STENHAM ASSET MANAGEMENT

Quarter 1 2019 Report

By Kevin Arenson and Tim Beck

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Market Data for Q1 2019

Equities	Q1 2019	YTD 2018
MSCI World (USD)	11.88%	-10.44%
MSCI EM (USD)	9.56%	-16.63%
S&P 500	13.07%	-6.24%
Eurostoxx 600	10.01%	-17.35%

Fixed Income	Q1 2019	YTD 2018
FTSE Global Bonds	1.74%	-0.84%
Investment Grade	6.22%	-3.67%
High Yield	7.50%	-1.48%
Barclays Global Agg	2.20%	-1.20%

Currencies	Q1 2019	YTD 2018
USD (DXY)	1.16%	4.40%
EUR (vs USD)	-2.02%	-4.74%
JPY (vs USD)	-1.00%	2.67%
GBP (vs USD)	1.94%	-5.75%

Commodities	Q1 2019	YTD 2018
Gold	0.63%	-1.94%
Oil ('WTI')	32.44%	-24.84%
Natural Gas	-9.46%	-0.44%
Bloomberg Commodity Index	5.70%	-12.99%

Source: Bloomberg, Stenham

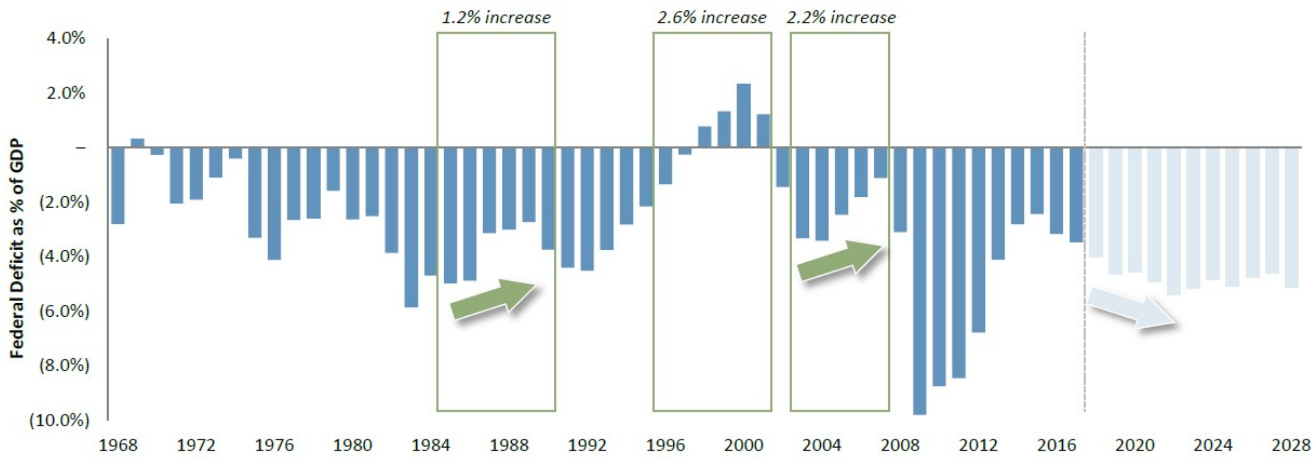
The new year saw a new wave of optimism with risk assets, both equities and credit, rallying strongly across the globe. The worst quarter since 2011 (Q4 2018) has been followed by the best quarter since 2010. Fears over an escalation in the trade war between the US and China, interest rates rising to an extent which would impact growth and broader concerns over a slowdown in global growth, especially in China, all abated and assets performed very strongly. Equities were up across the board. US equities outperformed, having also fallen less than other developed markets and emerging markets in 2018. Credit spreads tightened significantly, whilst the USD showed moderate strengthening, in particular against EUR. Within commodities, oil in particular performed well, with WTI rising more than 30%.

Strong performance came despite slowing economic growth and political turmoil in the UK, US and almost every region. Markets were driven by interest rate and monetary policy (and their impact on liquidity and availability of finance). Expectations over the path of interest rates have altered dramatically. The US Fed completely changed its outlook and the market has responded accordingly. With the weakness in Q4 2018, the Fed announced that from rates being “a long way” from neutral (as Fed Chair Powell stated in October), further rises were now on hold and it was taking a patient approach. This has been supported by numerous statements from Fed officials during Q1 and then from the March FOMC minutes when interest rate expectations from the “dot plots” showed no rate rises for 2019 and the ongoing balance sheet reduction programme would now be complete by end September. Markets are pricing in more than that, with a rate cut now more likely than a hike during 2019. Effectively, both the Fed and markets are pricing in no more rate hikes during this economic cycle.

The key questions are whether this assumption of no rate hikes is correct and what does this mean for policy in the next economic downturn. The assumption of no further rate increases has validity. The US Fed has clearly stated it has turned dovish and there is commentary from key Fed officials that they may change the way they look at inflation. Rather than 2% inflation being the absolute target, there is an indication that it should be seen as an average level. So, after many years of sub-2% inflation, the Fed could tolerate above 2% inflation for a period of time. The risk is that inflation rises to such a level that interest rates rise much quicker and further than expected. Current economic data, with limited inflation and slow but positive growth, is not showing any indication of this, though the significant rise in oil prices could push up inflation (as well as impact consumer spending).

In the next downturn, the usual tools for aiding a weakening economy will not be available. The scope for monetary easing is less. With rates unlikely to increase from current levels, the Fed will enter with interest rates at 2.25% compared with 5.5% in 2007. The Fed’s pivot also makes it much more difficult for the ECB and BoJ to normalise policy with the risk that doing so would lead to appreciation of their currencies, impacting already weak economies. As a result, the ECB could well have negative rates when a recession hits. This significantly limits the impact of traditional monetary easing to counteract any economic weakness. Admittedly, new policies may be adopted. Quantitative Easing was not really envisaged prior to the financial crisis, nor was its impact. But the reliance on a new policy being effective clearly has significant risk.

Fiscal policy will likely be constrained in the US by the already huge budget deficit. Usually, during economic growth, government deficits are reduced even if they do not become surpluses. The opposite is true this cycle following the Trump tax cuts and we are seeing expansion at a time of economic growth. Constraints on fiscal policy may countered by Modern Monetary Theory, the concept of which is that governments can run high deficits as long as they print their own currency and have investors to buy their bonds (including central banks?). Whatever the flaws may be with that argument, it is appealing to politicians, and policy will be adapted to try to offset/postpone any recession, with longer-term consequences as a result of the higher level of debt.



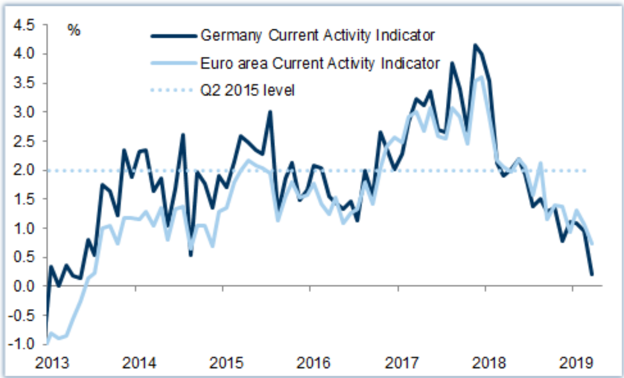
Source: The Budget and Economic Outlook: 2018 to 2028. Congressional Budget Office. April 2018.

Economic data varied over the quarter. In the US it was reasonable and ahead of what some were forecasting. There was a disappointing February payrolls number (33k jobs added), but March came back slightly more strongly with 200k new jobs. Importantly for monetary policy, inflation has been weaker than expected, wage growth has declined very marginally and core PCE (the Fed's favoured measure) fell to 1.6%.

Global growth is driven by China and the slowing of the Chinese economy, along with pressure on European growth, was a major concern in Q4 2018. China has reacted to this by adding significant stimulus. Part of the slowdown was driven by the authorities' desire to reduce credit growth and address potential bubble conditions, particularly in non-bank financing. The stimulus has been through fiscal expansion as well as encouraging credit growth, through the more traditional banking sector. There are signs of stabilisation in Chinese data, but not great acceleration. Q1 GDP came in at 6.4% (6.3% expected), overall credit growth has shown tentative indications of accelerating whilst both industrial production and retail sales for March have recovered and also beat expectations. There will be scepticism over the GDP figure at least and other metrics in Asia are not so strong. Japanese, Singapore and South Korea exports to China were all down by almost 10% in March. The bellwether PMIs of Korea and Taiwan continue to fall and are sub-50, indicating contraction. However, concerns over overall Chinese growth have abated.

The current Chinese stimulus package is much less than that employed in 2009 and 2016, when fears over economic growth rose as the Chinese authorities were, rightly, concerned about credit excesses within the economy and the misallocation of resources. The overall reform program is still intact with the emphasis on non-economic measures. The Chinese authorities have a delicate balance to achieve in order to maintain economic stability, in recent history the source of legitimacy of the ruling Communist Party, whilst also maintaining its reform agenda.

European economic data has not been strong. Industrial production is down 2.5% since its peak in December 2017. PMIs have continued to decline, especially in Germany where the manufacturing PMI fell to a very low 44.1 in March. German growth appears close to stalling. As growth slows, this again brings into question debt sustainability of the periphery. With monetary policy seeing limited further scope given the scale of the current QE program, the focus is on fiscal expansion which would bring into question the increase in the debt load. Europe has certainly suffered from slowing global and in particular EM growth. Exports represent around half of GDP, which could benefit from Chinese stimulus. However, there have been domestic factors at play. Within Italy, the deficit dispute and anti-EU/EURO rhetoric from the coalition government have pushed up credit costs and the country has fallen into recession. France has suffered from the "gilet jaunes" protests.



Source: Goldman Sachs Global Investment Research

Manufacturing PMIs

	2017 Jul	Aug	Sep	Oct	Nov	Dec	2018 Jan	Feb	Mar	Apr	May	June	July	August	Sept	Oct	Nov	Dec	2019 Jan	Feb	Mar
US	53.3	52.8	53.1	54.6	53.9	55.1	55.5	55.3	55.6	56.5	56.4	55.4	55.3	54.7	55.6	55.7	55.3	53.8	54.9	53	52.4
China	51.1	51.6	51	51	50.8	51.5	51.5	51.6	51	51.1	51.1	51	50.8	50.6	50	50.1	50.2	49.7	48.3	49.9	50.8
UK	55.5	57	55.5	56.6	58.2	55.7	55.2	55.3	54.8	53.8	54.3	54	53.9	52.9	53.7	51.1	53.3	54.3	52.8	52.1	55.1
Eurozone	56.6	57.4	58.1	58.5	60.1	60.6	59.6	58.6	56.6	56.2	55.5	54.9	55.1	54.6	53.2	52	51.8	51.4	50.5	49.3	47.5
Germany	58.1	59.3	60.6	60.6	62.5	63.3	61.1	60.6	58.2	58.1	56.9	55.9	56.9	55.9	53.7	52.2	51.8	51.5	49.7	47.6	44.1

Source: Stenham, Bloomberg

Political risks remain elevated. The US presidential election will occur in 2020 and the process of deciding the Democratic Party challenger to President Trump has begun with a huge number of candidates, including those with far left views, leading to the potential of a polarised Presidential race. The lack of criminal findings within the Mueller report increases Donald Trump's chances of a second term, with the state of the economy crucial. European Parliamentary elections are in May with the opportunity for anti-establishment parties to perform well, putting further pressure on existing structures.

Brexit dominated headlines particularly in the UK but also in Europe as the deadline for the UK exiting the EU of 29th March approached. The failure of the UK parliament to support PM Theresa May's exit deal or to produce an alternative which would command a parliamentary majority had led to confusion and uncertainty. The UK's exit from the EU has since been delayed until October 2019. There is seemingly a drift towards a soft Brexit. PM May bringing the opposition party Labour into negotiations shows her wish to achieve a deal by October, though progress in those talks seems low. Equally, on the continent there is the growing appeal of a soft Brexit to support a weak economy. But on both sides there are hard Brexiteers present and vocal and there is no certainty over the path this will take.

Outlook

We have previously said that one of our major concerns globally is the level of debt, at both the corporate and sovereign level. This remains the case. The question is when does this become an issue? The most obvious time is when the cost of servicing that debt becomes greater than the return generated. For corporates this would lead to debt service capacity declining through falling interest rate coverage and for sovereigns an increase in debt:GDP ratios. In Q4 as rates were rising and the US Fed looked set to continue that path, we felt we may be approaching the stage where credit became less sustainable. With the Fed now firmly on hold (followed by every other central bank) that has been pushed out and the economic cycle extended. There is some scope for deleveraging during this process, certainly if inflation does come back and interest rates remain low, effectively resulting in a negative real rate. At the same time, at the sovereign level there is no appetite for deleveraging and the narrative is for fiscal expansion. For corporates, debt is high, lending standards are loosening and multiple business models are being challenged. We maintain our concern that this will be an issue though the timing is unclear.

With decent US macro data, the Fed on hold and incremental Chinese stimulus, the chance of a recession during 2019 has fallen. There is no clear sign of a strong rebound in economic growth, but deterioration has stopped. Chinese PMIs have picked up and with credit and fiscal stimulus likely to find more traction, global growth may see a moderate recovery in the coming quarters. However, this more expansionary monetary (and fiscal) policy may have a consequence of less policy response in the next downturn. We are late cycle. As a result, we take risk but are unwilling to significant additional beta risk. We are looking for balance within portfolios where we can capture opportunities but also providing significant protection to capital in the event of a large sell-off.

Strategy Allocations

There were no major changes to strategy allocations during Q1.

Discretionary and Systematic Global Macro

Macro strategies were positive in Q1, but less so than other strategies, though this is balanced with the fact that they generated positive performance in 2018. There was dispersion within performance. Discretionary macro managers were overall positive. In particular, our emerging markets focused managers performed strongly, with common sources of gains being long fixed income in Brazil, Argentina and Puerto Rico. One manager performed very strongly with gains from equities in Greek banks being a contributor. Within developed markets macro, most managers entered 2019 with a long bias in equities, balanced with shorts in USD and longs in gold. These managers profited from the strong markets in Q1 whilst those who were more cautious saw flat performance or marginal losses. A commodity specialist was the primary detractor from performance, having generated strong gains in 2018, with losses coming from long positions in carbon credits. A new manager added at the start of the year had a very strong quarter with gains from commodity and equity trading.

Less directional managers saw less dispersion in returns and had a good quarter, slightly ahead of long-term return expectations. Spreads on certain fixed income relationships widened with the stress and volatility seen in Q4 2018 and fixed income relative value managers in particular added risk which was profitable.

Equity Long/Short

The majority of equity long/short managers saw good performance in Q1, with returns in part driven by overall levels of net exposure. Most maintained net exposures and profited from the rebound in markets. The deleveraging seen in Q4 2018 reversed and many dislocations and mis-pricings, which our managers observed, corrected.

Managers which outperformed their net exposures were our specialists in biotech and technology. We are constructive on the opportunities for these sectors given the level of innovation and the specialist knowledge required to fully analyse companies, which creates barriers to entry and inefficiencies. Our allocations to these strategies generated very strong performance, well in excess of net adjusted exposures. We acknowledge that biotech in particular could prove volatile as we enter the US election period, with likely rhetoric over healthcare reform and drug pricing. Some lower net exposure managers performed well following poor performance in Q4 as dislocations from that period normalised.

Event Driven

The event driven allocation performed well in Q1, with returns exceeding expectations. There was a slowdown in M&A activity in Q1 2019 with deal volume 17% lower than in Q1 2018. The level of mega deals (>$10bn) also fell to 9 from 14 in Q1 2018. Only two were cross border deals, the remainder were US domestic deals. This is still reasonable activity and our managers performed strongly, driven by the increased allocations they made in Q4 2018 when spreads widened. These spreads narrowed in Q1. Exposure levels are somewhat reduced and spreads narrower, but our managers have managed to maintain relatively healthy risk levels.

Credit

The credit allocation had a decent quarter with all managers positive. The best performing allocation was our emerging markets exposure, which also suffered most in 2018. This was driven by the overall portfolio as the manager has kept exposures and added electively to some of those which had sold off the most during 2018, the most notable being exposure to Argentina.

Elsewhere, there was some, but limited, dispersion. Some common profitable themes were gains coming from the Puerto Rico complex as the restructuring was completed. Some managers also profited from positions, largely debt, in Pacific Gas and Electric, the Californian based utility company which traded down following concerns over the company's liabilities for wildfires in California.

We remain optimistic that there will be opportunities for distressed debt given the huge amount of debt outstanding and that an increasing proportion of this is coming due for refinancing in the coming years. During 2019, there have been select opportunities where companies have looked to restructure their balance sheet due to excessive leverage and pressure on business models. Even absent an economic downturn, we are optimistic these opportunities will occur. However, the strategy is long-biased and will be correlated with major market moves.

Summary

We continue to believe our funds are well constructed to perform in an ongoing, benign scenario but recognise that there are risks present and the environment could quickly change. We therefore take moderate risk through capturing specific opportunities whilst also providing protection to capital in the event that the environment changes.

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

Kevin Arenson
Chief Investment Officer

Tim Beck
Senior Investment Executive