February 10, 2011

MERITAS ADVISORS

Comprehensive Wealth Management

Monthly Investment Outlook

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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 allocating across five asset classes, chosen for their ability to perform and behave differently from each other over time, we seek to create portfolios that do not require a strong economy or a bullish market to generate stable and positive returns.

Dear Clients and Friends: Thank you for all the positive feedback weôve received on the newsletter. It is a labor of love and to have it so well received is quite gratifying. As I sat down to write, reviewing Januaryôs activity, I felt decidedly uninspired by the data since not a whole lot has changed. Rather than give you anything less than my usual riveting prose, (feel free to groan) Iôm going to shake up the format this month. We open with the usual ñState of Investingò information followed by a few discussion points that have significant impact on investment decisions.
Lenore Hawkins, Principal

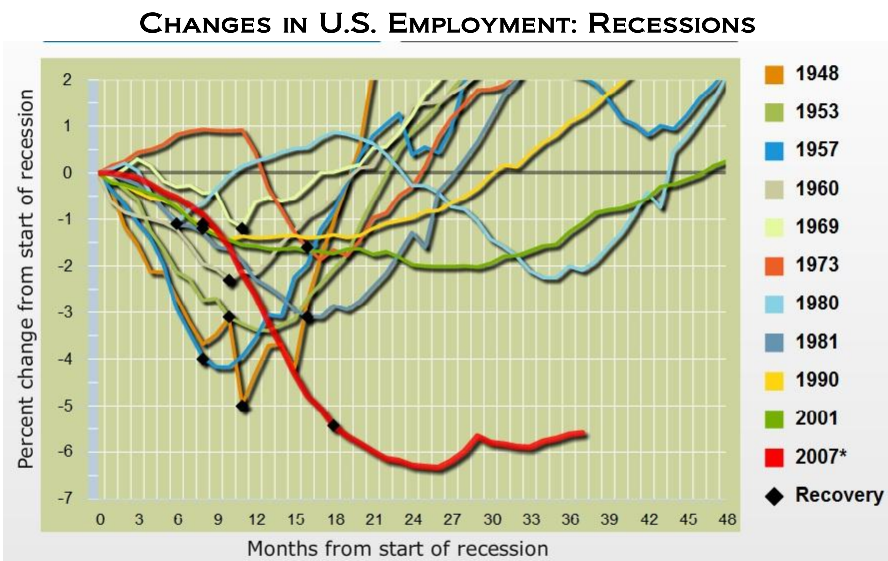
The Economy*:* GDP came in a little weaker than expected at 3.2% vs. a forecasted 3.5% for Q4 2010. GPD growth has moved into expansion mode, passing its previous high, but with the various headwinds such as unemployment and housing still blowing hard, the growth rate remains below potential. Consumer spending, which accounts for 2/3rds of GDP, was up 4.4% on top of a gain of 2.4% in Q3. Inflation concerns are now globally replacing recession or double-dip concerns for 2011. Unrest in Egypt and other middle eastern countries could dampen any recovery, bringing a flight to safety and discouraging risk-taking. January same store retail sales were up 4.4% year over year, beating the forecast of 2.6%. 70% of U.S. chains topped estimates. US auto sales rose 17%. Net trade is also helping the recovery, with exports up over 8% and imports down over 13%. The manufacturing part of the economy is booming, while construction is still suffering. ***Bottom Line****:* *Continued improvement, but the rate of improvement is expected to slow.*

Source: Bureau of Economic Analysis

Domestic Markets: We are watching the markets carefully. Treasury yields are near historic lows, the 10-year note yielded as little as 2.4% last fall and has recently hovered around 3.6%, and yields on corporate debt are also near rock-bottom levels, leading investors to search for higher returns elsewhere. Even yields on junk bonds have fallen below 7% for the first time in nearly six years. When investors get desperate for returns, money tends to flow into areas were it shouldnôt, bubbles form and that rarely ends well. Meanwhile the S&P500 is consistently reaching 52 week highs, day after day, and seems to be ignoring any bad news, another reason to be wary of a correction. We are seeing a high-level of merger and acquisition action as companies flush with cash have increased confidence. Commodity prices continue to rise, with copper consistently reaching new highs, cotton up 16% in January alone, silver up 82% in 2010 and oil continuing to push upwards. Tensions in the middle east are likely to push oil even higher.

***Bottom Line**: The market has been on a tear. Upward trends are rarely smooth, so we tread cautiously in anticipation of the inevitable pull back. Inflationary concerns are increasing.*

Emerging Markets: Investors pulled $7.02 billion from emerging market stock funds in the week ended Feb 2nd, the most in 3 years. They opted to invest in the US, Japan and other developing nations. The movement out of emerging market began in Q4 2010 amid concerns about valuations and inflation. Egyptian turmoil has cost the country at least $3.1 billion in lost revenue according to Credit Aricole which has cut its GDP growth estimate to 3.7% from 5.3%. They also believe the Egyptian pound could drop by up 20%. On Monday India predicted 2011 will deliver the strongest domestic economic growth in three years. On February 9th, China raised interest rates 0.25%, the third increase in four months which led to a sharp decline in the markets. The increase caused a hasty retreat in metal prices, led by zinc and copper, on concerns of falling demand in China. Latin Americaôs largest economy, Brazil, reported Tuesday that inflation is accelerating, leading markets to expect its central bank to increase its overnight rate, already at 11.25%. Although inflationary pressures, evident in rising commodity prices, are likely to dampen economic growth, emerging economies are still growing at a faster rate than developed countries. ***Bottom Line**: Emerging markets have outperformed the U.S. and other developed markets by a significant margin in the past, three, five and ten years, so a correction is likely, but these economies still hold a good deal more potential than the developed markets in the long-run.*



Source: Federal Reserve Bank of Minneapolis, updated Fed 4, 2011

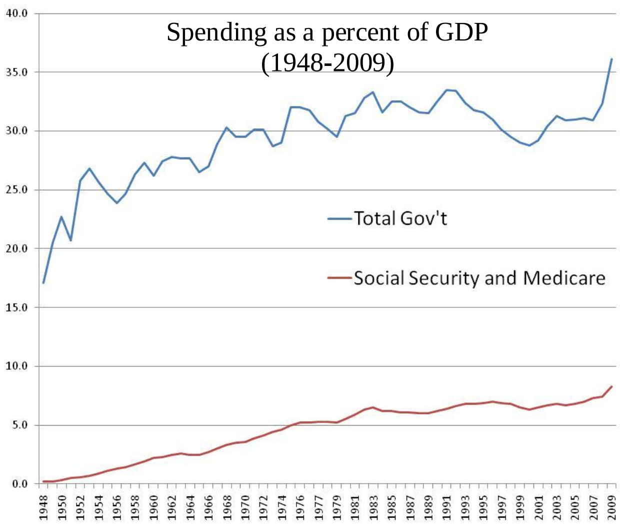
Employment: In January the percentage of people in the workforce sank to a 26 year low with about 2.8 million Americans claiming they've given up looking for work. We've now seen unemployment above 9% for 21 months, the longest stretch since WWII. From the chart to the right, it is clear that this is the worst employment recovery since the data has been tracked. The drop in unemployment could be weather related. If so, we would expect to see a strong snap back in the coming months. Good news for manufacturing which added 49,000, the largest increase since August 1998. The Institute for Supply Management reported that growth in the manufacturing sector rose to it's best level since 1973 with the services labor gauge at a 4 1/2 year high. ***Bottom Line**: Unemployment is still a major headwind for the economy that is not likely to resolve itself this year, but the directional changes continue to be promising.*

Credit and Debt: According to the Federal Reserve December Consumer Credit Report released February 7, 2011, consumer credit increased at an annual rate of 2.5% in the fourth quarter of 2010, increasing at an annual rate of 3% in December alone. Revolving credit declined at an annual rate of 2.75% and non-revolving credit increased at an annual rate of 5.5%. Consumer credit card debt is up for the first time since 2008. The difference between the yield on the 2 year and the 10 year Treasury is at 40 years highs, which can indicate that the market is expecting inflation. The yield curve continues to steepen, again an indication of potential inflation, meanwhile the federal government added $53 billion to the national debt in January, incurring $424 billion in deficit spending for the first four months of fiscal 2011. Based on current trends CBO anticipates a $1.5 trillion deficit by the end of FY 2011. ***Bottom Line**: Consumers are starting to spend more and use their credit despite continued high levels of unemployment. Good sign for growing GDP, but a cautious step towards growth.*

Weather vs. Climate: How is it that when the underlying economy is still struggling, the stock market can go on a tear? Why did the stock market reach for the stars when the underlying fundamentals in 2007 were so frightening? Because, wait for ité wait for ité. The market and the economy are not the same thing! Are you awestruck by my brilliance? We all understand this somewhat intuitively, but Iôd like to delve a bit into the whyôs and howôs.

The market is like the weather while the economy is like the climate. We can enjoy an unseasonably warm day in the middle of winter or shiver through an exceptionally cold day in the middle of summer, but that doesnôt change the season or latitude. The markets may push investments into an area beyond that which the fundamentals will support, sending returns higher and higher as everyone jumps for their seat on the rocket, igniting ambitions in much the same way as the gold rush of the 1840s and 1850s. Unfortunately for those who hop off to late, eventually reality, the inescapable gravity of economic fundamentals, exerts it pull. The bubble bursts, followed by much hand-wringing, finger-pointing and adamant pledging of politicians ensues. That is until the next Dutch Tulip Tornado (1637), South Sea Shindig (1720), Mississippi Mania (1720), Roaring 1920s, Computer/Tech Craze (1980s), Dotcom Dementia (1990s), and Real Estate Rage (2000s) ignites and off we go again. **Bottom Line**: *Prudent investing requires separating the weather from the climate, taking advantage of unseasonable trends, while always being wary of the inescapable gravity of economic reality.*

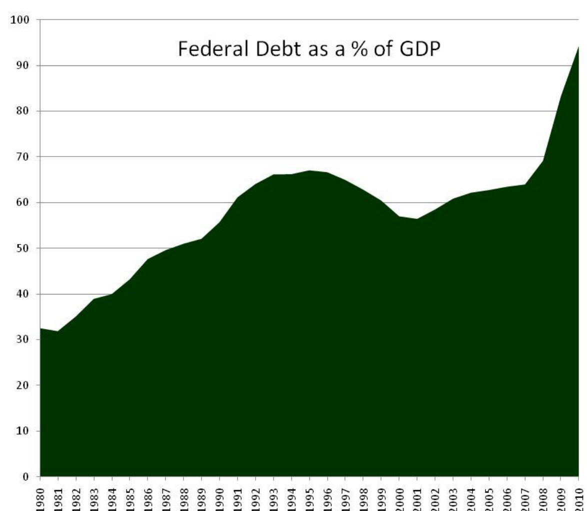
"As a very important source of strength and security, cherish public credit. One method of preserving it is to use it as sparingly as possible..." George Washington in his Farewell Address (1796).



Source: The White House

National Debt: The news these days is more and more focused on the national debt and the potential for inflation. These are two very real and significant concerns. First letôs review the debt vs. the deficit. The deficit is the amount of money the government spends in a year in excess of the amount of money it takes in primarily from taxes. The national debt consists of two main categories; debt held by the public (9.5 trillion as of 2/9/11) and intragovernmental holdings (4.6 trillion as of 2/9/11). Intragovernmental holdings are Government Account Series securities held by Government trust funds, revolving funds, and special funds; and Federal Financing Bank securities.

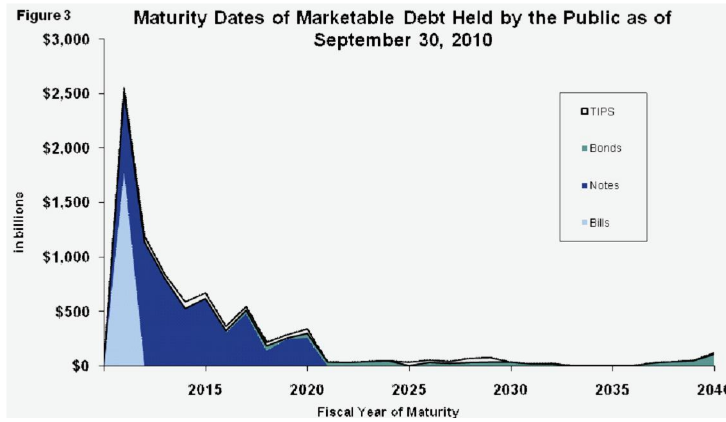
Government spending has increased from 17% of GDP in 1948 to over 36% in 2009. This means that for every dollar of goods and services produced by labor and property located in the United States, the federal government spent $0.36. Social Security and Medicare spending has grown from 0.2% of GDP in 1948 to 8.3% in 2009 and is expected to grow substantially as the largest generation in the United State begins retiring this year.



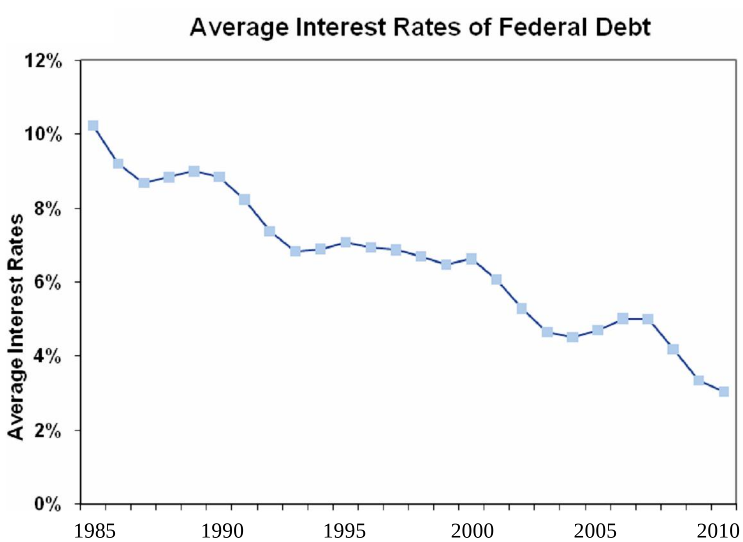
Source: Treasury Direct

The total outstanding Federal Debt has grown from 54.4% of GDP in 1960 to an estimated 96.4% as of January 31st, 2011. According to a widely cited study by Carmen Reinhard and Kenneth Rogoff, <u>This Time is Different: Eight Centuries of Financial Folly</u>, which examines economic data across 200 years and 44 countries, GDP growth is negatively impacted when debt to GDP rises above 90%. Average growth rate in countries with this level of debt was 4% below that of countries with lower debt, averaging 2.3%. The significance of lower growth rates becomes evident when we look at the interest payments on the debt. When the debt to GDP ratio is 1:1, a government can rarely grow out of its debt. It must cut spending and pay down its debt, something the U.S. has never done in any meaningful way.

As of September 30th, 2010, 61% or $5.18 billion of the national debt held by the public will mature within the next four years. This is important for two reasons: (1) private borrowers like you, me, businesses large and small, are competing against the federal government. With the government continuing to spend more than it takes in from taxes, (FY 2011 estimates $1.5 trillion in new federal debt) and all this outstanding debt needing to be reissued after it comes due, weôve got a lot of competition from an entity that is given a much higher credit rating than any of us, at least for the time being! This can lead to higher interest rates and slower growth with credit being less available to help the private sector grow.



Source: U.S. Government Accountability Office



Source: U.S. Government Accountability Office

In addition, all debt is at historically low interest rates. The chart on the left shows just how much interest rates have declined in recent years. As interest rates rise, and we are seeing signs that they are, the price of all that debt will increase significantly. With the debt to GDP ratio at nearly 100%, small rises in interest rates will have a large impact on the federal budget, much the way an interest rate increase on a $1,000,000 mortgage has a bigger impact on your household budget than a $500,000 mortgage.

But wait, thereôs more! Approximately 50% of the public debt outstanding is now owned by foreigners, which means that money is leaving the country. This is very different from years past when the interest was paid primarily to U.S. citizens, putting us in a very different situation from Japan where the majority of their interest expense is paid to their own people. These interest payments are not directly flowing back into the U.S. economy the way they would if the debt was owned by Americans, leaving us with less to invest back into our own economy.

So what is our government spending all this on? Only 37% of the 2011 budget is ñDiscretionary.ò The remaining 63% goes to spending on ñMandatoryò items such as Social Security, Medicare and Medicaid (32%) and interest on the debt (7%), according to the White House Office of Management and Budget. We are facing some very tough choices with so much of government spending in the ñMandatoryò category.

Wrap up: The level of government debt, inflationary pressures, unrest in Egypt and parts of the middle east, state and local debt and budget problems, all have us paying close attention as the impact of these factors can overpower the markets, reinforcing our commitment to portfolio design that is not dependent on market direction.

Our nation has faced seemingly impossible challenges throughout history, and while the future may have often looked grim, we eventually found our way. Ours is a nation of endless optimism, unbridled creativity, and an unwavering desire to succeed, a history of screaming into the abyss, ñYou shall not defeat us!ò I am confident that this time shall be no different.

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