Current Focus

September 2022

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

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Summary

- Central banks correct to focus on tackling inflation even to the detriment of other factors
- Wage inflation is a large contributor to core inflation and is the Fed's focus
- The US is far better positioned to manage high energy prices than the UK or Europe
- The new PM has wage and energy inflation as well as a weak currency to deal with
- UK equities remain attractive due to better valuations and high non domestic earnings
- Tactical adjustment will protect portfolios from the volatility we expect for the rest of the year

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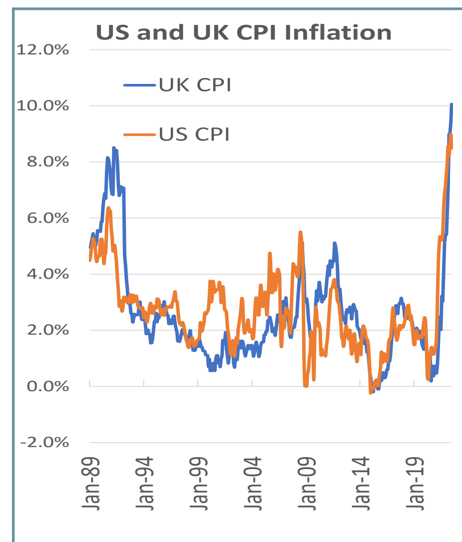
Market Comment

After such a positive July, at least for markets, we feared such positive sentiment would not last. We cut portfolio risk at the end of July, but perhaps we didn't cut it enough. Having said that, during August there weren't many places for investors to hide. The reversal in sentiment was primarily driven, as often is the case, by the US Federal Reserve. Its Chairman, Jerome Powell, made a speech, in a place called Jackson Hole, which reiterated his determination to fight inflation at almost any economic cost. We think he is correct in doing this but it is not going to be easy journey. This need to combat inflation is currently real in almost all regions of the world. It is true, as has been widely reported, that this inflation has a lot to do with energy prices (which have obviously been massively affected by the Russian invasion of Ukraine) but this is not the only inflationary factor. In fact it is not really the factor that Jerome Powell and other Central Bankers are most worried about. In this months Focus we return to inflation; we look at what concerns the Fed in the US; we consider the different inflation impact in the UK and with it the challenges facing new Prime Minister Liz Truss.

While energy prices are devastatingly high in the UK and Europe, they are falling in the US. The fall in consumer prices (CPI) seen in August in the US can almost completely be attributed to falling oil and gas prices. This mainly due to their independence in supply and lack of exposure to Russian supply. The stark differences in US Gas and European Gas are well publicised but the effect of currency is less well know. Given international prices are in US Dollar and both the Euro and Sterling have weakened significantly any energy price differences are extended. In the US many investors believed/hoped this fall in CPI, combined with some deteriorating economic data, would lead to a quicker change in direction for interest rates by the Federal Reserve. Powell's speech disabused anyone of that thought. He said the fall (to 8.5% from 9.1%) was modest, too short and in any case he wasn't particularly concerned with CPI. He was more concerned by the increase in wages. Wages, which are growing at over 5%, but not nearly 8.5%, were his greater concern. Unemployment is at historically low levels and despite many economic indicators pointing to a slowdown, employees remain in a strong position. Job vacancies far exceed applicants. It was for this reason, and not because of the



Source: ons.gov.uk & bls.gov

cost of energy, that interest rates had to rise to quell investment and lower demand. The market did not like this message, especially the growth focused high multiple technology stocks which, despite falls exceeding 20% year to date remain vulnerable to increasing interest rates. In simple terms, stocks with high multiples become less attractive if the risk free rate of return increases. (buying US treasury debt remains about as risk free as it gets). This is why we continue to avoid these stocks.

Turning to the UK, and the unenviable position Liz Truss is now in as Prime Minister, the spiralling cost of energy is undoubtedly the immediate issue. Unfortunately its not the only issue. Inflation is high, even discounting it for energy. Wages are still rising, demand remains high, unemployment low, debt levels are high and, also worrying to the Bank of England (and Kwasi Kwarteng the new Chancellor), as is the falling value of Sterling. The falling pound helps exporters but as the UK imports more than it exports the net effect is inflationary. The pound is free floating and neither a net exporter, like the Euro, nor the Worlds global currency, like the US dollar, nor is its debt owed mainly to its own people, like the Japanese Yen.

Prime Minister Truss is about to both cut taxes and provide support against the energy price spiral. The potentially £150bn energy support, announced on September 8th, limits household costs for two years while offering six months' cover for businesses.

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While limiting the price of energy may arithmetically lower the consumer price index the net effect will be to support demand. This is inflationary, so too is cutting taxes. The Bank of England is trying to soften demand, its mandate is only to control inflation. Its only tool to both slow demand, and potentially prevent further weakening of the pound is to raise interest rates. Even if the Bank does not change rates significantly, the market will, as Gilt supply outstrips demand. This is already happening. Despite all the headlines in August about falling stock markets, the worst performing asset class we look at was actually UK Gilts, which fall as rates rise. While cutting taxes may be welcomed by many of us, if it stokes inflation and causes interest rates to have to rise further, it will not create the growth the Prime Minister is hoping for. Monetarists and Keynesian economists unanimously agree on this.

Luckily, as global investors the proportion of UK Exposure in all the Rivers portfolios is comparatively low. The exposure to UK Gilts is minimal and UK Equities, to which we are underweight, tend to derive their earning internationally. Whilst they will not welcome further weakness in Sterling, or inflation, they are better placed to deal with it. In addition, on a valuation basis, UK equities offer much better 'value' than many regions, which is why so far this year their performance has been relatively strong. It is likely to be a challenging time ahead and with inflation now in double figures so we can not realistically expect positive inflation adjusted returns for 2022 or 2023. That said, we remain optimistic that the highest nominal returns can be achieved by remaining invested and tactically adjusting portfolios to reflect the changing conditions.

Market Returns (£) - 31st August 2022	1 Month	YTD	1 Year	3 Year	5 Year	S/I*
Anchors						30/06/2016*
Cash + 1%	0.1%	0.3%	0.3%	0.9%	2.0%	2.2%
Inflation Linked UK Bonds	-7.7%	-24.7%	-24.5%	-21.0%	-8.1%	1.5%
Gilts	-8.1%	-19.6%	-20.7%	-20.1%	-11.2%	-10.0%
Global Government Bonds (hedged)	-2.7%	-8.8%	-9.8%	-8.6%	-0.4%	-2.2%
Enhancers						
Global Corporate Bonds (hedged)	-3.3%	-13.4%	-14.3%	-8.2%	-0.5%	2.8%
Global High Yield (hedged)	-1.3%	-13.1%	-14.2%	-4.5%	-0.8%	11.6%
Emerging Market Bonds (hedged)	3.9%	5.4%	4.0%	-1.6%	4.3%	21.5%
FTSE 100 TR Index	-1.1%	1.6%	6.2%	12.5%	18.9%	42.5%
FTSE UK All-Small Cap	-1.6%	-12.6%	-13.7%	29.0%	29.0%	71.1%
Global Equity (MSCI)	0.2%	-4.3%	0.5%	34.7%	61.6%	103.2%
European Equity (MSCI)	-1.9%	-11.5%	-9.7%	8.4%	14.3%	48.4%
US Equity (S&P)	0.3%	-2.7%	4.5%	46.4%	88.6%	134.4%
Japan Equity (Topix)	2.0%	-3.6%	-4.2%	10.5%	17.7%	50.5%
Pacific Ex Japan Equity (MSCI)	3.8%	-6.4%	-10.8%	11.0%	12.8%	59.6%
Emerging Market Equity (MSCI)	5.0%	-4.0%	-7.5%	13.5%	14.1%	58.6%
Chinese Equity (Hang Sang)	3.8%	1.2%	-6.8%	-11.3%	-7.6%	33.5%
Indian Equity (Nifty)	8.9%	12.3%	14.5%	59.9%	67.3%	118.0%
Diversifiers						
Commodity Index	4.7%	43.9%	51.1%	68.3%	68.4%	67.7%
Gold	1.6%	8.7%	11.0%	12.8%	36.1%	39.3%
Silver	-7.9%	-11.7%	-12.9%	-3.3%	4.6%	0.2%
Brent Oil	4.7%	43.9%	51.1%	68.3%	68.4%	67.7%
UK Property	-1.2%	4.3%	10.8%	16.6%	24.8%	31.9%
Global Property Shares	-10.2%	-21.0%	-18.3%	2.9%	3.9%	15.7%
Rivers Model Portfolios						
Rivers Preservation Portfolio	-0.8%	-4.6%	-4.6%	0.0%	5.0%	13.5%
Rivers Cautious Portfolio	0.3%	-4.2%	-4.0%	6.7%	16.4%	32.1%
Rivers Balanced Portfolio	0.9%	-4.7%	-4.5%	10.9%	23.1%	43.4%
Rivers Adventurous Portfolio	1.2%	-5.3%	-5.2%	15.2%	28.2%	52.2%
Rivers Aggressive Portfolio	1.7%	-5.9%	-5.6%	17.5%	30.7%	61.6%
Rivers Cautious Income Portfolio	-1.2%	-6.1%	-5.9%	0.5%	5.5%	14.1%
Rivers Balanced Income Portfolio	0.0%	-4.5%	-4.2%	5.0%	11.8%	26.5%

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

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