John McCrary
Research Analyst

John McCrary is a member of the New Frontier Investment Committee and provides support and insights to both the Investment and Research teams. He joined New Frontier as a Research Analyst after graduating from Northeastern University with an M.A. in Economics. His interests include asset allocation, quantitative analysis, portfolio construction, and applied econometrics.

An Uncertain Rebound

Following the March downturn, the quarter featured an exceptionally fast rebound in stocks. The S&P 500 posted returns of 21%, and the NASDAQ climbed 31% this quarter. Stock prices closed the quarter close to January levels, with the S&P 500 down 3% and the NASDAQ up 13% year-to-date. The rebound occurred while the U.S. economy operated at limited capacity with many sectors at a standstill in April, including airlines, tourism, and much of retail.

Over 500,000 people worldwide have died of the coronavirus thus far. Infection rates declined across much of the world, but governments met with mixed success in reopening their economies. Several U.S. states experienced spikes in infections after reopening, which increased market volatility. The U.S. broke records for confirmed new daily cases in late June, surpassing April's peak and slowing reopenings. Meanwhile, markets mostly ignored the upcoming U.S. presidential election and the ongoing protests against police brutality and racism—the largest protests in the country since 1968.

New Frontier's global strategies, as calculated by S&P Dow Jones Indices, performed relatively well during the crisis and rebound. Our 20/80 index, NFGII, returned 6% this quarter and 2% year-to-date. Our 60/40 index, NFGBI, returned 14% this quarter and -1% this year. And our all-equity index, NFGEI, returned 20% and -6% for the quarter and year, respectively. For comparison, the MSCI ACWI index returned 19% and -6% respectively.

The Rebound

The recovery in stocks began with U.S. growth stocks and was followed by value, small cap, and international stocks. Treasury yields remain near historic lows. High-yield and corporate bond yields have returned to more normal levels. The recovery in asset prices was bolstered by all-in monetary policy and government fiscal stimulus. There is, nevertheless, continued market uncertainty. June spikes in U.S. coronavirus infections resulted in multiple days where stock prices whipsawed or declined significantly. The real economy in the U.S. remains under a cloud, with GDP expected to contract by 7% in 2020.[1] Much depends on future stimulus efforts, the development of a coronavirus vaccine, and the severity of summer and fall infections.

The stock rebound was uneven. Growth stocks significantly outperformed value

[1] Federal Open Market Committee, "June 10, 2020: FOMC Projections materials." June 10, 2020, https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20200610.htm.

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

stocks, both this quarter and year-to-date. The S&P 500 Growth index posted an 8% return this year, whereas the S&P 500 Value index returned -16%. Although U.S. small cap outperformed large cap this quarter, the Russell 2000 lost 13% year-to-date—10% worse than the S&P 500. U.S. stocks outperformed international equities by 4% this quarter (based on the S&P and ACWI ex-US indices).

The Federal Reserve

The Fed is responsible for a good portion of the recovery in asset prices. Perhaps most importantly, the Fed successfully implemented the policies it announced in March, including buying investment-grade corporate bonds and large quantities of Treasurys.

In April the Fed announced a set of programs worth $2.3 trillion. It pledged to purchase small business loans issued under Congress's Paycheck Protection Program. It also introduced the Main Street Lending Program, offering up to $600 billion to small and medium sized businesses. Moreover, the Fed declared it would purchase high-yield bond ETFs. Additionally, it promised to buy up to $500 billion in municipal bonds.

Later in the quarter, the Fed expanded many of its stimulus programs. The Fed also clarified its approach to buying individual corporate bonds: its secondary market purchases track an index of nearly 800 companies rated investment-grade in mid-March; however, the bonds must have a remaining maturity of five years or less. The Fed's balance sheet swelled from $4.2 to $7.1 trillion year-to-date, and it will maintain near-zero interest rates through 2022.[2] These efforts buoyed asset prices, as did bond-buying programs in Europe and Japan.

Fiscal Stimulus

Bipartisan stimulus programs have likewise bolstered asset prices. The $2.2 trillion CARES package supported firms of all sizes. Despite the shaky rollout of some CARES programs, they kept many companies afloat. Nevertheless, many unlisted mom-and-pop businesses have permanently shuttered.

No major fiscal stimulus package has passed into law since March. The largest package this quarter provided $500 billion for small business loans and hospitals. Nonetheless, more fiscal stimulus is likely. Fed Chairman Powell and President Trump have voiced strong support.

---

[2] The New York Federal Reserve. "FAQs: Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility." Updated June 29, 2020, https://www.newyorkfed.org/markets/primary-and-secondary-market-faq/corporate-credit-facility-faq.

Federal Reserve Economic Data. "Total Assets (Less Eliminations from Consolidation): Wednesday Level." Updated June 25, 2020, https://fred.stlouisfed.org/series/WALCL.

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.

Previous fiscal stimulus packages tempered the unemployment rate; however, another package is likely necessary to avoid more large-scale job losses. A company's value is greatly determined by the quality of its workers—its human capital. Laying off good workers sheds this essential capital, limiting a firm's economic output. Waiting until after the downturn to rehire workers would raise unemployment, reducing consumer demand further and slowing the recovery. An additional, appropriately defined stimulus package may mitigate harm to the economy in the long-term.

U.S. states face record revenue shortfalls. States have contemplated drastic budget cuts, including possible cuts to healthcare or unemployment benefits.[3] Congress's $600 weekly boost to unemployment payments is scheduled to expire on July 31. All of these factors threaten to undermine the recovery. More federal support for states is urgently needed.

A Puzzling Market

Despite the rally in stocks, returns on most bonds were positive or flat this quarter. Although the Fed issued a large volume of Treasurys, yields remain near historic lows. Investment-grade corporate bonds returned 9% this quarter and 5% year-to-date (based on the Barclays US Corporate index). Demand for low-risk assets has been high. Paradoxically, given the stock rally, investors seem simultaneously bullish and bearish.

Economic data on production, spending, and unemployment has been grim since March. April's economic data was stark. Yet the data improved markedly in May and June, albeit from a low level. The June 5 jobs report from the Bureau of Labor Statistics showed unemployment fell from 15% in April to 13% in May. The July 2 report showed a further 2% decline in unemployment in June. Despite the improved data, many investors have been concerned about the disconnect between stock prices and the real economy. According to the Fed, U.S. GDP will likely not return to pre-pandemic levels until 2022. Stock valuations may be unsustainable even with future monetary and fiscal support.

International Markets

Stocks in developed countries rebounded as infection rates declined, but markets remain below January levels. European stocks did well this quarter, in part because Germany supported the EU's proposed €750 billion stimulus. Although Latin America has become an epicenter of the virus, most emerging markets have rebounded.

---

[3] *The Economist*. "The state-budget train crash." June 18, 2020, https://www.economist.com/united-states/2020/06/18/the-state-budget-train-crash.

China, Hong Kong, and the U.S.

As China's recovery continued, it passed a national security law criminalizing "subversion" in Hong Kong. In response, the U.S. began revoking Hong Kong's status as an entity separate from China. The U.S. imposed restrictions on defense exports, and more changes are expected. This endangers Hong Kong's status as a global financial center.

Throughout the quarter, the Sino-American conflict continued. The U.S. and China routinely criticized each other publicly. They quarreled about tariffs and the South China Sea. In May, President Trump announced that the U.S. would withdraw from the World Health Organization (WHO), partly because he felt the WHO was soft on China. The U.S. also clashed with the EU and the World Trade Organization over tariffs. Taken together, these incidents disturb the global economic order and increase uncertainty for investors.

Oil and Gold

WTI crude prices went negative on April 20 for the first time in history. But prices recovered, and WTI crude ended the quarter at $39 a barrel. The recovery was largely driven by an expected uptick in economic activity, especially travel. Another round of lockdowns would likely harm oil prices.

Gold rose 13%, closing the quarter 6% below its all-time high in 2011. Fears about currency depreciation, inflation, or another stock crash are potential causes. Gold is a desirable store of value everywhere.

The Coronavirus Response in the U.S.

Many countries experienced spikes in June infections. In June, Italy's peak was 580 confirmed daily cases. In Japan, China, and South Korea, the June peaks were all under 120 daily cases. In contrast, the U.S. recorded over 25,000 new infections *every day* in late June, with a then-record 45,000 cases on June 26. These numbers are not mere artifacts of increased testing: California, Texas, and other states set records for hospitalizations.[4] A fearful spike in American deaths is likely over the summer.

Compliance with public health advice has been mixed in the U.S., especially in states

---

[4] *The New York Times*. "Coronavirus Map: Tracking the Global Outbreak." Updated daily, https://www.nytimes.com/interactive/2020/world/coronavirus-maps.html.

Worldometers.info. "Covid-19 Coronavirus Pandemic." Updated daily, https://www.worldometers.info/coronavirus/.

Czachor, Emily. "Coronavirus Hospitalizations Peak in California and Texas as Cases Soar." *Newsweek*, June 27, 2020, https://www.newsweek.com/coronavirus-hospitalizations-peak-california-texas-cases-soar-1513898.

with few initial cases. By March, mask wearing was nearly universal in East Asia, but tens of millions of Americans refused to wear masks and did not exercise social distancing well into June. Senior government officials challenged the opinions of health experts, pushed for lifting lockdowns quickly, and called into question the pandemic's severity. Many Americans tragically did not know what to believe, so they did not alter their behavior. Over 125,000 Americans have died from COVID-19 as of this writing.

If a country does not get the coronavirus under control, its economy and financial markets will suffer. The U.S. economy risks being left behind the world economy. The federal government needs to have a clear and effective response to the virus. This includes giving well-informed health advice. The consequences of failing to do so could be dire for thousands of Americans.

Looking Ahead

Until there is a broadly available vaccine, economic activity will likely not return to normal. The many businesses that depend on in-person interaction will struggle, and consequently unemployment will remain elevated. Even well-paid workers may reduce expenditures due to job insecurity and fewer spending opportunities. Demand will likely suffer further. Despite the recovery in stocks, there is a limit to the strength of an economic recovery without a widely available vaccine.

Advice for Investors

Investment uncertainty always exists in any time period. But investors who cashed out in March missed a historic rebound. Timing the market is not recommendable for long-term investors. A key lesson of 2020 is the importance of staying invested even during times of high volatility. We believe that an appropriately risk-targeted, globally diversified portfolio is as important as ever. Maintaining an optimally risk-controlled portfolio is most desirable.

Research Announcement

On April 16, New Frontier President and CEO, Dr. Richard Michaud, Managing Director of Research, Dr. David Esch, and Chief Investment Officer, Robert Michaud, presented their latest research in a landmark webinar sponsored by the CFA Society Boston to nearly 400 investment professionals and academics from all over the world. The presentation titled "Is Quant Fundamentally Flawed?" is based on the paper, "Estimation Error and the 'Fundamental Law of Active Management:' Is Quant Fundamentally Flawed?," published in the most recent issue of the *Journal of Investing*. A summary is given below:

> We present important new research on the likely limitations of a number of popular active quant investment strategies. For nearly thirty years, textbooks, formal university courses, journal articles, conferences, and institutional marketing have touted claims of applications of the Grinold (1989) "Fundamental Law" theory that may add investment value to optimized strategies even when only a small level of information is available. We show that many popular strategies associated with Grinold theory are likely unreliable and self-defeating. This is because estimation error (Michaud 1989) and constraints required in practical application are ignored. We show that far more information than commonly assumed and appropriate portfolio structure are likely necessary for outperformance in practice.

An edited and annotated transcript of the presentation, including a Q&A session with the authors of the paper, can be found here, and a full recording is available here.

July 2, 2020