SEI Strategic Portfolios

SEI Strategic Portfolios August 2022 Monthly Commentary.

The rally of late summer 2022 ends early, with markets responding to persistent inflation and rising rates; SEI Strategic Portfolios provided downside protection

Executive Summary

- Summer break ended early for the equity market as the rally that started in June began to cool by mid-August. Shares then began a concerted selloff that lasted through the end of the month. Developed-market equities led the slide; while emerging-market shares followed a similar path, they ended August essentially flat due to a milder decline.[1]

- Market watchers attributed the rally's reversal to signalling from the US Federal Reserve (Fed) that it remains committed to overcoming high inflation despite anticipated economic pain.

- The bond market's early-summer rebound, which began at roughly the same time as the bounce in equities, faltered at the start of August as interest rates climbed around the world (yields and prices have an inverse relationship).

- Government bonds from developed markets outside of the US were the worst performers in fixed income for the month, trampled by rising rates combined with the accelerating (near-relentless) climb in the US dollar (measured by the U.S. Dollar Index). Local-currency denominated emerging-market debt had the bond market's mildest loss for the month.[1]

- The bias towards valuation-focused managers returned to form in August, after modestly giving back some returns in July after a prolonged period of mainly positive relative returns. SEI have always indicated that the outperformance that we had been anticipating would not be delivered in a straight line, and that there will be short periods of reversal, however it remains our strong conviction to stay with this investment discipline.

- Performance against comparable peers remains strong, with many of the Strategic Portfolios delivering above average returns over both the short term YTD and 1-year periods, as well as over the long-term 7- and 10-year periods, irrespective of share class.

- It continues to be SEI's strong belief that the rotation into value stocks is nearer to its start than to its end; the metrics SEI uses to identify its preferred alpha source positioning continue to point strongly towards a bias toward valuation-focused managers. SEI feels that looking forward there remains a lot of potential for this positioning, even after a strong start to relative performance in 2022.

Market Overview

- The Bank of England's (BoE) Monetary Policy Committee (MPC) did not hold a meeting in July after increasing the bank rate to 1.25% in June and redeeming about £3.2 billion in balance sheet assets during

[1] According to data from FactSet and Lipper

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July. At its early August meeting, the MPC was expected to hike its benchmark rate by 0.50%, to 1.75%, which would represent the largest individual rate increase in 27 years[2].

- Consumer prices in the UK increased in July by 0.6% during the month and 10.1% over the prior year—up from 0.8% and 9.4%, respectively, in June—and setting a new 40-year high for the year-over-year inflation rate.[3] The UK economy contracted by 0.1% in the second quarter of 2022 (compared to growth of 0.8% in the first quarter) and expanded by 1.9% over the 12 months through June (after gaining 8.7% for the prior one-year period).

- UK manufacturing activity began to contract during August following three months of slowing growth.[4] The UK services sector continued to expand at modest-but-healthy levels in August that were roughly in line with the prior three months.[5] The UK's claimant count (which calculates the number of people claiming Jobseeker's Allowance) declined in July for the seventeenth consecutive month—by about 11,000—with total claimants holding firm at 3.9% of the population.

- The European Central Bank (ECB) increased its three benchmark rates by 0.50% at its July meeting for the first time in 11 years, surprising investors who were expecting hikes of 0.25%. Eurozone consumer prices increased in August by 0.5% for the month and 9.1% over the prior year, versus respective gains of 0.1% and 8.9% in July. August's year-over-year inflation figure was the highest since Eurostat began tracking data in 1997.[6] The eurozone economy grew by 0.6% during the second quarter and 3.9% year over year, compared to 0.5% and 5.4%, respectively, in the first quarter.

- The eurozone unemployment rate held at 6.6% in July for the third straight month, retaining the lowest level since Eurostat began recording employment data in 1998.[7] A modest contraction in eurozone manufacturing activity that began in July continued through August.[8] The expansion in eurozone services activity essentially ground to a standstill in August after peaking this spring.[9]

- The US Federal Reserve's (Fed) Federal Open Market Committee (FOMC) increased the federal-funds rate by 0.75% toward the end of July bringing the benchmark rate to a range between 2.25% and 2.50%. The US Personal Consumption Expenditures Price Index (the Fed's preferred inflation measure) fell to 6.3% year over year through July from 6.8% in June, easing off a 40-year record high.[10]

- Manufacturing growth in the US continued to slow in August, reflecting a modest expansion after declining sharply in June.[11] US services activity shrank at an accelerating pace in August after tumbling into

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[2] "Bank of England announces biggest interest rate hike in 27 years." Yahoo! Finance. 4 August 2022.

[3] "UK Inflation Hits Double Digits for the First Time in 40 Years." Bloomberg. 17 August 2022.

[4] S&P Global / CIPS UK Manufacturing PMI. 1 September 2022.

[5] S&P Global / CIPS Flash UK Composite PMI. 23 August 2022.

[6] "Eurozone inflation rises to record 9.1%." Financial Times. 31 August 2022.

[7] "Eurozone Unemployment Holds Stable At Historic Low." Barron's. 1 August 2022.

[8] S&P Global Eurozone Manufacturing PMI. 1 September 2022.

[9] S&P Global Flash Eurozone Composite PMI. 23 August 2022.

[10] "The Fed's preferred inflation measure set a new 40-year high in June." CNN. 29 July 2022.

[11] S&P Global US Manufacturing PMI. 1 September 2022.

contraction during July.[12] The overall US economy contracted during the second quarter by an annualised 0.6% after declining by 1.6% during the first quarter.

- US nonfarm payrolls increased by 315,000 in August, but the unemployment rate climbed to 3.7% (from 3.5% in July) as the labour-force participation rate increased (thereby expanding the pool of potential workers). Job openings in the US rose to 11.24 million during July from 11.04 million in June. The number of unemployed Americans measured 5.67 million in July, meaning there were about two jobs available for every jobseeker.

Selected Asset Class Commentary

- **Global Short Duration Fixed Income Building Block:** During the month, a duration underweight to the UK, US, Europe and other developed markets was generally favourable. AllianceBernstein gained due to an off-benchmark allocation to corporate credit. Wellington Management Company performed in line with the benchmark with duration positioning helping and currency positioning hurting. Colchester Global Investors underperformed due to negative currency positioning within Japan, Sweden, Colombia and Norway.

- **Global Equities Building Block:** The building block gained due to an overweight to value during the month. An overweight to financials and underweight to IT and mega-capitalisation companies contributed. Poplar Forest Capital underweight to mega-caps and overweight to financials (insurance) provided a tailwind. Towle & Co also registered solid performance due to its value positioning and positive security selection within energy and consumer staples. Sompo Japan Nipponkoa Asset Management Co (SNAM) allocation to materials and utilities aided returns. LSV Asset Management recorded positive performance during the month due to a beneficial allocation to low volatility stocks, and their overweight to defensive sectors was generally favourable. Rhicon Currency Management gained from its foreign exchange market exposure. Fiera Capital underperformed due to a negative allocation to higher-quality stocks.

Manager Changes

- Royal London Asset Management (RLAM) was added to the UK Core Fixed Interest building block as at August 2022. RLAM's investment strategy prioritises security selection and focuses on inefficient areas of the credit market, such as unrated bonds (which do not carry a grade or appear in benchmark indexes) which RLAM considers attractive due to pricing discrepancies. We expect the strategy to outperform the benchmark during periods of higher risk. We also believe RLAM will register favourable performance in a low-volatility environment when income is the primary driver of returns.

- PIMCO Europe Ltd was removed from the UK Core Fixed Interest building block as at August 2022. We made this change for portfolio construction reasons. We believe the removal of PIMCO's strategy will result in a lower long-term credit beta allocation in the Fund. Credit beta refers to systematic risk or volatility of returns for investments in credit or debt securities. The assets in PIMCO's strategy were transferred to the newly-added Royal London Asset Management UK Core strategy. We believe the new manager line-up will improve Fund diversification.

Outlook

- It's been SEI's mantra for the past year that US inflation would be higher for longer than most economists and investors appeared to expect. SEI believes this remains the case, although the gap between our expectations and those priced in US markets has narrowed considerably and the pace of inflations' increase is almost certainly close to a peak. Investors and the Fed still seem to be betting that inflation pressures will ebb significantly starting in the second half of this year and fall to 3% by the end of 2023.

- Fed Chairman Jerome Powell continued to expresses hope that the Fed can achieve a "softish" landing, where inflation gradually decelerates back to the central bank's 2% target without a recession. Unfortunately,

[12] S&P Global Flash US Composite PMI. 23 August 2022.

there has been only one successful instance since the end of World War II (1951-to-1952) when inflation was running above 5%.[13]

- Federal funds-rate futures indicate that investors are anticipating a series of increases between now and year-end that would bring the funds rate to 3.4%. The peak is indicated to be between 3.75% and 4% a year from now. Markets are presumably pricing in a recession by the second half of 2023, considering the funds rate is projected to decline at that point.

- SEI believes this to be a reasonable forecast, but the actual outcome will depend on how quickly the economy actually weakens and inflation ebbs. The evidence as of today suggests that the US economy may continue to show a resilience that surprises both the Fed and investors.

- There are signs of economic trouble ahead. The surge in US mortgage rates is delivering a big blow to the housing market. Beyond real estate, economists have begun citing the big increase in retail inventories as a harbinger of recession.

- There is no denying that rising interest rates will slow economic growth. But changes in monetary policy affect the economy with a long and variable lag. While the financial strength of US businesses and households is likely to ebb, the starting point is a very high one. The labor market, for instance, remains exceptionally tight. Until a better balance between the demand and supply of labor is achieved, one should expect further large wage gains at the lower end of the wage-income spectrum, where the job market is tightest.

- American job switchers have enjoyed a sharper-than-average wage gain of 7.5% over the past 12 months. It should not be surprising that the US quit rate is significantly higher than in 2019 or at the previous economic peak in 2007.

- Other major developed economies are not too far behind. The U.K. has an unemployment rate below 4%. Canada and Europe usually have unemployment rates that are considerably higher than the US and the U.K. That remains the case, but both report jobless totals that are below previous cyclical lows.

- All this suggests that workers are in a strong position to seek bigger wage gains in an effort to keep up with inflation. The possibility of a global wage-price spiral still cannot be dismissed. This could force central banks to raise interest rates more than they would prefer.

- In Europe, the need to hike interest rates has once again raised the specter of another periphery debt crisis. Italian 10-year bonds are trading some 70 basis points higher against German bunds than they were at the start of the year. This is on top of the two percentage-point jump in German rates that has been logged over the same six-month stretch.

- The stress has not reached the crisis levels of the 2010-to-2012 period. Given all the other problems facing Europe, the ECB has vowed to support the weaker members of the eurozone with continued bond purchases.

- As was the case last time, the economic priorities of the strongest countries are diverging from their weaker neighbors. The German-led bloc needs a more aggressive policy tightening along the lines of what the Fed is expected to do. Meanwhile, the weaker countries, Italy and Greece especially, now bear an even heavier debt burden relative to the size of their economies than was the case a decade ago. The interest expense on that debt could get out of hand fairly quickly if the cost of capital continues its sharp upward trajectory.

- The ECB is so concerned about the situation that it actually held an emergency meeting the same day as the Fed's interest-rate announcement in order to assure markets that it is working on an "anti-fragmentation tool" that will keep spreads narrow while still allowing the central bank to fight inflation.

[13] According to SEI's analysis of data from the Economic Cycle Research Institute and U.S. Bureau of Labor Statistics.

- The poor performance of financial markets this year suggests that investors have already discounted a lot of bad news. The price decline in the S&P 500 Index recorded in the year-to-date contrasts sharply with the ongoing increases in forward-earnings estimates. The result has been one of the sharpest reductions in stock multiples outside of a recession in the past 25 years.[14]

- The froth certainly appears to have been taken out of the markets by this year's pullback. That's the good news. The bad news is that an economic recession and a corresponding decline in earnings might not yet be fully reflected in stock prices.

- Multiples tend to slide as projected earnings estimates fall. Even if price-to-earnings ratios remain at current levels, there could be a decline in projected earnings—and a comparable drop in stock prices—as analysts incorporate a recession's impact into their models. While the consensus view is that stock prices face rough seas ahead, it is possible that earnings multiples do not need to contract much further than they have already—with the caveat that bond yields stabilize near current levels and do not climb significantly higher.

Important Information on Performance

This is a Marketing Communication. Past Performance does not predict future returns. Standardised performance is available upon request. All data is as a 31 August 2022.

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.

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[14] According to SEI's analysis of data provided through Factset.

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