Quarter 2 2020 Report

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Market Data for Q2 2020

Equities	Q2 2020	2020
MSCI World (USD)	18.84%	-6.64%
MSCI EM (USD)	17.27%	-10.73%
S&P 500	19.95%	-4.04%
Eurostoxx 600 (USD)	15.38%	-13.24%

Fixed Income	Q2 2020	2020
FTSE Global Bonds	2.04%	4.08%
Investment Grade	9.67%	6.12%
High Yield	7.75%	-5.18%
Barclays Global Agg	3.32%	2.98%

Currencies	Q2 2020	2020
USD (DXY)	-1.67%	1.04%
EUR (vs USD)	2.48%	0.12%
JPY (vs USD)	-0.04%	0.71%
GBP (vs USD)	-0.15%	-6.67%

Commodities	Q2 2020	2020
Gold	11.63%	17.13%
Oil ('WTI')	91.75%	-35.69%
Natural Gas	6.77%	-20.01%
Bloomberg Commodity Index	5.04%	-19.67%

Source: Bloomberg, Stenham

Markets in Q2 rebounded strongly from the severe losses seen in Q1. Both equities and credit performed well as central banks and governments provided enormous amounts of stimulus and economies started to reopen. Equity markets made substantial progress towards recouping their first quarter losses. All markets performed well, though the US outperformed Europe and emerging markets, as it has for the year, and the S&P 500 gained 20.0% in the quarter to leave it down 4.0% for the year. The US high yield index posted a 7.8% return, its best result since the third quarter of 2009, which moderated the index's year to date decline to -5.2%. Investment grade credit, which directly benefited from many of the market stabilizing initiatives rolled out by the US Fed, was arguably the standout during the quarter on a risk-adjusted basis with a 9.7% gain. Despite the strong rebound in risk assets, traditional portfolio hedges such as government bonds and gold also performed well. US Treasuries are up about 9% year to date, while gold is up just over 17%.

As economies have started to reopen, economic data has shown signs of a sharp rebound. For example, US retail sales rose 17% month-on-month in May, while UK retail sales rebounded by 12%. While sales are still down 6% and 13% year on year (y-o-y) respectively, the speed and magnitude of the bounce back is clear. US unemployment levels have declined from a peak of 14.4% to 11%. This is still high and greater than levels seen in the Great Financial Crisis, where the peak was 8%. There were fears of it reaching high teens though and the strong payroll number in May of 2.5 million jobs created was one of the greatest data surprises seen. PMIs have shown an upward trend and most recent figures for June surpassed expectations.

Composite PMIs

	2019												2020					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Global	52.1	52.6	52.8	52.2	51.2	51.2	51.6	51.3	51.2	50.8	51.4	51.5	52.1	46.1	39.2	26.2	36.3	47.7
Developed	52.3	52.9	52.7	52	51.1	51.3	51.7	51	50.7	50.3	50.8	51.2	52.1	49.5	36.4	22.2	33.2	46.9
Emerging	51.6	51.7	52.9	52.4	51.3	50.9	51.5	51.8	51.8	51.8	52.6	52.1	52.2	38.9	44.9	34.6	42.7	49.7
US	54.4	55.5	54.6	53	50.9	51.5	52.6	50.7	51	50.9	52	52.7	53.3	49.6	40.9	27	37	47.9
Japan	50.9	50.7	50.4	50.8	50.7	50.8	50.6	51.9	51.5	49.1	49.8	48.6	50.1	47	36.2	25.8	27.8	40.8
UK	50.3	51.5	50	50.9	50.9	49.7	50.7	50.2	49.3	50	49.3	49.3	53.3	53	36	13.8	30	47.7
Eurozone	51	51.9	51.6	51.5	51.8	52.2	51.5	51.9	50.1	50.6	50.6	50.9	51.3	51.6	29.7	13.6	31.9	48.5
China	50.9	50.7	52.9	52.7	51.5	50.6	50.9	51.6	51.9	52	53.2	52.6	51.9	27.5	46.7	47.6	54.5	55.7

China's economy rebounded strongly in the second quarter of the year, with real GDP growing 11.5% on the previous quarter. As one of the economies that was first-in and first-out in terms of the pandemic lockdown, China has been one of the leaders in restarting economic activity. The industrial side of the economy has been faster to normalise, with production rising to 4.8% y-o-y in June. Retail sales have also improved from a trough of -20.5% y-o-y in February, but at a slower pace. However, nearly a fifth of China's GDP comes from exports, and so the economic outlook will also depend on how quickly key trading partners, such as the US and Europe, are able to recover and impact trade activity.

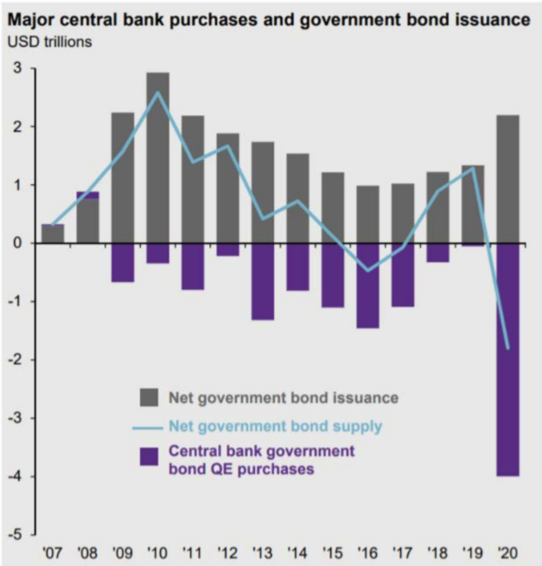
Economies are gradually easing lock-downs and the trend and desire from authorities is for more localised lock-downs rather than the full-scale, total lock-downs experienced up to now. Much remains unknown about COVID-19, but it appears that the virus is as contagious as was feared, but not as fatal, as the ability to treat those infected has improved. There has been positive news on the development of potential vaccines and this has led to increased optimism surrounding a rebound in economic activity. However, continuing this trajectory of growth is likely to be far more challenging.

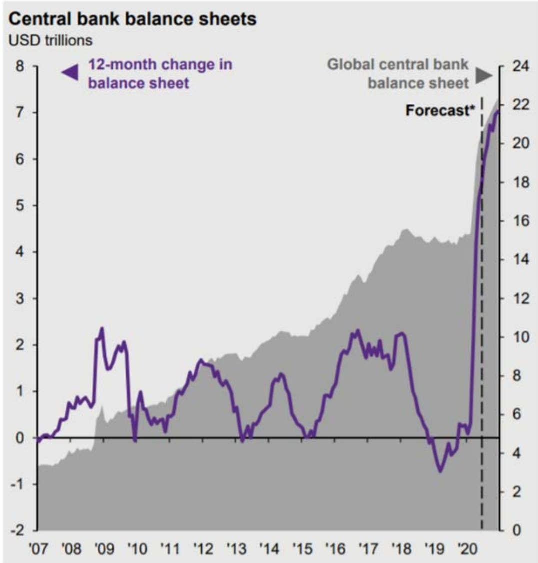
The initial recovery and rebound has been strong and reassuring to many and positive news on the development of potential vaccines has led to optimism for a continued rebound. This is a man-made shut down so not completely irrational to believe that the economy can recover through man-made actions and that, by easing lock-down, we go back to a pre-COVID-19 world. However, we believe that the longer-term impact of the shut-down will have a profound impact on economies.

A depression has been prevented but the world is in the middle of the deepest recession since the Great Depression. There has been a staggering fall in revenues for a wide array of businesses, along with major disruption of supply chains, as the world's relationship with China is re-examined. On the revenue side, the recovery path will be very slow in any areas which necessitate proximity to others, such as spectator sports, restaurants, shopping in stores, airline travel (business and pleasure), hotels etc. Mass tourism in general recently accounted for 11% of global GDP, with much higher proportions in several countries. Some will recover as COVID-19 disappears, but many may not. Sports may attract spectators back in short order but there may be permanent reduction in visiting restaurants. High-street and mall shopping was already under pressure from e-commerce and that process has been accelerated. The ability to work remotely, often with greater efficiency, has surprised many businesses, with a detrimental impact on commercial real estate.

These are not all bad changes. Maybe the time and money spent shopping in a store, along with the economic growth it created through store employees, shop rents, were not the best use of resource. One aspect that is not as frequently discussed is unemployment. Unemployment is high, though did not reach the levels feared in the immediate aftermath of the response to the pandemic. As shown above, many companies are seeing permanent impairments to their business models, many others will see the desire to raise capital and liquidity for unforeseen events and many will be re-assessing their supply chains, especially if they are dependent upon China. There are then also companies which have discovered greater efficiencies from working remotely, which may eradicate some layers of management. The initial response from companies was to furlough the most obviously impacted staff in the chaos and confusion of the shutdown. Now companies are looking more strategically at how they are run, therefore there is the real possibility that employment does not recover in the way that is hoped. What has been so far a blue-collar recession, impacting those on the front-line of manufacturing and retail industries, migrates into a white-collar recession.

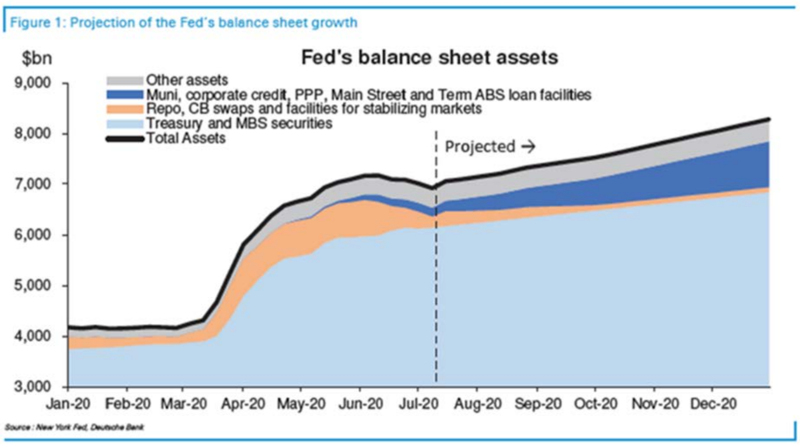
Actions taken by authorities to counteract the impact of COVID-19 have been truly unprecedented and extraordinary with profound long-term consequences. Monetary policy successfully prevented the crisis morphing into a liquidity crunch. The scale of monetary policy has been more extensive than anything seen before, both in terms of volume and the expansion of the types of assets bought. The scale of purchases far outweighs debt issuance, creating a huge supply/demand imbalance.





Source: JP Morgan

To stabilise markets which were on the brink of collapse in 2008/9, the US Fed effectively introduced a put to financial markets. But it never took away that put in the ensuing 11 years. Now, to make good on it, requires ever greater action. Monetary policy went into this crisis at extreme levels with interest rates at or close to zero and central banks still embarking on QE programs. In response to the COVID-19 crisis, central banks have had to vastly increase the programs and actions that might have seemed radical in the years 2009–2019 but have now been taken to the next level. Assets bought are no longer broadly limited to government or government guaranteed securities, but are being expanded into corporate and other risk assets. There is a continual step of action which authorities will take and there seems no prospect of that slowing down. With widespread political and institutional support for their actions, there seems no prospect of this winding back and indeed the more entrenched central banks become, the more difficult this will prove.



The world entered this crisis with the developed world's governments running high levels of fiscal deficits, central banks engaging in quantitative easing and interest rates at historical low levels (negative in Europe). The argument can be well made that it was wholly unprepared for the crisis which occurred and, as a result, even more extreme policies have had to be taken. There is no debate over limiting fiscal stimulus, only if it is enough. Absolute debt levels are not considered. Action from monetary authorities has been extreme continuations of policies adopted post 2008 with new policies taken, such as buying corporate bonds.

The US election occurs later in 2020. Political polarisation has been on the rise throughout the last decade and that has only risen with views on the management of the pandemic and other domestic issues, such as the Black Lives Matter movement and wealth inequality. We are still months away and events can evolve very rapidly over that period, but there is the clear chance, even likelihood, of a Democratic clean sweep controlling the Presidency and both Houses of Congress. Whilst Joe Biden is a more moderate Democrat candidate, this could still lead to profound changes in domestic policies relating to taxation and regulation of key industries.

The one area there has been less obvious conflict between parties in the US has been on policy relating to China. The conflict between the US and China will likely define the coming decades. The world is dividing into a US-centric and China-centric world as evidenced most recently by the UK's decision to withdraw key infrastructure projects from Huawei. No-one knows how this conflict will escalate and its impact on the world, but there is growing division and the world is beginning to de-globalise with associated disruption and costs.

In the face of these changes and policies, investors should consider overall return expectations and their portfolio composition for the coming years. Historically, a strong level of returns, and de-correlation, has come from owning fixed income bonds. That has continued into 2020 and investors have been well-served by owning fixed income and longer-dated bonds (long duration). Today, the absolute yield is low (if not negative) and the potential for further declines in interest rates limited and clearly losses could ensue if rates were to rise.

US Asset Returns by Decade*

	1920s	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010s	1926-2019
S&P 500	19.2%	-0.1%	9.2%	19.4%	19.4%	5.9%	17.6%	18.2%	-9.9%	15.8%	11.2%
Corporate Bonds	5.2%	6.9%	2.7%	1.0%	1.0%	6.2%	13.0%	8.4%	7.6%	9.5%	6.2%
Government Bonds	5.0%	4.9%	3.2%	-0.1%	-0.1%	5.5%	12.6%	8.8%	7.7%	8.0%	5.7%
Treasury Bills	3.7%	0.6%	0.4%	1.9%	1.9%	6.3%	8.9%	5.0%	2.8%	0.7%	3.4%
Inflation	-1.1%	-2.0%	5.4%	2.2%	2.2%	7.4%	5.1%	2.9%	2.5%	2.0%	2.7%

Source: Blackrock

It seems clear that given the potential damage to investment portfolios and the destructive knock-on impact on economies that QE, ZIRP and NIRP are permanent to developed markets, with little challenge. The question must be what could cause central banks to even contemplate exiting such policies. The clear answer to our minds is inflation. There has been very little if any inflation in developed world economies since 2008. The first order effect of the COVID-19 pandemic has been dis-inflationary, potentially deflationary, but most definitely dis-inflationary given the scale of demand destruction. However, we think investors should be open-minded to some sort of return of inflation. Models for predicting inflation have failed over the last decade and so there must be uncertainty over ability to predict the future path. Central banks and fiscal authorities are embarking on massive stimulus to reflate economies. A return to inflation would most likely be welcomed by central banks as success of their policies rather than preceding any action to prevent it rising. It could even be seen as a good way of reducing government debt through expanding nominal GDP (though with the clear impact on the holders of that debt). Despite low inflation and inflation falling consistently below expectations, we think investors should consider the potential of it coming back in an environment of seeming bottomless fiscal spending, vast QE programs, a fracturing of supply-chains and essentially central banks around the world looking to debase their currencies.

Outlook

The recovery in asset prices and economies in Q2 has been welcome relief for investors but the long-term impact of this crisis should not be underestimated. A depression has been averted though the world is experiencing a very deep recession, the worst in living memory. The world is not going back to the structures in place pre-COVID-19. Many businesses have seen permanent changes to their business models, as individual and corporate behaviour is altered for the long-term. There is an increasing scope in the role of monetary authorities in the scale and types of assets they can buy whilst fiscal policy appears to know no limitations. What is interesting is that there is wide-spread consensus over these policies across political parties and it is very difficult to see that changing in the next year or so. This means greater levels of debt and more influential, potentially politicised central banks. Accusations of the Japanisation of economies was previously seen as something to be avoided at all costs but that now seems to be the benchmark for the developed world.

Political change will be even more important in the coming periods. Political debate is becoming ever more polarised and the US election could see the Democratic Party control both the Presidency and Houses of Congress. This could lead to radical changes in domestic policy relating to taxation and regulation surrounding certain industries (energy, healthcare, media etc.). Quantitative Easing has led to an increase in asset prices and wealth inequality; as QE is expanded in depth and breadth this will likely continue. As that occurs there must be the chance of radical changes in the way income and wealth are taxed. Geopolitically, we are at the start of conflict between the US and China which will likely define the 21st century. Global supply and product chains which have helped drive economic growth and efficiency over the last 20-30 years are in the process of being broken.

Strategy Allocations

We have generally been pleased with the performance of our portfolios in both Q2 and YTD. Portfolios protected capital well in Q1 and were able to generate returns in Q2 and are generally positive for the year, generating returns in line with longer-term expectations. We have taken advantage of capacity becoming available in some high quality managers which had previously been closed to new investments and have been able to upgrade portfolios at the margin. This process continues into Q3. Overall, we have not increased directionality significantly but continue to monitor opportunities such as in distressed debt for appropriate portfolios.

Discretionary and Systematic Global Macro

It was a very strong quarter across macro, relative value and quant strategies. Most notably a vast majority of our macro and relative value (RV) managers who had made money in Q1 tactically adjusted positions to also be profitable in Q2.

Macro gains were led by emerging market oriented managers. A general bias to be long sovereign credit and receiving local rates as well as short EM FX against USD worked well. Notable drivers of returns included positions in Latam and EMEA. Most macro managers were profitable for the quarter with the exception of one who trades with a thematic long volatility bias. This manager had an exceptional Q1 and only gave back 10% of those gains which we considered a good result.

RV managers performed strongly as basis positions which had dislocated in March recovered due to Fed support and the June calendar futures roll. We also saw good gains from quant event strategies particularly around the MSCI rebalance in Q2. One of our quant managers who trades both equities and futures with shorter holding periods had a good quarter, but another that focuses mainly on equities and has a longer-term holding period struggled.

Our managers continue to see an above average environment for their strategies. While the first half of the year might have been notable for moves in rates markets, our managers expect currencies to become more interesting in the second half. In general this group of managers remains overall more cautious on the market environment with potential risks including a second COVID-19 wave, US politics and extended positioning in risk assets.

Equity Long/Short

Our equity long/ short managers performed well for the quarter, generating close to double the performance they lost in Q1 and as a group are firmly positive for the year. Relative sector exposures were helpful to performance both in Q2 and YTD. The two sectors where we have the largest net exposure are technology and healthcare which are also the best performing sectors YTD. We believe both sectors offer a combination of growth and defensiveness as it becomes increasingly difficult to imagine most businesses and households being able to operate without adopting increasing amounts of technology.

The valuation disparity between growth stocks (essentially tech stocks) and value stocks (essentially cyclicals) has expanded to levels that have rarely been seen in history. To some extent there are good fundamental reasons for this. Tech stocks have in general been beneficiaries of the COVID-19 crisis, while cyclicals have been more in the eye of the storm. Interest rates falling towards zero also provide a natural boost to valuations for growth businesses whose real earnings power is further out in the future. Having said this we do also recognize that valuations in certain growth technology areas are being stretched to levels where the future growth assumptions required to justify current share prices have become difficult to believe. Given the challenge presented by high valuations for advantaged growth tech businesses we are adjusting our equity long/short exposure to limit exposure to high growth, high valuation multiple tech.

We continue to believe that healthcare offers an unusually attractive opportunity set. The sector currently trades at one of the widest discounts to the broader market in history. In our opinion it should trade at a premium valuation given its superior growth and defensive characteristics together with reduced political risk as compared to pre-COVID-19 levels.

Event Driven

It was a good quarter for our merger arbitrage managers. Spreads widened significantly during March and continued their normalisation. Major deals closed, including Abbvie/Allergan which was a major contribution for one of our managers, and whilst deal breaks have been limited, our managers have avoided exposure to e.g. Advent/Forescout.

One of our managers increased exposure to Special Purpose Acquisition Companies (SPACs) during March and April. SPACs are companies which raise capital to be able to buy other companies. This cash is typically invested in US treasuries and when the company identifies an acquisition target, holders of SPACs can elect to convert into the acquisition company's equity or take the cash. If the company does not identify an acquisition target during a defined period (typically 12-24 months) SPAC holders receive back cash. Many SPACs traded below cash value during March/April and this manager significantly increased exposure. Since then, many SPACs have risen significantly in value on announcement, or even rumour, of an acquisition. Often these acquisitions are of private companies. Our manager's strategy is to sell these SPACs when they rise above cash value and is not seeking to hold exposure to the equity of these companies but to monetise gains.

Deal activity has declined in Q2 and it is unclear if that picks up or remains depressed given the levels of uncertainty surrounding the US elections and conflict between the US and China.

Credit

The credit allocation performed well in Q2 following losses in Q1. All managers generated strong performance with the best performers being our emerging markets and structured credit managers. Structured credit performed well as the technical pressures experienced in Q1 abated. Assets focused on consumers, be they backed by residential mortgages or consumer debt, performed best whilst those related to commercial real estate, where there is the potential for real fundamental impairment, performed worse. One of our emerging markets managers benefited in particular from positions in Argentina, which rose as progress seemed to be made towards a settlement between the government and debt holders on debt restructuring. Our global distressed debt managers also performed well and have increased exposure to their highest levels for a number of years.

The distressed environment is likely to improve over the coming months. Bond and loan defaults have increased and the value is the highest level since 2009. With the deep recession and impact on revenues, companies are likely to continue to need to restructure their balance sheets. The action to open up debt markets by the Fed has enabled some companies to improve their liquidity, but has not helped solvency and with the level of debt outstanding, our managers are optimistic on the coming opportunity set.

Summary

During Q2, following receipt of all required regulatory approvals, management successfully completed the acquisition of 50% of the share-ownership in Stenham and there is the potential for the acquisition of the remaining 50% in a short time frame. We believe this is an extremely positive development for the firm which not only secures the future of senior management within the firm but will also contribute to the continuity, sustainability and long-term growth of the business.

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