

Ellerston Global Macro Fund

Performance Report | December 18

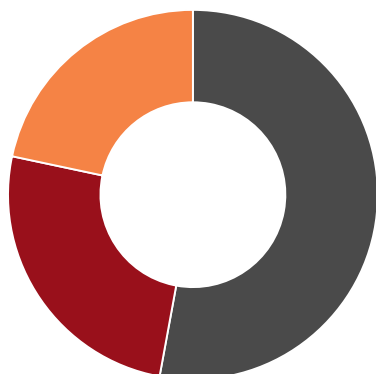
FUND PERFORMANCE (%)

	1 Month	3 Months	6 Months	1 Year	Since Inception p.a.
Fund Net	-0.59	-0.77	-1.64	-2.03	-1.25
RBA Cash Rate	0.13	0.38	0.75	1.50	1.50

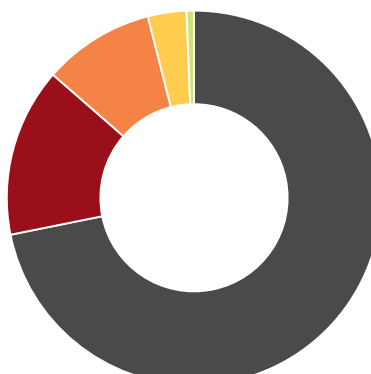
	Jan	Feb	Mar	April	May	June	July	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.85	0.54	-2.27	0.61	-1.07	-0.01	-0.34	-0.51	-0.03	0.73	-0.90	-0.59	-2.03
2017							-0.59	-0.90	0.81	-0.45	0.64	0.66	0.16

Source: Ellerston Capital Limited

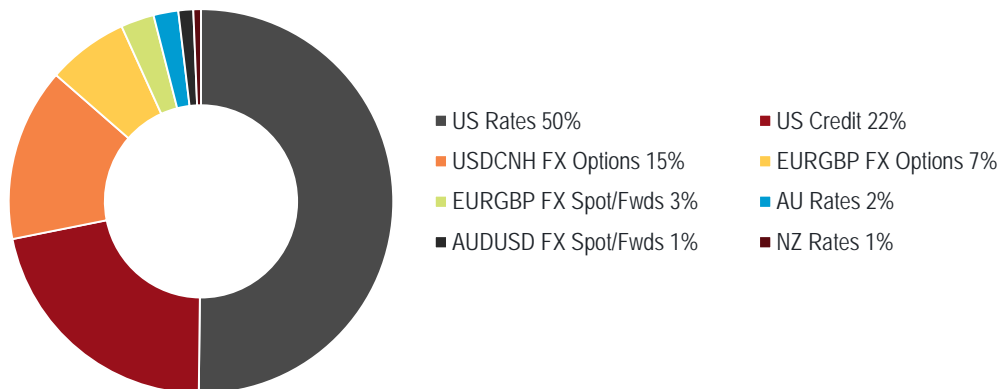
Asset Class Exposure



Geographic Exposure



Portfolio Exposure



Source: Ellerston Capital Limited

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 July 2017

Date

Liquidity Daily

Management Fee 1.00%

Performance Fee 15% of outperformance

Buy/Sell Spread 0.25%

Distribution Semi-annually

Frequency

Strategy AUM 206.8M

Firm AUM Over \$5 billion

PORTFOLIO COMMENTARY

The fund returned -0.59% net of fees in December.

We thought November was volatile. And then in December equity markets had their worst December since 1931! Over the month, US equities (the S&P) fell 9.2%. US 10 year bonds fell (rallied) 31 basis points, to 2.68%. Market expectations of Fed hikes in 2019 dropped from 31 basis points to -2 (i.e. a chance of a fall). The US investment grade credit spread moved from 75 to 88. And the broad USD currency basket was little changed (1% weaker).

Last month we signed off with;

At month end, we still contain a reasonable exposure to a large credit market deterioration in the US. If credit markets settle, we will again increase our exposure to US rate shorts.

The last sentence proved premature. Mid-month market conditions appeared to have settled. The S&P had declined from 2760 to 2583 and then bounced 2685, holding the key 2600 level. With less than one rate hike priced in 2019, we started to position short rates (looking for two hikes to be priced as we moved through Q1.) At this point the tightening in our financial conditions index (FCI) still suggested above trend growth, and our nowcasting model (which derives the underlying pulse of growth) was still solid. As equities fell, the rate hike pricing was reduced to zero, our FCI suggested back to trend growth or lower, and we closed this position at a cost of 0.82%.

Indeed, we pivoted long US interest rates, mostly US 10 year bonds, and some curve trades, and added 0.55% to performance. Hence US rates net for the month was -0.27%.

Credit contributed 0.30% to performance as spreads widened.

Equities subtracted 0.30% from performance. Half was a long position in Hong Kong equity calls, a market which we expected to benefit from positive trade talks in Buenos Aires. The market briefly did, before being overwhelmed by US stock market falls. And we both bought and sold the US equity market during the month, as we sought to re-adjust the beta of the portfolio to the equity market. This cost 0.16%.

We also started building an exposure to Brexit during the month via the currency, EURGBP. This cost 0.07%. I provide some colour over the page. But we are seeking to take advantage of the limited number of scenarios and high volatility to construct a favourable risk/reward on what we see as the central case, some sort of soft Brexit. As such, we feel we have constructed a 10:1 risk-reward for a 60% scenario. We are risking 0.32% of capital with a target return of 3.2%, on the assumption the outcome is determined over the next 3 months.

As noted above, as the equity market fell, we pivoted to long US 10 year rates, and maintained our short credit position. That is how we finished the month.

Looking into January, we expect the markets to remain volatile. Most of our positions are in options, to limit risk. As I write (Jan 11th), the Fed pulled a possible game changer on January 3rd, promising to pause rate hikes. Although we have failed to connect with the ball in November and December, we have also pulled the fund through relatively unscathed, and are excited by the opportunities the market is creating for the New Year. Following the Fed switch, we have built up good risk/reward option positions in both the Chinese Yuan and Singapore Dollar in early January, looking for those currencies to strengthen. We have the Brexit trade. And we still think a credit bubble burst is on the horizon, and were quite aggressively positioned for that at month end, but have lightened it significantly following the Fed pivot in the first week of Jan. Plenty of detail on our thoughts is provided over the page.

OUTLOOK

So tonight I'm gonna party like it's nineteen ninety-nine (maybe)

"Only in the sales presentations of investment banks do earnings move forever upward." Buffett

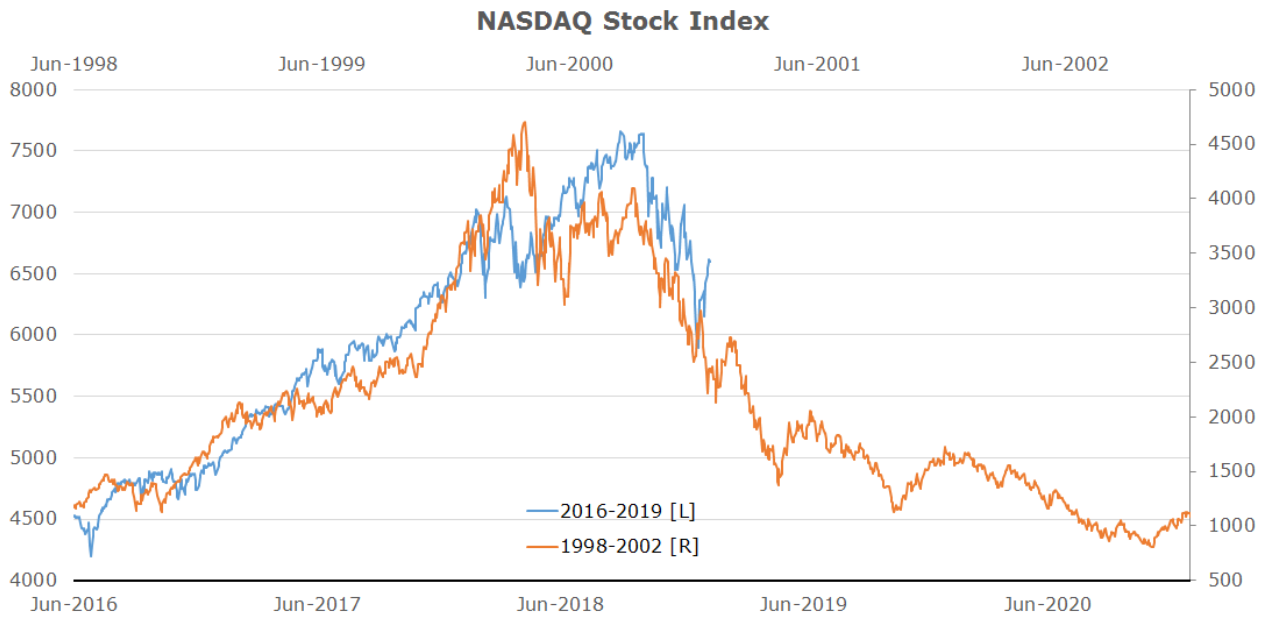


In October the whole firm was rounded up and marched over the road to the grand ballroom of the Wentworth Hotel to hear about the launch of the new US Technology Fund. And I must say it sounded very exciting. Our US equity portfolio manager outlined the penetration of technology that has occurred over the last 4-5 years, the accelerated use of internet and online shopping, and the new wave of telecommunications that are going to redefine the mobile phone world. I must say it was one of the most impressive presentations I have ever seen, brilliantly presented by the Portfolio Manager, combining fact, anecdote and humour to open my mind to possibilities I hadn't even considered. And I must admit I found myself thinking one does have to own technology stocks, despite how incredibly expensive they looked on any traditional multiple. Which is why of course so many traditional value managers, like our Australian equity manager, had capitulated into technology stocks. And Tiger in Asia. But not Warren Buffett...

I should point out that I am not talking about the portfolio managers with my current employer, Ellerston Capital. Nor even talking about last year. I am talking of another employer and another year. Any idea? The employer was BT Financial Group, and the year was 1999. I managed AUD 6 billion in cash and fixed income funds. And we were one quarter away from the dot-com crash of 2000, when the NASDAQ fell 39% in one year and 83% over 3 years...

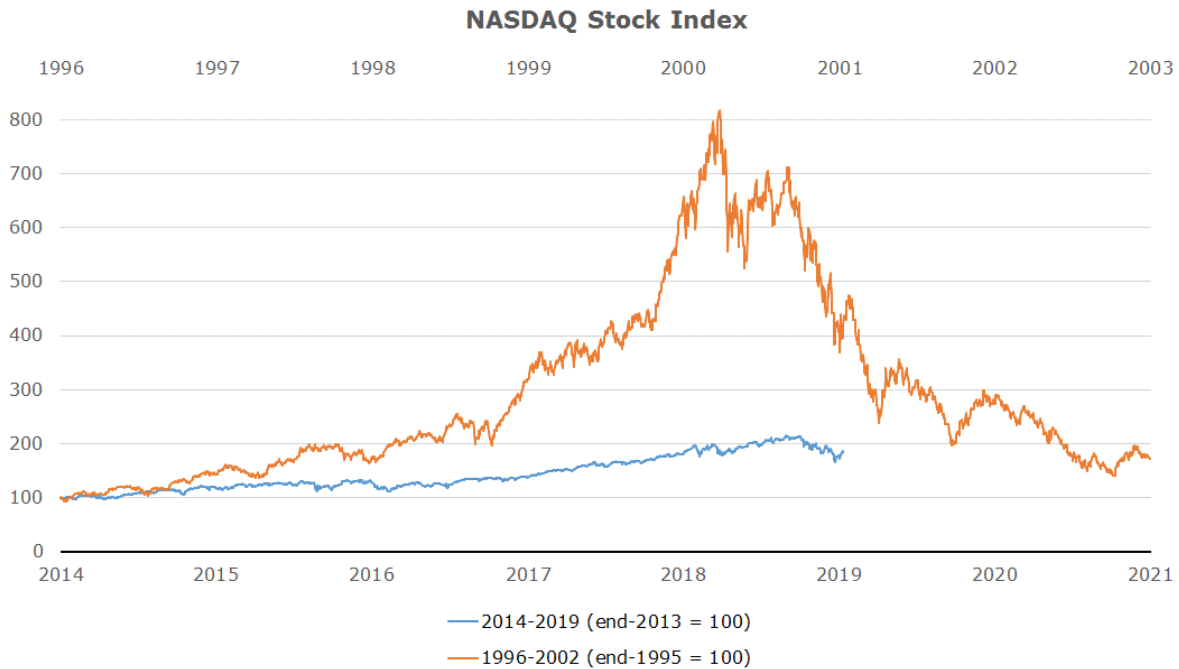
The Dot-com crash wiped out both our technology bulls and technology bears. It's no mystery for the bulls. But why the bears? Because most fought the bubbles for years, before finally capitulating, mostly near the peak as the explosive rally (and explosive underperformance) caused them to fold and buy tech. The most famous manager who didn't/wouldn't capitulate was Warren Buffet, who refused to pay a ludicrous price for something he couldn't value...

So am I drawing an analogy between the tech crash in 2000 and the tech (FANG) crash last quarter? Well the price action might suggest so.



Source: Ellerston GMF, Bloomberg

Scary right? Only if you are naïve, which I'm sure most of my readers aren't! As they say there are lies, damn lies and statistics. If we normalise the scale, we can see the Dot-com bubble was about 4x larger.



Source: Ellerston GMF, Bloomberg

Indeed, on Tim's valuation measure, US equities are now fair value. Not cheap mind you, just not expensive.

When we consider the likely evolution of the Brexit stand-off, we can see 5 paths;

1. May's plan gets accepted.
2. Parliament settles on "Norway+" Brexit, or Common Market 2.0 (the only plan with enough support in the parliament to possibly pass, despite immigration concerns).
3. The decision gets returned to the people via a new referendum.
4. An election gets called and then a referendum.
5. A hard Brexit occurs.

By the time you read this May's plan will likely be rejected. Meanwhile parliament has passed a number of bills to ensure 5 can't happen, and May will likely get replaced if she moves in that direction. None in the Tory party or DUP want to risk an election, as they will likely lose. And so that brings you back to 2 or 3. Two is a soft Brexit, and that would be a relief for the economy. And the polls suggest if another referendum were held the people would now vote to remain. For the economy and markets, scenario 4 and 5 are bad. And 1, 2 and 3 are good. Depending on who you debate, the "good" scenarios are between 60 and 90% likely, albeit it could take many months to get there.

So how is that an opportunity? What if I told you we have created a likely (not guaranteed) risk reward of 10:1 for that 60-90% chance? You would want some of that wouldn't you? So how do we do that? We are taking advantage of 3 factors

- a) EURGPB volatility is near decade highs.
- b) At some point, we don't know exactly when, but sometime over the next say 3 months, a decision will be reached and that high volatility will fall dramatically.
- c) The option market expects that to be a positive resolution for the UK relative to what could happen, and so the option market has a very large "skew" to options that capture a rally in GBP.

We have constructed option trades that take advantage of all three of those features. And we believe they will provide roughly a 10:1 return if a decision on Brexit is reached over the next 2-3 months. We are risking 0.4% to make 4%.



Source: Ellerston GMF, Bloomberg

So in summary:

1. We are not sure whether 2016 or 2000 is the right analogue for the next 6 months
2. But the market uncertainty is providing excellent risk rewards for either option
3. As well as idiosyncratic opportunities such as Brexit
4. We will continue to control risk and seek out high risk/reward outcomes for reasonably likely outcomes
5. Whilst ready to strongly position for the bubble bursting scenario when the dots line up

And one final word on 2018. We would have hoped to do much better for you, our investor. Nonetheless, in essence we were wrong. Not on the economy in the US, which proved very strong and wages are now clearly rising, but the path of the tightening in financial conditions. We had expected higher bond yields to do most of the work in tightening financial conditions. As you know we have talked about 3.5-4% US bond yields all year, and the year finished with yields at 2.68%! Of course they were at 3.25% as recently as November, but then the equity market tanked and the driver of the tightening in financial conditions pivoted from rates to equities and credit. As we wrote in recent months, we expected an element of this to play out, but not to the degree we saw. And perhaps quantitative tightening is having a bigger impact directly on credit and equity markets rather than bonds. Being the first episode in history, one can't be sure.

Nonetheless, had we been right, we would have returned handsomely for you. Why does that matter? Because it reinforces what I have been writing about above – risk/reward. Throughout the whole year we were positioned aggressively for higher rates in the US. Despite rates falling, our performance for the year was about flat (before fees and execution costs). Over 2018, we constructed 178 exposures.⁴ And our correlation to the equity market was zero.

So whilst I am not happy with 2018, I am not discouraged. We missed some opportunities, but our defence was very good. If it were AFL, we have just finished the first quarter a little behind. And in the break I would be saying to my team, "Great defence, we failed to capitalise on a couple of opportunities, but keep doing what we are doing and the goals will come." And I believe that very strongly as we look into 2019...

Happy New Year!

Brett Gillespie



⁴ I say an exposure rather than a position, because an exposure could include one or a number of positions in the one instrument, for example USDCNH. (Chinese currency)

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