Growth-Focused SEI Strategic Portfolios

# SEI Strategic Portfolios: Q2 2021 Quarterly Commentary

**Equity and equity-like fixed income markets deliver gains in Q2 2021, while concerns over the state of the pandemic partially reverse the 'great rotation/reopening' trade**

**Executive Summary**

- The broad-based advance in equities, commodities and riskier fixed-interest asset classes since earlier this year accelerated during the second quarter. A shift among global investors toward favouring cyclical and value-oriented asset classes that began in the second half of 2020 halted in mid-June.

- Market observers attributed this to the US Federal Open Market Committee (FOMC) deciding to increase its projection for the federal-funds rate in 2023. In SEI's view, clear opportunities in this space remain, specifically when viewed against some of the significantly overvalued parts of the market; the 'great rotation' was never going to play out in a straight line, especially as pandemic concerns fluctuate.

- Developed-market equities outpaced emerging markets for the second quarter of this year. US shares gained the most among major markets, followed by Europe, the UK, Hong Kong and mainland China. Japanese equities were modestly negative.

- UK gilt and US Treasury rates declined across most maturities for the first two months of the second quarter; short-term rates bounced in June, resulting in flatter yield curves. Conversely, Eurozone government-bond rates climbed throughout April and May before falling in June, but generally ended up higher compared to the beginning of the quarter. Emerging-market debt was the best-performing fixed-interest asset class.

- 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. While the mid-June retreat from this area had a negative impact on relative return, on a year to date basis this position is still adding meaningful value. SEI's view is that there is more relative return opportunity associated with the value-biased positioning, however as we keep reiterating, it will not be delivered in a straight line.

- SEI's indicators, such as valuation dispersion, even after the beginnings 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.

- 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. Flare-ups in concerns around the pandemic are likely to be counterproductive but from an investment point of view, we would urge investors to stay invested and try to look past this.

## Market Overview

- The world's daily infection rate climbed past the peak recorded in January to an all-time high at the end of April as India continued to battle a severe COVID-19 outbreak. While the daily number of virus-related deaths reported globally also increased during the second quarter, it remained significantly below its early-year peak. India's daily case count began to rapidly decline in early May, leaving Brazil with the highest country-level count by the end of the second quarter.

- As for COVID-19 vaccination trends, Canada, the UK and Chile reported the largest numbers of people (relative to their total populations) that received at least one vaccine dose by the end of the three-month period. Perhaps as a result, the daily average number of deaths in the UK attributed to COVID-19 remained in the low double digits despite a resurgence in new infections that began in mid-May.
- The UK's manufacturing frenzy reached the fastest pace of growth since 1994 in May before cooling ever so slightly in June, according to the IHS Markit / CIPS UK Manufacturing Purchasing Managers' Index (PMI) survey[1]. Similarly, services growth peaked in May at its strongest pace since 1997 before slowing somewhat in June[2]. The UK claimant count (which calculates the number of people claiming Jobseeker's Allowance) declined by about 56,000 in April and 93,000 in May, with claimants representing 6.2% of the population as at May's reading. The overall UK economy contracted by 1.6% during the first quarter and 6.1% year over year through March.

- 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 throughout the second quarter. It shared a projection following its late-June meeting that inflation would temporarily top 3% amid the country's economic reopening before returning toward 2%.

- Eurozone manufacturing measured its fourth straight month of record-high growth in June, according to IHS Markit's PMI survey, with Spain and Greece reaching their greatest levels in more than 20 years[3]. Services activity in the Eurozone emerged from contraction to start the second quarter before accelerating to the fastest rate of growth in more than three years by June, according to IHS Markit's PMI survey[4]. The Eurozone unemployment rate declined steadily, from 8.1% at the end of the first quarter to 8.0% in April and 7.9% in May. The overall Eurozone economy shrank by 0.3% during the first quarter and 1.3% year over year in March.

- The European Central Bank (ECB) began the second quarter with a pledge to increase the pace of asset purchases under its €1.85 trillion Pandemic Emergency Purchase Programme (PEPP). It reaffirmed the acceleration at its June meeting. Purchases averaged about €80 billion per month during the second quarter after running closer to a monthly pace of €60 billion during the first quarter.

- The prospect of a bipartisan US infrastructure deal appeared to brighten in mid-June as a group of Senate Republicans and Democrats agreed to a White House compromise that would direct $1.2 trillion toward improving the country's structures and facilities over an eight-year period. The plan would provide about $580 billion in new spending and sidestep tax increases.

- Multiple PMI surveys depicted US manufacturing at red-hot growth levels during the second quarter. US services activity peaked during May at the highest level on record dating back to 2009, according to IHS Markit's

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[1] "UK manufacturing sees input costs and selling prices rise at record rates in June." IHS Markit / CIPS UK Manufacturing PMI. 1 July 2021.

[2] "Employment growth hits record high amid sharply rising workloads, but inflationary pressures also strengthen." IHS Markit / CIPS Flash UK Composite PMI. 23 June 2021.

[3] "Eurozone manufacturing PMI sets fresh record high in June." IHS Markit Eurozone Manufacturing PMI. 1 July 2021.

[4] "Eurozone economy grows at fastest rate for 15 years." IHS Markit Flash Eurozone PMI. 23 June 2021.

PMI survey, before slowing to a still-remarkable pace of growth in June[5]. US nonfarm payrolls increased at an accelerating pace throughout the second quarter as new US jobless claims declined from about 700,000 per week at the end of the first quarter to 364,000 in late June. The overall US economy grew by a 6.4% annualised rate during the first quarter.

- The US FOMC held the federal-funds rate near zero throughout the second quarter and continued its asset purchases apace. Its latest Summary of Economic Projections (SEP), release in mid-June, featured a projected increase in the federal-funds rate to 0.6% in 2023 (up from 0.1% in its March projection). The SEP also depicted significantly higher real gross domestic product (GDP) and inflation projections for 2021, although out-year projections were only modestly higher.

## Selected Asset Class Commentary

- **Global Equities Asset Class:** The asset class suffered from its pro-cyclical, contrarian positioning through an overweight to fundamental value managers. All value managers lagged during the period. Maj Invest detracted due to stock specific factors. Metropole Gestion underperformed as a result of a correction to value in Europe. LSV Asset Management benefited from short positions in lower market-cap, negative momentum companies, particularly outside of the US. Fiera Capital Corporation registered solid performance due to its allocation to fundamental stability. Exposure to high-quality financials enhanced returns.

- **Pan European Small Cap Equities Asset Class:** The market environment during the second quarter supported the asset class' alpha-source-driven approach as the most overpriced stocks lagged higher-quality stocks and those that enjoyed positive share-price momentum. Given this favourable backdrop, the asset class benefited from both style factor drivers and solid stock selection during the quarter. Exposure to select names in industrials, IT and retail was particularly strong.

- **Emerging Market Equities Asset Class:** Emerging markets trailed both developed international and US equity markets during the second quarter due to the resurgence of COVID-19 in many countries. The asset class struggled due to a combination of weak company-specific results that led to underperformance of most managers relative to their alpha sources. Neuberger Berman Investment Advisers was hurt by its valuation sensitivity, which caused a bias against the more growth-oriented stability stocks that performed well during the quarter. Robeco's poor selection in Chinese consumer names detracted. KBI Investors was challenged by value style headwinds. Qtron Investments' solid selection in the consumer and industrial sectors overcame weak selection within information technology.

## Manager Changes

- Principal Global Investors, LLC was removed from the Asia Pacific (ex-Japan) Equity building block during the quarter. We decided to remove the strategy due to organizational changes that have occurred at Principal, which caused turnover in the strategy's senior portfolio management team. Additionally, Principal's staffing resources have been reduced over time. The assets in Principal's strategy have been transferred to the newly-added Sophus Capital's Asia Pacific ex-Japan strategy.

- Sophus Capital was added to the Asia Pacific (Ex-Japan) Equity building block during the quarter. The strategy has a bias towards momentum-oriented stocks, or those whose prices are expected to keep moving in the same direction (either up or down) and are not likely to change direction in the short term. We believe the combination of quantitative and fundamental inputs results in a resilient and repeatable process, enabling the team to identify opportunities quickly, while adapting and avoiding potential risks.

[5] "Substantial expansion in private sector activity, but delivery delays stymie manufacturing growth." IHS Markit Flash U.S. Composite PMI. 23 June 2021.

**Outlook**

- Equity markets have long anticipated the economic improvement we now are watching unfold. There is increasing concern, however, that equity prices have risen so much that there is little appreciation potential left, even if the global economy continues to forge ahead into 2022.

- The last several weeks have witnessed a partial unwinding of the rotation trade that began last autumn. So far, this appears to us as a temporary pause in a longer-term upswing. The global recovery and expansion have a long way to go, especially since many countries are still imposing lockdown measures to varying degrees.

- In today's environment, with economies opening up and interest rates still at extraordinarily low levels, the dominant trend favours further price gains over the next year or two. Still, investors must take into account that the US economy appears to have reached "peak growth."

- In the meantime, companies are expected to enjoy a great deal of pricing power and will almost certainly pass along at least a portion of their increased costs to customers. Unfortunately, one person's pricing power is another person's inflation. The big question is whether the price pressures seen this year are transitory, as central bankers around the world say they are.

- Investors in the bond market seem to agree with the central bankers. Although US bond yields rose sharply in the first quarter, they have fallen over the past three months. There's no telling how long bond investors will maintain such a calm perspective if prices keep rising at a pace that has not been seen in almost 30 years.

- The recent stumble in the rotation theme was exacerbated by the shift in Fed expectations. It is clear, however, that the US central bank will be cautiously moving away from its current policy stance. The first move will likely be the tapering of its bond-buying programme, which may be announced in late August at the annual Jackson Hole conference, with actual tapering beginning in the first quarter of 2022 at the earliest.

- The path of US fiscal policy is harder to decipher given strained bipartisanship and the narrowness of the Democratic majority in the Congress. A traditional infrastructure bill is a good bet, but the push for non-traditional forms of infrastructure will depend on whether the Democrats in the Senate can come to terms with each other.

- The combination of (1) above-average economic growth, (2) significantly higher inflation than seen in the past decade (3) a fiscal policy that expands the size of federal government spending and (4) extreme monetary ease aimed at suppressing interest rates is the perfect backdrop for risk assets—and for the creation of speculative bubbles.

- We remain optimistic that the more cyclical and value-oriented areas within emerging markets will bounce back from their modest stumble in June. But there are near-term challenges besides the shift in perceptions about Fed policy and the future course of the US dollar and commodity prices. Credit growth has decelerated significantly in China, similar to the slowdowns recorded in 2013 and 2018, years when the performance of emerging markets was less than stellar.

- As vaccination rates slow in the developed world, more shots will be available for the rest of the world. We expect a rolling reopening of the global economy that will extend well into 2022. This wave of recovery could resemble a prolonged up-cycle that keeps the pressure on supply chains, leading to continued shortages of goods and labour. Investor faith in the "transitory inflation" narrative probably will be tested as we head into year-end and enter 2022.

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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 30 June 2021.

Asset class performance discussed is based on the majority SEI fund underlying the asset class. This does not include analysis of the manager pools, hedged share class investments within SEI Funds, additional SEI funds or any third-party funds within the Strategic Portfolios. As a result, performance for the total asset class allocation may vary. Not all asset classes discussed are included in all Strategic Portfolios. All asset class comparative performance is relative to the benchmark of the specific SEI fund representing the majority of the asset class investment.

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Investment in equity securities in general are subject to market risks that may cause their prices to fluctuate over time.

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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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