*Finbou Thales - Investor Letter H1 2019*

Dear investors,

The strategy (1x) ended H1 up 1.1% net of fees. In this letter, I will provide an overview of H1, review a few trades, and discuss the outlook going into H2 2019.

Overview of H1

Central banks have been busy switching gears from policy tightening to easing. Six months ago, the US Federal Reserve was flagging two rate rises for 2019, while these days it has opened the door for rate cuts. Meanwhile, the Reserve Bank of Australia has reduced the interest rate two times - at the beginning of 2019 it had a bias that hikes would come next. The European Central Bank has flagged that it is ready to ease policy, despite signalling rate rises for autumn 2019 just half a year ago. The rest of the central banks have either put their tightening cycles on hold or have opened the door for easing in case the economic conditions deteriorate.

One could label the moves gestalt shift without exaggeration, yet volatility in FX markets remains close to all-time lows of 2014. In fact, during Q2 volatility became even more suppressed at times as virtually every central bank started providing easing signals at a relatively similar pace and FX markets have struggled to take direction.

Meanwhile, stock markets have been booming. Under the current market environment, policy easing is unambiguously positive for stocks – for currencies, it has only meant that markets turn their attention to how other central banks will respond in kind – i.e., a push and a pull dynamic. This has been reflected in extremely choppy conditions in currencies. As a result, the strategy has been overperformed by its global macro benchmark and the SP500.
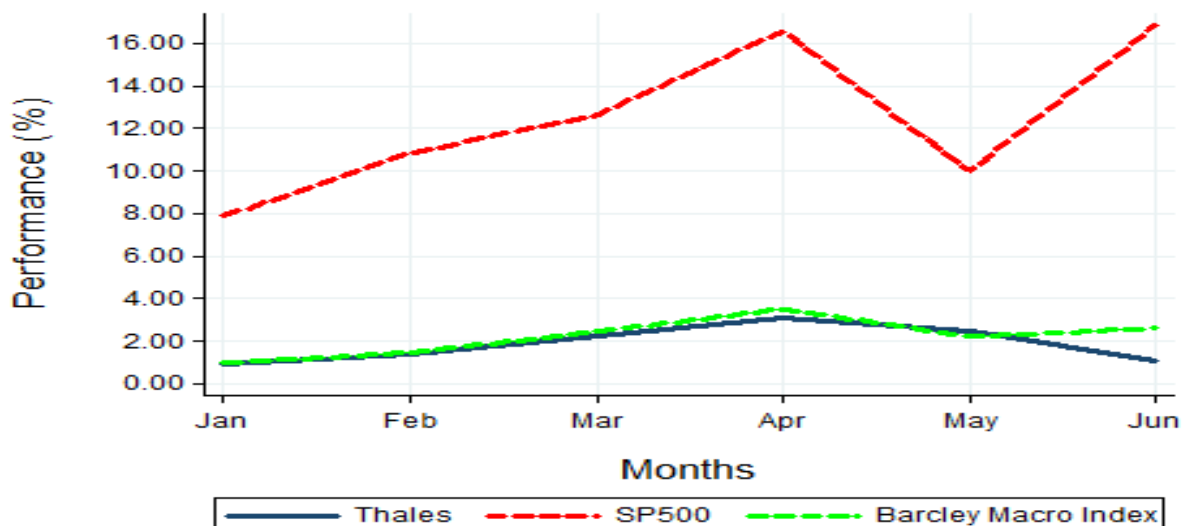
Assessing H1 trades

Going into 2019, we had assumed that the major discrepancy between central banks and market expectations for further easing would act as a catalyst for volatility and opportunities. During Q1, this scenario looked to be playing out as expected, at least partially. Almost all central banks started signalling bias for easing.

However, even though all central banks were easing, single decisions were less impactful than before. Take the extremely dovish decision by the Fed in January, where it practically pre-announced an end to quantitative tightening and moved to a neutral bias. The Fed had only a month ago, in December, suggested QT was on autopilot with a firm tightening bias. While the equity markets soared higher during the following days, the dollar erased most of the losses in anticipation for more easing from other central banks, especially the ECB. Similarly, and after the highly dovish March ECB decision, the euro rebounded in anticipation of dovish Fed.

While we managed to provide performance on those events (*table below*), it was around three times less than similar events provided by historical standards, as the market reactions remained much smaller.

H2 2019 Top 3 best and worst performing trades (growth) [1]

Event	P/L net of fees	Risk
FOMC Statement 1.19	1.5 %	1.2 %
ECB Press Conference 3.19	1.2 %	1 %
Riksbank Monetary Policy Report 4.19	1.1 %	0.8 %
ECB Press Conference 6.19	-0.6 %	1%
FOMC Statement and Projections 6.19	-0.6 %	0.8%
RBNZ Monetary Policy Report 3.19	-0.7 %	0.8%

During Q2, volatility became even more suppressed as virtually every central bank started giving easing signals *at a similar pace*. As put by the Reserve Bank of Australia Governor Lowe, "when all central banks are easing the impact on the exchange rate is offset". As such, the

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[1] The worst and best performing trades are not correct representation of our risk. Average risk on 2019 was 0.3%

performance weakened markedly - events stopped moving FX markets almost entirely. Under choppy conditions, our hit rate took a plunge, despite remaining high at the start of the year.

For example, with the ECB in July, despite providing an unexpected easing signal, the market refused to budge. Markets severely doubt whether ECB will have ammunition to ease, which seemed unreasonable to us as the legal hurdles for quantitative easing have been cleared. However, such trades reflect the uncertainty aspect of the strategy. We still liked to think the market should have sold EUR based on the unexpected easing signal, but we also recognized the alternative angles and traded the event with lower risk than before, had there been certainty market finds the easing signal credible.[2]

Outlook

Certainly, things have not played out as expected at the time of writing of the last investor letter. The main question still remains, whether the current period we are experiencing is an anomaly or the new normal? We like to think a year is a too brief period to answer that question conclusively.

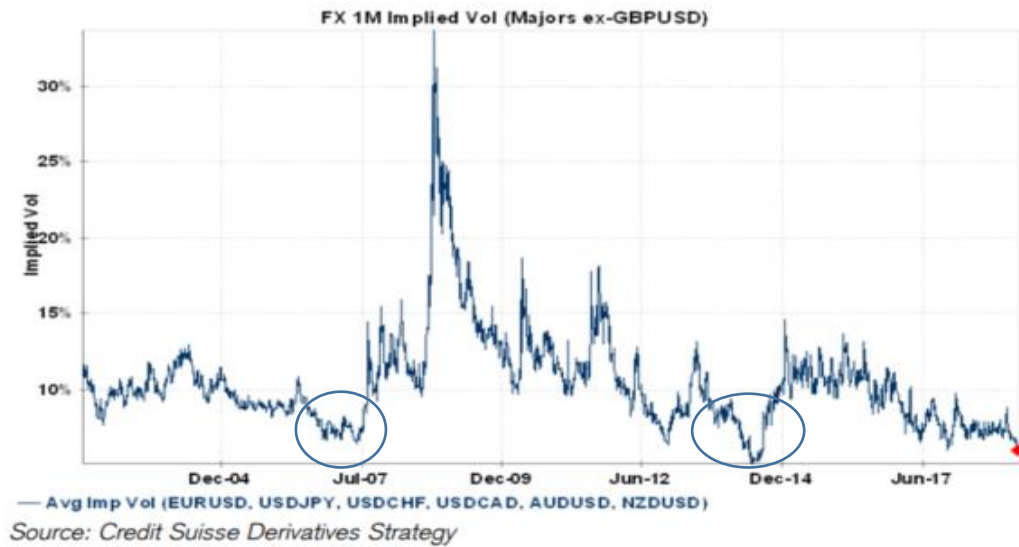*A glance at historical volatilities*

If we look at implied volatilities apart from GBP for FX majors (*chart2*), the recent period of low volatility has been longer lasting than ever before. Implied volatility is around two to three times below historical *averages* for the past 20 years or so! Admittedly, this period covers the highly volatile financial crisis, but in general, the pendulum tends to swing back. Volatility may be at all-time lows, but volatility is inevitable as economic cycles do not last forever. However, you cannot know the exact timing once we move from boom to bust.

Between 2008-2010 and 2014 and 2016, a major driver for FX markets was the policy divergence between the Fed and the rest of the world. This triggered massive moves in the markets, but it took some time until market participants understood who goes at a faster pace. These periods were always presaged by times of bottoming volatility.

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[2] For understanding difference to a credible easing signal, I recommend studying the news flow around 10.2015 ECB.

Chart2: Volatility at historical lows

FX 1M Implied Vol (Majors ex-GBPUSD)

— Avg Imp Vol (EURUSD, USDJPY, USDCHF, USDCAD, AUDUSD, NZDUSD)
Source: Credit Suisse Derivatives Strategy

Risk and return

The highlight of this discussion is that we do not need high volatility to perform. The strategy performed very well during 2015-2017, when volatility was around historical averages.

What would happen in the hypothetical scenario where volatility returned with a boom? Most certainly, we would take significantly higher risk under the circumstances. With higher risk, stronger results should follow, as low risk reflects our lower opportunity-based conviction as well.

The risks we have taken lately have been very conservative. This is a natural response as we assess that our chances of winning are lower. We still like to think there have been some opportunities, which has been reflected on some volatility in the performance, especially on the 3x setup. The chart below illustrates observations for all monetary policy related trades since the strategy started in 2015. Although the strategy was delevered significantly since 2016, the last 100 events or so (since 2018) show that our risk-taking has been particularly muted, as there has been little reason to take major risks.

Chart3: Risk per event
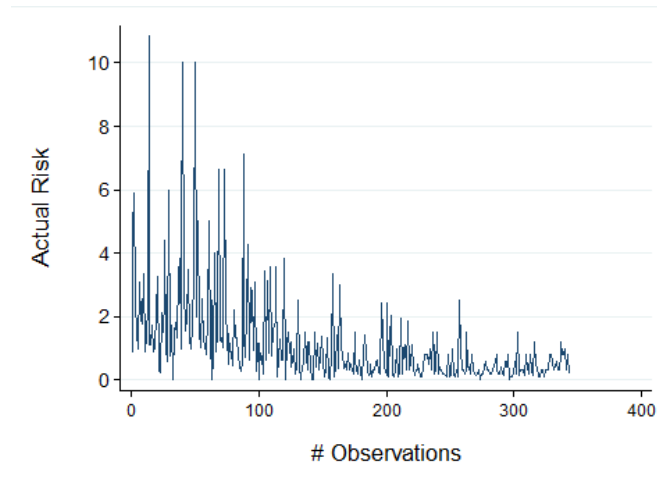
Assessing fundamental drivers that could potentially drive volatility

We want to underline that we cannot know when volatility will return. We can look for potential catalysts for very high volatility, such as trade impasse (i.e. tariffs are implemented fully), hard Brexit or Chinese debt bubble implosion, but ultimately none of them are necessary. We only need signals that monetary policies across different jurisdictions are going at a different pace.

Even with current drivers, we could see pockets of very high volatility given central banks are making important decisions in H2, namely with ECB deciding on QE. For now, it is relatively understandable that EUR has failed to gain vs the USD despite plenty of rate cuts priced in from the Fed since the market participants have rapidly revised their estimations for a comprehensive easing program from the ECB.[3] Any QE related decisions from the ECB or the Fed have historically swung markets hundreds of pips.

We like to think that once we get to the actual decisions, we will see who has been 'swimming naked when the tide goes out' as the saying goes. If the expectations that are baked into the market are not met or they exceed, markets will move, and we will get a better idea of who is providing more policy accommodation than others.

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[3] For ECB expectations, see for example https://think.ing.com/snaps/ecb-draghi-tltro-rates-qe-ing-carsten-brzesk-talk-june-minutes-meeting/ or https://e-markets.nordea.com/#!/research

Conclusion

Low volatility has turned out to be a more persistent phenomenon than we had expected. However, as the central banks are moving from talk to action, there are good reasons to believe volatility will return in H2, even without major external catalysts that would sag global growth.

Current market conditions have been exceptionally challenging for us and for most funds trading FX in general.[4] However, and unlike our competition, if history is any guide, we only need volatility returning to historical averages to produce performance.

Hence, we remain unyielding in our conviction that better times are ahead of us soon.

Sincerely

Aatu Kokkila

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[4] https://www.bloomberg.com/news/articles/2019-04-16/why-no-one-wants-to-invest-in-currency-hedge-funds-anymore

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