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[OUTLOOK](#)

2024 Outlook: Hedge Funds

By: Mark van der Zwan | & Robert M. Rafter, CFA | December 14, 2023

A Changing Environment May Usher in a New Era for Absolute Return Investing

KEY POINTS

1. Falling inflation levels remain stickier above central bank targets, supporting price dispersion and hedge fund alpha opportunities across asset classes
2. Potential shift in central bank posture and cross-asset correlations may support more directional strategies.
3. We anticipate a structurally different regime in terms of inflation, interest rates, volatility and dispersion, as well as alpha opportunities over the medium term.

What We Are Seeing

We expect tension between a higher-for-longer yield curve - and a hotly anticipated central bank easing cycle - to play out through ongoing cross-asset re-pricings in 2024, accompanied by increased levels of fixed income volatility. The forces of creative destruction become amplified in this environment, with a fundamentally widening gap between winners and losers. Greater asset price dispersion at the security, sector, and country levels comprises the raw material for potential hedge fund alpha and enhanced absolute returns. The positive correlation between stocks and bonds has materialized as a principal theme for investor asset allocation. The structural significance of this shift places renewed emphasis on hedge funds as alternative diversifiers.

Meanwhile, higher risk-free rates also create a meaningful tailwind to hedge fund returns, especially for derivatives-based strategies, such as relative value and global macro. These strategies tend to have higher levels of unencumbered cash to potentially invest at prevailing market rates. This also signals an improved environment for short selling as the short rebate exceeds the equity dividend yield for the first time since 2008, benefiting long/short equity strategies. Heightened economic and market uncertainty has manifested in interest rate volatility and the higher absolute level of yields, which will continue to produce dispersion and alpha opportunities that are favorable for hedge fund strategies.

What We Are Doing

Within equities, we expect fundamentals to increasingly drive returns, and we are constructive on alpha-oriented portfolios with a clear edge on both long and short name selection. We are cautious about emphasizing directional exposure, with the combination of elevated yields and 20-year lows in equity risk premium presenting headwinds to market beta. We recommend absolute return strategies, such as equity market neutral.

In our view, credit spreads are unlikely to remain at their current low levels. Relative value strategies that reduce credit investors' reliance on directionality may benefit from potential spread widening or an uptick in volatility. Higher yields should also increase baseline returns for long books, while the event-driven opportunity set may expand as managers seek to capitalize on corporate liability management given upcoming debt maturities in an elevated yield environment.

The dynamics of market dispersion caused by idiosyncratic stock price dislocations should benefit systematic equity managers when coupled with ample liquidity. Likewise, through our interest rates-focused, fixed income relative value strategies, we continue to harvest profits from dislocations throughout the government bond markets prompted by yield volatility and tightening central bank balance sheets.

What We Are Watching

While cautious about index-level expected returns, we anticipate that a resumption of the deal calendar may favor certain pro-cyclical trading strategies, such as hedged portfolios active in equity capital markets, convertibles and merger arbitrage. Further, following a remarkable coordinated rise of policy rates globally, easing inflation pressures may now open the door to ongoing disparity among yields and risk premiums on a cross-border, cross-asset, and cross-industry basis. Should interest rate volatility subside, we may see an environment more conducive to directional trades capitalizing on more persistent price trends across asset classes, such as breakout trades in equity, bond, currency and commodity markets.

We believe, however, that we are in a structurally different era for absolute return investing, and we are doubtful that inflation, interest rates and volatility will fully revert to pre-COVID-19 levels in the near-to-intermediate term. We believe the resultant environment will be rife with alpha opportunities and conducive to hedge fund returns through 2024 and beyond.

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