July 18, 2011

MERITAS ADVISORS

Comprehensive Wealth Management

Monthly Investment Outlook

In This Issue:

- *Major Warning Signs*
- *The National Debt*
- *Employment*
- *New Businesses*
- *Eurozone debt continues*
- *Housing*
- *Emerging Markets and the 3D Hurricane*
- *Market Recap*
- *Wrap up*

Dear Clients and Friends: We believe that the state of the global economy and the markets is such that investors need to be especially agile and focused. Despite the onslaught of frightening headlines bombarding us almost daily, this is not the time to be running for the hills, but rather to preserve, protect and prepare to take advantage of the opportunities that such unstable times will inevitably present.
Lenore Hawkins, MBA, Principal

Major Warning Signs:

- Real disposable income peaked in March. *(Ugh)*
- Household employment peaked in March. *(Double-ugh)*
- Real business sales peaked in March. *(Are you kidding me!)*
- Manufacturing production peaked in March. (N*ow I need a drink!)*
- The ECRI leading economic index just dropped to a 28-week low of 1.7%
- Rating agencies warn of a downgrade for U.S. debt and the markets respond with a flight INTO Treasuries as the Eurozone troubles worsen! *(Apparently many in the markets have already hit the pub for a couple of pints.)*

Four critical areas of the economy all peaked in the same month with the current trends indicating that we are close to sliding back into a recession. The market seems to have lost its senses and ignores any warning signs.

The National Debt

Not since the battle over healthcare legislation have we seen such acrimonious debate coming out of our nation's capital. Outside of the moral, political and Constitutional arguments, we as investment advisors must assess the impact of the situation on our investment strategy. We see three main issues:

1. We believe it is *exceedingly unlikely that the U.S. will default* on any payments on its existing debt. The Federal government takes in nearly $200 billion a month in revenue with about $35 billion going to pay interest on the debt every month, thus additional debt is not necessary to pay interest on the existing. The Federal government is also legally bound to pay on its debts before any discretionary spending is possible.

2. The major ratings agencies have warned that they *may downgrade the quality of U.S. government debt*, whether or not there is an impasse in the debt ceiling talks. This has the potential to be a rather earth-shattering event for the markets *as never in history has the world's reserve currency had a less than AAA rating*. At best, a downgrade would likely increase our borrowing costs, which would only add to the ballooning national debt. Keep in mind that this rating would affect not only Treasuries, but the $7 trillion of Fannie Mae and Freddie Mac debt, plus the other $130 billion of AAA rated state and local government debt and bank bonds insured by FDIC. It would also impact other countries that rely on the backing of the U.S. government. Talk about contagion! *Be prepared for rising interest rates.*

3. Regardless of the outcome of the debate on the debt ceiling, D.C. will have to curb its spending habits. Since 1970 Federal spending has increased about 300% while median income has risen only 27%, (using inflation adjusted dollars). This will mean that more federal employees will have to lose their jobs, adding to those already laid off from the states, municipalities and cities facing their own fiscal woes. For example, Chicago Mayor Rahm Emanuel is about to lay-off 625 municipal workers after the public unions missed a deadline for a proposal to help close the budget gap. *In the short-term, this will be drag on the economy as more government workers join the unemployed.*

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

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.

Employment: The unemployment rate continues to weigh down the recovery. In June nonfarm payroll was essentially unchanged with the unemployment rate increasing from 9.1% to 9.2%. Since March of this year, *the number of unemployed persons has increased by 545,000 and the unemployment rate has risen by 0.4%*. Over 1 million people have run out of time on their unemployment benefits this year and face grim prospects in their job hunt. If the jobless rate goes up another 0.5%, the odds of a recession will increase as this level of unemployment led to a contraction in GDP in December 2007, March 2001, July 1990, October 1981, January 1980 and January 1970. A 9.7% unemployment level also occurred in February 1963, July 1986, June 1992 and June 2003, but was not prelude to recession in these instances. ***Bottom Line****: If unemployment doesn't improve soon, the risk of another recession will rise.*

New Businesses: Through the 12 months ended in March of last year, 505,473 new businesses started in the U.S. according to the latest data available from the Bureau of Labor Statistics. *That is the weakest growth since the bureau started tracking the data in the early 1990s*. This is not good for jobs since small and midsize businesses have driven employment gains in the U.S. for years. Between the recession that ended in late 2001 and the start of the most recent recession in late 2007, business with fewer than 500 workers added nearly 7 million employees (according to ADP) vs. business with over 500 workers which cut nearly 1 million over the same period. This trend highlights concerns over changes to the tax code that negatively affect smaller businesses. ***Bottom Line****: Small businesses in particular need to be more confident in the future for the economy to heal. We are particularly concerned at this time about any tax changes that could further weaken this sector.*

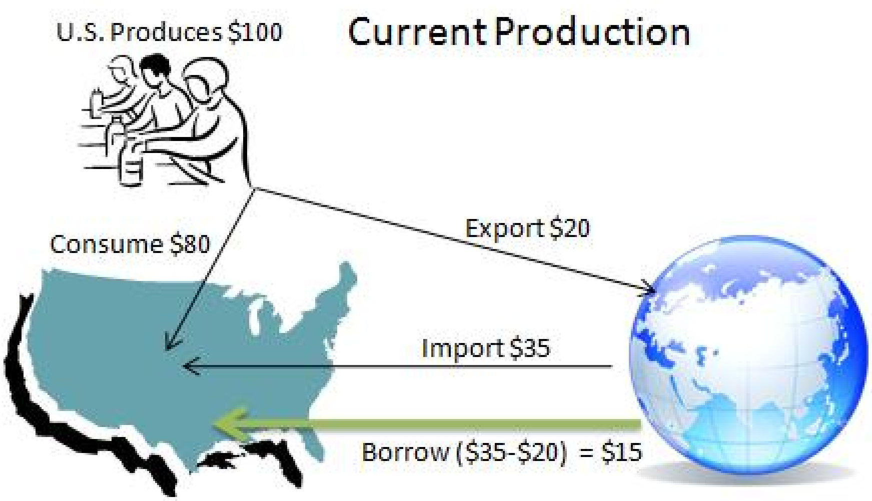
Eurozone debt continues:
U.S. Banks have sold some $90 billion in credit default swaps (CDS) on Greek, Irish and Portuguese debt to European banks. This means that if there is a default on the debt, U.S. banks will have to pay those banks per the terms of the swap agreement. These are balanced to some extent by the purchase of swaps, but if the purchase of swaps is from European banks that become insolvent upon the default of this sovereign debt, those swaps won't be worth much of anything, leaving the U.S. banks with liabilities to European banks that are unprotected. Talk about tensions across the pond if that occurs! The potential for another banking crisis here is far too high for comfort as it would most likely mean another recession with the U.S. economy already close to stall speed and global growth slowing significantly. Adding to the pressure, in France the Purchasing Manager's figures were down to 56.7 in June from 62.5 in May and for Service down to 52.5 from 54.9. (A PMI of under 50 indicates worsening conditions). ***Bottom Line****: Kick the can policies are running into a wall with an already weakening global economy and Greece just realized that it has the power, not the ECB. Sparks are going to fly, European yields will rise and gold looks awfully good!*

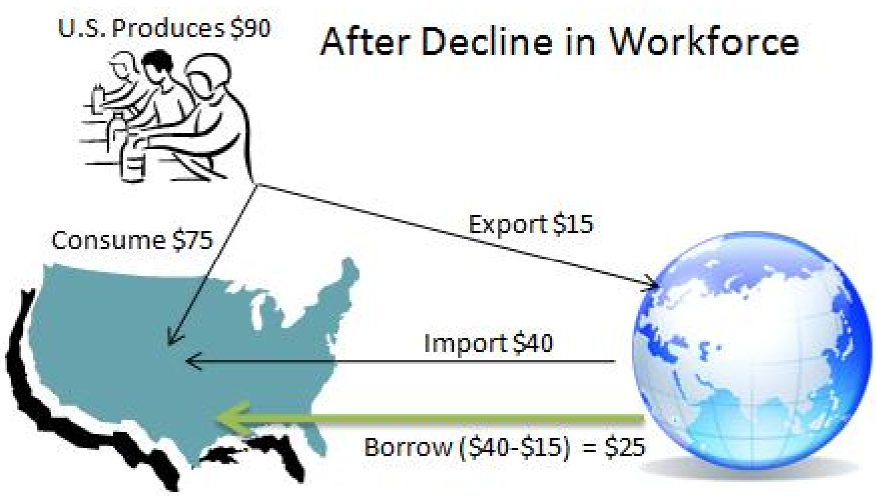
Housing: On June 28th, the Case-Shiller Home Price Indices report showed a monthly increase in prices for the 10- and 20-City Composites for the first time in eight months, with a 0.8% and 0.7% increase respectively. The indices are now back to their summer 2003 levels. Six cities showed new index lows in April (Charlotte, Chicago, Detroit, Las Vegas, Miami and Tampa). For California, Los Angeles posted a 0.3% MoM increase, San Diego a 0.4% increase and San Francisco a 1.7% increase. All metropolitan areas are still in negative territory looking year-over-year, with the exception of Washington D.C. which has a 4% increase (your tax dollars at work). Finally, as if housing wasn't struggling enough, starting October 1st, Fannie Mae and Freddie Mac will adjust the size of mortgages they will guarantee in high-priced areas around the nation - the maximum loan amount that these GSE's insure will drop from $729,750 to $625,500 which is not likely to help things! ***Bottom Line****: Housing won't be able to improve much without an improvement in employment. Perhaps rather than moving, we can just repaint! (The home improvement sector is benefiting from this struggle, up 1.4% in June with positive growth 4 months in a row.)*

Emerging Markets and the 3-D Hurricane:
I read a great piece by Jason Hsu, Chief Investment Officer of Research Affiliates. He coined a phrase, "Debt, deficit and demographics - the 3-D hurricane." This 3-D hurricane will induce an extended period of lower economic growth and subdued returns for the aging and debt-ridden developed world. Meanwhile the emerging economies which have healthy government and household balance sheets, significantly more constrained fiscal policies, and a young labor force, are poised for strong growth. These emerging markets will generate additional demand for resources and goods which will inevitably lead to higher prices, putting further strain on the debt-ridden developed economies.

The impact of the demographic shift in developed economies cannot be understated. The support ratio in developed countries will decline from today's ratio of 3.5 working adults for every retiree to below 2:1 by 2050. In 1970 that ratio for the U.S. was 5.3:1 and in 1950 16.5:1 (Source: CRS Report for Congress, updated October 27, 2006).

So how does this affect the economy? People consume goods and services which are produced by workers. If the level of workers declines without a compensating increase in productivity per worker, the amount of goods and services available within that economy will decline. If the supply of domestically produced goods and services declines, prices will increase and/or imports will increase. If imports increase, the trade deficit between developed and emerging economies will widen.





In the picture to the left, the U.S. produces $100 worth of goods and services. It consumes $80 of what it produces and exports $20. The country then imports $35 worth of goods and services in order to consume a total of $115. But it only produced $100, so how can it consume more than it produced? By borrowing $15 from the rest of the world.

If the labor force declines, the U.S. will not be able to produce as much as it currently does, unless technology is able to increase the productivity per person sufficiently. It is unlikely that productivity could take this big of a leap, so let's explore what would happen if it did not. Production would decline from say $100 to $90. With only $90 total production, domestic consumption and exports would fall. In order to keep the same standard of living, we would now have to import $40 instead of $35. With exports dropping to $15 and imports rising to $40, the trade deficit increases to $25, so we would need to borrow $25 instead of $15.

The only way to fund this ever-growing trade deficit is for developed economies to continue to borrow from emerging economies. Given the current state of finances in the developed economies, it is unlikely that developed economies will be able to continue to borrow from emerging economies indefinitely. If developing economies are unable to borrow from emerging economies, and are not able to increase domestic production of goods and services, the standard of living must decline. Not a pretty picture for us.

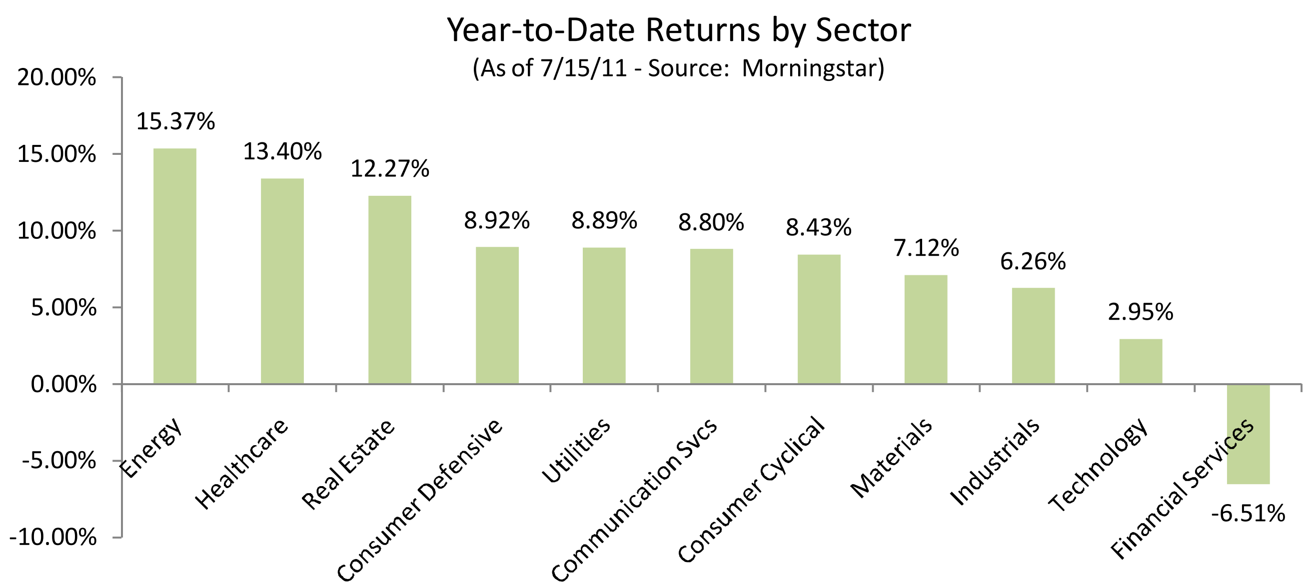
Emerging economies have generally maintained trade surpluses, thus serving as the suppliers of global capital to the more debt-laden developed economies. We believe that in many instances these more robust economies represent lower credit risk than many of their developed counterparts and anticipate that over-time the markets will adjust credit costs in line with this analysis, which presents us with an investment opportunity.

In fact, we have seen credit spreads between emerging market and developed market debt declining for many years. During this period of "austerity" in the developed markets, we suspect that not only will the spreads converge, but that emerging market debt could become less expensive than developed. Emerging economies are currently priced higher than developed, despite the fact that they often have stronger underlying collateral quality and debt capacity. This irrational bias in the global bond markets will not continue indefinitely, although the shift will most likely take place over an extended period of time, with many bumps along the road. ***Bottom Line****: As investors, this economic power shift presents tremendous opportunities. As Americans, we need to address (1) our national debt, which has been funded in no small part by these emerging economies, at historically low rates that are bound to rise at some point (2) the rules, regulations and taxes which have made us less competitive globally and exacerbates the trade deficit and (3) our need for foreign capital inflows to maintain our standard of living. If those flows decline, so does our standard of living.* (Suggested Reading - **Wall Street Journal**, July 5th Opinion piece by David Malpass and Stephen Moore entitled "America's Troubling Investment Gap" and **The Washington Times**, July 18th "Rahn: The end of progress?" by Richard Rahn)

MERITAS ADVISORS
Comprehensive Wealth Management

Market Recap

Index Levels	Close 07/15/11	Year End 12/31/11	Year Ago 07/15/10	Commodities	Close 07/15/11	Year End 12/31/11	Year Ago 07/15/10
Dow Jones 30	12,480	11,578	10,359	Gold	1,587	1,405.50	1,208
S&P 500	1,316	1,258	1,096	Crude Oil	95.69	89.84	76.62
Nasdaq	2,790	2,653	2,249	Gasoline	3.64	3.05	2.72
Russell 2000	829	784	635				
Bond Rates				**Currency**			
Fed Funds Target	0.25	0.25	0.25	$ per ú	1.41	1.34	1.29
2 Year Treasury	0.36	0.60	0.60	$ per £	1.61	1.7	1.54
10 Year Treasury	2.91	3.30	2.98	¥ per $	79.06	81.11	87.45
10 Year Municipal	3.29	3.75	3.2				
High Yield	7.21	7.51	8.69				



Wrap Up: The era of the liquidity-based rally is over, at least for now, and what we are left with is one of the most horrible economic recoveries in modern history. Now is the time to be selective and cautious. We are favoring high-quality, with a focus on yield and consistent cash-flow streams, strategic assets like food and energy, investments that are not correlated with economic cycles, and currency alternatives, while minimizing volatility. It is easy to get discouraged in such challenging economic times, with the news blasting titillating tales of woe on a nearly daily basis. We are very cautious at the moment, but also very excited by the opportunities we believe this great upheaval will present. The coming years will be difficult as the world undergoes deep, fundamental changes. The developed nations will no longer be the engines of growth as the emerging economies drive into a more prosperous position. This is a time of conflict, but also of great opportunity both economically and philosophically. As ever, we remain vigilant in protecting our clients and are honored and humbled by your trust.

Meritas Advisors, LLC is a Registered Investment Advisor with the State of California Department of Corporations. This newsletter is provided for educational purposes only, does not constitute a complete description of our investment services and is not intended to provide specific advice or recommendations. The information contained herein is based on information we consider to be reliable, however, accuracy is not guaranteed.

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

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

info@MeritasAdvisors.com
www.MeritasAdvisors.com