SEI UK Strategic Portfolio

SEI Strategic Portfolios February 2022 Monthly Commentary.

Conflict in Ukraine adds to long term inflationary pressures and delivers increased volatility in markets

Executive Summary

- Global equities added to their 2022 losses during February, although collectively they fell by less than in January. Russia was unsurprisingly the worst-performing country: shares cratered, with the MSCI Russia Index down by 52.75% during the month, as its invasion of Ukraine invited sanctions from around the world that crippled its financial markets.

- Among major markets, the UK was the best performer with a small gain. Japan declined by less than Europe and the US, while Hong Kong and China had steeper selloffs. Value-oriented shares continued to fall by considerably less than their growth-oriented counterparts. Globally, the only equity sectors with positive performance were materials and energy.

- Government bond rates increased across all maturities in the UK, eurozone and US during February. Rates rose sharply thru mid-month before partially retreating during the second half of the month. Long-term US Treasury yields fell significantly in late February, flattening the Treasury yield curve.

- Emerging market debt plummeted during the month, most sharply within local-currency assets, and most other areas of fixed interest were also down. Inflation-indexed securities were positive.[1] Commodity prices made a subdued advance for most of February before catapulting higher in the final days of the month (and into the beginning of March) as markets reacted to the implications of the unfolding conflict in Ukraine.

- It is SEI's strong belief that the so-called 'Great 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 an already strong start to relative performance in 2022.

- This would be consistent with an economic outlook that reflects a view of a world that moves more meaningfully towards the exit of the Pandemic in 2022 and deals with the global fall-out from the conflict in Ukraine. The result of this is likely to be higher and more persistent inflation, increasing rates, increased levels of volatility, all of which would be favourable for the positioning in the SEI Strategic Portfolios.

[1] According to data from FactSet and Lipper

Market Overview

- The Bank of England's (BOE) Monetary Policy Committee (MPC) reconvened at the beginning of February for its first meeting since raising its bank rate in December 2021, and issued another increase for the first back-to-back rate hike in 18 years[2]. A large minority of MPC members voted for a larger 50 bps increase to counteract high inflation.

- UK manufacturing growth edged upward in February, returning to the high side of the generally strong expansion that has prevailed over the last six months.[3] UK services activity exploded in February after cooling to a more modest expansion in December and January.[4]

- The UK claimant count (which calculates the number of people claiming Jobseeker's Allowance) declined in December for the eleventh straight month, by roughly 32,000.

- The European Central Bank (ECB) also held its inaugural meeting of 2022 at the beginning of February, after which ECB President Christine Lagarde acknowledged that the widespread stress inflation has caused will likely continue over the short term.

- Manufacturing growth in the eurozone remained quite strong in February, expanding at roughly the same pace that it has been able to maintain since September.[5] Eurozone services sector activity leapt to heathier growth levels in February after slowing to a relatively anaemic expansion in December and January.[6]

- An early estimate of eurozone consumer price inflation measured 0.9% in February and 5.8% year over year, up from 0.3% and 5.1%, respectively, in January.

- The US Federal Open Market Committee (FOMC) did not hold a meeting in February. Federal Reserve (Fed) Chair Jerome Powell stated at the beginning of March that he believed a 0.25% increase in the fed funds rate would be appropriate at the FOMC's mid-March meeting; if enacted, this would be the first FOMC rate hike since December 2018.

- The robust expansion of US manufacturing growth accelerated in February, after cooling in December and January, as new order growth jumped and employment growth slowed.[7] Growth in the US services sector accelerated sharply in February after nearly pausing altogether in January.[8]

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[2] 6 Bank of England hikes rates in first back-to-back rise since 2004." CNBC. 3 February 2022.

[3] IHS Markit / CIPS UK Manufacturing PMI. 1 March 2022.

[4] IHS Markit / CIPS Flash UK Composite PMI. 21 February 2022.

[5] IHS Markit Eurozone Manufacturing PMI. 1 March 2022.

[6] IHS Markit Flash Eurozone Composite PMI. 21 February 2022.

[7] IHS Markit US Manufacturing PMI. 1 March 2022.

[8] IHS Markit Flash US Composite PMI. 22 February 2022.

- New US jobless claims moderated in February, ranging between 200,000 and 250,000 per week during the month. The broad US economy grew at a 7.0% annualised rate during the fourth quarter (up from a preliminary estimate and the third quarter's 2.3% pace).

Selected Asset Class Commentary

- **US High Yield Fixed Income Asset Class:** The asset class gained from positive security selection within energy, consumer goods and services and basic industry. Meanwhile, selection within health care and telecommunication detracted. J.P. Morgan Investment Management outperformed due to selection within energy and telecommunications. Brigade Capital Management benefited from selection within basic industry and consumer goods. T. Rowe Price suffered from an underweight and selection within leisure. Ares Management registered weak performance from security selection within telecommunications and energy.

- **Global Managed Volatility Equities Asset Class:** During the month, the asset class' favourable overweight to quality and value-oriented stocks enhanced performance. Strong stock selection within value contributed to returns. The asset class' small-capitalisation bias and underweight to large-cap technology names also contributed. LSV Asset Management's value-orientation and underweight to large-cap IT aided performance. LSV's low volatility exposure also contributed. Acadian Asset Management benefited from its low-volatility preference, which led to an underweight to low-quality stocks. Allspring Global Investments gained from its value-orientation and defensive positioning within consumer staples, utilities and health care. Allspring's underweight to large-cap technology names also contributed.

- **Global Equities Asset Class:** The asset class gained due to an overweight to value during the month. The asset class' low volatility investing was generally favourable, while the allocation to quality stocks detracted. The building block's overweight to financials and underweight to IT was helpful. Exposure to pharmaceuticals and banks detracted. Poplar Forest Capital, a US value manager, contributed due to the outperformance of value during the month. Metropole Gestion, a European value manager, underperformed due to headwinds to value investing in Europe. LSV Asset Management registered favourable performance during the month due to tailwinds from low volatility investing. LSV's selection within consumer discretionary and underweight to large mega-cap stocks also contributed. Fiera Capital Corporation, a US quality manager, lagged during the month, suffering from weak stock selection within financials.

Manager Changes

- N/A

Outlook

- SEI expects a gain in overall US economic activity of around 4% in 2022, appreciably above the economy's long-term growth potential of 2%. While Russia's invasion of Ukraine has dimmed our expectations, SEI still believe other countries are capable of continuing to post above-average growth as they recover from the past two years' worth of lockdowns and shortages.

- China's performance in 2022 is one of the key unknowns that will influence global economic growth. Consensus expectations call for a soft landing of the Chinese economy, with gross domestic product (GDP) growing by about 5% in 2022 versus 8% in the past year.

- The year ahead promises to be another one of tight labour markets. We think more people will return to the workforce as COVID-19 fears fade, but there likely will still be a tremendous mismatch of demand and supply. US wage gains have climbed at their fastest pace in decades over the past year[9].

- Predicting a bad inflation outcome for 2022 isn't exactly much of a risk. Where SEI departs from the crowd on inflation is in the years beyond 2022. SEI is sceptical that the US Fed will be sufficiently proactive as it struggles to balance full and inclusive employment against inflation pressures that are starting to look more entrenched. SEI believes this will be the central bank's biggest challenge in 2022 and beyond.

- SEI also doesn't think the Fed's inflation and economic projections are internally consistent. Since it projects the economy to be even closer to full employment later into 2022 and beyond, we find it hard to understand why price pressures should ease so dramatically.

- Even the central banks that are most likely to taper their asset purchases and raise policy rates in the months ahead will probably do so cautiously. By contrast, policy rates in emerging economies have already jumped.

- It remains to be seen whether this pre-emptive tightening of monetary policy will forestall a 2013-style taper tantrum as the Fed embarks on its own rate-tightening cycle.

- The People's Bank of China (PBOC) cut a key interest rate in December and then again in January, both by modest amounts. These cuts followed a reduction in reserve-requirement ratios aimed at increasing the liquidity available to the economy; it will take a while for any beneficial impact to be felt on China's domestic economy, and even longer for the world at large.

- In addition to the start of a new monetary tightening cycle, some economists have expressed concern about the next "fiscal cliff" facing various countries, the US in particular. While there will be a negative fiscal impulse in the sense that the extraordinary stimulus of the past two years will not be repeated, we argue that the impact should be less contractionary than feared.

- Perhaps economists should be more concerned about the negative fiscal impulse in the UK, Canada, Germany and Japan. They are all facing a potential fiscal tightening equivalent to 4% of GDP this year. By comparison, the International Monetary Fund predicts that the cyclically adjusted deficit in the US will contract by less than 0.5% of GDP.

- Investors always need to deal with uncertainty; SEI is focused on three main areas of geopolitical risk. We have been stressing since the beginning of the year that the Russian invasion of Ukraine was the most important flashpoint in terms of near-term probability and economic impact.

- Next is the ongoing tug-of-war for influence and military advantage between China and the US. The most worrisome flashpoint would be over Taiwan given its dominant position in advanced semiconductor manufacturing.

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[9] U.S. Wages, Benefits Rose at Two-Decade High as Inflation Picked Up." The Wall Street Journal. 28 January 2022.

- The third major area of concern is the Middle East and the negotiations with Iran over its nuclear development program. Two things are clear: Iran is now much closer to having a nuclear bomb, and Israel still will not tolerate such a major change in the region's balance of power. The risk of war may be low, but developments continue to head in a direction that could someday have catastrophic consequences.

- In SEI's view, the real anomaly in the financial markets is the ultra-low levels of interest rates in the face of higher inflation and above-average growth in much of the world. This may force central banks to adopt more aggressive interest-rate policies than they and market participants currently envision.

- SEI urges our investors to look past the challenging relative returns of the 2019 and 2020 period and notice how the positioning has started to play out much better in 2022. Inflation, rising rates, potential increased levels of regulation around big tech, increased levels of market volatility are all themes that are likely to support the positioning in the underlying asset class components. Terrible as the conflict in the Ukraine is, this event further supports the positioning in the SEI Strategic Portfolios.

- It is SEI's view that this positioning will not only continue to provide downside protection as the market rotates away from growth stocks where the growth story is fading rapidly and is more volatile due to the conflict in Ukraine, but also provide relative performance benefits as we move into a post-Covid economic recovery.

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