SEI Strategic Portfolios

SEI Strategic Portfolios July 2022 Monthly Commentary.

Fixed income and equity markets experience a positive reversal in fortunes in July; given the strong volatility particularly in the second quarter, this was not entirely unexpected.

Executive Summary

- The selloff that shaped the first half of 2022 came to a halt as equities and fixed-interest asset classes rallied in July. Shares and bonds moved sideways during the first half of the month after climbing off a bottom in mid-June, and then recovered at an accelerating pace as the end of July approached.[1]

- Data showing softening economic activity counterintuitively provided investors with a confidence boost, as slower growth and milder inflation would likely mean that central banks won't need to increase rates as much as feared, thereby keeping a lid on borrowing costs.

- Equity performance patterns reversed, with US shares leading major markets after delivering one of the second quarter's worst performances. Japan also had a large one-month gain, as did Europe; UK shares trailed these markets, but nevertheless benefitted from a large rebound in July. Emerging-market equities, meanwhile, generated a small loss as China's second-quarter rebound faltered.

- Growth-oriented shares outpaced their value-oriented counterparts during the month, although the difference was considerably greater within large-cap equities than in small caps.

- UK and eurozone government bond rates fell across most maturities in July, with the steepest declines in the *medium*-to-long-term segment of the yield curve. Short-term US Treasury rates increased, while medium-to-long term rates fell, resulting in a flatter curve that also grew more inverted (that is, when shorter-term rates are higher than longer-term rates).

- High-yield bonds were the best-performing fixed-interest asset class in July in keeping with the resurgent appetite for risk. Most other segments of the bond market were also positive given the general decline in rates (yields and prices have an inverse relationship).[2]

- Many of the positions that have provided strong relative returns for the Strategic Portfolios in first two quarters of 2022, which had provided downside protection this year and robust results over the 1 and 2 year period, reversed in July, which to a degree was inevitable, given the speed and strength of this earlier return pattern.

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[1] According to data from FactSet and Lipper

[2] According to data from FactSet and Lipper

- SEI have always said 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.

- It remains SEI's strong belief that the rotation into value stocks is just beginning; 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 providing robust downside protection in 2022 so far.

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 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[3].

- Consumer prices in the UK jumped by 0.8% in June and 9.4% over the prior year—up from 0.7% and 9.1%, respectively, in May—and setting a new 40-year high for the year-over-year inflation rate[4].

- UK manufacturing activity settled further into low-growth territory during July for the third consecutive month of slowing expansion.[5] Growth in the UK services sector held at modest-but-healthy levels in July that were roughly in line with May and June's expansion.[6]

- The UK's claimant count (which calculates the number of people claiming Jobseeker's Allowance) declined in June for the sixteenth consecutive month—by about 20,000, with total claimants representing 3.9% of the population in June compared to 4.0% in May. The UK economy expanded by 0.4% in the three months to May 2022 and by 3.5% over the prior 12 months. These growth rates were slower than the first quarter rate of 0.8% (and 8.7% for the year through March).

- 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%[7].

- Consumer prices increased by 0.1% in the eurozone during July, and 8.9% over the prior year, versus 0.8% and 8.6% in June. July's year-over-year inflation figure was the highest since the Eurostat began tracking data in 1997[8].

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

4 S&P Global / CIPS UK Manufacturing PMI. 1 August 2022.

5 S&P Global / CIPS UK Manufacturing PMI. 1 August 2022.

6 S&P Global / CIPS Flash UK Composite PMI. 22 July 2022.

7 European Central Bank raises interest rates for first time in 11 years." The Guardian. 21 July 2022.

8 Euro zone inflation hits yet another record high after big jump." Reuters. 29 July 2022.

- Eurozone manufacturing began to contract during July, albeit modestly, continuing an uninterrupted decline in activity from January's peak.[9] The expansion in eurozone services activity continued to grind lower from a springtime peak, nearing a standstill in July.[10]

- The eurozone unemployment rate held at 6.6% in June—the lowest level since Eurostat began tracking the dataset in 1998. The eurozone economy grew by 0.7% during the second quarter and 4.0% year over year, compared to 0.5% and 5.4%, respectively, in the first quarter[11].

- The US Federal Reserve's (Fed) Federal Open Market Committee (FOMC) increased the federal-funds rate by 0.75% toward the end of July—the second hike of its size in this tightening cycle—bringing the benchmark rate to a range between 2.25% and 2.50%.

- The central bank has also begun to reduce its balance sheet, allowing Treasurys and mortgages to run off (that is, mature without being replaced) at maximum respective paces of $30 billion and $17.5 billion per month in July and August (and rising in September to $60 billion and $35 billion per month, respectively).

- The US Personal Consumption Expenditures Price Index (the US Federal Reserve's preferred inflation measure) jumped to 6.8% year over year through June, from 6.3% in May, setting a new record dating to early 1982.[12]

- Manufacturing growth in the US slowed modestly in July, essentially preserving a mild expansion after declining sharply in June.[13] US services activity tumbled into contraction during July after attaining low growth in May and June.[14]

- US job openings fell in June, from 11.3 million in May to 10.7 million. The number of unemployed Americans measured 5.91 million, meaning that there were about 1.8 jobs available for every jobseeker.The overall US economy contracted during the second quarter by an annualised 0.9% after declining by 1.6% during the first quarter.

Selected Asset Class Commentary

- **Global Short Duration Fixed Income Asset Class:** During the month, the asset class gained from a duration overweight to Australia and New Zealand. However, a duration underweight to the US, Europe and other developed markets detracted. AllianceBernstein gained due to an off-benchmark allocation to corporate credit. Favourable duration overweight to Australia and New Zealand also contributed. Colchester Global Investors gained due to a favourable duration underweight to

9 S&P Global Eurozone Manufacturing PMI. 1 August 2022.

10 S&P Global Flash Eurozone Composite PMI. 22 July 2022.

11 Eurozone Unemployment Holds Stable At Historic Low." Barron's. 1 August 2022.

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

13 S&P Global US Manufacturing PMI. 1 August 2022.

14 S&P Global Flash US Composite PMI. 22 July 2022.

Europe. Wellington Management Company suffered as a result of an underweight to core European duration.

- **Global Equities Asset Class**: The asset class suffered due to an overweight to value during the month. An overweight to financials and underweight to IT and mega-capitalisation companies significantly detracted. Poplar Forest Capital, Towle & Co and Sompo Japan Nipponkoa Asset Management Co (SNAM) all experienced unfavourable performance due to a headwind to value. LSV Asset Management recorded poor performance during the month due to headwinds from low volatility investing. LSV's overweight to defensive sectors was a drag on performance. Valuation dispersions remain at levels where a bias towards value, which will in SEI's view continue to drive outperformance, but it will not be delivered in a straight line, with positive returns every month.

Manager Changes

- N/A

Outlook

- It has 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, there has been only one successful instance since the end of World War II (1951-to-1952) when inflation was running above 5%.[15]

- 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

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

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.

- 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.[16]

- 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

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

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 July 2022.

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