Current Focus

January 2023

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

- It has been a positive start to the year as headline inflation rates fall
- Inflation fall attributed to transitory factors while ignoring systemic factors
- Core Inflation will be more difficult to reduce and require higher interest rates
- Full employment is welcomed but will sustain high inflation until rates ensure recession
- Plan to reduce portfolio risk to lock in gains and protect from short term volatility

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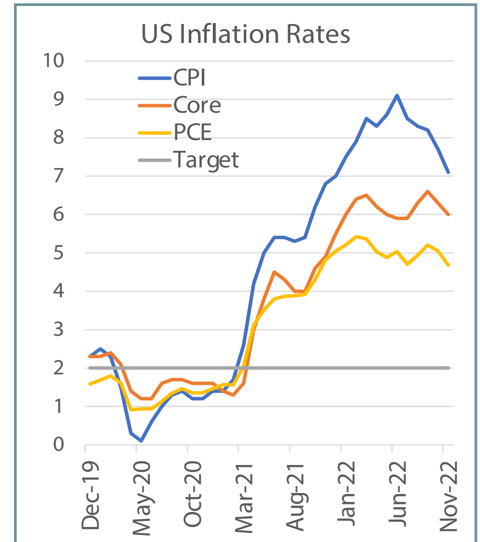
Market Comment

For many investors, the negative performance in December finished what had been a difficult 2022, badly. Not for the first time last year, both Anchors and Enhancer assets struggled. Diversifiers did provide some protection, but it was generally a month of interest rates rising and asset valuations falling. The opposite has been true so far in 2023. Top line inflation data in the UK, Europe and the US appears to have peaked. As a result, interest rate expectations have decreased and asset valuations have increased. Most assets are set for a positive start to the year with Anchors and Enhancers widely benefitting. This is welcome news, and should be reflected across all the Rivers portfolios, but is somewhat surprising. Despite having tactically increased all portfolio risk exposure in October, we do think it is too early to be celebrating. Asset prices in many sectors hardly reflect ongoing risk, and it is premature to be predicting a sustained economic turnaround, or even the end of central bank rate increases. It looks as if some are expecting a return to ultra-low interest rates in the foreseeable future. We, however, think that is highly improbable. There is a fundamental difference between the fall in the inflation rate and a return to the disinflationary period of the 2010s. The former is factually true but hides the real inflationary risk, the latter is not happening. In the first Focus of 2023 we look at why we think inflation will be harder to control than many expect. We look at the systemic causes of inflation and how they matter more than the vagaries of the oil price. Finally, we look at the changes we expect to be making to the portfolios in light of this and how, with volatility likely to remain, what tactical opportunities we expect in 2023.

Recent falls in the level of inflation, both in the UK and around the world, can be primarily attributed to the reversal of recognized transitory factors. These are factors such as the price of energy or the short-term supply constraints caused by Covid-19. These factors cause temporary imbalances between supply and demand and are, mainly, temporary. Once supply catches up with demand then prices either stop rising or, in some cases, fall. Transitory factors were often cited by the Federal Reserve and other Central Banks, during 2021, as a reason for not being



Source: tradingeconomics.com

concerned about inflation rising at that time. This was a policy error, not because transitory factors did not exist, they did, but because other systemic factors appear to have been ignored. At least until last year. These systemic factors include rising wages, protectionism, demographics, underinvestment in critical commodity supply chains, the drive to sustainability and many others. Many of these factors are outside the control of Central Banks but are likely to endure for years to come. Covid may have been a catalyst for them, but they have been building up for years. They make for a fundamentally different investment environment than the one that followed the Great Financial Crisis. With this background not only will the target of circa 2% inflation be hard to meet but the likelihood of a return to deflation is negligible.

There is not enough space here to cover these factors in detail, but they explain why Central Banks appear less excited by falling headline rates and are more inclined than many commentators to look at the core Inflation rate. As ever, market leadership comes from the Federal Reserve but if we look there and just consider wages, there is little indication of direction change. Unemployment rates remain historically low, while wages, at the last reading, were rising at 6.2%. This rate will have to fall considerably to satisfy the Fed and there are reasons this is unlikely. A shrinking workforce may be a hangover from Covid but is also related to an ageing population.

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RIVERS CAPITAL MANAGEMENT

Even in the US as the population ages, the total workforce is shrinking (it's worse in Europe). Either immigration is needed or wages, at all skill levels will continue to rise. Without productivity increases this will simply be inflationary.

In terms of immigration, it is politically unpopular and recent economic growth in Emerging Markets act against it. Protectionism, onshoring, energy independence also push production costs higher, but not productivity. This wage cycle can be broken by higher interest rates but there is little sign that it has started.

These systemic factors will ensure inflation stays stubbornly high and ensure that rates do not fall as quickly as currently expected. On the other hand, we do not expect interest rates to rise substantially higher from here. Raising them much higher would be counterproductive, as it would not help alleviate or solve the systemic factors. Recession in the UK and US remain our base case scenario but we do not expect this to continue for a protracted period. Our expectation is that higher levels of inflation, 3-5% with interest rates 4-6%, will become normal, but this will not be a smooth transition. Generally speaking, this will favour sectors with lower valuations and those with less leverage. It will offer low but inflation adjusted positive returns from fixed income, while favouring Enhancers with lower earnings multiples.

Regarding risk, the Rivers portfolios have been neutrally positioned since adding risk in October. Given the gains since, both in Anchors and Enhancers we plan to reduce risk imminently. The duration in fixed income will be cut and, where appropriate, absolute return strategies increased. Within Enhancers, the overall exposure will be reduced to secure gains. Diversifiers including real assets and gold will be maintained.

Market Returns (£) - 31st Dec 2022	1 Month	YTD	1 Year	3 Year	5 Year	S/I*
Anchors						30/06/2016*
Cash	0.3%	1.1%	1.3%	1.7%	2.9%	3.1%
Inflation Linked UK Bonds	-5.1%	-15.1%	-34.5%	-24.2%	-19.7%	-11.6%
Gilts	-4.4%	-12.1%	-25.1%	-22.8%	-16.8%	-16.2%
Global Government Bonds (hedged)	-1.7%	-3.7%	-11.7%	-9.4%	-3.3%	-5.3%
Enhancers						
Global Corporate Bonds (hedged)	-0.8%	-2.2%	-15.3%	-10.0%	-3.1%	0.6%
Global High Yield (hedged)	-0.1%	4.0%	-12.4%	-6.6%	-0.9%	12.5%
Emerging Market Bonds (hedged)	1.6%	1.5%	2.9%	-1.9%	7.2%	18.7%
FTSE 100 TR Index	-1.5%	5.7%	4.7%	9.7%	17.5%	46.9%
FTSE All-Share	-1.4%	5.1%	0.3%	7.1%	15.5%	46.3%
Global Equity (MSCI)	-5.2%	4.0%	-7.8%	27.3%	51.5%	95.7%
European Equity (MSCI)	-0.9%	8.5%	-6.5%	11.2%	20.2%	56.7%
US Equity (S&P)	-6.7%	3.0%	-8.3%	35.4%	71.8%	121.0%
Japan Equity (Topix)	-1.1%	5.2%	-5.5%	4.9%	9.4%	47.5%
Pacific Ex Japan Equity (MSCI)	-0.1%	-5.2%	-11.7%	-0.3%	3.2%	50.5%
Emerging Market Equity (MSCI)	-2.4%	-2.1%	-10.0%	1.5%	4.8%	48.6%
Chinese Equity (Hang Sang)	3.0%	-8.9%	-3.9%	-17.4%	-14.4%	26.8%
Indian Equity (Nifty)	-6.4%	9.7%	3.6%	47.9%	50.6%	101.2%
Diversifiers						
Commodity Index	-3.4%	-1.0%	30.7%	57.4%	53.7%	52.4%
Gold	3.1%	1.8%	11.8%	26.6%	48.3%	43.2%
Silver	9.7%	19.6%	15.5%	41.2%	47.5%	31.0%
Brent Oil	-3.4%	-1.0%	30.7%	57.4%	53.7%	52.4%
UK Property	-2.7%	-13.9%	-9.2%	0.6%	5.8%	14.8%
Global Property Shares	-0.4%	-15.7%	-31.9%	-26.2%	-16.1%	-0.2%
Rivers Model Portfolios						
Rivers Preservation Portfolio	-0.7%	0.1%	-5.8%	0.0%	3.0%	12.2%
Rivers Cautious Portfolio	-1.0%	2.0%	-5.2%	6.6%	13.6%	30.8%
Rivers Balanced Portfolio	-1.2%	2.8%	-5.5%	9.7%	19.7%	42.2%
Rivers Adventurous Portfolio	-1.4%	3.6%	-6.1%	13.8%	24.8%	51.0%
Rivers Aggressive Portfolio	-1.2%	5.0%	-6.4%	14.6%	26.8%	60.8%
Rivers Cautious Income Portfolio	-1.2%	-1.6%	-9.3%	-4.4%	1.8%	10.2%
Rivers Balanced Income Portfolio	-1.3%	-0.4%	-7.3%	0.0%	7.7%	22.8%

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