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MERITAS ADVISORS

Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

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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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Dear Clients and Friends: Europe is again taking center stage with the kerfuffle over Cyprus. The risk-on, risk-off trade is starting to look like a bad case of market Tourette syndrome while many of those caffeine and sugar powered analysts on Wall Street breathed an enormous sigh of relief as Mayor Bloombergõs attempt to ban large sugary drinks was struck down by the New York Supreme Court. Congress worked out a temporary cease fire over yet another fiscal pseudo-crisis concerning the looming debt ceiling, pushing the battle back to September in God-only-knows-what round of can kicking. President Obama appears to have done the only sane thing by retreating to a more peaceful region, the Middle East.
Lenore Hawkins, MBA, Principal

Cyprus

This tiny island, with only about a million inhabitants and less than 1% of Europeõs GDP, kicked off the latest furor in the ongoing euro zone crisis. One cannot help but be deeply moved by the images on television of people desperately trying to get at their savings in Cypriot banks. Can you imagine having diligently saved in order to start a business, or buy a house, or perhaps celebrate your sonõs wedding, only to have your savings taken away because some group of bureaucrats in another country forced your country to take your money away from you? It is truly heartbreaking to see what has become of this tiny nation and any claims that the problem is solved are at best misinformed.

Over the past ten days weõve seen the troika, (the European Union, the International Monetary Fund and the European Central Bank) make a series of political blunders and stumbles, which have remarkably reduced their credibility. The initial proposal was to levy a ñtaxò on all deposit accounts in Cyprus, even those within the insurance guarantee limit. This would be akin to the government here seizing funds from your checking account, despite the explicit protection provided by FDIC insurance. This was not a tax, despite attempts to call it such. It was an ad-hoc seizure of private money by public officials. It was and is a confiscation engineered by the finance ministers of respectable European countries, not by some lunatics in a third-world, despot-controlled sham of a nation. The rest of Europe is paying attention. We are now clear that forcible seizure of private assets by government officials is on the table. This will have lasting ramifications throughout Europe.

For those who claim this is a tiny country that doesnõt warrant much attention, recall a minor league player on the global field, Archduke Ferdinand and his rather unpleasant day in July 1914. We certainly are not on the brink of any sort of global armed conflict, but Germany has lobbed one heck of a stink bomb at Russia, inciting Alexander Nekrasov, a former Russian government advisor to warn, ñMoscow will be looking for ways to punish the EU.ò According to the IMF (International Monetary Fund), Russian depositors account for up to ú25

billion, a third of the Cypriot bank accounts over 100,000 euros, which are frozen as part of a new restructuring deal agreed to on Monday. Remember that Russia is not part of the EU and as such was not included in troika discussions over Cyprus. As of Tuesday, March 26th, the opening of Cypriot banks has once again been postponed, now to Thursday, and no date has been established for when any remaining funds in the seized accounts over ú100,000 will be accessible. Steven Englander, head of the Group of 10 currency strategy at Citigroup expressed the situation aptly, ñThe Cyprus crisis has opened up some precedents that will make investors more worried about how future euro zone crises will evolve.ò

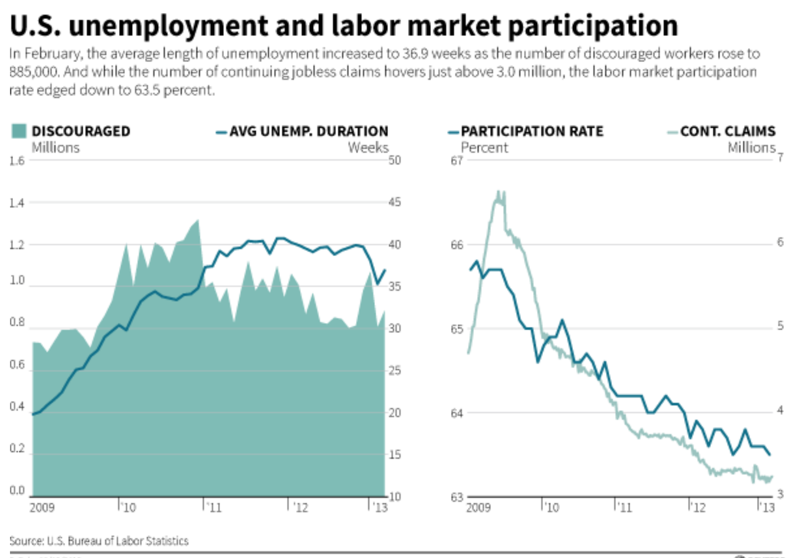
This fear was heightened on Monday when in an interview with Reuters and the Financial Times, Dutch Finance Minister and President of the Eurogroup of euro zone finance ministers Jeroen Dijsselbloem said that the Cyprus deal will serve as a template for future bank restructurings in the euro zone. When the interview hit the newswires, stocks fell, naturally prompting an immediate recanting of the statement by Dijsselbloem. On Tuesday, according to the Financial Times, ñEwald Nowotny, European Central Bank governing council member, said Cyprus was a special case and the rescue plan used to bail out the country should not serve as a model for other countries in the euro zone.ò Good thing everyone is on the same page! Watch for this to affect banking throughout the euro zone, particularly in the troubled nations like Spain, Italy and Portugal as deposits reconsider leaving their funds vulnerable to seizure. For those that point to the protestations of officials that the Cyprus solution will not be revisited elsewhere, we point you to an article on March 1st, 2013 in the Wall Street Journal.

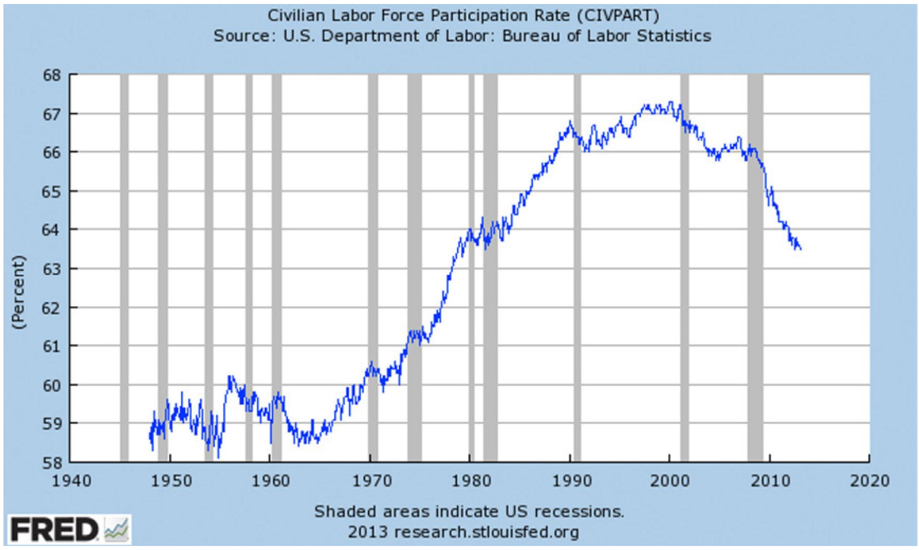
> *Cyprus' newly appointed Finance Minister Michalis Sarris Friday rejected talk of depositors taking losses as part of the country's bailout as he took control of the country's purse strings following Sunday's presidential elections. "**There is nothing more foolish than talking about a deposits haircut**," Mr. Sarris told journalists.*

For Cyprus, this is likely the final nail in its coffin. 81.3% of Cypriot GDP in 2011 came from the service sector, according to the CIA ï World Fact Book. Most of these services are related directly and indirectly to the banking sector, with indirect services being those of lawyers, accountants and the hospitality industry. With the effective destruction of the banking sector, all those other sectors will suffer dramatically, making the economy contract even more. It is likely that this tiny nation will have to leave the euro zone at some point.

Employment

The market media is full of high-fives over the ñrecovery,ò yet those same talking heads all quietly concede that there is no real recovery without a recovery in employment. Tough for housing to be on long-term solid footing if people still donôt have jobs, or if they do, they are paid well below what they were getting paid five years ago. On Friday March 15th, the Bureau of Labor Statistics announced the creation of 236,000 new jobs in February with the unemployment rate dropping down to 7.7%. Hurrah! Unfortunately after actually reading the report, one is reminded that the devil is in the details. Part-time jobs rose 446,000, so doing a little math here, *the economy actually lost 276,000 full-time jobs*. Is swapping full-time jobs for part-time jobs cause for celebration?





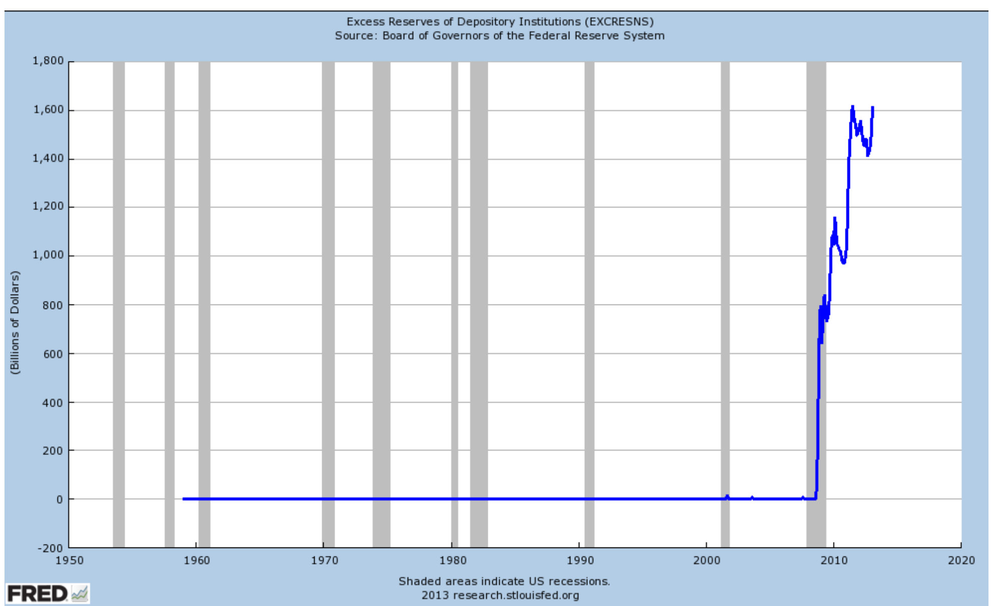
There is also that fantastic drop in the unemployment rate. For our frequent readers, you know just how much we dislike that easily misleading statistic. If we again look into the details, we can see that the drop in the unemployment rate is due largely to a decline in the labor participation rate. The unemployment rate is falling because people are exhausting their benefits and dropping out of the workforce. According to a new report from UniCredit, the U.S. workforce has been shrinking rapidly in recent years, amounting to 3.6% of U.S. unemployment, which means that the unemployment rate would be around 11.3% if all those discouraged workers had not dropped out. If your first thought now is, ñWhat about the aging population?ò Bravo! Yes, that does account for about half according to the UniCredit model, still leaving us at 9.5% unemployment. Not exactly a booming recovery.

Making Sense of it All

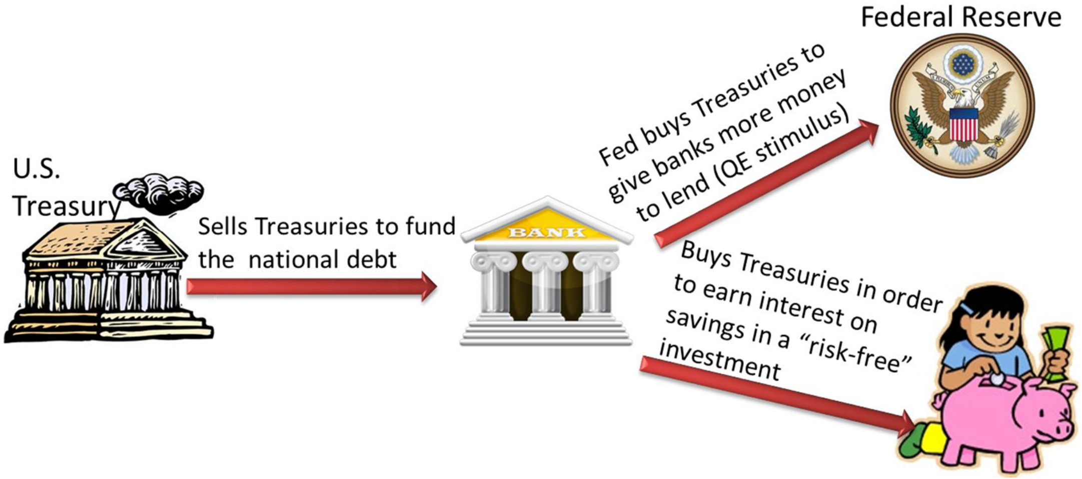
Weôve heard a lot lately about financial repression in relation to the Federal Reserveôs policy of Quantitative Easing. We thought weôd briefly explain just what that means and how it affects you, the investor.

The initial goal of quantitative easing was to get the economy moving again by getting banks to lend more. The thought was that if banks had more money on hand to lend, theyôd lend out more. More money lent out to individuals and businesses would drive economic activity and the economy would start growing more robustly. In order to get more money into the hands of banks to lend, the Fed needs to buy something from the banks. We first discussed quantitative easing in our March 2011 newsletter, so weôll just do a quick review here.

In order to fund federal deficit spending, the U.S. Treasury issues bonds to the market. Banks buy these bonds, giving the Treasury cash for the federal government to spend in return for the bonds. In **Quantitative Easing**, the Federal Reserve buys these bonds from the banks, giving the banks cash to now lend to the private sector. The chart at right shows the growth in excess reserves as a result of the program, increasing from historically near zero for decades to over $1.6 trillion today.



So how does this lead to financial repression? The Fed buys bonds from banks in order to keep down interest rates by keeping bond prices high. [For a full discussion on how prices are related to bond yields, interest rates, please visit our website and go to Resources, then White Papers and read Bonds 101.] The Fed is currently buying about $45 billion of Treasuries a month in addition to the $40 billion of mortgage debt it has been purchasing a month, **effectively purchasing about 90% of all new dollar-denominated fixed-income assets**, according to J.P. Morgan Chase & Co. This means that investors who want to buy bonds are in competition with the Federal Government to purchase these securities and there is only 10% of the market available for purchase once the Fed is done buying.



This means that investors are pushed out of the market for what was traditionally deemed ñsafeò investments by its own government in two ways. (1) The market of available securities to buy has been drastically reduced. (2) The interest rates on those securities are far below historical norms, making them less attractive to investors. So investors are forced to buy riskier securities than they would like in order to get the interest rates they used to be able to get from ñsaferò securities. Those who refuse to take on additional risk are forced to accept interest rates that are often below the rate of inflation. This is known as financial repression.

We believe it is important to acknowledge that this means the portfolios for investors across the globe are forced to either take on more risk than is appropriate for them or accept exceptionally low rates of return, which is likely to result in increased market volatility in the future.

Circling back to the tragedy in Cyprus, banks use deposits to help fund loans. If depositors now fear that their deposits are no longer safe in these institutions and begin to withdraw them, bank lending will be significantly curtailed, countering any quantitative easing efforts by central bankers. Any additional headwinds to lending will only further suppress economic growth, something the euro zone does not need.

Your Money

The S&P 500 index is off to a strong start in 2013, up over 9% year to date as we near the close of the 1st quarter on Friday. This 13 week return is about equal to the average *annual* performance of large cap stocks since 1926. However, the two sectors leading the way are defensive sectors, consumer staples and healthcare. Defensive sectors have a tendency to provide the market leadership when investorsô concerns are elevated. Jeff Gundlach, founder of the DoubleLine Funds, hosted a public webcast on March 6 in which he described Gundlachôs Rule of Investment Risk. His equation is: (Frequency of Problems) * (Severity of Problems) = A Constant. He suggests that policymakers have a choice between more frequent, shallower recessions, or less frequent, deeper recessions. The Federal Reserveôs Quantitative Easing program is an attempt to prop up the economy and the stock market in the short term that may be pushing us in the direction of less frequent, deeper recessions. The Fedôs Easy Money policies may continue for years, but consistently predicting the timing of broad stock market upturns or downturns is highly unlikely. Thus, we remain vigilant and position portfolios that seek to effectively manage risk while staying consistent with client specific growth objectives.

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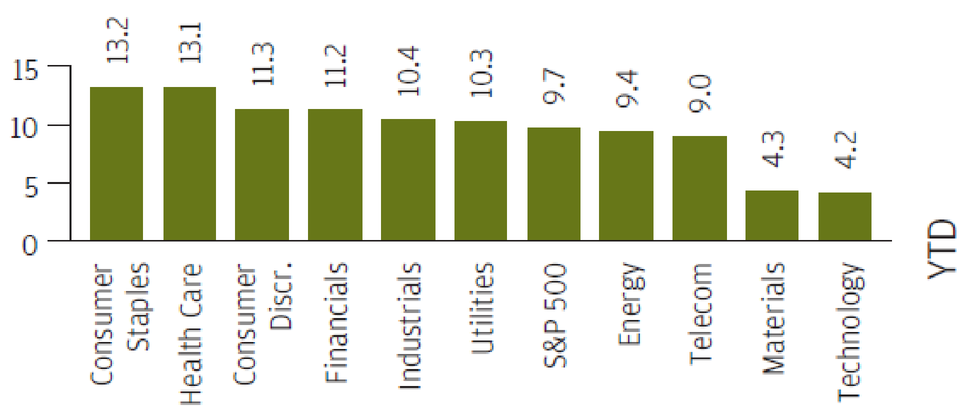
Market Recap
(as of Mar 22nd, 2013)

Equities	Level	1 week	QTD	YTD	1 year	3-yr. Cum.
		Index Returns (%)				
S&P 500	1557	-0.24	9.69	9.69	14.34	42.37
Dow Jones 30	14512	0.04	11.46	11.46	14.24	45.79
Russell 2000	2352	-0.63	11.69	11.69	16.89	44.31
Russell 1000 Growth	470.08	0.07	8.45	8.45	10.25	43.33
Russell 1000 Value	490.70	-0.50	11.47	11.47	19.26	42.92
MSCI EAFE	1687	-1.47	5.80	5.80	12.69	19.30
MSCI EM	1015	-2.51	-3.44	-3.44	0.53	11.33
NASDAQ	3245	-0.11	7.75	7.75	7.37	40.02

Fixed Income	Yield	1 week	QTD	YTD	1 year	3-yr. Cum.
U.S. Aggregate	1.88	0.23	-0.27	-0.27	3.88	16.82
U.S. Corporates	2.79	0.35	-0.23	-0.23	7.68	25.77
Municipals (10yr)	2.09	0.35	0.15	0.15	6.10	20.62
High Yield	6.47	0.08	2.74	2.74	13.03	38.14

Key Rates	3/22/13	3/15/13	12/31/12	12/31/12	3/22/12	3/22/10
	Levels (%)					
2-yr U.S. Treasuries	0.26	0.25	0.25	0.25	0.37	1.01
10-yr U.S. Treasuries	1.93	2.01	1.78	1.78	2.29	3.67
30-yr U.S. Treasuries	3.13	3.22	2.95	2.95	3.37	4.57
10-yr German Bund	1.38	1.45	1.31	1.31	1.91	3.07
3-mo. LIBOR	0.28	0.28	0.31	0.31	0.47	0.28
3-mo. EURIBOR	0.22	0.21	0.19	0.19	0.83	0.65
6-mo. CD rate	N/A	0.27	0.33	0.31	0.51	0.34
30-yr fixed mortgage	3.82	3.82	3.52	3.52	4.19	5.01
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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