Current Focus

June 2021

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

- Central Bank stance currently adding more liquidity than any time during the financial crisis
- Inflation continues to rise and shows few signs of being transitory
- Economic growth now almost certain but supply constraints likely to persist
- Government deficits and central bank balance sheets on unsustainable trajectory
- High liquidity inflates asset prices but if left unchecked could end very abruptly

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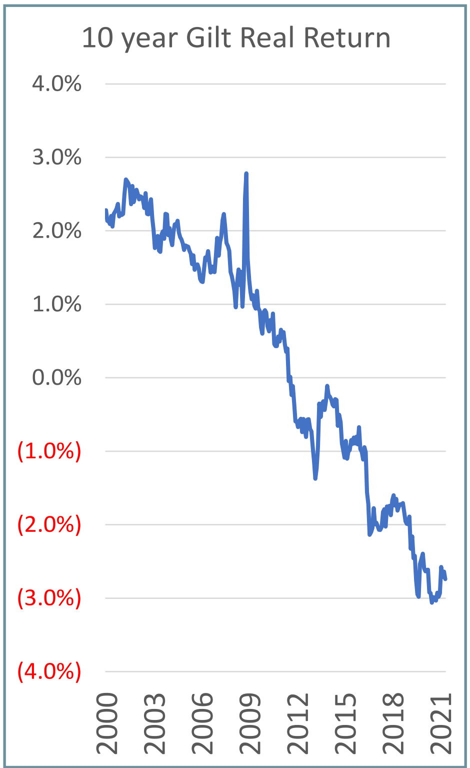
Market Comment

In this month's Focus we discuss the topic of inflation and the potential impact on markets. We are in unusual times and wanted to discuss some of the common arguments about whether inflation is temporary and transitory or more likely to be sustained. We also look at just how extreme the current policies of the US Federal Reserve in particular, but also the Bank of England and the European Central Bank, appear given increasing growth expectations. It looks to us like Central Banks are risking an inflationary spiral and not reacting to the accelerating growth potential. Despite recent investment market gains, should the current level of inflation rise, it could be negative for the economy. If left too late in order to protect the investment markets, when Central Banks do decide to put on the brakes, it may damage the real economic recovery unnecessarily.

By any measure inflation in the US, and the UK, is rising. At the initial peak of the pandemic last year Central Banks in most major economies, backed by fiscal support from governments, cut interest rates to zero and implemented quantitative easing at levels that were materially greater than any seen in the aftermath of the financial crisis. For comparison in November 2008 the Fed announced it would buy $600bn in agency MBS paper but would offset this unprecedented step by a similar sale of short dated treasury debt. Having not solved the liquidity problem for banks, in March 2009 the Fed announced its plan to purchase, and not offset, up to $300bn of treasury debt. This was historically the first quantitative easing seen in the US. In March 2009 the stock market was crashing due to a liquidity crisis and the inflation rate in the US was negative for the first time in decades. By contrast in 2020 the Fed cut rates to zero again and announced an immediate and unprecedented $3triillion QE program. Due to the unknown nature of a global pandemic, and again a falling market and low inflation, this intervention was welcomed. A year on, however, the insistence on zero interest rates ad infinitum and an indefinite QE program of $120billion a month appears, to us, a different situation entirely. With fiscal stimulus adding to pent up consumer and business demand coming out of lockdown, some obvious medium term supply constraints and the US stock market at all-time highs the situation could not be more different. It is difficult to imagine a period of higher liquidity.



Source: Bank of England

The primary argument heard from Central Banks, for continuing their policies, is that inflation is transitory and worth risking to ensure a sustained recovery. Federal Reserve Chair Jerome Powell made the latest of multiple attempts by Fed officials to reassure markets that they have nothing to fear from a temporary bout of higher inflation in the U.S. The reason most often given for inflation's current temporary nature is due to inflation expectations which are apparently well anchored, but is this the case? Looking at the breakeven rate on US Inflation-linked bonds suggests investors do not appear too 'anchored', currently 2.45% up from 0.14% last summer. The last time it was that high was in April 2011.

The evidence from almost all supply chains or commodities also appears to contradict the transitory argument. Even in the sector most often used as the deflationary stalwart, technology, is having to deal with rising computer chip prices due to shortages which are expected to last at least into 2022. The semi-conductor shortage directly affects the car industry and other industrial sectors. In the endeavour to increasingly turn to green energy and the lack of investment in traditional energy, especially oil and gas, has led to price rises there that look likely to continue. A study of history shows that sustained low inflation was generally the belief of central bankers in the mid-1960s following an extended period when inflation had been firmly anchored below 2%. Over the next five years inflation rose steadily before spending most of the 1970s over 10%. We don't expect that now but the market continuing to price in low rates and falling costs is very optimistic in our view.

We could be wrong and it is true that a reflationary boost helps some markets grow profits without excess costs, but there is an awful lot more optimism than caution currently priced into equity valuations. If we are correct and inflation continues to rise over the next few months, the Fed, and other Central Banks ,will change their language around inflation being merely transitory in nature. This will be the first indicator. Just last week the Dallas Fed President stated: 'we're going to have to put on the brakes not before too long' this immediately impacted the market which was only calmed by repeated reassurance that this wasn't 'tapering' but the start of possible thinking about tapering.

If they are not yet openly discussing 'tapering' once they accept inflation is not transitory, the market will, we suspect, react more than they did in mid-June, as they will have to react faster. In terms of our portfolios we are looking for a change, and positioned defensively as a result. Current valuation may get higher still, especially if the current policy is continued and the portfolios will participate but growth is expected more through Diversifiers than Enhancer assets. The risk of the current stance of Central Banks being marked as a policy error is high and the rewards of full participation from here seem modest. We would prefer to wait for opportunities to add risk at more attractive prices in the coming months.

Market Returns (£) - 31st May 2021	1 Month	3 Month	YTD	1 Year	3 Year	S/I*
Anchors						30/06/2016*
Cash + 1%	0.1%	0.3%	0.4%	1.1%	4.7%	7.6%
Inflation Linked UK Bonds	2.9%	5.7%	-2.8%	-3.4%	15.2%	26.1%
Gilts	0.5%	1.1%	-6.5%	-7.7%	8.7%	10.5%
Global Government Bonds (hedged)	0.2%	0.0%	-2.5%	-1.8%	9.0%	6.7%
Enhancers						
Global Corporate Bonds (hedged)	0.5%	0.2%	-2.1%	3.9%	15.6%	17.4%
Global High Yield (hedged)	0.6%	1.7%	1.8%	14.3%	15.0%	27.8%
Emerging Market Bonds (hedged)	-0.1%	0.7%	-4.3%	-4.2%	5.5%	13.7%
FTSE 350 TR Index	1.1%	9.5%	10.7%	22.2%	5.1%	35.2%
FTSE UK All-Small Cap	2.3%	13.0%	18.2%	53.8%	33.3%	87.8%
Global Equity (FSTI)	-1.2%	7.9%	7.1%	22.3%	40.2%	85.0%
European Equity (FSTI)	1.6%	10.5%	9.0%	23.6%	20.8%	55.8%
US Equity (S&P)	-1.7%	9.1%	8.4%	21.8%	51.7%	101.8%
Japan Equity (Topix)	-1.4%	-0.4%	-2.5%	7.2%	8.7%	49.7%
Pacific Ex Japan Equity (FSTI)	-2.3%	-1.6%	1.7%	30.2%	25.5%	87.5%
Emerging Market Equity (FSTI)	-0.3%	1.6%	3.2%	31.3%	23.4%	73.2%
Chinese Equity (Hang Sang)	-0.5%	-0.1%	3.9%	14.2%	0.1%	54.8%
Indian Equity (Nifty)	5.9%	8.3%	8.8%	46.3%	30.7%	65.8%
Diversifiers						
Commodity Index	0.3%	7.3%	14.7%	27.5%	-0.3%	4.2%
Gold	5.1%	8.4%	-3.5%	-7.4%	31.5%	27.9%
Silver	5.7%	4.3%	2.0%	28.6%	51.0%	30.6%
Brent Oil	0.3%	7.3%	14.7%	27.5%	-0.3%	4.2%
UK Property	0.8%	2.0%	3.2%	4.0%	3.2%	14.8%
Global Property Shares	1.8%	10.7%	11.4%	23.0%	6.0%	26.6%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*0.4%*	*1.4%*	*-0.1%*	*3.2%*	*7.3%*	17.5%
Rivers Cautious Portfolio	*0.5%*	*2.7%*	*1.3%*	*7.8%*	*15.7%*	34.3%
Rivers Balanced Portfolio	*0.5%*	*3.5%*	*2.2%*	*11.7%*	*20.8%*	45.5%
Rivers Adventurous Portfolio	*0.4%*	*4.5%*	*3.2%*	*15.8%*	*26.3%*	54.8%
Rivers Aggressive Portfolio	*0.7%*	*5.2%*	*4.3%*	*19.5%*	*27.6%*	63.9%
Rivers Cautious Income Portfolio	*0.4%*	*2.4%*	*1.2%*	*9.1%*	*9.3%*	18.3%
Rivers Balanced Income Portfolio	*0.4%*	*3.1%*	*2.2%*	*12.4%*	*11.6%*	28.4%

Source: Financial Express in GBP (unhedged unless stated) as at 31st May 2021. *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.