Investment Update

Meritage
PORTFOLIO MANAGEMENT

October 3, 2018

Strong economic and corporate fundamentals fell into place in the third quarter, triggering an impressive rally in stock prices. Annualized GDP growth exceeded 4% and corporate earnings (abetted by tax reform) grew over 20% for a second consecutive quarter. Markets also took a more measured view of the trade concerns, in spite of an escalation in tariffs. By quarter's end, most major stock indices had registered new all-time highs.

KEY STORYLINES FOR THE THIRD QUARTER

Trade issues are not going away

Trade talks with China have stalled. Additional tariffs of 10% and 25% have been targeted and partially applied to another $200 billion of Chinese imports, on top of the initial $50 billion. The limited impact on U.S. stocks underscore expectations that an agreement will be reached. The strategic mindset is that the U.S. will hold up better as long as our economy remains strong. In the meantime, the pressure on the Chinese stock market and numerous emerging market countries has been significant with many suffering declines in excess of 20%. More recently, U.S. companies across multiple industries have been vocal about how their cost structures have been or will be impacted by tariff activity, while a select category of high tech products from Apple and others have been spared from the impact of Chinese tariffs. On the positive side, Canada has agreed to join Mexico in a revised NAFTA-like agreement.

Markets steer clear of political drama and mid-term elections

Markets continue to focus on positive investment fundamentals. With tax cuts in place and regulatory relief coming primarily from the White House rather than Congress, the markets have been less sensitive to news around the upcoming election. Current expectations have the Democrats recapturing the House and Republicans holding on to the Senate. If the Democrats have a better than expected showing, the markets might become more concerned about a regime shift in 2020 and the possibility of giving back some of the earnings gains from tax reform and deregulation.

Technology stocks take a breather

The market's affection for tech stocks in general and a few mega-cap tech stocks in particular cooled off in September. While rotational shifts between sectors is common, there are interesting implications should this be the start of a more sustainable trend. Tech has had a disproportionate role in leading the market higher this year and last. Much of that has been justified by distinguished sales and earnings growth. Recent tech weakness may be a temporary reaction to expensive valuations.

A rising market with stronger "breadth" (more diverse leadership) is said to be a healthier market, so it is welcome news when the Health Care and Industrials sectors lead the way, like they did this quarter. If a shift toward Value investing occurs, leadership will likely spread to the Financials and Materials sectors. This would be another positive sign. Still, if Tech stocks continue to report the best financial results next quarter, the recent shift away from this sector might be short-lived.

Bull market's longevity is questioned

The 10-year anniversary of the Financial Crisis stirred predictable discussion about how far stocks have come, whether something like that could happen again, and the likely cause(s) of the next bear market. Revisiting the collapse of Lehman Brothers, the bailing out of Citigroup and AIG, and the near meltdown of the world's financial system provides a good opportunity to take stock of where we are and how that experience can better prepare us for what's ahead.

Regulatory and policy changes that resulted from the crisis will be helpful in addressing some of the more egregious of the imbalances. We can take some comfort knowing the traditional banking system has stronger reserves set aside for a future financial event. Still, most agree that the next financial crisis will not necessarily look like the one before, from outward appearances. The inner ingredients, however, will likely be the same – excess leverage, speculative financial instruments (especially those that incentivize risk creation and transfer the downside to others), leverage, fear of missing out, short memories - and did we mention leverage?

Outlook

The current economic expansion is now the second longest on record. Given the collapse that preceded it and the sluggish growth trajectory that has followed, this should not be all that surprising, even with the help of unprecedented financial stimulus and historically low interest rates.
As we have previously observed, our macro models continue to confirm that a recession, triggered by a traditional late-cycle, inflation-driven, overheated economy is not in the foreseeable future. Liquidity is tightening somewhat from higher interest rates and the Fed unwinding their previous monetary stimulus, but overall financial conditions are not yet restrictive. Stock market valuation is stretched on many measures, but the spike in corporate earnings has allowed the market to settle back into more reasonable valuations based on forward earnings.

We have also looked at various factors dealing with the credit cycle, business conditions, and the market, and measured how far in advance these factors showed deterioration prior to the two previous recessions. Factors that were predictive gave an advance signal in the range of six to twenty months. At present, we see no material signs of deterioration in these factors.

We are also mindful that in the two previous recessions that were part of the Tech Bubble and the Financial Crisis, the bear market in stocks preceded the official start of the recession. While both instances included signs of monetary tightening and slowing growth in advance of the decline in stocks, the collapse was amplified by market excesses - dotcom valuation in one and the sub-prime mortgage debacle in the other.

This broader view that looks beyond economic fundamentals is important as we assess risk in the environment. Macro models can be helpful in evaluating where we are at any point in time in the economic cycle. But as the recent past has demonstrated, risk can emerge from multiple sources. We will address our thoughts on this component of risk in a subsequent correspondence. For now, we expect the positive economic and business environment to continue through the next several quarters. Given the high average returns already achieved and a nearer-term peak in the "rate" of growth in corporate earnings, profit margins, and economic growth, share prices could continue to trend positively, although more moderately than in recent years.

Data as of September 30, 2018

Meritage Value Equity Fund

Top 10 Holdings	% of assets		% of assets
Utilities Select Sector SPDR	3.8%	Bristol-Myers Squibb	2.5%
iShares Russell 1000 Value	3.0%	Helen of Troy Corp. LTD	2.5%
China Petroleum & Chem Corp. ADR	2.7%	PRA Health Sciences Inc.	2.4%
Royal Dutch Shell PLC – ADR A	2.6%	CDW Corp.	2.4%
Cigna Corp.	2.5%	Torchmark Corp.	2.4%

Meritage Growth Equity Fund

Top 10 Holdings	% of assets		% of assets
Apple Inc.	7.0%	Home Depot Inc.	4.1%
Mastercard Inc.	6.6%	Zebra Technologies Corp.	4.0%
Amazon Inc.	5.8%	Intuitive Surgical Inc.	3.2%
Microsoft Corporation	5.3%	Fiserv Inc.	2.5%
Alphabet Inc. Cl A	4.4%	IAC Interactive Corp.	2.3%

Meritage Yield-Focus Equity Fund

Top 10 Holdings	% of assets		% of assets
Plains GP Holdings LP	3.0%	Cummins Inc.	2.5%
Belden Inc. 6.75% Conv Pfd 07/15/2019	2.9%	PPL Corp.	2.3%
International Business Machines	2.8%	Public Service Enterprise Group	2.2%
Merck & Co Inc.	2.5%	Piedmont Office Realty Trust Inc.	2.2%
AT&T Inc.	2.5%	Duke Energy Corp.	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.

Distributed by Unified Financial Securities, LLC.

Meritage
PORTFOLIO MANAGEMENT