Investment Update

Meritage
PORTFOLIO MANAGEMENT

July 8, 2019

U.S. stocks added to the strong gains of the first quarter, giving the broad market its best six month start in over twenty years. A slightly longer perspective shows more moderate returns, with stocks just ahead of where they were in late January, 2018. Most notable over these past 18 months has been a dramatic pickup in volatility, as often occurs in the latter stages of an economic cycle.

The losses from last year's fourth quarter were largely recouped by late April in one of the fastest recoveries on record from a 20% decline. A steep drop in May was the worst for that month in almost ten years, while June's recovery was the best in over 80 years. These recent swings have been driven primarily by changing sentiment around late cycle U.S. economic trends.

Following is a discussion on some of the key issues that prevailed in the second quarter and our thoughts on the near and mid-term outlook.

KEY STORYLINES FOR THE SECOND QUARTER

Fed rate cuts are likely. How deep and how long?

The most stunning development over the past six months has been the Fed's reassessment of their monetary strategy. The December rate hike and talk of further rate increases were quickly seen as mistakes. Fed Chairman Powell's prompt retraction of future rate hikes triggered the vigorous first quarter rally in stocks.

Over the past quarter, both stock and bond markets moved out in front of the Fed, anticipating several rate cuts over the balance of the year. Initial Fed rhetoric tried to temper these expectations. As more evidence pointed to existing policy being too tight for current economic conditions, the Fed's recent commentary has now opened the door for a rate reduction when they meet later this month. Both markets are pricing in additional cuts after that.

The question for investors is whether the Fed sees this as a modest adjustment to undo the December hike or if this is the beginning of a protracted easing cycle. If the latter, the Fed has typically gone into these cycles with more ammunition to work with, meaning they've been able to begin the easing cycle from a higher level of rates than 2.5%. This lower starting point potentially lessens the benefit from this accommodative activity.

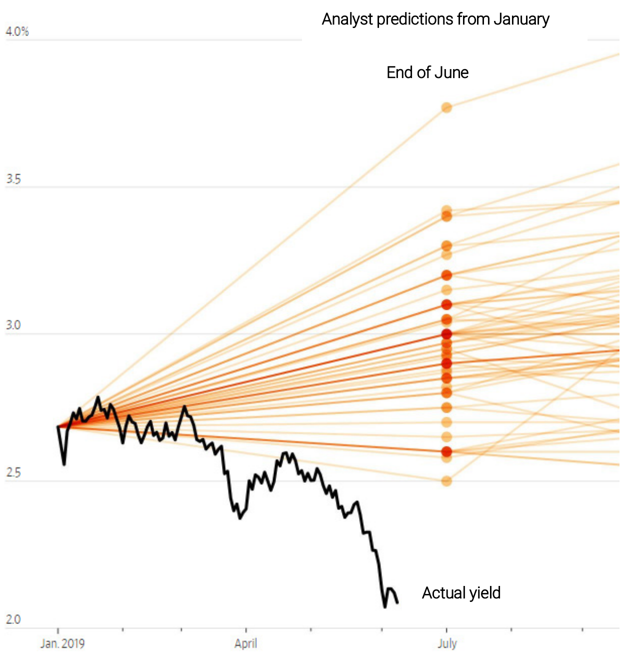
With stocks at all-time highs and employment levels at historic lows, it seems an odd time for the Fed to embark on an easing cycle. That said, given the miserable track record of economists in foreseeing a recession, following their traditional script shouldn't instill much confidence either. History shows that underlying economic conditions before a recession are almost always worse than what is (or can be) known at the time. This is why many are calling for the Fed to take a more proactive approach as the best hope to extend the current business cycle.

Few foresaw the latest collapse in bond yields. Now most see as the new norm.

It has become harder to make a case for the normalization of interest rates. Powerful disinflationary forces around the world have turned the "lower for longer" mantra into reality. These long-building forces are a combination of globalization, technology, demographics, and debt.

Seven months ago the 10-Year Treasury exceeded 3.2%. In a Wall Street Journal survey conducted in January, none of the 69 economists predicted yields would fall below 2.5% by June, as shown in the graph below. The 10-Year Treasury ended the quarter at 2.0% and fell through that level in early July. Economic softness around the world has added pressure to domestic rates as 10-Year bond yields in Germany, Japan, Switzerland, and other major countries remain stuck in negative territory. And while not negative, the Austrian government just issued a 100-Year bond at the tempting yield of 1.17%.

Yield on 10-Year Treasury Note



Sources: WSJ Survey of Economists (predictions); Tuillett Prebon (actual)

While stocks and bonds can both appreciate at the same time, it is rarely sustainable because the implications of each rally point in opposite directions. Stock prices are positively correlated to economic growth and earnings growth. As stocks have reached new highs, it is worth noting that both these measures are trending lower.

The strong bond market means bond holders are clearly less optimistic and falling yields are more in line with weakening economic fundamentals. As an offset, declining bond yields encourage investors to take more risk (either by chasing higher yielding alternatives or shifting more assets to stocks). Lower interest rates also justify higher Price/Earnings multiples for stocks. In the end, something has to give as one bull market will eventually undermine the other.

Trade issues with China remain a major overhang

In our Investment Update last quarter, we noted that stocks were discounting a successful trade agreement with China. That proved correct, given the sharp decline in May when the agreement abruptly fell apart. The subsequent application of new tariffs, threat of additional tariffs, and now a cease-fire on new tariffs coming out of the G20 meetings have kept this issue front and center with investors.

Odds still favor a positive resolution, but ongoing tensions with China will likely prevail even after an agreement. In the meantime, existing tariffs and the uncertainty around future tariff activity have begun to impact the outlook from corporations, affecting their capital investment decisions and earnings guidance.

The trade issue is also becoming more complex. It has always included matters of national security and intellectual property, but stakes have been raised with the ban imposed on products produced by Huawei, the Chinese telecommunications juggernaut.

This quarter also saw the use of tariffs as a policy tool in the case of border security against Mexico. Some have expressed disapproval of tying tariffs to political issues, but there is a good chance we'll see tariffs used as a bargaining chip again here and by other nations around the world. As we saw with Mexico, it can be effective, but with these threats comes a cost that's often borne by specific companies or industries.

Outlook

Since quarter-end the economic recovery has become the longest on record, now exceeding ten years. Five years ago, noted economist, Dr. Ed Yardeni projected the recovery should last into 2019 and beyond, based on his thesis of "no boom, no bust". As economic expansions go, the last ten years have been a laggard compared to previous expansions. Measures like industrial production, real GDP, and real personal consumption expenditures have been among the weakest.

Yardeni reasons that the absence of a boom has left us without the normal speculative excesses that typically accompany cyclical recoveries – excessive debt, soaring asset prices, and inflation – all leading to Fed tightening, credit crunches, and a bear market. The current cycle may have also been extended due to several smaller setbacks along the way, what Yardeni calls "Panic Attacks". These would include the Eurozone debt crisis in 2011, the collapse of oil prices in 2015 - 2016, and last year's mini-credit crunch around Fed Chairman Powell's hawkish commentary.

Others are more circumspect about the absence of speculation and debt accumulation, especially given the length of time interest rates have been low and the usual pattern of human behavior. While higher interest rates would likely flush out possible excesses, we are more likely to remain in the existing cycle of slow growth, especially if the Fed's focus is to err on the side of growth rather than their natural inclination to squash inflation.

Inside the market, interest sensitive sectors like Utilities and Real Estate have performed well for the year. Technology continues to lead all sectors, in spite of the pickup in regulatory and political pressures. Cyclical sectors performed better in the second quarter, suggesting more confidence in the economy, while Energy suffered from weaker global demand around trade risks. Valuations remain full, but not at extremes.

Our own macro work continues to track an economy that is losing momentum, especially on the manufacturing side. For now, stocks will most likely key on anything Fed related and any new insights that come from second quarter earnings reports. Too soon for politics to weigh in and hopefully no reason for Iran to become an investment issue. Longer term, the upside from current levels will need to be supported by improving corporate performance.

Data as of June 30, 2019

Meritage Value Equity Fund

Top 10 Holdings	% of assets		% of assets
Chevron Corp	2.5%	Royal Dutch Shell Plc-ADR A	1.7%
iShares Russell 1000 Value	2.3%	Wal-Mart Stores Inc.	1.7%
AutoZone Inc.	2.2%	Verizon Communications	1.7%
CDW Corp	2.1%	Dollar General Corp	1.7%
Torchmark Corp	2.0%	Berkshire Hathaway Inc Cl B	1.6%

Meritage Growth Equity Fund

Top 10 Holdings	% of assets		% of assets
Microsoft Corp	6.7%	Home Depot Inc.	4.2%
Apple Inc.	6.2%	Alphabet Inc. Cl A	3.9%
Amazon Inc.	5.4%	CyberArk Software Ltd.	3.4%
Zebra Technologies Corp	4.7%	IAC Interactive Corp	3.2%
MasterCard Inc.	4.5%	Johnson & Johnson	3.0%

Meritage Yield-Focus Equity Fund

Top 10 Holdings	% of assets		% of assets
Invesco S&P 500 High Div Low Volatility ETF	4.5%	Belden Inc. 6.75% Conv Pfd 07/15/2019	2.4%
Valero Energy Corp	3.0%	Target Corp	2.4%
Centerpoint Energy Inc. 7.0% Conv Pfd 09/01/2021	2.9%	Unilever Plc Spon ADR	2.4%
Kinder Morgan Inc.	2.7%	Stanley Black & Decker Inc. 5.375% Conv Pfd 05/15/2020	2.3%
PPL Corp	2.5%	National Health Investors	2.3%

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