Ellerston Global Macro Fund

Newsletter – April 2018

Fund Facts

Inception date	1 July 2017
Liquidity	Daily
Management Fee	1%
Performance Fee	15%
Strategy AUM	$139.7 million
Firm AUM	Over $6 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

Platforms

BT Wrap, BT Panorama, Asgard, Powerwrap, Hub24, Netwealth, Managed Accounts

Research

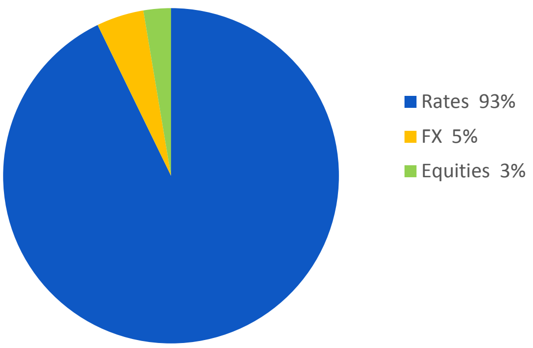
Zenith Recommended

Net Performance

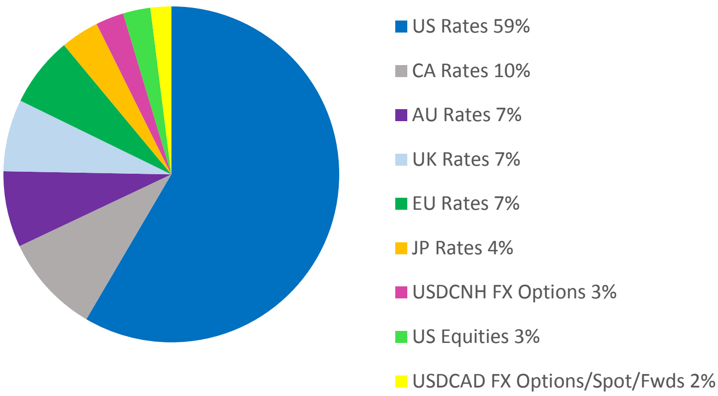
Year	Jan	Feb	Mar	April	May	June	July	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.85%	0.54%	-2.27%	0.61%									0.69%
2017							-0.59%	-0.90%	0.81%	-0.45%	0.64%	0.66%	0.16%

Return	1 Month	3 Months	6 Months	Since Inception
Global Macro Fund	0.61%	-1.14%	2.00%	0.85%
RBA Cash Rate	0.12%	0.36%	0.74%	1.25%

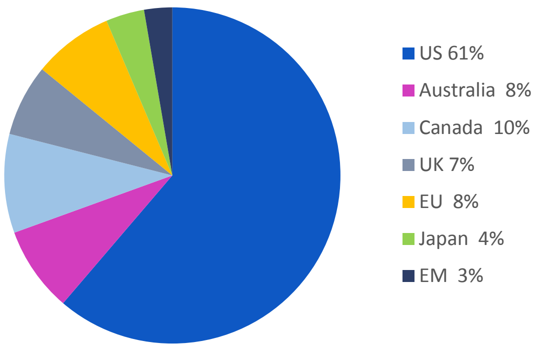
Asset Class Exposure



Portfolio Exposure



Geographic Exposure



Ellerston Capital Limited
ABN 34 110 397 674
AFSL 283 000

Level 11
179 Elizabeth Street
Sydney NSW 2000

Tel: 02 9021 7797
Fax: 02 9261 0528

info@ellerstoncapital.com
www.ellerstoncapital.com

APIR Code: ECL6698AU

Portfolio Commentary

The fund had a net return of 0.61% in April.

We commenced April with a simplified portfolio, as well as reduced risk. The core view was that the Fed would continue to raise rates unless financial conditions tightened significantly, and the key way for financial conditions to tighten would be via a fall in the equity market. As such, we were positioned for more Fed hikes to be priced by the market all the way out to 2021, with portfolio protection against a sharp fall in equities.

Our US rate positions contributed 0.86% to performance in April, with an additional 0.10% of performance coming from paired US rate trades vs Canada and Europe. Our hedge, put option structures on the US equity market (S&P), detracted 0.18% (mostly in time decay). And our FX hedge, AUDJPY, detracted a further 0.13%. This was as intended. Other contributions/detractions to performance were minimal.

By month end, we again increased the fund exposure to higher US rates. But unlike earlier months, we are now positioned for lower rates in Canada in the next 2 years, and looking for less rate rises than the market in Europe in 2019/2020. Softer data in both countries has seen the likelihood of rate hikes delayed, giving us an opportunity to now receive rates in those countries, and diversify risk for the portfolio.

Paradoxically, a reduced likelihood of a rate hike in May by the Bank of England has created an opportunity for us to position for rate rises in calendar 2020, where there was only 15 points of rate rises priced and where we expect the "normalisation" of rates to largely occur after Brexit is resolved.

With this divergent policy outlook, FX is also looking more interesting as we end the month. Indeed, of note was interest rate differentials emerging as the key driver of many currencies, a situation we haven't seen since last year. At this stage the signal is tentative, but close to encouraging us to position long the USD as we enter May (indeed in the first week of May we have initiated some long USD positions).

The Tide is high but I’m holding on

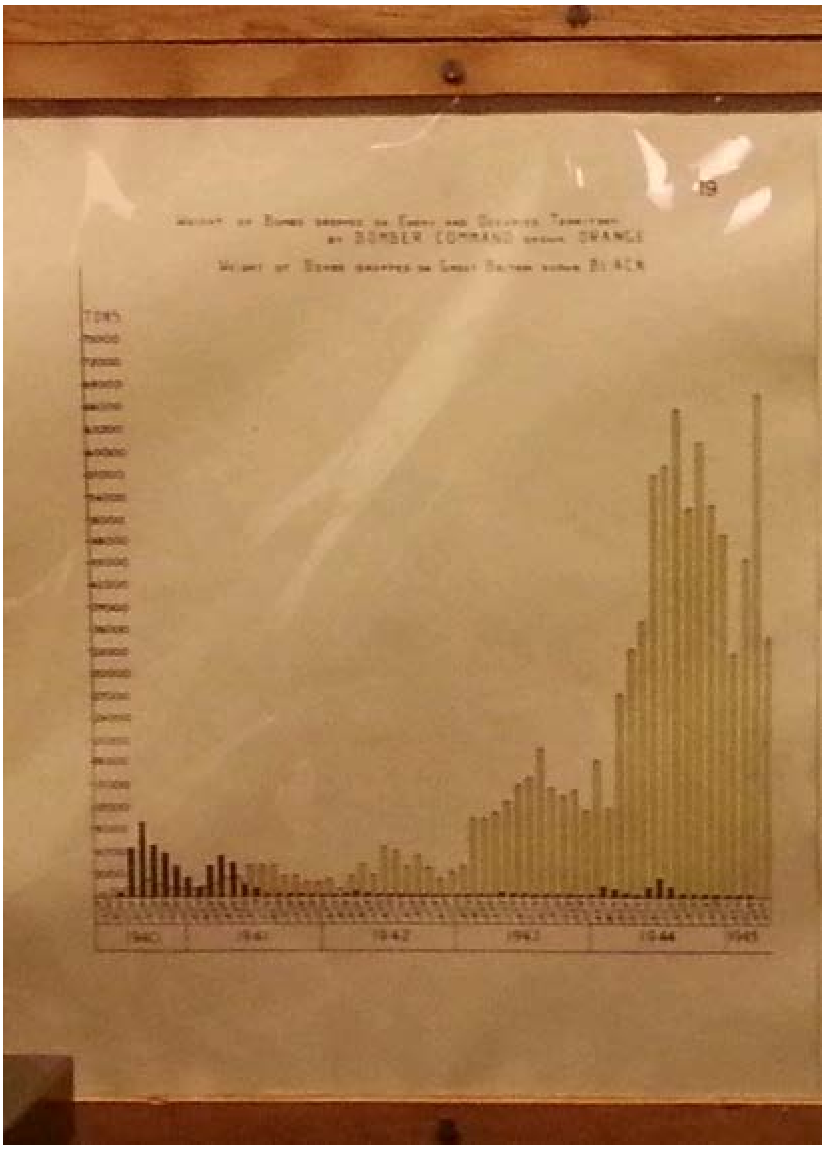
“The captain of a ship[1] can run a great ship, but he can't do anything about the tides.”
— **Matthew Norman**, **Domestic Violets**


[2]

Have you been in the Churchill war rooms? I found it fascinating. The rooms are preserved as they were in WWII. Indeed, it’s like the military staff have literally got up and walked out, leaving all their maps and information on the walls.

[1] Dare I say “manager of a bond fund”?
[2] I couldn’t help using a picture from another movie my twin brother directed, “The finest hours”

One chart I found particularly interesting is the chart below. The dark bars represent the number of bombs dropped on England by the Germans. The peak was the middle of 1940, fading away to virtually none by the middle of 1941. The "Blitz" lasted 12 months, saw 90,000 sorties and over 61,000 tons of bombs dropped, causing an estimated 32,000 civilian casualties. The little pop in 1944 was the German "V-1" flying bomb – the first cruise missile, where at its peak in 1944 more than 100 were being fired a day.



And the green bars? The Allied bombing effort. Some 1,415,745 tons of bombs dropped on Germany, or 23 times the Blitz.[3] Frankly, before I saw this chart in the war rooms, I had no idea of the scale of the Allied bombing on Germany. It sparked a little research on my part. From Wikipedia;

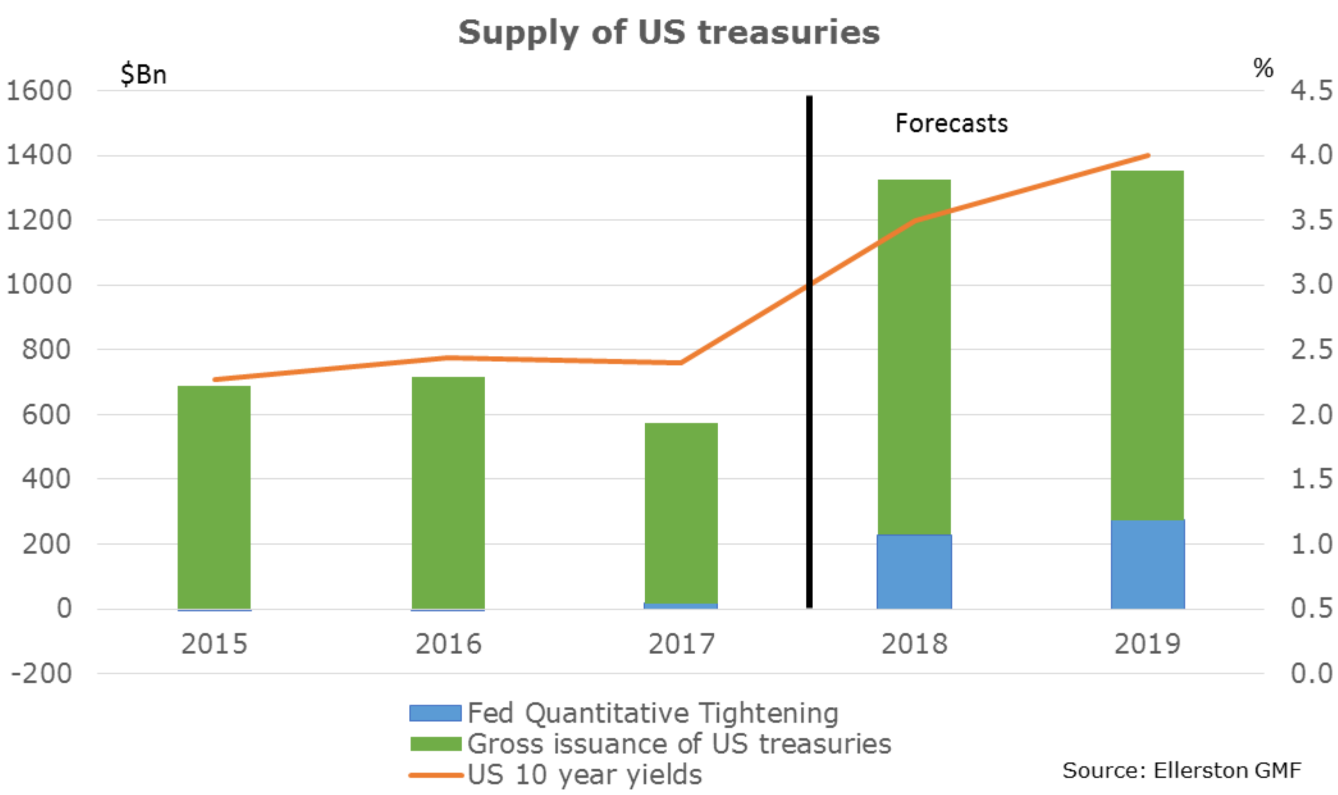
In 1942, Lindemann [Churchill's leading scientific advisor] presented the "dehousing paper" to the Cabinet showing the effect that intensive bombing of German cities could produce. It was accepted by the Cabinet, and Air Marshal Harris was appointed to carry out the task. It became an important part of the total war waged against Germany. Professor Lindemann's paper put forward the theory of attacking major industrial centres in order to deliberately destroy as many homes and houses as possible. Working-class homes were to be targeted because they had a higher density and fire storms were more likely. This would displace the German workforce and reduce their ability to work. His calculations (which were questioned at the time, in particular by Professor P. M. S. Blackett of the Admiralty operations research department, expressly refuting Lindemann's conclusions) showed the RAF's Bomber Command would be able to destroy the majority of German houses located in cities quite quickly. The plan was highly controversial even before it started,

[3] *Baldoli, Claudia; Knapp, Andrew (12 April 2012). "Forgotten Blitzes: France and Italy Under Allied Air Attack, 1940–1945". A&C Black. Retrieved 16 April 2017 – via Google Books.*

but the Cabinet thought that bombing was the only option available to directly attack Germany (as a major invasion of the continent was almost two years away), and the Soviets were demanding that the Western Allies do something to relieve the pressure on the Eastern Front… On 14 February 1942, the Area bombing directive was issued to Bomber Command.[4]

Looking at that chart, it's quite clear the tide turned in 1942. And by 1944 it was a torrent. The civilian casualties for Germany are estimated at anywhere from 350,000 to 600,000.

So why am I talking about this? Two reasons. It surprised me, so I suspect it will surprise quite a few others. After all, I don't think many of us have seen the movie about the Area Bombing Directive, and the controversy it created (apparently one has been made, a Canadian drama-documentary called "Death by Moonlight: Bomber Command"). And second, not to diminish the tragedy of war by comparing WWII bombing to mundane financial matters, but I was looking at another chart of the tide turning that prompted my recollection of the war room's chart.

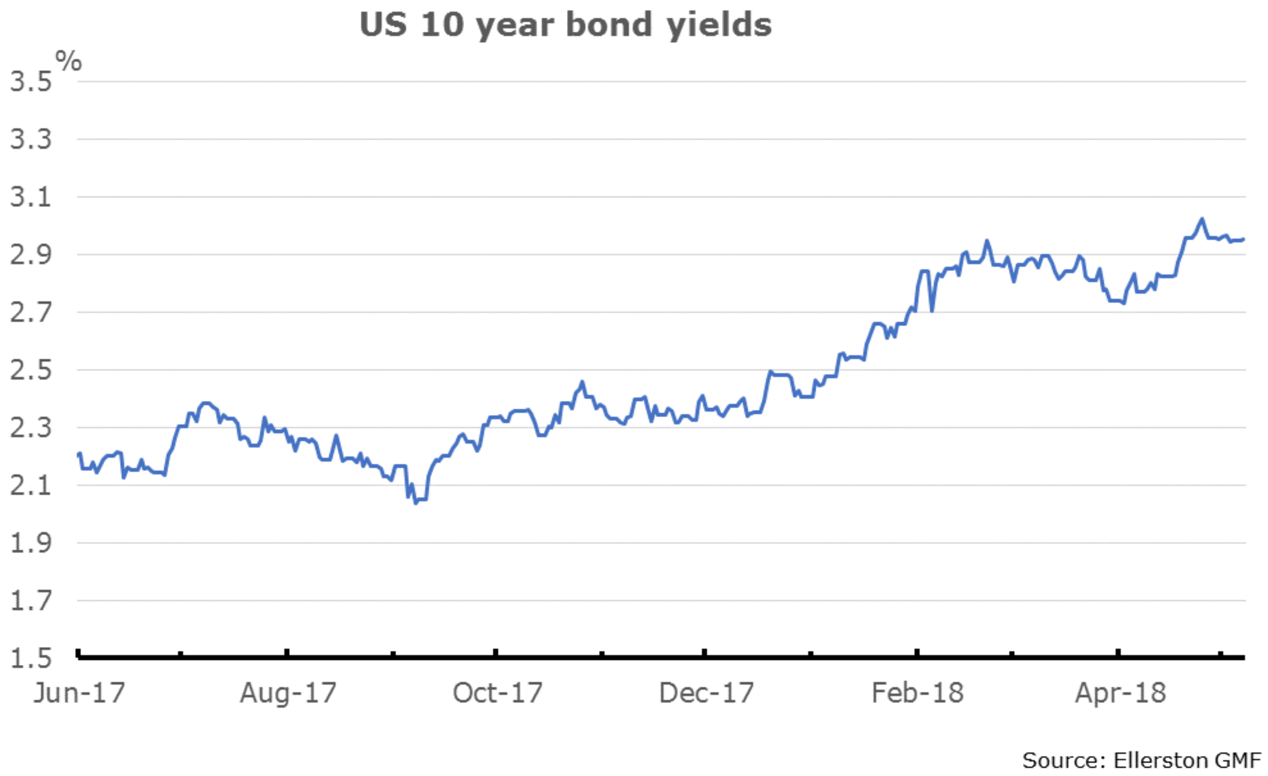


For the US treasury market the tide has turned.

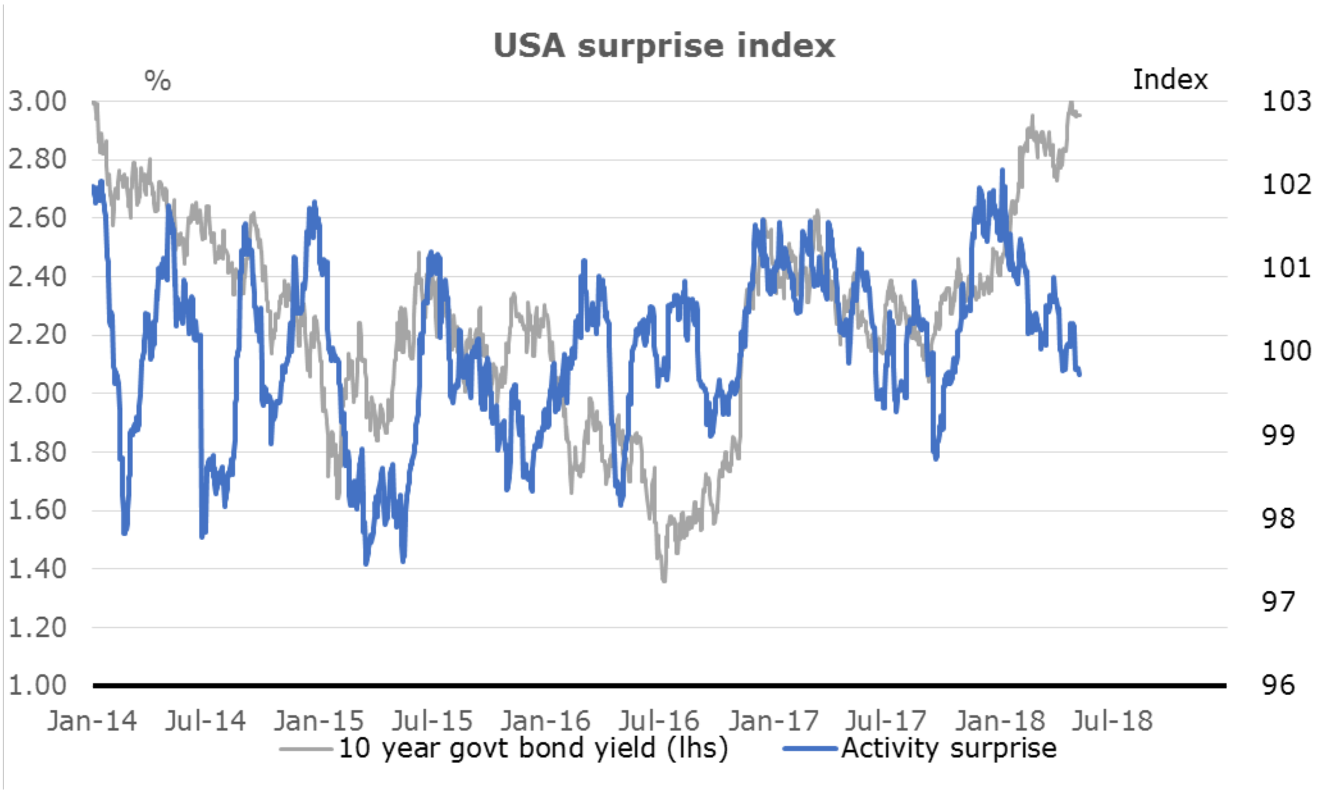
Yes, I know we all know that. But it is very important. And what was interesting about April was the current of the tide increased…

Why do I say that? After all, it was a bit of a nothing month for US bonds. They nudged towards 3%, but failed to break.

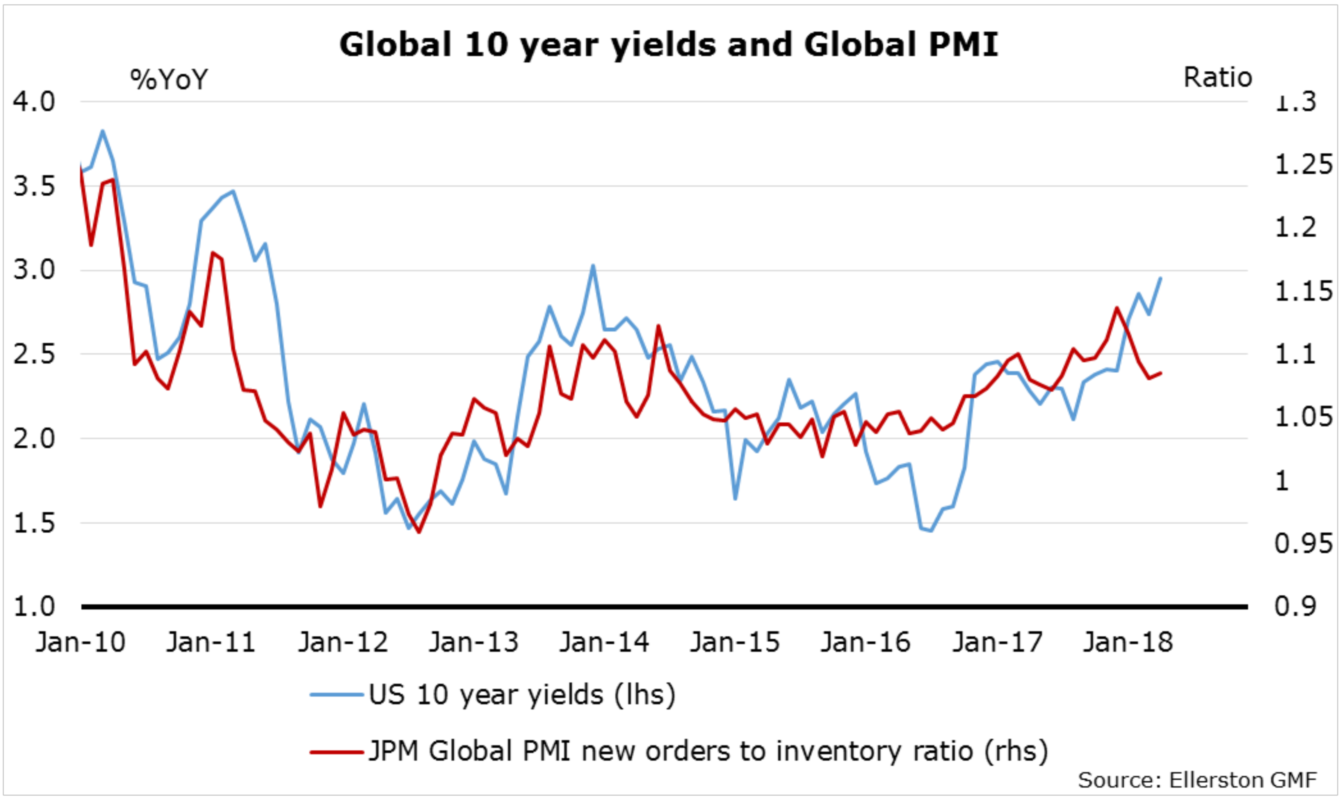
[4] https://en.wikipedia.org/wiki/Strategic_bombing_during_World_War_II



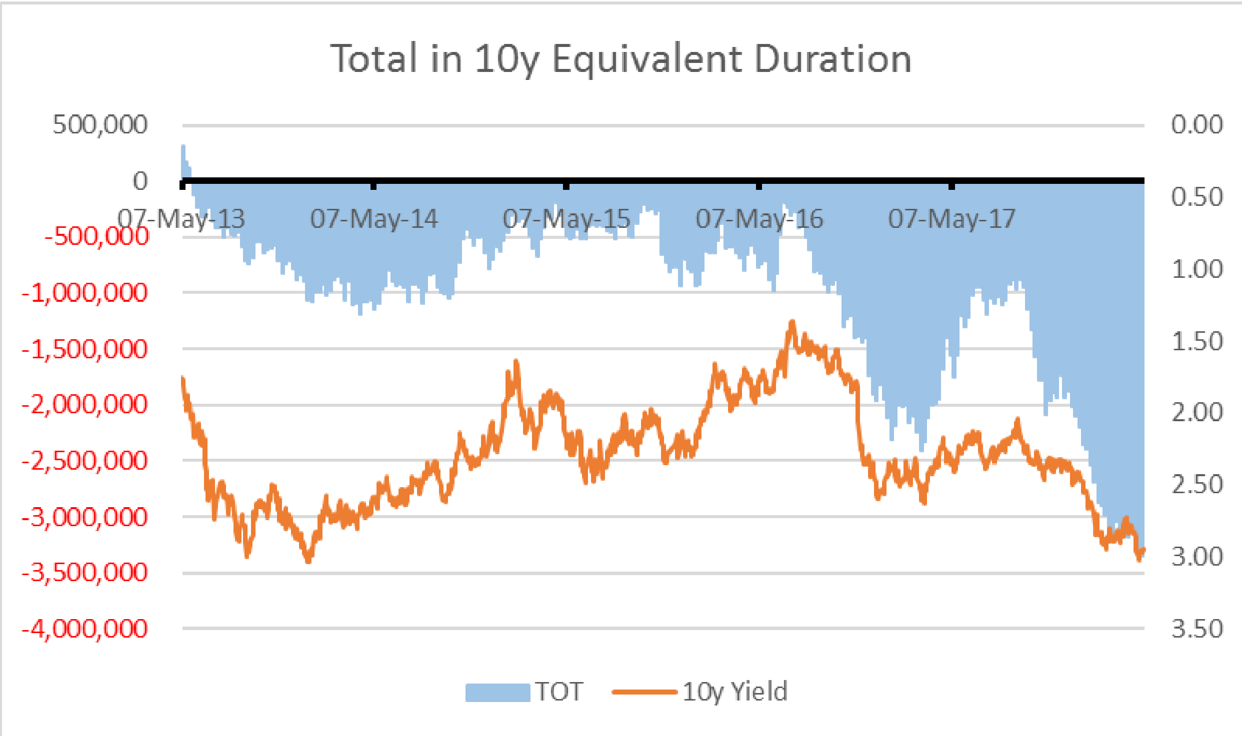
However, by all accounts US bonds should have rallied in April. Indeed, we were open to that possibility. We have had a softening of data, captured by the surprise index;



And the global Purchasing Managers Index



And we know from the exchanges that the speculative market is holding "record"[5] short positions in US rates, usually meaning the market will see a short covering rally in bonds at some point. Given the data, it was risky to stay short bonds…

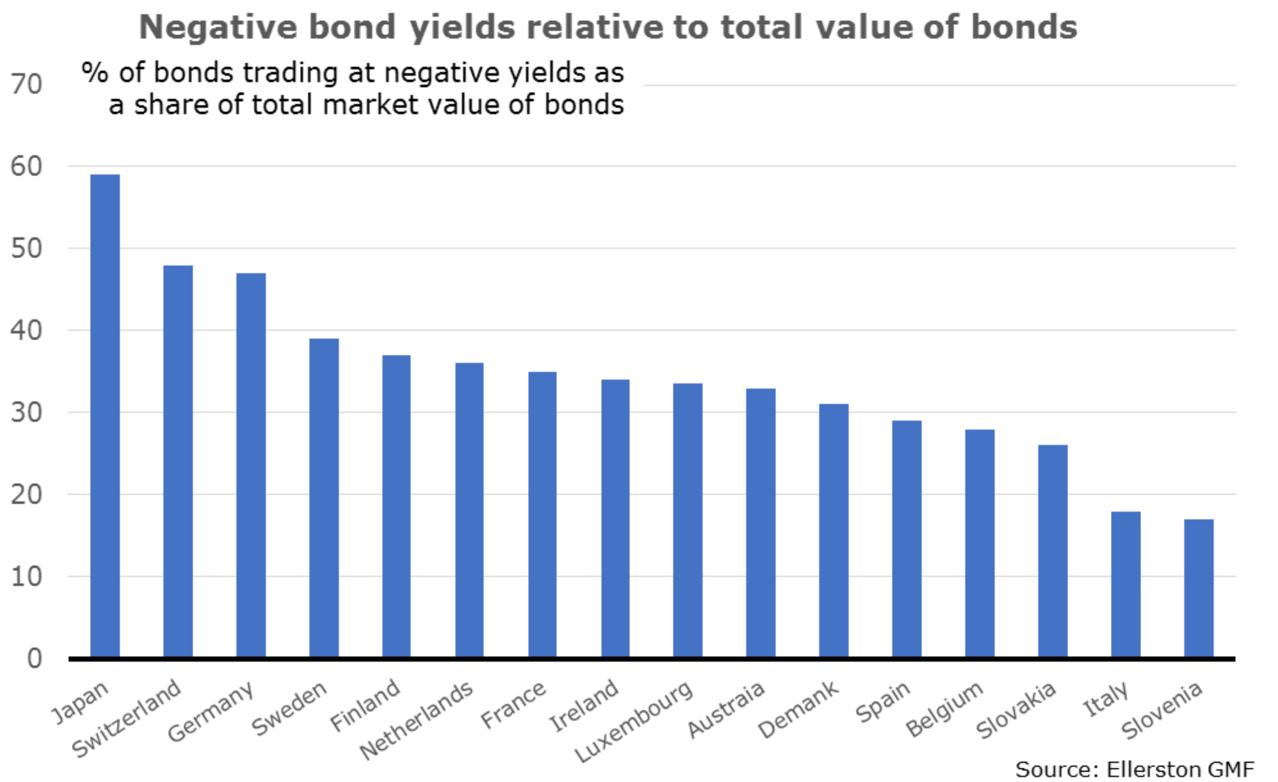


[5] I use inverted comma's because when we adjust the position for open interest ie the increased size of the market, the short positions are very normal/average for tightening cycles. Most people who cite positioning data do not go back to the last tightening cycle, 2004-2006, let alone 1994 for comparison. In addition, short positions via options are about 2/3rds what they were in the taper tantrum of 2013, and 1/3 what they were in the 94 meltdown. So certainly not extreme.

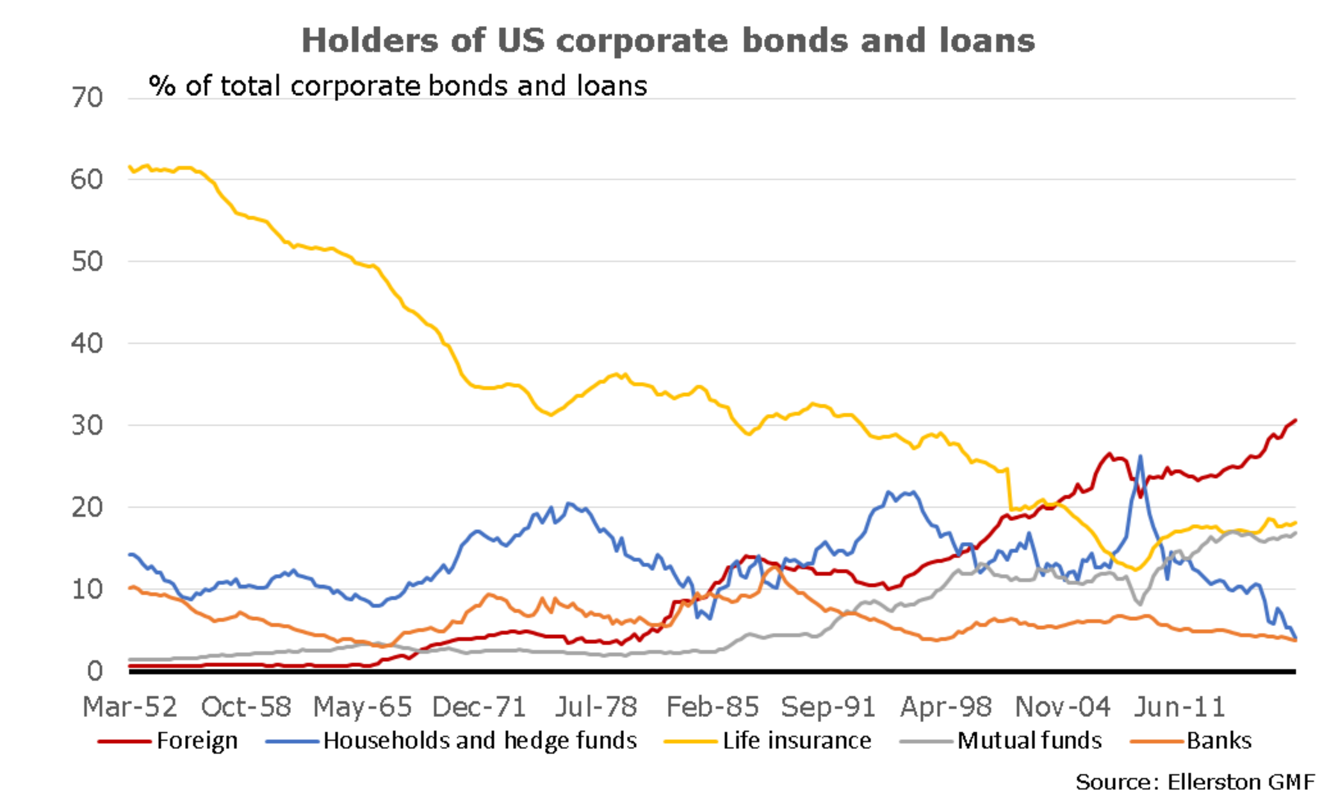
Indeed, German yields fell in April.

And yet US bonds finished near their highs in yield for the year.

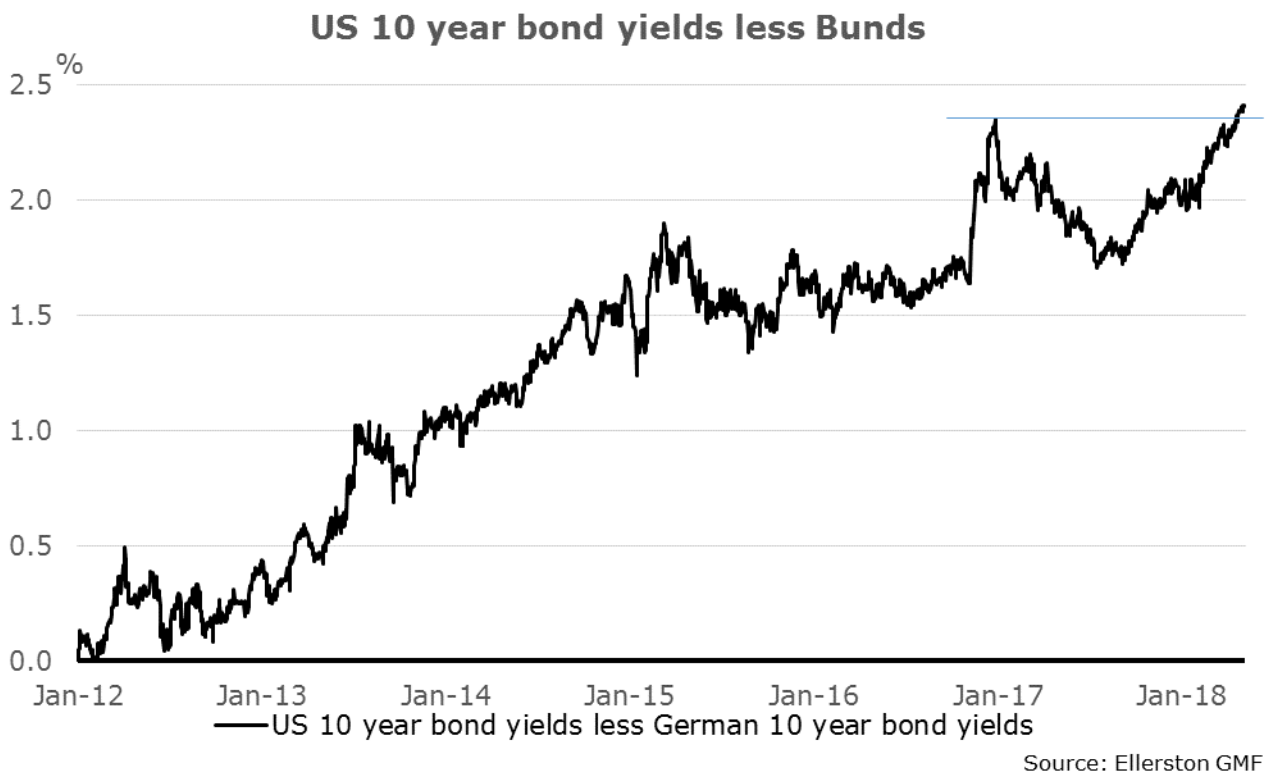
Why is that so interesting? Well 6 months ago, I was biased to the view that it was going to be very hard for US treasury yields to rise substantially with global yields so low. Indeed the chart below shows the % of bonds currently trading at <u>NEGATIVE</u> yields in Europe and Japan.



Bond investors in these countries would find, and have found, US bonds very attractive by comparison. Foreigners are by far and away now the biggest holder of US corporate bonds.

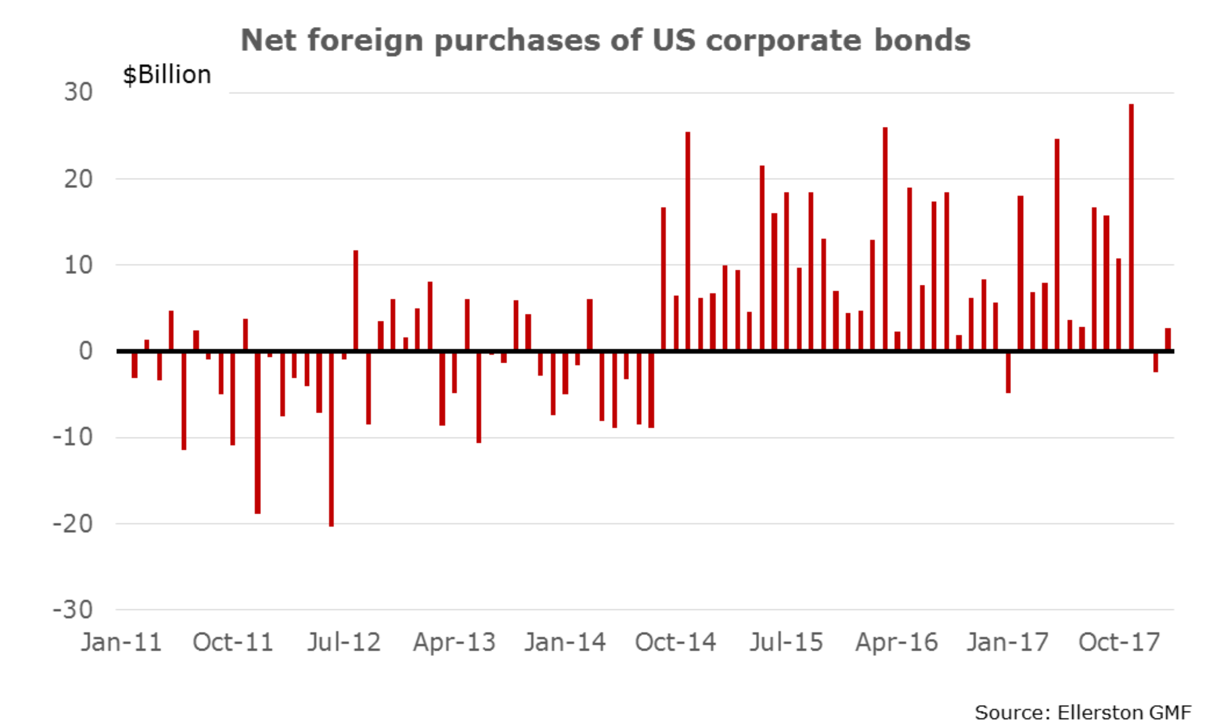


So one might think there is a natural limit to how high bond yields can go in a world still starved for yield. I had in the back of my mind the spread between 10 year German bonds and 10 year US treasuries, thinking when treasury yields are about 2.25% higher than German yields, they will be capped by foreign purchasers, as we saw in 2017. But in April we decisively broke through this level. Can that be sustained? Is the tide getting stronger?



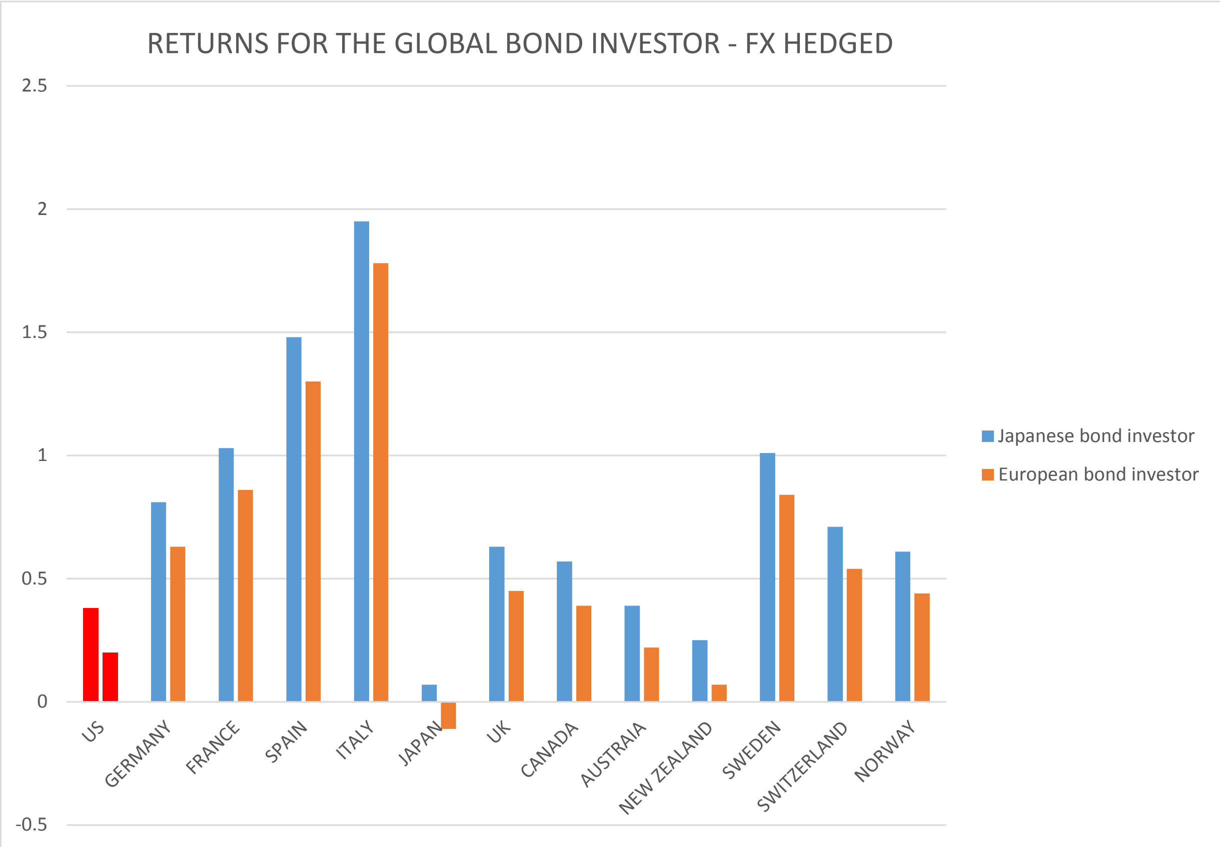
Why would the tide be getting stronger? Well, if you are a European fixed income investor, and all you want is yield, when you buy a US treasury for yield, you don't want currency risk. So you "hedge" the currency. And the cost of hedging is basically the difference in the cash rates in the two countries.[6] So as the Fed has kept hiking over the last 12 months, the cost of hedging has become increasingly prohibitive.

So as you might expect, foreigners no longer want to buy US bonds, at least not at this price. Over the last 3 months foreign purchases of US corporate bonds have been zero. (Note purchases went sharply positive in 2014 when the ECB went to negative interest rates.)



[6] More precisely we use the 3 month cross currency basis to calculate hedging costs.

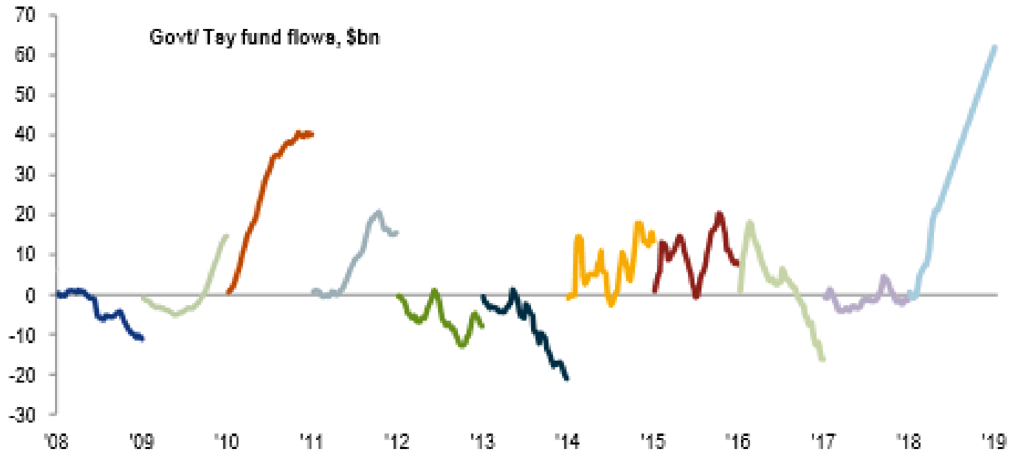
We are now approaching a tipping point. Why do I say that? Because the case to purchases US bonds only gets incrementally weaker from here. Well costly actually. The chart below shows what a European or Japanese bond investor can earn on a hedged basis by buying bonds in another country.



Clearly every bond investor after yield should be buying European bonds. Indeed, why would a global bond investor buy anything else! Certainly US bonds aren't too flash. And this difference is getting larger every 3 months as the Fed continues to hike. With two more Fed hikes, ie in 6 months' time, US bonds will yield about zero for a European or Japanese buyer. So no surprise, as the previous chart showed, that foreigners have stopped buying. Will the next hike, or the one after, be the tipping point? When they start selling. Quite possibly.

Will it be orderly? Possibly. It has been so far. Many investors have only experienced a yield starved world. And many US investors don't want to buy global bonds. So at a new high of 3% yields in US 10 year bonds, we have seen the biggest surge into bond funds by US residents in a decade. After all, for every buyer there must be a seller. It is just a question of price. So lower prices (higher yields) naturally attracted some buyers. But they are responding to the price, not driving it. Thus yields ended the month higher.

Chart 1: Record pace of inflows into Govt/Tsy bond funds

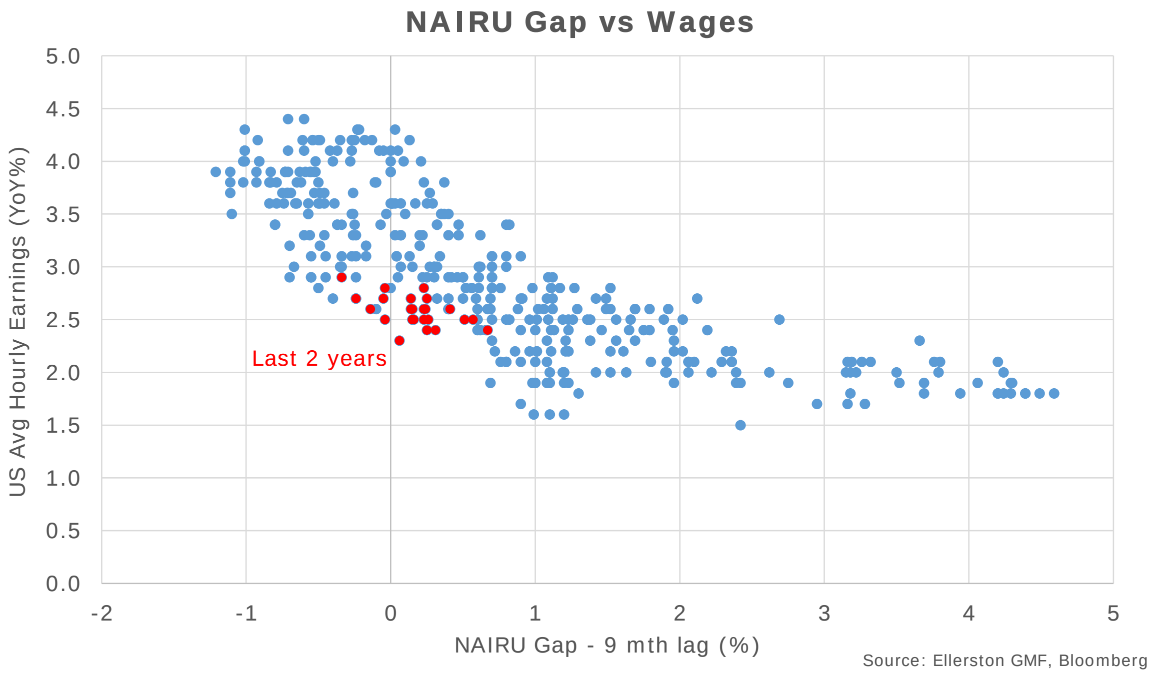


Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, EPFR Global, 2018 annualized

So in April I think the tide strengthened. **US treasuries had every reason to rally. Except they are getting less attractive every time the Fed hikes.**

Is it time to pay the piper for 7 years of zero interest rates? When the Fed put interest rates at 0%, they deliberately pushed investors out the risk spectrum, to 10 year bonds initially, then investment grade debt, high yield debt, equities and finally emerging markets. As the Fed continues to hike, all these higher risk trades are incrementally less attractive. Just as investors went out the risk spectrum, they are now moving back down. The first to move has been the foreigners. But everyone is moving. The current is picking up with every Fed hike.

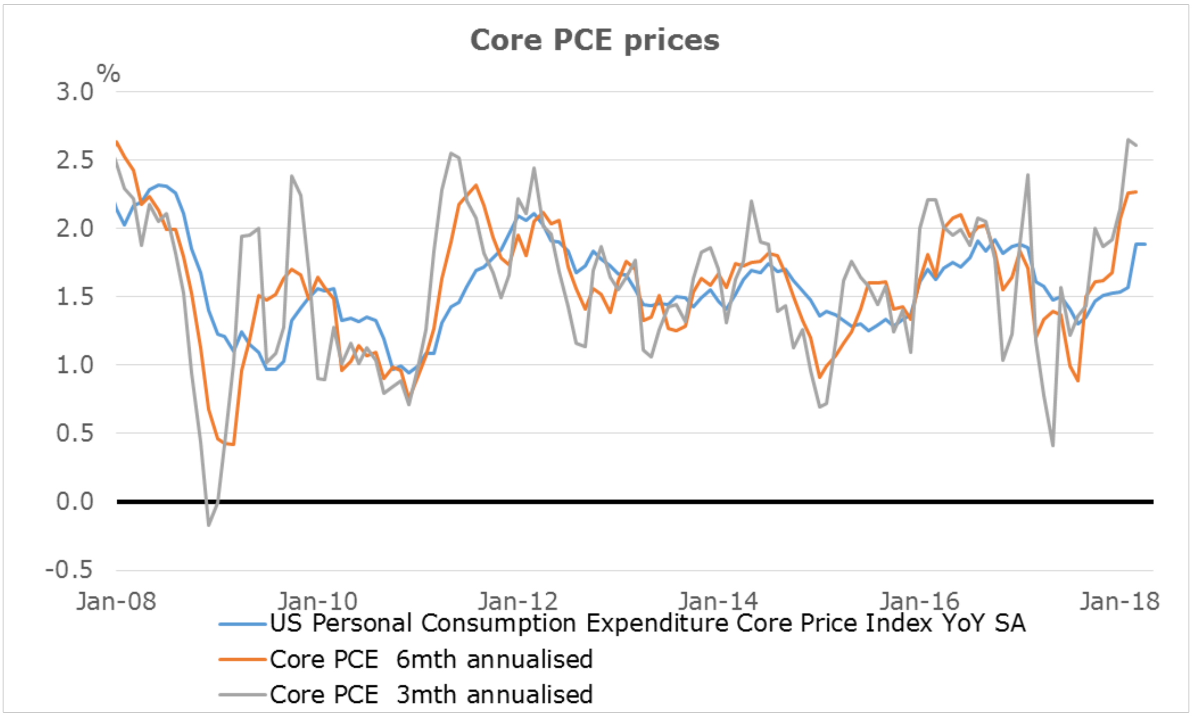
What would cause a torrent? I'm sure you are tired of me saying it, but it can't be ignored. **Any sign that there is a trend rise in inflation, either driven by wages or other factors, and then no one will want to buy bonds.** At the moment, wages are only trending very slowly higher. It is hard to argue they are alarming. But history guides that they can move very quickly when the labour market is this tight.



[7]

I for one won't be sitting around in a year or two's time going "Golly, I'm surprised how quickly wages picked up in the US!"

But **inflation is also getting a lot of tailwinds from other factors**. In particular, the weak USD, inflation in producer prices in China, reversal of Obamacare, and the cost of housing. The recent pick-up is striking, and we expect inflation to sit comfortably above 2% now until Fed policy is well above neutral (which the Fed thinks is 3%, we would be higher).



[7] Chart shows US average hourly earnings (AHE) v the NAIRU gap (advanced 9 months) back to 1986. The AHE all employees' data only runs back to 2007. From 1986 to 2007 we use AHE Production and Non supervisor. NAIRU is the Non-Accelerating Inflation Rate of Unemployment. The Fed estimates that rate to currently be 4.5%. We use the historical estimate of the NAIRU, which moves through time, from the Congressional Budget Office. When the unemployment rate is below NAIRU, we have a negative gap. The chart shows when it has been negative for 9 months it impacts wages. The more negative the greater the impact. The Fed forecasts the NAIRU gap to be -0.9% next year. We expect greater than 1% below.

What else could cause a torrent? The European Central Bank. When the market is confident of an end date for their bond purchases, “carry” buying of European bonds will cease. A rise in European bond yields will make US bonds even less attractive. However, that risk diminished marginally this month following a surprisingly soft inflation report in Europe. But there were distortions from Easter. Let’s see what May brings.

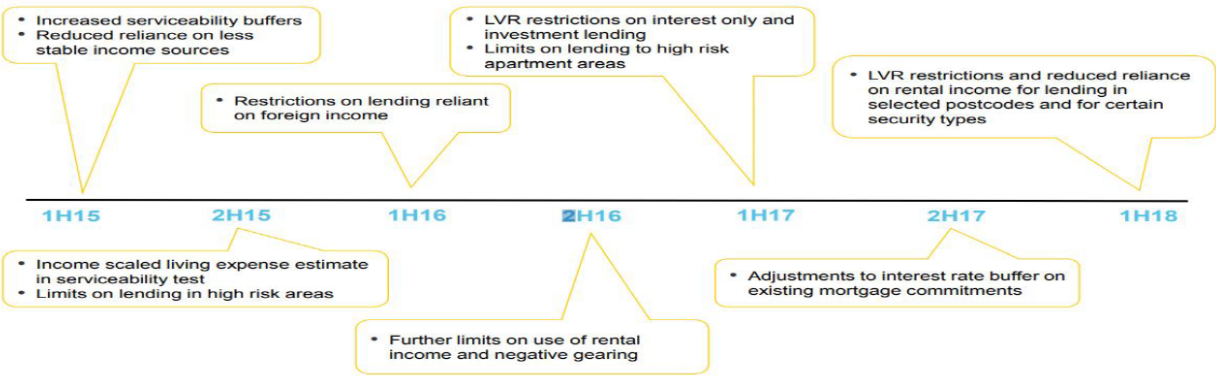
So that is the world bond market. The tide is turning. Each Fed hike is strengthening that current now. Will the tidal walls hold? Possibly. Our forecast is for the king tide (carry unwind) to combine with a storm, quite possibly a cyclone, of higher wages, inflation, bond supply and no central bank bond purchases. April was a month that saw no upgrade in the storm warning. But the tidal current picked up. Don’t fight the current. And as with all cyclone build-ups, prepare for the worst and hope for the best.

How are we positioned?

- Our highest conviction is the Fed keeps hiking until rates are well above 3% (currently 1.7%). To capture this, we have both short fixed income positions in the 0 to 3 year part of the US curve, as well as a number of option structures that maintain exposure through volatility.
- In addition, to hedge the portfolio, we are long fixed income in both Canada and Europe, again in the 0 to 3 year part of the curve. We feel the fixed income market is fairly priced in these countries, so it provides good protection if there is a major risk off event globally.
- We also are short the US stock market, but only via options to limit potential losses. A sharp fall in the stock market, say 10% from here, could delay the Fed and hurt our core position.
- If inflation accelerates in the US, we would like to be short 10 year bonds, if not 30 year. So we have options that profit if 10 year yields rise faster than 2 year yields in the US. This would ricochet across all bond markets in the world, and so we have similar option positions in Japan for 20 and 30 years yields to rise (where options are the cheapest in the world)
- We maintain a modest exposure to a rate hike being delivered in Australia by February 2019.
- Finally, we have started to build a long position in the US dollar (initially against Canada and China, but in early May we have added Euro and Aussie dollar shorts). The relatively strong performance of the US economy v the rest of the world has seen interest rates re-emerge as a key driver of currencies in the last few weeks. This position is predominantly in exotic options, which improves the risk/reward.

And just one final comment on Australia. The Royal Commission into Banking. My lord! But rather than opine over the content, we are interested in the potential impact. Several months ago our economist Tim Toohey estimated the impact on consumer spending when interest only loans switched to principle and interest. We were pleased to see Deputy Governor Chris Kent come out with very similar estimates, directly rebuking some of the more alarming estimates in the market place. But the Royal Commission has chastised banks for not verifying expenses on home loan applications. The natural recourse for banks is to more diligently access expenses in home loan applications. Some commentators have suggested this will reduce the amount of the average loan by 30-40%. We have spent a lot of time over the last month investigating the potential for this impact. We dived deep with some of the banks’ own economists, spoke to mortgage brokers, reviewed the history of changes to date, and the current loan calculators. It is too early to say whether the banks will get even more conservative on their expense assumptions, but the interesting thing is a lot of adjustment has already been made. Below are the adjustments CBA have made to date[8] (the banks have all made similar adjustments):

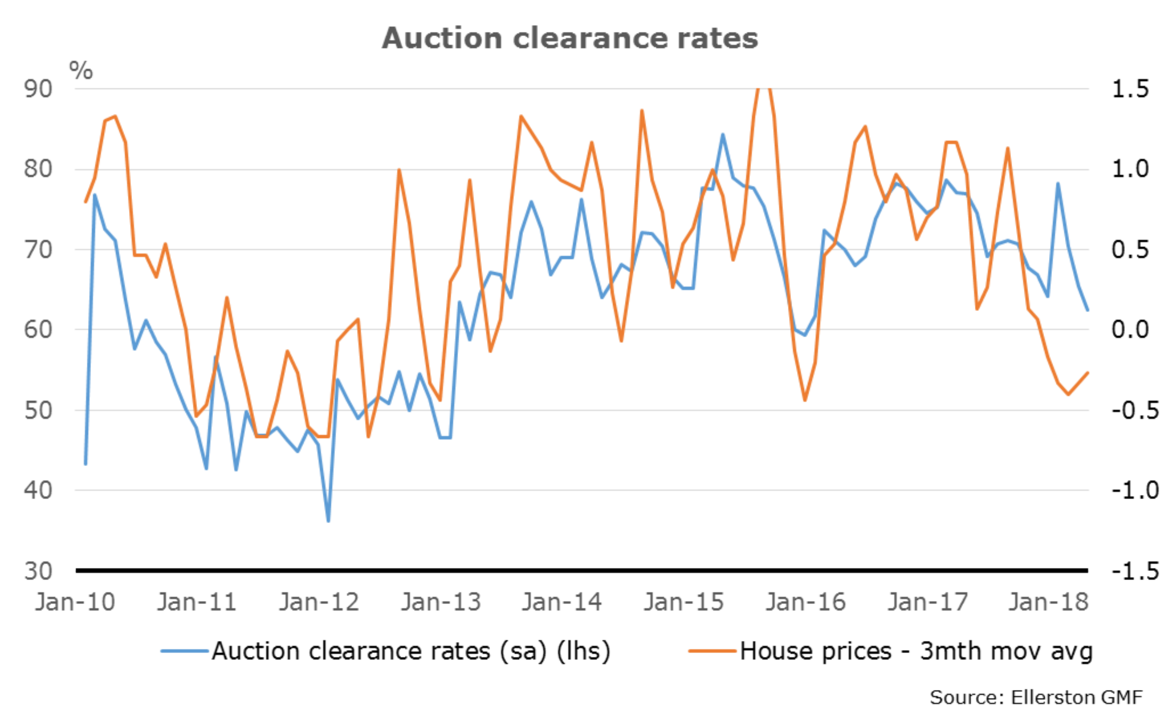
[8] CBA half yearly results – February. Westpac had a very similar table in their results.



To be honest, the more we dug here the less clear the answer is. But a few things are clear:

a) There has already been a broad switch by the banks to incorporating more realistic expense assumptions over the last couple of years. So the housing market has already weathered this and similar impacts since 2014.
b) It is too early to say whether the Royal Commission will lead to a material tightening in credit availability, but some tightening is to be expected. "Some" the housing market can cope with, as we have witnessed over the last 4 years. "Material" would be a problem.

It does have the potential to delay an RBA hike this year, and at this stage we would not argue emphatically one way or the other. The broad Australian economy is performing very well, and will get a boost from tax cuts this month. We have a very real time indicator of housing- the weekly clearance rate for house auctions. We will watch this closely and continue to liaise with the banks and mortgage brokers for an early indication of more restrictive lending. **The prospect of an RBA rate hike in either November or February next year is very fluid. If clearance rates stabilise at 65 or higher, the RBA will commence hiking.** If not, they wait. They won't cut.



Brett Gillespie

For further information, please contact either:

Andrew Seddon
0417 249 577
aseddon@ellerstoncapital.com

Simon Glazier
0410 452 949
sglazier@ellerstoncapital.com