ELLERSTON CAPITAL

Ellerston Global Equity Managers Fund (GEMS)

Performance Report | April 2020

PERFORMANCE SUMMARY

Performance*	CYTD	FYTD	3 Year (p.a.)	5 Yr (p.a.)	Since Inception** (p.a.)
GEMS C	1.63%	13.77%	6.25%	8.36%	10.25%

Source: Ellerston Capital

*Net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance

PORTFOLIO COMMENTARY & MARKET OUTLOOK

Portfolio:

Fiscal Year to Date from June 30 to April 30, the Australian ASX 200 was down -13.78%, and the US S&P500 was up +0.62%. **Your fund is up +13.77%.**

Calendar Year to Date from January 1st to April 30, the Australian ASX 200 was down -16.35%, and the US S&P500 was down -9.29%. **Your fund is up +1.63%**

For the Month of **April 2020**, **your fund was up +4.13%**

Your portfolio currently has a net exposure of circa 47% plus an exposure to gold of circa 15% and continues to have no foreign currency exposure. As at the writing of this letter, the fund has had a strong performance for the month to date in May.

Market Outlook: Market collapse, market recovery. What comes next?

With the uncertainty of COVID-19, forecasting is an even more dangerous business than usual.

We intend to invest for the coming months based on our framework of opportunity and risk. The sport is not a level playing field and it is important to be flexible and pivot as necessary.

The S&P 500 appears to have found a new level around 2900 off a 2200 low. In terms of value, that is 20x 2021 and 17x 2022. The 172 EPS forecast for 2022 is 5% higher than the last normal year of 2019. Factor in a dramatically lower discount rate of say 2.5-3% vs the previous 3.5-4% and you can understand the market rally and rotation back to growth with the NASDAQ within reach of its all-time high.

However, make no mistake, the market recovery had less to do with valuation and more to do with liquidity. The Fed in March and April created $1 trillion of QE in excess of Treasury issuance. The largest liquidity injection on a relative or absolute basis in history.

When investors sell the lowest risk of all securities, the spill over spending in riskier assets is automatic. For it to happen in a month is unprecedented. Money leaked from sovereign debt to corporate debt to junk bonds and to equities.

If the Fed backs off and tapers at the current rate of $30B per month then the current pattern of Treasury issuance is almost certain to overwhelm any liquidity injection.

This leaves the equity market with a deteriorating liquidity outlook, a rotten economic outlook, earnings weakness and rising insolvency. All this needs to be balanced by a larger discount to a 2022-23 valuation.

The relentlessness of QE1, 2 and 3 have cornered the Fed. We have got too much Government debt, corporate debt and household debt just when the Fed balance sheet at $7 trillion looks closer to getting maxed out.

A bad risk reward looms. The beta may not be our friend going forward and Long/Short with a low beta looks tempting.

It is also tempting to be too bearish in these circumstances, but the long side opportunity is also compelling. Off a 2019 base, if we assume 2022 earnings at a similar level, we get the S&P 500 at over 4000 assuming a 2% discount rate. So, 30% upside in 18 months. Hard to imagine as the economy craters, but in line with meaningless earnings next year and an appropriately high multiple of the next normal year.

Long/short investing looks like its time has come again.

Investment Objective

The investment objective is to generate superior returns for Unitholders with a focus on risk and capital preservation.

Investment Strategy

The Fund provides investors with exposure to global markets through a long short equity strategy. The strategy overlays fundamental bottom-up stock selection with global macroeconomic and market outlook.

Key Information

**Class Inception Date	1 December 2009
Portfolio Manager	Ashok Jacob
Application Price	$1.6448
Net Asset Value	$1.6407
Redemption Price	$1.6366
Liquidity	Monthly
No Stocks	64
Gross Exposure	101%
Net Exposure	62%
Management Fee	1.50%
Performance Fee	16.50%
Buy/Sell Spread	0.25%/0.25%

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Gold

"The great merit of gold is precisely that it is scarce; that its quantity is limited by nature; that it is costly to discover, to mine, and to process; and that it cannot be created by political fiat or caprice." **— Henry Hazlitt**

A month ago, as we were espousing the merits of investing in Gold, the CIO of one of the largest family offices in the world asked us ***"Is Gold an asset or a Currency?"*** After giving this some thought, we actually got more excited than before. The weakness of Gold over many decades came consequent to its transition from "Currency" to "Asset". That emanated from Bretton Woods and the USD breaking its peg to Gold. It's relative strength from the GFC till today comes from its transition back to "Currency" from "Asset". When the US Fed began QE post GFC, the price soared from $730 to $1,840. As the global economy stabilised the price fell back as it appeared that Governments and Central Banks had control of our monetary system again and its potential return to Currency status was cast into doubt. Then, at the very end of 2018, when Fed Chair Powell very publicly did an about face on QT and went back to promising President Trump and Financial Markets a balance sheet expansion, the yellow metal ran up $400 to a pre COVID-19 level of nearly $1,600. When Powell then came back to the party in March/April with possibly the greatest short-term QE of all time, we saw Gold start another powerful move up to the current $1,740 level. **Is Gold a "Currency" today? Not yet but it is not far away**. Look at the maths. Annual production of Gold runs at a tad over 80m Oz per year. One half is consumed by jewellery and industrial demand. The rest is Investment or "Currency" demand.

However, **in our view, COVID-19 may prove to be a game changer. The US Fed has brought its ability to expand its balance sheet to finance US Government spending to a level where it cannot expect to be repaid at any level of interest rates** without causing a level of social unrest. That would be intolerable, not just to the masses, but by extension to any politician.

Additionally, the decisive move by Merkel and Macron to move toward a game changing subsidisation of the weaker economies of Europe was inevitable. Failing that, European currency union had no future.

All this is made possible by Central Banks providing trillions of dollars and euros of zero cost financing to the Governments of the day. Once started, this will never end, and asset owners know that. The day of Hard Currencies was probably dead a decade ago. The actions of the US Fed have well and truly buried them for ever.

The market capitalisation of all the Gold Stocks in the world is circa $350 billion. A fraction of any individual FANG or STAT stock. The ability of any gold company to lift production is limited. The easy discoveries have been made and there is no supply side response to rising demand.

The merits of Gold and Gold Stocks have never been better. We will provide more granularity around the tailwinds and the fund exposures in coming months.

GENERAL APRIL MARKET COMMENTARY

Market Overview

April was a triumph of optimism over fear, as unprecedented fiscal and monetary support from governments and central banks saw investors drive global markets sharply higher. Also, the developed world appeared to be past the peak of new COVID-19 cases and there were tentative plans for reopening economies. Cyclical sectors were the most robust, with the energy sector looking through the depressed oil price and rallying hard. The surging stock markets were in stark contrast to the dire economic data hitting the newswires globally, especially in the developed world. Flash PMIs for the G-4 plunged, with the services sector hit the hardest. US GDP contracted 4.8% in 1Q and yields on US 10-year bonds remained at record low levels, closing at 0.64%.

USA

In April, the S&P 500 surged 12.8%, the Dow Jones was up 11.2% and the NASDAQ Composite was up an astonishing 15.5%. As at the end of April, the NASDAQ was only down -0.6% for the calendar year-to-date! US equities rallied, as optimism that the number of COVID-19 cases were stabilising led to increased talk of reopening key segments of the economy. April was dominated by US reporting season. The picture that emerged wasn't pretty. Earnings have begun to deteriorate with around one-third of reported companies having missed expectations. Outlook statements from technological giants Apple and Amazon offered a reality check about the economic impact of the pandemic. Apple was unable to provide a forecast for the first time in a decade and Amazon missed consensus estimates for its Q1 EPS by 20%, saying it would incur a loss in the current quarter as it boosted spending for logistics.

US March activity indicators weakened further, with manufacturing ISM at 49.1 (previous: 50.1). Non-farm payrolls fell -701,000 in March (substantially worse than consensus: -100,000; previous: +275,000). Approximately, 30 million Americans have now filed for unemployment benefits since mid-March, representing around 19% of the US labour force. The outlook for earnings, given falling employment and demand is looking grim.

Europe

European exchanges joined in the global rally, with the Euro STOXX 50 recording a 5.3% gain. Among the major exchanges, the returns were: UK's FTSE 100 +3.9%, France's CAC 40 +4.1%, and Germany's DAX +9.3%.

European activity indicators were dreadful. Flash Eurozone manufacturing PMI for April plunged to 33.6 (consensus: 38.0; previous: 44.5). Composite PMI also fell to 13.5 (consensus: 25.0; previous: 29.7). Towards the end of April, EU leaders, after some disagreement, ultimately agreed to a further stimulus package of around 1 trillion euro.

Asia

Asian equities also rose on optimism that the virus was showing signs of containment in some countries in the region. The Hang Seng Index was up 4.1% and the Chinese SSE Total Market Index was up 4.9%. But in Japan and South Korea, where there was greater optimism on the curve being flattened, markets were buoyed even further, rising +6.8% and 11.0% respectively. The Indian market, after falling very dramatically last month, regained some poise, rising 14.4% in April.

Commodities

The BBG commodities Index fell 1.6%, mainly driven by the continued fall in oil - down another 10.7% (refer more detailed comment below). Despite rallying equity markets, precious metals rose, with gains in Gold and Silver of 6.9% and 5.5% respectively. Iron Ore was broadly flat.

Oil prices ended the month slightly higher, yet the level of volatility was off the Richter scale, with prices bizarrely going negative for the WTI May contract - paying someone to take the crude oil. OPEC+ agreed on the 10 April to reduce oil supply by 10mbpd, with both Saudi Arabia and Russia cutting output by 2.5mbpd each. This is less than the apparent demand collapse from the COVID-19 impact, with demand destruction estimated to be around 25mbpd. However, given limited oil storage, non-OPEC producers will need to start curtailing production quickly. The chart below highlights the large decline in new wells in the US, which will lead to much lower production in the near future. The physical markets require storage to operate and we continue to see material discounts in the US to the benchmark West Texas Intermediate (WTI), which unlike the Brent oil price, can be settled by either cash or physical delivery. **On 20 April the WTI May futures contract went into negative territory for the first time and closed at an all-time low of - $37.43/bbl**, as no-one wanted to take physical delivery. This was not the only "once in a lifetime" oil event during the month. **For the first time since WW2, Royal Dutch Shell cut its dividend**. Things may seem bad, but it means the market should rebalance much quicker. **The North Sea Brent oil price under US$20.00 per barrel is clearly unsustainable and we would expect a recovery from these levels.** This is why globally, energy was the best performing sector during the month.

China's three biggest state oil producers will also slash their spending plans this year by a combined US$19 billion, with PetroChina's 32% chop leading the way.

Bonds

Global bond yields remained at very low levels in April. The US 10-year bond yield ended the month slightly lower at 0.64%, while the Australian 10-year bond yield rose 13 basis points to 0.89%. The Australian 3-year bond yield closed at 0.25%, at the RBA's target level.

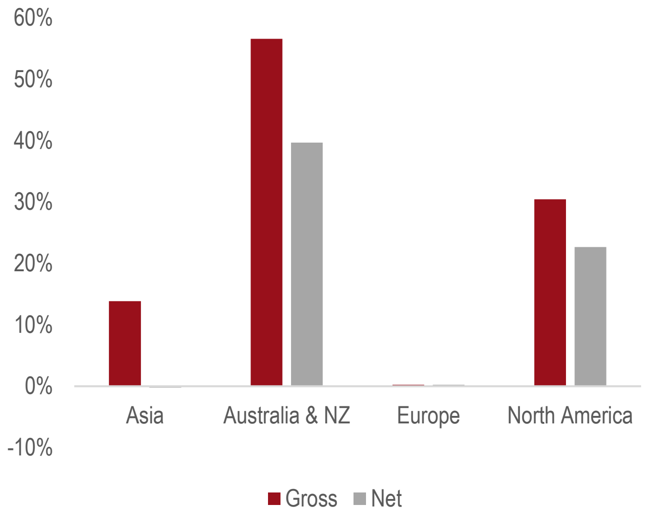
Australia

The S&P/ASX 200 Accumulation Index had a rebounded strongly, up 8.8% and is now down 16.4% CYTD to the end of April 2020.

Not surprisingly, the RBA left rates unchanged in April. This helped sentiment toward the Australian dollar, which after plunging to a recent low of 55 cents, was up 7% against the US dollar, to end the month at 0.65 US cents.

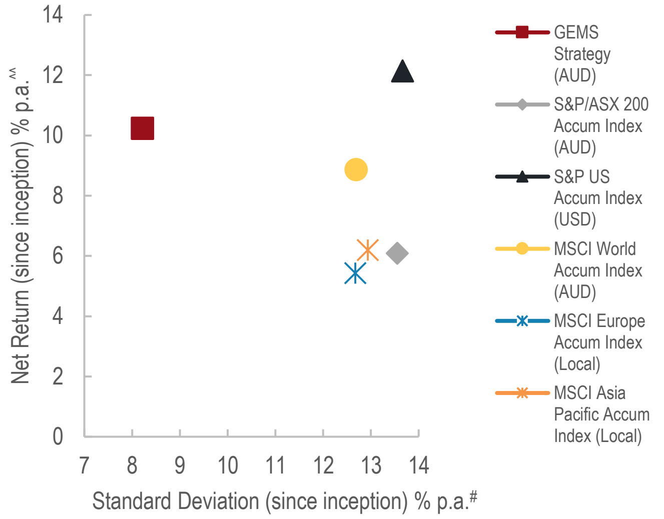
PORTFOLIO CHARACTERISTICS

Market Exposure as a % of NAV



Source: Ellerston Capital

GEMS Strategy Performance & Volatility^



Top 10 Holdings (Alphabetical, Long Only)

- AMAZON.COM INC
- FACEBOOK.COM
- GENERATION DEVELOPMENT GROUP LTD
- GRAINCORP LTD
- HEALIUS LTD
- MICROSOFT CORP
- NEXTDC LTD
- SKY CITY ENTERTAINMENT GROUP
- SPDR GOLD SHARES (USA)
- UNITED MALT GROUP LTD

All holding enquiries should be directed to our registrar, Link Market Services on 1800 992 149 or ellerston@linkmarketservices.com.au

Should investors have any questions or queries regarding the Fund,

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