ALTERNATIVES

K2 Advisors: It's the End of the Fed's World as We Know It

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Market volatility returned with a vengeance towards the end of 2018, with numerous uncertainties invoking memories of the Great Recession. K2 Advisors' Robert Christian and Brooks Ritchey believe the most recent turmoil has been a function of some asset-price distortions stemming from central bank actions. They explain what it all means for investors—and for hedge-fund vehicles in particular.

Painful memories of the "Great Recession" howled back to the surface in the fourth quarter of 2018. Volatility returned, and asset classes across industries, geographies and capital structures were significantly challenged—often indiscriminately.

In our view, this most recent tempest is a function of markets beginning to connect the dots between the 10+ year bull market in risk assets and its association with cheap government money. That is, the spectacular rebound we've enjoyed since 2008 was in some parts synthetically driven.

While the US Federal Reserve's (Fed's) massive quantitative easing (QE) program was originally deployed to stabilize financial markets, it created asset price distortions along the way. We believe these are beginning to correct.

The QE response to the 2008 crisis was swift and surprisingly effective, but in many ways, it treated only symptoms and not the cause. Essentially more leverage was added to the system, not removed. Debt was moved from one pocket to the other—from the private sector to the public. In addition, instead of it being a short-term intervention, QE persisted for more than a decade.

The result? Bond yields were pushed down and equities buoyed, while the costs of capital were kept artificially suppressed. This steered many investors toward riskier assets, encouraged leverage and, in some instances, rewarded complacency.

Looking ahead, we expect the reversal of QE to have significant impacts on bond and equity markets. Persistently low yields and the Fed's "buyer of last resort" role will not be a permanent arrangement. The dynamic cannot be sustained.

Ultimately many of the financial sins of the "Great Recession" (unwarranted debt, excessive leverage and spending, etc.) have yet to be fully atoned. At some point, the world's margins will have to be called.

Just this past fall, we saw bond and equity markets in the United States decline concurrently as interest rates rose. That may seem anomalous, but in our view, because bonds and equities were equally propped up by Fed intervention, they have been equally vulnerable to the opposite effect as Fed policy unwinds. These are the types of valuation corrections we expect to see as the artificial effects of prolonged monetary accommodation are dismantled. Investors who are not prepared in 2019 may be exposed to unintended risks.

So what does this all mean for hedge funds? From a very high level, we would say the environment looking forward is promising. While no one wins with panicked, indiscriminate and forced selling, modest volatility is good in that it provides intelligently hedged strategies an opportunity to earn fundamental alpha on both sides (long and short) of their trades.

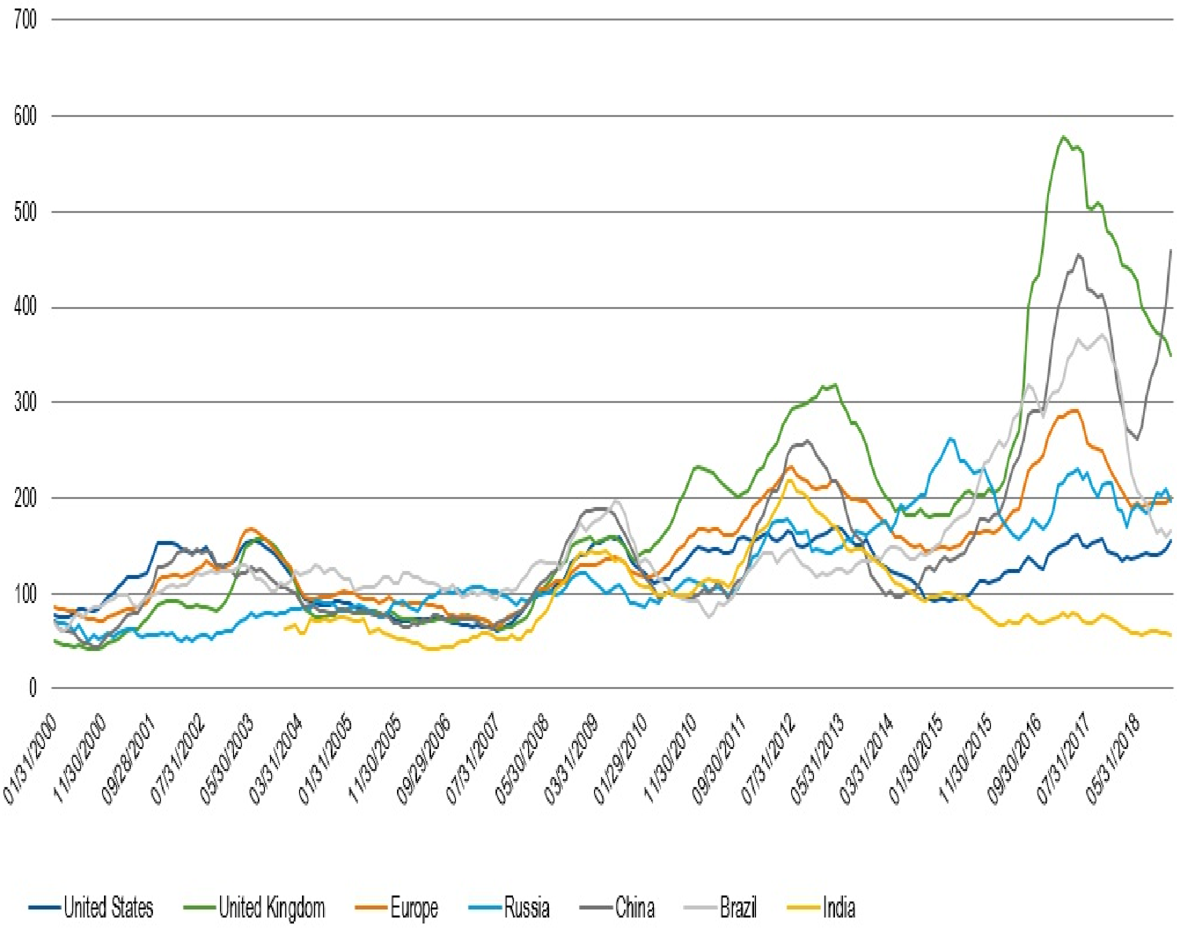
Discretionary Macro

There are many potentially attractive trade opportunities for discretionary managers. These stem from broad macro risks, including the aforementioned central bank policy divergence and geopolitical risks associated with leadership changes in major economies. The importance of those factors was highlighted by the recent market selloff, and we believe they will continue to drive market volatility. Recent increases in volatility favor managers with return profiles positioned to take advantage of increased volatility and expertise in diversifying asset classes, including commodities, currencies and fixed income.

Economic Policy Uncertainty

News Based, Index 12-Month Rolling Average

January 2000 to December 2018



Sources: Franklin Templeton Capital Market Insights Group, FactSet, Economic Policy Uncertainty. The "Economic Policy Uncertainty Index" uses newspaper articles and several other factors to measure economic uncertainty. Important data provider notices and terms available at www.franklintempletondatasources.com. Indexes are unmanaged and one cannot invest directly in them. They do not reflect any fees, expenses, or sales charges.

Relative Value Fixed Income – Sovereign

Diverging macroeconomic data, and varied policy responses coming from central bankers in both developed and emerging markets are likely to persist in the intermediate term. Resulting price action in global fixed income markets is expected to remain volatile and potentially create attractive trading opportunities, favoring relative value opportunities rather than outright directional bets.

Target Rates of Central Banks around the World

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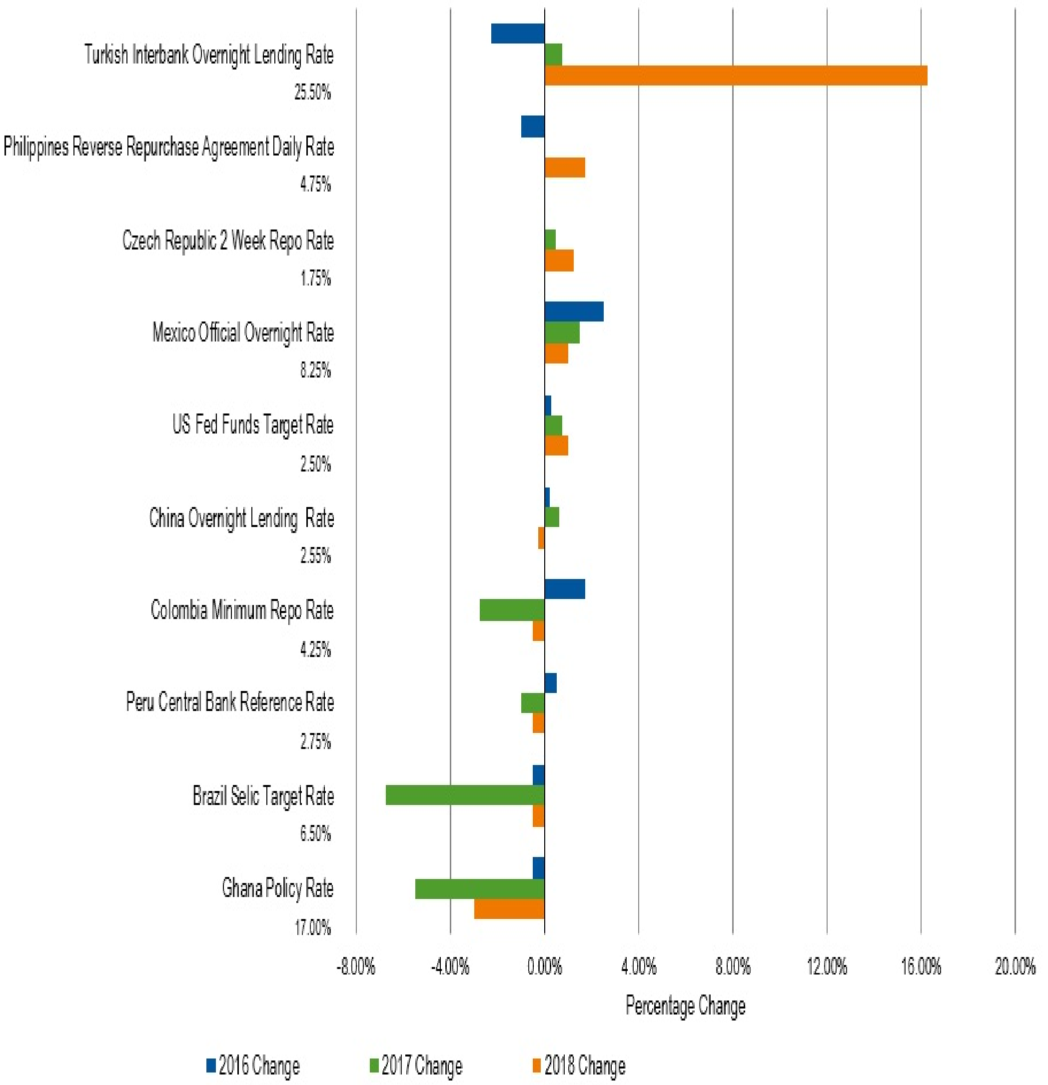
As of December 31, 2018



Source: Bloomberg as of December 31, 2018. Most central bank rates are expressed in overnight terms (the rates depository institutions pay to borrow money from the central bank), however some exceptions apply. **Past performance is not an indicator or guarantee of future results.**

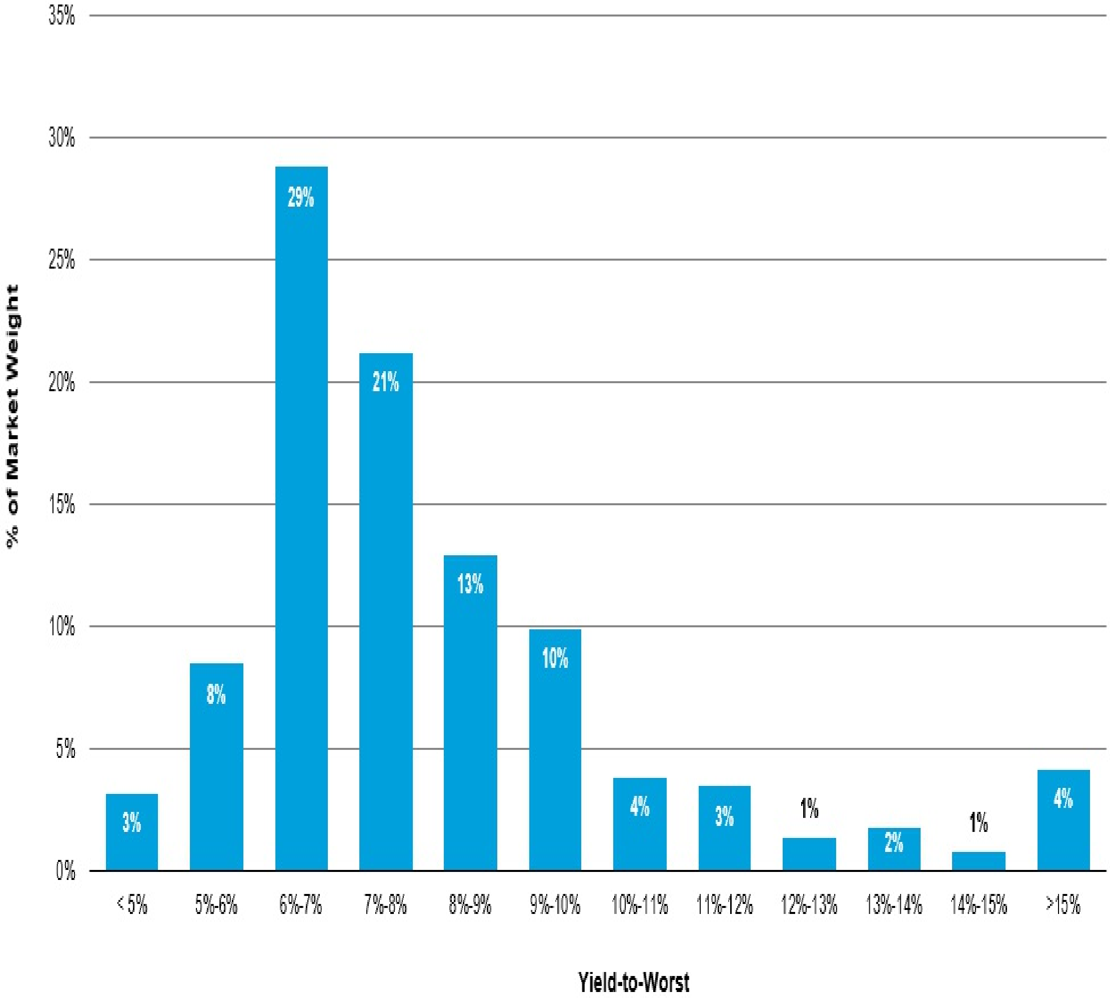
Long/Short Credit

With interest rates generally higher over the course of 2018, we expect that portfolio duration has likely driven losses for some fixed income investors. Long/short credit managers are well positioned for this environment, given their shorter duration portfolios, and should be able to generate alpha from rising sector and rating bucket dispersion. Managers are seeing many buying opportunities in select higher quality credits given recent spread widening around year-end.

High-Yield Market Weight by Yield-to-Worst

FRANKLIN TEMPLETON

As of December 31, 2018



Sources: ICE BofAML, Bloomberg. Data as of December 31, 2018. High-yield market represented by the ICE BofAML US High Yield Index. Important data provider notices and terms available at www.franklintempletondatasources.com. Indexes are unmanaged and one cannot invest directly in them. They do not reflect any fees, expenses, or sales charges. **Past performance is not an indicator or guarantee of future results**.

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