MERITAS ADVISORS
Comprehensive Wealth Management

Monthly Investment Outlook

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Strength and Stability in Volatile Times

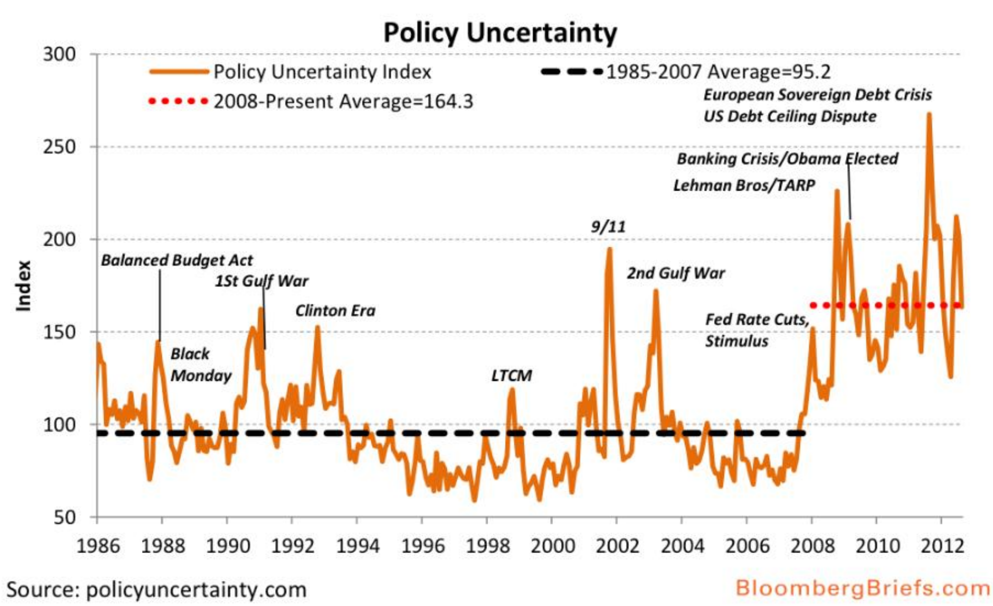
Our mission is to generate stable real returns, regardless of the direction of the economy, while providing the highest level of service and exceeding expectations in performance, planning and communication.

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: Last week the S&P500 declined for the third week out of the last four, down 2.2%, with Technology stocks leading the decline. We expect this week to be an interesting ride as 80 S&P 500 companies will report earnings and 11 pieces of economic data will be released. Estimates for Q3 earnings are now at a 3% decline year-over-year, still falling from a forecasted 2% decline as of the beginning of the month. Meanwhile consumer sentiment has just jumped to a five-year-high. Things are getting interesting!
Lenore Hawkins, MBA, Principal

Policy Uncertainty

One of the most powerful forces in the market these days is uncertainty. Investing using the theory of efficient markets is a reasonable strategy in a relatively stable political and economic environment. Granted, stability is always a relative term, and there has never been a truly "stable" time, but there are times of increased uncertainty and increasing rates of change. We are currently in such an environment, as the chart below illustrates, thus investment strategies must evolve as conditions change. The European Central Bank and the Federal Reserve recently removed part of the market tail risk, (meaning risks that have a low probability but high impact) namely liquidity risk. But that has not addressed the issues around solvency and barriers to economic growth.

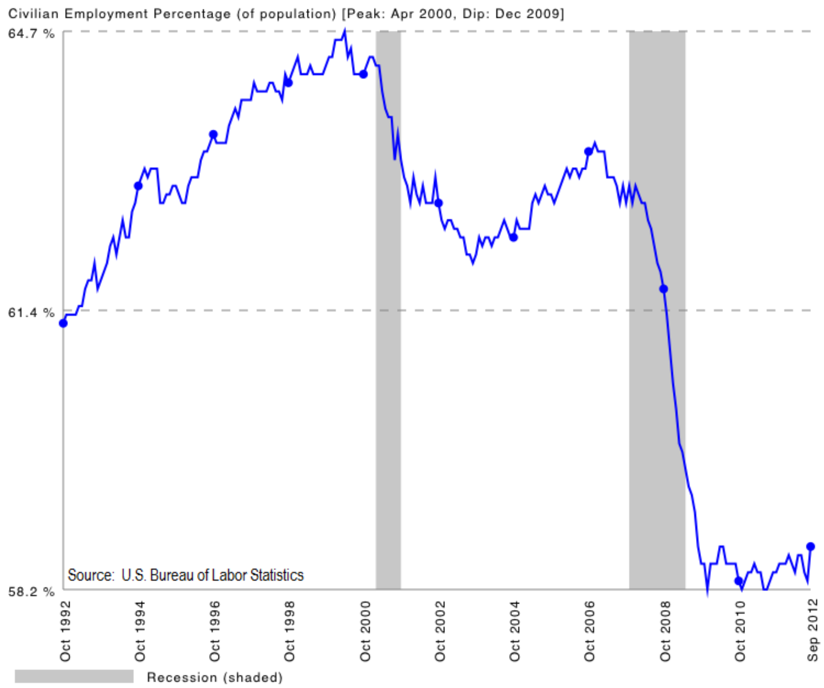


So what is an investor to do? Opinions vary widely as to how to manage the current climate, even among the most famous investment professionals. Blackrock's Larry Fink claims the key is to be 100% in equities. Bill Gross of PIMCO fame maintains that equities are dead, while Jack Bogle argues investors should stay the course with a balanced portfolio. The only thing they all agree on is that current market conditions do not provide the same return potential for either stocks or bonds, seeing tougher times ahead for all financial assets.

Bottom Line: *We believe that when we look at future earnings and the economy, the majority of stocks are currently overvalued. It is interesting to note that Treasuries have outperformed the S&P500, (dividends included) for over 13 years! We believe that many risks are currently being overlooked or are at least underweighted by the markets, such as a U.S. recession, the ongoing financial/banking disaster in the Eurozone, and the budgetary and national debt problems in the U.S. We also believe that there are considerable risks in bonds, relative to their potential return because the U.S. has benefited from exceptionally low monetary velocity, which we discuss at length in a later section of this newsletter. This has allowed the Federal Reserve to essentially triple the monetary base without any meaningful inflation, since velocity has declined proportionally as households, corporations and foreign governments have been content, so far, to hold significantly higher levels of U.S. dollars than is the historical norm. This is a time for considerable caution and not a time to get caught up in temporary, seductive market swings.*

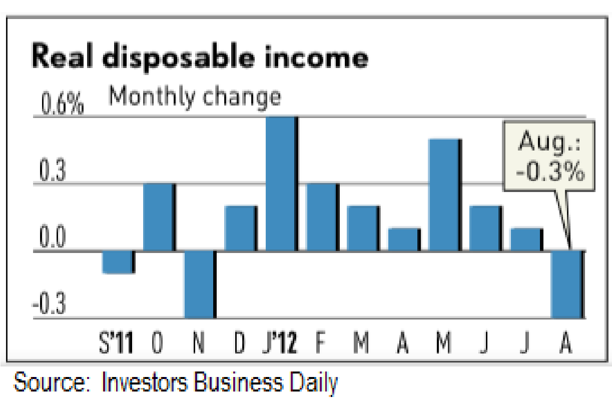
Unemployment

This month there was much cheering on the news that the unemployment rate had finally fallen below 8%. As we've mentioned before, this number is of little use other than for grabbing headlines as it does not take into account those individuals who have given up looking for work. As you can see from the chart at right, employment as a percent of the population is still rather range-bound since the great plummet that ended in Dec of 2009, with this number at 58.2%. We are now at 58.7%, up 0.5% from September 2011. The JOLTS data, (Job Openings Labor Turnover Survey) provides much more useful information. We learned last week that there is a good deal more going on in the labor market, with job openings falling 32,000 in August, down for a second month and now at the lowest level in four months. Layoffs have unfortunately accelerated with a 266,000 increase, the most in a decade. On the bright side new hires did rise 112,000 (2.6% increase), but comes on the heels of two consecutive monthly declines. **Bottom Line**: *Very little real progress here which means a continuing drain on the economy.*

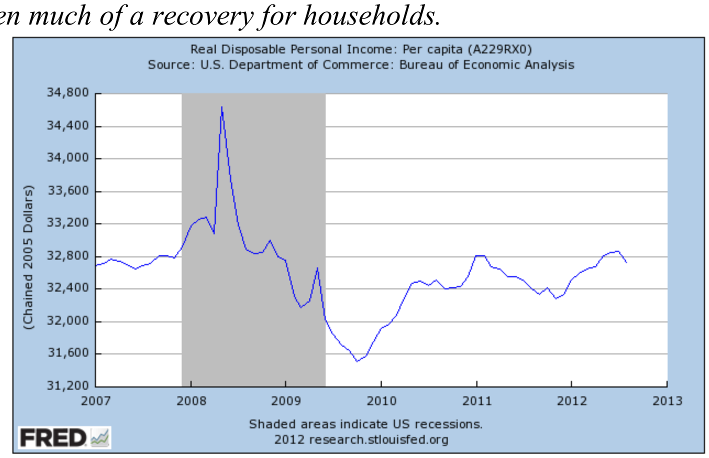


Household Income

As if the employment situation didn't warrant enough concern, household income isn't exactly peachy either, falling 0.3% in August and still at 2007 levels. On October 16th we learned that real average hourly earnings fell 0.3% in September. **Bottom Line**: *So far, we've not seen much of a recovery for households.*

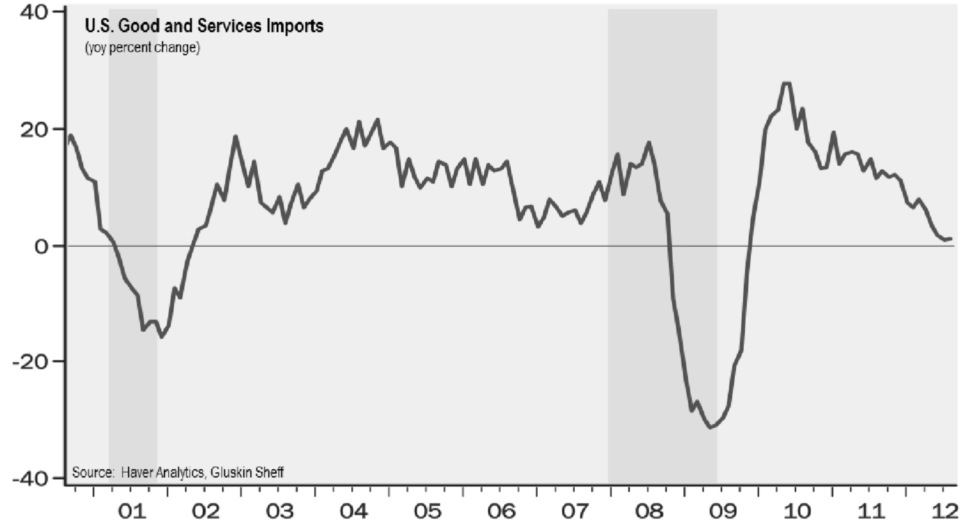


Source: Investors Business Daily

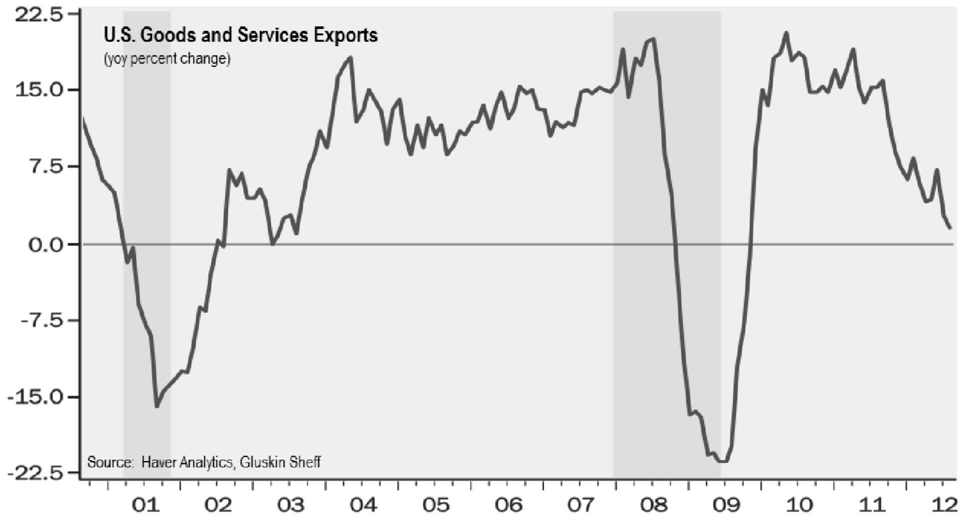


Imports, Export, and GDP

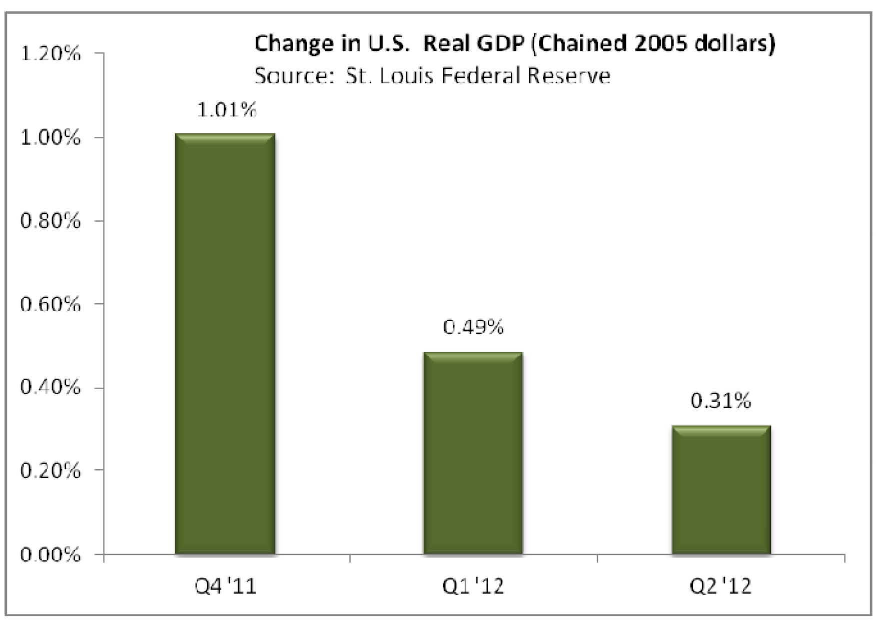
It isn't surprising to see household income and unemployment struggling when we look at imports, exports and real GDP growth. The import of goods and services into the United States has been steadily declining after the initial rebound in 2010 from 2009 lows, as is shown on the chart at right.



We see a similar trend in exports of U.S. goods and services to the rest of the world, which is consistent with the slowing of the global economy. There was an initial rebound after the 2009 lows, but that rebound was very short-lived, with rapid declines since then.



We've also experienced a consistent decline in real GDP, quarter after quarter since the last quarter of 2011. **Bottom Line**: *On a broad-based level, there are signs of continuing economic contraction, which doesn't bode well for longer-term corporate earnings, which translates into lower stock prices unless there is an increase in price to earnings ratios.*



U.S. Exporting oil?

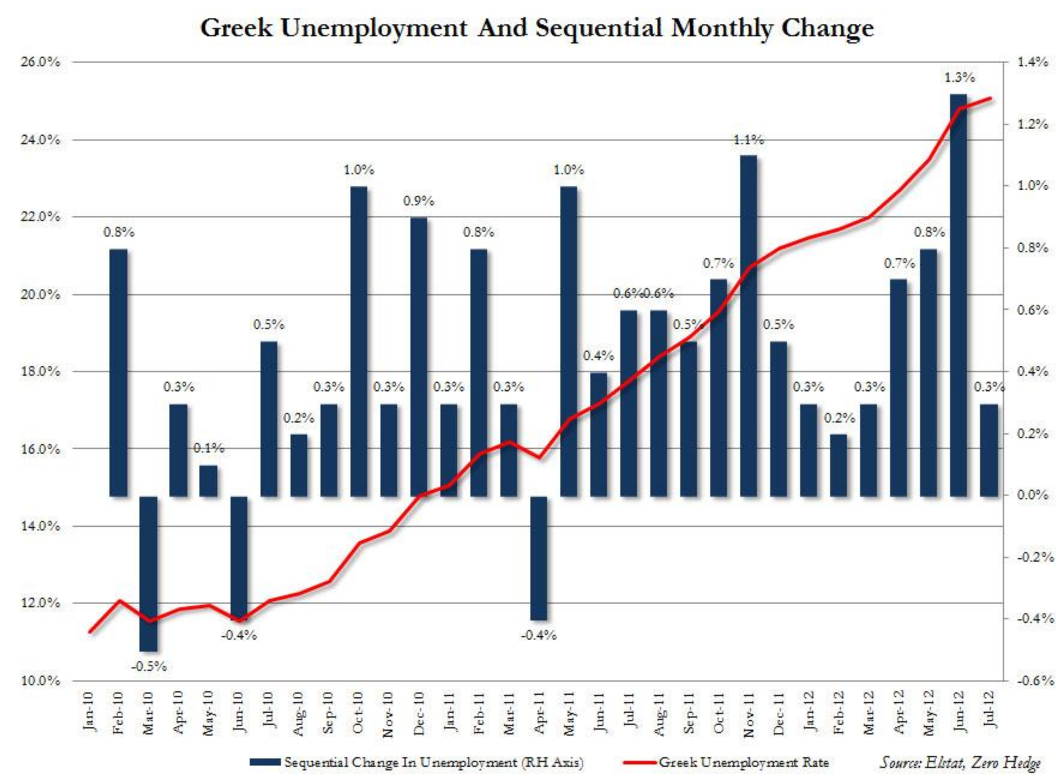
One potentially bright spot for the domestic economy lies in the energy sector. On October 11th, Royal Dutch Shell Plc announced that it had applied for a permit from the U.S. Department of Commerce to export crude oil in a sign of how a boom in U.S. oil production from shale rock is reshaping the country's role in the global energy marketplace. The revolution in hydraulic fracturing technology that has coaxed large volumes of light sweet oil from shale rock previously thought unprofitable has generated an unprecedented boom that the U.S. Energy Information Administration (EIA) says will bring U.S. production to its highest level in nearly two decades next year. Oil production in the U.S. totaled 194 million barrels of crude oil in July, the most in 14 years according to the latest data from the EIA. **Bottom Line:** *Increased energy production can help bolster employment and reduce our dependence on foreign supplies, which many believe is a source of political weakness for the nation.*

Declining impact of Quantitative Easing

	Announcement Date	S&P close prior day	14 Trading Days Later Close	Impact
QE1	11/25/08	851.81	913.18	7.20%
QE2	08/28/10	1,064.59	1,125.59	5.73%
Operation Twist	09/21/11	1,202.09	1,195.54	-0.54%
LTRO	12/21/11	1,241.30	1,295.50	4.37%
QE3	09/13/12	1,436.56	1,450.99	1.00%

The last three charts showed how economic activity for the U.S. has been continually declining, despite the attempts by the Federal Reserve to stimulate the economy using Quantitative Easing. This policy has also had less and less of an impact on the stock market with each successive program. **Bottom Line:** *As the chart at right illustrates, all the quantitative easing projects are losing whatever effectiveness they may have had while the global economy continues to lose momentum and Europe is becoming unglued... again. Despite this lackluster impact, the Bank of Japan is loudly hinting at further easing! In Spain we've seen a national strike and violent demonstrations, meanwhile S&P just downgraded its sovereign debt to BBB- with a negative outlook, just two weeks after Egan-Jones dropped it to CC. In Portugal widespread demonstrations have already forced the government to shift policy and focus more on tax hikes than spending cuts. Greece is descending into economic Dante's inferno.*

Greece



The situation in Greece has hit a level of horror that is difficult to comprehend, with unemployment rising for the 35th consecutive month, hitting a record high of 25.1%. Youth unemployment, (those 25-years-old and under) is a mind boggling 55.4%. Youth unemployment for extended periods effectively creates a permanent economic drain on a nation because that cohort isn't able to develop the necessary skills during key times in their lives. This level of unemployment means that labor related taxes are being paid by a record low percentage of the population. GDP has decreased by ú47 billion in the last five years, with 5 years of recession. **Bottom Line**: *There is no way out for this nation as long as it remains within the unified currency. Its economy will continue to contract and unemployment will continue to rise until the pressure gets so great that we have massive riots and perhaps even some level of civil war. It is horrifying to see what the people of this nation are being put through to further political goals thousands of miles away. Clearly the fear is that if Greece exits, pressure will increase dramatically on Spain, which is rapidly losing its footing and is far too large for any bailout mechanism the euro-politicians can devise. Keeping Greece within the Eurozone is simply prolonging its agony and postponing the inevitable in hopes that Spain can right itself before it is too late.*

Money Supply, Inflation and Deflation

There has been a lot of talk lately about the *inflationary* policies of the U.S. Federal Reserve under Ben Bernanke and the European Central Bank under Mario Draghi versus the *deflationary* forces from the financial crisis. We thought in this month's newsletter we'd go over the topic of inflation vs. deflation and why it can be difficult at times to understand the talking heads on TV or what you read in the newspapers.

First, *there is no universal standard definition for inflation*. Inflation is generally viewed as a **decline in the purchasing power of money, resulting in rising prices**. The disagreement comes in when we talk specifics. Some will argue that any increase in the price of something is inflationary. For example, suppose that we learn tomorrow that chocolate cures cancer. Yours truly would be in a level of nirvana that is heretofore unknown, but putting that aside, we can easily imagine that the demand for cocoa and chocolate products would rise considerably. Given that cocoa comes from a plant, the supply of cocoa could not be immediately increased, thus if the demand for something rises substantially but the supply doesn't, prices should go up. Some will argue that chocolate is facing inflationary pressures. For the record, I disagree. That's not inflation, that's an increase in demand outpacing potential increases in supply.

I subscribe to the Milton Friedman view of inflation. In 1963 he wrote, "*Inflation is always and everywhere a monetary phenomenon*," meaning that inflation, an increase in the general level of prices for all goods and services, is driven by increases in the money supply. Prices for individual goods and services are driven by changes in supply and demand for the specific products or services.

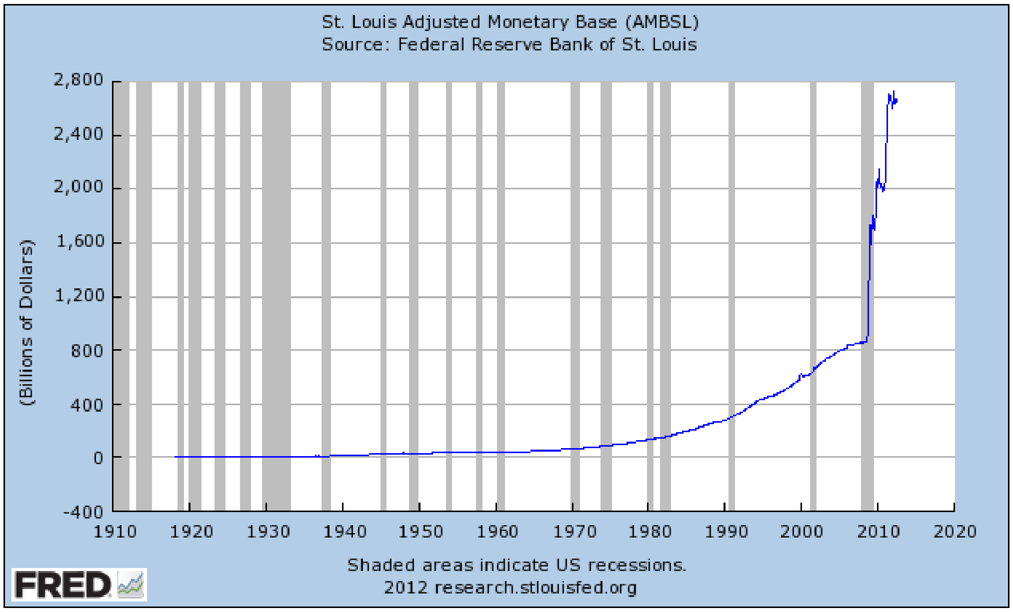
So what is the money supply and how does it relate to inflation? Anna Schwartz, an American economist who was best known for her collaboration with Milton Friedman on <u>A Monetary History of the United States</u> and according to Paul Krugman was, "one of the world's greatest monetary scholarsò) describes the money supply as *comprising currency - dollar bills and coins issued by the Federal Reserve System and the U.S. Treasury - and various kinds of deposits held by the public at commercial banks and other depository institutions such as thrifts and credit unions*. These measures correspond to various definitions of money starting with M0 (the monetary base), the moving on to M1, M2, M3 and so on with each successive definition including broader substitutes for money such as money market funds and longer-term deposits like CDs.

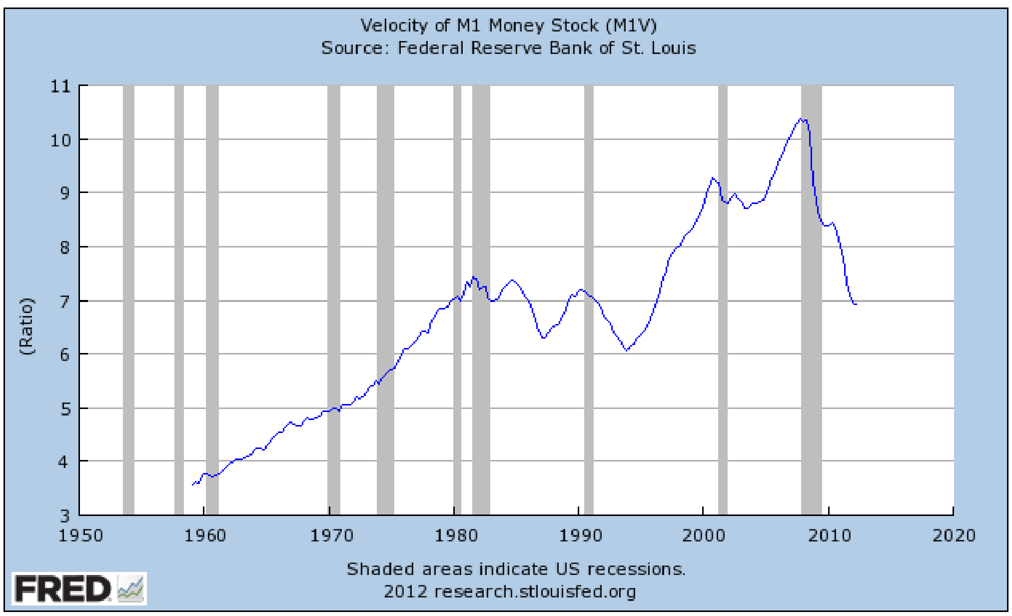
Money is used in virtually all economic transactions, thus it has a powerful effect on economic activity. An increase in the supply of money works both through lowering interest rates, which spurs investment, and through putting more money in the hands of consumers, making them feel wealthier, and thus stimulating spending. Businesses respond to increasing sales by ordering more raw materials and increasing production. The expansion of business activity increases the demand for labor and raises the demand for capital goods, (factories, machinery, tools, etc.). In a healthy economy, stock market prices rise and firms issue equity and debt. If the money supply continues to expand, prices begin to rise, especially if output growth reaches capacity limits. As the public begins to expect inflation, lenders insist on higher interest rates to offset an expected decline in purchasing power over the life of their loans.

The opposite effect occurs when the supply of money decreases or when its rate of growth declines. Economic activity is reduced and either disinflation (reduced inflation) or deflation (falling prices) results.

The monetary base in the United States was dramatically expanded by the Federal Reserve in response to the financial crisis as the chart at right illustrates.

Pretty dramatic isn't it? So why haven't we already experienced high inflation with such a shock? The answer lies in the velocity of money, which reached its peak in early 2008, and has dropped substantially since then, as is shown in the chart below at right. So what does the velocity of money have to do with anything? So very glad you asked!





Velocity of Money

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

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

You can think of this as the Money Supply x Velocity of Money = GDP (roughly, itӳ a bit more complicated than this, but we'll use this summary to keep it simple and get the concept straight).

To understand the importance of *velocity*, letӳ look at a very small economy with a farmer and a tailor with $50 between them. They buy goods and services from each other in just three transactions over the course of a year.

- Farmer spends $50 on a new suit and shirt from the tailor.
- The tailor buys $40 of corn and butter from farmer.
- Later, 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*.

Inflation

Let's now look at how the money supply affects prices using another example.

If M (money supply)=10, V(velocity) =2 and Q (quantity of goods available to buy)=4.
Then 10x2 = Px4 20 = 4P 20/4 = P P=5. So the average price of goods is 5.

It takes time and investing to increase the amount of goods and services a country can produce, but prices can be immediately adjusted up or down, so if M (money supply) doubles to 20 while V (velocity) and Q (quantity) remain unchanged we would have the following:

20x2=Px5 40=5P 40/5 = P P = 8 (Prices have increased 60%)

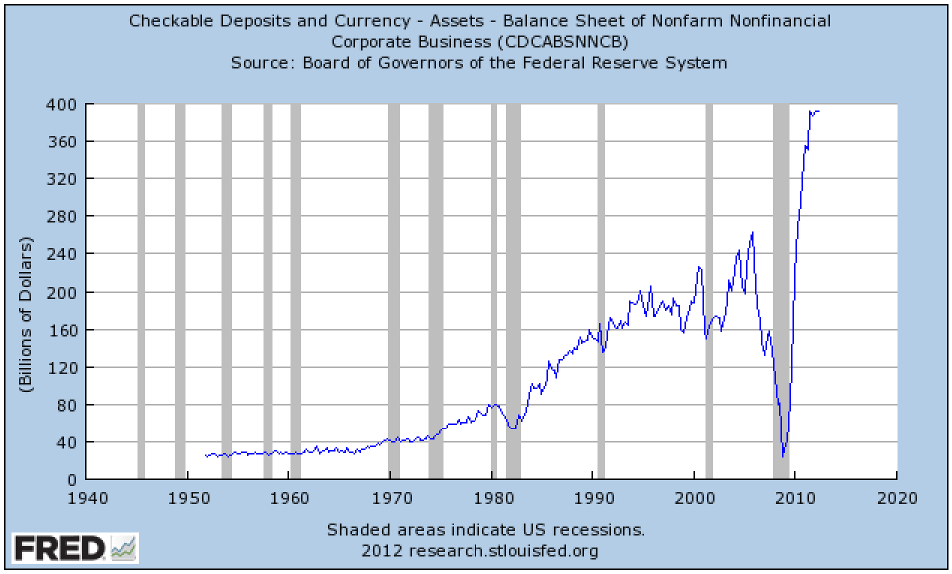
If the economy is not able to increase *Q* (*Quantity of goods and services)* to a sufficient degree relative to the increase in the Money Supply, (assuming velocity remains either unchanged or increases), that leaves only *P (Prices)* left to increase. This is how an increase in the supply of money causes inflation.

Deflation

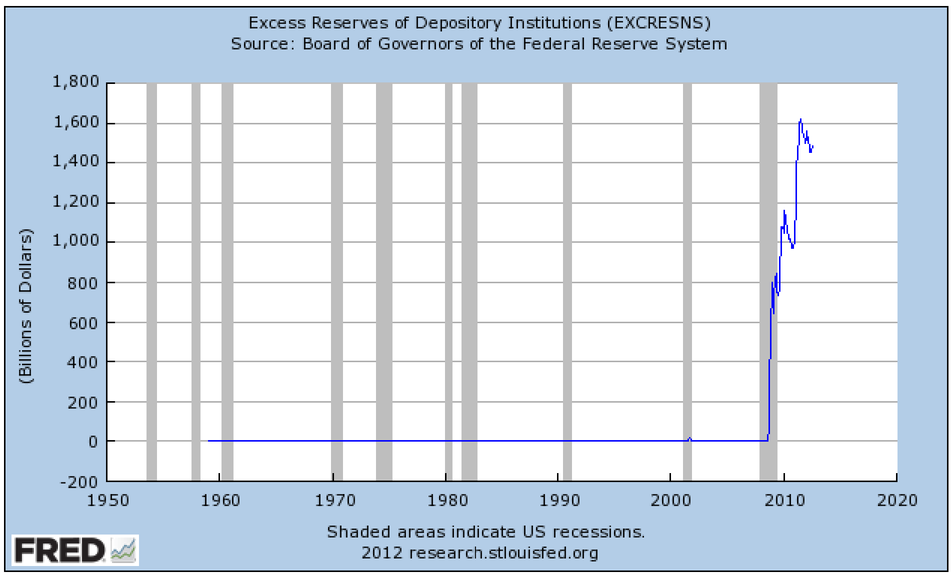
On the earlier chart we say that the money supply as measured by the monetary base has increased from about $800 billion to $2.66 trillion and increase of 2.3x! Yet we haven't seen rampant inflation. This is in part because the velocity of money has dropped from nearly 10.5 to under 7. So why would the velocity of money decline?

You've probably heard about all the cash businesses are now holding onto, well above their historical norms. The chart at right shows how corporate cash plummeted in the depths of the financial crisis, thus the panic, and is now at record level highs. Cash that just sits there slows down the velocity of money.

The chart at right shows the record high level idle cash held by businesses. They aren't the only ones keeping extra cash on hand though, banks as well have record high excess reserves on hold at the Federal Reserve as the chart below on the right illustrates. Not only are businesses nervous about making sure they have enough cash on hand in case of emergency, but banks too are skittish.

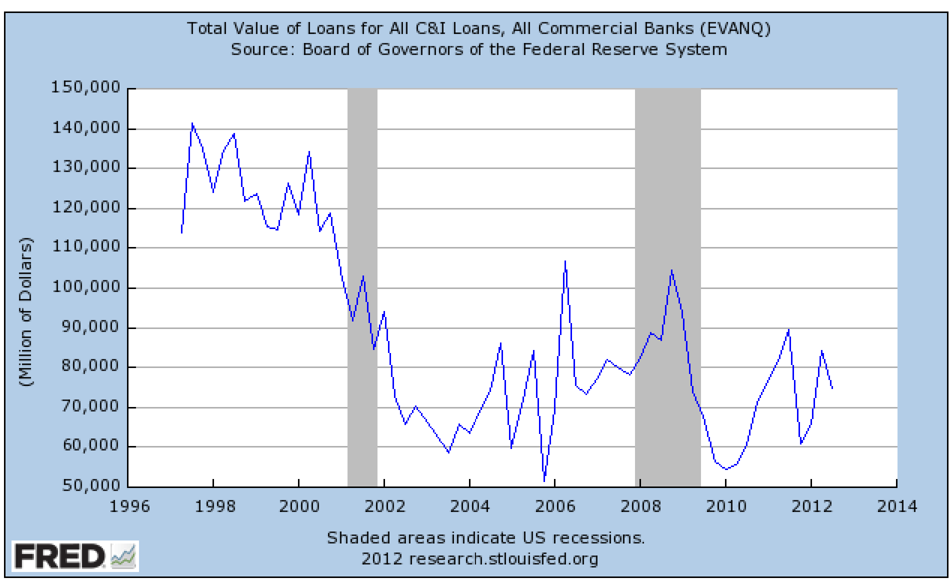


The next chart at right shows that the value for all commercial and industrial loans has also been declining, meaning that businesses are reducing their loans, or the amount of money they are borrowing.



Businesses are also reducing their levels of commercial paper(promissory notes with a fixed maturity of less than a year).

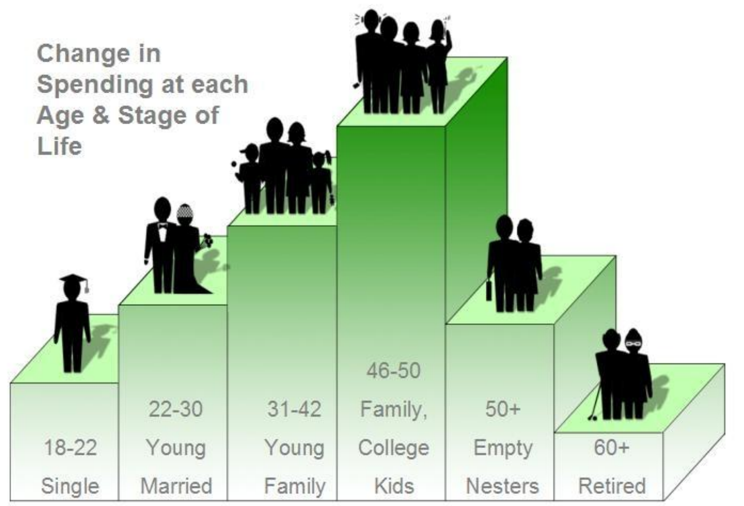
Bottom Line: *Businesses and banks are reducing lending and increasing cash, which slows the velocity of money. These actions help to counter the inflationary impact of the Fed's increase in the money supply. The challenge lies in how to handle all those excess reserves if and when the banks start lending and businesses start spending. That could result in a dramatic increase in the amount of money moving around in the economy and no longer lying idle in reserves, which would result in inflation.*



Answering our clients' questions

Last month we mentioned that we are experiencing deflation because of (1) deleveraging by households, corporations, state and local governments, and (2) fear, which is increasing the desire to hold cash. One of our clients had a very good question concerning the possibility of a third driver of deflation, namely demographics. The United States, Europe, Japan and China are all facing aging populations, meaning that there are more and more people in the senior/retired category per every working person.

According to Harry Dent, the most powerful economic force on earth is demographics, with peak spending occurring between 46-60 years old. He believes that peak spending rolled over for the first time in 2007, and the stock market rolled with it. If the economy continues to follow the historic spending wave, we're in for another lean 12 years, as the next peak spending pickup is not scheduled until 2022! This is due to the fact that baby boomers are now past peak spending - and we've got over a decade until the next "baby boomlet" hits peak spending stride.



As the baby boomers move through the empty nesters phase and into the retired phase, their overall spending will, as the chart above indicates, slow. The question posed to us is whether or not that is deflationary. A complete answer would be it depends on your definition of deflation/inflation. This group will reduce their spending in most areas of consumption, thus one could argue that aggregate domestic demand will decline. I would argue that a decline in demand will result in either a reduction of prices or a reduction in supply, or some combination of both.

Bottom Line: *This is not deflationary, but rather a shift in demand. I would also like to point out that with increasing age, the demand for medical products and services increases, thus we would expect to see a rise in demand in this sector of the economy with the aging boomer population. Again, this is not inflationary pressure in the healthcare sector, but simply an increase in aggregate demand that is likely to outpace the potential increase in supply, thus prices will be pushed higher.*

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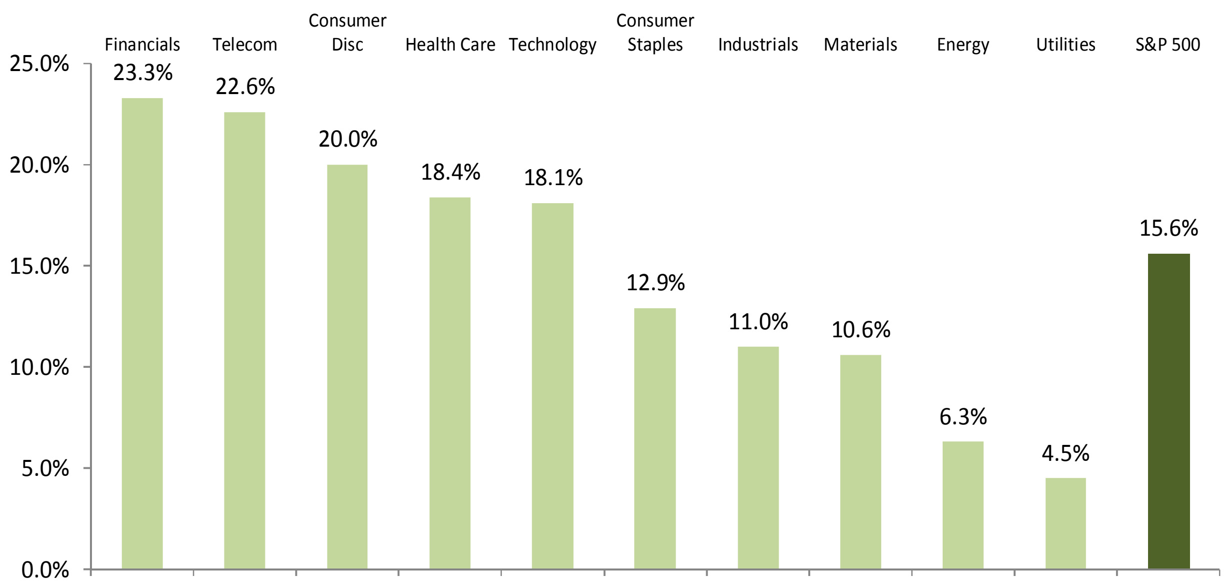
Market Recap

Index Levels	Close 10/15/12	Year End 12/30/11	Year Ago 10/12/11	Commodities	Close 10/15/12	Year End 12/30/11	Year Ago 10/12/11
Dow Jones 30	13,329	12,218	11,519	Gold	1,766.75	1,531.00	1,682.00
S&P 500	1,429	1,258	1,207	Crude Oil	91.86	98.83	85.57
Nasdaq	3,044	2,605	2,605	Gasoline	3.85	3.26	3.42
Russell 2000	823	741	700				
Bond Rates				**Index Characteristics**	**P/E Forward**	**P/E Trailing**	**Dividend Yield**
Fed Funds Target	0.25	0.25	0.25	S&P 500	13.15	16.04	2.24%
2 Year Treasury	0.27	0.24	0.29	Russell 1000 Value	11.88	14.62	2.51%
10 Year Treasury	1.66	1.87	2.23	Russell 1000 Growth	15.36	19.20	1.61%
10 Year Municipal	2.01	2.45	3.18	Russell 2000	18.14	25.04	1.41%
High Yield	6.44	8.36	9.36				

Year-to-Date Returns by Sector
(As of 10/15/12 - Source: JP Morgan)



Wrap Up: The S&P 500 has declined in three of the past four weeks. Congress doesn't appear to be any closer to preventing the so-called fiscal cliff, the Greek Troika talks just ended abruptly with the two sides reportedly in complete disagreement. Spain is getting closer and closer to needing to beg for a bailout, and the U.S. is inches from hitting its debt ceiling again. In other words, we're in Groundhog Day...again! We are reminded of Herbert Stein's Law, "If something cannot go on forever, it will stop." This endless kicking of the can and monetary policy induced stock market bounces cannot go on forever, reminding us of Bob Farrell's Rule #5, "The public buys the most at the top and the least at the bottom." Caution and patience continue to be of upmost importance as we watch for the inevitable tipping point.

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