July 2022 Review – Listed Hybrid Sector

Fund and market performance

The Elstree Enhanced Income Fund's total investment return for the month of July was 1.83%. This compares with the Elstree Hybrid Index return of 1.52%. In other markets the All Ordinaries Accumulation Index returned 6.34% while the All Maturities Bond Index returned 3.36%.

Central banks are scrambling to not be left behind the interest rate curve. A slowing of M2 in the US may just help their cause

The markets have been running scared for a while now unsure how the central banks will cope with accelerating rates of inflation in the face of decelerating rates of real economic growth. Talk of 'hard' landings, 'soft' landings and even 'crash' landings have been heard emanating from the corridors of central banks around the world. Amid a surge in inflation accompanied by central banks scrambling to not be 'left behind the interest rate curve' both short, and long term, bond rates moved sharply higher in early June before retracing materially over much of July. Milton Friedman famously said that inflation "is always and everywhere a monetary phenomenon". If that statement is true, then it is with little wonder that inflation has surged as its surge coincides with unprecedented increase in the money supply created by the responses of administrations around the world to the covid19 pandemic. While US M2 surged at a ridiculous pace in the immediate pandemic period it has stalled recently.

While the covid induced surge in M2 was without parallel global central bank involvement was integral to the process

The mechanism that enabled the surge in M2 bares consideration as it was unparalleled. As we know the US Government (indeed most governments in the Western world) bestowed large amounts of monies upon households and businesses, the funding of which was provided for by the US Treasury through participating banks (i.e. the Treasury issues bonds to participating banks). The Federal Reserve then monetized the debt created by the Government by buying the bonds issued by the Treasury from the participating banks (when the Fed buys bonds from a participating bank it increases the amount of money in the banking system by the amount of the purchase of bonds). This meant that the Federal Reserve effectively provided the funding for the US Government through its quantitative easing program (i.e. it 'created' money to fund the Government's expenditure through the banking system). Australia's Reserve Bank did something similar with the Term Funding Facility (TFF) and its 3year bond buying initiative.

…but that is a thing of the past. Central banks are now in the process of unwinding QE which is helping to moderate inflationary expectations

The charts below are from one of our favourite bloggers Scott Grannis. The lefthand chart details US bank reserves. The chart on the right details the US bond market's expectation of inflation. The decline in bank reserves by 25% from over USD4trillion to just over USD3trillion is significant and is reflective of the quantitative tightening (QT) program undertaken by the Fed. When the Fed sells bonds or assets it owns it receives cash in so doing reducing the amount of cash in the banking system by the amount of the sale. We note that despite bank reserves having fallen recently there is still a material 'surplus' in the system, legacy, it must be said, of the quantitative easing (QE) program(s) implemented by the Fed in the immediate post GFC period 14years ago. It's interesting that the US bond market (righthand chart below) is now coming around to thinking that maybe, just maybe, inflation has peaked. The bond market is now predicting, as determined by the spread between the 5year Treasury bond (red line) and the 5year Treasury Inflation Protected Securities or TIPs (blue line) that inflation will average 2.5% (green line) over the next 5years. This is broadly akin to something like 6% for the next 12months and 2% per annum for the following 4years. Only a matter of a month or so ago the market was predicting that inflation would average 3.5% over the next 5years. Why the moderation in inflationary expectations all of a sudden?

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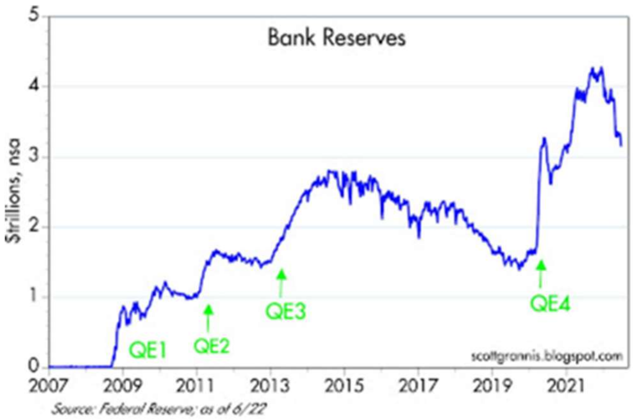

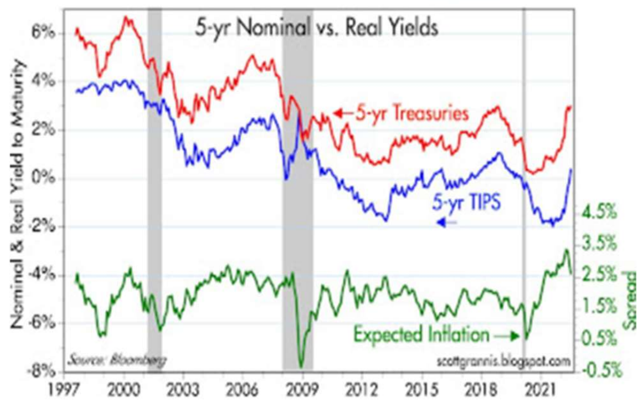

M2 has stalled, central banks are selling assets and the interest rate lever has been pulled hard

The moderation clearly has something to do with a slowly of the rate of growth of M2 as reflected by a reduction of bank reserves. What we are witnessing now is the opposite of quantitative easing (QE). Since April of this year the US Federal Reserve has not only pulled the interest rate lever hard but is now actively seeking to soak up excess liquidity in the banking system by selling government bonds and 'other' securities it owns as part of its quantitative tightening (QT) program. The turnaround in the rate of growth in US M2 in recent months has been equally as dramatic as its meteoritic rise and is likely a contributing factor behind the decline in inflationary expectations. Certainly, if the printing press is turned off, as is clearly now the case, it is fair and reasonable to assume that with a lag, inflation will likely decline also.

….this has resulted, not surprisingly, in talk of heightened recession risk

But the decline in expectations also has a lot to do with heightened recession risk which has gripped markets over the last month or so. Commodity prices have fallen, in particular the price of copper, which is a key leading indicator of global economic activity. The yield curve in the US has been inverted for much of the last month with the US 2year Treasury bond yielding fractionally more than the 10year Treasury bond. Typically, an inversion of the yield curve is the harbinger of a heightened probability of recession. While swap spreads, a key indicator of potential stress in the banking system, have widened they have not widened materially (swap spreads are used widely by market observers as a 'proxy' for bank risk). The chart below is drawn from Scott Grannis' blog of 26 July 2022. It is of US 2year swap spreads.

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A moderate widening of swap spreads - 'pay' interest the driver rather than increased bank risk?

The widening of swap spreads may have more in fact to do with where corporate borrowers including banks think interest rates are likely heading (up?) rather than a broad-based assessment of 'bank risk'. A surge for example, in corporate borrowers paying or selling fixed in the swap (as opposed to receiving or buying fixed) would put upwards pressure on swap spreads. The author recalls a unique period in 1996, when driven by the global credit arbitrage positions created by infamous hedge fund manager Long Term Capital Management (LTCM), Australian 10year swap spreads were priced in yield terms below 10year government bonds! This extraordinary anomaly, a function not of an incorrect assessment of bank and government risk but simply a function of the sheer magnitude of the sold 'short' government 10year bond positions created by LTCM at the time. This serves to highlight that movements in swap spreads are not necessarily truly reflective of risks inherent in the banking system and that other factors maybe involved. As an investor in capital instruments issued by banks this is particularly important to us.

The markets have moderated their interest rate expectations despite the NBER not yet determining if the US is in recession

Indeed, a recession in the US cannot be ruled out – the US economy reported real (after inflation) economic growth of (1.6%) in the March quarter 2022 with the June quarter (released on 28 July) recording (0.9%) annual growth. If we use the widely accepted definition of 2 quarters of negative real economic growth then technically, this means, the US economy is currently in recession. However, with the unemployment rate at 3.6% it is difficult to come to that conclusion (similar to Australia?). Indeed, the National Bureau of Economic Research, a not for profit, entity, that determines whether the US economy is in a recession or not, has not (yet) reached that conclusion. It's interesting to note however, that despite the NBER's reluctance to proclaim a recession the markets are now more sanguine about central bank interest rate increases compared with a month or so ago. In the US the market is now assessing that the Fed fund's rate will be 3% by the calendar year end from 3.75% previously. Similarly, in Australia the RBA cash rate is now predicted to be 2.5% by the year's from in excess of 3% only a matter of weeks ago.

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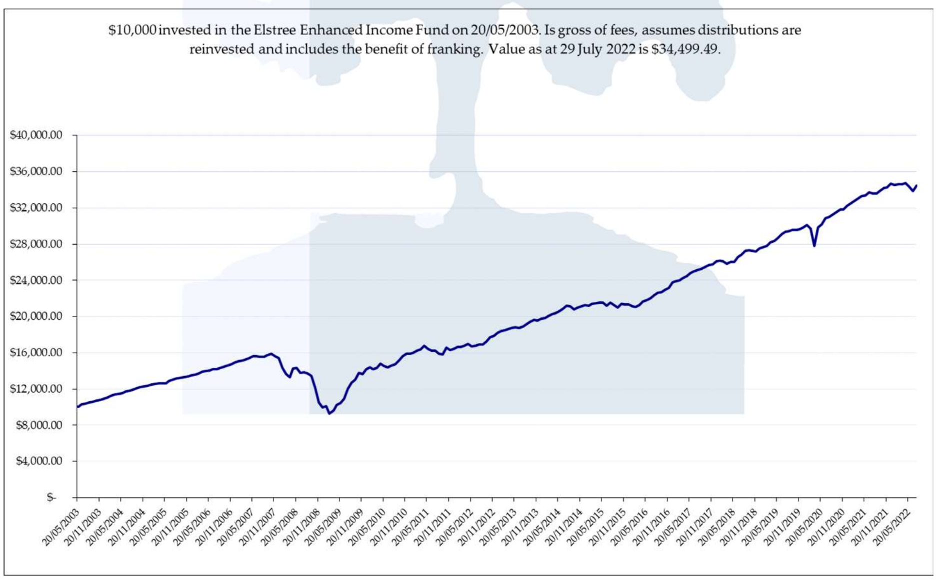
Elstree Enhanced Income Fund portfolio metrics as at (close of business) 29 July 2022

Yield to Maturity	4.50%
Cash yield to maturity	3.40%
Interest rate duration (years)	0.22
Credit term duration (average years)	3.60
Investment grade issuer (% holding)	87.6%
Bank tier 1 exposure (% holding)	41.2%
Value at Risk (VaR)	3.22%

Performance Table	1 month	3 months	1 year	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund *	1.83%	(0.68%)	2.71%	5.50%	6.52%
Elstree Enhanced income Fund (Basis NAV)	1.78%	(0.99%)	1.35%	4.08%	4.89%
UBS Australia Bank Bill Index	0.12%	0.21%	0.22%	0.33%	0.94%
Betashares Hybrid Fund (HBRD)#	1.40%	(1.45%)	(0.30%)	1.98%	n/a

Past performance is not necessarily a guide to future performance. *Is the total investment return. "NAV" is net of all fees and does not include the value of franking. **"()"** denotes negative return outcome. # Source: Betashares. Return is net of fees and does not include the value of franking credits.

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



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