January 23rd, 2013

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: As was expected, the politicians in Washington D.C. took a page out of the Eurozone playbook and kicked the proverbial can on January 1st, temporarily postponing the fiscal cliff. Recently the House passed a measure to temporarily remove the debt ceiling limit to give them a few more months to address the issues that were not addressed prior to the end of 2012. Across developed nations the level of can kicking and fiscal and monetary intervention gives a clear indication of just how challenging the problems have become. How and when they will be resolved is currently unknowable, yet we must continue to make choices and take action.
Lenore Hawkins, MBA, Principal

Global Economy

"The only function of economic forecasting is to make astrology look respectable." JK Galbraith.

Truer words have not been spoken and yet, we must make educated guesses on the future and take actions based on assessments using limited and imperfect information. The past few weeks have given economists some challenging bits of news concerning the U.S. Trade deficit and activity in Europe, leading the World Bank to cut its global growth forecast for this year as the economies of developed nations face headwinds from austerity measures, high unemployment and low business confidence. The new projections lower the growth of the world economy to 2.4% in 2013, down from 3% in June. The U.S. is now forecast to grow at 1.9% with the Euro area in contraction 0.1%, (versus growth of 0.7% expected seven months ago). The situation in the troubled economies such as Spain is continuing to worsen with the Spanish jobless rate hitting record highs. Almost 6 million are unemployed, representing an unemployment rate of 26.02% for the entire population and 60% of those under 25 years old.

Stock Market

In 2011 corporate earnings grew, but the stock market was essentially flat. In 2012, corporate earning stagnated, but the stock market rose. Intuitively this is perplexing. If a company's profits grow, one would expect, all things being equal, to see the stock price rise. If its profits fall or are flat, one would not expect to see the company's stock price rise as well.

The price to earnings multiple, (PE ratio) for the S&P500 expanded in 2012. The PE ratio can be thought of as how much an investor is willing to pay for every dollar of earnings (profit) for a company. The PE ratio for the S&P500 is essentially the ratio for all aggregated earnings versus the aggregated prices. A company with significant growth prospects would likely have a higher PE ratio, all else being equal, than a company whose market is rather stagnant. What's really interesting about this in 2012 is that global growth expectations continued to decline and corporate profits weakened, yet the market decided to pay more for every dollar in profits, which according to traditional investment philosophy would indicate that the market believes that corporate profit outlooks are improving.

So how can corporate profits improve? Profits are driven primarily by two levers, revenue and costs. If a company sells more products or services and/or is able to run the business more inexpensively profits expand.

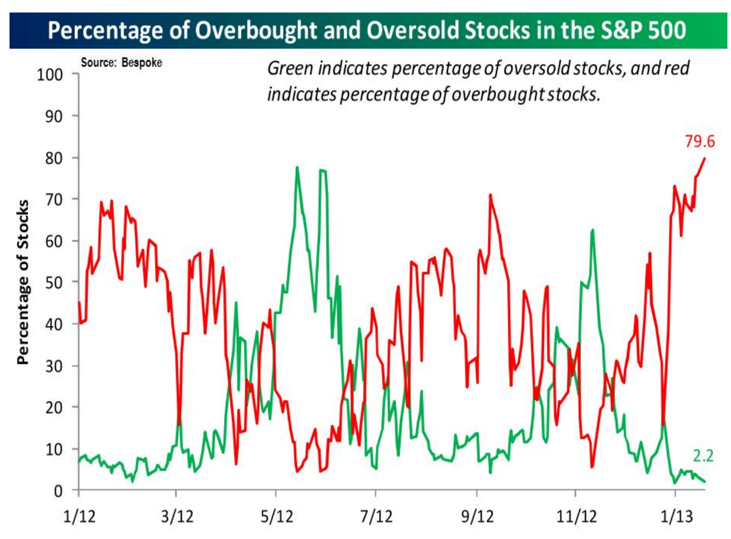
Revenue growth can occur for any one company relatively independent of the economy because a company can either take customers from its competition, (Hostess of Twinkie fame couldn't keep up demand for its products as consumer preferences evolved) or provide a product/service that customers find so attractive that they will cut purchases in other areas rather than forgo your product/service, (Apple still had incredible demand for its products as the unemployment rate reached new heights and household finances crumbled).

That being said, revenue growth for the market as a whole is limited by economic growth. If the economy grows at a 2% rate for a couple of years, it is tough for companies across the board to grow at 5%; fairly intuitive.

Profits can also be improved through cost cutting, but this strategy has a limit as a company cannot endlessly reduce costs. There is an optimal level of cost for every level of quality/quantity of production. Going beyond that eventually harms the company by reducing the quality of its goods/services and/or its future production by not investing sufficiently in its own infrastructure, (think of insufficient maintenance of plants and equipment).

So where are we with respect to corporate costs and revenue outlook? Corporations have done a spectacular job of reducing costs since the financial crisis. There doesn't appear to be a material level of cost cutting that can be done across the board at this point to improve corporate profits after so many years of effective cost reduction. As for corporate revenue across the entire market, it will be very difficult for revenues to increase substantially with global growth rates continuing to slow. Please keep in mind that doesn't mean that a particular company or sector cannot experience a noteworthy level of growth, but rather that with a global economy growing at around 2.4%, the sum total of all companies will not be able to experience a high level of growth.

So where does all this leave us? Financial markets do not always behave as if there is a connection between economic fundamentals and stock prices, at least in the near to mid-term. This is particularly true with the rise of high-frequency trading. For example, ***According to a recent study by Société Générale Cross Asset Research, the average holding period for U.S. stocks is down to about 22 seconds***. Even if we cleanse the numbers for high frequency and other computer generated trades, there is no question that the average holding period for stocks continues to shorten. It is part and parcel of the risk-on / risk-off mentality which prevails at the moment. We must keep economic reality in mind in the longer-term, while being cognizant of the short-to-mid-term trends. Most importantly, all research into the fine art of investment suggest that the best results are obtained through long-term investment, not by attempting to play shorter-term games, no matter how attractive they may appear to be in any particular period.



The second challenge is that equity markets are now driven primarily by policy. The Fed's balance sheet historically had a 20% correlation with the S&P500. Since 2009 that correlation has grown to 85%, meaning the central bank's balance sheet is more relevant to stock prices than corporate earnings, (hat tip to David Rosenberg of Gluskin Sheff). *Today Monetary Policy impacts stock prices significantly more than the actual fundamentals of the company!*

Currently the market appears to be significantly overheated, with almost 80% of stocks in the S&P500 overbought as of January 23rd.

Additionally, nearly 90% of S&P500 stocks are above their 50-day moving average, which is well above one standard deviation above the mean of 57.37%, (see chart above).

Howard Marks of Oaktree Capital fame made a great comment in his most recent newsletter.

"Security prices rise and fall much more than profits, introducing considerable investment risk. Why is that so? Primarily, I think, because of the dramatic ups and downs in investor psychology... Over the years, I've become convinced that fluctuations in investor attitudes toward risk contribute more to major market movements than anything else. I don't expect this to ever change."

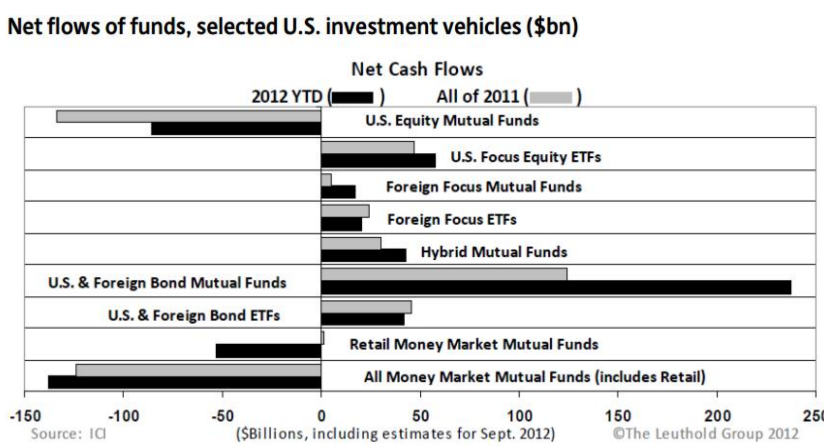
He then went on to point out that when he joined First National City Bank in the late 1960s, the bank built its investment approach around the "Nifty Fifty," which were considered to be the 50 best and fastest growing companies in America. Most of them did in fact turn out to be fantastic companies. Investing in them at that time however, would have been disastrous. He points out that had an investor bought the stocks of these truly great companies, they would have lost roughly 90% of their money as the PE ratios dropped from 80-90 to 8-9.

His point is that all other things being equal, the price of an asset is the principal determinant of its riskiness. No matter what the quality of an asset, at some price it is overpriced and dangerous. At some price it is underpriced and relatively safe.

Bond Market

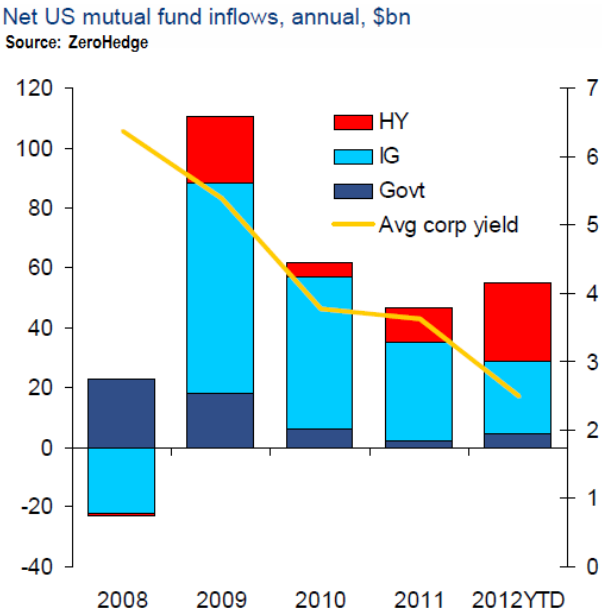
For bonds, price is reflected in its yield. Because a bondôs coupon is fixed, the higher the price of the bond, the lower its yield and vice versa. So let's look at what is happening in the bond market.

Since early 2011, about $450 billion has flowed into actively managed bond funds and bond ETFs, while around $250 billion has been taken out of U.S. equity mutual funds, (see chart at right).

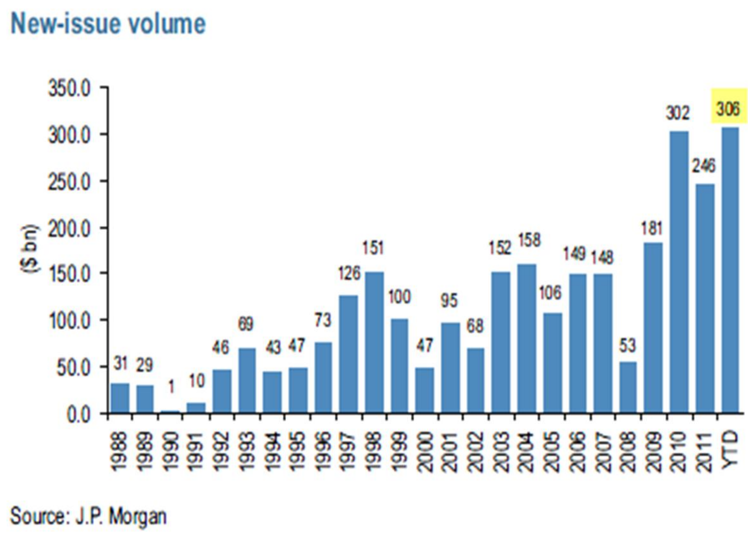


Source: The Leuthold Group (via Mebane Faber)

The chart below shows that most of the $450 billion has gone into high yield (HY) and investment grade (IG) corporate bonds.

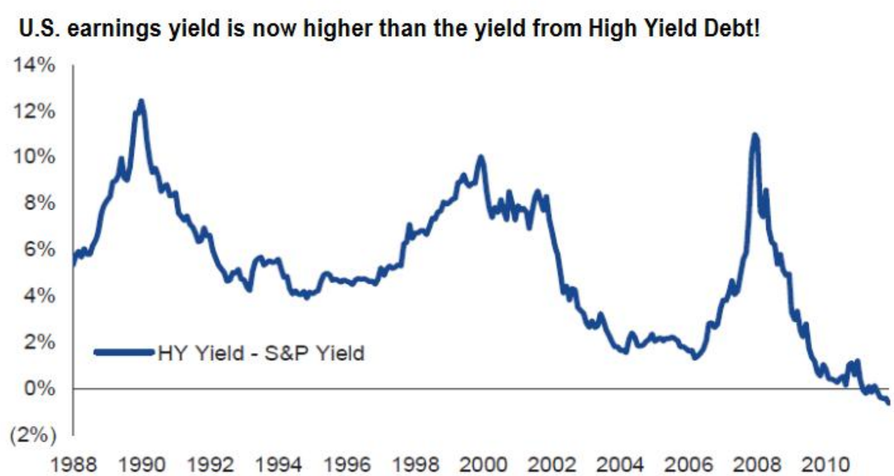


Which helps explain why high yield debt issuance hit an all-time high in 2012, (see chart below).



This brings us to the realization that despite a heavily overbought equity market, high yield has never been more expensive relative to stocks. This means that high yield, also referred to as non-investment grade, speculative grade, or junk bonds generate lower yield than the S&P earnings yield (or Earnings/Price, the inverse of the P/E ratio) for the first time in history. Let's hand it to the Federal Reserve. When it wants to push interest rates down, it appears to so far have the ability to make history. As central banks keep benchmark borrowing rates depressed, investors search further out on the risk spectrum for yield.

This is the very definition of financial repression whereby investors are forced to take on historically high levels of risk in order to generate relatively modest yields.



Source: "The 2013 Playbook", Morgan Stanley Research, November 2013

New Estate and Gift Tax Laws

The 11.999999th hour tax law passed by the Senate on New Year's Eve and by the House on New Year's Day made permanent some important aspects of estate and gift tax rules and rates that have been in flux for a number of years. Had these changes not been implemented, the estate tax exemption amount would have dropped to $1 million per person with any amount over that being taxed at 55%. This would have meant that if a beneficiary inherited a business valued at $1.6 million, they would have had to come up with $330,000 (($1.6 - $1)*55%) in order to keep it.

Here are the highlights of the new laws:

- For 2013, the estate tax exclusion amount for deaths in 2013 will be $5.25 million. This amount will continue to be adjusted upward for inflation going forward.

- Individuals can transfer up to $5.12m tax-free during their life or at death. This is referred to as the basic exclusion amount. Any amounts above this limit are taxed at up to 40%. Any gifting during an individual's lifetime needs to be reported and a running tally maintained as any gifting under this provision will lower the amount of the estate tax exclusion. For example, if an individual gifts $1 million over their lifetime, the estate tax exclusion upon their death in 2013 would be reduced to $4.25m ($5.25m- $1m)

- Spouses can still inherit from one another without estate taxes being triggered, provided that the inheriting spouse is a U.S. citizen.

- The 2010 tax law gave married couples a wonderful tax break, which the new law has made permanent. Widows and widowers can add any unused exclusion of the spouse who died most recently to their own. This enables them together to transfer up to $10.24 million tax-free.

- Starting in 2013, the annual gift exclusion is increased to $14,000 from $13,000 in 2012.

Wrap Up

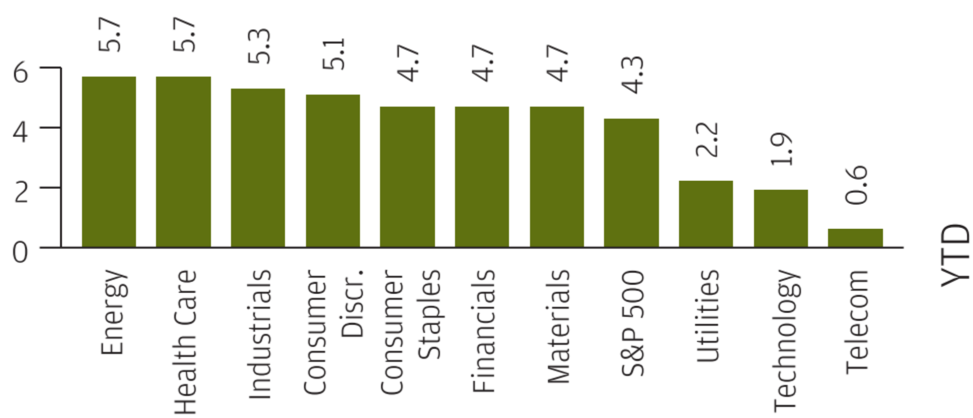
Our leaders in Washington addressed the 2012 year end fiscal cliff by raising taxes on income, dividends and capital gains, and by limiting itemized deductions for higher income taxpayers. They postponed the portion of the fiscal cliff that called for automatic federal spending cuts known as sequestration until March 1st. If the sequester goes into effect, the automatic cuts as they stand now would eliminate $55Bn in defense spending and $55Bn in non-defense spending this year, and are projected to lower the deficit by $1.2Tn over the next 10 years. On March 27th, there is the possibility of a government shutdown when Congressô last short term spending plan expires. Last week the House and Senate gave themselves more time and voted to suspend enforcement of the debt ceiling until May 18th. By lowering debt service costs, the central bankòs low interest rate policies are in part an attempt to help the federal government in its efforts to rein in Uncle Samòs excessive debt burden. Congress is trying to find a compromise between the tax increases they passed last month and the upcoming federal spending cuts, but without going so far with these austerity measures that they cause a recession. We at Meritas are ever diligent in researching and monitoring market conditions and the economic climate as we strive to meet our clientòs investment goals. Thank you for your trust in us. We are honored to be your advisor and appreciate your partnership.

Market Recap

(as of Jan 21st, 2013)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1486	0.96	4.28	4.28	16.19	39.41
Dow Jones 30	13650	1.31	4.37	4.37	11.47	39.43
Russell 2000	2219	1.37	5.14	5.14	16.28	45.73
Russell 1000 Growth	451.74	0.62	3.87	3.87	14.73	41.72
Russell 1000 Value	464.06	1.35	4.97	4.97	18.29	39.15
MSCI EAFE	1655	-0.06	3.20	3.20	18.88	12.49
MSCI EM	1081	0.72	2.44	2.44	13.47	15.78
NASDAQ	3135	0.29	3.82	3.82	14.67	41.52
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	1.82	0.04	-0.23	-0.23	3.69	18.02
U.S. Corporates	2.75	-0.02	-0.15	-0.15	8.88	27.35
Municipals (10yr)	1.90	0.27	0.81	0.81	4.97	24.07
High Yield	6.53	0.23	1.52	1.52	16.00	39.10

	Levels (%)					
Key Rates	**1/18/13**	**1/11/13**	**12/31/12**	**12/31/12**	**1/18/12**	**1/18/10**
2-yr U.S. Treasuries	0.26	0.26	0.25	0.25	0.24	N/A
10-yr U.S. Treasuries	1.87	1.89	1.78	1.78	1.92	N/A
30-yr U.S. Treasuries	3.03	3.05	2.95	2.95	2.96	N/A
10-yr German Bund	1.49	1.58	1.31	1.31	1.78	3.24
3-mo. LIBOR	0.30	0.30	0.31	0.31	0.56	0.25
3-mo. EURIBOR	0.21	0.20	0.19	0.19	1.22	0.69
6-mo. CD rate	N/A	0.30	0.33	0.31	0.59	0.30
30-yr fixed mortgage	3.61	3.61	3.52	3.52	4.06	5.00
Prime Rate	3.25	3.25	3.25	3.25	3.25	N/A



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