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**Market Review**

**Capital Markets**

August initially witnessed a continuation of the risk assets rally, but market action reversed quickly as the likelihood of the Fed’s “tapering” increased after some strong U.S. data (e.g. the ISM manufacturing report) and some bellwethers like Cisco and Wal-Mart reported poor earnings. The geopolitical concerns around Syria also weighed on markets in the second half of the month.

The S&P 500 dropped 3.1% for the month (14.5% YTD), while the MSCI World declined 2.3% (10.0% YTD). Emerging Markets held a bit better after their rout earlier in the summer – the MSCI EM lost only 1.9%, but was down 11.9% YTD.

Bond markets continued their indigestion at the prospect of “QE tapering”. The U.S. 10-year Treasury yield finished the month at 2.8%, rising about 20 bps on the month. European and UK 10-year yields rose 20 bps and 40 bps respectively. 2-year yields were up 10 bps in the Western part of the developed world.

G3 Central banks stayed on hold. While the Fed considered tapering its QE, it decided not to do it because of the rise in Treasury yields that also influenced mortgage yields and the housing market. So it decided to wait for further data, confirming the strengthening of the economy. The BoJ continues to be fully engaged with and the ECB considers launching its own version of QE.

The central banks of several Emerging Markets had to raise their rates to defend a too quick decline of their currencies. The central bank of Brazil hiked rates to 9% from 7.25% at the beginning of the year. The Reserve bank of India also hiked rates by 25 bps to 7.5% and installed some capital controls. The Bank of Indonesia has also raised rates aggressively this year from 5.75% to 7.25% in September. In spite of this general trend in Emerging Markets, some countries like Mexico, Turkey, and Australia have been cutting rates this year and they stayed the course.

Corporate credit spreads widened 10 bps (50 bps tighter YTD). The EMBI spread widened by 30 bps (110 bps wider YTD).

The euro dropped 0.4% against the U.S. dollar to 1.32. But it was a mixed picture with GBP rising 2.2% and the JPY gaining 0.2%, while the AUD, CAD, BRL, NZD, and RUB all declined between 0.7% and 3.6%.

Commodity indices bucked the risk asset decline with the DJ UBS CI up 3.4% (-6.2% YTD). WTI oil rose 2.5% (+17.2% YTD) and gold jumped 6.3% (-16.7% YTD).

Short dated implied volatility for the S&P 500 climbed 3.6 points to 17.0.

As of this writing, most risk assets have rebounded strongly with markets like the S&P 500 and DAX reaching new all-time highs.

**Economy**

**U.S. economic releases**

Industrial production gained 0.4% in August after a flat July. The YoY rate improved to about 3.0%. Capacity utilization improved to 77.8%, but this is a level it reached 18 months ago, so there has been no real progress in this measure since then.

**U.S. Industrial Production**

Survey results were strong for a second month in a row. The ISM Mfg. Index firmed from 55.4 to 55.7, after it registered its first below 50 reading since the end of the GFC in May.

Durable goods orders remained volatile. After a drop of 8.1% in July, they were flat in August, but the YoY rate rebounded from around zero to 13.7%.

GDP growth for Q2 was confirmed at 2.5% annualized from 1.8% in Q1.

CPI rose 0.1% in August, but the YoY rate declined to 1.5%. Excluding food and energy, CPI...
increased 0.1% (and the YoY rate rose to 1.8%). The YoY change of the PPI Index was a bit softer at 1.4% and 1.2% less food and energy respectively.

Jobless claims remain volatile, but on a downward trend. The more reliable 4-week moving average has declined to 308K. Levels above 400K are where negative job creation reports are to be expected.

The Establishment Survey showed that the economy added 169K non-farm jobs in August, but the previous month’s report was revised down by 58K. The U-3 unemployment rate was reported down to 7.3%, while U-6 declined to 13.7%. The employment-population ratio and the labor force participation rate remain subdued. The latter effect has pushed the U-3 unemployment rate lower. Additionally, the jobs growth in the last couple of months, albeit tepid, has been boosted by the passage of “Obamacare”, as employers have replaced full-time workers with part-time works (working below 30 hours on average a week).

Nominal retail sales gained 0.2% MoM. The YoY rate declined towards 4.5%. As always this statistic is to be taken with a grain of salt, as it does not account for stores and companies going out of business (survivorship bias).

Consumer credit continues to expand at a brisk rate ($10.4bn in July), driven mostly by student loans and auto loans, while revolving credit (including credit card debt) has been weak or flat for a long time.

The UoM Consumer Sentiment Index declined sharply in September to 77.5, which is generally a depressed level, typical for recessions.

**European economic releases**

The Eurozone recession ended in Q2. The Markit Flash Eurozone Composite PMI for September improved to 52.1 from 51.5 in August.

Output had fallen continually since September of 2011 with the exception of a marginal increase in January 2012.

German PMI improved to 53.8, while French PMI rose to 50.2, its first reading above 50 for quite some time.

European industrial production for July declined 1.5% in the Euro area and 1.0% in the EU28, while the YoY drop increased to -2.1% in the Euro area and -1.7% YoY in the EU27.

**European Industrial Production**

The Euro area construction industry seems to have found a bottom and increased in July, improving 0.3% MoM (0.7% MoM in the EU28). The YoY decline improved a lot to -1.2% and -1.1% respectively.

GDP had been flat or negative in the Euro area over the previous 6 quarters. In Q2 2013 it edged up 0.3% QoQ (1.2% annualized) in the Euro area and 0.4% QoQ (1.6% annualized) in the EU27. As a result the YoY GDP growth rates improved to -0.5% and 0.0% for the two areas respectively.

Unemployment levels in July improved a bit as well to 12.1% in the Euro area and 11.0% in the EU27. The worst levels were in Spain (26.3%), Greece (27.6%), Portugal (16.5%), Croatia (16.7%), and Cyprus (17.3%). The best levels are in Austria (4.8%), Luxembourg (5.7%), and Germany (5.3%).

Euro area inflation declined to 1.1% YoY in September (estimated) from 1.3% in August (1.5% YoY in the EU28 for August).
Real retail sales for July improved 0.1% MoM (-1.3% YoY) in the Euro area and were up 0.2% in the EU27 (-0.3% YoY).

**Asian economic releases**

Japan’s industrial production declined 0.7% in August, but the YoY rate has improved to -0.2% YoY over time. The Markit/JMMA PMI in September rose to 52.5 from 52.2 in August – the highest level since February 2011. So Japan continues exiting its recessionary conditions thanks to the cheaper JPY.

The Chinese economy’s reacceleration was restarted after a slow patch through a renewed credit boost via the central government. The September HSBC Flash PMI accelerated to 51.2 from 50.9 in August.

Some Asian countries with current account deficits like India, Turkey, and Indonesia have suffered a tightening of financial conditions as a consequence of the “tapering” rout in Emerging Markets exchanges. Conditions there are slowly improving as of this writing.

**Summary**

We seem to be on the verge of a synchronized improvement in global developed markets growth with Europe coming out of the double-dip recession and starting from a lower level, Japan pressing ahead with its currency debasement, and China stepping on the (credit) accelerator again. Thus the potential for an acceleration of profit growth (at 2-3% p.a. over the last 1.5 years in the U.S.) to 10-11% p.a. looks likely according to the BCA. Only the weak Emerging Markets (e.g. with current account deficits) may pose some local threats.

On the other hand, we recognize that the economy is structurally weak with high (albeit somewhat improved in the case of the U.S. private sector) debt levels, low organic demand growth, and vast amounts of “zombie” enterprises being bailed out by emergency monetary and fiscal policies that have become now part of normality. Especially, the situation in Europe with overlevered banks and an unworkable currency arrangement remains fundamentally unresolved.

Additionally, long-term asset valuations are poor across all asset curves with some potential pockets (in specific Eurozone countries or Emerging Markets) offering some niche opportunities. Finally, the market’s euphoria and groupthink may cause markets to drop on their own weight, as everybody moves to the same side of the boat or the supply of “greater fools” gets exhausted (e.g. this is what happened with the U.S. housing market over 2006-2008 in spite of “record affordability”).

The end of QE and/or tightening by the Fed in the next 1-2 years also remains as a potential longer-term risk. We see the true cost of QE in creating a fragile and unsustainable, echo bubble situation in markets that increases systemic instability for the sake of “kicking the can down the road” a bit further.

Over the short-term, the “no taper” decision should provide a further boost to markets, after the “government shutdown” discussions in the U.S. subside.
## Market Performance: August 2013

### Equities

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<thead>
<tr>
<th>Index</th>
<th>Level</th>
<th>Month</th>
<th>YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI World</td>
<td>1473</td>
<td>-2.3%</td>
<td>10.0%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>1633</td>
<td>-3.1%</td>
<td>14.5%</td>
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<tr>
<td>NASDAQ</td>
<td>3590</td>
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<tr>
<td>DJ STOXX 600</td>
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<td>-0.8%</td>
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<td>DAX</td>
<td>8103</td>
<td>-2.1%</td>
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<td>TOPIX</td>
<td>1106</td>
<td>-2.3%</td>
<td>28.6%</td>
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<tr>
<td>MSCI Emerging Markets</td>
<td>930</td>
<td>-1.9%</td>
<td>-11.9%</td>
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<tr>
<td>Shanghai SE composite</td>
<td>2098</td>
<td>5.2%</td>
<td>-7.5%</td>
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<tr>
<td>RTS</td>
<td>1291</td>
<td>-1.7%</td>
<td>-15.5%</td>
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<tr>
<td>Brazil Bovespa</td>
<td>50012</td>
<td>3.7%</td>
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### Commodities

<table>
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<tbody>
<tr>
<td>GSCI</td>
<td>486</td>
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<tr>
<td>DJ UBS CI</td>
<td>130</td>
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<tr>
<td>WTI</td>
<td>108</td>
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<td>Gold</td>
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<td>Copper</td>
<td>7086</td>
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<tr>
<td>Corn</td>
<td>482</td>
<td>-3.4%</td>
<td>-31.0%</td>
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<tr>
<td>Sugar</td>
<td>16</td>
<td>-3.7%</td>
<td>-16.2%</td>
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<tr>
<td>Nord Pool Power</td>
<td>37</td>
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<td>German Power</td>
<td>38</td>
<td>8.5%</td>
<td>-14.1%</td>
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<tr>
<td>Baltic Dry Bulk</td>
<td>1132</td>
<td>6.6%</td>
<td>61.9%</td>
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### Equities Level Month YTD

### Commodities Level Month YTD

### Volatility*

<table>
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<tr>
<td>CBOE SPX Volatility Inde</td>
<td>17.0</td>
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<tr>
<td>VDAX</td>
<td>18.0</td>
<td>1.3</td>
<td>2.0</td>
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### Bank Rates*

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<th>Level</th>
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<tr>
<td>Fed Funds Target Rate</td>
<td>0.3%</td>
<td>0.0%</td>
<td>0.0%</td>
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<tr>
<td>ECB Rate</td>
<td>0.5%</td>
<td>0.1%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Euribor 3 months</td>
<td>0.2%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>USD Libor 3 months</td>
<td>0.3%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Bank of England Rate</td>
<td>0.5%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Bank of Japan Target Rate</td>
<td>0.1%</td>
<td>0.0%</td>
<td>0.0%</td>
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### Currencies

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<th>Currency</th>
<th>Level</th>
<th>Month</th>
<th>YTD</th>
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<tbody>
<tr>
<td>EUR/USD</td>
<td>1.32</td>
<td>-0.4%</td>
<td>0.2%</td>
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<tr>
<td>JPY/USD (x 100)</td>
<td>1.02</td>
<td>0.2%</td>
<td>-11.7%</td>
</tr>
<tr>
<td>GBP/USD</td>
<td>1.55</td>
<td>2.2%</td>
<td>-4.5%</td>
</tr>
<tr>
<td>AUD/USD</td>
<td>0.89</td>
<td>-0.7%</td>
<td>-14.3%</td>
</tr>
<tr>
<td>CAD/USD</td>
<td>0.95</td>
<td>-2.4%</td>
<td>-5.6%</td>
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<tr>
<td>CHF/USD</td>
<td>1.08</td>
<td>-0.1%</td>
<td>-1.6%</td>
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<tr>
<td>BRL/USD</td>
<td>0.42</td>
<td>-3.6%</td>
<td>-13.9%</td>
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<tr>
<td>RUB/USD (x 100)</td>
<td>3.00</td>
<td>-0.9%</td>
<td>-8.2%</td>
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<tr>
<td>NZD/USD</td>
<td>0.77</td>
<td>-3.0%</td>
<td>-6.5%</td>
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<tr>
<td>CNY/USD</td>
<td>0.16</td>
<td>0.2%</td>
<td>1.8%</td>
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### Fixed Income*

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<th>Index</th>
<th>Level</th>
<th>Month</th>
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</thead>
<tbody>
<tr>
<td>UST 2yr</td>
<td>0.4%</td>
<td>0.1%</td>
<td>0.1%</td>
</tr>
<tr>
<td>UST 10yr</td>
<td>2.8%</td>
<td>0.2%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Euro 2yr</td>
<td>0.2%</td>
<td>0.1%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Euro 10yr</td>
<td>2.0%</td>
<td>0.2%</td>
<td>0.6%</td>
</tr>
<tr>
<td>UK 2yr</td>
<td>0.5%</td>
<td>0.1%</td>
<td>0.2%</td>
</tr>
<tr>
<td>UK 10yr</td>
<td>2.8%</td>
<td>0.4%</td>
<td>0.9%</td>
</tr>
<tr>
<td>JGB 2yr</td>
<td>0.1%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>JGB 10yr</td>
<td>0.7%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>CS High Yield Spread</td>
<td>5.0%</td>
<td>0.1%</td>
<td>-0.5%</td>
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<tr>
<td>JP EMBI Global Spread</td>
<td>3.8%</td>
<td>0.3%</td>
<td>1.1%</td>
</tr>
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* Level change in percentage points

Source: Prime Capital, Bloomberg
**Relative Value Review**

August was a slightly negative month for Relative Value strategies, as the HFRX Relative Value Arbitrage closed at -0.2% (1.2% YTD). Performance was relatively flat across the board: Convertible Arbitrage strategies lost 0.1% (9.6% YTD), Corporate Bond strategies were up 0.2% (3.1% YTD), while Fixed Income Asset-Backed strategies were up 1.0% (8.6% YTD).

**Structured Credit Arbitrage**

In August, once again, tapering caused volatility in the markets, along with geopolitical concerns around a possible military intervention in Syria. The ABS market performance was mixed during the month, with European ABS holding up better than the U.S. ABS, which caused the ABX 2006-2 AAA Index to decline 4pts to 67.75, partially due to increasing hedging activity. At the same time, daily volume reported by TRACE was $1.2bn (lower than the recent average of $1.9bn). On the other hand, recent regulatory developments such as the amendments to the risk retention rules under the Dodd-Frank Act (removal of the Premium Capture Reserve Account and changes in the Risk Retention Methodology, among other) should be beneficial for the market in the medium-to-long-term according to the CQS ABS Fund manager.

In Europe however, August was a rather positive month amidst low inventory levels in the CMBS markets, where investors sought to reinvest July’s repayments.

The HFRI Relative Value Fixed Income-Asset Backed Index gained 0.6% (5.7% YTD). CQS ABS was up 0.3% (6.3% YTD), while Halcyon Asset-Backed Value Fund was up 0.1% (5.0% YTD).

**Corporate Long/Short**

The Barclays Global Aggregate Corporate Index lost 0.6% in August. Results were mostly negative across all qualities and maturities.

In the U.S., investment grade (IG) credit ended the month 3bps wider, hence underperforming duration-matched Treasuries by 22bps; the CDX.IG.20 Index widened 9bps during the month. High yield (HY) declined 0.6% (2.7% YTD). A relatively strong sell-off in rates continued to push 5y and 10y Treasuries yields up 26bps and 21bps, respectively.

The Pan-European IG aggregate lost 11bps in August, mostly due to high quality mid- and long-term maturity assets. In contrast, Pan-European HY gained 40bps, bringing YTD performance to 4.1%.

U.S. fixed-rate, gross IG supply for June was about $61bn, mainly led by Industrials, which issued $24bn of IG debt. On the other hand, the HY primary market priced only $13.2bn. August supply brought the YTD figure to $212.9bn.

**Convertible Arbitrage**

The Barclay’s U.S. Convertibles Composite lost 1.2% in August in the wake of the equity market’s
decline. EMEA convertibles were up 0.7%, while Asia Pacific lost 1.7%.

New issuance in August reached $12bn YTD from 32 deals in the EMEA region, while they have only reached $7.7bn from 33 deals in Asia. Concerns over rising interest rates could lead convertibles to outperform straight bonds, thanks to their typical lower rho and positive equity delta.

However, August was a mixed month for US convertibles as credit spreads remained unchanged while rates sold off. As far as volatility is concerned, implied volatility of IG converts, with at least 1 year of call protection, closed at 29.7% (down 85bps from the last month).

Finally, non-investment grade convertibles’ spreads tightened 6bps to 417bps, while the Barclays US HY ‘B’ Index tightened to -24bps from -13bps in July.

**IG and Non-IG Converts Spreads**

![IG and Non-IG Converts Spreads](image)

Source: Barclays

The HFRI RV FI Convertible Arbitrage Index gained 6bps (5.2% YTD), while the DJ Credit Suisse Blue Chip Convertible Arbitrage Broad Index was up 0.9% (3.1%). Aristeia gained 1.6% (11.3% YTD), while Waterstone also gained 2.1% (-10.8% YTD) due to an overall short positioning on credit and equities. The more trading focused fund, Wolverine Capital, gained 0.4% (4.3% YTD). Finally, Northwest Market Neutral funds posted a negative performance of -1.2% (17.1% YTD), while Northwest China Opportunities Fund gained 25bps (-2.67% YTD).

**Volatility Arbitrage**

August saw implied volatility move higher in its second half, after the S&P 500 reached all-time highs on August 2\textsuperscript{nd} before trading lower amidst concerns over the Fed’s tapering as well as a potential military action in Syria. The latter developments have encouraged volatility buyers, although mainly in indices.
Outlook

Credit Arbitrage - neutral
- Structured Credit – neutral/positive:
  ABS markets have outperformed over the year, driven by the recovery in the housing market, particularly in the hardest affected areas, which implicitly coincide with the highest subprime concentrations. Technicals and fundamentals are expected to continue to support this space. However, recent Fed comments caused an increase in market volatility, which shows their relative vulnerability to the macro picture. Carefully choose managers who apply macro overlays and are able to successfully exploit disparities in issues through true relative value trades based on thorough due diligence.

- Corporate Long-Short - neutral
  Spreads have compressed, although their fair level depends on a market participant’s view of both the economy’s path and how technicals will play out – the search for yield driven by low ‘risk free’ alternatives may well support spreads going forward. Choose managers with a proven ability to source idiosyncratic risk and hedge vs. those riding the market.

- Asset Based Lending – positive:
  ABL strategies are attractive given low public market yields, reticent bank lending and plateauling defaults. Avoid legacy portfolios.

Convertible Arbitrage – neutral
Convertible spreads are still below their straight bond brethren and valuations are on average fair. We continue to be constructive on the overall market technicals in the sector (long-only buyers now making up a majority of investors vs. leveraged hedge funds previously, low primary supply) and the opportunities for capital structure trades.

Volatility Arbitrage - positive
Volatility has experienced large moves in the last few years and has recently come down to what seems like very complacent levels (both implied and realized). Given the current environment, and the relative lack of risk capital in the market, we expect volatility to remain... volatile and hence provide good trading opportunities for skilled managers. Appetite for tail risk hedging also remains elevated and not unjustifiably so, and we continue to view a small allocation to this as beneficial.

Insurance Linked Securities – neutral
Pricing remains relatively attractive in this market, though it has risen recently, and for those who can commit capital for up to a year, higher return per unit of risk will add to the diversification benefit of the asset class.
Event Driven Review

The HFRX Even Driven Index posted a negative performance in August (-0.3%; +8.9% YTD). Both the HFRX Merger Arbitrage and the Distressed/Restructuring strategies were about flat, totaling YTD performances of 2.5% and 4.0%, respectively.

M&A

According to Bloomberg, 2010 M&A deals were reported worldwide in August for a total amount of $140bn of announced deals. Overall, the aggregate volume of global M&A transactions has totaled $1378.3bn this year, lower than the $1489.7bn of the 12-month moving average.

Global M&A Activity

Source: Bloomberg

Among the more noteworthy transactions in August was Sinopec’s offer for Apache’s Egyptian oil and gas business ($3.1bn), Amgen’s offer for Onyx Pharmaceuticals Inc. ($9.7bn), Valeant’s acquisition of Bausch+Lomb Holdings Inc. and Pinnacle Entertainment’s acquisition of Ameristar.

Distressed Securities

High yield bonds posted a negative performance in August, closing at -0.6% (+2.7% YTD), as did HYCDX at -1.2% (+8.0% YTD). Over the course of August, gross supply in fixed-rate IG bonds totaled $62.1bn, mainly led by industrials ($24.1bn), while new speculative-grade issues totaled $13.2bn ($212.9bn YTD).

According to Moody’s Default Report, the trailing-12-month global speculative-grade corporate default rate ended Q2 at 2.9% in August from 3.0% in July. Only two Moody’s-rated corporate debt issuers defaulted last month, among which 27 from North America, 13 from Europe and the remainder from Latin America. Moody’s expects the global speculative default rate to close 2013 at 3.1%, before falling to 2.7% in August Q2 2014. Finally, Moody’s global distressed index decreased to 8.5%, compared with 8.8% in July and 17.5% a year ago.

HY Spread vs. Trailing 12m Default Rate

Source: Barclays

Some Distressed managers generated positive performances in August. For example, Canyon, which has a bias towards ABS paper, reported a positive 0.2% performance (+9.9% YTD), while King Street Capital also posted a positive 0.2% (8.3% YTD).

Over the past month, Multi-Strategy Event Driven managers we follow posted mixed results, remaining mostly flattish. AG Super Fund International lost 0.1% (+9.8% YTD), while OZ Overseas Fund was down 0.12% (+5.9% YTD).

Outlook

Risk Arbitrage - neutral

Despite strong cash balances, future macro events may continue to cause spikes in volatility which may discourage CEOs to initiate deals.

The risk arbitrage market is divided between very tight spreads on deals which seem to be safe and particularly wide spreads for deals which are risky (for instance antitrust risk, Chinese involvement, partially announced/strategic reviews, etc.).

Regulators’ interventions further increase the uncertainty surrounding future deals.

Distressed Securities - positive

The inability of many companies to sustain over-levered capital structures will inevitably produce a tremendous supply of dislocated credit.

Furthermore a lot of managers are involved in the recovery of various ABS securities (especially in...
the mortgage sector) or bankruptcies (e.g. Lehman Brothers) still offering attractive idiosyncratic opportunities.

A volatile political and economic environment, especially in Europe, offers good opportunities in trading highly liquid securities as well stressed sovereigns bonds.
Equity Hedge

Review

In August, equity hedge strategies finished the month in negative territory. The HFRX Equity Hedge Index was down 1.7% (+5.5% YTD) mainly driven by the HFRX Quantitative Directional Index (-1.1%; +5.3% YTD). The HFRX Equity Hedge Short Bias Index generated a negative performance for the month (-1.2%; -7.6 YTD), while the HFRX EH Fundamental Value Index was also down (-2.1%; +9.5% YTD). Overall, equity hedge strategies retreated less than the broad market in August, but are still lagging behind it in terms of YTD figures – the MSCI World and the S&P 500 lost 2.3% (+10.0% YTD) and 3.1% (+14.5% YTD), respectively.

Many macroeconomic and geopolitical events contributed to the deterioration of the equity trading environment during the last month: the Fed’s tapering expectations causing the yield curve to steepen, the FOMC meeting conclusions lacking clear positive signs, the Chinese deleveraging effect impacting liquidity, and the spike in oil prices (to a 12 month-high) resulting from a possible military action in Syria. On the other hand, economic data in Europe continued to confirm improving conditions, allowing stock markets there to limit their monthly losses.

Cumulative equity net trading as % of total gross exposure

The equity markets’ sell-off across all regions was reflected in the managers’ use of leverage, which dropped as well.
picking environment. Finally, the second half of August was relatively tough for emerging markets. As a consequence, conservative net exposures helped managers navigate a tough, high volatility environment.

On the manager level, results reported to us were mixed for the month. Among discretionary equity hedge managers, the BTG Pactual GEO Fund gained 2.2% (+7.4%), while the Marshall Wace Global Opportunities Fund dropped sharply, posting a negative 3.9% performance (+7.7% YTD).

The results of quantitative focused managers were mixed. The Millennium International Fund gained 0.5% (7.8% YTD), while Highbridge Statistical Opportunities Fund lost further 2% (-6.2% YTD).

Outlook

**Continue to favor stock pickers with rather tight net exposure**
Investors should diversify across styles and regions. Overall high volatility levels and quick changes in the macro environment might result in rapid market bounces and/or corrections.

**Emerging Markets**
Favour managers that do not have a country bias. Managers focused on a specific country tend to be more beta-driven than other managers. Pure beta exposure to a specific emerging market can be achieved cheaper and with better liquidity terms.
Tactical Trading

Review

August was quite a poor month for Tactical Trading managers on average.

The DJ CS Managed Futures Index dropped 2.8% (-7.3% YTD). Losses were made primarily in longs in stocks and high-yielding currencies and shorts in precious metals. Winton Futures lost 3.7% for the month (-0.1% YTD), while BlueTrend declined 0.5% (-11.6% YTD).

Recently, Managed Futures managers have switched to a “risk on” exposure. This helps offset the losses incurred due to decreasing market volatility, but reduces their protective and risk-diversifying capabilities and exposes them more to tail risks.

Short-term traders also had a difficult month. For example Amplitude Dynamic declined 2.6% (2.0% YTD) and Kaiser Trading 2X lost 2.4% (+10.7% YTD), while Crabel Multi-Product and QIM managed to gain 0.5% (+5.4% YTD) and 1.3% (-5.5% YTD).

Global Macro managers were down on average as well. The DJ CS HFI Global Macro index declined 0.9% (+0.7% YTD). Of the managers we follow, Brevan Howard lost 1.9% (+0.7% YTD) due to a reversal in their Japan trades.

The opportunity set for macro managers may be getting richer, as “risk on” / “risk off” appears to be dead and correlations between and within asset classes have declined. The correlation decline if it persists is a benefit for Managed Futures managers as well.

Outlook

Global Macro - neutral

Tactical trading around policy interventions currently provides the most attractive opportunities. Global Macro managers should also be able to profit over the long term from the outperformance of Emerging Markets’ (and other positively diverging countries’) equities, currencies and bonds. However, this task has been complicated by overweight positioning in these markets by investors and a corresponding underperformance of the universe. Currently Emerging Markets seem poised to continue underperforming, facing inflationary pressures, slower commodities demand from China, and higher competition from Japan due to the weaker JPY. Prefer nimble, tactically trading and liquid managers who are able to protect capital in a stressful scenario.

Managed futures – neutral

Managed Futures managers still face difficulties with market choppiness, so we maintain a negative stance on long-term trend-followers.

Quicker reacting trend-following managers with horizons of around 4-8 weeks can benefit from markets that trade in wide volatile ranges and also act as a partial tail hedge for portfolios, so we remain neutral on them.

We keep our stance on short-term traders at neutral, as the high valuations of risky assets and the multitude of risk factors may cause new volatility spikes that can be traded profitably. These managers can also serve as a partial tail hedge of a portfolio.
Commodities

Review

In August, commodity trading managers posted an estimated average gain of 0.6% (-0.1% YTD) as measured by the NewEdge Commodity Trading Index. Commodity markets outperformed this month the international stock markets in terms of performance (3.4%; -6.2% YTD) as measured by the Dow Jones UBS Commodity Index.

An interesting phenomenon currently is the continued breakdown in commodity/equity and cross commodity correlations. While it may be early to say that the long period of positive commodity correlations with equities is over, the latest move is part of a consistent trend of diminishing positive correlations since late last year, suggesting that commodities can still provide investors with some diversification.

Cross Commodity Correlations Fall

WTI crude oil (2.5%; 17.2% YTD) rose throughout the month with the gain stemming among others from the uncertainty associated with a potential Syrian strike, as well as news on Libyan terminal and field stoppages. Surprisingly, this increase has gone hand in hand with a stronger dollar, leading to a strong rise in the correlation between the two (see next chart).

The Correlation between WTI and the USD Spikes Sharply Higher

A major development throughout the month of August was the widening of the WTI-Brent differential with -6 USD/b being a level last seen last June 2012.

The WTI-Brent Front Month Differential Widening Again

The major reasons for the WTI side of the differential were among others the lower refineries’ demand due to expected maintenance for example of Motiva’s 325 and 255 thousand b/d refineries in Texas and Louisiana respectively. On the other hand, large supply shortfalls and geo-political tensions are supporting crude prices outside of North America. For example the North Sea region continues to be characterised by planned and unplanned outages which are likely to reduce overall output in Q4. Planned outages at BP’s Ula (Norway) and Noreco’s Huntington (UK) fields as well as at Norway’s Kollsnes gas processing plant will reduce production further in September. In addition the main Libyan oil
terminals, Es Sider and Ras Lanuf, are still offline weighing on exports.

The base metals complex was positive on average for the month. Copper (5.4%；-8.6% YTD) was the best performer within the complex mainly due to short covering activity as well as pipeline restocking, tight scrap supply and strong power sector demand. The price recovery was additionally supported by housing related restocking and car demand in the US. On the supply side the picture continues to look strong though with Chilean production continuing to increase.

**US Copper Demand Boosted by Housing**

![Graph showing NAHB housing market index vs US copper demand (Kt)](source: Barclays Capital)

Base metal specialist Galena lost 2.6% (-4.2 % YTD).

Precious metals, similarly to base metals, had a positive month. Silver (+19.8%；-22.2% YTD) was the largest winner within the complex as the month saw large ETP inflows. In addition, U.S. and Australian coin demand increased strongly.

**Huge Inflows into Physically Backed Silver ETPs**

![Graph showing monthly flows to silver ETPs (tonnes)](source: iShares, ETF Securities, ZKB, JB, Bloomberg, Barclays Capital)

Broadly, retail demand in silver has remained relatively robust despite sizeable holdings being a loss-maker YTD and as a consequence when these holdings are redeemed significant downward pressure on prices is likely.

A weaker dollar and equity markets have provided a short covering boost to gold prices (+6.3%；-16.7% YTD), but the physical market is still weak as shown by continued ETP outflows.

**ETPs Disinvestment Continues**

![Graph showing CFTC net long speculative positions (tonnes)](source: EcoWin, CFTC, various ETP issuer websites, Bloomberg, Barclays Capital)

Hinde (+9.6%；-21.1% YTD) moved in tandem with the market.

Grain markets were on average positive in August due to record breaking dry weather across the US Midwest. Conditions were least favourable for soybeans (+8.6%；-3.7% YTD) and US production estimates have been revised lower in response. Merricks (-1.7%；-0.02% YTD) lost mainly from being long soybean oil, short soybean and long soybean put vs. short soybean call option spread.

**Outlook**

Commodity markets are expected to deliver a diversified and differentiated price performance across and within sectors for the rest of 2013, continuing the on-going process of disentangling from broad macro drivers. With cross-commodity correlations coming off, prices have performed less like a single factor driven complex and more as a set of individual markets driven by specific supply and demand fundamentals. Nevertheless flexibility and nimbleness remain crucial for commodity trading managers. Currently, managers continue to focus more on relative value trades among commodities rather than taking directional (long-biased) views.
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Source of data: Prime Capital AG