Q2 2023 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q2	YTD
MSCI World (USD)	6.3%	14.0%
MSCI EM (USD)	-0.1%	3.5%
S&P 500	8.3%	15.9%
STOXX Europe 600 (USD)	1.3%	10.8%

Fixed Income	Q2	YTD
FTSE Global Bonds	-1.8%	1.7%
Investment Grade	-0.4%	4.0%
High Yield	1.2%	4.9%
Bloomberg Global Agg Bond	-1.5%	1.4%

Currencies	Q2	YTD
USD (DXY)	0.4%	-0.6%
EUR (vs USD)	0.5%	1.9%
JPY (vs USD)	-8.0%	-9.2%
GBP (vs USD)	3.0%	5.1%

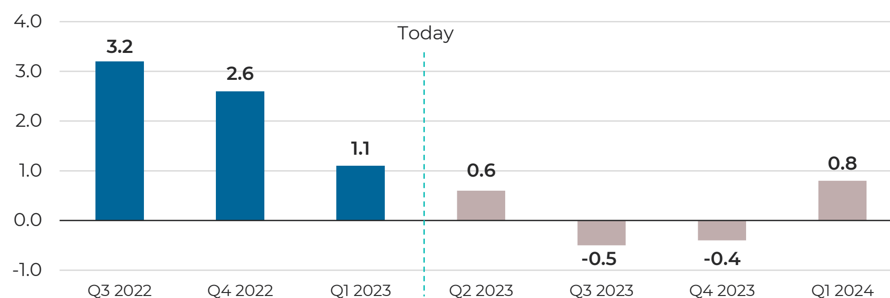
Commodities	Q2	YTD
Gold	-2.9%	5.3%
Oil (WTI)	-6.6%	-12.0%
Natural Gas	26.3%	-37.5%
Bloomberg Commodity	-3.8%	-10.0%

Source: Bloomberg as of 30 Jun 2023

Q2 2023 overall was a time when many investors pushed out forecasts of a recession until at least Q1 2024 and even a failed coup in Russia could not disrupt the markets optimistic feel. Focus was instead on micro developments, the most significant of which was the development of Artificial Intelligence (AI) with the launch of ChatGPT in particular. This led to some spectacular individual equity performance, the most notable being Nvidia which rose 52.3%, adding some $358bn to its market cap. Technology overall led performance with the Nasdaq Composite up 12.8% (31.7% YTD) posting its strongest H1 performance in 40 years. Equities were strongly positive with the S&P 500 up 8.3% (15.9% YTD). In fixed income, the High Yield (HY) was up 1.2% (4.9% YTD), and the Investment Grade (IG) was down 0.4% (4.0% YTD).

The debate over the direction of risk assets rests firmly on the potential for a recession, and whether it would be a soft or hard landing. Risk markets seem to be pricing in a soft landing. Consensus expectations are overall growth in 2024, albeit with 2 negative quarters, causing a technical recession, though a mild one, and a soft landing for the economy. There is historical precedence for soft landings, however hard landings are more common. The most recent data on inflation (US CPI annualised at 3.0%, MoM 0.2%) while the labour market has remained firm.

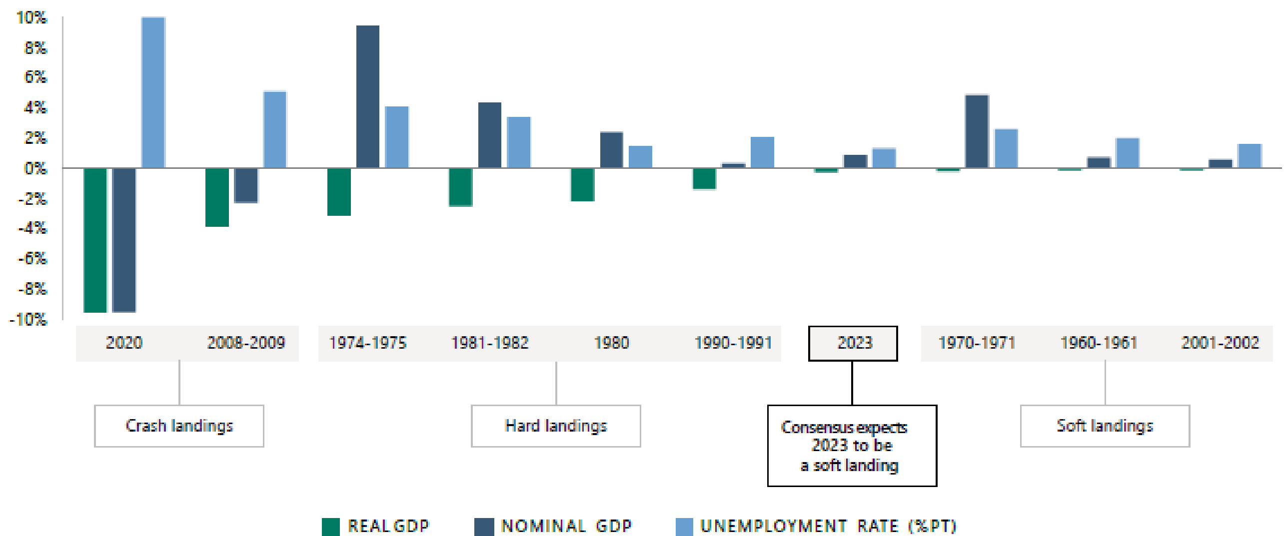
The consensus sees negative GDP growth in the US for the coming three quarters
Real GDP (% change QoQ, seasonally adjusted annual rate)[1]



[1] *Data as of 6 Jun 2023. Source: Bloomberg, Apollo Chief Economist.*

Expectations are for a soft landing... but a hard landing is still possible

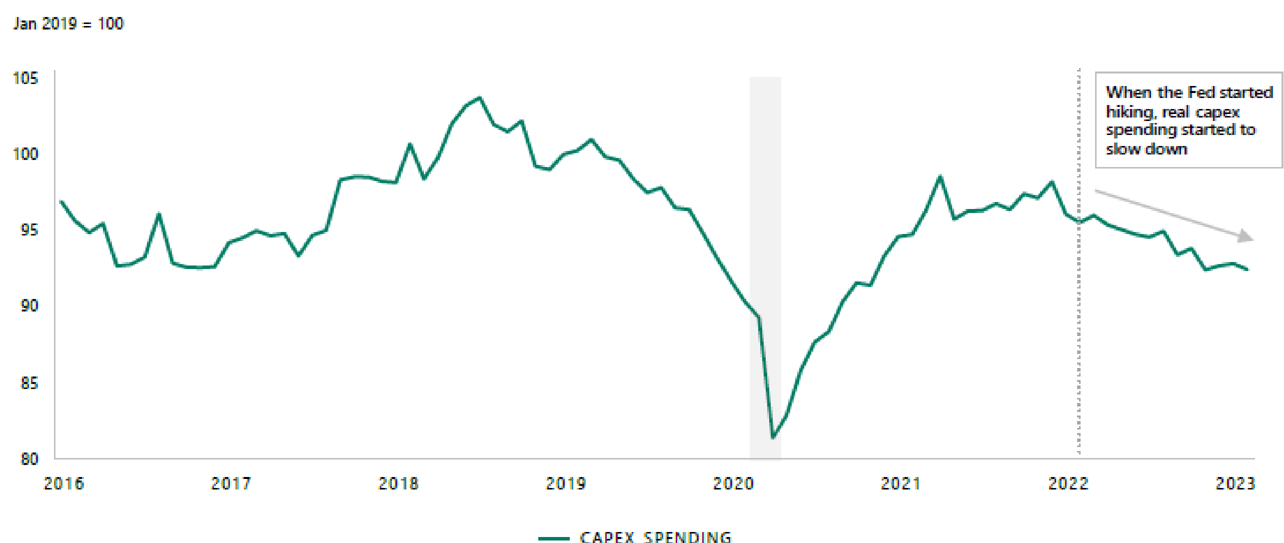
Change in GDP and unemployment rate during recessions[1]



The debate over a hard or soft landing depends primarily upon the direction of inflation and, with it, interest rates and what this means for the provision of credit within the economy.

It is easy to forget about the US regional banking turmoil in Q1, which saw three of the four largest bank failures in US history, not to mention the collapse of Credit Suisse in Europe. An argument in support of a hard landing is that the lagged effects of this banking turmoil are greater than the consensus thinks. Credit availability is becoming tighter; surveys show credit conditions becoming tighter and demand also lower, both for consumers and corporates.

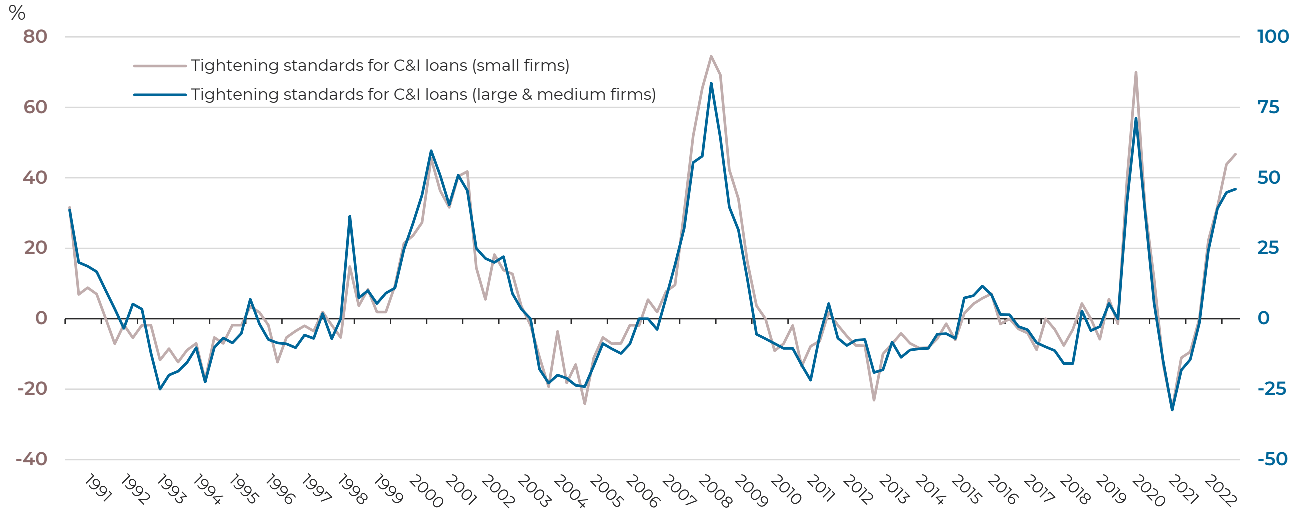
The lagged effects of Fed hikes combined with banking turmoil have tilted risks to the downside[2]



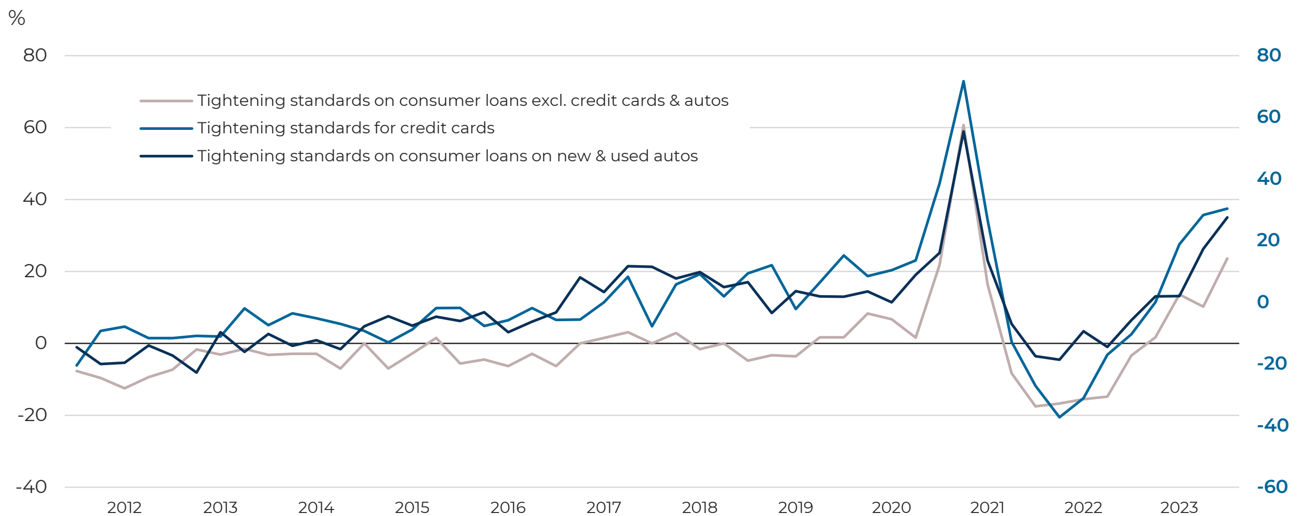
[1] *Data as of 5 Jun 2023. Source: BEA, Haver Analytics, Apollo Chief Economist. Estimates shown for real GDP and nominal GDP are for the period covering the peak-to-trough decline in real GDP. Unemployment rate is trough to peak.*

[2] *Data as of Apr 2023. Source: Census Bureau, Bloomberg, Apollo Chief Economist. Capex spending is real capital goods orders and non-defense ex-aircraft deflated by private capital equipment PPI.*

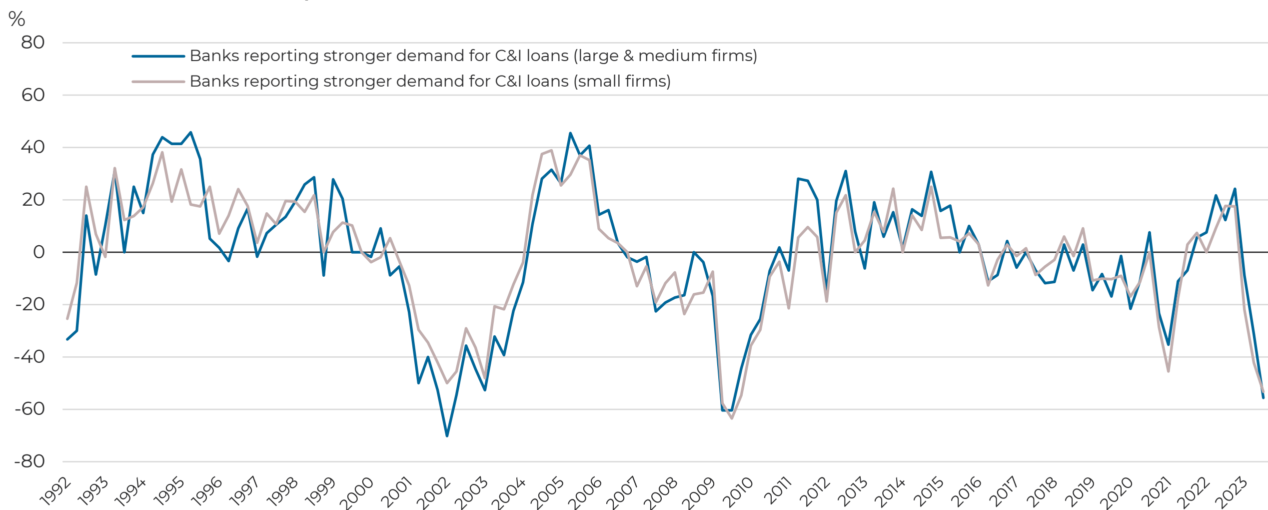
Banks are tightening lending standards significantly, for both commercial and industrial loans…[1]



…as well as consumer loans[1]



As a result, demand for corporate loans is at 2008 levels[1]



[1] *Data as of Q2 2023. Source: Federal Reserve Bureau (www.federalreserve.gov).*

Recent data has supported the argument towards a soft landing. Inflation has come in lower than expectations, while economic growth has remained positive. Although certain leading indicators have shown some weakness, overall data has come in better than expected. We believe that the rise in interest rates will have a lagged impact on the economy. One reason the increase in rates has not impacted the economy as quickly as in the 1970s is that the economic mix between manufacturing and services has changed from being 75:25 to 50:50 in most developed markets. With a rise in rates, corporates look to scale back capital expenditure quickly. Consumers are less responsive and this cycle may be even more extreme. This can be seen from the difference in performance of PMIs[1], where manufacturing has declined globally and firmly below 50 (the level which indicates expansion or contraction) while services have declined much less and remain robustly above 50.

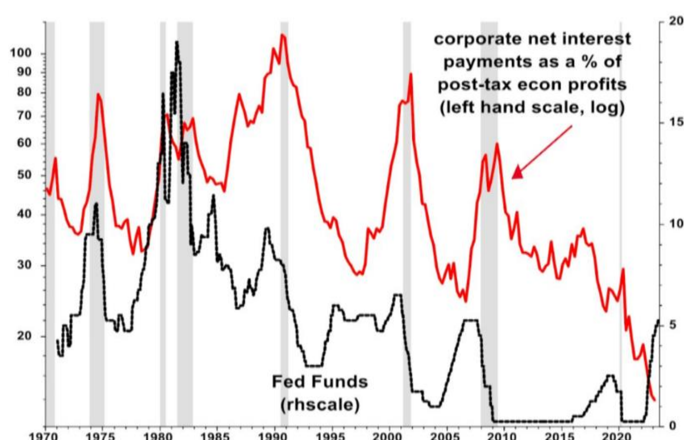
Composite PMIs	2022												2023					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Global	51.1	53.5	52.8	51.2	51.3	53.5	50.8	49.3	49.6	49.0	48.0	48.2	49.7	52.1	53.4	54.2	54.4	52.7
Developed Markets	51.3	54.7	55.9	55.4	53.7	52.5	49.0	46.9	49.3	48.5	47.3	47.1	48.5	51.1	52.6	53.7	53.7	52.2
Emerging Markets	50.8	51.3	46.9	43.5	46.9	55.2	53.9	53.4	50.1	49.8	49.0	50.0	51.9	53.9	54.6	54.9	55.6	53.6

Manufacturing PMIs	2022												2023					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Global	53.2	53.7	53.0	52.3	52.4	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	49.6	49.6	48.8
Developed Markets	56.3	56.5	56.5	56.3	55.0	52.5	51.2	50.2	50.1	48.8	47.8	47.3	48.1	48.1	48.4	48.5	47.6	46.3
Emerging Markets	50.0	50.9	49.2	48.1	49.5	51.7	50.8	50.2	49.3	49.8	49.7	49.8	49.9	51.6	50.7	50.5	51.4	51.1

Services PMIs	2022												2023					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Global	51.0	54.0	53.4	52.2	51.9	53.9	51.0	49.2	50.0	49.2	48.1	48.1	50.1	52.6	54.4	55.4	55.5	54.0
Developed Markets	50.8	55.0	56.5	55.8	53.9	53.1	49.1	46.7	49.6	48.8	47.5	47.2	48.7	51.8	53.4	54.6	54.9	53.6
Emerging Markets	51.5	51.6	46.3	43.7	47.2	55.5	55.4	54.9	50.6	49.9	49.2	50.1	53.1	54.5	56.7	57.3	56.7	54.7

Equally, the impact on corporates is different from what would be expected. Corporates locked in very low rates on their debt in the last 2 years and, in aggregate, net interest payments have declined as rates have risen as returns on assets (even just cash) have gone higher. According to Datastream this has added 5% to corporate profits for the last 12 months; this is very much against what has happened historically and the intended consequence of raising rates to cool inflation and the economy.

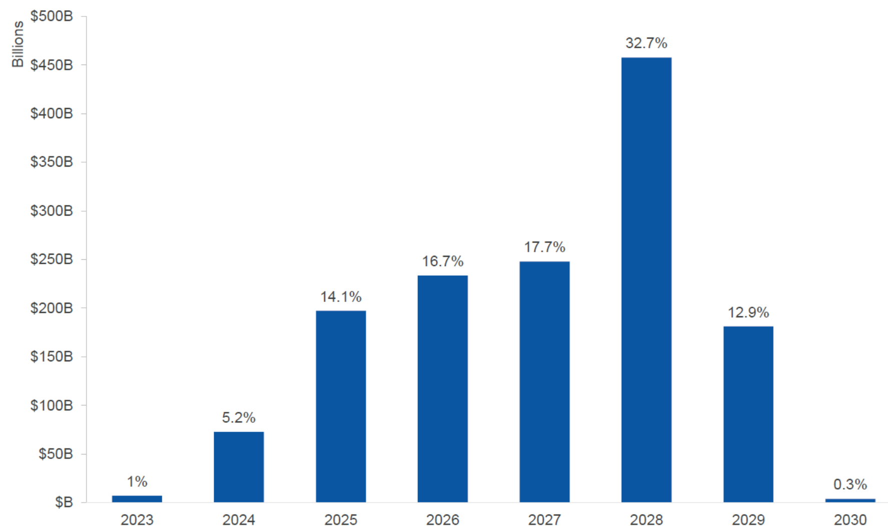
US non-financial corporate net interest costs (% post-tax profits) are the lowest in 60 years[2]



[1] *Source: Bloomberg.*
[2] *Source: Datastream.*

This will reverse as corporates refinance their debt, which happens over the coming 2 to 4 years.

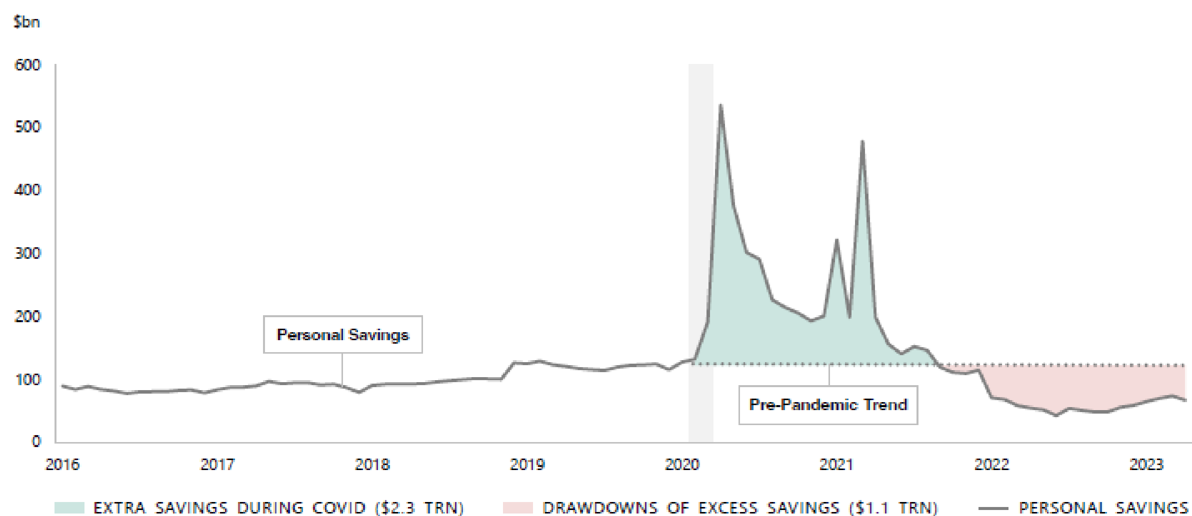
Increased amend & extend / refi activity expected[1]



Consumers have similarly been protected so far from the impact of rising rates. With the cash transfers received during the Covid pandemic, there were a lot of excess savings which consumers could use to offset any decline in net income arising from either lower-than-inflation pay increases or higher debt costs. Similar to corporates, a lot of consumers have locked in low rates so will only feel the pain when that debt comes due for refinance. This varies by country, but is perhaps most extreme in the US where a 25-year fixed rate mortgage is common. Given rates were so low just 18 months ago, many people are not impacted by the higher rates. Indeed, there is some analysis showing that the net cash increase from higher rates being received on savings is greater than the increased cost in mortgages. Eventually higher borrowing costs will come through, either from more borrowers refinancing or new buyers having no alternative but to borrow at these rates, but there is a lag.

There are some signs of stress emerging in consumer debt. Excess savings remain high, but have declined and, if conditions remain difficult, may be less of a factor during 2024.

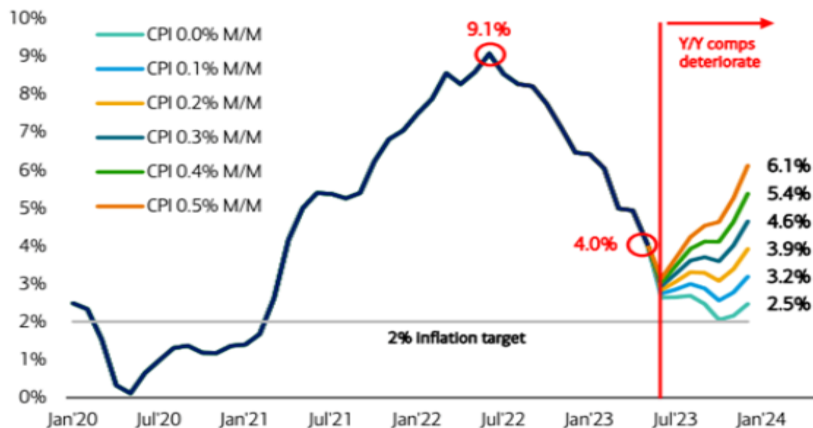
Consumer savings are dwindling after an exceptional rise during the Covid pandemic[2]



[1] *Source: Leveraged Commentary & Data Comps (www.lcdcomps.com) as of 20 Jan 2023.*
[2] *Data as of Apr 2023. Source: FRBSF, Bureau of Economic Analysis. Excess savings calculated as the accumulated difference in actual de-annualised personal savings and trend implied by data for the 48 months leading up to the first month of 2020 recession as defined by the NBER.*

A soft landing depends upon inflation remaining low and so interest rates being able to be cut in coming quarters. We are mindful that inflation in the 1970s came in waves. Just as current prices, such as in energy, are benefiting from comparison with the very high levels of a year ago (in the immediate aftermath of Russia's invasion of Ukraine), any prices in one year's time will be compared with what may be low prices.

Unless MoM CPI stays <0.2%, inflation heads higher by 2024[1]
US inflation assumptions



We did not anticipate the rally we have seen in risk assets for 2023. Despite that, we remain cautious and are not looking to add beta to our portfolios. Markets seem exhuberant, driven in Q2 at least in part by AI. We do not question the potential for AI to transform many industries and businesses, but the specifics are difficult to understand at this stage. One manager pointed out to us that, at their count, Booking.com was included in four AI-themed short baskets that sell-side banks were proposing, as well as in two AI-themed long baskets.

There are real risks, excluding just the (lagged) impact of rising rates. Regional banks have stabilised (the S&P Regional Banking Index is up 7% in Q2). However, these business models must still deal with higher deposit rates and questions over the quality of their loan portfolios, particularly in secularly challenged Commercial Real Estate (CRE), let alone how they may fare in a recession. There is instability overseas, from lacklustre growth in China to political instability in Russia. Economic pressure is rising. Corporates will have to refinance at higher rates, pressuring profitability. Retail sales are slowing, bank loan growth falling and delinquency rates are rising for credit cards and auto loans. Excess consumer savings from the Covid pandemic are declining and, for the poorest, potentially exhausted.

Given the impact of rising rates on both corporates and consumers, the reverse of the intuitive and historic effect, it does make sense that an economic downturn/recession has been, at the very least, delayed. However, there will likely be an impact from higher rates and we see a significant risk that rates will remain higher for longer than currently anticipated. We are also sceptical that all the risks and consequences of excessive risk taking from a decade of zero interest rates have played out. Defaults are already occurring frequently within CRE and we expect this to continue and broaden into the corporate sector in the coming quarters and years.

[1] *Source: BofA Global Investment Strategy, Bloomberg.*

Strategy Allocations

Performance was positive in the second quarter, following a slightly more mixed period in Q1, itself coming off a strong 2022. All sub-strategies were positive, with no real standout performance. 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, though we are looking at the margin to add some strategies where we feel the opportunity set is improving. This is primarily within credit-related strategies, though we are mindful of not taking embedded directional risk.

Discretionary and Systematic Global Macro

Discretionary macro strategies recovered well from the losses in March around the SVB fallout to post positive returns for Q2. There was increasing dispersion in manager performance. Our top performers included a classic thematic macro manager with a specialist focus in rates, who generated gains primarily from short positions in UK rates. We also saw strong performance from our Asia-focused macro managers. Not only did they sidestep the volatility in March, but they were able to capitalise on trading opportunities in both rates and currencies, with gains stemming from short positions in the Chinese yuan, tactical trading of the Japanese yen and net long bias to Asian rates versus US rates. Our main detractor was a classic thematic macro manager who remained defensively positioned in expectation of a US recession. This manager saw losses from long positions in rates and a short bias to equities.

Relative value strategies had a good quarter with all of our managers positive. The main source of returns was fixed income relative value. Increasing volatility in bond markets and higher level of rates has created more dislocations and opportunity. Our managers are watchful on potential crowding risks and have maintained leverage well below historical ranges.

There was mixed performance across quantitative strategies with May, in particular, a challenging month. We did see some recovery in June into quarter-end as short-term statistical arbitrage managers rebounded.

Commodity managers were slightly down with gains from a European gas specialist offset by losses from our oil traders.

Equity Long/Short

Our equity long/short allocation contributed positively to overall performance in Q2, a period that was marked by strong gains across most equity markets. The excitement surrounding the proliferation of AI was a major driver of gains, with investors bidding up the prices of any stock considered an AI beneficiary. Many of these were mega-cap tech names, which constitute a large part of most market cap weighted indices. This resulted in narrow market performance through the quarter, with a handful of stocks contributing an outsized amount to the return of most indices. There was also a significant outperformance of growth vs. value.

Over the course of 2022, we reduced our overall allocation to long-biased funds and, in particular, to those with a growth bias. Our remaining equity long/short exposure is mostly to niche managers, many of whom tend to run with low net exposure. Almost all our managers posted positive returns for the quarter, but given their more hedged approach, they did not capture the full extent of the move up in equities. One of our remaining TMT allocations is to a manager who invests in the semiconductor and broader tech hardware

space. This fund was well positioned to take advantage of the excitement surrounding AI, and has returned close to 30% on a YTD basis.

Healthcare remains a prominent theme across the Stenham portfolios, and all the healthcare funds to which we are allocated contributed positively to performance this quarter. Within healthcare, we remain particularly constructive on biotechnology. The sector is supported by several favourable trends, including ageing demographics, the rise of personalised medicine and the integration of technology in drug development. Successful investing in biotech also requires a highly specialised skill-set; something which we believe our managers possess. The return of M&A activity to the sector was a positive development, with several of our managers correctly positioned in takeover targets.

At the end of the quarter, we made full exits from several underperforming funds. A decent portion of this capital was redirected to one of the world's most highly respected platform funds, which has demonstrated an ability to post attractive returns with very little correlation to traditional asset classes.

Event Driven

Our event driven allocation was positive in Q2, following positive performance in 2022. Q2 was a very eventful period for merger arbitrage, in particular, with key large broadly-owned deals hitting regulatory difficulties. Microsoft's acquisition of Activision was blocked by the UK's Competition & Markets Authority (CMA) and the US's Federal Trade Commission (FTC) looked to block Amgen's acquisition of Horizon Therapeutics. This led to broad losses across the merger arbitrage peer group and an overall widening of spreads. Our managers avoided the scale of these losses with one not invested (they hold announced, friendly deals with limited regulatory risk) and others trading the situation aggressively. The widening in spreads has, we think, set up a very strong opportunity set with spreads based off the risk-free rate and now offering often low double-digit annualised returns for relatively safe deals. Deal activity has remained somewhat muted, but as capital markets start to reopen this may change. However, it should be noted that if one of the major deals is successfully blocked, it is likely that spreads across all deals may widen significantly.

Credit

The credit allocation continued to perform well, following a strong Q1, which is pleasing given in aggregate the allocation was also firmly positive in 2022. The managers are tilting marginally net long, though this is constrained. Gains have predominantly come from long positions, where convexity in returns is available for the first time in many years. In essence, low coupon bonds need to trade at a low $ price to enable a higher yield to maturity. Trading below par creates convexity should those bonds be refinanced, which involves them being called and holders being paid back par. This, as well as dislocations within financials following the regional banking crisis and failure of Credit Suisse in Q1, combined with some event driven situations where companies have looked to address issues within their capital structures, drove gains. There is also increased dispersion within credit, something which we expect to continue as companies come up against the need to refinance debt and the economic environment potentially proves more difficult.

We are excited by the opportunity in private credit. Both direct lending and distressed/special situations, such as bridge financing, companies needing financing at short notice, are benefiting from the same dynamics but in a different way. When companies come to refinance, they will need to do so at both lower leverage and higher rates. A typical IPO is being completed at, on average, a turn of leverage less than 12 months ago. Rates are materially higher. For direct lending, this results in i) higher returns (rates) but with ii) less risk (leverage). Combined with a lack of supply of credit, as seen through new issue volumes remaining depressed and CLO issuance very depressed, this sets up a very attractive opportunity set as lenders can select which companies to finance. It should be noted that higher interest costs and less leverage will, all else being equal, hurt returns earned by equity holders.

Distressed and special situation investing benefits from the same themes but in different ways. Not all companies will be able to operate at the higher interest costs, nor have the ability to delever the business, either through earnings or raising fresh equity. This will necessitate the need for some companies at least to look to restructure their balance sheets and businesses. In the immediate term, it may take the form of some type of bridge financing, being able to provide often short-term debt, top of the capital structure, to provide time for businesses to make a plan ahead of maturities coming due. Longer term, it could be a full restructuring of the balance sheet, carve out of certain assets or some other event. One thing we find particularly attractive in this coming cycle is that it is being caused by an increase in financing costs. There has not been a full distressed cycle since 2008/9, and the mini cycles since have been driven by specific economic downturns in sectors, such as energy and retail. To invest in those cycles, you had to make the decision to want to own a company in those sectors 2-3 years later. This time, companies across the industry will be impacted; it is just driven by the amount of leverage they hold and if they need to refinance in the coming years. The old mantra of "investing in a good business but with a bad balance sheet" looks likely.

Given the growth in size of credit markets since 2008, even a moderate pick-up in defaults could cause a material opportunity set, multiples in size of that in 2008/9.

Summary

We are optimistic on the opportunity set and return potential of our portfolios. Our expected return is higher due to the increased risk-free rate, which generally leads to a targeted return of high single digits. 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
Chief Investment Officer

Tim Beck
Senior Investment Executive

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