NEWSLETTER *June 2015*

The MONOGRAM Portfolio returned an estimated +0.51% (net) for the month of May, bringing the year-to-date performance (since the 27th of January 2015) to +0.77% (net). Equity markets continued to make gains, albeit with high volatility (MSCI World: +1.8% for the month), while sovereign bonds were under pressure and sold off by almost 2% (Bloomberg G7: -1.9% in May). Commodity markets also lost ground (GSCI Index: -1.4%) as oil consolidated after a strong month in April. Currency markets were nervous while the dollar retraced half of the ground lost since a trade-weighted multi-year peak was reached towards mid-March.

The market, particularly in Europe, remains subject to the continuing ebb and flow of news surrounding Greece, with Syriza continuing to pursue its popular mandate of loosening the imposition of "Troika" (the European Union, The International Monetary Fund and the European Central Bank) policy restraint and the Troika still insistent upon meaningful, verifiable and impactful Greek institutional reform.

While the stand-off has played out, in public and in private, with tensions raised on both sides over the last few months, it appears that the point of conclusion is nearing with Greek debt amounting to €20 billion (around 8% of GDP) coming due in the next few weeks. The Greek government, unless hitherto undisclosed reserves of cash can be found, needs to come to a workable agreement with its creditors or default. As we have pointed out in a recent blog entry, Greece currently runs a primary budget surplus (revenue less spending excluding debt interest repayments) of approximately 1-1.5% of GDP (this is nearer 7% of GDP if Greece were assumed to be working at its potential output level) which implies that it requires an additional fiscal policy tightening of 5-6% of GDP simply to stabilise (not reduce) its debt/GDP level. Greek real GDP is 25% below its historical peak level, a scale of contraction on a par with the era of the early 20th century Great Depression, and the imposition of tightening on that scale is likely to be both ineffective and socially unacceptable.

From the Greek perspective, the fiscal imposition placed upon it that it should run a 3% primary budget surplus appears unusually onerous and, more importantly, requires a degree of fiscal control that no country in the Eurozone, not even Germany, has been able to demonstrate in the last 20 years. **Figure 1** shows the primary balance for the major countries over that period: Italy and Ireland met the 3% threshold for a spell during the early 1990s boom period while Germany has met it just once (France not at all).

Although the Greeks have fallen short of the targets set by the Troika over the last 5 years, have they been any less successful than other countries within the PIIGS bloc that were subject to Troika support? **Figure 2** shows actual primary balance outcomes relative to the targets set for each country by the Troika as a condition for support: all of the countries missed conditional budget targets, with Spain, and to a slightly lesser degree Portugal, doing especially poorly. Greece, even after recapitalizing the banking system in 2013, at least managed to deliver a primary surplus last year, unlike Spain. Despite this, Spain appears, for now, to be out of the spotlight while Greece is caught firmly in its beam. Why?

Well, for one thing, the Greek gross debt/GDP ratio started the crisis at a far higher level than in Spain, 118% versus 53% in 2008, and currently stands at 185% versus 130% in Spain. In a sense,

past sins have come back to haunt the Greeks and make the situation so much more unstable. When your debt level is that much higher and your institutional structure that much less efficient (for instance at collecting tax revenue), your ability to withstand exogenous shocks is so much weaker.

Why, in fact, should anyone really care if Greece defaults and leaves the Euro (it could default and remain inside)? In recent years, the Troika, and particularly the Eurozone institutions, have done a very good job of reducing systematic banking exposure to Greece. As Figure 3 shows, French, German, British and Italian banks (we include the UK banks on account of their scale) have reduced their exposure to all Greek entities from a peak level in excess of €100 billion in 2009 to just below €23 billion at the end of last year. While still a decent amount of money, this is almost irrelevant to the financial health of the European banking system. To put this in perspective, under its Quantitative Easing program, the European Central Bank "spends" more than that in just 10 days. What was a serious risk to the whole banking system back in 2010 is therefore no longer, at least on paper, mostly because these assets, mainly Greek government bonds, have largely been transferred to the so-called Brussels Group ("The Troika"). Losses will still have to be paid for by someone, but losses are much easier to pay for when one has the ability to print money. At worst the ECB and IMF need to be recapitalised by participant governments (the irony there would be the Japanese government, which is in itself insolvent and beyond the point of return and is now reliant upon unprecedented central bank liquidity support, would, as the second largest shareholder, have to help recapitalise the IMF).

Given that the systemic risk from a Greek default/exit, especially with ECB QE already in place, looks extremely manageable, and Greece as an economy (less than €200 billion in size) is a relatively insignificant part of the €10 trillion market, what are the other concerns? Of course, there is the political element that a model put in place at great cost and with great political will is seen to be unwinding, particularly at a time of growing nationalism with the UK forging ahead with an EU membership referendum.

Perhaps more importantly, there is a significant geo-political component to the problem. One powerful reason for European bodies to remain engaged with Greece, despite its economic insignificance and the trivial cost of exit is the threat that a separatist Greece might become more attached to Russia and provide the Russian navy with a very desirable foothold in the Mediterranean. With a dockside shed passing as a warm water port in Tartus, Syria, the full extent of Russian naval presence, the Russian government would find a welcoming Greece extremely valuable in the midst of NATO expansion up to Russian borders in the last decade or more. Indeed, Greek Prime Minister Alexis Tsipras received a warm welcome in Moscow on April 15th. Dismissed by German Chancellor Merkel and French President Hollande as a "sideshow", for us it was a powerful display of intent.

Chinese shipping firm Cosco already has a strong presence in the Piraeus port and Russian naval access could be worth several hundred billion Euros over coming years to a financially shackled Greek government. Add to that Russian interest in Greek energy resources and a strong combined Chinese/Russian presence right on the very doorstep of NATO would be extremely undesirable. Greece has very few "economic chips" to bargain with but one big "political chip" which will ultimately, in our view, see it come to an acceptable compromise with its creditors. Whether that be, in typical European fashion, a default dressed up as a restructuring, a loosening of the primary surplus target and extension of the conditionality for support or "Troika 3" with greater flexibility, we do not know, but one thing we are sure of is that no European politician wants to see a "failed state" in its back yard ready to fall into Chinese and Russian hands. A solution will be found, a solution that keeps Greece inside the Eurozone and one that the weary German taxpayer can accept, albeit grudgingly.

Once over this period of political wrangling, the backdrop remains the same. The ECB, after an

initial burst of enthusiasm when its balance sheet expanded by €207 billion (10%) in the 4 weeks through mid-April, has slowed its QE balance sheet expansion to a crawl (its balance sheet has risen by just €44 billion in the last 4 weeks). With a commitment to €1 trillion in balance sheet expansion, taking it from 21% back up to 32% of GDP, net equity issuance in the non-financial corporate sector running at just 0.3% of GDP and net government debt issuance in the area at 2.5% of GDP, the ECBs QE policy will create a substantial overhang of liquidity. In short, the liability side of the ECBs balance sheet will expand at a far greater pace than the supply of financial assets (equities and government bonds). With Greek uncertainty and tensions set aside, the backdrop, subject to US market developments, would appear to remain favourable.

Our Portfolio remains therefore positioned in a carefully constructive bias towards risk assets. Our exposure is broad-based within developed countries, with the US a dominant theme, representing a quarter of the overall assets. Another quarter is invested in UK, Euro, and Japanese equities. The balance (c. 50%) remains invested in investment grade bonds with positive yields.

Figure 1: Primary Budget Balance (% of GDP, Budget Balance Excluding Debt Interest), Selected European Countries

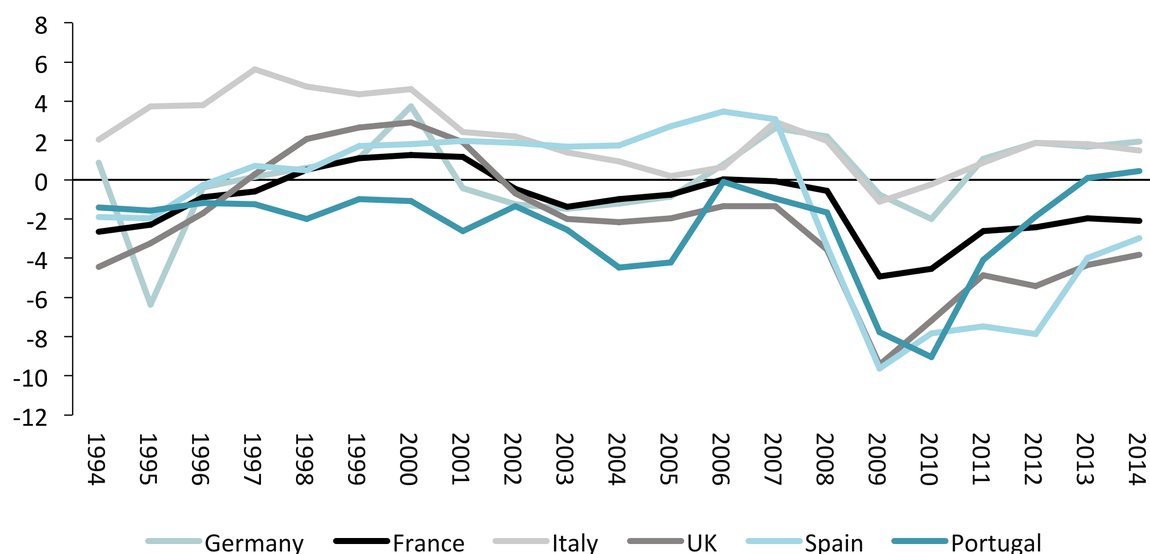
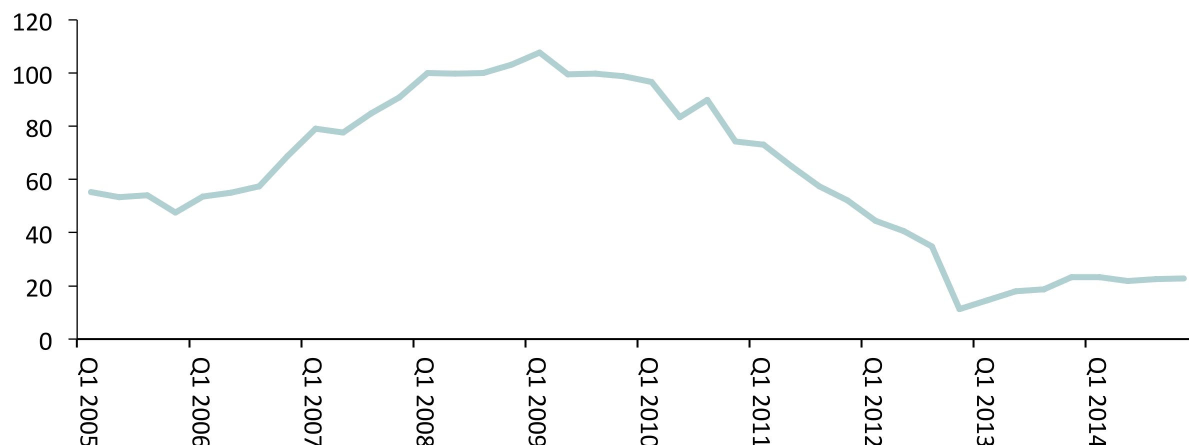


Figure 2: Primary Balances of the Bailout Countries vs. Troika Targets, IMF Data

	Ireland		Portugal		Spain		Greece		
	Troika Program Target Dec 2010	*Actual*	Troika Program Target Dec 2011	*Actual*	2011 Stability Target	*Actual*	"Troika 1" May 2010	"Troika 2" March 2012	*Actual*
2011	-6.7	-9.2	-1.7	-3.0	-3.8	-7.0	-0.9	-2.4	-2.9
2012	-4.1	-3.9	0.3	-0.6	-1.9	-7.4	1.0	-1.0	-3.6
2013	-1.4	-1.3	2.1	0.1	-0.3	-3.5	3.1	1.8	-8.2
2014	1.2	0.1	2.8	0.4	0.8	-2.3	5.9	4.5	1.7

Figure 3: Combined Exposure to Greek Financial Assets in Euro Billions (Banks in the UK, Germany, France & Italy), BIS Data



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.

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