STENHAM
ASSET MANAGEMENT

Q3 2021 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q3	2021
MSCI World (USD)	-0.4%	11.8%
MSCI EM (USD)	-8.8%	-3.0%
S&P 500	0.2%	14.7%
Eurostoxx 600 (USD)	-1.9%	7.9%

Fixed Income	Q3	2021
FTSE Global Bonds	-1.2%	-5.9%
Investment Grade	-0.2%	-1.8%
High Yield	0.7%	3.7%
Barclays Global Agg Bond	-0.9%	-4.1%

Currencies	Q3	2021
USD (DXY)	1.9%	4.8%
EUR (vs USD)	-2.4%	-5.4%
JPY (vs USD)	-0.3%	-7.3%
GBP (vs USD)	-2.5%	-1.4%

Commodities	Q3	2021
Gold	-0.8%	-7.2%
Oil (WTI)	2.1%	54.6%
Natural Gas	60.7%	131.1%
Bloomberg Commodity	6.6%	29.1%

Source: Bloomberg as of 30 Sep 2021

Headline markets were more mixed in Q3 2021. The quarter began strongly as economic growth continued to recover. That turned in September as concerns over the level of inflation and distress within the Chinese housing sector drove the market. Overall, equities were marginally negative though emerging markets, led by the concerns in China but also political upheaval elsewhere such as Brazil, fell high single digits bringing the EM index into negative territory for the year. Bond yields continued to rise with further losses for fixed income securities, leading to a significant loss for the year, all the more so when the level of yield offered by those securities is considered. The largest moves were seen in commodities; the Bloomberg Commodity is at a near all-time high, driven in particular by energy prices. Natural gas rose 61% in the US, but European natural gas rose an astonishing 139%. Gold declined close to 1%.

There was meaningful progress made towards a post-Covid environment in Q3. Most Western countries saw significant relaxation, if not a complete end, to many behavioural restrictions which led to a continued recovery in economic activity and consumer spending. Economic activity remains strong and growing; PMIs have levelled off from the very high levels seen in Q1, but remain firmly in positive territory.

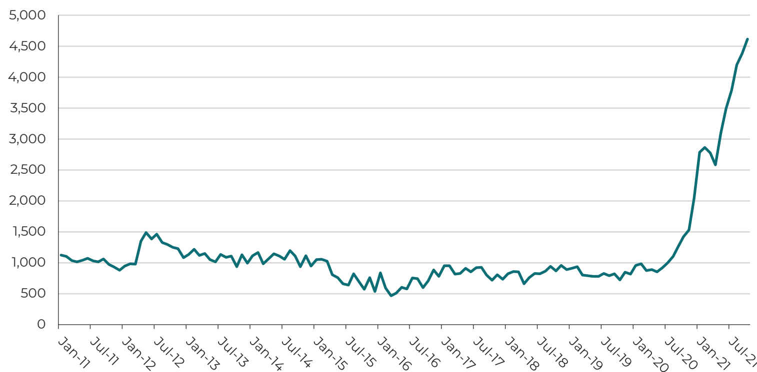
Composite PMIs

	2020												2021								
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Global	52.2	46.1	39.2	26.2	36.3	47.8	51.1	52.5	52.5	53.4	53.1	52.7	52.3	53.2	54.8	56.7	58.5	56.6	55.8	52.5	53.0
Developed	52.1	49.5	36.4	22.2	33.1	46.9	51.1	52.2	51.9	52.7	52.2	52.0	52.4	53.9	55.9	58.2	61.2	59.3	57.5	54.1	53.8
Emerging	52.2	38.9	44.9	34.6	42.7	49.7	50.9	53.0	53.6	54.6	54.9	54.1	52.1	52.0	52.6	53.5	52.8	50.8	52.0	49.3	52.3
US	53.3	49.6	40.9	27.0	37.0	47.9	50.3	54.6	54.3	56.3	58.6	55.3	58.7	59.5	59.7	63.5	68.7	63.7	59.9	55.4	55.0
Japan	50.1	47.0	36.2	25.8	27.8	40.8	44.9	45.2	46.6	48.0	48.1	48.5	47.1	48.2	49.9	51.0	48.8	48.9	48.8	45.5	47.9
China	51.9	27.5	46.7	47.6	54.5	55.7	54.5	55.1	54.5	55.7	57.5	55.8	52.2	51.7	53.1	54.7	53.8	50.6	53.1	47.2	51.4
Eurozone	51.3	51.6	29.7	13.6	31.9	48.5	54.9	51.9	50.4	50.0	45.3	49.1	47.8	48.8	53.2	53.8	57.1	59.5	60.2	59.0	56.2

Source: Bloomberg as of 30 Sep 2021

However, this recovery has been met with significant supply-side constraints which have led to a rise in inflation, certainly in developed markets. There is evidence of significant weakness in supply chains across a number of measures; shipping costs have risen massively, inventories are low, shortages in certain goods is becoming apparent and companies are having difficulty in filling employment vacancies.

Shanghai Freight Shipping index[1]



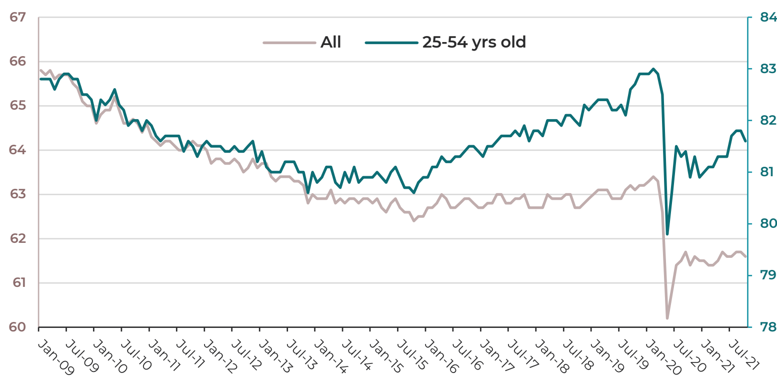
These supply-side constraints have led to an increase in inflation. US CPI has exceeded 5% for 5 consecutive months. Inflation rates were always likely to exceed the long-term targets given the base effects of comparing with 12 months prior when the world economies were in lockdown and activity significantly curbed. However, the levels and persistency of inflation have been higher than expected with the tightness in labour and energy markets in particular exceeding expectations.

US CPI[1]

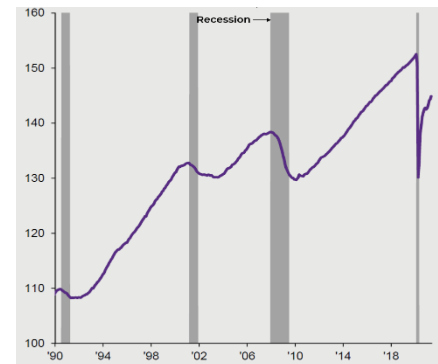
The labour market has been something of a quandary. By many metrics, it is a very strong labour market, with increasing wages, record job openings and many companies reporting difficulty of finding suitably qualified workers. At the same time, employment levels are around 5 million lower than pre-pandemic as the labour participation rate has dropped. It is not just older workers where this level has fallen, but for "prime" workers (aged 25-54) it has also dropped. Unemployment benefits were very high during the pandemic, leaving many better off on benefits than they had been in work. The vast majority of these have now ended. Maybe there is a lag as people adjust to the need to work again, but currently the stock of workers has fallen, putting pressure on wages for the economy.

[1] *Source: Bloomberg as of 30 Sep 2021*

US participation rate[1]

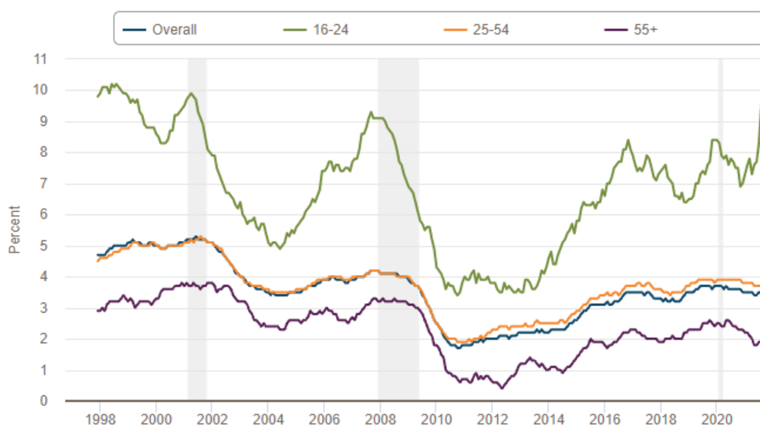


US non-farm payroll employment[2]
(millions of people)



Wages are very interesting. They have increased for the lower age group but very limited for older cohorts. Using age as a proxy for seniority, the question is whether the rise in wages for junior workers will result in future increases for supervisory workers in coming months.

Wage growth tracker by age[3]
12M moving averages of median wage growth, hourly data



Chinese markets declined sharply amidst an intensified regulatory rollout, the default of the largest real estate developer Evergrande and a slowing of economic growth. Since the beginning of the year, Chinese authorities have been extending in an unprecedented way the regulatory framework for many industries causing massive moves in the valuation of companies in those sectors and bringing into question the commitment to transparency and a market economy. In February, the education sector was hit by a new requirement that any organisation engaged in after-school tutoring be registered as non-profit. Within a week of the multi-billion dollar listing of Didi, the largest taxi hailing platform in China, it was suspended from the app store for data security reasons. In Q3, this was followed by more stringent regulation in data security and anti-monopoly measures targeting internet platforms.

Evergrande is the largest property developer in China and has $300bn of debt and liabilities. With the huge liability structure, some questioned whether this was China's "Lehman moment". This has proven not to be the case; not least if there was an escalation in the impact on other sectors, the authorities would be quick to act. The impact is likely to be much longer term. The growth of

[1] *Source: Bloomberg as of 30 Sep 2021*
[2] *Source: BLS, Refinitiv Datastream, J.P. Morgan Asset Management as of 30 Jun 2021*
[3] *Source: Federal Reserve Bank of Atlanta* https://www.atlantafed.org/

the Chinese economy has driven a very high proportion of total world economic growth, both before and after 2008. In turn, much of this growth has been driven by real estate investment.

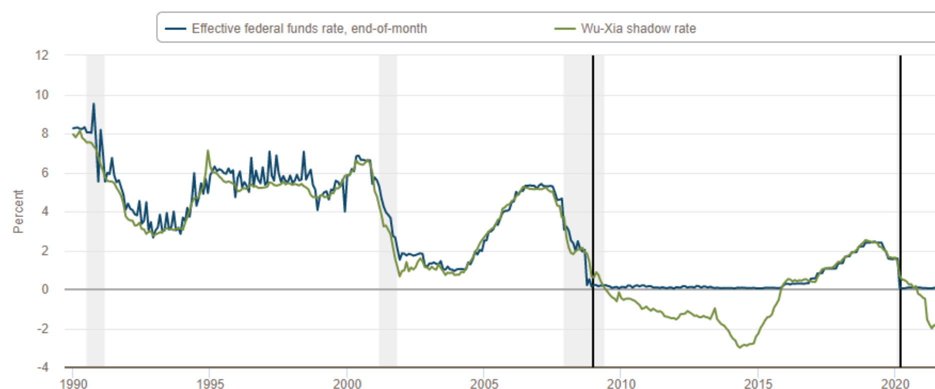
The most recent Q3 GDP figure of 4.9% growth (down from 7.9% in Q2 and 18.3% in Q1) shows a slowdown in the Chinese economy. Much of this is policy driven and stimulus could be added to support growth. President Xi has stated the objective for the economy of "prosperity for all" and the unknown is what does that mean for overall levels of growth for China, but also globally.

Outlook

The debate in markets centres around inflation, how transitory or permanent it is and what impact it will have on interest rates. The debate ranges from the pure transitory, where the world reverts to the low yield, low inflation, generated by technological developments and access to cheaper pools of labour through globalisation, to the other extreme of stagflation, where supply shortages are so acute that the world will experience high inflation and low growth.

The risk with inflation is that central banks have not acted quickly enough to be in a position to counteract it. Inflation is significantly higher than target, and has been so for a number of months, it is worth also looking at how accommodative monetary policy continues to be. Asset purchases by central banks remain at very high levels, and whilst the US Fed in particular has stated its intention to taper the purchases, they will remain positive. The US Fed never introduced negative interest rates as happened in Europe, but there was a massive expansion of quantitative easing and asset purchases. The Atlanta Fed looks to approximate the impact of quantitative easing as if they were interest rates; so for a given level of quantitative easing, what is the associated level of interest rates. That model shows the effective interest rate to be around -2% in the US.

Wu-Xia shadow federal funds rate[1]



The Fed is looking to taper and cease quantitative easing by mid-2022 (though no official timeline has been given), which would imply an effective 2% move in effective interest rates.

Inflation has been over 5% for 6 months. If this continues, interest rates will have to rise quite significantly and that would be a massive move from the current accommodative stance and a shock to markets. The current anticipated gradual process may not prove sufficient and is premised on inflation actually being transitory. A massive move in rates would likely cause a significant fall in risk assets, which itself could cause a recession. There is the risk that we are in an

[1] *Source: Federal Reserve Bank of Atlanta. Black vertical lines at Dec 2008 and Mar 2020 indicate months where the FOMC lowered the target range for the federal funds rate to 0 to ¼ percent*

environment of extended or permanent inflation with the two paths of a very sharp rise in rates or else living with high inflation, which would erode asset values in real terms.

We feel the outcome will likely to be somewhere in between. There has been a sudden shock from forced closure of many businesses, huge uncertainty leading to a lack of investment followed by an almost equally sudden reopening of economies looking to cater to pent-up demand. Some, or even many, of the supply chain constraints will likely work themselves out as companies renew processes, etc. However, there are changes. Globalisation is in many ways in decline. The reliance on China as a location for cheap and skilled labour will, to some extent at least, be replaced by higher cost options, including onshoring. Investment into fossil fuel extraction is largely politically unacceptable. Higher wages, especially for those in lower skilled jobs, are seen by many as a good thing. We are most likely in a higher inflationary environment than we have been for a number of years and the risks are that inflation does persistently exceed expectations.

Strategy Allocations

Performance was mixed in Q3. Our less directional strategies performed more or less in line with longer-term performance expectations, though mostly at the lower end of those expectations. More growth orientated portfolios suffered from both exposure to China and further weakness in the biotechnology sector (S&P Biotech -7.2%), though there were signs of fund outperformance. Where we hold gold, that performance also detracted.

We have not altered the portfolios significantly, at the margin we are looking to add some non-directional long/short credit managers. With the risk of a higher inflation and higher interest rate environment, we are focusing on making sure that portfolios are balanced across the potential outcomes. We maintain no embedded exposure to fixed income and view investing in assets which have relied on ever falling interest rates (much of the fixed income market) as very dangerous.

Discretionary and Systematic Global Macro

The quarter was difficult for most discretionary macro managers as their core reflation view was challenged. Gains from relative value and quantitative managers partially offset overall losses.

Discretionary macro managers suffered losses as concerns around the spread of the Delta variant dampened reflation and reopening narratives. The Fed's June meeting suggested a shift from the previous AIT framework to a more reactionary stance. This led market participants to question their core "steepening" views in yield curves, believing instead that the Fed moving quicker may cause front-end rates to sell off more than the back-end. The flattening of the yield curve and decline in volatility in interest rate and currencies led to losses in June and July. Most managers abandoned their steepening view and instead shifted to a more outright short stance, but these positions became challenged in the early part of August with Covid-19 cases rising in the US. The middle of August marked the low point for yields and macro performance. As yields drifted higher from that point to the end of the quarter we saw a good recovery in performance. Currency trading was difficult during the quarter with no clear trends, however, we saw improved performance towards the end of September as some funds captured the move lower in JPY.

Quantitative performance was led by a systematic macro manager who incorporates elements of trend following. This manager continued to capture the upward moves in energy markets in particular. We also saw good performance from our multi-strategy relative value managers and

performance was led by quantitative equity strategies. After a somewhat boring market environment for much of this year, the opportunity set for fixed income relative value began to look more interesting towards the end of the quarter as basis started to widen following increasing volatility in front end rates. This augurs well for returns in the coming quarters.

Overall, macro managers ended the period with renewed commitment to the reflation view mainly expressed in interest rates and, to a lesser extent, in commodities. The quarter saw a flurry of central bank activity, which has continued into October. Global central banks are normalising monetary policy at different speeds across emerging and developed markets, and this sets up for interesting opportunities in currencies and interest rates in the near future.

Equity Long/Short

Performance of the strategy was mixed in Q3, with lower net exposure managers able to grind out positive performance in the context of flat equity markets. More directional managers had a difficult period with two main headwinds: the weakness in Chinese markets and continued weakness in the biotechnology sector. It is worth noting that our managers dedicated to these two areas both outperformed the relative indices. Across the equity long/short strategy, after a poor Q1, alpha generation has improved in both Q2 and Q3.

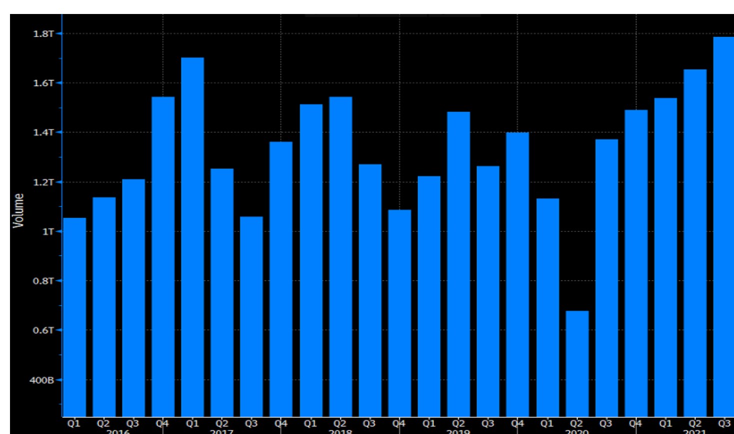
We maintain exposure to both these areas but have a greater scepticism over China than biotechnology. At the very least, a higher risk premium must be attached to Chinese exposure but we still see that, over the long term, growth opportunities will continue to arise in the country. We are invested with local managers who are, we believe, often best placed to be able to understand policy direction.

Biotechnology continues to be weak. However, Q3 did see a number of M&A transactions which had been notably absent prior to the quarter, and positive news flow with regard to moving closer to satisfactory resolutions around both drug pricing legislation and the appointment of a permanent Head for the FDA in the US.

Event Driven

Our event driven allocation was marginally positive in Q3. This is slightly disappointing given the scale of merger activity, though this does set up what should be an attractive opportunity set. Merger activity continues to be robust, with Q3 2021 seeing the largest quarterly volume since 2016.

M&A activity[1]



[1] *Source: Bloomberg as of 30 Sep 2021*

There was little dispersion in the end performance of the individual managers, though the drivers were diverse. One of our managers continues to find strong opportunities in SPACs, which trade at a discount to trust value and, even though issuance has slowed down, there remains a much higher stock of SPACs outstanding following the explosion in issuance in 2020 and early-2021. Our other managers are more focused on merger arbitrage. There was some volatility in the market following the break of the Aon / Willis Towers Watson deal. Our managers had minimal exposure, but the break drove surprisingly high deleveraging across other merger positions, which led to some volatility in performance, though most spreads tightened again within 3-4 weeks. Risk levels remain relatively high given the scale of merger activity.

Credit

The credit allocation continued to generate good returns in Q3, as it has all year. Returns were led by event driven type trades such as refinancings, with credit spreads remaining fairly flat. Our managers have reduced overall exposure in the expectation of volatility in the coming months and are very focused on identifying particularly shorts in companies which are most exposed to the risk of higher inflation.

We continued to be active in allocation to 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

As with the previous quarter, valuations of traditional assets remain high, particularly global bonds. We have seen a sustained pick up in inflation over the last few months and there is much uncertainty around central bank policy action as we look ahead into 2022. Inflation could well be rising faster and spreading across economies based on recent data, which might in turn lead to faster tapering and rate hikes even in the US and Europe. It is difficult to predict with various cross-currents but we expect volatility across most asset classes to increase into next year.

We continue to believe that hedge funds are a compelling investment across a variety of strategies. Equity focused hedge funds continue to benefit from disruption in specific sectors, such as healthcare, technology or utilities; macro hedge funds can generate asymmetric returns with the use of options; and relative value hedge funds can generate fixed income type returns without taking duration risk. Thematic investments, including commodities and energy transition strategies offer significant returns if one can identify the right managers. Private credit continues to fill the void in credit markets with a large differential in returns to traditional credit assets.

Stenham has seen a strong pick up in client interest in recent months and we thank you for your interest and confidence in our team. We remain focused on identifying the right managers and opportunities to help our clients take advantage of a more exciting and volatile market environment in the months ahead.

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

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