Current Focus

May 2023

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

- After raising interest rates by 5% the Federal Reserve will enter a period of "pause"
- The ECB and BoE will not be far behind but rates are unlikely to be cut soon
- Core Inflation needs to fall below current interest rates to tighten policy sufficiently
- Current market expectations of significant cuts this year will require unexpected shocks
- Inflation will continue to fall but requires further economic slowdown

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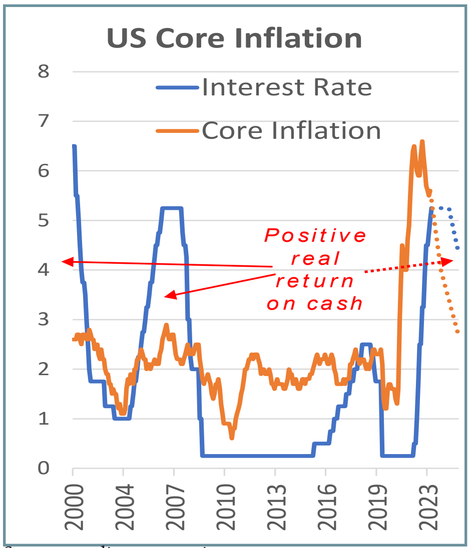
Market Comment

Despite some reasonable earning numbers from the largest US tech corporates during April economic indicators, in many regions, are showing signs of slowing growth. Given interest rate increases in the US, UK and Europe the surprise continues to be on how resilient growth has been. On May 3rd the US Federal Reserve, which over the last 15 months has raised rates over 5% appeared to announce a pause. We think that is likely. While the European Central Bank (3.75% on May 4th) has strongly hinted that further increases are planned we do not think they, nor the Bank of England (May 11th) will be far behind. Despite inflation, and in particular Core Inflation, remaining stubbornly high, this cycle of increasing rates is ending. The question now, and the Focus of this article, is on how long this pause will last. The consensus view remains that now (near) peaks has been reached cuts are imminent. We do not think this is case. The justification for further increases is difficult to make but so too is the justification for interest rate cuts.

Looking at the US the futures market is currently expecting a series of rate cuts to start in the third quarter. Why this is the case is not clear. The main reasons given are falling inflation, a slowing jobs market, falling house prices and the troubles experienced by medium sized banks in the US. These do all point to progress towards achieving the Central Bank's objectives of raising rates but, on current evidence, it is difficult to conclude that those objectives will be reached quickly.

Looking at consumer price inflation (CPI) alone – which is backward looking and notoriously difficult to predict – it has fallen much more in the US (than in the UK or Europe) from a high of over 10% to around 6% in recent months. This is encouraging but with Core inflation rate (which excludes food and energy) ticking up in March (to 5.6% having peaked in October at 6.6%) the job is far from done. As pressure from wages and other non-transitory inflationary factors persist further reduction gets more difficult. Even if Core inflation does fall in the coming months to below 5% (creating the first real return on cash since fleetingly in 2018) it simply creates the restrictive financial environment that Fed is aiming to achieve. A recent fall in job openings does support the idea that the policy is slowing job creation but this has not yet translated into rising unemployment. Unit wage prices on the most recent data are still



Source: tradingeconomics.com

accelerating (6.3% in Q1) and unemployment remains at historic lows. The Fed is at pains to point out that its decisions remain data-dependant, this data does not appear to be changing quickly.

The one area, in the US and the UK, where there has been data-change is within real estate. House prices have fallen but still remain high by most historic measures when compared to earnings. Sales volumes are declining, and inventory increasing but given the increases in rates the impact has been, so far, modest. Other indicators, such as the Purchasing Managers' Index (PMI), are pointing only to a modest slowdown, or a slowing in the rate of expansion more than signs of contraction. The US economy appears robust and not one in need of dramatic interest rate cuts. The recent collapse of First Republic Bank, which followed Silicon Valley Bank into bankruptcy, does highlight some of the consequences of higher rates but this, and SVB, was more related to mismanagement and regulation changes than indicative of a systemic problem. Deposits have moved to money market funds and to larger, better capitalised banks, but there are few signs of a liquidity crisis. Recent results show the largest US Banks have seen profits grow as a result of deposit flows. These deposit flows have slowed in any case as the Fed has used the Federal Deposit Insurance Corporation (FDIC) and a bond buyback program to wall off the liquidity problems. The effect of real estate losses and other expensive refinancing (especially leveraged private equity and high yield bonds) will see continued challenges for Banking but it is not in the data yet.

Overall leading economic indicators do point to a slowdown but this will not justify, within only a few months, the pivot expected by the Fed. A soft landing, which is the Fed's desired outcome, would see job creation fall, a modest rise in unemployment and a reduction in inflation towards target. This will take time. While it remains difficult to predict how the real estate slowdown, or other refinancing challenges, will play out, it would require a calamity for the Fed to end the period of pause so quickly.

The enormous injection of liquidity (which followed Covid) pushed inflation higher than was ever expected too. Afterall it had followed about 10 years of loose monetary policy during which inflation appeared benign. Rising post Covid inflation was exaggerated by the spike in energy and food prices that followed the Russian invasion of Ukraine. How quickly the effects of a now reasonably restrictive monetary environment bring inflation down, and how quickly Central Banks adapt to it is the ultimate question. We think it will take longer than is expected. Judging by the recent history of Central Bank responsiveness the pause is more likely too long than too short. Given the returns available from money markets and the low valuations in some sectors, not to mention the underinvestment and geopolitical pressures that may sustain inflation, we think it is a time to be patient. The Rivers Model portfolios are positioned for such patience. They remain underweight risk and well diversified.

Market Returns (£) - 30th Apr 2022	1 Month	YTD	1 Year	3 Year	5 Year	S/I*
Anchors						30/06/2016*
Cash	0.4%	1.2%	2.5%	2.7%	4.0%	4.4%
Inflation Linked UK Bonds	-4.0%	0.0%	-25.6%	-29.1%	-17.4%	-11.6%
Gilts	-1.8%	0.4%	-16.2%	-29.7%	-15.7%	-15.9%
Global Government Bonds (hedged)	0.3%	3.1%	-2.4%	-10.2%	-0.1%	-2.3%
Enhancers						
Global Corporate Bonds (hedged)	0.7%	3.5%	-1.5%	-6.7%	2.8%	4.2%
Global High Yield (hedged)	0.3%	2.9%	-1.2%	8.7%	3.1%	15.8%
Emerging Market Bonds (hedged)	-1.2%	-0.4%	2.4%	6.7%	7.3%	18.2%
FTSE 100 TR Index	3.4%	7.1%	8.2%	48.5%	26.9%	57.3%
FTSE All-Share	3.4%	6.5%	6.0%	45.2%	24.2%	55.8%
Global Equity (MSCI)	0.1%	4.9%	3.1%	45.2%	62.1%	105.3%
European Equity (MSCI)	2.5%	10.1%	12.0%	46.2%	33.9%	72.5%
US Equity (S&P)	-0.1%	4.3%	2.0%	48.6%	83.5%	130.5%
Japan Equity (Topix)	-0.1%	3.1%	6.6%	19.0%	14.3%	53.6%
Pacific Ex Japan Equity (MSCI)	-4.7%	-1.4%	-5.8%	4.1%	1.7%	48.5%
Emerging Market Equity (MSCI)	-2.7%	-1.6%	-6.6%	14.0%	4.0%	46.2%
Chinese Equity (Hang Sang)	-4.0%	-1.7%	-2.5%	-13.3%	-16.9%	24.7%
Indian Equity (Nifty)	2.5%	-6.6%	-7.1%	64.3%	47.7%	87.9%
Diversifiers						
Commodity Index	-2.4%	-10.1%	-16.7%	78.4%	37.7%	37.0%
Gold	-0.6%	4.5%	4.6%	14.5%	58.3%	49.7%
Silver	2.3%	0.3%	9.8%	64.2%	59.1%	31.3%
Brent Oil	-2.4%	-10.1%	-16.7%	78.4%	37.7%	37.0%
UK Property	0.5%	-0.3%	-14.2%	3.1%	3.3%	14.4%
Global Property Shares	6.4%	4.9%	-25.1%	2.0%	-12.8%	4.7%
Rivers Model Portfolios						
Rivers Preservation Portfolio	0.6%	2.3%	-1.3%	3.1%	5.4%	14.7%
Rivers Cautious Portfolio	0.4%	2.0%	-0.6%	10.6%	16.2%	33.4%
Rivers Balanced Portfolio	0.3%	2.3%	-0.2%	16.2%	23.0%	45.5%
Rivers Adventurous Portfolio	0.4%	2.1%	-0.2%	20.0%	28.2%	54.1%
Rivers Aggressive Portfolio	0.3%	1.4%	-0.2%	24.2%	29.8%	63.0%
Rivers Cautious Income Portfolio	0.6%	2.1%	-3.9%	5.8%	4.6%	12.6%
Rivers Balanced Income Portfolio	0.7%	1.8%	-3.3%	12.4%	10.1%	25.2%

Source: Financial Express in GBP (unhedged unless stated) as at 30th April 2023. *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.