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.

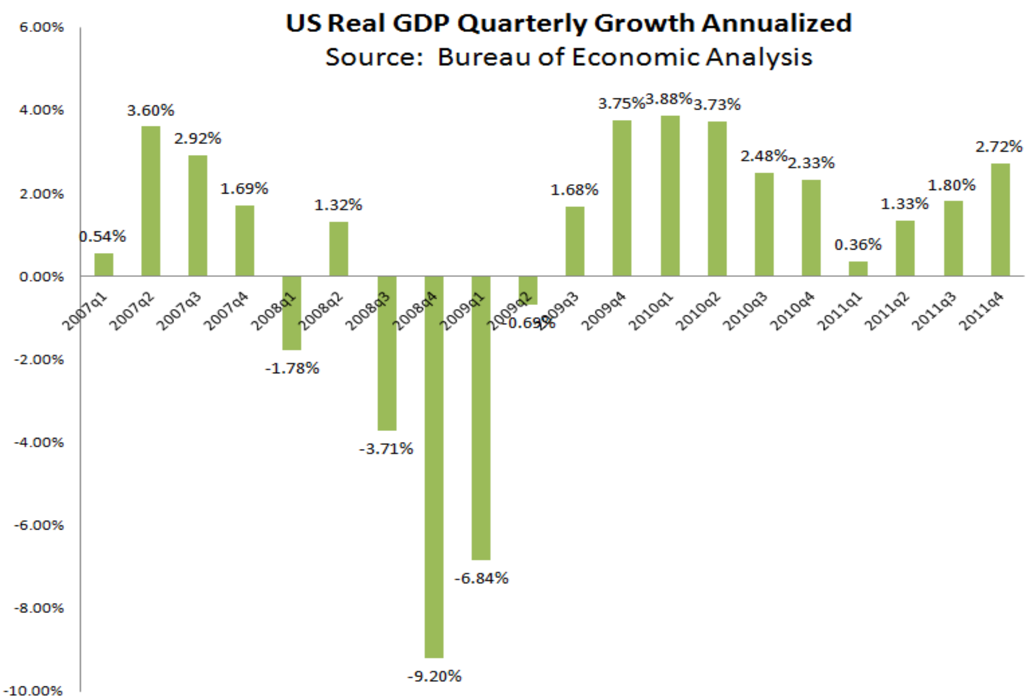
We seek to generate returns from market movement, rather than being dependent on a particular market direction. We utilize the strongest performing investments across a wide range of sectors and strategies that when combined seek to optimize opportunity, while minimizing downturns.

Dear Clients and Friends: The markets can and often do divorce themselves from economic reality. We believe that the current bull market is to be only cautiously "rented" as it is a rally based on central bank liquidity injections and government interventions, rather than on fundamentals. As we've discussed before, market winds can float securities up into the air, but the gravitational reality of the economy and fundamentals eventually win. We believe the current market is a bit like a child with no perceptible memory of the past and an unquestioning belief in the Tooth Fairy and Easter Bunny, which in this case are central bankers and politicians. It is vital to remember that while **central banks may be able print money, which temporarily distorts asset prices, they cannot create real wealth.**
Lenore Hawkins, MBA, Principal

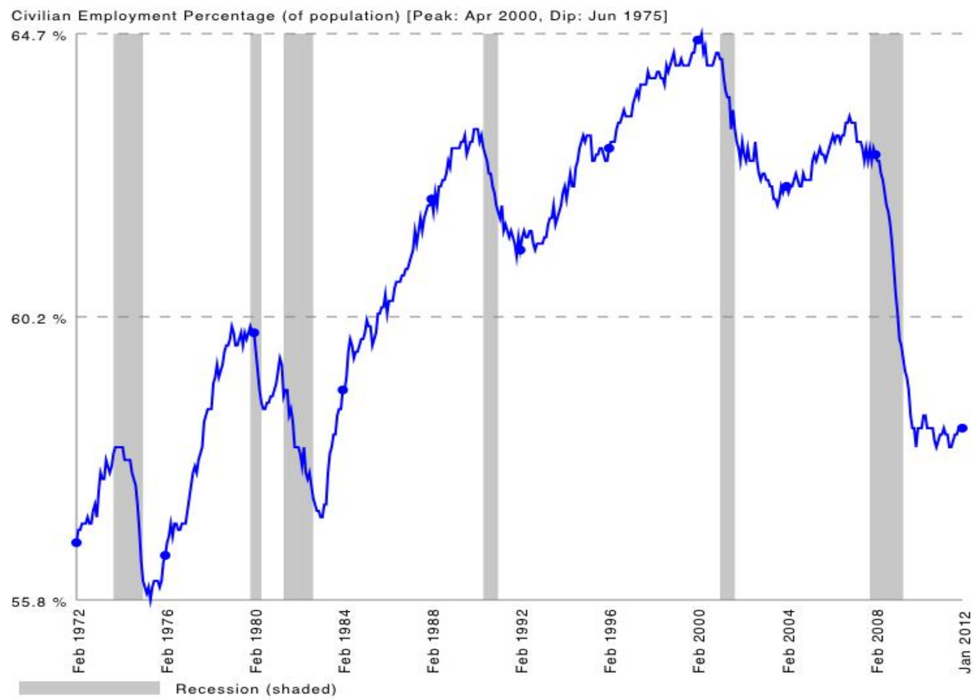
US Economy

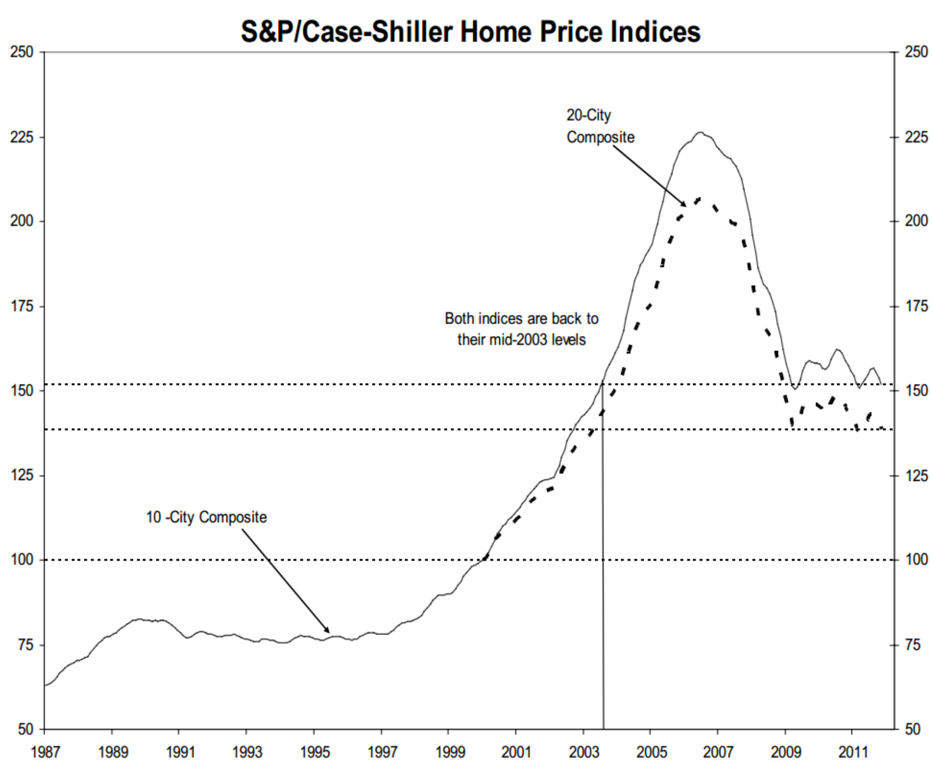
To understand the economy these days, one needs to read between the headlines. For us it isn't about being bullish or bearish. It isn't about what we *want* the markets or the economy to do. We simply *observe*, striving to do so as objectively as possible and *respond accordingly*. So let's breakdown the headlines.

GDP Growth: In 2011 the U.S. economy grew 1.7% versus 3.0% in 2010. In the fourth quarter of 2011, U.S. GDP grew at 2.72% (real rate), which was the fastest pace in 18 months - so far so good. However, much of the growth was fueled by an increase in consumer spending of 2.3% and this growth was financed by a decline in savings, rather than from an increase in household income as real personal income fell 1.7% on a year over year basis in December 2011. **Bottom Line**: *Growth fueled by a decline in savings is not sustainable.*



Unemployment: The markets went bonkers, a technical term, earlier this month when the unemployment rate dropped to 8.3%, but let's looks a bit deeper into the numbers. The level of long-term unemployed persons, those unemployed over 27 weeks was little changed at 5.6 million and represents 42.5% of those unemployed. This number is important as the longer an individual is unemployed, the less relevant their skills become and the more grim their prospects. We prefer to look at the percentage of the population that is employed, (see chart above) rather than the unemployment rate as that simply gives the percent of the population that is actively looking for work. While the unemployment rate dropped to 8.3%, those employed as a percentage of the population stood at 58.5%, which is only 0.3% better than at its worst level of 58.2% in December 2009 and unchanged from December 2011. The percentage of the population employed is still hovering around lows not seen in almost 30 years. **Bottom Line**: *The unemployment rate may be improving, but the percent of people actually working, (which is what really matters) has barely budged.*

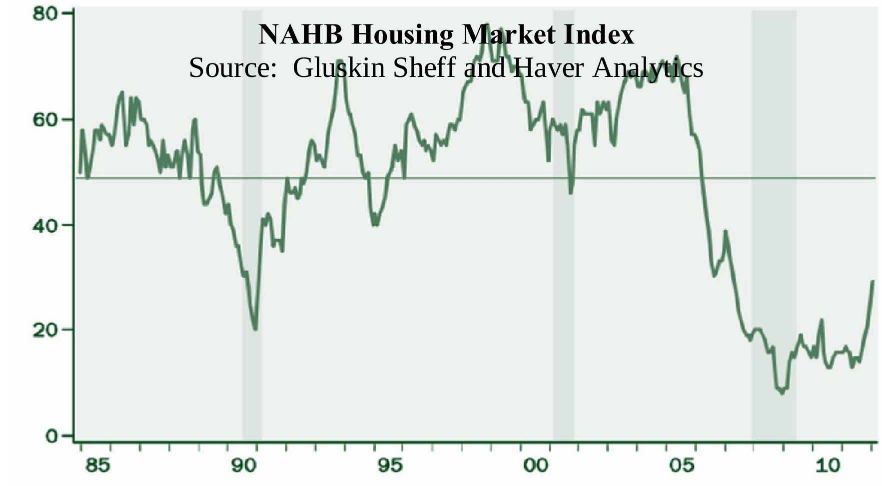




Source: S&P Indices and Fiserv

Housing: On January 31st the leading measure of U.S. home prices, (the S&P/Case-Shiller Home Price Index) showed declines of 1.3% for both the 10- and 20-City Composites in November 2011 over October. For a second consecutive month, 19 of the 20 cities covered by the indices also saw home prices decrease.

According to a January 26th US Census Bureau release, 302,000 new homes were sold in 2011, which is 6.2% below the number in 2010.



Shaded regions represent periods of U.S. recession

On a *positive* note, the National Association of Home Builders (NAHB) housing market index, (which rates market conditions for the sale of new homes at the present time and into the next 6 months as well as the traffic of prospective buyers) came in at 29 for February, which was above January's level of 25 and beat expectations that were for 26. This index is now up for five straight months in a row and is at the best level since May of 2007. Now before we get too excited, this is still below the longer-term average of 49, but it is a positive sign! **Bottom Line:** *The biggest asset for most households continues to drop in value, but there are reasons for optimism.*

> *Overall Caution for US Economy: We note that both real income and household net worth declined in 2011, despite the positive growth in GDP. When wealth and income decline, a recession is likely to follow, and rising prices at the pump are only increasing our concerns. We do not believe that the U.S. economy is out of the woods just yet and believe that the potential harm to portfolios, if we do slide back into a recession, warrants enhanced diligence and caution.*

Europe

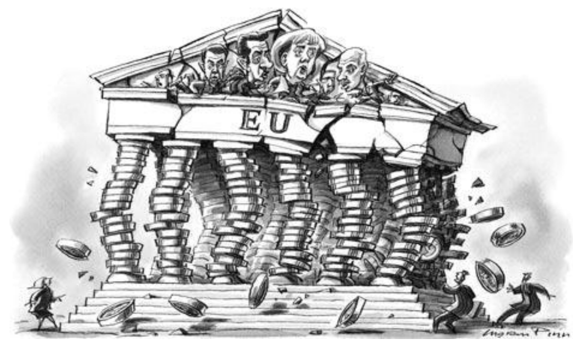
The drama in Europe continues to provide endless entertainment, which is some small consolation for the havoc it plays with the markets. We could easily write a novel on all that is happening over there, which would probably put all but the most die-hard nuts like us to sleep. So rather than exhaust those of you who are kind enough to give our monthly publication your time, we'll stick to what is most important.

On February 21st, a "deal" was reached between the Greek government, its trio of lenders, (the so call "troika"), the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF). I wince at the thought of the volumes of antacids that must have been consumed by this group over the past few months. According to the deal, the Greek government has to complete a lengthy checklist of reforms before the end of February to receive a ú130 billion bailout. No pressure there! Additionally, the group representing private investors, which had previously agreed to take a 50% loss on the face value of their bonds, was pushed late on Monday February 20th to instead take a 53% loss to cover the widening hole in Greece's finances. Anyone want to take bets on the likelihood of demands for more concessions?

First, it is vital to understand that this group of representatives has no authority to force everyone who owns Greek bonds to accept the deal. Any one of the private bondholders can simply refuse to take the cut and file for a ruling of default with the ISDA, (International Swaps and Derivatives Association). If the ISDA were to rule that a default had in fact occurred then all credit default swaps (CDS) purchased against Greek debt would be triggered. The risk here is similar to what happened with Lehman and Bear Stearns in the U.S. in which the ability of the entity that issued the CDS to actually pay out on the "insurance" issued is questionable, thus the desperate attempt to avoid a declaration of default. (Note: You can think of a credit default swap as akin to an insurance policy. You are worried that the bond you own may not get paid back so you buy insurance that will pay what the bond should have in case of a default.) If you own a Greek bond *and* bought such insurance, why would you not want to use the insurance you paid for? If you are a bank or a fund, don't you owe it to your investors to honor your fiduciary duty and do so? This is so much messier than the headlines indicate!

Here's the real kicker that ought to get your goat. The ECB is refusing to take any haircut on the Greek debt it owns. You seriously cannot make this stuff up! Europe's central bank and the European leaders are strong-arming holders of Greek debt in the private sector into taking a loss, while the ECB is going to enjoy one whopper of a profit! The ECB bought these bonds when Greece was already in dire straits, which meant the bond prices were considerably below par. Talk about do as I say not as I do! But they didn't stop there. The ECB has also subordinated all Greek debt to the ECB's holdings of Greek debt, which means the ECB gets paid first. Talk about gumption!

For a bond, par means that if the "face value" of the bond is $100, you would buy the bond at $100 and enjoy the stated interest payments until the bond comes due, at which point you would receive your $100 back. If a bond is trading below par, you could, for example, buy the same bond for $70 and upon the bond coming due, receive $100, even though you only paid $70, thus you'd not only enjoy the interest payments but get an attractive gain when the bond comes due.



Second, Greece has been given dozens of actions on which it must deliver in order to receive the rescue within the next nine days, and these actions are not going to go over well with the already enraged Greek people. Bureaucrats can negotiate, pontificate and photo op all they want, but at the end of the day the Greek people need to accept this deal or they could choose to revolt. The rising violence, the sense that they have very little to lose at this point all indicate that this process is certainly not going to go smoothly and may sadly end up in potentially violent revolution.

Third, according to the Financial Times, a "strictly confidential" report on Greece's debt projections prepared for the Eurozone finance ministers revealed that the Greek government may need yet another bailout after this one because the assumptions used in the projections are much too optimistic and Greece's economy will likely grossly underperform what the plan expects. No, can't be! They've been so dead-on in every previous estimate. I'm shocked I tell you, absolutely shocked. (Yes, you are noticing just the slightest note of sarcasm.)

Fourth, any bailout does nothing to solve the deeper underlying problem that Greece simply has a currency that is too strong for its economy, which makes it highly uncompetitive when it comes to exporting to the rest of the world. How is the country supposed to get its financial affairs in order when the strength of its currency makes it darn near impossible for the Greek economy to grow through exports?

Fifth, Portugal, Ireland, Spain... the list goes on, may look at the Greek deal and wonder why they can't get similar debt forgiveness and now we enter the lovely realm of moral hazard. Portugal will likely be the first in line asking, "Me too, please." Exactly what rationale could be used to argue that other countries can't be treated similarly is beyond my wee noggin. This sets up quite the conundrum for the ECB in which countries are now incentivized to make their situation look *really* bad, (which according to a Reuters report, Spain's government did just last year) so as to get similar favors. People respond to incentives; be wary of the incentives being established!

Bottom Line: *The market really has its head in the proverbial sand as far as we are concerned and is making entirely too little of the very real risks that still remain in the Eurozone, and we didn't even get into the level of economic contraction occurring there!*

Eyes on Iran

As we watch the increasing tensions in the Middle East, the riveting lyrics of that titan of symphonies, Nelly, come to mind, "It's getting hot in here." In a move that is reminiscent of high-school dating tactics, Iran responded to the EU's oil embargo threats with the traditional, "Oh no, I'm breaking up with **you** first" strategy and imposed a ban on oil exports to Britain and France as they were the two main states which pushed the EU to sanction oil imports from Iran.

On a more serious note, tensions between Iran and Israel are reaching increasingly dangerous levels, with the discussions concerning Israeli action shifting from a possibility to a probability. The Iranian "Great Prophet VII" war games that were scheduled to take place by February 19th in the Strait of Hormuz appear to have been delayed, and potentially even cancelled outright, as a reciprocal gesture after the United States on January 15th delayed military exercises with Israel. Instead, the Iranian air force announced on February 20th, that it had begun a four-day drill covering a zone of 190,000 square kilometers in southern Iran, dubbed *Sarollah*, which has been presented as a largely defensive exercise. On February 21st, Mohammed Hejazi, the deputy head of Iran's armed forces, hinted that Tehran could possibly order militant groups in Gaza and Lebanon to fire their rockets into Israel claiming, "We are no longer willing to wait for enemy action to be launched against us." UN weapons experts ended a two-day visit to Iran on February 21st, while officials in Tehran insisted that the regime's pursuit of a "peaceful" nuclear program remained non-negotiable, however the UN experts were reportedly denied access to a key military installation believed to house nuclear testing equipment. Hawks within the Israeli administration have claimed that Iran will soon reach a "framework of immunity" by moving the majority of its nuclear production into underground facilities that will be beyond the reach of Israel bombers. **Bottom Line**: *We cannot predict how this frightening situation will play out, but we can state with absolute conviction that rising tensions and potentially devastating outcomes place more risk on an already fragile global economy.*

Sports Illustrated Swimsuit Edition Indicator

After the heaviness of the Middle East, here's one that just might give you a reputation for the most interesting tidbits at a cocktail party! In yet another sign that some in the investing world have entirely too much time on their hands and desperately need to improve their social lives, Bespoke Investment Group recently released their analysis on the correlation between the nationality of the model on the cover of the annual Sports Illustrated Swimsuit edition and U.S. equity market performance, referred to as the *Swimsuit Indicator*. You just can't make this stuff up! Since 1978, an American has appeared on the cover of the annual Sports Illustrated Swimsuit Issue in 18 different years. The average total return of the S&P 500 during the 17 prior years has been a gain of 14.3% with positive returns 88.2% of the time. Of the 17 years where no American appeared on the cover, the S&P 500 has averaged a total return of 10.8% with positive returns 76.5% of the time. Please note however, that an American did grace the cover in 2008, when the S&P 500 declined 38.5% which caused the spread between the American vs. non-American performance numbers to narrow considerably. This year the lovely Kate Upton, an American, won the coveted cover. **Bottom Line**: *Too much time spent analyzing correlations without a balanced social life can be detrimental to one's mental health.*

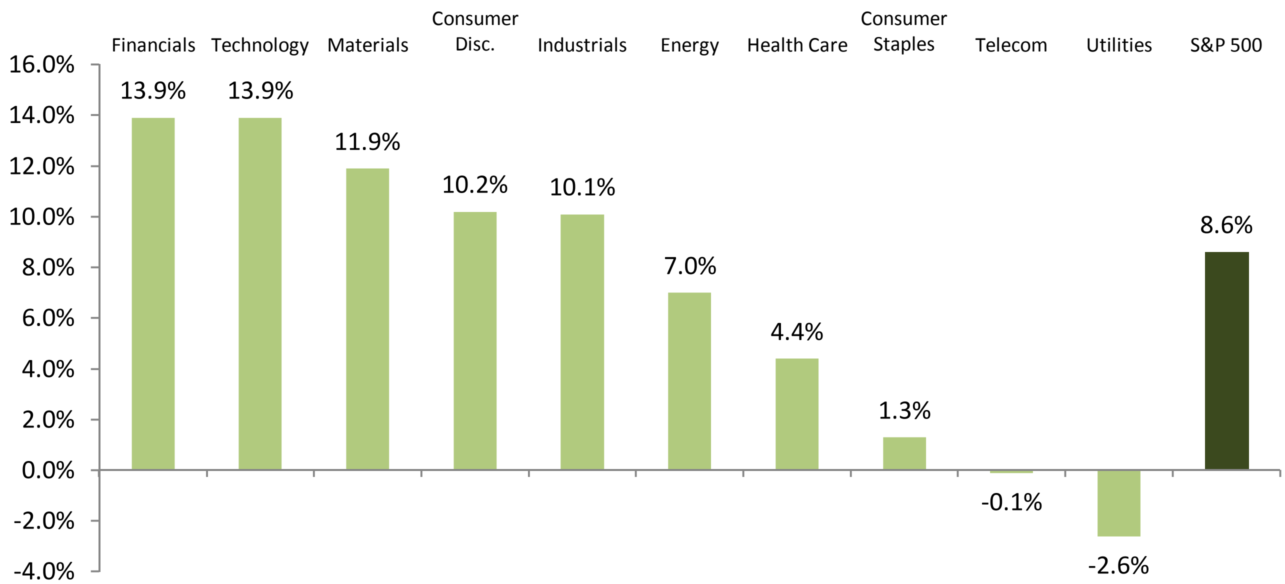
Market Recap

Index Levels	Close 02/17/12	Year End 12/30/11	Year Ago 02/17/11	Commodities	Close 02/17/12	Year End 12/30/11	Year Ago 02/17/11
Dow Jones 30	12,950	12,218	12.318	Gold	1,723.00	1,531.00	1,379.00
S&P 500	1,361	1,258	1,340	Crude Oil	103.24	98.83	86.36
Nasdaq	2,952	2,605	2,832	Gasoline	3.52	3.26	3.14
Russell 2000	829	741	834				

Bond Rates				Index Characteristics	P/E Forward	P/E Trailing	Dividend Yield
Fed Funds Target	0.25	0.25	0.25	S&P 500	12.93	15.45	2.09%
2 Year Treasury	0.29	0.24	0.77	Russell 1000 Value	11.94	13.91	2.57%
10 Year Treasury	2.01	1.87	3.57	Russell 1000 Growth	14.63	16.34	1.55%
10 Year Municipal	2.27	2.45	3.82	Russell 2000	19.20	24.00	1.38%
High Yield	7.30	8.36	6.75				

Year-to-Date Returns by Sector

(As of 02/17/12 - Source: JP Morgan)



Wrap Up: From a technical standpoint the equity markets are heavily overbought and the "risk-on" trade has been the flavor of the month, despite the still very tenuous state of the global economy from both a financial and political standpoint. Last year's laggards continue to be this year's winners. We have cautiously implemented strategies that will allow some components of our portfolios to participate in this rally, while simultaneously positioning portfolios to be protected from and benefit from the market correction and rising volatility that we think are highly likely in the coming months.

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