August 2017 Review – Listed Hybrid Sector

Performance

The Elstree Enhanced Income Fund's total investment return for August 2017 was 0.45%. This compares with the Elstree Hybrid Index return 0.39%. In other markets the All Ordinaries Accumulation Index returned 0.79% while the All Maturities Bond Index returned (0.01%).

The next crash

We're read a lot of commentary about the certainty of the next crash. This certainty seems to be a function of the age of the business and economic cycles, the last 12 months of extremely low volatility and the expensiveness of nearly every asset class with a number of writers daring to use the "bubble" word. While we have absolutely no idea when the next crash will occur, there's some evidence to suggest that the low volatility, "expensive" phase for investment grade credit and bank capital securities may continue for a while yet. The bubble/crash trade looks a bit crowded to us.

Risk for financial markets and financials at very low levels

The two charts below show the Stern School Systemic Risk (SRISK) for Europe and the St Louis Fed Financial Stress index (STLFSI) onto which we've added the US "BBB" margin to explore the relationship. Both measure slightly different things: the STLFSI looks at 18 weekly data series including interest rates and credit spreads to measure financial market stress while the SRISK estimates the equity shortfall (in European banks in this chart) if there is another systemic risk event.

Chart 1

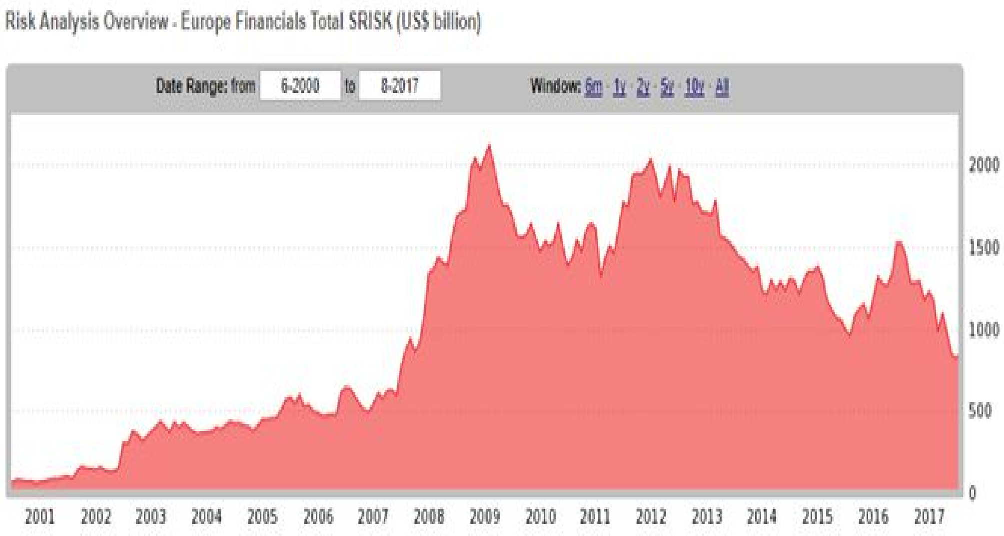

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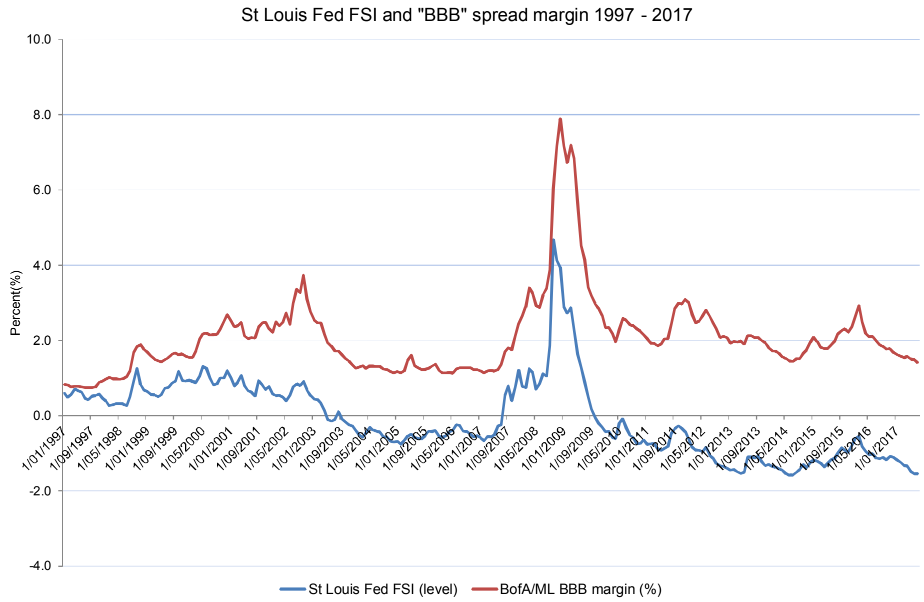
Chart 2



So what are the important points?

-Without getting into causality, a high score in either or both indicates a financial sector that is under stress with consequent negative effect on spread margins.
- Most importantly, both indices are at very low levels indicating current financial risk is at very low levels. European SRISK (Chart 1) is at around 1/3 peak levels. US SRISK (not shown) is at around 20% of peak levels while the St Louis Fed's FSI (Chart 2 – blue line) is not only at record low levels but has been below a reading of "0", which constitutes normal financial conditions, for over 6 years.
- It's not clear if credit margins lead the indices, but they are certainly co-incident indicators.
- It takes at least 6 months to see a material change, so the prospect of a big spike in financial risk that will lead to higher credit margins/bank solvency problems seems to us to be minimal in the short term.

Why are these indicators so low when it is so obvious that thing are overvalued

Well, either history is wrong and the market (and these indicators are based on market data) is stupidly complacent or there is some basis for the low risk scores. And these might be that the risk has been taken out of the global financial system and the current low steady growth and lack of obvious bubbles (excluding generally stupidly high valuations) means that investors should be contented (not stupidly complacent). On an inductive basis we can only think of a few bubbles (rather than overvaluation) and none of these have the retail participation that makes the bursting of real bubble painful. We think real rates are stupid, the China enigma wrapped inside a paradox is a bubble somewhere (interestingly the SRSIK for China and Japan now makes up around 45% of total global SRISK), and venture capital valuations come to mind.

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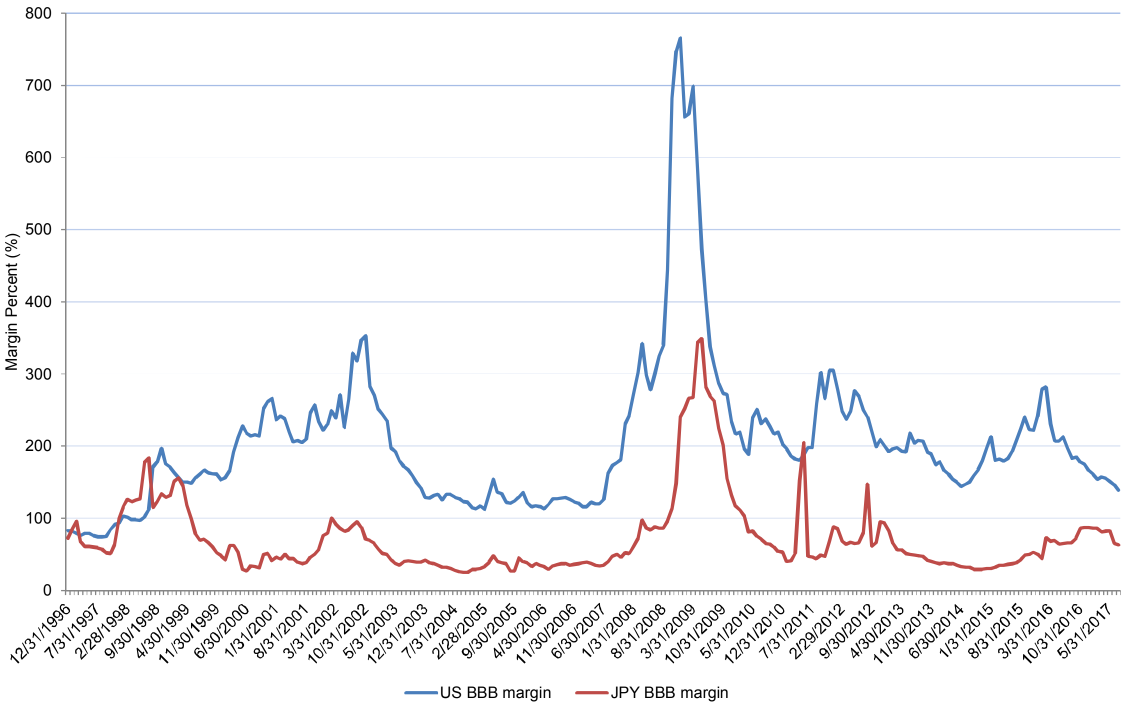
The first chart we look at when we get too dogmatic about historical averages

The first thing we do when we get too dogmatic is we drag Japan out of the closet. The chart below shows “BBB” spread margins in the US and Japan. As the chart below shows, Japanese and US “BBB” margins were around the same level in 1998, but Japanese spread margins have been materially lower since. The current “expensive” US “BBB” spread margins have only been seen twice in the last 20 years in Japan: in the Asian financial crisis in the late 1990’s and the GFC. Interestingly, default loss rates of Japanese “BBB” securities have been negligible for those 20 years and far less than non-Japanese “BBB” securities, so maybe there is a structural change at play, which means Japanese BBB investors still get well compensated for taking credit risk. Typically, a “BBB” rating of any instrument in any country provides an indication of the default risk. If the low growth/secular stagnation/high liquidity does result in structurally lower default loss rates, the current US “BBB” margins might not only be not “expensive” but it might also be the last time you see them at current levels.

Chart 3

US "BBB" Margins and JPY "BBB" Margins 1996 to 2017



So are we prepared to call that structural change?

On “BBB” credit: not quite yet. But markets are giving that scenario zero probability, so from a valuation sense there is an opportunity. We are prepared to say that we think there has been a semi structural change for bank capital securities. The high degree of scepticism and risk aversion towards bank solvency since the GFC is unwinding, but it’s not fully priced into bank capital securities yet.

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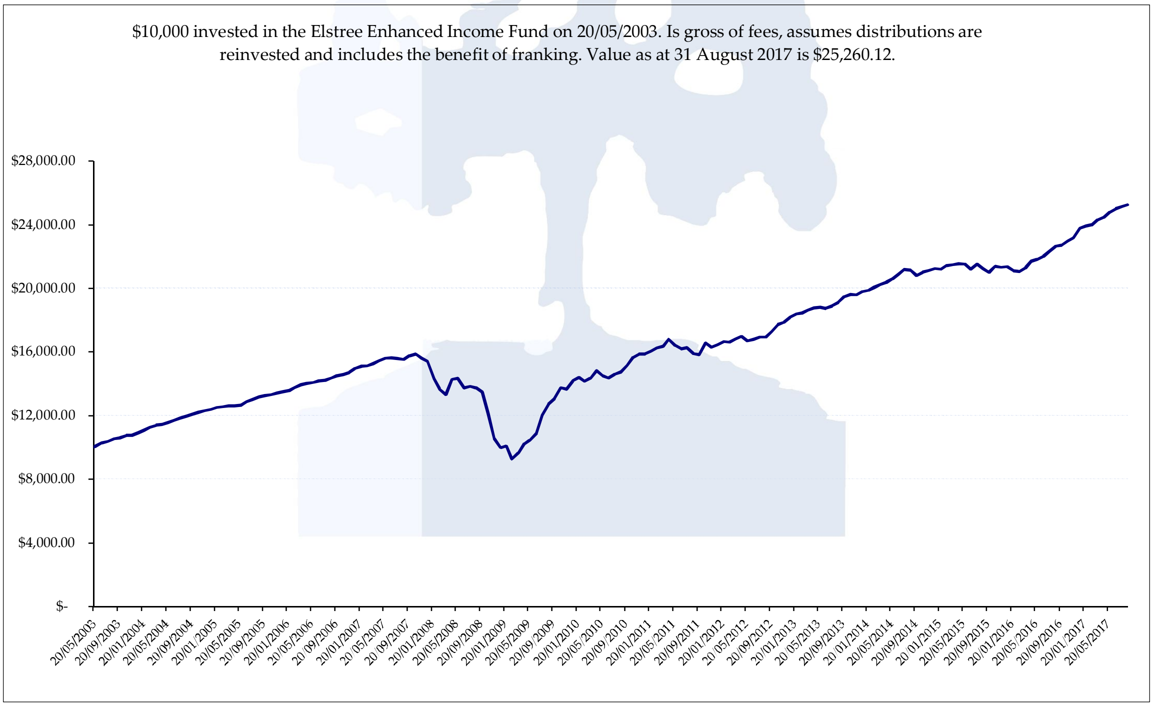
Fund characteristics as at 31 August 2017

Yield to Maturity	5.00%
Cash yield to maturity + franking (income yield)	5.25%
Investment grade issuer	93%
Fund average term (years)	4.4
Bank Tier 1 exposure	51%
Property exposure	5%

Performance Table	1 month*	3 months	12 months	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund	0.45%	1.96%	11.54%	6.14%	8.35%
UBS Australia Bank Bill Index	0.14%	0.43%	1.76%	2.16%	2.46%

*Returns are gross of fees and include the benefit of franking credits. Past performance is not necessarily a guide to future performance.

Value of $10,000 Invested on 20/05/2003



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