Interest rate turnaround and inflation:

Hedge Funds, Liquid Alternatives, and Commodities could be profiteers – investors expect geographical shifts in asset allocation

Executive Summary:

Rising interest rates and high inflation impact institutional investors’ strategic asset allocation (SAA). However, effects vary depending on the respective alternative asset class. Representative data from our BAI Investor Survey 2022 and BAI Member Survey 2022 show that investors and asset managers see **Commodities as the alternative asset class benefiting most from the current environment.** They are technically interconnected to inflation. Also, in the current volatile environment with high downside risks but the constantly existing possibility of dynamic market recoveries, alternatives to long-only strategies are seen to offer good opportunities. Therefore, **Hedge Funds and Liquid Alternatives are widely regarded as possible major profiteers of the interest rate turnaround and inflation.**

Current data also suggest a break in the negative trend regarding the importance of Hedge Funds and Liquid Alternatives in SAAs, although not yet far advanced. The experts’ voices in interviews support the findings from data of Commodities, Hedge Funds, and Liquid Alternatives being relative profiteers. However, they derive distinctions between strategies and sub-strategies within the Hedge Fund sector. In this context, t**rend-following- and macro strategies were considered advantageous** in the inflationary environment. The analysis of benchmarks for strategies and sub-strategies shows that Hedge Funds considerably outperformed the MSCI World in 2022, a year characterized by rising inflation, interest rate rises, and high volatility.

Also, we could observe a significant variance between different Hedge Fund strategies and sub-strategies. For example, relying on momentum-driven market shifts with trend-following sub-strategies generated the highest performance among all sub-strategies. However, looking at the big picture, we can see in the data that Hedge Funds, especially trend-following sub-strategies, historically proved useful in times of market downturns and high volatility, which is not necessarily connected to an inflationary environment.

Furthermore, we show that the **current geopolitical context**, and risks linked to the macroeconomic environment, also impact Alternative Investments’ **geographic asset allocations.** For example, according to the BAI Investor Survey 2022, most LPs expect **higher allocations in the USA**, and a majority sees **lower allocations in China**, for which we discuss reasons.

1. Introduction

The year 2022, with events such as the ongoing Russian war of aggression in Ukraine, high inflation rates, and interest rate reversals by central banks worldwide, with a move away from so-called "quantitative easing," can be seen as drastic in many respects. Macro outlooks indicate that the global economy might be entering a new regime characterized by higher levels of volatility. In our publications based on the BAI Investor Survey 2022[*] , we show that the expected effects of the changing macroeconomic environment vary depending on the respective alternative asset class. It could be precisely those alternative asset classes that have had a hard time in the environment of low interest rates and low inflation, which could regain importance in the new market environment.

This is the third part of a series of publications in which we examine how the interest rate turnaround and inflation affect the performance of Alternative Investments (AI)[**] and their relative strategic attractiveness and role for institutional investors. In this context, we already discussed how the impact might be in terms of the need for diversification and which role the expected duration of the shifts in the interest rate and inflation plays regarding the expected impact on AI[***].

Furthermore, we examined the impact on AI in strategic asset allocation (SAA) due to greater competition from rising bond yields and the role of the denominator effect for LPs in Germany[****]. Now, with this publication, we look at those AI, which seem to enter into a positive trend. Since the current inflationary environment and the reactions of central banks around the globe are, to some extent, linked to a complex system of geopolitical interdependencies and crises, we also address its possible geographical impact on asset

2. Hedge Funds, Liquid Alternatives, and Commodities as potential beneficiaries of interest rate turnaround and inflation

Which alternative asset classes are gaining significance due to the ongoing interest rate turnaround and elevated inflation? Our analysis is based on two pillars: On the one hand, we asked German institutional investors and asset managers in our representative BAI Investor Survey 2022 and Member Survey 2022 which alternative asset classes are expected to gain in relative strategic attractiveness; on the other hand, we talked to experts to gain deeper insights.

We used the data from a total of 165 LPs and GPs about the expectations of the impact of sustained elevated inflation (>3%) and ECB's monetary policy (rising interest rates) on different asset classes to calculate representative indicators for the expected impact on relative attractiveness, strategic importance, and performance. Only considering the invested or involved GPs and LPs, the delta of positive and negative expected impacts is set relative to all responses that expect impacts. Responses that do not expect any effect on the asset class were not considered.

For both sustained inflation and sustained interest rate, Commodities have the highest score of +60% and +66,7%, respectively (Figure 1, Figure 2). Therefore, **Commodities are the asset class investors and asset managers see benefiting most from the current environment.**

* https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Investor_Survey/Investor_Survey_2022_final_red.pdf.

** Defined as: Liquid Alternatives, Hedge Funds, Commodities, Corporate Private Dept, Corporate Private Equity, Venture Capital, Real Estate Equity, Real Estate Debt, Infrastructure Equity, Infrastructure Debt, Other Real Assets, Specialities, cf. https://www.bvai.de/en/alternative-investments/alternative-investments-in-general.

*** https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/Interest_rate_turnaround_and_inflation_2022__0509_.pdf.

**** https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/Alternative_Investments_remain_robust_-_despite_competition_from_rising_bond_yields.pdf.

The reasoning behind this is, Commodities are technically interconnected to inflation since commodity prices are a component in calculating inflation rates. So, it is unsurprising that commodity prices and inflation rose parallelly last year. In addition, Commodities are widely considered suitable for diversification - to hedge losses that arise when other asset classes lose out due to inflation. In the Preqin Investor Survey 2022, almost 70% of respondents cited diversification and a good 50% inflation hedge as reasons for investing in natural resources.

However, when assessing the possible outlook for Commodities, it is essential to consider that demand is partly strongly dependent on the economic situation. For example, a significant global economy weakening due to interest rate increases could also lead to declining commodity prices. This, in turn, is usually accompanied by a decrease in inflation, except in a stagflation environment, where inflationary pressures do not diminish despite the recession.

As expected, Hedge Funds and Liquid Alternatives can be identified as clear beneficiaries of elevated inflation and rising interest rates from GPs' and LPs' points of view. Regarding inflation protection, the score for LP and GP sentiment is +42.9%, and for robustness regarding higher interest rates, +42,9%. In an environment with high downside risks and, at the same time, the permanent possibility of dynamic market recoveries, alternatives to long-only strategies accordingly are seen to offer good opportunities. In this context, Hedge Funds and Liquid Alternatives can deploy financial options to hedge.

Data shows Hedge Funds, Liquid Alternatives, and Commodities are ahead of all other alternative asset classes regarding the expected impact score of sustained inflation and rising interest rates. However, all other asset AI asset classes are not analysed in this paper and require additional examination.

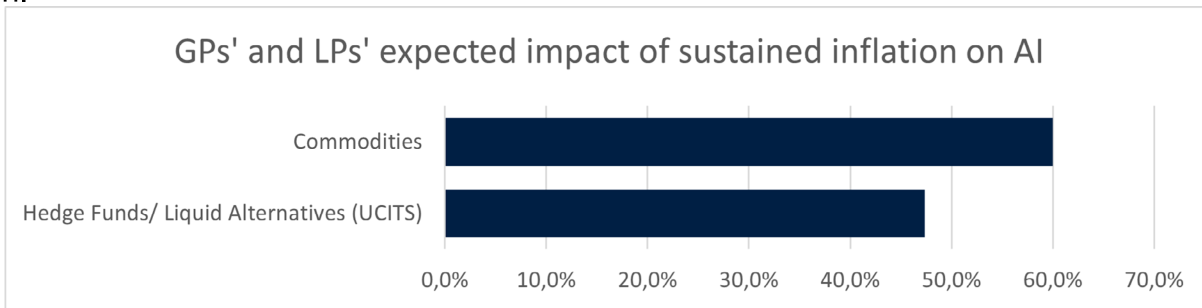

Figure 1: How does sustained elevated inflation (>3%) affect your expected performance of the following asset classes relative to the other asset classes in which you are invested? Delta of LPs and GPs expect a positive and negative impact as a percentage of respondents.
Source: BAI Investor Survey 2022 and BAI Member Survey 2022

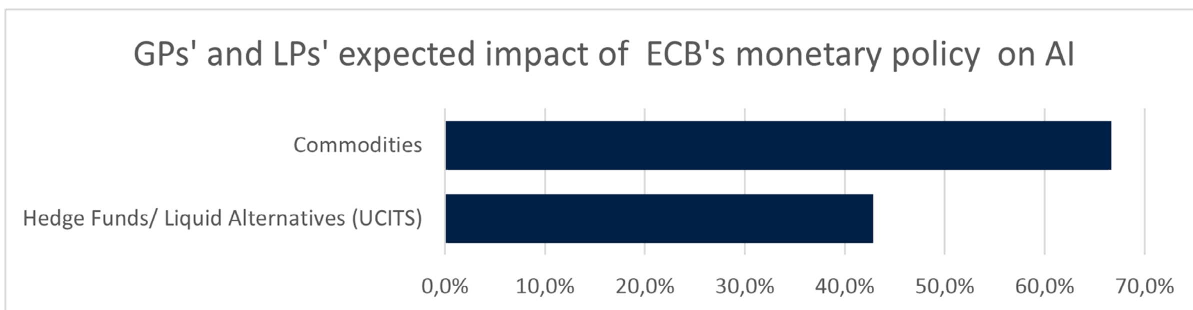

Figure 2: How does the ECB's monetary policy (rising interest rates) affect your expected performance of the following asset classes relative to the other asset classes you invest in? Delta of LPs and GPs expect a positive and negative impact as a percentage of respondents.
Source: BAI Investor Survey 2022 and BAI Member Survey 2022

Survey data indicate a trend break for Hedge Funds and Liquid Alternatives

As also shown in our BAI Investor Surveys, Hedge Funds and Liquid Alternatives have been subject to decreasing interest from institutional investors in recent years. Commodities did have also a hard time in the German institutional investors' landscape. However, the current data of the BAI Investor Survey 2022[*] may indicate a break in this negative trend.

It shows that the shares of Hedge Funds and Liquid Alternatives in the portfolios of German institutional investors are expected to remain constant. Thus, for the first time, there is no longer a decrease compared to the past years. We even see a slight increase in Commodities and demand for absolute return strategies. These adjustments can be explained by the fact that due to interest rate adjustments and shifts caused by inflation, new market equilibria arise, and equilibria shift more frequently. Putting this into the global context, it is even more evident that Hedge Funds are strategically gaining importance in institutional investors' portfolios. According to the Preqin Fund Manager Survey from November 2022, 53.5% of global institutional investors expect increasing assets under the management of Hedge Funds, while only 4.2% expect a decrease (Figure 3).

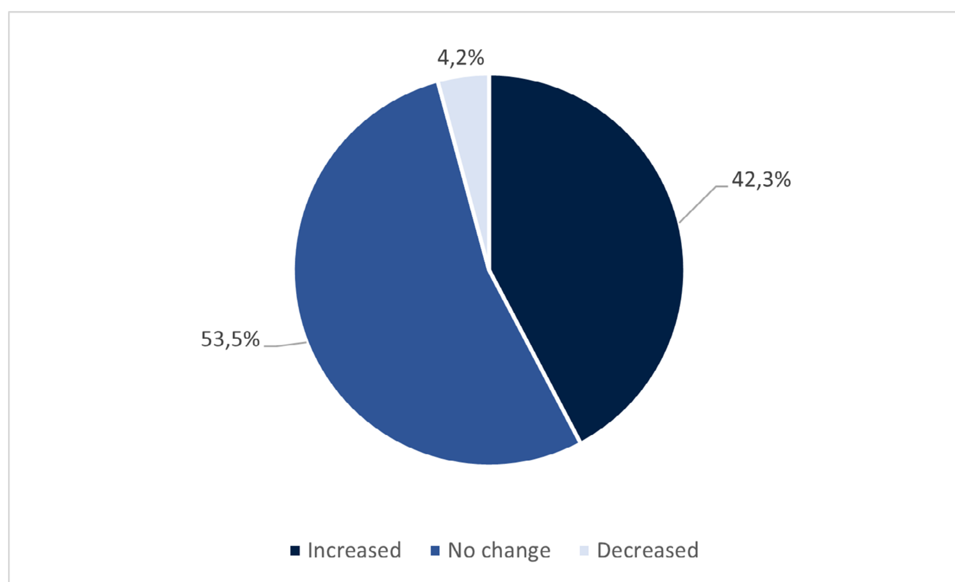

Figure 3: Global institutional investors' AUM change in Hedge Funds relative to the past 12 months, source: Preqin Fund Manager Survey, November 2022

3. Experts' perspectives

To understand the impact of the expected change in the macroeconomic environment, practical implications, different implications regarding sub-strategies, and historical experience on the performance of Hedge Funds, Liquid Alternatives, and Commodities, we held multiple talks with members and interviewed experts. Discussions and interviews showed that asset managers and investors are increasingly discussing the topic. Also, it shows asset managers are noticing an increase in customer demand in this regard, which is already leading to the launch of new products.

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* https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Investor_Survey/Investor_Survey_2022_final_red.pdf

Henry Neville:

Historical standout performances for Commodities and equity trend strategies during inflationary periods

In 2020 Henry Neville, Portfolio Manager at Man Solutions, was one of the authors of the paper "Inflation Regime Roadmap.* " He argued, "policy change may create an inflationary regime for the coming decade." In Autumn 2022, he saw them being "half right, still expecting being fully right" with their prognosis. For this reason, it is interesting to look at the historical performances of different asset classes during inflationary regimes in their analysis.
They make out historically standout performances for Commodities and equity trend strategies during inflationary periods. Neville argues that from the historical data, they deduce that **long-short equity factors strategies have worked particularly well during an inflationary regime**. This is because **trends tend to persist during inflationary periods, quality outperforms, and larger companies outperform smaller ones because they have better infrastructure.**

However, it must be considered that one must refrain from extrapolating historical performance. Asked how the situation is currently different from historical ones, Neville said Infrastructure could be more robust because infrastructure renewal is one of the current inflationary regime drivers. Also, "central banks cannot respond as Volcker did in the 70s".

Antti Ilmanen, Principal and Global Co-head of the Portfolio Solutions Group at AQR Capital Management, argues that we are facing **a prolonged period of low returns across all asset classes.** We must recognize that the past decade's outsized returns have been fueled by central banks keeping interest rates extremely low and suppressing macroeconomic volatility. As a result, valuations and multiples rose across asset classes, "making everything expensive."

However, these high returns were borrowed from the future, he argues. We are facing an era that could bring persistently higher interest rates, inflation, and, correspondingly, lower valuations that will bring lower returns in all asset classes and higher volatility. Ilmanen also argues that investors should not make the mistake of extrapolating past returns and the relative performances of different asset classes. Instead, they need to adapt to fundamentally new circumstances. Ilmanen agrees that a positive stock-bond correlation can be a central challenge** ; therefore, regular repositioning of strategic asset allocations will be necessary, and many investors should be looking at increasing their exposure to alternative asset classes that can provide diversification.

* https://www.man.com/maninstitute/inflation-regime-roadmap.
** Cf. https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/Interest_rate_turnaround_and_inflation_2022__0509_.pdf.

All long-only asset classes – bonds, stocks, and private assets – have historically low starting yields which virtually ensure that their future returns will be lower than in previous decades. Investors face either the slow pain of picking tiny coupons, dividends, etc. or the fast pain of seeing asset valuations cheapen. The fast pain of 2022 due to monetary policy tightening has not yet "solved" the slow-pain problem: Asset yields are still closer to all-time lows than to long-run averages. Private asset yields have hardly budged. Long/short strategies are especially useful diversifiers in this situation because the headwinds that long-only assets face tend to "wash out" between the long and short legs. Some of them may even thrive due to heightened macro volatility, notably trend-following and macro strategies.

Antti Ilmanen
Principal and Global Co-head of the Portfolio Solutions Group, AQR Capital Management

Further, he argues **higher volatility favours Hedge Fund strategies, especially due to their low correlation with liquid assets.** In particular, he attributes increasing importance to long-short strategies for all asset classes to achieve alpha. Also, he attributes increasing significance to Commodities. Overall, he does not see illiquid assets increasing in importance since they are correlated with their public market counterparts, and illiquidity can be understood as an obstacle. In particular, he argues that the inflow of capital and low interest rates have increased valuation multiples in illiquid asset classes and are correspondingly challenging their future returns. However, he acknowledges the need to differentiate within asset classes and agrees with the point that infrastructure – in particular, the renewable energy sector could benefit.

4. Implications for different Hedge Fund strategies and sub-strategies

The experts' voices support the findings from data that within an inflationary environment, Commodities, Hedge Funds, and Liquid Alternatives are relative profiteers. However, they clarify that a distinction must be made between strategies or sub-strategies within the Hedge Fund sector. Trend-following and macro strategies were named as advantageous[*].

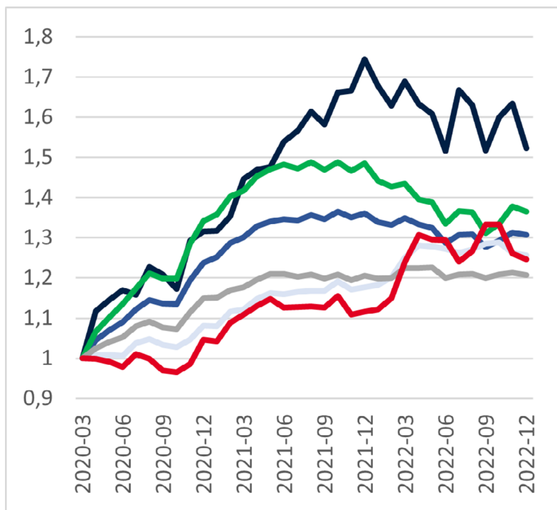
Market data for the global equities benchmark MSCI world and Hedge Fund benchmarks for strategies and sub-strategies support their statements. For example, looking at data from Eurekahedge[**] for the benchmark for all Hedge Fund strategies, the Eurekahedge Hedge Fund Index, and for different sub-strategies , we see that during the bull market after the Covid-19 crash in 2020, the global equities benchmark MSCI world outperformed all Hedge Fund Strategies and sub-strategies[***] by a high margin (Figure 4).

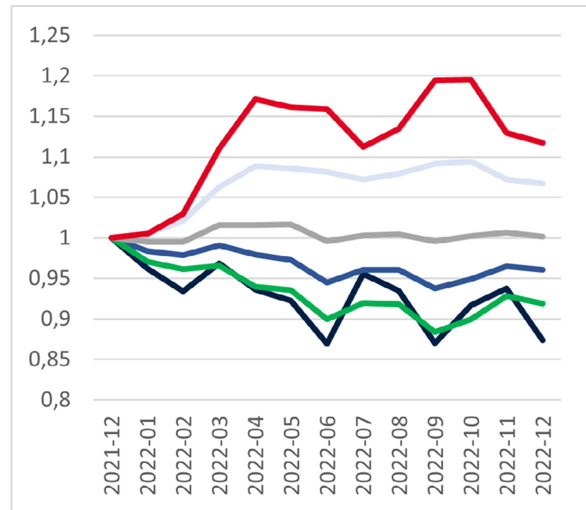
However, data from 2022 shows that in the wake of high inflation, the turnaround in interest rates by central banks around the world, and the resulting market dislocation, Hedge Funds, and sub-strategies outperformed the equity market. Therefore, as of December 2022, the MSCI World Index had lost about 13% from the all-time high. The Eurekahedge Hedge Fund Index, the benchmark for all Hedge Fund strategies, outperformed the equity benchmark; however, it still recorded a loss of about 4% (Figure 5).

* For overviews of Hedge Fund strategies, cf.: https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Fact_Sheets/Fact-Sheet_Hedge_Fund_Final_12_04_22.pdf; https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Informationsbroschueren/BAI_Informationsbroschuere_Hedgefonds_092020.pdf; https://www.preqin.com/academy/lesson-3-hedge-funds/hedge-fund-strategies.

** There are numerous benchmark indicators with strengths and weaknesses that have to be discussed. In principle, comparing Hedge Funds with benchmarks (indices) is controversial. Not only do Hedge Funds usually pursue absolute return strategies, making them difficult to compare with conventional financial market indices, but investments in Hedge Funds are even more dependent on the skills of the respective Hedge Fund manager than is the case with listed investment funds. Cf. BAI Informationsbroschüre Hedgefonds, p.47.

*** https://www.eurekahedge.com/Indices/IndexView//473/Eurekahedge-Hedge-Fund-Index.





MSCI World

Eurekahedge Hedge Fund Index

Eurekahedge CTA/Managed Futures Hedge Fund Index

Eurekahedge Long Short Equities Hedge Fund Index

Eurekahedge Macro Hedge Fund Index

Eurekahedge Trend Following Index

Figure 4: Equities benchmark and Hedge Funds benchmarks for strategies and sub-strategies, from the low point of the Covid-Crash until now
Source: own representation

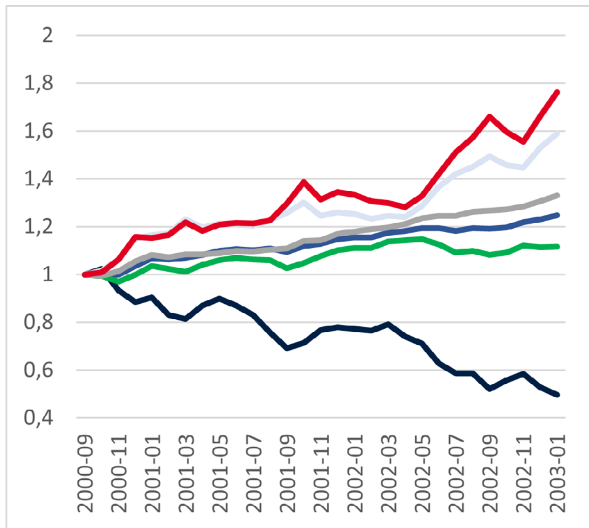
Figure 5: Equities benchmark and Hedge Funds benchmarks for strategies and sub-strategies, from the equity market all-time high until now
Source: own representation

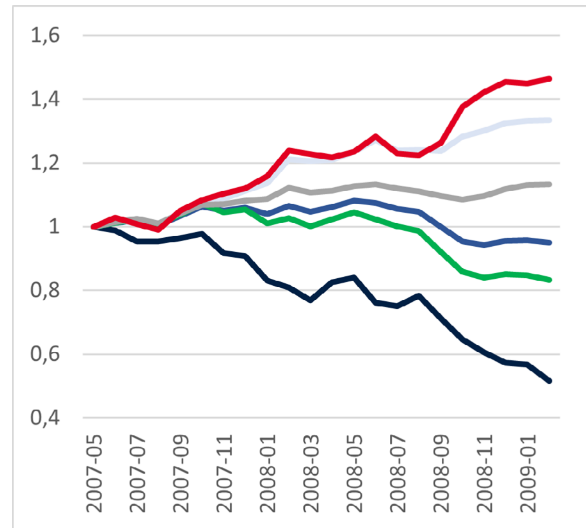
But we see a significant variance between different Hedge Fund strategies and sub-strategies. While the benchmark for Long Short Equities Hedge Fund strategies was down about 8%, macro strategies showed a slightly positive return, in line with the argumentation of our experts. Since they are based on forecasting and profiting from the impact of changing market parameters through comprehensive market analysis, macro strategies increase efficiency in an environment with rapidly changing market fundamentals. Also, we can see that CTAs showed the best performance among all top-level strategies. During the highly volatile inflationary market environment in 2022, they had a return of +6,7%. Their trend-following sub-strategy even had a return of +11.7%. In line with the analysis from our experts, relying on momentum-driven market shifts has worked remarkably well in an environment with market stress and changing market equilibria. *

However, looking at the big picture, we can see whether Hedge Funds prevail over equity long-only benchmarks highly depends on the period observed, especially the starting point. Therefore, though the market downturn of 2022 looks small in historical comparison, the performance of Hedge Funds and Strategies/Sub-Strategies showed similar patterns during the two major market downturns of this millennium. During the burst of the so-called “Dotcom bubble,” the MSCI world lost about 50% from its high in September 2000 until its low in January 2003. During this time, Hedge Funds showed significantly positive performances. Regarding strategies/sub-strategies, the Trend Following Index also had the strongest performance, with +76% in that period, followed by the CTA/Managed Futures Hedge Fund Index, with about +59% (Figure 6).

During the market downturn caused by the world financial crisis, the broad equity benchmark lost again about 50% from the temporal peak in May 2007 until the low in February 2009. Once again, the Trend Following Index and the CTA/Managed Futures Hedge Fund Index showed the most significant outperformance. However, the variance between different Hedge Fund strategies was higher, and the Eurekahedge Hedge Fund Index benchmark for Hedge Funds could not resist the market turmoil and lost about 5% (Figure 7).

* using data from the “Preqin Global Report 2023: Hedge Funds”, published, in December 2022, leads to similar results, however, data for Hedge Fund sub-strategies are only available until 09/22.





MSCI World

Eurekahedge Hedge Fund Index

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Eurekahedge Long Short Equities Hedge Fund Index

Eurekahedge Macro Hedge Fund Index

Eurekahedge Trend Following Index

Figure 6: Equities benchmark and Hedge Funds benchmark for strategies and sub-strategies during the market downturn after the „Dotcom Boom“ Source: own representation

Figure 7: Equities benchmark and Hedge Funds benchmarks for strategies and sub-strategies during the market downturn of the World Financial Crisis, Source: own representation

Looking at the longest possible time series for which Eurekahedge data exists for Hedge Fund strategies shows that Hedge Funds have significantly outperformed the MSCI World since December 1999 (Figure 8). The benchmark for all Hedge Fund strategies Eurekahedge Hedge Fund Index, has since risen by a factor of 6.17, while the MSCI World has only just tripled. Trend-following strategies showed the strongest long-run performance, with a total rise of a factor of 7.55. However, splitting the time series show that Hedge Funds' overall outperformance can be rooted back to the highly volatile time until 2009, with the two historic market crashes, the burst of the so-called Dotcom bubble and the world financial crisis in the wake of the bursting of the real estate bubble in the USA and the resulting bankruptcy of the systemically important investment bank Lehman Brothers. Trend-following strategies had risen with factor 4.4 until then, and the MSCI world was down on 55% of the initial time series level.

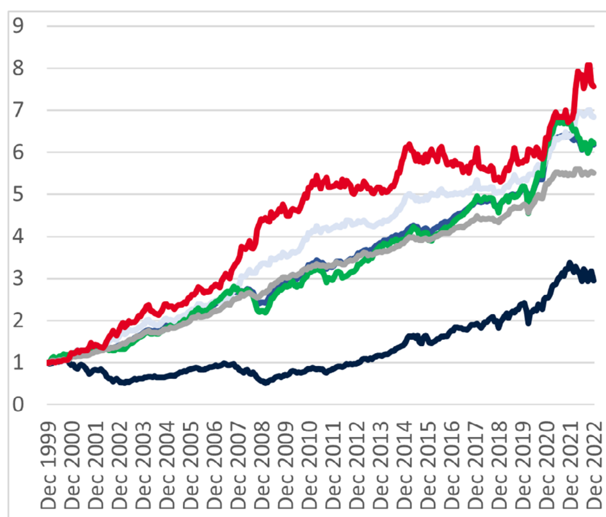
In the mid of December 2009, when key interest rates were already close to zero, the American central bank Federal Reserve started its policy of so-called quantitative easing and bought long-term securities to stabilize and stimulate the economy*. It marked the beginning of a period characterized by low interest rates, low inflation, and, apart from brief interruptions, continuously rising markets, which did not end until 2021.

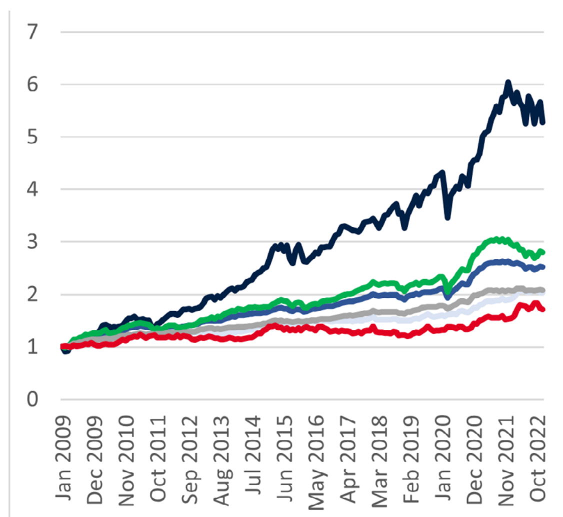
An examination of the cumulative performance since the beginning of the "quantitative easing" shows that equities have left Hedge Funds far behind since then (Figure 9). The MSCI world increased by about a factor of 5.3, while trend-following strategies showed the weakest performance in this period, rising about 72%.

* https://www.philadelphiafed.org/-/media/frbp/assets/economy/articles/economic-insights/2016/q1/eiq116_did-quantitative_easing_work.pdf.

Literature also finds a significant impact of quantitative easing on decreasing stock volatility*, which seems to be linked with the underperformance of Hedge Funds in this period. Joenväärä and Kauppila (2021)** argue that the critical juncture for Hedge Fund performance was around 2008, related to the effects of the world financial crisis. Therefore, monetary policy since then has reduced volatility, which, combined with increased financial market regulation, adversely impacted Hedge Fund performance. Thus, with long-short strategies in mid- to long trends, one must always be careful that the strategies do not turn into expensive long-only strategies so they can keep up with the equity market.

With 2022, the period of low interest rates, low inflation, and a continuous equity bull market seems to have come to a, at least temporary, end. Hedge funds as a base rate plus alpha (or partly also alpha/beta mix) driven business, could profit nominally at higher interest rates in almost all strategies without having to generate additional alpha. Monetary tightening is one factor responsible for a possibly highly different upcoming environment. Macro outlooks partly indicate, driven by multiple factors, the global economy might be entering a new regime characterized by higher levels of volatility***.





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Eurekahedge Trend Following Index

Figure 8: Equities benchmark and Hedge Funds benchmark for strategies and sub-strategies since data are available
Source: own representation

Figure 9: Equities benchmark and Hedge Funds benchmark for strategies and sub-strategies since the beginning of the monetary policy of quantitative easing
Source: own representation

* Cf. The Effect of Fed's Quantitative Easing on Stock Volatility, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2215423
** https://www.tandfonline.com/doi/abs/10.1080/0015198X.2021.1921564, for a summary cf.: https://www.cfainstitute.org/en/research/financial-analysts-journal/2021/hedge-fund-performance.
*** Cf. https://www.blackrock.com/corporate/literature/whitepaper/bii-global-outlook-2023.pdf.

5. Expected shifts in geographic asset allocations for AI

However, the macroeconomic scenarios with possibly higher inflation figures and increased interest rates in the medium term do not only affect the attractiveness of individual asset classes and potential shifts between asset classes. Current inflation and the reactions of central banks around the globe are, at least to a certain extent, linked to a complex system of geopolitical context and crises. Due to the Chinese Covid policy and the ongoing war in Ukraine, sustaining supply chain bottlenecks are factors firing rising commodity prices and, therefore, inflation. Also, leading analysts see the strategic rivalry between the USA and China and global technology decoupling as some of the most significant geopolitical risks. This rivalry is connected to increased global fragmentation and deglobalization*. In this context, the conflict over Taiwan and legal and political uncertainties in China will also likely play a role.

Our data from the BAI investor Survey 2022 also indicates that investors expect shifts in geographic asset allocations for AI due to geopolitical crises (Commodity prices, supply chain bottlenecks, the war in Ukraine, political risks in China, etc. – Figure 10)

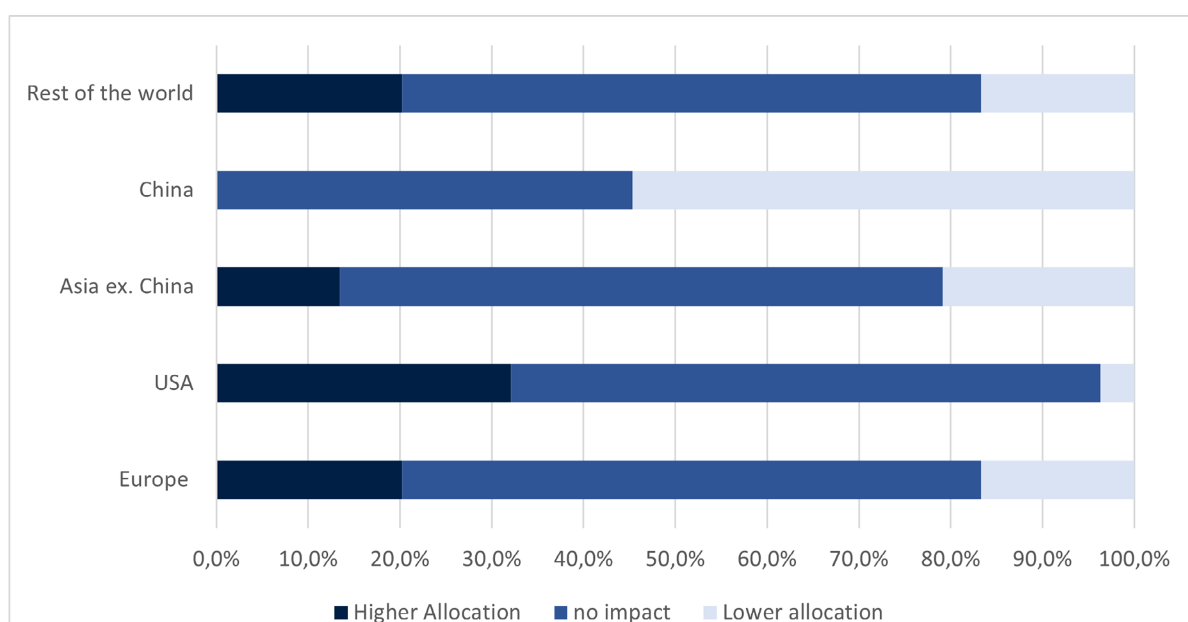

Figure 10: Influence of Geopolitical Crises (Commodity prices, supply chain bottlenecks, the war in Ukraine, political risks in China, etc.) on Global AI Allocation, Source: BAI Investor Survey 2022

We observe the relatively highest expected inflow into the US, with 32.1% of the LPs claiming geopolitical crises are leading to higher allocations and only 3.7% expecting a decrease. This could be explained by the fact that the US is seen as a safe haven and is less affected by the impact of the war in Ukraine, also because it is essentially less dependent on energy imports. Europe and the rest of the world follow with slightly more expected increases than decreases in AI. It can be assumed that there are substantial differences within these regions and that sub-regions serve as catch basins for those regions where outflows exist. This is the case for Asia, excluding China, and particularly China, where no inflows are expected, and 54.7% expect outflows, presumably due to China‘s increasing political and legal uncertainties and increasing geopolitical tensions.

* https://www.blackrock.com/corporate/insights/blackrock-investment-institute/interactive-charts/geopolitical-risk-dashboard#market-movement.

6. Conclusion

In this paper, we argued that Commodities, Hedge Funds, and Liquid Alternatives, might become asset classes that are beneficiaries of the interest rate turnaround and inflation. Therefore, we outlined expert views indicating we might enter a higher-volatile macroeconomic regime. Also, we showed that historically Hedge Funds, particularly trend-following sub-strategies, proved useful in times of market downturns and increased volatility. However, whether Hedge Funds or long-only equity prevailed was highly dependent on the time period observed and the investment starting point. Regarding possible implications, therefore, factors overlap, which are connected to market volatility and downside protection on the one hand, and effects caused by interest rate turnaround and inflation on the other hand. Impacts on Hedge Funds can be mainly attributed to equity market mechanisms, while the technical calculation of inflation rates plays a decisive role for Commodities. It is accordingly difficult to root back the benefits discussed for those asset classes purely on monetary policy and the macroeconomic environment. Impacts on other asset classes, addressed in follow-up publications, might be linked more straightforwardly to the effects of higher interest rates and inflation.

Also, the analysis of historic benchmark indicators' performances in this paper is purely descriptive in nature. In any case, avoiding the extrapolation of historical performances and being cautious in deriving forecasts is necessary.

Complex systems determine the performances of asset classes, and future scenarios can be impacted anytime by unexpected shocks – positive or negative ones. Also, forecasts vary widely between analysts. However, discussing possible impacts on different asset classes due to interest rate turnaround and inflation and presenting different perspectives aims to raise awareness for the topic and, therefore, to be beneficial for the readers.

We would like to thank all those who supported this study, especially the investors and members who participated in the BAI Investor Survey 2022 and the BAI Member Survey 2022, and the participants of the expert interviews who are also quoted in the paper:

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