MERITAS ADVISORS
Comprehensive Wealth Management

June 18th 2013

MONTHLY INVESTMENT OUTLOOK

In This Issue:

- Home Prices
- Manufacturing
- Debt Debauchery
- Markets & the Fed
- Banks Demystified Part II
- Greg Tull's 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

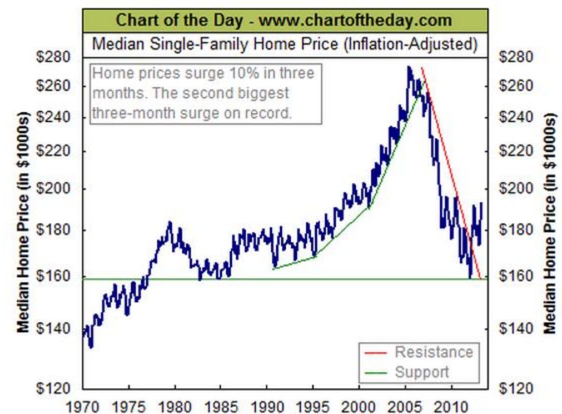
Southern California
11622 El Camino Real
Suite 100
San Diego, CA 92130
858.461.8547

www.MeritasAdvisors.com

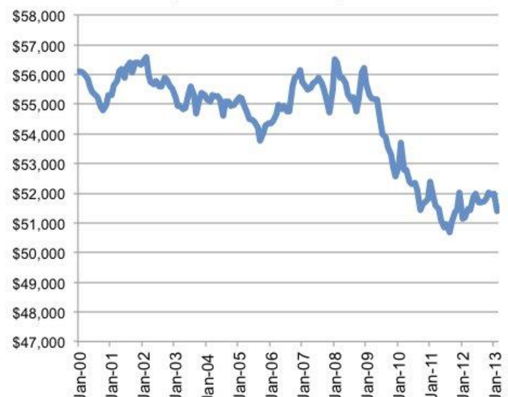
Dear Clients and Friends: Next month I'll be on a panel debating the best asset classes at FreedomFest in Las Vegas, a great conference which invites the "best and the brightest" from around the world to talk, strategize, socialize, and celebrate liberty. Other speakers include Steve Forbes, John Allison, former CEO of BB&T Bank, Stephen Moore of the Wall Street Journal and New York Times best-selling author Dinesh D'Souza. It is wonderful experience to be around a plethora of disparate perspectives in an environment that respects independent, critical thought. Please join me if you can!
Lenore Hawkins, MBA, Principal

Home Prices

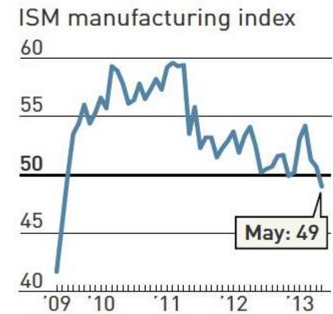
The chart below, courtesy of Chart of the Day, shows home prices from 1970 to present day. While housing prices did increase at an increasingly rapid rate from 1991 to 2005, all those gains were given back during the following 6.5 years. Over the past three months the median price of a single family home has again surged over 10%, the second biggest three-month gain on record, with data going back to 1968.



While we are quite pleased to see an improvement in housing, the artificial suppression of interest rates, courtesy of the Fed, *negatively affects income from investments which in turn reduces consumption*. Add to this that median household income levels have continued to fall. The chart below from Sentier Research shows that median annual household income in February 2013 was 5.6% lower than in June 2009, the month the recovery technically began and 7.3% lower than in December 2007 when the recession officially started and 8.4% lower than January 2000, the earliest date that the group began tracking the data. Depressed income levels make it that much harder to afford housing and for an economy whose GDP is 70% consumption, this is no minor concern. **Bottom Line**: *It will be difficult to get sustained, longer-term improvements in home prices and the overall economy until families see their income start to rise again.*



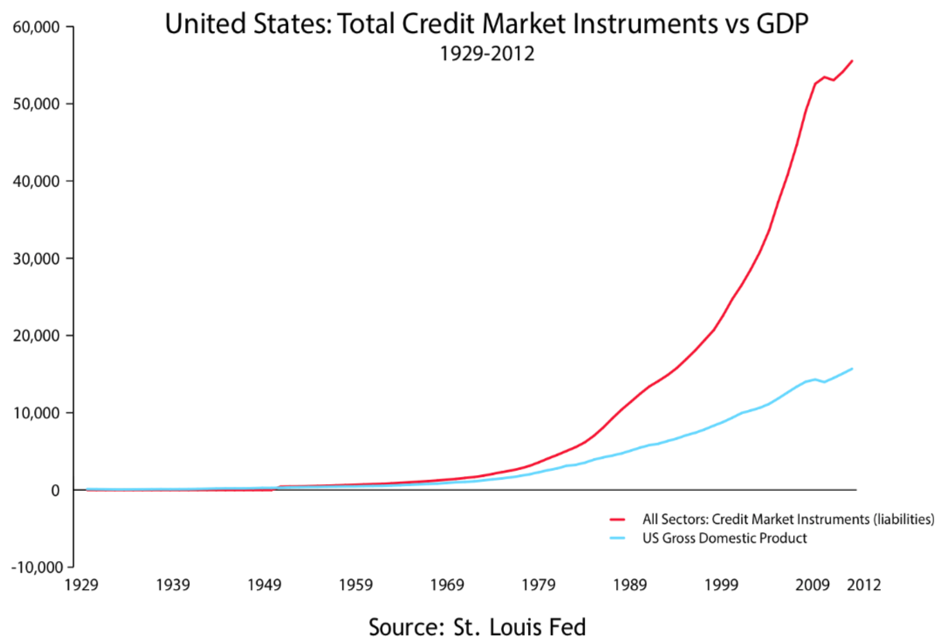
Manufacturing



While residential real estate has enjoyed improvements recently, the auto sector's continued strength wasn't enough to prevent a surprise retreat in manufacturing, which suffered from federal budget cuts and global economic weakness. On June 3rd, the Institute for Supply Management said its factory gauge fell to a four-year low of 49 in May from 50.7 in April, meaning activity pulled back into contraction from expansion. Analysts expected a slight improvement to 51. Sub-indexes on production, orders and backlogs also swung into negative territory. Employment dipped to a near-stagnant reading of 50.1 while export growth slowed significantly. **Bottom Line**: T*he U.S. economy appears to be slowly getting some traction, which is great news for us. However U.S. manufacturing cannot avoid being negatively affected by the slowing global economy. In addition, if Japan is able to significantly weaken its currency and if other manufacturing oriented economies follow suit in order to maintain their competitiveness, U.S. manufacturing could be further harmed by reduced pricing competitiveness as a result of a relatively stronger currency. It's a complicated world!*

Debt Debauchery

We are now some five years post-Lehman bankruptcy with global markets becoming ever more dependent on Central Bank QEInfinity to prop up asset prices. The chart at right, courtesy of the fantastic data provided by the St. Louis Federal Reserve, shows how U.S. GDP has grown relative to credit in the U.S. economy. The chart illustrates how the relationship between debt and GDP growth was fairly stable until 1970. At that point, the amount of debt necessary to generate additional economic growth continued to rise such that the level of debt in the economy grew much faster than the economy itself. Felix Salmon of Reuters described the situation by pointing out the following credit market to GDP ratios over time. We added 2012 Q4 for comparison using data from the St. Louis Federal Reserve.



Source: St. Louis Fed

Year	GDP *(trillion)*	Credit Markets *(trillion)*	Ratio
1970	$1	$1.6	1.6 to 1
2000	$10	$28.1	2.8 to 1
mid-2008	$14.4	$53.6	3.7 to 1
2012 Q4	$15.8	$56.3	3.6 to 1

Bottom Line: *While the ratio has declined a bit since the financial crisis, the chart above shows that the rate of growth in debt remains on a far steeper trajectory than GDP. With an economy that is more and more dependent on ever increasing levels of debt to generate additional economic growth, is it any wonder that the*

Federal Reserve is buying 90% of new debt issuance every month in an effort to keep interest rates low? Recall our discussion last month concerning how higher levels of debt affects returns, by exacerbating either up or down movements. It is worth contemplating the impact of a more highly leveraged economy as asset prices fluctuate… increased volatility anyone?

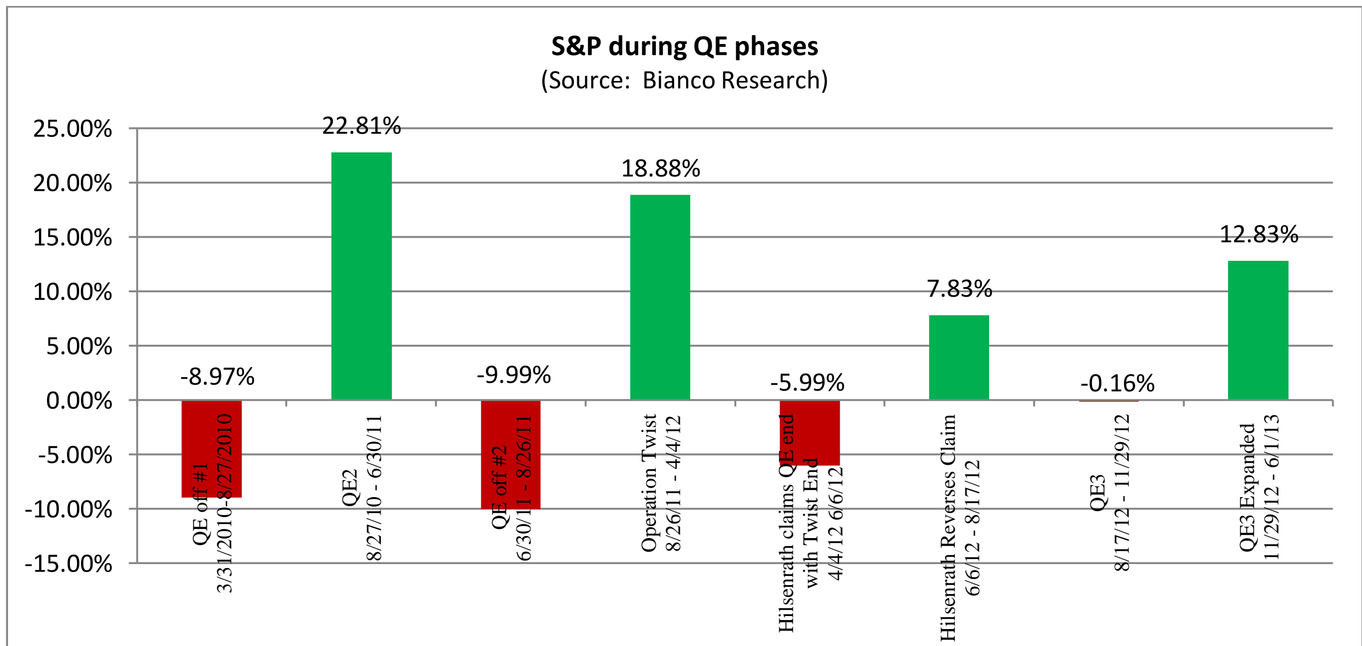
Markets and the Fed

For months we've been warning that the run up in the equity market is fragile and based more on monetary policies than on economic fundamentals. The recent *Tapering Tantrum* we've seen post Bernanke's comments about a potential decline in support levels attests to the level of dependency. Last week the market closed down for the week and has been down in three of the past four weeks. Stocks have turned into a white-knuckle ride since topping out in late May, with intraday swings of more than 1% becoming increasingly frequent. The recent market tumult after Ben Bernanke's "tapering" comments at his Joint Economic Committee testimony on May 22nd has resulted in global bourses losing over $2.5 trillion in market cap. The chart at right illustrates the markets nerves on May 31st, when afternoon trading pushed the markets dramatically lower, perhaps as is suspected by ZeroHedge,

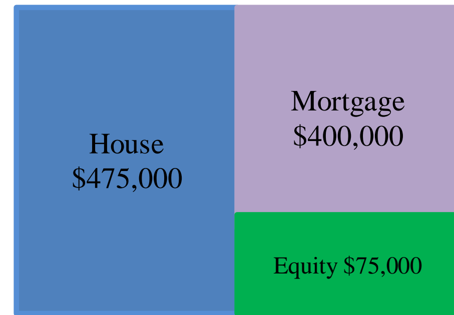
Source: Bloomberg

> *"Uncertainty exists about how markets will reestablish normal valuations when the Fed withdraws from the market. It will likely be difficult to unwind policy accommodation, and the end of monetary easing may be painful for consumers and businesses. Given the Fed's balance sheet increase of approximately $2.5 trillion since 2008, the Fed may now be perceived as integral to the housing finance system."*

Bottom Line: *Economic realities continue to be significantly less relevant than the Fed in a market in which good economic news is bad, (likely to induce tapering of QEInfinity) and bad news is good, (Fed more likely to keep its foot on the pedal). Bianco Research has provided a great perspective on how the S&P 500 has fared with QE on/off over the years which is shown graphically below.*

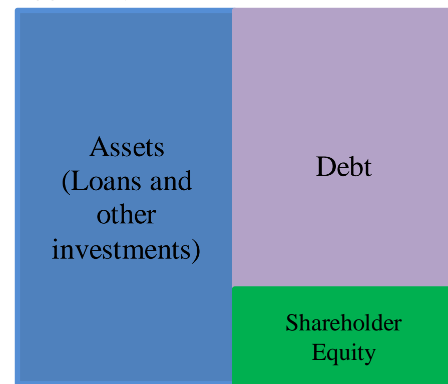


Banks Demystified Part II (Making sense of mark-to-market)



Last month we discussed how banks work and why leverage ratios are important. To recap, the chart on the right shows Jane's balance sheet with respect to her home. She put $75,000 down and borrowed $400,000. For Jane to be "underwater" on her mortgage, her home's market value would have to drop 15.8%, or $75,000, thus wiping out her entire down payment. For Jane to know whether she is underwater or has happily enjoyed an increase in her home's value, she can put her home up for sale and see what kinds of offers she gets or request an appraisal.

A bank can be looked at in a similar manner. The second chart on the right shows a bank's balance sheet with its assets, (instead of the home) on the left, and its debt, (instead of the mortgage) on the right and its shareholder's equity, (instead of down payment) on the bottom right. In 2007 new mark-to-market accounting rules were implemented by the FASB (Financial Accounting Standard Board). The 2007 vintage rule known as FAS 157 is intended to provide vital insight into companies' financial health. Mark-to-market accounting (also known as fair value accounting) requires companies to value the assets on their balance sheets based on the latest market indicators of the price of those assets. Essentially, the asset should be valued on the balance sheet based on the price at which they currently can be sold, regardless of purchase price. This means that the items in blue, (think home price) are reevaluated based on current market prices.



This sounds like a great idea for everyone doesn't it? Here's the problem. During the financial crisis it became more and more difficult to find buyers for anything, particularly mortgage-backed securities which were a bank favorite due to regulations such as the Basel Accords. The world was in panic mode so estimates on the assets banks' held were exceedingly low, or in some cases even zero. To put it in terms of our home analogy, imagine if everyone in your neighborhood put their home up for sale at the same time in 2009 when many felt the world was coming to an end. What would be the market price of your home then? Awfully low in this situation, a veritable fire sale price! Would that be a realistic price? Would the price be relevant to your personal financial situation? If you have a steady income with no problems paying your mortgage every month and no desire or need to move, does your home's price really matter on any particular month? You could just stay in your home for months or years until the price became something more attractive to you. For banks, they could just hold onto their assets until the market prices for them became something more attractive, *as long as they could continue to make payments on their debt.* That's the important part, as long as you can pay your mortgage, you don't have to sell your home. As long as banks can pay their version of a mortgage, which in their case is typically bonds, they can hold onto their assets until prices improve. **Bottom Line**: *Mark-to-market can actually greatly distort a company's financials as it may grossly overstate the value of its assets when those assets are greatly favored by the market and understate the value of its assets during difficult times such as the recent financial crisis.*

Greg Tull's Your Money

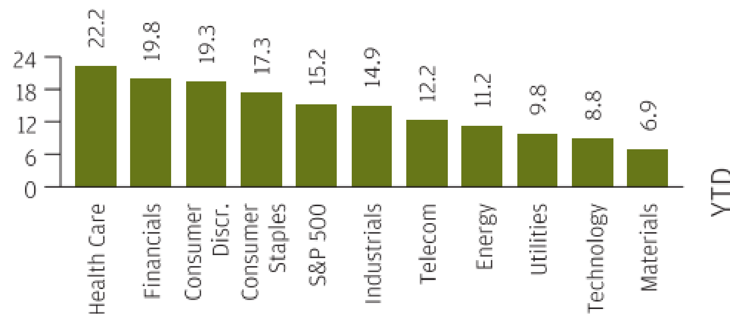
One of the primary ways for an individual investor to gain a competitive advantage relative to the markets is to have a long term time horizon. When viewed through this lens, investors with a disciplined long term approach can benefit from short term market fluctuations systematically. An important way to benefit from market run-ups and sell-offs is through a process called rebalancing. Each client of Meritas has a customized Investment Policy Statement (IPS) that includes an asset allocation designed to meet their specific goals, needs and tolerance for risk. The equity, fixed income, and specialty funds in each portfolio have a tendency to perform differently from each other. This divergence of short term performance is what provides the opportunity for effective rebalancing. Here's a simplified example to illustrate point. Let's say that a client has a 30/30/40

target portfolio, 30% bonds, 30% stocks, and 40% specialty. Then, a selloff in the equity market causes the actual portfolio weightings to diverge from the target, and become 35/20/45. At that time, Meritas would expect to sell 5% of the bond positions and 5% of the specialty positions and add 10% to the stock positions in order to bring the actual portfolio back into balance with the target in the IPS. By following this rebalancing discipline, the positions which have outperformed are trimmed, and the proceeds are added to the asset class(es) that have underperformed. Taking the long term view with this disciplined approach is a way of implementing one of the first rules of investing, to buy low and sell high.

Market Recap

(as of June 14th, 2013)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1627	-0.97	4.16	15.21	25.18	59.23
Dow Jones 30	15070	-1.12	3.84	16.31	22.23	60.10
Russell 2000	2439	-0.58	3.40	16.21	30.61	56.77
Russell 1000 Growth	489.82	-1.00	3.59	13.48	21.51	59.81
Russell 1000 Value	511.80	-0.85	4.09	16.91	30.17	58.68
MSCI EAFE	1689	0.45	2.24	7.59	28.50	34.69
MSCI EM	953.68	-2.61	-6.85	-8.31	7.32	11.56
NASDAQ	3424	-1.28	5.10	14.06	22.43	57.88
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.10	0.20	-0.86	-0.98	0.94	13.99
U.S. Corporates	3.01	0.13	-1.11	-1.22	4.31	23.50
Municipals (10yr)	2.42	-0.58	-1.32	-0.97	2.16	18.71
High Yield	6.69	-0.48	-0.06	2.84	13.00	39.90
	Levels (%)					
Key Rates	**6/14/13**	**6/7/13**	**3/29/13**	**12/31/12**	**6/14/12**	**6/14/10**
2-yr U.S. Treasuries	0.29	0.32	0.25	0.25	0.30	0.77
10-yr U.S. Treasuries	2.14	2.17	1.87	1.78	1.64	3.28
30-yr U.S. Treasuries	3.28	3.33	3.10	2.95	2.73	4.20
10-yr German Bund	1.51	1.54	1.28	1.31	1.49	2.63
3-mo. LIBOR	0.27	0.28	0.28	0.31	0.47	0.54
3-mo. EURIBOR	0.21	0.21	0.21	0.19	0.67	0.73
6-mo. CD rate	N/A	0.26	0.27	0.31	0.47	0.78
30-yr fixed mortgage	4.15	4.15	3.76	3.52	3.88	4.82
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 views expressed represent the opinions of the author and not necessarily those of Meritas Advisors, LLC and are subject to change without notice. The information contained herein is based on information we consider to be reliable, however, accuracy is not guaranteed. Past performance is not an indicator of future results.

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