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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: Thanks to my wonderful partners who keep Meritas running smoothly every day, I had the great joy of spending the first week of September in the lovely city of Prague for a meeting of the Mont Pelerin Society. I have had the great fortune to be granted membership into this small, (less than 800 members) but prestigious international organization, founded after World War II by giants in the world of economics such as Friedrich Hayek, George Stigler, and Milton Friedman. Current members include Václav Klaus, the President of the Czech Republic, who gave a fascinating talk on the evolution of capitalism vs. socialism in his country. Allan Meltzer, another member and professor of Political Economy at Carnegie Mellon, is widely considered to be one of the world's leading experts on monetary policy. He gave a timely presentation on the economic downturn and why he believes the most predominant sovereign responses, namely debt shuffling and printing money, have been ineffectual. For a monetary geek like me, it was akin to diving into a pool full of fat-free, zero calorie dark chocolate pudding. We hope your summer ended with some fun as well! *Lenore Hawkins, MBA, Principal*

Crank Up Those Presses!

The other day I was talking to a friend of mine who is the Chief Investment Officer for a firm that manages several billion dollars. Heȏs a pretty sharp cookie. We were pontificating on how the financial crisis will be referenced decades from now. It is impossible to know how the world economy will pan out over the years to come, but we agreed that the third quarter of 2012 will be viewed as a major inflection point in this ongoing saga. That's when we learned that Central Bankers are going to print and print and then print some more.

We find ourselves in this global mess because economic growth over the past few decades has been jacked up, like a kid after an exceedingly successful Halloween, from rapid expansion of debt in households, corporations and governments. A debt crisis is elegantly simple, there are only a few methods for dealing with it:

1) Outright default, or
2) A soft default in the form of restructuring or inflating it away, or
3) Pay it back.

Pre-2008 most believed that the various troubled economies would be able to grow their way out of their debt problems, thus option 3 was considered the most likely option and yields, (interest rates) reflected this optimism. After the crash, the government response was to enable a massive shifting of debt from the private sector to the public sector. The household and corporate responses were to deleverage, which led to deflationary trends that took hold in 2008. The negative growth rates of the Great Recession made it clear to most that enabling the pay back of the debt via economic growth was no longer an option. This left only two real options:

1) Default
2) Print

What politician can resist the enticing lure of the printing press when the only other option will forever imbue their once hopeful legacy with the stench of default and the economic hardships that will inevitably follow?

Over the past few weeks, the path to dealing with the enormous levels of sovereign debt has been made clear by the world's most powerful central bankers, Mario Draghi of the European Central Bank and Ben Bernanke of the Federal Reserve. On September 6th Draghi defied German Chancellor Angela Merkel and the Bundesbank by vowing to purchase "unlimited" amounts of shorter duration sovereign debt, (three year or less) of any European nation that had submitted to a program administered by the Troika, (ECB, IMF and the European Commission). A week later Bernanke announced that the Federal Reserve was launching an open-ended Quantitative Easing program in which it would purchase $40 billion of agency mortgage debt every month as well as extending Operation Twist for another $45 billion per month through the end of the year. My read of the FOMC committee minutes is that they will continue to print until they think things have gotten to the point where they should stop. Then they'll stop. Until that point, they'll print. How's that for clarity of metrics and a more transparent Federal Reserve?

> Ben Bernanke also stated that, *"We do think that these policies can bring interest rates down, not just Treasury rates, but a whole range of rates including mortgage rates and rates for corporate bonds and other types of important interest rates. It also affects stock prices. It affects other prices, home prices, for example. So looking at all the different channels of effect, we think it does have impact on the economy."*

The Divorce

Remember back when the economy actually drove prices on things like homes and stocks? Remember when the prices of things were based on valuations? Now the Federal Reserve is bent on manipulating asset prices, which it believes will in turn drive the economy! Talk about the cart leading the horse.

We are facing markets in which investor sentiment is utterly dependent on policy-maker actions. Investment decisions can no longer be based mainly on traditional metrics, such as corporate earnings, the strength of a company's balance sheet, management expertise etc., but are now driven to a greater degree by monetary and fiscal policies.

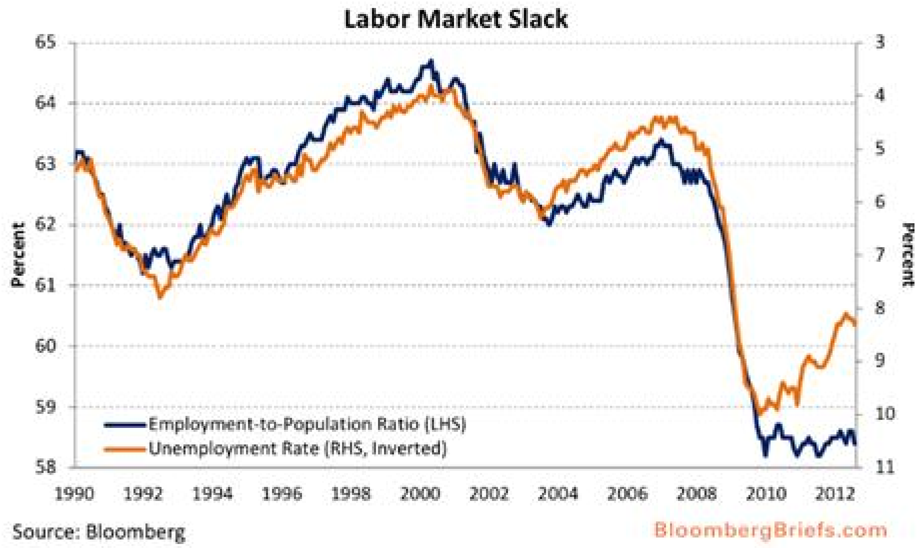
Global Manufacturing PMIs

	Current	Previous	3 Months Ago	6 Months Ago	12 Months Ago
Global	-	50.6	51.1	50.5	52.6
US	49.7	53.5	53.4	53.1	55.8
Brazil	48.5	49.3	51.1	49.1	49.0
Canada	-	54.7	52.4	54.0	53.3
Euro Area	45.1	45.1	47.7	46.9	52.0
Austria	50.1	50.2	51.5	49.0	53.0
Czech	49.4	47.6	52.1	49.2	55.1
Denmark	53.0	54.0	52.5	59.3	59.1
France	45.2	44.7	46.7	48.9	52.5
Germany	45.0	45.2	48.4	48.4	54.6
Greece	40.1	43.1	41.3	42.0	45.5
Ireland	53.1	51.2	51.5	48.6	49.8
Italy	44.6	44.8	47.9	44.3	49.9
Netherlands	48.9	47.6	49.6	46.2	52.1
Poland	48.0	48.9	50.1	48.8	51.2
Russia	51.0	53.2	50.8	51.7	50.6
Spain	41.1	42.0	44.5	43.7	47.3
Switzerland	48.1	45.4	51.1	49.1	54.2
Turkey	51.4	50.2	49.6	52.0	52.3
UK	48.6	45.9	51.7	50.1	51.8
China	48.2	48.4	48.3	48.7	50.1
Hong Kong	-	49.4	52.0	49.7	50.3
India	55.0	54.7	57.5	52.0	58.0
Japan	49.9	50.7	51.1	50.2	50.8
Korea	49.4	51.0	52.0	46.4	51.1
Singapore	-	50.4	50.2	49.5	50.4
Taiwan	49.2	50.5	54.1	47.1	49.9
Australia	47.2	42.4	49.5	50.2	52.9
New Zealand	48.2	55.7	54.0	52.0	53.9
Israel	53.2	0.0	46.3	42.7	52.3
Saudi Arabia	-	60.4	58.7	57.7	62.8
South Africa	48.2	53.6	55.1	49.4	54.2
UAE	-	53.8	52.3	51.7	55.2
% Expanding	12%	27%	30%	15%	58%
% Contracting	61%	48%	33%	61%	18%
% Neutral	9%	24%	36%	24%	24%

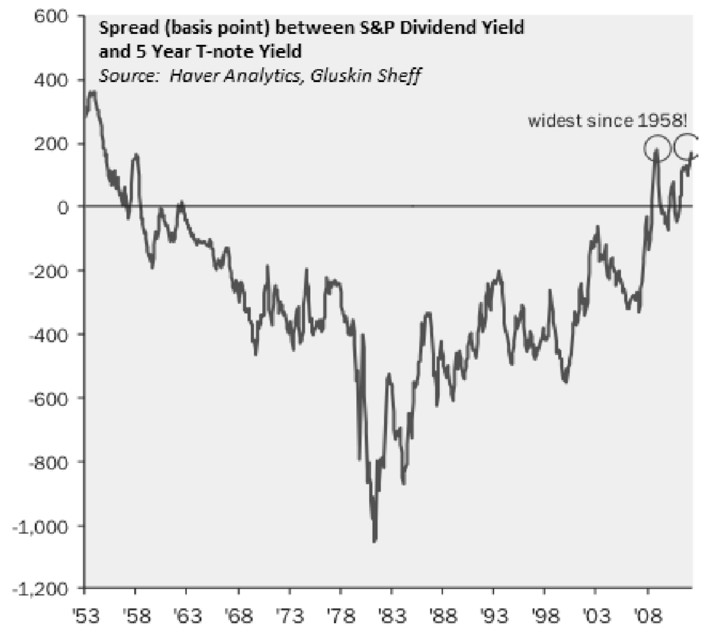
*current percentages do not add to 100% due to PMIs yet to be released

Source: RBC Capital Markets, Haver, Markt

Central Banks have engineered a divorce between the economy and the stock market, a truly epic accomplishment evidenced by major averages butting up against five-year highs while falling industrial production (PMI chart above), employment is still in the doldrums with 26 states reporting month-over-month increases in unemployment in August, (chart below), declining core retail sales, stalling U.S. GDP growth and a recession in the Eurozone.



How is this possible? The Fed has completely altered the relationship between stocks and bonds by engineering increasingly negative real interest rates, (actual interest rate, typically referred to as nominal, less the rate of inflation). Both earnings outlook and the economy are weakening, but the interest rate used to discount them keeps getting more and more negative which mathematically, keeps raising future profit expectations. While earnings aren't exactly looking rosy, the dividend yield on the S&P is about triple the mid-point of the Treasury yield curve, so for those looking for income from their investments, stocks look more attractive than Treasuries, despite less than stellar corporate guidance.



So what does this mean? History has shown that whenever the printing press gets going, inflation eventually follows, yet we've been experiencing deflation. Why?

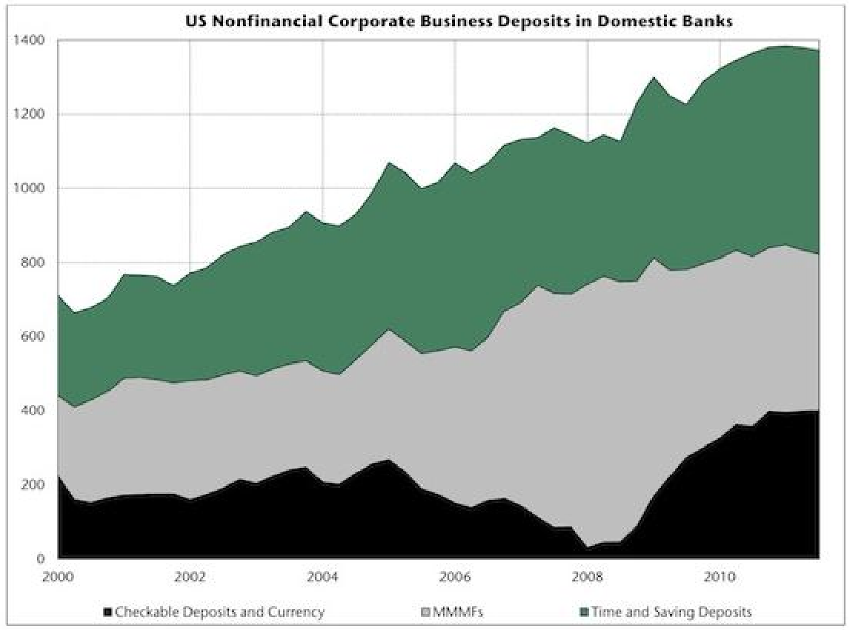
1) Deleveraging: Households, corporations and state and local governments are trimming their finances which has a deflationary impact.

2) Fear: The recent crisis is likely to impact household and corporate finances for decades to come. The western world learned that housing prices don't always go up, salaries don't always continue to increase and it can be incredibly difficult to find a new job. Frugality and saving are the new cool kids. Corporations are facing far

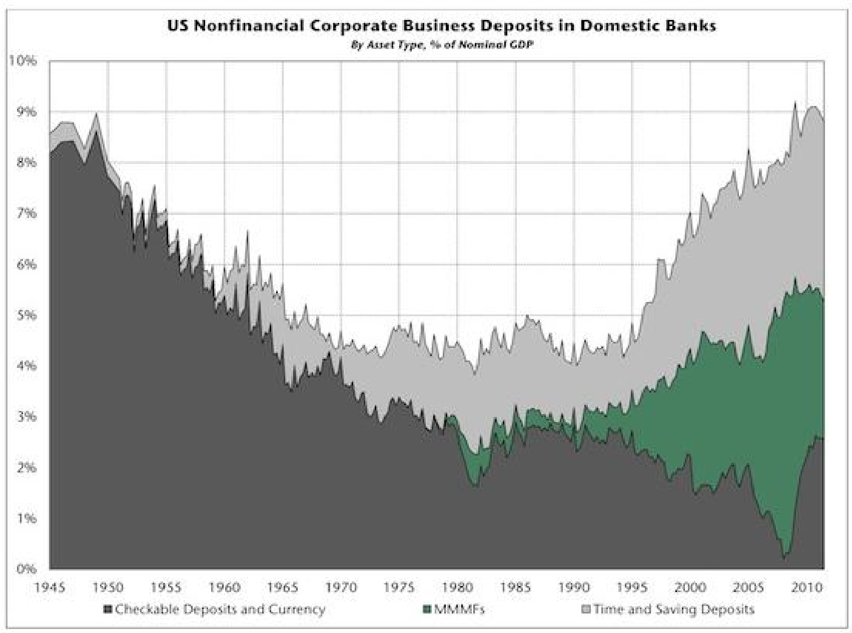
greater levels of uncertainty than is typical as they look to the future. This manifests itself in increasing cash holdings, see following chart.

Corporate Cash Levels

The chart at right shows non-financial corporate "liquid" deposits, broken down into checkable deposits, time deposits and MMMFs. Since 2000 the total has risen from $600 billion to $1.4 trillion. Our annual GDP is just over $15 trillion, so we've got nearly 10% of the annual economy sitting around idle, waiting for someplace to go. If the environment were suddenly to change and businesses no longer felt the need to hold onto so much cash, the inflationary pressures would be significant.



This next chart gives a more historic perspective. Corporate defensiveness is about where it was during WWII.



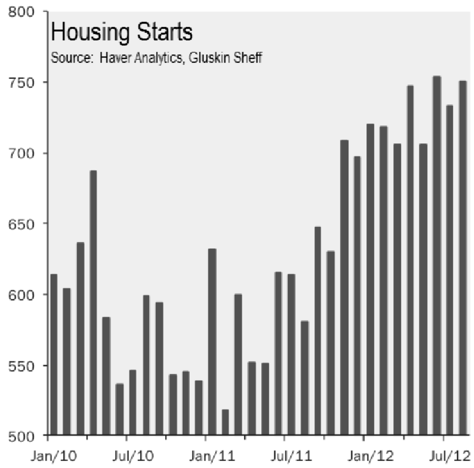
Source: Bloomberg, Fed Z.1

Businesses would ***rather earn zero nominal returns, and guaranteed negative real returns, on a large chunk of capital instead of taking on risk***, now that's fear! The silver lining in this cloud is that lower interest rates have allowed most businesses to refinance debt, which in turn has improved their earnings and strengthened their balance sheets.

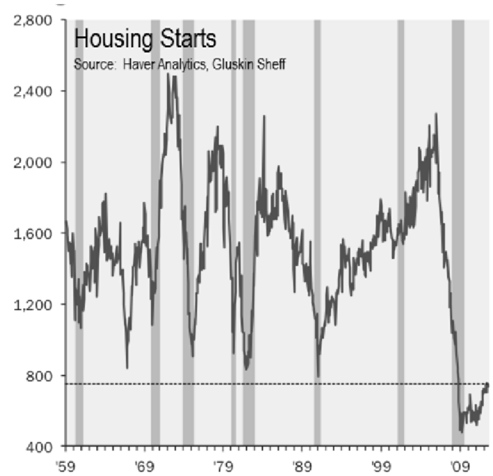
You'll also notice that back in 2006, securities plus mutual fund holdings at non-financial corporations were around $450 billion, today they are $360 billion. You might recall that FDIC insurance was raised from $100k to $250k during the financial crisis. That increase is due to expire at the end of this year, leaving many to predict that these deposits will leave banks and money market mutual funds and go into Treasuries, driving prices even higher and yields even lower.

But wait, there's more! Remember that pesky fiscal cliff? Last week the Bank of America Merrill Lynch survey of global fund managers showed that concern over the fiscal cliff is at 35%, exceeding the share who are worried about Europe's debt crisis, now at 33%, down from 48% a month ago. This might help explain why fund managers continue to be underweight equities, despite the ECB and FOMC announcements.

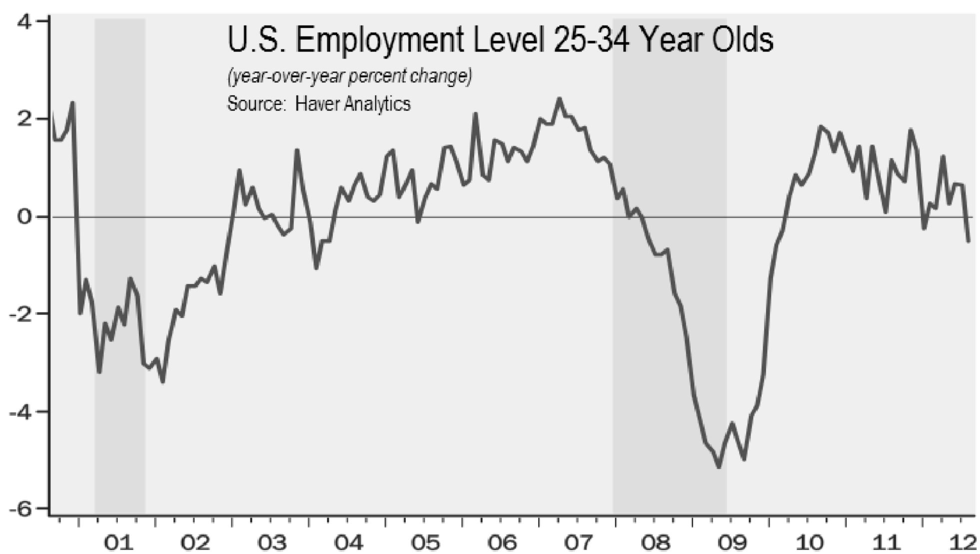
Housing Continues to Improve



Signs of strengthening are continuing in the housing sector, which should boost household confidence. Housing starts rose 2.3% in August to a 750k annual rate and the shorter-term data shows we are moving in a positive direction, (see chart at left). Before we get too excited though, look at the longer-term view on the right to see where we are from a historical perspective, (note that the shaded areas represent recessions).



Part of the ongoing problem comes from the continued struggle with employment. Keep in mind when you hear the unemployment rate is improving that much of the improvement comes from people dropping out of the labor market, thus are no longer unemployed. First-time buyer share of housing turnover activity is in decline and at barely over 30%, which is the lowest since June of last year. The push behind housing at the moment is driven primarily by investors, and that can only take us so far. The 25-34 year old segment of the population has seen jobs decline 263k so far this year with conditions continuing to worsen, (see chart at right). This demographic represents the bulk of the first-time homebuyers, so weakness in employment here is a serious headwind to sustained improvements in housing.



That caution being said, existing home sales did surprise to the upside coming in at 4.82 million units, which was a 7.8% increase and well above expectation of 4.56 million units. Unfortunately, pricing didn't give us the warm fuzzies as both the median and average prices fell last month, indicating a market with excess supply. However, year-over-year home prices continued to rise, so there are still reasons to be optimistic.

Investor buyers continue to dominate, with all-cash buying accounting for 45% of the entire sales turnover in August, up from 43% in July. First-time home buyers dropped from 35% in April, to 34% in July to 31% in August. Improvements have also been fairly regional, as most of the gains in starts and sales over the past three months have been in the Midwest. In August though, sales rose in three of the four regions, slipping only in the South.

Overall, the uptrend in housing continues to look strong, despite the ongoing headwinds.

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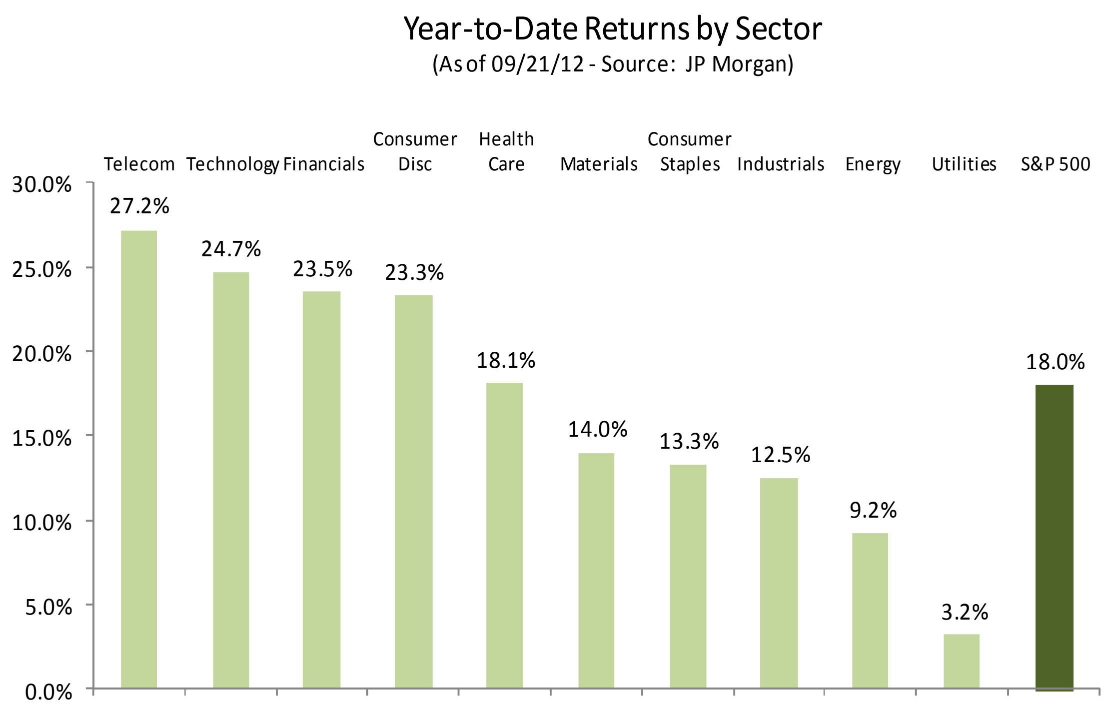
Market Recap

Index Levels	Close 09/21/12	Year End 12/30/11	Year Ago 09/21/11	Commodities	Close 09/21/12	Year End 12/30/11	Year Ago 09/21/11
Dow Jones 30	13,579	12,218	11,125	Gold	1,784.50	1,531.00	1790.00
S&P 500	1,460	1,258	1,167	Crude Oil	92.89	98.83	85.92
Nasdaq	3,180	2,605	2,538	Gasoline	3.88	3.26	3.60
Russell 2000	856	741	665				
Bond Rates				**Index Characteristics**	**P/E Forward**	**P/E Trailing**	**Dividend Yield**
Fed Funds Target	0.25	0.25	0.25	S&P 500	13.49	16.28	2.19%
2 Year Treasury	0.26	0.24	0.20	Russell 1000 Value	12.14	14.34	2.57%
10 Year Treasury	1.76	1.87	1.87	Russell 1000 Growth	15.81	18.10	1.60%
10 Year Municipal	2.12	2.45	2.73	Russell 2000	18.58	23.45	1.45%
High Yield	6.26	8.36	8.65				



Wrap Up: The markets are once again getting jittery, and this time it is unclear if the Central Bankers will be able to pull another set of rabbits out of their collective hats given that the last round was essentially a "to infinity and beyond" policy. It would be very easy to get down these days and put one's head in the sand, but if we take a longer-term perspective, the U.S. and the global economy has survived multiple world wars, the collapse of a nuclear super power, horrific terrorist attacks... I could go on and on. Despite all that, the world didn't end, fortunes continued to be made, people continue to fall in love, have children and shoot for the stars despite the hang-wringing on TV. As my mother always says, this too shall pass, and so it shall. Throughout whatever comes, we will be at our clients' side, ever vigilant, ever thorough and ever humbled by your trust.

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