MONOGRAM

NEWSLETTER *December 2015*

The MONOGRAM Portfolio returned +0.31% in November, bringing performance since inception (the 27th of January 2015) to -2.8%. Both US and EAFE Equities contributed to performance, with a modest and continuing drag from Investment-grade Bonds.

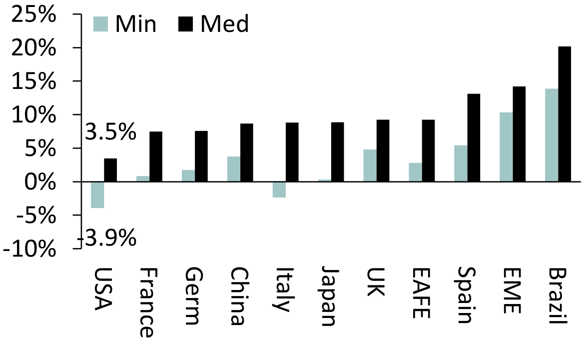
Having written extensively in recent months about the strong and persistent underlying economic pressures facing the global economy in the next year (Chinese banking system stress, capital outflows, over-investment and deflation threatening western economies already facing borderline deflation and modest growth before the pressures are truly disseminated), now seems a good time to appraise the current picture in asset markets and the longer-term outlook for returns.

A vast body of empirical research shows that economic growth differences between economies do not explain their differing equity market returns through time and, moreover, that valuation has no bearing on returns from one year to the next. Analysts conceal their own guesswork and speculation behind the façade of being "*fundamental and value driven*". With that truth in mind, we have to think carefully and more subtlety about the interaction between the economy, valuation and asset returns. There is, however, a similarly large body of research showing that valuations do correlate with equity index returns over horizons of ten to twelve years and that economies running well below their potential and with very depressed valuations do, in fact, deliver superior long-run returns (and vice versa).

The arithmetic of equity returns is really very simple. It relies, unfortunately, upon assumptions about several key variables: the length of your investment holding period, earnings per share growth over your holding period and the price-to-earnings ratio (or any other fundamental valuation ratio) at the end of the holding period. Of course, if you knew those with certainty you would be a sage and life would be wonderfully certain. However, life is not like that and so we face two alternative options, either we forecast the variables or we rely upon very long-run and highly stable historical inputs. Since guesswork, masquerading as a forecast or otherwise, has no place in a robust investment process we simply set our time period at ten years, assume earnings per share grow at the annualised rate observed in the last twenty years and assume that the valuation ratio of ten years stands at today's historical median level (to test the downside we also estimate implied returns assuming that the valuation ratio reverts to its historical trading low point at the end date). All nice, conservative and plausible assumptions, no wishful thinking or sleight of hand.

With those assumptions applied to all of the main markets, **Figure 1** shows the implied equity returns from current valuation levels.

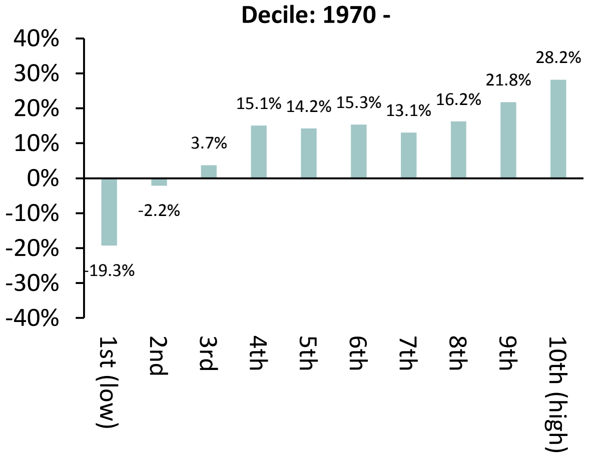
Figure 1. Implied Nominal 10 Year Holding Period Annualised Total Return (assuming trend EPS growth and a return to either historical trailing minimum or median valuation from the current multiple)



Assuming long-run (and highly stable) earnings per share growth the implied ten year annualised return for the US equity index is just 3.5%, with -3.9% being the figure if valuations revert to the historical low. After inflation, implied real returns are close to zero and well below the kind of level necessary for most pension fund assumptions to be valid. Implied US equity market returns have rarely, if ever, been lower than today. In fact, implied returns have been higher 87% of the time in the last century. By contrast, implied returns in Europe are in the range of 7.5% - 9.5% (with Spain closer to 13%) and in emerging markets close to 15% annualised. In the US, the implied equity risk premium (the implied equity return less the government bond yield) has been higher 80% of the time historically and we know that high risk premia tend to be correlated with fewer and smaller market drawdowns (and vice versa). Historically, and for good reasons, the implied return to EAFE (developed non-US markets) and to EME (emerging markets economies) is higher than that for the US. This remains the case, but the current premium for EAFE is towards the lower end of its past range.

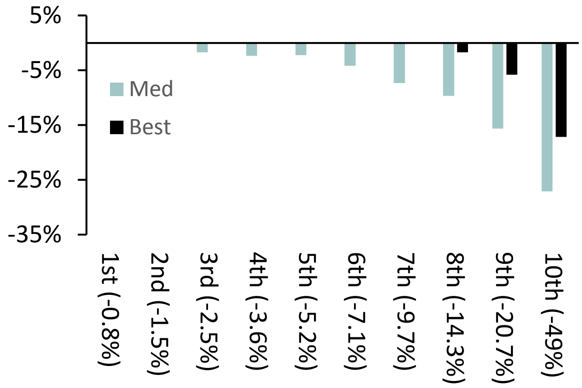
That the US market is expensive in absolute and relative terms is a serious concern. As **Figure 2** shows, when the US market does well the rest of the developed world does well, and when the US market does badly so does the rest of the developed world. When US annual returns are in the lowest two deciles then returns for the rest of the world are typically negative.

Figure 2. Median World ex-US Equity Index Annual Return Ranked by US Median Equity Index Annual Return Decile: 1970 -



Moreover, **Figure 3** shows the median annual drawdown and the best-case drawdown for the rest of the world when the US market drawdown is ranked by decile. For example, when the US drawdown is 14.3% or more, non-US markets have *always* suffered drawdown.

Figure 3. Median and Best Drawdown from the Trailing 12 Month Peak Level for the World ex-US Equity Index Ranked by US Equity Index Drawdown Decile: 1970 - end 2014

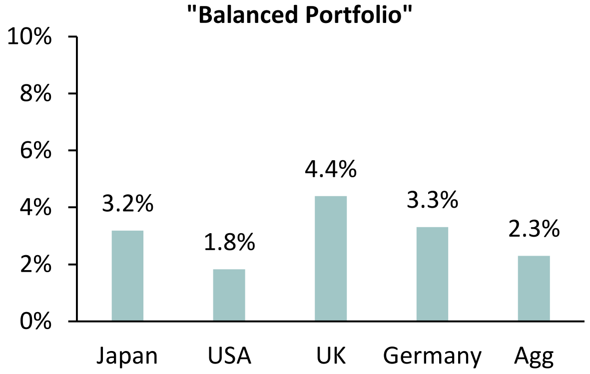


Historically when the US is in annual drawdown, 78% of the time the rest of the world is also in drawdown.

In summary, when US valuation is high and the risk premium low, implied returns in the US and non-US developed markets are correspondingly low. Moreover, when US valuations are high and risk premium low then the US typically suffers its largest drawdowns which have always triggered drawdowns in other markets. When the US sneezes, the rest of the world does, indeed, catch a cold it seems.

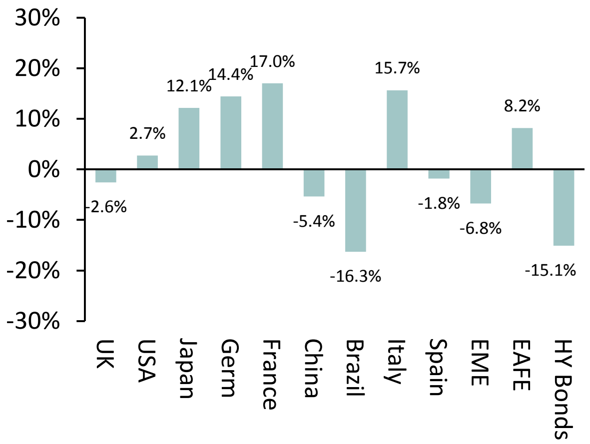
When we combine these estimates for implied equity market returns (the maths behind the calculations are available for those of a more technical persuasion) with current bond yields, we get the implied balanced portfolio returns suggested in **Figure 4** where we have deflated the nominal numbers with trailing inflation to produce approximate estimates for real returns. A typical US balanced portfolio offers barely 2% implied real annualised return for the coming decade, with Germany and the UK offering about 3 – 4%. Weighing them together, a global balanced portfolio appears to offer just about 2.5%.

Figure 4. Implied 10 Year Annualised Real Return on a 50% Equity/50% Bonds "Balanced Portfolio"



Of course, it would be wonderful to have a ten year holding period, but few people are afforded that luxury, so we need to relate the near-term to that long-term valuation anchor. As you know, we believe the evidence supports the case that the "glue" holding together the short and long term is simply momentum. So, **Figure 5** shows the current momentum of the major countries/blocs.

Figure 5. Equity Index Momentum



UK, China, Spain, emerging markets and, for comparison, high-yield bonds all have negative momentum. Our strategy has held no emerging market equity for several years and exited high-yield bonds in the latter half of 2014. We would not anticipate adding back either asset any time soon. The US remains in modest positive momentum and, by virtue of its drawdown correlation to other markets, is the key to forward returns. At some point we would expect a sizeable US market correction (high-yield bonds have already fallen 25% from the peak) and a corresponding decline in other markets. On the basis that the picture suggests it, but that we cannot predict its timing, we simply have to rely upon momentum to identify the regime shift and we will respond rather than predict. Going into 2016, the situation is finely balanced with modest positive momentum and a poor structural outlook.

The prospects for other asset classes, particularly commodities, are more macro-outlook dependant. Oil prices are currently at a seven year low, with global consumption growth lagging global supply growth and driving stocks up almost two million barrels per day over the last year. The growth in stocks matches that of the late 1990s and with China accounting for 54% of the growth in demand in the last decade (BRICs account for 92% of the increase in global demand), only a recovery in Chinese demand/large reduction in output could justify higher prices. China has lost $554 billion in foreign reserves from mid-2014, a 14% decline, offsetting 70% of the beneficial impact of reductions in bank reserve requirements. The real exchange rate is 11% higher over the same period and real interest rates (for a horrifically leveraged corporate sector with profits declining) are a little above 10% (with producer prices declining 6% year-over-year and likely to deflate more rapidly under the weight of huge overcapacity). The fundamentals behind the oil market are undeniably poor, Chinese monetary policy can do little but try to cushion the impact of a long-run, negative supply shock (the effects of which have barely been felt at this point), leaving suppliers with the pressure to cut production. For example, Saudi Arabia, accounting for 10% of global production, is still growing output 4% year-over-year and at the same time has seen a $98 billion (13%) decline in its foreign reserves since mid-2014 as capital flight intensifies (as is the case throughout the emerging market world). Capital flight is forcing it to keep pumping.

Gold, an asset we have written extensively about on our blog, remains, against this whole backdrop, an exceptionally unattractive asset to hold. As we have shown, it is an appallingly bad inflation hedge (for those worried about monetary excess) and only really has merit under conditions of extreme credit market stress. Whilst the ingredients for a credit crisis are very much in place, the clear commitment from central banks to supply all necessary liquidity lessens its attractiveness as a systemic risk hedge.

As we have also argued in previous newsletters, the Bank of Japan is on the path to full ownership of the domestic bond market as it continues to expand its balance sheet at a faster rate than the growth of both government and private financial liabilities. The Central Bank of China has no choice but to devalue the yuan if it wishes to hold the dollar peg with exceptionally high and crippling real interest rates. Then finally, the ECB has already signalled its willingness to continue expanding its own balance sheet as it wrestles deflation and weak activity. Regardless of whether the US Fed raises interest rates – and it would seem to us that with the economy slowing and 44% of the core inflation components already in deflation that a rise is unnecessary from a macro-economic viewpoint – just standing still implies a material *relative* tightening in US policy. A continuation of US dollar strength would appear most likely, further adding to downward pressure on commodities (looking back over the last ten years, 72% of the time commodity prices have fallen when the US dollar has appreciated on a monthly basis).

Moreover, US dollar strength has significant implications for the troubled emerging markets. In the emerging bloc in aggregate, US dollar-denominated debt outstanding is $3.2 trillion (up $1.7 trillion since early 2009), with US dollar credit to non-bank borrowers in China, especially, at $1.2 trillion (up $0.9 trillion since early 1999), for the BRICs bloc as a whole US dollar credit to non-banks stands at $1.9 trillion (up $1.2 trillion since early 2009). A stronger dollar will place *enormous* strain on the emerging markets, with, for example, China, Singapore and Brazil especially vulnerable. Add in the developed markets and US dollar-denominated debt, for non-US borrowers, is almost $10 trillion. The possibility of a dollar-related credit crisis cannot be ignored.

Paradoxically, and with nominal yields at extremely low levels, government bonds may be the main beneficiary from this environment of Chinese-led deflation, falling gold and commodity prices and US dollar strength. And, of course, should equities correct significantly in this scenario we would expect government bond yields to decline.

With all this in mind, we continue to manage and maintain our Portfolio in a disciplined manner, ready to react should the investment landscape change materially. Across the board, assets valuations hover around levels that are somewhat close to a tipping point and, as a result, a material change in portfolio allocation is entirely possible in the months to come. Thank you for your support and with a few days remaining to an eventful 2015, the whole MONOGRAM team wishes you a Merry Christmas and a prosperous 2016.

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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