as doubts on the sustainability of the “Goldilocks” lifespan periodically re-emerge as investors become increasingly nervous in the late stages of the musical-chair yield-seeking-game.

The first quarter was satisfactory for our portfolio, but certainly less-than-exciting when compared to a staggering market bounce that recovered all the losses of the previous quarter.

Our **Systematic Relative Value** managers brought a nice positive performance contribution in March. Performance was again driven by a single main performer in equities, but different from the previous month. This underlines our diversification profile on non-overlapping return sources. The manager has best-of-class extensive expertise in idiosyncratic market moves, that manifest themselves following violent dislocations that expose generic herding behaviour in long-biased market participants. The fund deploys one of the most impressive brain-trusts in the markets to analyse and exploit non-trivial, non-easily arbitraged market behaviour.

Discretionary Relative Value was mostly neutral for the month as managers adopted a more neutral stance as it became evident the strength of the previous two months rally began to wane. Profit taking started early in the month. A few unfortunate events, like the Ethiopian Airlines crash, had an impact on Boeing where some of our managers hold exposure which further contributed to dampen performance. The behaviour of Discretionary Relative Value managers was nevertheless attractive throughout the complete volatility episode.

Event Driven managers were the second biggest contributors to returns with marked dispersion. Our Asian managers were marginal detractors triggering a cautious reduction in our allocation in one of them. Our risk analysis is not only on the capacity of the manager to control drawdowns but also on the potential shortfall of opportunities. We cut one allocation as it became apparent that this Asian managers' returns flattened following active analysis of the managers environment. The event-driven space remains overall very strong. High valuations spur mergers, acquisitions and diverse corporate actions. Structuring trades using options is one way we achieve favourable asymmetric returns: one of our managers successfully traded put spreads on the Bristol-Meyer deal to cover its merger position.

Our **Relative Value Fixed Income** managers delivered a strong month, mainly on the back of the fixed income rally in Europe. Our fixed income managers have been consistently sceptical of the soundness of the risk-asset goldilocks environment. When Central Banks finally capitulated and turned accommodative to attempt to stave-off a forward-looking recession, like the proverbial wolf our managers were positioned to capture the yield curve reversal lunch. The move was further exacerbated by the radical change to the initial balance sheet reduction trend. Weak PMI numbers in Europe, implied a discounted rate in the SONIA curve in the UK (following the postponing of Brexit), were some of the triggers. Our managers made money through asset-swap trading and bond-basis strategies.

Within **Structured Relative Value,** losses on corporate credit spreads of the preceding months began to slow down. Due to the "lag effect" on structured credit products, legacy non-agency bonds finally started to reverse during March, offsetting the losses of the shorts. As yield hunters could not find attractive opportunities in corporate credit, they look for other investments, typically allocating to less liquid sectors. Seasoned non-agency residential mortgages present today a very appealing option. The underlying loans pools have seen incremental improvement in prepayment speeds as lower interest rates have translated to an increased refinance incentive. The pace of voluntary conditional prepayment rates fell to just over 1% annualized in the years following the housing crisis. Due to the higher home prices and the declining interest rates of the last twelve months, the average rate is now over 7%. The recent shift in the Fed's stance will support this positive dynamic.

Global Macro directional fixed income trading accounted for the strongest portion of the gains in our portfolio last month, with small losses in commodity, FX, and volatility trading mostly cancelling out smaller gains in equity trading. Within fixed income, our managers made money trading around bond issuance as well as running a long duration bias (bearish view), with large long positions in Australian bonds, Treasuries and more mixed positioning in European duration. In the US, after having made money in flattener positions, the portfolio managers covered the trade and moved into steepeners, making money when the US yield curve started reversing the flattening trend. Worldwide yield curves reacted to economic fundamentals firstly by reducing

long term yields and lately by reversing the trend of the last three months, that started right after Powell's speech in January.

Our **Distressed Securities** manager delivered a strong month. It is important to note that the returns come from very idiosyncratic positions as the overall beta of the fund remains low, at around 0.2. The month was supported by specific catalysts the manager was well positioned on: business expansion for a UK listed gas company and tender announcement form the shareholder of a European grocery retailer. It is important to note that we selected this manager because of his ability to find as many short opportunities as long ones, with well-sourced catalysts.

Portfolio Commentary – Azure

Azure navigated remarkably during an egregious quarter for markets. Azure, fully focused on equity, delivered best-in-class risk-adjusted performance since inception. Since the correction of February 2018 to date the portfolio delivered the same returns as the equity markets with none of the downside! The fund has two and half years of track record which shows an enviable capacity of delivering a high Sharpe ratio both in peaceful and stressed times. The positive performance was spread across all strategies and geographies. The high diversification of the fund gives the portfolio the ability to navigate through periods when corporate buybacks, retail and short-covering accelerations move the markets close to their pre-sell-off levels. We are also convinced that, as it happened during the last market correction, the superior blend of event-driven, discretionary and systematic managers that we selected for Azure, will be able to continue withstand the return of equity volatility. The portfolio is constructed to represent an ideal way to participate on the equity upside with very limited exposure to the eventual corrections we expect to periodically return as doubts on the sustainability of the Goldilocks lifespan periodically re-emerge as investors become increasingly nervous in the late stages of the musical-chair yield-seeking-game.

Portfolio Commentary – Narrapuno Spectrum

Spectrum navigated remarkably during an egregious quarter for markets. Spectrum delivered best-in-class risk-adjusted performance since inception. Since the correction of February of 2018 to date the portfolio delivered the same returns as the equity markets with none of the downside while capturing most of the upside! The fund has a long and award-winning track record which shows an enviable capacity of delivering a high Sharpe ratio both in peaceful and stressed times. The positive performance was spread across all strategies and geographies. The high diversification of the fund gives the portfolio the ability to navigate through periods when corporate buybacks, retail and short-covering accelerations moved the markets close to their pre-sell-off levels. We are also convinced that, as it happened during the last market correction, the superior blend of event-driven, discretionary and systematic managers that we selected for Spectrum, will be able to continue withstand the return of volatility of markets. The portfolio is constructed to represent an ideal way to participate on the markets upside with very limited exposure to the eventual corrections that we expect to periodically return as doubts on the sustainability of the Goldilocks lifespan periodically re-emerge as investors become increasingly nervous in the late stages of their musical-chair yield-seeking game.

Portfolio Commentary – Convexity

Our Convexity portfolio delivered an expected flattish month given the continued market bounce. The portfolio is structured to deliver favourable asymmetric returns, strong performance when markets are under selling pressure, with very little or none cost of carry. So far performance behaviour is exactly reflecting this pattern. The substantial drop in volatility observed during the last three months has been mitigated by relative value opportunities in equities, volatility and cross-asset correlation. The end result exceeded our expectations. Since the launch of the fund in August 2018, the fund displayed how it can play a paramount role as beta mitigator in any portfolio, with the addition of very idiosyncratic sources of return and very limited exposure to the eventual corrections that we expect to periodically return as doubts on the sustainability of the Goldilocks lifespan periodically re-emerge as investors become increasingly nervous in the late stages of the musical-chair yield-game.

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