LYNX PROGRAM 2023 MIDYEAR REVIEW

LYNX

Summary

The Lynx Program realized a negative return of 5.7% net of fees[1] in the first half of 2023 as gains in foreign exchange and equities were outweighed by losses in commodities and fixed income. Stubbornly high inflation despite tighter monetary conditions, an ongoing war in Eastern Europe and a regional banking crisis in the US which resulted in three of the largest bank failures in the country's history were not enough to derail the positive sentiment during the first half of the year. Equity markets climbed and bond yields declined, shrugging off much of the turmoil that defined financial markets in 2022. Additionally, commodity prices collapsed as declining industrial production and a stalled economic recovery in China resulted in sluggish demand.

While the trend-following and diversifying components of the program both contributed to the loss, long-term models in each category were positive. In fact, the shorter-term timeframes – those that have historically performed best during developing crises and periods of heightened volatility – significantly underperformed other models on a risk-adjusted basis. The result brings annualized performance since inception to 9.7% net of fees with an annualized standard deviation of 14.8%[1]. Performance fell short of the Société Générale CTA Index which ended the period flat and also trailed traditional investment benchmarks; the MSCI World NDTR Index (local currency) and the JPM Global Government Bond Index (local currency) were up 13.5 and 1.5%, respectively[2].

Midyear result[1]

-5.7%

Lynx Program total assets

7.2 bn
USD

Annualized performance since inception[1]

9.7%

Annualized standard deviation[1]

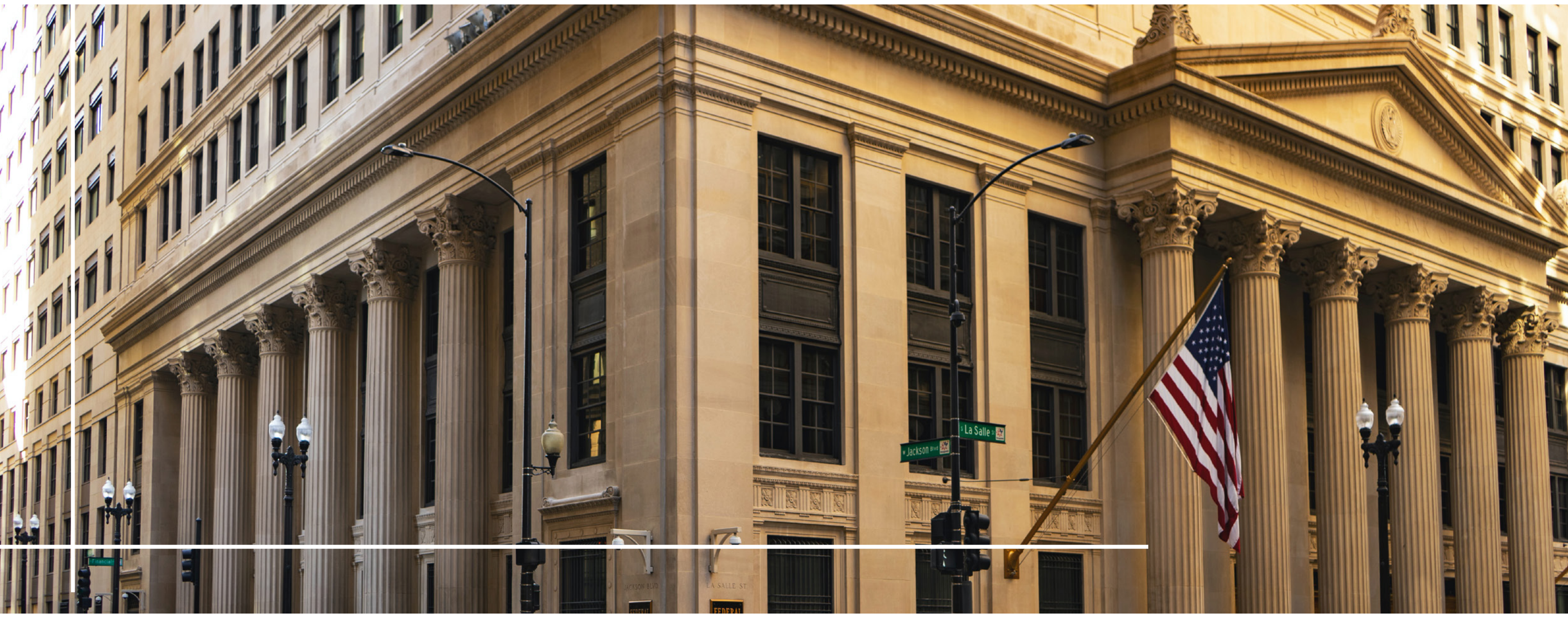
14.8%

[1] The net performance figures include interest, costs and fees and reflect the standard leverage Lynx Program with a 1% management fee and a 18% (20% up until 1 July 2018) performance fee for a USD investment. For the period 1 May 2000 up until 31 March 2004, pro forma numbers have been calculated based on a SEK investment and thereafter an equivalent investment in USD. [2] Index-figures are based on available data at the time of publication and are subject to revision.

Market Developments

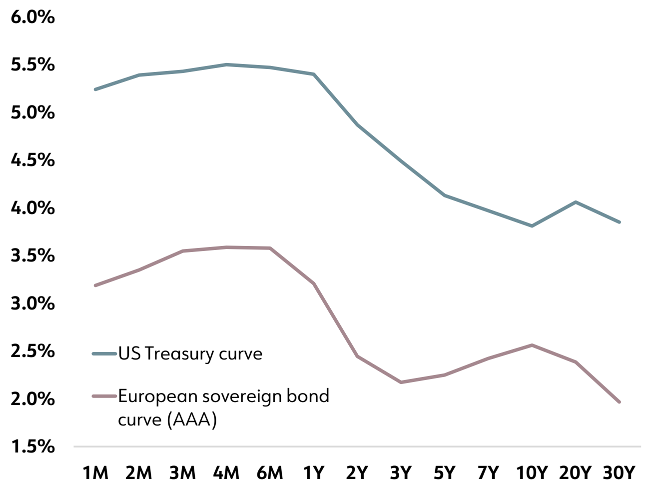
In a welcomed outcome, tighter monetary policy across much of the Western world did not result in a global recession, spiking unemployment and collapsing stock prices in the first half of 2023. While inflation softened by most accounts, economic activity remained remarkably resilient and jobless figures held reasonably steady in both the US and Europe. Markets benefited from optimism that tighter financial conditions were beginning to have the desired impact on consumer spending without the severe adverse consequences some had feared. Easing supply chain constraints and falling energy prices bolstered the narrative that a soft landing was possible, and sentiment improved markedly from the year before.

However, while inflation readings moderated across much of the world, levels remained significantly above the targets of most developed market central banks. Many of these banks were still raising interest rates into June and indicated their intention to continue doing so until inflation was truly under control. Notably, policy diverged considerably based on geography. Benchmark lending rates in US and Europe climbed markedly during the period – with the ECB and Bank of England each tightening 150 basis points and the Fed hiking one percent – while in Asia, the Bank of Japan maintained their extraordinarily accommodative policy stance and the People's Bank of China cut rates in the face of a faltering economic recovery. The shifting interest rate differentials had a significant impact on foreign exchange as the Japanese yen depreciated by nearly 9% against the US dollar and the Chinese renminbi fell by almost 5%.



In sovereign fixed income, yield curves in Europe and the US remained inverted as short-term interest rates climbed with tighter monetary policy while longer-dated bonds factored in the potential for future recession. The Australian curve inverted in June for the first time since the global financial crisis and a total of 32 countries experienced inverted curves as the first half of the year came to a close. In fact, the US curve began the second half in the deepest inversion between 2- and 10-year rates since 1981. While historically an indication that trouble was on the horizon, investors largely wrote off the phenomenon as a temporary condition until inflation eventually abates.

Yield curves as of June 30, 2023



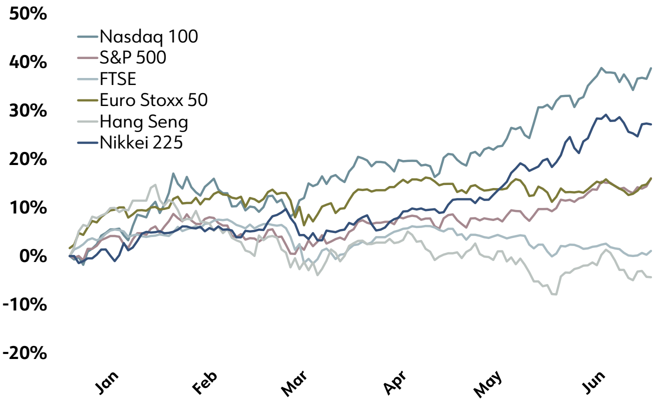
Source: U.S. Department of the Treasury and the European Central Bank.

Higher interest rates and the inverted curve had negative consequences for the regional banks in the US. Historically low Treasury yields in recent years encouraged some banks to extend their fixed income duration to generate additional revenue. The speed and magnitude of rate hikes over the past year, and the corresponding inversion of the curve, left these same institutions with unrealized capital losses on some of their holdings. Depositors, concerned about potential insolvency, began pulling their capital and banks started collapsing. Silicon Valley Bank ("SVB") was seized by regulators on March 10th, as was Signature Bank two days later. At the time, these were the second and third largest bank failures in US history, until First Republic Bank unseated them at number two at the beginning of May.

While the markets initially reacted as would be expected, essentially a classic flight-to-quality, the US Treasury and Federal Reserve quickly instituted emergency measures to quell the panic. By extending depository insurance beyond the limits of the FDIC and providing emergency loans to other banks, the government signaled that they were prepared to act as necessary to avoid widespread contagion. Interestingly, the failure of Credit Suisse later that month and the subsequent collapse of First Republic did not have the same market impact as SVB and Signature. In the former case, the Swiss government brokered a deal for UBS to buy the troubled bank before the situation deteriorated further.

Equities generally ended the period higher although performance was quite mixed depending on market sector and geography. Gains in European and US equity indices were due largely to a very small group of stocks. In France, increasing Chinese demand for luxury products briefly made Bernard Arnault the richest man in the world as LVMH rallied over 25% early in the year along with other distinguished high-end brands. In the US, mega-cap technology companies drove positive returns.

Global stock index performance during first six months of 2023

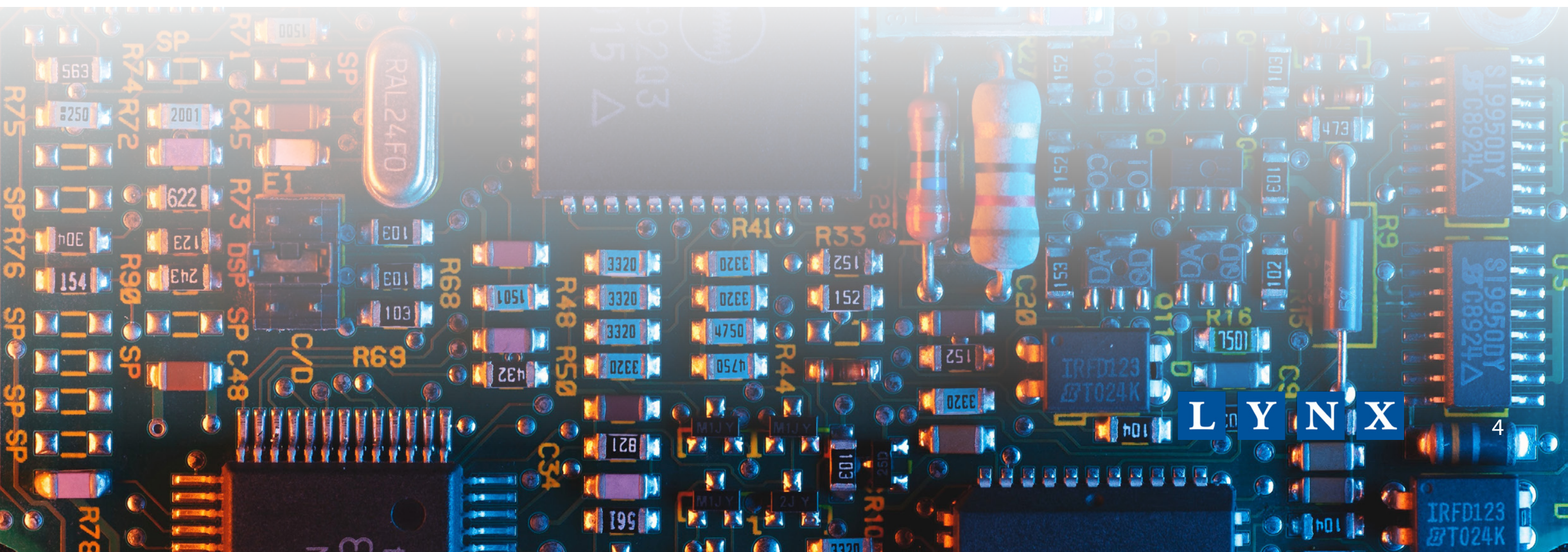


Source: Bloomberg

The first six months of 2023 were the best for the NASDAQ in 40-years although the breadth of participation was remarkably narrow. The seven largest companies in the index (Microsoft, Apple, Alphabet, NVIDIA, Amazon, Tesla and Meta – also known as the "Magnificent Seven") constituted approximately 43% of the overall market capitalization of the NASDAQ composite at the end of June and over 50% of the NASDAQ 100. The market cap weighted average performance of these stocks in the first half was over 60%, accounting for a majority of the index returns.

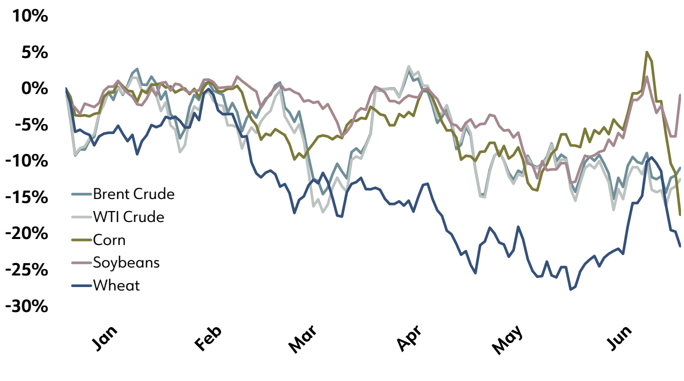
The extraordinary popularity of generative AI was largely responsible for the technology boom as ChatGPT brought artificial intelligence to the masses. From the forecasted demand for microchips to the potential application of machine learning in the future, investors attempted to identify those companies which would benefit from the expected revolution. Interestingly, the tech sector underperformed considerably in 2022 as investors focused on those companies' rising cost of capital and tighter margins, so the turnaround was especially remarkable.

Meanwhile in Asia, accommodative monetary policy in Japan, a renewed focus on corporate earnings with improving governance rules, and the much anticipated return of inflation all contributed to a 27% gain in the Nikkei Index. The positive result marked the strongest start to a calendar year in the nation since the onset of "Abenomics" a decade ago. Korean stocks similarly climbed, led primarily by technology companies, although the positive performance was not experienced across the region. Major indices in China, Hong Kong, Singapore and Thailand all ended the period in negative territory driven primarily by concern regarding global growth and the health of the Chinese economy.



With few exceptions, most notably gold, commodity prices weakened in the first half of the year. Industrial metals and energies declined as manufacturing slowed and global demand fell short of expectations. After three years of quarantines, lockdowns and other restrictions under their strict "zero-COVID" policy, optimism was high when China began rolling back many of these provisions in late 2022. However, the economic recovery that many predicted has yet to materialize. Imports have declined sharply, falling every month from October 2022 through May 2023. In agricultural commodities, grain prices slumped to multi-year lows after fluctuating broadly amid drought conditions in North America early in the planting season. Improving weather and increased planted acreage now have forecasters calling for record US production. Meanwhile, gold approached an all-time high in the spring despite rising policy rates and lower inflation readings, although gave back some of those gains later in the second quarter.

Crude oil and grain price development during first six months of 2023



Source: Bloomberg

Geopolitical tensions remained elevated as the war in Ukraine passed its one-year anniversary without an end in sight. Western support of Kiev remained strong allowing the country to limit territorial losses and Ukrainian forces were in the midst of a counteroffensive as the first half came to a close. While official statistics indicated that GDP began expanding during the second quarter in Russia, additional sanctions on individuals and companies linked to the Putin regime limited the country's access to global financial markets resulting in declining growth expectations in the years to come.

Meanwhile, increasing signs of internal opposition to the way in which the conflict has been managed created uncertainty regarding the stability of the political and military hierarchy in Russia. Late in June, Yevgeny Prigozhin, the controversial leader of the Wagner private military company, pulled his troops off the front lines where they fought alongside Russian soldiers and began a march towards Moscow. Speculation regarding his intentions abounded, although the apparent insurrection was called off before fighting ensued and mercenaries were given the option to rejoin Russian forces as professional soldiers, return to Russia or head to exile in Belarus.

Elsewhere, tensions between the US and China were raised when spy balloons – purported to be gathering weather data by Beijing – were identified and shot down over the Americas. The incidents added to an already stressed relationship between the two nations due to the longstanding disagreement over the sovereignty and status of Taiwan. Contentious trade relations worsened with threats of new embargoes and punitive tariffs on top of those still in place from the Trump presidency, although US-China trade hit a record early in the year before additional restrictions were later implemented.

In US national politics, Republicans took control of the House of Representatives as the 2023 session commenced after gaining a slight majority in midterm elections. An unusually controversial selection of House Speaker requiring 15 rounds of voting illustrated the rather fractured nature of the legislature. Later in the year, negotiations between the Biden administration and Congressional leaders over raising the debt ceiling came into focus as investors weighed the implications of a potential default on US obligations. Despite concern that a deal would not be reached, stock and bond markets remained relatively stable on expectations that central bank policy would pivot in an adverse outcome.

In France, over one million people reportedly gathered in January to protest the government's plan to push back the retirement age by two years to 64. Strikes and demonstrations continued as the year progressed. In China, the National People's Congress unanimously reelected Xi Jinping to an unprecedented third term as the nation's president. Elsewhere in the world, the shift towards nationalism continued in April as the Finns Party, Finland's largest rightwing party, secured enough seats to gain a place in the new coalition government in the Lower House of the Eduskunta. Elections across the European continent similarly saw conservative, largely anti-immigration parties increasing in popularity.

Unfortunately, climate change continued to have an adverse effect on the globe. Land and sea temperature records were set and broken in quick succession and the average global temperature eclipsed the 1.5°C / 2.7°F threshold above preindustrial levels set at the 2015 Paris Climate Accords multiple times. Abnormally hot and dry weather in Canada created a ripe environment for wildfires during the spring and blazes have continued virtually unabated since. Smoke from these fires has created hazardous air quality conditions across North America and even made their way across the Atlantic to Europe. In Asia, Cyclone Freddy formed in the Indian Ocean during February and became the most powerful – and one of the deadliest – tropical cyclone in history. While agricultural commodities have not seen significant changes in yield expectation due to the hot and dry conditions, forecasts for an El Nino weather phenomenon to develop later in the year could change that quickly.

Performance attribution

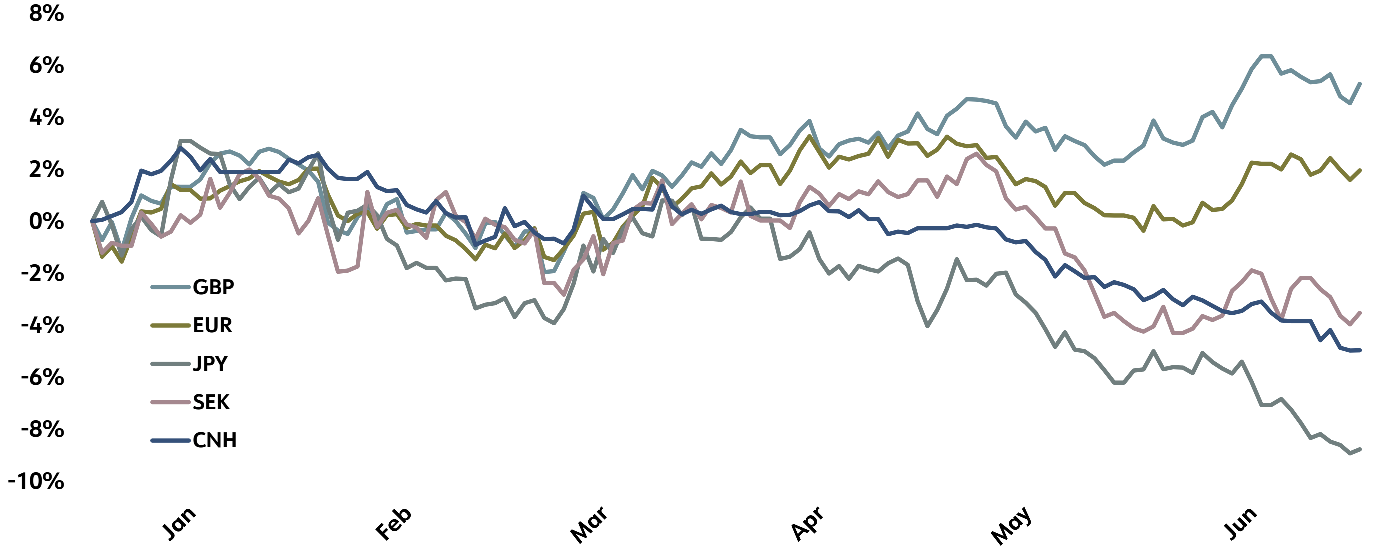
The Lynx Program ended the first half of 2023 down 5.7% net of fees[1], as losses in commodities and fixed income outpaced gains in currencies and equities. In aggregate, both the trend-following and diversifying components of the program realized losses with shorter-term timeframes having particular difficulty on a risk-adjusted basis. Meanwhile, long-term models in each category were positive as they were less prone to the periodic, short-lived reversals that occurred over the first six months of the year.

Lynx entered 2023 with a sizeable net short position in bonds and short-term interest rates and realized a sharp loss as rates declined precipitously on optimism that global central banks might scale back the pace of future rate hikes. Although German 10-year bund yields subsequently climbed to their highest level since 2011 midway through the first quarter, the banking crisis in March disproportionately impacted longer-dated securities and yield curves in the US and Europe became more steeply inverted. Ultimately, the program generated a modest gain in short-term interest rates which correlated to expected central bank policy but realized sharp losses in global bonds. Short positions in long-dated German and US bonds were particularly unprofitable. Trend-following models were responsible for a majority of the loss and had difficulty across timeframes. In aggregate, diversifying models were also unprofitable although modest gains were generated by the longer holding periods.

The program similarly maintained a net short position in equities at the beginning of January but reversed course as stocks rallied on improving sentiment. Models tactically adjusted exposure in response to changing market conditions yet remained net long until late June. Performance was mixed by geography as positioning in Japan was particularly profitable, modest gains were generated in Europe, and losses accrued in the US and the rest of Asia. Ultimately, the asset class contributed positively largely due to long positions in the Nikkei and TOPIX indices. By model category, trend-followers generated gains across timeframes with longer-term models outperforming others on a risk-adjusted basis. In the diversifying segment, short-term models were the only positive timeframe, while long-term models underperformed the rest.

In foreign exchange, profitable trading in emerging market currencies and the Japanese yen was largely responsible for the gain in the asset class. As central bank policy diverged considerably during the period, models quickly responded to shifting exchange rate differentials, pivoting between short to long net US dollar exposure multiple times. Ultimately, largest gains were generated in a long Mexican peso position and short positions in the Japanese yen and Chinese renminbi. By model family, medium- and long-term timeframes in trend-following performed well, although short-term models were challenged as they were out of phase with the price action. In the diversifying component of the strategy, gains were generated across timeframes with medium- and long-term models performing particularly well.

Foreign exchange rates during the first six months of 2023 against the US dollar



Source: Bloomberg

Finally, losses in commodities were spread across sectors as energies, metals and agricultural markets all detracted from the result. Unprofitable trading in energies was due to crude oil and distillate as prices vacillated broadly within a wide range, ultimately ending the period lower on concerns over global growth and indications of a waning Chinese recovery; a gain in natural gas offset some of negative performance. Meanwhile, the loss in metals was split between base and precious metals as gold, silver and copper all contributed negatively. Finally, grains were primarily responsible for the loss in agricultural commodities as the program had particular difficulty with the moves in the soybean complex and corn. Trend-following and diversifying models lost money across timeframes, with short-term trend and medium-term diversifiers generating the largest losses.

Outlook

While inflation has clearly been declining across the globe, levels remain elevated and central banks appear willing to continue hiking rates to achieve their objective. Consumers have been remarkably resilient in the face of tighter credit conditions and employment has remained reasonably robust, but will that continue as rates go even higher? Equities are off to a strong start to the year, although the participation has been very thin. To be sure, we have seen an incredible run in technology stocks with the "magnificent seven" increasing their market capitalization by over US $4 trillion so far this year. However, most other businesses are not experiencing the same success. Rising capital costs with higher interest rates will likely result in tighter margins as companies may find it difficult to raise prices. Falling earnings combined with the relative attraction of bonds at their current yields could put additional downward pressure on stock prices in the second half. The resulting trends could be quite attractive for the Lynx Program should they develop.

Additionally, increasing optimism that global economies will experience a "soft landing" as inflation eventually falls back to longer-term targets may be unfounded. Recession remains a likely risk scenario across the globe as the impact of higher interest rates on economic activity is generally lagged and even tighter policy going forward could tip the scales on growth. The IMF forecasts growth in advanced economies to fall to 1.3% in 2023 from 2.7% in 2022 and envisions a plausible risk scenario where the number could drop to 1%. While the Chinese government continues to forecast 5% growth this year, recent economic reports indicate that the recovery following the end of their "zero-COVID" policy is faltering. Going against most other global central banks, the People's Bank of China cut interest rates on benchmark one and five-year loans by 10 basis points in an attempt to stimulate economic activity. However, easier monetary policy and looser credit could potentially be risky given widely reported concerns regarding the banking system and soaring bad debts. Divergent monetary policy and the potential for policy mistakes could offer opportunities for the Lynx Program. Changing interest rate differentials have already resulted in strong trends in the Japanese yen and Chinese renminbi, while policy mistakes could offer profit opportunities across financial markets in the second half of the year.

Geopolitical risk remains elevated as the ongoing war in Ukraine has pushed Russia and the West closer to direct military conflict. The acceptance of

Finland as the 31st member of NATO over doubled the alliance's border with Russia and reversed generations of neutrality. With Sweden likely to join next now that Turkey has pledged support for their bid, tensions could increase further. To date, the impact of the war on financial markets has been limited. Commodity inflation due in part to grim forecasts of supply shortfalls have largely dissipated as supply lines have shifted and increased production has mitigated the impact on consumers. This has been perhaps most evident in energy markets as prices have collapsed since last summer. However, an expanding conflict could result in heightened uncertainty across commodity and financial markets and a potential return to similar market action seen in the first half of 2022.

As always, Lynx is committed to managing your capital responsibly and profitably. We are invested alongside our clients in every program we manage, aligning our interests directly with yours. While we are disappointed with the lackluster results in the first half of 2023, we are optimistic that the environment for the Lynx Program will improve and look forward to again delivering positive, differentiated returns when it does.

Lynx Asset Management

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