SEI UK Strategic Portfolios: May 2021 Monthly Commentary

Equity markets continued their advance in May 2021 with valuation-focused investment strategies remaining in the spotlight

Executive Summary

- Global equity markets advanced during May for the fourth straight month. Emerging-market shares outpaced developed markets as a group, but performance varied widely from country to country. Valuation-focused investment strategies continued to be in favour and delivered positive relative returns.

- Europe generated the greatest equity gains during May, driven by sharp rallies across Hungary, Poland, Austria and Czech Republic; UK shares also performed quite well. Japan and Hong Kong equities produced healthy returns, while mainland China and US performance was positive but restrained.

- Rates for UK gilts and US Treasury's declined across most maturities during May, with the most pronounced moves centred on intermediate- to long-term rates. Eurozone government-bond rates increased across all maturities. West Texas Intermediate's crude-oil price crept up to its highest level since late 2018 as energy demand continued to rise during May.

- Considering the more Stability-Focused Strategic Portfolios, fixed income allocations provided positive absolute returns for a second consecutive month, after a difficult first quarter. Short duration fixed income underperformed as an asset class given broadly declining rates. The Global Managed Volatility Equities Building Block also provided a positive absolute and relative return contribution. The allocation to Emerging Markets debt was also a positive contributor over the month.

- 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, delivered another month of strong positive relative return. 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.

- 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

- In the UK, 58% of the population had received at least one dose of a COVID-19 vaccine by the end of May, while its daily COVID-19 infection rate fell to 5% of its peak. At the same time, the US one-dose number stood at 51% of its population as the country's daily infection rate was 7% of its all-time high; Germany's respective figures were 43% and 16%, while France's were 37% and 17%. India's severe COVID-19 outbreak eased somewhat, with its daily infection rate falling to 45% of its peak by the end of May; several other countries in Southeast Asia along with a number of South American and Caribbean countries remained at or near their highest infection levels[1].
- Within the UK, England's reopening timetable has continued according to schedule. Restaurants and pubs were allowed to provide indoor service starting on 17 May, while hotels opened up, and people from multiple households were permitted to congregate inside. Prime Minister Boris Johnson said there was no apparent reason to doubt that the final reopening stage, which would eliminate all remaining restrictions on social contact, live performances and nightclubs, would occur on 21 June as scheduled.

- UK manufacturing activity during May surpassed a growth record set in 1994, according to IHS Markit/CIPS' purchasing managers' index (PMI) surveys, while UK services activity expanded to the highest level in 91 months[2][3]. The UK claimant count (which calculates the number of people claiming Jobseeker's Allowance) remained at 7.2% of the population in April as the total number of claimants decreased from 2.64 million to 2.63 million. The broad UK economy grew by 2.1% during March after expanding by 0.7% in February and contracting by 2.6% in January.

- The Bank of England's (BOE) Monetary Policy Committee (MPC) kept the bank rate at 0.1% and retained an £895 billion maximum allowance for asset purchases at its early May meeting. The BOE upgraded its forecast for 2021 UK economic growth to 7.5% from 5% in February, and stated that it could now begin to slow the pace of its monthly asset purchases as planned.

- In a push to re-establish tourism ahead of the traditionally busy summer season, the EU approved a proposal made by the European Commission in May to ease travel restrictions within the bloc for vaccinated foreigners. In May, the European Parliament suspended ratification of the Comprehensive Agreement on Investment that EU and Chinese leaders had finalized in December 2020. As for EU-US trade relations, friction smoothed as the European Commission delayed an increase to tariffs on the US that had been planned in response to the Trump administration's tariffs on European metals; existing tariffs will remain as the two sides negotiate a long-term solution.

- Eurozone manufacturing growth move further into record-high territory during May, according to IHS Markit's Eurozone manufacturing PMI survey (which dates back to 1997)[4]. Eurozone services activity returned to a healthy pace of growth in May, the Eurozone unemployment rate edged lower from 8.1% to 8.0% during May and economic activity contracted by 0.6% during the first quarter of 2021 and by 1.8% year over year.

- The European Central Bank (ECB) did not hold a monetary-policy meeting during May; it held course at its late-April meeting, increasing the pace of asset purchases under its €1.85 trillion Pandemic Emergency Purchase

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[1] "COVID-19 Global Tracker." Reuters.

[2] "UK Manufacturing PMI surges to record high in May." IHS Markit / CIPS UK Manufacturing PMI. 1 June 2021.

[3] "UK private sector signals fastest output growth for more than two decades. Prices charged inflation hits series-record high in May." IHS Markit / CIPS UK Composite PMI. 21 May 2021.

[4] "Eurozone manufacturing PMI reaches new heights in May." IHS Markit Eurozone Manufacturing PMI – final data. 1 June 2021.

Programme (PEPP). This move, previously announced in March, is intended to counter the negative economic impact of rising interest rates.

- US President Joe Biden's administration proposed a $6 trillion budget for the 2022 fiscal year that would serve as a starting point from which Congress can appropriate the country's economic funding. The president incorporated his two major economic initiatives into the budget: infrastructure (estimated $2.3 trillion) and families programmes (estimated $1.8 trillion), along with $1.5 trillion for defence. Negotiations during May produced an offer from the White House to lower its infrastructure price tag to $1.7 trillion and a counter bid from Senate Republicans for a $928 billion package.

- US manufacturing activity remained at red-hot growth levels in May, according to multiple PMI surveys. In the same month, IHS Markit's preliminary US services PMI survey (which dates back to 2009) reported that US services growth set a new high[5]. New claims for jobless benefits continued to decline, from just below 500,000 per week at the start of May to 444,000 at the end of the period. 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) did not hold a monetary-policy meeting in May and 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 Treasury's and $40 billion in agency mortgage-backed securities per month.

Selected Asset Class Commentary

- **Emerging Markets Fixed Income Asset Class:** During the month, the asset class benefited from its modest risk-on positioning and overweight to Ukraine. The allocation to European currencies aided performance. An underweight to South Africa detracted. Colchester Global Investors gained on overweights to Brazil and Mexico. Ninety One benefited from overweights to Poland and Egypt. Neuberger Berman benefited from an overweights to Ukraine and Russia. Stone Harbor Investment Partners suffered on underweights to China and Paraguay. Marathon Asset Management struggled on an overweight to Columbia and underweight to China.

- **Global Managed Volatility Equities Asset Class:** During the month, the asset class' underweight to large-cap technology stocks helped performance. An overweight to defensive areas of the market, such as consumer staples and utilities, further contributed. LSV Asset Management's value orientation added. Acadian Asset Management gained on low volatility exposure and an overweight to consumer staples. Wells Capital Management's exposure to momentum was beneficial.

- **Global Equities Asset Class:** The asset class benefited from its value positioning. Poplar Forest Capital, a US value manager, was also a notable contributor. Poplar's exposure to cyclical value and overweight to banks, insurance and energy boosted returns. LSV Asset Management's underweight to information technology and consumer discretionary contributed. Maj Invest registered flat performance during the month. Stock selection within consumer discretionary and materials hurt performance. Rhicon Currency Management suffered due to an unfavourable market environment.

[5] "Output growth surpasses series high once again amid stronger client demand, but cost pressures mount further." IHS Markit Flash U.S. Composite PMI. 21 May 2021.

Manager Changes

- Principal Global Investors, LLC's was removed from the Asia Pacific (ex-Japan) Equities building block in May. Principal was removed due to organizational changes that have occurred at the firm, which caused turnover in the strategy's senior portfolio management team. Additionally, Principal's staffing resources have been reduced over time.

- Sophus Capital was added to the Asia Pacific (Ex-Japan) Equities building block in May. Sophus focuses on earnings momentum, which is characterised by accelerating (or decelerating) growth in corporate earnings. Sophus' approach also maintains a tilt toward value and quality factors. We believe this approach possesses high awareness thanks to the investment team's due diligence and understanding of the factor cycle.

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 (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 $4.09 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. 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.

- However, having confidence is not the same as being complacent. Beyond COVID-19 concerns, we expect investors will be increasingly focused on the next multi-trillion dollar US spending package, which will almost certainly include tax increases on corporations and high-income households. Compromises will be needed to keep the Democratic caucus unified.

- Generally speaking, the tax and regulatory changes championed by the Biden administration are not considered business- or equity-market friendly. But the same could be said of the economic policies pursued during President Barack Obama's administration. That did not prevent one of the strongest and most enduring bull-market runs in US history. We caution against making broad asset-allocation changes based on perceived shifts in the political winds.

- As for monetary policy, we will be watching whether the US Fed can maintain its stance of a near-zero federal-funds rate through 2023. If the acceleration in inflation proves stronger and longer-lasting than investors expect, bond yields could climb appreciably from today's levels.

- If the Fed accelerates policy rate hikes, we would expect a neutral-to-negative reaction in equities and other risk assets. On the other hand, suppressing the rise in bond yields through even more aggressive policy actions could lead to a weaker US dollar and a sharper investor focus on inflation-hedging. Equity valuations could get even more expensive than they are now as investors grow even more exuberant. Interesting times, indeed.

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- Absolute return investments utilise aggressive investment techniques which may increase the volatility of returns. If the correlation between absolute return investments and other asset classes within the fund increases, absolute return investments' expected diversification benefits may be decreased.
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