MONOGRAM

NEWSLETTER *November 2016*

The Fund returned net -1.51% last month, bringing year to date returns to -1.99%. In a momentous month, where the world of political orthodoxy continuous to move out of the orbit of the world of the people, the MSCI Global Equity Index (local) returned 3.1%, investment grade and high yield markets lagged modestly and Gold fell 3.6%.

Obviously, the election of a flamboyant TV reality show host as the 45th President of the United States once again exposed the flaws in political polling and the disconnect between the traditional media and voters. Journalist Salena Zito, in *The Atlantic*, captured the election of Donald Trump perfectly when she said, "The press takes him literally, but not seriously; his supporters take him seriously but not literally".

Politics is not our ground; we'll leave others to pore over the polling data and come to terms with the result of the election, but Zito's analysis (hereby "Zito's rule") seems to capture the mood perfectly. Aside from all the outlandish, outrageous and inflammatory commentary, what does President Trump believe? Anthony Scaramucci, a member of the President-elect's economic advisory council recently wrote that he would cut deficits by promoting growth and face disinflationary risks with fiscal stimulus and a boost to America's failing infrastructure (given a GPA of D- in the last American Society of Engineers' assessment and in need of $3.6trn in investment up to the year 2020). That spending would, he said, be financed with, "historically cheap debt and public-private partnerships" and "Economies around the world are fighting deflation largely because of a post-crisis move toward fiscal austerity. We can close the wealth gap in America by replacing emergency-level interest rates with fiscal stimulus".

Interesting stuff - it could have been written by an advisor to the UK Labour Party or a Democrat of old, but strong words from a Republican President (albeit one who has spent much of his life flitting between the Democrat and Republican parties! Did Trump "out-Democrat the Democrats"?).

So, Fiscal stimulus over Monetary Policy, tax reform and tax cuts (including tax cuts to bring all or some of the $2.6trn in cash held outside the US by US companies back home, to provide a source of funding for good old-fashioned Keynesian infrastructure spending) and a tougher stance on trade. If that is what taking Trump "seriously" implies, what are the implications for asset markets?

Well, firstly, it will have consequences for US corporate profitability. At this point a little arithmetic is required, to demonstrate precisely where corporate profits come from and just how they are impacted by government fiscal policy. The feint hearted, and those chilled by maths in any form, should look away now and proceed to the following paragraphs. For those still with us, it is useful to start with some basic National Accounting identities:

Very simply:

- Aggregate Investment (all sectors) = Aggregate Saving (all sectors)

So:

- Aggregate Investment = Household Saving + Government Saving + Corporate Saving + Rest of the World Saving

And, in the National Accounts:

- Corporate Saving = Corporate Profit – Dividends

If we substitute the term in for Corporate Saving and just rearrange the resulting terms, we find:

- Corporate Profit = Aggregate Investment *plus* Dividends *Less* Household Saving *less* Government Saving *less* Rest of the World Saving (the Current Account Balance)

This is simply an accounting identity; it says absolutely nothing about causality but simply decomposes aggregate corporate profits into the contributory components. It is the "Kalecki-Levy equation" taught to Economics undergraduates (at least it was taught in my day, at my university).

Now, straight away you can see that Corporate Profit is influenced directly by Government Saving: if the Government saves less, *all other things constant*, then Corporate Profit must increase.

We have shown in previous letters that US corporate profit margins have declined markedly in the last few years after rising sharply from the historical depths after the 2008/9 crisis period.

Chart 1

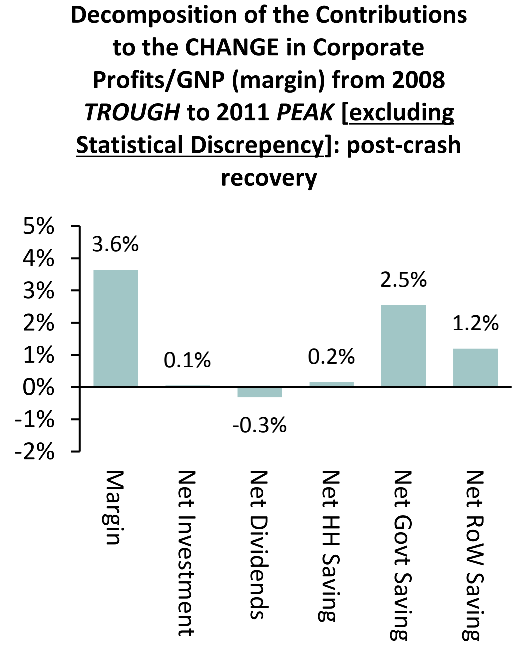
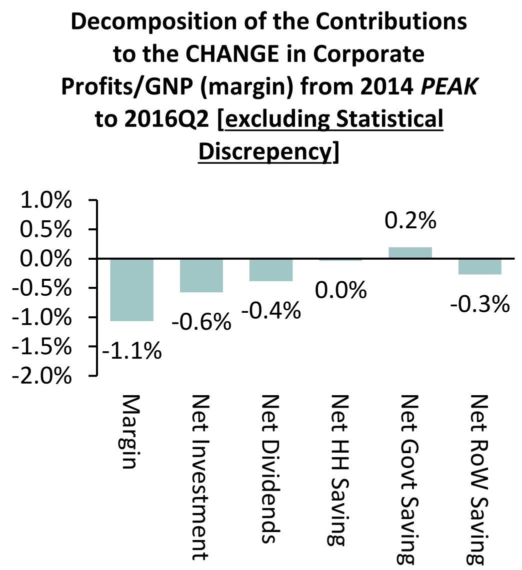


Chart 1 shows the source of the increase in corporate profits from the low in 2008 to the recent peak in 2011 and Chart 2 shows the source of the decline in profits since the 2011 peak level.

In Chart 1, we can see that fiscal stimulus – a reduction in Net Government Saving – accounted for the bulk of the improvement in profitability from 2008-2011, whilst in Chart 2 we can see that the deterioration in profitability in recent years is very largely due to falling Net Investment (in fact, Net Investment has fallen 16% over the last year, with Government Net Investment down 11%) with little offsetting impact from Government Net Savings.

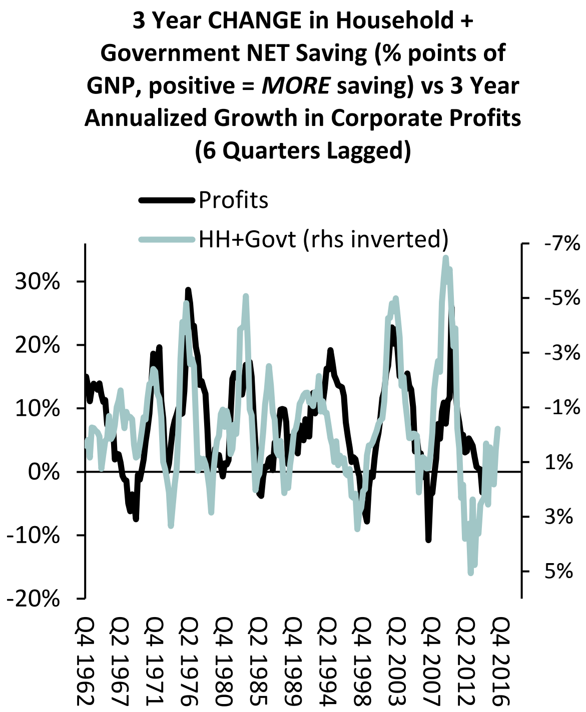
Chart 2



Clearly, there is a path from Trump Fiscal Stimulus to improved Corporate Profits – it was absolutely clear in the data after 2008 – and that is what the equity market appears to like after the "profits recession" of recent years. An increase in Government Net Investment and reduction in Government Net Saving – a policy evidently favoured by Scaramucci and the President-elect, is likely to significantly boost US Corporate Profitability. When we look in the US data, we see that the combination of Household Net Saving and Government Net Saving is a very good predictor of US profit growth.

Chart 3 shows the 3-Year CHANGE in the Household and Government balance combined versus the 3-Year growth in Corporate Profits with a modest lag:

Chart 3

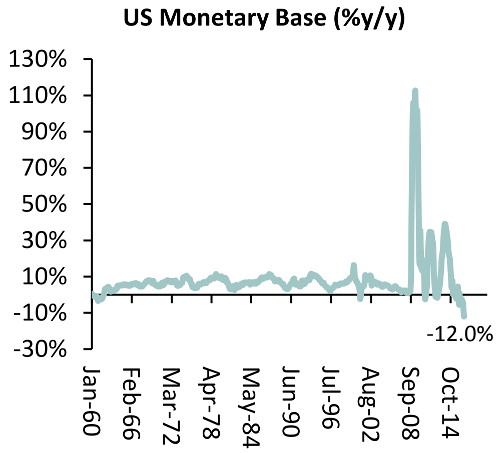


You can see that the “profits recession” of recent years was entirely predictable in 2010/11, Household and Government “austerity” pointed strongly that way. The reversal of that austerity pressure (for Households and the Government) in coming years under Trump would strongly suggest a path like that seen in 2000/2 and 2008/11. Trump could be just what Corporate America wants, no wonder they love him so! In short, if the President-elect can follow through and boost Net Investment significantly (a big IF) then the “profits recession” is over and the market would like that.

There is, however, the not-so-small matter of US Monetary Policy to contend with, as Trump goes head to head with his arch-nemesis, Janet Yellen. Tighter monetary policy has the potential to drive a wedge between government stimulus and improved corporate profitability and, in recent data, we are seeing the greatest liquidity contraction in US history unfold before our eyes.

Chart 4 shows the rate of growth in the US monetary base (notes and coins in circulation plus bank reserves) and you can see the biggest annual contraction in the US in the post-war period: in fact, the monetary base is down 12% y/y, 5.5% annualized over 2-Years and 0.2% annualized over 3-Years.

Chart 4

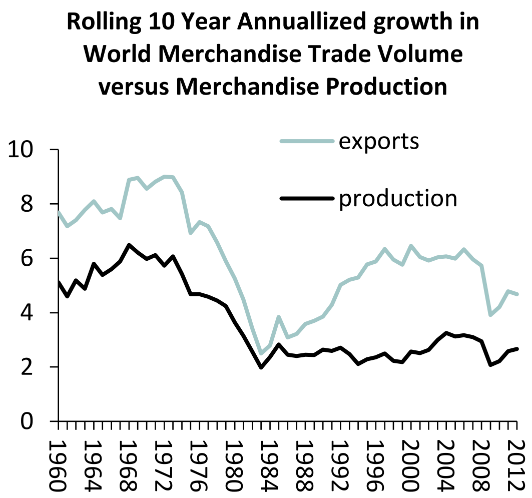


This is an unprecedented squeeze on liquidity – the 2008/15 inflation in the monetary base is going into reverse aggressively – with a $260bn contraction so far, this calendar year alone. According to the BIS, the stock of USD denominated Non-US domiciled debt outstanding has risen from $6trn to $10trn since 2009, with $340bn due for roll-over in the 2016/18 window. If the supply of US Dollars is contracting while the demand for US Dollars (debt issued outside of the US) is growing at a 6% annualised rate, we have here the perfect recipe for a shortage of US Dollars and a huge funding crisis in Emerging Markets. A rise in US rates triggered by Fiscal stimulus would just exacerbate the situation. This is one major tail risk associated with the new US Presidency.

A second major tail-risk comes from the President-elect’s apparent disdain for “Globalisation” (although here, again, we would apply “Zito’s rule” and separate “seriously” from “literally” when it comes to trade!). That said, trade wars and trade barriers are one of the most likely causes of inflation, issues we have written about for very many years now: globalisation turns local markets into global markets, price setters into price-takers and suppresses inflationary pressure (for the more technically minded, it makes global supply curves more “elastic”).

In Chart 5 we show the rolling 10-year growth rate of World Merchandise Production and Trade: the widening gap between trade growth and production growth in recent decades points directly to price stability and anything which closes the gap, or shifts it the other way with production growth faster than trade growth, would put upward pressure on inflation and interest rates and put into reverse a trend established over decades.

Chart 5



Finally, on a wave of Trump enthusiasm, should investors rush headlong into Infrastructure Funds (they seem to be drowning under new cash inflows)? Well, a quick look at the Brookfield Global Infrastructure Fund (a widely-recognised benchmark for the sector) would suggest not: Charts 6 and 7 show the “beta” of the Infrastructure Index against Small Cap equities and the comparative drawdowns for Small Cap equities and the Infrastructure Index. At first glance, listed infrastructure looks very much like Small Cap beta to us. “Buy the spade manufacturer and not the mine,” as someone said to us recently!

Chart 6

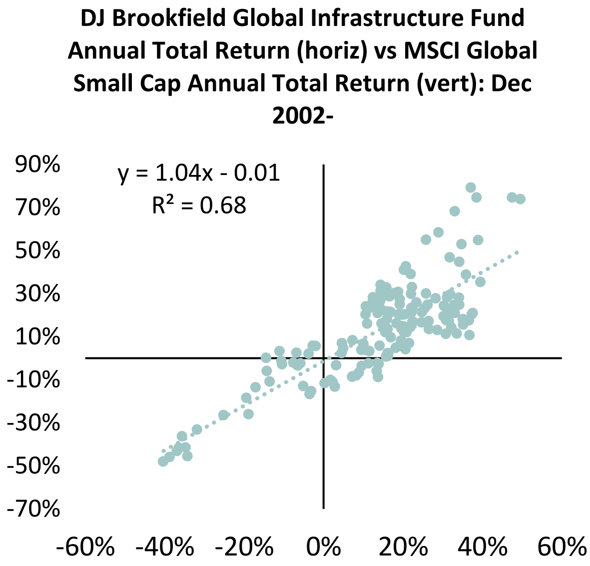
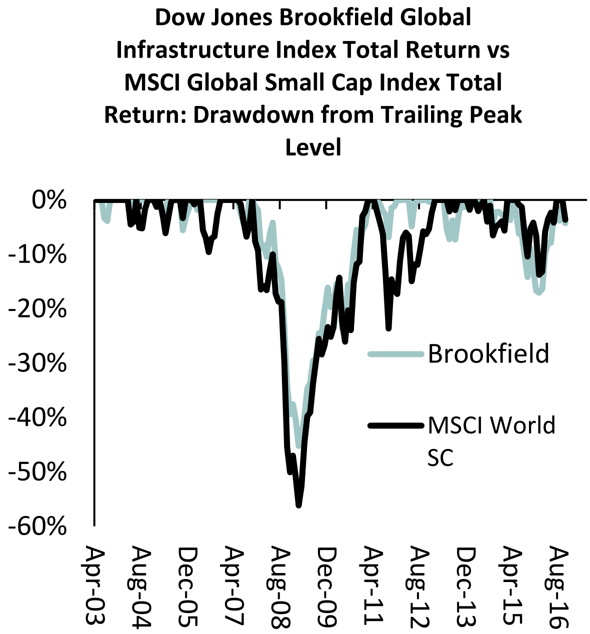


Chart 7



As always, there are lots of competing pressures and forces in global markets, many of which we can identify but few of which we can predict with any persistency, and we will respond accordingly as events unfold.

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.