Growth-Focused SEI Strategic Portfolios

SEI Strategic Portfolios: Q4 2021 Quarterly Commentary

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Strong signs of life in the value positioning in the Strategic Portfolios in December and 2021 overall, despite a challenging fourth quarter 2021

Executive Summary

- Sky-high COVID-19 cases, a volatile equity-market rally, and worry over rising interest rates can describe both the first and last weeks of 2021. An obvious difference between those two is that the prospect of widespread vaccination became reality, with nine billion vaccine doses were administered worldwide through the end of 2021, rendering roughly 49% of the global population fully vaccinated.[1]

- In financial markets, the fourth quarter began in the shadow of September's selloff, which was the most extended shakeout of 2021. After recovering in October, equities vaulted higher through mid-November before unrestrained inflation, tightening central-bank policy and the emergence of the Omicron variant combined for a choppy climb to finish the year.

- Across the UK, Eurozone and US, short-to-medium-term government bond rates increased during the fourth quarter, while long-term rates declined, resulting in flatter yield curves. Fourth-quarter fixed income performance mirrored the full year: inflation-indexed bonds were the top performers, followed by high yield. Most other sectors were mildly negative given the impact of rising rates, but global bonds were down by more due to currency effects. Local-currency emerging-market debt had the steepest losses for the quarter and year.

- The SEI Growth-Focused Strategic Portfolios benefitted from SEI's alpha source approach, with all three alpha sources adding value through the ever-changing market and showing the benefits of being multi-style and multi-manager. The long-standing overweight to value was the biggest overall contributor, with managers like Poplar and Towle performing particularly well.

- It is SEI's strong belief that the process of recovery in value and the so-called 'Great Rotation' into value stocks is just beginning; the metrics SEI uses to identify its preferred alpha source positioning continue to point strongly towards a bias toward valuation-focused managers. Consistent with its disciplined investment approach, despite the challenges this faced through the Pandemic, SEI never capitulated on this positioning. SEI feels that looking forward there remains a lot of potential for this positioning, even after an already strong start to 2022.

- This would be consistent with an economic outlook that reflects a view of a world that moves more meaningfully through and towards the exit of the Pandemic in 2022, potential big-tech regulation, higher and more persistent inflation, increasing rates, increased levels of volatility and a return to more pre-pandemic consumer and business habits.

[1] "Covid vaccines: How fast is progress around the world?" BBC News. 30 December 2021.

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Market Overview

- The UK government's autumn budget traded improved benefits for tax increases[2]. On the revenue side, a 1.25% bump in national insurance contributions was scheduled to begin in the spring, and a long-telegraphed increase in the corporation tax remained set for 2023.

- The Bank of England (BOE) became the first major central bank to increase rates since the pandemic began; its Monetary Policy Committee (MPC) voted 8-to-1 in favour of raising the bank rate by 15 basis points (bps) to 0.25% in mid-December[3]. The MPC's inflation forecast for spring 2022 jumped to 6% at its December meeting from 5% at its prior monthly meeting.

- UK manufacturing growth essentially held steady at a high level throughout the fourth quarter after peaking in May and cooling through September. Growth in the UK services sector ground down to a modest pace in late 2021 as activity hit a 10-month low in December[4].

- The UK claimant count continued to decline in November, with roughly 65,000 fewer claimants compared to the prior month, representing 4.9% of the population as at November's reading. The UK economy expanded by 1.1% during the third quarter and 6.8% year over year through September.

- Germany's new governing coalition came together in late November. The coalition has coalesced around an ambitious series of climate-centric policy pledges, including new commercial and residential construction that host solar-power production capabilities; additional support for seaborne wind farms; and a targeted 15 million electric vehicles in service by 2030 along with the necessary charging infrastructure.

- Following its mid-December meeting, the European Central Bank (ECB) announced that its Pandemic Emergency Purchase Programme (PEPP) would conclude by March 2022. However, the central bank said it would rely on its long-standing Asset Purchase Programme to provide monetary support when needed, and does not anticipate an increase in benchmark rates during 2022.

- The expansion in Eurozone manufacturing continued at a brisk pace during the fourth quarter, but continued to soften. Eurozone services sector growth slowed unevenly during the fourth quarter, ending in December with the weakest expansion since returning to growth in April 2021[5].

- The overall Eurozone economy strengthened by 2.2% during the third quarter and 3.9% year over year through September, in line with the second-quarter pace of 2.1%, although the year-over-year figure was well below the 14.2% growth measured through June.

- The US Congress voted to raise the debt ceiling twice during the fourth quarter, first with an October stopgap bump of $480 billion, and then with a December increase of $2.5 trillion, which is expected to cover spending through early 2023.

[2] "Autumn Budget 2021: Key points at-a-glance." BBC News. 27 October 2021.

[3] "BoE becomes first major central bank to raise rates since pandemic." Reuters. 16 December 2021.

[4] IHS Markit / CIPS Flash UK Composite PMI. 16 December 2021.

[5] IHS Markit Flash Eurozone Composite PMI. 16 December 2021.

- US President Joe Biden signed the Infrastructure Investment and Jobs Act into law during November[6]. The initiative appropriated $1.2 trillion, with nearly $300 billion of new spending to fund transportation projects over the next decade, another $65 billion apiece dedicated to broadband internet and power grid projects, and $55 billion reserved for water infrastructure.

- The US Federal Open Market Committee (FOMC) shared in early-November a timeline to reduce its asset-purchase programme by June. By the end of November, it signalled that high inflation could drive the FOMC to reduce asset purchases at an accelerated pace. The latest Summary of Economic Projections points to a commencement of rate hikes in 2022.

- US manufacturing growth remained quite elevated at the end of 2021, but continued to soften throughout the fourth quarter from its peak in July. Services sector growth accelerated in October from an August-to-September soft patch, and remained strong through the end of the year.

- The weekly number of new US jobless claims reaching the lowest levels in more than 50 years during November with less than 200,000 filings per week, and remaining close to these lows through the end of 2021[7]. The US economy expanded at a 2.3% annual rate during the third quarter, significantly below the 6.7% annualised pace in the second quarter.

Selected Asset Class Commentary

- **Global Managed Volatility Equities Asset Class:** Despite a strong December, the asset class underperformed over the full quarter. Detractors included the preference for cheaper low-volatility names and a smaller-cap bias. LSV Asset Management's preference for poorly-performing deeper cyclical names detracted. Allspring Global Investments benefited from low-beta positioning. Acadian Asset Management gained on an underweight to the lowest-quality stocks in the benchmark. Its low-volatility positioning also contributed to a lesser degree.

- **Global Equities Asset Class:** The asset class suffered during the quarter, but in December showed the type of strong positive relative return its value bias has been promising. All valuation-focused managers struggled over the quarter. Momentum and quality managers generally enjoyed favourable market conditions and outperformed during the quarter. Lazard outperformed due to basic momentum factors and tilts towards profitability. Regionally, excess returns were concentrated in US stocks, notably in IT and healthcare.

- **Emerging Market Equities Asset Class:** Emerging markets trailed both developed international and US equity markets during the fourth quarter as Chinese equities sold off following a slowing Chinese economy and government regulations. JO Hambro Capital Management gained on a tailwind to momentum and solid selection within industrials. JO Hambro's selection within China and Taiwan was favourable. A value tailwind aided Robeco and KBI Global Investors' performance, as did a favourable underweight to Chinese internet companies. Neuberger Berman Investment Advisers benefited from a quality tailwind, while selection within Brazil hurt returns.

Manager Changes

- None in the reporting period.

[6]"H.R.3684 - Infrastructure Investment and Jobs Act." Congress.gov. 15 November 2021.

[7]"U.S. Jobless Claims Reach 52-Year Low." The Wall Street Journal. 24 November 2021.

Outlook

- Equity markets stumbled in late 2021 owing to nervousness over the latest COVID-19 surge. This wave, too, shall pass. SEI remains optimistic that global growth will accelerate as the Omicron wave fades.

- SEI expects a gain in overall US economic activity of around 4% in 2022, appreciably above the economy's long-term growth potential of 2%. Other countries are also likely to continue to post above-average growth as they recover from the past two years' worth of lockdowns and shortages.

- The year ahead promises to be another one of extremely tight labour markets. We think more people will return to the workforce as COVID-19 fears fade, but there likely will still be a tremendous mismatch of demand and supply.

- Predicting a bad inflation outcome for 2022 isn't exactly much of a risk. Where we depart from the crowd on inflation is in the years beyond 2022. We are sceptical that the US Fed will be sufficiently proactive as it struggles to balance full and inclusive employment against inflation pressures that are starting to look more entrenched. We believe this will be the central bank's biggest challenge in 2022 and beyond.

- SEI also believes the Fed's inflation and economic projections are internally inconsistent. Since it projects the economy to be even closer to full employment than it is now, we find it hard to understand why price pressures should ease so dramatically.

- Even the central banks that are most likely to taper their asset purchases and raise policy rates in the months ahead (the Fed, the BOE and the Bank of Canada) will likely do so cautiously. By contrast, policy rates in emerging economies have already jumped. The pace of tightening is picking up, with 11 emerging countries having instituted policy-rate hikes in December alone.

- SEI remains optimistic that growth in the major economies will be buoyed by the strong position of households. In the US, household cash and bank deposits were still almost $2.5 trillion above the pre-pandemic trend as of the end of September. This total is equivalent to almost 14% of disposable personal income. Excess savings in the UK, meanwhile, has reached 10.6% of annual personal disposable income. Euro-area bank balances aren't quite as high, but still amount to 5% of after-tax income.

- Investors in equities outside of the US can be forgiven for being somewhat frustrated. Earnings growth in 2021 for developed- and emerging-market equities both exceeded the earnings gain for the US. Consequently, the relative valuation of non-US markets versus the US has become only more attractive in the past year.

- But old habits die hard, and the emergence of the Omicron variant has further delayed a long overdue rotation to cheaper, more cyclical stocks that are also less correlated to bond prices.

- Turning to the US, the trajectory of S&P 500 earnings growth probably will slow next year, but a gain in the 8%-to-12% range seems consistent with SEI's macroeconomic call for continued above-average growth and inflation.

- In SEI's view, the real anomaly in the financial markets is the ultra-low levels of interest rates in the face of higher inflation and above-average growth in much of the world. This may force central banks to adopt more aggressive interest-rate policies than they and market participants currently envision.

- SEI have pencilled in a 50-to-75 basis-point rise in 10-year US Treasury bond yields for 2022. That gain should not derail the bull market in equities, but it could further catalyse a shift away from the most highly valued, interest-rate-sensitive areas of the market into the broader grouping of stocks that have been neglected for the past several years; should this happen it will likely bode well for the positioning in the Strategic Portfolios.

- SEI urges our investors to look past the challenging returns of the 2019 and 2020 period and notice how the positioning has started to play out much better in 2022. Inflation, rising rates, potential increased levels of regulation around big tech, increased levels of market volatility are all themes that are likely to support the positioning in the underlying asset class funds.

Important Information on Performance

Past Performance is not a reliable indicator of future results. Standardised performance is available upon request. All data is as at 31 December 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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- 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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