2017. And Now for Something Completely Different

True Partner Fund

True Partner Fund - *Volatility update*

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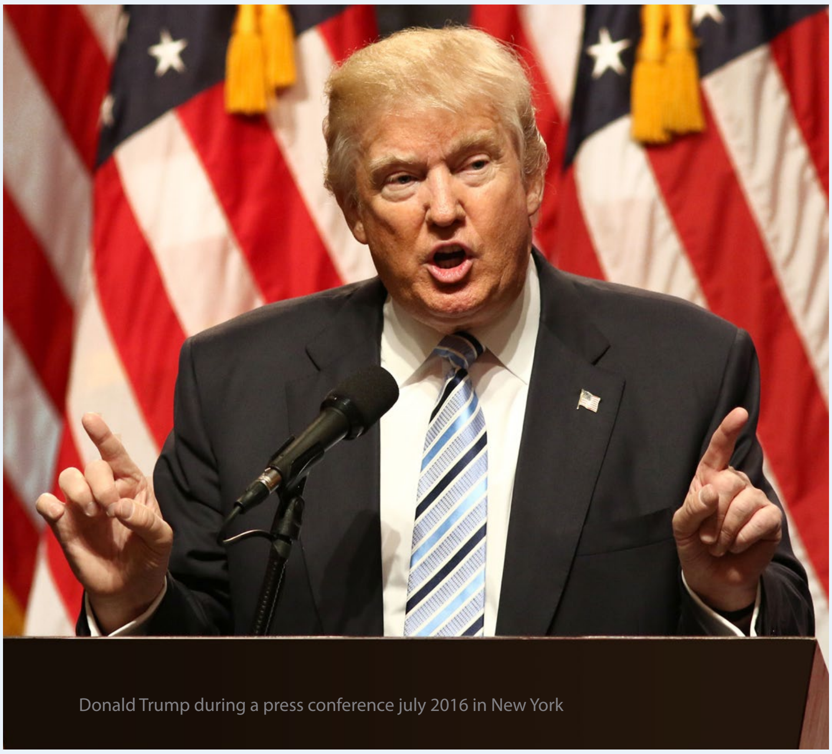
To declare that 2016 has provided some pivotal surprises would be to state the obvious. While antipathy against the political configuration across the Western world has been rising ever since the Great Financial Crisis of 2008, it has come to full fruition this year.



Donald Trump during a press conference july 2016 in New York

No longer do politicians seem to represent their constituents, no longer is the knowledge of experts deemed relevant and no longer is international trade perceived to be an engine of global growth. The voices of 2016 eerily resemble those of a distant past, where isolationism and 'law and order' were solutions to economic ails.

The change in the political climate is widely discussed globally. In our opinion just as interesting are the repercussions of the shock events we have witnessed, (Brexit and Trump), as well as the potential shocks in the coming year on global markets with Europe taking central stage. After all, the wave of discontent does relate to the (perceived) effects of massive monetary stimuli across the globe.

For us, the two main areas of impact would be monetary policy and global asset inflation.

1. **The global, concerted suppression of volatility, especially in equity and bond markets, by central banks is bound to end**
2. **While contagion between asset classes will remain, general movement will decouple**

Govert Heijboer: 'Where the few shocks of 2016 were quickly digested by the markets with a rapid return to complacency including long periods of quiescence, we do not expect more of the same for 2017'

Brexit was partly about the self-proclaimed '99%' not benefitting from monetary stimuli and the resulting rise in financial assets. Real-estate rose, wages and purchasing power did not. In his campaign, Trump continuously attacked loose Federal Reserve policy as 'politically driven'. We expect sentiment to further curtail central bank mandates (especially in Europe). In addition, the toolkit for the Bank of Japan appears to be virtually empty now. As a result, we would expect not just

an occasional spike in volatility as we have seen in 2016. But unlike this year where market calm rapidly returned after events, the 'all-clear sign' and the resulting decline in volatilities might prove elusive in 2017.

Whereas we witnessed an increase in contagion between asset classes, the spill-over into equity markets has remained relatively limited. Compared to the continued volatility in currency and commodity markets and the renewed volatility in the bond markets following the Trump election, the equity markets have been very stable with the S&P 500 having one of its most quiet periods since 1995 between Brexit and the US elections.

With shifts in trade flows, fiscal stimuli and a resurgence of interest rates this would be expected to change. The conundrum over the past years has been that all asset classes could rise simultaneously (the 'cash' tsunami lifting all boats). The return of interest is akin to a return of a normal ebbs and flows tidal wave pattern and will reshuffle the relation between asset classes. This sudden change would normally be less orderly and as such can be expected to occur in leaps and

bounds. This would typically result in volatility events across the affected asset classes. If rhetoric becomes policy, curtailment of international trade will be felt across markets with the most open economies having the most risk.

All in all, where the few shocks of 2016 were quickly digested by the markets with a rapid return to complacency including long periods of quiescence, we do not expect more of the same for 2017. The trend towards a 'normal' volatility environment will continue, reflected in both elevated, or should we say, not depressed, levels of volatility but also in more continuing turbulence in the aftermath of events. Expect less Brexit and more Taper Tantrum (we will refresh your memory on that one later).

A trip around the world starting in the USA and moving towards Europe...

As the impact could vary across different geographies, we will take you around the world markets touring the various potential flashpoints similar to last years' update.

US: IMPACT OF TRUMP WILL BE 'HUGE'

Regardless of ones opinion on President-Elect Donald J Trump, one thing is certain. The impact is going to be 'huge'. But it remains to be seen which parts of the agenda will actually be enacted. Will the GOP-dominated Capitol pull a '2009' where the massive tax cuts will be implemented, but the fiscal spending will be blocked? Will the investment program be implemented at the expense of other budget items, or will debt spiral upwards to a level certain to awake the Bond Vigilantes of the past?

The markets seem to point at the latter, judged by the sharp rise in US interest rates. To the extent that one subscribes to either 'trickle down' or Keynes, US equity markets have room to continue their rally. On the other hand, those who have rallied behind the necessity of low rates to stimulate the economy should be quite worried. Mortgage rates, to name just one example, have increased over 50 points since November 8th. It is interesting to note that the 'losers' of the Trump presidency appear to be the very same FANG stocks that have catapulted the S&P 500 and Nasdaq 100 towards their highs earlier this year.

But as there are so many moving parts, the only certainty appears to be the continuation of uncertainty and mutability. Arguably, the President-Elect's character is inherently more volatile than that of the outgoing President, which seems inevitable to manifest itself in US government policy as well. However, the US economy was in relatively good shape going into November, so the de-facto engine of the global economy remains in a bit of an enviable position, compared to other markets.

UK: A PAINFUL VOLATILE DIVORCE

Traveling East, the United Kingdom is not so lucky. The clearer it becomes that the Brexit vote was not necessarily an economic one, but a social one, the consequences are increasingly deemed to be negative. Recent data from OBR (non-partisan Office of Budget Responsibility) reflect a net negative impact exceeding GBP 200 million per week. A red bus springs to mind for the keen observer. While the FTSE has recovered, it would be the Dollar/Pound exchange rate that is an actual gauge of the UK economy. That is still down significantly (or should we say 'bigly').

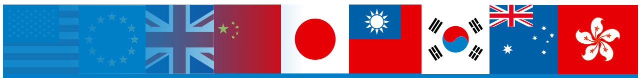
And as in the US, the process is just getting started. Official divorce talks are set to start in the spring of 2017 with the invocation of Article 50, but knives are being sharpened on either side of the British Channel. The big price will be role of Europe's financial capital (i.e. passporting rights for UK located firms) but in true form, where two dogs fight for a bone, a third one might snatch it. If talks break down, it will not as much be Paris, Frankfurt or Dublin who will benefit but New York City.

Expect continued volatility in the UK when the longer term effects of devaluation of the Pound start to sink in and as other unresolved issues reach the surface, for instance in Northern Ireland and Scotland. It may seem far-fetched, but because of that significant volatility would also occur should Article 50 not be invoked.

EU: DENTS IN THE EUROPEAN PROJECT

On the opposite side of the Channel, the Eurozone is looking continuously grim. Economic growth is dismal and inflation refuses to pick-up while dissatisfaction at the ECB policies mounts. In line with Anglo-Saxon populism, the mandate of Draghi is under fire with 'exit' movements gaining traction across the richer North. While French presidential hopeful Fillon would not be as toxic as Le Pen from the far right, his views are hardly constructive for European integration. A looming set of contested elections (next to France, The Netherlands and Germany are worth observing) could further dent the European project. Or will it be the Italian finances that ring the death knell.

As the main European indices reflect a more global set of companies, it might be the uncertainty over the European project reflecting on the Euro that drives volatility for this part of the world. The Eurozone could do well without the added uncertainty of Brexit, and there is bound to be plenty on the plate of the rotating EU presidency. As luck would have it, for 2017 this role is to be taken by experienced heavyweights from two core countries, Malta (H1) and Estonia (H2)…



... and continue to Asia

Traveling into Asia, we enter the realm of the collateral damage. This is where the June 2013 ‘Taper Tantrum’ springs to mind. Whereas in the US, the rhetoric was all about the possible detrimental effects of rising interest rates, the emerging Asian economies were already impacted on a day to day basis. Massive outflows from Emerging Market Equity and Emerging Market Bond ETF’s triggered severe declines in their underlying capital markets. Then as now, local companies with excessive US Dollar denominated debt appear caught out in the combination of rising rates and appreciating Dollar. In 2013, the risen US interest rate reverted back to its downward trajectory and subsequently markets calmed down. However, in our opinion, the current relative quiet across Asian markets is the proverbial calm before the storm. If Trumponomics is the cause of rising US interest rates, there is less of a trigger for rates to revert down. Moreover, the Fed has started on a hiking trail as well, albeit slowly.

GREATER CHINA

For the main markets, some individual aspects might result in different development over the coming year. For **China** and **Hong Kong**, the interest rates will be the main event. The Hong Kong real estate market, crowned as the world’s most unaffordable for the past years, is based on floating rate mortgages pegged to US interest rates. Increased mortgage payments could lend new meaning to the term unaffordable. For China, higher US rates and a declining Yuan will only increase the desire of capital to flow out of the country. China indeed appears to be manipulating its currency, but Trump has the direction wrong. A free-floating Yuan would most likely resemble a brick in water. And in the background, the governance conflict for Hong Kong escalates. This in turn is not helping cross-strait relations with **Taiwan**, where Ing-Wen Tsai would be reinforced in her more critical chance on China, which subsequently results in more of a chill out of Beijing.

KOREA: BALANCE SHEET VS. POLITICS

Korean companies look to have stronger balance sheets this time around, but the political situation could become a spoiler. With a 4% approval rating and millions marching in the streets of Seoul, GyunHye Park’s presidency can be considered over. This tends to beg the question as to what the Northern neighbors are up to in this temporary void.

JAPAN: DEFLATE, INFLATE

Japan seems to be in an opposite situation, where after throwing the kitchen sink and more at attempting to deflate its economy, Bank of Japan president Kuroda might now be aided by the situation in the US. Finally, the Japanese Yen seems to nestle weaker than 110 to the US dollar. But how will it fare should its major trading partners (mentioned above) be captured in a negative swell? And speaking about unaffordable, one can hardly fathom the damage to the Japanese finances should reflation indeed occur and with JGB interest rates going up accordingly.

AUSTRALIA: COMMODITIES

Finally, the main story for Australia will be commodities. Quite a lot of infrastructure building appears to be priced into the commodity space, leaving some room for disappointment. With both personal and corporate indebtedness high as a hangover from the boom years, the margin of error is limited.

All in all, the picture remains similar to the previous years with a mapping of potential market moving events, which could at any time be supplemented with known or unknown low probability events. These could be unwelcome; such as acts of God or the occurrence of terrorism, or welcome in the form of technological changes that both improve the world, but also rapidly disrupt markets and industries.

FUND POSITIONING

How does this narrative affect the True Partner Fund?

With regards to positioning, 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 and to what extent less quantifiable factors not captured by the model play a role. This will translate into slightly higher risk aversion with regards to opportunities that point to positions opposite to the developments we describe above. This would relate to opportunities involving short volatility positions in European markets as well as Asian markets that are deemed particularly vulnerable. These will be more scrutinized before being entered. One could imagine an additional risk premium would be required, or that next to the short at-the-money volatility position, event insurance will be applied (in the form of out-of-the-money options).

However, what we highlighted in our previous annual updates as well, expectation of continued market volatility does not necessarily translate into a default position of volatility long. Should the proverbial calm before the storm last, such a position could be subject to a degree of time decay that is undesirable.

Our active trading style allows us to benefit from mispricings in volatility by applying a relative value approach. Furthermore, the continuous monitoring of marketsallows us to quickly interact when markets change or events happen; members of our trading team are always monitoring equity markets as soon as any of them is open. Therefore, we would not need to be prepositioned into an event to benefit from it. As long as markets react in an asynchronous manner, i.e. not at the same time or with the same magnitude, relative mispricings will occur.

2016 has proven to be an odd year for volatility traders, where quick and prolonged return to complacency followed the few large surprises, allowing for only a limited duration of turmoil in their wake. However, the rise in interest rates and the curtailment of Central Bank liquidity will be taking away most of the fuel for the rapid-risk-on phenomenon that characterized most of the year. As a result, we expect, in line with our track record of the last 5 years, to able to monetize the inevitable volatility and events that will be shaping 2017.

ABOUT THE AUTHORS

Mr. Govert Heijboer, Co-CIO of True Partner, 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.

Mr. Tobias Hekster, Co-CIO of True Partner, has been actively trading for the past 18 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.

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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