Jefferies Prime Services Monthly

JULY | AUGUST 2017

CONTACTS

John Laub
Global Co-Head of Prime Services
+1 212.284.1726
jlaub@Jefferies.com

Nick Rankin
Global Co-Head of Prime Services
+1 212.444.4432
nrankin@jefferies.com

Barsam Lakani
Head of Prime Services Sales
+1 212.284.1783
blakani@jefferies.com

Leor Shapiro
Global Head of Capital Consulting
+1 212.336.6267
lshapiro@jefferies.com

Shannon Murphy
Prime Services Capital Consulting
Strategic Content
+1 212.336.1139
shannon.murphy@jefferies.com

Jefferies

Everything We Know Could Already Be Wrong…

So said Interscope Records chief and Beats Electronics co-founder Jimmy Iovine in a 2013 commencement address. Innovations can change markets and businesses overnight. The Jefferies Prime Services Capital Consulting Team is constantly working to identify nascent trends, themes or emerging realities that could impact how you do business.

Currently on top of our minds:

1. **When the Bottom Drops Out:** Vol lingers near multi-decade lows while many equity markets continue to march to all time highs. It's been nearly a decade since a prolonged period of acute stress – is now a good time for managers to revisit assumptions and processes around "in case of emergency" plans? The summer doldrums could offer a window to white board various unconventional stress scenarios and walk through systemic risk response.
2. **The Next Generation speaks 'data science' as a second language. Do you?** In addition to Intro to Computer Science currently topping enrollment lists at many universities, some firms are now setting up training programs for all new hires that require a data science component, or offering tuition reimbursement and time off for coding or data science classes. There are currently more than 150 active searches for data science related roles at hedge funds.
3. **MIFID.** Our ETS desk is hard at work helping educate clients understand impacts to trading, settlement and reporting obligations. Clients are also digging into issues around defining "sufficient" steps to ensuring best execution vs. "reasonable," and other requirements to create enhanced transparency (particularly around transaction reporting).

Jefferies - Capital Introductions July 2017 Performance		
Strategy	**Jul -17**	**YTD 2017**
Hedge Fund Median	**1.41%**	**6.68%**
Credit Median	0.60%	7.99%
Equity Long Short Median	1.64%	8.84%
Generalists	1.80%	8.68%
Consumer & TMT	0.92%	7.24%
Energy	1.60%	9.98%
Healthcare	0.31%	7.12%
Event Driven Median	1.10%	5.62%
Macro Median	1.34%	0.40%
Multi-Strategy Median	0.97%	6.63%

All stats derived from Jefferies proprietary data unless otherwise noted

Quantifying Intuition

On the back of Jefferies exclusive sell-side sponsorship of the June 20th Learn 2Quant conference in New York, we released the whitepaper **Quantifying Intuition: Mapping the Data Science Landscape at Hedge Funds.**

Quantifying Intuition argues that we have passed a tipping point - data science is now, and will increasingly be, of strategic importance to all hedge funds in the coming years. This mainstreaming of data science solutions means managers, investors and counterparties should be informed about and conversant in the opportunities and challenges offered by these technologies.

We mapped how hedge funds have incorporated data science into their firms and note they largely fall into one of four buckets:

i) **Early Adopters** – quant focused firms for whom data science has been embedded in their organizational DNA since day one. Early Adopters leverage all data science has to offer – artificial intelligence, machine learning, big data from countless sources across each vertical in their firm.

ii) **Early Mainstream** – firms which have been working to incorporate data science into their investment processes for the last few years, working to scaling appropriately across the organization as available and appropriate.

iii) **Mainstream** – have begun to incorporate or look into incorporating data science at their firms as a complement to pre-existing investment approaches.

iv) **Nascent Adopters** – have not yet begun to explore incorporating data science into their firms.

Jefferies is hosting a series of events around data science at hedge funds, including sessions on data science for the COO/CFO and regulatory issues and data science. Contact your Jefferies coverage person for a copy of the full report.

shannon.murphy@jefferies.com
dfurstenberg@jefferies.com

Upcoming Conferences & Events		
August 10	NYC	Jefferies Financial Services Investor Relations Summit
August 29-30	Chicago	Jefferies Semis, Hardware and Communication Infrastructure Summit
September 11	Kyoto	Jefferies Kyoto Summit
September 14	Hong Kong	Learn 2Quant Hong Kong
October 11	London	Learn 2Quant Europe
October 11	London	Jefferies 2017 Hoare Govett UK Companies Forum

Difference Makers

TOP JEFFERIES RESEARCH READS IN RECENT WEEKS

Leaders of the Pack:

JEF's SMID-Cap Manager Scorecard—A mixed July puts more managers behind

AZN LN: Still Plenty of Unknowns Post-MYSTIC

Top 58 Biotech notes Most Read by Buyside in July…

JEF’s SMID-Cap Strategy – Thoughts & Observations

Two Weeks in Two Minutes (Video)

Other Notable Reads

JEF's SMID-Cap Outlook—Being stubborn or stupid but not raising Russell target

GOOGL: Sustained Levels of High Growth Driven by Mobile Search, YouTube and Cloud

Halfway Through the Year for SMID

Steven DeSanctis, US Equity SMID Cap Strategist, looked into first half SMID cap manager performance and pointed out that June caught many managers off guard. He believes growth and value managers outperformed core with lower cap, lower quality and domestically oriented names outperforming, including bond proxies and biotech.

Additionally, he highlights that the forward P/E multiple for the Russell 2000 rose to 19.7x from 19.5x in June and is now ~25% above the historical average. He remains cautious on the outlook for small given his expectation for 2Q earnings compression and reiterated his preference for growth over value. Notes here and here.

desanctis@jefferies.com

Global Fund Flows*

- Since 2009, global fixed income (government bonds to high yield credit) has seen around $1.3 trillion of net inflows while global equities have witnessed less than half that - ~$600 billion
- Global bond funds have experienced 20 straight weeks of inflows in a row, the longest since 2012 (latest: U.S. $7.3 bn through August 2)
- The enthusiasm for European Equities continues, capping 34 straight weeks of net inflows through 2 August

*Source: Bloomberg, EPFR, Jefferies. All references to mutual funds and ETFs

Capital Consulting Updates

Focus on North Carolina

This summer, the Jefferies Capital Introductions team traveled to St. Louis, Maine, Michigan, Philadelphia, Boston, Pittsburgh, Columbus, Cincinnati, and Israel, among others. Each month we will highlight a different region.

In North Carolina, the team met with **investors in Winston Salem, Greensboro, Raleigh, Durham, and Chapel Hill** across an array of investor verticals. We met with endowments, foundations, family offices, pensions, fund of hedge funds, and wealth managers.

Among the key themes:

- Most **interest seemed to be in Diversified/Uncorrelated strategies**, specifically Quant and Macro came up consistently. Additionally, the bar is higher than ever for US long short managers, even those with sector or geographic specializations.
- **Data Science was on everyone’s mind**. One advisory firm recently invited a local professor in to share how data science is being leveraged across the industry. Others are exploring how discretionary managers are increasingly incorporating quantitative approaches in their investment processes.
- Partially related – there was also an increased focus on best practices for **Quant manager due diligence**. One endowment just hired an external team to do ODD on their systematic funds as they acknowledge more expertise is required and they don’t currently have it in-house.
- Finally, many of the groups reported they are **actively meeting with and evaluating managers but are unlikely to make many new allocations** between now and year end, meaning it is even more important for managers to well articulate their value proposition for clients.

kdinsmore@jefferies.com

Business Consulting Trends

Recent discussions with legal and compliance groups report an apparent increase in regulatory audits and exams, with a **heightened focus on issues around communication**. Specifically, there seems to have been an increase in limited scope exams, which typically begin with questionnaires and lead to either more detailed questionnaires, phone interviews, or on-sites.

We hear regulators have turned their eyes to electronic communications - digging into managers' compliance policies and monitoring around **all** "electronic messaging." This does not just pertain to email or text on firm devices, but also third party applications (i.e. What'sApp, etc.), and business communication conducted on personal devices.

Policies, privacy and security of communications, as well as recordkeeping around electronic messaging, are all topics in focus.

eshea@jefferies.com

Jefferies Event Driven Strategies: Unique Opportunities in Merger Arbitrage, Version 3 - Rainbow Redux

In 2015, the historic "Golden Era of Merger Arbitrage©" created an enviable set of unique investment opportunities. We first highlighted the "Golden Era" in late 2015 as significant supply and demand imbalances presented attractive merger arbitrage spreads of 10-15% gross in "safe" transactions. Subsequently, in early 2016 we recommended investors exploit the extreme skepticism in event driven securities by buying a basket of pro-forma stocks we called "Rainbow Securities." Both strategies rewarded investors handsomely with large transactions such as BG, BXLT, CHTR, EMC, MAR, SAB, SNDK etc. closing on (or greater than) original deal terms **and our "rainbow" portfolio outperforming the S&P 500 by 1,600bps since inception last March**.

Today, despite a significantly reduced M&A cadence (the dam is poised to break soon) and significantly less duress priced into shares, we again see a number of interesting "rainbow" opportunities. As is often the case, impatient investors fail to appropriately price in the often numerous financial and strategic benefits of pending transactions.

This "Rainbow Redux" is a thorough analysis of eighteen securities based on fifteen different factors (selectively available on request). Of this opportunity set, we created four quartiles of securities and find KEYS, TSN, BATS LN, DOW, and DXC to be the most compelling. Moreover, numerous securities (DOW, DXC, FMC, PX) possess "Be Great" potential, where shares could appreciate over 50% on a medium term basis (18-24 months).

- **KEYS** – Ixia accelerates the growth, expands SAM and extends leadership in communications design and testing as all three end markets are inflecting yet shares trade at a meaningful discount to peers.
- **TSN** – margin expansion, improved product innovation and distribution capabilities from AdvancePierre with dry powder optionality**.**
- **BATS** – 20% discount to PM despite superior end market and technology**.**
- **FMC** – highly accretive deal with DuPont as the ag cycle inflects on top of conservative synergy estimates and upcoming Lithium spin**.**
- **PX** – multi-year growth story with best in class management, significant synergy potential and troughing/improving key end markets**.**

We have also begun to look at the "Super Rainbow," a list of ~50 acquisitive companies. In short, the goal of the "Super Rainbow" is to identify the next RB/ LN, AVGO, CHTR, IACI, i.e.- the next great serial acquirer. Given the significant consolidation that has occurred in many industries, coupled with today's elevated multiples, our expectations are tempered, but we are confident there are a number of aggressive "Be Great" management teams, operating in healthy and unconsolidated industries, to find a diamond (or two) in the rough.

skroculick@jefferies.com

Original Rainbow Performance; Inception (3/24/2016) – Today

Stock Loan Monthly

	North America June			North America July		
Industry Group	**6/1/2017**	**6/30/2017**	**Monthly Change**	**7/1/2017**	**7/3/2017**	**Monthly Change**
Automobiles & Components	2.75%	2.45%	-0.30%	2.45%	2.38%	-0.07%
Banks	4.58%	4.65%	0.07%	4.76%	4.51%	-0.26%
Capital Goods	6.17%	6.37%	0.20%	6.38%	6.16%	-0.23%
Commercial & Professional Services	1.25%	1.36%	0.11%	1.38%	1.58%	0.20%
Consumer Durables & Apparel	3.18%	3.11%	-0.07%	3.11%	2.98%	-0.13%
Consumer Services	2.76%	2.45%	-0.31%	2.45%	2.57%	0.12%
Diversified Financials	2.74%	2.83%	0.09%	2.81%	2.96%	0.15%
Energy	8.55%	10.34%	1.79%	10.41%	8.91%	-1.50%
Food & Staples Retailing	1.24%	1.16%	-0.08%	1.19%	1.28%	0.08%
Food, Beverage & Tobacco	2.70%	2.47%	-0.23%	2.51%	2.82%	0.31%
Health Care Equipment & Services	5.30%	5.56%	0.26%	5.51%	5.03%	-0.48%
Household & Personal Products	1.08%	0.94%	-0.14%	0.94%	1.05%	0.11%
Insurance	1.85%	1.68%	-0.16%	1.65%	1.59%	-0.06%
Materials	4.73%	3.97%	-0.76%	3.94%	4.00%	0.06%
Media	2.96%	2.87%	-0.08%	2.88%	3.03%	0.15%
Pharmaceuticals, Biotechnology & Life Sciences	5.62%	6.06%	0.44%	5.95%	5.80%	-0.15%
Real Estate	5.41%	5.78%	0.37%	5.61%	5.47%	-0.14%
Retailing	6.57%	6.26%	-0.31%	6.32%	6.40%	0.08%
Semiconductors & Semiconductor Equipment	3.79%	3.43%	-0.36%	3.42%	3.66%	0.24%
Software & Services	15.94%	16.31%	0.37%	16.30%	17.48%	1.18%
Technology Hardware & Equipment	3.16%	2.79%	-0.37%	2.75%	2.80%	0.05%
Telecommunication Services	2.70%	2.55%	-0.14%	2.59%	2.83%	0.24%
Transportation	2.27%	2.03%	-0.24%	2.05%	2.19%	0.14%
Utilities	2.71%	2.59%	-0.12%	2.64%	2.52%	-0.11%

Information sourced from Jefferies and MarkIt, reflecting month-over-month change in percentage composition of short book by subsectors. Green indicates becoming a smaller percentage *of the short book; red indicates a largerpercentage.*

US Commentary

Flows were skewed to covering across Energy, Materials and Telecommunications.

We continue to see large focus around shorting Volatility, this strategy has gained large momentum throughout the year, easily expressed through products like VXX, UVXY and TVIX. YTD SI increases for VXX (+67.13%), UVXY (+403.84%) and TVIX (+373.80%). As of late we have seen some unwinds as well as hedging short volatility positions with crowdedness of the strategy & continued low volatility.

SNAP Inc. (SNAP) – Borrow liquidity was the focus throughout the month across Agent Lenders, Prime Brokers and Hedge Funds, borrow expense averaged -50-55%, with spot levels reaching -70% at times. Ongoing catalysts were led by future earnings pressure as well as the first of 3 locks up expirations (7/31, 8/29, 3/2). Post lock up expiration we have seen liquidity & cost improve significantly, latest borrow found in the -2/-3% range, with additional easing expected.

APAC Commentary

6502 JP Toshiba which was one of top shorted- now seeing -24% of borrows returned Month on Month on index deletion. Still $730mm USD lent out, 306mm shs, 72% utilized

3333 HK Evergrande saw a short squeeze (stock is up 4x YTD) as covering continue it's now -28% covered month on month, $765mm UDS lent out, 307mm shs, 63% utilized.

2409 TT AU Optronics continued to see short interest- however it has hit it's short quota limit and unable to get more short access on this name.

U.S. Equity Strategy - R is for Rotation

On the surface, the S&P 500 was able to scrape out a 2.74% gain over the past quarter amid softening economic data and low volatility; however, investors should not be too complacent. While the economy and the equity market are enjoying a 'disinflationary boom', a rotation may be starting that could sharply alter the character of the market in 2H17. A number of non-macro factors are coinciding with a change in the shape of the yield curve.

While the recent flattening of the US yield curve has surprised many (including us) and has been explained away by the lack of follow-through on President Trump's original proposals, a drop in economic surprises alongside a temporary peaking in inflation expectations, we had warned in US: Watching The Long End of The Bond Market Carefully (XI) that the 2005 Greenspan 'conundrum' was back with a subtle twist. The mini 'taper tantrum' on the back of the ECB President's comments are a warning that the long end of the bond market is much more important for equities than short rates. Equities are long duration assets. **There are five observations to make.**

1) The US equity market despite accruing gains has been underperforming global peers in the past two quarters. The sheer size of the US outperformance over the past seven years has questioned whether global equity leadership could be fulfilled by other DM and EM markets. To date, the answer is yes since flows have also supported this argument.

2) Despite the sharp move in long rates, equity volatility slipped. Fortunately and oddly, the dollar has been weakening while credit spreads remain tight. This has kept the disinflation boom intact. However, if US real long rates were to move above 1.25% and credit spreads were to widen, we would become much more concerned overall about the durability of the rally. To date, both remain well behaved. We remain Bullish on US financials. Moreover, the reform process is moving much quicker than other proposals
3) At the start of the year, S&P 500 earnings were very dependent on changes in energy prices. The reality is that the 'growth in earnings' is far more dependent on the weak dollar and overseas revenues now . A big re-rating in 2017 US earnings is not that likely.

4) While investors have focused on healthcare reform, the spotlight should also be on US steel import tariffs and overseas fines/penalties on US FANG stocks. While the publication of the investigation into US steel imports (section 232) has been delayed until after the G20, the concern is that it is a form of 'creeping protectionism'. While it would benefit the US steel companies, the cost for the overall economy is less clear. Equally, the number of fines and penalties being imposed on US internet/media companies by EU entities suggests that there are growing worries over their monopolistic powers.

5) It is not time to be passive. Last quarter sector dispersion rose. While S&P 500 realized sector correlation continues to decline at the same time as the CBOE implied correlation index is falling towards decade lows, the shift in the US yield curve suggests that a reversal is close.

sdarby@jefferies.com