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: Last week the world lost a brilliant mind and an astounding innovator with the passing of Steve Jobs; a man whose vision and creativity enhanced the lives of millions, brought down by the great equalizer of cancer. After we learned of his passing, my partner Greg Tull sent me a few lines from a commencement speech Steve Jobs delivered in June 2005 at Stanford University, almost a year after he was diagnosed with cancer, "Remembering that you are going to die is the best way I know to avoid the trap of thinking you have something to lose." What a way to live life fully! Neither failure nor fear could stop him. We should all be that brave in pursuit of our passions, our love of life and our love for each other. May the greatest one man success story of our times rest in peace. He will be missed.

Lenore Hawkins, MBA, Principal

Volatility and Uncertainty Rule

At Meritas we believe that volatility represents change and the world is changing alright! Volatility is neither fear nor the VIX index, but rather quantifies the path from the world as we believe it to be to the world as it truly is. We are in uncharted territory on a global basis and have a long way to go to get from conventional wisdom's erroneous beliefs to the underlying realty:

- The U.S. dollar, the world's primary reserve currency, has only been a pure fiat currency since 1971 when Nixon cancelled the direct convertibility of the dollar to gold. It is now being manipulated to a level never experienced in modern history with ramifications that are likely to be painful.
- The U.S. Treasury Bond has historically been the standard measure of the risk-free rate. Its risk-free status is now in question given our current debt level, future liabilities and poor growth prospects as noted when Standard and Poor's downgraded U.S. debt for the first time in history.
- The euro is an 11-year-old experiment under enormous strain as nations with exceptionally heterogeneous economies attempt to repair themselves under a unified monetary policy and constrained fiscal policies.
- The global banking system is more interconnected and interdependent than ever before.
- High frequency trading represents 40%-75% of daily trading.
- The growth rates of emerging economies are surpassing those of the developed countries, and the emerging nations have far less onerous debt levels - a global changing of the guard.

We are in a period of violent economic change. Markets are experiencing the highest correlations between securities ever measured, which we believe is largely due to the unprecedented degree of loose monetary policy. Markets are driven almost exclusively from headline news concerning what new solution is being proffered by bureaucrats, which can only mean continued volatility and uncertainty as no one can consistently predict the desperate acts of politicians as they face continuing crises with fewer and fewer arrows in their collective quiver and eroding credibility. **Bottom Line**: *The conventional wisdom approach to solving national and global problems has not delivered results, thus the difference between the world as the market expected it to be and as it truly is continues to widen. We expect market swings to be increasingly wild with securities moving together more and more, making diversification exponentially more challenging.*

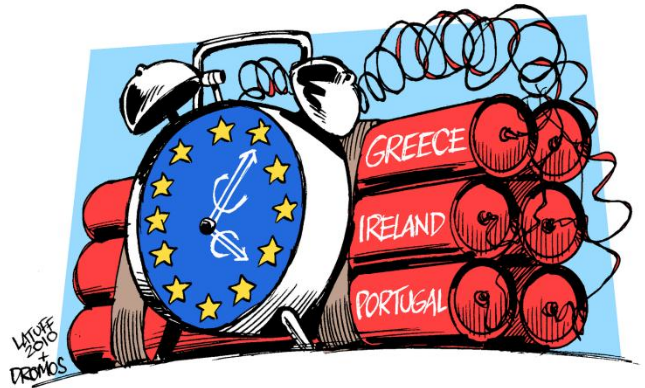
Slowing US Economy

Well here's something you don't hear much these days, the economy is not doing well. Shocker, right!? We've noticed with considerable amusement that typical Wall Street market commentary has evolved from a "soft patch" to a "global slowdown" and now into "prospective recession." Amazing how the commentary can change so quickly while the underlying economic fundamentals have changed very little.

- It should be of no surprise to our regular readers that on Friday September 30th, Laksham Achuthan of the Economic Cycle Research Institute (ECRI) notified clients that *the U.S. is heading into a recession* and that there is nothing policy makers can do to prevent it. The ECRI has correctly predicted the past three recessions without any false alarms, thus their predictions are widely respected.
- Q3 was the *worst quarterly performance* for the markets since Q4 of 2008. The S&P500 fell 13.87%.
- The S&P500 is down almost 20% from late-April highs and has now fallen in each of the past 5 months. This is the *longest losing streak since March 2008*.
- Financials have dropped over 25% and the industrial sector is down by 12%, while transports are down to July 2010 levels despite lower energy prices - a sure signal that economic contraction is imminent.
- The average *adult in the U.S. is spending 2% less on goods and services* in real terms compared to four years ago. Only a decline in the savings rate, which has gone from 5.3% in June to 4.5% in August, is preventing an even bigger drop. This is the *lowest savings rate since Dec. 2009*.
- The income of the typical family has dropped for the third year in a row and has *dropped to 1996 levels* when adjusted for inflation.
- Mortgage *delinquencies rose in Q2* after declining for 5 consecutive quarters.
- The unemployment rate remains unchanged at 9.1%.

Bottom Line: *We think a new recession is very likely. Years of excessively loose monetary policy in the form of artifically low interest rates helped fuel an* unprecedented *rise in household debt, from a historical norm of 70% household debt to GDP to a peak of 140% in 2007. We are now around 120%, thus much more debt reduction must occur. This will depress spending and economic expansion. Attempting to stimulate the economy with lower interest rates in order to increase debt levels is counterproductive. We believe further action on the Fed's part is equivalent to shooting a water pistol at a charging buffalo!*

Europe: Signs of the Inevitable Default



The last week the markets rallied on the hopes that European political leaders will be able to miraculously solve the Greek crisis. On October 6th, we finally heard some honest commentary instead of the usual platitudes. In a BBC interview with International Monetary Fund (IMF) advisor Robert Shapiro, the bailout expert confirmed our assessment:

> *"If they cannot address [the financial crisis] in a credible way I believe within perhaps 2 to 3 weeks we will have a meltdown in sovereign debt which will produce a meltdown across the European banking system. We are not just talking about a relatively small Belgian bank, we are talking about the largest banks in the world, the largest banks in Germany, the largest banks in France, that will spread to the United Kingdom, it will spread everywhere because the global financial system is so interconnected. All those banks are counterparties to every significant bank in the United States, and in Britain, and in Japan, and around the world.* ***This would be a crisis that would be in my view more serious than the crisis in 2008****.... What we don't know the state of credit default swaps held by banks against sovereign debt and against European banks, nor do we know the state of CDS held by British banks, nor are we certain of how certain the exposure of British banks is to the Ireland sovereign debt problems."*

Highlights of European economic stats:

- UK economy grew by a weaker than expected 0.1% in Q2.
- Last week *Standard and Poor's slashed Italy's government bond ratings* by three notches to A and Moody's shortly followed dropping Italy to A2. Both have a negative outlook which means further downgrades are possible. After Greece, Italy has the highest debt-to-GDP ratio of 120% with a stagnant economy.
- *German retail sales had the largest decline in 4 years* in August, down 3% and this is the economy that is expected to help holdup much of the Eurozone!
- Eurozone *inflation jumped to 3%* from 2.5% with a target of 2% which may tie the ECB's hands since any monetary easing will be inflationary.
- Switzerland's leading economic indicator is now down 5 months in a row and stands at 2 year low.
- Spain's *jobless rate rose to 21.2%* from 21.1% in July.
- Eurozone PMI signaling contraction - falling to 49.2 in September from 50.7 in August.
- Auto sales in Spain and Italy hit *15-year lows* in September.

Bottom Line: *There is no easy fix to the Eurozone problems. We believe that European officials have unofficially accepted the inevitability of a Greek default and are making preparations in an attempt to contain the fallout. Greece's Finance Minister announced that Greece can wait until mid-November for the next bailout tranche vs. the previously announced mid-October. This could be a sign that the Eurocrats goal is to distract the markets while they try to shore up the European banks with additional capital in an effort to control the inevitable contagion upon Greece's default. Governments recapitalizing or nationalizing their banks will in turn lead to further rating downgrades in sovereign credit which will result in even more recapitalization needs. Recapitalization of banks and governments will force more fiscal tightening, which when combined with the necessary deleveraging, will translate to a period of ultra-weak growth.*

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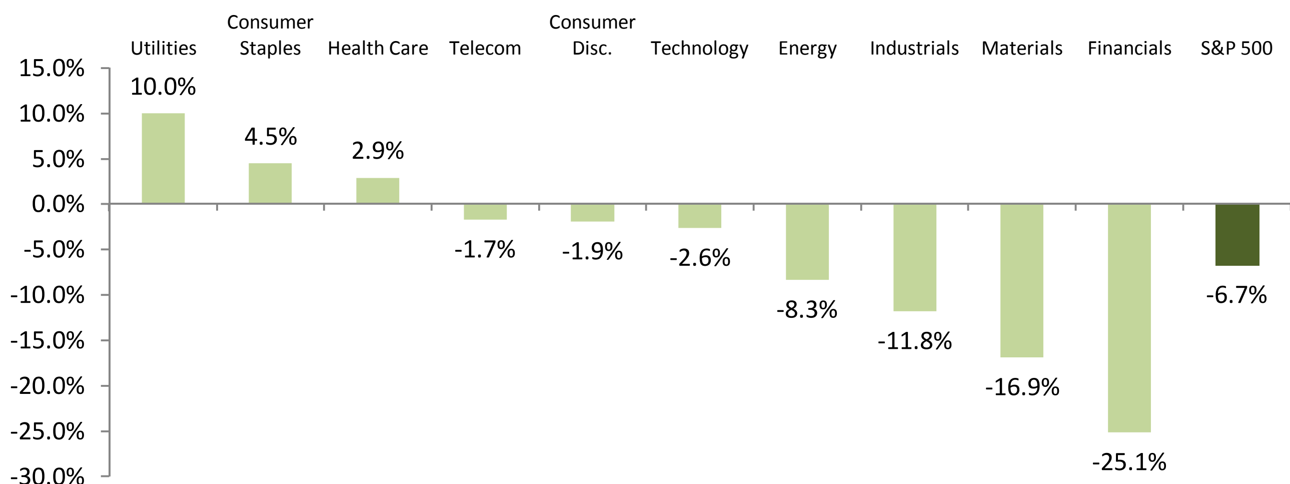
Market Recap

Index Levels	Close 10/07/11	Year End 12/31/10	Year Ago 10/07/10
Dow Jones 30	11,103	11,578	10,949
S&P 500	1,155	1,258	1,158
Nasdaq	2,479	2,653	2,384
Russell 2000	656	784	684
Bond Rates			
Fed Funds Target	0.25	0.25	0.25
2 Year Treasury	0.29	0.60	0.36
10 Year Treasury	2.07	3.30	2.40
10 Year Municipal	3.15	3.75	2.86
High Yield	9.76	7.51	7.53

Commodities	Close 10/07/11	Year End 12/31/10	Year Ago 10/07/10
Gold	1,652.00	1,405.50	1,345.00
Crude Oil	82.98	89.84	81.67
Gasoline	3.43	3.05	2.73
Currency			
$ per þ	1.35	1.34	1.39
$ per £	1.56	1.57	1.59
¥ per $	76.76	81.11	82.30

Year-to-Date Returns by Sector

(As of 10/07/11 - Source: JP Morgan)



Wrap Up: We believe that many stocks and equity funds are becoming more attractively valued; however the deteriorating macroeconomic picture makes it difficult to be confident in the outlook for corporate earnings, thus our target purchase price for anything but the most defensive holdings are below current market prices. We believe the primary risks; recession, default and global credit strains, are accelerating. Thus despite current valuations, we believe the market is more likely to fall than rise, giving us even more attractive prices if we are patient. Thus we have continued to shore up the defensive nature of our clients' portfolios, while maintain a high level of cash in order to take advantage of the opportunity from what we believe will be the continued downward pressure on equity prices. Since no advisor or money manager can predict the magnitude nor the timing of such moves with any degree of certainty, caution and patient discipline are of utmost importance in the current environment.

Every day at Meritas we strive to repeatedly earn your trust by protecting your financial future so that you can focus on that which is truly important, your loved ones and your passions, during these challenging times. We share all this so that you can rest comfortably knowing we are aware. This period of great upheaval will, over time, present significant opportunities for those who are prepared.

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