

## Fund Facts

Inception date	1 July 2017
Liquidity	Daily
Management Fee	1%
Performance Fee	15%
Strategy AUM	\$14.9 million
Firm AUM	\$5.37 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.

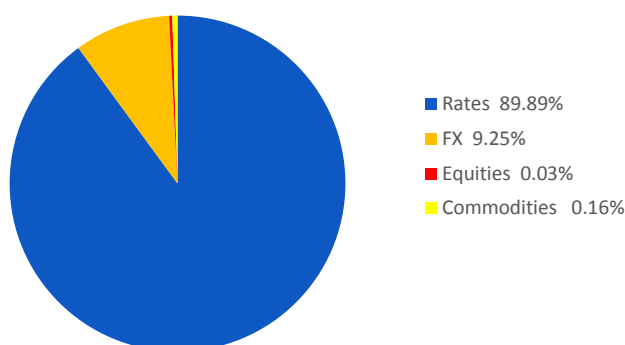
## Characteristics

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

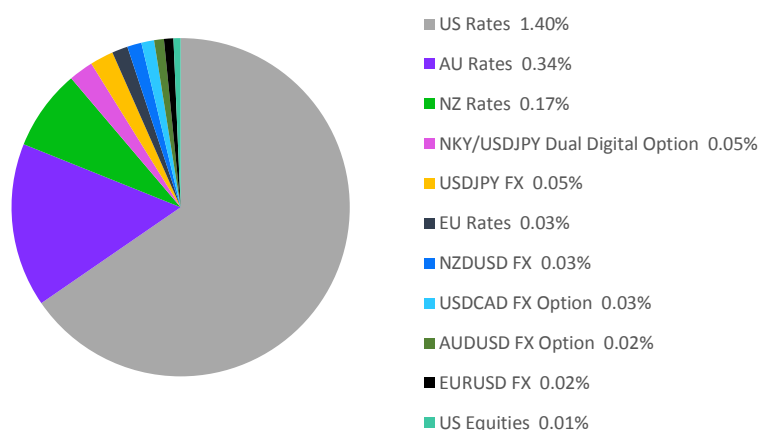
## Net Performance

	1 Month	3 Months	ITD
Global Macro Fund	0.64%	1.00%	-0.50%
RBA Cash Rate	0.12%	0.37%	0.62%

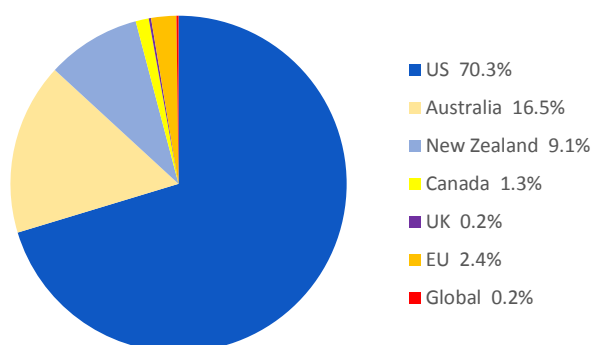
## Asset Class Exposure



## Portfolio Exposure



## Geographic Exposure





## Portfolio Commentary

The fund net return of 0.64% in November.

Generally the month was defined by a robust performance in the US share market (mainly on building optimism in the tax package), but little change in other developed markets and some weakness in EM. The USD weakened modestly against most currencies. Rates markets were generally little changed, albeit mixed.

All of our performance came from US rates, up 0.98%.

US data conformed to our expectations in November. In particular, US core CPI printed a solid 0.225%, and 3 month annualised has moved to 2.4%. This is very much in line with the CPI basket modelling Tim has done, and increases our conviction of higher US rates in coming months.

Despite little change in US 10 year yields (up 3 basis points), the market increased expectations for hikes in 2018 by 12 basis points. There is now 45 basis points of rate hikes priced in 2018. We expect this to increase to 75 or more. We also expect the curve to start to steepen in coming months ie for the 10 year yield to rise more than the 2 year yield, as inflation corrects higher and unemployment tests 4%. So the portfolio remains positioned for higher rates across the whole yield curve.

Again performance was negatively impacted (-0.20%) by our modest short position (for higher rates) in Australia. Yields fell when the wages number printed a low 2% yoy. We closed our short positions for a period and have rebuilt them towards the end of the month. Employment remains very strong, and capital investment expenditure data showed a clear improvement (the mining states detraction fading). Business surveys suggest very strong growth. We expect 50 points of rate hikes next year. The market expects 16. The trigger will be the unemployment rate testing 5% in Q2.

European data has been exceptionally strong, consistent with 3% growth. Inflation is starting to rise, and is now 1.7% across the Eurozone. However, the ECB is still conducting open ended bond purchases, for now suppressing bond yields. We are positioned for higher rates in Europe in 2019. The trade is likely to be a slow burn, likely requiring acknowledgement from the ECB sometime around March that bond purchases will end in Sep 2018.

In FX we are lightly positioned. The correlation between Yen and US rates has broken down, as the market speculates on an earlier exit from “yield curve control” (BOJ buying bonds at zero yield) by the Bank of Japan. The catalyst was a speech by Kuroda flagging the profitability impact on small and medium sized banks of “yield curve control” and suggesting this cannot continue indefinitely. We think the market is ahead of itself, but are no longer using Yen as a portfolio hedge.

Elsewhere our FX views are highly correlated to our rate views, and we generally see better value in the rate trades.

More medium term, as Tim writes, we see volatility as far too low. At a minimum we ensure our portfolio can withstand a volatility shock, by using a lot of limited loss options. Where we can do so cheaply, we are positioning long volatility. Whenever the VIX dips we are happy to purchase cheap calls. And in rates, we like long volatility positions correlated to the US 10 year bond. Pricing is very complacent...

## Outlook

# Burning down the house

*When I broke the back of Australian inflation they say, "Oh, you're the fellow that put the interest rates up." Am I not the same fellow that gave them the 15 years of good growth and high wealth that came from it? Paul Keating*

In 1989, I was hired by Bankers Trust as a graduate to work at the Sydney Futures Exchange. I pulled on the colourful jacket and went into the "pits". It was heady and exciting times, and opportunities presented quickly. Within 6 months, I was trading the biggest book on the floor, shouting and screaming in the bank bill pit.<sup>1</sup>



So here I am<sup>2</sup> feeling super clever and super important, trading bank bills. But I was only good at execution. I really had no idea what was causing the prices to move. But moving they were. The RBA and Keating were working to contain a housing bubble, and interest rates were smartly rising to 18%! House prices had risen 50% in 1988 alone!

Meanwhile, my father had turned into a property speculator. My parents divorced in 1987, and he bought an apartment and sold it 4 months later for a 30% profit. How easy was this he thought? So he bought two apartments in Noosa and retired. Or at least so he thought.

In his lifetime, mortgage rates had been regulated. Prior to 1983, there were caps on credit, and mortgage rates had never gone over 13%. So he figured that was his worst case scenario. As they edged to 17%, he asked me what was going on. Were interest rates going to stop rising? When will they fall? What will happen to house prices?

Frankly, I had little idea. I was in the bank bill pit, so trading the 90 day paper based on the RBA cash rate (which in those day wasn't even announced) and prices were swinging around 100 basis points a day. I had not developed my economic knowledge enough to have a handle on why rates were moving and where they were going over the medium term.

<sup>1</sup> If you want an idea what it was like, watch "Trading Places" with Eddie Murphy. They capture it brilliantly!

<sup>2</sup> No not in the picture. The only picture I found of myself was the back of my head standing around doing nothing!



As we rolled into recession, Keating kept his foot firmly on the throat of the property market. Property prices starting falling. “It was the recession we had to have” he famously said. Needless to say my father was not a huge fan of Keating, despite my protestations.<sup>3</sup> Cash rates were declining painfully slowly for him. He had to fold. He simply couldn’t afford the repayments. But prices were down 50% in Noosa! He went close enough to bankrupt.

By 1991, I was a proprietary trader for Bankers Trust. If I knew exactly what was driving rate decisions and where they were going. I would have advised my father to hold on, rates would fall quickly. Alas, my knowledge was gained too late to have advised my father.

### Australia: 90 day bank bill future



Source: Ellerston GMF

Why am I relating this story? A consistent part of my outperformance over my career has come from correctly forecasting interest rates. So at the barbecue, when people come to understand this, the first thing they want to know is what is going to happen to interest rates and housing. Like my father did...

So here it is. We think the RBA is going to start hiking by August, possibly May next year, and roughly do 2 hikes every 12 months. And house prices are going to go sideways to small up for a number of years.

That can’t possibly happen, they say; housing is already slowing, debt is too high, and prices will collapse.

So let’s first understand a few basics about Australian housing. The two most important drivers of Australian housing are

1. The cost to service a mortgage
2. The unemployment rate.

Notice I said the cost to service a mortgage. That is the repayment, and not the debt. People and the banks have to take debt into account in assessing how much the repayments will change, but at the end of the day it is all about the repayments. So when a borrower (and bank) sits down and considers the worst case on repayments, implicitly they

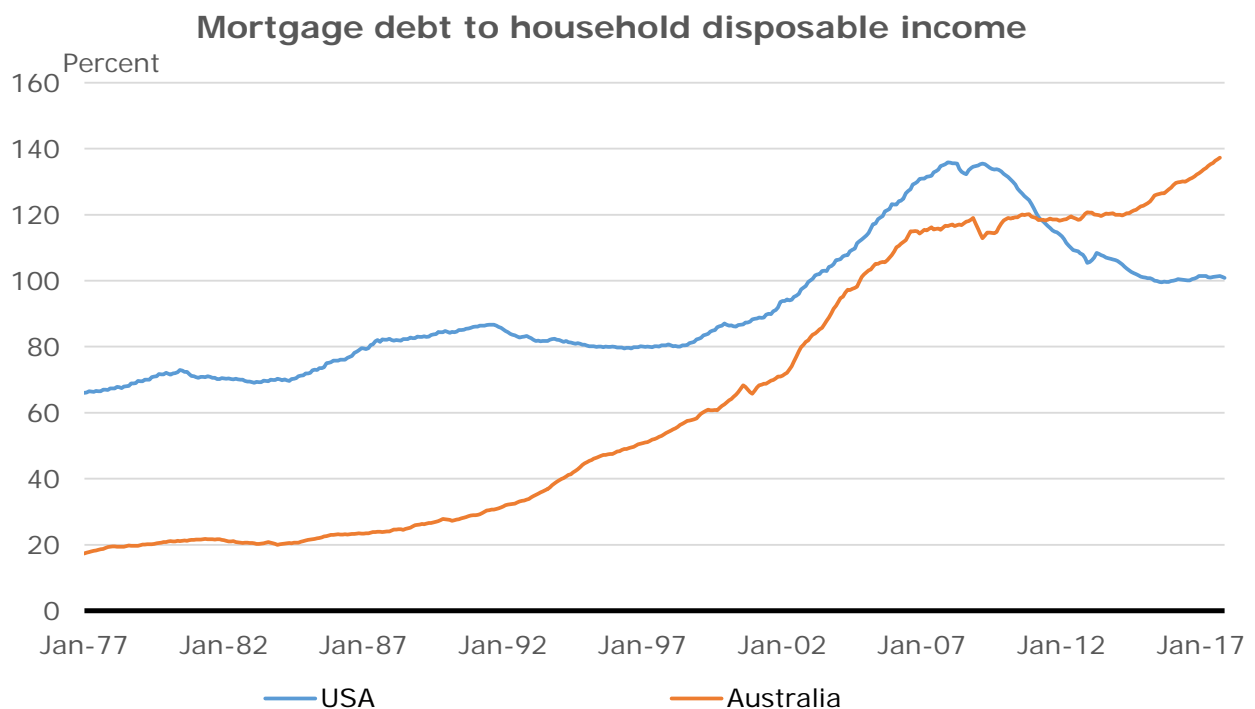
<sup>3</sup> Keating’s policies, in particular floating the dollar and a flexible low inflation target originally enabled by the Wages Accord, did set Australia up for its world record expansion continuing to date.



decide what's the highest the mortgage rate can rise too. My father thought 13%. Today most people would think 6-7%.

The thing is, this assumption changes relatively slowly. Each time there is a hiking cycle, the peak informs that assumption. The 1994 hiking cycle peaked at 7.5%. The 2000 cycle peaked at 6.25%. Wow, people realised, my mortgage repayments won't ever rise anything like they did in 1990. I can borrow a lot more.

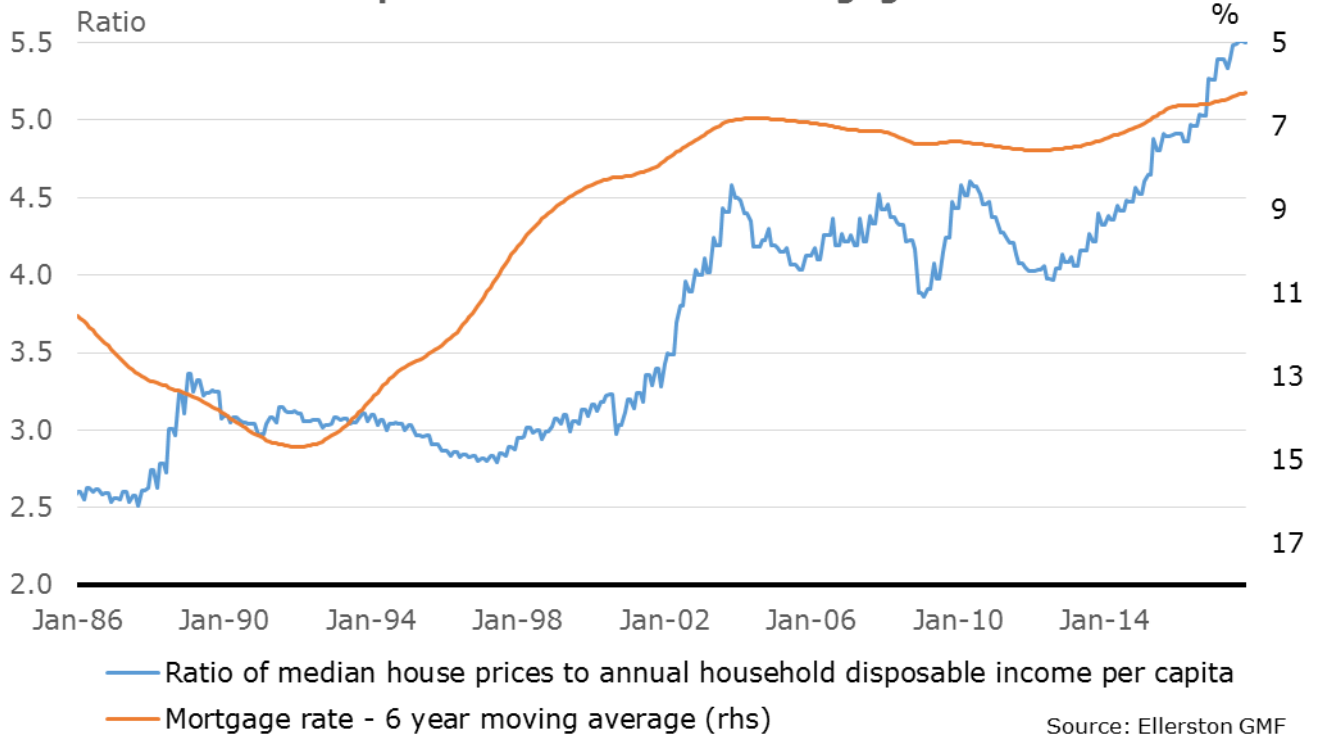
The RBA saw this coming. Indeed, they saw it as a perfectly natural development. In 1998, mortgage debt to income in Australia was around 55% (compared to 137% today). In the US, it was around 80%. In 1998 I was at a lunch with a senior RBA official, and I vividly recall him saying there was no reason housing debt/income in Australia shouldn't be similar to the US. By 2002 it was.



Source: Ellerstun GMF

So what does this mean? It means low (and stable) interest rates have been capitalised into property prices. Is that a problem? From a financial stability perspective, not at all, provided interest rates don't go up too much, which they won't.

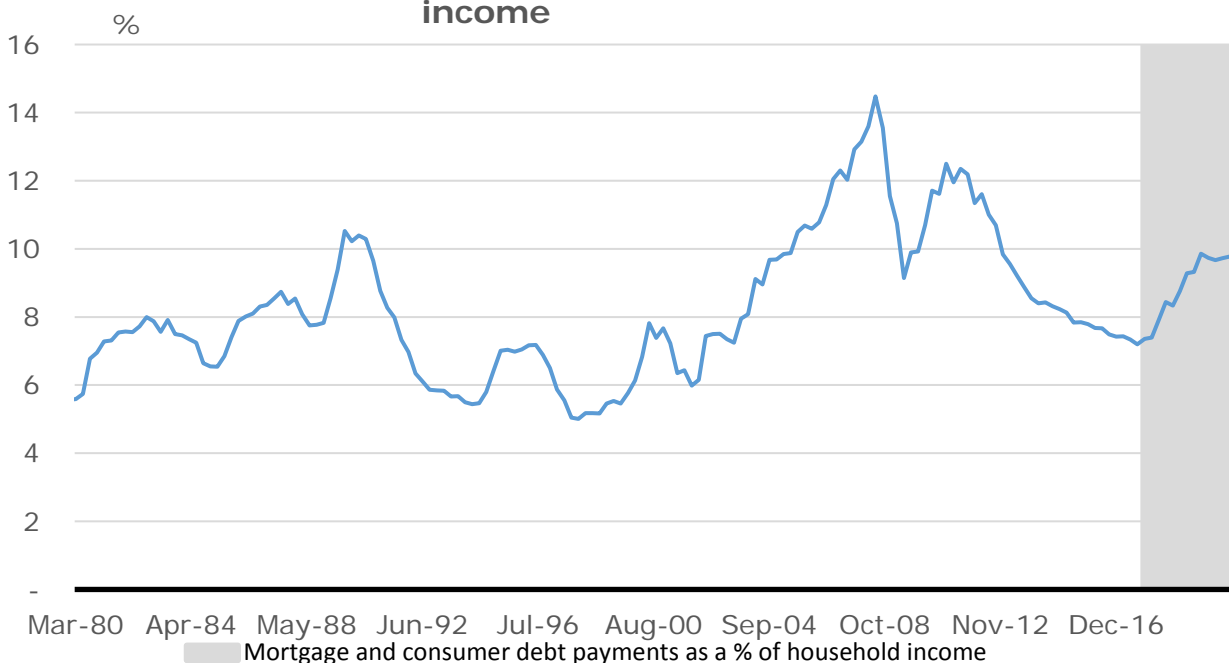
### House price to Income and mortgage rates



Why won't they? Well the real efficacy of monetary policy is the impact on debt servicing. Leaning against the mining boom, interest paid as a % of income had to hit 15% to slow the economy (and the GFC intervened, so we are not sure how restrictive that would have proved). Post the GFC, 11.5% appeared enough, though again the European crisis intervened to stifle global growth.

We forecast 150 points of rate hikes over the next three years. That will take the debt servicing ratio to around 10%. Historically not onerous. Indeed, neutral over the last 15 years.

### Australia: Household debt servicing ratio to disposable income

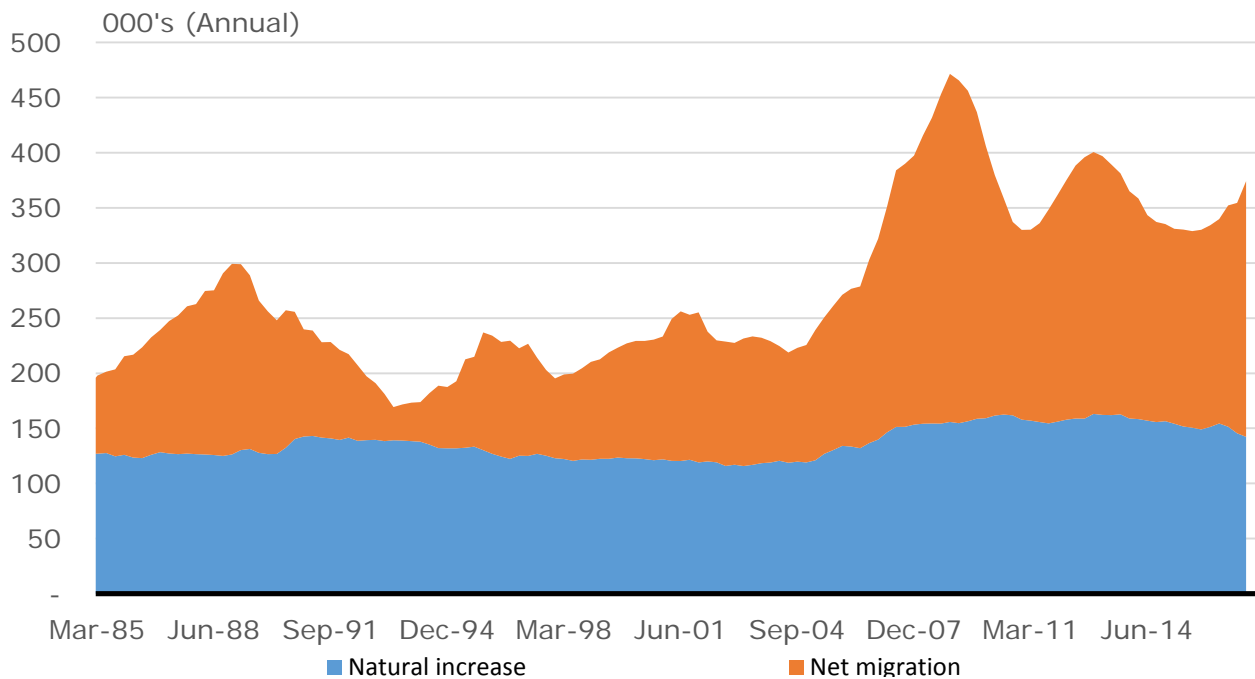




What might change that? Well immigration, and Chinese purchases, for sure. And more, or less, reliance on macro prudential tools.

Immigration is the big swing variable in population growth, and is obviously controlled in large degree by the government. We have had a decade of exceptional strong immigration growth, and although it has faded through 2014 and 2015 it has recently reaccelerated. It looks like it will remain supportive, at least for the time being, whilst interest rates rise.

### Australia: Population change



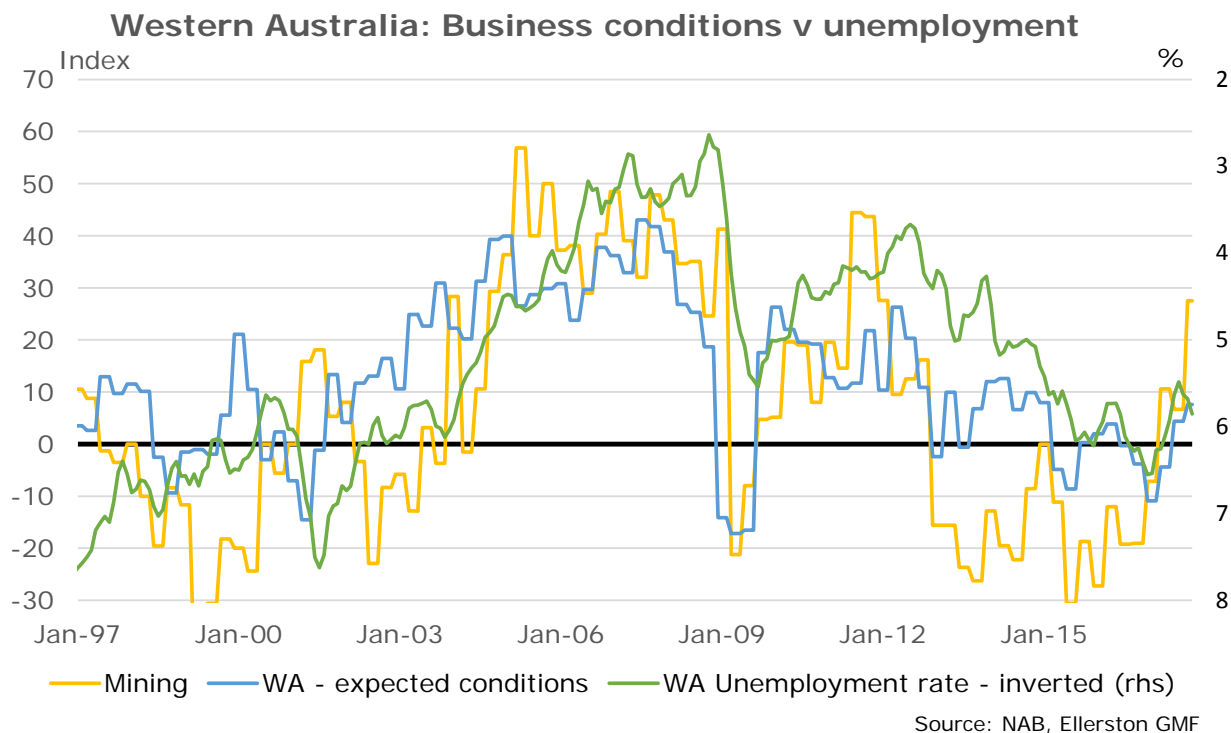
Source: Ellerston GMF, ABS

Chinese purchases? Well, given the improving wealth in China, some studies indicate Chinese purchases will increase 5 fold over the coming 5 years! However, governments globally are now leaning against this source of demand, and I would expect this to continue. If the impact is too large, expect more intervention.

So will house prices fall? The media is obsessed with doom and gloom stories, because that is what sells. Either house prices are rising too rapidly, or they are about to crash. I mentioned the other key factor, unemployment. Given full recourse loans in Australia, losing money on your house can wipe out all your wealth, as my father found. Hence Australians will do everything they can not to sell their house at a loss. They simply don't sell unless they absolutely have to. Typically, that means when they lose their job. So the only time we have seen a meaningful fall in house prices in Australia is when the unemployment rate rises significantly. Otherwise housing turnover just drops.

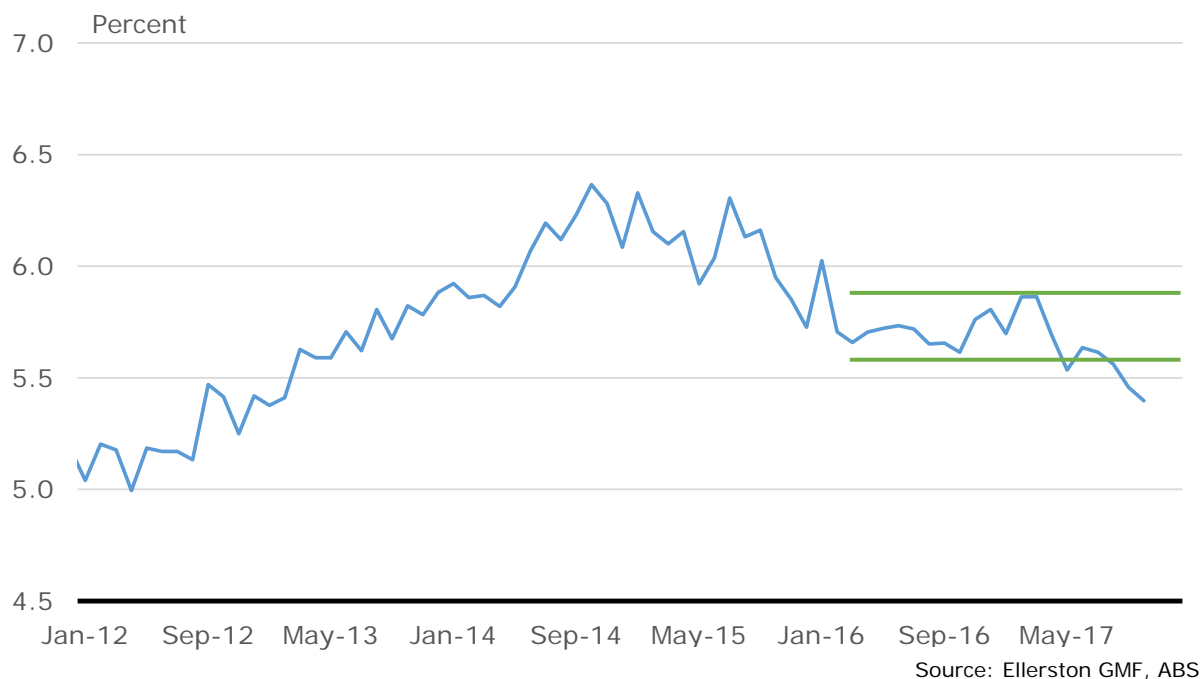
So why will interest rates rise? As George Bush learnt, "It's the economy stupid". Rates were set at 1.5% to support the economy as mining investment plummeted. They were intentionally set at 1.5% to fire the housing market to offset the slump in growth from mining investment, which hit WA particularly hard. But now WA is recovering, and so is the broader economy.





And this is manifesting itself in the Australian unemployment rate breaking its 18 month consolidation and starting to fall.

### Australia: Unemployment rate

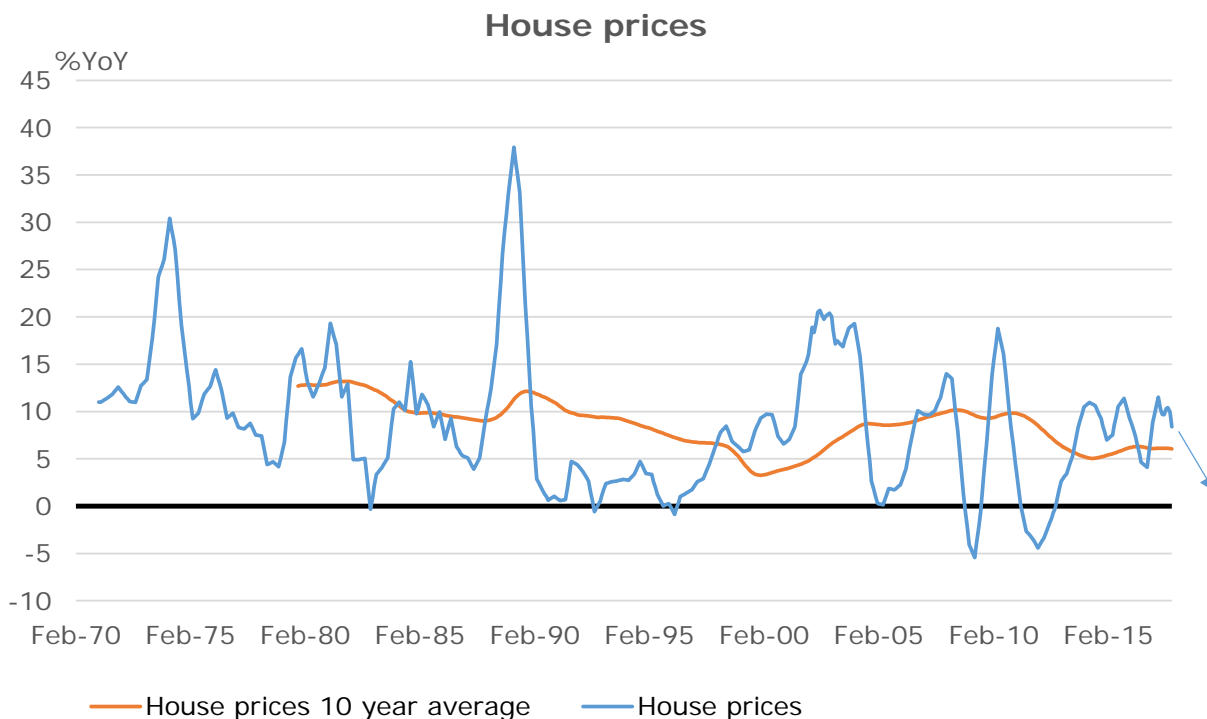


When this hits 5% the RBA will be hiking, or hiking soon. It's the green light to ease back on super low interest rates as the mining states recover. We think it will hit 5% in 2Q18. The RBA sees a more muted decline, around 5.25% by the end of next year.

What about inflation? With 5% unemployment, they can confidently forecast inflation back to target in the medium term.

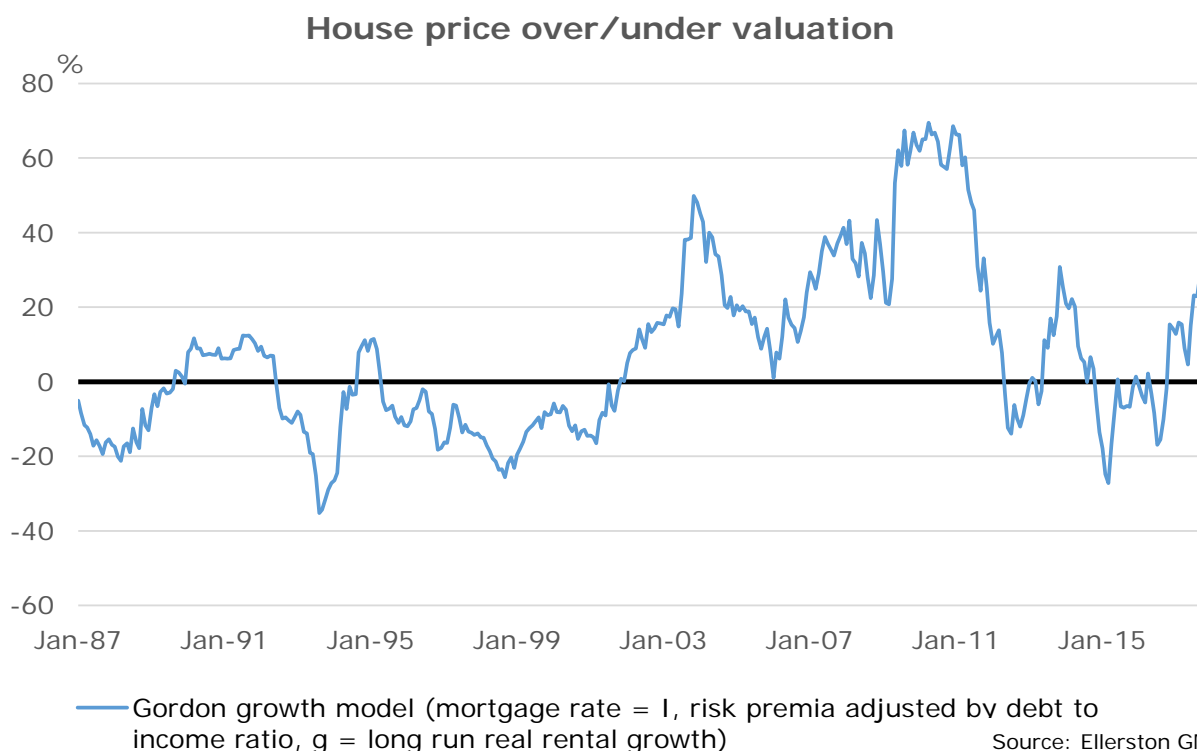
And housing? Think 2004-2005. Slower turnover, and muted price rises. Around 0-5% a year.





Source: Ellerston GMF

But isn't housing a bubble? Won't the bubble burst? Well actually not. Tim's work see's Australian house prices about 20% overvalued. Which is not high historically. And can be painlessly corrected with 0-5% price growth over a number of years.



Source: Ellerston GMF

So what do I tell people now when they ask about housing at the barbecue?



Firstly, understand that the spectacular returns in property the last 25 years is almost entirely due to moving from a high inflation/high interest rate environment to a low inflation/low interest rate environment<sup>4</sup>. Low rates have been capitalised into prices. It has happened. It won't happen again.

Secondly, expect rates to rise, but only about 150 basis points to the peak of the cycle.

Thirdly, don't expect a property crash, at least not until you expect a recession, which we don't. Property prices are not a bubble about to burst. But it is also an asset class that won't be a good investment.

To my children I say, buy a house for a lifestyle. Not for an investment.

For our portfolio, we are positioned for rate hikes in Australia next year. We have just started rebuilding this position in the last week and it is now the second largest risk position in our portfolio, after our US rate position.<sup>5</sup>

Brett Gillespie

### Further Information

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<sup>4</sup> In the 1980's the big driver of the property boom was the deregulation of the banking sector. Some argue that deregulation has driven the 30 year housing boom, particular Basle changes to capital reserves required for mortgages. I would argue the freely available credit allowed low borrowing costs to be capitalised into prices, not caused.

<sup>5</sup> Please refer to Oct newsletter for an outline of our US rate view.