Monthly Market Commentary

JUNE 2004

JOHN W HENRY & COMPANY INC

LOOKING FORWARD WITH OPTIMISM AFTER A DIFFICULT SECOND QUARTER

So we beat on, boats against the current borne back ceaselessly into the past
— F. Scott Fitzgerald

At mid-year 2004, returns were down for all JWH programs for the month of June, the second quarter and the first half of the year. We move forward with cautious optimism into the second half of the year after a difficult June and second quarter because drawdowns in most JWH programs have historically been followed by strong performance. Although there is no way to predict if and when this will occur, periods of trendless market behavior usually end with strong market moves. Experience and statistical analysis suggests that change in markets is the norm because the underlying balance between supply and demand is always in a state of flux. We look forward to change and divergent opportunities.

The primary problem with generating positive returns in the JWH programs during 2004 has been the lack of strong trend direction in the most liquid markets we trade. These are usually the markets where we have the highest portfolio allocations. The markets where we have been able to generate returns have relatively low impact on the overall portfolio. We have not made any changes to our strategy and, after careful review of the performance attribution of each program; we do not believe that a change in our programs is necessary. Longer-term trends have not existed in many key markets.

These types of events – or more specifically non-events – have happened previously in our 22-year history. It is never easy to get used to or accept them, and such times are painful, regardless of an investor's or trading advisor's experience level. Nevertheless, it is especially important at these difficult times for investors to understand the almost counter-intuitive notion relative to traditional investing that markets that do not trend will create greater losses for JWH. It is easy to see why trendless or choppy markets may be a time of minimal return; however, it may be difficult to understand why such markets would produce a period of high drawdowns unless you closely look at how we generate returns. Later in our commentary, we will discuss the question of how losses occur when markets are not moving, but first, we will review results for the last month, the second quarter and the half year mark.

What Causes Trendless or Choppy Markets?

A very general perspective suggests that there are trendless markets because there is no consensus between buyers and sellers on a change in the value of the markets traded. In fact, the worst situation is when there is almost equal disagreement on the direction of markets. Especially in the last three months, there has been little sustained agreement on the direction of inflation, economic growth or the impact of monetary policy. Consequently, with the announcement of any new information which itself has been wavering between directions, there is swift shifting in the balance of opinions. Will the Fed's raising of interest rates cut off growth or will it allow for more sustained growth in the longer-run? Is the current inflation we now see a signal of further price increases or are these isolated shocks to specific markets? Is the strong growth that we have witnessed sustainable, or will growth stay within a tight range? While these above questions focus on the US, the same questions can be asked about the major markets in any of the countries that we trade. It is unusual to have this lack of conviction in market expectations. Hence, there are no sustained trends.

Will this uncertain environment of equally divided views persist? We cannot make a prediction: but historically, it is unusual that so many markets in so many sectors and regions will fall into the same balanced environment. Our models, in many cases, have picked up on this lack of conviction and have moved to neutral phases to reduce leverage, but even with these adjustments, it has been difficult to find the types of trends we exploit and minimize the risk in the actual environment faced.

Currency Returns have been Extremely Sensitive to Range Trading

Currencies serve as one of our highest sector allocations in all of our programs and they have traditionally and consistently served as the sector with the best and most consistent trending characteristics. We have four programs that are focused only on currencies. Unfortunately, 2004 has been unusually poor for currency trend-following. The two largest sector exposures are outright and cross exposure to the euro and yen. In both cases, there have been limited longer-term changes in price coupled with strong reversals in the existing changes in price. The shaded area in Figure 1 shows the current rangebound environment.

Figure 1: Euro was rangebound for most of the second quarter after the strong run in performance

For the euro, the long-term decline of the dollar has fallen short of expectations and it has become range bound. A confluence of stronger growth in the US, which has attracted capital, versus the long-term fiscal and current account imbalances have offset each other and forced the market into this trading range.

In the case of the yen, strong Japanese government intervention helped smooth prices in the first few weeks of the year, but more aggressive intervention in February and early

Figure 2: Japanese Yen has been an unusually choppy market with quick reversals in price

March increased volatility. More recently, there has been no government intervention, but the relatively high level of volatility has continued. Strong capital flows, which have been somewhat lumpy along with the overhang or threat of intervention has produced poor trading conditions for longer-term trend-followers. Figure 2 shows the extent of the recent choppy behavior.

For both the case of the euro and the yen, we have found times for our three-phase models to avoid the market, but have taken losses because of strong reversals after our market entry. In those cases, we have been required by our stop loss management to exit the market and protect principal. However, the repeated process of being stopped out after entry in the market has caused the yen to be one of our largest contributors to losses in 2004.

Trading in exotics is intended to provide diversification in some of our currency programs. However, the value of diversification in 2004 has not been as strong as expected. While returns have not been perfectly correlated with the majors and have been better than our exposures to major currencies, the overall impact of trading the minor and exotic currencies has not been able to lift overall returns. In certain conditions, we expect that correlation will grow across all currency markets; however this usually does not occur during periods of a relatively trendless environment, as we've seen in the second quarter.

Interest Rates on the Long-end do not Match Short Maturity Expectations

The interest rate markets have focused on the expected action of the Fed to raise interest rates to end its easing policy. The markets got what they expected with a 25 basis point increase, the first rate increase in four years; however, the short-end of the yield curve may not always move as expected relative to the long-end of the curve. We were able to generate profits from rising rates expectation in the front-end of the yield curve, but there has not been the same level of follow through in the back-end. In fact, the price of 10-year bonds is only slightly higher than at the beginning of the year, but the large price decline expected to materialize did not occur; and in fact June saw a US bond rally.

The bund market, representing long-rates in the euro, also was range bound and never saw the same extremes as the

bond because of the steadier monetary policy by the European Central Bank (ECB), as well as the more muted growth and inflation prospects in Europe.

The Japanese Government Bond (JGB) market saw a significant increase in yields. As equity prospects grew in response to some of the strongest growth numbers in years for Japan, capital started to move out of the bond market. However, the relatively abrupt nature of this move has not allowed us to capture the gains expected by a change of this magnitude.

Energy Markets still Driven by Geopolitical Risks

The increased demand for crude oil associated with higher world growth, especially in the Far East, has been a boom for this market. This upward trend has been exacerbated by the supply shocks from events in the Middle East. Along with some disruptions in oil production in key areas around the world, there has been a continued geopolitical risk premium in the energy markets. These factors have pushed oil prices above $40/barrel earlier in the year and kept the market hovering just below $40/barrel at the end of the quarter.

More than ever, the vast majority of proven reserves are in politically inhospitable regions of the world. While geopolitical risk may subside over time, there are growing concerns that longer-term supplies, as measured in proven reserves, may be reaching a maximum and that cheap oil is not likely to continue. This may lead to greater swings in price because there is no residual supply to meet changing demand. If supply is uncertain, OPEC and other major producers cannot control price when there are strong changes in demand.

Energy trading has provided a strong area of profits for JWH in 2004; however, the relatively high volatility and need for diversification have not allowed us to capitalize on these swings to a degree that would lift diversified program returns into positive territory. The volatility in oil is multiples higher than currencies and interest rates and an over allocation to this sector would not be prudent. We do not change allocations to programs in response to price expectations or a desire to capitalize on perceived opportunities.

Metals Markets Tied to World Business Cycle

The first quarter of the year saw a significant upswing in base metals prices as construction demand, especially in China, continued at a fast pace. With the change in Chinese monetary policy in mid-April, there was an abrupt turn around in prices as expectations for strong growth diminished. This caused a significant giveback of profits. More recently, there has been a realization that current growth will still lead to strong metals demand; consequently we have seen a return to some trends albeit at a slower rate. Nevertheless, some markets such as copper have been profitable for our programs in 2004.

In the precious metals markets, a strong move in silver provided profits in the first three months of the year. Again, with the change in growth expectations, there was a turn in silver prices that lead to a give back in profits. While moving higher, the gold market has seen short-term swings that have not been friendly for trend-followers. Short-term changes in perceived geopolitical wealth and a flight to gold on fears of a lower dollar have caused these abrupt changes.

Commodities Show Mixed Opportunities

The commodity markets were a strong contributor earlier in the year, but again the markets have been beset with some key reversals especially in some of the most liquid markets. In the grain sector, corn prices rose on higher demand expectations and some concerns about moisture in key growing areas. Strong rainfall at key times this spring and a relatively cool summer has caused harvest expectations to increase and a corresponding fall in price.

There were some strong gains in some of the other markets in the first quarter only to see reversals in many markets in May and June. Sector performance has been dragged down by loses in coffee, sugar and cocoa markets.

Stock Indices have not Found a Direction

With the view that strong earnings cannot continue at the same pace as seen in 2003, and mixed views on the growth prospect in key economies around the world, stocks

have also moved in a relatively tight range after strong gains in 2003. Equity markets often focus on movement or acceleration in economic growth. Regardless of current cash flow generation, any slowdown in growth expectations caused prices to reverse and become range bound as we have seen so far in 2004.

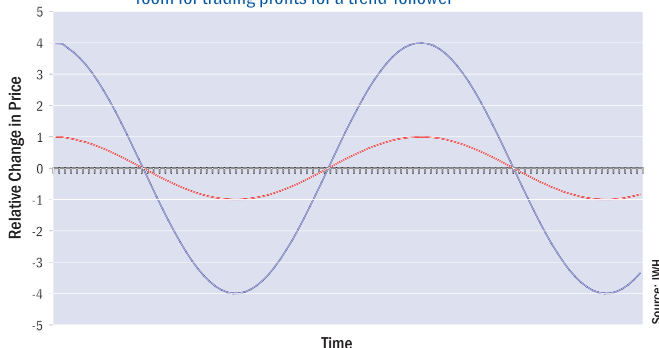
The Highest Risk is When Markets do not Move

What is most important for the trend follower is a market movement that is extended or has high amplitude and lasts for a long time. JWH is a divergent trader and not a long volatility trader as suggested by some researchers. I like to say that amplitude is necessary and sufficient for profitable trend-following while higher long-term volatility is necessary but not sufficient. If a market stays in a range or reverses quickly there is little room for profitable trading, especially if you are taking a longer-term perspective. It may be seem obvious, but it is an important point.

I have provided two stylized graphs which have what can be considered good and poor trading conditions for longer-term trend-followers. Certainly markets do not work with such smooth precision, but the charts can illustrate the issues faced. I took a simple cosine function and showed what could happen when there is a shallow trend versus a deeper trend and a longer-term trend versus a shorter phase or choppier market conditions.

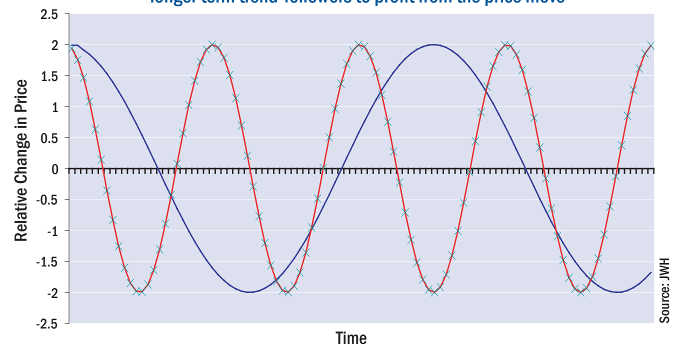
In the figure 3a, the low amplitude red curve never allows the trend-follower to gain significant profits. There will be a longer lead time to find a trend and a longer time period before the end of the trend is recognized. Additionally the overall size of the price move is lower. This would represent a trendless market.

Figure 3a: Shallow or low amplitude price moves leave little room for trading profits for a trend-follower



In figure 3b, we show a good trending market versus choppy conditions where there are large moves but the size is very compressed with abrupt changes in price. There is limited time to identify the trend and there is a giveback of profits with the reversal of price. Because a longer-term trend-follower uses more past information, the time of entry is longer as well as the time of exit. In this case, a faster model is necessary for strong profits.

Figure 3b: Choppy markets or markets with swift reversals do not allow longer term trend-followers to profit from the price move



The red lines, on a relative basis, represent the type of market conditions we have faced in 2004. Will this continue? I cannot predict; we can only hold to the certainty of our past experience, the basis for all our models. We have historically reversed and recovered as markets have found directions. We will hold firmly to past experience and beat against the currents of trendless markets.

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Past performance is not necessarily indicative of future results.