SEI UK Strategic Portfolios

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SEI UK Strategic Portfolios: January 2021 Monthly Commentary

Value rotation benefits continued amidst equity market volatility increases and rising yields in fixed income

Executive Summary

- Capital markets were resilient throughout the uncharted political waters that engulfed the first few weeks of January, with equity-market volatility actually declining during these events. Later in the month, volatility spiked as subscribers to WallStreetBets triggered a classic speculative frenzy, while several hedge fund giants were briefly paralyzed by the amateurs' coordinated trading bonanza. This shift in attention benefited smaller beleaguered shares, yet weighed on broad market indexes as it detracted from mega-cap technology shares that have been leading markets in recent years.

- Emerging-market equities had strong overall performance in January, with gains in the Asia-Pacific region more than offsetting steep losses in Latin America. In developed markets, stocks were generally negative for period, excluding US small caps, which were among the best-performing equities. US large caps and Japanese equities lagged UK shares, which were modestly lower for the full month, while European equities had a steeper decline.

- Fixed-interest sectors, with the exception of inflation-protected securities and high-yield bonds, were also down in January. US investment-grade corporate debt, global sovereign bonds and emerging-market debt had the poorest performance. Government-bond yield curves generally steepened across major developed markets for the month.

- Considering the Stability-Focused Strategic Portfolios, absolute returns struggled as interest rates broadly rose globally. Allocations to shorter duration bonds provided some downside protection, as did the allocation to the Global Managed Volatility Equities asset class, after a long period of lagging rising and narrow equity markets. 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 asset class, a key representative of this view and positioning, continued on its welcome recent path of delivering positive relative return.

- SEI's indicators, such as valuation dispersion, 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]

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- 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

- January set a high bar for memorability. The UK and EU parted ways upon entering the New Year, finally fulfilling the Brexit referendum of 2016. They returned to separate political realms for the first time since 1993 and distinct economic realms for the first time since 1973.

- Six days into the month, the US presidential transition took a bizarre turn as thousands of President Donald Trump's supporters gathered in Washington, DC, to protest the formal declaration of Joe Biden's victory. This protests culminated in a violent security breach of the Capitol by a mob of protesters who successfully delayed the vote count, while damaging property and causing severe injury to and loss of life both for police officers and rioters.

- Trump was impeached by the House of Representatives for inciting an insurrection; the first president in US history to be impeached twice. Still, perhaps the most consequential fallout of the riot was Trump's permanent ban from Twitter, his preferred mode of public communication for much of the last decade. Two weeks later, Joe Biden was inaugurated as president under heavy security provided by 25,000 National Guard troops.

- COVID-19 infection rates continued to climb around the world during January. UK daily case counts topped around New Year's Day, while its daily death toll peaked in mid-January. The US experience was roughly a week ahead of the UK on both metrics. The pandemic's foothold strengthened as new, more infectious coronavirus mutations that are believed to have originated in the UK and South Africa began spreading around the globe, a disconcerting development that risked setting back timetables for a return to normal.

- The Bank of England's Monetary Policy Committee did not hold a meeting in January. It abstained from new actions during its mid-December meeting, having just committed in November to a new £150 billion toward bond purchases (for a total of £895 billion). Its next scheduled meeting in on 4 February.

- UK manufacturing growth weakened during January after strengthening throughout the fourth quarter. Activity in the country's services sector plummeted for the month after working its way out of a contraction in November and December. The UK claimant count (which calculates the number of people claiming Jobseeker's Allowance) increased by 0.1% to 2.6 million in December, generally in line with elevated levels that have become the norm since last spring. The broad UK economy shrank by 2.6% during November after recovering for six consecutive months. [Source, SEI]

- The European Central Bank (ECB) made no new monetary policy changes at its January meeting after increasing the scale of asset purchases associated with its Pandemic Emergency Purchase Programme (PEPP) by €500 billion to a total of €1.85 trillion in December.

- Eurozone manufacturing activity continued to expand at a healthy pace in January. Services sector activity remained mired in a contraction that began in September. The eurozone unemployment rate held at 8.3% during December, having edged lower in prior months from a September climb. The eurozone economy contracted by 0.7% during the fourth quarter of 2020 (after changes of -3.6%, -11.8% and 12.5% during the first, second and third quarters, respectively) and shrank by 5.1% during the 2020 calendar year. [Source, SEI]

- In the US, the new Biden administration worked with the Congress to confirm top-level cabinet positions, enacted a series of COVID-19-related executive actions, and began to tackle a range of other priorities. President Biden also began promoting the "American Rescue Plan," which proposes a $1.9 trillion fiscal stimulus package.

- Biden's Democratic Party holds slim majorities in both houses of the Congress and can therefore enact budget-related plans without bi-partisan support; nevertheless, as January concluded, the new administration remained open to negotiations with moderate Republicans over a potential compromise.

- The US Federal Open Market Committee (FOMC) retained its existing monetary policy stance at its late January meeting. The federal-funds rate target continues to range between 0.0% and 0.25%, and the FOMC remains committed to purchasing Treasurys and agency mortgage-backed securities at respective rates of $80 billion and $40 billion per month. [Source, SEI]

- US manufacturing growth remained strong during January. Services sector activity returned to a high level of growth for the month after its strengthening trend was interrupted in December. New US claims for unemployment benefits were volatile, reaching nearly one million per week in early January before declining to about 850,000 toward the end of the month. The overall US economy expanded at an annualised 4.0% rate during the fourth quarter (after annualised changes of -5.0%, -31.4% and 33.4% during the first, second and third quarters, respectively) and contracted by 2.3% for the 2020 calendar year. [Source, SEI]

Selected Asset Class Commentary

- **Global Opportunistic Fixed Income Asset Class:** During the month, the asset class benefited from an overweight to US mortgage-backed securities (MBS) and off-benchmark exposure to high-yield corporate debt. There were no material detractors in January. Wellington Management International's overweight to commercial mortgage-backed securities (CMBS) enhanced returns. An underweight to US duration further contributed. AllianceBernstein gained on an overweight to CMBS and underweight to US duration. Schroder Investment Management's overweights to communications and consumer non-cyclicals detracted.

- **Global Managed Volatility Equities Asset Class:** During the month, the asset class provided minor downside protection benefits. An overweight to defensive areas of the market, such as consumer staples and utilities, detracted. Wells Fargo Asset Management struggled against style headwinds. Acadian Asset Management benefited from favourable country positioning and an overweight to health care. The building block clearly has struggled in rising equity markets, specifically ones dominated by narrow stock leadership. However, SEI strongly believes the investment philosophy behind this vehicle remains intact and that when the time comes for this component to play its role in downside protection, it will once again be able to do so.

- **Global Equities Asset Class:** The asset class outperformed its benchmark due to its favourable value positioning. Fondsmæglerselskabet Maj Invest suffered due to a strong overweight to transports. Unexpectedly, Maj Invest also lagged during a solid month for value investing. Sompo Asset Management (SNAM) registered positive performance, but did not fully participate in the value bounce. Poplar Forest Capital and Towle & Co were the strongest contributors due to their value positioning. Additionally, the manager's higher-volatility and smaller-cap-bias was beneficial. Rhicon Currency Management lagged in January. The majority of Rhicon's trades executed through the options markets remained out of the money.

Manager Changes

- N/A.

Outlook

- Recent market conversation has hinted at the notion 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 so far in 2021, it seems that this trade is starting to gain 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, 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.

- SEI believes investors will prove willing to shrug off the likely prospect of more bad news during the difficult months that 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.

- Politics will also come into play, with potential to act as either a tailwind or a headwind. The US Congress struggled for months to provide additional income support to the people and businesses most seriously affected by the economic disruptions caused by the virus. The lawmakers finally came up with a $900 billion compromise that is limited in scope and falls far short of what is needed. Most of the benefits are set to expire in March and April, and it does not address revenue shortfalls facing state and local governments. SEI believes there's a high likelihood that the Biden administration's American Rescue Plan (or a variation thereof, pending negotiations with moderate Republicans) will succeed in getting more fiscal support to those who need it.

- Across the Atlantic, U.K. equity valuations, in our 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.

- Emerging-market equities have been on a tear since they bottomed out last March. For 2020 as a whole, the MSCI Emerging Markets Index (total return) has climbed by 18.3%, a slightly better performance than the 15.9% gain registered by the MSCI World Index (total return), which tracks the performance of developed-country stock markets. [Source, MSCI]

- However, the Emerging Markets Index is still just 10% above its previous high-water mark recorded in January 2018. Frontier markets have fared even worse. The MSCI Frontier Emerging Markets Index (total return) has yet to surpass its most recent pre-pandemic high level recorded last January.[Source, MSCI]

- 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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