NEW FRONTIER

Market Perspectives: 3rd Quarter 2016

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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A Fitful Calm

Markets

It was a profitable period for well-diversified multi-asset strategic investors in global equity markets. The S&P 500 was up 3.3% for the quarter and 6.1% year-to-date, the Dow Jones gained 2.1% this quarter and 5.1% for the year, and the NASDAQ was up an impressive 9.7% in the quarter and 6.1% for the year. Domestic small cap outperformed large cap with the Russell 2000 gaining 8.7% for the quarter and 10.2% for the year. Diversified international equity was also profitable with the ACWI gaining 5.3% this quarter and 6.6% for the year, and the ACWI ex US up 6.9% in the quarter and 5.8% for the year. However, on a more micro basis, individual international indices were mixed. The STOXX 50, representing developed European markets, increased 4.8% in the quarter but was down 8.7% for the year. Similarly, the Japanese Nikkei 225 gained 5.6% quarterly but is down 13.6% for the year, while the SSE Composite was up 2.6% in the quarter but down 15.1% for the year. On the other hand, the Hang Seng was up 12.0% for the quarter and up 6.5% for the year. The MSCI Emerging markets index was also up 8.8% for the quarter and up 15.0% for the year.

Fixed income and equity alternatives were mixed, with major indices down for the quarter though typically up for the year. REITs were down 1.3% for the quarter, but up 12.5% for the year while minimum volatility was down 0.9% for the quarter but gained 11.0% for the year. The US Aggregate Bond Index, commonly known as AGG, gained 0.5% in the quarter and 5.2% for the year. The US dollar lost 1.8% for the quarter and 15.9% for the year against the yen. On the other hand, the US Dollar gained 2.8% in the quarter and 13.7% for the year against the pound. Though gold lost 0.7% for the quarter, it was a stellar performer for the year gaining 23.3%. The VIX is below normal volatility at 13.3 while the 10-year T-bill is at 1.6%, down from 2.24% at the beginning of the year.

Perspectives

For the first two months of the quarter, markets reflected an uneasy calm of historically low volatility followed by a September with a spate of fitful spikes only to return to near status quo of grinding growth rates. This is a reminder that the Great Recession of 2008-9 remains with us in important ways. While the Federal Reserve has taken their foot off the pedal of quantitative easing, other central banks had aggressive monetary stimulus programs. Investors remain hypersensitive to central bank decisions, uncertainty from a bizarre presidential election cycle, and the presence of highly leveraged investment strategies.

For the Fed, the issue at the September meeting was whether the U.S. economy had exhibited sufficient economic health that interest rates could begin slowly moving

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.

toward a more neutral policy. While there were three dissenters, the Fed did not vote to raise rates. The reasons were less whether the American economy has healed sufficiently than the existence of major global risks. The presumption of the sustainability of U.S. economic growth when the American economy remains the major persistent driver of global growth mandates caution. U.S. markets reacted positively to the no-change decision. Given current trends the consensus is that the Fed will begin to raise interest rates modestly by the end of the year with a small number of small increases in 2017.

In contrast, the major European and Asian central banks were actively implementing further stimulus programs. There are some signs of positive effect. Though yearly returns were down, quarterly index returns were up for Europe, China, and Japan. This is in spite of demographic, structural, and political headwinds and, in the case of Europe, no unified banking system. It is worth noting that Brexit looms as a notable disruptive economic factor for the eurozone. It is potentially an existential threat to the ultimate hegemony of the European compact, the long-term viability of the euro, and London's status as a premiere global financial center. Europe remains an enormous and very rich engine of potential economic growth but near-term prospects remain clouded.

Look Ahead

It is important to be cognizant of economic reality in order to have a reliable perspective on future investment opportunities. The fact that the American economy has taken so much longer to recover than prior historical recession periods since the Great Recession has often been used to critique the Bernanke-Yellen Fed macroeconomic monetary policies as ineffective or even perverse. However, there are important rationales for understanding the historically slow recovery. In the pantheon of macroeconomic theory, fiscal policy is a howitzer and monetary policy is a rifle. While the 2008-2009 Bush-Obama fiscal stimulus packages were helpful, congress has been unwilling to provide any further direct fiscal stimulus support during this eight year period. Monetary macroeconomics, the only game in town globally, is designed to be useful for managing economic cycles, not for stimulating economic growth long-term. While the prospects for fiscal stimulus have been politically stalemated, spending for infrastructure, research, and education has been neglected with potentially dire long-term consequences for American global competitiveness. In retrospect, it seems remarkable that the U.S. economy has been able to grow as much and as persistently as it has.

From a global perspective, there is a sense that monetary policies may be reaching a limit in the ability to be further effective. Remaining arrows in the quiver may have unexplored and unintended negative side effects. The European Central Bank has made plain the need for fiscal stimulus by eurozone members in order to support further benefits of monetary policies.

continued on page 3

New Frontier Portfolios

New Frontier develops and manages a broad range of ETF asset allocation portfolios for advisors and their clients, and currently oversees nearly $2 billion in global ETF asset allocation portfolios.

A long period of very low volatility in capital markets tends to encourage investment in highly leveraged investment strategies. Samuelson has called such strategies "desert flowers." The presence of significant levels of leverage in capital markets, with uncertainty of short- and long-term interest rates, may often result in large spikes in market volatility. This is one of the downsides of a long period of low interest rates and predictable monetary policies. There is much levered strategy risk in U.S. markets.

The era of predictable long-term low interest rates also has important consequences for global financial intermediation. Intermediaries typically rely on historically nominal long-term interest rates to fund insurance, banking, and pension liabilities. A 30 year T-bill interest rate of 2.3% is well below nominal actuarial assumptions for pricing many long-term liabilities. At some point, the strain of funding long-term liabilities could be commercially unsustainable, with the prospect of even large well capitalized institutions being likely to fail. This is a looming unresolved long-term risk for global capital markets.

A number of reports have noted the underperformance of many active fund managers over recent periods. More than 90% of large cap managers, short- and long-term, have underperformed standard benchmarks. In addition, hedge funds are under fire for short- and long-term underperformance and high fees. New Frontier's multi-asset strategies only invest in well-diversified index ETFs. We rely on institutional quantitative investment expertise and unique patented state-of-the-art portfolio management technologies to add value to meeting relevant strategic benchmarks. Recent Morningstar reports have noted that many of New Frontier's multi-asset strategies have been ranked in the top five and ten of ETF managers over recent five year periods.[1]

For the U.S. market, the presidential election is the joker in the current global capital market deck. Political risk is fundamentally the single most important risk facing investors. Major, possibly radical, changes in domestic economic policy and foreign relationships could result in unhinging much trade, military, and geopolitical relationships, not to mention domestic entitlement, tax, and social policies. There is no way to forecast the potential tumult of a major change in political direction at the presidential level. Investors are well advised to be effectively-diversified domestically and globally over the next few weeks.

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[1]Source: Morningstar ETF Managed Portfolios Landscape Report Q2 2016. The Morningstar report displays gross performance. Real performance would be decreased by fees.
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