MONOGRAM

INVESTMENT REVIEW: FEBRUARY 2015

A MONETARY PIECE OF STRING

Almost seven years on from the start of the global financial crisis, and well behind the Fed and Bank of England, the ECB finally relented and committed in January to a Quantitative Easing ("QE") program of at least Euro 1.1 trillion "until we see a continued adjustment in the path of inflation". Worryingly, after a $20 trillion expansion in the balance sheet of Chinese banks, a $9.7 trillion expansion in the balance sheet of the five major central banks and a $23 trillion increase in developing and developed country government debt, amounting to almost $53 trillion in stimulus [84% of 2008 Global GDP!], developed world underlying inflation is at 1.8% versus 2.3% in late 2008 and is trending down in the Eurozone, UK and USA.

Almost a fifth of the bonds in the JPMorgan Global Government Bond Index now have a negative yield. These bonds will be worth less at maturity than now, even in the absence of default. This should come as no surprise since monetary policy, like fiscal policy, is only effective if it relieves a constraint: banks are awash with reserves, the private sector in most cases is in financial surplus [against governments in deficit] and not in need of external financing. Excess liquidity created by QE therefore has to find a home, and this drives bonds price to levels that make no economic sense.

However, a quick look at the relationship between the rate of growth of money supplied by central banks and the speed at which it circulates in the system to finance transactions shows that the two are near perfectly negatively correlated. In short, QE is a monetary piece of string, the effect of $1 circulating once is the same as $2 circulating half as fast: QE is a policy with the explicit objective of creating asset price inflation, driving up asset prices, not those of goods and services. The effect is, hopefully, two-fold, people feel wealthier and spend part of that wealth and move away from low expected returns on financial assets and spend the money on consumption and investment. Given that Eurozone households hold 17.1% of their financial assets in shares and equities [versus 33.1% in the USA and just 9.4% in Japan] and 35.2% in currency and deposits [versus 13.5% in the USA and 52.6% in Japan] any wealth effect is likely to be not only transitory but modest.

Unfortunately, one of the few clear conclusions in economic research is that people consume from permanent income and not from transitory/temporary increases in wealth: asset prices need to rise endlessly for any continuous consumption/investment cycle to develop. That, in itself, means a repeat of 2000 and 2008. This is not an edifying prospect, rather than a sustainable boost in economic activity. When asset inflation fades so does growth, as we are observing now globally.

With respect to inflation, when substantially greater QE has historically failed to boost underlying inflation in either the UK [1.2% vs 2.0% at inception] or the USA [1.6% vs 2.0% at inception], Draghi's and the ECB's faith in policy is, in our view, misplaced. Current Eurozone headline inflation at -0.6%, with 0.7% underlying inflation, reflects a collapse in oil prices which is completely outside of the influence of the ECB. Meanwhile underlying inflation is a simple reflection of the massive overhang in the global supply of goods and services originating from global investment at 25% of GDP, the highest level since 1990. When more goods and service compete for the same amount of demand, prices adjust downwards, which reduces inflation to the currently observed levels.

How did that happen? In the last decade, China has accounted for almost 20% of the increase in global goods exports and the 14% rate of growth of investment in fixed assets in the Chinese manufacturing sector in the last year still exceeds demand growth in the Eurozone by 13 percentage points [10 percentage points for the US and UK]. So long as Chinese capacity is not destroyed, as it would under unconstrained circumstances, and new capacity is added at such a ferocious pace, the disinflationary/ deflationary pulse to the western economies will remain severe. Since the Chinese cannot permit the Schumpeter's Gale of "creative destruction" to blow and are shifting themselves to more monetary stimulation, there is little reason to believe that we or they will observe any continued adjustment in inflation: it will not increase any time soon.

Paradoxically, the lax Chinese monetary and credit policies actually worsen inflation in the Eurozone and more widely by maintaining excess investment and supply: the Bank of China and the ECB are in direct competition. Given previous experience, we can guess who has the greatest appetite for the fight!

In the meantime, structurally hard-wired disinflationary pressures, and the diminishing marginal returns to asset inflation, suggest to us that global monetary policy environment will remain accommodating for some time to come.

The challenge in this environment is to build portfolios which benefits from further increases in asset prices and are resilient in the event of declines. Our strategy is built to deal with this asymmetry in the profile of implied returns.

Since the potential for further appreciation in asset prices exists but, against a background of mounting risks, the equity portion of the portfolio, or approximately 50%, is invested in US equities. This is because in periods of stress, US equities are typically more resilient than other stock markets. The remainder of the portfolio is invested in government and high quality investment grade bonds, which should appreciate and therefore protect the portfolio in a downdraft.

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.