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Capital Gearing Trust

Q3 2022 Report

Volcker's Ghost

Inflation, indebtedness, and the cost of stability

The current inflationary environment across developed economies has, understandably, given rise to comparisons with the last period of prolonged inflation during the 1970s and early 1980s. These comparisons all point to Paul Volcker's decision as chair of the Federal Reserve to raise interest rates to double digit levels, which was ultimately credited with bringing an end to sustained high inflation.

It is important to remember that Volcker's tightening programme had two stages. The first was characterised by a combination of tight monetary policy, involving the targeting of money supply, combined with imposing additional controls on the extension of credit. These included voluntary credit constraints, special deposits, and increases in margin requirements. The result was to restrict consumption severely, meaning that headline inflation began to fall rapidly. Consequently, credit controls were eased within a few months of taking effect.

However, the underlying inflation was not defeated and began to rise again, leading to a second phase. By this point, inflation had finally become politically more important to the American public than unemployment, and the long experience of inflation had purged balance sheets so that powerful medicine could be applied. Interest rates were increased to even higher levels, commensurate with real yields of 4.5%. At these levels, higher interest rates caused a deep recession that was able to curb inflation in a more enduring way.

The question must be asked: are we going back to the 4.5% real interest rates that we saw in early 1980s? Our answer is resoundingly no. Recently, Anglo-Saxon countries have seen significant tightening of monetary policy. Surprisingly to us, this seems to have anchored markets' inflation expectations: forward expectations in the Treasury markets remain consistent with the 2% inflation target being achieved as soon as the short-term distortions from Covid and the war in Ukraine pass. This is the case despite the fact that central banks now face a trade-off between their monetary policy and financial stability objectives. Their ability to raise interest rates will be constrained by the extraordinary amount of debt that has built up over the previous decades of easy monetary policy.

Debt is now at high levels in every sector: across households, corporates and especially governments. This characterises large parts of the financial system, although it is extremely difficult to analyse precisely where the excess leverage lies. Who would have thought that UK pension funds would be a source of instability? The fragility of the current debt structure and the sensitivity of the real economy and financial system to interest rate changes suggest that we need not fear that interest rates would need to go back to Volcker-era levels.

The exact sources of future debt crises are difficult to identify, but it is a fair guess that shadow banking, private equity, zombie companies, real estate markets, and residential mortgages are all candidates. In the UK, residential mortgages will be an immediate issue because of the short-term financing of UK housing. A two-year fixed mortgage rate has more than tripled from around 1.6% nine months ago to its current level of around 6.0%. There will be considerable pressure on mortgage holders as their two-year fixed terms expire, and on average, they have one year to go. Just as importantly, new buyers look unlikely to be able to support house prices at current levels relative to the average income. Consequently, we anticipate considerable falls in real house prices, with nominal prices supported by inflation as time goes by. However, this adjustment will come with considerable concern for financial stability.

Volcker's Ghost

Inflation, indebtedness, and the cost of stability

Looking ahead, it seems likely that in a situation which echoes that of 1980, central banks will be forced to back off their tightening programmes by financial distress in parts of the economy before they can be confident that they have overcome the momentum of inflation. If we go forward six to nine months, we expect headline inflation to be more modest, because of the anniversary effects of energy prices, food prices, shortages of semiconductors and shipping. Central banks' approaches will probably be influenced by the very low rates of headline inflation that will prevail next summer, notwithstanding that wage increases may still be too high. If that is true, and we remain in an environment that is characterised by expansionary fiscal policy, a fully-employed economy, and a monetary policy stance that is constrained by a fragile financial system, then we should expect to see core inflation continue to accelerate.

There is a positive aspect to inflation. The accumulation of debt and associated asset bubbles need to be addressed, but this will be much easier if the adjustment process does not involve very substantial falls in nominal asset values. More broadly, current debt levels are not likely to be sustainable at current interest rates and levels of income. The least painful policy to address that imbalance is financial repression, which requires elevated levels of inflation. In this situation, we would expect to see moderately positive nominal rates of interest that will not fully compensate lenders for the inflation that is eating away at the value of the loans that they have made. At the same time, borrowers will benefit from the declining real value of their debt. With enough inflation, debt can resume a more appropriate relationship with asset values and incomes, and the economy will begin to stabilise. Only then would it be possible to employ real interest rates of 4.5% to defeat inflation.

Volcker's ghost continues to haunt the current moment, reminiscent of a Greek tragedy. Unfortunately, it seems likely that we are still only in the first act. It will be an interesting journey.

Peter Spiller
Emma Moriarty
September 2022

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Fund information as at:

30th Sept 2022

Share price:

£47.60

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

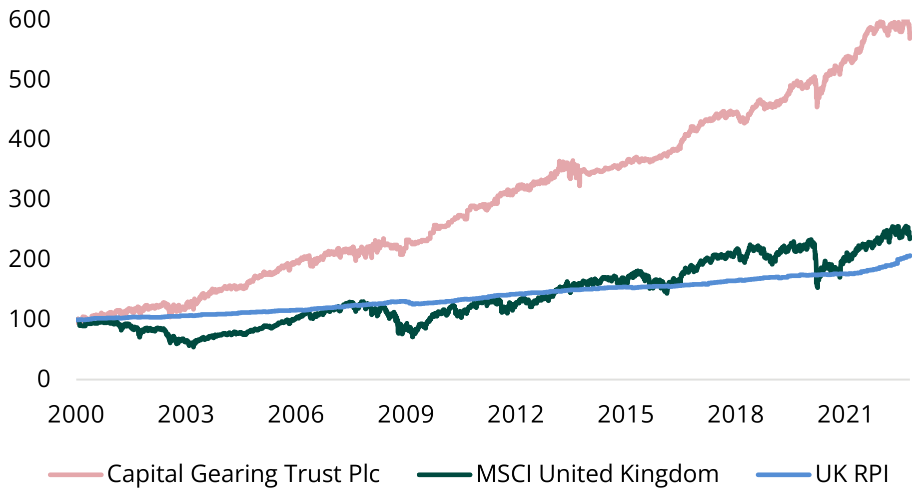
Return history (total returns)

1 month	-4.9%	2021	11.3%
3 months	-1.9%	2020	8.3%
6 months	-3.5%	2019	8.6%
Year to date	-3.9%	2018	2.1%
1 year	-1.8%	2017	5.1%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	3.7%
SPDR MSCI Europe Energy ETF	3.2%
Grainger	1.6%
Vonovia	1.5%
Greencoat UK Wind	1.4%

Performance since January 2000 (total return)



Largest bond holdings

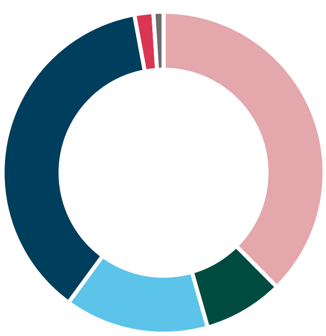
UK I/L 0.125% 22/03/24	9.1%
US I/L 0.75% 15/02/45	2.0%
US I/L 1.375% 15/02/44	1.6%
UK I/L 2.50% 17/07/24	1.5%
US I/L 0.625% 15/02/43	1.4%

Currency exposure

GBP	50%
USD	25%
SEK	3%
EUR	7%
JPY	11%
Other	4%

Asset allocation

Index Linked Gov't Bonds	38%
Conventional Gov't Bonds	8%
Pref Shares / Corp Debt	14%
Funds / Equities	37%
Cash	2%
Gold	1%



Fund/equity breakdown

Property	11%
Equities	11%
Infrastructure	6%
Loans	3%
Energy & Commodity	5%
Private Equity / Hedge	1%

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September 2022

The impact of recent government policies on UK financial markets has been like watching a drunken dynamite fisherman. An erratic and poorly coordinated event is shortly followed by a violent explosion in the liquid pool of assets that is the gilt market. As the ocean boils, the ecosystem within it suffocates. Fortunately, a majority of our portfolio is far enough away from the blast zone to have avoided the worst of the fallout, but frustratingly not all of it. Any asset that had effectively been priced as a spread over government bonds was in the suffocation zone. Our property and infrastructure holdings, which we held as high-yielding equities in place of poor value UK and European government bonds, have been collateral damage of recent events.

The most significant impact was on our property holdings (12% of the portfolio) where returns were -12% in the period, with falls in value concentrated in September. Property companies became a significant part of the portfolio in the wake of the Covid bear market of 2020, when stunning value emerged and we bought in scale. To that end, a year ago property represented 20% of the portfolio. By early 2022, alternative property companies had materially rerated from significant discounts to premia, so as the froth started to build, we became sellers. With hindsight, we did not sell aggressively enough. In what can only be described as a mistake, our property holdings were too high when this unanticipated explosion occurred, which has set the portfolio back.

Our infrastructure holdings (7% of the portfolio) performed better in the period, returning -2%. These modest losses have turned out to be the tip of the iceberg. After the government's clumsy introduction of a power price cap on renewable energy generators, our infrastructure holdings have also continued their weakness post period-end. Our holdings of power and energy equities had been central to the significant outperformance of our risk asset portfolios (compared to broader equity markets indices) over the last year. Sadly, a part of that outperformance was handed back in September and October.

As we survey the aftermath of this unexpected explosion, it is worth considering whether there are now opportunities in these markets after serious falls. Using current share prices to calculate implied yields, alternative property companies have been repriced to a range around c.6% net initial yields. In many cases, rents can be expected to rise at or close to the rate of inflation. These two factors combined suggest that property companies could deliver c.10% annual returns if inflation averages 4% over the next few years. These returns are attractive, but not sufficiently high for us to make additions at these levels.

In the short term, the only additions of consequence have been to our gilt holdings. Fortunately, we did not hold UK index linked bonds of any duration before the gilt market explosion. During the last few weeks, we have added 4% to our gilt holdings, mostly at reasonably short durations. That said, we have invested as long as the index linked 2050s, albeit in small size. It is exciting to be able to invest into the gilt market again, after many years of being priced out. It is a natural asset for a conservative sterling investor to hold. However, our excitement is tinged with a sense of regret that the recent disruption will have long term negative consequences for the UK. It is unwise to go dynamite fishing when drunk. Not only do you indiscriminately kill everything in the sea, but you might end up in advertently blowing up your own boat.

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September 2022

The last decade in financial markets can be summarised by two mantras: 1. don't fight the Fed; and 2. there is no alternative ("TINA", for short) – to equities, that is. Of course, the two are intimately related. Confronted with a profound economic slump and governments that were unwilling or unable to provide fiscal stimulus, it fell upon central banks to do the macroeconomic heavy lifting. Fed Chair Jerome Powell is fond of reminding us that monetary policy works through financial conditions and the goal of the last decade was to ease financial conditions. In practice "financial conditions" means three things: interest rates, credit spreads and equity valuations. The "easy" financial conditions that followed were characterised by high prices and correspondingly low prospective returns.

This backdrop was the source of the TINA narrative. In a search for yield, confronted with low returns, investors were forced out along the risk curve substituting government bonds with credit, credit with quality equities, and quality equities with speculative equities. To quote 19th century economist Walter Bagehot, "John Bull can stand many things, but he cannot stand 2%". In one sense, the TINA approach was perfectly rational: for the past decade the prospective return on equities was higher than on bonds and the equity risk premium was high relative to its historical average. Our concern with the narrative was and is one of duration. Equities are the longest duration assets – becoming longer still at higher valuations. It follows that a small increase in investors' required rates of return results in large capital losses. The weakness of equities this year is a consequence of rising interest rates, which has increased investors' return requirements. Should investors start to forecast an earnings recession, equities will take another leg down.

What of the Fed? Today its stance is the mirror of the last decade. With the Core PCE price index at a 40-year record high, the Fed wants tighter financial conditions to restore its credibility. It is rare to see Fed Governors commenting explicitly on the equity market; when they do investors should pay attention. In August, Neel Kashkari (President, Minneapolis Fed) said that he was "not excited to see the stock market rallying after our last FOMC meeting".[1]

More recently, Mary Daly (President, San Francisco Fed) was uncharacteristically blunt in her assessment of the chance of rate cuts in 2023: "I don't see that happening at all".[2] The Fed put appears to have turned into a call.

Just as the Fed's stance has changed so too has TINA given way to TALA: "there are lots of alternatives". 10-year UK linkers yield around 0.6% real,[3] 10-year TIPS yield 1.6%, 5-year gilts pay 4% (with much of the return coming as tax-free capital gains) and your corporate credit portfolio yields 5.7% with a sub 18-month duration. In the event of a recession, these government bonds should perform well. The credit portfolio may suffer: spreads will widen and the portfolio could suffer defaults.

The short duration of the credit portfolio should protect us from the former and the preponderance of economically insensitive credits should provide insulation against the latter. In addition, corporate credit spreads in the UK are much higher than in other jurisdictions due to the unwind of the BoE's balance sheet and the liquidity challenges facing UK pension funds.

For the last 10 years "don't fight the Fed" was excellent advice. We believe that it remains so. Today the Fed is telling investors that it wants asset prices to be lower. Investors should listen.

1. See Transcript: Neel Kashkari on the Fed's commitment to fighting inflation.
2. See Fed's Daly says futures market wrong in seeing 2023 rate cuts.
3. When adjusted for the idiosyncrasies of RPI that equates to a CPI real yield of c. 1.5-1.7%

CG Asset Management
20 King Street
London EC2V 8EG
+(44) 203 906 1637
info@cgasset.com
www.cgasset.com