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Capital Gearing Trust

Fourth Quarter Report

December 2021

The Yen Conundrum

Reviewing value in currency markets

The joke has it that the US Dollar will sustain its value because its principle competitors are so flawed: the EU is a museum, Japan is an old peoples' home and China is a prison. There is a grain of truth in these characterisations, but the US currency has plenty of challenges itself.

Fashion plays a role in the factors that determine day-to-day reaction functions in the fx market. In the past the dominating factor has varied from relative inflation, relative growth of money supply, balance of trade and anticipation of central bank interventions. Today's dominant fashion is relative nominal interest rates, reflecting an absence of significant inflation in recent years, a reach for yield in all asset classes and the greater financialisaton of the global economy. For emerging markets government indebtedness has been important, but that has not typically been a feature of developed markets. In addition, some currencies, notably the US Dollar, have benefited from a safe haven status in a time of crisis. The Yen also can catch a bid in difficult times for asset markets, in part because it's a funding currency and is the beneficiary of short covering in times of distress.

Over the longer term, currencies tend to revert to their fundamental value; that is to say the exchange rate which makes the associated economy competitive but no more; factors affecting this include relative rates of inflation, relative productivity growth and structural change. That makes the Japanese Yen interesting, given it is trading at a five year low and on competitive criteria it is extraordinarily cheap. According to one Bloomberg model the Yen is valued at half its long term level versus the US Dollar. Productivity growth is similar in Japan and the US, but in Japan wage growth has been negligible in recent years, whereas in the US wages are growing at 5% with upwards momentum. Similarly, the CPI in Japan struggles to reach 1.5%, whereas the US CPI, according to the market will rise by 2.8% per year over the next 5 years (a figure we find implausibly low). In other words, if the exchange rate does not move, the Yen will become even more competitive.

There are two negatives to the Yen: demography and government debt. The falling population in Japan is indeed a factor that calls for a low neutral real interest rate and the concomitant rising dependency ratio is also a competitive challenge. This is somewhat offset by high levels of economic activity among the elderly, but nevertheless suggests that the equilibrium exchange rate is lower; just not nearly as low as it is now. Government debt, even after decades of fiscal deficits, is less worrying. The Bank of Japan has purchased government debt to the value 135% of GDP, and these holdings are unlikely to be sold back to the market. If they were replaced by the fabled quadrillion Yen coin, neither growth nor interest rates would be affected. If inflation rises meaningfully beyond the 1% level now forecast for 2022 and 2023, then purchases by the BOJ may be more constrained given a forecast fiscal deficit still close to 5.8%. At worst that would raise long term interest rates, which, *ceteris paribus*, would be supportive of the Yen. The debt/GDP level would not be unduly alarming.

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The explanation for the Yen's weakness lies in the dominance in fx markets of relative nominal interest rates. As the Federal Reserve attempts to maintain credibility, short term interest rates have risen in the US. By comparison there are no expectations for rate rises in Japan hence the Yen has depreciated by 10% in the last year.

So what is the outlook for Dollar/ Yen? The longer an investor's horizon, the more attractive the Yen seems to be, given its solid fundamentals as a store of value. In the shorter term, momentum and the dominance of interest rate differentials suggest caution. Given our base case of higher-than-consensus inflation in the US, it is likely that the interest rate differential will increase over the next couple of years. However we are long term value focused investors. Currency misalignments this extreme are rare.

Peter Spiller

December 2021

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Fund information as at: *31st December 2021*

Share prices: *£51.50*

Status: *Open*

Investment objective

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

Fund information

Market Cap.	£995m
Dividend Yield	< 1%
OCF*	0.58%
OCF (PRIIPS)	0.90%
Comparator Index	RPI

*Ongoing Charge Figure

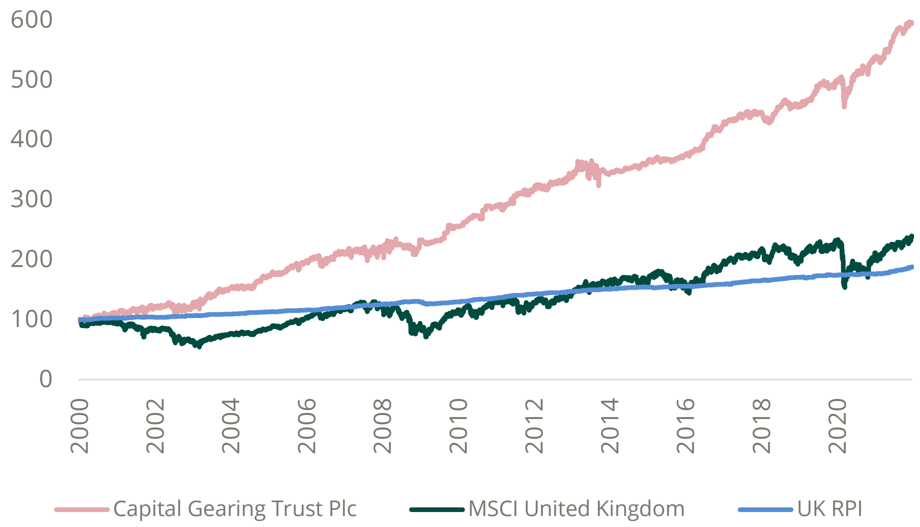
Return history (total returns)

1 month	1.0%	2021	11.3%
3 months	2.1%	2020	8.3%
6 months	5.3%	2019	8.6%
Year to date	11.3%	2018	2.1%
1 year	11.3%	2017	5.1%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	4.2%
Vonovia	2.2%
Grainger	2.1%
Ishares FTSE 100 ETF	2.0%
North Atlantic Smaller Co	1.8%

Performance since January 2000 (total return)



Largest bond holdings

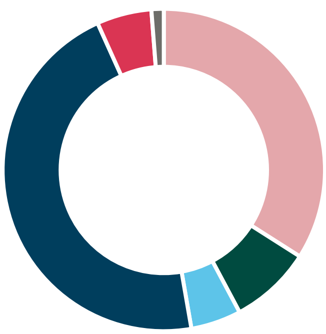
UK I/L 0.125% 22/03/24	4.4%
Secure Income	1.9%
US I/L 1.375% 15/02/44	1.6%
SWEDEN I/L 01/06/22	1.5%
JP I/L 0.10% 10/03/29	1.4%

Currency exposure

GBP	50%
USD	27%
SEK	4%
EUR	8%
JPY	7%
Other	2%

Asset allocation

Index Linked Gov't Bonds	34%
Conventional Gov't Bonds	9%
Pref Shares / Corp Debt	5%
Funds / Equities	45%
Cash	6%
Gold	1%



Fund/equity breakdown

Equities	17%
Property	18%
Loans	4%
Infrastructure	4%
Private Equity / Hedge	2%

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Despite its challenges, 2021 will be remembered as a great year for humanity. Almost 8.5bn doses of Covid-19 vaccine were administered helping to protect almost three quarters of the global population. This is a truly staggering achievement which underpinned a huge economic recovery, mercifully confounding concerns about persistent mass unemployment. The cherry on the cake was recent research suggesting that cheese isn't actually bad for you[1]. In this spirit of unvarnished optimism this report will focus purely on what went right for the multi asset funds in 2021. For those interested in what went wrong, the pessimistic yin to this optimistic yang can be found overleaf.

During a year that included a notable inflation shock the portfolio benefited from its extensive exposure to inflation linked equities and bonds. The seeds of this bountiful harvest were sown in the aftermath of the Covid bear market of 2020. In those dark days many investors were focused on the risks of deflation and nervous that the pandemic had undermined the prospects for all property. This opened up a buying opportunity in alternative property companies, namely those in the logistics and residential subsectors ("beds and sheds"). These assets are characterised by strong asset backing, high levels of revenue visibility and inflation protection; all characteristics that were in strong demand in 2021. Holdings like Secure Income Reit plc, GCP Student Living plc, Tritax Big Box plc and Urban Logistics plc delivered close to or in excess of 40% during 2021. That these "tech" like returns were available on such low risk assets was truly extraordinary.

At its peak during the year our property holdings represented more than 22.5% of the total portfolio, although by year end this level was reduced to 17.5%. Many of our large holdings had moved from significant discounts to premia. Fully three holdings had been exited completely due to successful bid activity. The proceeds of these sales were invested into infrastructure assets, with a particular focus on renewable energy. Unlike property companies, infrastructure had a lacklustre first half 2021 with many renewable energy companies derating by as much as 30% from their late 2019 highs. This derating fortuitously coincided with a surge in power prices so provided an attractive entry point. Our infrastructure portfolio, which now represents 6% of our portfolio, delivered 6% returns in the last quarter of the year and still enjoys a strong tailwind. We also increased our broader energy and power holdings via specialist ETFs which have delivered even stronger returns since purchase.

The most notable area of relative outperformance came from our bond portfolio and again the inflation linking was key. The wider bond market endured a poor year, with an inflation shock causing a sell of in nominal bonds. UK gilts delivered -5% and the global aggregate bond index delivered -2% (all returns reported in sterling). Our bond portfolio delivered 4% with the stand out performers being our 20% holding in US TIPS which returned 6%. TIPS were protected from the nominal bond sell off by a combination of strongly positive in-year inflation accruals and rising break evens which collectively more than offset the nominal sell off. We believe that inflation is likely to remain more sticky than the market is currently forecasting again in 2022. If so TIPS, and our other inflation linked bond holdings are well placed to outperform conventional bonds for another year. Corporate credit and preference shares account for a shrinking portion of the overall portfolio but made a helpful contribution. They returned 5%, considerably outperforming the sterling corporate credit market which returned -3%.

So whether by luck or by judgement much of the portfolio positioning in 2021 worked well and risk adjusted returns were strong. The portfolio starts 2022 defensively positioned, with a focus on inflation protection and value equities. Those with an optimistic predilection should stop reading now. Those more interested in examining our shortcomings should read on.

[1] Great News, America: Cheese Isn't Bad for You. Wired Magazine Feb 2021. Please do not change your dietary approach on the bas is of this evidence

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In fund management it is a relatively straightforward task to account what has gone right. To say what has gone wrong is an Augean task. The potential number of portfolios that we might select for our clients is, for all practical purposes, infinite; even when allowances are made for our mandate and good risk management. Nevertheless, what follows is an attempt to honestly critique our decision making over the past year. In a year where a significant majority of the portfolio appreciated in value, it is inevitable that the sins of omission will outweigh the sins of commission in severity. We shall deal with the sins of omission first.

Our longstanding underweight to US equities once again proved expensive as the S&P 500 delivered a return of 28% in sterling terms. The S&P 500 accounted for fully 18% of the 23% returned by the MSCI World index. As in previous years, good stock selection elsewhere has allowed us to keep pace with the MSCI World with, we believe, somewhat less risk. Nevertheless, our job would have been far easier without this headwind. Conversely our substantial overweight to Japanese equities – which delivered a positive return of just 2% was a major drag on performance.

Perhaps the least forgivable mistake, given our well known views on inflation, related to sterling cash management. At the end of the year we held around 5% in cash and treasury bills vs. 6% in short dated UK index-linked. These latter delivered extraordinary returns of 5.4% over the year with, given their short duration, very little risk. Our enthusiasm for “linkers” had been tempered by the high starting level of breakevens in the UK. We weren’t completely asleep at the wheel and bought around 80 million nominal across the multi-asset funds throughout the year. We clearly should have bought far more.

Turning to the sins of commission, the first was our index-linked holdings outside of the US and UK. With the US Dollar in ascendancy throughout 2021 – and Sterling the only major currency (nearly) keeping pace with it – our diversification into Japanese, Australian and Swedish index-linked provided the worst kind of diversification: outright losses. Japan has been particularly frustrating. We initially began buying JGBIs immediately after the Covid crisis in April and May 2020, attracted by the positive real yields which at the time were unique among the G7. We added further in spring 2021 on Yen weakness. In local currency terms the bonds have performed very well, meanwhile the Yen has depreciated to a five year low to the US dollar.

Only one meaningful risk asset position in the portfolio delivered negative returns in 2021: German residential property. Some of the malaise was idiosyncratic (Vonovia carried out a large, deeply discounted rights issue to finance its purchase of Deutsche Wohnen; Adler, which we held in very small size, became the target of short sellers) but even stalwart stocks like LEG lost us money. There are some crumbs of comfort: this sector has been a fantastic long-term performer for the fund; and our one major overweight – Phoenix Spree Deutschland – returned 21%. Today the German residential stocks offer a beacon of good value in a dark, expensive world.

Finally, we come to two errors which are each other’s mirror. The first is cash: we held to much of it. It is a counterintuitive feature of inflationary periods that cash can be one of the best performing asset classes. Inflation’s biggest threat is not to real value of cash but to the repricing of long duration assets both through rising term premia and the stickiness of the nominal return on corporate capital. Until that repricing occurs, and its option value comes good, cash is painful to hold. And the mirror? Nearly everything we sold, given the strong performance of most of our portfolio, we did in error. Yet for all these mistakes, the fund returned 10.3% in the year and is trading close to a record high. We hope to make better decisions this year. Even if we are successful, the high starting level of asset prices means the returns will likely be worse.

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