MERITAS ADVISORS
Comprehensive Wealth Management

April 16th 2013

MONTHLY INVESTMENT OUTLOOK

In This Issue:

- Then and Now ó A Comparative Review
- GDP Growth Rates
- Corporate Earnings
- Employment
- Interest Rates and National Debt
- Market Volumes and Lessons from M&A
- Your Money
- Market Recap

Investment Committee:

Lenore Hawkins, Co-Founder
Lenore@MeritasAdvisors.com

Michael Mink, Co-Founder
Mike@MeritasAdvisors.com

Greg Tull, Co-Founder
Greg@MeritasAdvisors.com

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.

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

www.MeritasAdvisors.com

Dear Clients and Friends: Next week I will be heading to Monaco as I have been given the great honor of being asked to speak at the International Convention of Independent Financial Advisors concerning saving the worldøs financial systems. Iøm sure that there will be much discussion of the recent events in Cyprus and the tenuous situations next door in Italy and in France. It is always stimulating to talk to others in the industry from a variety of geographic perspectives, and the food and view wonøt be too painful either!
Lenore Hawkins, MBA, Principal

Then and Now – A Comparative Review

Recently the Dow Jones Industrial Average set a new all-time high, surpassing its previous high set back in October 2007, in nominal terms. (In inflation-adjusted terms, we have not yet reached the previous highs.) Many of the talking heads on Wall Street have been cheering the news as proof that the country is back on track and all is well. The reality for those outside of those marbled Wall Street halls is strikingly different between then and now.

On April 10th, CNBC interviewed David Rosenberg of Gluskin Sheff and Sam Zell, billionaire founder of Equity Office Properties. We thought a few quotes from the interview were worth sharing:

õ*So don't fight the Fed?"* - Maria Bartiromo (interviewer)

õ*That's a pretty glib comment for what is going on. You could have fought the Fed in 2000 and 2009 and done quite well…[thanks to the Fed] the markets will tend to drift up,* ***until something breaks****.*ö ó David Rosenberg

----

"The ***current stock market feels like the housing market of 2006****. Everybody can't afford to miss it."* - Sam Zell

*"That's a scary comment.*ö ó Maria Bartiromo

"Why? Every single day it goes up. What were the headlines in 2006? Housing prices going up every day. What are you talking about every day now? New high in stocks every day." ó Sam Zell

	2007	Now	Change
GDP Growth (annual ó trailing) *((Bureau of Economic Analysis)*	2.50%	1.60%	-0.90%
American Unemployed in Labor Force (millions) *(BLS)*	6.7	13.2	+97%
Americans on Food Stamps (millions) *(BLS)*	26.9	47.69	+77%
Labor Force Participation Rate *(BLS)*	65.80%	63.60%	-3.3%
Consumer Confidence *(Michigan Survey)*	99.5	69.5	-30%
Size of Federal Reserve Balance Sheet (trillions) *(Federal Reserve)*	0.89	3.01	+238%
US Debt as a Percent of GDP* *(BEA)*	38%	74.20%	+95%
US Deficit (LTM) in Billions *(BEA)*	97	975.6	+905%
Total US Debt Outstanding (trillions) *(BEA)*	9	16.7	+86%
US Household Debt (trillions) *(Federal Reserve)*	13.5	12.87	-4.7%
S&P Rating of US Debt *(Standard and Poor's)*	AAA	AA+	NA
10 Year Treasury Yield *(U.S. Treasury)*	4.64%	1.89%	-2.75%
NYSE Average LTM Volume (billion shares per day)	1.3	0.545	-58%

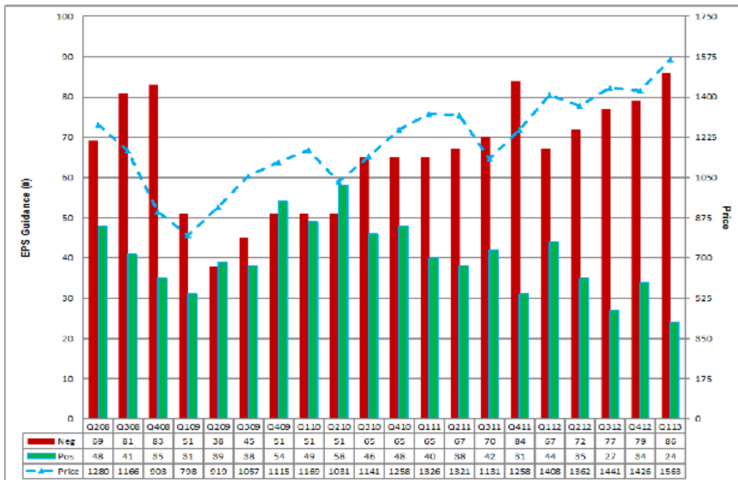
** Excluding inter-departmental*

GDP & Corporate Growth

None of the four major components of the business cycle, (real income, sales, production and employment) have managed to get back to their 2007 highs, even now as we enter the fifth year of the recovery. This is truly a record, if an unfortunate one.

Real GDP growth is measured at seasonally adjusted annual rates.

The chart at right shows the continual stop and go pattern that has been GDP growth since the financial crisis. Never before in modern history has the U.S. experienced this many post-recession quarters without having at least one back-to-back 3% plus growth in GDP. The evidence so far for the first quarter of 2013, which is expected to be much stronger than the second quarter of 2013, is sub 2%.



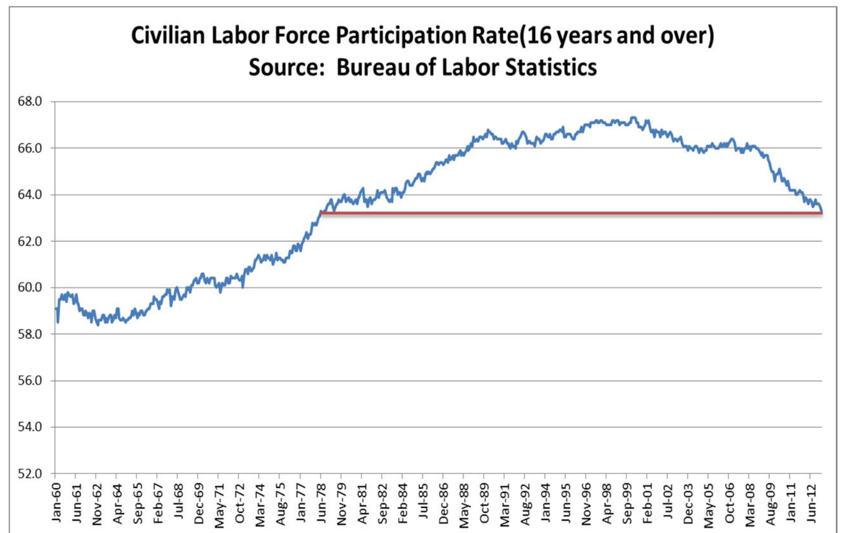
Source: Factset and Jashua Brown

Corporate Earnings

As we head into the first quarter's earnings season, 78% of companies have issued negative earnings preannouncements, the highest percentage of companies issuing negative earnings guidance since FactSet began tracking the data in Q1 2006. The chart at left shows in red, the percent of negative preannouncements by quarter and in green the percent of positive preannouncements with the S&P in blue. This is a troublesome trend to say the least and has us watching the market movement carefully. Eventually, stock market growth must be supported by corporate earnings growth and the trend for the past 11 quarters has been fewer and fewer positive corporate earnings surprises, as this chart clearly illustrates. The quantitative easing objective of driving up stock prices in order to create a wealth effect that leads to consumers and businesses spending more is not translating into better than expected corporate earnings.

Employment

With such slow growth, it isn't possible to get the employment situation to improve significantly, despite the attempts at upbeat headlines. On April 5th we learned that March experienced the biggest monthly increase in people dropping out of the labor force since January 2012, with 663,000 no longer looking for work. This means that we now have 90 million working age Americans who are not in the labor force. Of those, 6.5 million want a job and want to be in the labor force, (Bureau of Labor Statistics). The labor force participation rate has now dropped to 63.3% of the

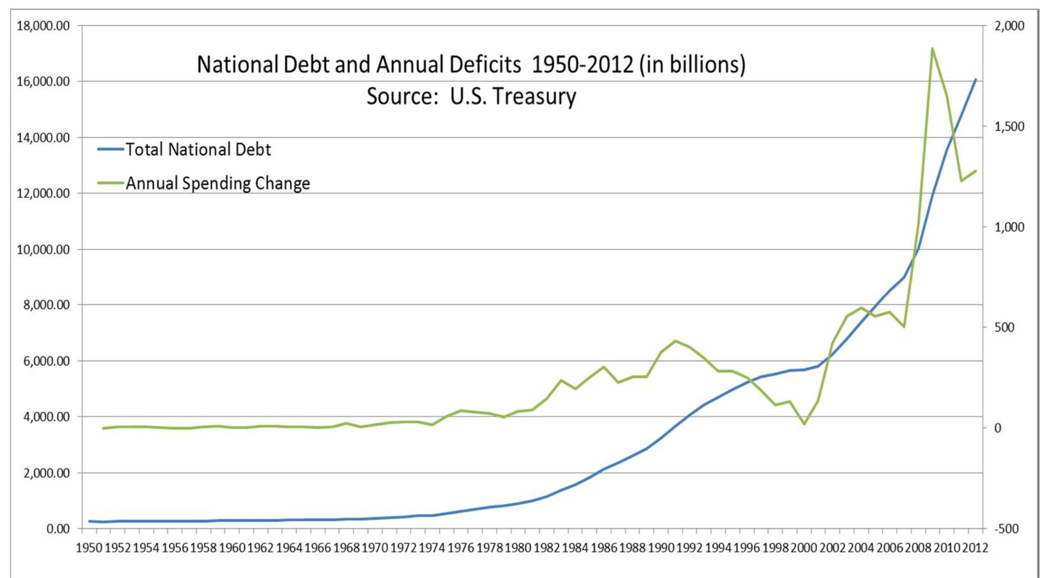


population, a level not seen since October 1978. The number of Americans officially unemployed has almost doubled since the market hit these levels in 2007 while the number of Americans on food stamps has risen to levels never before seen, with an almost an 80% increase since 2007. It is no wonder that consumer confidence continues to sit in recessionary territory.

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

What is most troubling is that a full 40% of those unemployed have been long-term, (see chart at right). Remember that the growth of our economy is dependent on the **quality** and **quantity** of labor and capital in the economy. With so many leaving the workforce and so many others out of work for an extended period, both quality and quantity are being materially reduced, which is a detriment to future growth prospects.

Interest Rates and National Debt



The Federal Reserve has been under considerable pressure to provide details for just how it will control all the excess liquidity that it has created through quantitative easing. The Fedøs balance sheet, which can roughly be thought of as a proxy for the potential money supply, is almost 2.4 times the size it was in 2007. Last month we discussed how excess bank reserves have skyrocketed to nearly $1.7 trillion after having historically averaged near zero since the inception of the Federal Reserve. The Fed has argued that it will be able to slowly raise interest rates and carefully reign in those excess funds to prevent rampant inflation. This is something that has never in history been accomplished, so there is no clear roadmap for how to do this successfully, but for argumentøs sake, letøs assume that the Fed is indeed capable. The question then becomes, õHow will rising interest rates affect the economy and investing?ö One of the largest impacts of rising interest rates will be on the financials of the federal government. The chart above shows the U.S. National Debt from 1950 to 2012 (left hand axis) and the annual deficit/surplus (right hand axis). The current national debt is over $16 trillion. Over the past 5 years, the annual deficit has averaged $1.4 trillion. The **national debt as a percent of GDP is almost double** what it was in 2007. **The annual deficit is 9 times the size it was in 2007**. The recent sequester cuts sent D.C. into apoplectic fits with dire warnings of impending doom, however those õcutsö, according to the Congressional Budget Office, represented a decrease in the amount of spending increase that is less than the total increase, which means **there will still be an increase in net spending after the sequester**, (see Congressional Budget Office õFinal Sequestration Report for Fiscal Year 2013ö published March 2013). Given the emotional hoopla and doomsday rhetoric, it is reasonable to assume that the current level of deficit spending is unlikely to decrease significantly anytime soon.

The current 10 year Treasury interest rate is about 1.8%. It reached its lowest level in July 2012 at 1.53% and the highest rate was 15.32% in September 1981 when Paul Volker put the kibosh on inflation. The historical average rate has been about 4.6%. The current annual interest payment on the debt is just over $220 billion. If interest rates were to rise to only the historical average of 4.6%, that would be an increase of 2.8%, which would be an increase of nearly $110 billion, if we assume for simplicity that all the new issuance is a 10 year terms. (The reality is that some would be shorter term, some would be longer, and this is just meant to give an approximation to illustrate the magnitude of the impact.) That means interest expense on the debt would increase a whopping 50% in the next year. If the deficit spending continued at about the same rate for the next 6 years, annual debt interest payments would become the governmentøs costliest expense by 2020. For every year that we continue to deficit spend, increasing the national debt, the magnitude of the impact of rising interest rates increases.

That puts the Federal Reserve into quite a pickle if the economy does in fact gets some legs and inflation ignites. Donøt raise rates and face punishing inflation. Raise rates and D.C. is going to be put under even more pressure to reduce spending. No wonder Chairman Ben Bernanke has been giving subtle indications that he isnøt keen on yet another term as Chairman!

Market Volumes and Lessons from M&A

Equity markets are being propped up by impressively cheap money: central bank liquidity injections and the over-time-price of money, interest rates. Typically during times of rising equity prices, merger and acquisition activity ramps up. Most expected 2013 to be a banner year for M&A activity and began trumpeting the return of such with the Heinz deal involving Warren Buffet. That deal warrants a closer look however as Buffet didnøt invest in the equity side, that side is primarily coming from Brazil. Buffet provided debt financing to the tune of 9%, not exactly a ringing endorsement of longer-term growth. Right now M&A activity continues to be in a noteworthy low because M&A is not dependent on cheap money, but rather on long-term growth prospects and confidence. The lack of such activity is yet another signal that the recent rise in equity markets warrants caution. If we look at market volume, **the number of shares traded on a daily basis has fallen almost 60% since 2007**. This shortage of volume implies that there is little conviction in todayøs directional trends.

Your Money

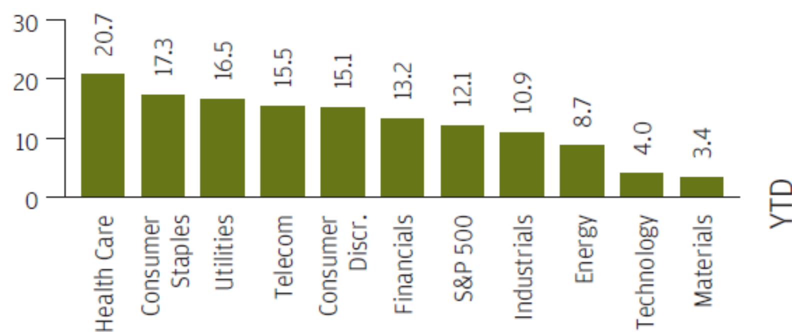
The negative news about the economy continues and yet the stock market has kept going up. This divergence reinforces one of the key lessons of active management, which is that the broader the financial instrument, the less predictable the movement of its price. For example, letøs consider the shares of a single company, a very narrow financial instrument. Apple (AAPL) shares gained 90% in value from November 2011 to Sept 2012. From Sept 2012 until now, AAPL shares have fallen 40%. An active manager has to effectively analyze an enormous number of factors affecting the perceived value of AAPL in order to benefit from some of the rise in the share price and avoid some of the fall in price. If an active manager bought AAPL at a good time in the past 18 months, the value of the investment nearly doubled in less than a year. If an active manager bought AAPL at a bad time in the past 18 months, the value of the investment was nearly cut in half in less than a year. A concentrated, actively managed fund has 30 to 50 stocks in it, so in order to do well for investors, the manager needs to make more good decisions than bad ones. Similar to baseball where batting .350 is hall of fame material, the best active investment managers make a number of mistakes every year. The key is that if their expertise and skill is great enough, and their area of concentration is focused enough, active managers have the potential to add value to an investorøs portfolio. Now imagine a broader instrument, such as the S&P 500 index. The amount of factors affecting whether the value of the shares of these 500 stocks collectively moves up or down in any given period is unquantifiable. Thus, consistently and repeatedly trying to figure out when it would be beneficial to own the S&P 500 index, and when it would not be, is probably an exercise in futility. However, we do know that, while this broad index is extremely volatile and experiences periodic temporary losses of 10%, 20%, 30% or more, on average over the past 90 years or so, the S&P 500 has gained over 9% per year. Having an appropriate amount of exposure, commensurate with each individual investorøs life situation, goals and risk tolerance, to broad indexes such as the S&P 500 is best achieved through having a portion of oneøs portfolio consistently invested in passive management or index funds.

Market Recap

(as of April 12th, 2013)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1589	2.34	1.34	12.08	17.12	41.60
Dow Jones 30	14865	2.11	2.01	14.27	17.52	46.28
Russell 2000	2343	2.14	-0.88	11.40	18.32	39.29
Russell 1000 Growth	479.90	2.56	1.16	10.82	12.33	43.64
Russell 1000 Value	499.64	2.17	1.21	13.66	22.60	40.53
MSCI EAFE	1715	3.40	2.61	7.98	18.18	17.43
MSCI EM	1020	1.22	-1.35	-2.89	2.50	6.34
NASDAQ	3295	2.85	0.88	9.47	9.32	38.61
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	1.78	-0.04	0.76	0.64	3.95	18.14
U.S. Corporates	2.65	0.11	1.44	1.33	8.47	27.70
Municipals (10yr)	1.92	-0.01	0.97	1.32	5.69	23.39
High Yield	6.34	0.66	0.76	3.67	14.31	37.40

	Levels (%)					
Key Rates	**4/12/13**	**4/5/13**	**3/29/13**	**12/31/12**	**4/12/12**	**4/12/10**
2-yr U.S. Treasuries	0.22	0.24	0.25	0.25	0.29	1.07
10-yr U.S. Treasuries	1.75	1.72	1.87	1.78	2.08	3.87
30-yr U.S. Treasuries	2.92	2.87	3.10	2.95	3.22	4.70
10-yr German Bund	1.26	1.21	1.28	1.31	1.70	3.17
3-mo. LIBOR	0.28	0.28	0.28	0.31	0.47	0.30
3-mo. EURIBOR	0.21	0.21	0.21	0.19	0.77	0.65
6-mo. CD rate	N/A	0.27	0.27	0.31	0.48	0.40
30-yr fixed mortgage	3.68	3.68	3.76	3.52	4.10	5.17
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



Meritas Advisors, LLC is a Registered Investment Advisor with the State of California Department of Corporations. This newsletter is provided for educational purposes only, does not constitute a complete description of our investment services and is not intended to provide specific advice or recommendations. The information contained herein is based on information we consider to be reliable, however, accuracy is not guaranteed.

4040 Civic Center Drive, Suite 200
San Rafael, CA 94903
415.690.8547

11622 El Camino Real, Suite 100
San Diego, CA 92130
858.461.8547

info@MeritasAdvisors.com
www.MeritasAdvisors.com