MONOGRAM

NEWSLETTER *September 2016*

The Fund returned net -0.64% in August, bring year to date returns to -0.43%. In an otherwise relatively benign month, Gold fell 3.1% against the backdrop of broadly unchanged Global Equities and US Investment Grade bonds, whilst High Yield debt gained 2% on the month. The decline in Gold, which at the end of last month was still 5.5% higher than our entry point in early April, largely explains last month's net performance.

In last month's letter, we looked at the case for Emerging Market Equity (EME) and showed, quite convincingly, that it is not growth-based but more complex and related to a broader array of economic conditions that tend to coincide during periods of relative outperformance. Amongst them were depressed economies, current account surpluses, depressed currencies and low valuation; we deliberately passed over the impact of the US Dollar directly. So, in this month's letter we look more closely at the influence of broader US Dollar cycles on capital flows and *relative* EME performance.

Before that, though, it is time to revisit market valuation, as we do periodically, to see where several more months of monetary experimentation have left us, in a historical context. As the reserve currency of choice (still), the world's largest economy (still) and the funding currency of choice (still), the US seems like as good a place as any to start. Regular readers will know that we have no truck for market valuation ratios that *do not correlate strongly with ex-post/realised market returns.* Accordingly, in **Table 1** we have looked at 7 well knows valuation metrics for the US Equity Market, each over a minimum of 50 years, and show the percentile ranking for each metric at the point of the 12 major market peaks in the post-war period. We want to know if the market is typically stretched at market peaks, or not, and we show them listed from "Worst - Best" in terms of their correlation with 10 year forward annualised returns historically.

On the left (worst) side we see the two metrics that seem most popular with market analysts - despite their having the lowest correlation to forward returns – valuation versus the last 12 months of *Reported* and the next 12 months of forecast *Operating* earnings. On the right (best) side we show the metrics that actually have the strongest, most consistent, correlation with forward returns – Market Capitalization versus GDP and versus Gross Value Added (Revenue). We have excluded our favourite Price/Sales, it would be on a par with the Market Cap ratios for predictive power and currently sits at/near record levels, to look at it next time.

Table 1

Equity Peak	P/12m Trailing Reported Earnings (1880)	P/12m Forward Operating Earnings (1955)	CAPE (1880)	P/Peak E (1880)	NFC Corp Tobin's "Q" (1951)	MC/GDP (1951)	NFC MC/GVA (1951)	NFC Credit / GVA (1951)
	Worst						*Best*	
Dec-1961	98%	91%	96%	100%	100%	100%	95%	80%
Feb-1966	81%	57%	98%	95%	96%	88%	82%	68%
Nov-1968	88%	40%	98%	97%	100%	100%	100%	99%
Jan-1973	87%	94%	91%	96%	69%	55%	59%	86%
Sep-1976	76%	0%	60%	57%	17%	10%	15%	75%
Nov-1980	14%	12%	41%	35%	20%	19%	22%	61%
Aug-1987	98%	93%	93%	100%	61%	57%	58%	100%
Jul-1990	75%	56%	88%	82%	45%	26%	31%	100%
Jul-1998	100%	100%	100%	100%	96%	98%	98%	94%
Mar-2000	99%	98%	100%	99%	100%	100%	100%	99%
Oct-2007	86%	78%	95%	90%	72%	93%	95%	99%
Apr-2011	65%	48%	90%	78%	87%	87%	91%	86%
Current	89%	90%	91%	95%	85%	95%	96%	99%

The first thing that stands out is the 2000 bull market peak: on every measure, even the worst ones, the S&P500 was at or very close to its 100th percentile, or record valuation, only the 1961 peak gets anywhere near. The 2007 market peak was greatly stretched on the better measures and today we see that valuation is exceptionally high, again, on practically every measure of valuation. We still here people telling us the S&P500 is not so expensive: **Table 1** presents pretty undeniable evidence that it has rarely ever been more expensive than it is currently.

Look at the far right of the table and you will see the percentile ranking for the Non-Financial Corporate Sector Credit Market Debt/GVA ratio (essentially the debt/revenue ratio). Leverage was at a record in 2000 (the 99th percentile is, in our minds, enough) and again today we are practically at a point of record leverage. Now, think about that: extremely stretched valuation, on all measures, at the peak of the corporate leverage cycle. Add in historically high profit margins, but against the backdrop of a 4% decline in net profits in the last 3 years (a trivial 0.7% annualized increase in the last 5 years), and record leverage/high equity valuation does not look, at least to us, to be a strong and stable equilibrium. So, in that event, what gives?

Well, Liquidity, of course, Central Bank Liquidity that comes to the rescue every time that fragile equilibrium is threatened. In this environment it is little wonder that a number of extremely talented and successful money managers have thrown in the towel, complaining of “rigged markets”, it seems like a market where fundamental factors that once appeared to matter no longer display the same influence - at least for now.

All that said, we wondered if there are any common patterns in key variables - related to leverage and valuation – prior to major market peaks: **Table 2** shows the change in real 3-month bill rates, real 10-year government bond yields, real Baa rated corporate bond yields and net profit margins (Non-Financial Corporate sector net profits / GVA) in the 24 months leading up to the market peak.

Table 2

	REAL 3 month rate CHANGE 24 months prior to peak %	**REAL 10 year Yield Change** 24 months prior to peak %	**REAL Baa Corp Yield Change** 24 months prior to peak %	**Net Profit Margin Change** 24 months prior to peak %
Dec-1961	-1.9	0.3	0.7	0.5
Feb-1966	1.1	0.1	0.6	1.0
Nov-1968	0.1	-0.9	0.4	-1.9
Jan-1973	1.0	1.5	0.2	0.9
Sep-1976	-3.0	-1.4	0.3	3.2
Nov-1980	5.1	-0.6	0.2	-2.4
Aug-1987	-1.1	-1.3	0.3	-2.3
Jul-1990	0.9	-2.0	0.2	-1.6
Jul-1998	-0.2	-0.9	0.3	-0.6
Mar-2000	0.7	0.7	0.2	-2.2
Oct-2007	0.2	0.1	0.4	-1.9
Apr-2011	-0.1	0.9	0.3	3.5
Current	0.3	-0.2	0.3	-1.9

Interestingly, it took very little in the way of increase in real short rates (with the exception of 1980) or government bond yields - there is no apparent tendency for either to rise materially, if at all - prior to equity market peaks. Perhaps more telling is the tendency of real corporate bond yields to increase, they did so in every case, generally by about 30-40bp and for profit margins to fall. Higher real corporate yields alongside high leverage and falling margins might suggest that the origins of equity bear markets are to be found in corporate debt markets, if anywhere. It's worth noting the rise in real corporate bond yields and the near 2%-point fall in margins in the last 24 months, just when leverage is hitting record levels (also, bear in mind, that 70% of all outstanding US corporate sector credit market debt is now "covenant-lite", that means it contains no protective covenants for the creditor, meaning that creditors get no warning of debt servicing problems until it is too late – worrying!).

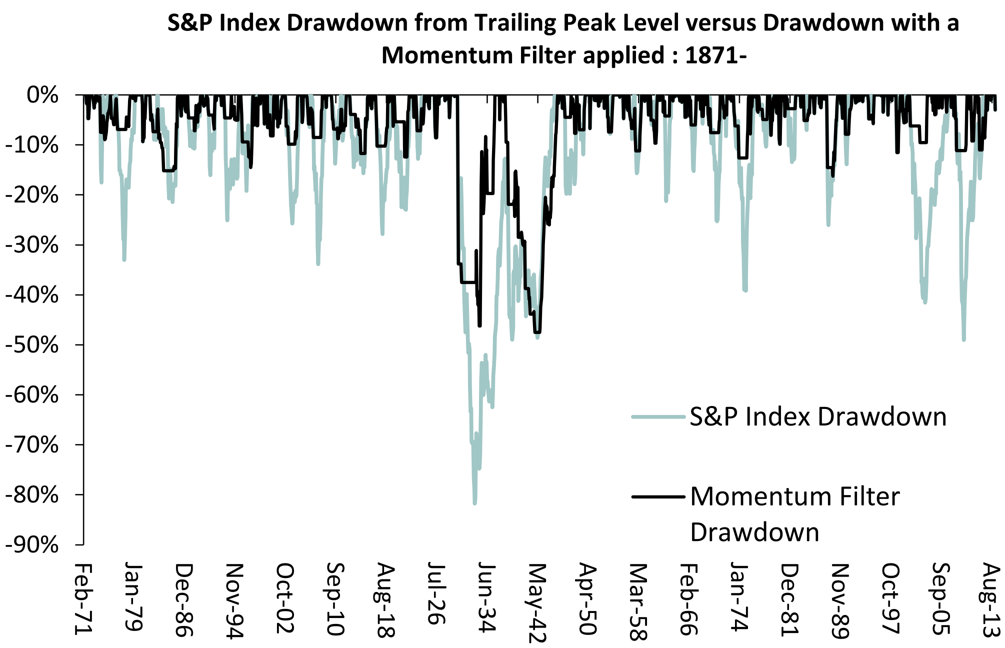
So, we are observing "symptoms" that typically prevail prior to market peaks: falling margins (falling net profits), rising real corporate bond yields, rising real short rates, record leverage, elevated valuation. Each, alone, might be interesting but unworthy of recognition, but taken together they present a stronger basis for the diagnosis of an extremely fragile equilibrium.

How should an investor behave in such circumstances? The answer, surely, must be that they keep an extremely close eye on the one factor (we have seen, heard, read of no alternatives that work consistently within the historical data-set) that identifies severe drawdown in sufficient time for unbearable pain to be avoided: *absolute momentum*. In Chart 3 we show a simple/crude absolute momentum filter applied to the US market over the last 150 years:

Using a simple absolute momentum rule, the maximum drawdown in the 2009 bear market was cut to 11% from 49%, in the 2000/3 bear market from 42% to 10% and in 1974 from 39% to just 13%. Even in the 1929/32 cycle you bagged bragging rights with a drawdown reduced from 82% to a modest 38%!

Of course, there are occasional errors and two of those account for our underperformance in the last 18 months, but we think a period of underperformance from errors is a price very well worth paying at times of extremely fragile equilibrium (go back and look at Table 1). It's all very well doing as Chuck Prince, Citi CEO, said just before the credit crisis crushed his bank, "As long as the music is playing, you've got to get up and dance", we have no problem with that, it's just best to dance close to the exit!

Chart 3

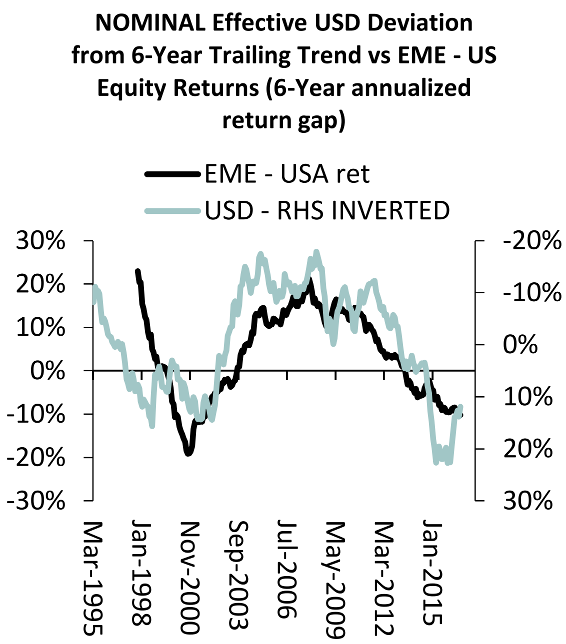


Moving on, we thought it might be interesting to add to last month's letter on EME and link the outlook for that asset class to the "will she / won't she" saga that is Janet Yellen's Fed.

As investors are aware, EME has been a relatively unsatisfying investment for several years now, delivering 5% annualized return in the last 6 years versus 15% annualized returns, for example, in US equities. Indeed, it is still 5% down from its peak level early last-year. Those heady days of 2000-2007 seem a distant memory; BRICs funds (whatever happened to those, we wonder?) were the rage; and China and the Emerging Economies were going to impoverish all of us decadent, idle and ageing westerners.

In **Chart 4** we show the relationship between the US Dollar cycle and the EME *relative return* cycle: we look at the deviation of the nominal effective US Dollar exchange rate from its 6-year trailing average (a good representation of a currency cycle in our experience) versus the 6-year rolling annualized performance of EME less US equities.

Chart 4



The Emerging Economies tend to fund in US Dollars and so a weak Dollar suits them perfectly, they leverage, they grow on the proceeds, investors get excited and the markets outperform. That is the narrative for the 1999-2007/8 period, an undervalued Dollar driving EME risk taking. Looking prior to that, the Asian crisis in 1997 equates to a period of Dollar strength – a stronger Dollar makes all that Dollar debt harder and more expensive to service. Typically, EME relative outperformance coincides with a structurally weak Dollar and EME relative underperformance (crises) tend to coincide with a structurally strong Dollar. Now, the effective Dollar has gone from structurally 10-20% undervalued in the 2004/7 window to almost 25% structurally over valued in early 2016 (when, incidentally, the "China Crisis" exploded). Interestingly, EME started to improve just as some of the steam came out of the Dollar in the springtime.

The outlook for EME would seem to us to be conditional upon your view of the outlook for the US Dollar and that, in turn, seems to be conditional upon your view of Janet Yellen's "will she / won't she" lottery. "Heads" she tightens, the Dollar resumes its upwards trajectory and the EME rally falters, "Tails" she doesn't and the Dollar falters and the EME rally continues and pulls in more investors. The absolute *and* relative momentum of EME is such that, for the first time since January 2011 a long position in EME becomes attractive and compelling in the event the Fed delivers less monetary tightening than the Dollar currently implies. On that front, it is worth bearing in mind the Fed's mandate in the Federal Reserve Act (amended in 1977), namely "*……to promote effectively the goals of maximum employment, stable prices and moderate long term interest rates*". Essentially, the Fed's dual-mandate is "maximum sustainable employment growth without inflation".

With core inflation at 2.1%, just 0.2% points above the trailing 20-year median, and a near record 69% of 106 individual line items having an annual inflation rate below 2%, the US is as close to "stable prices" as we have seen in decades. And, whilst the unemployment rate, at 4.9% and at the bottom of the 50 year 4-10% range, has fallen, there is an appreciable lack of labour market cost pressure. The commonly implied link between the unemployment rate and inflation is based upon a misinterpretation of research from the 1960s which shows, in fact, the possibility of a relationship between *real wages* and the unemployment rate and not i*nflation* and the unemployment rate.

Unit Labour Costs in the Non-Financial Sector are growing at 2% annually, as they have done for many years. Moreover, with the economy growing at just about 2% annually in the last 2-3 years, notwithstanding the possibility that the potential growth rate might now be lower than that, the general picture does not seem to be one that threatens the mandate and implies the need for much in the way of tightening. The current level of accommodation would be ludicrous if the Fed's mandate was the avoidance of asset bubbles, but it isn't. Anyway, the rise in 3-month Libor over the last 12-18 months, to a 7 year high, as a result of changes to money market fund regulations, amounts to a Fed Funds tightening of almost 0.75%: the market has *already* tightened for the Fed!

If, as seems most likely, the Fed delivers very little, we may have passed the Dollar peak and that would be very supportive of EME (and, of course, Gold). We will know for sure in a month or two.

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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