

MONTHLY INVESTMENT OUTLOOK

Highlights:

- *The Stock Market*
- *Taxes*
- *Employment*
- *Consumer Credit*
- *Housing*
- *GDP*
- *Eurozone*
- *China*
- *What does this all mean?*

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Strength and Stability in Volatile Times

Meritas Advisors seeks to generate returns for our clients that are independent of the direction of the economy.

You work hard to build your life savings only to see your work eaten away by market swings.

By diversifying across five major asset classes, our goal is to generate more stable returns with the potential to profit when prices rise, fall, and/or when markets experience high volatility.

Dear Clients and Friends: This monthly report is intended to give you our perspective on various aspects of the economy and their impact on investing. We hope you find it enjoyable and informative and welcome your feedback.

- Lenore Hawkins, Principal

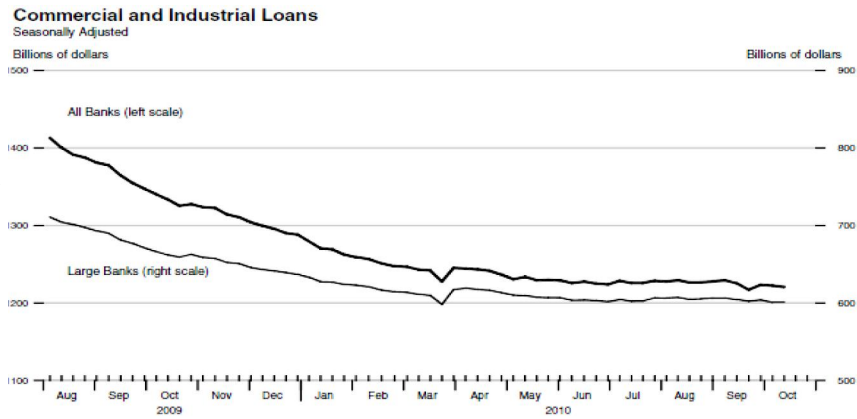
The Stock Market: With the Fed's injection of \$600 billion and the statements of Ben Bernanke and the FOMC, (Federal Open Markets Committee) suggesting that they will not allow a significant stock market decline, we can expect solid performance from equities in at least the near future. The FOMC's stated goal is to use the Federal Reserve's ability to print money to produce an increase in the "price" of all assets in order to create the "wealth effect" whereby individuals spend more because they perceive their wealth to have increased. The catch is that if we experience inflation, which is most likely inevitable, the price of assets may have increased, but so have costs so we aren't really any better off, we just feel better about seeing bigger numbers in our savings. **Bottom Line:** *We're optimistic about equity prices in the short-term..*

On the other hand, a potentially bearish signal for next year is the record level of selling by corporate insiders. Between November 2nd and November 9th alone, directors and executives at 125 companies in the S&P500 unloaded shares, outnumbering buyers by more than 12 to 1. This is the highest level of insider selling based on data going back to January 2004, according to Insider-Score.com. **Bottom Line:** *Be on the alert when insider selling trends like this. When the market sends mixed messages a long/short strategy can help protect.*

Taxes: The talk in D.C. seems more strongly in favor of extending part if not all of the current income tax rates. An extension of the current rates would alleviate the potential sell off before year-end in order to take advantage of lower tax rates. Facing the largest tax rate increase in U.S. history during such difficult economic time is not likely to help further the recovery. A postponement of any potential increase might encourage businesses to hire, believing that they will have more money left over after taxes to invest back into their businesses and providing them with some much needed certainty. This may also either encourage spending, as individuals and families are able to keep more of their income and/or contribute to a lowering of family debt levels. All of which are good in the long-run for the economy. **Bottom Line:** *Cautiously optimistic.*

Employment: On December 3rd, we learned that nonfarm payrolls rose by 39,000 in November, well below the consensus estimate of economists surveyed by Bloomberg which forecasted a 150,000 increase. The unemployment rate rose from 9.6% to 9.8%. Average hourly earnings were flat month-over-month, versus the Street's forecast of a 0.2% increase. **Bottom Line:** *Unemployment is still a major headwind for the economy.*

Consumer Credit - Consumers have reduced their credit levels by \$1 trillion (yes, that was a trillion) since the later part of 2008. This is good news for household finances as true long-term recovery can only occur when households get financially healthy. **Bottom Line:** Good for the long-term health of our economy.

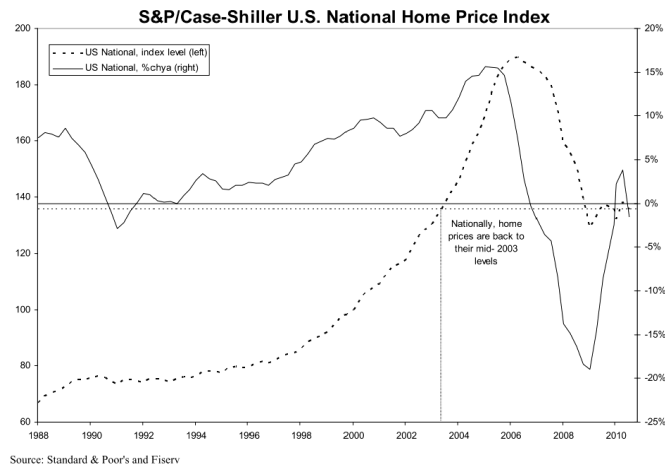


Source: Federal Reserve Bank of St. Louis

Corporate Credit - Businesses appear to still have little interest in borrowing and according to the Federal Reserve, they are holding about \$1.8 trillion in cash.

The chart to the right shows that there is absolutely no sign of growth in lending. **Bottom Line:** If this graphs starts rising, it would be a bullish sign and then we know the economy is on the right track.

Housing: I attended a Monetary Policy conference in Washington D.C. in mid-November and was concerned by how much of the conversation was centered on the housing market. At today's sales pace, it would take 40 months to work through current inventory levels of homes for sale. The number of vacant homes has remained relatively unchanged for the last two years at around 19 million. The Case-Shiller 2010 third quarter report shows that nationally home values fell by 2.0% over the second quarter, giving an annual decline of 1.5%, putting home prices today around where they were in the middle of 2003. Meanwhile, pending home sales unexpectedly jumped, rising 10.4% month-over-month in October, compared to the decrease of 1.0% that economists were anticipating. Compared to last year, the gauge of the pipeline of existing home sales is down 22.4%. For those of us in California, the news is a bit rosier with home prices in the three California cities in the Case-Shiller Composite, namely Los Angeles, San Diego and San Francisco, rising 4.4%, 5.0% and 5.5% respectively on a yearly basis.



Source: Standard & Poor's and Fiserv

Bottom Line: Good news for California, but overall housing continues to be a headwind on the economy. Hopefully we are starting to see a light at the end of the tunnel.

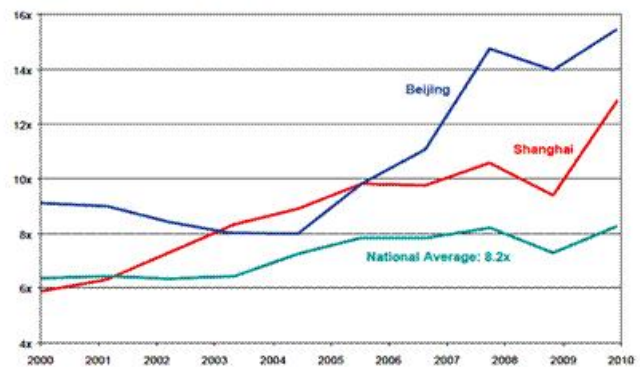
GDP: Third quarter GDP growth was a meager 2%. At this stage, when reviewing other post-recession recoveries, we should be experiencing 5%-6%. Approximately 70% of GDP growth has been driven by inventory accumulation. If holiday sales don't match or beat expectations, we could see negative GDP growth in the first quarter of 2011. So far the reports from holiday sales are strong, so keep those chilly winter fingers and toes crossed. On a positive note, the December 3rd ISM Non-Manufacturing Index report, (a national survey of purchasing managers which covers new orders, employment, inventories, supplier delivery times, prices, backlog orders, export orders, and import orders) increased from 54.3 to 55 in November, beating expectations. **Bottom Line:** Optimistic that consumers are getting more confident which will help the economy.

Eurozone Crisis Part II: The government bond yields for Ireland and Greece are reaching new highs relative to the more stable countries like Germany with a spread of about 7%, (meaning Irish and Greek debt has to pay 7% more than German to be attractive) which indicates that the market is betting on some sort of default. This problem is likely to worsen as Greece will have to raise more money through bond issuance to pay for their deficit. Since they are deemed a bigger credit risk, they will have to pay more interest on this new debt, which will only exacerbate their deficit. The greater the deficit, the more they need to borrow. The more they need to borrow, the higher the interest rates they will have to pay. But wait, we aren't done yet. Tax revenues are declining in the PIIGS countries, (Portugal, Italy, Ireland, Greece and Spain – who comes up with these acronyms!?) as well with their poor economic conditions, which only adds to the deficit. On top of that, the major European banks hold most of Greece's debt and will have to mark down its value, which will force them to raise more capital. The IMF will undoubtedly contribute billions more in rescue packages, which will be funded in no small part by the U.S. tax payer. **Bottom Line:** *Continuing Eurozone crisis is a headwind on global economy, but it can help prop up U.S. bonds and makes the U.S. Dollar slightly less ugly in comparison... so a mixed bag. Perhaps some strong egg nog at this point would be wise.*

China: In the 1930s, Americans looked at the Soviet Union's version of a managed economy as being far superior to the United States version of capitalism. In the 1970s and 1980s, the western world was convinced that Japan was the superior country with superior policies and an economy that was unstoppable. Now we watch China with the same fear and envy. Is China the next great superpower? Possibly, but I don't like to put that question into perspective. In the 1980s Japan was 18% of world GDP. Today Japan and China *combined* are about 8% of world GDP. In 1991, Japan was expected to surpass the U.S. as the world's largest economy within the next 20 years. During that time Japan's economy remained at about the same size, \$5.7 trillion GDP, using current exchange rates, while the U.S. doubled to \$14.7 trillion.

So what is going on in China right now? One area of great concern is real estate. Much like in the United States, housing prices in China have gone through the roof, my apologies for the bad pun. The best way to evaluate the relative "expensiveness" of a home is to compare average home prices divided by median disposable income. When that ratio gets very high, you know you have an unsustainable situation. This chart shows how big this problem has become. In Tokyo, at their peak, the ratio was around 9x, the national average for China is over 8x with Beijing well over 14x and Shanghai over 12x. According to Ned Davis Research, this ratio peaked in the U.S. at just over 5.2x in 2006 and is currently around 4.3x with a historical mean of 4.1x.

China nationwide property value/annual disposable income per urban household – cities



Source: CEIC, Morgan Stanley, GMO calculations As of 12/09

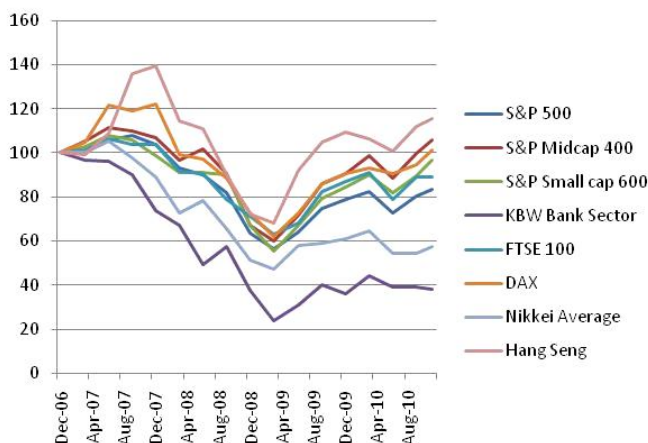
It has also been reported, but these things are very difficult to verify in China, that over 64 million apartments don't use electricity because no one lives there. Again, this is unsustainable. **Bottom Line:** *Long-term, China will help push raw material and food prices up as they build out their infrastructure and the affluence of their population grows, but as a nation, they have a long way to go before becoming a global economic powerhouse.*

What does all this mean? Long-term problems have yet to be solved as we continue to see short-term solutions that simply postpone the inevitable. We believe that an investment strategy which focuses on market fluctuations rather than being reliant on the market consistently moving in one direction over the long-term while also protecting from inflation will be the most productive.

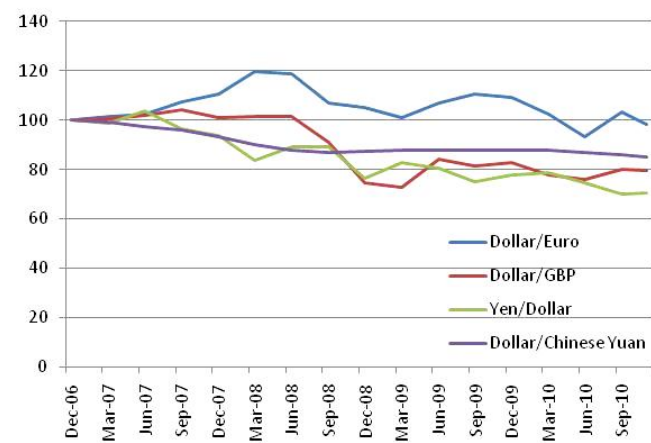
On a personal note, I also like to maintain a historical perspective. During the 1930s, no one would have imagined the great affluence that our nation, and a good part of the globe for that matter, would experience in the coming decades. In the late 60s and 70s, we again lost our confidence as our economy struggled and yet we experienced incredible growth in prosperity in later decades. We find ourselves facing another crisis of faith, faith in our ability to get through it, faith that one day things will be good again. We have a lot of cleaning up to do, of that we are all in agreement. How to do it is still under considerable debate and perhaps we have not yet fully understood the magnitude or causes of the problems. I believe that we will yet again work our way through to prosperity, most likely with a few stumbles on the way, but some day, children will read about this period in their textbooks with very little appreciation of the challenges we face as they live in a world of abundant optimism and opportunity.

But for now, we are living with the realities of an economy under strain. You hired us to protect and grow your wealth through both good and bad economic times, so like the soldier on the front lines, we are ever-vigilant, ever wary of potential dangers lurking in the dark. We are honored by your trust and seek to earn it every day, in everything we do.

Change in Equity Indices, from base of 12/31/06



Change in exchange rates, from base of 12/31/06



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