MEEDER
INVESTMENT MANAGEMENT

Q2 2019 CAPITAL MARKETS UPDATE

President's Perspective

CAPITAL MARKETS AS OF JUNE 30, 2019

Equity volatility subsided some during the second quarter of 2019, compared to the first three months of the year. The S&P 500 regained it's footing and eclipsed the prior high set in September 2018 to reach a new all-time closing high of 2,954 on June 20th. After finishing 2018 in negative territory, the S&P 500 Index has increased more than 18% year-to-date. Market breadth continues to improve as the number of advancing stocks to declining stocks on the NYSE Composite continues to validate that more stocks are participating in the rally.

Many are encouraged to see this upswing in performance, but not every segment of the market is "hitting on all cylinders" and it has led some investors to caution the sustainability of this rally. Different investment styles and market capitalizations are showing various levels of strength. This year, in some cases, growth stocks have doubled the performance of their value peers. While small-cap stocks, represented by the Russell 2000 Index, returned less than half of the S&P 500 during the quarter, they have managed to climb nearly 17% in 2019. When looking back at the past 12 months, the disparity among small cap stocks (Russell 2000 Index) relative to large caps (S&P 500 Index) has maintained the widest range since 1998.

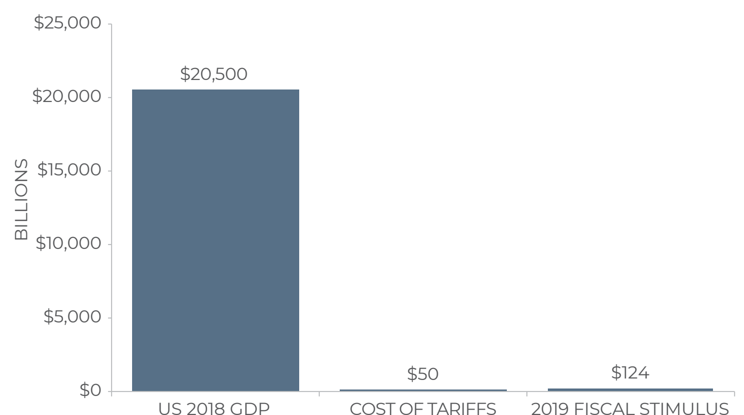
First quarter GDP posted 3.1% growth, in line with analyst expectations, but some data is showing signs that the U.S. economy's growth is slowing. June's ISM Manufacturing Index level of 51.7 showed growth but the results were the weakest in almost three years. Employment data over the past two months has varied widely and been difficult for investors to gauge. The May non-farm payrolls report was shockingly low as just 75,000 jobs were created despite expectations of 180,000. On a positive note, June's saw a rebound in employment numbers by creating 224,000 jobs, exceeding estimates of 165,000. When looking forward, the Leading Indicators Index shows that the rate of growth from April to May remained flat. This index is important because it is a composite of ten forward-looking components that attempt to predict what the economic future looks like up to six months into the future. This stagnation has caused some investors concern as this indicator has historically stopped increasing and turned negative prior to each of the last seven recessions since 1960.

While inflation remains restrained and unemployment is at 3.7%, the Fed continues to reaffirm their commitment to economic growth. In a recent speech, Fed Chair Jerome Powell said that the central bank will work to sustain the economic expansion. In March the Fed stated that they would be "patient" with future rate increases. Now, because some economic factors are starting to show signs of a slowing economy, some investors feel that the Fed is entertaining the possibility of cutting interest rates. This thought process represents a major shift on the part of the Fed over the last nine months. These comments caused short-term bond yields to plummet, and in May, the 10-year U.S. Treasury yield fell below the 3-month yield. Since 2000, this was the third market cycle that an inversion in the yield curve has occurred between these maturities. As longer-term bond yields fall below shorter-term yields, it suggests serious concerns about future economic growth. This means, given the amount of uncertainty present in the marketplace, investors are unwilling to be compensated with additional yield for longer dated maturities. Despite the Fed's indecision regarding interest rates, the Bloomberg Barclays US Aggregate Bond Index increased over 6% in the first half of 2019.

Some investors also believe the Fed is closely watching international trade talks and would reduce short-term interest rates should there be economic fallout from the ongoing trade war. While there is no resolution to talks between the U.S. and China, both sides have indicated that progress is being made on a deal and agreed to hold off on implementing additional tariffs. As trade talks with China improved, a new trade dispute garnered the attention of investors. Frustrated by the number of undocumented migrants entering the U.S., the President announced that the United States would begin imposing a 5% tariff on all Mexican imports. Mexico responded by placing nearly 15,000 troops along the border to prevent illegal immigrants from entering the United States.

While trade wars continue to make media headlines, it is important to put the projected cost impact of these tariffs into perspective. According to Bloomberg, the estimated cost of tariffs to the U.S. economy so far has been roughly $50 billion. In 2019, the estimated impact of U.S. tax reform to the American economy, along with an increase in government spending, equates to approximately $124 billion in the U.S. economy. Although trade disputes have historically not been economically positive, the current impact is a mere fraction of the U.S. GDP, which equaled $20.5 trillion last year.

PROJECTED COSTS OF TARIFFS RELATIVE TO STIMULUS*



In June, two commercial oil tankers were bombed in the Gulf of Oman, which is located near the Strait of Hormuz. This is a strategically important location because over 30% of the world's oil is shipped through this channel making it a major artery for transportation. While officials from the U.S., U.K. and Saudi Arabia believe that Iran is responsible for the tanker attacks, the Iranians have categorically denied the accusations. This is important because the Trump administration pulled out of the 2015 Iran Nuclear Deal. Feeling that the terms of the deal were not strong enough to prevent Iran from continuing its quest toward the creation of a nuclear bomb, the administration instead began imposing economic sanctions on the country. These sanctions are crippling Iran's economy and it is believed that Iran conducted this attack in retaliation. Just one week later, Iran claimed responsibility for shooting down a U.S. drone that was conducting surveillance. Iran claimed that the aircraft entered Iranian airspace, but U.S. aerial footage shows that the drone, at its closest point, was still 34 kilometers away from Iran. The U.S. decided not to launch a military strike on Iran but did impose further sanctions on the country.

Meanwhile, the American Petroleum Institute reported that U.S. crude inventories fell 7.5 million barrels compared to an expected 2.5 million. The international unrest along with the inventory shortages have caused the price of oil to increase to over $59 a barrel. All the political and economic instability in international markets has caused investors to be even more cautious. Despite lagging domestic market performance so far this year, the MSCI EAFE still managed to post returns of more than 14%, while emerging markets represented by the MSCI EM Index is up 10% at the end of June 2019.

MEEDER PORTFOLIOS

At Meeder, we manage an array of investment solutions across a wide spectrum of risk profiles and time horizons. These strategies utilize a multi-discipline/multi-factor approach that guide us in the allocation of our portfolios. Many of these solutions employ one or more of our core investment strategies; Growth, Defensive Equity and Fixed Income.

Portfolios comprised of the Growth Strategy are more aggressive in their objective. Therefore, these strategies typically remain invested in stock market. In May, these portfolios experienced drawdowns similar to the S&P 500 Index when the performance of broader markets suffered. As the S&P 500 rebounded and reached a new all-time high in the latter part of June, the performance of these portfolios captured the most upside of our investment offerings.

Meeder Defensive Equity is a strategy designed to minimize volatility by reducing exposure to the market in high-risk environments and increasing exposure in lower-risk market environments. We began April with 70% exposure in the stock market. Our measure of market volatility continued to fall early in the quarter and was the primary driver for our increase in equity exposure that reached as high as 100% in early May. As previously noted, poor economic data results released throughout the rest of the month confirmed the U.S. economy's rate of growth was slowing and the most notable signal included an inversion in the yield curve, as the 10-year U.S. Treasury yield fell below that of the 3-month yield. This confirmed that investors were unwilling to be compensated with a higher yield for a longer dated maturity given the uncertainty present in the marketplace. By late May, we reduced exposure to the stock market to 90%. The Fed affirmed their commitment to economic growth as Fed Chair Jerome Powell said that the central bank will "act as appropriate to sustain the expansion." Just days following this, our model identified a significant increase in the demand for stocks from institutions, which continued to improve our investment model scores. As this occurred, we increased our exposure back to 100% in the last week of June.

Meeder Fixed Income is designed to actively monitor the credit quality and emerging market debt exposure of a portfolio. In the middle of May, momentum, spread and volatility factors in our investment model signaled a move to a more conservative allocation as the trade war between the U.S. and China escalated. We reduced our high yield and emerging market debt positions and increased our allocation to Treasuries and investment-grade securities. In early June, momentum and currency factors strengthened as economic data suggested signs of slowing global growth and investors began to price in the likelihood of an interest rate cut by the Fed. We increased exposure in emerging market debt and reduced investment-grade exposure as a reduction in rates would signal a weakening U.S. Dollar, benefitting emerging market currencies. By the end of the quarter, momentum factors in our model improved and we also increased our allocation to high yield securities. Meanwhile, the Fed confirmed the possibility of a rate cut in the near-term was possible aiding in the performance of high yield securities as investors tend to move to higher yielding bonds when interested rates are reduced.

LOOKING FORWARD

Meeder is dedicated to keeping clients committed to their investment strategy throughout a full market cycle. This is because studies show that the average investor has historically participated in just a fraction of the market's long-term gains. Wide swings in the markets often lead investors to make decisions based on emotion, rather than data, especially in periods of market selloffs. Therefore, to keep investors committed to their goals, we have developed investment models to analyze data to make fact-based decisions when allocating our portfolios. At Meeder, we have been successfully utilizing investment models to navigate markets for over 45 years! On behalf of all of us at Meeder Investment Management, we want to sincerely thank you for placing your trust in our investment management services and look forward to working with you in the future.

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*Source: Bloomberg

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