Finbou
Asset Management

Finbou Thales – COVID-19 update

Dear investors,

Recent developments related to the coronavirus have been vicious and heart-breaking. A month ago, the world appeared a whole different place, and the consensus among most experts was that the virus would not be much different from the SARS epidemic, which, although tragic, was nowhere near as infectious as the coronavirus.

Due to the new degree of uncertainty, in this update, we assess the impact of the virus on market conditions, our strategy, and what it means to your investment.

How are the current market conditions different?

It is still early days, but it has come abundantly clear that the world economy is now in a recession, and that most developed equity markets have crossed the bear market threshold. Markets are more volatile, driven by developments related to the virus. Almost every G10 central bank is throwing everything they have in their arsenal to combat the situation, in a coordinated fashion and governments are taking significant fiscal policy action. Monetary policy decisions are having a different impact than before and are following a bear market logic; monetary policy is not used to stimulate growth or inflation but to limit the damage to the real economy. Ultimately, the value of financial assets in the near-term depends on how fast the virus starts peaking and whether quarantines are one-off or need to be re-imposed.

The FX market is behaving markedly differently than pre-crisis. It is suffering from an acute USD shortage. This reflects an environment where USD is perceived as a safe haven during times of crisis. Moreover, many companies and asset managers have debt or assets denominated in USD, and when they need to liquidate their positions, they are putting upward pressure on the buck, causing some abnormal price movements that happen irrespective of fundamentals.

As such, the USD has been stronger despite the Fed, which has implemented the same amount of easing it did during the financial crisis within weeks (!) of the Corona pandemic. Another peculiar development has been price action in gold. Gold was sold off over 20%, while equities took a massive hit. Usually, you can trust on gold's strength in times of uncertainty and when equity markets go down, but as many equity market strategies were struggling with redemptions, they had to liquidate whatever they had including long positions that were working, such as gold, causing the yellow metal to sell-off. This phenomenon was evident after Lehman went bankrupt as well in 2008.

How are we adjusting to the new market conditions?

There have been monetary policy decisions almost daily. We have been trading more frequently as we have had contingency plans in place for surprise announcements. We don't think there will be as many surprise announcements as there were in March, as central banks have thrown everything they can at the crisis in the interim. The interest in central banks will probably shift to their regular meetings and how they can create new monetary policy instruments if the crisis worsens. Alternatively, if the situation turns brighter, the focus will turn to who scales the extraordinary measures back the fastest.

Many people have the question, whether central banks are out of tools. We feel like that is semantics if there is political will, the tools are limitless. The Fed could, for example, buy ETFs (like the BOJ already does), commodity indices or even consider helicopter money. These tools may be last resort, but if the crisis deepens, they will be considered.

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We have decreased leverage across the board. However, the market is also more volatile, so we estimate overall our risk per event has been the same as before during the 2018-2019 period (as we have repeatedly emphasized leverage is a very poor proxy for risk).

The good thing with trading is that when you take some losses, you get immediate feedback on your understanding of new markets conditions and whether you are in synch. We did not get good results in March for trading the interim meetings. In essence, we were down on the interim meetings, while up on the regular meetings.

If there are further interim meetings, we are looking to trade them with considerably lower risk, while trading the regular central bank meetings as we used to. Once we start making profits, we will seek to scale leverage and risk per event higher, and if all goes well, the risk per event should ultimately be at 2017 levels.

Markets are considerably less liquid outside FX majors, so we are not trading currencies such as the Scandies for the time being. We will also not be holding overnight long positions on currencies that suffer from potential gap risks such as AUD and GBP.[1] We also need to be profitable for a wider margin to justify overnight positions even on liquid pairs (EURUSD and USDJPY) since liquidity is weaker. However, if we do become profitable, we might aim to hold parts of positions for longer in this market, since there will be likely significant weekly swings and trends.

Concluding remarks

We would like to emphasize the virus should not increase the risk premium of the strategy (unlike it does for equities and any other tangible non-safe haven assets). We are not more exposed to swings in the market than previously. We are already in cash, roughly 95% of the time and trade the most liquid market in the world. You can justifiably take comfort that we continue to trade as we used to, and the strategy is not in any way riskier than before the crisis. [2]

The new high volatility environment has not persisted for longer than a month (equity markets started declining at the end of February); therefore, it's premature to assess its impact on performance. We believe this market should be a considerably better environment for us in the medium-term than that of 2018-2019, but acknowledge the crisis takes careful navigation as the market is in a different phase of the economic cycle.

Ultimately, we think that if you want to wait until the dust has settled, you will miss the best opportunities because by then they are usually gone. We don't know when our performance will pick up, but if history is any guide, it will come out unexpectedly and explosively.

Sincerely,

Aatu Kokkila
Investment Manager
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[1] Although we feel gap risk is often overestimated and the gaps tend to happen overnight. For example, the flash crashes of the AUD in March 2020, January 2019 and of the GBP in 2015 all occurred overnight during the most illiquid periods.
[2] Unlike many supposedly low risk equity strategies, such as risk parity.

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