Investment Update

July 7, 2020

The surprisingly strong rebound in stocks against a backdrop of severe economic and social duress is among many storylines that have emerged over the recently completed quarter. We'll comment below on some of the drivers behind this strength and offer thoughts on where we go from here.

Whatever it takes

The market's recovery from the March lows was seen by many as a profound disconnect between the market and the visible economic hardships of the present day. We'll summarize brief explanations for this:

- The forward looking pricing mechanism of stocks allows for a "V" shaped recovery in stocks without expecting the same pace of recovery from the economy.

- Bold and preemptive policy action was taken by the Fed and Congress. It's hard to overstate the impact this had on diffusing fears of mass insolvencies and economic depression. Fed Chair Powell's commitment to do "whatever it takes" echoes the commitment of former Fed Chair Ben Bernanke in 2009 and E.U. Central Bank President, Mario Draghi in 2012. Their action paved the way for recoveries from deep recessions. In addition to the $2 trillion CARES act passed by Congress to assist workers and families, the Fed launched their own $2.3 trillion lending and liquidity program redefining the power behind these three words.

- There was a growing sense that the worst of the collapse would be contained in the second quarter numbers. Q2 earnings are expected to decline over 40% and GDP over 30%. From the market's dispassionate perspective, the distressing spike in unemployment to 14.7% and the loss of an additional 20 million jobs in May simply meant the recovery would look that much more impressive because of the catastrophic decline that preceded it.

- Periodic news about progress on treatments and vaccines lent support to the developing optimistic scenario.

Some have observed that the steep recovery in stocks from the economic shutdown looks more like how markets have treated natural disasters, not cyclically-driven recessions. This rationale posits that it is easier to put the pieces back together because the economic impairment was man-made, due more to the response to the problem and not inherent in the problem itself. Unlike previous recessions, the current downturn was not preceded by rising interest rates, inflation, and expanding unemployment. Nor will Congress be consumed with repairing a broken banking system as they did eleven years ago.

The markets also received a boost as lockdown restrictions were gradually eased and reopening efforts began in many communities. The initial data from the uptick in activity offered some tangible hope of a healing economy, certainly coming sooner than originally expected. However, the recent resurgence in infections suggests some of this newfound confidence may be premature. Stocks have largely shrugged this off for now, though volatility has picked up again and gains flattened out in June.

Compression

Among the more shocking aspects of the market's collapse and recovery has been the swiftness of both. The pattern for large swings to be condensed into shorter and shorter periods of time has been evolving for over a decade. It took only six trading days from the market high in February to enter a 10% correction (fastest ever) and 33 days for the markets to decline 34%. The previous record for a similar drop was in 1987 when it took 101 days for stocks to fall from their August highs to the Black Monday low in October.

The subsequent surge of 42% off the March lows last quarter eclipsed the previous fastest rebound in stocks from the 2009 lows (then coming off a 50% plus decline). We saw a similar V-shaped pattern in the fourth quarter of 2018 when stocks dropped approximately 20% over 90 days and recovered by mid-April, 2019.

The speed of these pivots brings less meaning to the market cycle categories commonly used to identify them. We've gone from a bull market, to a correction, to a bear market, and to a new bull market in just 90 days. Small cap stocks, in fact, entered a new correction in late June. This trend has reinforced a "buy the dip" mentality among investors, though we suspect first movers probably lost their appetite in the current decline by the time stocks reached their bottom. A stronger explanation for the condensed swings is the increased influence of automated trading programs, which we have discussed before.

Crisis outlook

While we now know more than we did about dealing with a pandemic, the uncertainties and risks remain high. The recent increase in reported infections was inevitable as activity picked up and testing became more widespread. Pent-up demand and complacency pushed some aspects of re-opening too far. A middle-ground of activities and behavior that keeps the spread under control has not yet been defined.

Absent news of a near-term vaccine breakthrough, the renewed growth in community transmissions suggests an ongoing period of rolling hotspots and shutdowns. While some states and communities have been reluctant to impose new restrictions, re-opening too soon has led some to take a step back. This will have implications on employment, politics, and the expectations built into today's stock prices. The good news is that fatalities are proving to be fewer and the asymptomatic population higher as more data is collected.

As the first wave of financial relief to workers and families expires over the next month, pressure to follow up with additional support will be intense. Some of the shortcomings of the original programs are now better understood. On the other end, the political cover of a crisis environment has faded and partisanship will likely make it more difficult to get things done.

A $1.5 trillion infrastructure bill from the House is in play with little chance of advancing in its present form. In recent testimony, Chairman Powell warned that severe recessionary pressures remain and the outlook will depend on containing the virus and ongoing support from both monetary and congressional programs. The Fed is all in on their part; the markets are counting on Congress to do the same.

Election cycle

Absent the pandemic and racial equity issues, the election cycle would probably have had more presence in the news cycle. That will change in the coming months. Current polling shows an improbable Democratic sweep now has a fair shot. In a recent speech to donors, Joe Biden affirmed his pledge to raise corporate taxes to 28% and remove the loopholes on capital gains and stepped-up basis. Pledges of higher taxes and increased regulation will not be been seen as pro-business from the market's perspective.

While there is still a long way to go before the election, the odds of this outcome have increased. It is difficult to discern if this has had any impact on markets to date. Under the current economic circumstances and with the enormous debt incurred to keep our economy afloat, the inevitability of higher taxes may become more of a base case expectation. Either way, the uncertainty of what happens in November is bound to become more of an investment issue. That said, four years ago taught that it's hard enough to predict the outcome, let alone know what the market's response to it will be.

A discerning market

Over the course of the past several months, we've seen the market discern winners and losers amidst broad downward and upward trends. Not surprisingly, companies that were better positioned to cope with a weak economy fared better from the outset. This favored growth equity strategies as investors were drawn to companies whose growth was less dependent on the broad economy. In particular, those businesses that fit well with the stay-at-home theme (home entertainment, sanitation, digital communications, food delivery, etc.) were singled out by investors, as were those businesses that took a direct hit (travel, hospitality, food service, etc.).

As confidence built around the prospects of a quicker recovery, there was a noticeable rotation to companies that would perform better in an improving economy. Several of these sectors (Energy, Materials, and Consumer Cyclical) were among the better performers for the quarter. During this mid-quarter transition, there was a shift to value-driven equity strategies. While this move reversed later in June when the recovery outlook became more muddled, this recognition of an unloved group of stocks was a welcome reprieve to value investors.

Technology stocks have continued to lead the market throughout these shifts. This is somewhat unusual since most bear markets coincide with a change in market leadership (think tech stocks after the tech bubble and financial stocks after the Financial Crisis). Many tech stocks today are in the enviable position of generating their own growth and are seen as a more stable part of the market because of their strong financials and dominant competitive positioning. Many fit the stay-at-home theme and the larger companies have come out of this crisis stronger relative to their competitors. The concentration of the largest 5 – 10 companies continues to grow in the major indices, as does their valuation.

On the heels of the strong second quarter, equity investors should brace for another challenging six months given that more things have to go better than not in order to support higher stock prices. The pause in some re-openings, expected dip in consumer spending, and impact on people getting back to work will delay the recovery timetable. Unemployment is expected to come in around 10% by year-end. Tensions with China are never far from disrupting trade again. Congress will have to agree on something in front of a contentious election. And stock buybacks (off 44% this year) are not likely to be as helpful as usual.

The stock market has done an admirable job keeping the blinders on and maintaining its gaze over the horizon. Over the next year, that view may periodically get disrupted, diverting sightlines to the rubble that surrounds us. That risk goes with the territory for equity investors. So do the rewards of seeing through that to an economy recovering from historical depths. Continued liquidity support from the Fed will facilitate that perspective. Positive news on a vaccine will go a long way in providing clarity on an actual timeframe, not to mention the lifting of spirits.

Data as of June 30, 2020

Meritage Value Equity Fund

Top 10 Holdings	% of assets		% of assets
Consumer Disc. Select Sector SPDR	3.8	Alphabet Inc. Cl A	2.3
Vanguard Consumer Staples ETF	3.5	Walmart Stores Inc.	2.3
B2Gold Corp.	2.6	Amerisourcebergen Corp.	2.2
Utilities Select Sector SPDR	2.5	Roche Hldg Ltd Sponsored ADR	2.2
Associated British Foods PLC	2.4	Chevron Corp.	2.1

Meritage Growth Equity Fund

Top 10 Holdings	% of assets		% of assets
Apple Inc.	8.8	Micron Technology	3.1
Microsoft Corporation	8.7	Generac Holdings Inc.	3.0
Amazon Inc.	6.8	Fortinet Inc.	2.9
Alphabet Inc. Cl A	5.4	Zebra Technologies Corp.	2.8
Best Buy	3.2	Adobe Inc.	2.6

Meritage Yield-Focus Equity Fund

Top 10 Holdings	% of assets		% of assets
Centerpoint Energy Inc. 7.0% Conv PFD 9/1/2021	2.8	PPL Corp.	2.4
British American Tobacco PLC ADR	2.6	Invesco S&P 500 High Div Low Volatility ETF	2.4
National Health Investors	2.6	Verizon Communications	2.4
Unilever PLC Spon ADR	2.5	CVS Health Corp.	2.4
National Grid PLC ADR	2.5	Siemens A G Sponsored ADR	2.4

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