SEI UK Strategic Portfolios

SEI Strategic Portfolios Q3 2022 Quarterly Commentary – Growth Focused.

Markets flow, then ebb, in the third quarter of 2022, as investor realisation of continued upward interest rate pressure becomes manifest

Executive Summary

- A line chart of global equity market performance during the third quarter looks remarkably like a mirror image: climbing higher toward mid-quarter, then tumbling downward thereafter. Correspondingly, the SEI Strategic Portfolios provided further downside protection in August and September.

- The relationship between signs of softening economic activity in late spring and the presumption that it would enable central banks to increase rates by less than feared spurred a rally across equity and fixed-interest markets from June to August. US Federal Reserve (Fed) Chair Jerome Powell shattered this complacency by explaining that lower growth and softer labour markets will likely be the unfortunate costs of hiking rates to fight inflation, and that expectations for a premature pivot to looser policy will probably be disappointed.

- Developed-market equities fell by less than emerging markets during the third quarter, although the relatively small decline posted by the US masked steeper declines by Europe and the UK. Latin American shares had the only positive regional performance for the period, while Hong Kong had the steepest decline.[1]

- Government-bond rates climbed in the UK, Eurozone and US for the full third quarter—declining during July in the UK and Eurozone while the US yield curve flattened as short-term rates rose and long-term rates fell; rates then climbed through August and September across all three jurisdictions. The UK and US yield curves grew more inverted (that is, when shorter-term rates are higher than longer-term rates) as the quarter progressed.

- Fixed-interest performance produced a range of losses during the quarter as yields increased around the globe (yields and prices have an inverse relationship). Global government bonds had the deepest losses, while US high-yield bonds had a comparably modest decline.[2]

- The bias towards valuation-focused managers returned to form in August and September, after modestly giving back some returns in July after a prolonged period of mainly positive relative returns. As a result, the 1- and 2-year returns remained in strong positive relative return territory.

- SEI have always said that the extended outperformance that we had been anticipating would not be delivered in a straight line and that there will be short periods of reversal. However, it remains our strong conviction to stay with this investment discipline.

[1] According to the country- and sector-level performance of MSCI ACWI Index

[2] According to data from FactSet and Lipper

- It continues to be SEI's strong belief that the rotation into value stocks is nearer to its start than to its end; the metrics SEI uses to identify its preferred alpha source positioning continue to point strongly towards a bias toward valuation-focused managers. SEI feels that looking forward there remains a lot of potential for this positioning, even after a strong start to relative performance in 2022.

Market Overview

- At its early August meeting, the Bank of England's (BoE) Monetary Policy Committee hiked its benchmark rate by 0.50%, the largest individual increase in 27 years, and then issued another increase of the same size at its late September meeting, bringing the bank rate to 2.25%.[3] The BoE was compelled to intervene with temporary gilt purchases toward the end of the quarter over concerns about financial stability as long-term rates skyrocketed in response to the new government's poorly-communicated mini-budget.[4]

- UK manufacturing activity contracted in August after a few months of softening growth, but the slowdown eased in September.[5] UK services sector activity tipped into contraction during September after growing at a modest-to-healthy pace through the summer.[6]

- Broad UK consumer price inflation peaked at 10.1% in the year through July before edging down to 9.9% during August. Core consumer prices, however, continued to accelerate through August, peaking at 6.3% year over year. Improvement in the UK claimant count (which calculates the number of people claiming Jobseeker's Allowance) levelled off during the third quarter, declining by roughly 14,500 from June to July, and then increasing by 6,300 in August, with total claimants holding at 3.9% of the population during the time frame.

- The European Central Bank (ECB) increased its three benchmark rates by 0.50% at its July meeting for the first time in 11 years, surprising investors who were expecting hikes of 0.25%.[7] At the same meeting, the ECB approved the establishment of a Transmission Protection Instrument (TPI) to ensure the smooth transmission of monetary policy normalisation across Eurozone countries. At its early September meeting, the ECB raised rates by 0.75%.

- Manufacturing conditions steadily deteriorated in the Eurozone during the third quarter. Growth ground to a standstill in July and began to contract modestly through August, before the slowdown accelerated in September.[8] Activity in the Eurozone services sector contracted during September. Growth in services slowed abruptly beginning in June from a relatively robust pace in May, then continued to cool throughout the third quarter.[9]

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[3] "Bank of England announces biggest interest rate hike in 27 years." Yahoo! Finance. 4 August 2022.

[4] "Bank of England announces gilt market operation." Bank of England. 28 September 2022.

[5] S&P Global / CIPS UK Manufacturing PMI. 3 October 2022.

[6] S&P Global / CIPS Flash UK Composite PMI. 23 September 2022.

[7] "European Central Bank raises interest rates for first time in 11 years." The Guardian. 21 July 2022.

[8] S&P Global Eurozone Manufacturing PMI. 3 October 2022.

[9] S&P Global Flash Eurozone Composite PMI. 23 September 2022.

- The Eurozone consumer price index jumped to 10.0% in September, from 9.1% in August, hitting an all-time high and essentially doubling the inflation rate from the beginning of the calendar year, as consumer prices increased in September at a 1.2% monthly pace.[10] Eurozone unemployment held at a 6.6% rate in August for the third straight month, remaining at a record low (since Eurostat began tracking the dataset in 1998).[11]

- The Fed's Federal Open Market Committee (FOMC) increased the federal-funds rate by 0.75% toward the end of July, and again in late September, raising the benchmark rate's target range to 3.0%-3.25%. The central bank also began to accelerate balance sheet reduction in September, doubling the amount of monthly Treasury and mortgage holdings that mature without being replaced to maximum respective paces of $60 billion and $35 billion.

- US manufacturing growth ended with a mild acceleration in September, remaining otherwise modest throughout the third quarter after slowing sharply in June.[12] A contraction in US services activity that began in July started to ease back toward breakeven levels at the end of the third quarter.[13]

- The US labour market remained quite healthy during the third quarter. New claims for unemployment benefits declined throughout the quarter, falling back below 200,000 per week in late September for the first time since the spring.

- The US Personal Consumption Expenditures (PCE) Price Index (the Federal Reserve's preferred inflation gauge) slid to 6.3% in the year through July and 6.2% in August (from 6.8% in June). The core PCE Index, however, climbed to 4.9% in August, its highest level since April, on a monthly increase of 0.6%.

Selected Asset Class Commentary

- **Global Equities Asset Class:** The asset class was anchored by its allocation to valuation- and low volatility-focused managers. Underperformance was driven by an underweight to IT and poor stock selection. Security selection within healthcare and industrials further detracted, as did an underweight to mega-cap IT stocks. Sompo Japan Nipponkoa Asset Management Company (SNAM) also underperformed from its value orientation. SNAM's positioning in defensive utilities and consumer staples detracted. Momentum-oriented Lazard Asset Management gained due to sector allocation effects and positive security selection. Rhicon Currency Management benefited from increased foreign exchange volatility.

- **Emerging Markets Equities Asset Class:** Robeco Asset Management was challenged by a value headwind and poor selection in financials and materials. KBI Investors was hurt by a value headwind. KBI's underweight to Indian financials hurt performance. Qtron Investments benefited from selection within energy and financials, while selection within materials and consumer staples detracted. J.O. Hambro Capital Management's momentum style, which led to underweights to Chinese e-commerce and industrials, helped. Neuberger Berman Investment Advisers gained on a tailwind to quality.

[10] "Eurozone inflation hits record 10% as energy prices continue to soar." Financial Times. 1 October 2022.

[11] "Eurozone unemployment rate stabilized in August." Marketwatch. 30 September 2022.

[12] S&P Global Flash US Composite PMI. 23 September 2022.

[13] S&P Global Flash US Composite PMI. 23 September 2022.

Manager Changes

- **Royal London Asset Management (RLAM)** was added to the UK Core Fixed Income building block as at August 2022. RLAM's investment strategy prioritises security selection and focuses on inefficient areas of the credit market, such as unrated bonds (which do not carry a grade or appear in benchmark indexes) which RLAM considers attractive due to pricing discrepancies. We expect the strategy to outperform the benchmark during periods of higher risk. We also believe RLAM will register favourable performance in a low-volatility environment when income is the primary driver of returns.

- **PIMCO Europe Ltd** was removed from the UK Core Fixed Income building block as at August 2022. We made this change for portfolio construction reasons. We believe the removal of PIMCO's strategy will result in a lower long-term credit beta allocation in the Fund. Credit beta refers to systematic risk or volatility of returns for investments in credit or debt securities. The assets in PIMCO's strategy were transferred to the newly-added Royal London Asset Management UK Core strategy. We believe the new manager line-up will improve Fund diversification.

Outlook

- The war in Ukraine and Russia's energy blackmail against Europe, high global inflation and central banks' aggressive response to it, and a severe COVID-related slowdown in China are not exactly new; they have simply increased in intensity. Most important, they have forced monetary policy makers to finally admit that they have a major inflation problem on their hands, one that is neither transitory nor likely to be resolved without pain.

- In our opinion, investors should be prepared to see a federal funds rate that could exceed 5%. Other central banks are following the Fed's lead, talking tough and following up with outsized policy-rate increases. In the UK, the bond market has gone haywire and the country's currency has come under at minimum temporary intense downward pressure. To use a newly popular phrase among economists and financial-market participants, things are starting to break.

- Europe will continue to be the area most under the gun owing to Russia's suspension of natural gas exports. Although storage facilities within the European Union are now 80%-to-90% full, the continent still needs to have a steady flow of gas to get through the high-usage winter months.[14] Governments may be forced to impose disruptive energy-saving restrictions on businesses and citizens. Heavy users of electricity, from aluminium smelters to glassmakers, have already been shutting down.

- The UK's new Prime Minister, Liz Truss, has rolled out a plan to cap the cost of residential electricity at £2,500 per year over the next 18 months. Along with other measures previously announced, funding totals £180 billion, or 6.5% of GDP. Other countries that have allocated funds for energy-related relief in excess of 3% of GDP include Croatia, Greece, Italy and Latvia.

- It would not be surprising to see more energy-related relief come down the pike. Deficits could balloon in the same way they did during the early months of the COVID crisis as policy makers do what they must to protect their populations.

- Central bankers are forced by their mandates to lean hard against the rising trend in prices, although they are essentially working at cross purposes against their own governments' stimulus

[14] "89.3% of EU gas storage is filled." Reuters. 1 October 2022.

efforts. Unfortunately, they're running just to keep up with the Fed. Interest-rate differentials versus the US are still wide, with only Canada on par with the US.[15]

- The large differential in favour of the US, along with the perception that it's better positioned economically, are two major reasons behind the US dollar's extraordinary appreciation this year. Although a declining currency may give a competitive boost to domestic firms that export goods and services to the US market, it exacerbates the inflationary pressures stemming from imports that are priced in dollars, most importantly, oil and liquefied natural gas.

- Several large US multinational companies have warned that dollar strength is beginning to exert a negative impact on revenues, suggesting that the currency's value has risen well beyond its purchasing power parity (PPP) level. But discrepancies can last for a long time between PPP and market-based exchange rates.

- That noted, it would not be surprising to see at least a temporary reversal in the dollar's trend. Given a catalyst—coordinated government action to weaken the dollar or a surprisingly weak US unemployment report, for example—traders might cover their long positions in a major way, causing the dollar to fall abruptly.

- The rise in US hourly compensation has been extensive, with annualized gains exceeding 6% even when measured over a three-year span.[16] This is the sharpest increase in almost four decades. Similar to the 1970s experience, compensation gains have been accelerating even as productivity growth has slowed. This divergence is concerning.

- The difference between the change in compensation and the change in productivity equals the change in unit labour costs. Although unit labour costs are more volatile than inflation, there is still a strong positive correlation between the two.

- Unfortunately, history shows that it usually takes an outright recession to beat down inflation, especially when it gets this intense. Fed Chairman Powell's hope for a soft landing appears to be an exercise in wishful thinking. Unit labour costs have run far ahead of inflation, and we see no reason to expect a major reversal in the near term, even if the economy stumbles into a bona fide recession.

- US companies have been able to push higher employment and supply costs onto the consumer. There hasn't been much of a decline in profit margins yet, they've remained above all the previous cyclical peaks going back to 1947. But we suspect that margins are on the cusp of a substantial erosion. It's typical for profit margins to decline well before an economic recession materializes.

- If the economy does fall into recession and profits decline, analysts will probably be forced to mark down earnings estimates aggressively to catch up with reality. Investors aren't waiting for those earnings revisions. They have been pushing equities lower in reaction to the Fed's aggressive shift and in anticipation of a recession, both in the US and globally.

- A funds rate in the 4.4%-to-4.9% range next year, as projected by Fed policymakers, might still be lower than the actual out-turn. But unless the Fed is truly ready to engineer a severe recession,

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[15] According to data from Bloomberg.

[16] According to SEI's analysis of data from the US Bureau of Economic Analysis.

we think PCE price inflation could settle in a 3%-to-4% range instead of the sub-2% pace recorded over much of the past 25 years.

- Emerging economies would be big beneficiaries of a revival in Chinese economic activity. Yet dollar strength is a central factor for investors in emerging market equities. The relative performance of the MSCI Emerging Market Total Return Index versus the MSCI World Index peaked in 2010, more-or-less concurrent with the trough in the trade-weighted value of the US dollar. EM equity has now given up almost all of its relative gains versus advanced-country stock markets achieved between 2000 and 2010 as the dollar has grown stronger.

- The rate-hiking cycle actually began far sooner in less-developed economies, during the latter months of 2020. Interest-rate hikes in the emerging world have accelerated significantly this year, in both frequency and magnitude. Three-month government bonds are in double digits in Brazil (14.3%), Colombia (10.4%), Hungary (10.0%) and Turkey (17.8%).

- Among these four, only Brazil's rate is comfortably above the inflation rate. Turkey, by contrast, is facing an inflation rate of close to 80%. Little wonder that the Brazilian real has maintained its value against the dollar this year, while the Turkish lira has declined by almost 30%.

- The bottom line is that a global recession is forming on the horizon, with Europe and the UK more vulnerable to a downturn than the US in the months immediately ahead.

- Short-term gyrations notwithstanding, the primary trend in risk assets still appears negative. Inflation in the US has probably peaked, but we do not expect it to fall as rapidly or as far as the Fed projects. The central bank may still be underestimating the extent to which it needs to tighten policy in order to slow the economy and produce slack in the labour markets.

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Past Performance does not predict future results. Standardised performance is available upon request. All data is as at 30 September 2022.

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