Lucerne
Alternative
Investments
Fund

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Quarterly Report | March 2024

The Lucerne Alternative Investments Fund (LAIF) is projected to deliver a quarterly performance of 5.95%. Global markets have stabilised, although they mainly continued their rise after the strong 2023 year-end rally, driven by several factors, but primarily the expectation that inflation and, therefore, interest rates had peaked and would be cut multiple times in 2024.

Our core allocations in Systematic Trend Following, Global Tactical, and Global Long Short strategies have been the key contributors to this pleasing quarterly performance. The Fund's core holdings perform as intended, while the tactical holdings continue providing uncorrelated absolute returns.

As we move into the new year, we anticipate many of the same risks we've discussed throughout 2023 will continue and perhaps be more pronounced. However, we believe the portfolio is positioned to capture the increased market dispersion.

Understanding the Uphill Battle: Grappling with Stubborn Inflation Trends

The first quarter of 2024 underscored the persistent challenge of managing inflation, proving to be more stubborn than anticipated. Despite a notable slowdown compared to the peaks of 2023, inflation rates remained higher than desired by central banks. This defied earlier expectations of a swift return to price stability, prompting a reassessment of interest rate projections. The US Federal Reserve (Fed) and other global central banks have delivered mixed signals on interest rates, and this has led the market and investors to maintain their optimistic bias. This is in contrast to our own views that inflation will be stickier for longer and, therefore, interest rates will remain higher, thus becoming a weight on investor sentiment.

During this period, the equity markets have become excessively fixated on short-term results, often neglecting longer-term trends and potential growth opportunities. Prices continue to react positively (and strongly) to seemingly minor shifts in inflation data or monetary policy announcements.

Some key observations emerged during the quarter:

Consumer resilience waned as high prices and borrowing costs strained spending despite strong household balance sheets.

The labour market paradox persisted, with low unemployment and robust job growth driving wages and contributing to persistent inflation concerns.

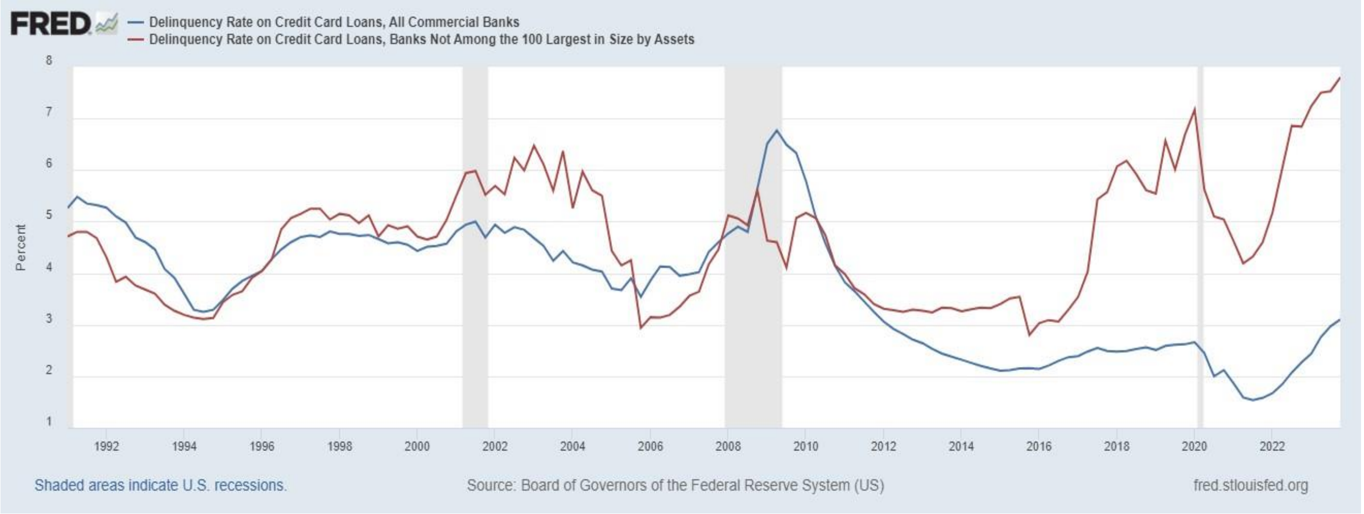
Geopolitical tensions, particularly in energy markets and global supply chains, added further complexity to inflation management efforts.

Some concerns are that reducing policy rates may not necessarily lead to a decrease in longer-term bond yields. This is due to high levels of deficit funding and reliance on buyers sensitive to price fluctuations. As a result, corporate funding costs could remain high. This is particularly concerning for small and medium enterprises who may struggle to refinance their debt. (A topic that we have recently discussed with investors)

Despite challenges, the consumer shows growing confidence fuelled by rising real wages and falling inflation.

The company reporting season ended on a highly positive note, with most experiencing better than anticipated outcomes, albeit from a very low base expectation. However, we note that most margins came from effective cost management and cost-cutting activities. Though we appreciate this approach's efficacy, it lacks diversity and consider it a one-off trick in the face of slowing consumer demand.

Chart 1: Increasing Credit Card Delinquencies (US)

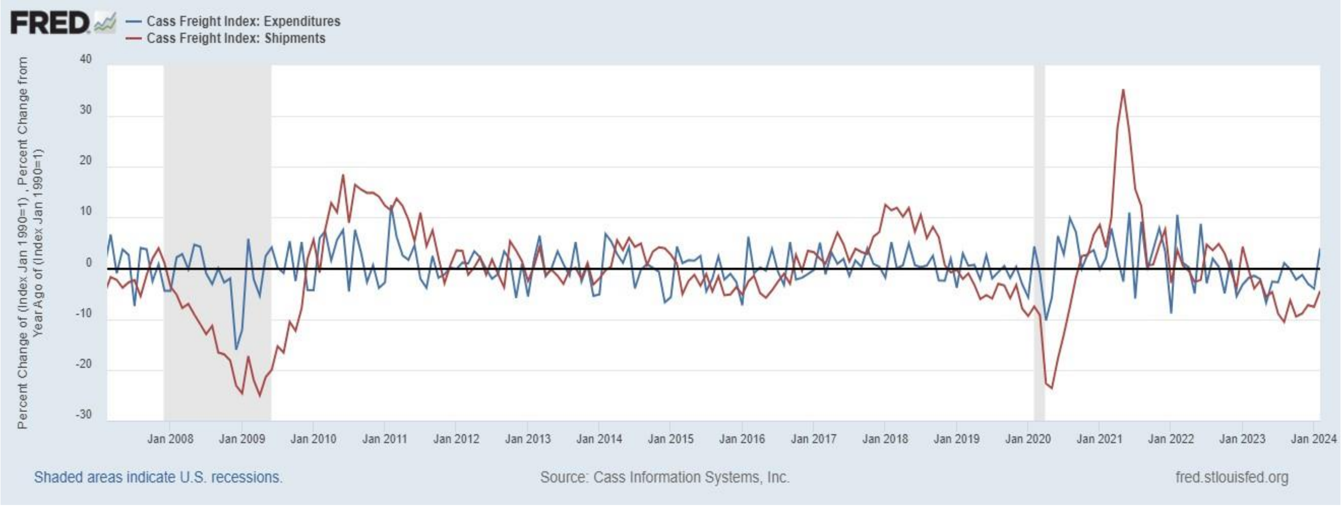


Moreover, the European economy lagged, with external pressures such as US interest rates and the Bank of Japan's yield curve management potentially hindering an effective response from the European Central Bank, exacerbating the downturn.

Looking ahead, while growth projections did not see substantial improvement, the economy's resilience and a reduced likelihood of a severe downturn validated aggressive moves in risky assets. This was particularly significant for Europe and the UK, where growth had stagnated for several quarters. Purchasing Managers Indices (PMIs) suggested a gradual improvement in economic activity as the year progressed.

The main risks ahead included the possibility of a sustained resurgence in inflation. This scenario is becoming more probable as the disruptions in the Red Sea continue to challenge the global supply chain and shipping costs. Additionally, geopolitical risks remained significant, exemplified by conflicts in Gaza, Russia's stance towards Ukraine, and China's domestic economic challenges and tensions over Taiwan, heightening volatility and increasing the likelihood of major geopolitical events.

Chart 2: Cass Freight Index showing cost resurgence



Emerging Challenges in Junk Refinance

The decline in interest coverage ratios for the lower end of the high yield (HY) market, along with a weaker economic outlook, is likely to initiate a series of downgrades within the high-yield (junk) bond sector. Some bonds will be shifted from B to CCC ratings, which will cause a wider gap between investment-grade (IG)/BBB-rated bonds and lower-rated credits.

Early Signs of Distress

Although high yield bonds maturing in 2025 will increase significantly, corporate acknowledgement of ongoing concerns in quarterly statements will start to crystallise this year. This is evident in the challenges faced by European corporations, with increased debt restructuring announcements in March 2024, whose bulk of capital structure requires refinancing next year. We believe that this situation may result in a major distress event.

Having this level of default activity in a benign credit environment is uncommon, and we are seeing significant opportunities arise from it. These issues are already apparent in distressed exchanges, which accounted for over 40% of defaults in 2023, reaching a 10-year high (excluding the pandemic period).

More broadly, this creates a significant opportunity in European dispersion, meaning that the ten widest names (out of approximately 75) now account for the highest proportion (37%) of the total spread of the HY Index. This tells us that the market is not in a correlation mindset and that it thinks these are isolated and idiosyncratic.

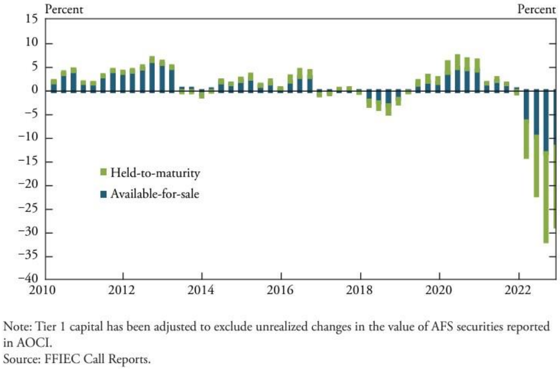
The US has lagged Europe in distress, but it is catching up, and we are seeing similar pricing dynamics starting to play out. In short, this should only happen if the European episode is truly idiosyncratic.

Concerns Regarding Private Credit

There are doubts regarding the potential of private credit to alleviate the strain in leveraged finance. Despite raising $185 billion in 2023, the lowest in three years, the portion dedicated to distressed credit was the weakest since 2010. An increasing concentration of funds might encourage the deployment of private credit to broadly syndicated loans for large-cap companies.

Challenges in Global Commercial Real Estate (CRE) Markets

The global Commercial Real Estate (CRE) market is currently facing challenging conditions, and it is expected that the full extent of the crisis is yet to come, posing a significant challenge in 2024. Weak leasing demand and higher interest rates significantly pressure CRE owners, leading to challenges in maintaining asset values and servicing loans. Early indications of financial stress are particularly evident among office owners in the United States. However, this issue primarily affects regional and smaller banks, where CRE comprises about 29% of assets, compared to approximately 7% for larger lenders.



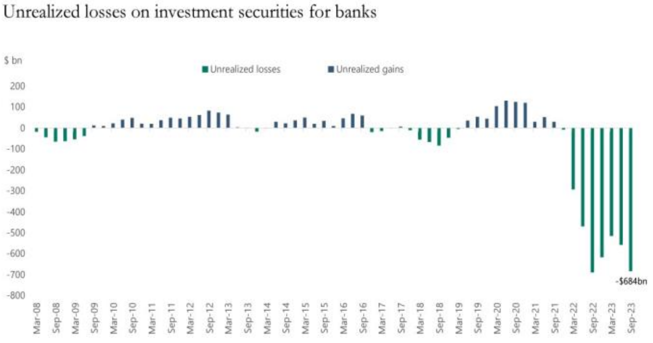


Chart 3: Unrealised Losses making 30% of bank equity **Chart 4:** Unrealised losses currently at $640bn (Source: FDIC, BIS, Apollo)

The market may have misunderstood the depth of the problem. The transition to hybrid working arrangements could leave certain office CRE assets stranded with minimal discernible value, resembling the illiquidity and pricing challenges experienced with "Level 3" assets during the Global Financial Crisis (GFC). Holding the senior-most lending position in such assets may offer little solace as their value diminishes, providing no advantage even at the top of the lending hierarchy.

Systemic Risks and Banking System Exposure

While CRE markets have improved lending standards since the GFC, systemic risks are higher in jurisdictions where the banking system has significant exposure to CRE, such as the United States and Sweden. Australian CRE markets face similar challenges, but systemic risks are lower due to reduced exposures and tighter lending standards by Australian banks since the GFC.

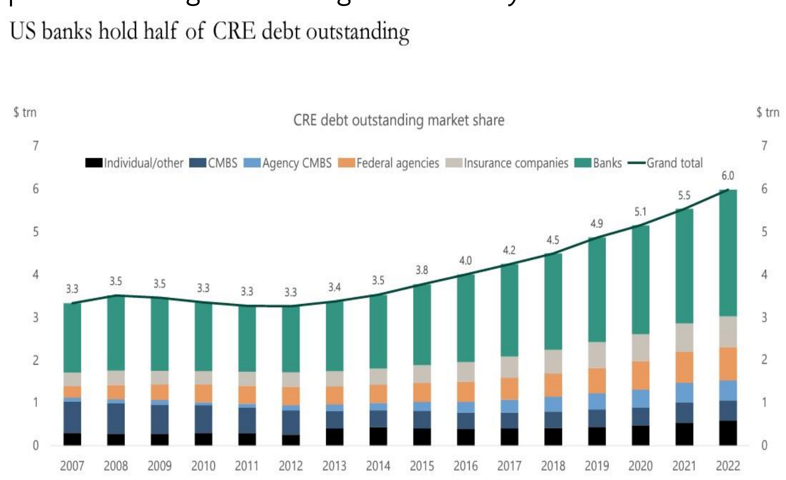


Chart 5: US Banks hold a large portion of the outstanding CRE loans. *(Source: FDIC, BIS, S&P)*

Influence of Declining Securities Valuations on Bank Behaviour:

The decline in securities valuations can significantly influence bank behaviour in four ways:

1. Increased Business Risk: Higher unrealised losses threaten bank solvency, driving up equity funding costs and rising business risk.
2. Debt Usage: Reluctance to sell securities in loss positions may increase debt usage and raise funding costs.
3. Impact on Lending Costs: Banks may raise lending costs or tighten standards as funding costs rise due to reluctance to sell securities.
4. M&A Considerations: Banks with large unrealised losses may hesitate to pursue acquisition opportunities, fearing depressed offer prices due to underwater securities.

Conclusion

The economic resilience, particularly in the US, has been driven by a robust consumer base. We have consistently highlighted that any slowdown in consumer spending could signal potential risks on the horizon. Despite the strength of the labour market and continuous government spending, signs of a slowdown are evident in various indicators. Stress in consumer loans, credit cards, and auto loans, often early indicators of economic shifts, are currently flashing warning signs, albeit at a cautious level.

The portfolio has been constructed with a primary focus on risk management. Given the vast amount of data available and the macroeconomic uncertainty prevailing in the market, a wide variety of scenarios could play out over the course of 2024. Our core-satellite approach is specifically designed to help compound capital over time. To achieve this goal, we aim to manage downside risk during difficult market conditions while positioning the portfolio to maintain participation in rising markets, with the objective of absolute returns to the Fund investors with far less volatility (risk) than traditional investments. This is an objective the fund has delivered for five years, and we expect to continue.

Portfolio Movements

If you, or someone you know, would like to talk with us, please do not hesitate to contact us at laif@lucernefunds.com to arrange a call. Again, thank you for your interest in LAIF, and we wish you safe investing for the quarter ahead.

The Lucerne Alternative Investments Fund

April 2024

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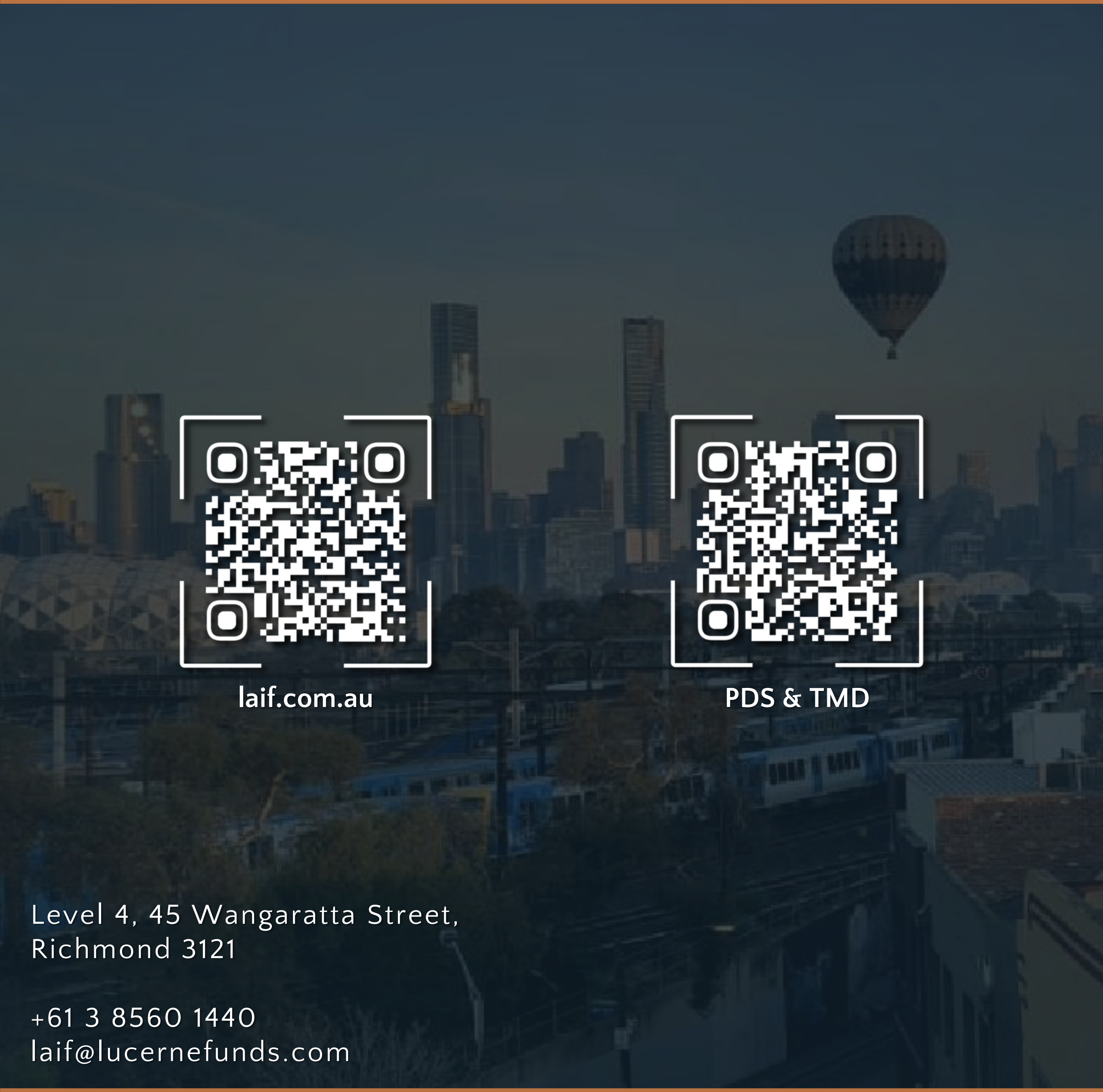

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