JUST THE FAQs

CTAs are back...what has changed?

Through the end of May 2022, CTAs are off to their best start to a calendar year since 1995 using the Barclay CTA Index as a proxy, exceeding early returns from 2008. Consequently, both those who have recently benefited from a trend-following allocation and others considering new investments are now asking the same question: "What has changed?"

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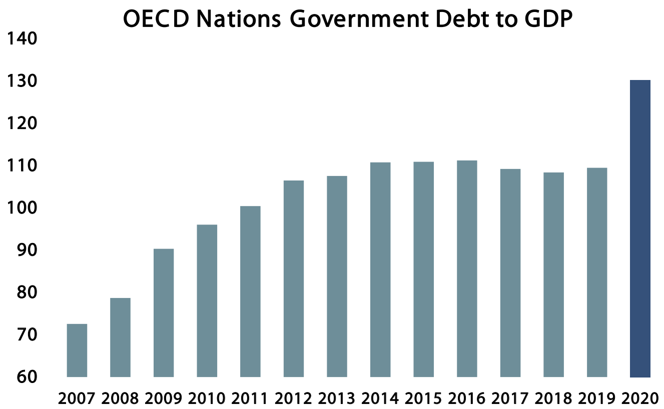
In the years following the global financial crisis, markets tended to settle into their equilibrium for extended periods. Coordinated, accommodative monetary policy contributed to extraordinarily low financial market volatility and swift policy reactions to equity market stress prevented downward trends from developing. Meanwhile, globalization limited the opportunities in commodities as the supply response to shifting demand was relatively quick reducing the likelihood of prices diverging markedly from their marginal cost of production for any extended period. As such, trend-following returns during this time were less attractive on a standalone basis as compared to prior years and significantly less appealing than a passive long equity investment which benefited tremendously from this regime.

However, times have changed from both a macroeconomic and geopolitical perspective. Much of the developed world is now experiencing the highest inflation readings in 40 years and central banks have reacted. In the outlook from our 2019 annual report prior to the pandemic, we focused on three primary catalysts which we believed could trigger a shift in the market environment: policy normalization in response to increasing inflationary pressures, deglobalization and the societal impact of protectionism, and geopolitical conflict. COVID-19 exacerbated the risks associated with these potential scenarios and what we have seen so far in 2022 is the result. The pressures being exerted on global markets are exceptionally strong and not easily remedied.

The macroeconomic and geopolitical landscape

The compounding effect of monetary and fiscal stimulus have left many global economies in an unenviable position: sovereign debt in OECD countries exceeded 130% of GDP at the end of 2020 and overall global debt surged to over 250% of global GDP. Debt servicing has remained manageable given the exceptionally low-rate environment, but there will likely be challenges ahead. Central banks have been consistently tightening policy to combat rising inflation and have indicated their commitment to continue doing so until prices stabilize. In the US, the Fed has even indicated it could adopt a more "restrictive" policy stance should the outlook warrant. The ability of individuals, corporations and even governments to meet their debt obligations should interest rates continue to climb could become increasingly difficult. The resulting uncertainty and potential dispersion between debtors could lead to heightened financial market volatility and potentially attractive trading opportunities in financial futures.



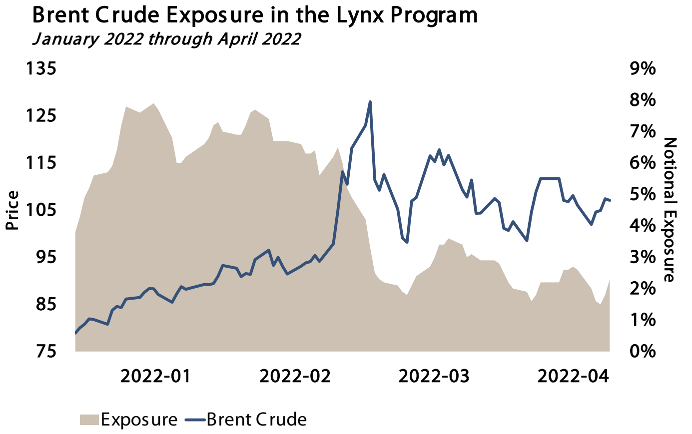
Source: Organization for Economic Co-operation and Development (OECD)

Further, supply chains around the globe continue to be impaired by the ongoing COVID crisis intensifying inflationary pressures. What were thought to be temporary challenges regarding production and distribution have now extended for over two years. Geopolitical conflict in Europe has only worsened these issues and there do not appear to be any immediate solutions forthcoming. In fact, the contrary may be the case as potential new sanctions on Russia, Europe's commitment to reduce their dependence on Russian oil and gas, and a ravaged Ukrainian infrastructure impeding their ability to export agricultural commodities could drive prices even higher.

Shifting market dynamics

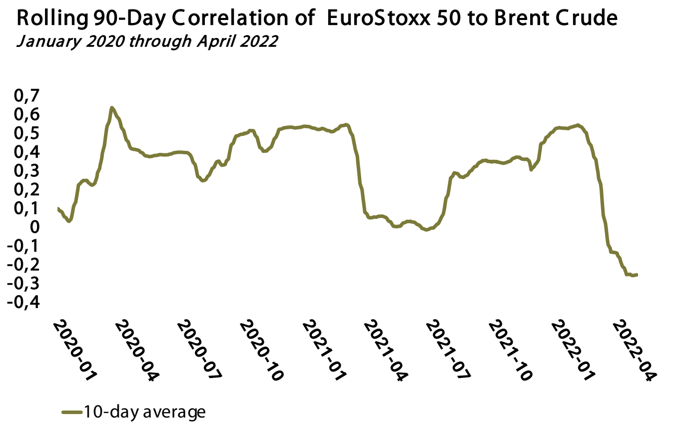
While it is impossible to forecast how the environment might change over the coming months – and the impact those changes may have on performance – there have also been dramatic shifts in market dynamics this year that make the current environment particularly interesting. Specifically, significant increases in market volatility and changes in the correlation structure have altered the way many managers have participated in trends as they have developed. Normally, trend-followers will size positions inversely proportional to market volatility to better manage portfolio risk; a 10% notional position in Eurodollar futures has a markedly different risk profile than a similarly sized position in natural gas. Additionally, most managers analyze the correlations of positions in their portfolio to identify and manage concentrated bets. In the Lynx Program, this shift in regime has resulted in a notable change in market exposures.

As an example, the following chart illustrates how the exposure in Brent crude oil developed over the course of this year in the Program.



Source: Bloomberg and Lynx Asset Management AB

Note the sharp decline in exposure (in tan) as prices spiked following Russia's invasion of Ukraine. Importantly, volatility was not the only contributing factor as Lynx' multivariate models consider many other variables when constructing the portfolio, including correlation. Following the identification of COVID-19 infections outside of China in early 2020 through late last year, energies and equities had been positively correlated. Changing sentiment regarding the course of the pandemic resulted in shifting expectations of global growth which similarly influenced prices in both asset classes. As concerns regarding the virus eased, the correlation declined as rising inflationary pressures became the primary factor explaining returns; conversely, as new variants emerged in June and November 2021, the coefficient again spiked. Entering 2022, the correlation between Brent crude oil and the Euro Stoxx 50 index became negative and the Russian invasion of Ukraine in late February amplified this relationship.



Source: Bloomberg

As portfolio exposures became more dependent on singular factors, the risk allocated to those positions declined.

What now?

Having said all of this, attempting to forecast the future path of inflation, central bank policy or geopolitical conflict when evaluating a CTA investment going forward is perhaps not the ideal approach. While the strategy has done well as inflation has climbed, it is not preordained that it will do poorly should numbers stabilize or even fall. Heightened volatility and relatively large changes in asset prices have created a ripe environment for most managers, and softer inflation numbers may not result in a reversion to the prior regime.

Perhaps of equal importance, even if the regime were to revert, markets would likely not immediately correct. It takes time for macroeconomic events to evolve and even more time for investors to process the implications on asset prices. Given the significant moves in commodities, interest rates, foreign exchange and equities, the trends that would likely develop as prices moved back to their prior equilibrium could be exceptionally profitable. For example, increasing energy demand, tight inventories and supply disruptions have combined to push crude oil prices over US $100 a barrel for the first time since 2014. Imagine the potential gains that could be generated with short positions should prices fall back to $10 a barrel as they were in the depth of the COVID crisis only two years ago. Similarly, US 10-year Treasury yields have hovered around 3% in recent months after touching a historic low of 52 basis points in 2020. Until recently, there was a perception that trend-followers could not make money in a rising rate environment as there had not been a sustained period when rate expectations were climbing. However, trend managers have a long history of capturing gains in extended bond bull markets.

In conclusion, the environment for trend-following has been exceptionally attractive in early 2022. Relatively large moves in financial and commodity futures have enabled many CTAs to deliver on their promise of differentiated, positive returns during a more challenging environment for equities and bonds. Whether these moves will continue, reverse or stagnate at their current equilibrium will be instrumental in determining CTA performance going forward. While it may be impossible to say what happens next, the opportunities remain strong and our optimism remains high.