MERITAS ADVISORS
Comprehensive Wealth Management

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MONTHLY INVESTMENT OUTLOOK

In This Issue:

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: While most of us are enjoying the good cheer of the holiday season, we feel we must take a minute to reflect on the unspeakable national tragedy that occurred on December 14. We never imagined that we would spend part of the morning reading bios in the Wall Street Journal for five and six-year-olds that had been shot, alongside those of the adults who died trying to protect them. The pain of their families is truly unimaginable and our hearts go out to them. Such acts of senseless horror remind us of just how fragile life is, despite the seeming safety of our modern world. In the blink of an eye, everything can change. During this time of national grief, let us all remember how important it is to not let the day-to-day hustle and bustle distract from what is most dear to each of us. Hold those you love close and let them know just how precious they are. We wish you all a joy-filled holiday season, surrounded by those you love, full of laughter and the warmth that comes from knowing you are exactly where you want to be.
Lenore Hawkins, MBA, Principal

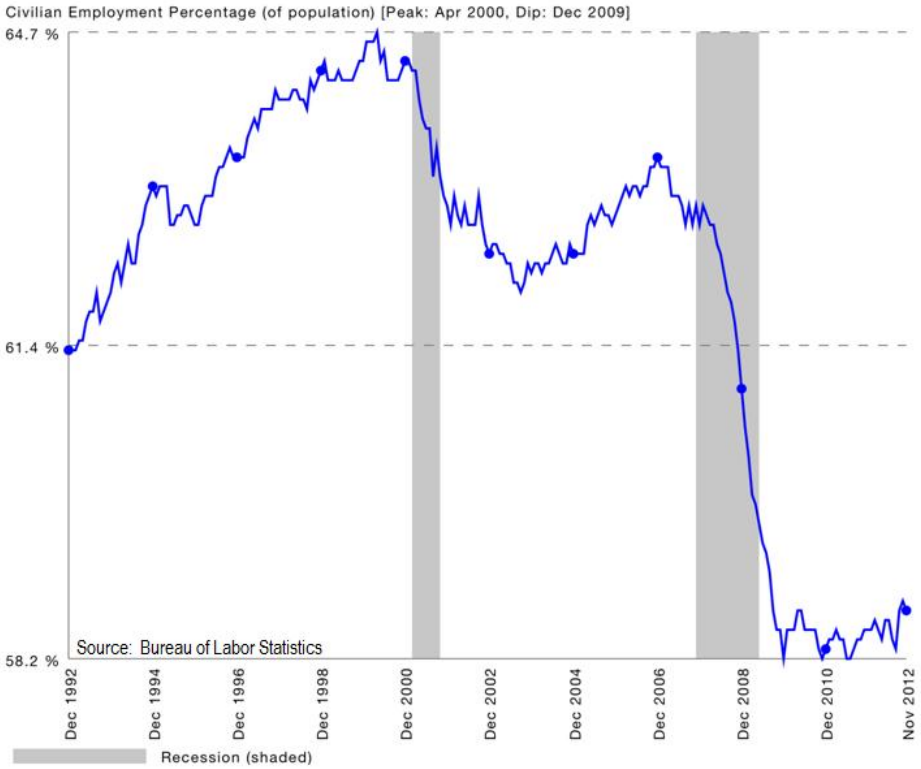
Fiscal Cliff

If Congress and the White House are unable to come to some sort of an agreement on the fiscal cliff, the U.S. is likely headed into a recession. If no agreement is reached, unemployment benefits will drop from 99-weeks back to 26 weeks and payroll taxes on employees will rise from 4.2% to 6.2%. According to the Brookings Institution and the Urban Institute, about 90% of American households will pay higher taxes in 2013 post-cliff. Due to progressive tax rates, the top 20% with incomes over $244,576 would pay 60% of the increase and the bottom 20% would pay 3.7% of the increase. A couple earning $350,000 would see their federal taxes rise by $13,847 or a 20.3% increase. A couple earning between $20,000 and $30,000 would see their taxes increase 5.6% or $1,423. Most concerning, Timothy Geithner announced on December 26th, that the U.S. would hit its statutory debt limit on December 31st, significantly earlier than the Treasury's previous estimates. **Bottom Line**: *According to the Congressional Budget Office, going over the cliff would reduce GDP growth by 2.9%. For a nation with barely 2% growth, this would be a bitter pill. Reaching the debt ceiling without any plan in place, puts the country in a challenging position to pay its bills.*

Manufacturing

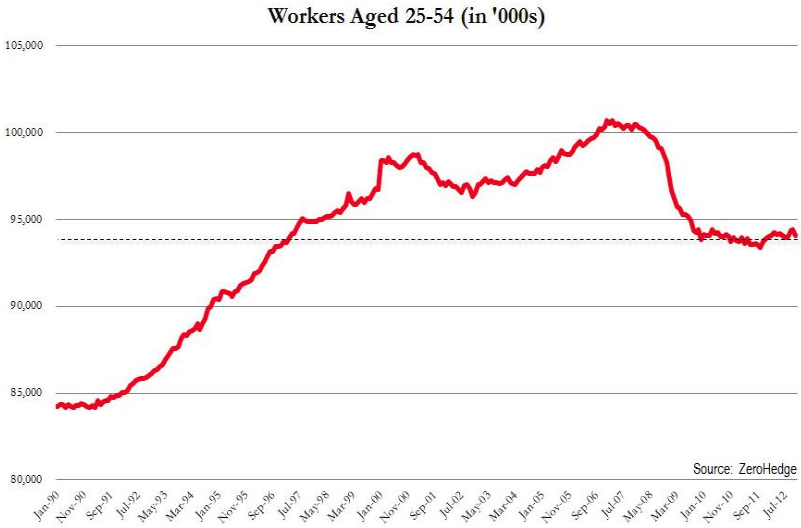
The U.S. manufacturing sector fell back into contraction last month and employment weakened sharply, according to data released by the Institute for Supply Management. The ISM's purchasing managers' index unexpectedly fell to 49.5 in November from 51.7 in October. A reading below 50 indicates shrinking activity. Economists surveyed by Dow Jones Newswires had expected the index to fall but only to 51. **Bottom Line**: *The looming fiscal cliff and global contraction is having an impact on business activity, which in turn affects employment, which affects housing and any potential recovery for the consumer.*

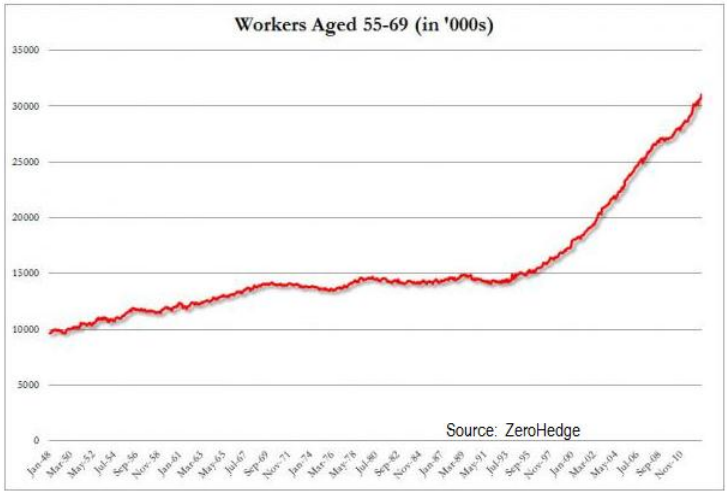
Unemployment



The FOMC released their statement on December 12th with two surprises. First, the mid-2015 date to keep Fed Funds at 0 ï 0.25% was replaced with numeric thresholds. Front end rates are anticipated to remain low ñat least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half a percentage point above the Committeeôs 2% longer run goal, and longer-term inflation expectations continue to be well anchored.ò This is the first time that rates have been tied to numeric thresholds, with a specific focus on the unemployment rate. Meanwhile, the unemployment situation, despite the headlines, continues to look grim. The chart at above shows that employment, as a percent of the population, continues to be significantly below historical norms.

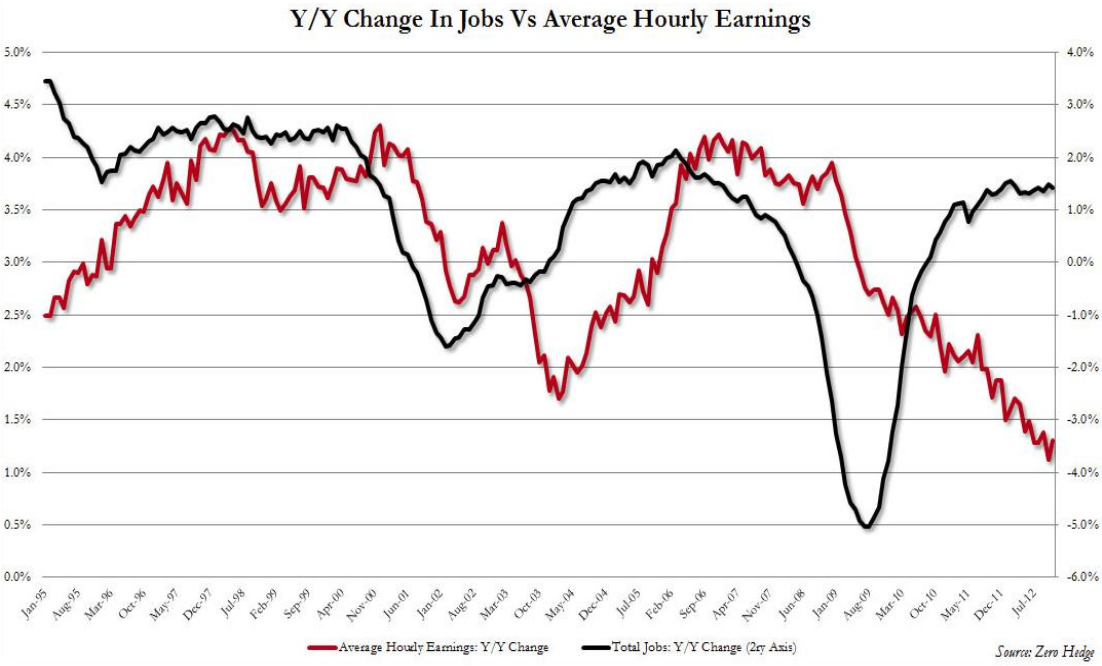
The chart at right shows the number of workers in the most productive and lucrative age group, those 25-54. This chart shows that in the past fifteen years, no jobs have been gained in this group. Given the aging population in the U.S., this is particularly troubling as there is no good demographic reason for this lack of growth.





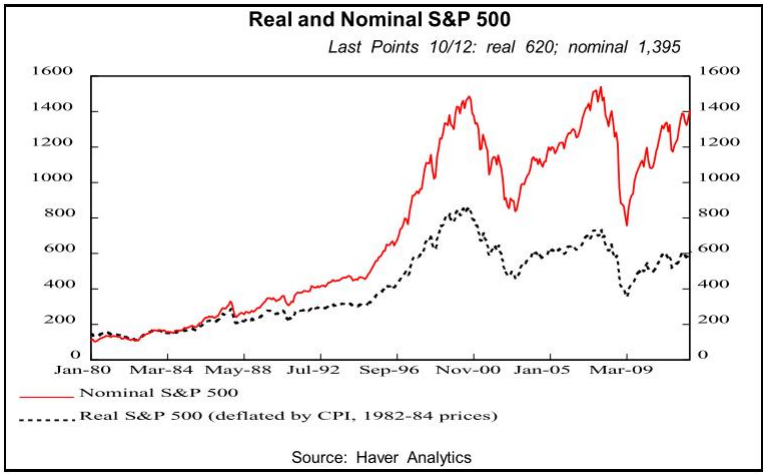
For those who argue that the continuing lag in the percentage of the population employed is due to the aging population, thus increasing rates of retirement, the chart at left illustrates that we are experiencing the exact opposite, with new jobs primarily going to those aged 55-69.

The chart at right shows that average hourly earnings have continued to fall alongside any new jobs. This means that new jobs are paying at much lower rates than prior ones, which in turn affects consumers' ability to spend and save.



Consumer Spending

Household income continues to drop. The level of equity for the average mortgage-holder has dropped from almost 50% of their homeôs value in the early 1980s to around 24% today. Moreover, nearly 25% of mortgages are currently underwater.



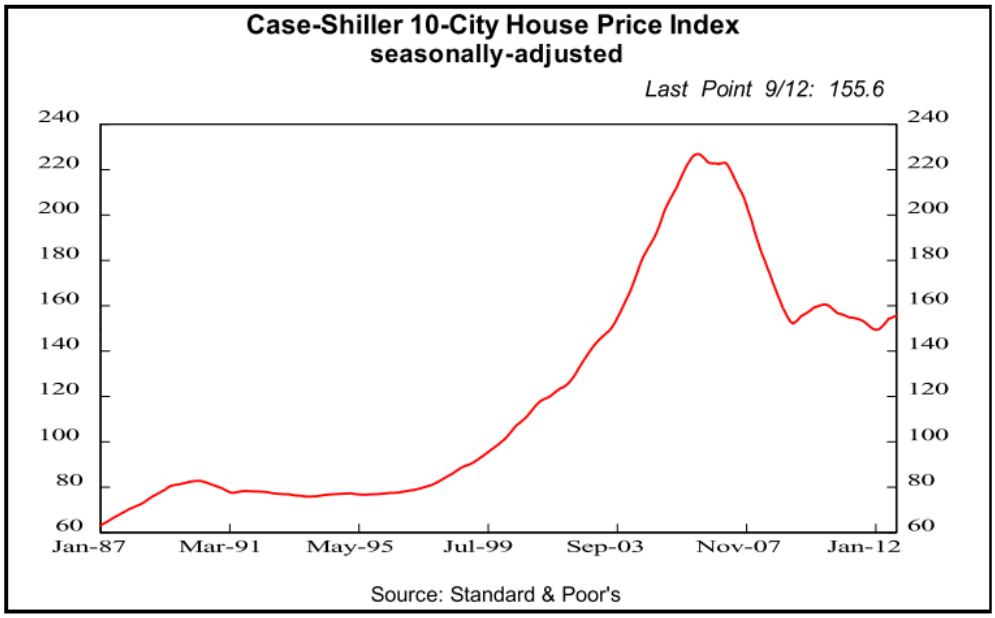
The stock market hasnôt provided a reliable source of supplemental savings either, with real S&P 500 levels, deflated by CPI, right around where it was in 1996, see chart at left. Student loans have skyrocketed from $241 billion in 2003 to almost $1 trillion today, according to the New York Federal Reserve, and default rates are over 9%. The department of Education predicts that 20% of those with a federal student loan will default at some point, yet another potential burden on taxpayers. With all these headwinds, it is hard to understand how consumer spending can pull us out of the doldrums. So it is not surprising that holiday spending has yet to excite with the National Retail Federation estimating holiday sales for November and December increasing 4.1% compared with 5.6% in 2011.

The Fed Energizer Bunny

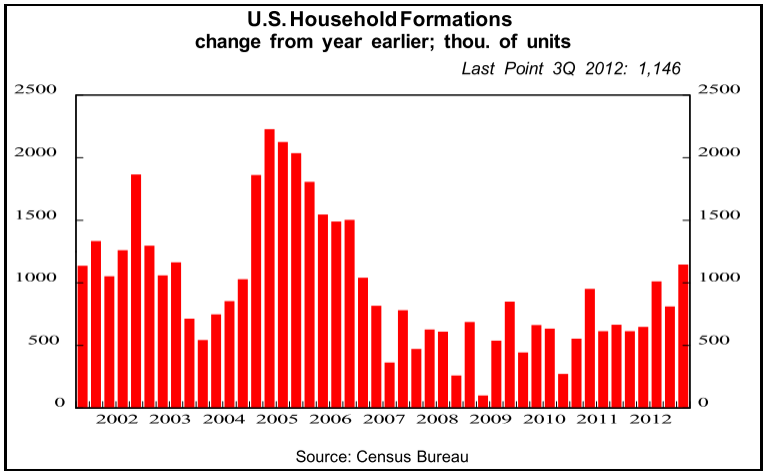
The Fed continues its attempts to stimulate the weak economy with unprecedented expansions of its blunt edged toolkit. In mid-September the Fed promised us QE-Infinity and last week we got QE Infinity-plus-one where it will make unsterilized purchases of $45 billion per month in incremental bonds on top of the $40 billion a month in agency mortgage-backed securities. This will be another open-ended enormous liquidity injection into the markets, which just keeps going and going and goingé We can see the impact of these market perversions where companies are borrowing money cheap, thanks to Fed policy, and using the borrowed funds to pay

dividends or buyback shares. Yes, you read that right. Companies are taking on debt in order to pay dividends! Remember the last time you heard nutty stories about borrowing money cheap (think a home equity line) to do some crazy things like take whirlwind vacations? That didnôt end well and we suspect this story wonôt either. **Bottom Line**: *Increasing debt levels can help grow an economy, when the borrowed funds are invested in something that generates a rate of return in excess of the rate of borrowing. Dividends do not generate returns for the corporation any more than a 5 star vacation in Bali generates return in excess of the cost of a home equity line of credit. When we see market perversions like this, a correction of some sort is coming, but just as the craziness of 2005 didn't get its comeuppance until 2007-2008, perversions can continue much longer than one would imagine, particularly with a dedicated Central Bank behind them.*

Housing



Housing continues to offer signs of hope, but conditions are still mixed. Existing home sales, which includes single family homes, condos, townhomes and co-ops, rose to the highest level in three years at a 5.9% increase in November from October and a 14.9% increase year-over-year. Of those sold 12% were foreclosures with an average 20% discount and another 12% were short sales, at an average 14% discount to market. The all-important first-time home buyer accounted for 31% of the October sales, with investors buying 29% of the monthôs sales.



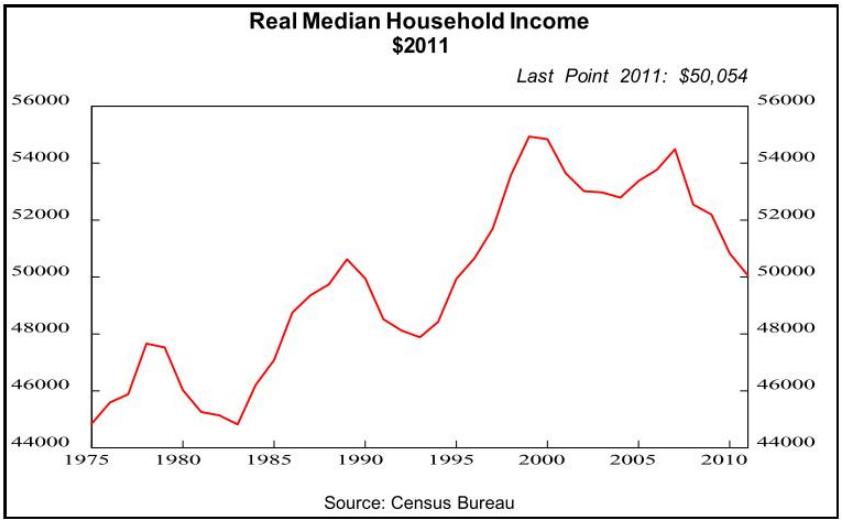
Weôve also seen a recent pickup in household formations. A household is defined as one or more people living in a separate dwelling unit. Formations dropped dramatically during the Great Recession, but are starting to move upwards again. Most of these new households are choosing to rent versus buy, with renters increasing by 5 million since 2006 to 39.6 million while homeowners have declined by 1.4 million to 75.1 million. The national homeownership rate peaked at 69.2% in Q2 of 2004 is now at 65.5%, down from 65.9% last year.

One of our major concerns in this area is the enormous dependence on government, with government entities financing or guaranteeing about 90% of new residential mortgages. Taxpayers have already spent $137 billion to rescue Fannie Mae and Freddie Mac while the Housing Administration, which insured one-third of new mortgages last year, is incurring enormous losses that will also end up on the shoulders of taxpayers.

9.6% of the $1.08 trillion it guarantees are 90 days or more delinquent and the number of delinquencies or foreclosures rose by 100,000 at the end of September. The FHA projected losses of $16.3 billion at the end of September. The agency is able to directly draw from the U.S. Treasury to cover any short-falls, thus this isnôt something one hears much about in the popular media. However, the Federal Housing Administration reported in November that it could exhaust its reserves because of rising mortgage delinquencies. That could result in the agency needing to draw on taxpayer funding for the first time in its 78-year history.

Despite all this, real quality-adjusted home prices, which corrects median single-family home prices for both inflation and the tendency of homes to get larger over time, still shows prices about 20% above the long-term trend, see chart at right. This is particularly concerning when we look at real median household income, which has continued to drop and is now at late 1990s levels, see chart below at right.

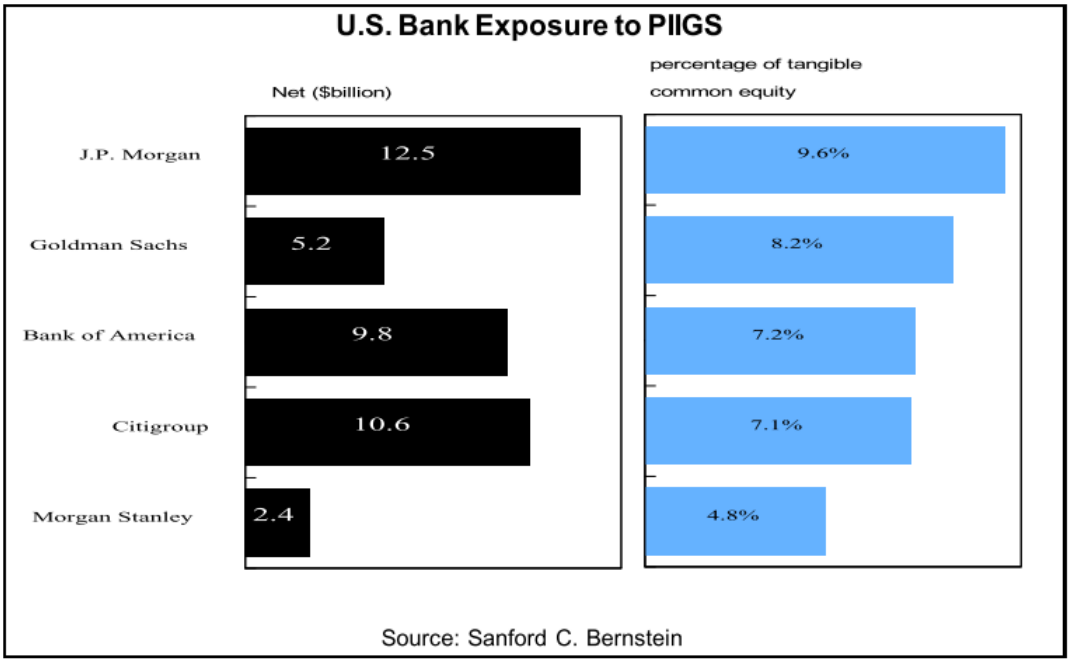
Bottom Line: *Home prices and household income are inseparable over the long-term. In the shorter to medium-term, mortgage rates and availability can alter the relationship, but over time home prices inevitably revert back to their relationship with income. Thus if household incomes continue to fall, home prices are going to have a difficult time generating sustainable price increases.*



Outlook

While some of the economic headwinds have lessened and there are reasons for optimism in the near-term with the enormous amounts of Central Bank liquidity injections, we believe a recession is possible in 2013. The chart at right shows the Dow Jones Industrial Average during its secular bull and bear cycles from 1925. The current cycle began in the early 2000s, and will likely persist until the deleveraging process has completed. If we do go into a recession, it will be very different from every other recession since WWII, in that each prior one was initiated by the Federal Reserve raising short-term interest rates in order to fend off inflation, which inverted the yield curve, (which is when short-term rates are higher than long-term rates) a sure-fire way to kick off a business downturn. The Fed has made it quite clear that it has no intentions to tighten anything for at least a few years, thus a recession would most likely be cause by some sort of a shock to the economy. We see the following as possible catalysts:

- **Fiscal Cliff**: Going over would be bad, enough said on that point!
- **Hard Landing in China**: So far China has given the appearance of having engineered a soft-landing, however data out of the country is notoriously unreliable, so we must keep this on our radar. A downturn for China would further depress global growth and commodity prices.
- **Middle East**: An oil price shock caused by an escalation of conflicts in any one of the troubled nations in the region.
- **Failure of a major European Bank**: The hullabaloo over in Europe concerning sovereign debt is really about each nationôs concern for its own banks failing. Banks buy their nationsô debt. Politicians love banks that buy their debt as it allows them to spend more than the tax burden they place on those who elect them. Spending more and taxing less tends to make a politician more popular. A failing bank in Europe could significantly affect its ability to continue deficit spending, and the contagion effects throughout the world would be quite dangerous.



- **Corporate Earnings Disappoint**: The slowing global economy and a strong dollar led to revenue for the S&P500 companies falling 1% year-over-year in Q3, the first decline since 2009. Revenue typically tracks nominal GDP, but nominal GDP rose 4.2% in Q3, so this is a warning flag. Eternally optimistic Wall Street expects that earnings will rise from $99.95 in 2012 to $107.73 in 2013. If the global recession depresses earnings and the fear trade further strengthens the dollar, earnings could disappoint in a big way.

Wrap Up: We believe that markets in 2013 are likely to look like they did in 2012, with Central Bankers providing a floor to the markets and the economic reality of slowing global growth and the protracted deleveraging process providing a ceiling, thus we would not be surprised to see the markets continue their range-bound fluctuations. We believe that many of 2012ôs headwinds have been at least temporarily eased heading in 2013 and the U.S. economic data appears to be stabilizing. Our strategy is focused on investments that deliver cash flow at a reasonable level of risk and take into account the long-term implications of the explosion of Central Bank balance sheets. We wish you and yours a joyous holiday season.

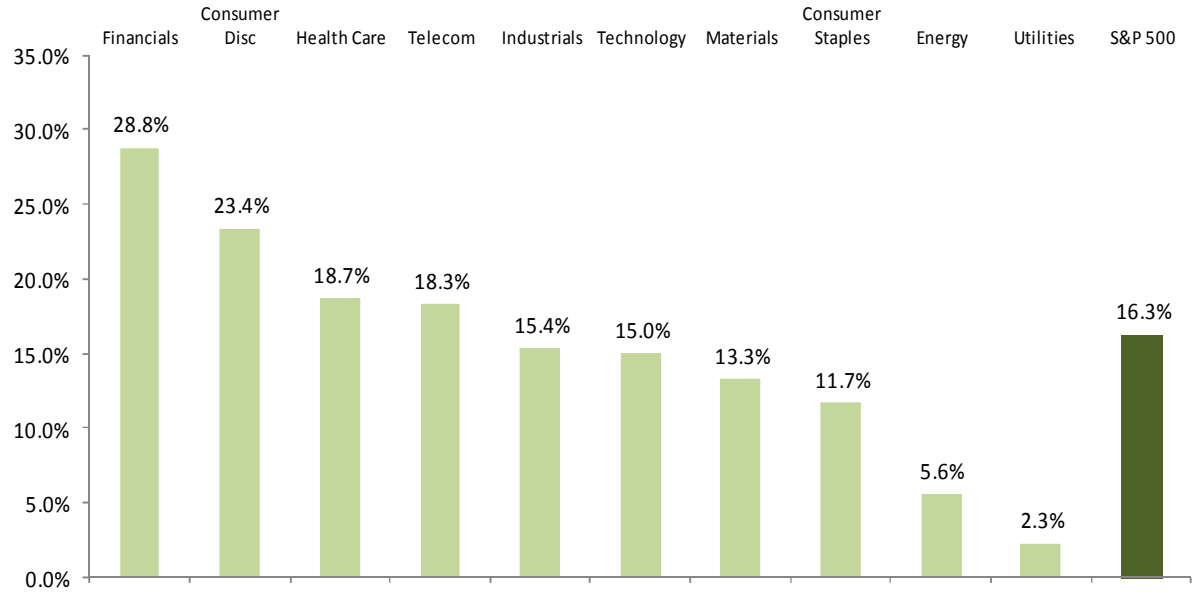
Market Recap

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1430	1.21	-0.14	16.28	17.64	36.83
Dow Jones 30	13191	0.48	-1.25	10.83	11.91	37.22
Russell 2000	2107	2.98	1.61	16.07	16.24	42.75
Russell 1000 Growth	436.25	1.24	-1.11	15.51	16.71	39.26
Russell 1000 Value	443.61	1.29	1.71	17.72	19.26	36.16
MSCI EAFE	1606	1.30	6.72	18.03	20.44	15.01
MSCI EM	1043	0.03	4.31	17.17	17.23	19.51
NASDAQ	3021	1.68	-2.65	17.46	18.72	39.44
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	1.76	-0.07	0.12	4.12	4.65	19.01
U.S. Corporates	2.73	0.05	1.01	9.76	10.76	29.04
Municipals (10yr)	2.05	-0.69	0.50	5.40	6.06	22.61
High Yield	6.80	0.11	3.19	15.71	16.58	40.80

	Levels (%)					
Key Rates	**12/21/12**	**12/14/12**	**9/28/12**	**12/30/11**	**12/21/11**	**12/21/09**
2-yr U.S. Treasuries	0.26	0.24	0.23	0.25	0.28	0.89
10-yr U.S. Treasuries	1.77	1.72	1.65	1.89	1.98	3.69
30-yr U.S. Treasuries	2.93	2.87	2.82	2.89	3.00	4.56
10-yr German Bund	1.38	1.35	1.46	1.84	1.93	3.19
3-mo. LIBOR	0.31	0.31	0.36	0.58	0.57	0.25
3-mo. EURIBOR	0.19	0.19	0.22	1.38	1.44	0.72
6-mo. CD rate	N/A	0.32	0.34	0.64	0.68	0.30
30-yr fixed mortgage	3.50	3.50	3.53	4.07	4.08	4.92
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25

Year-to-Date Returns by Sector

(As of 12/21/12 - Source: JP Morgan)



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