Ellerston Global Macro Fund

Newsletter – August 2017

ELLERSTON CAPITAL

Fund Facts

Inception date	1 July 2017
Liquidity	Daily
Management Fee	1%
Performance Fee	15%
Strategy AUM	$10 million
Firm AUM	$5.0 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.

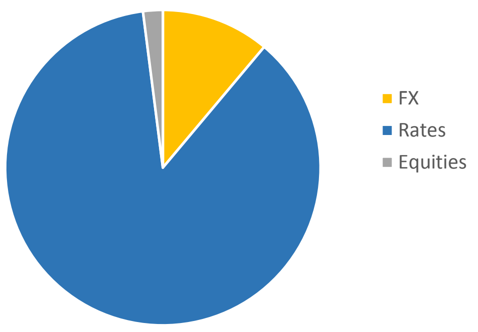
Characteristics

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

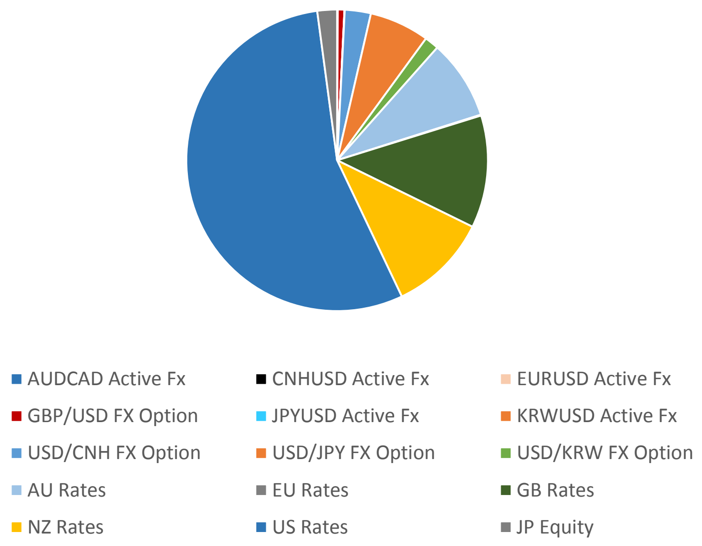
Net Performance

	1 Month	ITD
Global Macro Fund	-0.90%	-1.49%
RBA Cash Rate	0.13%	0.25%

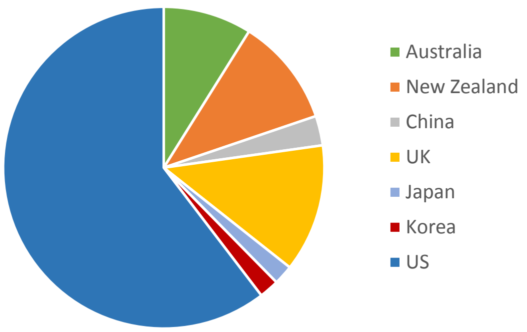
Asset Class Exposure



Portfolio Exposure



Geographic Exposure



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Portfolio Commentary

August was a particularly volatile period for markets, with a stream of risk-off headlines from North Korea, Hurricane Harvey, as well as Trump's controversial Charlottesville remarks. The latter resulted in his business councils being disbanded and worries of a possible Gary Cohn exit from the Administration. The market also struggled to digest the fifth consecutive disappointment in US CPI, leading to the largest single monthly rally in rates in over a year (18bps), and further consolidation of the US Dollar Index (DXY) sell-off from July. The chances of an additional Fed hike by the end of the year reduced to less than 30%. Locally, our view of abating headwinds from an improving WA story continued to play out in the robust data prints through August, including strong building approvals, retail sales, rising business confidence, and respectable capex intentions, giving us increasing confidence for an RBA hike by mid next year.

As outlined in this month's thought piece, we expect bond yields globally to rise significantly over the next year. The strategy for the portfolio during August was to identify and establish medium term trades for rising rate markets, on a 3-4 month horizon, which the portfolio could hold during any sustained period of market volatility. We overlaid these positions with varying levels of insurance to protect the portfolio through any geopolitical risks and hurricane headlines, including options on gold, US government bonds and stocks, USDKRW and USDJPY. In each case we analysed the structure and shape of the yield curves and volatility markets to arrive at attractive risk/reward ratios, and to optimise asymmetric payouts. Some of this protection was short dated and designed to cover only outsized moves, which came at a modest cost (seen in the small negative performance in equities for the month) but provided insurance to the portfolio in case of North Korean conflict or massive hurricane damage, and allowed us to sit comfortably on our higher conviction rate short positions. We also looked across different asset classes to try and identify where correlations and excessive skews could give us an opportunity for cheap hedging - these opportunities worked best for when fear and tensions escalated, but never resolved in any sustained downturn. Markets like USDKRW and USDJPY which are highly sensitive to headline geopolitical risk, allowed us to construct excellent risk/reward combinations in the exotic options space that would reduce losses on a sustained fall in US yields, but would not limit profits on a rise. USDJPY is particularly useful to hedge our rates exposure, as the correlation between the US 10-year yield and USDJPY over the last 3 months is 76%.

The themes remained broadly the same in August as in July, including global industrial reflation; Eurozone German outperformance/Eurozone dispersion narrowing; and the removal of emergency easing from developed markets. We spent considerable time focussing on a couple of new proprietary models which broke down the constituent baskets within US CPI and gave us renewed confidence of an uptick later this year; and also some modelling of how the cumulative slowdown in global flows due to simultaneous taper from central banks may impact global yields. A paper on Quantitative tapering is available on the Ellerston Website: https://ellerstoncapital.com/wp-content/uploads/2017/09/Tim-Toohey-Quantitative-tapering-1.pdf

Key positions that we accumulated over the month include exposures which would benefit from:

- a higher probability of hikes being priced in the US by December 2017 as well as by December 2018;
- an increase in the relative number of hikes between June 2018 and 2019 priced into the US curve vs UK curve (given our view of improving US data, in particular for US CPI in Q4 this year vs data starting to turn down in the UK, and Brexit timeline);
- US 10-year Treasury yields rising back towards the 2.40-2.60% range seen earlier this year;
- an increase in the relative number of hikes to be delivered by RBA vs RBNZ by the first half 2018.

Outlook

How deep is your love?

The way to build long-term returns is through preservation of capital and home runs.

Stanley Drukenmiller

What is global macro?

Wikipedia says "Global macro is an investment strategy based on the interpretation and prediction of large-scale events related to national economies, history, and international relations." They add "Global macro trading strategies are based on educated guesses about the macroeconomic developments of the world."

"Educated guesses"? Well yes. All investing is based on "educated guesses".

So what is the secret to a good macro manager? Good educated guesses?

The secret, I would say, is discipline. Every macro manager that has been around for a long time shares one trait. They protect capital. That means it is not about being a good guesser. It is about not losing too much money when you are wrong. Of course the job is a lot easier if you are right, but some of the best returns are generated by managers who are wrong more often than they are right.

I'm fortunate enough to have worked with one of the best, Paul Tudor Jones, for 11 years. Discipline was his mantra.

At Tudor, like most firms, we had a conference every year. And many years Paul would have a "fireside chat" in front of the traders with another invited macro giant, discussing how they approached global macro trading.

For me, there were two observations.

Firstly, they all knew what their edge was.

Secondly, they all controlled their losses.

Clearly the edge was often very different, but the discipline was a constant.
Stanley Druckenmiller I found very interesting. In 2010 he closed Duquesne Capital. At the time he said "he'd been worn down by the stress of trying to maintain one of the best trading records in the industry while managing an 'enormous amount of capital'." [1]

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[1] *Burton, Katherine (August 18, 2010). "Druckenmiller Calls It Quits After 30 Years as Job Gets Tougher". Bloomberg*

He said to us that he felt like a boxer that had taken too many hits to the head...

But Duquesne had not had a loss in its 30 year history of managing capital, and an average annual return of 30%!

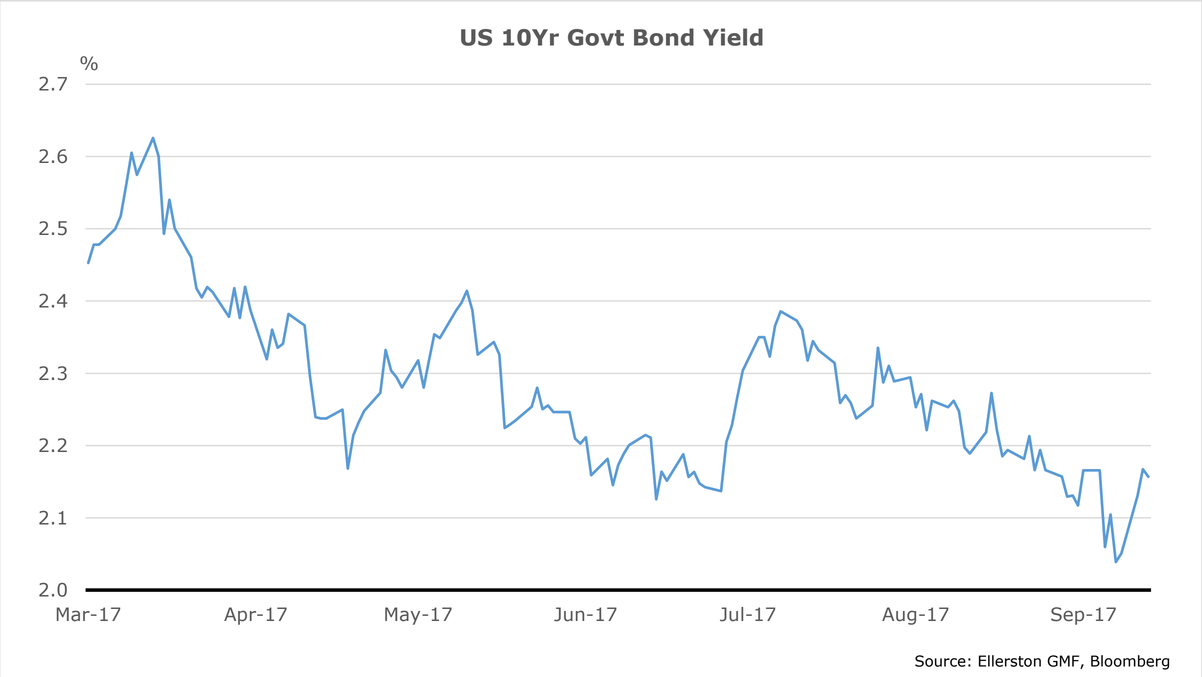
Clearly he was putting a lot of pressure on himself.

But what fascinated me was the difference between Paul and Stanley's trading style. Paul was typically relatively short term, a few weeks to months. Sometimes days. Stanley was long term, 6 to 18 months. And he talked about the difficulty of sustaining a view and confidence through that horizon, particularly when the market was going against you.

Clearly Stanley was not always right. He got hurt in the tech crash in 2000. He talked of painful positions in EM markets. Every macro trader, even the greats, get it right and wrong. Often more wrong than right. But then it comes to the discipline.

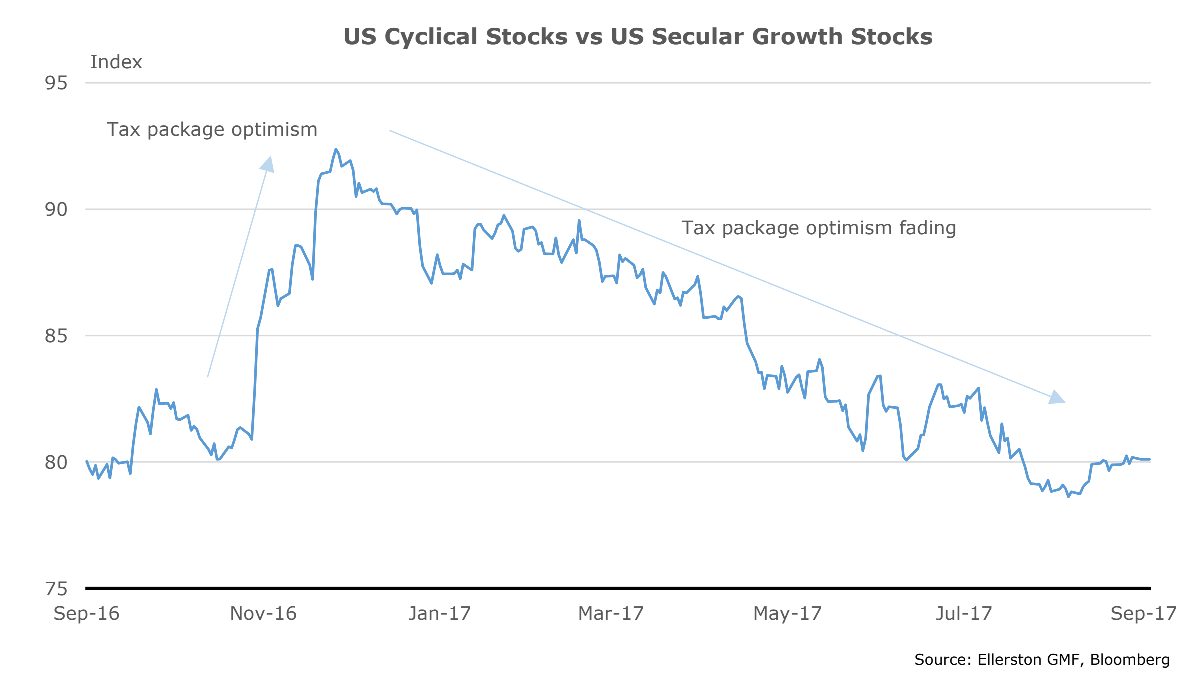
So what's my edge? This is not an egotistical question. Every active investor needs to understand why they can outperform the market. For me, it is twofold. Firstly, a better than average ability to forecast economies and markets on a 3-9 month horizon. Secondly, the ability to construct a portfolio that can weather volatility whilst I wait for my view to transpire, or not.

This year again it would seem every macro forecaster is getting it wrong. At the start of the year most were convinced bonds yields were going to rise and this would trouble equity markets. Myself included. Yet yields are 40 basis points lower, and equities 10% higher. A bad educated guess?

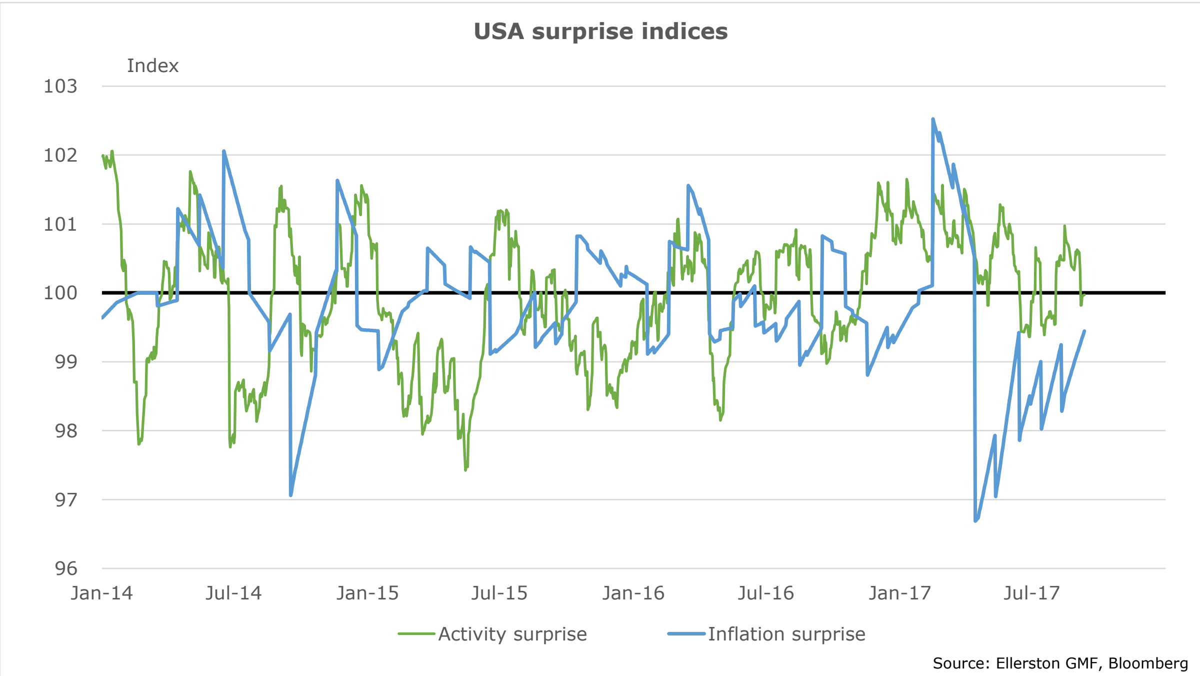


Quite possibly. So why was the consensus so wrong? Well in hindsight the answer is easy

a) Trump hasn't delivered



b) US inflation has surprised lower for 5 months in a row now

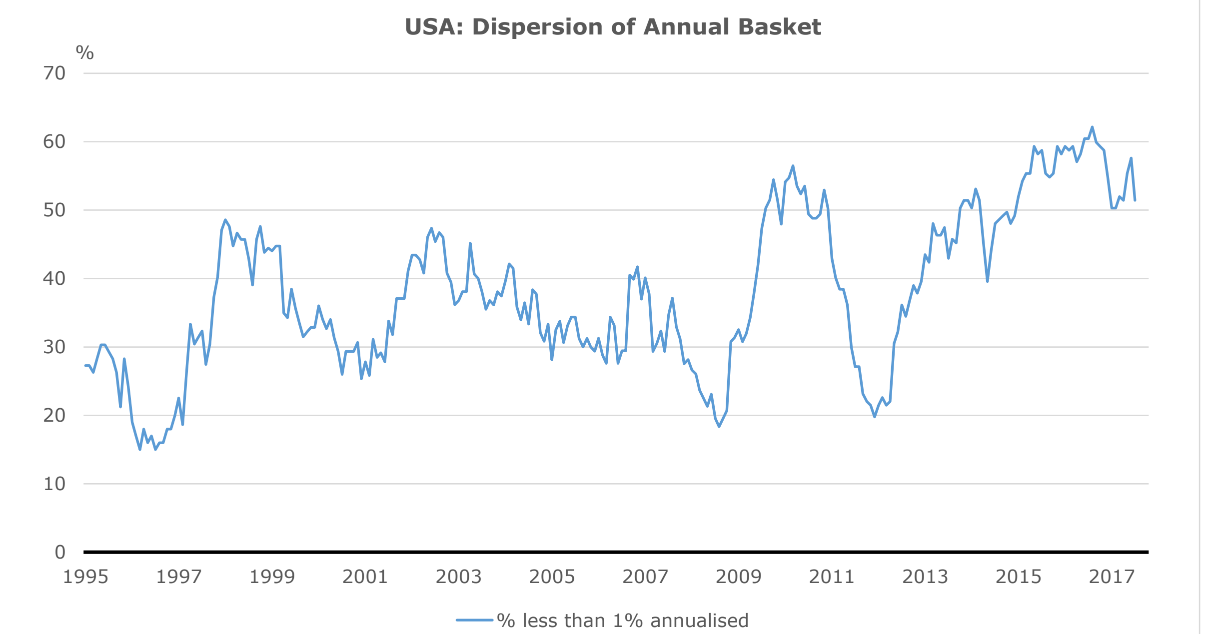


Some might say we shouldn't be surprised by Trump not delivering. Perhaps. But given expectations of Trump delivering anything now is close to zero, it would seem he can only pleasantly surprise from here (at least on tax!). Perhaps the mistake people make now is assuming tax reform depends on Trump. It is Congressional Republicans leading the drive for tax reform now. They have the mid-term elections next November, and it is imperative for them that they deliver something. As Cohn said in the FT a fortnight ago

In the next three or four weeks the tax bill will be written in the ways and means committee and Congress is going to own the writing of legislation — that is key. They are going to create the piece of legislation — we feel there will be enormous buy-in from the committees — and we will try to do this in an accelerated basis.[2]

Anything would be a positive! I expect a package to be passed by January costing USD 1-1.5 trillion over 10 years, focussed on tax cuts for low to middle income, and a 25% corporate rate.[3]

What about inflation? Five downside surprises surely mean "something" is different. It was certainly a question we were asking. Our economist, Tim Toohey, wasn't satisfied with the explanations of "one-offs". He noted that the soft inflation readings had very wide dispersion – most of the items in the CPI basket were falling.



Source: Ellerston GMF, Bloomberg

So were we in a new regime? Tim did a deep dive on US inflation – Aussie style. He broke inflation into 5 subcategories and modelled their influences. You see, most of the movement in inflation is not driven by how strong the economy is. In fact, only about 35% is driven by the economy. The rest is driven by the currency, energy prices, taxes and other factors that Tim identifies. (He will be releasing a detailed note in coming weeks on the Ellerston website).

The bottom line is the lags and drivers of each basket are very different, but we had a co-incidence of all 5 baskets falling in the last 6 months driven by very different factors. So that's good – we understand why inflation was so weak. What now? Well, Tim's analysis now shows inflation will rise about 0.5% over the next 6-9 months. Now that would surprise the world. And in particular the bond world.

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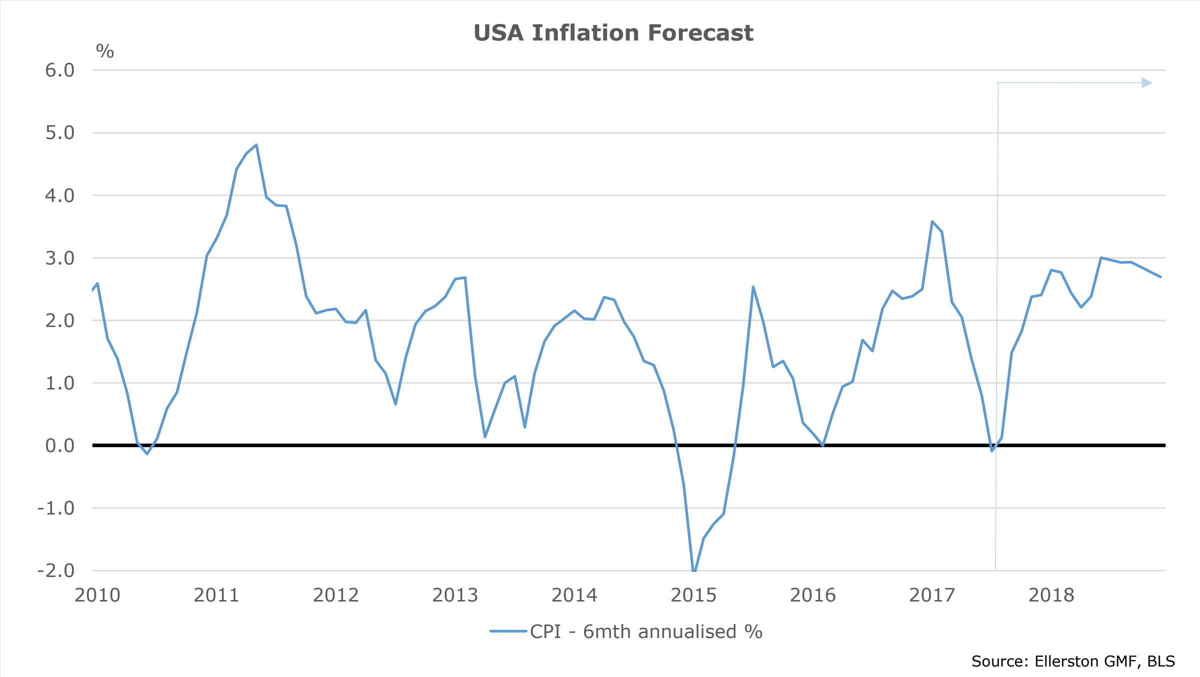
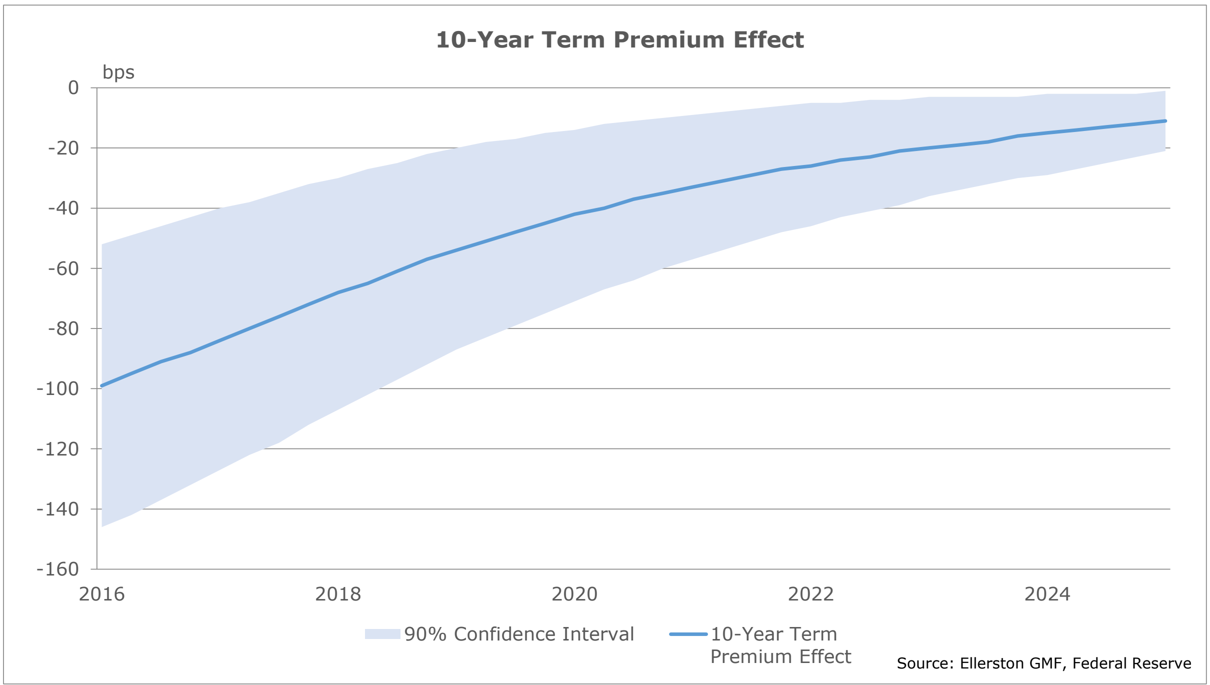
[2] https://www.ft.com/content/cb068f94-8915-11e7-bf50-e1c239b45787

[3] Three of our Washington consultants are telling me this, so it is clearly taking shape.



What about the unwinding of global quantitative easing that everyone is talking about? It's starting to sound like the boy who cried wolf. The central banks, and in particular the Fed and the ECB, are desperate to achieve a wind down of their bond holdings without causing a "taper tantrum" like 2013, when yields rose 160 basis points in 6 weeks…

The Fed analysis argues the wind down of its bond holdings will cause yields to rise 85 basis points over 6 years, some 10-15 basis points a year.[4] Inconsequential really.



Our work suggests it is the change in flow (not stock) of global central bank (not Fed) bond purchases that will drive yields some 90 basis points higher as well.

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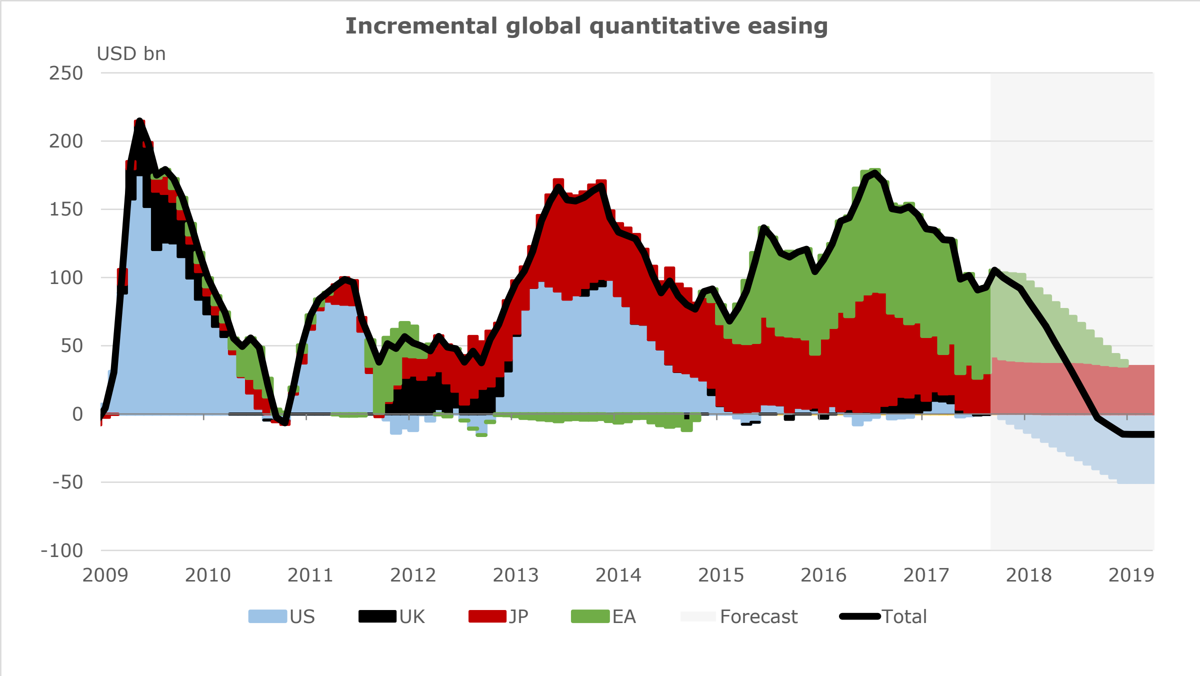
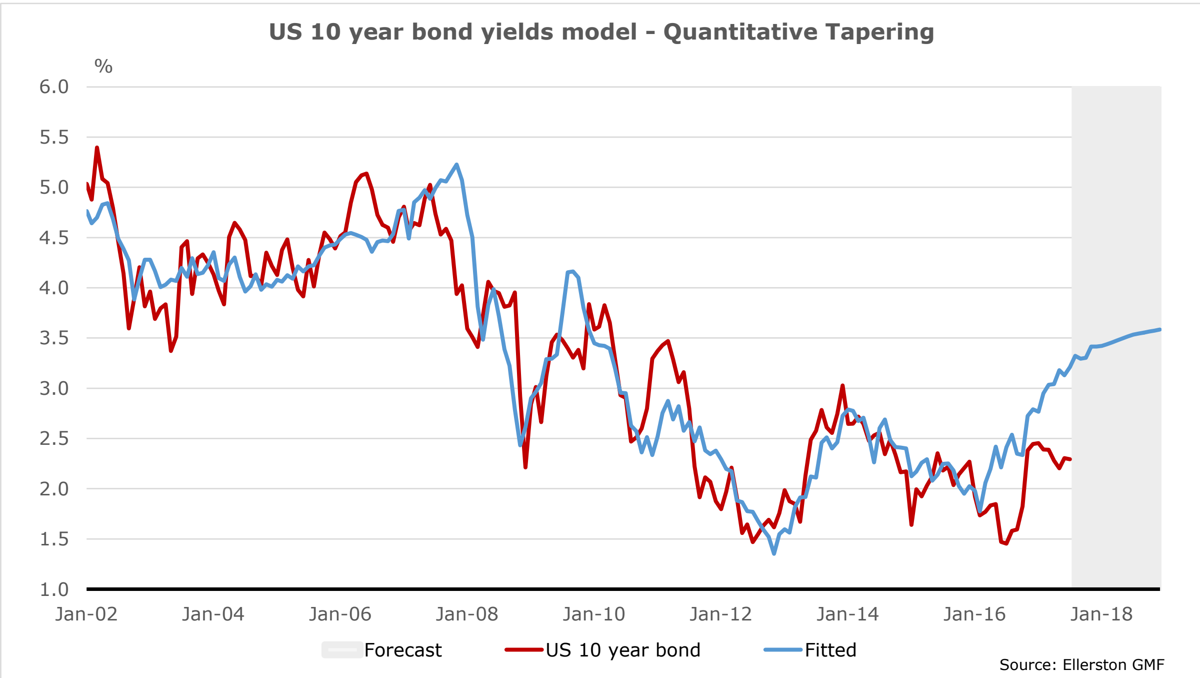
4 effect-of-the-federal-reserves-securities-holdings-on-longer-term-interest-rates-20170420.htm



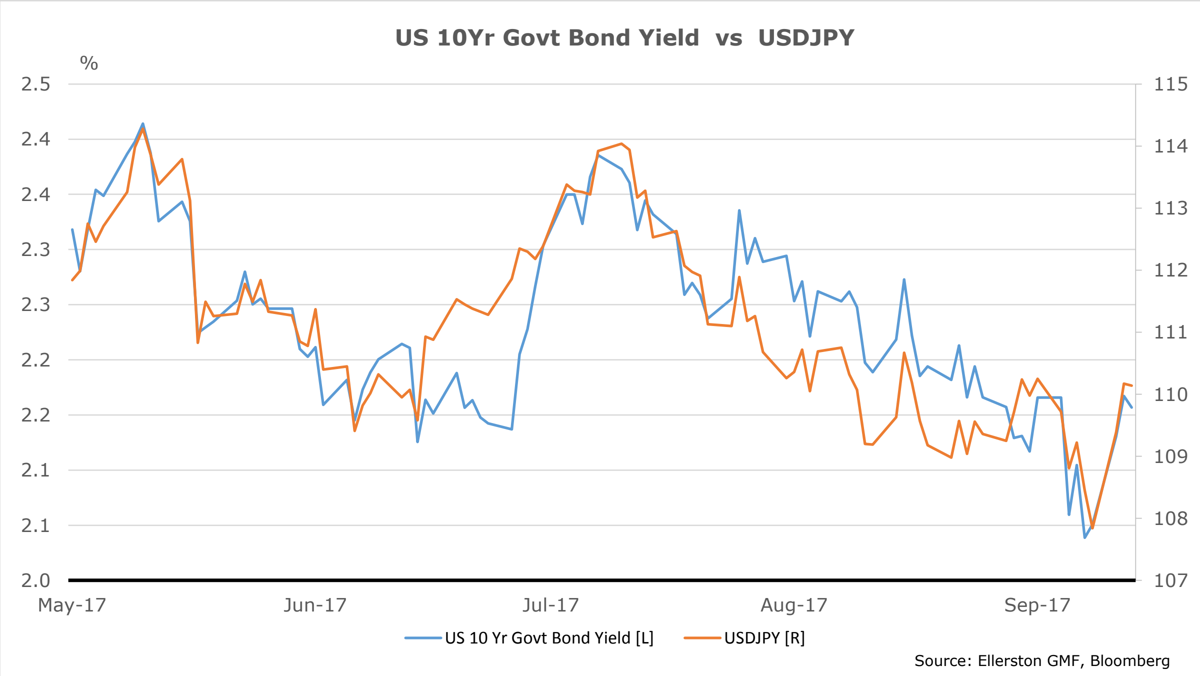
But by the end of next year, not 6 years!



So we have a strong view. We have done a lot of deep research. We have stress tested the thesis. I'm starting to relate to Stanley… at the moment we are focussed on preserving capital. Bond yields are rallying, we have to be patient and careful.

So how do we have exposure to rising rates, and preserve capital? **We expect our thesis to be validated in the next 3-6 months. So we position in the US rates market for higher yields over that time frame.** We have been doing that through August. We think we are clever about it – we have constructed a variety of structures that return between 4:1 and 8:1 for higher US rates over this period. We limit the loss to about 2-3% of capital.

We also have a few other tricks up our sleeve. We don't want to watch our option premium simply decay and have no offset. **So we use exotic options in FX to generate some income if markets do nothing.** The correlation between USDJPY and US 10 year yields is 76% over the last 3 months.



Without being overly complicated, the fear of an escalation of tensions on the Korean peninsula allows us to construct excellent risk reward in exotic option trades on Yen if US yields consolidate or move lower. This reduces losses on a fall in US yields, but doesn't limit profits on a rise.

The exotic options market for the Korean Won also provides excellent risk reward trades for heightened tensions. We have some protection there as well.

What if things got really ugly with North Korea? **From time to time we hold call spreads on gold, just in case.**

But at the moment our exposure in FX and gold is all "insurance" related. We hope to lose on these positions. But **it allows us to build a short US rate exposure and not be exposed to a catastrophic event, or even rising tensions.**

What if we are wrong? Well, we will lose a little bit of capital. But only a little bit. Capital preservation. That is key. How deep is your love? Ours has a limit!

Oh, and we have several other themes in the portfolio. More on that next month. The world is getting very, very interesting.

Brett Gillespie

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