MONOGRAM

NEWSLETTER *May 2015*

The MONOGRAM Portfolio returned an estimated -0.3% for the month of April 2015, bringing the year-to-date (from the 27th of January 2015) to +0.3%. Equities were generally supported, with indices approaching or at record highs in the US and across non-US developed markets, despite a violent broad-based sell-off that took place in the last two days of the month. Bond markets retreated modestly as yields bore the continued brunt of money being thrown at sovereign bonds, mostly through the European and Japanese Quantitative Easing ("QE") programs. Commodities continue to evolve at depressed levels in spite of a bounce in crude oil, supported by what looks like temporary weakness in the US Dollar.

Our Portfolio is Bayesian in nature as our views and actions are conditioned by an external variable – price action. From this perspective, there are instances when we are cautiously – and perhaps, nervously – long risk assets in spite of structurally weak levels of economic and corporate activity. Since equities are driven by a combination of the fundamental picture and monetary conditions, we find ourselves in this position when the "heavy lifting" in equity market gains disproportionately comes from monetary policy rather than healthy, underlying growth in corporate profits. This unbalanced, stimulating mix has been the rule, rather than the exception, since 2009. It was then that equity markets finally found their footing after a brutal meltdown to stage a powerful bull market in which we still find ourselves today, more than 6 years later. However, never before has this bull market been so reliant on monetary policy in the face of weak and diminishing growth.

The consequences of attempts to stop the flow of new debt, alongside investment at a multi-decade high as a share of global GDP, together with Chinese manufacturers still growing their capacity at 10 percentage points faster annually than domestic demand growth overseas are anaemic global growth and widespread disinflation. **Chart 1** shows that the proportion of countries, accounting for 80% of global GDP, with inflation below 1% (and countries with core inflation below 1%) is near record levels. Excess supply, coupled with predictably sluggish growth (wealth effects are no basis for a sustainable recovery), places a structural disinflationary bias into the system.

Unsurprisingly, the percentage of OECD countries with growth below 3% is trending higher and is now reaching 75% (**Chart 2**). Alongside efforts to contain budget deficits, this is hardly conducive to growth in corporate profits; further gains in equity markets should therefore come from multiple expansion (In other words, further optimism about the corporate world's ability to deliver higher profits) rather than broad-based earnings growth.

However, US equities (which drive other equity markets as we have shown previously) seem very expensive. According to the median US price-to-sales ratio for the S&P500, they are at a record level of 2.2 – more than double the long run normalized level. Further optimism, it can be argued, would bring us into euphoric bubble territory. However, markets rarely stop as they trade past fair value and the probability of overshooting further is certainly not easy to judge. Our portfolio construction recognizes that the possibility of additional gains should at the same time be well cushioned in the event of a substantial market decline; asymmetry in the expected return profile is something that we strive to achieve.

The places where this excess optimism is likely to express itself the most are Japan and the Eurozone. This is because both jurisdictions have excess combined savings (Chart 3). At the same time, new net issuances of equities are modest in the Eurozone and in Japan – less than 0.5% of GDP annually. Even allowing for net government bond issuances in the Eurozone and Japan, central bank liquidity creation of 8% and 15% of GDP respectively annually gives rise to a significant imbalance between the supply of monetary liquidity and the net supply of financial assets; negative bond yields are the inevitable consequence. Chart 3 illustrates why we see negative yields in the Euro area and Japan, but not in the UK and US. In the Eurozone, a surplus of domestic savings plus additional central bank liquidity is chasing a shortage of assets while external deficits in the UK and US, with no liquidity stimulus, means that those countries must rely on net foreign savings inflows to finance deficits (something they are, rightly, unwilling to do at negative yields).

In the short to medium term, the other reason to be somewhat weary of European and Japanese assets is because Quantitative Easing depresses the value of the local currency, namely the Euro and the Yen. Since both the European and the Japanese economies have large export components, a lower Euro and Yen mechanically boosts the local companies' profits. This effect was less established in the US when the Federal Reserve went through three rounds of Quantitative Easing (2008 – 2014) simply because the US Dollar is the only global currency (about two-thirds of global reserves are held in USD against less than a quarter held in Euro and about 5% in Yen). The marginal note printed dilutes the Euro and Yen monetary bases much more than that of the US. As a result, the trade-weighted value of the USD over the whole QE experiment was literally unchanged, whereas the trade-weighted value of the Yen and the Euro since the beginning of the current QE program (October 2011 and January 2015) are respectively 28% and 10% lower.

The jurisdictional switch of the Quantitative Easing effort from the US to Japan and Europe is nonetheless not neutral, even when the higher printing pace is taken into account (currently approximately $110 bn/month vs $85 bn/month for the sole US QE program). This is because, historically, the performance of non-US developed markets has been much more influenced by whether the US is in recession than whether these countries find themselves contracting.

The major European markets, paradoxically, perform better when they are in recession but the US is growing than they do the other way around. Fading US growth, within the context of a broad slowing in global GDP growth, creates risks.

With exceptionally high US valuations, the expected return on a balanced portfolio at record low levels and ongoing QE, caution is warranted. We maintain a maximum allocation to performing (i.e. positively yielding) investment-grade sovereign and corporate bonds. This represents approximately 50% of the current portfolio. The balance is invested through liquid indices mostly in the USA, Europe, the UK, and Japan, where we have hedged the portfolio against currency risk.

Charts on next page

Chart 1: Proportion of Countries with Inflation Below 1%

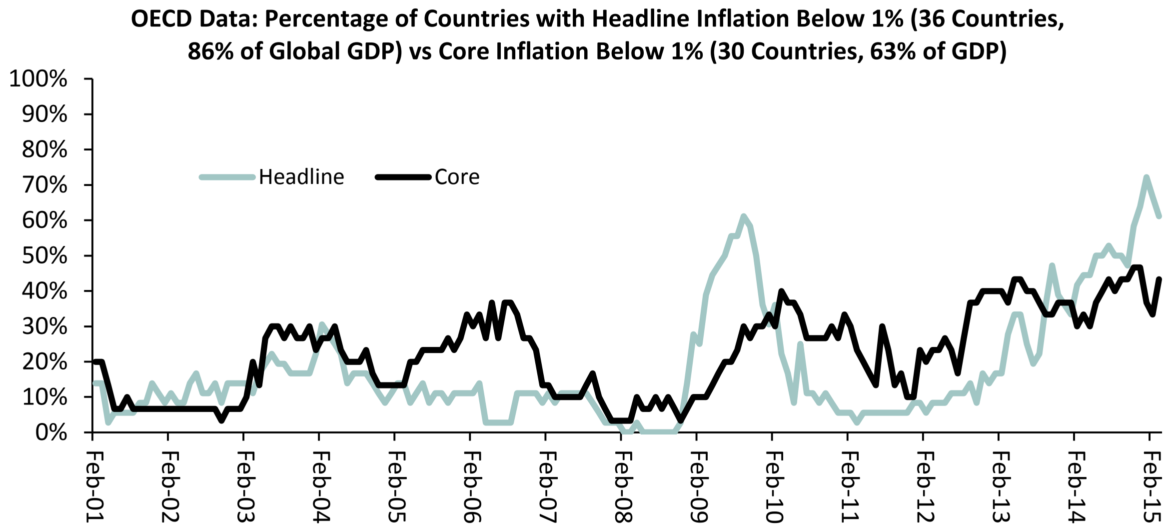


Chart 2: Sample of 35 Countries with Percentage of Annual Real GDP Growth Below 3%

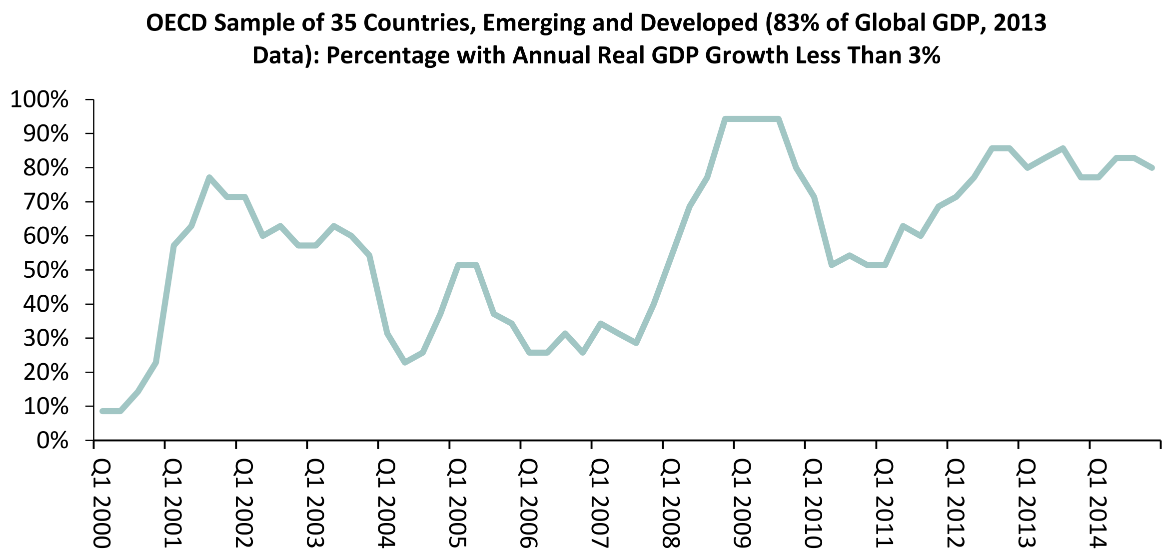
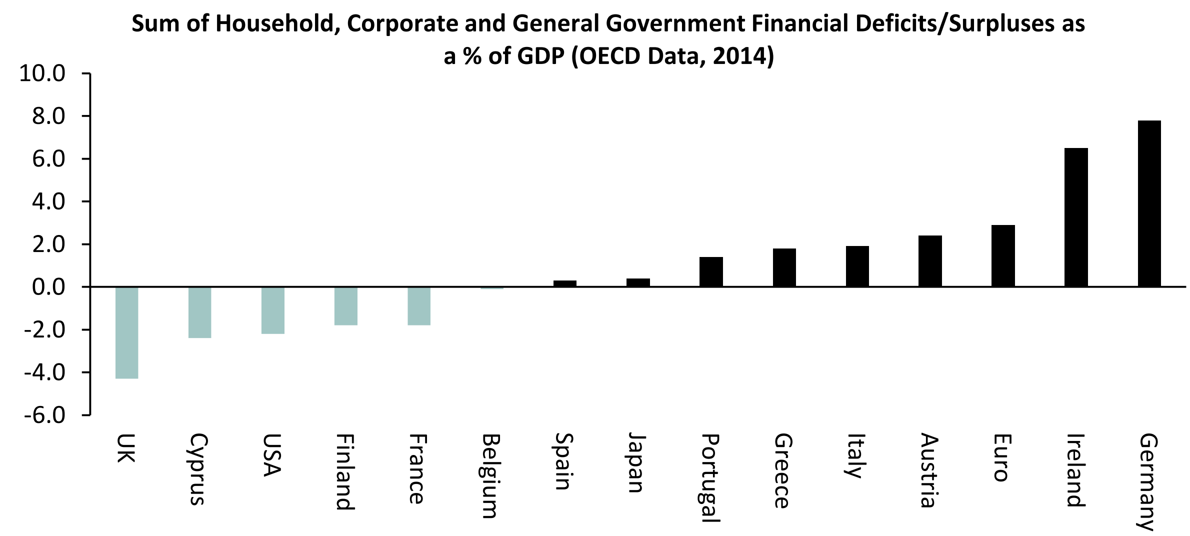


Chart 3: Total Country Financial Deficits and Surpluses as a Percentage of GDP



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.