Capital Gearing Trust

Q4 2023 Report

- Rational attention
- The year in review
- Running in circles
- Crossing the Rubicon
- Crusaders will march

cgam

Rational attention:

Inflation expectations must adjust to the new regime

One of the most striking features of the recent inflationary episode is that despite a prolonged period of elevated, above-target inflation, US market expectations of inflation have remained anchored to central bank targets of 2%.

The market's expectations of inflation are observable in inflation breakevens. The breakeven rate is the inflation rate that makes the investor indifferent to owning an index-linked government bond or a nominal government bond. Alternatively, using the logic of the Fisher equation, the breakeven rate of inflation is the difference between the nominal yield on a conventional government bond and the real yield on an index-linked bond issued by the same government with the equivalent duration.

At the time of writing, the market's assessment of expected inflation is astonishingly low. All the way out from the five-year to the 30-year horizon, the breakeven rate of inflation is essentially flat at 2.2% on US CPI. Given the Federal Reserve's inflation target is set in terms of the PCE deflator, which typically prints at 30-35bp below CPI, this implies that the Fed will struggle to meet its inflation target over the medium to long term.

This looks to be an extraordinary belief. While not inconsistent with the low inflation experienced over the past two decades, it ignores that this low inflation occurred against a backdrop of exceptional circumstances which are now in the process of normalisation. These include the rise of globalisation and the integration of China into the global economy, which brought with it a vast increase to the global labour force and correspondingly weakened the bargaining power of labour. Similarly, favourable demographics and technological advance have enabled sustained economic stimulation without elevated inflation.

These exceptional circumstances have now come to an end. Protectionism is becoming increasingly entrenched: the localisation of production, often combined with large government subsidies, is emerging in all the major Western economies. As the global economy becomes less integrated, the available workforce is shrinking. Recent wage settlements in both the US and UK have shown the increased bargaining power of local workers. Beyond this, governments are now having to internalise the cost of major externalities – particularly with respect to climate change, but also arguably with respect to defence, where the post-Cold War peace dividend has seemingly evaporated. In this new environment, we expect inflation to be more cyclical as economies grow and recede. We also expect to see more sustained pressure on government fiscal balances, meaning that the balance of underlying forces has shifted from being *deflationary* to *inflationary.*

Given these developments, why does the market continue to price a permanent return to inflation at target levels? Fortunately, the literature – summarised by Catherine Mann of the MPC – can assist.[1] In theory, there are two types of agents in the real economy: forward-looking "fundamentalists" and backward-looking "random-walkers". When inflation varies modestly around its target, fundamentalists, whose expectations are anchored to central bank targets, dominate. This creates an environment akin to Alan Greenspan's desired central bank outcome of "rational inattention", where agents are able to ignore inflation when making decisions. As realised inflation shifts further away from target for more prolonged periods, inflation expectations become more backward looking and can accelerate more quickly, putting the random-walkers in charge. So far, in all but the very near term, inflation expectations have remained close to target.

In the UK, there is one additional complication to interpreting inflation breakevens. Because risk-free index-linked gilts are ideal assets for funds with liabilities that are fixed in real terms (most notably, defined benefit pension funds), such investors have been willing to pay an insurance premium for the assets in case their estimate of inflation proved too low. This led to eye-poppingly negative real yields in long-term index-linked gilts: in 2021, 50-year bonds traded at a -250bp real yield, meaning that investors were prepared to spend £3.50 to receive £1.00 adjusted for inflation in 50 years' time. Few investors seriously thought this was a reasonable investment return. Instead, they were paying a large premium to achieve that certainty. As such, UK breakevens can be thought of as a combination of an inflation expectation and an insurance premium.

[1] See Catherine L. Mann (2022), "Inflation expectations, inflation persistence, and monetary policy strategy". Full speech avai lable here: https://www.bankofengland.co.uk/speech/2022/september/catherine-l-mann-53rd-annual-conference-of-the-money-macro-and-finance-society

All of this leaves a question of timing: when will inflation expectations adjust to the new regime? The major Western economies may not have entered recession yet, so the next major challenge to the market's view will be the reacceleration in the next upturn in the economy, where the confluence of inflationary factors will become more prominent. Given where we sit currently in the economic cycle, this moment may still be some years away. In the meantime, we endorse neither a fundamentalist nor a random walk view. Instead, we will be adopting a policy of paying rational attention to developments in the outlook for inflation as they emerge.

Peter Spiller
Emma Moriarty
January 2024

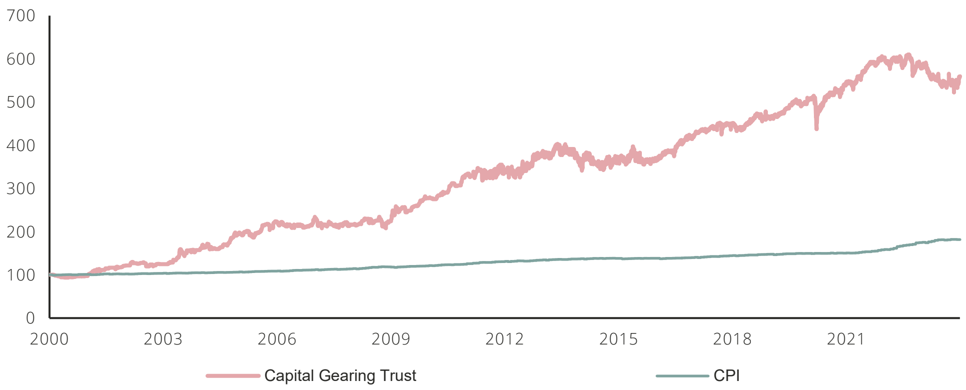
Capital Gearing Trust

31 December 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)



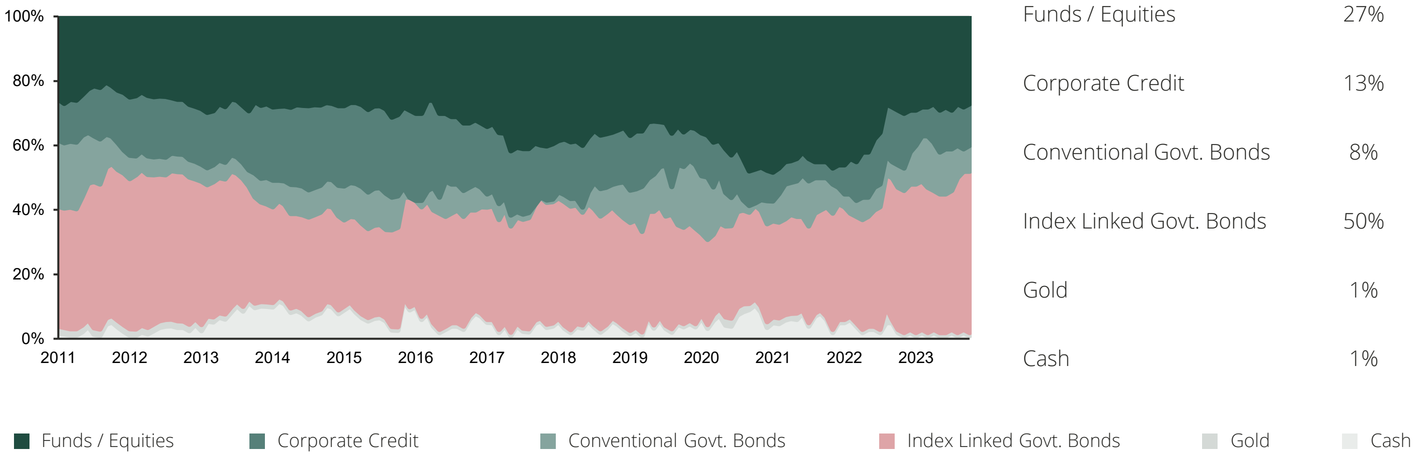
Fund Information

Share Price	£46.50
Market Cap.	£1.1bn
No. of Holdings	220
Dividend Yield	<2%
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	5.1%	2.1%	3.1%	-3.3%	-3.3%	3.0%	8.9%	8.2%	10.8%	-4.0%
NAV	2.9%	3.4%	4.5%	1.3%	1.3%	2.1%	8.6%	8.3%	11.3%	-3.1%

Asset Allocation Development



Asset Allocation

Funds / Equities	27%
Corporate Credit	13%
Conventional Govt. Bonds	8%
Index Linked Govt. Bonds	50%
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	3.9%	7.2%	-13.6%	7.4%	8.9%	-13.6%
NAV Price	5.1%	5.6%	-7.4%	8.5%	5.9%	-8.2%
CPI	4.2%	2.3%	-0.7%	2.5%	1.6%	-1.4%

The year in review

The macroeconomic backdrop was challenging in 2023. Real yields on index-linked bonds rose throughout the year. Sterling appreciated against all major currencies. While the S&P500 performed strongly, most of this performance was concentrated in the – so-called – Magnificent Seven stocks. Equity markets elsewhere were rather more muted. In the investment trust market discounts widened, particularly in the arena of alternative investments.

Capital Gearing Trust returned +1.3% in NAV terms and -3.3% in share price terms over the year. We would not describe that performance as satisfying, but given the headwinds described above, it could have been worse. All asset classes contributed positively over the year, the largest single contribution came from corporate credit with nearly half the gross return. This was pleasing given it only comprised 17% of the portfolio at the start of 2023.

There were no fundamental changes to portfolio composition. The most material change was increasing the allocation to UK linkers from 19% at the start of the year to 28% at the end, while adding duration. Two beliefs underpin this allocation shift. The first is that the repricing of UK real yields has been quite extraordinary. The second is that the rollover of inflation that we are seeing around the world will be most slow to take hold in the UK. UK wage growth remains very strong and, with the national living wage set to increase by 9.8% this April, wage growth is likely to remain embedded for some time to come. Growth in rents is likely to also remain high. There is a housing shortage in much of the western world but it is particularly acute on this small, crowded and nimbyish island. The Bank of England will not get inflation sustainably to target without getting wages and rent under control. RPI also includes mortgage interest payments, where the impact of interest rate rises has not yet been felt and may yet contribute a further 1-2% to inflation, although the fall in nominal house price values will partially mitigate this.

The allocation to credit has fallen from 16% in January to around 13% today. This was in response both to falling credit spreads and falling gilt yields. It seems likely that the gilt market has got ahead of itself. In Q4, two year gilt yields fell from 4.9% to 4.0% and the market is currently pricing more than 5 rate cuts for 2024. For the time being we prefer UK treasury bills yielding 5.2%.

The overall allocation to risk assets is not much changed over the year. We added modestly to infrastructure and continued to trim property. Infrastructure was the poorest performer among the risk assets as infrastructure trusts traded at large discounts to their NAVs on investor concerns over rising interest rates. These vehicles have good long term track records, relatively low risk investment portfolios and offer prospective returns of around 6% real.

Our equity holdings returned 7% over the year which, while satisfactory, was rather less than the MSCI World, owing to our underweight to US equities. Japanese equities performed very well in local currency terms, rather less well when converted to sterling, but nevertheless 14% overall. We trimmed our holdings of energy equities in October which was well timed: they have since fallen by 7%. We continue to think they offer compelling long-term returns and are happy with the residual position. The fund was also active in trading investment trust discounts and special situations.2

Turning to 2024, the macro-economic outlook remains unclear with a hard landing, soft landing and no landing (stagflation) all possible. We hope to have structured the portfolio to perform satisfactorily across all those scenarios. The highest real yields in 15 years on index linked bonds and treasury bills, combined with large discounts on conventional and alternative investment trusts, means we are more optimistic about the prospect for returns from our portfolio than for many years. Time will tell if that optimism is well placed.

[2] Please see the CG Portfolio Fund Report for more detail.

Chris Clothier
December 2023

Running in circles

The 10 year conventional US treasury ended the year yielding 3.9%, modestly higher than its starting point of 3.7%. This fairly inconsequential annual move masks remarkable volatility. Yields were well anchored in the first half of the year in the face of four interest rate hikes. Ironically the bond market only started panicking in July at precisely the same time that the Federal Reserve stopped raising rates. Between July and October the 10 year bond sold off at alarming speed to hit c.5% yield. At that point a number of shell-shocked FOMC committee members were wheeled out to make dovish speeches resulting in yields plummeted back down to 3.9%.

What to make of these extraordinary movements? Most obviously volatility in the US Treasury market, as measured by the MOVE index, remains historically elevated. Bond investors remain scarred by their recent experience of inflation, concerned about deficit issuance and moves are magnified by high levels of leverage in government bond markets. This is in sharp contrast to equity market volatility which, as measured by the VIX Index, has reached lows last seen in the halcyon days before COVID. Bond investors seem to be suffering from paranoia whilst equity investors suffer from complacency. Another important take away is the complex and reflexive relationship between bond markets and interest rate policy. Short rates peaked in July in part because long bonds sold off significantly in the following months, thereby tightening financial conditions. The bond markets did the Federal Reserve's tightening job for it.

However this reflexivity works both ways. The 13th December FOMC press conference in which Jerome Powell made clear the committee is turning its mind towards interest rate cuts resulted in dramatically plunging yields. Market prices now imply six interest rate cuts in 2024, or double the amount suggested by the Federal Reserve's own "dot plot" projections. So 2024 has started with the easiest US financial conditions since before the Ukraine Invasion[3] and it is starting to look like the market has done the Federal Reserve's cutting work for it. Having gone out of its way to sound dovish in late 2023, the Federal Reserve might now need to strike a slightly more hawkish tone to reign in market expectations.

The clearest reason for hawkishness is that core CPI remains at 4%, twice the Federal Reserve's target level. Whilst core CPI has steadily reduced from 5.1% at the start of 2023, there is still a lot of inflation to squeeze out of the underlying economy. Unlike a year ago when core goods inflation was still a major driver, today core CPI growth is exclusively explained by core services inflation which in turn has been supported by a tight labour market. Historically, services inflation has been fairly sticky outside periods of significant recession. Whilst the Federal Reserve believes the air is slowly leaking out of the US economy it does not anticipate a recessionary slowdown. So after a number of positive surprises on inflation there is a risk that in 2024 inflation proves disappointingly sticky due to service inflation remaining stubbornly above target.

With real yields across the TIPS curve close to 2%, valuations remain undemanding, largely because breakevens are exceptionally good value at close to 2%. This leaves the TIPS market attractively priced for the longer term but at some risk of short term reversal if the Federal Reserve keeps short rates above the market's current dovish expectations in the first half of this year. The fund duration remains at c.9 years to lock in the good value on offer but not so long to suffer significant draw-down in the face of any short term reversal.

[3] As measured by the Bloomberg Financial conditions index

Alastair Laing
December 2023

Crossing the Rubicon

In Q1 2023, we wrote about the conflicting monetary and fiscal policy stances facing some of the major Western economies as they confronted elevated inflation. In summary, governments and central banks had "one foot on the accelerator, the other on the brake". By this we meant that while central banks were attempting to contain inflation by increasing interest rates and reducing the size of their balance sheets, governments were stimulating the economy by running persistent budget deficits and hence contributing to inflationary pressures.

This contradiction characterised much of 2022 and 2023. Elevated inflation was largely seen as an issue for central banks to deal with, despite the pressure that deficit spending was beginning to place on inflation. However, bond markets are now increasingly sceptical of the fiscal positions of several of the major advanced economies. One feature that characterised the last quarter was seeing markets devote a similar level of attention to fiscal events as had been devoted to central banking events. The most notable example was the positive market reaction to the US Treasury's decision to slow the pace of increases in issuance of long-dated Treasuries in favour of shorter bonds in response to concerns about the sustainability of the US debt position.[4] In the days following the Treasury's announcement, the 30-year Treasury yield fell from a high of 5.1% back to 4.8% and by the end of the year stood at 4%.

Looking ahead, should we be greedy or fearful in global bond markets in 2024? There is reason for hope and for caution. We expect to see continued tensions between monetary and fiscal policy stance, with monetary policy pushing down on yields while fiscal policy continues to provide upward pressure.

One of the themes of the recent round of monetary policy tightening has been "don't fight the Fed". In Q4, the FOMC crossed the central banking Rubicon in explicitly forecasting three cuts to the Federal Funds Rate over the coming year. Fed speakers, most notably Lorie Logan, have suggested that the Fed's QT may also have to be slowed in response to evidence of low liquidity in financial institutions. Taken together, this suggests a continued loosening of monetary policy stance and a corresponding fall in government bond yields. However, we say this with caution – while markets expect policy rates of 3.7% by end-2024, the FOMC's median prediction is 90bps higher, at 4.6%.

Against this, the fiscal backdrop remains challenging. For example, in the US, the fiscal deficit projected for 2024 is 6% and government debt is predicted to grow by an additional percentage point of GDP, to just under 100%. And while 2024 will see several general elections take place, we are yet to see a political constituency emerge in favour of running persistent fiscal surpluses in an environment where bond markets have shown a heightened focus on fiscal stance. Given this, ongoing fiscal deficits are likely to provide continued upward pressure on yields – in the short term through elevated supply of government bonds and over the medium term as an aggregate demand stimulus that puts more pressure on inflation.

It would be remiss to discuss global bond markets without mentioning Japan. While Western central banks begin discussing when to make the first cuts to policy rates, the Bank of Japan continues to consider crossing a different Rubicon: managing the exit from its yield curve control policy. In an economy with deeply engrained fears of deflation, the Japanese CPI has – for the better part of two years – been above 2%. The brake on exiting yield curve control has been a deep reluctance to tighten monetary policy too early or too quickly and risk deflation. Speculation that the BoJ might use its December 2023 meeting to tweak their stance of monetary policy did not come to pass – instead, the BoJ stated that it will "patiently continue" with its current policy stance until it sees wages increase sustainably. So we too will patiently continue to wait for the results – and pass through – of the Japanese shunto wage negotiations in the spring.

At end-2023, Capital Gearing Trust's global index-linked bond portfolio had a running yield of 1.3% real overall. It is in a position to benefit both from falling global interest rate expectations, and from higher realised inflation accruals should our fears of more persistent inflation come to pass. But given continued policy tensions, we expect a bumpy ride.

[4] U.S. Department of the Treasury (November 2023), "Quarterly Refunding Statement of Assistant Secretary for Financial Markets Josh Frost". See https://home.treasury.gov/news/press-releases/jy1864.

Emma Moriarty
December 2023

Promises must be kept or more crusaders will march on boards

For the first time since 2008, the discount on the average investment company has remained in double digit territory throughout the year, averaging 15%. The pain felt most acutely in private equity (40%), property (29%) and infrastructure (18%). Whilst some chairs have shown real back-bone in containing discounts, many boards have failed to arrest them from widening. We are seeing increasing evidence of shareholders running out of patience, especially where companies have made promises to contain such volatility which they are not keeping.

Some progress is starting to be made, the investment company sector saw 8 liquidations, 8 manager changes and 8 mergers announced or completed before year end; we too have increased the number, and intensity, of our engagements on buybacks, gearing, capital allocation policy and fees. The year saw us complete the exit of European Opportunities Fund (at 9% return), which was subject to a hostile campaign by a US activist investor, build a position in Ediston Property as one of its largest shareholders ahead of a proposal to liquidate this month, and initiate a number of small merger arbitrage positions. After productive engagement, we have also largely exited our position in Fidelity Japan Value (at +14% return), which saw an increase in buybacks from the company to help honour its commitment to a single digit discount.

Over 125 investment companies with a market capitalisation less than £400m charge ongoing fees >1%. If, having on average traded at a discount for the entire year, companies are unwilling to shrink further from buybacks then they should at least lower their fees. Whilst 26 companies have reduced, removed, or tiered fees this year to the benefit of shareholders, more should follow. Boards may disagree with our view on buybacks, discounts, or scale but we can all agree that lower fees protect shareholder value.

For conventional trusts there is no excuse for any fund with liquid underlying holdings to trade on a material discount. If companies enthusiastically issue shares at a modest premium, then their lack of enthusiasm to forgo double-digit risk-free returns from buybacks should be questioned. The economics are hard to ignore, so we are starting to see a return of capital across the sector (now c.£260bn in assets) after buybacks or tenders of £4.2bn this year (up 32%), and dividends (up 14%) to £6.2bn.

For alternative trusts - particularly infrastructure - where asset level liquidity is often cited as a barrier to buybacks, the zeitgeist on capital allocation discipline has shifted. After a period of unrestrained issuance, which saw assets in infrastructure balloon to £33bn, the market is now telling the sector there is just too much issued capital relative to demand from investors. Why date TINA anymore if dating TARA is less demanding?[5] The message has started to sink in as multiple companies have initiated some mixture of asset sales, buybacks, strategic reviews or deleveraging exercises but the fact remains that there are too many unviable trusts. If companies do not pre-empt with an internal solution either a hostile party will, or they may find it hard to win back the support of income investors that do not expect such discount volatility. With Octopus Renewables' (ORIT) recent takeover approach of Aquila European (AERI) and continuation votes coming up in Next Energy Solar (NESF) and Foresight Solar (FSFL) this year, there is some dynamism in the sector to continue our engagement with companies who are becoming more receptive to improving capital allocation.

Overall exposure to risk assets remains close to historical lows at 27%, these have delivered a +6% return over the quarter. Our appetite to add is constrained by the powerful correlation of American equities with global markets. The US may well be expensive, but crucially, it is priced with little room for error; and the market looks overly optimistic in forecasting six interest rate cuts by the Fed Reserve this year. The combination of these factors would expose risk assets to an asymmetric risk-reward outcome from here; our preference is to deploy dry powder from a defensively positioned portfolio when the margin for error and safety is greater.

[5] "TINA" - There is no alternative, is often used by investors to justify tolerating lackluster returns in risk assets on the basis of few alternatives, typically fixed income. "TARA" - There is a reasonable alternative, is the more attractive cousin, prospective suitors can make acceptable risk adjusted returns without the high maintenance.

Hassan Raza, CFA
December 2023

The Investment Team

Peter Spiller
Co - Chief Investment Officer

Chris Clothier
Co - Chief Investment Officer

Alastair Laing
Chief Executive Officer

Emma Moriarty
Investment Manager

Hassan Raza, CFA
Investment Manager

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Any person subscribing for an investment in the Fund must be able to bear the risks involved and must meet the Fund's suitability requirements. Some or all investment products may not be suitable for certain investors. No assurance can be given that the Fund's investment objectives can be achieved. Among the risks that we wish to call to the particular attention of prospective investors are the following:

- The Fund is speculative and involves a degree of risk;
- An investor could lose all or a substantial amount of his or her investment;
- CG Asset Management Limited ("CGAM") has total trading authority over the Fund, and the Fund is dependent upon the services of CGAM. The use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequentially, higher risk;
- There is no secondary market for the investors' interest in the Fund and none is expected to develop; and
- The Fund's performance may be volatile.

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CG Asset Management Limited

IR@cgasset.com
+44 20 3906 1649
www.cgasset.com

20 King Street
London
EC2V 8EG