NEW FRONTIER

Market Perspectives: 3rd Quarter 2019

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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Economics in the Time of Twitter

It has been a good year for U.S. investors. The global economic slowdown and geopolitical turmoil created a nearly irreversible thirst for super safe assets as reflected by the Barclays AGG bond index gaining 8.5%. At the same time, the health of the U.S. economy produced robust gains in equities, with the S&P 500 index up 21%. Happy surprises included long-term Treasuries up 20%, gold up 16%, and REITs up 25%. Continuing a long-term trend, international equities underperformed domestic and U.S. value stocks underperformed growth. However, the last quarter was a politically and economically volatile period in Europe, China, and the U.S. coinciding with a halt, and in some cases, a reversal, of long-term financial market trends. The AGG was up 2.3%, and the S&P was up a modest 1.2%.

The Federal Reserve

The Federal Reserve is at the center of investor interest relative to ongoing monetary policy and as a reflection of the state of the U.S. economy. There was a great deal of interest in whether the Fed would cut the fed funds rate at their meeting in mid-September. On the one hand, the U.S. economy appears robust. Low unemployment, strong consumer activity, steady though unspectacular GDP growth, and manageable inflation suggested no need to lower interest rates. On the other hand, global tensions from the U.S.-China trade war and slowing global growth suggested a narrative of possible near term recession. More importantly, presidential jawboning for more rate cuts from the Fed added a note of political interference in the management of the economy. Tealeaf readers were particularly anxious to parse whether any rate cut was due to pure economics or due to political influence by the President. While the Fed ended up cutting the fed funds rate by a quarter percent, the minutes provided no clear guidance of future policy.

The Fed is trying to thread a needle between economic and political factors. It is a legitimate concern that business confidence has fallen for the sixth consecutive quarter as geopolitical uncertainty has taken hold. No one wants to kill the long-term economic expansion that is well into its tenth year. Leaving rates as they are gives the Fed headroom for further action if more serious risks arise. Interest rates are already low, and further cuts may have little impact. However, the 2020 presidential election is only a year away. If the economy were to fall into a major slowdown or even recession, this would be a serious problem for President Trump's reelection efforts. Pressure for a rate cut to supercharge growth or limit any downturn is very desirable from a purely political perspective.

The problems created by the President's U.S.-China trade war are not of little moment. There is near universal agreement that the President's trade policy has been somewhat

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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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to very negative on global economic growth. The Fed is well aware of the decline in positive sentiment from shareholders, customers, suppliers, workers, and communities. The forever trade war may become a fixture for some time to come.

Shadowing all these issues is the widening U.S. deficit that topped $1T in the first eleven months of the fiscal year. This is the first time year-to-date fiscal deficits have topped that amount in seven years. Government spending climbed 7% to $4.1T, outpacing federal tax receipts which grew 3% to $3.1T. The last time deficits were growing at the same rate, the U.S. was attempting to climb out of a deep recession. Currently, no serious policy exists for reducing the deficit at a time when interest rate costs for servicing debt are at near historic lows.

The Repo Spike

There was a short-lived spike in the fed repo rate during the quarter. The fed funds rate pushed too high for a day. The Federal Reserve Bank of New York intervened and supplied liquidity to keep the rate within the fed policy range. Repo rates can surge when banks trim balance sheets for regulatory purposes near the end of the quarter. But this time the spike came two weeks before quarter end. The Fed Chair conceded that bank reserve levels may have been too low and that a spike could happen again as a consequence of the Fed's effort to pare back its balance sheet. An October meeting is scheduled to further examine the issue.

The European Central Bank

The European Central Bank (ECB) announced cutting interest rates even further into negative territory. The ECB cut the deposit rate by 0.1% to -0.5% and restarted a 2.6B euro bond buying policy. In the new policies announced by Dr. Draghi, the ECB president until October, the central bank will lend banks euros at less than it pays for putting money on deposit. The process requires banks having to qualify for the program by keeping their excess reserves down and their lending up. This is part of President Draghi's effort to get good banks to play an active part in encouraging investment and growth in the Eurozone. Draghi warned that the Eurozone is likely to face a prolonged "sag" in economic growth. He blames geopolitical uncertainty as the cause of the bank not reaching its goals. Dr. Draghi described the mandate as doing whatever it takes to hit the inflation target. From Draghi's perspective, there were no monetary policy alternatives for saving the euro and reviving the Eurozone economy.

This dual rate Draghi policy reflects the view that the ECB is essentially out of ammunition. The only real solution according to Dr. Draghi is for Eurozone countries with room to loosen their budgets to act in an effective and timely manner with taxes and spending patterns that cause deficits to move countercyclically. But cheap loans hardly seem the answer for much of Europe. Companies pay more attention to

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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.

opportunities for putting money to work than they do to borrowing costs. Investing capital often makes little sense where spending has been weak due to falling wages and fiscal austerity policies. The European economy is absent a technology sector that has created much wealth in the U.S. In the meantime, President Trump is threatening tariffs on European manufacturers. Mr. Trump may view the threat of cutting interest rates as weakening the euro and requiring retaliatory tariffs.

The mid-September announcement drew fierce criticism and showed deep divisions at the ECB. At least seven members of the 25-member body opposed Dr. Draghi's plans of restarting a multibillion-euro bond-buying program. The criticism has been particularly fierce in Germany. Critics complain that the measures would be ineffective while penalizing savers and fueling asset bubbles. The critics charge that the ECB president is stealing German savers' money, reflecting growing skepticism and fatigue with the ECB president's policies. A major aspect of the criticisms is that the Draghi policies conflict with elected government policies. From the point of view of a robust German economy, ECB policies are seen as subsidizing spendthrift governments, particularly Italy's, sparing them the painful process of reforming their economy. He leaves the new ECB president, Christine Largarde, with a slowing growth rate economy, a vulnerability to trade disputes, low inflation, and limited room for policy changes.

Bonds

The three-decade run of gains in fixed income assets may be ending. The end of August to mid-September saw yields climb dramatically, whipsawing bond investors. Yields on the Bloomberg Barclays Multiverse rose from a record low of 1.46% to 1.82% before easing to the current 1.71%. At the same time, the Bund yield went from -0.70% to -0.45% and the 10-year Gilt from 0.48% to 0.76% before back to current 0.49%. The bond market lost over $1T in 10 trading sessions and saw the reduction of $3T of negative-yielding bonds. The critical issue in the minds of fixed income investors is whether this is a pause or a reversal. Bond yield declines may not be inevitable, but there is no reason to fight the rise. It is rational to admit a great deal of uncertainty concerning the direction of yields. The bottom may not have been seen yet.

It may be time to worry about investments in corporate and junk bond debt. The amount of money U.S. companies have borrowed continues to rise. Domestic nonfinancial companies had nearly $10T in debt outstanding in the second quarter, an increase of $1.2T from two years ago, and roughly 47% of gross domestic product. U.S. companies seem sufficiently healthy to be able to pay off the debt. The rise in borrowing is surely due to the fact that companies are taking advantage of the low-rate environment. But warning signs are starting to flash for junk debt. The percent of junk bonds that yield more than 10% has jumped this year from 6% to 9.4%. Investors pulled $6B from junk bond mutual funds and ETFs and put about $19B into investment-grade corporate bond funds.

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Quant Factor Funds

September was a painful month for many computer-driven hedge and factor funds. The quant models were caught with a sharp reversal of a number of long-term trends. Managed futures funds had been betting heavily on a continuing rally in government bonds. The double whammy of a sell-off of factors such as momentum and growth stocks with rising yields made for further significant difficulties.

China

Chinese companies have shed $40B in U.S. investments. It is a clear reflection of the increasingly sour relationship between the U.S. and China on trade, confiscatory policies for foreign investors, theft of intellectual property, and Chinese militarism in the China Sea. The yuan was the eighth most traded currency this year. China's failure to promote the yuan as a core element of the international financial community, and as an alternative to the dollar, is the result of international skepticism about the "managed convertibility" policies of the world's second largest economy. A decelerating economy has also limited global interest in the yuan.

Gold

Gold was up 16% year-to-date. It has been a pleasant surprise for a non-equity ETF. Gold maintained its role as a valuable diversifying asset in a long-term well-diversified core portfolio. Gold's performance has been more useful as a countercyclical fear index than the VIX during this period. Gold also plays an important part in the uncertainties associated with the China-Hong Kong political turmoil and U.S.-China trade war. The confiscatory financial policies of the Chinese government relative to foreign investors have motivated many to move their holdings out of Hong Kong to Singapore and Switzerland. If someone wants to hold gold, Singapore and Switzerland are politically far safer places.

Look Ahead

It is often useful to look back at financial history for a perspective on the current state of financial markets and the economy. The 2007-2008 Great Recession included many economic and political shocks to the domestic and global economy, with dramatic bankruptcies and downturns in capital markets. While there were many moving parts, a central underlying cause came down to out-of-control overleveraging strategies in many large financial institutions. In the current case, the impact of oil price shocks from a drone attack, sharp changes in sentiment on bond yields, the trade war, and domestic political turmoil do not have much of a common thread. Unlike the 2007-2008 period, the pattern of risks may be measured on their own

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terms. While the President's tariff policies have the potential to be very disruptive long term, recent accommodations to the President's views have significantly reduced tensions for now. For U.S. investors, the central unknown risk is domestic political risk. Well-diversified investors relative to the key global and domestic equity and fixed income risks may be best able to ride out the likely disruptions.

A Note on the Impeachment Inquiry

Democratic representatives in the U.S. Congress are in the process of issuing articles of impeachment on President Donald Trump. The inquiry and related issues change the narrative of the 2020 presidential election and the level of uncertainty for a wide range of legislative and political issues for the remainder of the President's term. The initiative is the result of what have been deemed "credible" charges by a whistleblower in a letter delivered to Congress concerning the President's alleged impeachable offenses. All these events are in the context of the Presidential election that is now in full swing. More information is likely to evolve from the multiple investigations in process, and the outcome is impossible to predict. This is not the forum for discussing the merits of the charges. While political issues will often dominate the headlines, economic fundamentals may matter more.

Index Fund Milestone

This month, the index funds that track broad U.S. equity indexes hit $4.27T AUM as of August 31, 2019, giving them more invested assets than stock-picking funds for the first time ever, as reported by Morningstar Inc. The event is a milestone in American financial capital markets. In the past decade, nearly $1.36T in net flows were added to U.S. index-tracking equity mutual funds and ETFs, while $1.32T fled higher costing actively managed funds. The rise of indexing has been a long-time coming. Research has indicated that low-cost index funds often outperformed high-cost active funds. The history of index funds began more than four decades ago with Vanguard and Wells Fargo (now BlackRock Barclays) and in the 1990s with index-tracking exchange traded funds (ETFs). The 2008 period was a watershed for many investors when high-priced active managers did not protect them from the market downturn. More than 80% of active funds underperformed the S&P Composite 1500 in the decade ending in 2018.

There are downsides to the continued growing popularity of mutual index funds and index-tracking ETFs. At some point, active asset management will be necessary for a well-functioning capital market. There is also the issue of a small number of large index fund companies having outsized power in corporate governance. The increasingly attractive solution is active management of index-tracking, low-cost, low-risk, and tax-efficient ETFs relevant to objectives. New Frontier has pioneered this solution for nearly fifteen years.

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Research Announcements

The *Journal of Investing* has accepted the Michaud, Esch, Michaud paper: "Estimation Error and the Fundamental Law of Active Management" for publication. The paper is a fundamental challenge to the orthodoxy of quantitative asset management technology that has largely failed institutional and retail investors for over fifty years.

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