# Stenham Quarter 1 2012 Report

## Fundamentals Ultimately Dictate

April 2012




## 1. Market Movements

| Equity Indices | Q1 2012 Change % | Fixed Income Markets | Q1 2012 Change % | Currencies vs USD | Q1 2012 Change % | Commodities | Q1 2012 Change % |
|---|---|---|---|---|---|---|---|
| MSCI World (LC) | +10.94 | Global Bonds | -0.91 | GBP | +3.11 | Gold | +6.69 |
| S&P 500 (USD) | +12.00 | Investment Grade | +3.15 | EUR | +2.87 | Oil | +14.91 |
| DJ Euro STOXX (EUR) | +6.94 | High Yield | +5.03 | JPY | -6.84 | DJUBS | +0.87 |

## 2. Review of the 1st Quarter of 2012

The main issue dictating the direction of assets in the first quarter of 2012 has been the receding 'tail risk' within Europe as compared to the end of last year. This reduction in tail risk, triggered by the LTRO programme (or QE), caused risk assets to rally in the first two months of the quarter while moderating in the latter part, as risks relating to Spain came into focus.

The three main economic blocs of the US, Europe and Asia face differing opportunities and challenges as 2012 unfolds.

In the US, GDP growth came in at 3% for Q4 2011, an increase from 1.8% in the previous quarter. The improved economic data is a result of healthy consumer spending, underpinned by a recovering labour market. There is growing evidence that the housing market is, at worst, stabilising but may already be in the early stages of a recovery. This, together with other areas such as better auto sales, is further evidence of the recovery. The encouraging data together with lower unemployment numbers is giving consumers the confidence to increase their spending after a few years of rebuilding their balance sheets.

Europe, however, is facing mixed fortunes. On the one hand Germany is growing very strongly with unemployment at record lows and industrial activity at multi-year highs, while Spain is suffering from 24% unemployment and falling housing prices. The LTRO programme which was put in place in December substantially reduced the tail risk of things going horribly wrong but hasn't solved the longer term problems of the need for debt reduction; a very difficult task in an environment where there is no growth. Already the new Spanish government has indicated that this year's budget will not comply with the deficit target agreed with the EU. Spreads on government bonds in both Spain and Italy have recently widened on the back of such risks. The divergence in growth between the Northern European countries and the peripheral economies remains a significant challenge for the politicians to navigate, in particular if we start to see changes in governments which heightens the risk of policy errors.

China has lowered its growth target to 7.5% from the previous target of 8.0% which had been in place since 2005. The revised growth target comes together with an attempt to rebalance the economy away from dependence on exports towards a more consumer-driven economy. Inflation has been a problem in China for the past two years, in particular in the real estate market, and it has been the government's specific target to lower prices and make property more affordable. Towards the latter part of last year the inflation rate started to decline again which led to some easing in monetary policy and the lowering of Bank reserve requirements. Q1 2012 GDP growth came in at 8.1% from 8.9% in the prior year, the slowest since 2009 albeit still very robust. The debate on China continues to be whether the government will be able to engineer a soft landing or whether we will see a hard landing with severe implications for commodity prices and world growth. To date, the evidence would suggest that they are in for a soft landing but this needs to be carefully monitored as the re-orientation progresses.

In Japan there are indications of a revival following last year's tsunami. The government has followed an expansionary fiscal policy implementing quantitative easing which has led to a weaker Yen, boosting export- related activity.

Risk assets performed strongly in Q1 2012 as a result of better growth prospects in the US and in particular because of the receding European tail risk. January and February were particularly strong while we have started to see some nervousness re-enter the market in March and April, as evidenced by yields on government bonds rising in Spain and Portugal.

## 3. Outlook

One of the most interesting developments over the past two years has been the new extraction techniques developed within the shale gas industry which could have severe implications for commodity prices, notably the energy complex, over the next five years. Excess supply of natural gas in the US has caused the price to fall from around US$14 per mBtu to below US$2 today despite being only at the early stages of exploiting natural gas based on this new technology. The US could become a net exporter in the years ahead and with the extreme pricing differential between different parts of the world (in Europe the price is in the region of US$13 per mBtu), it could have major economic and geopolitical consequences. An example of this is the impact on the trade deficit in the US as they start to import less energy and possibly a substantial lowering of input costs on manufacturing industries with positive implications for equity markets.

Despite the risks associated with Europe (which we see as the biggest tail risk followed by the risk of a war in the Middle East) the global growth outlook has improved. Central banks are easing, the US is growing and corporates are strong.

Looking at the relative pricing of assets it would seem that equities offer the best risk/reward trade-off. Cash yields very little and is expected to remain low for an extended period of time; bonds have been the asset class of choice despite the generational low yields. Taking a five year view it is very difficult to see yields going anywhere but up from here which would not bode well for bond market returns; while equities, despite the historically high margins, still have high imbedded risk premia and low allocations from investors. If tail risk continues to diminish we would expect equity-type investments to outperform over a 3-5 year time horizon.

## 4. Strategy Allocations

The allocations within our multi-strategy portfolios have remained broadly unchanged over the quarter, with the largest allocations being Global Macro and Equity Long/Short followed by Event Driven, Relative Value and Tail Risk Hedges.

### Discretionary and Systematic Global Macro: 36%

The Global Macro strategies produced a positive return for the first quarter with gains achieved from the general risk-on trade. Specific areas which contributed positively were equity markets generally, weakening of the Japanese Yen and higher government bond yields in the first part of the quarter. FX themes contributed strongly with a longer-term play on emerging market vs developed market currencies being a key driver in the first two months.

### Equity Long/Short: 34%

We are beginning to see a return to fundamentals with differentiation emerging in equities on a regional, global and sector basis. The past 2 years have been a particularly difficult environment for fundamental stock-pickers because of the risk-on/risk-off trade. We see that subsiding in the period ahead which should enable such managers to achieve their longer-term return objectives. Q1 2012 was, on balance, positive for these managers although one manager disappointed with negative performance due to stock-specific selection.

### Event Driven/Relative Value: 29%

The fundamentals for Event Driven are extremely positive after several years of delayed activity due to the macro environment. We expect this to change as the global macro issues recede and greater confidence returns to boardrooms together with the fact that corporates have very strong balance sheets.

The Relative Value strategies in which we are invested are focused in the fixed income space. We do not believe that this is the time to be directionally long of fixed income instruments, instead preferring to participate in this space on a relative value basis.

Our tail risk protection cost us in the first quarter given strong performance of the markets. We had reduced the allocation in Q4 2011 by meaningfully selling down the position after strong performance throughout the year.

## 5. Summary

We are optimistic that as the year progresses fundamentals will increasingly dictate the direction both across and within each of the asset classes. The difficulty over the past two years has been the extreme risk-on/risk-off environment we have witnessed. While we do not expect the path to resolving some of the issues to be smooth, we do believe that fundamentals ultimately dictate the pricing of assets and that our thorough investment process will continue to stand us in good stead.

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

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