Elstree

May 2024 Review – Listed Hybrid Sector

Fund and market performance

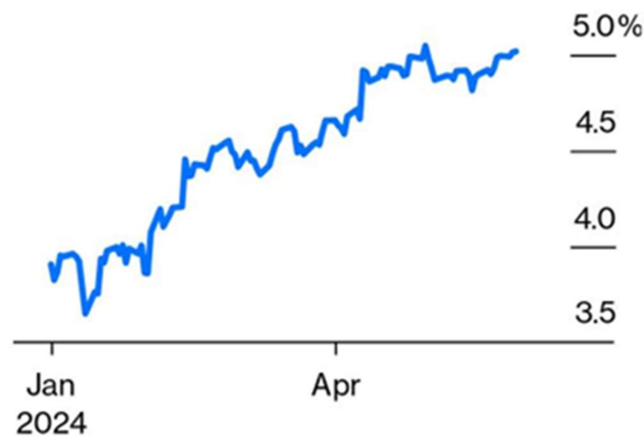
The Elstree Enhanced Income Fund's total investment return for the month of May 2024 was (0.27%). This compares with the Elstree Hybrid Index return of (0.64%). In other markets the All Ordinaries Accumulation Index returned 0.87% while the All Maturities Bond Index returned 0.39%.
"()" Denotes negative return outcome.

The correction we had to have, was long overdue. IPO supply the catalyst

It had to happen. After a 6month run traded spread margins rose marginally and security prices fell over the course of May. The catalyst for the weaker price structure was the $1billion 2032 NAB issue. Competitively priced at 260bps over BBSW the issue is due to pay an annual coupon rate (including the value of franking) over the first 12months of approximately 7%. While the issue was over-subscribed it did create an overhang in the secondary market as investors sold down previously issued securities to invest in the new security. We have been expecting some weakness for a while as the market had experienced an extraordinarily good run since October 2023. Since that time the broader market, as determined by the Elstree Hybrid Index (franked series) returned 5.80%. This compares with the income return over the same 6month period of approximately 3.75%. The difference between the total return and the income return being attributed (simply) to the change in the capital value (i.e 2.05%) of the securities over the period. We welcome the broader market's 0.64% decline over the month as it allows us to reevaluate.

While the key indicators remain the higher for longer narrative remains the underlying driver

We articulated in previous commentaries the (many) reasons why the capital value of securities has risen to the level that it has, and we also explained why it is likely to remain elevated. It's makes sense with central banks trumpeting almost in unison that interest rates will now almost certainly remain higher for longer. As we know the RBA is in no hurry whatsoever to cut rates as indeed is the US Federal Reserve. In support of higher for longer narrative we reference a chart sourced from a note compiled by John Authers in the week beginning 27 May. The chart is the US money market's implied cash rate. It is the markets' calendar year to date estimate, of where the cash rate will be, post the Fed's final meeting in December this year. What the chart is telegraphing is that over the last 5months the market has gone from pricing in numerous interest rate cuts (in January) to just one 25bps cut now (end May). The cash rate in the US currently stands between 5.25% and 5.5%.



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The US Federal Reserve can afford to sit on its hands for a while yet

Despite interest rates being elevated for a long period of time the US economy is "doing just fine" and so the urgency to cut interest rates has diminished. And inflation, while falling is not falling at a fast enough pace so the Fed can afford to sit on its hands. As we know US households are less vulnerable to rate rises or sustained periods of higher rates than their Australian counterparts simply because of Australian household exposure to floating interest rates and what that means for loan serviceability. If you were an existing homeowner in the US, you would likely be blissfully unaware of what interest rates were doing being locked into a fixed rate 30year mortgage materially below the current 30year mortgage rate. However, should you be trying to get into the housing market, that is a totally different story! The chart below is sourced from Scott Grannis at Blogspot.com. It is of US housing affordability.

Despite the US housing market facing a concoction of limited demand and supply and constrained lending the Fed is likely to remain steadfast

Grannis makes some very interesting points apart from the obvious that US housing is as unaffordable as it has been in 35years. Grannis points out that the current 30year mortgage rate is 7.2% - this compares with the average household mortgage rate of about 3.9%. Based purely on a cost of funding, there is little incentive for non-homeowners to become homeowners. Logically, this impacts the demand for housing. While the demand for housing is constrained, so too is supply. Supply is constrained because existing homeowners are reluctant to sell and buy a new property faced with the prospect of refinancing at a much higher interest rate just as builders and developers, cognisant of higher labour, material and borrowing costs are less likely to build and develop. But lenders too are constrained because they are less willing to lend at a fixed rate for 30years understanding that should rates fall the 30year loan, will almost certainly be refinanced by the borrower at a lower interest rate, (this is one of the vagaries of the US banking system – borrowers are not penalised for refinancing with another provider at a lower rate). Grannis points out that this unhealthy concoction is unlikely to persist much longer. While the solution would appear to be obvious the US Federal Reserve is seemingly not willing to pander to a particular cohort of households as it continues to hold firm on interest rates.

The RBA faces a conundrum

Australia is faced with a similar problem in terms of housing affordability only the constituents are different with the majority of mortgages being floating rate mortgages. Clearly, households have been constrained in their consumption as materially higher interest costs impacted household

as its position is diametrically opposed to that of the government	disposable income in 2023 and now 2024. The Federal government recognising the strain on heavily indebted households has moved to ease the pain by granting tax cuts effective 1 July 2024 while a raft of other measures announced in the Federal Budget of 14 May were designed to relieve household stress. Herein lies the conundrum for the RBA, a conundrum, which has its beginnings in the immediate covid period when the RBA set about slashing interest rates to 0.1% and providing excess liquidity to the banking system all the while the government embarked on an unprecedented expenditure program designed to bolster household and business balance sheets. While there was nothing wrong with doing what the RBA and the government did, after all they didn't know what they were dealing with, the conundrum the RBA now faces is that by keeping interest rates higher for longer it is diametrically opposed to the government who is doing its best to stimulate economic growth and bolster constrained household balance sheets.
The money markets and the RBA are on the same page for the first time in a long time and that's a good news story for investors in hybrid capital	It would appear, that for the first time in a long time the RBA and the money markets are broadly in agreement with each other on interest rates, remembering, of course, that in 2022 they were poles apart when the then, RBA governor, Philip Lowe, trumpeted that the cash rate would remain at 0.10% until 2024! The money markets of course had other ideas suggesting that by the end of 2022 the cash rate would be 2.5% which it duly was. While we have shown these charts before they bear repeating. The lefthand chart is of 90day bank bill futures – a cash rate proxy. Data was extracted from ASX24 on 29 May. The last data point on the horizontal axis is December 2027. It shows that 90day BBSW is not predicted to fall below 4% (blue line) at any time over the next 4years. On the same chart we have shown the average expected annual hybrid coupon rate including the value of franking (it assumes an average coupon margin of 3%). Based on 90day BBSW not falling below 4% the average annual hybrid coupon rate is not expected to fall below 7% over the next 4years. And finally, the chart on the righthand side details the difference between the annual hybrid coupon rate (assuming an average coupon margin of 3%) and the RBA's All Terms Average Special Term Despoit Rate. Those with a keen eye will notice it has "ticked" up fractionally over the last couple of months (circled). This is a function of 90day BBSW remaining elevated and the banks competing aggressively in the home loan market and attempting to maintain some semblance of margin by reducing term deposit rates. With banks awash with term deposit funding, term deposit rates were always going to come under pressure and will likely continue to come under pressure. For investors in hybrid capital these charts represent a good news story.

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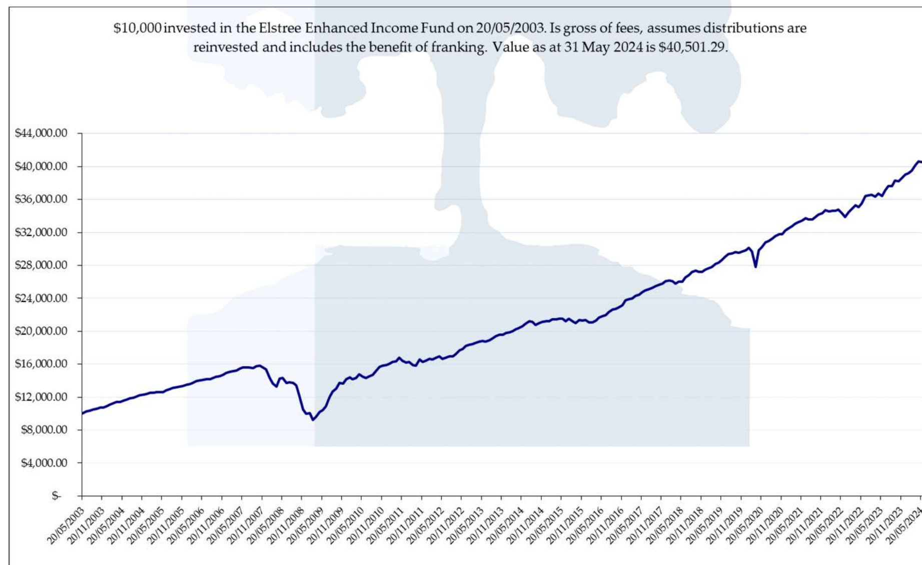
Elstree Enhanced Income Fund portfolio metrics as at (close of business) 31 May 2024

Performance Table	1 month	3 months	1 year	3years p.a.	5years p.a.
Elstree Enhanced Income Fund *	(0.27%)	2.50%	11.13%	6.64%	7.14%
Elstree Enhanced income Fund (Basis NAV)	(0.37%)	1.90%	8.46%	4.65%	5.35%
UBS Australia Bank Bill Index	0.37%	1.10%	4.32%	2.32%	1.60%
Betashares Hybrid Fund (HBRD)#	0.14%	1.60%	7.28%	3.66%	3.66%

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	6.7%
Cash yield to maturity (excludes franking)	5.0%
Credit term duration (average years)	3.69
Default cost (per annum)	0.09%
Investment grade issuer (% holding)	92.0%
Bank tier 1 exposure (% holding)	57.9%
Value at Risk (VaR)	3.18%

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



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