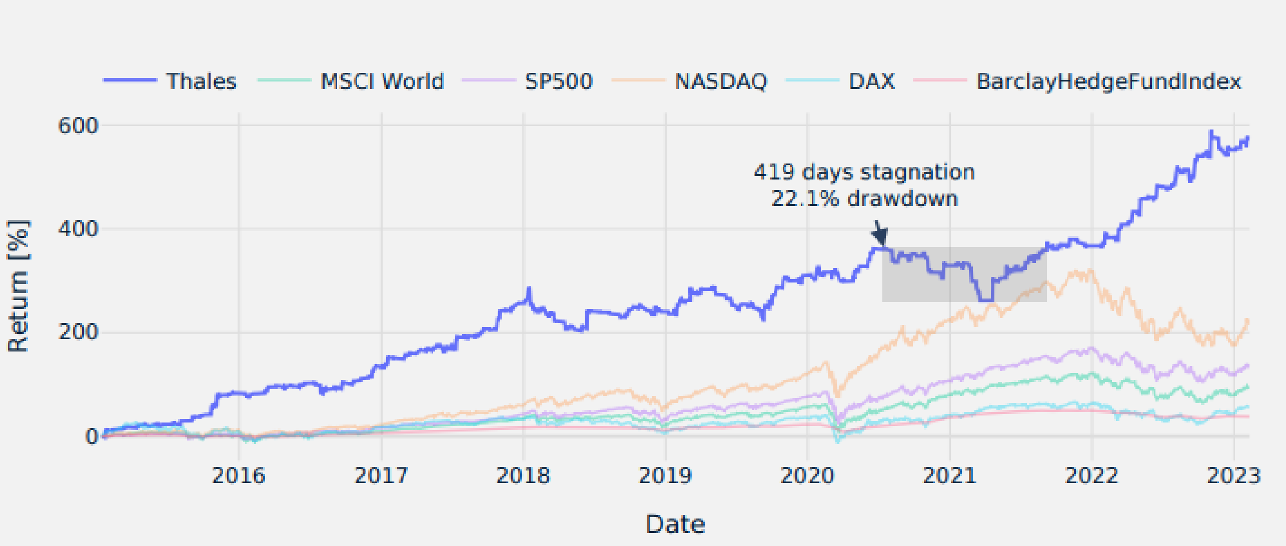
Finbou Thales - Investor Letter H2 2022

Dear investors,

The strategy ended H2 up 11.62%, and the entire year up 39.66% net of fees. The peak-through drawdown for the year was 4.3%. In this letter, we will discuss 2022, and assess the outlook for H1 2023 and recent changes to our team.

Strategy monthly net of fees returns at 9% value at risk (VaR)

Performance After Fees Compared to Benchmark Indices



Monthly Returns [%]

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
2015	12.02	0.54	4.11	3.93	-0.33	-0.22	0.55	6.79	7.85	13.05	13.92	1.39	**83.24**
2016	-1.79	0.81	6.92	1.08	-0.42	3.72	-8.87	3.83	6.52	1.96	3.28	8.29	**27.04**
2017	7.61	-0.70	4.12	3.55	2.82	0.16	5.22	0.11	5.13	6.73	4.43	4.48	**53.01**
2018	-4.14	-1.61	-4.15	-3.66	0.38	9.50	-0.47	-0.90	2.27	2.22	-4.80	1.70	**-4.44**
2019	3.49	3.06	3.53	1.93	-2.73	-5.41	0.07	-2.80	3.72	13.46	-1.01	2.51	**20.28**
2020	1.33	0.34	-4.04	3.51	3.40	7.70	-0.56	-0.95	-0.40	-1.62	-6.32	3.09	**4.82**
2021	0.39	-7.37	-9.33	10.07	5.92	-0.57	6.60	2.72	0.34	1.20	1.64	-1.46	**8.86**
2022	1.18	2.36	5.10	4.09	5.94	3.84	0.31	5.17	4.40	-0.44	2.09	0.05	**39.61**
2023	2.04	1.25	-	-	-	-	-	-	-	-	-	-	**3.31**
												Total	**573.83**

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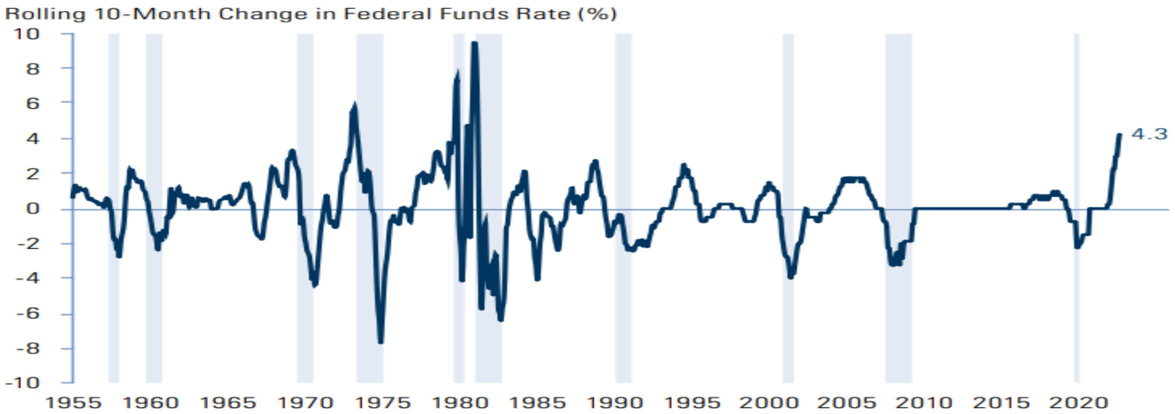
Rear-window look at 2022

Monetary policy stood up from its comfortable backseat last year. At the beginning of 2022, the FED was expected to hike once in, and the ECB was only expected to hike in 2023, if at all. Inflation was elevated, but it was expected to be" transitory" as a result of the easing of COVID restrictions. In H1 the policymakers finally awoke to the crude reality; this inflation is not going away by itself, and they were late in policy tightening.

The result was a rate hiking race the likes of which the developed world hasn't seen since the 80s (see chart). This time it was not only the Fed, but everywhere: central banks were rising rates by 50, 75, and even 100 basis points at a time. The sole exception was the Bank of Japan (BOJ) which stood steadfast with its very loose monetary policy, though even the BOJ had to capitulate on its yield curve control policy in December and increase the band.



Data as of December 2022.
Note: Shaded periods denote recessions. Effective federal funds rate used before February 1994. Federal funds target rate used thereafter.
Source: Investment Strategy Group, Bloomberg, Haver Analytics.

(Source: Goldman Sachs)

The further the year went on, the more it became a story about the Fed and US data. In the latter half of the year, the markets (not just FX, but stocks and crypto as well) were fixated on every word of Chair Powell's communications and US CPI. As a result of the Fed slowing its hiking pace and two consecutive softer-than-expected US CPI readings, the markets were convinced that inflation will come down. As a result, equities made a bit of a recovery in the last quarter of 2022. We believe this was mainly driven by positioning as the market consensus has been very crowded in favour of a weak equity market and a strong dollar.

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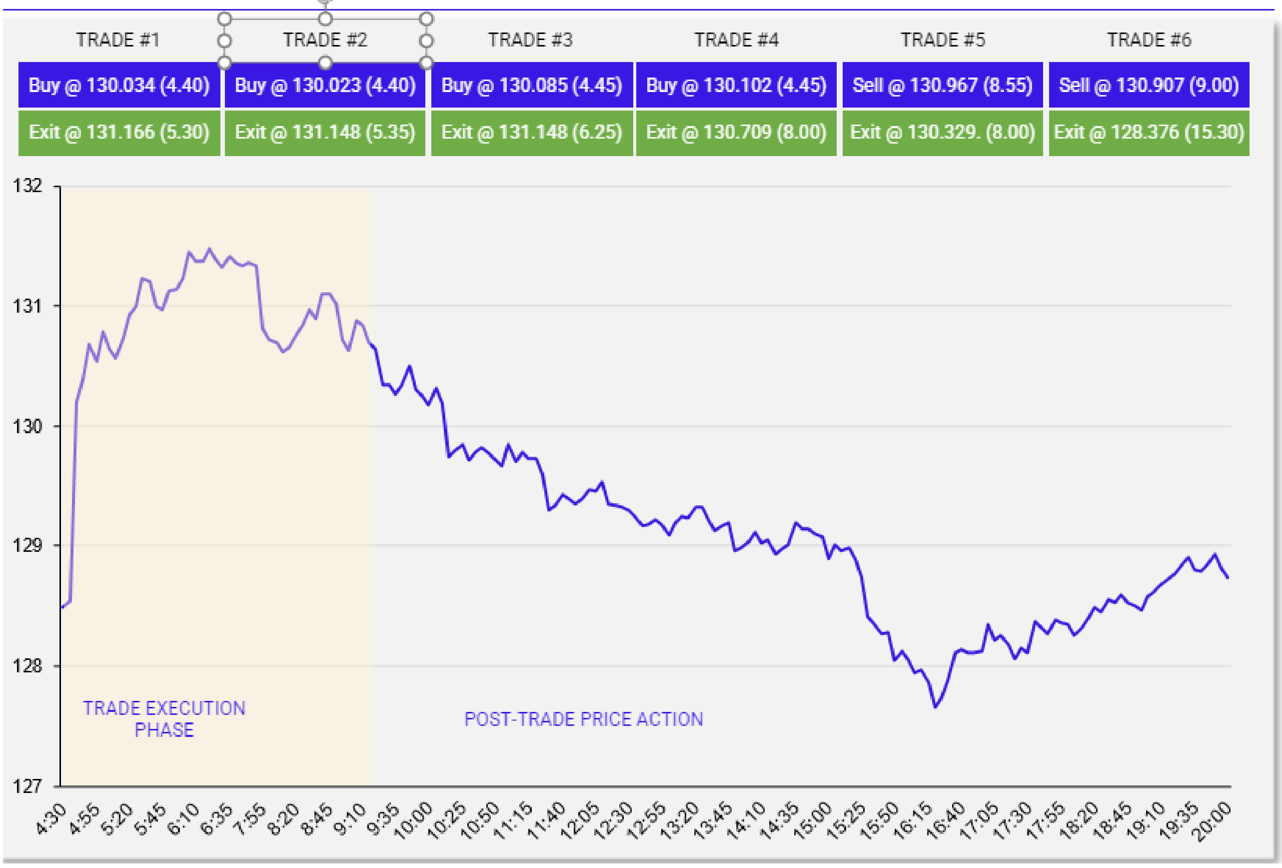
Outlook

At the time of writing, markets are sanguine about the odds of a US recession and volatility expectation is low. Regardless we have had a strong start to the year because all we need is volatility around the events. Volatility may stay low overall for H1 until it picks up in H2 as the recessionary forces build up. Regardless, we believe event-based volatility stays elevated throughout, and as a result of constant improvements to the strategy, we believe it's the only thing we need to perform. To demonstrate this, we have taken an example of the Bank of Japan's monetary policy decision in January.

- The market expected a change to BOJ's yield curve control policy, with over 300 pips of volatility priced into the event. The decision was a no change, hence a dovish result for the JPY.
- Markets sold off the JPY, but the initial reaction, at 150 pips was an underreaction, hence we went long USDJPY targeting roughly 100 pip gains given the volatility pricing.
- Historically such decisions are mean reverting, so after taking profits on longs after the market had moved over 250 pip, we reverted to shorts given historically such decisions are mean reverting.

EXAMPLE BANK OF JAPAN 16.1.2023 TRADE BREAKDOWN (USD/JPY)



We returned 2% on the event, with a risk of 0.2% in total. The BOJ is an apt demonstration of how we have improved through the years. Back in 2018-2020, we would have probably sat down with our take profits and this would have been a flat event for us.

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Team grows

We have recently added new hires to our team. While we initially remained sceptical, that for example research and execution monitoring could be partially delegated, hiring people has been one of our best decisions during the past years. It has helped us grow in capacity, events we trade and improved our risk-adjusted performance significantly.

Firstly, an analyst joined our team, and since our research database and the analysis of central bank language during events is up to date. His research input has allowed us to trade more events, which has resulted in a pick-up in performance, whilst retaining a lower drawdown. Moreover, his analysis of event signals has been extremely valuable in determining the market impact of the events.

Furthermore, an experienced trader has joined our team, who has been tasked with monitoring the execution of trades and risk management. We realized in the past, that we lost a lot of money in execution, however, given how much was going on during events, it was sometimes difficult to monitor the execution cost of each position. Now we know the exact dollar amount per position lost, which is always factored in our risk and hence we don’t anticipate the capacity will be a problem in the future.

Conclusions

We anticipate a marked pick up in volatility in H2, as the market wake-ups again to the prospect of stickier inflation and higher rates. The whole rally in stocks was predicated on inflation peaking and coming down gradually from Q4, a view which is already being challenged. Inflation numbers from Q4 have been revised up and the US labour market is historically tight, both of which imply Fed will need to raise rates more and engineer a deeper downturn. As a result of higher rates, we think stocks and real assets are going to struggle.

Hence the outlook for our strategy continues to stand in stark contrast to the more traditional asset classes, which are likely to experience a decade of choppy returns. Interest rates are likely to stay high for the time being and due to the resulting focus on news events, we are likely entering a golden decade for macro and event trading. We remain adamant that we can provide our investors with significant alpha, a strong hedge, and capital protection in this challenging environment.

Sincerely,

Aatu Kokkila,

Investment manager

Finbou AG

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