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Monthly Investment Outlook

In This Issue:

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

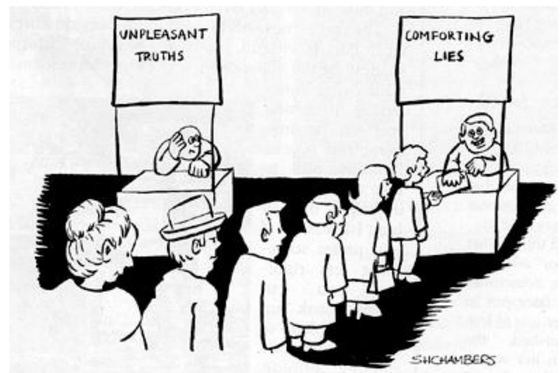
Strength and Stability in Volatile Times

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.

Dear Clients and Friends: Last month we talked about the wild ride we anticipated and boy did we get one! Starting in mid-July we've experienced more triple digit gains and losses during such a short timeframe than ever before in history. We expect that we are in for an extended period of tumultuous markets and challenging economics which requires proper planning, focus and discipline. Fortunately, ***crises beget solutions which in turn create opportunities***. In our view, the global economy will be anything but stable over the next 5-10 years, but during that time a great many opportunities will arise.
Lenore Hawkins, MBA, Principal

The Quest for Truth

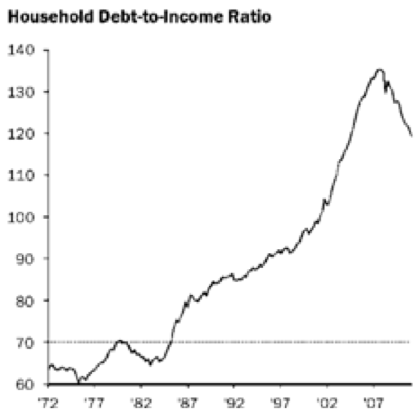


For quite some time we've had a rather grim view on the state of the economy, yet we show up to work every day with a great deal of enthusiasm and even (gasp!) enjoy ourselves. How is that? Most investment strategies require a strong economy in order to be productive. Implementation of such a strategy has, by virtue of human nature, a bias towards positive news and becomes disconsolate when the news isn't so pleasant. We don't particularly enjoy being downcast, so we intentionally developed a strategy which may be productive in both good times and bad, requiring that we "simply" identify the truth and respond appropriately. Sounds easy enough? The hard part is weeding out reality from all the noise. We constantly work through mountains of data and review the opinions of both those we respect and those we often don't agree with in order to develop, to the best of our ability, a comprehensive and unbiased view. For those who've been with us a while, you'll recall that earlier this year we were very concerned with how optimistic the market was relative to what we saw as the underlying fragile global economy. We shifted our portfolios to be even more defensive, not waiting for the markets to price in the truth of a weak economy that was evident to us. *Under the current conditions, defensive means holding a relatively high level of cash in preparation for buying opportunities, overweighting positions that we believe will do well in a bear market and underweighting those positions that perform better in a bull market*. We are still positioned defensively with a shopping list of securities on hand, waiting for prices to fall to our buy targets. Our targets are currently based on a rather pessimistic view of the economic outlook for the coming quarters. We regularly review these prices as conditions change, either moving them up or down, based on how our view has evolved. We have also incorporated some shorter-term strategies to take advantage of the market fluctuations while we monitor for our target prices. **Bottom Line**: *With a solid plan in place, market fluctuations provide opportunities not indigestion. A strategy based on identifying the underlying economic and market truths allows us to confidently adjust our plan as conditions evolve, the way a captain adjusts his sails as the winds shift, staying on course but responding to the realities of the day.*

Equity Markets

- The S&P fell 16.5% from the July 18th high of 1,345 to the August 15th low of 1,123. The August 15th low was a full 17.6% drop from the 2011 high of 1,363 on April 25th.
- Last Friday the 10 year Treasury yield hit a 60 year low, indicating very poor expectation for economic growth.
- The recent VIX volatility index trend is almost without precedent, with the index staying above 30 in every trading day since early August, the longest stretch since early 2009.
- Correlation between the largest 250 stocks in the S&P500 is in excess of 80% versus the historical norm of 30%, once again calling into question the level of protection traditional asset allocation can provide.

Economy Slowing or Contracting?

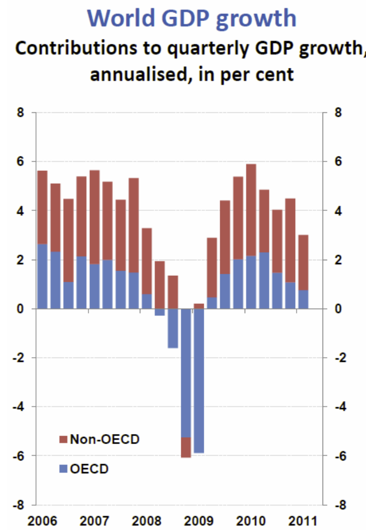


The big question now is are we facing prolonged tepid growth or contraction which means recession/depression. *We think that economic contraction rather than increased slowing is most likely because we are not in a typical business cycle recession*. In a typical cycle strong economic growth eventually leads to over-production which causes a recession so that demand can catch up with production. Once the catch up completes, we are off running again. This time we went into a *balance sheet recession* which means that we had *too much demand made possible by excessive use of debt*; picture an over-achiever from an 80s movie using cocaine to help increase his productivity. For the economy, debt was the cocaine, allowing more and more consumption and debt-funded projects that would never have occurred under saner circumstances. This is expected when interest rates are kept artificially low. The only way out is, in the case of the over-achiever, detox in rehab, for the economy, deleveraging in which debt is slowly and painfully paid down. Neither process is pleasant, but both are necessary to get back to a healthy level of productivity. We now have historically high levels of debt at both the household and government level. The charts at left show how far above historical norms, the horizontal line, current household debt levels still remain.

Bottom Line*: We are most concerned now with the consumer*. Job growth is sputtering and the broader U-6 (includes underemployed and discouraged workers) unemployment rate is north of 16%. The excess supply of labor is exerting downward pressure on wages at a time when the savings rate will begin to rise in response to the recent financial shock and wealth loss from the equity market decline. *With consumer spending accounting for a full 70% of GDP, this is a potent brew for a consumer-led recession.*

Global Slowing

If we face a weakening domestic consumer, can exports help support growth? No luck there as according to a report by the OECD presented on September 8th in Paris, the developed economies are all sputtering, (see chart at right) and we have much to be concerned with in the worsening euro sovereign debt crisis. **Bottom Line**: *Growth across the globe is slowing, particularly in developed nations, reducing demand for U.S. goods and services on top of weakening domestic demand.*



Titanic Across the Pond

On Friday the markets plummeted as rumors that Greece may soon default and the resignation of the European Central Bank's chief economist overshadowed the President's proposal for job growth. Protests are erupting all over Greece, Spain, Ireland, we can go on and on, against further austerity measures. Greece can't borrow directly from the markets because its perceived default risk is so high that the interest the markets demand makes borrowing impossible. It must borrow from the European Central Bank (ECB) in order to continue to pay its bills and according to Greek officials, the government will run out of cash in a few weeks. Many in the ECB are reluctant to give Greece more money as it has continually failed to reduce its deficit by the agreed amounts so additional support looks to many like throwing good money after bad. But if Greece defaults on its debt, the European Banks (many of them German) will be hit hard as they hold those bonds. A Greek default would put these banks in jeopardy much the way the Lehman, AIG etc. crisis put U.S. banks in dire need of federal rescue. **Bottom Line**: *We believe a Greek default is imminent. While U.S. companies are in a much stronger position than during the 2007/2008 credit crisis, U.S. banks are still struggling. We expect the Eurozone crisis will have significant domestic impact and will expand beyond Greece.*

Rabbit in that Hat?

The markets are desperately looking to President Obama and Federal Reserve Chairman Bernanke to pull a magical rabbit out of the federal hat that will get the economy moving again. By adding over $4 trillion to the national debt since 2007, a 50% increase, and expanding Federal Reserve assets and liabilities by around 170%, economic growth was a measly $0.499 trillion or an anemic 3.6% growth from 2007 to 2010. These are historically unprecedented increases with marginal impact on economic growth. The phrase "pushing on a string" comes to mind. The economy shows no sign of strengthening on its own, it is unlikely that this level of fiscal and monetary stimulus will continue, thus we believe economic contraction is likely. Now the Fed is talking about "Operation Twist",(Who comes up with these names?) in which it will replace shorter-dated Treasuries on its books with longer-dates ones in an attempt to lower long-term rates, thus decreasing the slope of the yield curve. This strategy has been received with much criticism, including comments from PIMCO's Bill Gross in the Financial Times who argues this will serve to decrease available credit as the rewards for lending longer term will be lowered under this plan. **Bottom Line**: *Economic contraction to the point of a recession is likely. D.C. is running out of options and the markets are losing faith that impactful solutions are forthcoming which is likely to increase household savings levels and corporate austerity, defensiveness and non-hiring, not expansion.*

Source: BEA & Federal Reserve (billions)	2007	2010	Increase
U.S. GDP	14,028	14,527	499
Federal Debt	9,007	13,561	4,554
Federal Reserve Assets	914.7	2,427.8	1,513.1
Federal Reserve Liabilities	877.9	2,374.8	1,496.9

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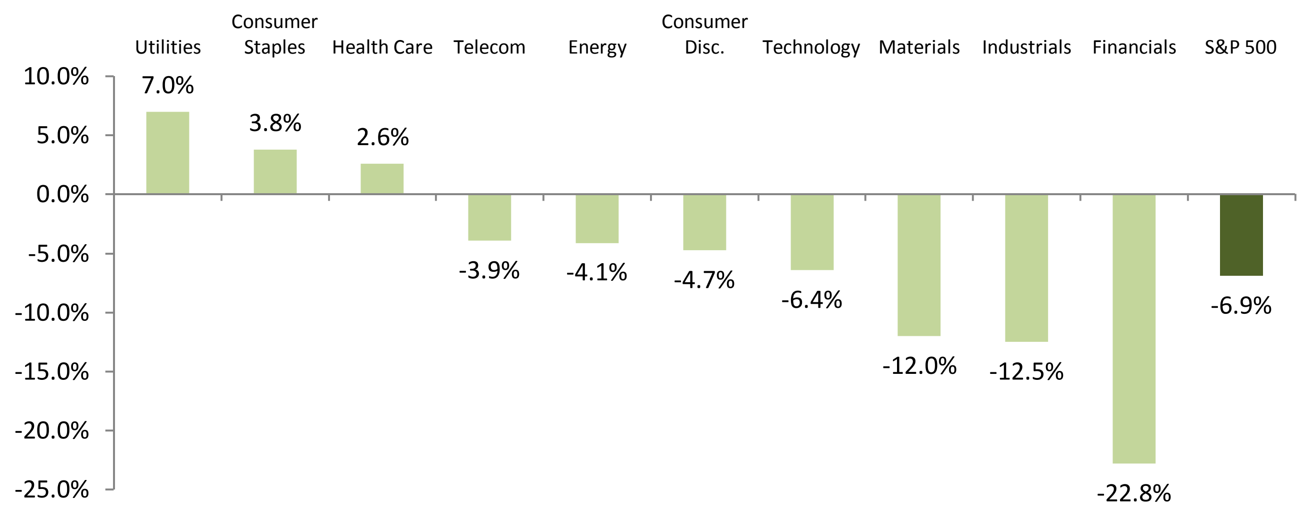
Market Recap

Index Levels	Close 9/9/11	Year End 12/31/10	Year Ago 9/9/10	Commodities	Close 9/9/11	Year End 12/31/10	Year Ago 9/9/10
Dow Jones 30	10,992	11,578	10,415	Gold	1,851	1,405.50	1,255.00
S&P 500	1,154	1,258	1,104	Crude Oil	87.24	89.84	74.25
Nasdaq	2,468	2,653	2,236	Gasoline	3.67	3.05	2.68
Russell 2000	674	784	635				
Bond Rates				**Currency**			
Fed Funds Target	0.25	0.25	0.25	$ per ú	1.37	1.34	1.27
2 Year Treasury	0.17	0.60	0.57	$ per £	1.59	1.57	1.55
10 Year Treasury	1.92	3.30	2.76	¥ per $	77.75	81.11	83.77
10 Year Municipal	2.72	3.75	2.86				
High Yield	8.54	7.51	8.21				

Year-to-Date Returns by Sector

(As of 9/9/11 - Source: JP Morgan)



Wrap Up: The events in Europe are critical as this is a full-fledged crisis with global implications. Twenty years ago world equity markets had a 40% correlation with each other. Today it is over 80%. Greece cannot meet the fiscal targets necessary to get more financial support from the ECB and is literally weeks away from running out of cash. We now have two prominent members of the European Central Bank resigning this year alone in protest, putting the ECB's credibility into question as it is a central bank modeled after the Bundesbank with no Germans on it and about to be run by an Italian - you can't make this stuff up! Europe is divided. The U.S. is divided. The Fed is divided. Just 25 out of 1,004 months over the past 83 years have experienced higher volatility than in this past August! The Arab spring is degenerating into worrisome riots that may evolve into a Jihad winter. *The world is in great tumult, but this too shall pass as winter eventually becomes spring and the fallen leaves of autumn feed the flowers of spring. At Meritas we've got mittens aplenty and diligently pursue opportunity whether it be in the falling snowflakes or the not yet visible green shoots of spring.*

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