SEI UK Strategic Portfolios

SEI Strategic Portfolios Q1 2023 Quarterly Commentary – Stability Focused.

Equity and Fixed Income markets rally in Q1 overall; the banking crisis in March created a short-term set back to SEI positioning but our forward-looking view remains consistent: inflation and rates are likely to stay higher for longer and value managers have more to give in terms of relative returns

Executive Summary

- Global equity markets finished in positive territory for the first quarter of 2023, amid numerous periods of volatility in reaction to the latest monetary policy actions and public comments from central banks. Additionally, late in the period, turbulence in the banking sectors in the U.S. and Europe led to a selloff in equity markets globally before stocks rallied towards the end of the quarter.

- In early March, California-based Silvergate Capital, a major lender to the highly speculative cryptocurrency industry, announced that it was entering a voluntary liquidation due to significant losses following massive withdrawals of funds by depositors. Soon thereafter, two U.S.-based regional banks, Silicon Valley Bank (SVB) and Signature Bank, failed after depositors withdrew funds on fears regarding the valuation of the institutions' bond portfolios.

- The bank troubles were not limited to the U.S. Swiss lender Credit Suisse also came under pressure after suffering significant investment losses in 2021 and 2022. The Swiss National Bank, Switzerland's central bank, announced that it would provide the embattled bank with 50 billion francs ($54 billion) in financial support. Soon thereafter, Swiss bank UBS took control of rival lender Credit Suisse in an emergency 3 billion franc ($3.2 billion) deal negotiated by Swiss government regulators.

- Developed markets garnered positive returns over the quarter and outperformed emerging markets. Europe was the top-performing region among developed markets for the quarter due primarily to strength in Ireland and the Netherlands.

- U.S. fixed-income assets ended the quarter in positive territory as Treasury yields declined for all maturities of one year or greater (yields and prices have an inverse relationship). High-yield bonds were the top performers for the period, followed by corporate bonds and U.S. Treasurys.[1] The yields on two-, three-, five-, and ten-year Treasury notes decreased 0.35%, 0.41%, 0.39%, and 0.40%, respectively, over the quarter. The spread between ten- and two-year notes widened 0.05% to -0.58% during the period, further inverting the yield curve.

[1] According to the ICE BofA U.S. High Yield Constrained, ICE BofA Corporate, and ICE BofA U.S. Treasury indexes.

Market Overview

- In the U.S., all eyes (and ears) were on the Federal Reserve (Fed) over the quarter. The Fed raised the federal-funds rate to a range of 4.75%-5.00% in two increments of 0.25% on February 1 and March 22. Towards the end of the quarter, Fed Chair Jerome Powell acknowledged that the FOMC members had considered a pause in the rate-hiking cycle, given the recent turmoil in the banking sector. He also noted that prior to the onset of the banking crisis, the Fed had discussed the possibility of a more hawkish 0.50% rate increase as U.S. economic data remained relatively strong.

- The U.S. consumer-price index (CPI) rose 0.4% in February, down 0.1% from January, according to the Department of Labor, and was up 6.0% year-over-year. Higher housing and services costs contributed significantly to the rise in inflation in February. The government attributed the year-over-year upturn in the CPI to sharp increases in prices for energy services and food. Core inflation, as measured by the CPI for all items less food and energy, was up 0.5% in February and 5.5% over the previous 12 months.

- The Department of Labor reported that U.S. payrolls expanded by 311,000 in February, down sharply from 517,000 for the previous month. The unemployment rate, which had dipped to a 54-year low in January, rose 0.2% to 3.6%. The Department of Commerce reported that U.S. GDP grew at an annual rate of 2.6% in the fourth quarter of 2022, marking a slowdown from the third quarter's increase of 3.2%. The U.S. economy expanded by 2.1% for the 2022 calendar year.

- Within the Eurozone, the proposal of President Emmanuel Macron of France to raise the minimum retirement age for the country's public pension program from 62 to 64 led to civil unrest in that country. There were many violent demonstrations and several large labor unions staged widespread job actions in opposition to the plan.

- The European Central Bank (ECB) boosted its benchmark interest rate from 2.0% to 3.0% in two increments of 0.50% in February and March. In its rate-hike announcement in March, the ECB commented that "Inflation is projected to remain too high for too long" that the increase was "in line with [the ECB's] determination to ensure the timely return of inflation to the 2% medium-term target."

- Inflation in the Eurozone slowed by 1.6% to 6.9% in the 12-month period ending in March. Natural gas prices decreased 0.9% year-over-year, while food, alcohol and tobacco costs climbed 15.4% for the same period.[2]

- Eurozone manufacturing activity declined in March, with the S&P Global Flash Eurozone Manufacturing Output Index falling 1.2 points to 49.9. Services activity in the Eurozone reached a 10-month high in March, with the S&P Global Flash Eurozone Services PMI Activity Index increasing 2.9 points to 55.6.

[2] According to Eurostat. March 2023.

- According to Eurostat's third estimate issued in March, Eurozone GDP was stable in the fourth quarter of 2022. The Eurozone economy grew 1.8% year over year in the fourth quarter and expanded 3.5% for the 2022 calendar year.

- On March 15, U.K. Chancellor Jeremy Hunt unveiled the government's new budget, which directly addresses the nation's tight employment situation. Among some of the proposals: increasing vocational training; providing tax incentives, enhancing access to capital and easing certain regulations to encourage the creation of new enterprises.

- The Bank of England (BOE) increased its benchmark rate by an aggregate of 0.75% to 4.25% over the quarter. The central bank noted its ongoing concerns about inflation, as the government's consumer-price index rose 10.4% year-over-year in February (the most recent available data).

- According to the Office for National Statistics (ONS), consumer prices in the U.K. rose 1.1% month-over-month in February, a notable reversal of the 0.4% decrease in January. The year-over-year inflation rate increased 10.4% over the previous 12-month period, up from the 10.1% annual rise in the previous month. The ONS also reported that U.K. GDP increased 0.3% in January 2023, following a decline of 0.5% in December 2022, and was flat for the three-month period ending in January. The services sector grew 0.5% in January. Conversely, production output fell 0.3% for the month.

- The S&P Global/CIPS Flash UK Manufacturing Output Index declined 1.9 to a two-month low of 49.0 in March due to a decrease in demand. A reading below 50 indicates contraction in the manufacturing sector. The S&P Global/CIPS Flash UK Services PMI Business Activity Index was down 0.7 to 52.8 in March, but indicated expansion for the second consecutive month. There was particular strength in the services sector.

Selected Asset Class Commentary

- **Global Short Duration Fixed Income Asset Class**: AllianceBernstein underperformed because of long currency exposures to Norwegian krone and Japanese yen. Wellington underperformed because of duration underweights in the UK and Japan rates and an underweight to Italian government bonds. Colchester underperformed because of an underweight to U.S. rates, long currency positions in Norwegian krone, South Korean won, and Polish zloty, and short exposure to the euro.

- **Emerging Markets Debt Asset Class:** Stone Harbor Investment Partners managed to stem its losses in March, having taken off some risk in the January rally, to end the quarter near flat. Given an overweight in local interest rate duration, Colchester outperformed as local rates decline over the quarter. Despite being on the right side of the short U.S. dollar trade for the quarter, local-currency manager Ninety One UK Ltd was significantly hindered by its long position in South Africa. Neuberger Berman Investment Advisers' performance was also hindered by long high-yield hard currency exposure, but it managed to more than offset this with a long position in interest rate duration and short U.S. dollar exposure. Marathon Asset Management benefited from security selection and a bias to investing in investment grade, which outperformed.

- **Global Managed Volatility Equities Asset Class:** During the quarter, the building block underperformed its benchmark. Exposure to low volatility and value were key detractors over the period, as investors reallocated to speculative growth stocks and away from value. Diversity and smaller size tilts detracted as large-cap IT stocks led markets higher. LSV Asset Management underperformed in this environment, as their holdings lean further into value within the low-volatility cohort of the market. Allspring Global Investments was similarly challenged. Their portfolio tilts had increased towards value, as their momentum-based factor model followed favourable trends further into value over the past year. Acadian Asset Management's broad multifactor model held the least concentrated exposure to value compared to the other managers, partially dampening some of the value style headwinds.

Manager Changes

- None in the period.

Outlook

- Economists have been struggling for the past several months to find the right analogy to describe the future trajectory of growth and inflation in the U.S. The optimists favor the term "soft landing," whereby growth in business activity slows just enough to reduce inflation pressures without causing a recession. Pessimists see a "hard landing" ahead as the global economy stumbles into recession due to overly tight central-bank monetary policies. Still others see "no landing" whatsoever—economic growth actually accelerates, along with inflation.

- SEI suggests a fourth possibility: a "holding pattern" in which the economy moves in circles with no estimated time of arrival. Economic growth slows, but not enough to push inflation back to the 2% target rate that the Fed and other major central banks have set as their goal. We believe, eventually, the plane runs out of gas and a recession develops.

- The federal-funds futures curve has swung dramatically in just three months, with traders beginning 2023 expecting the central bank to cut interest rates in the second half of the year. When the nonfarm payrolls report for January was released in early February, however, sentiment began to change and those anticipated rate cuts were completely priced out of the futures curve. Before the failure of SVB and the other banks, the entire futures curve had shifted upward in dramatic fashion, with the peak funds rate rising into the 5.50%-to-5.75% area, and the December 2023 contract yielding 5.58%. The federal-funds futures curve now has been reset well below where it was at the start of this year.[3]

- SEI understands the market's willingness to "fight the Fed" at this juncture. The tumult in the banking system is not over yet; even after this panic stage passes, smaller banks will face ongoing pressure to raise deposit rates to more competitive levels, while borrowing from the Fed and U.S. government agencies to improve their liquidity.

- A recession becomes likelier due to the important role that community and regional banks play in the U.S. financial system. According to the Fed, smaller banks (below the 25 largest banking

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[3] Sources: FactSet, SEI

institutions ranked by domestic assets), account for roughly two-thirds of commercial bank loans. They also comprise a very large proportion of credit extended to small businesses.

- SEI is assuming that the current banking panic will be quelled by the government's "whatever-it-takes" attitude. If that belief proves wrong, the Fed could indeed blink and cut rates as the futures curve applies; however, the surge of liquidity being injected into the banking system may well make the job of reducing inflation that much more difficult.

- The FOMC has underestimated the extent and persistence of core PCE inflation for nine consecutive quarters. And, in every quarter since March 2021, the FOMC members have forecast a return to a 2.0% to 2.5% within the next two years. The latest forecast follows the same trajectory, with core PCE inflation falling to 3.6% by December 2023, 2.6% by December 2024, and 2.1% by December 2025. By contrast, PCE core inflation ended 2021 at 4.8% and 2022 at 4.7%.[4]

- The current panic in the banking sector doesn't seem to be dissuading other central banks from pursuing their inflation-fighting goals. In particular, the ECB surprised the markets by raising its three key policy rates by 0.5% in March, as members of the Governing Council strongly hinted they would prior to the onset of the recent market turbulence. The ECB's rationale was clear; the mandate is to bring inflation back to its 2% target rate, and the central bank will use its monetary toolset (interest rates and security sales from its balance sheet) in an effort to achieve this goal.

- SEI believes that recent events in the financial markets have raised the odds of recession in the U.S. beginning later this year or in early 2024. As has been the case following previous recessions, wage pressures most likely will ease and inflation should fall as well. However, global financial markets are probably getting ahead of themselves, pricing in near-term cuts in policy rates and a rapid decline in inflation back below 2% within a year.

- Both cyclical factors (tight labor markets and consumer resiliency especially) and secular factors (a persistently tight labor market, an emphasis on supply chain resiliency over efficiency, higher capital costs, and higher future tax burdens) suggest to us that inflation will remain higher than what central banks and market participants expect. On this basis, SEI believes that the positioning in fixed income and equities will continue to add value as we look into the future, despite another shorter term set back to positive returns over the medium term. SEI continues to warn that the return pattern SEI expects from its positioning will not be delivered in a straight line; investors should continue to expect short-term setbacks on the path to potential medium and long-term success.

[4] Sources: U.S. Federal Reserve, SEI

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