Current Focus

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

RIVERS CAPITAL MANAGEMENT

Rivers Capital Management
27 Gloucester Place
London
W1U 8HU

+44 (0)20 7866 2140

Summary

- Positive global economic growth has been sustained and continues to boost returns
- Valuations remain a major concern requiring continued economic improvement
- Risk to investors of central bank policy remains elevated and is underestimated by investors
- Relative equity/bond valuation argument ignores inherent asset class risk fundamentals
- Rivers portfolios remain underweight risk assets in order to protect long term value

Contacts

Richard Bonnor-Moris
020 7866 2137
rbm@riverscm.com

Eduardo Tomacelli
020 7866 2138
etomacelli@riverscm.com

Najib El-Rayyes
020 7866 2139
ner@riverscm.com

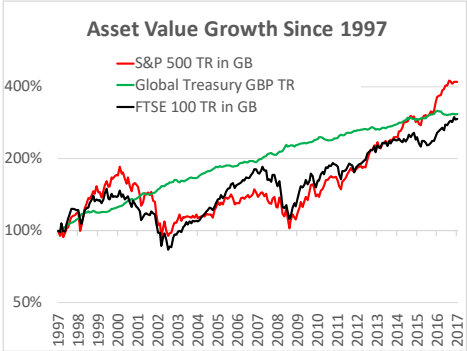
Mark Hill-Reid
020 7866 2140
mhr@riverscm.com

Market Comment

July was a positive month for most asset classes with many equity markets setting all-time highs. The strongest performing region was the emerging markets led by Indian and Chinese equities. Fixed income saw modest gains as inflation failed to continue to accelerate in the UK or abroad. Commodity prices increased, after falling for the previous few months, led by copper and oil. Corporate earnings continued to improve reflecting what appears to be a sustained global period of economic growth. Rivers portfolio returns have been positive but investment markets remain expensive and we continue to maintain a defensive allocation. Despite a positive economic outlook, we expect an opportunity to invest capital at more attractive valuations in the coming months.

During July, the IMF upgraded its forecast for global economic growth to 3.5% with most areas expecting to show economic improvement. Even in the UK, where it saw growth slowing to 1.7%, it still predicted expansion. The IMF expects the strongest growth in the Asian giants of India and China but for the rest of the world to continue the positive trend. What a difference from a year ago. At this time last year, many were expecting that there would be a significant cooling down to worry about by now. This was predicted to be led by China, which has, primarily through government spending, pushed any slowdown out into the future. At present, there are no signs of imminent economic slowdown in China, the US or globally. Most forecasters expect that to be the case until at least 2018/9.

All good then? Well not quite. The first question for us as investors is whether the improvement in economic conditions is 'priced into' current asset valuations? We think it is. From an historical perspective, extremely good news is already 'priced in'. The best measure of that is the Cyclically Adjusted Price Earnings (CAPE) ratio which in the US equity market has only been this expensive in 1929 and 1999. Both clearly bubble territory. This is our major concern and remains the case despite the recent improvement in the fundamentals and earnings. History shows that whenever the US market has been bought on a CAPE ratio as high as it is now, the expected returns over the next decade have only been 0.2% per annum,



Source: Financial Express Limited.

on average. As a result, many investors have already rotated out of the US market to Europe or Emerging Markets this year. This allocation change following relatively more attractive valuations, makes some sense but the valuations in these areas are much higher than they were just 12 months ago and any risk related correction is likely to be global in any case.

The second question is to what extent the growth is dependent on low interest rates and central bank stimulus? Despite the Federal Reserve raising rates modestly the Bank of Japan and the European Central Banks are both still providing an almost limitless supply of liquidity to global investment markets. Does this account for the global growth? Probably not. Paradoxically we don't think the quantitative easing programs (from all central banks) have ever done very much to stimulate economic growth, at least directly. What they have done is increased asset prices. Indirectly they have lowered borrowing costs (which have in turn increased buybacks) therefore increasing earnings and probably employment, but evidence is contradictory in most regions. The effect therefore, should the amount of quantitative easing fall, (which for the record we don't expect imminently) is more likely to affect asset prices than economic growth. This should encourage central banks to do it but in turn should concern investors more than it currently is.

Regarding Central Banks their recent intervention has led many commentators to argue that while equities are expensive they are not as expensive as government bonds. The thing that is clearest is that the low Central Bank mandated short-term interest rates make high valuations seem reasonable. When yields are low on fixed

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income instruments, low earnings yields on equities seem justified. We're not sure the comparison is that straight forward but understand the point. Recent data on volatility even suggests that the volatility in equities is lower than that in bonds although if that isn't a sign that the market has become complacent its difficult to know what is. The illustration above shows the logarithmic path over 20 years of Government Bonds against both the FTSE 100 and S&P 500 in sterling terms. The difference being that stocks do tend to go up and down much more quickly than bonds – they are inherently different asset classes. As Warren Buffett said in February, "Measured against interest rates, stocks actually are on the cheap side compared to historic valuations.... the risk always is that interest rates go up a lot, and that brings stocks down." While interest rate rises will affect bonds over time the short-term impact on equities will likely be more significant.

Overall we do not think current expected returns fully justify the risks inherent in the assets we categorise as 'Enhancers' – equities and correlated assets . Current valuations show the temperature of today's market to be elevated. This is not a nonsensical bubble, economic growth is positive, its simply that asset prices are high and therefore risky. The current market is one in which riskiness is being tolerated and perhaps ignored, and one in which most investors are happy to bear excessive risk. When this occurs we prefer to remain cautious, we underweight 'Enhancers' and overweight safer and more diversifying assets. The portfolios are positioned to add risk opportunistically over the coming months when more attractive valuations become available.

Benchmark Returns - 31st July 2017	1 Month	3 Month	6 Month	YTD	1 Year	S/I*
Anchors						
Cash + 1%	0.1%	0.3%	0.7%	0.8%	1.4%	1.5%
Inflation Linked UK Bonds	-0.2%	-1.3%	-1.4%	-1.9%	1.9%	3.6%
Gilts	0.3%	-1.3%	2.4%	0.5%	-2.8%	-0.7%
Global Government Bonds (hedged)	0.1%	0.0%	1.2%	0.4%	-2.9%	-2.6%
Enhancers						
Global Corporate Bonds (hedged)	0.6%	1.4%	3.2%	3.3%	1.0%	2.6%
Global High Yield (hedged)	0.9%	1.5%	4.2%	5.7%	9.2%	11.9%
Emerging Market Bonds (hedged)	1.5%	3.2%	5.7%	6.8%	10.8%	12.2%
FTSE 350 TR Index	1.1%	2.9%	6.9%	6.5%	14.6%	19.1%
FTSE UK All-Small Cap	2.3%	4.0%	11.1%	12.8%	23.3%	31.9%
Global Equity (MSCI)	0.9%	3.0%	5.6%	6.2%	16.9%	22.7%
European Equity (MSCI)	1.5%	4.7%	10.7%	11.0%	20.7%	26.5%
US Equity (S&P)	0.5%	2.0%	4.2%	4.2%	16.1%	21.2%
Japan Equity (Topix)	0.6%	4.8%	4.6%	6.7%	16.8%	25.0%
Pacific Ex Japan Equity (MSCI)	3.6%	10.0%	16.0%	21.3%	29.2%	36.2%
Emerging Market Equity (MSCI)	4.4%	8.1%	13.5%	17.6%	25.7%	33.0%
Chinese Equity (Hang Sang)	5.0%	10.7%	13.5%	18.6%	29.4%	37.2%
Indian Equity (Nifty)	5.1%	6.6%	18.8%	22.1%	22.7%	29.7%
Diversifiers						
Commodity Index	2.1%	0.4%	-3.7%	-3.7%	-0.2%	-5.4%
Gold	0.5%	-2.1%	-0.4%	2.7%	-6.5%	-3.8%
Silver	-0.4%	-4.7%	-9.4%	-2.3%	-18.4%	-10.2%
Brent Oil	8.2%	-0.1%	-10.8%	-13.3%	24.6%	7.3%
UK Property	0.7%	1.7%	3.8%	4.3%	8.7%	5.2%
Global Property Shares	1.6%	-0.9%	10.4%	5.7%	6.0%	11.6%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*0.4%*	*0.2%*	*1.7%*	*1.6%*	*5.3%*	7.1%
Rivers Cautious Portfolio	*0.5%*	*0.5%*	*2.7%*	*3.2%*	*8.6%*	11.9%
Rivers Balanced Portfolio	*0.6%*	*0.7%*	*3.4%*	*4.1%*	*10.3%*	14.6%
Rivers Adventurous Portfolio	*0.6%*	*0.8%*	*3.9%*	*5.1%*	*11.9%*	16.9%
Rivers Aggressive Portfolio	*1.1%*	*1.8%*	*5.7%*	*7.5%*	*15.7%*	21.4%
Rivers Cautious Income Portfolio	*0.3%*	*0.8%*	*2.7%*	*3.0%*	*4.9%*	7.3%
Rivers Balanced Income Portfolio	*0.6%*	*1.4%*	*3.9%*	*4.8%*	*9.0%*	12.4%

Source: Financial Express in GBP (unhedged unless stated) as at 31st July 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.