MEEDER
INVESTMENT MANAGEMENT

MID-YEAR REVIEW AND OUTLOOK:

Probabilities vs. Possibilities

We are encouraged to see such an upswing in the market's performance since the end of 2018, but not every segment is "hitting on all cylinders." It has led some to caution the sustainability of this rally. In this Mid-Year Review and Outlook, we examine what has transpired in the market through the first half of this year. Then, we also provide reasons to be optimistic about the outlook for the market, as well as some reasons for caution.

Probabilities vs. Possibilities

Why have the past nine months been such an "Unprecedented Period?"

In the fourth quarter of 2018, the S&P 500 dropped 19% from an all-time high. Since 1970, a 19% decline following a new all-time high in the market has occurred only eight times. Two months later, the average return over these eight periods was 5.4%. Our research indicated that it is not beneficial to immediately buy after a 19% decline since 75% of the time, the stock market has historically fallen further by an average of 22% before reaching its respective bottom. The 2-month period following the 2018 drawdown returned 18.4%, making it three times higher than the historical average. In addition, during the previous eight declines of 19% or more from all-time highs, it took 685 days on average to fully recover and make a new all-time high. Yet, it only took 81 days to exceed the September 2018 all-time high, and that is eight times faster than the historical average. *See Figure 1.*

FIGURE 1
S&P 500 HISTORICAL DECLINES OF –19% SINCE 1970

ALL-TIME HIGH	DATE OF -19% DECLINE	TRADING DAYS TO REACH -19% DECLINE	SUBSEQUENT 2-MONTH RETURN	TRADING DAYS TO EXCEED PREVIOUS HIGH	RETURN FROM -19% DECLINE TO BOTTOM
1/5/1970	5/14/1970	91	-1.4%	173	-8.2%
1/11/1973	11/26/1973	220	0.1%	1678	-35.5%
11/28/1980	9/25/1981	208	9.5%	280	-9.2%
8/25/1987	10/19/1987	38	8.1%	447	-0.4%
7/16/1990	10/11/1990	60	9.1%	86	—
7/17/1998	8/31/1998	31	13.4%	61	—
3/24/2000	3/2/2001	236	2.7%	1567	-37.1%
10/9/2007	7/2/2008	184	1.3%	1192	-46.4%
	Average	134	5.4%	685	-22.8%
9/20/2018	12/24/2018	65	18.4%	81	

Source: Bloomberg S&P 500 Price

How was our Defensive Equity strategy positioned during this "Unprecedented Period?"

During the fourth quarter of 2018, we adopted an extremely defensive posture for our tactical funds and portfolios, which helped minimize losses during the 19% correction in the S&P 500 and nearly 30% correction in the Russell 2000. At the beginning of the year, we released a video that expressed our analysis that the stock market was extremely oversold, and it would not surprise us if the stock market experienced a rally that retraced a significant part of the fourth quarter decline. However, 85–90% of the time after significant declines, the market retests its previous lows during these base building processes and our multi-factor / multi-discipline models would identify if it was a healthy or unhealthy consolidation. We also communicated that we thought there was a low probability that the stock market would "V-bottom," as this only occurs 10–15% of the time.

At the beginning of the year, the market continued its V-bottom process, which it rarely does. However, our data-driven model maintained a partially defensive position for numerous reasons. Our average equity exposure for the first quarter was 45%. As the year progressed, our model output continued to improve and guided us to gradually increase exposure to the stock market. For the second quarter, our average equity exposure was 88%.

It is important to remember that our exposure to the market is based on a combination of risk and reward, with a focus on probabilities over possibilities. Historically, after such a significant drawdown, the U.S. equity market takes much longer to recover. However, as we highlighted in Figure 1, a very low probability scenario occurred. Despite this, we continue to evaluate the market with a focus on the highest probability outcomes. We do this by reducing market exposure in our funds and portfolios when risk is high and increasing market exposure when risk is low. We believe a systematic approach, based on the highest probability outcomes, will generate a better risk-adjusted return for investors over the long-term.

What are some reasons to be optimistic?

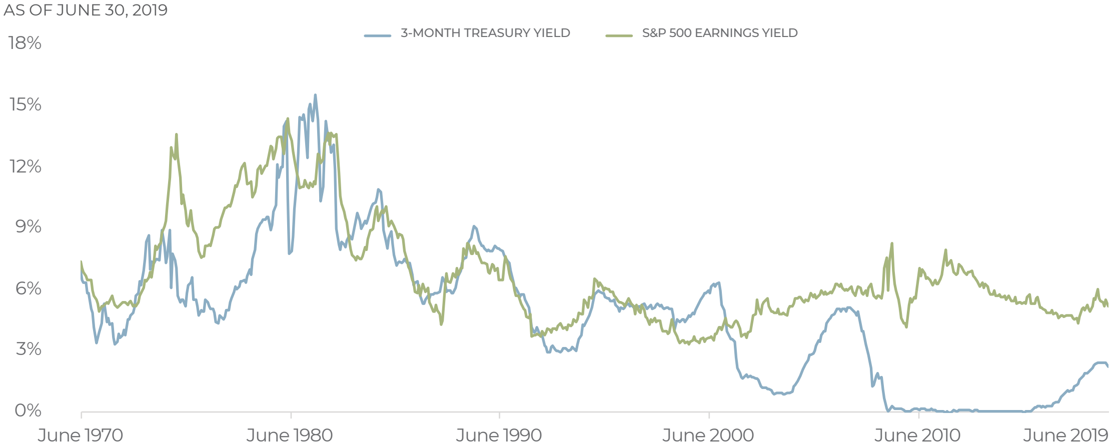
VALUATIONS

Price-to-Earnings ratio (P/E) is a popular valuation metric that divides the price of the S&P 500 by its 12-month trailing earnings. The S&P 500 Earnings Yield (E/P) is the inverse of the P/E ratio. It is the earnings of the S&P 500 divided by the price. One reason this metric is used is to compare the earnings yield of stocks to fixed Income alternatives. An example of a fixed-income alternative is the three-month U.S. Treasury yield, which is widely considered a risk-free investment. At the end of June, the S&P Earnings Yield was 5.17% and the three-month U.S. Treasury yield was 2.22%. The wider the spread between the earnings yield and the three-month Treasury yield, the more attractive equities are to investors. In the late 1990s, ahead of the tech bubble, valuations were stretched, and the three-month Treasury yield was higher than the earnings yield which indicated extreme overvaluation of equities. Right now, the current spread indicates that equity valuations relative to interest rates are attractive. *See Figure 2.*

FIGURE 2

HISTORICAL VALUATION RATIO

AS OF JUNE 30, 2019



Source: Bloomberg

MARKET BREADTH

Market breadth is the analysis of the total number of advancing stocks relative to the total number of declining stocks. The daily market breadth is simply the number of those advancing securities minus the number of declining securities. The New York Stock Exchange Advance/Decline line (NYSE A/D) takes the daily market breadth calculation for stocks on the NYSE and tracks it on a cumulative basis over time. At Meeder, we use this metric and compare it to stock indices such as the S&P 500 to capture a more complete picture of the health of the stock market. During a bull market, we want to see strong market breadth, which would consist of a large number of advancing stocks and fewer declining stocks.

Let's review 2019 and why this truly is a historic year from a market breadth perspective. It was a volatile fourth quarter as the S&P 500 was down nearly 20%, but what happened on February 12th was very historic. The NYSE A/D line surpassed its previous September 2018 peak and made a new all-time high at a time when the S&P 500 made a lower high. This was only the 10th time that this scenario occurred during the past 80 years. In 8 of the 9 previous occurrences, the S&P 500 went on to make a new high. As we now know, the market eventually made an all-time high on April 23rd, which makes this the 9th example of breadth successfully leading price. As we look at market breadth going forward, the S&P 500 finished the second quarter near an all-time high with market breadth near its all-time high. And as we mentioned, we view strong market breadth in combination with strong price action as very bullish for the market. *See Figure 3.*

FIGURE 3

S&P 500 INDEX VS. NYSE ADVANCE/DECLINE

JULY 1, 2018 – JUNE 30, 2019

Source: Bloomberg

INTEREST RATES

The Fed's policy has remained a primary focus for investors. As the market climbed to new highs at the end of September 2018, investor expectations were placing an 80% likelihood of a rate hike. In October 2018, Fed Chairman Powell stated that rates were "a long way from neutral." As a result, market volatility increased in the fourth quarter of 2018 as there was uncertainty about whether the Fed would continue to raise interest rates. In fact, at their December meeting, the Fed once again raised short-term rates.

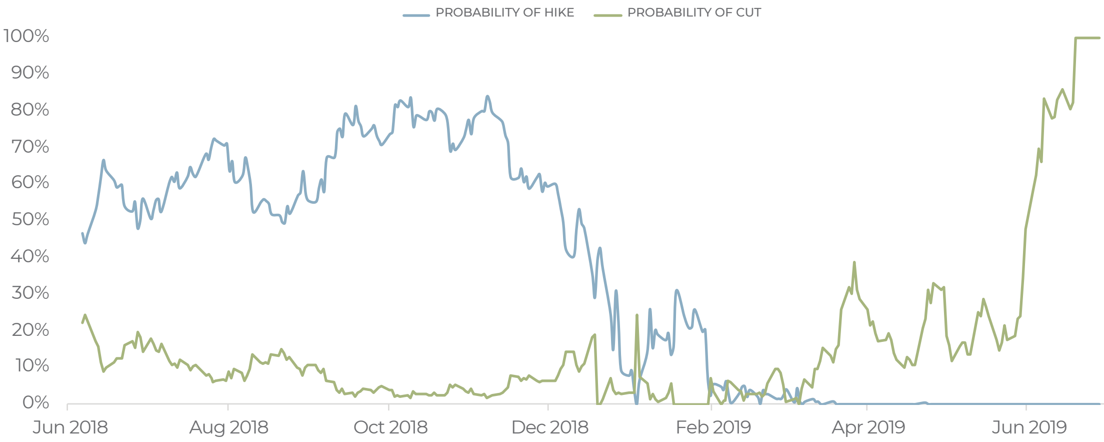
In January, the Fed reversed their prior guidance by stating they would be "patient" with future rate increases and the likelihood of a rate hike plummeted. By the end of the second quarter, the market's anticipation of a rate cut reached 100%. It is important to note that the stock market peak in 2018 occurred at a time when the markets expected a rate hike.

In contrast, with the stock market trading near an all-time high, the markets are expecting additional rate cuts. *See Figure 4.*

FIGURE 4

FEDERAL RESERVE PIVOT

PROBABILITY OF RATE CHANGES AT FED'S DECEMBER 2019 MEETING



Source: Bloomberg

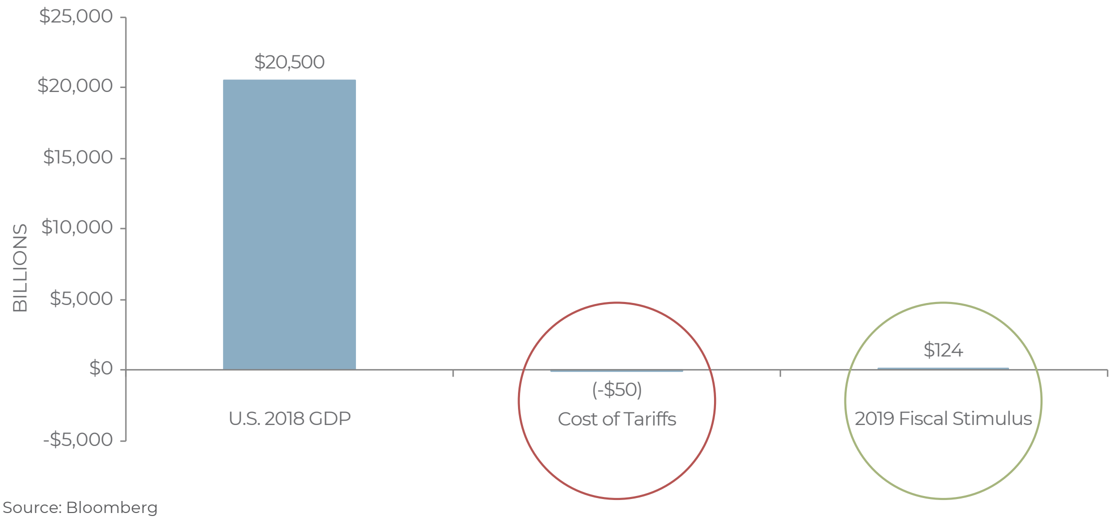
TARIFFS

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 has been roughly $50 billion. In 2019, the estimated impact of U.S. tax reform, 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. *See Figure 5.*

FIGURE 5

PUTTING IT IN PERSPECTIVE

PROJECTED COSTS OF TARIFFS RELATIVE TO STIMULUS



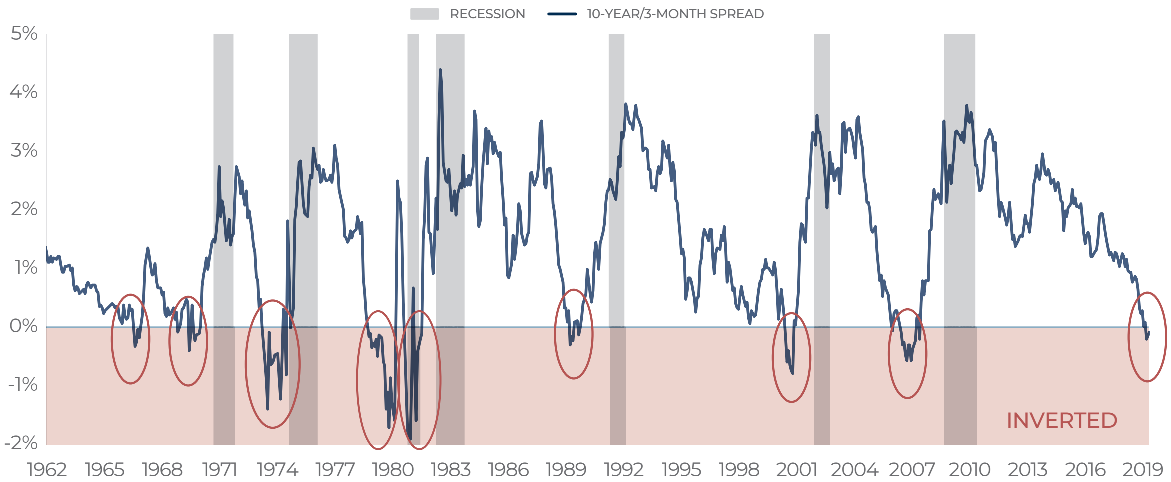
Source: Bloomberg

What are some reasons to be cautious?

YIELD CURVE

The U.S. Treasury yield curve inverted, meaning longer-term U.S. bond yields have fallen below shorter-term yields. This suggests concerns about future economic growth. Historically, inversions of the yield curve have preceded many U.S. recessions. Due to this historical correlation, the yield curve is often seen as an accurate forecast of the turning points of the business cycle. An inverse yield curve predicts lower interest rates in the future as longer-term bonds are demanded, sending the yields down. It is important because an inversion has historically preceded a recession by 18–24 months. *See Figure 6.*

FIGURE 6
10-YEAR/3-MONTH U.S. TREASURY SPREAD
FEBRUARY 1962–JUNE 2019



Source: Bloomberg, NBER

DISPERSION OF RETURNS

Over the past 12-months, the difference in performance among asset classes remains substantial. Domestic markets like the S&P 500 Index have increased 10.1% while Developed International markets (MSCI EAFE Index) are up just 2.6% and Emerging Markets (MSCI EM Index) are up 2.1%. Small-cap stocks have fallen nearly 6% over the past year and the spread between large-cap and small-cap stock performance is greater than any 12-month period since 1999. *See Figure 7.*

FIGURE 7
EQUITY PERFORMANCE
JULY 1, 2018–JUNE 30, 2019

Source: Bloomberg, Includes Dividends

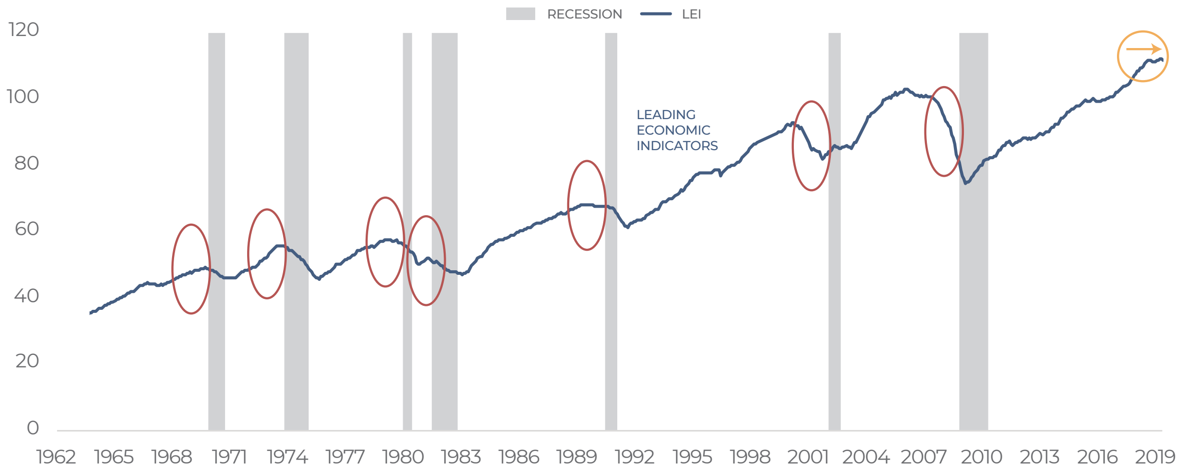
LEADING INDICATORS

The Leading Economic Index 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 based on economic data. It includes leading indicators such as employment, manufacturing and interest rates. Recent data shows that the rate of growth from April to May remained flat, while June data trended down 0.3%. This recent stagnation has caused some investors concern, as this index has historically stopped increasing and turned negative prior to each of the last seven recessions since 1960. Historically, this index tends to decline for six to eight months before a recession occurs. *See Figure 8.*

FIGURE 8

ECONOMIC STRENGTH

FEBRUARY 1962–JUNE 2019



Source: Bloomberg, NBER

THE MEEDER DIFFERENCE

At Meeder, we have been successfully navigating markets for more than 45 years. We are dedicated to keeping clients committed to their investment strategy throughout a full market cycle. 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, we developed investment models which analyze data to make fact-based decisions that project the highest probability outcomes. This is designed to minimize losses in high-risk market environments, while participating in low-risk environments to help investors stay committed to their investment strategy.

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