“LIFE CAN ONLY BE UNDERSTOOD BACKWARDS; BUT IT MUST BE LIVED FORWARDS.”
-SOREN KIRKEGAARD

2013 was a year in which the FQ currency process delivered on all objectives. Not only did we make money (in fact, slightly more than what we would normally expect, we did it with controlled risk (realized risk - annualized volatility of daily returns - was 90 % of target risk) and without being correlated to almost any kind of beta. On the latter, we had our best performance periods in May and June when practically all other markets were down, “delivering returns when returns are needed most”. (TCA Return and Risk)

2013 was not void of all disappointment, however. During the second half of the year, performance drifted downwards from the high reached at the beginning of July. As such, 2013 was a “normal” year in the sense that even though results could not be easily defined by the artificial constraints of the calendar, there were still distinct periods and themes driving markets and our portfolio with them.

2013 left us still very much beholden to the official sector when it came to catalysts for moves in the market. There was, however, a change in how that impact was created and the way that it was felt. Where the actions of politicians and policy makers in general determined asset prices, leaving little room for the underlying fundamentals, markets did in fact begin to react to fundamentals – albeit only when given the “nod” by the official sector. Although one of my colleagues has taken to referring to this as “markets having been (re-)released into the wild”, I wouldn’t go quite as far. It seems more like the wildlife park has added some acres, with asset prices reacting to the traditional supply and demand attributes that our process is intended to pick up on, more freely, but only to a point. The fence, keeping the market forces from fully reacting rationally, is still there.

There were plenty of examples of global macroeconomic risk events that should have left a longer-lasting imprint on markets, but instead resulted in mere blips in market volatility: a change of government and the establishment of a new set of policy priorities in the second largest economy in the world, early political “brinkmanship” in the US, periods without governments in Europe (in Italy and for a long period of time, in Germany), flare-ups in the euro zone crisis (Greece and Portugal), tension and outright civil war in the Middle East, and finally, a total government shutdown in the US. Add to these events disappointing growth in most
regions and countries and it becomes even more surprising that market risk wasn’t higher or more volatile than what we experienced during most of 2013.

EXHIBIT 1: WORLD CURRENCY BASKET EX-ANTE RISK
(January 2013 - December 2013)

![Chart showing currency market volatility through the ex-ante annualized volatility of the FQ World Currency Basket.

Source: First Quadrant, L.P.]

Of course, the main exception was April to June, where the Fed’s communication of a desire to reduce (or in popular terminology “taper”) their level of bond-buying led to a significant re-pricing of asset markets and a related increase in volatility (in particular, the volatility of longer term rates). The graph above illustrates currency market volatility through the ex-ante annualized volatility of the FQ World Currency Basket, with an 11-day half-life. At the time, I described the changes as a re-pricing of the Bernanke put option to a price further away from current spot. This was probably the time during the year when the markets were allowed the most freedom to roam; and not coincidentally the time of greatest positive performance for our process. However, apparently the market movements and the related effective tightening of monetary policy in the US were too much for policy makers, who spent the remainder of year moving the strike price for Bernanke’s put option back toward spot. This feat seemed fully accomplished by the end of the year, when the next Chair of the US Federal Reserve proceeded through her Senate confirmation hearings.

With this backdrop we saw our process going through a number of distinct phases during 2013. The early months mainly saw currency markets closing out trades based on the US “fiscal cliff” and the strong eur/weak jpy themes that dominated the end of 2012. We booked good profits from both of those themes in January (following an already strong December).

Late winter/early spring witnessed stronger than expected growth in the US and weaker than expected growth in Asia. What was special about this period, however, was not that we captured this rotation in growth, but our high level of confidence in the theme despite the market’s initial price action. Although market data, in particular growth data, had actually printed in line with our view, it was initially ignored, indicating to us that sentiment was the main driver of markets. We typically find high risk/reward opportunities in these kinds of situations, and that proved true in this case also. We lost money on our view early on (March) but later capitalized on the opportunity.

Although we had not anticipated the strong negative market reaction to the US Federal Reserve interpreting the incoming data in the same way (and thereby signaling a tapering of stimulus), we were very well positioned to participate in the opportunities created by this particular shock to risk. The reaction to this change in the outlook for US monetary policy accelerated the gains we had achieved from being exposed to – on a relative basis – better growth in the US, as the growth theme turned into a full-fledged risk aversion event with the concomitant flight to safety into the USD. This period turned good performance into great performance, with an almost classic overshoot to the other side. Our process reacted to the overshoot by taking profit on the positions that had moved the most, and by reducing overall portfolio risk. However, we still gave back some of the good performance in the aftermath, as markets, with the help of “clarifying” comments by Fed officials, returned to a calmer state from the frenzy of May and June.

The great first half of the year was followed by a disappointing second half. The strong (relative) growth theme that impacted the portfolio during the spring did not work as cleanly for us, as US
macroeconomic data started printing less solidly and provided the window for any reduction in stimulus to be pushed back even further. This negatively impacted the portfolio in September, when we still viewed the US as outperforming the minor economies in particular. We were aided by not having EUR/USD exposure during this period of time (the long euro position was accompanied by a long US dollar position), and by having risk below target risk. As mentioned above, we have great confidence in our views when there is disparity between markets (driven by sentiment) and data (where the data have already printed in line with our views). This was a different market environment, where we were making forecasts around particular outcomes and, as such, were much more beholden to how data printed (rather than sentiment swinging back to reflect the underlying fundamentals). At the same time, policy maker rhetoric in not only the US but in a number of countries had an impact on currency markets, with everybody from central bank governors (Australia and New Zealand in particular) to prime ministers (Norway) opining on the strength of their currencies. In fact, the biggest surprise to me was that the financial press didn’t dust off the tired “currency war” label but that might just be a matter of time. For the period from August to December, dominated by that market environment, we ended down.

As the main monetary policy implementation tool in many economies still consists of bond market intervention through QE, it is not surprising that our bond flow signal suffered with the return of increased policy uncertainty, after having had a good run in the first half of the year. However, a good sign of return to a more normally reacting market – again within the confines of the wildlife park, of course – was our equity flow signal which performed with great consistency throughout the year.

It’s the time of year when my countryman Soren Kirkegaard’s most famous quote is used and misused that “Life can only be understood backwards; but it must be lived forward”. We often set out to try and gain insights that are useful for the future by looking back, but more frequently end up making observations that apply in a particular market environment with very little likelihood of being repeated. This retrospective is no exception. However, some “insights” in my mind do have staying power: we will see increased market volatility from changes in monetary policy, in particular in countries where monetary policy is implemented through extraordinary measures; and policy makers will continue to have little appetite for such volatility, with continued efforts to verbally intervene in the free functioning of markets. What gives us hope for the immediate future is the expectation that the extraordinary influence of policy makers and their desire to constrain market reactions should abate as economies heal and recover from the global financial crisis.

Endnotes
1Journalen JJ:167 (1843), SKS 18, 194 / sks.dk/JJ/txt.xml#k167
2FQ World Currency Basket ("WCB") is an equally weighted basket composed of the following developed market currencies: Australian dollar, British pound, Canadian dollar, euro, Japanese yen, New Zealand dollar, Norwegian krone, Singapore dollar, Swedish krona, Swiss franc, US dollar.
3Better known as the "Greenspan Put", and probably better described as just the "Fed Put" given the fact it has survived longer than the occupants in the Fed Chair, it is based on the belief that the Fed will not tighten monetary policy in reaction to increases in asset prices, but will react swiftly to counteract, in particular, sharp drops in the same, providing what is essentially a put option to investors at no cost.