MERITAS ADVISORS
Comprehensive Wealth Management

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MONTHLY INVESTMENT OUTLOOK

In This Issue:

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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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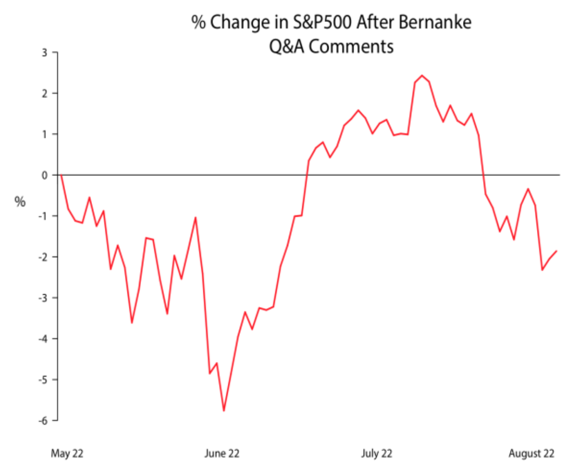
Dear Clients and Friends: My what a month it has been with potential strikes against Syria dominating the headlines, rumblings over an upcoming debt ceiling debate and tumult in emerging markets. So without further ado, let's get going.
Lenore Hawkins, Principal

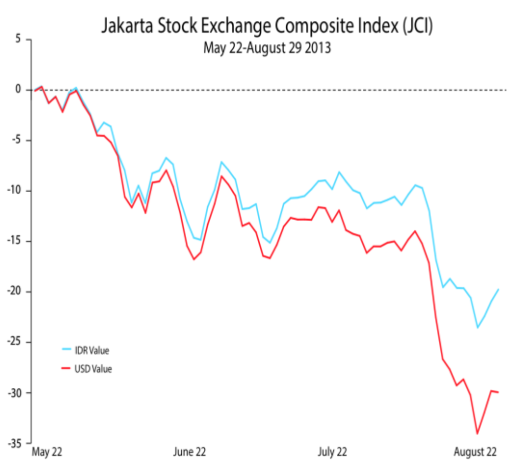
Market Update

Markets across the globe continue to be driven by the potential for tapering, (reduction in quantitative easing programs) by the Federal Reserve. The chart below shows changes in the S&P from immediately after the Q&A session in front of Congress (May 22nd), in which Fed Chairman Ben Bernanke first mentioned possible tapering, through the end of August. After the market's initial panic, the Federal Reserve quickly assured the world that there was no need to worry, as Ben's got your back. While the assurances appear to have soothed the U.S. equity market somewhat, emerging markets have been ravaged.

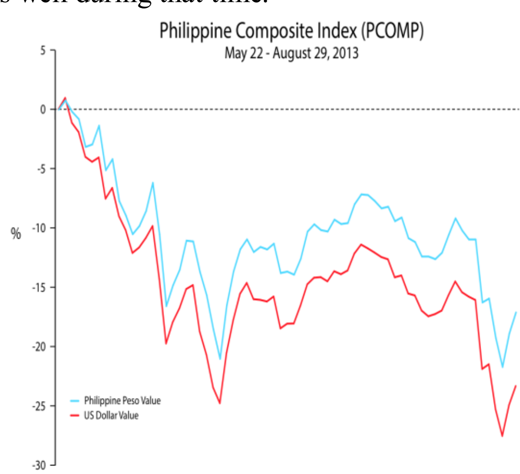


Source: Bloomberg

As the taper tantrum caused tumult in the markets, all the excess liquidity that had been running into emerging markets suddenly did an about-face. The currencies of Indonesia, the Philippines, Thailand and Brazil were pummeled in the May 22nd aftermath, wreaking havoc in their equity markets. By the end of August the Jakarta Stock Exchange Composite Index had, in USD terms, fallen 30% from May 22nd. The Philippines, one of the best performing equity markets in 2013 before the taper talk, fell 25% from May 22nd. Thailand's equity market fell nearly 30% as well during that time.



Source: Bloomberg



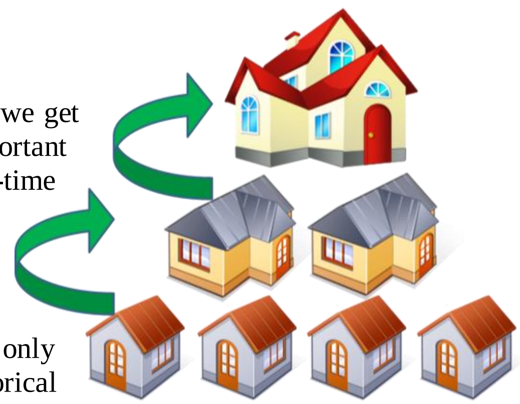
Source: Bloomberg

When asked if the Federal Reserve does or should consider the impact of tapering on emerging markets, the response was essentially that those affected, (Asia, Latin America, Africa and Eastern Europe) should mind their own business and stop whining. This unfortunately echoes the grave policy errors in 1998 as emerging markets, (representing about 50% of world GDP today versus 15% in the early 1980s when then Fed Chairman Paul Volcker's interest rate hikes crashed Latin America) are now large enough to have a significant impact on the global economy. The recent rousting is forcing them to start dipping into their reserves, in part by selling U.S. and European bonds.

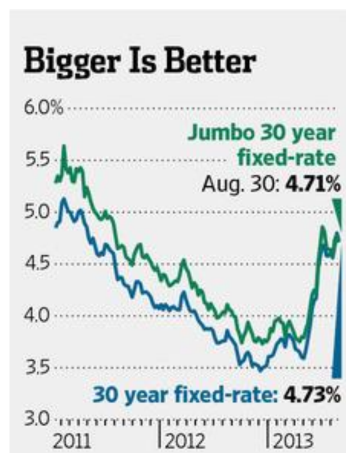
But isn't the U.S. economy improving dramatically at least partially as a result of the Federal Reserve's policies? According to a recent research report by the San Francisco Fed (click here to read), all that the Central Bank has accomplished with its intervention has been a net contribution of 0.13% per year to annual real GDP growth.

Bottom Line: *The Fed's enormous liquidity injections inflated, among other things, a bubble in emerging markets which inevitably had to pop. Net capital flows into emerging markets doubled from $4 trillion to $8 trillion after 2008. Central Banks in these markets find themselves trapped with no way out unless they can get some significant organic growth, and whether than can be achieved remains to be seen. The substantial increase in the size of these markets means that shocks emanating from the emerging world may have a deeper impact here in the U.S.*

Housing Fundamentals



We have a recovery in housing, yay! Not so fast there Mr. Headline. Before we get too giddy about the happy run up in home prices, we need to assess some important fundamentals. House prices across the spectrum are heavily dependent on first-time homebuyers. The first-timer buys a home from an existing homeowner who is then able to purchase a more expensive home, which allows that homeowner to buy an even more expensive home and so on. Over the past 30 years, first-time homebuyers represented 40% of existing home sales. According to the National Association of Realtors, in June of 2013, first-time buyers represented only 29% which was a drop from 32% a year earlier. Why this deviation from historical norms? First-timers are typically younger than existing homeowners. In today's market, younger workers have a higher unemployment rate than the overall workforce and are also saddled with much larger student loans than in the past. Their required payments on these loans reduce how much of a mortgage they can afford, their ability to save up for a down payment and lower their credit score.



Source: Mortgage Bankers Association
The Wall Street Journal

- In August, sales of new single-family homes dropped to their lowest level since last October, according to the department of Housing and Urban Development.
- The Mortgage Banker Association reported that their mortgage application index just fell 13.5% from the week ended September 6th, reaching a five-year low.
- Median household income, which greatly affects home affordability thus prices, was $52,098 in June 2013. That's still down significantly from the start of the recession in December 2007 when it was $55,480. (Both figures adjusted for inflation)
- Now for one heck of a head scratcher! Interest rates on jumbo mortgages, which are too big for government backing, have historically been at higher rates than conforming loans, which are back by Fannie Mae, Freddie Mac or other government agencies. At the end of August the relationship flipped, putting the interest rate on larger mortgages that lack government backing lower! This is the first time in history that this has happened, further highlighting the dramatic impact of the recent sharp rise in interest rates.

Bottom Line: *Until youth unemployment and the mind-boggling rise in tuition fees are addressed, home prices will continue to face limiting headwinds. In addition, there have only been 16 periods in the past 50 years when interest rates rose more than 20% in 200 days. The recent rise in rates has been dramatic on a percentage basis. Be wary of the impact on housing.*

Employment

The unemployment rate is falling, but this is primarily because the labor force has shrunk to a level not seen in 35 years. In August the labor force participation rate fell to 63.2%, a level not seen since August of 1978. Some of this decline can be attributed to the retirement of the baby boomers, but according to the Economic Policy Institute somewhere between two-thirds and three-fourths of the drop is attributed to the lack of jobs.

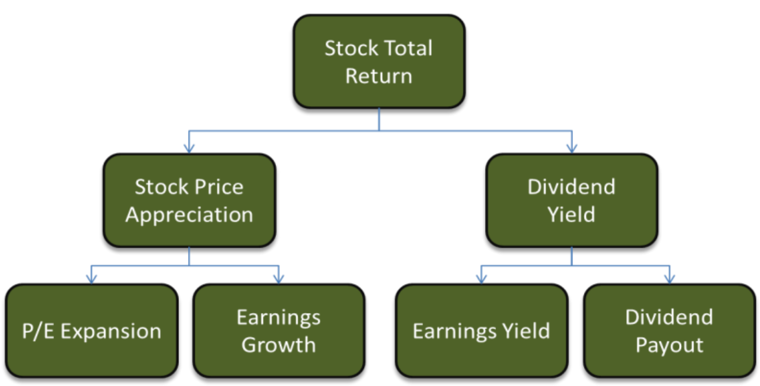
There are now 90.5 million Americans, 16 years-old and above, who have removed themselves from the workforce. It is estimated that 40 million of them have simply given up looking for work for a variety of reasons.

According to the September 6th employment report, only 169,000 new jobs were created in July and the prior two months were revised downward for a total of 74,000. Job openings in July fell to the lowest level in six months.

Bottom Line: *As we face rapid growth in Social Security and Medicare payments, having a smaller and smaller portion of the population involved in growing the economy creates a situation that will impossible to sustain.. Those who are working are facing declining real wages in aggregate, causing further strain. How entitlement programs will adapt is uncertain, but major changes in the years to come are likely. The decline in the working population also puts downward pressure on potential tax revenue as there are fewer income earners to shoulder the income tax burden. On the bright side for municipal budgets, many folks who are not in the labor force still pay sales taxes, and are members of households that still pay property taxes. And given our paralysis in Washington, a long-term solution to our entitlement woes seems dubious. However, we remain optimistic that a solution can and will eventually be reached, because, as Stein's Law states, "if something can't go on forever, it will stop", but the adjustment period could prove to be painful.*

Stock Market Math (continued from last month)

Last month we discussed how total stock returns are driven by two things: (1) stock price appreciation and (2) dividend yield, which in turn are driven by the expansion/increase in P/E ratios, earnings growth, earnings yield, and dividend payout as shown in the chart below.



In the second quarter we saw just over 1% growth in earnings from a year ago while the S&P 500 index rose by nearly 25%. Recall from last month that **Stock Price = Price to earnings ratio x Earnings per share**

We've seen earnings growth rates decline in recent quarters as more of the improvements in earnings since the financial crisis came more from reducing expenses, a process that clearly cannot go on indefinitely, than from revenue growth. For earnings to continue to grow at this point, companies will have to grow their revenues more than in the quarters since the crisis while continuing to manage expenses.

If we look at the current economy, any one company can implement strategies that will grow their revenues, but with an economy still in the doldrums and weak household income, it will be difficult for companies across the board to all grow their revenues, thus increases in stock prices across the markets will have to come more from an increase in PE ratios. *This highlights the need in the current market for an increased emphasis on specific securities as opposed to 2009 through much of 2011 when the correlation between asset prices were very high.*

For the price to rise by 25% with only a 1% increase in earnings, the P/E ratio must have expanded in the last quarter. On January 1st, 2013 the Current PE ratio, (using data from Robert Shiller which uses the latest reported earnings and the current market price) was 17.0. On March first it had risen to 17.7. By July 1st, the ratio rose to 19.2, which is a 12.5% increase from January 1st and an 8.4% increase from March 1st. *This means that from January to July the market valued a dollar of earnings as being worth 12.5% more.* The historical mean for this type of PE ratio is 15.5 and the median is 14.5. *Today's PE ratio stands at 19.2, which is 24% above the mean and 33% above the median.* Given the premium valuations that stocks are commanding currently, equity markets have room for a pullback if investors get concerned, or surprised by negative news flow.

Two key contributors to the run up in stock prices in 2013 are the excess liquidity provided by the Federal Reserve and the perception that the economy is improving. A reduction in the level of liquidity (tapering) and/or a perception that the economy is not strengthening to the degree previously believed would likely have a negative impact on the recent expansion in PE ratios, and therefore on stock prices.

According to our model, the next two factors for total stock returns are earnings yield and the dividend payout ratio. The earnings yield is simply the inverse of the PE ratio, so the higher the PE ratio, the lower the earnings yield. As a rule, we prefer companies that are increasing their dividend payout ratio. Companies with strong dividend payout ratios have historically delivered better returns than their competitors, despite the belief held by many that companies pay dividends only when they don't have something better to do with the funds. Research by Cliff Asness and Robert Arnott (click here to read) has shown that the fiscal discipline required in firms with high dividend payout ratios has generated stronger earnings growth over time.

Bottom Line: *In the early part of the post-crisis market, asset prices were highly correlated, making individual selection less valuable. Today we are in a market in which specific selection is once again key and those companies and sectors that have shown fiscal discipline over time and have PE ratios that are attractive relative to the broader market can help limit investors' downside risk in a market that is technically overheated.*

Greg Tull's Your Money

"Reversion to the mean" is a useful concept in investing. When we apply this concept to stock index valuation, this implies that there is a tendency for stock prices to trend higher when the market PE is well below the historical mean, and a tendency for stock prices to trend lower when the market PE is well above the historical mean. Reversions to mean valuations can take place over a long or short period of time, and it can happen by stock prices adjusting or by earnings adjusting. For example, one way for an overvalued stock market to revert to a more normal valuation level is for stocks to "grow into their valuation." In other words, earnings growth could exceed stock price growth for a period of time, bringing valuations back into line with historical norms. Another way to revert to mean valuations is for stock prices to pull back. In most cases, stocks remain at valuations above or below their historical mean PE for years at a time, and it's never known in advance by what mechanism, or when, the reversion to the mean will occur. Nonetheless, it's always helpful to know where we are in the valuation cycle, since persistently high stock market valuations will eventually be a headwind to future stock price gains, and persistently low stock market valuations will eventually be a tailwind.

As mentioned in a previous newsletter, the bond market in 2013 got off to its weakest 1st half start since 1994. One silver lining to point out is that bond yields have increased as a result, since bond prices and interest rates move in opposite directions. Therefore, the silver lining of the bond selloff is that interest rates for investors in bonds are a good deal higher than they were at the start of the year. At the low of 2013, a purchaser of a 10 year Treasury bond would have received an interest rate of only 1.6%. Today, a purchaser of a 10 year Treasury bond would earn interest of 2.9%. This is good news for bondholders who are being compensated better for lending their money to borrowers.

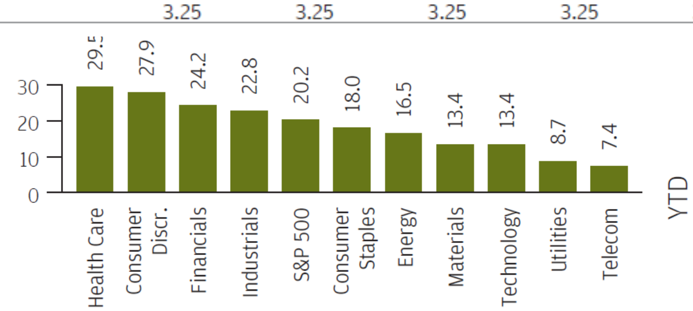
Market Recap

(as of September 13th, 2013)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1688	2.03	5.58	20.18	18.21	60.49
Dow Jones 30	15376	3.09	3.72	19.46	16.50	57.79
Russell 2000	2619	2.42	8.08	25.22	24.88	68.38
Russell 1000 Growth	516.77	2.28	7.53	20.22	17.28	64.46
Russell 1000 Value	528.07	1.91	4.69	21.34	21.30	59.20
MSCI EAFE	1787	2.45	9.45	14.34	20.60	30.33
MSCI EM	986.84	3.32	5.73	-4.20	3.35	3.95
NASDAQ	3722	1.72	9.69	24.42	19.65	68.72

Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.59	0.32	-0.92	-3.34	-2.62	8.01
U.S. Corporates	3.54	0.22	-0.80	-4.19	-1.93	13.43
Municipals (10yr)	3.15	0.92	-1.09	-3.83	-2.10	10.38
High Yield	6.82	0.44	1.70	3.14	6.31	31.20

	Levels (%)					
Key Rates	**9/13/13**	**9/6/13**	**6/28/13**	**12/31/12**	**9/13/12**	**9/13/10**
2-yr U.S. Treasuries	0.45	0.46	0.36	0.25	0.24	0.53
10-yr U.S. Treasuries	2.90	2.94	2.52	1.78	1.75	2.74
30-yr U.S. Treasuries	3.84	3.87	3.52	2.95	2.95	3.83
10-yr German Bund	1.98	1.95	1.73	1.31	1.55	2.43
3-mo. LIBOR	0.25	0.26	0.27	0.31	0.39	0.29
3-mo. EURIBOR	0.23	0.23	0.22	0.19	0.26	0.89
6-mo. CD rate	N/A	N/A	0.27	0.31	0.39	0.39
30-yr fixed mortgage	4.80	4.80	4.58	3.52	3.75	4.47
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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