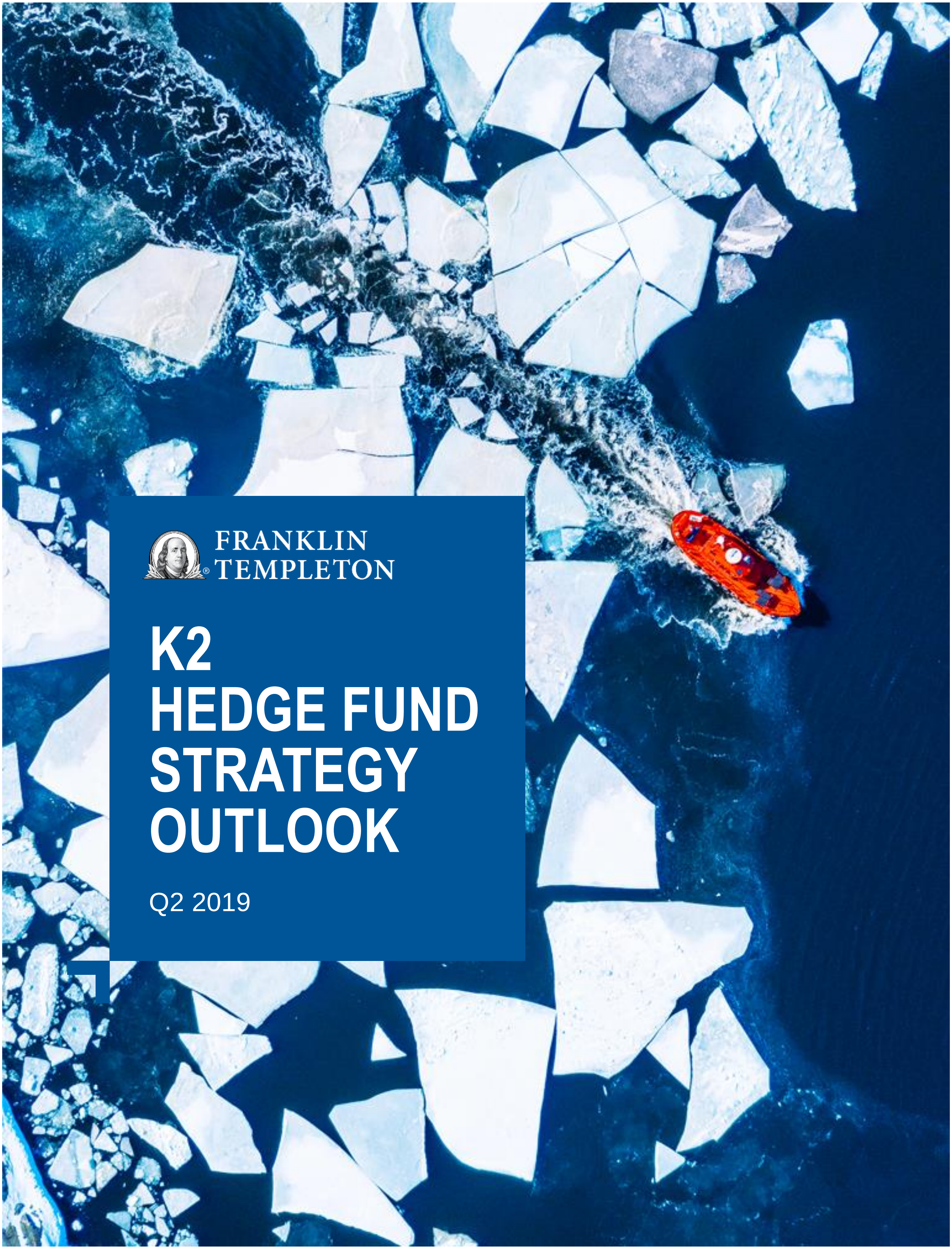

FRANKLIN TEMPLETON

# K2 HEDGE FUND STRATEGY OUTLOOK

Q2 2019

# Q2 2019 OVERVIEW

In our view, the changing rate environment, broad macroeconomic risks, and a dramatic repricing of volatility should create opportunities for the 2nd quarter. Our top strategy convictions: Long Short Credit, Discretionary Macro, and Volatility Arbitrage.

## OUR TOP CONVICTIONS

1

**Long Short Credit**
The changing rate environment and market technicals are leading to variation in performance among different credit asset classes such as investment grade, high yield, and leveraged loans.

2

**Discretionary Macro**
Broad macro risks including central bank policy changes, a busy political calendar, and unstable correlations across asset classes can create potentially attractive trade opportunities

3

**Volatility Arbitrage**
Our positive outlook is a function of improved relative value and trading opportunities globally, as well as by the potential for higher "volatility of volatility".

### LONG/SHORT EQUITY

Strong rebound in the market in early 2019 indicates that weak first quarter earnings and softened FY 2019 guidance is largely discounted. Managers are ready to capitalize on both the systematic and idiosyncratic moves in the long and short books.

### RELATIVE VALUE

In our view, the less directional nature of relative value strategies remains attractive amidst the greater uncertainty in the markets.

### EVENT DRIVEN

Corporate activity remains healthy but has slowed down from a strong 2018. Tailwinds for corporate activity continue – corporate tax cuts, cash repatriation, high CEO confidence, and low interest rates

### CREDIT

We feel long/short credit managers are well positioned to benefit from shifts in investor sentiment through actively managing net exposures and to generate alpha from a catalyst rich environment.

### GLOBAL MACRO

We believe an active geopolitical calendar, diverging central bank policies, and higher volatility across asset classes should present attractive trading opportunities for nimble relative value macro managers.

### COMMODITIES

We expect niche relative value strategies to continue to perform well but remain more cautious until there is more clarity on a trade deal given China's large representation of demand for many commodities.

### INSURANCE-LINKED SECURITIES

We expect to see a robust cat bond new issuance pipeline in cat bonds ahead of the start of hurricane season.

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## We Have the Printing Press…and Other Worries

This quarter we're highlighting a topic recently addressed by our colleague Sonal Desai in her blog post titled "Modern Magical Thinking". In it she discusses Modern Monetary Theory (MMT), a hot topic in current economic circles and a subject we have been asked about in recent client meetings.

So what is MMT? Interpretations of the theory are broad and somewhat ambiguous. It often depends upon whom you ask. As Sonal alludes to in her blog, there's a deep rabbit hole of books and articles on the subject (you've been warned). Collectively it's hard to pin down exactly what MMT says. It presents itself as a set of sensible principles, then morphs into what we think are questionable policy ideas.

In her blog post our colleague Sonal Desai describes the basic tenets as follows: (1) the government has a monopoly over the issuance of national currency; (2) unlike households or companies, the government does not have a budget constraint; it can never run out of money to spend because it can print money; and (3) the only limit to the government's spending power kicks in when it generates excessive inflation.

So MMT proponents argue that the government's role is to help generate maximum employment and moderate inflation. Fair enough. And in doing so, according to MMT, it has carte blanche regarding monetary policy and deficit spending. In other words — spend and spend, and if that doesn't work, spend some more. The argument is that if a government runs a significant budget deficit to invest in something like education, infrastructure, etc., the debt it accumulates in the process can eventually be paid down by the growth the spending creates. The end justifies the means.

In theory this sort of makes sense… in theory (ahem). But the challenge is in the notion that any level of public debt, no matter how onerous, does not matter. This is where we, and many other economists for that matter, get stuck.

MMT argues the government can never run out of money to spend — it can simply print more as needed. Hence the only restriction is related to inflation. The catch is the government must be wary of printing too much money, to avoid creating a Weimar Republic type of hyperinflation crisis.

But (and here is the big issue in our view), MMT proponents also claim that inflation is never a serious risk for the US…ever. This is because we are different from the rest of the world. Our currency — US dollars — is the global reserve currency. The rest of the world will always want more, they argue. To paraphrase former US Treasury Secretary John Connally,[1] "our spending, your problem".

From our standpoint this is somewhat short-sighted. As our colleague Sonal Desai explains, "this happily ignores that it was not always this way. It was the rest of the world that chose to adopt the US dollar as the global reserve currency after decades of growth-boosting, responsible policies… If US policies change dramatically, the rest of the world could shift its preferences to other reserve currencies (a few competitors are already in the running). The notion that it's the US's choice to have the US dollar as the global reserve currency is profoundly mistaken."

In other words, this is where MMT thinking may be a bit flawed. Fear of adverse consequences associated with unconventional monetary policy and excessive budget deficits has dissipated in recent years. We think this is a mistake.

Proponents will argue — QE hasn't been a problem, Brexit did not trigger a recession, so who says we can't print our way to prosperity? We would argue there are many, many reasons, and not enough space in this small missive to elaborate in detail.
In the simplest of terms, however we offer a quote from the November 2013 Edelweiss Journal that summarizes our thinking quite succinctly: "And as for the economy, we know only this: it is a complex system. From this observation can be derived a straightforward corollary on economic policy makers: trying to control a variable you can't measure (inflation), with a tool you don't fully understand (money) in a complex system with hidden, unobservable and non-linear interrelationships (the economy) is a guaranteed way to ensure that most things which happen weren't supposed to happen."

If we accept this ignorance as an undesirable however no less valid truth, then it seems hard to deny the probability that policy actions taken today may also have unintended, perhaps far reaching, and potentially significantly damaging longer term consequences tomorrow. MMT policy would certainly be no exception, and in our view likely add a substantial amount of fuel to the proverbial fire.

### Long Short Credit

The changing rate environment growth prospects may lead to variation in performance among different credit asset classes such as investment grade, high yield, and leveraged loans. Long short credit managers are well positioned to profit in this environment given their nimbler trading profiles and increased focus on issuer-specific catalysts. Managers are also finding attractive opportunities in capital structure arbitrage.

1.Shortly after his appointment as Treasury secretary in 1971, Connally met a group of European Finance Ministers who expressed concern about the US exporting inflation to the rest of the world via the dollar. He famously replied, "The dollar is our currency, but your problem."

**Credit ETFs Experienced Significant Declines in AUM in Q4**
As of March 25, 2019


Source: Bloomberg
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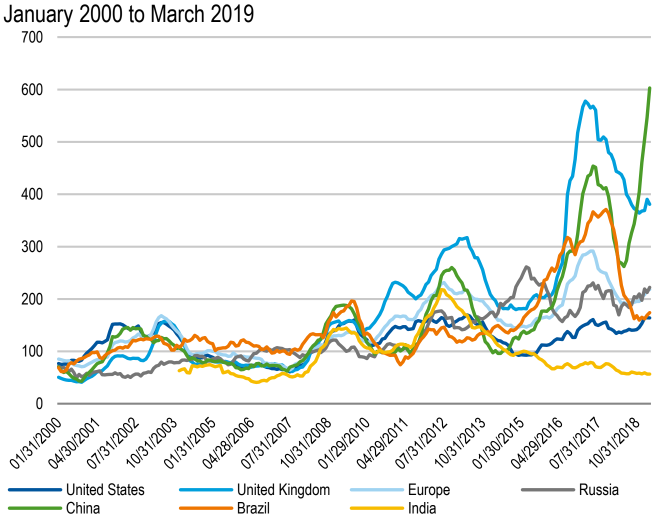
### Discretionary Macro

There are many potentially attractive trade opportunities for discretionary managers stemming from a number of broad macro cycles, including central bank policy changes, a busy political calendar, and unstable correlations across asset classes. Both the high-level macro risks and individual idiosyncratic situations at the country level are likely to continue to drive market volatility, and potentially offer interesting asymmetric investment opportunities across both developed and emerging markets.

**Economic Policy Uncertainty, News Based, Index**
**12-Month Rolling Average**
January 2000 to March 2019




Source: 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.
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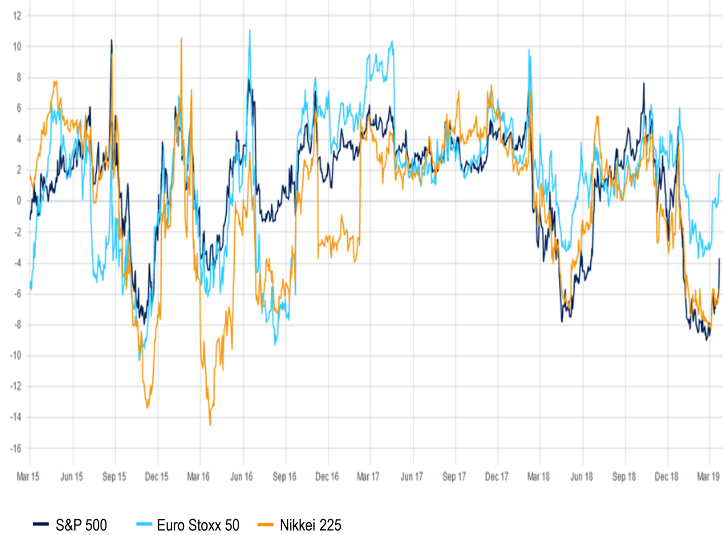
### Volatility Arbitrage

The rebound in equity prices after last year's market sell-off has resulted in a dramatic repricing of volatility and skew lower. Although still above the absolute lows of 2017, implied volatility remains below long-term averages, and could potentially stay there for prolonged periods of time. Our positive outlook for volatility arbitrage is a function of improved relative value and trading opportunities globally, as well as by the potential for higher "volatility of volatility" given the various crosswinds of risk factors that can rear their head later in the year.

**Difference Between 3-month Implied and Realized Volatility for S&P 500, Euro Stoxx 50, and Nikkei 225 Indices**
March 2015 to March 2019




Source: Barclays Live, Global Volatility Center. Data from March 2, 2015 through March 22, 2019. 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.

## Strategy Outlook Summary

### Long/Short Equity

We are cautiously optimistic on the outlook for long/short equity managers. We believe the strong rebound in the market in early 2019 indicates that weak first quarter earnings and softened FY 2019 guidance is largely discounted. Managers are ready to capitalize on both the systematic and idiosyncratic moves in the long and short books. They have been slowly increasing their gross and net exposures and are still ready to deploy further capital in times of significant dislocation.

### Relative Value

The less directional nature of relative value strategies remains attractive amidst the greater uncertainty in the markets. We have a neutral outlook for fixed income arbitrage and convertible arbitrage. Maintain a favorable outlook for volatility arbitrage with higher market volatility presenting attractive trading opportunities.

### Event Driven

Corporate activity remains healthy but has slowed down from a strong 2018. Tailwinds for corporate activity continue – corporate tax cuts, cash repatriation, high CEO confidence, and low interest rates. However, delays in a trade war resolution between the US and China remain a headwind. Merger arbitrage spreads remain attractive relative to Treasury yields. We are cautious on special situations due to the many value traps caused by disruptive technology but believe the market has discounted a significant amount of the risk.

### Credit

Long/short credit managers are well positioned to benefit from shifts in investor sentiment through actively managing net exposures and to generate alpha from a catalyst rich environment. Defaults remain low with limited new opportunities. In structured credit, fundamentals remain strong and yields look attractive on a relative basis. In private credit, we prefer niche strategies.

### Global Macro

Favorable outlook for the strategy overall, with preference given to discretionary managers. An active geopolitical calendar, diverging central bank policies, and higher volatility across asset classes should present attractive trading opportunities for nimble relative value macro managers. More cautious outlook in systematic strategies, which can benefit from an improving correlation environment but remain susceptible to choppy market action.

### Commodities

A US-China trade deal still looms as a key event for commodities market. We expect niche relative value strategies to continue to perform well but remain more cautious until there is more clarity on a trade deal given China’s large representation of demand for many commodities.

### Insurance-Linked Securities

The January renewal period saw lower than initially expected rate increases given the largest level of insured losses over a two year period.  We expect to see a robust cat bond new issuance pipeline in cat bonds ahead of the start of hurricane season.  The April Japan renewals will likely be stronger given the heavy event activity of 2018 in the region.

## Outlook Trend For Strategies And Sub-Strategies

| STRATEGIES | Q4 2018 | Q1 2019 | Q2 2019 | CHANGES |
|---|---|---|---|---|
| **Long/Short Equity** | +1 | 0 | **0** | – |
| Activist | +1 | +1 | **+1** | – |
| Asia | 0 | -1 | **0** | ↑ |
| Sector Tech/Healthcare | +1 | 0 | **0** | – |
| Equity Market Neutral | 0 | 0 | **0** | – |
| Europe | +1 | -1 | **+1** | ↑ |
| **Relative Value** | +1 | +1 | **+1** | – |
| Fixed Income | 0 | 0 | **0** | – |
| Convertible Arbitrage | +1 | 0 | **0** | – |
| Volatility Arbitrage | +1 | +2 | **+1** | ↓ |
| **Event Driven** | +1 | 0 | **0** | – |
| Special Situations | 0 | -1 | **-1** | – |
| Merger Arbitrage | +1 | +1 | **+1** | – |
| **Credit** | +1 | +1 | **+1** | – |
| Distressed | -1 | -1 | **-1** | – |
| Structured Credit | +1 | +1 | **+1** | – |
| Direct Lending | +1 | +1 | **+1** | – |
| Long/Short Credit | +2 | +2 | **+1** | ↓ |
| **Macro** | +1 | +1 | **+1** | – |
| Discretionary | +1 | +1 | **+1** | – |
| Systematic | 0 | 0 | **0** | – |
| Emerging Markets | 0 | 0 | **+1** | ↑ |
| **Commodities** | 0 | 0 | **0** | – |
| Agriculture | +1 | 0 | **0** | – |
| Metals | 0 | 0 | **0** | – |
| U.S. Natural Gas | -1 | +1 | **+1** | – |
| Oil & Products | 0 | 0 | **+1** | ↑ |
| **Insurance-Linked Securities** | +1 | +1 | **+1** | – |
| Life Securitization | -1 | -1 | **-1** | – |
| Retrocessional | -1 | +2 | **+1** | ↓ |
| Industry Loss Warranties | -1 | +1 | **0** | ↓ |
| Private Transaction | +1 | +1 | **+1** | – |
| Catastrophe Bonds | +1 | +1 | **+1** | – |

## Sub-Strategies Ranked By Score

| RANKINGS (TOP DOWN) | SCORE |
|---|---|
| Retrocessional | 1.3 |
| US Natural Gas | 1.3 |
| Volatility Arbitrage | 1.3 |
| Long/Short Credit | 1.3 |
| Cat Bonds | 1.2 |
| Structured Credit | 1.2 |
| Private Transactions | 1.0 |
| Discretionary | 0.9 |
| ED - Merger Arbitrage | 0.9 |
| Emerging Markets | 0.8 |
| Europe | 0.7 |
| Direct Lending | 0.7 |
| Activist | 0.6 |
| Oil & Products | 0.5 |
| Convertible Arbitrage | 0.4 |
| Long Short Equity | 0.3 |
| Asia | 0.2 |
| Fixed Income | 0.2 |
| Equity Market Neutral | 0.2 |
| Agriculture | 0.1 |
| Sector Technology/Healthcare | 0.1 |
| Systematic | 0.1 |
| Metals | 0.0 |
| Industry Loss Warranties | 0.0 |
| ED - Special Situations | -0.5 |
| Distressed | -1.1 |
| Life Securitization | -1.4 |

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**GLOSSARY**

**Alpha –** A mathematical value indicating an investment's excess return relative to a benchmark. Measures a manager's value added relative to a passive strategy, independent of the market movement.

**Correlation –** The degree of interaction between the Fund's return and that of the comparison Index. The correlation coefficient, expressed as a value between +1 and -1, indicates the strength and direction of the linear relationship between Fund's returns and the returns of the index.

**Yield to Worst** – The lowest potential yield that can be received on a bond without the issuer actually defaulting.

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