SEI UK Strategic Portfolios

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SEI UK Strategic Portfolios: April 2021 Monthly Commentary

Equity markets continue their push upwards; fixed income yields take a breather from recent highs

Executive Summary

- Capital markets posted strong performance across asset classes in April. Once again, equities raced ahead around most of the world, with developed markets leading emerging markets. US shares were the top-performing major market, followed by Europe, the UK, Hong Kong, and then mainland China. Japanese shares declined for the month.

- Government-bond rates underwent varying changes across different regions during April. In the UK, rates moved higher for gilts with maturities of less than 13 years and lower for gilts of more than 13 years, resulting in a flatter yield curve. Eurozone government-bond rates increased across all maturities; long-term rates rose by more than short-term rates, leading to a steeper curve. US Treasury rates were mixed across short-term maturities, while intermediate- and long-term rates fell, creating a flatter curve.

- The pause in interest rate increases during April was beneficial to bonds and the broader fixed-interest universe, which generally delivered positive returns. Commodities also continued to increase in price during April, with the Bloomberg Commodity Index advancing by 6.92% and West Texas Intermediate crude oil rising by 7.47% to $63.58 per barrel.

- Considering the more stability-focused Strategic Portfolios, fixed income allocations provided positive absolute returns after a difficult first quarter. The Global Managed Volatility Equities Building Block also provided a positive absolute return contribution, but by design underperformed in a rising market. SEI remains a strategic investor, and continues to believe that this asset class component will play its role in investor outcomes at the appropriate time and that their long-term return patterns will revert to the mean.

- For the growth-focused Strategic Portfolios, SEI continues to favour exposure to value and small size, in the firm belief that the valuation-focused approach is one of the best long-term sources of strong relative return. The Global Equities asset class, a key representative of this view and positioning, while giving back a little in April in terms relative returns, remains strongly ahead of benchmarks year-to-date, after a difficult 2020. SEI's view is that there is plenty more relative return opportunity associated with the value-biased positioning, however it will not be delivered in a straight line. At the time of writing, the relative returns that were given back in April were already more than recouped at the beginning of May.

- SEI's indicators, such as valuation dispersion, even after the beginning of this 'Great Rotation', continue to exhibit some of the highest readings ever. In SEI's view, what is normally seen as a once-in-a-generation opportunity continues to represent a once-in-a-lifetime opportunity, and for the medium to long term investor, there should be plenty left in the tank in terms of positive relative return from this positioning. [Source, SEI]

- 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 and the potential for inflationary impacts. 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

- The US began April in the midst of a mild increase in new COVID-19 cases, but returned to the March low by the middle of the month. President Joe Biden's administration announced in mid-April that all adults in the US are eligible for vaccination; by the end of the month, about 30% of the US population was fully vaccinated. Globally, more than 1.1 billion doses of COVID-19 vaccine were administered by the end of April.

- President Biden unveiled a set of spending proposals in late April during a joint address to the Congress that would total about $4 trillion, but which would be funded mostly by tax increases. The proposals encompassed The American Jobs Plan, which focuses primarily on infrastructure, would cost $2.3 trillion and be funded by an increase in corporate taxes; and The American Families Plan, which focuses on childcare, education, healthcare and a range of other issues, would cost $1.8 trillion and be funded by higher income taxes for top earners.

- US manufacturing activity continued to expand at or near multi-decade highs according to multiple PMI surveys. Services growth accelerated from an already strong pace, reaching the highest rate since the 2009 inception of the IHS Markit US services PMI survey[1]. Jobless claims fell in late April to 553,000 per week, a sharp improvement from an early-month reading of 742,000, and the lowest level since early March 2020. Overall US economic growth jumped to a 6.4% annualised rate during the first quarter of 2021 from 4.3% in the prior quarter.

- The US Federal Open Market Committee (FOMC) made no significant policy changes following its late-April meeting: the federal funds rate remained near zero and asset purchases were set to continue at a level of $80 billion in US Treasuries and $40 billion in agency mortgage-backed securities per month.

- COVID-19 infection rates dropped in Europe during April to less than 150,000 per day from more than 200,000 per day in the prior month. However, progress was uneven across countries.

- Eurozone manufacturing growth continued at a red-hot pace during April, reaching the highest level since the 1997 inception of IHS Markit's Eurozone manufacturing purchasing managers' index (PMI) survey[2]. Meanwhile, services activity improved modestly in April, moving from a mild contraction to a mild expansion. The unemployment rate fell from 8.2% to 8.1% in March despite consensus expectations for an increase. Overall Eurozone economic activity contracted by 0.6% during the first quarter of 2021 and by 1.8% year-over-year, compared to contractions of 0.7% and 4.9%, respectively, in the prior quarter.

- The European Central Bank (ECB) held course at its late-April monetary policy meeting, increasing the pace of asset purchases under its €1.85 trillion Pandemic Emergency Purchase Programme (PEPP). This move, previously announced in March, is intended to counter the negative economic impact of rising rates.

- Non-essential retail businesses reopened in England on 12 April in keeping with the second stage of the country's four-part reopening plan. The next stage, set for 17 May, pending continued progress on lower infection rates, will allow restaurants and pubs to provide indoor service and multiple households to congregate inside.

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[1] "Business activity expands at fastest pace on record amid marked uptick in client demand." IHS Markit U.S. Services PMI. 5 May 2021.

[2] "Eurozone expansion gathers pace as manufacturing enjoys record boom." IHS Markit Flash Eurozone PMI. 23 April 2021.

- UK manufacturing activity accelerated further into high-growth territory during April, building on a recovery that unfolded throughout most of the first quarter after a brief pause around Brexit at the beginning of 2021[3]. UK services growth accelerated in April to its highest rate of expansion in 80 months[4]. The UK claimant count remained at 7.3% in March. The broad UK economy expanded by 0.4% in February after contracting by 2.9% in January.

- The Bank of England's (BOE) Monetary Policy Committee (MPC) did not hold a meeting during April. In its March meeting, the MPC maintained the bank rate at 0.1% and retained an £895 billion maximum allowance for asset purchases.

- Asia continued to struggle with a severe outbreak centred in India that began in March; it expanded drastically in April, accounting for the overwhelming majority of new global cases that reached an all-time high of 15.5 million new cases that dwarfed the previous peak of 3.9 million[5]. This outbreak initially spread to other countries in the region, but appeared to crest in India by late April.

Selected Asset Class Commentary

- **Emerging Markets Fixed Income Asset Class:** During the month, the asset class benefited from its modest risk-on positioning. An overweight to Ecuador contributed to returns. An underweight to high-quality emerging markets debt detracted. Stone Harbor Investment Partners gained on overweights to Argentina and Brazil. Neuberger Berman benefited from an overweight to Egypt and off-benchmark position to Israel. Marathon Asset Management registered positive performance due to an overweight to Ecuador and the Ivory Coast, while underweights to Brazil and Hungary detracted.

- **Global Managed Volatility Equities Asset Class:** During the month, the asset class was hurt by headwinds to low volatility during the risk-on rally. An overweight to defensive areas of the market, such as consumer staples and utilities, further detracted. The asset class' underweight to large-cap technology stocks hampered returns. Acadian Asset Management suffered due to its low volatility exposure and overweight to health care and consumer staples. Acadian also faced headwinds due to selection within consumer staples and an overweight to Japan.

- **Global Equities Asset Class:** Following a period of strong relative performance, the asset class suffered due to its diversified positioning, effectively limiting its participation in the mega-cap bounce. This posed a headwind for the value alpha source. As a result, all value managers lagged. SEI's view remains that opportunity continues to exist in the value alpha source, but it is not going to come through in a straight line. Maj Invest was the largest detractor in April. Metropole Gestion also struggled due to the correction to the value alpha source in Europe. Poplar Forest Capital, a US value manager, was also a notable detractor. Momentum managers were broadly flat, with INTECH Investment Management slightly underperforming and Lazard Asset Management modestly outperforming its benchmark. LSV Asset Management was restrained by its high diversity stance and low volatility factor.

Manager Changes

- N/A.

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[3] "Manufacturing PMI at near-record high in April but sector still beset by supply-chain disruptions." IHS Markit / CIPS UK Manufacturing PMI. 4 May 2021.

[4] "Looser pandemic restrictions result in fastest UK private sector growth since late-2013." IHS Markit / CIPS Flash UK Composite PMI. 23 April 2021.

[5] "COVID-19 Projections: Daily Infections and Testing." Institute for Health Metrics and Evaluation, University of Washington.

Outlook

- The war against COVID-19 is not over, but the path to victory has become clearer. Investors are anticipating the return to a more normal world. This is reflected in the rapid rise in bond yields, the most important change in the financial environment so far this year. This jump has caused outsized price drops in long-term fixed income securities and has helped fuel the sharp rotation in the equity market away from expensive growth shares and into value-oriented and cyclical sectors.

- At the start of the year, most economists and bond investors expected higher rates. Few, however, predicted the speed and extent of the increases. While yields on US sovereign debt are setting the pace, they are rising in other countries too.

- With the passage of the latest US fiscal stimulus package, the cumulative amount of US fiscal support over the past 12 months totals a remarkable $6 trillion, approaching 30% of US GDP (Source, "Gross Domestic Product." U.S. Bureau of Economic Analysis) . The Fed has gone to great lengths to protect the bond market from the rising tide of Treasury issuance with its purchases of outstanding issues. In the 12 months ended March 2021, the Fed has bought $2.3 trillion of Treasury securities; as of February, the federal deficit over the past 12 months amounted to $3.55 trillion.

- Higher bond yields may cause bouts of indigestion for equities, but they should not derail the bull market. SEI expects to see cyclical and value-oriented shares continue to advance relative to growth and defensively oriented sectors. In most previous cycles, value shares outperformed growth when the yield curve is rising or is very wide. Value's performance against growth bottomed on 1 September, and has been on a tear since.

- As a further facet to this 'Great Rotation', while value-oriented shares have been making a comeback against growth in the US, other countries' equity markets are making a comeback against the US. To reiterate, this market adjustment is unlikely to occur in a straight line; similar to the unwinding of the Tech Bubble at the beginning of the millennium, there will be starts and stops to this process.

- Although the UK has lagged the MSCI World Index over the past seven months, its 14.34% total return nonetheless was slightly ahead of that of the US (Source, MSCI). Considering all the uncertainty surrounding Brexit and the harsh lockdowns associated with COVID-19 in recent months, this is not a bad outcome.

- As spring arrives and lockdowns end on the back of the country's successful vaccination effort, SEI look for the UK to experience a strong recovery in consumer demand and business activity that should outpace the rest of that on the European continent.

- UK government policy remains supportive in the near term. However, the recently proposed fiscal budget appears rather restrained compared to the measures taken by the Biden Administration, adding only about 3% of GDP to the budget deficit for the 2021/22 fiscal year. From fiscal year 2023/24 and beyond, policy actions begin to reduce the deficit, mostly through an increase in the corporation tax rate from 19% to 25% and through the freezing of income tax thresholds.

- Developed equity markets still look cheap compared to the US. The forward price-to-earnings ratio for the MSCI USA index is still above 23. The MSCI World ex USA Index therefore trades at an unusually wide 27% discount. Although longer-term growth differentials justify a structurally higher multiple for US equities, rebounding economies and rising interest rates should lead to a narrower valuation gap.

- The jump in US bond yields this year has raised investor concerns that emerging markets will be the victims of a 2013-style taper tantrum. Rising rates are a headwind, but we believe emerging economies are generally in a better position to withstand the pressure than they were eight years ago. Strong growth in the world economy over the next year should help lift most emerging markets.

- SEI believes the economic backdrop strongly supports cyclical and value-oriented equities in the emerging markets, just as it does in developed markets. The MSCI Emerging Markets Value total-return Index is highly correlated with industrial commodity prices, which have already vaulted higher from their year-ago lows.

- Emerging economies also look less susceptible to a 2013-style taper tantrum because their external positions are much healthier. Current account balances as a percentage of GDP are generally much smaller now than eight years ago. Emerging market local-currency and US-dollar bond yields have moved higher this year, but the increase has so far been quite modest.

- Overall, SEI's base case is an optimistic one. Developing countries will likely take longer to reopen fully since vaccination distribution will take time. Yet, even these countries will benefit economically from the upswing in developed market consumer demand. However, should a period of risk aversion manifest itself, SEI believes the portfolios to be well positioned, specifically through the use of Global Managed Volatility Equities building block at the defensive end of the risk range, as well as through the value-biased positioning at the aggressive end.

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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 30 April 2021.

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