STENHAM
ASSET MANAGEMENT

Q4 2021 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q4	2021
MSCI World (USD)	7.5%	20.1%
MSCI EM (USD)	-1.7%	-4.6%
S&P 500	10.6%	26.9%
Eurostoxx 600 (USD)	5.5%	13.9%

Fixed Income	Q4	2021
FTSE Global Bonds	-1.1%	-7.0%
Investment Grade	0.3%	-1.5%
High Yield	0.7%	4.5%
Barclays Global Agg Bond	-0.7%	-4.7%

Currencies	Q4	2021
USD (DXY)	1.5%	6.4%
EUR (vs USD)	-1.6%	-6.9%
JPY (vs USD)	-3.1%	-10.2%
GBP (vs USD)	0.5%	-0.8%

Commodities	Q4	2021
Gold	3.9%	-3.6%
Oil (WTI)	0.2%	55.0%
Natural Gas	-36.4%	46.9%
Bloomberg Commodity	-1.6%	27.1%

Source: Bloomberg as of 31 Dec 2021

Equity markets had a strong finish to the year. The start of the quarter saw weaker markets, driven by the fear of a rise in interest rates to counter the continued high levels of inflation, coupled with renewed concerns of the economic impact of the new Omicron variant. These fears abated in late December as concerns over the new variant subsided as data showed it to be less harmful than prior variants. The yield on the US 10 Year fell by 30bps, driving a rally in risk assets broadly. Overall for Q4, and in keeping with the year as a whole, there was differentiation between markets and under the surface of headline indices. Fixed income showed a negative return as a result from the rise in interest rates. Broad commodities were marginally negative (Bloomberg Commodity -1.6%) with gold performing better.

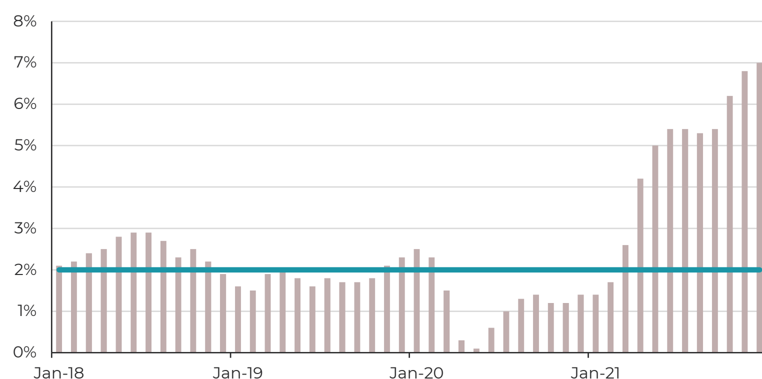
We saw continued disruption caused by Covid; infection and restrictions remained a constant theme with the emergence and growth of the Omicron variant, a more virulent but less harmful strain. Omicron spread across much of the world and led to, in many countries, renewed restrictions on movement and concerns over further disruption to supply chains. This impacted economic growth, but it is positive to see that the number of hospitalisations and deaths are much lower than feared. The hope is that much of the developed world at least (vaccination rates are still very patchy in less developed countries) will have strong levels of immunity and protection from Covid (both from vaccinations and also the very high number of people infected by Omicron) and activity can start to normalise.

2022 has begun with a strong and often violent sell-off in equity markets, centred around growth stocks. Following a rebound late in the month, the Nasdaq Composite returned -9.0%, S&P 500 -5.3% and MSCI World -5.3%. This has been caused by the belief that valuations are too high. Anchored as they have been to ultra-low, typically zero, interest rates, valuations of all equities, but in particular those with a higher P/E, the high growth but unprofitable stocks, have come under pressure. The ARK Innovation ETF, a proxy for these stocks,

has fallen 27% in 2022. This follows -14% in Q4 2021 and is now over 50% below its all-time high set in February 2021.

The big question surrounds inflation and the action central banks, in particular the US Federal Reserve, must take to bring inflation down to target. Inflation has been above 5% for 7 consecutive months in the US, well above the target of 2% and has been accelerating, reaching 7% in December. The initial stance of the Fed was to label inflation as transitory, that inflation was driven by short-term disruption largely attributable to Covid's effect on supply chains which would dissipate. That narrative was dropped in December, and the Fed has stated its intention to raise rates 4 times in 2022 (largely priced in by the bond market) and begin the wind down of asset purchases (quantitative easing) by March 2022 to start the process of reducing its $9tn balance sheet. The last time the Fed indicated such a tightening was late 2018 and then, faced with a drawdown in markets, pivoted and did not tighten. Then inflation was 2.2%. At 7%, the narrative is very different. The political environment is also very different. Whilst President Trump put pressure on the Fed to keep rates low, and frequently referenced the performance of US equity markets, the current administration is a lot more focused on inflation and the impact it has on living standards, especially for the poor.

US CPI[1]



The Fed switched its policy to average inflation targeting in August 2020, stating that it no longer believed in long and variable lags for monetary policy. In essence, they would wait to see inflation alongside full employment before acting. As recently as the start of 2021, the Fed indicated it would not increase interest rates until 2024. The question is whether the Fed is late to raise rates and does that mean it must act more than it would previously have had to in order to bring inflation down. The Fed's inflation target for end-2022 is 2.6% to 2.8%, though in his recent comments Powell stated he would probably add some to this, whilst reaffirming the overall target of 2%. To bring inflation down from 7% to 2.6% would be the largest fall in any one year since 1975. At that point, inflation was already declining. Today, inflation is increasing and interest rates are 0-0.25% and the Fed continues to increase its balance sheet. Some counts of inflation will most likely moderate during the year; certain supply chains may improve and energy may be less of a driver due to base effects. However, two key components are likely to be rising; housing and wages.

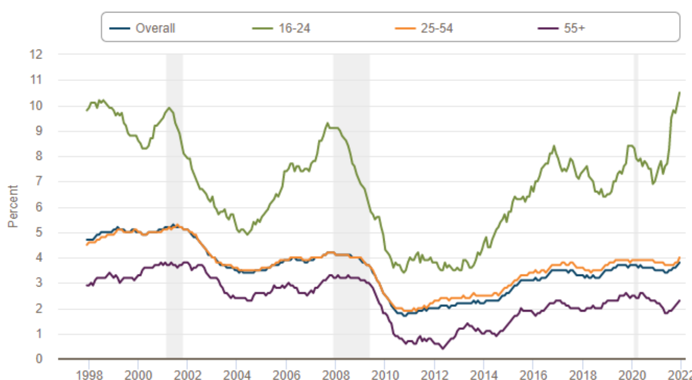
House prices across the US are up more than 20% over the past year, and that appreciation will eventually work its way into rent price growth. Shelter overall comprises more than a third of CPI; even as Covid- and supply-related inflation begins to be alleviated, higher rents can go a long way in supporting elevated levels

[1] *Sources: US Bureau of Labour Statistics*

of inflation. The technicals also appear supportive of housing costs; the number of people in the 25–34 cohort – the prime family formation age group – who are living with their parents has risen from 10% in 2003 to 18% today. As they begin to move out on their own and form households, that will increase demand for housing and likely put upward pressure on rents.

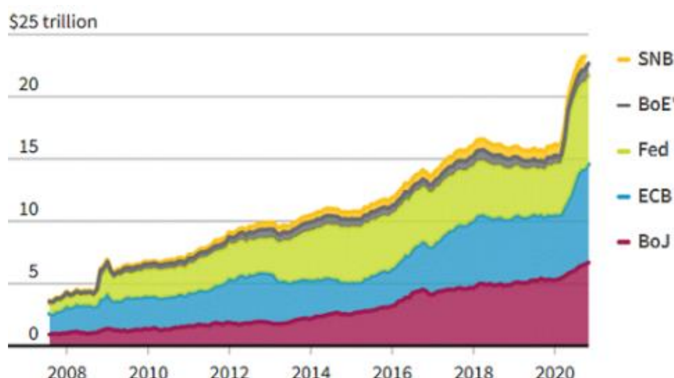
The job market is strong, supported by a lack of workers; the labour force participation rate in the US has fallen since Covid as workers have not returned. This could be for a variety of reasons; increased savings or investment gains may mean some people do not feel the need to return to work and some older people may have retired early. Whatever the reason, job openings are high and wages are rising. The longer this continues, the more imbedded inflation becomes.

Wage Growth Tracker by Age[1]
12-month moving averages of median wage growth, hourly data



Alongside pure monetary policy, central banks globally have helped enable monetary policy by the huge scale of their asset purchasing programmes. Asset purchases on this scale (over 50% of net issuance of the US government) have not been seen before and have certainly been an aid to markets, both in driving risk premia down as well as limiting volatility. The impact of reducing this balance sheet is highly uncertain with no historical precedence.

Central Bank Balance Sheets[2]
Assets for European Central Bank, Bank of Japan, Federal Reserve, Swiss National Bank, and Bank of England

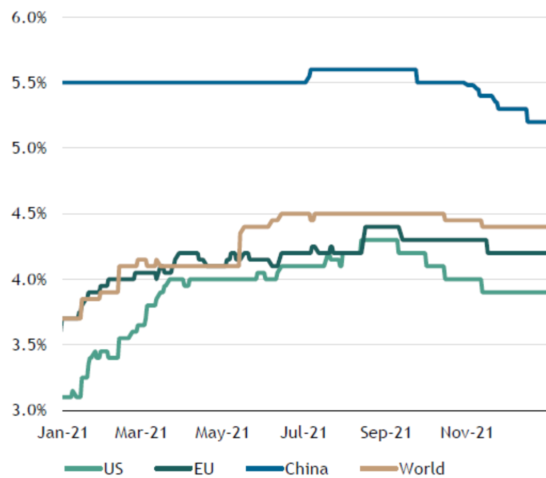


The US economy grew by 10.0% in nominal terms and 5.7% in real terms in 2021. Forecasts are for further strong growth in 2022, though growth expectations globally have moderated during the latter period of 2021.

[1] *Sources: Current Population Survey, Bureau of Labour Statistics*
[2] *Converted to USD at current rate*

The end of 2021 saw a slight weakening of data across a number of indicators; retail sales fell 1.1% MoM, industrial production, new order PMIs and certain measures of consumer confidence. Some of these can be ascribed to the disruption caused by the Omicron variant, but do reflect some cooling in economic growth.

2022 Real GDP Growth Estimates[1]
YoY change



Composite PMIs

	2020			2021											
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Global	53.3	53.1	52.7	52.3	53.2	54.8	56.7	58.5	56.6	55.8	52.5	53.3	54.5	54.8	54.3
Developed	52.7	52.2	52	52.4	53.9	55.9	58.2	61.1	59.3	57.5	54.1	53.8	55.2	55.8	54.8
Emerging	54.5	54.9	54.1	52.1	52	52.6	53.5	52.8	50.8	52	49.3	52.3	52.8	52.5	53.3
US	56.3	58.6	55.3	58.7	59.5	59.7	63.5	68.7	63.7	59.9	55.4	55	57.6	57.2	57
Japan	48	48.1	48.5	47.1	48.2	49.9	51	48.8	48.9	48.8	45.5	47.9	50.7	53.3	52.5
China	55.7	57.5	55.8	52.2	51.7	53.1	54.7	53.8	50.6	53.1	47.2	51.4	51.5	51.2	53
Eurozone	50	45.3	49.1	47.8	48.8	53.2	53.8	57.1	59.5	60.2	59	56.2	54.2	55.4	53.3

Source: Bloomberg as of 31 Dec 2021

Outlook

This is a changed environment. We are exiting a prolonged period of falling interest rates, accommodative monetary policy and declining and subdued inflation. The focus is on the pace of interest rate hikes and whether the Fed is behind the curve in tightening policy to bring inflation to target and, as a result, how aggressive they may need to be. Economic activity is strong, but there have been some signs of weakness. Increasing interest rates in such an environment could lead to significant economic weakness and, worst case, a recession.

Whilst the focus has clearly been on growth stocks in the early weeks of 2022 given the extreme price moves, it is worth bearing in mind that supposedly lower risk assets have also suffered. Global bonds are down over

[1] *Source: Blackstone*

1% and investment grade -3%, its worst start to the year ever. Many risk assets are at prices which could be brought into question as interest rates rise. Investment approaches which have worked over the last decade, predicated on low and declining interest rates, are unlikely to be the best approach during this period. Overarching, with such uncertainty over the path of inflation, increasing interest rates and the Fed reducing its balance sheet (which on this scale has never been done before), we believe this is a time to be cautious.

Strategy Allocations

In Q4 and for the year it was a mixed performance. Overall, the less directional managers, be they in event driven, relative value or equity long/short, generated decent performance; in line with the range of expectations but generally at the lower end of those expectations. This cohort of managers have continued to protect capital in 2022. The more directional strategies underperformed expectations. To a large extent this is due to the sectors they are focused on; one of our core areas of focus has been biotech where we see long-term growth opportunities coming from increased and rapid innovation. This sector returned -20.5% in 2021 and the S&P Biotech is in the middle of a significant drawdown. Whilst we maintain conviction on such positions, there is clearly much basis risk when comparing with long-only equity indices, which led to the underperformance of some portfolios.

Discretionary and Systematic Global Macro

It was a challenging quarter for macro and relative value strategies, particularly during October when managers suffered from volatility in interest rates markets. These losses were partially offset by gains in December. Quantitative equity strategies had a strong run with December a particularly good month for our managers and the broader peer group overall.

As mentioned, October was a challenging month for macro and relative value hedge funds as volatility in fixed income markets picked up during the last week of the month for a combination of fundamental and technical reasons. Hawkish comments from the BoE led to a sharp sell-off in UK front-end rates. Uncertainty around ECB policy action and lack of clarity from the ECB Chair led to European front-end rates to also start pricing in potential rate hikes. These fears spread to other interest rates markets, most notably Australia, where the RBA failed to defend the cap on the 3 Year bond as part of their yield curve control framework. While there was no one clear reason for these moves, it led to liquidations and stop-outs of positions across macro, relative value funds and larger platforms. The last week of October was particularly painful as liquidations led to irrational price behavior against a backdrop of poor market liquidity. One macro manager, a key detractor for the month and quarter, had long positions in the front-end of UK and European rate markets. Relative value managers also struggled with fixed income relative value trades underperforming in the same week. Stop-outs and liquidations led to a widening of relationships in cash futures basis and bond relative value strategies. Returns from our quantitative managers was mixed, two managers were positive, while one manager focused on liquidity provision strategies saw losses.

The volatility in October appeared to have created opportunities for most macro and relative value funds and we saw a strong recovery in performance initially in November, but then the news of the Omicron variant saw these losses evaporate toward the end of the month. However, many of these positions in rates markets recovered well in December, as the central banks led by the Fed reiterated their commitment to fight

inflation. Macro managers finished the year strongly and have also begun 2022 in a positive fashion. The main theme continues to remain a short bias to US fixed income, particularly in the belly of the curve. In order to minimise directional risks, some managers have added long positions in select markets in Asia, which they believe is a good counterweight to shorts in the US. Inflation remains another key theme. Managers ended the year running a short bias to expensive speculative stocks and long bias to commodities, and rates positions that would do well should real rates in the US normalise from the current negative levels. We expect, if market volatility persists, our macro managers will be able to provide diversification as has been evidenced thus far in January 2022.

For the year overall we saw positive performance from macro, relative value and quantitative strategies. Our top performers included a manager focused on trading macro and relative value strategies with an expertise in equity derivatives. This manager benefitted from positions around rotation and reflation. We also saw strong performance from two multi-strategy managers, one of whom recovered well from a difficult year in 2020. Our main detractor was a macro manager who saw significant losses in October from rates trading. This manager posted very strong performance in 2020 and while we knew the manager could show higher volatility than peers, we were surprised by the level of drawdown in October. We believe the manager is making changes and we have seen a positive recovery thus far.

The outlook for macro and relative value strategies looks promising heading into 2022. There are numerous cross currents globally, including persistently high inflation, unpredictable monetary policy, geopolitical risks and potential for new Covid variants. The pivot by the central banks towards fighting inflation could cause further volatility in bond markets. This is a key theme and exposure for our managers and we believe they are well positioned for any sell-off in global fixed income and a pick up in currency volatility. These strategies have good potential to add diversification to portfolios in what looks to be a more volatile environment.

Equity Long/Short

For most of our managers, Q4 performance was somewhat disappointing relative to broad indices. The quarter was characterised by a notable divergence in emerging market vs. developed market performance; with developed markets being led by a strong end to the year for US equities, while emerging market equities generally took the strain.

Markets faced two notable headwinds. Firstly, the Fed pivoted their view on inflation and the direction of interest rates, announcing that rate hikes might be necessary to curb inflation, which had proved stickier than initially expected. Secondly, the rapid spread of the Omicron variant slowed economic reopening. However, strong company profit growth supported by continued fiscal and monetary stimulus was enough to offset these headwinds for US markets.

One of the things that became apparent as 2021 drew to a close was how narrow US stock market performance had been throughout the year. Within the Nasdaq Composite, for example, just 20% of stocks outperformed the overall index between May and November. For the full year, just six mega cap stocks were responsible for 70% of the Nasdaq's return and 35% of the S&P 500's return.

Performance from our equity long/short managers was generally below expectations. This was driven mainly by disappointing performance from managers within our secular growth bucket who are generally positioned in parts of the market that underperformed in Q4. These include:

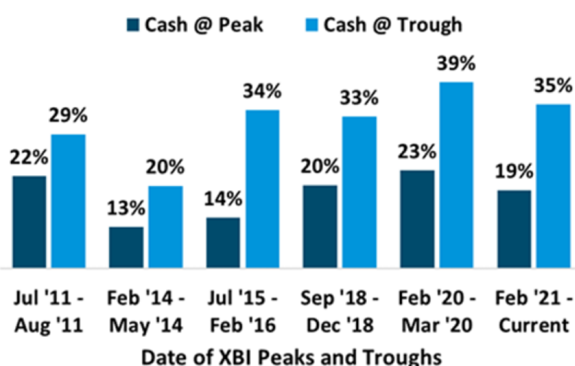
1) Biotech: the S&P Biotech was down over 10% for the quarter, with investors becoming concerned over a complete lack of M&A, as well as several disappointing drug trial data releases

2) Ex-mega cap tech: our tech focused funds are not heavily positioned in mega cap stocks, which as mentioned were very strong during Q4. They are typically allocated to either smaller cap long duration growth stocks, whose valuations came under pressure due to concerns over rising inflation or in tech businesses geared to reopening, which suffered with the onset of the Omicron variant

3) Asia: one of the other large allocations in our secular growth bucket is to Asia focused funds, where returns were hampered by concerns over continuing Chinese regulatory scrutiny of various sectors, as well as the zero Covid policy enacted by government

Biotech has generated very attractive returns over the last decade, but alongside significant volatility; the S&P Biotech (XBI) has experienced 6 bear markets in the last 11 years. We have experienced a very deep drawdown and valuations are now looking compelling. Cash represents 35% of market capitalisations of the index, a level similar to the prior troughs of performance.

Cash as % of Market Cap at XBI Peaks & Troughs[1]



In addition, other metrics indicate biotech is close to lows compared with historic valuations, and also compare favourably with metrics for other parts of the equity market.

Valuations: 12-month FWD PE[2]

	Now	Ave. 10 Yr	Ave. '95	Max	Min
S&P 500	20.6	16.6	16.6	24.5	10.4
US Healthcare	16.8	15.3	17.5	31.8	10.1
Relative	0.8	0.9	1.1	1.4	0.7
US Pharma	13.6	14.7	17.1	34.4	9.3
Relative	0.7	0.9	1.0	1.6	0.6
US Biotech	10.9	14.1	20.7	63.6	9.9
Relative	0.5	0.9	1.2	2.6	0.5
US Medtech	29.3	19.8	20.7	33.2	11.4
Relative	1.4	1.2	1.2	1.6	0.9

[1] *Source: Factset/Bloomberg – SVBLeerink as of 17 Jan 2022*
[2] *Source: Datastreat, Refinitiv, MSCI and Schroders*

The top contributor to performance was a low net utilities, infrastructure and telco manager that finished the year with a strong fourth quarter. The fund generated good alpha and benefitted from the performance of the US utilities sector, which was up over 12% in Q4.

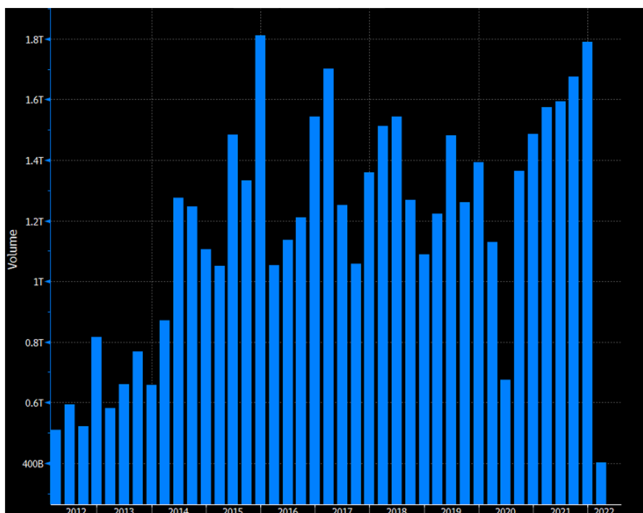
The largest detractors were our technology and biotech focused managers. Our exposure to China also detracted, although most China focused managers significantly outperformed their benchmark indices during Q4 and indeed through the entire year.

Headline indices largely masked the volatility in equities. It continued to be a tough environment to navigate. We remain of the view that we are allocated to managers who have unique skill sets that in the long term, will grow returns at an above average rate.

Event Driven

Our event driven allocation was positive during the quarter. Merger activity continues at a high pace; $1.8tn deals were announced in Q4, the highest quarterly figure since Q4 2015.

M&A activity[1]



The best performing manager was our higher risk manager, who benefited from some merger positions closing during the quarter. The manager enters 2022 with a relatively high amount of risk in the portfolio, reflective of the high level of merger activity during 2021. Our other managers saw more subdued, though overall positive performance. One manager continues to have a high proportion of the portfolio in SPACs. SPACs within the portfolio trade at a discount to Trust value and offer a positive return with optionality if a SPAC announces a deal which is well received by the market.

Credit

The credit allocation continued to generate good returns as it has all year. Returns were led by event driven type trades such as refinancings, with credit spreads remaining fairly flat. Our managers have reduced overall exposure in the expectation of volatility in the coming months and are very focused on identifying particular shorts in companies which are most exposed to the risk of higher inflation.

[1] *Source: Bloomberg*

We continue to be active in our allocation 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 difference in returns and yield available from private credit compared with publicly-traded credit is at wide levels and offers attractive yield in today's low interest rate environment.

Summary

We believe there is a high chance we are entering a more challenging investment environment, different from that which has prevailed for the last number of years. Inflation is high and interest rates look set to rise to counteract this. It is unclear how embedded inflation is, or could become, and how far interest rates will need to rise. The Fed, at least, is also looking to reduce the size of its balance sheet. At the very least, this is likely to create a far more challenging environment for traditional assets, both equities and bonds. We believe that in this environment, alternatives offer strong risk/rewards.

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 at www.stenhamassetmanagement.com

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