NEWSLETTER

December 2016

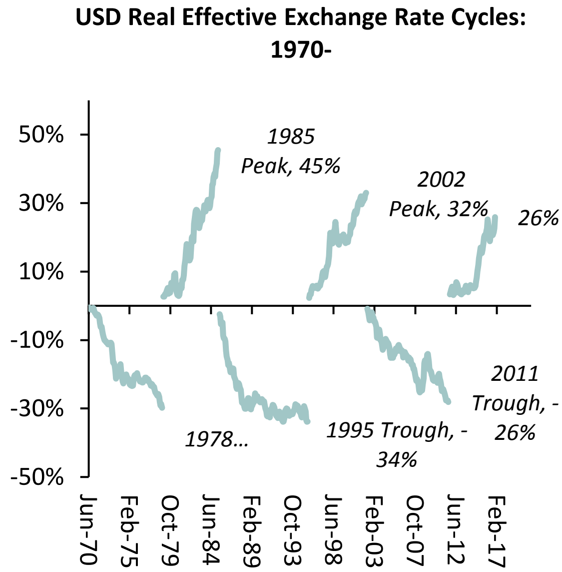
The Fund returned net -0.85% last month, bring year to date returns to -2.82%. In a month dominated by the US Presidential election, Gold was the major casualty, falling 7.9% (monthly volatility is 6% and annual volatility 20%, so such outsized moves are not unexpected, indeed we saw 9% and 10% gains in June and February and near 7% declines in June and November last year).

The Global equity index added 2.7% (local), with the US up 3.7% and EAFE just 1.4%. Most significantly, and an issue we address later, the trade weighted US dollar rose 2.7%, the largest monthly gain since late 2011, and pushed Emerging market equities lower.

In the global financial system, the US Dollar obviously plays a pivotal role, as the currency of an economy accounting for a quarter of global output, the world's largest net debtor currency and the longstanding safe-haven asset. Moreover, there is $10 trillion in non-bank non-US domiciled USD debt outstanding and almost $30 trillion of debt globally priced off USD Libor. In short, the US Dollar matters.

With that in mind, it is interesting to note in Chart 1 that the trade weighted Real US Dollar exchange rate has followed a serious of very distinct cycles since the end of the Bretton Woods exchange rate regime in the early 1970s:

Chart 1



The typical Dollar-cycle lasts about 8 years and we are now just a few years into the 6th cycle in the last 50 years. In our opinion, "excesses" develop in the system during periods of US Dollar weakness and are then purged during subsequent periods of US Dollar strength.

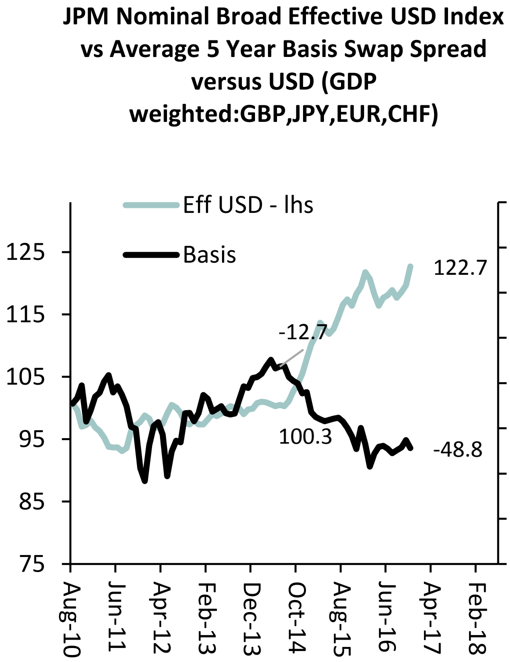
For example, the LatAm debt crisis in the early 1980s and the Asian debt crisis in the late 1990s followed periods of US Dollar weakness. What happens in these periods of weakness? Well, the lower US Dollar encourages non-bank non-US domiciled borrowers to borrow cheaply in US Dollars: leverage grows rapidly during the weak US Dollar years only for that leverage to seed the crisis in the periods of US Dollar strength.

In short, Emerging Market crises have their roots in the US Dollar cycle. A recent BIS research paper ("The Dollar, bank leverage and the deviation from covered interest parity", November 2016, no 592, Avdjiev et al) very neatly explains the nature of the pressures created by the US Dollar cycle in terms of the impact on the cost of debt for borrowers and the impact of leverage on the ability and willingness of banks to continue to supply credit.

In chart 2 we show the relationship between the Real US Dollar trade weighted exchange rate index and the US Dollar currency basis spread (that is the cost of US Dollar borrowing for Americans minus the cost of US Dollar borrowing for Non-Americans, in this case for a weighted average of Euro, Japanese, Swiss and British borrowers. Briefly put, as the basis goes more negative it means the cost of US Dollar bowing for Non-Americans is rising).

The chart shows that the US Dollar has risen significantly since 2014; meanwhile the currency basis has widened significantly, i.e. the cost of US Dollars for Non-Americans has risen as the US Dollar has risen.

Chart 2



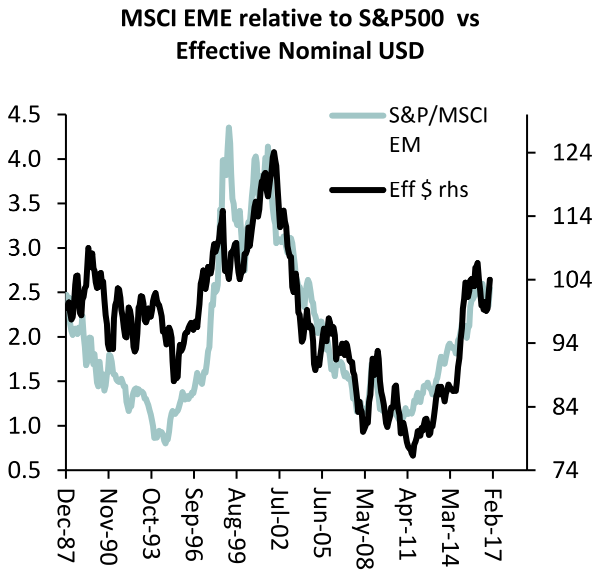
The relationship holds in reverse (i.e. the cost of US Dollars to Non-Americans falls when the US Dollar falls) and this variability in the cost of US Dollars goes a long way to explaining the boom/bust credit cycles in markets heavily dependent on US Dollar credit (Emerging Markets) that follow the US Dollar cycle. Constraints on bank leverage restrain the *supply* of US Dollar credit whilst the widening basis increase its *cost.*

All very interesting, but so what? Well, as the Fed begins a tightening cycle and the US Dollar continues to appreciate, it matters a lot when we have a record $10 trillion in outstanding non-bank non-US domiciled US dollar debt, growing at a 10% annualized rate. Almost $350 billion of that debt must be refinanced in the next 18-24 months.

Remember what just $1 trillion in sub-prime debt "did for" the US and the global banking systems in 2008/9 and you see the scale of the issue and potential consequences of a rise in US rates and material further US Dollar appreciation. With US money base (notes and coins in circulation plus bank reserves) declining at the fastest rate in the post-war period, the underpinnings of US Dollar strength certainly look robust at this point in time.

At the very least, it suggests that Emerging Market equities will continue to underperform for the foreseeable future, at least until the Nominal and Real US Dollar enters a depreciation cycle, as shown in Chart 3:

Chart 3

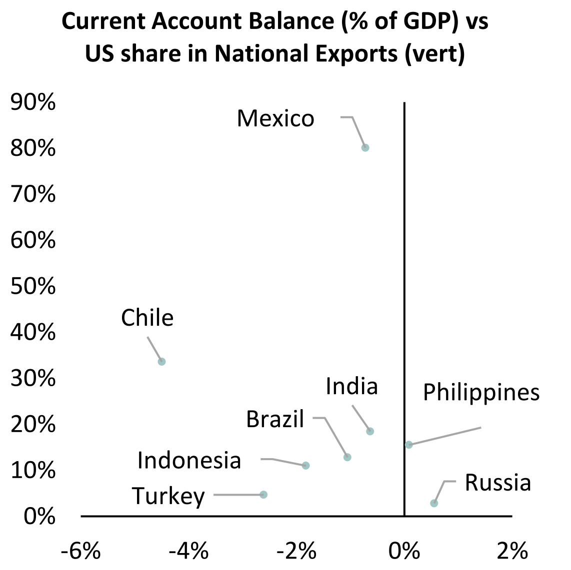


Buy Emerging Market equities when you want to sell US Dollars!

Additionally, given the anti-globalisation rhetoric from the Trump team (and, here, it is well worth keeping in mind "Zito's rule" from last month's letter "the press takes him literally, but not seriously; his supporters take him seriously but not literally") we also need to consider the likely winners and losers from the protectionist path to making America great again.

In chart 4 we show the current account balance (a surplus means a country exports capital and is less vulnerable to rising financial market tensions, and vice-versa) versus the US share in national exports for a selected group of Emerging Markets:

Chart 4



There is clearly only one winner: Russia.

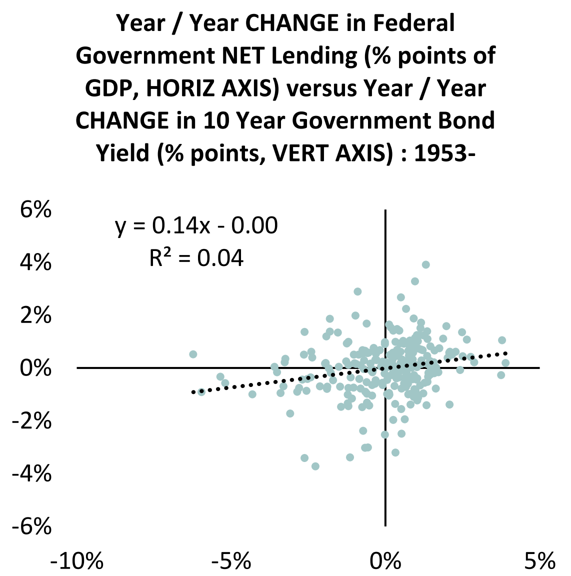
With a current account surplus, the US market representing less than 3% of its exports, an undervalued currency and a cheap equity market it stands to be the big winner in any drift away from globalisation, a point we highlighted many months ago, but is worth repeating. The market has risen sharply in the last year, and strongly in recent weeks, as this realisation builds. Countries with large US Dollar borrowing, largely in Asia and prominently China, are at the epi-centre of the potential crisis.

At the very least it means a much weaker Yuan (*we cannot rule out the possibility of a floating Yuan*) as Chinese capital runs for cover and the authorities there are unable to contain the flow.

Turning to bond markets, high yield debt continues to perform well and offers an equity proxy with less volatility and drawdown risk whilst US treasury yields have risen sharply on fears of "Trumponomics" and large debt financed fiscal stimulus.

A quick look back, as we do in Chart 5, suggests that increases in net government borrowing are not associated with correspondingly higher government bond yields, the same is evident in the UK data as well (simplistic economics textbook models suggest a rise in government borrowing "crowds-out" private sector borrowing and puts upwards pressure on bond yields).

Chart 5



Nevertheless, Treasury yields have risen significantly in recent months. Why? Several arguments have been made, some convincing and others simply fanciful. Beginning with the latter, we do not believe it reflects some "great rotation" from debt into equity: *someone* must own the equity and the debt and the cash in the market, investors hold a lot of debt because a lot of debt has been issued in the last decade. Rotation is a fallacy. It might be Chinese official liquidation, corresponding to a Trillion Dollar loss in Foreign Reserves, as they fight the tide of capital outflows, with new holders of the treasuries only willing to hold them at a more realistic premium (after-all, we cannot imagine the Chinese being the most rational and conservative investors). If that were the case, letting the Yuan go or even float would almost certainly drive US yields lower again. We must be alert to that possibility.

It might be a sudden and material increase in inflation/inflation expectations, but with median Real GDP growth in the Emerging bloc (14 countries with 27% of global GDP) and the Developed bloc (27 countries with 57% of global GDP) at just 1.8% in both cases, the world still oversupplied and the US Dollar strengthening we think that unlikely.

For the time being, we consider Chinese sales the most likely culprit with the extent of the rise exacerbated by “forced selling” from Risk Parity Funds (they allocate *risk equally* amongst assets and so hold a lot of bonds and comparatively little of other assets; when yields rise and bond volatility/risk rises they are forced to sell to keep the risk share of bonds in their portfolio at the target level. This accelerates bond yield moves up and down).

Heading into the New Year we will be watching the US Dollar very closely, its impact on Emerging market borrowers and, specifically, its impact on the Chinese Yuan. In the meantime, we remain fully allocated to US equity, driven by robust absolute and relative momentum against the backdrop of elevated valuation, to high yield and, for the time being at least, to Gold as a crisis hedge. We will respond accordingly as market conditions change.

About MONOGRAM

MONOGRAM Capital Management is an investment boutique founded in 2014 and headquartered in London. The management team has over 55 years of investment management experience, having met and worked together at Goldman Sachs before holding leading investment positions at other institutions.

We take an innovative empirical, evidence-based approach to investing and believe there are fundamental, identifiable, persistent, and exploitable sources of return; risk is the permanent impairment of capital (peak-to-trough drawdown) and not volatility in its various forms.

There are two options for investors to access MONOGRAM’s investment strategy. Investors can invest in the Luxembourg Domiciled MONOGRAM Fund or in MONOGRAM’s bespoke segregated managed account, provided the investors meet the minimum subscription requirements. Further details are contained in the subscription documents to the fund.

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