STENHAM ASSET MANAGEMENT

Q1 2023 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q1 2023	2022
MSCI World (USD)	7.3%	-19.5%
MSCI EM (USD)	3.5%	-22.4%
S&P 500	7.0%	-19.4%
STOXX Europe 600 (USD)	9.3%	-18.1%

Fixed Income	Q1 2023	2022
FTSE Global Bonds	3.5%	-18.3%
Investment Grade	4.5%	-17.9%
High Yield	3.6%	-10.7%
Bloomberg Global Agg Bond	3.0%	-16.2%

Currencies	Q1 2023	2022
USD (DXY)	-1.0%	8.2%
EUR (vs USD)	1.5%	-5.9%
JPY (vs USD)	-1.3%	-12.2%
GBP (vs USD)	2.1%	-10.6%

Commodities	Q1 2023	2022
Gold	8.4%	-0.1%
Oil (WTI)	-5.7%	6.7%
Natural Gas	-50.5%	20.0%
Bloomberg Commodity	-6.5%	13.8%

Source: Bloomberg as of 31 Mar 2023

Markets were overall positive in Q1 with equities returning mid-single digits and credit spreads more or less flat (investment grade 7bps wider and high yield 17bps tighter), allowing investors to benefit from the carry. This is quite remarkable given Q1 also saw two bank failures in the US following a run on deposits, the collapse of one of the largest banks in Europe, and volatility in fixed income markets reach levels not seen since the Global Financial Crisis.

The beginning of the year saw a growing belief in the chances of a soft landing in developed markets economies as inflation reports showed some element of moderation amid stable if unspectatular growth. This then switched in mid-February as inflation and growth data both picked up and markets began pricing in a 50bps hike in rates by the US Fed in March, fuelled by comments from Fed Chair Jerome Powell. From soft landing, the narrative began to grow of a “no landing” where economic growth does not weaken to recessionary levels (largely supported by consumer spending) and inflation does not moderate, leading to a higher-for-longer interest rate environment.

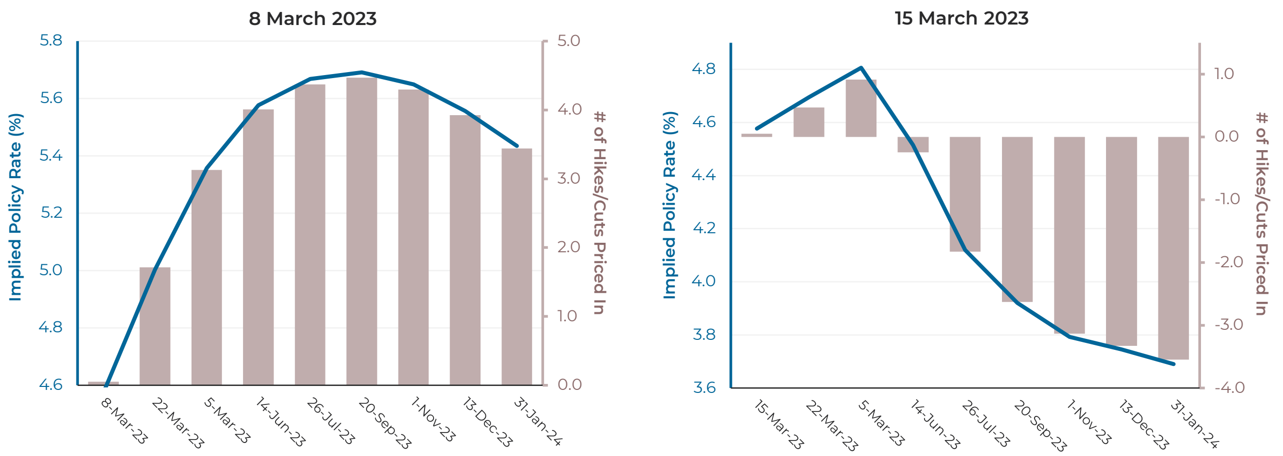
This abruptly changed in March as Silicon Valley Bank (SVB) failed in a matter of days, followed by Signature Bank and then not long after by Credit Suisse in Europe. This stress in the banking sector threatened to escalate and destabilise the overall economic environment. SVB was in some ways an extreme case. It had a high proportion of deposits above the Federal Deposit Insurance Corporation (FDIC) insured balance of $250,000, making it more susceptible to deposit flight should the perceived risk of non-payment rise, as well as a concentrated business model servicing the tech sector, which was under pressure and using deposits to fund their businesses. The fear was of a broader run on deposits at the regional banks, though this was averted with the FDIC guaranteeing all deposits.

The collapse of Credit Suisse was somewhat different, though again had the potential to lead to great disruption in the market. Again the distress came from a run on deposits, but one of the main controversies came from the treatment of the Additional Tier 1 (AT1) securities following the regulatory sanctioned sale of the bank to UBS. These securities form hybrid capital; paying out a coupon (similar to debt) though can be converted to equity under certain stress conditions and, in portion, can count towards banks meeting required capital ratios. These stress conditions were met, the securities were "bailed in" and received zero payment following the takeover of Credit Suisse by UBS. The controversy was that the shareholders of Credit Suisse did receive some funds on the takeover; effectively, equity owners received more than the hybrid securities, which are seen as more senior in the capital structure. European banks are reliant upon hybrid securities to meet capitalisation ratios. The risk of being seen as junior to equity raised the possibility of a large repricing of these securities and, at the very least, a much greater funding cost and cost of capital for banks. To allay this crisis, both the UK and European regulators (Credit Suisse was regulated by the Swiss FINMA) came out with confirmation that they would treat hybrid capital as senior to equity, preventing much greater turmoil.

While SVB's structure may have made it more vulnerable, the fact remains that the bank was running large interest rate risk, owning a large portfolio of longer-dated US treasuries whose price had come under pressure with the rise in interest rates, but was not reflected in accounts as they were held at cost (classified as "hold to maturity"). This is again an example of the build up of risk in a decade of free money and zero interest rates. We commented in the previous investment letter that the FTX fraud and the near collapse of the UK LDI pension schemes may have had more in common than would initially appear with excesses built up over the last decade. It is also quite remarkable that a highly-regulated institution was allowed to run such risk in an environment of rising interest rates.

Even if these bank collapses did not lead to much wider stress in the banking system, there will be significant consequences. The impact was immediate with a dramatic repricing of future interest rates in the US; from expectations of over four further rate hikes to reach over 5.7%, this reversed to rate cuts during 2023 and 2024, with the Fed funds rate being less than 4% at end-2023. This repricing was immediate and resulted in volatility in fixed income markets surpassing that during Covid and not seen since the Global Financial Crisis.

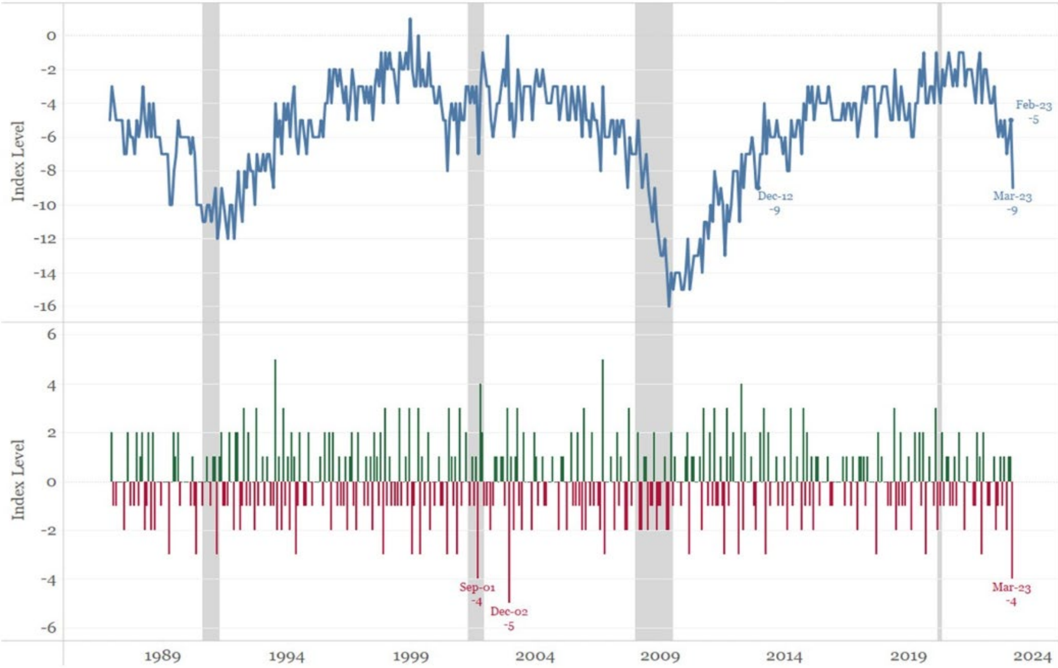
Implied Overnight Rate & Number of Hikes/Cuts[1]



[1] *Source: Bloomberg.*

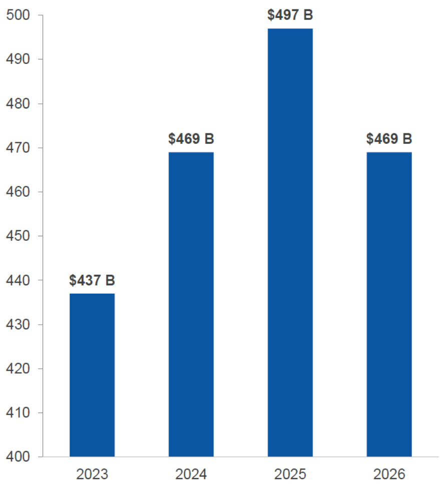
From systemic collapse of the US regional banking market, the debate has shifted to the scaling back of the activity on regional banks as they look to reduce risk and restore liquidity. At the very least, the provision of credit may be much reduced with a potentially very significant impact on the economy. The scale of this is unclear, but we are already seeing signs of this through surveys showing the availability of credit. Small businesses in particular will likely suffer, not having access to capital markets as larger companies do.

NFIB small business credit conditions availability of loans[1]



In particular, focus is on commercial real estate. The commercial real estate market has nearer term maturities than the corporate debt market, not being able to refinance its debt in the ultra-liquid environment of 2020 as corporates did. Fundamentally, there are real issues with occupancy rates much pressured with many firms continuing with a hybrid-working policy.

$1.8tn of CRE Debt Maturing over Next 4 Years[2]

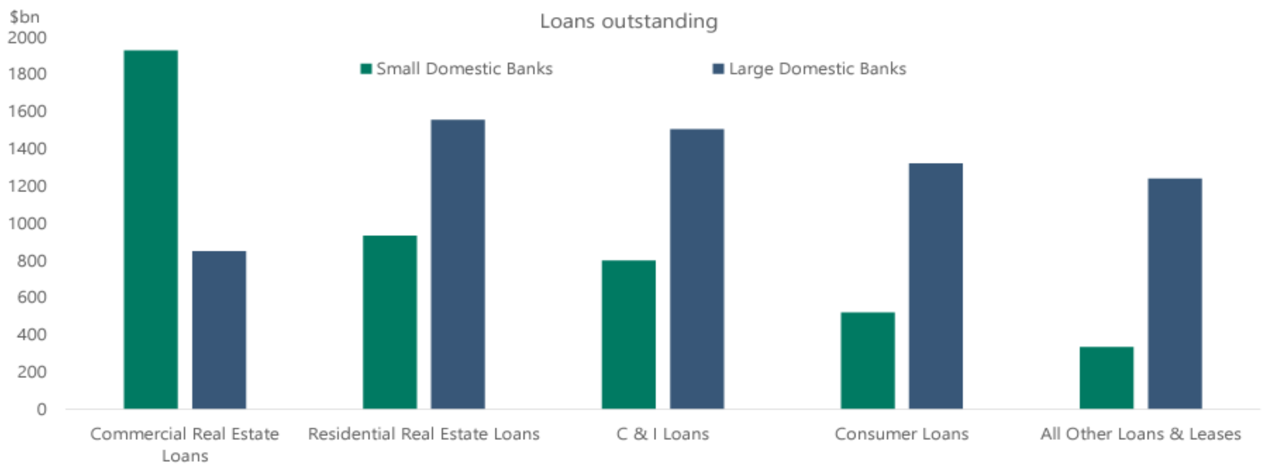


[1] *Source: National Federation of Independent Businesses, Bloomberg.*
[2] *Source: Trepp (www.trepp.com) as of 22 Dec 2021.*

New York City office use at 46% of capacity[1]

In addition, regional banks are proportionally larger in this market than others, a result of regulation which had lower capital requirements for regional banks lending to the commercial real estate market than for larger banks. The lack of provision of capital will likely mean further difficulty in refinancing capital structures beyond that of fundamental deterioration. Not only does this increase the risk of losses for the regional bank balance sheets but severe stress across the CRE area and losses for investors across the board.

High concentration of commercial real estate in small banks[2]
Average from Dec 2022 – Feb 2023



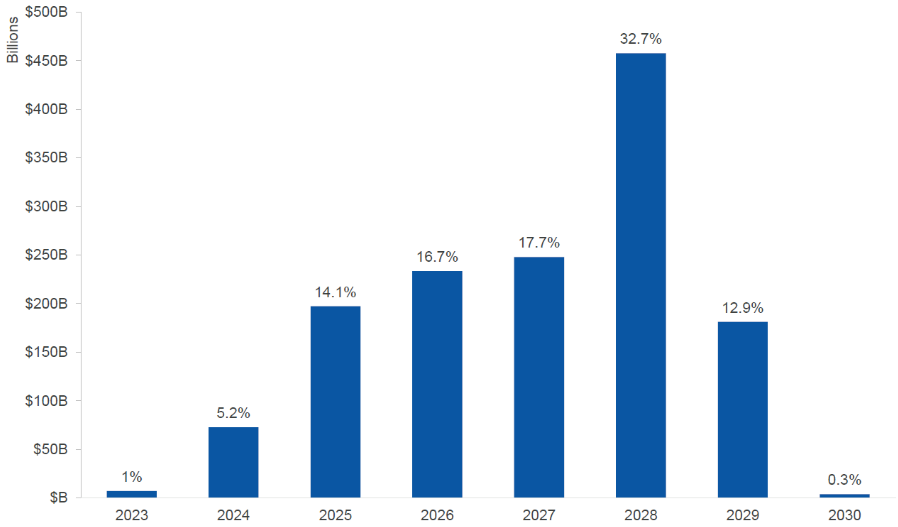
The scale is unknown but the chances of a credit-induced recession is now higher than it was. The risk of a decline in deposits from regional banks has turned into the risk of a decline in credit. Financial condition indices have shown a significant deterioration since the collapse of SVB, effectively a tightening of conditions without further rate rises. Defaults and bankruptcies remain low, but are rising. According to Moody's, the trailing 12-month global speculative-grade default rate finished the quarter at 2.9%, up 90bps versus last year. The total issuer default count of 33 during Q1 2023 was the highest quarterly total since Q4 2020, and March's

[1] *Source: Apollo Global Management.*
[2] *Source: Federal Reserve Board, Haver Analytics, Apollo Chief Economist*

default count of 15 was the highest monthly total in 2 years. Moody's expects the corporate default rate will rise to 4.9% over the next 12 months and we would add that many of our managers think it will be higher.

Many lower-rated corporates refinanced their debt following Covid, at very low interest rates. This will change. Refinancings begin to pick up in 2024/5 and companies will, at the very least, suffer greater interest rate costs and in some cases need to reduce leverage, which means to raise and dilute equity.

Increased amend & extend / refi activity expected[1]



Absent the events in the banking sector, economies have continued to perform relatively well. In particular, consumer spending has held up well. The most recent PMIs below[2] show healthy consumer levels, not consistent with a recession, and greater pressure in the manufacturing sector.

Composite PMIs	2022												2023		
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Global	51.1	53.5	52.8	51.3	51.3	53.5	50.8	49.3	49.6	49	48	48.2	49.7	52.1	53.4
Developed Markets	51.3	54.7	56	55.5	53.6	52.5	49	46.9	49.3	48.5	47.3	47.1	48.4	51.1	52.6
Emerging Markets	50.8	51.3	46.9	43.6	46.9	55.2	53.9	53.4	50.1	49.8	49	50	51.8	53.9	54.6

Manufacturing PMIs	2022												2023		
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Global	53.2	53.7	53	52.3	52.3	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6
Developed Markets	56.3	56.5	56.5	56.3	55	52.5	51.2	50.2	50.1	48.8	47.8	47.3	48.1	48.1	48.4
Emerging Markets	50	50.9	49.2	48.2	49.5	51.7	50.8	50.2	49.3	49.8	49.7	49.8	49.9	51.6	50.7

Services PMIs	2022												2023		
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Global	51	54	53.4	52.2	51.9	53.8	51	49.2	50	49.2	48	48.1	50	52.6	54.4
Developed Markets	50.8	55	56.5	55.9	53.9	53.1	49.1	46.7	49.6	48.8	47.5	47.2	48.6	51.8	53.4
Emerging Markets	51.5	51.6	46.2	43.8	47.3	55.5	55.4	54.9	50.6	49.9	49.2	50.1	53.1	54.5	56.7

[1] *Source: Leveraged Commentary & Data Comps (www.lcdcomps.com) as of 20 Jan 2023.*
[2] *Source: Bloomberg as of 31 Mar 2023.*

The current period is often compared with the 1970s. One major difference is that developed markets economies are now much more focused on consumer than manufacturing. Interest rate changes have a rapid impact on corporate activity; the cost of embarking on capital expenditure increases or decreases. The consumer is slightly different with less direct impact; many consumers had locked in mortgages (especially following the ultra-low rates seen before) and the impact has been even less with the high level of savings built up during Covid.

The rise in interest rates has led to significant stress in certain sectors of the economy, especially given the pace of the increases, a reflection of Central Banks being behind the curve in addressing inflation. The most immediate concern is with the US Commercial Real Estate market, with the near-term maturities, reliance on funding from regional banks, as well as the ongoing fundamental impairment in certain areas. However, there will likely be broader pain when corporates need to refinance.

Geopolitical risk remains elevated. The war in Ukraine continues with no clear prospect of a ceasefire, let alone a full resolution. Analogies continue with the 1970s with the Cold War between the US and the Soviet Union replaced by Cold War II between the US and China. Though there were proxy wars, the first Cold War did not result in direct conflict. We can only hope that the same holds true in Cold War II, though escalating rhetoric over Taiwan is the most obvious risk of spilling over. This is in addition to flashpoints in the Middle East. Prospects of reviving the nuclear deal with Iran appears over and the potential of an escalating conflict in that region has only risen.

Strategy Allocations

Performance was mixed in Q1 2023, coming off a strong 2022. Our less directional portfolios were slightly positive to slightly negative. This was driven by volatility in certain macro funds following the failure of SVB and subsequent extreme repricing of fixed income markets, as well as some losses from equity long/short. Relative value, credit and event strategies were all positive, as were the more directional equity managers.

We are positive on the outlook for our strategies. The investing environment is likely to continue to be volatile, which we think lends itself to trading strategies. As credit default risk rises with companies needing to refinance debt at higher rates, dispersion in the performance of individual credits, particularly at times of stress, should rise, lending itself to a long/short strategy. Relative value and event driven strategies should also prosper, with their investments being priced off a (higher) risk-free interest rate.

We are not making significant changes to portfolios. We remain opportunistic in taking advantage of capacity when it arises especially at times of stress; we did this in small size in April and we will continue to do so in the coming months.

Discretionary and Systematic Global Macro

Macro strategies detracted in Q1 after benefitting from clear trends in 2022. Relative value strategies remained profitable throughout the period despite a tricky trading environment. The main challenge so far this year has been the very rapid changing narrative which has prevented any major macro trends from developing. Up until March, US economic data had surprised to the upside with upward revision to the US inflation data. Fed Chair Powell subsequently opened the door in March to a re-acceleration in the pace of interest rate hikes, just 48 hours before the regional bank crisis involving SVB and causing immense volatility in the markets.

Discretionary macro contributed negatively during the quarter. The hawkish Fed rhetoric in March led to heavy positioning among the macro community for higher yields. Positioning dominated the price action, with moves in the short end of fixed income not seen since October 1987. Government bond markets went from pricing in rate hikes to discounting sizeable rate cuts in a few days. Some of our classic macro managers mainly lost from delta moves from their short Japan and US rates positioning. The largest detractor was a classic macro manager losing from both delta and vega moves in the short end of the US yield curve. Long convexity positioning across other asset classes, including FX and equities, did not help in March as volatility was concentrated in short-end rates. Asia macro managers with spread risk in rates partly offset the losses.

Relative value strategies held up well. Fixed income relative value trading was profitable as managers took advantage of increased volatility in US treasuries. It was also interesting that the volatility in rates did not cause a spill over into the bond basis relationships. One manager outperformed with gains coming from equity volatility trading.

Commodity strategies were negative with losses coming from both discretionary and quantitative strategies. Managers had built up directional long oil positioning based on tight fundamentals. These positions were impacted by the global de-risking in March with growing concerns on financial stability, but tight risk management helped to limit the losses. Our quantitative strategies also outperformed the broad CTA space which suffered from forced liquidations. One discretionary manager focused on trading natural gas was a net positive contributor in Q1 by cautiously sizing up the opportunity to short European gas late last year.

The market volatility in March has led many managers to reduce overall risk levels as they look to navigate the tensions between persistent inflation on the one hand and growing concerns of financial stability on the other. In the medium term, our managers believe the trading environment continues to offer rich opportunities with increasing two-way volatility in currencies, interest rates and commodities as there is greater uncertainty around the path of monetary policy and economic growth. Over the past few decades, we have historically seen that these moments of uncertainty and policy shifts often have provided for the best opportunities for macro hedge funds, and we remain confident in the ability of our managers to monetise these opportunities.

Equity Long/Short

Through Q1, Stenham's allocation to equity long/short managers delivered a roughly flat return in aggregate. Performance was somewhat muted relative to equity indices, most of which posted positive returns.

During 2022, we intentionally reduced our exposure to directional managers. This decision was driven by the observation that some of the key drivers of equity returns through the last cycle were potentially reversing. Among these were globalisation, as well as an environment of low inflation and interest rates, which had persisted since the Global Financial Crisis. As a result, Stenham came into the year with a greater allocation to less directional managers, who typically run with low net exposure. This made it challenging to capture the upside in equity markets during Q1.

The quarter was also marked by a clear outperformance of growth vs. value, and larger cap vs. smaller cap stocks. The Russell 1000 Growth outperformed the Russell 1000 Value by 13.7%. The S&P 500, a market-cap-weighted index with a natural skew towards large cap stocks, outperformed the S&P 500 Equal Weight by 4.6%. Our equity long/short managers have very little directional exposure to the growth and large cap factor, which made them a headwind during the period.

Perhaps unsurprisingly, two TMT equity long/short managers in which we remain invested were the top performers. Both managers benefitted from a resurgence in the performance of growth. Allocations to two generalist long-only managers also contributed positively. It was a particularly challenging start to the year for our healthcare allocation, particularly to those managers with noteworthy exposure to biotech. The collapse of SVB and concerns over a broader banking crisis meant that industries/businesses which are heavily reliant on a healthy funding environment were punished, biotech being one of these.

Healthcare remains an area we like and one in which we believe managers can deliver significant alpha. Within this space, our exposure is split across directional managers who typically focus on biotechnology, as well as managers with low net exposure who generally have a broader focus across the healthcare spectrum. In general, we continue to favour managers with specialist skills, many of whom run low net exposure and are capable of delivering positive returns regardless of the market environment. Outside of healthcare, we also have notable exposure to two specialists in the utilities and infrastructure space.

We continue to allocate to several multi-manager platform strategies which have demonstrated their ability to generate attractive returns with no correlation to equity markets. We are looking to increase our allocation to this strategy type during Q2, via one of the world's most well-renowned platform funds.

Event Driven

Our event driven allocation was positive in Q1, following a decent year in 2022. Key drivers to returns were the closure of a number of deals, including Shaw Communications, as well as positive news on anti-trust relating to the Microsoft/Activision deal (though the most recent information in April indicates this deal may not complete).

The quarter saw a lack of deal volume and the lowest level since 2010, if the start of 2020 and the Covid pandemic is excluded. This has resulted in our event driven funds being less invested. There have been some larger deals, particularly in the healthcare sector, but overall the higher interest rate environment, a lack of confidence in valuations and also private equity funds holding cash back in case they need to support existing investments, has resulted in a lack of deals. This can change quickly and we continue to like the strategy as merger spreads are priced off the risk-free rate, which is now much higher, but overall return expectations are moderate in the near term.

Credit

The credit allocation was strong in Q1, following a positive 2022, which we are pleased about. Our managers captured dispersion in the performance of individual credits and, importantly, traded successfully around the dislocations and disruption resulting from the failure of SVB and Credit Suisse. Opportunities from this type of event are diverse and funds look to take advantage in different ways; one fund provided liquidity to regional banks, secured at very attractive LTVs on portfolios of loans, another traded relative pricing both between banks but also within the capital structure given the uncertainty resulting from the treatment of hybrid capital securities, while more distressed and private credit managers are looking to benefit from the lack of competition in the provision of lending from, in particular, US regional banks, as well as potential sales of distressed assets and portfolios of assets.

We continued to be positive over the opportunity set for private credit funds. This encompasses distressed debt, as well as niche areas of direct lending and specialty finance. With the disruption in the US regional banking sector, competition for the provision of loans has fallen. Stress in the economy and greater distress will only increase these opportunities.

Summary

We are optimistic on the return potential of our portfolios. Our expected return is higher due to the increased risk. The ability to target these gains 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
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