Q2 2021 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q2	YTD
MSCI World (USD)	7.3%	12.2%
MSCI EM (USD)	4.4%	6.5%
S&P 500	8.2%	14.4%
Eurostoxx 600 (USD)	6.3%	10.7%

Fixed Income	Q2	YTD
FTSE Global Bonds	1.0%	-4.8%
Investment Grade	4.1%	-1.6%
High Yield	2.3%	3.0%
Barclays Global Agg Bond	1.3%	-3.2%

Currencies	Q2	YTD
USD (DXY)	-0.9%	2.8%
EUR (vs USD)	0.8%	-3.1%
JPY (vs USD)	-0.4%	-7.3%
GBP (vs USD)	0.0%	0.9%

Commodities	Q2	YTD
Gold	3.5%	-6.4%
Oil (WTI)	21.9%	52.0%
Natural Gas	40.0%	44.8%
Bloomberg Commodity	13.3%	21.2%

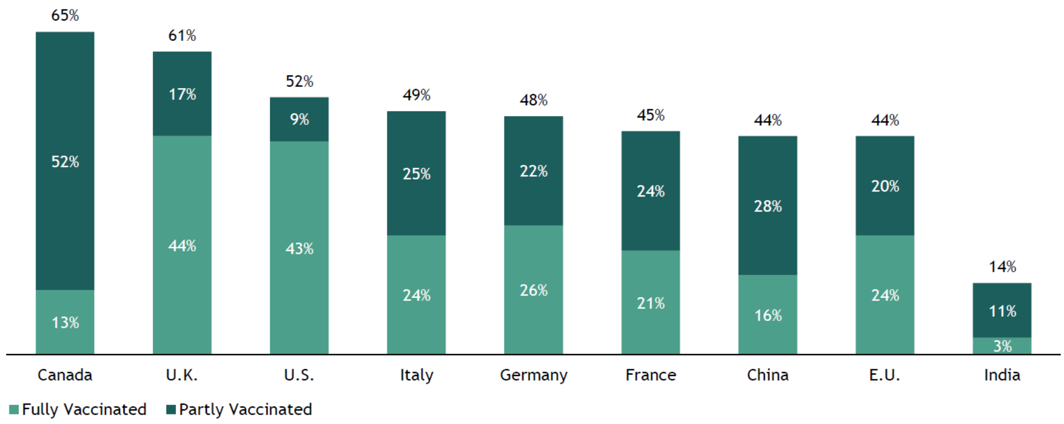
Source: Bloomberg as of 30 Jun 2021

Markets continued to rise in Q2, supported by the effect of additional fiscal stimulus (including the $1.9tn US Covid relief package) and optimism over a global economic recovery. Economic data and corporate earnings recovered strongly, driven by the reopening of economies as vaccinations accelerated in the US and Europe in particular, but also developing countries, albeit the latter was more patchy. There were bouts of volatility centred around concerns that structurally higher inflation could result from the unprecedented levels of monetary and fiscal stimulus injected globally, linked to a more hawkish tone from the US Federal Reserve suggesting interest rate increases could come sooner than previously expected. This then switched towards the end of June and into July, as volatility originated from the concern that the increase in cases of the Delta variant of Covid could constrain the opening up of economies and so growth.

Equities performed well. The MSCI World rose 7.3% bringing YTD to 12.2%, matched similarly by the S&P 500 rising 8.2% and ending the quarter at an all-time high. The rotation seen between growth and value stocks in Q1 somewhat reversed with S&P Growth outperforming S&P Value, rising +11.7% and +4.5% respectively. Earnings growth has been strong; 87% of S&P 500 companies beat earnings expectations for Q1, the highest level on record. Credit markets remained firm as investors continued to search for yield. The high yield bond market rose 2.3% with lower quality credit again leading the way; CCCs returned 4.1%. Yields on government debt fell particularly during the end of the quarter, with the US 10yr yielding 1.5% from 1.7% at the end of Q1 (and has fallen further to below 1.3% at the time of writing). Returns from fixed income remain negative for the year. Commodities have continued to perform strongly while gold increased moderately, but remains down for the year at -6.4%.

Vaccinations have continued to be rolled out, particularly in the developed world, allowing economies to open up most evidently in North America and Europe. The importance of the vaccination programme has been laid bare by new lockdowns both in emerging markets, as Covid-19 rates have risen, as well as in similarly unvaccinated populations in developed markets, such as Singapore and Australia.

Share of total population vaccinated against Covid-19
(select major economies)



Source: Our World in Data as of 15 Jun 2021

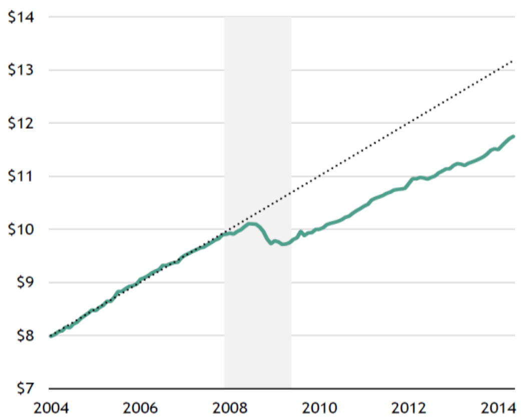
Economic growth and recovery from 2020 has continued. PMIs remain firmly in expansion territory, though they have levelled off somewhat in the regions which have grown and recovered first; Asian-led emerging markets and the US, emerging markets also impacted by the rise on cases of Covid-19 and renewed lockdowns.

Composite PMIs	2020												2021					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Global	52.2	46.1	39.2	26.2	36.3	47.9	51.1	52.5	52.5	53.3	53.1	52.7	52.3	53.2	54.8	56.7	58.5	56.6
Developed	52.1	49.5	36.4	22.2	33.1	46.9	51.1	52.2	51.9	52.7	52.2	52	52.4	53.9	55.9	58.2	61.2	59.3
Emerging	52.2	38.9	44.9	34.6	42.7	49.8	50.9	53	53.7	54.5	54.9	54.1	52.1	52	52.6	53.5	52.8	50.9

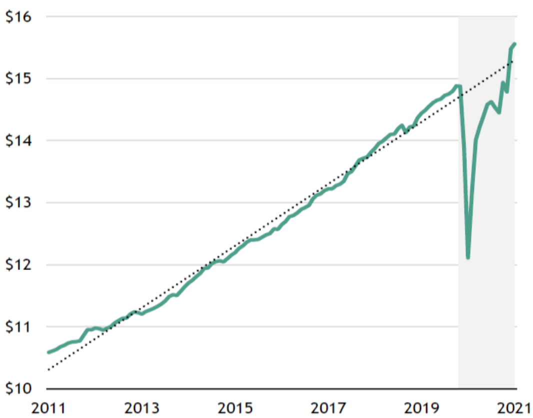
Source: Stenham, Bloomberg as of 30 Jun 2021

Other indicators are also encouraging. Consumer spending in the US has now exceeded pre-pandemic levels, a stark difference from prior recessions, such as in 2008/9, and undoubtedly a result of the unique nature of this recession and the huge level of fiscal stimulus leaving many consumers better off than before.

Personal consumption expenditures: global financial crisis
($tn, seasonally adjusted annual rate)



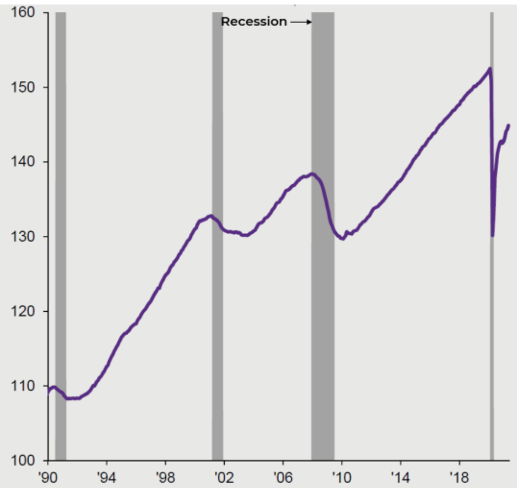
Personal consumption expenditures: Covid-19 crisis
($tn, seasonally adjusted annual rate)



Source: Bureau of Labour Statistics and Blackstone Investment Strategy as of 30 Apr 2021. Dotted lines represent the trend from the beginning of the time period shown until the beginning of the recession in question

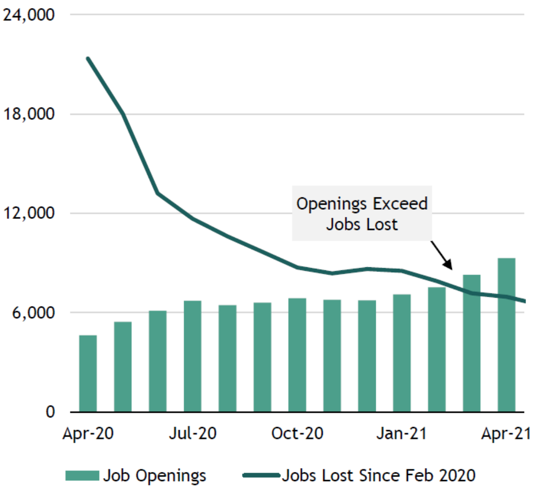
Employment growth remains strong in the US, with the unemployment rate continuing to fall to 5.9%. Employment does though remain well below pre-pandemic levels and wage growth has not accelerated as some had feared, despite evidence of an inability to fill job vacancies, employees voluntarily leaving jobs (a sign of a strong labour market) and some notable employers, such as MacDonald's and Amazon, raising minimum wages.

US non-farm payroll employment
(millions of people)

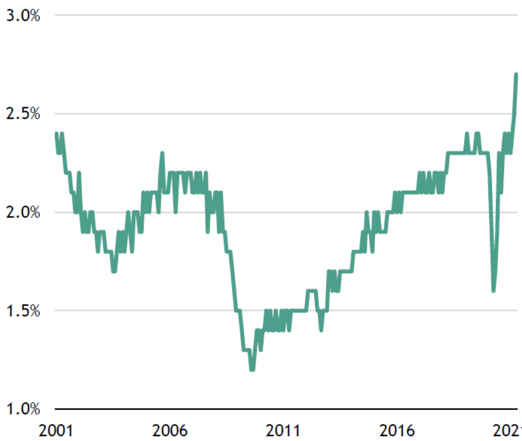


Source: BLS, Refinitiv Datastream, J.P. Morgan Asset Management as of 30 Jun 2021

Job openings vs. jobs lost since Feb 2020
(in thousands)



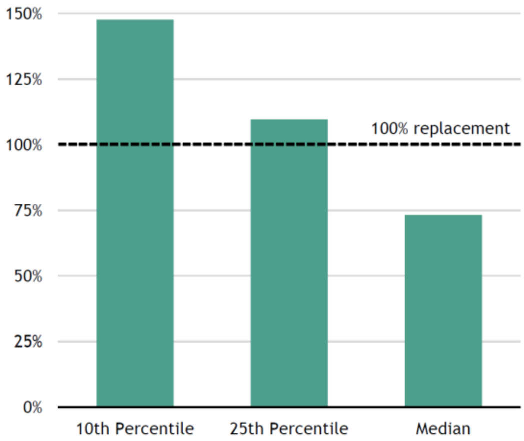
Rate of voluntary quits
(no. of quits / total employment + no. of quits)



Source: Bureau of Labour Statistics and Haver Analytics as of 30 Apr 2021

The explanation for the relatively high unemployment rate compared with other indicators of a strong labour market vary and seem to indicate some element of a jobs skills mismatch, as well as the lasting impact of very generous unemployment benefits, which exceeded prior wages for over 1 in 4 workers. These benefits roll off in September, and the true condition of the labour market may only be known then.

Income replacement from unemployment insurance benefits, incl. federal
(relative to 2019 usual weekly earnings, post-payroll tax)



Source: Blackstone Investment Strategy calculations, Department of Labour, Bureau of Labour Statistics, and Haver Analytics as of 30 Jun 2021

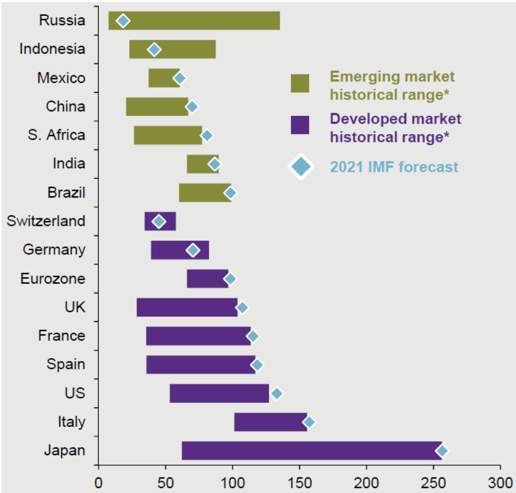
The key question for investors remained centred around inflation and the impact it could have on interest rates. US CPI data accelerated as expected and indeed exceeded consensus expectations in April, May and June, reaching the highest 12-month rate since August 2008. The debate is unchanged from Q1 and centres around whether the current increase reflects a structural increase in inflation or if it is just transitory, and a high level due to comparisons of price levels in 2020 when lock-downs were at full force in the developed world, as well as temporary supply side constraints as global manufacturing comes back on line and disruption continues to supply chains, but will ameliorate over the coming months. PMI data is clearly showing an increase in delivery days of products, inventories being at low levels and price rises.

The debate has merits on both sides and clarity may only be reached towards the end of the year at the earliest, with supply chain disruption from Covid-19 having the potential to prolong the debate. The argument for higher inflation being structural is based on the increase in wages seen across the labour market and the high, unprecedented levels of fiscal and monetary stimulus.

In the June meeting of the Federal Open Market Committee, the “dot plots”, which show the aggregate of all members of the FOMC’s view on the path of interest rates, rose moderately. This indicates a somewhat more hawkish tone from the Fed, but Fed Chair Jay Powell subsequently reinforced the view that the Fed saw price rises as transitory.

Certain asset prices appear priced for perfection. High yield credit ended the quarter with a yield-to-worst (YTW) of 3.8%, near its all-time low. The CCC-index had a YTD of 6.5%. The continued hunt for yield has been shown in a lack of dispersion in credit, which is much less than pre-pandemic levels. 18% of debt outstanding globally has a negative yield, 75% yields less than 2% and 86% less than 3%. Against this backdrop, high yield can look interesting because of a potential return as defaults remain low. However, it does seem to us that there is very little margin for safety within credit, even the riskiest areas. Within CCC rated credit, the lowest rating level, 60% of CCC debt is yielding less than 7%, where this was 23% at the start of 2020 and just 19% yields more than 10%; 50% did at the start of 2020. Companies have naturally looked to take advantage of this with record levels of issuance. This has led to continued ever greater levels of debt outstanding at both the corporate and sovereign level, which stand at historic highs.

Government gross debt-to-GDP ratios by country
% of nominal GDP



*Source: IMF, Refinitiv Datastream, J.P. Morgan Asset Management as of 30 Jun 2021. *Historical ranges are since 1990 or more recent, depending on data availability up until the end of 2020*

Outlook

With vaccine rollouts continuing and fiscal and monetary stimulus remaining strong, global economic recovery is likely to stay, albeit subject to disruption as Covid-19 cases rise in various regions. This will likely continue to support risk assets, though for many asset classes there is limited room for further price appreciation. Within credit, both investment grade and high yield spreads are at pre-pandemic tights and at close to the all-time low yield, it is difficult to envisage gains in excess of low single-digit yield (with little margin for error) and potentially losses in more interest rate sensitive areas. Equities are expensive on many metrics, but with more dispersion. With the current uncertainty around inflation and the longer-term consequences of the increase in global debt, we think it appropriate to be prudent and selective in the level of risk investors take.

The key risks to markets and economies in the short term remain (1) the path of interest rates (and so inflation) and (2) the risk of a variant of Covid-19 against which vaccines lack efficacy. There is uncertainty over interest rates and inflation. Interest rates fell in Q2 despite inflation exceeding expectations and the Fed taking a more hawkish slant (though Fed chair Powell did reiterate he saw inflation as transitory). There are various explanations, from technical short covering to slowing economic growth, but this in some ways demonstrates the uncertainty. With record debt levels, the path of interest rates will remain key to the performance of risk assets. There should be greater clarity as we progress towards the end of 2021 as comparison levels are normalised and supply chains should have the chance to repair. Longer term, the consequences of record and unprecedented levels of monetary and fiscal policy with record levels of debt are unclear.

Strategy Allocations

Performance was mixed in Q2 as it has been for the full year. More directional strategies performed better as the value to growth rotation within equities abated and growth equities performed well. The less directional strategies were more muted and were moderately impacted in June from the strong sell-off in rates. Our more directional strategies, though performing better in Q2 than Q1, remain below where we would have expected. We have material exposure to both biotechnology and to China, and both these themes did not participate in the recovery in growth equities. We believe these remain areas where investors should have long-term exposure and the funds we invest with have shown an ability to extract alpha in these markets. However, they are volatile and we have experienced that this year.

We are not making large changes to the portfolio. We have looked to rotate our exposure to tail-risk strategies to include funds which are long volatility (in rates and FX, as well as equities) and a short credit fund, where we see constrained negative carry but strong upside in the event of a sell-off in risk assets.

Discretionary and Systematic Global Macro

Overall our allocation to macro and relative value strategies was profitable during the quarter for our multi-strategy funds, with gains from relative value managers offsetting losses from macro funds.

Our macro managers saw mixed performance with gains made in April and May offset by losses in June. For macro funds, the reflation narrative remained the dominant theme during the quarter. Managers continued to be positioned with a short bias to developed market global fixed income, as well as steepener positions along the yield curve. These positions worked well in April and May as global yields drifted higher and curves steepened on the back of strong economic data and higher-than-expected inflation prints. However, the unexpected hawkish pivot from the FOMC in June led to flattening of yield curves and a stop out of short positions in the long end where positioning had grown given the consensus nature of the reflation trade. Simultaneously, fears around the spread of the Delta variant also led to a bid for global fixed income leading to a sharp rally in bonds towards the latter part of June. This reversal hurt some of the classic discretionary macro funds.

Our relative value funds were profitable overall with gains led by one manager who trades macro and relative value strategies. This manager continued their strong start to the year with their bias towards reflation expressed across equities, equity derivatives, commodities and fixed income. After running elevated risk for the last 9 months, which has led to very strong returns, the manager sensibly reduced risk in May as they felt some of the reflation themes were no longer as attractively priced. This was prudent on their part and has meant they have preserved much of their YTD gains despite the recent reversal in the reflation narrative. Our fixed income focused relative value funds were also profitable overall albeit with muted returns. The opportunity set in bond basis appears muted for the time being with the system awash with liquidity and repo financing plentiful. Our managers believe increasing volatility in fixed income and potential Fed tapering could change the backdrop in the coming quarters. Finally, our multi-strategy managers with exposure to quant strategies also performed well. Index rebalancing proved a profitable strategy in Q2.

Looking ahead, despite the recent reversal in the reflation theme, our macro funds continue to believe long-dated interest rates remain too low. They feel that inflation will challenge the Fed in coming quarters and we could see a pick-up in employment date in the US. While new Covid variants might emerge, they believe the global appetite for complete or even partial lockdowns is very limited, especially as we enter into 2022 with Presidential elections in France and mid-term elections in the US. They continue to use options were possible to build asymmetry in their positions.

Equity Long/Short

The second quarter saw somewhat improved performance from our equity long/short managers in aggregate, following what was a challenging quarter for them in Q1.

The main factor which drove the improvement in performance was the easing of investor fears around inflation and interest rates. This, combined with strong fundamental operating performance from growth businesses, allowed for some rotation of capital back towards structural growth and away from cyclical recovery. Our managers are positioned more long structural growth as opposed to cyclical recovery in general and were helped by this move.

It is also important to note that, insofar as stocks are driven in the near term by changes in earnings revisions, Q2 saw a slowdown in the pace of upward earnings revisions for recovery/reopening stocks, which then naturally improved the relative attractiveness of the earnings revisions from secular growth businesses.

Performance from our equity long/short managers was not as strong as we would have liked. We put this down to the following key reasons:

1) Shorting has remained very challenging. Somewhat surprisingly, there has been no let-up in the high level of retail investor market participation, which has contributed to clear pockets of speculative excess and short squeeze dynamics. "Meme stocks", a category of stocks that entered the general vocabulary of most investors for the first time in Q1, remain a thing. It is quite remarkable that AMC, a struggling highly indebted movie theatre chain, still has a market capitalisation value of $18bn. Other meme stocks, such as Newegg and Sgoco, are popping up almost every day. Eventually the stock prices for these businesses should follow their fundamentals, but for now there are still a surprisingly large number of speculative areas in the market where stock prices are completely divorced from any notion of fundamentals.

2) Within our secular growth equity long/short allocation, we have material exposure to biotechnology and to China, neither of which participated in the growth recovery in Q2. The Chinese market was hampered by continued regulatory crackdowns against domestic large tech businesses, while biotechnology continued to lag under fears around drug pricing and a possible change in tone at the FDA.

3) Within cyclical recovery, our managers have gravitated towards travel and leisure stocks on the long side as opposed to more traditional cyclicals, such as autos or financials. The thesis for travel and leisure has been that it should see a sustained boom in spending post-Covid as a result of pent-up demand being released. In Q2, travel and leisure stocks lagged other cyclicals due to the emergence of the Covid Delta variant, which delayed the reopening of travel.

When considering the factors that negatively impacted performance in Q2 we feel comfortable that they are largely temporary. The areas of speculative excess will eventually prove to be attractive short opportunities. The biotechnology and China markets will inevitably grow in size and will continue to be among the relatively rare areas of global growth, and travel/leisure spending will likely experience a large boom when economies and borders reopen.

The top contributors to performance for the quarter were technology focused managers, in particular those with material exposure to software. The areas of technology which performed best were those which had the most limited sensitivity to GDP growth, such as high growth software. These are also the areas that had fallen the most in Q1.

The largest detractors from performance were the healthcare/biotech focused managers. These managers largely suffered due to the continued weakness in biotechnology.

Exposure to China managers was unhelpful in terms of contributions to return, but they also did not suffer material losses. In general, the China managers, all of whom are local, on-the-ground managers have navigated a difficult YTD environment fairly well.

Event Driven

It was a reasonable quarter for our event driven allocation. Merger activity has continued apace with $1.7tn deals announced in Q2, up from $1.4tn in Q1 and the highest quarterly level since 2017. There is some correlation to the larger deals with a number in technology, which could face anti-trust issues and typically have operations in China, which would require Chinese regulatory approval.

One of our managers lost money in June on a special situations position but has performed strongly from the core merger arbitrage portfolio. Risk levels at the end of Q2 remain high, which bodes well for future performance. Another manager with a high allocation to SPACs saw good performance. The manager was positive in Q1 but saw volatile performance as SPACs traded down in the latter half of the quarter. This resulted in the SPAC allocation trading below Trust value, where it remained at the end of Q2. The strategy is to own SPACs trading at or close to Trust value and to sell should they rise above cash value (on announcement or rumour of a deal) and not hold exposure to the equity of these companies but to monetise gains. With the current size of the SPAC market, this strategy is likely to remain a core allocation for the manager.

Credit

The credit allocation continued to generate strong returns. Distressed managers have continued to perform well, with restructurings in positions bought both pre- and post-Covid occurring. Credit markets remain wide open and positions entered are often being re-financed at much lower rates. Our long/short credit manager has reduced exposure to liquid credit markets as spreads have continued to tighten and are looking to event driven trades to take risk.

We continue to find interesting investments within drawdown private credit funds. This encompasses distressed debt, as well as niche areas of direct lending and specialty finance across the risk spectrum, though we target a net IRR of 10%+ for our investments. The difference in returns and yield available from private credit compared with publicly-traded credit is at wide levels and offers attractive yield in today’s low interest rate environment.

Summary

Valuations from traditional investments are overall high and given uncertainty over interest rates, inflation and the impact of economic growth and asset valuations, we think it wise to be prudent in risk taking. Yields on high-quality bonds, especially sovereign, continue to offer minimal returns and potentially losses in real terms. High yield credit seems priced for perfection. Equity returns are likely to be specific with structural winners and losers. Prospective returns from traditional investments are, at the very least, lower than they have been.

Performance has been more mixed in Q2 but we continue to feel that hedge funds are a compelling investment across a variety of strategies; relative value strategies to generate traditional bond-like returns with limited beta to markets, equity focused managers in specific areas, or private credit to fill the void in credit markets with a large differential in the returns available between liquid and illiquid credit. Stenham, with our experienced and stable investment team, is very well positioned to help clients take advantage of these opportunities.

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 at www.stenhamassetmanagement.com

Kevin Arenson
Chief Investment Officer

Tim Beck
Senior Investment Executive

DISCLAIMER