NEW FRONTIER

Market Perspectives: 2nd Quarter 2012

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

Dr. Richard O. Michaud

President and CIO

New Frontier

Dr. Michaud earned a Ph.D. in Mathematics from Boston University and has taught investment management at Columbia University. He is the co-holder of four U.S. patents and is the author of *Efficient Asset Management* and many professional and academic articles.

A Long Road Ahead

The slowdown in global economic activity and heightened macroeconomic risks were reflected in negative equity returns for the quarter. The Dow fell 3%, the S&P 500 3%, and the NASDAQ 5%. International equities were even more affected by the downturn with the MSCI EAFE dropping 7% and the MSCI Emerging nearly 9%. The flight to quality resulted in positive returns for bond indices. The Barclays Capital Aggregate Bond Index was up 2% and long term treasuries up 12%. U.S. market volatility as measured by the VIX spiked at 26 during the quarter but ended at 17 which is nearly the lowest point for the quarter. The dollar rose 5% relative to the euro but declined by 3% relative to the yen. Oil prices fell by over 17% reflecting the downturn in the global economy. However, the Dow was up 5.5%, the S&P 8%, and the NASDAQ 13% year-to-date. Almost all of New Frontier's ETFs were in positive territory for the year.

Perspectives

The most important economic news in the quarter occurred in the last two business days. Investors were losing patience with seemingly endless and ineffectual eurozone summitry. But the resolutions by the four major eurozone members at the end of the quarter were different. The agreements allow recapitalization of Spanish banks and purchase of Italian sovereign bonds. The proposals appear to effectively address short- and long-term problems in the eurozone economies. Importantly, the resolutions indicate that Berlin was willing to make concessions to use short- and long-term bailout measures.

Details of the agreement still need to be worked out and voted on. However, the basic structure is clear. Funds in the existing European Financial Stability Facility (EFSF) will be used to address the short-term credit needs of Spanish banks. The funds in the soon to be implemented European Stability Mechanism (ESM), scheduled to replace the ESFS, will be available for purchase of Italian debt. Perhaps most importantly, European leaders pledged to establish a new agency at the European Central Bank (ECB). Under the new rules, Mario Draghi's role as the head of the ECB is to be expanded and will be closer to that of the Federal Reserve Chair. The proposal is that the ECB has direct supervision and regulation of all eurozone banks. The agreement for the ECB's regulator role is to be hammered out by the end of the year, which is necessary if ESM funds are to be used in a bailout. The agreement correctly recognizes that only eurozone-wide instruments and policies can affect solutions.

continued on page 2

About New Frontier

New Frontier is a Boston-based institutional research and investment advisory firm specializing in the development and application of state-of-the-art investment technology. Founded in 1998 by the inventors of the world's first broad spectrum, patented, provably effective portfolio optimization process, the firm continues to pioneer new developments in asset allocation and portfolio selection. Based on practical investment theory, New Frontier's services help institutional investors across the globe to select and maintain more effective portfolios.

More information is available at **www.newfrontieradvisors.com**.

Berlin's conditional willingness to address the eurozone banking crisis rallied capital markets worldwide. Even so, the eurozone is almost certainly in recession. The June Purchasing Manager's index (PMI) indicated that the manufacturing sector is shrinking at its fastest rate in three years. Sovereign bond yields are unsustainably high, not only for peripheral, but also for the third and fourth largest eurozone countries. Unemployment has been increasing and is now over 11% eurozone-wide and is far higher in many countries.

Germany's calculation has to be that they are likely to lose far more in a major euro breakup than in trying to maintain it. But can the resolutions resolve the problems? No problem can be solved without understanding the causes and having appropriate remedies at hand.

Germany's bailout requirement for austerity is easily rationalized. Without good fiscal and political order, bailouts simply postpone the inevitable. Structural reforms and fiscal discipline are essential. Most European economies are afflicted with social immobility, social divisions, static societies, and closed economies. The politically difficult, but economically necessary conditions for effective resolution require tax, labor, and social welfare reform in most European countries. Only the threat of a complete economic meltdown seems sufficient to concentrate political will for fiscal discipline.

But Germany's insistence on deficit reduction for indebted economies in a severe economic downturn compounds the problem. Drastic spending cuts lead to massive layoffs and high unemployment resulting in an inevitable decline in demand, slowdown in economic activity, and negative economic growth. The laws of economics grind inexorably. Keynes-Samuelson principles of modern macroeconomics teach that the more appropriate course is to borrow and stimulate now and have the discipline later to cut back when the economy has been primed. Austerity in a downturn is a severe, possibly fatal, macroeconomic management error that can lead to a deflationary spiral and depression. While there is hope, it is far from inconceivable that sufficiently poor macroeconomic management in Europe could yet lead to massive unemployment, political chaos, and a global depression.

The U.S. economy remains in a slow growth pattern. While jobs are still being created, there is little optimism of significant reduction in unemployment or of GDP growth exceeding 2% anytime soon. The U.S. factory sector shrank in June for the first time since July 2009. The Institute for Supply Management's (ISM) manufacturing index indicated that

continued on page 3

New Frontier Portfolios

New Frontier develops and manages a broad range of ETF-based asset allocation portfolios for advisors and their clients, and currently oversees over $1 billion in global ETF asset allocation portfolios.

contraction in the U.S. economy is being negatively affected by the slowdown in Europe, China, South Korea, and Taiwan. While the U.S. economy is relatively self-contained, it is nevertheless affected by economic factors beyond its borders.

Look Ahead

The news from Europe seems hopeful. The EU summit resolutions are headed in the right direction and have buoyed global markets. The availability of ESFS and ESM bailout funds is good news in the short- and medium-term. A eurozone-wide banking regulator at the ECB under Mario Draghi's direction is a solid step in a longer-term solution. The EU summit resolutions and economic activity slowdown have reportedly also encouraged a more accommodating ECB monetary policy.

But the final details of the bank regulator proposal at the ECB have yet to emerge. Will the new agency have the power to rein in risky practices and hold offending banks accountable? To the skeptical, recent policy changes are still not much more than stopgaps. The existence of a true banking union, where regulation and backstops are handled at the federal level, is the biggest difference between the financial systems in the U.S. vs. Europe. The long necessary road of a banking union and more political and fiscal integration lies ahead.

Domestically, a shrinking manufacturing sector is disturbing. But most macroeconomists feel that the ISM should rebound and the U.S. will continue to grow. The Fed continues to stand ready to promote economic growth with all the tools at its disposal. U.S. stocks seem relatively fairly valued. While there are still serious Middle East concerns, the threat of rising oil prices seems distant. Economic analysis does not suggest another recession is looming.

However, the greatest risk to the American economy is political dysfunction throttling the recovery. If nothing is done, the looming "fiscal cliff" of sharp budget cuts and expiring tax cuts at year end is likely to toss the economy into a deep recession. The uncertainty associated with the presidential election and ongoing congressional stalemate may already be stalling business activity. In many cases, modern macroeconomic principles of economic management are being ignored in the name of political calculation. The fervor for fundamental change in the American economic and financial system has largely abated. The J.P. Morgan hedge losses are a reminder that even the best managed banks take risky bets that, in other instances, may

continued on page 4

cause serious economic disruptions. Rating agency credit downgrades continue to indicate weaknesses in the nation's current financial system. Many of the largest banks are undercapitalized and host balance sheets cluttered with toxic assets. We are seeing many lost opportunities for repairing the problems in the nation's financial system and enhancing the competitiveness of the American economy for the 21st century.

Effective diversification remains the single most reliable strategy for managing economic uncertainty. Investors should carefully weigh the level of systematic risk appropriate to their long-term investment objectives and consistent with contemporary global macroeconomic risk. Time horizons and global forces are always considerations. The importance of diversification is always prudent for long-term core investments.

Research News

Dr. Michaud presented the New Frontier paper: "Portfolio Monitoring in Theory and Practice," co-authored by Dr. David Esch and Robert Michaud, at the International Symposium on Forecasting conference June 26, in Boston. The paper is scheduled to appear in the *Journal Of Investment Management*, 3rd quarter. The Richard Michaud interview of Dr. Harry Markowitz published in the *Journal Of Investment Management* is recommended to all students of modern finance and is available as a free download at our website: www.newfrontieradvisors.com.

July 6, 2012