July 24th, 2012

Meritas Advisors

Comprehensive Wealth Management

Monthly Investment Outlook

In This Issue:

- Domestic Economy
- Domestic Markets
- Housing
- Jobs, Earnings and Income
- Earnings Season
- Eurozone
- Stocks vs. Bonds
- 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.

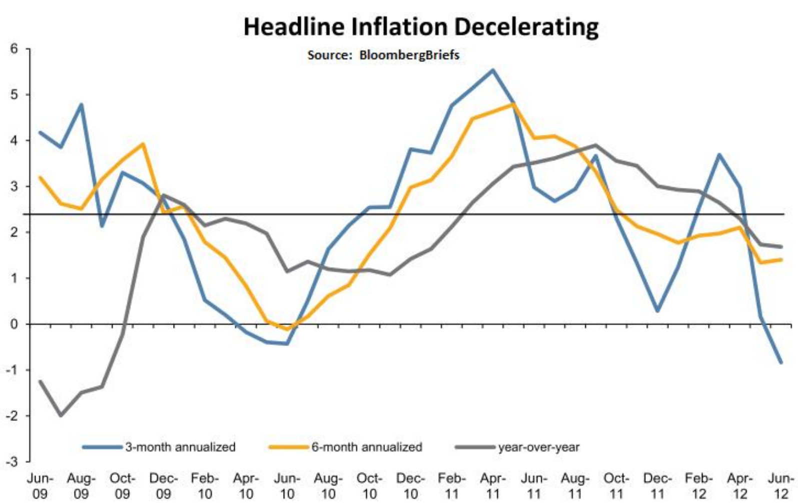
Dear Clients and Friends: As we head into the third quarter the markets are increasingly tumultuous with the situation in Europe unraveling, the U.S. economy weakening and emerging markets struggling. We are increasing the defensive nature of our portfolios and ensuring that we have sufficient dry powder on hand to take advantage of the opportunities we believe the next round of chaos will present.

Lenore Hawkins, MBA, Principal

Domestic Economy

In his semiannual report to Congress on monetary policy, Federal Reserve Chairman Ben Bernanke painted a fairly unpleasant picture of the economy. He gave no hint of any imminent action from the Fed, but warned that if Congress does not move quickly on a new budget agreement, it could get worse. He states that the economy is growing modestly, but recent data shows that the recovery has weakened. He cited slowing manufacturing activity and job growth as well as a decline in consumer spending as the primary culprits.

- For example, manufacturing in the Philadelphia region shrank for the third consecutive month as a global economic slowdown curbed demand for U.S. exports coming in at minus 12.9 in July from minus 16.6 the month before. Economists forecast the gauge would improve to minus 8, according to the median estimate in a Bloomberg News survey. This is the fourth reading to come in below expectations. Readings of less than zero signal contraction in the area, which covers eastern Pennsylvania, southern New Jersey and Delaware.
- Job growth has slowed and firings are on the rise (details on the next page).
- On July 16th, the Commerce Department reported that retail sales fell 0.5% in June from the month before as Americans spent less on autos, furniture and appliances. This was the third straight month of declining sales, a worrisome trend. The last time sales slumped for so long was in the fall of 2008, at the worst point of the global financial crisis.
- The recent deceleration in the headline consumer price index (see chart below) could also put further pressure on the Fed to undertake additional monetary stimulus at their September meeting.



In his testimony, Chairman Bernanke also noted that the economy has slumped from a 2.5% annual rate of growth at the end of 2011 to 1.9% in the first quarter and stated that growth will likely decline further in the second half of 2012. We anticipate weak GDP growth numbers will be revealed this Friday as the first estimates are released. Some members of the Federal Reserve board, according to the minutes from its June meeting, favor easing now, while others including Bernanke, have adopted a wait-and-see approach. **Bottom Line**: *We believe weak numbers this Friday will likely prompt action sooner rather than later, thus in a continuation of the bizarre, upside-down world of investing these days, poor economic news could easily cause another jump up in the markets based on anticipated monetary stimulus.*

Domestic Market

Despite the worsening economic news, the market is marching to its own drummer more than likely in anticipation of increased accommodation on the part of the Fed and belief that the Germans will extend Spain and Greece a lifeline while the IMF is helping out Ireland. Since the June 4th lows, the S&P 500 has rebounded 7.3% while the Small Caps have been even stronger with the Russell 2000 posting a gain of 9% over the period. All of the key averages are comfortably above their rising 50- and 200-day moving averages. The Russell 2000, S&P 500, Wilshire 5000, and NASDAQ are exhibiting short-term staircase patterns. Itõs interesting to note that the S&P 500 recently declined for six consecutive trading sessions. On Monday July 23rd, the S&P500 was down again for the eighth consecutive down Monday with the market down a total of 4% in the second quarter. **Bottom Line**: *The short-term outlook for the third quarter is quite murky, with a wide range of possible outcomes depending primarily on the actions of politicians and bureaucrats. During these tumultuous times, we believe that success requires longer-term focus as focus on short-term market swings rather than underlying fundamental can push investors into dangerously risky allocations.*

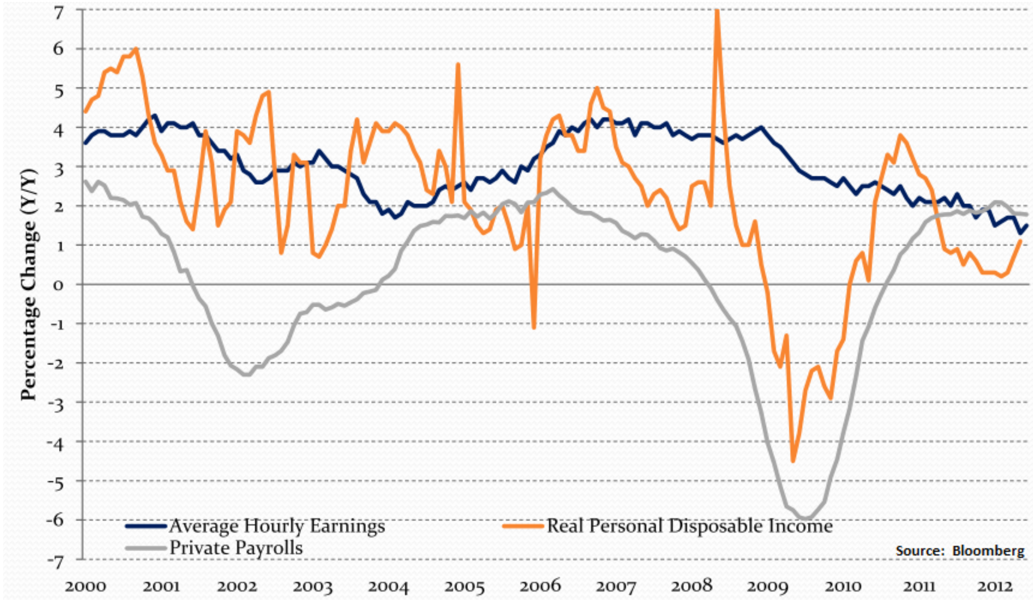
Housing

It is a bit of a fingers crossed moment when it comes to housing. U.S. home builders broke ground on the most new homes and apartments in nearly four years in June, with housing starts rising 6.9% from May to a seasonally adjusted annual rate of 760,000 to reach the highest level since October 2008. On the flip side, the number of permits to build homes fell 3.7% to 755,000. Permits to build apartments declined as well. On July 19th we learned that sales of previously owned U.S. homes unexpectedly declined 5.4% to a 4.37 million annual rate in June, an eight-month low. Slower job growth, stricter lending standards and competition from cheaper distressed properties may be impeding the market even with mortgage rates at all-time lows. The drop in home values since the last recession has also left some homeowners owing more than their property is worth, limiting their ability to relocate, which in turn may be affecting the employment rate. **Bottom Line**: *In the coming months banks are likely to increase the pace of foreclosures. Nearly $7 trillion in real estate value has been wiped out from the cycle peak five years ago. 25% of homeowners are upside down on their mortgages and another 5% have near-negative equity. A slowing economy will depress job growth which will be a headwind to housing. On the plus side, the sector has become more regionalized, with areas of strength slowly emerging. We aren't out of the woods yet, so caution is warranted, but signs of strength are increasing.*

Jobs, Earnings and Income

Job growth has declined from 225,000 a month from January to March to just 75,000 during the April to June period. On July 19th we learned that initial weekly jobless claims rose 34,000 the previous week to 386,000. Additionally, the pace of firings is currently on the rise.

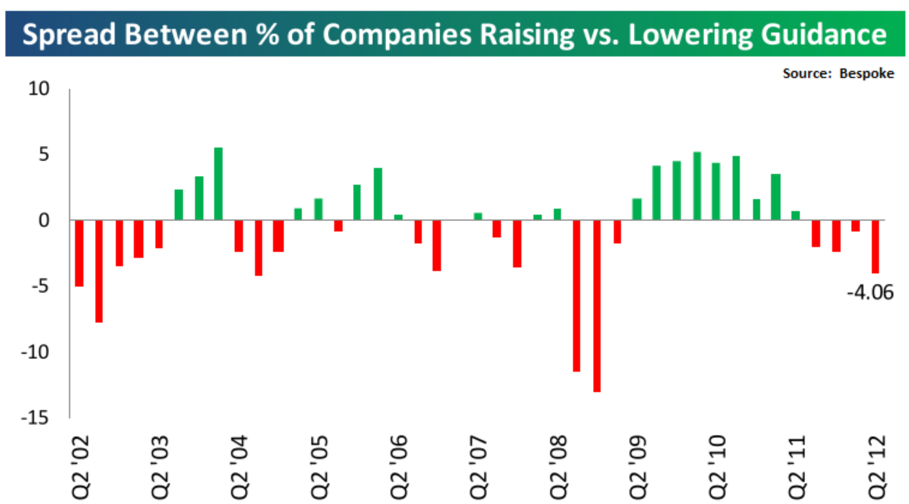
The chart below shows that over the past 12 years, average hourly earnings has fallen as has disposable personal income, while private payrolls are roughly where they were in 2000.



More workers joined the federal government's disability program in June than got new jobs, according to two new government reports, a clear indicator of how bleak the nation's jobs picture is after three full years of economic recovery. The economy created just 80,000 jobs in June, the Bureau of Labor Statistics reported July 6th. But that same month, 85,000 workers left the workforce entirely to enroll in the Social Security Disability Insurance program, according to the Social Security Administration. The disability ranks have outpaced job growth throughout this tentative economic recovery. While the economy has created 2.6 million jobs since June 2009, roughly 3.1 million workers signed up for disability benefits.

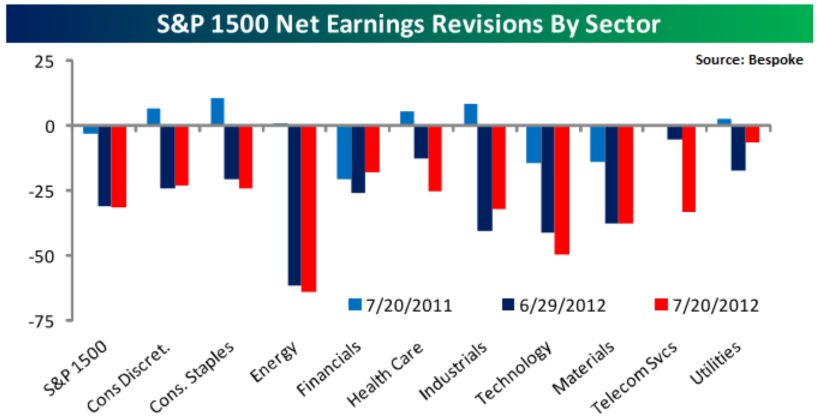
Bottom Line: *Adding to weak employment growth and increasing firing rates, tepid earnings and income indicate that weak consumer consumption is likely to persist for some time, especially when we look at how much further household debt needs to fall to return to historical norms. Gasoline prices have stabilized, however food prices have surged, not providing further squeezing the struggling consumer.*

Earnings Season



As of July 19th, 197 companies had reported their quarterly numbers with 59.4% beating earnings per share estimates. If earnings season were over now, this would be the lowest level of earnings beats vs. misses since the 2009 lows and would be in line with Q4 2008 and Q1 2009. What is more concerning is the revenue beat rate, which is only 43%. That means that earnings beats have come from cost cutting, layoffs and productivity improvements that are not indefinitely repeatable. Over the long run, top line revenue growth has to happen for earnings to grow. Weak employment, weak jobs growth, and weak income growth for consumers make revenue growth for companies difficult to achieve. The most concerning aspect so far of the earnings season has been forward looking guidance. Coming into this season, more companies have lowered guidance than raised over the last three earnings seasons and the spread between raises vs. lowers is as negative as it has been since Q4 2008. At the moment it looks like we are going to have a negative spread for the fourth straight quarter, which hasn't happened since the 2002 recession (see chart at right). In terms of individual sectors, all ten currently have negative revisions ratios, while Utilities at -

6.3% is the only sector with a revisions ratio that is not in the double-digit negatives. With a net revisions ratio of -63.7%, energy has the most negative revisions ratio with technology at a noteworthy -50.0%! **Bottom Line**: *While we are seeing a decent level of earnings beating the significantly lowered expectations, revenue growth is disturbingly low and forward guidance is decidedly grim. Fundamentals going into the second half warrant a good deal of caution.*



Eurozone

On July 23rd, Spanish 10 year bond yields rose over 7.5%; recall that anything over 7% is seen as a death knell for sovereign debt as the interest rate at that point is so high that a country can no longer reasonably borrow from the public markets. Even the Spanish two year rose 0.51% to breathtaking heights at nearly 6.08% with Italy coming up quickly as well at 4.7% for the 2 year and 6.37% for the 10 year. Meanwhile, the U.S. 10 year fell again to record lows below 1.4% in the proverbial flight to safety. Moody's Investors Service lowered the outlook on Germany's triple-A rating from stable to negative. The euro currency dropped to its lowest level in two years and market regulators in Spain and Italy stepped in to temporarily ban so-called short sales of stocks, making July 23rd one whopper of a day for the markets.

The government debt of the Eurozone rose to the highest level since the introduction of the euro currency in 1999 at 88.2% of GDP in Q1 from 87.3% in Q4 2011. Greece topped the Eurozone charts with 132.4% debt to GDP, but Italy isn't far behind at 123.3%. Not to be outdone, Spain's recession reportedly worsened in Q2, according to the Bank of Spain, shrinking 0.4% from Q1 when it contracted 0.3%. U.K. factory output is expected to fall 0.3% this year, according to the Engineering Employers Federation. Finally, talks of a Greek exit are back in the headlines as its troika of international creditors arrive in Athens on July 24th amid doubts that the country will be able to meet its commitments and increasing reluctance among euro-area nations to continue to fund the Greek bailout. **Bottom Line**: *Eurozone troubles persist and will serve as a significant headwind to the global economy and induce frequent periods of market volatility that for those who are patient can provide significant opportunities.*

Stocks versus Bonds

From 1928 to 2011, stocks returned 9.23% annually versus a return for U.S. Treasury bonds of 5.41% annually, meaning stocks have outperformed bonds by almost a 2 to 1 margin over this time period. But if we look at smaller time frames such as decades, the performance is quite varied. From 1990 to 2000 stocks delivered 17.30% per year, with bonds returning 8.4% per year.

> **In the 12 years from 1999 to 2011, stocks have returned just 0.53% per year versus a return for bonds of 7.23% annually! In the past nine years, from 2002 to 2011, bonds have outperformed stocks by over a 2 to 1 margin. In the past four years, from 2007 to 2011, bonds gained 7.66% per year while stocks lost -1.63% annually.**

Thirty years ago the U.S. Treasury Bond yield peaked at 13.65%, with rates declining since then to record lows, allowing bonds to return 9.16% per year when we combine interest earned and price appreciation. Remember that when yield (interest rates) drop, bond prices rise. With yields now at all time lows, additional price appreciation is becoming more challenging and return from yield minimal. **Bottom Line**: *We are in a period of financial repression in which both equity and bond returns are exceptionally low, pushing many investors into highly risky assets in search of elusive returns. We are at an inflection point, however the timing of the turn is impossible to determine as it is heavily impacted by the actions of politicians and bureaucrats.*

Market Recap

Index Levels	Close 07/20/12	Year End 12/30/11	Year Ago 07/20/11
Dow Jones 30	12,838	12,218	12,572
S&P 500	1,363	1,258	1,326
Nasdaq	2,925	2,605	2,814
Russell 2000	792	741	832

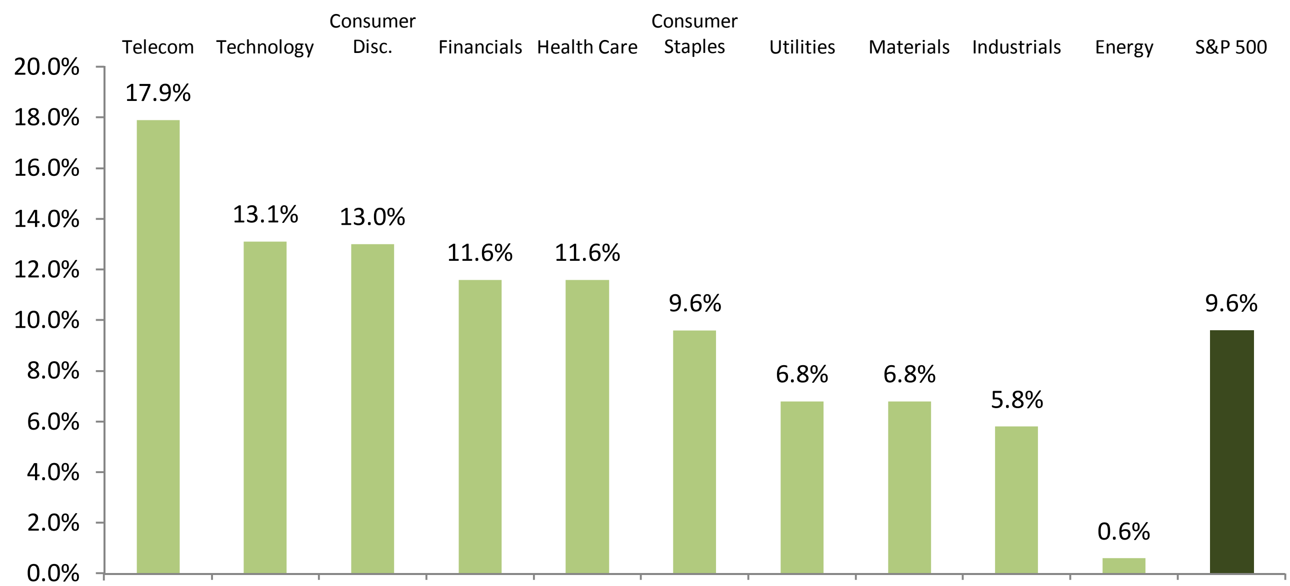
Commodities	Close 07/20/12	Year End 12/30/11	Year Ago 07/20/11
Gold	1,576.25	1,531.00	1,586.00
Crude Oil	91.44	98.83	98.14
Gasoline	3.43	3.26	3.68

Bond Rates			
Fed Funds Target	0.25	0.25	0.25
2 Year Treasury	0.21	0.24	0.37
10 Year Treasury	1.46	1.87	2.93
10 Year Municipal	2.10	2.45	3.28
High Yield	7.01	8.36	7.20

Index Characteristics	P/E Forward	P/E Trailing	Dividend Yield
S&P 500	12.67	15.19	2.21%
Russell 1000 Value	11.29	13.95	2.60%
Russell 1000 Growth	14.89	18.16	1.63%
Russell 2000	17.19	23.32	1.42%

Year-to-Date Returns by Sector

(As of 07/20/12 - Source: JP Morgan)



Wrap Up: The markets are now moving into more tenuous territory with the flight into more liquid assets such as Treasury bonds picking up momentum as investors retreat from risk. There are severe fundamental problems in the European markets, and slowing in the United States, China and the rest of the world. This is not the time to take on unnecessary risk, but rather focus on preserving dry powder during the tumultuous times in order to best take advantage of opportunities as great assets get beaten down in a baby with the bathwater market move that is becoming increasingly likely. As always, we are humbled by the trust of our clients and strive to protect during times of chaos and take advantage of opportunities as they inevitably arise during periods of fear and frustration.

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