ELLERSTON CAPITAL

Ellerston Global Equity Managers Fund (GEMS)

Performance Report | May 2020

PERFORMANCE SUMMARY

Performance*	CYTD	FYTD	3 Year (p.a.)	10 Yr (p.a.)	Since Inception (p.a.)^^
GEMS A	6.06%	18.72%	8.38%	10.70%	12.08%
GEMS B	6.05%	18.72%	8.38%	10.45%	11.92%

Source: Ellerston Capital

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

MARKET OUTLOOK & PORTFOLIO COMMENTARY

Portfolio:

Fiscal Year to Date from June 30 to May 31, the Australian ASX 200 was down -10.03%, and the US S&P500 was up +5.41%. **Your fund is up +18.72%.**

Calendar Year to Date from January 1st to May 31, the Australian ASX 200 was down -12.70%, and the US S&P500 was down -4.97%. **Your fund is up +6.06%**

For the Month of **May 2020**, **your fund was up +4.36%**

As of June 29 your portfolio has a net exposure of circa 51% plus an exposure to gold of circa 14% and has minimal foreign currency exposure. The Fund has also had a positive performance for the month to date in June.

Market Outlook:

As the markets soar, we find ourselves surrounded by investors assuring us that the markets are wrong, and the economy is going to fall off a cliff at some point in the future. In fact, the negativity of the bears is deafening and makes it hard to think clearly.

Therefore, the question that must be answered is perversely whether the market could possibly be right? Is the global equity market simply climbing the wall of worry? We think that there is a possible case for that. On a valuation basis, the market is relatively speaking cheap!

How could that be?

The S&P 500 is now on circa 21x consensus, COVID-19 affected 2021 earnings. Even assuming the estimates are 10% off and the multiple is at 23x, that is an earnings yield of 4.4%. 10-year treasuries now yield 0.64%.

That implies Earnings Yields are 6-7x Bond Yields. Prior to March we are hard pressed to find this happening post the Second World War.

Investment Objective

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

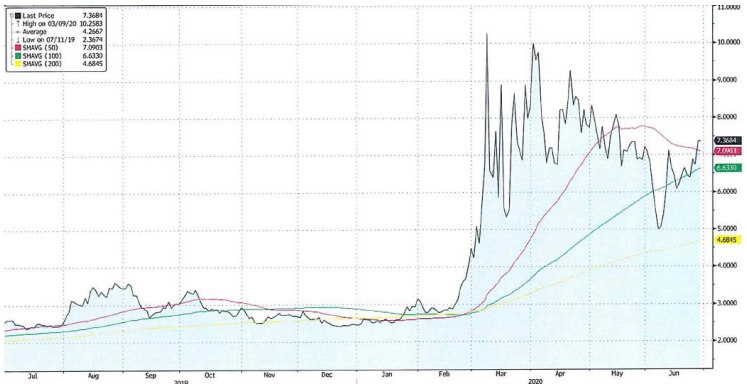
Investment Strategy

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

Inception Date	1 January 2002
Portfolio Manager	Ashok Jacob
Class A Redemption Price	$1.5558
Class B Redemption Price	$1.5186
Liquidity	Quarterly
No Stocks	84
Gross Exposure	118.18%
Net Exposure	70.65%
Management Fee	1.50%
Performance Fee	16.50%
Buy/Sell Spread	0.25%/0.25%

The chart below is a repeat from prior newsletters, where we divide the S&P 500 Earnings Yield by the US 10-year bond interest rate. Currently the S&P Earnings Yield / US 10 YR Treasury is now at 7.37.



Source: Bloomberg

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Now let's go to 2022. PE of 18x consensus. 5.5% earnings yield.

Simplistically, if the earnings yield falls to 4x the bond yield, we can see almost 40% upside in the market. Let's say the 10-year yield rallies back to 1.2% and the ratio stays at 4x then the earnings yield is 5, PE of 20 and at least 20% upside. But these are heroic assumptions. At lower multipliers of bond yields we reach S&P 500 levels of 3900 quite easily. The number that can break this is the 10-year bond yield breaking above 1.5% and heading towards 2%. When we have a US Fed talking about "doing whatever it takes " and keeping rates lower for longer, it all points towards lower rates and higher multiples.

To us, the reference by Powell to the Fed's indifference to asset bubbles forming seemed a specific reference to a problem that they were prepared to ignore in their crusade to ensure full employment. *"Really it's about getting the labour market back and getting it in shape. That's been our major focus. I would say if we were to hold back because, we would never do this, but the idea that, just the concept that we would hold back because we think asset prices are too high, others may not think so, but we just decided that that's the case, what would happen to those people? What would happen to the people that we're actually, legally supposed to be serving? We're supposed to be pursuing maximum employment and stable prices, and that's what we're pursuing".*

If there is enough liquidity in the system, all roads lead to asset price inflation at a faster pace than ever before. The aggressive responses from the ECB, BOJ all point in the same direction. The unholy alliance between Governments and Central Banks make this all possible. As long as the USD can hold its position as the world's reserve currency then the TINA principle holds (There Is No Alternative to equities). If that reserve position is ever threatened, then GOLD becomes a real alternative as a CURRENCY. We hold gold, gold shares and gold equity indices in case that scenario comes into play. If it does not, we see another raging bull market in risk assets, particularly the equity market.

Low or zero rates through to the end of 2022 create a more than meaningful uplift in the valuation of various share classes. Super techs with their inbuilt growth and long duration assets may enter a new and even more rapid bull market than what we saw in 2019. Growth, long duration and sustainable income look highly likely to outperform in both relative and absolute terms. Gold is a buffer with very little downside in the current environment. Its upside is potentially explosive. We see gold either grinding up as the Fed prints to buy treasuries relentlessly or moving more rapidly if the market begins to dislocate.

There is however a significant difference to be mindful of between Fed activity in 2008 versus Fed activity in 2020. This is well articulated by livemint.com -

"Just like back in 2008, the Federal Reserve has pumped record amounts of cash into the financial system this year to stave off an economic collapse. But unlike in 2008, when that money mostly piled up in banks' accounts at the Fed, funds are pouring into Americans' checking accounts. And that's a big distinction. When kept at the Fed by banks as excess reserves, the money fails to give the jolt to the economy. But put it directly in people's pockets -- which occurred this time because Fed support was matched by government stimulus - and the potential boost suddenly becomes meaningful. The numbers are eye-popping. In the three months through May, the most liquid portion of the money supply, as measured by a gauge known as M1, surged 26%. That's triple the jump posted in the corresponding three-month period in 2008 and is more than any full-year increase recorded in the six decades that officials have been tracking the data."

When we consider what possible solutions there may be to the low growth/no growth/shrinking economy/deflationary grip that the world seems to be headed for, there is only one solution that we can visualize currently. That is 'inflation'. The best way to create inflation is by keeping borrowing rates below the rate of growth for a period of time. This needs to be coupled with increased money supply, M1 and M2 and the velocity of money. That can be driven by banks lending more aggressively.

While at this point we are only seeing glimmers of potential inflationary drivers, investors do need to be alert to a potential game changer if this happens. With such a massive difference between the valuations being attributed to growth versus value companies, the rotation would be breath-taking.

As we indicated in previous letters, the three dimensions to this year are health, economy and finance.

A sustained health crisis or a second wave emerging are all cause for alarm. Markets are however capable of looking through this. In the zero to negative interest rate environment that continues, equities appear to be the best asset class.

Extreme extended volatility in this environment is something to be expected. Potentially it provides good entry and exit points.

GENERAL MAY MARKET COMMENTARY

Market Overview

Global equity markets continued to rebound in May as investor confidence rose. Ongoing massive government stimulus and a progressive reopening of societies were expected to help economies and earnings recover quicker than was previously expected. All world developed markets rallied, with more cyclically exposed sectors like materials, IT and industrials outperforming. The Australian dollar was stronger, in part due to iron ore breaking through US$100/t. Oil also rebounded sharply on a better than expected demand outlook from the IEA, coupled with the expectation that OPEC+ would remain supply disciplined.

USA

In May, US stocks were buoyed by continued optimism around the reopening of the economy. The S&P 500 was up 4.8% (and astonishingly, has bounced 36% off its March lows), the Dow Jones was up 4.7% and the NASDAQ Composite was up 6.9%. As at the end of May, the NASDAQ was back in positive territory, up +6.2% for the calendar year-to-date!

May was a tricky month: geopolitically, tensions between the US and China flared up again and economically, services PMI indicated that the US services industry shrank for the first time in over a decade. The jobs report was also the worst on record (over 40m Americans out of work), with the unemployment rate surging to 14.7%. US activity indicators continued to be negative, with manufacturing ISM retracing to 41.5 (previous 49.1). By month's end and in early June, violent civil unrest

and looting spread across a number of US cities, but markets pushed upward as investors bet on the number of COVID-19 infections continuing to fall, the prospect of a vaccine, and the economy rebounding as it reopened for business.

Europe

European equities also participated in the rally on hopes of an economic revival as coronavirus cases plateaued, economies commenced opening up again and the EU announced new stimulus measures for hard hit members. The Euro STOXX 50 closed the month up 4.7%. Among the major exchanges, the UK's FTSE 100 recorded a 3.3% gain, France's CAC 40 closed +3.4%, and Germany's DAX finished +6.7%.

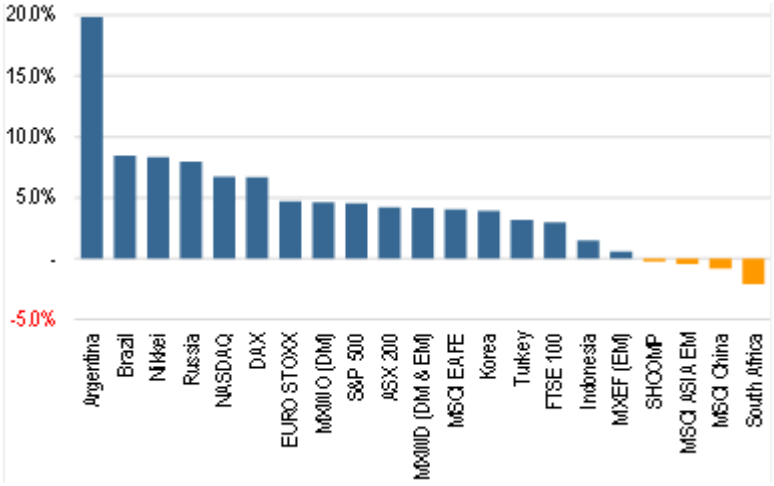
European activity indicators continued to be weak, but were better than expected. Surprisingly, the flash Eurozone manufacturing PMI for May was ahead of expectations at 39.5 (consensus: 38.0, previous: 33.4). Composite PMI also rose, but still to a woeful 30.5 (consensus: 27.0, previous: 13.6).

Asia

Asian equities were rather mixed, as some markets were hit by renewed tension between the US and China and new protests in Hong Kong that were in response to the Chinese government's proposed new laws likely to impact Hong Kong's domestic security. Against this backdrop, the Hang Seng index was hit hard and bucked the global trend, returning -6.3% in May. India's S&P BSE Sensex was down 3.7% as the cases of COVID-19 there continued to rise sharply. However, countries with more success in controlling the spread of COVID-19 like Japan and South Korea saw their equity markets rebound: Japan's Nikkei 225 was up 8.3% and Korea's KOSPI Composite was up 4.2%.

The Chinese market, as represented by the SSE Total Market Index was modestly down 0.6%. In the government work report released during the National People's Congress in late May, Beijing alluded to further stimulus, called for an extension of small business loans and vowed to create new monetary policy tools to support businesses. True to form, on 1st of June, the People's Bank of China (PBoC), together with the Ministry of Finance, announced two new credit easing measures to support bank lending to small businesses: RMB400 billion for purchasing qualifying credit loans directly from small banks, and another RMB40 billion for setting up a special purpose vehicle to help extend as much as RMB3.7 trillion in loans to small business. These two programs represented two new quantitative easing (QE) measures after the medium-term lending facility, through which the PBoC lends to large banks and pledged supplementary lending, through which the PBoC lends to policy banks. These two new QE-style programs should have the effect of increasing base money, should add to bank reserves and help small banks and small businesses survive.

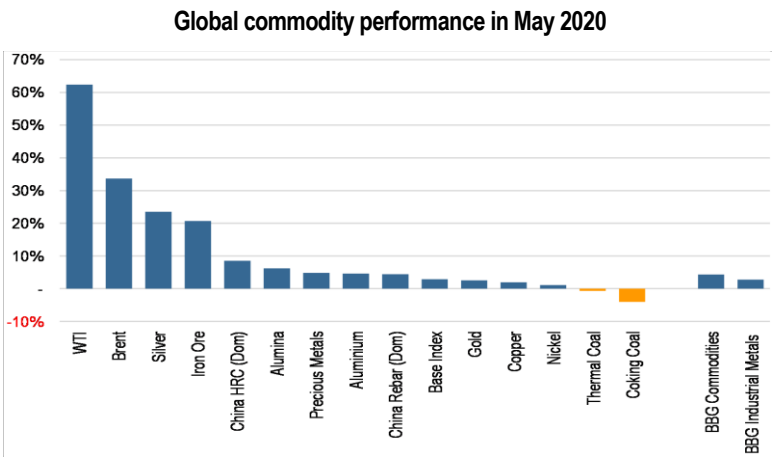
Global equity markets performance in May 2020



Source: JP Morgan, Bloomberg

Commodities

Global commodity markets staged a recovery in May. Brent oil ripped from a low base, in part driven by the improving global demand outlook and lower global supply, especially from OPEC+ and the US shale producers, with sharply lower rig counts. Iron Ore broke through the $100/t level for the first time in almost a year, driven by a combination of stronger Chinese steel demand and ongoing supply constraints in Brazil, where some mines were impacted by rising COVID-19 infections.



Source: JP Morgan, Bloomberg

Bonds

Global bond yields remained low despite the rally in equity markets. 10-year yields in the US and in Australia were largely unchanged in May, with the former ending the month at 0.65% and the latter at 0.88%.

Australia

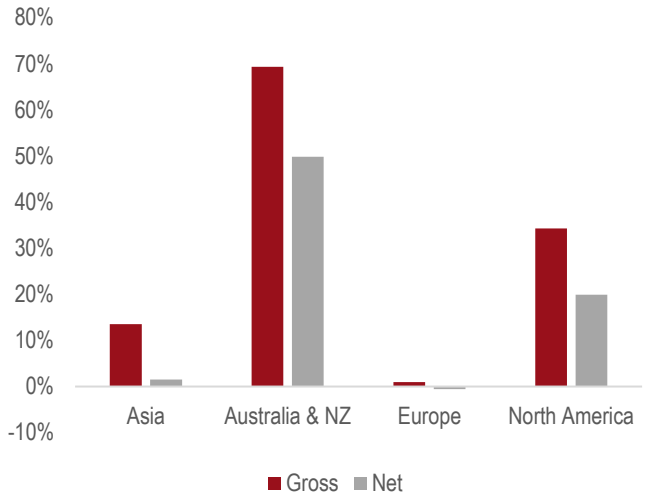
The S&P/ASX 200 Accumulation Index continued its strong upward trajectory, up another 4.4% in May. It is now down 12.7% calendar year to the end of May 2020.

The RBA left rates unchanged in May and not unexpectedly, also left rates unchanged at 0.25% in early June. In its statement, the RBA commented on the nature and speed of the expected recovery being highly uncertain. It went on to say that the RBA Board was committed to do what it could 'to support jobs, incomes and businesses' and that this 'accommodative approach will be maintained as long as it is required'. There is an increasingly vocal debate on the merits or otherwise of negative interest rates. To date, the RBA governor has remained consistent in his opposition to negative rates, calling the move 'extraordinarily unlikely'. But these are extraordinary times!

The AU dollar continued to strengthen against the US dollar, supported by the rally in commodity prices, especially iron ore, and a widening interest rate differential to the US. It is was up 2.4% to finish the month at 0.667 and has recovered 20% from the mid-March low of 0.55!

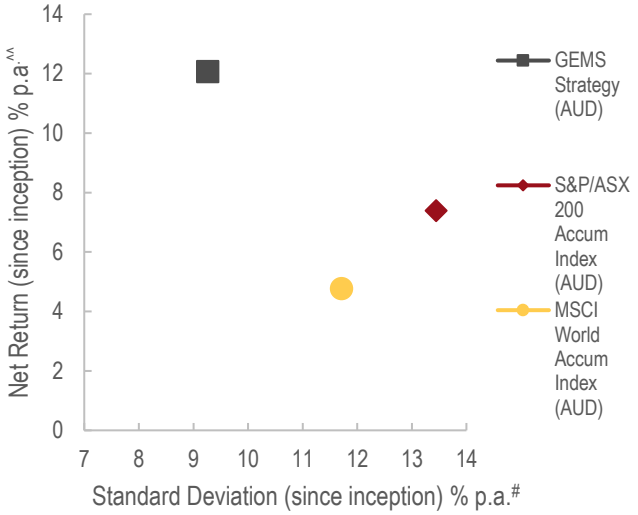
PORTFOLIO CHARACTERISTICS

Market Exposure as a % of NAV



Source: Ellerston Capital

GEMS Strategy Performance & Volatility^



Top 10 Holdings (Alphabetical, Long Only)

- CELSIUS HOLDINGS INC
- FACEBOOK.COM
- GRAINCORP LTD
- HEALIUS LTD
- MICROSOFT CORP
- NEXTDC LTD
- NORTHERN STAR RESOURCES LTD
- SKY CITY ENTERTAINMENT GROUP
- UNITED MALT GROUP LTD
- VANECK GOLD MINERS

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,

please contact our Investor Relations team on 02 9021 7701 or info@ellerstoncapital.com

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