STENHAM
ASSET MANAGEMENT

Q3 2023 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q3	YTD
MSCI World (USD)	-3.8%	9.6%
MSCI EM (USD)	-3.7%	-0.4%
S&P 500	-3.6%	11.7%
STOXX Europe 600 (USD)	-5.6%	4.6%

Fixed Income	Q3	YTD
FTSE Global Bonds	-4.3%	-2.7%
Investment Grade	-4.3%	-0.4%
High Yield	0.4%	5.3%
Bloomberg Global Agg Bond	-3.6%	-2.2%

Currencies	Q3	YTD
USD (DXY)	3.2%	2.6%
EUR (vs USD)	-3.1%	-1.2%
JPY (vs USD)	-3.4%	-12.3%
GBP (vs USD)	-4.0%	0.9%

Commodities	Q3	YTD
Gold	-3.5%	1.6%
Oil (WTI)	28.5%	13.1%
Natural Gas	4.7%	-34.5%
Bloomberg Commodity	3.3%	-7.1%

Source: Bloomberg as of 30 Sep 2023

The third quarter saw consensus expectations of an imminent US recession push back further out to 2024 in the face of resilient economic growth. Despite this, global equity markets were volatile, beginning the quarter strongly before turning negative in August and September as belief that central banks would keep rates higher for longer weighed on markets. Long-term interest rates moved higher, with an overall steepening of the yield curve with the US 2-Year yield rising 20bps and the 10-Year yield rising 80bps to finish the quarter on 5.04% and 4.57% respectively. This move in rates also drove losses in fixed income, leading indices to be negative on the year.

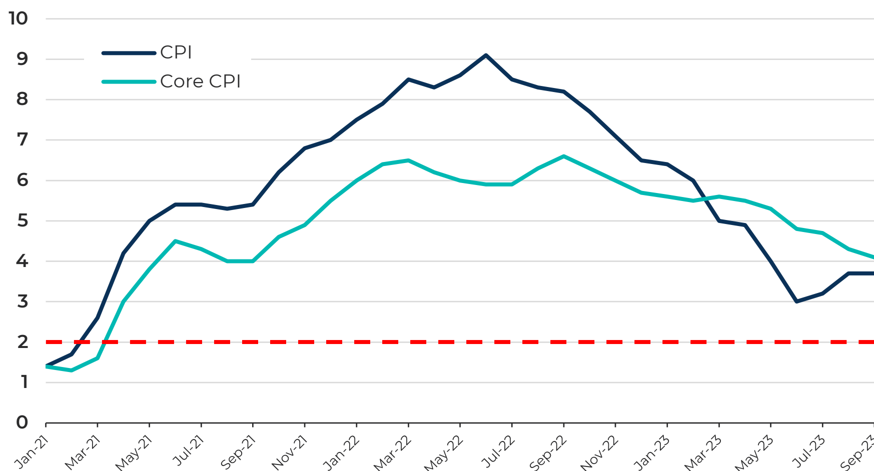
Whilst negative in the quarter, equity indices have shown reasonable performance year to date, though the breadth of gains has been narrow. The S&P 500 is +11.7% for the year, but much of this driven by seven stocks; the S&P 7 has returned over 50% and the S&P 493 barely positive.

S&P 500 performance[1]

[1] *Source: Bloomberg, Apollo Chief Economist.*

Inflation has come down in recent months with 12-month CPI down to 3.7%. Core inflation, the Federal Reserve's preferred measure, has also declined, but at 4.1% continues to trend above the target of 2%.

US Consumer Price Index (%)[1]



The persistence of core CPI above 2% and comments from central banks led to the expectations of rates remaining higher for longer. Following the Fed's Jackson Hole Economic Policy Symposium, Chair Jerome Powell stressed that they will keep rates high until they are confident that inflation is moving sustainably down towards their target of 2%. In the September meeting, the Fed's dot plots (which show the median of the expected level of interest rates by Fed members) rose for end-2023, indicating that they are willing to contemplate a further rate rise. For the end-2024, this showed a forecast of 5.125%, implying just two interest rate cuts in 2024 and a significant revision upwards from the June meeting, where the level was 4.625%.

It is easier for central banks to say they will keep rates higher to fight inflation when the economy is growing, as it currently is. The attitude when there is a true trade-off between economic growth and fighting inflation may differ. However, the message at the moment is firmly that there is the willingness to keep rates higher for longer. The comments also indicate how data dependent the Fed is. This is appropriate to some extent, but interest rates do operate with a lagged effect; waiting until there is clear data raises the risk of a policy mistake and that interest rates are kept too high for too long and drive the economy into recession.

Economic growth has remained strong with Q3 US growth coming in at a strong 4.9%, exceeding consensus expectations. Forward looking indicators are more negative though. Manufacturing PMIs[1] are firmly below 50 (indicating contraction), though services remain stronger.

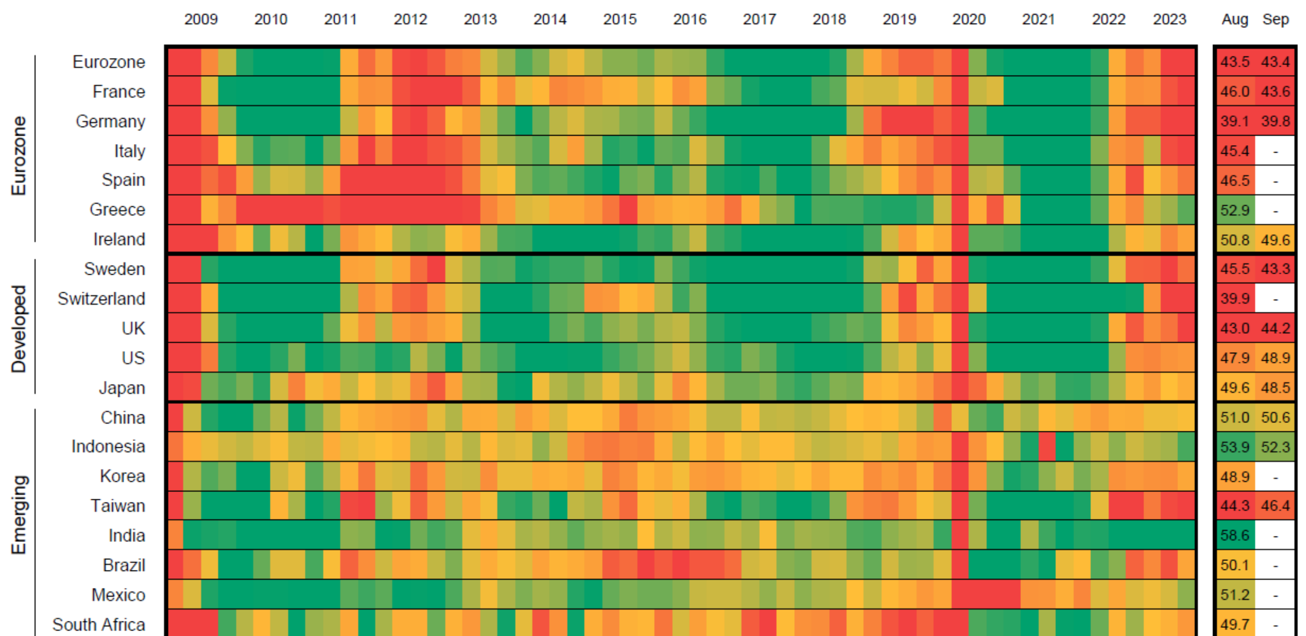
	Manfacturing PMIs																		
	2022												2023							
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Global	53.2	53.8	53.0	52.3	52.4	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	49.6	49.5	48.7	48.6	49.0	49.1
Developed	56.3	56.5	56.5	56.3	55.0	52.5	51.3	50.2	50.1	48.8	47.8	47.3	48.0	48.1	48.4	48.5	47.6	46.3	47.1	46.8	47.4
Emerging	50.0	50.9	49.2	48.1	49.5	51.7	50.8	50.2	49.4	49.8	49.7	49.8	49.9	51.6	50.7	50.5	51.4	51.1	50.2	51.4	50.9
US	55.5	57.3	58.8	59.2	57.0	52.7	52.2	51.5	52	50.4	47.7	46.2	46.9	47.3	49.2	50.2	48.4	46.3	49	47.9	49.8
Japan	55.4	52.7	54.1	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49	48.9	48.9	47.7	49.2	49.5	50.6	49.8	49.6	49.6	48.5
UK	57.3	58.0	55.2	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47.0	49.3	47.9	47.8	47.1	46.5	45.3	43.0	44.3
Eurozone	58.7	58.2	56.5	55.5	54.6	52.1	49.8	49.6	48.4	46.4	47.1	47.8	48.8	48.5	47.3	45.8	44.8	43.4	42.7	43.5	43.4

[1] *Source: Bloomberg.*

	Services PMIs																				
	2022												2023								
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Global	51.0	54.0	53.4	52.2	51.9	53.8	51.1	49.3	50	49.2	48.1	48	50.1	52.6	54.4	55.4	55.5	53.9	52.7	51.1	50.8
Developed	50.8	55.1	56.5	55.8	53.9	53.1	49.2	46.7	49.6	48.8	47.5	47.1	48.7	51.8	53.4	54.6	54.9	53.6	51.9	50.2	50.2
Emerging	51.5	51.6	46.3	43.7	47.2	55.5	55.4	55.0	50.6	49.9	49.2	50.1	53.1	54.5	56.7	57.2	56.7	54.6	54.5	53.1	51.9
US	51.2	56.5	58	55.6	53.4	52.7	47.3	43.7	49.3	47.8	46.2	44.7	46.8	50.6	52.6	53.6	54.9	54.4	52.3	50.5	50.1
Japan	47.6	44.2	49.4	50.7	52.6	54.0	50.3	49.5	52.2	53.2	50.3	51.1	52.3	54.0	55.0	55.4	55.9	54.0	53.8	54.3	53.8
UK	54.1	60.5	62.6	58.9	53.4	54.3	52.6	50.9	50	48.8	48.8	49.9	48.7	53.5	52.9	55.9	55.2	53.7	51.5	49.5	49.3
Eurozone	51.1	55.5	55.6	57.7	56.1	53.0	51.2	49.8	48.8	48.6	48.5	49.8	50.8	52.7	55.0	56.2	55.1	52.0	50.9	47.9	48.7

In a historical context, the manufacturing PMIs are more stark.

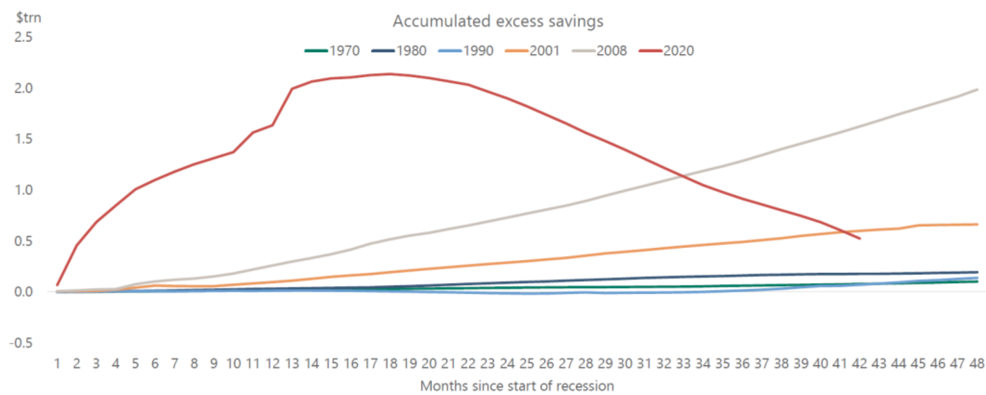
Global Manufacturing PMI[1]
Index level



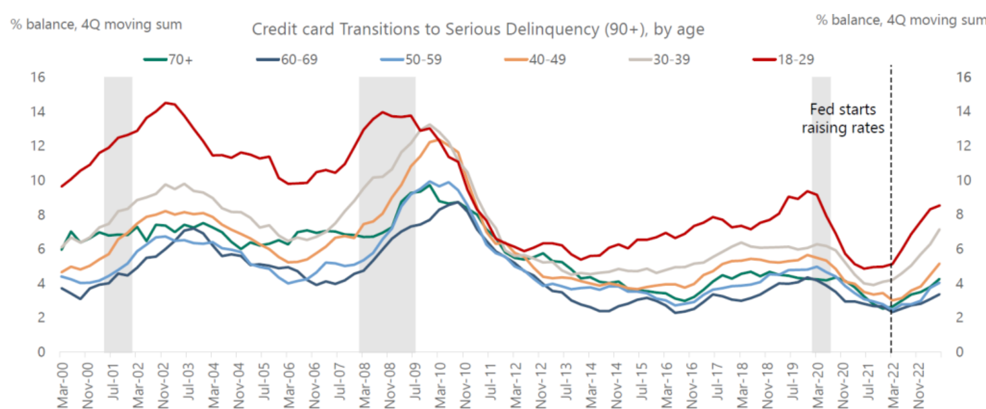
Supporting economic growth, and the divergence between the service and manufacturing parts of the economy, consumer spending has been resilient. September retail sales rose 0.7%, well ahead of the 0.3% forecast. We think that there may be at least some easing of consumer spending. Excess savings built up during Covid are starting to disappear. Student loan payments (affecting 44 million people) restarted on 1 October. Credit card and auto loan delinquency rates are rising. Consumers in different economies exhibit different sensitivities to interest rates, largely a function of how exposed they are through floating rate or short-term fixed rate mortgages. The US is in the extreme with the dominance of 30-year mortgages. This has meant that many are not moving house, in order to protect their ultra-low mortgage rate. However, at some point people do need to take out mortgages, be it as a result of the size of a family growing or needing to move geography. The impact is just lagged.

[1] *Source: Bloomberg.*

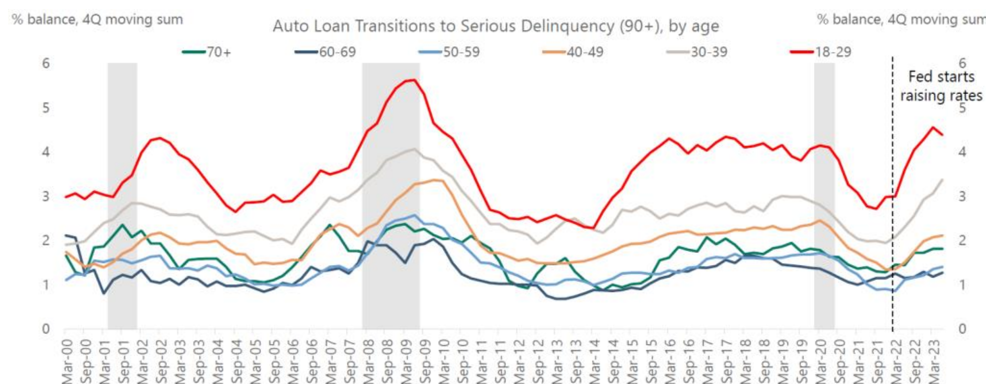
US households running out of excess savings[1]



Credit card delinquency rates rising[2]



Auto loan transitions to serious delinquency approaching 2008 levels[3]



Employment data has remained strong, though there are some signs of easing pressures. Voluntary resignations have fallen and wage growth for those switching jobs has eased.

Government debt has risen inexorably since 2008, initially as a response to the Global Finance Crisis and, more recently, to counteract the worst impacts from Covid when much of the world economy went into some form

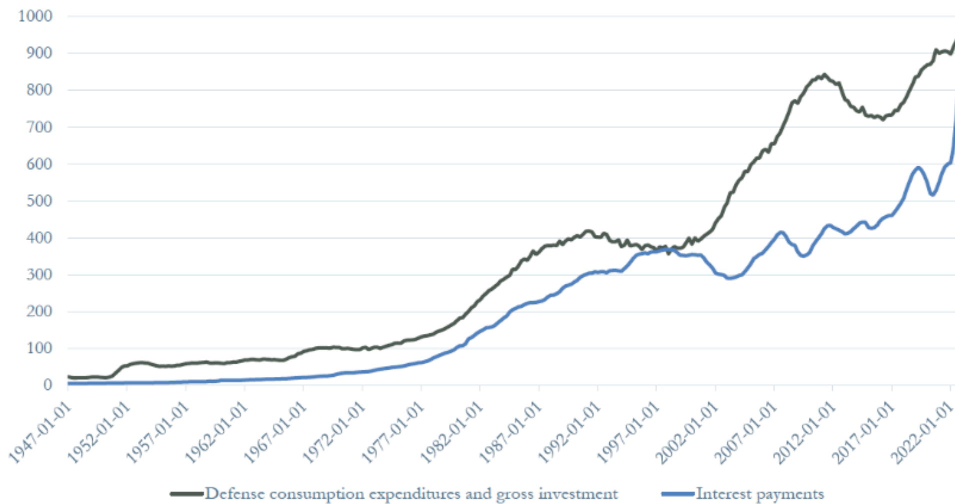
[1] *Source: BEA, Haver Analytics, Apollo Chief Economist. Note: Excess savings are calculated as the accumulated difference between actual personal savings and the trend implied by data for the 48 months leading up to the first month of each recession, as defined by the NBER.*

[2] *Source: New York Fed Consumer Credit Panel / Equifax, Apollo Chief Economist.*

[3] *Source: FRBNY Consumer Credit Panel, Equifax, Haver Analytics, Apollo Chief Economist.*

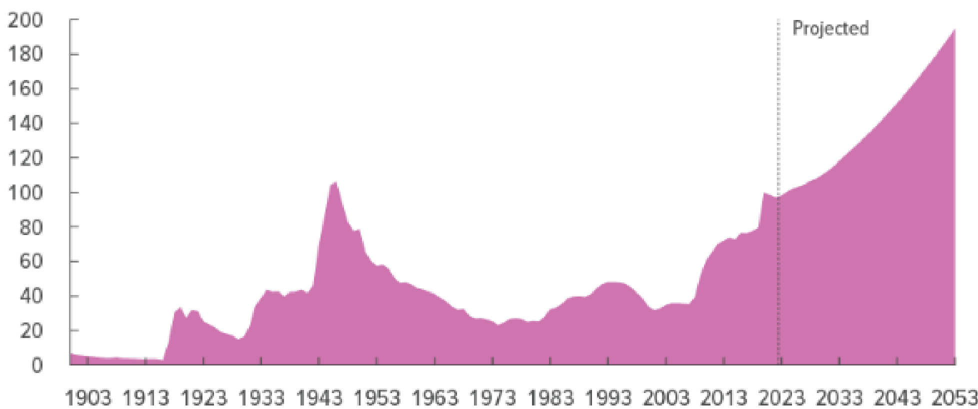
of lockdown. Increased debt is not felt when the servicing costs are close to zero. However, when they rise they have the potential to put significant pressure on government finances. In the US, the debt service cost is now forecast to pass the defence budget in 2024.

Defense and debt service ($bn)[1]



In its most recent report, the Congressional Budget Office (CBO) has forecast US debt to rise from 98% of GDP at end-2023 to 118% in 2033 (and then much further still). Interest expense will be 3.6% of GDP by 2033. This trajectory is unsustainable. Of course, policies can change, but at least currently there seems little appetite to reduce public spending.

Federal debt held by the public, 1900 – 2053[2]
% of GDP

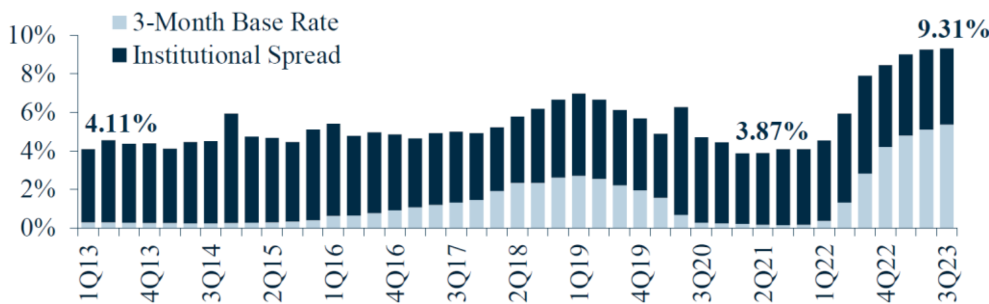


Corporates are equally as impacted. Funding costs for corporates have more than doubled from their trough and are higher than they have been in over a decade. This is with credit spreads remaining relatively tight and certainly tighter than they usually are at times of recession. It is also at a time of increased leverage.

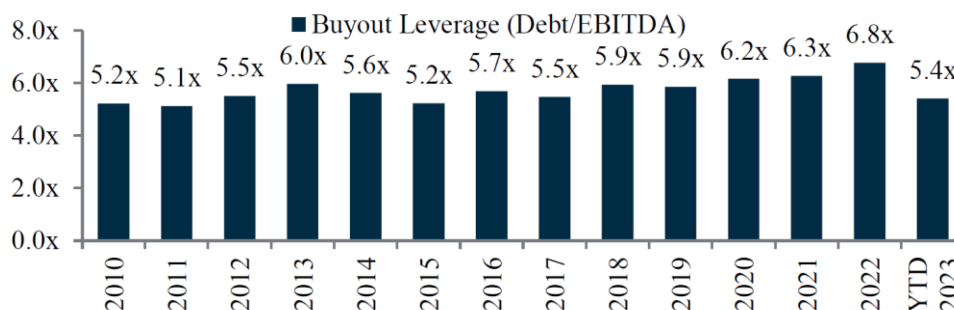
[1] *Source: LCD Research as of 30 Sep 2023.*

[2] *Source: Congressional Budget Office (www.cbo.gov).*

Weighted average absolute institutional rates reached its highest level in over a decade[1]



Buyout leverage reached all-time highs in 2022, but the capital markets have begun to close for riskier issuers[1]



Put simply, corporates need to refinance high amounts of leverage at potentially more than double the cost. This could lead to material defaults and credit rating downgrades, along with liquidity issues.

We remain cautious over the outlook for economic growth; and, with it, markets. This is primarily driven by the direction of interest rates and the (lagged) effect it has on corporates, consumers and governments. All have to refinance their debt, which was written at historic low interest rates, at higher though simply more normalised levels. We cannot see interest rates being cut significantly outside of a major economic downturn. This interest rate cycle has seen much quicker rate increases than in prior cycles and the impact of the higher rates may be more severe, with the impact delayed all the more so by excess savings built up during Covid.

The current situation in Israel is unfolding and, from talking about heightened geopolitical risk, we are experiencing it. At this stage, broader implications are hard to foresee though escalation into a broader regional conflict, potentially with the direct involvement of the US, could have severe ramifications for the world economy and markets.

Strategy Allocations

Performance was positive in Q3. All sub-strategies bar equity long/short saw gains. We are positive on the outlook for our strategies. The investing environment is likely to continue to be volatile, which we think is well suited to trading strategies. As credit default risk rises with companies needing to refinance debt at higher rates, dispersion in the performance of individual credits should rise, particularly at times of stress, lending

[1] *Source: LCD Research as of 30 Sep 2023.*

itself to a long/short strategy. Relative value and event driven strategies should also prosper, with their investments being priced off a (higher) risk-free interest rate.

We are not making significant changes to portfolios, though we are looking at the margin to add some strategies where we feel the opportunity set is improving. This is primarily within credit-related and trading strategies, though we are mindful of not taking embedded directional risk with the former.

Discretionary and Systematic Global Macro

This was a strong positive quarter for discretionary macro and other related trading strategies. Discretionary macro funds were well positioned for yields going higher in the US and Japanese bond markets. In addition, long-held curve steepening positions were also profitable. Currency trading was generally also positive, with short positions in the Chinese yuan and European currencies driving gains. Our top performers were thematic discretionary macro managers, some of whom had suffered the most in Q1 2023. Performance has recovered strongly, with most managers ending Q3 now positive on a YTD basis. This puts them in a good position for the remainder of the year, as macro funds are generally more inclined to add risk when they have a profit cushion.

Relative value strategies were also profitable, with fixed income focused strategies leading the way. Increasing volatility in treasuries and higher returns from cash management led gains.

Quantitative market neutral strategies delivered good returns in Q3, with equity statistical arbitrage strategies driving gains. Our machine learning and AI manager focused on systematic equity and futures trading, was flat on the quarter.

Commodities were also profitable overall, with discretionary managers focused on trading oil driving returns. Our smaller exposure to systematic strategies was negative as systems struggled with choppy price action, particularly in European energy markets.

We remain very constructive on the opportunity set for discretionary macro and related trading strategies. We favour discretionary macro over relative value strategies at this moment and we remain cautious on potential crowding risks from levered relative value strategies as hedge fund multi-manager platforms continue to grow their footprint.

With heightened geopolitical risks, market volatility is likely to remain above average in the near to medium term on the back of geopolitics, inflation and central bank policy action across the globe. These two-sided risks, particularly in interest rates are likely to create numerous trading opportunities. We also remain constructive on commodity and quantitative market neutral strategies.

We believe a well-constructed portfolio of diversified macro and trading managers can deliver compelling returns in such a volatile market environment, particularly without taking any beta risk to equities and bonds.

Equity Long/Short

In aggregate, our allocation to equity long/short funds made a slightly negative contribution to overall performance in Q3, although there was meaningful dispersion across funds. Following a strong Q2, most major equity indices were weaker this quarter with stubborn inflation, rising interest rates and oil prices

proving notable headwinds. These trends had an outsized impact on long duration stocks and rate sensitive sectors, such as utilities, renewables and biotechnology.

One of the key equity market drivers this year has been the proliferation of AI, which has created outsized returns for a narrow handful of large cap tech stocks. Some of the excitement around this theme subsided during Q3 with a sell-off in some of the perceived AI beneficiaries. It has now become generally accepted that spending on the infrastructure layer for AI, epitomised by Nvidia, is going to continue to be very strong in 2024. The debate, which the market is currently having, is whether this level of spending will be sustainable, or whether it will represent a near-term peak. The answer to this question probably rests on whether "killer AI applications" emerge, and the magnitude of the advancement in AI capabilities from the current models to the next models.

Stenham's allocations to uncorrelated strategies fared better than directional strategies through Q3. Our exposure to two multi-manager platform strategies contributed positively, as did our quantitative systematic equity manager allocations.

The key detractors were two low net utilities and infrastructure managers. These funds suffered from relentless flows out of their space in response to higher interest rates. We have experienced similar cycles with these managers in the past where they suffer from macro flows which do not particularly distinguish between stocks based on fundamentals. These moves, however, then tend to open up wider than normal dislocations, which the managers can benefit from as things calm down and investor focus returns to fundamentals.

We have made no notable new equity long/short investments or redemptions, but continue to prefer funds that exhibit lower volatility and drawdown profiles. Our broad stance remains cautious. We do not believe that this is an environment where taking higher levels of risk is sensible and likely to be rewarded.

Event Driven

Our event driven allocation performed well in Q3, driven by positive developments in key merger situations. Of note, Amgen reached agreement with the US's Federal Trade Commission (FTC), paving the way for the completion of its acquisition of Horizon Therapeutics, and Microsoft won approval from the UK's Competition & Markets Authority (CMA) for its acquisition of Activision. Regulatory risk around large-scale mergers had been seen as elevated, with these two situations held up as flagship cases, and the fact that these deals have now been approved, with seemingly minimal (if any) additional concessions by the acquirors improved sentiment, driving spreads tighter across the investment universe.

Our managers performed well. One, in particular, increased risk significantly during Q2 as spreads widened and generated strong profits as these spreads tightened. Another manager, who looks to avoid the riskier deals also generated positive returns, but less so though this manager was also largely unimpacted by the spread widening in Q2. Overall, this strategy has performed well in 2023, following positive performance in 2022, and we like the return potential as deals are priced as a spread over the risk-free rate and so, in absolute terms, have increased as interest rates have risen.

Credit

The credit allocation continued to perform well and has generated strong returns for the year. The managers are tilting marginally net long, though this is constrained and has been reduced during Q3. Gains have predominantly come from long positions, where convexity in returns is available for the first time in many years. Opportunities in financials also helped some of the funds, including the completion of the merger between Credit Suisse and UBS. There is also increased dispersion within credit, something which we expect to continue as companies come up against the need to refinance debt and the economic environment potentially proves more difficult.

We are excited by the opportunity in private credit. Both direct lending and distressed/special situations, such as bridge financing and companies needing financing at short notice, are benefiting from the same dynamics, but in a different way. When companies come to refinance, they will need to do so at both lower leverage and higher rates. A typical IPO is being completed at, on average, a turn of leverage less than 12 months ago. Rates are materially higher. For direct lending, this results in i) higher returns (rates) but with ii) less risk (leverage). Not all companies will be able to operate at the higher interest costs, nor have the ability to delever the business, either through earnings or raising fresh equity. This will necessitate the need for some companies at least to look to restructure their balance sheets and businesses.

Given the growth in size of credit markets since 2008, even a moderate pick up in defaults could cause a material opportunity set, multiples in size of that in 2008/9.

Summary

We are optimistic on the opportunity set and return potential of our portfolios. We continue to take limited beta to broad markets and believe the return potential of high single digits with limited downside is very attractive given the risks which we see.

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.

Kevin Arenson
Chief Investment Officer

Tim Beck
Senior Investment Executive

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