Ellerston Global Macro Fund

Newsletter – January 2018

Fund Facts

Inception date	1 July 2017
Liquidity	Daily
Management Fee	1%
Performance Fee	15%
Strategy AUM	$118.5 million
Firm AUM	$5.79 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

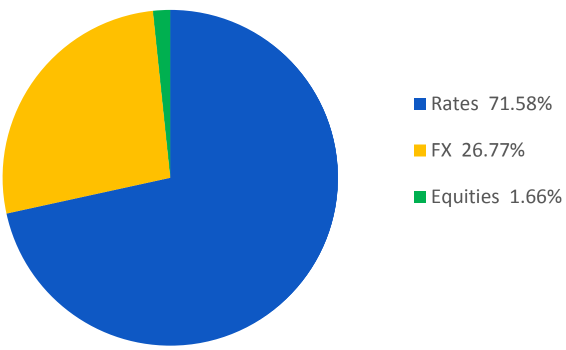
- Uncorrelated return stream
- Strong emphasis on capital stability
- Lowers overall portfolio volatility

Net Performance

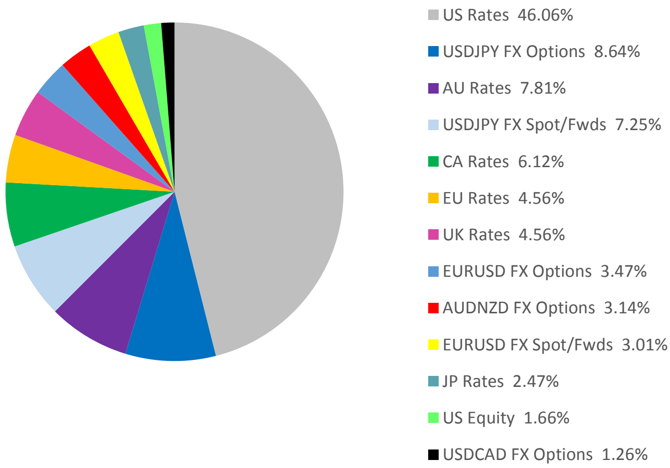
Net	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2018	1.85%												1.85%
2017							-0.59%	-0.90%	0.81%	-0.45%	0.64%	0.66%	0.16%

Return	1 Month	3 Months	6 Months	Since Inception
Global Macro Fund	1.85%	3.18%	2.62%	2.02%
RBA Cash Rate	0.13%	0.38%	0.75%	0.88%

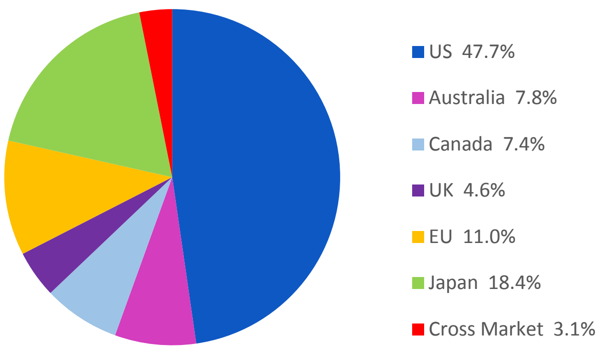
Asset Class Exposure



Portfolio Exposure



Geographic Exposure



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Portfolio Commentary

The fund returned 2.25% gross in January. By asset class 2.39% from fixed income, -0.10% in foreign exchange and -0.04% in equities.

Our long talked about move in US rates started in earnest in January, and this contributed 1.88% to performance. US 10 year yields rose from 2.405% to 2.705%, some 30 basis points. We weren't positioned specifically in 10 year yields in the US. We were running "safer" trades in the 3 year part of the curve, and using options to improve our returns if a sell-off in rates ensured, as it did.

We also started to accumulate positions for global bonds curves to "steepen"; that is for 10 to 30 year bond yields to rise more than 2 year bond yields. During January the US 2-10 year yield curve remained in a fairly tight range of 50-60 basis points. We have accumulated options for the curve to steepen over the next 6 months. In Japan, we have done similar in options, looking for the 10 year 20 year curve to steepen as the Bank of Japan keeps the 10 year anchored around zero (I discuss this in more detail in the newsletter).

Globally the economic picture is unfolding as we have outlined over the last 6 months. One frustrating position for the portfolio has been Australian rates. Performance was flat in the month here, with yields in Australia ending the month a little lower following the low inflation print. We still believe the RBA will join the rate hiking cycle this year, and remain positioned for a move in August. Tim Toohey outlines our view here.

Europe added a healthy 33 points to performance in January. Here we are positioned for no rate hikes in 2018, followed by rate hikes in the first 9 months on 2019. For example the market currently prices 18 points more hikes in H1 19 compared to H2 18 in Europe. We think it should be more like 40. Once the ECB commences rate hikes, it will want to get back to zero (from -0.40%) relatively quickly. We put this trade on at 2 points back in October.

The strong US and Canadian growth performance indicates a more extended hiking cycle in Canada, and we have positioned for rate hikes to continue through 2019 and 2020.

We are also positioned for a rate hike in the UK by May. An earlier move would not surprise.

FX was a fairly benign affair for us in January. Again in exotic options, we were positioned for a weaker USD by being long EURUSD and short USDJPY. But we were also long USDCAD based on our outlook for relative interest rates. We made money for the first two, and loss on the third. We still hold these trades.

Towards the end of the month, our econometric work suggested the pace of the bond sell-off might trigger a correction in equities, and so we bought options on volatility (VIX call spreads) for the US stock market. If equities fall quickly, this will contribute to performance and mitigate any loss performance if bonds react by rallying.

Outlook

Right into the danger zone

Leadership is, among other things, the ability to inflict pain and get away with it – short term pain for long term gain. – George Will

February 4th, 1994. I was on a plane to LA from Sydney. I was treating myself to a 4 week holiday skiing in Aspen and on to NY. 1993 had been a good year. Initially when my boss, Richard Farleigh, had resigned 10 months earlier I wasn't sure what was going to happen. I was a proprietary trader in a team of 13 working for Richard at Bankers Trust in Sydney. He was the guru. I was 26 and obscure to management. What were they going to do?

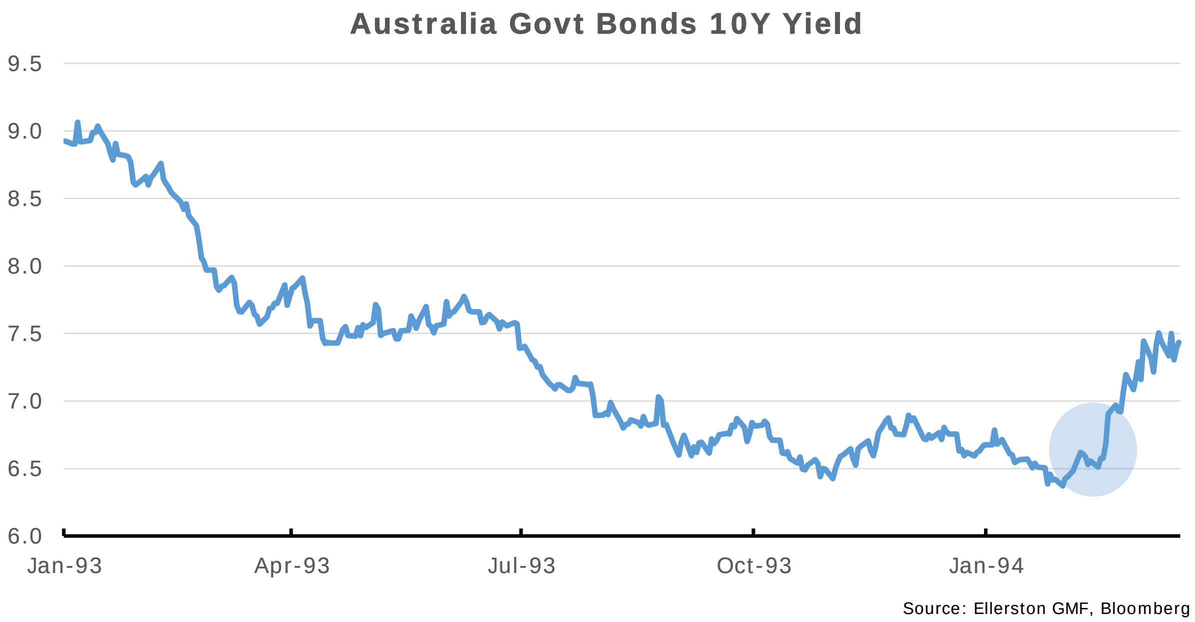
To my excitement, Peter Warne made the decision to appoint me joint head of the desk (with Ian Cassie). I produced a record year for me at the time, about 9m AUD profit, and secured BT's confidence.

So here I am, about to party. But I couldn't afford not to trade for a month. So I kept my highest conviction trade – long Australian 10 year bonds, reduced it modestly so it could wear a little more volatility, and set a $1m trailing stop. I figured I had given the stop enough room that the trade should have no trouble surviving the month.

Disembarking after the 14 hour flight I am walking past a TV in the airport, and the banner at the bottom reads;

"Fed hikes interest rates"

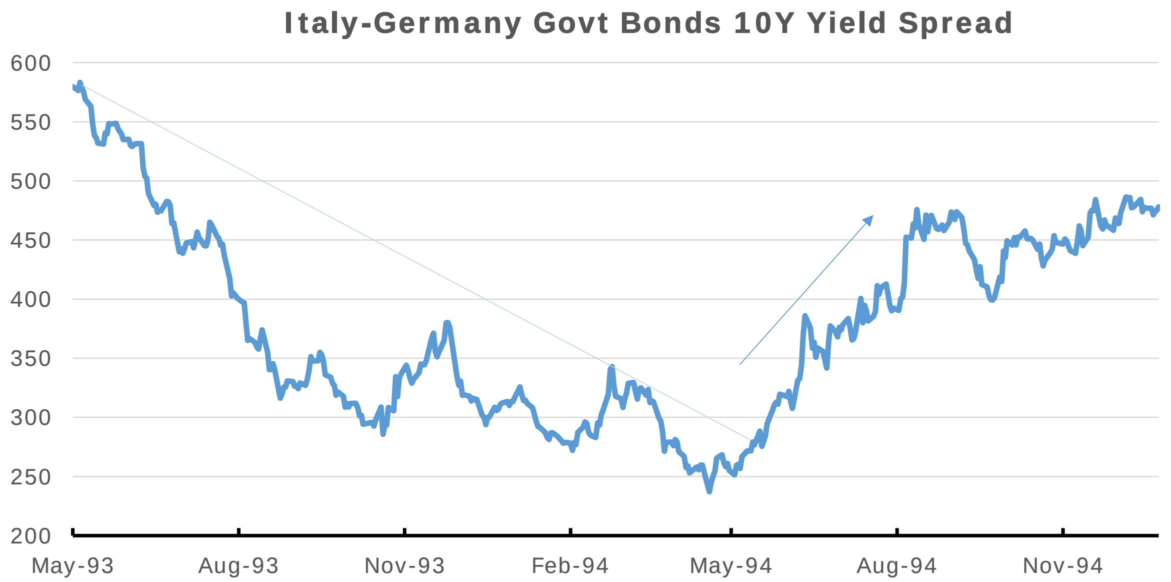
What? It was 9am and the Fed was still meeting. And they have hiked rates?[1] Indeed they had. And my $1m stop had already been hit, the position closed, and it wasn't the most pleasant way to start my celebratory holiday…



The initial market commentary was this was no big deal, it would be a modest cycle, and the rest of the world would be little affected. But the rest of the world had been in the mother of all carry trades. In particular, the favourite was long bonds in peripheral Europe. And everyone was fully loaded.

Bankers trust had 70 proprietary traders in New York and London. They had made a fortune for the bank in 1993 on peripheral bonds. By the end of 1994, they had "released" 68 of them. It was a bloodbath.[2]

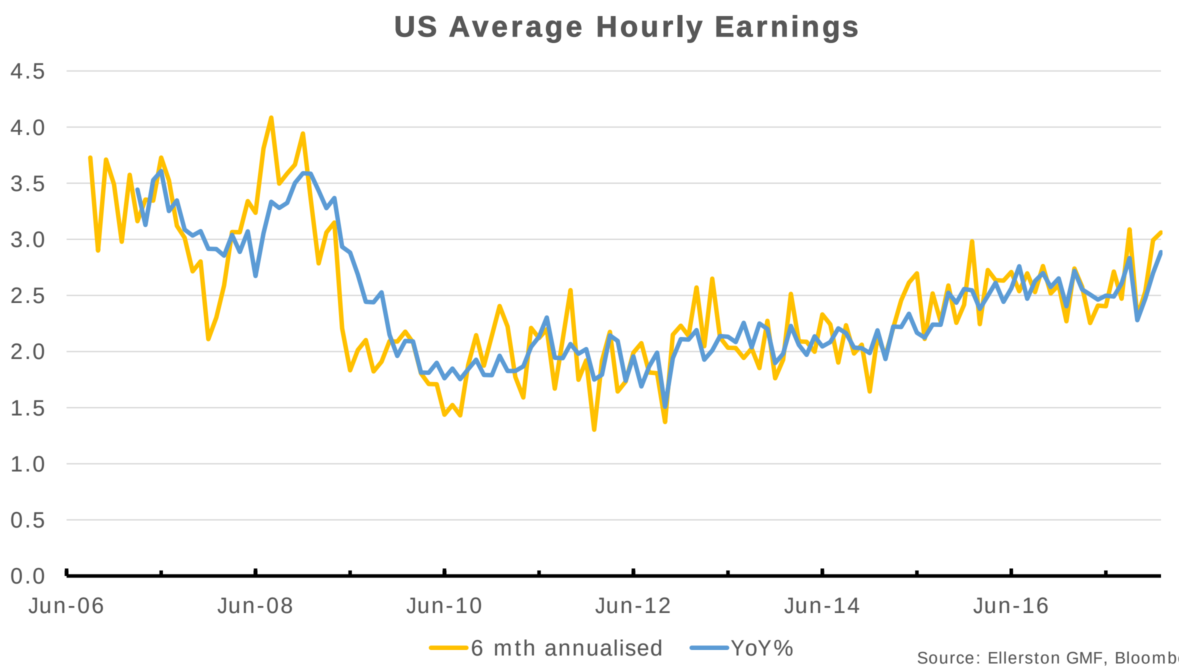
[1] https://www.federalreserve.gov/fomc/MINUTES/1994/19940204min.htm The market was only pricing a 22% chance of a rate hike the week before the meeting
[2] Note the Bundesbank did not even hike rates in 1994. It was a pure carry unwind…



Source: Ellerston GMF, Bloomberg

In Australia, BT traders as a group didn't have a loss month. The traders turned and went with the move. It was a great opportunity. It took me until May to get profitable, but I finished with a solid result.

Are we about to repeat 1994? Last month I implicitly gave it a 25% chance (a wages break-out in the US would be the catalyst in my mind, particularly combined with above consensus growth). On February 2nd, with the latest release of the US non-farm payrolls, the probability just went up.



Source: Ellerston GMF, Bloomberg

This will silence the Fed doves. So what we now know is 3 hikes from the Fed this year is the minimum. We still think 4.

Could there be more? Certainly, but hard to say given we are still waiting to see who Trump will nominate for 3 new Fed governors this year. Which is very unfortunate. 2018 is shaping up as a year that is going to require very confident and brave leadership from the Fed. Will they be up to it? What if they are not?

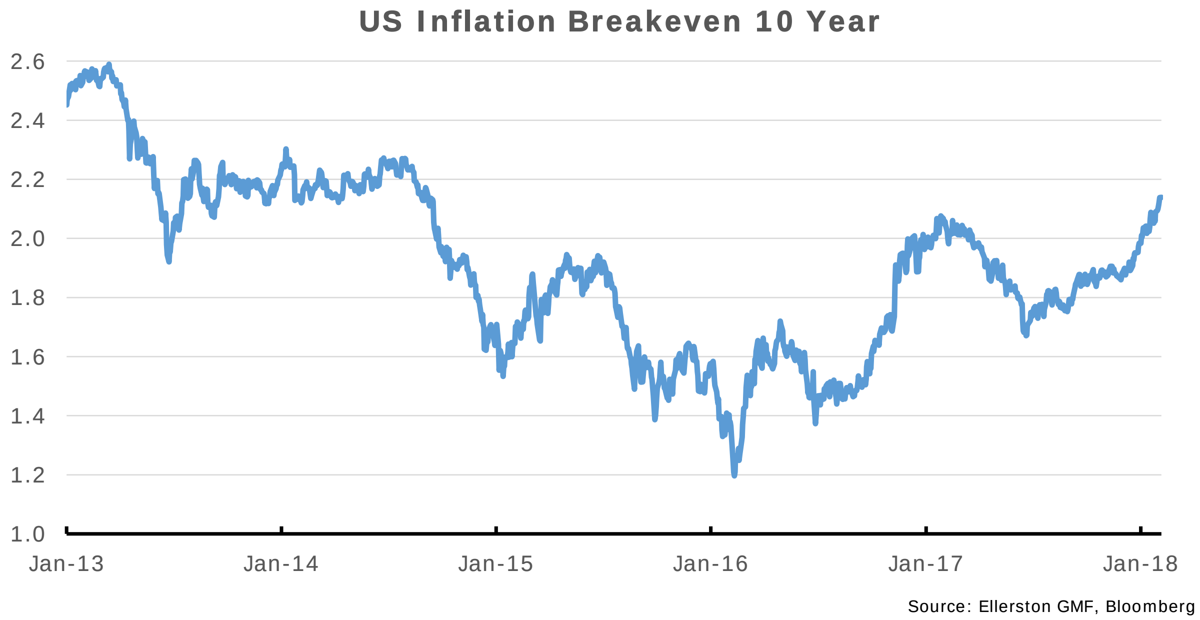
What do I mean by brave? Brave means willing to apply the painful treatment. Short term pain for long term gain. Volcker did it in spades in 80 and 82. Greenspan in 94 and 2000. In these times these men had one goal. To tame inflation. And no one liked the medicine. But they gave it.

I think Yellen would have been brave had she stayed. She is a labour market economist, and she was with Greenspan as a hawk in the 90's. But Powell? Ehhh. Who knows? He is a lawyer with 5 years' experience as a governor. Will he be confident enough to make the tough decisions? Does it matter?

It does to bond markets. And so it will to equity markets. You see, bond risk premium hinges amongst other factors on the confidence that inflation will remain low and stable. Aggressive hiking cycles by the Fed in 94 and 99/00 created this confidence. Indeed, in these cycles, the Fed hiked when they forecast wages to rise. Given the delay in the impact of changes in monetary policy, they knew they had to be pre-emptive. But today, like the late 60's, there is a high conviction that inflation and wages will never rise. The world has changed right? Technology, global supply chains, robots…

Except wages are now rising.

And inflation expectations are now starting to rise[3].



Could it be that a near 30 year low in unemployment does create wage and price pressures? Could it be that the Fed has complacently drifted well out of the flags, and is about to find itself in serious trouble as the riptide of wages gains momentum…

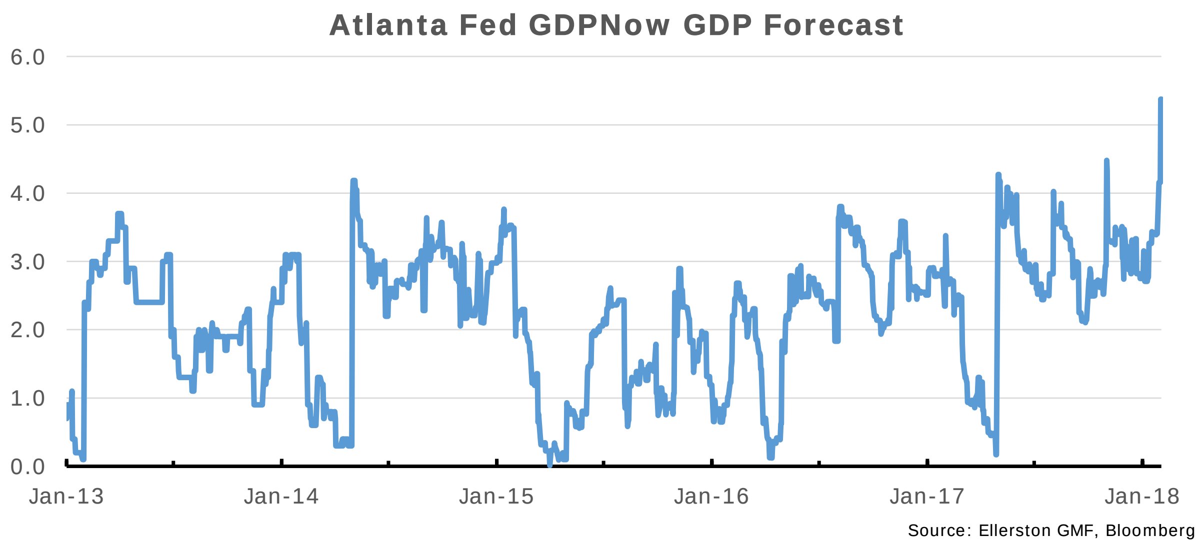
[3] 10 year inflation break-even rate

At this stage they should be clearly more concerned. Perhaps, like our chap above, raising an arm for the lifeguard to help. But not panicked. Hence **my 25% probability perhaps has moved to 33%.**

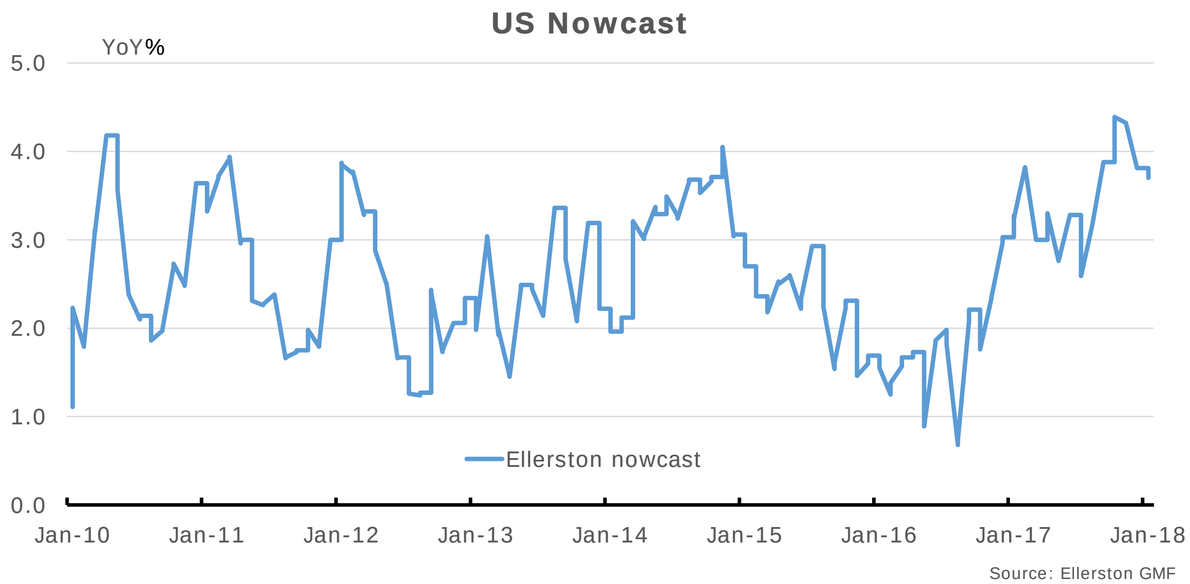
When should they/we panic? Well this is where it gets interesting. One consultant was suggesting to me this week that if bond yields rise too much, the Fed will merely stop hiking and that will contain them. Rather naïve.

You see, if bond investors are worried about rising inflation, a Fed that pauses will only increase that worry. After all, the economy needs to be slowed. A pause will allow growth to strengthen.

Which leads me to the key. If growth was to strengthen this year at the same time that wages accelerate, that is terminal for bonds. Will growth strengthen? The latest Atlanta Fed forecast for GDP would alarm you.[4]



Our forecast is a little more benign, but clearly strong.



Whether bonds yields have a major capitulation will depend on many factors. The Fed, reversal of leverage, and liquidity.

The Fed may need to be aggressive to maintain confidence that its inflation objective will be met. (Haven't we come a long way from 6 months ago!) That would likely mean more frequent hikes. Possibly even a 50 at some stage.

[4] The Atlanta fed utilises all current data to econometrically forecast current GDP growth (annualised). It does jump around a lot as data comes in.

Then we have the leverage unwind. How will that progress? Usually it's ugly. We have written about the leverage in risk parity funds and volatility targeting funds. Our estimate is an increase in volatility could trigger anywhere from 1.5 trillion to 3 trillion in bond sales. Like the impact of portfolio insurance in 1987, the more that bonds weaken and volatility picks up, the more the funds will have to sell.

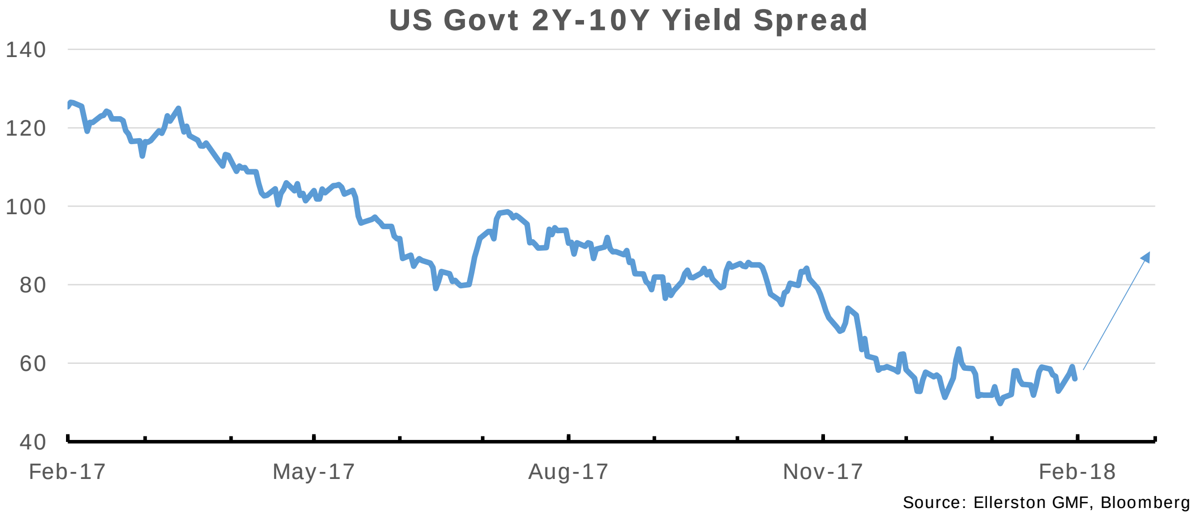
And then there is liquidity. Not quite what it was. The increase in bank regulation in the US has meant banks no longer actively trade fixed income securities. Hence when a fund wants to sell, the banks find a buyer. They don't warehouse. Markets move more…. In fact liquidity is now back to mid-90 levels.

All this sounds rather apocalyptic. To be clear it is not my central case. **But it is a significant risk. If it happens, and your portfolio is not protected, you have no excuse.** It is a material risk you should have foreseen.

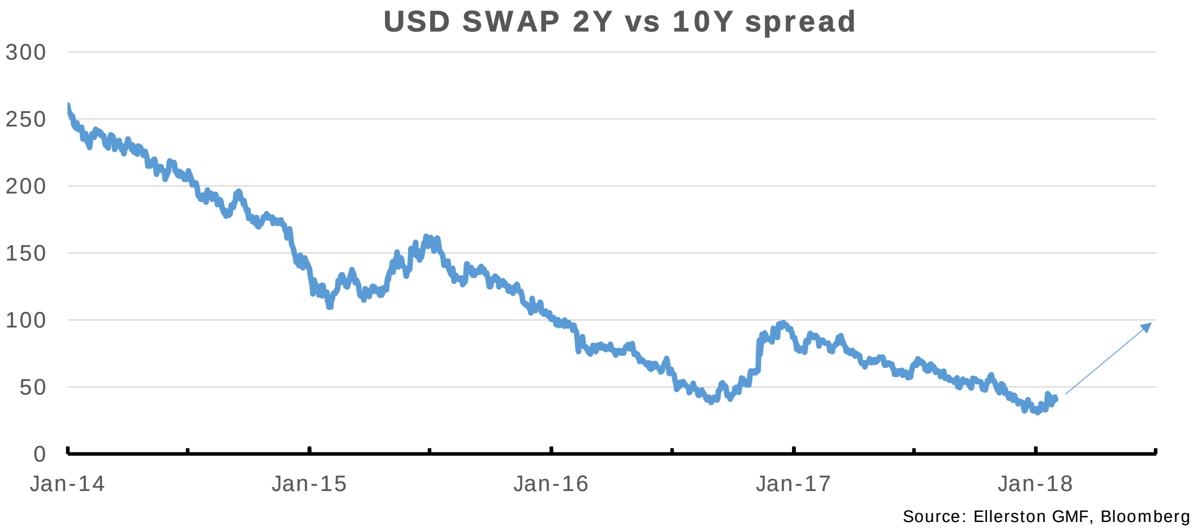
Our central case still revolves around a modest pickup in wages and inflation. And a faster restoration of risk premium in bonds. This would still see us **targeting 3.25-3.5% for the US 10 year this year.** So equities might suffer some setbacks, but not a disaster. This keeps the Fed, and indeed other central banks, very active. And the bond curve relatively stable, meaning 2 year bond yields and 10 year bond yields rise by a similar amount. For this scenario, we are heavily positioned short US rates around the 2-3 year sector. It has been very rewarding for the portfolio since September, and almost embarrassingly easy. We think it very much continues in 2018.

But **we are also acutely alert to the risk of a complete capitulation in bonds**. And very excited about how "cheaply" we can cover this scenario.

Let me give you a few examples. If the bonds panic, the difference between the 2 year bond and 10 year bond will increase. The curve will steepen.



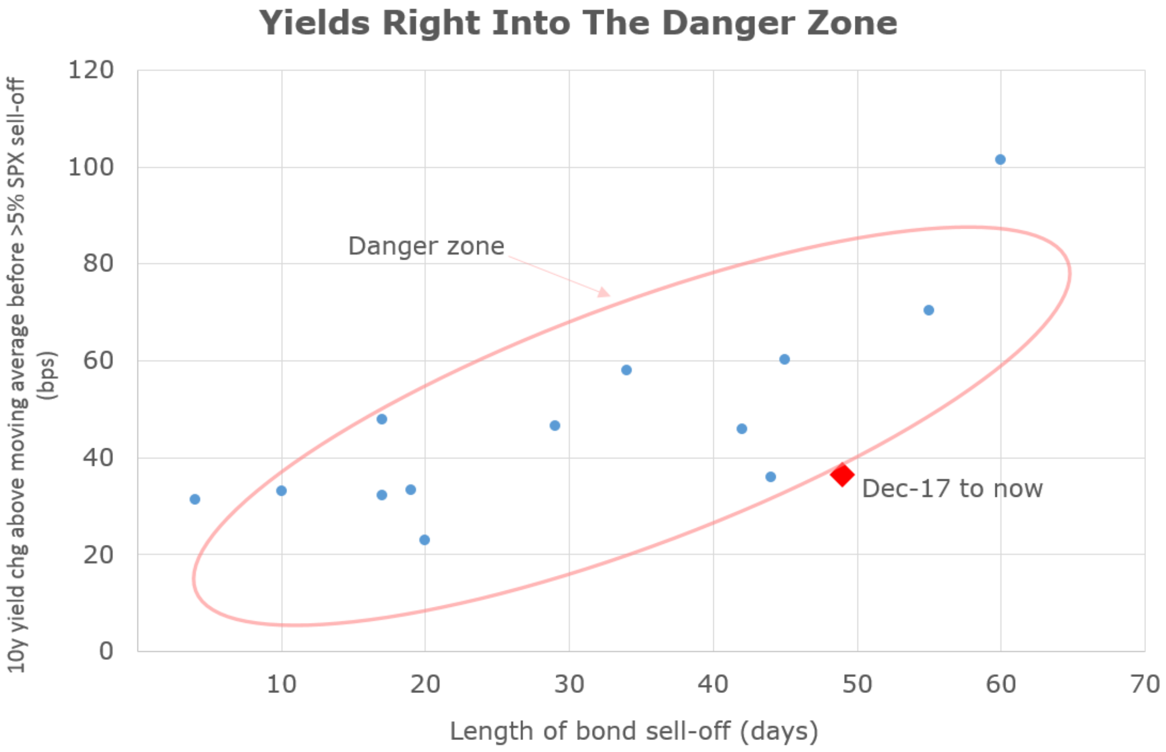
We can buy an option on the shape of the curve. And because it has been relatively stable, we can buy it very cheaply. So we have a call on this spread moving above 60, as well as call spreads. On the former, if the spread went to 100 in the next 6 months, we return 28:1. If it moves above 65, we return 16:1 on our call spreads. Pretty nice risk rewards!



These trades are even cheaper in Japan. There we are positioned for the 10 year/20 year curve to steepen, given the Bank of Japan is determined to anchor 10 year yields near 0%. If this curve went to 80, we would make 80:1.[5] Hello, that's what we are after. 80:1 returns for a 25% chance. With global volatility still so low, there are just so many dare I say sensational ways to have these scenarios covered

What about equities? At the end of the day, it depends how far and how fast bonds sell-off. The chart below shows the instances where a bond sell-off generated a 5% correction in equities. The size as well as the pace of the sell-off matters. If I were to update the current sell-off, we have had a 36 point move in 49 days. **Right into the danger zone…**

[5] In actual fact we have paid 0.2 for a conditional steepener. If yields rise on the 10 year or the 20 year our options will be exercised, and we will be long 10 year bonds and short 20 year bonds. Our loss on the 10 year is limited (we have sold a put spread rather than a put) If the BOJ terminates yield curve control the position will need to be managed, but we still believe it will be profitable



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