STENHAM
ASSET MANAGEMENT

Quarter 2 2019 Report

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Market Data for Q2 2019

Equities	Q2	YTD 2019	Fixed Income	Q2	YTD 2019	Currencies	Q2	YTD 2019	Commodities	Q2	YTD 2019
MSCI World (USD)	3.35%	15.63%	FTSE Global Bonds	3.57%	5.38%	USD (DXY)	-1.19%	-0.04%	Gold	9.17%	9.86%
MSCI EM (USD)	-0.31%	9.22%	Investment Grade	5.39%	11.94%	EUR (vs USD)	1.23%	-0.81%	Oil ('WTI')	-2.78%	28.76%
S&P 500	3.79%	17.35%	High Yield	2.42%	10.10%	JPY (vs USD)	2.67%	1.64%	Natural Gas	-13.30%	-21.50%
Eurostoxx 600	2.77%	13.06%	Barclays Global Agg	3.29%	5.57%	GBP (vs USD)	-2.29%	-0.40%	Bloomberg Commodity Index	-1.77%	3.83%

Source: Bloomberg, Stenham

Risk assets continued to rise in Q2 following the very strong rebound seen in Q1, though with greater volatility. Economic data showed some signs of weakness and political risk rose, particularly in the trade war between the US and China. However, markets generally coped well with these risks, driven by the belief of continued and further central bank support. Key to the quarter was the expectation of further monetary easing in the coming months, which resulted in a significant decline in government bond yields and interest rates across the board. Equities overall performed well; MSCI World rose 3.3%, led by the S&P500 (3.8%). Emerging markets performed worse and were slightly down for the quarter, impacted by the slowing of global growth. Yields on government bonds fell significantly; the US 10yr yield fell from 2.41% to 2.01% and on the German 10yr from -7bps to -33bps. The USD fell against most currencies with the greater decline in interest rate expectations. Gold rallied very strongly (9.2%) with rates falling and economic weakness rising.

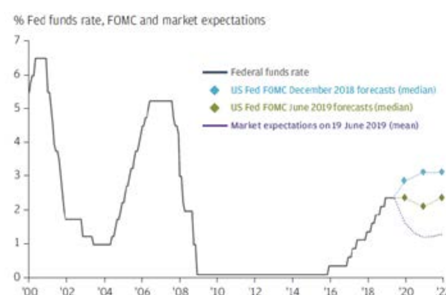
Despite the length of the US expansion and with unemployment at, or near, multi-decade lows in the US, Japan, Germany and the UK, there are few signs of over-heating and the expansion reaching its natural limits. In fact, the reverse is true, with inflation remaining stubbornly low. There has been some weakness in economic data. PMIs have fallen from the highs seen 18-24 months ago, but this is more driven by political action than economic excesses. Especially impacted have been manufacturing PMIs, those which are more exposed to global trade and likely a consequence of the US/China trade war. Globally these have now dropped below 50, the level which defines expansion or contraction and particularly impacted has been Europe and within that Germany; the latest figure is well below 45, a level rarely seen

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	Apr	May	June	July
Global	52.6	53.1	53.2	53.4	53.9	54.4	54.3	54	53.2	53.4	53	52.9	52.7	52.5	52.1	52	51.9	51.4	50.8	50.6	50.6	50.4	49.8	49.4	-
Developed	53.9	54.2	54.6	55.2	55.8	56.2	56.3	55.7	54.8	55.1	54.7	54.4	54	53.8	53.6	53.2	52.8	52.3	51.8	50.4	50	50.2	49.2	48.9	-
Emerging	50.9	51.7	51.4	51.2	51.6	52.1	51.8	51.9	51.3	51.3	51.1	51.2	51	50.8	50.3	50.5	50.7	50.3	49.5	50.6	51	50.5	50.4	49.9	-
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	52.6	50.5	50.6	50
Japan	52.1	52.2	52.9	52.8	53.6	54	54.8	54.1	53.1	53.8	52.8	53	52.3	52.5	52.5	52.9	52.2	52.6	50.3	48.9	49.2	50.2	49.8	49.3	49.6
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	53.1	49.4	48	-
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	47.9	47.7	47.6	46.4
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	44.4	44.3	45	43.1

In light of this economic weakness, the lack of inflation has enabled central banks to offer support to economy and markets through further easing. Starting in January, but accelerating during Q2 when economic data deteriorated, the change in expectations in interest rates has been huge. In the US, the one major market that had begun raising rates, the market is now pricing in 3 rate cuts before the end of 2019 compared with a steady level of rate rises just 18 months ago. Importantly, the market is pricing in more easing than the central bank has forecast and there is huge pressure on the US Fed to alter course.

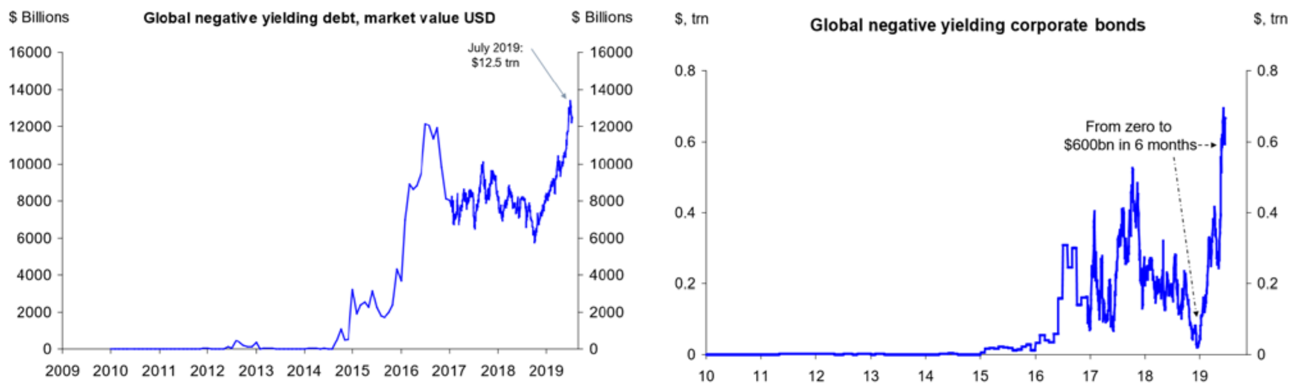
US Fed Funds Policy Rate Expectations



Source: JP Morgan

In recent market/economic cycles, investors have been well served by bond/equity portfolios and moving increasingly into bonds as valuations rise and they are faced with the end of the economic cycle. Even if not timing the allocation to bonds perfectly, the carry and yield on the bonds offset price losses and then bonds acted as a risk mitigant when markets and economies turned. This is not possible this cycle. Despite the length of the economic cycle, monetary policy has continued to be extreme and driven yields to historic low levels. With the recent fall in interest rates, there is now $12.5trn of debt (over 20% of the total) which trades with a negative yield, including some corporate debt.

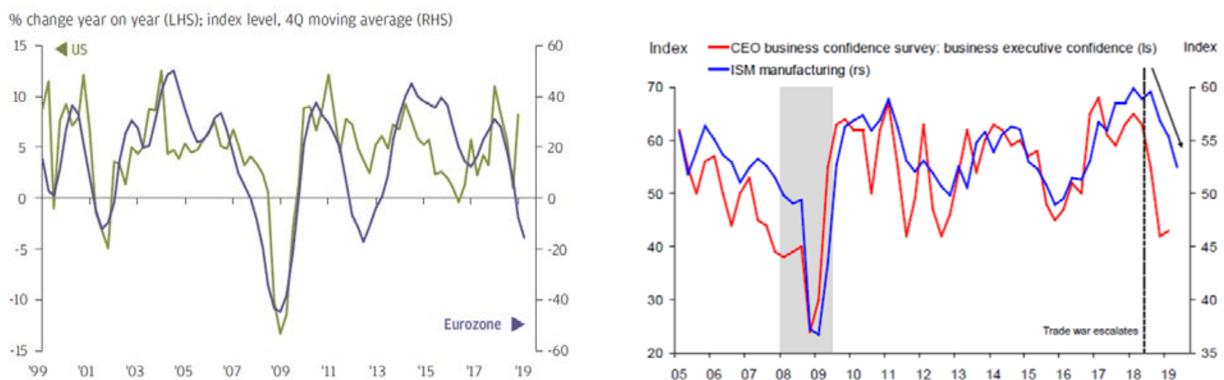
Negative Yielding Debt



Source: Deutsche Bank

Politics remains a key risk. The UK has a new Prime Minister who appears willing to countenance a no-deal Brexit, whilst Europe has not resolved the conflicts within its structure. Most importantly though continues to be the trade war between the US and China. There appeared to be some prospect of a deal being reached following the G20 meeting, but nothing has yet been achieved. There is also difficulty in reaching a fully comprehensive deal. The US has framed the dispute on Chinese state support for its technology industry as not just unfair competition but with an overlay of a national security threat, which is a far more difficult issue on which to compromise. The tariffs themselves should have limited direct impact as the US exports 0.6% GDP to China and China 3.6% to the US. However, the indirect impact of disruption to supply chains and companies scaling back investment plans is of more concern.

Eurozone and US Future Capex Intentions

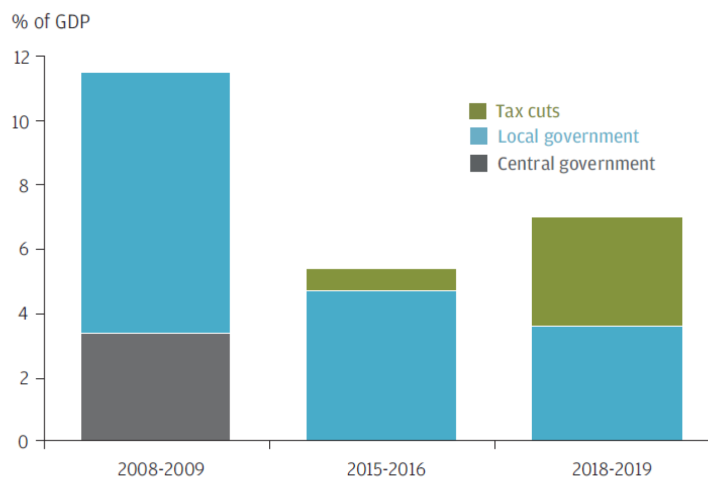


Source: JP Morgan, Deutsche Bank

The upcoming US election may also play a role in any resolution; one policy that the Democrats have not attacked Trump for has been the trade negotiations with China. Reaching a deal may aid the economy and so Trump's chances of re-election, but equally he may want to make the case that only he initiated the process and only he can complete the trade negotiations, which would entail negotiations not being concluded before the next election.

There may be questions over how aggressive the US Fed will be in supporting the US economy, but Chinese commitment seems absolute. Local government bonds are being issued to fund infrastructure projects and taxes cut to support spending. The stimulus is greater than that seen in 2015/6 and is significant. In the face of the trade war with the US, there appears a strong commitment to prevent a significant downturn in the economy.

China Stimulus



Source: JP Morgan

As monetary policy becomes ever looser, there is increasing political pressure on ostensibly independent central banks. President Trump has made no secret of the course of action he feels the US Fed should take. The degree, if at all, this influences the Fed is unknown but it certainly brings into question true independence and the respect for that independence. We have also seen this in emerging markets, most obviously in India and Turkey, but it seems to be a trend that as political populism rises, will only increase.

Europe is in a particularly difficult position. It is suffering more from the trade war and weakness in emerging markets. Business confidence and capex expectations have fallen here more than elsewhere. If there is a resolution to the US/China trade war, there is concern over whether Europe will face sanctions from the US. Cars exported from the EU to the US face a tariff of 2.5% but from the US into the EU the tariff is 10%. The auto industry represents 5% of German GDP. This is a significant risk. At the same time, the UK has seen a transition in leadership to Boris Johnson who, in campaigning to be the new Conservative leader, made a commitment to leave the EU on 31st October with or without an exit deal. Certainly if you look at currency markets, the risk of a no deal Brexit has risen significantly; GBP fell 2% in Q2 and a further 1.7% in July as the campaigns accelerated. This would clearly have a negative impact on an already weakened economy.

The ECB has stated that it is prepared to further ease monetary policy to offset economic weakness and the succession from Mario Draghi to Christine Lagarde is likely to see this policy continue. However, interest rates are already negative

and there must be some diminishing return from reducing further. QE in Europe has been far more extensive than in the US, purchasing corporate bonds. Again, there are diminishing returns from extending this and the distortions created only grow. German government bond yields are negative out to 15yrs; what benefit can there be from any further decline in yields? There is the potential for fiscal policy to address the weakness, but there appears to only be appetite for this in the heavily indebted countries of Italy and Spain and limited appetite in Germany, where there is scope. This brings the EU fiscal limits into question, but it seems unlikely that in the current environment the EU will aggressively respond to Italy flouting the rules.

Outlook

Monetary policy has firmly reversed. From a steady weaning away of emergency monetary policy envisaged 18 months ago, central banks globally are now easing again and it seems that “normal” interest rates, or at least those previously considered normal, will not be seen this cycle. There has also been fiscal stimulus, led by the US with the Trump tax cuts but also in China and globally, the narrative is firmly for fiscal expansion and more debt. Market action in Q4 2018 and H1 2019 have shown how reliant markets have become on monetary policy and such policy is only possible due to the absence of inflation.

Inflation is below target levels almost everywhere and there are no signs of it rising. However, the easier monetary policy is, the greater the level of debt (both sovereign and credit) and the more reliant markets are, the more susceptible markets are to even a moderate sign of inflation. Current policies are possible, even warranted now, but we feel excesses are growing and economies and markets are more vulnerable to a shock.

That said, the base case is that this economic cycle has been extended by the fiscal and monetary stimulus. Political risk remains key and only seems to increase, which may derail this expansion. In light of this, we maintain current risk and exposure levels, which were reduced over the last 6-12 months.

Strategy Allocations

We have made no major changes during Q2.

Discretionary and Systematic Global Macro

Macro and relative value managers performed well in Q2 and were able to generate positive returns both in May and June, highlighting the uncorrelated nature of these strategies. Our top performers were emerging markets oriented macro managers. Dovish turns from the Fed and ECB led to a rally in EM sovereign credit and rates. We also saw strong performance from our thematic macro manager who trades with a long volatility bias. This manager benefited from long positions in US front-end rates and long volatility positions.

Our less directional relative value managers were positive although absolute level of returns were lower. Fixed income relative value strategies performed well and market volatility in May led to widening of spreads and more opportunities. Our volatility arbitrage manager was positive in April and May but struggled in June.

Returns for quantitative managers were mixed with short-term equity statistical arbitrage outperforming our manager who trades longer-term signals.

Equity Long/Short

Our long/short allocation was the best performing strategy in Q2. Most managers performed well, aided by positive markets. The best performers were a tech long/short manager and a low net financials specialist. Both these sectors outperformed broader markets in Q2 (5.7% and 7.4% respectively). What was pleasing was that two of our healthcare specialists generated very strong returns, both over 10%, whilst biotech as a whole was negative (Nasdaq Biotech -2.4%). We continue to favour healthcare investments due to the innovation within the sector and the idiosyncratic nature of many of the investments.

Emerging markets have lagged broader markets in both Q2 and for the year as a whole. However, we do see that within Asia, there is potential to generate greater alpha than in more crowded and competitive markets. As such, we are likely to allocate to an Asian long/short manager before year-end. We have been allocating to Asian managers for over 15yrs and until recently many managers had a heavy long-bias. As the markets have developed, liquidity has improved and regulatory restrictions have reduced, we are seeing greater ability to short stocks.

Event Driven

The event driven allocation performed reasonably in Q2, with limited sensitivity to markets in May. There was a pickup in M&A activity in Q2 2019 with deal volume of $1.55trn, the highest since Q1 2017. Deals were skewed towards larger deals, with some prominent transactions in the healthcare space including Abbvie buying Allergan. This is still reasonable activity levels and our managers performed strongly, driven by the increased allocations they made in Q4 2018 when spreads widened. Exposure levels have increased moderately with some of the large healthcare deals having attractive rates of return.

Credit

The credit allocation had a decent quarter. The best performing allocation was our emerging markets exposure, which continued to benefit from positions built during 2018, particularly in Argentina. Argentinian positions, largely in sovereign and provincial debt, rose as the risk if Cristina Kirchner regaining power receded during the quarter. Other managers performed well, with common positions being in Pacific Gas and Electric, the Californian based utility company which traded down following concerns over the company's liabilities for wildfires in California. Our multi-strategy credit manager was a detractor for the quarter, with losses coming from the hedge book, which had short interest rate positions as a hedge for long structured credit positions.

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, but with interest rates on hold, there may be a delay in this and timing is difficult. 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 are pleased with how our funds performed during Q2 2019, with limited losses in May and decent performance overall. We continue to operate with limited direct equity exposure but are long risk through other strategies with the prospect of the current cycle continuing but risk and market excesses increasing.

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:

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