STENHAM
ASSET MANAGEMENT

Quarter 3 2018 Report

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October 2018

Market Data for Q3 2018

Equities	Q3 2018
MSCI World (USD)	4.53%
MSCI EM (USD)	-2.02%
S&P 500	7.20%
Eurostoxx 600	0.31%

Fixed Income	Q3 2018
FTSE Global Bonds	-1.62%
Investment Grade	1.14%
High Yield	2.50%
Barclays Global Agg	-0.92%

Currencies	Q3 2018
USD (DXY)	0.70%
EUR (vs USD)	-0.54%
JPY (vs USD)	-2.40%
GBP (vs USD)	-1.15%

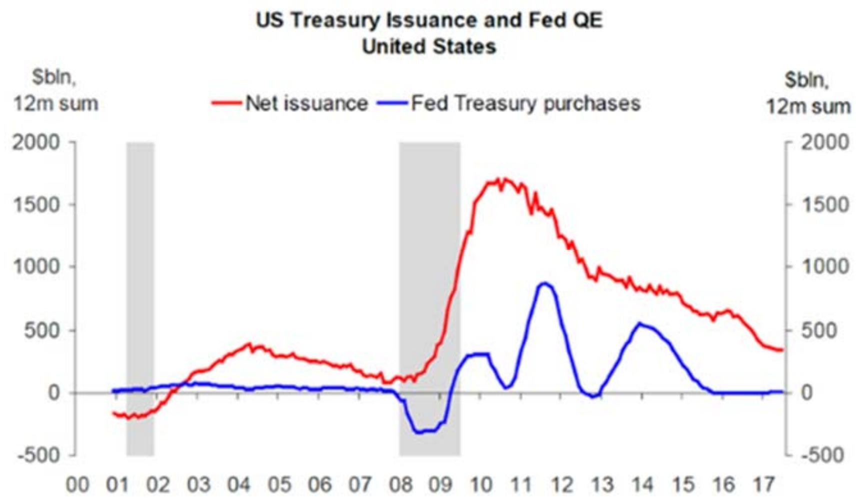
Commodities	Q3 2018
Gold	-5.01%
Oil ('WTI')	-1.21%
Natural Gas	2.87%
Bloomberg Commodity Index	-2.53%

Source: Bloomberg, Stenham

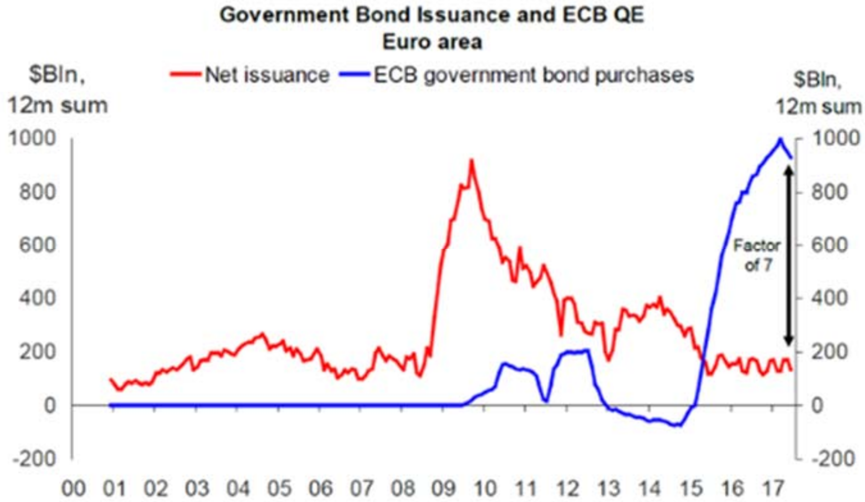
The third quarter saw increased volatility, with fears of rising rates in the US coupled with concerns over an escalation in the trade war between the US and China and broad concerns over emerging markets exacerbating volatility levels. The US economy continues to outperform the rest of the world which led to outperformance of US assets (equities and FX). The MSCI World returned a healthy 4.8% in Q3 but it is telling that within that, emerging markets were down in aggregate and Europe was flat. Rates continued to rise (US 10 yield increased by 20bps) causing further issues for fixed income performance.

As we write this, markets are in the midst of a bout of volatility with MSCI World –9.5%, S&P500 –9.4% and MSCI Emerging Markets –10.2% with just a couple of days left in the month. There has not (as yet anyway) been more full-scale risk aversion as credit spreads have remained contained with only marginal widening and merger arbitrage spreads are largely unchanged.

The structure of the market is changing and in some ways reverting to normal, which entails much higher levels of volatility. We should look at 2017 as an outlier in its lack of volatility; since 1980 the years when the S&P500 has delivered positive returns the average maximum drawdown has been 11%. 2018 has seen a return of volatility, albeit sporadic. In late January and early February there was a spike in market volatility and a drop in asset prices surrounding the unwind of short volatility trades. We then saw further volatility when the coalition Italian government was formed in April. The cause of the most recent sell-off can, in part, be pointed to an increase in interest rates and a resetting of the prices of risk assets in that context. However, we do see these market moves as a change in the structure of the market rather than due to purely idiosyncratic factors. Quantitative Easing ("QE") has been massive and its decline and unwind will have profound effects. There is a deceleration of global liquidity growth (liquidity is still growing, though is forecast to shrink in 2019) and there is a transition from central bank derived liquidity to more organic, less predictable forms. It is worth remembering that the ECB and BoJ are still buying assets. Since the US Fed stopped additional purchases in 2016, the ECB and BoJ combined have injected nearly USD4trn of liquidity. This will turn negative with the ECB exiting its purchase program at end-2018.

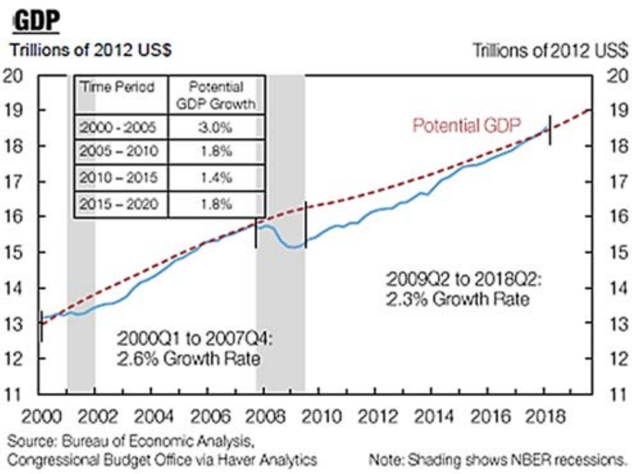


Source: Deutsche Bank, Bloomberg, Stenham



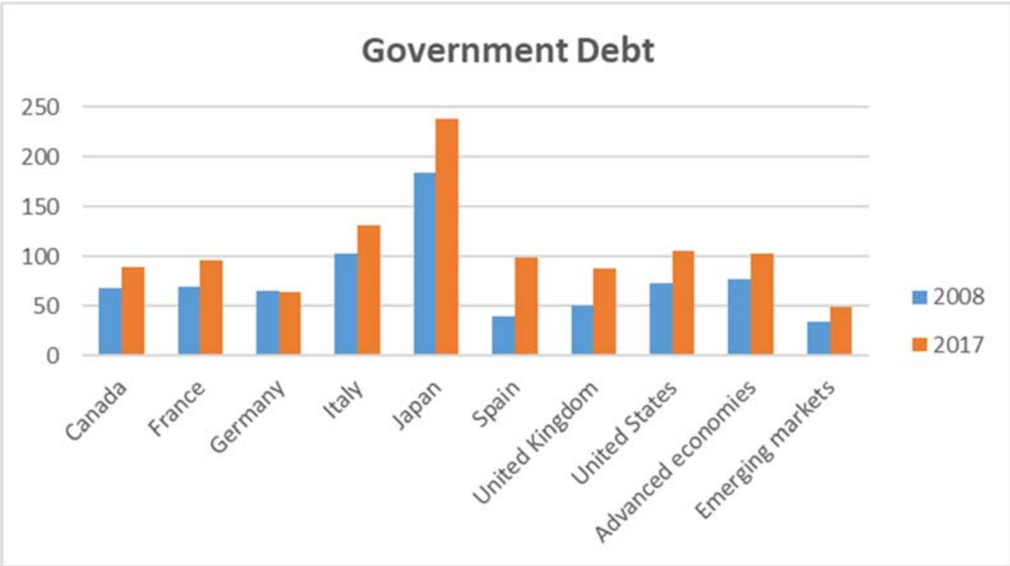
Source: Deutsche Bank, Bloomberg, Stenham

Regional dispersion continued in Q3 as a booming US economy drove US stocks and treasury yields higher. Economic growth for Q2 came in at 4.2% with 3.3% consensus for Q3 (the Atlanta Fed GDPNOW forecast is 4.4%). Consumer confidence hit its highest level since 2000 whilst unemployment fell below 4% and wages showed some (albeit tepid) signs of rising. The US is growing above trend, perhaps twice trend growth. There are few signs of this tempering in the short-term with continued fiscal stimulus, higher capex levels from corporates and highs in consumer confidence. Data from the US Congressional Budget Office shows that actual GDP is now higher than potential. This is unsustainable and there is a real risk this will feed through to higher inflation. It really is remarkable that there is such aggressive fiscal stimulus at this time.



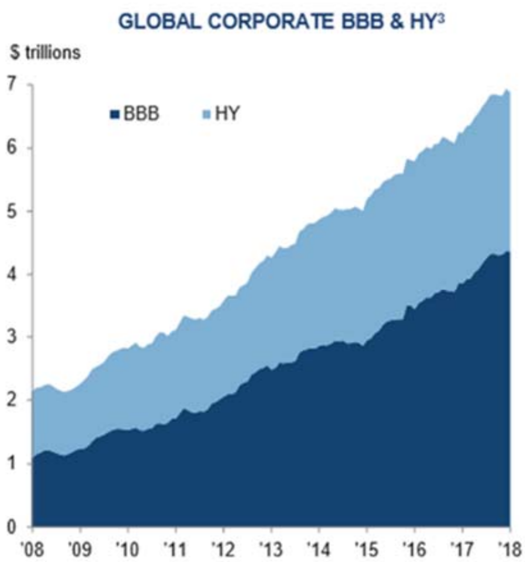
This prompts the question of whether US outperformance is sustainable and, if not, whether the US slows down or the rest of the world catches up. If the US continues to outperform, a logical consequence will be increased interest rates and a higher USD. The strength of the USD has already put pressure on certain emerging markets and further strength would make this more widespread. So far the weakness here has not impacted the US significantly, and it is unknown at what stage it does. Either way, interest rates would rise, though if non-US weakness were to hit the US, this could lead to some reversal or slowdown of rises. The alternative view is one where the rest of the world catches up to the US. This would most likely be achieved through fiscal stimulus and there does seem to be the appetite for this with a changing narrative in various countries. China is key and has announced both monetary and fiscal stimulus, hurt by the deterioration in trade relations with the US and increased levels of tariffs. From a position at the start of the year of looking to constrain credit growth following its multi-year expansion (and most likely poor allocation of resources), interest rates have since been cut four times and additional fiscal spending announced. This has yet to come through substantially in loan growth measures or a pick-up in economic indicators, but it shows the intent of authorities. Longer-term, it will be impactful how transitory these measures are given the recent focus on quality of economic growth and looking for better resource allocation. It is of note that 2018 has seen a reasonable acceleration in onshore corporate bond defaults.

These scenarios all entail rising interest rates, a natural consequence of such strong growth at a time of contained excess capacity, which will impact debt. Debt is higher now than in 2008. Sovereign debt has increased markedly and with the political narrative tending towards further fiscal stimulus, this is likely to increase.



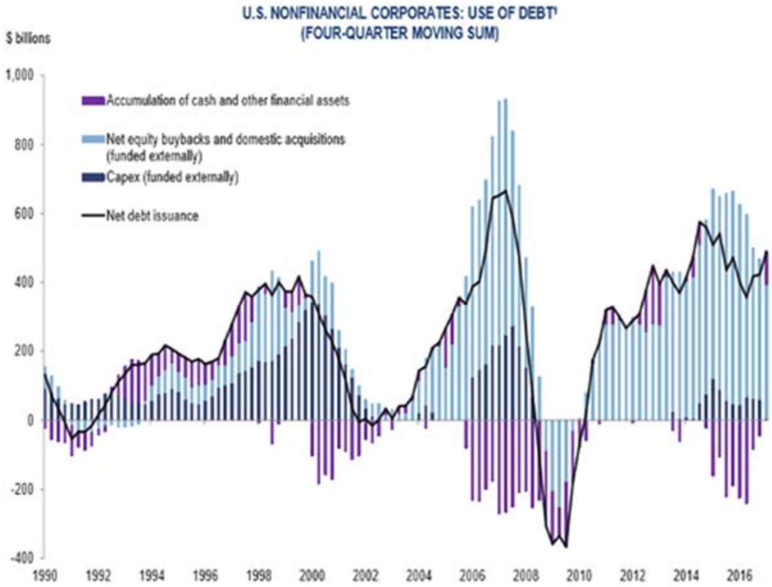
Source: Stenham, IMF

Corporate debt is also high, also increasingly massively since 2008. This has mainly occurred in lower rated securities, in high yield and BBB (the lowest rated segment of investment grade).



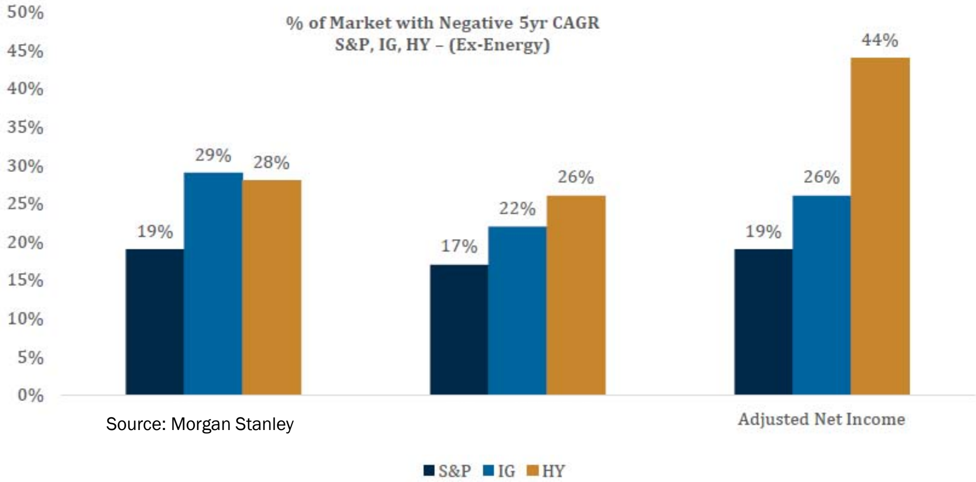
Source: Bloomberg, Barclays, US Federal Reserve

This debt has often been used, completely rationally, for share buy-backs and financial engineering.



Source: Bloomberg, Barclays, US Federal Reserve

An increase in interest rates puts pressure on the ability to service that debt. This might not lead to defaults (though that is a real possibility) but impacts corporate profitability more generally. It is stark that, even in a strong economic environment, many high yield issuers are seeing declining fundamentals, driven by the huge, secular, disruption occurring to so many industries.



Source: Morgan Stanley

Moving away from the US, politics rather than economics continue to dominate in Europe which is in political limbo with no notable signs of improvement. The bullish case for Europe was that Macron would succeed in proposals for greater co-ordination across main policies, notably a European finance minister and a Eurozone budget aimed at discretionary fiscal stabilisation. These now seem to have very limited chance of being achieved in the near-term in particular with Angela Merkel's increasing weakness. Populism is on the rise making the likelihood of structural reforms remote.

Italy remains front and centre of risk. We remain more concerned than most, but that may be changing with the market move since the budget proposal to the EU in September and subsequent comments by members of the Italian government. The counter argument we receive is that it makes no logical sense for either the EU or Italy to have Italy leave the EUR with the costs of the economic turmoil which would ensue. We agree. However, the narrative from the Italian government and belief within the Italian population (and most likely elsewhere in Europe) is that the decade long stagnation in living standards is due to German/EU imposed austerity rather than the lack of structural reforms. The worst case scenario of Italy leaving the EUR may not happen, but either the EU will have to make concessions or the market must force Italy to backtrack. We struggle to see why the new Italian government would backtrack from its proposals at this stage when there has been no major, sustained market impact, made all the more difficult with the comments made by Salvini such as the budget not changing by even “one comma.”

Outlook

Markets are changing. Increased volatility should be expected and portfolios should be constructed to withstand that volatility. Given high valuations and risks out there, the ability to extract returns through low cost passive ETFs will be much reduced.

Assets prices are high in many cases, especially in fixed income. We can see how the cost of credit and capital could rise significantly and that would put pressure not only on credit spreads but also levered companies. Geopolitical risks remain high, with focus currently on Italy and US/China relations. By their nature, geopolitical risks can arise unexpectedly, witness the recent issues surrounding Saudi Arabia and the journalist Jamal Khashoggi, which has the potential to have a profound impact on politics in the Middle East as well as the oil price. At current asset price levels, we feel it prudent to reduce overall portfolio risk in the face of these risks and take a more cautious approach.

Strategy Allocations

We continue to see limited turnover within portfolios. At the margin we are reducing exposure to managers with a higher exposure to markets, particularly equity markets, and allocating to less directional managers, either in equities or other asset classes.

Discretionary and Systematic Global Macro

In aggregate, the macro strategy was marginally positive, though with significant dispersion. Quant strategies were strong, particularly in August, as there was some element of mean reversion from underperformance in June and July, impacted by liquidations by other quant firms. Discretionary macro managers were more mixed. Some of our emerging markets focused managers performed well, benefiting from long positions in Brazil and Argentina. For developed markets orientated managers, there were few meaningful trades, either positive or negative. Our fixed income relative value managers were positive, albeit marginal, as volatility in fixed income markets was muted.

Equity Long/Short

Our long/short managers were slightly positive for the quarter. The best performing sectors were healthcare and technology (MSCI World Healthcare +11.4%, S&P IT +8.5%) and these were the most common source of gains for our managers. The healthcare managers were positive, but lagged broader healthcare indices. Our managers are overweight biotechnology, attracted by the huge innovation in the sector, and the sector underperformed in the quarter (IBB +0.7%) as the lack of M&A (which had been anticipated) and fears over the upcoming US mid-term elections weighed on sentiment. Short positions in US consumer stocks such as retailers and restaurants also weighed on performance. These sectors performed well due to robust consumer spending in the US where consumer confidence high highs. Longer-term, our managers continue to believe that these business models face significant challenges impacted by new entrants and shifting technology.

Event Driven

Merger activity continued to be strong in Q3 and 2018 is on track to set a new annual record for deal activity. Bloomberg data showed USD1.3trn of deal announced in the quarter following just over USD1.5trn in both Q1 and Q2. It was an eventful quarter for merger arbitrage managers beginning with a break in the Qualcomm/NXPI deal. This deal had proven volatile, dependent upon Chinese regulatory approval, the likelihood of which seeming to rest upon the state of political relations between the US and China at any point in time. NXPI traded at a reasonable discount to the price at which Qualcomm had offered (reflecting this risk) and was very widely held across merger arbitrage managers as well as many fundamental equity managers, the latter in the belief that the underlying value of NXPI made it worthwhile holding as the company was worth more than its trading price as a stand-alone entity. It was also a large capital structure and offered strong returns over a short timeframe should the deal be approved. After multiple extensions, the deal did not receive Chinese regulatory approval and Qualcomm withdrew from the deal. Many funds lost money from this, but it also created significant risk aversion towards merger arbitrage, especially from non-specialist funds. This has created opportunities with widened spreads across many deals with perceived risk. Later in the quarter, Sky was subject to a competitive auction between Fox and Comcast, resulting in Comcast significantly raising its bid. Our managers were positive for the quarter and have become significantly invested as deal activity has remained strong and spreads have in certain circumstances widened.

Credit

The credit allocation had a good quarter. Gains were led by our emerging markets specialist manager who had seen losses earlier in the year, primarily on positions in Argentina. The manager has added moderately, mainly in fixed income (both sovereign and regional debt) as well as select equities, largely in regulated entities which should benefit from continued regulatory reforms such as the lowering of tariffs. These assets performed well in Q3. The manager expects further disruption in emerging markets, but feels it appropriate to take targeted risks in Argentina in particular which has seen very material falls in asset prices. Other credit managers also performed well. Gains were fairly diverse but generally came from more recently added positions, including positions in Puerto Rico where there was further progress towards settlement between different entities. Managers remain very optimistic about the opportunity set as rates potentially rise and disruption across different industries leads to new opportunities as levered companies have their business models challenged. We are optimistic on the opportunities managers are seeing.

Summary

We believe that our funds are constructed to perform well in an ongoing, benign scenario but will also offer some protection should that environment change. Identifying turning points are often challenging, but should a higher volatility environment continue, we are confident in the blend of strategies and managers we have and their ability to adapt to a changing environment.

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:

www.stenhamassetmanagement.com

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