Current Focus

July 2017

A monthly market comment from Rivers Capital Management. Views expressed here are subject to change and for professional advisors only

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Summary

- Political and interest rate risk impact U.K. investment market
- Global growth remains positive but does not justify equity valuation levels
- Volatility increases as FAANG momentum fades
- Rivers managed portfolios remain underweight risk with a bias to passive solutions

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Market Comment

Investment markets saw an increase in volatility during June. In the UK, political uncertainty and a surprise vote from the Bank of England, which raised the possibility of increased interest rates, saw equity markets experience their worst month of the year. Globally, equity markets held near record levels in local terms but the momentum seen in recent months appears to have stalled. In the UK benchmark interest rates increased causing losses to bonds and increasing the value of Sterling although we don't believe that this trend will be sustained. The portfolios we manage remain defensively positioned with an underweight allocation to equities and a high allocation to diversifying assets.

Increasingly, in our view, there are signs in the background indicating that the one-way-only momentum rush we have enjoyed so far this year may be changing. Although still strong, the US Equity market has two specific problems: the first, as we have said before, is valuation, which as measured by the Cyclically Adjusted Price/Earnings Ratio has never been higher except in 1929 and 1999. Second, the indices have been supported by just a few famous stocks with the acronym of FAANG and there are signs that may be ending. The five stocks are Facebook, Apple, Amazon, Netflix and Google (actually now known as Alphabet) which combined are now worth more than the entire FTSE 100. They have been largely responsible for the US equity market's value gain this year, but during June their status changed as these very highly rated stocks appear to have had a wobble. The US market was held up in part by financials, which added nearly 8% and benefited from rising rates. This change in focus is contrary to the reflation trade that has dominated the market and adds to our concerns.

It has never been easy to manage money, but it appears to have become even harder of late.. Many investment styles have been struggling. The Trump Rally really ended in March and ever since then the US market has just been about "FAANG" and little else. These stocks have been largely responsible for driving the S&P index to new highs. It is a fact that bull markets usually go out with a narrowly focused momentum charge. When that charge is going on, the well-informed value investor always struggles. This supports our research that suggests this is a good time for passive investment. While the change in June is not conclusive and the momentum could easily return there does need to be a catalyst. Such a catalyst does not appear obvious at present so this increases risk.

"During June the highly rated FAANG stocks appear to have had a wobble"

Beyond the investment market the US Fed has signalled that the period of super-low interest rates is over and it has the desire to normalise interest rates in an orderly manner. How this is done without triggering the usual economic recession is the obvious question. Unfortunately, the Fed only controls the short end of the curve, whereas the long end is driven primarily by economic growth and inflation dynamics. Neither of these look like they are about to pick up anytime soon. This tells us that despite the initial Trump euphoria, the US Economy is not generating the inflation pressures that had been hoped for. That's the problem and goes some way to explain the change in leadership in the equity market.

The only reassuring news is that the main risk is a stock market one rather than an economic one. The last two major setbacks, 2001-3 and 2007-8 involved both the economy and the stock market. At present, however, the relatively high valuation of the stock market index is not aggravated by the economy. In the US the latter may well cool down a bit but is still not about to go into recession or depression. Provided the Fed doesn't make a policy error, the jury is out but the risk is 'to the downside'. That said while the IMF has lowered its forecast for the US economy to 2.1% from 2.5% this is not a negative number. In addition, looking beyond the US, and despite UK domestic worries over politics and Brexit, growth in the rest of the World looks more buoyant. India, which we hold in higher risk portfolios, has seen growth pick up nicely post demonetisation and is a major positive.

Economically what keeps us awake is the global debt mountain and unfunded entitlements. Economies with very high debt levels and overvalued financial markets remain the most vulnerable to a major drawdown down the road. They include Belgium, Netherlands, Denmark, the US and Ireland. Whilst nothing has changed recently, at some point it will matter - just not yet. Until then, our models say we have to go with the flow of equity markets and expect only the most expensive of these to have a significant correction.

In conclusion equity markets have been super strong ever since Mr Trump became President of the USA. These trends are still in place. China, India, and Europe have the strongest momentum now and are the only markets beating a passive holding of the World Index. The problem with the US market is that it is expensive. The Cyclically Adjusted Price Earnings Ratio has only been this high in 1929 and 1999. The US index has also been supported by just a few huge market cap stocks under the acronym of FAANG. June saw these now starting to wobble on their pedestals. We are not worried by the Global economy. It is slowing down, but even the US economy is still growing at a healthy clip of 2.1%. The main risk is of a stock market event owing to the high valuation of the US equity market at a time when the Fed is trying to raise interest rates. Overall we believe the underweight risk and overweight passive position we have recommended since March continues to be appropriate.

Benchmark Returns - 30th June 2017	1 Month	3 Month	6 Month	YTD	12 Month*
Anchors					
Cash + 1%	0.1%	0.3%	0.7%	0.7%	1.4%
Inflation Linked UK Bonds	-1.5%	-1.8%	-1.7%	-1.7%	3.9%
Gilts	-2.1%	-1.3%	0.2%	0.2%	-1.0%
Global Government Bonds (hedged)	-0.4%	0.5%	0.3%	0.3%	-2.8%
Enhancers					
Global Corporate Bonds (hedged)	-0.1%	1.6%	2.6%	2.6%	2.0%
Global High Yield (hedged)	-0.1%	1.9%	4.7%	4.7%	11.0%
Emerging Market Bonds (hedged)	0.0%	-0.9%	5.2%	5.2%	10.6%
FTSE 350 TR Index	-2.5%	1.3%	5.3%	5.3%	17.8%
FTSE UK All-Small Cap	-0.8%	3.8%	10.4%	10.4%	29.0%
Global Equity (MSCI)	-0.2%	0.1%	5.3%	5.3%	21.6%
European Equity (MSCI)	-1.7%	3.2%	9.3%	9.3%	24.6%
US Equity (S&P)	0.0%	-0.9%	3.7%	3.7%	20.6%
Japan Equity (Topix)	0.7%	1.9%	6.0%	6.0%	24.2%
Pacific Ex Japan Equity (MSCI)	1.3%	4.9%	17.1%	17.1%	31.5%
Emerging Market Equity (MSCI)	0.4%	2.3%	12.7%	12.7%	27.4%
Chinese Equity (Hang Sang)	0.6%	4.0%	12.9%	12.9%	30.7%
Indian Equity (Nifty)	-2.0%	0.2%	16.0%	16.0%	23.3%
Diversifiers					
Commodity Index	-0.3%	-3.2%	-5.7%	-5.7%	-7.3%
Gold	-3.1%	-4.5%	2.2%	2.2%	-4.2%
Silver	-5.4%	-12.9%	-1.9%	-1.9%	-9.8%
Brent Oil	-5.2%	-12.7%	-20.0%	-20.0%	-1.0%
UK Property	0.5%	1.6%	3.5%	3.5%	4.4%
Global Property Shares	-2.0%	2.3%	4.0%	4.0%	9.8%
Rivers Model Portfolios					
Rivers Preservation Portfolio	*-0.5%*	*-0.2%*	*1.1%*	*1.1%*	*6.7%*
Rivers Cautious Portfolio	*-0.6%*	*-0.1%*	*2.6%*	*2.6%*	*11.3%*
Rivers Balanced Portfolio	*-0.9%*	*0.0%*	*3.5%*	*3.5%*	*14.0%*
Rivers Adventurous Portfolio	*-1.0%*	*0.2%*	*4.5%*	*4.5%*	*16.2%*
Rivers Aggressive Portfolio	*-1.2%*	*0.5%*	*6.3%*	*6.3%*	*20.0%*
Rivers Cautious Income Portfolio	*-0.8%*	*0.4%*	*2.7%*	*2.7%*	*7.0%*
Rivers Balanced Income Portfolio	*-0.7%*	*0.8%*	*4.3%*	*4.3%*	*11.8%*

Source: Financial Express in GBP (unhedged unless stated) as at 31st May 2017. *Rivers Portfolios since launch June 30th 2016

Model Performance is indicative only and is net of Rivers Capital Management Charge and Underlying Fund charge but not advisor or platform costs.