STENHAM
ASSET MANAGEMENT

Quarter 4 2019 Report

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Market Data for Q4 2019

Equities	Q4	2019
MSCI World (USD)	8.19%	25.19%
MSCI EM (USD)	11.36%	15.42%
S&P 500	8.53%	28.88%
Eurostoxx 600 (USD)	8.93%	20.76%

Fixed Income	Q4	2019
FTSE Global Bonds	-0.35%	5.90%
Investment Grade	1.36%	17.27%
High Yield	2.77%	14.65%
Barclays Global Agg	0.49%	6.84%

Currencies	Q4	2019
USD (DXY)	-3.01%	0.22%
EUR (vs USD)	2.99%	-1.95%
JPY (vs USD)	-0.41%	0.99%
GBP (vs USD)	7.92%	4.09%

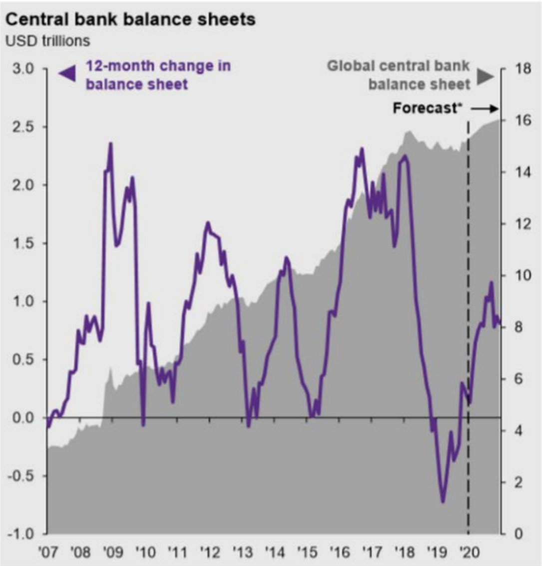
Commodities	Q4	2019
Gold	2.90%	17.86%
Oil ('WTI')	2.93%	34.46%
Natural Gas	-6.05%	-25.54%
Bloomberg Commodity Index	4.00%	5.44%

Source: Bloomberg, Stenham

2019 saw strong performance across both equities and fixed income and the year turned out to be a much more positive period for markets than many commentators predicted. Equities ended the year up significantly after a strong Q4. The MSCI World returned +8.2% for the quarter bringing performance to +25.2% for the year. In contrast with the rest of the year, emerging markets outperformed in Q4 with MSCI EM rising 11.4% against the S&P500 8.5% and Eurostoxx600 8.9%. The stand-out performer in FX was GBP, which rallied with the conclusive victory of the Conservative Party in the UK general election. After the inversion of the US 2/10 yield curve in Q3, curves steepened. Gold rose 2.9%.

2019 has seen a reversal of monetary policy, particularly in the US. 2018 saw some first steps in monetary tightening and the prospect of that continuing led to the market turmoil of Q4 2018. That policy has been firmly reversed. From forecasting further rate rises in 2019, we actually saw 3 rate cuts, with the market currently pricing in an additional 1 to 2 cuts in 2020. This has allowed the discount rate for many financial assets to fall and hence we saw the (perhaps surprising) strong performance of equities as economic data worsened. This is much to do with monetary policy driving asset prices; S&P500 companies have seen no increase in corporate earnings and virtually of the market rise was through rerating of shares.

Given the market reaction to tightening in 2018, any pre-emptive tightening by central banks this cycle seems unlikely. Jay Powell, the Fed Chairman has said that there would need to be a sustained increase in inflation to lead to any increase in interest rates. There has also been further injection of liquidity into the market; in October, the US Federal Reserve announced it would begin buying T-bills at a rate of USD60bn per month, continuing purchases through Q1 2020. As a result, in just 6 months, the Fed's balance sheet has grown back to the level at the end of 2018. We are back at peak central bank holdings and a significant inflow of liquidity into the system.



Source: JP Morgan

Economic data deteriorated during 2019, but there was no recession and positive growth continued. Global growth as a whole was 2.4%, the lowest since the financial crisis. The US grew at 2.1% in Q4, whilst China grew at 6.1%, a slowdown from previous levels and the lowest level since 1990. Europe has been badly hit by the slowdown in EM as well as its own anaemic domestic growth levels. For the Eurozone as a whole growth came in at 1.0%. Germany suffered more and narrowly avoided a technical recession as its economy fell 0.2% in Q2 and then grew by 0.1% in Q3. Outside headline growth numbers, employment data remains relatively strong with employment gains in both the US and Europe and unemployment at low levels. Notwithstanding the fact that growth in EM may require less heavy industrial goods than previously, and resulting structural issues facing Germany, consumer spending is of more importance for the economy than manufacturing, just to a lower degree than in other economies, notably the consumer heavy US. German wage growth has remained fairly consistent at 4% per year and consumption growth at 1.5%. Consumption has shown signs of rebounding so the economic outlook may not be as bleak as some indicate.

PMIs remain low, but are showing signs of bottoming out which could lead to a rebound in economic growth, along the lines we saw in 2016-7. PMIs improvement has been led by emerging markets, and within that China. One key difference in dynamics is that China has been pursuing a policy of taming credit growth, in particular from the shadow banking system, where there were systemic concerns over the quality and quantum of credit granted. With that having been done, it seems that credit growth will resume. China is entering middle income stages with the expectation of lower ongoing growth compared with the previous decade, but nonetheless could see a rebound in growth.

PMIs

Composite

	2018												2019											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Global	54.5	54.8	53.2	53.8	54	54.2	53.7	53.4	52.8	53	53.1	52.7	52.1	52.6	52.8	52.1	51.2	51.2	51.6	51.3	51.1	50.8	51.4	51.7
Developed	54.9	55.4	53.6	54.4	54.8	55	54.2	54	53.3	53.6	53.4	52.7	52.3	52.9	52.7	52	51.1	51.3	51.7	51	50.7	50.3	50.9	51.2
Emerging	53.5	53.3	52.3	52.4	52.2	52.4	52.4	51.8	51.6	51.3	52.6	52.5	51.6	51.7	52.9	52.4	51.3	50.9	51.5	51.8	51.8	51.8	52.7	52.2

Maunfacturing

Global	54.3	54	53.2	53.4	53	52.9	52.7	52.5	52.1	52	51.9	51.4	50.7	50.6	50.5	50.4	49.8	49.4	49.3	49.5	49.7	49.8	50.3	50.1
Developed	56.3	55.7	54.8	55.1	54.7	54.4	54	53.8	53.6	53.2	52.8	52.3	51.8	50.3	49.9	50.2	49.2	48.9	48.6	48.7	48.6	48.6	49.5	49.1
Emerging	51.8	51.9	51.3	51.3	51.1	51.2	51	50.8	50.3	50.5	50.7	50.3	49.5	50.6	51	50.5	50.4	49.9	50.1	50.4	51	51	51	51

Services

Global	54.2	54.8	53.2	53.8	54.3	54.6	54	53.5	52.9	53.4	53.7	53	52.7	53.3	53.7	52.7	51.6	51.9	52.5	51.8	51.4	51	51.6	52.1
Developed	54.3	55.3	53.4	54.2	54.9	55.3	54.4	54.1	53.2	53.9	53.7	52.8	52.5	53.7	53.7	52.5	51.6	52	52.6	51.6	51.3	50.7	51.1	51.9
Emerging	53.8	53.5	52.5	52.7	52.5	52.6	52.8	51.6	52.1	51.9	53.7	53.6	52.9	52.1	53.7	53.2	51.7	51.5	52.1	52.3	51.8	51.8	53.2	52.4

Source: Bloomberg, Stenham

Key to the recovery in the global economy is trade. January has seen a phase one agreement between the US and China in their trade dispute, which prevents the implementation of further planned tariffs on Chinese imports to the US. Importantly, the US also postponed tariffs on EU auto imports. Whether this is a precursor to a more comprehensive trade agreement remains to be seen and seems unlikely in the near-term. The future of global trade relationships is unclear and may be heavily dependent upon the result of the US presidential election in November 2020. In the run-up to that, it would seem logical that President Trump will want to maintain a growing economy. Should he be re-elected, it is unclear what path he would take, the concern being that unencumbered by the prospect of needing re-election, he could pursue more extreme policies.

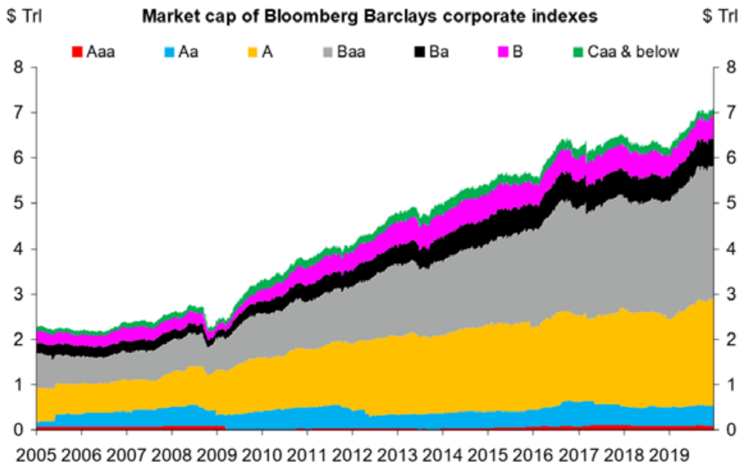
Along with supportive monetary policy, fiscal stimulus looks set to be adopted globally. Within the US, the leading Democratic candidates indicate there would be significant government spending, under the guise of a Green New Deal or otherwise. President Trump has also stated that he would implement tax cuts for middle earners. In Europe, the UK election was won in part by the Conservative party adopting a more fiscally expansive approach. There remains some reticence from leading European countries, notably Germany, but the tone of the debate there is changing and Christine Lagarde, the incoming ECB president, has let it be known that monetary policy has largely run its course and fiscal policy is left to stimulate the economy.

Leading our concerns are fixed income markets. 2019 saw a significant increase in negatively yielding debt. This has come down from the highs seen in Q3, when recession fears were at their worst, but there is still an extraordinary level of negative yielding debt, some USD13trn at end-Dec 2019. This strong decline in interest rates led to a reasonable return in fixed income in 2019; the US Agg returned 4% to 10% depending upon duration. However, there must be some constraint to the amount to which interest rates can continue to fall and create gains. At some point, negatively yielding debt will lead to negative returns in a static environment.

Source: Bloomberg, Stenham

Within high yield, headline numbers were also strong, but beneath that there was evidence of strain; 'CCC' debt underperformed broad high yield, something which is abnormal when high yield performs well. Indeed in the prior 10 occasions when high yield has returned over 10%, 'CCC' securities outperformed, being higher beta. The underperformance in 2019 has been a result of certain industries being troubled, most notably energy, but also shows that, with corporate leverage high, business models can struggle. Equally, there were more rating agency downgrades than upgrades in 2019, an oddity in such a strongly performing market. This may be due to industry specific troubles but also seems to reflect companies publishing, and being rated on, 'adjusted' EBITDA levels based on forecast and anticipated cost and synergy savings. When these did not materialise, the rating agencies downgraded. Defaults remain low, but increased by 50% in 2019 while distressed exchanges increased 4 fold.

Overall, there has been a huge increase in corporate debt issued since 2009. Generally, quality has deteriorated; in investment grade, 'BBB' debt represents 50% of the investment grade universe, up from 35% in 2009. This huge increase, often owned by vehicles offering daily liquidity, has coincided with a decline in market liquidity as banks have stepped back from holding risk even for short periods of time. These risks are both fundamental from the underlying quality of the debt and also structural should there be any selling of fixed income and demand for liquidity.



Source: Deutsche Bank

Political risk is always present and can be unexpected, as the death of Qasem Soleimani in January 2020 as well as the anti-government protests in Hong Kong in 2019 have shown. However, there may be some signs of it moderating in the short-term. The comprehensive victory of the Conservative Party in the UK general election has brought some certainty over Brexit, albeit trade negotiations remain. The US election is the key known event for 2020. President Trump often quotes the stock market level, seeing it as a barometer for his popularity and it would be logical to assume that he will look to adopt policies to keep economic growth, and markets, intact. It is unclear who the Democratic candidate will be as Elizabeth Warren rode high in the polls in Q4 before tailing off and being superseded by Bernie Sanders and Joe Biden. There are a number of democratic primaries in Q1 (notably Super Tuesday and the Iowa and New Hampshire primaries) which may or may not add some clarity. Should Trump win a second term, it is unclear what the consequences are of him being unconstrained by the desire to be re-elected. One could question whether he will have such a focus on economic and market performance and, if not, whether that could lead to a more aggressive stance, especially in foreign policy.

Outlook

We tend to sympathise with the bulls in the short term and bears in the long-term. There is good reason to be bullish in the short-term; economic data appears to be bottoming at least and most likely improving, the risk of premature tightening by central banks is slim, 2020 will likely see both fiscal and monetary (through expansion of balance sheets) stimulus and with the US presidential elections, there is every reason to think that Trump will seek to minimise any political risk to markets. There is a feeling that this cycle is reaching a natural end, but that may not be true in itself. This has been a long cycle and economic expansion has outlasted that of the 1990s. However, the quality of this business cycle has been poor. Since March 2009 the US has only seen 60% of GDP gains seen in the 1990s. Inflation has undershot targets rather than becoming a looming issue. There is no reason for any major central bank to resume monetary tightening in 2020. Indeed, the Fed has indicated it would be happy to see inflation move above its target for a period. It could be that we have seen a series of mini-recessions, triggered by the significant manufacturing slumps in 2014/5 and 2018 and so those sighting the length of the cycle are being somewhat misled.

Longer, or maybe in the medium-term, we continue to have concerns. Monetary conditions are supportive, but this would reverse dramatically if there were any change in the sanguine inflation environment we are in. There has been a calm in trade tensions between the US and China, but longer-term solutions are required and may not be easy to achieve. Political risk could escalate either geopolitically, such as in the Middle East, or from a political upset from the far left in the US Presidential election. In fixed income markets, corporate credit has grown in volume, much of it in lower rated areas, which gives concern over its quality. There are significant unknowns over the impact of zero and negative interest rates. Government debt is higher everywhere and only looking to increase whilst political discourse becomes more polarised. Considering current levels of asset prices, the risks here are sufficiently large and structural to suggest that investors should at least be thinking about them in the medium-term.

Strategy Allocations

Q4 was a good quarter for our portfolios. Some of the drivers of losses in Q3 rebounded, such as Argentina and exposure to biotech, but our core allocations, including less directional managers, performed well. This came from a variety of sources; fixed income relative value managers benefited from dislocations which occurred during the disruption of repo markets in the US which then normalised, merger arbitrageurs profited as some of the large healthcare deals closed and there was little market disruption as a whole. Where the volatility in Q3 proved too high for certain portfolios, we have implemented changes to a lower volatility profile. For most portfolios we are making little change overall, though continue to add opportunistically to new funds which are upgrades or complementary to our existing portfolios.

We are working extensively on opportunities in India, where we think there are significant structural tailwinds to capture and a number of high quality managers in the equity space and will make allocations in appropriate portfolios likely from the start of Q2. For a number of clients we are also investing in longer-dated credit opportunities. Notwithstanding the risks we see in fixed income and credit markets overall, there are structural opportunities in certain parts of credit markets due to regulation restricting the activities of banks. It is critical to be selective but we see good opportunities in alternative credit, specifically speciality finance, certain niche direct lending strategies and to some extent distressed debt.

Discretionary and Systematic Global Macro

Macro and relative value managers generated good gains during Q4, with both discretionary macro and relative value managers generating gains. The best performance came from emerging markets; key to this was a rebound in asset prices in Argentina, though other long positions, both equity and fixed income, also worked well.

Our fixed income relative value managers performed well, delivering consistent gains and in excess of what we would typically expect. The spike in US repo rates in September created a number of dislocations and these managers added to relative value positions which proved profitable as these normalised during Q4 We were pleased with how they managed the funding scare in September and were then able to position to benefit from the subsequent normalisation.

Discretionary managers saw good gains, driven by our emerging markets focused managers, though other discretionary managers also profited from long positions in risk assets. Managers with a long volatility bias suffered as volatility declined, which is what we would have expected and we see these managers offering protection in a market dislocation or downturn.

Equity Long/Short

Our long/short allocation saw strong performance in Q4, in particular our healthcare managers. Healthcare outperformed broader markets (MSCI Healthcare 13.4% vs MSCI World 8.2%); biotech performed well and our managers outperformed respective indices. Biotech in particular saw a strong tailwind from the level of merger and take-over activity; Merck acquiring ArQule, Astellas acquiring Audentes, Sanofi acquiring Synthorx, as well as further drug approvals from the FDA. Despite the outperformance in Q4, healthcare as a sector lagged broader markets during 2019 though now trades at a discount to broader markets. It is however seeing the second best earnings growth and the best revenue growth of any sector. There is some political risk, particularly relating to drug pricing and the upcoming US election, but political risk seems to be priced in more to healthcare than other sectors. As seen in Q3, the sector can be volatile and suffer draw-downs. Nonetheless, we believe this to be a key area to have exposure as we see strong opportunities and are willing to tolerate some volatility for the longer-term gains.

Other managers also performed well. Lower net managers were more variable (benefiting less from the market performance) though overall they generated good performance; our utility managers returned 2-3% over the quarter. Our low net Asian manager suffered due to shorts in Chinese consumer stocks which performed strongly.

Event Driven

It was a strong quarter, and indeed a strong year, for the event driven allocation. Spreads are tight and there are few deals offering a wide spread, albeit with risk. Our managers have less exposure now compared with the start of the year, especially as some larger deals (e.g. Bristol Myers/Celgene) closed successfully in Q4. We continue to like the strategy and are happy for our managers to run lower risk if opportunities do not present themselves and await opportunities as spreads widen or new deals are announced. 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 performed well in Q4. Our best performing manger was an emerging markets manager who benefited from exposure to Argentina. This followed a draw-down in Q3 and the manager added and amended positions given the violent price action in those securities. The manager maintains high conviction in positions in Argentina and this remains a core position. All other funds were positive in Q4.

Overall, our credit allocation, in particular distressed debt holdings, underperformed what we would have expected in such a strong environment for risk assets. This is true across the strategy and not specific to our holdings. Part of the explanation for this is the underperformance of 'CCC' and lower rated securities and there has also been less risk appetite for corporate turn-around stories until there is real, tangible evidence of it occurring.

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:

www.stenhamassetmanagement.com

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