STENHAM ASSET MANAGEMENT

Q4 2022 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q4	2022
MSCI World (USD)	9.4%	-19.5%
MSCI EM (USD)	9.2%	-22.4%
S&P 500	7.1%	-19.4%
STOXX Europe 600 (USD)	19.9%	-25.2%

Fixed Income	Q4	2022
FTSE Global Bonds	3.8%	-18.3%
Investment Grade	4.2%	-17.9%
High Yield	4.3%	-10.7%
Bloomberg Global Agg Bond	4.6%	-16.3%

Currencies	Q4	2022
USD (DXY)	-7.7%	8.2%
EUR (vs USD)	9.4%	-5.9%
JPY (vs USD)	10.5%	-12.2%
GBP (vs USD)	8.7%	-10.6%

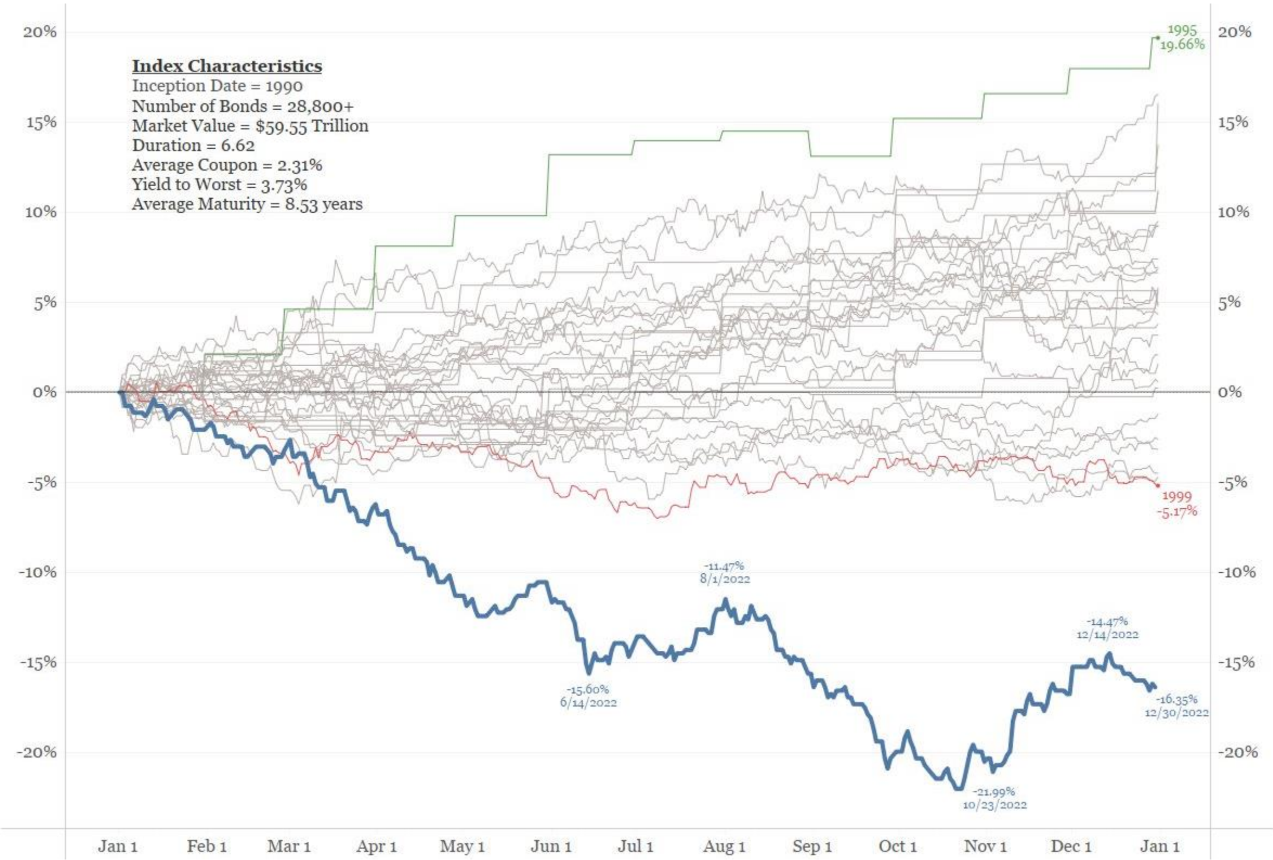
Commodities	Q4	2022
Gold	9.6%	-0.2%
Oil (WTI)	1.0%	6.7%
Natural Gas	-33.9%	20.0%
Bloomberg Commodity	1.2%	13.8%

Source: Bloomberg as of 31 Dec 2022

Q4 was a strong finish to a historically terrible year for most asset classes. The MSCI World returned 9.4%, recouping around a quarter of the year's losses. Emerging markets also performed well, driven by the sudden about-turn by China from its zero-Covid policy. Europe outperformed, both in equity and credit, as fears of a significant gas shortage subsided, with performance in USD also helped by the strong rally in EUR, another reversal from the trends seen earlier in the year. The yield on the US 10-year Treasury rose moderately, though ended the year well below its 4.2% October peak (a 15-year high) at 3.9%. In a year where surprises were plentiful, the Bank of Japan made the unexpected announcement that it was raising the effective cap on 10-year Japanese yields by 25 bps to 0.5%.

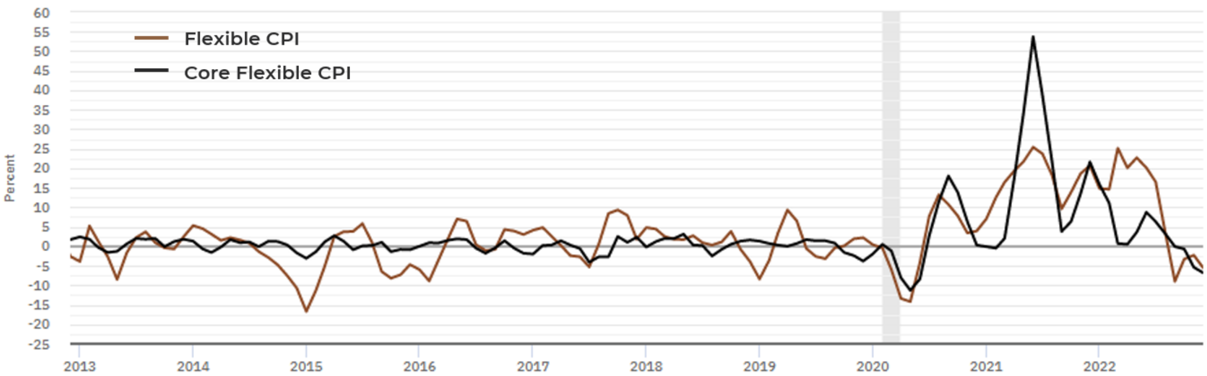
2022 was an awful year overall for most asset classes and investors. Fixed income securities had their worst year ever, with the Bloomberg Global Aggregate Bond falling 16.3%. The model 60/40 portfolio had its second worst year on record since 1988. Investment grade and high yield bonds suffered losses of over 17% and 10% respectively. Equities fared worse; the Nasdaq Composite fell 25.1% and the S&P 500 down 19.4%. Areas such as cryptocurrency, unprofitable technology and SPACs ended the year in tatters.

YTD Total Return for Bloomberg Global Aggregate Bond Index[1]



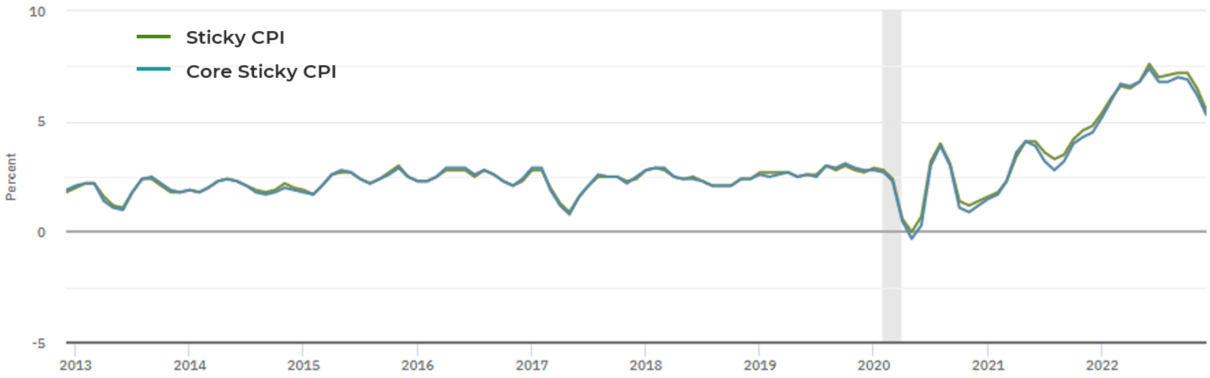
The fourth quarter saw markets rally on the back of more benign inflation data. US CPI declined each month during the period, offering the prospect that, while high, inflation is in retreat. The Federal Reserve Bank of Atlanta splits inflation into "flexible" and "inflexible" items. Flexible prices are now declining on a 3-month basis. Inflexible remain higher, though around a third of this comprises housing costs where there seems to be evidence of prices having peaked.

Flexible CPI[2]
3-month annualised



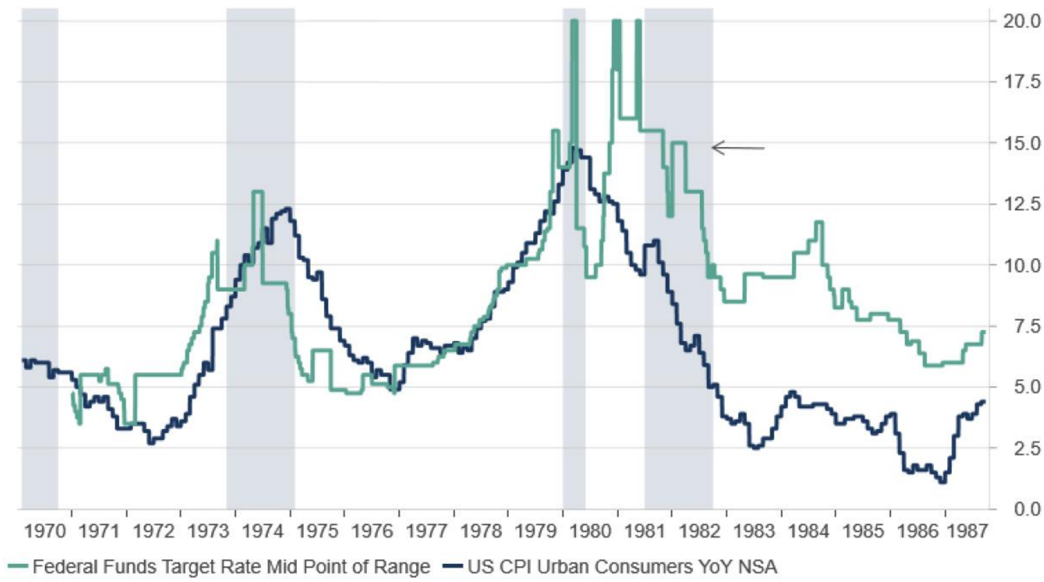
[1] Source: Bianco Research (www.biancoresearch.com), Bloomberg.
[2] As of 31 Dec 2022. Grey bar indicates a period of recession. Source: Federal Reserve Bank of Atlanta.

Sticky CPI[1]
3-month annualised



It would be wrong to extrapolate three months of data with too much confidence. In the 1970s and early 1980s, inflation came in rolling periods as central banks sought to ease at signs of any let up in inflation – until Paul Volker forced a longer period of positive real rates, along with an ensuing recession.

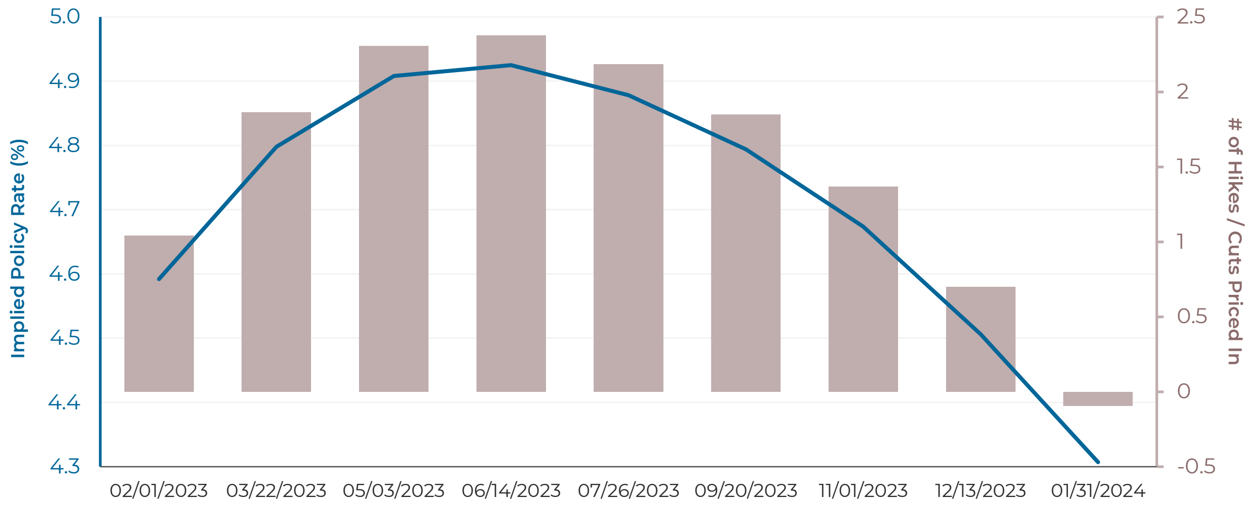
CPI vs Fed Funds (1970s – 80s)[2]



Indeed, the market is assuming that the US Federal Reserve is overly hawkish in its comments. The current market expected interest rates are materially lower than that guided by the Federal Open Market Committee (FOMC) through its “dot plots”, which are published at every Fed meeting. The market is expecting the Fed to begin cutting rates in H2 2023, with rates ending the year at 4.4%, compared with the FOMC target of 5.125%. For end-2024, the market is expecting 2.9% compared to the FOMC at 4.125%.

[1] *As of 31 Dec 2022. Grey bar indicates a period of recession. Source: Federal Reserve Bank of Atlanta.*
[2] *Source: Macrobond.*

Implied Overnight Rate & Number of Hikes/Cuts[1]

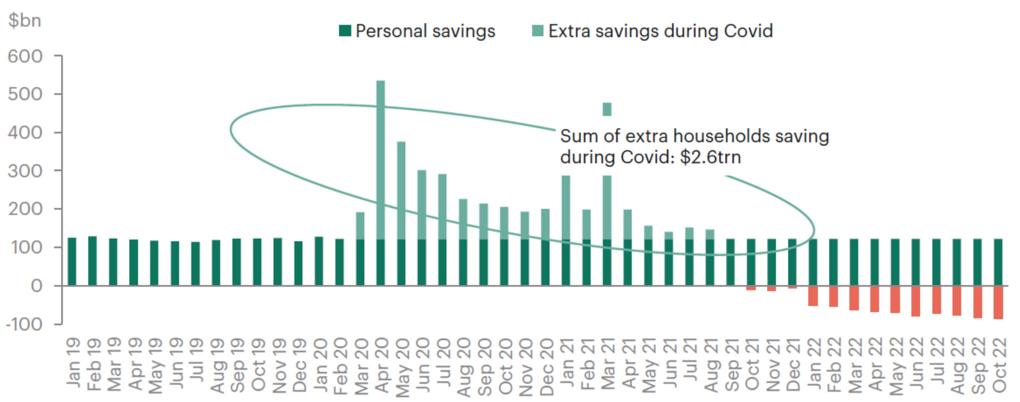


However, if the last 3 months do turn into a trend, the soft landing targeted by the US Fed will likely be a reality. We would have a year of high but declining inflation, low unemployment, high wage growth and strong consumer finances, which themselves would feed through to robust corporate earnings.

Economic data has remained more robust than many had expected. US GDP growth in Q4 came in at 2.9%. Europe has fared worse, being more sensitive to increases in energy prices, though the worst case scenario has been avoided and the region will likely benefit from the opening up of China. Trends in labour markets have been a big focus and for the most part remained strong. Outside of some high profile lay-offs within technology, job growth and openings have remained strong, unemployment has come down during the year (3.9% to 3.5% in the US) and wage growth in the 4-5% range.

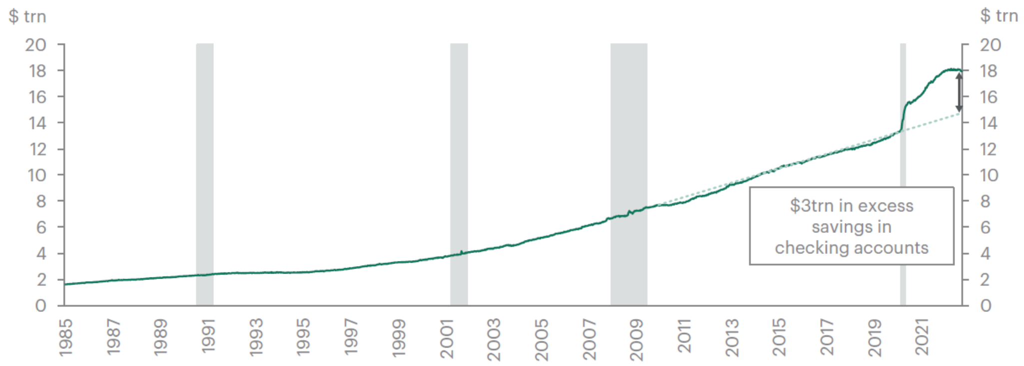
Similarly with the labour market, the US consumer has proven resilient. While consumer confidence has fallen, overall condition of the consumer remains strong, driven by the excess savings accumulated during Covid. While these balances have fallen, and the bottom 20% have seen them fall, there has been no wider signs of stress.

US Personal Savings[2]



[1] *Source: Bloomberg as of 30 Jan 2023.*
[2] *Data as of 31 Oct 2022. Source: Bloomberg, Apollo Global Management.*

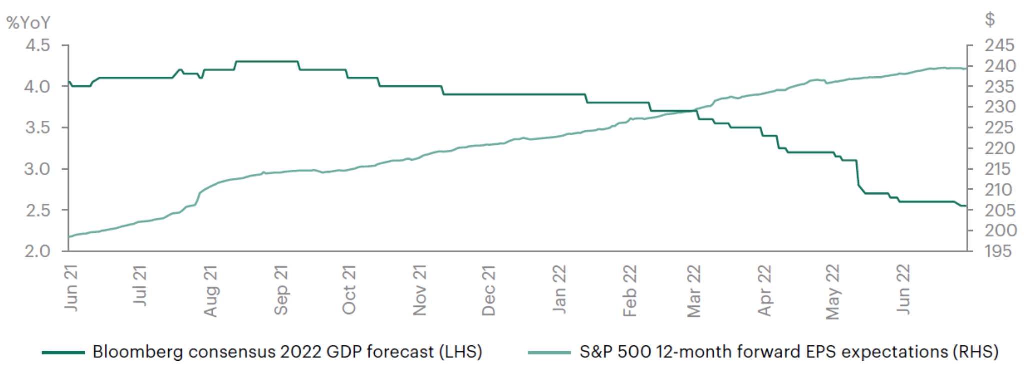
US Deposits – All Commercial Banks[1]



The investment world is full of nuance, and valid arguments can be made to form diametric views. This is always the case to some extent, but seems very pronounced today. Weak economic data is seen as good insofar as it eases inflationary pressures and so eases or reverses interest rate increases, unless it is so weak, it really brings into question economic growth. Chronic underinvestment in fossil fuels could lead to an oil supercycle, unless there is a resolution to the Ukraine war or the world economies really do enter a severe recession. China's abandonment of "zero-Covid" will act as a fill-up to global economic growth and mitigate the risk of a recession, unless it itself drives inflation higher and so further monetary tightening. With these strong arguments on both sides also comes with them how binary the outcomes are. If inflation remains elevated, it will be difficult for the demand side of the economy to sustain and easy for central banks to continue to tighten policy. If inflation eases, consumers will feel price relief and there will be less pressure for monetary policies which would trigger a recession. To be sure, there are middle grounds, but they all ultimately take one path or the other.

It seems economic recession is the base case for many. 70% of Wall Street economists are calling for a recession. Bloomberg Economics' recession model shows a 100% probability of recession within the next 12 months. The inverted US yield curve indicates similarly. The US high yield market is less sure, with spreads less than 450 bps, inside its 10-year average level. According to JP Morgan, less than a 20% chance of recession is priced into this market. Equally, the concerns for equity markets are less multiple related but more earnings, with positive earnings growth expected for 2023. Indeed, there does seem to be a disconnect between earnings growth estimates and GDP estimates.

S&P 500 earnings and GDP growth expectations[2]



[1] *Data as of 2 Nov 2022. Source: Federal Reserve Board (FRB), Haver Analytics, Apollo Global Management.*
[2] *Data as of 11 Nov 2022. Source: Bloomberg, Apollo Global Management.*

We are minded to believe that inflation will prove more difficult to bring down to 2% target levels and that interest rates may need to remain higher for longer than is currently priced in, not least with wages rising at 4-5% in a strong labour market. However, it is difficult to know which argument will prove correct and we think the best way to navigate this is with a flexible investment approach across different asset classes, especially in sectors and strategies where the opportunity set, and expected returns, have risen.

Strategy Allocations

2022 was a decent year for our portfolios. All strategies bar equity-related strategies were positive for the year, and indeed within equity strategies we saw good performance in lower net, less directional funds.

Key is that the return expectations for our strategies has risen. The increase in the risk-free rate leads to a natural increase in returns for many of these strategies, in particular certain relative value strategies, which operate with high cash balances. From earning 0% at the start of 2022, these cash balances now earn in the region of 4%. Many strategies also invest in spreads, be it relative value spreads or merger arbitrage spreads. These are short duration in nature (the event which should cause the spread to close) often occurring within 3 to 6 months, and priced off the risk-free rate. The expected return has increased commensurately; what used to be expected to return mid- to high-single digits is now high-single to low-double digits. These are less directional strategies and, in aggregate, were positive for us in 2022.

This is in addition to a positive outlook for the fundamentals of our investment strategies. Our best performing strategy in 2022 was macro with funds able to profit from the volatility in markets, be it commodity, FX, fixed income or equity. Regardless of the ultimate direction, we feel that there will continue to be volatility as the debate around inflation and the direction of monetary policy continues. This volatility will also likely lead to dislocations within similar securities, which relative value strategies should be able to profit from. We see increasing opportunities in long/short credit; it is a fair assumption that rates will be higher in the coming 12 to 18 months than they have been in the last 10 years. This will add to interest costs for companies and, at a time of high leverage across corporates, will lead to differentiation in performance of credits with certain companies needing to address their capital structure. A similar dynamic leads to opportunities within equity long/short. While it may be less likely that the very large leveraged buyout (LBO) transactions occur in the near term, private equity firms hold high levels of cash which they will likely look to deploy. Should markets stabilise, M&A activity may well increase, both from private equity as well as industry buyers.

Discretionary and Systematic Macro

Macro and relative value strategies were profitable despite a more challenging trading environment. After clearer trends in the first half of 2022, Q4 saw increasing uncertainty around important macro variables, including questions on whether inflation was peaking, economic growth was slowing and how monetary policy would respond as a result. October was a positive month and November was slightly negative, but gains were primarily generated in December on the back of the hawkish central bank meetings and the surprise decision by the Bank of Japan to modify its Yield Curve Control (YCC) policy. Discretionary macro, which remains our largest allocation, led attribution during the quarter, but relative value, quantitative and commodity strategies were all profitable.

Our top gainers among the classic macro managers benefitted from the move higher in bond yields in December and the move higher in commodity markets as well. We also saw strong performance from an Asia-focused macro manager who gained from spread positions with longs in Asian rates versus shorts in US and Japanese rates. A macro manager focused on trading European fixed income also had a good quarter with gains coming mainly in December, as they were well positioned for the European Central Bank meeting.

Relative value strategies grinded out positive returns during the quarter. Fixed income relative value trading was profitable as managers benefitted from higher volatility and dispersion across yield curves. Equity quant strategies also had a good finish to the year, particularly around the upcoming February MSCI Index rebalance.

Commodity strategies were positive with gains from discretionary managers offsetting losses from systematic funds. Performance was led by a European gas specialist, who benefitted from the sharp drop in European gas prices, and a metals-focused manager. Our main detractor was a systematic manager who struggled with the trend reversals during the quarter.

After a strong year, we remain optimistic on the outlook for macro and related trading strategies as we enter 2023. We believe the opportunity set continues to look compelling, especially with greater uncertainty both on the macroeconomic front and central bank policy making.

Equity Long/Short

Q4 was another decent period for our equity long/short managers, following on from the previous quarter where we saw stabilisation and improvement in strategy returns.

Looking at performance overall for 2022, this was a year of two halves; the first half very challenging followed by a second half of stabilisation and improvement.

The main difficulty for most fundamental equity long/short managers in H1 2022 was that equity markets were dominated by macro uncertainties, particularly around the outlook for inflation and interest rates. This manifested itself in falling indices, increased volatility and increased correlation, which presented a challenge for both directional and low net exposure long/short managers. In H2 2022, the dominance of macro considerations started to wane somewhat, most particularly with US inflation data trending downwards and indicating that a peak in inflation had been reached.

For the full year of 2022, there was a clear distinction between the performance of our low net exposure managers relative to the more long-biased managers. Our low net exposure equity long/short managers finished the year with marginally positive returns in aggregate, while our more long-biased managers were down and with some negative alpha relative to indices.

We were relatively pleased with the full year performance from our low net equity long/short managers, given that the market environment was quite challenging. Our best performing low net investments were in utilities specialist managers, which benefitted from being correctly positioned for the volatility surrounding European power prices, as well as the passing of the Inflation Reduction Act (IRA) in the US, which provides huge stimulus for a transition to clean energy.

We continue to think that the energy transition will present huge opportunities over time and that the significance of events, such as the IRA, might still be underestimated.

Analysis of the negative alpha for the year generated by our more directional equity long/short managers clearly indicates that underperformance was a function of overweight exposure to growth. Growth equities underperformed value equities due to higher levels of multiple contraction caused by the impact of increased discount rates being applied to long duration cash flow forecasts.

It has become increasingly clear to us that a regime change has occurred with some key factors that drove prior cycle returns (globalisation, declining inflation and interest rates) now moving in reverse. In light of this regime change, we are not doubling down on growth equities given lower multiples. Our view is more that the areas of the market which performed the best in the prior cycle are unlikely to be the top performers in the current cycle. We are, therefore, looking to balance our exposures more across sectors, geographies and styles. For the moment this involves adding some additional exposure to managers who invest more in cyclicals and value.

Event Driven

Our event driven allocation was positive in Q4 and generated good returns for the year. A number of deals closed and events crystalised, which drove returns, including Twitter and a Canadian miner. Merger activity continued to slow with $0.9tn deals announced, a similar level to Q3 but lower than $1.4tn in Q2 and $1.3tn in Q1. For the full year, 2022 saw $4.5tn of deals announced compared with $6.6tn in 2021. We expect that deal activity will remain a challenge with financing more difficult to obtain. However, private equity funds continue to have high amounts of capital raised which they will look to deploy and if there can be more certainty over pricing of companies, deal volume may remain robust. What is encouraging for the strategy is that merger arbitrage spreads are priced off the risk-free rate; as this has risen the expected return for the strategy has also.

Credit

The credit allocation was positive in Q4 and 2022 as a whole; 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 tighter than the 10-year average and 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 are seeing an increased opportunity set and we believe the need for companies to address and restructure their capital structures will increase. Maturities within high yield do not really increase until 2025/6, but companies will look to address these ahead of time, typically 12-18 months. Combined with the very high level of debt outstanding, we are optimistic on the opportunity set rising considerably during 2023.

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 very optimistic on the return potential of our portfolios. We are pleased that non-directional strategies were positive in 2022. Our expected return on those strategies is now higher, not least due to the increase in the risk-free rate. The ability to target these returns without needing to take meaningful beta to broad equity, credit or fixed income markets is, in our opinion, very attractive.

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

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