Current Focus

April 2022

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

- Economic growth remains strong but high inflation is challenging its sustainability
- BofE and FED have allowed this escalation but are now maximising hawkishness
- Wage increases concern the Central Bankers more than commodity prices
- The risk is highest in the UK where sterling weakness enhances the problem
- We see opportunity for tactical investment and still expect positive real returns going forward

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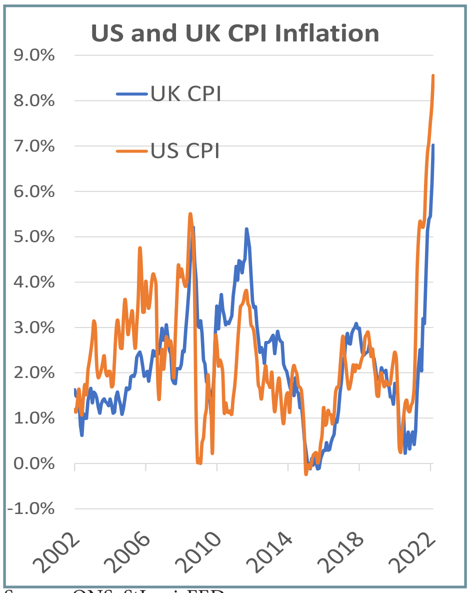
Market Comment

Global economic growth has been positive throughout the first quarter of 2022 and unemployment levels continue to fall across the world. Despite this, consumer and investor confidence has fallen considerably since the highs seen in December and January. The reason for this is inflation. Inflation that is global and has been rising since late 2020; inflation that has been accelerated by the tragic events in Ukraine; and inflation that is now (finally) seriously worrying Central Bankers. Having imprudently delayed any response to inflation during 2021 Central Bankers are now increasing inflationary rhetoric with many planning substantial interest rate rises in the coming months. For the first time in decades the choice between sustaining GDP growth or subduing inflation will have to be made. In this month's Focus we look more closely at that choice. We consider the likely measures needed for inflation to be controlled both in the UK and the US. We look at why the inflation risk appears higher in the UK and its threat to Sterling's value and finally we consider what investment implications and opportunities we expect all this to have on the portfolios we manage.

It is hard to believe that only a year ago, in April 2021, minutes from the Federal Reserve monetary policy meeting "signalled a strong likelihood that there may be no rate hikes through 2023." Similarly the Bank of England in March 2021 said "it does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity". A year on and on April 20th the governor of the Bank of England said he was "concerned about the risks of persistent inflationary pressure from a strong labour market" and the Federal Reserve Chairman said "We're really going to be raising rates and ..tightening policy if that turns out to be appropriate once we get [to neutral levels]". Interest rates are now expected to rise to 2.5% in the UK over the next 12 months and 2.8% in the US by the end of this year. This has led to a substantial fall in bond values globally and a flattening of the yield curves. The question now is whether it will be enough (to slow inflation) and what consequence it may have on economic growth and corporate earnings.

The argument against a higher interest rate policy, particularly in the UK, is that the rising cost of living, especially for energy



Source: ONS, StLouisFED

and food, will naturally reduce demand to sufficiently combat inflation. The UK is uniquely positioned as it is both very exposed to rising living costs and is close to full employment. It also has a number of Brexit related inflationary pressures to contend with. This is why, unlike the US, medium term (say 5 year) inflation expectations continue to materially exceed medium term Gilt yields. This explains the recent weakness in Sterling's value and leaves the Bank of England in the difficult position of having to increase rates further (than the 2.5% currently expected) increasing government debt financing costs and probably assuring recession. The alternative is to allow inflation to continue and risk stagflation as real economic growth slows. History tells us the latter is more likely to occur first with the former becoming inevitable after some time.

In the US there appears to be slightly more monetary flexibility. The employment market is similar to the UK, in being close to full employment and overheated, but there is less pressure from rising food and energy costs, particularly those resulting from the Ukraine conflict. The Federal Reserve is also to start selling some of the bonds it accumulated over the last ten years in what is being deemed as 'quantitative tightening' (QT). This should help increase the slope of the yield curve and create positive real medium term Treasury returns. If medium term Treasury returns start to exceed say

3.5% (higher than medium term inflation) we can expect to see capital flows increasing from equity to bonds. This may not prevent recession in the US but it has interesting investment implications. It's bad for Gold, bad for the inflated US property market and bad for higher valued technology sector. In fact it is bad for any equity where earnings multiples are high. The earnings per share may remain higher (than inflation) but no longer higher enough to justify the uncertainty of equities.

These investment consequences have already started, despite Central Banks having done little but talk, but we expect them to continue in the coming months. Interestingly despite the "very, very fine line", to quote governor Bailey, that the Bank of England is now having to tread, we think the broad UK equity market is much less susceptible to downside than the US equity market. This is because we expect any correction to be very sector specific in the coming months. This also explains why, in terms of overall risk in the portfolios we manage, we expect to be adding risk in the near term, not cutting it.

Before the end of the year we hope to get answer to the question of whether slowing economic growth through rate rises (and other costs) will be sufficient to tame inflation. If it is not, in the US, UK or globally, will central banks continue to raise rates or will they pause and risk inflation becoming entrenched (if it isn't already). Only time will tell. For now we are avoiding expensive equity sectors and will be opportunistically increasing risk by adding better priced Enhancer and Diversifier assets.

Market Returns (£) - 31st March 2022	1 Month	3 Month	1 Year	3 Year	5 Year	S/I*
Anchors						30/06/2016*
Cash + 1%	0.0%	0.0%	-0.1%	0.9%	1.6%	1.8%
Inflation Linked UK Bonds	-2.7%	-5.7%	4.6%	9.6%	16.5%	27.2%
Gilts	-2.2%	-7.6%	-5.4%	-1.3%	3.1%	3.5%
Global Government Bonds (hedged)	-2.2%	-4.5%	-3.8%	1.2%	5.8%	2.4%
Enhancers						
Global Corporate Bonds (hedged)	-2.2%	-6.8%	-4.6%	5.1%	10.3%	10.6%
Global High Yield (hedged)	-0.7%	-5.3%	-2.9%	5.7%	11.7%	21.7%
Emerging Market Bonds (hedged)	1.2%	0.2%	3.5%	3.8%	3.6%	15.5%
FTSE 100 TR Index	1.4%	2.9%	16.1%	15.5%	24.6%	44.3%
FTSE UK All-Small Cap	1.5%	-6.0%	5.7%	38.9%	48.2%	84.1%
Global Equity (MSCI)	4.7%	-2.4%	15.4%	50.4%	70.6%	107.2%
European Equity (MSCI)	0.7%	-7.0%	5.9%	22.1%	29.2%	55.9%
US Equity (S&P)	5.7%	-2.0%	20.7%	63.9%	94.0%	136.1%
Japan Equity (Topix)	0.7%	-3.7%	-3.1%	17.1%	23.7%	50.3%
Pacific Ex Japan Equity (MSCI)	-2.0%	-6.4%	-14.7%	10.9%	27.3%	59.6%
Emerging Market Equity (MSCI)	-0.4%	-4.3%	-7.1%	14.4%	27.0%	58.0%
Chinese Equity (Hang Sang)	-1.2%	-3.4%	-17.2%	-17.6%	1.4%	27.4%
Indian Equity (Nifty)	5.6%	1.0%	23.5%	42.2%	60.6%	96.0%
Diversifiers						
Commodity Index	10.7%	29.2%	56.4%	55.0%	46.1%	50.6%
Gold	4.6%	9.7%	18.6%	42.9%	40.1%	40.5%
Silver	5.2%	10.6%	6.5%	55.8%	21.2%	25.4%
Brent Oil	10.7%	29.2%	56.4%	55.0%	46.1%	50.6%
UK Property	1.8%	4.2%	16.3%	16.8%	28.2%	31.7%
Global Property Shares	5.6%	-1.5%	23.1%	25.3%	34.4%	44.2%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*0.6%*	*-1.5%*	*0.7%*	*6.9%*	*9.9%*	17.2%
Rivers Cautious Portfolio	*1.4%*	*-1.6%*	*3.0%*	*15.8%*	*21.8%*	35.7%
Rivers Balanced Portfolio	*2.1%*	*-1.7%*	*3.9%*	*20.7%*	*29.6%*	47.8%
Rivers Adventurous Portfolio	*2.8%*	*-2.4%*	*4.3%*	*25.6%*	*35.2%*	56.9%
Rivers Aggressive Portfolio	*3.4%*	*-3.1%*	*4.8%*	*28.7%*	*39.3%*	66.4%
Rivers Cautious Income Portfolio	*1.2%*	*-2.1%*	*2.1%*	*8.6%*	*11.5%*	18.9%
Rivers Balanced Income Portfolio	*2.0%*	*-1.2%*	*4.0%*	*13.3%*	*17.9%*	30.8%

Source: Financial Express in GBP (unhedged unless stated) as at 31st March 2022. *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.