MERITAS ADVISORS
Comprehensive Wealth Management

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MONTHLY INVESTMENT OUTLOOK

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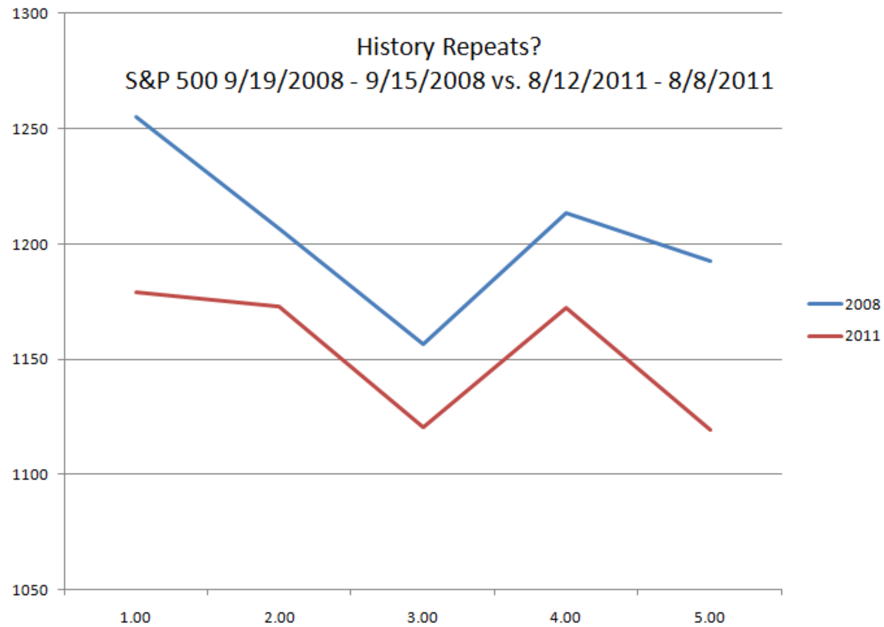
Strength and Stability in Volatile Times

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: Hold onto your hats, we are in for a wild ride! As you may have already read, last week was one of the most volatile in history. For those of you who have been reading our newsletter for a while now, you understand why we are not at all surprised but are rather relieved to see some semblance of economic reality entering the markets. We expect to see more swings as we are in unprecedented times with complicated problems for which there are no easy solutions. The good news is that this kind of volatility can provide exceptional opportunities for those who are prepared. We remain ever vigilant in our approach to the goals of protecting and growing our clients' wealth.
Lenore Hawkins, MBA, Principal



The Market: The chart above shows the striking similarity in the market movement from last week to a week in September of 2008 after which the markets began their downward movement in earnest. While we don't believe that we will see a repeat of 2008, many of the problems that led to that market crash are still in force today. We'll discuss those problems in the next section on the economy. As of Friday's close, the market is in negative territory YTD (year-to-date) with the S&P down 5.14%. The two year Treasury yield dropped from 0.60% on 12/31/2010 to 0.18% on 8/12. The ten year Treasury yield dropped from 3.30% to 2.9% while 10 year high yield increased from 7.51% to 8.58%. This indicates that the bond market is expecting a recession. Internationally the UK markets were down 7.31%, Europe ex-UK down 14.33%, Japan down 14.62% and Asia ex-Japan down 11.3 YTD. The only positive sectors domestically YTD are Utilities, up 3.4%, Consumer Staples up 2.3% and Health Care up 1.6%. **Bottom Line**: *The grim reality is that the market peaked in April and has been moving down since then. About 74% of earnings beat expectations but about 2/3 of companies did not offer any guidance, which is the highest level of non-guidance since Q1 2009 when it looked like the world was coming to an end! Usually fewer than half the companies reporting don't give guidance, which tells you how low confidence is out there. Add to this that we see higher volume on the dips and lower volume on the rises - more warning signs.*

Debt Ceiling Debate and the S&P Downgrade: The deficit reduction plan from the debt ceiling debacle fell well short of the $4 trillion that the rating agencies were looking for. Despite all the rhetoric thrown about during the seemingly endless debate, the crux of the problem is not another increase in the debt ceiling, but rather the massive increase in the annual deficit (annual spending in excess of tax receipts). In the past three years deficit spending has been so extreme as to have increased the national debt from $10 trillion as of 9/30/2008 to over $14.6 trillion today. That represents a 46% increase in just 3 years!

So how did the U.S. receive a debt downgrade and then see Treasury yields (the price of debt) actually drop? Seems counter-intuitive right? There are two factors at play.
(1) The U.S. is currently the least ugly in the ugly economic dog contest. (See picture at right for a proper visual of just how good we are!) Europe is potentially in worse shape than us, (for the time being) while China is facing an increasing likelihood of a hard-landing, which will have far reaching effects.
(2) The downgrade gives hope that the politicians will now have to take deficit and hopefully even debt reduction more seriously.

Why does the size of the national debt matter? For a detailed discussion, please see our February 2011 Newsletter, available on our website, but the short answer is when the national debt is about the same size as GDP, an economy slows. As the economy slows, the debt typically continues to grow as politicians try to tax and spend their way out of a sluggish economy. The national debt becomes an increasingly voracious beast, consuming more and more of the nation's resources until the economy finally has to give up its attempt to outgrow the debt and a default becomes the only way out. This is akin to an individual declaring bankruptcy when the level of personal debt is something that can never be paid off given the individual's income prospects. So how does our income potential look today?

Domestic Economy: On July 29th, the Bureau of Economic Analysis released a revised GDP analysis, reporting that the drop in GDP during 2008 and the first half of 2009 was -5.1% vs. the previously reported -4.1%, meaning the recession was worse than previously reported. In addition, Q1 2011 growth was revised from 1.9% to 0.4% (big drop!) and Q2 GDP increased only 1.3%. If not for the payroll tax cut in Q1, we would have had negative real GDP growth! Keep in mind it takes 3.3% real GDP growth just to keep the unemployment rate STABLE, let alone reduce the level of unemployment. **Bottom Line**: *The last crisis was worse than originally thought and perhaps we never really got out of that recession as another is looking more imminent.*

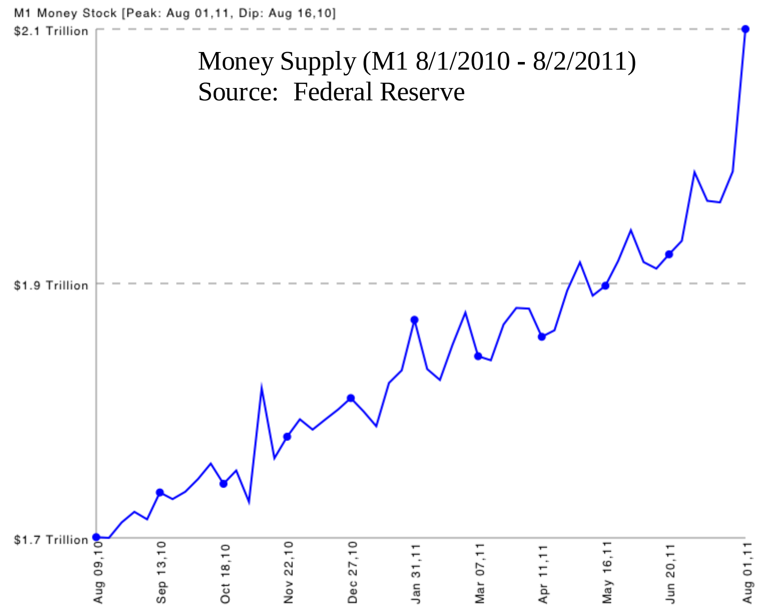
Manufacturing: ISM (Institute for Supply Management manufacturing index) came in well below expectation of 54.5 at 50.9 in July from 55.3 in June. The ISM has now plunged 9.5 points in the past three months and such a move in the past foreshadowed all six recessions in the past five decades with only one exception in 1984. This was also the lowest level since the economy was struggling to emerge from the Great Recession in July 2009. Of the 25 times since the late 1950s that the ISM fell to this level of 50.9, it went on to break below 50 on 24 occasions with the only exception in 2006. As if that wasn't enough, ISM orders fell below the 50 mark ð to 49.2 from 51.6 ð for the first time since the recession depths in June 2009. **Bottom Line**: *US production is slowing and the outlook is not improving.*

Household income and spending: Wage growth slowed for the fifth month in a row and was actually negative in June for the first time since November of last year. *The median starting salary of college graduates is now 10% lower than it was 3 years ago.* The U.S. Commerce Department announced on August 2nd that consumer spending declined 0.2% in June, the first slip since September 2009. **Bottom Line**: *Income and spending are declining.*

Home ownership hit a 13 year low in Q2 of 66% from the peak of 69.4% in 2004. 23% of mortgages are currently underwater and 4-5 years of excess inventory must be worked through. **Bottom Line**: *Housing continues to be a drag on the economy with no relief in sight.*

Outlook: The 10 year Treasury auction on August 10th priced yields at 2.14%, which is below the prior all-time low of 2.42% in January 2009. You might recall rather painfully that was in the midst of the worst recession since the Great Depression! More evidence that the bond market is pricing in a recession. As if that wasn't enough, last week the Federal Reserve announced that it will keep rates at their current levels at least through 2013. Talk about admitting that growth prospects are grim! We find ourselves almost a year after QE2 with essentially no change in the stock market, a weaker economy, unemployment essentially unchanged, and businesses becoming increasingly defensive as they look not to grow, but to survive. **Bottom Line**: *We believe that the probability of another recession is increasingly likely; perhaps we are already in one. Unless we see significant changes coming out of D.C, we may be in for a long period of Japanese-style stagnation.*

Inflation: On August 11th we learned that M1, (the total of the physical currency in circulation, plus the currency portion of bank reserves plus demand accounts such as checking accounts) increased a whopping 21.2% from August 2nd, 2010 and 5.0% since July 25th, 2011. Our research indicates that foreign banks apparently used QE2 as an opportunity to load up on US dollars, increasing their cash assets at their US branches from an already elevated $350 billion in 4Q10 to around $1 trillion today. Foreign holdings of US dollars are now greater than those held by domestic banks and represent 50% of the assets of these foreign-related branches! This hoarding of cash shows that foreign banks have been preparing for a serious crisis, with the lessons of 2008 fresh in their minds. **Bottom Line**: *The Fed's unprecedented increase in the monetary base since 2008 has not yet caused significant domestic inflation since much of the currency has left the country. As the U.S. becomes the least ugly in the economic ugly dog contest, that money is coming back home and with it, the potential for high levels of inflation.*



Eurozone Drama Continues: The Eurozone crisis is likely to worsen, with the U.S. downgrade by S&P only adding to the problem. On August 4th, the European Central Bank (ECB) started buying Portuguese and Irish Bonds. The decision to do so revealed a deep rift in the central committee with two German and two Benelux representatives against the initiative, thus the ECB does not have the full backing of the committee. This controversy raises legitimacy concerns as actions were initially agreed to take place only upon unanimous consent, but the ECB went ahead with its latest rescue effort without full support. **Bottom Line**: *The risks of a breakup of the ECB are increasing. We are now expecting economic contraction in the Eurozone. (Keep in mind that as China's largest customer, a contraction in the Eurozone will exacerbate China's financial woes.)*

Banning Shorts Again? In response to the market volatility, Spain, France, Belgium, Turkey and Greece have all moved to ban shorting against all financial instruments/banks. This is not good for the markets as shorts actually provide stability and liquidity to the system. When the longs begin to sell, there will be no short covering buyers to support the financial shares in these markets! We've been down this road before and it doesn't end well. The following highlights some recent activity:

- The *UK* 10 year bond reached its lowest yield in history at 2.53%, another indication that markets expect contraction.
- On July 28th, *Italy* held an auction of its benchmark 10-year security and was only able to fill 90% of its ú3 billion tender, even though the debt was priced to yield at 5.77%, a big leap from the last 4.94% yield at the last auction on June 28th. In September, Italy is scheduled to auction ú61.7 billion, more than double its normal monthly offering - critical offering!
- On July 28th, S&P gave *Greece* a partial default, as expected. The 2-year note has skyrocketed to over 33%!
- The IMF issued a warning to *France* on its debt, stating that more budgetary cuts are going to be needed in 2012-2013 to achieve deficit reduction goals. Meanwhile France's Q2 GDP stagnated vs. expectations of a meager 0.3% increase.

Bottom Line: G*rowth is slowing, exacerbating debt problems while the pressure increases on Germany to save the day.*

What about the Australasian Markets?

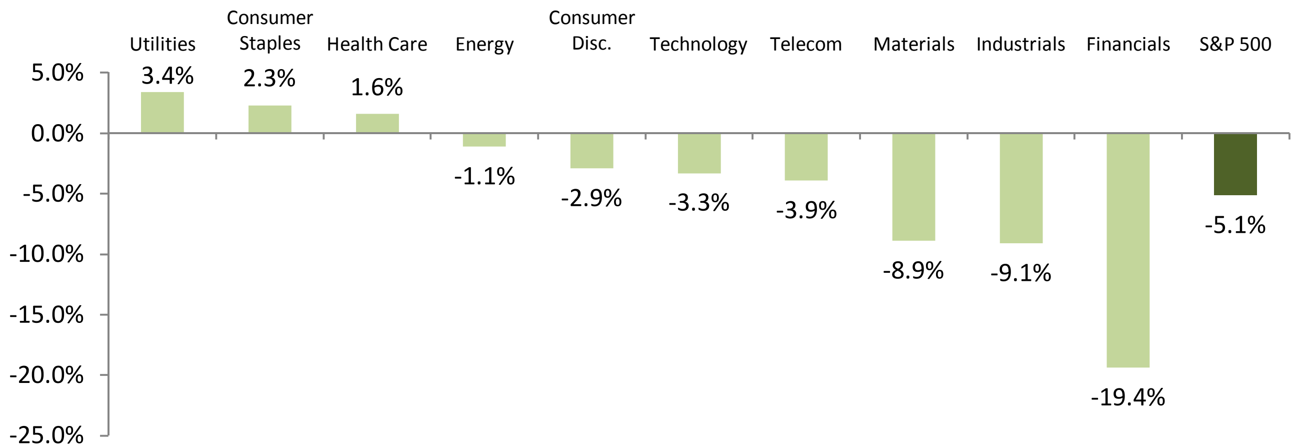
- *Australia* posted its first decline in private sector credit in two years in June with mortgage growth slowing to levels not seen since July 1984.
- *India's* economy grew 7.8% in Q1 2011 vs. 9.4% Q1 2010 and 8.3% in Q4 2010. (Slowing)
- *China* is especially vulnerable to export volatility because consumer spending is so low 36% of GDP vs. *India* at 57% of GDP and even *Russia* at 55% of GDP. *Housing in China* is reaching mind-boggling levels with new apartments in Beijing selling at 57x average after-tax income. U.S. prices peaked at 6x average income! Estimates are that half of China's GDP comes from real estate activity.
- *Japan* dropped its 2011 GDP growth forecast to 0.5% from 1.5% with 2012 growth at 0.4%. Q2 contracted at -1.3% vs. expectation of -2.5%. This is the 3rd consecutive quarterly contraction for Japan.
- In *Hong Kong*, (considered by some to be the global canary in the coal mine) exports declined 11% in Q2.

Bottom Line: *Growth here is slowing with China's economy in a precarious position and highly vulnerable to declining exports.*

Market Recap

Index Levels	Close 08/12/11	Year End 12/31/10	Year Ago 08/12/10	Commodities	Close 08/12/11	Year End 12/31/10	Year Ago 08/12/10
Dow Jones 30	11,269	11,578	10,320	Gold	1,736	1,405.50	1,213
S&P 500	1,179	1,258	1,084	Crude Oil	85.38	89.84	75.54
Nasdaq	2,508	2,653	2,190	Gasoline	3.67	3.05	2.78
Russell 2000	698	784	617				
Bond Rates				**Currency**			
Fed Funds Target	0.25	0.25	0.25	$ per ú	1.42	1.34	1.28
2 Year Treasury	0.18	0.60	0.55	$ per £	1.63	1.7	1.56
10 Year Treasury	2.24	3.30	2.73	¥ per $	76.77	81.1	85.95
10 Year Muni	2.90	3.75	2.95				
High Yield	8.58	7.51	8.49				

Year-to-Date Returns by Sector
(As of 8/12/11 - Source: JP Morgan)



Wrap Up: The global economy today is fundamentally weak, in the midst of a dramatic deleveraging phase with central bankers implementing a variety of untested experiments, attempting to ease the pain. Growth prospects continue to weaken while the potential for inflation increases. The recent market downturn will most likely result in an upward bounce, but investors should not lose sight of the fundamentals. The home buying intentions index is the lowest it has been since October 2008, the month after Lehman collapsed. Auto purchase plans are also at October 2008 levels. Household sentiment of government policy has dropped to unprecedented lows. Layoff notices have soared 80% in the past three months. We are likely to see GDP contraction in Q3 and possibly in Q4 as well. The systemic problems from the last crisis have not been addressed. Unmanageable private debt was simply made public and then augmented to unprecedented levels. High volatility is just a symptom of markets' realization that we are in unchartered and dangerous territory. **The good news** *is we anticipated the recent market turmoil and the volatility can provide significant opportunities for those who are patient and prepared. By maintaining perspective on the macroeconomic situation, we believe we can position portfolios to take advantage of the inevitable opportunities as they arise.*

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