

# Monthly Market Commentary



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COMPANY  
INC

## STRONG TRENDS ACROSS MAJOR SECTORS LEAD TO GAINS

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*"If you can look into the seeds of time and say, which grain will grow and which will not, speak then to me." Shakespeare, Macbeth*

The market has spoken with clearly defined trends. Positive performance in ten of JWH's eleven investment programs was mainly driven by the strength of the dollar, but profits were broad-based with participation from stock indices, energy, and metals. Returns for our diversified and financial programs ranged from 7.1 percent for the JWH GlobalAnalytics® Family of Programs to a high of 13.2 percent for the Global Diversified Portfolio. The only exception to this positive performance was in the global bond sector where uncertainty concerning central bank behavior and a change in the trend in economic data and sentiment caused a reversal from the earlier sell-off in the quarter. All of our currency programs were positive. Our flagship Strategic Allocation Program gained 8.6 percent for the month. At month end, two of our programs were positive for the year, the JWH GlobalAnalytics® Family of Programs at 10.9 percent and the Global Financial and Energy Portfolio at 0.5 percent.

### The dollar rally continues

The emphasis on what variables are important to currency investors shifts. The current account fundamentals do not seem to be a focus like last year. The relatively high pace of inflation in the U.S. has not been disturbing to investors. Currently, the key is investment capital flows associated with interest rate differentials. The dollar rally continued strengthening in both the Asian and European markets based on the desire to hold higher interest-bearing dollar denominated assets. The dollar rally against the euro, albeit with less strength, continued even with the rise in the European Central Bank (ECB) target rate. Given the lack of clarity on any trend in future ECB rate increases, investors are still looking at a differential that is approximately 200 basis points in favor of the United States and growing if the Fed follows its current course.

The yen has continued its strong trend since the summer and has declined to its lowest level in over two years. It has depreciated over 18 percent in 2005. This decline has been good for exporters who have little incentive to hedge at this time. Fueling the decline have been Japanese investors, who have stayed away from their domestic stock market and have diversified their new wealth internationally. The continued near-zero short-term interest rates have made domestic cash unattractive. Foreign investors, who have been driving the Nikkei higher, have been hedging most of their yen exposure, which has reduced any upward pressure on the currency. Unlike a few years back, the Bank of Japan (BOJ) has not intervened in the markets, so the equilibrium yen rate has been determined by private flows. In fact, Japanese officials have not discouraged the move. Gains were also present in yen-cross rate trading.

The only drain on currency returns was in the emerging sector which did not produce the sizeable gains seen in the major currencies. Profits were obtained in our exposures to the exotic currencies – Indian rupee, Brazilian real and Mexican peso positions – with the rest of the markets generally range bound. Emerging market stock returns are negatively tied to rising U.S. interest rates which carries over to currencies, so we may see more movement in this sector if short-term rates march higher.

### Stock indices march higher

The Nikkei stock index has been in a very strong up-trend, more so than what may be expected given the overall growth in Japan. While Japanese economic growth is strong and clearly higher than what has been seen in recent years, it is still lower than what is occurring in the United States. Clearly, these stock market gains are not just a reaction to growth, but also an increase in equity valuation based on the improvement of balance sheets. European

stock markets have also moved upward and have continued their trend from earlier in the year, although in a much more subdued manner and with higher volatility than Japan. The U.S. equity markets, which have been moving sideways because of growth uncertainty, have gained with the better economic releases during the month.

### **Precious and base metals move upward**

Significant gains were obtained in both our precious and base metals trading. Gold has moved above \$500 per ounce for the first time since 1987. Gold is back and the goldbugs are stirring. Given higher core inflation rates around the world and significant economic uncertainty in parts of the world where there have been traditional strong gold buying, the price has moved to levels not imagined just a few years ago. Gold as a store of value during inflationary times seems to again be an important investment story.

Once again, just when obituaries are written about this "barbaric relic", there is a price move to excite the often determined gold investors.<sup>1</sup> Gold moves through long cycles of love and hate from investors. We have always been agnostic about this market.<sup>2</sup> During the period of inflation excesses, it was a great hedge and diversifying asset with strong uptrends. We were also able to catch downtrends from the periods of oversupply and central bank dumping. Like the other markets we trade, it will be a good trend until at some point it is not and stops are hit.

Potential market disruptions out of China concerning copper trading did not slow the trend that has lasted for most of the year. The opaque nature of trading by state owned enterprises did not spook the market. This is not the first time we have seen possible rogue trading in this metal. Stockpiling, warehousing, and delivery issues are all the current talk of this market and a reason to stay away from nearby contract disruptions and minimize portfolio exposures, but with the base metals sector still moving higher on expected world growth, this is still a place to take advantage of business cycle trends.

### **Energy affected by weather**

The revaluation in energy product prices continued with unleaded gas and heating oil both moving down to their

pre-Katrina levels. Natural gas is off of its highs but showed mixed behavior with a strong price increase associated with colder weather at the end of the month. Crude oil has again pushed above \$60 per barrel, also in response to weather activity.

Cold fronts moving through the Northern U.S. will cause spikes in price because the supply congestion issues which have been the major theme of the market this year have not abated. The perceived tight supplies mean that any market events that suggest increased demand will cause price increases. Many of our programs adjust to these price spikes by lowering positions sizes to offset the noise relative to the trend.

### **Commodity moves are mixed**

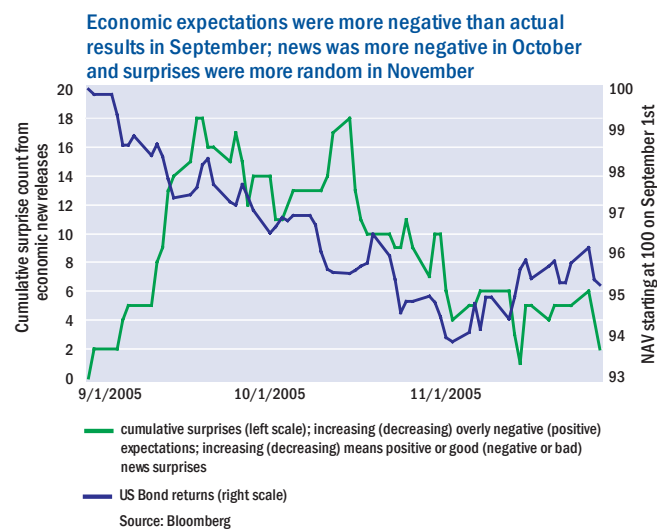
Our GlobalAnalytics® Family of Programs and Global Diversified Portfolio both have showed gains in the agricultural sector; however, our two phase Original Investment Program was slightly negative for the month in this sector. Gains were concentrated in the grain and sugar markets while losses in the two phase program were focused in the soft markets. In the longer-run, the current world trade talks (Doha Round) may have significant price impact on many of the agricultural markets like sugar, which has been heavily subsidized. Changes in quotas and subsidies affect the supply mix, especially for developing countries, and can cause shifts in demand from trade agreement adjustments.

### **Interest rates are mixed**

The global bond sector underperformed in November. A combination of mixed economic data and central bank uncertainty were the main causes for poor performance. After prices trended lower for the previous two months based on higher inflation expectations post-hurricane Katrina, November saw a bond rally which itself was cut short after the latest economic releases which showed stronger growth. The market has bounced from higher inflationary expectations to now higher growth scenarios. Given the mixed growth prospects and core inflation uncertainty, global bond investors are not willing to bet on a clear interest rate direction.

We have discussed in the past that surprises in economic data are market drivers. Surprises are the difference between market expectations and the actual economic announcements. It is this unanticipated surprise that will cause markets to move. If the sequence of surprises is random, the market moves will be also be random. If the sequence of surprises is biased to good (bad) news, there will be a market rally (decline). When analysts seem to be misforecasting a market move, there will be a price trend.

Looking at the cumulative surprises for economic announcements for the last three months finds some interesting developments. The U.S. bond market has declined over this period, but there were actually good news surprises in September. Analysts were overly pessimistic relative to the positive economic data. October showed negative surprises and the market declined. November did not show bias.



The uncertainty with central banks applies to the G3, the Fed, BOJ and ECB.<sup>3</sup> All three may be biased to raising rates, but the questions is when and how much rates will rise to bring core inflation within target. Central banks are awaiting economic news before committing to further rate increases.

With the Fed having a new chairman, there has been greater focus on deciphering FOMC committee member speeches and a corresponding increase in the uncertainty concerning the future course of interest rates. While Chairman Greenspan's pronouncements have been, at

times, impenetrable, they also have had a degree of predictability with code words for whether a change is possible. He was also able to sway the other members of the Fed to follow his bidding in an effort to show a united front. The Bernanke era, while likely more transparent, will need time to be understood by investors. Right now with strong growth numbers, the course may have become clearer, but that was not the case during the month of November. Nevertheless, the Fed fund futures are expecting at least two rate hikes before the end of the first quarter.

The ECB has taken the step of raising rates by 25 bps for the first time in years. While this was somewhat expected, the future direction of the ECB actions is less clear after the press conference with Chairman Trichet. The Euribor movements after the ECB announcement showed the market was expecting a stronger statement of future intent by the central bank. Economic growth is still relatively slow and not expected to change appreciably and the future direction of core inflation after accounting for the oil price shock is not expected to rise significantly above their 2% target.

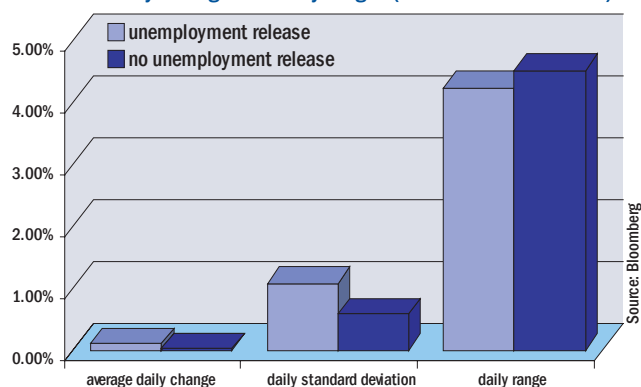
One of the harder future policy directions to decipher is the BOJ. Quantitative easing may have come to an end but not the corresponding zero interest rate policy. The replacement policy and the mechanics for Japanese monetary policy are unclear. Japanese professionals indicate that there seems to be political battles forming both inside the BOJ and with finance ministry officials to determine the future direction of policy. This has spillover to the fiscal side and any future regulatory change leading to increased competitiveness. A tightening of monetary policy may weaken the current growth trend. In this environment, the range bound behavior of the Japanese Government Bonds does not seem surprising.

### Information packets and trend-following

We are often asked the question of why don't we use fundamental information. Surely the inflation numbers or unemployment reports could tell us something about the direction of market prices. Nevertheless, there is a problem relying on this somewhat limited information. It just

does not come that often. For example, inflation and unemployment reports come once a month. With twelve announcements each and 250 plus trading days, these announcements make up less than 10 percent of trading time. What do you do the rest of the time? A simplistic economic modeler may say that you should look at monthly price data to fit the same time frame and ignore the rest, but the markets are actually open every day. These fundamentals announcements are important information packets but have to be balanced against market expectations and the daily activity of the markets.

**Unemployment announcement days have greater average change and more volatility, but non announcement days actually have greater daily ranges (Dec-2002 - Dec 2005)**



The price volatility and market move on unemployment days can be compared with all other trading days to explain our point. While the announcement days are more volatile, the daily range for non-announcement days is actually higher. This could be caused by other announcement effects, or more importantly, the daily information from trading.

We prefer using the continuous information that is available through prices every day. There has to be some filtering of this continuous information, but we believe processing continuous information is better than focusing on information announcement packets which may have changing sensitivities with the markets.

## Happy Holidays

We have found that trends in late November have the potential to carry over to December as the market starts to quiet before the Holidays and year-end. We hope this pattern continues. We wish every one of our clients a

Happy Holiday and New Year. May your good trends continue and any disappointments be reversed!

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<sup>1</sup>A great read on the history of gold was written by Peter Bernstein, *The Price of Gold: The History of an Obsession*. Understanding this long history provides some perspective for why gold continues as a store of value for many investors in spite of long periods of dormancy.

<sup>2</sup>Detachment from the markets is important. Stephen Yafa in *Big Cotton: How a Humble Fiber Created Fortunes, Wrecked Civilizations and Put America on Map* describes the fascination of some with cotton but can be a warning for an investor about any market. "Cotton was like a woman, some said demanding; plain one moment and beautiful enough to take your breath away in the next, never entirely allowing you to relax but making you aware of the dangers of getting overly comfortable too. There was a lesson there for any man."

<sup>3</sup>As a slight play on the "We are all Keynesians now" phase, "We are all inflation targetters now". While every major central bank has paid some lip-service to targeting, it is not always certain how the target approach is employed and what variables are used to determine the true inflation rate. Implementation uncertainty seems to be a current problem.

**Past performance is not necessarily indicative of future results.**