STENHAM ASSET MANAGEMENT

Q3 2022 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q3	YTD
MSCI World (USD)	-6.6%	-26.4%
MSCI EM (USD)	-12.5%	-28.9%
S&P 500	-5.3%	-24.8%
STOXX Europe 600 (USD)	-11.0%	-31.6%

Fixed Income	Q3	YTD
FTSE Global Bonds	-7.6%	-21.3%
Investment Grade	-5.9%	-21.2%
High Yield	-0.7%	-14.4%
Bloomberg Global Agg Bond	-6.9%	-19.9%

Currencies	Q3	YTD
USD (DXY)	7.1%	17.2%
EUR (vs USD)	-6.6%	-14.0%
JPY (vs USD)	-6.2%	-20.5%
GBP (vs USD)	-8.6%	-17.8%

Commodities	Q3	YTD
Gold	-8.1%	-8.9%
Oil (WTI)	-24.8%	5.7%
Natural Gas	24.7%	81.4%
Bloomberg Commodity	-4.7%	12.4%

Source: Bloomberg as of 30 Sep 2022

Markets continued to be volatile during the quarter, with declines across almost all major asset classes. For the first time since the Global Financial Crisis, equity indices worldwide declined for a third consecutive quarter; the S&P 500 returning -5.3%, the Nasdaq Composite -4.1% and the MSCI World -6.6%, bringing YTD losses to 25-30%. Fixed income fared equally poorly as the Bloomberg Global Aggregate Bond fell -6.9%. Investment grade credit fell 5.9% (-21.2% YTD) on pace to realise its worst annual return since 1975, and similarly high yield fell 0.7%, close to -15% for the year. A 60/40 portfolio of US stocks and bonds remains on track to realise its worst annual return since the Great Depression.

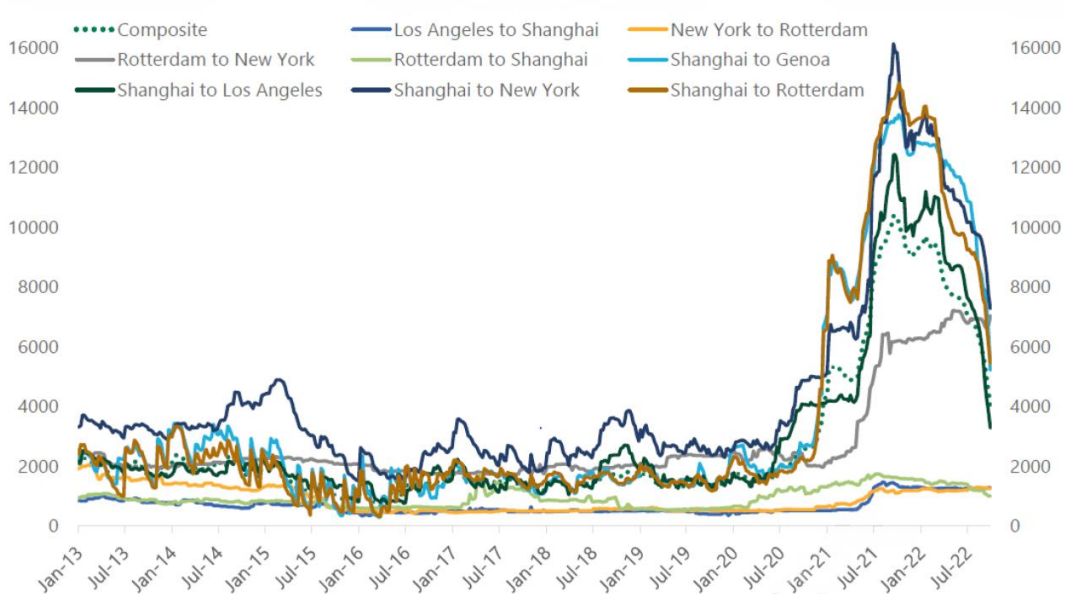
During the first 6 weeks of the quarter, fueled by a “peak inflation” narrative, risk assets rallied. However, performance across markets deteriorated rapidly as investors became increasingly concerned about a recession amid a range of macro headwinds, including sustained elevated inflation, hawkish central banks, the energy crisis in Europe and continued geopolitical tensions.

After US inflation reached a 40-year high of 9.1% in June, a lower-than-expected July report sparked optimism that inflation had moderated, which would have allowed the Federal Reserve to pivot toward rate cuts heading into 2023. However, concerns about higher rates and slower growth intensified as US inflation remained persistent at 8.3% in August. The Fed stayed firm in its commitment to control prices, delivering a third consecutive 75 basis point rate hike at the September FOMC meeting and explicitly stating a willingness to hike rates even if growth slowed. The 10-year US Treasury yield moved above 4% for the first time since 2010 in reaction to the news. Meanwhile, the 2s/10s curve was inverted by 45 basis points at the end of the quarter as the likelihood of a US recession increased.

Market volatility was particularly elevated in Europe as inflation continued to run at the highest level in decades in both the eurozone and the UK. Despite the European Central Bank raising rates by 75 basis points in September, flash estimates showed inflation at 10%. Higher prices were exacerbated by disruptions to Europe's energy supply as the Nord Stream pipeline was closed indefinitely, although the UK government attempted to contain costs by adding a cap for businesses and consumers. Further market turmoil ensued after the UK government announced its largest tax cuts in half a century, to be funded by increased borrowing. The resulting sell-off in Gilt yields (from ~3.5% the day before the announcement to ~4.5% at their peak) forced the Bank of England to launch an emergency bond-buying program to protect certain pension funds from a margin call-induced collapse.

Inflation remains elevated. There have been mixed signals over the path of inflation. Some of the earlier drivers of inflation (used car prices, freight costs) are showing signs of declining from their huge spikes. Housing costs, in the form of Owners Equivalent Rent, operates on a lag from changes in house prices and the S&P CoreLogic Case-Shiller posted a monthly decline in September.

Container freight rates[1]
US$ rate per 40ft box

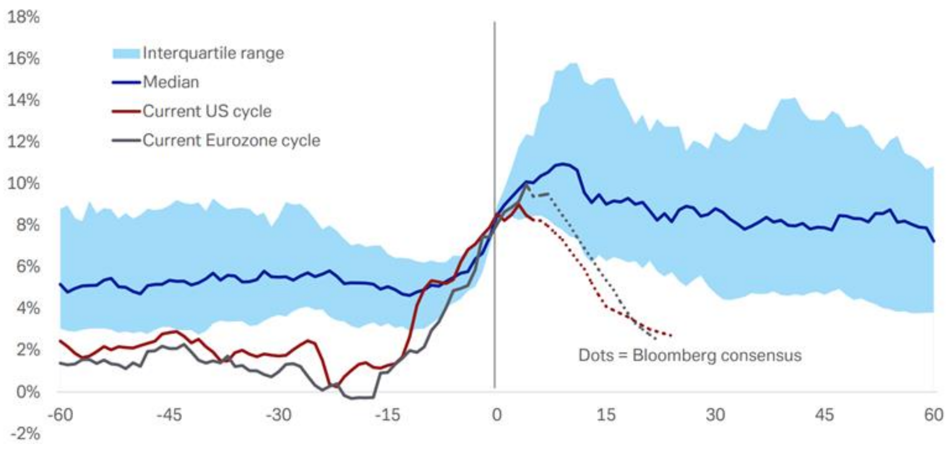


However, as inflation remains at high levels, inflation expectations rise and become more embedded. There are some signs of it becoming more widespread. The Cleveland Fed's narrower core inflation (trimmed median CPI) rose in September and the number of items within CPI rising more than the 3-month average also rose, though the latter has proven volatile. Inflation will fall, the question is whether the current expected path of interest rates is sufficient for it to fall to, or close to, the 2% target. Inflation expectations across time frames is that it will fall pretty much to this target. The expected terminal rate rose to over 5% in Q3, from less than 4% at end-June, with rates being cut during 2023. The real risk continues to be that interest rates act with a lag and so the risk of over tightening (causing a more severe economic downturn and potential inflation to fall below target) and easing too early, which happened in the 1970s, could lead to future waves of inflation, exceeding the target levels. The key point for us is that, because central banks have reacted so late and the lagged impact of their actions on the economy/inflation, the risk of a policy error is high.

[1] *Source: Diameter Capital Partners as of 30 Sep 2022.*

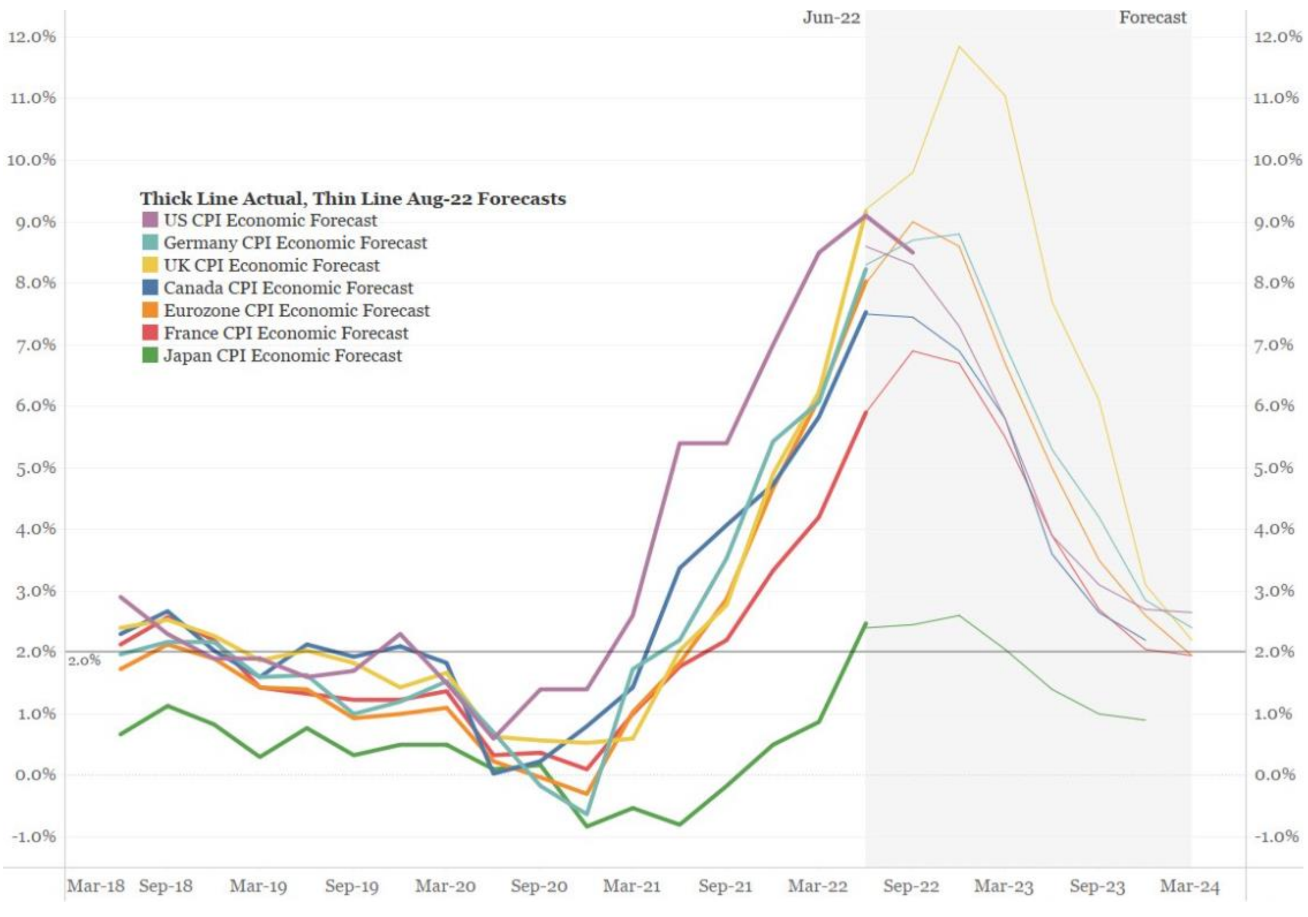
Historically, inflation does not come down as quickly as the market anticipates, though equally this cycle saw inflation rise much quicker than seen before.

What happens globally when inflation hits 8%[1]



The concern is that these estimates are not accurate. All the way through the current inflation spike, the estimates have been that it would trend to 2%.

All forecasts lead back to ~2%[2]



[1] *Data since 1970 (126 observations) with current US/EU consensus included. Source: GFD, Bloomberg Finance, Deutsche Bank.*
[2] *Source: Bloomberg, Bureau of Labour Statistics, www.biancoresearch.com*

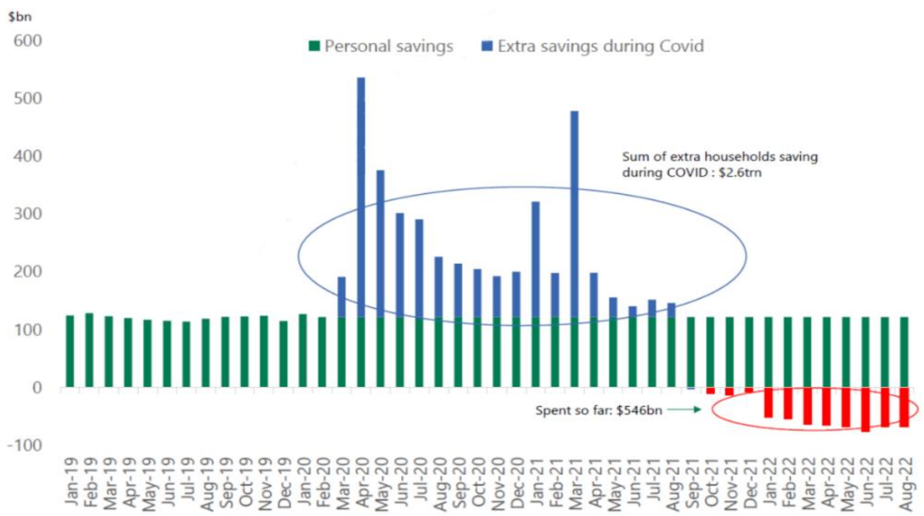
An economic recession seems the base case. As a reprint from prior letters, there has never been this combination of inflation and unemployment without it resulting in a recession.

Historical probability of a recession conditional on different levels of CPI inflation and unemployment[1]

	Avg quarterly inflation above:	Avg quarterly UR below:	Probability of recession over next 4-quarters	Probability of recession over next 8-quarters	Number of quarters	When did US economy most recently cross threshold?
Inflation only	3%	#N/A	27%	48%	95	Q2 2021
	4%	#N/A	37%	59%	51	Q2 2021
	5%	#N/A	45%	62%	29	Q3 2021
UR only	#N/A	6%	25%	47%	142	Q2 2021
	#N/A	5%	31%	57%	83	Q4 2021
	#N/A	4%	42%	69%	26	Q1 2022
Inflation and UR	3%	6%	43%	75%	53	Q2 2021
	3%	5%	54%	85%	26	Q4 2021
	3%	4%	54%	85%	13	Q1 2022
	4%	6%	59%	89%	27	Q2 2021
	4%	5%	73%	100%	11	Q4 2021
	4%	4%	57%	100%	7	Q1 2022
	5%	6%	83%	100%	12	Q3 2021
	5%	5%	100%	100%	5	Q4 2021
	5%	4%	100%	100%	3	Q1 2022

Economic activity levels have fallen, financial conditions have tightened, and business and consumer confidence levels have both declined. These all suggest that the economy will weaken and most likely enter a recession globally. The main case against a recession has been the strength of the consumer, especially following the increased savings accumulated during the Covid lockdowns and fiscal transfers received. As the cost of living rises, in aggregate the level of savings has fallen, but still much below the excess savings of the pandemic period.

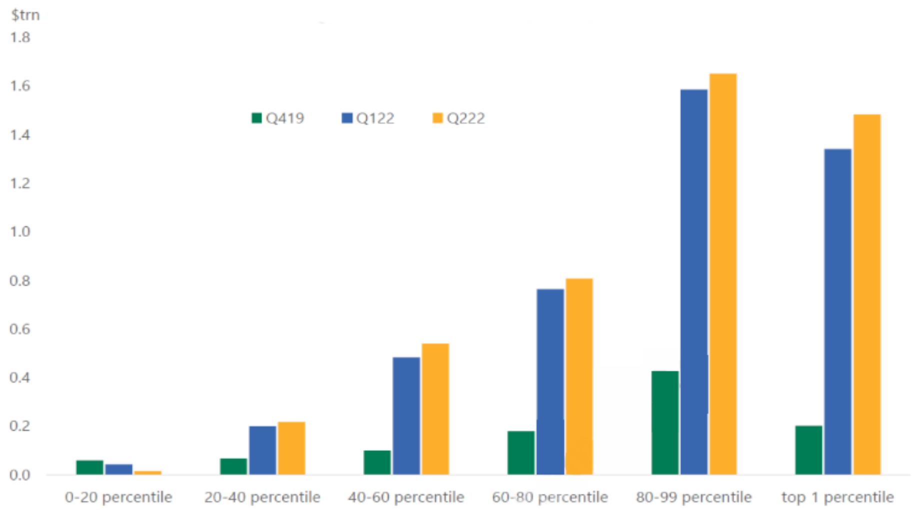
Consumer savings pre/post pandemic[2]



[1] *As of 31 Mar 2022 using data from 1955 – 2019. UR = unemployment rate. Sources: Bureau of Labour Statistics via FRED, authors' calculations.*
[2] *Source: Diameter Capital Partners as of 31 Aug 2022.*

However, the key for consumer spending is very much what happens to the lower income groups, as here the impact is much worse and disposable income is falling. This is also seen in the greater use of credit cards, etc., raising the prospect of an increase in consumer debt defaults and weaker spending.

Checkable deposits and currency[1]



Geopolitical risk remains elevated. War remains in Europe with the risk of escalation, in the worst case to include nuclear conflict. Domestic politics across the developed world remains more volatile, partisan and divided. An extreme example may be Liz Truss's short tenure as British PM (the shortest in history) but also signifies how divisive policies may be as countries seek to deal with inflation, inequality and declining living standards. Perhaps the biggest risk and change from the previous 2-3 decades is in China. Details and opinion remain opaque. The recent Communist Party conference seemed to confirm President Xi's hold on power and, importantly, the priorities for the Party seemed to move from pure economic growth. US actions against China has also been more forthright and aggressive, most clearly in limiting the export of technology to China. As Edward Luce noted in the Financial Times, "the new restrictions are not confined to the export of high-end US semiconductor chips. They extend to any advanced chips made with US equipment. This incorporates almost every non-Chinese high-end exporter, whether based in Taiwan, South Korea or the Netherlands. The ban also extends to 'US persons,' which includes green card holders as well as US citizens."

In a recent speech, US National Security Advisor Jake Sullivan stated that the sanctions on Russia following the invasion of Ukraine "demonstrated that technology export controls can be more than just a preventative tool… they can be a new strategic asset in the US and Allied toolkit." What is remarkable is that the US has not waited for China to invade Taiwan to implement this. Historian Niall Ferguson, who believes the US and China have been in Cold War II for a number of years, likens this to the oil sanctions actioned against Japan in 1941 and it is an especially hazardous move when more than 90% of the production of those chips takes place in Taiwan, an island that China claims as its own.

[1] *Source: Diameter Capital Partners as of 30 Jun 2022.*

Outlook

Central banks are late to combat inflation. This raises the risk of a policy mistake in either over tightening or easing too soon. In any event, we see the outlook for the economy and markets to be both uncertain and volatile. Geopolitical risk is high and probably the highest it has been since the end of the Cold War. We do not think the full consequences of this have yet been reflected. At the very least, the costs of business have risen, but significant disruption within those business operations is also much higher. Countries will likely retrench and globalisation decline.

As much as these concerns lead us to be cautious on taking significant market directionality, they also offer strong investment opportunities.

Strategy Allocations

All strategies bar equity-related strategies were positive in Q3, which is how they have been for the year. The strongest performance has been from discretionary macro, but it is also encouraging how other strategies have performed given the difficult and volatile environment. Within long/short, the performance has also been bifurcated between those with low net exposure and more directional managers. We continue to be cautious on markets overall and are making few changes. As yields rise and spreads widen, we see an increasing opportunity in credit strategies, initially long/short but also distressed debt as we move through the cycle.

We are very conscious of the increase in the risk-free rate and this, in turn, raising the return hurdle for our investments. Some strategies operate with high cash balances (notably macro and some relative value) where the return on the cash has risen. Others are more spread orientated, priced off the risk-free level, such as merger arbitrage, and these strategies have a natural rise in the expected return.

Discretionary and Systematic Global Macro

It was a strong quarter for our discretionary managers. Markets pricing in a more substantial path of rate hikes and the Fed, ECB and BoE (who all raised rates during Q3) presented strong trends, which our managers profited from. Managers with directional risk performed well, benefiting mainly from clear macro trends including a stronger USD, especially against EUR and GBP, rising yields in the US, Europe and UK, as well as declining US and European equity prices. These managers also generally gained from their long volatility bias, especially in rates and FX, as volatility spiked in these asset classes during the period. Less directional managers also benefitted from their spread positioning in rates after a more muted first half of the year, as an uneven pace of policy normalisation and economy reopening across Asia provided attractive cross market trading opportunities. There were no significant detractors in Q3. Positioning and risk levels were significantly reduced towards the end of the quarter after the strong directional year so far for assets. Many discretionary macro managers are now looking to transition to a more trading-oriented environment.

Equity Long/Short

Despite continued equity market weakness, Q3 was a decent quarter for the equity long/short managers in which Stenham invests. The lower net exposure managers generated gains while more directional managers were down only modestly.

Gains for the quarter were fairly broad based among the lower net exposure managers with no funds in this bucket suffering losses. The best performing manager in this group was a US utilities and infrastructure specialist, which returned 7% for the quarter. This manager benefitted from being correctly positioned for the passage of the Inflation Reduction Act, which seems to represent a meaningful step forward for the development of renewables in the United States.

Among the more directional hedge funds, our TMT focused managers continued to suffer losses with increased inflation and interest rates continuing to compress the multiples for growth equities.

Interestingly, however, Q3 marked a turn in fortunes for our more directional biotech and healthcare focused managers with the biotech sector picking up somewhat despite the broader weak environment for growth equities. The S&P Biotechnology +6.8% versus the Nasdaq Composite -4.1%. Positive fundamental developments with regard to both M&A and clinical trial data helped to lift the sector. Given that biotech started its sell-off in early 2021, well in advance of the broader market, and fell as much as 60%, it seems possible that the sector could now stabilise despite possible broader market weakness. We also continue to expect that M&A and innovation success should provide catalysts for idiosyncratic gains for the sector over time.

In terms of our positioning within the strategy, we have continued to reduce exposure to more directional managers in line with Stenham's broader view that this is a time to reduce risk and to focus on preserving capital. Equity markets have fallen and multiples have compressed but it is debatable whether earnings estimates sufficiently account for a likely weaker economic environment. It is also increasingly hard to underwrite the various geopolitical risks that exist in the world and hard to envisage how inflation can fall back down to 2% without a significant recession.

Our remaining equity long/short exposure is increasingly concentrated with low net specialist managers in areas such as utilities or healthcare where we have experienced that unusual levels of alpha are available, or with multi-manager platforms which provide alpha combined with tight risk management.

Event Driven

Our event driven allocation was positive in Q3. Our lower risk manager performed well as deals closed. Spreads had widened in Q2, but the deals the manager is invested in closed and the gains were realised. Our higher risk manager performed better. A number of larger positions, including Twitter and a Canadian miner, led to good performance and this manager has fared well for the year.

Merger activity has slowed with $0.9tn of deals announced in Q3, compared with $1.4tn in Q2 and $1.3tn in Q1. We expect deal volume to slow as private equity deals will become more difficult. Lenders are no longer willing to provide the same amount of leverage as previously and, indeed, the appetite of banks to provide any financing is reduced as they have been left with “hung” deals, notably Citrix and Twitter. Not only is available leverage less, but the cost of that leverage has risen as interest rates have increased, putting pressure on the equity value that private equity firms are likely prepared to pay. Counteracting this is the huge amount of dry powder there is for private equity firms to deploy. We expect strategic deals to continue.

Credit

The credit allocation was slightly mixed, but overall positive in the context of credit spreads widening significantly. Our European manager continued to perform well and adjusted net positioning to benefit as spreads widened, but then also as they tightened (within tight bands). Our US manager operates with a slightly long bias and saw small losses as credit traded off. As expected, our tail risk manager performed well as credit spreads widened.

We are becoming more enthusiastic about the opportunity set for credit. Spreads and yields have widened and now there are longs, which offer strong returns with a 1-2 year horizon. Overall, index level credit spreads are wide but have tended to go wider during a recession and, as such, we favour long/short funds which can identify opportunities on both the long and short side. Distressed will most likely become very attractive. It is difficult to not see corporate defaults and restructuring opportunities rise. Combined with the very high level of outstanding credit, we think this may be a very attractive investment opportunity in the coming quarters.

We continued to be active in private credit funds. This encompasses distressed debt, as well as niche areas of direct lending and specialty finance. As banks step back from providing credit, this provides the potential for very strong risk-adjusted returns.

Summary

We are pleased overall with performance in Q3 and for the year. This has been a very difficult period for traditional asset classes. Importantly, we continue to see strong opportunities across our strategies. The retrenchment of central banks means that volatility, which has been suppressed for the last decade, will be more elevated. Risk in core markets (equity, credit, government bonds) will once again become real and this is a benefit to our strategies.

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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