Finbou Thales - Investor Letter H1 2021

Dear investors,

The strategy ended the half down 0.5% for 1x and 1,5% for the 3x variant. Although we are trailing our benchmarks this year, we remain adamant better times are ahead of us. We are still overperforming our benchmarks significantly on both risk-adjusted and absolute return basis since the inception of the strategy in 2017.

Figure 1: Thales 3x vs benchmarks

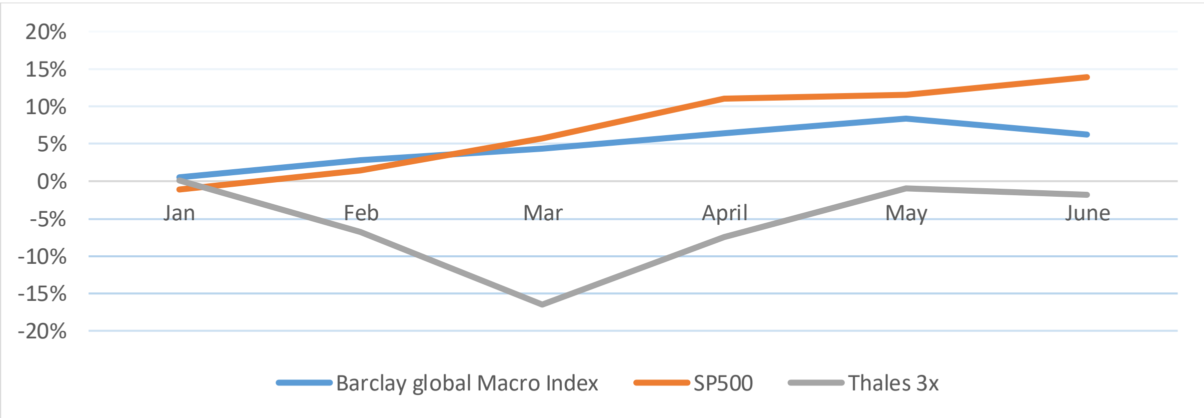
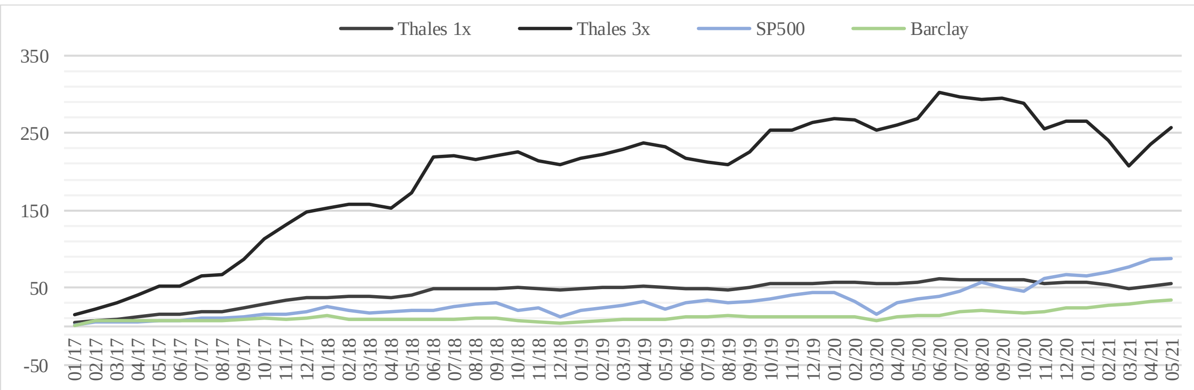


Figure2; Thales 3x and 1x performance vs benchmarks



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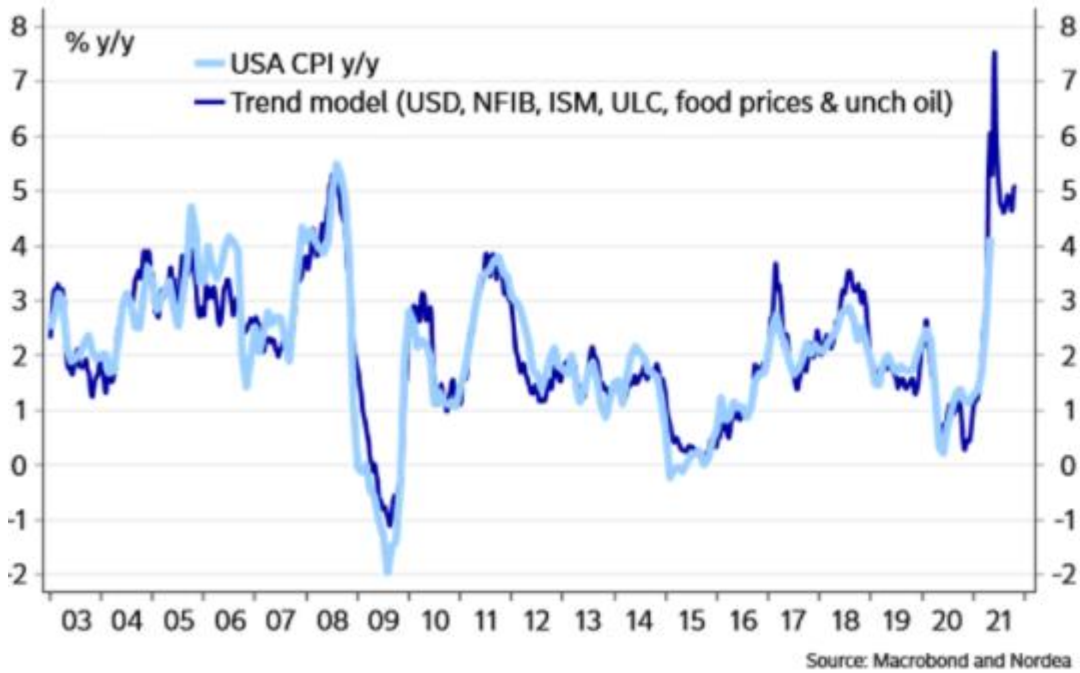
Vaccine lead optimism continues to drive markets higher

The major developments for the half were the re-opening of economies, higher than expected inflation, and growth readings globally. During the first quarter global economy was suffering from another wave of COVID; however, given the anticipation of vaccination by summer, stock markets largely ignored the COVID-driven closures. After that, attention has turned to the prospect of higher inflation; given inflation readings have surprised considerably to the upside.

With real interest rates currently at -4% in the US, there have been very few alternatives to stock markets in the short term. Initially, markets bought the message from central bankers that inflation is transitory – mainly due to supply-side bottlenecks – leaving bond yields largely unmoved and FX volatility wanting. However, since June, the Fed has shifted its stance on inflation, suggesting it is more prepared to adjust policy if high inflation proves persistent. Although markets are still not altogether buying that higher inflation is coming, volatility has picked up recently as few other G10 central banks have put forward their expectations of tightening policy.

Figure 3; US Year-on-Year inflation and prediction from Nordea



Higher inflation has significant ramifications on the strategy. Monetary stimulus is being rolled off sooner than expected, which is likely to lead to entrenched volatility. Most central banks expected to raise rates only in 2023 or 2024, yet the debate has transitioned to whether rates should go higher in 2021 or 2022. As tightening prospects are pulled forward, monetary policy divergence is emerging as the main driver for FX movements again. Historically divergence in policy due to economic developments is what drivers FX markets, apart from global crises

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where interest rates are driven to rock bottom across jurisdictions. Therefore we are returning back to normal from the pandemic-driven markets.

Assessing the trading in H1

During the first half of 2021, initially, we underperformed considerably in the environment where market reactions to events stayed choppy. During the first quarter, many of our trade ideas were outright wrong, and we hit a significant drawdown. Overall, we underestimated how different markets behaved during a pandemic, as the market was decidedly different, even if monetary policy decisions had plenty of historical precedents.

Despite being the main driver for the rally in stock markets, for our strategy, the aggressive monetary policy response has meant that there was little divergence in policy across jurisdictions - an element that is integral for us in generating alpha. Historically there has always been some divergence in the policy. Yet, at a point in Q1, most central banks were priced for rate hikes only in 2023, essentially mitigating the potential for market reactions.

Therefore at the start of Q2, we acted by trading fewer events and by trading the highest probability signals with similar risk as before. We realized that specific trade ideas needed more evidence to work out, and we would be better off not amplifying the drawdown with them. Thankfully, as a few central banks started to send signals on unwinding stimulus sooner than expected, we were able to recoup most of the losses during April and May.

Since May, we increased the risk to normal levels and traded more events, as volatility has picked up on almost all G10 pairs. This time, for us, the volatility is for the right reasons, i.e. monetary policy and economic divergence, instead of pandemic driven markets where market reactions were much more unpredictable or choppy compared to history.

As a result, many more central bank decisions are moving markets again, and economic data has a more considerable impact. For example, the US Non-Farm payrolls that have been a non-event for the past two years has emerged as a highly volatile event again. US employment drives future Fed decisions along with inflation; therefore, the rationale is that the understandable market is paying attention again to the labour market. Overall this provides us with a favourable backdrop going in the second half of the year.

Conclusion

Scars signal skin in the game – Nassim Taleb

In summary, the year has been a rollercoaster for the strategy, having opened with the largest drawdown since inception, only to recover it quickly afterwards. After the recovery, we have adjusted the risk back to normal levels and are trading more events since volatility has arisen. We look to build on our strong returns of Q2 in the coming quarters as monetary policy divergence has become the main driver for large FX movements again.

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We are grateful to our clients who have remained with us through these challenging periods. As stewards of your and our capital, we want to express our unwavering belief that better times are ahead of us and thank you for your trust.

Sincerely,

Aatu Kokkila
Investment manager
Finbou AG

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