MONOGRAM

NEWSLETTER *February 2016*

The MONOGRAM Portfolio declined 1.7% in January, bringing performance since inception (the 27th of January 2015) to -6.6% (net) and the peak/trough drawdown to -7.9%. Markets appear to be confirming our central macro-market thesis and, in accordance with our "observe and infer" mentality, we responded by removing all non-US equity market exposure at the end of the month. We now hold 50% in Investment-Grade Bonds, 25% in Cash and the remaining 25% in US Equities. Our position has become increasingly defensive as warranted by deteriorating market conditions and, without wishing to tempt fate, it appears likely that we will remove all remaining equity exposure at the end of February leaving our peak/trough drawdown for this cycle at its worst point (barring an unanticipated collapse in US government bond prices).

This month we want to take a more detailed look at the prospects (look away now if you are squeamish) for US corporate profits (and, by default, global corporate profits) from this point in the market cycle. However, before we turn to that, I am afraid we have to say more about our favourite subject… China.

Regular readers should know by now that we view the current situation in China as the culmination of the biggest credit bubble in human history, far larger than the $1 trillion US subprime debacle that rippled global markets. We were in a meeting recently (with an extremely thoughtful and intelligent gentleman, formerly a theoretical physicist at several world-leading universities and a true polymath) at which we got around to discussing views of the world. When asked how he saw the markets, he ascribed market cycles to credit cycles and emphasised the importance of debt growth and leverage. At the same time, he was surprised that former Fed Chairman, Ben Bernanke, appeared not to share his view when suggesting in a speech that credit growth was of little or no importance and played no role in his own "mental model". I, cheekily, and a little to his surprise, said that Bernanke was right. This theoretical physicist was extremely surprised to hear that in the standard economic model, the textbooks used to teach economics and in the equilibrium macro-econometric models so beloved of central bankers (I played with such models as a Bank of England economist), banks are simply intermediaries. They play a benign role and there is no role for banks and for debt. In the textbooks, "impatient agents" borrow from "patient agents" and banks simply intermediate, they are a sort of economic dating agency for savers and dis-savers to pair up happily. As Nobel Laureate Paul Krugman says when discussing the possible problems associated with indebtedness "...these are problems of distribution and incentives, not the burden of debt as it is commonly understood" (2011).

Really, as horrifying as it seems, mainstream economists schooled in equilibrium economic theory are blind to leverage; they have no interest in bank balance sheets and debt. They allow for no possibility that banks actually *create* debt, that debt creation is endogenous. Indeed, the much-loved Modigliani and Miller "capital structure irrelevance principle" says that the value of a firm is unaffected by the way it is financed – debt or equity, it makes no difference. In fact, the theory, with certain assumption, can even be used to show how the value of a company *increases* in proportion to the amount of debt used – debt is positively beneficial. Those non-economists amongst you will, at this point, be left speechless by the preposterous notion that debt is benign but, nonetheless, to classically trained economists and believers that is the reality. Perhaps it helps explain why central bankers ignore(d) the monetary economy (where debt has exploded and balance sheets have ballooned in successive cycles) and obsess about the real economy where the product of that ballooning leverage – excess investment and huge excess supply – is manifest in a noteworthy absence of inflation in the shops and looming deflation. This cannot be happening; the models say it is not possible.

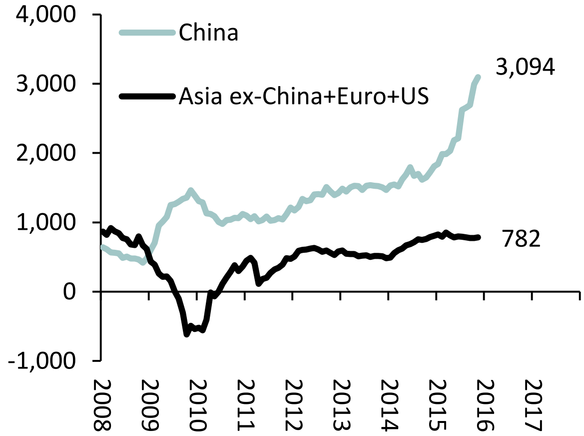
Because central bankers, and much of the economics community, fixes on *describing "outcomes"* and not *understanding "processes"*, the theory does not go in that direction. We are left in a world where credit can expand uncontrollably and they use the one tool in their possession, quantitative easing, to try to manage the consequences. Unfortunately, the theoretical and empirical underpinnings for QE are also extremely flimsy at best (as we have shown elsewhere in our materials).

Sadly, to paraphrase Keynes, we have all become slaves to defunct economics.

That said, returning to dry land and the current credit bubble in China, **Chart 1** illustrates perfectly the astounding scale of the current bubble. It shows the year/year (y/y) growth in bank lending (measured at fixed exchange rates to remove exchange rate effects when aggregating into US dollars) in China versus the Eurozone, US and a bloc of other Asian countries. In the last twelve months Chinese banks have extended $3.1 **trillion** in credit – that is 25% y/y growth – an amount four times that extended by banks in the Eurozone, US and non-Japan/China Asia combined.

Moreover, the credit growth is *accelerating*. This is the kernel of another global market crisis. To recap why, take the $15.8 trillion in outstanding bank loans to the Chinese "private" non-financial sector and apply a typical (for China) 30% non-performing loan ratio (that is not unusual in prior cycles) and assume a 30% recovery rate (again typical in prior cycles). The losses, just from that part of the bank balance sheet amount to $3.3 **trillion** (that is 0.3 * 15.8 * 0.7). *At best,* losses in the Chinese banking system amount to one-third of Chinese GDP and those losses are likely to be taken largely onto the balance sheet of the government and the central bank (a CEPII paper from 2006, "Who Pays China's Bank Restructuring Bill?" by G. Ma, suggests losses in the previous banking cycle amounted to 22 – 28% of GDP and were 85% absorbed by the government and central bank).

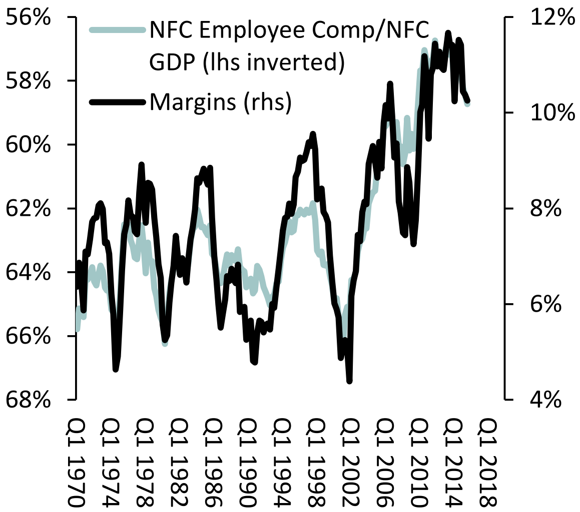
Chart 1: Bank Lending: "Asia ex-China (Singapore, Hong Kong, Philippines, Malaysia, Indonesia, Thailand and Taiwan)" plus Eurozone and the US, y/y Change in USD bn vs China (2000 Q1 exchange rate aggregation for non-US)



To summarize: probable losses in China dwarf those from the subprime mortgage crisis with consequences far more severe. With Singaporean and Hong Kong leverage ratios at record levels, those countries are extremely vulnerable. A yuan devaluation of 25% plus seems almost inevitable and unavoidable under the weight of a collapsing credit system. To be clear, capital outflows from China are <u>structural and domestic</u>, they do not reflect the actions of speculators and are not a benign repayment of US dollar-denominated debt (BIS data shows that standing at approximately $1 trillion a year ago, and if that hypothesis is correct the outflow last year re-denominated that debt entirely into yuan and we should see outflows dry up and normality resume). No banking system, not even a heavily centrally controlled one, can lend on this scale without loss and consequence. The loss is likely to amount to around 5% of **global** GDP *<u>at best,</u>* the consequence a substantial bear market in risky assets. Government bonds are likely to look quite attractive when viewed from the "Gate of the Year" 2017 (apologies to Minnie Haskins and King George VI).

Enough about China, and the severity of the looming credit crisis, let us turn to the profit outlook, and more specifically the US corporate profit outlook. As shown in **Chart 2**, US corporate profit margins (gross profits in the non-financial sector over gross income in the non-financial sector) stand close to all-time highs as a consequence of the workers compensation share in gross income being near an all-time low. All of the spoils of the QE-fuelled madness since 2009 have accrued to "capital" in the form of profit and "labour" has seen its share collapse; perhaps this is one reason why Bernie Sanders is finding favour amongst disillusioned American working families?

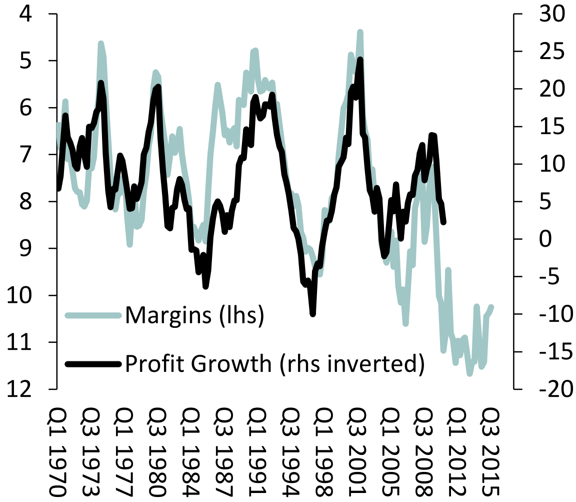
Chart 2: Non-Financial Corporate Sector Employee Compensation/non-Financial Corporate GDP vs Profit Margin



Clearly, profit cycles are correlated with the ebb and flow of a historically highly stable split of national income between "workers" and "capital providers". The question is, "how sustainable is the current severely depressed labour share in national income"? In our view, not very is the most reasonable answer.

As **Chart 3** shows, forward profit growth is highly correlated with profit margins; that is to say, high margins today imply low profit growth over the following years (and vice versa). You can see that the extremely low margins observed in 2000 were a good harbinger for rapid profit growth through 2005 just as the high margins observed in the mid-1990s were a harbinger of weak profit growth. Right now, record margins imply a five-year profit growth outlook that can best be described as dire – 10% *annualised* profit declines.

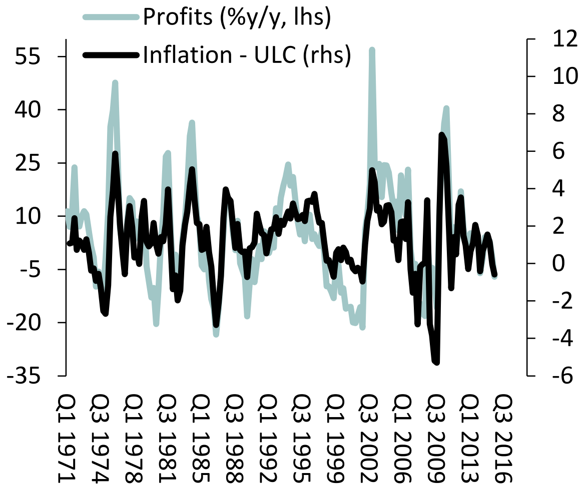
Chart 3: US post-Tax non-Financial Sector Corporate Profits/non-Financial Corporate GDP vs Five Year Forward Corporate Profit Growth (annualised)



Moreover, as **Chart 4** shows, profit growth is simply a product of the difference between price inflation and unit cost inflation (largely unit labour costs). Contrary to the "theory of the firm" taught to generations of students in university microeconomics classes, firms set their prices as a simple mark-up on costs (not according to the intersection of marginal cost and marginal revenue curves). We know already that 41% of the 106 components in the US Core Consumer Price Index are in deflation (close to the levels only ever observed at the *bottom* of the 2003 and 2009 market declines) and 56% of the components have inflation below 1%. That is before the exogenous deflationary shock looming from China. We also know that the labour share in income tends to rise in recessions as workers are hoarded, but more importantly because, as all the entrepreneurs amongst our readers know well, it is exceptionally hard to cut wages (they tend to be sticky downwards). Putting things together, it is easy to see how the current 9% y/y decline in post-tax, non-financial sector corporate profits is likely to worsen dramatically in the coming quarters.

Simply, the profit outlook for the US is extremely worrying and, by extension, that conclusion also applies outside of the US in a global economy with an inherent deflationary bias. Why worry? Well, because the US equity market is valued at twenty-five times the trailing ten-year average reported earnings – 87% of the time since 1880 and 75% of the time since 1950 the market has been cheaper (implied return, by default, is higher) than it is today.

Chart 4: US non-Financial Corporate Sector Unit Profit Growth (% y/y) vs Consumer Inflation less Unit Labour Cost Growth (% y/y)



A $10 trillion expansion in major central bank balance sheets since 2008 has created gross overvaluation that has been exacerbated by explosive Chinese credit expansion. In addition, the ongoing reversal of $6 trillion in net capital inflows into emerging markets alongside the horrifying frailty of the Chinese financial system promises to re-rate all risky assets. That process is just beginning in developed equity markets, is probably halfway completed in emerging markets, is well advanced in high-yields and MLPs (master limited partnerships) and is likely to be reflected in a substantial decline in high-quality government bond yields. In effect, the death throes of QE will see "risk free" assets like government bonds yield nothing (or have negative yields as in Japan) and leave central bankers hoping this will push unwary investors into taking more unwise risks.

Against this backdrop, our Fund is very conservatively positioned and likely to be even more so at month-end. Our drawdown limit is modest and easily recoverable in the next cycle where, in our view, patient and considered investors will have the opportunity of a lifetime to double their wealth.

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**.