STENHAM
ASSET MANAGEMENT

Q2 2022 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q2	YTD
MSCI World (USD)	-16.6%	-21.2%
MSCI EM (USD)	-12.4%	-18.8%
S&P 500	-16.5%	-20.6%
STOXX Europe 600 (USD)	-15.5%	-23.1%

Fixed Income	Q2	YTD
FTSE Global Bonds	-8.9%	-14.8%
Investment Grade	-8.6%	-16.2%
High Yield	-9.9%	-13.8%
Bloomberg Global Agg Bond	-8.3%	-13.9%

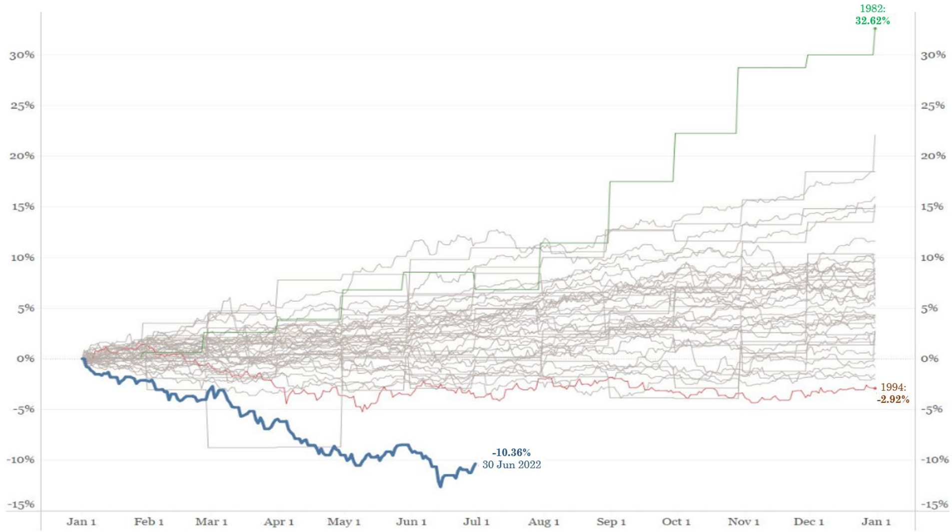
Currencies	Q2	YTD
USD (DXY)	6.5%	9.4%
EUR (vs USD)	-5.4%	-7.9%
JPY (vs USD)	-10.4%	-15.2%
GBP (vs USD)	-7.3%	-10.0%

Commodities	Q2	YTD
Gold	-6.9%	-0.9%
Oil (WTI)	5.5%	40.6%
Natural Gas	-3.9%	45.4%
Bloomberg Commodity	-5.9%	18.0%

Source: Bloomberg as of 30 Jun 2022

Risk assets continued to fall in Q2, leading to most asset classes, with the notable exception of commodities, to experience significant losses for the year. Equity markets across the board are down significantly, with the S&P 500 entering bear market territory for the first time since March 2020, but the fall in value of fixed income is more significant for many investors. Fixed income indices have seen greater drawdowns, often by an order of magnitude, than ever before. The Bloomberg US Aggregate is a broad index of US fixed income securities and shows the scale of losses experienced by investors.

Bloomberg US Aggregate Total Return Index[1]
YTD total returns



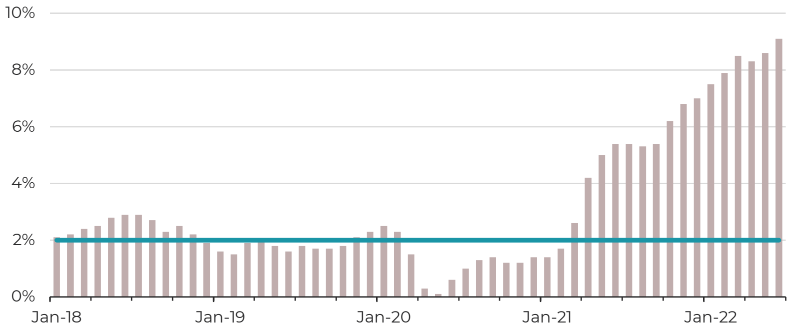
[1] *Source: https://www.biancoresearch.com/*

High yield returned -9.9%, the third worst quarterly performance on record (and worse than Q3 2008) whilst investment grade returned -8.6%, bringing year to date to -16.2%. These two indices have had their worst performance ever for the start of a year. Crypto-currencies also fell precipitously (Bitcoin -59%) and various crypto funds ended up either in liquidation or unable to meet redemption requests. Commodities have been one exception to this trend, though gold did decline.

Bonds fell as interest rate expectations rose sharply during the quarter. This is maybe best illustrated by the highest point on the Fed's March "dot plot" (i.e. the highest interest rate forecast from any member of the FOMC[1]) becoming the lowest point by June's meeting.

The macro story is very much a continuation from late 2021 and early 2022. Inflation greatly exceeds targeted levels, this is creating pressures in the economy, and to bring down inflation central banks are increasing interest rates. This could well, even will likely, create a recession across most regions. Central banks do not want to create a recession, but reducing demand is the only way to tame inflation, which has clearly taken them by surprise.

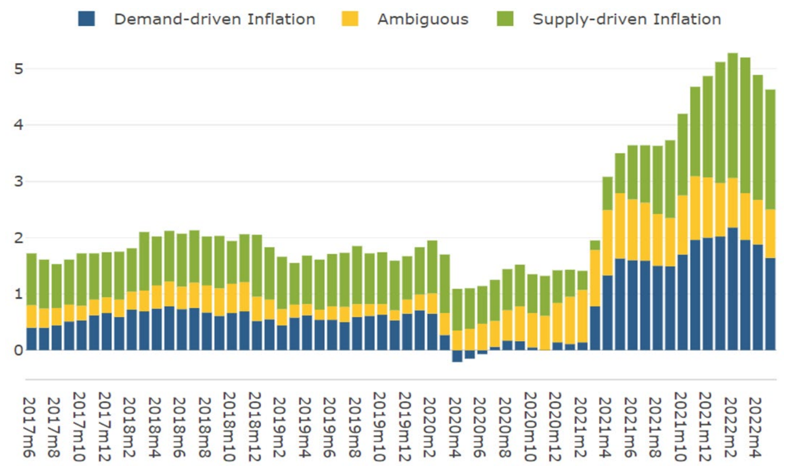
US CPI[2]



To help ease the scale of tightening central banks have to achieve, there could well be improvements on the supply side. This would come most notably from some sort of resolution or calming of the conflict in Ukraine, though this is unknown. Outside of that, there is some element of thinking inflation may have peaked.

The Federal Reserve of San Francisco estimates that contributions to core PCE inflation from unexpected demand and supply have begun to decline.

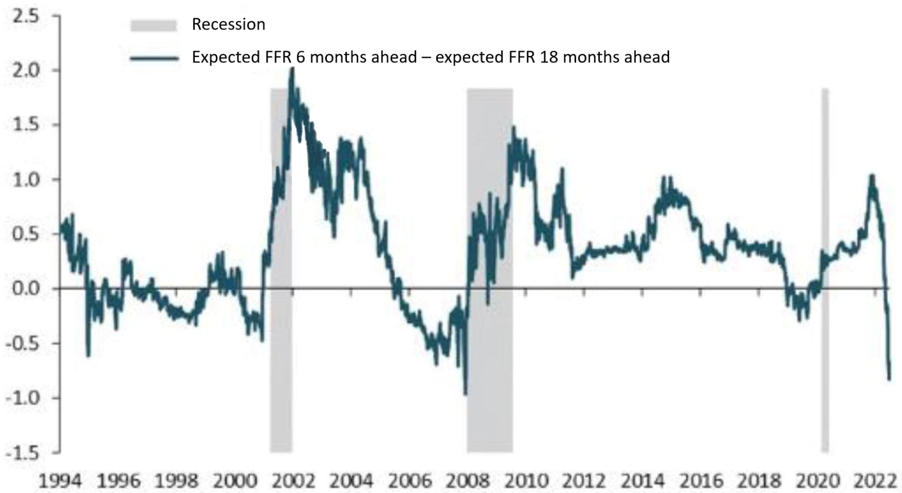
Supply- and demand-driven contributions to YoY core PCE inflation (%)[3]



[1] *Federal Open Market Committee.*
[2] *Source: Bloomberg as of 30 Jun 2022.*
[3] *Source: Federal Reserve Bank of San Francisco (https://www.frbsf.org/)*

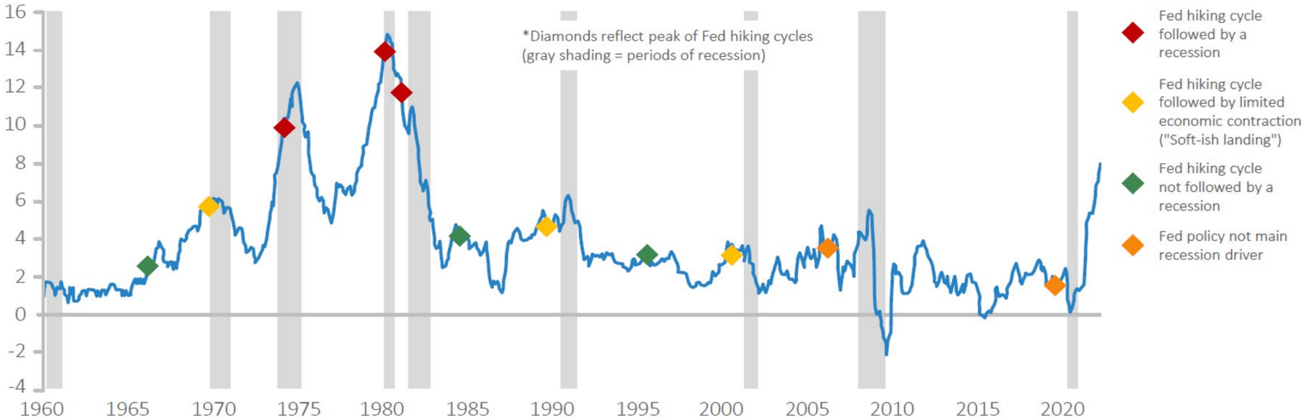
Indeed, the peak in inflation is what is being priced into the market with expectations of rates hitting highs in late 2022 and then being cut in 2023 (illustrated by the inverted US treasury yield curve). This was only confirmed by Fed Chair Powell's July FOMC comments following the 75bps hike to bring rates to 2.5%, a level he considered to be neutral for interest rates. The chart below shows the implied direction of federal funds rates by subtracting the market expected 18-month rate from the 6-month. A negative number implies interest rate cuts, with 2023 showing a steep decline following further, more moderate increases during 2023.

Federal funds rates trajectory[1]



There are risks to this. Inflation can remain stubbornly high depending what happens to commodity prices and also any further disruption to supply chains. Interest rate rises have a lagged impact on economic behaviour. With inflation being so high and central banks having been behind the curve in looking to address the situation, the risk of a mistake is elevated. There is the potential for (1) raising interest rates too high and causing a deeper economic downturn than needed, and (2) stopping raising rates too soon, allowing inflation to take hold. Inflation in the 1970s actually came in a number of waves as the Fed pivoted too early when the cost of bringing down inflation, economic deterioration, became evident. Both these risks are present today.

Headline CPI Inflation, % YoY[2]



[1] *Source: Diameter Capital Partners*
[2] *Source: "Landings Hard and Soft: The Fed, 1965 2020" Alan Blinder (2022), Alan Blinder (2022), Goldman Sachs Global Investment Research.*

Whilst we do not know the path of inflation, we can see the impact now. Corporate earnings are coming under pressure, with companies seeing, in particular, margin pressures. Real wages are also falling aggressively, impacting the discretionary income notably of those at the lower end of the income spectrum. This has probably only begun to filter through to consumer spending as pent-up savings are eroded initially. It seems close to certain that the economic situation will deteriorate over coming quarters and this will show up in corporate earnings.

Effective change in real disposable income[1]
(Q4 2021 – Q4 2022, by income quintile)

This is, and will, filter through to economic growth. It seems highly likely that Europe is in a recession, impacted more than the US from higher energy prices with the greater dependency on Russian energy, but the US is also experiencing a recession and slowdown. PMIs have declined across the board.

Composite PMIs[2]

	2021												2022					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Global	52.3	53.2	54.8	56.7	58.5	56.6	55.8	52.5	53.3	54.5	54.8	54.3	51.1	53.5	52.7	51.2	51.3	53.5
Developed	52.4	53.9	55.9	58.2	61.1	59.3	57.5	54.1	53.8	55.2	55.8	54.8	51.2	54.7	56.0	55.4	53.7	52.5
Emerging	52.1	52.0	52.6	53.5	52.8	50.8	52.0	49.3	52.3	52.8	52.5	53.3	50.8	51.3	46.8	43.5	46.9	55.2
US	58.7	59.5	59.7	63.5	68.7	63.7	59.9	55.4	55.0	57.6	57.2	57.0	51.1	55.9	57.7	56.0	53.6	52.3
Japan	47.1	48.2	49.9	51.0	48.8	48.9	48.8	45.5	47.9	50.7	53.3	52.5	49.9	45.8	50.3	51.1	52.3	53.0
China	52.2	51.7	53.1	54.7	53.8	50.6	53.1	47.2	51.4	51.5	51.2	53.0	54.2	59.9	60.9	37.3	42.2	55.3
Eurozone	47.8	48.8	53.2	53.8	57.1	59.5	60.2	59.0	56.2	54.2	55.4	53.3	52.3	55.5	54.9	55.8	54.8	52.0

Outlook

After large market sell-offs, investors will typically be looking at when to buy. Markets can rally when the narrative of recovery begins to take shape; witness the bank stress test announcements of March 2009 or the reopening of certain economies in 2020. This market cycle is likely to be the change in inflation and, whilst there is some hope that inflation make be peaking, there are real risks to inflation being more stubborn and

[1] *Source: Goldman Sachs Global Investment Research.*
[2] *Source: Bloomberg as of 30 Jun 2022.*

a policy mistake from central banks. It seems almost certain the economic situation will deteriorate further; we are likely to see a recession in the US and PMIs are below 50 in a number or European countries, as well as China. There are growing investment opportunities across different asset classes, but we remain cautious about being aggressive given the large uncertainties that continue to exist. We are in a very different investment environment from that we have experienced in recent decades, with different themes driving markets. Most obviously, this is the reversal of ever lower interest rates driving markets. Markets have yet to see the impact of quantitative tightening with the reduction in the size of central banks' balance sheets.

Strategy Allocations

Less directional strategies continued to perform well in Q2 and have protected capital, as well as generating some performance for the year as a whole, one in which almost all asset classes are strongly negative. Macro and relative value strategies drove positive returns, with credit and event driven modestly negative and long/short equity the worst performing strategy.

We are making slight changes within the portfolios, but at this stage are not increasing overall market exposure. We have reduced some long/short equity allocations, which have underperformed our expectations, but have retained exposure where we see attractive valuations; in particular, in healthcare and within that biotech. We feel the opportunity set in credit is becoming more interesting, but by no means feel the time is to be all-in and will tread carefully when adding directional exposure.

Discretionary and Systematic Global Macro

Macro strategies gained during Q2, which was marked by heightened volatility across all asset classes. It was a quarter of two halves for our classic thematic discretionary macro managers. Managers with directional risk initially gained from long exposure to commodities and a short bias to US rates, which was partly expressed via options and therefore benefitted from higher rates volatility. The inflation narrative, however, led to a recession narrative as near-record inflation prints led the Fed to hike rates by 75bps, triggering uncertainty over long-term global growth among investors. We saw increased dispersion through the quarter. Directional discretionary macro lost from these trend reversals and gave back part of their gains in June, especially those who were positioned for higher yields in the long end of the curve and with a long bias to commodities. These managers had the view that terminal rates remained underpriced by the markets and that global growth concerns were premature, so they suffered from the rates curves flattening. Our less directional macro allocation saw more muted performance over the period. There were no significant detractors during Q2.

Relative value strategies were slightly positive. The quarter was marked by extreme volatility in Japanese bond markets and a sharp widening in bond-basis, which then quickly reverted as the Bank of Japan intervened in markets. We were pleased with our managers against this backdrop, as their exposure to fixed income relative value strategies held up well. We remain comfortable with our managers who are highly specialised in the space. These managers are in a good position to weather dislocation as they are carrying tail hedges with high levels of cash; some of them have diversified from being pure RV to trading macro.

Quantitative and commodity strategies also performed well, with quantitative strategies benefitting from the volatility in single name equities. Our long volatility overlay manager also had a good run with gains coming from long positions in US/Japanese interest rate volatility, widening credit spreads and currency volatility. Our commodity exposure performed well over the quarter, despite the reversal in June. Our managers benefitted from long exposure to energy and RV positioning in oil, and were quick to adjust this directionally in their books and reduce risk. One detractor was a metal-focused manager who had a bullish bias mainly in copper and aluminium, which suffered as recession fears grew. This manager, however, limited losses compared to the industrial metal index by actively adjusting the directionality in the portfolio.

We remain constructive on trading strategies in this environment. Central banks' policy paths are a clear focal point for markets as policymakers seek to navigate record-high inflation prints and slowing growth. There has been increasing volatility in all asset markets, which is creating more opportunities. Risk management is vital in this environment, and we are continuing to favour those managers with a proven history of protecting from left-tail risks and who can navigate periods of market dislocations.

Equity Long/Short

The second quarter proved to be a difficult period for equities, with most major indices posting double-digit declines. Much like Q1, there was a wide range of performance dispersion across the equity funds we are allocated to, which vary greatly in investment style, as well as geographic and sector focus.

With equity markets suffering a broad pullback, it was unsurprisingly our directional managers that struggled. We remain pleased with the performance of our more defensive managers, who typically aim to minimise correlation with markets through low net exposure and careful hedging. In aggregate, they have been successful in achieving this objective, with several of these managers generating positive returns over a period where equity indices have fallen 15-25%.

Rising inflation and interest rates, combined with the increasing risk of an economic slowdown has made it a poor environment for high valuation growth stocks, as well as low valuation cyclical/economically sensitive stocks. As a result, our long-only and long-biased managers have come under pressure regardless of their orientation towards growth or value.

Chinese equities stood out, posting positive returns over the quarter. Sentiment towards the region improved drastically in June as Covid restrictions started to ease and the government announced several policy measures to support the economy and markets. Our China and broad Asia managers have been successful at reducing risk during a tough 12 months for Chinese equities. They continue to monitor the opportunity set to determine whether a more positive stance is warranted.

Healthcare remains one of our core areas of equity allocation. Broad healthcare continued to prove reasonably defensive on a relative basis, although the biotech sub-sector posted another torrid quarter. Our broad healthcare managers, particularly those that use a lot of hedging, performed reasonably well. The more long-biased biotech managers once again struggled, although most view current valuations and the broad opportunity set in the sector as remarkably attractive.

Event Driven

Our event driven allocation was moderately negative in Q2. Merger activity continued at a decent pace ($1.4tn of deals were announced following $1.3tn in Q1) and at a higher level than would have been anticipated given the performance of markets. It has been a fairly precarious market, with regulators taking a more aggressive path to investigating mergers. There have been a few breaks or renegotiations on acquisition prices, which is a risk in a falling market. Thoma Bravo's acquisition of Anaplan did see a reduction in the price, though this can be argued as being due to specific company issues, as well as Elon Musk's acquisition of Twitter coming under pressure, though the motivations for the latter are unclear. Reflecting this greater risk, spreads widened significantly during the quarter and proved volatile. One of our managers focuses on investing in debt of target companies, not just equity, and suffered from the widening in credit spreads and general sell-off in credit; the manager maintains conviction in the positions and added on the widening of spreads. Overall, the return outlook is positive for the strategy, but there is heightened deal and regulatory risk.

Credit

The credit allocation was moderately negative in aggregate. Our managers typically have low net exposure and have managed a difficult market well. The opportunity set seems to be increasing. Spreads have widened across the board and managers are now identifying opportunities which they believe can generate mid-teen or higher returns with a 18-24 month view. That said, spreads at the index level, whilst wider, are not as wide as have typically occurred during a recession. Spreads are increasingly compensating for a default cycle, but it feels as if, at the index level at least, they can go wider. We are looking to increase our allocation to the strategy over the coming months as the opportunity set appears much more compelling than for a number of years.

Should we enter a recession, it is likely that corporate defaults will increase and this will generate strong opportunities for restructuring opportunities. Funds in this strategy tend to be more directional and have less liquid investment terms; we will look at allocating to this strategy for appropriate portfolios, but again are in no rush to increase investment.

We continued to be active in allocating to drawdown private credit funds. This encompasses distressed debt, as well as niche areas of direct lending and specialty finance across the risk spectrum, though we target a net IRR of >10% for our investments. The opportunity set for these different strategies has increased significantly and we feel offers a real opportunity to earn high returns over the coming years.

Summary

Overall, we are pleased with performance this year; a period when our portfolios have protected capital when investors have needed it most. Uncertainty continues and the themes which have dominated investing for previous decades, most clearly the continuous decline in interest rates, may well be changing. There is the real chance that returns from traditional investing disappoint and do not meet the return objectives of investors. We feel that alternative investments offer a valuable role in portfolios to address these concerns.

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 can also be found on our website.

Kevin Arenson
Chief Investment Officer

Tim Beck
Senior Investment Executive

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