MONOGRAM

NEWSLETTER *September 2015*

In a difficult and turbulent month for markets, the fund declined 3.6% in August to bring performance since inception (the 27th of January 2015) to -3.4% net, with the maximum drawdown from the late May market peak at a bearable 4%. Global Equities (MSCI All Country Global Equity Index) fell 6.6% during August, Emerging Market Equities fell 6.5% and UK Equities fell 6.1% with Bonds largely unchanged and Gold up 3.6% after falling 14% cumulatively as it declined in five of the prior six months. The drawdown since the end of May ranges from 12% in Emerging Market Equities and 10% in UK Equities to 14% in Commodities and 5% in Gold. It has, without doubt, been an exceptional period and our Fund has been reassuringly resilient.

Identifying the incidence of these sudden market declines in advance is always exceptionally difficult, as is untangling the likely consequences and implications. Once again, an investment approach that is dependent upon "observation and inference" is preferable to one built upon "forecast error and reaction".

Readers of our frequent blog updates should by now understand our view on the current state of the Chinese economy and markets and the far-reaching global consequences. The market has appeared to hit an "air-pocket" to the point where Chinese authorities have initiated the largest Yuan depreciation in over twenty years and, unavoidably, have told the world that the "Chinese Miracle" is no longer.

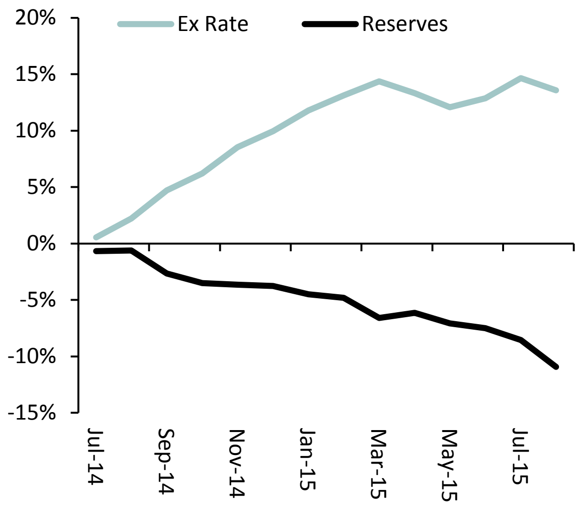
In our view, the chain of events begins with the 13.2% and 33.1% growth in domestic real estate loans in 2012 and 2013 respectively. This pushed house price inflation up to 30% in 2014 and prompted the authorities to clamp down on lending which led to a decline in home prices through the middle of this year as lending contracted for the first time in over twenty years. In an economy like China, with a gross savings rate of around 50% of GDP and a household savings rate near 30% of disposable income, that flow of savings inevitably steered away from property (Who would buy property in a falling market that is grotesquely over-supplied?) and towards the equity market. Hence, a 142% rise in the Shanghai Composite between early January 2014 and mid-summer this year, driving the market capitalization/GDP ratio from 45% to a record 100% (almost a mirror image of the surge, and subsequent collapse, in the market from early 2007 to late 2008). One bubble rolled seamlessly into another and debt and bank balance sheets continued to surge. Of course none of this asset inflation is remotely productive in any way, it simply reflects an enormous overhang of domestic liquidity searching for a home in an economy with a high wall around it and a very small exit door.

All bubbles burst, so it is simply a matter of time before turbulence erupts and cascading, or herding, drives prices markedly lower. That is what we saw in June when the Chinese equity market, despite widespread trading restrictions, short selling restrictions and the injection of up to $250 billion in liquidity by the China Securities Finance Corporation to support prices, commenced its descent. Now, with fewer than 8% of Chinese citizens actually owning Equities and with Equities accounting for just 1% of household financial assets, the consequences in direct financial wealth terms are trivial but the confidence effects, and the underlying exposed fissures, are far more meaningful.

Firstly, the broad trade-weighted Chinese Yuan has appreciated approximately 13% since mid-

2014. This is hard enough on an over-leveraged, over-invested and barely profitable corporate sector, but to add to that has been substantial "capital flight" as investors have flocked to the exit door. Since June of last year the Chinese have lost $436 billion (11%) of their foreign exchange reserves. Those assets, as we have shown, are the counterpart to a domestic currency liability (Yuan) that was created by the Central Bank over years to "mop up" the capital and to stop the currency, which was flooding into the country in the boom days, from appreciation. Over the last decade, capital flows to Emerging Markets amount to approximately $6 trillion, perhaps half of that to China, so the potential scale of outflows from this regime shift is enormous. Combine a double-digit real exchange rate appreciation with a double-digit contraction in foreign reserves/domestic liquidity (see **Figure 1**) and you have the most unimaginable and ferocious policy headwind. Chinese policy conditions have tightened *very* substantially in the last year which is reflected in the collapse of activity. Forget the official Chinese numbers – they were famously "trashed" in 2007 according to a 2010 WikiLeaks document reporting the thoughts of, now party leader, Li Keqiang. The reality is more that output and profits are falling broadly with output contracting in around 75% of the known sub-components of the GDP statistics, leaving the remaining "dark GDP" with the burden of growing 20%+ annually to deliver the official 7% GDP growth overall. That is simply implausible and nonsensical in our view; the Chinese economy is flat at best and contracting at worst. The headwind in **Figure 1** is a crushing blow and explains why the Central Bank has devalued the Yuan, cut rates and cut reserve requirements in a futile effort to resist. Some have argued that the recent devaluation reflects Chinese desire to fulfil IMF requirements for the Yuan to be included in the IMF SDR (Special Drawing Right), an argument we find entirely unconvincing when the Chinese are promoting the AIIB (Asian Infrastructure Investment Bank) as a direct alternative to the IMF and US influence in international monetary policy. Our view remains that a devaluation of 20% or more is ultimately necessary to prop up this ailing debt monster. Marginal devaluations, rate cuts and reserve requirement changes are simply "lipstick on a pig" when bigger and bolder action is required to address widespread weakness in activity and widespread deflation.

Figure 1: Real Effective Yuan Exchange Rate versus Chinese Foreign Exchange Reserves since mid-2014



Secondly, the sheer scale of the Chinese banking system, with an asset base in excess of four times GDP after unprecedented expansion, within the context of a sclerotic economy must imply a serious bad loan problem. Ordinarily, an economy with so much credit and so little growth would be showing stress in its bank ratios, but this of course is China and the Chinese measure NPLs (Non-Performing Loans) in a uniquely Chinese way. Unlike the BIS which defines an NPL as a loan with interest payments overdue by one hundred eighty days, or the US alternative of ninety days overdue, in China it is somewhat more imaginative. Believe it or not, Chinese banks typically define a loan as non-performing when the principal payment is delayed beyond the loan maturity date, or an agreed extended date, or when a borrower is declared bankrupt or has been out of business for 6 months. In effect, a loan in China is overdue if it cannot be repaid after restructuring, if nobody else will extend you credit or you go out of business. Unsurprisingly, the Chinese banking system here looks like a picture of health. How could it be otherwise under those conditions? Again, the reality is a large and rising pool of NPLs amid a period of significant liquidity tightening. That must be true when you consider that Chinese Depository Institutions alone (forget the shadow system) grew assets by the equivalent of 51% of total Chinese GDP annually in the five years through the end of 2013 (it has slowed to "just" 35% in the last twelve months). No country has ever experienced a credit boom on this scale and unwinding it is likely to be a long and tortuous process. China faces a prolonged period of slow growth as debt growth comes more into line with underlying GDP growth, excess capacity is worked off and bank balance sheet quality is improved.

Inevitably, we always hear the retort "but China is rebalancing growth/transitioning the economy away from investment and debt towards a more consumer/domestic demand-led model" when presenting our hypothesis. However, consumer demand as a proportion of GDP is just 37% (versus, for example, approximately 60% in the US when health spending is excluded) and has declined steadily and continuously from 60% over the last forty years, with investment rising correspondingly from 20% to 44% of GDP. Firstly, a model put in place over forty-five years is not likely to be reversed materially in just a few years, it will take many years. Secondly, we have seen no empirical evidence of any kind to support the "transitioning hypothesis" on a scale even remotely sufficient to compensate for the very evident and structural problems elsewhere in the economy. Consumption has risen from 35.9% of GDP in 2010 to 37.7% in 2014; at that rate it will be 2020 before we hit 40% of GDP.

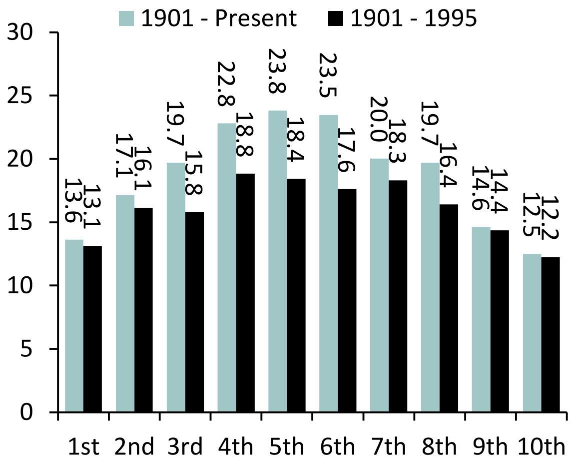
The consequences of developments in China have been described in detail in our blog postings but it is worthwhile summarising the main points:

A sizeable Yuan devaluation, when China accounts for 18% of world merchandise trade growth in the ten years to 2013 (27% in the five years to 2013) and 54% of the growth in global oil consumption over the last ten years, suggests that China's main export going forward will be …*deflation*. This at a time when, after $57 trillion of bank balance sheet and government debt growth since 2008, 65% of countries in our thirty-four country (86% of global GDP) sample have producer price inflation below zero in the last twelve months and 74% have producer price inflation below 1% in that period. Looking at consumer price inflation, in our thirty-six country sample (86% of global GDP), 22% of countries have inflation below zero and 64% have inflation below 1% in the last twelve months. This is disinflation/deflation on a scale typically seen at the bottom of deep recessions, not after unprecedented monetary stimulus. Attempts by central banks to normalize interest rates or exit QE risk a serious policy error that could tip a large number of economies into a corrosive Japanese-style situation with price deflation and anaemic growth. With record global debt, that is not where central bankers want to take the system.

Germany (Eurozone) and Japan will pay the highest price for Yuan devaluation. China's top three exports (45% of total) are "Electronic Equipment", "Machines, Engines, Pumps" and "Furniture, Lighting, Signs". The first two categories account also for 35% of Japanese exports and 27% of German exports. As we have argued previously, the ECB (European Central Bank) will be engaged in a monetary race to the bottom with the PBOC (People's Bank of China), suggesting that the ECB will be on the QE path for some considerable period to come. Japan, with a sizeable output gap that continues to foil Bank of Japan efforts to deliver on its inflation target, likewise is also now in a monetary race with the PBOC and we should expect even more QE on top off the staggering 15% of GDP already being administered annually to little or no effect other than asset price inflation.

Generally, equity market valuation is impervious to the inflation rate (the two year sub-period around the 2000 bubble peak distorts the picture in the long run), but as Figure 2 shows there is a tendency in the US data for the valuation ratio to decline noticeably at extremes of deflation and high inflation. Deflation, at near record profit margins and, depending on whatever statistically important measure one uses, near record valuation is demonstrably a serious headwind for the US and, by default, global equity market.

Figure 2: US S&P 500 Valuation (P/10 Year Earnings) versus Consumer Price Inflation Decile (1st is lowest, 10th is highest)



Typically, market cycles always have a dominant theme: the tech bubble and corporate sector borrowing in 2000, the housing boom and household sector deficit in 2008 and, going back through time, the bio-tech boom of the 1980s and the so called "tronics" boom of the early 1960s. This cycle, in our view, is characterised by the regime shift reversal of huge capital flows into China and the Emerging Markets in the last decade and the associated build-up of debt and excess capacity. Its consequences are likely to be long-lasting and far-reaching. Not knowing the scale, timing and precise nature of the policy response, good investors must build portfolios that have an asymmetric return profile i.e. they deliver positive returns should things be resolved in an orderly and efficient manner and suffer only modest losses should the worst case scenario unfold. To that end, we remain positioned comparatively defensive while fully invested. We still have no Emerging Market exposure, no Gold exposure or High-Yield Debt exposure, preferring Investment-Grade Fixed Income and an even split between US and EAFE (Developed non-US) Equities. We will, as always, observe and respond to the emergence of drawdown conditions in any asset class as and when they appear.

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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