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: The proverbial wall of worry is getting higher and higher this month, as the drama in Europe unfolds and signs of significant distress emerge in China. Once again the government leaders have it wrong, believing that this is a liquidity crisis when it is a solvency crisis. Money was borrowed and wasted away, which represents a real loss of wealth. Someone will have to take the loss. This continual game of kick the can won't go on indefinitely.
Lenore Hawkins, MBA, Principal

Timing Matters

The current markets are almost exclusively headline driven, with frequent wild swings based on fear or relief from the latest political shenanigans. We are in a directionless market with seemingly endless volatility, bulls and bears battling daily, so we thought we'd discuss the importance of timing and patience.

Correct secular views can be difficult to stay with during transitional periods, when trend reversals are often preceded by extremes in the trend that is about to change. Say that five times fast! Translation: *October saw an incredible rise in the stock market despite many worsening fundamentals. It can be challenging to stay firm with one's view of economic reality when the stock market temporarily disagrees.*

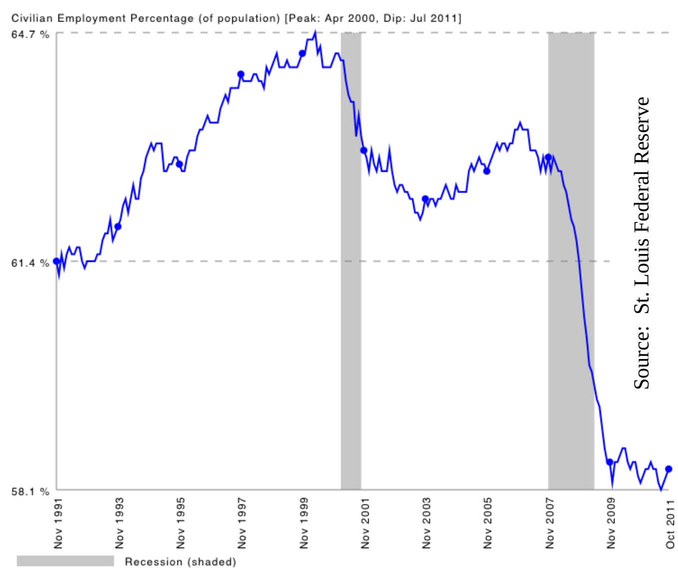
Plenty of astute investors were correctly skeptical about the case for internet stocks in 1999, just prior to their greatest rally of modern times. Two years later they were properly regarded as sages, yet many were no longer in the business. Over the past several weeks, we saw a strong stock market and a strong Euro currency while Italian debt problems intensified and the Greek situation worsened - an impossible paradox. On November 9th, reality set in and the Dow plunged over 420 points intraday and closed down 389 points. As we've seen many times before, things can hold up for an excruciatingly long time until suddenly, and violently, they don't. Thus, a combination of patience and pragmatism is necessary, knowing when to fight the market and when to roll with it for at least the time being.

It is quite possible that we will have an end-of-year rally in the stock market. However, we are biased towards preservation of capital, thus we remain defensive and are not increasing our equity positions as we believe the risks outweigh the potential rewards. Our clients will not fully enjoy the gains possible if there is a rally, but are comfortable with that because we believe that any rally will be short-lived, with the eventual market breakdown coming fast and without warning. Eventually the markets will give up hope that European leaders can pull a rabbit out of the sovereign hat and the markets will get in step with reality. Preparation is essential. We feel that now is not the time for hopeful heroics.

Mixed US Economy

The US Economy is quite the mixed bag these days, with some reasons for optimism in the long-run, but the short to medium-term is likely to be challenging.

- *GDP*: Q3 GDP was 2.5%, which sounds pretty good! Especially with all the doom and gloom we hear these days, (not to mention the recently rather dour tone of this monthly publication.) However, if we look a bit deeper (you knew weâd end up here) this growth rate isn't exactly as sunny as one would hope. The majority of the growth came from a reduction in household savings, rather than rising income. Increased spending at the cost of savings is unsustainable, particularly during a deleveraging cycle like the one we are currently experiencing. Even worse, what did they spend it on? Primarily on utilities and healthcare. Ugh. Not exactly something to get jiggy about. One of these days it will turn around. Until then, all we can do is face reality and respond accordingly. 20% of our exports go to Europe, so the looming recession over there is likely to hurt our growth prospects.
- *Recession?:* Researchers at the San Francisco Federal Reserve report that the probability of the U.S. entering a recession in the beginning of 2012 is now over 50%! (Think they read our stuff? One can dream...)
- *Retail Sales*: Retail and food services sales provided a surprise to the upside, rising 0.5% in October from September, on top of 1.1% gain in September from August. The U.S. consumers' resiliency is remarkable!
- Inflation: U.S. wholesale prices dropped 0.3% in October after a 0.8% gain in September, reducing inflation pressures. This could potentially fortify the argument of the doves in the Fed for another round of quantitative easing.
- *Housing*: In Q3 75% of US cities posted a decline in home prices. The National Association of Realtors reported that prices fell in Q3 in 111 of the 115 urban areas it covers, (up from 109 declining in Q2) with median home prices down 4.7% year over year.
- *Employment*: The unemployment rate fell slightly in October to 9.0% from 9.1%. As the chart at right shows, we are slightly above the nearly 30 year lows for Civilian Employment as a Percent of Population, but are still well off the all-time high reached in April 2000 of 64.7%. Adult male unemployment rate is 8.8%; a near record high and a level that has only been seen in the very deepest recessions. The youth jobless rate is a horrifying 24%. All those unemployed young people are not developing much needed skills at a critical time in their lives, which could further hurt the economy in the future.



Source: St. Louis Federal Reserve

- *Income*: Real average hourly earnings rose 0.3% from September to October, seasonally adjusted. Average hourly earnings rose 0.2%, while the CPI-U fell 0.1%.
- Credit: The Federal Reserve recently reported that Commercial and Industrial loans from all banks increased about $125 billion recently. This is cause for optimism.

Bottom Line: *The U.S. economy is fragile and facing some serious headwinds from Europe and possibly a hard landing in China in the future, (details in our next newsletter). The continued lack of progress by the debt super committee, (not looking too super these days) and the continued brinkmanship in D.C. is exacerbating the climate of uncertainty, further hampering longer-term investments necessary for economic growth.*

Europe on the Ropes: The smoke has pretty much cleared from the past few months of smoldering hope followed by flames of despair. The Eurozone has just two options, break up or print money. At this point it really is just that simple. The distinct scent of eau-de-contagion weighs heavy in the air.

For a welcome change of pace, (note wry grin) Greece is no longer public enemy number one as Italy takes center stage, with Spain and France elbowing their way into the spotlight. With the long-anticipated demise of the Papandreou government in Greece and the fall of Berlusconi in Italy, events in Europe are likely to pick up speed. As you read the following points, keep in mind that when a country's 10 year bond yield gets above 6%, it is time to worry as that high of an interest rate is generally considered unsustainable.

- Last week we saw yields on Italian 10-year bonds rise to a record high for the euro-era above 7.2%, then drop back below 7% as Berlusconi took his leave, only to again this week rise above 7%. Italy cannot afford to fund its debt through the public markets at this level, which means it needs help from the ECB, which really means knocking on Germany's door asking Frau Merkel for her support. The chart on the right shows the painful increase in borrowing costs for Italy over the past year.
- On November 15th, the Spanish bill auction, (this is when a country sells additional public debt into the markets) wasn't filled, meaning there weren't enough buyers. This is a VERY big deal for a country.
- French 10 year bonds have also risen dramatically in recent months, with the yield rising from 2.6% to over 3.6% in less than 2 months. That's a 38.5% increase! France may officially still be AAA rated, but the markets aren't pricing it as AAA. (Recall that when the U.S. lost its AAA rating, Treasury bond yields fell!) If France officially losses its rating, the EFSF (European Financial Stability Facility) will be seriously impaired, dimming the prospects even further that any sort of bailout is even possible.
- German GDP came in at a meager 0.5% growth rate in Q3. France had 0.4% growth in Q3 after contracting 1% in Q2, while Spain and Italy were flat. Borrowing costs are rising and economic growth is stagnating - a poor combination.
- Eurozone factory output fell by 2.0% in September.
- Italy and Greece are now led by appointees, rather than their duly elected officials. For the time being, there is no reason to believe these appointees will have any more success than their elected predecessors.
- On Nov. 3rd, the various heads of the EU and finance ministers met in Cannes, but achieved no agreements. Last month Siemens in Germany withdrew between $5 and $8 billion of its deposits from Euro banks and placed it with the ECB. Lloyd's, the world's oldest insurance company, is apparently now following suit. Lloyd's didn't just withdraw from Greece, but from banks all over Europe. When the world's oldest insurance company, a firm that has made its living for 323 years calculating risk, makes a move like this, it is a red flag.

Bottom Line: *Back to our point about timing. The fundamentals have not changed; the market is just now starting to appreciate the reality of the situation, of which we've been aware for some time, (See our Newsletters for October, September, August... you get the point!). What makes this even more startling is that while all these yields are rising dramatically, the ECB is furiously buying up buckets full of all these bonds. Imagine what yields would be without this ECB wingman! There is a clear flight to safety into the German Bund and U.S. Treasuries.*

The growing pessimism over the policymakers' ability to deal with the crisis is prompting many investors to trim their holdings of euro-denominated bonds, with the exception of German bunds, and pile into other assets perceived to be safer. This process can quickly become a spiraling self-fulfilling prophecy.

We believe the most important question is not if the European leaders can muster the collective will to solve this crisis, but whether they have the ability to solve it. We believe it is unlikely that they can solve it in any meaningful way, regardless of what agreements arise. Political will cannot make 2 + 2 = 5, despite what bureaucrats may claim!

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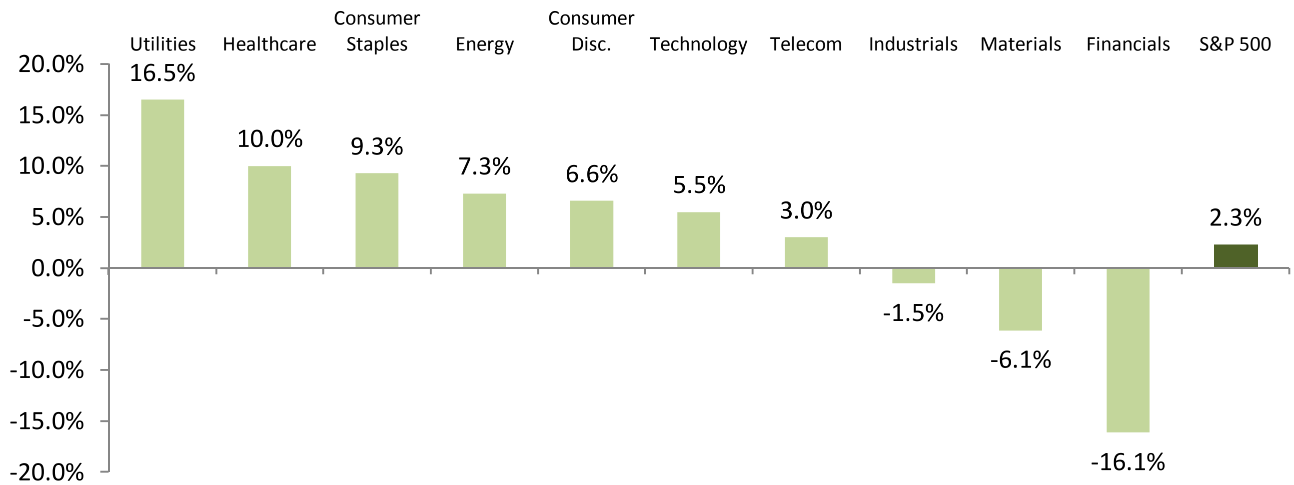
Market Recap

Index Levels	Close 11/11/11	Year End 12/31/10	Year Ago 11/11/10
Dow Jones 30	12,154	11,578	11,283
S&P 500	1,264	1,258	1,214
Nasdaq	2,679	2,653	2,556
Russell 2000	745	784	732
Bond Rates			
Fed Funds Target	0.25	0.25	0.25
2 Year Treasury	0.23	0.60	0.43
10 Year Treasury	2.06	3.30	2.66
10 Year Municipal	2.87	3.75	3.11
High Yield	8.50	7.51	7.12

Commodities	Close 11/11/11	Year End 12/31/10	Year Ago 11/11/10
Gold	1,773.00	1,405.50	1,398.50
Crude Oil	98.99	89.84	87.81
Gasoline	3.42	3.05	2.87
Currency			
$ per ú	1.37	1.34	1.37
$ per £	1.61	1.57	1.62
¥ per $	77.07	81.11	82.48

Year-to-Date Returns by Sector

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



Wrap Up: In today's climate, capital preservation and income generation are critical. Despite all our domestic economic problems, the U.S. is the least ugly of the developed nations, thus domestic investments are preferable, for the time being, to European and even emerging markets. However, we believe it is still wise to maintain highly selective, minor exposure to these markets. We are focused on equity themes that transcend the business cycle, such as energy, gold miners and healthcare. We are also taking advantage of the occasional "fat pitch" to generate some additional returns and provide enhanced portfolio protection. Such a fat pitch occurred on October 27th, when the S&P500 rose 3.43% on the belief that the Eurozone problems were going to be under control. We took advantage of the market's error and our clients were rewarded. We remain defensive, patient and on alert for the inevitable next "fat pitch."

As we head into the holiday season, we would like to thank our clients for their trust. We know that these are exceptionally volatile times, which makes your faith in us even more precious. We work diligently every day to discern opportunities and identify potential dangers as we seek to continually deserve your trust and give you peace of mind so that you can enjoy what is most precious in life, time with those you love.

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