LYNX PROGRAM 2023 REVIEW

LYNX

Summary

While 2022 was marked by strong trends driven by the repricing of global assets on the back of rising inflationary pressures, the environment in 2023 was more challenging. Following up a 36.8% positive net return the previous year, the Lynx Program ended 2023 down -7.6% net of fees, as losses in commodities, fixed income and stock indices outweighed a gain in foreign exchange.[1] Trend-following models were responsible for approximately 80% of the negative result, as losses were experienced across timeframes.

Entering the year, few expected central bankers to successfully walk the fine line between meeting their policy objectives and avoiding tipping economies into recession. However, as the year progressed, inflation readings consistently fell while economic indicators remained reasonably sanguine. Equity investors welcomed these developments with major US and European indices ending the year near record highs and Japanese stocks climbing sharply. While short-term interest rates rose as most central banks continued to tighten policy, investors began anticipating a soft-landing keeping longer-term rates in check. The US 10-year Treasury yield ended the year largely unchanged while yields on similar duration bonds in Europe declined.

To be clear, the paths of both stocks and bonds were not straight lines. The failure of Silicon Valley Bank in March highlighted the vulnerabilities of some financial institutions to higher interest rates catalyzing a flight-to-quality. The sudden and sharp declines in stocks and bond yields were difficult to navigate as was the subsequent reversal once the US government guaranteed depositors. The loss in March was ultimately greater than the decline for the year. While we are not satisfied with the return for this specific period, we were nonetheless encouraged that our models and risk management procedures worked as expected.

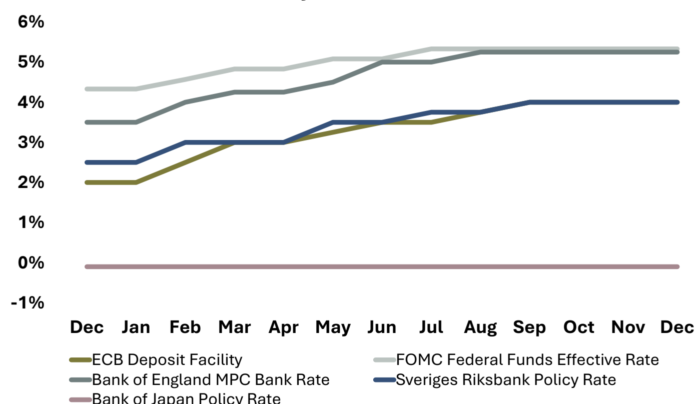
After March, changing forecasts of monetary policy also periodically created directionless volatility which was difficult for our models to capitalize upon. And price action in the commodities was even more challenging. Industrial commodities oscillated with changing growth forecasts, grains fluctuated with unexpected weather conditions due to the El Nino effect, and energy markets were influenced by geopolitical conflict in Ukraine and Israel. Our relatively reactive models reversed exposure across asset classes multiple times during the year looking to profit from the market developments, but ultimately ended down.

[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. Please read more information on pro forma numbers on page 12.

Market Developments

With CPI peaking at over 9% in the US in June 2022, and at similar levels across much of the rest of the developed world, central banks desperately needed to raise interest rates. As they did, inflation began to soften and continued to decline as the year progressed. However, from all accounts, they still believed that there was much work left to do as 2023 commenced. Speculation of how far central banks would go in the face of economic contraction and when they would ultimately pivot were in focus throughout the year. However, bankers were resolute, determined to reclaim price stability despite the near-term potential economic impact. After being slow to react to rising inflationary pressures following the COVID pandemic – and having learnt the lessons from the 1970's – it seemed they would rather err on the side of doing too much than not doing enough. As levels remained elevated, policy tightened further. Ultimately, the Fed hiked rates in the US by 100 basis points while the ECB increased their policy rate by 2% and the BoE by 1.75% during the year.

Coming into the year, many market commentators expected most Western economies to fall into recession as tighter monetary conditions impacted consumers and slowed growth. However, in the US, surprisingly strong employment numbers and indications that consumers remained remarkably resilient lent credence to the hope that avoiding a prolonged downturn was possible. Similarly, the IMF began forecasting a "soft-landing" in Europe although they warned that inflation could remain elevated and even require additional central bank action in the future. In November, the US Fed held rates steady for the second consecutive meeting and notably indicated that tighter financial conditions, along with tighter credit, were "likely to weigh on economic activity, hiring, and inflation." Comments from Chairman Powell that rates were "likely at or near" their peak late in December was an even more explicit indication that the bank was considering a shift. Weaker-than-expected employment figures bolstered that narrative and contributed to a meaningful pullback in US rates and the US dollar. Similarly, the ECB signaled that "the disinflation process was proceeding somewhat faster than expected" supporting optimism of looser global monetary policy in 2024 and contributing to a notable decline in rates.

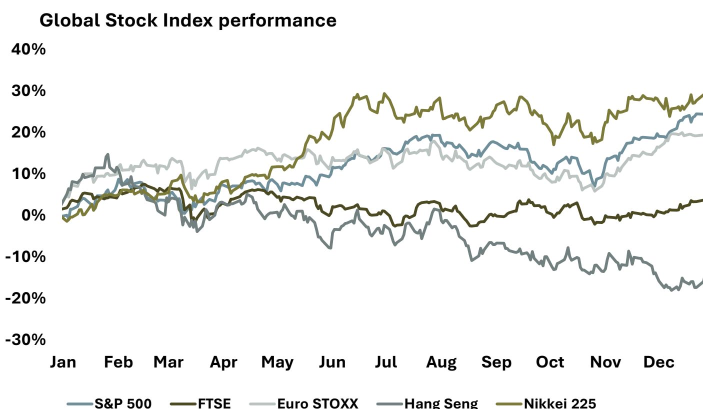


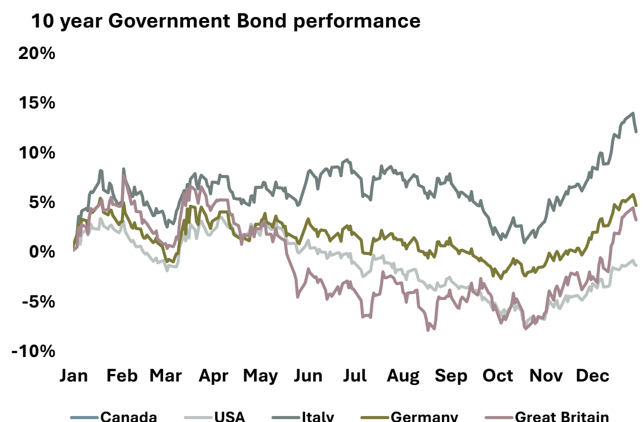
Inflation moderated considerably in 2023, but perhaps more importantly, central banks did a remarkable job reining in speculators anticipating the eventual dovish pivot in monetary policy. This does not mean that investor optimism could be completely quelched. Following a disappointing 2022, equities rallied back strongly in 2023 led largely by technology stocks. In the US, the Magnificent Seven (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla) – the highest market capitalization public companies in the US, along with Berkshire Hathaway – drove much of the return of major equity indices. Generative AI and the future potential of artificial intelligence were largely responsible for the outperformance as investors sought to gain access to a generational technology at a nascent stage. Nearly two thirds of the annual gain in stocks was generated in the final two months of the year as a change in central bank rhetoric bolstered optimism that major economies in North America and Europe could be heading for a "soft landing."

Meanwhile, China was unable to emerge from their zero-COVID policy as robustly as many had forecast, leaving speculators unwinding "reopening" trades as the economic reality did not meet expectations. Domestic spending remained subdued, unemployment climbed, and real estate came under increasing pressure with the defaults of major lenders. In June, the People's Bank of China cut the one-year loan prime rate and the five-year rate by 10 basis points each, and subsequently reduced the prime rate again in August, going against most other global central banks. They also added liquidity to the market, including a record increase in policy loans through its one-year medium-term lending facility (MLF) in December. However, despite pledges from government and banking officials to support growth in the nation, weak domestic demand contributed to falling consumer prices and persistent deflation, particularly in the latter part of the year. As a result, both Chinese equities and the renminbi ended 2023 weaker.

US Regional Banking Crisis

The failure of Silicon Valley Bank in early March shined a light on less than responsible practices by some regional banks across the US. With previously stable deposits and extraordinarily low interest rates, many banks extended the duration of their assets to generate excess yield. However, as interest rates climbed, the value of their bonds fell leaving many vulnerable to a flight of deposits. In the case of SVB – and Signature Bank and First Republic Bank afterward – this is precisely what occurred. The impact on markets was immediate and astounding. Stocks collapsed and bonds climbed in a classic flight-to-quality. Other than the Washington Mutual collapse in the midst of the global financial crisis in 2008, these were the largest bank failures in the history of the US. However, despite concerns regarding potential





Source: Bloomberg

contagion to the broader financial system arising after Swiss authorities negotiated the takeover of Credit Suisse by UBS, quick action by US governmental agencies mitigated the risk to depositors and equities reversed sharply. Their move has been credited for preventing a cascade of regional bank failures and potentially a more extensive global crisis.

Geopolitics

On the geopolitical front, the conflict in Ukraine continued into its second year with no end in sight. Kiev generally enjoyed the military support from the West, although cracks began to emerge in the façade as the year progressed. In the US, Republican lawmakers began voicing concern over the continued funding of the war, with some high-profile politicians – including Republican presidential front runner, Donald Trump – suggesting that the US should stop sending weapons altogether. In Europe, trade disputes with Poland, Hungary and Slovakia led Ukraine to file a complaint with the World Trade Organization for banning imports of agricultural commodities. The move elevated tensions between the countries and resulted in Polish Prime Minister Mateusz Morawiecki declaring that Poland would "no longer transfer any weapons to Ukraine." While his comments were later stepped back by President Andrzej Duda, the alliance between the two countries weakened. Additionally, extremist elements within some European parliaments – both nationalists and social populists – gained ground threatening the status quo and endangering continued support for Ukraine. Meanwhile, Finland became the 31st member of NATO in April, extending the alliance's border with Russia by 1,340 kilometers. On October 7th, Palestinian militant groups backed by Hamas surprisingly attacked Israel from the Gaza Strip. The response from Israel was immediate and overwhelming as war was declared and military action commenced. Despite pleas from the United Nations and humanitarian organizations, the borders from Gaza remained largely closed to Palestinians attempting to flee the violence. Attacks from Lebanon by the Iran-backed Hezbollah increased markedly and fighting along the border between the nations rose. Further, conflict between Israeli defense forces (IDF) and Palestinians in the occupied West Bank intensified, threatening a multifront war. While the fighting remained largely contained to the region, increased attacks by purportedly Iran-backed groups against US forces in Syria and Iraq risked pulling in other nations into the fray.

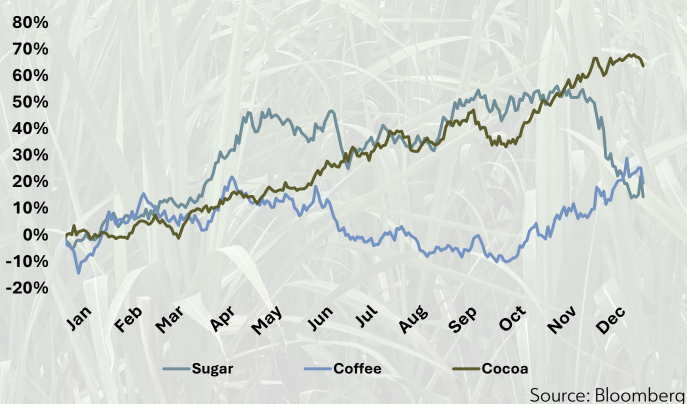
Relations between the US and China deteriorated after multiple balloons determined to be collecting information for China were tracked and ultimately shot down over the Americas. Subsequently, other high-altitude objects (HAO) were similarly identified and destroyed over the country. While the Chinese government asserted that the objects were weather balloons that had been blown off course, the US claimed that they were a violation of the nation's sovereignty and postponed an official diplomatic visit to Beijing. Tensions were already elevated due to ongoing trade disputes, the US support of Taiwan as an independent nation, and China's allegiance with Russia, so the incident set back the restoration of normalized relations.

National politics

In politics, Xi Jinping was unanimously reelected to an unprecedented third 5-year term as the President of China. After the two-term presidential limit was removed from the Chinese Constitution in 2018, speculation began to emerge that Xi could rule for life. In the US, the Republican Party gained control of the House of Representatives creating a divided legislature. Pressure on Congressional leaders from the Biden administration to raise the debt ceiling to avoid a potential default on US obligations in the late spring and contentious negotiations on the floor of the House over a continuing resolution in the fall highlighted the distrust and disfunction between the political parties. Additionally, House Republicans also showed signs of internal conflict. After requiring a record 15 rounds of voting to be elected speaker, Kevin McCarthy was ousted from his role in October, becoming the first Speaker of the House to be removed from his position in a motion to vacate. He ultimately resigned from Congress as the year was coming to a close. In Turkey, Recep Tayyip Erdoğan was narrowly reelected to his third term as president. Erdoğan has made headlines in recent years for opposing a policy response to climbing inflation but changed course in 2023 stating that the Turkish central bank would use “tight monetary policy” to slow inflation to the single digits.

Commodities

In the commodities, the US National Oceanic and Atmospheric Administration (NOAA) declared an El Nino event had developed in June. El Nino is a natural climate phenomenon characterized by above average water temperatures in the Pacific Ocean around the equator that influences weather across much of the globe. Soon after the announcement, the ECB forecasted that global food prices could rise 9% should a strong event unfold. Tropical commodities such as sugar, cocoa, and coffee immediately began climbing as production estimates fell and adverse weather began impacting growing conditions. Prices vacillated afterwards as market-specific factors also influenced supply/demand dynamics, although in the case of cocoa and coffee, they ended the year much higher than where they began. Meanwhile, sugar prices collapsed late in the fourth quarter after the Indian Food Ministry restricted the conversion of cane juice and syrup to ethanol and Brazil significantly increased production. El Nino was still in place entering the new year.



Source: Bloomberg

In the energies, US natural gas prices collapsed on record production and benign weather across much of the US. By the end of 2023, Henry Hub gas had declined over 40% from the end of 2022 – and nearly 75% from last year's peak – bringing prices to the lowest level since the COVID-19 pandemic in 2020. Meanwhile, crude oil and distillate prices vacillated on a combination of supply/demand-related concerns and geopolitical risk, ultimately ending the year down over 10%. With Russia successfully rerouting their oil from the European Union to China, India, and Turkey, the increase in global production – initially meant to counterbalance the impact of the oil embargo from Western nations – resulted in higher-than-expected supply. However, the Israel-Hamas war in the fourth quarter led to a price reversal as concerns grew regarding the impact of a widening conflict on production. In December, Houthi rebels attacked commercial vessels transiting the Red Sea and Suez Canal from Yemen, forcing ships to reroute around Africa. Additionally, the frequency of confrontations between Israel and Iran-backed Hezbollah on the Lebanese border increased dramatically following the Hamas attack.

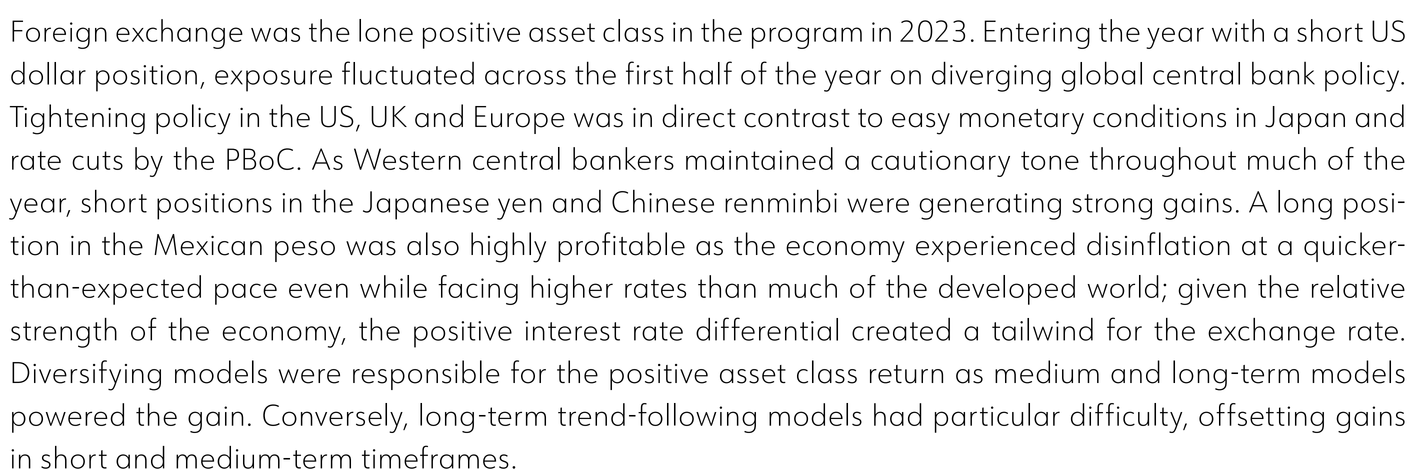
Industrial metals fluctuated with changing forecasts of demand from China and developed Western economies. Global production of copper continued to increase, reaching a record by the end of the year, while consumption did not keep pace despite the ongoing electrification of transport, heating and industrial processes as part of the transition to renewable energy. Expectations of increased Chinese demand as their economy reopened following the pandemic were not realized to their full extent, although imports were markedly higher than 2022. Meanwhile, early expectations of recessions developing in the US and Europe waned as the year progressed resulting in a rise in potential demand. In the precious metals, gold prices vacillated as downward pressure from rising real rates were met by increased demand for the commodity as a safe-haven asset following the US regional banking crisis and the Israeli-Hamas war.

Performance attribution

Following the second-best year in Lynx' history, 2023 was a disappointment as the program realized a negative return of -7.6% net of fees.[1] Interestingly, the result was not much different than that delivered in 2009, the year after the global financial crisis when Lynx had its best annual performance historically. Losses in commodities, fixed income and equities outweighed a more modest gain in foreign exchange. Trend following models underperformed their diversifying counterparts, although both families of models lost money across timeframes.

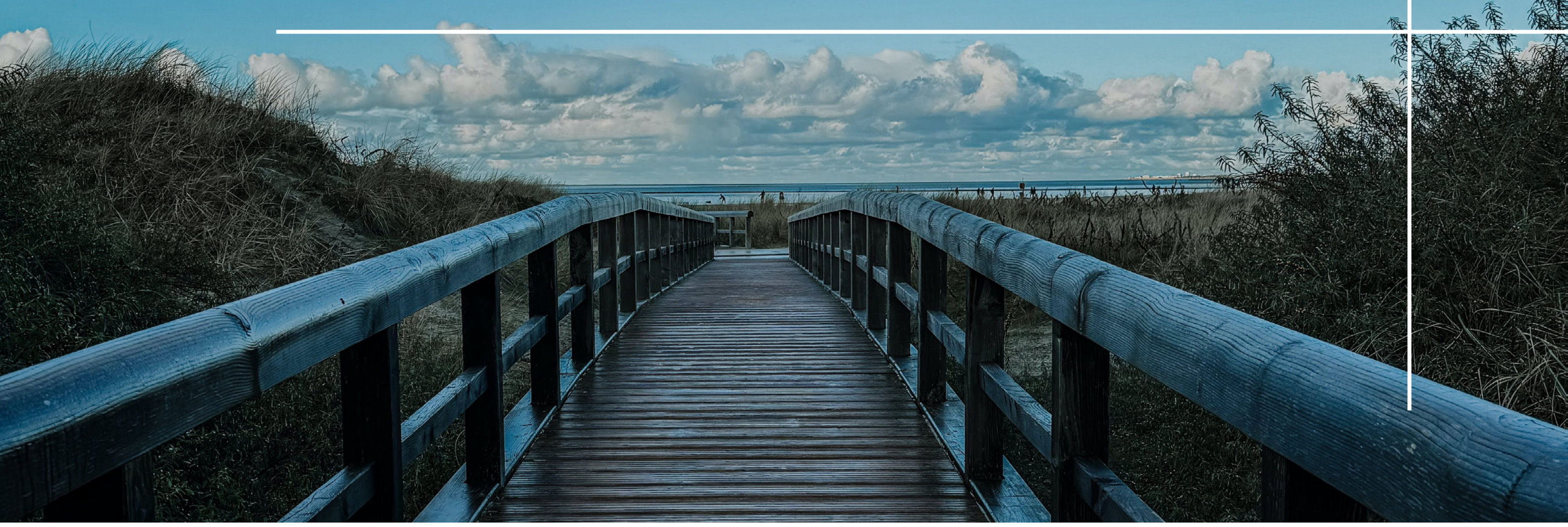
Fixed income generated a loss as interest rates vacillated broadly, particularly early in the year, on changing forecasts of monetary policy and the regional banking crisis in the US, making it a challenging environment for the program. However, from the beginning of June, the models were more successful forecasting the price action and recovered most of the earlier loss. Notably, net fixed income exposure reversed from short to long in early December following more dovish comments from global central bankers. Ultimately, European and North American bonds detracted equally from performance, while short-term European rates outpaced the rest of the globe. Both trend-following and diversifying models were unprofitable in aggregate, although long-term timeframes were positive in both groups. Medium-term trend-following and short-term diversifying had particular difficulty.

Equities similarly generated a loss as the program had difficulty forecasting the changing market regime. As with fixed income, the program maintained a net short equity position entering the year but changing sentiment and various macroeconomic events resulted in relatively active repositioning. Performance varied markedly by region as gains in Asia and Europe were outweighed by losses in North America and Australia. Long positions in the Nikkei and TOPIX indices in Japan were particularly profitable as prices rallied to levels unseen since 1990 fueled by corporate reform – with a specific focus on shareholder value – and accommodative monetary policy. Trading in the DAX and EuroStoxx indices were also solidly profitable. Conversely, the three worst markets in the asset class for the program were all in the US: the NASDAQ, S&P 500 and Russell indices. Trend-following and diversifying models generated negative returns in aggregate, although short-term timeframes in both categories were profitable. Medium and long-term trend models realized losses commensurate with their risk allocation while long-term diversifiers were the worst performing model category.



Foreign exchange was the lone positive asset class in the program in 2023. Entering the year with a short US dollar position, exposure fluctuated across the first half of the year on diverging global central bank policy. Tightening policy in the US, UK and Europe was in direct contrast to easy monetary conditions in Japan and rate cuts by the PBoC. As Western central bankers maintained a cautionary tone throughout much of the year, short positions in the Japanese yen and Chinese renminbi were generating strong gains. A long position in the Mexican peso was also highly profitable as the economy experienced disinflation at a quicker-than-expected pace even while facing higher rates than much of the developed world; given the relative strength of the economy, the positive interest rate differential created a tailwind for the exchange rate. Diversifying models were responsible for the positive asset class return as medium and long-term models powered the gain. Conversely, long-term trend-following models had particular difficulty, offsetting gains in short and medium-term timeframes.

Finally, commodities were the worst performing asset class for the program in 2023. The disappointing return breaks a streak of solid annual performance in recent years as commodities were the best performing asset class in the portfolio in both 2020 and 2021 and the second-best performer in 2022. Negative results were realized across sectors. In the metals, gold was especially difficult to trade as the moments when the models maintained their greatest short exposure, prices spiked on flights-to-quality, the first following the SVB failure and the second after the Hamas attack on Israel. In the agricultural markets, the soybean complex was particularly challenging as beans and soymeal were the worst two performers. Prices reversed sharply multiple times during the year on unpredictable weather from the start of the growing season through harvest. In the energies, crude oil generated the largest losses as prices vacillated broadly on both supply/demand dynamics and geopolitical risk. Despite the challenges experienced during the year, there were a few notable positive outliers, specifically a short position in natural gas and long exposure in cocoa. Trend-following and diversifying models were both unprofitable across timeframes.



Outlook

With strong performance in 2023, equity valuations are again becoming stretched, particularly in technology which saw tremendous appreciation on the back of the AI frenzy. While we believe that artificial intelligence and machine learning can be incredibly powerful when applied responsibly and result in a productivity boom across an array of industries – evidenced by the fact that we have been employing machine learning models in the Lynx Program since 2011 – investors have perhaps been overly optimistic regarding how quickly and broadly the technology will be adopted. Regulatory oversight will very likely increase in 2024, evidenced by the Biden administration pushing Congress to focus on the technology. Disregarding the existential risks posed by AI, concerns regarding security, intellectual property, and employment are real and could create headwinds for those companies which benefited last year. Outside of technology stocks, there are no guarantees that a "soft landing" can be achieved as inflation remains above most central bank targets and the impact of sustained higher rates is unclear. While US Fed Chairman Powell recently suggested that rates had potentially peaked, he nevertheless indicated that the "path forward is uncertain" and there are potentially "tragic" consequences if the recovery is not supported by fiscal policy. Regardless of whether the recovery continues or encounters a roadblock, trend-following only needs prices to move from one level of equilibrium to the next to prosper. Opportunities could arise if the Goldilocks scenario plays out as some are expecting or if the environment deteriorates.

Sovereign debt exploded after the global financial crisis although collapsing interest rates made debt servicing manageable. However, with interest rates markedly higher now than over the past 15 years, paying off creditors will become more challenging. The United States national debt in 2007 was approximately US $13.25 trillion dollars adjusted for inflation according to the US Treasury Department. At the end of 2023, that figure was US $33.17 trillion. US government debt as a per cent of gross domestic product (GDP) nearly doubled from 63% to 123%. And the picture is no brighter across the rest of the globe. The Institute for International Finance (IIF) estimated that total global debt hit a record US $307 trillion in 2023, an astounding 336% of global GDP. The European sovereign debt crisis was less than 15 years ago and a similar situation could potentially develop anywhere in the world should the current trajectory continue. The opportunities that may develop in financial assets and currencies should this

occur could be attractive for Lynx, particularly as central banks may not be able to coordinate as they had in the past – nor act as aggressively – given the dispersion in global inflation.

Geopolitical risk is perhaps greater now than at any time since the end of the Cold War. The ongoing conflict in Ukraine is entering its third year and neither side seems close to surrendering. The impact on agricultural and energy markets was significant in 2022, although the effect has largely waned over the past year. However, Russia and Ukraine remain major global commodity producers and any significant change in supply from either country could again have major consequences across the globe. Additionally, war in Israel has the potential to escalate into a much larger conflict. Middle Eastern oil production could be at risk should bad actors look to destabilize the region and inflict damage on Western economies. Finally, China continues to assert their sovereignty over Taiwan over the objections of much of the rest of the world. A feared Chinese invasion of the island could catalyze a global conflict with incalculable consequences. The repricing of financial and commodity assets that may occur could be historic.

Over the longer term, the green transition will likely be one of the most significant changes to impact society and the environment over the coming decades. The path will almost certainly be rocky and political pressures will likely challenge universal adoption. For example, after the European Parliament approved a ban on the sale of new internal combustion engine vehicles in the European Union from 2035, Germany protested the decision given the burden placed on automobile manufacturers. Motor vehicles are the country's main export, and they successfully negotiated an exception for vehicles burning "climate-neutral" fuels. However, the cost of renewable energy plummeted through 2022 and – despite a modest increase in 2023 – remains well below fossil fuels which are expected to increase dramatically in the future. The impact of this transition will likely also have a tremendous impact on financial and commodity markets.

As we have mentioned before when providing our outlook on the market environment, Lynx is a systematic manager dependent on the forecast accuracy of our models to profit. Our opinions on macroeconomic factors and geopolitical events have no impact on our trading. Most of our models need markets to trend. We believe that any of the catalysts above could trigger a significant repricing of markets across asset classes that could offer opportunities for the program.

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. To be sure, we are disappointed with the results in 2023, but remain hopeful that the environment for the Lynx Program will improve in the coming year. We look forward to better times ahead and again delivering positive, differentiated returns to our investors.

Lynx Asset Management

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