SEI UK Strategic Portfolios

SEI Strategic Portfolios Q1 2022 Quarterly Commentary - Stability Focused

Bond and Equity markets suffer from a challenging Q1 2022; SEI Strategic Portfolios provided downside risk mitigation

Executive Summary

- Investors faced inhospitable conditions on multiple fronts during the first three months of 2022. Global equities delivered their poorest quarterly performance since early 2020, bottoming in mid-March before mounting a sharp partial recovery. Global bonds fared worse, tumbling by the most since late 2016.[1] UK shares earned a positive return during the quarter, outpacing other major markets. Hong Kong was slightly negative, while the US, Japan and Europe had steeper losses.

- Meanwhile, with commodities markets having been the epicentre of the financial fallout from the conflict in Ukraine, commodities had their strongest quarter in at least 30 years.[1] Commodity-producing nations, therefore, were the first quarter's big winners, led at a distance by Latin American equities' double-digit gains.

- Fixed income markets delivered an array of negative performances as interest rates climbed (yields and prices have an inverse relationship). Inflation-indexed securities had relatively mild declines, while emerging-market debt and investment-grade corporates tumbled dramatically. The longest-term government bonds in advanced economies posted double-digit losses.

- Consistent with SEI's all-weather approach to asset allocation, the Global Managed Volatilities Equities asset class is likely to provide a cushion against any meaningful declines in equities markets, while the Global Short Duration asset classes are likely to provide similar benefits in the fixed income space.

- Looking at the equity side more closely, it is SEI's strong belief that 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. SEI feels that looking forward there remains a lot of potential for this positioning, even after an already strong start to relative performance in 2022.

- This would be consistent with an economic outlook that reflects a view of a world that moves more meaningfully towards the exit of the Pandemic in 2022 and deals with the global fall-out from the conflict in Ukraine. The result of this is likely to be higher and more persistent inflation, increasing rates, increased levels of volatility, all of which would be favourable for the positioning of the SEI Strategic Portfolios.

Market Overview

[1] According, respectively, to the MSCI ACWI Index, Bloomberg Global Aggregate Index and Bloomberg Commodity Index

- The Bank of England's (BoE) Monetary Policy Committee (MPC) issued three consecutive rate hikes bringing the bank rate 0.75%. MPC members voted unanimously in February to begin reducing the size of the BoE's balance sheet by ceasing to re-invest proceeds from its asset-purchase programme and through corporate bond sales. The wind-down cannot be completed any earlier than toward the end of 2023.

- UK manufacturing growth dropped in March to its lowest (albeit still healthy) level since February 2021—falling below the range that defined the fourth quarter of 2021 and the first two months of this year.[2] Growth in the UK services sector accelerated sharply in February and March after a low-growth lull as we moved into the New Year.[3]

- Inflation climbed to 6.2% in the UK for the 12-month period through February, the highest level since 1992.[4] The UK claimant count (which calculates the number of people claiming Jobseeker's Allowance) continued to improve in the first two months of the year—declining by roughly 125,000, with total claimants representing 4.4% of the population in February compared to 4.6% in December.

- The European Central Bank (ECB) announced plans following its mid-March meeting to conclude its Asset Purchase Programme in the third quarter after decreasing net purchases from €40 billion in April to €30 billion in May, and then to €20 billion in June. The final net purchases under the Pandemic Emergency Purchase Programme (PEPP) concluded during the first quarter.

- The expansion in eurozone manufacturing stumbled at the end of the first quarter, diluting an otherwise strong start to the New Year as March delivered the slowest monthly rate of growth since January 2021.[5] Growth in the eurozone services sector cooled to still-healthy levels in March, having accelerated in February after slowing to a near standstill to start the year.[6]

- The year-over-year rate of consumer price inflation in the eurozone climbed to 7.5% in March, hitting an all-time high for the fifth successive month.[7] Labour-market improvements persisted into 2022—with the eurozone unemployment rate declining to 7.0% in January and 6.8% in February, the lowest level since Eurostat began tracking the dataset in 1998.[8]

- The US Federal Open Market Committee (FOMC) voted to increase the federal-funds rate by 0.25% in mid-March, its first rate hike since December 2018, after making a final $30 billion round of new asset purchases. Its latest quarterly Summary of Economic Projections showed a decline in

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[2] IHS Markit / CIPS UK Manufacturing PMI. 1 April 2022.

[3] IHS Markit / CIPS Flash UK Composite PMI. 24 March 2022.

[4] "UK inflation hits 6.2%, the highest level in three decades." The Guardian. 23 March 2022

[5] IHS Markit Eurozone Manufacturing PMI – final data. 1 April 2022.

[6] IHS Markit Flash Eurozone Composite PMI. 24 March 2022.

[7] "Euro zone inflation hits new peak, deepening ECB's dilemma." Reuters. 1 April 2022.

[8] "Unemployment statistics." Eurostat.

the median real gross domestic product (GDP) projection in 2022, an increase in broad inflation expectations for 2022 and smaller increases for anticipated inflation for 2023 and 2024. The median outlook for the federal-funds rate increased to 1.9% for 2022 (from 0.9% in December) and 2.8% for 2023 (from 1.6%).

- US manufacturing growth started 2022 by continuing to cool from the red-hot activity of last summer, bottoming in January before accelerating through February and March.[9] Services-sector growth jumped to notably high levels in March after recovering in February from a near-standstill at the start the year.[10]

- US joblessness remained on a multi-year downward path, with the March unemployment rate of 3.6% sitting just above the lows attained in late 2019 and early 2020. The US consumer price index climbed to 7.9% year over year in February, while the Federal Reserve's (Fed) personal-consumption-expenditures price index (the central bank's preferred inflation gauge) rose to 6.4%—both measures reaching their the highest respective levels since January 1982.[11]

- New US jobless claims moderated in February, ranging between 200,000 and 250,000 per week during the month. The broad US economy grew at a 7.0% annualised rate during the fourth quarter (up from a preliminary estimate and the third quarter's 2.3% pace).

Selected Asset Class Commentary

- **Global Short Duration Fixed Income Asset Class:** The first quarter of 2022 was characterised by a sharp sell-off in government yields, flatter yield curves, rising inflation expectations, and widening credit spreads. Short duration as an asset class provided risk mitigation in this environment. Wellington Management delivered strongest performance due to an underweight to European and UK duration. Colchester Global Investor's outperformance was a result of an underweight to US and European duration. Long currency positions in Columbia and Mexico further boosted returns. AllianceBernstein suffered due to an overweight to Australia and New Zealand duration.

- **Global Managed Volatility Equities Asset Class:** The asset class benefitted from the outperformance of low volatility during a volatile first quarter. Its value tilt drove outperformance as investors rotated out of mega-cap growth stocks and into value stocks. LSV Asset Management's large value tilt, which led to exposure to outperforming deeper cyclical names, contributed. Allspring Global Investments benefited from its value tile and low-beta positioning. Acadian Asset Management gained on an underweight to the lowest-quality stocks in the benchmark.

- **Global Equities Asset Class:** An overweight to valuation-focused managers assisted performance in Q1 2022. The asset class' allocation to momentum and quality detracted. Poplar Forest Capital and Towle & Co both gained from exposure to value. Sompo Japan Nipponkoa Asset Management Company's (SNAM) also gained from its value orientation, primarily in Japan. Maj Invest suffered from poor stock selection with negative allocation effects. Metropole's underweight to mega-cap tech companies and higher exposure to energy and financials benefited returns. Metropole's portfolio was positioned to benefit from cyclical value companies and experienced tailwinds.

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[9] IHS Markit US Manufacturing PMI. 1 April 2022.

[10] IHS Markit Flash US Composite PMI. 24 March 2022

[11] U.S. Bureau of Labor Statistics and U.S. Bureau of Economic Analysis.

Momentum and quality managers generally experienced less favourable market conditions and underperformed during the quarter.

Manager Changes

- N/A

Outlook

- Like the pandemic that hit with full force this time two years ago, no one knows how long the conflict in Ukraine will last or how extensive its impact will be on the global economy. However, our experience with COVID-19 and the economic and financial response to prior geopolitical events serve as a guide.

- Prior to the conflict, SEI was optimistic that global economic growth would remain solid as countries eased their COVID-19-related restrictions. Europe was expected to improve at least as fast as the US, if not faster. This is now a questionable assumption.

- While supply-chain pressures eased in January and February, they were still at exceptionally high levels relative to history. SEI thinks the odds favour a return to their previous peaks as freight carriers suspend Russian bookings and increase rates in response to pileups, higher energy costs, and hazardous geopolitical conditions. COVID-19-related disruptions in Asia also remain an ever-present threat.

- It is fortunate for the advanced economies that households and businesses were in mostly good financial shape coming into the crisis. Year-over-year growth in employment was continuing to accelerate heading into 2022 despite the omicron outbreak.

- The US, Canada, France, and Italy have been recording gains well ahead of their longer-term trends. Job growth in Germany and the UK is still at or slightly above the pre-pandemic trend after having experienced smaller year-on-year declines during the 2020 pandemic lockdowns.

- Despite this labour-market vibrancy, workers' wages have begun to fall behind the high inflation rates recorded in the US and elsewhere. One would think that a contraction in real compensation is a sure sign that an economic recession is already underway. Yet that is not the case.

- While wage gains are lagging inflation at the upper quartiles, higher-income groups have benefited from the boom in home prices and the long bull market in financial assets; they also hold the bulk of excess saving that built up during the pandemic.

- Although incomes in the aggregate are not keeping up with inflation, we anticipate that households will draw down savings and increase debt in an effort to maintain living standards. In the US, the household saving rate has already fallen to 6.3% of disposable income from an average of 7.5% over the 2014-to-2019 period.

- Businesses face a similar scenario. The long period of ultra-low interest rates has allowed companies to engage in a refinancing boom. Earnings before interest and taxes in the US nonfinancial corporate sector cover interest expense 7.9 times, the highest ratio in more than 50 years.[12]

- Government leaders in the US, Europe and other advanced countries have been placed in a quandary. They have been tasked with providing support while simultaneously pulling back on monetary and fiscal excesses that are partially to blame for the worst inflation in decades.

- The U.S. fiscal response to inflation is likely to remain bedevilled by political gridlock. Not only has the U.S. registered one the largest increases in emergency spending among the major economies over the last two years, it also has one of the worst inflation problems at a time when the domestic political environment is in an extremely fractious state. It probably will be difficult to pass additional legislation aimed at supporting the domestic economy between now and the November mid-term elections.

- There is no denying that these conditions present major challenges for financial assets beyond the uncertainties caused by the conflict. This is especially so for long-duration assets such as growth-oriented equities that trade at higher price-to-earnings ratios and longer-maturity bonds.

- Periods of crisis and instability are worrying for all investors, particularly as the turn of events in the short term can be difficult to predict. We saw this in the first weeks following beginning of conflict in Ukraine, as impacts from the crisis overwhelmed more traditional market drivers.

- During times like these, one of the greatest mistakes an investor can commit is to panic and indiscriminately make changes for fear of losing money. In periods of unusual stress, a clear philosophy and process can guide calm, rational, long-term decision making.

- 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 SIS building blocks. Terrible as the conflict in the Ukraine is, this event further supports the positioning in the SEI Strategic Portfolios.

- It is SEI’s view that this positioning will not only continue to help to mitigate risk as the market rotates away from growth stocks where the growth story is fading rapidly and is more volatile due to the conflict in Ukraine, but also provide relative performance benefits as we move into a post-Covid economic recovery.

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 March 2022.

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

[12] Ned Davis Research Inc – April 2022.

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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