Capital Gearing Trust

Q2 2024 Report

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cgam

There is no money left

The result of the 2010 UK General Election saw the beginning of the era of fiscal austerity. In the aftermath of that election, much was made of a note to the incoming Chief Secretary to the Treasury, David Laws, from his Labour predecessor Liam Byrne. The letter read simply: "Dear Chief Secretary, I'm afraid there is no money. Kind regards and good luck!".

The new Labour Government faces a similar inheritance. The OBR last opined on the fiscal sustainability of the UK government's position after its Spring Budget. At that point, the now former Chancellor Jeremy Hunt was – barely – on track to meet to meet his government's two fiscal rules. Even so, in the IMF's estimates, Hunt's fiscal path would leave a 'black hole' of £30 billion per year of spending required to maintain non-core government services at current levels. And so, while the new Prime Minister Keir Starmer has announced his intention to "take the brakes off Britain", his Chancellor of the Exchequer, Rachel Reeves, has been very fast to warn of the difficult decisions that will need to be made on public finances.

Despite this, the Labour manifesto has promised a modest uplift to the Conservatives' planned spending path. It is worth noting, that even very core services require annual spending uplifts even just to maintain the current level of service. For example, the NHS alone usually requires an annual spending increase of 3-4% over the level of general inflation. This is before accounting for the current environment, with large patient waiting lists and uncertain, but likely elevated, settlements with their staff. In the Tony Blair era, NHS budgets were increased by 7.1% over inflation to achieve meaningful improvements. Beyond the NHS, much of the same spending pressure pervades different government departments: prisons, justice, local government and defence – as well as areas such as education and water, where underinvestment in infrastructure has now created a very significant upfront spending need. All in all, it seems inevitable that fiscal deficits will continue to widen.

Expenditure-driven widening fiscal deficits imply greater excess demand in the economy. Persistent excess demand relative to supply brings inflation. Although commentators speak as though inflation is entirely the central bank's responsibility, there is little doubt that larger deficits create inflation. One of the main mechanisms by which this inflation becomes more prolonged is the wage-price spiral, where increase prices create pressure for increased wages to maintain workers' standard of living, which are then in turn passed on into even higher prices. To this end, we do not know that the next increase to the minimum wage will be, but there will be pressure for it to be generous when announced this autumn.

This may not be the end of central government wage increases. Torsten Bell, formerly of the Resolution Foundation, published a book, Great Britain?, just prior to his election as a Labour MP. In this book, Bell suggests that particular sectors, such as social care, should have a Good Work Agreement with a higher wage floor – a premium of, for example £2 per hour over the national minimum wage. It also suggests more protection for workers in areas such as textiles, warehousing, cleaning and security. The details of the new employment laws are unknown and subject to negotiation, but any reduction to labour market flexibility will likely put further upward pressure on wages. This is, of course, in the context of a labour market which is already operating close to full employment, where the latest wage increases have come in at 5.7%.

Put in terms of the Bernanke-Blanchard model of inflation persistence,[1] while inflation expectations remain relatively well-anchored, wage resistance, which is the desire to use wage settlements to make up for past falls in real wages – is still sufficiently widespread (those doctors!) to suggest that overall wage growth will remain elevated.

The Labour government's 'get out of jail free' card, is supply-side-driven economic growth. Supply-side growth will, it is hoped, come from planning reform across housing and infrastructure. The combined effect of this plan should, in the government's view, enable the UK economy to grow at a rate of 2.5% per annum. For context, this is against the OBR's latest forecast of 1.67% per annum over the coming five years, and 0.7% for 2024. That is all to say that this would be a dramatic increase to the UK's trend growth rate. It also looks difficult to achieve: for example, the government has announced an ambition to build 1.5 million houses over the next five years. This should definitely increase the number of housing starts across the country, but it still clear that capacity – in terms of construction workers, building materials and available working capital – is still far too low to achieve anything near the targets.

[1] For a detailed explanation of the model, see the recent speech by Jonathan Haskel, external member of the Bank of England's Monetary Policy Committee: UK inflation: What's done and what's to come – speech by Jonathan Haskel (bankofengland.co.uk).

The other area of growth is spending to facilitate the transition to net zero. This will now be supported by private sources of finance and co-ordinated by Great British Energy. However, this private capital will need to be rewarded, and it looks as though the subsidy will come through households' electricity prices. The original claim that energy costs would fall no longer looks credible at current prices. This spending will add further to excess demand in the economy, and while for now inflation expectations remain anchored, as inflation stays stickier for longer, the less reliable this assumption will be.

Our economic base case is that we expect to see more persistent inflation and wider fiscal deficits – which is a combination that creates a challenging environment for the Bank of England to bring down interest rates. However, should the Chancellor be successful in achieving supply-driven growth of 2.5% or more, this would come with increased productivity which has the potential to suppress wage-driven inflation and to narrow the fiscal deficit. This is the essence of the gamble on growth.

Peter Spiller
Emma Moriarty
June 2024

Capital Gearing Trust

Company information as at:

30th June 2024

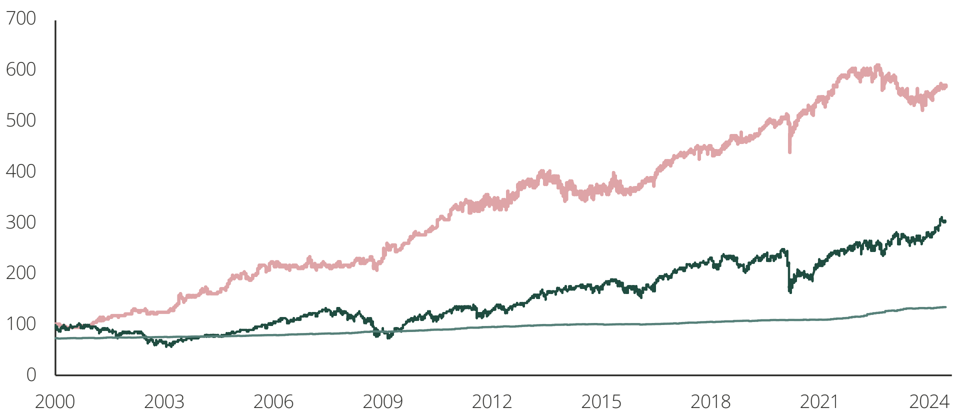
Share Price:

£47.03

Investment Objective

Capital Gearing Trust's (CGT) goal is to preserve and grow shareholders' wealth over time. CGT seeks long-term absolute returns through a global portfolio of equities, bonds, and commodities, using a low-cost approach without the use of gearing or short selling. Since 2015, CGT's discount control policy ensures the share price closely tracks the Net Asset Value (NAV) per share by issuing or purchasing shares as needed.

Performance Since January 2000 (share price total Return)



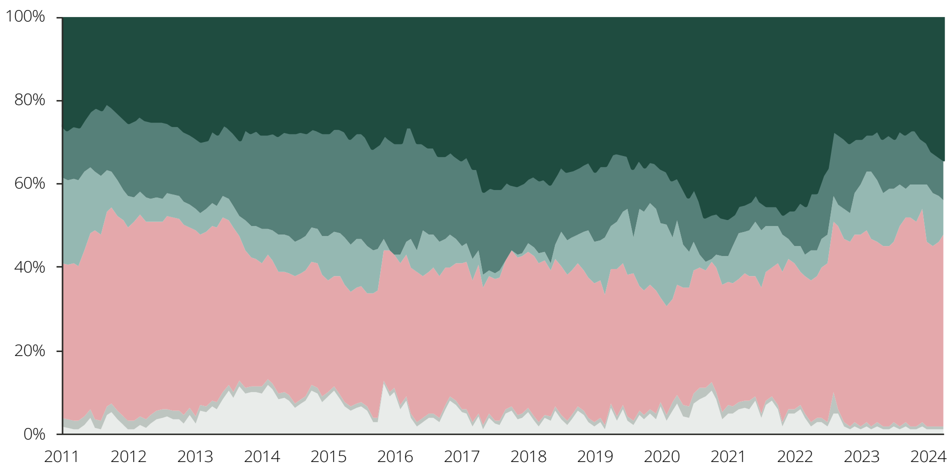
Fund Information

Market Cap.	£976m
No. of Holdings	190
Dividend Yield	<2%
Ongoing Charge Figure	0.47%
Ongoing Charge Figure (PRIIPS)	0.70%

Return History (total return)

	1 month	3 months	6 months	YTD	1 year	2019	2020	2021	2022	2023
Share Price	0.6%	1.9%	2.4%	2.4%	5.6%	8.9%	8.2%	10.8%	-4.2%	-3.3%
NAV	0.3%	1.0%	0.7%	0.7%	5.2%	8.6%	8.3%	11.3%	-3.2%	1.3%

Asset Allocation Development



Asset Allocation

Funds / Equities	34%
Corporate Credit	10%
Conventional Govt. Bonds	8%
Index Linked Govt. Bonds	46%
Gold	1%
Cash	1%

Funds / Equities · Corporate Credit · Conventional Govt. Bonds · Index Linked Govt. Bonds · Gold · Cash cgam

The silent argument

The process of price discovery resembles a never ending argument. In any transaction the buyer and seller, by definition, have come to the opposite conclusion about the same opportunity. Both sides believe they will profit from their superior decision making capabilities and implicitly that their counterpart understands the future less well than they do. This silent argument culminates for a fleeting moment in a price, which fades immediately as new belligerents lock horns and create new prices at new levels. Nowhere is this argument as unceasing and urgent as in the US Treasury market.

In the red corner are the fiscal and inflation hawks who believe that government spending is uncontrollable and that inflation remains embedded in a surprisingly robust economy. The toxic brew of rampant debt issuance and diminishing investor confidence in debt management will result in bond vigilantes demanding higher yields. Liz Truss is living proof of the potency of this argument.

In the blue corner are the growth pessimists, who believe that deficit spending has been papering over the cracks of a fundamentally weak economy. In this view high and restrictive interest rates are suffocating activity and any residual inflationary impulses are leaking out of the deflating economy. The Federal Reserve has made clear that it is looking to cut interest rates and bond yields will fall when they do, resulting in gains on bonds at a time when equities are likely to be soft.

Capital Gearing Trust holds 18% of its portfolio in US Treasury Inflation Protected Securities (TIPS) with 9 years of duration. From a portfolio construction point of view our TIPS holdings are an insurance policy. So what is the expected payout on this insurance policy in these different scenarios?

If team blue are correct that a weak economy requires lower interest rates, and real yields fall by 100bps across the TIPS curve from the current 2% to 1%, our TIPS should deliver total returns of c.14% over the next 12 months. That kind of gain should significantly offset the weakness that would be expected from the equity market in such an environment. If the red team are right that a robust economy will result in the highest interest rates for more than two decades, with real rates moving from 2% to 3%, then the downside on the TIPS portfolio would be c.-3%. So in this simplistic characterisation TIPS are a credit risk free insurance policy denominated in the global reserve currency. The likely payoff on this policy over the next twelve months is between +14% and -3% and those returns are likely to be negatively correlated to equity returns. That type of positively asymmetric return that is negatively correlated to equities demands a role in any portfolio.

Over the last few years the bond market has been through a profound repricing, which has dramatically improved medium term return prospects. The prospective returns of our risk asset portfolios are also unusually high given the elevated discounts on investment trusts. However even good value equities are volatile and can suffer significant short term losses during a recession. Over the last quarter we have increased our holdings of risks assets to 34% of the portfolio due to the attractive discounts, however the higher the risk asset weighting the greater the reliance on portfolio insurance for the worst case scenarios. The defensive and asymmetric pay off profile of longer TIPS is an important portfolio construction tool and allows us to seize attractive equity opportunities with equanimity.

Alastair Laing
June 2024

Another false dawn in Japan?

With the excitement of artificial intelligence capturing the imagination of most investors, it's easy to have missed that last week Japan's digital minister Taro Kano declared victory over his three-year war on floppy discs.[2] Up until last month 1,034 regulations required their use to submit government documents. Once considered a manufacturing and technology hegemon, in recent years the country has lagged in the global wave of digital transformation because of a deep resistance to change. For instance, earlier plans to remove fax machines from government offices were scrapped because of pushback. With plenty of opportunity, reforms have been in the works for near twenty years but progress has been glacial at best. Experience tells us it is too early to call a corporate revolution in Japan Inc. but recent results have been impressive.

Last year the Tokyo Stock Exchange pushed companies to implement plans to improve capital efficiency, shareholder engagement and share price performance. All public companies trading at less than 1x price-to-book were instructed to publish a reform plan to raise their valuations with a list published monthly on those meeting the request, and by exclusion a naming-and-shaming of those failing to meet the threshold. Later this year the exchange intends to publish anonymous case studies of companies that are failing to properly address governance concerns and is planning on increasing the free float threshold to reduce the number of companies listing "aimlessly".

In the first year since the reforms the percentage of companies listed on the TSE Prime Market with price-to-book ratios above 1x has risen from c.50% to c.66%, policymakers have their sights set on closing the gap with the Euro STOXX (c.80%). Among these companies a cohort of 'future value creators' are selected (where return-on-equity exceeds its cost) to form the JPX150 Index, offering a carrot by attracting inflows behind the top prospects. Amendments to the takeover guidelines to facilitate consolidation has also put laggards on watch with the value of buyouts last year highest since 2006.

Whilst the TSE may want to take all of the credit, the Yen's real effective exchange rate is at levels below the era of the first floppy discs. A c.50% undervaluation against the dollar (on a purchasing parity basis) has been a real tailwind for overseas earnings. Despite a 25% increase in the TOPIX over the last twelve months, valuations are still below their long-term averages (P/E of 16x vs. CAPE of 24x) and are undemanding in a world where US estimates are assuming exuberant levels of growth and profitability, not just today, but far into the future. On a EV/EBITDA basis the S&P is twice as expensive as the TOPIX at 7.2x. Cash piles built over decades of deleveraging should give reformers and value creators plenty of room to either improve return on equity or just, return the equity.

However with more than half the sterling portfolio returns for our Japanese equities given up to the currency, it is worth considering why a 9% exposure to the Yen is attractive. Remarkably cheap on fundamentals, the Yen will also require rate differentials to narrow in the near term. If the emergence of inflation is to be sustained, the key will be the re-anchoring of wage expectations. This year the spring wage negotiations led to a 5.2% increase – the largest in 33 years. This growth in real wages, if sustained, would lead to broad based demand growth, a virtuous circle in inflation starved Japan. And perhaps more importantly, convince investors that the economy can succeed without the extraordinary measures the BoJ has taken in the past. BoJ Governor Kazuo Ueda believes "the certainty for attaining a virtuous cycle has risen to 75%, and if it goes up to 80% or 85%, that would be a factor that might allow another move." A move up in the Japanese benchmark rate simultaneously with the Federal reserve cutting in the coming quarter could mark the start of a stronger Yen. Whilst the Fed will do most of the heavy lifting, the BoJ has a history of intervention where it believes currency volatility threatens this virtuous cycle.

[2]For our younger readers, the save icon on your screen is inspired by these square shaped devices created in the 1960s, largely abandoned by most of the world 1990s as more efficient storage solutions were found Sources: Japan Exchange Group, Bloomberg, Reuters, FT

Hassan Raza, CFA

June 2024

Growing pains

The new Labour government has put growth at the centre of its economic policy. While this is welcome, the path is unlikely to be straightforward.

GDP growth per capita in the UK has been on a downward trend since the 1990s. But this is common to most western economies whether one considers the UK's continental peers (Germany, France, Sweden) or Anglo-Saxon cousins (Canada, Australia, New Zealand). The notable outlier among developed economies is the US whose growth per capital has held up much better.

GDP growth per capita can essentially all be attributed to productivity growth, given steady terms of trade. In turn, productivity is driven by human capital,[3] physical capital[4] and social capital.[5] The new government is placing great emphasis on physical capital, largely through attempts to loosen the planning system. The early signs are encouraging with the approval of three large scale solar farms that had been stymied in planning, and recalling the decision to prevent the building of two new data centres. Widespread planning reform would be an unalloyed good. Even if large scale housebuilding doesn't affect productivity directly, it would increase economic growth and bring huge societal benefits.

Less encouraging are some of the state interventions that are proposed. It is not exactly clear what Great British Energy and the National Wealth Fund will *actually do*. From the available announcements it appears – *inter alia* – that they will provide risk capital to sectors that cannot attract private capital. That immediately sounds like making investments which will generate low economic returns. And that is before considering the poor historic track record of state directed capital allocation. The new government rightly wishes to address climate change. It is likely that this would be better achieved by providing a mixture of subsidies and low cost debt finance which the private sector can bid for via competitive auction.

Probably the best path to growth would be to help foster industries where the UK has genuine competitive advantages: biotechnology & pharmaceuticals, TV & film production, artificial intelligence, financial services, and certain areas of precision manufacturing. This requires legislative finesse: just enough government to create a supportive environment and provide a strong regulatory framework; but not so much as to stifle innovation or attempt to pick winners. State directed "winners" are usually anything but.

The new government has not yet set out plans for developing the nation's human capital or social capital in any detail. In any event, it would be a long, slow process.

What of index-linked bonds? Should the potential output of the economy increase, we would expect the neutral real interest rate to rise *and* trend inflation to fall. Neither would be good for index-linked bonds. Given the magnitude of the task, and the long-term nature of any change, it doesn't cause us to lose much sleep. Of greater concern would be if the government became frustrated that the expected productivity gush turned out to be a mere trickle and it resorted to Keynesian priming of the pumps. Increasing borrowing to finance growth which would likely cause a steepening of the yield curve – as markets absorbed the greater supply of bonds – and an increase in short term inflation. The new government is at pains to present its fiscal *bona fides* so for now this is only a risk, not our central forecast. Nevertheless it reinforces our preference to maintain a short duration which has served this portfolio well so far.

[3] Ensuring people have the right skills and education or, if those skills aren't readily available, enabling immigration.

[4] Physical infrastructure whether state (e.g. transport) or private (property, plant & equipment)

[5] The social infrastructure that facilitates commerce: supportive regulatory and legal environments; supply-chain networks; frictionless trading relationships; clustering of expertise and related social networks

Chris Clothier
June 2024

Flat as a pancake

The TIPS yield curve is flat. Extraordinarily flat. At the time of writing yields at the key points along the curve are as follows: 2Y = 2.25%, 5Y = 1.92%, 10Y = 1.90%, 20Y = 2.15%, 30Y = 2.13%. Each bond on the curve is separated by less than 35bps in yield. We aren't able to think of a time before when that has been the case. The implications of this curve shape on the positioning of the portfolio have been profound as this report will hopefully make clear.

There are roughly four main sources of return from government bonds. First is the yield to maturity. Second is the capital gains (or losses) arising from changing interest rates. Third is the returns arising from yield curve roll-down. Fourth is the impact of convexity on returns.

Roll-down is the capital gain that arises where there is a conventionally shaped, upwards sloping yield curve. Provided that the shape of the yield curve remains roughly constant, a five-year bond on a higher yield becomes a lower yielding four-year bond after 12 months and delivers an associated capital gain. The bond is said to "roll-down" the yield curve. The potential for roll-down is greatest when the yield curve is steep. In a normally shaped yield curve – which might resemble a stretched out "S" – the opportunities tend to be greatest in the belly of the curve at durations of, perhaps, 3-7 years. All else equal, the presence of a steep yield curve encourages a bond fund manager to overweight the belly.

Roll-down is not a source of return at present, indeed with the curve slightly inverted from 2Y to 5Y and flat from 5Y to 10Y, roll-down today generates negative returns.

Convexity tends to operate at odds to roll-down and pushes an investor towards a barbell portfolio. Convexity is the observation that the capital gains and losses from falling and rising yields are asymmetric *and* that convexity becomes greater with longer duration instruments. Taking the current 30Y TIPS as an example, should its yield fall by 1% it will deliver a capital gain of about 25% but should yields rise by the same amount the capital loss would only be 19%. For a 10Y TIPS subject to the same changes in yield the gains and losses would be 9% and 8% respectively.

Recently, the portfolio has been selling 20Y TIPS and buying a package of 30Y and 2Y TIPS. The impact is to leave the duration of the portfolio substantially unchanged but to benefit from greater convexity. The switch sacrifices a small amount of running yield – 0.01% per annum, but the expected return on the portfolio rises because while we can't be sure *which* direction yields will go it seems highly unlikely that they will stay the same.

The increase in expected return described above is naïve – it makes no assumptions about the development of the yield curve. However the change in curve positioning fits our macroeconomic views. 2Y TIPS appear to offer an attractive risk-reward profile. The Fed has signalled that it would like to cut rates, and should the economy weaken suddenly it might cut aggressively. Conversely, it seems unlikely that the Fed will raise rates. The only scenario in which that might happen, or where the pace of rate cuts is materially delayed, is where inflation suddenly reaccelerates. So while short nominal yields might rise, real yields would most likely remain flat or even fall.

What of the other half of the trade? Selling 20Y TIPS to buy 30Y TIPS. If yields fall the convexity will work in the portfolio's favour. The only scenario where the fund does worse is if 30Y yields rise faster than 20Y yields. This certainly could happen, but history suggests that 20Y and 30Y yields march in lockstep in a pretty tight range. Taken together we hope that these adjustments to the portfolio increase the prospective risk adjusted returns. In plain English, it should give investors greater bang for their buck.

Chris Clothier
June 2024

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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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