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Hedge Fund Outlook

J.P. Morgan Alternative Asset Management

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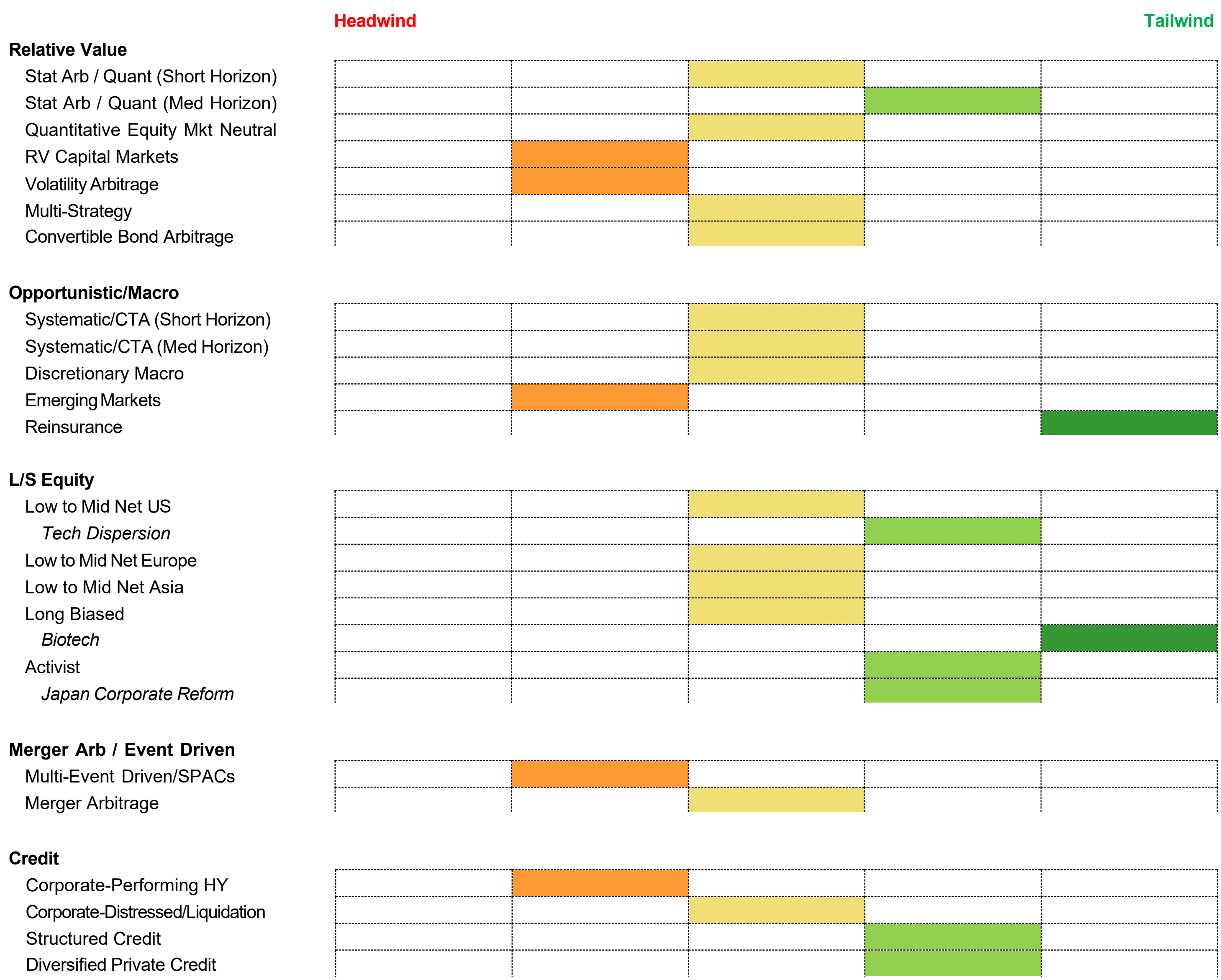
In Brief

- The outlook for the hedge fund industry remains robust with a number of highly compelling opportunities.
- Despite broadly elevated equity valuations, there are a handful of fundamental equity strategies that we think offer exceptional value today. Japanese Activism and Long Biased Biotech are two examples. In each of these cases, we believe that cheap markets create a downside buffer while corporate events can help unlock value in specific stocks, irrespective of underlying market direction.
- Within credit, forced selling and pockets of stress have created an attractive dislocation in Structured Credit. While distressed opportunities are increasing, tight spreads limit the scope of capital we can deploy across the high yield market today.
- Capital remains undersupplied across the Reinsurance ecosystem, leaving premiums at multi-decade highs and helping to preserve an attractive opportunity set heading into 2024.
- While equity volatility has normalized, dispersion remains elevated and points towards an attractive opportunity set for most relative value strategies.
- Interest rate, FX, and commodity volatility should remain above average amidst ongoing economic and central bank uncertainty. We expect this backdrop to bode well for discretionary macro managers in 2024.

Strategy Outlook

The quarterly strategy heatmap is integral to our portfolio construction process. It guides our portfolio allocations and represents our conviction in different strategies over the next year, albeit with a focus on the near-term.



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Biotech

Within equities, we are particularly excited with the prospects for biotechnology investing and believe it is one of the most attractive across the hedge fund landscape. Within the area, many small to mid-sized biotechnology companies are 40% to 60% from their 2021 peak and we expect several catalysts that will unlock value over the coming year. Importantly, we foresee an ongoing acquisition / partnership wave between large pharmaceutical companies and biotechnology firms. Why so? Given current financing challenges, biotech companies are in need of cash in order to develop their promising drug pipeline.

At the same time, pharmaceutical companies are facing a material decline in revenue as key drugs roll off patent expiration (see Exhibit 2) and, as such, are anxious to replenish their pipeline. In fact, such consolidation is already underway with a ~35% increase in consolidations in the space on a year-over-year basis. And while that has benefited select companies, biotech has broadly faced a headwind as sharply rising rates gave investors pause. We believe that tide has turned and are encouraged by the recent stock reactions to drug announcement milestones, both positive and negative, and see considerable alpha potential in the sector.

Exhibit 1: Small Cap Biotech vs. S&P 500 since 2021

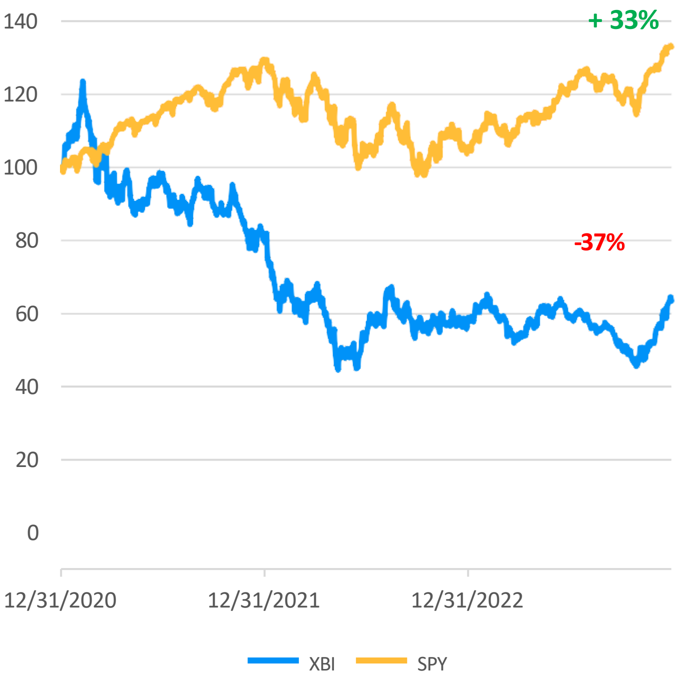
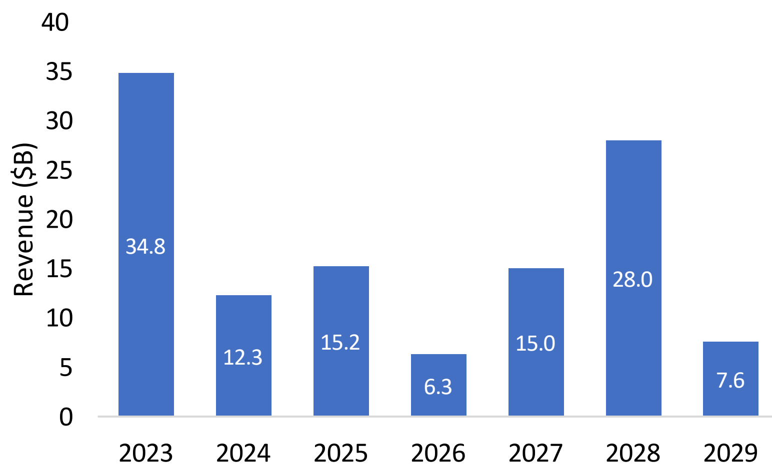


Exhibit 2: Upcoming Patent Cliff, At-Risk Annual U.S. Revenue



	2023	2024	2025	2026	2027	2028	2029
Notable Examples (~ $1B in U.S. sales in 2022)	Humira	Eylea	Stelara	Pomalyst	Trulicity	Keytruda	Ocrevus
	Actemra	Xarelto	Soliris	Cabometyx	Ibrance	Cosentyx	Ofev
	Vyvanse	Victoza	Yervoy	Perjeta	Entresto	Jakafi	Enbrel
	Prezista	Brilinta	Xeljanz	Bridion	Januvia	Otezia	
	Latuda	Simponi	Benlysta		Januvet	Eliquis	
	Aubagio		Prolia		Xtandi	Opdivo	
	Gilenya				Kadcyla	Dovato	
	Xyrem					Vyndaqel	
	Symbicort					Lynparza	
						Jardiance	

Source: RBC Capital Markets

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Japanese Activism

Elsewhere in equities, we see continued progress in Japanese corporate governance as another highly compelling opportunity. For much of the past two decades, Japan has faced a lackluster equity market driven by a combination of deflation, a death of innovation and, perhaps most importantly, entrenched management which often failed to act in investors best interest. But beginning with Prime Minister Abe's 'Three Arrows' policy, a series of important regulatory and policy reform has taken place which has created an environment for material corporate reform. One of the most encouraging statistics is the decline in cross shareholding across Japanese companies (see Exhibit 3) – which historically thwarted shareholders are attempts to implement change. In contrast, activist investors are finding material success as voting agencies and passive shareholders increasingly supportive of such actions. That has led to more pressure on under performing companies with both privately negotiated and more visible actions translating to success through increased capital returns, margin improvements, consolidation and even hostile acquisitions. While progress and stock appreciation in 2023 was noteworthy, valuations are still low as compared with other markets with half of the listed companies in the TOPIX trading below book value. As reform continues, we expect to see a significant repricing in many of these stocks.

Structured Credit

Structured credit strikes us as the most compelling opportunity across the liquid credit spectrum. In our view, Structured Credit remains the best risk/reward across credit markets at this juncture as dislocation, lack of capital and investor angst has resulted in material opportunities. As an example, forced selling and pockets of stress in commercial real estate have pushed IG structured credit spreads to levels that exceed the average levels in high yield corporate bonds. This has allowed managers to source attractive exposures at the top of the capital structure which have high yields, short duration, and strong structural protection. As rates continue to normalize, we expect underlying fundamentals to improve (especially in CRE/CMBS and consumer ABS) which could result in additional returns from pull-to-par. On the corporate side, we note that broad high yield spreads are tight and not particularly interesting. That said, the amount of stressed and distressed paper in the market has increased meaningfully over the last few years as certain sectors, such as real estate, healthcare and certain areas of consumer have faced material headwinds and present an increasingly interesting, albeit targeted, opportunity set.

Exhibit 3: Transition in Shareholder Base - Shareholders vs. Stakeholders

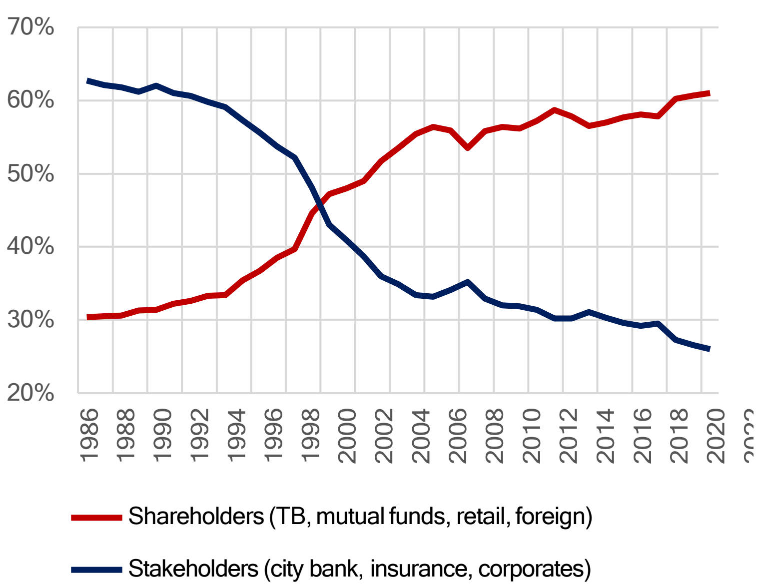
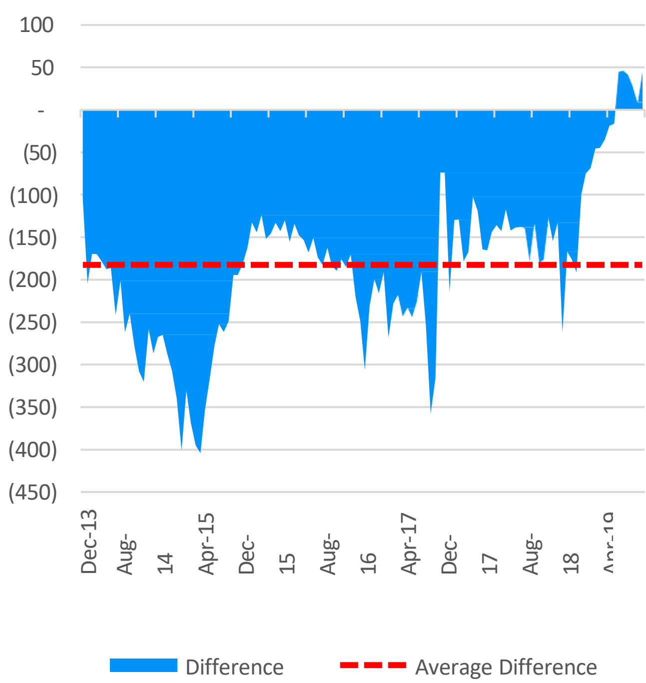


Exhibit 4: IG Structured Credit vs. High Yield credit spreads – By Basis point



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