

The MONOGRAM Portfolio returned an estimated -2.2% for the month of June, bringing performance since inception (the 27th of January 2015) to -1.5% (net). The month was difficult across all asset classes and jurisdictions, with no major market posting performance even remotely close to positive territory. In the Equities space, the US resisted best with a monthly loss of -2.1%, while European and UK equity indices retreated by 4.1% and 6.6%, respectively. Fixed Income markets suffered as well. US Bonds consolidated as investors expect the Federal Reserve to raise rates soon, with US 10 year Bonds trading 1.2% lower on the month. European Peripheral Sovereign Bonds sold off in sympathy with Greek assets. Finally, Gold lost 1.5% as the US Dollar stabilised against major currencies.

While there has been a fair amount of speculation and commentary about the current events in Greece, the real elephant in the room is unquestionably the Chinese market. China, with its \$9.3 trillion economy, is about 30 times as large as Greece and thus is much more likely to influence global financial outcomes. The country currently has to deal with a slowing and over-indebted economy in addition to a rising competitive landscape. This signals the need for major structural changes.

In an ideal world, equity markets would be driven by the performance of their underlying economies. Slowing economies would translate into lower equity valuations, while expanding economies would fuel a rally. The transmission mechanism would be clear – in times of expansion companies show higher revenues, which in aggregate translates into higher profits. Investors would buy enough stocks for their price to adjust

to a somewhat fixed multiple of profit or revenues.

While a non-trivial proportion of money managers consciously or unconsciously apply this thought process to their investment decisions, the world unfortunately does not work that way. This is mostly because market participants try to predict the future rather than react to the past. Work done by Elroy Dimson, Paul Marsh and Mike Staunton at the London Business School established this back in 2005. Over the 17 countries they studied, dating back to 1900, there was actually a negative correlation between investment returns and growth in GDP.

The current state of play in China is a poetic example of this reality as Equities have turned parabolic in spite of slowing fundamentals. The Shanghai Composite Index (**Figure 1**) and the Shenzhen Stock Index are respectively up 114% and 111% over the last 12 months through the

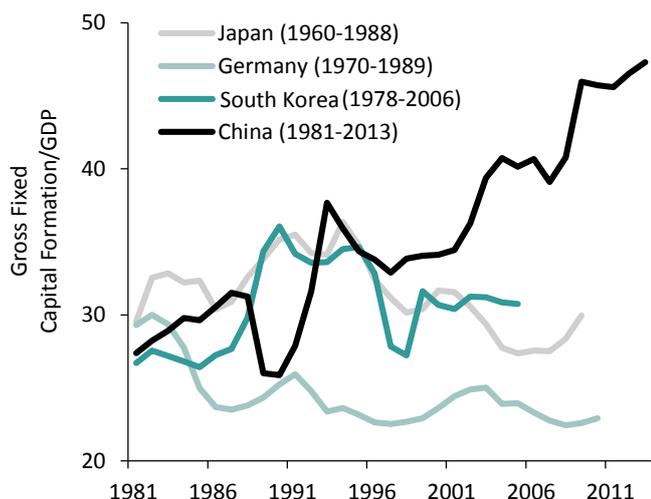
Figure 1: Shanghai Composite Index



end of June. China, however, is slowing down markedly and is facing the need for urgent structural reforms of a gigantic scale.

The Chinese economic miracle that has unfolded over the last 35 years, translating into a growth rate of close to 10% per annum, can be broadly split into three sequential periods. The first phase began in the 1980s when Den Xiaoping initiated modest reforms, such as the liberalisation of prices in the agricultural sector. The second phase took place shortly after the Tiananmen events. This phase concentrated on the rationalization of labour and resulted in a proliferation of light industries at the expense of agriculture and state-owned enterprises. The third and final stage focused on the expansion of heavy industries and infrastructure. What these three stages share in common is that they were fuelled by investments – unleashing rates and volumes of Gross Fixed Capital Formation (GFCF) at scales never experienced before by any country (Figure 2).

Figure 2: Gross Fixed Capital Formation for selected countries; Source: IMF



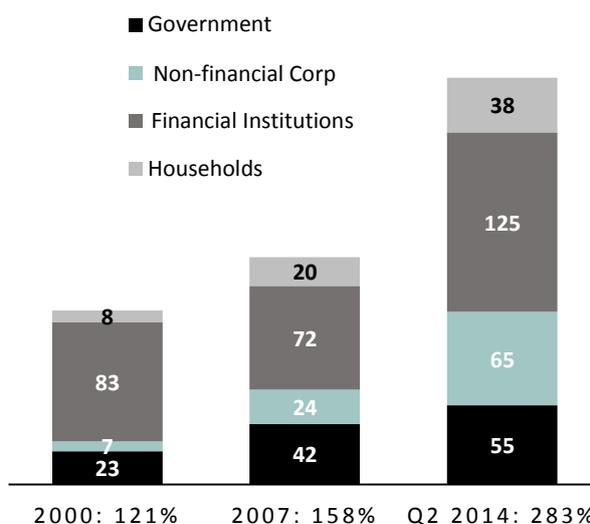
The Capex Boom that China has experienced over the last 17 years dwarfs the previously observed “records” seen in Singapore between 1991 and 1998 and Thailand between 1989 and 1997 both in duration and intensity (at its peak, China dedicated more than half of its annual GDP to capex). History, however, has showed us that Forced Fixed Capital Formation for extended periods of time actually increases the risk of severe economic crisis substantially.

During this period, capital in the China clustered principally in basic resources, housing and exported industries. China became the “factory of the world” and fuelled global growth, while the excess

supply kept prices in check. The world went through a “goldilocks” phase where growth was accompanied by low to moderate inflation and China grew its net exports by a factor of 10 in the five years to 2008.

The country’s economy became completely dependent on aggregate external demand, which became evident when the global economy came to an almost complete standstill in the same year. The People’s Bank of China rapidly injected approximately \$600 billion of GDP into the system. The process of capital allocation then became even less efficient, leading to vast amounts of bad loans and countless examples of wasted resources. As GDP growth started to fall, from a peak of 12% in 2007 to about 7% today, the authorities encouraged financial institutions to aggressively grow their loan book (Figure 3).

Figure 3: China Debt-to-GDP Ratio (%); Source: McKinsey



Now, as leverage in the system is reaching stretched levels, China again finds itself in a historically unique situation. There are only a few historical examples where a country has grown domestic credit at 20% per annum. This is mostly because a credit crisis strikes before there is a chance to sustain the effort past that point. China is doing exactly that, but from an already extended leverage level (Figure 4).

This rather bleak picture of both China’s assets and liabilities also comes with an increasingly competitive landscape. As wages have risen in the

Figure 4: Selected episodes of uncontrolled credit growth; Source: IMF

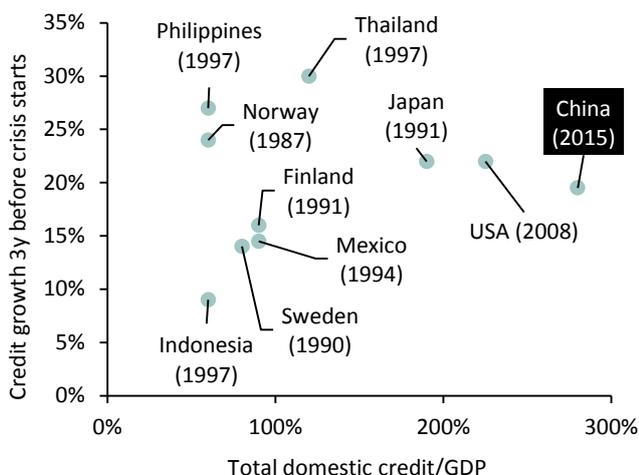
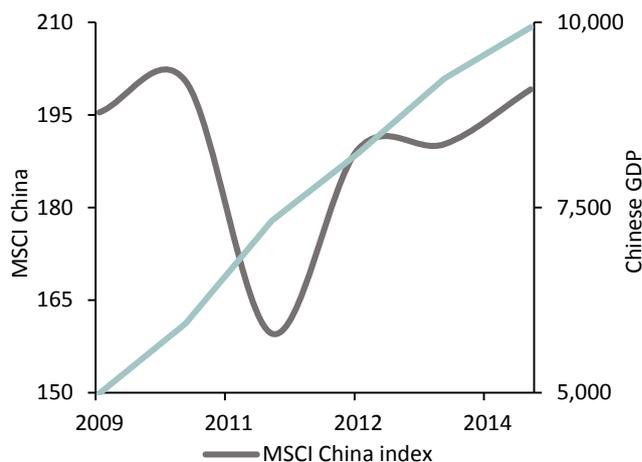


Figure 5: Chinese Stocks vs Chinese GDP, last 5 years; Source: Bloomberg



country, it means that China is incrementally losing out to cheaper neighbours such as Vietnam.

Construction can no longer be the locomotive of growth it once was for China. In contrast to common beliefs, the country's degree of urbanisation does not leave room for sustained, high-rate, construction-led growth over the decades to come. Officially, China would need to build a city the size of London every year for forty years to close the gap between its official urbanisation rate (45%) and Western standards (70%) – a major reason for the bulls to be optimistic. However, this statistic is misleading since the Chinese define urban centres as areas with density in excess of 1,500 people per square km. That definition would exclude, for example, cities such as Brisbane or Houston. In practice, the secular urbanisation effort that has sustained growth for decades is mostly behind us.

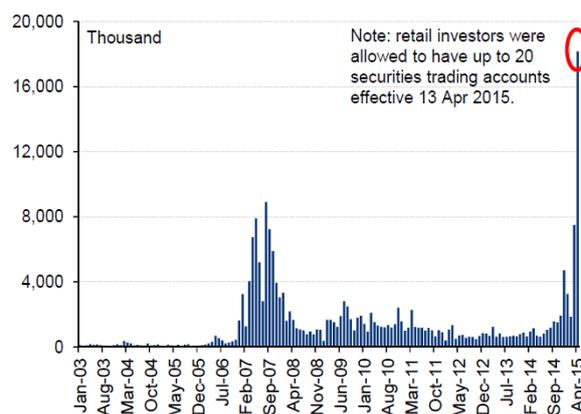
Despite the recent effort by the Chinese authorities to operate an economic tectonic shift away from basic industries, housing and exports, the combination of slowing GDP, the vast amount of bad debt (\$1.5 trillion to \$3 trillion), continuous misallocation of resources and the disappearance of traditional engines of growth has fuelled the general defiance of investors towards Chinese stocks. At the end of 2014 while the Chinese economy was twice as large as five years previous, its stock market had gone nowhere (Figure 5).

It is in this rather gloomy context that the market has suddenly taken off, with domestic stocks doubling in value in less than 12 months.

Unfortunately, this price action has nothing to do with a fundamental improvement of the Chinese economy. The Chinese long-term strategy necessitates further liberalisation of its financial markets and the integration of mainland stock exchanges with the much larger and influential Hong Kong financial centre. This is why, around mid-2014, the Chinese authorities took steps to facilitate the foreign purchase of A-shares (listed in Shanghai and Shenzhen) by foreign investors.

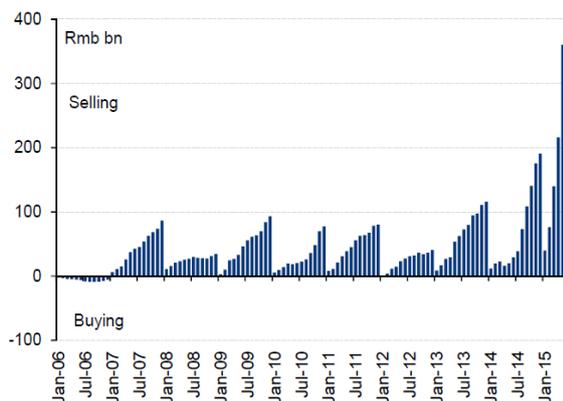
The sudden liberalisation of the stock market in China was bound to create large amounts of speculation and a broad-based rally. Optimists are betting that the authorities will keep the rally going to help more businesses tap the stock market. However, while retail investors (who represent a whopping 80% of daily volume in domestic stocks) are busy speculating on margin (Figure 6a), insiders are cashing out (Figure 6b). At

Figure 6a: Number of new brokerage accounts in China; Source: BofAML



Source: CEIC, BofA Merrill Lynch Global Market

**Figure 6b: Insider activity in China;
Source: BofAML**



Source: WIND, BofA Merrill Lynch Global Research

MONOGRAM, we believe it is obvious that we are seeing a large bubble forming in front of our eyes,

and bubbles always end up popping. Time will tell if we are right. As we write, the market has already corrected by 30%. In financial market speech, this is bear market territory...

In conclusion, and perhaps unsurprisingly, our Portfolio has no exposure to any Chinese assets. With Greece and China, the global investment landscape remains uncertain, which explains why the volatility of assets has increased. We are however, still in a secular bull market and as such our Equity Portfolio (c. 50% of the fund's assets) remains fully invested. Our position is defensive with the allocation equally split between US and Developed Non-US Equities. The balance of the fund remains invested in performing 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.

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