Stability-Focused SEI Strategic Portfolios

SEI Strategic Portfolios: Q1 2021 Quarterly Commentary

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The 'Great Rotation' continued as valuation-focused equity strategies lead in Q1 2021

Executive Summary

- The first quarter of 2021 was marked by numerous transitions, perhaps, the most relevant to SEI investors was (what SEI believes to be) the beginnings of what is being called a 'Great Rotation' in markets. Geopolitically, the UK bid the EU adieu after more than four years of anticipation, while the US federal government came under the leadership of the Biden administration and unified control of his Democratic Party in the Congress.

- This season of change was perhaps most evident in the trajectory of COVID-19's toll: case counts and daily deaths began the calendar year at or near their all-time peaks in many parts of the world, which created a sense for much of the quarter that the state of COVID-19 affairs was improving, albeit from a bleak starting point. The increasing availability of vaccines boosted this impression.

- Forward-looking capital markets focused on the brightening outlook. Globally, the cyclically sensitive energy and financial equity sectors led at a distance for the second consecutive quarter, while the defensive consumer staples sector was the only negative performer. Valuation-focused strategies, which SEI has been emphasising for some time given their relative appeal compared to extremely price-heavy sectors of the market, gained meaningfully over the period.

- Government bond rates in major developed countries generally increased during the first quarter, and yield curves steepened as longer-term rates rose by more than shorter-term rates. The greatest increase in long-term rates came during February. The 10-year US Treasury rate nearly doubled during the quarter, moving from 0.93% to 1.74%.

- Considering the Stability-Focused Strategic Portfolios, absolute returns struggled as interest rates broadly rose globally. Allocations to shorter duration bonds provided some downside protection. Countering some of its unusual behaviour in 2020, Global Managed Volatility outperformed in a rising market in Q1. 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.

Market Overview

- UK Chancellor of the Exchequer Rishi Sunak's Spring Budget announcement contrasted upfront spending and tax incentives with higher taxes in the coming years. The budget extends, among other programmes, income replacement schemes for furloughed employees and the self-employed, provides payments for non-essential retail, hospitality and leisure businesses and Restart grants for businesses that were required to shut down.

- UK manufacturing growth slowed to a modest pace in January before accelerating through February and March to end the first quarter with a robust expansion. UK services activity contracted sharply in January and essentially maintained pace in February before returning to strong growth in March. The UK claimant count decreased slightly in January to 7.2%, then jumped in February to 7.5%, tying August 2020 for the highest level since 1995 and representing about 2.68 million total claimants.[1] The overall UK economy grew by 1.3% during the fourth quarter of 2020, down from 16.0% during the third quarter's sharp recovery, and contracted by 7.3% year over year through the fourth quarter.

- The Bank of England's Monetary Policy Committee (MPC) kept the bank rate at 0.1% and retained a maximum allowance for asset purchases of £895 billion throughout the first quarter. Following its early-February meeting, the MPC communicated that it had no intention of lowering rates into negative territory within the next six months; by mid-March, faced with rising rates, the MPC stated it wouldn't increase rates "at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably."

- Growth in Eurozone manufacturing activity started at healthy levels in January before climbing through February and March to a red-hot pace. Eurozone services, meanwhile, continued to contract throughout the first quarter, worsening through January and February after a partial recovery in December, and then improving in March to the mildest levels since September. The overall Eurozone economy contracted by 0.7% during the fourth quarter of 2020 after expanding by 12.4% during the third-quarter snapback.

- The European Central Bank (ECB) announced plans in mid-March to increase the pace of asset purchases under its €1.85 trillion Pandemic Emergency Purchase Programme (PEPP) relative to the speed and size of purchases made in early 2021. This move is intended to counter the negative economic impact of rising rates. The ECB's latest forecast showed a modest improvement in GDP for 2021.

- In the US, President Biden signed an aid package totaling $1.9 trillion into law on 11 March, providing funding for extended and expanded unemployment benefits, direct stimulus payments, child tax credits, schools, state and local governments and elsewhere.

- On the last day of March, Biden announced a $2.3 trillion package targeted at modernising travel and utility infrastructure, care for the elderly and disabled, manufacturing, affordable housing and expanded access to broadband internet, coupled with a broad low-carbon electricity generation mandate. The price tag for Biden's proposal would be offset by increasing the corporate tax rate from 21% to 28% for a 15-year period and raising taxes on overseas corporate profits.

- US manufacturing growth continued to increase at robust levels throughout the first quarter. US services sector growth also accelerated throughout the first quarter starting with a substantial increase in the rate of expansion during January. New US jobless claims climbed back to nearly 1 million per week in mid-January before declining unevenly to almost 700,000 by the end of the quarter. The overall US economy grew by a 4.3% annualised rate in the fourth quarter, down from 33.4% during the third quarter's huge rebound.

[1] Souce: Claimant Count – Percentage (%). UK Office for National Statistics

- The US Federal Open Market Committee (FOMC) held the federal funds rate near zero throughout the first quarter and continued its asset purchases apace. Economic Projections released in mid-March, showed marked improvements in 2021 estimates for GDP and employment, as well as a significant increase in the inflation rate, compared to the December's outlook. Federal Reserve (Fed) Chair Jerome Powell followed the March meeting by communicating that the FOMC would not seek to pre-empt rising inflation with tighter monetary policy.

Selected Asset Class Commentary

- **Global Opportunistic Fixed Income Asset Class:** The asset class benefited from an overweight to the securitised sector, which continued to benefit from positive US housing-market dynamics and lack of interest-rate sensitivity, as well as from an underweight to government-related bonds. An overweight to Australian rates detracted. Wellington Management International Limited's US securitised mandate benefited from exposure to off-benchmark mortgage Credit Risk Transfer Securities (CRTs). The government-related mandate managed by Wellington gained on an underweight to UK rates. AllianceBernstein's government-related and non-US securitised mandates underweight to US rates and exposure to off-benchmark high-yield corporates contributed. There were no detractors at the manager level during the quarter.

- **Global Managed Volatility Equities Asset Class:** A focus on attractively-priced names in the low-volatility space overcame style headwinds during the quarter's rising-rate environment. An underweight to mega-cap IT stocks further contributed. LSV Asset Management benefited from a value tailwind and its focus on diversification. Acadian Asset Management suffered from its deeper low-volatility bias, which resulted in an unfavorable overweight to health care and consumer staples at the expense of riskier financials and energy stocks. The asset class' primary objective is to achieve market-like returns at a lower risk. Prices have become more attractive for low-volatility strategies, particularly given below-average long-term interest rates, which could be potentially beneficial for the risk-adjusted returns in the long run.

- **Global Equities Asset Class:** The asset class benefited from its pro-cyclical, contrarian positioning through an overweight to fundamental value managers. The asset class' deep value managers were attracted to risky cyclical stocks that rebounded once it became clear that lockdowns would not last forever. Poplar Forest Capital and Towle & Company, US value managers, both benefited from their allocation to value. Additionally, a small cap bias enhanced returns for the managers. Stock selection was robust within financials and energy. Sompo Asset Management Co., Metropole Gestion, Jupiter Asset Management and Maj Invest all contributed to outperformance. Rhicon Currency Management detracted during the quarter.

Manager Changes

- None

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. 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. We expect 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 also making a comeback against the US equity market.

- 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 22. The MSCI World ex USA Index therefore trades at an unusually wide 24% 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.

- As for monetary policy, investors will be watching whether the 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.

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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 31 March 2021

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