2016. Divergent. Insurgent.

True Partner Fund - *Volatility update*

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What a difference a year makes. Going into 2015, global markets had witnessed several years with exceptionally low volatility. Beta ruled supreme on the coattails of ever increasing central bank balance sheets. And now, on the first trading day of 2016, Chinese markets closed early after hitting the limit down for the CSI300 index, on the very first day this circuit breaker was implemented. Since August, volatility has been a recurrent theme in market commentary.

Having called for an awakening of volatility in last year's prediction, we would like to take this opportunity to put the current volatility in perspective and provide the key areas to be looking at for this year.

For equity index volatility in 2016, we would see two characteristics:

1. Sudden spikes and equally quick receding of volatility, similar to 2015

Nearly forgotten because of central bank interference, but this is actually what a more normalized volatility trading environment looks like. Catastrophic events like we have witnessed in 2008 could happen, but are unlikely. The tectonic plates of global markets are shifting and some fault lines will rupture. But investors will be prepared to douse the fire, assuming volatility risk. As a result, volatility can recede just as suddenly as it appears.

2. Contagion between asset classes will rise

In 2015, the equity markets have actually been remarkably resilient compared to carnage witnessed in asset classes such as commodities, emerging market currencies and high-yield. Reduced backstop in the form of central bank intervention will expose the transmission channels that exist in the global interconnected financial markets.

The foundations of these two developments have been laid in 2015, but are not limited to the new **divergence in monetary policy** between the US Federal Reserve and the European and Japanese central banks. A second source of volatility is the **rout in commodities**, in particular energy, and the feedback that logically ought to arise into both the credit and the equity markets. Finally, 2015 has shown a stream of unpleasant **geopolitical events including many insurgencies** which unfortunately is not likely to abate in 2016.

MONETARY POLICY

Much has been said already about the Federal Reserve's gradual raising of interest rates. But the most discussed part of the divergent Central Banks is in our opinion less interesting. In order to have a proper divergence, both the ECB and Bank of Japan would need to continue their aggressive stimuli. That is not a certainty. Draghi appears to have reached the limits of his mandate, as was visible in the disappointing statement in December. Also, Bank of Japan's Kuroda who has embarked on the most aggressive Quantitative Easing on our planet seems reluctant to expand, having to do all the heavy lifting by himself while Abe's reforms (the third arrow) remain elusive. Finally add the Peoples Bank of China to the mix, whose balance sheet is rapidly shrinking in the face of the devaluation of the Yuan.

Therefore, the state of divergence might be a fair weather outcome for market bulls; a situation where the US mops up the excess liquidity provided elsewhere in the system. But a worse case outcome might be an overall tightening when the ECB and Japan would refrain from significant stimuli.

THE COMMODITY ROUT

While we referred to the decline in commodity prices last year, initially the main impact was that to offset inflationary pressure from

Quantitative Easing. But the degree of the rout in commodity prices was such that it is starting to be felt way beyond just inflation numbers. Global capital flows will be altered not unlike the El Nino phenomenon in global weather.

For starters, one of the drivers of the performance of both stocks and bonds was the **recycling of Petro-dollars from oil producers**. From Norway's Sovereign Wealth Fund to the Gulf States, vast quantities of dollars found their way back to Western capital markets. Especially the deep US markets tend to attract a large portion of this flow. But with oil revenues collapsing, this flow has reversed with even Saudi Arabia having to tap the capital markets in order to finance government expenditure. Therefore, one often overlooked source of global liquidity went in reverse.

But true to the form of boom and bust cycles, high prices across the commodity space have spawned ambitious expansion programs. In the context of global monetary easing, it is no surprise a significant part of these capital expenditures have been debt financed. And in developing fields such as the US shale boom, even initial operating expenditures have been debt financed. After the rout across commodities, debt obligations of a large number of companies, ranging from small exploration firms to global mining firms and commodity traders have become unviable. This was a key trigger for the severe declines witnessed in the high yield space. With commodity prices showing no sign of recovery yet, we feel there could be more pain to come. The turbulence in the market last December also indicated a spill-over between asset classes with the Shale complex in the US driving losses in High Yield credit which subsequently drove losses in both the equity markets and higher rated credits.

However, one should not discount the possibility of a recovery of commodity prices. In the energy complex, the **renewed tensions between Shiite Iran and the Sunni Gulf States** might be such a trigger. It is a bit odd that these tensions are being translated into lower oil prices, expecting a competitive flooding of markets between Saudi Arabia and Iran. In the past, the sheer mentioning of skirmishes around the Strait of Hormuz resulted in large risk premiums in the oil price.

More in general, the divergence we mentioned could just as well apply to a **commodity fueled market rally**. In the event of a rebound of commodity prices, this will reflect in the inflation picture becoming far less benign. And that in turn could trigger an equity rally at the expense of fixed income but also fueled by cash on the sidelines. With the global monetary bases at highly elevated levels, such an inflation driven rally might be fierce (so there could be upside for bulls afterall).

GEOPOLITICAL EVENTS

The overall background worsened materially over the last months of 2015. Economic issues such as the Greek crisis have been replaced with the sour fruits of the insurgencies in Syria and Iraq. Especially Europe has been hit by a wave of refugees (or economic migrants, depending on who one speaks to) as well as a spate of terrorist attacks inspired or even originated by the Islamic State. It appears the 'cold war dividend' in the form of a revaluation of equity markets in times of geopolitical stability has become a thing of the past. Also, **the turmoil in the Middle East has further spread** adding Yemen to the mix, where Iran and Saudi Arabia are engaged in a proxy war. Further escalation along sectarian fault lines seems in the cards following the sacking of the Saudi embassy in Tehran.

Next to the humanitarian suffering, these issues also cast their shadows politically. Across Europe and arguably with **the rise of Donald Trump** also in the US the politics of polarization and partisanship are increasingly popular. Frictions in the European Union are bound to occur with a set of national elections on the calendar and less than a year after avoiding a Grexit, now a Brexit (or Breccident) becomes a real possibility.

Finally, like last year in Asia events linked to the South China Sea and North Korea will probably pop up occasionally and could escalate.

On a regional basis, let's make a trip around the world traditionally starting in Europe and travelling east…

EUROPE: NEW PROBLEMS, SAME LACK OF SOLUTIONS

Last year Europe has dodged the proverbial bullet of a Grexit, but the process would hardly instill any confidence. Like cutting off the head of the mythological hydra, solving one problem only exposes new problems. This year's list of major issues is as follows:

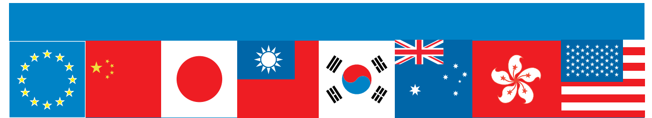
- Economically, inflation refuses to appear in Europe. While lower energy prices are a boon for consumers, their depressant effect on inflation is less welcome for the debt-ridden governments of Europe. With Draghi receiving increasing pushback from Northern European council members, **Europe continues to drift** on the path of a Japanese style lost decade. The fact that over a third of European sovereign debt trades at negative yields is telling.

- An influx of **over 1 million refugees** last year is expected to further swell in 2016 and test the foundation of the European project. The free flow of commerce and persons (the so-called Schengen Treaty) is becoming undone as a result of the lack of a coordinated response. While Germany's welcoming stance appears to become untenable, also the lack of cooperation from the Eastern European members draws criticism of cherry picking. More than last year's Greek tragedy, this might be the issue that breaks Europe. At the very least, it plays into the hands of right wing and nationalistic parties whose anti-EU and anti-immigrant rhetoric continues to gain traction across Europe, paralyzing political decision making.

- Economically, the **North-South divide remains present** and as such Greece continues to simmer on the margins of Europe. But the main exit fear now stems from the United Kingdom, where opinion polls indicate the referendum on EU membership to be a tossup. With the City of London the main driver of the British economy over the past decades, one wonders whether the Brits are indeed capable of killing their golden goose.

GREATER CHINA: WHAT GOES UP MUST COME DOWN (AND BACK AGAIN?)

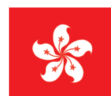
Stating the Chinese markets were volatile last year would be a bit of an understatement. After reaching a peak in June, losing over 40% within one quarter was too much for the government to stand. Measures including a near-prohibition on selling futures have calmed market



On a regional basis, let's make a trip around the world starting in Europe and travelling east...

gyrations, but also annihilated trading, with volume in the main CSI futures contract down 98%. This begs the question of the cause of the relative quiet last months. Is the economy stabilizing or are frozen markets just postponing the inevitable.

Depending on where one stands on the issue, one could either see a bubble or a bargain. It is interesting to see that the sentiment towards China's markets appears to be significantly more negative in the US than it is in China itself and its vicinity. One thing that the turmoil on January 4th has learned us is that **China can no longer be seen as an isolated case**. So the inevitable Chinese volatility can be expected to spill over into other markets, not limited to just Hong Kong anymore.



On a macro-economic field, the Yuan will be a currency to watch in the face of US rate hikes. Initially pegged to the US dollar, it has strengthened in its coattails and last August's small devaluation seems to be the start of a trend. Expectations of the magnitude differ, but one interesting proxy is the value differential between A-shares listed in China (in RMB) and H-shares listed in Hong Kong (in HKD). The full differential of some 40% cannot be attributed solely to expected devaluation off course, but it does point to some serious dislocations.

The rising US interest rates also open another interesting aspect, **Hong Kong real estate**. While consistently judged a bubble over the past years, even small nominal increases of mortgage costs could be the proverbial straw that breaks the camel's back. In this perspective, residential real estate would follow commercial real estate which is already heading south following the retreat of Mainland Chinese consumers in Hong Kong.

To complete Greater China, the Taiwanese market has remained volatile over the past year. In the near future, all eyes are at the **presidential elections** in mid-January.

JAPAN: KURODA'S LAST STAND

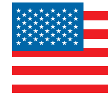
Japan has been remarkably quiet the last year, despite the large stakes of Abenomics. With an ever increasing balance sheet for the Bank of Japan, there is scant evidence of the extreme monetary easing actually paying off. With the third arrow (structural reforms) still lacking, Bank of Japan President **Kuroda is hesitant** to further escalate the tools of easing. With yet another fiscal spending spree in the cards (Tokyo 2020 Olympics) the dynamics of Debt to GDP in Japan are not expected to improve. As the Bank of Japan owns vast portions of Japan's sovereign debt, the call for that ultimate step in monetary financing (a Weimar style cancellation) becomes ever so tempting.

AUSTRALIA: DOWN UNDER

Life is not pleasant if demand for your key exports vanishes. More than the energy exporters, Australia is dependent on China's previously voracious appetite for construction materials. As prices of some key materials (iron ore for example) have fared even worse than oil, years of debt-fueled investment have left key players with a significant hangover. With contagion into the banks credit portfolio's threatening, the Australian markets remain a play on commodity prices. Should China recover, significant upside volatility cannot be ruled out.

SOUTH KOREA: PYONGYANG CALLING

South Korea remained a beacon of stability last year, while the local Kospi index continues to lag its Asian peers. The steady depreciation of the Won could trigger a rally in equity markets based on improved prospects for its dominant exporters. But recently, its Northern neighbor decided to ring the bell with another nuclear test. While most likely not the Hydrogen bomb that North Korea claimed, it remains a sign that the Hermit Kingdom should never be fully discounted or forgotten. So the Korean picture matches our global outlook with possibilities for volatility on both upside and downside.



US: YELLEN FOR PRESIDENT

While the US appears to have the most healthy prospects of the major economies, the multi-year bull run of the S&P 500 has ended. If it were not for the so-called FANTA stocks (Facebook, Amazon, Netflix, Tesla and Alphabet), the S&P 500 would not have been able to seek out a gain for 2015. **A cocktail of trends** does seem to provide headwinds for the US economy:

- Not as much the rise of interest rates itself, but the corresponding **appreciation of the US dollar** is starting to bite exporters. It is doubtful relief is in sight in a world marred by competitive devaluations. This starts to translate into disappointing earnings figures.
- The **Shale boom** will turn into a bust at the current prices. The key question will be whether the inevitable stream of defaults will remain contained or whether other categories of credit will be impaired as well. The December rout in credit points towards the latter.
- And then there is **The Donald**. Should his political rhetoric actually turn into policy if he gets elected (two very big ifs), branding China a currency manipulator and closing the borders for Muslims on day 1 of his presidency are not exactly pro-business decisions.

With the path of rate increases being data dependent (the dot plot), there will be plenty of data releases and FOMC meetings for the markets to get excited about.

All in all, we have provided a map of **potential market moving trends** and events that in our opinion could materialize in 2016. On top of that, there are always known or unknown low probability events that could happen and shake the world or a region. One could think about insurgencies, terrorism and acts of God but also breakthroughs in technology which disrupt markets and industries.

FUND POSITIONING

How would this current context affect the positioning for the True Partner Fund?

Please note that foremost, Fund positioning is determined by our quantitative model. But the approach is not purely quantitative as perceived opportunities are judged given the market environment. From this perspective, we will be a bit more risk averse with regards to opportunities that point to positions opposite to the trends we have identified. In particular, opportunities pointing to short volatility positions in Asia and to a lesser extent Europe will be scrutinized additionally before

being entered. This will be reflected in an additional risk premium for these opportunities, but also in the type of exposure sought. Short volatility positions will be paired with purchasing protection in the same product in the so-called wings. This will be guided by our risk-scenario analysis where the tolerance for single market shocks will be decreased in light of this volatility expectation.

While we expect the **market volatility** witnessed last year **to continue into 2016**, this does not lead us to take an a-priori volatility long position. With the subdued volatility in recent years, notably 2012 through 2014, carrying of outright volatility long is not necessarily a profitable position. Therefore, while we expect continued volatility, our positioning remains focused on relative opportunities in volatilities. While generating significant returns in more volatile years, as reflected in **last year's performance of approximately 17%**, this strategy avoids large draw-downs cause by holding too much premium in years that lack volatility.

We are confident in our strategy to continue to capitalize on opportunities occurring with large downside volatility. Given our expectation of continued volatility, we do see profitability continued to be driven by the long legs of volatility spreads.

As the sharp rises in China have again illustrated, the current market environment also caters for bouts of upside volatility. We will remain careful here. Given that volatility curves remain downward sloping opportunities are less plentiful to the upside. Defensively, one can benefit from the downward sloping volatility curve in rising markets: if the movement is large enough, actually a higher at-the-money volatility would be justified, whereas the curvature initially guides a lower volatility. We employ quantitative triggers to detect such opportunities.

All said, we are optimistic that as per the above analysis the market environment will provide us with a set of opportunities in the volatility space. In combination with the capabilities and technology of the team at True Partner to translate volatility into returns, we are confident in making 2016 a successful year for the Fund.

Finally, there is another reason we referred to the Divergent Trilogy in the title. 2016 will mark the ***opening of our Chicago office****. Set in Chicago, the Trilogy shows a post-apocalyptic view of the Windy City. We however foresee a brighter future for what remains the global capital of derivatives trading.*

ABOUT THE AUTHORS

Mr. Tobias Hekster, Senior Strategist of True Partner Advisor, has been actively trading for the past 17 years in various different roles in several markets across the globe. Starting at IMC in 1998 as a pit trader in Amsterdam, Tobias has established the off-floor arbitrage desk, headed the Chicago office in the transition from floor trading to electronic trading and set up the Asian volatility arbitrage desk in Hong Kong. Tobias holds an MSc in Economics and he teaches as an Adjunct Associate Professor at the Chinese University of Hong Kong and as an Adjunct Professor of Financial Practice at National Taiwan University.

Mr. Govert Heijboer, CIO of of True Partner Advisor, has been active as a market maker trading in the European and Asian derivatives markets as well as positional trading since 2003. Govert started as a trader/researcher at Saen Options in Amsterdam and rose to become the director of derivatives trading and a member of the executive team in 2007. In 2008 he moved to Hong Kong to set up and assume responsibility for all trading activities in the new Saen Options Hong Kong branch office. Govert holds a PhD in Management Science and an MSc in Applied Physics from the University of Twente, Netherlands. He is a founding partner and has worked on the launch of the True Partner Fund since March 2010.

ABOUT TRUE PARTNER FUND

True Partner Fund (TPF) is an Asia Equity Volatility Arbitrage fund that trades global listed securities predominantly in equity indices and equities across all time zones via a single book. The strategy utilizes proprietary models and systems to efficiently identify and trade relatively undervalued and overvalued options across multiple exchanges. The fund aims to provide uncorrelated returns by using a generally Delta neutral and on average Vega neutral approach.

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