SEI UK Strategic Portfolios

SEI UK Strategic Portfolios: October 2020 Monthly Commentary

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Global equity markets continued their decline in October; valuation-focused strategies offered some relief to the downside

Executive Summary

- Global equity markets declined in October for the second month in a row.[1] A broad-based advance for the first few weeks of October gave way to a sharp late-month spike in volatility and a short-but-steep selloff driven by a new wave of rising COVID-19 cases. Looking closer, developed markets were down, while emerging markets rallied following their September slide. European and UK shares had large losses in October, followed by the US, and Japan's decline was comparably mild. China's gains helped propel the rebound in emerging markets, while Brazilian shares were modestly negative.

- The West-Texas Intermediate crude-oil price declined by approximately 11% from its October peak through the end of the month as prospects for global economic activity cooled alongside rising cases.[2] UK and U.S government-bond rates generally increased across the yield curve, while rates declined in the Eurozone. U.S dollar weakness returned in October: the greenback slid against a trade-weighted basket of foreign currencies after a large late-September rebound temporarily interrupted the trend that began with the passage of massive US fiscal stimulus in March.

- Considering the Stability-Focused Strategic Portfolios, returns were boosted by stronger returns from allocations to economically-sensitive debt, including corporate bonds, US high yield fixed income and emerging markets bonds. Unusually for the Global managed volatility equities asset class, it did not provide the downside protection it is designed to deliver in a declining market, primarily due to style headwinds within the asset class as well as poor stock selection. However, it was able to deliver risk reduction over the period.

- For the Growth-Focused Strategic Portfolios, SEI continues to favour exposure to valuation-focused strategies and smaller sized companies, in the firm belief that the valuation-focused approach is one of the best long-term sources of positive relative return. Today, SEI's indicators, such as valuation dispersion, exhibit the highest readings ever. In SEI's view, a once-in-a-generation opportunity is turning out to be an once-in-a-lifetime opportunity. In October, there were clear signs of life in this investment approach. Crucially, this 'margin of safety' approach also provided downside protection during declining equity markets. In this context, it could be argued that SEI's equity large-cap asset classes are more defensively positioned. US smaller companies and emerging markets also contributed positively in October.

[1] According to the net performance of the MSCI ACWI Index.

[2] "Spot Prices." U.S. Energy Information Administration.

- SEI further believes that the post-crisis environment may provide further support for this positioning, given the huge stimulus either being provided or under discussion, the potential for inflationary impacts, and the increasing likelihood for a vaccine sooner rather than later. Crucially, where there have been sell-offs in recent times, it looks to be in evidence that this positioning has potential for meaningful downside protection, should markets enter into a more protracted downward leg.

Market Overview

- UK and EU negotiations over a potential post-Brexit trade agreement continued through the end of October but remained stuck on fishing rights and state aid to businesses. Talks accelerated to a daily pace as of late October, and negotiators now estimate that the terms of a final deal must be agreed by mid-November if it is expected to be enforced by the time the Brexit transition period expires at the end of 2020. An agreement would need to be passed through UK and EU parliaments before becoming law.

- The rebound in UK manufacturing growth peaked in August before slowing through October. Growth in the UK services sector followed a similar path, although the August peak was higher and the deceleration in October was sharper. UK mortgage lending jumped sharply in September and beat forecasts for the first time since June. Meanwhile, consumer credit shrunk by £622 million in September on expectations for a similar-sized expansion, indicating a potential return to the contractionary conditions of the spring after growing through July and August.[3]

- Neither the Bank of England's Monetary Policy Committee nor the US Federal Open Market Committee (FOMC) held meetings in October.

- The Eurozone's recovery in manufacturing activity continued to solidify in October after a promising improvement in growth during September. A contraction in services sector activity that began in September deepened in October, after hitting peak growth in July. The Eurozone unemployment rate trended higher in September, to 8.1%, for its fourth consecutive monthly increase. The overall Eurozone economy grew by 12.7% during the third quarter and contracted by 4.3% year over year.

- The European Central Bank (ECB) made no new changes to monetary policy following its late-October meeting. However, the Governing Council announced plans to use periodic economic projections due for its December meeting to conduct a thorough reassessment and take new actions if appropriate. ECB President Christine Lagarde noted that the Eurozone economy appeared to be "losing momentum more rapidly than expected" and that the "rise in COVID-19 cases and the associated intensification of containment measures is weighing on activity, constituting a clear deterioration in the near-term outlook."

- Another major round of fiscal stimulus remained elusive in the US. President Donald Trump expressed willingness to meet the high price tag proposed by Democrats in control of the House of Representatives, while Republicans controlling the Senate did not appear willing to go along. Early votes in the 2020 US general election pointed to a high turnout, with a significant likelihood of reaching the largest participation rate in more than 50 years. A shift in ballot-casting methods meant to accommodate the challenges of the COVID-19 pandemic produced a higher vote-by-mail share and produced a series of legal challenges over ballot collection and counting in the run up to Election Day.

- US manufacturing growth has been holding steady with moderate growth since August, although reports were mixed for October, showing both a growth spike and a continuation of the moderate expansion. Growth had been driven by new orders in prior months, but manufacturing employment began expanding again in October for the first time since July 2019 and after being sharply curtailed this spring. Initial US jobless claims oscillated between 800,000 and 900,000 during most of October, before dipping to 787,000 in a late-October report. The

3 UK mortgage approvals jump to 13-year high." Reuters. 29 October 2020.

overall US economy grew at a 33.1% annualised rate during the third quarter, the largest quarterly gain on record following the second quarter's record-breaking decline.

- The World Trade Organization handed down a ruling in mid-October that allows the EU to impose retaliatory tariffs on $4 billion of US exports in response to favourable tax treatment for major US aerospace companies.

Selected Asset Class Commentary

- **Global Opportunistic Fixed Income Asset Class:** The asset class benefited from its down-in-quality bias within corporate credit, which included off-benchmark exposure to mortgage credit risk transfer securities. Exposure to a French utility company detracted. Active duration and currency positioning were broadly neutral. AllianceBernstein gained on favourable exposure to off-benchmark corporate credit and mortgage credit transfers. Wellington's global government-related mandate benefited from an underweight to US duration. A currency underweight to Japan and off-benchmark exposure to corporates further contributed. Schroder Investment Management's overweight to BBB rated securities helped.

- **Global Managed Volatility Equities:** The asset class' favourable underweight to IT and a strong tailwind to diversity could not overcome style headwinds against low volatility and an unfavourable overweight to defensive consumer staples and health care. Poor selection further detracted. LSV suffered due to weak selection in US health care and IT, specifically Merck and Intel. Wells Fargo Asset Management benefited from its momentum preference, which translated to more favourable sector positioning.

- **Global Equities:** The asset class' strong size diversity orientation contributed to outperformance. In a welcome return to positive performance from this investment approach, valuation-focused managers performed well during October. However, momentum, stability and low volatility managers suffered during the period. Towle & Co contributed during the month as large cap technology fell out of favour. Poplar Forest Capital also benefited from avoiding large cap technology stocks. LSV Asset Management underperformed as its low volatility and value positioning interacted negatively.

Manager Changes

- None in the reporting period.

Outlook

- It has already been an eventful and exhausting year, but there is a sense that the next few months could prove critical to the future course of the global economy and financial markets. Most countries were in V-shaped recovery mode during the third quarter, moving sharply off their low points in May and June. SEI are working with the assumption that future lockdowns to contain COVID-19 outbreaks will be far more limited in scope. For developed countries, treatments have improved, vulnerable populations appear to be better-protected, and younger, generally healthier people are accounting for a much larger share of confirmed new cases.

- However, there remains a clear doubt there will be a full return to normal economic behaviour until safe and effective vaccines are introduced and distributed globally. The news on this score has been positive, and probably is a key reason for the continued buoyancy of equities and other risk assets. According to the World Health Organization, researchers were testing 45 vaccines in clinical trials at the end of October, while 156 more were in pre-clinical testing.[4]

- There is no disputing that US economic activity remains far below normal. Although incomes are now recovering as more people get back to work, the lack of additional income support may drag down consumer spending as we head into the end of the year. Business sentiment appears to have bottomed, but the outlook remains sufficiently uncertain to keep us in a watch-and-wait mode. We would not be surprised to see the official US

[4] "Draft landscape of COVID-19 candidate vaccines." World Health Organization. 2 October 2020

unemployment rate move up in the months ahead as hard-hit industries eliminate jobs now that government support has run out.

- In August, Fed Chairman Jerome Powell officially unveiled a new framework for conducting the central bank's monetary policy. The Fed has decided to see how low the US unemployment rate can get before it causes the inflation rate to exceed the 2% mark by a meaningful extent. The FOMC's own inflation projection does not envision a return to 2% inflation until the end of its forecast window in 2023, so it may be a long time before the federal-funds rate rises.

- In SEI's view, all that is really left in the Fed's monetary toolbox is quantitative easing, along with the provision of lifeline support to corporations as well as state and local governments through its various credit facilities. Monetisation of debt will likely continue until the pandemic crisis is well past and the US unemployment rate approaches its previous lows.

- The US presidential election will have a major impact on the economy and financial markets in the months and years ahead. Still, SEI firmly believes that it would be a mistake to base even a short-term investment strategy that necessitates accurately predicting the policies proposed by the newly inaugurated president; the ways in which Congress will modify those proposals throughout the legislative process; or the impact those new laws would have on the economy and financial markets.

- Regardless of the election's outcome, we assume the winning candidate will see his platform tempered before it is put into practice. While there could be some market volatility plausibly attributed to the election, it is usually best to pay strict attention to the fundamentals and to ignore the politics.

- UK-EU trade negotiations have created their own unique political melodrama. Obviously, a hard Brexit will not help matters. However, the worst impact potentially will be sustained by financial companies and other service-producing entities, since World Trade Organization rules deal mostly with tradable goods. The increase in tariffs, for the most part, will be bearable once border-related issues are worked out. In the meantime, the UK and the rest of Europe are facing a second wave of COVID-19 that could turn what has been a V-shaped recovery into something looking more like a W.

- The contrast of the big Asian stock markets versus other large emerging-market equities is dramatic. China's strong gains can be chalked up to its rebound in economic activity. Although travel and other services are still constrained due to lingering concerns about the virus, infrastructure-related spending and manufacturing have experienced an almost-complete recovery to pre-pandemic levels. Investors seem to be unfazed by the deterioration in the US-China economic relationship or by the increasingly fraught diplomatic relations between China and other countries.

- Emerging markets are already showing some good news. The price of raw industrials bottomed in early May, and have since enjoyed a sharp move higher. If industrial commodity prices advance in a sustained, multi-year fashion as they have in previous cycles, it is a good bet that emerging-market corporate profits will also rise sharply.

- SEI's optimism around emerging markets is somewhat tempered by the rising debt burden facing many emerging countries. Much of the increase in emerging-market debt has been tied to the corporate sector, especially in China, where private domestic, non-financial debt has reached an eye-watering 216% of GDP[5]. Of more concern are the mostly small-to-medium-sized countries that are running current-account deficits and are too dependent on external hard-currency debt, or do not have the reserves to easily cover their debt service.

- The actions of the world's major central banks back in March, especially the US Fed's provision of US dollar liquidity, have helped to ease the strain on the market for emerging-country debt. Governments and other official lenders, meanwhile, have granted loan forbearance to nearly 80 countries; it is a tougher job to get private

[5] "Total credit to the private non-financial sector (core debt)." Bank for International Settlements.

creditors to agree to do the same.[6] Nonetheless, emerging-market sovereign yields on dollar-denominated debt have fallen back toward their previous record lows, more than reversing the spike endured in March, prior to the Fed's rescue operations.

- Overall, the outlook remains challenged and uncertain. SEI believes that investors should continue to align their portfolios towards goals and to avoid making any knee-jerk reactions based on headlines. Overall, our positioning could be described as defensive; should 'Big Tech' continue to rally to even loftier valuations, SEI portfolios will continue to lag. However, SEI continues to believe in an ultimate reversion to the mean, and that eventually the economic impact of the extending coronavirus crisis will also impact those stocks, most likely disproportionately. Should this occur SEI's emphasis on 'margin of safety', a tried and tested investment approach, may provide a meaningful level of downside protection for the patient investor.

[6] "The IMF's Response to COVID-19." International Monetary Fund.

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Past Performance is not a reliable indicator of future results. Standardised performance is available upon request. All data is as at 31 October 2020.

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