SEI Strategic Portfolios

MAY 2019 MONTHLY COMMENTARY

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Equity markets decline in May 2019; headwinds for valuation-focused strategies intensify as US-China trade war heats up and European politics bifurcate

Executive Summary

- Global equity markets gave back a significant part of earlier gains in May 2019, primarily driven by a negative escalation of the US-China trade negotiations. Emerging markets lagged developed markets and are now some 5% behind on a year-to-date basis. Fixed income markets overall gained, providing some benefit to the diversified investor, however US high yield was a stand-out detractor, emphasising the equity-like character of this asset class.
- Considering the Stability-Focused SEI Strategic Portfolios, an overweight to credit in the global investment grade asset classes detracted as did an overweight to higher yielding fixed income. The strategic allocation to US high yield fixed income also detracted. Consistent with its objective, the Global Managed Volatility Equities asset class outperformed the equity market and by design was able to provide meaningful risk reduction.
- For the Growth-Focused SEI Strategic Portfolios, positioning around valuation-focused managers detracted further from the broad-based market declines. Despite the ongoing challenges, taking a historical perspective, SEI believes it is important to remain patient, as evidenced by previous cycles. While so-called 'growth' stocks outperformed 'value' stocks between 1988 to 2000 and since 2007 to the present day, 'value' stocks outperformed meaningfully between 1980 to 1988 and very significantly between 2000 to 2007. SEI's view, given valuation dynamics today that are comparable to the dot-com frenzy of the late 1990's, is that the pendulum is likely to swing the other way again.
- 85 years ago, Sir John Templeton, one of the world most successful investors during his lifetime, suggested that the four most costly words in investing are: 'this time, it's different'. Analysis has shown that on a 10-year rolling basis, the current performance differential has only been experienced three times: during the great depression, the dot-com bubble, and the current market; clearly these are once again difficult times for this investment approach.
- However, viewing matters from another lens, it is estimated that value stocks beat growth stocks by four percentage points a year between 1926 and 2007, outperforming in 90 percent of 10-year periods. Combining the hard data presented by the current difficulties with time-tested wisdom from some of the world's leading investors supports SEI's positioning, which is based on a view that there is an investment opportunity at hand.
- While somewhat painful and definitely frustrating, SEI continues to believe that this scenario will ultimately mean revert. Some of the world's most successful investors have achieved their results through hard-nosed discipline; SEI believes strongly that this is the correct approach. In this context SEI feels there is a lot of embedded investment value in a number of the underlying equity asset classes, and continues to present a strong opportunity on a forward-looking basis.
- Despite the market reversal and the challenges around valuation-focused managers, the SEI Strategic Portfolios maintained their highly competitive position against peer groups, with the Stability-Focused portfolios delivering on their mandate of drawdown protection through the challenging last quarter of 2018 and in May 2019, while the Growth-Focused portfolios provided above-average returns against peers, with the Aggressive Fund outperforming the average of its peers in the first five months of 2019, as well as over the 3- and 5-year periods to end of May 2019. (Wealth A Distributing Share Class, in GBP, net of all fees).

Market Overview

The early-year global rebound in stocks came to a halt during May. Emerging market equities were hit hard, particularly China, and cyclical sectors tumbled sharply around the globe alongside oil prices. Government bond yields declined in the UK, Europe and US; the 3-month-to-10-year spread on US treasuries turned negative again after briefly inverting in March, prompting renewed speculation about the reliability of this fairly dependable recession indicator.

Prime Minister Theresa May announced on 24 May her intention to resign in early June following a poor showing for Conservatives in European Parliamentary elections; more than a dozen candidates have since announced plans to run as her replacement. UK manufacturing activity tipped slightly into contraction during May, as the respectable growth exhibited during April evaporated. Services sector activity remained modestly within growth territory. Labour-market conditions were firm in April, with the claimant-count unemployment rate holding at 3%; the broader January-to-March unemployment rate edged down to 3.8% (from 3.9%), while average year-over-year earnings growth eased to 3.2% (from 3.5%) in the three month period.

Elections for European Parliament exposed support for centrist parties shifting toward more polarising alternatives on the left and right. Concerns about the impact of climate change bolstered the Green Party alliance, especially in Germany, where it outpaced the Social Democratic Party. Euro-sceptic nationalist parties also fared well, particularly in France and Italy, where they earned a plurality of votes. Eurozone manufacturing conditions contracted in May for the fourth straight month. Services sector activity continued to expand, albeit at a slower pace. The eurozone unemployment rate edged down to 7.6% in April, primarily thanks to a large decline in Spanish joblessness.

The US Fed and the Bank of England held their respective meetings at the beginning of May; both declined to adjust their monetary policy paths. The US announced an escalation in tariffs on Chinese imports in early May as a trade delegation was headed to the US. Tariffs on USD200 billion of Chinese imports were increased from 10% to 25%, with proposed additional tariffs of 25% on the remaining USD300 billion in US imports from China, which could take effect in the coming months. China responded with plans to raise the tariff rates on about USD60 billion of imports from the US in June. US manufacturing and services growth continued to decelerate in May. The US economy grew at a 3.1% annualised rate during the first quarter, based on a slight downward revision in the latest estimate.

Selected Asset Class Commentary

Global Managed Volatility Equities Asset Class: The asset class outperformed its benchmark in May and delivered significant risk reduction. All three managers outperformed the benchmark and achieved meaningful risk reduction favoured by style tailwinds. Wells Fargo Asset Management performed best due to its deep low volatility exposure. Meanwhile, LSV Asset Management was hurt by its value tilt. The asset class is designed to provide risk mitigation in stressful market environments at a cost of lagging in rallying markets. It was overweight defensive sectors, such as consumer staples, utilities and health care. It was underweight more risky sectors, such as information technology and industrials.

UK Equities Asset Class: The asset class modestly underperformed its benchmark in May. Style effects were neutral; although the concentration of the benchmark index can make it tricky to untangle style effects from stock specifics. Ultimately, the strongest performance for the month came from the largest stock in the index (Royal Dutch Shell); the building block's underweight to the stock detracted. The asset class' holdings in a number of out-of-favour consumer stocks that were de-rated after disappointing results also hurt. Jupiter Asset Management faced style headwinds during the month. Its underweight to energy also detracted. Lindsell Train benefited from quality style tailwinds.

Manager Changes

None over the period.

Outlook

There's no denying that a synchronised global growth slowdown is underway. However, it does not mean that the global economy is in (or near) recession. China and the UK, for example, are the second and fourth worst-performing countries, according to the Organisation for Economic Co-operation and Development's composite leading indicators. Yet China continues to post gross domestic product growth in the vicinity of 6%, while the UK recorded an increase of 1.3% last year (both in inflation-adjusted terms).

The spread between 3-month and 10-year US treasuries turned convincingly negative in May after narrowing throughout much of the expansion. Recession historically occurs within 12 to 18 months of the yield curve either narrowing to 25 basis points or inverting. The only time recession did not follow a yield curve inversion was in the 1966-to-1967 period, although US economic growth did slow dramatically.

Deeper recessions usually cause sharper share-price declines, as was the case in 1973. More expensive stock markets, as seen following the 1998-to-2000 tech bubble, also are more vulnerable. But the time between an initial yield curve inversion and the emergence of a bear market can be extremely long.

By stressing patience and data dependence, the US Fed's change in rhetoric at the start of the year certainly has been a helpful catalyst in sparking the risk-asset rally and credit-spread narrowing. The Fed's decision makers approvingly noted that the benefits of the long economic expansion are finally being distributed more evenly as the labour market tightens; they seem confident that the economy can grow without generating worrisome inflationary pressures, even as most measures of labour-market activity point toward accelerating wage inflation.

In SEI's view, there are plenty of opportunities in emerging equities as investors gain confidence that the worst is behind us for the asset class. But a sustained improvement depends on better global growth. In SEI's view, China is the linchpin; SEI remains optimistic that the country's economic conditions will improve as it begins to feel the lagged impact of easier economic and monetary policies.

SEI also expects domestic political pressures will likely force the Chinese government to ease further. Those political pressures certainly have influenced China's trade discussions with the US. Meanwhile, Trump is grappling with similar pressures; he does not want the US economy to sputter or the stock market to turn down as the country heads into a presidential election year. To put it bluntly, the leaders of both countries need a "win".

While it may seem like a remote possibility today given the recent acrimony between the US and China, an expansive trade agreement would provide a much-needed boost to the Chinese economy. It also would benefit nations that have high export exposure to China, both directly and through the supply-chain network. MSCI Emerging Markets Index performance will depend on the economic fortunes of China, South Korea and Taiwan, which now account for 54% of its market capitalisation as at 31 May, according to MSCI.

Investor pessimism about Europe appears overwhelming. The European Central Bank recently cut its forecast for 2019 eurozone gross domestic product growth to 1.1% from 1.7% just three months earlier. It's a wonder that the year-to-date performance of European equities managed to nearly keep pace with that of US equities.

Many of Europe's problems are structural and difficult to improve. Its demographic profile, for example, looks rather bleak. Europe is the only major region where the population is expected to contract between now and 2050. The unemployment rate for Europeans aged 25 to 29 is still in double digits. Of course, demographics alone do not explain Europe's poor economic performance. A well-developed welfare state has its costs in the form of high taxation, extensive work rules, and regulations.

The shadow of a looming trade war with the US surely hasn't helped sentiment in Europe. European autos appear safe from tariffs for the time being, but headline risks may continue to have negative impacts and it's still possible that Trump will turn his full attention to trade with Europe once his administration concludes negotiations with China. China's slowdown is an additional factor behind the slide in Europe's exports. Not only was European industrial production in decline for the 2018 calendar year, but it started this year 23% below its January 2008 level.

The uncertainty surrounding Brexit outcomes and timing remains a depressant for economic growth in the UK and the rest of Europe. Bottom-up analysts expect UK earnings to decelerate to just 1.8% in 2019, which is in stark contrast with last year's surprisingly strong rate of 10.9%.

The re-emergence of heightened volatility since the beginning of 2018 is a reminder that one should always expect the unexpected when it comes to investing. Cash was king in 2018, providing a 2.1% return. However, cash was consistently one of the worst performers in most other years going back to 2009. Emerging equities fell at the other end of the performance spectrum in 2018, sustaining a total-return loss of 14.6%, but was the strongest category in 2017 and posted a double-digit return in 2016.

In a world where the best- and worst-performing asset classes tend to dominate the headlines, it can be easy to forget that diversification has historically been the most reliable approach for meeting long-term investment goals—especially when looking through the lens of risk-adjusted returns. While a diversified portfolio rarely wins from one year to the next, it also rarely loses, and therein lies its beauty.

Important Information on Performance

Past Performance is not a reliable indicator of future results. Standardised performance is available upon request. All data is as at 31 May 2019.

Asset class performance discussed is based on the majority SEI fund underlying the asset class. This does not include analysis of the manager pools, hedged share class investments within SEI Funds, additional SEI funds or any third-party funds within the Strategic Portfolios. As a result, performance for the total asset class allocation may vary. Not all asset classes discussed are included in all Strategic Portfolios. All asset class comparative performance is relative to the benchmark of the specific SEI fund representing the majority of the asset class investment.

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- *Fixed income securities are subject to credit risk and may also be subject to price volatility and may be sensitive to interest rate fluctuations.*
- *Absolute return investments utilise aggressive investment techniques which may increase the volatility of returns. If the correlation between absolute return investments and other asset classes within the fund increases, absolute return investments' expected diversification benefits may be decreased.*
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