MONOGRAM

NEWSLETTER *October 2015*

Amid a continuation of the turbulence, largely explained by extraordinary net capital outflows from an excessively leveraged and investment-reliant emerging markets bloc that began mid-year, the MONOGRAM Fund declined 1.5% in September, bringing performance since inception (the 27th of January 2015) to -4.9% net. This comes in the context of a sharp rise in asset price volatility over the third quarter of the year, during which most asset classes suffered severe losses (Global Equities lost 8.3% while Commodities in aggregate tumbled, losing 19.3%). Traditional "safe heavens" such as Bonds were barely up (+0.5%), while Gold lost 4.9% over the same period.

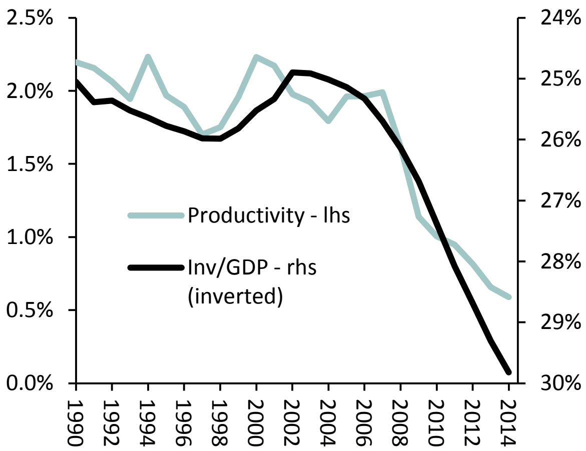
In previous newsletters and blogs we have explored China and emerging markets issues that have been the dominant theme in the current cycle. Much slower global growth and a worsening deflation risk, alongside increased credit losses in the Asia region, are clear consequences. In this month's newsletter we take a step back to look at the current state of the global economy and we also seek to explain differences in performance and outlook as well as identify sources of potential tension.

From 2008 through the end of 2014, $58 trillion of stimulus was applied to the global economy (government debt increase, central bank balance sheet expansion and the expansion of Chinese bank balance sheets). Yet the *median* GDP growth rate across a sample of thirty-five developed and emerging countries (83% of Global GDP) currently stands at only 2.1%, with 74% of those countries with a growth rate below the 3% level. That is the growth profile typically seen at the *bottom* of growth cycles, after a period of policy tightening, not at the peak of the cycle after unprecedented policy stimulus. In fact, the current global growth picture looks remarkably like that observed at the bottom of the cycle in 2003 following the tech market crash. Unsurprisingly, given the shocking overhang of capacity that lingers, which in prior cycles would have been shaken out in a wave of bankruptcies and closures, the median core inflation rate is just 1.2%, the lowest level in decades. Aside from the avoidance of widespread sovereign default and a systemic banking collapse, that is an exceptionally poor return on policy.

The US economy, which has grown at a 2.1% annualised rate in the last three years (a three year growth profile second only to the early 1980s recession trough in its lack of vigour in the post-war period) epitomises the problem. A problem which, at the heart of it, can be traced to very poor productivity growth. Over the long run, US productivity growth has been a remarkably stable 2% annually, despite waves of technological and financial market innovation and the boom of the internet. That growth has slowed even more and in the last 5 years productivity has grown just 0.5% annually (1.3% annualised in the last decade). In fact, Ben Bernanke, former Chairman of the Federal Reserve, recently suggested that more investment was needed to boost productivity growth and reinvigorate the US economy and that monetary policy alone was insufficient. The same picture can be seen in the UK where the trend productivity growth rate in the post-war period is almost identical to that in the US and where productivity growth has slowed to just 0.9% and 0.6% annually in the last five and ten years respectively.

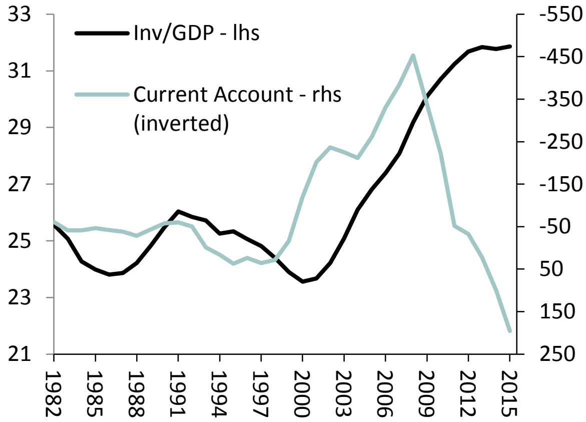
How do we explain this "productivity puzzle"? Well, in our view, the lack of productivity growth (and hence anaemic growth rate in the western economies) can be attributed to the surge in investment growth in the developing economies in the last decade or more. In effect, within the context of a global investment/GDP ratio at the highest level in almost twenty-five years, emerging economy investment has "crowded out" advanced economy investment. To see this clearly, **Figure 1** shows the rolling ten year annualised rate of productivity growth in the UK versus the rolling ten year average investment/GDP ratio in the developing economies (including China).

Figure 1: Developing Economies Investment/GDP Ratio (ten year average) vs UK Productivity Growth (ten year annualised rate, %)



Deteriorating UK productivity growth corresponds remarkably well to the surge in investment in the developing world (a period in which the investment/GDP ratio in the advanced world has fallen to the lowest levels in over thirty-five years). The investment/GDP ratio in the developing and advanced markets was almost identical, at 25% from 1980 – 2000 before diverging. We hold the view that productivity is so poor, and hence trend growth so modest, in the advanced countries simply because the developing economies are "over-investing". **Figure 2** shows their investment/GDP ratio versus the current account balance of the advanced countries. The developing country investment ratio surged in response to a rapid growth in indebtedness and a widening in the external deficit in the advanced countries. The advanced countries experienced "excess growth" due to leverage and the developing countries experienced "excess growth" due to a surge in investment to feed advanced country demand.

Figure 2: Advanced Countries Current Account Balance ($bn, 3 year m.ave) vs Developing Country Investment/GDP Ratio (%)

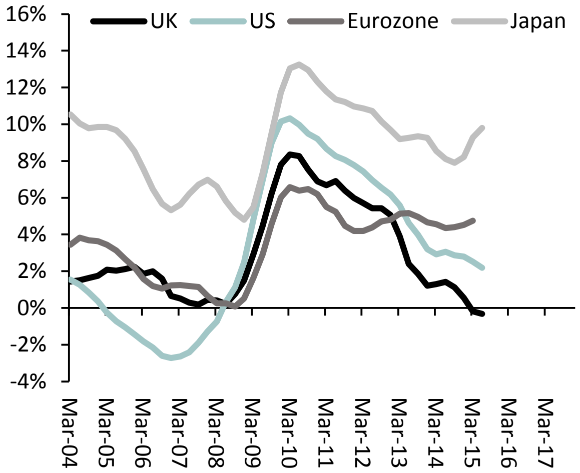


Unfortunately, with the disappearance of that advanced country deficit, the developing country investment ratio looks extraordinarily unsustainable. Adjustment in the developing world looks likely to be "forced" by a net capital outflow for the first time in two decades and the stresses apparent in excessively bloated bank balance sheets. That adjustment is likely to take several years to play out.

Remaining with the UK, where government officials take every opportunity to proclaim loudly how wrong the IMF has been and how strong the UK economy is among global, advanced economies (Chancellor Osborne has suggested that "there is no reason why Britain cannot be the richest major economy in the world [by the 2030s]"), how does an economy grow without productivity? Simple, as always, it does so through leverage.

From an accounting perspective, the economy is simply the sum of private sector activity and public sector activity; the balance with the rest of the world (the current account) is the sum of the financial balances (savings less investment) of the public and private sectors. With this simple framework, it is very easy to explain why the UK economy is outperforming its peers. It is not a consequence of George Osborne's brilliance and the success of apparent austerity, it is because the UK is the only advanced country in the world with a *private sector deficit, it is the only advanced country where the private sector is accumulating net liabilities and not net assets.* As **Figure 3** shows, the UK private sector (households plus businesses) invests/spends more than it saves, that is to say it is borrowing from overseas (since the UK public sector is also a net borrower).

Figure 3: Private Sector Financial Balance (Net Lending/Borrowing) as a % of GDP (rolling 4 qtr m.ave)



Pretty clearly, the relative strength of UK growth is not founded on productivity growth, which is at multi-decade lows, but on debt growth driving resurgent private sector demand growth. Those are fragile foundations and is no basis for the victory flag to be raised. In the face of a commitment to austerity and a commitment to delivering budget surpluses, a further deterioration in the private sector balance, and even more rapid debt accumulation in the private sector, looks necessary to keep the UK growing at its recent pace. We are not sure if this is a desirable path at all given historical precedent.

The distribution of global growth, or the lack there-of, is simply described by the substantial decline in private sector surpluses (and entry to deficit in the UK case, only Cyprus among developed countries also has a private deficit) in the US and the UK and the comparative lack of dis-saving in the Eurozone and Japan. Of course, in a world of record leverage teetering on the brink of Chinese-led deflation, countries with external deficits, and more importantly with private sector deficits, are the most vulnerable to a shift in risk tolerance.

Lastly, ahead of what we expect to be a significant Yuan devaluation over the next few years, it is useful to recap the inflation picture alongside the growth picture just outlined.

When we look across the thirty developed and emerging countries we follow closely (accounting for approximately two-thirds of global GDP), a near record 42% have core consumer price inflation below 1%, 75% have core inflation below 2%, and 54% of those countries have seen annual core inflation decline over the last year. The median inflation rate is low and the dispersion of inflation rates is low – disinflation/border-line deflation abounds.

Looking at just the US, a near record 43% of the 106 sub-components of the US Core Consumer Price Index are already in annual deflation, with 68% of the components having an annual inflation rate below 2%. Of the forty-two sub-components in the Non-Energy Services Index, a near record 13% are in deflation and a near record 44% have annual inflation below the 2% level.

This picture of disinflation/deflation would be worrying at the best of times, least of all in the aftermath of the greatest policy stimulus in history.

Our case remains for anaemic global growth and worsening disinflation/deflation and we will continue to monitor developments closely and alter our risk exposures accordingly if/when this scenario evolves. In the meantime, our Portfolio remains very defensively positioned with 25% in Cash, 25% in Developed Market (EAFE) Equities and the remainder in Investment-Grade Bonds.

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**.