STENHAM
ASSET MANAGEMENT

Quarter 3 2019 Report

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Market Data for Q3 2019

Equities			Fixed Income			Currencies			Commodities		
	Q3	YTD 2019		Q3	YTD 2019		Q3	YTD 2019		Q3	YTD 2019
MSCI World (USD)	0.08%	15.72%	**FTSE Global Bonds**	0.85%	6.27%	**USD** (DXY)	3.38%	3.33%	**Gold**	4.26%	14.53%
MSCI EM (USD)	-5.11%	3.65%	**Investment Grade**	3.35%	15.69%	**EUR** (vs USD)	-4.01%	-4.79%	**Oil ('WTI')**	-7.53%	19.07%
S&P 500	1.19%	18.74%	**High Yield**	1.33%	11.56%	**JPY** (vs USD)	-0.24%	1.40%	**Natural Gas**	0.95%	-20.75%
Eurostoxx 600	-1.95%	10.86%	**Barclays Global Agg**	0.71%	6.32%	**GBP** (vs USD)	-3.19%	-3.58%	**Bloomberg Commodity Index**	-2.35%	1.39%

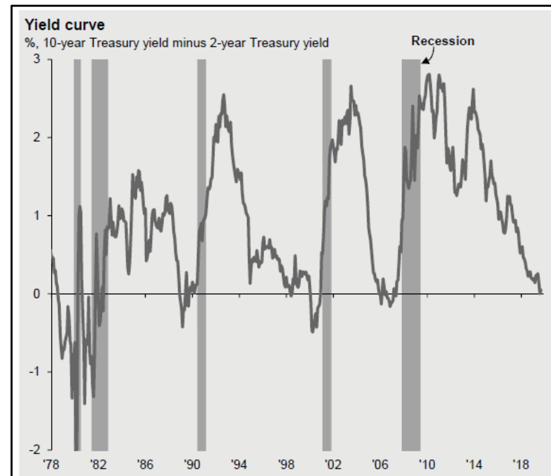
Source: Bloomberg, Stenham

After a difficult summer, equities moved higher in September to leave them flat for the quarter. In many ways Q3 saw a conflict between weakening economic data against further central bank easing and the prospect of accommodation in trade talks between the US and China. The MSCI World returned 0.1%; the S&P500 outperformed, rising 1.2%, whilst Eurostoxx600 returned +2.2% in EUR, -2.0% in USD. Emerging markets came under further pressure from trade tensions and MSCI EM fell 5.1%. Of limited sustained market impact, but highlighting the continued political risk in the Gulf, was the drone attack on two Saudi oil refineries, an act blamed on Iran by the US. The oil price reaction was short lived (WTI rose 14% on the day after the attacks) as supply came back online quickly, but this was a reminder of tensions in the region. Overall WTI fell 7.5% in Q3. Long-term interest rates continued their drift lower; the US 10yr yield fell below 1.5% in late August, a level not seen since 2016. Significantly for many investors, the US 2/10 yield curve inverted. Gold rose 4.3%.

Beneath the surface of seemingly calm markets, there was significant disturbance. Equity markets saw a violent move away from growth-orientated and momentum-driven stocks in favour of value equities in September. The DJ Market Neutral Value index returned +7.8% in September whilst the equivalent momentum index returned -8.0%, a 16% spread. This was a significant change from year to date and prior years which has seen growth sectors significantly outperform. Symptomatic of this, many recent venture capital backed IPOs such as Uber, Lyft and Slack fell precipitously. Within credit, lower rated 'CCC' and distressed securities significantly underperformed high yield as investors flocked to higher quality names. The underperformance in the distressed market was particularly acute with the index down 11.4% in Q3 (S&P US high yield corporate distressed bond index) as stressed oil and gas and other secularly challenged issuers suffered whilst overall high yield returned 1.3%.

Central bank eased policy further in Q3 as the US Fed, in well signalled moves, cut rates in July and September whilst the ECB cut interest rates further into negative territory to -50bps. The ECB restarted its QE programme, committing to continue with asset purchases until its inflation goal is achieved. The move away from a date-dependent forward guidance has led some to dub this "QE infinity" and could lead to significant further asset purchases. In Japan, the BoJ resisted the need to join further easing, though with consumption tax hikes now in place, there may be some impact on the economy that could lead the bank to ease at its next meeting.

The US 2/10 yield curve inverted in August (i.e. the annual yield on a US 10yr bond fell below that of a 2yr bond) for the first time since 2007 and such an inversion is often seen as a precursor of an economic recession. The five previous inversions of the US yield curve preceded recessions by 10-34 months, with an average lead time of 20 months. Q3 saw rate cuts of 50bps, with the market pricing in at least one further cut this year.

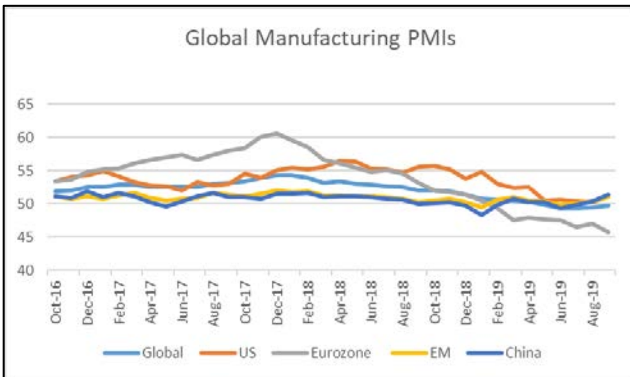


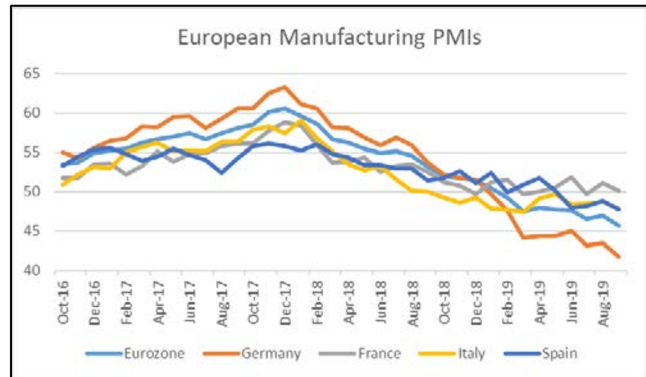
Source: JP Morgan

There are compelling arguments about why the yield curve inversion is not relevant this time. The most prevalent and appealing is that yields are so low world-wide, with an abundance of negatively yielding debt, this has pulled the yield on US treasuries below their fair value; in essence the inversion is technical rather than fundamental. This does feel somewhat of a convincing argument with the extreme monetary policies adopted; these have artificially impacted absolute pricing so why not the shape of the yield curve also. However, it is also worth highlighting that at prior instances of inversion there have been what seemed at the time similarly compelling arguments. In 2006 we felt protected given the robustness of house prices, in 1998 technology had created a new investment paradigm and in1989 inversion was applauded as it showed the scourge of inflation had been conquered.

Monetary policy is firmly easing in an effort to support economic growth. Fiscal expansion is less clear but also seems to have positive momentum. Within Europe, the big question is whether the weakness in the German economy will add impetus to fiscal expansion or if the instinct will be to respond to lower revenues by lowering spending. The latter has historically been the case, but there is growing pressure for Germany to increase spending, especially as economic weakness is concentrated in Germany specifically rather than elsewhere. Draghi, in his final press conference as ECB President, said that monetary policy is close to the limits of what it can be and now the onus is on fiscal policy to stimulate growth. The UK looks set to increase spending and the US could well follow suit as recent impetus from the Trump tax cuts subsides.

Economic data continued to deteriorate. The US had proven more resilient than Europe and emerging markets, but data is now weakening. PMIs have dropped and show a significant decline globally from highs seen 12-24 months ago with the US, though still above others, falling. Manufacturing has been worse hit than services, most directly linked to trade disputes.





Source: Stenham, Bloomberg

The US labour market has seen a mixed picture; whilst the economy has continued to add jobs, the pace of growth of new hires has slowed, as has growth of aggregated hours worked. In early 2018, the number of unfilled jobs exceeded the number of unemployed workers for the first time in history. At their peak, job openings outnumbered job seekers by 1.5 million. But since January, the number of open jobs has fallen by more than 400,000.

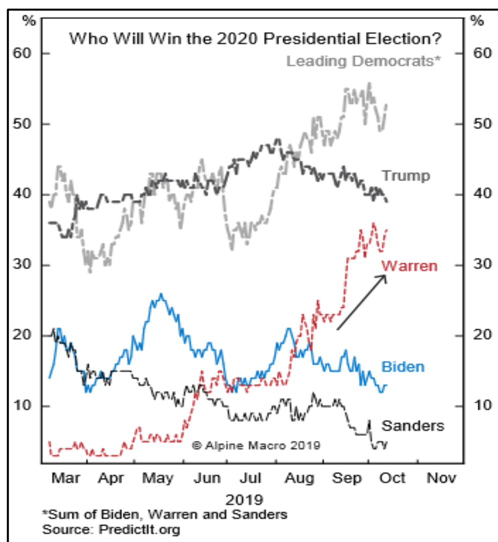
China's economy continued to slow. Q3 growth came in at an annualised 6.0%, which is the slowest level since 2009. Industrial production is growing at 5.8%, down from 7% at the start of 2018 whilst retail sales also slowed to 7.5% from close to 10%.

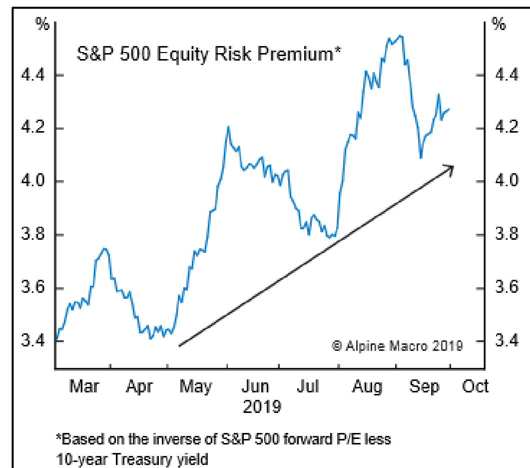
Europe has seen the most significant economic downturn and is most likely in recession. The post-2008 characteristic of Europe has been of a strong German economy compensating for weakness in the periphery. This has reversed with Germany leading the recent downturn. Most notable has been its large auto sector but more broadly the export orientation of the economy which has been impacted by the slowdown in global trade. More significantly, Germany may need to re-orientate its economy away from heavy industry and manufacturing, which benefited from the strong emerging market growth and infrastructure investment after the financial crisis but has been exposed since. By contrast, southern Europe may not have addressed all of its structural issues (though there has been progress made, particularly in Spain), but, by virtue of being more heavily indebted, will benefit most from the ECB's interest rate policy and will see its debt service cost decline leaving room for fiscal expansion and stimulus.

Politics continues to be at the fore for investors. The trade dispute lingers between China and the US, where prospects of a resolution, or at least a de-escalation, oscillates on a frequent basis often based on public announcements from either side. There is good reason to see why both sides would want to reach some agreement (weakening economies and, in the US, the prospect of upcoming elections) but the situation remains fluid. There are current talks underway, where there is optimism of some accord which would lead to at least a postponement of future tariff increases. Within the UK and Europe, Brexit continued to dominate headlines. Since quarter-end, UK PM Johnson agreed an exit deal with the EU but this failed to be passed by the UK parliament. There is now a UK general election scheduled for December whilst the EU has agreed to delay Brexit until January 31st 2020. However, the risk of a no-deal Brexit appears significantly reduced and the GBP has recovered to close to $1.30 as a result.

Q3 saw an intensity of the debates between candidates for the Democratic Party Presidential candidacy in 2020. At the start the front-runner was the more centrist Joe Biden, but the left-wing Elizabeth Warren has risen substantially to lead

the opinion polls. The Primary elections for the candidate do not begin until February 2020 and the Presidential election is over 12 months away, but increasingly investors began to focus on the potential impact of some of her policies would have. There is a lot of time for the formation of policies and it could be that more extreme policies are stated and more popular during internal party campaigns than in presidential elections. However, Warren's policies are quite extreme left and could disrupt significant sectors within the economy, be it healthcare, energy, banking or technology. The equity risk premium has risen at least in part due to Elizabeth Warren risk. If she proves successful in the Democratic primaries, this risk could increase; US Presidential elections in recent times have all been extremely tight in the end result.





Outlook

Economic data has firmly declined and central banks have eased policy in response and look set to continue to do so. There is growing pressure on fiscal policy to follow suit in supporting growth. This will result in greater debt, higher levels than we have seen historically, though it is unclear what the consequences are. At zero or negative interest rates, there is a strong case that governments should borrow and be able to identify investments which can generate a positive return. The risk is interest rates rise and so the cost to support this debt rises above the benefit; there is more justification for matching debt to specific infrastructure projects and so locking in current rates. However, we do see excesses in certain debt markets.

The key question facing investors is when the next recession occurs and how deep this will be. The US yield curve inverted during the quarter and at least merits caution that it is indicating a recession, albeit the timing unclear. Fiscal and monetary policy is acting to mitigate this risk, but it is uncertain if this will be sufficient.

Strategy Allocations

Most of our funds saw low single digit losses in Q3, underperforming broad markets. Depending upon the fund, this was driven by i) losses from Argentina and ii) the rotation which saw growth equities significantly underperform. Losses from Argentina came from our emerging markets distressed and macro managers and is discussed below; this was a small position but the moves in asset prices were significant. We have reduced overall equity long/short and equity beta in most funds, but one key area where we do hold exposure is in healthcare. We continue to hold this due to the huge innovation taking place, particularly within biotech and medical devices, which lends itself to both gains but also

specialists in the sector who can best understand the complex science behind many of these products and firms. Healthcare as a sector underperformed in Q3 (MSCI Healthcare -1.6%), though the more growth orientated sector of biotech fared materially worse (Nasdaq Biotech -8.8%, S&P Biotech -13.2%). This underperformance was in part attributable to the political risk of healthcare reform especially as Elizabeth Warren rose in opinion polls but also, at least for biotech, as part of the growth equity underperformance. There will likely be continued noise surrounding healthcare leading into the Presidential elections, but valuation in the sector does, in part at least, appear to be pricing in this risk. We continue to see the sector as offering opportunities given the huge innovation taking place, most recently highlighted by the performance of Biogen announcing progress with its Alzeimher's drug, which we believe is a long-term theme. We are willing to tolerate some volatility to capture these longer-term returns.

Against these losses, the protection we had, in the form of long volatility managers, saw moderate losses as volatility overall fell. We believe that these managers will perform well in a more systemic sell-off and continue to hold them.

Whilst we see good opportunities in these sectors and strategies, for certain multi-strategy funds the volatility is too high in the current environment. We have therefore moved progressively towards lower volatility managers and we will continue and substantially finish this process during Q4.

Discretionary and Systematic Global Macro

Macro and relative value managers lost a moderate amount during Q3. Key losses came from emerging markets focused managers. This originated from exposure to Argentina (see discussion under "Credit" below). Other areas such as long fixed income in Brazil, as the central bank continued to cut rates there, proved profitable but could not offset the losses. Our fixed income relative value managers performed relatively well, delivering consistent gains. We were pleased with how they managed the funding scare in September, which saw a spike in repo rates, with the managers having been cautious about potential stress in that market.

Discretionary managers saw moderate losses. Those with a long volatility bias suffered slightly as volatility declined. More importantly, a common position has been to position for US interest rates to decline, which worked well in July and August but suffered as rates rose in September. Managers still hold this position and believe it to be a strong hedge to broader markets and that if economic weakness persists, US interest rates will converge with the rest of the developed world at close to zero.

Equity Long/Short

Our long/short allocation saw mixed performance in Q3. Managers generally dealt with the overall decline in markets well in July and August but suffered from the growth/value rotation seen in September. In particular, our biotech and technology focused managers suffered drawdowns in their long portfolios. These managers maintain conviction in their portfolios and have not meaningfully adjusted exposure,

The best performing managers were lower net managers who also manage factor risk quite tightly and so were less exposed in September. This includes our utility focused and some lower net healthcare managers.

Emerging markets continued to lag broader markets. However, we do see that within Asia, there is potential to generate greater alpha than in more crowded and competitive markets. From being largely long-biased, managers there have

evolved as market liquidity has improved and now can have a greater focus on short positions. We have begun to allocate to Asian long/short at the beginning of Q4 and may increase this exposure, though moderately, in the coming quarters.

Event Driven

The event driven allocation performed well in Q3. Returns were more lacklustre than earlier in the year, a function of tighter spreads. M&A activity has remained fairly robust; deal volume in Q3 2019 was $1.31trn, down from $1.56trn in Q2, but still a healthy level. There have been some larger deals with attractive spreads still outstanding, but overall spreads have declined. We continue to like the return profile offered by merger arbitrage managers and accept spreads will vary. Importantly, our managers have not recklessly increased risk or exposure to compensate for the lower spreads.

Credit

The credit allocation lost money primarily due to exposure to Argentina. In the Argentinian presidential primary elections (PASO), the opposition leader Alberto Fernandez secured a victory over the incumbent Macri by a far greater margin than anticipated, and has since won the presidential election. Driven by concern over the economic policies that may be pursued by Fernandez, Argentinian assets fell materially (50-75%). Given the scale of the fall one emerging market manager, along with many others, has been meeting with Fernandez to evaluate expectations for his policies. There is growing conviction that Fernandez will pursue a consensual restructuring with bond holders. Key to Fernandez's economic policies is the development of Argentina's hydro-carbon resources which will necessitate foreign investment, a process made all but impossible if the country is embroiled in a protracted conflict with bond holders.

Outside of this, distressed managers saw moderate losses, driven by overall market/sector weakness. The multi-strategy and long/short credit managers saw gains during the quarter, particularly driven by single name short positions working as over-levered capital structures came under pressure and longs performed relatively well.

We are seeing opportunities in less liquid credit, some of this is awaiting a coming distressed opportunity set, which could be very appealing given the record levels of leverage and credit issuance. The underperformance of 'CCC' and distressed credits in 2019 may be symptomatic of companies running into trouble fundamentally and prices of securities not just being influenced by broader markets. We are also seeing opportunities for credit solutions which continue to fill the gaps where banks used to operate pre-2008. This includes niche lending to companies and speciality finance.

Summary

We are in a difficult investment environment. There is economic weakness, and authorities will likely adopt whichever policies they can, monetary or fiscal, to address that weakness. No-one really know the consequences of zero or negative interest rates, or of an ever rising level of sovereign debt when the cost of servicing that debt is itself zero (or even negative). We feel it wise to be cautious in positioning in this environment, taking targeted risk where we think real inefficiencies lie.

Thank you for your ongoing confidence in Stenham. Please contact us if you would like to hear more about our strategies or funds. Further information and the relevant Business Development contact details can also be found on our website:

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