STENHAM
ASSET MANAGEMENT

Quarter 1 2020 Report

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Market Data for Q1 2020

Equities	Q1 2020	2019
MSCI World (USD)	-21.44%	25.19%
MSCI EM (USD)	-23.87%	15.42%
S&P 500	-20.00%	28.88%
Eurostoxx 600 (USD)	-24.80%	20.76%

Fixed Income	Q1 2020	2019
FTSE Global Bonds	2.00%	5.90%
Investment Grade	-3.24%	17.27%
High Yield	-11.89%	14.65%
Barclays Global Agg	1.45%	6.84%

Currencies	Q1 2020	2019
USD (DXY)	2.76%	0.22%
EUR (vs USD)	-2.30%	-1.95%
JPY (vs USD)	0.75%	0.99%
GBP (vs USD)	-6.53%	4.09%

Commodities	Q1 2020	2019
Gold	4.89%	17.86%
Oil ('WTI')	-66.46%	34.46%
Natural Gas	-25.08%	-25.54%
Bloomberg Commodity Index	-23.53%	5.44%

Source: Bloomberg, Stenham

The first quarter of 2020 will forever be synonymous with the global coronavirus pandemic. In just four months, the spread of COVID-19 has claimed the lives of more than 200,000 people and decimated economies across the globe. The moves in March were unlike any many investors have seen in their careers. The pace of moves, outflows from funds and response from governments and central banks have been extreme and truly historic. Equity markets fell precipitously, though a rally late in the month provided some relief. Six trading days before the end of March, the S&P500 was down 28.7% for the quarter before improving to -20%, with a peak to trough fall of 36%. Credit markets were also badly hit; high yield and investment grade spreads widened out to levels only exceeded during the Global Financial Crisis (“GFC”). US investment grade experienced its worst ever month on record and US high yield its second worst. Certain parts of the structured credit market started to see forced liquidations from mortgage REITs and other levered investors. Commodity prices, other than gold, fell precipitously. Oil was front and centre of this, not just due to the economic slowdown, but also an oil price war between Russia and Saudi Arabia. Oil fell from $66 to a low of $19, a level not seen since 2001. Volatility measures hit levels not seen since 2008 and market circuit breakers were reached 4 times on the S&P500. In fact, the VIX (a measure of volatility of the S&P500) hit the highest level since the inception of the index in 1993, surpassing 2008 highs. The US Dollar benefited from safe haven status and rose 2.8%. Global bonds rallied with the yield on the US year treasury falling from 1.92% to 0.67%. Those bonds already trading at negative interest rates saw more muted gains and whilst lower on the quarter, yields on German 10yr bonds actually rose in March. Some peripheral European bonds (Italian, Spanish) actually saw a rise in yield as investors sought true safe havens.

With the spread of COVID-19 to much of Europe and the US, unprecedented measures were put in place to limit its spread and mitigate the impact on health services, severely curtailing individual freedom to go about everyday activities and businesses to operate anywhere close to normal, often enforcing closure. The economic impact has been swift and extreme. The world is facing the deepest and fastest economic downturn in history, including the Great Depression of the 1930s. If a depression is avoided, it will only be due to massive government stimulus. US GDP estimates fell from 1.5/1.6% for Q2 to a range of estimates from -16% to -30% within 3 weeks as the cost of the response to prevent the spread of COVID-19 took hold. This is a staggering number. In 2008, the largest quarterly decline in GDP was -2.8%.

The depth and length of the recession is unknown, but the severity is clear in some initial data. In 4 weeks, 22m jobs have been lost and this is only going to increase. PMIs in Europe have hit record lows, and by an order of magnitude, not just marginally worse. The latest Eurozone composite PMI is 13.5, for the US 27.4. For reference, anything below 50 indicates economic contraction and reached the mid-30s during the financial crisis. The world is facing vast unemployment rates (potentially 20% in the US, less in Europe given policies designed to keep employees with existing companies) and a significant economic decline. Companies may be managed to withstand a recession, but for many, especially those facing secular challenges to their business models as revenues decline close to zero, it will be a challenge.

As the market and economic impact has been swifter than ever before, so too has the response from authorities. Central banks (those with positive interest rates) have cut rates aggressively; the US Fed cut twice in March to bring rates down to

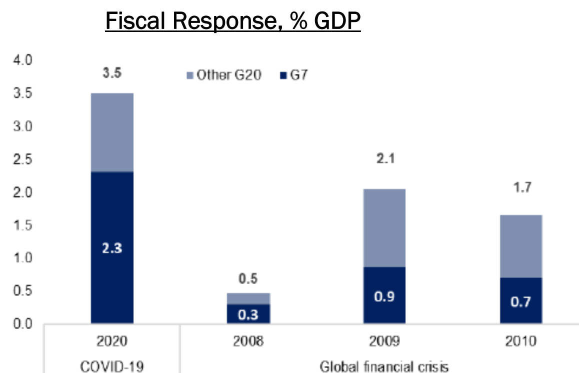
0-0.25% along with announcing unlimited Quantitative Easing ("QE"). The ECB followed suit with a USD1.1trn extension of its QE program. It would be difficult to overstate the level of intervention. The US Fed's balance sheet grew twice as much in 6 weeks in response to COVID-19 than in the first year of the Global Financial Crisis. At the peak of QE the US Fed bought USD120bn of Treasuries every month, today they are buying USD70bn each day. Never before has the US Fed's purchases exceed treasury net issuance, now it will be twice as large.

Source: Deutsche Bank

One of the concerns has been that, with monetary policy still at extreme levels (zero or negative interest rates, record holdings of securities on central bank balance sheets) 10 years on from the GFC, the scope central banks would have to counteract a renewed downturn would be limited and whether they should have normalised policy in the decade since the GFC. It has been shown that there is limited, or no, constraint on action they will take. Renewed QE will dwarf that already seen. For the first time, the US Fed will buy corporate bonds and has indicated it may also be prepared to buy high yield bonds, ones explicitly designed to reward investors for non-payment and default risk. The scale, pace and breadth of asset purchases from central banks exceeds what has ever been seen before.

Fiscal response has also been vast. The exact impact of this on government finances is unknown and dependent upon the length of the downturn, but involves huge fiscal transfers to the unemployed, or employers to keep employees in employment (such as the UK's furlough scheme). Fiscal deficits globally will likely be in the high single to low double digits for 2020; beyond that will depend upon the shape of the economic recovery and how long-lasting the fiscal stimulus will be, though these can be difficult to reduce once in place. The fiscal measures announced exceed those adopted during the GFC. Announced on-balance sheet measures (excluding contingent liabilities such as loan guarantees) are only just lower than those seen during the GFC. This is within a number of initial months and that number will only rise. Including "off balance-sheet" measures, the majority of the developed world has announced incremental spending of 10%+ GDP.

Fiscal Response, % GDP



Source: IMF

Government fiscal deficits will be huge with assistance measures designed to ameliorate the impact of the downturn, the scale of which is unknown. Government debt came into this crisis significantly higher than before 2008. Even if the deficits are not long-lived (which would necessitate a strong economic recovery), the absolute stock of government debt would increase significantly.

Debt % GDP

	2007 [1]	2017 [1]	2020e [2]
USA	60.8%	82.3%	**90.0%**
Germany	64.9%	64.1%	**68.3%**
France	68.1%	97.0%	**114.4%**
Italy	104.0%	131.5%	**157.0%**
Spain	36.2%	98.4%	**113.5%**

Source: [1] Central Intelligence Agency, [2] IMF

Heaving learnt lessons from 2008, authorities took swift action to stabilise and ensure the proper functioning of the financial system, through primarily the US treasury market and agency mortgages, but also different parts of the credit market, short-term credit facilities and commercial paper. Initially there was a spike in measures of financial stress and a decline in broad financial conditions, but the almost immediate measures put in place helped alleviate this. The action has worked to stabilise the system.

Source: Deutsche Bank

Whilst markets are functioning, there have been some extreme price moves. Most recently, the April WTI oil price contract fell to US$ -37 on the day before settlement. With a lack of storage, investors (or speculators) were willing to pay people to take the contract and take physical delivery of the oil. While we can explain what happened, the impact of seeing something which many would have thought well beyond the bounds of possibility, should not be ignored.

Longer-term consequences could be far-reaching. Government action has been swift and extensive and likely to successfully ameliorate at the least the worst case of the impact of this crisis, but the economic impact will still be substantial and long-lasting. Many companies will struggle to survive both in the short-term due to revenue pressures but also in the changed world coming out of this crisis. Many, particularly those in the technology sector, may well emerge

stronger. It is difficult to make strong assumptions outside of the most extreme examples when the timing and shape of any economic recovery is unknown.

Government measures have included aid to individuals and business (fiscal transfers as well as loan guarantees and provision), moratoriums on mortgage and loan payments (including formal and informal forbearance on debt and interest costs) and an increase in the provision of unemployment benefits. Some of these are relatively conventional, but many are not, with potential future consequences. What will happen to the provision of mortgages if there could be forced forbearance rendering valuation models somewhat redundant? Will repossession of properties be permitted? Corporate loan (or loan guarantees) will be given without consideration of the quality of the underlying business, necessary for the scale and speed with which these are required. However, this will lead to companies which maybe should go out of business and be replaced with more efficient ones being kept alive, so-called zombie companies, which would result in lower levels of economic productivity and so growth. Bailouts during the financial crisis were often discussed in the context of moral hazard and the incentives such action may provoke; there is no such debate currently.

Political changes may be more profound. What changes will occur in the political landscape in an environment of mass unemployment? Supply chains have been severely disrupted and there may be a move towards countries becoming more self-sufficient, at least in certain key industries and the protection of so-called "national champions". Before this crisis, populism was rising with a challenge to globalisation and these may be exacerbated. Government debt will increase significantly. Given the wealth inequalities which have occurred with the rise in asset prices since 2008, it seems unlikely that austerity-like policies which were adopted post-GFC to help mitigate fiscal deficits will be accepted in the same way. We suspect that there will be an acceptance of governments running higher fiscal deficits to finance spending in the longer-term.

Outlook

Comparisons with 2008/9 are inevitable given that is the most recent recession and the only one that many people actually experienced in a meaningful way. This crisis looks very different. The economic impact will be worse and more sudden than 2008. Equally, the response from authorities has been more extreme and quicker. What is of critical importance is that authorities are set to ensure the smooth functioning of the financial system; in 2008/9 there was a real fear that the banking sector would collapse. Now, there may be certain institutions which run into trouble, but the grave systemic risk of 2008 is not present.

Markets took six months to find a bottom during the GFC of 2008/9, reaching lows in March 2009. There is a strong argument that this time events will be quicker; the impact and response have both proven to be materially faster than then. But equally the impact and depth of this crisis is yet unknown. Many developed economies have yet to exit lock-down and, if they have, it has been partial. No-one knows if there will be subsequent lock-downs in response to any resurgence or second wave of infections, nor the timing of development and subsequent mass production of any vaccine. There are no guidelines or historical precedents to guide how to exit the current situation, which will vary significantly by locality.

The longer-term questions over the impact of this downturn are far-reaching. Many secular trends which were in force, such as e-commerce and virtual meetings, have been accelerated and are likely to continue to do so. Many companies, even those with quality underlying businesses, may not be able to survive in their current form through this shut-down. The level of government debt will escalate beyond what would have been contemplated possible 10 years ago. Interest rates

will likely be managed to be kept low to keep the cost of servicing the debt equally low. The appetite for any sort of austerity is likely to be very constrained and so to reduce the level of debt to the degree that is required, will likely necessitate nominal GDP growth to exceed the cost of the debt (and any ongoing deficit spending). There will be a push and pull of inflationary forces. Deflation is driven by the sharp fall in demand for products and services, continued (or even greater) technological progress and over-capacity in the provision of certain industries. The collapse in demand and over-capacity are shorter-term in nature. Inflationary pressures come from the disruption to supply chains (effectively reducing capacity for goods and services), the potential re-trenchment of economies away from globalisation and potentially from the huge fiscal and monetary expansion.

Strategy Allocations

In Q1, our portfolios protected capital and we are generally pleased with the way they performed. Some of the losses we did experience came from relative value strategies, due to technical selling pressures in certain assets and much is mark-to-market. We believe there to be short-term catalysts in place for substantial portions of those losses to come back in coming months, signs of this are already present through April. Some managers have disappointed against our expectations and we evaluate on a case-by-case basis the action to take and the time-frame over which to take it, but we are pleased that these are relatively few. Some high quality managers which have previously been closed to new investment are now looking to raise limited amounts of fresh capital in response to both an improved, broader opportunity set and/or to offset redemptions they are receiving, often due to stress at the underlying investor level. At the margin we are actively looking to upgrade portfolios through this period.

We hold long-volatility managers across a number of portfolios, designed to provide protection during periods of market stress. This worked well in Q1. We are taking profits on these and are looking at renewed ways of adding protection to portfolios, targeting managers which do not run with an explicit or structural short position but with a long volatility bias.

Many opportunities have presented themselves as a result the disruption seen in Q1. Equity markets have rallied back significantly but with strong differentiation between companies. Credit markets have rallied from the wides, but spreads remain at historically wide levels. Other dislocations are less directional and more relative value in nature, such as within government fixed income markets and merger arbitrage. We have not made significant immediate changes to our portfolios and our focus has been on the less directional opportunities initially. We will continue to monitor the more directional, structural opportunities (such as distressed debt) for appropriate portfolios.

Discretionary and Systematic Global Macro

It was a good quarter overall for our macro and relative value managers and our flagship macro fund, Stenham Trading, generated a positive return for Q1. There was notable divergence in performance. The strongest performers were managers who have strong derivatives expertise and trade with a long volatility bias. These managers used the benign environment at the end of last year and start of 2020 to build positions with good asymmetry, particularly in interest rates markets betting that rates in the US would approach the zero bound. Managers also had long volatility positions in credit indices and currencies, which paid off in late February and early March, often with very strong gains.

The main detractors were emerging markets macro managers who struggled in March as emerging markets saw bigger outflows than even during the peak of the financial crisis. Amongst our relative value managers the strongest performers were those who generally make a habit of carrying tail hedges. Despite losses in their core relative value trades, the gains

from tail hedges mitigated overall losses and most were positive for the quarter. One notable detractor was a multi-strategy relative value manager who saw losses from event, dividends and volatility strategies. This manager historically has preserved capital even in more volatile periods such as Q1 2016 or Q4 2018, which made the extent of losses surprising. Overall however, our macro and relative managers as a group performed better than expected for the quarter given the scale of market volatility and dislocations. Thus far in April, the very managers who protected capital well in Q1 have been able to generate positive returns despite the market rally. Our managers generally remain very constructive on the opportunity set, particularly from a tactical trading perspective.

Equity Long/Short

Our equity long/ short managers performed relatively well for the quarter with our equity long/ short fund of funds, Stenham Growth, being down 8.0% for the quarter as compared to the HFRI Equity Hedge Index which was down 12.9%. Notably our long/short allocations within our multi-strategy portfolios, where the holdings tend to be more conservative, were down closer to 5% for the quarter. It was pleasing to see that the lower net exposure managers in these portfolios all performed according to expectations, or better than expectations, in protecting capital. Importantly they have also captured a decent portion of the market rally in April.

Managers were helped by their overweight allocations to tech and healthcare, both of which outperformed for the quarter. There were also good returns on the short side, driven by a bias towards being net short cyclicals given the view (pre-Covid) that the economy was late cycle and that technological disruption was having an increasing impact on these sectors. A few of our managers were able to spot the risks emanating from the Covid-19 crisis relatively early and generate gains through longs in select tech and biopharma businesses and shorts in areas like travel and leisure.

Central to our long/short equity allocation has been investing in healthcare. This has been on the premise that healthcare is both defensive in a recession and offers strong long-term growth due to powerful structural trends such as the aging global population and exponentially increasing health science innovation. We have also noted that healthcare is one of the few sectors where specialist manager knowledge is essential and can generate outsized alpha.

Our healthcare managers performed relatively well for the quarter and, as noted above, the sector outperformed broader markets given its defensive attributes. We are, however, particularly excited by the outlook because healthcare looks unusually well positioned given the Covid-19 crisis. Specifically:

- Earnings for healthcare businesses should hold up much better than for other sectors during the recession;
- Healthcare entered this crisis trading at an unusually low relative valuation, the second cheapest sector in the S&P 500 after financials;
- US political developments in Q1 have been very positive for the sector with left wing Democrat candidates, Warren and Sanders, dropping out of the nominee race. Previously this was viewed as the main risk to the sector; and
- Lastly, and most importantly, we expect a real shift in perceptions as regards the value of the healthcare and particularly biopharmaceutical sector. Regulation has, for decades, been the main risk to the sector and that risk has been increasing due to populist politics and strongly negative public perception around the industry. With biotech and pharma businesses now being viewed as potential global saviours we think that you should see a real shift in perception around the value of having a strong biopharma industry.

Event Driven

Merger arbitrage spreads saw widening across the board through March as risk aversion set in. There was a fear of buyer remorse given the scale of the equity market declines and whether buyers would look for ways to exit deals. An additional concern was whether the spread of COVID-19 would trigger Material Adverse Event clauses within signed merger contracts. Many contracts explicitly ruled out the spread of health pandemics as a potential cause to break the contract. As this became clearer and buyers often issued statements confirming their intention to complete often strategic deals, spreads began to tighten but remained significantly wider than they began the month. Our managers experienced high single digit draw-downs but have so far in April made back at least half of that loss as spreads have begun to tighten.

Credit

The credit allocation suffered in Q1, seeing losses across both corporate and structured credit. Structured credit saw massive price declines and the market has seen technical declines driven by a lack of liquidity. The initial source of this came from forced selling of assets from levered holders of the assets. Some, including listed mortgage REITs, operated on short-term leverage facilities which were withdrawn as prices began to decline. This led to further selling by levered holders of structured credit who had to meet margin calls. Even those structures with better financing arrangements started hitting NAV decline triggers, which in turn added to financing pressure and more selling. Price moves were extreme across the capital structure, with senior parts of the capital structure widening significantly, not just more junior and riskier tranches. The sector remains under a lot of stress with the potential of more selling pressure as some of the worst performing managers face potential redemptions at the end of Q2.

Distressed corporate debt managers also found it a difficult environment and incurred double digit losses. As corporate credit and equities fell in value, long distressed positions came under pricing pressure. There were few fundamental issues with underlying companies and our managers had limited exposure to energy, a sector particularly hard hit. They maintain conviction in existing positions but are also very optimistic about opportunities in the coming months. As companies see stress in their underlying businesses and struggle to meet current liabilities, the opportunity set for rescue financing, direct lending and widespread corporate restructurings should be substantial and have the potential to produce excess returns.

Summary

As an organisation, our employees have been operating remotely at home for over a month. This has been working well and we have been making extensive use of technology to communicate both internally and with our clients and service providers. We speak regularly with underlying managers to firstly understand how they are positioned and see opportunities within markets, but also to learn and understand risks which could affect other investments we hold and our business as a whole. We encourage our clients to contact us to discuss any aspect of their portfolios or the investment landscape.

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:

www.stenhamassetmanagement.com

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