Managed Futures and Macro

Q1 2012 Market Commentary

April 2012

> If geo-political headlines are finally giving way to fundamentals as primary market drivers, we believe that extended market trends could persist and the diversification benefits that are the hallmarks of managed futures and global macro could once again come to the fore.

Overview

The first quarter of 2012 may have marked an important inflection point for global markets. Entering Q1, activity across markets was driven largely by day-to-day developments in the European sovereign debt crisis—news of which overshadowed virtually all fundamental factors in determining investor sentiment and market direction. As the quarter progressed, however, the crisis receded (at least temporarily) and fundamentals seemed to be retaking control—and rallies across a number of asset classes ensued. In a final twist, at quarter's end the market received a reminder of how fragile the recent gains could be, as concerns grew over the sustainability of Spain's debt levels.

Not all of the fundamentals that surfaced during the quarter were positive, of course. While a series of data releases from the United States pointed strongly in the direction of a long-awaited, sustainable recovery, austerity measures in Europe convinced many observers that the Eurozone as a whole was entering a recession.

The performance of several key indices highlighted the shifting currents within the markets during the first quarter of 2012 (FIGURE 1). Equities (as represented by the S&P 500 Total Return Index) were up 12.58%, and bonds (as represented by the Barclays Aggregate Bond Index) were up 0.31%. Meanwhile, among alternative investment strategies, managed futures (as represented by the Altegris 40 Index®) returns were down 1.57% during the quarter, while global macro performance was up 3.55% (as measured by the Barclay Global Macro Index).

FIGURE 1.

MANAGED FUTURES AND GLOBAL MACRO LAGGED BEHIND THE PERFORMANCE OF OTHER MAJOR INDICES IN Q1

	Quarterly Returns	Yearly Returns					10-Year Returns April 2002-March 2012			
	Q1 Return	2012 YTD Return	2011 Return	2010 Return	2009 Return	2008 Return	Total Return	Ann ROR	Std Dev	Max DD
Altegris 40 Index®	*-1.57%*	***-1.57%***	-3.23%	11.33%	-7.98%	15.47%	92.83%	6.79%	10.55%	-13.24%
Barclay Global Macro Index	*3.55%*	*3.55%*	-3.65%	6.74%	7.49%	-0.65%	92.56%	6.77%	5.28%	-6.42%
HFRI Fund Weighted Composite Index	*4.94%*	*4.94%*	-5.24%	10.25%	19.98%	-19.03%	82.63%	6.21%	6.57%	-21.42%
S&P 500 Total Return Index	12.58%	12.58%	2.11%	15.06%	26.46%	-37.00%	49.72%	4.12%	15.99%	-50.95%
Barclay US Aggregate Composite Bond Index	0.31%	0.31%	7.86%	6.56%	5.93%	5.24%	75.82%	5.80%	3.65%	-3.82%
MSCI EAFE Index (Net)	10.86%	10.86%	-12.14%	7.75%	31.78%	-43.38%	74.04%	5.70%	18.71%	-56.68%
NAREIT Composite Total Return	10.36%	10.36%	7.31%	27.55%	27.79%	-37.84%	151.51%	9.66%	24.58%	-68.17%
GSCI Total Return Index	5.88%	5.88%	-1.18%	9.02%	13.67%	-46.49%	59.90%	4.81%	24.88%	-67.65%

** Estimates as of April 13, 2012. There is no guarantee that any investment product or strategy will achieve its objectives, generate profits or avoid losses. SOURCE: Altegris.*

Fundamentals Reasserting Strength

Despite some mixed signals, investors at the end of Q1 2012 could take considerable comfort from the fact that—for the first time in a long time—it appeared to be fundamentals, as opposed to political machinations, that were driving the markets. Indeed, as the quarter progressed, investors experienced lower volatility, reduced correlations and a welcome reprieve from the wild "risk-on/risk-off" swings that characterized the environment for significant stretches of time last year.

In March, the CBOE Volatility Index fell below 14—its lowest level since 2007 (FIGURE 2). In Q1, S&P 500 futures moved at least 1% (either positive or negative) on only seven days, compared with 33 such days in Q4 2011.

If geo-political headlines are finally giving way to fundamentals as primary market drivers over the short- and medium-term, we believe that extended market trends could persist and the diversification benefits that are the hallmarks of investment strategies such as managed futures and global macro could once again come to the fore.

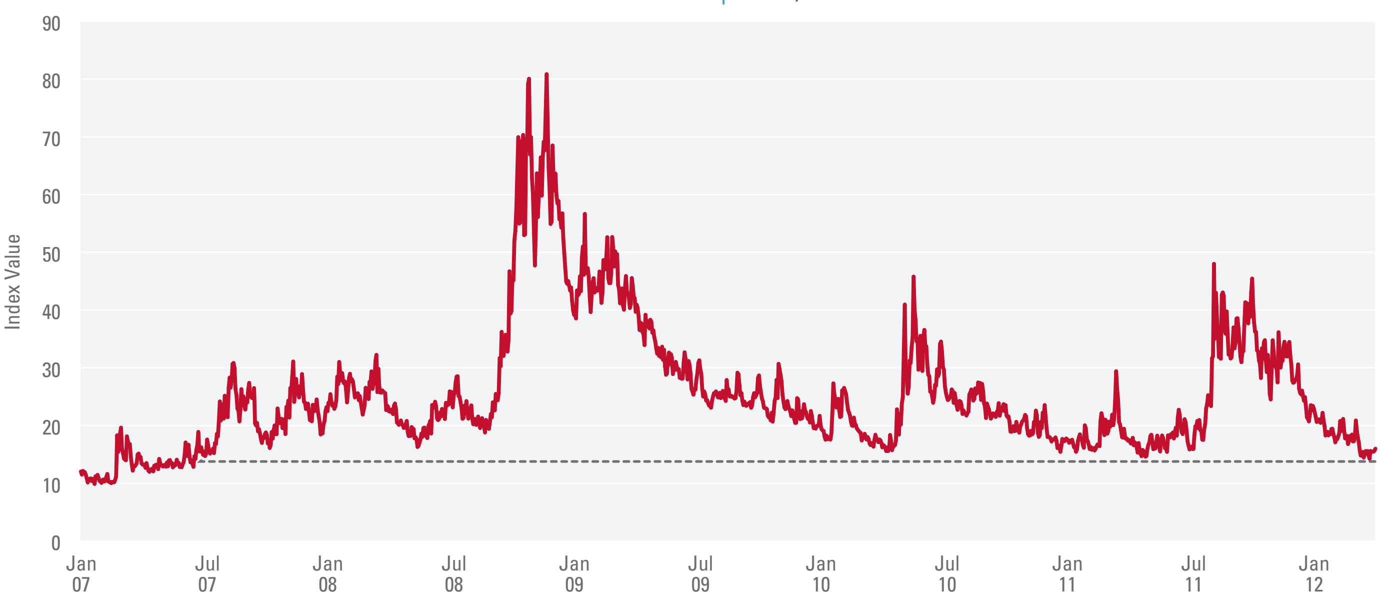
Eurozone Crisis Contained… For the Time Being

In many respects, the cornerstone event of the quarter was the February announcement of an agreement avoiding a potentially calamitous disorderly default for Greece. On February 20, Eurozone finance ministers agreed to provide a $170 billion bailout in return for a promise by Greece to reduce its debt to 120.5% of GDP from 160% within eight years. The bad news: within hours of the pact's announcement, the market—and EU officials themselves—began expressing skepticism about Greece's ability to hit required targets and speculating that the deal, like others in the recent past, had failed to address underlying structural issues. Nevertheless, the hard-won agreement postponed Greece's day of reckoning—even as European countries in general, with additional austerity measures looming, continued to suffer from a challenging mix of persistently high unemployment and deleveraging on the part of both banks and consumers.

In another critical development in Europe—which began in Q4 2011 and continued throughout the first quarter of

FIGURE 2.

VOLATILITY AS MEASURED BY THE VIX HAS DECLINED THIS YEAR | January 2007–March 2012



SOURCE: Altegris, Bloomberg.

2012—the European Central Bank provided the region with a much-needed lifeline in the form of its long-term refinancing operations (LTRO), which were larger and enjoyed much broader participation than anticipated. To date, the ECB has lent Europe's banks more than EUR 1 trillion through the program, thus helping alleviate the liquidity tension on the Continent. The loans have also allowed the banks to resume large-scale purchases of European government bonds, reducing pressure on and lowering borrowing costs for the likes of Italy and Spain—although concerns over the scope of Spain's debt burden grew toward the end of the quarter and began to impact the market.

Together, the progress on Greece and the apparent success of the LTRO helped set the stage for the burgeoning optimism of the quarter—as a region that entered the year on the precipice of disaster achieved at least a temporary level of stability. As a result, investors who were perhaps expecting conditions in Europe to get even worse were able to turn their attention from the long-simmering debt crisis to other factors, including more positive economic numbers from elsewhere around the world. This renewed optimism (or perhaps just a lack of pessimism) in the Eurozone kindled bullish sentiment, and most financial markets rallied as a result. While the widespread market rally buoyed traditional portfolios, most trend followers entered 2012 with a slight "risk-off" stance (as further detailed in the *Trend Following Strategy Summary* below) and their portfolios incurred minor losses throughout the quarter as they gradually transitioned to a "risk-on" position that reflected the growing optimism across financial markets.

Surprising Economic Strength in the US

A series of strong data releases in the first quarter convinced many investors that a sustainable economic recovery had at last taken hold in the US—and helped spur an extended rally in US equities (FIGURE 3). In January, the market received encouragement from stronger-than-expected numbers for US manufacturing and the Purchasing Managers Index. That

FIGURE 3.

THE S&P 500 SURGED IN THE FIRST QUARTER | October 2011–March 2012

SOURCE: Altegris, Bloomberg.

was followed in February by bullish reports on jobless claims, automotive sales and consumer confidence, and by a report on housing starts that gave investors reason to believe that the troubled US real estate market was beginning to firm up. Later in the quarter, comments from Fed Chairman Ben Bernanke suggesting that the Fed plans to stick with its accommodative policy for the foreseeable future gave an additional boost to US equities and commodities. In the closing days of the quarter, however, the markets were given a powerful reminder of the fragility of any nascent recovery. Mixed results for February housing starts and a softer-than-expected report on February US durable goods orders were among the factors that dampened enthusiasm—as well as the S&P 500—at the end of March. Even those end-of-quarter clouds, though, were seen by some investors as having a silver lining, in that they increased speculation about additional quantitative easing by the Fed. By quarter-end, a dominant theme in trend followers' portfolios was long positioning across developed equity markets as a result of the extended rallies that began in late 2011 and persisted throughout Q1.

Elsewhere, a political flare-up in the Middle East combined with tight global supplies to reintroduce rising oil prices as a significant risk factor for the markets. Increasing tensions between Iran and the West and the possibility that the crisis could come to a head in the critical Straits of Hormuz—through which about 35% of seaborne oil passes—sent oil prices surging in Q1. In this volatile environment, a spike in oil prices must be viewed as a real threat to the fledgling economic recovery in the US, as well as a continued impediment to a European turnaround.

Notes of Caution

At the strategy level, while the upswing in equities and energies benefited some managed futures traders, the prevailing theme throughout the first quarter was that a dominant market trend had yet to be fully reflected in these managers' trading models.

As Q1 progressed, the market clearly showed signs that it could be entering a more bullish phase and trend following managers began to adjust their positions to take advantage of this course. However, while a continued rally is indeed a possibility, we acknowledge that current market trends could yet reverse. Such a backslide, particularly a sudden one, would likely present a difficult environment for managed futures managers in general, and trend following traders more specifically.

As represented by the Barclay Global Macro Index, macro managers generally had a good quarter, up 3.3%. This index is dominated by the largest macro hedge fund managers, many of whom carry substantial equity positions in their portfolios, and these managers benefited from the surge in global equities in Q1. In contrast, the discretionary macro managers that specialize in futures were generally less bullish as a group, and they continued to question whether many of the underlying structural issues that have long vexed global markets have been resolved. Until the market provides a greater level of certainty on these structural points, a number of global macro managers will likely continue to proceed with caution and maintain a defensive position to protect against a possible downturn.

Against this backdrop, following is a detailed review of the managed futures and macro strategies for Q1 2012, which should provide some perspective on how trend following, short-term systematic, global macro discretionary and global macro foreign exchange managers performed during the beginning of this year.

Trend Following Strategy Summary

As we discussed in our last commentary, trend followers entered the quarter having confronted a period of both "noisy" markets and sharp trend reversals throughout 2011—conditions that have historically posed significant challenges to the strategy. At the beginning of Q1, managed futures portfolios were still largely positioned "risk off" across most sectors, but to a much lower degree than in Q4, as managers reduced their "short economy" bets in light of the broad risk rally in late 2011. Many of these traders began the quarter with a flat equity position, as a rally in the asset class late in the previous quarter prompted managers to eliminate their short positioning in the sector. At the same time, in the interest-rate sector, managers held significant long positions, particularly on the medium to long end of the curve—five-year and 10-year government bonds issued by the US, Germany and UK, for example. In currencies, managers were largely long the Japanese yen, and short the euro and British pound. Commodities were mixed, with long exposure to precious metals, short positions in softs and base metals, and a flat stance in energies (due to the strong rallies late in Q4). Because of this broad "risk-off" positioning, the "risk-on" price action that took place in Q1 led to modest losses as trend followers transitioned their portfolios throughout the quarter to a long economy stance. The Japanese yen represented an important story for the quarter and had a negative impact on trend followers' portfolios. Many managers had been long the yen for a significant period of time, as the currency had been in a strong and sustained uptrend since the onset of the financial crisis in July 2007 and provided managed futures portfolios with strong returns over this period (FIGURE 4).

FIGURE 4.

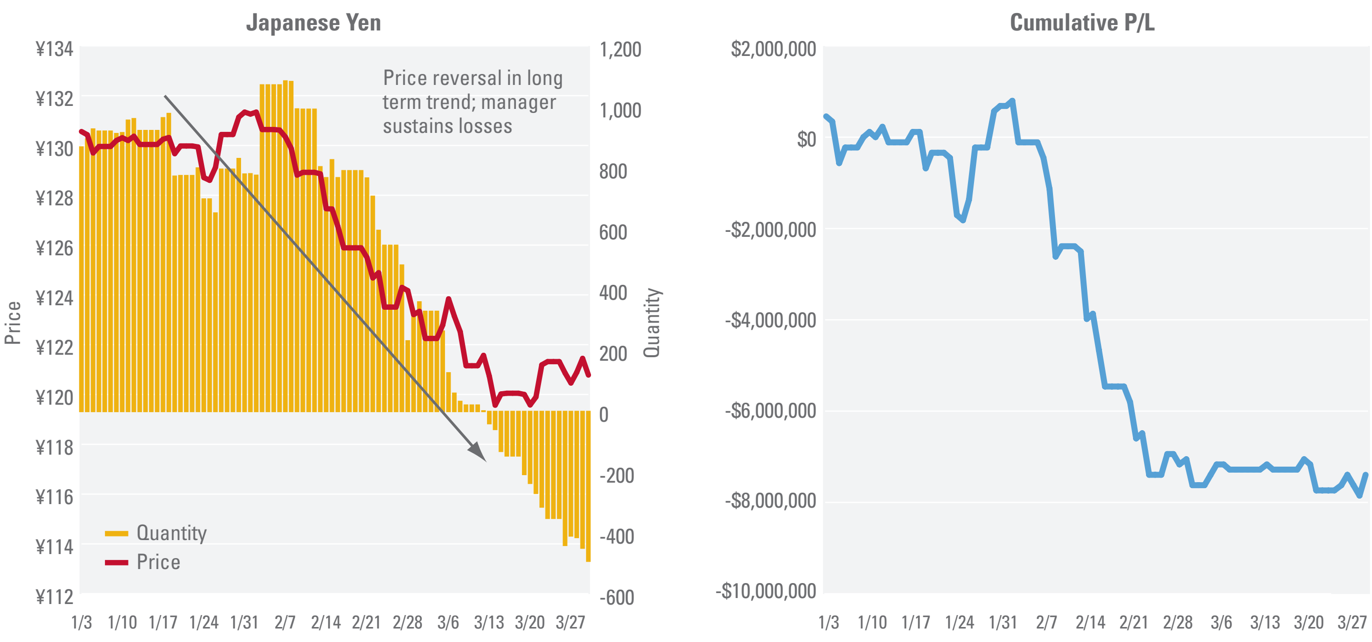
THE JAPANESE YEN ENJOYED A STRONG AND SUSTAINED RALLY FROM 2007 TO EARLY 2012 | June 2007–March 2012

SOURCE: Altegris.

The primary reason for this powerful trend was that of all the major economies, Japan had been among the least aggressive in pursuing large-scale asset purchases along the lines of TARP in the US and LTRO in Europe, and had thus been regarded as a "safe haven" currency both during and in the aftermath of the financial crisis. This sentiment changed swiftly and dramatically on February 14, as the Bank of Japan unexpectedly announced an asset purchasing program totaling 10 trillion yen (more than $120 billion) as well as a 1% inflation targeting policy, which surprised many market participants and served as the catalyst for a weaker yen. In the six weeks following that announcement, the yen sold off approximately 8% and drove meaningful losses within trend followers' portfolios (FIGURE 5). By quarter end, the magnitude of the price decline drove most trend followers to subsequently reverse their positioning to a short yen stance.

FIGURE 5.

THE YEN SAW A SIGNIFICANT SELLOFF FOLLOWING NEWS OF JAPAN'S ASSET PURCHASING PROGRAM, AS REFLECTED IN THE PERFORMANCE OF A HYPOTHETICAL TREND FOLLOWER'S PORTFOLIO | January 2012–March 2012



SOURCE: Altegris.

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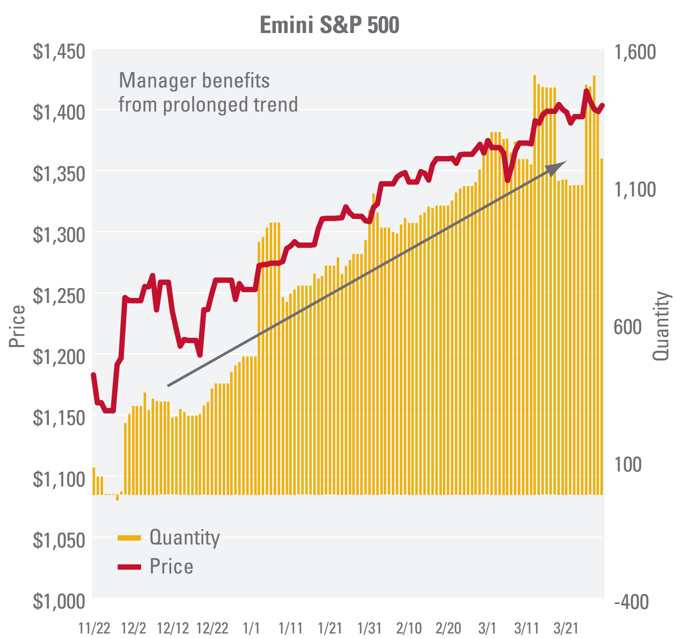
With the markets experiencing several significant price reversals during Q1, trend followers began broadly switching their positions from a "short economy" stance to a "long economy" position throughout the quarter (generally speaking, most trend followers need sustained price trends for weeks to months in order to re-position their portfolios to profit from the new market trend). Long stock index and energy positions were a common thread across trend following managers by quarter-end and were indicative of the sustained rallies in these sectors over the last several months (FIGURE 6). In addition, a number of managers began reducing their substantial long bond positions after the spike in longer-term interest rates during March, a further indication that the "risk-off" trade was no longer the dominant theme in trend followers' portfolios.

FIGURE 6.

GOING LONG THE S&P BENEFITED TRADERS IN Q1, AS ILLUSTRATED BY A SAMPLE MANAGER'S PORTFOLIO | November 2011–March 2012



SOURCE: Altegris.

In this respect, Q1 2012 could represent an important inflection point: if multiple markets can sustain some of the trends that have recently been emerging, and fundamentals continue to drive those markets, the environment could lend itself well to a trend following strategy. Clear, prolonged trends of several months or more generally offer the most potentially profitable environments for trend following traders—the extended market rally of late-2010 to early-2011 being a prime example—and if the current upward trends become more established, investors in the strategy could find themselves well-positioned.

If, however, most markets revert back to the risk-on/risk-off whipsawing and trendless action (such as what occurred in the S&P 500 throughout the course of 2011), then we would expect trend following managers to face a more difficult climate—and, indeed, some of the choppiness in the markets at the end of the quarter demonstrated the challenges those types of conditions can present.

Short-term Systematic Strategy Summary

Short-term systematic managers are a diverse, idiosyncratic universe within managed futures, with trading strategies varying greatly from manager to manager. As a result, it can be difficult to discuss the performance of short-term traders as a monolithic group. That said, there were some particular events and themes that emerged in Q1 that had a substantial impact on this set of managers.

Significant government actions or pronouncements generally have negative consequences for short-term systematic traders. Short-term trading models tend to exploit the behavioral tendencies of market participants, and when governments intervene, these tendencies tend to be overpowered and/or washed out. While Q1 saw less intervention than previous quarters, Chairman Ben Bernanke's unprecedented announcement in late January that the US Federal Reserve planned to keep interest rates low through 2014 created an extremely challenging environment for short-term managers trading bonds. In the final month of the quarter, however, as the Fed news was digested, those traders' short-term models began to function more normally and perhaps even began to capitalize on a behavioral over-reaction to the news that originally caused their losses.

While short-term traders employ a diverse mix of strategies, many can be classified as either momentum or mean-reversion in nature. Momentum traders seek to profit from the continuation of a price move following a breakout from an established range, while mean-reversion traders attempt to take advantage of a return to "normal" after prices have moved too far beyond an established range. In Q1, momentum traders were generally able to profit early in the time period, as their faster-moving models could capture the sustained upward moves across many financial markets. Mean-reversion traders, in contrast, struggled during the straight-line moves early in Q1, but were able to regain some ground in March as equity markets pulled back before bouncing to new highs.

Global Macro Strategy Summary

Going into the quarter, the dark cloud looming over Europe generally overshadowed fundamental considerations for market players. As a result, a number of global macro managers—who employ fundamental strategies in which they use macroeconomic data to predict price movements—held a highly skeptical view in Q1.

Even with a series of positive surprises emerging in the area of market fundamentals in the quarter, that skepticism persisted among a subset of these managers, and they were deliberate in shifting toward a bullish outlook as a consequence. These managers continued to question whether many of the underlying structural issues facing the markets have indeed been resolved, and as a result, they remained positioned somewhat defensively to protect against the possibility of a downshift in the market. Unfortunately, this caution did not serve this group of managers well, as their bearish positioning resulted in losses—as global markets rallied higher and peers with bullish views in the global macro space were able to take advantage of this rally.

Indeed, managers profited from bullish positioning in specific sectors in Q1. For example, in addition to those that benefited from equity exposures, some managers held long commodity positions based largely on two dynamics: 1) fundamental factors relating to supply/demand imbalances and long-term emerging market growth; and 2) governments devaluing their currencies generally represent a tailwind for commodities and real asset valuations. Oil in particular proved to be a profitable trade for many of these managers early in Q1, although a pullback during March resulted in diminished profits for some.

Among foreign exchange traders in the global macro space, shorting the euro was a prominent theme in Q1. This made intuitive sense, given the fundamental headwinds facing Europe, as well as the volatility of that currency's prices (weak in early January, stronger in the middle of the quarter, then weakening slightly again toward the end in the wake of the liquidity injection into the market). Despite the economic rationale for a short trade, however, the euro ended Q1 at a higher level than it started the quarter and led to losses in most FX managers' portfolios.

Viewing currencies as proxies for economies, some systematic FX managers saw the yen as essentially representing a "less-negative" bet relative to other countries. That is, while the Japanese economy hasn't been growing, it has not been weakening dramatically compared to other economies either (particularly Europe). However, the monetary easing announced by the Japanese government changed the equation for the yen in early February, and a number of FX managers incurred losses in their long yen positioning and subsequently reduced their positions in the currency as a consequence. The yen weakness and euro strength were the two dominant themes of the quarter for both discretionary and systematic currency managers, with most managers experiencing modest losses from these positions.

> Some global macro managers continued to question whether the underlying structural issues facing the markets have indeed been resolved, and they remained positioned somewhat defensively.

Conclusion

With Eurozone concerns receding and the macroeconomic picture showing some surprising signs of strength, the market outlook at the end of Q1 is notably brighter than at the end of last year. Reduced correlations, lower volatility and the prospect of less government intervention have led some market players to hope for a return to a "new old" period in which fundamentals drive the markets. If that theme does indeed prove to be sustainable, we would expect that: a) more managed futures managers, having time to adjust their positions, would profit from stronger, extended trends; and b) more circumspect global macro managers could be persuaded that the fundamental picture has indeed turned positive and may take advantage of increasingly bullish positioning. However, if recent trends weaken or reverse, we would expect trend followers to sustain losses, while macro managers may benefit from their remaining defensive positions.

Nonetheless, during this period of transition, caution remains the operative—and prudent—stance, and we remind investors that the diversification benefits and downside protection that are the traditional characteristics of both the managed futures and global macro strategies should serve them well within the context of a long-term investment approach.

INDEX DESCRIPTIONS

An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented.

Altegris 40 Index®—The Altegris 40 Index tracks the performance of the 40 leading managed futures programs as reported to managedfutures.com each month. Each month MF.com ranks its' database to find the top 40 Composite CTA Programs based on ending monthly equity for the previous month. MF.com then calculates the dollar-weighted average performance of those 40 programs for the monthly Altegris 40 Index performance. Although the Altegris 40 tracks only 10% of the CTAs who report their performance, their combined equity represents approximately 50% of the equity of the entire managed futures industry.

Barclays Capital U.S. Aggregate Index—The Barclays Capital U.S. Aggregate Index covers the U.S. Investment grade fixed rate bond market representing taxable U.S. dollar securities.

Barclay Global Macro Index—The Barclay Global Macro Index track the performance of ~175 global macro programs, by ending monthly values, net of fees, as reported to Barclay Hedge.

HFRI Fund Weighted Composite Index—The HFRI Fund Weighted Composite Index is an equal-weighted return of all funds in the HFR Monthly Indices, excluding HFRI Fund of Funds Index.

S&P GSCI Total Return Index—The S&P GSCI Total Return Index measures a fully collateralized commodity futures investment. Currently the S&P GSCI includes 24 commodity nearby futures contracts.

S&P 500 Total Return Index—This index is the total return version of S&P 500 index. The S&P 500 index is unmanaged and is generally representative of certain portions of the U.S. equity markets. For the S&P 500 Total Return Index, dividends are reinvested on a daily basis and the base date for the index is January 4, 1988. All regular cash dividends are assumed reinvested in the S&P 500 index on the ex-date. Special cash dividends trigger a price adjustment in the price return index.

MSCI EAFE Index—The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

NAREIT Composite Total Return Index—The NAREIT® Composite Total Return Index includes both price and income returns of all publicly traded REITs (equity, mortgage, and hybrid).

VIX—VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge." There are three variations of volatility indexes: the VIX tracks the S&P 500, the VXN tracks the Nasdaq 100 and the VXD tracks the Dow Jones Industrial Average.

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