SEI UK Strategic Portfolios

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SEI Strategic Portfolios: November 2021 Monthly Commentary

A new COVID variant and signs of more persistent inflation rattle investors in November 2021

Executive Summary

- Global equities started November on promising footing. Shares advanced for the first week, then treaded water through mid-month before declining, modestly at first, and then sharply during the last week.
- Developed-market shares continued to perform better than emerging markets. China, Hong Kong, the UK and Europe sustained sharp one-month drops. Japan's losses were less severe, and the slide in US shares was mild compared to other major markets.
- Government-bond rates declined across all maturities in the UK and eurozone; yields went negative on eurozone bonds with maturities all the way out to 30 years (negative yields were out to 12 years at the end of October). Short-term US Treasury rates increased, while intermediate-to-long-term rates declined, resulting in a flatter yield curve. Treasurys were the best-performing fixed-interest segment, while emerging-market debt continued to sustain the deepest losses.
- Considering the Stability-focused Strategic Portfolios, short duration positioning proved challenging to relative returns. The persistence of the investor's preference for expensive technology names proved a headwind to the performance of the Global Managed Volatility Equities Building Block despite falling markets. With inflationary pressures persisting and central banks starting to pare back their asset purchases, SEI continues to believe this positioning to be prudent.
- For the Growth-focused Strategic Portfolios, SEI remains committed to the ongoing narrative, continuing 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 and that currently this area of the market looks extremely promising on a forward-looking basis. The rotation to value has come through in patches since Q4 2020 and in 2021. SEI expects that as investors recognise new variants are something we just need to learn to cope with, sector and security fundamentals will once again be the key driver of investment return.

Market Overview

- Emergence of the omicron coronavirus variant in southern Africa was a key factor in rattling investors as November progressed. Omicron appears to contain significantly more mutations than other variants, which could potentially make it more effective in sidestepping neutralisation by antibodies generated from earlier infections and vaccinations.

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- Chancellor of the Exchequer Rishi Sunak faced scrutiny from UK House of Commons Treasury Committees at the beginning of the month for tax increases included in his Autumn Budget. He contended that the revenue raisers are needed to fund necessary spending and intended to be temporary.

- The Bank of England's Monetary Policy Committee left its policy orientation unchanged at its early-November meeting, with the bank rate remaining at 0.1% and the maximum allowance for asset purchases at £895 billion. The central bank's November report on monetary policy upgraded its inflation forecast to peak at 5% in spring 2022, and indicated that a rate hike would be necessary if its economic outlook comes to pass.

- The expansion in UK manufacturing activity held in November at a strong pace of growth[1]. Services growth settled slightly lower in November, but remained quite robust[2]. The UK claimant count declined further in October by roughly 15,000 claimants, lowering the claimant share of the population from 5.2% to 5.1%. The UK economy expanded by 0.6% in September.

- Germany's new governing coalition came together in late November. The centre-left Social Democrats (SPD, with 25.7% of the September election's vote share) will work with the progressive environmentalist Greens (14.8%) and pro-business Free Democrats (FDP, 11.5%). SPD leader Olaf Schultz will head the government as chancellor, while Christian Lindner, the FDP's leader, will serve as finance minister.

- The European Central Bank (ECB) did not hold a meeting on monetary policy during November and continued to pursue a moderately lower pace of net asset purchases under the pandemic emergency purchase programme (PEPP). The European Commission's Autumn Economic Forecast, released in November, showed inflation projections above the ECB's 2% target in 2021 and again next year, with import prices contributing steeply and compensation to a lesser extent.

- Growth in eurozone manufacturing activity continued during November in line with the robust pace of the prior two months[3]. Eurozone services growth strengthened in November after slowing in October[4]. The eurozone unemployment rate continued to decline in September, hitting 7.4%. The overall eurozone economy expanded by 2.2% in the third quarter, in line with the second quarter's 2.1% rate.

- For the second time this fall, US Congressional negotiators appeared on the verge of a last-minute agreement to fund the government in early December ahead of a funding lapse that would otherwise take effect on 4 December. The agreement, which has already passed the House of Representatives, would provide funding through mid-February.

- The US Federal Open Market Committee (FOMC) announced a long-anticipated timetable to reduce its asset purchase programme following its early-November meeting. Reductions were expected to continue until asset purchases conclude altogether in June 2022, although the pace can be adjusted "if warranted by changes in the economic outlook." At the end of November, Federal Reserve (Fed) Chair Jerome Powell expressed that high inflation could drive the FOMC to reduce asset purchases at an accelerated pace and conclude the programme a few months earlier than planned.

- The US manufacturing expansion maintained it strong pace in November[5]. Services activity remained strong during November despite moderating after October's sharp acceleration[6]. New weekly US jobless claims held

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[1] IHS Markit / CIPS UK Manufacturing PMI. 1 November 2021.

[2] IHS Markit / CIPS Flash UK Composite PMI. 23 November 2021.

[3] IHS Markit Eurozone Manufacturing PMI. 2 November 2021.

[4] IHS Markit Flash Eurozone Composite PMI. 23 November 2021.

[5] IHS Markit US Manufacturing PMI. 1 November 2021.

[6] IHS Markit Flash US Composite PMI. 23 November 2021.

just below 270,000 for most of November before declining to 194,000 later in the month, the lowest level since 1969. The broad US economy grew at a 2.1% annualised rate during the third quarter, down from the second quarter's 6.7% pace.

Selected Asset Class Commentary

- **US High Yield Fixed Income Asset Class:** J.P. Morgan Investment Management and T. Rowe Price benefited from allocations to health care and leisure. Ares Management gained from an allocation to basic industry. There were no material detractors during the month.

- **Global Managed Volatility Equities Asset Class:** During the month, the asset class' favourable overweight to quality-oriented stocks could not overcome an unfavourable underweight to large-cap technology names. Other detractors included overweights to defensive areas of the market and poor stock selection in telecommunications. The asset class' overweight to value further hindered returns. LSV Asset Management's value orientation and underweight to large-cap information technology hurt performance. Acadian Asset Management benefited from its low-volatility preference, which led to an underweight to low-quality stocks.

- **Global Equities Asset Class:** The asset class suffered due to an overweight to value during the month. Stock selection results were negative. Poplar Forest Capital detracted due to the underperformance of value. Poplar's underweight to mega-caps further detracted. Metropole Gestion, suffered from similar dynamics, as well as from their allocation to communication services and overweight to materials. Fiera Capital Corporation, a US quality manager, was the only bright spot during the month, benefiting from favourable tailwinds to quality and positive stock selection. Strong selection within communication services and financials enhanced returns.

Manager Changes

- N/A

Outlook

- Investors continue to fret over the appearance of new variants which in turn automatically leads to support for companies that benefited the most during 2020; work-from-home, big technology stocks and other expensive companies that have done well when bond yields fell. SEI does not believe this bounce-back at the expense of value and cyclical stocks will be long lasting, and it has already shown signs of deteriorating as rates spiked at the end of the third quarter.

- At some point, the world may need to learn to live with the appearance of new variants without these knee jerk reactions. SEI expects economic growth to continue at a rate over the next year or two that meaningfully exceeds the sluggish pace that followed the Great Recession of 2007 to 2009; recent gloom about flagging economic growth is likely a bit overdone.

- Household wealth is at an all-time high, owing to booming stock and home prices. A big decline in the saving rate has helped cushion consumer spending, yet saving as a percentage of disposable income remains elevated compared to pre-pandemic levels. SEI thinks households can adjust to a decline in pandemic relief payments without necessitating a sharp contraction in their expenditures.

- Corporate pricing power is the good news. Inflation that keeps exceeding consensus expectations is the bad news. SEI still expects inflation to run at a higher rate for a longer period than has been commonly assumed, not just over the next one or two years, but well into the decade.

- Growth in unit labour costs typically falls significantly as the economy emerges from recession. Now, however, unit labour costs are running near a 2.7% rate, the fastest pace since the peak of the 2002-to-2007 expansion.

- While commodity inflation and parts shortages may indeed prove transitory, it is uncertain if the labour shortage and resultant pressure on compensation growth will be as quick to revert to lower levels. The tax and regulatory initiatives of the Biden Administration will likely add to the cost pressures facing businesses in the years immediately ahead.

- Since US demand will likely remain robust as economic growth normalises, it would not be surprising to see companies continue passing along their increased costs. Inflation over the long haul could thus be closer to 3% than the 2% or so currently expected by the Fed and most investors.

- If that turns out to be the case, the current yield structure may also prove to be unsustainably low, and the Fed may be forced to raise interest rates higher and faster over the next three years than anticipated.

- Another concern, one that is much nearer in timeframe, is the fight in Washington over infrastructure spending and the debt limit. We assume President Biden will get about half of what he is seeking, but the devil will be in the details.

- SEI would encourage investors to focus on longer-term considerations: The delta wave will pass. The Omicron wave will pass. Vaccines seem to be working. People are hungry for a return to pre-pandemic social and business conditions. Economic growth should stay relatively strong in 2022. Households are in good financial shape and will benefit as employment and wages continue to move higher. Companies are still able to pass along increased costs and maintain high profit margins.

- Meanwhile, Fed policy remains biased toward accommodation, allowing the economy to run hot at the risk of higher inflation. This should all create a favourable backdrop for risk assets, and support a resumption in the coming months of the cyclical-financial-value trend versus growth-technology, from which SEI's positioning would stand to benefit.

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