SEI Strategic Portfolios:
Q2 2018 Quarterly Commentary

STABILITY-FOCUSED

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Markets finish Q2 2018 on a more pessimistic note due to politically driven uncertainties, despite the global economy remaining on a sound footing.

Executive Summary

- The spectre of trade wars loomed heavily on the horizon for most of Q2, ultimately causing the quarter to finish on a weaker note. Investor sentiment was further rattled by arguments over immigration policy and uncertainty over the impact of rising interest rates as well as a lack of clarity on Brexit.
- For the Stability-Focused Strategic Portfolios, dedicated short duration allocations as well as short duration positioning cushioned the impact of rising yields. Emerging market debt allocations detracted at the strategy level. Global managed volatility equities once again provided meaningful risk reduction, despite lagging in global equity markets in absolute terms. A stronger US dollar over the period also provided a tailwind to unhedged, non-UK positions, relevant because the SEI strategic portfolios structurally are global in nature.
- The Stability-Focused Strategic Portfolios (the Defensive, Conservative, and Moderate Funds, collectively "the Funds", Sterling Wealth A share class, in GBP, net of all fees) returns ranged between -0.04% and 1.93% in Q2 2018, compared to the 0.06% return of BofA Merrill Lynch Sterling Broad Market index over the same time period, which can be seen as a representation of the UK fixed income market, while the Bloomberg Barclays Global Aggregate GBP-Hedged index declined by -0.26% Crucially, with the exception of the ultra-conservative Defensive fund, each of the funds continued to achieve their longer-term returns with a higher level of risk-adjusted return than the above-mentioned benchmark, consistent with their unique asset allocation design.
- Consistent with their Goals-based investment design, SEI manages the Stability-Focused Strategic Portfolios to specific maximum drawdown targets which tend to result in an asset allocation structure that seeks to deliver a smoother investment journey for investors. Evidence of the success of this approach can be found in the 5 years to 30 June 2018 volatility data of the Stability Focused Strategic Portfolios, with respective values of 1.61%, 2.77%, 3.99% for the Defensive, Conservative and Moderate Funds, comparing favourably against the fixed income only BofA Merrill Lynch Sterling Broad Market index volatility number of 6.33%.

Market Overview

The imposition of trade barriers served as the defining global economic development of the second quarter. US President Donald Trump's administration applied tariffs against China, a major trading partner and geopolitical rival, as well as traditional US allies in Europe and Canada, inviting comparable tariffs in response. These retaliations prompted follow-on threats of tit-for-tat escalations from President Trump.

The governing coalitions in Italy and Germany pointed a spotlight on the issue of immigration, forcing action at a European Council meeting in late June with a deal that seeks to establish an EU-wide approach centred on financial-burden sharing and more restrictive borders. In the US, the Trump administration enacted a zero-tolerance policy in recent months that targets illegal immigration at the southern border.

Counterbalancing the negative sentiment stemming from trade wars and the immigration debate, the relationship between the US and North Korea appeared to continue warming amid a June summit in Singapore between President Trump and Supreme Leader Kim Jong Un.

The quarter was also marked by a strong US stock market.

Major government bond yield curves generally continued to flatten during the second quarter. The US dollar mounted a fierce recovery after bottoming early in 2018. The quarter was also marked by a strong US stock market, driven by companies in the energy, consumer discretionary and IT sectors. UK Equities also did well over the period. Throughout the rest of the world, equities mostly performed poorly; particularly in emerging markets, and most severely in Latin America.

The BoE made no changes at its May and June meetings yet registered a third dissenting vote in June that favoured a higher bank rate. UK industrial conditions picked up surprisingly in June after lacklustre reports in April and May, while services-sector activity accelerated in the same months. Labour-market conditions appeared frozen but solid, with the jobless claimant count remaining 2.5% in May and the unemployment rate a steady 4.2% from February to April. Economic growth improved by a modest 0.2% in the first quarter, but registered an unchanged rate of 1.2% for the year-over-year.

The European Central Bank (ECB) announced at its mid-June meeting plans to taper net asset purchases in September; it also said benchmark rates will likely remain at their current levels until at least mid-2019. Eurozone manufacturing growth maintained healthy levels at the end of the second quarter despite continued easing since the beginning of the year. The unemployment rate fell to 8.4% in May from 8.5% in the prior month. The final reading of overall economic growth was unchanged at 0.4% for the first quarter and 2.5% year-over-year, confirming a slowdown in growth from the fourth quarter of 2017.

The US Federal Reserve (Fed) increased the federal funds rate at its June meeting and suggested that it could hike rates by a total of four times in 2018. Growth in US manufacturing activity finished the second quarter on a strong note after buoyant reports in April and May; services-sector growth accelerated as well. Economic growth was measured at an annualised 2% rate in the final reading for the first quarter, 0.2% lower than earlier readings.

Selected Asset Class Commentary

Global Short Duration Asset Class: Yield curves continued to flatten; the 20-year to 30-year spread in the US is now less than 50 bps, meaning that just two additional rate hikes could cause the yield curve to invert. The flatness of the curve is being encouraged by heavy treasury issuance at the front end and a healthy bid at the long end where yields are attractive versus other core markets. All managers detracted from relative performance over the quarter. Schroder Investment Management, the top detractor, was hurt by overweight positions to UK duration, Brazil and South Africa local currency bonds.

UK Core Fixed Income Asset Class: The asset class' overweight to corporate bonds, primarily through exposure to banks, was the top detractor for the quarter as spreads widened. Wellington Management Company, the top contributing manager, benefited from long US dollar and short sterling positioning. Schroder Investment Management was the top detractor due to short US dollar, and long Spain positioning. A small short to Italy was beneficial. PIMCO Europe detracted as exposure to spread sectors, primarily banking, hurt performance.

Global Managed Volatility Equities Asset Class: Equity markets again experienced a volatile quarter. What began with a broad market recovery, especially in large-sized growth companies, morphed into a market sell-off beginning in the second week of June, due to fears of trade wars. All managers had positive absolute returns for the quarter but lagged due to strong style headwinds in the first two months. Analytic Investors was the best performer as non-US exposure was beneficial in April, while the managers' ultra low-beta exposure contributed positively when the market melted down in June. LSV Asset Management was the worst performer, as valuation-focused approach to low volatility equities did not work well this quarter. The asset class is designed to provide downside protection in stressful market environments, such as the last couple of weeks in June, with a cost of not rising as much when market rallies, such as what occurred in May.

Global Equities Asset Class: The asset class struggled during the quarter, suffering from an overweight to valuation-focused managers, an underweight to stability-focused managers, as well as poor stock selection. The asset class' local managers generated strong losses due to their value exposure. LSV Asset Management suffered strongly, as trade tensions and narrow rally in expensive technology names left undervalued securities deeply in the red. METROPOLE Gestion's style-driven losses were compounded by political developments in Italy and their effects on the manager's holdings in banks. The asset class' global managers benefited from exposure to momentum which partially mitigated losses. Rhicon Currency Management, which performed strongly, benefited from increased volatility and a major break-out in the euro versus US dollar.

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Manager Changes

T. Rowe Price Group, Inc. (TRP) has been added to the US High Yield Fixed Income Asset Class. SEI likes the firm's experienced investment team and approach, which emphasises fundamental credit research and opportunistically accessing smaller, under-researched credit issuers. TRP's smaller team and asset size allows for efficient decision making, a higher degree of flexibility as it relates to credit quality and industry positioning and a relatively concentrated best-ideas portfolio.

Outlook

Investors were raging bulls at the beginning of 2018 as equity prices vaulted higher. But that optimism faded dramatically as the news flow turned less favourable. SEI ultimately believes that the market can take this in its stride, because the potential for a meaningful advance in equities is greater when investors are pessimistic and bad news is already largely discounted in the price of riskier assets.

If one believes, as SEI do, that the global economy is sound and that the political uncertainties currently roiling markets will be contained, then the proper course should be to remain exposed to risk assets and ride out the short-term ups and downs.

Fears of a trade war pitting the US against foes and allies alike notwithstanding, American investors, businesses and consumers have much to applaud. US corporate tax reform, tax cuts for households, and reduced or modified regulation of various industries have led to record-high consumer and business confidence.

But sabre-rattling between the US and China has deteriorated into actual skirmishing, and the latest back-and-forth suggests this spat will get worse before it gets better. To be blunt, the Trump administration's strategy of waging a trade war with China could prove to be the equivalent of cutting off one's nose to spite one's face.

SEI will be watching closely how this drama plays out in the months ahead. With any luck, the Trump administration will shy away from further ratcheting tensions. But we must admit that doesn't seem to be in the cards in the near-term.

The economic data coming out of Europe has been hugely disappointing this year. Instead of building upon the improved business activity of 2016 and 2017, there has been a widespread deceleration. At SEI, we have been reluctant to get too bearish on Europe's fundamentals, but there's no denying that financial market participants are disbelievers.

Recent UK economic data reports, like those of other countries in Europe, suggest that Great Britain is wending its way through a soft patch. Underlying growth nevertheless appears solid, indicating the UK economy is in stable condition; although the trade sector looks to be a problem spot. The biggest source of uncertainty facing the UK remains its looming withdrawal from the EU.

A confluence of events has conspired to hurt the performance of emerging market assets. An extensive trade war that disrupts multinationals' supply chains would disrupt the flow of raw commodities and semi-finished materials from developing economies, which depend on these exports for economic growth. Rising US interest rates, which would likely result in another period of sustained US dollar strength, is a second threat. The soft patch in Europe and recent signs of deceleration in China's economic growth is a third.

But while emerging market stocks and bonds have come under pressure this year, we've yet to see any widespread deterioration in economic performance or financial conditions. On balance, we think most emerging markets have the ability to weather the storm, assuming the disruption to global trade does not devolve into something more encompassing.

We still believe this old bull has some life left in it, but the risks to the equity market seem more balanced.

Investors should make no mistake about it: the headwinds blowing in the face of risk assets have picked up. Growth in business activity has slowed a bit, especially in Europe. Monetary policy in the US is getting tighter, and is set to become less expansionary in Europe as well. Inflation has ticked higher, driven by synchronised global growth and a tightening of labour markets and industrial capacity in the US, Germany, the UK, China and elsewhere in Asia.

Most important, the stoking of trade war tensions by the US threatens to undermine the very foundation of the system that has supported the global economy since the end of World War II. Although the actual trade actions to date have been modest, the impact on global supply chains bears close watching.

But the economic fundamentals that drive the stock market still appear solid, even in places like Europe and developing economies. Plus, interest rates remain at levels that will crunch global economic growth. The key risks, namely escalating trade tensions and the polarisation of electorates over issues like immigration and fiscal sovereignty, appear more political in nature. The positives include a still-solid global economy; strong momentum in corporate-profits growth; and equity valuations that still appear reasonable against the backdrop of still-low, albeit rising, interest rates.

A broadening of the trade war with China or a US departure from the NAFTA accord would likely have a severely negative impact on the profitability of US manufacturers, prompting us to reassess our still-positive view. Impediments to trade also could lead to a higher inflation rate as US companies use the tariffs umbrella to raise their selling prices. The Fed may feel compelled to lean against this threat to price stability, thereby aggravating any economic shock arising from the disruption of global supply chains—which is how a bear market could develop.

This is not our best-case scenario. SEI still believe this old bull has some life left in it, but the risks to the equity market now seem more balanced than skewed to the bullish side.

Important Information on Performance

Past Performance is not a reliable indicator of future results. Standardised performance is available upon request. All data is as at 30 June 2018.

Asset class performance discussed is based on the majority SEI fund underlying the asset class. This does not include analysis of the manager pools, hedged share class investments within SEI Funds, additional SEI funds or any third-party funds within the Strategic Portfolios. As a result, performance for the total asset class allocation may vary. Not all asset classes discussed are included in all Strategic Portfolios. All asset class comparative performance is relative to the benchmark of the specific SEI fund representing the majority of the asset class investment.

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