JWH MARKET COMMENTARY

MAY 2006

JOHN W HENRY & COMPANY INC

ECONOMIC UNCERTAINTY CAUSED MARKET VOLATILITY TO INCREASE CAUSING SWINGS IN JWH PERFORMANCE

The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelope our future.

– John Maynard Keynes

The dark forces of time and ignorance as measured by volatility seem to have won for the month of May. A strong change in market expectations coupled with higher uncertainty drove investors to find "safe-haven" assets around the world. This flight to quality, while unexpected was not surprising given the rise in volatility in the global equity markets and the continued flatness in the yield curve. Cash is attractive and investors are not being paid for risk-taking. The increased market volatility and adjustments in market expectations were a reaction to new information on economic growth, inflation, and monetary policy in the second half of the month after the Federal Reserve (Fed) meeting on May10th.

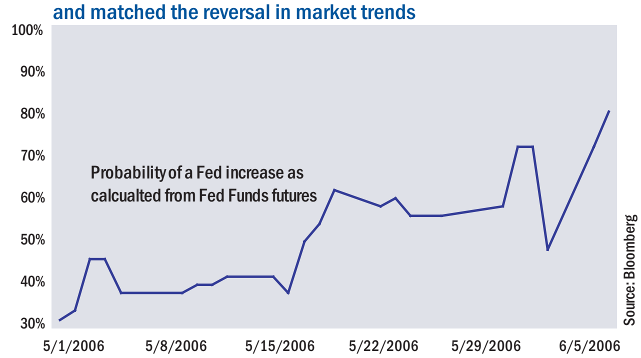
These market changes following the Federal Reserve's news caused a significant performance reversal after a strong first half of the month for many JWH programs. Many of the programs gave back earlier profits and ended the month without any gains. Some program exposure to the fixed income sector has been lost, but the core exposure in currencies remain unchanged.

Generally, JWH's diversified program returns were flat to negative based on declines in interest rates and metals. All currency programs produced positive returns for the month driven by the declining U.S. dollar. Performance for our financial programs was mixed, with bond sector returns declining on the downturn in interest rates, and the currency components showing gains. An increase in JWH program volatility has also gone hand-in-hand with the growing market volatility.

INTEREST RATE CONFLICT BETWEEN GROWTH AND INFLATION — Investors are still trying to gain an understanding of the new Fed chairman. The markets were leaning towards the view that the Fed would likely pause from raising rates in June, but the latest Fed increase, its sixteenth in a row, was coupled with a statement that "further action may yet be needed." This unexpected, but seemingly straightforward, statement meant a heightened focus on economic news to determine the Fed's future intentions. The news that came after the Fed's meeting suggested that the economy may be slowing. Consumer confidence, housing, durable goods, jobless claims, and manufacturing data all declined relative to survey expectations. Nevertheless, hawkish Fed comments suggesting inflation is still very much an issue dominating the focus of investors.

The impact of changing Fed expectations can be seen with the jump in probabilities for Fed action in June as measured by the Fed fund futures. As shown in the chart below, after starting the month at only a 30% probability, odds moved to above 75%. The mid month jump matched the change in trends.

Odds of 25 bp Fed hike in June changed signifcantly and matched the reversal in market trends



Economic data in other countries showed similar patterns that were not as dramatic; consequently, the global bond markets all moved in tandem. These reversals caused JWH programs to lose fixed income positions and giveback some of the accumulated profits from the rising rate trend.

CURRENCIES DRIVEN BY DOLLAR DIRECTION — The strong U.S. dollar decline lost momentum with investors looking for the new catalyst or "scapegoat" to drive foreign exchange markets. A potential for a Fed pause which was a diver for the U.S. dollar decline in April, seems less likely. Stories of slower growth or specific central bank action can be woven to cause the U.S. dollar to move in either direction, so the only certainty is that the market is facing more uncertainty. Profit momentum for JWH has declined and currencies became range bound on this uncertainty. There is still no supporting news for a strong U.S. dollar rally and a long-term U.S. dollar adjustment may not be complete as long as the underlying issues of high current account deficits, low U.S. savings and global imbalances remain unsolved.

While trend momentum slowed in May, the pace for deleveraging carry trades accelerated as capital flowed away from high-yielding currencies. This caused more volatility with our emerging market positions.

EQUITY INDICES DECLINE WITH ECONOMIC SLOWDOWN AND UNCERTAINTY — Equity markets will be negatively affected by three major factors: a change in expectations concerning future earnings which will decline if economic growth slows; increasing interest rates which raise the discount factor for cash flows; and an increase in uncertainty which will cause the need for compensation for taking risk. With all these effects simultaneously occurring, global stock markets gave back most of their gains from earlier in the year. This led to higher correlation across global equity markets. This has been especially true of emerging market stocks which have moved downward with developed markets.

METALS DECLINE FROM EXTREMES — Precious and base metals markets have moved off of their year highs and have seen increasing volatility. With a slowdown in economic growth, higher interest rates and expectations that inflation is not being tamed, the gold market lost almost $100 per ounce. Silver also declined significantly for the month as concerns that rising global interest rates may curb demand in India and China.

The base metal markets, copper in particular, have been the focus of discussions on whether they are in speculative bubbles. There is a social cost if a bubble occurs from the reallocation of resources based on the high variable prices, but from the prospective of a trend-follower, JWH is agnostic about bubbles for two reasons. First, to declare that a bubble exists assumes that true value is known. We do not make value predictions, so we cannot determine whether a market is in a bubble. Trends can last longer than most expect. Second, bubbles create trends both on the way up and on the way down. JWH generally will give back some profits on a reversal but we also expect that we can potentially profit from the descent of prices which can provide good trading opportunities.

While we do not predict the true value for these markets, the price increases have some basis in fact. A key driver in the copper, and to a lesser extent nickel, market has been large strikes at key mines, sporadic wildcat walkouts, and the threat of government action to change terms of royalty deals. All of the factors upset the production of copper and have had an impact on the price.[1] Supply cannot change quickly in the mining sector through the development of new mines, but supply is sensitive to production shocks like a labor strike especially during periods of high demand. Shifts in labor cost or royalty payments to governments can have a large impact on the cost of extraction and will be reflected in the price.

AGRICULTURAL MARKETS MIXED — The excitement that has been associated with metals has not occurred with the agricultural sector. In fact, live cattle and hogs are down for the year and many of the grain markets have been range bound. Some of the largest moves have been in corn and sugar which have become energy-related through ethanol production. The impact of this sector was minimal on JWH's overall portfolio performance.

ENERGY MARKETS STILL REFLECT GEOPOLITICAL RISKS — The oil market has been relatively unchanged for the month of May with movement tied most closely with the geopolitical risks of the Iranian nuclear situation. Risk premiums have moved with the announcements on the changing politics of this issue. Natural gas, on the other hand, has continued to move back to the same levels as last year based on increasing inventories because of the warm winter.

HANDICAPPING MARKETS — MORE INFORMATION DOES NOT ALWAYS WORK — We began our monthly commentary with a quote from Keynes on the dark forces of time and ignorance. How can you fight ignorance? The simple answer is that you should go out and seek more information. More information never hurt anyone, yet an interesting old study on decision-making suggests otherwise.[2] Racing handicappers were tested on the accuracy of their forecasts using different levels of available information. What observers found was quite surprising. More available information did not increase accuracy, in fact there was a slight decrease, but there was a marked increase in confidence.

More data seems to give us more confidence on our guess, but does not always make us better predictors. There is an overconfidence bias. We place more certainty on our estimates when we have more information. It could be that we are looking for confirmation when we have more information. It could also be that we gain confidence when we see more that is familiar to us and we put less emphasis on what is not known. Nevertheless, this bias is strong.

This issue has been discussed in behavioral finance. Money managers are considered an overconfident lot. We don't want to pick on the profession because researchers have also found that a large percentage of most professionals think of themselves as above average. We sometimes place too much stock in ourselves and our ability to solve problems. It is not an issue that can be easily solved.

Facing uncertainty may not always be solved by digging for more information to prove our case. Sometimes simplifying the approach is more practical, such as just following what prices do. When in doubt, follow the trend. JWH believes in always following the trend, and if the trend stops or reverses, the best course of action may be to exit and wait until conditions are more favorable. It is not always glamorous and may not always generate profits, but it is a well tested method that can work in uncertain situations like the current environment we face.

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

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS

[1] *It has been suggested that the number of labor negotiations in the mining sector is high for 2006. These negotiations will lead to higher costs as labor tries to extract some of the higher profits generated from price increases. There have been large strikes in some of the key mines of Grupo Mexico S.A., labor conflicts in Indonesia, the Philippines, and New Caledonia as well as strike threats with Canadian nickel producers.*

[2] *This issue is explained in Winning Decision: Getting it Right the First Time by J. Edward Russo and Paul Schoemaker. They have also written a great book on the topic called Decision Traps. Their research is also consistent with the work we have mentioned in the past on "fast and frugal" decision making by the ABC Research Group of the Max Planck Institute of Human Development lead by Gerd Gigerenzer.*