MONOGRAM

NEWSLETTER *July 2016*

The Fund returned net +1.77% last month, bringing year to date returns to net -0.13%. For the month, the Global Equity Index in Local Currency terms returned -1.3%, EAFE (Non-US developed Equities) lost 2.6%, the US Aggregate Bond Index returned 1.9% and Gold jumped 8.8%. Markets remain very choppy and prone to sizeable monthly moves.

The big news for the month was obviously the somewhat surprising BREXIT result, which has prompted a torrent of commentary and analysis in the last few weeks. Whilst we do not wish to rake over old ground, we will offer a few observations on the economic and market implications of the impending British exit from the European Union, but more of that later. First we want to return to Japan, source of some of our most serious concerns, to ask “What Next?”

We have illustrated the importance of Japan as a driver of global asset prices in previous notes, showing its net international investment position in excess of $3 trillion, 60% of GDP, and its role as the marginal provider of investment demand. A stronger Yen typically drives down US bond yields and in the current environment, this seriously undermines banks in Japan and Europe. The Yen, in our view, is a perfect pulse for global markets. It measures the stress and strain in the system, and as it approached 100 against the US Dollar, policymakers once again returned to the Mario Draghi “whatever it takes” playbook. Measured per capita or per worker, at current or purchasing power exchange rates, Japanese GDP growth has, perhaps surprisingly, been comparatively strong in the last decade or so. This is despite (or because of) its persistent deflation and sclerotic nominal GDP profile. For example, Japan’s real GDP growth per worker has been almost double that of France and Germany since 2000, and only modestly slower than that of the UK. Deflation has clearly not been a terrible burden, nor has zero nominal GDP growth in the last 20 years. But this points to the very nature of the “Japanese problem”: put deflation alongside working population contraction and you get a good picture of what ails Japan. It is not a lack of monetary liquidity (we have shown that banks are drowning in liquidity), but a lack of people.

The Japanese working population, aged 15-64, peaked at 87 million in 1993 before falling to 77 million today (where it was in the mid-1970s). It has declined 0.5% annually since 1993 and at an annualised rate of 1.2% in just the last ten years. With investment and GDP globally at the highest levels in more than three decades, trending up in the “low cost” developing world and correspondingly down in the “high cost” developed world, there is little incentive to add more capital in Japan. Consequently, with the labour stock shrinking, the direction of Japanese potential real or nominal GDP growth appears to be irresistible.

Strength in the real GDP growth per worker would suggest that such a demographic drag should not, ordinarily, present a problem. Who cares if the economy in aggregate is going nowhere when each individual is becoming better off? It has raised the question “Does Japan need to grow?”. In our view, the answer is found elsewhere, in the horrendous state of public finances. The total stock of Japanese government debt, 30% of which is currently owned by the Bank of Japan with its balance sheet now at 80% of GDP, is just shy of Yen 1.1 trillion, or 20 * government tax and stamp revenue. With a surplus of domestic savings, reflected in a structural current account surplus, that stock of debt and large flow of new debt has been readily financeable at real rates that have been extremely rewarding for domestic buyers. However, with yields now negative out beyond ten years and a substantially less attractive real yield on offer, cash hoarding by otherwise keen domestic JGB purchasers pushed the Bank of Japan into the arena as a buyer of last resort. It now buys the net flow of new debt in its entirety and is eating rapidly into the stock of accumulated debt. It might be considered that this is not a problem, but, and there is always a but, it gets to the heart of the steps the Japanese authorities should take to stabilise public finances. From a starting point of a near 6% primary (non interest) budget deficit and 135% net debt/GDP ratio, a fiscal policy tightening of approximately 4% would be needed to stabilize that debt ratio at current real rates, assuming 1% real GDP growth per annum can be generated. When you bear in mind that Japan has managed just less than half that rate of growth in the last decade, the enormity of the task ahead becomes clear.

So, what options are open to the Japanese Government and the Bank of Japan?

- They could just continue under the veil of "Abenomics": becoming individually better off but within the context of ever declining and ageing population. The Bank of Japan accelerates its buying of government debt until it owns all debt and buys all new debt, until in effect there is no Japanese debt market. Cash holdings in the economy explode, banks implode and capital eventually flees. The central bank cancels the debt it holds and the monetary overhang becomes structural and permanent. This is probably not their preferred path.

- Alternatively, with the kind of tortured logic and cognitive dissonance only Nobel Laureate economists seem capable of sustaining, they could suggest that they were on the right path all along, but their communication needed clarity regarding whether or not liquidity was permanent. The same economists who see no role for banks seem to believe that the source of the problem is "poor and unclear communication of policy intent". We would think that a Bank of Japan balance sheet at 80% of GDP and rising (containing 30% of the government debt stock), Yen 300 trillion of excess bank reserves at the Central Bank (60% of GDP) and rising and cash in circulation at 18% of GDP and rising are all obvious statements of intent. It is unclear what benefits could be gained from a policy official issuing a press release saying "This is permanent."

- The underlying problem of demographic could be tackled. Immigrants represent just 1.9% of the Japanese population, versus about 11% in the UK, France and Germany and 14% in the United States. Net immigration has been -1 /+1 per 1000 of population for the last three decades. The economy is in trouble, it is disappearing; the natives are ageing and dying and they are not being replaced by immigrants.

The Yen has weakened in recent weeks following prospects of the announcement of further measures to tackle deflation and drive the Yen lower. This potentially underpins some of the more recent bullish sentiment in the post-Brexit markets. The Yen has fallen 4% from the low immediately after the BREXIT result, and is now back at early June levels. Very recent Yen weakness seems contingent upon the forthcoming announcement of additional measures – point two above being amongst them – intended to boost growth and drive the Yen lower. The likely tweaks and additions to the existing policy stance will do little to turn things around, and the Yen should resume its strengthening once this period of optimism passes and fundamentals once again take hold. Pushing rates more deeply into negative territory weakens a banking system already in trouble, while buying more ETFs reduces liquidity further, and buying more JGBs gives banks more cash to worry about. Right now, we can't see any policy measures that do not make the situation worse, aside from a re-run of the "shopping coupons" scheme of 1999 on a much bigger scale, but even then the effects are transitory. As before, Yen strength will bring back into focus the problems in European and Japanese banks and the anaemic pace of global growth.

In the meantime, the average P/Forward E ratio in the US S&P500 is now at the 89th percentile and the median P/Forward E ratio is at the 99th percentile over the last 40 years, whilst the median P/Sales ratio is at the highest ever level. On reliable, and amusingly unreliable, measures of valuation the US equity market is now at stratospheric valuation. All of this on QE and the hopes for more QE. Following robust recent US employment data, it is worth remembering at this point in the current cycle that US real GDP growth annualised 7.8% in the quarter before the bubble peak in 2000, with 250,000 plus monthly payroll gains. The fastest quarter of real growth this millennium tipped the market over the edge in 2000. In the second quarter of 2000, just weeks before the crash, the economy could really not have looked better.

Against this backdrop, Gold and US Investment grade bonds remain very appealing in our opinion, as general momentum remains mixed to poor.

Lastly, we were somewhat concerned by the response of the Bank of England in the days after the BREXIT vote, especially the decision taken to cut the counter-cyclical capital buffer requirement. On the same day that the Bank of England Governor highlighted excessive leverage in the Household sector, he cut capital requirements and encouraged banks to lend more. Surely we are not the only ones puzzled by this contradiction. The UK private sector has a 1.7% of GDP financial deficit, the largest in many decades, the only major economy with such an imbalance. The UK economy is one of the most leveraged on earth and the average house price is 5.7* average income (a staggering 10.3* in London and 8.4* in the South East region). Perhaps now is not the time to be thinking about giving banks the ability to create up to £150 bn of credit (or 8% of GDP), if you believe the Bank of England's fanciful 26* "credit multiplier" assumption. With a record current account deficit, the public and private sector in deficit, and record valuations in real estate (to which the banks still have excessive exposure). It seems like Draghi, Yellen, Carney and Kuroda believe that a lack of liquidity truly is the "binding constraint" holding back the global economy. When your mandate is generalized price inflation, held down by the most enormous exogenous supply shock in history, and the interaction of asset prices and bank balance sheets are irrelevant, then you have every incentive to keep on with the "same old same old". The problem is that the consequences will be the same as those following the 2000 and 2007 bubbles, but this time monetary policy may well have exhausted its possibilities. The stage is set for the return of fiscal activism: the new British Chancellor, Philip Hammond, has hinted at such a possibility and we would expect similar sentiment to emerge in the US after November's Presidential elections. After all, if a government cannot find any real economy projects that pay a nominal return over ten years greater than zero in Germany, 1.5% in the US or 0.8% in the UK then we really are in trouble.

In the meantime, given market momentum, valuation and fundamentals, our fund remains cautiously positioned and resistant to the abrupt drawdowns that have been experienced at intermittent periods. These have, to date, been limited by central bank intervention but may prove more damaging and irresistible as excesses build.

About MONOGRAM

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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.

For further information on MONOGRAM or to invest, please contact Milena Ivanova on **milena.ivanova@monograminvest.com** or **+44 (0)7931 776206**.

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