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Reflation Trade Spreads to Europe and Japan… and Hedge Funds

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The momentum in the reflation trade continued unabated. Equity, the U.S. dollar and rates kept on heading north. With JPY in free fall and the Italian referendum out of the way, Japan and Europe enjoyed a powerful valuation catch-up. Higher oil prices and the more hawkish Fed's dots and speech could not throw cold water – yet – on investors' optimism and their on-going reweighting.

Almost all hedge fund strategies were up. CTAs outperformed thanks to their long USD and equity positions. By contrast, L/S Neutral funds lagged, especially in Europe, where they still struggle to navigate the political agenda and the reverberations of the reflation trade.

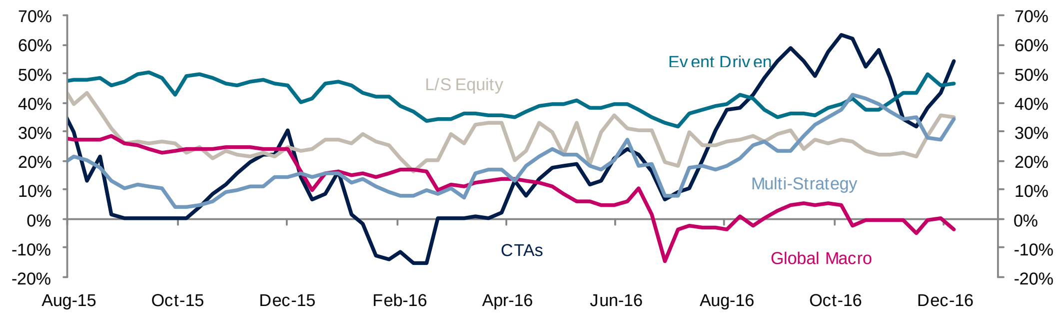
Meanwhile, hedge funds portfolio rotations are going fast. L/S Equity reinforced their net exposure by a third, in financials in particular. CTAs are now overall short bonds. Global Macro are taking some profits in the US and are cautiously moving toward Europe and Japan. In the Event Driven space, Merger funds are getting more aggressive.

We too made changes to our positioning over the recent weeks. The shift toward less monetary support, more fiscal push, and a rising call for policy ruptures are favorable to active managers. The turn in rates and inflation are resulting in greater valuation discrimination. They also favor more fundamental pricing, especially in the U.S. where the process is more advanced. It's not to say that hedge funds got back in a goldilocks position overnight, but the current regime shift calls for some changes.

We reaffirm that the time has come to reweight U.S. fundamental pickers. By contrast, we are underweight Market Neutral in Japan & Europe, at a lagging stage of the regime shift. We reweighted Special Situation and kept Merger funds at slight O/W, to benefit from heating up US corporate activity. We believe the wheel will soon turn to the advantage of CTAs, but not just yet. Though market drivers remain speculative due to elevated policy uncertainty, greater opportunities will benefit Macro funds.

L/S Equity and CTAs have increased their exposure to equity

Median equity beta on the Lyxor platform by strategy



As of 06/12/2016. Source: Lyxor AM

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THE WEEK IN 3 CHARTS

Hedge Fund Snapshot: Up across the board

	WTD*	MTD	YTD
Lyxor Hedge Fund Index	**0.6%**	**0.8%**	**-0.9%**
CTA Broad Index	**1.8%**	0.3%	**-5.0%**
Event Driven Broad Index	**0.2%**	0.3%	**1.5%**
Fixed Income Broad Index	0.3%	**0.2%**	0.2%
L/S Equity Broad Index	0.3%	0.4%	-3.6%
Global Macro Index	1.2%	**1.7%**	-0.4%
MSCI World Index	*2.9%*	*3.4%*	*8.7%*
Barclays Global Agg Bond Index	*-0.2%*	*-0.6%*	*3.4%*

*From 06 December to 13 December 2016

The Lyxor Hedge Fund Index was up a healthy 0.6% last week, with all strategies delivering positive returns.

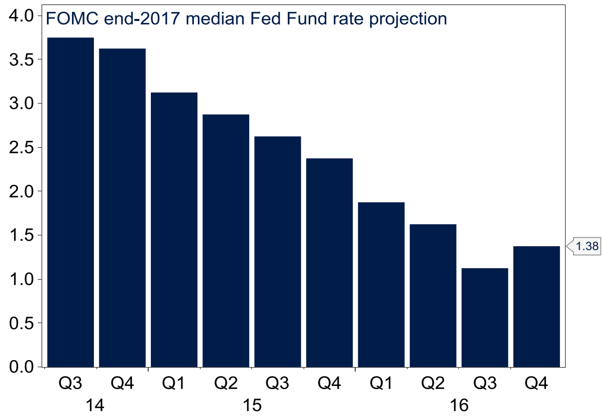
CTAs outperformed (+1.8%) as their portfolio repositioning began to bear fruit. They have recently turned short on U.S. fixed income and increased exposure to U.S. equities.

Global Macro posted a solid +1.2% mainly on the back of successful equity trades. L/S Equity returns (+0.3) were driven by the Variable and Long Bias segments, while Market Neutral Funds continued to decline.

Special Situations funds pushed Event Driven higher.

The Fed to continue its normalization at a faster pace in 2017

Fresh rate projections for 2017 spurred the median rate at 1.375%
FOMCmedian projection for end-2017, Fed Fund rate



Source: Bloomberg, Lyxor AM

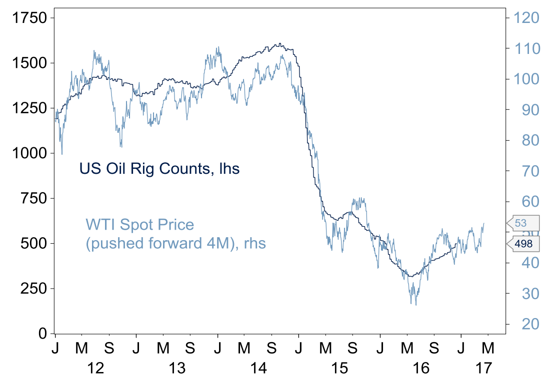
As widely expected the Fed hiked short-term rates by 25 bps for the second time in this cycle. The dots now imply three hikes in 2017. Yellen's speech was also more hawkish on balance, consistent with encouraging economic data and a tight labor market.

The rate increase pushed USD higher, especially against JPY and European crosses, reflecting a widening monetary gap. Additionally, the 10Y Treasury yields increased above 2.6%.

CTAs and Global Macro benefited from the divergence in monetary policy, particularly through their common long exposures to the USD. CTAs' short positions on U.S. bonds also paid off.

Global oil markets may re-balance earlier than previously expected

Higher oil prices have been spurring U.S. oil production
U.S. oil rig count vs. WTI spot price



Source: Lyxor AM.

Oil prices continued to rally after non-OPEC members, including Russia, joined the OPEC deal to cut production as of January.

These agreements could contribute to rebalance energy markets earlier than expected. Accordingly, the International Energy Agency estimates that the market will be in deficit as soon as the first half of 2017.

By contrast, the prospect of resuming U.S. production and the stalling accumulation of OECD and China stock could cap the progress of oil prices.

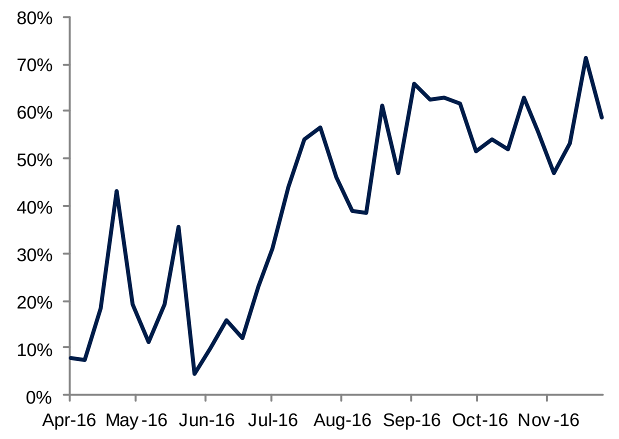
CTAs

	WTD*	MTD	YTD
CTA Broad Index	**1.8%**	**0.3%**	**-5.0%**
CTA Long Term	2.0%	0.4%	-5.1%
CTA Short Term	0.2%	0.1%	-6.0%

*From 06 December to 13 December 2016

CTAs have increased their net exposure to equities

Net Exposure to equities, % NAV



As of December 6th, Equally weighted. Source: Lyxor AM

Equity markets drove the P&L

CTAs delivered strong returns last week. The end of year rally on Equity markets was the main performance driver.

Both short term and long term strategies managed to extract alpha, but the higher equity exposure held by long term strategies explained most of their outperformance. Long term systems' positive exposure to equities has increased lately, following the post-Trump rally.

FX was the other main performance source. The weakening trend of the Euro was once again a large contributor last week. Some managers extracted alpha from commodity currencies like the Rubble.

Fixed income had limited impact, but it is noteworthy to mention that the long-awaited transition from long to short exposure had little influence on performance.

Commodities were once again the major detractor to performance, with all buckets posting negative figures.

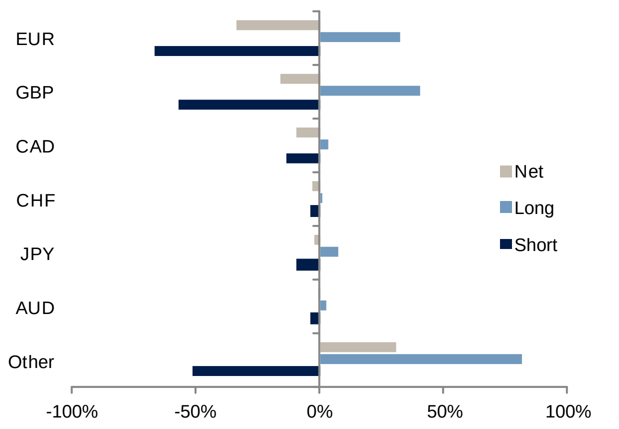
GLOBAL MACRO

	WTD*	MTD	YTD
Global Macro Index	**1.2%**	**1.7%**	**-0.4%**

*From 06 December to 13 December 2016

Short EUR is still a positive contributor for Global Macro

Net Exposure to currencies, % NAV



As of December 6th, Equally weighted. Source: Lyxor AM

Risk-on time

Global Macro managers went through a contrasted week that rewarded risk-on positioning and sanctioned bearish plays.

Equity was the main contributor for managers with long exposure on this complex. The geographical split was insignificant as markets were up across regions. Still, the European equity catch up (vs. US equity) has been also a source of alpha.

Managers refrained from repositioning fixed income portfolios ahead of the FED meeting and announcements. Directional trades had limited impact while technical arbitrage buckets managed to extract some alpha.

On the FX side, safe haven currencies drove most of the underperformance of bearish managers, who have focused on these currencies since the U.S. election. However, Euro weakening drove positive returns for most managers.

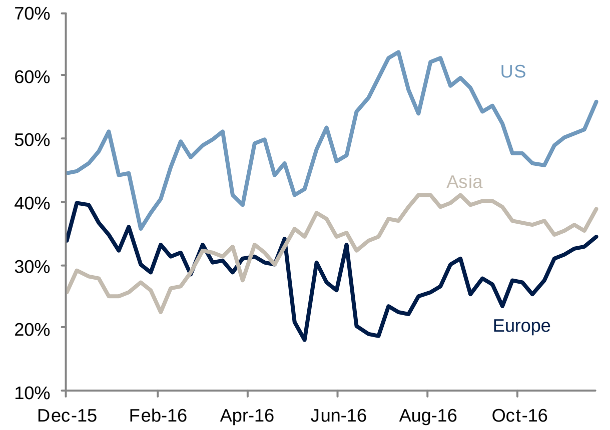
Commodities had very limited impact last week.

L/S EQUITY

	WTD*	MTD	YTD
L/S Equity Broad Index	**0.3%**	**0.4%**	**-3.6%**
Long Bias	0.4%	1.4%	4.6%
Market Neutral	-1.1%	-1.5%	-10.0%
Variable Bias	0.6%	0.3%	-6.4%

*From 06 December to 13 December 2016

Managers have increased net exposure to benefit from the rally
Net Exposure to equities, % NAV



As of December 6th, Equally weighted. Source: Lyxor AM

Bull Markets

Stock markets ended the week on a strong note as they continued to benefit from positive momentum with all sectors up broadly. As appetite for risk grew, LS equity managers have increased their net exposure.

European-focused funds returned solid performance as markets proved very supportive. Long books were the main source of alpha, especially within the financial and consumer non-cyclical sectors. On the flip side, quantitative models were dragged down by their short book.

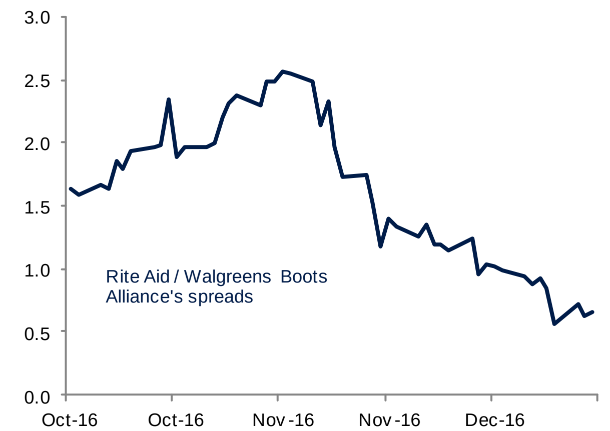
In the U.S., value and size continued to outperform with cheap domestic mid-cap names benefiting strongly from higher growth expectations. The best performer profited from the outperformance of defensive sectors as well as long positions in telecom and staples.

EVENT DRIVEN

	WTD*	MTD	YTD
Event Driven Broad Index	**0.2%**	**0.3%**	**1.5%**
Merger Arbitrage	0.0%	0.1%	2.6%
Special Situations	0.9%	1.1%	0.0%

*From 06 December to 13 December 2016

Rite Aid/ Walgreens Boots Alliance spread tightened
Spread in USD



As of December 13th, Equally weighted. Source: Bloomberg

Special Situations outperform

Event Driven funds delivered positive returns last week with Special Situations strategies outperforming.

Gains were led by managers' core investments in basic materials, consumer non-cyclicals, financials and technologies. Prominent winners include Dow Chemical, ConAgra Brands, Broadcom Ltd. Dow Chemical rallied previously as the CEOs of DuPont and Dow expressed their confidence about the closure of the deal and mentioned they did not anticipate an impact from the incoming administration on the $130 billion merger. Following the successful spinoff of Lamb Weston earlier last month, ConAgra Brands announced the addition of a new member to its board of directors and approved its first dividend post spinoff. Broadcom Ltd's share price rose last week on the back of strong earnings and the doubling of its quarterly dividend.

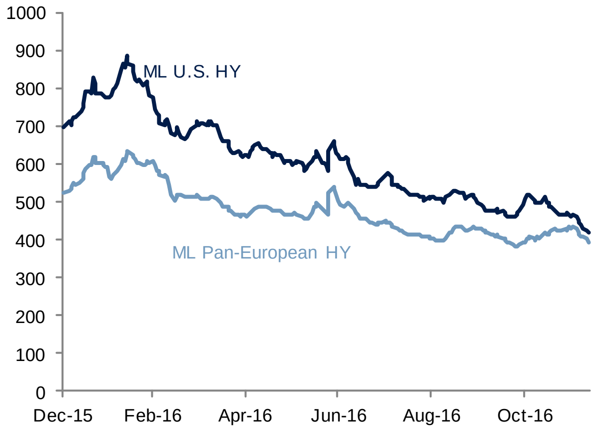
In the M&A space, spread compression in Walgreens Boots Alliance's planned acquisition of Rite Aid Corp contributed to performance. In addition, the LinkedIn/Microsoft deal received all regulatory approvals and closed successfully on December 8th.

L/S CREDIT ARBITRAGE

	WTD*	MTD	YTD
Fixed Income Broad Index	**0.3%**	**0.2%**	**0.2%**
L/S Credit Arbitrage	0.3%	0.5%	4.9%

*From 06 December to 13 December 2016

HY spreads : U.S. filling the gap with Europe
Merrill Lynch HY Indexes, Option Adjsuted Spreads, bps



As of December 13th, Source: Bloomberg, Lyxor AM

The Dovish Tapering

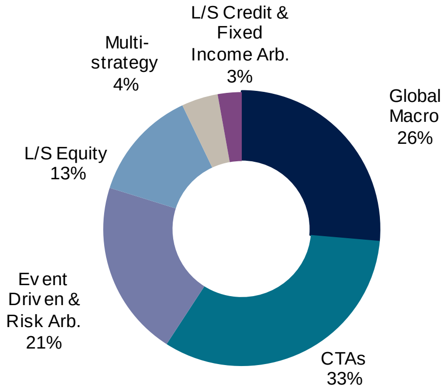
The ECB announced an extension of the current QE with some technical adjustments, which all in all has been viewed as a positive in Credit markets. In that context, the Merrill Lynch European Corporates IG and Merrill Lynch Pan-European HY tightened by 2 and 25 bps respectively. After positive outcomes regarding Italian banks, financials also performed well last week with the Merrill Lynch CoCo index tightening by 18 bps. In the U.S., as the Fed decision to hike rates this Wednesday is fully priced, markets ended the week strong with the Merrill Lynch U.S. IG and HY tightening by 3 and 30 bps.

In this favorable environment for credit markets, all managers posted positive performance. On the European side, one fund posted attractive performance equally distributed between the Financial and the Corporate buckets. Several positions in the communication and the consumer cyclical sectors were particularly rewarding. The other European fund delivered returns on the back of positive developments on two names in the industrial and the energy sectors. The Asian manager outperformed the JACI non IG posting significant gains on energy and financial sectors.

METHODOLOGICAL APPENDIX

The information contained in this report on the performance and positioning of hedge funds is based on proprietary data from our Managed Account Platform. The universe of underlying funds is relatively stable, though it evolves according to fund openings and fund closures.

Lyxor Managed Account Platform: breakdown of assets under management by strategy as of November 30th, 2016



- **USD 8.4 billion** of assets under management
- Replicating approximately **USD 220 billion** of AUM

Lyxor Hedge Fund Indices

Based on the complete range of funds available on the Lyxor Managed Account Platform, a universe of funds eligible for inclusion in the indices is defined on a monthly basis taking into account the following elements:

- Investability threshold: to be included in any index, the managed account must have at least $3 million of AuM.
- Capacity constraints: all index components must possess adequate capacity to allow for smooth index replication in the context of a regular increase in investments.
- Index construction: for each index, the relative weightings of the component funds are computed on an asset-weighted basis as adjusted by the relevant capacity factors.
- Each Lyxor Hedge Fund Index is reviewed and rebalanced on a monthly basis.
- The Index construction methodology has been designed to mitigate well-known measurement biases. Inclusions and exclusions of new Hedge Funds do not impact the historical index track record.

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