Investment Update

Meritage
PORTFOLIO MANAGEMENT

April 5, 2019

Deeply oversold conditions at year-end set the stage for a vigorous recovery for stocks in the first quarter of 2019. Similar to other corrections during the course of this bull market, the retracement in stock prices has occurred quickly.

At the risk of oversimplifying, the turnaround in stocks and investor sentiment is largely attributed to the stunning reversal of Fed policy. As a result, the perceived risk of recession has receded. Expectations have moved toward a resumption of the slow growth, low inflationary, “Goldilocks” environment that has characterized much of the past six years.

It is interesting to note that last year’s negative equity returns occurred when economic growth and earnings growth were the strongest in many years. In contrast, the first quarter rally occurred in the face of declining corporate profitability, weak consumer spending, and slowing economic growth. On the surface, these outcomes seem disconnected from their respective fundamental backdrops. What it reminds us instead is that stocks are forward looking and the positive results we are seeing now are driven by an outlook today that is not as dire as it seemed three months ago.

We’ll discuss below some of the key factors that impacted the first quarter and offer our thoughts on what we can take away from this recent spike in volatility.

KEY STORYLINES FOR THE FIRST QUARTER

Fed Chairman Powell gets schooled by the markets

There is no way to underplay the impact of the Fed’s 180 degree pivot on rate hikes. From the market’s view, the Fed erred in their insensitivity to weakening economic trends and in the way Powell communicated the Fed’s view. After the steep slide in December, the Fed began to backtrack in their position and basically took rate hikes off the table for the foreseeable future. They also slowed the pace of unwinding the accommodative measures put in place after the Financial Crisis. Chairman Powell acknowledged they could have done a better job communicating and now he seems to be following a script that could have been written by equity investors.

Another intriguing development is a discussion on how to assess future inflationary pressures. After years of falling short of the Fed’s 2% target, the premise is to allow inflation to exceed this target for a period of time before responding with tightening measures. The markets would likely cheer this justification for leaving rates lower for longer.

Markets spooked by the latest yield curve inversion

This arcane reference to the term structure of interest rates has moved into the mainstream for market watchers. At the base level, a yield curve inversion is when an investor earns a higher yield from owning a short-term Treasury than a longer-term Treasury. At quarter-end, the 30-day T-Bill was yielding 2.43%, while the 10-Year Treasury was yielding 2.41%. This unusual structure means the markets are anticipating the Fed will be cutting interest rates in the near future, typically to cushion an expected economic downturn.

The common understanding is that an inversion always precedes a recession. That has been true, but less understood is that a recession does not always follow an inversion. History also shows that yield inversions occur, on average, about one year before a recession and it takes several months for an inversion to provide any meaningful signal, especially given the unconventional monetary policy currently in place.

The implication from this is that there is no imminent concern for investors. Maybe not when recession is the focus, but the track record is mixed when looking at the relationship to a bear market. Like yield curve inversions, bear markets also precede recessions in most cases. Since 1966, the average lead time has been about 10 months, including several instances where a bear market had already begun by the time the yield curve inverted.

Like many single indicators, the predictive value of an inversion is limited, given differences in other factors. At best, this recent inversion is one of many potential signals that could indicate the risk of a bear market/recession is higher. As such, it is one of ten factors that make up the Index of Leading Indicators. That index today is still registering positive.

The second level relevance of a yield curve inversion is its impact on lending institutions and the credit cycle. A bank's typical model of borrowing short (through CD issuance) and lending long is handicapped when there is no spread between rates to profit from. This will eventually discourage banks from making new loans and, due to a slowing economy, may also tighten the bank's credit standards on rolling existing loans.

Businesses may then respond to tighter credit conditions and slower growth expectations by cutting back on capital expenditures and employment needs. Consumers may not be looking at yield curves, but they may respond to a weakened job market by spending less. This, in turn, is confirmation to businesses that their markets are slowing, reinforcing their instincts to invest their capital more conservatively. While credit cycle trends are still holding up ok, this will be an important early indicator to watch, especially if the business cycle continues to muddle along.

China, Brexit, and German bond yields hang over U.S. markets

In a time where political trends are moving in more of an isolationist direction, our markets remain acutely exposed to developments around the world.

China plays the largest role, both in terms of how the current trade talks are resolved and in their role as a major economic power that supports growth around the world. The markets have clearly embraced the administration's signals that a trade agreement is imminent. Anything less will be a disappointment. China's recommitment to stimulate their economy after a series of flagging growth indicators may be the lynchpin to shore up deteriorating economic trends in the Eurozone, and would feed over positively to our economy. Adding to risk is the uncertainty of a Brexit agreement which will allow for either a smoother transition or a hard exit.

Weakening global growth has caused interest rates on a broad base of foreign bonds to return to zero or negative levels. What was once thought as an anomalous set of circumstances have now become a fixture in this global deflationary environment. As we have seen, low yields on higher quality sovereign debt, like German bonds, keep downward pressure on U.S. Treasuries rates.

With stocks close to where they were six months ago, what can we learn from the almost 20% round-trip in stock prices?

- The 20% decline in the fourth quarter qualifies as a bear market, but has been categorized more as a correction. The distinction between these two labels probably becomes less meaningful going forward, but it does underscore the risk of larger sentiment-driven declines without being accompanied by an actual economic downturn.

- The 4th quarter slide, similar to the "taper tantrum" in 2013, underscores the market's intolerance for higher interest rates when economic growth is perceived to be slowing. This market reaction makes a strong case that investors have become addicted to low interest rates. This will become a problem again when growth and/or inflation picks up beyond current expectations.

- The growing influence of automated and algorithmic trading strategies, utilized primarily by quantitative hedge funds, implies that there will be more of these events, not less. Don't count on legislative curbs.

- Macro (top-down) analysis that is focused on business cycle risk may not be helpful in capturing risks that are more associated with investor behavior. Business cycle analysis can be helpful in identifying late-cycle status (where we are currently), which is when markets are more vulnerable to shifts in sentiment.

- There is typically a high cost to market timing. This 20% round-trip would underscore how difficult it is to make both ends of the timing decision correctly.

- The steep declines that occurred in December and February of 2018 remind us that there is usually little discernment between stocks on the way down, rendering equity diversification principles of little value in the short run. This is magnified by the proliferation of index securities and trading "baskets". Value and risk get sorted out eventually.

Outlook

When the extreme swings of the past two quarters are viewed together from a six month timeframe, the resulting modest decline from September's all-time highs seems rational, given the likelihood that the peak in earnings growth and economic growth is behind us. With the panic-driven losses now mostly restored, investors face the reality of an economic backdrop that is slowing. That tells us nothing in terms of when the next recession will occur, but it does reduce the cushion to absorb any unexpected hit to the economy that could develop from any number of domestic or international sources.

Estimates on upcoming corporate earnings have been reduced to levels that make it easier for companies to exceed. Inflationary trends would seem to give the Fed more flexibility to stay on the sidelines longer. Valuations have recovered to above-average multiples. The key limiting factor here is how much higher investors will pay on earnings in the late stage of the business cycle, but there is clearly room for valuations to move higher.

A slower growth environment should again favor less cyclical companies found more in Growth strategies. Higher yielding stocks should also benefit from the lower interest rate structure. Our stock selection process verifies that momentum has been a helpful factor in identifying outperforming companies. Our value orientation and the multi-factor composition of our process help us establish the fundamental investment case to go along with opportunities where momentum is strong. We believe this will be important as the current economic recovery approaches the longest positive run on record later this summer.

Data as of March 31, 2019

Meritage Value Equity Fund

Top 10 Holdings	% of assets		% of assets
Utilities Select Sector SPDR	6.4%	Dollar General Corp.	3.1%
AutoZone Inc.	3.7%	PRA Health Sciences Inc.	3.0%
Vanguard REIT ETF	3.6%	Royal Dutch Shell PLC – ADR A	3.0%
Entergy Corp.	3.2%	Equinor ASA ADR	3.0%
CDW Corp.	3.2%	Comcast Corp. Cl A	2.8%

Meritage Growth Equity Fund

Top 10 Holdings	% of assets		% of assets
Apple Inc.	6.2%	Intuitive Surgical Inc.	4.3%
Microsoft Corp.	5.7%	MasterCard Inc.	4.2%
Amazon Inc.	5.3%	Home Depot Inc.	4.0%
Zebra Technologies Corp.	4.9%	CyberArk Software LTD	3.3%
Alphabet Inc. Cl A	4.4%	IAC InterActiveCorp	3.2%

Meritage Yield-Focus Equity Fund

Top 10 Holdings	% of assets		% of assets
PPL Corp.	2.6%	National Health Investors	2.3%
CenterPoint Energy Inc. 7.0% Conv PFD 9/1/2021	2.6%	Tapestry Inc.	2.3%
Kinder Morgan Inc.	2.6%	Entergy Corp.	2.3%
Piedmont Office Realty Trust Inc.	2.5%	Belden Inc. 6.75% Conv PFD 7/15/2019	2.3%
DSW Inc.	2.4%	Stanly Black & Decker Inc. 5.375% Conv PFD 5/15/2020	2.2%

Investing involves risk, including loss of principal. Past performance is no guarantee of future results.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Meritage Mutual Funds. This and other important information about the Funds is contained in the Prospectus, which can be obtained by calling Shareholder Services at (855) 261-0104. The Prospectus should be read carefully before investing.

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