When you follow a divergent trend-following strategy, program performance can change radically in just a few weeks. This characteristic is what provides our unique value. Trend-following provides for a high probability of a large positive return event. These return events often provide unique diversification benefits for a traditional portfolio. Over the last two months, markets have moved from range-bound behavior to showing a clear longer-term directional trend. A combination of rising oil prices, declining interest rates, and a fall in the dollar led to strong gains across all of the JWH programs. A significant portion of the earlier negative returns for 2004 have been reversed in the last two months of trading, as the impact of high oil prices has spilled over to other sectors. Additionally, the prospects of lower growth in China because of a rise in lending rates also have affected world markets.

After a decline for the first eight months of 2004, our flagship Strategic Allocation Program (SAP) shows a gain for the year through October. SAP produced the second largest monthly gain in its history at 20.05 percent. This is not surprising given the gains realized in the individual JWH programs. All of our programs had positive returns for the month, with performance ranging from a low of 6.10 percent for the Worldwide Bond Program to a high of 26.08 percent for the Dollar Program. The two-phase programs showed the largest program gains. The reversal system led the way because it will often hold positions through periods when trends are shallow or faced with higher volatility. As trends extended in October, our three-phase programs, which take positions after a price threshold is achieved, showed better performance. For example, some of our currency programs had neutral positions during much of the summer because of the paucity of trends.

Over our history, we have noticed that strong performance is often related to spillover effects from one sector’s move or price shocks spreading to other markets. The lag effect between a price shock and different markets allows for a sustained period of gains. Even with strong market integration, this lag effect occurs because the portfolio managers in the equity markets are often not the same as the managers making fixed-income or currency decisions. The reaction to an oil shock, by equity managers who are discounting earnings, historically will not be the same as fixed-income managers who discount coupons and focus more on real interest rates and inflation. In the current case, the sustained move in oil first spilled over to fixed income markets, and now to currency markets and has had less impact on equities. The reaction in the fixed income markets may be more direct through growth expectations, while the impact on currency markets has to play through the differential impact across countries.

Energy Trading Still Played an Important Role

The continued strength in the energy markets had a growing spillover effect on other market sectors in October. With prices pushing above $50 per barrel during the month, there was a clear signal that this price rise is not something temporary but may last longer than expected, especially as we enter the winter season. Even a decline in oil prices from the highs may not cause a complete reversal in the effects on other markets if there is a perception that the economic drag from this energy shock will continue. It is often perceptions rather than the immediate facts that drive markets. In spite of conservation efforts in developed countries, the economic drag may have a greater global impact because of the significant increase in demand for energy in the developing world, especially in countries such as China. China has a per capita consumption of oil that is only 1/14th the size of the United States but is growing at a faster rate. Of course, economies are not static and new factors may dominate in the weeks ahead; but for October, oil was a major story.

Interest Rates Continue to Slide Lower

Interest rates continued their slide lower across the world as the price of oil increased. Yield curves flattened as the long-
end of the curve further declined. The extent of the decline in the United States is actually surprising given the fact that retail sales, the Chicago Purchasing Managers Index, and the University of Michigan confidence survey all showed improvements in October. The fundamental data paints a better picture than the one that bond investors are seeing. These investor are focusing on payrolls which are still soft but improving, as evidenced by the November reading. Europe is the only region where economic growth data is more consistent with a decline in interest rates. The inflation factor, however, seems to be under control because there has not been an outright accommodation of the oil price shock by central banks, which have generally moved to tighten liquidity further this year. Nevertheless, the desire to cut liquidity by raising short-term rates after the move to the 2% level could wane if there is renewed evidence of a slowdown.

The current link between economic data and bond prices could be confusing, yet we continue to find evidence that market prices in the short-run do not move with fundamental data or facts. Markets are driven by future expectations. Are those expectations driven by the economic numbers today or what is believed to be happening tomorrow? What is the window into the future that current information may give us? Often, there are no clear answers. Even when we believe there is a strong relationship between fundamentals and price, the actual correlation can be quite low. Often times fundamental models can only explain a small portion of return variation. The majority of price movements are actually unrelated to fundamentals, and the empirical reality of markets is that the link between fundamentals and prices is often messy. Consequently, we focus on the price action which has been clear over the last eight weeks.

**Dollar Decline is Renewed**

In spite of our comments concerning bond markets, the drive of fundamentals eventually will cause prices to adjust when the size of the fundamentals is large relative to the norm, as we see with factors concerning the dollar. The problem is that the time and range of prices away from an equilibrium value can be significant. This is the real inherent risk of markets; they do not behave nicely relative to fundamentals. In the case of currencies, there is once again a focus on the twin deficits of the US current and fiscal accounts. Why is this issue resurfacing now after a multi-month hiatus when prices were range-bound? It is hard to say, especially to see this move before an uncertain election. It could be that markets realize that no president will be able to fix these problems without allowing currency prices to adjust. It could also be that slower growth around the world will slow US exports but not imports. Nevertheless, this is a trend that we do not intend to fight, and it has contributed significantly to our monthly performance.

**Commodities Showed Mixed Results**

Impressive harvests in North America have led to further declines in grain prices during October. There is nothing that farmers can do to stop this decline. The other commodity markets have shown mixed results, with return declines in many soft commodities. The base metals markets were again rocked by news from China concerning steps to slow growth. As China is one of the largest purchasers of metals, any news that could affect growth will cause a swift reaction, as seen by the decline in base metals prices.

**Conclusions**

Our performance was very strong in October. We do not forecast markets, but JWH’s philosophy meant that our models were ready for the price move opportunities when they appeared. Ultimately, our style employs models that look for price signals without regard to the fundamentals. It seeks to take risk exposure only when markets display a direction and October was an excellent demonstration of how our models can capture these movements.

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

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1One of the reasons we trade the entire yield curve available in the futures markets is the fact that yield curves do not move in parallel fashion. Most research suggests that yield curves can be expressed through three factors, a level shift, a slope change, and/or a curvature change. The level or parallel change can explain about 75 percent of the variation in the curve while the slope and curvature components can each explain a little over 10 percent of the variation. The three factors can explain, in total, about 97 percent of the variation on the US yield curve. The reaction to macroeconomic news will differ for each of these components. For example, nonfarm payroll and unemployment have different effects on the level and slope factors. This work is expressed nicely in the paper by W. Brian Barrett, Thomas F. Gosnell, and Andrea J. Heuson “Term-Structure Factor Shifts and Economic News”, *Financial Analysts Journal*, September/October 2004.

Past performance is not necessarily indicative of future results.