MONOGRAM

NEWSLETTER *April 2016*

The MONOGRAM Portfolio came through an extremely challenging first quarter in asset markets comparatively un-scathed, up 0.57% in March bringing year-to-date performance to -1.39% (net) with a benign 3.40% peak-to-trough drawdown (against the backdrop of, for example, the biggest swing in the Dow Jones Index since 1933). The absence of any equity exposure for much of the period, particularly important in the EAFE (non-US Developed) region where returns were especially poor, and our defensive positioning in Investment-grade Bonds and Cash obviously helped performance. Our readers should well understand our underlying fundamental view of asset prices and risk premia and patterns of absolute and relative asset price momentum appear to be turning to reflect those views more clearly.

In this month's newsletter we want to take a closer look at corporate profitability and the sources of equity returns. We also will try to explain the apparently puzzling strength of the yen ("puzzling" on the basis that the country is contracting, in structural deflation, has China as its major trading partner and has a government debt stock that is twenty times government tax receipts and debt service eating up over 40% of those receipts).

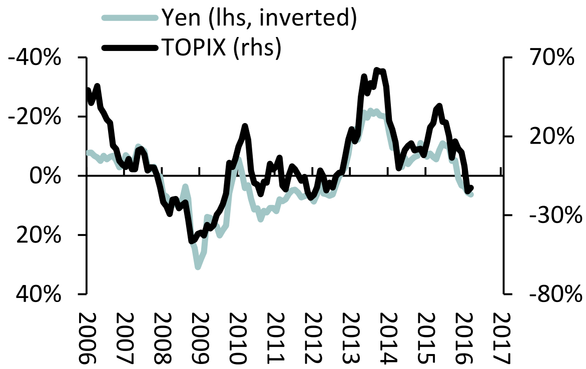
The nominal effective yen exchange rate index (the yen against its weighted basket of trade partners) has appreciated almost 6.5% in the last year whilst the yen has appreciated almost 9% since its peak last summer (of course, as we have noted previously, it has appreciated close to 20% against the yuan in the same period). How do we square this appreciation with the indubitably dire domestic state of Japanese finances and the economy? Simple, Japan is the world's largest net creditor. Japanese savings are the largest provider of liquidity in global financial markets, the net private sector *stock* of overseas assets amounts to 60% of Japanese GDP (that is approaching $3 trillion at current exchange rates). Japanese savers have swallowed up vast overseas assets in recent years (the private sector net investment position has gone from 20% of GDP to 60% of GDP in a decade). When analysts talk of the fabled "yen carry trade (investment positions in global asset markets financed in yen)" the positions taken by *domestic* Japanese savers absolutely dwarf anything in the hedge fund community. When you run a large, and rising, current account surplus and are the world's greatest net savers, your investment decisions have the power to move markets from Birmingham to Brisbane and everywhere in between. In short, the risk appetite of Japanese investors sets the tone for global risk premia. On the other side, of course, the US is the world's largest net debtor.

So, put yourself in the shoes of Mr. and Mrs. Watanabe, an average Japanese couple. You are ageing faster than feels comfortable, you have saved and continue to save hard, Japanese banks offer nothing for deposits (remember that Japanese households keep a remarkable 55% of their financial assets in cash) and the once attractive real yield on government bond funds is but a far distant memory. What do you do? You look around for more attractive alternatives to domestic assets; you look for foreign assets and your local bank is more than happy to provide a plethora of choice of the exotic and baffling structured products that only Japanese bankers could sell with a straight face. We highlighted in previous analyses that the dominant theme in this current cycle would probably be the unwinding of the near $6 trillion in net capital inflows into emerging markets. Where do you think those inflows came? Yes, as the world's greatest savers and largest net asset holders, Mr. and Mrs. Watanabe supplied their hard-earned savings (that is abundantly clear in the surge in the net foreign investment position detailed above). The Japanese private sector swallowed up enormous amounts of overseas assets; they supplied the capital that fuelled growth in many parts of the world.

Now, wind forward a few months/quarters and the world starts to look a little different. China now sits on the verge of the bursting of the greatest debt bubble in history (and is your largest trading partner), emerging market growth has stalled and credit concerns are mounting, commodity markets are mired in structural overcapacity/oversupply and facing far more modest global demand growth and global credit market debt is at record levels. What do you do? Well, it appears that the Japanese private sector is doing what it has always done at times of stress in global markets – it is "returning to base". Whilst it makes absolutely no sense for an American, British or Bulgarian to buy yen as a "safe haven" trade, for a Japanese creditor with a natural home country bias (you have predominantly yen liabilities after all) it makes enormous sense. *We think, just in the same way that **domestic** investors are driving the capital outflow in China, **domestic** investors are driving a capital inflow in Japan.*

To see how Japanese domestic investor appetite for yen has a broader impact on equity markets, **Chart 1** shows the change in the nominal effective yen index against the change in the TOPIX equity index. There is a clear and strong relationship there, unsurprisingly, with yen strength pressing hard upon the equity market (as a general rule of thumb, there is a 2.5:1 link, a 1% appreciation in the effective exchange rate corresponding to a 2.5% decline in stock prices). In accordance with the "flight" response, the yen has, puzzlingly for many, appreciated when storm clouds have gathered over global markets.

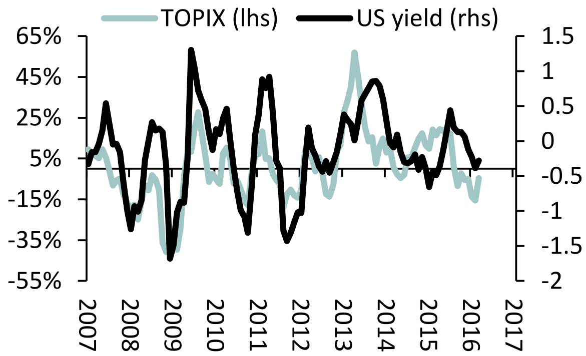
Chart 1. Nominal Effective Yen Index (%y/y) vs TOPIX Equity Index (%y/y)



A stronger yen obviously implies higher costs for domestic producers and correspondingly lower earnings and, as we have shown in our blog, it puts considerable downward pressure on Japanese core inflation. In short, "Abenomics" suffers horribly when global markets are under pressure. Indeed, if we look at the US equity index *in yen terms* the correlation with the Japanese TOPIX in the last ten years is 0.9. It seems as though Japanese investor risk aversion pushes the yen up, the TOPIX down and the US market down.

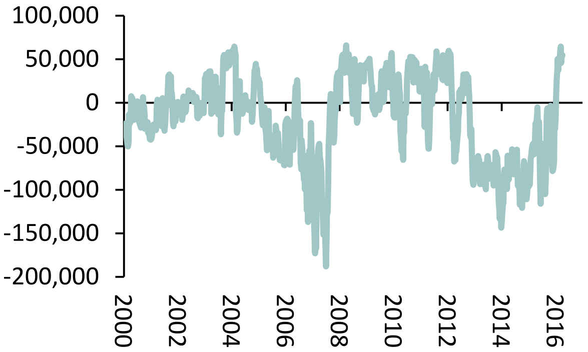
Moreover, the link of "Japanese investor risk aversion/stronger yen/weaker TOPIX/weaker US equities" to the US Treasury Bond market is seen in **Chart 2**. It shows the six-month change in the 10-year treasury yield alongside the six-month change in the Japanese TOPIX index. A stronger yen helps push US treasury yields lower.

Chart 2. Six-month % Point Change in US 10-Year Government Bond Yield vs Six-month % Change in TOPIX Equity Index



In our opinion, this channel of events is vital in understanding the recent yen strength and the picture in **Chart 3** that shows the net long yen position of "non-commercial accounts", i.e. speculators, on the CME close to record levels.

Chart 3. COT non-Commercial Long Yen Futures (USD per contract) Less Short Yen Futures (USD per contract)



The recent swing looks uncannily similar to that seen at the end of 2007/early 2008 just prior to the meltdown in global markets (and the reverse of the liquidity-driven bullishness in the period 2004-2007 and 2012/2015).

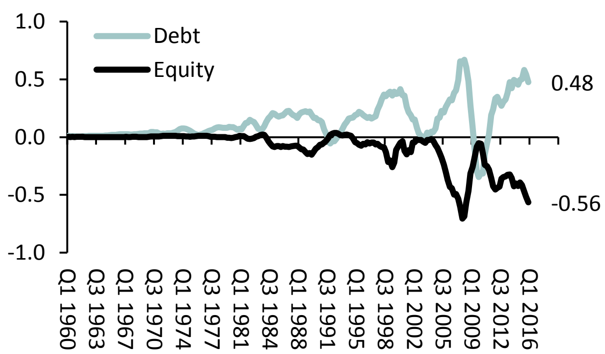
It will bear careful observation, but we think, perhaps, that the yen (and the TOPIX and US treasury yields) might just be the "canary in the coalmine". Unchecked, yen appreciation (and the correspondent decline in the TOPIX) might just be the catalyst for a marked decline in global equity markets.

Certainly, as deflation takes grip, the economy weakens and the TOPIX suffers, the Bank of Japan will have to do something. As "Abenomics" is seen to be a dreadful failure, the central bank will do what all central bankers appear to be doing (Draghi included) - they will panic and continue down the only path they face, more QE and more balance sheet expansion. However, as we argued in a recent newsletter and in our blogs, all of that liquidity from QE (that currently amounts to a mind-boggling 15% of GDP annually) just piles up in the current account (excess reserves currently amounting to a whopping 55% of GDP and rising rapidly) at the Bank of Japan. The velocity of money then declines proportionally and the Bank of Japan just ends up adding to the near 30% of the outstanding debt stock it already owns. Besides the distortion to the "risk-free" reference rate, and consequent mispricing of risk, holders of Japanese government bonds i.e. pension funds, banks, and social security funds lose the assets that defease their liabilities, adding to their difficulties. Pointless, futile, wishful thinking, call it what you like, but we doubt even "nuclear QE" in Japan could move the dial far on the yen right now.

Put yourself in the shoes of Mr. and Mrs. Watanabe again, bank profitability gets destroyed by negative rates, you pay the government to hold their exploding debt stock and you pay the banks to look after your hard-earned savings. What would you do? That's right, you'd buy a bigger bed, and stuff the mattress with bank notes. All that before the Chinese bubble truly bursts. The hoarding of cash balances outside of the banking system is a serious and significant threat both to the economy and to the stability of a comparatively fragile financial sector. One more reason to worry.

Lastly, we want to highlight one recent development that appears to have gone comparatively unnoticed, namely the sharp decline in net debt issuance in the US non-financial corporate sector in late 2015 (and almost certainly continuing into this year). Over the last twenty to thirty years, US companies (and private equity firms) have become quite skilled at issuing credit market debt and buying back corporate equity, as shown in Chart 4. In fact, there have been several large debt/equity swap waves over that period. In the last year US non-financial corporates disbursed $584 billion in dividends and repurchased $564 billion in stock – stock repurchases effectively doubled the dividend yield on US equities and improved returns materially. Now, look at the chart closely and you can draw several important conclusions:

Chart 4. Rolling One-year Net Equity Issuance vs Net Credit Market Debt Issuance for the US non-Financial Corporate Sector (SUM, $trn)



Firstly, each wave of debt/equity swaps clearly defines a market cycle. The swap trade peak marks the peak of the 1987, 2000 and 2007 stock cycles.

Secondly, each wave also defines a peak for private equity activity and, as a consequence, a trough for private equity vintage returns.

What is happening? Well, simply, earnings per share are the product of book value multiplied by the return on equity (RoE) and, in turn, the RoE is simply the product of net profits on sales, sales on assets and assets on equity. That is to say, the final term, “leverage” is an important component in earnings generation for the financial engineers in many private equity firms and for companies in general. Swap equity for debt, increase leverage and the RoE and you have higher earnings per share. Voila. Increase the price of the stock to bring the price/earnings ratio back up and you have an instant profit.

However, net debt issuance declined to $214 billion (annual rate) in the last quarter of 2015, the lowest level since early 2012, and we expect that weakness to have extended into the early part of this year. With earnings per share in the S&P500 down 1.9% y/y in March and net profits in the non-financial corporate sector ending last year down 19% y/y (down 6% excluding the energy sector), a marked decline in net debt issuance only points to further weakness in earnings and a lower supplement to dividends. A recent blog highlighted the sharp rise in the labour compensation share of corporate income, from historical lows, and the pressure on profit growth from margin mean reversion and the possibility that the latest debt/equity swap wave may have peaked adds to the headwinds for the US market. You might also say that the risk aversion of Japanese creditors ties in nicely with the weaker issuance of net debt by US net debtors.

Our fund remains extremely cautiously positioned, essentially short Equities and long Gold and Investment-Grade Bonds. The addition of Gold exposure, for the first time in several years, reflects improved absolute and relative momentum, consistent with heightened stress emanating from a stronger yen, deteriorating prospects for equity markets and continuing concerns surrounding credit conditions in Europe and Asia.

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.

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