Frontier Funds

Quarterly Commentary
March 31, 2018

Frontier MFG Global Plus Fund – Institutional Class (FMGPX), Service Class (FMPSX)

Sub-advised by MFG Asset Management – Sydney, AU

Global stocks fell for the first quarter in eight in the March quarter after U.S. President Donald Trump imposed import restrictions that could lead to trade wars (especially with China), concerns mounted that U.S. inflation might accelerate enough to prompt the Federal Reserve to tighten monetary policy more quickly than expected, worries gripped that regulators would crack down on U.S. technology companies, and populist parties dominated in Italy's election. During the quarter, nine of the 11 sectors in the MSCI World Index fell in US-dollar terms. Telecoms (-5.9%) and Energy (-5.4%) fell most while Information Technology fared best (+3.4%).

U.S. stocks slid as concerns mounted about trade wars, the stability of the Trump administration, inflation and tech regulation. The White House imposed tariffs on steel (25%) and aluminum (10%), prompting Trump's top economic adviser Gary Cohn to resign, and targeted China with at least US$50 billion worth of tariffs. After a report showed accelerating wages growth, investors fretted that fiscal stimulus in the form of corporate tax cuts and extra spending would prompt the Fed to raise the cash rate more than three times in 2018. In March, the Fed raised the U.S. cash rate by 25 basis points to between 1.5% and 1.75%, its highest range since the global financial crisis began, but still flagged only another two rate increases this year. The clouds over tech stocks included concerns about data privacy, and moves by the EU to tax their revenues. Over the quarter, economic reports showed consumer prices rose a higher-than-expected 2.2% in the 12 months to February, the jobless rate stayed at a 17-year low of 4.1% for a fifth consecutive month in February and the U.S. economy expanded a revised 2.9% in the fourth quarter.

European stocks fell amid political uncertainty even though economic readings were positive. Investors were concerned about the shape and direction of Italy's next government after Eurosceptic and anti-establishment parties won 55% of the popular vote in elections that left the debt-heavy country with a hung parliament. Reports out over the quarter showed the eurozone economy expanded 0.6% in the fourth quarter, consumer prices rose 1.1% in the 12 months to February and industrial production rose 2.7% in January from a year earlier.

In Asia, Japanese stocks sagged as a cronyism scandal enveloping Prime Minister Shinzō Abe could see him lose a party leadership election this September. Over the quarter, a report showed Japan's economy, after expanding at an annualized rate of 0.5% in the fourth quarter, had notched eight consecutive quarters of growth, the longest such stretch in 28 years. In China, parliament abolished the term limits on the presidency that were installed in 1982, effectively making Xi Jinping ruler for as long as he wishes.

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400 Skokie Blvd., Suite 500 – Northbrook, IL 60062 – 847-509-9860 – www.frontiermutualfunds.com

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The Fund recorded a negative return for the quarter. Stocks that lagged included the investments in Kraft Heinz, Wells Fargo and Facebook. Kraft Heinz dropped after disappointing sales figures in the fourth quarter showed the plight of the U.S. packaged-food industry and margin improvement was below expectations. Wells Fargo slid after the Federal Reserve took the unusual step of banning the bank from expanding its assets until the lender can show it has resolved its "widespread consumer abuses and compliance breakdowns". Facebook slumped after news that the data of about 50 million users was improperly gained by a UK company and used to target voters in the U.S. elections of 2016 triggered investigations in the UK and U.S. that pointed to stiffer regulation of tech companies. (In April, the number of users whose data was improperly gained was boosted to 87 million.)

Stocks that performed best included the investments in Mastercard, Visa and HCA Healthcare. Mastercard and Visa gained after the payments companies revealed that fourth-quarter earnings beat estimates – in Mastercard's case, for instance, adjusted earnings per share surged 33% – due to higher consumer spending, and the companies boosted forecasts for 2018. HCA surged after the hospital chain reported a higher-than-expected profit for the fourth quarter on higher revenue and better control of expenses, said it would enjoy a lower effective tax rate of 25%, announced it would pay its first-ever quarterly dividend, and disclosed a US$10.5 billion investment plan over the next three years.

We remain cautious about the outlook for global markets and think the risks are asymmetrical to the downside.

While the major central banks would like to engineer a 'soft landing' with gradual increases in interest rates, there is a material risk that they could be forced to tighten monetary policy faster than expected. MFG Asset Management's view is that the U.S. administration's recent budget measures have elevated the risks. The tax cuts and additional spending will make a fiscal injection into the U.S. economy of nearly 2% of GDP per annum for the next two years. The timing of such a large fiscal stimulus at, or near, the top of an economic cycle when central banks are trying to exit the largest monetary expansion in modern history may prove to be reckless. The U.S. unemployment rate at 4.1% in February is at a 17-year low and the U.S. economy has added jobs over the past 89 months (to the end of February), which is the longest such consecutive stretch on record. While there appear to be powerful longer-term secular forces at work that are likely to result in low inflation over the longer term, there is a significant risk that the size and timing of the U.S. fiscal stimulus could trigger a jump in U.S. inflation, in particular from stronger wages growth, over the next year or two. This may be highly problematic for the Federal Reserve and complicate its efforts to engineer a gradual tightening with a soft landing. We cannot think of a similar combination of circumstances in modern history. The cocktail could be explosive.

Other sources of concern are President Donald Trump's protectionist action and rhetoric, particularly when it comes to the trading relationship with China. We are vigilant for any signs that China's government might retaliate or a Chinese consumer backlash might be directed at U.S. technology stocks held in the portfolio.

In terms of other risks, North Korea's endeavors to advance its nuclear intercontinental ballistic missile capability could be destabilizing, if talks with the U.S. break down. Much uncertainty surrounds the direction of Italy's new government following the elections.

Due to these risks, over the quarter we increased the cash position held in the strategy from approximately 10% to 17%. Notwithstanding the uncertainty surrounding stock markets, we are confident about the long-term outlook for the investments selected for our portfolio and the portfolio's risk profile. Many of the stocks in the portfolio benefit from being leading digital platforms, the shift to a cashless society, a stronghold on the enterprise software market or the dynamics of ageing populations.