NEW FRONTIER

Market Perspectives: 1st Quarter 2019

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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Turnabout

Perspectives

U.S. stocks experienced their biggest quarterly gains in nearly a decade. The S&P 500 completed its best quarter since 2009, gaining 14%, while the S&P MidCap 400 and S&P SmallCap 600 gained 14% and 12%, respectively. The VIX ended March at a low of 13.7. Major indices have recouped almost all of the losses experienced in the prior quarter. Notably, every U.S. equity sector and factor rose this quarter, with growth continuing to lead value. Global indices were nearly as positive as domestic, with the notable exception of the SSE Composite, which was up more that 23%. On the other hand, fixed income yields continued to decline globally. The U.S. Treasury yields were at or near two year lows with 10-year Treasurys at 2.41% while globally there is $10T held in negative interest rate bonds.

The U.S. bull market in stocks had a ten year anniversary this quarter. But arguably the bull market ended on September 20, 2018 with the S&P's record close. The current quarter was a good one for equity investors but it was essentially a rebound from the prior one that did not cancel out the negative returns in Q4. While a recession is not forecast anytime soon, the extraordinary low volatility and grinding positive returns for most of the last ten years, credited to the Fed's slashing of interest rates and a resurgence of the U.S. economy, is likely to reflect a slowing down of economic growth. The GDP growth rate for 2018 was 3%, but growth in the final quarter was revised downward to 2.2% from the original estimate of 2.6%. The Fed and National Association for Business Economics have both recently lowered their forecasts for growth in 2019 to 2.1%. Reasons include trade tensions and slowing growth in the rest of the world.

The most important economic event in the quarter was the Fed's change to a dovish tone for monetary policy, influenced by the wild volatility and significant declines in capital values in the prior quarter. The Fed Chairman suggested that rates may be on hold for many months. The Chairman cited mild inflation, a sharp pullback in financial markets, and clear issues on U.S. growth. Whereas in the prior quarter the Fed expected two rate increases in 2019 they now expect none, and next year perhaps one. The health of the U.S. economy has been very robust thanks to a big tax cut and federal spending. Growth topped 3% last year, unemployment dropped steadily, and inflation hit the Fed's target of 2%. But recent data has reflected a decline in economic activity in retail sales, business investment, and job growth, with inflation falling below 2%.

The Fed is in a wait-and-see policy. Investors have become convinced that the Fed will not raise rates this year. U.S. growth and inflation will likely remain low for the year. Federal-funds futures showed the market pricing a 40% chance of lowering rates

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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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at least once in 2019. While the U.S. economy has been resilient, the outlook dimmed elsewhere around the world, pushing central banks to have a more cautious approach to monetary policy.

The Fed announced that in May it would slow the pace at which it is shrinking its $4T asset portfolio and end the runoff of its Treasury holdings at the end of September. The Fed currently allows $30B in Treasurys and $20B in mortgage bonds to mature every month without replacing them. Beginning in May, the Fed will allow only $15B in mortgage holdings to mature each month, invest the proceeds into Treasurys, and stop the runoff of the Treasury holdings in October.

The composition of the Fed balance sheet is policy-relevant and can provide tools for managing the economy. Investing proceeds into short-maturity holdings returns the composition of holdings towards pre-crisis levels. In any future downturn, the short-term securities could be used to buy long-term bonds that would provide stimulus to the economy without changing interest rates or overall levels of the balance sheet if a downturn seems a concern.

The Fed's caution has made investors worry more about the global outlook. While the halt to interest-rate increases removed fears that the central bank will lift borrowing costs, they also raised worries that the economy is slowing down on its own. Instances of yield inversions between short and long Treasurys have recently occurred. Such events have sometimes been thought of as a leading indicator for a recession. Persistent inversion may imply significant cuts in short-term rates, which is unlikely without a fear of recession. But the notion that it is a reliable leading indicator of recession can be mistaken. While 10-year Treasurys are usually thought to have a term premium, it has been nonexistent or even negative due to QE policies. It is worth noting that yield inversion forecasts of recession do not seem to work in other economies such as Japan, Germany, and the U.K. In addition, yield inversion, to be significant as a signal, needs to be more than a momentary event.

Central banks around the world have similarly considered delays in interest-rate increases, in large part motivated by signs of slowing economic growth, particularly in the Eurozone and China. The European Central Bank (ECB) never raised its interest rates in the eight-year Mario Draghi era. Responding to a slowdown in the European economy, the ECB said it would keep rates below zero through December at the earliest. It also confirmed that it would keep constant the amount of financial securities it had acquired as part of its QE program until well after interest rates begin to rise, until quantitative tightening finally starts. This was partly because of the ECB's downgrade to this year's growth forecast from 1.7% to 1.1%. These data-dependent logical policy changes are responses to a weakened euro, falling bond yields, and pessimism on growth. Similarly, the Bank of Japan has given no sign of raising its target rate from negative territory anytime soon.

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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.

The recurring need for policy "adjustments" during President Draghi's term at the ECB reflects fundamental weaknesses and pervasive uncertainty in the Eurozone. The Eurozone runs a large current account surplus reflecting northern Europe's tendency to save more than it invests. It also has a flawed monetary union that delivers an over-competitive exchange rate to Germany and other northern Europeans. The end result is a dependence on monetary tools at the limits of their effectiveness with limited hope of a coordinated Eurozone fiscal stimulus policy anytime soon.

The Fed's policies of cheap money have important consequences for global investors. Emerging markets can be the beneficiaries of dovish surprises in the U.S. A weak dollar can boost the credit of emerging markets (EM), making them look stronger and more attractive than they are. Investors may often attribute economic improvements and crises to local political developments rather than the ebb and flow of global capital. In addition, the fact that money flows into emerging economies can make them look safer than they are. Last year is a reminder of what can and does occur. The year started with a rally helped by a strong consensus that the dollar would weaken. When that did not happen, EM assets suffered their deepest sell-off since 2013. Today, investors are more confident that the Fed will hold off on raising rates.

While trade tensions between the U.S. and China have receded a bit from the headlines, there is little if any apparent resolution on the major issues of intellectual property theft, forcing foreign companies to give up their technology, and potential cyber security threats. The Chinese cybersecurity law requires businesses operating in China to store sensitive data in China and to favor Chinese network equipment over foreign ones. Major obstacles persist including how to enforce an agreement on technology-related matters.

The European Commission has produced a new strategy document that makes unprecedented criticisms of Chinese policies and Chinese threats. It brands China a "systemic rival promoting alternative models of governance." It focuses on corporate subsidies and the dangers posed by competition with China's "state-dominated economy." The paper notes that China's subsidies had caused overcapacity and other distortions in markets such as steel and included tax incentives and soft loans from state banks to buy technology companies. Profits at large Chinese industrial companies fell at the fastest pace in almost a decade at the start of 2019. Uncertainty caused by the U.S.-China trade war as well as a government crackdown on China's high levels of corporate debt led the country's economic growth to decline.

Look Ahead

The quarter experienced a truly dramatic shift in Fed policy from hawkish to dovish. The change in policy can be seen as the Fed governors properly following data-dependent policy and reacting to it appropriately. The contrast, however, has been sharp. The Fed

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was on a path of virtually robotic federal funds rate increases according to the monetary macroeconomic theory of the neutral or natural rate, estimated at 3.4%, in the prior quarter. At the urging of President Trump, the Fed became more concerned with a persistent low inflation rate as well as with troubling economic data and markets. But the turnabout is something of a rejection of classic monetary macroeconomic theory, the policies that guided the American economy to escape an economic depression.

The new dovish Fed policy leaves little monetary ammunition to fight an economic downturn if it occurs in the near future. But the Fed has not totally abandoned its monetary policies or concern with availability of stimulus policies. The roll-off of the debt accumulated in QE is planned for short-term securities that can be invested in longer-term bonds if stimulus is desired in the future.

Where does this leave the investor in the street? The American economy remains the envy of the world. Forecasts for a recession are generally more than a year out. The American consumer is still a dominant economic force. The unemployment rate is low, wage growth has improved, and inflation is low. If the bull market has in fact ended, the outlook may remain for comfortable, though perhaps unexciting, normal economic growth and market returns. But the most important risk is unforecastable risk. That's why a policy of effective diversification with some international exposure is always appropriate.

The passive/active debate continues to dominate academic and professional discourse. But the issue of performance versus cost is not well formed. Any investor should want the benefit of professional management of their savings. In finance, as in all other transactions, you get what you are willing to pay for. New Frontier's solution attempts to combine the best of active and passive management. We apply institutional quality quantitative professional management consisting of multi-patented state-of-the-art investment technology and invest in low-cost, low-risk, high-quality index ETFs. Index ETFs are often more liquid than their underlying assets, have far lower fees than mutual funds, are more tax efficient, and often outperform their active mutual fund peers over five and ten year periods. All of the firm's investment offerings are monitored for optimality on a nightly basis using our unique patented Michaud-Esch rebalancing process and reviewed weekly by New Frontier's investment policy committee.

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