NEW FRONTIER

Market Perspectives: 2nd Quarter 2010

Enhanced Return ■ Effective Diversification ■ Managed Risk

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Austerity or Growth?

Second quarter stock performance was the worst since the financial crisis in 2008. The Dow declined 10%, S&P 500 11% and Nasdaq 12%. Stocks gave back all their gains for the year: the Dow ended down 6%, S&P 7% and Nasdaq 7%. For equities, there was no place to hide. MSCI small cap fell 10% for the quarter and 1% year to date, MSCI Europe 15% for the quarter and 17% for the year, MSCI Pacific 12% for the quarter and 6% for the year, MSCI Emerging 8% for the quarter and 6% for the year. The fear that gripped the global economy from late April onward triggered a flight to quality, which benefited U.S. fixed income indices. The Lehman Aggregate bond index rose 4% for the quarter and 5% for the year. U.S. 20 year treasuries were stellar performers rising 15% in the quarter and for the year. The dollar gained 13% relative to the euro in the quarter and 21% for the year. Oil declined 9% for the quarter and 5% for the year. Global diversified strategic portfolios were a welcome moderating influence the volatility in markets year to date.

Perspectives

The quarter began on an upbeat note. By late April, the Dow rallied to 11,000 and the S&P to 1,200. The CBOE's VIX was below 15%. But the Greek debt crisis that surfaced in February touched off market fears. The three main engines of global economic growth – Germany, China, and the U.S. – were experiencing economic and political problems. The quarter ended with fear indices flourishing. Gold soared to new highs while the VIX approached 35%. Contributing to investor concerns were the BP oil spill in the Gulf of Mexico and the May 6 'flash crash" that exposed weaknesses in the trading structure of U.S. stock exchanges.

The threat of Greek insolvency led to questions of the euro's viability and the European Union's ability to respond effectively. It took three months for the European Union and the International Monetary Fund to agree to a bailout plan. It was not easy politically for Germany, the ultimate guarantor, to explain to their electorate why supporting a $135 billion (and possibly more) bailout of Greece's profligate spending and entitlements was in their best interests. The alternative of Greece withdrawing from the euro had its own set of dire consequences. Many German, French, and Spanish banks were likely to be insolvent resulting in a credit crisis of dramatic proportions. The political consequences for the euro zone were no less desirable. But supplying liquidity per se does not change underlying structural problems.

The G20 summit did little to solve this crisis or calm investor worries. Serious policy differences among participants for managing the Great

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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**.

Recession were visible to all. The G20's call for "growth friendly fiscal consolidation" provided something for everyone. But the European Union's focus on austerity could choke the budding global recovery. In the American view, rising national debt is a legitimate concern but it must be addressed gradually so that people are not hurt in the process.

It is important to understand that Germany's focus on fiscal austerity has a dimension very different from the U.S. Deficit reduction is often rhetoric that proxies for a toxic political agenda on entitlement reform. Unlike in the U.S., labor contracts in the euro zone often guarantee life employment. The result in many European economies is distorted labor markets, high costs, uncompetitiveness, social unrest and generational conflicts. Europe needs change. Germany's insistence on deficit reduction forces uncompetitive sectors to face economic reality and institute deeply needed, though painful, social-economic changes. While this perspective rationalizes Germany's insistence on austerity, the consequences are no less likely to be adverse for global economic growth short- and medium-term.

China's policy of U.S. dollar parity with the renminbi negatively affects U.S. and European recoveries. China's recent announcement of gradual easing was largely political window dressing for the G20 summit. In addition, China's hot markets have turned cold.

Currently 14.6 million Americans are unemployed, nearly 7 million for more than 6 months. An additional 11.2 million have given up their job searches or are working part-time. This adds up to an underemployment rate of 16.5%. The private sector added only 83,000 jobs in June, not enough to sustain the recovery. The jobless rate fell to 9.5% from 9.7%, but only because more than 650,000 people gave up looking for work. Unemployment is expected to be at double digits by the end of the year. Unemployed Americans can't spend or remain in their houses for long. The partisan vote not to extend unemployment insurance affected 1.7 million jobless June 2nd, 1.3 million now, and 3.3 million by the end of July.

Until recently, the consensus of practicing economists was that fiscal stimulus packages and the Fed and Treasury lending policies had the American economy on a sustainable growth path. However, a steady stream of disappointing economic news in employment, consumer spending, housing, consumer confidence, ongoing European credit crisis, the end of stimulus programs and continued partisan political jockeying raised serious concerns of the recovery. The pace of private sector employment growth is not enough to sustain population growth. The issue is whether there is enough gas left in the tank for reaching escape velocity or is the economy likely to fall back to earth.

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New Frontier Portfolios

New Frontier develops and manages a broad range of ETF-based asset allocation portfolios for advisors and their clients, and currently oversees over $1 billion in global ETF asset allocation portfolios.

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Look Ahead

The Congressional Budget Office recently warned that federal debt is on an unsustainable path. The report highlights the difficult position facing the Obama economic team of balancing the need for stimulus in order to sustain the economic recovery relative to growing concerns of the country's fiscal position that will require retrenchment at some point. In Keynesian theory, an economy can reach an end point after which fiscal issues should dominate. The key issue is to decide when that point occurs in order to optimally manage the recession.

There are recent reminders of the potential impact of removing federal support in a fragile economy. After home-buyer credits expired in May, the numbers of new homes breaking ground fell 10% and sales plunged 33%, the lowest on record. Loss of stimulus funding is hitting state and local governments hard. They are facing a combined budget deficit of some $137 billion this year and $144 billion next. Some states have already gone through most of the federal education funds and have been cutting services and firing tens of thousands of teachers.

Fundamentally, deficits are not toxic or mysterious but are a normal part of the management of any economic unit. U.S. deficits are largely a product of prior tax cuts, spending programs, and more recently the recession, which has reduced tax revenue, justified the bailouts and last year's stimulus package, and brought unemployment insurance and other stabilizers into effect. Solve the recession, and the deficit can be managed.

Major complex economies such as the U.S. require large sophisticated mathematical models and careful informed thought for effective management. A wide consensus exists among practicing economists for further fiscal and lending stimulus programs. There are many European countries who can't afford further economic stimulus. But the American economy is not one of them. Unlike Europe, calls for balancing the budget and reducing government programs in the U.S. are less economically motivated than with political calculation relative to the midterm elections coming in November.

Have we been here before? In the first term of the New Deal, deficit spending policies helped grow the economy out of the depths of the Great Depression. At that time, deficit spending was a novel concept that was part of early Keynesian theory and very unpopular on the political right. In 1937, Roosevelt was urged to change his focus and slash budget spending. The economy subsequently plunged into deep recession. In only a few months, stock prices fell 58%, employment 28%, and payrolls and industrial production 43%. Austerity policies were reversed and economic growth returned when spending increased in order to arm a nation for World War II.

The stakes are high. Paul Krugman, the Nobel laureate in economics, in an op-ed article (NYT, June 28, 2010) declared that we are entering a third depression. He warned that the decision by many in Europe to focus on fiscal tightening and the political inability or unwillingness in the U.S. to further

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Announcements

New Frontier developed and has gradually implemented a number of technological enhancements to its investment process. Bayesian group estimators or contrasts are now an integral part of our investment process. Stein estimators have been updated with weighted hierarchical linear models for improved statistical estimation. Finally, a new averaging process has been introduced in computing Michaud optimized portfolios for improved investment performance.

New Frontier has been in the news. We are very proud to announce our sponsorship of the Harry M. Markowitz award and two additional awards for papers of distinction published in the *Journal Of Investment Management*. New Frontier's optimization technology was prominently featured in the May *Institutional Investor* article on "Portfolio Theory: From Markowitz to Michaud". Our work on target date and target risk funds has been featured in *Investment News* magazine. Our recently updated website has more information on these and other recent announcements.

stimulate the economy will lead to a deflationary spiral leading to millions of workers going jobless for years and thousands of businesses destroyed.

So far, the American economy has exhibited positive economic signs. The current working consensus among practicing economists is that the recovery is sustainable though slowing. For the 80% of Americans still employed, individual incomes are rising and corporate cash flows are strong. The economy grew by 2.7% first quarter, may have grown by 3.6% in the second quarter, with forecasts of possible growth of 2 to 3% in second half of the year.

From an investment point of view, China is unlikely to be helpful to grow the global economy anytime soon. While U.S. political and economic uncertainties rival those of the E.U., the systemic weakness of the euro, the benefit of the dollar as the world's reserve currency, the economic hegemony of U.S. federalism, relatively flexible labor markets, and no likelihood of a sharp reversion to fiscal austerity for the time being, provide an edge against the effects of deflationary risk relative to many other economies. On a relative basis, the likelihood of the U.S. muddling through seems a reasonable, though far from certain, bet.

Prospects for future economic growth are uncertain and may have dimmed. While the VIX, at 30 to 35%, is not at historical highs, it remains indicative of elevated levels of systematic risk in global markets. All things the same, lowering systematic risk reduces the riskiness of invested assets. Given heightened global economic and political uncertainties and possible deflationary risk near term, investors may be well advised to consider reducing systematic risk relative to long-term objectives on a temporary basis for new or current funds.

Effective global diversification at an appropriate systematic risk level remains the most likely route for core investors to optimally meet long term objectives. Innovation remains the ultimate source of economic growth in capital markets.

July 6th, 2010