NEW FRONTIER

Market Perspectives: 3rd Quarter 2018

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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A Historic Bull Market

Markets

As the quarter ends, the Dow Jones and S&P 500 indices, fueled by growth stocks' appreciation, are at all-time historical highs, dominating the return from global investing. While the MSCI ACWI rose more than 3.5% for the quarter and 2% for the year, the MSCI ACWI-ex US was flat for the quarter and declined more than 5% year-to-date. In general, international equity and fixed income investing were challenges. The European STOXX 600 rose less than 1% for the quarter and was down more than 1.5% for the year. The Hang Seng China (offshore) index was down more than 4% for the quarter and more than 7% for the year, while the Shanghai composite was down nearly 15% for the year. The MSCI EM index was down more than 2% for the quarter and more than 9.5% for the year. Japan was a bright spot for international equity indices with the Nikkei 225 up more than 5.5% for the quarter and 5% for the year. On the fixed income side, the Bloomberg AGG was flat for the quarter and down over 1.5% for the year. On the other hand, the Dow Jones US Select REIT index was up nearly 1% for the quarter and over 2.5% for the year. Rounding out major financial indices, the 10-year T-bill rate was over 3%, oil over $73 a barrel, the VIX at 12, gold below $1200 an ounce, unemployment at 3.9%, and U.S. PCE core inflation at 2.1%. The New Frontier NFGBI index, an optimized multi-asset ETF 60/40 stock/non-stock balanced index and a unique institutional and advisor benchmark for diversified global investors, was up more than 2% for the quarter and 1.5% for the year.

Perspectives

Robust economic growth and historic highs in the Dow Industrial and S&P 500 indices contrasted sharply with the rest of the world markets. American monetary macroeconomic policy, as well as tariff policies, were out of sync with the rest of the global economy.

A Historical Achievement

The quarter marks more than nine-and-a-half-years (115 months) of generally rising U.S. stock prices, the longest bull market in history. The level of gains in stock prices remind scholars of capital markets of the bubble markets in the 1920s. The recent period was remarkable for the unearthly low volatility that began with the lows of March 2009. While there was a jolt of energy following the surprising Presidential election results in 2016 and the passage of the Trump tax cut, with the exception of the double dip in 2015-16, the market behaved like a very slowly rising tide. In contrast, hedge funds, the darlings of institutional pension and endowment funds, have underperformed the stock market even as they accumulate a record level of assets.

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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.

More information is available at www.newfrontieradvisors.com.

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Rising Rates

At the end of September, the Fed announced an additional hike in the federal funds rate, a quarter of a percent, to 2.25%. The Fed described the state of the American economy as experiencing "a particularly bright moment." The Fed claimed that the rise in the federal funds rate was not expected to get in the way of continual growth. The committee expects to continue to increase rates at a quarter percent one more time this year and twice next year, with a possible additional increase in 2020. One consequence of Fed policies has been the possibility of an inverted yield curve, when short-term rates are higher than long-term rates. An inverted yield curve has often been taken as a precursor to recession. However, given the Fed's current views, the American economy is in robust health with no sign of a recession anytime soon.

International Investing

International investing was a serious challenge for U.S. dollar investors. There were few places to hide. Robust economic growth and rising interest rates and capital markets in the U.S., plus unsettled geopolitical and trade risks, negatively impacted a number of international economies already experiencing a slowdown in economic growth. Given its importance, China was among the most serious of underperformers. While Japan was a happy exception, many important economies such as South Korea and Australia underperformed. In addition, a number of emerging market economies, where debt was denominated in dollars, were seriously impacted by the strengthening dollar and currency fluctuations. Special cases such as Turkey and Argentina were important contributors to negative returns.

China Tariffs

At the end of September, the administration imposed a 10% tariff on $200 billion of Chinese goods. This is in addition to tariffs imposed earlier on Chinese goods. The tariff tax is expected to rise to 25% at the end of the year. China's retaliatory tariffs are now showing up in US export data. President Trump is following up on his campaign promise to put America first and renegotiate trade agreements with much of the world. The most important of the President's tariff policies is with China. This is because China has as a state policy the appropriation, by whatever means, of the world's intellectual property to support Chinese economic and military world dominance. There is a wide consensus that Chinese intellectual property policy has impacted the economic viability of many American companies and resulted in the loss of many American jobs over many years. The President is convinced that China has been unfair to America and seems determined not to back down. The consequence is the prospect of an all-out trade war with the world's second largest economy. The political forces are in place for conflict that could last many years.

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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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European Economy

Europe is America's most important trading partner. The European Central Bank (ECB) under President Draghi has been in the process of implementing a 2.5 trillion euro stimulus program that has revived the Eurozone economy following the severe contraction a decade ago. Dr. Draghi announced the end of the ECB's bond buying stimulus program by the end of the year. The 30 billion euro per month bond purchasing plan will be reduced to 15 billion euro for the last three months of the year. Interest rates will remain steady until the middle of 2019. While there are important positive economic factors that led to the decision to terminate the stimulus program, there have also been some recent worrying signs of a slowing economy accompanied by flat capital markets. President Trump's long-term game plan for imposing tariffs on European cars and many other goods is still being formed. By all indications, Europe remains in guarded economic health.

Look Ahead

Trade wars and central bank policies will likely dominate near term financial markets. The American economy should continue to be the major economic growth engine for the world economy for the foreseeable future. Major political and economic risks exist with unforecastable consequences.

The Natural Rate

The process the Fed is going through has to do with the concept of the "neutral" or "natural" rate. The neutral rate is said to be the federal funds rate at which the economy is in equilibrium. If the federal funds rate were at this neutral rate, monetary policy would be neither loose nor tight, and the economy neither too hot nor too cold. If the Fed's policy rate is set below the neutral rate it can stimulate the economy, but only by causing price inflation. On the other hand, if the Fed sets the policy rate above the neutral rate, then unemployment rises higher than desired and price inflation comes in below target. Currently the Fed believes the "neutral" rate to be 3% and considers the "terminal" rate for Fed policy to be 3.4%. This set of considerations explains why the Fed is on course of nearly automatic increases to reach a 3% funds rate and why they do not consider their increases in interest rates likely to impact inflation. However, it is worth noting that no one knows the true "natural" rate for the economy. It is simply a very educated empirical and theoretical guess that only time will tell if correct.

Subdued Volatility

In spite of unprecedented political turmoil and dysfunction, the stock market has remained remarkably calm. The S&P 500 has gone many trading days without a 1%

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move in either direction. The market is apparently convinced of the robust health of the American economy and its continuation into the foreseeable future. A gradual rising interest rate environment is seemingly no threat to economic growth. Quiet summer trading has continued into September. The VIX fear gauge has largely been flat since February. With corporate earnings growing at a fast pace there seem few storm clouds on the horizon. Analysts are cautious and waiting for new catalysts such as trade discussions and political events before making changes.

A Two-Sided Sword

The Trump administration feels that America has been treated unfairly by essentially all its trading partners and has signaled willingness to wage a trade war with virtually all of them. The likely disruption in longstanding world trade patterns and agreements is impossible to measure. It should be understood that tariffs, plain and simple, are a tax on the American consumer. Although even a president can't simply decide to arbitrarily abrogate trade agreements, legalities can be manipulated. For example, the patently absurd rationale for rewriting trade rules with Canada is that the Canadian government poses a threat to national security. Tariffs planned for any entity require stipulation of which goods and companies. There will be various "exemptions" and "special interests" that can easily be opportunities for political corruption and sweetheart deals. Trust is one of the most important components of productive negotiation. If America is perceived as an unreliable trading partner, it will surely impact the ability to make trade deals for years to come. In the history of human affairs, trade wars have often led to military conflicts. If the purpose is encouraging economic growth, friendly respectful trade negotiations should be the rule and trade wars considered only as a last resort.

A Long-Term Trade War

The consequences of a long-term trade war with China has severe economic and military implications for the global economy. China has been the go-to source for cheap, high quality manufacturing for much of the world for many years. It is also an intellectual powerhouse through, in many cases, appropriated expertise. How it reacts to the administration's determined thwarting of China's global ambitions in economic and militaristic dominance can only be speculated. The President's tariff policies are an existential threat to the Chinese political class. It is important to note that the Chinese economy is awash in debt while its presumptive adversary is in robust economic health. There is no way that China can win a trade war with a determined U.S. president. However, China has many other recourses including making it impossible for American firms to do business in China. The evolution of the China-U.S. relationship remains one of the most important question marks on global economic risk.

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No Witch Hunt

The Mueller investigation is an uncomfortable presence for partisans of the President. The probe is no witch hunt. It has already resulted in 100 criminal counts against 32 people and three companies. The tally of convictions and guilty pleas include George Papadopoulos, Sam Patten, Paul Manafort, Michael Cohen, Alex van der Zwaan, Rick Gates, Richard Pinedo, and Michael Flynn. In addition, thirteen Russian nationals and a Russian associate of Paul Manafort have been indicted for conspiracy and obstruction of justice. While some may wish it away, it is clearly driving political calculation, such as the Kavanaugh Supreme Court nomination, with the possibility of explosive risks at any time as the mid-term elections approach.

A Changing of the Guard

At the end of October, Dr. Draghi's term as President of the ECB will end. A new president will be appointed. Dr. Draghi is an MIT trained economist. By almost any measure, his term has been a major success given the severe economic contraction a decade ago. However, if custom dominates, likely candidates for his replacement may be scholars of far more conservative economic policies. The outcome of the political debate will have important global economic consequences – short- and long-term.

Federal Debt

A fundamental financial axiom is that you get what you pay for. Buoyant economic growth and rising capital markets have come with rising debt. American Federal debt, at 105% of GDP, represents levels only exceeded during World War Two for funding the war. Borrowing to avert a financial depression, funding a war, or build infrastructure that will pay off in the future is recommendable. But debt spending with little or no prospect of return implies economic hardship in the future. Paying interest on federal debt is the fastest-growing major government expense on track for $390 billion next year. Within a decade, the government could pay more in interest on debt than what it spends on military, Medicaid, and children's programs. The problem is that the need to finance a fast-growing budget deficit has been worsened by tax cuts and rising interest rates. Much of recent tax reform legislation was more politics than economics. Unnecessary spending will result in inflation and indebtedness that will have to be paid for by future generations or result in the shutdown of politically vulnerable entitlements such as health care and social security benefits.

A Complacency Error

The danger of a low-volatility long-life bull market is that it inspires policy maker complacency. Markets have been in a slow rising march in spite of convulsive political

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turmoil and congressional dysfunction. But the economy is not immune to incompetence. The continuation of a robust business climate depends on sound fiscal and monetary policy and coordinated political function. At some point the bill for extreme partisanship and ignoring infrastructure and productive tax and entitlement reform will come due.

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