January 06, 2011

MERITAS ADVISORS

Comprehensive Wealth Management

Monthly Investment Outlook

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Northern California
4040 Civic Center Drive
Suite 200
San Rafael, CA 94903
415.690.8547

Southern California
11622 El Camino Real
Suite 100
San Diego, CA 92130
858.461.8547

info@MeritasAdvisors.com
www.MeritasAdvisors.com

Strength and Stability in Volatile Times

Meritas 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.

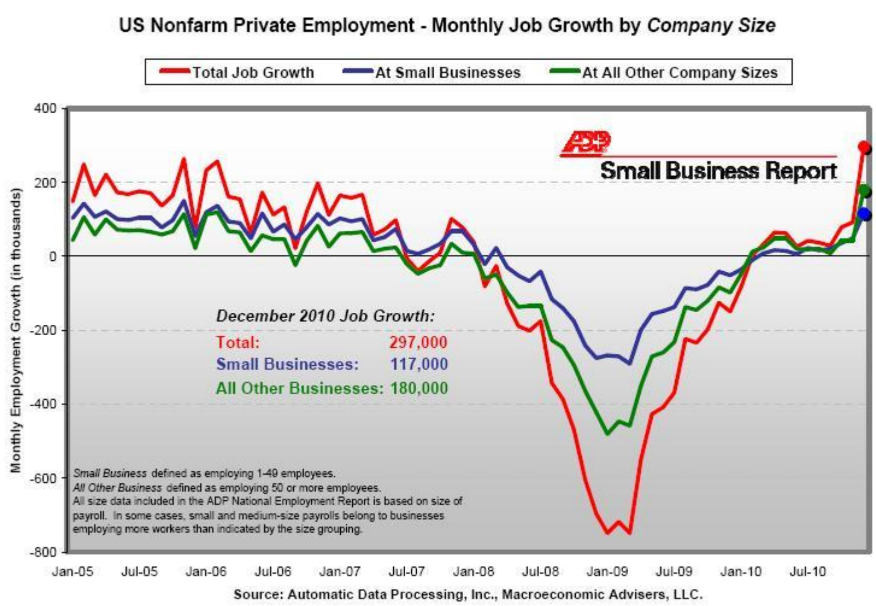
Dear Clients and Friends: Happy New Year! We hope you had a wonderful holiday season and have already recovered from any excesses in the eggnog, pumpkin pie and turkey department. Yours truly has banished the bathroom scale to the cupboard until February. We hope you find this monthôs newsletter useful and informative. Please call or write with any questions.
Lenore Hawkins, Principal

The Economy: Household net worth rose 2.2% in the third quarter, which amounts to almost $55 billion and should be positive for consumer spending. U.S. rail carloads fell 1.1% in November and have dropped in three of the last four months, a negative sign as we would typically see an increase in an expanding economy. Industrial Production increased by 0.4% in November, but we still have significant excess capacity. Utilization increased 0.3% in November over October to 75.6% which is still below the 1972-2009 average of 80.6%. Factory orders strengthened in November, increasing 0.7% after falling 0.7% in October, well above expectations of 0.3%. Retail sales are improving, (Decemberôs numbers were disappointing, but stronger than weôve seen in years), housing foreclosures and defaults are declining, and restaurant business is increasing. Even Vegas gambling business picked up 11% in October. ***Bottom line***: *Signs of improvement are emerging. Short-term interest rates will be kept artificially low, liquidity will be plentiful, bailouts will occur as needed - all this will continue to push the stock market up. Positive for 2011.*

The Stock Market: 2010 ended on a strong positive note, although it was a tumultuous year. During May-June, the Dow Jones Industrial lost a whopping 1,636 points, but the year ended with the S&P 500 gaining 12.8%, the DJ Industrial up 11.0% and the NASDAQ up 16.9%. The month of December was the best December in 19 years with the S&P experiencing only three down days. We are currently at some rather nervous highs, with markets consistently reaching 52 week highs every couple of days, including January 6th. When the bears all appear to be hibernating, a bull burger buffet is often in the works! The last time we saw the weekly American Association of Individual Investors (AAII) measure of bulls vs. bears near the current levels of 63.3% to 16.4% was in October 2007. In the U.S. weôve watched the market soar back up to pre-Lehman meltdown levels, but have yet to see an expansion in the primary indicators of economic growth, namely commercial and consumer credit. The excess liquidity, courtesy of the Federal Reserve, has gone into pushing the stock market higher, not into expanding the economy by any significant degree. The longer term outlook may be better for the economy than the stock market as the markets may have been too optimistic about the impact of quantitative easing and the extension of the tax rates. We anticipate merger and acquisition activity as companies deploy their huge cash cushions. ***Bottom Line***: *We continue to be optimistic about equity prices in the short-term, with the caveat that we could experience a correction soon. We are at an inflection point, reaching the 2008 highs. The market could either push upward into new highs or retract for a correction. A long/short strategy is particularly comforting now as timing the market isn't necessary for success.*

Taxes: Santa came early this year in the form of an extension of the current tax rates and a surprise 2% reduction in the payroll taxes paid by employees. After the November elections, the markets were expecting a continuation of the current rates, but we were pleasantly surprised by the increase in the exemption level for estate taxes to $5 million and perhaps even more exciting, (Did I just refer to a change in the tax code as exciting? I also go bonkers over monetary policy analysis, but letôs keep that between us.) is the reunification of the estate tax and gift tax. If an individual passes away in 2011 or 2012 and does not have a living spouse, 35% of their estate over $5 million goes to the federal government. ($6 million estate => $6m - $5m = $1m* 35% = $350,000 in taxes). So where is the exciting part? If a couple today has, for example, a $12 million estate with $8 million in real-estate (or some other appreciating asset), they could gift $5 million of that real-estate, at todayôs depressed prices, which means more real-estate for that $5 million, to their children or to a trust today. That real-estate would then grow outside of their estate, meaning that by they time they both pass away that $5m could have grown considerably, giving them the ability to pass on much more to their chosen beneficiaries without being subject to estate taxes. ***Bottom Line****: Great time to take advantage of what could be a short window of opportunity to get highly appreciating assets out of your estate now. If you would like to talk about how this opportunity could work for you, please contact our office.*

Employment: On December 30th we learned that initial jobless claims fell to 388,000 for the week ending 12/25 which was the first time since July 2008 that the claims had fallen below 400,000. On January 5th, the ADP report showed a job expansion of 297,000 with 117,000 coming from small business. This is the eleventh consecutive monthly gain and the largest monthly increase in the history of the report. ***Bottom Line****: Unemployment is still a major headwind for the economy, but we are starting to see a light at the end of the tunnel.*

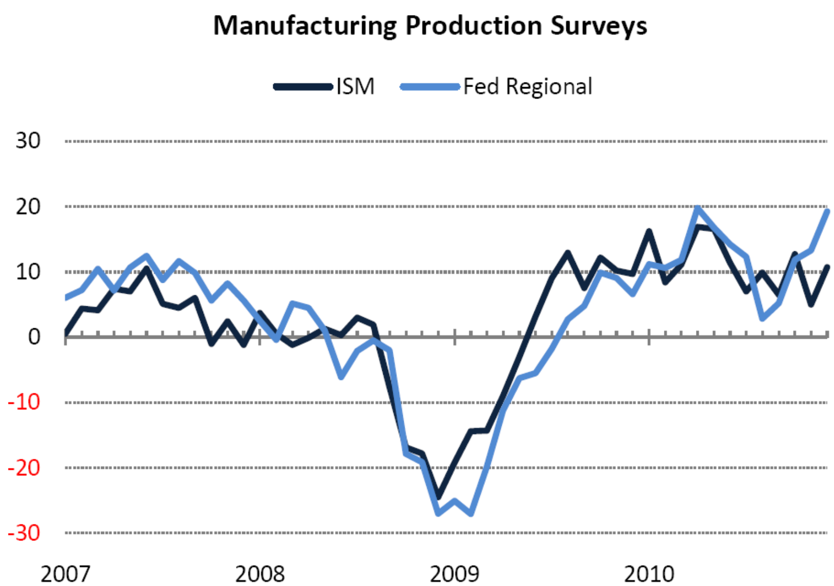


Commercial Credit: In December, the delinquency rate for commercial real-estate mortgages that were packaged together into bonds reached new heights. Rates climbed to 9.2% in December from 8.9% in November, with the previous high reached in September at 9.1%. On the other end of the spectrum, Warren Buffetôs Berkshire Hathaway issued $1.125 billion in fixed-rate debt this week in order to retire outstanding floating-rate debt which tells us that (1) even Buffet cannot time the market perfectly as he could have gotten a better rate in October and (2) the Oracle of Omaha thinks rates are going to rise. We agree. ***Bottom Line****: The problems in commercial real estate have not yet been worked out and increasing interest rates are not likely to help.*

Housing: On January 5th, housing stocks were among the biggest gainers. Construction spending rose 0.4% in November after a 0.7% increase in October. New home sales in November only increased from 275,000 in October to 290,000. Existing home sales in November were the strongest since the homebuyer tax credit expired in June. ***Bottom Line****: Overall housing continues to be a headwind on the economy but we are seeing more reasons to be optimistic, while being wary that the stock market seems to once again be pricing with an excess optimism. We suspect there may be bargain hunters out there who will jump in quickly when they see housing prices rise, so once things start to go up, they could go up quickly.*

Auto Sales: Domestic auto sales jumped from 9.27 million units in November to 9.46 in December, making December the strongest month in 2010 and the best month since September of 2008, excluding the one-time surge from the Cash for Clunkers program last August. Decemberõs year-over-year sales increased 17% and for the second consecutive month, every motor vehicle manufacturer saw yearly sales growth in December, with the exception of Toyota (-6%). On average, sales in 2010 compared to 2009 increased by 11% over 2009 with Hyundai Group (22%), Nissan (18%), Chrysler Group (17%) and Ford (17%). GM (7%), Honda (7%) and Toyota (0%) lagged the industry. ***Bottom Line****: Homes and cars are typically the biggest ticket items for households. The growth in auto sales indicates that households are becoming more confident with longer-term purchases. We are watching housing closely to see if it is next.*

Manufacturing: The chart to the right shows the ISM Index which is released on the first business day of the month and provides the market with a timely and succinct view of the manufacturing sector. Briefing.com has created a ñFed Regionalò index using the average of the real manufacturing output per state. These two indexes combined indicate that if the Fed data is correct, while ISM has been moving primarily sideways since August, manufacturing demand is actually growing at an accelerating rate. ***Bottom Line****: Optimistic about signs of growth in manufacturing which could improve employment, consumer spending and the housing market.*



Source: FactSet, Briefing Research

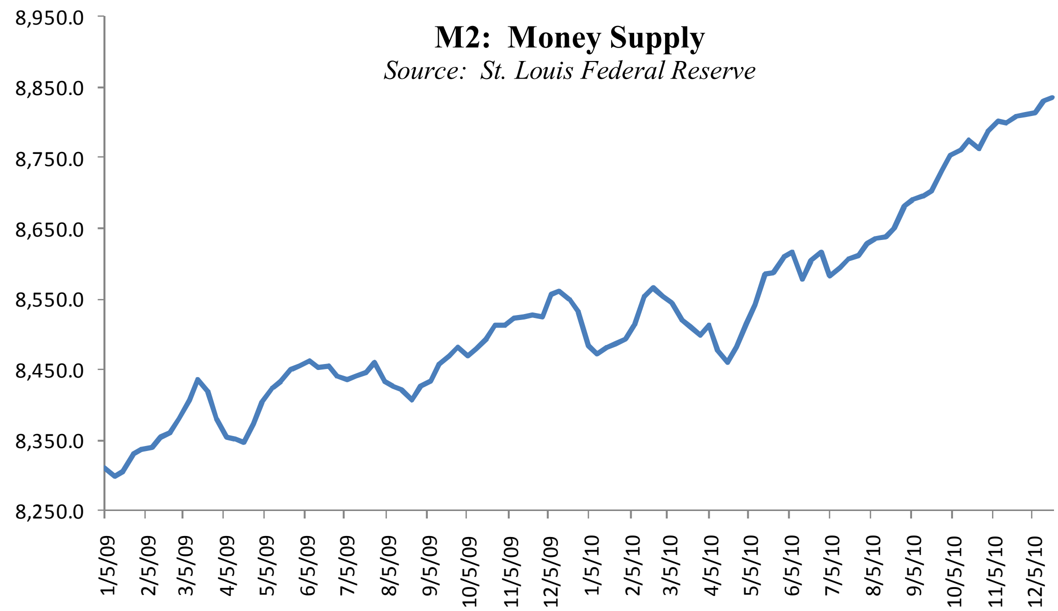
Europe*:* The PIIGS collectively owe over $2 trillion to European and U.S. banks with the U.S. holding about $353 billion (17%) of the debt. The large European banks have not revealed the size of their big loan exposure to the EU countries, nor the Eastern European nations. Q3 employment was flat vs. a 0.2% increase in Q2, with Greece and Spain dropping 0.7% and Germany increasing 0.3% (vs 0.4% in Q2) and France 0.2%. The divide in the strength of domestic economies within the Eurozone continues to grow. ***Bottom line****: When the European sovereign debt crisis returns, the dollar could strengthen in a flight to safety. In this case the USD is simply "less ugly."*

China: Poor economic data in China has furthered the belief of many analysts that China will continue to raise their interest rates in the near future. Commerzbank recently said, ñShould interest rates actually be raised and measures to dampen the economy be introduced, metal prices would most probably remain under pressure for awhile.ò On December 24th, the Peopleõs Bank of China raised the benchmark one-year lending rate by 25 basis points to 5.81% with the one-year deposit rate at 2.75%. Over the past month, China has raised bank reserve requirements three times, with the latest increase on December 11th at 0.5%. Chinaõs broadest measure of money supply, M-2, increased 55% over the past two years, and loans have climbed 60% to about $6.8 trillion in USD. For some perspective, Chinaõs economy is less than one-third the size of the U.S. so this would translate into $20 trillion in loans here. ***Bottom line****: The potential bursting of the property bubble in China could further strengthen the dollar while areas which depend on a strong Chinese economy, like commodities, could be hit hard. Since once again, timing here is critical, we prefer long/short options that remove the need for a crystal ball.*

Wrap up: We anticipate that the markets will be quite volatile this year but we are positive on the economy for 2011. The major headwinds are any tax hikes from Washington, Euro-zone problems, and China. Sovereign debt of the weaker EU nations could decline sharply, causing banks to face markdowns on $600-$700 billion of suspect debt which could push the euro even lower. In China, the credit bubble induced property bubble is in danger of popping, with the government forced to fight both property speculation and now intense consumer inflation. When Chinaôs growth declines, it could harm all the Asian markets and spread across the globe. Unfortunately we fear this isnôt a matter of if, but when.

Another area of concern is the potential liability of banks on the fraudulent mortgages, which is estimated to be in the tens of billions of dollars. Recently the Treasury agreed to settle with Bank of America on the claims of Fannie Mae and Freddie Mac for $1.52 billion on settlement of 12,045 Countrywide loans. Now the bank is left facing the claims of private investors who will be much tougher negotiators and could cost them dearly. We expect that this liability will haunt the big banks for years to come.

As we work our way through these challenging times, I like to look back at the perspective of those far wiser than I and have found comfort in the words of one of my favorite historians, ñ*The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults," Alexis de Tocqueville.* I am confident that his sage words still ring true.



A final word on **why stock prices rise when the underlying economy did not grow significantly in 2010**. The money supply (M-2) grew at 6.7% over the past six months. That is a much greater rate than GDP which grew around 3.2% real, annual. So where does the money beyond the 3.2% go? Into investments, like stocks, pushing prices up. If the economy begins to grow at a faster rate, more of this excess will go into economic growth vs. stock prices. When this shift will occur is impossible to predict, thus we prefer portfolios that don't rely on the direction of the economy nor the direction of the stock market for positive returns.

4040 Civic Center Drive, Suite 200
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