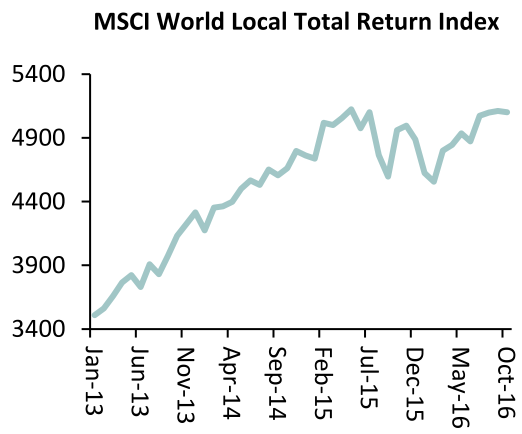
NEWSLETTER October 2016

The Fund returned net -0.06% last month, bringing year to date returns to -0.49%. In a benign month, and consistent with the directionless Global Equity market in the last 18-months, the Global Equity index rose just 0.2%, EAFE Equity 0.6% and US Aggregate Bonds up a modest 0.1%. On the other side, Gold and High Yield debt rose 1.1%.

As **Chart 1** illustrates quite strikingly, the MSCI World Equity Index rose 26% in the 18 months prior to February 2015 but just 1.1% in the ensuing 18 months. Of course, in that latter period there were two very appreciable drawdowns - "false starts" if you like - suggestive of a more significant correction to overvalued asset prices, which for a drawdown and momentum influenced strategy, largely explain the continued drag on our performance.

We have "paid the price for prudence", preferring to respect tried and tested methods, mindful that the last bear market in the Global Equity index wiped out the last five years of returns in just about 18 months. The slow-moving nature of our favourite signals is not best suited for a market like this but its time will come; its time always comes and it will demonstrate its validity once again and its superiority over "new model" thinking.

**Chart 1**

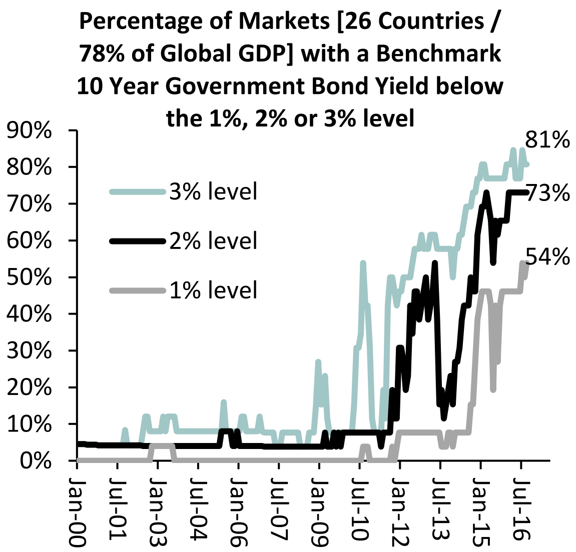



Having discussed in past newsletters the valuation picture and the influence of rate cycles and leverage in the US market, as well as the factors we feel are key to understanding Emerging Equity returns, this month we turn our attention towards inflation. Whilst unprecedented QE initially raised the spectre of run-away inflation in the minds of many analysts (it certainly had that effect in asset markets), inflation has been remarkably stable and subdued for many years.

Indeed, World headline consumer inflation stands at just 2.4% which, outside of the drop to 1.4% in mid-2009, is the lowest level recorded in just over 50 years: moreover, inflation has been extraordinarily stable in low/mid-single digits for two decades now, a period of stability almost without precedent in modern times. Of course, there has been a corresponding decline on Global bond yields: we follow 26 countries, representing 78% of Global GDP, and as shown in **Chart 2** we see that a record 81% of those countries have a benchmark ten year bond yielding less than 3%, indeed almost half those countries have a benchmark ten year yield below zero.

Recent years have been good for bond managers, although the price is now being paid with yields so low (especially for "Risk Parity" fund managers, who allocate risk equally amongst their chosen asset classes and then leverage-up the bond element to "juice-up" returns), encouraging perverse yield-chasing behaviour.

**Chart 2**




Could this period of exceptionally low bond yields be coming to an end? Is the real bubble and possibility of collapse in bonds and not equities? Well, to attempt to answer those questions you need to understand why inflation has been, and remains, so extraordinarily low (setting aside the effect of QE on bond markets).

In our view, and in that of many economists, super injections of liquidity will always create inflation *somewhere* - it's just the distribution of that inflation that is in question. All that base-money created by Central Banks must be held by someone, somewhere and at some absolute and relative price. Now, think of the economy as two parts: the "real economy" where people make things like furniture and clothes, toys and equipment and the "monetary economy" where men (and they are largely men) buy and sell money in the form of bonds, equities and real assets.

In both parts of the economy there is a supply curve and a demand curve. Put liquidity into both parts of the economy and you shift demand upwards – very quickly you see that the distribution of inflation between the "real economy" and the "monetary economy" will be determined by the relative plenteousness of supply in both places (what economists call the *relative elasticity of supply*). Bonds have been made scarce by Central Bank purchases and the Global Developed Equity market has shrunk by virtue of US companies issuing debt to buy back their equity in recent decades, the supply curve in the "monetary economy" is inelastic, supply is not plentiful. Consequently, as demand rises, prices rise, and you get runaway asset price inflation.

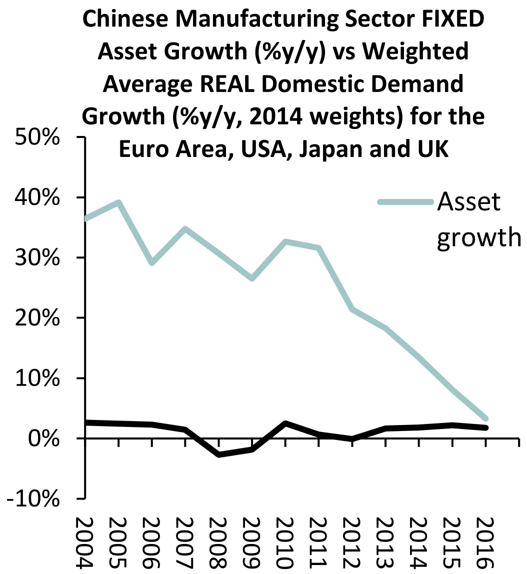
In the "real economy", on the other hand, supply has rarely been more plentiful because global investment is at its highest levels, relative to income, in decades. Put liquidity into that part of the economy and demand goes up and output rises, as we have seen, but prices go pretty much nowhere. Elasticity in supply suppresses price pressures in the "real economy". Consequently, we have a world of asset price inflation and real economy price stability.

Now, to understand the sustainability of this equilibrium, we need to understand its origins. Quite clearly, Chinese investment above 40% of Chinese GDP might have rather a lot to do with it, as do the 20 million plus Chinese who moved from farms to factories each year for much of the last decade, thereby increasing the global supply of labour and, in turn, suppressing the labour share of income globally and elevating the capital "profit" share correspondingly.

It's hard to be a worker with big wage rises in Gloucester when factories in Guangzhou are popping out of the ground like weeds and workers are queuing around the block. So, Chinese excess appears to be at the heart of a) the declining/depressed labour share in national income; b) the elevated level of corporate profit margins; and c) amazingly low and stable "real economy" or shop-inflation.

Interestingly, we may finally be seeing early signs of an end, even a reversal, of those forces, and that would spell the end to the long period of very low bond yields. As shown in **Chart 3**, the rate of growth in Chinese manufacturing assets has simply collapsed in the last few years and has now, finally, converged upon the rate of growth of real demand in the West.

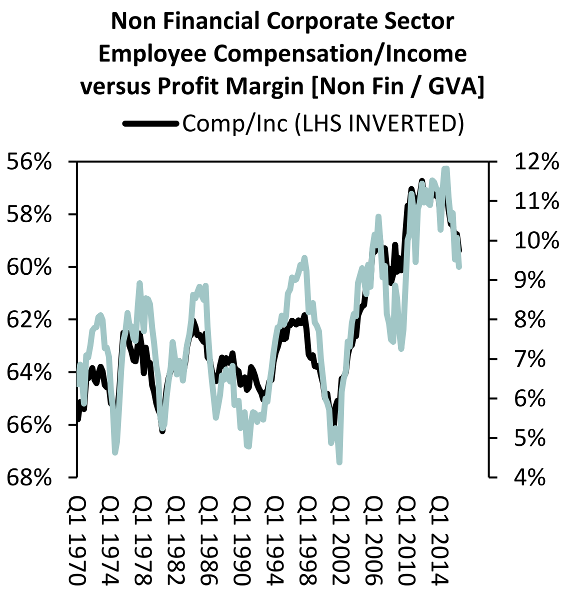
**Chart 3**




Now, it will obviously take some time to work off the past excess. Nevertheless, this convergence of supply and demand in the real economy is exceptionally important when we consider the forward path for inflation.

It is also significant in terms of its impact on corporate profit margins, as shown in **Chart 4**, where the labour share in US corporate income is recovering from all-time lows and depressing profit margins in the process:

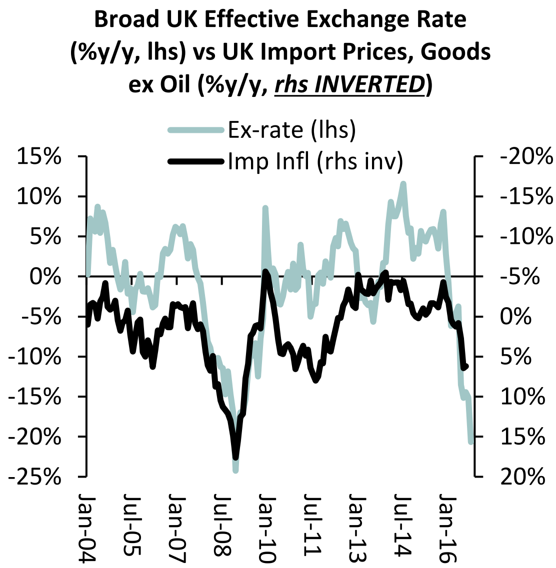
**Chart 4**




Slower Chinese investment growth in manufacturing implies less pressure on labour versus capital and more pressure on margins, which have already fallen 2.5% points in the US in the last two-years and are under material pressure. Could we be entering a phase where margin and profit pressure hurt equities and price pressures hurt bonds? Time will tell but we must surely be alert to the possibility.

One area where the impact will be felt most obviously is in the UK, where the sharp fall in Sterling (it has even fallen against the Chinese Yuan by 15% since last August, meaning the UK is the only major country actually importing Inflation from China) is already being felt in higher import prices, as shown in **Chart 5**:

**Chart 5**

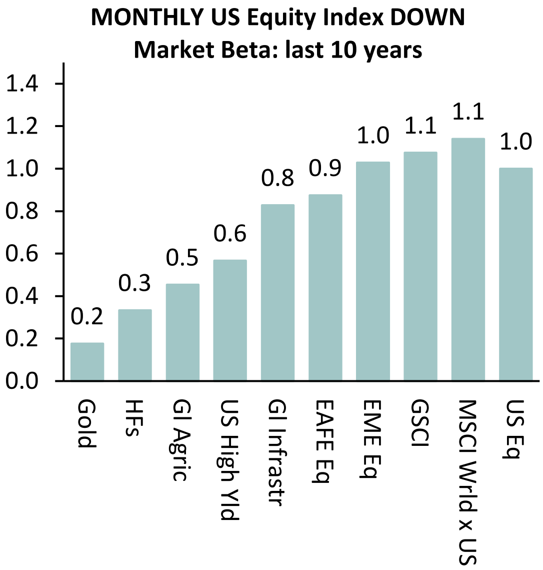



With a 33% import share in UK GDP and 15-20% import inflation looming, it only takes basic arithmetic to see that inflation in the UK is going to rise appreciably, eating into margins and real wages. We see little real sign of inflation outside of the UK but there appears to have been a shift in the global supply/demand balance that merits a very watchful eye on inflation going forward.

Finally, as a reminder and to encourage investors to focus on actual rather than perceived diversification, **Chart 6** shows the drawdown beta of various asset classes to US equities in the last

10 years (a 0.8 beta says an asset goes down 0.8% for every 1% decline in US equities):

**Chart 6**




It is just a reminder that under stress, which is when you need diversification, non-US equity markets have a beta at or above one, i.e. they will not limit downside. Global infrastructure, currently a fashionable choice, offers only modest diversification whilst beaten up agriculture, generic hedge funds and gold offer material diversification.

At record valuation levels, against the backdrop of record leverage and exceptionally low interest rates, with declining margins and a possible shift in the dynamic of global supply and demand, diversification based upon the reality of stress betas/correlations - and not averages - needs to be in the forefront of all investors' minds.

We will, as always, let markets guide us and will respond accordingly if and when conditions change but we remain invested in High Yield, Gold, Investment Grade Bonds and US equities - perversely a defensive equity allocation based on **Chart 6**.

## 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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