Current Focus

October 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

- Economic growth in the US has accelerated despite political uncertainty fears of trade war
- Low interest rates and the recent fiscal boost has escalated fears the economy may overheat
- The Fed has warned that interest rates remain accommodative and will continue to rise
- Equity valuations remain the primary concern although economic growth will continue

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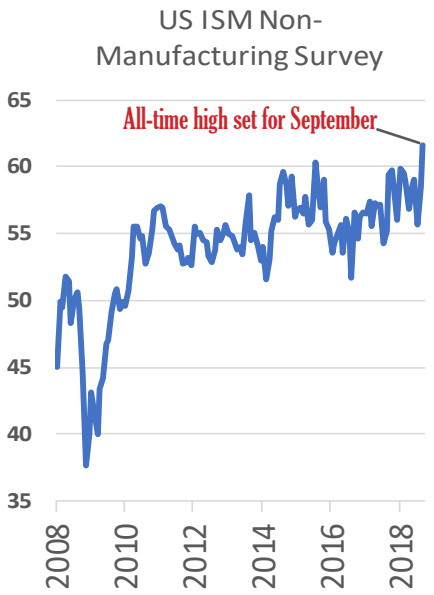
Market Comment

September saw new all-time highs in US equity indices despite several apparent head winds. Rising interest rates, high equity valuations, political uncertainty, imminent trade war, to name just a few. Despite all this there is little doubt that the US economy is booming. Trump may be objectionable in many eyes and he may be benefiting from the economic policy decisions made before him, but the US economy is certainly strong. This month we Focus on what is happening in the US Economy and US Equities. We look at interest rates and explain why we think they are likely to rise more, not less, than current expectations. While the US economic boom will not last forever we are not expecting the trajectory of the US economy to change imminently. A slowdown will come as loose monetary and fiscal policy reverse, but we do not expect that in the next 12 months. How the market interprets the growing headwinds is difficult to forecast but volatility is more likely to rise and should provide opportunities to reallocate risk.

After 8 years of interest rates at record lows, the US economy began gaining traction in 2016. The fiscal boost provided by the Trump tax cuts introduced last year has accelerated that recovery despite interest rates rising from zero to 2% over the last 2 years. Current expectations are for one more rate rise this year followed by 3 next year. This would take short term US rates to about 3% by the end of 2019. Many economists question whether, given the fiscal boost, the current policy of gradually increasing rates is appropriate. Given that Federal Reserve Chair Jerome Powell said, when recently asked if the economic outlook in the US was too good to be true, it was "a reasonable question", the Fed may agree.

As a measure of the 'too good to be true' economy, the ISM survey for US Non-Manufacturing came in at 61.6 for September, a record-high and beating the expectation of 58. With any value over 50 predicting expansion this level is unprecedented in the 21 years of the survey. Should this level be sustained it is consistent with US GDP growing at about 7% per annum. Few think that growth at this pace is likely, but the effect on wages, and therefore inflation, with unemployment at historical lows, is a concern.



Chairman Powell also said that he feels interest rates were still 'accommodative', and therefore below the level he would consider neutral. Perhaps the interest rate Hawks have a point. An economy growing at over 4% with sub 4% unemployment should no longer require loose monetary policy. Monetarists would argue that when growth is strong rates should be 'restrictive' (i.e. above neutral) to avoid inflation and to enable rates to be 'accommodative' (i.e. below neutral) during downturns to encourage investment and soften the landing. Keynesians would say something similar regarding Fiscal policy, but so far it seems that no one has told President Trump. Many debate what is 'normal' for interest rates in a deflationary environment of an aging population and technology. 'Normal' rates are probably lower than the historical level of 4-5% but if the Chairman of the Federal Reserve says that current rates are 'accommodative' current rate expectations may be set to change. It seems likely now that that interest rates could rise more significantly than is currently suggested, if only to enable them to be effectively reduced during a downturn.

What this means for the US economy is that short term interest rates could exceed long-term interest rates (currently 3.05%) by about the middle of next year and may continue to rise. This inversion of the yield

curve is a reliable indicator of impending recession, and will coincide with the reversal of the tax cuts introduced by President Trump. Fiscal and Monetary tightening are not a welcome combination for investors. Nouriel Roubini is not usually known for his optimism, but his recent description of this scenario as the 'perfect storm' for the US in 2020, is worth considering. As we know, 2020 coincides with the Presidential election, so the politics surrounding it, and the independence of the Federal Reserve, will be interesting. President Trump's criticism of the Fed for raising rates in July when US GDP growth was over 4% was unprecedented, imagine his reaction to them if the economy is slowing and he is seeking re-election.

From an investment perspective few of these concerns are currently priced into valuations. In fact, despite the boost to earnings from the impressive economic growth, and the tax cuts, US Equity valuations, as measured by the Cape Shiller index, have increased to a higher level than in January. This, and not our medium-term concerns about the economics in the US was the reason we cut risk during September, having raised it after the correction earlier this year. As we said in the introduction, there are few signs that either current monetary or fiscal policy will affect US economic growth for at least 12 months. While the trade war escalation, and dollar strength, has impacted non-US assets it has, so far, not affected US equities. Animal spirits are strong and confidence high (at least in the US). We do expect these to increase volatility and will continue to adjust the risk allocation to the portfolios we manage accordingly.

Market Returns (£) - 30th Sep 2018	1 Month	3 Month	6 Month	YTD	1 Year	S/I*
Anchors						
Cash + 1%	0.1%	0.4%	0.9%	1.3%	1.6%	3.4%
Inflation Linked UK Bonds	-1.1%	-0.4%	2.3%	0.3%	2.3%	5.1%
Gilts	-1.6%	-1.8%	-1.7%	-1.6%	0.6%	-0.8%
Global Government Bonds (hedged)	-0.5%	-0.8%	-1.0%	-0.7%	-0.3%	-2.7%
Enhancers						
Global Corporate Bonds (hedged)	-0.4%	0.4%	-0.5%	-2.3%	-1.4%	1.5%
Global High Yield (hedged)	1.3%	1.8%	0.2%	-0.9%	-0.6%	12.5%
Emerging Market Bonds (hedged)	2.4%	-0.2%	-5.8%	-4.8%	-5.7%	5.3%
FTSE 350 TR Index	0.7%	-0.8%	8.4%	0.9%	5.9%	27.3%
FTSE UK All-Small Cap	-0.1%	-0.2%	6.0%	1.0%	5.3%	39.9%
Global Equity (MSCI)	0.2%	6.3%	14.9%	9.4%	14.4%	41.3%
European Equity (MSCI)	0.2%	2.1%	6.7%	1.0%	2.5%	31.8%
US Equity (S&P)	0.2%	8.9%	19.5%	14.2%	20.6%	46.9%
Japan Equity (Topix)	2.7%	4.5%	7.7%	4.9%	13.0%	42.1%
Pacific Ex Japan Equity (MSCI)	-0.8%	-0.3%	-0.3%	-2.4%	4.5%	42.4%
Emerging Market Equity (MSCI)	-0.9%	0.1%	-2.1%	-4.2%	2.1%	35.8%
Chinese Equity (Hang Sang)	0.0%	-1.0%	2.5%	-0.6%	7.2%	47.3%
Indian Equity (Nifty)	-8.7%	-2.0%	6.1%	-4.0%	4.9%	29.7%
Diversifiers						
Commodity Index	1.8%	-2.4%	-2.4%	-3.3%	1.0%	-4.4%
Gold	-1.0%	-3.8%	-3.4%	-6.0%	-5.0%	-9.2%
Silver	0.9%	-8.2%	-3.3%	-11.6%	-10.1%	-21.5%
Brent Oil	4.1%	4.9%	24.5%	26.3%	45.0%	67.6%
UK Property	0.1%	0.7%	2.1%	3.5%	5.8%	12.3%
Global Property Shares	-2.5%	-5.0%	-0.3%	-4.1%	3.8%	14.1%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*-0.3%*	*0.1%*	*0.6%*	*0.0%*	*1.0%*	9.2%
Rivers Cautious Portfolio	*-0.5%*	*1.2%*	*3.2%*	*1.5%*	*3.3%*	16.8%
Rivers Balanced Portfolio	*-0.9%*	*1.5%*	*4.9%*	*2.6%*	*5.2%*	21.8%
Rivers Adventurous Portfolio	*-1.2%*	*1.4%*	*5.4%*	*2.5%*	*5.2%*	23.9%
Rivers Aggressive Portfolio	*-1.2%*	*1.6%*	*6.8%*	*2.7%*	*6.4%*	30.1%
Rivers Cautious Income Portfolio	*-0.3%*	*0.4%*	*2.7%*	*0.4%*	*1.3%*	8.6%
Rivers Balanced Income Portfolio	*-0.4%*	*0.2%*	*3.7%*	*1.0%*	*2.4%*	15.0%

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