Current Focus

July 2018

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

RIVERS CAPITAL MANAGEMENT

INTELLIGENT INTUITIVE INVESTING

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Summary

- Positive returns in second quarter reversed losses year to date
- Equity valuation levels near the high point at the start of the the year
- US Earnings expected to be very strong for Q2 but gains already reflected in price
- Valuation and poltical risks remain high and justify catious allocation to risk

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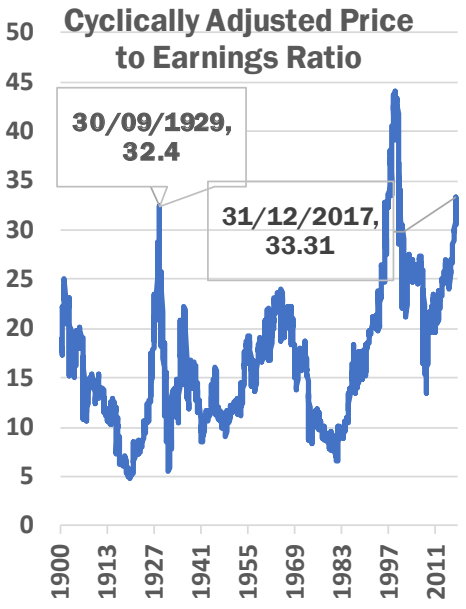
Market Comment

Trade-war rhetoric re-emerged in June. The US tariffs being discussed seemed to relate to Europe and Canada but the main target, as far as President Trump is concerned, remains China. In the UK, not- withstanding the welcome distraction of the World Cup, all political focus appears to now be on Brexit and the clock ticking inexorably towards the March 2019 deadline when the UK leaves the EU. Negotiations need to make progress by October but so far there appears to be scant sign of that. Whatever your politics what is gradually unravelling is unlikely to have been what you had hoped for 2 years or even 2 months ago. This will undoubtably be huge for all of us in the coming year but this month we will again leave that debate to others. Instead our Focus for June will be on the coming second quarter earnings season and its likely effect on equity valuations.

Having experienced what is best described as a 'wobble' in the first quarter, global equity markets recovered most of these losses to finish the second quarter in the black. Economically many concerns over the sustainability of strong global growth have not come to fruition and generally corporate earnings have remained very strong despite concerns surrounding geo-politics, trade wars and Brexit. In fact, with US corporations having reported an average earnings growth of an impressive 24% in the first quarter there are many who argue the bull market stateside is likely to continue for some time yet. We are still relatively sceptical of that and believe that with valuations still very high the geo-political factors will, in time, have a marked effect on the markets.

A quick look at the cyclically adjusted valuation measure, the CAPE Shiller, shows that despite strong earnings how high equity valuations in the world's biggest market remain. This index peaked at 43.2 in 2000, during the Dot Com bubble, but apart from then has never been higher than where it was in January this year (33.2). We were concerned about it then and despite the high volatility seen in the first quarter, very strong earnings, and a generally flat market, this has not changed significantly. The fact that it remains so high (currently 32.8), if anything, indicates what level of earnings growth is required going forward.



Source: RCM

Valuations alone are not a good indicator of market inflection points, but unless the growth achieved in the first quarter can be sustained for a long time it does justify a cautious approach.

On the other hand, corporate earnings for the second quarter are expected to remain very strong in the United States. According to analysts, earnings for the broad large company index, the S&P500, are expected to exceed those from the same period last year by over 20%. At a 20% growth rate earnings will mark the second highest earnings growth reported by the index since Q3 2010 (34.0%), trailing only the previous quarter (24.8%). It will also mark the third straight quarter in which the index has reported double-digit earnings growth. The Oil and Gas sector is expected to have seen the biggest growth over the last year. The combination of a year-over-year increase in oil prices and a comparison to unusually low earnings in the year-ago quarter are the main drivers. The earnings growth is not expected to be so high in other sectors but is broad enough, it is predicted, to include all eleven sectors.

With such positive expectations the question for us as investors is how much of this is already 'priced in' to the index

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and how sustainable this high level of growth is. Much will depend on the future guidance given from corporations and to what extent any benefit from tax reduction can be converted into further growth. As was seen after the first quarter the level of corporate earnings growth that is required just to sustain index levels is high and unless current high expectations improve it is unlikely to be a catalyst for further appreciation. This leaves little room for improvement and a lot of room for disappointment. US interest rate increases and the politics of trade tariffs will likely affect future expectations more than past earnings and how this is reflected in corporate forecasts is as significant as earnings. Add that to the fact that it has been nearly 10 years since the last meaningful recession in the US and the reasons to remain cautious, to us at least, are clear.

Brexit and UK political malaise look set to dominate news headlines in the UK over the summer but thankfully, it will be the direction of global growth which will largely determine investors returns. That direction remains positive but with valuations and pollical risk still elevated we would prefer to remain invested but with a moderate underweight to risk. This allows the opportunity to increase risk later in the year when valuations may have improved. In the meantime, we can try to ignore the Brexit negotiations for a couple more weeks and enjoy the world cup. A World Cup which maybe, I hope, is 'coming home'.

Market Returns (£) - 30th June 2018	1 Month	3 Month	6 Month	YTD	1 Year	S/I*
Anchors						
Cash + 1%	0.1%	0.4%	0.8%	0.8%	1.5%	2.9%
Inflation Linked UK Bonds	0.7%	2.8%	0.7%	0.7%	1.6%	5.6%
Gilts	-0.6%	0.2%	0.2%	0.2%	2.0%	1.0%
Global Government Bonds (hedged)	0.2%	-0.1%	0.1%	0.1%	0.8%	-1.9%
Enhancers						
Global Corporate Bonds (hedged)	-0.5%	-0.9%	-2.7%	-2.7%	-0.8%	1.1%
Global High Yield (hedged)	-0.6%	-1.6%	-2.7%	-2.7%	-0.4%	10.5%
Emerging Market Bonds (hedged)	-2.1%	-5.6%	-4.7%	-4.7%	-4.6%	5.5%
FTSE 350 TR Index	-0.2%	9.3%	1.7%	1.7%	9.1%	28.4%
FTSE UK All-Small Cap	-0.5%	6.2%	1.2%	1.2%	8.7%	40.2%
Global Equity (MSCI)	0.7%	8.1%	2.9%	2.9%	9.3%	33.0%
European Equity (MSCI)	0.1%	4.5%	-1.0%	-1.0%	3.6%	29.1%
US Equity (S&P)	1.4%	9.7%	4.9%	4.9%	11.9%	34.9%
Japan Equity (Topix)	-1.9%	3.1%	0.4%	0.4%	9.5%	36.0%
Pacific Ex Japan Equity (MSCI)	-4.4%	0.0%	-2.1%	-2.1%	8.6%	42.8%
Emerging Market Equity (MSCI)	-3.4%	-2.2%	-4.4%	-4.4%	6.5%	35.6%
Chinese Equity (Hang Sang)	-3.8%	3.6%	0.4%	0.4%	13.8%	48.8%
Indian Equity (Nifty)	-1.4%	7.5%	-2.7%	-2.7%	5.2%	31.5%
Diversifiers						
Commodity Index	-3.7%	0.0%	-0.9%	-0.9%	5.8%	-2.0%
Gold	-2.9%	0.4%	-2.2%	-2.2%	-1.4%	-5.6%
Silver	-1.1%	5.4%	-3.7%	-3.7%	-5.2%	-14.5%
Brent Oil	1.6%	18.7%	20.4%	20.4%	61.1%	59.8%
UK Property	0.3%	1.4%	2.8%	2.8%	6.8%	11.5%
Global Property Shares	0.5%	5.0%	1.0%	1.0%	9.3%	20.1%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*-0.6%*	*0.5%*	*-0.1%*	*-0.1%*	*2.3%*	9.1%
Rivers Cautious Portfolio	*-0.5%*	*2.0%*	*0.4%*	*0.4%*	*3.7%*	15.5%
Rivers Balanced Portfolio	*-0.3%*	*3.4%*	*1.1%*	*1.1%*	*5.3%*	20.0%
Rivers Adventurous Portfolio	*-0.2%*	*3.9%*	*1.1%*	*1.1%*	*5.1%*	22.2%
Rivers Aggressive Portfolio	*-0.2%*	*5.1%*	*1.0%*	*1.0%*	*6.6%*	28.0%
Rivers Cautious Income Portfolio	*-0.1%*	*2.3%*	*-0.1%*	*-0.1%*	*1.1%*	8.1%
Rivers Balanced Income Portfolio	*-0.1%*	*3.5%*	*0.8%*	*0.8%*	*2.7%*	14.8%

Source: Financial Express in GBP (unhedged unless stated) as at 30th June 2018. *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.