MONOGRAM

*NEWSLETTER* *April 2015*

The MONOGRAM Portfolio returned -0.57% for March 2015 bringing the 2015 year-to-date performance to +1% (net). All major asset classes sold off over the course of the month, sometimes abruptly. The GSCI Index, a broad measure of commodities performance, lost 5.8% while the MSCI World Index and the Bloomberg Global Investment Grade Bond Index finished the month at 1.5% and 1.2% lower, respectively, than at the end of February. Meanwhile, asset class volatility has shifted upwards, with the GIVIX Index (a measure of overall asset price volatility compiled by financial firm 36 South) having doubled in value since the summer of 2014. This reflects the increased nervousness amongst investors in regards to the growing tension between the valuation of financial assets and the somewhat mediocre state of the underlying economies.

More than 6 years after the collapse of Lehman Brothers, the global economy is indeed still healing. Real growth has only been around 3.5% vs. a 20-year average of 5% according to the World Bank. This lack of dynamism is perhaps most obvious in the general absence of price inflation. Economic expansion normally comes with increasing prices as factors of production adapt with a lag to additional aggregate demand. As of the end of 2014, approximately 3 out of 4 countries were showing negative annual producer price inflation (i.e. deflation). This proportion has been increasing steadily since the beginning of 2011, when virtually the whole world was showing some degree of price expansion (see Charts 1 and 2).

Deflation is bad for at least three reasons. The first one being when people expect falling prices, they are less willing to spend and less willing to borrow, which is of course a headwind to growth. Secondly, falling prices increase the real burden of debt, with borrowers transferring more of their wealth to lenders. This, unfortunately, as shown by Yale professor Irving Fisher, is not a zero-sum game as borrowers have to cut their spending while lenders will not necessarily increase their consumption. Finally, salaries generally do not follow prices downwards. This effect, which economists call nominal wage rigidity, means that the costs to companies increase in real terms, depressing growth further.

Meanwhile, financial assets have been doing just fine. The MSCI World Index, a measure of how equities perform globally, has generated a total return of approximately +150% since the beginning of 2009. The price-to-sales ratios of equities, historically the best predictor of future performance, are reaching all-time highs in the US, indicating that future returns are likely to be depressed. Meanwhile, bonds have returned +30% over the same period. In addition, prices have gone up so much that approximately a third of government securities in the JPMorgan Global Government Bond Index are now trading at a negative yield; as an investor, you are now paying rather than getting paid to lend money.

The dichotomy between the real and financial spheres essentially sums up the conundrum that Central Banks are currently facing. Having accumulated a net $10 trillion of financial assets over the last 10 years, banks have favoured lax monetary policies. They have essentially created large sums of money in an attempt to stimulate activity. However, this has only had a limited impact, if any, on the real sphere as the increase in base money has been matched by a corresponding decrease in velocity. So while there is more money, it circulates less fast. The net effect to economic activity, while difficult to measure effectively, has probably been close to zero. This stands in contrast to the financial economy, which we now know has been the main beneficiary of the whole exercise. This disparity has widened so much that financial and real assets are now showing clear signs of flirting with bubble territory. If logic prevails, central banks should be less accommodative, since accommodative policies have had no net effect on the real economy while financial assets have been over-heating. Perhaps for this reason, the market is pricing a 70% probability of higher interest rates in the US by September of this year.

At MONOGRAM, we do not think central banks are ready to raise rates. History shows us that monetary policies tend to favour the interests of the financial sphere. This bias can take many forms, one of which is printing money. Money creation is necessary as the money in circulation should track the amount of wealth and activity in an economy. However, over the last 30 years, the US GDP has only grown at a real rate of approximately 2.5% per annum, while base money has grown by at least twice the amount. Since banks are the main channel of capital allocation in liberal economies, they have been best positioned to be a major beneficiary of the process. Unsurprisingly, the financial sector now represents 16% of US market capitalization vs. 8% in 1990. According to Forbes, a quarter of the world's billionaires have made their money in finance (33% if we include real estate), with these findings generally extending to all the G7 countries. In short, while the financial sector is still a major influence, banks will prefer accommodative policies.

In addition, central banks and the US Federal Reserve might be suffering from cognitive dissonance. This behavioural trait, which we believe is everywhere in practical finance, means that information conflicting with current beliefs tends to be ignored. A common belief of central banks maintains that accommodative monetary policies and inflation are tightly linked – even if the most recent evidence strongly suggests otherwise. So if tightening means less inflation, let's not tighten.

This leads us to cautiously believe that the investment backdrop for equities and bonds is still reasonable. We have, however, switched a portion of our equities portfolio from US equities into non-US developed equities (mainly Europe and Japan). Our growth component is now equally invested in US and non-US developed equities. We have hedged the currency risk of non-US equities as we believe that the US Dollar is likely to outperform all major currencies. The balance of the portfolio (approximately half of total assets) remains invested in US investment grade bonds.

**Chart 1: Price Inflation in a Sample of 34 Countries**

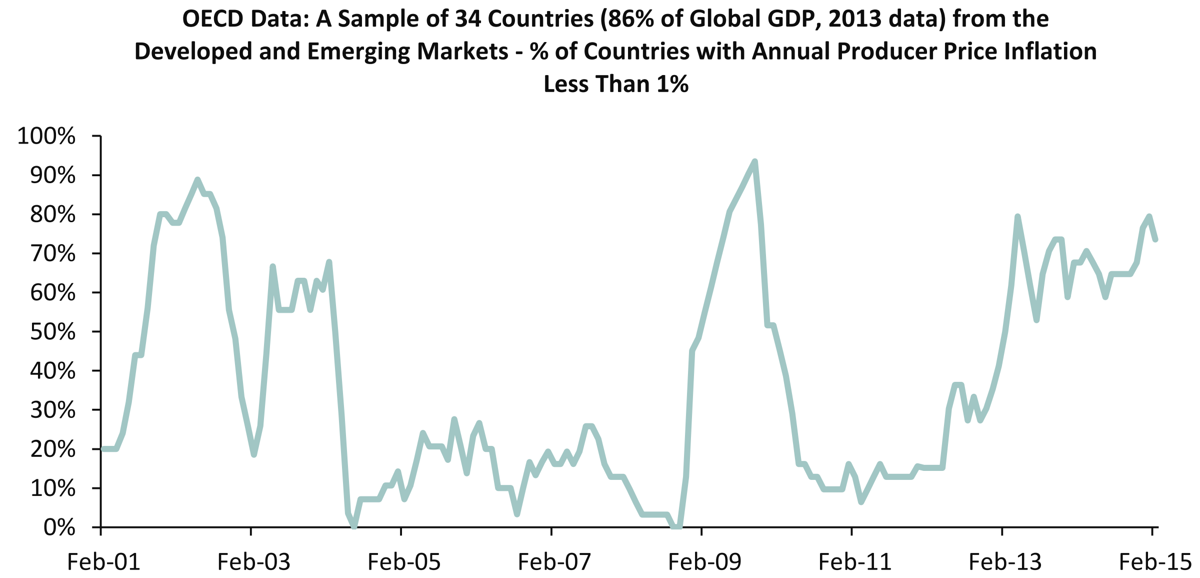
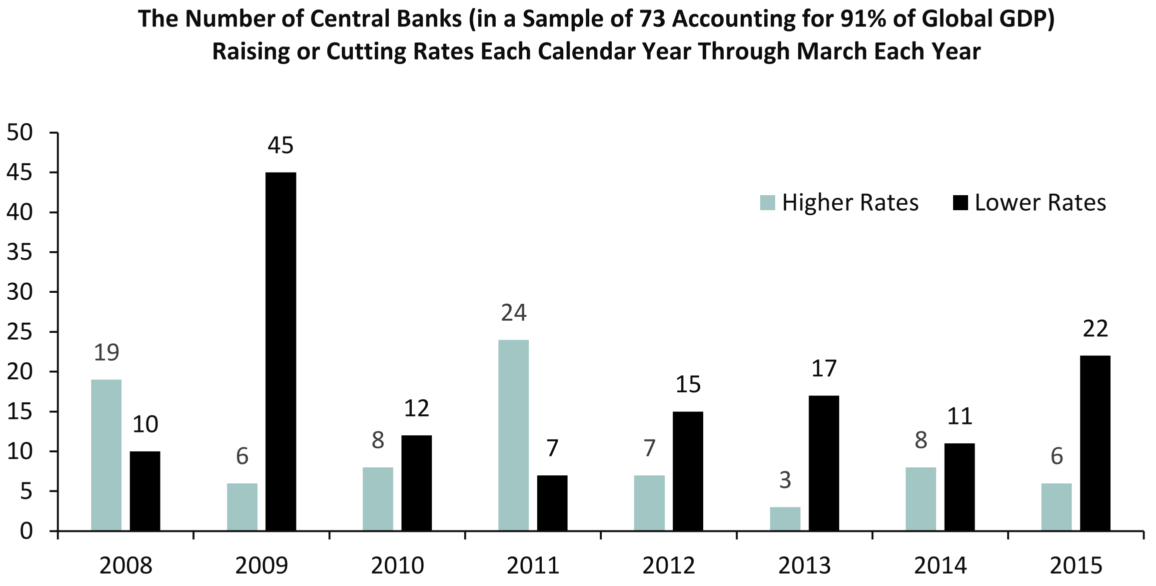


**Chart 2: Number of Central Banks Raising or Cutting Rates per Calendar Year**




## 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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