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Capital Gearing Trust

Second Quarter Report
June 2022

The Price of Energy

And consequences for Europe

It has been argued that the availability of cheaper energy has been the driver of human progress; starting, perhaps, with the discovery of fire and then the use of draught animals to replace humans at the plough. And, although the energy intensity of modern economies has reduced markedly, even in the last 50 years, the cost of energy remains important.

To begin with the short term, the war with Russia has raised the price of oil and gas, and hence electricity. Such increases act as a tax on consumers and, to the extent that they are imported, on countries as a whole. That tax is on top of the secondary effects from the resulting inflation. Particularly with respect to gas, Europe has been hit much harder than the rest of the world because of its dependence on Russian gas through pipelines. Using current futures prices, and normal consumption rates, Schmieding and Feilder have estimated additional costs over the next year to be €220bn; that is equivalent to 1.5% of EU GDP in 2021 and 3% of consumption. Of course, some of that burden will be assumed by governments at the expense of tax payers but these numbers are large enough when added to the headwind of other rising prices and slow world growth to make a recession likely. It is not known whether Russian supplies will be maintained at their reduced rate in the second half of 2022, but if not, then rationing will be necessary. That would hit Germany, as the industrial powerhouse, hard.

Just as importantly, over the medium term the price of power in Europe will be higher in relative terms to its competitors than in 2019. That is because the pursuit of energy security will require more nuclear, though with a long lag and expensively, and LNG. New sources of gas will have to be developed, but on top of the shipping costs, just freezing and refrigerating LNG uses 15% of the gas. So the competitive position of Germany in particular will be weakened.

Turning to the longer term, the impact of climate change, and attempts to limit it are significant for futures prices of fossil fuels. The cost of capital for fossil fuel production has increased substantially as banks and investors have been reluctant to develop new oil or gas fields. Nor is investment encouraged by windfall taxes. Given that oil fields deplete at roughly 5% per annum, a high level of capex is required to maintain production. Yet, with a supply base now 14% higher than 2014, capex is now 40% lower. Production capacity will probably fall over the next several years in the absence of rapid improvements in Venezuela or Iran. Indeed, the impact of sanctions on Russian production is unknown but could add to the problems. Demand for fossil fuels over the medium term will remain frustratingly high, close to current levels.

Meanwhile the search for alternatives continues. Wind and Solar will sustain their growth, but their overall market share is still constrained by intermittency. Hydrogen is promising but a long way from being competitive. Nuclear has very long lags and sets a new, much higher, cost base for electricity.

Peter Spiller

June 2022

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Fund information as at:

30th June 2022

Share price:

£49.83

Investment objective

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

Fund information

Market Cap.	£1.2bn
Dividend Yield	< 1%
OCF*	0.52%
OCF (PRIIPS)	0.78%
Comparator Index	RPI

*Ongoing Charge Figure

Return history (total returns)

1 month	-1.6%	2021	11.3%
3 months	-1.6%	2020	8.3%
6 months	-2.0%	2019	8.6%
Year to date	-2.0%	2018	2.1%
1 year	3.2%	2017	5.1%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	3.4%
SPDR MSCI Europe Energy ETF	2.4%
Vonovia	2.1%
Grainger	1.9%
Greencoat UK Wind	1.5%

Performance since January 2000 (total return)

Largest bond holdings

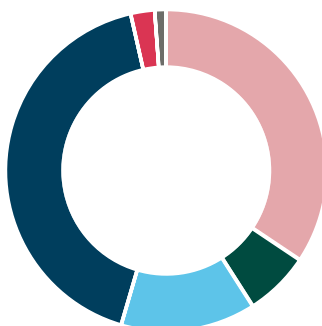
UK I/L 0.125% 22/03/24	8.9%
US I/L 0.75% 15/02/45	2.2%
US I/L 1.375% 15/02/44	1.8%
JP I/L 0.10% 10/03/29	1.3%
US I/L 0.125% 15/07/26	1.2%

Currency exposure

GBP	52%
USD	25%
SEK	2%
EUR	8%
JPY	7%
Other	5%

Asset allocation

Index Linked Gov't Bonds	34%
Conventional Gov't Bonds	7%
Pref Shares / Corp Debt	14%
Funds / Equities	42%
Cash	2%
Gold	1%



Fund/equity breakdown

Property	14%
Equities	12%
Infrastructure	8%
Loans	3%
Energy & Commodity	4%
Private Equity / Hedge	1%

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June 2022

"I can't eat an iPad" heckled an audience member at the New York Federal Reserve Governor during a 2011 speech. Bill Dudley was trying to explain how rising food prices had been offset by the falling cost of technology and one can assume he felt this powerful retort to his technocratic speech.

It is a great shame that, to paraphrase, "you can't eat relative performance" as this quarter would have been a sumptuous feast. All the major asset classes within the fund – risk assets, corporate credit and government bonds - comfortably outperformed their respective benchmarks. Unfortunately, against a backdrop of near-universally falling asset prices, this relative outperformance still resulted in a return of -2.7% in the quarter (-3.5 YTD Q2).

Mindful of this bitter pill, it was pleasing to see the defensive attributes of the portfolio come to fore. The strongest relative performance came from the credit portfolio. The backdrop was weak as rising risk-free rates and ballooning credit spreads caused the sterling corporate bond index to fall by more than -8% in the period. The fund was protected by short duration and high-quality character of its credit portfolio. The first exciting glimmers of value in the credit market are beginning to emerge, so the weighting to credit increased by 3% to 13%, and it is likely that this weighting will continue to rise.

Risk assets represent 44% of the portfolio and returned -5.4%, which compared favourably to the Investment Trust Index which was down -11.7%. Infrastructure and UK property holdings, which collectively comprise 17% of the portfolio, delivered positive returns. Renewable energy infrastructure continues to benefit from high-power prices and performed solidly despite the threat of a windfall tax on UK power generators. Given the continuing tailwinds we added to our positions by taking placings in both Bluefield Solar Income Fund and Downing Renewable & Infrastructure Trust. The UK property returns benefited from a bid for one of our largest holdings, Secure Income REIT. Profits were also taken in Supermarket REIT, a position that was built in an April placing, only to exit completely into an index rebalance in June, at pleasingly higher prices.

The weakest returns of -24% came from European property holdings, which make up about 6% of the portfolio. These positions comprise of pan-European logistic "sheds", German residential "beds" and Swedish commercial property. Whilst Europe is facing a clear recessionary risk it is hard to identify a deterioration in the underlying dynamics of these property companies that would justify such a dramatic rerating. With yields above 5% and growth underpinned by regulated rents that will rise proximately with inflation, we are excited about prospective returns from these assets.

Index linked government bond holdings, representing 34% of the portfolio, were broadly flat because of two powerful and offsetting dynamics. Global bond yields have risen dramatically, as persistent inflation has turbo charged a new interest rate rising cycle. Offsetting these losses were significant foreign exchange gains as sterling weakened relative to the dollar. Our response has been to sell many of our short TIPS holdings, crystallising the foreign exchange gains and repatriating the proceeds to sterling. For the remaining TIPS holdings (19% of the portfolio) we have lengthened the duration locking in the improved value. We believe the 1.2% real yields available on 20 year TIPS are extremely attractive in a world that is likely to be characterised by negative short real yields for many years and potentially decades to come.

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