Ellerston Global Macro Fund

Newsletter – May 2018

ELLERSTON CAPITAL

Fund Facts

Inception date	1 July 2017
Liquidity	Daily
Management Fee	1%
Performance Fee	15%
Strategy AUM	$142 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

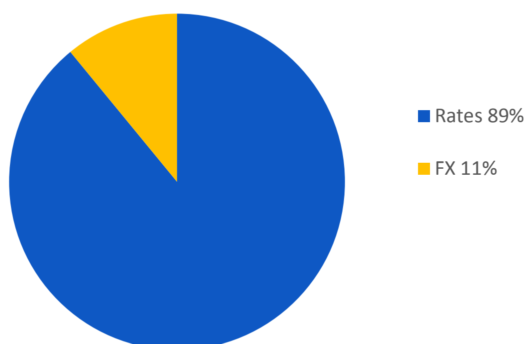
Zenith Recommended

Net Performance

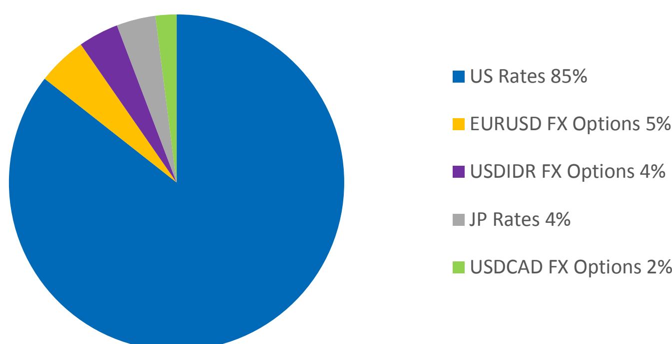
Year	Jan	Feb	Mar	April	May	June	July	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.85%	0.54%	-2.27%	0.61%	-1.07%								-0.39%
2017							-0.59%	-0.90%	0.81%	-0.45%	0.64%	0.66%	0.16%

Return	1 Month	3 Months	6 Months	Since Inception
Global Macro Fund	-1.07%	-2.72%	0.27%	-0.23%
RBA Cash Rate	0.13%	0.38%	0.75%	1.38%

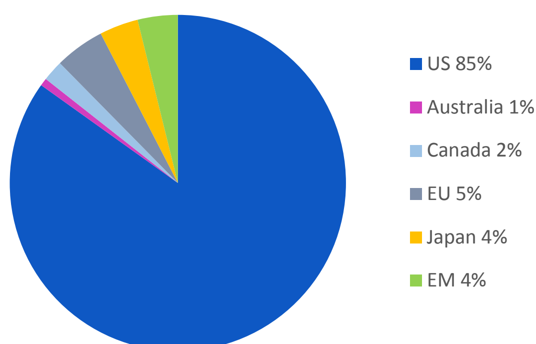
Asset Class Exposure



Portfolio Exposure



Geographic Exposure



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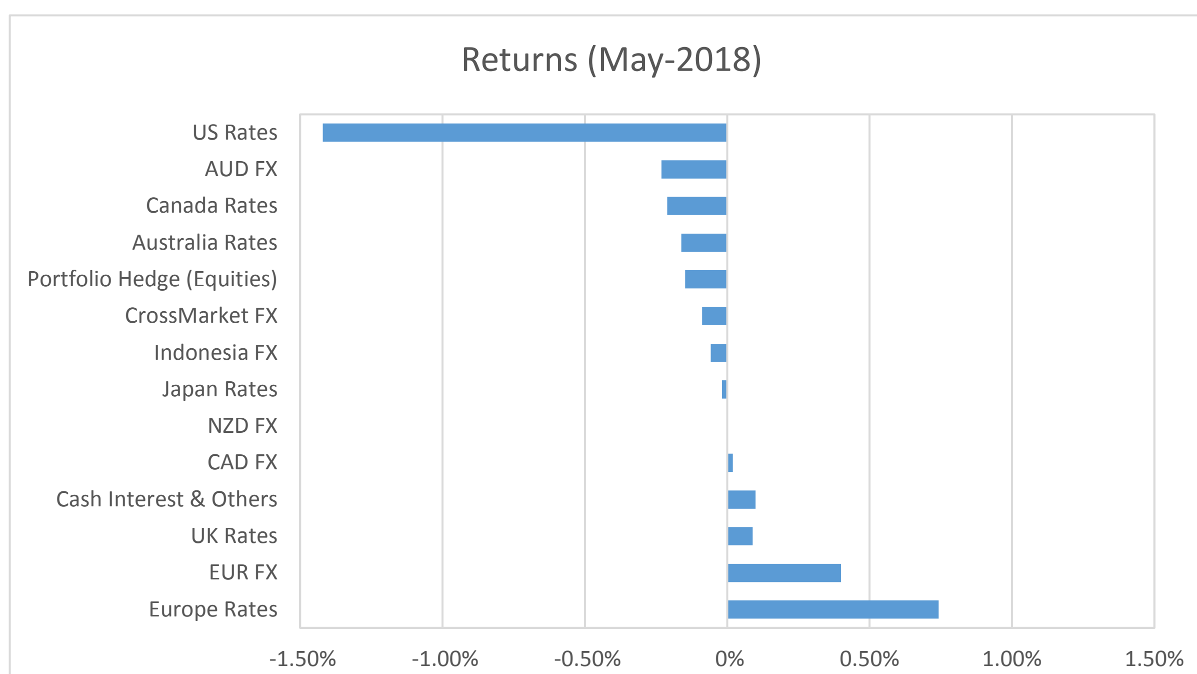
Portfolio Commentary

The fund's net performance for the month was -1.07%. The USD strengthened by 2.3% in May on average, and developed market equities fell 1.43%. US 10 year yields fell 10 basis points during the month, from 2.95% to 2.85%. But they traded as high as 3.13% and as low as 2.76%. It was a volatile month for bond yields. The big macro event during the month was the panic in the Italian bond market. I discuss this in detail over the page. But in short a panic in Italian bond markets caused US bond yields to have their biggest one week fall in 2 years. We were positioned for higher US yields, and as such performance suffered with the global move in bonds.

Indeed, the fund lost 1% on the 29th of the month alone, and we reduced risk from 60% of our maximum to 15% as positions were automatically stopped out, so as to preserve capital. However, within hours of reviewing the drivers of the panic, we resolved that it was likely to reverse quickly. We re-entered short positions in US bonds (that benefit by rising yields). But so as to limit risk, we did this in one week options. We don't usually comment on early month performance, but given the volatility at month end and the short term strategy, it is worth noting the fund made back the loss and is up over 1% in the first two days of June.

In May the fund lost 0.98% in fixed income, 0.15% in equities, and made 0.04% (flat) in currencies. Geographically, the fund lost 1.42% in the US (mostly short US fixed income), made 1.14% in Europe (65% long fixed income, 35% short EUR currency), and lost 0.39% in Australia (short Australian rates and currency). Given the volatility during the month, there were significant adjustments in exposure. We were alert to the risk in Italy, and hence had bought German bonds. As such we were happy with the outcome over the week, namely flat, but unfortunately month end captured the dip in performance during the week before the bounce back in US yields.

We still have very high conviction that US yields will move substantially higher. The trick is to make sure we don't lose too much money when the world suffers bouts of panic, which is typical when interest rates are rising. By the second business day of June, US 10 year bonds had returned to 2.94%, within one basis point of where they started in May. And our performance over that period was flat, yet we had virtually closed the portfolio to avoid a larger loss, and then re-established exposure in short dated put options on US treasuries to limit further losses but recoup what was lost if the market reversed. We did the same in February, and that is what we endeavour to do so as to achieve an asymmetrical risk/reward when bond yields do rise. At month end the portfolio had been simplified to a short position in US rates, mostly in options, and a modest short position in the EUR currency. In times of dramatic volatility it is better to keep the portfolio simple so risk can be controlled. As market conditions normalise more alpha sources will be added.



Outlook

But you won't fool the children of the revolution

Let them eat cake!

Who said "Let them eat cake"? Most will answer Marie Antoinette (when she was told there was no bread for the people[1].) The Storming of the Bastille on the 14th July, 1789 marked the beginning of a French Revolution that was to last 10 years, overthrow the monarchy and replace it with a Republic, only to then see a military coup by a new Emperor and dictator - Napoleon. Indeed, many historians regard the revolution as one of the most important events in human history. However, few historians realise it also included arguably the first aggressive experiment and most spectacular failure of quantitative easing.

The Chinese invented paper money of course (commonly called fiat money[2]) around 1000AD. They too debased it from time to time. But nothing like this period in French history.

Imagine you are a peasant in 18th century France. 50% of your income is spent on bread. Between 1790 and 1795, the price of flour rose *ten thousand per cent…* Perhaps then not so hard to understand the execution of King Louis XVI in 1793.

But how did it happen? I love the explanation given by Professor Andrew White[3], of Cornell University. In 1912. From 1860 he collected all the information he could on the period, in particular from newspapers and pamphlets of the day. And then documented how smart people could oversee such a disaster. Well worth a read (and only 90 pages). But for the 99% who won't read it; the government seized all the church land in France – 1/3 of all French land no less –

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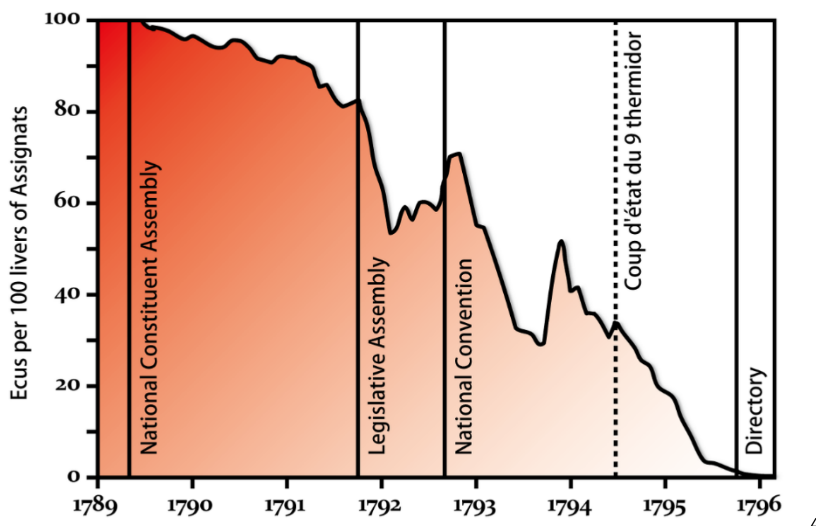
[1] Apparently most are wrong. Historians believe now that she did not actually say that, and the quote has been misattributed. https://en.wikipedia.org/wiki/Let_them_eat_cake

[2] Fiat money is inconvertible paper money made legal by government decree. If the money can be converted to say gold (like the Bretton woods system), it is called representative money.

[3] http://www.libertarianpress.com/fiatmoneyinflation/Fiat%20Money%20Inflation%20in%20France%20by%20Andrew%20Dickson%20White.pdf I'm told there is also another good book, 'Stuff and Money in the Time of the French Revolution', by Rebecca Spang

and then used that land as the asset to back the paper currency. They argued that as the paper money was convertible for land, the supply was limited and as such not inflationary. The only problem was when they started printing, they couldn't stop. Within 7 years, the currency was literally worthless.



[4]

Naturally inflation soared. Some made fortunes as they borrowed heavily and moved into real assets – land and stocks, and sold the currency. But anyone who relied on a wage was destitute. France turned into a nation of "stock jobbers and gamblers".

Why am I talking about this? After all, there is no rampart inflation anywhere in the developed world. Yet we are seeing a modern day revolution. Brexit, Trump, and the rise of right wing parties in Germany, France and Italy.

Why is that? One word.

Inequality.

Inequality drives revolutions. Put simply, a lot of people are finding life very hard.

Piketty's "Capital" explains that wealth will accumulate to the wealthy simply because investment returns generally exceed wage rises. [5] Except in war. Most of Europe's wealth was wiped out in WW1 and WW2, before re-starting the trend rebuild in 1950.

[4] By AFP Facing the World - Own work, CC BY-SA 3.0, https://commons.wikimedia.org/w/index.php?curid=18689502

[5] yes I may not be doing Pikkety justice, but for me that was it in a nutshell.

CAPITAL IN THE TWENTY-FIRST CENTURY

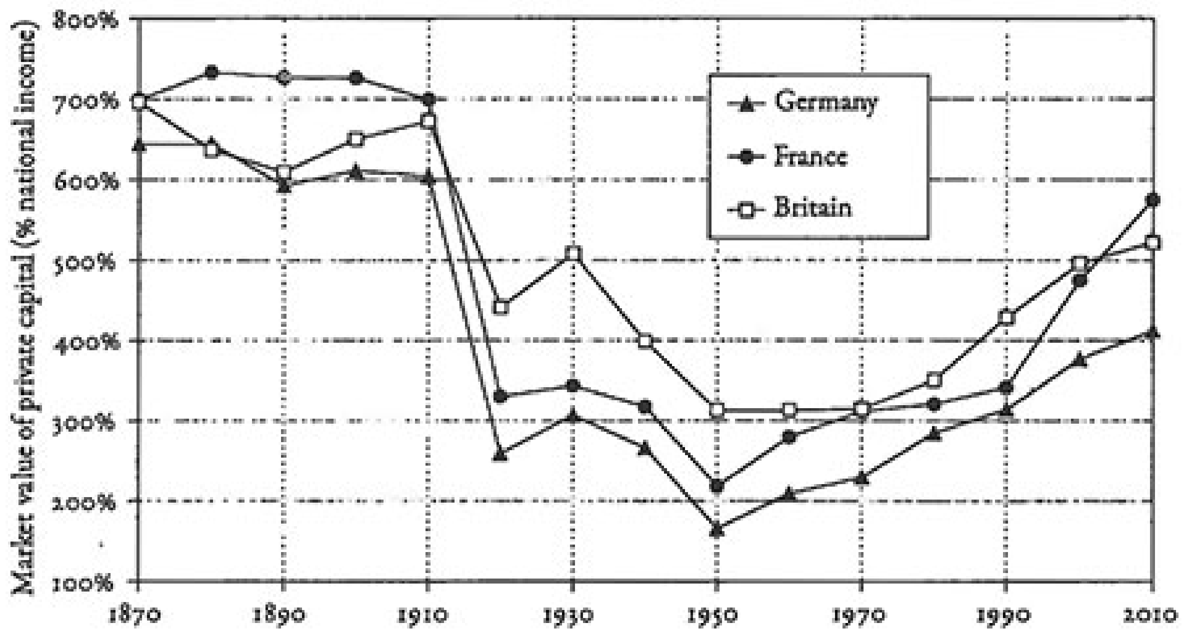


FIGURE I.2. The capital/income ratio in Europe, 1870–2010

Aggregate private wealth was worth about six to seven years of national income in Europe in 1910, between two and three years in 1950, and between four and six years in 2010.

Sources and series: see piketty.pse.ens.fr/capital21c.

The long term inequality in income is also very interesting. Pikkety shows what % of national income goes to the top 10% of earners in the US. It plummeted during WW2. But it accelerated sharply from 1980.

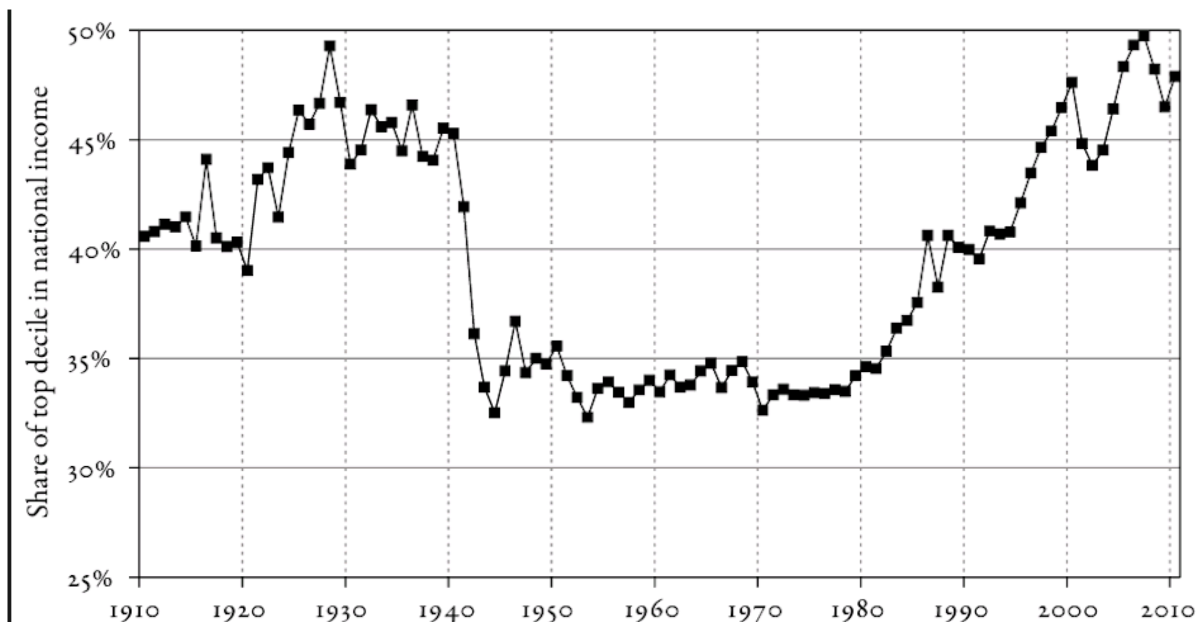
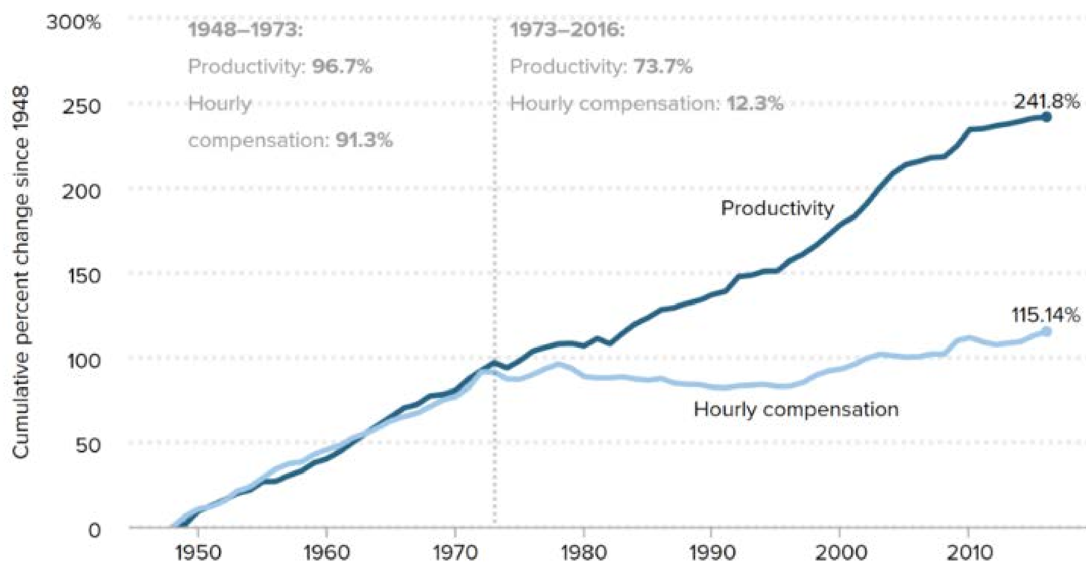


FIGURE I.1. Income inequality in the United States, 1910–2010

Why? Globalisation and deregulation (some call it financialisation), initated by Thatcher and Reagan and the mantra of every Western Government ever since. And more recently, quantitative easing (QE) and zero interest rates. It can certainly be shown that economies benefit in aggregate from globalisation, deregulation and QE. The problem is the benefits have not been evenly distributed. For example, there has been virtually no rise in real wages in the US since 1973.

The gap between productivity and a typical worker's compensation has increased dramatically since 1973

Productivity growth and hourly compensation growth, 1948–2016

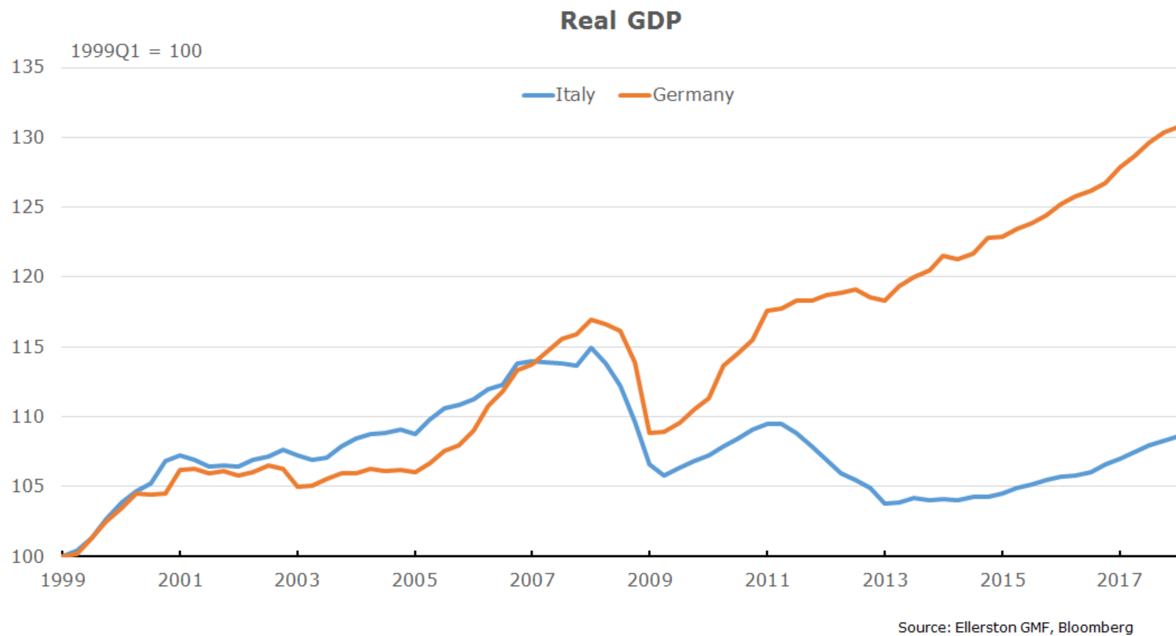


Note: Data are for compensation (wages and benefits) of production/nonsupervisory workers in the private sector and net productivity of the total economy. "Net productivity" is the growth of output of goods and services less depreciation per hour worked.

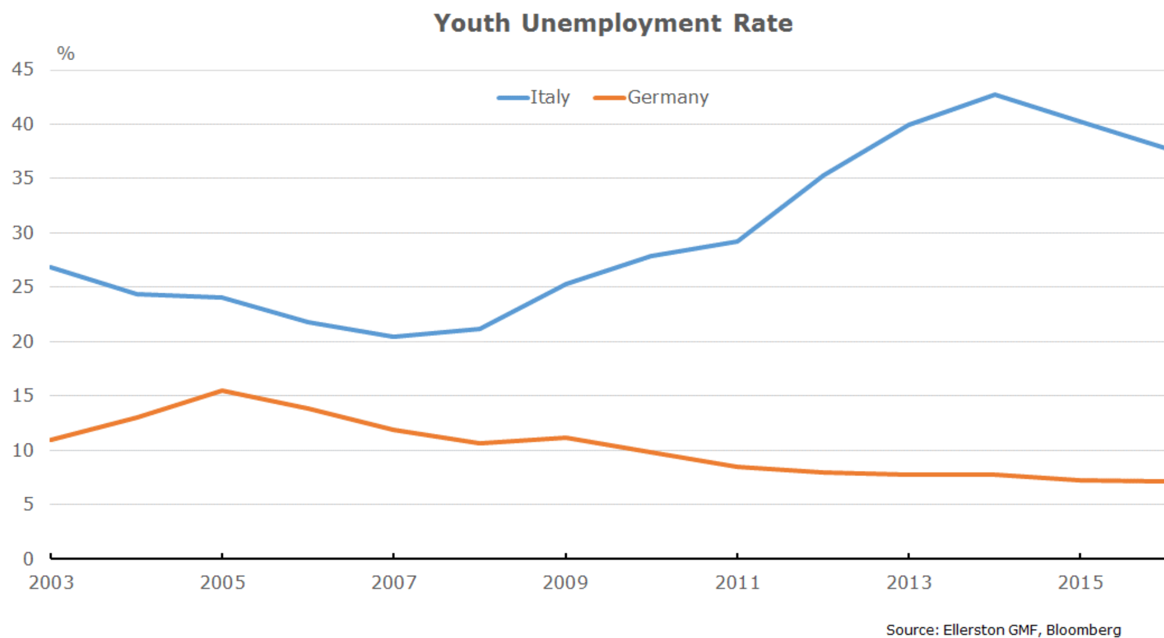
Source: EPI analysis of Bureau of Labor Statistics and Bureau of Economic Analysis data

This is a massive topic, and I am not even scratching the surface. But what is clear is the global financial crisis has seen the proverbial dummy spit by many voters. For decades they have been promised the benefits of globalisation and deregulation. After the financial crisis, the rebellion has started. Many voters, in many countries, are saying enough, it hasn't worked for us!

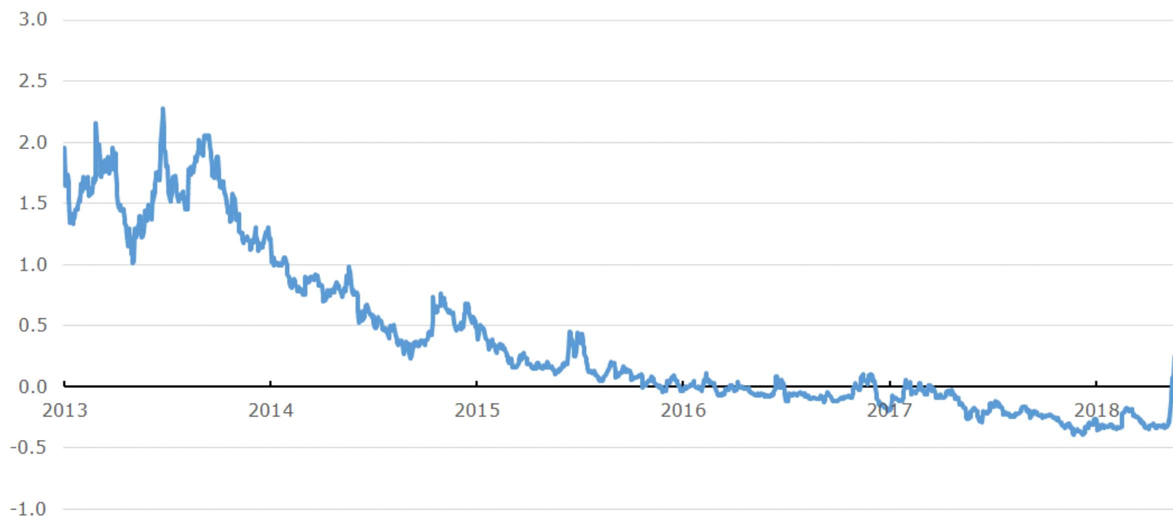
Which of course brings me to Italy. And the Eurozone. This week saw the formation of a coalition between the extreme left and the extreme right of Italian politics – the most unlikley of bedfellows one would assume! And well it may prove to be…But they have one thing in common. They are both populist parties supported by people who have had enough of the current arrangement. And like the US worker, it is not hard to understand the Italian citizen when we look at the relative performance of the Italian economy.



Or perhaps if we look at the average young Italian. Youth unemployment in Germany is 7%. In Italy? Call it 40%!



Hence the revolution, with both the extreme left and extreme right parties winning the most votes, and strangely forming a coalition at the end of May. The 5 Star party is anti-establishment. The Nothern league is anti-immigration. 5 Star has pledged guaranteed income for the poor and a lower pension age. The Nothern League has promised hefty tax cuts and tougher immigration policies. Initially they wanted as finance minister 81 year old Paola Savona, a fierce critic of the Maastricht Treaty and the Euro. Markets panicked. It was one thing to have a fiscally irresponsible government in Italy. It was entirely a different matter if Italy by any stretch of the imagination would seek to leave the Euro. The interest rate the Italian government has to pay to borrow for 2 years jumped from -0.3% (yes they have negative rates in Europe) to 2.75%. Levels not seen since Greece threatened to leave the Eurozone.



Savona's main complaint is that the construct of the Eurozone, and the power of Germany, are crippling Italy. Savona makes two good points.[6]

1. There needs to be fiscal transfer in Europe, particularly with regard to unemployment benefits.[7]
2. The cost of illegal immigrants to Europe is being disproportionately worn by Italy, estimated at some 4 billion Euro a year by the Italian government.[8] (and Germany, which of course he doesn't mention)

Markets calmed as Savona was moved from the finance ministry to Minister of EU Affairs, and 5 Star and Northern League re-iterated they have no intention of leaving the Euro. If so, it could be what saves the Euro, rather than destroys it, as reform is sorely needed. But it will be a bumpy ride. It is hard to get Germany motivated about reform – without a crisis…

With the conniption in Italian bonds, the world went "risk-off". US treasuries had the biggest one week rally (fall in yields) in 2 years, some 30 basis points.

We were heavily positioned for Fed rate hikes to continue through this year and next. On the 22nd of May the market expected the US cash rate to be 2.75% at the end of 2019 (currently 1.9%). By the 29th of May that expectation had dropped to 2.35% - where it was at the end of January.

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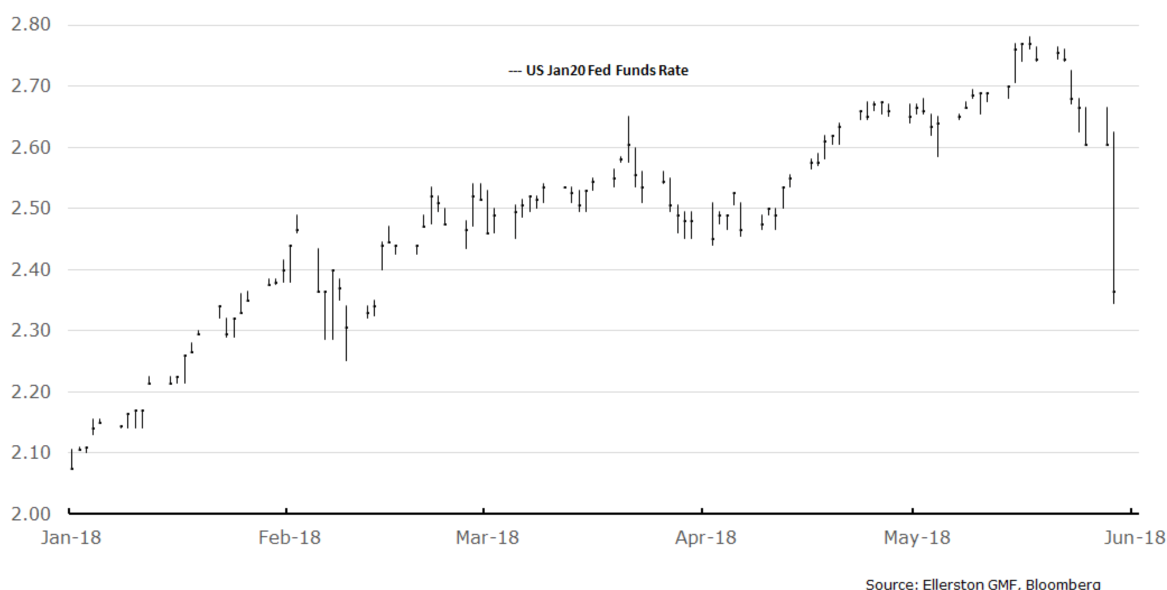
[6] That's not to say all his points are good!

[7] Like in the US and Australia. A single currency and single interest rate leaves only fiscal policy to smooth growth between regions. Here we transfer GST revenue and unemployment benefits around the country to support weaker states. There is no such relief in the Eurozone.

[8] https://www.ft.com/content/b964453a-72b1-11e7-aca6-c6bd07df1a3c



We expect it to get to 3.15-3.4%.

What did we do? What would you do? If, for example, you bought Facebook at $190, expecting it to rise to $220, and it drops to $150, what would you have done?

For us, **when an outsized move like this happens that is contrary to our view, we defend**. Our first and foremost goal is don't lose (too much) money. Hence when Italian yields started to rise, we increased our holdings on bunds in case the situation escalated. This helped mitigate losses.

Most importantly, we have "stop loss" trades in the broker market to close our exposure when the market is moving against us. Think an order with your broker to sell your Facebook shares at $175. That way you limit your loss and the investment has a good risk reward. Every "stop loss" we had in US rates was executed on May 29th by 4am Sydney time. **Portfolio risk was automatically reduced from 55% of maximum risk to 15%.** (Some option trades remained). We were automatically de-risked and capital was preserved.

Secondly, we then look to take advantage of the situation. Is the move correct? Will it go further? Or is it an opportunity?

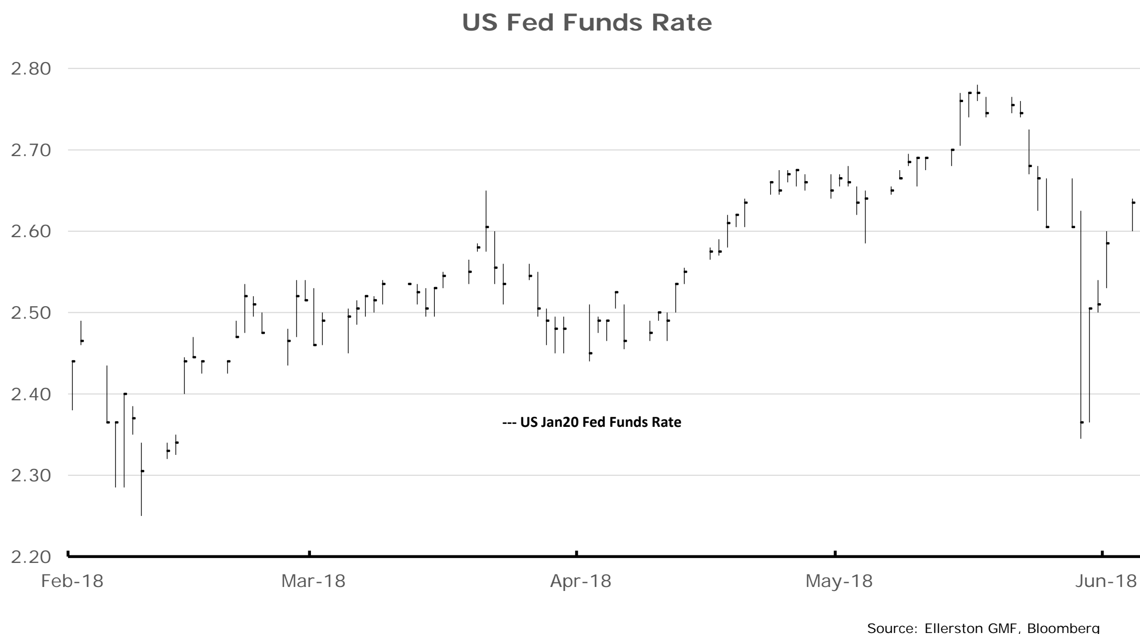
By 7am, after assessing the reason for the move and the relative market performances, we concluded the following;

1. The markets that had moved the most were the markets that had the largest "positions" in them and were most prone to reversal, namely Italian bonds and German and US bonds. Other "risk" markets, such as equities, had much more muted responses.
2. Often when markets have these "positioning wipe outs" they reverse very quickly
3. The Italian political situation was still unclear, but the market had quickly jumped to the worst case.
4. We had important US data at the end of the week, namely employment and manufacturing data, which we believed would show a reaccelerating economy and support ever higher interest rate expectations in the US.

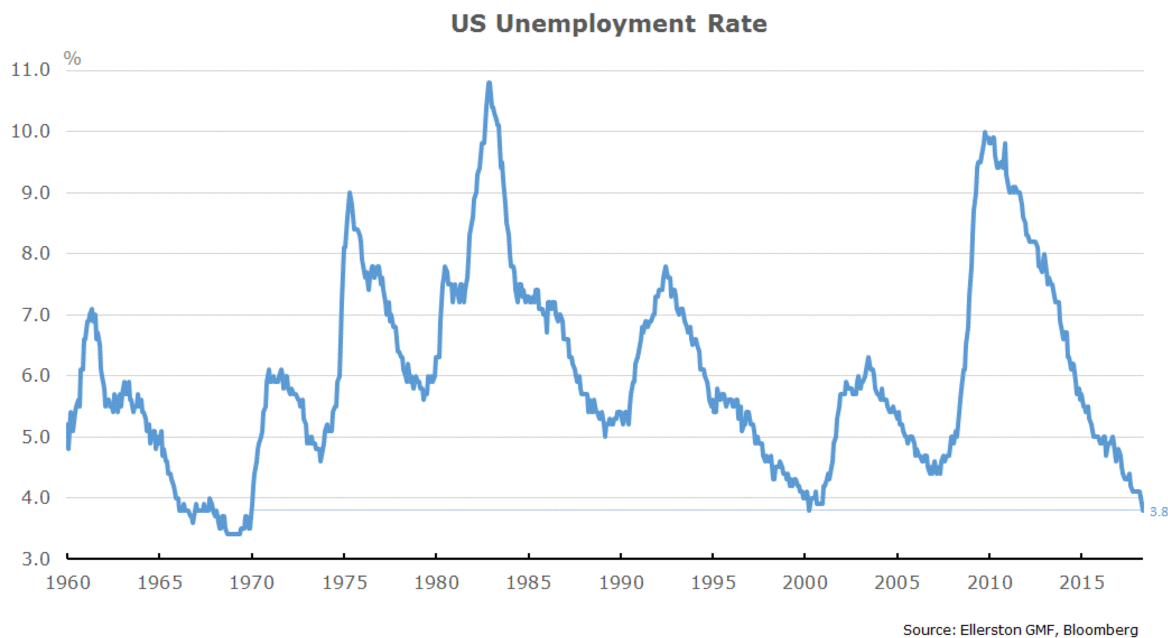
So what does one do? Well once the portfolio is under control, my goal is if the market reverses we at a minimum make back what we have lost, preferably more given the opportunity.

We decided to go for more, but safely. So like February, **we bought 1 week put options on US 10 year bonds. Very short dated, to capture a quick reversal** plus strong data at the end of the week.

Unfortunately our May performance does not include the day the data was released, the 1st of June. Whilst making no guarantee about performance in June, I can say we got the economic data and reversal right, and have recaptured all of the under-performance in May in first 2 days of June. If yields fully reverse the rally we are on track to comfortably make more than we lost.



So what was the data? Well the unemployment rate has not been lower in the US since 1969.



And where the consensus believed the US manufacturing sector was slowing, is has suddenly reaccelerated.

So after the dislocation in May, we find ourselves in a situation where the data in the US suggest the case for higher US rates is only getting stronger. Indeed, the risk that the Fed is "behind the curve" is nudging higher. If you recall, **we have two drivers for higher US yields**.

a) **Normalisation of global real rates in bond markets, which have been suppressed by bond purchases by global central banks**. This should comfortably see US 10 year yields rise to 3.5- 3.75%, probably by year end depending on the ECB (though less so as the Fed continues to hike)
b) **A restoration of inflation risk premium**. Policy is incredibly accommodative across the developed world for this stage of the business cycle. The US is most progressed in the business cycle, and accelerating. Business surveys and company anecdotes indicate significant inflation pressure is building. An acceleration in inflation now would be very alarming given the policy stance, and likely see a break of 4% bond yields in the US.

At the same time, we are in a new political world, indeed what could be a multi decade political readjustment away from the economics of globalisation and deregulation, and back to nationalism and protectionism. This both taxes growth and boosts inflation – (mild) stagflation if you like. That will mean different things for different economies, but for the US it will require tighter policy.

On the geopolitical front, North Korean/US tensions appear set to ease, but tariff tensions continue to ebb and flow, as will Italian concerns. For mine, Italy can cut both ways. It might accelerate reform and save the Eurozone, or end it. Either way the Italians have decided to move the patient into the operating theatre. It is going to be a long operation…

So we will still need insurance in the portfolio. European interest rates are no longer attractive given how far they have moved in the last week of May. We remain short the Euro currency, which works as a hedge when/if Italy escalates, but is also supported by our work on currency drivers.

And **we have rebuilt short bond positions in the US**.

But between a recalcitrant Italy and a vacillating Trump, the market will remain on tender hooks. Either have the potential to illicit panic as markets extrapolate suggestions. As such, we will be careful to keep hedges in the portfolio in the most cost effective fashion, typically utilising currency options, equity put options, and bonds in countries outside the US as opportunities arise. **At month end we held options for a weaker Euro currency.**

Meanwhile it is vital not to miss the forest for the trees. The US economy is not only fully employed, but accelerating. As one might expect if policy is still accommodative. The real risk over the next two to three years is not Italy. It is not tariffs. **It is restrictive monetary policy and a "normal" US recession.**

Brett Gillespie

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