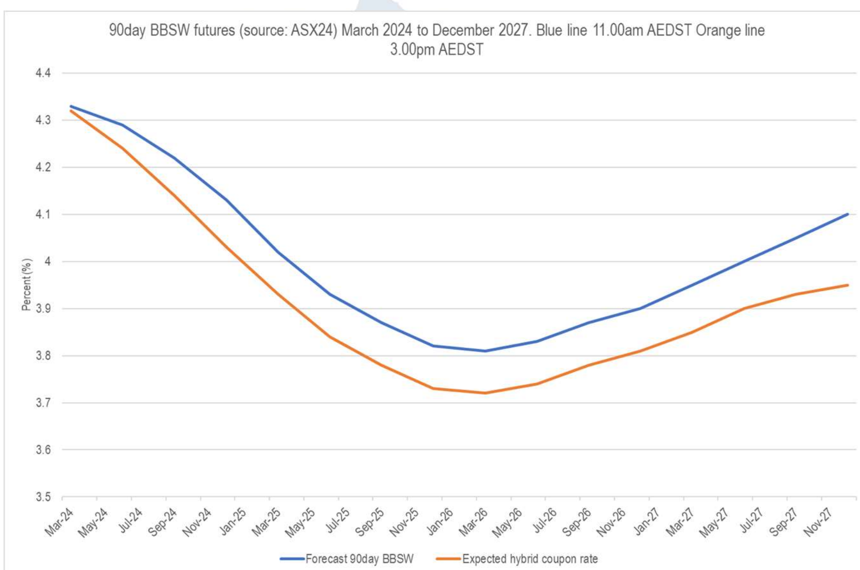
February 2024 Review – Listed Hybrid Sector

Fund and market performance

The Elstree Enhanced Income Fund's <u>total</u> investment return for the month of February 2024 was 0.82%. This compares with the Elstree Hybrid Index return of 0.78%. In other markets the All Ordinaries Accumulation Index returned 1.17% while the All Maturities Bond Index returned (0.3%).
"()" Denotes negative return outcome.

While money markets are uncertain about the exact timing of interest rate cuts in Australia, they are more certain about the quantum – and that is significant, for it says a lot about the probability of recession

We began our December 2023 review and commentary, by saying "what a difference a month makes". When the author was drafting this month's edition, he was thinking of headlining it by saying "what a difference a day makes" in reference to the release mid-month of the US CPI, which, in and of itself, wasn't all that bad, but it was sufficiently bad for risk markets to sell off as investors speculated that the US Federal Reserve would now almost certainly keep rates higher for longer. 10year US Treasury bonds sold off heavily touching a 4month high of 4.3% from 3.75% not all that long ago. Australian risk markets were not immune. Money markets sold off with 90day BBSW – a cash rate proxy – moving sharply higher prompting CBA CEO Matt Comyn to comment that it was unlikely the RBA would cut interest rates until 2025. Futures markets at the time were speculating that 90day BBSW would set above 4% for the next 12 months. And then, out of the blue, Australia's unemployment rate jumped unexpectedly from 3.7% to 4.1% prompting the money markets to once again, price in an interest rate cut as early as September this year. The chart below is of 90day BBSW futures extracted on February 15 from ASX24. February 15 being the day that employment data was released by the ABS. The blue line is the money market's expectation of 90day BBSW at 11am on February 15, the orange line is the money market's expectation of 90day BBSW at 3.00pm on the same day! This serve to highlight that money markets are very nervous as they attempt to predict the timing of when the RBA will likely move to cut interest rates. It is fair to say that the volatility suggests that the collective is no clearer to a definitive answer as to the exact timing. What is telling however, is that the money market are more certain of the quantum of interest rate cuts – just over two 25 basis point cuts - and that is significant for it is speaks volumes about the money market's expectation of recession (i.e a low probability event).



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The RBA is not giving too much away but the ongoing "dialogue" between the government and the central bank will go a long way to determining the timing and extent of interest rate cuts

Of course, we have been around long enough to know that one or two data releases, is not going to change the thinking of the RBA or indeed any central bank. US Federal Reserve voting members continue to talk down the prospect of interest rate cuts in the US in a reminder to risk markets not to get too far ahead of themselves. Similarly, in Australia where RBA Governor Bullock remains firm in her rhetoric even going as far to say that further rate hikes have not been ruled out! While that is highly unlikely in view of the level of economic activity accompanied by the sudden rise in the unemployment rate it provides a clear insight into central bank thinking. Make no mistake central banks communicate with each other all the time. This is evident by the consistent messaging across different geographies. It's interesting in Australia that Governor Bullock continues to make mention of the contribution government policy has made to inflationary pressures. We know intuitively that the rate of inflation correlates with the amount of money available to spend. And Governor Bullock knows that the ongoing infrastructure spend along with income tax cuts due on 1 July 2024 accompanied by a surge in net migration will continue to underpin inflationary pressures. Just how the "dialogue" between the government and the Reserve Bank plays out will go a long way to determining exactly when and by how much the RBA will move on interest rates. While a cohort of Australian households are hurting in the face of a materially higher cost of living not every household is in the same position. Retiree baby boomers underpinned by the riches bestowed on them by higher asset prices are awash with savings which they are investing in money market and interest-bearing accounts. Indeed, it is the baby boomers who are now providing the means for their children to access the residential property market.

Compared with Australia real cash rates are high in the US and the "real" yield curve steeply inverse. While the Fed is certain to cuts rates aggressively the outcome is less certain in Australia

One thing that we pay close attention to and have made mention of previously are real, inflation adjusted, interest rates. The chart below is from Scott Grannis from scottgannis@blogspot.com The chart overelaf details the real US 5year (using the 5year Treasury Inflation-Protected Securities or TIPS, red line) and the inflation adjusted overnight cash rate (blue line). Scott argues that economists and forecasters alike should direct their focus on the shape of the real yield curve as opposed to the nominal yield curve as a predictor of the future level of economic activity. While nominal yield curve inversions come and go, the inversion of the real yield curve is more telling, accurately predicting the last 2 "significant" US recessions (recessions are highlighted in chart below by the grey shaded area). The real yield curve in the US is about 1.0% inverse from cash to 5years. Scott contends (and logically so) that high real yields are disinflationary. This is because households are incentivised (by higher nominal and real interest rates) to hold cash in money market or interest-bearing accounts rather than spend it. Conversely, there is less of an incentive to borrow. While real cash rates in the US are closing in on 3%, in Australia real cash rates are 0.25% (and the real yield curve cash to 5years is quite flat). Perhaps the opposite is true of Australia where there is little incentive at present to save? Governor Bullock and the RBA will be well conversant with real yields and the shape of the "real" curve notwithstanding that interest rate policy in Australia is more of a blunt instrument than it is in the US due to the differences in the term structure of household borrowing.

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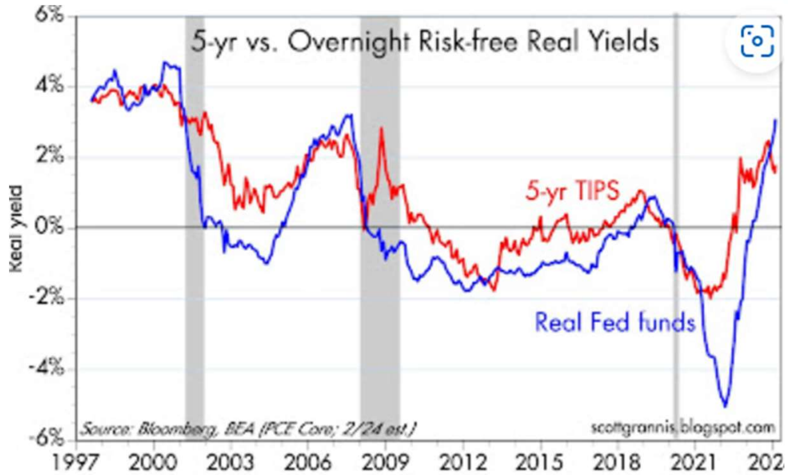
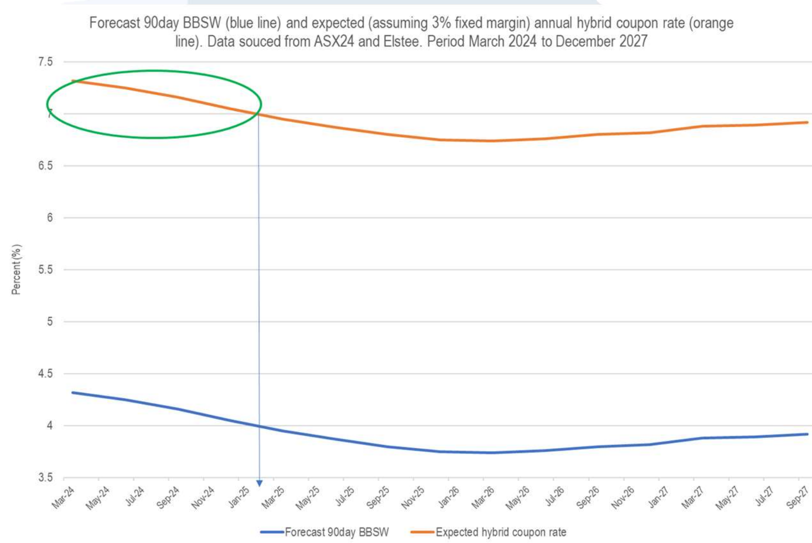


Money markets have been very accurate in their predictions. With only 60 basis points of interest rate cuts now predicted the runway looks clear for investors in floating rate instruments

Without trying to predict what Australia's RBA will do – because that can be fraught with danger - it is best to call on the collective wisdom of the money markets. Over the last 24months the money markets have been eerily accurate with their forecasts. While the money markets are predicting interest rate cuts, they are not predicting wholesale cuts. Indeed, if you were a heavily indebted household, you may well continue to call on the "bank of mum and dad" for some assistance to help make the payments or paydown some principal. While the markets are a little coy about the exact timing they are only predicting an uneventful and uninspiring 60 basis points or 0.6% of interest rate cuts over the next 24months whereupon rates are predicted to rise again! That is nothing to get terribly excited about if you have a variable mortgage, although 60 basis points is certainly better than nothing. Of course, the opposite is true if you are a lender or an investor in floating rate instruments such as hybrids. While we have shown it before the chart below bears repeating and highlights the very reason investing in hybrid capital instruments issued by Australian banks and insurers is so attractive. The data is extracted from ASX24 on 20 February 2024. It shows forecast 90day BBSW (blue line) and based on 90day BBSW forecasts and assuming a 3% fixed coupon margin, the forecast average annual coupon rate (orange line). The forecast annual coupon rate includes the value of franking. The green circle highlights forecast annual cash flows above 7%.



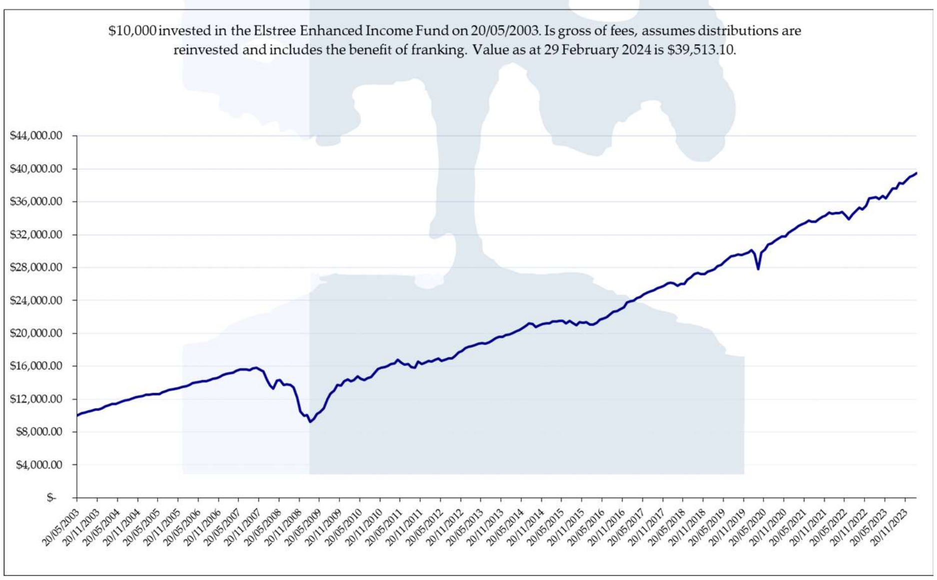
Elstree Enhanced Income Fund portfolio metrics as at (close of business) 29 February 2024

Performance Table	1 month	3 months	1 year	3years p.a.	5years p.a.
Elstree Enhanced Income Fund *	0.82%	2.39%	8.12%	6.45%	7.28%
Elstree Enhanced income Fund (Basis NAV)	0.72%	1.78%	5.60%	4.53%	5.50%
UBS Australia Bank Bill Index	0.35%	1.09%	4.10%	1.95%	1.47%
Betashares Hybrid Fund (HBRD)#	0.71%	1.72%	5.07%	3.31%	3.90%

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.

Yield to Maturity	6.6%
Cash yield to maturity	4.0%
Credit term duration (average years)	3.42
Default cost (per annum)	0.09%
Investment grade issuer (% holding)	94.2%
Bank tier 1 exposure (% holding)	63.3%
Value at Risk (VaR)	3.08%

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



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