ELLERSTON CAPITAL

Ellerston Global Macro Fund

April 2017 update

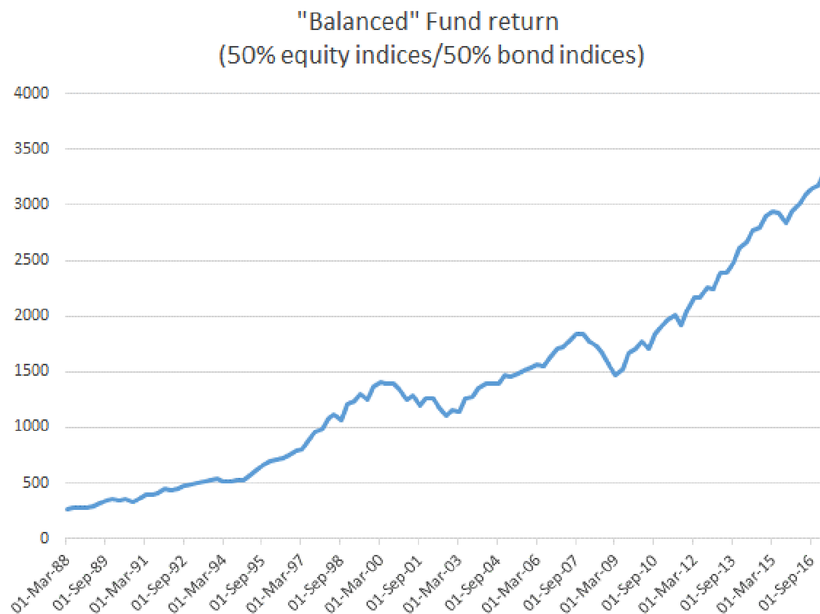
I should be so lucky, lucky, lucky, lucky

"No," the old man said. "You're with a lucky boat. Stay with them."

— **Ernest Hemingway**, **The Old Man and the Sea**

Are you lucky? Do you even know if you have been lucky with your investments? I would wager most investors in a balanced fund - holding bonds and equities, have no idea how "lucky" they have been.

Why? Two words. Quantitative easing. It has been manna from heaven for balanced portfolios.



Source: Ellerston GMF

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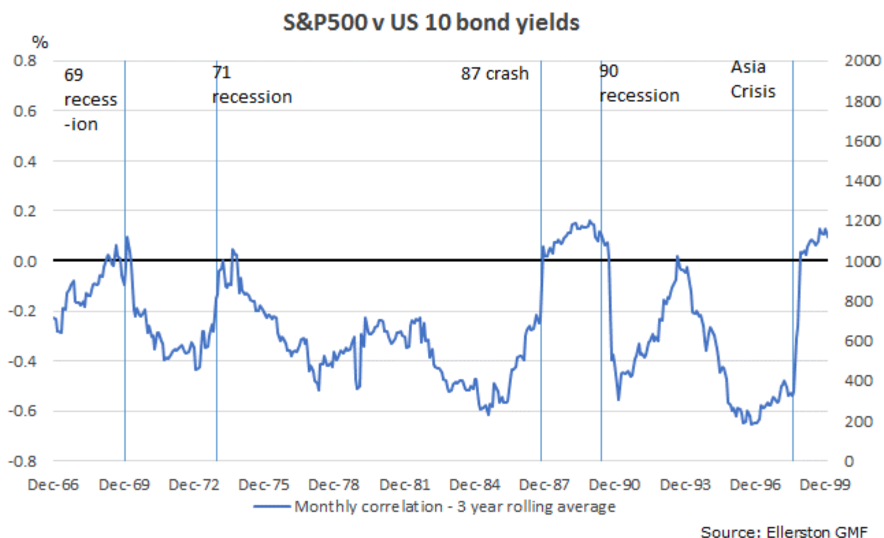
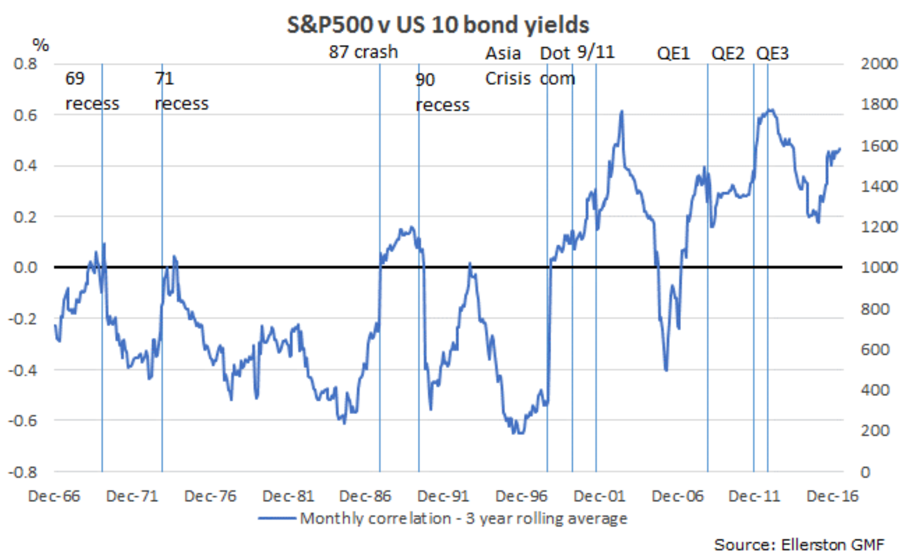
Do you understand why? It's because both bond prices and equity prices have rallied together. Isn't that great? Well yes, whilst it continues. But it is not what they were designed to do. They were designed to reduce volatility for a given return. QE has turned balanced fund logic on its head and provided stellar returns for balanced funds over the last decade. Now the unwinding of QE will work in reverse, at best providing very ordinary returns, and at worse double digit negative.

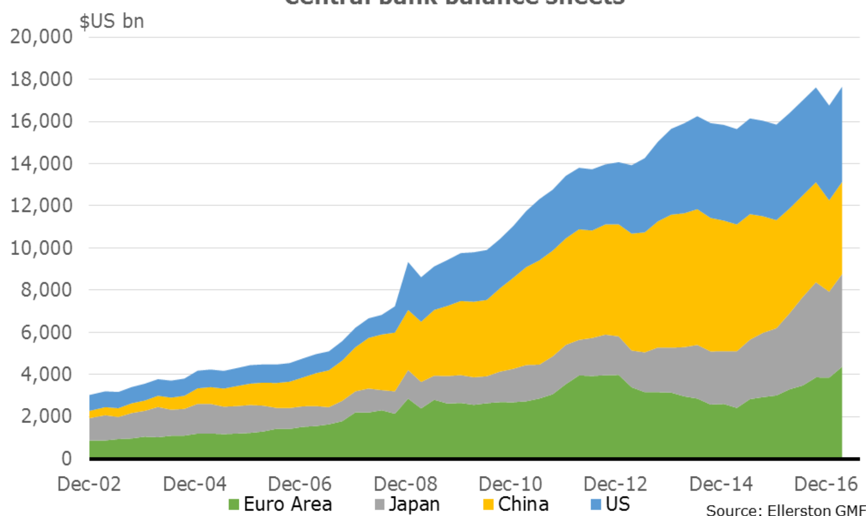
To understand why, we must first understand the basic logic of a balanced fund. Last century, the correlation between bond prices and equity prices was negative. What that meant was that when equity markets fell, bond prices rose. The gain in your bond holdings would offset the loss on your equities, and smooth your returns. This made sense. If equity markets fell sharply, it indicated generally that the economy was slowing. Hence a central bank would lower interest rates, supporting the economy. A balanced fund was a smart investment model.



As we moved into this century, the correlation changed. Bond and equities became positively correlated.



Why? It is easy to understand how QE reversed the correlation from 2009 to today. Central banks have made unprecedented purchases of their own bonds, dramatically suppressing bond yields.



The logic for the switch between 2000 and 2007 is less transparent. But it boils down to Greenspan taking interest rates much lower than history would have counselled, in his belief the economy could grow faster (the productivity miracle), and his aggressive response to stock market falls (what came to be known as "the Greenspan put"). Ironically, in 1996 Greenspan suggested caution in the stock market, warning of the famous "irrational exuberance" of equity markets. After a roasting for his "irrational exuberance" comment from both the press and congress, Greenspan switched his mantra, saying that bubbles cannot be identified in advance, but can be dealt with through accommodative monetary policy when they burst. The result was interest rates moving ever and ever lower, fanning one bubble after another.

Are we in the final bubble? Central banks globally have expanded their balance sheets with the explicit goal of lowering long term interest rates, in turn to support asset markets. And they have been very successful. Ten year yields in the US went as low as 1.36%, in Germany -0.18%, and Japan -0.29%! I'm pretty confident in saying we won't see new lows.

So if you have been invested in a balanced fund, you have received stellar returns because both your bond holdings and equity holdings have added value. Not what they were designed for, but hey, better lucky than smart.

But should you push your luck?

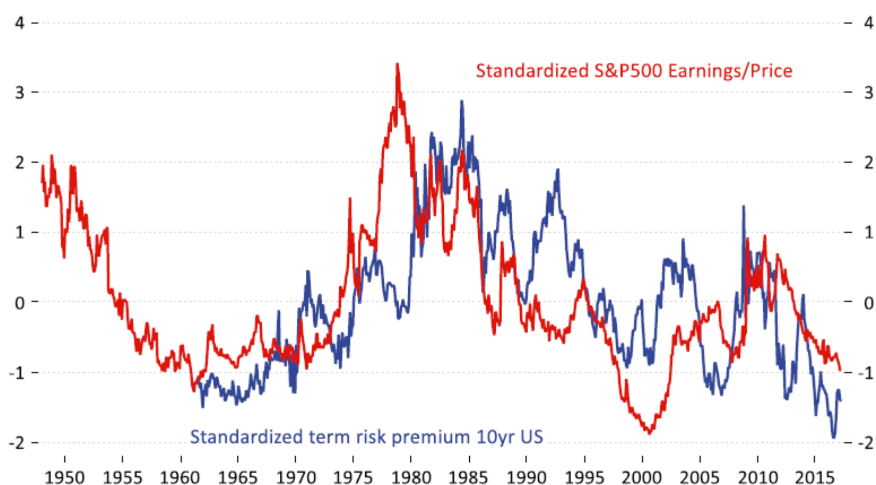
If you remember Clint Eastwood in "Dirty Harry" (was there another bullet in the gun? Is there another round of QE to come? The answer was/is no and no) then you are old enough to remember what a bond market sell-off looks like. Really there hasn't been a "proper" bond market crash since 1994. Most investment managers today can't imagine it…Even if they acknowledge QE has created a "bond bubble" they don't see it bursting. Just a very slow deflating…

Well, we know the Fed has stopped QE, and from next year they are going to start winding it back. We also know the European central bank is going to start winding back their QE next year. The Bank of Japan is still going, but they are in the 9th innings. So most concur that we are on the cusp of the bond bubble "deflation".

At this stage, most investment professionals emphasise low global inflation, driven by globalisation, technology and usually throw in demographics, and argue this will contain bond yields. Perhaps, if it wasn't already in the price.

What gets a little less attention is what the impact of QE has been on risk premium. It has compressed risk premiums, in both equity and bond markets. What does that mean? Put simply, it means you are not getting the usual extra return you would expect for taking risk in equity markets and bond markets.

Figure 4: Risk Parity has performed at the Expense of falling risk premia



Source: Applied Global Macro Research

And it turns out that risk premium itself is a very good predictor of returns on balance funds 10 years forward. The model from one of my favourite consultants, Applied Global Macro Research, suggests a balance fund will return 0% pa over the next 10 years as risk premiums normalise.

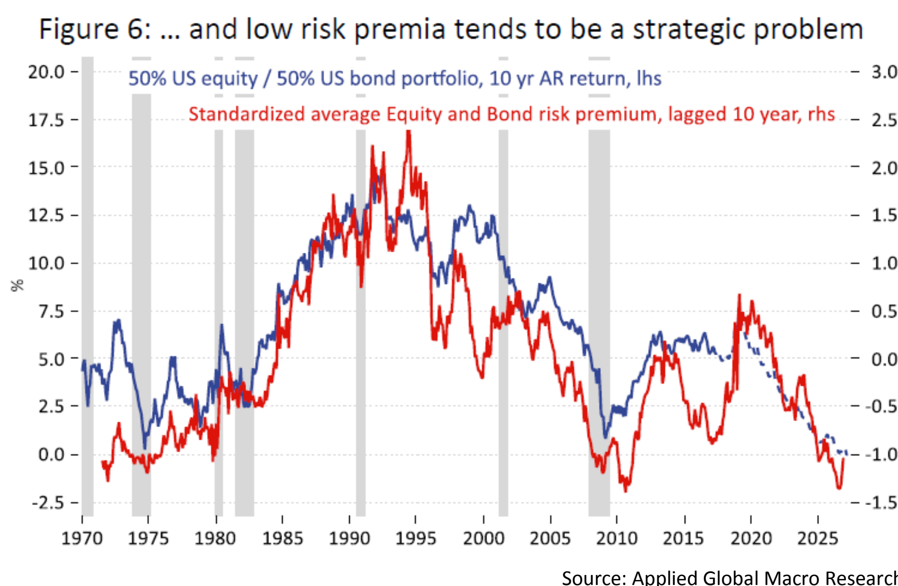


Figure 6: … and low risk premia tends to be a strategic problem

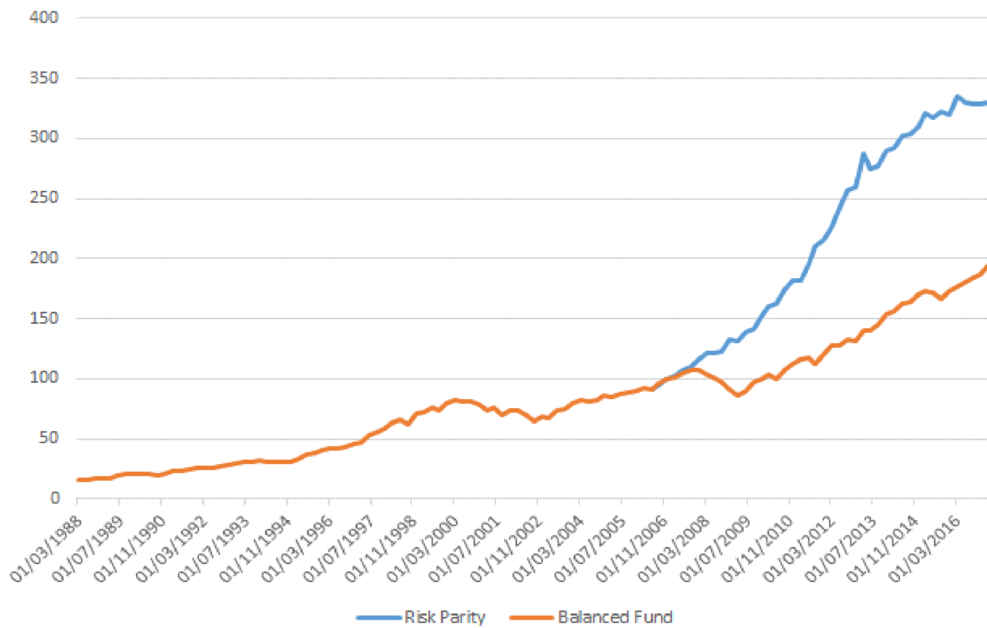
The above chart assumes a slow normalisation of bond yields. At the moment, as I wrote last month, we would assign a 30% chance to a significant bond market sell-off. The catalyst would likely be US growth north of 3%. We currently project 2.5% without a fiscal stimulus. A US tax package, when delivered, could take growth north of 3%…

Couple this with wages rising in the US, a trend clearly in place across a range of indicators and likely to increase as the unemployment rate falls further below NAIRU in the US, and you could very well get a bond panic. Which would drive an equity market sell-off. Which for a balanced fund holder means after winning on both assets for the last decade, you are suddenly losing on both. Your “luck” has run out.

So a 70% chance of say 3-4% in a balanced fund, or a 30% chance of negative returns over the next couple of years. Not sounding great.

Unfortunately it gets worse.

There is another group of investors that very intentionally took an exposure of long equities and long bonds in so called “risk parity” funds. Pioneered by the Bridgewater “All Weather” Fund back in 1996, risk parity means leveraging up the risk of less volatile assets - bonds - so that all the asset classes you hold carry the same risk. So for Risk Parity (RP) funds, QE has been manna from heaven - turbo charged.



Source: Ellerston GMF

It is estimated that RP funds are now approximately $500bn, even excluding in-house RP strategies in pension funds and insurers that have also embraced the concept. With leverage, that means that the RP industry now controls about $1.5tn of assets.

That is a ticking time bomb. Because they manage their exposure according to volatility, if markets get more volatile, they have to reduce their exposure. So let's imagine a bond sell-off that is so large it causes an equity market sell-off. As volatility increases, a RP fund has to reduce its holdings by selling both bonds and equities into a falling market. And then there are redemptions. There has been massive inflows into these funds over the last decade. This money will quickly flee. And the imposition of increased regulation on US banks mean as the selling comes, they can't "warehouse" the risk. Many are likening the rise of RP funds to the invention of "portfolio insurance" in the 1980's, a product that was supposed to protect stock investments by using derivatives, but played a crucial part in the Black Monday wall street crash of 1987. This would not be pretty if a trillion dollars of bonds and equities need to get sold quickly.

So rationally we have a 70% chance of a balanced fund returning 3-4%. (In that scenario, equities are still doing ok, it is bonds that are hurting). Or a 30% chance of negative returns. But we also have the potential dynamics in place for the mass exodus from RP funds driving these moves much further than anyone would expect. Or maybe not. Bubbles never burst right?

The moral; if you have been in a balanced fund the last decade you have been lucky. Now it is time to be smart.

Brett Gillespie

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