Stability-Focused SEI Strategic Portfolios

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SEI Strategic Portfolios: Q3 2020 Quarterly Commentary

Global markets continued to reflect (and anticipate) the ongoing economic recovery in Q3

Executive Summary

- Global equity markets delivered another quarter of outsized gains, moving further from the March 2020 lows as the economic recovery that took hold in the second quarter continued throughout the summer. European and Japanese equities advanced over the quarter with relative consistency, and Chinese shares jumped in early July and finished the quarter with strong performance, but other markets suffered more volatility.

- UK equities were flat in July, higher in August and flat again in September (finishing lower in sterling but higher in US dollars). US shares climbed steadily for the first two months of the quarter until peaking at the start of September and mostly declining for the remainder of the period. Hong Kong equities also started July in a rally, but finished the third quarter on a downbeat after selling off in September.

- The US dollar continued to decline versus a broad trade-weighted basket of foreign currencies throughout most of the third quarter before beginning to recover in a mid-September reversal. Short-to-intermediate-term US Treasury rates declined and long-term rates increased, resulting in a steeper yield curve. UK Gilt rates increased across most maturities during the third quarter. Eurozone government-bond rates generally decreased, although shorter-term rates were mixed in both markets.

- Considering the Stability-Focused Strategic Portfolios, strategy returns were boosted by stronger returns from economically-sensitive debt, including corporate bonds, US high yield and emerging markets bonds. Global managed volatility equity, designed to provide downside protection in falling markets, detracted in a rising equity market.

- SEI believes that the post-crisis environment may provide further support for this positioning, given the huge stimulus being provided, the potential for inflationary impacts, and the increasing likelihood for a vaccine sooner rather than later. Crucially, where there was a meaningful sell-off in the markets over the quarter, it also seemed to be in evidence that this positioning has potential for meaningful downside protection, should markets enter into a more protracted downward leg.

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Market Overview

- The Bank of England's (BoE) Monetary Policy Committee held the Bank Rate at 0.1% throughout the third quarter after announcing at the end of the second quarter that it would expand its stock of asset purchases to £745 billion. Committee members have debated the implications of employing a negative interest rate at recent meetings.

- Prime Minister Boris Johnson announced in late September new restrictions in England on pubs and restaurants, transportation, and group gatherings as COVID-19 cases in the UK climbed to their highest levels since the spring. At the end of the same month, the UK House of Commons voted for passage of an internal market bill that contradicts the Brexit divorce agreement. The EU announced it would pursue legal remedy given the bill's contradictions with the Brexit agreement, even as trade negotiations continued.

- UK manufacturing activity cooled a bit in September after returning firmly to growth territory in July and peaking in August. The UK services sector started the third quarter with solid growth, which heated up in August before settling back to a slower, but still-healthy expansion in September. The number of people claiming UK unemployment benefits drifted higher by 2.8% between July and August, reaching 2.7 million. The overall UK economy contracted by 19.8% during the second quarter and 21.5% year over year, slightly less than recorded by earlier estimates.

- The European Central Bank (ECB) held its benchmark rates unchanged during the third quarter. ECB President Christine Lagarde expressed an expectation that the central bank's Pandemic Emergency Purchase Programme (PEPP) would need to be fully employed given the current outlook.

- A sluggish recovery in Eurozone manufacturing activity through July and August warmed to healthier levels in September. Activity in the services sector plunged from a solid expansion at start of the quarter to an outright contraction by September. Loans to non-financial European corporations grew steadily through July and August, at 7.0% and 7.1%, respectively, continuing a trend that began in April. The Eurozone unemployment rate increased through August, jumping to 8.1% from 7.9% in July.

- US companies announced a large wave of layoffs for workers that had been furloughed earlier in the year as the quarter concluded. Employers in the worst-affected industries have generally run short of resources after depleting the Paycheck Protection Program loans that were helping to support workforce retention. Prospects for additional fiscal stimulus dimmed amid election-season politics, with Democrats and Republicans holding firm on their respective funding demands. However, the US Congress did pass resolution on the last day of the third quarter to continue funding the federal government through mid-December, avoiding a government shutdown. The overall US economy contracted at a 31.4% annualised rate during the third quarter, improving a bit on preliminary readings.

- The US Federal Open Market Committee (FOMC) kept the federal-funds rate near zero during the third quarter. During July, the Federal Reserve Board of Governors announced extensions of temporary US dollar-liquidity-swap and repurchase-agreement facilities with other central banks through March 2021. In August, the FOMC introduced a new average inflation target that would allow above-target inflation following periods of below-target inflation. This change indicates that the FOMC will likely let the US economy run hotter than in the past before taking policy action to temper growth. At the end of September, the Fed announced it would extend an order through the fourth quarter of 2020 for large banks to cut dividends and halt stock buybacks given expectations for a higher rate of loan defaults.

Selected Asset Class Commentary

- **Global Opportunistic Fixed Income:** The asset class benefited from off-benchmark exposure to high-yield corporate bonds and the general down-in-quality bias within corporate credit versus the benchmark during the quarter. Duration positioning had no impact on performance. A currency underweight to the euro detracted. AllianceBernstein's government-related mandate gained on off-benchmark exposure to corporates and mortgage credit risk transfer securities (CRTs). Wellington Management International's US securitised mandate's off-benchmark allocations to non-agency residential mortgage-backed securities (RMBS) and CRTs contributed. JP Morgan's global corporate mandate benefited from a lower-quality bias. Wellington's government-related mandate struggled due to an underweight to the euro.

- **High Yield Fixed Income:** The asset class benefited from its underweight to and selection within energy (exploration and production) as oil prices remained in a narrow band during the quarter. The building block's allocation to leisure (gaming) hurt. Brigade Capital Management gained on a favourable overweight to and solid selection within retail; as well as an underweight to and selection within energy. Benefit Street Partners' selection within telecommunications and healthcare helped. T. Rowe Price benefited from a favourable overweight to and selection in leisure. Selection within financial services further contributed. JP Morgan Investment Management's unfavourable underweight to and weak selection within retail hurt. An overweight to and selection in health care also detracted. Ares Management struggled on poor selection within basic industry and real estate.

- **Emerging Markets Fixed Income:** The asset class benefited from a long duration position in hard-currency emerging-market debt as spreads tightened during the quarter. An overweight to corporates helped as they recovered in line with hard-currency sovereign debt. Positions in some local-currency debt, such as the Russian ruble, detracted. Stone Harbor Investment Partners gained on overweights to Ecuador and Mexico; underweights to Qatar and the Philippines detracted. Marathon Asset Management, benefited from strong selection in Argentina and Ecuador. Unfavourable underweights to Saudi Arabia and Mexico hurt. Neuberger Berman Investment Adviser's overweights to Ecuador and Argentina helped, while overweights to Russia and South Africa detracted. Ninety One's favourable overweights to Mexico and South Africa could not overcome unfavorable overweights to Brazil and Russia.

Manager Changes

- There were no manager changes during the period.

Outlook

- It has already been an eventful and exhausting year, but we have a sense that the next few months could prove critical to the future course of the global economy and financial markets. Most countries were in V-shaped recovery mode during the third quarter, moving sharply off their low points in May and June. We assume that future lockdowns to contain COVID-19 outbreaks will be far more limited in scope. For developed countries, treatments have improved, vulnerable populations appear to be better-protected, and younger, generally healthier people are accounting for a much larger share of confirmed new cases.

- But it is doubtful that there will be a full return to normal economic behaviour until safe and effective vaccines are introduced and distributed globally. The news on this score has been positive, and probably is a key reason for the continued buoyancy of equities and other risk assets. According to the World Health Organization, researchers were testing 38 vaccines in clinical trials at the end of September, while 93 more were in pre-clinical testing.[1] Ten vaccines have been approved for large-scale efficacy and safety trials.

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[1] "Draft landscape of COVID-19 candidate vaccines." World Health Organization. 2 October 2020.

- There’s no disputing that US economic activity remains far below normal. Although incomes are now recovering as more people get back to work, the lack of additional income support may drag down consumer spending as we head into the end of the year. Business sentiment appears to have bottomed, but the outlook remains sufficiently uncertain to keep us in a watch-and-wait mode. We would not be surprised to see the official US unemployment rate move up in the months ahead as hard-hit industries eliminate jobs now that government support has run out.

- In August, Fed Chairman Jerome Powell officially unveiled a new framework for conducting the central bank’s monetary policy. The Fed has decided to see how low the US unemployment rate can get before it causes the inflation rate to exceed the 2% mark by a meaningful extent. The Federal Open Market Committee’s (FMOC) own inflation projection does not envision a return to 2% inflation until the end of its forecast window in 2023, so it may be a long time before the federal-funds rate rises.

- In SEI’s view, all that is really left in the Fed’s monetary toolbox is quantitative easing, along with the provision of lifeline support to corporations as well as state and local governments through its various credit facilities. Monetisation of debt will likely continue until the pandemic crisis is well past and the US unemployment rate approaches its previous lows.

- The US presidential election will have a major impact on the economy and financial markets in the months and years ahead. Still, we firmly believe that it would be a mistake to base even a short-term investment strategy that necessitates accurately predicting: the election winner; the policies proposed by the newly inaugurated president; the ways in which Congress will modify those proposals throughout the legislative process; or indeed the impact those new laws would have on the economy and financial markets.

- Regardless of the election’s outcome, we assume that both candidates would see their platforms tempered before they’re put into practice. There is a high degree of institutional inertia, which is partly deliberate (constitutional checks and balances) and partly happenstance (increasing polarisation of opinion in the country tends to favour a draw). While there could be some market volatility plausibly attributed to the election, it is usually best to pay strict attention to the fundamentals and to ignore the politics.

- The UK is undergoing its own unique political difficulties, with Prime Minister Boris Johnson facing a rebellion among his own backbenchers and intense criticism from senior Conservatives over his proposal to renege on the withdrawal treaty that would allow Northern Ireland to trade without border restrictions with Ireland and the rest of the EU. The move to abrogate the treaty, if successful, would almost certainly lead to a hard Brexit—a reversion to World Trade Organization’s most-favoured-nation trading rules with the EU. It also could breathe new life into the separatist movement in Northern Ireland itself, not to mention Scotland.

- Obviously, a hard Brexit will not help matters. But the worst impact potentially will be sustained by financial companies and other service-producing entities, since World Trade Organization rules deal mostly with tradable goods. The increase in tariffs, for the most part, will be bearable once border-related issues are worked out. In the meantime, the UK and the rest of Europe are facing a second wave of COVID-19 that could turn what’s been a V-shaped recovery into something looking more like a W.

- The contrast of the big Asian stock markets versus other large emerging-market equities is dramatic. China’s strong gains can be chalked up to its rebound in economic activity. Although travel and other services are still constrained due to lingering concerns about the virus, infrastructure-related spending and manufacturing have experienced an almost-complete recovery to pre-pandemic levels. Investors seem to be unperturbed by the deterioration in the US-China economic relationship or by the increasingly fraught diplomatic relations between China and other countries.

- Emerging markets are already showing some good news. The price of raw industrials bottomed in early May, and have since enjoyed a sharp move higher. If industrial commodity prices advance in a sustained, multi-year fashion as they have in previous cycles, it’s a good bet that emerging-market corporate profits will also rise sharply.

- Our optimism is somewhat tempered by the rising debt burden facing many emerging countries. Much of the increase in emerging-market debt has been tied to the corporate sector—especially in China, where private

domestic, non-financial debt has reached an eye-watering 216% of GDP . Of more concern are the mostly small-to-medium-sized countries that are running current-account deficits and are too dependent on external hard-currency debt, or do not have the reserves to easily cover their debt service.

- The actions of the world's major central banks back in March, especially the US Fed's provision of US dollar liquidity, have helped to ease the strain on the market for emerging-country debt. Governments and other official lenders, meanwhile, have granted loan forbearance to nearly 80 countries; it's a tougher job to get private creditors to agree to do the same. Nonetheless, emerging-market sovereign yields on dollar-denominated debt have fallen back toward their previous record lows, more than reversing the spike endured in March, prior to the Fed's rescue operations.

- 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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Past Performance is not a reliable indicator of future results. Standardised performance is available upon request. All data is as at 30 September 2020.

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