MONOGRAM

NEWSLETTER *January 2016*

The MONOGRAM Portfolio returned -1.6% in December, bringing performance since inception (the 27th of January 2015) to -4.9% (net). Bringing to an end an unusually challenging year (Warren Buffet was down 11%, his worst year since 2009 and only his eleventh year of underperformance in the last fifty years), there were no places to hide in December as US, Developed Market and Emerging Market Equities all declined, along with Commodities and US Government Bonds.

Having written last month about the outlook for asset class returns over the course of the next cycle, this month we, reluctantly, return to a topic we first highlighted last May and have written about in considerable detail over the ensuing months – China. For those exhausted by this topic we apologise, but there is still more to say about the topic centred on China, emerging market capital flight, which we have described as the dominant theme for the next market cycle.

The heart of the Chinese problem is a banking system that has quadrupled in size, now over $31 trillion. Since the crisis began in 2008, the country has expanded its balance sheet by $4.3 trillion in the last year as GDP apparently grew $0.5 trillion and which now holds a non-performing loan ratio close to 20% (according to Charlene Chu at Autonomous Research) – far away from the fantastical and ludicrous official 1.5% estimates that suggest Chinese bankers are a model of probity. The Chinese banking system, with a balance sheet at 40% of global GDP, is at the heart of the "Chinese problem", not a benign economic slowdown (as bizarrely suggested by Nobel Prize winner Professor Joseph Stiglitz) or weaker global GDP growth (although that doesn't help the real economy one bit). We are witnessing the biggest debt crisis in economic history and the ultimate distribution of pain between banking sector losses, deflation and economic contraction will be determined by the response of the authorities. Take a "head in the sand" approach and you follow Japan into deflation and contraction in nominal income, take an active approach and there is some prospect of eventual rebalancing and a return to positive growth and inflation. Applying a 20% NPL ratio, with a 50% recovery rate, losses are broadly on a par with total Chinese foreign exchange reserves whilst those reserves are just 15% of M2 money supply (currency and deposits in the system). At best, the Chinese banking system is likely to require a multi-trillion dollar recapitalization in the next year or two.

Whilst so few Chinese own equities and the direct wealth effect is likely to be trivial, developments in China matter for global economic growth since it accounted for 18% of growth in merchandise exports and 32% of growth in merchandise imports globally in the period 2008 – 2013. China has been a supplier of demand and deflationary pressure in the period since the crisis began back in 2008. The current "tipping point" has been reached as a result of the collapsing marginal return to credit growth and precipitating capital flight (let's be clear for a moment, this is not a voluntary, pro-active attempt by the Chinese authorities to manage the yuan lower, the decline in the currency is a direct response to the desire of investors to get their money out of China, and fast).

Unfortunately, judging from the official response, Chinese policymakers appear to favour the "head in the sand" approach to policymaking. A crisis of economic management caused by excessive debt, and capital flight, should trigger serious efforts to reduce debt and increase equity in the financial system. Instead, as interbank lending rose 340% to Yuan 8.4 trillion ($1.3 trillion), banking system leverage is actually increasing at an alarming rate. This must surely be exacerbating the non-performing loan situation and adding to the fragility of the banking system.

The wider consequences of a Chinese banking system teetering on the brink of crisis are seen in the exposure of BIS (Bank for International Settlements)-reporting banks to China and its banking system. Exposure to China amounts to $765 billion, a $571 billion increase since early 2009, with the UK accounting for almost $190 billion and the US for approximately $110 billion. Exposure to Chinese banks amounts to $320 billion, a $245 billion increase since early 2009, with the UK accounting for approximately $60 billon, the US $36 billion, Japan $26 billion and France and Germany $36 billion combined. The *increase* in exposure since the bottom of the bear market in 2009 is extraordinary. Remember, when putting these numbers into perspective, the total US sub-prime mortgage debt stock was "just" $1.2 trillion.

So, capital is fleeing China (foreign reserves have fallen 17% or $663 billion from the 2014 peak and Chinese banks settled a net -$376 billion of foreign exchange in the first eleven months of last year), that much is beyond dispute. What, if any, are the implications and consequences?

Well, first of all we must consider the likely policy responses open to the Chinese authorities. Lumbered with excess and rapidly expanding debt, deflation in producer prices and at the level of GDP, over-capacity and insufficient domestic demand growth (we challenge anyone to show us some evidence, any evidence, that the fabled Chinese middle class consumer is stepping into the breech to hold back the tide of decline) and a politically/socially important currency peg to the US dollar under threat from capital flight, what would you do? Moreover, the "secondary sector" (defined in China as manufacturing and construction), accounting for 45% of GDP, has experienced just 0.7% y/y growth in the latest official data (its electricity consumption was down 2.1% y/y in the three months through last November, so the situation is worsening) but accounts for approximately 65% of bank loans outstanding. Let's recap that to be clear, the most debt burdened sector is contracting and faces double-digit real interest rates. Obviously a rate rise to defend the yuan is out of the question.

A rate cut, on the other hand, lessens the attractiveness of Chinese versus non-Chinese assets and almost certainly feeds accelerated capital outflows. What to do?

You could cut reserve requirements for banks to stimulate more inefficient lending ("head in the sand") – a 10% point cut would inject $2.1 trillion. But, on the face of it, a debt-related loss of investor confidence is unlikely to be alleviated by the encouragement of an enormous spike in leverage. That said, the budget deficit has widened sharply to the highest level in over thirty years, with net issuance rising from Yuan 150 billion monthly in late 2014 to a record Yuan 600 billion monthly in the third quarter of last year (much of it taken onto bank balance sheets).

Perhaps a rigid and strongly enforced system of capital controls might help? But that doesn't encourage the IMF to look favourably upon the yuan for inclusion in the SDR (Special Drawing Rights) or sit easily with a freely traded offshore Hong Kong yuan. Driving Hong Kong yuan interest rates higher to punish shorting speculators is nothing other than a short-term distraction either, since Hong Kong-domiciled "offshore" yuan deposits amounted to a trivial $130 billion ($0.1 trillion) in November 2015 against $21 trillion in deposits in the "onshore" Chinese banking system.

Our opinion remains as described many months ago – you either abandon the USD peg altogether or you simply manage the descent and use it to buy time for a beleaguered and contracting secondary sector whilst you attempt to tackle the problem of systemic leverage. The latter seems most digestible; a decline around 20% or more is the minimum at this point (it puzzled us as to why all those Wall Street Banks forecasted negligible declines in their beginning of 2016 forecasts, levels that have already been passed. Political pressures blinding economic reality perhaps?). The "pain for Chinese gain" in this scenario is pretty obviously distributed:

Decline in the Yuan

A sharp decline in the yuan versus the US dollar forces the Japanese to act (China accounts for 27% of Japanese imports and 18% of exports) – the yen has already appreciated 12% versus the yuan since last August. With an economy in deflation, a stated commitment to inflation and your largest trading partner devaluing substantially, you have no choice but to respond. Expect a substantial increase in Japan’s already extraordinary liquidity injections and watch the JGB market disappear entirely onto the central bank’s balance sheet in the next few years (the Bank of Japan’s share of Japanese government debt outstanding has gone from 7% to 26% in just two years).

Weaker Currencies

In Australia, where banks have $35 billion of exposure in China and are the supplier of choice to Chinese manufacturers, there will again be pressure to engineer a weaker currency. In fact, throughout all of Southeast Asia and in emerging markets in general, in response to a material decline in the yuan, central banks will be under significant pressure to respond and weaken currencies. In fact, Chinese exports to developing countries have risen almost 20% annualised since 2009. Exports to advanced countries were four times those to emerging countries just ten years ago, today they are two times and declining sharply in relative share. A yuan decline will export deflation directly into the emerging world and Southeast Asia in particular; China has flooded the developing world with cheap goods and those goods are about to get a whole lot cheaper. Late last year, 63% of the ten major Asian economies already had inflation below 1% (with 77% seeing declining annual inflation, a worse picture than evident at the bottom of the 2000 and 2008 bear market crashes) so a Chinese devaluation risks tipping them into a worrying deflation. The same applies in the West where a deflationary tsunami threatens at a point where, for example, 44% of the one hundred and six individual sub-components in the US Core CPI Index are *already* in annual deflation. Despite the efforts of the Fed (Federal Reserve) to begin to exit the state of monetary emergency represented by QE, we fear that for the Fed, and other central banks, it has become rather akin to *The Hotel California*, “you can check out any time you like, but you can never leave”.

Stronger US Dollar

A stronger US dollar simply exacerbates the already high burden of debt service in Asia/emerging markets (debt service estimates for China, for example, are in the order of 15-20% of GDP) – net non-bank bond issuance amounted to $940 billion in emerging markets from early 2009 – mid 2015 with the non-financial sector in China, for example, borrowing $950 billion alone over the same period ($1.7 trillion for emerging markets in aggregate). A stronger US dollar represents a significant burden on the whole developing world. Of course, part of the outflow of capital from China that we are witnessing represents a desperate effort on the part of Chinese banks and businesses to swap US dollar debt back into yuan. To us, with debt costs where they are in China, that’s rather like “jumping out of the frying pan into the fire”.

The scale and complexity of the unwinding of $6 trillion in net capital inflows into emerging markets is self-evident and it is worth reminding ourselves that in the case of both the Asian crisis in 1997 (Thailand is far too small to be relevant) and the banking crisis in 2008 (“At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained” Ben Bernanke, Fed Chairman, March 2007) the impact of disruption in credit markets was significantly underestimated.

Our view remains that the markets will not regain some sense of an “equilibrium” nor commodities form a base until the yuan problem is resolved satisfactorily (almost certainly through a sizeable decline). At some point, undoubtedly, commodities (oil, uranium, industrial metals) will represent an extraordinary opportunity, but the conditions for a meaningful rebound are not yet in place.

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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