SEI UK Strategic Portfolios

SEI Strategic Portfolios Q2 2022 Quarterly Commentary – Stability Focused.

There was no safe harbour from choppy markets during the second quarter. Equities and fixed-interest asset classes alike capsized, SEI Strategic Portfolios provided strong downside protection.

Executive Summary

- Value-oriented equities tended to fall by less than growth-oriented equities across both large- and small-cap markets, although the performance spread was much wider within larger companies. No sectors were spared from losses, but energy and consumer staples had the mildest declines, while IT and consumer discretionary had the steepest.[1]

- Emerging-market equities fell by double digits during the quarter, although they still fared better than their developed- market counterparts, buoyed by a rebound in China. UK shares posted significant losses, but they were not as steep as those of Japanese or European equities. US shares, meanwhile, had the sharpest drop among major markets as the US dollar appreciated by 6.49% versus a trade-weighted basket of foreign currencies.

- Government-bond rates climbed throughout the second quarter as prices fell. UK gilt and Eurozone government-bond rates rose across the yield curve, with longer-term rates increasing by more than shorter-term rates. US Treasury yields also increased across the curve, but shorter-term rates outpaced longer-term rates for the full quarter.

- Fixed-interest performance ran the gamut of losses, moving from relatively modest declines for government bonds to more severe losses for emerging-market and high-yield bonds. [2]

- The Global Managed Volatility allocations have provided downside protection through 2022, most evidently in the second quarter with 8% outperformance of the market alongside 12% YTD.[3]

- There is also clear evidence starting to take shape that the value positioning in the equities building blocks can provide both downside and upside relative return benefits, as the market continues to rotate in favour of stocks with actual fundamentals and not based on a mirage of ever-growing sales into infinity.

- It remains SEI's strong belief that the 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 a strong start to relative performance in 2022.

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

[2] According to data from FactSet and Lipper

[3] According to data from SEI

Market Overview

- The Bank of England's (BoE) Monetary Policy Committee (MPC) voted to increase the bank rate by 0.25% at both its May and June meetings, increasing the benchmark rate to 1.25%. It also continued to reduce its balance sheet by ceasing to reinvest proceeds from its asset-purchase programme, with an expected £3.2 billion in redemptions for July 2022.

- Inflation climbed to 9.1% in the UK for the 12-month period through May, the highest level in 40 years.[4]

- UK manufacturing activity settled lower throughout the second quarter. Manufacturing growth in June was positive, but soft.[5]

- The European Central Bank (ECB) concluded new purchases in its Asset Purchase Programme (APP) with net purchases of €40 billion in April, €30 billion in May, and €20 billion in June. Following its early June meeting, the central bank announced it would cease new purchases in the APP and intended to increase benchmark rates in July and September.

- The spectre of rising rates sent government bond spreads higher for economically weaker European countries—like Italy, Greece and Spain. The ECB convened an unscheduled meeting in mid-June to ensure markets it would intervene to avoid the fragmentation of the European government bond market.

- The Eurozone unemployment rate held at 6.8% from February through April, before cracking through to 6.6% in May to set a new record low (since Eurostat began tracking the dataset in 1998).[6]

- The expansion in Eurozone manufacturing continued to slow throughout the second quarter, ending in June with an anaemic pace of growth.[7]

- The US Federal Open Market Committee (FOMC) increased the federal-funds rate by 0.50% (the first hike of its size since 2000) at its early-May meeting, and then by 0.75% (the first of its size since 1994) at its mid-June meeting, bringing the benchmark rate to a range between 1.50% and 1.75%.[8]

- The central bank also announced plans to reduce its balance sheet in June, allowing Treasurys and mortgages to run off (that is, mature without being replaced) at maximum respective paces of $60 billion and $35 billion per month. Economic fundamentals deteriorated in the FOMC's latest quarterly Summary of Economic Projections (SEP), released in June.

- Real GDP projections declined for 2022, 2023, and 2024 compared to the March SEP, while projections for the unemployment rate increased across all three years, and inflation expectations increased for 2022. Projections for the federal funds rate were higher across the board as well.

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[4] "UK inflation rises to 9.1%, its highest rate in 40 years." The Guardian. 22 June 2022.

[5] IHS Markit / CIPS UK Manufacturing PMI. 5 July 2022.

[6] "Euro zone unemployment falls to new record low of 6.6% in May." Reuters. 30 June 2022.

[7] IHS Markit Eurozone Manufacturing PMI – final data. 5 July 2022.

[8] According to data from the Board of Governors of the Federal Reserve System.

- The US labour market remained quite healthy during the second quarter. New claims for unemployment benefits trended higher—from roughly 180,000 per week in April to about 230,000 per week in June—but remained low relative to history.

- US manufacturing growth peaked in April after accelerating through early 2022, then cooled (slowly in May, and then sharply in June), leaving a soft expansion at the end of the second quarter.[9]

Selected Asset Class Commentary

- **Global Short Duration Fixed Income Asset Class:** During the month, the asset class suffered from duration overweights in Australia and New Zealand. An off-benchmark allocation to corporate credit also detracted. Long currency positions in Japan and Sweden and short currency positioning in Australia and New Zealand further anchored returns. Colchester Global Investor's underperformance was a result of a duration overweight in Norway, South Korea and Singapore. Colchester's long currency positioning and off-index exposure to US Treasury Inflation-Protected Securities (TIPS) also detracted. AllianceBernstein suffered due to an overweight to Europe, Australia and New Zealand duration.

- **Global Managed Volatility Equities Asset Class:** During the quarter, the asset class gained on its value exposure as investors rotated out of mega-cap growth names. All of the asset class' managers benefited not only from their value tilts, but also from allocations to defensive and low-volatility sectors. LSV Asset Management gained on the strong performance of value within the low-volatility area of the market. Allspring Global Investments' allocations to defensive sectors contributed. Acadian Asset Management's broad multifactor model added.

- **Global Equities Asset Class:** The asset class benefited from its allocation to value and low volatility. Strong outperformance in the US and Japan took place due to an underweight to IT and favourable stock selection. Security selection within retail, automobiles and healthcare also aided returns. Poplar Forest Capital gained from its exposure to value. Poplar's underweight to mega-cap IT stocks was highly beneficial. A higher exposure to energy and healthcare further boosted returns. Sompo Japan Nipponkoa Asset Management Company (SNAM) also gained from its value orientation, primarily in Japan. SNAM's positioning in defensive utilities and consumer staples contributed. Positive security selection in consumer discretionary and industrials also added to performance. LSV Asset Management's managed volatility investing was favourable. Momentum-oriented INTECH Investment Management and Lazard Asset Management struggled due to sector allocation effects and negative security selection.

Manager Changes

- N/A

[9] IHS Markit US Manufacturing PMI. 5 July 2022.

Outlook

- It's been our mantra for the past year that US inflation would be higher for longer than most economists and investors appeared to expect. We believe this remains the case, although the gap between our expectations and those priced in US markets has narrowed considerably and the pace of inflations' increase is almost certainly close to a peak. Investors and the Fed still seem to be betting that inflation pressures will ebb significantly starting in the second half of this year and fall to 3% by the end of 2023.

- Fed Chairman, Jerome Powell, continued to expresses hope that the Fed can achieve a "softish" landing, where inflation gradually decelerates back to the central bank's 2% target without a recession. Unfortunately, there has been only one successful instance since the end of World War II (1951 to 1952) when inflation was running above 5%.[10]

- Federal funds-rate futures indicate that investors are anticipating a series of increases between now and year-end that would bring the funds rate to 3.4%. The peak is indicated to be between 3.75% and 4% a year from now. Markets are presumably pricing in a recession by the second half of 2023, considering the funds rate is projected to decline at that point.

- We believe this to be a reasonable forecast, but the actual outcome will depend on how quickly the economy actually weakens and inflation ebbs. The evidence as of today suggests that the US economy may continue to show a resilience that surprises both the Fed and investors.

- There are signs of economic trouble ahead. The surge in US mortgage rates is delivering a big blow to the housing market. Beyond real estate, economists have begun citing the big increase in retail inventories as a harbinger of recession. We are doubtful that the inventory problems of department stores and general merchandisers are serious enough to throw the economy into recession in the near term.

- There is no denying that rising interest rates will slow economic growth. However, changes in monetary policy affect the economy with a long and variable lag. While the financial strength of US businesses and households is likely to ebb, the starting point is a very high one. The labour market, for instance, remains exceptionally tight. Until a better balance between the demand and supply of labour is achieved, one should expect further large wage gains at the lower end of the wage-income spectrum, where the job market is tightest.

- American job switchers have enjoyed a sharper-than-average wage gain of 7.5% over the past 12 months. It should not be surprising that the US quit rate is significantly higher than in 2019 or at the previous economic peak in 2007.

- Other major developed economies are not too far behind. The U.K. has an unemployment rate below 4%. Canada and Europe usually have unemployment rates that are considerably higher than the US and the U.K. That remains the case, but both report jobless totals that are below previous cyclical lows.

- All this suggests that workers are in a strong position to seek bigger wage gains in an effort to keep up with inflation. The possibility of a global wage-price spiral still cannot be dismissed. This could force central banks to raise interest rates more than they would prefer.

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[10] According to SEI's analysis of data from the Economic Cycle Research Institute and U.S. Bureau of Labor Statistics.

- In Europe, the need to hike interest rates has once again raised the spectre of another periphery debt crisis. Italian 10-year bonds are trading some 70 basis points higher against German bunds than they were at the start of the year. This is on top of the two percentage-point jump in German rates that has been logged over the same six-month stretch.

- The stress has not reached the crisis levels of the 2010-to-2012 period. Given all the other problems facing Europe, the ECB has vowed to support the weaker members of the Eurozone with continued bond purchases.

- As was the case last time, the economic priorities of the strongest countries are diverging from their weaker neighbors. The German-led bloc needs a more aggressive policy tightening along the lines of what the Fed is expected to do. Meanwhile, the weaker countries, Italy and Greece especially, now bear an even heavier debt burden relative to the size of their economies than was the case a decade ago. The interest expense on that debt could get out of hand quickly if the cost of capital continues its sharp upward trajectory.

- The ECB is so concerned about the situation that it actually held an emergency meeting the same day as the Fed's interest-rate announcement in order to assure markets that it is working on an "anti-fragmentation tool" that will keep spreads narrow while still allowing the central bank to fight inflation.

- On a more positive note, China's economy appears to be in recovery mode. COVID-19 lockdowns in Beijing, Shanghai and other parts of the country have eased. The zero-COVID policy pursued by the Chinese government has hurt the economy to an extent seldom seen in the past three decades.

- Home sales have also plummeted, falling 34% over the 12 months ended May. Chinese authorities are now trying to revive the property market by lowering mortgage rates, cutting mortgage down payment requirements and encouraging banks to start lending again.

- Economy-wide lending has picked up, finally turning positive for the first time in a year. If that trend continues in the months ahead, other measures of current economic health should begin to recover too. Whether that will be enough to stave off a global recession is doubtful, however, in view of the rising interest-rate trend in the advanced economies. It might even prove counterproductive if a revival in Chinese demand for energy and other raw materials exacerbates the commodity-price boom at a time when global supplies are still constrained.

- The poor performance of financial markets this year suggests that investors have already discounted a lot of bad news. The price decline in the S&P 500 Index recorded in year to date, contrasts sharply with the ongoing increases in forward-earnings estimates. The result has been one of the sharpest reductions in stock multiples outside of a recession in the past 25 years.[11]

- The froth certainly appears to have been taken out of the markets by this year's pullback. That's the good news. The bad news is that an economic recession and a corresponding decline in earnings might not yet be fully reflected in stock prices. Multiples tend to slide as projected earnings estimates fall. Even if price-to-earnings ratios remain at current levels, there could be a decline in projected earnings—and a comparable drop in stock prices—as analysts incorporate a recession's impact into their models. While the consensus view is that stock prices face rough seas ahead, it is possible that earnings multiples do not need to contract much further than they have already—with the caveat that bond yields stabilize near current levels and do not climb significantly higher.

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[11] According to SEI's analysis of data provided through Factset.

Important Information on Performance

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

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