

Dear investors,

In this letter, I will provide an overview of H2, assess the reasons behind weak performance by historical standards, and discuss the outlook going into 2019.

Overview of H2

Similar dynamics as in H1 prevailed, as intraday FX movements remained contained and volatility around monetary policy events remained persistently lower than before. Low volatility is generally a function of fewer events deviating from expected, which depends on how global and domestic economies evolve.

H2 2018 Top 3 best and worst performing trades (Thales main) ¹

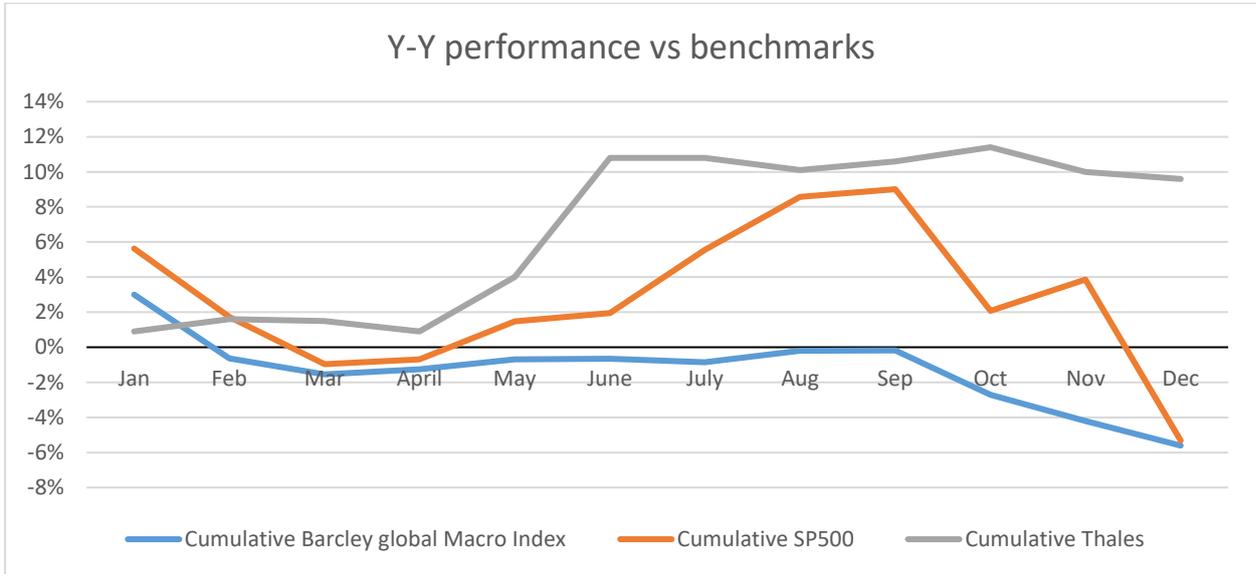
Event	P/L net of fees	Risk
FOMC Statement and Projections 9.18	1.2 %	0.4 %
BOC Statement 12.18	0.7 %	1.0 %
ECB Chair Draghi speech 5.18	0.6 %	0.4 %
Norges Bank Monetary Policy Report 9.18	-0.4 %	1.5 %
Riksbank Monetary Policy Report 12.18	-0.8 %	0.8 %
Riksbank Monetary Policy Report 9.18	-1.0 %	1.2 %

Volatility has not only dried down around monetary policy events, but it has also dissipated from FX majors overall. For example, EURUSD stood at 2 cent range in December, while S&P *moved* 2% in six different days during the period. Admittedly stocks are traditionally much more volatile than currencies, but the discrepancy has become more noteworthy recently, with a steady increase in equity markets volatility in 2018.

¹ The worst and best performing trades are not correct representation of our risk. Average risk in 2018 was 0.3%

Given stocks usually get more volatile, when they are moving to the downside, performance was still better than benchmarks. December was the weakest month for stocks for a decade. Overall the year-on-year performance was considerably stronger than benchmarks for Thales main. However, it was considerably weaker than historical performance.

Performance vs. benchmarks 2019



Reasons behind weak performance

The most important question any investor faces after bouts of weak performance of an asset is, if something has changed to counter the investment thesis. This question is timely under such circumstances notwithstanding the asset class (from stocks, real estate to short-term trading strategies like ours). I will try to answer this question in the following sections as it's my firm belief the recent bout of weak performance is transitory.

Lack of volatility illustrated

Lack of volatility around monetary policy events stands far and wide as the main reason for weaker performance. While I have repeated this on a number of instances, it is a phenomenon that deserves continuous expansion from different angles. For one it sounds at face value one of those esoteric excuses typical investment manager makes after periods of weak performance. It is easy to hide behind a veil of jargon when you are uncertain what is taking place. Information asymmetries make this kind of communication compelling. Few investors can understand a strategy as deeply as the manager - not only because most strategies have a proprietary element, but also because an investor investing in multiple strategies and assets only has so much time in the world.

Lack of volatility stems from (1) other drivers being more important for markets than monetary policy and (2) lack of important policy decisions² which would deviate from expected, which is also a function of global economic developments being as expected. If developments are as expected, it's easy to predict the central bank decisions for consensus, making large deviations less likely.

Now the former dynamic changed drastically since October as global growth faltered and stock markets have been very volatile ever since. There have been little spillovers to FX though. While market pricing has shifted violently in terms of policy expectations, markets have overall ignored central bankers relatively hawkish messages, which have lacked credibility.

The environment is perhaps most luminously illustrated by the following table which provides the number of events where markets moved over 2% to one direction in two-day aftermath of the event. Historically the highest net performance for the strategy has been a product of these momentum-based events.³

² When I use the word important policy decisions, I mean decisions, where central bankers provide guidance on future policy moves, or direct policy moves such as interest rate changes which are not fully priced in.

³ Technically there are three types of trading for any short-term strategy, momentum based, trading on pullbacks or mean reversion. Vast majority of profits for the strategy have been derived from momentum-based trades, although mean reversion has been more prominent lately as well.

Table 1: Monetary Policy Events with over 2% reaction to one direction within 2 days

Event	H2 2018	2018	2017	2016
BOC	0	0	3	2
BOE	0	0	2	3
BOJ	0	0	0	3
ECB	0	2	2	2
FOMC	0	0	0	2
RBNZ	1	1	1	1
RBA	0	0	0	1
RB	0	1	0	1
NB	0	0	0	1
Total	1	4	8	16

Overall, there weren't that many opportunities for mean reversion either as the FX ranges remained extremely contained.

Table 2: Monetary Policy Events with over 1% range during the first 8 hours of the announcement in 2018, 2017 and 2016

Event	H2 2018	2018	2017	2016
BOC	2	5	4	4
BOE	0	3	6	3
BOJ	0	0	0	5
ECB	0	4	4	5
FOMC	0	0	2	4

RBNZ	1	1	2	2
RBA	0	0	1	3
RB	1	2	1	3
NB	1	1	2	3
Total	5	16	22	32

Credibility and lack of alignment

Overall the market has not been entirely devoid of deviations from expected. There have been some events which deviated from expected in a quite large fashion. However, monetary policy is only one driver among myriad of other drivers at a given time and contradiction with policy decision vis-à-vis to rest of the drivers tends to lead to lackluster market reactions.

As such, credibility plays a large role in the extent of market reactions triggered by central bank decisions. For example, in somewhat simplification of the decision, in January 2018, due to strong growth developments and prospects in the euro-area at the time, Euro was in a short-term bull market, when ECB issued bullish guidance on the future of asset purchases and inflation. Generally, the short-term drivers aligned with the central bank's message that the bank might tighten earlier than expected - in essence, the message for tightening was credible at the time. As such the market jumped the gun and took EUR over 3% higher during the ensuing two days.

If we compare this with BOC 10.18 where the bank issued bullish guidance relative to expectations (one of the larger deviations from expected during the half), the market was very much focused on the Brent versus Western Canada Select spread which was exploding due to pipeline issues in Canada. The monetary policy decision contradicted with fundamentals and short-term trend; hence the market did not assign much credibility to the decision. As such, CAD traded ultimately weaker.

You cannot always be certain pre-trade whether the market assigns credibility to the potential message. If there's uncertainty over the credibility of the message I simply use lower risk, as I consistently did with decisions in H2. Credibility also depends on the degree of ambiguity in the message and the timeframe. If central banks indicate it will act certain way next month, the message is of course much more credible than signaling it expects to act a certain way within six months. First, there's a considerable difference between the choice of words between will (high probability) and expectancy (less probable subjectively). Second, the longer the timeframe, the less credible the message becomes as new developments and surprises could render the prognosis obsolete.

As such, alignment with the trend, fundamentals, and central bankers message occurs quite rarely. Markets are of course quite efficient, so exceptional opportunities are rare. However, we have had a relatively steady amount of historical decisions⁴ where markets aligned with the decisions and triggered large movements in the past years. Historically, if an economy is either growing or deteriorating at a faster pace than forecast, it is more difficult for the central bank to match consensus which triggers volatility and occasionally the bankers want to become bold and surprise markets with expectations defying decisions. Regardless, there's no denying the frequency has come down last year and particularly during the second half.

More efficient markets?

Given the lower frequency of market-moving events, there's a question whether markets have become more efficient at pricing events. Clearly, Table 1 shows that large movements associated with policy decisions have become rarer.

To answer the question, only since October we have had a more uncertain environment, where it's more difficult for the consensus to predict the outcomes of decisions. October developments triggered a discrepancy between economists and financial markets expectations on future pace of tightening. Under these conditions, as there's no clear consensus, policy decisions tend to trigger larger market reactions. It does not mean decisions would still not arrive close to consensus, but probabilities for market-moving decisions under such circumstances are higher.

In short-term, for the investment manager, trying to predict the occurrence of deviations from expected is equivalent to playing imaginary poker with the central bank in question. While we can make somewhat reasonable predictions, when there should be volatility, timing the specific decisions is difficult. Sometimes even when conditions are in place for large deviations, the bankers still manage to deliver close enough to consensus, which prevents large market reactions.

For example – looking at the historical Fed reaction function - I thought December was an excellent time for the Fed (and ECB)⁵ to turn more dovish. Taking a simplified look at a historically similar period, the Fed turned considerably more dovish in March 2016, which helped to smoothen the global growth concerns stemming from China's weakness and disinflationary pressures from oil.⁶ However, the FOMC delivered broadly an as expected message.⁷ As such FX markets were contained to tight ranges. Equity markets - which are more sentiment driven currently - took a hit.

⁴ Most of the reactions in table 1 were triggered under such circumstances.

⁵ The mechanics of the December ECB decision were quite similar to FOMC.

⁶ Of course, there are important differences to 2016 as well. Domestic US drivers, such as labour market are roaming an much tighter than in 2016. Moreover growth remains considerably stronger than in 2016.

⁷ Do not be fooled by the media pundits who claimed the decision was bullish relative to expectations. Most economists and bank analysts had expected the FOMC to stay consistent signalling rate rises for 2019 and retaining language on gradual rises, even if market pricing had shifted. Instead, market pricing for Fed hikes did not much, indicating there was nothing surprising in the decision.

Overall, the efficiency view is disproved by the fact, market conditions have not been there to trigger larger movements before October, making the present timeframe very short. Moreover, once conditions emerged, central bankers have yet to make truly expectations defying decisions.

Isolated reasons

There are some other reasons for weaker historical performance. I have not assessed them in such detail, because lack of volatility stands far and wide the most important reason. Overall many data trades and lower risk trades have not worked as well as they previously did as described in previous letters. Historically such trades have constituted only 10-20% of performance, depending on the year in question. It is, also related to volatility overall as less volatility decreases the risk-reward when trading such events.

Another key element for weaker performance has been the fact GBP was untradeable throughout H2 2018. Historically around 10-20% of yearly profits have been derived from trading the GBP and Bank of England decisions. In H2 the currency became almost purely Brexit headline driven, analogous to H1 2016.

Conclusion

All in all, I believe conditions are in place for monetary policy decisions to start moving markets more, given market view on how the economy will develop differs so much from central banker's view. Recent lack of volatility can be also considered within the domain of randomness – 6 months is a short period, and there was very little happening for FX markets (apart from GBP and emerging markets) during H2. Moreover, as is true to the economy in general, volatility in FX markets is also quite cyclical – some years are more volatile than others.

There are also some factors that are holding back volatility, which will near certainly subside in 2019. For example, there will be a conclusion to the Brexit, after which pound will become incredibly interesting monetary policy-wise. It was the most responsive currency to policy decisions after Brexit vote for the ensuing 18 months.

Taking these factors together, while I am reluctant to express predictions for 2019, I believe the year should result in considerably more opportunities than 2018 did. Moreover, as we lengthen the timeframe, even under challenging market environments such as this one, there has always been at least some opportunities to provide us with a backdrop to produce adequate returns. Ultimately, on a year-on-year basis, it takes only a few opportunities for the strategy to provide adequate performance. During the year 2018 – a large chunk of the performance was produced by three events (ECB decisions in June and January, and BOC in May). Predicting precisely when these market moving events occur, is however, fiendishly difficult.

I would like to end the letter with a quote from the legendary boxing coach Cus D'Amato – “We have to wait for our moment, like crocodiles in the mud. We don't know when the drought will come, and the animals will have to migrate across the Sahara. But we'll be waiting. Days, weeks, months. But it will come. And the gazelles and the wildebeests will cross the water and when they come, we are going to bite them so hard the whole world will hear from us”.

While we are perhaps not looking to the whole world to hear from us, we are quite comfortable reflecting the analogy to our approach.

Sincerely

Aatu Kokkila

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