Investment Update

October 7, 2019

Stocks advanced slightly in the third quarter, adding to their strong gains in the first half and closing just under the market highs of late July. Volatility remained high as headlines around China trade negotiations and prospective Fed policy moved stocks in both directions. Economic news showed contraction in manufacturing for the first time since 2016, while the consumer side of the economy remained relatively strong, keeping recessionary concerns in check.

KEY STORYLINES FOR THE THIRD QUARTER

The Fed delivers on rate cuts

Two separate quarter-point rate cuts were administered since July. While this represents a significant pivot in Fed policy after four rate hikes in 2018, the moves were relatively anti-climactic by decision time.

The Fed is now taking a more cautionary approach to the economy, leaning toward providing the accommodation necessary to sustain the current expansion. This approach is supported by subdued inflationary pressures, a belief that trade risk with China has already begun to weigh on U.S. growth prospects, and increased global uncertainties, exacerbated by the three year overhang of Britain's exodus from the European Union.

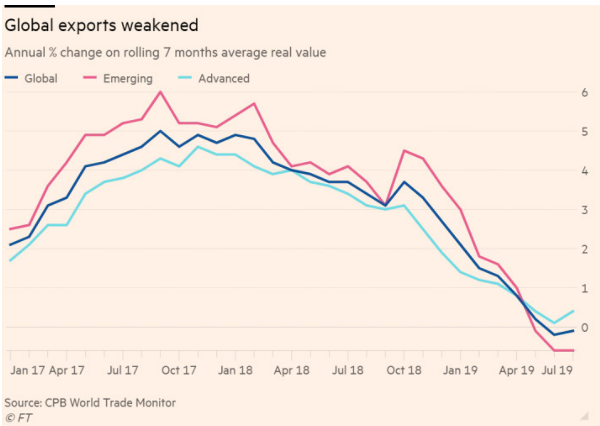
Fed Chairman Powell has also downplayed the prospect of following the European Central Bank's path to negative interest rates. Once thought of as a short-term anomaly, negative rates have now been in place in Europe for over five years. The rationale for negative rates is to incentivize investing by making it costly to hold cash reserves.

More recently, there has been pushback from economists, questioning the effectiveness of this supposedly stimulative monetary tool. Given the continued sluggishness in Europe, there is little evidence that negative rates have had a positive impact. Some believe that the unconventional nature of negative rates have actually created more uncertainty, leading consumers to save more, not less. Most agree that it will be harder for countries to get out of this policy trap than it was to get in.

Stakes raised in China negotiations

What started 21 months ago with tariffs on solar panels and washing machines has expanded to essentially all imported goods, broad intellectual property concerns, sanctions against the leading Chinese communications firm and shipping firm, and most recently, potential restrictions on capital flows to and from Chinese companies.

With this as a backdrop, global trade has contracted since the start of the year (see below) as tariffs have been on the rise. The uncertainty around an outcome has led companies to defer on capital investment decisions and adopt a more conservative approach to growth. Investors have continued to take a constructive view that an agreement will eventually be reached, though the timetable may extend well into election season and beyond. Interim developments will continue to move markets.



A shift to value?

For two days during an uneventful week in mid-September, investors exited high momentum stocks in favor of cheap value stocks at the fastest pace since 2008. This rotation out of the year's best performing stocks into the year's worst raises questions as to whether this was the beginning of a long awaited reversal toward value or just a computer driven technical correction.

Coinciding with this move was a bounce in bond yields off worrisomely low levels, signaling to some that threats to the economy were receding. This improved outlook triggered a sharp sale (most likely by hedge funds or automated trading programs) of momentum stocks and purchases into undervalued companies that would be expected to perform better in a stronger economy.

This sudden swing into value stocks is not the first time this has occurred in recent years. Previous attempts have faded as quickly as they appeared and most likely this will be the case again as the underlying reasons for growth's outperformance are still largely intact. Still, it is notable to observe how quickly momentum stocks can fall out of favor and to see what can happen when the focus returns to valuation.

Factor investing

Shifts within the market like this recent momentum/value swap can be measured by tracking the performance of specific factor groups. Factors represent common characteristics that drive a stock's return. Key fundamental factor groups include price momentum, valuation, company size, volatility, and quality. Each of these factor groups have demonstrated discrete periods of long-term superior performance over broad market returns.

In recent years, the momentum factor (buying outperforming stocks) has generated strong returns, while the factors representing value stocks and small-cap stocks have languished. Momentum stocks have typically been associated with higher growth companies, often represented by tech stocks and higher risk companies.

Following the fourth quarter correction last year, investors reduced their exposure to risk and shifted to more defensive-like stocks with lower volatility, higher quality, and stable growth characteristics. As such, Utilities, Real Estate Investment Trusts, and Consumer Staples have been the best performing sectors over the past 12 months. Consequently, many of these "defensive" stocks have uncharacteristically moved into the momentum category. This explains why these stocks felt the brunt of the two-day trade into value.

A move like this does not usually show up in the headline narrative, but it does underscore how any stock can become a momentum play and why a utility or traditional food stock might look so expensive, even if the underlying business does not fit what most would consider a traditional growth company.

Outlook

A year ago when we wrote this Outlook section after Q3, GDP was growing at 4% and earnings growth had notched its second consecutive quarter of 20% growth (aided by tax reform). We acknowledged then that these were probably peak numbers, but even pending a slowdown, there were no imminent signs of a recession and no reason to think that stocks were on the cusp of a 20% decline by quarter's end.

In our Q3 note, we did observe that market downturns did not need to be preceded by recessions and that turned out to be somewhat prescient. We know now that the panic over misdirected Fed policy faded after year-end and the markets recovered the Q4 losses in record fashion. As discussed above, a year later, the Fed is following a different path.

As for the markets, there are numerous signals (inverted yield curve, manufacturing contraction, reduced corporate profitability) that will keep the prospect of recession on the radar. As of this writing, stocks pulled back the first week of October due to weaker industrial and service numbers. For much of this expansion, bad news on the economy has translated to good news with respect to the Fed providing cover with lower interest rates. It does raise the question, at what point does an additional rate cut not provide any incremental stimulus nor have the intended calming effect? It's not like corporations and investors don't already have access to cheap capital at current rates.

While we think there is some positive life left in the current extended economic cycle, it is also realistic to expect a natural slowdown phase, as we are currently experiencing. We'd be cautious about expecting significant further equity market upside over the short-term until we move past this cycle slowdown. Longer term, with inflation tracking at around 2%, real returns from stocks should still be respectable relative to other liquid asset classes.

Data as of September 30, 2019

Meritage Value Equity Fund

Top 10 Holdings	% of assets		% of assets
Vanguard Value ETF	4.8%	Pinnacle West Capital CP	2.0%
iShares Russell 1000 Value	4.0%	Wal-Mart Stores Inc.	1.9%
Chevron Corp	2.4%	Verizon Communications	1.8%
Globe Life Inc.	2.2%	Alphabet Inc. Cl A	1.7%
Idacorp Inc.	2.1%	JP Morgan Chase & Co	1.6%

Meritage Growth Equity Fund

Top 10 Holdings	% of assets		% of assets
Apple Inc.	7.0%	iShares Russell 1000 Growth ETF	4.5%
Microsoft Corp	7.0%	Alphabet Inc. Cl A	4.5%
Amazon Inc.	5.0%	IAC Interactive Corp	3.2%
Zebra Technologies Corp	4.6%	Fiserv Inc.	3.1%
Home Depot Inc.	4.6%	Micron Technology	3.0%

Meritage Yield-Focus Equity Fund

Top 10 Holdings	% of assets		% of assets
Centerpoint Energy Inc. 7.0% Conv Pfd 09/01/2021	3.0%	Verizon Communications	2.3%
Target Corp	2.9%	Lazard Ltd	2.3%
Public Service Enterprise Grp	2.7%	Stanley Black & Decker Inc. 5.375% Conv Pfd 05/15/2020	2.3%
PPL Corp	2.5%	Bristol-Myers Squibb	2.1%
National Health Investors	2.4%	AT&T Inc.	2.1%

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