Market Perspectives: 1st Quarter 2018

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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The Return of Volatility

Markets

Markets began the year as they had been over much of 2017, but changed their tone over the quarter—volatility reemerged, interest rates rose, the dollar fell, and equity markets retreated. The VIX began 2018 at 10.95, the lowest first day of any year in its history, but ended the quarter above its historical average at 19.97. Major domestic large cap indices were mixed for the quarter: the S&P 500 and the Dow were down 1.2% and 2.5% respectively, but tech heavy NASDAQ was up 2.3% and small cap was essentially flat with the Russell 2000 declining only 0.4% for the quarter. Value and growth securities continued on their separate paths – the S&P 500 Value index declined 4.2% for the quarter while the S&P 500 Growth index was up 1.6%. International equities were also down. ACWI was down 1.0% for the quarter, and the ACWI ex-US declined 1.2%, with the STOXX 50 down 4.1% and the Nikkei 225 declining 5.8% for the quarter. Emerging market indices were a bright spot: the MSCI EM index gained 1.4% in spite of the SSE Composite falling 4.2% for the quarter.

Interest rates rose and US bonds were down for the quarter with the 10-year rate rising 0.34% to 2.74% and the US AGG down 1.5%. The Dow Jones US Select REIT index fell 8.4% for the quarter – by far the worst performer out of common indices. The global currency US Dollar Index fell 2.1% – declining 3.7% against the Pound, 5.6% against the Japanese Yen, and 2.4% against the Euro. Gold rose 1.7% to $1324 per ounce and oil rose 7.5% to $64.94 per barrel. Perhaps the best single indicator of market performance across all global asset classes is New Frontier's 60/40 Global Balanced Index. NFGBI was down 1.0% for the quarter.

Perspectives

This quarter marked an inflection point in market volatility. 2018 brings the first negative quarter for the US or global markets since 2015. These nine quarters of positive returns compare to the record 14 consecutive positive quarters for the S&P 500 ending in 1998. January began the quarter with another month of rising markets and low volatility, albeit with the dollar falling and interest rates rising, but then the market environment changed.

The market's unnaturally smooth 14-month post-election period ended abruptly in early February. On February 5, the VIX index had the largest one day increase in its history, rising 116% to 37.3. Investors betting on continued low volatility were rudely awakened and some inverse VIX exchange traded products were shut down after losing nearly all their value. Volatility has not been low since. The spike in volatility was likely a result of over leverage and investor uncertainty rather than the result of an identifiable major surprise shock to the market. In particular, the brief and largely symbolic shutdown of the federal government and generally pent-up doubts of

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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.

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continued smooth positive returns to financial assets may have contributed. One theme that remains consistent is the decline of the dollar, with the dollar index down 2.1% this quarter, bringing the decline to 11.8% since 2016.

On the economic front, the effects of corporate tax reductions and immigration policy have yet to play out. Lower immigration generally increases the cost of labor, whereas lower taxes stimulate investment in capital. Where the economy will land between higher wages and lower economic productivity is not known. Most economists do not agree with these policies. Keynesian economics would not recommend stimulus during a phase of the business cycle with a healthy economy and low unemployment. Nor would fiscal conservatives—tax revenue is expected to decline and spending to increase, and future generations will need to pay. According to the FY 2019 Budget published by the Office of Management and Budget, the interest on federal debt stands to be 7.4% of all federal expenditures, rising to 12.2% by 2028.

There are significant positive forces in the market. The US economy has remained relatively healthy. Growth continues with lower unemployment and moderate inflation. Other major economies of the world also continue similar trends for growth and employment with most having solidly transitioned to a post-recession state. On a less macro level, it is also worth noting that corporate earnings have generally remained strong.

Political risk remains a primary concern. While fears of a direct confrontation with North Korea have subsided for the moment, strongmen are in vogue and larger concerns remain. Russian president Vladimir Putin "won" an "election" by a landslide, with stated public support approaching Gaddafi levels. Xi Jinping firmly entrenched himself as a leader of the Chinese Communist Party for life. This raises the potential for future crises. A return to a cold war with Russia may begin with spies and diplomatic expulsions, but it's unclear where it will end. A trade war with China has more immediate economic consequences. Trade wars are rarely "won" and the short-term consequences are largely negative for all involved. It may also be poor timing for building barriers to trade since the relatively expensive US producers of goods and services are beginning to see a market among the newly affluent consumers in China.

Domestic political risks are no less significant. It's unclear what effect, if any, the continued stream of scandals coming out of the White House will have. While Donald Trump may not be a stranger to lawsuits, America isn't used to this much legal activity surrounding the personal life of a sitting president.

Personal issues can be a distraction from national issues. The continued turnover of senior White House staff and vacant positions leave the potential for a lack of management in key departments of the national government. The Secretary of State was dismissed over Twitter, and remaining high-level executives may be as

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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 $4 billion in global ETF asset allocation portfolios.

interested in dismantling their respective institutions as they are in managing them. Gary Cohn resigned as the head of the National Economic Council. It should be a significant economic event that his replacement, Larry Kudlow, a television commentator with a colorful background but no formal economics education, is now the top economic advisor to the President. However, given that Cohn's resignation was a result of his guidance on the clear and significant economic issue of tariffs and trade being ignored, it's unclear how much influence he ever had on policy. This move may merely be an acknowledgement of the focus on messaging to media rather than signaling any shift in policy.

Look Ahead

Changes in Fed policy after the transition from Yellen to Powell have yet to manifest. The healthy economy has allowed the Fed to continue its plan to gradually raise interest rates. The .25% rate hike in March is expected to be followed by two more this year. But the Fed only directly controls the short end of the yield curve. Investors are naturally concerned with the future of the full yield curve. Recent moves in the yield curve have been a moderate upward shift in the entire yield curve, but the promise of more short-term rate hikes has not had a proportional impact on long-term futures, leading to speculation of a continued flattening of the yield curve.

Inflation risk has risen. Full employment, a weaker dollar, tax stimulus, and a growing economy all contribute to an environment where inflation could return and potentially exceed Fed targets. However, a relatively flat yield curve means the market as a whole does not forecast this.

A general consensus is that we are currently in a period of readjustment. The economy reacts to macroeconomic shocks and attempts to reach some sort of equilibrium. A return of volatility associated with the readjustment was essentially a wakeup call for investors to revisit capital market expectations lingering from the bull market. Recent events have shown the calming influence of a largely healthy global economy can be quickly disrupted by political risk, both domestic and foreign, and may well keep volatility high for the foreseeable future.

With expected elevated volatility there is a demand for diversifying assets. It is also important to note that safe haven fixed income securities and currencies can't be considered safe in this environment; there is a great deal of both interest rate risk as well as potential political risk.

April 6, 2018

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DISCLOSURES: Past performance does not guarantee future results. As market conditions fluctuate, the investment return and principal value of any investment will change. Diversification may not protect against market risk. There are risks involved with investing, including possible loss of principal.

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