

October 2020 Review – Listed Hybrid Sector

Fund and market performance

The Elstree Enhanced Income Fund's total investment return for the month of October 2020 was 0.67%. This compares with the Elstree Hybrid Index return of 0.33%. In other markets the All Ordinaries Accumulation Index returned 2.08% while the All Maturities Bond Index returned 0.28%.

The creation of jobs is behind the RBA's initiatives

You would have to have been living under a rock recently not to realise that the key to the economic recovery created by the destruction of Covid-19 is to create jobs and reduce the stock of unemployed or underemployed. We have known for a long time that the RBA was almost singularly focused on the rate of unemployment suggesting that a rate as low as 4.5% was the level after which wage and price pressures would begin to emerge. Indeed, we would argue that the RBA was well within in reach of this target before Covid got in the way. Unemployment was 5.1% in February and was predicted to fall in lock stock with the cash rate which was 1.5% at the time. An unemployment rate of 4.5% seems a long way away now with the RBA suggesting in its most recent forecast that it will be above 7% at the end of 2022, a full 26 months from now. This simply means that in the likely absence of price (and wage) pressures, the RBA will continue to ensure that the term structure of interest rates will remain low well beyond 2022 in so doing supporting both household and corporate balance sheets. While the term funding facility would ensure, through incentives, that credit was readily available for small and medium enterprises where jobs will be most likely created.

...but the RBA has been ably assisted in its endeavours by the Federal Government

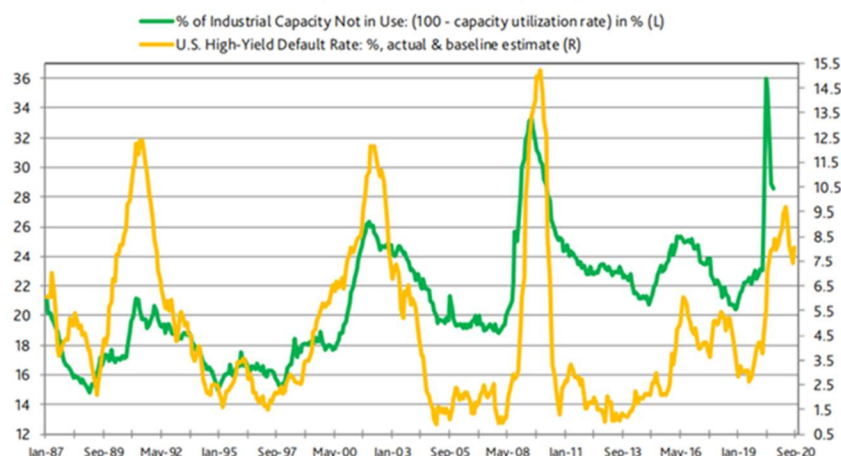
The RBA of course was never going to do all the heavy lifting, the responsibility for that falling fairly and squarely on the governments' shoulders. The Federal Government responded alongside the RBA in March with jobkeeper (JK) and jobseeker (JS) and a raft of other incentives targeted at employers prioritising keeping people in work. It was unsurprising then when the Federal Government handed down the budget on 6 October (deferred from May) it transpired that the projected budget surplus of \$c7billion for FY 2020 never eventuated, instead morphing into a deficit (on a cash basis) of C\$85billion with a projected deficit forecast for FY2021 of \$213billion. The magnitude of 2020's actual deficit and projected deficit for FY2021 were considered by most commentators to be 'fair and reasonable' in the context of the considerable economic damage caused by Covid. The centrepiece of the budget was simply employment and creating jobs by whatever means possible. We know that "JK" and "JS" are being wound back but the government was quick, in the 6 October Budget, to offer cash incentives to employers to employ unemployed persons with the caveat that the persons employed were within a particular demographic determined by age. The immediate tax right offs for capital expenditure items, which are expected to increase corporate profitability and bolster employment opportunities just as the ability to apply tax losses incurred in the 2019/20 to 2021/22 FY's against income earned in the 2018/19 FY (and future years) will. And it simply goes without saying that the government's infrastructure spend will create employment opportunities just as personal income tax cuts will bolster spending creating opportunities in a raft of beaten up industries including retail, hospitality and travel. Economists know just how important job creation is for the economic recovery. As a commentator we applaud the initiatives of both the RBA and the Federal government.

Making sense of utilisation rates

A piece of capital markets research from Moodys on 9 October provided an interesting insight into the relationship between capacity utilisation rates and the default rates of US sub investment grade or high yield bonds. The chart below is sourced from Moodys Research and shows the capacity not

in use (i.e 100% capacity less the capacity utilisation rate) and high yield default rates. The takeaway from the chart is that as capacity utilisation rates increase (denoted by a downwards sloping green line) high yield default rates decline. This makes sense as rising rates of utilisation result in increased earnings and stronger balance sheets which reduces default rates (as an investor in bank capital instruments we are always interested in events that reduce default rate activity). One of the key determinants of utilisation is of course labour. This is particularly true of labour intensive, service economies like Australian and the US (any job creating initiative in the current environment is to be applauded). Another key determinant of utilisation is capital. And we know in Australia exactly what the RBA is trying to achieve by (i) keeping the term structure of interest rates at record low levels (i.e. keep capital costs down) and (ii) through the TFF, distribute capital to small and medium business enterprises. With the government and central bank initiatives designed to influence labour and capital markets we reasonably expect rates of utilisation to increase which will be positive for corporate balance sheets and default rates.

Figure 3: High-Yield Default Rate Moves in Direction Taken by the Percent of Industrial Capacity Not in Use
sources: Federal Reserve, Moody's Investors Service, Moody's Analytics



The US purchasing manager indices (PMI's) are optimistic about the path the US economy is taking

It follows then that if corporate balance sheets are strengthening because of higher rates of utilisation then this should, everything being equal, be reflected in increased economic activity. And so it is, if the closely monitored and highly regarded US purchasing manager indices or PMI's are any guide. Through its series of PMI's, the Institute of Supply Management (ISM) attempts to measure the level of activity in critical sectors of the US economy. The PMI's are "diffusion" indices where a reading of less than 50, in a range of outcomes between '0' and '100', indicates a 'contractionary' outcome while a reading of more than 50, indicates an 'expansionary' outcome. There are PMI's for a range of sectors of the economy including manufacturing, services and health. The PMI's are closely scrutinized by economists and risk investors alike as they are a reliable leading indicator of US economic activity. ISM's PMI's covers employment, business activity, new orders, supplier deliveries, prices, backlog of orders export orders, imports and inventory. The chart below is the non-manufacturing (services) PMI from ISM to October 2020. The grey shaded area denotes US economic recessions.

ISM Non-Manufacturing Index (NMI)

Source: Institute for Supply Management (ISM)



*The PMI
takeaways
are....*

The key takeaways from the chart (and the underlying data) are that (i) the services sector, which contributes approximately 70% to US GDP, is expanding (last 'print' was '57.8'), (ii) the low recorded in April 2020 was nowhere near as low as that recorded in the GFC and (iii) the sector has now recorded 4 months of 'expansion' since May. If you have faith in the ISM non-manufacturing PMI, the US economy is well on the road to recovery.

Westpac & Melbourne Institute. Consumer Confidence Survey.



*Similarly,
with
consumer
confidence
in Australia*

Along the same lines and with a similar confidence level we conclude with a comment on Australia's October consumer confidence survey conducted by WBC and the Melbourne Institute. Despite the heavily recessed economy and the negativity surrounding Covid, the index, released on 14 October, climbed 12% to the highest level since July 2018 (refer chart above). Importantly, an index reading of 105 reveals that a greater number of respondents were positive about the future rather than negative. The survey of 1200 people, conducted after the release of the Federal Budget and amid a backdrop of the possibility of (still) lower interest rates revealed a number of interesting sub plots, the most striking of which was the outlook for the economy, and (would you believe?) job security. Confidence in housing also improved with the 'time to buy' index rising 11%. This is an extraordinary

result and we can only conclude that individuals are feeling pretty damn good about their balance sheets, job security and the prospects for the economy. It's little wonder then, that RBA Governor Lowe in a speech of 15 October was moved to comment (and we are paraphrasing) *now that household and corporate balance sheets are strengthening what were people going to do with additional savings amid a backdrop of lower debt levels?*

Fund characteristics as at (close of business) 30 October 2020

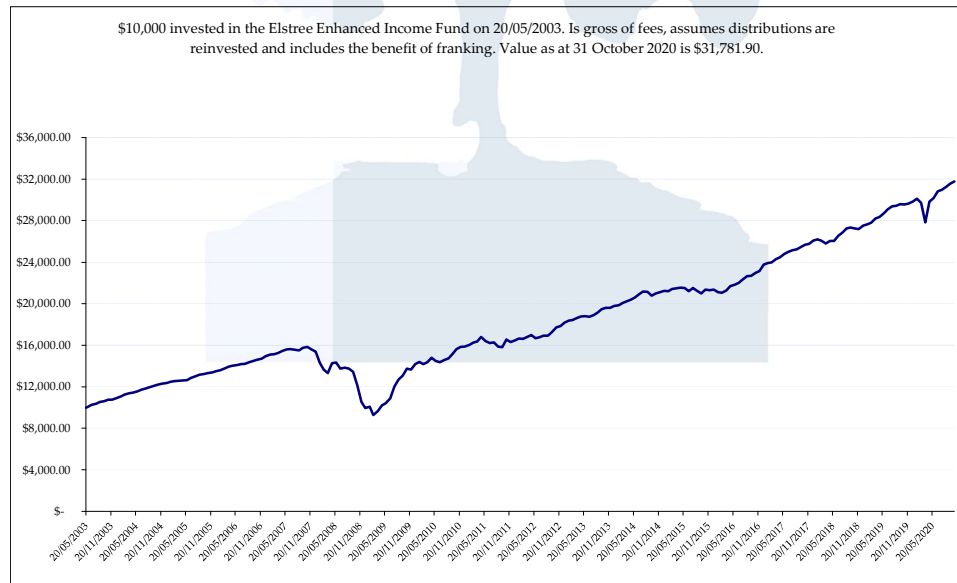
Yield to Maturity	4.00%
Cash yield to maturity	2.70%
Interest rate duration (years)	0.08
Credit term duration (years)	3.49
Investment grade issuer (% holding)	94.0%
Bank tier 1 exposure (% holding)	51.4%
Value at Risk (VaR)	3.40%

Performance Table	1 month	3 months	12 months	2 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund *	0.67%	2.61%	7.52%	7.99%	8.26%
UBS Australia Bank Bill Index	0.01%	0.03%	0.51%	1.08%	1.59%
Betashares Hybrid Fund (HBRD)#	Refer Betashares	1.76% (est)	3.15% (est)	5.10% (est)	n/a

*Returns are gross of fees and include the benefit of franking credits. Past performance is not necessarily a guide to future performance. "()" denotes negative return outcome.

Source: Betashares. Return is net of fees and includes the value of franking credits. "est" – estimated.

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



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