Fourth Quarter Report

December 2018

Capital Gearing Trust plc

CG Asset Management

General Commentary

December 2018

Recessions are a natural and necessary part of the business cycle. The current expansion, 10 years old, is quite mature and consensus expectations are that the US will experience a downturn sometime between the second half of 2019 and the end of 2020. Other parts of the world, notable Europe and SE Asia may even be on the cusp now. Yet, a recession is not viewed as acceptable in any major economy.

China, which has not endured a recession since it emerged into the capitalist world, has particular issues. The deal is that consumers get growth and leave political power to the Communist party. Faced with structural issues of overinvestment and high debt and with a cyclical slowdown in consumption and real estate, the authorities can be expected to strain every sinew to stimulate growth through the normal channels of credit (yet more debt) and directed investment. It is an open question as to whether it will succeed, regardless of the outcome of tariff negotiations, because it is clear that the market share of Chinese exports will, one way or another, be constrained.

In Europe, the continuing debt crisis, was mitigated but not solved in 2012 ("whatever it takes") and in 2015 (QE). Both policies were of doubtful legality at the time, though subsequently endorsed. Unfortunately, and unlike the US, the time bought has not seen the European banks restructure and recapitalise; they typically trade at a fraction of book value demonstrating that investors believe that bank assets are still overvalued. In addition, the completion of the reforms necessary to address the flaws in structure of the Euro – deposit insurance, a common budget, the issuance of European bonds and fiscal co-ordination – have not been adopted. With the diminished stature of their chief proponent, President Macron, momentum has been lost. The Eurozone could go into the next recession with deposit rates at -0.4% and an ECB balance sheet that is at its limit in ownership of some sovereign names. The prospect of deflation, especially in the South; expanding budget deficits; bailing out banks; and rising unemployment threatens the existence of the Euro. The response can be anticipated to be vigorous. Ideally, the strong nations, notably Germany, would cut taxes and raise expenditure; that would require a change both of attitude and of law. More likely would be a sweeping away of restrictions on the ECB – substantial buying of assets, including but not restricted to, governments bonds. Against a background of significant budget deficits and already alarming government debt to GDP ratios, this would amount to monetary finance. If done with sufficient determination, it might hold the Euro together, but at a likely ultimate cost of elevated inflation; threats of speculative attack on the currency; and unforeseeable political developments.

The US is in many ways better placed; its financial system looks stronger. But a recession would be a threat because corporate debt is so high and of such poor quality – one third of it is in the form of leveraged loans and junk bonds. As a result, any downturn would threaten to spiral into something worse, again with powerful deflationary effects. The prospect of such an outcome in the current intellectual climate may lead to a rapid reversal of interest rates and renewed QE. Meanwhile the budget deficit, already over 5% of GDP, would automatically be rising alarmingly. Even the Trump administration is not likely to add to that. The whole burden of stabilisation will fall on the Federal Reserve which may be aggressive given the low inflation of recent years.

With large fiscal deficits, this is again monetary finance. The issue is whether the deflationary force of recession or the inflation force of the stimulus will prevail. Probably both, deflation in the short term, high inflation in the medium, of necessity. Inflation is needed to address the distortions in the economy incurred by two decades of accommodative monetary policy. Even the tightening cycle since 2015 has been assess at running a consistent 2% discount to the level advocated by the Taylor Rule. No doubt that reflects in part the greater sensitivity to interest rates of an over indebted economy, but it points to the difficulty of tightening financial conditions without overdoing it. If a recession looms, the monetary policy response will be unstinting.

The form of QE will have to be different from that of the post Great Financial Crisis era. The distributional effects have elicited a political response that suggests that though the size of the stimulus may be as great or greater, its nature will be different. Of course, interest rates will play a role, but some expression of Milton Friedman's helicopter money seems more likely than wholesale purchases of financial assets. It will be an interesting time.

Peter Spiller 8th January 2019

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Fund Information as at:

31st Dec 2018

Share price:

£40.59

Investment objective

The Company's dual objectives are to preserve shareholders' real wealth and to achieve absolute total return over the medium to longer term

Fund information

Market Cap.	£283m
Yield	< 1%
Total Expense Ratio	0.77%
Benchmark	RPI

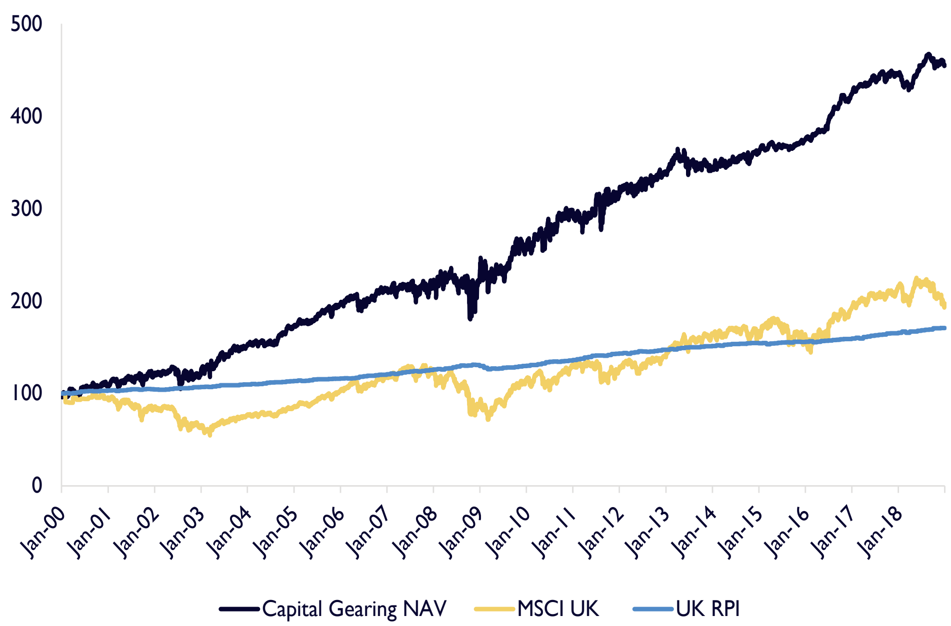
NAV return history (total returns)

1 month	-1.8%	2018	2.1%
3 month	-1.6%	2017	5.0%
6 month	0.0%	2016	13.0%
Year to date	2.1%	2015	4.2%
1 year	2.1%	2014	5.2%

Largest fund/equity holdings

Vonovia	2.7%
Vanguard FTSE Japan ETF	2.3%
North Atlantic Smaller Co	2.0%
Deutsche Wohnen	1.9%
investor	1.9%

NAV performance since January 2000 (total return)



Largest bond holding

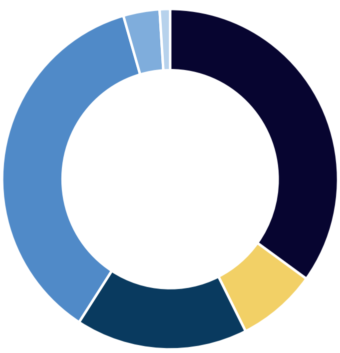
UK I/L 0.125% 22/11/19	8.1%
US I/L 2.00% 15/01/26	3.3%
US I/L 0.25% 15/01/25	3.3%
US I/L 3.875% 15/04/29	2.2%
US I/L 2.375% 15/01/25	2.1%

Currency exposure

GBP	53%
USD	29%
EUR	9%
SEK	4%
JPY	2%
Other	3%

Asset allocation

Index Linked Gov't Bonds	34%
Conventional Gov't Bonds	7%
Pref Shares / Corp Debt	16%
Funds / Equities	36%
Cash	6%
Gold	1%



Fund/equity breakdown

Property	16%
Equities	13%
Infrastructure	3%
Loans	3%
Private Equity/Hedge Fund	1%

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It is axiomatic to a true value investor that when the price of a security falls its value improves. To such a mind-set momentum and volatility are irrelevant, value is all that matters. Has the recent weakness in equity prices caused a buying opportunity or has value improved but still remains poor?

When considering the appropriate exposure to equities we place by far the most weight on the valuations of the US equity market. This is due to its scale, global influence and the quality of the data sets available. As global stock markets have become increasingly correlated the direction of travel in the US market has a huge influence over all others. According to our models recent weakness in US prices has improved the prospective 10 year real returns however the centre of the range remains below 1% real. This is clearly well below the historic experience and below the return offered by the risk free 10 year US TIPS. The value on offer in US equities appears to have improved but is still poor in both relative and absolute terms. In sterling terms the S&P 500 was actually up last year. The fund retains its low weighting to equities and an extremely low weighting to the US.

What about other global equity markets? Of particular interest to us is the UK market. Parochially it is the fund's domestic market. More importantly Brexit related concerns could be causing investors to underestimate medium term return prospects. The FTSE 100 fell almost 10% in 2018 and the FTSE 250 by more than 13%. Important value metrics including dividend yield and price to sales ratios suggest the UK market is amongst the best value of all developed markets. The bear case for the UK is the concentration in structurally low growth industries, low levels of investment and the not un-related very high dividend pay-out ratio. These factors suggest real earnings growth will be low and possibly negative over the next decade with the associated risk of dividend cuts. Furthermore whilst Brexit fears may be more than fully reflected in UK stock prices, it appears the risk of a Corbyn led labour government is insufficiently discounted. Notwithstanding these negatives the UK market could deliver 3% real over the next decade, which is attractive in relative terms although not sufficiently attractive in absolute terms to increase the overall allocation to equities further. Within our equity weightings the fund is heavily allocated towards the UK, and if prices fall further this weighting and potentially our overall risk asset weighting will increase.

Another interesting region is Asia Pacific, which fell almost 10% in sterling terms in 2018. There was marked weakness in China, with the Shanghai composite being one of the few global markets that looks cheap relative to its, admittedly short, history. However the prospects for regional equities, which are intimately linked to the prospects for the Chinese economy remains extremely hard to call. It is not hard to find alarming data points about the fragility of China, with George Magnus' recent book Red Flags highlighting many. The low quality of regional economic and financial data and the uncertain political response to any weakness make it hard to allocate to Asia Pacific in a really meaningfully way. Returns may well be similar to that of the UK over the next decade, albeit with a wild ride expected. This region looks attractive in relative terms but not sufficiently attractive in absolute terms to increase the overall allocation to equities.

Return prospects for equities everywhere are better at the start of 2019 than 12 months ago, however they mostly remain poor relative to history. If the US market has a very weak period dragging all other markets with it, then the case for increasing equity exposure would become more compelling.

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2018 was a rare year when all major asset categories in the funds delivered a positive return, albeit none was sufficiently large to allow for much overall appreciation. The stand out in portfolio contribution terms was the c.25% holding in US TIPS which delivered returns in excess of 5%, all of which came from the appreciation of the dollar. The stand out performance in relative terms came from the risk asset portfolio which delivered a c.1% return, a respectable outcome given the weakness across global equity markets. The large allocations to alternative property and infrastructure were key to grinding out the small positive return. These alternative holdings more than offset the negative contribution from the conventional equity funds. Even the fund's tiny holding in gold, the perennial underperformer, delivered a positive return in sterling terms.

Perhaps the most pleasing and surprising outcome of the year was the positive contribution made by our direct and indirect holdings in corporate credit and loans. The market backdrop was not encouraging; in the last quarter of the year there were huge outflows of capital from the credit market. The result of this capital outflow was widening spreads and increasing yields, most noticeable in junk bond and leveraged loan markets but observable across all corporate credit.

This is a dynamic of greater importance than the recent weakness in equity markets. In isolation the equity market weakness is not likely to have an impact on the economy. By contrast a tightening of financial conditions, leading to difficulties in corporate refinancing can be the cause of, as well as the effect of, future economic weakness. It remains unclear whether the recent widening of corporate credit spreads is a temporary cyclical phenomenon, such as occurred alongside the oil price weakness in early 2016, or the start of a more serious structural deterioration.

The structural concerns are well founded. There has been an alarming build-up of low quality corporate debt over the last 5 years, stimulated by low interest rates and ample liquidity supplied through the quantitative easing programme. Janet Yellen stated in an October interview that she was "worried about the systemic risks associated with these loans…..there has been a huge deterioration in standards; covenants have been loosened in leverage lending". Apparently it is easier to make these statements after leaving office then when as chair of the Federal Reserve Janet Yellen presided over and implicitly encouraged the phenomenon.

Mindful of these risks we have been very focused on the quality of, and any emerging vulnerabilities in, our credit holdings. Our direct credit and preference share holdings which make up c.16% of the portfolio are collectively short duration and high quality. They delivered a return of c.2% in 2018, an acceptable outcome given the backdrop. Of greater focus was the c.3% of the portfolio in lower quality bond and preference share holdings and closed-ended loan funds. These holdings, which are categorised as risk assets in fund reporting, collectively delivered a c.9% return. The strong returns are unlikely to persist and reflect the performance of very specific often illiquid securities. When our current holdings mature it is likely that our exposure to this area will decrease, at least until there are more obviously compelling opportunities associated with forced sellers in an illiquid market. If Janet Yellen's concerns prove prescient that opportunity may not be too far away.

Thoughtful Investing

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