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

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Summary

- Asset valuations still appear high despite recent economic improvements
- Central Bank policy will determine asset returns in 2018
- Reduction in asset purchases will enhance volatility and increase borrowing cost
- A market downturn is expected although economic growth should be sustained

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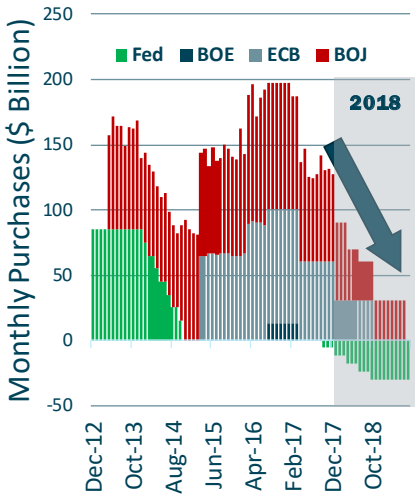
Market Comment

Overall 2017 was a good year for investment assets. According to our classifications it was 'Enhancer' assets which provided the strongest returns, 'Anchor' assets offered positive risk adjusted returns and although some 'Diversifier' assets struggled, overall they also added to portfolio returns. In a measure of the strength of returns, despite adopting a cautious tactical stance since the first half of the 2017 all the Rivers Portfolios achieved their respective return objectives for the year. While economic indicators improved in the second half this failed to justify increasing risk as any improvement was exceeded by subsequent increases in valuations. Assets are expensive but we have participated in the gains. As we start 2018 we look at what we think will be the biggest change during the year and why we continue to believe the opportunity to add risk at more attractive valuations is worth waiting for.

In 2018, as has been the case in most of the last 8 years, investor returns will be more affected by the decisions made by the central banks than they will be by anything else, even Brexit. Since the financial crisis central banks have provided a high level of monetary support through quantitative easing (QE) programs. The idea being that by purchasing government (and other) debt Central Banks can increase the price and lower the yield on that debt. QE is designed to lower the overall cost of capital and encourage the corporate and consumer sectors to borrow and invest. It effectively lowers the cost of long term debt further than can be achieved by simply lowering short term interest rates. This process was led by the Federal Reserve, the People's Bank of China and the Bank of England in 2009. In 2014 the Bank of Japan increased its QE program substantially and in 2015 the European Central Bank started the most aggressive QE program of all. The total value of ongoing purchases has varied a bit over time, as programs at different banks have expired but in late 2017, after a brief fall in 2016, it returned to a level not seen since the peak of the crisis in 2010. The result has been that a fairly constant stream of liquidity has kept yields low and indirectly boosted investment markets. This liquidity provision is likely to be significantly reduced in 2018.



Source: Central Banks, RCM

What happens when this liquidity tap is turned down is difficult to predict. The Federal Reserve and People's Bank of China have already reversed some of their previous purchasing programs but they have, so far, been dwarfed by the programs still in place by the ECB and BoJ. From this month the ECB has agreed to reduce by half its asset purchasing program and while data from the BoJ is less clear indications of a reduction in their program are now being reported. The current situation is that with most economies across the globe now growing, the case for extreme measures (essentially negative interest rates) is difficult to make. Any changes will be implemented very slowly but Central Banks will be aware that they need to reduce stimulus soon, to some degree, to be able to increase it if and when required in the future.

This need is most apparent in the US where the Federal Reserve is keen to raise interest rates to a more normal level in advance of the next downturn. The fiscal boost likely from the Trump tax cuts, passed in December, is likely to further encourage this prudence but with the 10 year Treasury yield anchored at around 2.5% the danger of a yield curve 'inversion' (as discussed last month) is high. They will be keen to avoid that scenario and the tapering by the ECB and BoJ will be welcomed. In fact with falling liquidity from other central banks we expect the yield on the 10 year Treasury to increase to nearly 3% by the end of the year. An increase of this magnitude should not immediately affect the economy but will likely affect corporate bond yields

substantially. The effect on equites will result from the direct effect on borrowing costs and the discount rate on earnings.

Current high asset valuations are vulnerable to any disappointment. Confidence in some areas feels so high that there may be some similarities with the end of the 1990s technology bubble. The subsequent market correction came about from a profits recession and valuations rerating rather than an economic downturn. Higher costs combined with higher interest rates will likely be the catalyst this time. This may lead to a downturn but not in 2018.

Concern regarding political events are also likely to impact markets this year. Obviously Brexit will dominate the headlines in the UK but the Italian Elections in May, the US mid-term elections in November, and a possible return to the polls in Germany will all keep us interested. Valuations remain the main reason for our caution though and we expect it to be decisions by the Central Banks that will provide the catalyst to bring them to more normal levels. We expect to see an increase in price volatility for investment assets during 2018, we also expect benchmark returns to be lower than 2017. This will make it a more challenging environment for investing but will provide more opportunity for measured tactical adjustment and active management.

Market Returns (£) - 31st Dec 2017	1 Month	3 Month	6 Month	YTD	1 Year	S/I*
Anchors						Jun-16
Cash + 1%	0.1%	0.4%	0.7%	1.4%	1.4%	2.1%
Inflation Linked UK Bonds	1.3%	2.0%	1.0%	-0.7%	-0.7%	4.8%
Gilts	1.6%	2.2%	1.8%	2.0%	2.0%	0.8%
Global Government Bonds (hedged)	0.0%	0.4%	0.7%	1.1%	1.1%	-2.0%
Enhancers						
Global Corporate Bonds (hedged)	0.5%	0.9%	1.9%	4.6%	4.6%	3.9%
Global High Yield (hedged)	0.3%	0.4%	2.3%	7.2%	7.2%	13.6%
Emerging Market Bonds (hedged)	1.6%	-1.0%	0.1%	5.3%	5.3%	10.7%
FTSE 350 TR Index	4.9%	5.0%	7.2%	12.9%	12.9%	26.3%
FTSE UK All-Small Cap	2.6%	4.2%	7.4%	18.6%	18.6%	38.5%
Global Equity (MSCI)	1.4%	4.6%	6.2%	11.8%	11.8%	29.2%
European Equity (MSCI)	1.7%	1.5%	4.7%	14.5%	14.5%	30.4%
US Equity (S&P)	1.1%	5.6%	6.7%	10.6%	10.6%	28.6%
Japan Equity (Topix)	1.0%	7.7%	9.0%	15.6%	15.6%	35.5%
Pacific Ex Japan Equity (MSCI)	2.5%	7.0%	10.9%	29.9%	29.9%	45.9%
Emerging Market Equity (MSCI)	3.7%	6.6%	11.3%	25.4%	25.4%	41.8%
Chinese Equity (Hang Sang)	2.5%	7.9%	13.4%	28.0%	28.0%	48.1%
Indian Equity (Nifty)	5.1%	11.3%	11.3%	28.9%	28.9%	38.9%
Diversifiers						
Commodity Index	2.9%	4.4%	6.7%	0.7%	0.7%	-1.1%
Gold	-1.6%	1.0%	0.9%	3.0%	3.0%	-3.4%
Silver	-4.1%	1.7%	-1.5%	-3.4%	-3.4%	-11.2%
Brent Oil	4.5%	14.8%	34.8%	8.1%	8.1%	32.7%
UK Property	0.9%	2.2%	3.9%	7.6%	7.6%	8.5%
Global Property Shares	8.2%	8.3%	8.3%	12.7%	12.7%	19.0%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*0.5%*	*1.1%*	*2.4%*	*3.6%*	*3.6%*	9.3%
Rivers Cautious Portfolio	*0.7%*	*1.8%*	*3.4%*	*6.1%*	*6.1%*	15.1%
Rivers Balanced Portfolio	*1.1%*	*2.6%*	*4.2%*	*7.9%*	*7.9%*	18.8%
Rivers Adventurous Portfolio	*1.3%*	*2.7%*	*4.1%*	*8.8%*	*8.8%*	21.0%
Rivers Aggressive Portfolio	*1.6%*	*3.6%*	*5.6%*	*12.2%*	*12.2%*	26.8%
Rivers Cautious Income Portfolio	*0.6%*	*1.0%*	*1.1%*	*3.9%*	*3.9%*	8.2%
Rivers Balanced Income Portfolio	*0.6%*	*1.2%*	*1.7%*	*6.0%*	*6.0%*	13.7%

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