MERITAS ADVISORS
Comprehensive Wealth Management

Monthly Investment Outlook

In This Issue:

- Eurozone Rating Cuts
- Greek Drama Intensifies
- European Solvency Bomb
- Volatility on the Rise
- Don't Believe the Hype
- Don't Trust Wall Street
- Market Recap
- Wrap up

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

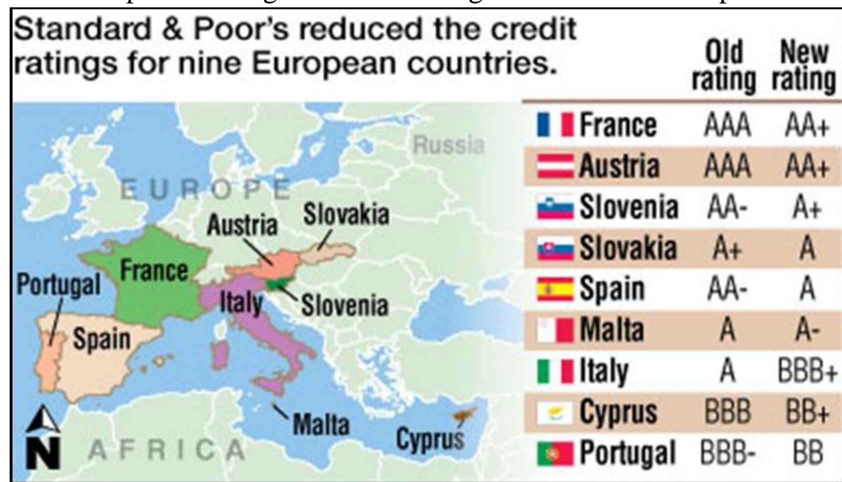
Our mission is to generate stable real returns, regardless of the direction of the economy, while providing the highest level of service and exceeding expectations in performance, planning and communication.

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: As Shakespeare once wrote in Macbeth, "*...it is a tale told by an idiot, full of sound and fury, signifying nothing*." And so it was in 2011. The year ended with the S&P500 essentially in the same place it ended in 2010, 1,257.60 in 2011 vs 1,256.64 in 2010! What an astounding end to a year that experienced the most one day swings of 400+ points in history and dropped nearly 20% from the peak in April to the trough in September, (the definition of a bear market). Barely two weeks into the new year and once again, Europe is taking center stage. We long for the day, when our newsletter has no mention of the euro crisis, but alas, as Tolkien wrote, "*Today is not that day!*"
Lenore Hawkins, MBA, Principal

Eurozone Rating Cuts

While the U.S. markets have recently decoupled a bit from Europe, meaning the two markets aren't moving quite as in sync, the risks from across the pond continue to mount. The biggest news of the New Year came last Friday as S&P delivered the much anticipated downgrades on sovereign debt for nine European countries.



	Old rating	New rating
France	AAA	AA+
Austria	AAA	AA+
Slovenia	AA-	A+
Slovakia	A+	A
Spain	AA-	A
Malta	A	A-
Italy	A	BBB+
Cyprus	BBB	BB+
Portugal	BBB-	BB

What do these ratings mean? The largest investing entities such as endowments, retirement and pension funds, banks and insurance companies, often have rules concerning how much risk their portfolio can take. Bond ratings are deemed the best way to determine risk; the higher the rating, the lower the risk. When a bond is downgraded, it is deemed riskier, thus it increases the risk level for the overall portfolio and may need to be sold, or may force the sale of other even riskier bonds, in order to get back to the required overall risk level for the portfolio. A lower rating often means that the bond issuer, in this case the various European countries, will need to pay higher interest rates on the next bonds it issues to compensate for the higher perceived risk.

While the downgrades were not unexpected, as the sovereign debt of these countries was already trading at yields consistent with even more draconian downgrades, we were surprised to see how harsh Standard and Poor's was concerning the source of the problem and their critique of current steps being taken. The following is an excerpt from their explanations on the downgrades:

> "We also believe that the agreement is predicated on only a partial recognition of the source of the crisis: that the current financial turmoil stems primarily from fiscal profligacy at the periphery of the Eurozone. In our view, however, the financial problems facing the Eurozone are as much a consequence of rising external imbalances and divergences in competitiveness between the EMU's core and the so-called "periphery". **As such, we believe that a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating**, as domestic demand falls in line with consumers' rising concerns about job security and disposable incomes, eroding national tax revenues."

We agree that fiscal austerity alone is not going to address the deeper, fundamental problems with the Eurozone. *The core of the problem is that the profligate nations were able to borrow at an artificially low rate thanks primarily to their association with Germany. Germany on the other hand enjoys an artificially weak currency, thanks to its association with the profligate nations, which makes its exports more attractive.* Austerity does nothing to fix either of these problems!

On Monday the 16th, S&P continued the downgrades, stripping the Eurozone's bail-out fund of its AAA credit rating, moving it to AA+. The European Financial Stability Facility (EFSF) relies on the triple-A rating of its guarantors to raise cash in debt markets to support the struggling Eurozone governments. This downgrade is likely to force the EFSF to pay higher interest rates and/or operate with less cash to support those countries in need. The pension funds which were relied on to buy EFSF debt can only hold AAA-rated securities. Ouch!

We are especially concerned with a statement by German Chancellor Angela Merkel written up the Financial Times on January 14th, 2012.

> "Speaking on the fringes of a start-of-year retreat of the Christian Union lawmakers in the city of Kiel, Ms. Merkel said she would consider calls from her party colleagues for legislation to bar institutional investors such as insurance companies from being forced by their statues to sell bonds when ratings were downgraded, or fell below investment grade."

This is moving towards a situation in which bureaucrats would be able to force institutions to keep bonds that their risk management would otherwise sell in order to defend their financial health. What a way to deal with a global debt crisis! Make the debt even riskier by threatening to force an owner to keep it when they want to sell. This is akin to trying to shore up the housing market by barring a homeowner from selling their house if a neighbor's home sells for less this year than its last sale price. How many people do you think would be buying homes then? We can only hope that she'd had a few too many s 'mores at her retreat and the sugar got to her. **Bottom Line**: *European debt of any flavor is looking less and less attractive, which make more debt as a solution to existing debt more challenging. The Eurozone looks to be solidly in a recession (mild so far) which makes growing out of the debt problem unlikely as well. Quite a pickle over there which is likely to affect emerging markets as well as the U.S.*

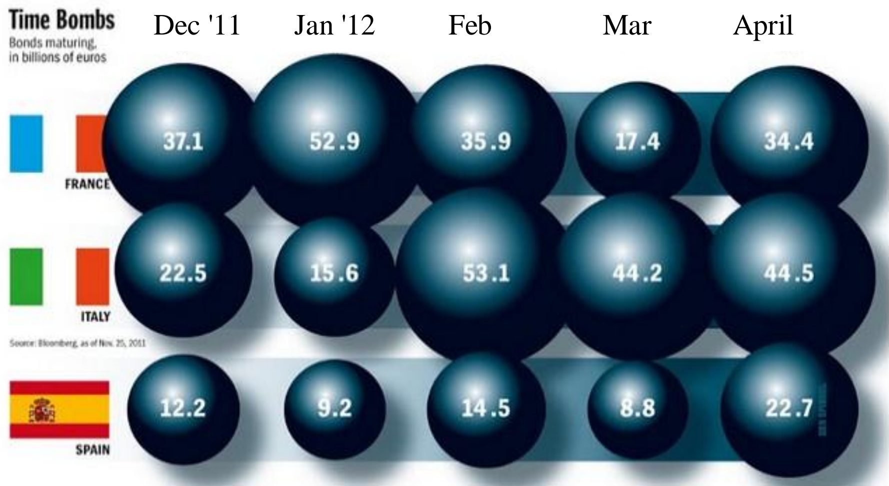
Greek Drama Intensifies

Last week we learned that the talks between Greece and holders of its debt broke down over how large bondholder's losses should be. These are the discussions concerning implementation of the "voluntary" 50% write down of Greek debt that the public was told was essentially a done deal months ago. Unfortunately for the Eurozone, this can cannot be kicked much further, as on March 20th Athens faces 14.4 billion euros of bonds, (about 7% of its GDP) coming due with no way to pay. Talks are scheduled to resume Wednesday, but given how far apart the parties currently are, an agreement seems unlikely. Contagion is already appearing with Portuguese 10 year yields experiencing their second biggest one-day rise on record on Monday the 16th to a fresh high of 12.1%. **Bottom Line**: *We believe a Greek default is only a matter of time and its*

departure from the Eurozone highly likely. If/when that happens, the euro currency may enjoy a temporary bounce, but the region's problems are solved with the departure of Greece.

European Solvency Bomb

When credit expands, markets rally. When credit tightens, things tends to go south. Most investors rely on a "bottom-up" analysis in which the focus is on the individual investment. This is an effective strategy in a bull market, but is fraught with danger in the current environment in which credit contraction and solvency fears dominate. The chart at right, from Der Spiegel, shows the enormity of the debt that the Eurozone needs to roll over in the coming months. Eurozone sovereign bond yields have been spiking to record levels, making this a particularly painful time to be forced to refinance so much debt.

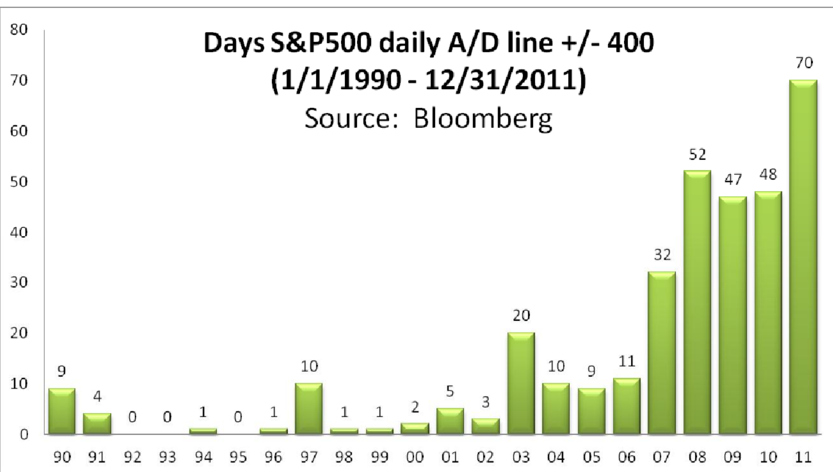


Over Thanksgiving six central banks of the world were forced to come together to supply cash to struggling banks. That addressed a short-term liquidity problem, but the underlying solvency problem remains. (Think of liquidity vs. solvency this way. Liquidity aid is when mom and dad chip in to help their son make the minimum payment on his credit card this month. A solvency crisis is when their son's home is worth less than the mortgage on it, his variable interest rate is about to double and his current income level is barely keeping food on the table.)

Bottom Line: *When it appears that the problems in Europe are being adequately addressed, the markets rally. When the plans appear insufficient, with disagreement among the nations increasing, the markets plunge. We anticipate an environment very reminiscent of 2007-2008, with market turmoil incited by problems in the credit market. This will push global money flows into the region of greatest safety, like U.S. Treasury bonds.*

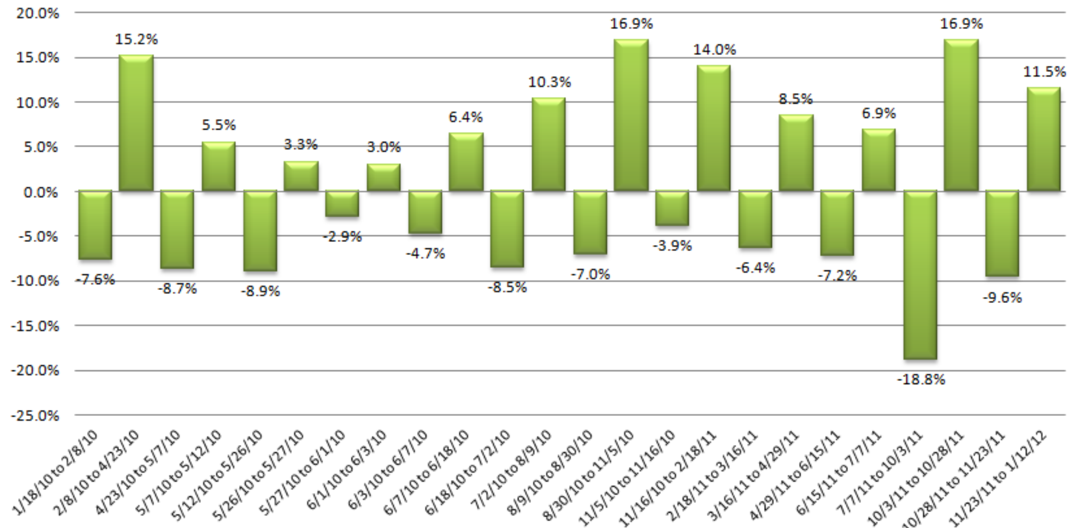
Volatility on the Rise

The past year saw the greatest volatility in stock market history. In the entire history of the S&P, there have only been eleven days when 490 or more of the 500 stocks in the S&P index posted either gains or losses. Six of the eleven occurred in 2011! That is a market that often doesn't care one whit about the fundamentals of a company, but is more focused on macroeconomic factors. The chart at left, which shows the number of days the Advance/Decline line is +/- 400, illustrates just how wild the market swings were in 2011. It also shows how volatility has been increasing over the past decade.



We've yet to have one of these turbulent days this year, we expect that the volatility of 2011, will continue in the year ahead for the simple reason that nothing has fundamentally changed.

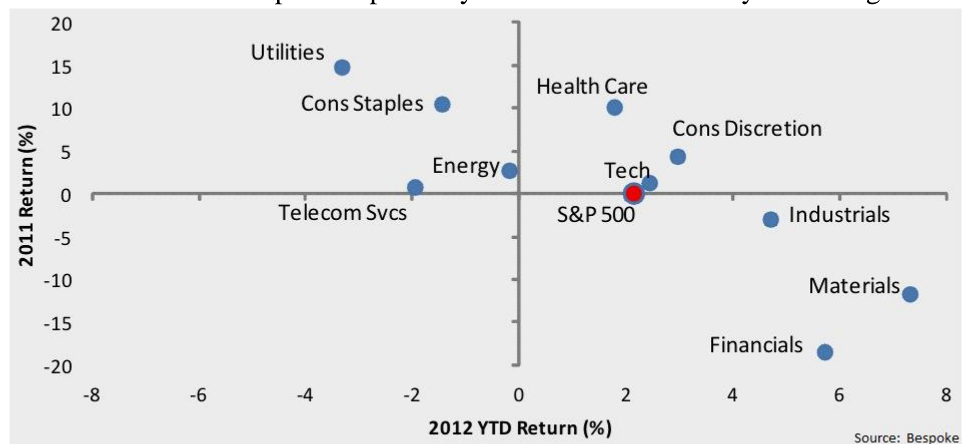
We believe that we are still in a *secular bear market*, one that is characterized by tremendous volatility in which rallies are to be rented, not owned. The chart on the right shows just how dramatic the market directional swings have been over the past two years. The recent rebound occurred on the back of a 19.4% collapse earlier in the year. Our clients have been able to avoid this gut wrenching ride thanks to our defensive positioning and focus on reducing correlation within portfolios. **Bottom Line**: *The underlying problems still remain. There has just been more kicking of the can and temporary window dressing. Most importantly, investors need to remember that many of the opportunities that arise during these turbulent times require the investor to disagree with the market.* ***The best investments or strategies will periodically have several months of declines. This doesn't mean the strategy is wrong, it just means that it takes a while for the market to align with the underlying economic realities.***



Don't Believe the Hype

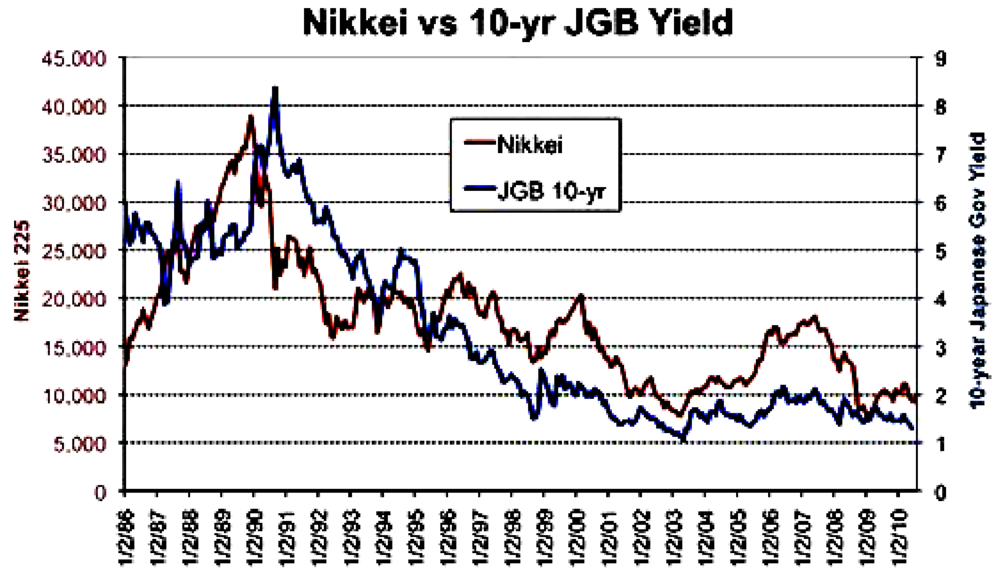
Early in 2012 the seasonal and technical trends appear to have taken over from the fundamentals and the market is rather desperate to get some nice rallies going. The strongest performers of 2011 are now the laggards in 2012. At Meritas, we don't for a minute believe that all is well, the angels are singing, Kim Kardashian's marriage to Kris Humphries has been saved, Superman is wearing Tim Tebow pajamas, and this year the "Bachelor" will finally find true love courtesy of "reality" TV. Well... the one about Superman probably was true until Saturday's crushing defeat by the Patriots.

The chart on the right shows returns by sector for 2011 vs returns YTD in 2012 (through 1/13/12). Utilities and consumer staples, which led in 2012 are significant laggards so far this year. Financials and materials were the worst performers in 2011, but the two strongest so far this year.



Bottom Line: *We came into 2012 with the market rather overbought and that trend has continued, with the market in short-term rally mode. We believe that buying opportunities for the more defensive and income producing sectors are likely to open up here shortly. We believe these are the times when it is most important to not lose sight of the underlying economic realities and mistake market trends for economic predictions.*

Don't Trust Wall Street



We've been hearing a lot about how today's low interest rates will help corporate profits, thus stocks will do well. We beg to differ and point out that the Japanese Nikkei is down almost 80% from its peak 21 years ago while Japanese government yields have continued to fall. The U.S. is in a very different climate than the secular bull market that ran from the 1950s to the early 2000s. During that period, the Fed would raise rates when inflation got too high. When the economy contracted into a recession, the Fed would lower rates, which would increase the money supply and the economy would expand. In that dynamic, a prudent investment strategy was fairly straightforward. When the Fed lowers rates, buy. When inflation gets close to the point when the Fed will step in, sell.

This all changed starting the 2000s, when the markets no longer responded so nicely to Fed intervention. The Fed can't lower rates any more and any attempts to jump-start the economy through monetary expansion became the proverbial "pushing on a string" as the money that the Fed expects to have the banks inject into the economy simply winds back up in excess reserves back at the Fed! What's a central banker to do? It's a bit like increasing one's coffee consumption consistently for years. Eventually no amount of caffeine can get your morning roaring!

The chart at left shows how the S&P 500 has become more positively correlated with the 10 year Treasury Bond. This is because rather than having declining interest rates spur on economic growth, they have become a sign of a deflationary debt cycle, which is contrary to economic growth. Remember, when credit expands, markets rally. **Bottom Line**: *Wall Street analysts still use the same old theories. We saw how well that worked for them in 2007-2008! Market conditions change, and with them correlations can quickly take a 180. It is vital to understand the environment in which one is investing, rather than relying on historical norms which may no longer apply. Watch was they do, not what they say. On January 17th, we learned that for the for the first time, Wall Street's biggest bond trading firms held more U.S. Treasuries than corporate securities over concern about the economy.*

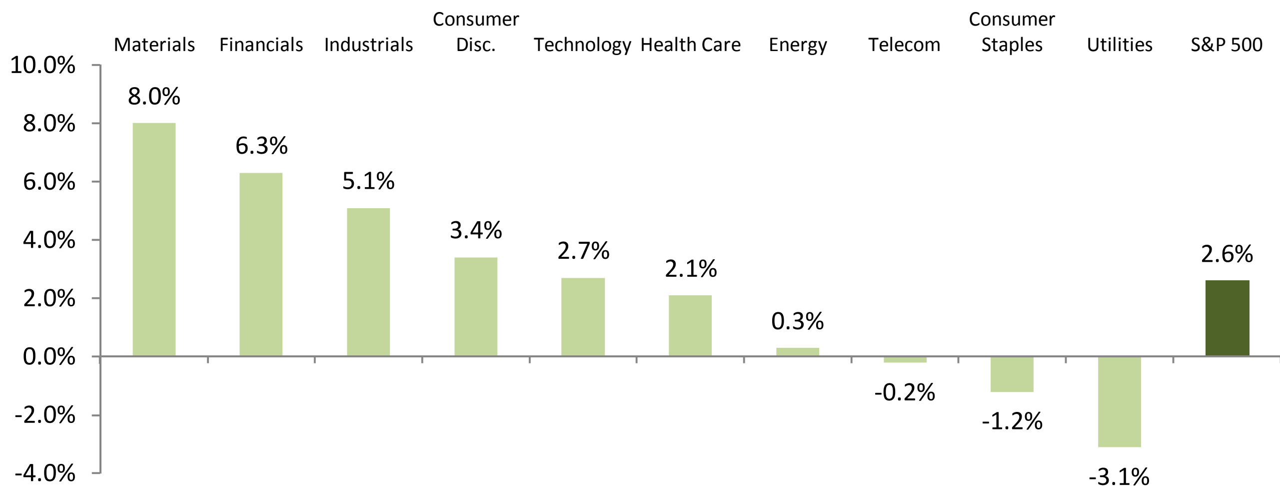
Market Recap

Index Levels	Close 01/13/12	Year End 12/30/11	Year Ago 01/13/11
Dow Jones 30	12,422	12,218	11,732
S&P 500	1,289	1,258	1,284
Nasdaq	2,711	2,605	2,735
Russell 2000	764	741	801

Commodities	Close 01/13/12	Year End 12/30/11	Year Ago 01/13/11
Gold	1,642.00	1,531.00	1,381.50
Crude Oil	98.70	98.83	91.4
Gasoline	3.38	3.26	3.09

Bond Rates	Close 01/13/12	Year End 12/30/11	Year Ago 01/13/11
Fed Funds Target	0.25	0.25	0.25
2 Year Treasury	0.22	0.24	0.59
10 Year Treasury	1.85	1.87	3.30
10 Year Municipal	2.27	2.45	3.93
High Yield	8.00	8.36	7.15

Index Characteristics	P/E Forward	P/E Trailing	Dividend Yield
S&P 500	12.53	14.63	2.17%
Russell 1000 Value	11.57	13.33	2.64%
Russell 1000 Growth	14.02	15.90	1.62%
Russell 2000	18.13	23.02	1.46%



Wrap Up: With all the major events this month we were left with no room to talk about the implications of the increasing turmoil in Libya, Iraq, and Syria, let alone Iran's threat to close the Strait of Hormuz. Japan looks to have sunk back into deflation and recession with debt of almost $13 trillion at nearly 240% of GDP and a shrinking working population with a plunging birthrate. China's economy expanded at the slowest pace in 10 quarters as export demand slowed and the government's campaign to slow consumer and property price gains dampened growth. In the U.S. the housing situation has gotten to the point where the Federal Reserve Chairman is threatening to step in and buy more mortgages in an attempt to bolster the market. Phew! And yet... the world goes on, people get married, have children, grab take out on the way home and most still enjoy a level of affluence that affords them the luxury of getting perturbed over the little things. We are still a very blessed nation.

While these will be trying times, they are also ones of great opportunity. We expect 2012 to continue the heightened levels of volatility from 2011 and look forward to this year's investing prospects with great enthusiasm. The world faces considerable challenges, but with the right tools, challenges are simply opportunities in disguise.

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