NEW FRONTIER

Market Perspectives: 3rd Quarter 2020

Enhanced Return ▪ Effective Diversification ▪ Managed Risk

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A Fragile Recovery

Propelled by large cap growth stocks, the S&P 500 reached an all-time high on September 2. New economic data exceeded expectations, and COVID-19 cases were falling in the U.S. Yet stocks soon declined, driven by a correction in large cap tech stocks. Equities still closed the quarter in positive territory, with the S&P returning 9% this quarter and 6% year-to-date. However, unlike the NASDAQ, the S&P finished the quarter below pre-pandemic highs.

The U.S. economy improved significantly this quarter, but investors continue to face several serious risks. In late September, confirmed COVID-19 cases were rising worldwide, and the pandemic may intensify as winter approaches. A combative U.S. presidential election looms. Meanwhile, Congress has struggled to pass another stimulus package, and the Sino-American conflict has escalated. Two other sizeable risks have received less investor attention: climate change and socioeconomic inequalities. A well-diversified, risk-targeted portfolio is essential for navigating these risks.

New Frontier Performance

New Frontier's global strategies, as calculated by S&P Dow Jones Indices, performed well this quarter and year. The 20/80 New Frontier Global Income Index, NFGII, returned 2.3% this quarter and 4.3% year-to-date. The 60/40 New Frontier Global Institutional Index, NFGBI, returned 5.2% this quarter and 4.2% this year. Finally, the 100/0 New Frontier Global Equity Index, NFGEI, returned 7.8% and 0.9% for the quarter and year, respectively. For comparison, the MSCI ACWI IMI index, returned 8.1% and 0.5%, respectively.

Our recently launched domestic strategies also performed well. The 60/40 New Frontier U.S. Institutional Index, NFDBI, returned 4.6% this quarter and 4.6% this year. The 100/0 New Frontier U.S. Equity Index, NFDEI, returned 8.0% and 5.8% respectively on the quarter and year. As a reference, the S&P returned 8.9% this quarter and 5.6% this year.

An Uneven Quarter

The stock rally continued in July and August: the S&P rose 13%, growth outperformed value by 10%, and U.S. stocks outperformed international ones by 4%. The dollar declined 5%, and U.S. large caps outperformed small caps by 5%.[1] However, stocks

[1] These comparisons are based upon the S&P 500, the S&P 500 Value and Growth indices, the ACWI ex-US Index, the Russell 2000 Index, and the ICE US Dollar Index.

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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changed course in September: the S&P fell 4%, growth underperformed value by 2%, and the U.S. underperformed international by 1%. The dollar rose 2%. Investors became concerned about the high valuations of large cap tech stocks, and the options market experienced abnormally high volumes. Value stocks also suffered in September as confirmed coronavirus cases increased and vaccine news was mixed. Despite all this activity, it was the least eventful quarter of 2020.

Real economy performance has diverged around the world. Bolstered by exceptional monetary and fiscal stimulus, the U.S. economic recovery has been impressive. GDP is expected to contract by only 4% in 2020 according to the Fed, and unemployment fell to 8% in August. In contrast, the Eurozone and Britain will contract by 8% and 10% respectively this year, according to the OECD. China's GDP is even expected to expand by 2%.[2]

This diverging economic performance is due to a variety of factors, including the size of a country's fiscal stimulus and its success at managing the pandemic. Another significant factor is sectoral composition. Economies with sizable manufacturing sectors, such as China and South Korea, have generally recovered faster than service-dominated economies—for example much of Europe, which has also squabbled over fiscal stimulus. The exception is service economies with big tech sectors. Yet sectoral composition has not determined stock performance. For instance, European tech stocks have trailed U.S. tech stocks significantly this year. U.S. equities have outperformed international ones largely because growth stocks are a considerable component of the U.S. market.

The Pandemic

The coming months may be sobering. COVID-19 was not defeated over the summer, and confirmed cases are rising. As fall began, almost 300,000 new infections were recorded worldwide each day, near the record. Over a million people have died globally of the virus, including more than 207,000 Americans. Although coronavirus treatments have become more effective, the human and economic costs will likely be considerable if cases keep climbing. Governments might impose additional lockdowns. The University of Washington model projects 2.5 million cumulative deaths worldwide by yearend, including 370,000 Americans.[3] Some investors believe herd immunity is within reach, but few epidemiologists agree. A yet-to-be-discovered vaccine remains the best hope for defeating the virus.

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[2] Bureau of Labor Statistics. "Employment Situation Summary." October 2, 2020, https://www.bls.gov/news.release/empsit.nr0.
Reuters Staff. "OECD's Latest GDP Forecasts." Reuters, September 16, 2020, https://www.reuters.com/article/oecd-economy-idUSL8N2GD1SM.

[3] The New York Times. "Covid World Map." Updated daily, https://www.nytimes.com/interactive/2020/world/coronavirus-maps.html.
The Institute for Health Metrics and Evaluation. "COVID-19 Projections." Updated weekly, https://covid19.healthdata.org/global.

New Frontier Portfolios

New Frontier develops and manages a broad range of ETF asset allocation strategies for advisors and their clients, and currently oversees over $3 billion in global and domestic ETF asset allocation portfolios.

The Fed's New Framework

The Fed's new policy framework—using an *average* inflation target of 2%, sometimes tolerating higher inflation to achieve full employment—is timely given the high unemployment rate. This is a sharp break from the Fed's old approach, in place since 1979, of prioritizing low inflation over full employment. This presents the prospect of low interest rates and low yields for years.

The Fed's commitment to maintain near-zero interest rates through 2023 should boost economic growth and employment. This commitment, along with its bond and loan-buying programs, tamed the bond market. Treasury yields remained near record lows, and investment-grade corporate yields were stable this quarter. The AGG returned just 0.6%, while junk bond yields fell moderately. Low yields helped drive gold to an all-time high in August, yet gold slipped closing the quarter up only 5.9%. Despite their low yields, investment-grade bonds are still critical for risk management.

Stalled Stimulus Efforts

Congress failed to agree on a new stimulus package this quarter. The economic recovery has exceeded expectations, but Jerome Powell and many economists argue the recovery will probably slow without more stimulus. Recent layoff and furlough announcements from airlines, banks, and Disney raise the possibility of layoffs increasing in the fourth quarter. Moreover, unless there is a federal extension, millions will no longer be eligible for unemployment benefits by January. This could dampen consumer spending. Targeted stimulus is therefore justified on both economic and welfare grounds.

If the U.S. experiences a severe second wave, then another substantial stimulus package might be needed, possibly larger than the $2.2 trillion CARES Act. Negative interest rates, yield curve control, and exotic monetary policy tools would likely be considered. Perhaps the U.S. should conserve its fiscal and monetary firepower for this worst-case scenario. Yet appetite for Treasurys seems so strong that accumulating trillions more in federal debt could have few near-term consequences.

U.S. Election Risk

Derivative and currency markets reveal high levels of expected volatility surrounding the upcoming election. VIX futures indicate anticipated volatility through December. If the election results are close—or if a candidate rejects the official outcome—a protracted court battle could follow, as *The Wall Street Journal* has explained.[4] Banks are preparing for the possibility of "weeks of chaos" in world equity and bond markets, according to *Reuters*. This includes performing stress tests to gauge liquidity and credit risks.[5] Additionally, some policy experts argue that widespread street-level violence could erupt.[6] Another risk is that public policy may become more unpredictable as the election approaches. The implications of President Trump testing positive for COVID-19 on October 1st are uncertain.

China and the World

China is the only G20 economy expected to expand this year, due in part to large government infrastructure projects. The OECD also forecasts an 8% expansion in 2021, indicating China will likely remain a key driver of global growth. China has been the best performing major equity market in the world, returning 16% this year and 12% this quarter. Other emerging markets have returned -11% year-to-date.[7] Mainland China A-shares are becoming an institutional asset class, and institutional investors have significantly increased their allocations to A-shares over the last two years.

China has thrived despite recent escalations in the Sino-American conflict. The U.S. strengthened its sanctions on Huawei and pressured ByteDance to sell control of TikTok's U.S. operations. China-U.S. relations could deteriorate further as the election approaches. More broadly, the escalated conflict exacerbates fractures in the global economy. The world economy—and the respective roles of the U.S. and China—could change substantially in the coming years.

Climate Change and Socioeconomic Inequality

Investors have paid less attention to two other significant economic risks. This quarter's frequent tropical storms and massive forest fires highlight the increasingly destructive effects of climate change. Natural disasters fueled by climate change destroy productive resources and disrupt economic activity. Far-reaching regulations

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[4] *Ramkumar, Amrith and Julia-Ambra Verlaine. "Investors Ramp Up Bets on Market Turmoil Around Election." The Wall Street Journal, September 27, 2020, https://www.wsj.com/articles/investors-ramp-up-bets-on-market-turmoil-around-election-11601199001.*

Leary, Alex and Alexa Corse. "Trump Won't Commit to Peaceful Transfer of Power After Election." The Wall Street Journal, September 23, 2020, https://www.wsj.com/articles/trump-ties-supreme-court-vacancy-to-possible-disputed-election-11600899074.

[5] *Scuffham, Matt. "Global banks ramp up preparations for U.S. election night chaos." Reuters, September 30, 2020, https://www.reuters.com/article/usa-election-banks/global-banks-ramp-up-preparations-for-u-s-election-night-chaos-sources-say-idUSL4N2GQ4B2.*

[6] *Brooks, Rosa. "What's the worst that could happen?" September 3, 2020, https://www.washingtonpost.com/outlook/2020/09/03/trump-stay-in-office/?arc404=true.*

[7] This is based on the MSCI China and MSCI Emerging Markets ex-China indices.

on climate change may be enacted within a decade in the U.S. California has already pledged to ban the sale of new gas-powered cars by 2035.

The pandemic and antiracism protests revealed deep socioeconomic inequalities in the U.S. Low-income workers were laid off in disproportionate numbers due to the pandemic, and the protests highlight unequal incarceration rates. Beyond being a source of social instability, these disparities are relevant to markets for two reasons. First, they may hamper economic growth. Several peer reviewed studies show economic inequality can reduce growth. Citigroup economists estimate that racial inequalities have diminished U.S. GDP by almost $1 trillion annually.[8] Second, socioeconomic disparities might inspire redistributive legislation involving tax increases. More generally, these inequalities reveal unsustainable socioeconomic disequilibria that will likely need to be corrected.

The improved U.S. economic data is encouraging, but it should be interpreted with care. The unemployment rate fell sharply this quarter; however, permanent job losses have steadily increased since March, rising from 2.9 million in June to 3.8 million in September. Overall retail spending has surpassed pre-pandemic levels for four consecutive months. Yet in-person retail expenditures are well below pre-pandemic levels. Much of the surplus spending can be explained by high savings rates in the spring. Moreover, overall consumption has remained below pre-pandemic levels. Nevertheless, the Fed recently raised its GDP forecast for 2020 from -6.5% to -3.7%.[9] So the real economy has improved considerably, although the recovery is fragile and not genuinely V-shaped.

Looking Ahead

It is notable that the largest risks for markets are exogenous to traditional financial and economic theory. These risks, many of them rooted in the pandemic or U.S. politics, have the potential to interact dangerously with each other and disturb capital markets. Maintaining an effectively diversified, risk-controlled portfolio is as essential as ever for long-term investors.

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[8] *Nolan, Brian, Wiemer Salverda, and Timothy Smeeding (editors). The Oxford Handbook of Economic Inequality. Oxford University Press, 2011.*
Peterson, Dana and Catherine Mann. "Closing the Racial Inequality Gaps." Citi Global Perspectives and Solutions, September 2020, https://www.citivelocity.com/citigps/closing-the-racial-inequality-gaps/.

[9] *Torry, Harriet. "U.S. Retail Spending Grew at Slower Pace in August." The Wall Street Journal, September 16, 2020, https://www.wsj.com/articles/us-economy-august-retail-sales-coronavirus-recovery-11600200513?st=1hpy3pg7tunc5ok.*
Federal Open Market Committee. "September 16, 2020: FOMC Projections materials." September 16, 2020, https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20200916.htm.
Federal Reserve Economic Data. "Personal Consumption Expenditures." Updated monthly, https://fred.stlouisfed.org/series/PCE.

Recent Research on Bond ETFs and Liquidity

A recent CFA Society Boston research presentation — co-sponsored by Dr. Richard Michaud, a member of the Program and Education Committee — demonstrated that bond ETFs served as valuable vehicles of price discovery during the March crisis.[10] Critics often note that during a crisis, fixed income ETFs trade at a discount or premium relative to Net Asset Value (NAV). But this is often normal behavior: many bonds in an index may trade infrequently, with NAVs based on yesterday's valuations. Bond ETFs allowed markets to determine the "true" prices of underlying bonds through numerous ETF transactions per minute. This liquidity also allowed investors to quickly adjust their fixed income exposures at low cost. New Frontier was able to confidently rebalance all its strategies at the height of the March panic.

The high liquidity of bond ETFs distinguishes them from mutual funds and individual bonds. Finding comfort in securities with stable prices on volatile trading days should be a warning sign. Mutual funds are priced once each day, and many individual bonds are not traded every day. During a volatile trading session, the listed price of an illiquid security can be far different from the price a trader would receive. Bond ETF prices are frequently more informative.

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[10] *Laipply, Stephen and Ananth Madhavan. "Pricing and Liquidity of Fixed income ETFs in the Covid-19 Virus Crisis of 2020." Journal of Index Investing (forthcoming).*