Current Focus

July 2019

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

INTELLIGENT INTUITIVE INVESTING

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Summary

- Portfolio returns remain strong driven by expectation of central bank intervention
- Interest are low and at the limit of conventual policy for many economies
- The US and China are able to provide some stimulus if slowdown is limited
- Valuations look high given Central Bank constraints
- Rivers portfolios remain defensively positioned with diversification maximised

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Market Comment

Despite rising concerns regarding global growth, June saw expectations for a fall in interest rates boost equity markets. With the global economy slowing and inflation falling below the targets set by many Central Banks, in this month's Focus we consider what the next easing cycle from policy makers will look like. With conventional monetary policy seemingly much more constrained than it was ten years ago the options appear limited.

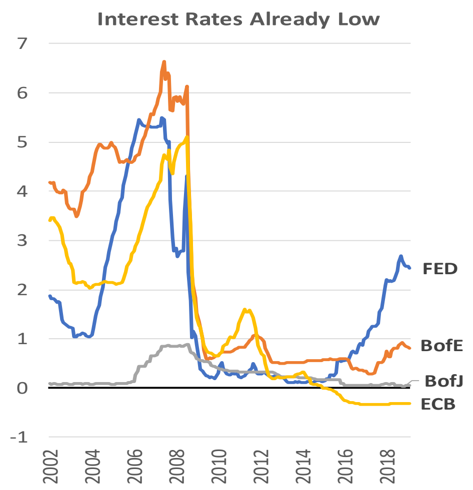
When the financial crisis occurred over ten years ago, developed-economy Central Banks lowered interest rates aggressively, including a major coordinated move in 2008. Now, however, policy choices are constrained by low and in many cases negative interest rates. Faced with the unappetising prospect of pushing rates further into negative territory, some Central Banks may choose immediately to opt for unconventional measures and asset purchases.

If global economies only encounter a modest slowdown, with growth and inflation in the 1% to 1.5% range, then policy makers everywhere can probably respond with a mix of limited rate reductions and commitments to keep monetary policy loose for an extended period. This seems to be the consensus view and probably why equity markets have remained so positive during June. After all, the U.S. economy grew more than 3% on an annualised basis last quarter, and the eurozone grew 1.6%, led by Germany, which eased fears of a recession in Europe. China's economy has slowed, but the People's Bank of China has taken steps to boost lending.

If global growth stalls, and key economies enter recession, things could get tricky. Central bankers may then have to confront the limits of what they can do with their depleted tool kits, As well as potential asset bubbles that could cause destabilising ripples if they burst.

The big question is what happens if there's a big shock. There you get quite quickly to the limits of monetary policy. Trouble spots linger that could trigger just such an outcome, such as the U.S.-China trade war, the build-up of corporate debt and rising prices for homes and other assets in some countries, including China. In that case, whatever mix of measures the world's Central Banks bring forth to combat the next recession, it may not be enough. Also any eventual downturn could worsen if investors grow concerned that the Central Banks are unable to turn things around.

China's central bank is probably in the



Source: Short Term Rates - OECD.org

strongest relative position and it has been the most significant to have acted in the last few months. It announced on May 6 that it would lower the reserve-requirement ratio for the nation's small and medium-size banks, releasing about 280 billion-yuan ($40 billion) liquidity to encourage more bank lending to private small businesses. This easing move was also seen as a sign that Beijing was attempting to shore up market sentiment amid renewed trade tensions with the U.S. In the coming months it is likely that the PBC may cut open-market interest rates to reduce financing costs for lenders.

The only other major Central Bank with some flexibility is the U.S. Federal Reserve which, after raising interest rates over the last 2 years, is expected to change tack and lower rates within months. The Federal Funds rate has been between 2.25% and 2.5% since the rate increase in December. The market is currently 'pricing-in' a U.S. rate cut in July and at least one further cut before year end. If a recession were to loom that led to increased unemployment and inflation came down towards zero, even the Fed would run out of conventional ammunition very quickly. It lowered rates by more than 5 percentage points in a little over a year from 2007 to late 2008. It cut rates by a similar amount from 2001 to 2003 after the tech bubble burst, even though that recession was milder than the one during the financial crisis. It now has less than half that much room in which to start lowering rates before it hits negative-rate territory.

The European Central Bank is in a more difficult position, with real rates below zero in much of the region. Cutting rates, even under the new stewardship of Christine Lagarde (announced on July 2nd) wouldn't do much to stimulate their economies and could further weaken the commercial banks. Some members of the European Central Bank's rate council discussed lowering rates or restarting bond purchases at their June 6 meeting, outgoing ECB President Mario Draghi said after the meeting. The deposit rate has been at minus 0.4% since 2016, and the ECB only recently ended net bond purchases under its quantitative-easing program, which it started years after the Fed did. But restarting it might not help much and would prove controversial in Germany.

The most constrained Central Bank of all must be the Bank of Japan (BOJ) who, despite strong global growth for the last few years, has taken unconventional monetary policy to new levels. The BOJ, which now holds nearly half of all Japanese government bonds in circulation, has slowed the pace of its asset purchases from ¥80tn ($715bn) a year to about half of that but remains the most aggressive in the world. There is little incentive to increase the QE program in Japan who openly now admits it is more dependent on policy in the US and China.

In the U.K. the issue of Brexit remains dominant, and the effect of a global slowdown will likely exacerbate any impact this uncertainty may cause. In contrast to the strong global growth that coincided with sterling's fall in value in 2016. The one positive is that the Bank of England has slightly more room for manoeuvre than the ECB having at least maintained positive rates, but there is not much in it.

With many equity indices at or above valuations seen in September, despite slowing growth, the market seems to be relying on Central Banks at a time where their effectiveness appears to be constrained. While the effect of quantitative easing on asset prices has been significant so has the effect of an economic slowdown. Given this we believe a defensive allocation remains appropriate for the coming months.

Market Returns (£) - 30th June 2019	1 Month	3 Month	6 Month	YTD	1 Year	3Y S/I*
Anchors						
Cash + 1%	0.1%	0.5%	0.9%	0.9%	1.8%	4.8%
Inflation Linked UK Bonds	0.6%	4.7%	6.3%	6.3%	7.5%	13.5%
Gilts	0.2%	1.4%	5.0%	5.0%	5.3%	6.3%
Global Government Bonds (hedged)	1.2%	2.4%	4.6%	4.6%	5.7%	3.6%
Enhancers						
Global Corporate Bonds (hedged)	1.9%	3.4%	7.6%	7.6%	7.6%	8.8%
Global High Yield (hedged)	2.7%	2.4%	8.6%	8.6%	6.6%	17.8%
Emerging Market Bonds (hedged)	4.4%	8.3%	9.1%	9.1%	14.3%	20.6%
FTSE 350 TR Index	3.8%	3.3%	13.1%	13.1%	0.7%	29.3%
FTSE UK All-Small Cap	0.6%	2.9%	8.7%	8.7%	-2.7%	36.4%
Global Equity (MSCI)	5.6%	6.5%	17.1%	17.1%	10.3%	46.6%
European Equity (MSCI)	5.7%	7.2%	16.1%	16.1%	6.2%	37.0%
US Equity (S&P)	6.0%	6.6%	18.3%	18.3%	13.9%	53.6%
Japan Equity (Topix)	2.6%	2.7%	7.5%	7.5%	-2.1%	33.1%
Pacific Ex Japan Equity (MSCI)	6.4%	1.6%	11.1%	11.1%	2.3%	46.1%
Emerging Market Equity (MSCI)	5.2%	3.0%	10.7%	10.7%	5.0%	42.3%
Chinese Equity (Hang Sang)	6.1%	2.8%	13.1%	13.1%	6.8%	58.9%
Indian Equity (Nifty)	-1.2%	2.9%	8.6%	7.8%	12.8%	41.8%
Diversifiers						
Commodity Index	1.7%	1.2%	5.1%	5.1%	-3.3%	-1.7%
Gold	7.0%	11.6%	10.1%	10.1%	16.3%	9.8%
Silver	4.0%	3.4%	-1.8%	-1.8%	-2.7%	-16.8%
Brent Oil	2.0%	-0.1%	24.6%	24.9%	-11.6%	41.6%
UK Property	0.0%	0.3%	0.7%	0.7%	1.4%	13.1%
Global Property Shares	0.3%	-2.0%	9.1%	9.1%	-6.0%	12.9%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*0.9%*	*1.7%*	*3.8%*	*3.8%*	*2.4%*	11.8%
Rivers Cautious Portfolio	*1.8%*	*3.1%*	*7.0%*	*7.0%*	*4.5%*	20.7%
Rivers Balanced Portfolio	*2.5%*	*3.5%*	*8.6%*	*8.6%*	*5.5%*	26.6%
Rivers Adventurous Portfolio	*2.8%*	*3.8%*	*9.7%*	*9.7%*	*6.0%*	29.5%
Rivers Aggressive Portfolio	*4.0%*	*4.9%*	*11.6%*	*11.6%*	*5.9%*	35.6%
Rivers Cautious Income Portfolio	*1.5%*	*2.4%*	*6.9%*	*6.9%*	*3.6%*	12.0%
Rivers Balanced Income Portfolio	*1.8%*	*3.0%*	*7.8%*	*7.8%*	*3.4%*	18.7%

Source: Financial Express in GBP (unhedged unless stated) as at 30th June 2019. *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.