NEW FRONTIER

Market Perspectives: 2nd Quarter 2018

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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Tariffs and the End of Stimulus

Markets

The second quarter was marked with market volatility from geopolitical tensions, the president's tweets, and "America first" rhetoric. But the market largely ignored front page political tensions, and domestic large cap indices were positive for the quarter: S&P 500 up 2.9%, Dow up 0.7%, and NASDAQ up 6.3%. Year-to-date, the S&P 500, Dow, and Nasdaq are up 1.7%, down 1.8%, and up 8.8%, respectively. Domestic small cap posted impressive returns with the Russell 2000 gaining 7.4% for the quarter and 7.0% for the year. The difference in performance between domestic value and growth securities has continued to persist – the S&P 500 Value index returned 0.8% for the quarter and is down 3.4% for the year, but the S&P 500 Growth index is up 4.9% for the quarter and up 6.6% for the year.

Diversified global equity is mixed: ACWI is down 0.1% for the quarter and down 1.5% for the year. The ACWI ex-US declined 3.4% for the quarter and is down 5.3% for the year. International developed markets were mostly mixed as well, with the STOXX 600 returning 2.4% for the quarter but still down 2.4% for the year. Nikkei 225 appreciated significantly in this quarter, almost reversing its previous decline: the index is up 5.4% for the quarter and is now down only 2.0% for the year. Emerging market indices were a major disappointment: the MSCI EM index lost 8.5% for the quarter and is down 7.7% for the year. The SSE Composite followed the trend, decreasing by 9.9% for the quarter and by 13.9% for the year. Hang Seng declined by 3.8% for the quarter and is down 3.2% for the year.

New Frontier's 60/40 Global Balanced Index, a unique global multi-asset ETF optimized index, was up 0.5% for the quarter but down 0.5% for the year. Due to Michaud optimization technology and the New Frontier investment process, our ETF index is one of the few globally diversified bright spots in these tumultuous markets.

Bonds and equity alternatives posted mixed results. The US AGG is down 0.2% for the quarter and down 1.6% for the year. Dow Jones US Select REIT index posted an impressive quarterly return in an otherwise mixed market - up 10.0% for the quarter and up 1.8% for the year. The US Dollar strengthened against major global currencies, appreciating 6.4% for the quarter against the Pound, 4.2% against the Japanese Yen, 5.3% against the Euro, and 5.5% against the Yuan. For the year, the US Dollar is up 3.2% on the Euro, down 1.7% against the Yen, up 2.2% against the Pound, and up 2.0% on the Yuan. Gold is at $1252.60; oil has continued to rapidly appreciate in value amid OPEC output controls, settling at $74.15 per barrel. The VIX, at 16.09, is at historically average levels. The 10-year T-Bill is at 2.86%.

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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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Perspectives

Despite extreme international and domestic political risks, domestic equity volatility as reflected in the VIX, interrupted only by the prior quarter, was slightly below historical norms at levels that have persisted since March 2009 through the end of 2017. The U.S. equity market continued to outperform many international indices. It is a story very much associated with central bank policies.

The U.S. Economy

The Federal Reserve raised interest rates in June and signaled that two additional increases were likely this year. The economy has strengthened dramatically since the 2008 financial crisis and is approaching a "normal" level of economic functioning. According to the new Fed Chair Jerome Powell, the economy is in great shape, with the Fed's benchmark rate at 2% and an unemployment rate of 3.8%. The Federal Bank of Atlanta has forecast that the U.S. economy will grow at a 4.8% rate in the second quarter. The Fed plans to continue a policy of a gradual series of increased interest rates to bring the inflation rate to a target of 2%. The Fed also continues to reduce the size of bond holdings. Treasury and mortgage debt has been scaled back by more than $110 billion since September and is scheduled to reach a rate of $50 billion a month in October. This has impacted recent declines in prices for risky assets internationally. Fed policies have led to a number of emerging market currencies falling against the dollar by more than 10% since end of March. Decreased bond demand raises yields and generally impacts stocks, especially if the expansion is nearing an end. High yield bonds have benefited from the strong economy in part because they are not exposed to emerging markets and Europe.

The effects of corporate tax reductions have yet to play out. Tax revenue is expected to decline and spending increases will have to be paid for by future generations. According to 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.

The European Economy

The European Central Bank (ECB) will cease its bond buying stimulus program by the end of the year in spite of sluggish Eurozone economic growth. A number of considerations beyond pure economics motivated the planned change in ECB policy. The bank feels that the Eurozone should be able to manage sufficient growth without monetary stimulus and is unwilling to save politicians from themselves. In addition, the ECB wants to remain in economic sync with the U.S., its crucial trading partner, as it winds down its stimulus program. It is well understood that the ECB's new policy is full of risks. Italy has been taken over by anti-euro populist politicians.

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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 over $3 billion in global ETF asset allocation portfolios.

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Trade relations are at a low ebb due to proposed tariffs by President Trump. Deutsche Bank, one of the most important European banks, is in crisis. While the ECB's policies for stimulating Eurozone growth were successful in 2017, recently warning signs have appeared.

U.S. Tariff Policies

The Trump administration's proposed unilateralist trade policies are a dramatic and likely disruptive challenge to global economic growth. The President has long complained that foreign governments, allies and foes alike, have taken advantage of the U.S.'s low tariff policy for many years. In his view, U.S. free trade is the reason for the hollowing out of many U.S. industries. The global world trade order is unbalanced and inequitable. In a prisoner's dilemma game framework, the U.S. has cooperated while global economies have been defecting, leaving the U.S. with the least beneficial outcome.

The European Union is a prime agent of Trump trade inequity. The Eurozone is a free-trade area that often penalizes American companies that want to trade in the region. For many years America has paid for military infrastructure and manpower to keep Europe safe and prosperous. In contrast, Europeans spent little or nothing on defense while building vast welfare systems, including free universities and health care, with well-protected export industries.

But by far the most iniquitous trade relationship with the U.S., by universal consensus, is China's. The opening of China to the World Trade Organization (WTO) was rationalized as a way to enrich the Chinese middle-class and to encourage the country to democratize by engaging in the world economy. The opposite has happened. China has grown wealthy stealing intellectual property, while denying reciprocity in investment and trade relations. China requires foreign businesses to participate in joint ventures in which they have no control. Foreign companies must pursue approval procedures that depend on the transfer of technology for access to Chinese markets. China's unchecked abuse of the global free-trade regime makes a mockery of the very idea that the world can operate according to a rules-based order. All of these arrangements violate World Trade Organization principles, an organization deemed ineffectual by the Trump administration.

President Trump validly insists on a fair deal with all of America's trading partners and has proposed imposing unprecedented tariff policies if he does not receive it. In the prisoner's dilemma game context, all agents defecting leads to a suboptimal equilibrium for all. The additional downside is that trade wars can change the global economic and political dynamic as well as reduce global economic value for all in many unforeseeable and dangerous ways. It is worth noting that wars have often been fought over trade policies.

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The Singapore Meeting

The quarter was marked by a significant and potentially very positive geopolitical event: President Trump's meeting with Kim Jong Un, the North Korean leader, in Singapore. In the meeting, Kim pledged denuclearization of the Korean peninsula. A peaceful North Korea is likely to be the historical signature accomplishment of the Trump administration. Good news also came from meetings between the two Korean leaders with pledges of cessation of hostilities. However, there are many questions on just what the North Korean leader promised and when it would happen. No timetable has been set for necessary inspections for compliance. For all the ambiguities of the historic meeting, the effort by the President to reach out to North Korea in peace is viewed as good news for the world. But future non-compliance by North Korea could turn euphoria into bitter conflict.

Domestic Political Risks

Political ferment continues to dominate domestic news. After a two-year investigation, the New York Attorney General sued the Trump Foundation, charging that it was little more than a checkbook for payments for Mr. Trump, his children, and his businesses. The "zero-tolerance" immigration policy of the Trump administration that separated parents from children was widely condemned and apparently rescinded leaving more than 2000 children still not reunited with their parents. The Cohen probe, the Stormy Daniels affair, and the Mueller investigation continue, with Paul Manafort, the prior chair of the Trump campaign, remanded to jail for witness tampering. While Trump is no stranger to lawsuits, this much legal activity surrounding the personal life of a sitting president is highly anomalous with many risks to the political stability of the country.

Look Ahead

Up until recently, the global economy had synchronized growth. This has now changed. Capital markets are in the crosshairs of the administration's trade policies. The U.S. is strengthening as Europe and other major economies are turning sluggish. While the ECB is winding down the Eurozone stimulus program, the Fed has indicated that it may need to increase the pace of future rate increases. Europe had been expected to lead global growth, but labor strikes in France, a populist anti-euro government in Italy, softer economic data, and political turmoil within the nineteen nation block have diminished growth expectations. China is also experiencing slowing growth expectations while U.S. economic growth is accelerating. Low unemployment, strong consumer spending, and modest inflation are likely to power the U.S. economy this year. A relatively normal U.S. central bank policy may emerge by mid-2019.

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The proposed administration's global tariff policies are at a crossroad. Despite China's strong and sustained expansion, the economy is widely considered vulnerable to U.S. tariff and investment restrictions because growth has been underwritten by an even faster increase in debt. One sign of China's vulnerability is that the Shanghai Composite has hit bear territory while the yuan hit a six-month low in the quarter. With a July 6 deadline, administration officials have been trying to promote new discussions, though none are planned before the first round of tariffs. The President is said to support a less hawkish approach proposed by Senate Republicans who have introduced legislation to give new authority to the Committee on Foreign Investment in the U.S. (CFIUS) for mediating security concerns regarding Chinese investments in U.S. technology firms.

The Fed's rising interest rate policies have important consequences for investors. The relative attractiveness of defensive stocks such as REITs and high dividend yielding stocks such as utilities, telecoms, pharmaceuticals, and consumer staples has diminished. With the yield on 10-year Treasury notes in a 3% range, it is little different from the 3.1% dividend yield of real-estate stocks in the S&P, which is one of the highest yielding groups in the index. All have seen recent redemptions. Rising U.S. interest rates also negatively impact emerging markets tied to a strengthening dollar.

A consequence of rising rate Fed policy is the flattening of the yield curve. A flat yield curve has often been associated with a coming recession. But there is little economic evidence of a downturn on any near term investment horizon. The lack of benefit of duration risk has coincided with a steepening corporate-bond maturity yield curve. Investors seem to be saying they are more uncertain long-term though relaxed short-term.

Wall Street has been unnaturally calm in spite of domestic political turmoil. By any economic measure, a trade war should matter a great deal to financial markets. The market has been choppy at times but largely undisturbed. One theory is that the health of the U.S. economy trumps any geopolitical concern or domestic political risk. In effect, the U.S. can win a trade war with anyone. Unemployment is at multiyear lows, retail sales are strong, consumer confidence high, and inflation subdued. Tax cuts for businesses and consumers promote higher spending while corporate earnings are set to rise at a fast pace. Wall Street economists are not forecasting big hits to the U.S. economy from trade policies.

But a darker view is also worth considering. The S&P remains below its January peak while ignoring the benefits of new fiscal stimulus policies. Interest rates are rising and the federal government needs to increase borrowing to cover fiscal shortfalls from the recent tax cuts. Also, it is unknown what happens when targeted tariff countries begin to retaliate against U.S. trade policies. Tariffs increase the costs of

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business and limit profits. Tariff policies will likely limit global economic growth. Concerns over protectionism and an aggressive U.S. foreign policy have begun to have real global economic implications. Though some will be less impacted than others, the net impact is likely to result in sharp declines in many markets.

Global Political Risks

The global risks of the new tariff policies have soured many long term relationships with allies, some going back to the revolutionary war. Geopolitical trade tensions are among top investor concerns. While the administration can validly argue that current trade relationships need change and have needed change for many years, the global political climate is turning toxic. America is now seen by many as a politically unreliable friend. Even mutual defense treaties and policies seem no longer reliable. The likely backlash of bitter friends can't only be measured in economic terms. The future is fraught with many dark and long-term political risks.

Demographics and the Immigration Challenge

America is getting older, and the active workforce is shrinking. Baby boomers are driving up the share of non-working older adults, posing a major challenge to funding retirement medical programs. The implications have serious consequences for the immigration debate.

For much of the past few decades, the ratio of retiree-aged adults to those of working age has hardly changed. In 1980 there were 19 U.S. adults 65 and older for every 100 adults between the ages of 18 and 64. That number has barely edged up over the last 30 years. But there has been an increasingly rapid shift in the ratio. In 2017 there were 25 adults 65 and older for every 100 in their working years. That ratio could rise to 35 by 2030 and 42 by 2040. The issue is global - many countries such as Canada, Germany, and Japan will have even higher ratios.

Trustees for the Social Security Trust have warned Congress that the funds are running out of money faster than expected. Revenues from payroll taxes are lower than predicted and spending for social security benefits and Medicare is higher. Spending now exceeds revenue and spending of principal has begun, a critical moment in a pay-as-you-go system. States have also addressed the problem of rising retirement costs by reducing spending on education and health care. State pension funds now have $4 trillion in liabilities and $2.6 trillion in assets.

The U.S. has a low population growth problem. Without an expanding labor supply, it is hard to achieve economic growth. A decline in U.S. birth rates since the 2007-2009 recession is making the country more reliant on immigrants. Immigration accounts for more than half of U.S. population growth. Moreover, the U.S. currently

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has a labor shortage with job openings now in excess of the number of people listed as unemployed. Note that 27% of doctors practicing in the U.S. are foreign born. Without working-age immigrants expanding the American labor force, the trust funds would be going broke even faster than they are now. While robots can take over much of manufacturing, the service sector employs far more workers in the U.S., and a doctor or teacher can't be replaced by a robot.

The problem of Social Security is not going away and is becoming urgent. Yet Congress, under pressure from President Trump and other nativists, has been focused on limiting rather than expanding the supply of immigrant labor. Efforts by politicians to make immigration more difficult and America less attractive as a destination for a better life may have extremely serious consequences for the country's long-term economic health. An America unreceptive to immigration reform may be heading down a very dark road for ourselves and our children. Be very careful what you wish for.

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