Growth-Focused SEI UK Strategic Portfolios
Q2 2019 Quarterly Commentary

GROWTH-FOCUSED

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Investors remain focused on US-China trade negotiations and developing central bank stances; markets overall delivered a positive second quarter of 2019.

Executive Summary

- Global equity markets zigged and zagged over the quarter, depending on the latest stance in the US-China trade negotiations and the latest tweet from the US president. Ultimately, they ended on a more positive footing. Government bond markets overall fared well in an environment of falling rates in many major markets. Corporate bonds outperformed, as did those with a higher-yield profile. Emerging markets fixed income also delivered robust returns.
- Considering the Growth-Focused Strategic Portfolios (the Core, Balanced, Growth and Aggressive Funds, collectively "the Funds," Sterling Wealth A share class, in GBP, net of all fees), stock selection as well positioning around valuation-focused managers continued to detract from relative performance. Despite the ongoing challenges, we believe that one of the best opportunities in this area in decades continues to build. This may be an opportune entry point for new clients or additional funds to be deployed.
- Both on a strategic (long-term) and tactical (short-term, entry-point) basis, we firmly stand by the belief that the valuation-focused investment approach works, that investors will ultimately see markets revert to the mean and, consequently, benefit from this positioning. Patience and discipline are required for this approach, and at SEI, we intend to exercise both of these virtues. The programme has seen periods like this before. Remaining patient and disciplined together served our clients well then, and we believe it will do so now.
- Returns for the Growth-Focused Strategic Portfolios ranged between 2.93% and 4.15% in Q2 2019, compared to the 3.26% return from the FTSE All-Share Index and the 6.48% return delivered by MSCI World (net) Index over the same period. (Source: SEI)
- Performance from the Growth-Focused Strategic Portfolios continued to be competitive over the medium term (5 years to 30 June 2019), maintaining these funds' positions near the top of their respective Lipper peer groups.

Market Overview

Government bond rates increased in the UK, Europe and US during April, but ultimately moved lower over the quarter. As for US treasuries, after briefly inverting in March, the 3-month-to-10-year spread again turned negative in May, where it remained through the second quarter. This triggered concerns about the US economy, as an inverted-yield curve is commonly considered a reliable recession indicator.

Stocks around most of the world continued their early-year rally before tumbling throughout May and then recovering to varying degrees in June. UK and European equities rallied much of the way back to their late-April tops but failed to reach new heights. US and Brazilian stocks recorded all-time highs in the second half of June. Japanese stocks jumped sharply at the end of the quarter, yet did not hit their late-April peak. Mainland Chinese stocks bounced back more convincingly than those in Hong Kong.

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The Bank of England made no changes at its May or June meetings. It maintained a preference for a tighter monetary policy with the caveat that this stance could be upended by Brexit uncertainty, which it noted has increased. The UK services sector accelerated out of a contraction early in the second quarter and with increased speed in May, while manufacturing conditions moved in the opposite direction. UK economic growth accelerated in the first quarter to a rate of 0.5% from 0.2% in the prior quarter. The year-over-year pace also increased during the first quarter to 1.8% from 1.4% in the final three months of 2018.

After Theresa May announced her resignation in late May, a race opened for her role as UK prime minister and leader of the Conservative Party. The crowded candidate field quickly narrowed, pitting former Foreign Secretary Boris Johnson as widely favoured over his successor Jeremy Hunt. Johnson has campaigned on an explicit willingness to depart the EU without a deal upon the 31 October deadline, but has made conflicting comments on the likelihood of this outcome. Jean-Claude Juncker, president of the European Commission, stated in June that the divorce deal established during May's tenure is not open for renegotiation despite the British leadership contest.

The ECB extended its commitment to retain current low European benchmark rates through the first half of 2020 and said it will continue to reinvest the principal proceeds from its asset-purchase programme for at least as long. Eurozone manufacturing activity contracted throughout the second quarter as output steadily declined and new orders continued to drop. The European unemployment rate moved lower through the first two months of the quarter, settling at 7.5% in May. The eurozone economy expanded by 0.4% during the first quarter, doubling the rate of growth in the prior quarter. Year-over-year growth increased to 1.2%.

Trade negotiations between the US and China had promising momentum at the start of the quarter but soon deteriorated in early May. The US announced an escalation of existing tariffs, then stalled the proposals in late June to entice Chinese President Xi Jinping to meet with President Donald Trump on the sidelines of a Group of 20 summit. The meeting produced a temporary truce, as both sides agreed to return to the negotiating table.

The US Fed made no changes at its May or June meetings. However, its statement following the June meeting did not include its prior commitment to patience and indicated increased uncertainty along with a less-positive assessment of economic fundamentals. Growth in the US manufacturing and services sectors slowed sharply in the beginning of the second quarter before maintaining a modest expansion. Meanwhile, the US unemployment rate declined to 3.6% in April and held steady in May. Overall economic growth registered an annualised 3.1% rate during the first quarter.

Selected Asset Class Commentary

Global Equities Asset Class: The asset class underperformed its benchmark due to poor stock selection and an overweight position to value. Maj Invest was the primary detractor because of poor stock selection. Larger losses stemmed from UK and US retail, as well as auto and semiconductor positions. Poplar also detracted during the quarter, influenced by its overweight cyclical, especially energy, smaller size and higher beta positioning. The asset class is favouring value on the basis of wide valuation spreads and signs of investor capitulation: Poplar and Towle in the US, Jupiter in the UK, Arcus in Japan, Metropole and Trigon in Europe. In our view, on several metrics, there is the strongest forward-looking opportunity in value stocks in several decades. Clearly, the last 12 to 18 months have been somewhat painful, as we decided to take an early position, but the view remains that this will ultimately pay off.

Pan European Smaller Companies Asset Class: The asset class outperformed its benchmark during the quarter. Whilst its tilt towards managers with a greater focus on valuation marginally detracted, both the momentum tilt and higher-quality bias contributed. Stock selection was additive to relative returns, particularly within UK consumer and financial stocks.

Favouring value on the basis of wide valuation spreads and signs of investor capitulation.

Emerging Markets Fixed Income Asset Class: The asset class underperformed its benchmark for the quarter. From a sector perspective, weak selection within communications services detracted. Selection within telecommunications also hurt. From a regional perspective, selection within Canada and Korea hurt, while selection within Brazil and Russia helped. Macquarie Investment Management suffered due to weak selection within media and entertainment and retailing. RWC Advisors struggled with selection within materials in the commodities sector. Qtron Investments benefited from selection within China, India, utilities and consumer discretionary. Lazard Asset Management's selection within emerging Asia and emerging Latin America helped.

Manager Changes

Wellington Management Company LLP has been added to the Global Fixed Income asset class and the Global Opportunistic Fixed Income asset class in June 2019. Wellington's global fixed-income investment teams seek to identify and capture inefficiencies within each one's respective opportunity set. At SEI, we expect Wellington's performance to give the asset class a more all-weather performance profile over the course of a market cycle, meaning the asset class should be less vulnerable to risk-off environments.

PIMCO has been added to the UK Core Fixed Interest asset class in May 2019. PIMCO seeks to identify attractive new opportunities consistent with its long-term focus and to diversify risk by applying a variety of strategies to achieve outperformance. We view PIMCO's strategy as an all-weather portfolio and expect it will generate excess returns from security selection and opportunistic duration trades.

Wellington Management Company, LLP (Wellington) has been added to the UK Core Fixed Interest asset class in May 2019. Wellington's global fixed-income investment teams seek to identify and capture inefficiencies within their respective opportunity sets. We expect the strategy to generate positive returns across the market cycle and to complement more value-biased strategies in the asset class.

Copeland Capital Management, LLC (Copeland) has been added to the U.S. Small Companies Fund asset class in June 2019. Copeland's investment philosophy has a strong focus on dividend growth. Many quality-oriented strategies have a dividend element but few share Copeland's strict requirements. Copeland's strategy aligns with the stability alpha source. We expect it to perform well during market volatility, when investors tend to favour quality and stability.

ArrowMark Partners, Rice Hall James & Associates and William Blair & Co, LLC have been removed from the U.S. Small Companies asset class. At SEI, we want to have fewer—but more alpha-source-pure—managers in the asset class.

Outlook

July marks the 10th anniversary of the US economic expansion. The bull market reached its 10th birthday in March, and the S&P 500 Index appears to be celebrating by moving into new-high territory. But there now seems to be anxiety that the bull market in equities is on its last legs, the victim of a slowing global economy, the lagged impact of last year's US interest rate increases and, perhaps most importantly, a worsening trade war between the US and China.

Certainly, the US economy is hardly firing on all cylinders. There's a good chance that capital spending will continue to ease in the months ahead, but we're not forecasting a major downturn. Corporate cash generation continues to run slightly ahead of capital expenditures. The main point to remember: It's not unusual for capital expenditures to run well in excess of cash flow, especially toward the end of the economic up-cycle. And that's not happening yet.

We believe investors need to see a severe deterioration in financial and leading economic indicators before climbing onto the recession train. Even after the past two years of multiple Fed rate increases, there are still few signs of a buildup in financial stress.

The big unknown is how the evolving tariff war between China and the US will affect US economic growth and global trade in the months ahead. Tariff tensions and worries about global growth have put only a modest dent in the confidence of American businesses. But it certainly looks as if the US-China trade relationship is frosty at best, even though the countries' leaders declared a tariff truce to continue negotiations.

In our view, the US economy should be able to weather this storm. An all-out tariff war between the two largest economies in the world will certainly disrupt supply chains and likely lead to higher prices for a broad range of consumer goods. Still, we think it helps to keep the problem in perspective. Even if the US imposes a 25% tariff on all Chinese imports, total duties will amount to roughly 0.5% of the US gross domestic product, according to our calculations of data provided by the U.S. International Trade Commission.

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In all, we think the US economy will show resiliency in the face of what is admittedly a stiff headwind. Household income growth has continued to advance at a good pace. The decline in US interest rates that began late last year should certainly help consumers.

The market-implied rate projects a federal-funds rate of 1.7% by the close of 2019, according to the Chicago Board of Trade, consistent with three 25 basis point cuts. Although the forecasts of FOMC members have been more cautious, they are moving in the direction of the markets. The recent decline in bond yields to levels last seen in 2016 ranks as one of the year's biggest surprises. We find it hard to justify these moves; recession is not likely without a severe policy mistake, such as fighting a tariff war on multiple fronts.

Considering all the headwinds facing emerging economies, including a significant slowdown in Chinese economic growth, ongoing trade tensions between the US and China, weak commodity pricing and a still-resilient US dollar, it is surprising that emerging stock markets have appreciated at all this year. But as long as a tariff truce remains in place with the US, we expect China's economy to improve in the months ahead. Scores of measures, both monetary and fiscal, have been put in place over the past year.

Europe currently faces a variety of idiosyncratic challenges, both economic and political, that make it hard for even contrarian investors to get terribly enthusiastic about the near term. Economically, the downward trajectory is similar to that of the 2011-to-2012 period amid the region's periphery debt crisis. This time, however, Germany's industrial economy is fully participating in the slowdown.

It's not just the region's heavy exposure to manufacturing and international trade that makes German industrialists glum. There is also a worrisome vacuum of political leadership. Chancellor Angela Merkel is on her way out, and a politically distracted Germany is a concerning issue given the country's central importance in the eurozone and EU.

President Draghi has reason to be concerned. But unconventional monetary policy in the form of negative European interest rates, quantitative easing and term lending facilities do not carry a lot of punch nowadays. An aggressive easing of fiscal policy makes sense, but that strategy is a nonstarter in the eurozone. Once again, the structural flaws of the eurozone are coming to the fore.

And then there's the looming cloud of Brexit. Although it has been delayed until 31 October, there is little sign that the breathing space will be put to good use. It appears likely that Boris Johnson will win the Conservative Party's search for a new prime minister. It's hard to see how that improves the chances of an orderly exit.

Corporate profits should continue to expand and push global stock markets to higher levels in the months ahead.

Although economic growth is sluggish, the UK economy is not exactly failing as the deadline approaches. In fact, the UK unemployment rate fell to a multidecade low. The eurozone also recorded steady labour-market improvement, although the jobless rate remained far higher, owing to structural factors. That said, we can't help but think Brexit, if it indeed occurs, will prove to be a highly disruptive event for the UK and the EU. Roughly half of the UK's trade in goods, both imports and exports, is with the EU.

We think there is still life in the economic expansion in the US and globally. This view means corporate profits should continue to expand and push global stock markets to higher levels in the months ahead. This may seem like a bold statement at a time when the world seems increasingly unpredictable and economic data points to slowing growth.

We simply do not yet see the economic imbalances or nosebleed equity-market valuations that normally bring on recessions and an associated contraction in earnings and stock prices. It is also clear that central banks have investors' backs, as monetary policymakers promise to cut interest rates in various parts of the world and provide additional liquidity to their banking systems in both developed and emerging countries.

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 2019.

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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- Absolute return investments utilise aggressive investment techniques which may increase the volatility of returns. If the correlation between absolute return investments and other asset classes within the fund increases, absolute return investments' expected diversification benefits may be decreased.
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