LYNX PROGRAM 2021 MIDYEAR REVIEW

SUMMARY

The Lynx Program ended the first half of 2021 up 3.62% as gains in commodities and equities outpaced losses in fixed income and foreign exchange. The positive result brings annualized performance since inception to 9.47% with an annualized standard deviation of 14.77%. Anticipation of economies reopening around the globe impacted markets from energies to bonds. Concerns over rising inflation also surfaced. As most developed economies have benefited from generally benign conditions over the past 40 years, uncertainty regarding how rising inflation may impact asset prices created some unease for investors. The resulting price action produced both opportunities and challenges for Lynx as the models adapted to the new regime. Trend-following models generated positive results across timeframes, while losses from long-term diversifying models slightly outpaced gains in short- and medium-term holding periods.

Three new models were added to the portfolio at the beginning of June as the research team continued to develop new and innovative concepts to complement the existing lineup. The additions were all diversifying models employing a variety of techniques from machine learning to quantitative macro, some utilizing non-price data from new sources for Lynx. Meanwhile, the risk allocated to model families changed marginally from the end of 2020, reflecting an increasing adaptivity of the portfolio to shifting market conditions. By the end of June, total assets under management in the Lynx Program had increased to approximately USD 6.45 billion due to positive performance and significant inflows during the first half of the year.

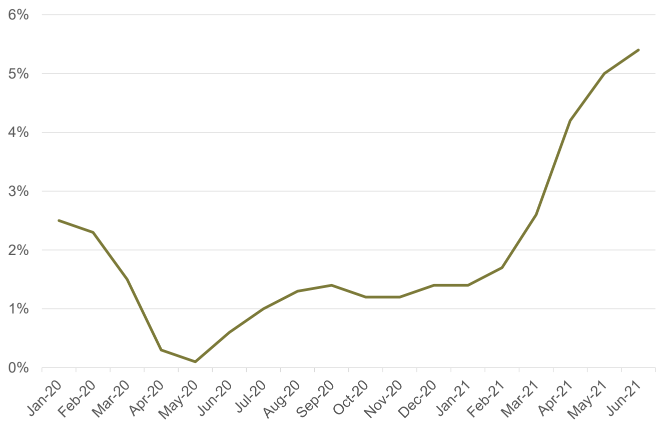
MARKET DEVELOPMENTS

While most have been looking forward to the time when the COVID-19 pandemic is no longer capturing the headlines and driving markets, they will need to look beyond the first six months of 2021. However, unlike last year when shutdowns and quarantines were stifling economies and the humanitarian crisis seemed to get more dire by the day, the increasing availability of COVID-19 vaccines as the year progressed resulted in an optimism that had been absent for most of 2020.

Access to these vaccines – and the robustness of vaccination programs – had a marked impact on economic activity. While some countries struggled to secure enough doses to control the spread of the virus, governments in most developed Western nations were able to begin lifting the most extreme pandemic restrictions as their populations became increasingly immunized. The spread of more contagious – and potentially vaccine-resistant – variants slowed the reopening in Europe late in June and lockdowns returned across Asia and Australia as the second quarter drew to a close, but significant advances were made and global growth accelerated as a result.

In the US, GDP climbed 6.4% in the first quarter and higher frequency economic indicators signaled continued strength as the year progressed. Inflation similarly rose and the US Federal Reserve became slightly more hawkish as a result. Although the Fed indicated last year that they would be comfortable loosening their inflation target – particularly given rather anemic conditions in recent years – some governors revised their monetary policy expectations and dissented from the consensus opinion that price risks were transitory. Labor force participation rates generally remained below pre-pandemic levels as expanded benefits contributed to fewer employees reentering the workforce. Meanwhile, the unemployment rate continued to decline but remained over 2% higher than in February 2020 adding to the uncertainty surrounding policy.

CPI for all Urban Consumers - 12-month percent change



Source: U.S. Bureau of Labor Statistics

The Eurozone contracted in the first quarter as vaccine availability on the continent was initially well below the UK and North America, although the tide shifted markedly as the year progressed and growth accelerated. Inflation rates generally exceeded expectations – approaching pre-pandemic levels – and the ECB began considering their options should it exceed their 2% target for an extended period. Levels varied widely across the continent, although price pressures generally rose. As was the case in the US, unemployment rates remained elevated, particularly on the periphery.

Dramatic declines in manufacturing during the depths of the crisis – and the resulting low inventory levels coming into the new year – created an opportunity for many Asian nations to benefit from the recovery. However, relatively slow vaccinations across the continent contributed to muted domestic demand and lower inflation levels than developed Western economies; rising commodity prices further hindered growth. Even those nations that experienced increasing price pressures were impacted by rising COVID-19 infection rates as a third wave began spreading across the region late in the period.

Expansionary monetary policy stayed in place across much of the globe as most central banks remained committed to keeping rates low at least through the end of 2021 and asset purchase programs continued. Prospects of increasing fiscal stimulus, including plans for infrastructure development, spawned optimism that governments would continue to support economic growth by any means necessary. Due in part to the ample liquidity bolstered by these accommodative policies, most global stock indices ended the first half of the year in positive territory; MSCI World, a global equity index, rose 13.0%. Major US indices closed at or near record highs, while European bourses similarly performed well after a relatively slow start; the S&P 500 and Euro Stoxx 50 indices each climbed 14.4%. Expectations that nations would begin tapping the EU recovery fund further supported European stocks in the second quarter. With headwinds from rising COVID infection rates and speculation of tighter monetary policy in China and elsewhere in the region, Asian equity indices generally trailed US and European counterparts. The Japanese Nikkei index ended the period up 4.9% while the Hang Seng index rose 5.9%.

2021 Equity index performance

Source: Bloomberg

Despite sanguine growth forecasts and continued accommodative monetary policy, global yield curves flattened in the second quarter after steepening earlier in the period. Rising inflation data had the greatest impact on the US curve, particularly after the FOMC dot plot revealed two rate hike projections in 2023 – earlier than previously forecast – and more robust economic projections for the current year. Skepticism regarding future policy resulted in some price fluctuations, but after peaking at 1.75% on March 31st, 10-year Treasury yields declined by 28 basis points to 1.47% by the end of June. Even after the pullback, 10-year rates remained 55 basis points above where they were coming into the year. European interest rates also climbed but real rates in most countries remained negative; German 10-year bund rates climbed by 37 basis points, yet nominal yields remained below zero at -0.20%. Speculation that the ECB would begin tapering their pandemic emergency purchase program (PEPP) contributed to climbing rate expectations during the period.

As the US economy gained momentum, indications that the Fed was considering tapering quantitative easing began to emerge. Official statements indicating that insufficient progress had been made, particularly regarding employment, created some ambiguity regarding future policy, but the greenback nevertheless appreciated by 2.8% against global counterparts in response, as measured by the US dollar index. Developed market European and Asian currencies similarly moved on changing monetary policy expectations, particularly as pandemic restrictions and lockdowns returned. Emerging market currencies fluctuated broadly as growth expectations and expected interest rate policy influenced exchange rates. The Turkish lira depreciated markedly on concerns over nonconventional monetary policy; despite persistent inflation in the country, Turkish president Erdogan was outspoken over the need for more accommodative monetary policy.

In commodities, rising demand for industrial metals and energies as economies reopened was met with extraordinarily tight inventories leading to speculation of another commodity "super-cycle." Crude oil prices were particularly strong as voluntary Saudi Arabian production cuts – beyond levels previously negotiated within OPEC – and refinery closures in Texas during the first quarter contributed to the move; Brent crude rose 44% during the period. Copper prices also rose significantly due to increasing industrial demand – specifically for electrical wiring and battery production – and decreasing South American production. Attempts by China to curb the appreciation – including pledging to release base metals from strategic national reserves – resulted in some weakness in June, although prices remained elevated, ending up over 22% on the year. Weather had the greatest impact on agricultural markets as grain and bean prices hit multiyear highs early in the year before US crop estimates rose on improving conditions as summer arrived.

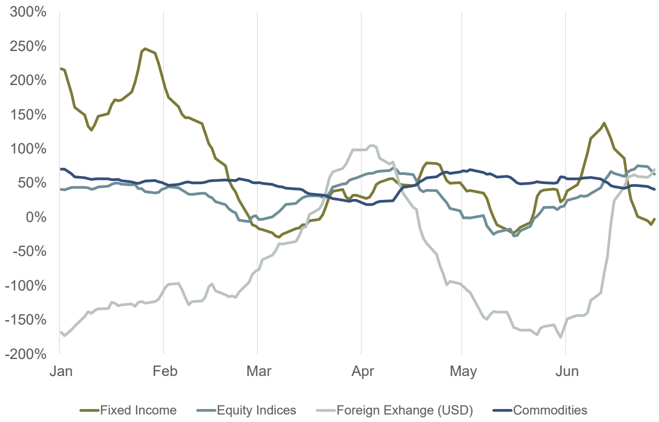
2021 Performance of Brent crude and copper

Source: Bloomberg

PERFORMANCE ATTRIBUTION

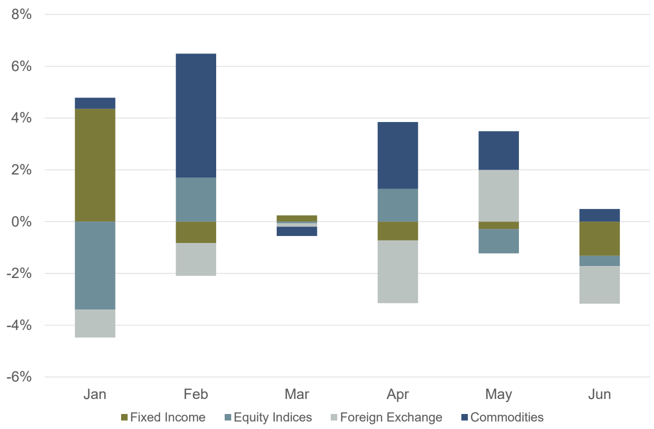
Commodity markets continued to drive positive performance as they did in 2020 contributing approximately 10.6% to the total gain of 3.6% generated by the Lynx Program in the first half of 2021. Energies were exceptionally profitable generating a 6.7% return as prices climbed on rising demand and tight supply. Meanwhile, agricultural markets generated strong results early in the year but softened in the second quarter, ultimately producing a gain of 2.9%. Long positions in grains were particularly profitable as soybean and corn prices extended their meteoric rise from 2020 on increasing Chinese imports and dwindling global inventories through the end of May. Prices declined precipitously in June as Chinese farmers significantly increased planted acreage to meet domestic demand and weather conditions in the US improved, but the program's exposure fell quickly resulting in only a partial giveback of previous gains. In the metals, solid profits in copper and aluminum outpaced losses in gold and silver to yield an approximate gain of 1.0%. Industrial metals climbed on the "reopening trade" while precious metals weakened as the pandemic began to ease. Commodity profits were distributed relatively equally between trend-following and diversifying models with all timeframes generating a positive return.

Net exposure by asset class in H1 2021



Equity index futures were also profitable, contributing approximately 2.0% to the six-month return. Not only did results vary by region, but also within regions, as multiple factors from vaccine distribution to monetary and fiscal policy to the composition of each index influenced price action. Net exposure vacillated broadly between long and short as models attempted to forecast market direction and optimally express equity beta. Interestingly, many of the multivariate models periodically maintained neutral or net short notional exposure as they viewed correlated opportunities in industrial commodities as more attractive alternatives. Ultimately, gains in North America and Asia outweighed losses in Europe; large cap US indices and the Korean KOSPI made the largest positive contribution, while trading in the EuroStoxx index was the most challenging. Medium to long-term trend-following models were particularly profitable while medium-term diversifiers had the most difficulty in the sector; short-term models in both groups generated slightly negative results.

Contribution to performance by asset class during H1 2021



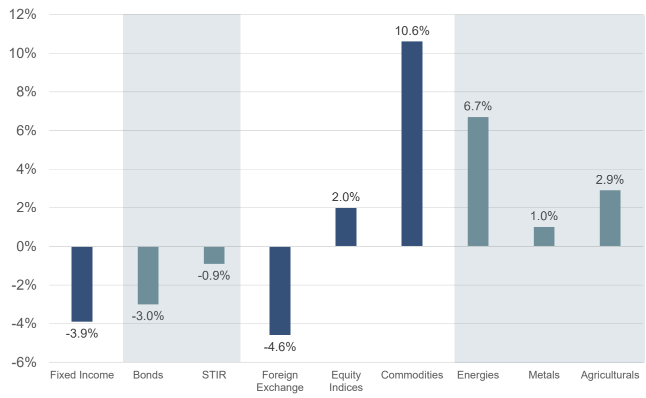
Conversely, foreign exchange was the most challenging sector for the Lynx Program in the first half of the year, generating a loss of approximately -4.6%. The program entered 2021 with significant short positions in the US dollar which suffered as the US currency rose early in the first quarter on increasing rate expectations. Net exposure fluctuated broadly afterwards as exchange rates moved in part on changing expectations of future monetary policy. While the Fed remained highly accommodative, indications of rising inflation resulted in an increasingly hawkish tone from some – but not all – Federal Reserve governors. This dissention contributed to a relatively challenging trading environment in the dollar. Additionally, rising COVID-19 infections in some countries and the consequential reinstatement of lockdowns and extensions of pandemic restrictions also had a marked influence on foreign exchange which was difficult for the models to decipher. Trend-following models were unprofitable across timeframes, although the medium-term holding periods were particularly challenged. Medium-term diversifying models similarly had difficulty, while long-term models realized a slight gain.

Fixed income also weighed on performance, contributing a loss of approximately -3.9%. Bonds and short-term interest rates were both unprofitable as losses were realized across regions. In the US, models maintained curve steepening positions throughout much of the half; however, gains generated on the long end of the curve were insufficient to cover losses in shorter-term instruments as interest rate expectations increased dramatically with the emergence of inflationary pressures. Results were similarly mixed in Europe, as a profitable short position in Euro-buxl futures was outweighed by losses in other German and French bonds. European fixed income exposure fluctuated broadly during the first six months of the year as models had difficulty accurately forecasting the trajectory of rates.

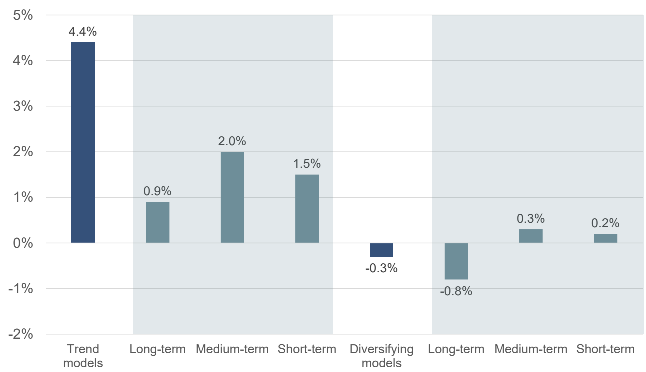
Elsewhere in the world, Korean and Australian bonds were also modestly unprofitable. By model family, losses were relatively equally split between trend-following and diversifying models, although performance varied by timeframe. Short-term holding periods were the most successful trend models while medium-term diversifying models performed best. Conversely, long-term timeframes performed poorly across both.

The charts below illustrate a summary of returns by asset class and model category, respectively.

Contribution to performance by asset class during H1 2021



Contribution to performance by model type during H1 2021



OUTLOOK

We recently wrote about the potential for an inflationary environment to develop over the coming years and the challenges investors may face managing risk should this occur. Extraordinarily accommodative monetary policies are still in place from the aftermath of the global financial crisis and the compounding effect of recent stimulus has the potential to exacerbate fiscal imbalances globally. Government debt continues to rise and while quantitative easing mitigates the risk of a rate spike, it is only a matter of time before asset purchases are tapered and programs abolished.

However, as a quantitative systematic manager our job is not to predict what the world will be like months or years from now. Rather, our models attempt to forecast how market prices will move tomorrow based only on data that is available today. "History doesn't repeat itself, but it often rhymes," as the adage goes. Using history as our guide, we attempt to navigate through any regime and – to the extent that the future reflects the past – capitalize on the opportunities that emerge.

Having said this, certain environments tend to be more attractive than others. Trend-following models generally need market prices to move from one level of equilibrium to the next to prosper. As investors respond to the extraordinary changes that have taken place since the pandemic began and digest the potential impact of increasing monetary and fiscal stimulus, markets could move significantly. We believe that the Lynx program is prepared to capitalize on the market opportunities that should arise if they do.

As always, Lynx remains committed to managing your capital responsibly and profitably. We are invested alongside our clients in every program we manage, aligning our interests directly with our investors. We hope to reward your confidence in us with differentiated, positive returns for the rest of 2021 and beyond.

Lynx Asset Management

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