Current Focus

December 2017

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

RIVERS CAPITAL MANAGEMENT

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Summary

- November was eventful for news but surprisingly uneventful for markets
- Valuation, political and economic risks are high going into 2018
- The potential for political crisis affecting investment markets is increasingly elevated
- US yield curve flattening indicates less optimism than valuations assume
- Rivers portfolios remain underweight risk assets in order to protect long term value

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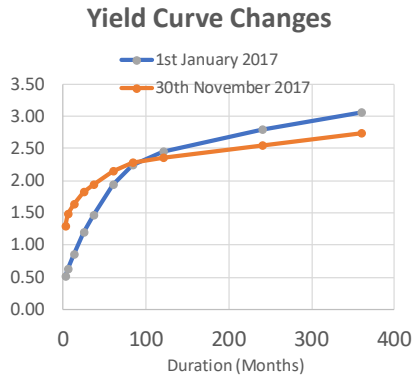
Market Comment

During November the UK saw the Bank of England raise rates for the first time in a decade, heard Philip Hammond's first Autumn Budget and enjoyed another month of Brexit uncertainty, but it turned out to be a surprisingly uneventful month for investors. Many regional equity indices recorded modest losses, as did the UK, but the positive trend managed to continue in Japan and, notably, in the US which set record highs. Investor confidence is high and barring an unlikely December correction it looks as if 2017 will end having been overall positive for most asset classes. We will review the year in full in January's Focus, but this month we look ahead and focus on what we believe are the elevated investment risks and how they may affect returns in the coming year.

The first risk and the one we have highlighted for a number of months is the current asset valuation level. While high valuations can be sustained for a long time they are sufficient, in our view, in justifying a defensive allocation. Relative valuations are relevant, that US equity values are higher than those in Japan or Europe is important and affects regional allocations, but at a portfolio level our concern is the overall level of Enhancer valuation. While allocating less to Enhancers may affect short term performance if valuations continue to rise, the primary purpose of such an allocation is to enable us to increase it significantly at more attractive valuations. The fact that valuations keep rising should not be the justification for increasing any allocation. This is why we will not be adding Bitcoin to our portfolios. There may be other good reasons to own Bitcoin, but the fact that the value of Bitcoin has risen, a lot, is not one of them.

It is true that markets can push valuations to extremely high levels. This has been called 'irrational exuberance' and it can last for a long time. To support our defensive stance it is not difficult to find other risks that we think are 'not priced in' to many investment markets. The first is political risk. It is difficult to recall a period when political risk has been higher than it is today. Without wanting to mention Brexit, which has dominated nearly every UK news bulletin since the referendum,



Source: US Treasury

or the current malaise of the UK political system, you don't need to go far to consider other potential global political crises; Trump, North Korea, German elections Saudi Arabia, Yemen and Iran to name a few. It is hard to predict the outcome to any of these during 2018, or for any other period, but it is also hard to imagine that none will significantly affect investment returns over the next 12 months. Recent history has shown politics is almost impossible to predict, but combined with high valuations the investment cost of political events should not be ignored.

Another risk is the sustainability of current economic growth. Global growth has been increasing for most of this year and appears to remain positive. In fact, on average the global economy is growing at a rate of around 3.7% led mainly by China, India and the US and nearly all world economies are showing GDP growth . This is positive, but after 9 years of aggressive monetary stimulus the question is how sustainable that growth is if the stimulus was to be removed. In the US interest rates have been rising very slowly since 2015, but from October the Federal Reserve has begun to reduce the size of its balance sheet – or in effect reverse its quantitative easing program. This is a fundamental change, the impact of which has been muted by the continued QE programs of the European and Japanese central banks (which together exceed all previous Federal Reserve programs). The real question, set to be answered in the next year or two, is to what degree global growth will be affected if the overall level of monetary stimulus was to be lowered, removed or reversed.

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The recent changes in the US yield curve gives some indication over this concern. While short term interest rates have risen three times already this year (and are widely expected to rise in December) amounting to a 1.00% increase in rates, the effect on the benchmark 10 year rate for US treasuries over the same period has been almost zero. What has happened is a significant 'flattening of the curve', which in the past has indicated a forthcoming slowdown in the economy. Throughout history whenever the curve has inverted, meaning long term borrowing rates fall below the short term rates, a recession has always begun within 12 months. Should rates continue to rise the curve could invert as early as the summer of 2018.

Current US equity valuations predict accelerating economic growth, no chance of recession, and little chance of any escalation of any of the world's political risks in the year ahead. They also predict an increase in corporate earnings without any increase in wages or borrowing costs. While other regions, in particular Japan and Emerging Markets, do offer more attractive equity valuations we think any reversal of the current situation will affect all equity markets. We, therefore, prefer to maintain a defensive allocation to protect against elevated risk and allow a reallocation at more attractive levels when they become available.

We wish all our readers a Merry Christmas and Happy New Year, whatever opportunity it may bring.

Market Returns (£) - 30th Nov 2017	1 Month	3 Month	6 Month	YTD	1 Year	S/I*
Anchors						Jun-16
Cash + 1%	0.1%	0.4%	0.7%	1.2%	1.4%	2.0%
Inflation Linked UK Bonds	-0.3%	-3.9%	-1.8%	-2.0%	0.0%	3.5%
Gilts	0.3%	-2.2%	-1.9%	0.3%	2.3%	-0.8%
Global Government Bonds (hedged)	0.2%	-0.2%	0.3%	1.1%	1.2%	-2.0%
Enhancers						
Global Corporate Bonds (hedged)	-0.2%	0.1%	1.3%	4.1%	4.7%	3.4%
Global High Yield (hedged)	-0.4%	0.7%	1.9%	6.9%	8.8%	13.3%
Emerging Market Bonds (hedged)	-0.4%	-6.6%	-1.5%	3.6%	7.3%	8.9%
FTSE 350 TR Index	-1.7%	-0.3%	-0.3%	7.7%	13.1%	20.4%
FTSE UK All-Small Cap	-0.7%	1.8%	3.8%	15.5%	20.9%	35.0%
Global Equity (MSCI)	0.2%	1.3%	4.5%	10.2%	14.1%	27.4%
European Equity (MSCI)	-1.7%	-1.2%	1.2%	12.6%	19.9%	28.2%
US Equity (S&P)	1.0%	2.3%	5.4%	9.4%	12.7%	27.2%
Japan Equity (Topix)	1.1%	4.5%	8.8%	14.5%	17.0%	34.2%
Pacific Ex Japan Equity (MSCI)	-1.1%	0.5%	9.5%	26.7%	25.2%	42.3%
Emerging Market Equity (MSCI)	-1.7%	-1.7%	7.8%	21.0%	22.6%	36.8%
Chinese Equity (Hang Sang)	1.3%	0.1%	11.3%	24.8%	21.9%	44.5%
Indian Equity (Nifty)	-2.5%	-2.7%	1.4%	20.0%	21.8%	27.6%
Diversifiers						
Commodity Index	-0.5%	1.3%	3.4%	-2.1%	-0.5%	-3.9%
Gold	2.7%	-4.1%	-0.7%	4.7%	3.9%	-1.8%
Silver	4.7%	-3.3%	-2.8%	0.7%	-1.2%	-7.4%
Brent Oil	2.4%	16.1%	21.7%	2.7%	17.5%	27.0%
UK Property	0.1%	1.9%	3.6%	6.7%	7.5%	7.6%
Global Property Shares	0.1%	-1.3%	-2.0%	4.1%	10.9%	9.9%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*-0.1%*	*0.4%*	*1.5%*	*3.2%*	*4.3%*	8.8%
Rivers Cautious Portfolio	*-0.2%*	*0.7%*	*2.0%*	*5.4%*	*7.0%*	14.3%
Rivers Balanced Portfolio	*-0.2%*	*0.9%*	*2.2%*	*6.8%*	*8.6%*	17.5%
Rivers Adventurous Portfolio	*-0.3%*	*0.6%*	*1.7%*	*7.4%*	*9.5%*	19.4%
Rivers Aggressive Portfolio	*-0.4%*	*1.0%*	*2.8%*	*10.5%*	*13.0%*	24.8%
Rivers Cautious Income Portfolio	*-0.3%*	*-0.4%*	*-0.2%*	*3.3%*	*4.6%*	7.6%
Rivers Balanced Income Portfolio	*-0.2%*	*0.1%*	*0.4%*	*5.4%*	*7.0%*	13.0%

Source: Financial Express in GBP (unhedged unless stated) as at 30th November 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.