Stenham Quarter 2 2018 Report

July 2018




Market Data for Q2 2018

Equities	Q2 2018
MSCI World (local)	2.92%
MSCI EM (local)	-4.24%
S&P 500	2.93%
Eurostoxx 600	2.44%

Fixed Income	Q2 2018
FTSE World Govt Bonds	-0.18%
Investment Grade	-1.38%
High Yield	1.38%
Barclays Global Agg	-2.78%

Currencies	Q2 2018
USD (DXY)	5.00%
EUR (vs USD)	-5.27%
JPY (vs USD)	-4.13%
GBP (vs USD)	-5.99%

Commodities	Q2 2018
Gold	-5.41%
Oil ('WTI')	14.18%
Natural Gas	6.99%
Bloomberg Commodity Index	-0.07%

Source: Bloomberg, Stenham

After a difficult first quarter, equity markets performed better in Q2, driven by continued strong economic data from the US alongside corporate earnings. S&P 500 companies reported Q1 earnings growth of 25%, the highest growth since 2010 whilst unemployment continued to decline to 3.8%, the lowest level since 1968. Counterbalancing that was an escalation in political tensions. Trade war rhetoric between the US and China (more latterly with the EU as well) escalated whilst Italy's newly formed coalition brought renewed instability to the EU. There was significant movement in FX markets, which saw substantial appreciation of the USD (DXY +5.0%) across most currencies in both developed and emerging markets. Central banks followed through with their indicated paths as the US Fed increased interest rates by 25bps and whilst the ECB kept rates static, they indicated that they would end QE purchases by the end of 2018. Commodities saw further strength in oil (WTI +14.2%) though gold fell by over 5%. Fixed income markets continued to struggle.

2018 began with the narrative of synchronised economic growth, as Europe and most emerging markets saw growth accelerate to become the leaders in global growth during 2017. That has reversed with global growth now slowing and the US outperforming the rest of the world. Leading indicators, be they PMIs or the OECD leading economic indicators, suggest this trend will continue.

PMIs

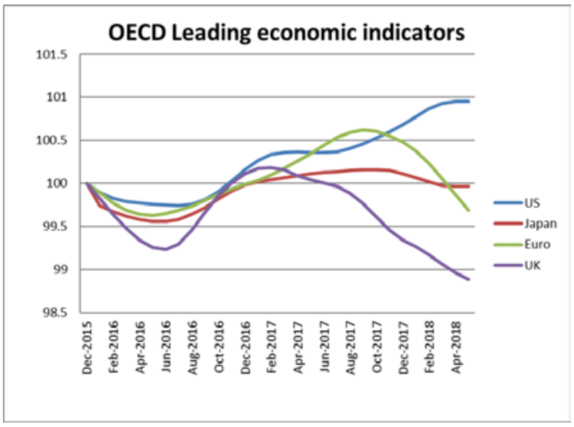
Composite

	2016					
	Jul	Aug	Sep	Oct	Nov	Dec
Global	51.6	51.6	51.8	53.2	53.3	53.5
Developed	51.6	51.7	52.0	53.7	54.0	54.1
Emerging	51.4	51.3	51.2	51.8	51.5	51.9
US	51.8	51.5	52.3	54.9	54.9	54.1
Eurozone	53.2	52.9	52.6	53.3	53.9	54.4

	2017											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Global	53.8	53.6	53.8	53.7	53.8	53.7	53.5	54.0	53.9	54.0	54.1	54.4
Developed	54.6	54.1	54.2	54.4	54.4	54.5	54.4	54.6	54.6	55.0	54.9	54.8
Emerging	51.9	52.1	52.5	52.0	52.3	51.5	51.4	52.1	51.9	51.5	51.9	53.0
US	55.8	54.1	53.0	53.2	53.6	53.9	54.6	55.3	54.8	55.2	54.5	54.1
Eurozone	54.4	56.0	56.4	56.8	56.8	56.3	55.7	55.7	56.7	56.0	57.5	58.1

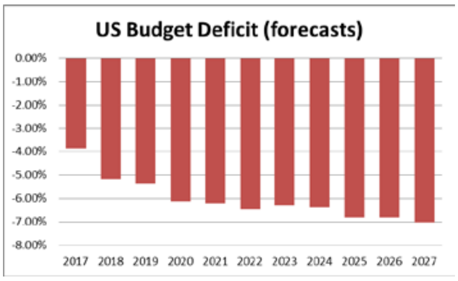
	2018					
	Jan	Feb	Mar	Apr	May	Jun
Global	54.6	54.8	53.3	53.9	54.0	54.2
Developed	54.9	55.4	53.6	54.4	54.8	55.0
Emerging	53.5	53.3	52.3	52.4	52.2	52.4
US	53.8	55.8	54.2	54.9	56.6	56.2
Eurozone	58.8	57.1	55.2	55.1	54.1	54.9

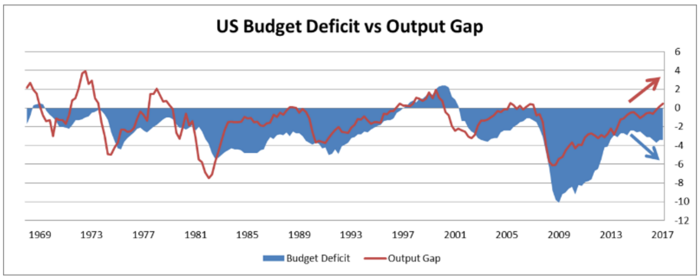
Source: Stenham, Bloomberg



Source: Stenham, Bloomberg

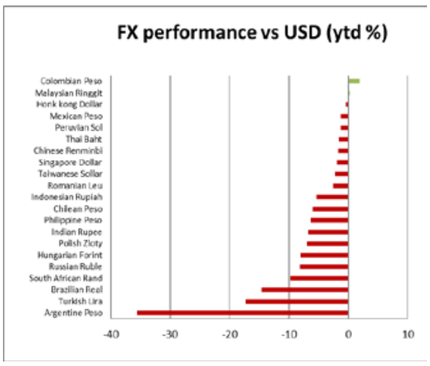
Economic growth in the US is strong. Q2 growth came in at 4.1%, which is more than double most estimates of trend growth. Such growth cannot be sustained and there are signs of capacity constraints in the US. Unemployment fell to 3.8% and for the first time in the history of the data, there are more job vacancies than unemployed workers. Reported hourly earnings have increased though not excessively, though forward indicators of wage growth have accelerated and there is the real potential for overheating in the labour market. The resultant increase in wages would add to aggregate demand within the economy which puts pressure on inflation and, if this exceeds the Fed's target, could lead to unanticipated rises in interest rates. Markets are pricing in the Fed's interest rate rise expectations for the rest of 2018 but not for 2019 and there is a risk that they will have two hikes, potentially more should inflation pick up. As a re-print from last quarter's letter, this is happening at the same time as the US government is expanding its fiscal deficit at a time of reduced (or zero) excess capacity, unprecedented in over 50 years.





Source: Bloomberg, Stenham

Outside the US, economic conditions have proved more difficult. The combination of an escalation in trade war rhetoric (with a resultant slowdown in economic growth) and a much stronger USD led to significant pressure on emerging market assets. In local currency, equities were down mid-single digits (MSCI EM -4.2%), though in USD this was materially worse (-8.7%). Those countries with significant USD liabilities were worse hit (Brazil, Argentina, South Africa, Turkey) and the scale of the moves were extreme and a reminder of prior EM crises; Argentina had to negotiate an IMF credit line.



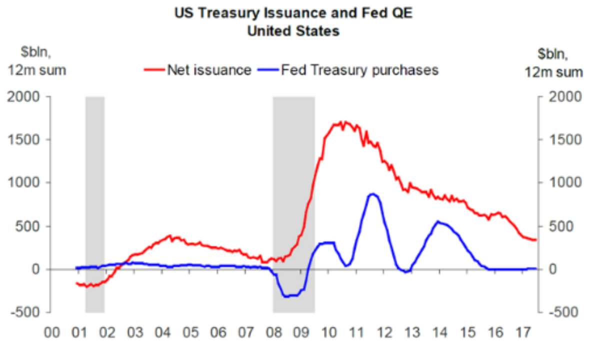
Source: Stenham, Bloomberg

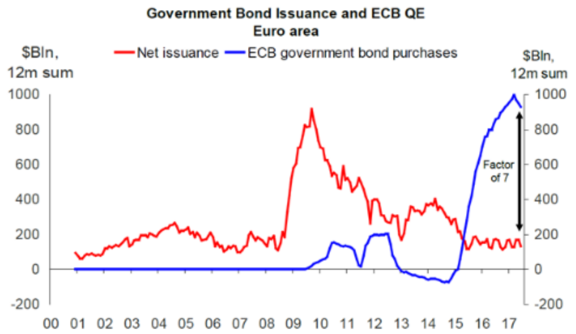
The trade war rhetoric has escalated, though on current announced measures the impact on economies is minimal. It would seem in both the US and China's rational interests not to escalate tensions. The US will have mid-term elections in November and the prospect of higher prices for consumer goods may not sit well with Trump's voter base, though we also accept that the image of fighting unfair foreign competition and advancing American jobs may prove popular. In China, the legitimacy of the Communist Party rests on delivering economic growth. The US exports far less to China than it imports and so the trade war will very much be governed by the US than China.

Europe was not without volatility, driven largely by politics. The populist Five Star Movement and The League, the two largest parties following the Italian general election of March 2018, formed a coalition government in May. Whilst holding major differences in stated policies, both parties are anti-establishment and populist in nature. The initial policies stated by the coalition were a clear challenge to prevailing Eurozone rules. Proposals were for significant fiscal stimulus, creating a deficit greater than currently permitted, driven by both tax cuts and greater spending. This includes cancelling pension reforms which were a prerequisite for Draghi and the ECB to embark upon its vast QE programme. Just as important have been comments made by the parties even if not part of the official government programme, such as cancellation of the debt held by the ECB and, more significantly, the possibility of a dual currency and even exiting the EUR.

There is good reason for believing that Italy would not look to leave the EUR. The costs would be huge; financial institutions hold much government debt and would require recapitalisation, the general population also has savings in sovereign debt to a greater extent than most countries and would incur large losses. However, there are real grievances within Italy where much of the population has seen at best stagnating living standards for an extended period of time. Five Star and the League are also not traditional, established political parties and their motivations may be more ideological and less constrained. At the very least, there may well be much further tension between Italy and the EU (largely Germany) as policies diverge.

Italian bond yields rose significantly in May as these political tensions came to light. 2 year yields rose from -34bps at the start of the quarter to a high of 270bps and the 10yr from 178bps to 316bps. Importantly, at certain points there was minimal liquidity for investors to sell their positions, causing both pain for certain investors and more extenuated price movements. This is the third largest bond market in the world and is a worrying indication of what could happen to other asset classes. This in part reflects the extreme price distortions which have resulted from the extensive programme of QE by the ECB. As shown previously, the scale of QE in Europe is far more extensive than that in the US and equally the price distortions greater. Even without such an escalation, the potential for extreme price movements as the ECB scales back asset purchases is high.





Source: Deutsche Bank, Bloomberg, Stenham

Tensions in the EU outside of pure economics also escalated. Within Italy, the League in particular advocates taking a harder line on the acceptance of migrants into the country. In Germany, the same issue threatened to break up the long-standing coalition between the CSU and CDU, which would have put severe pressure on Chancellor Merkel remaining in power. It appears a compromise has been reached but there is clearly greater support for populist parties in Europe. It is easy to forget with Macron and Merkel as the leaders of France and Germany that in both countries parties considered extremists or populists (The Front Nationale and AfD) significantly increased their share in the most recent elections. In Austrian and Hungry, populist leaders are in power and in the UK, the Labour Party has taken on a more radical and populist slant.

Monetary policy from the US Fed and ECB continued on its indicated path. The US Fed increased rates by 25bps and indicated there would be a further two rate hikes during H2 2018. The ECB kept rates constant, but reaffirmed its intention to exit QE by the end of 2018. The flattening of the US yield curve is receiving a lot of attention given there has not been a recession in recent history that has not been preceded by an inverted yield curve. The difference between the yield on the US 10yr and US 2yr began the year at 52bps and ended Q2 at 33bps (and since declined further). The US Fed has indicated it will raise rates two further times this year, by 25bps each. If this happens and yields on the 10yr do not increase, the yield curve will invert.

Outlook

The narrative of synchronised global growth which started the year has morphed into one with pockets of economic slowdown, increased political risk and the timing of the next recession. The latter has only increased with the flattening of the yield curve. We question the ability to predict such events with any degree of accuracy or consistency, but also appreciate the validity of some of the arguments and believe that portfolios should beconstructed with that as a distinct possibility, if not the main premise. Equally, there is strong economic growth in the US in particular, only stimulated in the short-term by the coming fiscal expansion. Political risk only seems to increase, but if it were to reduce other regions may see heightened growth.

We see the key risks to markets being an unexpected increase in interest rates and political risk, whatever form that may take. An increase in interest rates would lead to a repricing of risk assets globally and a reversal, at least in part, of the large price movements since the start of QE and the ultra-low interest rate policy. If not derailed by an escalation in the trade war, it is difficult to see how inflation does not pick up in the US. Political risk, with the potential for a trade war driven by the US but also the increasing success of populism across both developed and emerging markets, seems on an upward trajectory. By its nature it is difficult to assess how this will assert itself and can be unpredictable. Elections can be won by a wafer thin amount but lead to very different policies and outcomes. At the very least, this demands an increased risk premium. It is fair to say that we are more concerned about Italy than most investors we speak with and believe that there continues to be a lot of complacency.

We continue to take targeted risk across different asset classes and look to ensure we have no embedded exposure to those assets classes we see most at risk. These are centred on fixed income assets, where the extreme monetary policies seen has led to extreme price distortions and an explosion of lower quality debt, but equally on equities where valuations have been based on these same dynamics such as by balance sheet engineering and increased leverage.

Strategy Allocations

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

Discretionary and Systematic Global Macro

It was a decent quarter for our macro strategy with gains from discretionary managers whilst relative value funds were flat. Within discretionary macro, underlying managers showed significant dispersion. As a high level, developed markets focused managers were positive and emerging markets focused managers saw losses, though even within that there was meaningful differences in performance. Some of our discretionary managers also generated gains from a short bias to the Chinese currency, which was tactically establishing during the quarter on the back of trade war fears.

One of the key drivers of performance for discretionary managers centred around the movement in Italian bonds which proved to be a very profitable event for two in particular. Whilst Italian bond yields widened significantly, the stress did not become systemic and other asset classes such as equities and corporate credit more broadly across Europe did not suffer. Managers who see continued significant risk from Italy have moved some of their exposure to these assets and it is interesting that those managers which profited from the sell-off remain far more concerned than other managers.

Our emerging markets focused managers saw losses from the severe price movements, in particular in Latin American fixed income and FX. Whilst these losses were sometimes quite high (up to high single digits), they were not outside expectations and the managers were able to trade as they saw appropriate rather than hitting stop-losses and being forced to reduce risk. Our managers have being adding to risk selectively.

Performance from relative value managers was flat overall. Our manager focusing on volatility arbitrage was positive while our fixed income relative value managers had mixed performance. One was marginally positive for the quarter but we did have one manager who suffered sharp losses during the month of May from a macro position in Italian fixed income. This was a small position in the context of their overall portfolio but given the scale of moves it caused severe drawdowns. Our statistical arbitrage managers were profitable in the quarter which was pleasing as it was a particularly difficult quarter for peers, especially during June. We are very mindful of the large capital inflows into these strategies in recent years and continue to focus on those managers who we think adopt unique techniques that are differentiated from the broader peer group.

Equity Long/Short

Our long/short managers had a good quarter. Underlying sector performance was in line with how our managers are generally positioned, with technology (S&P IT +6.8%) outperforming and consumer staples suffering (S&P consumer staples -2.3%). Our sector specific managers across utilities and healthcare performed well and in particular there were strong gains made by our specialist biotech managers. The biotech index was up broadly in line with markets and outperformance here was driven by strong single name allocations.

Losses were few and centred around exposure to emerging markets, which is relatively light across portfolios.

We have increased our allocation to sector specific managers over the last few quarters, focused on sectors where we believe there to be a high analytical barrier to entry. This is particularly evident in healthcare but also includes utilities and certain areas of financials. We continue to see strong opportunities in these areas, but we also see improved prospects for generalist managers. On the long side tech businesses with real growth prospects continue to trade at mostly reasonable valuations, although there are pockets of exuberance amongst earlier stage businesses. As a trend we have seen valuations being premised on future cash flows which are increasingly further out and as a result with less visibility. There are also pockets of real value still available in areas such as financials which continue to trade at low valuations and which would benefit from rising interest rates. On the short side these positions can be contrasted with stocks that when taking a 5 year view face very real existential threats to their businesses from technology disruption and where current valuations seemingly don't reflect this threat at all. We have seen bifurcation of performance so far in 2018 and we believe this will continue, presenting a strong opportunity set for long/short strategies.

Event Driven

Merger activity continued to be very strong in Q2 and 2018 is on track to set a new annual record for deal activity. Bloomberg data showed USD1.51trn of deal announced in the quarter following USD1.54trn in Q1.

Performance was strong for the event driven allocation, driven in large part by the judgement on the AT&T/Time Warner merger. The DoJ had looked to block the AT&T/Time Warner deal, which would have reversed 40 years of precedent on vertical mergers. During June, Judge Leon ruled that the DoJ had failed to meet its burden to prove that the merger would lessen competition. The deal closed 2 days after the judgement. This generated performance in its own right (the spread to deal closure was 10.8% on March 31st) but also led to spread tightening in other vertical mergers (especially in deals involving the HMOs with Aetna being bought by CVS and Express Scripts by Cigna).

The AT&T/Time Warner judgement also triggered a bidding war in media as Comcast made a (telegraphed) bid for entertainment assets that Twenty-First Century Fox had agreed to sell to Disney. This offer is in addition to Comcast's existing offer for the public shares of Fox's UK-listed affiliate Sky. This led to Disney topping Comcast's bid for Fox's assets, whilst Fox also wants to buy the minority shares in Sky it does not own.

Other notable positive contributors to performance included the closure of the Bayer acquisition of Monsanto after agreeing to the largest ever negotiated antitrust divestiture.

On the negative side, further doubt was cast on Qualcomm's acquisition of NXPI. This deal requires Chinese regulatory approval, which has yet to be granted, and is seen as less likely as trade conflicts rise between the US and China.

We remain positive on the outlook for M&A activity and the opportunities it presents. However, risks, particularly those requiring Chinese regulatory approval are higher and if economic conditions weaken, CEO confidence to pursue deals may fall.

Credit

The credit allocation had a reasonable quarter. Gains were made by our global / developed markets focused funds with losses from our emerging markets specialist manager. Gains across managers were fairly diverse but generally came from positions added fairly recently. This included positions in Puerto Rico where a budget proposal was beneficial to debt holders. These managers have maintained a healthy level of investment as disruption across different industries has led to new opportunities as levered companies have their business models challenged.

Our emerging markets manager saw high single digit losses centred on some Greek equities but more relevantly on Argentinian assets, be it equities or debt (corporate and sovereign). The losses were not inconsistent with the manager's profile and at the margin the manager has been adding to positions.

Summary

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

Thank you for your ongoing confidence in Stenham. Please contact us if you would like to hear more about our strategies or funds. Further information and the relevant Business Development contact details can also be found on our website:

www.stenhamassetmanagement.com

Kevin Arenson
Chief Investment Officer
Stenham Advisors Plc

Tim Beck
Senior Investment Executive
Stenham Advisors Plc

DISCLAIMER

This document contains macroeconomic commentary and information relating to the services of the asset management division of the Stenham Group and certain unregulated collective investment schemes (the "Funds") as defined in the Financial Services and Markets Act 2000 ("FSMA"). It has been approved for distribution (except in South Africa, where its distribution has been approved by Stenham Asset Management Inc – see below) by Stenham Advisors Plc. The Funds have not been authorised or otherwise approved by the Financial Conduct Authority. This communication is directed only at, and the units to which this communication relates are available only to, such persons who satisfy the criteria for one or more of the following : (a) an investment professional, being a person having professional experience of participating in unregulated schemes within the meaning of article 14(5) of the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) Order 2001, as amended (the "CIS Promotion Order"); (b) a certified high net worth individual, being an individual who has signed, within the preceding 12 months, a statement complying with Part I of the Schedule of the CIS Promotion Order; (c) a high net worth company, unincorporated association etc, being an entity to which article 22(2) of the CIS Promotion Order applies; (d) a certified sophisticated investor, being a person: (i) who has a current written certificate signed by an authorised person stating that the person is sufficiently knowledgeable to understand the risks associated with participating in unregulated schemes; and (ii) who has signed, within the preceding 12 months, a statement in the terms set out at article 23(1) of the CIS Promotion Order; (e) an association of high net worth or sophisticated investors within the meaning of article 24 of the CIS Promotion Order; and (f) any other person to whom it may otherwise be lawfully communicated, including, where the communicator is an authorised person, those persons listed in rule 4.12 of the Conduct of Business Sourcebook of the FSA Handbook ("COBS"); (collectively, "Exempt Recipients"). It is not intended for Retail clients. This communication is exempt from the scheme promotion restriction in section 238 of FSMA on the communication of invitations or inducements to participate in unregulated schemes on the grounds that it is made to Exempt Recipients. It is a condition of your receiving this communication that you are, and you warrant to Stenham Advisors Plc that you are an Exempt Recipient. Persons who do not satisfy the criteria to be an Exempt Recipient should not rely on this communication nor take any action upon it, but should return this communication immediately to Stenham Advisors Plc at 180 Great Portland Street, London W1W 5QZ. This communication is confidential and intended solely for the person to whom it is delivered. No part of this communication may be reproduced in any form or by any means or re-distributed without the prior written consent of Stenham Advisors Plc. This communication should not be construed as an offer to sell any investment or service. This communication does not constitute the solicitation of an offer to purchase or subscribe for any investment or service in any jurisdiction where, or from any person in respect of whom, such a solicitation of an offer is unlawful. This communication does not constitute investment advice or a personal recommendation. If you are in doubt about the units to which this communication relates, you should consult an authorised person specialising in advising on participation in unregulated schemes. The information in this communication has been prepared in good faith, however, no representation or warranty, expressed or implied, is or will be made and no responsibility or liability is or will be accepted by Stenham Advisors Plc or its officers, employees or agents in relation to the accuracy, completeness or fitness for any purpose of this communication. Past performance is not a reliable indicator of future results. The information stated, opinions expressed and estimates given are subject to change without prior notice.

Stenham Advisors Plc is authorised and regulated by the Financial Conduct Authority The distribution of this document in South Africa has been approved by Stenham Asset Management Inc which is a licensed financial services provider (FSP No:-13300)

www.stenhamassetmanagement.com