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MERITAS ADVISORS
Comprehensive Wealth Management

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.

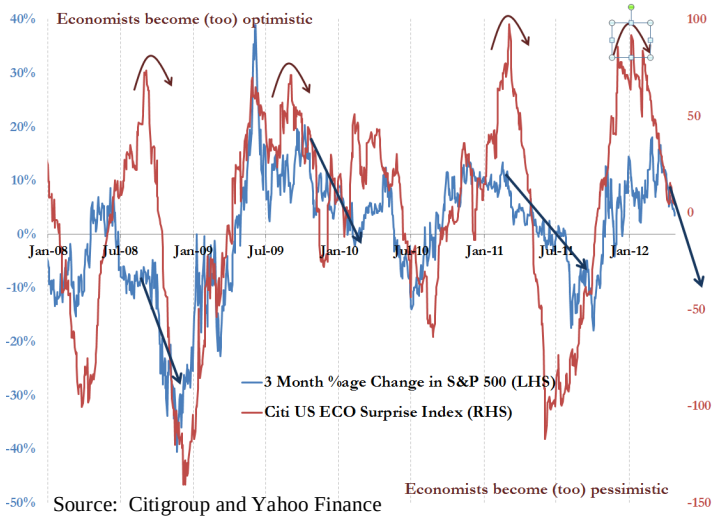
We seek to generate returns from market movement, rather than being dependent on a particular market direction. We utilize the strongest performing investments across a wide range of sectors and strategies that when combined seek to optimize opportunity, while minimizing downturns.

Dear Clients and Friends: As this newsletter goes out, stocks are on track for their biggest monthly loss since last September, which is of no surprise to us. The situation in Europe has once again taken center stage with the markets as global economic indicators have taken a turn for the worse. On the bright side, U.S. employment continues to improve, albeit weak improvement, but is still moving in the right direction
Lenore Hawkins, MBA, Principal

Global Economy

The macroeconomic data for the G-10 countries has turned negative and is at its lowest level in over six months. The last time this happened was in July 2010, which instigated the Federal Reserve program now referred to as QE2, (which is discussed in detail later). As you can see from the chart below, the Citigroup Economic Surprise Index has turned negative and dropped below its 200 day moving average. The negative reading means that actual economic data releases are no longer beating the consensus estimates. On a positive note, the U.S. is still a little bit less bad than Europe.

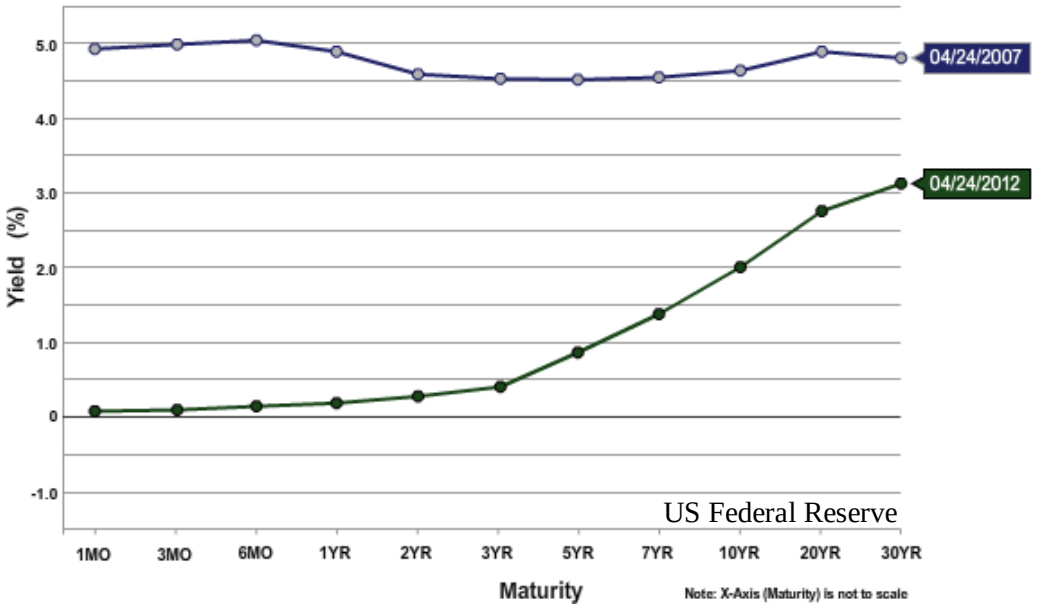
The chart at right shows how closely the S&P 500 moves with the surprise index.
Bottom Line: *The correction we have been talking about is getting more likely.*



Source: Citigroup and Yahoo Finance

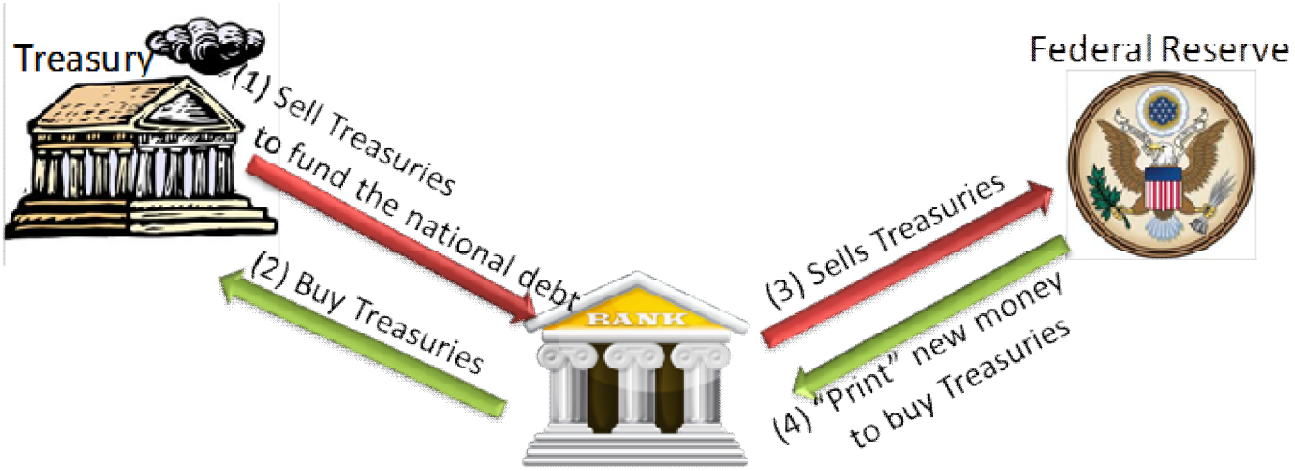
Quantitative Easing: You canôt turn on the television or pick up a newspaper without seeing speculation on the Federal Reserve's or the European Central Bank's (ECB) potential next moves and the corresponding concerns over inflation and/or deflation. The most recent meeting of the Federal Reserve reiterated earlier pledges to keep rates low through late 2014, with a slight downgrade of expectations for the domestic economy. Chairman Ben Bernanke left open the possibility of further programs if the recovery falters, which as we just discussed is becoming more likely. Other Fed officials expressed concern with leaving rates so low for so long, thus we are seeing increasing divergence of opinions at the Fed. How that will play out is anyone's guess. To understand the inflationary and deflationary concerns facing the Fed, we need to first review what the Federal Reserve did during the financial crisis and how those actions can lead to inflation.

The federal government spends more money than it takes in every year through taxes. The excess in government spending over tax receipts (income to the government) is referred to as the *annual deficit*. The *national debt* is the accumulation of all those years of deficits. In order to spend more money than it takes in, the federal government has to borrow. It borrows by issuing *Treasury Bills* (loans of 1 year or less), *Treasury Notes* (loan of 1 to 10 years), *Treasury Bonds* (loan of 20 to 30 years), or *Treasury Inflation-Protected Securities* (TIPSð inflation indexed borrowing for 5, 10 or 30 years). The interest rate the federal government pays on the borrowed money depends on what lenders, (institutions and individuals in the marketplace) are willing to accept. This rate changes over time and is based in part on expectations around inflation and expectations concerning the risk of actual default. (If you are willing to loan money at 5% for one year when you believe there will be no inflation, you will demand 8% if you think that there will be 3% inflation so as to still get the same effective interest rate on the loan. The chart on the right shows how interest rates on *Treasuries*, (a generic term for anything issued by the Treasury) for various lengths of borrowing from 1 month to 30 years, have changed from April 24, 2007 to April 24, 2012. This is called the *yield curve*. An upward sloping curve means that interest rates are less for short-term borrowing than long-term. An inverted yield curve, (2007 curve is somewhat inverted) means that interest rates for longer-term borrowing are lower than short-term, which is typically a sign that a recession is on its way.



Back to Quantitative Easing, you've probably heard a lot of references to QE and QE2. Here's how that worked. U.S. banks, as well as foreign governments, foreign banks, corporations, investment funds and individuals purchase Treasuries. Quantitative Easing refers to the process shown on the next page wherein (1) the Treasury Department sells Treasuries to Banks in return for cash to fund the annual deficit. This money is then spent by the federal government. Banks then turn around and sell the Treasuries to the Federal Reserve in return for cash. This cash is typically in the form of a ñcreditò in their reserve account, but for all practical purposes it can be thought of

as cash since these reserves can then be used to loan money to businesses and individuals, who then effectively have cash in hand. For a detailed description of how this process works, please read our White Paper on the U.S. Banking system (Fractional Reserve Banking) on our website, under Resources > White Papers. So how can this lead to inflation?



Monetary Policy & Inflation

Now that we've discussed how and why the Federal Reserve increased the monetary base so much through quantitative easing, let's look at how this can affect the economy. For those who aren't inclined to enjoy equations quite as much as yours truly, I promise that if you stick with me, it will all make sense and you'll be a hit at cocktail parties with your new found monetary savvy.

In 1911 Irving Fischer proposed the *Equation of Exchange* which is simply stated as $M \times V = P \times Q$ where

- M is the total dollars in the nationôs money supply (*Money Supply*).
- V is the number of times per year each dollar is spent (*Velocity of Money*).
- P is the average *price* of all the goods and services sold during the year.
- Q is the *quantity* of assets, goods and services sold during the year.

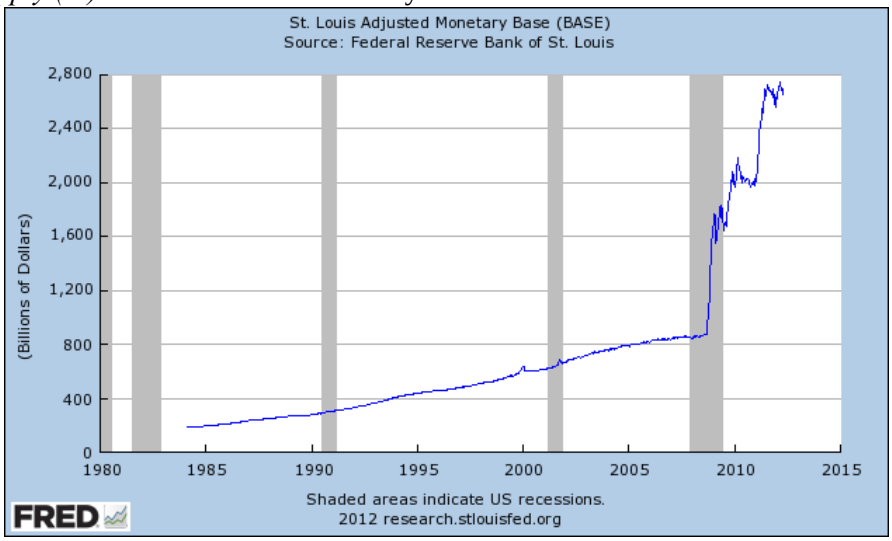
To understand the importance of *velocity*, letôs look at a very small economy with a farmer and a tailor with $50 between them. This is a highly simplified example to illustrate the concept. They buy goods and services from each other in just three transactions over the course of a year.

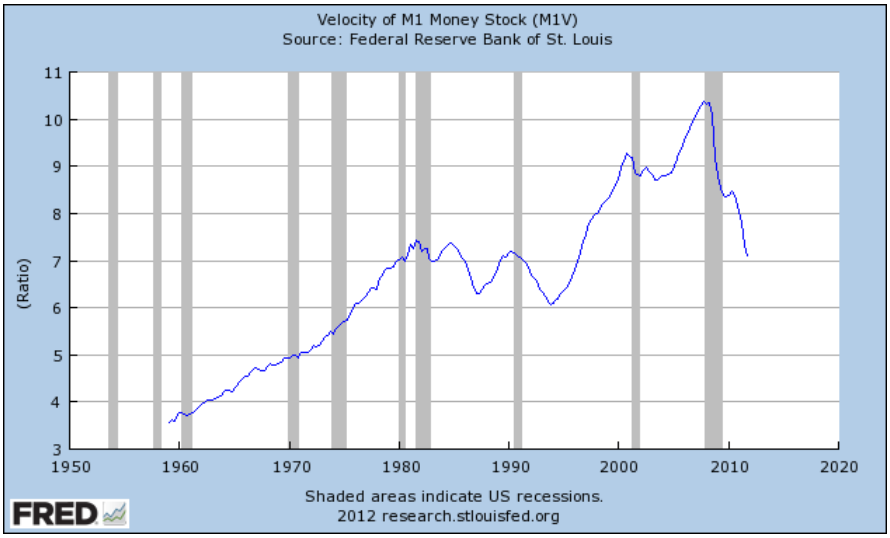
- In May, the farmer spends $50 on a new suit and shirt.
- In July, the tailor buys $40 of corn and butter from farmer.
- In November, the tailor spends $10 on milk from the farmer.

$100 changed hands in the course of a year, even though there is only $50 in this little economy. That $100 level is possible because each dollar was spent an average of twice a year, which is to say that the velocity was 2 / *yr*.

$50 x V = ($50 + $40 + $10) = $50 x V = $100 V = 2

The chart on the right shows the *money supply (M)* has increased dramatically when we look at the excess reserves held by depository institutions. This is money that could be used out in the economy, but is being held by banks. This explosion in excess reserves is in large part the result of the Fedôs quantitative easing programs, the process we discussed on the previous page. When this money sits in reserves and is not changing hands in the economy, the *velocity* of money declines. Add to this that companies are holding record levels of cash as well, (this is akin to the tailor only purchasing say $20 worth of goods from the farmer in a year) the *velocity* of money drops significantly.





The chart at left shows just how significantly the velocity of money has fallen in recent years. This explains how the potential supply of money can expand so significantly without having rampant inflation. The fear for those watching this is that an economic recovery will spur an increase in the velocity of money that the Fed cannot counter, causing potentially high inflation.

To understand the impact of an increase in the supply of money (M), letôs look at an example.

M=10, V=2 and Q=4. Using the equation (M x V = P x Q) we get 10x2 = Px4 20 = 4P 20/4 = P P=5.

It takes time and money to increase the amount of goods and services a country can produce, but prices can be immediately adjusted up or down. If M (the supply of money) doubles to 20 and V (the velocity of money) stays the same, Q (quantity of goods and services) wonôt be able to increase much over the short run which means P (Prices) must rise. If we assume that the quantity of goods and services is increased by even 25%.

20x2=Px5 40=5P 40/5 = P P = 8 (Prices have increased 60% from 5 in the first example)

If the economy is not able to increase *Q* (*Quantity of goods and services)* at the same rate as the increase in the (*Money Supply * Velocity)*, that leaves only *P (Prices)* left to increase. This is how an increase in the supply of money causes inflation. Phew - anyone up for a glass of wine?

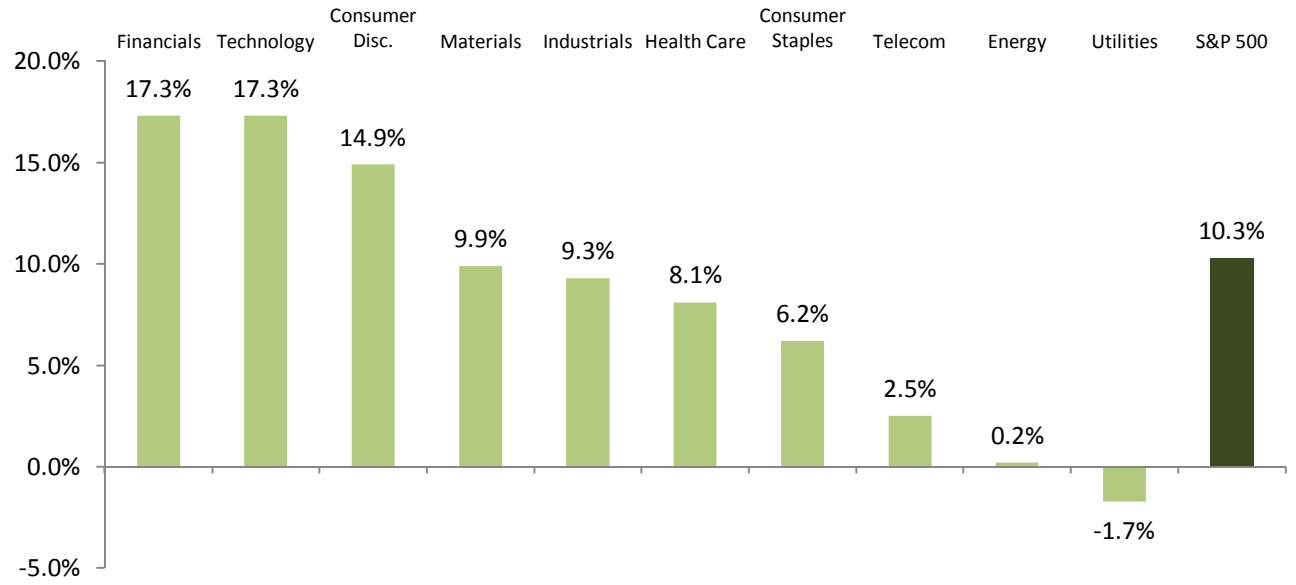
Market Recap

Index Levels	Close 04/20/12	Year End 12/30/11	Year Ago 04/20/11	Commodities	Close 04/20/12	Year End 12/30/11	Year Ago 04/20/11
Dow Jones 30	13,029	12,218	12,454	Gold	1,641.50	1,531.00	1501.00
S&P 500	1,379	1,258	1,330	Crude Oil	103.05	98.83	110.89
Nasdaq	3,000	2,605	2,803	Gasoline	3.92	3.26	3.84
Russell 2000	804	741	839				

Bond Rates				Index Characteristics	P/E Forward	P/E Trailing	Dividend Yield
Fed Funds Target	0.25	0.25	0.25	S&P 500	12.82	15.64	2.11%
2 Year Treasury	0.27	0.24	0.67	Russell 1000 Value	11.64	15.44	2.48%
10 Year Treasury	1.97	1.87	3.40	Russell 1000 Growth	14.64	17.97	1.48%
10 Year Municipal	2.26	2.45	3.69	Russell 2000	18.35	25.18	1.39%
High Yield	7.28	8.36	6.84				

Year-to-Date Returns by Sector

(As of 04/20/12 - Source: JP Morgan)



Wrap Up: The Conference Board's consumer confidence fell for a second month in a row in April, which hasn't happened since May-June 2011. The Case-Shiller Home Price index remains in negative terrain for the 17th month in a row, with the headline index down to its lowest level since October 2002. The raw data showed that 32,000 new homes were sold in March, making it the third worst March in recorded history going back to 1963. The good news is that we've anticipated this turn and have portfolios positioned accordingly. We are likely in for another wild year with much market volatility with the election process in the US and in Europe making investors swing from elation to fear and back again. Patience and a long-term perspective are becoming increasingly important.

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