Ellerston Global Macro Fund

Newsletter – July 2017

ELLERSTON CAPITAL

Fund Facts

Inception date	1 July 2017
Liquidity	Daily
Management Fee	1%
Performance Fee	15%
Strategy AUM	$10 million
Firm AUM	$5.2 billion
Distribution Frequency	Semi-annually
Investment Style	Discretionary, medium term
Targeted Volatility	6%

Investment Objective

Provide an annualised 5% net return above RBA Cash rate over rolling 3 year period.

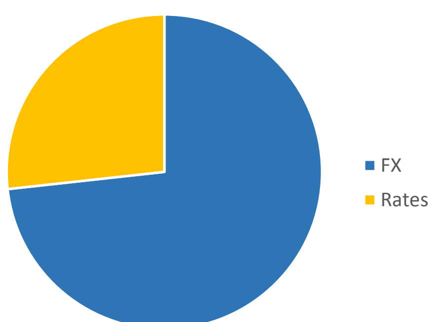
Characteristics

- Uncorrelated return stream
- Strong emphasis on capital stability
- Lowers overall portfolio volatility

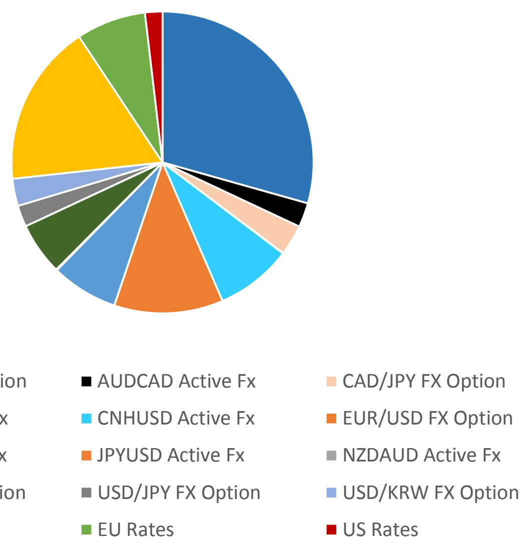
Net Performance

	1 Month	ITD
Global Macro Fund	-0.59%	-0.59%
RBA Cash Rate	0.13%	0.13%

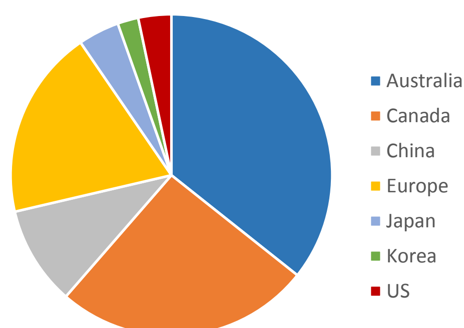
Asset Class Exposure



Portfolio Exposure



Geographic Exposure



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Portfolio Commentary

The portfolio modestly underperformed the RBA cash rate in the month of July. The three main investible themes we focussed on this month included:

1. Global industrial reflation

Portfolio was positioned in expectation of improving US wage data during the first half of July, contributing to the bulk of the negative performance for the month. The book had trades which would have benefitted from higher yields across the short end and belly of the US interest rate curve through option structures and steepeners, as well a cross asset hybrid structure contingent on USDJPY outperforming US 10-year yields, which took advantage of the high historical correlation between the two assets.

2. Removal of emergency easing from developed markets

The portfolio had a long AUDCAD FX exposure, which sought to capture the rotation in market focus from Canada (which had almost fully priced in 2 hikes by mid next year) towards Australia (which had relatively very little priced in the next 12-18 months). This view was optimised via an option structure overlay which took advantage of the term structure in the volatility markets and afforded steep discounts to only vanilla expressions. The portfolio also had a small short USDCAD FX exposure, which captured the weaker USD, and the hawkish rhetoric from the BOC, but did not expect for the overshoot in price action given the extent of rate hikes already priced in Canada.

3. Eurozone German outperformance, Eurozone dispersion narrowing

The book was long EURUSD FX in both cash and option format which performed well. However, this was offset by losses in short bund positons which experienced extremely volatile price action. Going forward the book has converted these bund shorts into an option structure which will better withstand the volatility in that market. Lastly, the portfolio also had some long exposure to China FX which took advantage of weaker USD, and positive carry experienced in EM space. The portfolio was also short CADJPY option structure as protection overlay in case of any risk off price action.

Outlook

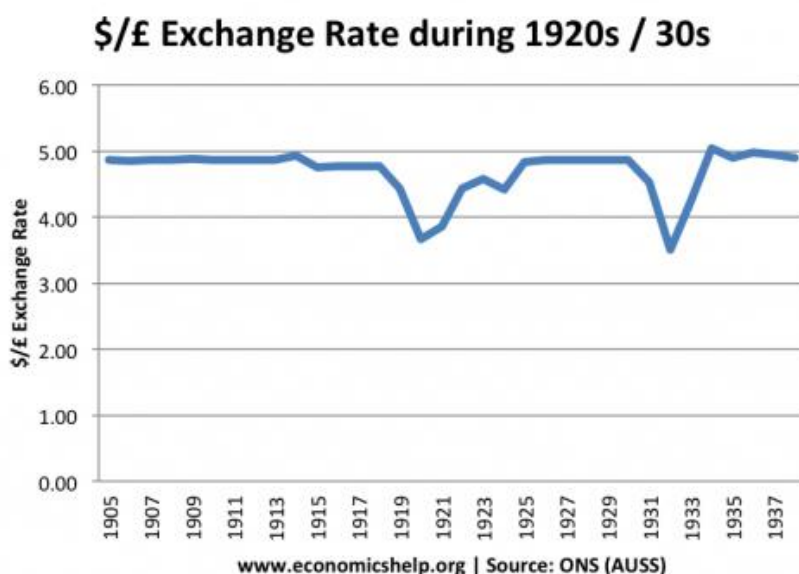
History never repeats, I tell myself before I go to sleep.

"Capital must protect itself in every possible way, both by combination and legislation." Montagu Norman, Governor of the Bank of England, 1924

On April 28th, 1925, Winston Churchill, then Chancellor of the Exchequer, rose before the Commons.

"It is imperative that I should fortify the revenue, and I shall now, with the permission of the Commons, proceed to do so."

He was returning Britain to the Gold Standard, which they had abandoned in WW1, at the same pre-war level of $4.85. There was much cheering and congratulations in the Commons and the financial press.



The Governor of the Bank of England, Mr. Montagu Norman, had been working towards a return to the pre-war level since he assumed the Governorship in 1920.[1] To Norman, to have returned to a lower gold rate, effectively a devaluation of the Pound, was unacceptable. He saw a return to the pre-war rate as "a moral commitment on the part of the British nation to those around the world who had placed their assets, their confidence, and their trust in Britain and its currency"[2]. He considered it his crowning glory.

The young John Maynard Keynes was stridently against it. When Churchill finally made his decision Keynes railed at those in charge of the Bank of England for acting like "the Louis XVI of the monetary revolution", and "for attacking the problems of the post-war world with unmodified pre-war views and ideas." [3]

Keynes was 100% right. Fixing the currency too high resulted in a decade of deflation.

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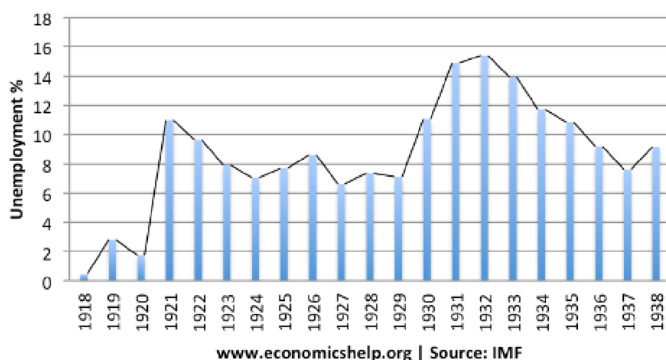
[1] Punishingly high interest rates in the early 20's to lift the pound towards 4.85 created an 8% rise in unemployment…

[2] Lords of Finance: The Bankers Who Broke the World. By Liaquat Ahamed. One of my all-time favourites

[3] Lords of Finance

And decimated industry in England, locking unemployment at 8% for most of the decade.



This stood in stark contrast to the French, who devalued 80% post WW1 and enjoyed a booming 20's.[4]

Did Churchill have regrets?
"In later life, he [Churchill] would claim that it was "the biggest blunder in his life". He blamed it on the bad advice he had received. In an unpublished draft of his memoirs, he wrote that "he had been misled by the Governor of the Bank of England [and] by the experts of the Treasury.""[5]

For Norman, he was simply fulfilling his mandate. Unemployment was not in his mandate, nor for that matter inflation. It mattered not that the mandate had outlived its usefulness…

So why am I interested in this window in history?

Today's central banks are fixated on a mandate developed in the early 90's in response to the unhinged inflation of the 70's and 80's. **Inflation targeting**. Designed to achieve low and stable inflation. And all, to a large extent, were successful.

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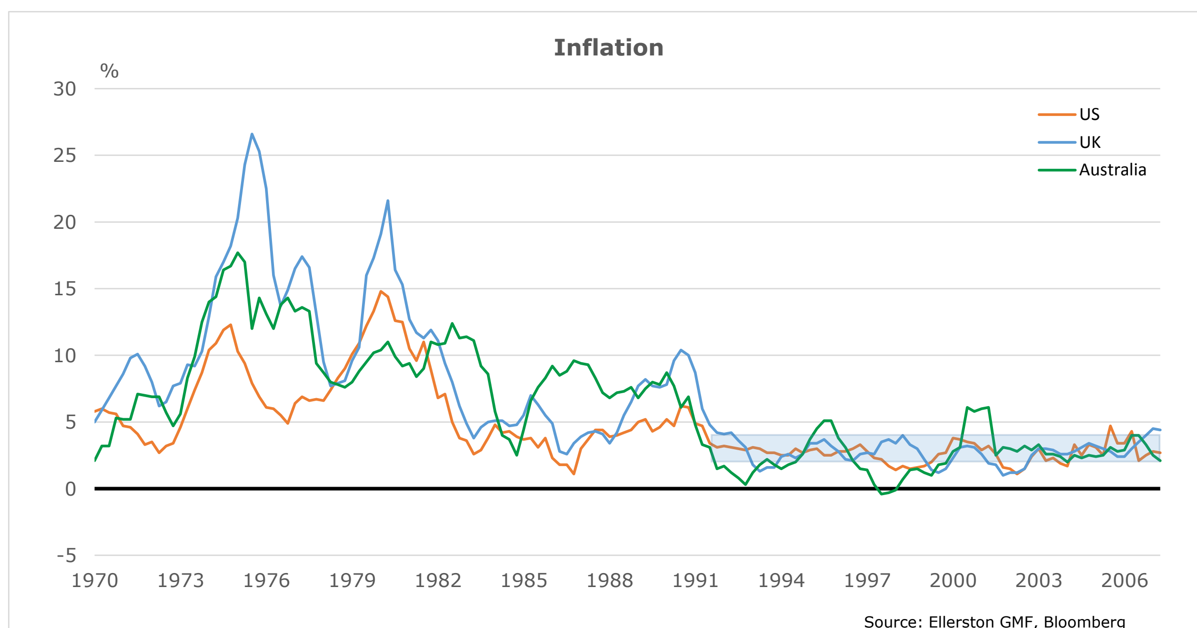
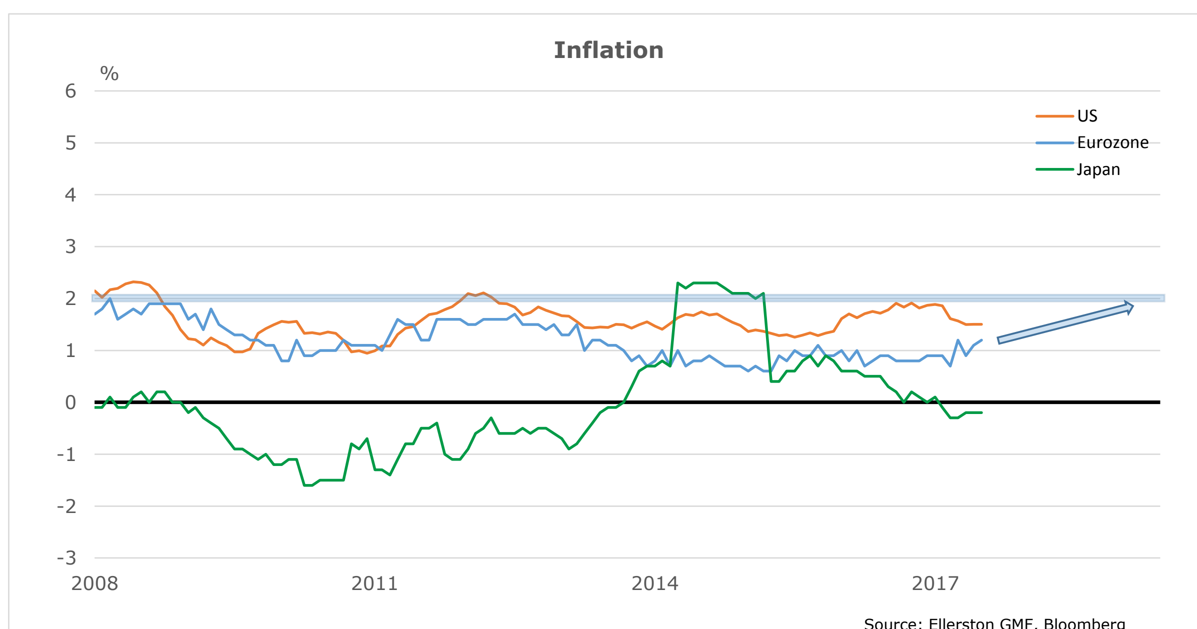
[4] The volume of industrial production, which had fallen to 55 in 1921 (indices are in constant prices, 1913=100), reached 140 in 1930

[5] Lords of Finance (again)



But then we move post the financial crisis, and inflation often fell below its "target". Returning inflation to target became the new mantra for maintaining zero and in many cases negative interest rates. In Europe, Japan and the US the imperative to return inflation to 2% has seen the experimental application of massive central bank bond purchases and in some cases negative interest rates.



Because deflation – falling prices, is an economic disaster, or so the argument goes, and it is imperative to move away from that precipice, or God forbid face the fate of Japan. [6]

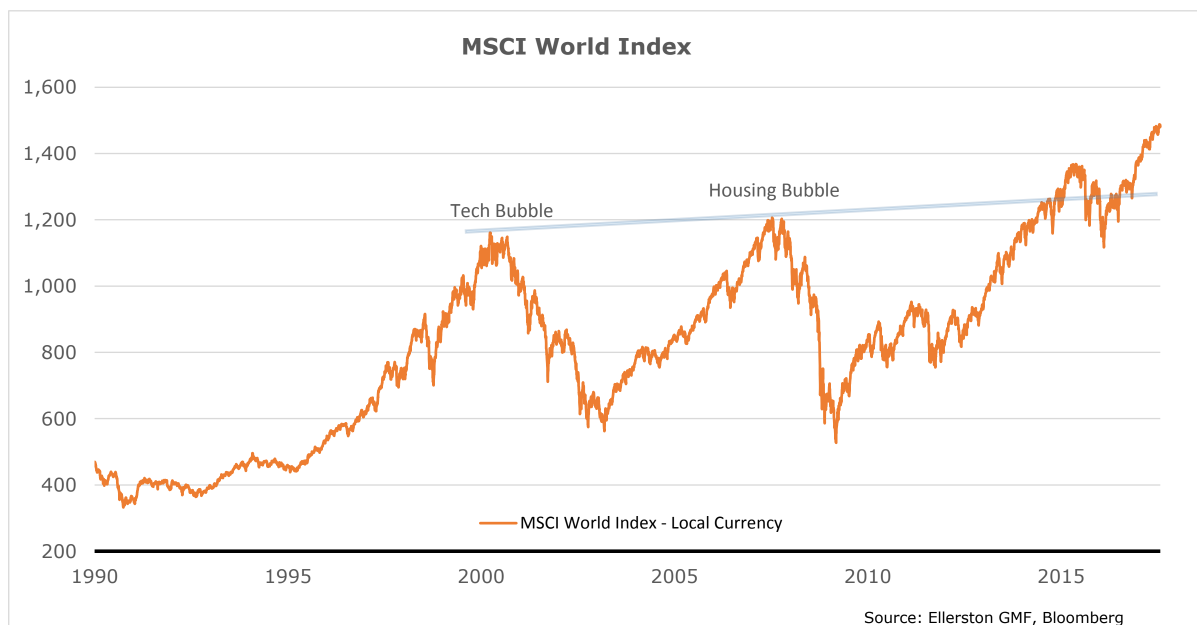
Alas, Japan and the 1930's Great Depression are the only examples of deflation in the last 140 years being a problem. The Bank for International Settlements studied 38 episodes of deflation[7], and found only in Japan and the Great Depression was there any relationship to growth. Why? Deflation only matters when there is property price deflation and high debt. Goods deflation is …good.

[6] It matters not to the argument that unemployment in Japan is 2.8%, or that GDP/per capita in Japan is stronger than Australia!

[7] The costs of deflations: a historical perspective by Claudio Borio, Magdalena Erdem, Andrew Filardo and Boris Hofmann

Yet we watch as many central banks morph their price stability mandates into a hard mandate to achieve 2% inflation regardless of the consequences.

Will they drive another asset bubble/crash?



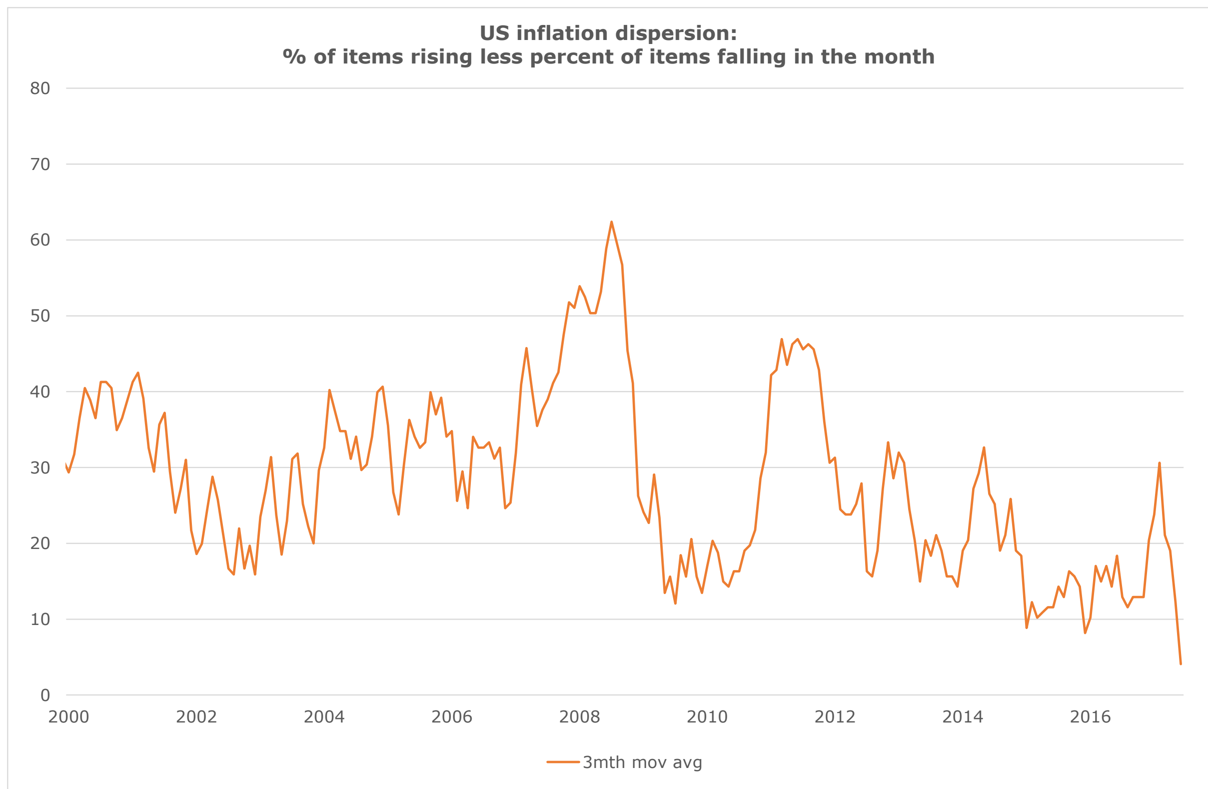
Will they suffer the same tragic judgment that followed the dutiful service of Mr. Montague Norman? Belligerent application of a mandated policy that has not just outlived its usefulness, but does pernicious harm…

The answer I suspect is not in yet. But the answer will be the sole driver of your portfolio performance over coming years.

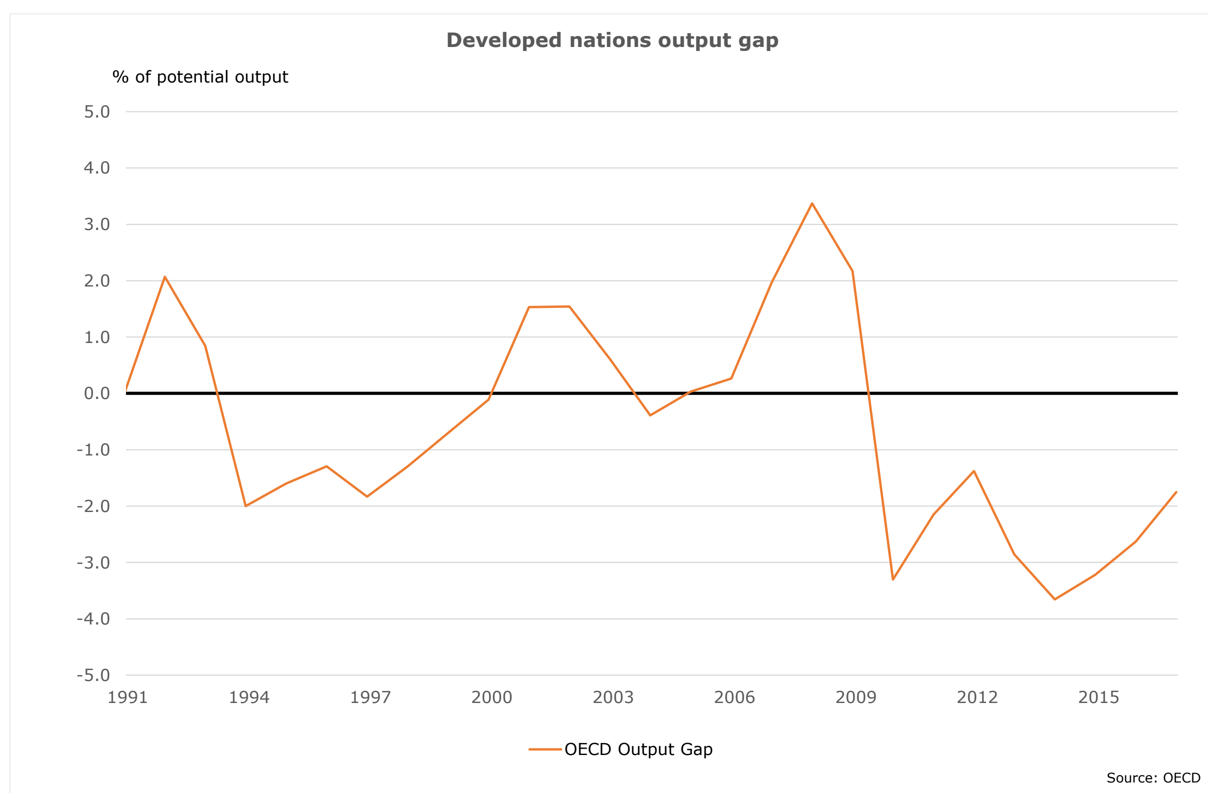
There are grounds to be encouraged. So far this year the Fed has been more determined than most imagined to raise rates. Are they implicitly putting more weight on financial stability? The Bank of Canada suddenly raised rates in July. Yet core inflation is only 1.4% in Canada. Did a 28% rise in house prices in Toronto over the last year tug that financial stability lever in the BOC conscience? Lowe at the RBA notes a stabilisation in household debt/income would be desirable…

So what happens next?

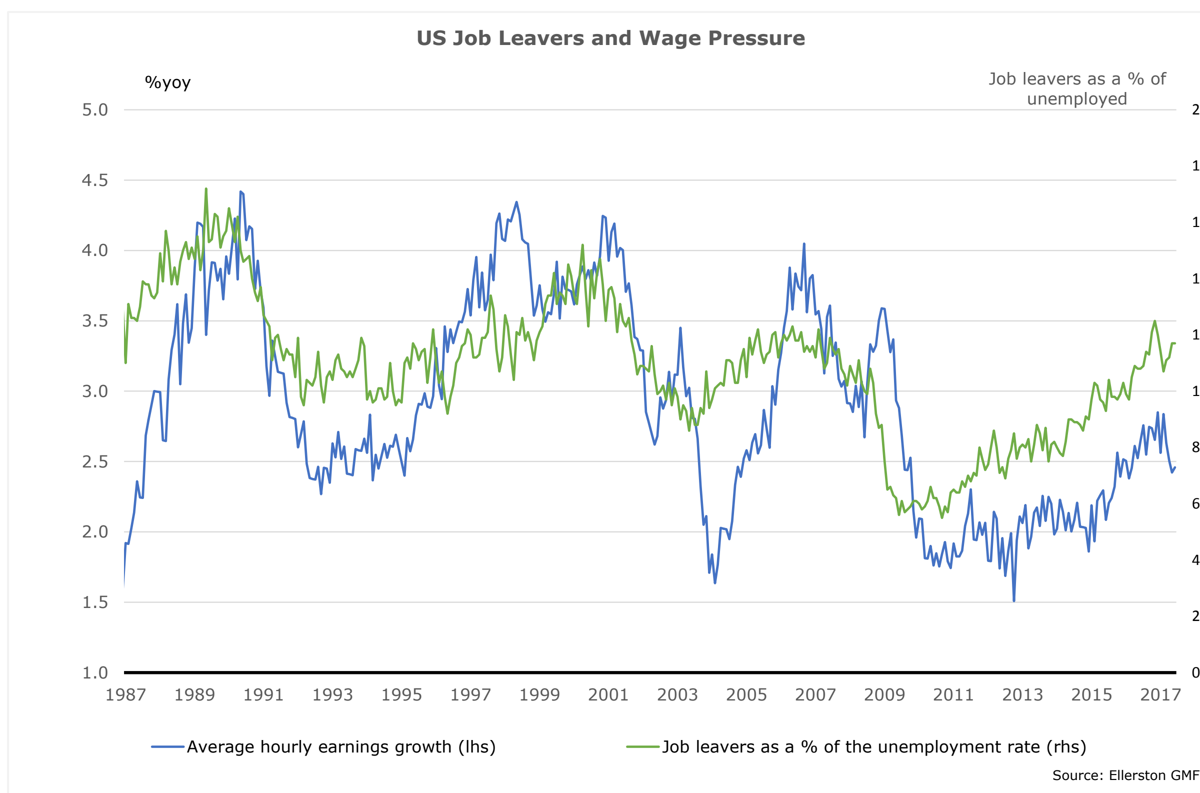
Well, first off inflation is low. And it will likely stay low for the next 12 months, possibly longer. There is a global secular downforce on goods deflation, driven by technology and hedonic (quality) adjustment, which leads to rolling downside “surprises” in the CPI basket each release.



And it will be sometime before global output gaps close and pressure inflation higher.



At some point, tight labour markets will push wages higher, and then inflation a little, but it will likely not be dramatic. Lead indicators in the US of wages suggest the rising trends are intact, but recent softness in actual wages means it will take some time for that trend to be realised.



Hopefully central banks will at least fudge their inflation forecast so they have room to address financial stability by slowly raising rates. To be clear, I don't think central banks should jettison inflation targets. But I do strongly believe they should broaden their inflation target and be more sensitive to credit creation/financial stability issues.[8]

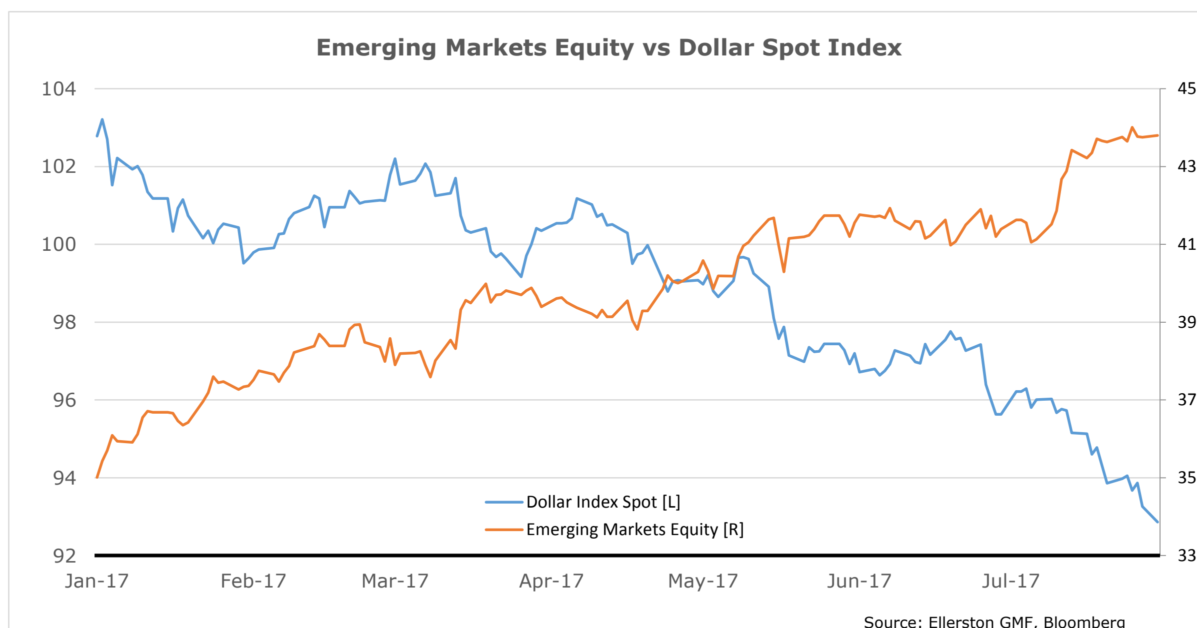
Is our portfolio positioned for this? Of course not! There is no room for hope in a portfolio. For now we expect the Fed to "back off". Inflation has surprised 4 months in a row to the downside in the US. They have flagged their taper of bond re-investments for September/October, giving them breathing space to make their next decision on a rate hike in December.

In June I cheered Ms Wilkins from the Bank of Canada, as well as the Bank of England and European Central Bank for stepping up their hawkish rhetoric. For mine, it was an implicit reweighting by the central banks towards financial stability in their mandates. At a minimum a reweighting of the balance of risks. We will monitor central bank communications very closely in coming months to discern if their weighting is shifting. I think it is, but if not history - bubble history - repeats.

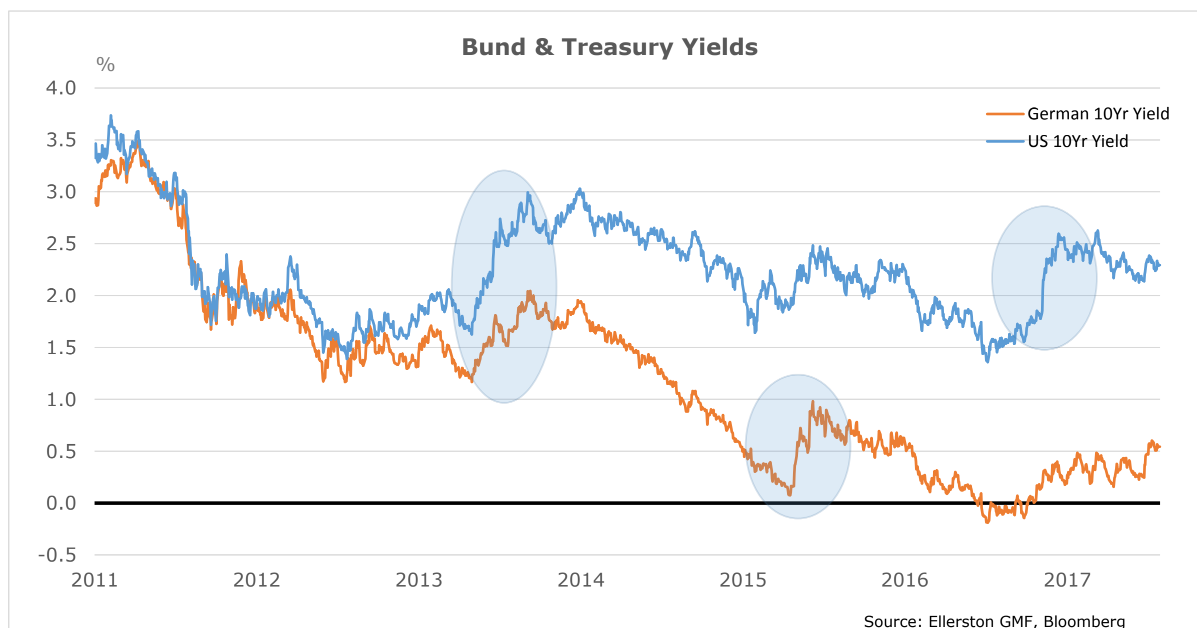
In the next couple of months little will likely change. The Fed will take its time now. A softening in recent data in the UK, and a rotation of Governors, will likely see them sound a tad less hawkish. Canada won't make another decision until October. And the RBA is in no rush to lead the pack and strengthen their currency.

For markets, that suggests goldilocks can continue a little longer yet. That is **US and emerging market equities grinding higher amid low volatility, bonds yields range bound, USD weaker**. Absent a Trump shock – China tariff, North Korea strike or impeachment. Our positions are modest but biased in that fashion.

[8] As the Fed has consistently argued, targeting asset prices suggests they are better at identifying bubbles than the market. I would agree they should not target asset markets per se. But they should be acutely aware of the risks of debt driven asset prices.



The elephant in the room is still the global unwind of central bank bond purchases. Whether the market prices this slowly over a number of years, or dramatically in a number of months, is something all portfolios should be prepared for. **We are happy to position in option markets for higher 10 year yields in the US and Germany,** given we can't be sure of the timing. Bond sell-offs when they come tend to be sharp - even the modest ones in recent years.

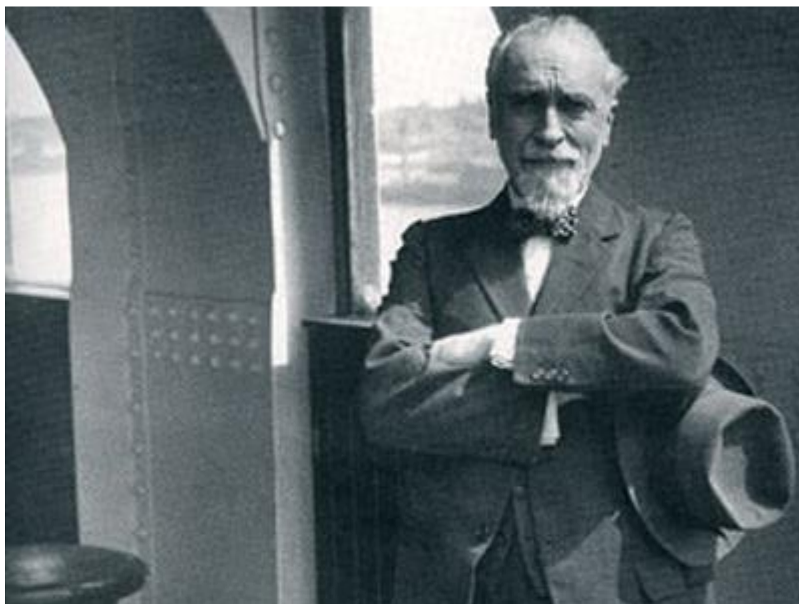


As the year progresses, we will get a better handle on how the central banks are weighing risks (financial stability). There are three main scenarios;

1. Stronger global growth allows the risk focus of central banks to turn to financial stability/bubble risks and slowly normalise interest rates. This is still our central scenario for the US, say 60%, and involves a relatively painless normalisation of rates for equity markets, albeit creating some volatility. **We expect strength in economic data and financial stability awareness to lead to more rate hikes in the US and Canada this year, and first rate hikes in the UK, Australia, NZ and Europe over the next 3-15 months (probably in that order).**

2. Low inflation keeps central banks on hold. Housing and equity markets will love this and a bubble will ensue – and burst. The bust would be a couple of years from now. In the short term risk parity funds love it. Say a 15% chance, but then again perhaps I have too much faith policy makers have learnt…
3. Wages suddenly accelerate in the countries with low unemployment. The US is most at risk here, and that would drive a bond crash and equity capitulation. We would still assign a 25% risk to this scenario.

When it comes to the emphasis on financial stability, the various central banks will cast varying shadows. Let's just hope not the shadow of Montagu…



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