SEI Strategic Portfolios:

July 2019 Monthly Commentary

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As Boris and Donald dominate the headlines, markets continued through July in an upbeat mood

Executive Summary

- In July the performance of equities was broadly positive, continuing the strong rebound for the year, with large US firms leading, and emerging markets lagging. Government bond markets overall fared well in an environment of falling rates in many major markets. Corporate bonds outperformed, as did those with a higher yield profile. Emerging markets fixed income overall delivered the best returns.

- Considering the Stability-Focused Strategic Portfolios, an overweight to credit in the global investment grade asset classes was beneficial, as was an overweight to higher yielding fixed income and emerging market debt. The strategic allocation to US high yield fixed income and emerging markets fixed income also contributed over the month. Consistent with its objective, the Global Managed Volatility Equities building block was able to provide meaningful risk reduction; as a consequence naturally lagging in a positive equity market environment.

- For the Growth-Focused Strategic Portfolios, stock selection was handsomely rewarded; so much so that they outperformed in an environment where most of the long-term alpha sources suffered continued pressure, as investors rewarded expensive, large cap, high sales 'growth' stocks. As a reminder, the SEI Strategic Portfolios employ positioning within the portfolios through alpha sources lenses; the best method in which to implement that positioning is through well-sourced investment managers and July was proof that skilful stock selection by the managers can generate attractive returns.

- Both on a strategic (long-term) and tactical (short-term entry point) basis, SEI firmly stands by the belief that the valuation-focused investment approach works - that investors will ultimately see markets revert to the mean and therefore benefit from this positioning. Patience and discipline are required for this; SEI intends to exercise both of these virtues. The programme has seen periods like this before and exercising discipline served clients well in those times, and SEI continues to believe it will do so now as well.

- **Despite the market reversal and the challenges around valuation-focused managers, the SEI Strategic Portfolios maintained their highly competitive position against peer groups, with the Stability-Focused portfolios delivering on their mandate of drawdown protection through the challenging last quarter of 2018 and in periods of market reversal in 2019, while the Growth-Focused portfolios provided above-average returns against peers, with the Aggressive Fund outperforming the average of its peers by 2.44% in the first seven months of 2019, as well as remaining ahead between 2.5% and 3.0% per annum over the 3- and 5-year periods to end of July 2019. (Wealth A Distributing Share Class, in GBP, net of all fees).**

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Market Overview

- Developed-market stocks crept higher in July, while emerging markets slid amid continued signs of slowing global economic growth. Regionally, the Middle East delivered some of the best country-level returns—Turkey and the United Arab Emirates were the month's top performers; Israel and Qatar also registered among the best returns. Meanwhile, Europe and Asia lagged the rest of the world.

- Government bond rates declined across all maturities in the UK and eurozone during July. The shortest-maturity US Treasury rates fell, while short-to-intermediate-term rates increased, reducing (but not eliminating) the yield-curve inversion that has persisted since the spring.

- Boris Johnson began serving as UK Prime Minister and leader of the Conservative Party in late July, using his new platform to double down on his campaign promise to depart the EU, with or without a Brexit deal, on 31 October. He signalled that if the EU wants to avoid a no-deal departure, the Irish "backstop" (part of the deal struck between former Prime Minister Theresa May and the EU) would need to be dropped before any substantive renegotiation could commence. EU negotiators, for their part, have expressed no plans to renegotiate the withdrawal agreement struck with Johnson's predecessor.

- In mid-July, European Parliament approved Ursula von der Leyen (a long-time cabinet member in German Chancellor Angela Merkel's government) to succeed Jean-Claude Juncker as president of the European Commission beginning in November. Earlier in the month, David Sassoli, an Italian member of European Parliament, was elected and immediately began to serve as president of the EU's legislative body. The European Council selected Belgian Prime Minister Charles Michel to succeed Donald Tusk as its next president later this year; it also appointed Christine Lagarde, chairman and managing director of the International Monetary Fund, to follow Mario Draghi as president of the European Central Bank (ECB) before the end of the year.

- Top-level US negotiators wrapped up the recently-resumed trade talks with China at the end of July. US President Donald Trump announced on 1 August that the US will impose 10% tariffs on $300 billion of Chinese goods beginning in September, essentially covering all remaining yet-to-be-tariffed imports. China responded that it will retaliate if the tariffs are enacted, but the uneven trade relationship leaves a limited pool of US exports to China that can be targeted (although China allowed the yuan, its currency, to depreciate in early August as a countermeasure). The US Congress approved a two-year budget agreement in late July, as was expected given sufficient bipartisan support for the deal.

Selected Asset Class Commentary

- <u>Global Managed Volatility Equities Asset Class:</u> The asset class is designed to provide risk mitigation in stressful market environments and July was positive from both risk reduction and return. The asset class' outperformance was led by Acadian Asset Management. Wells Fargo Asset Management lagged due to their underweight to the US and weaker stock selection.

- <u>UK Equities Asset Class:</u> The asset class outperformed its benchmark in July. Jupiter Asset Management powered higher due to the rebound of a number of out-of-favour value stocks, including tobacco, mining and a troubled UK retailer. Value headwinds were muted during the period. Lindsell Train benefitted from its higher-quality orientation. This included holdings in beverages (rather than tobacco) and non-bank financials. Los Angeles Capital Management detracted due to momentum headwinds. Higher volatility exposure and risk off sentiment associated with no-deal Brexit fears drove underperformance.

Manager Changes

- None over the period.

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Outlook

- Trump's decision to expand tariffs and China's decision to allow its currency to weaken were obviously unwelcome surprises. Markets had hoped that an uneasy trade truce would hold up as long as negotiations progressed, however slowly. The Treasury's subsequent decision to label China a currency manipulator is largely symbolic, but it does indicate we're likely to see a protracted impasse with both sides digging in their heels.

- These shocks come at a difficult time for the global economy, as leading sentiment indicators, especially in manufacturing, have continued to weaken. As a result, SEI would not be surprised to see the current market correction continue for a bit.

- If enacted, these new tariffs could dent both business and consumer confidence, given that they will put additional downward pressure on corporate profit margins and upward pressure on the prices of many US consumer goods. However, the US economy should weather this latest ratcheting up of trade tensions, as both fiscal and monetary policies are becoming more expansionary against a backdrop of reasonably healthy growth. Like credit spreads, financial stress indices remain relatively well-behaved.

- There are concerns about other regions, however, especially in light of the drop in the yuan. Weakness in emerging market currencies will make imports more expensive and hard-currency liabilities more costly to service for affected countries.

- SEI is cautious on ex-US developed markets as well. Europe's economy, which has strong trade ties to China, has been struggling. While German policymakers remain cautious on loosening fiscal policy to spur growth; the risk of a no-deal Brexit has increased in the UK. Furthermore, Japan is set to raise its national sales tax on October 1st.

- SEI would become increasingly concerned if Trump were to raise existing tariff rates on Chinese goods considerably or impose significant tariffs on other US trading partners such as Canada, Europe and Mexico. These are meaningful risks that SEI is monitoring carefully.

Portfolio Implications

- When markets sell off it provides opportunities to ensure that investors' portfolios are properly aligned with their investment objectives, as well as the investor's ability and willingness to assume market risk.

- It is important to keep any market sell off in perspective. Risky asset classes are still in modest correction territory. External shocks and turbulence are never fun, but they are recurring features of financial markets.

- In recent commentaries, SEI have illustrated why making wholesale portfolio changes in response to things like yield curve inversions, business cycle peaks and troughs, and bull/bear market turning points is the wrong thing to do. This same view also applies to political events such as trade wars.

- SEI believes in prudent active management and active allocation tilts, and managers will respond to market upheaval by looking for risk-reduction or risk-enhancement opportunities as and when appropriate. But it is important to emphasise the word "prudent," and remind investors that effective diversification remains the key to navigating market risks and uncertainties.

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- Fixed income securities are subject to credit risk and may also be subject to price volatility and may be sensitive to interest rate fluctuations.

- Absolute return investments utilise aggressive investment techniques which may increase the volatility of returns. If the correlation between absolute return investments and other asset classes within the fund increases, absolute return investments' expected diversification benefits may be decreased.
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