Q2 2019

Allianz Multi Asset Long / Short

Fund manager commentary

Rahul Malhotra
Fund Manager

Summary

– Global equities posted solid gains, while global bonds rallied over the reporting period. A series of dovish statements from key central banks provided further fuel for the rally, countering concerns over rising geopolitical risks in the Middle East. Currencies and commodities provided mixed returns.
– The fund's performance was strongly positive (in EUR terms). Positive drivers were our long positions in global bond futures, the positioning in natural gas and commodity related currencies. Main detractors were within developed equities, the exposure to JPY as well as positions in oil.

Market environment

Global equities closed a volatile quarter with solid gains. After advancing steadily throughout April, equities sold off sharply in May as the US/China trade dispute escalated again, with both countries imposing new tariffs on each other's exports. Central banks rode to the rescue in June, issuing a series of dovish comments which caused stocks to rally and countered concerns over heightened geopolitical risks in the Middle East.

Global bonds rallied, boosted by strong demand for safe-haven assets and dovish central bank statements. The yield on the 10-year US Treasury bond briefly fell below 2.0%, its lowest level since November 2016, while the yield on the 10-year German Bund touched a new record low of -0.34%. Economic news indicated that the US/China trade dispute may be starting to weigh on US economic activity, with job growth missing expectations in May and inflation remaining benign. The US Federal Reserve kept rates on hold at its June meeting but signalled it would "act as appropriate to sustain the expansion", citing "rising uncertainties" about the economic outlook. This more dovish outlook was mirrored by the European Central Bank (ECB), with ECB president Mario Draghi stating that the central bank had "considerable headroom" to restart its quantitative easing programme if required.

Oil prices were volatile. In mid-April, Brent crude rose above USD 75 a barrel after the US administration said it would eliminate sanctions waivers on Iranian oil imports. While oil prices subsequently weakened, falling back to a six-month low in early June, heightened geopolitical tensions in the Middle East helped lift prices again towards the end of the quarter, with Brent crude closing around USD 65 a barrel. Meanwhile, gold surged in June, approaching a six-year high, as it was buoyed by safe-haven buying and a weaker tone to the US dollar.

The Japanese yen strengthened against other major currencies over the quarter, buoyed by its status as a safe haven in times of uncertainty. The euro also gained against the US dollar amid rising speculation that the US Federal Reserve would soon cut rates. In contrast, the British pound weakened as Prime Minister Theresa May resigned as leader of the Conservative Party, kicking off a leadership contest in which Boris Johnson was the clear leader. Mr Johnson has stated many times that he would be prepared to leave the EU without a deal on 31 October.

Performance analysis and strategy

In this market environment, the fund's performance was strongly positive (in EUR terms). The strategy gained lightly in value during the mixed return environment of April, but increased strongly in the month of May with even much stronger returns in June. Primary positive drivers of performance during the reporting period were our long positions in bond futures (i.e. US, Europe and Australia). In addition to that our positioning in natural gas as well as commodity related currencies (i.e. the AUD and NZD) benefitted the Fund's performance, but to lesser amount. In contrast, the main detractors were our exposure to developed market equites (i.e. Asia and Europe), the JPY and our positioning in energy (i.e. oil) which hurt the Fund's performance during the second quarter of 2019.

From an asset allocation perspective, our net exposure to equities was rather volatile, showing ups and downs during the reporting period. Therefore, we started the quarter at about 18% and increased the exposure strongly to approximately 45% by the end of April. During the month of May, we decreased the net long position significantly, ending the month at about 17%. As per end of the quarter, the net long position has been increased again to about +23% as risky assets continued to rally. The small short position in VIX futures of approximately 1% has been switched to a net long position in May, albeit the quarter ended with a short position of about 1%. In contrast, global bond exposure was more stable. The exposure has been increased from about 150% to roughly 170% due to a strong bull market in duration by the end of April and was reduced somewhat to 162% during May, ending the reporting period at about 160%. In credits, the long position in US high yields from the first quarter was further increased during the month of April (16%), while it was significantly reduced to approximately 7% by the end of May. In June, we increased our allocation to US high yields again, ending the month a net long position of about 12%. The exposure to emerging market credits was more or less stable at 15% during April, while it has been almost eliminated in May and then went back to +15% in course of June. Within currencies, we began the reporting period with an approximately 30% short position in international currencies versus the US Dollar. While the positions were increased to about 38% by the end of April, they were reduced to 20% in May and then further to 7% in June. From a single currency perspective, the JPY positions witnessed the most volatility, beginning the quarter with a -15% short position but ending it with a 17% long position. For commodities, oil was pretty volatile through the quarter though positions were rather small. We mostly maintained a long position in natural gas through the first months of the period, but as trends went negative in June we initiated a short position, ending the quarter with a small short exposure of about -3%. Within the industrial metals sector, the quarter started with small long positions and then went progressively short, with positions peaking by the end of May. Therefore, short positions were reduced in June and in case of precious metals, we went long at about 3% by the end of June, mainly due to gold.

Overall, the performance of the fund during the reporting period was mainly based on the systematic trend-based component according to scores we retrieved from our Market Cycle Analysis. Therefore, as scores for global equities were rather volatile across the board in the course of the reporting period, so did our positioning in equities. Scores for global bonds, respectively global sovereign debt, remained favourable as global yields continued to fall. Consequently, we ended the quarter with a significant long position in global bonds. In credits, high yielding and emerging market bonds saw positive readings all over the period, also ending the period in full positive positions. In commodities, despite oil's advance at the beginning of the quarter, rising stockpiles and concerns of potential trade war caused oil prices to decline and scores to weaken, but ended modestly higher in terms of value and market cycle score at the end of the reporting period. This was also displayed in our portfolio positioning, causing rather small positions. While gold started at a rather neutral score, the market cycle moved into positive territory, ending the period even stronger. Therefore, the portfolio was overall long in precious metals end of June, mainly due to our exposure to gold. In currencies, the scores for the US Dollar remained generally favourable, and continued to be favoured vs. the EUR and the GBP, while the JPY vs. the USD moved in positive territory, gaining much stronger support during June. Therefore, our short positioning in international currencies against the USD was still in place, while we ended the period with a significant long positon in JPY against the USD.

From a fundamental view, according to the international Monetary Fund, geopolitics (trade wars, Brexit) continue to pressure the global economy. Against this backdrop, a central bank reaction looks almost certain which should support equity markets. Resumption of trade talks are a welcome reprieve however clarity on the potential outcome remains illusive. With slowing global growth and persistently low inflation, we have a very slight bias towards higher quality in both sovereign and corporate debt markets.

Lower rated credits appear fully valued after a strong performance in June, given where we are in the economic cycle. We remain positive on emerging market sovereign debt based on its relatively cheap valuation and modest funding needs. Conversely, high yield spreads have tightened and remain vulnerable to a change in liquidity conditions and/or economic weakness. For commodities, concerns about economic growth dominate the commodity market, while supply risks are side-lined. Rate cut expectations are fully priced-in, driving USD and real-yields lower. Bearish positioning in commodity markets reflects this scenario and slightly positive news could surprise market participants. We are optimistic on an agreement of OPEC+ for a product cut extension. Brent is in backwardation and most energy commodities as well as copper are oversold based on Commodity Futures Trading Commission (CFTC) data. We are more neutral for gold after the significant upward move. In currencies versus the USD, the strong vote in USD was driven by the discussions about trade war. The better than expected outcome of the G20 meeting in Osaka did not support the USD. US and China agreed to delay further tariffs and start negotiations again, but their key differences remain. The upcoming month the Federal Reserve (Fed) will be in the focus. If they start to cut rates by the end of July, this should have a negative impact on the USD over the coming months despite the fact that market participants are already expecting the Fed to be accommodative.

Opportunities

+ Prospect for attractive risk-adjusted return throughout the market cycle
+ Flexible use of different high-opportunity asset classes
+ Potential exploitation of rising and falling asset prices through combination of long and short positions

Risks

– Positive return or capital preservation not guaranteed. The fund unit price may be subject to strongly increased volatility.
– Above-average fluctuations and risk of loss particularly in high-opportunity asset-classes
– Above-average risk of loss in alternative investment strategies employing derivatives and long/short strategies

Source: Allianz Global Investors, June 2019