Ellerston Global Macro Fund

Newsletter – October 2017

Fund Facts

Inception date	1 July 2017
Liquidity	Daily
Management Fee	1%
Performance Fee	15%
Strategy AUM	$12 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 periods.

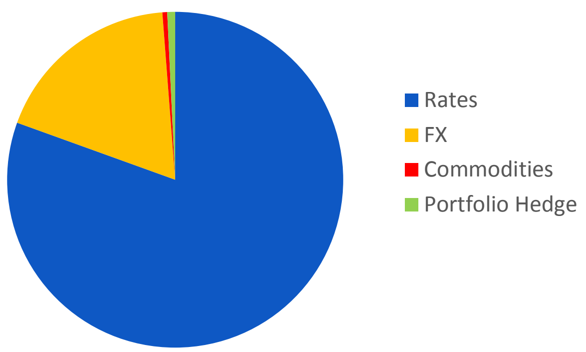
Characteristics

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

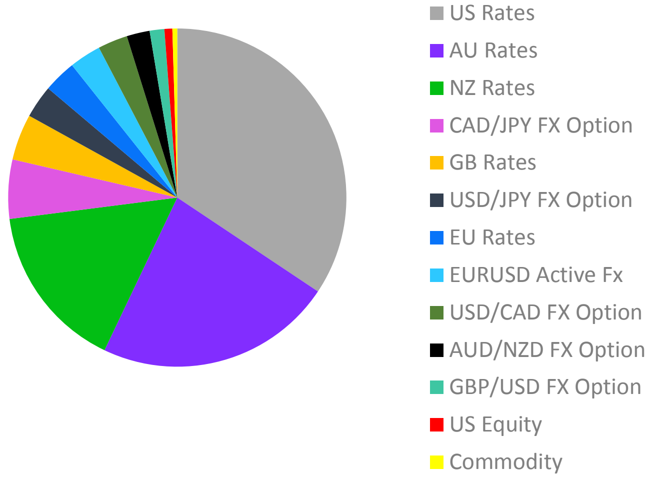
Net Performance

	1 Month	3 Months	ITD
Global Macro Fund	-0.45%	-0.55%	-1.13%
RBA Cash Rate	0.13%	0.37%	0.50%

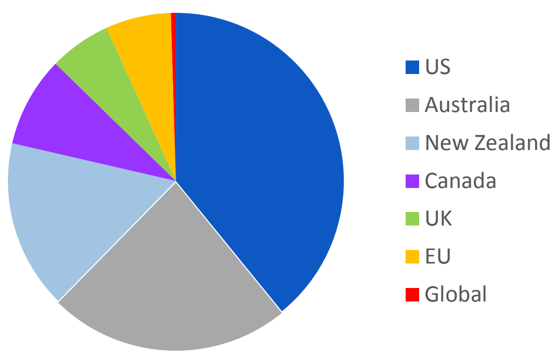
Asset Class Exposure



Portfolio Exposure



Geographic Exposure



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Market Commentary

The month of October saw some respite from the geopolitical tensions and North Korea headlines of August and September, as strong economic and earnings data propelled major equity markets to new highs.

The US 10-year bond yield ended the month relatively unchanged at 2.38% vs 2.34% the month prior, despite an intra-month range of 2.27-2.46%. The negative surprises in the month included the first negative US payrolls print since September 2010 at -33k, and US core inflation coming in at +0.1% vs +0.2% expected giving an unrounded yoy core print of 1.69%, the fifth disappointment relative to market expectations in seven months. On the plus side, the US unemployment rate fell to 4.2%, a 17-year low, average hourly earnings spiked to 0.5% mom (albeit skewed higher by the impact of the earlier hurricanes), new home sales surged to an 11-year high, and business surveys remained near cycle highs.

A JPM client survey showed that US Treasury shorts were at their highest level since 2006; whilst similar CFTC positioning data highlighted the concentration of those shorts were focussed in the 0-2y and 5y sectors of the curve. This positioning contributed to volatility in fixed interest markets during the month, with bond markets whipping around on headlines and polls of who Trump's Fed Chair pick would be, as the market tried to determine what each of Yellen, Cohn, Warsh, Powell and Taylor would mean for the course of monetary policy and quantitative tightening. US politics also played a hand, with risk markets welcoming the US Senate passing the 2018 budget blueprint, a small but necessary step for the Republican tax reform effort, and cautious as George Papadopoulos, foreign adviser to the Trump campaign, became one of the first people in the Mueller investigations to plead guilty to lying to the FBI about connections to Russia officials.

In Europe, investor confidence hit a 10-year high. German unemployment reached 3.6%, a 37-year low. Catalonia voted for independence and secession from Spain, which responded by disbanding Catalonia's regional government. The German DAX stock market hit a new record high. The ECB reiterated plans to buy EUR 60Bn of bonds per month until December, at which point it would commence a reduction to EUR 30Bn of monthly purchases and a 9-month extension of the program until at least September next year – all largely as expected. Bunds spiked in response, as the heavily short market exited positions.

In the UK, CPI rose to 3%, the highest level in more than 5 years, whilst unemployment reached a 42-year low.

In Canada, CPI came a little lower than expected at 1.6% vs 1.7%, whilst the central bank left its benchmark rate unchanged as largely expected, following hikes at the two previous meetings.

Australia saw some negative headlines in the month of October. A steadfastly neutral RBA disappointed the market looking for any signs of a shift towards a more hawkish bias; instead the meeting statement balanced the further slowdown in Sydney housing with a more constructive outlook in non-mining investment. Retail sales, a volatile series, posted a shock disappointment coming in at -0.6% vs +0.3% expected, in response to high utility prices and presumably some payback after a strong Q2. Headline Q3 CPI printed +0.6% vs +0.8% expected, while core CPI came at +0.35% vs +0.5%, largely affected by a sharp temporary drop in fruit and vegetable prices, which make up just under 15% of the basket. Lastly, the High Court ruled that the Deputy PM Barnaby Joyce and several senators were ineligible candidates at the time of the federal election due to their dual citizenships triggering by-elections across the country and causing the government to lose their majority. In response to these developments, Australian 3-year bond futures reversed their recent weakness, bouncing more than 20bp in price over the course of the month, from a yield of 2.22% to 2.00%, whilst the currency weakened through the 200-day moving average at 0.7694, a key support level held since mid-July.

The New Zealand election was finally resolved with "kingmaker" Winston Peters choosing to form a coalition with the Labour Party. New PM Arden announced a ban on non-residents buying existing homes from next year. Initial uncertainty around the election outcome, followed by the market digesting the raft of unfunded election promises, saw significant depreciation in the NZD currency against most crosses during the month.

More broadly across the Asian region, Japanese unemployment reached 2.8%, a 23-year low, whilst Abe's election win gave him control of two-thirds of the lower house and saw the Nikkei make a 21-year high. Chinese CPI eased to 1.6% yoy from 1.8% in August. The Communist Party Constitution was revised to include "Xi Jinping Thoughts" following the plenum in October – the only leader other than Mao to have this title bestowed while in office. India also announced a US$32bn plan to recapitalise state-controlled banks during the month.

Portfolio Commentary

The fund returned -0.45% in October. Investors should expect the bulk of monthly returns to fall in the +/-2% range. As such October was a modest underperformance for the fund. Underlying that, the fund lost -0.56% on interest rate positions, -0.08% on commodities, and -0.04% on equities. Currency positions generated +0.23%.

From a macro perspective, the catalysts for markets to re-price to our view did not present themselves during October. In particular, benign inflation in the US and Australia broadly suppressed yields. That combined with booming global growth saw equities explode higher. Our work suggests strong growth will continue, and inflation will clearly start to rise in the US over coming months. The next 3-4 months will be very telling.

As noted last month, the fund started October with short rate positons in Australia, NZ and the US. Most of the underperformance in rates came from our short positions in Australia. We were positioned for a rate hike by May next year, the probability of which declined from 64% to 18% during October. Fundamentally, our view has not changed. Despite softer retail sales and inflation prints during the month, employment and business surveys were very strong. We believe the domestic market remains too fixated on the modest slowdown in housing, and is missing Western Australia exiting a recession. By mid-2018 we expect the unemployment rate to be near 5%, supporting the first of two rate hikes in 2018 from the RBA despite low inflation. That said, we reduced our exposure in Australia (and NZ) during the month and will re-engage when the market stops trending against our view.

We have maintained our short rate positions in the US, as well as hedges in Yen options. We are also still looking for USD strength v Canada, the UK and to a lesser extent Europe. These positions are also largely held in option strategies targeting stronger ranges for the USD v those currencies.
If low inflation persists, equities will continue to do well. We have very modest exposure to the Japanese stock market and copper (both via options) in case that occurs. Like our Yen position, this is designed to mitigate portfolio underperformance should inflation not present. However, the portfolio is still very much positioned for higher bond yields globally, and a stronger USD, as the core themes. We would expect this theme (higher US inflation combined with strong growth and firming wages) to become evident in the US data over the next three months or so.

We have taken great care to create a portfolio that can perform handsomely if rates rise, whilst mitigating losses if it takes time or we are proven wrong. We do this by methodically scanning the pricing in option markets across all asset classes and countries, picking the best risk reward structures to support our themes.

Our themes are derived from deep econometric modelling, outlined in Tim Toohey's papers on our website. Over the next 12 months, our modelling of inflation, wages, quantitative tightening (central banks stopping bond purchases) and bond yields suggest the most exciting opportunities we have seen in this space for a decade. The fund is (carefully) positioned for that opportunity.

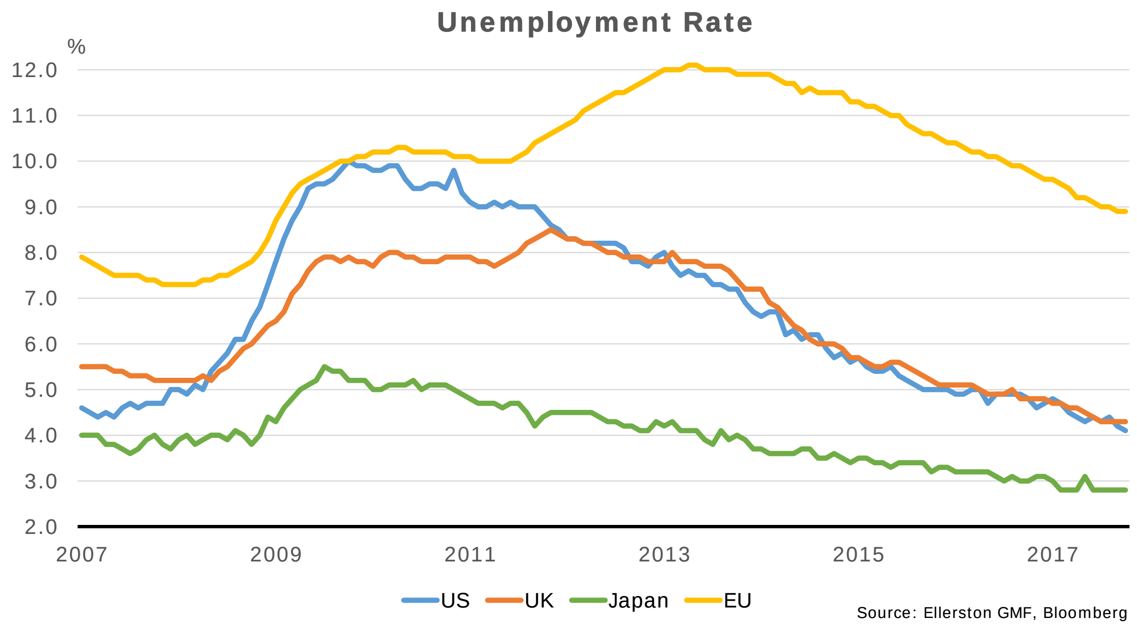
Outlook

When tomorrow comes

There are two possible outcomes: If the result confirms the hypothesis, then you've made a measurement. If the result is contrary to the hypothesis, then you've made a discovery. **Enrico Fermi**

First off, let's be happy. At least in an economic sense, the world is in a very good place.

US, UK and Japanese unemployment rates are lower than the best levels achieved last business cycle, just prior to the financial crisis. Europe will likely be there within 2 years.

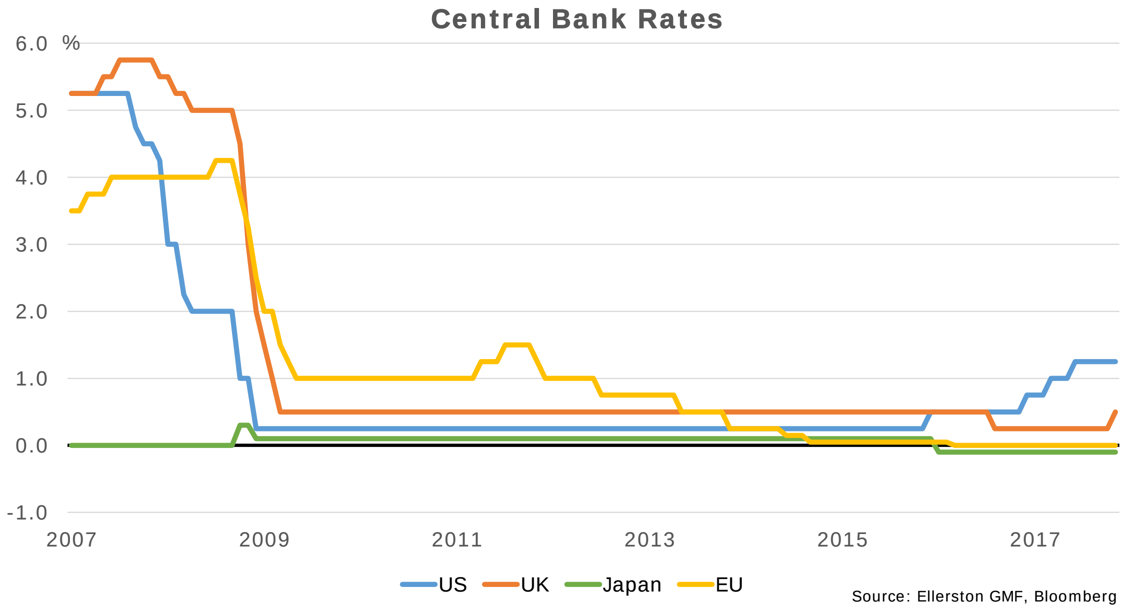


Yet the news cycle is always doom and gloom. No longer do we hear about secular stagnation and that the world will never recover from its GFC growth funk. Now we hear debt is too high, equities are overvalued, and we are on the cusp of a recession.

The truth will likely be far more boring.

That's not to say there is not some serious work ahead of central banks as they normalise interest rates. After all look where they are now compared to before the crisis[1].

[1] Yes the neutral rate is lower. And yes, higher debt levels mean less rate hikes. But debt servicing levels are still very low. So on average assume half the hikes we might have assumed pre-crisis.



But it is “good” work.

Equities certainly think so. US equity indices are up 15-25% YTD. Europe 10-15%. Asia typically 15-30%. Alas, Australia and UK 4-5%

So why are there always scary headlines about impending disaster?

Simple. It sells.

But wait, I hear you say, am I not also forecasting a scary disaster? Well, possibly. I have been giving the chance of a scary bond sell-off about 30% in recent pieces. That is still 70% chance of a more benign outcome. So not totally sensational…

How good is my forecast? Well, if I may, I will come back to that.

But let me first digress to Deputy Governor Guy Debelle, who opined on forecasting last month, in a speech titled “Uncertainty”. In it he references Tetlock’s “Superforecasting” book[2]. It came out a couple of years ago, and explains what makes a good forecaster. Tetlock is a University Professor at University of Pennsylvania who co-lead the “Good Judgement Project” (GJP), a forecasting competition, for anyone who cared to enter, asking over 100 questions per year for 4 years. And very random questions. They were asked to forecast anything from “Will Serbia be officially granted European Union candidacy by 31 December 2011?” Or “Will the London Gold Market Fixing price of gold (USD per ounce) exceed $1850 on 30th September 2011?” The best forecasters weren’t professionals. They weren’t even academic experts or IQ geniuses. They simply had above average intelligence and above average math’s skills, and they “Fermi-ised”.

Wonderful. With just a little bit of Fermi-ising, most of us can be super-forecasters. How exciting!

I was even more excited to learn that I already Fermi-ise! Most of us do when we seriously try and make a forecast. So what is it?

It is named after Enrico Fermi, the creator of the world’s first nuclear reactor in 1942. Post WW2 he was Professor of Physics at Chicago University, and he had a favourite question for his students;

How many piano tuners are there in Chicago?

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[2] Superforecasting – The Art and Science of Prediction. Philip E. Tetlock and Dan Gardner

Obviously without google, let alone the yellow pages (now half the people reading this don't know what I am talking about) most students had no idea. But they had to guess. He would encourage students to break it down, and then guess/estimate. Let's say one assumed the following;

1. There are approximately 9,000,000 people living in Chicago.
2. On average, there are two persons in each household in Chicago.
3. Roughly one household in twenty has a piano that is tuned regularly.
4. Pianos that are tuned regularly are tuned on average about once per year.
5. It takes a piano tuner about two hours to tune a piano, including travel time.
6. Each piano tuner works eight hours in a day, five days in a week, and 50 weeks in a year.

Based on the above, the answer is 225. The actual answer was 290. Not a bad guess.

By breaking down a forecast into components, and then determining the confidence of an estimate of each of those components, one can build a much more robust and objective forecast. We do that all the time, from our GDP forecasts, to the prospect of a central bank hiking, or even war on the Korean peninsula.

Another interesting observation by Tetlock is most "superforecasters" tend to have relatively boring forecasts. And that's because they are concerned with being right, not getting attention.

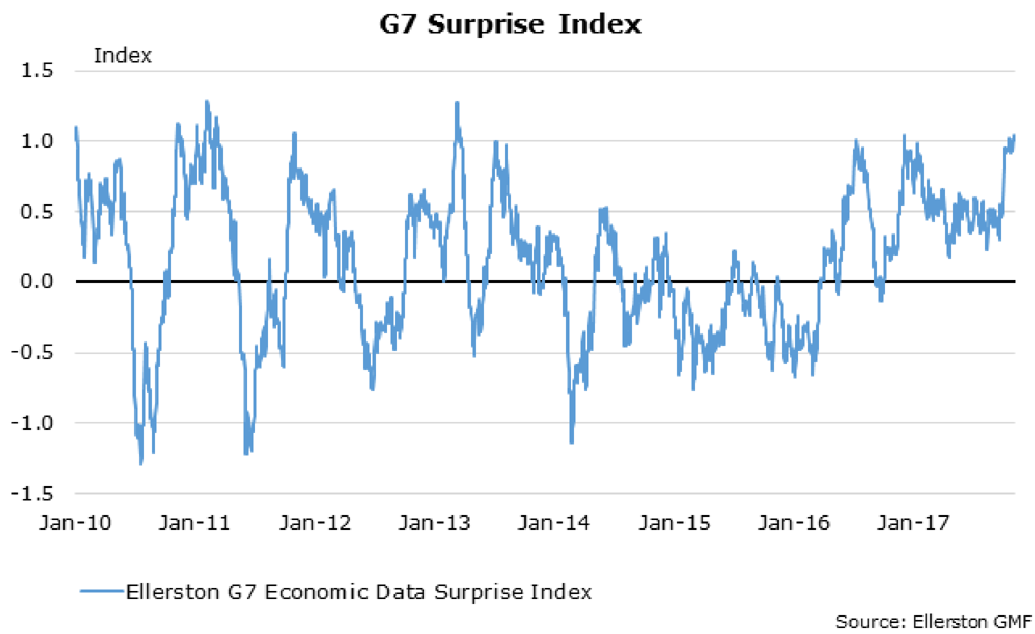
We don't have a boring forecast at the moment… The last few months we have written extensively about how US rates will rise significantly over the coming year. Are we being sensationalists? Should I be concerned?

Well, first off we have Fermi-ised. We break our forecast down into components. We model growth. We model inflation. We model wages. We review Fed reaction functions. We review asset market forecasts under various macro environments. We do a lot of Fermi-ising. We score each component, and we monitor and adjust those scores with new developments.

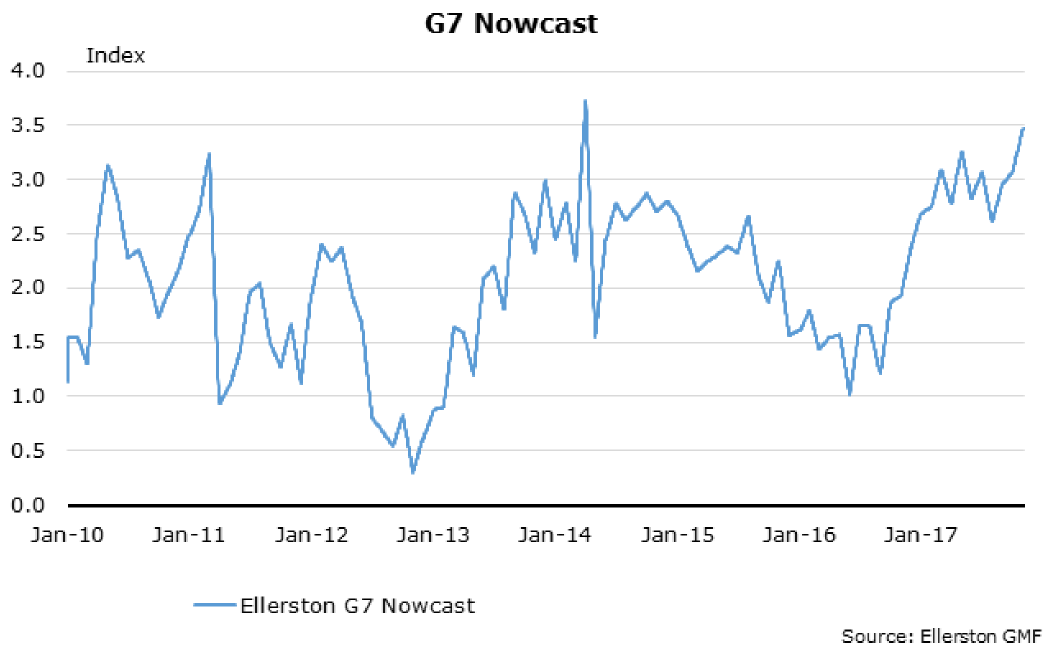
At the end, we have some factors we are very confident about, and some we are relatively confident about.

So let's start with the very confident.

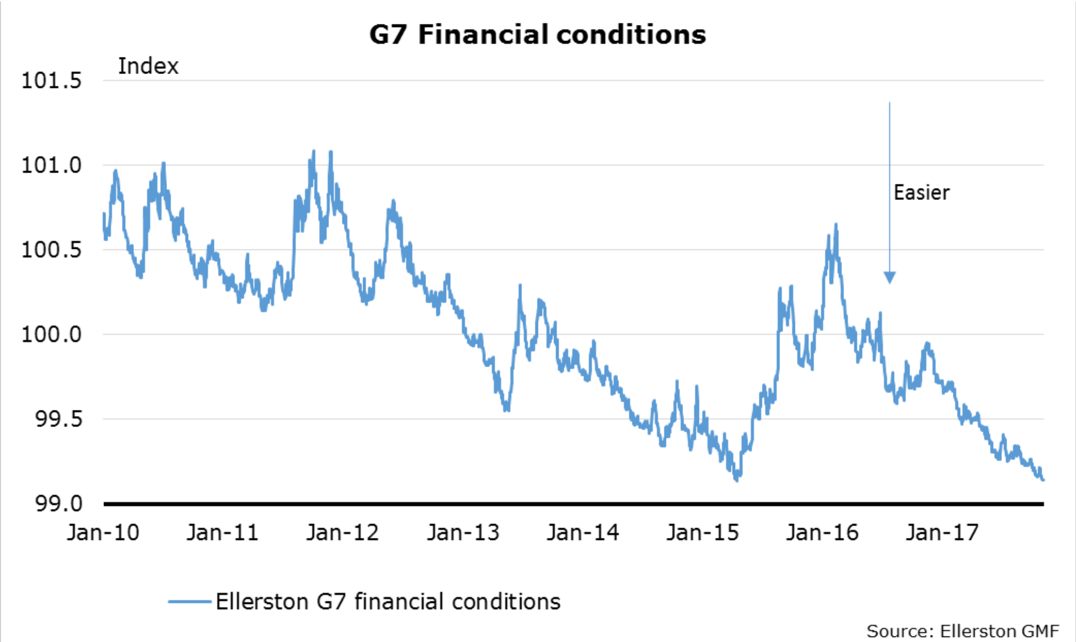
a) G7 economic data is surprisingly strong. The chart below measures the strength of economic data relative to consensus. It has rarely been stronger.



b) Our now-casting models collate all the data to estimate GDP in real time. They show G7 growth is very strong and accelerating



c) Further our models based around financial conditions say this is going to continue.[3] Indeed conditions have never been easier since the crisis!



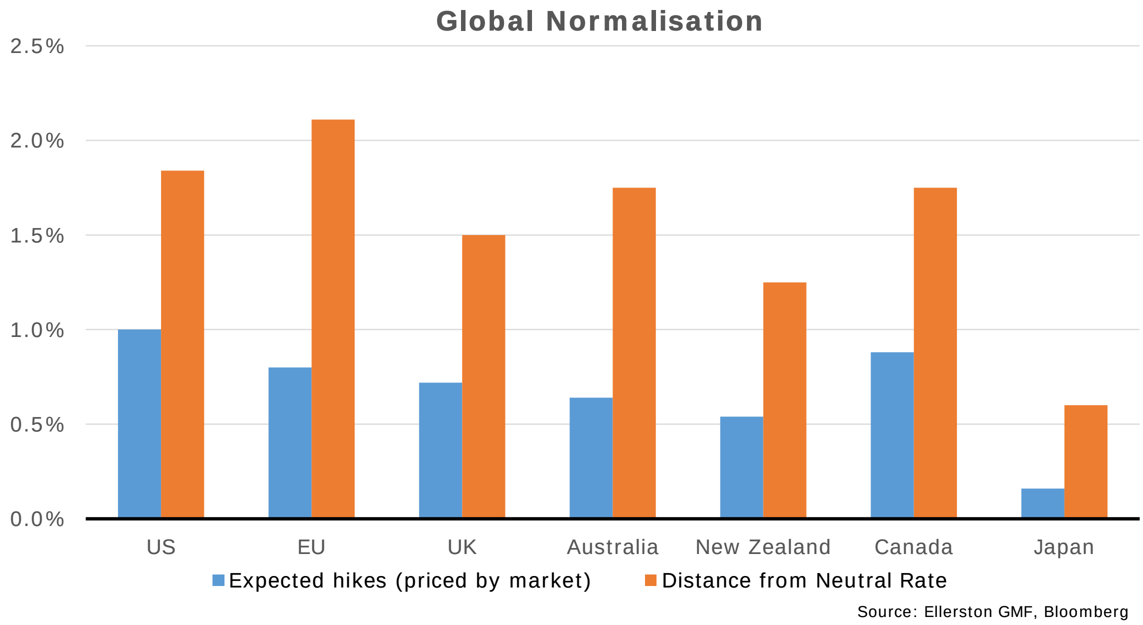
So global growth is tracking very strongly, and it will continue. Normally this would automatically mean higher interest rates.

The general consensus agrees. 87% of investment professionals think US yields will be higher next year (that in itself is a concern).

[3] If the index falls, the financial environment is more supportive of growth. A one point drop, all else equal, suggests growth will be 1% higher over the next 12 months.

Nonetheless, we are very confident central banks will continue to normalise. We take account of debt, debt servicing, demographics and productivity and estimate that the long run neutral cash rate will be lower. But there is still a lot of "normalising" to do.

How much? The chart below shows our estimate of how much (in orange). For most countries, it is around 150 basis points. And in blue we show what markets expect. On average about half that. We are very confident of most these countries getting back to the "new long run neutral" rate over the next 2-3 years. Possibly they will have to go higher, and sooner…



The journey to neutral is as we know well underway in the US. Canada fell in line in July, and now the UK. We expect Australia and NZ to join next year, and Europe and Japan the year after. They are all hoping for an orderly procession.

So should you be concerned if you hold equities, credit or even your house? Not yet. As I said at the outset, normalising interest rates is "good" work. Asset markets returns are generally fine, albeit not exciting, in these periods.

So when do you get concerned? I guess if you have read our forecasts for US inflation and wages you might be concerned. But will we be right?

Models work. Most of the time. Or we learn. At the end of 2015, the price of oil fell from $110 to $45. My models said this would be a big boost to US consumption (lower petrol prices freeing income). Yet growth slowed. Why? Because there had been a boom in shale investment in the US when oil was $100, and that investment slumped to near zero. The world changes, and sometimes we only realise when the models don't work. As Enrico Fermi said, "If the result is contrary to the hypothesis, then you've made a discovery."

I think Tim does amongst the best econometric work I have come across in my career. So I am excited by his forecasts. But inflation and wage modelling in the US? That has been the most difficult to forecast post the financial crisis. Indeed, many have simply thrown their hands in the air. So how confident is Tim Toohey? Well the forecasts are classic Fermi work. Break it down into forecastable baskets, and work on each forecast. We are "quietly" confident. After all, we are trying to tackle the hardest forecast gig in town. That and the impact of central banks winding down their balance sheets- quantitative tightening, which Tim has also modelled.

What we do now is monitor the incoming information relative to our models. What data is important? What are the big calls?

Well right now we have two big calls.

1. The weak patch in US inflation over the last 6 months will be followed by a strong patch over the next 6 months

2. Global quantitative tightening will push US 10 year yields some 90 basis points higher over the next 12 months.

The first call – inflation – is updated monthly in the US. We will know over the next few months.

The second we will only know when it happens. The effect of quantitative easing/tightening is notoriously difficult and controversial to forecast. We think we have a more robust methodology. Even if we are half right, it is a big deal. And a big deal is a lot of alpha for us.

We also have what I think is one easy call. Regardless of inflation and quantitative tightening, all central banks are going to normalise as the global economy continues to strengthen and unemployment falls. This is the bread and butter of macro funds. Pass the jam.

Brett Gillespie

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