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SEI UK Strategic Portfolios: July 2020 Monthly Commentary

Global equity markets once again showing their 'FAANGS', amidst continued pandemic uncertainty

Executive Summary

- Global equity performance varied across base currencies by more than usual in July, ending slightly down in sterling, flat in euro, and much higher in US dollars. The remarkable dispersion was a result of the US dollar's spot price dropping by more than 4% versus a basket of major currencies during the period, marking its largest one-month decline since September 2010.[1]

- Emerging-market shares, led by China and Latin America, handily outperformed those of developed markets for July, while US equities outpaced other major developed markets. The gold futures price rose to an all-time high in US dollars during the month, finishing with a gain of more than 10%.

- Government-bond rates generally declined across maturities in the UK, Eurozone and US during July. UK gilt rates declined most dramatically in the intermediate-to-long-term segment of the yield curve; in the Eurozone and the US, government-bond rates dropped the most in government bonds with the longest maturities.

- July was another strong month for fixed income, where relative returns were boosted by overweight positions to economically sensitive debt, including corporate bonds, selected emerging markets as well as peripheral Eurozone debt. However, for the Stability-Focused Strategic Portfolios, the Global Managed Volatility Equities asset class lagged in a rising equity market holding back performance, resulting in flat to slightly positive returns overall.

- For the Growth-Focused Strategic Portfolios, the same challenges faced by value managers at the start of the pandemic returned in July, with strong results for the newly named 'stay at home stocks' ending the style rotation from Q2. In addition, dollar weakness affected the returns of unhedged US stock allocations. Our core investment case for SEI's overweight to this area remains the same: extreme relative valuations between the most expensive and cheapest parts of the market. SEI believes that the post-crisis environment may provide further support for this positioning, given the huge stimulus being provided.

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[1] "US dollar has worst month since 2010 in 'relentless' sell-off." Financial Times. 31 July 2020.

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Market Overview

- The wide-ranging labour-market support that the UK's Job Retention Scheme has provided was set to begin receding at the end of July. Effective August, companies are required to begin paying the national insurance and pension contributions for their furloughed workers; companies must also pay 10% of their wages starting in September, and then 20% by October. Expanding this burden-sharing raises the possibility that employers will need to permanently lay off workers.

- Solid growth returned to the UK's services sector, according to an early July report, while manufacturing continued to rebound at a steady and moderate pace. Mortgage approvals re-accelerated to about 40,010 in June after bottoming at approximately 9,270 in May; associated lending jumped from about £290 million to approximately £1.22 billion in the same period. The latest available information on UK gross domestic product (GDP) showed a contraction of 19.1% from March to May 2020.

- The Bank of England's Monetary Policy Committee did not hold a meeting during July. Following its mid-June meeting, the central bank announced that it would expand its stock of asset purchases (from an initial £200 billion increase announced in March) by another £100 billion to £745 billion.

- The EU struck a landmark accord to help fund an economic recovery from COVID-19-induced containment measures. The agreement's €1.8 trillion price tag includes a €750 billion recovery plan (with more than half the figure intended as grants and the balance as loans), as well as funding for EU budgets through 2027. In a first, EU members agreed to partially fund the deal by issuing common EU debt, thereby tightening the fiscal union between member countries.

- The European Central Bank (ECB) held its benchmark interest rates firm after a mid-July monetary policy meeting, and emphasised the demand for and utility of its asset-purchase and lending programmes.

- The recovery in eurozone manufacturing remained subdued in July, while services activity accelerated, according to a preliminary report. Across the euro area, the unemployment rate increased by 7.8% in June, from 7.7% in May. The first reading of second-quarter GDP for the eurozone showed a contraction of 12.1%, its largest quarterly drop on record[2]. Germany's economy shrank by 10% for the second quarter, while Italy, France and Spain contracted by 12.4%, 13.8% and 18.5%, respectively; Lithuania's 5.1% second-quarter decline was the mildest in the Eurozone.

- At the end of July, US President Donald Trump's administration was still negotiating new fiscal-stimulus terms with the US House of Representatives, despite the end-of-July expiration of enhanced unemployment insurance benefits and protections from eviction within housing supported by the federal government.

- Tension between the US and China intensified throughout July. In a break from previous US policy that said maritime disputes must be resolved peacefully through UN-backed arbitration, the Trump administration formally denounced China's territorial claims in the South China Sea as illegitimate. The US also imposed sanctions in response to human rights abuses against Muslim Uighurs and ethnic Kazakhs in the Xinjiang region. China issued retaliatory sanctions against US senators who criticised the abuses.

- The US Federal Open Market Committee made no monetary-policy changes following its late-July meeting, but reiterated its commitment to using its full range of programmes to help support current economic challenges. During July, the Federal Reserve Board of Governors announced extensions of temporary U.S. dollar-liquidity-swap and repurchase-agreement facilities with other central banks through March 2021.

- US manufacturing activity expanded at a modest rate during July; new orders accelerated, while employment continued to contract. Services sector activity essentially maintained pace during the month, according to an early report, after moving lower in June. New US jobless claims bottomed in mid-July at 1.3 million per week

[2] "Eurozone GDP slumps by record 12.1% amid coronavirus pandemic chaos– as it happened." The Guardian. 31 July 2020

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before increasing through the end of the month. The U.S. economy shrank at a 32.9% annualised rate during the second quarter, its sharpest decline on record since 1947[3].

Selected Asset Class Commentary

- **Emerging Markets Fixed Income Asset Class:** The asset class outperformed in July. It benefited from overweight positions to countries that underperformed during March's sell-off, such as Mexico and Angola. Stone Harbor Investment Partners LP gained on overweight positions to Mexico and Argentina. Underweights to Panama and the Philippines detracted. Colchester Global Investors Limited benefited from overweight to Ukraine and Mexico, overweights to Russia and South Africa hurt. Neuberger Berman Investment Adviser's overweight positions to Mexico and Brazil helped, while underweights to Peru and Czech Republic detracted. There were no underperforming managers during the month.

- **Global Managed Volatility Equities Asset Class:** The asset class was hurt by its preference for cheaper stocks and its diversity exposure during the month, which led to lack of exposure to US technology leaders. Wells Fargo Asset Management benefited from favourable underweights to energy and financials and an underweight to value-oriented names. Solid selection within US industrials also helped. LSV Asset Management's value bias hurt, as did its exposure to cheaper stocks within the low-volatility space and underweight to large technology companies.

- **Global Equities asset class:** The asset class underperformed in the month of July, with the allocation to value managers and underweight to mega-cap companies detracting from returns. Maj Invest was the largest detractor, anchored by its large exposure to Japanese "lock-down risk" stocks as the virus reaccelerated in the country. Poplar Forest Capital, a US value manager, also lagged due to similar dynamics. Towle & Co, a US all-cap manager with a strong small cap bias, bucked the trend and continued its recovery in July. Towle benefited from a strong recovery in their housing and auto part holdings. Both momentum managers, INTECH Investment Management and Lazard Asset Management, contributed during the month. Furthermore, their larger cap bias enhanced returns. The currency specialist, Rhicon Currency Management, also extended its outperformance as foreign exchange volatility persisted.

Manager Changes

- N/A

Outlook

- Despite mounting infections, hospitalisations and deaths from the pandemic, as well as the unprecedented stoppage of global economic activity, stock markets around the world have managed to mount a resounding comeback. SEI's working assumption is that there will likely be another significant wave of infections going into the fall-to-winter flu season. The question is, how disruptive will it be to the global economy?

- Even if a sustainable economic recovery gets under way, investors seem to be ignoring the possibility that it may be a long time before most companies achieve previous levels of profitability. The after-tax profit margins of US domestic businesses were already on a declining trend before the onset of the virus and shelter-in-place orders.

- Margins around the globe will likely remain well below their previous peaks as long as COVID-19 is a severe health threat. Most businesses, to one degree or another, are expected to endure lower sales, higher costs and a decline in productivity. There also will probably be a deadweight loss for industries needing extra inventory on hand in order to guard against future shortages and supply-chain disruptions caused by periodic flare-ups

[3] "Coronavirus: US economy sees sharpest contraction in decades." BBC News. 30 July 2020

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of the virus. “Just-in-time” inventory management will turn into “just-in-case” inventory management, tying up cash.

- The extraordinary March-to-April lockdown in the US necessitated fiscal measures unparalleled in both scope and speed of implementation. The result has been a tsunami of red ink. As of April 2020, the Congressional Budget Office projected the deficit will reach nearly 18% of US GDP in 2020, and improve to only 10% of US GDP in 2021. US debt relative to GDP is forecast to rise to 108% by the end of fiscal year 2021 versus 79% at the end of fiscal year 2019.

- These are unsettling numbers. Many investors may wonder whether such a surge in government debt will provoke an economic crisis even after the pandemic runs its course. SEI do not believe that it will. The US has a large, dynamic economy and deep capital markets.

- The policies pursued by the Federal Reserve have also served to keep interest rates low. Its balance sheet has ballooned this year, far exceeding the increases logged by the ECB or the BOJ.

- The US certainly is not alone in engaging in a huge fiscal response that is then monetised by the central bank. In our opinion, governments are treating the fight against COVID-19 like they would a war. As many resources as possible are being thrown into the fight, supported by debt issuance that is absorbed primarily by the central banks.

- Investors do not seem too concerned about the speed of Europe’s economic recovery or the impact of the health crisis on countries’ fiscal positions. The bond yields of the most economically-fragile countries remain close to those of German bund yields, although spreads have widened from pre-pandemic levels. The ECB has been quite successful in short-circuiting the liquidity crisis and flight-to-safety that threatened the euro area’s financial structure.

- While many factors determine equity performance, it has correlated in the emerging-market space with the extent of economic disruption caused by the virus. Asian and central European countries have pulled back the most on their mandates to restrict movement and social interaction. Latin America and India have eased some of those constraints, but not nearly as much as the other two regions. We continue to keep close tabs on China, as it was the first to lock down and first to unlock activity. We expect recovery patterns elsewhere in the world to follow that of China.

- Central banks in the emerging world are also doing their part to help restore their economies. Interest rates have come down in almost every country in recent months, to record-low levels in many cases. In addition, a long list of emerging-country central banks, including those with shakier reputations, such as South Africa and Turkey, are either buying or planning to buy their government’s debt. We think this debt-monetisation may lead to an inflation problem in the future.

- It’s been said many times that bull markets climb a wall of worry. Maybe now they must learn to swim through waves of worry that include:

    - The possibility of a second wave of COVID-19 infections (or, arguably, a continuation of the first wave in some countries) forcing another round of extensive lockdowns and shelter-in-place orders that could lead to a double-dip recession

    - A possible breakdown of political consensus regarding the way forward as economies struggle to regain strength

    - The likelihood that economic recovery will take at least a year, and likely longer—and that few economies are apt to rebound fully to pre-pandemic levels, even if most countries manage to avoid a disruptive second wave of the virus

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- Expectations that companies will face higher costs and increased inefficiencies; taxes will almost certainly rise across many economies in the years ahead; and bankruptcies and defaults will climb as government aid programs end

- SEI believes that an ebb and flow of assorted concerns in the coming months will continue to spark volatility across financial markets. Such periods of instability are to be expected in any long-term investing plan. As always, ensuring that clients have aligned their goals with the correct portfolios remains key.

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 2020.

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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