Growth-Focused SEI Strategic Portfolios

SEI Strategic Portfolios: Q2 2020 Quarterly Commentary

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Global equity markets rallied in Q2, based on investors' continuing expectations that the economic impact of the global pandemic will remain limited

Executive Summary

- The 'risk-on' sentiment came amid a push by governments to slowly reverse lockdowns of non-essential economic activity; the promising news of progress made in the race to develop COVID-19 vaccines; and the sustained extraordinary support of central banks. All of this despite news of increased regional outbreaks of the virus, as well as a lack of any type of curve flattening on a global level.

- Equities around the world spent much of the second quarter embracing the sharp rebound that began at the end of March. Shares were universally higher for the full quarter, although every major market besides China peaked in early June and failed to make new highs thereafter. Recoveries varied in size, and some markets had their best quarter in several years.

- US Treasury rates with the shortest and longest maturities increased during the full quarter, while the rates of those with maturities of 1-to-10 years declined. European government-bond rates nearly completed a round trip over the quarter, ending June almost exactly where they concluded the first quarter. UK Gilt rates were lower across all maturities for the full three-month period.

- Considering the Growth-Focused Strategic Portfolios, some of the challenges faced by value managers in recent quarters eased in the second quarter, with several periods of stronger return potentially portending a bigger rotation. Our core investment case for SEI's overweight to this area remains the same: extreme relative valuations between the most expensive and cheapest parts of the market. SEI further believes that the post-crisis environment may provide further support for this positioning, given the huge stimulus being provided.

Market Overview

- The Bank of England's Monetary Policy Committee held the Bank Rate at 0.1%, during the second quarter; following its mid-June meeting, the central bank announced that it would expand its stock of asset purchases from an initial £200 billion increase announced in March by another £100 billion to £745 billion.

- The rate of change in UK manufacturing activity remained flat in June representing an improvement on the slowing contraction in May following an extraordinary drop in April. UK services activity nearly stopped contracting in June after a dive in April and a modest improvement in May. The UK claimant count unemployment rate spiked from 3.5% in March to 6.3% in April, and then to 7.8% in May. The overall UK economy contracted by 2.2% in the first quarter and 1.7% year over year.

- The EU and UK struggled to establish their regulatory equivalence in a combined effort to grant mutual access to their financial markets after the Brexit transition period concludes at the end of 2020. The two sides failed to reach an agreement by the proposed 30 June deadline; while the UK said it is prepared to grant the EU access to UK financial markets, the EU stated that the UK has not provided sufficient information to complete its evaluation.

- The European Central Bank held its benchmark rates unchanged during the second quarter. It unveiled the pandemic emergency longer-term refinancing operations (PELTROs) in April to help facilitate proper functioning of money markets; in early June, it also announced the expansion of its Pandemic Emergency Purchase Programme (PEPP), which is designed to facilitate asset purchases, by €600 billion to a total of €1.35 trillion.

- The eurozone's contraction in manufacturing activity continued to ease through May and June after an unprecedented slowdown in April. Eurozone services activity also plummeted in April, but improved somewhat in May before nearly coming out of contraction in June. Loans to non-financial European corporations accelerated for the fourth consecutive month, increasing by 7.3% in May after gaining 3.0% in February, 5.4% in March, and 6.6% April. The overall eurozone economy contracted by 3.6% during the first quarter and 3.1% year over year.

- The Office of the US Trade Representative issued a notice in late June that it was considering imposing tariffs on about $3 billion in imports from the UK, Germany, France and Spain. The World Trade Organization approved $7.5 billion in US tariffs on European products in late 2019, and may also approve retaliatory European tariffs on US products.

- US borders were set to remain closed to Canada and Mexico until at least 21 July as part of the Trump administration's latest one-month extension, which began on 20 March. The United States–Mexico–Canada Agreement (USMCA) took effect on 1 July, officially replacing the North American Free Trade Agreement (NAFTA).

- The US Federal Reserve maintained its monetary policy path throughout the second quarter, providing assurances in early June that it would not raise the federal funds rate and would maintain quantitative easing. It also began purchasing corporate bonds during the second quarter via programs that it established as part of its pandemic response, while also ordering banks to cut dividends and halt stock buybacks following stress tests on the prospect of an extended economic downturn resulting in a higher rate of loan defaults.

- US manufacturing activity nearly returned to growth in June after contracting sharply in April and improving in May. Activity in the US services sector plummeted more dramatically in April compared to the US manufacturing sector, and did not rebound to as great a degree as US manufacturing through June. American workers submitted more than one million unemployment initial claims for 14 consecutive weeks through late June, peaking in late March and early April above 6 million initial claims[1]. The overall US economy contracted by a 5.0% annualised rate during the first quarter.

Selected Asset Class Commentary

- **Emerging Markets Fixed Income:** The building block benefited from a long duration position as yields fell and spreads tightened. Overweights to some higher-yielding countries that recovered over the quarter, such as Angola, Ecuador, Argentina and Ukraine, contributed, as did a large overweight to Mexico. Stone Harbor Investment Partners LP gained on overweights to Ecuador and Mexico; exposure to Venezuela and an underweight to the Philippines detracted. Marathon Asset Management, L.P. gained an off-benchmark position in Argentina.

- **Global Equities Fund:** Relative performance in the building block, while not positive, showed some signs of stabilisation in the second quarter. The asset class struggled against a value headwind during the quarter, which favourable selection could not overcome. LSV Asset Management was the Fund's biggest detractor. While LSV underperformed the indexes by wide margins, the manager's results were in line with expectations considering the strategy's strong value overlay and diversified nature, both of which continued to face headwinds. Maj Invest and Sompo Nipponkoa Asset Management, both value-oriented managers, were also notable detractors. With no FAANG stocks in Europe and the UK, value performed well in the region, which helped Jupiter Asset Management and Metropole Gestion. US small-cap specialist Towle & Company was rewarded for staying the course and realized the biggest bounce by far. The manager's results were particularly strong in consumer discretionary and industrials as investors started looking beyond daily pandemic updates. Momentum-oriented managers Lazard Asset Management and INTECH Investment Management continued to benefit from the established trend favouring profitability and growth.

- **Emerging Market Equities:** The building block benefited from selection within online retailing in China and Brazil as consumers transitioned to online shopping due to the coronavirus pandemic. Selection within IT contributed. RWC Asset Advisors gained on selection within metal and mining stocks as well as selection in online retailing. Lazard Asset Management benefited from favourable tailwinds to growth stocks. J.O. Hambro Capital Management also enjoyed a growth tailwind, and also benefited from a favourable tailwind to momentum. KBI Investors struggled against headwinds for value and dividend stocks.

Manager Changes

- Macquarie Investment Management (Macquarie) was removed from the Emerging Markets Equity building block in May. Macquarie's strategy does not align with SEI's alpha-source framework. Alpha refers to returns in excess of a given investment's benchmark. Active investment managers seek to exploit various factors or sources of alpha in order to add value.

Outlook

- Despite mounting infections, hospitalisations and deaths from the pandemic, as well as the unprecedented stoppage of global economic activity, stock markets around the world managed to mount a resounding comeback.

[1] Initial Claims. Data Series Provide via FRED. Federal Reserve Bank of St. Louis.

- SEI's working assumption is that there will likely be another significant wave of infections going into the fall-to-winter flu season. The question is, how disruptive will it be to the global economy?

- Investors seem to be ignoring the possibility that, even if a sustainable recovery gets under way, it may be a long time before most companies achieve previous levels of profitability. The after-tax profit margins of US domestic businesses were already on a declining trend before the onset of the virus and shelter-in-place orders.

- Margins will likely remain well below their previous peaks around the globe as long as the COVID-19 is a severe health threat. Most businesses, to one degree or another, are expected to endure lower sales, higher costs and a decline in productivity. Supply chains will likely be diversified over time, a process that was already under way as a result of the trade war between China and the US.

- The extraordinary March-to-April lockdown in the US necessitated fiscal measures unparalleled in scope and speed of implementation. The result has been a tsunami of red ink. The Congressional Budget Office projected the deficit will reach nearly 18% of US gross domestic product (GDP) in 2020 and improve to only 10% of GDP in 2021. US debt relative to GDP is forecast to rise to 108% by the end of fiscal year 2021 versus 79% at the end of fiscal year 2019.

- These are unsettling numbers. Many investors wonder whether such a surge in government debt will provoke an economic crisis even after the pandemic runs its course. SEI does not believe that it will. The US has a large, dynamic economy and deep capital markets. If investors were truly concerned about the long-run fiscal viability of the US, the value of its currency would have been falling more convincingly and long-term US interest rates would have been going up, not down.

- The US certainly is not alone in engaging in a huge fiscal response that is then monetised by the central bank. In SEI's opinion, governments are treating the fight against COVID-19 like they would a war. As many resources as possible are being thrown into the fight, supported by debt issuance that is absorbed primarily by the central banks.

- Investors who remember the 1970s worry about the inflationary potential of such extraordinary debt monetisation. Given SEI's view that the economy will remain below full utilisation of labour or productive capacity for the next few years, we believe inflation is unlikely to break out of the 0%-to-3% range it has been in for much of the past decade.

- Investors do not seem too concerned about the speed of Europe's economic recovery or the impact of the health crisis on countries' fiscal positions. The bond yields of the most economically-fragile countries remain close to those of German bund yields, although spreads have widened from pre-pandemic levels. The ECB has been quite successful in short-circuiting the liquidity crisis and flight-to-safety that threatened the euro area's financial structure.

- This laid-back view may be severely challenged if the 27 members of the EU fail to approve a €750 billion emergency fund when the EU's leaders meet again in July. Disagreement, for example, over the split between grants and loans. Paying for the grants is an even greater source of contention. The European Commission would be empowered to issue long-term bonds, which would be paid down by giving it taxation authority, a power it currently does not have. The only alternative would be to increase contributions from member states or enact spending cuts in other parts of the EU budget.

- Speaking of the UK, the COVID-19 crisis has pushed Brexit concerns off the front pages. As the 31 December transition deadline nears, it could become an economic factor nearly as important as a second wave of the virus. If a deal on the UK-EU trading relationship is to be delivered before year-end, it probably should be concluded by the end of October so that countries have time to approve the treaty into law.

- While many factors determine equity performance, in the emerging-market space it has correlated with the extent of economic disruption caused by the virus. Asian and central European countries have pulled back the most on their mandates to restrict movement and social interaction. Latin America and India have eased some of those constraints, but not nearly as much as the other two regions.

- Central banks in the emerging world are also doing their part to help restore their economies. Interest rates have come down in almost every country in recent months to record-low levels in many cases. In addition, a dozen emerging-country central banks—including those with shakier reputations, such as South Africa and Turkey—are either buying or planning to purchase their government's debt. We think this debt-monetisation may lead to an inflation problem in the future.

- It has been said many times that bull markets climb a wall of worry. Maybe now they must learn to swim through waves of worry that include:

  - The possibility of a second wave of COVID-19 infections forcing another round of extensive lockdowns and shelter-in-place orders that could lead to a double-dip recession

  - A possible break down of political consensus regarding the way forward as economies struggle to regain strength.

  - The likelihood that economic recovery will take at least a year, possibly longer, and that few economies are likely to rebound fully to pre-pandemic levels, even if most countries manage to avoid a disruptive second wave of the virus

  - Expectations that companies will face higher costs and increased inefficiencies; that taxes will almost certainly rise across many economies in the years ahead; and that bankruptcies and defaults will climb as government aid programs end

- SEI believes that an ebb and flow of assorted concerns in the coming months will continue to spark volatility across financial markets. Such periods of instability are expected in any long-term investing plan; as such, SEI is prepared to continue to navigate the current wave of deep uncertainty, while also adhering to the principles of investing over speculation.

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