May 16th, 2012

Monthly Investment Outlook

In This Issue:

- Global Economy
- Domestic Economy
- Eurozone
- Financial Sector
- 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: It has been quite a month, both for the markets and my schedule with a series of economic and investment conferences. The markets across the globe continue to sell off as the German DAX is now down 10.56% from its 2012 high, British FTSE down 8.8%, French CACI down 15.46% and the Greece Athens index off a whopping 32.5% from its high for the year, as of May 15th. The S&P 500 which is negative 4.8% for the month of May is now down 6.2% from its high of the year, as of May 15th, while the economic news continues to worsen. The markets are finally facing the economic realities. We are likely in for a bumpy ride.
Lenore Hawkins, MBA, Principal

Global Economy

From late April through May every year I attend a series of conferences starting with the Milken Institute Global Conference and finishing up with the SALT Skybridge Conference, which is the biggest hedge fund conference of the year. The strong theme throughout every conference was concern bordering on outright fear of the impending fiscal cliff for the developed nations and its impact on emerging economies.

Developed nations have taken on increasingly burdensome welfare systems, funded through ever growing levels of debt. The high levels of debt combined with structural problems, (meaning it's hard to start and run a business) throughout many countries are strangling their economies' growth prospects. With growth stifled, it is increasingly difficult to increase tax receipts, which in turn makes more government borrowing necessary to pay for the ever growing welfare programs as more people leave the workforce in despair and so the downward spiral accelerates. As the developed economies struggle, the emerging economies will also suffer as many of them are export driven, with the developed economies their primary customer. In addition, many emerging economies depend on the developed economies to provide debt financing for their growth. As credit in developing economies contracts, a necessary and inevitable process, emerging markets will also struggle to fund their expansion.

This has led to high levels of fiscal, monetary and regulatory intervention, which according to many of the speakers, makes traditional value-based investing extremely difficult and risky. I heard the mantra of "This is a traders market" echoed throughout the days. Sadly, I agree with the consensus. **Bottom Line**: *This is a market in which individual fundamentals for a given company or sector can be made irrelevant by fiscal, monetary and/or regulatory actions that can easily overpower sound fundamentals. This is a market in which the wisest focus on a good defense rather than an aggressive offense.*

Domestic Economy

At the various conferences the discussions on the domestic economy focused on the desperate need for stability and predictability with respect to taxes, regulation and legislation. Businesses will continue to hold onto high levels of cash and will not take on the risks necessary to grow substantially while the future of tax rates remains unclear, regulation continues to expand in unpredictable ways, and legislative changes continue to put increasingly onerous burdens on businesses. New businesses, which are the primary source of new jobs, are struggling under the burden of all this taxation and regulation. As you watch the public debates, remember that big business has a strong affinity for anything that makes it tough for new potential competitors to enter their industry, thus existing businesses are often the natural enemy of free enterprise.

On January 1st, 2013 the so called **Tax Armageddon** arrives, unless Congress whips out an eleventh hour intervention. Long-term capital gains tax rate will increase 58.7% from 15% to 23.8%, including the 3.8% Medicare tax. Additionally the distinction between ordinary and qualified dividends will disappear with all dividends subject to the ordinary tax rates, which means the maximum rate on dividends will go from 15% to 39.5%. Federal income tax rates are also set to rise substantially, with the highest bracket rising from 35% to 39.6%. This means that the highest federal tax rate on investment income will be 43.4% (39.6% ordinary income and 3.8% Medicare). For Californians, add an additional 11% onto your income tax for the highest rate. If this increase goes through, it will likely have a substantial impact on markets towards the end of the year as investors seek to recognize gains at the lower rates, thus much selling is likely to occur.

The most recent domestic data is not terribly inspiring, particularly in light of the upcoming tax hikes:

- Household survey employment has contracted for two consecutive months, despite the unseasonably warm weather which typically boosts economic activity.
- The percentage of the population in the labor pool has plunged to 30 year lows. If someone tries to tell you it's because of the aging population, consider this: The number of employed persons over 55 has gone UP 3.8 million since 2007 while for those under 55, it has DROPPED 8.2 million. Clearly the decline in the workforce is not a result of retirement. Unemployment for 20-24 year olds is 25%! At least we aren't Spain where it is over 50%.
- The level of employment is the same today as it was 12 years ago, despite rising population.
- The average monthly job gain since employment bottomed out in February 2010 has been 144,000, making the 115,000 in April 2012 look rather grim.
- Real wages have declined in each of the past two months and in four of the past five.
- The number of people on disability, food stamps, and who have given up looking for work altogether, have each reached all-time highs.

The vast majority of the speakers at the various conferences expressed grave concern over the loose monetary policies of the developed nations, particularly the U.S. as so many asset prices are related to Treasury bonds. Chairman Bernanke has made it clear in his public speeches that the Fed stands ready to use every tool at its disposal if the economy weakens, and that is precisely what we are seeing. It is impossible to guess what level of economic weakening is necessary to get the Fed involved, but given that this is an election year, probably less than in other years, so we would not be surprised to see another round of Quantitative Easing. While this can serve as a temporary panacea for the markets, we are very concerned with the long-term consequences, so eloquently described by an economist who is widely cited these days.

> *The best way to destroy the capitalist system is to debauch the currency. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. By a continuing process of*

inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens... The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose. ~ ***John Maynard Keynes***

Bottom Line: *After almost four years of $1 trillion dollar-plus fiscal deficits, near 0% interest rate policies, and a Federal Reserve Balance sheet that looks like Octomom pre-delivery, we've still got an economy that is barely breathing on its own. An additional round of QE may provide a short-term boost to asset prices, but at some point the markets realize that more of the same isn't going to get a different result.*

Eurozone

Europe is once again in the spotlight as Angela Merkel has lost her austerity partner with the defeat of the conservative Nicolas Sarkozy in **France** by the socialist François Hollande on May 6th. The election in France marks the seventh European leader, (joining those of Greece, Italy, Spain, the Netherlands, Portugal and Ireland) to be forced out of office, courtesy of the continuing Eurozone crisis. Meanwhile in **Germany**, Merkel's party suffered its worst loss since 1950 in state elections, making it much more likely that the strategy of using the European Central Bank (ECB) printing press to help fund more government spending is likely to take center stage rather than Merkel's preferred so called "austerity" measures, which is just a fancy way of saying less government spending. Even the Bundesbank, Germany's version of the Federal Reserve, which has been the most hawkish of central banks, (meaning most concerned with inflation) was reported to have "*signaled its acceptance of higher inflation in Germany as part of an economic rebalancing in the Eurozone,"* by the Financial Times on May 9th.

We found a bright spot in the rather dour Eurozone news today as the **German** economy grew five times faster than forecast in the first quarter. Gross domestic product rose 0.5% from the fourth quarter, when it fell 0.2%, the Federal Statistics Office said today. The median of 40 economistsø estimates in a Bloomberg News survey was for a 0.1% expansion.

In **France**, Credit Agricole SA, France's third-largest bank by market capitalization, reported on May 11th that its first-quarter profit dropped 75%, primarily due to write-downs on Greek debt, resulting from the nation's sovereign debt restructuring, illustrating that there is no free lunch. French GDP in the first quarter was essentially flat at 0.1% growth, the same as the fourth quarter of 2011.

Over in **Greece**, the likelihood of an exodus from the Eurozone sooner, rather than later is increasing every day as the nation finds itself unable to muster sufficient votes to form a new coalition government.

Spain has begun trying to recapitalize is fragile banking sector, while default risks on its sovereign debt rise to new highs.

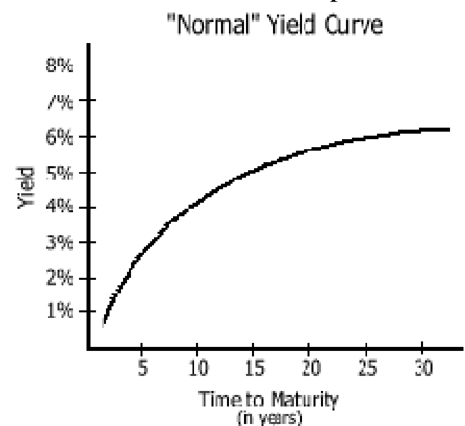
Meanwhile over in **Italy**, Moody's downgraded by one to four notches the long-term debt and deposit ratings for 26 Italian banks. The ratings outlooks for all are negative, with the ratings for Italian banks now amongst the lowest within advanced European countries, reflecting just how vulnerable these institutions are to the struggling economies in Italy and Europe as a whole. To add insult to injury, Italy's economy contracted for a third quarter in a row in the three months through March. GDP declined 0.8%, the most in three years.

The combined Euro-area manufacturing and services PMI feel to 46.7 in April from 49.1 in March, well below the estimate of 47.4, representing the third quarter in a row of economic contraction (readings below 50 signal contraction) on the continent. **Bottom Line**: *Europe is facing a challenging triumvirate of political instability, financial insolvency and economic fragility. More likely that we'll see some form of LTRO3, Europe's version of Quantitative Easing (QE), which, coupled with the increased likelihood of another round of Quantitative Easing in the U.S., is bullish for gold and gold mining stocks in the longer-term.*

U.S. Financial Sector

JP Morgan took center stage last week with its announcement of a $2 billion trading loss due to positions that were intended to hedge against market risk. Sadly this trade has cost 30-year banking veteran Ina Drew, considered one of the most powerful women on Wall Street, her position as she resigned on Monday. She is being replaced by Matt Zames, who previously worked at Long Term Capital Management (LTCM). You might recall that LTCM was initially an incredibly successful hedge fund, generating annualized returns of over 40%, only to lose $4.6 billion in less than four months in 1998 following the Russian financial crisis, requiring the first bailout by the Federal Reserve, and paving the way for the 2007/2008 crisis bailouts. We also find the choice of successor interesting in that Matt Zames is the Chairman of the U.S. Treasury Department's Borrowing Advisory Committee whose purpose is to present committee members observations to the Treasury Department on the overall strength of the U.S. economy, as well as providing recommendations on a variety of technical debt management issues. You just can't make this stuff up.

This move illustrates to us the ever closer relationship between large financial institutions and the federal government, which should give everyone cause for concern. We're also watching with great interest as Moody's reviews the credit rating of the industry while many of the biggest names in the sector such as Citi, Morgan Stanley, Bank of America, are more than 20% below their March peaks; BofA is down 26%, Citi is down 23.5%, Morgan Stanley is down 30.6% and the Financial Select Sector ETF (XLF) is down 9.2% from its March peak.



The toughest thing for banks these days, outside of trades gone wrong, is the threat of a flattening yield curve as longer-term Treasury yields fall. The chart at right shows a "normal" yield curve. Banks borrow money at short-term rates and lend at long-term rates. In the chart on the right you can see that this would mean borrowing at say 1% and lending out at 6% for a 30 year mortgage. The spread between the two represents the bank's ability to generate income. As the yield curve flattens, long-term rates get closer to short-term rates, making the spread on which banks depend shrink, weakening profit potential. On 5/11/11, the 10 year Treasury yield was 3.16%. It has fallen to 1.84% as of 5/11/12. **Bottom Line**: *The Financial Sector is still struggling and all the new rules and regulations have yet to be fully defined, let alone implemented. We are wary of placing any bets on this sector in either direction as we believe we are still in for sustained period of deleveraging (meaning debt reduction throughout the economy) which is a headwind to the industry, but are surely not willing to bet against the sector as the big ones clearly have the U.S. government behind them and the smaller ones are likely to get bought up by the big guys.*

Earnings

With over 90% of companies having reported their earnings, the good news is that operating EPS growth (earnings per share) is up almost 8% on a year-over-year basis, but that represents the weakest quarter for profit growth in this business cycle. We believe this is an inflection point, which makes large-cap preferable to small-cap, value preferable to growth, and higher quality companies and defensives preferable to cyclicals. Guidance for the next quarter has also been rather soft. The ratio of negative to positive pre-announcements has hit 3.3x, which is a new cycle high.

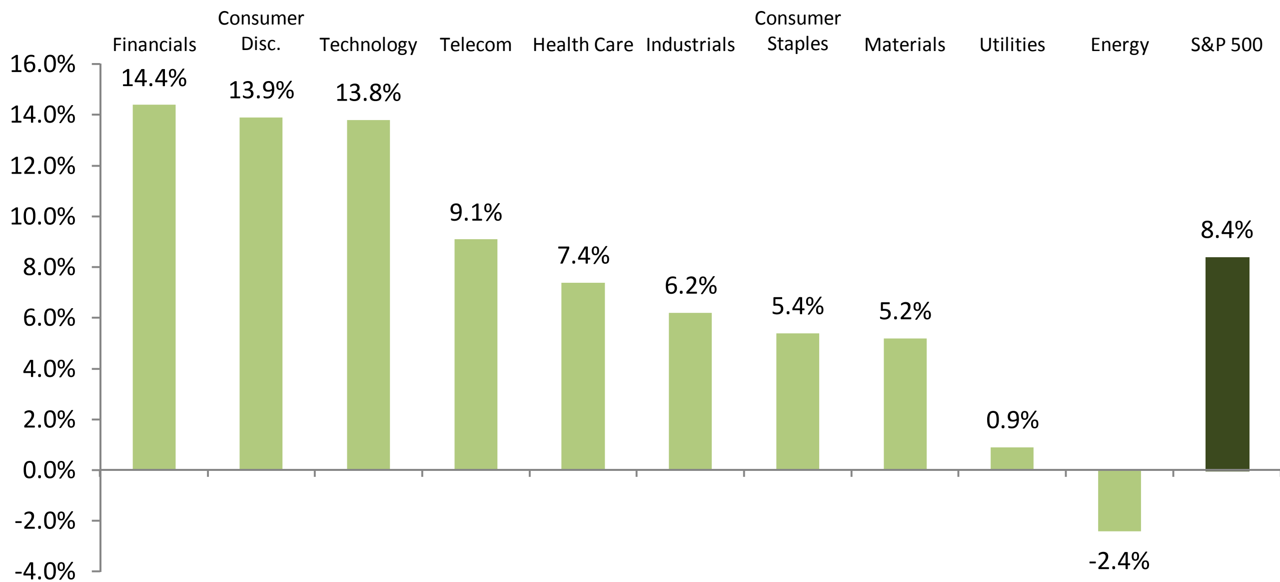
Market Recap

Index Levels	Close 05/11/12	Year End 12/30/11	Year Ago 05/11/11
Dow Jones 30	12,821	12,218	12,630
S&P 500	1,353	1,258	1,342
Nasdaq	2,934	2,605	2,845
Russell 2000	790	741	841

Commodities	Close 05/11/12	Year End 12/30/11	Year Ago 05/11/11
Gold	1,583.00	1,531.00	1,508.00
Crude Oil	96.13	98.83	98.21
Gasoline	3.79	3.26	3.97

Bond Rates	Close 05/11/12	Year End 12/30/11	Year Ago 05/11/11
Fed Funds Target	0.25	0.25	0.25
2 Year Treasury	0.26	0.24	0.55
10 Year Treasury	1.84	1.87	3.16
10 Year Municipal	2.13	2.45	3.34
High Yield	7.02	8.36	6.65

Index Characteristics	P/E Forward	P/E Trailing	Dividend Yield
S&P 500	12.41	15.36	2.20%
Russell 1000 Value	11.32	15.09	2.58%
Russell 1000 Growth	14.05	17.59	1.53%
Russell 2000	16.90	24.55	1.43%



Wrap Up: More uncertainty, more volatility and more risk-aversion are likely in the markets' future as we expect to see sovereign financial strength continue to deteriorate. To put the changes into perspective, since the beginning of the 2007/2008 Recession, the total value of government backed debt with AAA ratings has declined from over 50% of total outstanding sovereign credit to less than 10%. Seven European leaders have been replaced over the continuing crisis and in the U.S. we face a Presidential election that is still anyone's game, on top of an impending enormous increase in taxes and large cuts in government spending. This is an important time to avoid market head fakes and place a priority on defense versus taking excessive risks. As always we are honored by your trust and work diligently every day to earn it.

Meritas Advisors, LLC is a Registered Investment Advisor with the State of California Department of Corporations. This newsletter is provided for educational purposes only, does not constitute a complete description of our investment services and is not intended to provide specific advice or recommendations. The information contained herein is based on information we consider to be reliable, however, accuracy is not guaranteed.

4040 Civic Center Drive, Suite 200
San Rafael, CA 94903
415.690.8547

11622 El Camino Real, Suite 100
San Diego, CA 92130
858.461.8547

info@MeritasAdvisors.com
www.MeritasAdvisors.com