Primary Concerns

6th November 2018

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Material Witness - *insights from the Manager*

Mens horribilis

- We recorded our worst ever month in October as the global lurch to 'Risk-off' led to a massive liquidation in oil and, conversely, as Bolsonaro boosted softs. Proof positive that a discretionary overlay to the system is a sine qua non...

Thierry Ralet, CEO & Founder

Mark to Market - *observations from the front line*

The Mirror Crack'd

- Though it will not discourage either pundits or punters from the hunt, the proximate cause of last month's bloodbath must remain elusive. Perhaps the real reason is the simplest: viz., that we suddenly changed the story we all tell ourselves about what is afoot in the world ...

Sean Corrigan, Chief Investment Strategist

Material Witness - *insights from the Manager*

Mens horribilis

The paper portfolio which we are running at present on a month-to-month basis, solely for illustrative purposes, showed a return of -7.2% in October due to huge losses in energy and some in softs. The outcome was somewhat mitigated by a small positive performance in metals and grains.

As usual, we would point out that the model's returns do not reflect the full benefit of our unique methodology because they do not incorporate the effects of the intra-month rebalancing we will regularly be carrying out, once we are fully operational. Moreover, the better to illustrate the advantages of our approach, we also report results on an excess return basis—i.e., without the additional earnings to be made on the underlying collateral.

In energy, all positions were against us. WTI and Brent each took a huge hit (-10%) when we were long and, at the opposite extreme, Natgas roared ahead by 7% as the after-effects of Hurricane Michael and a spell of adverse weather confounded the usual seasonals and therefore caught us short. On softs, we went in short coffee & sugar only to watch these rally 10% and 18%, respectively.

This surge came in reaction to the results of the first round of the Brazilian presidential election which had a dramatic effect in strengthening the previously rocky real. Since Jair Bolsonaro was confirmed as the victor some of the anticipatory force behind expectations that he will introduce market-friendly reforms has begun to wane and a modest reaction has set in. Notably, too, the aggravating factor of mass short-covering by the leveraged crowd has largely dissipated as they have swung from a record 162k short to an 18-month high, 87k net long (a swing of no less than 27% of open interest) in sugar and from another record short, this time of 111k (constituting a remarkable one-third of total O/I), to a 13-month low exposure of just 24k (another massive 26% swing in terms of the proportion of O/I). This type of political event can, of course, not be anticipated by a systematic model. Such moves do, however, underline the rationale behind our intention to undertake discretionary adjustments in practice, once the fund is live.

Curves changed drastically during the month and we would patently have moved to cut some positions had we been actively rebalancing even if much of the damage had already been done. Despite this, we were far from breaching the limits of our maximum permissible drawdown and, with a target volatility of 15%, we still reached no more than 10%. Nevertheless, we recognize that improvements are there to be made.

For the month ahead, we begin with a short position specifically in WTI and globally in agriculture and are slightly long in some of the industrial metals.

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The story so far...

Historical Performance

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2015								-2.7%	8.0%	1.0%	8.3%	10.8%	27.4%
2016	4.2%	6.1%	-4.9%	-3.2%	-1.8%	-1.8%	4.2%	-2.4%	-3.8%	0.8%	-2.6%	-4.3%	-9.8%
2017	-1.2%	1.9%	6.3%	-0.4%	3.3%	1.9%	-3.9%	4.6%	-1.6%	2.3%	0.6%	2.3%	17.1%
2018	1.1%	-3.8%	4.0%	2.5%	1.3%	3.4%	-3.1%	-0.4%	2.1%	-7.2%			-0.7%

Performance Attribution

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Tot
BCOM - Energy	55.7	-117.2	76.6	127.5	-14.0	60.8	-31.7	-13.4	88.3	-218.2			14.5
BCOM - Livestock	-9.6	-4.2	-1.5	44.3	-9.1	-0.8	-29.4	2.0	-59.6	-5.7			-73.5
BCOM - Grains	-50.7	-120.0	36.7	-42.8	39.6	164.5	-63.0	80.9	47.3	11.3			104.0
BCOM - Metals	18.7	-8.2	-16.2	-70.0	4.2	-42.1	-41.1	-23.9	29.7	14.2			-134.8
BCOM - Precious Met.	-	22.2	-	-	11.3	31.9	8.3	-	-	-			73.8
BCOM - Softs	-22.0	-7.4	22.3	12.4	-4.2	16.1	32.3	10.0	-10.4	-66.2			-17.1
GSCI - Energy	168.3	-65.6	131.8	270.1	95.0	40.0	-121.2	-159.5	121.0	-373.9			106.0
GSCI - Metals	13.2	-6.0	-11.3	-53.5	1.4	-53.5	-41.0	-16.4	22.4	13.5			-131.3
GSCI - Precious Met.	-	-	-	-	4.8	12.4	8.4	-	-	-			25.7
GSCI - Agriculture	-60.9	-68.7	88.2	-38.9	19.2	112.8	-20.2	75.6	37.6	-86.8			58.1
GSCI - Livestock	-7.8	-5.3	70.2	2.8	-14.2	-2.1	-4.8	3.8	-71.1	-7.9			-36.3
Total Alpha	105.1	-380.4	396.8	252.0	134.2	340.0	-303.3	-40.7	205.2	-719.7			-11.0

Performance since inception (AUG-15)

	2015	2016	2017	2018	ITD
Portfolio CAR	27.4%	-9.8%	17.1%	-0.7%	9.6%
Benchmark	0.0%	0.0%	0.0%	0.0%	0.0%
Alpha (bp)	2736	-982	1707	-71	956
Volatility	19.6%	12.8%	9.8%	11.2%	13.8%
IR	1.39	-0.76	1.75	-0.06	0.69

Mark to Market - *observations from the front line*

The Mirror Crack'd

As October began, everything in the risk-asset garden smelled of roses.

The Nasdaq, having almost doubled since the end of the 'Hidden Recession' in early 2016 and having hit 7 ½ times its post-Lehman trough, was attempting to move up beyond the highs set at the very end of the third-quarter. Junk bonds were setting new peaks, both in absolute and relative returns, with spreads exploring levels not seen since the fateful summer of 2007. Commodities themselves – led by an oil price starting to find its cheerleaders again talking of three-digit handles – were at their best since mid-2015 when measured by returns and since the autumn of 2014 if gauged by price.

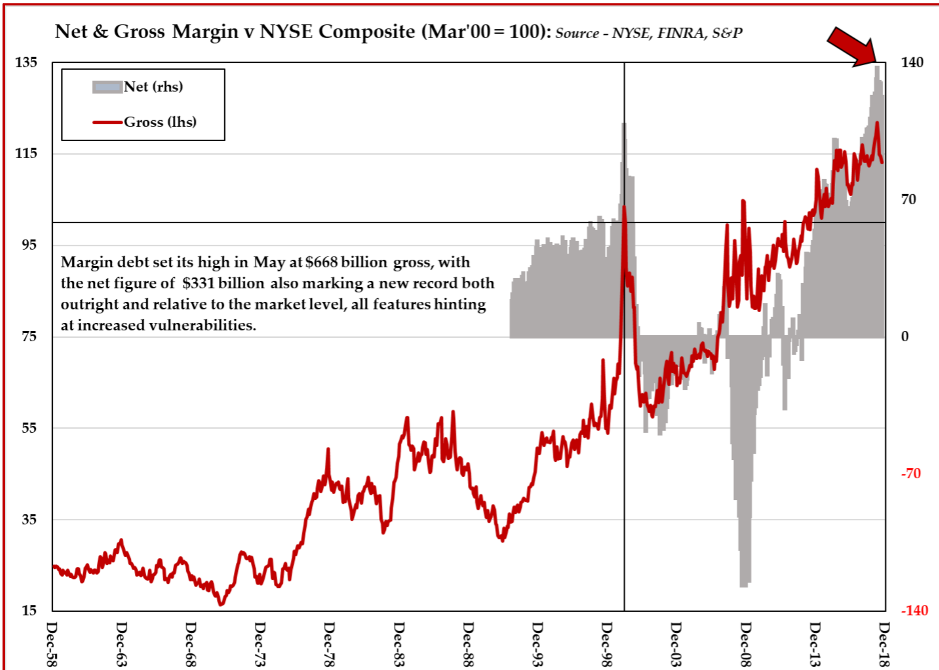
Then, almost overnight, it all changed. Suddenly, fear replaced greed; dips were no longer to be bought; HODL gave way to '*Get me out*'. 'Sentimentals' – as we like to refer to them – had shifted 180⁰ and – in classic Kremlin balcony style – the so-called 'fundamentals' were being radically re-interpreted in order to justify this collective loss of nerve, with bullish factors being airbrushed out and new, more bearish ones being quickly pasted into the resulting gaps in the picture.

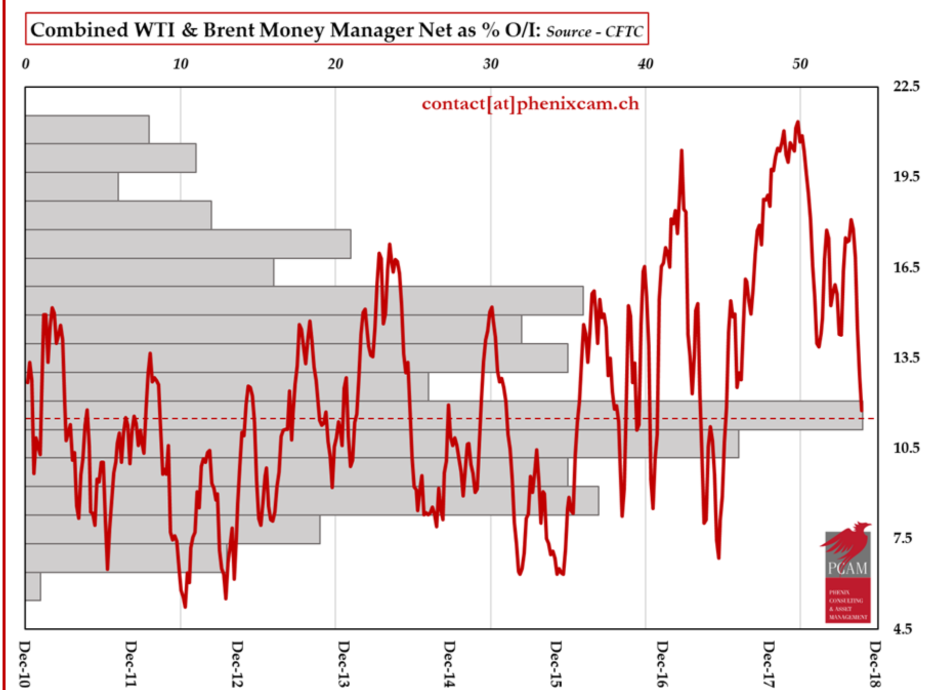
What had really changed? Was the Fed becoming more hawkish? Were the imminent sanctions on Iran about to be postponed? Was there some high-profile, bellwether bankruptcy or financial fraud at which to be astounded? Was the fact that the Chinese economy was in dire straits really such a startling revelation? Had corporate earnings suddenly collapsed?

Hardly. But the same heady cocktail of chronic insouciance and bullish self-reinforcement – by now mixed with a bracing slug of neat hubris - which had driven the market relentlessly higher these past several quarters had at last turned stale in the partygoer's glass. Finally, the lack of any fresh, new narrative began to puncture the ebullience, while the corrosive drip of mounting bond yields finally undermined the foundations of the rally.

If we can play Monday-morning quarterback ourselves a moment and so point to one isolated candidate for what triggered this *volte-face*, we would opt for the fact that 5-year Treasuries finished the first week of October at a new cyclical high yield of 3.1% - an elevation not seen since the very day Lehman fell, ten long years ago.

Though the Herd has long tried manfully to whistle past the traditional graveyard of Bull Markets Past, this time the ghastly apparition of rising interest rates may well have been what finally scared its members into their frantic clamour to sell.





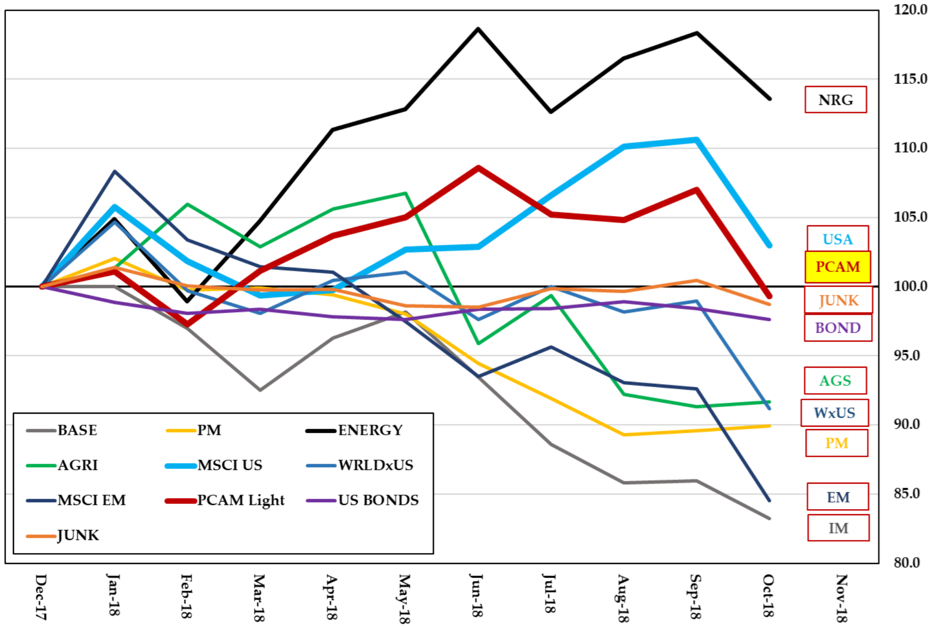
Whatever the real reason, once the '*Great Mirror of Folly*' was seen to be cracked, the reaction fed upon itself – not helped by a crescendo of anxiety emanating from China where a long-deteriorating economic situation had descended into outright panic and had provoked a barrage of increasingly desperate official attempts to halt the stock market's slide. '*Up by the stairway, down by the elevator*', as the saying goes, S&P500 non-financials lost nearly all of the 15% they had added over the prior five months in the space of less than four weeks, while the 'average stock' of the Value Line Index dropped 13% - the index's worst showing over a similar timescale since either the end of the 'Hidden Recession' in early 2016 or the end of the post-GFC reflation in June 2010 before that.

In credit, the hitherto bullet-proof high-yield sector saw spreads stretch out a nasty 75 basis points, leaving the US kind at 11-month highs and the euro equivalents at their widest since December 2016. Leveraged loans – the cause of so much mealy-mouthed official angst of late – simultaneously added 30bps on the back of the largest fund outflow in almost three years, a retreat which included a record loss by the ETF constituents of the class.

As for commodities, the GSCI TR shed 11%, pretty much wiping out the year's gains. Within the group, WTI itself went into free-fall despite the looming blockade of Iran – an ostensibly bullish development, but also one which was by now very much old hat, alas - The contract, accordingly, suffered its worst losses since the depths of the shale oil crash.

Remarkably, the 'money manager' category of crude traders liquidated 40% of their outstanding net longs in those few hectic weeks, selling almost a third of a billion barrels' equivalent in the stampede (a total which represents a hefty notional reduction of $28 billion in exposure across both NYMEX and the ICE). If there was a silver lining to be found, it was that this mass exodus left positioning at its lowest level – both outright and as a percentage of open interest – in 15 months and that no higher than it was, way back in 2011. Clutching such slender reeds were we therefore left to contemplate the next round of price action in the hope that the worst might have passed.

Note, however, that despite what are undeniably sizeable losses, commodities are still ahead for the year against fixed income (being up over 17% versus the long UST basket which comprises the TLT, for example); against emerging market equities (up almost 20%); and indeed in comparison with non-US stocks in general (+16% v ACWX).

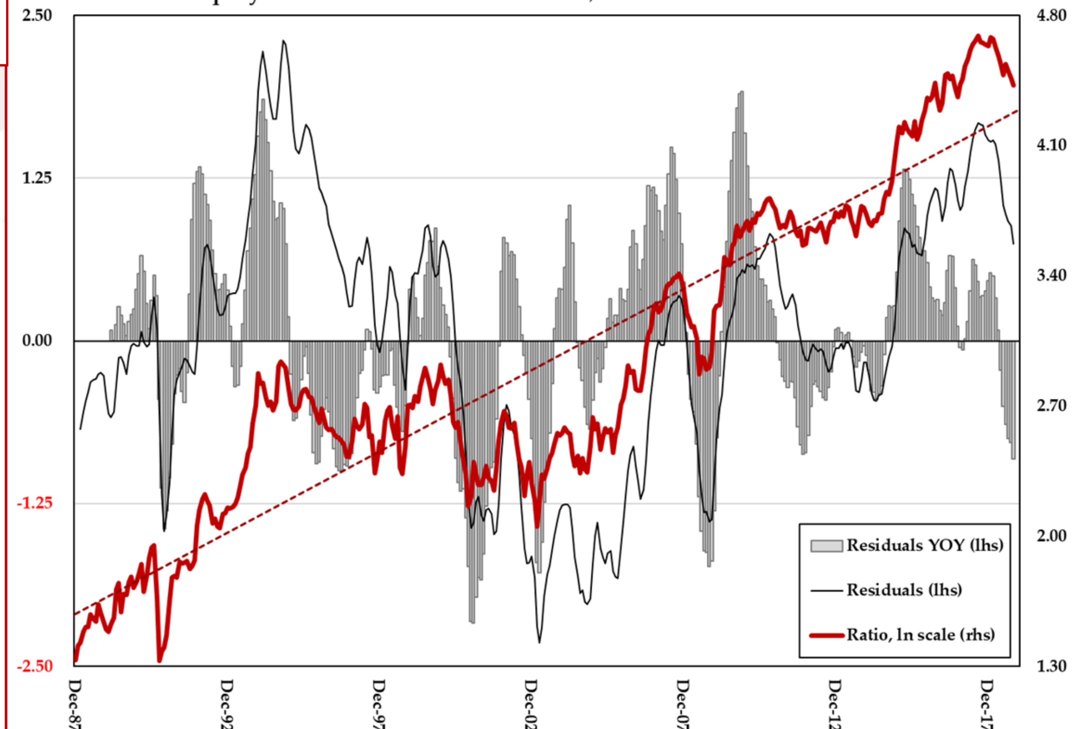


Be that as it may, with nerves now jangling as book-closing and bonus-day approaches; with bond yields again pushing to new highs as their brief 'flight to quality' bid has crumbled in the face of a strong US payroll report; and with all of China's kitchen-sink efforts to boost local equities only having left them clinging tenuously to the levels of mid-September, it is hard to be too sanguine about the next few weeks.

Caution has to be the watchword.

Sean Corrigan

Chief Investment Strategist



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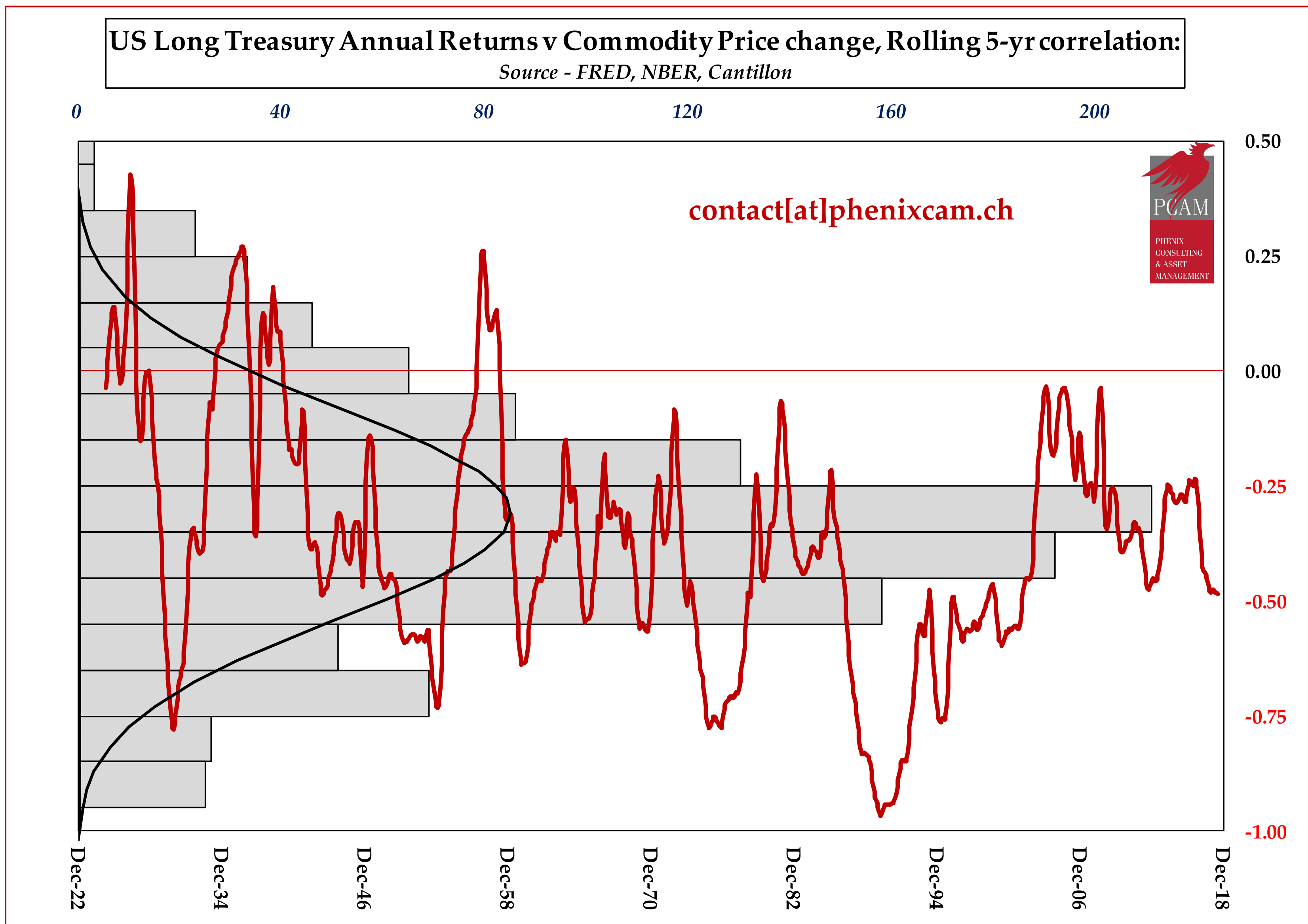
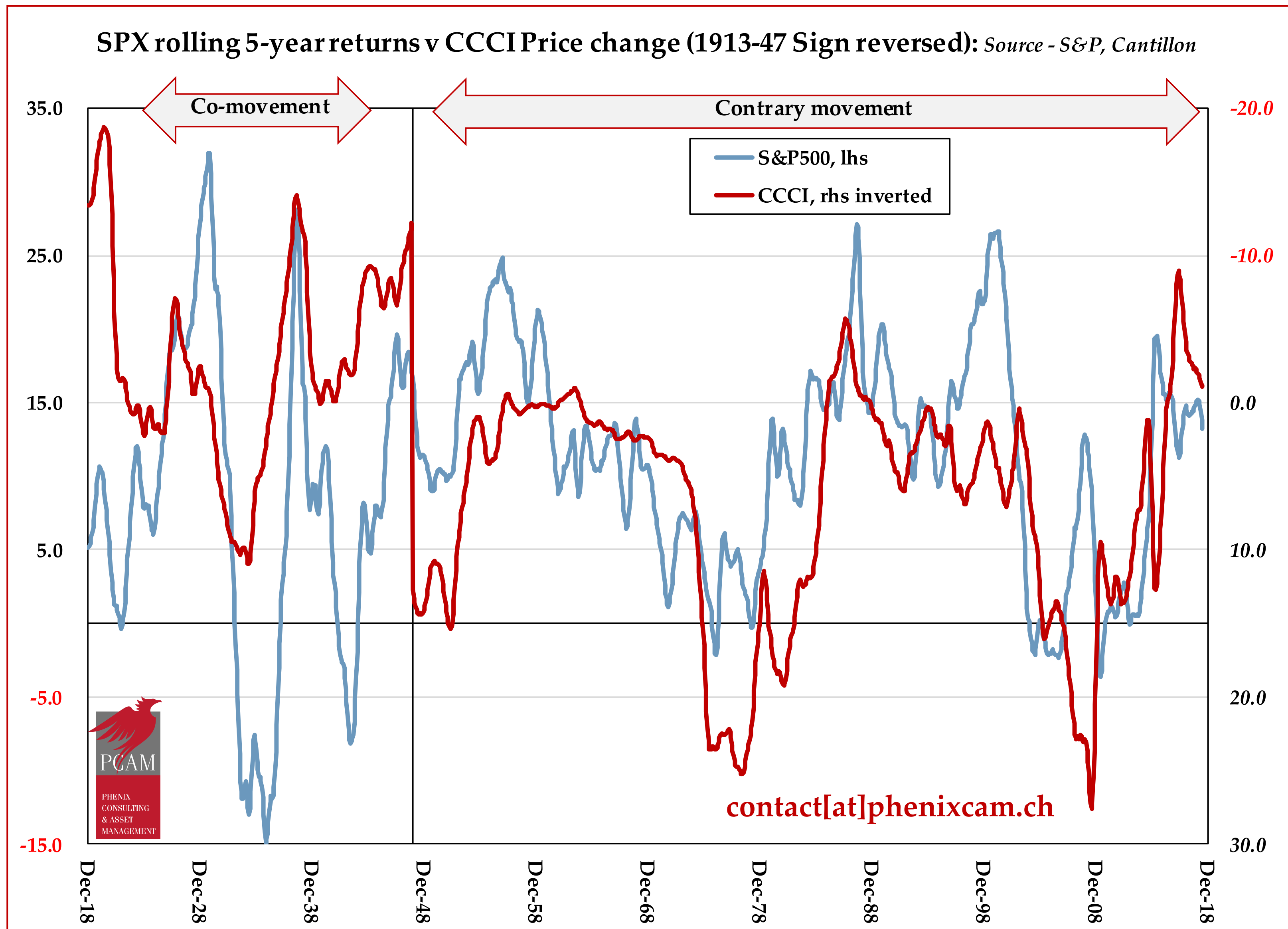


There has been only one sustained spell of positive correlation between commodity prices and 5-year rolling bond returns since the start of WWII—and that, six decades ago. We reiterate the point that it is primarily the fixed income portfolio which would benefit from the application of a commodity overlay



As for commodities and equities, though correlations per se have swung from positive to negative without leaving much of a clear pattern, since the War, there has been a more evident tendency for periods of rising commodity prices to coincide with episodes of lowered stock returns

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