Ellerston Capital

Ellerston Global Macro Fund

Performance Report | April 19

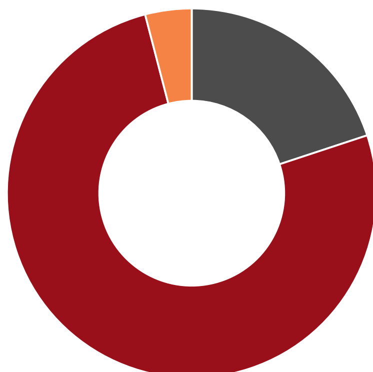
FUND PERFORMANCE (%)

	1 Month	3 Months	6 Months	1 Year	Since Inception p.a.
Fund Net	-0.64	-0.88	-2.81	-4.01	-1.75
RBA Cash Rate	0.12	0.36	0.74	1.50	1.50

	Jan	Feb	Mar	April	May	June	July	Aug	Sep	Oct	Nov	Dec	YTD
2019	-0.47	1.00	-1.24	-0.64									-1.35
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

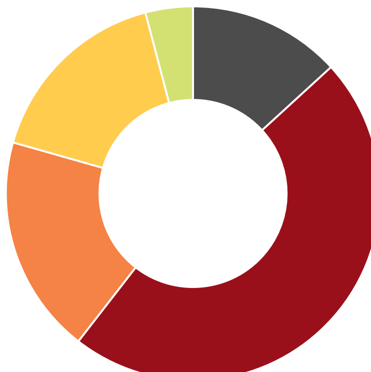
Source: Ellerston Capital Limited

Asset Class Exposure



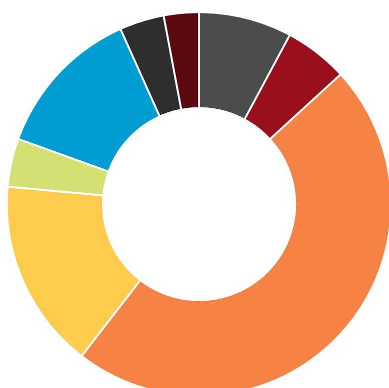
■ FX 20% ■ Rates 76% ■ Commodities 4%

Geographic Exposure



■ Cross Market 13% ■ US 47%
■ Australia 19% ■ EU 17%
■ Global 4%

Portfolio Exposure



■ EURGBP FX Options 8% ■ EURGBP FX Spot/Fwds 5%
■ US Rates 47% ■ AU Rates 16%
■ Commodities 4% ■ EU Rates 13%
■ EURUSD FX Options 4% ■ AUSUSD FX Spot/Fwds 3%

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 Date	July 2017
Liquidity	Daily
Management Fee	1.00%
Performance Fee	15% of outperformance
Buy/Sell Spread	0.25%
Distribution Frequency	Semi-annually
Strategy AUM	190.7M
Firm AUM	Over $5 billion

PORTFOLIO COMMENTARY

The fund returned -0.64% net of fees in April.

It was a modest "risk-on" month, with US stocks rallying 3.9%. US 10 year yields rose 9 basis points, from 2.41% to 2.50%. And US market pricing expects one rate cut this year, unchanged from March 31st.

In Australia, 10 year bonds were little changed in the month (up 1 basis point). The market is pricing 51 points of rate cuts this year, up from 42.5 in March.

The USD index was flat over the month. The Australian dollar weakened 0.7%, to 0.7050 v the USD.

We entered the month with 3 high convictions;

1. The RBA will cut interest rates in Australia this year (two 25 point cuts)
2. US growth will surprise higher, and so US yields will move higher
3. And positioned for Brexit to be resolved by mid-April.

The big impact on performance was 3, where we expected Brexit to be resolved by mid-April. As many would know, it wasn't. We believed the costs of failure were too high, and so had positioned strongly for a resolution, any resolution, during April. This cost the portfolio 1.14% in performance. We have now closed 80% of this exposure. We had run this position since December. At end March, the performance impact since December had been a small positive, meaning the total cost to performance of the Brexit strategy upon closing was about 1%. Had it been resolved, we expected to make 5%, possible as much as 8%. I mention this because the nature of the fund is to target good risk/reward opportunities, relative to the uncertainty. In time these probabilities pay off. However not this time. But I want to re-assure investors that their capital has not been frivolously risked, despite the highly uncertain event. It was about risk/reward, not certainty.

Australian rate positions contributed 0.74% to performance, due to the extra 9 points of rate cuts being priced, in line with our view (1 above).

US rates contributed 10 basis points to performance. Despite the modestly higher 10 year yields, the pricing of rate cuts was little changed.

We have been long copper (via options) to capture a stronger global growth theme. This cost 0.14%.

At month end we maintain exposure to the first two key themes. As explained over the page, we expect the RBA to cut rates in June or July. And we expect stronger US growth to erode the pricing of rate cuts in the US, and grind US 10 year yields higher. However, this latter view is contingent on a tariff resolution between China and the US. As we write, the May 10th tariff deadline looms, and the outcome is highly uncertain. So we have reduced our US exposure over this event, and will re-engage on a conciliatory outcome.

OUTLOOK

Once bitten, twice shy

For my regular readers, this month's note is a little different. Briefer with one myopic focus.

This month I am going to focus on Australia, and specifically the Reserve Bank of Australia (RBA).

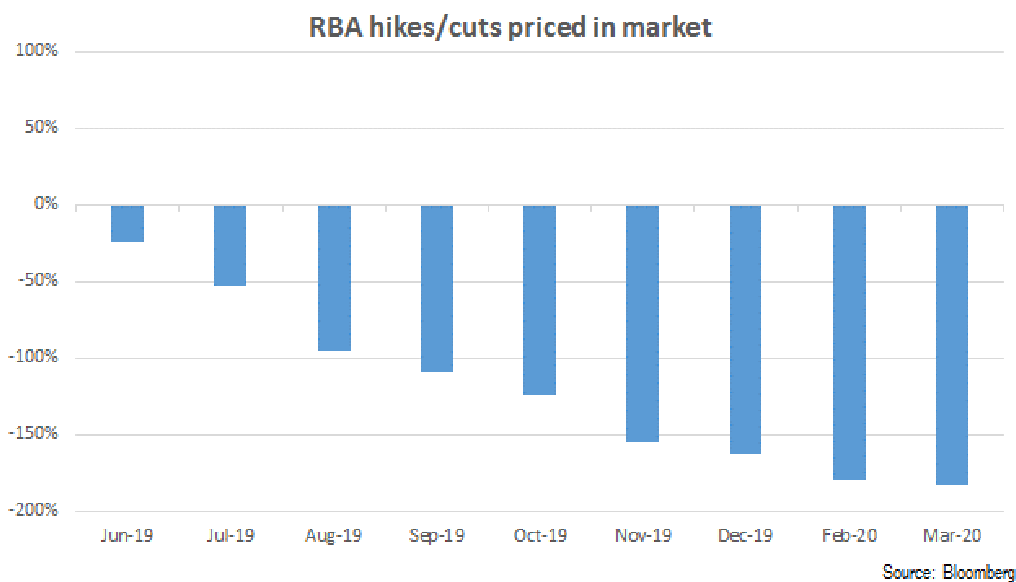
For the first time in over 2 years, we had a very "live" RBA meeting on May 7th. Market pricing for a rate cut was about 50/50, and indeed slightly more economists were backing one (13 out of 24 market economists expected a cut).

We did not expect a rate cut, though admittedly our confidence was not high. As you might recall, we have been focussed on a rate cut being delivered soon after the election. Even after the very low inflation print last month.

Following the decision not to move on May 7th, the market consensus has now flipped. The strong expectation now, some 75% of those we follow, is a move won't occur until August.

Is this minutia important? Does it matter if the RBA cuts interest rates in June or August? Ordinarily not really. Though perhaps at the moment, with housing markets still in decline and election and policy uncertainty, an earlier move reduces the chance of a negative sentiment cycle taking hold of the housing market.

However, the minutia is very important for us. The difference between a June move and an August move is the difference between a 4:1 risk reward for the portfolio, or no opportunity (in Australia rates). Why? Because current pricing in the futures market assigns a 20% chance to a move in June, and a 90% chance by August (and 50% by July).



So when will the RBA cut rates?

Quite likely June.

No later than July.

We think the market consensus has totally misinterpreted the RBA's decision on May 7th.

Why?

Once bitten, twice shy. We have seen this before with markets being disappointed by the timing of central bank moves. In the RBA's case, the pass in September 2012 and cut October 2012 comes to mind. Like then, the mistake the consensus is now making is to assume they misunderstood the RBA. Assume the RBA is much more reluctant to cut than they thought. And hence recalibrate the hurdle based on the May decision. Hence they have pushed the expected cut back several months, not one. But the market appears to be tone deaf to the tactics around this meeting.

So why do we think the cut is coming much sooner? To answer that, I first need to go back a couple of steps, and explain why we didn't think they would cut in May. Two reasons:

Philip Lowe has made a virtue of stability.

And the election.

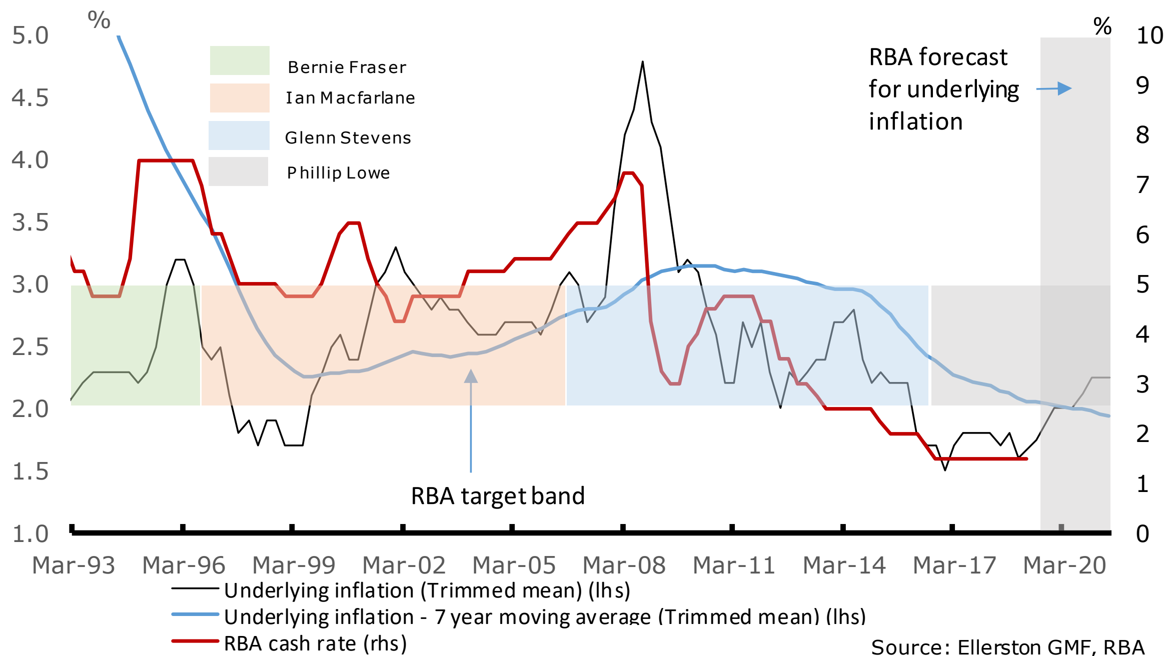
Many are convinced the election doesn't matter. They cite the easing in 2013 during the election campaign, or even the more important hike in 2007[1]. As well as the many protestations of the RBA over the years. But let's be clear.

The election does raise the hurdle for a rate move.

Why? Think about it. If you were the governor, and you have not moved the cash rate for almost 3 years, a move is going to create a lot of comment. It is not clear which party would spin it best, but it is certainly clear it would be front pages for the last week of the campaign and could be blamed for influencing the election result one way or the other. Waiting one month means nothing for the economy, but it significantly reduces the risk of the RBA creating enemies.

And then there is Lowes' "virtue of stability". For the last 18 months, Phil has talked about a stable cash rate creating stability for economic decisions in the real economy, and that is a good thing. Hence, when the time comes to make an adjustment, it stands to reason that the adjustment should be very well telegraphed, so as not to raise "stability" concerns.

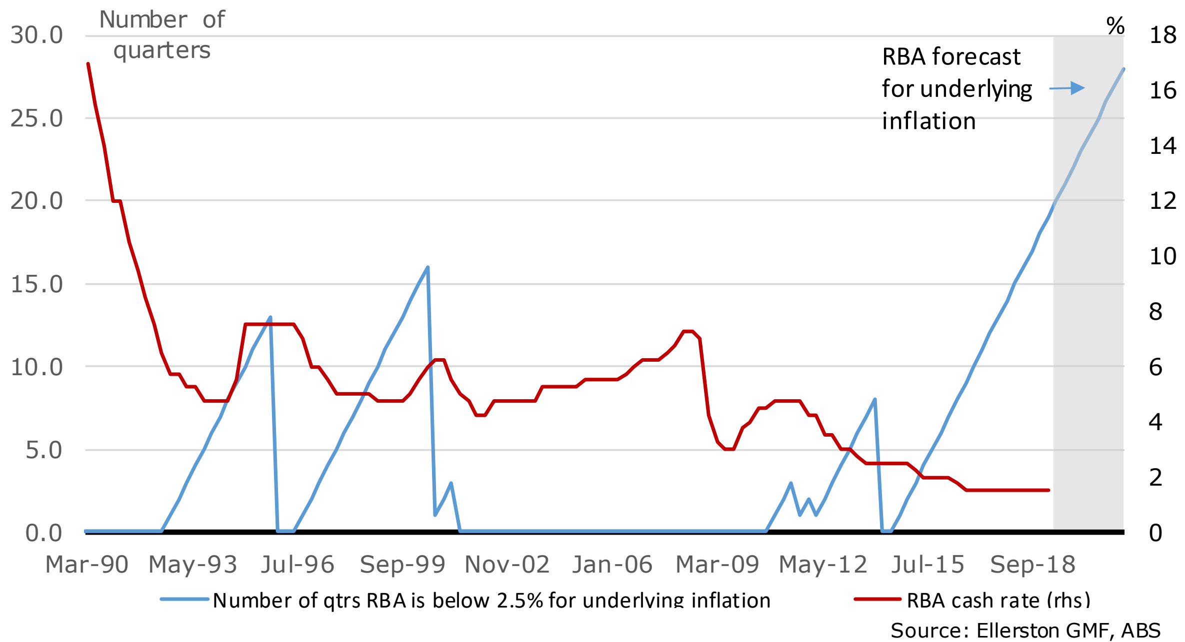
The market on balance expected the cut on May 7th. Why? Because the RBA is an inflation targeting central bank. And the inflation print on April 26th was very low. Governor Philip Lowe has a 7 year term. The chart below shows the 7 year moving average of underlying inflation. We have included the forecasts for inflation outlined in the RBA's meeting statement on the 7th May. Phil Lowe is forecasting that he will be the first Governor to miss the RBA's target band (on average over his term) since Bernie Fraser adopted inflation targeting in the early 90's.



What is even more startling, is he is forecasting that he is happy to be below target on inflation for an incredible 28 quarters in a row (or 7 years). Call it twice the level of "patience" as prior governors.[2]

[1] Note the RBA did not make statements in 2007 if they did not change rates. This meant they did not have the option of not moving but signalling a strong bias, as they did this month.

[2] One can reasonably ask whether the mandate should be changed. I for one believe it should. But if you are not going to change it, well then you should at least look like you are trying to achieve it.



In addition, indications for growth are coming in very soft. So the market was expecting the RBA has to downgrade growth for this year by some 0.5–0.75%, and inflation by 0.25–0.5%.[3] The logic of their framework simply dictated they must cut.

We agree. Except we thought the election mattered. So the question we asked ourselves, is how do you delay a rate cut by a month or two, without acknowledging the reason is the election?

The answer? You lower the hurdle to a rate cut. And this they did ever so eloquently.

In their Statement on Monetary Policy (SOMP) on February 5th, they commented;

If there were then to be a sustained increase in unemployment and a lack of progress in returning inflation to target, it might instead be appropriate to lower the cash rate.

The commentators latched on to the rise in unemployment as a necessary condition for a rate cut. At market lunches in the following month, Luci Ellis[4] commented at least twice that a rise in the unemployment rate was a clear scenario where they would cut interest rates, but not the only scenario.

The low inflation print in April provided the other scenario. Rather inconvenient given the election. We brainstormed how do you delay the rate cut a month without it being interpreted as political. Well, for one, you don't mention politics. And for two, you say you are waiting for more information. But what could you say you are waiting for if you don't want to mention politics? Well, you could say that given their new inflation forecast, they now would need to see the unemployment rate fall if they were to have any confidence in hitting their inflation mandate. Maybe something like this;

Further improvement in the labour market was likely to be needed for inflation to be consistent with the target.[5]

And so we cheered when we saw the statement from the RBA on May 7th. They have taken a very decisive step towards the rate cut, done it incrementally so as to be consistent with "the virtue of stability", and provided not so much a hurdle as a step to a rate cut. Unemployment will have to drop for the RBA not to cut in June, or at the latest July. [6]

Lowe has the opportunity to outline this step on the 21st of May, when he addresses the Economics Society. Quite likely sooner, with the SOMP release on May 10th.

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[3] In the May 7th statement, they revise down their growth forecast by 0.5%, and inflation by 0.25%. Some thought this was too little. But note the RBA uses market interest rates for their forecasts. That means, given the market was pricing 2 rate cuts in the next year, embedded in their forecast is the assumption of two rate cuts. So 2.75% growth and stable unemployment requires two rate cuts….Their last round of forecasts using market interest rates only had 15 basis points of cuts incorporated.

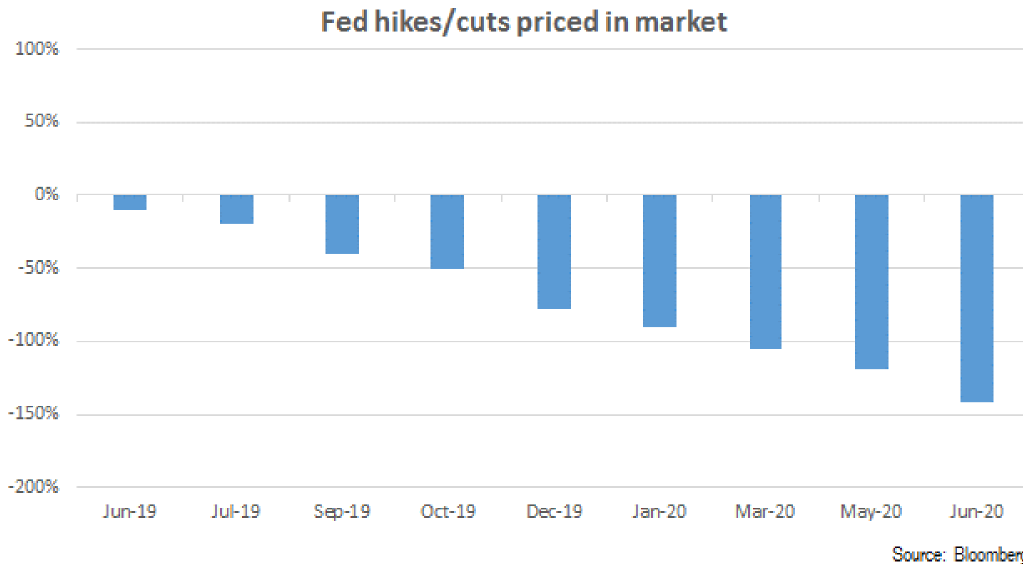
[4] Assistant Governor (Economic) at Reserve Bank of Australia – RBA's chief economist

[5] https://www.rba.gov.au/media-releases/2019/mr-19-11.html

[6] We are confident from our models that unemployment will drift higher in coming months. We expect 5.1% next week. But expressing high confidence in one print is a mug's game.

Why am I spending so much of my note on this? Well quite frankly, because we see the Australian rate pricing for the central bank as the most mispriced in the developed world. At least in the short term. As such, we have a large position in the fund looking for a rate cut in June, or the latest July. The RBA could not be clearer. Why does the market not see it? Once bitten, twice shy.

The other mispriced market? The US rate curve, which is still pricing rate cuts.



Again, we had the Governor, Jerome Powell, come out with a very emphatic statement at the last meeting;

… as we look at these readings in the first quarter for core [inflation], we do see good reasons to think that some or all of the unexpected decrease may wind up being transient. And I'd point to things like portfolio management, service prices, apparel prices, and other things. In addition, the trimmed mean measures of inflation did not go down as much, indeed Dallas trimmed mean is at 2 percent.[7]

At least not because of low inflation. And that is significant. There had been a lot of chatter, championed by Governor Evans (and behind the scenes by Governor Clarida), that the Fed should consider an insurance rate cut, or a recalibration like 1995, to ensure US economic growth continues amidst a modest US slowdown. Powell firmly closed that door. Maybe he is going to make "a virtue of stability". Indeed, when asked about prolonging the US expansion he commented;

There's always the example of Australia that everyone, I think, is aware of where I think they're in year 28 of their expansion. So things are possible.

It seems Phil (and his predecessors) have a fan.

For us, it re-enforced our belief that rate cuts will be removed from the US curve, and US 10 year treasuries will drift up to 2.8%. As I write, we have significantly reduced this exposure given the new tariff threats against China from Trump. It looks to us like they will escalate on the 10th May, but by the time you read this, you will know. If it doesn't, we will reposition for higher rates. We now expect 2.75% to 3% GDP growth in the US this year, absent tariff escalation.

And finally a footnote on Brexit. Crikey. We no longer have an opinion, nor a position of much consequence. They couldn't have made more of a meal of that if they tried…

Brett Gillespie

[7] https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190501.pdf

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