BRI Wealth Management PLC

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MARKET COMMENTARY

BRIDGE OVER TROUBLED WATER

Written by Paul Simon

When this classic song was first written by Paul Simon in 1969, America was in a state. The Vietnam War was on-going, Richard Nixon was president, and the country was still coping with the loss of Martin Luther King Jr. and Bobby Kennedy, who were both assassinated in 1968. "Bridge Over Troubled Water" spoke to the turmoil of the times and continues to adapt to more recent times, used as an uplifting anthem around more tragic events. The line "Like a bridge over troubled water" is a metaphor for someone living through a trying time in their life such as many may be experiencing today, whether that is through conflict or poverty or from losing a loved one.

As the cost of living crisis deepens for many around the world, now exacerbated by the growing threat of food shortages, it has been another difficult quarter for markets after what had already been a tough start to the year. This is now the worst first half of the year for developed market equities in over 50 years with all the key index benchmarks remaining firmly in a downtrend and with each attempted rally failing below the previous high. To make matters worse, government bonds remain under pressure, failing to provide the protection that investors traditionally expect from the asset class.

A quick glance - for that's all we need - as regional returns show a similar picture. The worst first half for the US market since 1970 ended with a second quarter loss of -16.5% for the S&P benchmark while the NASDAQ fell -22.4%. All eleven S&P sectors lost at least -5%. The Euro Stoxx benchmark closed the quarter with a -12.0% decline where Spain's IBEX (-4.1%) held up best of the major indices.

Relative outperformance from the UK indices was, unsurprisingly, driven by large cap stocks, the FTSE 100's decline limited to -5.9% whereas Mid and Smaller cap indices lost -12.5% and -11.5% respectively. Continuing the trend established in late 2021, the MSCI UK value index, down -3.0%, was ahead of growth which registered a loss of -5.2%.

Asia in general was similarly downbeat, with the Nikkei (-4.6%) performing better than most but some way behind China, the MSCI China Index rising 2.3%. The Chinese administration's zero tolerance approach to COVID created problems for the rest of the industrialised world by further delaying the manufacture and shipment of components needed to produce parts essential to the automotive and telecommunications sector.

Markets now expect interest rates to rise to 3.4%, 3% and 1.6% in the US, UK and Europe, respectively, by next year. That increase in expectations for the path of interest rates has contributed to the decline in equity valuations, along with concerns about the growth outlook. Recession fears have risen, due to the squeeze on consumers from higher prices and higher borrowing costs as the central banks single-mindedly fight inflation above all else.

Our concern is that inflation this time round is structural and cannot be dampened through monetary policy alone; the

disruption to global supply chains can only be fixed by an increase in production. However, by the time factory output reaches full capacity, it is conceivable that demand will have softened, should the consensus for most of the western world falling into recession next year prove correct.

But wait a moment. In the US, the Federal Reserves' preferred core PCE prices index rose +0.3% month on month in June, leaving the annual inflation rate of +4.7% year on year at its lowest since last November, a promising signal that upward pressure may be easing slightly. Recession fears are also weighing on the oil price, which in most cases in now trading around 10 per cent below the peak of early June. Not that you should expect an immediate fall in the price paid at the pump, thanks to the Dollar's strength against Sterling and the Euro.

And one should not ignore the fact that for the most part, stocks look relatively cheap compared to the long-term averages, the one exception being the US. Our research indicates a degree of bullishness by analysts for earnings despite falling confidence from business and the consumer.

In respect of asset allocation, we can see the beginnings of a sea change with pockets of value emerging in fixed income. Real returns will remain deep in negative territory, but we sense sovereign bonds are moving closer to peak rates and the realisation that perhaps sooner rather than later, cash rates will need to reverse to accommodate a return to economic growth. And we maintain our view that when it comes to inflation, holding assets such as Property and Infrastructure, with their exposure to index-linked rental income, should partly offset the downward pressure exhibited by Bonds and Equities.

Cryptocurrencies are worth a brief mention. While my colleagues and I are often asked about this alternative sector, it is not an asset class that BRI is exposed to nor has any interest in becoming involved in in the short to medium term. One reason is volatility. The price of Bitcoin dropped -59.0% in Q2 (in USD), marking its worst quarterly performance in over a decade. From a peak of over $3.2 trillion last year to less than $1 trillion today, the crypto market has lost more than two-thirds of its value.

Returning to our theme for this review, the line "I will lay me down" references the sacrifices and perseverance as people find a way through difficulty. It matters that we understand that when markets deliver a negative outcome, we do not lose sight of what else is happening around us. When I came to BRI fourteen years ago, I joined a small group of people committed to looking after the investment goals of our clients. Today we are a community, with a range of skill sets and an understanding that as the world changes, we can accommodate those changes for the benefit of our clients and their on-going needs.

Finally, in a postscript to our normal commentary - which tends to shy away from the deeds of our politicians - it seems appropriate to acknowledge the pending change at the top of Her Majesty's Government, not because of the soon to be ex-Prime Minister Johnson, but more because of who will replace him. From our perspective, it matters who will be appointed the next Chancellor of the Exchequer and whether this will result in looser fiscal policy to boost growth and business confidence.

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July has seen markets recover some of the ground that has been lost during 2022. Whilst the economic outlook remains hazy, there are some tangible signs that inflation and interest rate expectations may have peaked. This has caused most asset classes to rise during July, with the biggest gains being seen in the areas that have suffered most during 2022. It is pleasing to see a little bit of stability return to markets, but we remain cautious about the short-term outlook for markets due to the ongoing fall in economic growth that we're witnessing. We continue to have larger cash balances than normal on portfolios but expect that these will fall during the rest of the year as we find opportunities to deploy capital into attractively valued investments. The enclosed valuations represent a low point for markets (30th June) and due to the gains in July current valuations will look more positive. If you have any questions, then please contact your adviser.

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