SEI Strategic Portfolios

APRIL 2019 MONTHLY COMMENTARY

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Further gains delivered across equities and fixed income in April 2019; avoiding some of the largest names in the market continued to drag on the performance of a number of equity asset classes

Executive Summary

- April 2019 brought further broad-based gains across fixed income and equities market. Fixed Income markets continued to be led by economically sensitive US high yield fixed income and corporate bonds. Developed markets equities outperformed emerging, with US and European markets leading. Smaller companies lagged in the US, but outperformed in Europe.
- Considering the Stability-focused SEI Strategic Portfolios, an overweight to credit in the global investment grade building blocks was additive, as was an overweight to higher yielding fixed income. The strategic allocation to US High Yield fixed income also added value at the asset allocation level. Consistent with its objective, the Global Managed Volatility Equities building block lagged the equity market, however, by design was able to provide meaningful risk reduction.
- For the Growth-focused SEI Strategic Portfolios, the equity component again delivered robust absolute returns. We continue to observe that a number of very high capitalisation stocks, many of them struggling for profits, are leading the market rally.
- Companies like Netflix have a market capitalisation of around $160bn dollars with a price to earnings ratio above 120x, compared to Citigroup which is trading at 9x earnings on a similar market capitalisation. Investors seem to value potential future growth over present profitability, a dynamic last seen during the tech bubble. For the same valuation as Netflix, investors could own every single ASEAN Telco and still have $20bn to spare. As a further example of the current market mentality, Uber is likely to come to market with an IPO capitalisation of $80-$90bn USD, all the while making losses in a low-margin business and while experiencing shrinking revenue. It is figures like these which reinforce our belief that these “growth” stocks are overpriced and offer less opportunity than others in the market.
- While somewhat painful and definitely frustrating, we continue to believe that this scenario will ultimately revert. Some of the world’s most successful investors have achieved their results through hard-nosed discipline; we believe strongly that this is the correct approach. In this context we feel there is a lot of embedded investment value in a number of the underlying equity building blocks, and continues to present a strong opportunity on a forward-looking basis.
- As a result of the rebound, the SEI Strategic Portfolios maintained their highly competitive position against peer groups. The Stability-focused portfolios delivered on their mandate of drawdown protection through the challenging last quarter of 2018, while the Growth-focused portfolios provided above-average returns against peers. The Aggressive Fund outperformed the average of its peers by 2.2% in the first four months of 2019 (Wealth A Share Class, in GBP, net of all fees).

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Market Overview

The global stock-market recovery that defined early 2019 extended into April. Major developed equity markets climbed steadily throughout the month. Emerging markets also gained, but performance diverged in China, with Hong Kong slightly higher and mainland stocks essentially flat after a late-month selloff. Intermediate- and long-term government bond rates generally increased in the UK, Eurozone and US, while short-term rates were mixed, resulting in steeper yield curves. Oil prices advanced for the full month, but peaked in late April before retreating a bit.

The Bank of England's Monetary Policy Committee did not meet during April, and voted unanimously on 2 May to abstain from any policy changes. Committee guidance retained a bias toward higher rates in the future, depending on the Brexit outcome. British retail sales volumes showed strength in April, rebounding from a soft March, and a promising projection for May. Manufacturing conditions cooled in April following a spike during the prior month. The services sector, meanwhile, maintained pace in April after contracting in March. The claimant count unemployment rate edged upward again in March, to 3%; average year-over-year earnings growth for December-February increased to 3.5%, while the unemployment rate remained unchanged at 3.9% for the three-month period.

The EU and UK set a new Brexit deadline in early April, moving the UK's departure from the EU to 31 October. The European Central Bank's Governing Council did not meet to address monetary policy in April, but minutes released from its March meeting showed that some members argued for further accommodation. Eurozone manufacturing conditions contracted again in April, while an early estimate of services sector activity showed continued modest growth. The unemployment rate edged down to 7.7% in March due to large labour-market gains in Italy and Spain, which have struggled with higher unemployment. The broad Eurozone economy grew at a 0.4% quarterly rate in the first quarter, improving on the results of recent quarters.

US-China trade talks continued through the end of April, touching on foreign access to Chinese markets, with China's negotiators showing willingness to lower barriers to entry in the financial sector. Talks also covered whether and how far to remove the tariffs imposed last year, and mutually agreeable enforcement mechanisms appeared to take shape as talks progressed. A Chinese trade delegation is scheduled to visit Washington, DC beginning on 8 May. The U.S. Federal Open Market Committee began its latest meeting on the last day of April and announced no new policy actions on 1 May. US manufacturing activity expanded at a measured pace in April, while services sector growth slowed. Inflation continued to edge lower in March, touching 1.6% year over year. The U.S. economy grew at a 3.2% annualized rate during the first quarter, surpassing the fourth quarter and beating expectations.

Selected Asset Class Commentary

U.S. High Yield Fixed Income Asset Class: The asset class outperformed its benchmark in April. The primary points of interest were better-than-expected earnings, improving global growth, mild domestic inflation and accommodative monetary policy. Brigade benefited from selection within media and an overweight to and selection within technology and electronics. T. Rowe Price's selection with media and technology and electronics was positive. Ares' selection within health care and basic industry contributed. There were no detractors during the month.

Global Equities Asset Class: The asset class lagged its benchmark, generally suffering from underweighting mega-caps by most active managers and underweighting high growth stocks, which SEI believes do not offer attractive long-term return/risk opportunities. A strong overweight to valuation-focused strategies has mitigated underperformance, however aggregate stock selection from underlying valuation-focused managers remained negative. A strong underweight to Momentum and neutral weight on low volatility has mitigated the impact of Lazard and Intech, both Momentum managers, at the building block level. Intech's stocks specifics detracted further, as well as their current low beta positioning. Maj Invest was a standout disappointment over the month, as sector positioning and stock selection was poor. Jupiter, Metropole, SNAM and Towle all beat their benchmark. Whereas Towle's and SNAM's performance was driven entirely by their alpha source, Jupiter and Metropole benefited from other drivers. Stock specific rebounds, Asian-linked financials, helped the former, while sector allocation and high volatility bias was beneficial to the latter.

Manager Changes

None over the period.

Outlook

At the end of last year, we 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 equity 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 last five yield curve inversions preceded recessions by an average period of 18 months; and over those 18 months the S&P 500 was up by an average of 32%. This goes to show that, despite the gloomy headlines, there is a lot of potential for market upturn immediately following an inverted yield curve.

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 rate increases will slow considerably from that of the past two years.

We continue 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 our 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 we 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

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financial markets. While many view the delay in finalising a trade deal as a bad sign, we see it as a sign that both sides are willing to grapple with the hard, substantive issues in order to make a broader, more meaningful agreement.

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 their economic fortunes are very impactful.

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 (to 31 October) for the UK to decide on its course of action. A longer 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.

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 climate where it seems that leadership is concentrated within a narrow few, it can be hard to remember that diversification has historically been the most reliable approach for meeting long-term investment goals, especially when analysing on a risk-adjusted basis. Whilst it may be frustrating for investors to see a small group of stocks seemingly continue to climb, it is important to remember that this trend does not historically continue forever. On the other hand, a diversified portfolio may not climb as high in one year; but it naturally rarely falls as low, and that is what investors often value above all else.

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 April 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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- *Fixed income securities are subject to credit risk and may also be subject to price volatility and may be sensitive to interest rate fluctuations.*
- *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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