Ellerston Global Macro Fund

Newsletter – September 2017

ELLERSTON CAPITAL

Fund Facts

Inception date	1 July 2017
Liquidity	Daily
Management Fee	1%
Performance Fee	15%
Strategy AUM	$11.6 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.

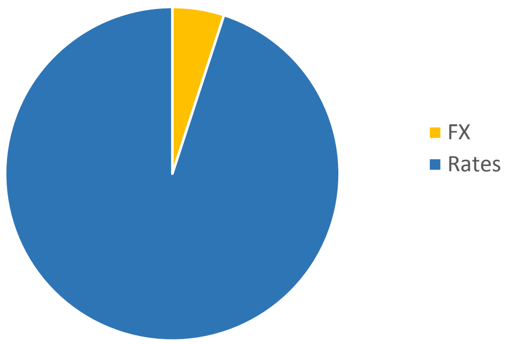
Characteristics

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

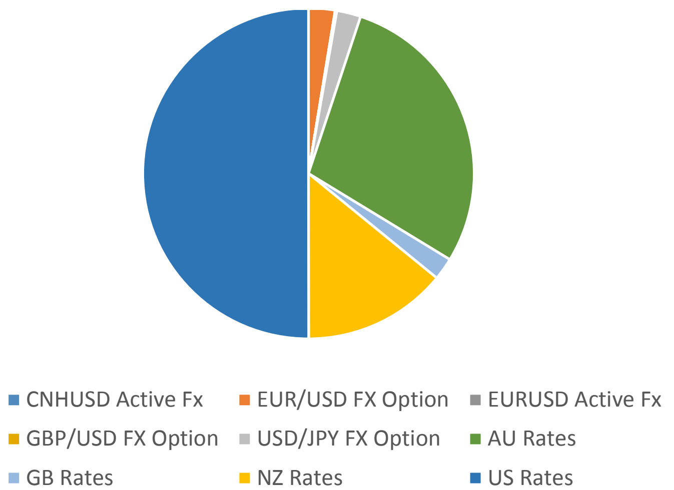
Net Performance

	1 Month	3 Months	ITD
Global Macro Fund	0.81%	-0.69%	-0.69%
RBA Cash Rate	0.12%	0.38%	0.38%

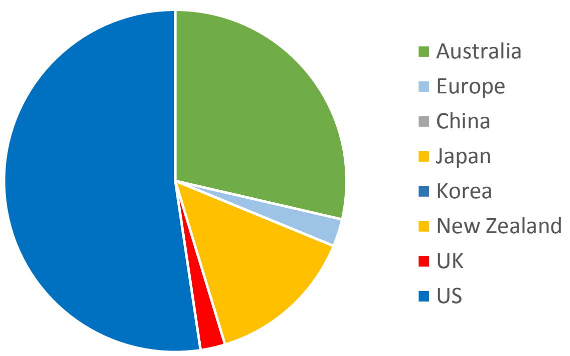
Asset Class Exposure



Portfolio Exposure



Geographic Exposure



Market Commentary

There was a fair amount of volatility in the rates market for the month of September, as US 10-year yields touched a low of 2.01% before rebounding back above 2.35%. Meanwhile US stocks rose to record levels and enjoyed their 8th straight quarter of gains.

The markets had to navigate through a series of geopolitical developments regarding North Korea, including the detonation of their most powerful hydrogen bomb to date (six times more powerful than anything previous); the celebration of their 69th anniversary (which many feared would provide occasion for a display of military strength); the firing of a missile over Japan, 1500km further than previously (in August); and Trump's address to the UN, which North Korea subsequently interpreted as a "declaration of war". This drove the low in bond yields early in the month.

In the US, Trump successfully negotiated a 3-month extension of the debt limit with the Democrats, tied to a Hurricane Harvey aid package. Payrolls data was weak across the board, including headline change, the unemployment rate, and average hourly earnings. The Fed Vice Chair Stanley Fischer resigned citing personal reasons, leaving the Trump administration having to fill 4 vacancies including Fed Chair. At the FOMC meeting, the Fed signaled they remain on track for another rate hike this year and another 3 in 2018, and as expected, revealed that their balance sheet unwind will commence in October at the rate of 10Bn per month. Yellen also warned in a speech that the Fed should avoid hiking rates "too gradually" given potential financial stability concerns. This saw expectations for a hike in December jump above 50%. Trump unveiled his tax plans for an individual tax rate of 35% and a corporate tax rate of 20%.

In the UK, BOE rhetoric turned hawkish after MPC dove Vlieghe indicated tightening was likely in coming months given stronger household spending and a changing inflation outlook. Policy remained unchanged at the BoE meeting with an expected 7-2 vote split, however the statement showed a majority of MPC members now saw scope for stimulus reduction in coming months, which saw the market pricing in an additional 1.4 hikes by the end of 2018. In the Eurozone, the ECB revealed no further details on the tapering of bond purchases at its meeting, and revised down their 2019 CPI forecast to 1.5%, presumably related to the recent appreciation in the currency.

Amongst the commodity countries, Bank of Canada hiked rates a second time in a row, against consensus expectations, citing stronger than expected growth. Australia saw a very strong employment report, with 54k jobs added vs 20k consensus (with the majority being full-time jobs), and the unemployment rate remained unchanged despite a material increase in the participation rate. ANZ revised their RBA forecast, bringing forward two hikes for next year in May and second half of 2018; NAB forecast 4 hikes for 2019; whilst JPM removed their forecast for RBA cuts. This saw the market price in the chance of another full hike by the end of 2018. However the market then retraced half that move, following a speech from Governor Lowe entitled "The Next Chapter", in which he acknowledged the economy seemed to be improving, but stated global rate rises had no automatic implications for Australia, and that at the moment it was hard to see inflation above 2.50% any time soon. In New Zealand, as widely expected, national elections did not result in a clear majority and they are currently awaiting a coalition government to be formed over coming weeks.

Lastly, Japan announced national elections to be held in October, which incumbent Shinzo Abe is widely expected to win.

Portfolio Commentary

The fund returned 0.81% in September. As we outlined in August, we are positioning the portfolio for higher rates, particularly in the US, but also in Australia and NZ next year. By and large, we recovered the lost performance in August. Over the two months, 10 year yields rallied from 2.29% to 2.004% and then back to 2.33% ie largely unchanged.

So what did we do? We managed to hold exposure to our medium term conviction of higher rates, without exposing investors to the magnitude of the fall in yields driven by the hurricanes in the US and Korean tensions

Despite with the aggressive rally (fall in yields) in bonds at the start of the month, the under-performance of the fund did not follow given our exposure via options and hedges in gold and stocks. However by being positioned in options we fully participated in the reversal in bond yields higher. That is our goal, to provide asymmetric performance. In addition, had the rallies been sustained, our FX exposure in USD/JPY we highlighted last month would have added approximately 0.5% to performance through September as the options expired. As it turned out, the bond move reversed and we did not need the insurance provided by $/yen.

Despite having a number of other positions during September, not much else moved the dial. We had a relatively large exposure in Australian and New Zealand rates, but they moved little during the month

However, we expect these trades to prove rewarding over coming months.

For October, we have very similar exposure to last month. The portfolio is largely positioned in the interest rate futures market and options, and will benefit if the market prices an expectation of higher interest rates in the US out to 2021, or in Australia and NZ next year. (We expect both Australia and New Zealand to have hiked by the middle of next year)

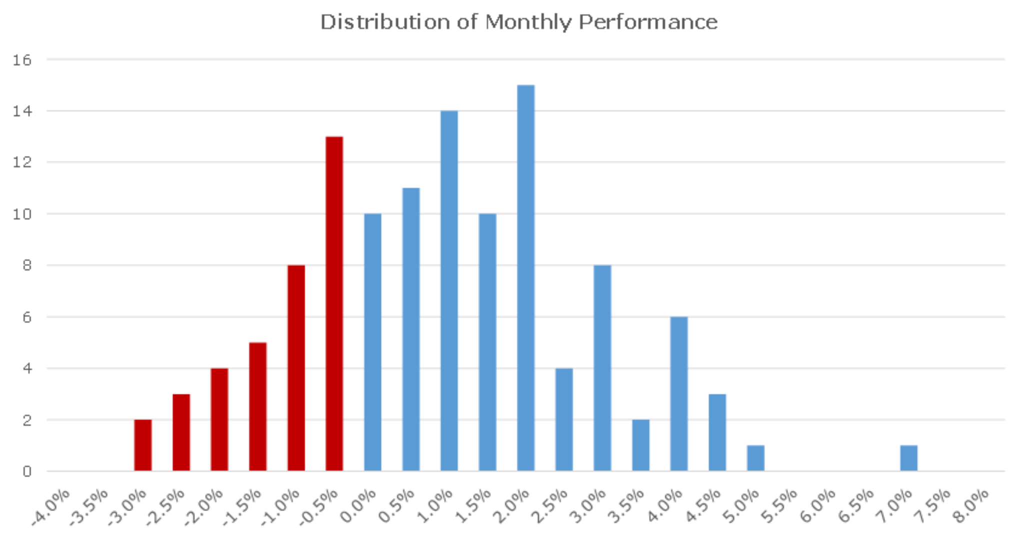
We currently favour a stronger USD, particularly v the Euro, and are positioned in the exotic FX markets for Euro to be around 113-116 at the end of October.

And again, we are using USDJPY exotic FX to protect against a rally in bonds through October, given the excellent risk reward provided in this market and the high correlation of JPY to US 10 year yields.

We closed our CNH exposure at no loss as the currency overshot our range target (only to return later in the month)

As mentioned, we are very focused on creating asymmetric returns for a sharp rise in yields. Currently volatility is low in rate markets, and this provides very exciting opportunities.

Many are asking what sort of volatility they should expect on this fund. Based on my historical records, the diagram below shows what the monthly profile might look like over 10 years. Of course it is a guide only.



Outlook

Free your mind and the rest will follow

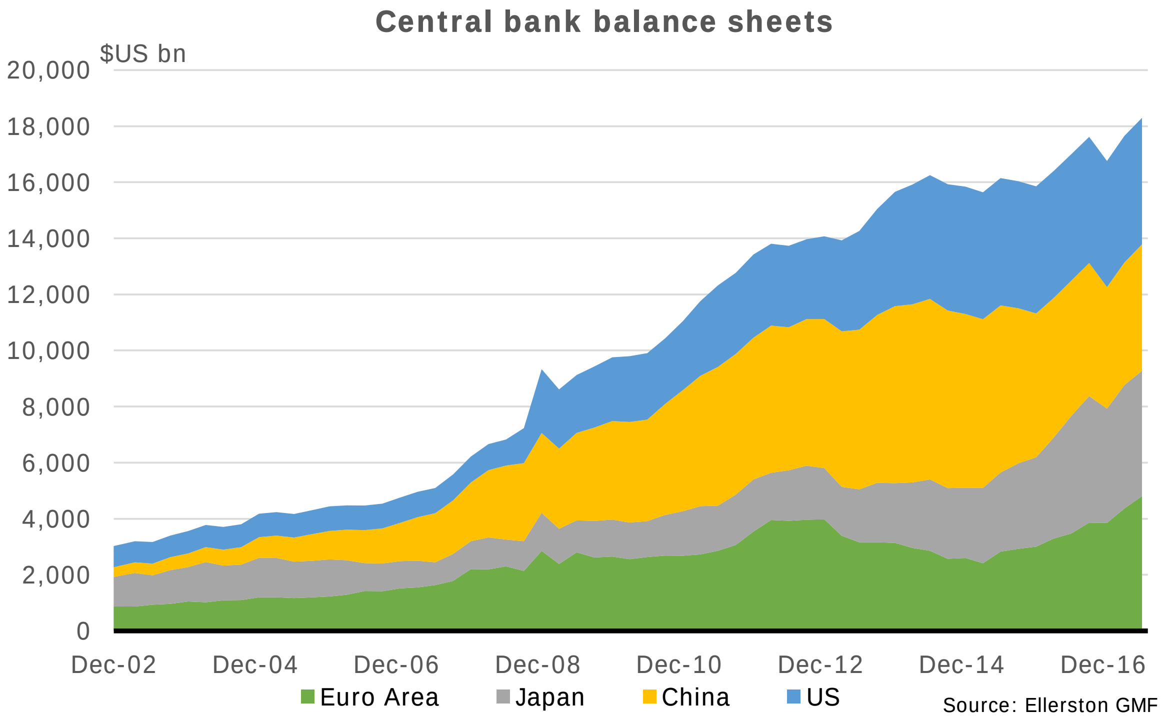
Wisdom consists of the anticipation of consequences. - Norman Cousins

Would you ring up the insurance company to insure your house after it has burnt down? Probably not… Well okay, perhaps after you have rebuilt it and learnt your lesson.

What about if you have never been insured and you lived near the bush. Would all the current warnings about the driest winter on record, with record fuel build up, encourage you to insure? Or at least go out and buy a diesel fire pump? Clean your gutters?

Those that make no preparation, or take insurance, particularly when they have been warned, tend not to get a lot of sympathy. And rightly so.

So have you heard all the talk about global central banks hiking? And unwinding their balance sheet purchases?



Is it a little too hard to understand? Like global warming? Isn't it easier to just ignore – take no preventative action or insurance? Or is your portfolio diversified enough already – that's your insurance?

Well I have presented at three investment conferences in the last month, and I would make a couple of observations;

1. Most Mum and Dad investors don't understand what low interest rates and quantitative easing has done for their portfolios
2. Most professional advisors do, but are still trying to work out how to protect their portfolio without compromising performance.

Related to that last point, I've learnt two things;

1. Investors are very skeptical about the ability of any manager to add value.
2. Many investors don't understand how a global macro fund works.

Was I surprised? I guess I was a little. After all, these were conferences for financial planners, investment professionals and academics. Not Mums and Dads. But the reality is that most Australian investors have had zero exposure to global macro investing.

Re managers outperforming, where do you start? It has been a raging debate in Australia since the late 90's. But let me make one observation;

<u>Understand the motivation of your portfolio manager.</u>

Is he motivated to accumulate assets?

Or is he motivated to perform for his clients?

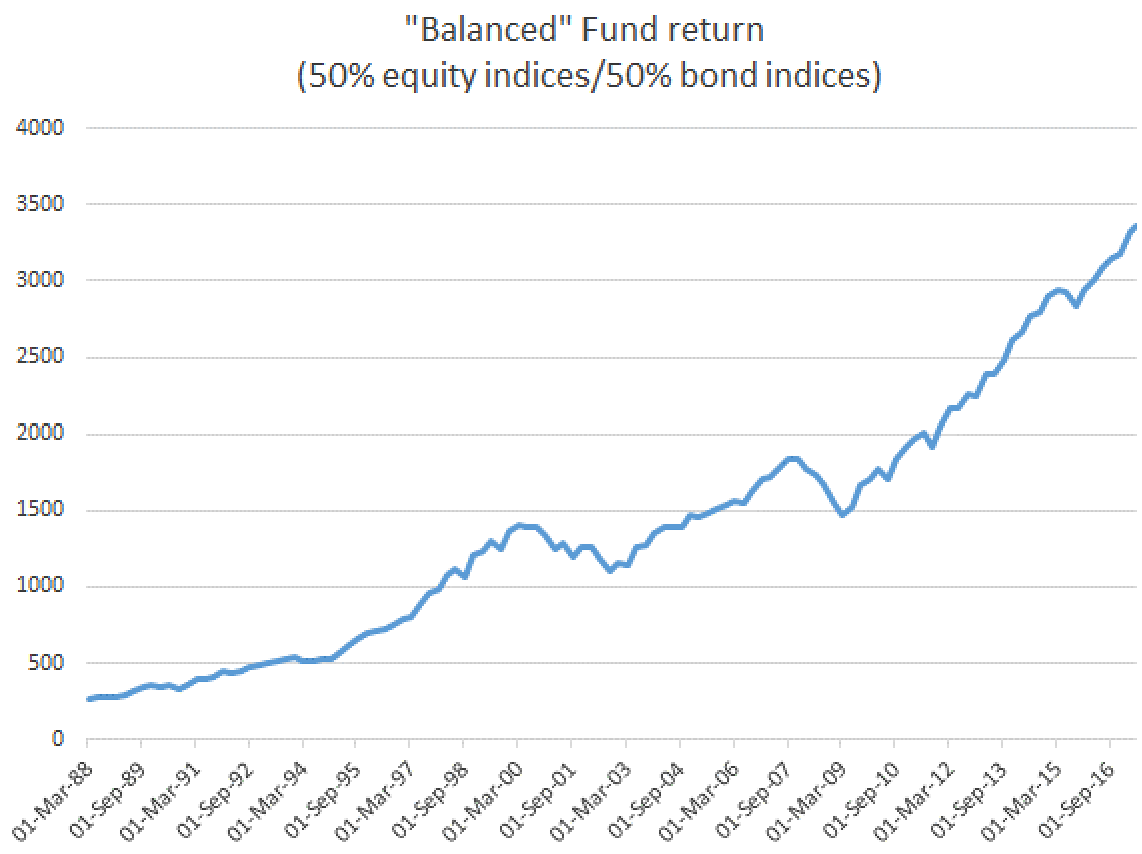
If it is the former, the worst thing he can do is underperform. There is no surer way to lose assets. But fear of underperforming leads to fear of taking risk, and hence benchmark performance.

If it is the latter, the worst thing your manager can do is not perform. Indeed, a hedge fund trader typically only gets paid if he/she outperforms enough to cover costs. Even their salary is advanced against future earnings. Like a tennis professional, no win, no money – at all![1]

Why is this important? Because most of the frustration I was hearing is about "traditional" asset managers, who I put in the accumulation class. After all, with a flow of 9.5% of all salaries coming into superannuation funds each year, all they want to do is make sure that flow continues.

I was ruminating over this after I answered questions following a presentation I did at the end of September[2]. One person was convinced no manager could out-perform over the long term (50 years in his mind!) But he seemed to know very little about global macro. Another suggested that whilst he was convinced by my arguments, he still felt reluctant to pull the trigger and invest. What could I say to get him over the line? In the interest of getting a laugh, I suggested he would likely do what most investors do, and chase returns. But what I should have said is can you afford not to do something? The warnings are loud and clear. Don't you need some protection?

What I presented was my "I should be so lucky" letter from April. For those who haven't read it, I argued that balanced funds (and risk parity funds) have had spectacular performance due to global quantitative easing, and this is now set to reverse. Investors need to consider how their portfolios will perform if yields rise, particularly if they rise quickly, which is a distinct possibility.



So will they?

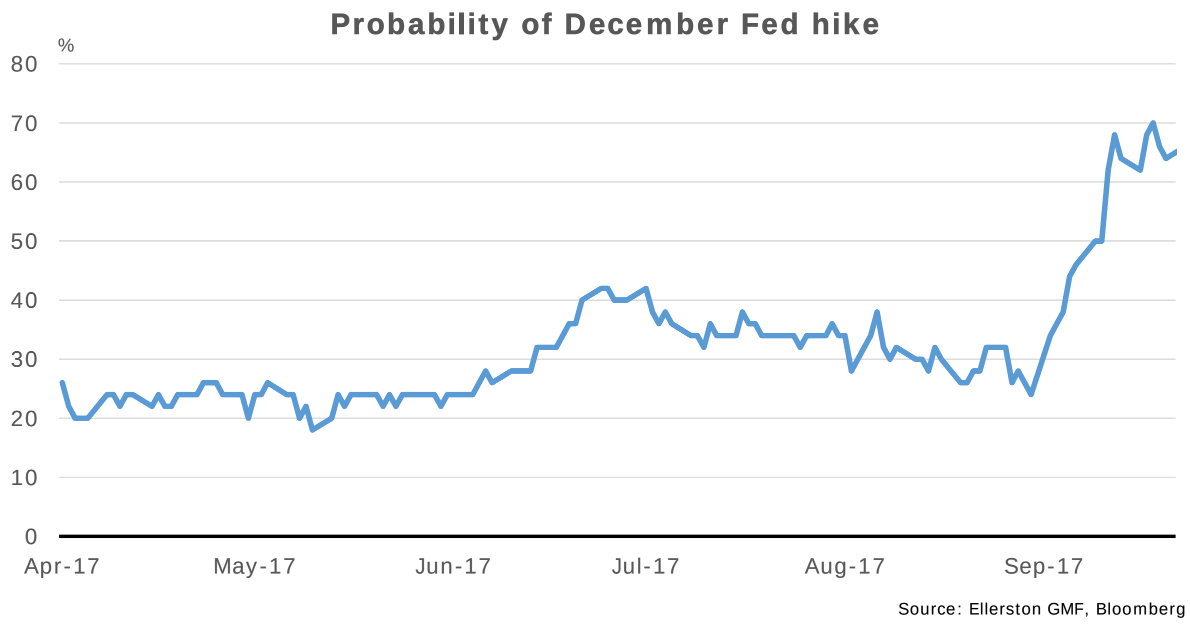
Well what yields are we talking about? The Fed's overnight rate? Or the US 10 year rate? Both?

---

[1] There are problems with the way hedge fund managers are remunerated as well, where traders are arguably incentivized to "have a swing" if they are deeply negative. But retained bonuses and bonuses linked to fund growth can navigate that

[2] IMR Program Conference, University of Technology - Sydney

Let’s tackle the Fed’s overnight rate first. The probability of a Fed hike in December jumped this last month, from 28% to 64%.



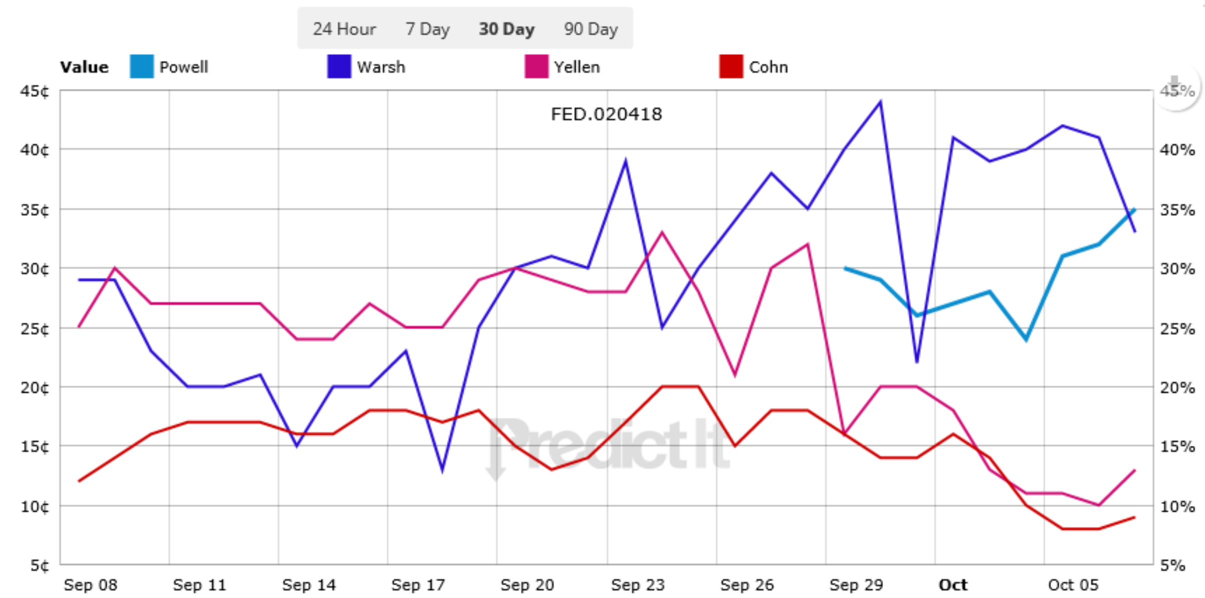
Why? Because in essence Yellen said so.

…without further modest increases in the federal funds rate over time, there is a risk that the labor market could eventually become overheated, potentially creating an inflationary problem down the road that might be difficult to overcome without triggering a recession. Persistently easy monetary policy might also eventually lead to increased leverage and other developments, with adverse implications for financial stability. For these reasons, and given that monetary policy affects economic activity and inflation with a substantial lag, it would be imprudent to keep monetary policy on hold until inflation is back to 2 percent.[3]

For central bank observers, the transition in Yellen was decisive. She confirmed she is and has always been a labour market economist. That means she believes in the so-called Phillips curve, that falling unemployment will eventually create wage and price pressures.

[3] September 26, 2017 *Inflation, Uncertainty, and Monetary Policy* Chair Janet L. Yellen. At the "Prospects for Growth: Reassessing the Fundamentals" 59th Annual Meeting of the National Association for Business Economics, Cleveland, Ohio

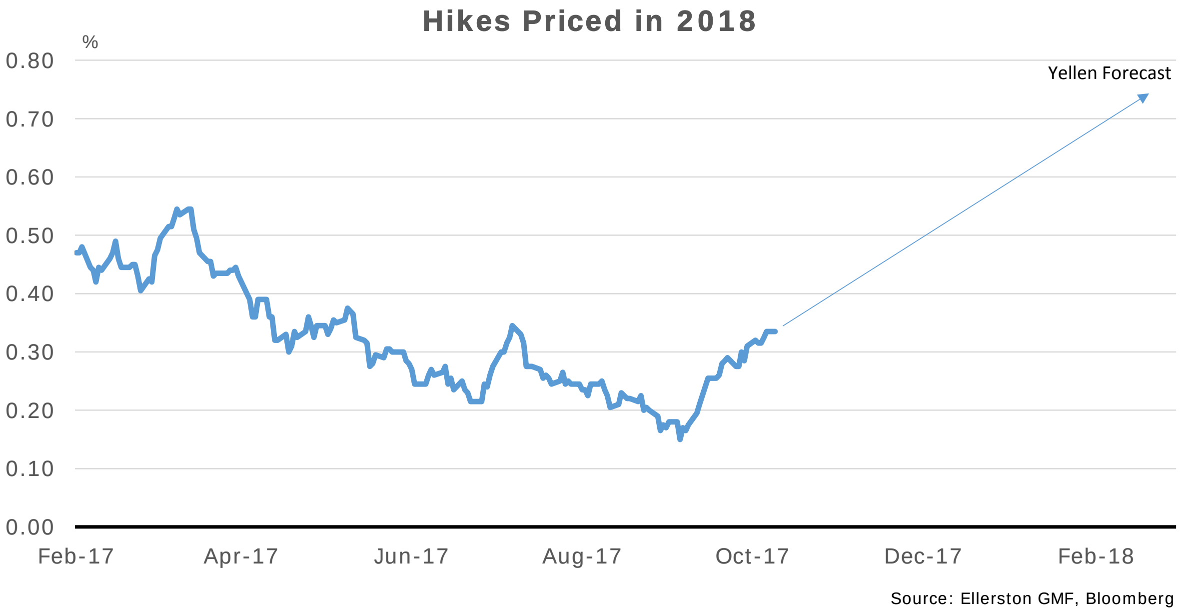
Okay so that makes December fairly clear. But what about next year. After all, Yellen leaves in February, so what does it matter what she thinks now? Perhaps not. But she has set the sails so to speak. The expectation is that if Warsh is chosen, he will be more aggressive than what Yellen would have done. If Powell is chosen, a new contender and current governor, he will likely follow the course she has charted. The chart below shows the current probabilities of the contenders. Warsh and Powell are neck and neck, though the momentum is with Powell.



[4]

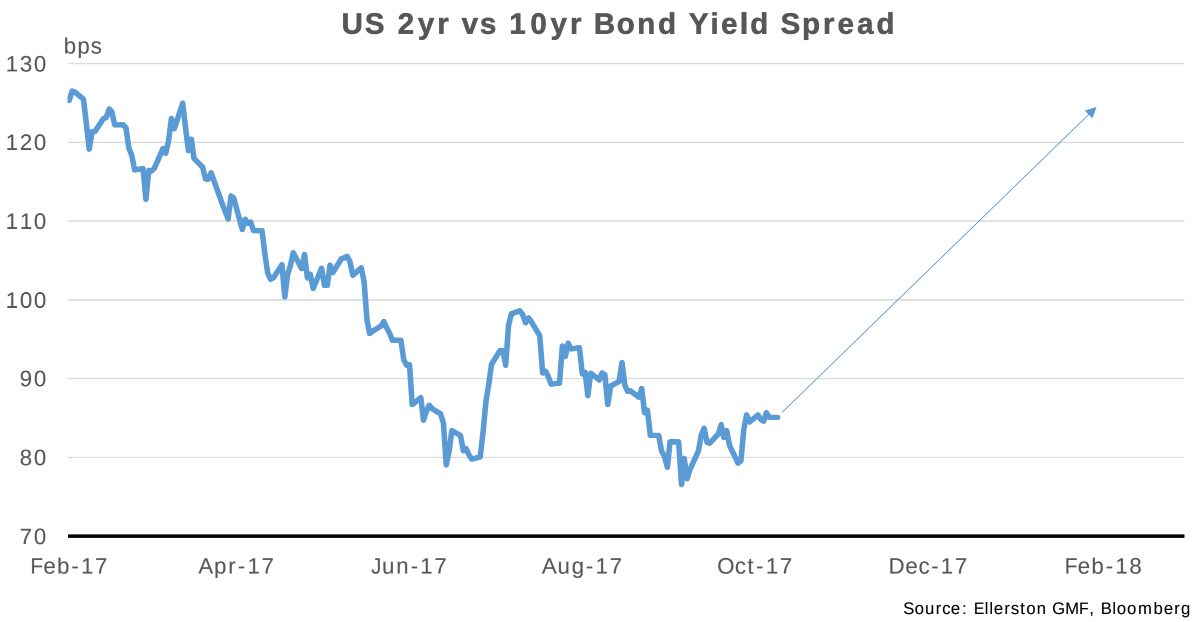
The US market currently expects a 33 basis point rise in rates in 2018, following the December 17 move. Yellen expects 75. We are pretty comfortable with Yellen's view.

[4] https://www.predictit.org/Market/3306/Who-will-be-Senate-confirmed-Fed-Chair-on-February-4%2C-2018



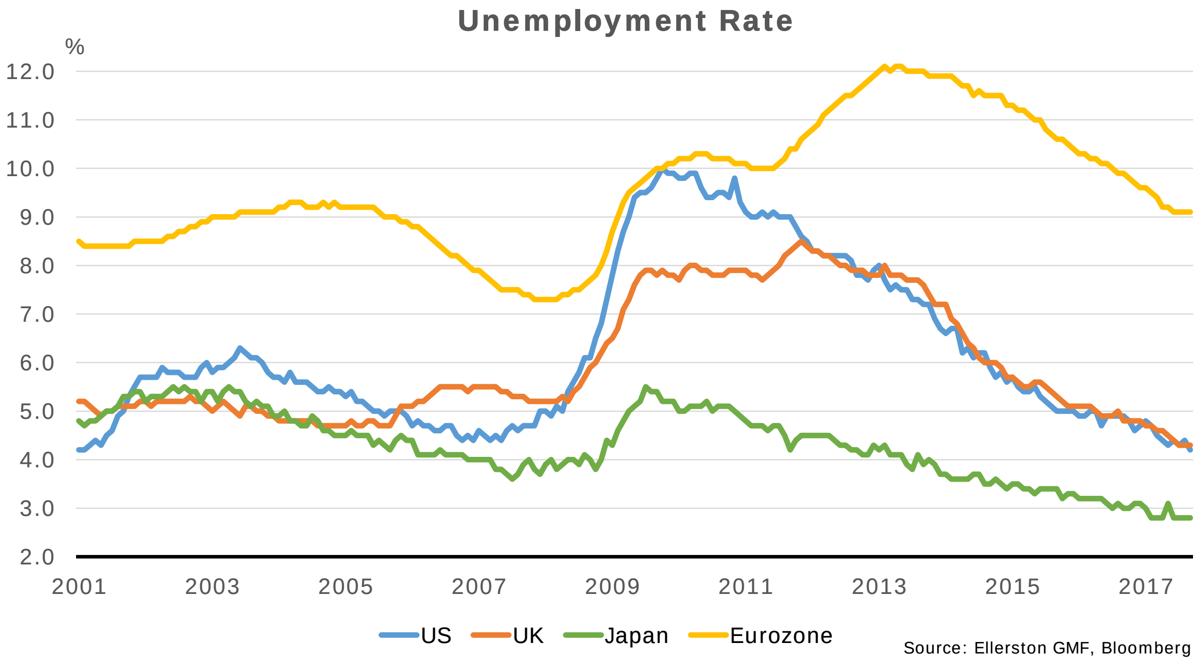
Where we see even more opportunity is for longer dated yields to rise. Why? That was last month's note; "How deep is your love?" We expect higher inflation in the next 6 months, and the unwinding of global central bank balance sheets, to see the real yields, or risk premium on bonds, return to "normal" levels, some 100 to 150 basis points higher.

So we expect US 2 year rates to go higher. But we expect US 10 year rates to go even higher. We can get an excellent risk reward for that view via the options markets.[5]



What is really exciting to us is that the whole world is improving. UK unemployment is the lowest in 42 years. Japan the lowest in 23 years. The US just shy of the lowest level ever, 3.8% in 2000.

[5] We have conditional steepeners in mid-curve Eurodollar contracts. Great for an explosive move in rates.



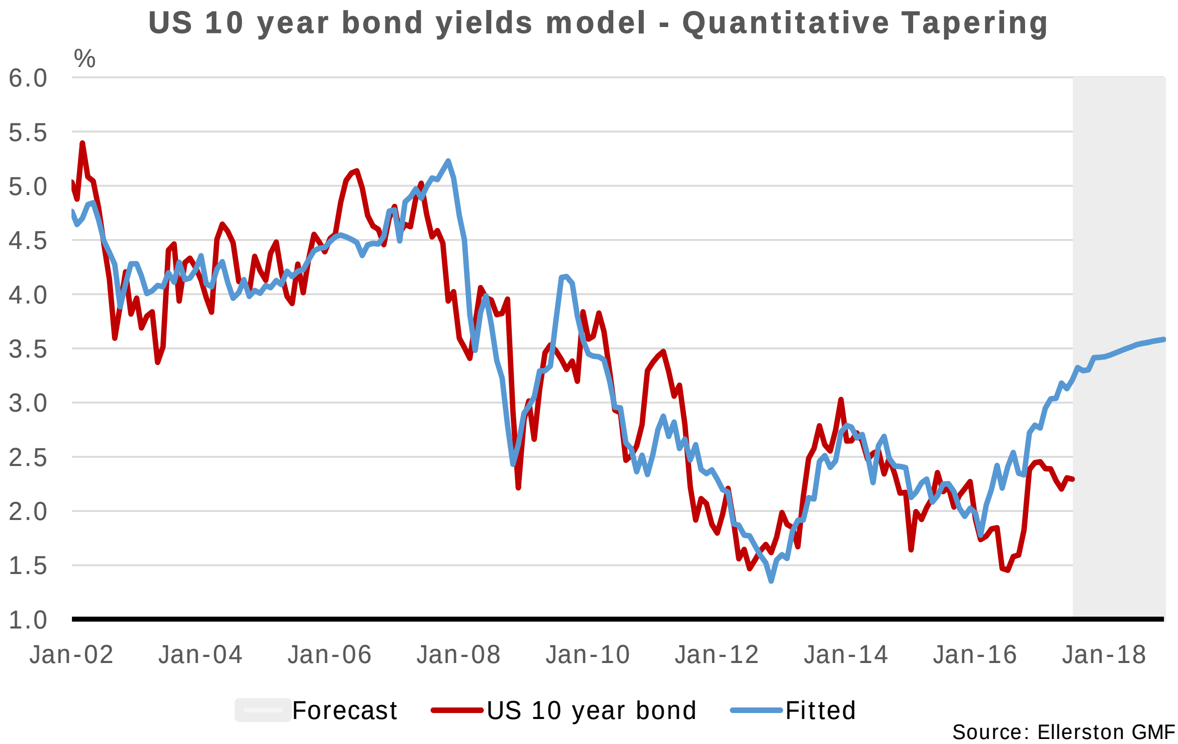
And with it we will get synchronised policy. We will likely have three rate hikes from the Fed this calendar year, three from the Bank of Canada and one from the Bank of England. We expect Australia and NZ to be hiking next year, and Europe and Japan in 2019. A fair bit for markets to digest…

So what should you do? Are things about to change? We think so. We think all investors should be asking two questions;

1. How will my portfolio perform if cash rates rise?
2. How will my portfolio perform if bond yields rise significantly?

It is pretty clear to most now that cash rates will rise globally. Most are debating the magnitude, not the direction. I have explained in the past that equity markets (and credit) can cope with a rising cash rate if bond yields don't rise significantly. If you expect benign movements in bond yields despite rising cash rates, you can continue to hold equities and credit.

However, we think bond yields will rise significantly. We expect a clear pickup in inflation in the US, but even without inflation the unwinding of central bank balance sheets will "normalise" risk premium on bonds.



Source: Ellerston GMF

If that happens, you don't want to be holding bonds or equities or credit.

So you could hold cash.

Or focus on an absolute return fund. But be careful if it is holding credit. And be wary if it needs liquidity, say an ETF. If things get rocky that quickly becomes a problem.

Of course this is an ideal environment for a global macro fund, which is why we are so excited. But there is no guarantee a global macro fund will deliver returns in this environment. It depends on the portfolio manager's view, and how well he positions for it. Nonetheless, it is what macro funds do – forecast economies, central banks, and market reaction, and then position in the best asset long or short to monetise that view. Historically when central banks are moving rates, global macro managers have performed very well, with or without a large movement in bonds.

I hope I have convinced you of at least one thing – consider what happens to your portfolio if bond yields rise.

Perhaps buy some insurance. Or at least a fire pump!

Brett Gillespie

Further Information

Andrew Seddon
0417 249 577
aseddon@ellerstoncapital.com

Simon Glazier
0410 452 949
sglazier@ellerstoncapital.com

DISCLAIMER