There was strong performance in September for all of JWH’s diversified and financial programs, given the exceptional move in the crude oil market and the continued rally in global bond markets. The gains were led by the Global Financial and Energy Portfolio, which generated returns of 25.44 percent for the month. The Global Diversified Portfolio, GlobalAnalytics® Family of Programs, Original Investment Program and the Strategic Allocation Program also showed double digit gains for September. The only exceptions were the currency programs, which have still not found any strong trends in the major foreign exchange markets. This capped a major turnaround for many of the programs in the third quarter, as six of our programs ended the period with positive numbers. Our broadly diversified programs performed best for the quarter, with all of them producing double digit returns.

The value of a longer-term trend perspective was rewarded in the energy markets, which seemed to be destined for a major reversal at the end of August after reaching a high in the mid-$40s per barrel range. A combination of hurricane disruptions in the Gulf of Mexico, political risk in Russia, and rebel problems in Nigeria, on top of the ongoing geopolitical risk in the Middle East, pushed crude oil prices higher than $50 per barrel at the end of September. This extended and continuing shock to oil prices may have a negative impact on growth expectations and a crossover effect on interest rates and other financial markets. Though the US is less energy sensitive due to conservation measures implemented over the years, we are seeing a price shock that rivals that of the late 1970s.

The Cycle of Major Trends and Performance

Strong performance for a managed futures program is normally not caused by significant moves in just one market; it’s usually the result of follow through in a broad set of markets. For example, a large price trend in oil and its products can have an appreciable impact on performance for JWH, but the greater spillover effects of a supply or demand shock carrying over to financial and currency markets is what truly leads to a period of strong performance. A shock that can be correlated to other markets creates better opportunities. At such times, lack of correlation is actually a hindrance. We may be seeing this correlated return potential for programs with the current oil shock if it is sustained.

The current trend continuation circle (top of next page) is a simple illustration of what may be occurring. A large move in oil will have a corresponding effect on business cycles around the world. It is a tax on consumers and increases the cost of production. A price shock that drives down growth expectations has an impact on financial markets, especially if the shock is not monetized or accommodated by monetary authorities. Equity markets will show declines as earnings expectations fall, and interest rates will start to trend lower if the shock is perceived as non-inflationary. We’re currently seeing this effect in the long bonds around the world. This may also carry over to currency markets, as growth rates and interest differentials begin to adjust to the oil shock.

The Fed, Trends and Bond Vigilantes

Conventional wisdom concerning market behavior often does not work. The largest fear concerning the Fed’s behavior prior to the June policy change was that this would be an environment like 1994. At that time, rates increased across the board, leading to a significant impact on leveraged market participants. The idea that the Fed cutting liquidity and raising short-term rates should lead to higher long rates is considered conventional wisdom. At worst, it will assume that the yield curve will flatten from rising short rates. However, in this case, the rise in short rates reduced growth and inflationary expectations. Lo and behold, there has been a major bond rally in the face of three 25 basis point increases over the last three months. Since the end of May, the 10-year bond has decreased 50 basis points, or just less than 6 points in the futures contract. Eurodollar futures have moved over 50 basis points in the opposite direction.
Conventional wisdom, though theoretically sound and logical, sometimes does not fit the facts. Trends can be different from what is expected. Perhaps the bond vigilantes are not buying the forecasts of the Fed, and are expecting a greater slowdown in growth than the government. The market may not always follow the professional forecasters; yet that does not mean the market is wrong.

The bond rally in the US is not an isolated event. Global bond vigilantes have been driving down rates in Japan, where there has already been a slowdown in growth. The same has also occurred in Australia and Great Britain and, to a lesser extent, in Europe. During this time, the Bank of England has raised rates 100 basis points since the beginning of the year, while Australia recently increased borrowing rates by 25 bps. Europe has not taken any action, but the economies in the EU have continued to experience languishing growth.

The strong trend in bonds has not been duplicated in the equity indices, which have moved sideways for most of the year. US equities have not been able to give strong conviction to the impact of the oil price shocks. However, the European and Japanese markets have not followed the same pattern. The Eurostoxx has been in a rally for a good portion of the summer, while the Nikkei index has bounced off the lows it reached earlier in the year. It remains to be seen if the bond or equity traders have gotten the right forecasts.

**Commodities and Metals also Added to Performance**

The precious metals markets have shown renewed strength in response to higher oil prices. This could be a knee jerk reaction to possible inflationary pressures, or just a form of protecting wealth during a business slowdown. It should be noted that oil is normally paid in dollars, and holding gold instead of a currency would be a form of diversification.

The grain markets continue to march lower in response to expectations that harvests will be very strong. In fact,
we are seeing corn prices move down to the level where they match government marketing loan rates. We have seen prices move to price support levels before and this is a point where farmers do not have a strong demand to hedge. If the subsidy programs are expected to remain unchanged, these provide strong support levels for the market and reduces the need for farmers to cut production.

What is Going on in the FX Markets?

We have been surprised by the lack of trends in the FX markets, especially after we viewed it in historical context. We ran a simple test that looked at the absolute returns for the NYFE dollar index on a daily, weekly, monthly and quarterly basis, and rank ordered the size of the moves to see if the number of lowest quartile days in 2004 were higher than normally expected. If the FX market has truly been less volatile, we should find a higher probability or number of smaller moves in 2004 over each of the time horizons. We should expect that 25% of the days in any sample period should fall in the lowest quartile of the total sample, which included data from 1986 to the present. Surprisingly, we discovered some interesting nuances in the behavior of the dollar over different horizons. The daily and weekly absolute moves did not show any extraordinary behavior for low volatility relative to our long historical sample; however, the monthly and quarterly data suggested a greater degree of calmness. Our table shows that both daily and weekly numbers are not unexpected, while there is a greater than normal number of low absolute moves for monthly and quarterly periods. The markets are choppy in the short-run relative to longer horizons. This analysis shows that 2004 has been unusual. This unusual volatility may not last for long, as there is generally a reversion to the mean; however, it is difficult to say if and when this will occur in the currency markets.

A positive view for the currency markets may be in the works, because large movements in other markets will often spill over into the currency markets. In particular, the continued run-up in oil prices will have a differential impact on business growth around the world. This will affect relative currency rates. Additionally, the current moves in interest rates have started to cause changes in the differential rates across countries, which will also have an impact on exchange rates. We are confident that there will be an increase in the set of opportunities in the futures as the macro adjustments move through the financial system. Until that time, our models have reduced market exposure in an effort to minimize the negative impact on portfolio performances.

Survey of FX Markets Shows Significant Increase in Trading Volume

The recent survey of FX turnover by the Bank of International Settlements was released this month, and it showed that there was continued growth of all types of trading in the currency markets. The market depth has increased, with average daily turnover of $1.9 trillion, up 57% since the last survey in 2001. Turnover rose especially in the spot and forward markets, with growth in turnover with all counterparties, but especially banks and financial customers. Much of this business is coming from hedge funds and CTAs. There was no change in the composition of the currencies traded and London continues to be the most active trading center.

Conclusion

September was a prime example of why investor’s patience can be rewarded. When markets begin to trend, JWH’s methodology has tended to capture the significant market moves. In any event, JWH’s diversified and systematic trading models stand ready to potentially participate in price trends if and when they emerge. I would like to thank our clients for their commitment and patience throughout the last few months as we waited for these trends.

Mark S. Rzepczynski, Ph.D.
President & Chief Investment Officer

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Percentage of daily moves of the dollar index in the lowest quartile

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<thead>
<tr>
<th></th>
<th>Daily</th>
<th>Weekly</th>
<th>Monthly</th>
<th>Quarterly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Period</td>
<td>53/196</td>
<td>5/40</td>
<td>4/9</td>
<td>3/3</td>
</tr>
<tr>
<td>%</td>
<td>27.0%</td>
<td>12.5%</td>
<td>44.4%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: Bloomberg

Note: We measured the number of periods within 2004 which were in the lowest quartile of absolute moves from the dollar index since 1986.

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1 A simple binomial test for each period will show that the daily data do not have a statistically different number of low moves. The weekly data has a significant number of few low-move days. While the moves on a monthly and quarterly data show a significant number of high-move periods at the 90 percent confidence level.

2 “Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2004”. Monetary and Economic Department (see www.bis.org)

Past performance is not necessarily indicative of future results.
Why do we Avoid the Nearby Oil Contract for Trading?

A recent client meeting focused on trading the crude oil market. The client asked what contract we traded, and we stated that we avoided the nearby contract. He looked at us somewhat puzzled; “Isn’t that where you find all of the market’s liquidity?” That is true, but there are often considerations besides liquidity that determine our choice of futures contracts to trade. For us, the signal-to-noise ratio is more important, and we believe that there is a clearer signal on the long-term direction of any commodity in the more distant contract months. To understand this effect, we have to go back to some of the earliest research work on futures markets. The following graphs provide some strong evidence of the risk from the changing shape of the contract to maturity or term structure curve. Returns are very sensitive to the time to maturity. Figure 1 shows the significant impact of maturity for the return profile for crude oil. As you move further from current spot prices, there is a dampening effect on returns. This is also clearly exhibited in Figure 2, which shows the 20-day rolling standard deviations across time to maturity. As you move further away from maturity, there is less volatility. Hence, there is less noise concerning the trend signal.

Futures markets also tend to have a characteristic called normal backwardation, whereby the futures price is often below the cash spot price. The size of backwardation can be significant. Oil is not a carry market whereby the futures price is just the carrying cost of the current spot price. This backwardation (inverted or negative carry) is associated with two factors. One factor is the risk premium associated with the compensation for long speculators to take positions from short hedgers. This premium will change with market conditions. The second factor is the convenience yield associated with holding the cash commodity. In the case of oil, this convenience yield is significant and volatile. Due to the combination of a highly volatile risk premium and a volatile convenience yield, we do not believe it is appropriate to trade the nearby contract. The nearby contract will actually have more noise or volatility as it responds to price pressure, which is unrelated to longer-term trends. Because we are interested in exploiting the longer-term trends, we do not want to be stopped out of our positions based on false signals caused by changes in the convenience yield or risk premium.

Trading in futures markets is more than just finding a model; it requires an understanding of the market dynamics so that we are able to maximize the performance of any model. In this case, the choice of time to maturity has an appreciable impact on model performance because of the market dynamics and structure.

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3 This is well noted in futures markets as mathematically articulated by Paul Samuelson in his work, “Proof that Properly Anticipated Prices Fluctuate Randomly,” Industrial Management Review 6, pp. 42-49, 1965.

4 Convenience yield is related to the theory of storage as developed by Nicholas Kaldor and Holbrook Working over 50 years ago. It states that immediate ownership has strong benefit relative to the deferred ownership of a futures contract. This is especially the case when there is a strong need for immediate consumption of oil.