

Ellerston Global Macro Fund

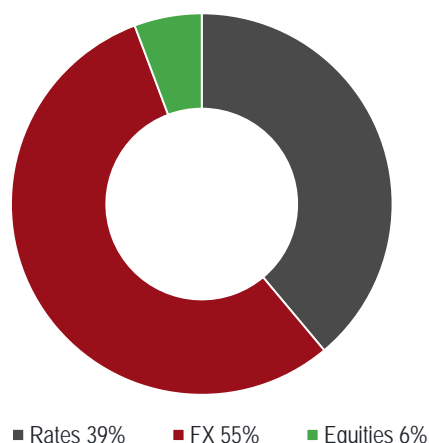
Performance Report | August 18

FUND PERFORMANCE

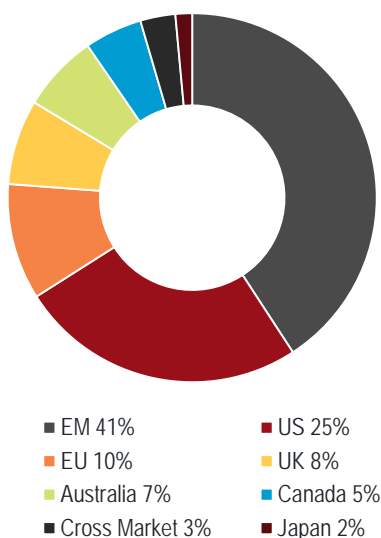
	1 Month	3 Months	6 Months	1 Year	Since Inception p.a.
Fund Net (%)	-0.51	-0.85	-3.55	0.41	-0.93
RBA Cash Rate (%)	0.13	0.38	0.75	1.50	1.50

%	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	-0.51					-1.24
2017							-0.59	-0.90	0.81	-0.45	0.64	0.66	0.16

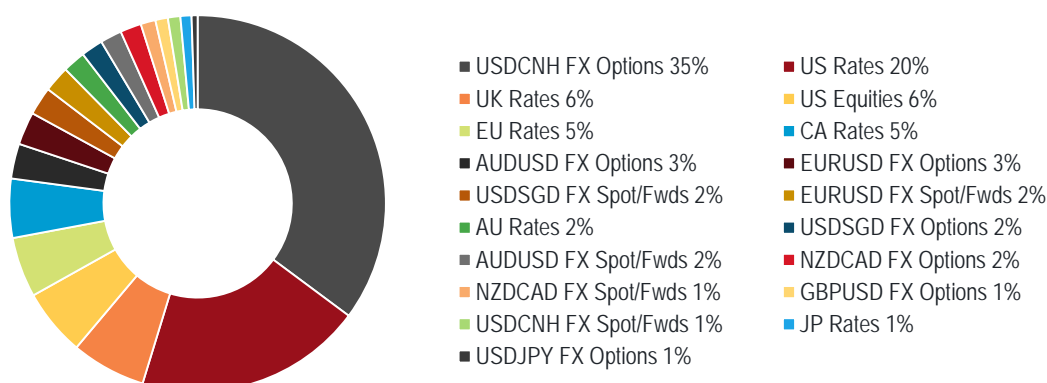
Asset Class Exposure



Geographic Exposure



Portfolio Exposure



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 146.9M

Firm AUM Over \$5 billion

PORTFOLIO COMMENTARY

Performance for August was -0.51%. The month was characterised by modest USD strength and a grinding rally in interest rates globally. US 10-year Treasuries ended the month 10bp lower in yield at 2.86% and German 10-year bunds 12bp lower in yield at 0.33%. Interest rate yield curves also flattened over the course of the month, with the US 10-year bond outperforming the rally in the 2-year bond by 5.5bp. Broadly speaking, by asset class, the portfolio lost 1.0% positioned for higher rates, made 0.7% on currency positions looking for a stronger USD, and lost 0.1% on portfolio hedges in equities and credit.

As mentioned in last month's review, we tried to position the portfolio tactically to profit from a fairly bi-modal outcome around the current biggest risk driver in markets – Trump and trade tariffs:

1. Long USD vs a basket of currencies vulnerable to sustained or heightened escalation of trade tensions. This included being short currencies like CNH and AUD. We were also able to target currencies with an idiosyncratic weaker domestic outlook such as GBP, NZD, and IDR, whose currency depreciation was given a further tailwind from the rising tide of broader USD strength. USD FX has also been the better asset class to play for improving US data, as bonds have remained sensitive to any risk-off sentiment in the current market environment.
2. Begin to accumulate medium term shorts in global bond markets to position for higher yields on a medium term horizon. These exposures mainly targeted November and December expiries, post US mid-term elections and around the time of the last US Fed meeting of the year.

The most profitable trade for the portfolio this month was being long USD vs short CNH, which depreciated 0.60% and added to 0.29% of performance. We held this exposure via a mix of vanilla and exotic FX option structures, as well as in spot/forwards, to optimise for a profile that delivered leveraged returns on any outsized move in the currency, but did not cost the portfolio too much in negative time decay if there wasn't one.

A related trade was our long USD vs short AUD position, which delivered 0.14% of performance and was our third most profitable exposure. The domestic story in Australia remains relatively robust in our view, with strong retail sales, business conditions towards cycle highs, unemployment rate continuing to trend lower, and auction clearance rates holding at reasonable levels despite an increase in most variable mortgage rates. Despite that, the currency depreciated in sympathy with market sentiment as the most liquid developed market proxy in the region for trade tariffs and a China slowdown.

Over the course of the month we were also long USD vs short NZD, which contributed 0.11% of performance. We established this position for the same reasons as above in the AUD, with the addition that RBNZ is the only central bank in G10 who is making it clear to the market that next central bank move could be either up or down (business sentiment has slumped to lows last seen in the height of GFC; business investment spending is projected to remain soft; lack of house price inflation is expected to persist, which should weigh on consumption growth; RBNZ continues to revise GDP forecasts lower accordingly).

On the other side of the ledger, whilst all the gains in the portfolio came from our FX positions, the losses we experienced all came from our interest rate exposures. Over the month our 10-year Treasury option positions lost 0.33%, and our front-end options (targeting more hikes being priced in to the US rate hike cycle across 2019) lost 0.25%. The silver lining is that the majority of the losses came from establishing medium-term positions via options expiring towards the end of the year, so that if the market retraces recent moves then the losses will reverse as we have maintained exposure to yields rising over the medium term.

The last major exposure we had in the book was focussed around the UK. We were positioned short GBP currency vs USD via exotic FX option structures which delivered 0.24% of performance, as the currency weakened 1.2% from increasing risk of protracted Brexit negotiations. It was our second best performer for the month. This theme was much harder to capture in the rates space, where we tried to play for diverging central bank rate path expectations over the course of 2019. This trade lost 0.20% of performance and has been unwound after hitting our pre-defined stop loss levels.

We expect a resolution around the next stage of Trump's tariff negotiations in September, one way or another, and continue to be positioned to respond in a tactical fashion accordingly, whilst keeping an eye out for good opportunities on a more medium term horizon.

OUTLOOK

It's getting hot in here

"A little knowledge is a dangerous thing" Alexander Pope 1706



Tariff wars, emerging markets in crisis, and the US economy overheating...where does one start when trying to work out what it all means?

Well, as always I like to start with history. Have we seen this before? Pretty much. We have many historical analogues to ponder, and so many possibilities. But for me the 60's and the 90's come to mind.

Let's start with tariffs. Is it simply brinkmanship, where Trump's true desire at the end of the day is to force the Chinese to lower tariffs? Or is it something more pernicious, perhaps a multi-decade turning point in globalisation?

If brinkmanship, how will it end? The market assumes rather gently, with the US stock market generally happy to look through the shenanigans and assume a positive end result. Perhaps that will be the case, but key to securing large concessions through brinkmanship is not only threatening large repercussions, as Trump is currently doing. But convincing your combatant that you are deadly serious about following through. More often than not deadly serious means actually following through.

Kennedy knew this. For a perspective on successful brinkmanship, one can't go past 13 days in October, 1962 – the Cuban missile crisis. In August 1962, the Soviet Union snuck nuclear missiles into Cuba¹ and assembled launch pads before the US noticed. Despite some suspicions, the US did not realise a nuclear arsenal had been deployed until October 14th when aerial reconnaissance confirmed launch pads and missiles ready to go in Cuba.

¹ In response to the US placing nuclear missiles in Turkey three months earlier



Kennedy threatened to invade if they were not removed. The Soviet Union protested. The missiles in Cuba were purely for Cuba's defence, and any invasion by the US of Cuba would trigger a war with the Soviet Union. Kennedy publically moved to DEFCON 2, said that the United States will "regard any nuclear missile launched from Cuba against any nation in the Western Hemisphere as an attack by the Soviet Union on the United States, requiring a full retaliatory response against the Soviet Union." After some rather tense exchanges, they took his threat seriously, and agreed to remove the missiles. Pretty heavy brinkmanship when the consequences of escalation were so high for both parties.²

Of course we are not talking about the same consequences here. But we are talking about the same game, namely the game of brinkmanship. To get big concessions, big threats need to be made convincingly. Which as we are seeing, needs some follow through. Sometimes the outcomes aren't as intended...

Beyond brinkmanship, there are a few other analogues that come to mind. Perhaps inflation breaking out, like in the late 60's when the Fed allowed unemployment to breach new lows? Or can the US economy handle stronger growth, like the productivity surge Greenspan embraced in 1996/97 to forestall rate hikes? Or does none of this matter, because we are about to repeat an EM crisis like 1997/98?

Perhaps there is no historical analogue? After all, we don't have a historical analogue of 10 years of zero to negative interest rates in the major economies of the world; combined with 18 trillion dollars of bond purchases by their central banks! (But we do have analogues of low interest rates generating financial bubbles)

Do you have a conviction? If you are highly convicted, perhaps you should heed Alexander Pope's famous phrase, "A little knowledge is a dangerous thing!"

Nonetheless, I think one can have conviction in how scenarios might play out. So let's start with the scenarios.

The scenarios;

1. **Tariff escalation.** If Trump imposes a tariff of 25% on 200b of US imports from China, and particularly if he follows it up with another 267b of tariffs, that is all that will matter for markets in the next 6 months. With the latter, one can't escape both a significant growth and inflation impact in coming months. EM equities will fall a further 10-15%, and US equities likely fall 5-10%. The USD would soar 5-10%, at which point the Fed stops hiking.
2. **Tariff de-escalation.** If the US agrees a resolution with China, the focus turns back to the current status of the US economy. It is too strong. Initially equities rally, the USD likely falls as emerging market equities outperform, and bond yields rise markedly. At some point in the next 6-12 months the market realises the Fed needs to take policy restrictive to slow the economy and quell inflation, and a recession gets priced.
3. **A bubble bursts.** What bubble? As I wrote in [June](#), after 10 years of zero interest rates and low bond yields, money has poured into any bonds that gives a little extra yield. We have seen the wobbles already...

² <http://www.nuclearfiles.org/menu/key-issues/nuclear-weapons/history/cold-war/cuban-missile-crisis/timeline.htm>

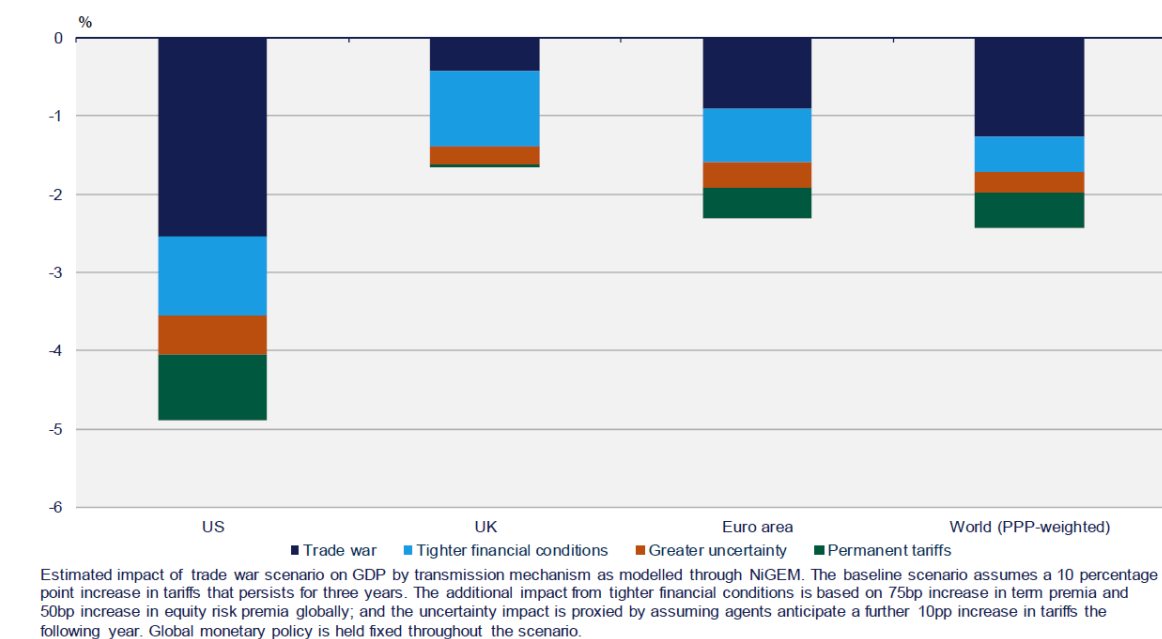
At the moment, with the unresolved tariff war, it is impossible to be emphatic. But the time is nigh when it will pay to be very decisive indeed. And conversely, a disaster, potentially, if you are not.

Am I being too alarmist? Or even too simple? Let me give you some facts, after which you can decide.

How bad can a tariff war be?

Well I could start with the Bank of England's prognosis;

A trade war would deliver a meaningful blow to the global economy



Wow, 5% off US growth...

However, note there are some pretty dire assumptions in there. Firstly, they assume every country imposes a 10% tariff. The impact of that is shown in the dark blue (about half the overall impact). The rest of the impact comes predominantly from higher bond yields, lower equity markets, and greater uncertainty. There is no assumption of stimulus, either from rate cuts or fiscal policy (which has just had a windfall from the tariff "tax").

So it is fair to say that the impact would be much less than this. But how much? Well the first point is we don't know what the final tariffs are yet. But if Trump proceeds with tariffs on all Chinese imports (about \$500 billion), as he is threatening, reasonable estimates would see a growth impact of 1 to 2% for each economy. And that will hurt.

Of course, many assume this is nothing more than brinkmanship. A game of chicken. As John Cirace argues, to win the game of chicken, the individual must "create the impression that nobody is crazier or badder than me".³ Ipso facto, Trump will win!

Or crash...I'm not sure he realises crashing is a possibility. So he just might not see it coming.

What does a crash look like? US stocks down 10%. That would get his attention, though not necessarily a reaction.

Will it happen? Well, by the time you are reading this, the answer might be clear. But I strongly believe as I write, one cannot hold a view on the evolution of the confrontation with conviction. We pay many consultants who are experts on Chinese and US politics. The more you know, you realise the less you can be sure.

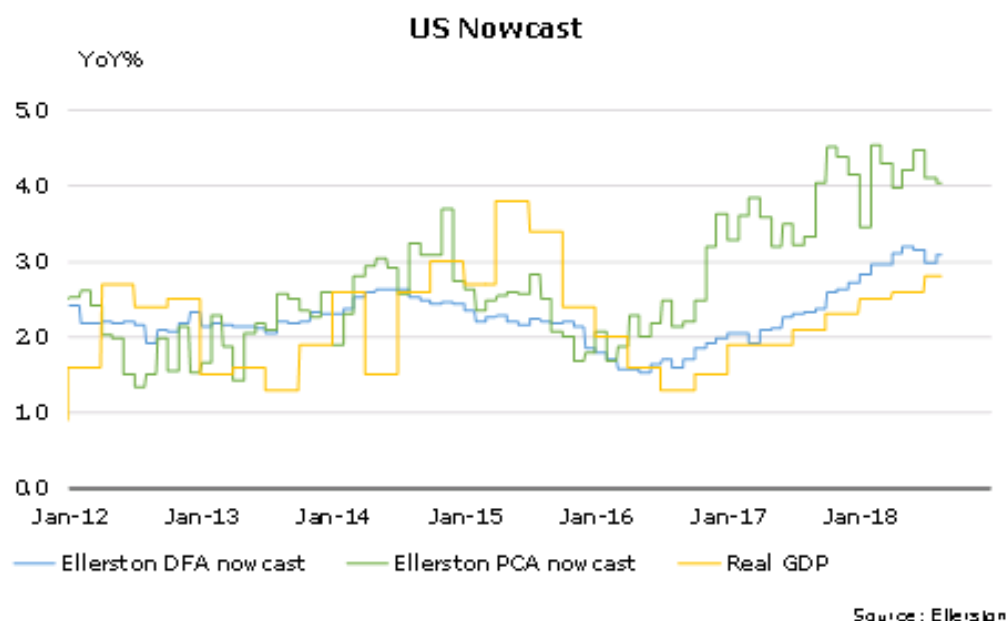
The US economy is too hot

What we can be sure of right now is the current momentum in the US economy and the building wage and inflation pressures. Yawn you say? Forecasters have been saying that for over a year. Boring!

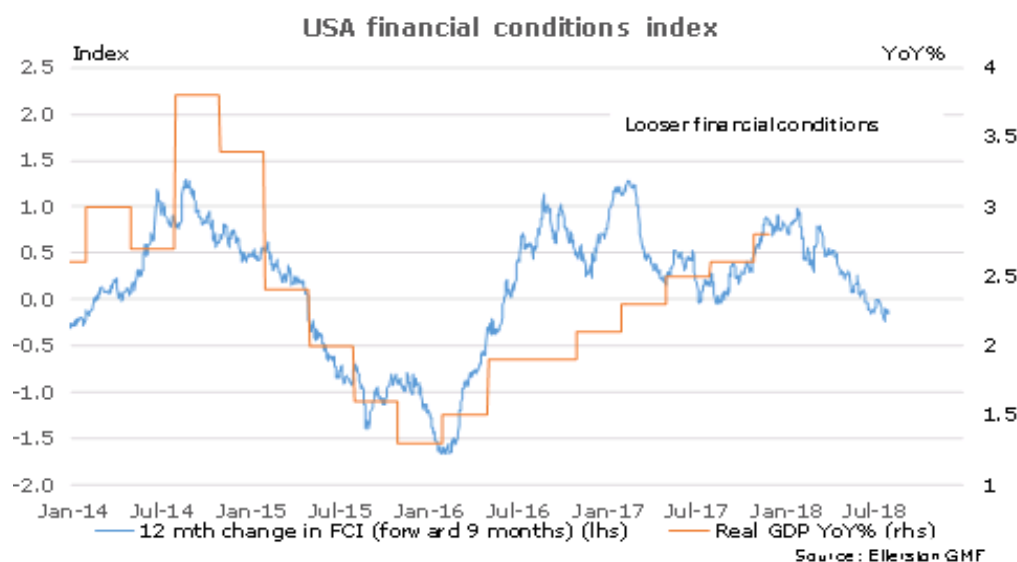
Well just because the bond market isn't pricing it, doesn't mean it isn't happening. Like the Russians stealthily shipping their missiles into Cuba and assembling them without the US noticing, the US economy is slowly but surely overheating whilst the Fed embraces patience.

Indeed, it is the storm clouds of tariffs and emerging market stress that has both the Fed and the market ignoring domestic strength. To be fair, that is fair. Both have to price a weighted possibility of the possible outcomes. But don't mistake market stability for market calm. There are two powerful forces at play for bonds, both getting stronger. One is going to give.

Why do I say getting stronger? First, let's take a look at US growth. Our nowcasting (which converts the pulse of US data into GDP) shows an accelerating US economy.



Our Financial Conditions Index suggests US growth will slow...



But when we incorporate the US fiscal stimulus largely still to come (worth about 0.7%), we forecast US growth of 3% in 2018, and a US unemployment rate below 3.5% by the middle of next year.

Isn't that great? Well no, as usual, it depends. It depends on two factors.

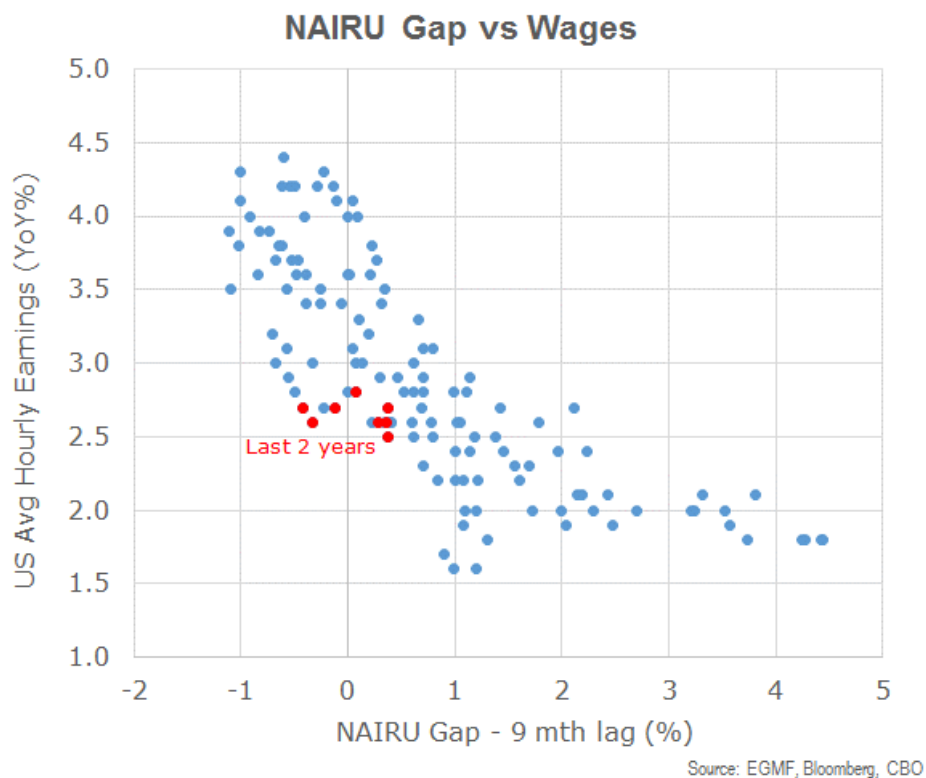
- Are inflationary pressures building
- If so, will those pressures fade, or intensify?

³ Law, Economics and Game Theory. John Cirace p120

I have waxed on ad nauseam in past monthlies about NAIRU (the non-accelerating inflation rate of unemployment), that we are through it, and that wages will rise followed by inflation. Some posit we are not through it, or at least not much through. Some go even further, suggesting in effect that NAIRU does not exist, and that wages will never rise. Let's quickly dismiss the later (can you really imagine a world with zero unemployment and employers aren't willing to pay higher wages? Even wages are rising in Japan now at 2.5% unemployment). So assume NAIRU does exist. So what is the evidence telling us about where it is?

Well, the evidence is telling us that the Fed's estimate of 4.5% looks about right. How can I say that, when so many smart people are suggesting that low wages today indicate NAIRU must be lower (and the Phillips curve flat)? I guess I don't think they are that smart.

Let's start with the Phillips curve (for wages). First point; it is not a curve. It is a hockey stick. Yes it is a little curvy when one considers an unemployment rate that is between 1% below NAIRU and 2% above. But when unemployment goes well above NAIRU, by say 5%, the curve is flat. It doesn't matter if unemployment is 1% higher than NAIRU, or 5%, it exerts no impact on wages. As long as there is excess workers available, employers don't need to pay up. Too many commentators have observed that no increase in wages, as unemployment has fallen, suggests the relationship is broken. Wrong, the relationship is perfectly consistent with the last 30 years of data.



And the latest employment number, dare I say, is emphatically conforming to past relationships.

Can we be confident it will continue? After all, the past relationship sample is small. Only 3 times in the last 35 years has the unemployment rate been this far below NAIRU.



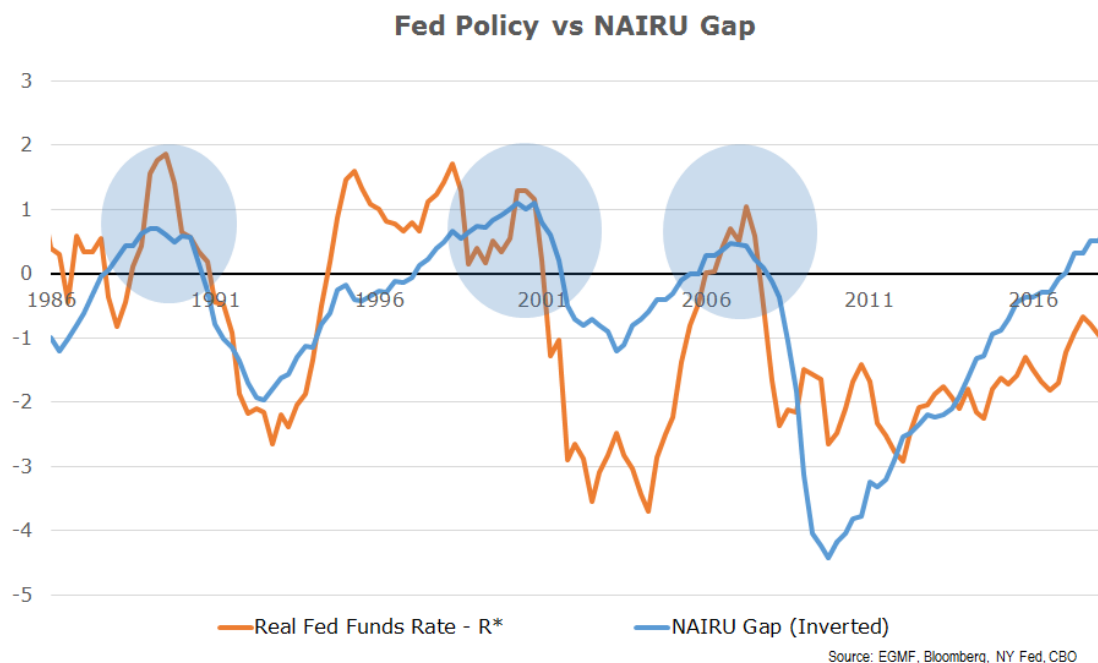
Perhaps we can look elsewhere for corroboration? What are businesses saying? Well businesses are saying they expect to put wages up the most in 35 years!



Ok, hopefully you accept that the pressures are building. Where to from here?

Well, what would normally be happening at this stage of the business cycle? With unemployment almost 1% lower than NAIURU, the Fed would be applying the brakes. The economy needs to slow down. If they are correct about NAIURU, it needs to slow enough to bring unemployment back to 4.5%. How would they do that? They would work out what is a "neutral" cash rate, a rate where they would expect rates to neither stimulate growth nor slow growth, and they would then set the cash rate a little higher so it slows growth. "Restrictive" monetary policy, rather than "accommodative" in central bank parlance. Are they doing that?

Not by a long shot. The chart below shows where the cash rate is in the US relative to the current best calculation of neutral⁴. Policy today is 1% accommodative (orange line).



The blue line shows the gap between NAIURU and the current unemployment rate. Today the unemployment is 3.8%, some 0.7% below NAIURU (chart shows NAIURU-unemployment).

Now here is what I want you to really take away from this chart.

In the last 35 years, when unemployment was this far below NAIURU (shaded circles) the Fed had policy 1% restrictive. They were "leaning against" growth. Today they have policy 1% accommodative. They are still a "tailwind" to growth. What's more? They expect to be a tailwind for another year. And they don't expect to lean against growth for another year after that. Might one say they are two years behind where they would normally be at this stage of the cycle?

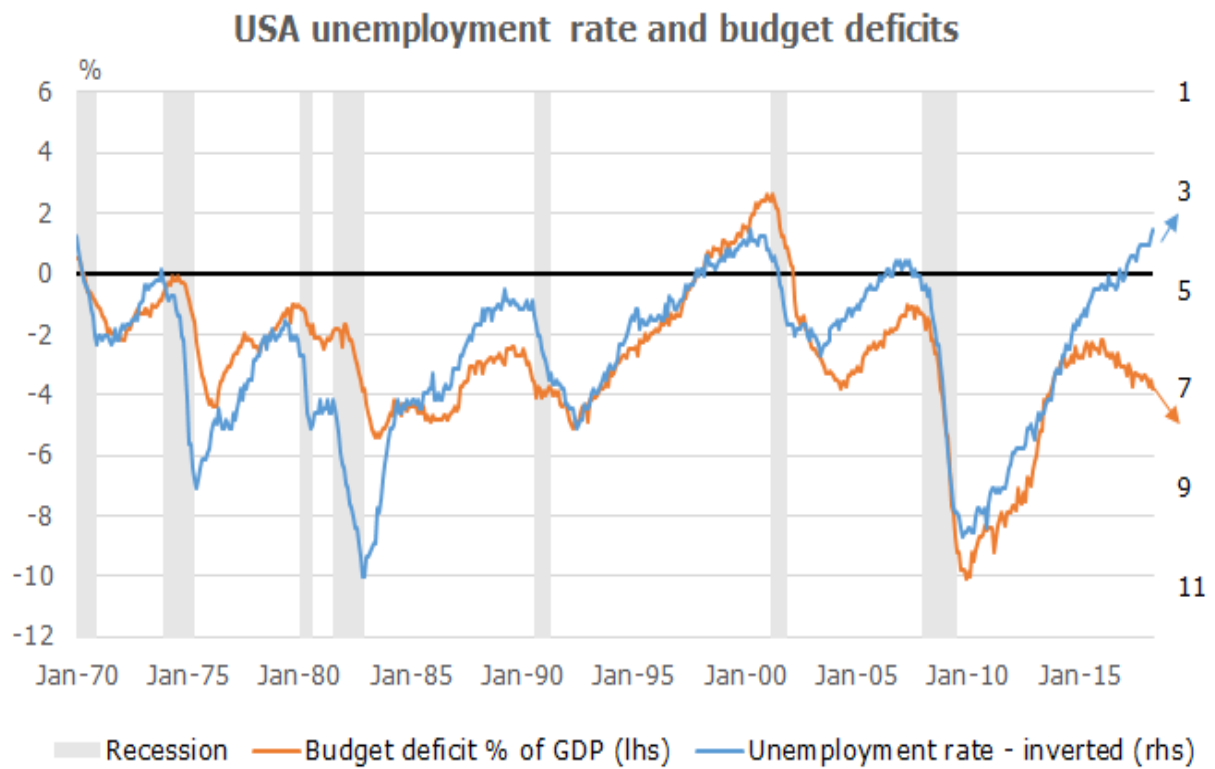
A few other observations: look at 1994. Look how quickly Greenspan took policy restrictive as the unemployment rate approached NAIURU. He hikes 300 basis points in 12 months. And no recession. In fact the only mid-cycle slowdown the Fed has ever engineered. Why? Because he stabilised the NAIURU gap near zero.

And when we consider the easing Greenspan did in 1998 to protect against the Asian crisis, note where he was coming from. Policy was already restrictive. Much harder to justify easing this time with policy this accommodative.

And finally, note the 2004-6 hiking cycle. The move too restrictive looks sharp by today's standards. Yet it was widely criticised in hindsight as being too slow and a key contributor to the housing bubble in the US and...well... Credit bond bubble anyone?

But wait. Don't forget the steak knives. Trump's tax cuts are boosting growth at exactly the same time fiscal policy would normally be leaning against growth. It's not an understatement to say this is unprecedented in post WW2 history.

⁴ <https://www.newyorkfed.org/research/policy/rstar/overview>

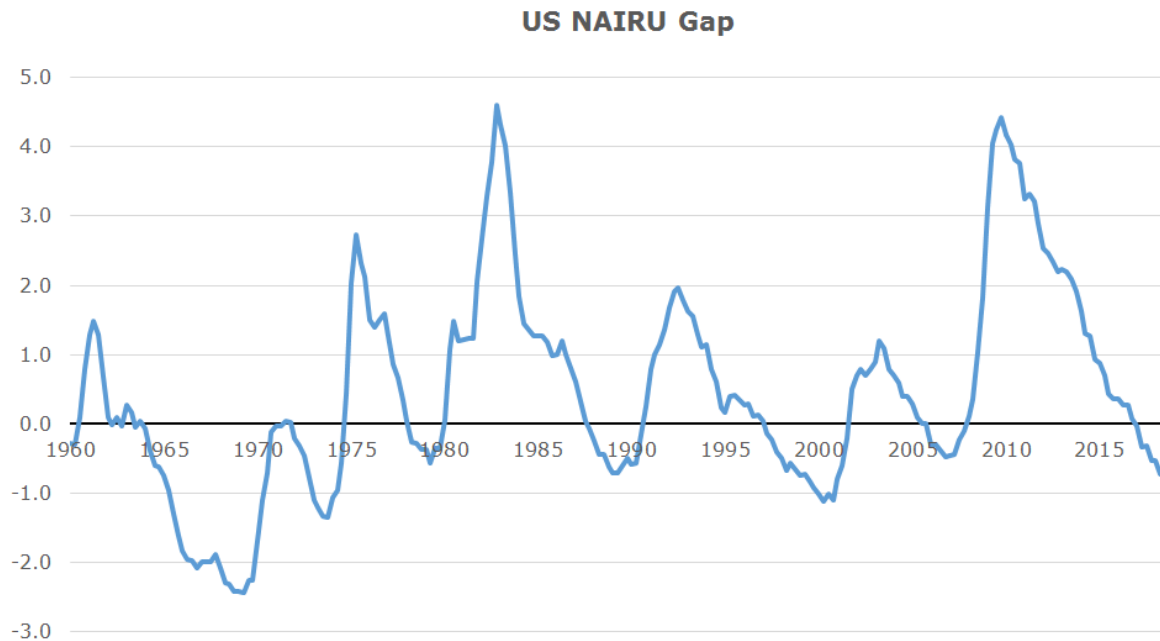


Source: Ellerston GMF

It really is like watching a slow motion train crash!



Incidentally, the last time the Fed was this far behind being restrictive was the late 1960's. That's the last time the Fed lost control of inflation. For two decades...



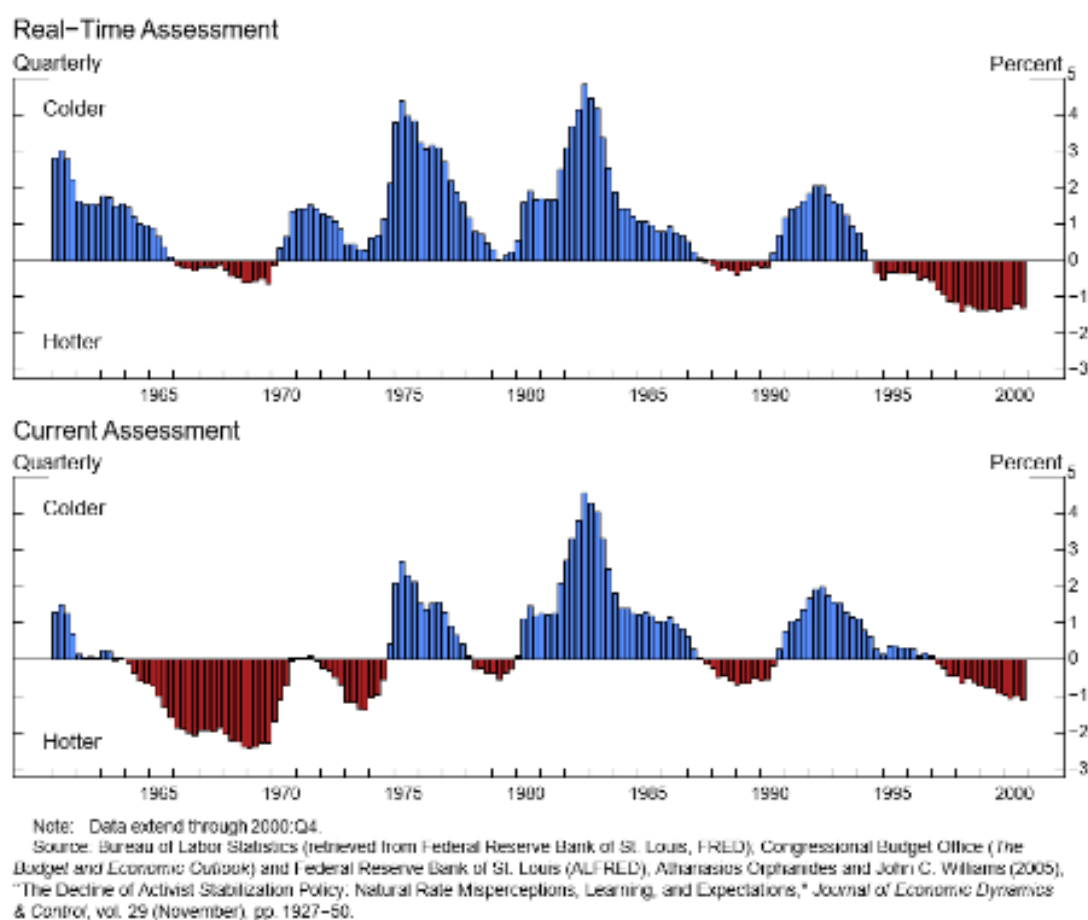
Source: EGMF, Bloomberg, CBO

Powell was at pains to dismiss this analogue in his July speech as I noted last month.⁵ But to me it was very unconvincing, for the simple reason they also thought inflation expectations were well anchored in the 60's.

The other point Powell made was it is very difficult to estimate NAIRU in real time. With the benefit of hindsight, they underestimated the negative NAIRU gap in the 60's, and overestimated it in the 90's.

⁵ <https://www.federalreserve.gov/newsevents/speech/powell20180620a.htm>

Figure 4. Unemployment Rate Relative to Assessments of the Natural Rate



Thus he argues if one can't be sure of the estimate of NAIRU, one must move cautiously, as Greenspan did in 96/97. Perhaps though, it also depends on whether wrong is too high or too low. In the 90's, Greenspan made the right call. In the 60's, Martin didn't. Recent Fed work⁶ suggests if you can't be sure, pay attention to the rate of change of unemployment. That would strongly suggest they should push on with rate hikes.

We are very convinced that if the tariff war de-escalates, the Fed will have to deal with an over-heating economy.

So how do we play it? We play the odds. We look for good risk/rewards for escalation, and good risk/rewards for de-escalation.

a) For de-escalation. We are;

- Positioned in options for 4 to 5 Fed hikes to be priced through the end of 2019. Risk reward 4:1
- Positioned in options for 10 year yields to move to 3.25-3.5 by year end. Risk reward 8:1 (chart below)

⁶ <https://www.federalreserve.gov/econres/feds/files/2018059pap.pdf>

Tariff de-escalation

Short US treasuries: Anywhere from 7:1 to 12:1 pay-out

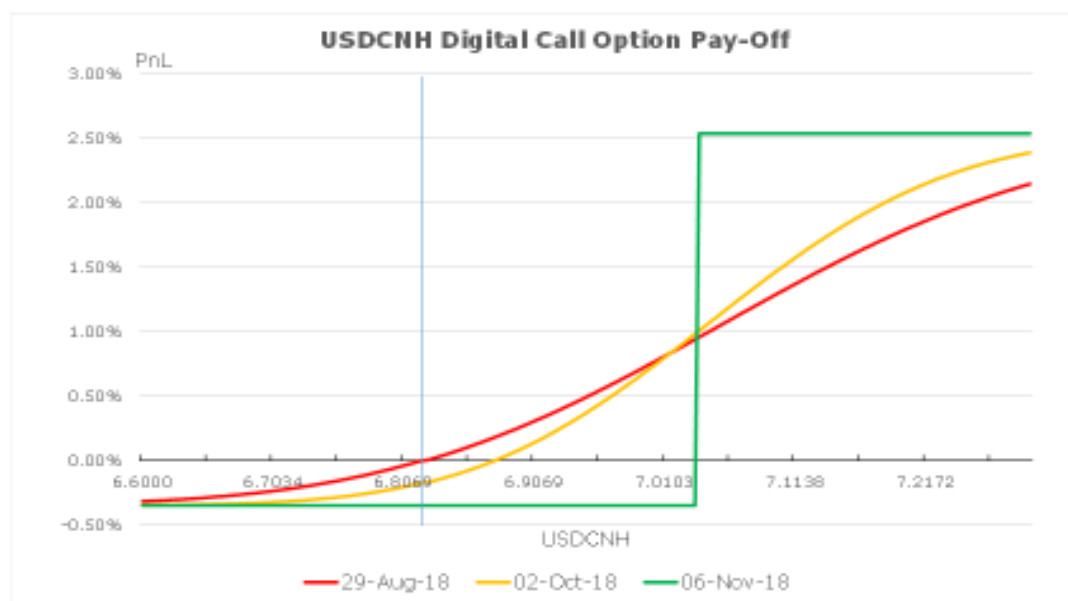


b) For escalation, we are;

- Short Chinese Yuan in options. Risk reward 7:1 (chart below)
- Long USD basket of currencies in options⁷

Tariff escalation

Short Chinese Yuan. 7:1 pay-out



⁷ USD v Singapore dollar, Australian dollar and Indonesian Rupiah

Note we hold option positions for both scenarios. Our risk is neither happens, and we lose the option premium. Our best scenario is a sustained (2 months) escalation in tariffs, or a sustained de-escalation. Then the options we have will do their best work.

We also are playing relative growth. We expect the Australian and Canadian economies to out-perform the New Zealand economy, and we have positioned in the rate and currency markets to reflect that view. Perhaps more on that next month. It is going to be a very interesting end to the year in financial markets...

Brett Gillespie



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