Stenham Quarter 1 2018 Report

April 2018




Market Data for Q1 2018

Equities	Q1 2018
MSCI World (local)	-2.67%
MSCI EM (local)	0.37%
S&P 500	-1.22%
Eurostoxx 600	-4.70%

Fixed Income	Q1 2018
FTSE World Govt Bonds	0.28%
Investment Grade	-2.92%
High Yield	-1.04%
Barclays Global Agg	1.36%

Currencies	Q1 2018
USD (DXY)	-2.33%
EUR (vs USD)	2.54%
JPY (vs USD)	6.01%
GBP (vs USD)	3.77%

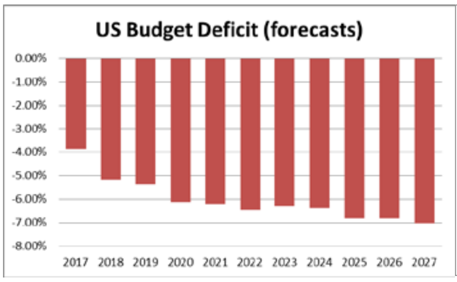
Commodities	Q1 2018
Gold	1.61%
Oil ('WTI')	7.48%
Natural Gas	-7.45%
Bloomberg Commodity Index	-0.79%

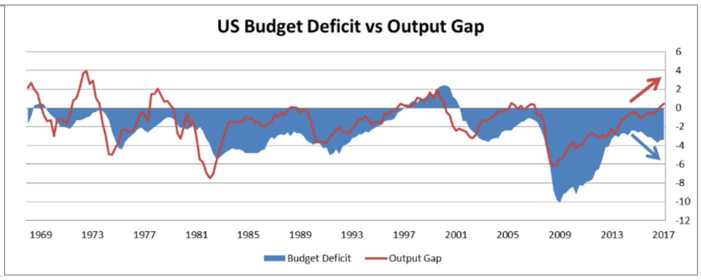
Source: Bloomberg, Stenham

The first quarter of 2018 saw a significant pick-up in volatility both in its own right and certainly relative to the calm seen in 2017. January began very strongly for markets; S&P500 had its strongest start to the year since 1997 (+5.7%), as the themes present in 2017 of strong economic growth, moderate inflation and accommodative central banks continued to drive markets. However significant volatility ensued, initially on inflationary fears as job data in the US continued to be strong, then also with strong fiscal stimulus from the Trump tax plan. Later in the quarter, volatility was centred around different concerns, most notably the potential escalation of a trade war between the US and China (with the impact on economic growth). Increased levels of regulation on technology firms following Trump's tweets on Amazon shipping costs and then, more significantly, breaches of data privacy by Facebook also added to volatility. The VIX hit an intra-day high of 50.3 and remained elevated for the remainder of the quarter. The change in regime can be illustrated by the volatility of volatility index ('VVIX') reaching an all-time high, surpassing levels seen during the financial crisis. Ultimately there was a material sell-off in equities and most developed markets were negative for the quarter; MSCI World returned -1.7%, S&P500 -1.2% and Eurostoxx 600 -4.7%, whilst emerging markets fared slightly better (MSCI EM +0.4%). Government bonds saw losses as interest rates rose most clearly in the US though all developed markets were impacted; US 10yr increased by 33bps to 2.74% whilst the German 10yr rose by 7bps to 0.49%. The more rate sensitive investment grade market (iBoxx IG -3.0%) performed more poorly than high yield (iBoxx HY -1.0%) though both were negative. Currency markets saw continued weakness of the USD (DXY -2.3%).

The key risk to markets remains inflation and the potential rise in interest rates to counteract inflation, leading to a slow-down in the economy but also re-pricing of risk. The February monthly CPI increase of 0.5% in the US caught most unaware and led to high volatility in both bond and equity markets. The pace of increase of inflation has since moderated but the direction is certainly upwards. Core CPI in the US is now above 2%. The Fed's preferred measure of PCE remains <2%, increasing modestly to 1.7% by end-Q1. We are not talking about hyper inflation or 1970s style high single digits, but just a normalisation which will lead central banks to exit their extreme policies.

Global growth generally remains robust and labour markets increasingly tight. The tax reform and fiscal spending package in the US also indicates a significant expansion in the fiscal deficit at a time of overall constrained excess capacity. This is somewhat counterintuitive and unprecedented. Increased fiscal spending typically and historically has occurred during and coming out of a recession, to increase demand as that of the private sector declines and reduce excess capacity, acting as something of a stabiliser on economic activity. This is the reverse with the real potential to cause accelerating inflation. The overall debt dynamics are also important. In a buoyant economy, the budget deficit is forecast to reach 7% GDP. One can only assume that this would be materially worse in the event of a recession or slow-down in economic activity.

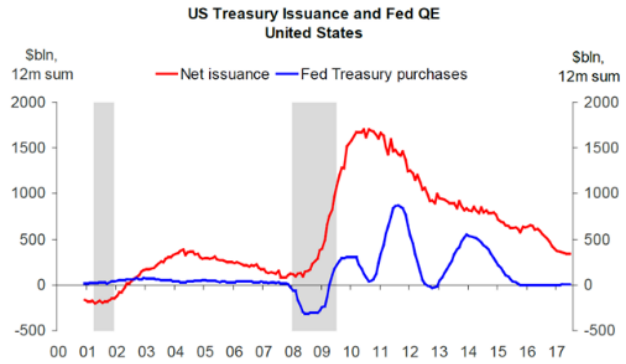


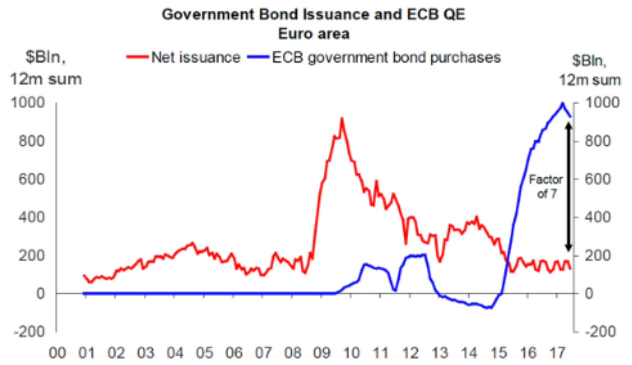


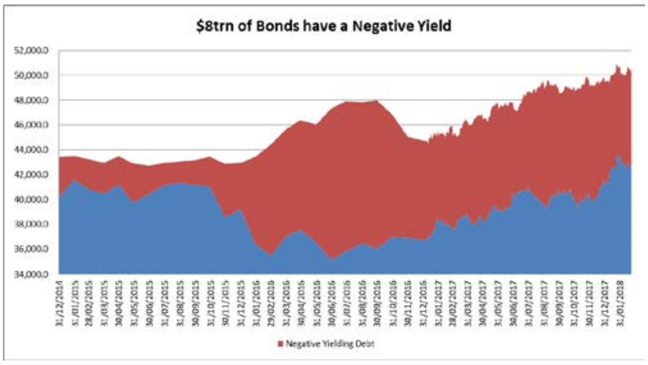
Source: Bloomberg, Stenham

The path of rate rises by central banks is key and if there is any deviation from the communicated policy of methodically raising rates to manage any acceleration in inflation beyond target levels, markets could be caught off guard. The new US Fed Chair Jay Powell has signified that he will broadly follow Janet Yellen's path for future rate increases. The last FOMC meeting (Powell's first) indicated a further 3 rate rises in 2018 and a steeper path to rate rises in 2019 and 2020, increasing the expected number of hikes in 2019 to 3 from 2. The market is broadly pricing in 2018 expectations, but very limited thereafter. Given there should be some risk premium priced in to an interest rate curve, it is difficult to say how much is actually priced in. This has been shown through a flattening of the yield curve during the first quarter, the 2/10 curve being the flattest since 2007. Whether this is due to investors really not believing the Fed given it has systematically overestimated the path of rate rises since the Financial crisis, due to an expected downturn in economic activity or due to more technical factors, such as the relative attractiveness of US treasuries as rates gradually rise above the S&P500 dividend yield and against still negative yielding European bonds, is unclear. If the former is true, other risks assets are probably overpriced and the US debt dynamics will come under greater scrutiny. If the latter is true, there is the potential for significant volatility as the ECB looks to exit its QE programme or should inflation take hold.

The Fed has exited QE and is in the process of reducing its balance sheet which is a huge change in policy and market dynamics. The ECB and BoJ are both still operating a QE programme though the ECB has announced its intention to wind its programme down by end-2018. The ECB's QE programme is vastly greater than that of the US Fed in relative size. This has led to distortions which are far greater. Negative yielding bonds (by definition, guaranteeing a negative loss if held to maturity) still represent an astonishing USD8trn or 18% of the total bond market. The exit of the US Fed has caused a significant pick-up in volatility and unveiled excessive risk which was being taken by market participants. There was a significant pick-up in equity market volatility during February resulting in short volatility funds being forced to close down after losing close to 100% of NAV and the Libor-OIS spread widened significantly. The exit of the ECB could be even more significant.







Source: Deutsche Bank, Bloomberg, Stenham

Outside of pure government bonds, we are concerned by the impact this could have on corporate balance sheets. Corporate leverage is high, higher than in 2007 and close to early 2000 levels when there were fewer issuers. Debt service levels in an environment of ultra-low interest rates has been easy. This will change as rates rise and supply increases as debt needs refinancing. There is the real potential for an increase in risk premia as investors look to price in an economic slowdown or recession over the next period of the debt (typically 5-7 years) and also the disruption in business models which has been pervasive across a growing number of industries.

One area which deserves attention is the oil price. Oil has risen significantly from its lows with WTI and Brent now trading at low 70s having risen 7.5% and 5.1% respectively during the quarter. In the same way as the fall in the price of oil meant an overall redistribution of income from producers to consumers and suppressed inflation (albeit transitory), the reverse is also the case. One impact will be on inflation, this is particularly acute in Europe where the ECB's mandate is to target headline inflation and any increase in inflation could force it to be more hawkish than would otherwise be the case. However, any significant spike will have a detrimental impact on consumer spending and so economic growth in any consumption based economy.

Whilst Germany formed a new grand coalition government between Merkel's CDU and the SDP, with the expectation that it would be more willing to work with Macron towards a closer union and looser fiscal framework in Europe, there was less stability in Italy. No one party won a majority in the Italian elections, but populist and Euro-sceptic parties of both the left and right significantly increased their vote at the expense of more status-quo parties and combined received over 50% of the vote. It is unclear who will be invited to lead the next government and whether they will be able to form a functioning coalition. Whilst opinion polls still show a majority of Italians in favour of the EU and Euro, the vote does show a clear dissatisfaction with current policy and in particular a desire for a reversal from fiscal austerity towards expansion. Whichever party assumes power may backtrack, much as Syriza did in Greece, but there is also the potential for policies contrary to current ECB rules and even for a dual currency or exiting the EUR, undermining the single currency. The EU's and ECB's reaction is key. Since the start of QE, the ECB has been the sole buyer of Italian government debt. If this is undermined, then markets are not prepared and the spread between Italian and German government debt has continued to tighten while equity and credit risk premia do not reflect this risk. It is true that there have been concerns over Italy in the past and a frequent comment is that investors will worry about Italian politics for their whole careers. This may well be true but could also signify complacency.

Ever since Trump was elected, there has been an increased focus on geopolitical risk. Tensions on the Korean peninsula appear to be abating whilst escalation of the conflict in Syria and sanctions with Russia are rising. Given their short-term nature, it is difficult to predict where these lead and what will come next. The potential for escalation into a trade war with China is more significant and could be an indication of future tensions between the two largest economies in the world. The US administration initially announced tariffs on steel and aluminium imports. This was followed by a 25% tariff on USD60bn of Chinese imports to which the Chinese announced increased tariffs on USD3bn worth of US imports. These tariffs represent 0.1% of Chinese GDP and much less for the US. Risks of an escalation exist but it is important to keep in proportion the current level of these measures.

Outlook

Q1 2018 saw equity markets as well as bonds fall in value. With the USD also declining, it was a difficult investment environment for many traditional investors, with few areas to hedge equity risk. Over the past 40 years interest rates have steadily declined, providing strong absolute returns for bond investors and especially so at times of stress for higher risk areas, primarily equity markets but also high yield credit. Given we see the greatest risk to markets and the economy to be an increase in interest rates, we think this will continue to be difficult for traditional investment strategies.

The exit from QE by the US Fed has changed the complexion of markets; volatility has increased and there have been some unintended consequences with for example short volatility funds being forced to close down after losing close to all of NAV. This is at a time when global QE is still positive. When the ECB exits its program other areas of excess may also be revealed.

We think it is a time to increase caution at the margin but to continue to take some risk. There are a number of attractive investment opportunities, but when investing investors must be mindful of asset prices, which at their best are at the high ends of historical levels, and the potential disruption due to the end of experimental monetary policy.

Strategy Allocations

We continue to see limited turnover within funds, at the margin we have increased exposure to specialist long/short equity funds as some funds which were previously closed allowed us to allocate to replace redemptions.

Discretionary and Systematic Global Macro

It was a good quarter for our macro strategy. Discretionary macro managers were positive, benefiting from short positions in fixed income as well as tactically trading equities well, reducing exposure significantly after January. Importantly, there was limited negative attribution from managers and where there was it tended to come from a long USD position. The emerging markets managers had strong performance, benefiting from long positions in Brazilian and Puerto Rico bonds in particular.

Relative value fixed income managers performed well as the normalisation of bond basis trades in January. We continue to see opportunities in these strategies. The widening of the LIBOR-OIS spread presents opportunities and our managers are seeing increasing opportunities in the US. This is a reverse from the trends seen in the prior 2 years and most likely reflects the exit from QE of the US Fed and the rise in interest rates. Quant equity strategies struggled slightly at the start of the quarter with the levels of inflows driving markets higher but systems worked much better towards the end of the quarter and performance improved.

Equity Long/Short

Our long/short managers generated positive performance in Q1. Whilst longs outperformed the general market, shorts also did well and typically fell by more than the market. This is an encouraging sign and one which we think will continue. During the very strong equity markets of the last few years, shorts have been a significant drag on performance and have even risen more than markets as interest rates have remained so low, aiding levered companies which many were short. This is changing and both longs and shorts look attractive with the opportunity set seemingly more balanced between the two than it has been for a number of years. There are a number of businesses, for example in retail and consumer packaged goods, which are facing real structural challenges. Thus far these challenges don't appear to be widely reflected in valuations.

We have been increasing our allocation to healthcare during 2017 and this continued in Q1 2018. This is due to positive dynamics in the development of treatments made possible by the recent huge scientific breakthroughs, most clearly in the mapping of the human genome as:

- i) these developments are made by smaller, focused companies; and
- ii) larger companies look to leverage their infrastructure to benefit these new treatments and replace legacy ones as they either become obsolete or patents expire. M&A activity really picked up in Q1 with notable deals being Celgene acquiring Juno Therapeutics for $9bn, Sanofi acquiring Bioverativ for $11.6bn, and Novartis acquiring AveXis for $8.7bn. Potential pressures on drug pricing puts a limit on how much exposure we will have in portfolios to healthcare; whilst funds will look to hedge some of this risk, particularly going into the US mid-term elections.

Event Driven

Merger activity was very strong in Q1 with USD 1.61trn deals announced, up from USD1.36trn in Q4 2017. Despite this, it was a difficult quarter for merger arbitrage funds and our allocation was marginally positive. There were two main causes:

- i) the continued impact of the DoJ legal case looking to block the Time Warner/AT&T vertical merger, which would change precedent from the last 40 years; and
- ii) the trade war between the US and China which could make cross-border mergers more difficult to gain US/Chinese regulatory approval.

The latter was most evident in the Qualcomm/NXPI deal. By blocking Broadcom's bid for Qualcomm, the US authorities effectively made Qualcomm its 5G champion which then brought into question the likelihood of Chinese approval for Qualcomm's take-over of NXPI.

We have been positive on the outlook for merger activity and by consequence for merger arbitrage managers. However, the regulatory environment is clearly more complex. It is difficult to say the degree to which this is reflected in spread levels, but it does seem as though it is at least in part and many multi-strategy funds which we monitor continue to have a healthy allocation, which adds support to the thesis. We continue to like the potential for uncorrelated returns and the high deal volume does create opportunities.

Credit

The credit allocation had a strong quarter with gains across all strategies and managers. Within distressed debt, performance was driven by post re-org equities which went through a restructuring. Encouragingly, this included positions which were added during 2017 and Q1 2018, where the disruption of business models has enabled funds to add to positions. The volatility seen in broad credit and equity markets was not sufficient to derail the re-valuation of companies as events occurred. The default rate remains low, but that for smaller cap positions is greater than the whole, and that is where our funds are concentrating efforts.

Summary

We have high conviction in our funds and the outlook for the individual strategies. We believe that we have funds that are constructed to perform well in an ongoing, benign scenario but will also offer protection should that environment change. This is particularly important as we enter the change in dynamics of Quantitative Easing.

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 and the relevant Business Development contact details can also be found on our website:

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