Ellerston Capital

Ellerston Global Macro Fund

May 2017 update

I'm coming home, coming home,

Tell the world I'm coming home

Luke, you will find that many of the truths we cling to depend greatly on our own point of view.
- Obi-Wan Kenobi

In early May 1915, several New York newspapers published a warning by the German embassy in Washington that Americans traveling on British or Allied ships in war zones did so at their own risk.

On the afternoon of May 7, 1915, the British ocean liner *Lusitania*[1], travelling from New York to Liverpool, was torpedoed without warning by a German submarine off the south coast of Ireland. It was a passenger ship, and among the 1,201 drowned in the attack were many women and children, including 128 Americans. The *Lusitania* sank in 20 minutes.

All vessels in UK waters at this time knew they were at risk of an attack. Indeed, there had been a number of smaller vessels attacked, but not a passenger liner. Captain Turner of the *Lusitania* believed the U-boats were not a threat as his ship was considerably faster than a U-boat. So he increased speed and made for port (home in my title of course. Bear with me there)

[1] For a fascinating account of the sinking of the *Lusitania* read "Dead Wake" by Erik Larson

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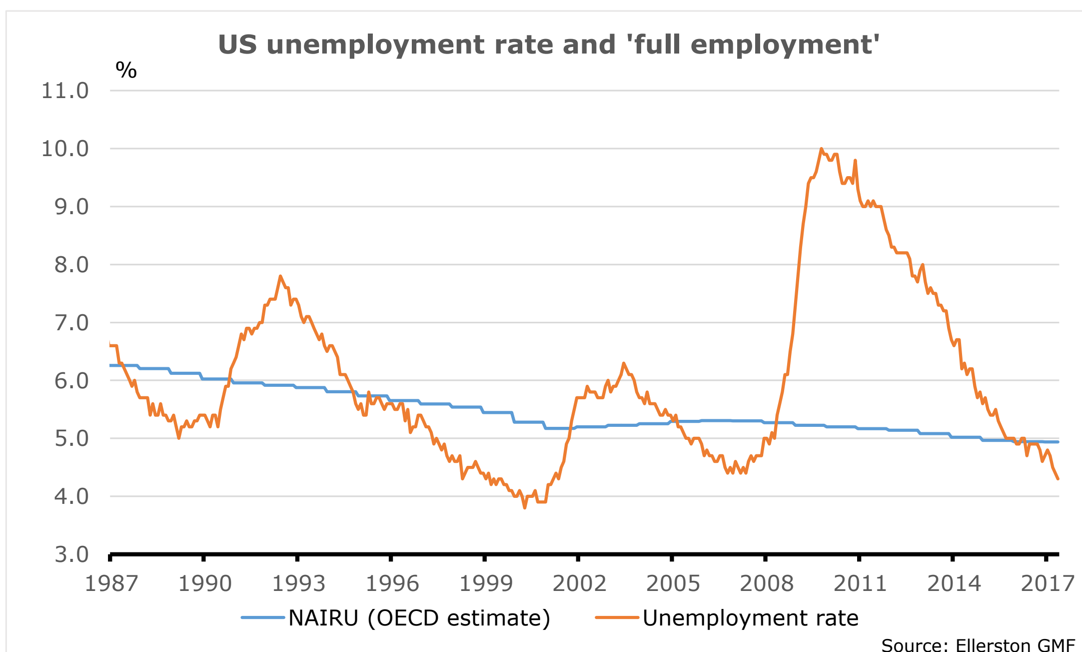
However, the British Admiralty advised Captain Turner to zig-zag so as to be a more difficult target. The *Lusitania* had already passed and left behind the U-boat, when it zagged and came back within range…

The moral to this story? When in dangerous waters, get to port (home). But make sure you have the right plan!

The Fed is in dangerous waters. Unemployment is well below NAIRU[2]. If wages were to lift sharply, the Fed has a lot of distance to cover to get to home (a neutral cash rate). So they have a plan. They will hike slowly in an orderly and telegraphed manner, and make the unwinding of its quantitative easing so boring it will be like watching paint dry.

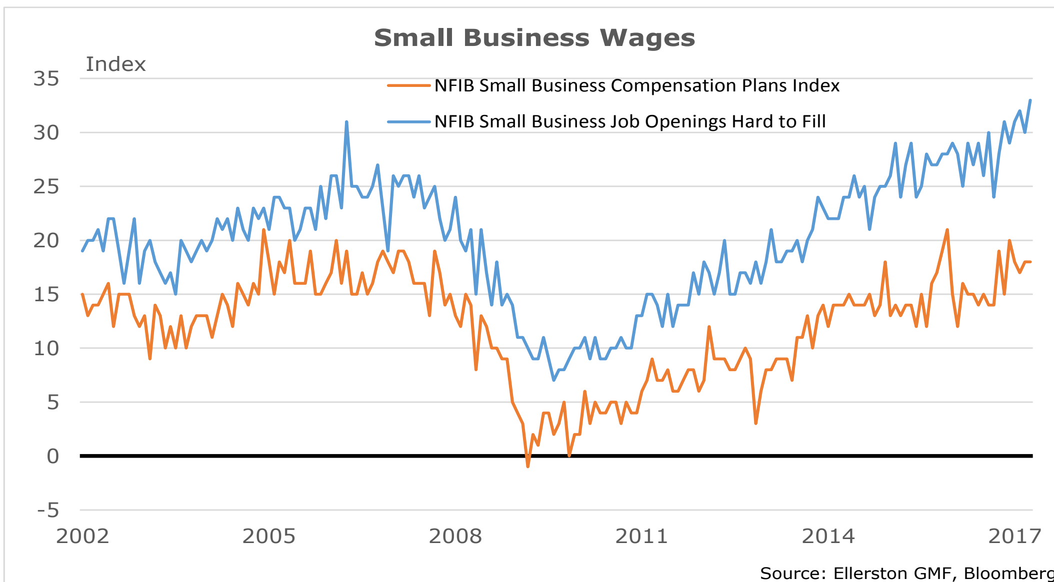
It is a good plan. It worked in 2004-06. But they have sailed deeper into dangerous waters this time. When does a plan become a hope?

The US unemployment rate, at 4.3%, is at a level that historically generates wage pressure. Indeed, it has not been this low since 2001.

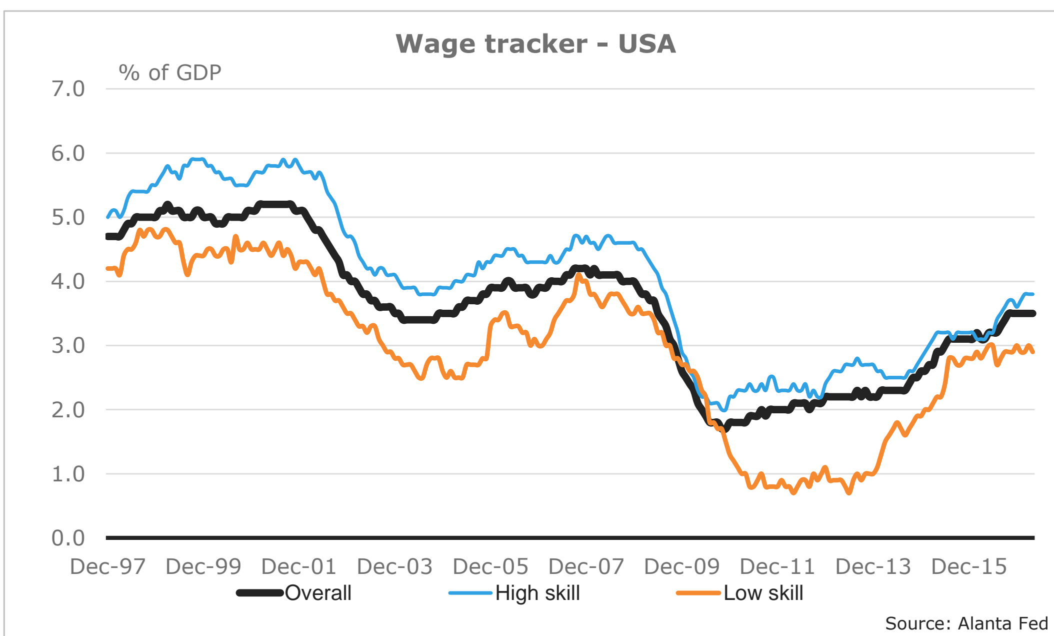


The business surveys tell us firms are feeling a lot of pressure to increase wages, if they are not already doing so.

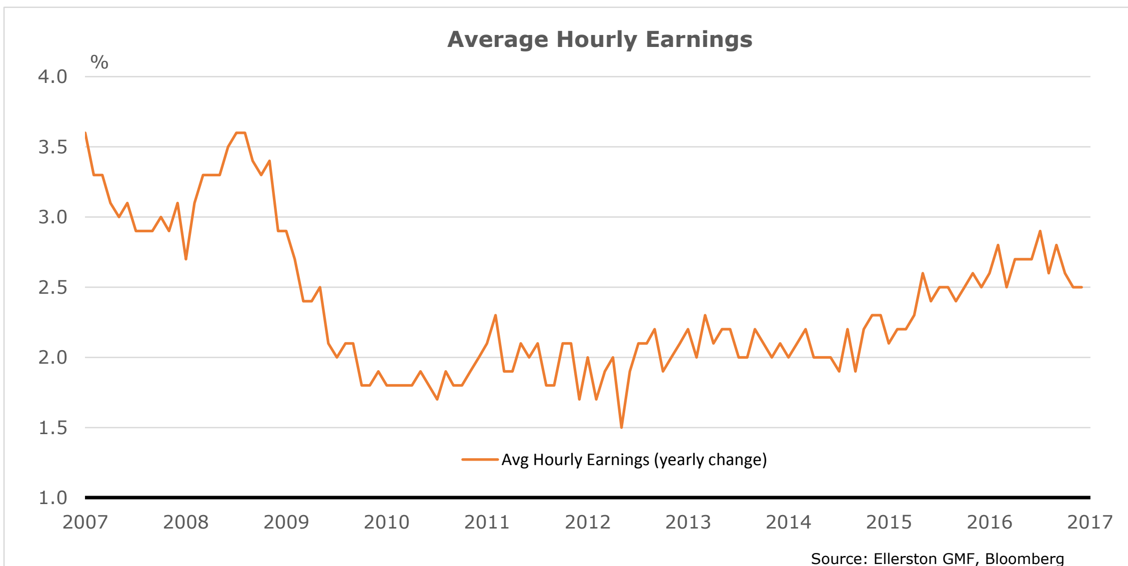
[2] NAIRU – Non-accelerating Inflation Rate of Unemployment. It is an estimate, only ever confirmed in hindsight, of what level of unemployment is low enough to generate a rise in wages/inflation.



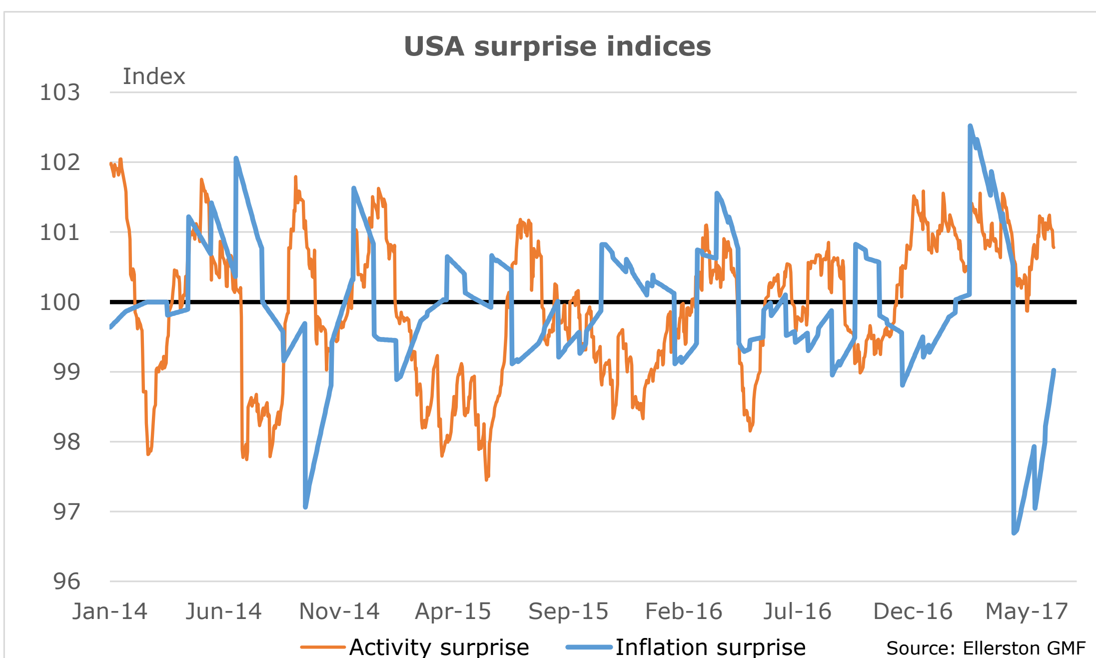
And the Fed wage measures that control for compositional changes (comparing pay rises for the same job, not worker) are showing a steady increase.



But so far the sea is quiet. The market is focussed on average hourly earnings (AHE) for wages from the payrolls release. This is the sum of all wages and can provide a false signal when jobs rotate between sectors (which is why the Fed prefers their measure). None the less, the market takes heart from a softer AHE number.



And heart from inflation surprising lower the last two months running. Even if it is driven by Verizon moving to unlimited data plans[3].



Should the Fed take heart?

There are reasons to think they are safe – technology holding down inflation. Robots replacing workers. Globalisation.

For the *Lusitania* they had four turbines making them the fastest vessel on the waters.

[3] Inflation calculations are based on hedonic adjustments. That means if you get more for the same price, the price has fallen. Hence unlimited data for the same price is measured as a sharp fall in price of phone plans.

None the less, regardless of an advantage, you would still prefer not to spend too much time here. Much better to get to port, or should we say a "neutral" cash rate, in a prudent fashion. Just in case those business surveys and Fed wage measures prove right.

This is why Fed Governors Harker and Kaplan after the US employment numbers on June 2nd re-iterated their conviction of 2 more hikes this year, and downplayed the inflation surprises.

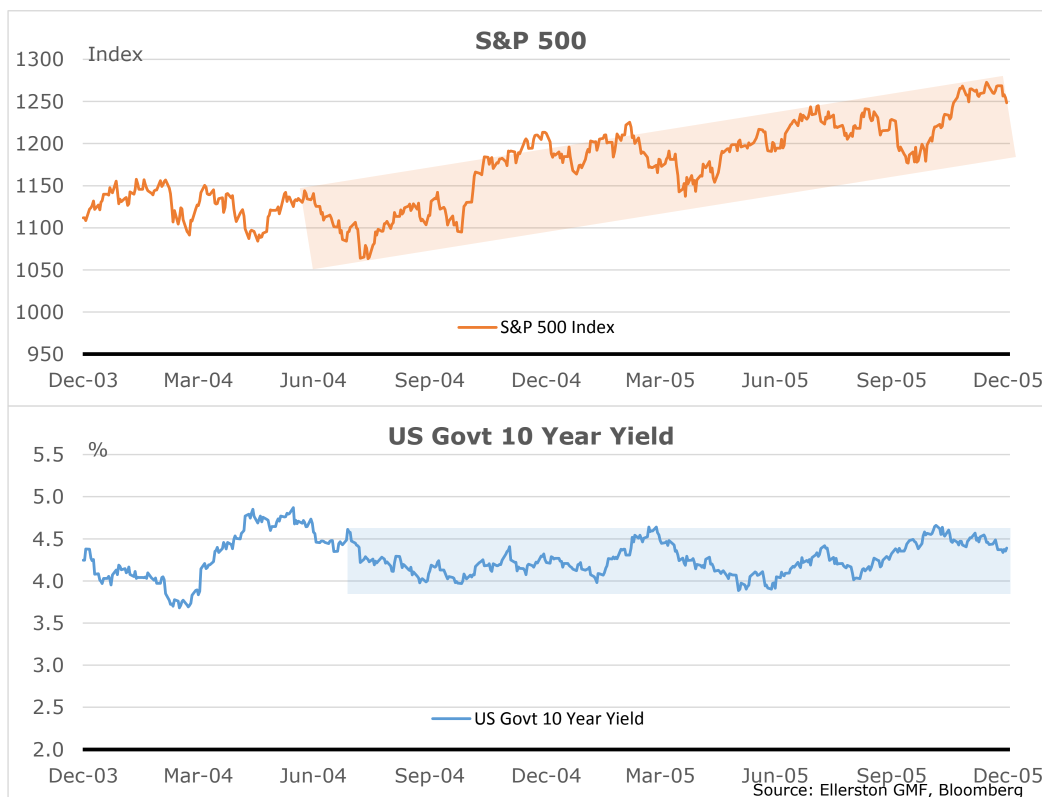
Put simply, the risks have shifted. If we were to get some high(er) wage numbers in the near future, or inflation (say from medical costs as Obamacare is reversed), the Fed does not want to find itself out to sea, some 100 basis points from their estimate of where the neutral cash rate is today, and 200bp from there assessment of neutral in the longer term.

So the Fed will hike in June. And we still think they will hike in September. Indeed, we still expect 4 hikes over the next 12 months.

What the benign readings on inflation does though is suggest there is no need to panic.

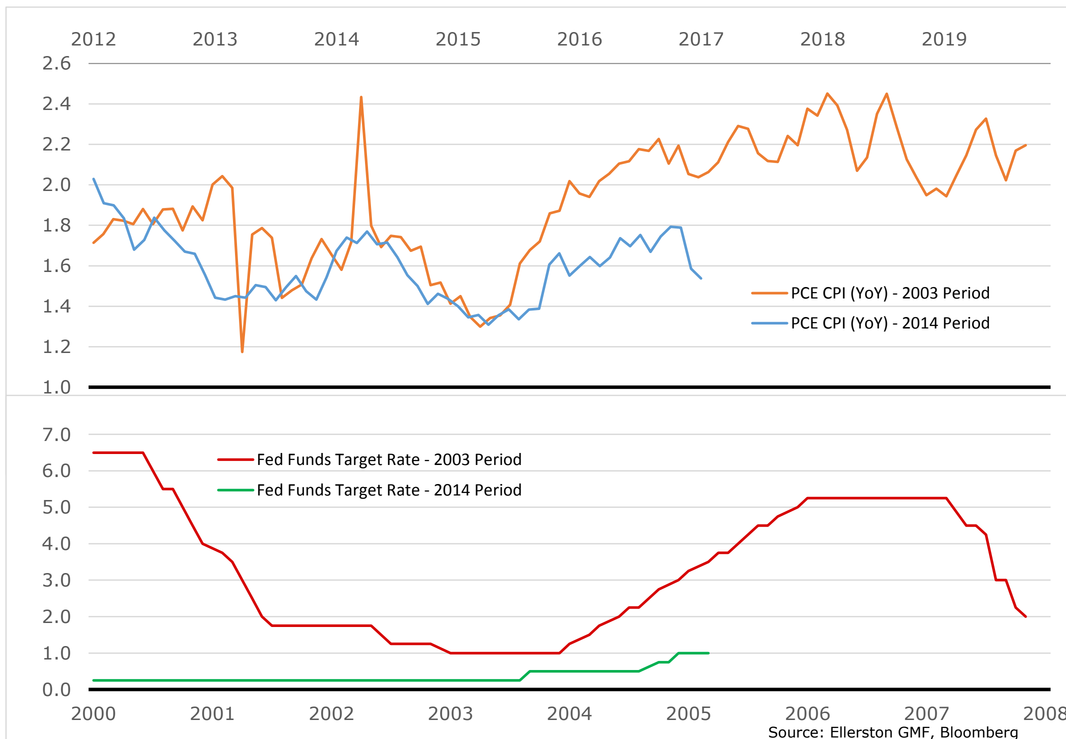
And that puts us firmly in the 2004-2006 analogue as discussed in my March note[4].

Recall equities can rally 5-15% a year, and bond yields remain range bound.

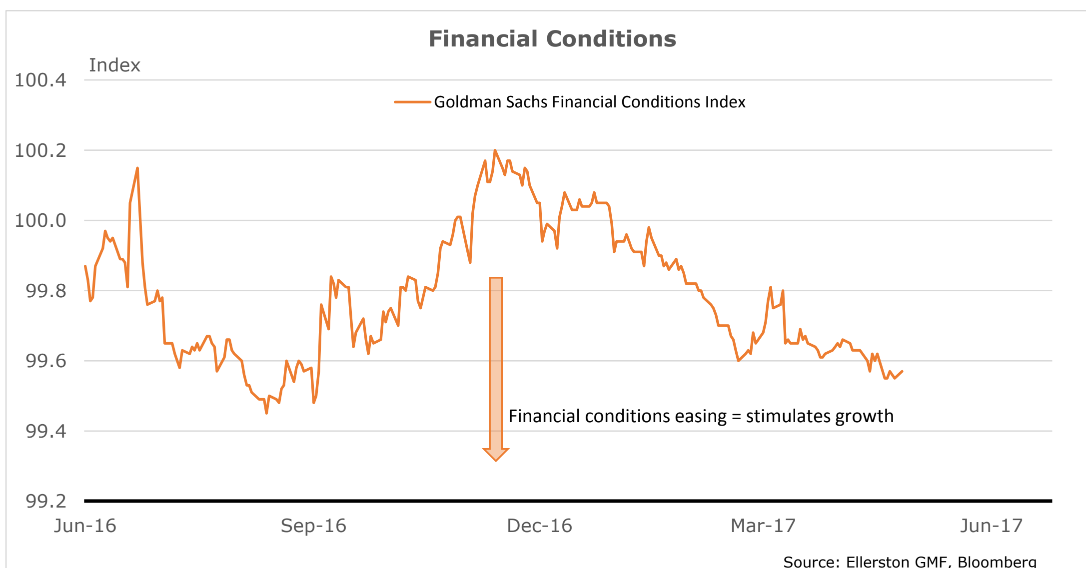


[4] *"There's murder on the dance floor…"* looks at past Fed hiking cycles.
https://ellerstoncapital.com/wp-content/uploads/Global-Macro-Newsletter-March-2017.pdf

But the Fed keeps hiking. To be fair, the lift in inflation is muted now compared to 2004. But so also are the rate hikes from the Fed. The chart below lines up the trough in core PCE price index[5], the Fed's preferred target, in 2003 and 2014, and the Fed moves at those times.



In addition, the Fed hikes to date have been impotent. Despite raising the cash rate, 10 year yields have fallen over the last 6 months, and equities have rallied. The net effect is financial conditions in the US, the real driver of the economy, have eased over the last 6 months. Indeed, instead of feeling the head wind of 2 rate hikes, the economy has effectively had a rate cut!



[5] The **core PCE price index** measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying **inflation** trends.

There is still a risk we rotate to the 1994 scenario, a dramatic sell-off in bonds. Particularly as US growth improves. But the recent low prints in inflation means that risk now takes longer to build. In April I suggested if the scenario was to develop it would take 6-9 months to build. Add another 3 months now.

Incidentally, the tragic loss of life when the *Lusitania* sank was because a second explosion blew the side out of the ship. It was believed, though never confirmed, that there were 20 tonnes of munitions being snuck in to the UK from the US.

Perhaps risk parity funds are akin to this hidden munitions stack…[6]

So what is one to do?

For now, relax. The benign wage and inflation numbers are good news.

Equities will likely continue to rally. Indeed, the uplift in global momentum, and particularly European, is impressive.

Bond yields will likely remain range bound. Volatility will remain low.

And the only surprise will be a Fed that just keeps hiking – no one likes being in dangerous waters… they want to get home.

As we move towards the end of the year the risks rise. The market will either understand the Fed is determined to get back to home (neutral), which will see bond yields back to recent range highs, but in an orderly fashion. Or recognise the Fed has left its run too late. With a lot of munitions on board…

Brett Gillespie

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[6] "*I should be so lucky, lucky, lucky, lucky*" discussed the risk of an accelerated sell-off in rates due to risk parity funds.
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