SEI UK Strategic Portfolios: February 2021 Monthly Commentary

The 'Great Rotation' continued as investors shifted away from overpriced Technology stocks

Executive Summary

- Risk assets continued their advance through the first half of February without any real setbacks. Shares were higher around the world until the middle of the month, when government-bond yields began to spike further. The spectre of a sharp increase in borrowing costs sent chills through markets during the second half of February, leading to selloffs of varying intensity, particularly in heavily overvalued areas of the market.

- Developed-market equities outperformed emerging markets during the month, with mainland Chinese equities negative and Brazil among the worst performers. UK shares led among major developed markets, followed by the US, Hong Kong, Eurozone and Japan. Value-oriented shares beat their growth-oriented peers, and small-cap shares outpaced large caps. This rotation in markets is proving beneficial to SEI's positioning, with the Global Equities building block for example now near or at double-digit outperformance since the end of September 2020.

- UK and Eurozone government-bond rates increased across all maturities during the month, although long-term rates rose by considerably more than short-term rates. In the US, short-term Treasury rates fell by a small amount, while long-term rates pushed higher. The 10-year Treasury yield briefly rose to its highest level in more than a year near the end of February.

- Considering the Stability-Focused Strategic Portfolios, absolute returns struggled as interest rates broadly rose globally. Allocations to shorter duration bonds provided some downside protection. The defensively oriented Global Managed Volatility equities building block lagged in a rising market. SEI remains a strategic investor, and continues to believe that these various asset class components will play their role in ultimate investor outcomes at the appropriate time.

- 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 Building Block, a key representative of this view and positioning, continued to deliver strong positive relative returns.

- SEI's indicators, such as valuation dispersion, even after the beginnings of a market 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, Factset]

- 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

- Following the January collapse of Italy's governing coalition and subsequent resignation of Prime Minister Giuseppe Conte, Italian President Sergio Mattarella asked former European Central Bank President Mario Draghi to form a technocratic government.

- Eurozone manufacturing growth jumped in February to strong levels, interrupting a fairly slow and steady recovery that began last spring. Eurozone services activity continued to shrink during February, having last experienced growth during a fleeting two-month period that ended in August 2020. The Eurozone economy contracted by 0.6% during the fourth quarter of 2020 and shrank by 5.0% during the 2020 calendar year.

- The European Central Bank (ECB) held no monetary-policy meeting during February. In testimony to the European Parliament about the inflation landscape, ECB President Christine Lagarde said, "Underlying price pressures are likely to remain subdued owing to weak demand, low wage pressures and the appreciation of the euro exchange rate."

- In late February, with COVID-19 cases expected to continue declining with the aid of vaccines, UK Prime Minister Boris Johnson unveiled a four-stage plan to reopen England.

- UK manufacturing growth improved to healthier levels in February after slowing in January from a relatively brisk fourth quarter. The country's services sector activity was in a holding pattern during February, neither expanding nor contracting, after plummeting in the prior month. The UK claimant count decreased by 0.1% to 7.2% in January, representing roughly 2.6 million total claimants. The broad UK economy grew by 1.2% in December after breaking a six-month recovery trend in November with a 2.6% contraction.

- The Bank of England's (BOE) Monetary Policy Committee (MPC) held course at its early-February meeting, keeping the bank rate at 0.1% and retaining a maximum allowance for asset purchases of £895 billion. In response to a banking-system review by the BOE's Prudential Regulatory Authority that found banks would need six months to prepare for negative benchmark rates, the MPC communicated that it does not intend to introduce a negative rate within the next six months.

- In the US, estimated daily COVID-19 case counts had fallen by the end of February near the low point of September last year. The US Centers for Disease Control and Prevention (CDC) released updated school reopening guidelines in mid-February that spurred state health departments and local school districts to coordinate plans for more in-person learning and fewer virtual classes.

- The US House of Representatives passed a $1.9 trillion economic relief bill at the end of February. The bill will likely be modified by the Senate to exclude a minimum-wage increase that is not allowed in packages passed under the Senate's reconciliation rules.

- Johnson & Johnson's (J&J) COVID-19 vaccine received emergency-use authorisation from the U.S. Food and Drug Administration at the end of February. J&J announced an immediate shipment of four million doses, and plans to ship 100 million doses by June and potentially one billion doses by the end of the year.

- US manufacturing growth remained strong in February. Services sector growth continued to heat up during the month, nearing November's highs. New weekly US claims for unemployment benefits broke below 800,000 to start February, but climbed to 861,000 by mid-month before recovering to 745,000 by the end of the period. The overall US economy expanded at an annualised 4.1% rate during the fourth quarter (after annualised changes of -5.0%, -31.4% and +33.4% during the first, second and third quarters, respectively).

- The US Federal Open Market Committee did not hold a meeting during February. Federal Reserve (Fed) Chair Jerome Powell pledged to continue supporting the economy via monetary policy during his semi-annual congressional testimony on 23 and 24 February. He also weighed in on recent concerns about rising price pressures, stating, “I really do not expect we’ll be in a situation where inflation rises to troublesome levels.” [Source: SEI, ‘Rising Rates Restrain the Rally’]

Selected Asset Class Commentary

- **Global Fixed Income Asset Class:** During the month, the asset class’ duration positioning effects in the UK, Europe and the US boosted returns. Currency overweights to the UK and Chile and an underweight to Switzerland helped. An overweight to duration in Australia, New Zealand and Japan hurt. Brandywine Global Investment Management’s underweights to duration in UK, Europe and the US contributed. Wellington Management International gained on underweights to US and UK duration. A US Treasury yield curve steepener further contributed. Insight Investment Management’s overweight to duration in the US and Australia 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 was beneficial. Acadian Asset Management suffered due to its low volatility exposure and overweight to health care and consumer staples. The asset class remained overweight the defensive sectors of consumer staples, utilities and health care. SEI’s view remains that this asset class is a valid long term component within the asset allocation context of more defensively oriented investors, and then in a more ‘traditional’ market decline, this building block should once again prove its worth.

- **Global Equities Asset Class:** During the month, the asset class benefited from its value-orientation. Poplar Forest Capital and Towle & Co were the strongest contributors to outperformance due to their value positioning. Poplar had strong selection within financials and consumer discretionary. All other managers outperformed but to a lesser extent. Momentum managers lagged modestly during the month. LSV Asset Management’s low volatility exposure was the only notable detractor in February. LSV’s exposure to low volatility sectors like utilities and consumers staples was headwind.

Manager Changes

- N/A.

Outlook

- Recent market movement continues to show strong evidence of a "Great Rotation" in capital markets, suggesting that investors may have begun to favour value and cyclical sectors over growth names. From what we have seen in the first two months of 2021, it seems that this trade is building momentum. Multi-trillion dollar stimulus packages, inflation and anticipated regulation of 'Big Tech' will all support this dynamic, which should it continue to manifest itself will be highly favourable for SEI's positioning.

- Since September 2020, value style equity indexes have outpaced their growth counterparts to varying degrees across geographies and market capitalisations, most notably within U.S. large caps. SEI have observed several signs of potential normalisation that seem to support the prospects for a style regime change.

- In the context of this market rotation, SEI believes investors will prove willing to shrug off most potential bad news during the difficult months that still lay ahead, which could include slowdowns or pauses in vaccine manufacturing, distribution, administration and uptake. SEI's firm view is that investors should use this moment to diversify away from tech-heavy portfolios, which includes a large number of the major indices and therefore passive implementations.

- Across the Atlantic, U.K. equity valuations, in SEI's opinion, reflect much of the bad news. Maybe it is time for investors to think about the things that could go right, including a vaccine head start, competitive labour unit costs, unfolding global trade deals and favourable conditions for engagement with the US on trade given successful navigation away from any pitfalls arising from the conditions of Brexit as it relates to Northern Ireland.

- Like so many other relationships in the equity market, the underperformance of the Eurozone benchmark has been going on for a long time. The European economy is more cyclical, value-oriented and less dynamic than the U.S. economy. But that certainly does not prohibit a rebound in performance against the U.S. stock market at a time when the latter appears to be excessively tilted toward technology stocks, the dollar is weakening and a global economic recovery is at hand. The EU's mishandling of vaccine procurement will likely lead to delays in 'reopening', which could yet act as a brake on European economic recovery.

- A weak U.S. dollar is an important catalyst for emerging-markets performance. Although the greenback has weakened meaningfully this year, pushing emerging-market stock markets higher, the performance of emerging markets relative to developed markets has been in a narrow range. We expect that the coming year will see emerging equities relative performance improve, partly because the dollar should continue to weaken.

- If the world economy enjoys a durable cyclical recovery in 2021, the dollar should continue to fall. This would also bolster the rally in commodity prices. Commodities of all sorts have been rallying sharply since the spring. This is the first time since the 2009-to-2011 period that metals, raw industrials and foodstuffs have all rallied at the same time.

- Signs of a recovery should continue to reveal themselves as COVID-19 abates and economic activity normalises. In the meantime, fiscal spending and accommodative central-bank policy should prop up inflation. As the market prices in these developments, "long-duration" growth and expensive high-profitability stocks should be pressured, while momentum investors are likely to rotate into new themes, potentially adding more fuel to this nascent cyclical rally.

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