Market Insights

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BOUSSARD & GAVAUDAN

Commentary from the Investment Management Team at Boussard & Gavaudan

Significant shifts beneath seemingly calm markets

Equity markets in Europe and the United States diverged in July, with European equities posting modest gains while US markets were broadly unchanged. Implied volatility remained relatively subdued despite widening credit spreads and a more complex macroeconomic backdrop. While headline market moves were limited, the underlying environment was anything but quiet. Investor sentiment shifted rapidly across sectors, particularly within technology and AI-related areas, reinforcing the importance of selective investing, disciplined analysis and a focus on fundamentals rather than broad market trends. One of the defining themes of the month was the sharp adjustment in parts of the technology sector, particularly among companies linked to artificial intelligence and digital infrastructure. Areas that had previously benefited from strong investor enthusiasm experienced significant volatility as market participants reassessed growth expectations and valuations. These moves highlighted the risks that can emerge when market narratives become dominant drivers of pricing. The contrasting performance observed across different segments of the technology ecosystem demonstrated that even within a popular investment theme, outcomes can vary significantly from company to company.

Convertible Bond Arbitrage

July was a turbulent month for US CB arbitrage, as 5-year yields rose from 4.23% to 4.45% and HY CDX was up from 306bps to 312bps. This was the modest backdrop against which a tsunami tore through the AI-related and neocloud space, which accounts for 35-40% of the US convertible bond space. We had been skeptical about this area for quite some time and had very little direct exposure to the neocloud space. We did have decent exposure to the semiconductor sector, but it was entirely in the form of high-delta, deep-in-the-money convertibles, all of which were nicely positive. Following 2-3 trading days of stable markets as we enter August, the best we can say about the neocloud space is that it has stabilized. However, in valuation terms, we do expect a relief rally, followed by another downturn, to create a double bottom.

As is typically the case during the earnings season, European primary market activity remained subdued in July, with only a single transaction completed. Lagfin, Campari's principal shareholder, issued a €600m exchangeable bond while simultaneously tendering its outstanding issue. Although the transaction is broadly cash-neutral for Lagfin, it effectively extends the maturity profile from 2028 to 2033 at a lower coupon. Market performance was largely driven by sector rotation and a number of idiosyncratic situations. Volatility within the technology sector remained elevated as investors continued to reassess expectations around semiconductors and AI-related companies amid a mix of enthusiasm and uncertainty. Outside of technology, realised volatility generally declined, with the notable exception of airlines due to tensions in the Middle East. M&A activity also re-emerged as a supportive theme, with several announced transactions, including Exail Technologies and Delivery Hero, alongside continued speculation around potential new deals.

In Asia, primary market activity was supported by several attractive new issues, while implied volatility increased for a number of AI-related equities. Most new issuance originated from Japan, notably Mitsubishi and Kawasaki, with only a single short- dated transaction coming from Hong Kong.

Volatility Trading

Despite significant swings across factor markets throughout the month, realised equity volatility remained subdued and below implied levels. At the same time, the low-correlation environment supported elevated realised dispersion, providing a favourable backdrop for relative value strategies. The macro environment became somewhat more uncertain, with investors increasingly questioning whether asset valuations had risen too far, too quickly. Meanwhile, the highly leveraged ETF ecosystem experienced several deleveraging episodes, although these remained orderly and did not trigger broader market dislocations. In FX, both the July FOMC meeting and the Bank of Japan's intervention to curb the yen's weakness generated significant moves in the USD and JPY.

Equity Strategies

Market dislocations resulting from hedge fund deleveraging created short-term volatility across a number of positions within our portfolio, but the overall impact was largely mitigated by favourable stock-specific outcomes. We viewed this period of market weakness as an opportunity and selectively increased exposure to several of our highest-conviction investments across both our risk arbitrage and special situations strategies. The corporate activity backdrop remains highly supportive. M&A markets continue to be active, with a healthy pipeline of announced and rumoured transactions involving both strategic acquirers and private equity sponsors. In Europe, recent examples include Exail Technologies, Delivery Hero, DCC, easyJet and SEGRO, among others. This robust environment continues to generate highly attractive opportunities for capital deployment. One particularly compelling investment is the Exail Technologies acquisition by Thales. The probability of completion appears very high, as reflected in the equity market, where the share price implies approximately a 90% likelihood of deal completion. In contrast, the convertible bond is pricing in an implied completion probability closer to 70%, creating what we believe is an attractive valuation discrepancy. This discount appears to be driven by a shift in the investor base. Historically, the convertible bonds were primarily held by traditional convertible arbitrage investors seeking exposure to volatility. Following the takeover announcement, ownership has been transitioning toward merger arbitrage investors focused on deal completion. We believe this temporary technical imbalance has created an attractive entry point and offers a compelling risk-reward profile. Meanwhile the announced acquisition of Integer Holdings by KKR at the end of the month further illustrates the strength of the current corporate activity environment.

Trading Strategies

Equity long/short trading strategies suffered from the massive rotation due to the US Asian AI /tech trade meltdown. The magnitude of this rotation was unseen since 2020 and the Covid pandemic. Over the last two days of the month, we saw some light at the end of the tunnel, with some major prime brokers calling for a rebound after a very significant deleveraging. The sector rotation that began in June intensified in July, to the detriment of the energy and technology sectors. It is worth noting, however, that the banking sector was unaffected. Rising rates accompanied by a steepening yield curve worked in our favour. Furthermore, energy contracts such as crude oil have recouped a large portion of their June losses. Stock indices, on the other hand, performed rather poorly, particularly those heavily weighted towards technology, such as the Nasdaq and the Taiwan index.

Outlook

Looking ahead, many of the themes that defined July are likely to remain relevant. The interaction between technological innovation, valuation considerations, corporate activity and macroeconomic uncertainty will continue to shape investment opportunities across regions and asset classes.

While predicting short-term market outcomes remains inherently difficult, the current environment suggests that company-specific factors, capital structure developments and corporate events may continue to play an increasingly important role in driving returns. At the same time, periodic shifts in investor sentiment are likely to create pockets of both opportunity and risk. In a world where market averages often conceal significant underlying differences, the ability to identify dispersion, assess changing probabilities and maintain a disciplined investment process is likely to remain a key source of long-term investment insight.

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