MONOGRAM

NEWSLETTER *August 2015*

The MONOGRAM Portfolio returned 1.7% net in July, bringing performance since inception (the 27th of January 2015) to +0.2% net. Despite turmoil in the Chinese equity market, continued weakness in gold, commodity prices and the "on-off" saga that is the Greek solvency debate, the Portfolio has remained as resilient as expected and continues to be defensively positioned at this point in the cycle.

After a $10.5 trillion (15.6% annualised and approximately 15% of starting global GDP) balance sheet expansion by the major central banks since the start of the crisis in 2008 and a period of convergent monetary policy that has left 38% of the 73 central banks we monitor with rates below 3% (and a record 27% with rates below 2%), we now enter a possible phase of policy divergence for the first time in a decade or more. Whether it be motivated by inflationary worries arising from a comparatively low unemployment rate (we doubt that given the absence of any relationship between the unemployment rate and price inflation in the historical data set and the pervasive overhang of global productive capacity) or robust growth (again, we doubt that given the trivial 2.1% annualised growth in GDP since the end of the recession in 2009), the US Fed seems determined to begin the phase of "policy normalization". While unlikely to confess to such "heresy" against the backdrop of a screaming absence of underlying consumer price inflation pressure or evidence of runaway growth, we believe that the Fed has finally recognized the corrosive nature of unfettered asset price inflation. The US Equity market, on the basis of measures which have reliably and consistently been highly correlated with realized returns, is at record levels of valuation and net rental yields in the national housing market have fallen almost 3% to a little over 1% in the last three years. With bond yields at historically low levels, the threat from an inflated Fed balance sheet and exceptionally prolonged accommodative monetary policy is more obvious in an economy with a record level of debt than the more traditional threat of consumer price inflation. Perhaps, at last, central bankers have finally found a place for asset prices, debt and balance sheets among their discussions of non-existent Phillips Curves (the fabled, and hard to find, trade-off between unemployment and inflation), output gaps and interest rates.

With that possibility in mind, the US Money Market assigns a 98% probability to a higher Fed Funds rate one-year forward, with a 75% probability of rates sitting between 0.5 – 1.25%. Reflecting that, the US Dollar has appreciated over the last 12 months against 92% of the currencies in the US Dollar trade-weighted currency basket. To put that into context, this is the broadest extent of US Dollar appreciation since the middle of 1993 and the most extreme over the last 30 years. Although we shy away from making forecasts, our strategy, thankfully, is not conditional on our ability to forecast the future. However, we must consider the likely consequences of a shift in the balance of global monetary policy.

Accepting that the ECB and the Bank of Japan are likely to remain in accommodative mode for quite some time, higher US rates and a stronger US Dollar imply, among other things, the following:

Appreciating Chinese Yuan

In effective terms, it has risen 11% in real producer-price, inflation-weighted terms in the last 12 months. This in turn crushes the meagre margins of a bloated, and still expanding, Chinese industrial sector and, through extreme corporate leverage levels, that stress passes into the Chinese banking system. Such a tightening in monetary conditions dampens trade growth and consequently demand for industrial inputs. On the other side of Yuan appreciation we see significant Russian Ruble and Brazilian Real depreciation (down 19% y/y in real effective terms as a weighted basket); the correlation between Yuan appreciation and Ruble/Real appreciation is extremely strong. We have long held the view that the Chinese would devalue their way out of the current mire and so we expect the Yuan to be devalued much more significantly in the next year or two to revive the declining Chinese economy. The consequence of that, of course, will be another massive deflationary/disinflationary pulse for the western economies. China will have little choice but to respond to tighter US policy with a weaker Yuan.

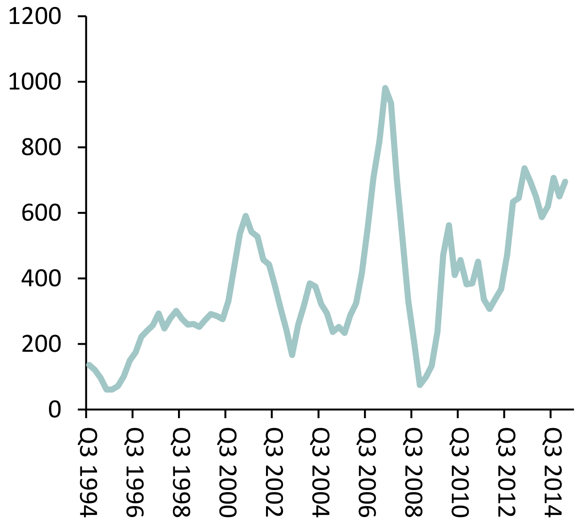
Correlation between the US Dollar and Commodity Prices

Yuan appreciation, and the importance of China in marginal trade growth, explains the increasing correlation between the US Dollar and commodity prices in general. In the last 10 years commodity prices have fallen in 72% of months when the Dollar has risen. That is a record level, having generally fallen 55-60% of the time in the previous 45 years. Put simply, commodity prices, not Gold, are more sensitive than ever to the US Dollar as a consequence of Chinese commodity demand. On that basis, prior to any Chinese policy response to dramatically weaken the Yuan and beyond the introductory 2% move this week, commodity prices look likely to remain under pressure. Widespread commentary on the *weakness* of emerging currencies against the US Dollar seems, to us, to have missed the point that the most important emerging currency, the Yuan, has actually *appreciated* against the US Dollar in the last year.

Increase in the US Dollar Credit Market Debt Issuance

Perhaps the most worrying consequence of a prolonged period of Dollar strength, after general weakness in the 2003-2014 period, is the dramatic increase in US Dollar credit market debt issuance, especially in South East Asia in the last decade. Being "short" large amounts of US Dollars is never a terribly good idea when the US Dollar is strengthening and your domestic activity is under pressure. According to BIS data (Figure 1), there was $9 trillion of USD-denominated International Debt and Money Market Securities outstanding as of the end of the first quarter, $695 billion up a year ago and $3.2 trillion higher than early 2009 at the height of the financial crisis.

Figure 1: USD-Denominated International Debt Securities Outstanding, $bn Year/Year Change



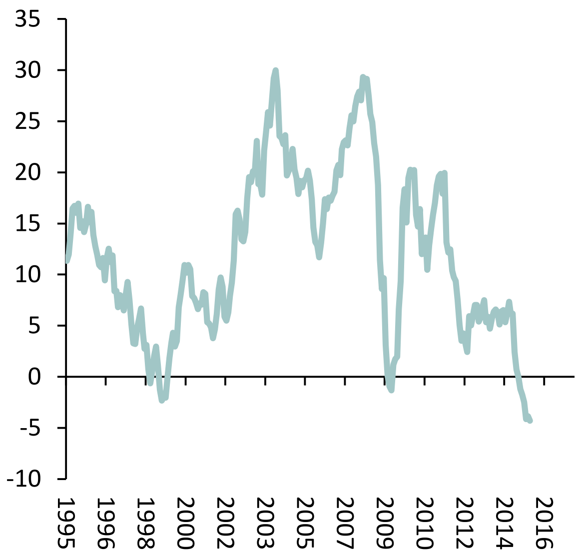
Looking just at the Asia Pacific Developing Bloc, and adding in cross border USD-denominated bank loans, the total US Dollar short position is approaching $2.5 trillion. Chinese banks, for example, have issued $113 billion in international USD-denominated debt in the last 3 years, accounting for 35% of all such issuance by banks globally.

That makes Asia, and China in particular, extremely vulnerable to both higher US interest rates and to higher debt servicing and rollover costs (since the short US Dollar position is predominantly less than 3 years in maturity).

Loss in International Reserves

In a related vein, the prospect of tighter US policy has already been reflected in a marked loss of International Reserves globally, and in China especially (Figure 2).

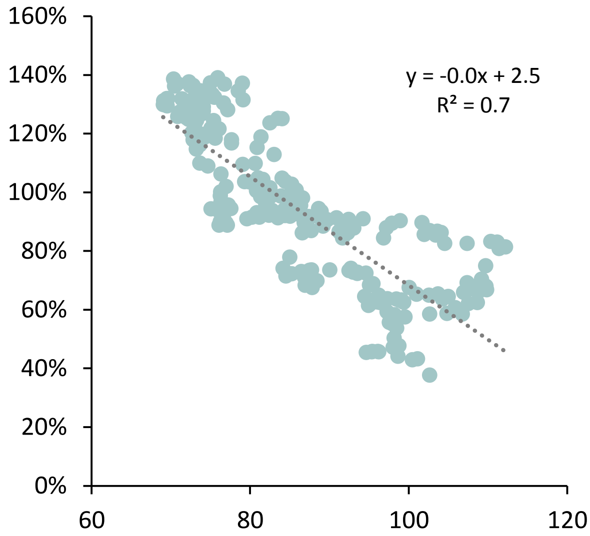
Figure 2: Global Foreign Exchange Reserves (%y/y)



Total reserves, 64% of which are allocated to US Dollars, have fallen 4.3% y/y, the fastest annual pace of decline in over 25 years. Chinese reserves have fallen $299 billion, or 7%, in the last year having risen at a 30% or so annual rate in the middle part of the last decade prior to the crash. Since these International Reserves, largely allocated in US Dollars, represent a balance sheet asset for the central banks in question, the corresponding liability is largely domestic currency issued to "mop-up" capital inflows. The unprecedented outflow of capital from China and the Developing Countries poses both a liquidity issue and, most importantly, a policy issue for those countries. It represents a substantial drain on domestic liquidity conditions as the prior "mop-up" is reversed. International Foreign Exchange Reserves have fallen $534 billion in the last 12 months, an unprecedented loss of liquidity, largely in the BRICs (Brazil, Russia, India and China) and other Emerging Markets.

So, to summarise, tighter US policy not only potentially tightens US liquidity conditions but also liquidity conditions in the Emerging Bloc. As International Reserves are lost, it puts pressure on the Yuan and commodity prices and stresses a significant US Dollar short position in the private sector in Developing Asia, through higher servicing costs, rollover costs and poorer liquidity. Unsurprisingly, despite a comparatively high and more stable Return on Equity, Emerging Market Equities tend to underperform EAFE (Developed non-US) Equities during periods of US Dollar strength; in Figure 3 EME has gone from a 39% valuation premium to a 16% discount since 2008.

Figure 3: Effective US Dollar (horizonal axis) vs Valuation of EME/EAFE Equity Indices (%, horizontal axis)



Hence, we do not anticipate owning Emerging Equities (we last viewed them positively in the period October 2009 – December 2010) at any point in the near future. The same is true of Gold, which we last viewed favourably between September 2009 – May 2012, and High Yield Debt which we last viewed favourably in the period from August 2012 – November 2014. The reach of US policy is indeed far beyond the US border.

The possibility that asset price concerns underpin a desire to raise interest rates is most apparent in the UK where 54% of the 80 consumer price index components have actually fallen in the last 12 months and 83% of the 80 components have seen inflation rates decline over the same period; the evidence for unprecedentedly widespread price disinflation in the UK is extraordinary. Will the Bank of England similarly ditch the orthodox, and horribly costly, view that growth and inflation are predictably linked via the unemployment rate and look deeper at the costs and consequences of asset price inflation and the exceptional global overhang of productive capacity? With a record £112 billion (6.2% of GDP), a Current Account deficit, a 1.5% of GDP private sector deficit (the largest since early 2002), a £50 billion (3% of GDP) structural underlying budget deficit, the average house price/income multiple at 5.2 nationally (versus 5.8 at the height of the pre-crisis boom) and a record 7.8 in Greater London, if any economy is in need of higher interest rates then surely it is the UK? The Bank of England should disregard the consequences of the overhang of global supply, which it cannot influence, and concentrate on the growth of domestic leverage and asset prices which it has at least some influence over. This is what happens when liquidity is the only means you have to manage liquidity and solvency crises and you rule out formal debt restructuring and other more heterodox measures that have typically been kept in the box labelled “For Emerging Market Use Only”. What you get is a grossly distorted economy that feeds temporarily off the effects of asset price inflation at the cost of worsening underlying fundamentals.

Keeping in mind the uncertainty surrounding the intentions of the US Fed and the global implications of higher US rates in a world of generally overvalued assets and record levels of leverage, it remains prudent to build portfolios with a degree of asymmetry in their return profile. Portfolios that perform in a favourable environment but are drawdown resilient, in a way that traditional “Global Balanced Diversified” Portfolios or Risk Parity Portfolios simply are not, during a period of severe stress. Our Portfolio remains suitably defensive, under conditions of stress, at this stage

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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