Market Perspectives: 1st Quarter 2010

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 4 U.S. patents and author of *Efficient Asset Management* and many professional and academic articles.

Inflection Points

The quarter's major stories were the positive performances of U.S. equities, the dollar, and many Asian markets, as well as climactic resolution of health care reform legislation and its implications for domestic economic management. The Dow rose 4%, the S&P 500 5%, and the NASDAQ 6%. The small cap Russell 2000 gained 9%. The quarter's performance was in spite of an 8% drop in the market during the height of the health care political storm. Many Asian markets reflected positive performance with the MSCI Pacific Index rising 6%. In particular Japan's Nikkei 225 Index gained 5% while the dollar was largely flat against the yen. However, in a reversal, the Shanghai Composite Index and Hong Kong's Hang Seng Index posted some of the worse performances falling 5% and 3% respectively. Global diversification was challenging due to a 6% rise of the dollar relative to the Euro. The MSCI Europe Index declined 2% in dollar terms even as major European markets ended higher in local currency. The credit worthiness of Greece and other Euro countries weighed heavily on performance. Indeed, the dollar's performance was a surprise to many institutional firms that had bet heavily against the dollar and had to rescind their recommendations. Commodity markets showed signs of stability, and the VIX reflected normal long-term values of volatility.

The bond markets were active, but returns were modest, roughly 2% for the Barclays Capital Aggregate Bond Index. The Federal Reserve's policies continued to favor economic growth and near zero interest rates. The Fed announced that it would end its mortgage purchasing program by the end of the quarter. The emergence of an exit strategy coincided with grudging but persistent indications that a recovery was taking hold. While productivity, sales, and inventory were positive indicators it will be a jobless recovery with large persistent budget deficits. Unemployment remained high with little hope of a major turnaround for the next two to four years.

Perspectives

Eight million jobs have been lost since the recession began three years ago, eight hundred thousand in the first month of the Obama administration. With 10% of the workforce unemployed, consumer spending will not be a major driver of the economy anytime soon. But the recession is a lot milder than it could have been. We are not experiencing depression level unemployment of 25% or wholesale destruction of businesses. A wide consensus now exists that the U.S. economy is in a state of slow, but sustainable, recovery. The fear of a double dip recession has largely receded. The 162,000 job growth reported in March, though 25% census

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**.

related, is a solid gain. The economy appears to be at an inflection point in the recovery.

Many political issues dominated the domestic economy. The Republican strategy of voting as a block was highly effective in limiting Democratic initiatives. Having no bipartisan support, and after a year of effort, the Obama administration decided to use a filibuster proof strategy to pass their signature health care bill, though it meant including some very unpopular elements. The Scott Brown election January 19th voided the filibuster strategy and raised the prospect that the executive branch of the U.S. government may be unable to implement their program for dealing with the most severe recession since the Great Depression. It is interesting to note that during this period of uncertainty the market declined 8% from January 19th through February 7th. After much reconsideration, an effective, though controversial, majority-rule-based strategy emerged.

Although political calculation was a factor, there are key differences in economic principles that contributed to recent political stasis. The Obama administration is using Keynes-Samuelson economics for managing the recession. This route requires government intervention with targeted spending and budget deficit financing while limiting the use of broad based tax cuts. These initiatives contradict the free market principles that have been popular in the Republican Party. While the Keynes-Samuelson principles appear to have been effective so far, there are limits to the benefits of deficit spending. There remain many uncertainties in practice.

The government's many stimulus and credit management policies are slowly ending. The U.S. program of supporting the MBS market, one of the world's largest, ended at the end of March. The purpose of this program was to pump liquidity into the mortgage market and slow the collapse of the U.S. housing market. The Fed now owns more than a quarter of Fannie and Freddie MBSs. Nevertheless, foreclosure rates remain high, and tighter credit standards slow the impact of the program, while the private mortgage market has not revived. The problems remain pervasive and difficult.

Look Ahead

The two main engines of global economic growth remain the U.S. and China. Both have uncertainties that will dominate the year. The dismantling of government stimulus programs and credit market support will be major factors affecting capital markets near and long term. Unemployment and foreclosures will continue to be a focus of the administration's policies. Success in managing the recession will determine the political landscape for some time to come.

In the case of China, there is a sense of some bloom off the rose. The Renminbi peg is not sustainable if for no other reason than rising global resentment and threats of intervention. The market is overheated; valuations

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.

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

are high; corruption is rampant; and insularity, as measured by the Google controversy, augurs increased uncertainty for foreign investment. Yet the Chinese economy is a major factor in global economic growth. Some accommodation on economic and intellectual property policies would be welcome and would relieve many of the growing stresses. On a related note, the recent revival of the Japanese stock market suggests that Asian markets may be important drivers in the revival of the global economy.

In the case of Europe, strong economies are being negatively affected by systematic weaknesses in the Euro. A number of Euro zone countries could end up defaulting on loans. The current agreement with the International Monetary Fund may not be sustainable if the weaker economies do not get their fiscal houses in order. But the demise of the Euro seems almost unthinkable. Too much is at stake for the healthier European economies not to find some way of effectively dealing with the problem. Euro uncertainty, however, may persist for some time until a clear path long term resolution evolves.

Global synchronicity, or the increase in correlations among global capital markets during financial distress, is often a symptom of excessive leverage in capital markets. The recession has resulted in an ongoing process of deleveraging that will lower correlations and enhance the benefit of global diversification. However, financial regulation particularly with respect to too-big-too-fail institutions has yet to be implemented. Proposals to return to Glass-Steagall have met with some support. The potential for self-dealing with respect to proprietary trading desks has yet to be regulated. Old habits of leveraged derivative strategies that have the capacity to be disruptive to global capital markets appear to be returning to hedge funds and investment institutions. The major economies have not been successful at proposing regulations all can abide. Each seems more interested in preserving their financial turf than making strides in necessary global reforms. This serious risk is yet to be addressed.

Investors often look to history to anticipate trends in stock prices. But there are many pitfalls. In a study of stock markets extending back to 1910, Elroy Dimson of the London Business School and his colleagues have found that stock performance relative to treasuries was nearly the same after the worst or best years in the market. They found that fundamental valuation, not past performance, determined future performance. Currently the U.S. has a somewhat higher P/E than historical, but inflation is low and productivity is improving. Barring unforeseeable risks, the prospects of steady growth seem promising. However, sentiment can run ahead of fundamentals, and it is always wise to remember that in spite of the good performance in recent quarters the market remains roughly 25% below its highs of October 2007.

Effective global diversification at an appropriate systematic risk level remains the most likely route for core investors to optimally meet long term objectives. Innovation remains the ultimate source of economic growth in capital markets.

April 5, 2010