Growth-Focused SEI Strategic Portfolios

SEI Strategic Portfolios: Q3 2021 Quarterly Commentary

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Equity and Fixed Income markets ran out of steam in Q3, while September provided support for the outlook for valuation-focused strategies

Executive Summary

- The global equity rally staged a modest retreat during the full third quarter, driven by challenges that accumulated as the clock ticked down towards the end of September, flipping performance from positive to negative in most regions.
- Developed-market equities were mixed for the period but generally remained quite strong in the calendar year to date, and Japan's gains were a rare bright spot among major markets during the quarter. Meanwhile, China and Brazil's deep losses sank emerging market equity returns for the third quarter and tipped them negative for the calendar year.
- Across the UK, Eurozone and US, government bond rates generally increased for the full third quarter. Rates declined across the yield curve in July, then rose in August and accelerated their climb in September. Inflation-indexed sovereigns were the top-performing segment in fixed-interest markets during the third quarter, followed by high yield, while emerging-market debt and non-indexed sovereigns had the steepest losses.
- 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. September's strong returns from valuation-focused managers across the strategies provide further support to this argument; in SEI's view, the receding direct impact of the coronavirus crisis couple with corresponding inflationary pressures mean that the backdrop for this positioning is likely to continue to improve.

Market Overview

- The Bank of England's (BOE) Monetary Policy Committee (MPC) voted twice during the second quarter to maintain its policy path: the bank rate remained 0.1% and the maximum allowance for asset purchases was unchanged at £895 billion. Elevated inflation pressures provoked an acknowledgment in the BOE's September Monetary Policy Summary that modest policy tightening may eventually be warranted.

- The fever pitch of UK manufacturing activity that defined conditions heading into July steadily declined over the course of the third quarter, leaving manufacturing growth at strong but perhaps more sustainable levels in September[1]. Services sector growth also slowed from multi-decade highs, but at an even faster pace, settling at moderately healthy levels toward the end of the quarter[2].

- The UK Jobseeker's Allowance claimant count continued to decline during the third quarter, by roughly 107,000 between June and August, with claimants representing 5.4% of the population as at August's reading. The UK economy expanded by 5.5% during the second quarter, and 23.6% year over year, after contracting by 1.4% during the first quarter.

- The centre-left Social Democrats (SPD), led by Olaf Scholz, the current vice chancellor and finance minister, earned the greatest share of votes in Germany's September election, edging out its coalition partner CDU/CSU. A coalition headed by the SPD will likely be formed this fall, leaving Chancellor Angel Merkel to continue as the head of a caretaker government in the interim.

- The European Central Bank (ECB) began the third quarter adopting a symmetric inflation target of 2% over the medium-term and acknowledging that it anticipates greater fluctuations over shorter time-frames. ECB President Christine Lagarde stated in September that the Eurozone's economic rebound and higher inflation would enable a moderately lower pace of net asset purchases in the pandemic emergency purchase programme (PEPP).

- Eurozone manufacturing growth remained slightly stronger throughout the quarter after setting an all-time high in June[3]. Services growth continued to strengthen through July, and then softened notably during September[4]. The Eurozone unemployment rate continued to decline throughout the third quarter, from June's 7.7%, to 7.6% in July, and August's 7.5%, while the overall Eurozone economy grew by 2.2% during the second quarter, and 14.3% year over year, after contracting by 0.3% during the first quarter.

- The People's Republic of China (PROC) had an vast sway over capital markets during the third quarter. President Xi Jinping's "Common Prosperity" campaign accelerated in July with a number of regulatory steps to rein in e-commerce companies and for-profit schools. Evergrande, one of China's largest real estate developers, also faced a pivotal turning point in July when several banks began denying mortgages on its backlog of unfinished projects, triggering a late September selloff in shares around the globe.

- A razor-thin majority that President Joe Biden's Democrats have enjoyed in the US Congress created an evolving array of challenges during the quarter. The progressive and moderate wings of the party debated through the end of September over the size and scope of legislation to fund an infrastructure plan, the overall federal budget, and an increase in the US government's debt ceiling, (that is, the total borrowing limit).

- The US Federal Open Market Committee (FOMC) moved incrementally closer to declaring a start date for tapering, or reducing, asset purchases over the course of the third quarter. The FOMC currently purchases $80

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

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

[3] IHS Markit Eurozone Manufacturing PMI – final data. 1 October 2021.

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

billion in US Treasurys and $40 billion in agency mortgage-backed securities per month, Federal Reserve (Fed) Chairman Jerome Powell shared that the tapering timeline could be determined at the November FOMC meeting.

- Growth in the US manufacturing sector moderated during most of the third quarter, then strengthened a bit in September[5], while growth in the services sector continued to slide during the third quarter from May's all-time record pace, finishing September at health but unremarkable levels[6]. New weekly US jobless claims essentially finished the third quarter where they started. The US economy expanded at a 6.7% annual rate during the second quarter, up from 6.3% during the first quarter.

Selected Asset Class Commentary

- **Global Equities Asset Class:** The asset class struggled during the quarter overall, but finished the quarter on a stronger footing, as the much-heralded rotation to value showed further signs of promise. SEI continues to anticipate outsize relative returns from this space. Jupiter Asset Management, Poplar Forest Capital, Maj Invest and Towle & Co all suffered from exposure to value over the full period. Jupiter also detracted as a result of weak stock selection results. Maj Invest's lack of exposure to energy did not allow them to benefit from the strong recovery through September's bounce-back. Metropole's underweight to mega-cap tech companies and higher exposure to energy and financials boosted returns. Lazard outperformed due to basic momentum factors and tilts towards profitability.

- **Europe Ex-UK Equities Asset Class:** While the post-pandemic recovery continued during the quarter, continental European Ex-UK equity markets achieved only modest gains for the period following a sell-off in September on expectations of tighter monetary policy, inflation worries and fears of a China slowdown. This shift in sentiment at the end of the quarter was accompanied by a strong rotation from interest-rate-sensitive and higher-growth IT stocks to cheaper energy names; although it was not enough for value as a factor to outperform for the quarter as a whole. From a factor perspective, momentum performed best. During the quarter, the asset class benefited from tilts to value and to stocks with positive earnings momentum. Exposure to a number of off-benchmark bank and materials names contributed. Value-oriented Metropole Gestion benefited from the rotation into value in September. Wellington Management International's holdings in high-quality financials added, as did an underweight to expensive luxury goods companies that had exposure to China.

- **Emerging Market Equities Asset Class:** Emerging markets trailed both developed international and US equity markets during the third quarter as Chinese equities sold off following new government regulations. The asset class benefited from an underweight to Chinese consumer discretionary and solid selection within healthcare. Poor selection in materials pared gains. JO Hambro Capital Management gained on a tailwind to momentum and solid selection within industrials. A value tailwind aided Robeco's performance, as did strong selection in real estate and a favourable underweight to Chinese internet companies. Neuberger Berman Investment Advisers and RWC Advisors suffered on selection in financials and Chinese internet names. A stability headwind further challenged Neuberger Berman.

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

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

Manager Changes

- Wellington Management International Limited was removed from the UK Core Fixed Income building block during the quarter. SEI believes the removal of Wellington and addition of M&G will allow the building block to put focus on the inefficiencies in UK rates going forward, and balances PIMCO Europe Ltd.'s credit selection and sector rotation across spread assets in the building block.

- M&G Investments Management Ltd was added to the UK Core Fixed Income building block during the quarter. M&G's strategy aims to generate excess return along the UK Gilt curve, and reduces the amount of active risk the building block takes in currency and other global rates curves.

Outlook

- The knee-jerk reaction of investors this summer to a delta-driven delay in the resumption of normal life was to return to those 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.

- 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[7]. 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.

- The impact of the COVID-19 on global supply chains has been a more significant impediment. Vendor deliveries, as measured by the Institute for Supply Management, have seldom been as slow as they are now in the 74-year history of the survey, although the situation has eased slightly since May. Inventories remain exceedingly low relative to demand.

- Input costs are rising rapidly, but companies have been able to compensate by passing along their increased costs to their customers. After-tax corporate margins hit a new all-time high in the second quarter, rising to 14.7% of sales.[8]

- 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.

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[7] Source: "Financial Accounts of the United States". Board of Governors of the Federal Reserve System

[8] Source: "Corporate Profits." U.S. Bureau of Economic Analysis

- 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. 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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Past Performance is not a reliable indicator of future results. Standardised performance is available upon request. All data is as at 30 September 2021.

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