

**March 8, 2011**

# 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.*

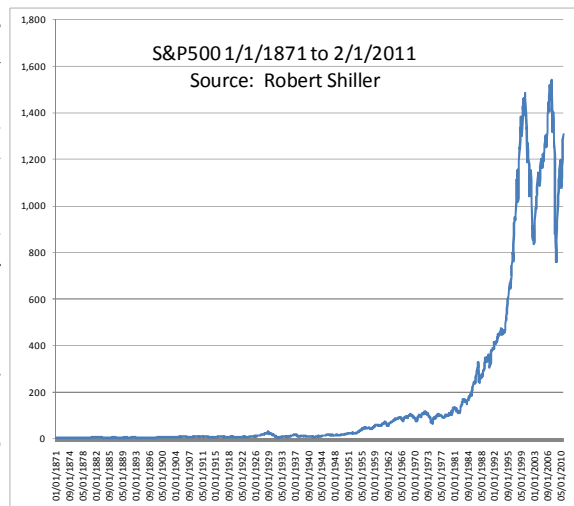
By allocating across five asset classes, chosen for their ability to perform and behave differently from each other over time, we seek to create portfolios that do not require a strong economy or a bullish market to generate stable and positive returns.

**Dear Clients and Friends:** We received such strong support for our enhanced discussion last month on the national debt, that we decided to continue with the format, discussing quantitative easing and its potential impact on inflation this month. As always, we'd love to hear your comments and/or questions.

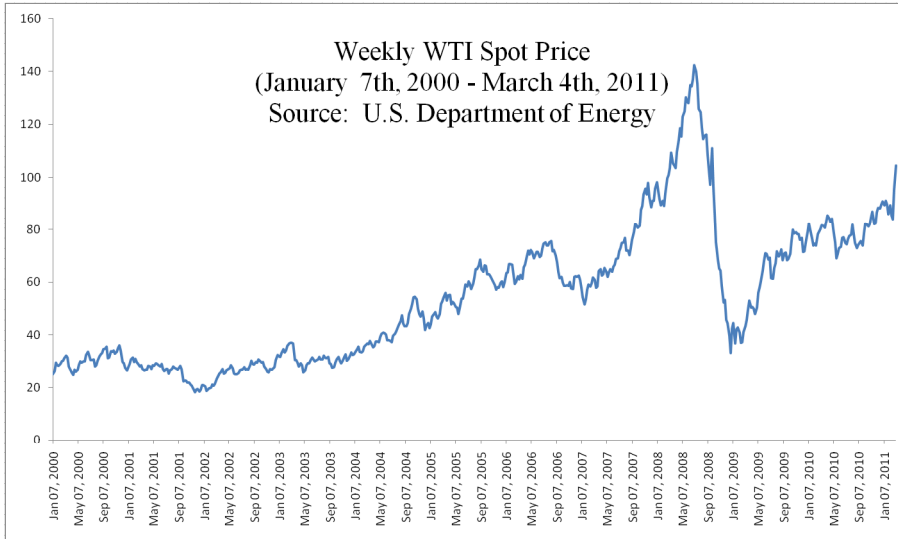
*Lenore Hawkins, MBA, Principal*

**The Economy:** Companies grow by reinvesting profits back into the business or by borrowing money to pay for expansion. Last month we discussed how borrowing by the federal government to fund the national debt reduces the funds available for private borrowing, making companies more dependent on their profits for expansion. Profits are dependent on the spread between what a company charges its customer and what it pays for inputs. The Philadelphia Fed Business Outlook Survey reported that 67% of firms experienced higher input prices in February, compared with 54% in the previous month. The Fed's Prices Paid less Prices Received Index reached its highest level since June 1979 when it was 46.90. The last time companies faced such an intense profit margin squeeze, the four quarter earnings per share trend degraded over the following year from 21% to 69%. On the other hand, the survey's Diffusion Index of Current Activity, the broadest measure of manufacturing conditions, increased from 19.3 in January to 35.9 in February, the highest level since January 2004. The demand for manufactured goods showed continued strength, while unchanged from January, it has increased over the past six months. **Bottom Line:** *Input prices continue to rise with businesses struggling to push those increased costs onto the consumer. Input prices are increasing.*

**Domestic Markets:** While the economy continues to be under pressure, the S&P500 is up around 27% since September. According to Paul Hickey at Bespoke, there are five periods where the S&P charts matched with the action of the last six months: 1935, 1949, 1953, 1958 and 1995. In each of these five cases, the S&P500 experience an average gain of 22.1% over the following 12 months. However, many other macroeconomic factors are very different this time around, so it remains to be seen if this period will be similar to the past. The chart on the right illustrates how dramatically different the market behavior has been since the mid-90s, with much wilder swings than were previously experienced. **Bottom Line:** *The markets continues to boldly press on, seemingly indifferent to any negative news.*



**International Markets:** Oil is up, gold is up, silver is up and the dollar is down. Oil is an increasing concern with WTI spot price rising 24% from February 18th to March 4th. On March 7th, Moody's slashed Greece's credit rating by three notches to "highly speculative", raising the risk that the euro zone may have to restructure its debt, a process we believe is becoming increasingly likely. Greece's debt rating is now lower than Egypt, with Moody's warning that further downgrades may come. This downgrade kicked off an increase in the price of insuring Greek, Portuguese and Spanish debt. Portuguese debt hit a euro lifetime high of 7.65% **Bottom Line:** Rising energy prices and sovereign debt problems may be headwind to the recovery.

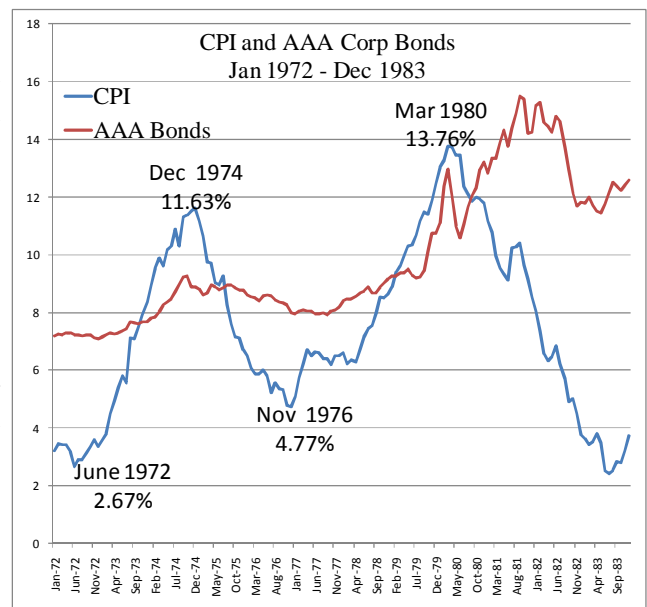


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**Employment:** Unemployment dropped to 8.9%, the lowest level since April 2009. Civilian employment as a percentage of the population is still at record low levels not seen since 1984 at just 64.2%. The median duration of unemployment has dropped 2.8% from January to 21.2 weeks, however this is an 8.2% increase from a year ago. We are still below the peak of 25.5 weeks reached in June 2010, the longest duration since the data has been tracked. **Bottom Line:** The employment situation shows improvement, but we have a long way to go. Unemployment continues to be a headwind to recovery, particularly for housing.

**Housing:** In a report published on February 24th, we saw the number of existing home sales rise unexpectedly in January, gaining 2.7% month-over-month to an annual rate of 5.36 million units vs. last year's rate of 4.9 million units. However, the median existing-home price declined 3.7% from a year ago, to the lowest level since April 2002 and 5.9% lower than in December. Out of all 20 metropolitan areas measured by this index, Washington, D.C., was the only one to see a slight increase in home prices. During the fourth quarter, home prices fell 3.9% nationwide compared with the third quarter. Last year was the worst year for home sales since 1997. Housing starts continue to be at their lowest levels since data recording began in January 1959, with starts of new privately owned single-family housing units in January 2011 at 413,000 vs. 1.82 million at the peak in January of 2006, but above the all time low of 360,000 in Jan 2009. **Bottom Line:** Housing continues to be a headwind to the economy. Unemployment and expectations of increased interest rates make price increases unlikely anytime soon.

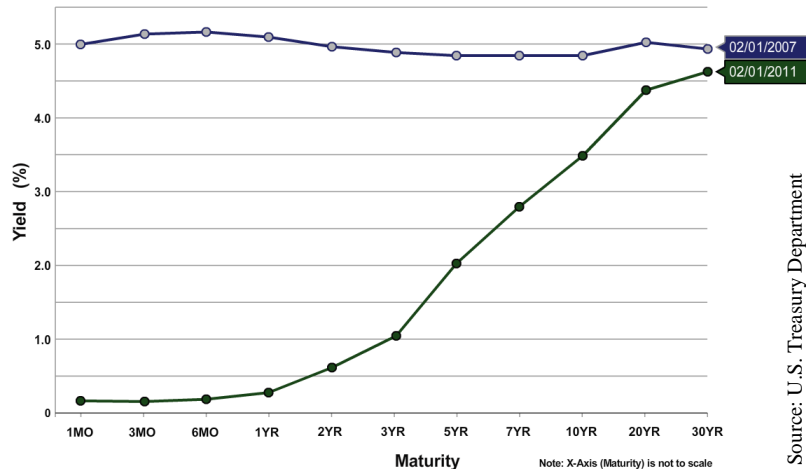
**Inflation:** Before we begin our discussion on quantitative easing and how it can cause inflation, let's briefly look at the last period of high inflation in the United States. The chart on the right shows that in just 2.5 years inflation increased almost 9%, then dropped almost 7% in the following two years, only to increase again by 9% in the next four years. Corporate AAA Bond interest rates almost doubled in just four years from 7.9% in Sept 1977 to 15.5% in Sept 1981.



Sources: Bureau Labor Statistics and The Federal Reserve

**Quantitative Easing:** You can't turn on the television or pick up a newspaper without hearing talk of inflation. To understand the inflationary concerns we need to first talk about what the Federal Reserve did during the financial crisis and how those actions can lead to inflation.

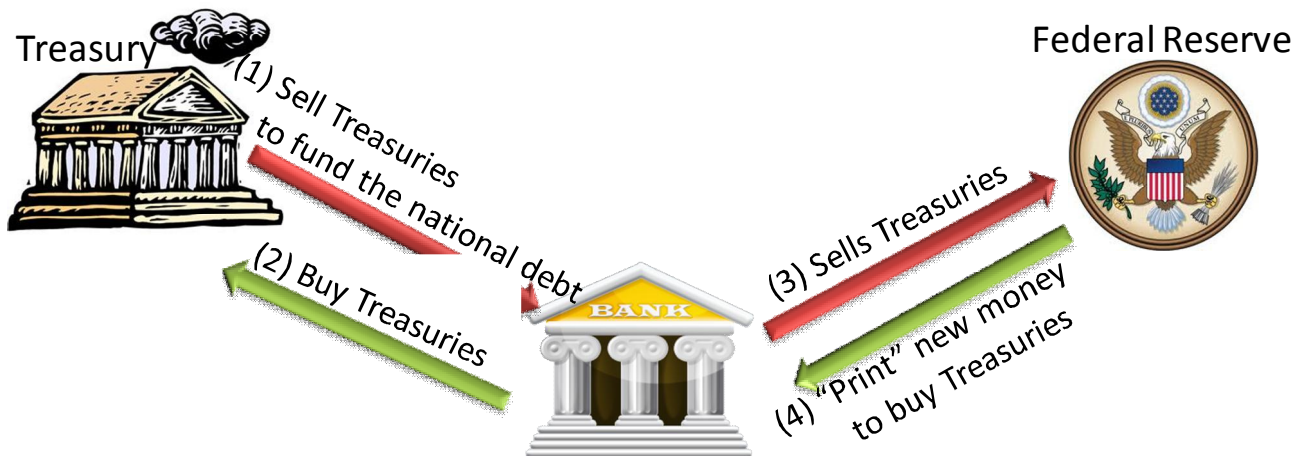
As we discussed last month, the federal government spends more money than it takes in every year through taxes, which is the *annual deficit*. The *national debt* is the accumulation of all those years of deficits. In order to spend more money than it takes in, the federal government has to borrow. It borrows by issuing *Treasury Bills* (loan of 1 year or less), *Treasury Notes* (loan of 1 to 10 years), *Treasury Bonds* (loan of 20 to 30 years), or *Treasury Inflation-Protected Securities* (TIPS— inflation indexed borrowing for 5, 10 or 30 years). The interest rate the federal government pays on the borrowed money depends on what the lenders are willing to accept. This rate changes over time and is based in part on expectations around inflation. (If you are willing to loan money at 5% for one year when you believe there will be no inflation, you will demand 8% if you think that there will be 3% inflation so as to still get the same effective interest rate on the loan. For more details on this please read the post entitled [“The Case for Rising Interest Rates”](#) from 11/1/2010 on our website under Weekly Commentary.) The chart on the right shows how interest rates on *Treasuries*, (a generic term for anything issued by the Treasury)



Source: U.S. Treasury Department

for various lengths of borrowing from 1 month to 30 years, have changed from March 1st, 2007 to March 1st 2011. This is called the *yield curve*. An upward sloping curve means that interest rates are less for short-term borrowing than long-term. An inverted yield curve means that interest rates for longer-term borrowing is less than short-term, which is typically a sign that a recession is on its way.

Back to Quantitative Easing, the most recent version of which was launched last fall and is typically referred to as QE2. U.S. banks, as well as foreign governments, foreign banks, corporations, investment funds and individuals purchase Treasuries. Quantitative Easing refers to the process shown below wherein (1) the Treasury Department sells Treasuries to Banks in return for cash to fund the annual deficit. This money is then spent by the federal government. Banks then turn around and sell the Treasuries to the Federal Reserve in return for cash. This cash is typically in the form of a “credit” in their reserve account, but for all practical purposes it can be thought of as cash since these reserves can then be used to loan money to businesses and individuals, who then effectively have cash in hand. For a detailed description of how this process works, please read our White Paper on the [U.S. Banking system](#) (Fractional Reserve Banking) on our website, under Resources -> White Papers. So how can this lead to inflation?



**Monetary Policy & Inflation:** In 1911 Irving Fischer proposed the *Equation of Exchange* which is simply stated as  $M \times V = P \times Q$  where

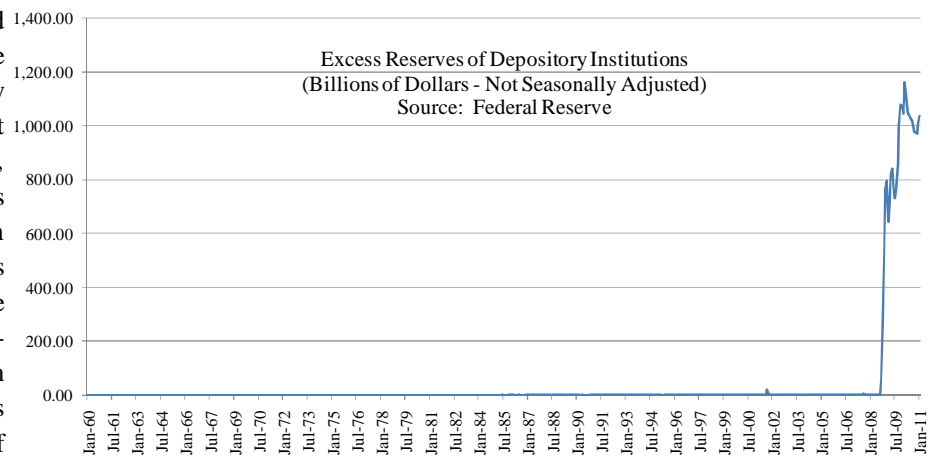
- M is the total dollars in the nation's money supply (*Money Supply*).
- V is the number of times per year each dollar is spent (*Velocity of Money*).
- P is the average *price* of all the goods and services sold during the year.
- Q is the *quantity* of assets, goods and services sold during the year.

To understand the importance of *velocity*, let's look at a very small economy with a farmer and a tailor with \$50 between them. They buy goods and services from each other in just three transactions over the course of a year.

- Farmer spends \$50 on a new suit and shirt.
- The tailor buys \$40 of corn and butter from farmer.
- Tailor spends \$10 on milk from the farmer.

\$100 changed hands in the course of a year, even though there is only \$50 in this little economy. That \$100 level is possible because each dollar was spent an average of twice a year, which is to say that the velocity was  $2 / yr$ .

The chart on the right shows the *money supply (M)* has increased dramatically when we look at the excess reserves held by depository institutions. This is money that could be used out in the economy, but is being held by banks. This explosion in excess reserves is in large part the result of the Fed's quantitative easing programs, the process we discussed on the previous page. When this money sits in reserves and is not changing hands in the economy, the *velocity* of money declines. Add to this that



companies are holding record levels of cash as well, (this is akin to the tailor only purchasing say \$20 worth of goods from the farmer in a year) the *velocity* of money drops significantly. Let's say initially  $M=10, V=2$  and  $Q=4$ . Then  $10 \times 2 = P \times 4$   $20 = 4P$   $20/4 = P$   $P=5$ .

It takes time and money to increase the amount of goods and services a country can produce, but prices can be immediately adjusted up or down. If M doubles to 20 and V increases to 3 in a short period of time Q won't be able to increase much. If we assume that the quantity of goods and services is increased by even 25%.

$$20 \times 3 = P \times 5 \quad 60 = 5P \quad 60/5 = P \quad P = 12 \quad (\text{Prices have more than doubled})$$

If the economy is not able to increase Q (*Quantity of goods and services*) to the same degree as the increase in the (*Money Supply \* Velocity*), that leaves only P (*Prices*) left to increase. This is how an increase in the supply of money causes inflation. Phew - anyone up for a glass of wine?

**Wrap up:** We are truth seekers. We divine to identify the truth from the distractions of market movements. The wind may toss a leaf up and down, back and forth, but eventually the truth, the reality of gravity will prevail. These truths, as Thomas Jefferson would say, are self-evident. We seek to identify those truths that are self-evident and in doing so protect your savings and when possible, take advantage of the market when it strays from the truth. The global economy is in for some very challenging times, but for those who can see the truth, which is often a difficult and murky endeavor, safety can be found and opportunities will be presented.

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