STENHAM
ASSET MANAGEMENT

Quarter 4 2018 Report

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Market Data for Q4 2018

Equities	Q4	YTD 2018
MSCI World (USD)	-13.74%	-10.44%
MSCI EM (USD)	-7.85%	-16.64%
S&P 500	-13.97%	-6.24%
Eurostoxx 600	-13.11%	-17.35%

Fixed Income	Q4	YTD 2018
FTSE Global Bonds	1.75%	-0.84%
Investment Grade	-0.51%	-3.67%
High Yield	-4.21%	-1.48%
Barclays Global Agg	1.20%	-1.20%

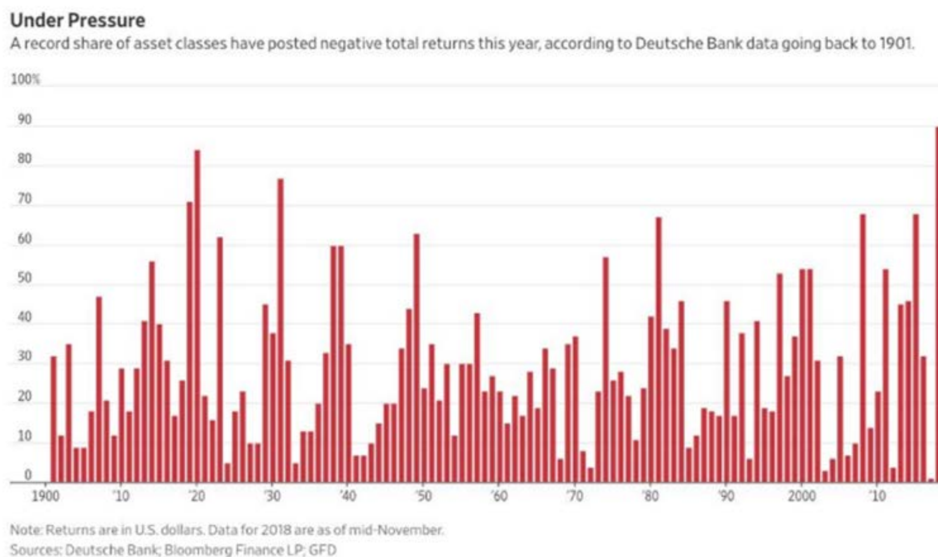
Currencies	Q4	YTD 2018
USD (DXY)	1.09%	4.40%
EUR (vs USD)	-1.40%	-4.74%
JPY (vs USD)	3.51%	2.67%
GBP (vs USD)	-2.27%	-5.75%

Commodities	Q4	YTD 2018
Gold	7.47%	-1.88%
Oil ('WTI')	-38.01%	-24.84%
Natural Gas	-2.26%	-0.44%
Bloomberg Commodity Index	-9.96%	-12.99%

Source: Bloomberg, Stenham

Q4 saw significant drawdowns across all major asset markets. Equities fell precipitously with US markets falling well into double digits, having outperformed in the prior 3 quarters. December was the worst monthly performance for the S&P500 since February 2009 and the worst December since the Great Depression. Other regions fell similarly, though went into the quarter already significantly down. Credit markets were not immune, with December being the worst month for 3 years for high yield bonds and the second negative year since 2008. Safe havens rallied, but only in the latter stage of the quarter as fears of a recession rose and any potential rate increase in 2019 diminished. US 10 yr bond yields fell from a November high of 3.23% to 2.68% and gold rallied over 7%. Other commodities fell, with oil declining close to 40% in the quarter, reflecting both an economic downturn as well as an increase in supply from Saudi Arabia and an easing of Iranian sanctions.

2018 was a difficult year for almost all asset classes. Per research from Deutsche Bank (to end-Nov), close to 90% of asset classes they track fell in 2018, the highest level for which they have records going back to 1901. Assets that rose in December, such as gold, were still negative on the full year.



Markets entered 2018 with a view of synchronised global growth. This gradually abated as economic data from Europe and China worsened significantly, whilst the US remained robust, buoyed by fiscal stimulus from the Trump tax cuts which drove higher corporate earnings, whilst interest rates remained, historically at least, low. This was reflected in the strong outperformance of US equity markets. This changed markedly in October with concerns that the Fed was increasing interest rates faster than warranted and, driven by comments from Fed Chair Powell, there were far more rate rises coming than priced in by the market as the US remained ”a long way” from neutral rates. These concerns mounted as trade tensions with China escalated and market participants began raising the probability of an economic recession.

Markets fell and volatility rose. Whilst during 2017 the US equity market did not experience a single day of +/- 3%, 2018 saw 15 days, 10 of which came in Q4. This does not reflect often huge intra-day moves.

Economic data has definitely weakened, most prominently outside of the US. During 2018, the first hit were the more fragile countries in Emerging Markets, notably Turkey and Argentina. This has now spread more broadly. Japan, after 8 consecutive quarters of growth, contracted in Q1 and then again in Q3 2018. China had been forecast to slow and this did come about with Q4 2018 growth at an annualised 6.4%, the slowest since the financial crisis. Europe has seen consistent weakness, driven in part by its exposure to trade with Emerging Markets but also domestically. Forward looking indicators, such as PMI surveys, have fallen consistently indicating barely any expansion. The high growth seen in 2018 in the US was not sustainable and driven by huge fiscal stimulus. This is slowing, but metrics such as job growth and business/consumer confidence do not indicate an immediate a recession.

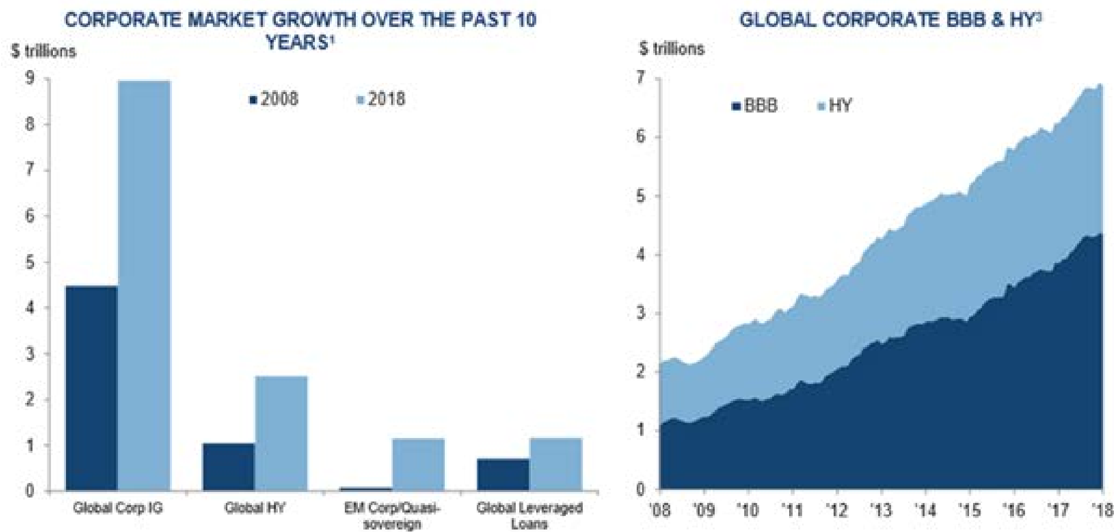
Political risk remains front and centre, impacting every region. China/US relations are key as hopes are high that a trade deal is struck in Q1 2019 following the announcements post the G20 meeting. It is difficult to have any real insight into this likelihood. Both nations seem under some pressure to reach a deal given the renewed fears of an economic downturn, which would be worse if the trade war escalated. Even if a deal is reached, continued tensions between these established and rising powers are likely to be much longer themes where conflict will rise and fall. Within Europe, market concerns over Italy potentially leaving the EUR have diminished as accord was reached with the EU commission over its budget proposal. Perversely, the increased spending that France will deploy in response to the 'gilets jaunes' protests seems to have alleviated the pressure on Italy, making them less of an outlier. The path for Brexit is uncertain and all outcomes, be it hard Brexit, soft Brexit, no Brexit or a change in government remain plausible. We remain concerned over the structure of the EUR, increased political conflict and what this means for the stability of the block. Globally, populism is on the rise.

Against this back drop, we are concerned about:

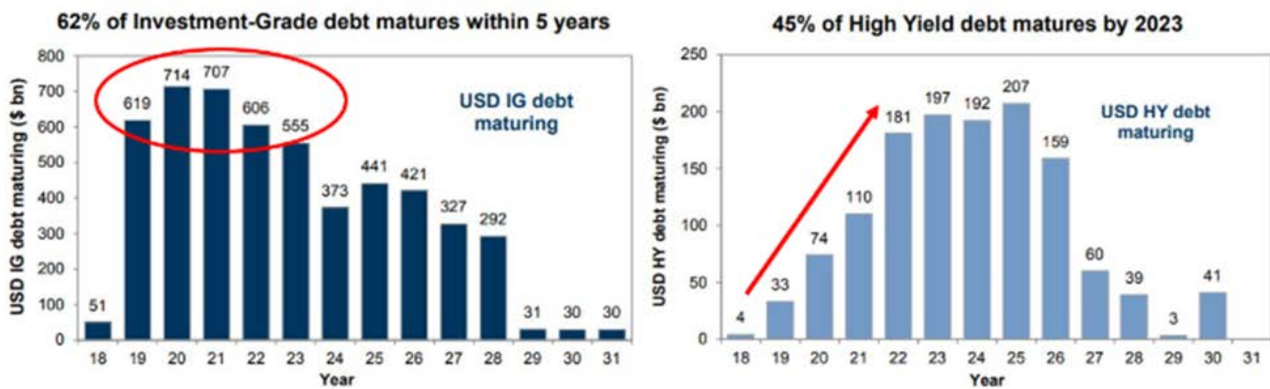
i) overall corporate profitability;
ii) excessive leverage at both the corporate and sovereign level; and
iii) the scope of monetary policy to mitigate the next economic downturn.

These issues are not exclusive but inter-related. The proportion of revenues going to shareholders has risen significantly since 2008. This is due to both cuts in corporate taxation, a global phenomenon but in the US recently exacerbated by the Trump tax bill, and the lack of wage growth which has depressed labour costs. Both look set to correct. Populism is leading to demands for higher taxation on the holders of capital, both corporates and higher earners. The unemployment rate is low and most indicators point to an increase in wages. Profitability looks set to decline yet estimates from IBES suggest analyst consensus is for long-term earnings growth of 16%, a level not seen since the early 2000s. This may not be a completely accurate reflection of the market, but does reflect potentially over-optimistic expectations that the recent past will continue.

Corporate and sovereign debt levels are worrying. Corporate debt as a percentage of GDP on the US is high and at similar cyclical peaks seen previously. Moreover, there has been a decline in quality, only supported by ultra-low interest rates, which makes the debt serviceable at current levels. The proportion of 'BBB' debt, the lowest investment grade rating, has increased to c.58% today at the same time as the total investment grade market has more than doubled since 2008. High yield has similarly expanded and 'B-' or below issuers are 25% of that market, fuelled by insatiable demand by the CLO market. This again is fuelling covenant-lite debt where reported debt and profitability metrics can be amended to appear more favourable. Much of the debt, certainly for investment grade companies, has been used for financial engineering (share buy-backs) rather than productive investment. There is also a rising maturity schedule, which will test the market appetite and risk for the sustainability of these debt burdens.

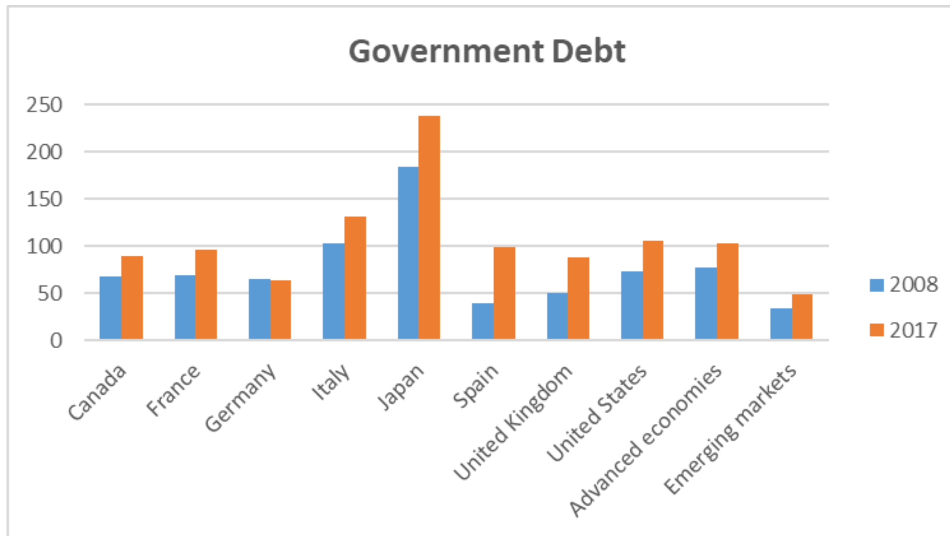


Source: JP Morgan



Source: JP Morgan

Sovereign debt levels have risen since the financial crisis. US government debt has grown from 74% of GDP in 2008 to 105% in 2017. This is repeated throughout the developed world. In the UK the ratio has gone from 50% to 88%, France 69% to 98%, Italy 102% to 132% and Spain 39% to 98%.



Source: Stenham, OECD

Any absolute limit on the level of government debt is controversial. Japan is running with debt levels well above 200% and in excess of any other developed country. Maybe others can follow that lead, but Japan is unique in its dependency upon domestic investors and savers to finance its debt and certainly not one enjoyed by the US. Debt is increasing. The Trump tax cuts have led to a significant rise in the fiscal deficit at a time of comparative economic strength. At the moment bond markets have not acted with great concern upon debt levels, but that could change and when it does, it could be rapid and difficult to address.

The expectations for US monetary policy changed markedly during 2018. There were 4 rate rises during 2018 and the US fed reduced its balance sheet. Going into Q4, expectations were still for steady rate rises during 2019. The market was not pricing in the pace of rises that the US Fed was via its 'dot plots' but was expecting a constant level of rate rises during the year. This altered dramatically during Q4 as economic growth fears surfaced. Fed Chair Powell indicated in October that interest rates were a long way from 'neutral', comments that attributed at least in part to the sell-off in markets. He then corrected or backtracked on these in December when he stated that the Fed would be pragmatic on interest rate rises and also, more of a change, on the pace of balance sheet reduction. These comments helped stabilise markets.

If the US Fed does not raise rates, or at least to any significant level, it will be very difficult for either the ECB or BoJ to do so; this would most likely lead to currency appreciation and further pressure on what are already weakening economies. As and when a recession occurs, the scope for monetary stimulus is much less, which concerns us. The US entered 2007 with rates at 5.25%, today they are 2.25%. In Europe, rates are -0.40%, an extraordinary figure at any time, but amazing following a sustained period of recovery and entering a downturn. Maybe interest rates can become more negative, but the impact is unknown and we would suspect a greatly diminished, if any, benefit. Quantitative easing could be expanded, but if the aim is to reduce overall bond yields, certainly in Europe, they seem extremely depressed already.

This leaves fiscal expansion. The Trump tax cuts are already leading to forecast budget deficits of high single digits in the US, something not seen at this point in an economic cycle since the 1960s and the Vietnam War. A recession would lead this deficit to widen (as tax receipts fall and entitlement spending rises) even without any additional fiscal impetus to mitigate the downturn. Whilst Europe could engage in fiscal expansion, in aggregate it is still running a deficit, albeit less than 3%. Future fiscal capacity largely lies with Germany and there would need to be political will for this to be used to benefit the rest of Europe, something which seems to be diminishing as political consensus diminishes.

Ultimately we see a world and markets where the longer-term view is one of declining corporate profitability, excessive debt and a political environment where these two effects only extenuate. Ultimately, debt will have to decline. Recent recessions have been addressed by both fiscal and monetary policies to mitigate the impact. In the next downturn, these may have reached their limit. Debt is at cyclical highs for corporates and record highs for many sovereigns. The next downturn may not be able to be addressed by further debt but necessitate a deleveraging. However this occurs will be painful. Fiscal austerity is almost unthinkable in the current political climate. That leaves deleveraging through inflation, eroding the value of that debt. This is not good for the holders of that debt and fraught with the potential for policy error to prevent inflation accelerating beyond a controllable level. But it is possible for those countries which control their own monetary policy; for those that do not (such as those within the Eurozone), policy is not necessarily designed for their individual economies but for the monetary union as a whole and the process can be a lot more severe.

Outlook

Investing today is not straightforward. In the shorter-term, there appears to be the willingness of authorities to respond and take action to support the economy and, by default, markets. There does not appear to be complacency, far from it and it could be argued they are being too responsive to market sentiment. In periods of such volatility and fear as Q4, there is often indiscriminate selling, which does offer investment opportunities. These will be somewhat correlated with markets and would suffer in a further sell-off. However, assuming no imminent recession, there are investments which look attractive.

Longer-term, we remain extremely concerned by the level of debt in the world combined with the lack of policy options in the next downturn. However the timing of that is very difficult and could be some years out. We are looking for balance within portfolios where we can capture some of the idiosyncratic opportunities we see but also providing significant protection to capital in the event of a large sell-off. Our portfolios generally will have less exposure to markets.

Strategy Allocations

We have further reduced exposure to equity long/short. This is both as a result of wanting to reduce overall equity beta and also reflective that the alpha generation for this strategy has disappointed, reviewing both our allocations and the broader peer group. This is particularly the case with more generalist managers where we have reduced our allocation significantly over the past 2-3 years and continue to do so. We have replaced these managers with less directional exposures and in strategies where we feel there are structural barriers to entry. In a very strong equity market, they will lag, but they are still targeting typically mid- to high single digits at a minimum and we feel that i) there is greater certainty of achieving that; and ii) the opportunity cost of less equity beta is not great in the current environment.

Discretionary and Systematic Global Macro

Macro strategies in aggregate suffered some losses in Q4, but remained positive for the year. There was dispersion in returns. Overall, less directional managers were positive in Q4 whilst discretionary macro managers lost money.

Relative value managers performed well for the year and in Q4, though returns were more muted as volatility was higher and risk dialled down. Some of our managers deployed more capital during Q4 as spread relationships widened and became more attractive and this should bode well for near-term returns.

Discretionary managers were negative in the quarter, but there was dispersion both in the quarter and the year. There are no guarantees to performance, but in extreme moves it is encouraging that our emerging markets focused managers were positive for the year despite the performance of overall EM assets. The worst performers came from managers with a greater focus on equities in developed markets and generally lost money during the quarter as markets declined.

Equity Long/Short

The strategy lost money in Q4 and for the year, a result of the strong falls seen across equity markets. In aggregate, our exposure performed in line with the average net exposure of these managers. We have moved our exposure towards sector specific managers in the last few years. This generally benefited us as these managers tended to outperform on a net basis. Within healthcare, the managers have tended to be more directional as we have held a positive view on sector, especially innovation within biotechnology. These managers fell with the market as biotechnology was particularly impacted with the sell-off in markets (Nasdaq Biotechnology -25% in Q4). The generalist healthcare managers also tended to be overweight biotech against broad healthcare indices. We have lower net managers focused on energy and utilities, which were positive for the year. They have different geographical focuses and different drivers of returns and we believe can outperform having expertise in a niche and specialised area.

Event Driven

Our exposure to event driven strategies is through dedicated merger arbitrage funds. These funds lost money in Q4, though moderate amounts (-2 to -3%) due to spread widening across certain deals. Spreads are now relatively wide and wider than they have been since 2016. Merger activity may slow if economic growth and confidence falls, but so far seems robust and 2019 has begun well.

For the full-year, performance from the merger arbitrage funds was healthy. The year was not without difficulties, such as the failure of the acquisition of NXPI by Qualcomm, but there was a strong level of activity and at USD5.4trn, deal activity slightly surpassed than of 2017 which enabled performance. With spreads wider, we continue to be optimistic on the strategy.

Credit

The credit allocation fell in Q4 and was flat for the year. Our developed markets distressed managers were overall marginally positive, with performance ranging from +3% to -2%. The losses came from our Emerging Markets distressed manager, which returned -10% for the year. We think that the opportunity set for this manager has risen and have marginally increased the allocation. The main contributor was a multi-strategy credit manager, which made money in

longs, concentrated in structured credit, whilst macro hedges and more structural shorts in commercial mortgage securities also contributed. Q4 saw losses as prices generally came under pressure; this tended to be across the board with few significant single name drivers. Our managers have increased the level of investment during this weakness, mainly adding to names they already owned.

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. However, it is long-biased and will be correlated with major market moves.

Summary

Overall, our portfolios protected capital in 2018 and some strategies generated positive returns in a difficult environment. We have made some marginal changes which we believe make these portfolios even more resilient as we move further through the economic cycle and face significant macro challenges.

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