Market Perspectives: 1st Quarter 2021

John McCrary
Research Analyst

David Esch, Ph.D.
Managing Director, Research

Robert Michaud
Chief Investment Officer

Which Way is Up?

As the end of the pandemic came into view in the U.S. and the new administration's stimulus plan became more probable, expectations for economic growth and inflation have increased. The economic optimism had broad consequences for markets—risky assets fared well and defensive assets were less in demand.

The new administration has brought significant changes to economic policy. Its $1.9 trillion stimulus package reflects a fundamental shift toward a more progressive fiscal policy. In taking a confrontational approach toward China, Biden demonstrated his commitment to making the U.S. economy more competitive globally.

New Frontier Global Index and Performance

All New Frontier strategies attained new highs during the quarter. The New Frontier Global (60/40) Institutional Index (NFGBI) returned 1.6% in Q1, while the New Frontier U.S. (60/40) Institutional Index (NFDBI) returned 2.9%, as calculated by S&P Dow Jones Indices. However, these strategies underperformed their benchmarks by 1.5% and 0.7%, respectively, due to the poor performance of Treasurys and corporate bonds.

However, New Frontier's all-equity strategies performed well. The New Frontier Global Equity Index (NFGEI) rose 6.0% in Q1, while the ACWI IMI returned 5.1%. The New Frontier U.S. Equity Index (NFDEI) also had a good quarter, rising 7.0% and outperforming the S&P 500 NR by 1.0%.

Market Performance

Following the theme of economic optimism, the quarter was good for equities but not bonds. The S&P 500 was up 6.2% but the AGG declined 3.4% in what was the worst quarter for Treasurys since 1980.[1] Tax-Sensitive and Multi-Asset Income portfolios fared better due to their higher exposure to municipal bonds and dividend stocks, respectively.

Asset classes diverged considerably. The kinds of equities expected to benefit most from a stronger economy outperformed. In the U.S., value outperformed growth by 9%, and small caps outperformed large caps by 7%. As with value, global dividend stocks outperformed ACWI by 10%. In contrast to 2020, the U.S. energy and financial sectors returned 31% and 16% respectively, while the U.S. technology sector was up only 2%.[2]

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[1] NFGBI's benchmark is a blend of 60% ACWI IMI and 40% 3-month T-Bills. NFDBI's benchmark is a blend of 60% S&P 500 NR and 40% T-Bills. The 1980 comparison is based upon the Bloomberg Barclays U.S. Treasury Index. Long-duration Treasurys had a terrible quarter, whereas 3-month T-Bills were flat.

[2] These comparisons are based upon the S&P 500 Value and Growth indices, the Russell 2000 Index, the S&P 500 Index, and the Dow Jones Global Dividends Index. The sector comparisons come from three SPDR sector ETFs: XLE, XLF, and XLK.

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

Inflation fears and economic optimism were not as kind to defensive assets. Yields on investment-grade bonds rose substantially this quarter, especially for long-duration government and corporate bonds. Treasurys and investment-grade corporate bonds returned -4% and -5%, respectively. This was the worst quarter for Treasurys since Fed Chair Volcker raised interest rates to new highs in 1980. Gold also fell 10%. On the other hand, returns on high-yield and municipal bonds were relatively flat. In addition, the U.S. dollar climbed 4%, reversing its nine-month decline.[3]

The Main Themes of the Quarter

A Fundamental Shift in U.S. Economic Policy

The $1.9 trillion stimulus package is expected to boost U.S. economic growth significantly. The stimulus checks inject roughly $400 billion of cash into the economy, and extended unemployment benefits provide additional short-term relief.[4] Many economists believe these provisions will be especially effective because they give money to those most likely to spend it. The economic recovery was already underway, with unemployment decreasing to 6.0% in March, and the stimulus will amplify the recovery. The Fed predicts that U.S. GDP will expand by 6.5% in 2021 and unemployment will stand at only 4.5% in Q4.[5] Although some critics argue the stimulus is too large, that is preferable to it being too small. Markets indicate higher near-term inflation expectations, with inflation tapering off over time.

The stimulus reflects the Biden administration's commitment to actively stimulate the economy while reducing inequality. This commitment—paired with the Fed's new approach of prioritizing maximum employment—may constitute a policy shift as momentous as the transformations that began in 1980 with President Reagan and Fed Chair Volcker. President Biden endeavors to overhaul and expand the safety net for a post-pandemic world unfriendly to less skilled workers. Stimulus checks, the child tax credit, and several other stimulus provisions are highly progressive. Such policies may further facilitate growth, as recent research suggests economic inequality can hamper growth.[6]

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[3]The returns cited are from the ICE U.S. Dollar Index, the Bloomberg Barclays U.S. Treasury Index, and the Bloomberg Barclays U.S. Corporate Bond Index.

[4]Siegel, Rachel. "What's in Congress's $1.9 trillion Covid Bill." The Washington Post, March 10, 2021, https://www.washingtonpost.com/business/2021/03/10/what-is-in-the-stimulus/.

[5]Federal Open Market Committee. "March 17, 2021: FOMC Projections materials." March 17, 2021, https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20210317.htm.

[6]Nolan, Brian, Wiemer Salverda, and Timothy Smeeding (editors). The Oxford Handbook of Economic Inequality. Oxford University Press, 2011.

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 ETF asset allocation portfolios.

Confronting China

Whereas the Trump administration's main goal was to limit China's economic ascent, Biden's central aim is to increase the long-term global competitiveness of the U.S. in "critical" technologies.[7] Both the U.S. and China are interested in reducing economic interdependence and securing supply chains for critical sectors. This economic and geopolitical confrontation will likely last for years given the bipartisan consensus regarding China in the U.S.

As vaccines have been distributed globally, China underperformed most major equity markets this quarter, returning -0.4%.[8] Rising U.S. yields, alongside Biden's confrontational stance, helped trigger capital outflows from China. Within China, fiscal and monetary policy has tightened while it remains loose in most of the world. Beijing also continued its clampdown on private tech companies.

The upshot is that investors must be cautious when deciding how much to invest in China, carefully weighing the trade-off between these risks and the benefits of participating in China's robust economic growth.

Other Notable Themes

Implications of the Rise in Yields

Yields rose on economic growth expectations. Treasury yields soared following the Georgia Senate runoffs, which rendered a large stimulus package probable. The 10-year yield, which had remained below 1% since last March, closed the quarter at 1.7% as investors priced in higher expectations for growth and inflation. The Fed has not directly intervened to stop long-duration yields from rising, but it reaffirmed its commitment not to raise rates soon.

Some investors have worried that the rise in yields would trigger a decline in equity prices. All else equal, higher yields make stocks less attractive relative to bonds because the discount rate on stocks has risen. But markets are rarely so simple, and the S&P rose 6.2% in Q1. Other investors worry about a decline in bond prices, but there is no guarantee that yields will continue rising. Bonds, particularly Treasurys, are used to help maintain the risk control of New Frontier's portfolios. Anyone invested in an optimized ETF portfolio, such as a 60/40 strategy, should not be deeply concerned about the recent rise in yields, so long as the overall portfolio performs well for their investment objective.

[7]Sanger, David and Michael Crowley. "As Biden and Xi Begin a Careful Dance, a New American Policy Takes Shape." The New York Times, March 17, 2021, https://www.nytimes.com/2021/03/17/us/politics/us-china-relations.html

U.S. interest rates have global implications. The rise in U.S. Treasury yields may complicate the recovery in developing countries by making their markets less attractive. Some developing countries recently experienced capital outflows and declines in equities. This in turn can pressure developing country central banks to raise rates, which could further slow their recoveries. Brazil, for example, has already increased rates.

Higher yields do not guarantee inflation. Treasury yields and inflation do not always move together—considerable changes in yields since 2008 were not primarily driven by inflation, and Volcker famously raised rates to lower inflation. Treasury markets indicate a modest increase in inflation that will subside after roughly five years.[9] But Treasury markets have historically been unreliable predictors of inflation and interest rates. Furthermore, any inflation forecast is debatable due to uncertainty surrounding the shape of the global recovery and the consequences of the $1.9 trillion stimulus, combined with the $2 trillion infrastructure proposal.

Global Divergence

International stocks underperformed U.S. stocks this quarter. According to the OECD, U.S. GDP is expected to grow at a faster rate in 2021 than all G20 economies except for China and India.[10] Much of the global divergence can be explained by COVID-19. The European Union (EU) has struggled to distribute vaccines, and European stocks underperformed as infections rose in several EU nations. Brazilian equities returned -10% in Q1 as Brazil became a global epicenter for COVID-19.[11]

Investment News

Retail Traders and Market Efficiency

Retail investor activity had a sizable impact on certain asset prices in Q1, with Bitcoin and GameStop being the most notable examples. The GameStop saga was not a normal short squeeze. GameStop's market price has risen nearly 900% in 2021 as of this writing. GameStop enthusiasts convinced enough people that the company was undervalued by an order of magnitude. Markets are inherently social institutions where popular beliefs shape expectations and valuations—but information might eventually show these beliefs to be wrong.

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[9] As of this writing, Treasury markets indicate that the average inflation rate over the next five years will be 2.6%. This comes from breakeven Treasury yields: the spread between T-Bills and Treasury Inflation-Protected Securities (TIPS).

Federal Reserve Economic Data (FRED). "Interest Rate Spreads." Updated daily, https://fred.stlouisfed.org/categories/33446.

[10] OECD. "OECD Economic Outlook, Interim Report." March 2021, https://www.oecd-ilibrary.org/economics/oecd-economic-outlook/volume-2020/issue-2_34bfd999-en.

[11] The returns cited for Brazilian equities are from the MSCI Brazil Index.

Archegos's Approach Was Not Long-Term Optimal

Another dramatic investment event was the collapse of Archegos Capital in March. The value of New Frontier's investment process can be illustrated by contrasting us with Archegos Capital. Archegos collapsed because it held highly leveraged positions in a small number of individual stocks. A leveraged portfolio can underperform by more than 100%. In contrast, our ETF strategies do not employ leverage and deliberately avoid being overly exposed to individual risk factors or asset classes, let alone individual securities. Consequently, over New Frontier's 16-year track record, our core global strategies have never underperformed their benchmarks by more than 3.3% in any calendar year.[12] In addition, New Frontier does not make speculative investments. For example, adding Bitcoin to any portfolio would significantly increase its risk. Bitcoin is extremely volatile, and cryptocurrency valuations remain poorly understood.

Looking Ahead

This quarter featured a dramatic reset in capital market expectations, epitomized by the substantial rise in yields. Investors therefore should not rely on expectations forged in 2020 to make asset allocation decisions in 2021. The underperformance of growth and Chinese stocks in Q1 illustrates this clearly. Moreover, uncertainty remains elevated, especially in international markets. Thus, being highly exposed to any single asset class is particularly risky. Maintaining an optimally diversified portfolio is a very effective way to navigate these uncertain times.

Research Update

New Frontier Institute is proud to present, in partnership with CFA Society Boston, the Distinguished Lecture Series for the Spring of 2021, presented online and hosted by Dr. Richard Michaud. The Series consists of highly topical presentations by widely acknowledged authorities on issues of particular interest to asset management practitioners. On March 17, in the second lecture in this year's series, Dr. Hendrik Bessembinder, a professor at Arizona State University's W. P. Carey School of Business and the Francis J. and Mary B. Labriola Endowed Chair in Competitive Business, gave a remarkable lecture focused on his paper "Do Stocks Outperform Treasury Bills?" published in the *Journal of Financial Economics* in September 2018.[13]

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[12] We underperformed by nearly 3.3% in 2009, a very unusual year. This underperformance calculation uses returns from our six global core indices, as calculated by S&P Dow Jones Indices. The underperformance calculations can be replicated by anyone with a Bloomberg terminal.

[13] Bessembinder, Hendrik. "Do Stocks Outperform Treasury Bills?" *Journal of Financial Economics* 129, no. 3 (2018): 440-457.

Bessembinder's lecture was an important back-to-basics wake-up call for stock investors, entirely consistent with New Frontier's views on investing. Much of the lecture dealt with a grand analysis and summary of the entire recorded history of U.S. listed stocks in the CRSP (Center for Research in Security Prices) database. As the provocative title suggests, although the average return on a single stock may be positive, most of the time a single stock is a losing investment when compared to T-Bills, which give reliable but paltry returns. In other words, the return distribution of individual stocks exhibits extreme positive skewness: a few big winners tip the overall average in a positive direction, while most stocks have underperforming lifetime returns. Examining the population of lifetime single stock returns, the most frequent outcome (mode) of the distribution is a total loss of capital, a -100% return.

The research itself is an update and continuation of a long line of research about skewness in terminal wealth distributions of investments, notably Fisher and Lorie (1970).[14] Bessembinder has provided an extremely valuable service to the investment community by continuing and promoting this essential thread of research.

This research also underscores the importance of holding a diversified portfolio of many stocks, as do all New Frontier's funds, to control risk and provide reliably positive long-term returns. It also emphasizes the value of using high-quality information to identify winners and losers over time rather than random selection. Although Bessembinder noted that this research does not definitively favor either passive or active management, our research supports that our approach of exposure to all available risk factors and multi-patented Michaud optimization based on high-quality publicly available information is at present the best known way to manage the issues presented in this talk. New Frontier's effective approach to risk control and careful asset selection provide the best advantages of both active and passive management.

Bessembinder's research also dovetails nicely with the main thesis of Dr. Richard Michaud's CFA lecture series from February 2018, "Finance's Wrong Turn."[15] If mainstream Quantitative Finance theory took a wrong turn somewhere in the 20th century, Bessembinder is showing us how to go back to the fork in the road by starting from first principles and reminding us of the most important features of investing in capital markets: the return distributions of the securities themselves.

Register for the upcoming lectures in the series in April and May—more information is available on the New Frontier and Institute websites.

[14]Fisher, Lawrence and James H. Lorie. "Some Studies of Variability of Returns on Investments in Common Stocks." *The Journal of Business* 43, no. 2 (1970): 99-134.

[15]Michaud, Richard O. "Finance's Wrong Turn: A Revisionist View of Modern Finance in Practice." Sponsored by the CFA Society Boston and New Frontier Advisors, LLC. March 6-April 3, 2018. Putnam Investments, Boston, https://www.cfaboston.org/WrongTurn.

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DISCLOSURES: Past performance does not guarantee future results. As market conditions fluctuate, the investment return and principal value of any investment will change. Diversification may not protect against market risk. There are risks involved with investing, including possible loss of principal.