STENHAM
ASSET MANAGEMENT

# Q3 2024 Investment Letter

with Kevin Arenson, Akshay Krishnan & Tim Beck

## Market Commentary

| Equities | Q3 | YTD |
|---|---|---|
| MSCI World (USD) | 6.0% | 17.5% |
| MSCI EM (USD) | 7.8% | 14.4% |
| S&P 500 | 5.5% | 20.8% |
| STOXX Europe 600 (USD) | 6.4% | 10.0% |

| Fixed Income | Q3 | YTD |
|---|---|---|
| FTSE Global Bonds | 7.0% | 2.7% |
| Investment Grade | 6.6% | 5.3% |
| High Yield | 5.4% | 7.8% |
| Bloomberg Global Agg Bond | 7.0% | 3.6% |

| Currencies | Q3 | YTD |
|---|---|---|
| USD (DXY) | -4.8% | -0.5% |
| EUR (vs USD) | 4.0% | 0.8% |
| JPY (vs USD) | 12.4% | -1.6% |
| GBP (vs USD) | 6.0% | 5.0% |

| Commodities | Q3 | YTD |
|---|---|---|
| Gold | 13.3% | 27.7% |
| Oil (WTI) | -16.4% | -4.9% |
| Natural Gas | 12.4% | 16.3% |
| Bloomberg Commodity | -0.6% | 1.7% |

*Source: Bloomberg as of 30 Sep 2024*

Equity markets were volatile in Q3, though ultimately finished higher, driven by optimism over future cuts in interest rates and declining US recessionary concerns. The S&P 500 returned 5.5%, underperforming both small-cap indices as well as emerging markets, which were driven in particular by strong gains in Chinese markets. Bonds rose in Q3, leading to a positive return for the year, as expectations for cuts in interest rates rose, leading to the 2s10s curve to no longer be inverted. Corporate credit performed well, driven by lower-rated credits. 'CCC' rated credits returned 11.6% (15.3% YTD) whilst 'B' and 'BB' rated credit returned 4.5% and 4.3% respectively.

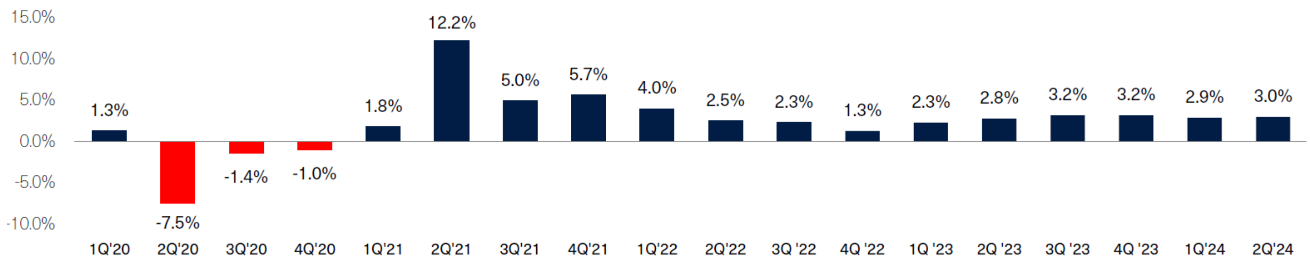
The most extreme market moves came at the end of the quarter in Chinese equities. These have been a real laggard in global markets with 3 years of double-digit declines in 2021-3. Following some weaker economic data, Chinese authorities announced stimulus packages with more expected. The MSCI China experienced its strongest 2 weeks on record, soon to be followed in October by the largest daily decline in 27 years.

Extreme moves were not limited to Chinese equities. The VIX (the 30-day expected volatility of the S&P 500) spiked very briefly following the Bank of Japan raising interest rates by 25bps, a seemingly very small move. This does show certain structures and common trades in place; one popular trade has been to exploit the interest rate differential between US and Japanese rates, borrowing in low interest JPY and investing in higher interest USD. The increase in interest rates by the BoJ, its first since 2007, forced an unwind of many of these trades, especially those run by quantitative machines.

Economic data varied during the quarter and helped drive markets, though overall allayed concerns over a US recession. The unwind from the JPY carry trade followed a disappointing July US jobs report (non-farm payrolls coming in at 114k against expectations of 175k), which led to a slight increase in the unemployment rate, raising concerns about a weaker US consumer. Concerns over a potential US recession rose, soon to be offset at least in part by strong retail sales. September again saw a weak jobs report, though the US Fed

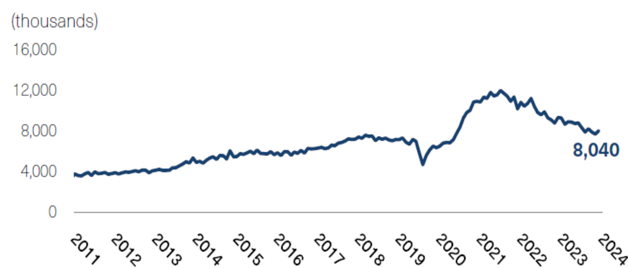
reducing rates helped offset these concerns. GDP growth has been strong, coming in at 3.0% for Q2 and the Atlanta Fed forecasting 3.3% for Q3.

### US real GDP: % change from the preceding year[1]

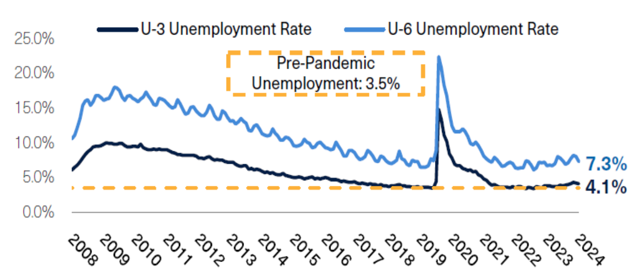



Somewhat disappointing employment data is reflected in a decline in job openings, but these remain well above pre-Covid levels, demonstrating continued tightness in the labour market. While the unemployment rate ticked up, it remains low despite high interest rates.

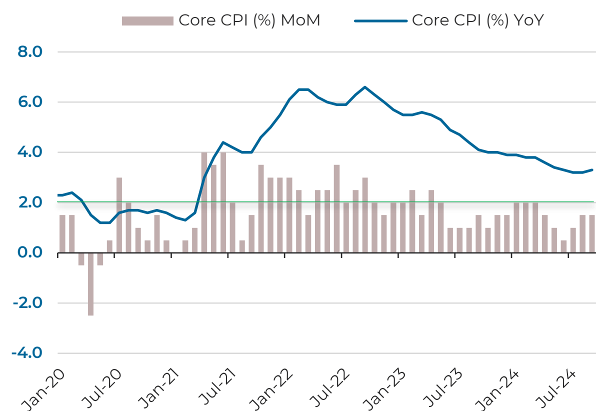
### US job openings[2]

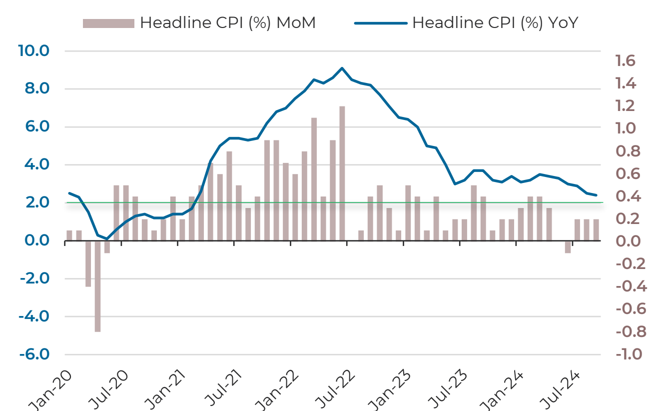



### US unemployment rate[1]




Interest rate expectations moved significantly in the quarter, driven by some weaker economic data but most importantly by comments from central banks with Fed Chair Powell saying in his Jackson Hole speech that "the time has come for policy to adjust." These expectations were then supported by cooling inflation data with US CPI reaching the lowest levels since March 2021, trending lower, though still above the 2% target, at 2.4% for the 12 months to September[1]. The US Fed cut interest rates by 50bps during its September meeting and indicated a further 50bps of cuts by year end.




[1] *Source: Bloomberg as of 30 Sep 2024.*
[2] *Source: Bloomberg as of 31 Aug 2024.*

Q4 will be dominated by the US election. Betting odds are increasingly favouring the re-election of Donald Trump, though with the election decided by a small number of swing States, and even counties within those States, it is hard to have any real conviction.

Geopolitical concerns remain at the fore, with high uncertainty and the potential for escalation. The Middle East conflict escalated during the quarter, with Israel launching attacks and a ground invasion into Lebanon, and the future path remains as ever uncertain. The conflict in Ukraine also continues, with heavy casualties, with Ukraine launching an offensive into Russia's Kursk border region in August. Both these conflicts could well see meaningful developments depending upon the result of the US election.

Our outlook remains consistent with prior quarters. We believe we are potentially seeing too much exuberance in markets given the risks and uncertainty that exists. Equities are at record highs and credit trading tight; 'BB' credits are trading in the 3rd percentile. Interest rate expectations are likely to continue to fluctuate, demonstrating far greater volatility and uncertainty than in the previous decade. Markets do seem to be able to ignore all but the most extreme events; witness the impact of 2 significant regional conflicts with the potential for escalation. Equally, the US presidential election does not seem to have a material impact either. Markets have been very robust since 2020, but we believe we are seeing potentially too much complacency in risk pricing.

# Strategy Allocations

We maintain limited directionality across our core portfolios. We feel this is the best way to navigate an uncertain environment. Our portfolios are designed and aiming to deliver high single-digit annualised returns in this environment with limited equity, credit or fixed income beta, which we feel is a compelling offering. We have been successful in, and continue to work hard at, securing access with the highest-quality managers, especially where capacity is constrained; this can be in new launches or with established managers.

### Discretionary and Systematic Global Macro

Across our broad suite of uncorrelated strategies, discretionary global macro, relative value and statistical arbitrage strategies outperformed during the quarter. Smaller allocations to commodity strategies and long volatility tail risk strategies were a slight detractor.

Discretionary macro managers benefitted primarily from interest rate trading. Curve steepeners, which have been a long-held view, finally played out. Gains came from steepeners in US dollar rates. Long positions in European fixed income and trading of spreads, where funds were positioned short France and long other European government bonds, were also profitable. A short bias to Japanese fixed income remains a popular theme and this worked particularly well earlier in the quarter. In terms of currencies, managers saw some negative performance from a short position in the Chinese yuan. Long positions in gold were profitable and there were no notable exposures to equity markets.

Relative value managers benefitted from an improving opportunity set for fixed income bond basis strategies. After a muted first half of the year, returns picked up from US dollar bond basis. Our managers continue to like the opportunity set for fixed income relative value in the US and Japan, but are wary of mounting event risks and tended to reduce leverage towards the end of the quarter. One of our managers struggled from relative value strategies in equity derivatives, particularly in early August, but they have bounced back more recently.

Our exposure to tail risk hedging strategies was negative as long-dated interest rate volatility and shorts in credit detracted, partially offset by an uptick in equity and currency volatility.

Our managers in the uncorrelated trading space are excited about the opportunity set ahead. There is an increasing focus on monetary policy divergence across the major global central banks, with Japan looking to continue hiking rates while other central banks continue to cut rates. Questions remain around both the magnitude and speed of rate cuts in the US, Europe and the UK which will create trading opportunities. Politics also promises to be a source of volatility with continued tensions in the Middle East and the upcoming US presidential elections. The market volatility in early August showed us some sense of the fragilities under the surface. Our managers continue to focus on staying nimble, adding hedges and maintaining long convexity exposure where possible.

## Equity Long/Short

Stenham's allocation to equity long/short and equity long-only managers contributed positively to returns across our portfolios in the third quarter. Equity managers generally produced positive returns regardless of their net exposure or strategy focus.

Among the top contributors was a top-tier global multi-manager platform. In line with its all-weather mandate, the fund has generated positive returns every month this year. Two of our core allocations are specialist low-net equity long/short managers focused on the utilities sector, one with a European bias and the other with more of a North American focus. The utilities space has garnered a lot of attention recently, with investors digesting the potential impact of AI-driven electricity demand growth and grid electrification. The sector is highly complex, and given the influx of capital into the space, both managers have highlighted the opportunity set for specialists as being compelling, both long and short.

Our healthcare/biotech-focused managers have navigated a challenging environment over the past few years. Several of them have pointed to what feels like some kind of normalisation, where fundamentals are once again dictating market moves.

One of the only detractors from performance was a Japan-focused multi-manager platform, which was marginally negative for the quarter. The fund struggled in August when Japanese markets experienced a severe pullback, which included the worst one-day selloff in the Nikkei 225 since Black Monday in 1987.

While our larger equity long/short allocations have, in recent years, leaned towards less directional strategies, we are looking to invest in a well-regarded, slightly longer-biased global long/short fund. This fund has been closed to new investors for several years but has recently offered us capacity.

## Event Driven

Our event driven allocation was positive in Q3. As would be expected, our lower-risk manager generated stable returns and now has achieved over 24 months of positive monthly performance. This manager has steadily increased the level of exposure during the quarter, which should benefit future performance. Importantly, more opportunities have been found in fixed income securities than in prior quarters as companies with debt (which would need refinancing) became incrementally more acceptable to being purchased. Our higher-risk manager saw more volatile, though still positive, performance as spreads moved on news surrounding large deals such as Nippon Steel's offer for US Steel. Soft catalyst positions, though small in aggregate size, detracted from performance.

### Credit

Our credit allocation also performed well. The quarter began with significant dispersion within credit; while higher-rated credit was trading at very tight spreads, lower rated 'CCC' credits were significantly wider. This corrected in Q3 and our managers profited from this trend, generally being long lower-rated credit against shorts in tighter spread names. Our managers have continued to reduce overall net and directional exposure, with a focus on event driven trades; typically companies which need to refinance in a short time frame. Our convertible bond manager performed well and continues to find strong opportunities through new issuance and refinancings, where we see increasing activity given the lower spread on convertible bonds compared with straight debt.

## Summary

We are very positive on the opportunity set and return potential of our portfolios. Our core portfolios are taking limited beta to broad markets and we believe the return potential of high single digits with limited downside and low sensitivity with broader markets (be they equity, credit or fixed income) is very attractive given the uncertainty and risks in the world.

We are pleased to announce the launch of two funds on 1 October:

1. **Stenham Credit Income Fund** invests in semi-liquid private credit funds; the underlying assets are in new origination, typically 1st lien senior secured debt to corporates originated by pre-eminent private credit firms. We see a strong case for the continued growth in private credit and this vehicle provides very attractive prospective returns (9-11%) relative to the risk being taken. The fund offers monthly subscriptions, full investment from Day 1, optional monthly income distributions, and quarterly redemptions subject to a 5% fund level gate.
2. **Stenham Tail Risk Solutions** provides exposure to a small number of tail risk solution funds, designed to provide significant performance at times of market stress. Given low absolute levels of volatility and historic tights in credit spreads, we see this as a strong complement to portfolios.

To learn more about these offerings, please contact your usual Stenham representative.

Thank you for your ongoing confidence. Please get in touch if you would like to hear more about our other strategies or funds as well.

**The Executive Advisory Committee**

**Kevin Arenson**

**Akshay Krishnan**

**Tim Beck**

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