M O N O G R A M

NEWSLETTER *March 2016*

Amidst considerable turbulence in global markets, the Fund was almost unchanged last month, declining just 0.3%, when the MSCI World Index recovered from a 7.5% intra-month loss to close 1.5% lower and the EAFE index (non-US Developed Markets) fell 9.9% intra-month before closing 3.5% lower. From inception our Fund is 6.8% lower, with a peak-to-trough drawdown of 8.2%.

Fears that the Chinese authorities might be losing control over monetary policy, and more precisely the yuan, as the on-shore/off-shore yuan differential pointed towards a substantial probability of meaningful devaluation appears to have been one major factor between the extreme intra-month volatility in almost all asset classes last month. With the implementation of numerous measures to make it more difficult for Chinese to take assets out of the country, administrative steps to conceal the extent of the pressure and substantial daily currency intervention, the yuan devaluation that had been priced into the off-shore market has been eradicated. Stability "appears" to have been restored and the Chinese authorities appear to have won round one in the fight with investors positioning for a substantial currency devaluation.

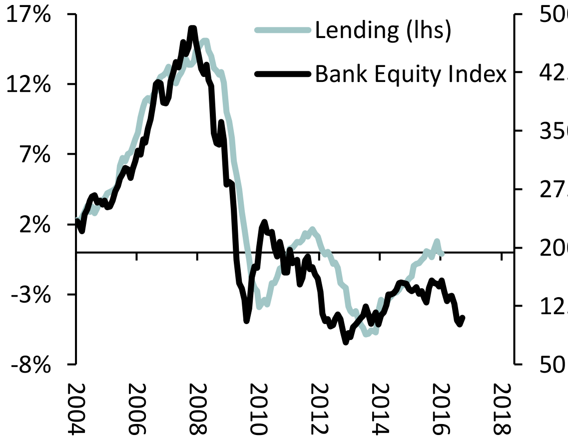
The victory, even if modest, comes at a substantial daily cost of intervention, however, and it is far too early to call time on the "China Crisis" when the economy continues to weaken, leverage continues to grow and a horrifying and unprecedented rate of capital continues to leak from the system. Could this be the calm before the storm? We don't know, but we do know that even the Chinese cannot stand in the way of the inevitable consequences of the greatest credit boom, being fuelled again by policymakers, in human history. Large, speculative long dollar positions seem to have been "shaken out" in recent weeks and leveraged investors have paid a heavy price. What we will say, with some confidence, is that in kicking the problem down the road, the problem just grows and the impact on global markets grows commensurately.

Anyway, enough about China as we have already written previously in enormous detail about the "train wreck" that is the Chinese economy and all of that analysis still stands and is as fresh as the day it was written. This month, we want to take a look at Europe, specifically European banks and the hapless – in our view – efforts of the European Central Bank (ECB) to force them into lending through a combination of negative rates, back-door subsidies and excess balance sheet liquidity.

Regular readers know well that we are not fans of Quantitative Easing (QE) and experimental central bank monetary policies (we cannot see the theoretical or practical case for ongoing liquidity injections) but, nonetheless, central bankers seem to want to keep going down a path with no possible end point but another financial crisis as a consequence of excess leverage and overvalued assets. Before its latest commitment to further balance sheet expansion, the ECB's asset base had risen a little over €700 billion (a one-third increase) since its last QE missive in early 2015 – its balance sheet is now back up to 26% of GDP, a little short of the 32% peak back in 2012. That last episode, when the ECB forced excess liquidity into bank balance sheets, saw overnight deposits held on the ECB's balance sheet (in the deposit facility) rise from zero to nearly €850 billion, as banks parked unwanted liquidity back at the central bank. Much the same has happened, predictably, this time around with overnight deposits going from zero to almost €270 billion in the more recent stab at QE. The accumulation of the liquidity on the balance sheet of the central bank demonstrates, in practical terms, that "you can lead a horse to water but you cannot make it drink" i.e. you can give banks the *means* to lend but you cannot *make* them lend. At least that is what experience would suggest, but the ECB has gone a step further (in common with a number of other central banks, for example Sweden) and turned up the pain on banks by charging them to hold all that cash on their balance sheet. In other words, with negative interest rates the ECB has imposed a tax on the banking system and offered to reimburse that tax in the event the banks hit loan targets. This is particularly important in the Euro-area where around 70% of all credit gets extended by banks. Banks are always and everywhere important but even more so in Europe where they are inordinately large and play a larger role.

We can see a number of problems with this policy path, not least with the fact that an already excessively large and excessively leveraged banking system will be forced to actively seek out borrowers either at home, or more worryingly, overseas, and that credit standards must inevitably loosen. The motivation for such drastic policy action, aside from the large and worsening drag on the global economy from China, can be seen in Chart 1 which shows the relationship between bank stock prices and bank lending in the Euro-area, with a six month lag. Unsurprisingly, banks tend to lend more when their stock prices are buoyant (and vice-versa).

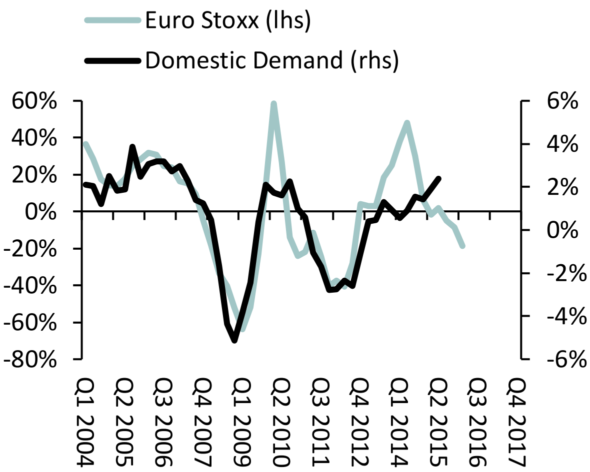
Chart 1. Euro-area Bank Stock Index (advanced 6 months) vs Euro-area Bank Lending to non-Financial Corporates (%y/y)



The weakness of bank stocks in the last year implies lending to the non-financial corporate sector falling 3 – 3.5% year over year (y/y) in the second half of the year. It seems to us that stronger, healthier banks with buoyant stock prices are the key to greater lending and stronger demand growth in the Euro area and we cannot, for the life of us, see how the ECB's latest policy pronouncements are consistent with that scenario.

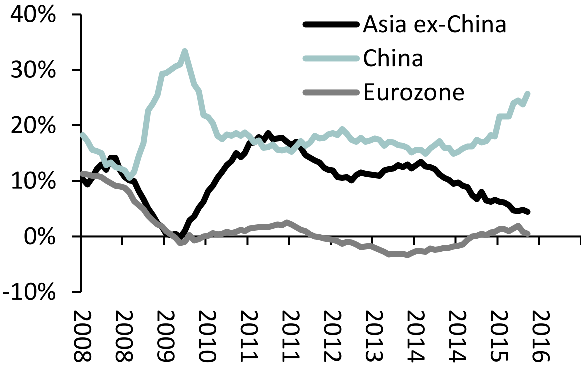
The "drag" on demand from weak bank stocks is clear in Chart 2 where domestic demand growth lags stock prices by six months.

Euro Stoxx Bank Equity Index (%y/y) vs Eurozone Real Domestic Demand Growth (%y/y) Lagged Two Quarters



The emerging credit crunch in the Euro-area is being magnified by the ongoing credit crunch in non-China/Japan Asia, as shown in Chart 3. At 2001 exchange rates, just $230 billion in credit has been extended in peripheral Asia and the Euro-area in the last twelve months in comparison to $3.4 *trillion* in credit extended by Chinese depository corporations over the same period. But, of course, we know much of that is "safety net" evergreening-lending with little or no net economic effect other than to keep alive the walking dead. To see that, consider that Chinese depository corporations have extended the $3.4 trillion in credit coincident with just a $130 billion increase in Chinese GDP (at 2001 constant exchange rates). Singaporean lending is down 1.5% y/y having grown at a 31% annual rate at peak back in 2011 and lending growth in Hong Kong has slowed precipitously to just 3.5% y/y from a similar peak rate in 2011.

Chart 3. Bank Lending: "Asia ex-China (Singapore, Hong Kong, Philippines, Malaysia, Indonesia, Thailand and Taiwan)" vs China and the Eurozone (%y/y)



Hardly surprising then that the ECB has stepped forward with negative interest rates, the Federal Reserve has downgraded its growth and inflation outlook and moderated its rate path and talk of a return to QE is beginning to be heard in London. The Bank of Japan, in our view, will be the next to "go nuclear" as net speculative yen positions stand near the highest levels in fifteen years, the yen strengthens, activity weakens and the pipe dream of inflation disappears into the ether. Central bankers are beginning to panic we think.

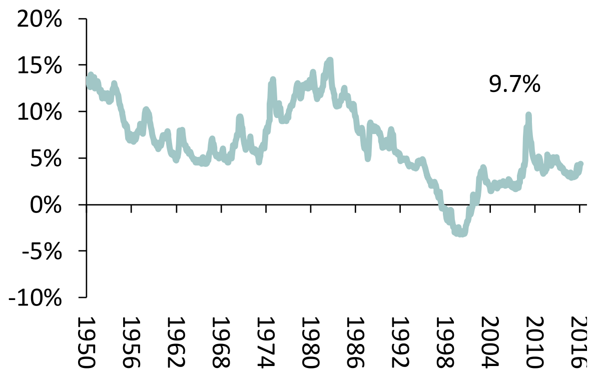
Common sense tells us that "going nuclear" should have a positive market impact when investors are in active risk-seeking mode, either because risk premia and valuations are at irresistibly enticing levels (they are not, in the main) or because they have an unbreakable confidence in visionary central bankers. The behaviour of markets over the last year suggests to us that the previously unshakeable belief in the ability of central banks to solve the problem of excess global debt, excess global capacity and structural deflationary pressures, might just be starting to wear at the edges. To that end, QE may be approaching its endgame.

Last year we wrote several pieces showing that gold has historically been an extremely poor hedge against inflation and that gold prices fell sharply after the major central banks entered QE. Quantitative easing, seen by many as the path to inflation and monetary ruin, via Weimar, and the ideal environment for gold bugs was associated with falling, not rising, gold prices, a conundrum recently touched upon by the legendary George Soros. We, however, noted the correlation between *sovereign credit risk* and the price of gold, pointing to gold as a great hedge for risk in a fiat money world (fiat money is notionally worthless paper money – money with no intrinsic value) and noting that it was no coincidence that the gold price fell when credit default swap (CDS) spreads collapsed in Europe after 2011 as the ECB moved to back Eurozone sovereign debt. Once again, it is worth noting that it is no coincidence that gold has rallied strongly this year alongside a material widening in sovereign CDS spreads – the weighted average for Italy and Spain (the poster boys for credit risk) widened last month to levels not seen since early 2014.

Sovereign CDS spreads and the price of gold will tell us if the hereto unshakeable belief in central bankers is, in fact, wearing thin.

Finally, with the US market acting as the heartbeat of the global markets and the ultimate barometer of risk appetite, it is worth returning to some analysis we did a little time ago looking at the implied S&P 500 return. Has recent market turmoil done much to improve US and, by default, Global Equity market prospective returns? In short, no, as **Chart 4** shows. The implied ten year annualised return still languishes at levels rarely seen in the last century or more, propped up by QE and the threat of ever more QE-inflicted pain to those doubters who dare to say no and not participate in the frenzy. This matters because, as we have shown in decades of data, no matter what, non-US markets find it hard to perform when the US market performs poorly.

Chart 4. Implied US 10 Year Equity Market Annualised Return Assuming Reversion to Trailing Median Valuation and Trend EPS Growth



Our Fund remains very defensively positioned, half in Cash and half in Investment-Grade Bonds, and will respond to improved fundamentals and stronger market momentum in the event that conditions change.

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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**.