Finbou Thales - Investor Letter H1 2020

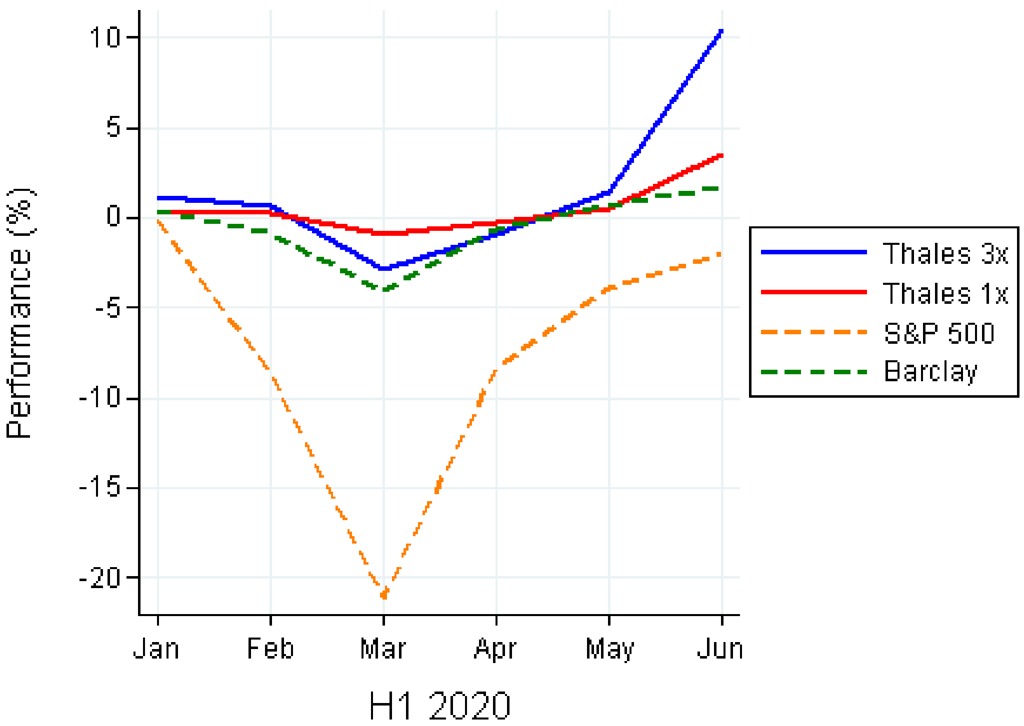
"I don't play the game by a particular set of rules, I look for changes in the rules of the game" - *George Soros*

Dear investors,

The strategy 1x (3x) ended H1 2020 up 3.5% (10.5%) net of fees versus the 1.59% return on Barclay Global Macro Index and -4.0% return on SP500.

Given the extraordinary circumstances due to the corona crisis, this letter will be slightly different from the preceding ones. The events in March alone constitute enough material to write several letters. We have tried to filter and explain the most meaningful developments to make this a more compelling and informative read.

Figure 1: Thales performance against the S&P 500 and the Barclay Macro Global Index



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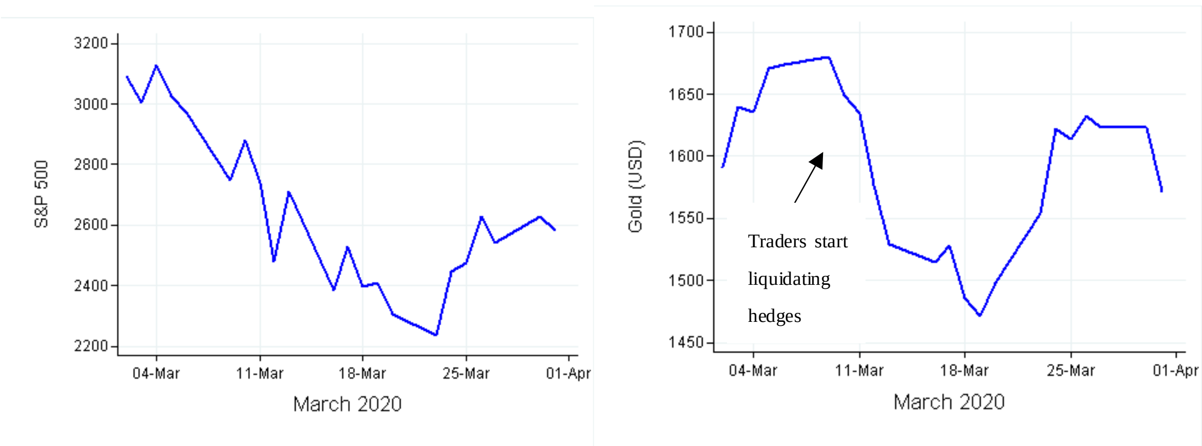
Virus-induced global recession

The outbreak and spread of COVID-19 outside of China in late February caused one of the most brutal seizures of global economic activity in history. As the pandemic does not distinguish among borders, nearly all countries in the world were put in lockdown, applied social distance measures, and suffered a sudden stop in economic activity. The consequence in terms of monetary policy has been a coordinated easing response from central banks around the world.

The outcome for financial markets was a dramatic pick up in volatility and deterioration in market functioning across all asset classes. Characteristically to mature bull markets, many positions had become crowded. Then, as the crisis culminated, large squeezes on various instruments occurred without a fundamental rationale. For example, traditional safe havens such as gold and treasuries became correlated with equities as investors rushed to liquidate traditional hedges.

Figure2; Gold sells off along with equities in March



In the financial crisis of 2007-2008, the Fed started easing first, and the rest of the central banks followed. This time, almost immediately, most central banks decreased rates to their effective lower bound and launched quantitative easing programs in a synchronized and coordinated move. The scale and speed of easing during March were truly astonishing.[1]

Alas, massive monetary policy responses had initially no real impact on markets, as nobody knew whether these measures would change anything (see *Fig 5*, dollar index on the right). After all, monetary policy cannot avert the spread of a virus. Something that appeared decisive a week earlier came out as weak and insignificant as the scale and extent of the virus damage unveiled. For example, on its regular meeting in March, the ECB eased monetary policy by adding a QE envelope for 120 billion of extra purchases for 2020. Five days later, it was abundantly clear the package was not enough, and on an unscheduled announcement, the ECB launched an unprecedented 750 billion pandemic purchase program.

[1] In March, the Fed decreased interest rates from 1.75% to 0.25%, launched an open-ended quantitative easing programme and injected further liquidity into the system via various liquidity facilities and loan programs. Essentially, all the post financial crisis tightening was undone within a period of three weeks.

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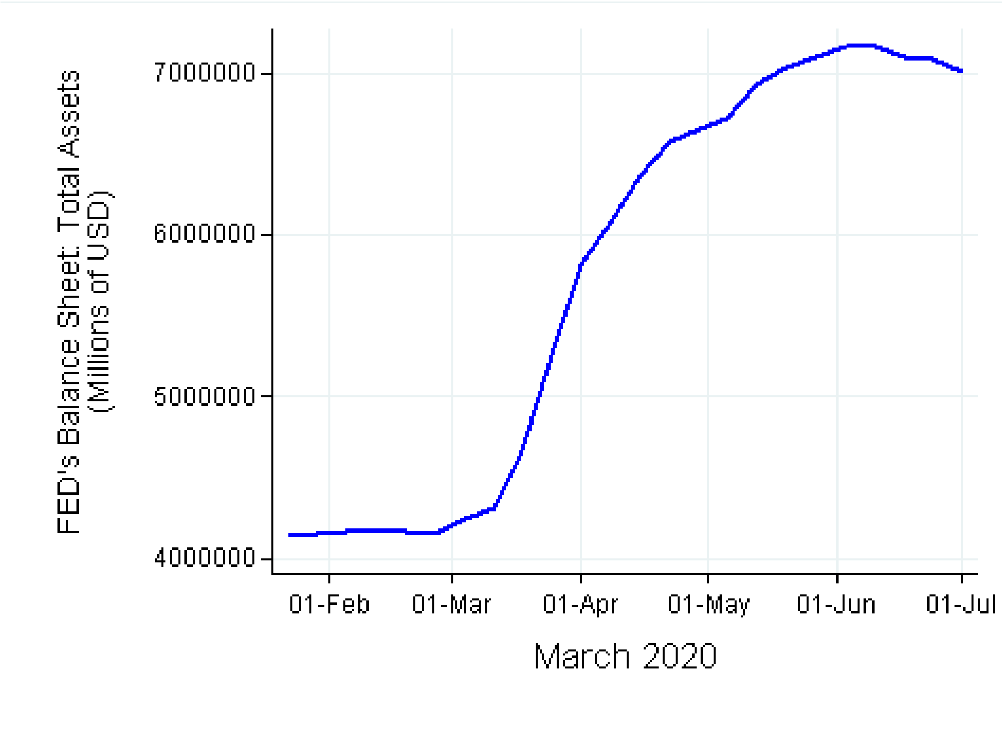
The markets did not stabilize until the Fed crossed the Rubicon on Monday 23th of March by implementing an entirely open-ended quantitative easing program, allowing it to purchase an unlimited number of treasuries in the bond markets. Within three weeks, the Fed balance sheet had expanded by a bewildering amount of 2 trillion. The Fed's determination to buy whatever assets were needed to restore 'market functioning' was integral in decreasing market volatility and restoring financial stability.

Figure 3; Fed balance sheet expands at a staggering pace



If the outbreak was unprecedented, the rebound in the stock markets has been equally remarkable, even if the recovery has been uneven and heterogeneous across sectors. SP500 lost 27% in March alone, at a point, but has since then rebounded to trade close to the levels since the start of the year. The stock markets have cheered the extraordinary level of stimulus provided by central banks and governments, and optimism on the reopening.

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Navigating through the crisis - research response

Notwithstanding the stress caused by the virus to our personal lives, from a business perspective the silver lining for our strategy was the pickup in FX volatility. Yet, after some losses in March, we realized we did not understand the *current* market sufficiently to trade the environment with high conviction. Our earlier work on historical precedents was rendered partially redundant as we had mainly focused on market conditions where global growth was positive.

There is a reason why we had barely researched monetary policy in recessionary environments. We believed we would have ample time once the next recession unfolded. It appeared to us that it would be more valuable to focus on research areas that were happening at the time or bore more resemblance to the concurrent situation. It was a matter of prioritization.

To understand the current situation in detail, we realized that we needed to go through many other crises that had happened before. Therefore, we embarked on an extensive study of several crisis episodes and the response from monetary authorities along the 20th century. We were not trying to answer the question of whether monetary and fiscal stimulus would solve the crisis (unlike everyone in equity space), but how the events are priced differently during different types of crises and market conditions.

Before we started studying the specific policy decisions, we also wanted to see some similar mechanics in play in terms of market conditions[2]. More specifically, we were looking for similarities and differences between the crises in terms of underlying drivers, market reactions, positioning and policymakers' responses. We were quick to disregard some periods as there was little resemblance, such as the tech bubble or inflationary markets in the 1970s.

In particular, the debt crisis of 2012, the financial crisis of 2007-2008 and the Great Depression had some meaningful similarities. The 2012 debt crisis bore significance to EUR in particular, as the market started increasingly worrying about rising spreads in the periphery. The dollar funding squeeze occurred in both financial crisis and the Great Depression, despite the Fed easing policy most forcefully, relatively speaking. The dollar price action after Lehman went bust during the financial crisis has been quite similar to what happened during Corona crisis (see Fig 5.), albeit in general market reactions have been more violent during the Corona crisis. Finally, at the initial stages of the financial crisis and the Great Depression, monetary policy and data had little impact as the level of uncertainty was extremely high. Event related price action generally remained quite muted, as there were more important underlying drivers.

[2] We define market condition as other important drivers that are impacting the markets outside central bank decisions.

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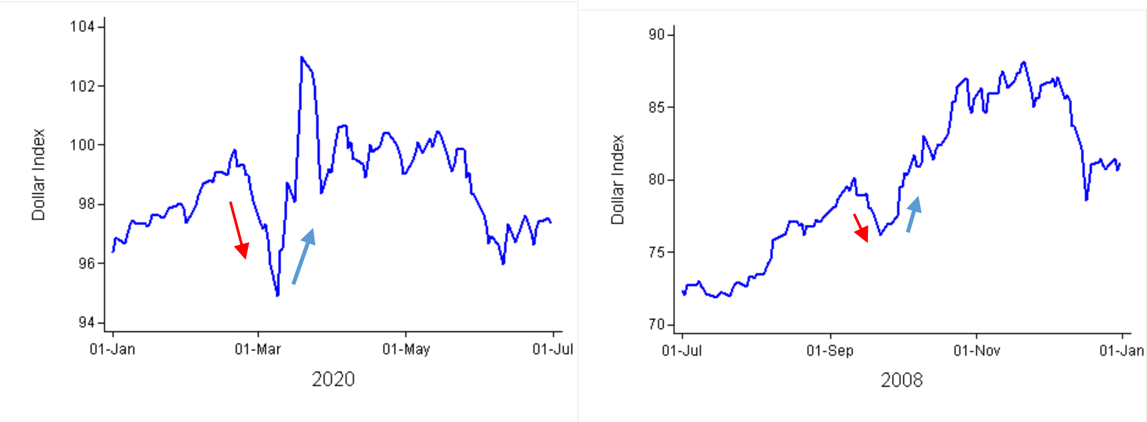
Figure4; Dollar index during the Great Financial Crisis (GFC) and the Corona crisis



The significant difference in terms of a policymakers' response has been that in the Corona crisis both the monetary policy and the fiscal action were immediate, coordinated, and decisive. The concept of moral hazard was comfortably ignored, as this was an exogenous shock instead of a banker, monetary tightening, or liquidity-induced crisis. Overlooking the vast side effects - from the stock markets perspective - the right response was to pump as much stimulus to the economy as possible. For event pricing, this meant that if the situation started stabilizing, event-related volatility might start re-emerging sooner than expected.

Performance picks up and outlook

Towards the end of March, we made some fundamental discoveries in our research odyssey, which allowed us to trade the period from April to June successfully. Market pricing for events works very differently during recessionary times (see *Table 1)*. During non-recessionary times, policy easing is usually negative for a currency. Yet, during recessions, it can become a positive driver, but it is not always so. As previously stated, during recessions, quantitative easing is generally perceived as a positive, yet rates easing remain in some cases negative. On top of that, these relationships vary across different currency pairs and jurisdictions, so it can be a little bit complex. However, often alpha resides in such intricacies.

Table1; Market pricing logic during crises vs. normal times

Period	**Quantitative easing**	**Rate cuts**	**Negative rates**
Recession	Currency up ex. USD and JPY[3]	Currency down/up	Currency down
Non-recession	Currency down	Currency down	Currency down

[3] Funding currencies tend to decline to QE decisions, as the decisions are risk positive.

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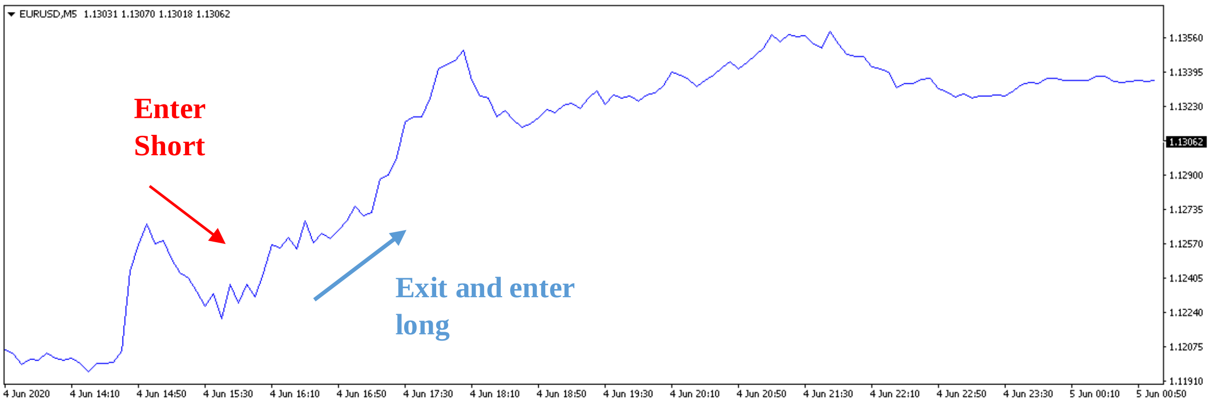
For example, most ECB events traded according to the logic that the more QE there is, the higher the EUR. Before the crisis, QE was one of the most important negative drivers for EUR weakness. Meanwhile, on rates, our evidence suggested that cutting is still considered a negative for the currency. When the June ECB event came out broadly as expected, but EUR rallied, we sold it initially, expecting a mean reversion.[4] However, when Lagarde suggested ECB focus had moved from rates to QE, we reversed positions and unloaded long positions that ended up working very well. Markets had expected a firm openness for ECB to go lower on rates, so this was a relatively high conviction bet (see Fig. 6).

Figure 5; Mean reversion and high conviction momentum bet on the ECB



The month of June saw several events where volatility picked up. Interestingly, apart from the ECB, there was not a single decision that had deviated from expected. Yet, due to the overall pick up in volatility, we were able to exploit inefficiencies related to as expected decisions. Interestingly, most of our winners were mean reversion based, instead of momentum. Historically most of our winners have been momentum-based trades.

Those who have read our letters longer, know that we are wary in making predictions about the market outlook. The adage “He who lives by the crystal ball will eat shattered glass” encapsulates our thoughts on making predictions. Discussing the existing drivers is a more meaningful way to approach the topic. What we can say is that judging by the scale of recent central bank liquidity in the system, the market looks considerably more favourable than before. Volatility has also returned to 2016-2017 levels, which is a welcome development as we thrive on uncertainty. These things can, of course, change fast, as most things ebb and flow in the markets.

[4] A quick refresher behind the jargon “mean reversion” and “momentum”. Mean reversion, in the context of event trading means market moves either up or down to a news release, but then reverts back to the levels before announce as it ultimately did not perceive the information impactful (“reverts to mean” on the parlance). On momentum-based trades, market continues the initial move as it perceives the information more important.

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Concluding remarks

In our previous communications, we have consistently emphasized that a crisis will highlight our edge and role as an uncorrelated "crisis hedge", that in addition to considerably lower risk profile, is also capable of providing benchmark beating returns. During this period, multiple days saw the SP500 index lose over 8%. In comparison, our 3x strategy experienced a *maximum of* 6% drawdown, which was spread across several weeks. Setting our risk compared to the market further into context, at a point, SP500 incurred a 16% drawdown in two days, which vastly exceeds the *maximum historical* drawdown of our 3x strategy at 12.4%.

Since the inception of the strategy in 2017, 10,000 dollars invested on our 1x and 3x strategies would be worth 16,169.47 and 40,254.37 dollars net of fees, respectively. Conversely, the equivalent amount invested SP500 would be worth 13,847.81 dollars, with significantly higher drawdown and intraday volatility. Finally, 10,000 dollars invested in a basket of Global Macro Hedge Funds would be worth a humbling 11,452.27 dollars.

While there will undoubtedly be years when especially the SP500 will trump our gains, and we might experience significant drawdowns, the outperformance has been notable. Moreover, with the experience gained in these turbulent times, we believe we are in a better position to trade through future crises. Our unique position as an asset manager that sits mostly in cash allows us to stay still when needed and deploy capital flexibly when opportunities emerge.

During the crisis, many investors pulled out cash from all sources, which at the time was understandable. Headlines looked almost apocalyptic in March. Uncertainty was unusually high, and many credible sources[5] were circulating numbers on high mortality and infection rates. Stock markets were crashing at a historic pace, and there were expectations of even longer-lasting shutdowns.

Regardless, we did not experience any meaningful redemptions and have since then seen further inflows. Therefore, we thank our investors for the remaining stern and level-headed. Our sincere hope is that we can continue to safeguard your capital during crises and to provide benchmark beating returns along the way.

Sincerely,

Aatu Kokkila
Investment manager
Finbou AG

[5] *See* https://www.who.int/news-room/detail/13-05-2020-people-living-longer-and-healthier-lives-but-covid-19-threatens-to-throw-progress-off-track and https://www.theguardian.com/world/2020/feb/11/coronavirus-expert-warns-infection-could-reach-60-of-worlds-population

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