Growth-Focused SEI Strategic Portfolios

SEI Strategic Portfolios: Q4 2020 Quarterly Commentary

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Equity markets finish 2020 on a high note, with a meaningful rotation into cyclicals, portending the start of a more durable value recovery over the mid-term

- The fourth quarter of 2020 began at a crossroad: September delivered the first monthly loss for risk assets since the start of a rally in March, and a recovery stumbled in mid-October as a new wave of COVID-19 cases accumulated around the globe. A sharp early-November advance coincided with the U.S. presidential election, with the market then propelled higher through the end of the calendar year by a series of constructive announcements relating to the effectiveness, approval, and distribution of COVID-19 vaccines.

- Emerging-market equities outpaced developed markets for the fourth quarter, pushing their full-year performance ahead as well. UK shares led among major developed markets during the quarter, but still ended up with a sizeable loss for the calendar year. European and Japanese shares followed the UK for the quarter; both delivered positive returns for the full year, but Japan fared much better than Europe.

- Meanwhile, US shares had a comparably modest quarter (albeit with a double-digit gain), but had the top major developed-market performance in 2020. Sector-level performance was shaken up during the final three months of the year: energy and financials—the top performers by a wide margin—lagged for most of 2020 and turned in full-year losses despite their huge fourth-quarter rallies.

- UK and Eurozone government-bond rates declined for the full fourth quarter. UK rates climbed through October and November, before dropping sharply across the yield curve in December. Eurozone rates tumbled across the curve in October, before bouncing higher during November; mixed movements in December resulting in a steeper overall curve.[1] US Treasury rates generally increased throughout the fourth quarter, with the 10-year Treasury rate rising by more than any other maturity.

- For the Growth-Focused Strategic Portfolios, SEI continues to favour exposure to value and small size, in the firm belief that the valuation-focused approach is one of the best long-term sources of positive relative return. Despite strong returns from this segment of the market in Q4, SEI's indicators, such as valuation dispersion, exhibit the highest readings ever. In SEI's view, a once-in-a-generation opportunity is turning out to be an once-in-a-lifetime opportunity, and there should be plenty left in the tank in terms of positive relative return from this positioning.

- SEI further believes that the post-crisis environment may provide further support for this positioning, given the huge stimulus either being provided or under discussion, the potential for inflationary impacts, anticipated regulation of 'big tech', and the increasing likelihood for a broader-based vaccine roll-out sooner rather than later.

[1] Source: SEI

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Market Overview

- The end of the year forced a scramble of deal-making on both sides of the Atlantic. EU and UK negotiators attained a measure of resolution on Christmas Eve with an agreement governing some terms of their ongoing relationship.

- Trade in services, which includes the financial industry, was not addressed under the scope of the deal, and each party's citizens will once again be subject to visa restrictions when working or travelling for an extended period in the other party's jurisdiction.

- The Bank of England's Monetary Policy Committee expanded its quantitative-easing programme at its early-November meeting, committing a fresh £150 billion toward bond purchases for a total of £895 billion. There were no additional policy changes at its mid-December meeting. The Committee's latest quarterly report projected that the UK economy could contract by 11% in 2020, [2]a deterioration from the 5.4% contraction estimated a quarter earlier. [3]

- UK manufacturing activity continued to grow at a healthy rate throughout October and November before accelerating in December. The UK services sector started the fourth quarter with strong growth, which gave way to an outright contraction by November, and activity essentially maintained pace in December. The overall UK economy grew by 16% during the third quarter after falling by 19.8% in the second quarter; the economy had shrunk by 8.6% year over year through the end of the third quarter. [4]

- The European Central Bank (ECB) made no new changes to monetary policy at its late-October meeting. Its December meeting produced a decision to increase the scale of asset purchases associated with its Pandemic Emergency Purchase Programme (PEPP) by €500 billion, for a programme total of €1.85 trillion. PEPP purchases were also extended through at least early 2022. Additionally, the ECB planned to expand the use of its Pandemic Emergency Longer-Term Refinancing Operations (PELTRO) programme, which is designed to promote bank lending through subsidised loans. [5]

- Growth in Eurozone manufacturing activity remained healthy through October and November, before strengthening in December. A contraction in the Eurozone services sector deepened from October to November, and then moderated during December. The overall Eurozone economy grew by 12.5% during the third quarter after declining by 11.8% in the second quarter; the economy had shrunk by 4.3% year over year through the end of the third quarter.

- US lawmakers, meanwhile, struck a deal for $900 billion toward pandemic economic relief and $1.4 trillion in federal government funding, which President Trump signed on 27 December. Direct payments to Americans were included in the relief legislation, at $600 per person below an income threshold, prompting Trump to withhold his approval for several days in favour of $2,000 payments, which passed the House of Representatives but never materialised in the Senate.

- Earlier in December, the outcome of the US presidential election was formalised when state-level electors cast their votes in accordance with the certified results of each state's popular vote, delivering a majority of electoral votes to President-elect Joe Biden. A legal campaign to contest the election results waged by President Trump and his allies was mostly retired at that point.

[2] Source: SEI

[3] "Bank Rate held at 0.1% and asset purchases increased by £150bn - November 2020." Bank of England; and "Monetary Policy Report - November 2020." Bank of England.

[4] Source: SEI

[5] Source: SEI

- The US Federal Open Market Committee (FOMC) made no changes at either its early-November or mid-December meetings. The US Federal Reserve's (Fed) latest summary of economic projections improved over the prior quarter, with expectations for higher economic growth and lower unemployment in 2021 and thereafter.

- The US central bank planned to extend four emergency lending facilities that had been established in March into the New Year—yet also planned to return $455 billion of unused funding for five other lending facilities to the U.S Department of the Treasury and then shutter the facilities at year end. President-elect Biden named former Fed Chair Janet Yellen as his nominee for US Secretary of the Treasury.

- US manufacturing growth picked up from moderately healthy in October to stronger levels in November and December. US services sector growth started strong in October, before heating up temporarily in November and then reverting back to generally strong levels in December. New US jobless claims bottomed in mid-November, before climbing until mid-December and then retreating through year end. The overall US economy grew at a 33.4% annualised rate during the third quarter after declining by an annualised 31.4% in the second quarter.

- The Regional Comprehensive Economic Partnership (RCEP), a free-trade group composed of 15 Asia-Pacific countries including China, was formalised in mid-November. RCEP nations have a combined population of 2.2 billion people and produce about one-third of global gross-domestic product, representing the most expansive free-trade area on the planet.

Selected Asset Class Commentary

- **Global Equities:** The asset class benefited from its pro-cyclical, contrarian positioning through an overweight to fundamental value managers. Momentum and stability managers partially mitigated outperformance. Deep value managers were attracted to risky cyclical stocks that rebounded once it became clear that lockdowns would not last forever. Apart from Sompo Asset Management Co., whose returns were held back by an unexpected COVID-19 resurgence in Japan, all value managers in the building block rebounded strongly. Among them, Metropole Gestion was the strongest contributor. The same risky, but cheap financials and energy drove Poplar Forest Capital's performance in US equities. Towle & Company, a US small cap value manager, further enjoyed tailwinds to their size positioning as the US small cap market delivered twice as good of return as US large caps. Jupiter Asset Management and Maj Invest also outperformed, helped by similar to other value managers' dynamics. Stability managers suffered most in the "junk" rally, as did the momentum managers riding the same high profitability and high growth trends. INTECH Investment Management's recent enhancement into volatility harvesting and away from price momentum has proven fortuitous.

- **Emerging Market Equities:** The asset class benefited from a tailwind to momentum and strong stock selection, largely in China. RWC Asset Advisors gained on solid selection in Asian consumer discretionary stocks. An underweight to large online retailers that performed poorly during the quarter further contributed. Lazard Asset Management's selection within financials and communication services helped. J.O. Hambro Capital Management benefited from a tailwind to momentum, which performed well as revisions were aligned to cyclical stocks that were boosted by positive COVID-19 vaccine news. Neuberger Berman struggled on a combination of stability headwinds and poor selection.

Manager Changes

- Acadian Asset Management (Acadian) was added to the US Large Companies building block in November 2020. Acadian's strategy takes a momentum-oriented approach that incorporates top-down and bottom-up elements. The team's investment process is quantitative in nature and focuses on drivers of outperformance for the momentum alpha source. We believe the team is well resourced and has deep experience. We expect Acadian's strategy to complement the manager line-ups.

- AJO, L.P. (AJO) was removed from the US Large Companies building block in November 2020. AJO announced that it will be closing after year end. According to a memo from firm founder Ted Aronson, trading was to cease 30 November 2020 and the firm was scheduled to wind down by 31 December 2020. [6]

- Lazard Asset Management (Lazard) was removed from the Emerging Markets Equity building block in December 2020. Lazard's strategy provided various degrees of exposure to factors at various times, depending on market conditions. However, based on the current manager line-up and the market environment, we have replaced Lazard with a value-oriented manager that is expected to provide consistent value exposure over time.

- Robeco Institutional Asset Management (Robeco) was added to the Emerging Markets Equity building block in December 2020. Robeco's strategy takes a fundamental approach that incorporates top-down and quantitative elements to enhance bottom-up stock selection. The addition of Robeco will provide us with the ability to better manage the exposure to value, both tactically and strategically. Robeco's strategy is highly concentrated, which we believe will benefit the building block and complement its manager line-up.

Outlook

- Recent market conversation has hinted at the notion of a “Great Rotation” in capital markets, suggesting that investors may have begun to favour value and cyclical sectors over growth names. From what we have seen so far in 2021, it seems that this trade is starting to gain momentum. Multi-trillion dollar stimulus packages, inflation and anticipated regulation of ‘Big Tech’ will all support this dynamic, which should it continue to manifest itself will be highly favourable for SEI's positioning.

- Since September, value style equity indexes have outpaced their growth counterparts to varying degrees across geographies and market capitalisations, most notably within U.S. large caps. SEI have observed several signs of potential normalisation that seem to support the prospects for a style regime change.

- SEI believes investors will prove willing to shrug off the likely prospect of more bad news during the difficult months that lay ahead, which could include slowdowns or pauses in vaccine manufacturing, distribution, administration and uptake. SEI's firm view is that investors should use this moment to diversify away from tech-heavy portfolios, which includes a large number of the major indices and therefore passive implementations.

- Politics will also come into play, and can either act as a tailwind or a headwind. One of the most important nominations put forth by President-elect Biden is that of former Fed Chair Janet Yellen as Treasury Secretary. A close working relationship between the Treasury and the Fed will probably be reassuring for investors in the near term, since there is little doubt that the central bank will continue its extraordinary efforts to support the economic recovery in 2021.

- Casting our focus across the Atlantic, the last-minute Brexit deal provided a Christmas gift of sorts, at least in terms of removing a degree of uncertainty. While a skinny deal is better than none, the U.K.'s long period of intense uncertainty continues to a degree, as the deal addressed the transfer of goods but not commerce in services.

- U.K. equity valuations, in our opinion, reflect much of the bad news. Maybe it is time to for investors to think about the things that could go right, including a vaccine headstart, competitive labour unit costs, unfolding global trade deals and favourable conditions for engagement with the US on trade given successful navigation away from any pitfalls arising from the conditions of Brexit as it relates to Northern Ireland.

[6] Source: SEI

- Like so many other relationships in the equity market, the underperformance of the Eurozone benchmark has been going on for a long time. The European economy is more cyclical, value-oriented and less dynamic than the U.S. economy. But that certainly does not prohibit a rebound in performance against the U.S. stock market at a time when the latter appears to be excessively tilted toward technology stocks, the dollar is weakening and a global economic recovery is at hand.

- The pandemic has had one good outcome for Europe. It finally forced Germany and other fiscal “hawks” to allow an expansion in fiscal policy. This move away from budgetary austerity should be viewed in context. Most countries have experienced a sharp rise in red ink this year, and the biggest deficits are outside the Eurozone. The Europeans probably can afford to run higher deficits than the IMF appears to be pencilling in for 2021.

- Emerging-market equities have been on a tear since they bottomed out last March. For 2020 as a whole, the MSCI Emerging Markets Index (total return) has climbed by 18.3%, a slightly better performance than the 15.9% gain registered by the MSCI World Index (total return), which tracks the performance of developed-country stock markets.

- However, the Emerging Markets Index is still just 10% above its previous high-water mark recorded in January 2018. Frontier markets have fared even worse. The MSCI Frontier Emerging Markets Index (total return) has yet to surpass its most recent pre-pandemic high level recorded last January.

- Fortunately, not only has the combined firepower of global central banks prevented a liquidity crisis, it has also driven borrowing costs down to near-record lows even as total emerging-market debt exceeds 200% of GDP. Only two problem debtors, Argentina and Turkey, had to increase their interest rates in recent months to stem investment outflows. As the world returns to normal, other nations may need to raise rates in order to attract sufficient investment inflows to sustain their fiscal and current-account positions.

- A weak U.S. dollar is an important catalyst for emerging-markets performance. Although the greenback has weakened meaningfully this year, pushing emerging-market stock markets higher, the performance of emerging markets relative to developed markets has been in a narrow range. We expect that the coming year will see emerging equities relative performance improve, partly because the dollar should continue to weaken.

- If the world economy enjoys a durable cyclical recovery in 2021, the dollar should continue to fall. This would also bolster the rally in commodity prices. Commodities of all sorts have been rallying sharply since the spring. This is the first time since the 2009-to-2011 period that metals, raw industrials and foodstuffs have all rallied at the same time.

- Signs of a recovery should continue to reveal themselves as COVID-19 abates and economic activity normalises. In the meantime, fiscal spending and accommodative central-bank policy should prop up inflation. As the market prices in these developments, “long-duration” growth and expensive high-profitability stocks should be pressured, while momentum investors are likely to rotate into new themes, potentially adding more fuel to this nascent cyclical rally.

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