Finbou Thales - Investor Letter H1 2022

Dear investors,

The strategy ended the half up 24.36% net of fees,[1] representing a meaningful overperformance against almost all asset classes. The combination of higher than expected inflation and the consequent central bank interest rate rises have provided a very favorable backdrop for our strategy.

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

Monthly Returns (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
2015	11.93	0.46	4.04	3.86	-0.43	-0.27	0.44	6.78	7.77	12.97	13.76	1.36	**81.63**
2016	-1.88	0.73	6.88	0.99	-0.46	3.67	-8.91	3.74	6.39	1.95	3.24	8.15	**25.99**
2017	7.53	-0.75	4.05	3.50	2.75	0.10	5.14	0.05	5.07	6.67	4.39	4.43	**51.90**
2018	-4.22	-1.69	-4.21	-3.70	0.28	9.41	-0.54	-0.97	2.18	2.17	-4.85	1.65	**-5.21**
2019	3.45	2.98	3.47	1.90	-2.62	-5.44	0.00	-2.87	3.64	13.50	-1.06	2.46	**19.79**
2020	1.30	0.31	-4.11	3.45	3.40	7.65	-0.59	-0.99	-0.48	-1.65	-6.34	3.05	**4.32**
2021	0.37	-7.41	-9.37	10.04	5.87	-0.62	6.53	2.65	0.42	1.15	1.63	-1.50	**8.43**
2022	1.17	2.33	5.07	4.06	5.87	3.78	-	-	-	-	-	-	**24.36**
												TOTAL	**452.22**

The markets brace for the largest inflation shock in decades

At the time of the last investor letter, we mentioned that central banks and economists are likely complacent about inflation, and there could be some pain in store in the coming months for stock markets as the inflation shock is proven less transitory than expected. Indeed, come the end of H1, most G10 central banks have started raising rates. Essentially, they have taken their foot firmly off the accelerator and suddenly pulled the breaks.

Many blame the inflation on Russia's unjustified and morbid invasion of Ukraine. However, the invasion has only exacerbated the problem, the real culprit is overextended monetary policy stimulus. To quote Milton Friedman, inflation is always a monetary phenomenon. The current policymakers got so used to low inflation that they were too slow in responding to the inflation shock.

The current crisis has drawn a lot of comparisons to the 1970s inflation crisis. During the 70s, central bankers also expected inflation to be transitory initially. *Inter alia*, they blamed supply-side issues, the war in the middle east, and rising oil prices, most of which were expected to

[1] For the 9% VaR variant. The drawdown for H1 was 3%.

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resolve themselves in the medium-term. As we all know, inflation didn't resolve itself and spiralled out of control resulting in a "lost decade" in stock markets and interest rates peaking at 20%.

The most alarming difference compared to the 1970s is the amount of debt in the system, which is much higher and the Fed has been even slower in reacting to inflation than in the 70s. The chart below highlights the Fed's policy error. The real rate (interest rate minus inflation) has never been this low in history. It is rare to see policymakers admit mistakes, as it can undermine credibility, but the Fed has done that already.[2]

US real-rates – most reckless Fed ever?[3]

Regardless, the Fed and the rest of the central banks are well cognizant of the dangers of inflation, and they will probably get it under control ultimately. It will lead to significant pain though, because policymakers are behind the curve and forced to raise rates much faster and higher than they would if they had started earlier.

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2 The Fed has acknowledged surprisingly many policy errors lately. Chair Powell said that the Fed should have raised rates sooner *see* https://www.washingtonpost.com/us-policy/2022/05/12/fed-powell-rates-marketplace/. He also acknowledged the Fed shouldn't have taken 75 bps off the table on May meeting. In an spectacular and embarrassing U-turn, the Fed was forced to hike rates by 75 bps after inflation surprised to the upside.

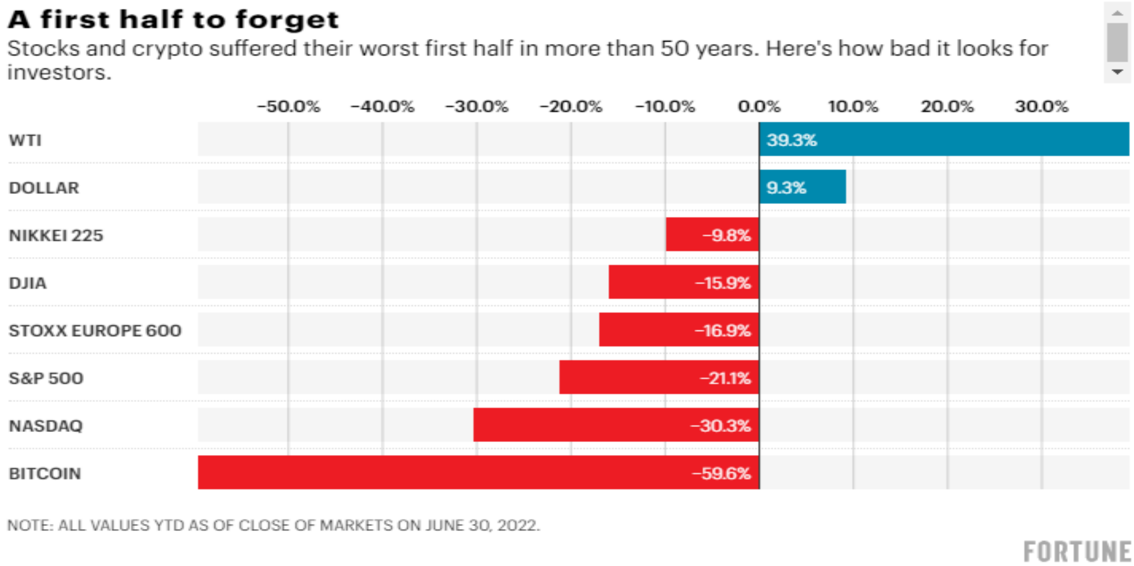
3 https://wolfstreet.com/2022/01/12/most-reckless-fed-ever-real-federal-funds-rate-now-the-most-negative-ever/

Soft landing? Wishful thinking ..

The Fed narrative has gradually shifted from "we are trying to orchestrate a soft landing" to "we can do a softish landing" to "there will be some pain" to "getting 2% inflation needs luck, or failing that, pain". [4] We can see where this is going. The Fed is raising rates at a faster rate not seen since the 70s, and on top, it is unwinding its balance sheet at an unprecedented rate. The ramifications in the medium-term are frightening.

Back in 2019, when Fed, for the last time, unwound its balance sheet, the repo market froze entirely at a point, approximately nine months after the Fed started QT.[5] The Fed has only begun unwinding at four times the rate (!), and the implications are not yet felt. The Fed has played down that the impact of balance the sheet unwind is equivalent to a few interest rate rises. Yeah right… If it truly was equivalent to a few rate rises, most assets wouldn't probably have rallied as they did after the Corona crisis. There was so much liquidity in the system that it had to go somewhere. Those assets rose rapidly and are now collapsing.

Performance by asset class in H1 2022



The future looks particularly tough for stock exchanges. Valuations have come down already, but the impact of slowing consumption on earnings, the potential for a recession, or even higher interest rates is far from discounted. Rate rises, especially abrupt ones, are the nemesis of equity markets. Even though markets price the Feds fund rate at 4%, it could easily go to 6%, putting enormous pressure on company balance sheets and households. There's a chance of both recession and high inflation occurring simultaneously. A stagflationary environment is highly bearish for stocks.

[4] See https://www.bloomberg.com/news/articles/2022-06-26/powell-s-path-to-2-inflation-needs-luck-or-failing-that-pain#xj4y7vzkg
[5] See https://ig.ft.com/repo-rate/

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It is not supposed to be easy

Our performance in the first half was catapulted for two reasons. Since most central banks are raising rates at a different pace, there is very clear monetary policy divergence, and volatility has picked up in FX. We have also improved[6] our risk management significantly. There were several events[7] that were historically losers that we either didn't trade or only took trivial losses. As such, despite considerable overperformance, we traded with a 3% drawdown for the half.

We recently got awarded the Hedge Fund Journal Award[8] for the best currency CTA in terms of five-year performance. While we think we have done our best past five years, FX was not the market where the action happened. The bull run in tech stocks and crypto made anyone staying away look like a Luddite. Making money that easily never seemed intellectually right to us, as investing and trading are not supposed to be easy. Yet if you take just a few years of trading or investing and pick the right market, it can look easy.

We are experienced enough to understand trading or investing is not easy, and therefore despite strong overperformance, we set our long-term expectation based on our median return, which stands at 15% net of fees[9] for the 9% VaR variant. We think it accurately reflects the expectation for our performance over five years. However, such uncorrelated annual return is highly compelling going into the future, as stock markets are unlikely to deliver similar returns as in the past.

Conclusion

The outlook for our strategy stands in stark contrast to the more traditional asset classes. This year almost every asset class has tanked except funds betting on rising bond yields or higher commodity trends. The *real* returns look even uglier when inflation is factored in. High inflation is unlikely to fade away rapidly; ergo, we are resolute 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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[6] Our post-trade improvement process is highly iterative and self-correcting. After each trade, we explain why the market did what it did, analyse our mistakes, write them down, and then take our lessons on how we can do better next time in a similar situation in terms of risk management and interpreting the event. This process has allowed us to refine and perfect our implementation around various events, be it momentum, mean reverting or range situations (which we generally want to avoid). Doing this repeatedly through years, we have built a library of experiences, that we are now capitalizing on.

[7] If you are interested on demonstration of some trades, please see the following podcast https://www.youtube.com/watch?v=NDyEeXtZluw&t=1533s

[8] https://thehedgefundjournal.com/the-hedge-fund-journal-cta-and-discretionary-trader-awards-2022/

[9] This is after deducting a management fee of 2% and performance fee of 20%. I have left the 2015 figure out of the calculation, as we had limited amount of capital under management back then.

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