CG INSIGHTS

Quarterly perspectives from the CG team

Q4 2025 - CG Insights Report

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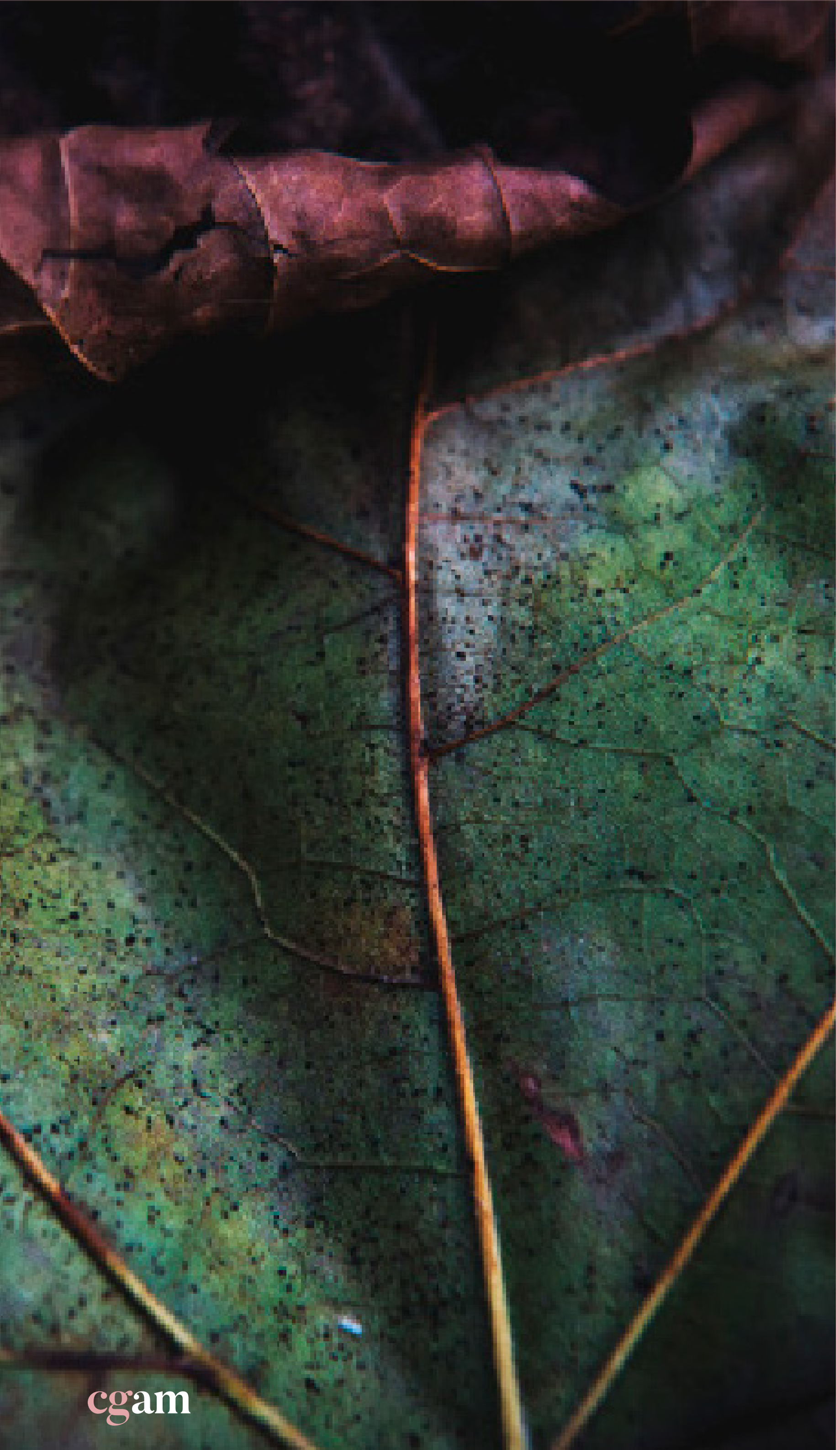

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Your Euro, Your Problem

A letter from Peter Spiller on the Euro

Imbalances proliferate as 2026 starts: in government deficits; government debt; private leverage; private credit and equity valuations to name a few. But there is an imbalance that has little impact in the short term, but profound consequences in the long term if sustained: namely the value of the euro, particularly against the yen and the yuan. Manufacturing production does not easily move and trade patterns change only slowly, but over time the impact is profound.

The structural headwinds facing Europe as a whole are partly of external origin. The invasion of Ukraine has meant that an important pillar of growth, namely the conversion of cheap Russian gas into manufactured products, has been reversed. Electricity prices in Europe are now 30% higher than its competitors. Similarly, the 15% tariff imposed by the US comes with few compensating benefits; indeed the EU has also promised that some $800bn of capex will be spent in the US. Finally, China has both developed technology that is more competitive and moved even further towards an overt mercantilist policy. Worse, the lobbying of European companies with interests in China has meant that there is little reciprocating protection from Chinese goods.

All those should have put downward pressure on the euro, but, in fact, policy decisions in China and Japan and to a lesser extent the US have pushed the euro higher. As a result, Volkswagen, for example, announced recently that it could build an electric car in China for half of the cost of building it in Germany.

On top of that, the problems of bureaucracy and regulation, reflecting a mindset dominated by risk aversion rather than opportunity, add to domestic constraints.

The reforms suggested by Draghi are widely acknowledged, but action is achingly slow. Add to that the necessity for diverting capital expenditure towards defence; debt capacity that, outside Germany, is fully utilised; and demographic issues; and the conclusion has to be that the EU will experience notably low structural growth. But an overvalued exchange rate clearly threatens to reduce even that growth rate to politically unacceptable levels.

Borrowed Conviction

The changing nature of US creditors

US Treasury issuance has risen sharply over the last two years (up 65%), particularly in Treasury bills, reflecting an increasing reliance of fiscal deficits on short term borrowing. Issuance is expected to remain elevated as deficits persist and interest costs compound. **The question is no longer whether supply will be large, but who absorbs it.**

As price insensitive buyers such as foreign central banks step back, some domestic banks have increased their Treasury holdings in response to both higher yields and regulatory incentives. However, balance sheet constraints limit the extent to which they can continue to support issuance. **Hedge funds (HF) have emerged as the increasingly dominant marginal buyer of Treasuries.**

These funds *are* price sensitive, focused on relative value strategies and absorb supply using borrowed funds, predominantly via the repo market. Treasury repo borrowing has risen dramatically over the last two years (see chart), reflecting both the higher issuance and greater participation of HFs. Their conviction in operating at such leverage (typically around 50x[1]) rests **on the belief that if repo markets seize, the Fed will step in to facilitate a roll over of short-term borrowing.** We do not believe this confidence is misplaced. A disorderly unwind would pose a systemic risk to the financial system and the Fed's actions through the Reserve Management Purchases Program recognise this risk, signalling a willingness to inject reserves pre-emptively to stabilise markets.

We believe the implications are two fold: In the short term, this masks volatility and enables profligate issuance to be absorbed where leverage and liquidity are most readily available, at shorter maturities. Over time, this embeds a structure reliant on leverage that is sensitive to shock, where the path of least resistance to restore calm is readily available: central-bank balance sheet expansion.

When central bank balance-sheet expansion occurs alongside persistent fiscal deficits targeted at the real economy, history suggests inflation risk rises materially. The current framework increases the probability of such outcomes.

1) In some instances, up to 100x

Source: SIMFA, Apollo Global Management

Our Investment Judgement

1. A structure reliant on balance-sheet expansion to absorb fiscal deficits and stabilise markets skews inflation risks higher over time. We therefore favour inflation-linked bonds to protect purchasing power.

2. Elevated debt issuance enabled through short-run refinancing support, concentrates fiscal credibility risk at the long end of the curve. We have allocated to shorter maturities over long-dated bonds.

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Hedge fund borrowing by source ($, trillion) [1]

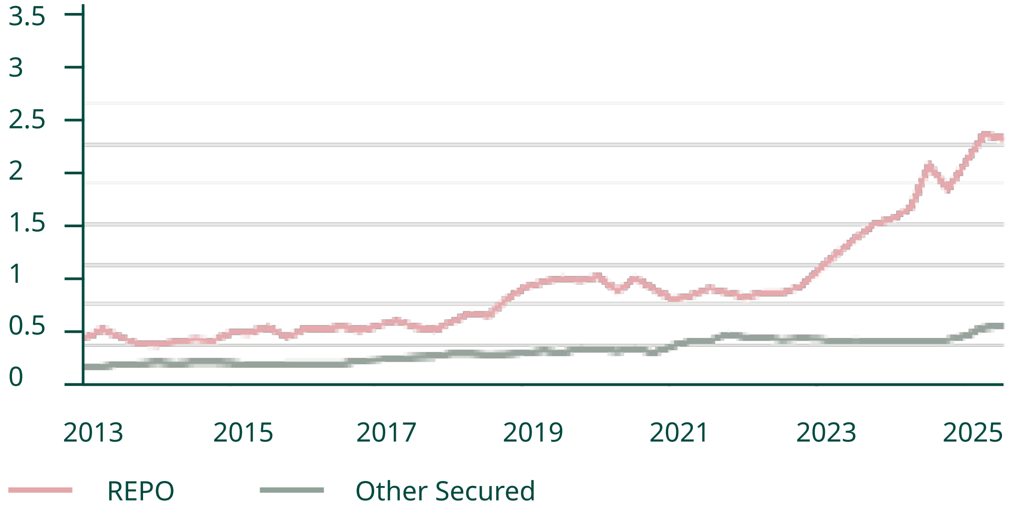

Chart takeaway: Hedge fund borrowing to fund relative-value trading in the treasury market has tripled to $3tn in the last two years.

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THIS EMBEDS A STRUCTURE RELIANT ON LEVERAGE THAT IS SENSITIVE TO SHOCK, WHERE THE PATH OF LEAST RESISTANCE IS CENTRAL-BANK BALANCE SHEET EXPANSION

Shorter for longer?

Reappraising the outlook for the US interest rates

In December, we took and executed the decision to reposition the TIPS portfolios across the CG multi-asset funds and the CG Real Return Fund. **We have reduced TIPS duration from 8 years to 4.5 years, versus an index duration of 7 years.**

Fundamentally, **our central expectation for the US economy is now one of stagflation – implying lower growth, stickier inflation, and a steep yield curve – rather than outright recession,** which would imply rapidly falling interest rates and a flatter yield curve.

This view is informed by several factors. **First, US inflation continues to be stickier and more persistent than markets, or most macroeconomists, expected.** Changes to structural economic features, such as the shift towards tariffs and protectionism, are likely to reinforce this inflationary impulse. As a result, it will be difficult for the Fed to cut short rates much further. The FOMC's latest Dot Plot corroborates this point.

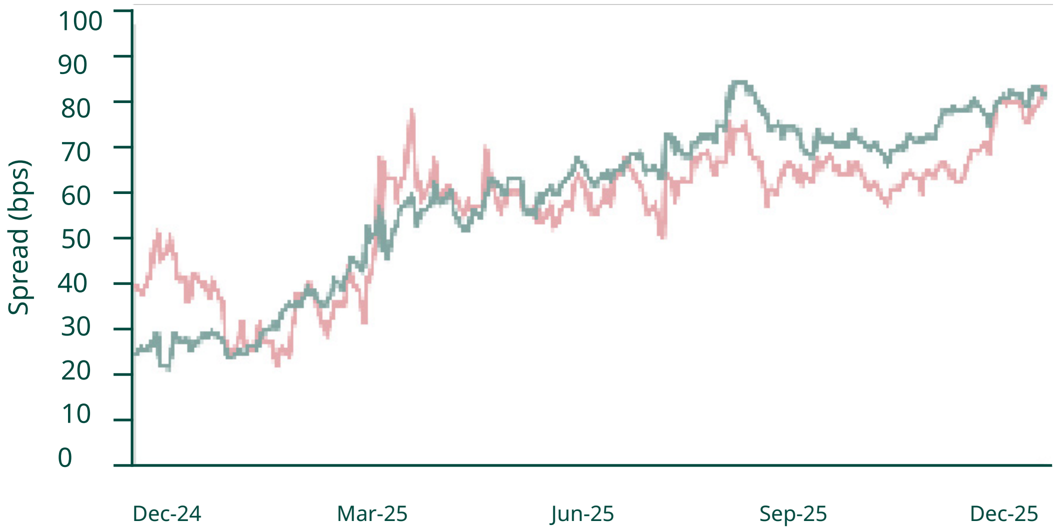
Secondly, the fiscal position continues to deteriorate. The US fiscal deficit is set to widen to 6.5% in 2026 and 2027 following the resumption of Trump tax cuts. At the same time, price-insensitive demand for government bonds – from the Federal Reserve and foreign central banks – continues to wane. This is particularly the case for longer-dated bonds.

For some time, our view has been that the only politically tenable way out of the growing pile of government debt is through financial repression, requiring a period of negative real interest rates. This could occur either in response to recession or as a result of a bond market crisis. Our view is that the probability of the former has decreased, and the probability of the latter has increased. In the latter scenario, investors in long-dated bonds are likely to suffer material capital losses before negative real interest rates can be achieved. **As a consequence, we judge that the risk-reward balance now favours shorter duration to protect investors from the growing risk of bond market crisis.**

Our Investment Judgement

1. Our outlook for the US economy is increasingly one of stagflation – slower growth, more persistent inflation, and steeper yield curves – rather than recession.
2. The fiscal position continues to deteriorate and price-insensitive demand for long-dated government bonds has waned. As time goes on, this increases the probability of a bond market crisis, where holders of long-dated Treasuries could suffer material capital losses.
3. Accordingly, we have reduced TIPS duration from 8 years to 4.5 years across the CG multi-asset funds and the CG Real Return Fund.

The US yield curve steepened over the course of 2025 [1]



2s 10s   10s 30s

Chart takeaway: Over the past year, the US yield curve steepened across all its key segments.

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OUR CENTRAL EXPECTATION FOR THE US ECONOMY IS NOW ONE OF STAGFLATION – IMPLYING LOWER GROWTH, STICKIER INFLATION, AND A STEEP YIELD CURVE – RATHER THAN OUTRIGHT RECESSION.

1) Term premia are measured by the US 2s10s, 5s10s and 10s30s spreads. This is calculated as the yield differential between the two benchmark government bonds quoted in the spread, e.g. 2s10s spread is the 10Y government bond yield less the 2Y government bond yield. Source: Bloomberg Finance LLP.

TRIGger Warning

When presented with an open goal, just kick the ball in the net

On the 15th November a large equity holding, HICL Infrastructure plc ("HICL") announced its intention to merge with The Renewable Infrastructure Group ltd ("TRIG"). HICL owns "core" social and economic infrastructure such as toll roads, hospitals and mobile phone towers, whilst TRIG owns renewable energy generation such as wind and solar power projects. **In our opinion there was no logic in combining these companies on the terms proposed, an assessment reinforced by a significant HICL share price fall.** Our Co-CIO Chris Clothier played a pivotal role in co-ordinating shareholder pushback and the proposal was abandoned on the 5th December. It was a busy, productive quarter.

After a difficult few years for the sector, investment trust directors are under pressure to act to narrow discounts. In certain cases mergers will be part of the answer, however combination alone achieves little; capital allocation is by far the most powerful lever. HICL has demonstrated that it can sell assets to third parties at high prices and buy-back its own shares at low prices. This is exactly the type of riskless self-help that boards should pursue with vigour to regain investor trust. **When you have a clear shot at an open goal just kick the ball in, don't come up with some unnecessarily complex alternative plan.**

HICL is a great example of the value on offer in the UK stock market. It holds high quality assets at undemanding valuations with return potential via income and capital gain. The income is underpinned by highly visible cashflows and capital gains from profit growth and share buy backs. This type of value has been on offer in the UK for some time but investors have shrugged their shoulders. However momentum has now shifted towards the UK, the FTSE 100 significantly outperformed the S&P 500 in 2025. Indeed over the last four years of AI hype the FTSE 100 has broadly matched the S&P 500. We do not believe it makes sense to have high levels of exposure to aggressively valued US equities when better value and returns are available elsewhere.

Our Investment Judgement

1. We believe quality listed infrastructure will deliver 8% - 10% returns over the medium term offering an attractive risk return profile.

2. With a relentless focus on capital allocation the sector will win back investor confidence narrowing discounts over time.

3. The FTSE 100 has delivered returns broadly in line with the S&P 500 since the ChatGPT moment in 2022 but without the extreme valuations and AI hype.

HICL share price before and after the merger proposal

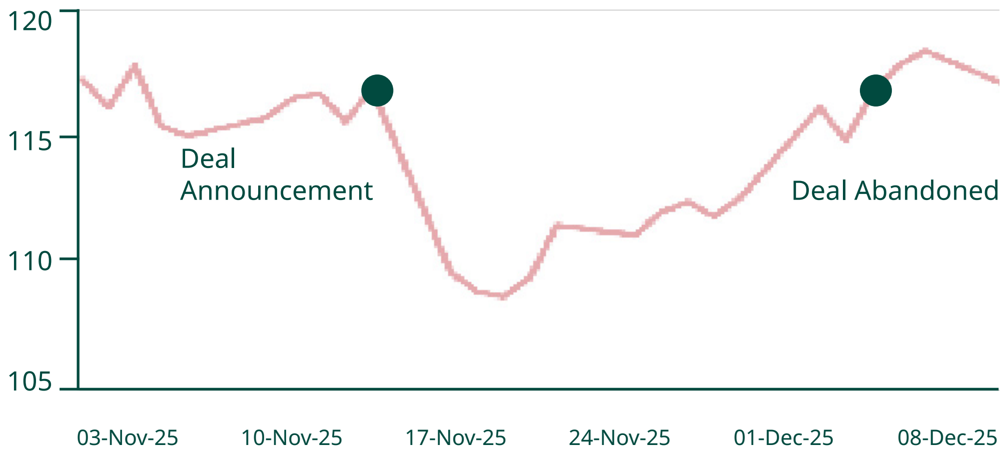

Chart takeaway: The proposed merger between HICL and TRIG was destructive to value, with the HICL shareprice recovering as resistance to the deal grew.

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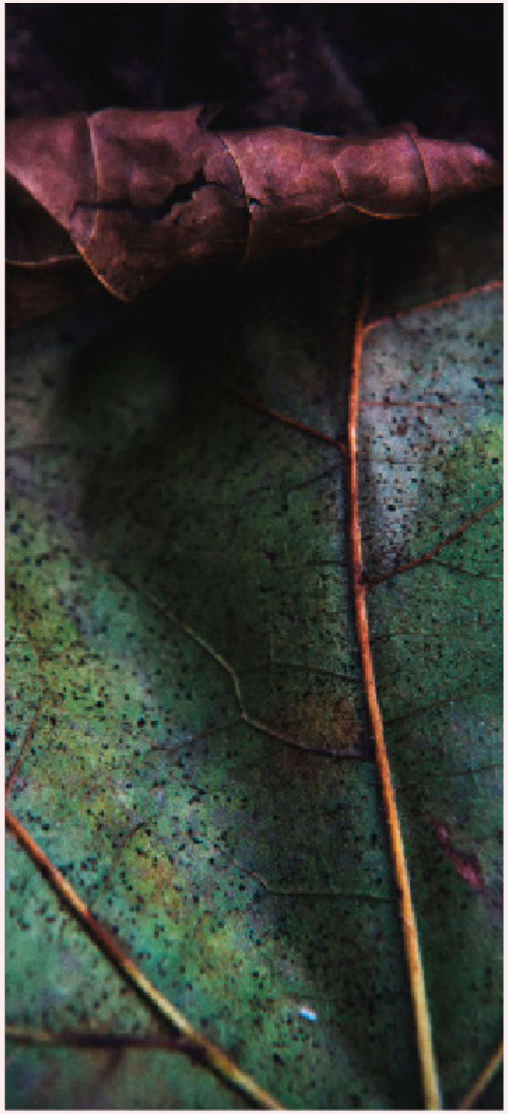
IN OUR OPINION THERE WAS NO LOGIC IN COMBINING THESE COMPANIES ON THE TERMS PROPOSED, AN ASSESSMENT REINFORCED BY A SIGNIFICANT HICL SHARE PRICE FALL.

Recent changes to multi-asset portfolio positioning



PORTFOLIO CATEGORY	CHANGES IN PORTFOLIO POSITIONING
↓ MANAGED LIQUIDITY RESERVE (32%) [1] ASSET CLASSES Cash, Treasury Bills & Short Duration Government Bonds Short investment grade credit Preference shares	• Managed liquidity reduced by 2% over the period • Corporate bonds fell from 11% to 7% of the portfolio with limited opportunities to reinvest maturing bonds as credit spreads remain tight
↑ INDEX LINKED BONDS (43%) [1] ASSET CLASSES Sovereign inflation linked bonds UK, US and other developed markets	• Allocation to index linked bonds has increased by 4% over the period • The US index linked bond weighting increased from 18% to 24% of the portfolio, with the TIPS duration falling from 8.1 year to 4.5 years • Our UK index linked gilts reduced by 2% this quarter with duration falling to 5.5 years
↓ RISK ASSETS (25%) ASSET CLASSES Investment Trusts ETFs Non-investment grade credit Gold	• Risk assets were reduced by 2% over the quarter against a backdrop of stretched equity markets and tightening discounts in the Investment Trust market • European energy holdings were sold early in the quarter following concerns around the oil price and a rerating of the stocks • Gold exposure remained at 1% of the portfolio

1) Data refers to Capital Gearing Trust. Weighting to index linked bonds in CG Absolute Return Fund is 35% (with 38% in managed liquidity reserve).

Asset Valuations and Investor Behaviour Summary

PORTFOLIO CATEGORY	UK	US	JAPAN	EUROPE	CG VIEW
INVESTMENT TRUST DISCOUNTS	FAIR		FAIR		Discounts have tightened yet opportunities remain within a backdrop of increasing corporate activity for both conventional and alternative trusts
EQUITY MARKETS	FAIR	UNATTRACTIVE	FAIR	FAIR	CAPE: UK (22), US (39), Japan (26), Europe (25), US equity markets valuations are at extreme levels with elevated risks of a significant correction
SHORT GOVERNMENT BONDS	FAIR	FAIR	UNATTRACTIVE	UNATTRACTIVE	UK T-Bills offer a risk free 3.8% return and short JGBs are attractive, specifically when hedged back to GBP
LONG INDEX LINKED BONDS	FAIR	FAIR	UNATTRACTIVE	UNATTRACTIVE	Although concerns remain about the long-end of the yield curve, short dated US and UK index linked bonds look attractive
CURRENCY	BASE CURRENCY	FAIR	ATTRACTIVE	UNATTRACTIVE	Yen remains attractive based on fundamentals. The Euro faces headwinds from trade competitiveness against both China and Japan
CREDIT	UNATTRACTIVE	UNATTRACTIVE			Credit spreads remain historically narrow, limiting the attractiveness of opportunities in the asset class
INVESTOR BEHAVIOUR	FAIR	UNATTRACTIVE	ATTRACTIVE	FAIR	Although Investors have recently favoured allocating to emerging markets, US valuations remain close to record highs. This is despite the backdrop of policy uncertainty, increasing deficits and a concerning economic outlook. Takaichi has proved constructive for shareholder engagement and corporate reforms in the Japanese market

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