February 25th 2014

Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

IN THIS ISSUE

UPCOMING EVENTS

- 05/07: **Top 10 Strategies to Enhance the Value of your Business** with M&A attorney Jessica Karner
- 09/24: **Maximizing the Value of your Privately Held Business** with David Ryan of Upton Financial
- Dec '14: **Vital tax Changes and Your Checklist** with Coree Cameron of Cameron Coffey & Kaye

SPEAKING ENGAGEMENTS

- April 23-25th **Lenore Hawkins in Monaco** at the **XIIth International CIFA Forum**
- July 9-12th **Lenore Hawkins in Las Vegas** at **FreedomFest**

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: The U.S. equity markets have netted very little so far this year. One well known market commentator I follow, John Hussman, fears that a bubble has been inflating since late 2009.

"The problem with bubbles is that they force one to decide whether to look like an idiot before the peak, or an idiot after the peak. There's no calling the top."

On the other hand, one of the managers of a conservative mutual fund family, Kimball Brooker Jr of the First Eagle Overseas Fund, stated in an interview with InvestmentNews on Feb 24,

"I wouldn't call the markets a bubble. They're fairly to fully priced…It's hard to say that sort of mindset – whether it's a high level of confidence or euphoria – I don't feel that way about the rest of the market [other than social media stocks], which is one of the reasons it's hard to say the market is in any sort of bubble territory. There's not the same level of confidence in the psychology of the market at the moment."

Opinions vary, which makes a market. Our job at Meritas is to be ever vigilant for warning signs, respecting the trust you place in us.
Lenore Hawkins, Principal

Market Update

From Dec 31st, 2013 to the lows for the year to date on Feb 3, the S&P 500 pulled back 5.8%, while the Dow Jones 30 gave back 7.3% in the same time frame. Both indexes rebounded in February, with the S&P 500 now about flat for the year as of Feb 24, while the Dow has rallied back to being down about 2.2%. Only the NASDAQ is in positive territory, up 2.28% year-to-date. In contrast, natural gas is up 37% year-to-date, gold up 9.8% and silver up 11.5%. By February 3rd, the volatility index (VIX) closed up as much as 51% from the first day of trading for the year, but has since fallen back to close on February 24th at the same level as it closed on the first of the year.

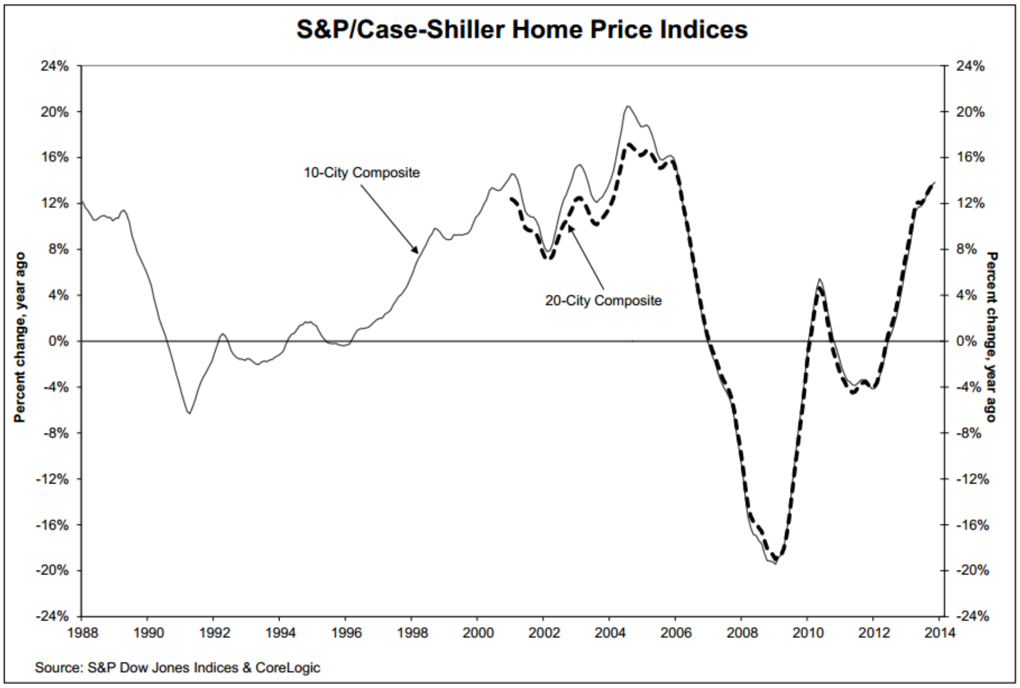
On February 25th, we learned that the previously robust Conference Board Consumer Confidence index dropped by the most in 4 months, missing expectations by the most since October. The Chart below, hat tip to ZeroHedge, shows the trend from 1995. Some good news within the Consumer Confidence readings were seen in the Jobs Plentiful Index, which rose to 13.9%, its highest reading since June 2008, and the Jobs Hard to Get Index fell to 32.5%, its lowest reading since September 2008. Both readings indicate continued gradual improvement of the US employment picture.

Meanwhile fears of a hard landing for China are resurfacing, with the Shanghai Composite falling nearly 10% in the past week and down another 2% overnight as of February 25th. In addition, China's yuan dropped the most in over a year and the Shanghai Composite declined the most in five months on speculation that the People's Bank of China will act to end the yuan's steady appreciation. Given the pressure that emerging markets have been under, this is one area where conservative managers such as Mr. Brooker and the First Eagle funds are searching for stocks that are cheap enough to buy.

Bottom Line: *Market volatility has returned as the Fed slows QEInfinity and economic news continues to surprise to the downside, coupled with increased fears over China and emerging markets, keeping markets mostly sideways so far this year.*

Housing recovery stumble?

First the good news, data through November 2013, released January 28th by S&P Dow Jones Indices for its S&P/Case-Shiller Home Price Indices, the leading measure of U.S. home prices, showed that the 10-City and 20-City Composites increased 13.8% and 13.7% year-over-year. Dallas posted its highest annual return of 9.9% since its inception in 2000. Chicago also stood out with an annual rate of 11.0%; its highest since December 1988. The three cities tracked by the indices in California also enjoyed strong year-over-year returns as of November, with San Francisco up 23.2%, Los Angeles up 21.6% and San Diego up 18.7%.



Now the bad news, in November, the non-seasonally adjusted version of the 20-City Composite, which as the report's authors acknowledge is the accurate one, posted its first monthly decline, dropping modestly from 165.9 to 165.8, or down 0.06%, since November of 2012. In December, the 20-City Composite showed its second consecutive monthly decline of 0.1%. The concern here is how much of the recovery in housing has been driven by investors, foreign, domestic and institutional, buying in all-cash sales on a speculative basis. According to RealtyTrac, sales of foreclosed and distressed homes made up 16.2% of all home sales last year, up from 14.5% in 2012. All-cash deals accounted for 29.1% of all home purchases, again up from 19.4% the year before. Institutional investors, including hedge funds and private equity groups, were buying up homes of all types last year including foreclosures. During the year, 7.3% of all home sales were to investors, up from 5.1% the year before. Major markets where investors claimed the largest percentage of sales in December included Jacksonville, Fla., (38.7%), Knoxville, Tenn., (31.9%), Atlanta (25.2%), Cape Coral, Fla. (24.9%), Cincinnati (19.3%), and Las Vegas (18.2%).

In January existing home sales fell by 5.1% from December to the slowest pace in over a year. While this is concerning, much of that could be attributed to the horrendous weather. Only the coming months will tell if this is a new directional trend, or a function of an exceptionally difficult winter.

On January 30th, we received more cautious news. Pending home sales fell 8.7% month-over-month, the worst since May 2010, missing estimates by the most in over 3 years. This is a 6.1% drop year-over-year. According to Larry Yun, the Chief Economist for the National Association of Realtors explained:

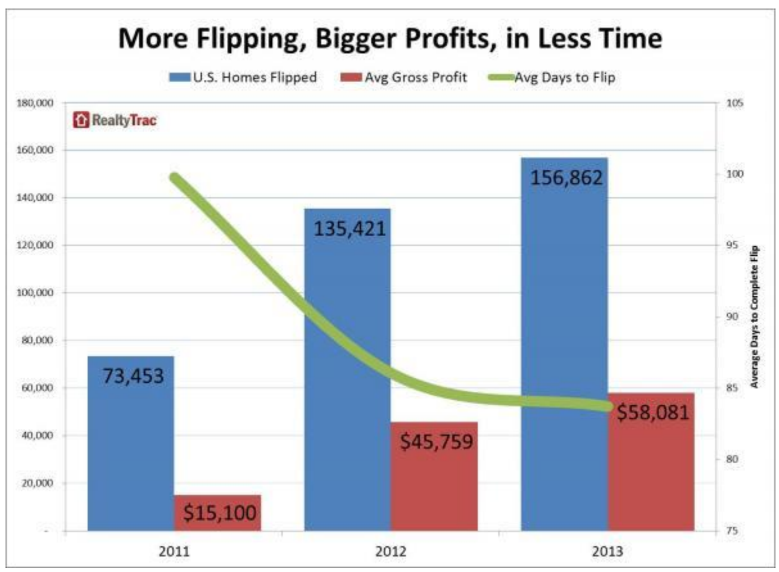
> *"Unusually disruptive weather across large stretches of the country in December forced people indoors and prevented some buyers from looking at homes or making offers," he said. "**Home prices rising faster than income** is also giving pause to some potential buyers, while at the same time a lack of inventory means insufficient choice. Although it could take several months for us to get a clearer read on market momentum, job growth and pent-up demand are positive factors."*

On Feb 26th, there was a glimmer of silver lining for the housing market, in that new home sales jumped a bigger-than-expected 9.6% to a seasonally adjusted total of 486,000 despite poor weather which hurt foot traffic. Economists were expecting sales to dip 3.4%. The report shows the housing market remains resilient despite bad weather and higher borrowing costs. We don't want to get too excited about the Feb 26th report, because new home sales figures can be volatile. January's numbers could be revised down in coming months, as October's and November's previously-reported figures were this month. It's also important to note that new home sales are a small portion of the overall housing market and they remain weak for a late stage economic recovery.

Flipping homes, (when a home is purchased and subsequently sold again within six months) has become quite the money making adventure for some. In 2013, 156,862 single-family homes were flipped, up 16% from 2012 and up 114% from 2011. Homes flipped in 2013 accounted for 4.6% of all U.S. single family home sales during the year, up from 4.2% in 2012 and up from 2.6% in 2011. The chart below at right shows how the magnitude of flipping has grown over the years.

However, the flipping trend appears to be slowing. Flips accounted for 3.8% of all sales in 4Q, down slightly from 3.9% of all sales in 3Q and down from 7.1% of all sales in 4Q 2012, the highest percentage of sales represented by flips in a single quarter since RealtyTrac began tracking flipping data in the first quarter of 2011.

Bottom Line: *The factors driving home prices up may not be sustainable. For housing to enjoy a sustainable recovery over the long run, employment and household income levels need further improvement.*



Fed Tapering

On January 29th, the Federal Reserve announced that it would again reduce its monthly purchase of longer term U.S. treasuries from $40 billion to $35 billion and will reduce its monthly purchase of mortgage-backed securities from $35 billion to $30 billion. This reduces the total monthly monetary expansion from $85 billion per month back in December, to $75 billion in January and now to $65 billion per month. With cumulative quantitative easing now reaching into the trillions and a federal budget deficit projected in the $500 billion range for 2014, $10 billion may not seem like a lot, so let's put it into context. $10 billion is more than the average monthly portfolio investments into Turkey, India, Brazil, Indonesia, Thailand, Chile and Ukraine *combined*! The now $20 billion reduction is approximately equivalent to all those *plus* Mexico and Canada. Is it any wonder the emerging markets have been rocking and rolling lately?

By reducing tapering by $10 billion two months in a row, the Fed is giving the markets the impression that it is creating a pattern of tapering, which is significantly altering expectations. We believe this trend will continue, particularly in light of the three academic papers presented at the Fed's Jackson Hole Federal annual conference in 2013 which concluded that the present approach of quantitative easing by the Federal Reserve has actually *slowed* economic activity.

Recall that the process of quantitative easing involves the Fed buying bonds from banks in return for cash that is placed in their "bank reserves" at the Fed. The Fed implemented Quantitative Easing under the theory that buying up large amounts of debt from banks would keep interest rates low and would increase bank lending thus stimulating the economy. It turns out that not all debt is equal and the program didn't produce the expected results. First, the money multiplier, which reflects the conversion of those bank reserves into deposits, meaning actual money in the economy, fell to a new 100 year low of less than 3 in late December 2013. To put that number in context, since 1913, the start of the Federal Reserve, $1 increase in bank reserves resulted in an increase of $8.20 in actually money being used in the economy. For more on how this process works read our White Paper on Fractional Reserve Banking by clicking here. Bank credit today is only about 2% higher than it was a year ago, which is a rate that is not quite keeping up with growth in GDP.

More importantly for markets, last week the Fed released notes from the 2008 financial crisis meetings. Those notes revealed considerable disagreement between Fed officials on the severity of the situation as the crisis unfurled and on how to best manage the situation. The day after Lehman Brothers filed for bankruptcy, most of the Fed officials were confident that the economy would continue growing, with the policy-making committee voting unanimously against using any monetary policy tools to support the economy. At the time, the Bank of St. Louis President, James Bullard, suggested, "To wait for some time to assess the impact of the Lehman bankruptcy filing, if any, on the national economy."

Bottom Line: *The decision to further reduce monthly expenditures may inject volatility into global markets and could contribute to further decreases in investor interest in developing countries, in turn creating buying opportunities for emerging market equities. Additionally, the recent release of Fed minutes during the heat of the crisis revealed, unsurprisingly, that the Fed really wasn't sure just what it was dealing with as the crisis evolved. We are in the middle of a monetary experiment, the magnitude of which is wholly unprecedented. It is highly unlikely that this experiment can be unwound without periods of significant volatility.*

Emerging Market Mayhem

On January 28 Business Insider reported that Turkey's central bank raised its overnight lending rate from 7.75% to 12%, a much higher increase than was expected. Turkey is trying to restore investor confidence and prevent a further plunge in the lira while still maintaining economic growth in an election year. The rate hike takes place amid a political power struggle that will only intensify in the lead-up to local elections in March. Unfortunately for the troubled nation, the impact of the sizeable rate hike lasted less than a day, as is evidenced in the chart at left from Bloomberg.

On the 29th, South Africa unexpectedly raised its overnight lending rate by 0.5% to 5.5%.

That begs the question, "Why are they raising rates and more importantly, why should I care?"

The Federal Reserve's quantitative easing programs reduced interest rates, believing that reduced rates would stimulate the economy. A side effect of the reduced rates is *financial repression*. That means that investors had to take on more risk than they'd like to get the kinds of returns that they need. Imagine how wonderful it would be if today you could buy a U.S. Treasury bond that gave you 6% annual rate of return! This *financial repression pushes all investors out into riskier securities* in search for reasonable yield.

Emerging markets have benefited from this financial repression in that there has been more demand for securities in EM than there would have been if you could get that 6% back home in Treasuries. When the Fed tapers, it will be buying fewer and fewer Treasury and mortgage bonds. We all know what happens when demand for something drops… prices tend to fall. For a bond, when prices drop the yield goes up. That means upward pressure on interest rates and a likely decline in the amount of money floating around, looking for a place to be invested.

For emerging markets, that means less money going in their direction. We've already seen that trend begin, which forced the emerging markets such as the one's mentioned above to increase their interest rates in an attempt to attract more investors. So far, it hasn't worked.

Many of the talking heads on TV are likening the current trends in emerging markets to the crises of the early 1990s, the Asian crisis of 1997 and the Russian crisis of 1998. There is one very big difference between now and then that warrants your attention.

Emerging markets today now account for about 40% of world GDP, twice what they represented 20 years ago.

Bottom Line: *A broad crisis in emerging markets would have noticeable impact on developing economies. Currently the most vulnerable are Argentina, Ukraine, Turkey, Chile, Peru and possibly Thailand. Together they account for about 4% of world GDP. Not terribly concerning for us in the States. However if you add in Brazil, Indonesia and India, which are less worrisome at the moment but have some major hurdles coming up, they add up to about 10% of world GDP, getting more impactful.*

GDP Weakening

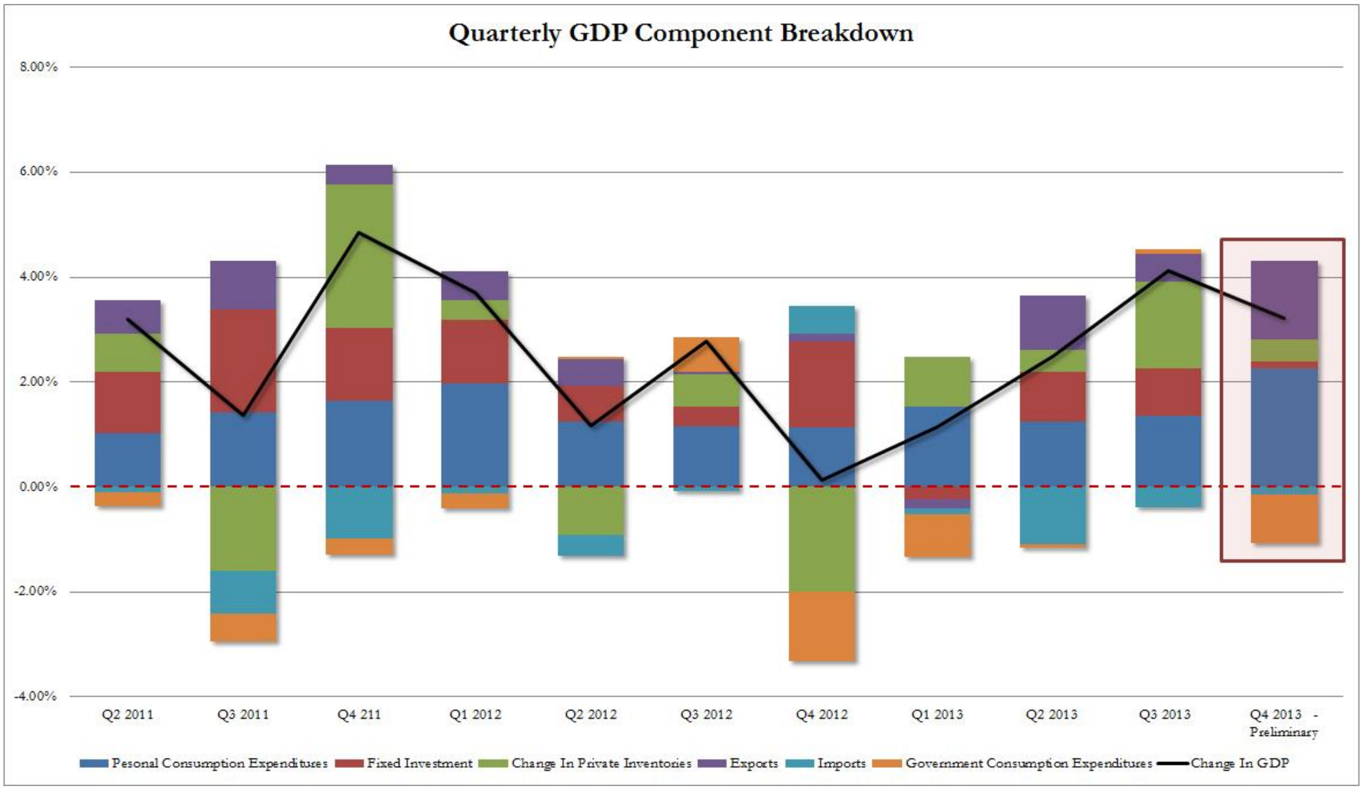
GDP growth is a mixed bag. Q3 2013 GDP growth was estimated to be a robust 4.1%. We would not be surprised if this turns out to be an overestimate that is later revised downward. The bad news is that Q4 GDP was recently estimated to be 3.2%, which leads to the not so good news that 2013 GDP growth by current estimates was 1.9%, which is down considerably from 2012's 2.8% growth rate. The good news is the composition of this preliminary estimate is better than in Q3, with inventory buildup accounting for only 0.42% of the 3.22% compared to 1.67% in Q3. Additionally, for the first time since Q1, personal consumption accounted for more than half of GDP growth.

The primary drivers of consumption growth were Services, and a jump in spending on housing and utilities (from negative 0.31% to positive 0.14%), as well as Food Services and Accommodations which rose from 0.02% to 0.43% annualized. How much longer consumers can keep this behavior up with shrinking purchasing power remains to be seen.

The bad news emerges from Fixed Investment, which fell from 0.89% to just 0.14% annualized, as investment across the board dipped but mostly in non-residential structures (down negative 0.03% from 0.35%) and a fall in residential fixed investment from 0.31% to negative 0.32%.

Net trade contributed a surprising 1.33% to GDP growth, the most since the 2.39% increase in Q2 2009. How much longer can the US continue boosting its GDP on the back of the shale boom, and declining imports, also remains to be seen. Just like the inventory build-up from the later part of last year that now has to be soaked up, so too a reversal of net trade boost could become a drag on growth, unfortunately at a time when the consumer could also pull back.

Households continue to muddle along, with median household income just over $51,000, which is about where it was 20 years ago. Real disposable personal income recently fell by 2.7% from a year ago, which is the biggest one year decline since the semi-depression of 1974. While the official unemployment rate has fallen to 6.6%, the labor force participation rate, which is the portion of the population either employed or looking for work, is at 63%, a level we have not seen since 1978. If the participation rate was at pre-crisis levels, the unemployment rate would be closer to 13%.



Bottom Line: *Enjoy the 2013 Q4 GDP surge as it may not last into 2014. Sustained growth in the economy and the housing sector in particular will remain constrained until household income levels improve on a consistent and stable basis.*

Greg Tull's Your Money

Morgan Housel over at the Motley Fool published a piece on Jan 29th entitled "50 Reasons We're Living Through the Greatest Period in World History." Click here to see the full article. "We ignore the really important news because it happens slowly, but we obsess over trivial news because it happens all day long." Below are some of my favorites from Housel's Top 50, in the areas of financial well-being and prosperity, living standards, education, peace, health, and productivity.

1. U.S. life expectancy at birth was 39 years in 1800, 49 years in 1900, 68 years in 1950, and 79 years today. The average newborn today can expect to live an entire generation longer than his great-grandparents could.
2. As of March 2013, there were 8.99 million millionaire households in the U.S., according to the Spectrum Group. Put them together and they would make the largest city in the country, and the 18th largest city in

the world, just behind Tokyo. We talk a lot about wealth concentration in the United States, but it's not just the very top that has done well.

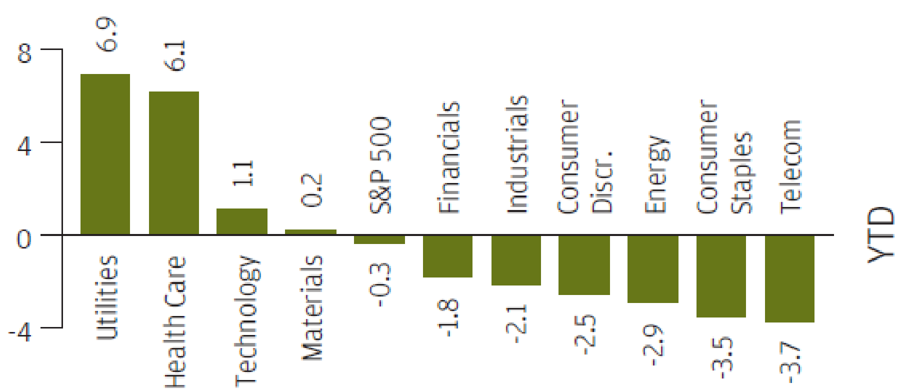
3. The average American now retires at age 62. One hundred years ago, the average American died at age 51. Enjoy your golden years — your ancestors didn't get any of them.
4. According to the Federal Reserve, the number of lifetime years spent in leisure — retirement plus time off during your working years — rose from 11 years in 1870 to 35 years by 1990. Given the rise in life expectancy, it's probably close to 40 years today. Which is amazing: *The average American spends nearly half his life in leisure.* If you had told this to the average American 100 years ago, that person would have considered you wealthy beyond imagination.
5. In 1940, less than 5% of the adult population held a bachelor's degree or higher. By 2012, more than 30% did, according to the Census Bureau.
6. No one has died from a new nuclear weapon attack since 1945. If you went back to 1950 and asked the world's smartest political scientists, they would have told you the odds of seeing that happen would be close to 0%. You don't have to be very imaginative to think that the most important news story of the past 70 years is what *didn't* happen. Congratulations, world.
7. Worldwide deaths from battle have plunged from 300 per 100,000 people during World War II, to the low teens during the 1970s, to less than 10 in the 1980s, to less than one in the 21st century, according to Harvard professor Steven Pinker. "War really is going out of style," he says.
8. In 1952, 38,000 people contracted polio in America alone, according to the Centers for Disease Control. In 2012, there were fewer than 300 reported cases of polio *in the entire world*.
9. From 1920 to 1949, an average of 433,000 people died each year globally from "extreme weather events." That figure has plunged to 27,500 per year, according to Indur Goklany of the International Policy Network, largely thanks to "increases in societies' collective adaptive capacities."
10. The death rate from strokes has declined by 75% since the 1960s, according to the National Institutes of Health. Death from heart attacks has plunged, too: If the heart attack survival rate had not declined since the 1960s, the number of Americans dying each year from heart disease would be more than 1 million higher than it currently is.
11. In 1900, 44% of all American jobs were in farming. Today, around 2% are. We've become so efficient at the basic need of feeding ourselves that nearly half the population can now work on other stuff.
12. In 1949, *Popular Mechanics* magazine made the bold prediction that someday a computer could weigh less than 1 ton. I wrote this sentence on an iPad that weighs 0.73 pounds.

Market Recap

(as of February 21st, 2014)

Equities	Level	Index Returns (%) 1 week	QTD	YTD	1 year	3-yr. Cum.
S&P 500	1836	-0.08	-0.34	-0.34	24.85	45.97
Dow Jones 30	16103	-0.28	-2.49	-2.49	18.76	40.36
Russell 2000	2894	1.35	0.19	0.19	30.33	45.42
Russell 1000 Growth	573.81	0.22	0.68	0.68	28.80	47.85
Russell 1000 Value	567.65	-0.08	-0.53	-0.53	22.91	45.50
MSCI EAFE	1925	1.57	0.67	0.67	20.34	22.40
MSCI EM	959.26	0.25	-4.08	-4.08	-6.23	-6.68
NASDAQ	4263	0.50	2.28	2.28	37.92	56.06
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.33	0.08	1.53	1.53	0.04	12.34
U.S. Corporates	3.08	0.16	2.16	2.16	1.27	19.59
Municipals (10yr)	2.59	0.25	2.49	2.49	0.17	18.55
High Yield	6.15	0.53	2.03	2.03	8.09	28.76

Key Rates	Levels (%) 2/21/14	2/14/14	12/31/13	12/31/13	2/21/13	2/21/11
2-yr U.S. Treasuries	0.33	0.32	0.38	0.38	0.26	0.78
10-yr U.S. Treasuries	2.73	2.75	3.04	3.04	1.99	3.59
30-yr U.S. Treasuries	3.69	3.69	3.96	3.96	3.17	4.70
10-yr German Bund	1.66	1.68	1.94	1.94	1.57	3.19
3-mo. LIBOR	0.23	0.24	0.25	0.25	0.29	0.31
3-mo. EURIBOR	0.29	0.29	0.29	0.29	0.22	1.09
6-mo. CD rate	N/A	N/A	N/A	0.27	0.28	0.38
30-yr fixed mortgage	4.50	4.50	4.72	4.72	3.78	5.00
Prime Rate	3.25	3.25	3.25	3.25	3.25	N/A



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