SEI UK Strategic Portfolios: August 2020 Monthly Commentary

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The global equity market rally continued through August, despite evidence of a virus resurgence and a potentially slower economic recovery

Executive Summary

- Strong equity-market performance continued around most of the world in August, led by Hong Kong, Japan and the US. Europe and the UK followed at a distance despite generating elevated one-month returns. Latin America suffered a sharp decline during the period as COVID-19 cases appeared to plateau at high levels there.

- The S&P 500 Index registered a new all-time high in late August, marking the fifth consecutive month of gains since the dramatic early-2020 selloff.[1] The US dollar continued to fall versus a basket of major currencies during August, albeit at a slower pace compared to its sharp July decline, settling at its lowest level in more than two years.

- Government-bond yields increased around the developed world. In the UK, Eurozone and US, long-term government rates rose by more than short-term rates, leading to steeper yield curves.

- Considering the stability-focused Strategic Portfolios, returns were modestly negative in the investment grade bond space, however strategy returns were boosted by broad-based positive relative returns at the asset class level as well as stronger absolute returns from US high yield and emerging markets bonds asset classes. Global managed volatility equity, designed to provide downside protection in falling markets, detracted in a rising equity market.

- For the growth-focused strategic portfolios, some of the challenges faced by value managers during recent quarters returned in August, however at the time of writing some of the first days in September saw several days of strong positive relative return, potentially portending a bigger rotation. Our core investment case for SEI's overweight to this area remains the same: extreme relative valuations between the most expensive and cheapest parts of the market.

- SEI further believes that the post-crisis environment may provide further support for this positioning, given the huge stimulus being provided, and the potential for inflationary impacts. During the first days in September, where there was a meaningful sell-off in the markets, it also seemed to be in evidence that this positioning has potential for meaningful downside protection, should markets enter into a more protracted downward leg.

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[1] "S&P 500 edges up to another all-time high in a mixed day on Wall Street, defying the recession." CNBC. 25 August 2020

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Market Overview

- UK and EU representatives made only marginal progress toward a trade deal during August. Negotiations hit an apparent impasse as the EU made demands that had previously been declared non-starters by UK negotiators.

- Neither the European Central Bank (ECB) nor the Bank of Japan (BOJ) held monetary policy meetings in August after having both made no changes at their respective mid-July meetings.

- The Bank of England's Monetary Policy Committee voted to leave its key lending rate unchanged at 0.1% and to maintain its existing level of asset purchases at £745 billion. The central bank also lowered its economic outlook from expecting a complete recovery by mid-2021 to anticipating a return to pre-pandemic levels of economic activity no earlier than late 2021.

- The UK's healthy rebound in manufacturing activity accelerated during August. A preliminary report on activity in the services sector during the same month depicted an increase in the UK's already-strong growth. UK mortgage approvals jumped to 66,300 in July from 39,900 in June, while consumer credit grew by £1.2 billion in July after contracting during the prior month; both measures exceeded consensus expectations for July.

- The eurozone's recovery in manufacturing activity remained slow during August. Services sector activity eased to a near standstill, according to an early report. The number of loans granted to non-financial corporations increased by 7% in July, keeping pace with the prior two months. The eurozone unemployment rate inched higher from 7.7% to 7.9% in July.

- The US Federal Open Market Committee (FOMC) did not hold a meeting in August; however, it announced major updates to its monetary-policy approach. The most significant change centred on the US central bank's new average inflation target, which highlights its explicit willingness to allow above-target inflation following periods of below-target inflation. This change indicates that the FOMC will let the US economy run hotter than in the past before taking policy action to temper growth.

- US manufacturing activity improved during August on July's modest growth, despite a persistent contrast between strong new orders and shrinking employment. A preliminary report showed that activity in the services sector accelerated during August after halting in the prior month. New US jobless claims briefly dipped below 1 million per week in mid-August before rising back to about 1.1 million later in the month. Existing US home sales surged by 24.7% in July amid historically low mortgage rates; by contrast, the number of delinquent mortgages insured by the US Federal Housing Administration reached 16% in August, the highest level on record since 1979.

- The US presidential election cycle formally progressed to its final phase before Election Day, as President Donald Trump accepted the Republican Party's nomination and former Vice President Joe Biden accepted the Democratic Party's nomination at their respective quadrennial conventions during August.

- Tensions between the US and China spilled into the social-media sphere as the Trump administration took a series of actions to wrest control of the US branch of TikTok, a popular video-sharing app. Several major US companies in the software, retail and private-equity industries announced intentions to bid on TikTok's US operations. China, for its part, contended that any sale of TikTok assets to a US company is subject to Chinese government approval.

- Aside from social-media drama, the US-China relationship was strained after a recent Beijing-imposed national-security law drove the Trump administration to end its extradition treaty with Hong Kong. In addition, the US imposed sanctions on senior government officials in China and Hong Kong, including Hong Kong's Beijing-appointed Chief Executive Carrie Lam, over their suppression of political dissent in the territory.

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Selected Asset Class Commentary

- **Emerging Markets Fixed Income Asset Class:** The asset class benefited from overweights to higher-yielding countries, such as Argentina, Egypt and Ukraine. Overweights to Ecuador and Mexico further contributed. An unfavourable underweight to Poland and overweights to Russia and Brazil detracted. Stone Harbor Investment Partners LP gained on overweights to Mexico and Argentina. An underweight to Bahrain and overweight to South Africa hurt. Neuberger Berman Investment Adviser's overweights to Argentina and Ukraine contributed, while underweights to Bahrain and Turkey detracted. Marathon benefited from selection within Brazil and an underweight to Saudi Arabia. Overweights to Israel and the United Arab Emirates hurt. Colchester Global Investors Limited's favourable underweights to Turkey and Thailand could not overcome unfavourable overweights to Brazil and Colombia.

- **Global Managed Volatility Equities Asset Class:** The asset class was hurt by style headwinds against low volatility and a large underweight to consumer discretionary during the month. Its value tilt and stock selection within IT further detracted. Wells Fargo Asset Management benefited from its momentum preference, which translated to more favourable sector positioning, including a more balanced allocation to consumer discretionary and a larger underweight to financials. The Building block's allocations to LSV Asset Management and Acadian Asset Management away from Wells Fargo detracted.

- **Global Equities Asset Class:** The asset class lagged its benchmark due to its underweights to the largest technology names in the US. As a result, most alpha sources struggled during the month. Outside of the US, without FAANGS, the results were relatively strong, with the best returns coming from value stocks. Stock selection was broadly flat. US value manager Poplar Forest Capital was the largest detractor. Bank and energy stocks also detracted. LSV Asset Management's managed volatility was also a notable laggard, as markets continued to rally and rewarded fundamentally unattractive stocks. Generally, both low beta and value themes lagged, creating headwinds as the market continued to recover from the pandemic related selloff. Results were generally in line with expectations, given the Building block's strong value exposure in addition to its holdings tilted to low beta and small size. Metropole Gestion, a European value manager, was the strongest contributor, capitalizing on rebounding value stocks and also some sector and stock specifics. Sompo Asset Management (SNAM) in Japan and Jupiter Asset Management Ltd in the UK also benefited from rebounding value, while INTECH Investment Management and Lazard Asset Management were held back by correcting momentum.

Manager Changes

- N/A

Outlook

- Despite mounting rates of infection, hospitalisation and death amid an ongoing pandemic, and the unprecedented side effect of a frozen global economy, stock markets around the world have managed to make resounding recovery.

- SEI's working assumption is that there will likely be another significant wave of infections going into the so-called flu season throughout autumn and winter in the northern hemisphere. The question is, how disruptive will it be to the global economy?

- Even if a sustainable economic recovery gets under way, investors seem to be ignoring the possibility that it may be a long time before most companies achieve previous levels of profitability. The after-tax profit margins of US domestic businesses were already on a declining trend before the onset of the virus and shelter-in-place orders.

- Profit margins around the globe will likely remain well below their previous peaks as long as COVID-19 remains a severe health threat. Most businesses are expected to endure varying degrees of lower sales, higher costs and a decline in productivity. There also will probably be an extra burden on industries that

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anticipate needing extra inventory on hand in the event of future shortages and supply-chain disruptions caused by periodic flare-ups of the virus.

- The extraordinary March-to-April economic lockdown in the US necessitated fiscal measures unparalleled in both scope and speed of implementation.[2] The result has been a tsunami of red ink. As of 2 September 2020, the Congressional Budget Office projected the deficit will reach 16% of US GDP in 2020, and improve to 8.6% of US GDP in 2021. US debt relative to GDP is forecast to rise to 104.4% by the end of fiscal year 2021 versus 79.2% at the end of fiscal year 2019 (Source: Congressional Budget Office)

- These are unsettling numbers. Many investors may wonder whether such a surge in government debt will provoke an economic crisis even after the pandemic runs its course. We don't think that it will. The US has a large, dynamic economy and deep capital markets.

- The policies pursued by the Federal Reserve have also served to keep interest rates low. Its balance sheet has ballooned this year, far exceeding the increases logged by the ECB or the BOJ.

- The US certainly is not alone in engaging in a huge fiscal response that is then monetised by the central bank. In our opinion, governments are treating the fight against COVID-19 like they would a war. As many resources as possible are being thrown into the fight, supported by debt issuance that is absorbed primarily by the central banks.

- Those who remember the 1970s are understandably worried by the inflationary potential of such extraordinary debt monetisation. If it does lead to inflation, it probably won't be any time soon, in our opinion. Given our view that the economy will remain below full utilisation of labour or productive capacity for the next few years, we believe inflation is unlikely to break out of the 0%-to-3% range of much of the past decade.

- Investors do not seem too concerned about the speed of Europe's economic recovery or the impact of the health crisis on countries' fiscal positions. The bond yields of the most economically-fragile countries remain close to those of German bund yields, although spreads have widened from pre-pandemic levels. The ECB has been quite successful in short-circuiting the liquidity crisis and flight-to-safety that threatened the euro area's financial structure.

- COVID-19 has pushed Brexit concerns off the front pages. Yet as the 31st December transition deadline nears, the post-divorce settlement could become an economic factor nearly as important as a second wave of the virus. At the time of writing, tensions around the ability to achieve a deal were high, although some of the noise is likely to be negotiation tactics as the finish line comes closer.

- While many factors determine equity performance, it has correlated in the emerging-market space with the extent of economic disruption caused by the virus. Asian and central European countries have pulled back the most on their mandates to restrict movement and social interaction. Latin America and India have eased some of those constraints, but not nearly as much as the other two regions. SEI continues to keep close tabs on China, as it was the first to mandate lockdowns and first to unlock activity. We expect recovery patterns elsewhere in the world to follow that of China.

- Central banks in the emerging world are also doing their part to help restore their economies. Interest rates have come down in almost every country in recent months, to record-low levels in many cases. In addition, a long list of emerging-country central banks—including those with shakier reputations, such as South Africa and Turkey—are either buying or planning to buy their government's debt. SEI thinks this debt-monetisation may lead to a future inflation problem.

- SEI believes that an ebb and flow of assorted concerns in the coming months will continue to spark volatility across financial markets. Such periods of instability are expected in any long-term investing plan; as such, we are just as prepared as always at SEI to navigate the current wave of deep uncertainty.

[2] "Trump signs $2 trillion coronavirus relief bill as the US tries to prevent economic devastation." CNBC. 27 March 2020.

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- In terms of active management returns, SEI's belief remains one where markets will ultimately revert to the mean, and investors will make the rotation from significantly overpriced large cap tech stocks into companies with more reasonable fundamentals. At the time of writing, a number of the first days of the month following this reporting period had shown significant results in favour of SEI's positioning (i.e. a downturn for the large US tech stocks), indicating that market tensions around this rotation are running high.

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