SEI Strategic Portfolios

# SEI Strategic Portfolios November 2022 Monthly Commentary.

**Transitory reflation led to risk on markets and significant returns for both Fixed Income and Equity markets in November**

**Executive Summary**

- Most global equity markets finished November in positive territory following a strong rally during the previous month. Emerging-market stocks outperformed their developed-market counterparts, led by mainland Chinese equities.[1] Regionally, emerging markets in Asia and Europe generated the world's strongest equity gains in November, while the Asia-Pacific region also performed well.[2] Conversely, North America fared the worst due to notable losses in US stocks. [3]

- UK gilt yields declined in the intermediate and long segments of the curve but moved modestly lower for all maturities under three years during the month. Eurozone government bond rates decreased for all maturities of five years or greater, while yields rose for maturities of four years or less—thereby inverting the 2-to-10-year curve.

- Yields on US Treasury securities with maturities of two years or greater moved lower in November (yields and prices have an inverse relationship). However, the 2-to-10-year yield curve remained inverted (short-term rates exceed long-term yields) and widened by 0.29% to 0.70%.

- Fixed-income asset classes posted gains in November as intermediate- and long-term interest rates moved lower. US investment-grade corporate bonds led the rally amid a flight to quality in the market; mortgage-backed securities (MBS) and US Treasurys—the most rate-sensitive areas of the market—also garnered positive returns. [4]

- SEI's Global Equity asset class components remain strongly positive (Vs MSCI World) for the year and are ahead for this current quarter, despite a negative November. Global Managed Volatility continues to protect and preserve capital for investors and Global Equity continues to help the more aggressive portfolios outpace the benchmark.

- SEI has started to adapt the allocations in the Global Equity asset class with the overweight to value coming down in favour of Momentum; with this alpha source now (in SEI's opinion) looking more attractive and no longer chasing the trend in expensive names. Quality is still underweight due to the fact it is still very expensive.

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[1] According to the MSCI China Index

[2] According to the MSCI EM Europe and MSCI EM Asia Indexes.

[3] According to the MSCI North America and MSCI USA Indexes.

[4] According to data from FactSet and Lipper.

- SEI have always said that the extended 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.

- Even after the strong recent returns of the last two years, 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 already strong relative performance in 2022.

**Market Overview**

- The Bank of England's (BOE) Monetary Policy Committee raised its benchmark interest rate by 0.75% to 3.0% in early November, yet cited the need to reduce the U.K.'s historically high inflation rate. The BOE also noted, "The labour market remains tight and there have been continuing signs of firmer inflation in domestic prices and wages that could indicate greater persistence."[5]

- Activity in the U.K. services sector contracted for the second straight month in November after expanding at a modest-but-healthy pace through the summer and leveling off in September.[6]

- Eurozone consumer prices dipped in November by 0.1%, the first decline since mid-2021, and slowed to a 10.0% year-over-year increase from a 10.7% gain in the 12-month period ending October.[7] A contraction in eurozone manufacturing activity that began in July continued in November, though there was modest improvement from the previous month.[8]

- Eurozone services activity declined for the fourth consecutive month in November after expanding for 17 straight months between March 2021 and July 2022.[9] Eurozone economic growth slowed in the third quarter to 0.2% from 0.8% over the three-month period and to 2.1% from 4.3% in the year over year.

- In early November, the Federal Open Market Committee implemented another 0.75% increase in the federal-funds rate—bringing it to a range of 3.75% to 4.0%, which will result in higher borrowing costs for consumers and businesses. Fed Chair Jerome Powell indicated at the end of the month that he believes the central bank will likely begin to slow the pace of interest-rate hikes in mid-December as recent data point to easing inflation. However, he also said there remains uncertainty with regard to inflation and that "History cautions strongly against prematurely loosening policy."[10]

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[5] "Monetary Policy Summary, November 2022." Bank of England. 2 November 2022.

[6] S&P Global/CIPS Flash U.K. Composite PMI. 23 November 2022.

[7] "Eurozone Inflation Eased in November, but Further Rate Rises Likely." The Wall Street Journal. 30 November 2022.

[8] S&P Global Eurozone Manufacturing PMI. 23 November 2022.

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

[10] "Jay Powell signals Fed will slow pace of rate rises next month," Financial Times, 30 November 2022.

- The Commerce Department's Personal Consumption Expenditures (PCE) Index—the Federal Reserve's (Fed) preferred inflation measure as it excludes volatile food and energy prices—slowed in October to 0.3% from 0.6% for the month and to 6.3% from 6.6% for the 12-month period.

- The US employment situation remained robust. The Department of Labor reported that US payrolls expanded by a larger-than-expected 263,000 during November, while the unemployment rate was unchanged at 3.7%. In October, average hourly earnings gained 0.6% for the month and 5.1% over the 12-month period.

- The US economy continued to improve in the third quarter, expanding at an annualized rate of 2.9% (up from the Commerce Department's initial estimate of 2.6%)—after contracting at annualized rates of 1.6% in the first quarter and 0.6% in the second quarter.

- The Institute for Supply Management's manufacturing purchasing managers' index (PMI) declined in November by 1.2% to 49.0%, ending 29 consecutive months of expansion as it reached lowest level since May 2020. A PMI reading below 50% indicates contraction.[11]

**Selected Asset Class Commentary**

- **Global Managed Volatility Asset Class:** During the month, the asset class' overweight to quality and value-oriented stocks aided performance. Meanwhile, the defensive positioning was generally neutral and did not contribute to performance. Stock selection within value and defensive sectors further helped returns. The asset class' small-capitalisation bias detracted. LSV Asset Management's value-orientation and underweight to large-cap IT boosted performance. LSV's low volatility exposure further contributed. Allspring Global Investments gained from its value-orientation and defensive positioning within utilities and industrials. Allspring's underweight to large-cap technology companies also contributed. Acadian Asset Management benefited from its multi-factor approach to low-volatility investing, which led to an underweight to low-quality stocks.

- **Global Equities Asset Class:** The asset class experienced weakness during the month due to momentum headwinds. Meanwhile, the allocation to value and quality benefited returns. Regionally, selection within consumer discretionary contributed, while selection within consumer staples and materials detracted. The asset class' low volatility investing was generally favourable. An overweight to financials and underweight to IT and mega-capitalisation companies further enhanced returns. Lazard Asset Management's momentum orientation resulted in poor security selection and allocation effects. StonePine benefited from selection within materials, IT and consumer discretionary. Maj Invests gained from an underweight to mega-capitalisation companies and exposure to semiconductors. Poplar Forest Capital, a US value manager, registered favourable performance due to strong results from value during the month. Towle & Co also registered solid performance due to its value positioning and positive security selection. LSV Asset Management recorded positive performance during the month due to a beneficial allocation to low volatility stocks.

**Manager Changes**

- N/A

**Outlook**

[11] November 2022 Manufacturing ISM Report On Business. 1 December 2022.

- Russia's assault on Ukraine and its energy blackmail against Europe (and, by extension, the rest of the world) and the aggressive response of central banks to high global inflation or the severe COVID-19-related slowdown in China are not new. All have simply increased in intensity. Most importantly (from an economic perspective) is that monetary-policy makers are finally acknowledging the major inflation problem on their hands, one that is neither transitory nor likely to be resolved without pain.

- In our opinion, investors should be prepared to see a federal-funds rate that could exceed 5%. Other central banks globally are following the Fed's lead, talking tough and implementing outsized policy-rate increases.

- Europe will continue to be the area most under pressure due to the possibility that Russia again will suspend natural-gas exports after agreeing to restart shipments under a deal brokered by the UN and Turkey. Although storage facilities within the EU are now nearly 95% full—aided by unusually warm autumn weather, which reduced demand—the continent still needs a steady flow of gas to get through the high-usage winter months.[12] Governments may be forced to impose disruptive energy-saving restrictions on businesses and citizens. Heavy users of electricity, from aluminum smelters to glassmakers, have already been shutting down.

- The U.K. announced plans to cap electricity costs that amount to 6.5% of GDP. Other countries that allocated funds for energy-related aid in excess of 3% of GDP include Croatia, Greece, Italy, and Latvia. It would not be surprising to see more energy-related fiscal relief. Deficits could balloon in the same way as they did in the early months of the COVID-19 crisis as policy makers do what they must to protect their populations.

- Central bankers globally are mandated to lean hard against the rising trend in prices—even though doing so goes against their own governments' stimulus efforts. Unfortunately, they're running just to keep up with the Fed. Interest-rate differentials versus the US are still wide, with only Canada's yields on par with those in the US[13]

- The large differential in favor of the US and the perception that the country is better positioned economically are two major reasons behind the US dollar's extraordinary appreciation this year. Although a declining currency may give a competitive boost to domestic firms that export goods and services to the US market, it exacerbates inflationary pressures stemming from imports priced in US dollars—most importantly, oil and liquefied natural gas.

- Several large US multinational companies have warned that US dollar strength is beginning to exert a negative impact on revenues, suggesting that the currency's value has risen well beyond its purchasing-power parity (PPP) level. But discrepancies can last for a long time between PPP and market-based exchange rates.

- Still, it would not be surprising to see at least a temporary reversal in the US currency's trend. Indeed, the greenback declined versus many major currencies following the US government's release of generally encouraging inflation data in November. Given a catalyst—coordinated

[12] "94.8% of EU gas storage is filled." Reuters. 30 October 2022.

[13] According to data from Bloomberg.

government action to weaken the dollar or a surprisingly weak US unemployment report, for example—traders might cover their long positions in a major way, causing the dollar to fall further.

- After lagging the inflation rate for several years, US hourly compensation has risen at an annualized rate of 5% over the three-year period ending November 30, 2022—virtually matching the increase in the US Consumer Price Index during the same period.[14] Similar to the 1970s experience, compensation gains have been accelerating despite slowing productivity growth. This divergence is concerning. The difference between the change in compensation and the change in productivity equals the change in unit labour costs.

- Although unit labour costs are more volatile than inflation, there is still a strong positive correlation between the two.

- Unfortunately, history shows that it usually takes an outright recession to tame inflation, especially when it gets this intense. Fed Chair Jerome Powell's hope for a soft landing appears to be an exercise in wishful thinking. Unit labour costs jumped in the year over year through August at a rate that far exceeded inflation—and we see no reason to expect a major reversal in the near term, even if the economy stumbles into a bona fide recession.

- US companies have been able to push their higher employment and supply costs onto consumers. While economy-wide profit margins have remained above almost all cyclical peaks since 1947, we suspect that margins are on the cusp of a substantial erosion. It's typical for profit margins to decline well before an economic recession materializes.[15]

- If the economy does fall into recession and profits decline, it will probably force analysts to mark down earnings estimates aggressively in order to catch up with reality. Investors are not waiting for those earnings revisions. They have been pushing equities lower in reaction to the Fed's aggressive shift and in anticipation of a recession, both in the US and globally.

- Fed policymakers project a federal funds rate in the 4.4%-to-4.9% range in 2023, but the actual result may still be higher. Unless the central bank is ready to engineer a severe recession, we think PCE price inflation could run in a 3%-to-4% range instead of the pace of less than 2% recorded over much of the past 25 years.

- Several asset classes looked extremely oversold by the end of the third quarter, including equities, bonds, currencies, and commodities. The US dollar's sharp climb has reversed most of this year's appreciation in the commodities complex. If the currency breaks to the downside, commodities should break to the upside.

- We maintain a positive outlook on commodities despite the demand destruction occurring in Europe and other parts of the globe. Years of underinvestment in fossil fuels and metals mines will likely lead to periodic shortages over the next few years.

- The Chinese central government has allowed Hong Kong and Macau to open up. This might be a harbinger of what will happen on mainland China as President Xi Jinping serves his unprecedented third term as General Secretary of the Communist Party National Congress. Xi's position may seem

[14] According to SEI's analysis of data from the US Bureau of Economic Analysis.

[15] According to SEI's analysis of data from the US Bureau of Economic Analysis.

unassailable, but we suspect he is looking for a way out of his zero-COVID-19 policy. The loosening of restrictions and return to stronger economic growth is the only logical way out.

- Other emerging economies would be big beneficiaries of a revival in Chinese economic activity. Yet US dollar strength is a central factor for investors in emerging-market equities. The relative total-return performance of the MSCI Emerging Market Index versus the MSCI World Index peaked in 2010, more-or-less concurrent with the trough in the trade-weighted value of the US dollar. (Trade-weighting measures the value of the dollar versus other major currencies.) As the US currency grew stronger, emerging-market equities weakened further—and, as of the end of the third quarter, surrendered almost all the gains achieved between 2000 and 2010 versus advanced-country stock markets.

- The rate-hiking cycle began far sooner in less-developed economies—during the latter months of 2020. It was not until this year that advanced economies began a general up-cycle in policy rates; in response, interest-rate hikes in the emerging world have accelerated significantly, in both frequency and magnitude. Three-month government bond yields are in double digits in Brazil, Colombia, Hungary, and Turkey, with only Brazil's yield is comfortably above the inflation rate. Turkey, by contrast, is facing an inflation rate of more than 85%.[16] Nonetheless, the Central Bank of the Republic of Turkey cut its benchmark interest rate by 1.5% to 9.0% in November. This action appears to reflect President Recep Tayyip Erdogan's efforts to spur economic and employment growth amid skyrocketing inflation. Little wonder that the value of the Brazilian real has fallen modestly against the US dollar this year while the Turkish lira has declined by nearly 30%.

- While the effort to tame inflation may prove successful, a global recession will likely result—with Europe and the U.K. more vulnerable than the US to a downturn.

- Short-term gyrations notwithstanding, the primary trend in risk assets still appears negative. Inflation in the US probably has peaked, as indicated by the relatively smaller increase in the PCE Index in October, but we do not expect it to fall as rapidly or as far as the Fed's projection of an annualized inflation rate of 2.8% to 3.5% for 2023.[17] The central bank may still be underestimating the extent to which it needs to tighten policy in order to slow the economy and produce slack in the labour markets.

**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 at 30 November 2022.

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**Important Information**

[16] "Turkey's inflation hits 24-year high of 85.5% after rate cuts." Reuters. 3 November 2022.

[17] According to the US Federal Reserve's economic projections. 21 September 2022.

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