MERITAS ADVISORS

Comprehensive Wealth Management

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Monthly Investment Outlook

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Strength and Stability in Volatile Times

Our mission is to generate stable real returns, regardless of the direction of the economy, while providing the highest level of service and exceeding expectations in performance, planning and communication.

We seek to generate returns from market movement, rather than being dependent on a particular market direction. We utilize the strongest performing investments across a wide range of sectors and strategies that when combined seek to optimize opportunity, while minimizing downturns.

Dear Clients and Friends: Weøve been warning that the underlying economy is still struggling while the bulls have been pushing for continued market expansion. We hope this monthøs Outlook provides some insights into the state of the world economy and the investment markets. As always, we love to hear your questions and comments.
Lenore Hawkins, MBA, Principal

It certainly feels like 2010 déjà vu as we head into summer with an end to round two of quantitative easing and once again the Eurozone is giving the markets baklava heartburn. Last summer the correction was about 15%. This time the slowdown is more global in nature and no pro-growth policy response is in the works, at least for now. We see three main forces at work:

1. Global slowdown and fighting inflation

- The Economic Cycle Research Institute's (ECRI) *global industrial growth index* has fallen now four weeks in a row and has slowed to a pace last seen in January 1980.
- *U.S. Q1 GDP* slowed to 1.8% growth vs. 3.8% in Q4 2010. Last week the Federal Reserve Chairman, Ben Bernanke, essentially announced that monetary policy has run its course and he has no more arrows in his quiver. (Some good news was retail sales came in better than expected, but still fell 0.24% MoM in May)
- *Canada's Q1 GDP* came in at 3.9%, but is expected to slow to around 2.5% in Q2 as manufacturing exports sagged more than 4% in April and automotive imports were down 8.6%.
- *Japan's post-quake Q1GDP* was -3.7% vs. expectations of -1.9%. The nation is likely to continue to be weighed down by consumption restraints, electricity shortages and a government lacking in leadership and decisiveness. This will continue to impact US automotive production as Japan is an important cog in the automotive supply chain.
- *Europe:* U.K. factory output fell 1.7% in April, the worst showing in two years. Jobless claims jumped 19,600 in May vs. expectations of a 6,500 increase while France saw a 0.3% drop in industrial production.
- *China* is trying to keep its economy from overheating, (inflation jumped to 5.5% in May) by moderating credit, raising its reserve requirement to 21.5%, the 6th increase this year. Property developers reportedly pay interest rates above 30% in non-bank channels for loans, causing a slowdown in construction of property and infrastructure. Auto sales in China have declined for 2 months in a row.
- *India* has raised interest rates by more than 400 basis points since it began tightening in March 2010, with core inflation at 7.2%.
- *Brazil* retail sales fell 0.2% in April, the first decline in a year.
- Bank of *Korea* hiked rates 25 basis points to 3.25% in a surprise move on June 10th as yet another emerging market seeks to combat inflation and prevent their economy from overheating.

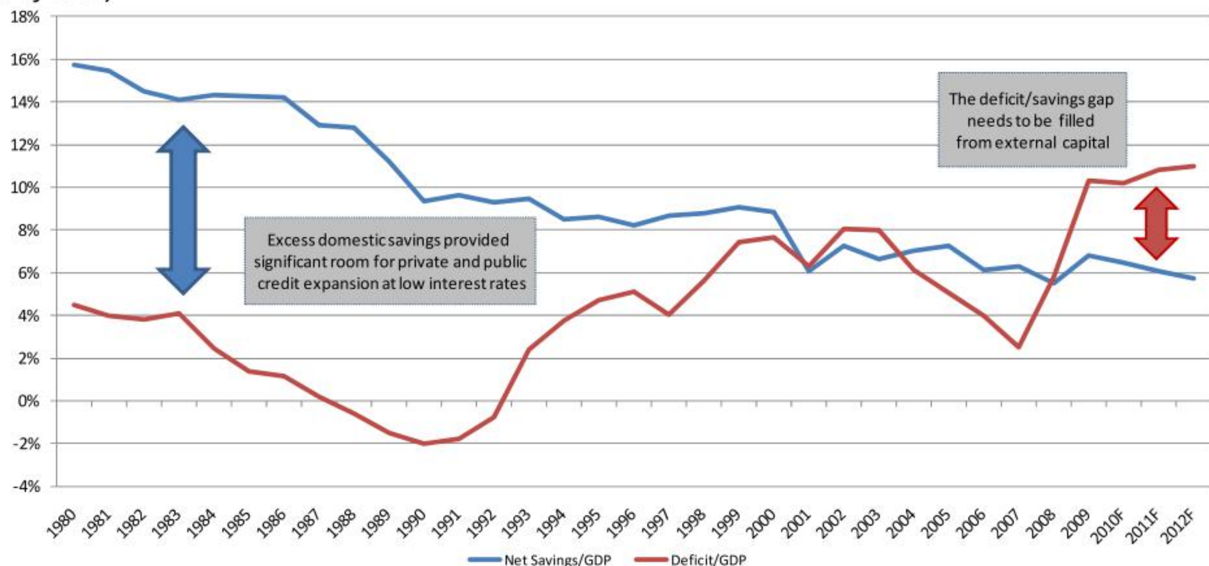
The yield curve has inverted in Greece, Portugal, Ireland, Brazil, India and has been flattening in China, Korea and Austria. This is generally considered to be a predictor of economic recession. (An Inverted Yield Curve is one in which long-term debt has a lower interest rate than short-term debt. The U.S. has a steep yield curve today, which is generally considered good for growth.

2. Sovereign Debt Dragging on Recovery and a Reduction of Fiscal Stimulus

- *U.S.:* Our debt has skyrocketed, there is currently no credible plan for addressing the mountain of unfunded liabilities, the extreme fiscal stimulus of the past few years has had questionable impact (pg. 4) and continued ZIRP (Zero Interest Rate

Policy) is pushing investors into riskier assets once again. One of the biggest problems with this strategy is that rates cannot be suppressed indefinitely. When rates do rise, payment on the interest for the national debt will jump, straining an already tenuous federal budget as every 1% increase in the cost of capital will end up costing the federal government approximately $142 billion in additional annual interest payments alone. **Federal spending is being reduced from its record high levels, while state and local reductions are also taking hold. In the near-term the government spending reductions are a headwind to growth.**

- *Europe*: Germany is drawing a line in the sand, calling for some sort of Greek restructuring in which bond holders also have to take a haircut. This has put the European Central Bank's (ECB) Trichet into nearly apoplectic fits, which I'm sure has nothing to do with the hundreds of billions of dollars in debt from the PIIGS. on the ECB balance sheet! Such a haircut could render the ECB itself insolvent, a situation worthy of such fits. Standard and Poor's downgraded Greece's debt on June 13 to CCC, making Greece the lowest rated of the 126 sovereigns covered by the rating agency. The Greek two year note is at a whopping 30% and we are seeing rioting in the streets. Greece is in an untenable position with overall tax revenue at 35.1% of GDP last year, making "restructuring" of the debt a must. **The other PIIGS may not be far behind while in most of Europe government spending is being reduced – a near-term headwind to growth.**
- *Japan*: For over a decade, Japan has been able to self-finance its growing national debt with its citizens' savings. Japanøs situation bears a similarity to the Bernie Madoff Ponzi scheme, without the fraud. The system works until the money being withdrawn exceeds the money coming in. The upcoming severe decline in the working population in Japan and its resistance to large scale immigration are combining to form a volatile catalyst for a major bond crisis. The chart below, (using data from the IMF, Japan National Accounts and Hayman Capital) shows this evolving relationship. The day of reckoning will come when the global markets are no longer willing to lend to Japan. When that happens, the Bank of Japan will have to get the printing presses up and running, **the Yen will plummet and yields on Japanese bonds will shoot up.**



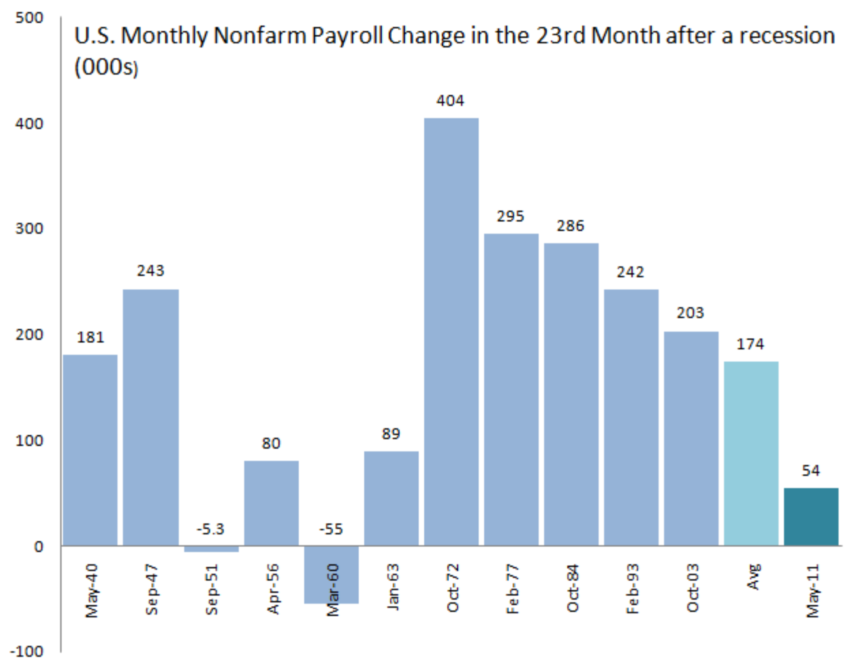
3. Uncertainty Reigns

- *Emerging Markets*: As we discussed above, emerging markets are trying to slow their economies down to combat the increasing inflationary pressures in their countries. They have been a primary driver of global growth, and their attempts to cool their economies, to engineer their own soft landings, leads to uncertainty for the global economy.
- *Europe*: We watch as last year's "3-year solution" is no longer effective and the battle of wills heats up. How the Eurozoneøs fiscal woes will all pan out is unclear and leads to more uncertainty. We do believe some form of debt restructuring is inevitable.
- *Dodd-Frank*: This law is due to go into effect in July and yet many of its provisions are yet to be defined. The complex and cumbersome new regulations affect more than the banking industry as the proposed rules affect companies using derivatives to hedge against business risk. It is not clear when these rules will be defined, nor how they will impact the economy.

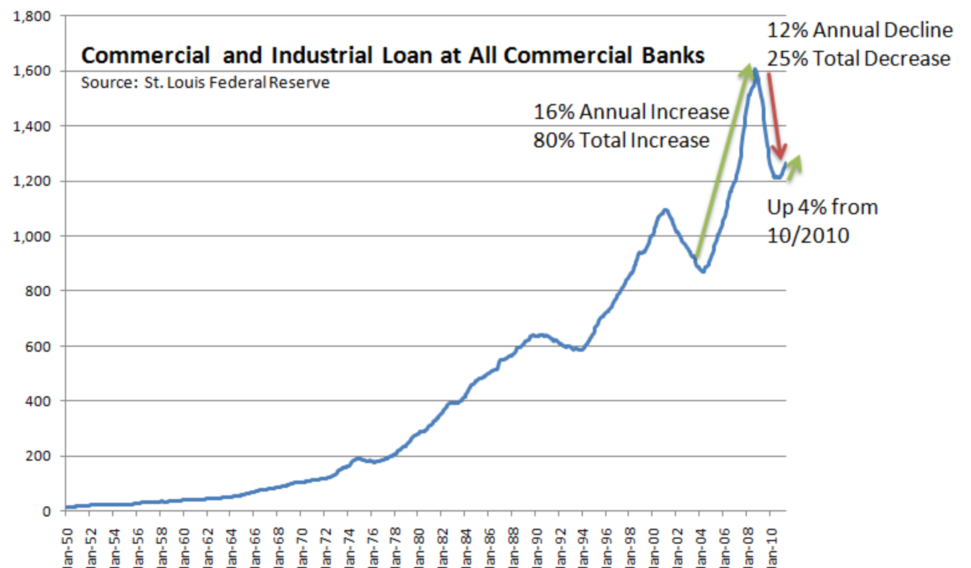
- *Tax rates*: The 2% cut in payroll taxes paid by employees granted last December is due to expire this December. The Administration is talking about another temporary payroll tax cut, this time aimed at helping employers while at the same time continuing to threaten to raise taxes. This uncertain tax environment keeps businesses in a defensive posture.
- *Dollar policy*: While the Treasury continues to insist that a strong dollar is good for the economy, the Fed's policies are causing a weaker dollar. This conflict between rhetoric and action leads to more uncertainty in an increasingly global economy where exchange rates have a substantial impact on businesses and consumers.

Market Response: We've seen yields drop which suggests a slowdown in economic growth as bonds typically tell the weak growth story before stocks catch on. The U.S. stock market just fell for the sixth week in a row. Since 1928, the S&P500 has only put together a six-week-in-a-row decline 16 times. Only three of these declines went on longer. If the current streak continues for a seventh week, it will have been the first time since the March 2001 tech wreck. As of June 15th, emerging market stocks were down in five of the past six sessions as concerns over China's inflation rate continue and the commodity complex is once again in retreat.

So how about the **Domestic Economy?**



Employment: At 131 million, payrolls are lower now than they were in March of 2000. Barely more than 20% of the 2007-2009 job losses have been recouped. Over this 11 year period of flat employment, the population has increased by almost 30 million. On average, 23 months after a recession ends, the total nonfarm payrolls have recovered by 174% of the jobs lost from the recession (See the Chart on the right). Payrolls today are still 7 million shy of where they were when the recession began.
Even more concerning is we are seeing a downward trend in total private job openings starting. This could be a seasonal problem, or a function of the natural disasters in Japan and the Southern U.S., so we'll have to watch over the coming months to see if this trend reverses. Should confidence not rise among executives, it is difficult to see employment improve substantially. ***Bottom Line****: We will not have a sustained recovery with such dismal employment. Until we see positive movement in this area, we will continue to position portfolios in a defensive manner.*



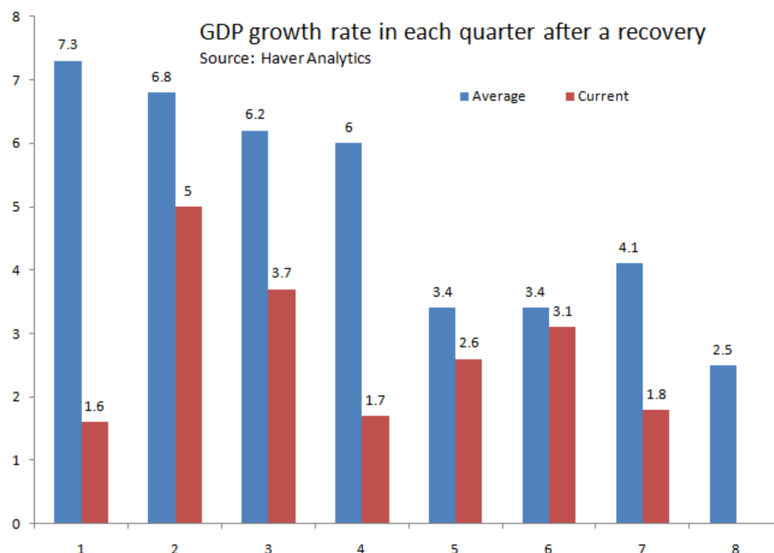
Commercial Credit: Small businesses employ over half of the country's private sector workforce, have generated 64% of net new jobs over the past 15 years, create more than 50% of the nonfarm private GDP and produce 13x more patents per employee than large firms!. During the recession, credit for these firms plunged, but we've seen a recent uptick, with Commercial and Industrial Loans up 4% from the bottom in October of 2010. This type of credit is typically for the small to mid size firms as large firms access credit through the capital markets by issuing bonds. ***Bottom Line****: Good news in that one of the tools for expansion, credit for small to mid-sized businesses could be moving in a positive direction.*

Inflation: CPI rose at an annualized rate of 2.0% in May after five months of gasoline fueled increases. For the past year CPI is up 3.5% while gasoline prices slipped 21.1% in May, falling for the first time since last June. ***Bottom Line**: Inflationary pressures are muted for the time being, particularly when we look at the labor and housing markets, but we are still watching closely as M2,(a measure of the money supply) is now growing at 7.4% which is a potential sign of impending inflation.*

Production: The impact of the earthquake in Japan and the natural disasters in the Southern U.S. continue to hold industrial production in a slump with nearly no gain in April and only a 0.1% increase in May. Capacity utilization for the total industry remains flat for the second month at 76.7%, which is 3.4% higher than in May of 2010. ***Bottom Line**: Production is at 83% of its 2007 average and down 3.7% from the historical average from 1972-2010. Bad news is we are well below our potential. The good news is this is a headwind to inflation and a tailwind to the bond market.*

Producer Prices: The PPI (Producer Price Index) rose at an annualized rate of 2.5% in May, compared with an 11.5% growth rate over the previous 6 months, with energy accounting for most of the increase. Producer prices for finished goods fell 16% in May and are up 4.0% over the past year. ***Bottom Line**: Again, the good news is lower producer prices can be a headwind to inflation, but also shows demand is slacking.*

Total Retail Sales: Dropped 0.2% in May after 0.3% gain in April. Year-over-year sales are up 7.7% with mixed performance across categories. Auto sales fell 2.9% in May after a 0.7% drop in April. Sales at home furnishing stores, electronics and appliance stores fell for the second consecutive month, dropping 0.7% in April and 1.3% in May. Retail sales excluding autos, building supplies and gas stations increased 0.2%, the smallest increase in five months. ***Bottom Line**: Is anyone really surprised that with housing prices continuing to drop and employment still in the doldrums that sales are slowing?*



Fiscal Stimulus: The recession technically ended in mid-2009. Since then the Federal government has expanded its balance sheet, meaning borrowed money, to the tune of about $2.8 trillion dollars for spending programs. Our current GDP is $15 trillion, so in the past two years weøve increased our debt by almost 1/5 of todayøs GDP. To put the spending in context:

- 1930-2007 Federal Government Outlay as a percent of GDP averaged 18.8%
- 2009 Federal Government Outlay as a percent of GDP was 25%
- 2010 Federal Government Outlay as a percent of GDP was 24%

So what did we get for all this spending? The chart on the right shows that the current recovery has yet to even match the *average* for any quarter since the recovery started. Across all recoveries since 1951, GDP growth in the 7th quarter averages 4.1%. This recovery GDP growth was only 1.8%. This is important because it gives an indication of what we can next expect out of the Federal government. Given these results, we believe it will be tough to pass any additional, large spending plans and have adjusted our outlook accordingly.

Wrap Up: We are focused on diversified, high-quality, low-leverage, cash-flow generating strategies with an emphasis on yield and dividend growth. We believe that an investor should be paid handsomely to take on risk, not pay to accept risk. We are also focused on segments of the market that have positive secular growth characteristics and provide defensive positioning during these turbulent times. The easier returns of 2009 and 2010 are not likely to be repeated in 2011. Heightened awareness, diligence and discipline are more important than ever in the current market conditions as the global economy works through very complicated and potentially dangerous problems. We remain ever vigilant stewards and seek every day to honor the trust that we have been given by our clients.

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