Investment Update

January 6, 2020

2019 was a banner year for stocks. In stark contrast to how the end of last year wrapped up, seemingly everything fell into place for stocks in the final quarter this year. This lifted broad market returns to their best showing since 2013.

While these results exceeded most expectations, the 2019 markets were set up for a good year given the debacle that preceded it and the near panic level of investor sentiment coming into the year. Today's markets reflect a much improved outlook and sentiment readings have swung back to optimistic levels.

This positive view has solid underpinnings, which we discuss below. That said, most projections for gains in the coming year are understandably modest and the matter of an election cycle will be sure to add a measure of uncertainty to an economic cycle that just registered its first decade ever without a recession.

KEY STORYLINES FOR THE FOURTH QUARTER

In the Zone

The 2% economy continues. Economic growth at this relatively slow rate has been strong enough to keep recession concerns in check, and weak enough to keep inflation below or near the Fed's 2% target. This has forced the Fed to reduce short-term rates below 2%, which also happens to be close to where the 10-Year bond yield currently resides. This combination of subdued conditions has served as a hospitable backdrop for stocks.

The strong returns in the fourth quarter were primarily driven by:

1) The Fed's third rate cut of the year and unusually frank commentary from Chairman Powell that sets a higher bar for future rate hikes.
2) The near completion of a Phase 1 agreement with China on trade. While the tangible concessions achieved in this pact look to be underwhelming, the rollback of current and prospective tariffs removes a significant overhang on global growth prospects.
3) Q3 earnings reports that should mark the low point in year-over-year comparisons, followed by the resumption of earnings growth in 2020.
4) A pickup in business activity here and abroad, including an unexpected surge in the November jobs report.

Other key areas of support for the full year included: the resiliency of consumer spending (more than offsetting a slump in manufacturing), strong leadership from the broad Technology sector, and beneficial effects of low interest rates, giving corporations and households easier access to credit and providing rationale for higher equity valuations. Most of the year's gains came from attaching higher value to a company's earnings as opposed to earnings growth.

Strong Correlation Among Asset Classes

It was a year of both broad-based gains across asset classes and striking outperformance from the biggest and brightest stocks. All eleven S&P sectors had double digit gains except Energy (+7.8%). Still, it was the strength of the Technology sector that was truly distinguished. This group gained 47% for the year and was responsible for almost a third of the index's total return. Almost half of the Tech sector's return came from the two largest publicly traded stocks, Apple and Microsoft. Both now represent slightly over 9% of the broad index.

It was also unusual to see so many asset classes move in the same direction. The combined returns for stocks and bonds was the best since 1998. Real Estate securities posted solid returns. Gold, often a hedge for inflation and distressed financial markets, gained 18% for the year, its best showing since 2010. Oil prices climbed over 20%. As central banks around the world have been growing their balance sheets, this additional liquidity seems to have found its way into most asset classes this past year.

Outlook

As is usually the case, the consensus view of 2020 and beyond extrapolates a lot of what is known now. First and foremost, the expectation that the Fed is on pause until after the election removes a lot of the near-term angst that drives stock volatility. Moving trade risk with China to the sidelines as a Phase 2 agreement takes shape portends well for improved global growth trends and capital spending. Recession risk should be diminished with central banks expanding liquidity. A year ago we all learned the market's tolerance for reducing liquidity while raising interest rates at the same time. Today, contained inflation gives them the luxury to do neither.

Consensus also concludes that further gains in stocks will come from profit growth, not higher valuations. Some recent signs are encouraging that the worst of the global slump is behind us, allowing the business cycle to gain traction in 2020. While wage gains grew by +3.7% in November, productivity improvements should help companies protect their profit margins.

With the macro risk regarding rates and trade diminished, more focus will be on whether economic growth validates a more optimistic view. If it plays out this way, we should see stronger relative returns from the more attractively valued parts of the market in 2020. There were signs of this in the second half of last year, but in the end, the flow of funds into the mega-cap tech names dominated year-end returns.

The consensus outlook for returns is predictably hedged for some reversion to normalcy after such a good year, leaving stocks with mid-level single digit results. History has shown that most years of strong returns are usually followed by positive returns the following year. History also shows how rare it is to actually get a year that matches the predictions of a more normal year (5% - 7%), so odds are we'll be closer to double-digits or flat.

Our own macro work has been more skeptical of an acceleration of growth in 2020, although we agree that a recession should be averted in the coming year. We also observe the growing concentration of ownership in the largest tech names as a trend that will likely reverse at some point, but we do not expect that to occur in the current slow growth environment. The idea that sentiment readings are strong and consensus expectations are benign should give any seasoned investor reason enough to maintain a measure of caution.

We'll hold off on elaborating on the election until we get further into the process, but the potential economic implications from various outcomes will undoubtedly make the election a fundamental investment issue. Positioning for that outcome will be challenging since we know from experience the outcome will be unknowable, regardless of what the polls say, until all the votes are counted.

Data as of December 31, 2019

Meritage Value Equity Fund

Top 10 Holdings	% of assets		% of assets
Chevron Corp	2.3	Total SA	2.0
Globe Life Inc.	2.2	Utilities Select Sector SPDR	1.9
Industrial Select Sector SPDR	2.1	Idacorp Inc.	1.9
Consumer Discr. Select Sector SPDR	2.0	JP Morgan Chase & Co.	1.8
Imperial Oil LTD	2.0	Wal-Mart Stores Inc.	1.7

Meritage Growth Equity Fund

Top 10 Holdings	% of assets		% of assets
Apple Inc.	8.4	Zebra Technologies Corp.	4.0
Microsoft Corporation	7.2	Micron Technology	3.4
Alphabet Inc. Cl A	5.4	IAC Interactivecorp	3.4
Amazon Inc.	4.8	Fiserv Inc.	3.1
MasterCard Inc.	4.6	KLA Corporation	2.3

Meritage Yield-Focus Equity Fund

Top 10 Holdings	% of assets		% of assets
Target Corp	3.2	British American Tab PLC ADR	2.2
PPL Corp	2.7	Verizon Communications	2.2
Centerpoint Energy Inc. 7.0% Conv PFD	2.6	CVS Health Corp	2.2
Lazard LTD	2.5	Morgan Stanley	2.1
Stanley Black & Decker Inc. 5.375% Conv Pfd	2.3	AT&T Inc.	2.0

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