Capital Gearing Trust

Q3 2023 Report

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The Limits to Monetary Tightening

Higher real interest rates will exacerbate the growing debt burden

Real interest rates continue to march higher. This trend is becoming increasingly central to the policy debate in the US, where nominal interest rate expectations continue to increase across the Treasury curve, while – surprisingly, given recent experience – inflation expectations remain anchored to the Federal Reserve's target of 2%. The steady increases to US real interest rates that have taken place since August 2021 now beg the question: how much higher will real rates go?

Central bankers, most notably Jerome Powell in his recent Jackson Hole speech, have reached for r* as a benchmark for the level of real interest rates. The neutral rate of interest, r*, is the policy interest rate at which the economy is fully employed and inflation is at target. It is a theoretical concept, and its value at any given time is unknown. Helpfully, the Federal Reserve Bank of New York publishes quarterly estimate ranges, with the most recent estimated range of 0.6% to 1.1%, representing the extent of the uncertainty around the value.[1]

There are reasons to believe that real interest rates will continue to rise in the short term. The theory behind real interest rates is that they represent the price at which the supply of savings and demand for investment is in equilibrium. In an open economy, the current account is the balancing factor between the demand for investments and the supply of private sector and government savings. At present, the US economy is characterised by a low household savings rate, and a widening government budget deficit.[2] The Federal Reserve's monetary policy stance compounds this dynamic: whereas central bank purchases under quantitative easing had absorbed some of the supply of government debt, the current policy of quantitative tightening has essentially added to interest rate pressures by creating a secondary supply of government debt to the market.

This combination of structural features suggests an increasing domestic savings shortfall, which in turn would need to be balanced by higher real interest rates, and financed in greater part by foreign sources, thus widening the current account deficit. The irony of this trend, as Warren Buffet commented almost two decades ago, is that it will turn a nation that aspires to be an ownership society into a "sharecropper's society". When Buffet made this conjecture, it was intended as hyperbole.[3] At this juncture, it appears an increasing reality.

Beyond the short term, there are wider debt sustainability considerations which mean that higher real interest rates are unlikely to persist. The most important determinant of government debt sustainability is the difference between the real interest rate that the government pays on debt and the real growth rate of the economy: $r - g$. Where $r - g$ is greater than zero, in the absence of a primary budget surplus, the debt stock will naturally increase over time. When the reverse is true, the debt stock will decrease. Taking the current 10-year US real interest rate of 2.4% and a real growth rate of 1.8%, if the US government continues to run a primary budget deficit, the stock of debt will continue to grow.[4] To reduce the stock of debt, the US government would need to start running meaningful primary budget surpluses.

Unfortunately, domestic pressures for increased government spending on defence, the environment and social security suggest that primary surpluses will be a challenging target. In the absence of an unexpected appetite for austerity from the US government and wider electorate, we expect that real interest rates will necessarily have to fall at least as far as the 0.6% at the bottom of the Fed's estimated range, or even revert to being materially negative, to ensure public debt sustainability against a backdrop of elevated demands on public spending.

[1]Federal Reserve Bank of New York, "Measuring the Natural Rate of Interest". See: https://www.newyorkfed.org/research/policy/rstar.
[2]US household savings currently sit at 3.5% of disposable income, and the US budget balance sat at -8.5% of GDP at 30 June 2023.
[3]Berkshire Hathaway Annual Report 2004, page 20. See: https://www.berkshirehathaway.com/2004ar/2004ar.pdf
[4]Our estimate of real growth is comprised of 1.5% productivity growth and 0.3% forecast growth in the labour force. This is consistent with the Federal Reserve Bank of New York's most recent estimate of trend growth of 1.87%.

Accordingly, although structural features of the US economy suggest that real interest rates may increase further in the near term, we believe that if real interest rates were to persist at or above the current levels, this would likely bring the economy into recession without necessarily bringing above-target inflation to an end. As a consequence, we expect to see a steepening yield curve and the re-emergence of term premia. The rationale is that if there is limited appetite from central bankers to increase short interest rates further, the strain from the supply-demand imbalance for government debt will have to be borne by the longer end of the yield curve.

This backdrop of elevated yields and elevated inflation creates an environment which will eventually place downward pressure on real yields. This will likely happen through a combination of: i) an increased likelihood of rupture in financial system or real economy, prompting reductions in nominal rates; and ii) increasing breakevens, as market expectations begin to align better with recent experience of inflation. In this environment, we expect that TIPS will dramatically outperform nominal Treasuries. It seems that financial repression is on the horizon.

Peter Spiller
Emma Moriarty
September 2023

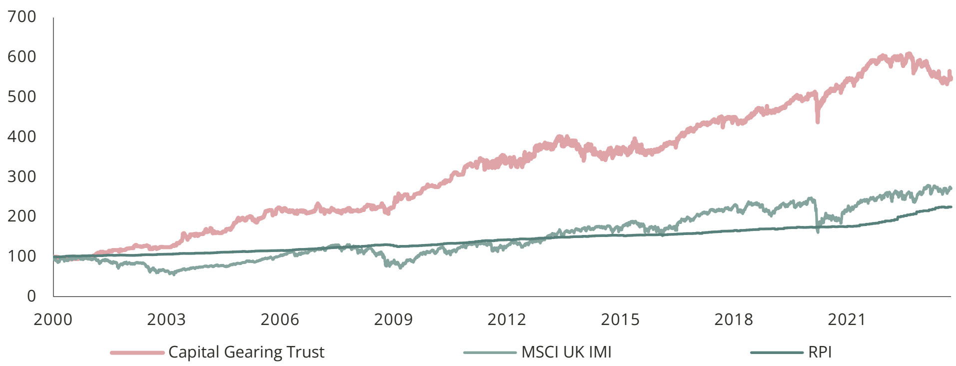
Capital Gearing Trust

30 September 2023

Investment Objective

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

Performance since January 2000 (share price total return)



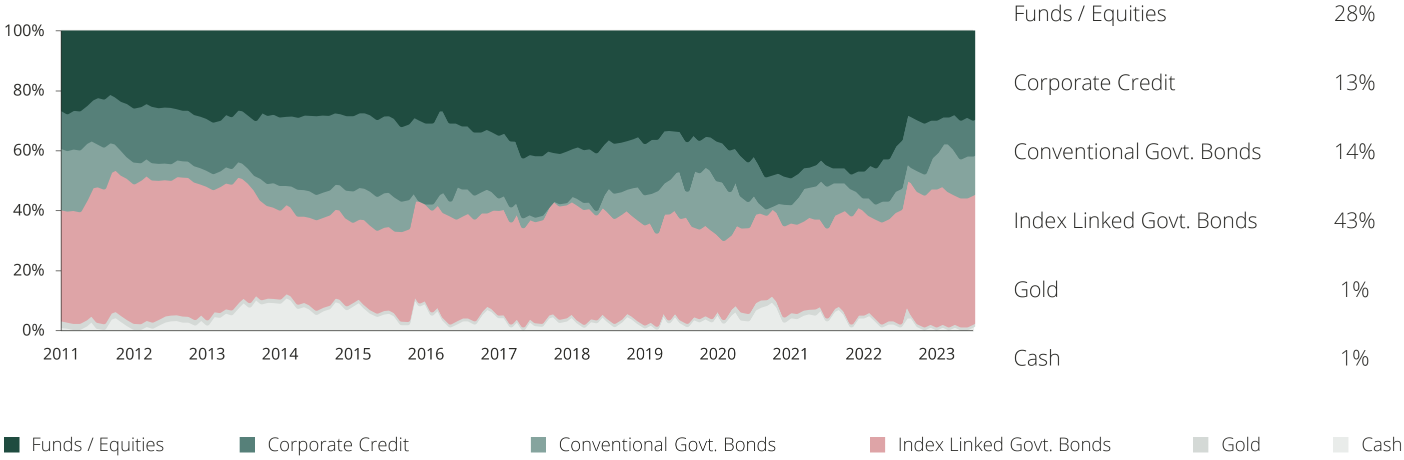
Fund Information

Share Price	£45.80
Market Cap.	£1.1bn
No. of Holdings	217
Dividend Yield	>1%
Ongoing Charge Figure	0.46%
Ongoing Charge Figure (PRIIPS)	0.64%

Return History (total returns)

	1 month	3 months	6 months	YTD	1 year	2018	2019	2020	2021	2022
Share Price	0.9%	1.0%	-1.8%	-5.2%	-2.1%	3.0%	8.9%	8.2%	10.8%	-4.0%
NAV	0.7%	1.0%	-1.3%	-2.7%	-1.3%	2.1%	8.6%	8.3%	11.3%	-3.1%

Asset Allocation Development



Asset Allocation

Funds / Equities	28%
Corporate Credit	13%
Conventional Govt. Bonds	14%
Index Linked Govt. Bonds	43%
Gold	1%
Cash	1%

Risk Data

	5 Yr Return Annualised	*5 Yr Standard Deviation*	*5 Yr Max Drawdown*	*Since 2000 Return Annualised*	*Since 2000 Standard Deviation Annualised*	*Since 2000 Max Drawdown*
Share Price	3.3%	6.7%	-10.7%	7.4%	8.8%	-12.9%
NAV Price	4.1%	5.5%	-7.0%	8.4%	5.9%	-8.2%
MSCI UK IMI	3.3%	14.5%	-25.2%	4.3%	13.7%	-41.0%
RPI	5.8%	2.8%	-0.9%	3.5%	1.9%	-3.8%

This Time Is Not Different

The chorus of voices expecting a soft landing for the US economy grows ever louder. Most recently Janet Yellen, the former chair of the Federal Reserve and current secretary of the US Treasury, added her voice to the chorus: she is "feeling very good" about a soft landing. Yellen is in good company: her predecessor, Larry Summers, has voiced similar optimism, and so too has Nobel Laureate Paul Krugman. Jerome Powell, the current Federal Reserve chair, has also moderated his tone from the unequivocal "we will get the job done", to reiterate instead that while the Fed still intends to get the job done, they will need to wait for the lagged effects of monetary policy to see how much of the job has been done already.

The strength of feeling is unsurprising. The labour market, which has been at the centre of the US inflationary narrative, appears to be coming into balance. While the unemployment rate remains little changed since the tightening cycle began, the labour force participation rate has increased, which has allowed wage growth to moderate without creating additional slack in the economy. To borrow a refrain from Reinhardt and Rogoff, perhaps this time is different.

The wrinkle to all of this is that despite the appearance of the labour market coming into balance, inflation remains elevated and above target and hence the Fed has continued to emphasise that interest rates will need to be kept at a restrictive level for some time. This creates problems for the US economy because elevated policy rates will combine with elevated levels of indebtedness across the government, household and corporate sectors. This indebtedness brings fragility. Even if policy rates are held constant, private sector financial conditions will continue to tighten as household mortgages roll off, as more consumer spending is financed with credit, and as more corporate refinancing becomes due.

However, the part of the national debt stack that has received by far the most attention is that owed by the US government. The very public debate around the debt ceiling earlier this year rightly drew attention to the lack of sustainability of the US government's deficit spending. But where to from here? Serkan Arslanalp and Barry Eichengreen, in a paper presented at this year's Jackson Hole symposium, concluded that high public debt is unlikely to decline materially for the foreseeable future, adding that "these are not normative statements of what is desirable; they are positive statements of what is likely."[5]

There are several important reasons for this. The most direct way of reducing government debt is to run persistent budget surpluses. Studies of historical episodes of successive budget surpluses highlight the importance of a political consensus in favour of debt reduction. And although recent years have seen the US political spectrum become increasingly polarised, there is no obvious political constituency in favour of fiscal probity. The second way of looking at the issue is through the lens of the real-interest-rate-growth-rate differential: "r-g". If the real interest rate that the government pays on its debt is greater than the economy's real growth rate, the debt stock will increase over time. At present, high real interest rates and lower trend growth rates suggests that this differential which has until recently been negative is now turning positive. Budget deficits are more than offsetting the impact of economic growth.

Consequently, "higher for longer" may be as much a description of the US debt position as it is of interest rates. In that scenario, we expect to see slower economic growth, and increasing financial stress placed on the household, corporate and financial sectors – all the ingredients for a "hard landing". The fund offers investors a portfolio of TIPS with a 10.6 year duration, is positioned to have its greatest payoff in a hard landing situation where real yields fall and above-target inflation persists. Unfortunately, the timing of a crisis difficult to predict. However the portfolio now offers a running yield of 2.5% with breakeven-beating inflation accruals, it should remain a place of shelter against any macroeconomic fragility to come.

Emma Moriarty
September 2023

[5]Arslanalp, S. and Eichengreen, B. (2023). "Living with High Public Debt". See: https://www.kansascityfed.org/Jackson%20Hole/documents/9749/Living_With_High_Public_SA_Sep_2_2023.pdf.

Start of a New Term

Perhaps the biggest conundrum in financial markets has been the complete absence, until very recently, of term premia in global government bond markets.

The yield on a nominal bond can be decomposed into 3 elements: the expected path of short real interest rates over the life of the bonds, the expected path of inflation over the bond and a term premium. The term premium is the additional return that investors require for holding longer duration instruments. Its existence arises from two main things. First, it provides compensation to investors should their forecast for the expected path of inflation and short interest rates prove wrong. Second, longer duration assets are more volatile and investors need additional return to endure that volatility.

Term premium is hard to measure since it requires an estimate of short nominal interest rates which, in turn, must be derived from the yield curve itself. Fortunately three researchers at the New York Fed – Adrian, Crump and Moench – have developed a model to describe the term premium. The so called ACM model has been resolutely negative since 2016. This was a consequence of the Fed's unconventional monetary policy, particularly Quantitative Easing and forward guidance.

What has puzzled us is why the term premium remained negative this year in the face of the most aggressive hiking cycle in history. The Fed has also gone from buying bonds under QE to QT and, while they aren't actively selling longer duration bonds, the lack of reinvestment of maturing principal is functionally the same thing. And, if we are indeed in an era of structurally higher and more volatile inflation then investors should demand a much higher term premium to compensate both for volatility in inflation and the associated volatility in short interest rates, as central banks attempt to control that inflation.

In the last week in September, the sell-off in nominal rates finally turned the ACM model positive. Today it stands at 0.15%. Our own "back of the envelope" calculations paint a slightly more favourable picture. If we take the current 2Y year of 5.1% as a correct estimate of the path of interest rates over the next 2 years and then assume an average short rate of 4% for the 8 years that follows, it implies a term premium of around 0.5% today. Our estimates for term premia in the UK and Germany are similar. However, the US premium is still significantly lower than the average of 1.1% since 1990.

Why so low? Our best guess is simply one of market muscle memory. After many years of low interest rates, government bond traders simply can't conceive that 10Y rates should be much higher than the levels that have prevailed in recent years. This makes us very cautious about owning nominal bonds of any significant duration. Of course, the situation for index-linked bonds is rather different. The term premium that an investor requires should be much lower since one of the biggest components of the premium – inflation uncertainty – is not a factor. Nevertheless, the re-emergence of term premia could yet cause a further leg down in nominal government bond markets and index linked bonds are unlikely to be insulated from such moves. In Alastair's report, he observes that real yields are attractive and assesses when to lengthen duration to lock in those returns. The re-emergence of a proper term premium might be just the right signal.

Chris Clothier
September 2023

One Lump or Two?

Across the developed world headline inflation is on the wane. So where does this leave the medium term inflationary outlook? Will inflation prove to be a transitory outcome of an energy price shock or will it continue, like a runaway train, rising and falling for as far as the eye can see?

Given the future is highly uncertain sometimes it pays to study the past for clues. In a recent working paper[6] the IMF reviewed 111 inflation shock episodes in 56 countries, of which roughly half occurred in the 1970's and the balance in the decades since. The paper studied how long inflation took to return to its pre-shock rate and assessed which policies were effective in taming rising prices. The conclusions are summarised in seven stylized facts, the most important of which are the three following ~

1. Inflation is persistent, especially after a terms of trade shock
2. Most unresolved inflation episodes involved "premature celebrations"
3. Countries that resolved inflation had tighter monetary policy

Digging into the detail of the paper, in about 60% of episodes inflation returned to its pre-shock rate within a 5 year period, taking on average 3 years to resolve. However in around 40% of cases "inflation declined materially within the first three years after the initial shock, but then either plateaued at an elevated level or re-accelerated". As the third fact makes clear the most significant factor differentiating between resolved and unresolved episodes was that monetary policy remained tighter for longer in the successful cases (interestingly fiscal policy does not show up as a significant factor). This study makes uncomfortable reading for central bankers, given it suggests that interest rates should remain higher for longer even if the economy crashes into a recession as a result of high interest rates. In that recessionary scenario there will be huge political pressures to cut rates to re-ignite the economy but historically that easing reflex has led to runaway inflation.

Investment managers face a slightly different conundrum given that rising interest rates mean improved investment returns. 20 year Treasury Inflation Protected Securities (TIPS) now yield 2.5% real, a level not seen since before the global financial crisis. There are plenty of multi asset investment mandates that target CPI+2% returns, an objective that can now be comfortably beaten in dollar terms with zero risk by purchasing 20 year TIPS and then playing golf for two decades. In short, for long term investors current real yields are extremely attractive.

However the long term is a journey through the short and then medium term. If the IMF's conclusions are relevant for our current situation, they suggest that either interest rates need to be held higher for longer (hurting bond prices) or that central banks cut interest rates then runaway inflation could establish itself (also hurting bond prices). This tension may explain why the attractive value has emerged in bond markets but also reveals there is little to prevent yields rising even further!

As the portfolio currently holds 71% of its portfolio in bonds the debate about whether and/or when to lengthen duration is a live one in our asset allocation meetings. Our overall fund duration is relatively short at 4.8 years, with an estimated nominal yield to maturity of 5.3% and a composite credit rating of A-[7]. Short duration should protect the portfolio from rising yields in either the "higher for longer" environment or the "higher due to inflation" environment. It is only in our index linked bonds portfolio that we hold any duration (6.8 years duration, 43% of the portfolio). Whilst the aggregate duration is not notably long at the margin we have been lengthening our TIPS holdings. To date the overall impact of longer purchases has been limited but real interest rates would not need to rise significantly from current levels for the value on offer to demand further attention.

Alastair Laing
September 2023

[6]One Hundred Inflation Shocks: Seven Stylized Facts. Ari,Mulas-Granados, Mylonas, Ratnovski, Zhao.

[7]Shareholders interested in our duration or other granular characteristics of the portfolio can refer to the monthly presentations we publish on our website (here).

Port in a Storm

This period saw a forceful convergence of market interest rate expectations to the Federal Reserve's forecast path. As investors reassessed their capacity to hold on for longer, the US 10-year yield reached levels last seen in the GFC, and the S&P fell 4%. In the UK, which is particularly vulnerable to resurgent energy prices, and where the economic outlook more dire, investors felt safer lending money to the Greek government for the next decade than to his majesty's treasury. There was no respite from the FTSE250, which also fell c.4% over the last three months. In this tough period for both equity and bonds markets, we are pleased with the robust returns (+1.0%) delivered by the portfolio, with positive contributions across all asset classes in equities, corporate credit, index-linked bonds and gold.

Weightings to Index-linked government bonds which returned +0.1% over the period remained unchanged with an overall duration of 6.8 years. This comprises primarily of a 4.0 year duration in the UK (23% of the portfolio) and 10.6 year duration in the US (16% of the portfolio) with approximately 4% across developed markets, namely Japan, Sweden, Canada and Australia at various lengths. The UK bonds benefited from falling yields in the belly of the curve, and their shorter duration protected the portfolio from steepening at the long end. In the US the abrupt shift in interest rate expectations put pressure on the TIPS holdings (-1.0% return, 16% of the portfolio). However, we believe the ability to lock in 2.5% returns in excess of inflation for the next decade is an essential and asymmetric cornerstone for a wealth preserving portfolio.

Corporate credit (14% of the portfolio) outperformed, returning +2.9% versus +2.2% for the sterling corporate bond index. This was not achieved by taking excess risk: both portfolios have a composite credit rating of Baa1, but the fund's credit portfolio offers a higher average yield (7.3% vs. 6.2%) and takes much less duration risk (2.2 years against c.6.1 years) than the comparator.

The weighting to risk assets (29% of the portfolio) has increased c.2% over the period from both organic performance (+1.7% return) and portfolio additions. Despite taking profits, a strong period of performance in our two largest equity positions, namely energy equities (up 16%) and Japanese equities (up 2%) saw their weight rise in the portfolio to 4.1% and 4.5% respectively. Some of these gains were recycled into investment trusts and infrastructure, where we could identify both extraordinary value, and favorable market conditions.

For example in infrastructure, investor apprehension of sensitivity to interest rates and pressure from redemptions in open ended funds has pushed discounts to between 15%-30% over the period. We believe this is overstated, unlike private equity, gearing levels overall are lower; largely fixed and falling in real terms with more certainty on inflation linkage and cashflows. In renewables, the government's failure to attract any offshore-wind developers in the latest auction and the politicking on net zero is delaying the roll out of new capacity which should be supportive of future power prices. Independent of this upside, the medium-term returns are underpinned by strong fundamentals. We took the opportunity to add to infrastructure (now 6% of the portfolio) including HICL, BBGI, INPP, 3IN,UKW and TRIG.

Although the change in interest rate expectations should require investors to reassess, and raise their required returns, sellers have been rather indiscriminate in some sectors as their sentiment swings from euphoria to despair. Within these volatile markets, we think there are openings to lock-in attractive returns in defensively positioned businesses at good margins of safety; whilst the economic outlook is poor, we are cautiously optimistic about returns for this portfolio, which is positioned defensively against unexpected inflation, generating attractive risk-free running yields and, at the margin, scouring for risk assets that are vulnerable to capitulation.

Hassan Raza
September 2023

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