ELLERSTON CAPITAL

Ellerston Global Macro Fund

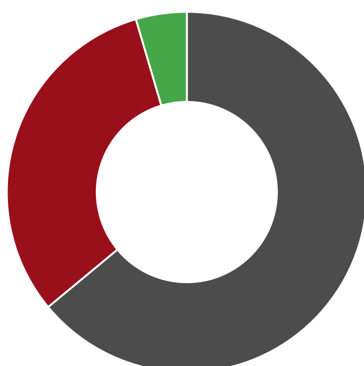
Performance Report | July 18

FUND PERFORMANCE

	1 Month	3 Months	6 Months	1 Year	Since Inception p.a.
Fund Net (%)	-0.34	-1.41	-2.54	0.02	-0.53
RBA Cash Rate (%)	0.13	0.38	0.74	1.50	1.50

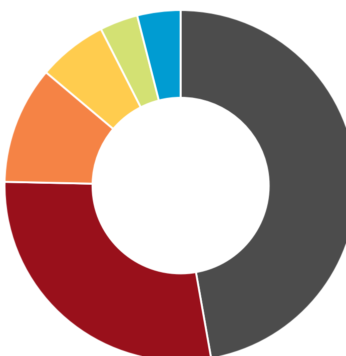
%	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2018	1.85	0.54	-2.27	0.61	-1.07	-0.01	-0.34						-0.73
2017							-0.59	-0.90	0.81	-0.45	0.64	0.66	0.16

Asset Class Exposure



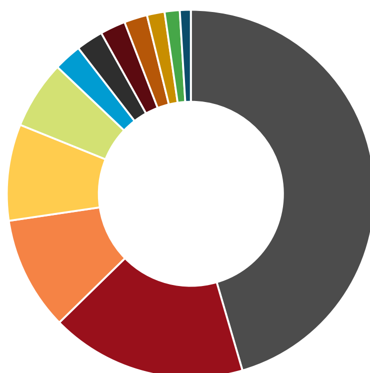
Rates 64% FX 31% Equities 5%

Geographic Exposure



US 47% EM 28% Australia 11%
EU 6% UK 4% Japan 4%

Portfolio Exposure



- US Rates 45%
- USDCNH FX Options 17%
- AU Rates 10%
- USDCNH FX Spot/Fwds 8%
- EU Rates 6%
- USDJPY FX Options 2%
- US Equities 2%
- GBPUSD FX Options 2%
- EM Equities 2%
- JP Rates 2%
- UK Rates 1%
- AUDUSD FX Options 1%

Investment Objective

Provide an annualised 5% net return above RBA Cash rate over rolling 3 year periods. Targeted volatility is 6% over rolling 3 year periods.

Characteristics

Uncorrelated return stream.
Emphasis on capital stability.
Lowers overall portfolio volatility.

Investment Style

Discretionary, Medium term.

Platforms

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

Research

Zenith Recommended

Key Information

Strategy Inception Date	1 July 2017
Liquidity	Daily
Management Fee	1.00%
Performance Fee	15% of outperformance
Buy/Sell Spread	0.25%
Distribution Frequency	Semi-annually
Strategy AUM	$146.4M
Firm AUM	Over $5 billion

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PORTFOLIO COMMENTARY

Performance for the month was -0.34%.

We started August with 3 key exposures

a) Short emerging market equities, emerging market bonds and US investment grade credit. This exposure lost 0.28%

b) A modest short position in US interest rates. This exposure made 0.26%

c) A short position in the Chinese currency (CNH). This exposure made 0.14%

Small losses were made in UK rates, Japanese rates and currency and Canadian rates and currency.

Relative to what we are trying to achieve, these are small numbers. The emerging market equity ETF we were short rallied 3.6%, but the loss was minimized by cutting early and using options. It appears now is not the time for large outflows from these asset classes as quantitative easing is unwound. We await another opportunity

In US rates, we might normally return 0.5-1% on a 10 basis point rise in yields, but our risk was light given the volatility in markets, and particularly the tariff war.

Indeed, CNH weakened 2.5% during July. Again, I would have hoped to perform better given we anticipated the direction, but volatility made sizing very difficult. The currency was about 3 times more volatile in July compared to June as it was buffeted by tariff headlines and Trump complaints.

In Japan, the Bank of Japan widened the range that it would allow Japanese 10 year bonds to trade, from +/- 10 around zero, to +/- 20. We were positioned in options for a move to the new boundary of the range, at a 10:1 risk reward, but the market failed to move to the new boundary.

Similarly in the UK, the market had a 90% chance priced for a Bank of England rate hike. We thought the likelihood was closer 60%, so we had a small exposure for no hike rewarding 9:1, again resulting in a small loss.

We will continue to populate the portfolio with good risk reward trades, aware that there is a modest cost to performance when they don't work, but generous returns when they do.

At month end, our focus is very much on the tariff war and the opportunities it presents. August should be relatively quieter for the markets as the US and China are even on their tit for tat tariff response and another response is not likely to come until later in September. So we are positioned for a weaker CNH in September, and a range bound CNH for August (in the option market). This might sound too clever by half, but if correct will provide up to 10 to one returns. We are risking 0.5% of the capital of the fund here.

But we also believe there is a bi-modal outcome for tariffs over the next 3 months. Our consultants expect an escalation in the tariff war, with a further 200b tariff being announced by Trump when the next 200b is implemented and China responds with their 65b. So probably late September, early October. Our CNH exposure will capture this `scenario. However, in brinkmanship there is always the possibility that someone caves. One of our consultants suggests the Chinese see a window to negotiate with Trump ahead of the November mid-term elections, given he might like to declare a "win" during the campaign. Markets would be very relieved, but CNH would strengthen and our trade here will lose. We are monitoring this as carefully as one can, but we are also positioned for higher US rates, and will add to these positions when prices are attractive. Our aim is construct a good risk reward in short US rate positions again via options, perhaps 5:1. In a 2 horse race (tariff or back down), getting 10:1 on one horse and 5:1 on the other would appear fanciful. The thing with markets is you often find out there is a third horse after the race has started! None the less, we like the opportunities and if the third horse is there out losses will be limited.

In addition to the above, we are also short GBP. And long rates in the UK (against out short rate positon in the US). Over the next 6-9 months our indicators suggest the UK economy will continue to slow. We also expect the Brexit confabulation to weigh on the economy (and currency).

OUTLOOK

Be careful what you wish for 'Cause you just might get it

Ah currencies. Just how important are they? Many pretend to understand, but are quickly confused. Even US presidents. I particularly like this exchange between President Nixon and his Chief of Staff, Haldeman[1]:

Haldeman: Did you get the report that the British floated the pound?

Nixon: No, I don't think so.

Haldeman: They did.

Nixon: That's devaluation?

Haldeman: Yeah. Flanigan's got a report on it here.

Nixon: I don't care about it. Nothing we can do about it.

Haldeman: You want a rundown?

Nixon: No, I don't.

Haldeman: He argues it shows the wisdom of our refusal to consider convertibility until we get a new monetary system.

Nixon: Good. I think he's right. It's too complicated for me to get into.

Haldeman: [Fed chairman] Burns expects a 5 percent devaluation against the dollar.

Nixon: Yeah, OK. Fine.

Haldeman: Burns is concerned about speculation about the lira.

Nixon: Well, I don't give a shit about the lira.

Oh, how times change. By 1985 the US was orchestrating the Plaza Accord to engineer a 50% appreciation of the Yen!

Trump remembers Japan in the 80's. Indeed, I think all his economic beliefs were formed in the 80's. And he now thinks China is the new Japan. And he doesn't like what is happening with their currency.

"China's currency is dropping like a rock", he complained on CNBC last month.

Is he right?

Well he appears to be. Since April the USD has strengthened over 9% against the Chinese Renminbi.

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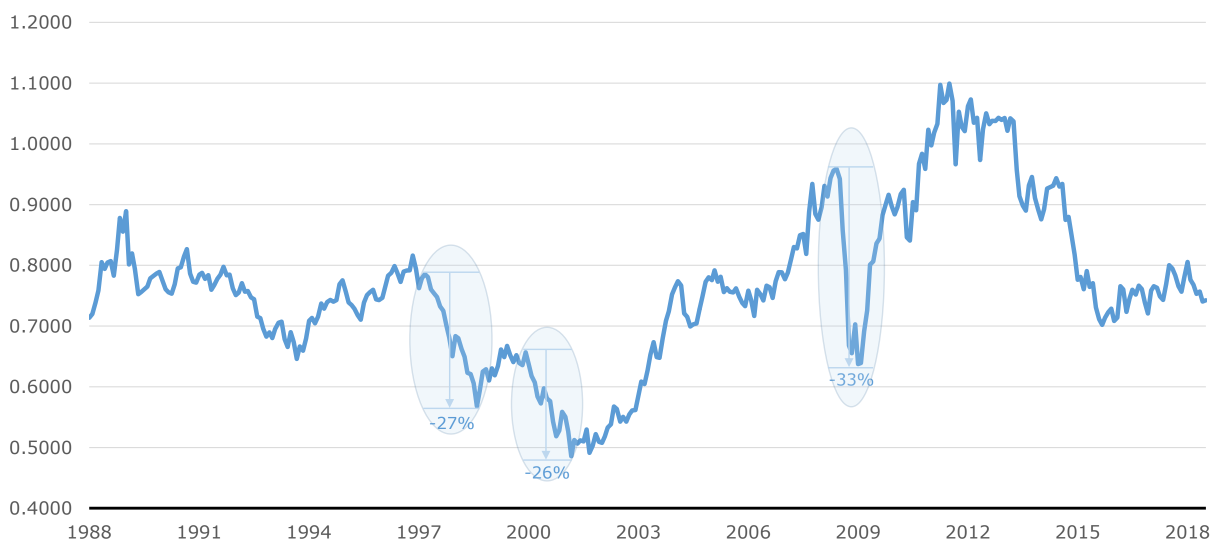
[1] The Euro: The Battle for the New Global Currency, David Marsh

Source: Ellerston GMF, Bloomberg

Indeed, it has been a very quick move. So I think it is fair to say Trump is right in his description. But is he right to complain? Ah, that is a much more complicated question; perhaps too complicated for even some presidents I dare say. But perhaps allow me to be brave enough to have a stab. (For those short of time, jump straight to the Market outlook).

Firstly, does it matter? As an Aussie might say, "Bloody oath it matters!" It is the key reason why Australia has enjoyed the longest period of growth without a recession in recorded history.

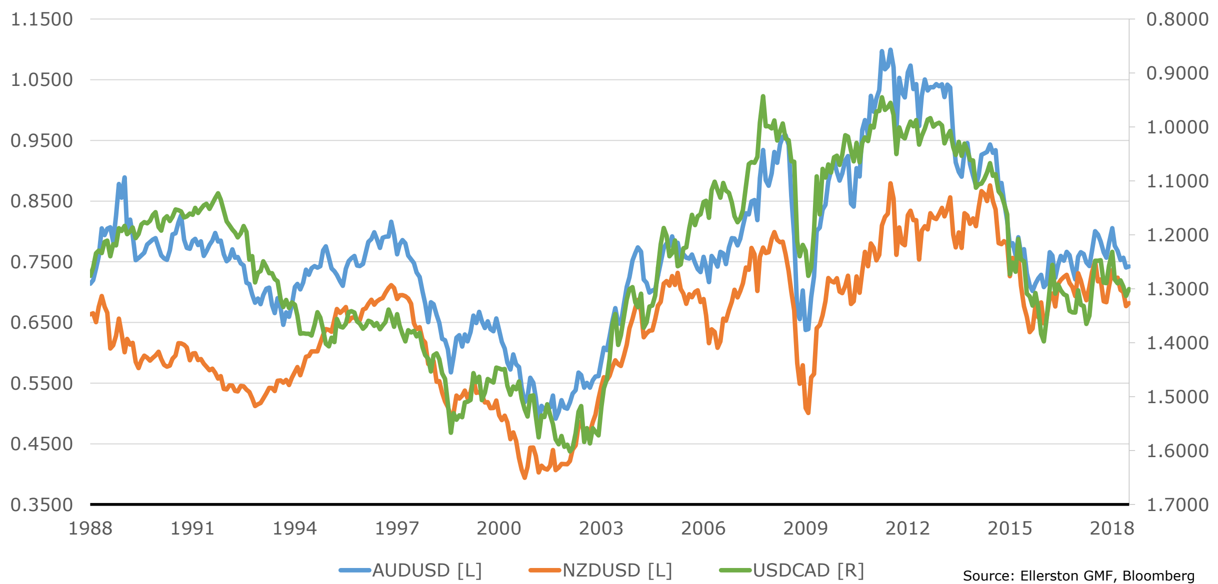
Is that too big a statement? No. Australia has performed three "global recession escapes" in the last 30 years, and in all three the currency did a lot of the heavy lifting (or falling as it was).



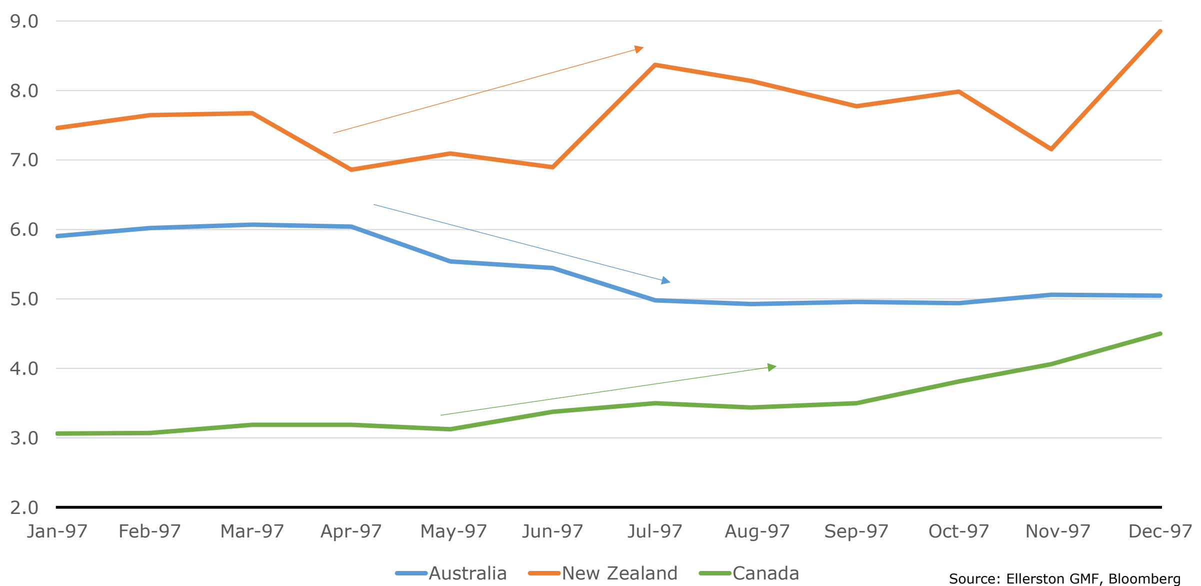
Source: Ellerston GMF, Bloomberg

The three episodes were the Asian crisis in 1997/8, the Dot Com recession in 2000/2001 and the Global Financial Crisis in 2008/9. In each instance the AUD fell 26 to 33 per cent.

Didn't that happen elsewhere? Well actually yes. Other commodity currencies followed a similar path.

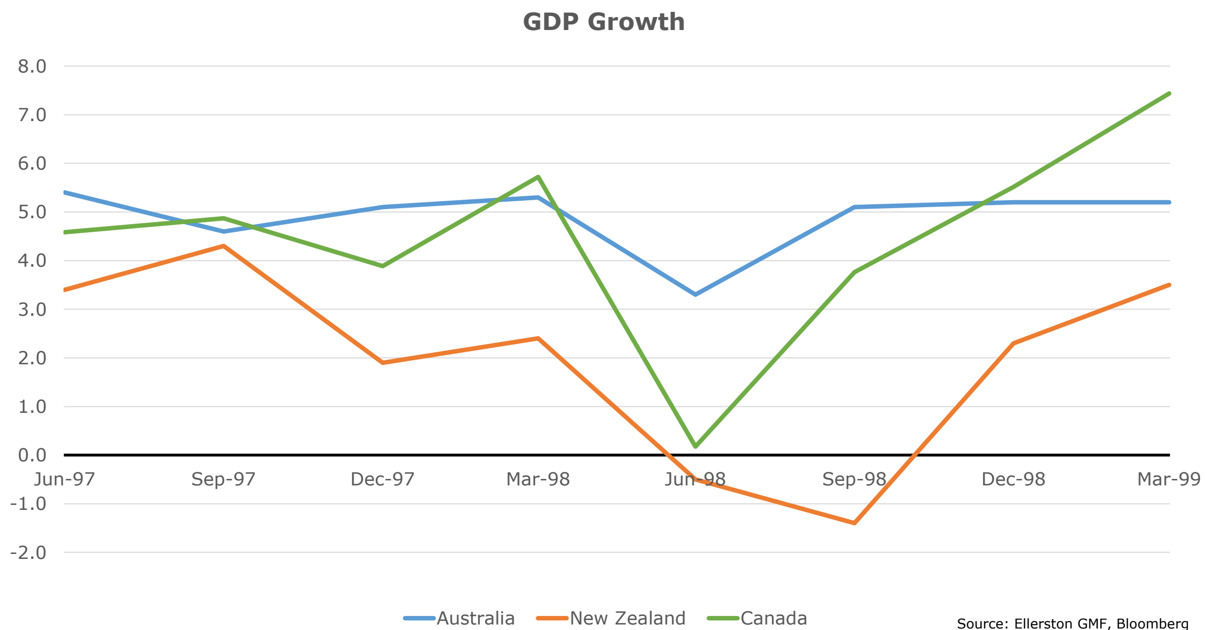


The difference was the RBA accommodated the weaker currency. Particularly in 1997. That was a watershed moment. Conventional wisdom at the time was that when the currency fell, the cost of imports went up, hence inflation would rise and the central bank would need to raise rates to ensure that inflation did not become entrenched.



That was the reaction of both Canada and NZ, with both increasing interest rates in 1997. But the Reserve Bank of Australia cut rates.

The consequences were seen the following year. Australian growth dipped trivially. Canada and NZ skirted with/had a recession.



The RBA at the time had taken the rather revolutionary view that inflation would prove transitory, and that they should support growth by keeping interest rates stable, or indeed lowering them. It was this break from the one-dimensional behavior of the past that was most instrumental in delivering a record expansion for Australia. Now Glenn Stevens might argue that it was the anchoring of inflation expectations in the prior 5 years that allowed them to pursue that strategy. That is true. But so it was for the other countries. No, the real epiphany was the realisation of what was possible with inflation tamed. Like Laird Hamilton using jet skis to open up the world of big wave surfing, the RBA used stable inflation expectations to bring the exchange rate into the policy tool chest[2].

Of course it is not the only reason Australia has enjoyed a 27-year expansion. An aggressive central bank when the need arose and a well-timed aggressive fiscal stimulus in the GFC also played significant roles. But the currency was always allowed to "do its part". Indeed, it is this "part" we capture today in our financial conditions indices (FCIs).

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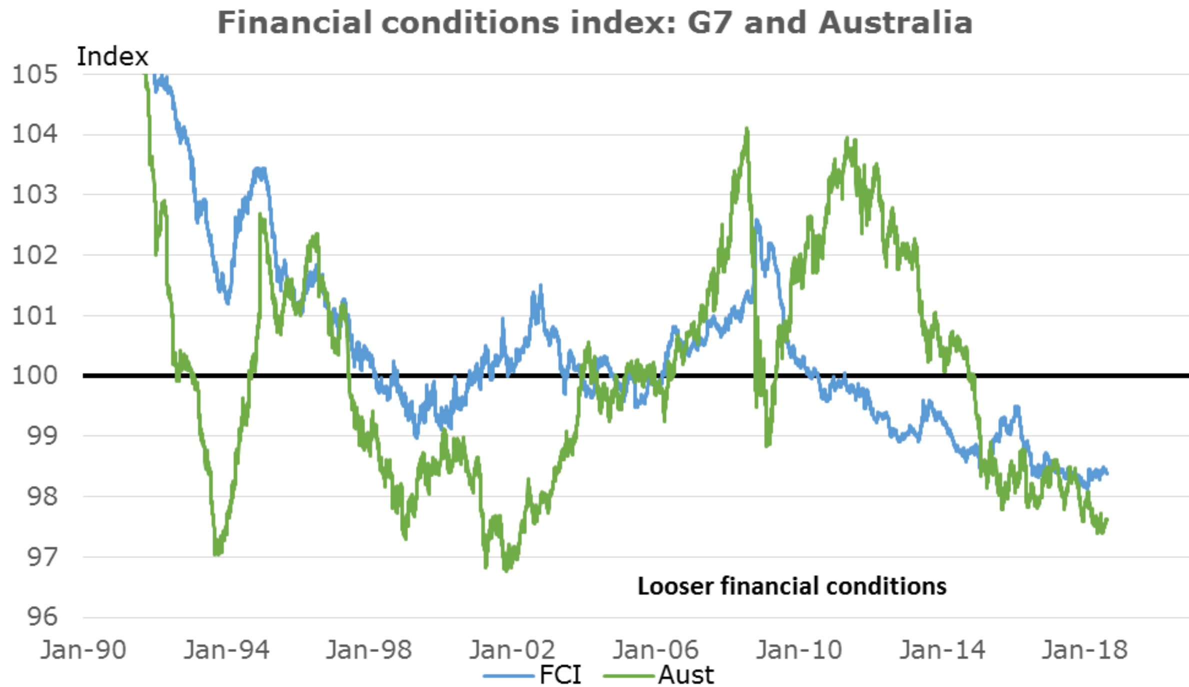
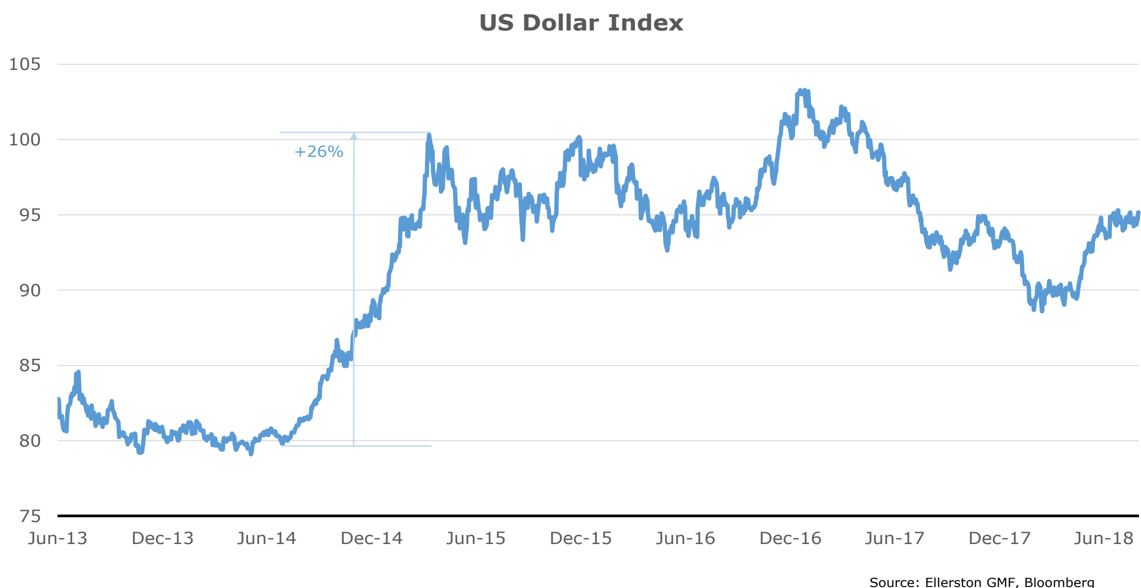
[2] Central banks had long been aware of the impact of currency movements on an economy. However, modern theory at the time was they had to lean against the inflation impact of a currency fall, rather than embrace the growth stimulus. The RBA were I believe the first to identify that stable inflation expectations allowed them to embrace the growth stimulus and look through the inflation impact.

So look at what happened to Australia's FCI in 1997. It loosened (fell) a lot more than the average country (G7 is the 7 largest economies in the world). By easing when the currency was also falling, the FCI fell from 101.2 to 97.2[3]. That's equivalent to financial conditions moving from a 1% headwind to growth to a 3% boost to growth over the next 9-12 months. And again in 2001, a 2% boost to growth. And in the financial crisis, moving from a 4% headwind to a 1% boost. By anchoring inflation expectations, the RBA could let the currency "do its part", and it fully embraced the support!



We calculate the FCI for numerous countries. The importance of the currency varies from economy to economy, because the amount each country imports and exports varies across countries. And also the importance of the currency depends on foreign debt levels and industry composition.

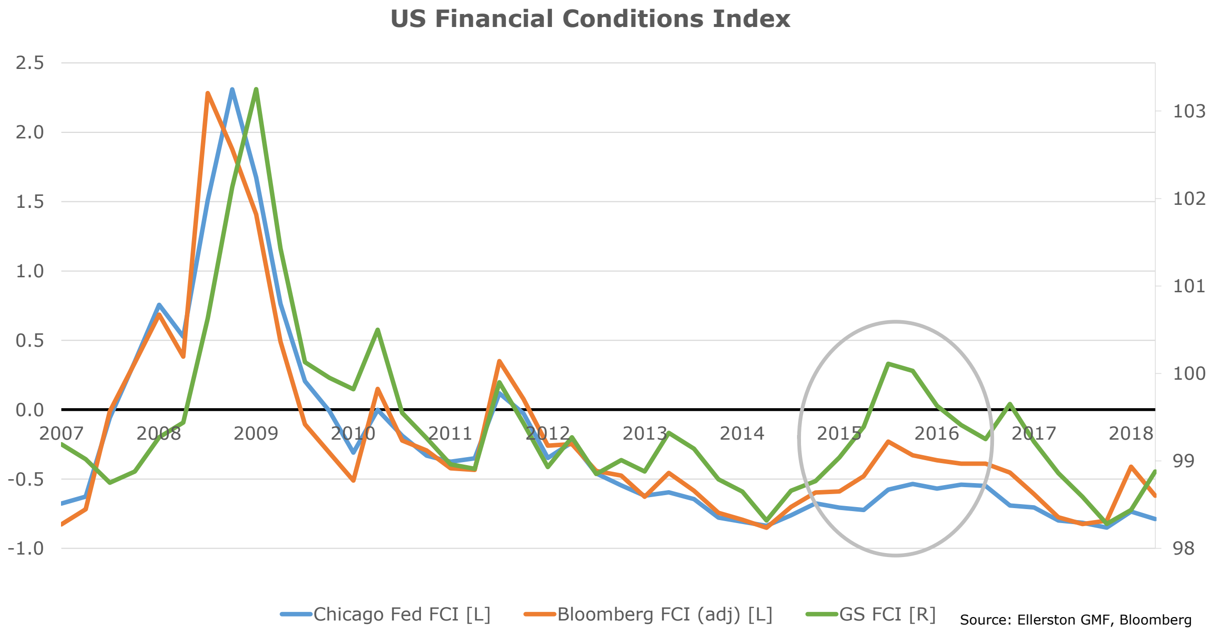
So our FCIs need to calibrate for how important the currency is in each economy. At my prior abode, I relied on the Fed for my FCI. My mistake. In 2014/15 the USD appreciated some 25%.



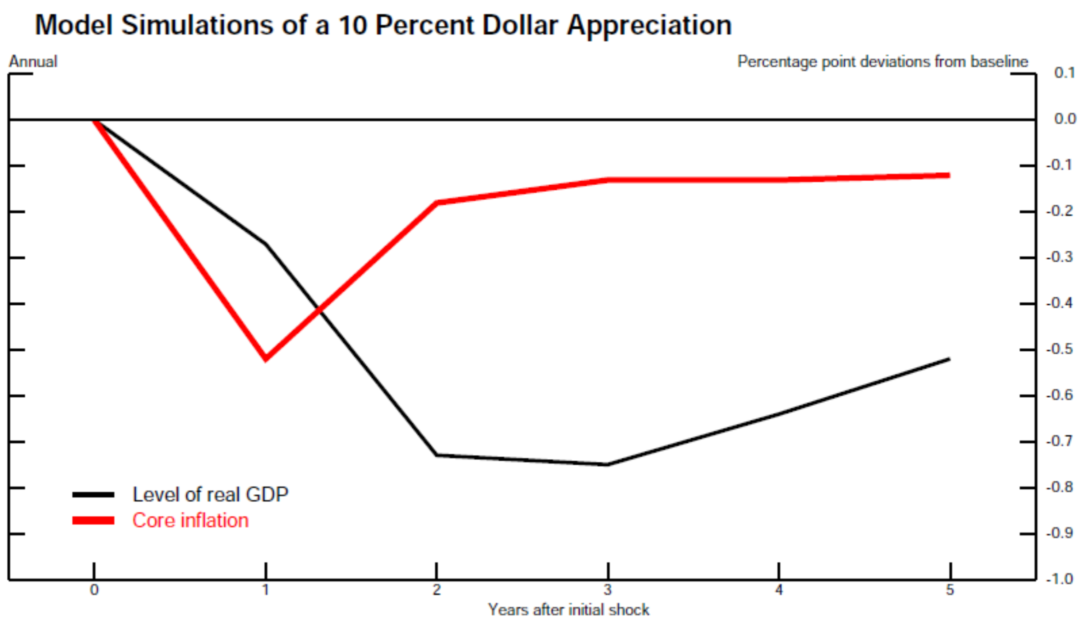
[3] A reading of 100 is neutral, meaning financial conditions are neither supporting growth nor hurting growth on a 9-12 month horizon. A reading of 99 means financial conditions are boosting growth by 1% over the next 9-12 months, and a reading of 101 means lowering growth by 1%. Both the level and change are important. For example the level may stay at 99 for several years, constantly supporting growth by 1%. Which might translate to growth sitting 1% above trend. But not accelerating. A move to 98 would suggest a 1% acceleration in growth to 2% above trend.

But, given the lower share of exports in the US economy, I (and the Fed) deemed the impact as limited.

On the chart the blue line below shows how much the Fed's financial conditions index tightened in 2015. Not much. We find a well calibrated financial conditions index forecasts the economy with about a 9 month lead. But note I say *well* calibrated. That is the art. There are many FCIs around, particularly for the US economy. Also on the chart I show the Bloomberg FCI and Goldman FCI. The measured tightening varied considerably.



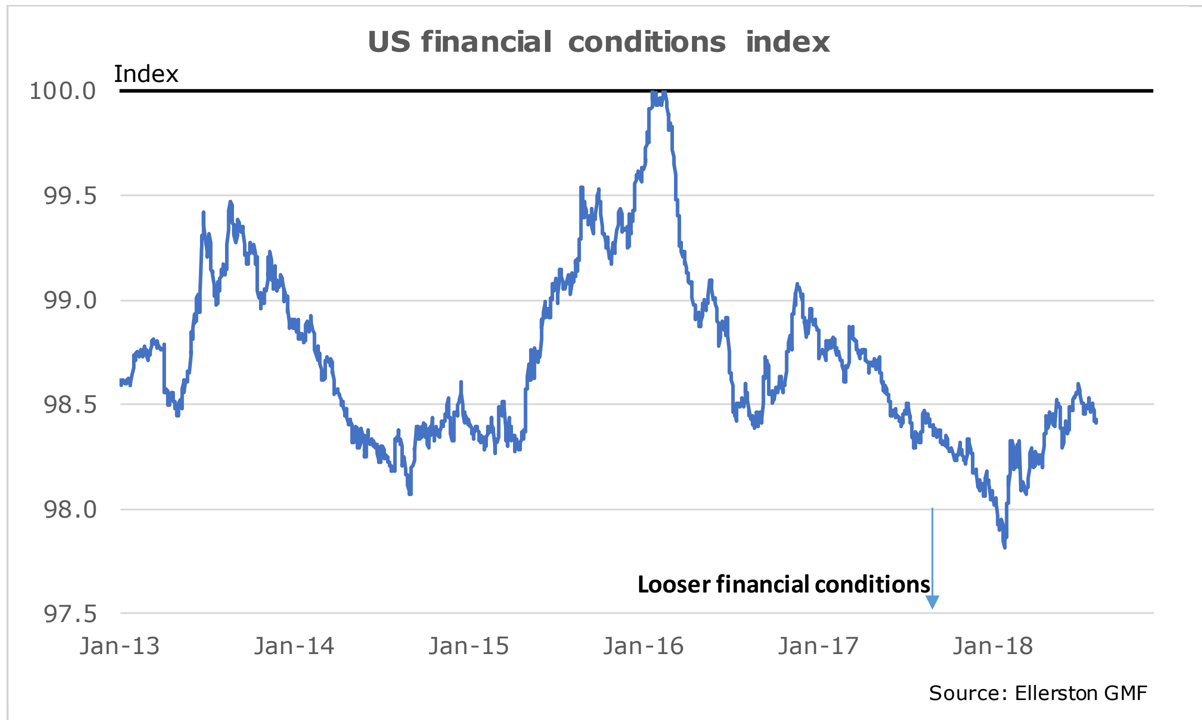
How wrong I was to follow the Fed! Indeed, Stanley Fischer opined in July 2015[4] that new Fed research showed the currency impact was the equivalent of a 1.75% hit to GDP growth over 2 years! Hence the Fed only hiked once in 2015, when at the start of the year they were forecasting 4 hikes…



[4] https://www.federalreserve.gov/newsevents/speech/files/fischer20150829a.pdf

So it is clearly important.

What did Tim's Toohey's FCI say? Well he hadn't built it for me then, but looking back we can see it was also worth a 1.75% detraction from GDP[5].



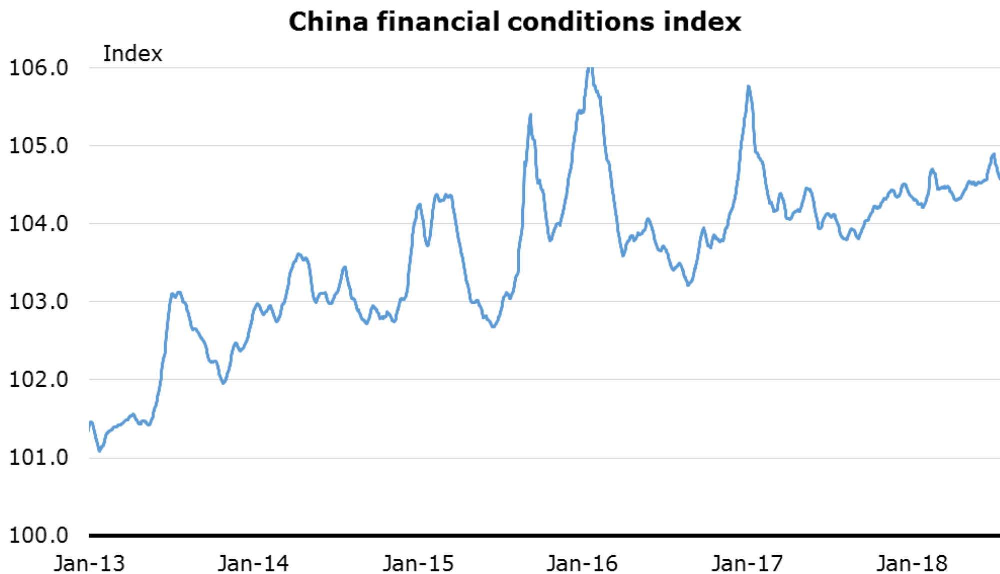
And so when someone asks does the move in the currency matter, we say it depends. It depends on what everything else is doing. This is where the FCI is so useful. It not only captures everything else, but if weighted correctly, it is a crystal ball to growth 9 months ahead. And that is the key. *Weighted correctly*. The weights do evolve, and Tim Toohey has been building these indices for well over 20 years now. I believe they are the best available.

[5] In Tim's FCI, a good portion of the tightening also came from an increase in the interest rate a corporate borrows at, as measured by the corporate bond spread. The key difference with our FCIs is they are calibrated to forecast GDP growth on a 9-12 month horizon.

MARKET OUTLOOK

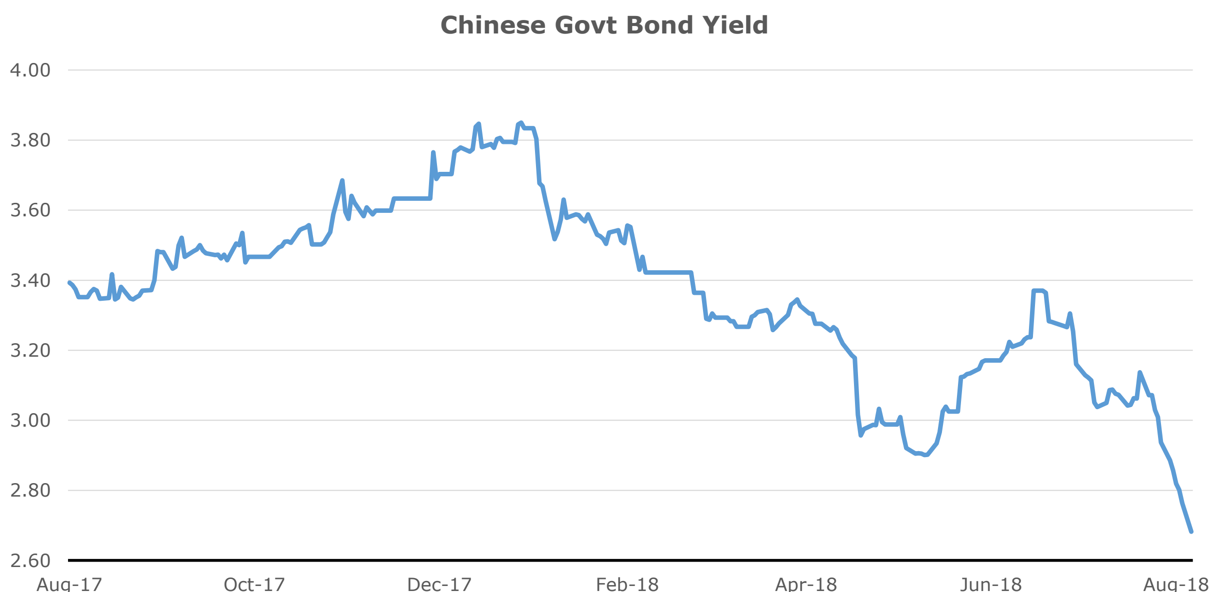
So does the current move in the CNY matter? Well not for the US. (See chart above)

And it would seem not for China, with financial conditions simply returning to where they were 12 months ago.

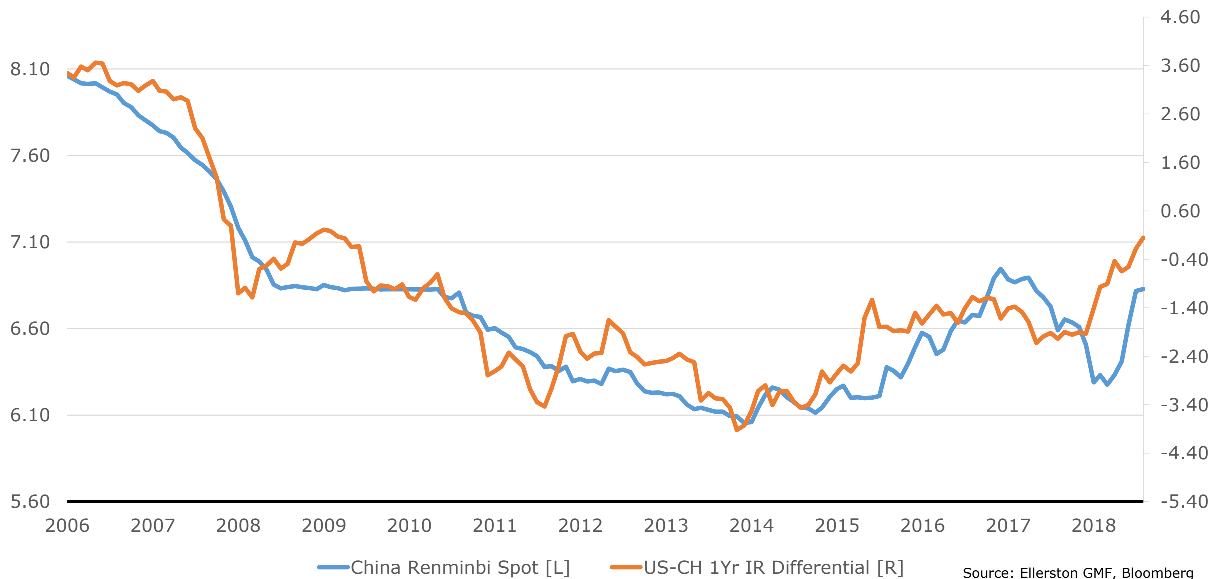


Indeed for China, the positive impact of a weaker currency has offset the negative impact of their falling stock market. Mmm, hasn't the falling stock market got something to do with tariffs? Doesn't it make sense for the Chinese currency to weaken to support the economy - for the currency to "do its part"? The RBA would certainly think so.

To be fair, the Chinese stock market started falling well before the tariff war broke out. Up until June, the Chinese had been engineering a slowdown. In particular, they had been focussed on reducing the "shadow banking" that was overstimulating the housing market and risky investment in general. As the tariff war has escalated, they have now fully reversed course, cutting interest rates, easing credit and easing fiscal policy.



At the same time the US has been raising interest rates, such that interest rates in the US are now higher than China. The rate differential would suggest it is perfectly natural that CNY would weaken.[6]



Indeed, the currency "should be" at 7.1 already. Perhaps it would be if the Chinese were not trying to SLOW the depreciation, with measures such as margin penalties for banks "shorting" the currency, as well as encouraging domestic banks to aggressively buy CNY at the close each day.

So to me it would appear the Chinese are deliberately trying to prevent their currency falling "like a rock". Whilst at the same time they are allowing it to "play its part". How very modern of them!

So why is Trump convinced otherwise? Because the answer is a little more complicated/opaque in the case of China, as their currency is not freely floating. It is a managed basket approach, similar to the Monetary Authority of Singapore, but less defined.[7] They are in transition from a fixed exchange rate, to a freely floating exchange rate. It is this opaqueness that allows Trump to twist the facts. Well, ignore them actually. But hey, that's what he does. The problem is he is asking China to strengthen their currency when his very own policies are driving CNH weaker.

In actual fact, Chinese currency management is well progressed from 3 years ago, when they first embarked from a pegged currency to a managed currency. The lack of intervention over the last 18 months would suggest they are allowing the currency to float relatively freely. The chart below shows Chinese offshore reserves in blue. In 2000 the Chinese held 160 billion in offshore currency, predominantly USD. Typically they would invest this in US 10-year Treasuries. There for a rainy day in case there was a crisis and they needed to support their currency by selling those USD and buying CNH (a lesson from the Asian crisis in 1997). However, when they broke their peg in 2005 and allowed the currency to slowly appreciate, the trend became clear. So many investors were jumping over themselves to buy CNH and get a free appreciation in the value of the currency. Had the central bank done nothing, the currency would have appreciated very quickly and hurt economic growth. So they "leaned" against it by selling their own currency and buying USD. To the tune of nearly USD 4 trillion worth of selling of their own currency over a decade.

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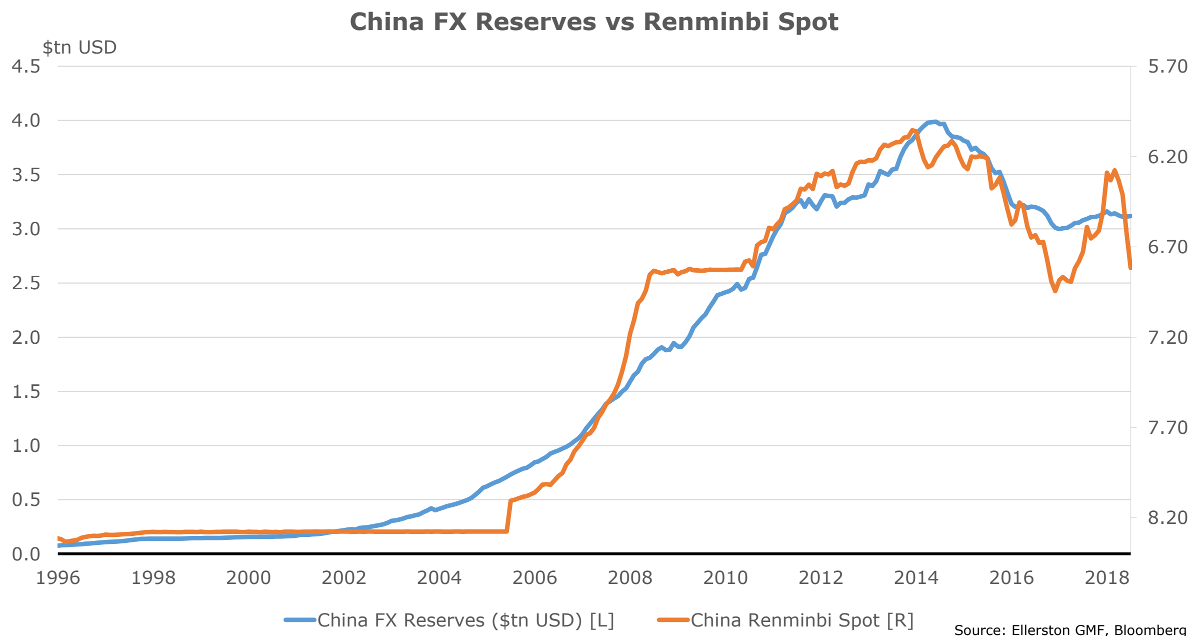
6 Note CNH, or Renminbi, is quoted as how many Renminbi to the US dollar. So a higher number indicates more Renminbi for a USD ie the Renminbi is weaker. The Chinese currency is also referred to as the Yuan, and CNY. CNY is traded "on-shore", and CNH is traded "offshore".

7 For the 18 months to June, CNH was managed in a very similar way to SGD, with a range around maintained around a trending trade weighted basket. Since June, they appear to have allowed the currency to float almost completely freely, paradoxically something the US has been requesting for many years. As they say, be careful what you wish for…



August 2015 was a pivotal moment. The Chinese economy was slowing, and for the first time fundamental pressure dictated it was appropriate for the currency to weaken. The Chinese authorities were slow to allow this, maintaining a peg at about 6.2 for the prior 15 months. When they let it go, the trend reversal saw Chinese citizens move their wealth overseas en masse to protect its value. The flow turned into a deluge, and the Chinese authorities had to buy almost USD 1 trillion worth of CNH, and restrict capital flows for Chinese citizens, to arrest the freefall (note the fall in reserves 2015).

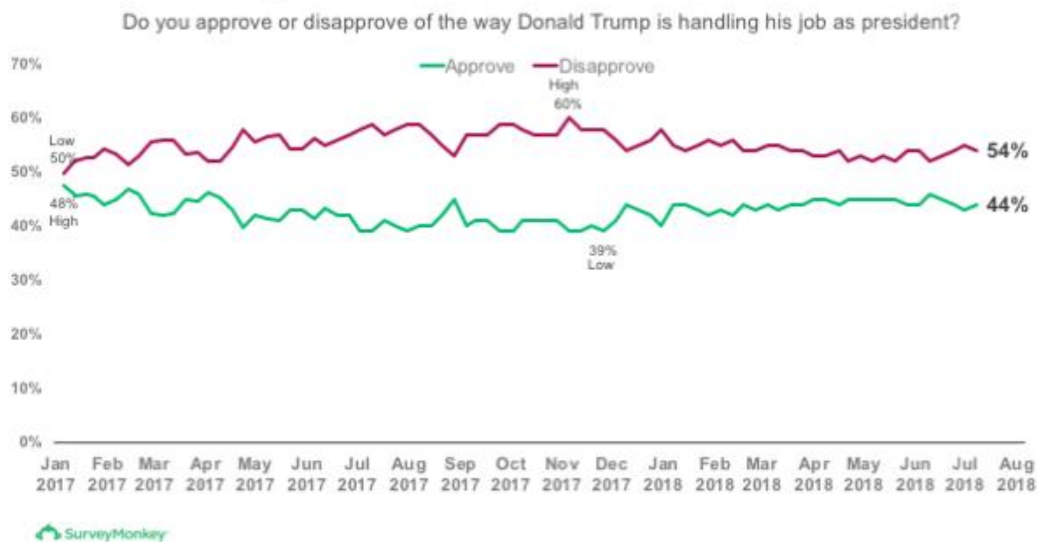
At the end of 2015, they shifted to a managed basket approach, similar to Singapore. And this has been successful, in that very little intervention has been required in the currency since then (indicated by the relatively stable reserves, and also indicating Trump's view is very last decade).

So now what? Should the Chinese stabilise their currency? One minute the world is telling them to let it float more freely, and when that doesn't suit, Trump wants them to intervene! No they won't intervene, except to smooth when the market gets too volatile. They are in the process of a long commitment of freeing up their currency, and they won't take a backward step now.

So expect the currency to go where the fundamentals dictate. And where is that? Well the interest rate differential suggests a weaker CNH, around 7.1. And the interest rate differentials are likely to keep moving in the USD's favour. Indeed our forecast in a year's time purely on rate differentials would suggest 7.2 to 7.3. But of course there are other factors at play, in particular the tariff war and accelerated capital flows. The Chinese would very much like to avoid a repeat of late 2015, when they had to intervene heavily to stop a freefall in the currency. If sentiment shifts quickly, perhaps driven by a sudden realisation that this trade war is going to last years rather than months, it may be very difficult to control the capital flow, despite the tools available to the Chinese. Hence their smoothing in July.

So how long will the trade war last? Put it this way. No one appears close to blinking.

Consider the pair. (No, neither are in an industry super fund). Trump has mid-term elections in November. His polls have been the poorest in the first 18 months of any new president since WWII. But now that he has switched to trumpeting tariffs, his polls have risen.



He thinks he has found the golden nectar. Well perhaps it is for a populist politician. The point is, he is being encouraged every day to push harder in this direction. Industry is complaining to be sure, but is yet to find a sympathetic ear in the White House. He is going to go harder on tariffs into the mid-term election, not softer.

The market knows this. But it also thinks this is all brinkmanship. Once the election is done, if not just before, Trump will agree on a deal and claim victory.

So no need to panic right?

Except there are a couple of wee problems there. Firstly, President Xi has a country of his own to maintain leadership of. My consultants suggest Xi has taken personal responsibility for managing the tariff "situation". Murmurs are mounting that he has not handled this well. Despite recently being sworn in as leader for life, he still has lurking discontents that will leap on failure. He now believes he has to show strong leadership and "win" against Trump. And a "win" does not mean backing down. The quashing of the Qualcomm deal, and the announcement (at the start of August) of a further $60 billion of goods the Chinese will impose tariffs on, both reflect a new determination of Xi to put Trump in his place.

Mmm, so it is not clear who is going to give here…

At the same time the White House is digging in. Last month Foreign Investment Risk Review Modernisation Act (FIRRMA) was expanded, giving it ability to reject foreign investments that seek to "obtain commercial secrets related to critical or foundation technologies" and investments which "reduce any technological or industrial advantage of the United States"

And the clock ticks. The US implements a 25% tariff on a further 16 billion of imports on August 23rd (bringing the total to 50 billion). China has instantly responded in kind. Public comment now closes on the proposed 25% tariff on a further 200b on September 5th. Expect the imposition about a month later. China have promised to respond with tariffs on 60 billion of US imports. Trump has promised to respond with another tariff on a further 200b if they respond! A sharp escalation in the tariff war is looking increasingly likely in September and October.

So how are we managing it? Well, brinkmanship is extremely difficult to trade. The whole idea of brinkmanship is to make the situation so unpleasant that the other guy caves in. The market is trying to look through the brinkmanship to the cave in. But in these situations it is usually the market that has to do the work of making it unpleasant. Trump is taking great pleasure in watching the Chinese stock market fall 20%. Whilst ever this is the situation, he will hold steady and assume the Chinese cave first. But if the Chinese don't cave, it will likely be the US stock market that does the fall and causes Trump to cave.

We are holding small short positions in both the US stock market and the emerging equity ETF. However, only in options, because if either leader caves, there will be a tremendous relief rally in equities. Indeed, any talk of talking sees quick reversal in markets.

The bulk of our exposure is still in currencies, and short the Chinese currency in particular. Fundamentally, we think the currency should weaken, driven by growth, and interest rates. Tariffs could turbo charge this weakening. But in July they created a lot of uncertainty. Like equities, any

sign of a resolution of the tariff deadlock will see a significant rally in the Chinese currency. Volatility increased significantly in the Chinese currency during July.[8] CNH weakened 2.5% during July, but it corrected by 1% to 2% five times.

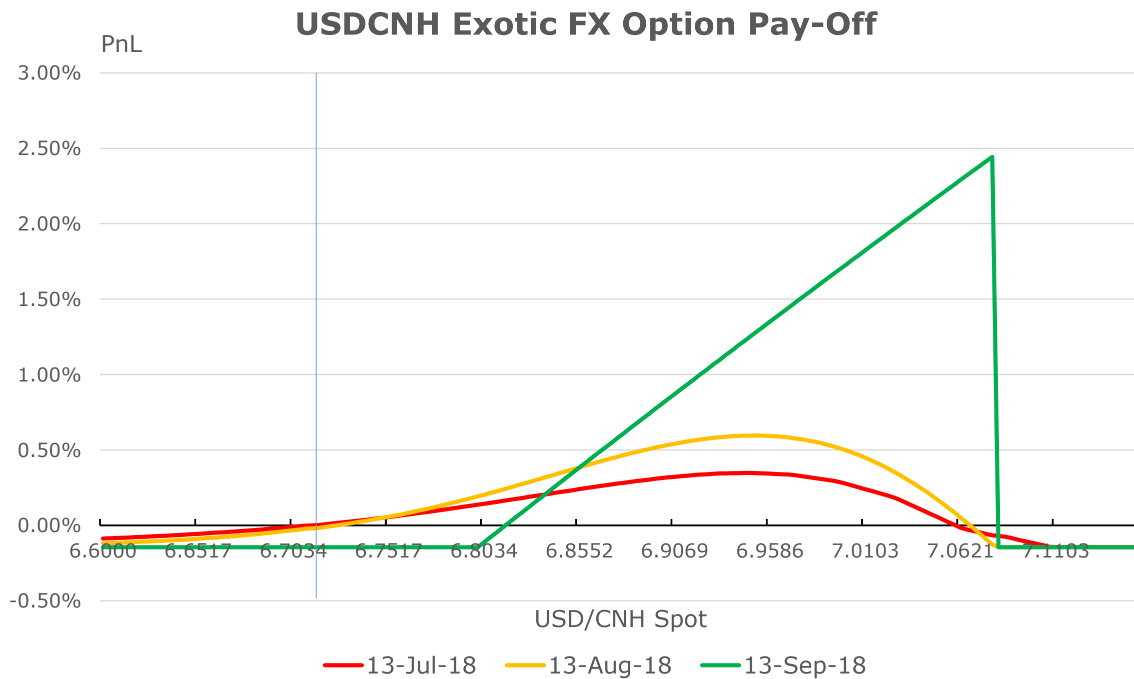
Source: Ellerston GMF, Bloomberg

So trying to sit short the Chinese currency at the moment is not dissimilar to grabbing a snake by the tail - it is whipping all over the place!

[8] As measured by the average true range, volatility was 3 times higher in July relative to June.

Nonetheless, we firmly believe the move has further to go, perhaps a lot further. Capital outflows have not started yet. The tariff deadlock looks set to escalate, particularly into September. So we are maintaining this exposure.

We like the opportunity the option market is presenting. The option market is very concerned about a sharp fall in the currency. So puts on CNH are trading at a premium. That means if we are willing to put a range on the currency move over the next month we will get an excellent risk reward. For example, on the 13th July we bought a put on CNH at 6.8. And we attached a condition to it. The condition was if CNH trade to 7.08, our option is "knocked out", or cancelled. By attaching the condition, we get a 62% discount. Now we think recent measures from the Chinese suggest they want to slow the pace of depreciation. And that 7 will be a natural level to defend for a period. And that August will be a quieter month for tariff headlines, making 7 more defendable. So we are happy to attach the "knock-out" to the option and improve the risk reward of a move to 7 over two months from 4:1 to 12:1.



We have a number of these structures in the portfolio, all over different dates and prices, but capturing the same idea, namely a more controlled depreciation in the Yuan over the next month before tensions increase in September and the move becomes potentially more volatile again. Perhaps we are threading the needle a little, but if right the risk reward is very good. If wrong the loss is very controlled.

We still have a short position in US rates, but it is the smallest it has been in since inception. Once tariffs are resolved, US rates will sell-off rapidly, and we want a toe in the water in case we miss the start.

And **we have modest shorts in EM equities and US stocks**. Because we think it gets worse before it gets better….

Brett Gillespie

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