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CG Portfolio Fund

First Quarter Report

March 2022

- Dollar Fund
- Real Return Fund
- Absolute Return Fund
- Capital Gearing Portfolio Fund

The Next Forty Years

Learning from the past to help peer into the future

As it happens, the fortieth anniversary of our managing Capital Gearing Trust fits in well with a major transition in the world economy from an era of deflationary bias to one which looks much more like the period from 1965 to 1980.

In 1982, Volcker put in place central banking policies that supressed the persistent high inflation that had characterised the earlier period. Certainly there was a recession, but companies and households were robust enough for it to be comparatively mild. That disinflation was given a major boost when China's change of policy and the liberation from Communist rule of Eastern Europe just about doubled the number of workers in the capitalist world. Demographics helped too, with the growing working age population in the west boosted by the increasing participation and improving opportunity for women. Technology, always at the heart of productivity gains, made a particular contribution in easing price discovery through the internet.

The result was that the bond yields fell, as a trend, throughout the 40 year period, a fabulous background for above normal returns in pretty well all assets. The deflationary impact of globalisation was so powerful that Central Banks could operate with a policy stance so stimulative that many nominal bond yields were actually negative without any problematic inflation resulting. Equity markets, rising on the same waves of liquidity, have reached extraordinary levels.

Obviously this wonderful period for financial assets has been interrupted by both Covid and the invasion of Ukraine. Inflation has reached levels of around 7 to 8% in Western economies that have Central Banks scrambling to restore their credibility. Rhetoric has been hawkish, though little action has yet been seen.

That credibility is actually largely intact, as evidenced in markets; breakevens suggest that inflation will revert to the 2% levels that prevailed for so long, once transitory price increases from shortages and supply interruptions work their way out of the system. These have been associated with the pandemic and the invasion of Ukraine. With luck, both will be in the past quite soon.

The background, however, is quite different from the last 30 years. Globalisation is being rolled back both for reasons of security of supply and of doubts about the benevolence of Russia and China. The just-in-time worldwide model of manufacturing is fading. Furthermore there are no realistic candidates for any equivalent increases in the workforce of the capitalist economy from elsewhere. Manufacturing closer to home will be more secure, but also more expensive. The consequence will be wider than just goods; the bargaining power of labour, emasculated by globalisation, will be at least partially restored. Union membership has of course contributed to inflation, but historically it has also grown in response to it.

Nor will commodities be as favourable. Since the middle of the last decade, capex in energy and mineral production has been constrained by investors pursuing an environmental agenda. Mines and oilfields deplete over time and insufficient investment in new opportunities has been made to allow the transition to net zero to take place at reasonable cost. And apart from commodity costs, that transition will in itself be inflationary. It requires large expenditure on, for example, heat pumps to replace gas boilers, for which there is no financial return associated with the environmental return. Of course, society could just cut back on other expenditure leaving supply and demand in balance. But there is a temptation, evidenced in speeches and academic work, that such an investment for mankind as a whole should not count in calculations of fiscal deficits, but simply be borrowed. Such an approach harks back to model for the last 30 years when fiscal incontinence was unpunished. The coming era will be quite different.

The Next Forty Years

Learning from the past to help peer into the future

This new, more inflation-prone era, will be reinforced by demographics, as Charles Goodhart has shown. A shrinking working age population allied with more retirees, who consume but don't produce, will put greater demands on the workforce.

Even technology, though always positive, may be less help than recently. The internet, by our calculations, has reduced the cost of, say, clothing by roughly 7%. No doubt the trend may continue. But at a much slower rate.

This will be a very different environment for fiscal and monetary policy makers. The greatest imbalance that has developed over the last 40 years has been the extraordinary increase in debt that has been encouraged by abnormally low interest rates. This both constrains growth, as demonstrated by Kenneth Rogoff, and makes economies much more fragile. The IMF points to the 20%, by number, of US companies that are zombies – they do not cover the interest service charges even once from their cash flows. That suggests that the Federal Reserve will have fine judgements to make if they wish to slow the economy enough to restrain inflation but not so much as to cause a recession.

In fact, history suggests that the only way to reduce the burden of excessive debt that does not risk a depression is to engage in financial repression; elevated inflation with moderate nominal rates. Even so, if this characterisation of the new era is correct, the potential for 'Fed mistakes' will move from overtightening in a deflationary environment to acting too late and too little, as characterised by the likes of Arthur Burns and Anthony Barker in the late sixties and early seventies. Fiscal policy may be on the same learning curve.

There may be some alarming crises on the way, not least in Eurozone sovereign debt, but eventually enough financial repression, sufficient to bring debt in better balance with assets, incomes and GDP, will allow a much more aggressive attack on inflation: The Volcker Moment. With luck that will produce an environment similar to 1982. That is to say, inflation and interest rates high but falling, p/e ratios low and debt no longer alarming. That would be a great opportunity to replicate the returns for the next 40 years that shareholders of Capital Gearing Trust have enjoyed for the last 40.

Peter Spiller

March 2022

Dollar Fund

Fund information as at:

31st March 2022

Fund price:

£173.63

Status:

Open

Investment objective

To achieve real returns through long only investment in Treasury Inflation Protected Securities (US government index linked bonds).

Fund information

Fund Size	£892m
Class Size	£337m
Dividend Yield	< 2%
Management Fee < £1bn	0.25%
Management Fee > £1bn	0.15%
Total Expense Ratio	0.34%

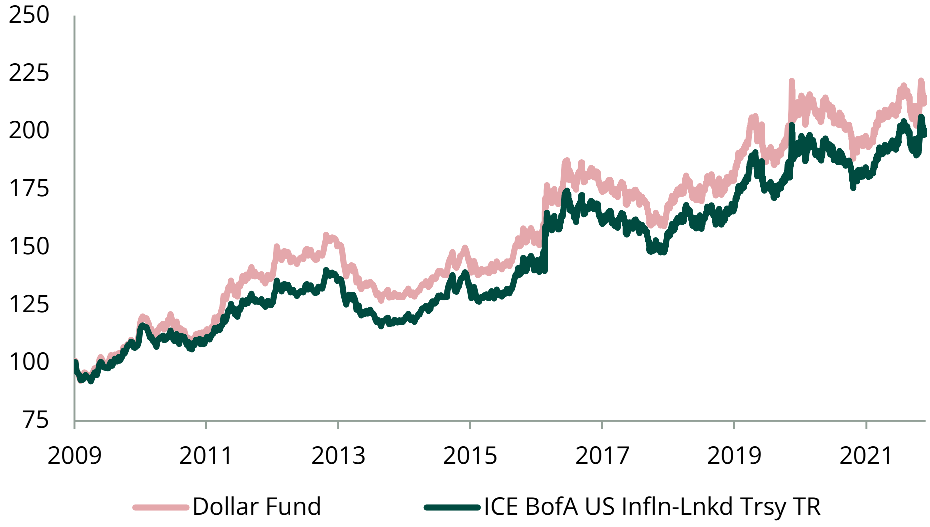
Return history (total returns)

1 month	0.0%	2021	6.0%
3 months	-0.9%	2020	8.6%
6 months	1.0%	2019	4.9%
Year to date	-0.9%	2018	4.9%
1 year	9.6%	2017	-6.3%

Largest holdings

US I/L 0.375% 15/07/27	4.7%
US I/L 0.75% 15/02/45	4.6%
US I/L 1.75% 15/01/28	3.9%
US I/L 1.375% 15/02/44	3.9%
US I/L 1.00% 15/02/46	3.7%

Performance since inception (total return)



Credit ratings

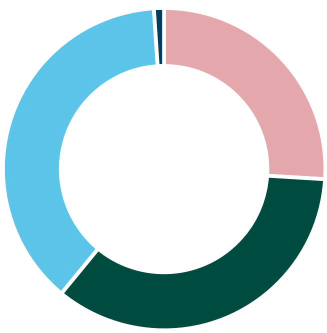
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	44
Yield to Maturity (real)	-0.7%
Average Maturity	9.2 Yrs
Average coupon (real)	1.0%
Composite rating	AAA

Maturity analysis

10+ Years	26%
5-10 Years	35%
0-5 Years	38%
Cash	1%



Duration history

31 Mar 22	8.1
30 Sep 21	8.5
30 Sep 20	10.3
30 Sep 19	8.9
30 Sep 18	7.4
30 Sep 17	6.8

Dollar Fund

March 2022

The dramatic flattening of the yield curve in recent weeks has brought about much excitement among the financial commentariat. Is the bond market signalling a recession and if it is what signals should investors be paying attention to? At a basic level the yield curve represents the expected path of future Fed funds rate. However, it must not be interpreted too literally since it contains other information including term premia and investor preferences.

To illustrate this point 20Y treasury yields have been higher than 30Y yields for several months. Taken at face value this would imply that the market believes that monetary conditions will be easier from 2042 to 2052 than from 2032 to 2042. Clearly this notion is absurd: the market has no "view" on the path of monetary policy so far into the future. Instead the lower yields on 30Y bonds most probably reflects demand from pension funds for longest possible debt to match their liabilities. It is also probable that the Fed's own participation in the treasury market via quantitative easing has distorted the market. The yield curve is not then, a completely open book.

Nevertheless, the premise is sound. An inverted yield curve implies that short term interest rates will be lower in the future than today, consistent with the Fed easing monetary policy, presumably resulting from the Fed attempting to support the economy during a recession.

But which inversions matter? There are three oft cited spreads: 5Y30Y[1], 2Y10Y and 3M10Y. Traditionally 5Y30Y has been seen as prediction of relative nominal GDP growth between the medium term (up to 5 years) and over the long term (from 5 to 30). As such it shouldn't be used as a recession prediction tool. 2Y10Y and 3M10Y both have an impressive track record of predicting recessions, the key difference is that a 3M10Y inversion probably portends a near term recession whereas 2Y10Y has a longer time horizon.

Some commentators assert that it is real curve inversions matter more than nominal curves. We disagree. A steep real yield curve is perfectly consistent with the Fed bringing inflation under control while causing a recession. In any event (and with apologies to Madonna) everybody is living in a nominal world and the Fed is a nominal girl.

The recent – brief – 2Y10Y inversion is unique in history because the 3M10Y curve is still quite steep. The market appears to be saying that the Fed will begin "lift off" shortly and soon thereafter cause a recession. This concern of the market is not so outlandish as we explain in the CG Portfolio report: it is hard to envisage the Fed getting a grip of inflation without causing a recession.

The Fed has declared inflation as enemy number one. The recent history of the Fed leads us to believe that it is not prepared to tolerate a recession. At some point the Fed will be forced to choose between these two incompatible positions. Until that tension is resolved investors should expect the bond market to remain volatile.

[1] In each case the spread is calculated as the yield on the longer tenor bond (in this case 30 year) minus the yield on the shorter tenor bond (in this case 5 year). When the yield on the shorter tenor bond is higher than the longer tenor bond the spread becomes negative and the yield curve is said to have inverted.

Dollar Fund (GBP Hedged)

Fund information as at:

31st March 2022

Fund price:

£107.26

Status:

Open

Investment objective

To achieve real returns through long only investment in Treasury Inflation Protected Securities (US government index linked bonds). All US dollar currency exposure is hedged back to Pound Sterling.

Fund information

Fund Size	£892m
Hedged Class Size	£461m
Dividend Yield	< 2%
Management Fee < £1bn	0.25%
Management Fee > £1bn	0.15%
Total Expense Ratio	0.34%

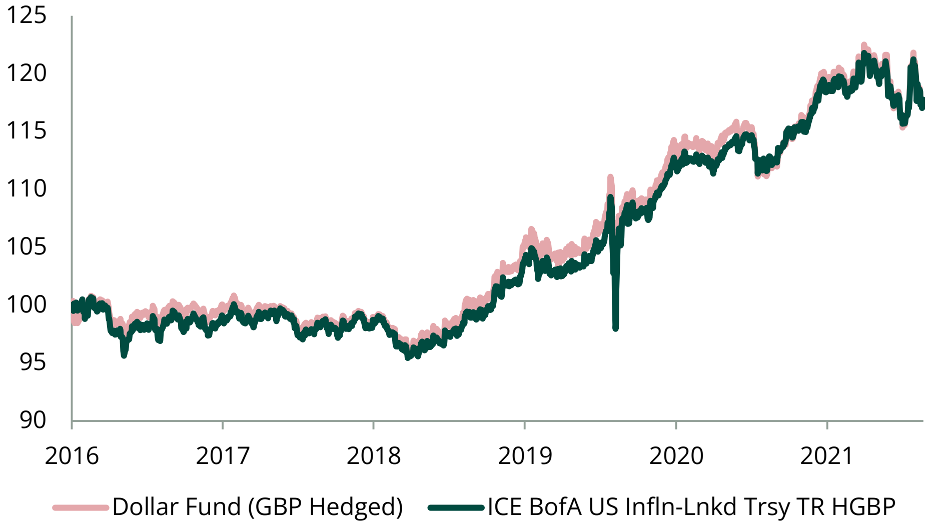
Return history (total returns)

1 month	-1.9%	2021	5.2%
3 months	-3.6%	2020	10.5%
6 months	-1.2%	2019	7.4%
Year to date	-3.6%	2018	-2.6%
1 year	4.9%	2017	1.4%

Largest holdings

US I/L 0.375% 15/07/27	4.7%
US I/L 0.75% 15/02/45	4.6%
US I/L 1.75% 15/01/28	3.9%
US I/L 1.375% 15/02/44	3.9%
US I/L 1.00% 15/02/46	3.7%

Performance since inception (total return)



Credit ratings

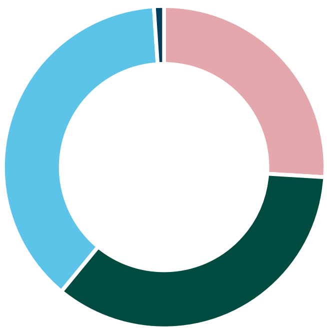
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	44
Yield to Maturity (real)	-0.7%
Average Maturity	9.2 Yrs
Average coupon (real)	1.0%
Composite rating	AAA

Maturity analysis

10+ Years	26%
5-10 Years	35%
0-5 Years	38%
Cash	1%



Duration history

31 Mar 22	8.1
30 Sep 21	8.5
30 Sep 20	10.3
30 Sep 19	8.9
30 Sep 18	7.4
30 Sep 17	6.8

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Real Return Fund (GBP Hedged)

Fund information as at:	Fund price:	Status:
31st March 2022	*£103.69*	*Open*

Investment objective

To achieve real returns through long only investment into a global portfolio of government index linked bonds outside the United Kingdom.

Fund information

Fund Size	£600m
Class Size	£143m
Dividend Yield	< 3%
Management Fee < £500m	0.30%
Management Fee > £500m	0.20%
Total Expense Ratio	0.39%

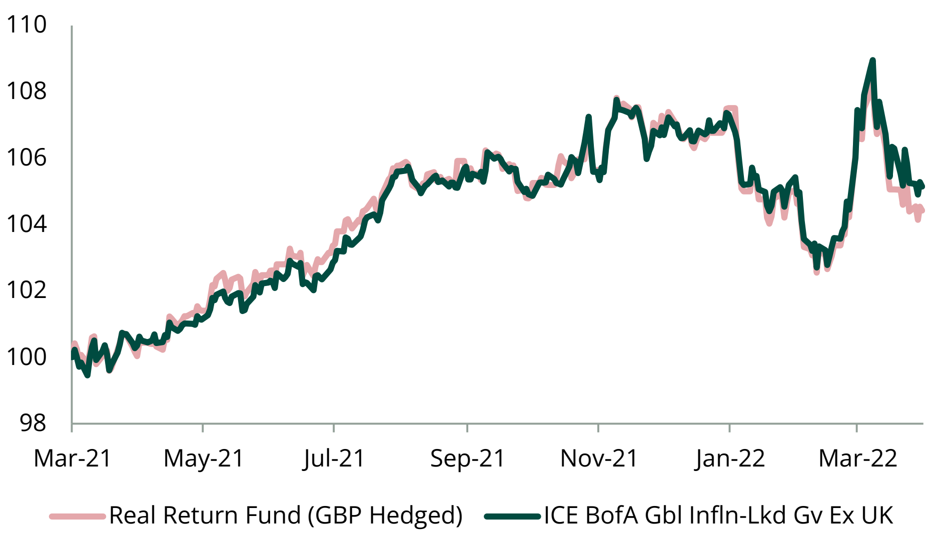
Return history (total returns)

1 month	-1.6%	2021	N/A
3 months	-2.9%	2020	N/A
6 months	-0.4%	2019	N/A
Year to date	-2.9%	2018	N/A
1 year	4.4%	2017	N/A

Largest holdings

US I/L 2.00% 15/01/26	3.9%
US I/L 2.375% 15/01/27	3.7%
US I/L 1.00% 15/02/46	3.5%
US I/L 0.75% 15/02/45	3.5%
US I/L 1.375% 15/02/44	3.3%

Performance since inception (total return)



Credit ratings

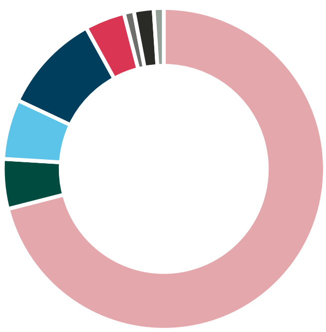
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	65
Yield to Maturity (real)	-1.1%
Average Maturity	9.1 Yrs
Average coupon (real)	1.1%
Composite rating	AAA

Asset allocation

USA	71%
Sweden	5%
Japan	6%
Germany	10%
Canada	4%
Denmark	1%
Australia	2%
Cash	1%



Duration history

31 Mar 22	8.2
30 Sep 21	8.6
30 Sep 20	8.6
30 Sep 19	7.6
30 Sep 18	6.4
30 Sep 17	6.2

Real Return Fund

Fund information as at:	Fund price:	Status:
31st March 2022	*£209.38*	*Open*

Investment objective

To achieve real returns through long only investment into a global portfolio of government index linked bonds outside the United Kingdom.

Fund information

Fund Size	£600m
Class Size	£457m
Dividend Yield	< 3%
Management Fee < £500m	0.30%
Management Fee > £500m	0.20%
Total Expense Ratio	0.39%

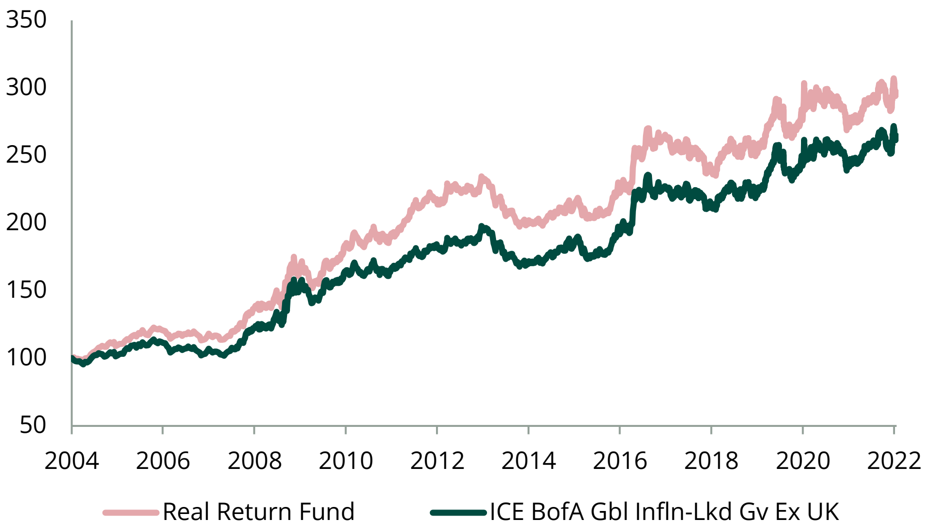
Return history (total returns)

1 month	0.1%	2021	4.1%
3 months	-0.7%	2020	8.0%
6 months	0.8%	2019	2.6%
Year to date	-0.7%	2018	3.5%
1 year	8.1%	2017	-4.4%

Largest holdings

US I/L 2.00% 15/01/26	3.9%
US I/L 2.375% 15/01/27	3.7%
US I/L 1.00% 15/02/46	3.5%
US I/L 0.75% 15/02/45	3.5%
US I/L 1.375% 15/02/44	3.3%

Performance since inception (total return)



Credit ratings

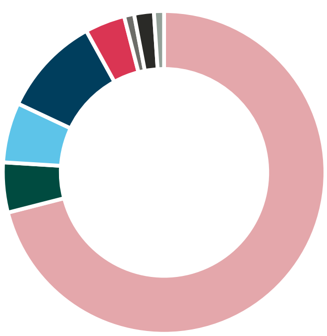
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	65
Yield to Maturity (real)	-1.1%
Average Maturity	9.1 Yrs
Average coupon (real)	1%
Composite rating	AAA

Asset allocation

USA	71%
Sweden	5%
Japan	6%
Germany	10%
Canada	4%
Denmark	1%
Australia	2%
Cash	1%



Duration history

31 Mar 22	8.2
30 Sep 21	8.6
30 Sep 20	8.6
30 Sep 19	7.6
30 Sep 18	6.4
30 Sep 17	6.2

Real Return Fund

March 2022

There was considerable German resistance to the 2011 appointment of Mario Draghi as ECB president. The lead candidate had been Axel Weber, the hard money president of the Bundesbank, but he resigned expressing frustration at ECB monetization of peripheral government bonds. The result left an Italian in charge of European monetary stability and set the stage for ten years of low level skirmishing led by the new Bundesbank president, Jens Weidmann.

The most dramatic standoff occurred in 2012 after the famous “whatever it takes” speech. Reportedly it took all of Draghi’s considerable skill and charm to stop Weidmann from resigning right in the middle of the Eurozone crisis. However 2015 was arguably the pivotal year when the ECB embarked on a huge quantitative easing programme in the face of bitter German resistance. This was the last stand for Bundesbank *stabilitätskultur*. The last stand was a massacre.

This is, of course, the story of how high inflation returned to Europe. As Peter is keen on reminding us*, the risks that you stop worrying about that are the most dangerous*. After 10 years of increasing isolation Jens Weidmann resigned from the ECB in December 2021. Three months later German inflation hit 7.3%, Spanish inflation hit a staggering 9.8% and Eurozone wide inflation averaged 7.5%. There is every prospect these levels will keep rising given the tragic events in Ukraine. German inflation and 10 year inflation expectations are now at a similar levels to those in the US, however the prospects for ECB rate rises lag far behind the expectations for the. The market has come to believe the Fed is behind the curve but trying to catch up. There are no such expectations for meaningful action by the ECB since the last hawk has left the building.

This explains why Euro real yields have hit new lows at a time that US real yields have been rising. This has been good news for the domestic price of Euro index linked bonds but also explains the recent weakness of the Euro relative to the Dollar, as the US becomes an increasingly attractive destination for yield hungry investors.

Euro weakness could be further exaggerated by the war in Ukraine. Germany and Italy are being dragged against their will towards imposing meaningful sanctions. Given the energy dependency of both economies on Russian gas, meaningful sanctions will be extremely damaging and very inflationary; potentially causing stagflation. This vulnerability can be contrasted with the position of the US, a relative beneficiary from sanctions. Not only is the US the largest oil producer globally but also the direct costs of sanctions to its economy are minimal.

Energy dependency on Russia is by no means the only feature in common between the Italian and German economies. There is also the patchwork currency that is the Euro. The “doom spread” between the German and Italian 10 year bond increased from around 1% in mid 2021, to 1.7% recently. This divergence is concerning, rather than panic inducing, however it is always worth keeping an eye on this canary in the coal mine. If this spread increases to 3% during a time of elevated inflation, rising interest rates and a European land war, it could presage a repeat of the Euro crisis. This scenario is not our central case *but the risks you stop worrying about are the most dangerous*.

The most distinctive feature of the Real Return fund allocation is our exclusion of poor quality Euro credits that collectively make up a large share of the index. These include Italy, Spain and France. Nothing in recent developments encourage us to change that stance.

CG Absolute Return Fund

Fund information as at: *31st March 2022*

Fund price: *£141.69*

Status: *Open*

Investment objective

To achieve absolute returns through asset allocation across equities, bonds and commodities. In most cases bond investments are made directly and equity investments via collective funds such as ETFs and listed closed ended funds.

Fund information

Fund Size	£911m
Dividend Yield	< 1.5%
Management Fee	0.35%
Total Expense Ratio	0.44%
Comparator Index	GBP SONIA

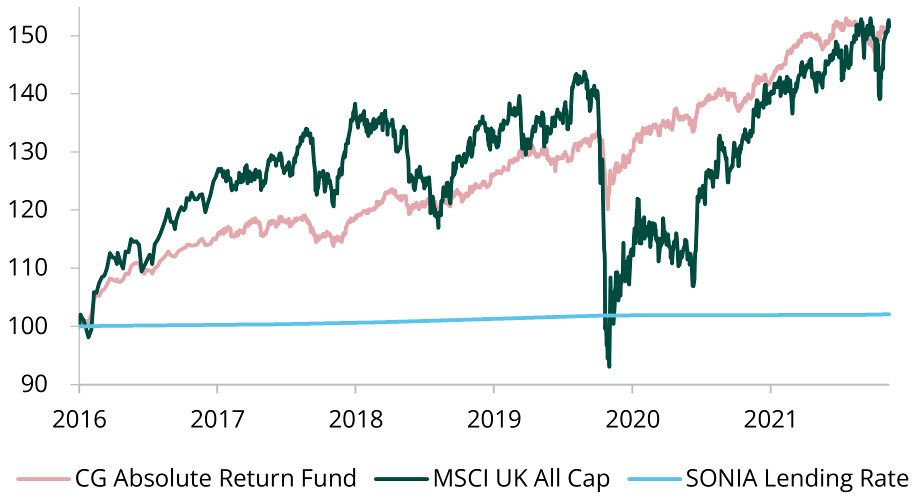
Return history (total returns)

1 month	1.6%	2021	8.9%
3 months	0.0%	2020	7.2%
6 months	2.1%	2019	8.2%
Year to date	0.0%	2018	1.5%
1 year	9.3%	2017	6.3%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	3.7%
Ishares FTSE 100 ETF	2.6%
Vonovia	2.5%
Grainger	2.0%
SPDR MSCI Europe Energy ETF	2.0%

Performance since inception (total return)



Largest bond holdings

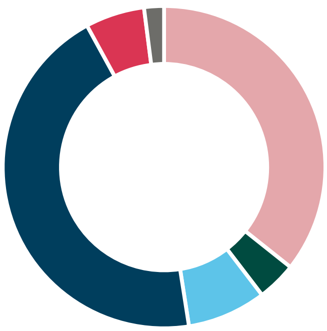
UK I/L 0.125% 22/03/24	5.9%
US I/L 1.375% 15/02/44	1.4%
US I/L 0.75% 15/02/45	1.4%
US I/L 0.625% 15/01/24	1.3%
SWEDEN I/L 0.25% 01/06/22	1.2%

Currency exposure

GBP	48%
USD	29%
SEK	5%
EUR	9%
JPY	8%
Other	1%

Asset allocation

Index Linked Gov't Bonds	36%
Conventional Gov't Bonds	4%
Pref Shares / Corp Debt	8%
Funds / Equities	45%
Cash	5%
Gold	2%



Fund/equity breakdown

Equities	18%
Property	17%
Loans	3%
Infrastructure	6%
Private Equity / Hedge	1%

Absolute Return Fund

March 2022

The debate about whether inflation is a transitory phenomenon concluded tragically as Russian tanks rolled over the Ukrainian boarder and the 200 million residents of Shenzhen, Shanghai and 21 other Chinese cities suffered from full or partial Covid lockdowns. Inflation feeds off human misery; its favourite diet is war, disease and disruption. For investors the debate has now moved on to a new topic; how best to respond to the reality of high inflation? That debate is far from settled.

The negative impact of inflation on cash and conventional bonds is well understood, with the term "certificates of confiscation" entering the popular vocabulary in the 1970's. This folk memory underpins the strong intuition that holding equities, or real assets such as property, is the best way to protect against high inflation. Unfortunately the historical record provides patchy empirical support for this intuition. In his excellent paper on Inflation and Asset Prices[1] John Tatom concludes ~

> *"For a variety of reasons reviewed here, inflation tends to raise investors' required real rate of return on equity and to lower real capital income for tax-related reasons.* ***As a result there is a strong negative correlation between inflation and real and nominal stock prices."***

Work by Dimson and Marsh[2] suggests there is a threshold of 4% above which rising inflation is near universally negative for asset prices. Any property owner looking to sell, intuitively understands that an inflation induced interest rate hike, which in turn makes mortgages more expensive, tends to reduce the price that a buyer can pay.

London commercial property is a case study in the failure of certain "real assets" to protect investors from inflation. According to the Knight Frank, prime central London commercial property rent per sq ft fell 60% in real terms between 1989 and 2019. However the poster child for failing to protect against inflation is gold, which suffered a real value fall of 80% between 1980 and 2001.

Pointing to the historical evidence that inflation surprises cause **all** asset prices to fall does not provide a clear path forward for investors. Rather, the value of these historical insights is in guiding investment strategy. The objective for the first stage of an inflation cycle, as inflation is rising, should be no more than keeping the real value of a portfolio intact. It is only in the second stage of the inflation cycle, as inflation peaks and then falls, that a greater exposure to riskier assets will be properly rewarded.

By historical analogy the Nifty Fifty bull market of the 1960's resulted in very high S&P valuations (although not as high as today). A prescient investor in 1970 that feared a decade of high inflation but who responded by selling bonds and buying the S&P index would still have suffered significant negative real returns. It was only in the 1980's when inflation was high but falling that one of the great bull markets of all time exploded into life. A strategy that avoids the real losses of the 1970's but participates in the real gains of the 1980's would be optimum. In our view US Treasury Inflation Protected Securities (TIPS) are the asset class best placed to keep portfolios whole in the face of the initial inflation onslaught. With luck investor patience today will be well rewarded in the future, with more attractive (lower) equity prices.

[1] Inflation and Asset Price, John Tatom, November 2011

[2] Credit Suisse Global Investment Returns Yearbook 2012, Dimson and Marsh

Capital Gearing Portfolio Fund

Fund information as at:

31st March 2022

Share prices:

P shares £39,237
V shares £190.83

Status:

Hard Closed

Investment objective

To achieve absolute returns through asset allocation across equities, bonds and commodities. Equity investments are made in quoted closed ended trusts and other collective investment vehicles.

Fund information

Fund Size	£411m
Dividend Yield	< 1%
Management Fee	0.75%
Total Expense Ratio	0.84%
Comparator Index	3m Libor

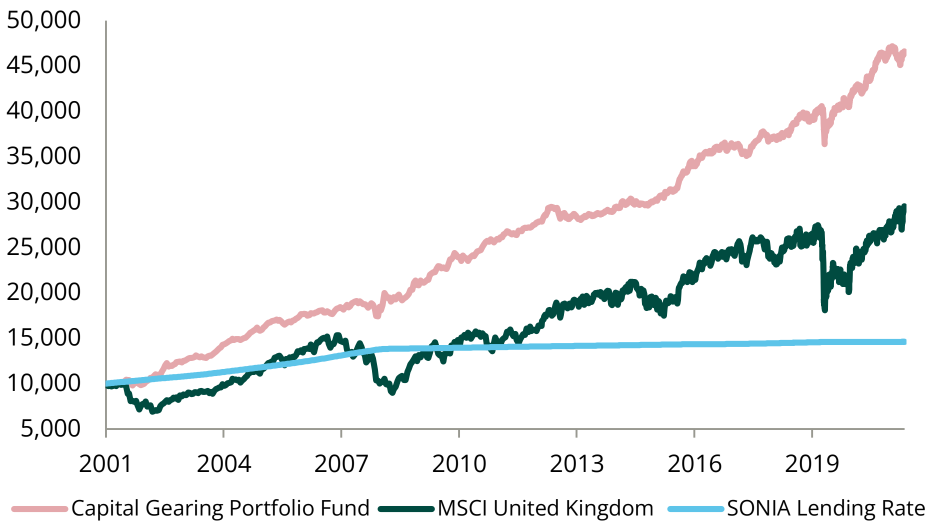
Return history (total returns)

1 month	1.7%	2021	10.3%
3 months	-0.8%	2020	7.3%
6 months	1.3%	2019	7.6%
Year to date	-0.8%	2018	1.5%
1 year	9.5%	2017	4.9%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	4.1%
North Atlantic Smaller Co's	3.0%
Grainger	2.4%
Vonovia	2.4%
SPDR MSCI Europe Energy UCITS ETF	1.8%

Performance since inception (total return, P Shares)



Largest bond holdings

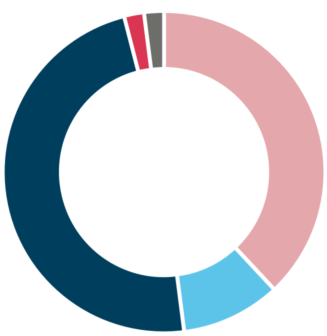
UK I/L 0.125% 22/03/24	5.2%
US I/L 2.375% 15/01/27	2.2%
SWEDEN I/L 0.25% 01/06/22	1.8%
US I/L 2.00% 15/01/26	1.8%
US I/L 3.875% 15/04/29	1.5%

Currency exposure

GBP	45%
USD	30%
SEK	5%
EUR	9%
JPY	8%
Other	3%

Asset allocation

Index Linked Gov't Bonds	38%
Conventional Gov't Bonds	0%
Pref Shares / Corp Debt	10%
Funds / Equities	48%
Cash	2%
Gold	2%



Fund/equity breakdown

Equities	18%
Property	18%
Loans	5%
Infrastructure	7%
Private Equity / Hedge	1%

Capital Gearing Portfolio Fund

March 2022

Bill Dudley, the former Chair of the Federal Reserve Bank of New York, has been enjoying the fact that he is no longer a public official. Free from the strictures of "FedSpeak" he is no longer part of a coordinated communication programme. Put another way, he is able to tell the truth. In a recent article for Bloomberg[1] he wrote:

> *It's hard to know how much the U.S. Federal Reserve will need to do to get inflation under control. But one thing is certain: To be effective, it'll have to inflict more losses on stock and bond investors than it has so far.*

In support of this he cites Jerome Powell's remarks in his March 2022 press conference "Policy Works through financial conditions. That's how it reaches the real economy". The US is less sensitive to nominal interest rates than many economies: most households have mortgages fixed over 30 years; a relatively high proportion of corporate borrowing is also fixed via the bond market. Households in the US also hold more equities than, for example, their European counterparts. If the Fed really is serious about tackling inflation and if Powell's assertion that the transmission of monetary policy is via financial conditions then Dudley's conclusion becomes inescapable: asset prices must fall.

A separate but related question is whether the Fed can tighten financial conditions while engineering a "soft landing"[2] . Two factors weigh against its probability of success. First, a key feature of previous soft landings[3], is that the unemployment rate actually fell during the tightening cycle. Given that today's unemployment rate of 3.6% is well below most estimates of NAIRU[4], it seems unlikely that the Fed can pull off a repeat. Second, the extremely elevated levels of government and corporate debt are a source of brittleness to the US economy: the Fed must walk a policy tightrope.

The Fed is confronted with a series of unappetising choices, leaving investors with a wide funnel of potential outcomes: i) unchecked inflation coupled with moderate growth; ii) inflation falling to target and moderate growth (AKA a soft landing); iii) inflation tamed via a Fed induced recession; iv) stubbornly high inflation despite a recession (AKA stagflation). We would judge 1 & 4 the most likely scenarios and 2 the least likely. Whatever the outcome, it is hard to imagine equities performing well under any scenario. Equities don't like high inflation. Equities don't like recessions. And, if monetary policy indeed works via financial conditions, they aren't going to like a soft landing either. Nominal bonds will also struggle under scenarios 1 & 4. What then is an investor to do?

Our ambition is limited to finding the "least dirty shirts". For bonds, we prefer index-linked to nominals, and our duration is moderate. For risk assets we prefer those which are likely to perform well during an inflationary environment. During the 1970s the worst performing stock market sectors were technology and consumer staples, the top performers were energy and materials. European oil stocks trade at around 7x earnings assuming a longer term oil price of $80. That price seems sustainable given the dearth of capex in recent years. We have put about 4% of the portfolio into energy and materials stocks, the largest position being a European energy ETF. Renewable infrastructure trusts (5% of the portfolio) also look attractive. Roughly half their revenues are derived from government subsidies which are linked to RPI in the UK. They stand to profit from higher inflation and any increase in long-term inflation forecast will flow through to their NAVs. Their other source of revenue is merchant power which looks well underpinned throughout Europe. Finally we continue to think that residential accommodation (c. 10% of the portfolio) looks well placed. Indeed German rents rose faster than inflation during the 1970s. Today if rents were only to keep pace with inflation we believe they would significantly outperform equities.

[1] https://www.bloomberg.com/opinion/articles/2022-04-06/if-stocks-don-t-fall-the-fed-needs-to-force-them

[2] Getting inflation under control without causing recession

[3] 1965, 1984 and 1994

[4] Non-accelerating inflation rate of unemployment

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