# Stenham Quarter 2 2011 Report: The End of Quantitative Easing

## 1. Market Movements

| Equity Indices | Q2 2011 Change | Fixed Income Markets | Q2 2011 Change | Currencies vs USD | Q2 2011 Change | Commodities | Q2 2011 Change |
|---|---|---|---|---|---|---|---|
| **MSCI World** (LC) | -1.38% | **Global Bonds** | +1.67% | **GBP** | +0.02% | **Gold** | +4.75% |
| **S&P 500** (USD) | - 0.39% | **Investment Grade** | +2.29% | **EUR** | +2.26% | **Oil** | -3.77% |
| **DJ Euro STOXX** (EUR) | -2.14% | **High Yield** | +0.93% | **JPY** | -2.74% | **DJUBS** | -6.74% |

## 2. Review of the 2nd Quarter of 2011

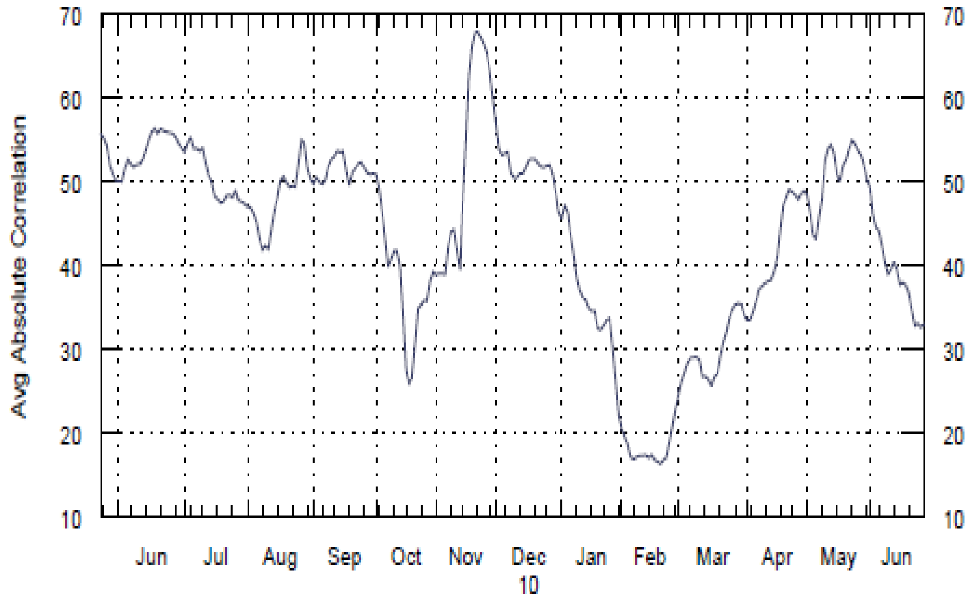
The second quarter of 2011 was characterised by continuing nagging doubts around the strength and sustainability of economic growth in light of the ending of a major stimuli: US Quantitative Easing (QE) programmes. This will be a major change to the economic backdrop, notwithstanding the fact that Fed chairman Bernanke recently indicated that there may need to be additional stimulus if US economic growth and employment does not pick up. Though the extent of any additional stimuli must be limited, given the overall level of US Government debt and the growing political realisation that the US must introduce a credible plan for long-term debt reduction, or face a rating downgrade. We face the prospect of the US no longer being a Triple A rated credit.

Despite not being as spectacular as the earthquake, tsunami and nuclear meltdown witnessed in the first quarter of 2011, the second quarter turned out to be no less eventful. It is not so much the uncertainty, as this is commonplace, but it is the extent of fluctuations that has made investing with a positive outcome so difficult to achieve year to date. The second quarter of 2011 was characterised by a period where financial market returns were heavily influenced by the interplay between Technicals and Fundamentals. Constantly shifting opinion and the juxtaposition between monetary policy and fundamentals resulted in many asset classes swinging wildly from being positive to negative on short term trends. This resulted in the widespread use of the expression “risk on, risk off” and a high degree of cross asset class correlation.

### High Degree of Cross Asset Class Correlation

Figure 1 shows cross asset class correlation rising throughout March, April, and the first three weeks of May producing an environment that was not favourable for long short investing. When asset class correlation is high, the short side of a hedge fund manager’s book tends to neutralise that of the long side, resulting in a marginal return outcome. The rising trend in cross asset class correlations turned during June.

**Figure 1: Cross Asset Class Correlation**

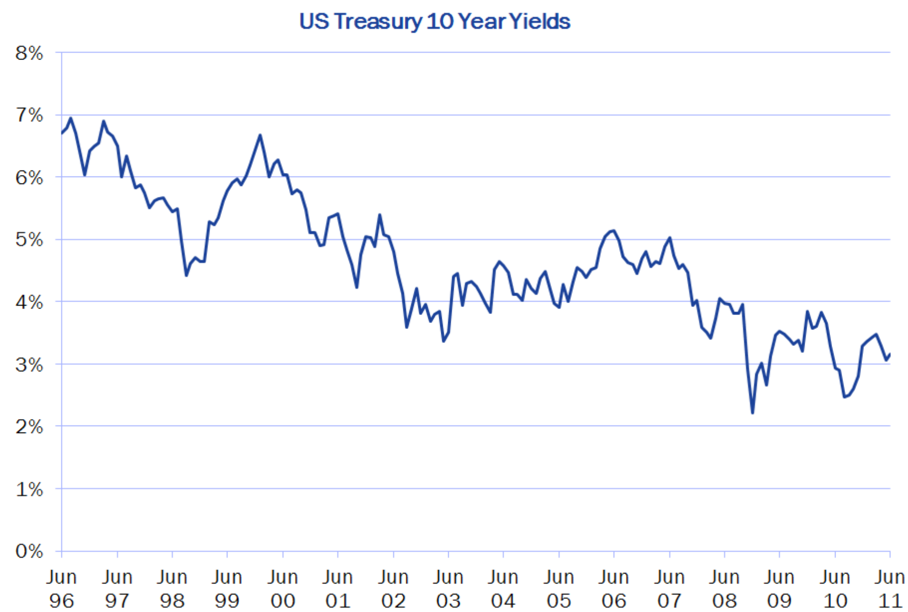



Source: Goldman Sachs

## The End of QE

We believe that it is important not to allow the disappointment of a consecutive quarter of poor returns to distract from meaningful analysis as to why the second half of the year is likely to bring a more conclusive and better return outcome. At the end of June 2011, the US brought to an end the addition of new money into its current program of Quantitative Easing (so called QE2) which has been the dominant force in the determination of asset prices over the last eighteen months. The scale of the commitment to QE may have surprised some and the cost has been eye-watering, but the departure of such a strong technical influence is likely to bring fundamentals back into sharper focus. Despite a decline in US Treasury yields of all maturities during the first two weeks of July, we believe the end of QE is likely to signal a broad change in the future direction of fixed income yields and spreads. This is the first major influence to have changed in the fixed income markets since the start of the downward trend in interest rates in 1998 – see Figure 2.

Figure 2: US Treasury 10 Year Yields




Source: Bloomberg

US QE was accompanied by widespread, co-ordinated and prolonged intervention by many other Central Banks including those in China, the EU and the UK. This widespread intervention has encouraged investment (partly by design) in more "risky assets" while discouraging the holding of "less risky assets". This encouragement has often been at odds with the fundamentals.

We believe that a number of Macro managers may have under-estimated the level of commitment to this form of loose monetary policy and some have taken time to adapt their trading styles to such a dominant force. The direct intervention in financial markets of these new players with strong balance sheets coincided with the withdrawal of many Investment Bank proprietary trading books as they sought to come in line with the US' so called "Volker rules" - these were in fact only strong suggestions but were the price paid for the liquidity provided by the Fed in 2008! We detect certain of our managers have taken some time to adjust to this new environment but we believe that these managers, with long track records of success, have constantly adjusted their trading styles in the past to suit varying market conditions and will continue to do so.

The uncertainties around the ending of US QE were compounded by the resurfacing of issues relating to the overall level of government debt in Greece and the short term financing needs there, as well as the implications for other Euro members. This brought into focus similar issues as the so called “peripheral countries” of Europe again became front and centre of investor focus. In the end the EU stepped up with another short term solution, but not before the Greek people again showed their level of disgust at the impending degree of austerity being imposed upon them. The EU recalculated the cost of a default and its impact on the German and French banks, the largest holders of Greek sovereign debt and forced through a short-term solution. However, it is only that and there are many other countries in Europe upon whom the EU Central Bank will need to apply similarly strong pressure for austerity and spending restraint.

During the deliberations around Greece, US Treasuries yields tightened. Investors are now faced with an interesting dilemma: normally at times of any global stress, investors buy dollars and invest in Treasuries. This would be the normal course of action with the Euro facing so many problems. However, with the withdrawal of QE, and with it trading volume declines and issuance at low levels, there are two opposing forces. The next area of focus is now the overall US debt ceiling that will technically be reached in August. A vote by Congress is required before then for any further increase and President Obama has asked that Congress come back with a “serious plan for deficit reduction…[in order] to avert Armageddon”.

## 3. Outlook

We remain confident that medium term fundamentals will drive asset valuations in absolute and relative terms going forward. They always have done and they always will do. Cross asset class correlations do not persist at high levels indefinitely, and historically, there has been a strong inverse correlation with US Treasuries, which look now to be rising. Dispersion looks likely to increase. No Sovereign balance sheet can suspend reality indefinitely and the US’ balance sheet and stage in its political cycle, looks to limit its appetite for further mass scale intervention. Cash continues to yield very little and Treasury yield compression looks to have come to an end. Only a very pessimistic outlook suggests US Treasury yields grind tighter from here.

Economic growth in the East continues to be strong and the corporate sector (in the US in particular) appears in rude health, with low leverage and high levels of balance sheet cash, suggesting a sweet spot for Event Driven strategies. Many US companies with high levels of debt took the opportunity to use the demand for yield left by the void in returns from cash deposits, to push out their potential problems by refinancing their debts with banks that were only too willing to postpone the day of reckoning without the need for a write-down at present. The High Yield refinancing bubble of which there was so much comment 18 months ago has now been pushed down the road for at least three years.

However, June saw two of the five largest weekly outflows from High Yield Bond funds on record in dollar terms and the largest in terms of percentage of assets under management. This shows growing investor awareness of likely higher yields and widening spreads both of which re-enforce our view that this is not the time to be exposed to directional credit strategies. Indications in the market place would also point to low levels of liquidity for credit related instruments which make them difficult to sell without taking a discount to market prices.

## 4. Strategy Allocations

The largest allocations in the multi-strategy portfolios are Equity Long/Short and Global Macro followed by Event Driven. All of these are long short strategies, to varying extents. Historically Equity Long/Short and Macro strategies have shown a high degree of inverse correlation but both have found 2011 a difficult trading environment while cross asset class correlations have been high and dispersion low. This is the least good environment for long/short investing.

We had hoped that we would have begun to see higher levels of dispersion during the second quarter of 2011, as noted in our first quarter report. While this did not occur for the reasons discussed above, we do believe that this is just a miss-timing of fundamentals again driving return outcomes rather than a permanent change in the determining factors.

However, going forward, we expect to see a more fundamentally driven outlook in a lower economic growth environment with greater dispersion and hence, increasing opportunity for our managers to make positive returns. There are signs across the Emerging Markets that the Inflation noted in our last quarterly report for the Q1 2011 is stabilising, mitigating fears that policy makers will have to extend tightening of monetary policy in the region to the point that risks economic growth.

### Discretionary and Systematic Global Macro: 37%

We believe that the outlook is for more trending markets now that the imbalances in the US and EU have reached levels that are provoking action. Emerging Market countries that have fixed currency pegs to the dollar have accumulated huge currency reserves thereby exacerbating global imbalances further. What we have high conviction in, is that these imbalances will end in some form and in some manner, creating significant investable trends across global markets. We believe macro managers to be well placed to understand the complexities of these global dynamics and structure their portfolios accordingly. Our confidence is reinforced by the risk control we have witnessed YTD and the asymmetric return profile typical of the strategy.

### Equity Long/Short: 31%

Equities are a good hedge against inflation in all but the most extreme cases. Inflation levels have risen across the Globe, and while the rapid rises seen in the East are showing signs of slowing, it remains to be seen as to whether the higher levels of inflation in the West can be squeezed by government policy. However, what seems certain is that economic growth both in the West and for the World overall is set at much lower levels than before 2008. As such, with the relief rally of 2009/10 now past, there is likely to be much more binary outcomes in terms of winners and losers. It therefore seems reasonable to expect high dispersion in terms of geographies, sectors and companies within sectors – all of which become investable for long short equity managers.

### Event Driven: 19%

We believe that the strength of many company balance sheets, lower levels of top line growth, attractive equity valuations and poor returns from money on deposit will continue to foster a favourable environment for event driven investing. Deals are being generally well received in the market place which we believe will continue to encourage more corporate activity. News International/Sky notwithstanding, we believe that the growing level of sophistication in the analysis of regulatory and legal frameworks around bids by our selected managers make likely return streams particularly attractive at present.

## 5. Summary

Uncertainty still abounds: the European sovereign debt crisis, the US debt ceiling stand-off, weakening US economic data, the possibility of a hard landing in China as well as the prospect of inflation being exported from the Emerging Markets. However, it was ever thus and we believe that the collection of managers in which our funds are invested have proven track records in adjusting their strategies to make positive returns in a wide range of environments. There are already encouraging signs that during the second half of June and early July fundamental factors are again driving market return outcomes. We invest for the medium term and historically, hedge fund returns can be erratic on a month by month basis, while still achieving superior positive return outcomes over a longer timeframe. We are excited at the opportunities presented to us and the longer term returns that these should yield for our portfolios.

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: www.stenhamassetmanagement.com

**Kevin Arenson**
**Chief Investment Officer**
**Stenham Advisors Plc**

**Jeremy Alun-Jones**
**Group Managing Director**
**Stenham Advisors Plc**