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Capital Gearing Trust

Q4 2022 Report

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- The prospects for TIPS
- The opportunity for Japan

Pensible Pence

The outlook for sterling in a fragmenting world

The UK has had an eventful year, in politics and in financial markets. Despite the tumult, on a broad trade-weighted basis, sterling has now recovered the losses associated with the Truss-Kwarteng regime and has even shown recent strength against the US dollar.

Relative interest rates have always played an important role in driving day-to-day currency movements, and we believe that these have been and will continue to support the value of sterling in the short term. The persistence of high inflation and stronger-than-expected growth means that the Bank of England will likely have to keep interest rates higher than current market expectations. Underlying labour market dynamics support this assessment. Private sector wage growth is currently running at 7.2%, but the wage settlements for public sector employees may be higher than that, and may in turn provide a further boost to the private sector. In addition, the minimum wage is due to rise by 10% in April, and this too will continue to drive inflation.

These factors suggest that the 4.5% peak for Bank Rate currently priced in by markets could be too low. More importantly, they also suggest that higher rates will have to be maintained until the labour market shortages that characterise the UK economy are addressed. Of course, the UK housing market will continue to act as a constraint on the extent to which the Bank of England can increase interest rates. But so far it has proved more resilient than many anticipated, given the marked changes to mortgage rates since tightening began. Although inflationary pressures in the US and Europe are not dissimilar, we expect increases in the short-term interest rates relative to market expectations to be greater in the UK than for either of its major competitors.

However, looking further into the future, it seems likely that the medium-term equilibrium value of sterling is significantly lower than its current price. At first glance, purchasing power indices provide a mixed picture. Measures that use consumer prices make sterling look very expensive, while producer prices make sterling look better value – although, unfortunately in this respect, the UK is no longer a manufacturing-led economy, so consumer prices may be the better guide. These factors combined with the backdrop of an overheated economy, and a large current account deficit, suggest that the outlook for the value of sterling looks less positive.

Beyond this, there are some important features of the UK landscape which we expect to weigh on the value of the currency going forward. Perhaps the most important of these is Brexit. In a world where protectionism is on the rise, and where being outside a large trading bloc is increasingly perilous, negotiating strong trade deals will be more challenging. To this end, the US has already been accused of undermining the WTO, and it would not be surprising to see the EU do the same.

The outlook for productivity continues to be problematic, and in the medium term we expect this to have a negative impact on the value of sterling. This phenomenon is not new: UK productivity has been relatively poor for a decade. One factor behind this is a lack of capital investment. With growth prospects weak, there seems little reason to expect any meaningful recovery. The political environment for investment also remains poor with higher corporate taxes and unanticipated windfall taxation, which are unlikely to promote further capital investment.

The macroeconomic environment also poses a particular threat to financial services, where the UK currently enjoys a comparative advantage. Although unquantifiable, a background of QT looks less helpful to financial services than one of QE. In addition, the European Commission has expressed a strong desire to relocate parts of financial services currently located in London to cities in the Eurozone – which would further reduce the financial services footprint in the UK.

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Pensible Pence

The outlook for sterling in a fragmenting world

A final threat to productivity is continued working from home. This is an issue faced by all western countries, but anecdotally the size of the issue is greater in the UK than in Europe, where the share of London workers that has returned to the office is markedly below that of major European cities. The exact effects are difficult to decompose, and we acknowledge that it is controversial to say that WFH has an impact on labour productivity, but our observation is that there is little doubt.

Turning to politics, the next general election is now at most 15 months away and will soon naturally enter thinking about the currency. The odds-on favourite to win the election is the Labour Party, which currently is presenting a very centrist programme. This is likely a good guide to how it will govern, but there are bound to be nerves that they will run from the centre but govern from the left. At a minimum, the taxation of 'non-doms' looks sure to change, and while the impact is very difficult to quantify, it is unlikely to be sterling positive. Beyond this, if the Labour Party does not win a clear majority, and then needs to rely on support from the Scottish Nationalist Party, the political uncertainty that this situation would create could also weigh on the value of the currency.

There are some points of light to this assessment. Notably, the UK continues to be a centre for research, culture, and scientific development. The country has some of the world's finest universities, and that gives significant advantages – particularly in biotechnology – and continue to attract good minds into the country. Nevertheless our view is that while relative interest rates may well see sterling trade higher in the short term, the fundamental outlook for the currency is one where we anticipate medium-term weakness. However, it is important to remember that currency valuation is as much a relative pursuit as an individual one, so the ultimate outcome will – at least in part – depend on the fortune of our competitors. We will continue to follow this spectacle with great interest.

Peter Spiller
Emma Moriarty

December 2022

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Capital Gearing Trust

Fund information as at:

31st Dec 2022

Share price:

£49.00

Investment objective

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

Fund information

Market Cap.	£1.3bn
Dividend Yield	< 1%
OCF*	0.52%
OCF (PRIIPS)	0.78%
Comparator Index	RPI

*Ongoing Charge Figure

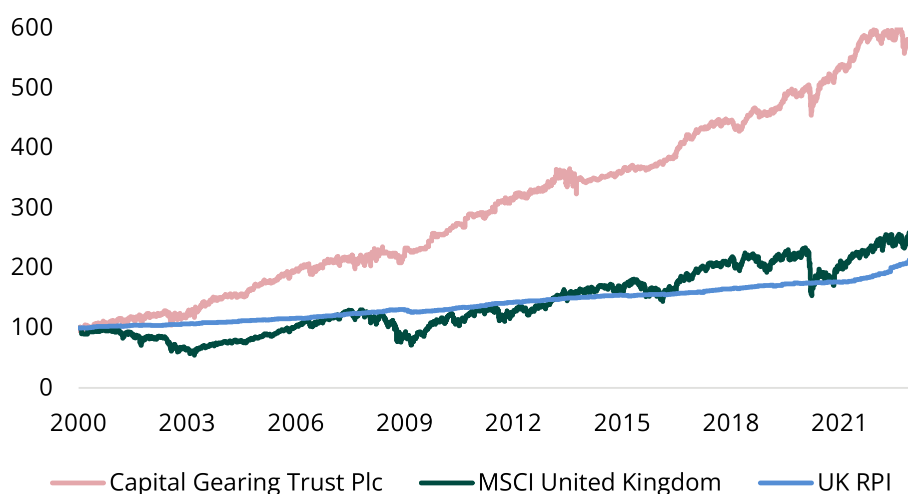
Return history (total returns)

1 month	-0.6%	2021	11.3%
3 months	0.4%	2020	8.3%
6 months	-1.6%	2019	8.6%
Year to date	-3.5%	2018	2.1%
1 year	-3.5%	2017	5.1%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	3.4%
SPDR MSCI Europe Energy ETF	2.4%
Lyxor Stoxx 600 Basic Resources	1.5%
North Atlantic Smaller Co's	1.2%
Greencoat UK Wind	1.0%

Performance since January 2000 (total return)



Largest bond holdings

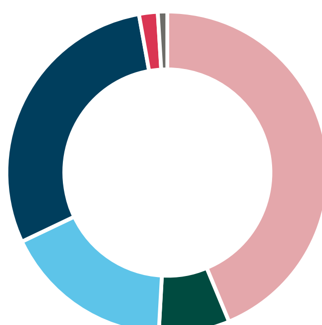
UK I/L 0.125% 22/03/24	9.6%
UK I/L 0.125% 22/03/29	3.4%
US I/L 0.625% 15/02/43	2.8%
US I/L 0.75% 15/02/45	1.9%
UK I/L 0.125% 22/03/26	1.8%

Currency exposure

GBP	55%
USD	24%
SEK	3%
EUR	5%
JPY	8%
Other	4%

Asset allocation

Index Linked Gov't Bonds	44%
Conventional Gov't Bonds	7%
Pref Shares / Corp Debt	17%
Funds / Equities	29%
Cash	2%
Gold	1%



Fund/equity breakdown

Property	6%
Equities	10%
Infrastructure	5%
Loans	3%
Energy & Commodity	4%
Private Equity / Hedge	1%

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A Year in Review

December 2022

At the start of 2022 few were anticipating a dramatic year ahead. A quick flick through a back copy of the "World Ahead 2022"[1] reveals the following headline predictions – worries about inflation will diminish, decentralised finance is booming and Vladimir Putin renews his attack on elections. All of these predictions turned out to underestimate the challenges ahead, most notably the extent of Putin's ambitions.

Viewed through the myopic lens of investing, inflation was the defining feature of the year. Twelve months ago few doubted that asset prices were stretched but justifications for high prices focused on historically low interest rates, corporate earnings growth and a robust economic recovery after COVID. A sustained period of inflation was one of the few scenarios that could simultaneously undermine all of these factors. The commodity price spikes that followed in the wake of Russian tanks crossing the Ukrainian boarder piled more fuel onto the inflationary fire. The result was an uncontrolled inflationary blaze that undermined the entire asset price structure.

Whilst nearly all assets fell in value, with hindsight there were three golden rules to avoiding the most savage losses in 2022. Don't own long bonds, don't own growth equities and don't own small capitalisation shares.

Don't own long bonds: against this first rule the fund did well. At the start of the year the bond portfolio comprised of 5% in very short duration corporate credit and around 34% in index linked bonds of moderate duration, mostly in the US. During the year, as yields rose and values improved, we consistently added to our bond holdings such that corporate credit increased to 17% and index linked bonds to 43% by the year end. Collectively our bond portfolio delivered a small positive return, an excellent performance relative to a bond bear market of historic proportions.

Don't own growth equities: against this second rule the fund also did well. For a number of years our significant underweight to growth stocks has been a headwind but over the last 12 months that turned into a tailwind. Excluding property (of which more below), the fund's 27% holdings of conventional equities, infrastructure and alternative funds delivered a small positive return, buoyed by significant exposure to power and energy producers. This was a strong performance given the investment trust market was down 17%.

Don't own small capitalisation stocks: against this third rule our record was less strong. Our largest exposure to smaller capitalistion stocks was via our property holdings, which started the year at 18% of the portfolio. After delivering exceptional returns during 2021, it was clear valuations were quite elevated and we began reducing our holdings but, with hindsight, insufficiently urgently. During the gilt market meltdown of September/October, property was in the eye of the storm. A toxic cocktail of rising interest rates, forced sellers and illiquid markets resulted in -28% losses within our property holdings, or -4% of total net assets. To put it another way, more than 100% of the fund's losses in the year were attributable to this minority part of the portfolio – our Achilles' heel. After consistently selling down over the year, our property position has been reduced to 6% at the year end.

To quote Meat Loaf, who died in 2022, "two out of three ain't bad". Whilst it is always painful to report a negative performance over a 12 month period, by limiting the drawdown to -3% the portfolio proved resilient against a very challenging backdrop. Positioning remains defensive, with a focus on inflation protection and capital preservation. Given current values in the bond market, we are more confident about prospects for delivering positive returns in the year ahead.

Alastair Laing

[1]An Economist publication from late 2021 that predicted the key trends for 2022.

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A closer look at equities and credit

December 2022

Janus the Roman god of transition (from whom January takes its name) is often depicted with two faces, one gazing into the future and the other reviewing the past. Investment trust shareholders reviewing the last 12 months are confronted with an unsettling scene. Overall the investment trust index shed 17%, with notable weakness in interest sensitive sectors including Growth Capital (-51%), European Property (-40%) and Tech (-37%). It was also the first time since 1978 that not a single IPO came to market in the sector, a stark contrast to the rampant issuance seen in 2021. In fact, a record £2.6bn was returned to investors via buybacks but these actions were not enough to contain average discounts which widened from 2% to 13% over the year.

Fortunately the fund's risk asset holdings outperformed returning 3% over the quarter and -9% over the last 12 months. At the start of the year narrow discounts meant our investment trust holdings were limited, indeed we were actively exiting positions like RIT Capital. As discounts began to appear in the second quarter bear market we added to a range of names, including the fallen retail stars such as Finsbury Growth and Smithson Investment Trust and some more specialist positions such as Bellevue Healthcare. With discounts narrowing again towards the year end a number of these positions have matured quickly and have been reduced. As a result our conventional equity holdings reduced in the quarter by 2% to 14% of the portfolio, with energy equities now comprising more than a quarter of this category.

Alternative funds were not spared the disruption. Concerns over lagged valuations, rising debt costs and increasing discount rates caused c.20% discounts to emerge even in quality names across core and renewable infrastructure. A period of uncertainty related to the government price cap on supernormal power profits was extremely unhelpful to the rating of renewable energy stocks. However explicit inflation linkage and supportive cushions on power price assumptions helped to offset rising discount rates, and with clarity on the regime we are happy with these holdings which make up 5% of the portfolio. Our infrastructure assets returned 8% over the last 12 months.

A real area of focus over the last quarter has been the corporate credit market. Much of the last decade was a borrowers' market but the pendulum has swung back. The sterling corporate bond index ended the year at a yield of 5.5% compared to 2.1% in January, with an intra year peak of 7.1%. Responding to improved value our corporate credit holdings increased to c.17% of the portfolio (from 5% 12m earlier) with 2% added this quarter across utilities, transport and financials. One recent addition, Quilter 4.5% 2028, was subsequently called generating extremely strong returns. Credit overall returned -0.1% over the quarter and -1.9% annually, which sounds dismal until it is compared with the corporate bond index that fell c.-16%.

Another area of focus has been property company bonds, as we know many of the issuers well from holding their equity. A large position has been built in Grainger 3.375% 2028 at an average yield to maturity of 6.8%, a very attractive return for a high quality bond. We have also made some more exotic additions including a number of perpetual debt notes issued by European property companies offering doubt digit returns. Towards the year end, spreads have narrowed but we continue to make selective additions to this asset class.

Notwithstanding the opportunities we remain concerned about the outlook for corporate earnings, and to the growing stresses in highly leveraged segments of the credit markets. Although Roman lenders gathered under the Arch of Janus to extend credit solely on the borrower's word and character, we feel better protected by the short duration (<1.5 years) and investment grade quality of our credit holdings.

Hassan Raza

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Prospects for TIPS

December 2022

“Whatever did he mean by that?” was apparently Count Metternich of Austria’s reaction to the news of the death of his rival, the French diplomat Talleyrand. It is often referenced in response to less-than-straightforward messaging from central bankers, and one could be forgiven for having a similar reaction to Jerome Powell’s press conference after the December FOMC meeting. On one hand, the pace of increase to the Federal Funds Rate has slowed from 75bp to 50bp, and there was a clear shift in messaging to emphasise the importance of waiting to see the lagged effect of tighter monetary policy on output and inflation. But on the other, Powell emphasised that rate rises “still have some way to go”, that the Fed’s median projection for federal funds rate has increased since September, and that they will “stay the course until the job is done”.

Although recent CPI data have shown that inflation has retreated from its peak, at 6.5% it still indicates inflation substantially above the longer-run target of 2%. And while we expect headline inflation figures to be lower over the coming year, partly driven by anniversary effects, recent US labour market data suggest that underlying inflationary pressures are likely to persist for some time: sustained wage growth and low unemployment indicate that the US economy is still supply-constrained.

Our central outlook for the US continues to be one characterised by elevated but more volatile inflation than we have seen over the previous few decades, combined with a ‘higher for longer’ policy rate environment designed to engineer a hard landing into recession. This view has meant that we have maintained the long duration of the TIPS portfolio, and over the quarter we have cautiously extended this just beyond ten years. That said, we acknowledge that the US economy has proved more resilient to tighter monetary policy than we initially expected: the FOMC has raised policy rates by 4.5% over 2022, and yet this appears to be showing up only in demand for the most interest rate sensitive sectors of the economy. To this end, the US economy has benefitted from several tailwinds this year.

The most notable of these have been the strongly stimulative fiscal stance of the current government, and the country’s position as a net energy exporter.

This resilience appears to inform market consensus on the US macroeconomic outlook. The OIS market and the Fed Funds Futures market both suggest that central bank rates may reach their peak in mid-2023. Similarly, 10-year US breakevens are currently around 2.1%, suggesting that the market’s inflation expectations remain well-anchored to the Fed’s target.

TIPS continue to offer a reasonable each-way bet on different scenarios for the US economy. In the event of a hard landing into recession, as is our expectation, investors will benefit from the capital gains associated with falling real yields. However, should the US economy continue in its current vein – with expansionary fiscal policy continuing to support demand – investors will benefit from a higher nominal yield overall on the portfolio, driven by the combination of continued elevated inflation (e.g. at 4%), and the current positive real yields (1.6% real for the TIPS portfolio).

The latter half of 2022 has been a tumultuous period in bond markets, and consequently in foreign exchange markets. Sterling appreciation in Q4 has been a drag on performance (for more detail on our views on Sterling see Peter and Emma’s covering letter). But as Atlanta Fed president Raphael Bostic recently described the situation, US inflation continues to be “way too high” – and so we continue to believe in the value of inflation protection going into the year ahead.

Emma Moriarty

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The opportunity in Japan

December 2022

The “third rail” runs alongside train tracks to provide electric power. In the UK it carries 750 volts which, combined with a high current, is enough to kill you should you touch it. In political parlance “touching the third rail” occurs when a politician grapples with an issue so charged and intractable that no matter their good intentions, it results in their immediate immolation. For the last 30 years or so finance has had its own third rail: shorting Japanese Government Bonds (JGBs). Each generation of macro-investors has been tempted into the trade and each received, if not actual death, then certainly a nasty shock. Investors are, once again, convinced that this time is different. Unusually for us, we think they are probably right.

Japan has a long history of quantitative easing, dating back to 2001. The program was, by contemporary standards, pretty modest until 2012 when it began rapidly accelerating. The Bank of Japan’ (BoJ) balance sheet grew from 30% of GDP in 2011 to around 130% today. In 2016 the BoJ introduced yield curve control (YCC) which set short term interest rates at -0.1% and 10 year yields at around 0%. At the time they wrote that the bank would “continue expanding the monetary base until the year-on-year rate of increase in the observed CPI [...] exceeds the price stability target of 2 percent and stays above the target in a stable manner”.

Fast forward to today, YoY inflation in Japan is 3.7% and the Japanese Trade Union Confederation is asking for a 5% increase in wages from this year’s *Shuntō*, the highest since 1995. Fast Retailing, the parent company of fashion retailer Uniqlo has said it will increase starting graduate salaries by 18% and those of store managers by 36%. Against this backdrop it seems that the requirements for abandoning YCC will be met. Sure enough, the BoJ shocked markets in December by shifting the upper bound from 25bps to 50bps for 10 year bonds.

Sensing blood, the market has begun to aggressively challenge the BoJ. Over a 3 day period this month the BoJ spent over JPY12 tn (c.£ 75 bn) in an attempt to cap yields. If the BoJ carried on this rate of purchases it would increase its holdings of JGBs by 160% of GDP within 12 months!

Examples of stress in the rates market abound. The yield curve has a pronounced kink as yields have risen significantly either side of the 10 year mark. 10 year interest rate swaps, having moved in lockstep with government bonds over 2021, have are now about 50bps higher than bond yields.

In its January meeting the BoJ has reaffirmed commitment to YCC. Nevertheless, it seems likely that the BoJ will eventually abandon it: either because it concludes that it has met its policy objectives; or under pressure from financial markets. What will be the consequences? The most obvious channel is the currency markets. Since its nadir in October, the Yen has appreciated 16% against the dollar. It could have much further to go. The Yen is still startlingly cheap. We understand that wages are higher for Chinese manufacturing workers than Japanese in some areas and it is cheaper to hire a junior software engineer in Tokyo than Vietnam. On some PPP measures, the Yen is still 50% below its fair value against the dollar.

A change of policy could cause Japanese government bond values to fall, however we judge the risks to index-linked government bonds to be acceptable, given that breakevens are less than 1%. Taken as a whole – currency attractions but asset price risks – we are comfortable holding 8% of the portfolio in Yen denominated assets.

Perhaps the greater risk to investors of a change in the stance of the BoJ lies outside Japan. Japan has a huge stock of savings. Faced with nugatory returns at home, Japanese investors have invested heavily overseas. Also, the Yen is probably the largest funding currency for carry trades: borrowing cheaply in one currency and investing the proceeds in a higher yielding currency. Rising Japanese rates could cause a huge repatriation of capital to Japan sending shocks through global equity and bond markets

Chris Clothier

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December 2022

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