STENHAM ASSET MANAGEMENT

# Q1 2021 Investment Letter

with Kevin Arenson & Tim Beck

## Market Commentary

| Equities | Q1 2021 | 2020 |
|---|---|---|
| MSCI World (USD) | 4.5% | 14.1% |
| MSCI EM (USD) | 2.0% | 15.8% |
| S&P 500 | 5.8% | 16.3% |
| Eurostoxx 600 (USD) | 3.5% | 4.5% |

| Fixed Income | Q1 2021 | 2020 |
|---|---|---|
| FTSE Global Bonds | -5.7% | 10.1% |
| Investment Grade | -5.5% | 11.3% |
| High Yield | 0.7% | 4.7% |
| Barclays Global Agg Bond | -4.5% | 9.2% |

| Currencies | Q1 2021 | 2020 |
|---|---|---|
| USD (DXY) | 3.7% | -6.7% |
| EUR (vs USD) | -3.9% | 8.9% |
| JPY (vs USD) | -6.6% | 5.1% |
| GBP (vs USD) | 1.1% | 2.9% |

| Commodities | Q1 2021 | 2020 |
|---|---|---|
| Gold | -9.6% | 24.4% |
| Oil (WTI) | 21.9% | -20.5% |
| Natural Gas | 2.7% | 16.0% |
| Bloomberg Commodity | 6.9% | -3.5% |

*Source: Bloomberg as of 31 Mar 2021*

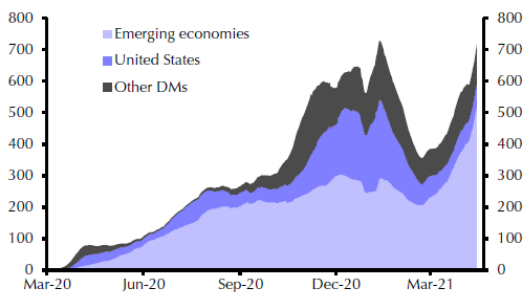
Headline markets were strong in Q1 2021, responding to the largely successful, if patchy, rollout of the Covid-19 vaccine and the simultaneous opening up of economies in the developed world, an improving macroeconomic picture and continued fiscal stimulus. Equity markets continued to rise, though there was significant dispersion between sectors with 'value' equities substantially outperforming 'growth', a strong reversal from 2020 and reflecting a rotation towards those companies which are most likely to benefit from the reopening of economies. The MSCI World Value Index returned 8.9% while the MSCI World Growth Index was largely flat at 0.1%. In 2020, the respective indices returned -3.6% and 32.7%. Currency markets saw the USD strengthen against most currencies while commodities, except for gold, rose strongly.

The one area that did not fare well during the quarter was fixed income, which suffered as rates increased (the yield on the US 10-year Treasury rose 83bps to 1.7%). High yield managed a very moderate return as spread compression outweighed the impact of the rise in interest rates, but investment grade debt (which is more sensitive to interest rates) and government debt all fell in value. The increase in rates was not in the short-end of the interest rate curve where investors remain confident that central banks will not raise interest rates any time soon, but further out pricing in expectations of interest rate increases in future years.

Q1 2021 marked the 1-year anniversary of the Covid-19 pandemic and the resulting measures on limitations of economic and social freedom many of us would have found hard to envisage probably at any point in our lifetimes prior to 2020. The rollout of vaccines is progressing, certainly in developed countries, with infection rates in the US and UK falling significantly with over half of

the population receiving at least one vaccine in those countries. Europe is more mixed and infection rates are around high levels in Italy, Spain and France. Unfortunately, infections have reached record highs globally, driven by the terrible wave occurring in India in particular, though emerging markets overall are suffering most.

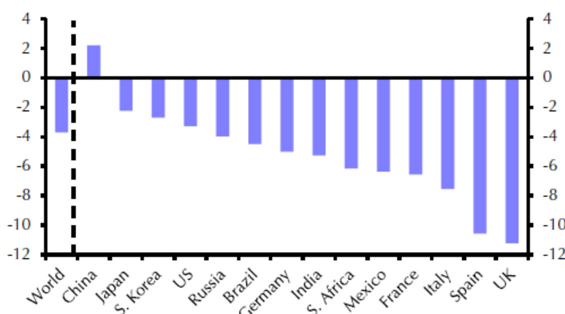
**Global Daily New Infections (000s, 7d MA)**



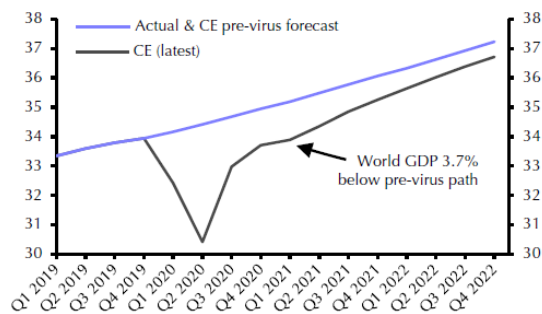

*Source: Capital Economics*

Economic recovery remains on track. Economic growth slowed in Q1 globally as some economies entered new lockdowns to combat a second wave of Covid-19, but forward looking indicators are positive. The World (except for China) is still below the pre-Covid trend GDP but is recovering. It is unclear what impact this new wave will have but, with the largest economies in the world improving, the expectation is for the recovery to continue. Recent US data has been very strong with Q1 2021 growth +6.4%, retail sales data blowing through consensus and close to 1 million jobs being added per month.

**Q1 2021 GDP % from Pre-Virus F'cast**




**World GDP (Int'l$tn, 2019 PPP & Prices)**




*Source: Capital Economics*

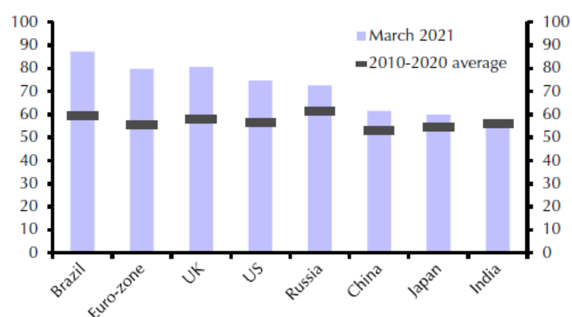
PMIs have continued to recover globally.

| | 2020 | | | | | | | | | | | | 2021 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar |
| **Global** | 52.1 | 46.1 | 39.2 | 26.2 | 36.3 | 47.9 | 51.1 | 52.5 | 52.5 | 53.4 | 53.1 | 52.7 | 52.3 | 53.2 | 54.8 |
| **Developed** | 52.1 | 49.5 | 36.4 | 22.2 | 33.2 | 46.9 | 51.1 | 52.2 | 51.9 | 52.7 | 52.2 | 52 | 52.4 | 53.8 | 55.9 |
| **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 |
| **US** | 53.3 | 49.6 | 40.9 | 27 | 37 | 47.9 | 50.3 | 54.6 | 54.3 | 56.3 | 58.6 | 55.3 | 58.7 | 59.5 | 59.7 |
| **Japan** | 50.1 | 47 | 36.2 | 25.8 | 27.8 | 40.8 | 44.9 | 45.2 | 46.6 | 48 | 48.1 | 48.5 | 47.1 | 48.2 | 49.9 |
| **UK** | 53.3 | 53 | 36 | 13.8 | 30 | 47.7 | 57 | 59.1 | 56.5 | 52.1 | 49 | 50.4 | 41.2 | 49.6 | 56.4 |
| **Eurozone** | 51.3 | 51.6 | 29.7 | 13.6 | 31.9 | 48.5 | 54.9 | 51.9 | 50.4 | 50 | 45.3 | 49.1 | 47.8 | 48.8 | 53.2 |
| **China** | 51.9 | 27.5 | 46.7 | 47.6 | 54.5 | 55.7 | 54.5 | 55.7 | 57.5 | 55.8 | 57.5 | 55.8 | 52.2 | 51.7 | 53.1 |

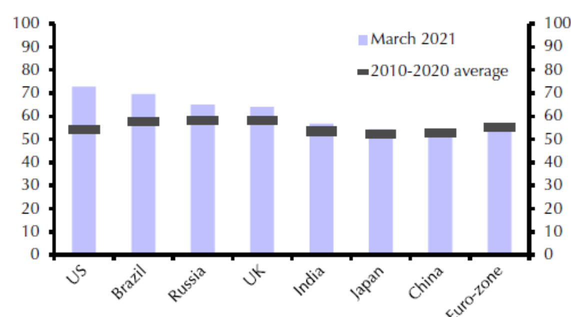
*Source: Stenham, Bloomberg*

As part of the PMI data, there are signs of inflation, particularly in manufacturing.

**Manufacturing PMI: Input Prices**




**Services PMI: Input Prices**




*Source: IHS Markit, Refinitiv, Capital Economics*

This is the key to the investment landscape. The potential for inflation, and the accompanying rise in interest rates, is the biggest risk to investments today. The 83bps increase in yield on the US 10-year Treasury caused significant, mid-single-digit losses across fixed income portfolios, be they sovereign debt or indeed investment grade corporate debt. It was a strong move from very low levels, but the yield still remains extremely low and is not pricing in any real pick-up in inflation. To illustrate the asymmetry of investing in fixed income, it would take multiple years to earn sufficient yield to just break even on that exposure.

Fiscal and monetary stimulus has continued apace. President Biden announced a new $1.9trn stimulus package, bringing post-pandemic fiscal programs to $5trn. There is little questioning on the scale of this, or if there is any upper limit to the stimulus. The thinking is that as long as interest rates remain low, then the debt is affordable, and you only need worry about the scale of the stimulus if inflation occurs. Central banks have also continued with very accommodative policies. The US Federal Reserve has indicated that it will continue with its current policy on asset purchases and the European Central Bank is looking to increase the scale of its program (to what is not stated). Indeed, the Goldman Sachs Financial Conditions Index reached its lowest level on record (since 2013) indicating the loosest environment it has seen.

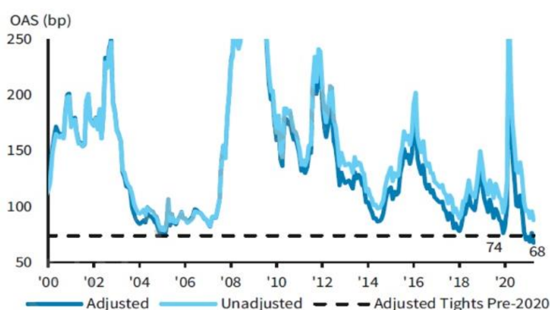
*Source: Goldman Sachs*

The Fed is also looking at broader measures for the labour market rather than targeting full employment as has been the case. The inflation target has also changed to reference an average

rate of inflation. All this appears to set the scene for the need of a sustained increase in inflation before interest rates are raised, aiming to look through any temporary increase in the data. It seems certain that there will be a pick-up in the inflation numbers during Q2 and Q3 as the comparisons are against the start of the lockdowns. The question is the ability to 'look through' this data and actually understand whether it is temporary or not.

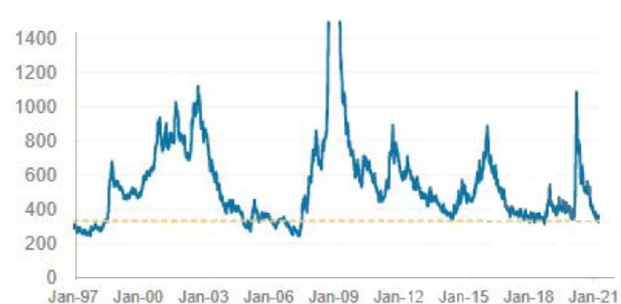
Corporate credit has been a big beneficiary of the strong monetary stimulus and the associated search for yield in a low interest rate environment. Spreads, both in investment grade and high yield, are at post-2008 tights. Indeed, analysis by Barclays adjusting the investment grade index for its current composition suggests that spreads are the tightest ever. For high yield, the Yield to Worst reached an all-time low of 3.9% in February. This at a time of increased corporate leverage, uncertainty over interest rates and challenges to existing business models following corporate and individual changes in behaviour post-Covid.

**US Corporate Index OAS**
Adjusted for Duration, Ratings and Price Changes




*Source: Bloomberg, Barclays Research (16 Apr 2021)*

**HY Spreads are at Post-GFC Tights**
ICE BofA HY Index Spread



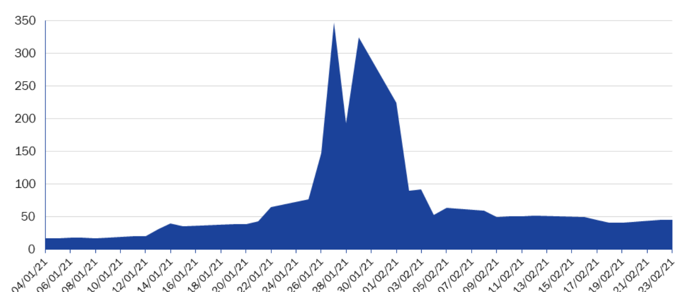

*Source: ICE BofA Index, Morgan Stanley Research, Bloomberg (16 Apr 2021)*

In a world of abundant liquidity, there have been clear unforeseen consequences and impacts on the financial system and markets, not in the overall direction but the ability for price discovery. Last year saw the oil futures trade at a negative price, something previously unthinkable. In January this year, there was an engineered short squeeze in certain stocks, most clearly GameStop, a video games retailer whose business model has been in decline for a number of years. Through the online platform Reddit, there was coordinated action to buy the stock, drive up the price and cause investors who were short the company to close out their shorts for risk management purposes, further driving up the price.

**GameStop Share Price 2014-2020**

*Source: Stenham, Bloomberg*

**GameStop Share Price 2021**



In March, we then saw the leverage induced collapse of Archegos, a private family office, with an estimated $100bn invested in a concentrated portfolio of stocks and leading to reported losses of $10bn across a variety of banks. This led to a number of stocks falling in value, e.g. Discovery -27% and ViacomCBS -27%. Ignoring the truly astounding moves in large, multi-billion dollar companies, previously a bank would have viewed this as a short-term liquidity event and looked to buy the portfolio and run the stocks back up to the fair/market value. This time, the debate was over what was the fair value and had they been over-extended in the first place. This also caused large losses for some banks, most notably UBS and Credit Suisse. These extreme price moves all reduce the confidence investors can have in the market as a means for price discovery, with technical factors such as liquidity having a far stronger impact on pricing than before.

# Outlook

The narrative of opening up and global economic recovery is likely to stay. Fiscal stimulus shows no sign of abating and monetary policy will remain accommodative. That said, for many asset classes there is very little 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.

We feel there are legitimate levels of uncertainty which lends itself to some caution in taking risk. We have never seen fiscal stimulus on the scale we are seeing now, at a time of economic recovery, coupled with central banks buying assets and keeping rates at close to 0%. Inflation seems inevitable, indeed there are signs now, but its scale or permanency is unknown. Many assets, particularly in fixed income, have low upside, which itself is dependent upon supportive conditions remaining and significant downside if they do not. It is a time to be positive on economic improvements, but selective on where to take risk.

# Strategy Allocations

Performance was mixed in Q1. Our less directional strategies continued to perform well, in line or exceeding longer-term performance expectations. More growth orientated portfolios suffered from price declines across some technology names but also specifically exposure to biotech within healthcare. Where we hold gold, that performance also detracted. We have not altered the portfolios significantly and see some of the price moves, e.g. in biotech, to be offering attractive entry points.

We have also increased our allocation to discretionary macro managers and reduced slightly relative value fixed income managers. This has been driven by the ability to access some very high-quality managers, who opened for limited amounts of new capacity, as well as volatility across fixed income, FX and commodities having the potential to present an attractive opportunity set.

### Discretionary and Systematic Global Macro

Macro strategies were profitable with gains led by rates trading. In particular, managers have been positioned short fixed income in developed markets, also expecting continued steepening in yield

curves in the US predominantly and, to a lesser extent, in the UK and Europe. The more simple short rates thematic worked well in Q1. With regard to steepeners, while it was profitable overall there were moments in late February when fears of inflation and a faster Fed rate hike cycle led the curve to bear flatten rather than steepen. Our managers generally believe this scenario is unlikely but have built in some protection in the front-end of curves. Commodity trading was also profitable with gains led by long positions in European carbon emissions and a long bias to industrial metals. Currency trading was mixed overall as most managers entered the year with a bearish bias to the USD. As economic data confirmed a strong recovery in the US versus the rest of the World, the USD strengthened over the quarter particularly against lower yielding developed markets currencies.

Relative value strategies had a very strong quarter led by one manager, in particular, who specialises in trading equity derivatives and macro volatility strategies. This manager was well positioned for reopening and reflation themes with trades structured via options in a limited downside manner and on a beta neutral basis. This manager has been running above-average levels of risk as a function of what they deem to be a very attractive opportunity set. We also saw strong performance from a multi-strategy relative value manager who continues to recover from their struggle in Q1 2020. Returns were positive across the board with convertible arbitrage, equity dividend arbitrage and quantitative equity strategies leading gains. Fixed income relative value managers had a quieter quarter but were profitable overall, leverage has generally drifted lower in the last 12 months as the opportunity set in cash futures basis trading is not as attractive. However, repo financing remains ample and these managers believe, with increasing volatility in interest rates, the opportunity set for relative value basis trading should improve in the months ahead.

### Equity Long/Short

The intense market rotation away from growth and towards cyclicals/reopening stocks made conditions difficult on both the long and the short sides for some of our managers and overall was a challenging quarter. This was exacerbated by high retail and quant investor market participation, which exaggerated market shifts and contributed to pockets of speculative excess and short squeezes.

Our managers have a bias towards being net long businesses with structural growth and higher quality, with quality being measured by metrics such as Return on Equity (ROE) and Return on Invested Capital (ROIC). During Q1, these types of stocks significantly underperformed stocks in more cyclical areas, such as financials, energy, travel & leisure, materials and industrials, with capital rotating towards cyclical sectors in order to capture the expected post-Covid reopening recovery. In general, the businesses that outperformed in Q1 tend to be lower quality with many also facing structural challenges from disruption, e.g. autos, traditional retail and energy. Our managers tend to be hesitant about wanting to be long these types of businesses given the uncertainty around their longer-term futures and also, post the severe rotation, questions about the extent to which a Covid recovery has already been priced in.

Manager performance for the quarter was largely linked to, i) the extent to which the manager is long growth, and ii) the size of their short book. In general, the worst performers were those with

the strongest bias towards growth and the largest gross short books. There was also strong negative correlation between performance in 2020 and performance in Q1 2021 with managers that performed best last year tending to underperform in Q1 given the shift in market focus towards reopening.

The largest performance detractor was a biotech specialist manager returning -14.3% for the quarter. For comparison, the S&P Biotech Index was -7.6%, including a -27% peak-to-trough drop from mid-February. This decline is similar in scale to that seen in March 2020 of -33%. Biotechnology tends to be volatile and a drawdown of this size is not abnormal. The subsequent period has historically proven to generate attractive returns.

| Drawdown | Size | Next 12-month return |
|---|---|---|
| Mar – May 2014 | -29% | 85% |
| Jul 2015 – Feb 2016 | -49% | 47% |
| Oct – Dec 2018 | -35% | 51% |
| Feb – Mar 2020 | -33% | 121% |
| Feb – Apr 2021 | -27% | ? |

*Source: Stenham, Bloomberg*

Our current expectation is that we have not moved into a new market paradigm and that the recent growth sell-offs will also prove to be transitory once macro concerns have abated and growth fundamentals can reassert themselves. The top contributor to performance for the quarter was a TMT and consumer focused manager, which returned 8.5%. This manager benefitted from long exposure to consumer stocks, retailers in particular.

### Event Driven

It was a reasonable quarter for our event driven allocation. Importantly, merger activity has increased and there are a number of large deals with attractive spreads to closure. There is some correlation to these positions 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 January on a special situations position but has since performed strongly from the core merger arbitrage portfolio. Risk levels at the end of Q1 were high and higher than they have been since 2018. This bodes well for future performance. Another manager with a high allocation to SPACs saw volatile but overall positive performance. 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. Some of the deals announced by SPACs fell in value, at least in part driven by the growth to value rotation (a number were in high growth technology companies) but also because a number of deals were likely bad deals. SPACs as a whole traded down, including those which had not announced deals. From a portfolio trading at a premium to Trust value going into the year, at the end of Q1 the fund's portfolio was trading at a healthy discount and generated over 5% return in Q1, which, despite the volatility, we are happy with. The manager has also added to positions as they have traded down.

### Credit

The credit allocation generated good returns in Q1 with all managers positive. Performance came from a variety of sources. Distressed managers performed well, having an almost defined position to benefit from any opening up of the economy as the capital structures which have been most under stress have been those most impacted by the pandemic. There were also idiosyncratic events, which benefited managers including more advanced restructurings looking for an exit. Our managers' portfolios look increasingly mature with events likely to occur in the next 12-18 months to monetise exits. In some cases, companies which arranged financing during 2020 to strengthen their balance sheets are now looking to make use of the extremely open capital markets to refinance that debt.

We are finding, and investing with, many 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

Prospective returns from traditional investments are, at the very least, lower than they have been and in many there is the risk of losses. Yields on high-quality bonds, especially sovereign, offer minimal returns and potentially losses in real terms. Equity returns are likely to be very specific with winners and losers arising from structural changes in individual and corporate behaviour following the Covid-19 pandemic.

We feel that hedge funds are a compelling investment in a variety of strategies, offering strong returns and avoiding some of the clear risks to traditional investments. Our lower risk relative value strategies generated good, positive returns in Q1 whilst bonds fell in value. Focused equity managers can identify winners and losers in a rapidly changing landscape whilst our private credit managers are seeing a large spread between the opportunities available in illiquid credit compared with liquid credit and are targeting double-digit annualised returns.

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

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