Review of Quarterly Performance:

The most important driver of currencies and commodities markets last quarter was the ongoing European debt crisis. Hence, our portfolio performance was primarily driven by the developments in the Euro Zone. At the beginning of the quarter, there was rampant fear of a messy Greek default, leading to the possibility of default by nations including Italy and Spain. Such fears resulted in massive sell-offs in commodities and commodities linked currencies.

In October, EU leaders tried to restore confidence by promising to bring out a comprehensive plan to address the Greek default issue. At the EU summit towards the end of the month, EU leaders decided to let Greek bondholders take a haircut of 50%. In another major step forward, the leaders decided to increase the size of the European Financial Stability Fund or EFSF to 1 trillion euros from 440 billion euros. The markets welcomed the steps taken, albeit with caution. A brief rally began, which ended towards the end of November.

Even though the EU leaders had termed their package as a “comprehensive one”, it was anything but so. Days after the summit, doubts began to emerge about the ability of EU leaders to increase the size of EFSF to 1 trillion euros, and prevent the European banking system from collapsing. Also, the fact that Greek bondholders had to take a 50% haircut did not go down well with bond investors. As a result, Italian and Spanish bond yields spiked to record highs. What started as a fear of Greece defaulting had now transformed into the fear of the entire Euro Zone economy collapsing and possibly leading to the exit of one or two nations from the Euro bloc. Fears emerged about the future of the currency bloc.

The idea that the ECB would enormously increase its bond buying powers gained traction, as Italian and Spanish bond markets were roiled. However, Angela Merkel, the German Chancellor and Mario Draghi, the ECB President, totally ruled out such a possibility. Another meeting of the EU leaders was held in December, where the leaders decided on automatic penalties for nations not spending within their limits. The ‘bazooka’ that everyone was expecting from the ECB did not arrive. As a result, we have not seen major movements in commodities markets in December.

The shining light amidst all this darkness was the resilience of the US economy. Positive economic data continued to emerge from the US in every month of the quarter. Improvements took place in measures such as consumer confidence, GDP growth, manufacturing indices and jobs outlook. Unemployment fell below the 9% mark.

Our portfolio positions for last quarter were primarily based on the mood of the market at that moment of time. To begin with, our portfolio was long on commodities like copper, corn, gold and silver, as we expected a rally in these commodities after the EU summit in
October. These positions benefited from the rally that followed after the summit. In November, we changed our complete long bias to a more balanced approach, as we went short on crude oil, cotton, cocoa and long on coffee. These positions benefited from the sell-off in commodities in the end of November. Towards the end of the quarter, we reengaged with copper, by taking a long position in copper, and also took a long position in natural gas.

Performance of Individual Positions:

Gold and Silver:

The notion that precious metals like gold and silver are ‘safe havens’ when fear is rampant of an economic crisis was proved false last quarter. In fact, both metals behaved like equities for most of last quarter. Keeping this in mind, we decided to invest in gold and silver with the mind set of equity investors. Our catalyst was a major announcement at the October summit, that would lead to a rally in equities and thus in these metals. We had initiated a long position in both metals and after the “comprehensive” package was announced both metals rallied. We kept the position for few weeks and took profits when doubts regarding the package had begun to emerge.

Crude Oil:

Crude oil has been one of the most volatile commodities this year. From the demand side, there were fears of a recession in the Euro Zone affecting demand for crude oil. One demand side factor that was positive for crude oil was the good economic data coming out from US, the largest crude oil consumer. From the supply side, WTI Crude inventories generally rise during October, because of seasonal maintenance. Because of the interaction of all these conflicting factors, we expected crude oil to trade in a range during October. Accordingly, we sold out of the money put and call options on crude oil. At the time we sold those options, WTI was trading in the $80 - $85 range. For us, profits could be made in the range of $72 to $98. Our position did quite well for most of October. However, in the few days before expiration, crude oil rallied after the announcement at the October EU summit. In this context, we had to close out our position at a small loss.

Corn:

Even the corn futures market was affected to a large extent by the developments in Europe. In spite of this, we were bullish on corn and initiated a long position in October. Our catalyst was the increase in US exports of corn, because of increase in Chinese demand for corn. China, with over 20% of corn consumption is a significant driving force of corn markets. Other bullish factors for the trade included – very low corn stocks and stock-to-use ratio for corn, increasing demand for corn in the production of ethanol. However, corn futures prices decreased, contrary to our expectations. The reasons for decrease were the increase in corn output forecasts made by the United States Department of Agriculture, and the slump in US corn exports because of competition from other corn producers. As a result, we took a loss on this position and closed out after keeping it for a month.

Coffee:
Although the fundamentals were against a sustainable bullish run in coffee prices, we initiated a very short time frame bullish position in coffee futures. The fundamentals were weak because of the record output predicted in Vietnam, one of the largest coffee producers. The reason behind our bullish position was the deteriorating weather conditions in South America, particularly in Colombia and Brazil, the two largest coffee producing nations. As a result of floods, reports came about damage in a sizeable portion of the coffee crop, and our position benefited a lot from such reports. After keeping this position for a very short time period, we closed it, as fundamentals were very bearish for coffee.

Cotton:

Towards the end of November, cotton prices increased for many consecutive sessions. Prior to this cotton had slumped to its annual low. The reason for the rise in prices in November end was increased in cotton purchases by China. Like corn, cotton markets are immensely influenced by activities of Chinese buyers. However, cotton fundamentals pointed towards a bearish trend. Cotton’s stock-to-use ratio was very high, indicating large cotton stocks. Moreover, forecasts made by Cotlook, a renowned organization providing news on cotton markets, pointed towards a large cotton output for next year. Thus we decided to sell cotton futures, as we believed that this increase in cotton prices would be short-lived and eventually the weak cotton fundamentals would set in. We made a sizeable profit on this position, as cotton began to slump, and broke its previous annual low.

Cocoa:

Cocoa was another commodity, where we initiated a short position. Ivory Coast and Ghana are the two largest producers of cocoa, and the US and EU are the largest consumers of cocoa. Both demand and supply side factors pointed towards a bearish trend in cocoa. On the supply side, large output forecasts were made by the authorities in the two African nations. On the demand side, there was not much growth in demand expected because of the fear of recession in Europe and its consequences in US. Thus, both these factors contributed to one of the biggest slump in cocoa prices, as futures touched a three year low. We closed out our position as reports came in of shipment stoppages in Ghana and a bullish forecast was made by Olam International, the leading supplier of cocoa. Olam predicted a deficit in cocoa supply compared to demand, compared to the current situation of a sizeable surplus in cocoa supply over demand. We acted accordingly and initiated a long position in cocoa for a very short period of time. We earned profits in both the short and long positions, and closed out after keeping both for a short period of time.

Currencies:

The FX market was highly volatile these past few months as investors were extremely focused on macroeconomic data releases and thus, currency markets largely tended to move in a risk on-risk off fashion. Consequently, cross-asset correlations were at all-time highs and historic technical patterns began to break down making it harder to both properly hedge positions as well as predict patterns going forward. The portfolio members found that the best way to make money in this market was to stick to short-term trading opportunities and only initiate long term fundamental views when extremely confident. While our long
term views proved to be profitable, the majority of the currency portfolio’s profits were
made through the short-term trades. These short-term trades rarely lasted more than a day
and were based on a swing trading algorithmic program which aimed to profit off of
correctly timing reversals in currency pairs which moved too far from their historic mean in
too short a time period. Once multiple technical indicators indicated a future correction, the
buy or sell signal would be triggered and entry, exit, and stop-loss points would be
determined through further chart analysis. This resulted in superb risk management during
an extremely erratic market. The strategy itself tended to be very profitable and will be
continued moving forward. Additionally, a variety of trading strategies are constantly being
tested and refined by taking small positions in the portfolio and the most promising ones
will also be put into play on a larger scale.

The main currency in focus over the last few months was, of course, the Euro. The Euro
proved extremely difficult to trade as it smashed through historic levels of volatility and
overtook GBP/JPY as the most volatile G10 FX cross. While the EUR/USD trade consistently
showed an adherence to chart patterns as trade volume increased in the pair, short-term
trading of the pair in the portfolio was passed over in favor of a long-term, fundamental
EUR/USD short as the portfolio sought to profit off of the crisis in the Eurozone as well as
provide a hedge for our metals positions. While shorting the EUR/USD proved to be an
extremely profitable trade towards the end of 2011 as “safe-haven” inflows into the USD
greatly increased, it was not, in hindsight, the ideal way to trade the Eurozone meltdown.
The ideal way to trade the meltdown would be by shorting EUR/CHF in the first half of 2011
(prior to the inception of the portfolio) and by buying EUR/HUF in the second half. The key is
to, again, focus on the flow of funds between currencies (in this case the “safe-haven” flows
into the Swiss Franc and then the Euro deleveraging flows out of Eastern Europe.) Going
forward, this nuance of the markets has been observed and we will seek to profit off of it.

The Yen has also had an interesting few months. JPY has consistently appreciated over the
last few months; however, the portfolio did not take advantage of the JPY momentum as it
went against our policy of short-term trading opportunities and the fundamentals in Japan
did not look too impressive (we can only conclude that the strength of the Yen must be due
to a risk-off phenomenon as Japan’s debt/GDP ratio, demographics, etc. don’t exactly make
for an enticing investment opportunity.) To profit off the Yen, we implemented a short-term
scalping strategy on the GBP/JPY which has historically been the most volatile pair on the
market. This strategy made consistent if small profits. The reason for the small size of the
profits was twofold: the quick turnover of positions and the low amount of leverage used in
the trades. Low leverage was used despite the consistency of profitability due to fear of the
Yen’s continued strength and the possibility of an intervention by the Japanese government.
Ultimately, our fears proved to be well-founded as the BOJ intervened to weaken the Yen.
Fortunately, we were on the right side of the position but if we had used greater leverage
and happened to be on the wrong side, we could have sustained a large loss. The GBP/JPY
scalping strategy will continue as the pair proves to still be one of the most volatile FX
crosses (calculated by ATR of pips.)
The risk currencies of the loonie, aussie, and kiwi tended to move in sync as the world focused on the macroeconomic data coming out of Europe and the US. As a result, the currencies were highly correlated. However, profit was made by shorting the AUD/NZD pair over the course of a month and a half. The antipodean trade was put on based on fundamentals rather than technicals as we felt that the threat of a Chinese hard landing and the interest rate differential between the two countries would weigh down on the Australian Dollar. The New Zealand dollar was chosen as the other end of the trade as the two currencies are extremely correlated and are both “risk-on” currencies which would hedge out the risk of a sudden bout of market optimism.

Significant positions were also taken in the currencies of emerging market countries in Eastern Europe, Africa, and Asia. Currencies in which such positions were taken include the Norwegian Krone, the Swedish Krona, the Danish, the Singaporean Dollar, the Turkish Lira, and the South African Rand. All bets made on emerging market currencies were made against a G10 currency as the EM FX crosses are very thinly traded and the bid/ask spread is far too wide for our purposes. Likewise, great care was taken when initiating positions as wide bid/ask spreads meant that trades could not be reversed without incurring large losses. Profits from EM trades largely derived from short-term bets in the Scandinavian currencies (especially the NOK/CHF pair) and long-term, fundamental trades on EUR/TRY and USD/SGD.

**Outlook for next quarter:**

Next quarter, uncertainty will continue to prevail in currencies and commodities markets because of the European debt crisis. I expect the positive momentum shown by the US economy to continue. Considering the fact that the next moves of EU leaders and ECB are highly unpredictable, it is best not to take any directional bets for a very long period of time. Rather, we will trade commodities for very short periods. Notable exceptions can be made for agricultural commodities where in some cases, like cotton, it is expected that the bearish trend will end soon. Already, forecasts are being made of a large decrease in cotton surplus stocks. In these exceptional cases, we may initiate directional bets for a longer period of time. We may also initiate long positions in metals, if we develop the view that the ECB will unleash a massive bond-purchase program. To sum it up, we shall continue to follow the developments in Europe in details and act accordingly, and trade markets such as cotton, which are not completely correlated to the events in Europe.