MONOGRAM

NEWSLETTER *May 2016*

Our fund returned +0.6% last month, bringing year to date return to -0.8% and performance since inception to -5.7%.

In our previous letter, we looked behind the recent strength of the Japanese Yen and its roots in the rising risk aversion of the world's largest net creditor.

Last month something very important happened in Japan that appears to have gone largely unnoticed and has significant implications for Japanese monetary policy, the Yen, the Japanese equity market, and global asset prices in general. On April 26th, Norihiro Takahashi announced that his pension fund now has a new policy in place: to hedge its foreign currency exposure.

Why does it matter? Takahashi-san happens to be the newly appointed head of the Japanese Government Pension Investment Fund (GPIF), the world's largest pension fund, with approximately $1.3 trillion under supervision. As startling as it might sound – although a Chicago purist might disagree – the GPIF historically has not hedged any of its foreign currency exposure back into Yen, selling Yen and doing their bit to support the efforts of the Bank of Japan to drive the Yen lower to stimulate activity, and import a little inflation to hit their comically unachievable 2% inflation target.

The timing of the change is interesting, coming just 18 months after the announcement of a New Policy Asset Mix which saw the target allocation to foreign bonds and equities raised from 23% to 40% of total assets. At the end of last year, total foreign (unhedged) holdings stood at $465bn (0.36 * $1280bn), just below the target allocation. To put that amount of potential Yen demand - as they move to place hedges against the foreign currency - into perspective, it is almost 40% of total Japanese Foreign Reserves, nearly double the size of the Current Account surplus and approaching 15% of the Monetary Base.

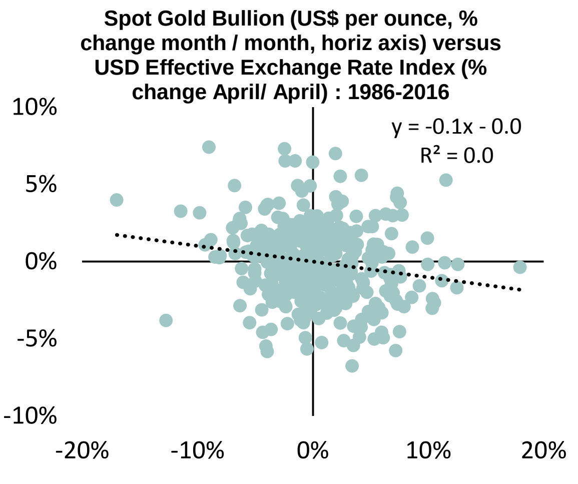
Not only did the world's largest pension fund increase its shortfall profile dramatically in the last 18 months, at probably the least appropriate time in living memory (more on that later), raising its equity weighting from 39% to 46% and reducing its bond exposure to 51% from 56%, but its barely positive actuarial return and fund shortfall will necessitate steady and continuous asset sales. So, think about that, if it isn't being hedged, and substantially increasing Yen demand, it is being sold, driving down asset prices. Perhaps it's no wonder the Bank of Japan appears to be a "rabbit in the headlights", the phrase "don't fight the Fed" doesn't appear to have its counterpart in Japan where the GPIF is quite clearly fighting the Bank of Japan.

We think the hedging demand for Yen from the GPIF alone will be sufficient to keep the Yen appreciating steadily from here, with all of the implications we highlighted last month (lower Japanese equities, severe stress for Japanese banks, persistent deflation, lower US Treasury yields, pressure on US equities and global asset prices in general), with asset sales just compounding the effects. In short, Yen strength is *structural.* When considered alongside Chinese Yuan *structural* weakness, the potential consequences for the global economy and markets are extraordinary.

As investors, you are well aware that we recently added Gold exposure to our fund, its first positive view on the metal since late 2011/early 2012. We have written extensively in our blog about the terrible inflation hedging properties of Gold and the compelling historical evidence that confirms its value as a *credit risk hedge*. We have also written about the relationship between the USD and Gold which appears to confuse many analysts, their lack of reference to the data still leading them to believe that a bullish Gold position is nothing more than a bullish USD position (gold rises when the USD rises, and vice-versa). To lay this myth to rest, we thought it useful to describe, once again, the precise role that the USD plays in the price of Gold: it is described by the following very simple equation,

USD / ounce of Gold = (USD / Foreign Currency) * (Foreign Currency / ounce of Gold)

Immediately, it should be clear that the USD price of Gold rises when (a) the USD rises and / or (2) the Foreign Currency price of Gold rises! So, there is simply more to the Gold price than the USD, there is also the mechanism for a credit risk induced Foreign Currency rise in the Gold price that has to be factored into your analysis. This can be seen in Chart 1 which shows the relationship between monthly *changes* in the Gold price and monthly *changes* in the effective USD exchange rate: the picture is a random scatter plot and the R-squared is zero, in effect the changes in the value of the USD on a monthly basis over the last 30 years have explained *none of the monthly variability* in the Gold price.



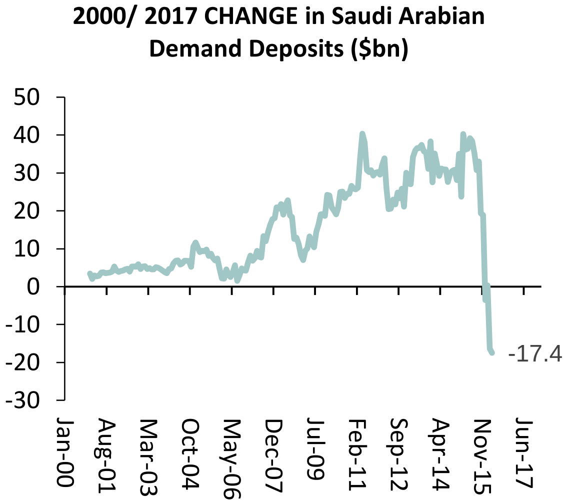
When you consider Gold as an investment, it pays not to fall into the traditional trap. Our bullish view, confirmed by the positive absolute and relative momentum of Gold for the first time in many years, reflects our ongoing credit concerns in a world where China and Japan are under severe strain and global credit market debt has broadly tripled from $85bn in 2000 to approximately $250bn today, still growing at a rate outpacing that of nominal income. For us, and for any investor with an eye for empirical evidence, Gold is a hedge against rapidly deteriorating global credit conditions.

Extending our focus on credit risks and currencies beyond the Yen and Yuan, the Saudi Riyal gets little attention amongst international investors but recent developments in the Kingdom merit a passing mention. As background, keep in mind the following: The Kingdom has a 14% of GDP Current Account deficit, a 15% of GDP Budget deficit, produces roughly 10 million barrels of oil a day with a breakeven price around $100 and has an exchange rate that is fixed at 3.75 against the USD. Remember that approximately 90% of Saudi Government Revenue comes from Oil.

As we can see in China, holding everything together within the constraints imposed by a USD exchange rate peg is proving quite a challenge: Chart 2 shows a $17bn (or 6%) outflow of bank demand deposits in the last year. In effect, we are seeing a run on Saudi banks. To keep everything together, just like China, intervention has seen the Saudi's lose $160bn (or 20%) of their Foreign Exchange Reserves in the last couple of years.

Although the oil price ebbs and flows with sentiment, the reversal of the $6 trillion net capital inflow into Emerging Markets in the last cycle remains the dominant theme in markets (seen in the $1.2 trillion decline in Global Foreign Exchange Reserves in the last year), and we doubt we will see oil anywhere near the required $100 for quite a long time to come. On that basis, the devaluation of the Riyal looks as inevitable, in time, as that of the Chinese Yuan: it is simply not sustainable for deposits to flow out of the banking system, the Government to meet its fiscal commitments and the current account deficit to be financed at the current exchange rate fix. The Riyal must surely follow the Russian Rouble significantly lower. Speculative pressure is clear, interbank rates are at a seven year high, M2 money supply is contracting and deposit rates have more than doubled in the last year. It can, surely, only be a matter of time – the Riyal looks, like the Yuan, as close to a one-way bet as we have ever seen.

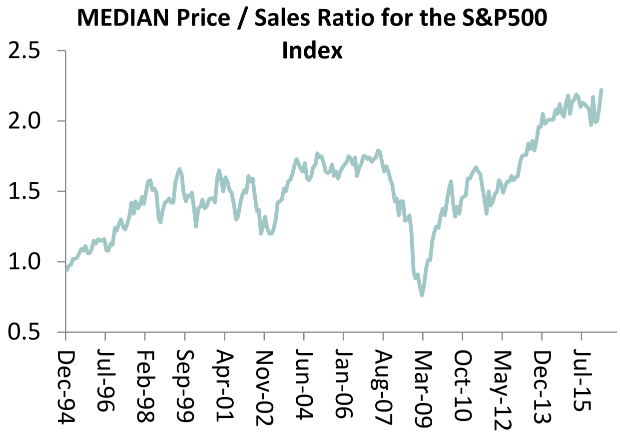
What might be the implications? Well, a sharp rise in Saudi inflation to start, the Kingdom produces virtually nothing of merit for domestic consumption and relies heavily on imports, accelerated capital flight (to be met with hard capital controls) and devaluations for the other Gulf states that are pegged to the US Dollar (and capital controls there to halt capital flight). Moreover, the oil price almost certainly moves to a much lower equilibrium (with Gold going the other way). Domestic, and regional, stability must also be threatened.



Continuing our stroll through the global markets, against this fundamental backdrop the US equity market has quietly crept to a new record level of valuation. On the usual, and more commonly discussed, metrics the market remains below the 2000 bubble peak valuation (although at 27 * trailing 10-year average reported earnings the market has been cheaper 90% of the time in the last century whilst at 17 * 12 month forward operating earnings it is 25% above the trailing median going back to the early 1960s) but on our preferred measure it has touched new highs. Regular readers will know that we like the Price / Sales ratio as a valuation measure; empirically it has a better correlation with ex-post realized returns than both of the traditional measures described above. Why? Because it augments the Price / Earnings ratio with Profit Margins,

Price / Sales = (Price / Earnings) * (Earnings / Sales)

It allows us to integrate into valuation the impact of (mean-reverting) profit margins: with margins near record levels that is extremely valuable information. As Chart 3 shows, the median Price / Sales ratio in the S&P500 index is now 2.22, well above the 1.1 median level for the ratio in the last 40 years and the 0.9 median level for the ratio since the early 1960s:



Call us old-fashioned, but we still believe that valuation is the structural component of returns, it pegs holding period returns over the course of a full market cycle. The current record level of valuation, against the backdrop we have described, and the close to zero returns it implies, seems unsustainable from our viewpoint. There is no margin of safety. At the moment, we see the Global Equity market in a drawdown state (EAFE and EME within that) with the US index dancing on the ring of descent with no absolute momentum, that's why we hold no equity exposure. With Chinese capital outflows in the first quarter almost equal to those for the 11 months through November last year, masked only by an extraordinary one-off $1 trillion surge in bank lending (10% of Chinese GDP and 1.5% of Global GDP) and the economy in a parlous state, the Yen and Japan in the spotlight, persistent and worsening deflationary pressures and this is no time to invest without a margin of safety.

Our fund remains very cautiously positioned, effectively short equities into Cash, Bonds and Gold. Market fundamentals, as well as behaviour, strongly support that positioning.

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**.