Growth-Focused SEI UK Strategic Portfolios
Q1 2019 Quarterly Commentary

GROWTH-FOCUSED

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Strong 'risk-on' environment delivers positive relative performance in fixed income, but valuation-focused investors continued to have their patience and discipline tested.

Executive Summary

- In what can only be described as a strong risk-on environment, global fixed-income and global equity markets rallied meaningfully in the first quarter of 2019. Fixed-income markets were led by economically sensitive US high yield fixed income and emerging markets debt. Consistent with higher projected, albeit slowing growth rates, equity markets were led by US, with the rest of the world lagging.
- 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), the equity component delivered robust absolute returns, with benefits coming from a strategic small-cap bias, however the valuation-focus that has been present in a number of the asset classes has continued to present relative performance challenges.
- Returns for the Growth-focused Strategic Portfolios ranged between 6.70% and 8.72% in Q1 2019, compared to the 9.41% return from the FTSE All-Share Index and the 9.94% return delivered by MSCI World (net) Index over the same time period. (Source: SEI)
- While the fixed-income aspect of the Growth-Focused Strategic Portfolios did well, on the equity side our allocations to valuation-focused managers continued to struggle. SEI continues to believe in this position, with buying signals as strong as they have been since the technology bubble. Consistent with that view, it is also the first time since 1999 that valuation- and low volatility-focused strategies are highly correlated. In SEI's view this continues to present a strong opportunity on a forward-looking basis.
- Performance from the Growth-Focused Strategic Portfolios continued to be highly competitive over the medium term (5 years to 31 March 2019), maintaining these Fund's positions near the top of their respective Lipper peer groups.

Market Overview

Investor sentiment took a 180-degree turn in the New Year. Government bond rates declined in the UK, eurozone and US during the first three months of the year. Long-term rates generally fell by more than short-term rates in the UK and eurozone, and German 10-year government bond yields dropped back below zero. The US treasury yield curve inversion continued to deepen over the quarter, with the yield on the 10-year treasury ultimately falling below those of treasuries with the shortest maturities.

Meanwhile, stock markets rallied around the globe through most of the first quarter, reclaiming much of the fourth quarter's losses. The S&P 500 Index delivered its best quarterly performance since 2009. West Texas Intermediate crude oil topped USD60 per barrel at the end of the quarter after climbing by more than 30%.

The eurozone recorded the softest year-over-year expansion in five years.

The Bank of England's Monetary Policy Committee took no action in either of its two meetings this quarter. Its post-meeting statements expressed continued bias toward gradually tightening monetary policy (depending, of course, on the Brexit outcome).

The original Brexit Day (29 March) came and went without fanfare, as the EU granted an extension to the UK in hopes of avoiding a no-deal departure. Prime Minister Theresa May's deal was defeated in Parliament three separate times during the quarter, as were additional options that legislators debated and voted upon in late March (and again on 1 April).

British manufacturing growth cooled through January and February before rebounding convincingly in March; services sector growth slowed to a standstill in January, re-accelerated in February and then contracted in March. Claimant-count unemployment edged up to 2.9% in February after a flat January. The UK economy grew by 0.2% during the fourth quarter and 1.4% year-over-year.

The European Central Bank (ECB) said it intends to maintain current eurozone interest rate levels at least until the end of the year and continue re-investing proceeds from its asset purchase programme for just as long if not longer. The ECB also announced the scheduled September revival of its targeted longer-term refinancing operation to provide banks with funding for credit to households and businesses.

Conditions in eurozone manufacturing deteriorated during the first quarter, starting in slow-growth territory, contracting modestly in February and tumbling further in March. Eurozone services sector activity picked up from slow growth to healthier levels over the same three-month period. Eurozone unemployment ticked down to a rate of 7.8% in January, where it remained in February. The eurozone economy expanded by 0.2% during the fourth quarter and by 1.1% for all of 2018, recording the softest year-over-year expansion in five years.

The US Federal Open Market Committee took a dovish turn during the quarter, with new economic projections that showed zero interest rate increases in 2019. It also unveiled a plan to start slowing the reduction of its balance sheet in May—before halting reduction altogether in September and converting its allocation of mortgage-related assets to treasuries.

The US and China continued to negotiate the terms of a trade agreement after President Donald Trump's administration waived an early-March deadline to impose tariffs in the absence of a deal. China's negotiators provided assurances toward the end of the quarter that foreign companies will have greater access to Chinese investments.

On the US domestic front, the government remained partially shuttered for most of January due to an impasse between Congress and the Trump administration about whether to fund a multi-billion dollar wall on the US-Mexico border championed by the president. The Trump administration received a measure of resolution in March, when the special counsel investigating the 2016 election determined that the Trump campaign did not conspire with Russia to sway the election.

US manufacturing conditions oscillated between modest and healthy growth during the quarter, while US services sector activity showed firmer strength. The US unemployment rate declined to 3.8% in February, and the labour-force participation rate increased; more Americans joined or returned to the labour market amid an increase in average earnings. The US economy expanded by a 2.2% annualised rate during the fourth quarter, propelled by strong consumer spending.

Selected Asset Class Commentary

Global Equities Asset Class: The first quarter of 2019 saw strong equity market returns, in stark contrast to fourth quarter of 2018. Mega-caps, particularly in the US, posted even stronger gains, all in spite of weakening economic outlook. The asset class lagged its benchmark, suffering from an overweight position to value in particular, but also poor stock selection in the UK. All of the value managers lagged substantially over the period, with METROPOLE Gestion and Jupiter Asset Management detracting the most. Poplar Forest Capital, SNAM, and Maj Invest all detracted due to their orientation towards value. The momentum managers, INTECH Investment Management and Lazard Asset Management, both strongly outperformed their lagging alpha source, providing diversification at the building block level.

US yield curve inverts increasing concerns about the near-term economic outlook.

UK Equities Asset Class: The asset class marginally underperformed as holdings in a number of cheaper stocks within communication services suffered from earnings downgrades and share price declines. Jupiter Asset Management detracted due to stock specifics, primarily in the aforementioned communication services sector. Los Angeles Capital Management performed well due to the rebound of oversold domestically oriented consumer related stocks. Invesco Asset Management was positively impacted by a value tilt but more prominently from positive stock selection within consumer discretionary.

Emerging Markets Fixed Income Asset Class: Strong selection within information technology enhanced returns; especially within China, Korea, and Taiwan. Selection within energy enhanced returns as oil prices recovered. RWC Asset Advisors benefited from strong selection in financials, IT, EM Asia, and Europe, the Middle East and Africa. Neuberger Berman's strong selection in technology and healthcare was offset by poor selection in communication services and consumer discretionary. KBI Global Investors detracted due to poor selection in EM Asia; selection in China and Korea was the biggest driver.

Manager Changes

None for the period

Outlook

At the end of last year, SEI correctly forecasted that global equity markets were poised to robustly recover from their late December lows. The assumption was that the sharp price correction sustained during the fourth quarter overstated the weakness in economic fundamentals and the various uncertainties that plagued markets throughout much of 2018, and that most global markets were deeply oversold.

Today, there's no denying that a synchronised global growth slowdown is underway. However, it does not mean that the world economy is in recession or that it will soon fall into one. China and the UK, for example, are the third and fourth worst-performing countries, according to the Organisation for Economic Co-operation and Development's composite leading indicators. Yet China continues to post gross domestic product growth in the vicinity of 6%, while the UK recorded an increase of 1.3% last year, in inflation-adjusted terms.

As has been widely reported, the spread between 3-month and 10-year US treasuries went negative in March after narrowing throughout much of the expansion. Recession historically occurs within 12 to 18 months of the yield curve either narrowing to 25 basis points or inverting. The only time recession did not follow a yield curve inversion was in the 1966-to-1967 period, although US economic growth slowed dramatically.

Deeper recessions usually cause sharper share-price declines, as was the case in 1973. More expensive stock markets, as seen following the 1998-to-2000 tech bubble, also are more vulnerable. But the time between an initial yield curve inversion and the emergence of a bear market can be extremely long.

The US Federal Reserve's change in rhetoric at the start of the year certainly has been a helpful catalyst in sparking the risk-asset rally and credit-spread narrowing. By stressing patience and data dependence, the central bank signalled that the pace of US interest rates increases will slow considerably from that of the past two years.

SEI continues to see plenty of opportunities in emerging equities as investors gain confidence that the worst is behind us for the asset class. But a sustained improvement depends on better global growth. In SEI's view, China is the linchpin; optimism is retained that the country's economic conditions will improve as it begins to feel the lagged impact of easier economic and monetary policies.

China and the US could reach a broader trade agreement than most observers currently expect. This is a more optimistic view than SEI expressed three months ago. Since that time, the Trump administration has deferred tariff increases. Both sides now recognise the damage that the trade standoff has caused to their respective economies and financial markets.

A more expansive trade agreement would provide a much-needed boost to the Chinese economy. It also would benefit nations that have high export exposure to China, both directly and through the supply chain network. China, South Korea and Taiwan now account for 57% of market capitalisation of the MSCI Emerging Markets Index, so its performance will depend on their economic fortunes.

Investor pessimism about Europe appears overwhelming. The European Central Bank recently cut its forecast for 2019 eurozone gross domestic product growth to 1.1% from 1.7% just three months ago. It's a wonder that the year-to-date performance of European equities managed to nearly keep pace with that of US equities.

Many of Europe's problems are structural and difficult to improve. Its demographic profile, for example, looks rather bleak. Europe is the only major region where the population is expected to contract between now and 2050. The unemployment rate for Europeans aged 25 to 29 is still in double digits. By comparison, the average annual unemployment rate in the US for this age group is approximately 4%.

The EU extended the Brexit deadline for the UK to decide on its course of action, with the understanding that the UK will fundamentally rethink its position. A long delay could entail another referendum or even a change of government. It also means that the UK must participate in EU Parliament elections starting 23 May.

Investor pessimism about Europe appears overwhelming.

The uncertainty surrounding Brexit outcomes and timing remains a depressant for economic growth in the UK and the rest of Europe. Bottom-up analysts expect UK earnings to decelerate to just 2% in 2019, which is in stark contrast with last year's surprisingly strong rate of 10.8%.

The plunge in risk assets during the fourth quarter and subsequent bounce back in the first quarter of this year is a reminder that one should always expect the unexpected when it comes to investing. Cash was king in 2018, providing a 2.1% return. However, cash was consistently one of the worst performers in most other years going back to 2009. Emerging equities fell at the other end of the performance spectrum in 2018, sustaining a total-return loss of 14.6%, but was the strongest category in 2017 and posted a double-digit return in 2016.

In a world where the best- and worst-performing asset classes tend to dominate the headlines, it can be easy to forget that diversification has historically been the most reliable approach for meeting long-term investment goals, especially when looking through the lens of risk-adjusted returns. While a diversified portfolio rarely wins from one year to the next, it also rarely loses, and therein lies its beauty.

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 31 March 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.

IMPORTANT INFORMATION

The SEI Strategic Portfolios are a series of the SEI Funds and may invest in a combination of other SEI and Third-Party Funds as well as in additional manager pools based on asset classes. These manager pools are pools of assets from the respective Strategic Portfolio separately managed by Portfolio Managers which are monitored by SEI. One cannot directly invest in these manager pools.

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Allocations shown are SEI's target strategic asset allocations, which are based on our long-term expectations for the global markets and are derived from our capital market assumptions. In the short term, we may over- or underweight these positions as part of our active asset allocation, which aims to take advantage of short-term market opportunities. Please refer to the most current fact sheets for the funds' target active allocations, which more closely reflect the funds' current allocations.

SEI sources data directly from FactSet, Lipper, and BlackRock, unless otherwise stated.

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