

Monthly Market Commentary



MARCH 2005

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BLACK GOLD CONTINUES TO SHINE FOR PROGRAM PERFORMANCE

“Events, dear boy, events,” is how Harold Macmillan, British prime minister in the 1950s and 1960s, responded when asked to name the biggest problem in political life. The same holds true for the markets. Events are what drive markets – both positively and negatively. When there is uncertainty surrounding economic events, there will be reactions that carry through time, which can lead to trends. However, when there are contradictory events and information, markets can be range-bound.

On the positive side this quarter, events in the oil market have taken on a new life as the rally in oil continued in March. There was intra-month volatility; but the result of the continued price rise was positive performance for almost all programs in March that had energy exposure. Additionally, there was positive performance in the G-7 Currency Portfolio, which profited from its diverse portfolio and concentration of outright and cross rates in the yen currency markets. The other JWH programs showed declines in March, especially in the currency and interest rate sectors, which were affected by key reversal events suggesting a change in direction for these sectors. The overall direction of the dollar has bounced between strengthening and weakening and back to strengthening, especially in Europe and the emerging market sectors. Bonds stopped their first quarter downfall and ended the quarter rallying in response to expectations for slower global economic growth. These relatively quick reversals have caused losses in our two major financial sectors for the month and quarter. The first quarter has been a difficult period for all JWH programs showing losses.

Ups and Downs in the Oil Market

With a strong upward price trend since the beginning of the year, OPEC announced an increase in production quotas at its March meeting and asserted that further increases could occur in the future if that level of production proved insufficient. Of course, this does not

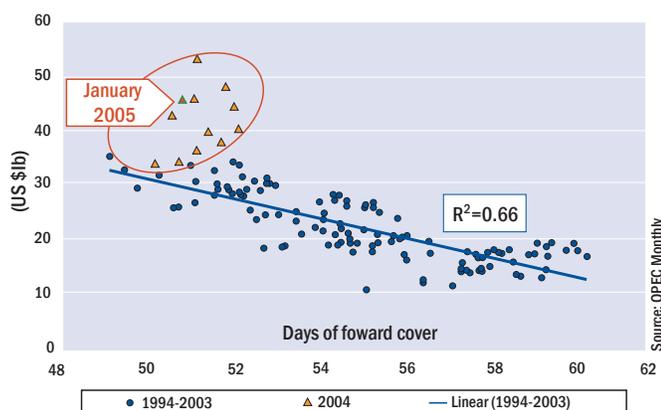
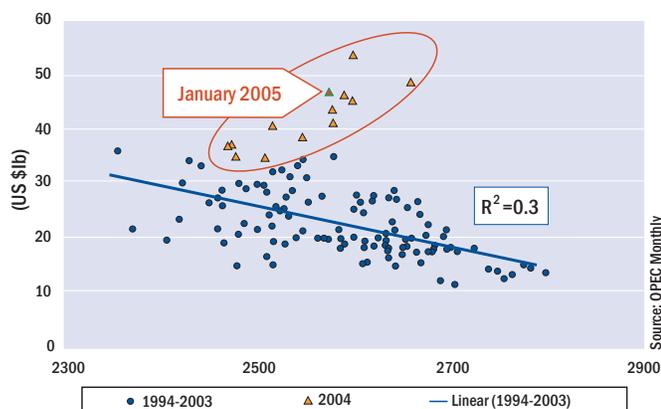
mean that supply imbalances will be eliminated because production has to be taken out of the ground and distributed to users. Nevertheless, it sends a signal that global demand is strong and that OPEC believes that oil market prices will not stabilize without further increases in supply. Along with this strong global demand, a combination of refinery capacity shortages and market storage congestion are contributing to the price increases within the energy complex.¹

Interestingly, the crude oil market is in contango with the prices for back months in oil actually higher than contracts closer to delivery. Usually, a strong price move will have front month performance leading price moves relative to contracts further from delivery. Given this contract curve behavior, the expectation from the markets is that the imbalance between supply and demand will not be eliminated in the near-term.² Volatility in the energy sector has also increased during the recent period after a declining trend since the beginning of the year. The month ended with a Goldman Sachs energy equity analyst suggesting the potential for a super-spike in prices to \$105 per barrel because of distribution congestion and shortages. With such a wide range of opinions, market participants seem to be unclear on the potential range of this upward trend, a key cause for higher volatility.

In spite of the speculative talks concerning this market, oil prices are still tied to fundamentals, such as the stock of inventories available to the market. The following charts from an OPEC report provide a good representation of the historical relationship between inventory and oil prices. When there are lower inventories or, more importantly, when there are declines in the days of demand covered by the inventory, there will be higher prices, an inverse relationship. The days covered by inventory shows a stronger relationship and truly suggests that 2005 demand is strong. There has not been enough inventory to meet demand; consequently, if there are any problems in the supply change process, a spike in price

is more likely. The last year has further accentuated the negative relationship between inventory levels and the days covered by that inventory, or, more seriously, expectations for higher prices have overridden the usual negative relationship.

The last year has accentuated the negative relationship between inventory, cover, and oil prices



Equity Markets also Affected by Oil Prices

Supply shocks, especially in crude oil, will generally have strong effects across other markets. We have argued that this negative correlation makes crude oil the new gold in a portfolio and provides significant diversification benefits.³ However, this negative correlation is a causal, not a passive, relationship. Oil price shocks usually precede a recession, which will have the added impact of potentially driving down stock prices. A potential recession will also cause a rally in bond prices if the price increases are not monetized by central banks and lead to higher inflation. This latest oil spike has coincided with the recent

decline in stock prices around the world, especially in the United States. However, higher volatility, as evidenced by the increase in the VIX options index of equity volatility, has limited our ability to fully exploit these stock moves.

Interest Rates and Conundrums

The bond markets reacted to the “conundrum” of Alan Greenspan by selling off through the middle of March, but the continued increase in oil prices may have caused growth prospects to diminish and thus led to a new rally in bonds. These changes in expectations make it difficult to generate profits in this sector. In spite of the expectations of many fixed-income professionals and the desires of the Fed, interest rates still have a life of their own and once again marched lower. This rally was further enhanced by the poor employment numbers in the U.S. at the end of the month, which prompted analysts to start talking again about a more significant slowdown later in the year.

The European markets followed the US markets with a rally in the second half of the month. This is not surprising given the historical relationship between European and U.S. rates and the lack of positive economic news from Europe. The global rally also continued in the Far East with Japanese Government bonds rallying on the poor Tankan survey results, the quarterly business sentiment survey produced by the Bank of Japan. Japan has been showing mixed signs of growth in the last quarter.

It has generally been found that U.S. rates will drive or lead European rates for both short and long horizons.⁴ The large size of the U.S. economy will have any change in growth prospects carry over to other parts of the globe. There is also evidence that the European Central Bank (ECB) generally follows the Fed in its behavior. Central banks will behave similarly around the globe if there is a change with the Fed. While this is not a foregone conclusion, there is enough support to suggest that the ECB usually will not take a clearly opposing view from the Fed for extended time periods.⁵ The risk is that a strong reversal in the U.S. bond market will also mean a similar change in rates in other countries, which will accentuate the return or loss potential in this market sector.

Dollar not Behaving as Planned

Like a prize boxer who will not go down, even though the fight is lost in the minds of the crowd, the dollar will not fall. As there has not been a clear direction for the currency market, we have not been able to generate profits in this sector. News concerning the currency markets has been mixed and contradictory: so no trends have met our longer-term style focus.⁶ There are a number of explanations for the lack of downward trend or, for that matter any trend. A higher interest differential in favor of the dollar has been one change in the market dynamics. Stronger U.S. growth rates (compared to rates in other parts of the world) also come to mind as a contributing factor.

It is not clear that other countries offer a better investment return. We don't care that the dollar has stopped its decline; we only care that there is some trend. In the first quarter, we have had limited follow-through on any of the moves. The yen has weakened relative to the dollar but this has only been a recent phenomena, and the European currencies have moved in a wide range without trends. We have also been hurt by the higher volatility seen in the emerging market currencies.

Soybean Rust and Planting Decision

In spring, farmers decide the amount of acreage to plant for each of their crops. After that decision, the weather is the primary determinant of the quantity that will be produced through the acreage yield. Corn planting decisions are usually made earlier in April, and soybeans are planted in May. Hence, conditions now will determine key planting decisions. After a strong run-up through the middle of March, corn prices declined substantially under the expectations that plantings will be higher than anticipated just two months ago. Part of the price decline in all grains is associated with rosier forecasts for harvest in Latin America after earlier dismal reports of drought. Additionally, fears of soybean rust, a fungus which rode up on hurricane winds from Latin America, has caused many farmers to plant corn as opposed to taking the risk of lower yields from infected soybean plants. Overall, the lower grains prices at the end of the month led to some declines in performance after a strong performance earlier in the quarter.

The only gains in the agriculture sector for March came from the soft markets, coffee and cotton which continued their upward movement, albeit with a substantial increase in volatility during the month. However, the agricultural sector contributed to the overall performance of our diversified programs for the quarter dampening the declines in the financial sectors.

Metals Markets March to Base

The gold market seems to have closely tracked the movements in the dollar during the month and quarter. With the declines in gold matching the resurgence of the dollar, we have been faced with unprofitable reversals. Silver also seems to move closely with the gold market. The reversal in March caused profit givebacks last month.

The base metals slowly marched higher, which provided gains from trading. Nevertheless, the daily swings in price have been very large. We have also kept our exposure to these markets fairly low because of the high volatility.

Conclusions

The strong reversals in the bond and currency sectors during the first quarter have placed all JWH programs in drawdowns. It is unclear where the next set of trends will potentially emerge but we have seen this type of market action before. Today's uncertainty may be the beginning of a new trend tomorrow. Until that time, we will manage our exposure to minimize risk and look for the next set of trends or for more carry through with the positions we currently have.



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¹The price impact from limits on refinery capacity is extremely important. Disruptions from refineries coming off line will have a meaningful impact on short-term prices which creates both price noise and opportunities. This issue is well discussed in "The Impact of Downstream Refinery Concerns on the International Oil Market" by the OPEC Secretariat in the December 2004 [OPEC Review](#).

²For more details on the potential imbalance between supply and demand in the global oil market, I refer readers to the [OPEC Monthly Oil Market Report](#). It provides a wealth of information on supply and world demand which can place some of the current talk of prices surges in perspective.

³Mark Rzepczynski, Cengiz Belentepe, Wei Feng and Philip Lipsky "Black Gold – Trading Crude Oil for Greater Portfolio Efficiency" [Journal of Alternative Investments Fall 2004, Vol 7 No. 2](#). We argue that crude oil by itself may be as good a diversifier as a commodity index and has statistically meaningful impact on the maximum Sharpe ratio on an efficient frontier.

⁴This relationship between the United States and other countries was closely analyzed by Menzie Chinn and Jeffrey Frankel in "The Euro Area and World Interest Rates" and by Michael Ehrmann, Manuel Fratzcher and Roberto Rigobon in "An International Financial Transmission Model" Both were presented at the Federal Reserve Bank of New York conference on Financial Globalization in December of 2004. While not always the case, there is strong statistical evidence showing U.S. rates leading Europe and the rest of the world. We should not be surprised when we see these bond reversals carried over through out the globe.

⁵See the interesting piece by Ansgar Belke and Daniel Gross: "Asymmetries in the Trans-Atlantic Monetary Policy Relationship" CESifo working paper No 1428 March 2005. The authors measure the behavior of the ECB after actions by the Fed to determine lead-lag relationship.

⁶Martin Evans and Richard Lyons' "Do Currency Markets Absorb News Quickly?" shows that news will actually lead to longer-term portfolio adjustments from many market participants and consequently lead to trends in markets. However, if the news is contradictory, then there is little opportunity for trends to get started or persist.

Past performance is not necessarily indicative of future results.
