NEW FRONTIER

Market Perspectives: 2nd Quarter 2019

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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Trump Economics

The quarter was a good one for investors, overcoming fears of an all-out U.S.-China trade war. The S&P 500 index rose roughly 4% for the quarter and was up 17% for the year. It was the market's best first half performance since 1997 and extended the more than decade long bull market. But it wasn't until April this year that the S&P 500 climbed back to its October 2018 highs and reversed the negative 14% return from the last quarter of 2018.

Mounting fears of an economic slowdown have pushed bond yields down globally. The yield on the 10-year U.S. Treasury closed the quarter at 2%, nearly a half-percentage-point below from the end of March, a drop that took many investors by surprise. Despite a downturn in May, investors were again rewarded for staying invested in the market and avoiding the early year selloff.

As may have been expected from the global decline in interest rates, duration (long treasuries, long corporates) have been a major positive contributor to portfolio performance. Some New Frontier strategies, especially lower risk profiles, delivered as much as 1% (net of fees) in excess of the stated benchmark. For example, the 60/40 New Frontier Institutional Index (NFGBI) which returned 3.4% for the quarter and is up 13.5% YTD compared to a 60% MSCI ACWI and 40% Bloomberg Barclays AGG benchmark of 12.2% YTD and 3.4% for the quarter. Other New Frontier Michaud Optimized Indices did correspondingly well. The all-equity New Frontier Global Index (NFGEI) was up 2.9% for the quarter and 16.3% for the year, outperforming not only ACWI (16.2%) but also EAFE (14.0%) and MSCI Emerging Markets (10.6%).[1]

Perspectives

The Federal Reserve's quantitative easing program in response to the Great Recession in 2008-09 resulted in buying more than $4T worth of Treasury bonds and mortgage-backed securities as a way to increase the supply of money in the financial system. As the economy recovered, the Fed began to reverse that program, slowly reducing its portfolio of bonds. According to classical macroeconomic monetary policy, the plan was to have nearly robotic increases in the Fed Funds rate toward the theoretical natural rate of 3-3.5%. The theory of the natural rate is of a not-too-high not-too-low interest rate for hands-off monetary policy for the economy. Achieving the natural rate is a means of re-arming the Fed's store of ammunition for managing the economy in any future unanticipatable economic collapse.

[1] As of 06/30/2019, performance quoted is total return unless noted otherwise. Source: MSCI (MSCI indices), Bloomberg (all other non-MSCI indices).

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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 newfrontieradvisors.com

The Fed raised interest rates four times last year, drawing severe criticism from President Trump. While the American economy is robust and unemployment historically low, the effects of the president's $1.5T tax cut are waning and his trade war has begun to hurt some American industries, as well as slow global economic growth. The President complained that the Fed's rate increases in 2018 "really slowed us down." He wants the Fed to do more to give the economy a lift. The President's advisers blame the Fed for economic growth falling short of the 4% annual rate last year as he promised. Democrats denounced Mr. Trump's comments, saying they showed his disregard for the traditional independence of the Fed and his desire to use its powers to help him win re-election.

Under pressure from the President, including threats of replacing the newly installed Federal Reserve chairman, the Fed reversed course and began to consider the potential weaknesses in the economy. The central bank no longer expects to increase rates at all this year. It has cut its growth projections to 2.1% for 2019 and may cut the Fed Funds rate as early as July. In the meantime, investors may not have noticed that the Fed has already cut the rate the Fed pays on bank reserves. While not a headline rate, it has a direct effect on the money supply. One reason is that the yield on one-year treasuries had fallen below the bank rate, motivating banks to build up excess reserves. In essence, the Fed cut interest rates based solely on the need to reconcile current yields with policy.

There is little doubt that the President is motivated to stimulate the economy to support his re-election as the country goes into the Presidential election cycle. Mr. Trump is banking on a much faster pace of growth than the Fed and most outside economists say is likely. Global growth is moderating, with slowdowns in Europe and China underway. And there are signs of weakness in the United States, where chief executives see investment, hiring, and sales growth all slowing this year.

Monetary policy can be a punchbowl for politicians concerned with re-election. Cutting the Fed Funds rate in the U.S. will stimulate the economy by reducing the cost of servicing debt and encouraging investment. The impact, of course, all other things the same, is a reduction in the value of the currency. But domestic voters may little notice the side effect of a reduction in purchasing power. In a global economy where each country is concerned only with themselves, there is little incentive to modulate policy for global implications. This was evident recently when the President called out Dr. Mario Draghi, the outgoing European Central Bank President, for a policy of additional interest rate cuts that was motivated to stimulate Eurozone growth, but also had the side effect of reducing the value of the euro vis-à-vis the dollar.

Macroeconomic monetary policy remains a theory in progress. At the moment, there is roughly 13T dollars of debt in negative interest rates in the global economy, a state not anticipated in modern macroeconomic theory first proposed by Keynes and

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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.

Samuelson during the 30s and 40s. The global economy is in a state of economic theory uncertainty.

Historically, stocks and bonds in the U.S. have a small positive correlation. But recently the stock-bond spectrum is more like a taut string pulled hard at both ends where both have similar returns. This may be a reason for cautious investor sentiment even as the market has been generous to staying-the-course investors.

Stock market investors must always be in the moment. The stock market is continuously in a state of fragile equilibrium. Exogenous volatility can destroy great wealth without warning. Long-term investors as well as traders must always watch for changes in market sentiment as experienced sailors always watch with a weather eye while at sea.

Look Ahead

The disposition of the U.S.-China trade war is the most important risk associated with global capital markets. While a truce has been called, it is likely temporary. The issues between Presidents Trump and Xi do not appear reconcilable. Either China will continue to take advantage of the U.S., as President Trump claims, or a sea change of policy will be required. A reversal of his Made in China 2025 economic agenda would likely lead to a political takeover of President Xi's authoritarian regime. While the conflict festers, implications of the stalemate include the possibility of armed conflict between the U.S. and China in the China Sea, and continued cyber-attacks on each other's military and economic infrastructure. The recently imposed tariffs, and the potential of much more, may be permanent at least through the time Mr. Trump is in office.

The most immediate risk to global capital markets is the U.S.-Iran conflict. There is a legitimate case for President Trump's effort to contain Iran's interest in having nuclear weapons while Iran supports conflicts in the Middle East and beyond. But the American government is imposing draconian sanctions on the Iranian economy in order to force Iran to accede to American demands. It should be remembered that Iran represents a proud Persian culture that once ruled the world. Iran may prefer conflict over subjugation by another country. The President's cancellation of the Obama-Iran treaty was a serious error that could easily lead to a new war in the Middle East.

Dr. Draghi's willingness to use more negative interest rate borrowing to stimulate the Eurozone economy is very risky. Modern monetary theory was not designed for such extreme situations. No one can predict whether the effort will succeed or what consequences will result. Problems of European fragmentation remain. Italy is fiscally unstable, and Brexit further challenges the bloc's unity. Despite Dr. Draghi's economic

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and political brilliance, the problem has always been that there is no central banking system in the Eurozone and no political will for a coherent fiscal stimulus policy. A thriving Eurozone economy propelling global economic growth seems unlikely for the foreseeable future.

The upcoming Presidential election in the U.S. will be in full swing from September on until November 2020 and will likely raise volatility in domestic and global markets. The impetus to impeach the President, the continuing saga of the Mueller report, the slow continuous drip of revelations surrounding the 2016 election, and continuing concern with Russian meddling could easily lead to a constitutional crisis by election time.

The President has often complained at what he perceives as unfair trade policies with many of America's trading partners, many of them longtime allies. Such issues are legitimized by the problem of American jobs leaving America due to industry protectionism policies. But the issue of disruptive trade policy was raised to a new level when the President was willing to raise tariffs on Mexico if it did not stop the flow of immigrants from South America. The possibility of the weaponization of trade policy is widely perceived as a grave threat to all of America's global trade agreements.

The impact of political tit-for-tat policies with China have had major implications for U.S. farmers and well targeted industries in the U.S. The consequence is that U.S. economic growth is slowing in various sectors of the economy. Even a supplicant Federal Reserve may not be enough to reverse a possible recession in 2020 or beyond.

The issue of great interest is the perceived health of the American economy. While the President claims that this is the "greatest economy," he is also demanding that the Fed cut rates to stimulate the economy. The Fed's wait-and-see policy could easily change given the President's re-election concerns. Sentiment in the business community could shift in the context of weak growth abroad, slowing manufacturing, consequences of a trade war with China, and other geopolitical risks. *The Washington Post*[2] recently examined seven key indicators: manufacturing (red flag), trucking (yellow to red flag), heavy truck sales (green flag), jobless claims (green), temporary hires (green flag), business spending (yellow flag), and bank lending (green flag). The American economy remains robust but not invulnerable to global economic and political risks.

The Facebook Announcement

Facebook plans to create a virtual currency called "Libra." Libra has a number of similarities to Bitcoin and other cryptocurrencies. But unlike the others it will be backed by real financial assets. It is designed to reflect a basket of securities including

[2] Long, H. 2019. "How healthy is the U.S. economy? Here's what 7 key indicators reveal." June 29.

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the dollar and will be backed up in its payment system by Visa and Mastercard and will be centrally domiciled in Switzerland.

It should not surprise anyone that Big Tech would have interest in revolutionizing the payments industry. J.P. Morgan recently announced the creation of JPM Coin, a blockchain-based technology which will facilitate the transfer of payments between institutional clients. In some ways similar to Libra, JPM Coin will be redeemable at a 1:1 ratio for fiat currency held by J.P. Morgan.

But Libra may have changed the narrative about cryptocurrencies. The potential threat to existing banks may be severe. Regulators will likely have serious questions concerning the enterprise. Libra may impact the ability of central banks to manage their economy. While it is foolish to dismiss the Facebook technological genius for using the internet in novel ways, it is also the case that many institutions may be aligned to rein in its ambition.

Gold (GLD) has had a surge of interest with a 9.2% return this quarter. Gold rises when global risks increase. Bitcoin has also surged from a relatively stable value of around $3000 to a recent high of $14000. The surges in prices for both gold and cryptocurrencies reflect trade war risks and the possibility of a weaker dollar that permeated much of the recent quarter. Gold is the classic example of a universal currency or numeraire. Bitcoin and other cryptocurrencies also have universal currency characteristics, though with much higher volatility. While far too early to speculate, Libra has the potential to be a new gold and a more institutionally useful Bitcoin.

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