MONOGRAM

NEWSLETTER *November 2015*

The MONOGRAM Portfolio returned +1.3% for the month of October, bringing performance since inception (the 27th of January 2015) to -3.6% (net). After a very volatile summer in risk assets, markets rallied strongly with Global Equities up +7.9%. Bonds sold off, with the US 10 year yield rising from 2.03% to 2.14% at month-end, while Investment-Grade Bonds also retreated globally. Commodities rallied modestly, adding 1.1% for the month, in what remains a very volatile and uncertain environment. We re-invested the cash raised in the Portfolio at the end of last month into US Equities, in full accordance with our investment process. As a result the Portfolio is fully invested with approximately 50% of the capital deployed in Investment-Grade Bonds, 25% is US Equities and 25% in Developed Market (EAFE) Equities, which remains a defensive posture, although less so than in the vey recent past.

The turbulence in financial markets in recent months, not unusual or unprecedented, is typically characteristic of transitional periods between growth and recession, boom and bust or inflation and deflation. As such, they must be endured, and asset allocation should recognize the possibility of a persistent phase-transition, from bull to bear market or from rising to falling asset prices.

With that possibility in mind, once again we return to our favourite topic of recent times, China – the source of recent turbulence and, through the severe stresses in the credit system, the probable source of the phase-transition. If you believe recent GDP data then you would think all is fairly calm in the South China Sea with growth near 7% and an unemployment rate of just 4% - a nirvana for policymakers. Nonetheless, interest rates have recently been cut for the sixth time this year, and bank reserve requirements have also been cut for the fourth time this year (and, of course, the currency has been devalued by a small, but symbolically important, amount). On the face of it, nominal rates have fallen 125 basis points and the reserve requirement cut has released approximately $500 billion of liquidity (gross, 5% of GDP) into the banking system. All that in an economy with, apparently, an enviable growth rate that has fallen only by 50 basis points from the level two years ago. Apparently, it does not seem to take much in China for monetary policy to do a complete reversal and shift into full-on easing mode.

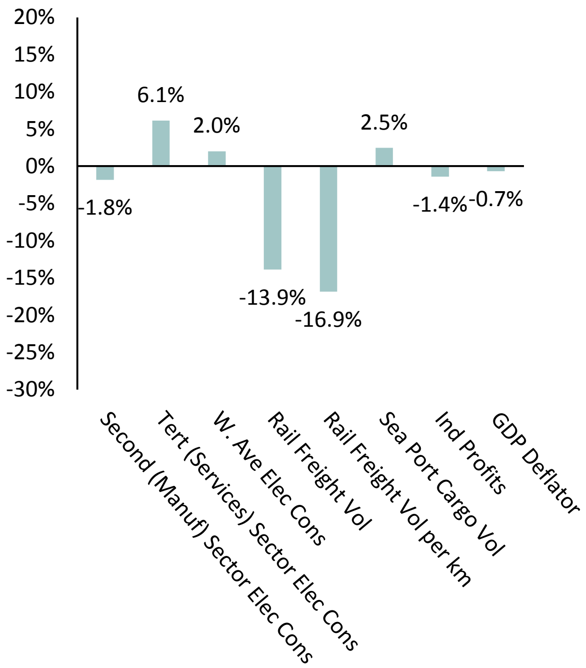
So, why the aggressive shift in policy stance? Well, in our view, it reflects a disconnect between image and reality in the Chinese economy. Taking a look at **Figure 1**, it shows the growth rate of a series of important economic metrics. Let's start with the most puzzling.

How can it be that the economy is growing 7% year/year when electricity consumption growth is decelerating in all three major sectors and is actually declining in manufacturing and only growing 6.1% in services? Secondary ("manufacturing") and tertiary ("services") activity account for approximately 48% of GDP value added each. Weighted together they have electricity consumption growing 2% year/year. Unless Chinese energy efficiency is improving at a mind-boggling rate (and the data for energy used per unit of GDP does not suggest this), Chinese businesses appear to be working miracles.

How can it be that the economy is growing 7% year/year when rail freight volumes, and rail freight volumes carried per km, are falling at the fastest rate in over twenty-five years? Moreover, sea freight cargo volumes are growing just 2.5% year/year, the slowest rate since the depths of the 2009 global recession. Parcels handled by China Post and telecoms are declining almost 40% year/year. If output really is growing across the whole economy at such a formidable rate, how on earth is it being moved from supplier to user?

How can it be that the economy is growing 7% year/year when industrial profits are declining, the GDP deflator is declining and producer prices are declining (consumer prices must surely be following that list into deflation in coming months/quarters)?

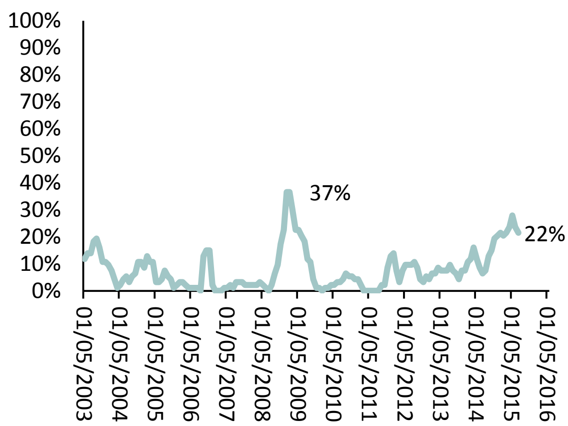
Figure 1. Key Chinese Economy Statistics (%year/year)



No, it is simply beyond belief that China is growing at such a rapid rate, albeit slower than the frenzied rate of a decade ago. The actions of the central bank speak louder than the numbers of the National Bureau of Statistics of China. The reality, in our view (and if you want to read an alternative view seek out the writings of Nicholas Lardy), is that China has slowed rather quickly since late 2014 and that growth is probably around 2% at best and is almost certainly heading into contraction.

As if it were necessary, the 3.1% of GDP federal budget deficit, the largest in over twenty-five years, also points to something not quite right when the image and reality are separated. At the provincial level, as **Figure 2** shows, almost one-quarter of the Thirty-one provinces are reporting budgetary revenue running below the levels of a year ago. That is almost on a par with 2009 and must surely only worsen as the economy continues to weaken. Inevitably, in the next year, some Chinese provinces are going to struggle to pay bills (pensions, wages and debt servicing).

Figure 2. Three Month Moving Average % of the 31 Chinese Provinces Reporting Declining Budget Revenue from a Year Ago

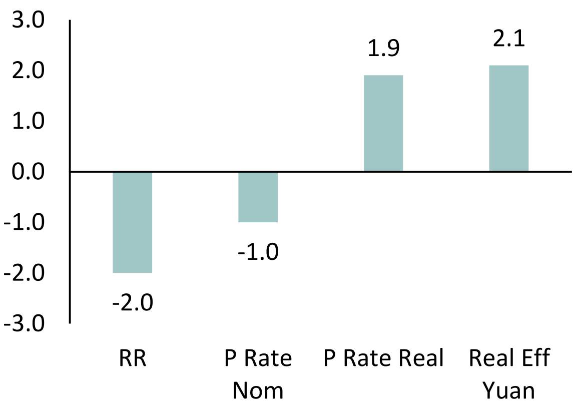


The truth of the picture, in our view, is a Chinese economy where nominal income levels are probably static, debt growth is still in double digits and deflation is widening. In addition, we believe that industrial profits are declining as the corporate balance sheets deteriorate at a rapidly accelerating rate, central government and provincial budgets are under increasing strain and capital flight is intensifying.

On the latter point, as we noted in a recent blog posting, the $500 billion gross injection from reserve requirement cuts since the beginning of the year has been offset by almost $330 billion of foreign reserve outflows from the central bank through September (almost certainly even larger in October, offsetting 80% of the liquidity inflow).

In **Figure 3** we show a selection of monetary policy parameters which suggests (in combination with a trivial **net** liquidity injection from reserve requirement cuts) that higher real interest rates and an appreciating real exchange rate – the consequence of worsening deflation – suggest that monetary policy remains extremely and unnecessarily tight in China.

Figure 3. The % Point Change in the Reserve Requirement Ratio (RR), Nominal (P Rate Nom) and Real (P Rate Real) Prime Lending Rate and Real Effective Yuan Exchange Rate (Real Eff Yuan) since the end of December 2014 - end of September 2015



For example, the real prime lending rate in China has risen almost 2% since the start of the year and now stands at around 10%, almost double of that in the Eurozone where growth is similarly sclerotic.

Why would an economy that has almost ground to a halt and is in deflation, where depository corporations have quadrupled the size of their balance sheets since the start of the financial crisis and debt growth is still in double digits, have such cripplingly high real loan rates? A hugely bloated banking system standing behind a grossly over-leveraged business sector in an environment of deflation represents a nightmare picture. When nominal revenues have been flat/falling in recent years for many Chinese companies and nominal debts are rising so rapidly, non-performing loans must be surging (they are, but Chinese data does not show it); the system is screaming for relief and lower nominal/real rates.

The problem the Peoples Bank of China faces, in our view, is that it is trying to hit two separate targets with just one bullet. Simply put, with capital streaming out, the yuan/dollar peg is under strain and high relative and absolute real rates are necessary to stop it from breaking altogether whilst deflation, surging leverage and flat/declining nominal incomes would suggest a much lower equilibrium real rate. What do you do? You do what the Chinese have begun to do, you loosen the peg before the noose of the peg strangles the economy.

It is just a matter of time, in our view, before inconsistency between the external and internal equilibrium interest rates forces their hand and gives rise to a further substantial yuan devaluation. Cutting rates, as China has done this year, just pushes more capital out through the exit. The deteriorating provincial and federal budgetary position suggests no room for fiscal relief and suggests that the vast overhang of capacity is easiest grown into with a materially lower real exchange rate. The recent small devaluation was just testing the water; a taster, if you like, of things to come. It would take a 20% devaluation to halt the slide of the economy at this point. Just look at what a 2% devaluation did to global markets and imagine what a move ten times that would do for global risk appetite. Is your total asset allocation philosophy/implementation suited for such a phase transition?

The effects of the Chinese response to double digit debt growth and net capital outflows in a period of deflation and stagnant nominal income will be profound and truly global. Most likely it will necessitate a substantial increase in Japan's already large (15% of GDP annually) liquidity injections, a more prolonged and more aggressive QE stance from the ECB and the deferral of rate hikes in the UK and US well into the future. UK banks have $200 billion of exposure to Chinese counterparties (according to BIS data), US banks have $100 billion and Japanese banks have $80 billion, so tighter monetary policy in those countries would not be a wise idea. Remember, 70% of economies globally are already growing at a rate below 3% and the median inflation rate is barely 1%, so a yuan decline on the scale we envisage, with the US dollar (and, by default, Commodities) taking the strain on the other side, would send global growth lower and the major economies into full-scale deflation. Amidst all this, government bond yields which are at historically very low levels, could well plummet to new depths.

Against this macro-economic backdrop, and following a "false alarm" at the end of

September, the Portfolio is fully invested in Equities and Bonds. In accordance with our investment approach, our positioning is not conditional upon the accuracy of our broad market views and responds only to actual market conditions. As always, we will observe and respond when/if our central hypothesis is proven correct and thus will not be detrimentally affected should it prove incorrect.

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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