MERITAS ADVISORS
Comprehensive Wealth Management

February 25th 2013

MONTHLY INVESTMENT OUTLOOK

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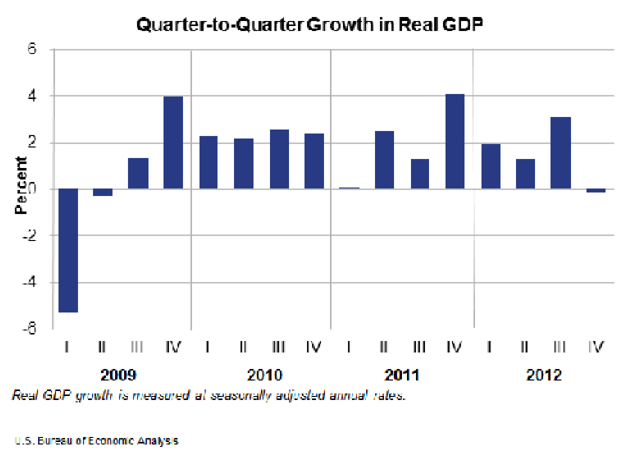
Dear Clients and Friends: Last week was the first down week for the S&P 500 in 2013. Political tensions in Europe, concerns over the ever-widening split within the FOMC, (Federal Open Market Committee) over the Fedôs monetary-easing program and some grim reports from global bellwether corporations like Caterpillar unnerved a technically overbought market. Italy is in the midst of a critical election process that could have effects throughout the Eurozone and this week the markets will undoubtedly hang onto every word out of Fed Chairman Ben Bernankeôs mouth as he gives his Semiannual Monetary Policy Report to Congress. We believe these are exceedingly tenuous times in the markets and are watching carefully for signs of an overdue correction.
Lenore Hawkins, MBA, Principal

U.S. Economy

Although the majority of the tax increases feared in the fiscal cliff game of chicken were largely avoided, payroll taxes were increased by 2.1%, which equates to roughly $1,000 for every $50,000 in income up to $113,700. Income taxes did go up on upper income earners. According to the Bureau of Labor Statistics, the top 20% of earners account for 40% of total consumption, suggesting consumer spending could be impacted more than is currently believed. With consumer spending accounting for about 70% of GDP; we believe this warrants attention.



We recently learned that the U.S. economy actually shrank in the last quarter of 2012. Given the prevailing bullish mania, this news was quickly dismissed. You may recall that third quarter growth was artificially boosted by an unusual rise in government spending, which was then reversed in the fourth quarter. If you merge the two in order to minimize the impact of the extraordinary level of spending, you get an economy growing at an anemic 1.5% to 2.0% annual rate for the second half of 2012. With the increase in taxes likely to slow growth, we donôt expect 2013 to have a strong start.

Recall that retail sales fell in April, May and June of 2012. In 27 of the 29 times that retail sales declined for at least three consecutive months since the data was tracked, starting in 1947, the economy was in or was within three months of a recession. The fourth quarter of 2012 showed negative growth; we believe this warrants attention.

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Meritas Advisors structures portfolios to meet our clients' personal goals and preferences within the scope of their risk tolerance. We strive to manage risk most effectively by utilizing a wider blend of asset classes, with the objective of achieving our client's goals with a reduced amount of overall portfolio volatility.

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As we look at the weak recovery so far, despite the unprecedented levels of fiscal and monetary support, we have to ask, ñIs this the best the U.S. economy can do?ò Based on the bullish tones on Wall Street, investors and consumers apparently trust that the politicians in Washington will eventually deal with the problems. However, this bullishness on the Street takes some of the heat off those in D.C. and gives them ample breathing room to continue the partisan squabbling and perpetual sound bite wars, rather than addressing the fiscal crisis and our long-run debt problems.

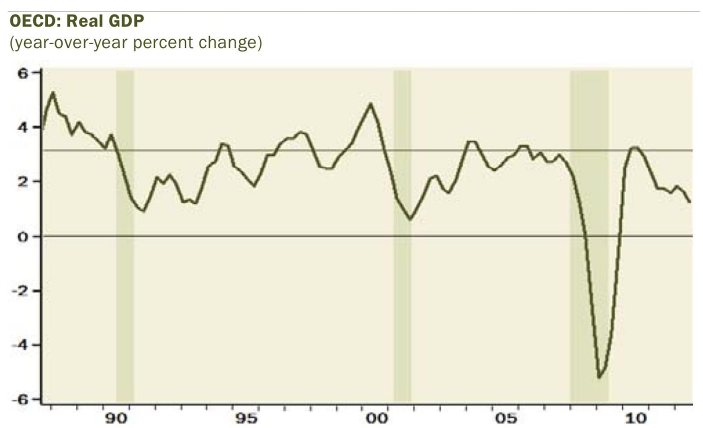
If that wasnôt frustrating enough, the historically exceptionally low interest rates, courtesy of the Federal Reserve, minimize the interest costs of the federal debt thus reducing the pressure on the D.C. crew to address the deficit and growing national debt in a meaningful way. If there is one thing history shows us, it is that politicians rarely act effectively until after they have exhausted all other possibilities.

This brings up the bizarre attitude on Wall Street that the U.S. economy is accelerating. If this were truly occurring, why would the Fed continue to believe that it must inject a trillion dollars a year into the banking system? Either the market or the Fed is wrong.

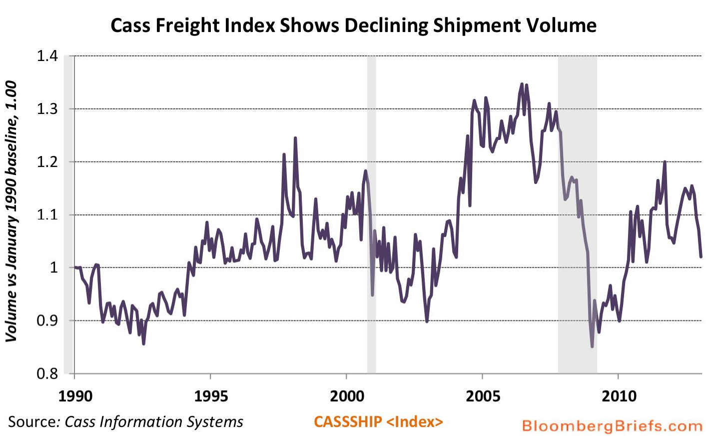
Wal-Mart reported in some internal emails that sales in 2013 have been a ñtotal disaster,ò the worst in seven years. The home builder Toll Brothers dropped 9.1% after reporting earnings that underwhelmed expectations, alongside many recent housing data reports that have called the recovery story into question.

Gasoline prices have risen for over a month now and are up an average of $0.43/gallon, a 13% increase. This represents a drain of about $60 billion from household wallets, a painful addition to the hit in January from the removal of the payroll tax cuts.

What about exports? Could that help grow the U.S. economy? Unfortunately 55% of the global economy is now either in contraction or stagnation mode, (see chart at right). Last week Caterpillar posted a 4% decline in global equipment sales in the first quarter, kicking off the largest one day drop in the markets in 2013.



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

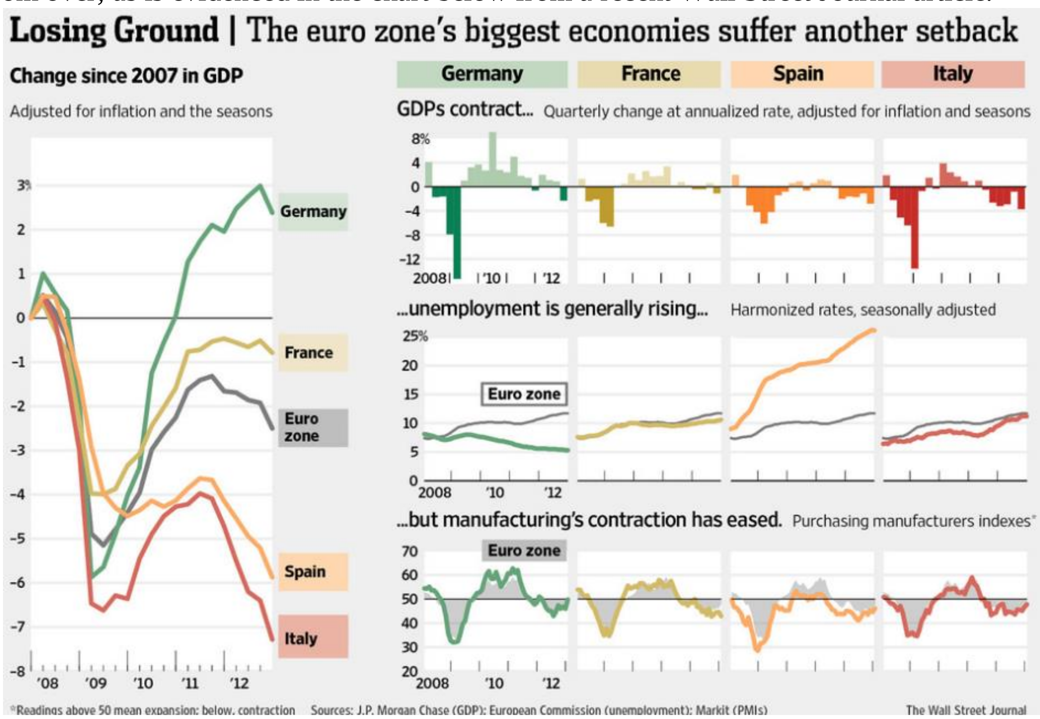


The Cass freight index, which measures trends in North American shipping activity based on $20 billion in paid freight expenses of roughly 350 of Americaôs largest shippers, reported that shipping volumes fell 4.8% in January compared to December and were 2.5% lower than January 2012. The January decline was unusual. According to the report, for each of the last two years, freight shipment volumes ended the year at about the same place they began. This was the first year since the recession period that January shipments were actually lower than January of the previous year.

Bottom Line: *The headwinds facing the economy continue to mount, despite the Fed's success in pushing asset prices higher and higher. The current Wall Street euphoria in the context of a contracting global economy brings to mind Wile E. Coyote running off the cliff, suspended in air until he realizes that there is nothing to hold him up.*

Eurozone

The euro zone's economy shrank 2.3%, (at an annualized pace) last quarter, the fastest pace since the height of the global recession in early 2009, as a worsening slump in Italy and other southern European countries infected the bloc's core economies of Germany and France. The contraction suggests that Europe's economic and financial crisis is far from over, as is evidenced in the chart below from a recent Wall Street Journal article.



The European Union's official economists predicted the Eurozone economy will shrink in 2013 for the second year in a row and for the third year of the past five, in a forecast that sees little hope that easing financial market tensions in the region will provide a jolt to the real economy any time soon.

While we are all aware of Japanôs ñlost decadesò of stagnation in the 1990 and 2000s, Italy, Europeôs fourth largest economy, is in many ways experiencing an even more painful level of stagnation, with per-capita GDP lower in 2013 that it was in 1999, in inflation adjusted terms. Portugal is in a similar slump.

Political tensions between Germany and France are mounting, while over in Greece, a new general strike was launched in a backlash against austerity measures that were a quid pro quo for the recent bailout funds. The European Commission sees falling spending by businesses, consumers and national governments pushing Eurozone unemployment to a new high. Mass joblessness is expected to increase in the countries hardest hit by the crisis, with the average unemployment rate expected to reach 27% in Greece, 26.9% in Spain and 17.3% in Portugal.

Bottom Line: *The Eurozone economy, which is roughly the size of ours, is showing signs of continued weakness with increasing headwinds, providing a rather weak consumer base for our exports, which serves as a headwind to our growth prospects.*

Federal Reserve

It took the federal government around 200 years to accumulate a trillion dollars in debt. Within the following decade it tripled that number, then doubled it again in just twelve years, and doubled it again in another 8 years. Overall the national debt has increased sixteen-fold in just 30 years. Incidentally, this period coincides with the complete delinking of the U.S. currency to the gold standard.

So how are we managing all this debt? In 2013 the Federal Reserve will buy approximately 90% of the countryôs issuance of Treasuries and mortgage bonds! Thatôs one way to explain how a nation facing such a growing mountain of debt, a slowing to stalling economy, and a paralyzed political process is able to maintain such incredibly low interest rates. Treasuries have long been used as the standard for the risk-free rate. With only 10% of the issuance to float freely in the market, the Fed is able to generate considerable demand for this ñrisk-freeò asset class, driving prices up, which means driving interest rates down.

The massive distortions from the various Quantitative Easing programs have damaged the market mechanisms for understanding the true price of risk, which gives markets an understanding of the appropriate cost of capital. A market that no longer can obtain this information has a big problem, because mispricing of risk leads to misallocation of capital.

The proverbial saying goes that markets love to climb a wall of worry. Weôve seen corporate earnings and revenue growth slow sharply through the past year, with corporate guidance for future performance continuing to be rather grim, yet equities have had quite a run. This is due to expanding P/E multiples as we discussed in last monthôs newsletter. This expansion is 85% correlated to the Fedôs ongoing balance sheet expansion, as it is now adding about $85 billion of relatively secure fixed income securities to its $3 trillion portfolio on a monthly basis. Such an enormous level of buying in the markets, leaving only 10% of new issuance available for purchase, is forcing investors into other assets, pushing up prices.

How is this level of Fed activity going to end? David Rosenberg of Gluskin Sheff described the situation well by saying,

> *"I am concerned over the unintended consequences of these experimental policy measures that have no precedence, but perhaps these consequences lie too far ahead in time from a 'tactical' sense, but we should be aware of them. The last cycle was built on artificial prosperity propelled by financial creativity on Wall Street and this cycle is being built on an abnormal era of central bank market manipulation." January 17th, 2013.*

Bottom Line: *When one looks over the past 12 years of active Federal Reserve monetary policy in which we experienced repeated bubbles followed by painful pops, why does anyone believe this time will be different? Particularly when this time we experienced monetary activism on an unprecedented scale: we are truly in uncharted waters.*

Your Money

The financial repression exemplified by the Federal Reserveôs zero interest rate policy (ZIRP), that was begun on Dec 16, 2008, has many side effects. One of these side effects is to drive down the interest income that savers and investors receive from their bond and fixed income investments. For example, many bank deposits are paying only 0.01% today. Similarly, locking up funds in a 5 year CD yields a paltry 1% to 1.5% today, which results in a negative return after inflation. In this yield starved environment, that recently entered its 5^{th} year, having some skillful active bond managers in your portfolio can be very helpful in seeking to generate returns above the fundôs relatively low yields. The fund managers do this by trading bonds in addition to holding them. For example, a domestic corporate and government bond manager that we like is running a multi-billion dollar fund that is currently yielding just 2.54%. Last year, the fund generated a total return of 9.3%. The additional return beyond the yield came from a combination of realized gains on bonds sold throughout the year, plus unrealized capital appreciation of the bonds the fund holds. Similarly, an international bond fund that we like is currently yielding 5.6%, while holding approximately 50% of their $68Bn in cash and the other 50% in foreign government bonds. In 2012, the fund generated a 15.8% total return for investors, including both the interest income from holding bonds plus the returns from trading them.

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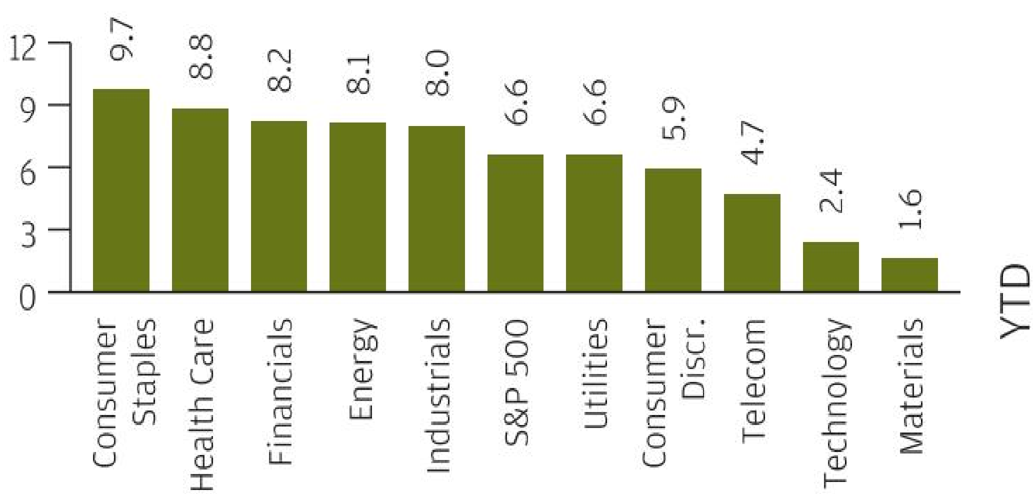
Market Recap

(as of Feb 22nd, 2013)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1516	-0.22	6.62	6.62	14.23	45.83
Dow Jones 30	14001	0.18	7.31	7.31	11.15	46.10
Russell 2000	2277	-0.74	7.99	7.99	13.87	50.89
Russell 1000 Growth	457.26	-0.39	5.33	5.33	10.19	46.52
Russell 1000 Value	476.98	-0.28	8.19	8.19	18.33	46.68
MSCI EAFE	1660	-0.15	3.73	3.73	10.94	22.20
MSCI EM	1053	-1.22	-0.01	-0.01	1.91	21.12
NASDAQ	3162	-0.90	4.91	4.91	9.26	45.74
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	1.91	0.13	-0.52	-0.52	3.07	17.81
U.S. Corporates	2.80	0.27	-0.56	-0.56	6.81	27.76
Municipals (10yr)	2.07	-0.15	0.11	0.11	4.49	21.56
High Yield	6.64	0.14	1.50	1.50	12.46	40.24

	Levels (%)					
Key Rates	**2/22/13**	**2/15/13**	**12/31/12**	**12/31/12**	**2/22/12**	**2/22/10**
2-yr U.S. Treasuries	0.27	0.29	0.25	0.25	0.29	0.91
10-yr U.S. Treasuries	1.97	2.01	1.78	1.78	2.01	3.80
30-yr U.S. Treasuries	3.15	3.18	2.95	2.95	3.15	4.73
10-yr German Bund	1.57	1.65	1.31	1.31	1.89	3.28
3-mo. LIBOR	0.29	0.29	0.31	0.31	0.49	0.25
3-mo. EURIBOR	0.22	0.23	0.19	0.19	1.04	0.67
6-mo. CD rate	N/A	0.28	0.33	0.31	0.51	0.30
30-yr fixed mortgage	3.78	3.78	3.52	3.52	4.09	5.03
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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