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Capital Gearing Trust

First Quarter Report

March 2022

The Next Forty Years

Learning from the past to help peer into the future

As it happens, the fortieth anniversary of our managing Capital Gearing Trust fits in well with a major transition in the world economy from an era of deflationary bias to one which looks much more like the period from 1965 to 1980.

In 1982, Volcker put in place central banking policies that supressed the persistent high inflation that had characterised the earlier period. Certainly there was a recession, but companies and households were robust enough for it to be comparatively mild. That disinflation was given a major boost when China's change of policy and the liberation from Communist rule of Eastern Europe just about doubled the number of workers in the capitalist world. Demographics helped too, with the growing working age population in the west boosted by the increasing participation and improving opportunity for women. Technology, always at the heart of productivity gains, made a particular contribution in easing price discovery through the internet.

The result was that the bond yields fell, as a trend, throughout the 40 year period, a fabulous background for above normal returns in pretty well all assets. The deflationary impact of globalisation was so powerful that Central Banks could operate with a policy stance so stimulative that many nominal bond yields were actually negative without any problematic inflation resulting. Equity markets, rising on the same waves of liquidity, have reached extraordinary levels.

Obviously this wonderful period for financial assets has been interrupted by both Covid and the invasion of Ukraine. Inflation has reached levels of around 7 to 8% in Western economies that have Central Banks scrambling to restore their credibility. Rhetoric has been hawkish, though little action has yet been seen.

That credibility is actually largely intact, as evidenced in markets; breakevens suggest that inflation will revert to the 2% levels that prevailed for so long, once transitory price increases from shortages and supply interruptions work their way out of the system. These have been associated with the pandemic and the invasion of Ukraine. With luck, both will be in the past quite soon.

The background, however, is quite different from the last 30 years. Globalisation is being rolled back both for reasons of security of supply and of doubts about the benevolence of Russia and China. The just-in-time worldwide model of manufacturing is fading. Furthermore there are no realistic candidates for any equivalent increases in the workforce of the capitalist economy from elsewhere. Manufacturing closer to home will be more secure, but also more expensive. The consequence will be wider than just goods; the bargaining power of labour, emasculated by globalisation, will be at least partially restored. Union membership has of course contributed to inflation, but historically it has also grown in response to it.

Nor will commodities be as favourable. Since the middle of the last decade, capex in energy and mineral production has been constrained by investors pursuing an environmental agenda. Mines and oilfields deplete over time and insufficient investment in new opportunities has been made to allow the transition to net zero to take place at reasonable cost. And apart from commodity costs, that transition will in itself be inflationary. It requires large expenditure on, for example, heat pumps to replace gas boilers, for which there is no financial return associated with the environmental return. Of course, society could just cut back on other expenditure leaving supply and demand in balance. But there is a temptation, evidenced in speeches and academic work, that such an investment for mankind as a whole should not count in calculations of fiscal deficits, but simply be borrowed. Such an approach harks back to model for the last 30 years when fiscal incontinence was unpunished. The coming era will be quite different.

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This new, more inflation-prone era, will be reinforced by demographics, as Charles Goodhart has shown. A shrinking working age population allied with more retirees, who consume but don't produce, will put greater demands on the workforce.

Even technology, though always positive, may be less help than recently. The internet, by our calculations, has reduced the cost of, say, clothing by roughly 7%. No doubt the trend may continue. But at a much slower rate.

This will be a very different environment for fiscal and monetary policy makers. The greatest imbalance that has developed over the last 40 years has been the extraordinary increase in debt that has been encouraged by abnormally low interest rates. This both constrains growth, as demonstrated by Kenneth Rogoff, and makes economies much more fragile. The IMF points to the 20%, by number, of US companies that are zombies – they do not cover the interest service charges even once from their cash flows. That suggests that the Federal Reserve will have fine judgements to make if they wish to slow the economy enough to restrain inflation but not so much as to cause a recession.

In fact, history suggests that the only way to reduce the burden of excessive debt that does not risk a depression is to engage in financial repression; elevated inflation with moderate nominal rates. Even so, if this characterisation of the new era is correct, the potential for 'Fed mistakes' will move from overtightening in a deflationary environment to acting too late and too little, as characterised by the likes of Arthur Burns and Anthony Barker in the late sixties and early seventies. Fiscal policy may be on the same learning curve.

There may be some alarming crises on the way, not least in Eurozone sovereign debt, but eventually enough financial repression, sufficient to bring debt in better balance with assets, incomes and GDP, will allow a much more aggressive attack on inflation: The Volcker Moment. With luck that will produce an environment similar to 1982. That is to say, inflation and interest rates high but falling, p/e ratios low and debt no longer alarming. That would be a great opportunity to replicate the returns for the next 40 years that shareholders of Capital Gearing Trust have enjoyed for the last 40.

Peter Spiller

March 2022

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Fund information as at:	Share prices:	Status:
31st March 2022	*£51.40*	*Open*

Investment objective

The Company's objective is to preserve, and over time to grow shareholder's real wealth.

Fund information

Market Cap.	£1.1bn
Dividend Yield	< 1%
OCF*	0.58%
OCF (PRIIPS)	0.90%
Comparator Index	RPI

*Ongoing Charge Figure

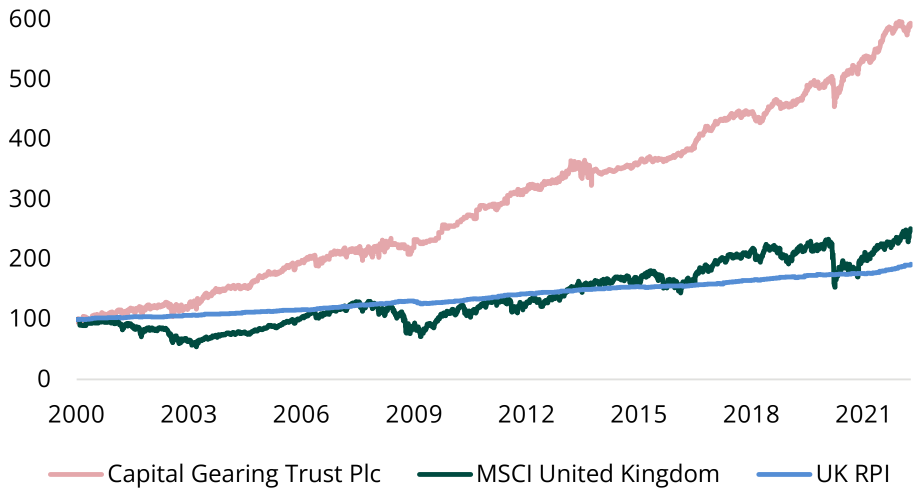
Return history (total returns)

1 month	1.6%	2021	11.3%
3 months	-0.4%	2020	8.3%
6 months	1.7%	2019	8.6%
Year to date	-0.4%	2018	2.1%
1 year	10.7%	2017	5.1%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	3.6%
Vonovia	2.5%
Grainger	2.0%
SPDR MSCI Europe Energy ETF	1.8%
North Atlantic Smaller Co's	1.5%

Performance since January 2000 (total return)



Largest bond holdings

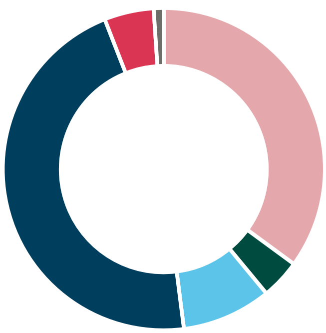
UK I/L 0.125% 22/03/24	5.8%
US I/L 0.75% 15/02/45	1.5%
US I/L 1.375% 15/02/44	1.4%
SWEDEN I/L 0.25% 01/06/22	1.4%
US I/L 0.625% 15/01/24	1.3%

Currency exposure

GBP	49%
USD	28%
SEK	5%
EUR	9%
JPY	7%
Other	2%

Asset allocation

Index Linked Gov't Bonds	35%
Conventional Gov't Bonds	4%
Pref Shares / Corp Debt	9%
Funds / Equities	46%
Cash	5%
Gold	1%



Fund/equity breakdown

Equities	18%
Property	17%
Loans	4%
Infrastructure	7%
Private Equity / Hedge	1%

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The debate about whether inflation is a transitory phenomenon concluded tragically as Russian tanks rolled over the Ukrainian boarder and the 200 million residents of Shenzhen, Shanghai and 21 other Chinese cities suffered from full or partial Covid lockdowns. Inflation feeds off human misery; its favourite diet is war, disease and disruption. For investors the debate has now moved onto a new topic. How best to respond to the reality of high inflation? That debate is far from settled.

The negative impact of inflation on cash and conventional bonds is well understood, with the term "certificates of confiscation" entering the popular vocabulary in the 1970's. This folk memory underpins the strong intuition that holdings equities, or real assets such as property, is the best way to protect against high inflation. Unfortunately the historical record provides patchy empirical support for this intuition. In his excellent paper on Inflation and Asset Prices[1] John Tatom concludes ~

> *"For a variety of reasons reviewed here, inflation tends to raise investors' required real rate of return on equity and to lower real capital income for tax-related reasons.* ***As a result there is a strong negative correlation between inflation and real and nominal stock prices."***

Work by Dimson and Marsh[2] suggests there is a threshold of 4% above which rising inflation is near universally negative for asset prices. Any property owner looking to sell, intuitively understands that an inflation induced interest rate hike, which in turn makes mortgages more expensive, tends to reduce the price that a buyer can pay.

London commercial property is a case study in the failure of certain "real assets" to protect investors from inflation. According to the Knight Frank, prime central London commercial property rent per sq ft fell 60% in real terms between 1989 and 2019. However the poster child for failing to protect against inflation is gold, which suffered a real value fall of 80% between 1980 and 2001.

Pointing to the historical evidence that shows high inflation causes **all** asset prices to fall does not provide a clear path forward for investors. Rather, the value of these historical insights is in guiding investment strategy. The objective for the first stage of an inflation cycle, as inflation is rising, should be no more than keeping the real value of a portfolio intact. It is only in the second stage of the inflation cycle, as inflation peaks and then falls, that a greater exposure to riskier assets will be properly rewarded.

By historical analogy the Nifty Fifty bull market of the 1960's resulted in very high S&P valuations (although not as high as today). A prescient investor in 1970 that feared a decade of high inflation but who responded by selling bonds and buying the S&P index would still have suffered significant negative real returns. It was only in the 1980's when inflation was high but falling that one of the great bull markets of all time exploded into life. A strategy that avoids the real losses of the 1970's but participates in the real gains of the 1980's would be optimum.

Any such strategy must also be sufficiently flexible to withstand the Federal Reserve's reaction function to such inflation. Bill Dudley, the former Chair of the Federal Reserve Bank of New York, has been enjoying the fact that he is no longer a public official. Free from the strictures of "FedSpeak" he is no longer part of a coordinated communication programme. Put another way, he is able to tell the truth. In a recent article for Bloomberg[3] he wrote:

> *It's hard to know how much the U.S. Federal Reserve will need to do to get inflation under control. But one thing is certain: To be effective, it'll have to inflict more losses on stock and bond investors than it has so far.*

[1] Inflation and Asset Price, John Tatom, November 2011

[2] Credit Suisse Global Investment Returns Yearbook 2012, Dimson and Marsh

[3] https://www.bloomberg.com/opinion/articles/2022-04-06/if-stocks-don-t-fall-the-fed-needs-to-force-them

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In support of this he cites Jerome Powell's remarks in his March press conference "Policy Works through financial conditions. That's how it reaches the real economy". The US is less sensitive to nominal interest rates than many economies: most households have mortgages fixed over 30 years; a relatively high proportion of corporate borrowing is also fixed via the bond market. Households in the US also hold more equities than, for example, their European counterparts. If the Fed really is serious about tackling inflation and if Powell's assertion that the transmission of monetary policy is via financial conditions then Dudley's conclusion becomes inescapable: asset prices must fall.

A separate but related question is whether the Fed can tighten financial conditions while engineering a "soft landing"[4] . Two factors weigh against its probability of success. First, a key feature of previous soft landings[5], is that the unemployment rate actually fell during the tightening cycle. Given that today's unemployment rate of 3.6% is well below most estimates of NAIRU, it seems unlikely that the Fed can pull off a repeat. Second, the extremely elevated levels of government and corporate debt are a source of brittleness to the US economy: the Fed must walk a policy tightrope.

The Fed is confronted with a series of unappetising choices, leaving investors with a wide funnel of potential outcomes: i) unchecked inflation coupled with moderate growth; ii) inflation falling to target and moderate growth (AKA a soft landing); iii) inflation tamed via a Fed induced recession; iv) stubbornly high inflation despite a recession (AKA stagflation). We would judge 1 & 4 the most likely scenarios and 2 the least likely. Whatever the outcome, it is hard to imagine equities performing well under any scenario. Equities don't like high inflation. Equities don't like recessions. And, if monetary policy works via financial conditions, they aren't going to like a soft landing either. Nominal bonds will also struggle under scenarios 1 & 4. What then is an investor to do?

Our ambition is limited to finding the "least dirty shirts". For bonds, we prefer index-linked to nominals, and our duration is moderate. For risk assets we prefer those which are likely to perform well during an inflationary environment. During the 1970s the worst performing stock market sectors were technology and consumer staples, the top performers were energy and materials. European oil stocks trade at around 7x earnings assuming a longer term oil price of $80. That price seems sustainable given the dearth of capex in recent years. We have put about 4% of the portfolio into energy and materials stocks, the largest position being a European energy ETF. Renewable infrastructure trusts (5% of the portfolio) also look attractive. Roughly half their revenues are derived from government subsidies which are linked to RPI in the UK. They stand to profit from higher inflation and any increase in long-term inflation forecast will flow through to their NAVs. Their other source of revenue is merchant power which looks well underpinned throughout Europe. Finally we continue to think that residential accommodation (c. 10% of the portfolio) looks well placed. Indeed German rents rose faster than inflation during the 1970s. Today if rents were only to keep pace with inflation we believe they would significantly outperform equities.

So far our approach is working, our risk assets returned -0.7% in Q1 vs. -8.4% for the investment trust index and our bonds returned 0.1% vs. -7.3% for sterling aggregate.

We are hopeful this relative outperformance should continue, although making strong absolute progress in this environment is a challenge. At this stage in the cycle our aim is to keep capital in tack with a defensive portfolio focused on inflation protected assets. With luck investor patience today will be well rewarded in the future.

[4] Getting inflation under control without causing recession

[5] 1965, 1984 and 1994

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