

# Ellerston Global Macro Fund

Thought piece by Brett Gillespie | April 19

## 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).

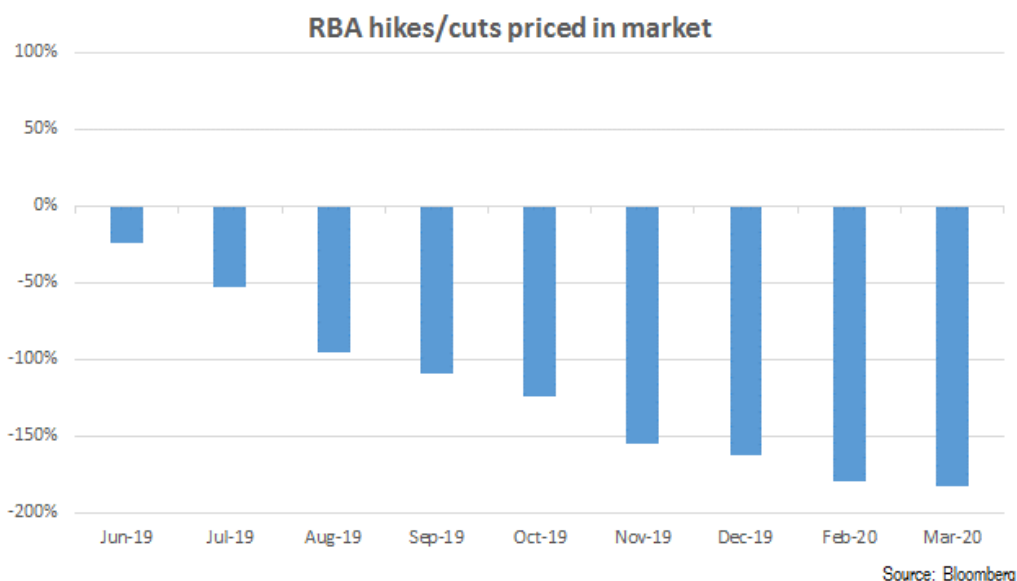
For the first time in over 2 years, we had a very "live" RBA meeting on May 7<sup>th</sup>. Market pricing for a rate cut was about 50/50, and indeed slightly more economists were backing one (13 out of 24 market economists expected a cut).

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 7<sup>th</sup>, 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 7<sup>th</sup>.

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:

1. Philip Lowe has made a virtue of stability.
2. 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<sup>1</sup>. As well as the many protestations of the RBA over the years. But let's be clear.

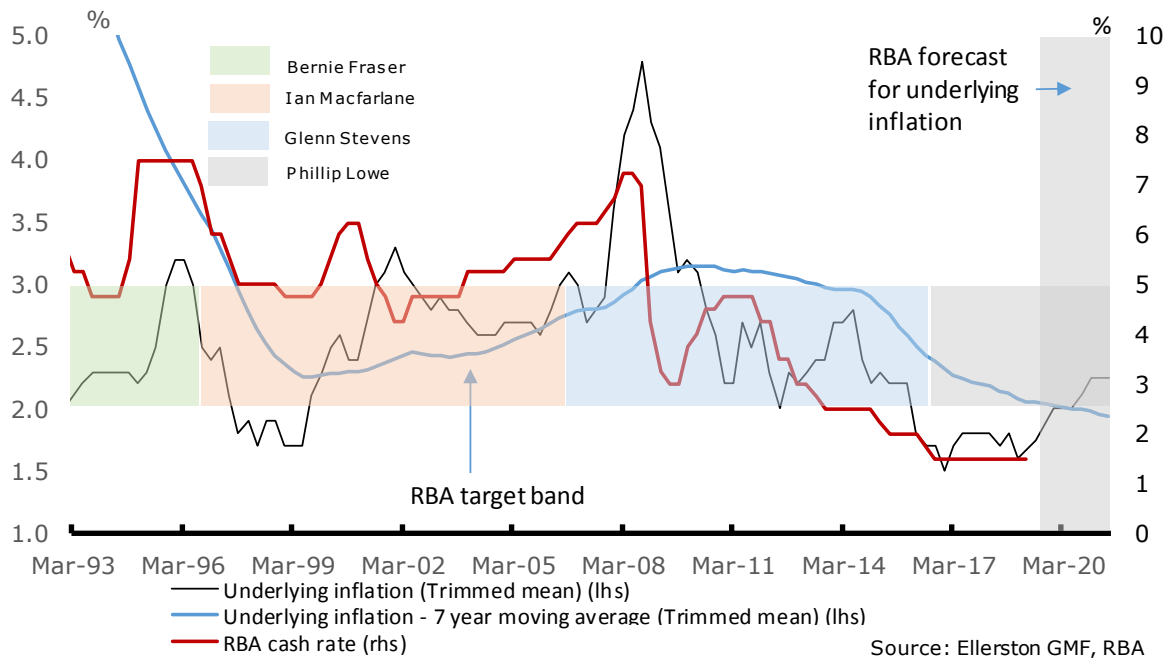
The election does raise the hurdle for a rate move.

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 Lowe's "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 7<sup>th</sup>. Why? Because the RBA is an inflation targeting central bank. And the inflation print on April 26<sup>th</sup> 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 7<sup>th</sup> 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.

### RBA regimes and underlying inflation record

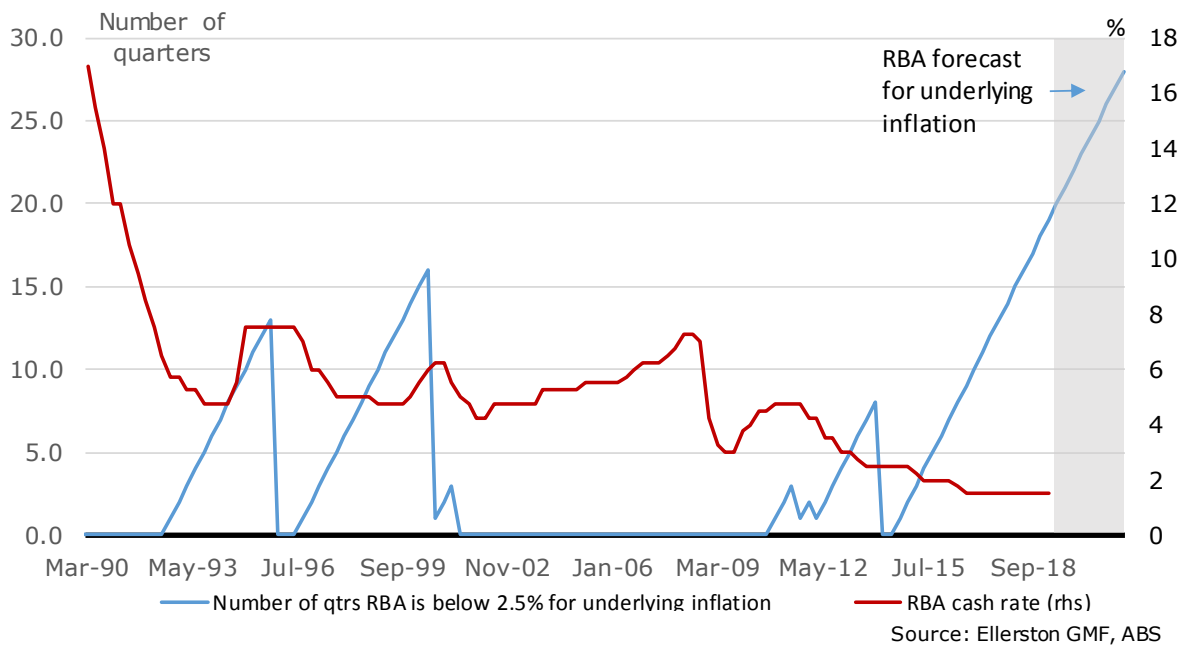


What is even more startling, is he is forecasting that he is happy to be below target on inflation for an incredible 28 quarters in a row (or 7 years). Call it twice the level of "patience" as prior governors.<sup>2</sup>

<sup>1</sup> 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.

<sup>2</sup> 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.

## Time missing the mid-point of the target band



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%.<sup>3</sup> 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 5<sup>th</sup>, 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<sup>4</sup> 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.*<sup>5</sup>

And so we cheered when we saw the statement from the RBA on May 7<sup>th</sup>. 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.<sup>6</sup>

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

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.

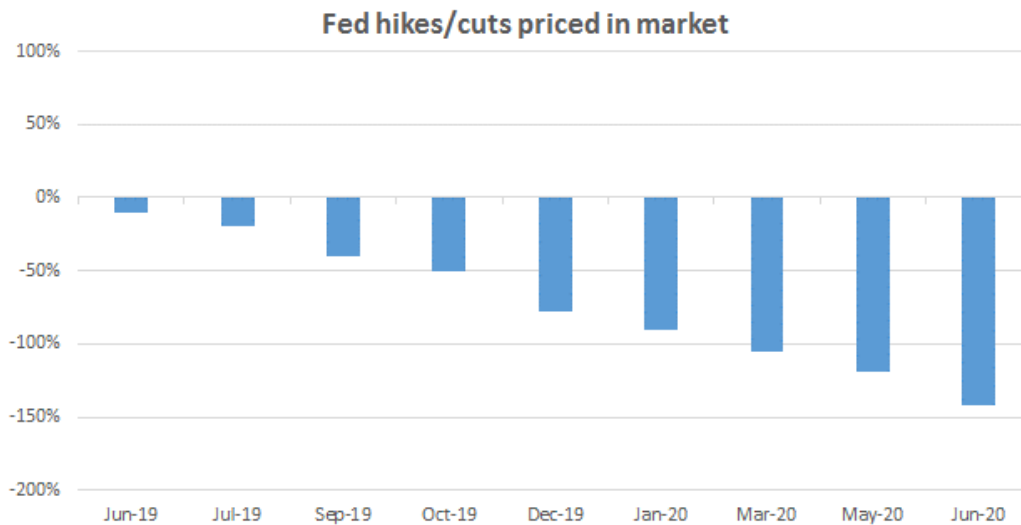
The other mispriced market? The US rate curve, which is still pricing rate cuts.

<sup>3</sup> In the May 7<sup>th</sup> 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.

<sup>4</sup> Assistant Governor (Economic) at Reserve Bank of Australia – RBA's chief economist

<sup>5</sup> <https://www.rba.gov.au/media-releases/2019/mr-19-11.html>

<sup>6</sup> 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.



Source: Bloomberg

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.<sup>7</sup>*

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 10<sup>th</sup> 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



<sup>7</sup> <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190501.pdf>

## Ellerston Global Macro Fund Overview:

The Fund aims to operate a discretionary, medium-term global macro strategy with an unconstrained, absolute approach. It focuses on capital preservation and aims to have low to negative correlation to traditional asset classes.

The Fund aims to generate superior returns over a range of market conditions. The Fund aims to achieve its objective by implementing a strategy which focuses on a number of fundamentally derived core themes optimised via trade execution and portfolio construction. The Fund invests in a portfolio of fixed interest, foreign exchange, equity and commodities.

## Ellerston Global Macro Team:

### **Brett Gillespie – Head of Global Macro**

Brett has worked in the financial services industry for over 29 years with over 26 of these as a fundamental medium term macro trader. Brett joined Ellerston Capital in November 2016 as Head of Global Macro. Before joining Ellerston, Brett spent over 10 years as Senior Portfolio Manager at Tudor Investment Corporation in both London and Sydney.

Prior to this Brett spent two years contracted to manage capital for Commonwealth Bank of Australia on an absolute return basis. Brett began his career in 1989 at Bankers Trust as a Futures Broker then Proprietary Trader. Brett transitioned to BT Funds Management Ltd to the position of Executive Vice President, Head of Cash and Cash Enhanced Products and in 1999 commenced management of Intermediate Bond Funds. Brett's last held position here was Head of Global Sovereign Bonds.

Brett has a Bachelor of Economics degree from the University of Sydney and has been a guest panel speaker at the OECD Business and Finance Outlook Conference and a guest lecturer at the London Business School.

### **Tim Toohey – Chief Economist**

Tim joined Ellerston capital in March 2017 as Chief Economist within the Global Macro Team, bringing 25 years industry experience as an economist. Tim joined from Goldman Sachs where he was Chief Economist and Head of Macro Strategy Australia and New Zealand. In 2002, Tim joined JBWere (who later merged with Goldman Sachs in 2003) as a Senior Economist in the research department and was named Managing Director in 2009. Prior to this, Tim was Macroeconomist with the ANZ Banking Group for two years. Tim began his career as a Senior Economist with the National Institute of Economic and Industry Research.

Tim has been voted in the Greenwich survey as the number one Economist in Australia from 2003-2016.

Tim has a Bachelor of Commerce degree from the University of Melbourne (Honours in Economics) and a Masters of Economics also from The University of Melbourne.

### **Howard Chang – Analyst**

Howard joined Ellerston as an Investment Analyst in February 2017. Howard joined from Russell Investments, where he worked as an Actuarial Analyst, valuing and modelling superannuation funds for 3 years. Prior to this, Howard was an Analyst in the Group Finance Division at Westpac. Howard began his career in an Analyst role at Russell Investments.

For further information, please contact:

Sam Stobart  
0423 292 299  
sstobart@ellerstoncapital.com

Simon Glazier  
0410 452 949  
sglazier@ellerstoncapital.com

**SYDNEY OFFICE**

Level 11, 179 Elizabeth Street,  
Sydney NSW 2000

**MELBOURNE OFFICE**

Level 4, 75-77 Flinders Lane,  
Melbourne VIC, 3000

Ph: +61 2 9021 7797  
E: [info@ellerstoncapital.com](mailto:info@ellerstoncapital.com)

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