MERITAS ADVISORS
Comprehensive Wealth Management

May 27th, 2014

MONTHLY INVESTMENT OUTLOOK

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UPCOMING EVENTS

- 09/24: **New Tools for 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

- 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: Earlier this month I had the distinct pleasure of attending the Altegris Strategic Investment Conference where I was lucky enough to speak with such well respected thinkers as Kyle Bass of Hayman Capital, Dylan Grice of Aeris Capital, David Rosenberg of Gluskin Sheff, and Richard Yamarone of Bloomberg. Some of the main themes of the conference include: there remain significant global structural and demographic problems that will limit growth; the market has had one heck of a run up and is likely to need some sort of correction, but we are unlikely to see a major economic downturn this year; and overall there continues to be entirely too much debt/leverage in the developed world and China. So far, 2014 has been a year with some increased volatility relative to 2013, and with returns much closer to their long run historical averages. Without further ado, let's get started.
Lenore Hawkins, Principal

Market & Economic Overview

US equities finished last week a tad higher, breaking a two-week losing streak, with the S&P 500 again hitting an all-time high: the Dow was up 0.70% for the week, with the S&P up 1.21% and the NASDAQ up 2.33%, for the year they are up 0.18%, 2.82% and 2.38% respectively. Volume continues to be light, which is typically considered to mean that there isn't a whole lot of conviction behind recent price movements. Last week even the usually bullish CNBC acknowledged that an increasing number of high-profile investors and strategists as well as technical analysts are calling for a market pullback in the 10%-25% range. We'd like to point out however, that when you get a lot of people agreeing on some future action in the market, that very action often does not occur.

In Q1 2014, Italy's economy contracted, with GDP falling 0.1% versus expectations of 0.2% growth. Meanwhile its 10 year bond traded at a yield of 2.88% on May 15th, (when Euro GDP numbers were released) while the US 10 year was trading at 2.6%. Things are decidedly not kosher in the bond world when Italy warrants only a 0.2% risk premium over the US! On the same day Spain's 10 year was trading at 2.38%, a lower yield than the US? We've discussed at length just what a colossal pickle that nation's economy is in, so that sort of risk discount is noteworthy! Meanwhile Germany was trading at 1.33%? Holy bond market Batman, Germany trading at ½ the yield of the US?

Yields in Europe have adjusted up since the 15th, but days like that tell you there is a lot going on under the headlines. US yields have most likely fallen recently because the Fed has in effect given a rate cut by offering indications that any increase in rates will be further out than previously believed. Meanwhile, the sorry state of Eurozone economic growth, (at a meager 0.2% vs 0.4% expectations for Q1) is going to be putting pressure on the ECB to do something to bolster the region as the much needed structural changes appear to be impossible to enact.

Jeff Gundlach, who spoke at the Altegris Conference I mentioned earlier and has a long track record of reading the bond market with impressive accuracy, stated that he believes the 10-year yield is likely to drop below 2.5%, potentially falling even to the 2012 lows. Gundlach has been a contrarian on interest rates all year, forecasting that rates would fall, while the prevailing opinion in the markets has been that rates would continue to rise in 2014 as they did in 2013.He cites the massive short positions in Treasuries as a major driver. So far in 2014, his analysis has been correct, with the 10-year yield having fallen from 3.03% on Dec 31, 2013 to 2.44% on May 28, 2014. The "crowded short" in Treasuries is the result of a widely held, and so far incorrect, view that interest rates would rise in 2014. An investor would take a short position against Treasuries if they think that Treasury bond prices are going to fall, which is what would occur if yields (interest rates) were to rise. This is an unsurprising position given that the Fed is reducing its purchases of Treasuries month-after-month. When the Fed slows its buying, if other market participants don't make up for the reduction in purchases, prices are likely to fall. When a bond price drops, its yield rises, for more on how this works and why click here to read our White Paper on Bonds 101.

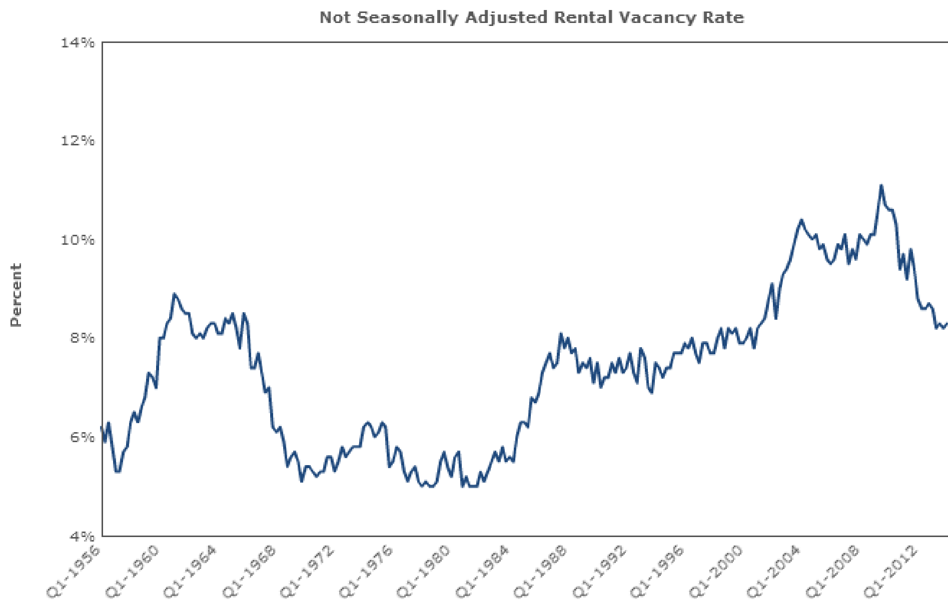
Bottom Line: *We've experienced unprecedented manipulations of the bond markets through Quantitative Easing programs. It should come as no surprise that as these programs are reduced here in the States, we will see unusual machinations in bond markets around the world. We believe it is likely that we will see increased movements of this kind if and when central banks find themselves again under pressure to do something to spur economies that continue to lag behind growth expectations as politicians in the US and Europe struggle to implement any beneficial reforms on the fiscal side.*

Housing Update

At Meritas we always seek to look below the headlines, assessing the underlying data ourselves in a more rigorous manner than you often see in the popular media and with a longer term perspective. Last week yours truly spoke on the Stuart Varney show about the housing sector, click here for the video. The topic warrants a thorough discussion as it is such an impactful part of the US economy outside of its direct contribution to GDP.

Earlier this month we learned that the National Association of Homebuilders Housing Market index sagged to its lowest level in a year in May, declining to 45 from 46 in the prior 3 months vs expectations of a rise to 49. Existing home sales have increased a little since 2010, but are now falling dramatically, dropping 7.5% on a year-over-year basis in March. New housing starts also down by 5.9% in March on a year-over-year basis. According to Zillow, close to 1/5th of U.S. homeowners are underwater in their mortgages. Late last week we learned that sales of new U.S. single-family homes rose more than expected in April and the number of homes on the market hit a 3-1/2 year-high. Overall it's been a mixed bag, but what exactly are we hoping to see and why?

Home ownership rates have fallen to where they were about 20 years ago at 64.8% in Q1. This is the lowest rate since Q2 1995. The rate peaked at 69.2% in June 2004. Such a decline sounds bad… or is it? Is a high level of home ownership really the Holy Grail for a society? Is more always better?



Our interpretation of the data indicates that the peak of home ownership is not something to which we ought to aspire. Not every household should own the place in which they reside as the costs and risks can easily outweigh the potential benefits. Home owners can't easily move if they need to change jobs. We've seen the impact of this in the way the current labor market has been the most inflexible with respect to geography in history. They are unable to rapidly react to changing conditions in the economy that affect their household finances, not to mention the hassle of home ownership and all the costs that are unimaginable beforehand. As a home owner myself, I have seriously questioned the sanity of my purchase decision on many a Sunday spent nursing wounds, covered in Band-Aids post-umpteenth unsuccessful trip to Home Depot during one of my "I am so Bob Vila" weekends.

Why did home ownership rates increase so much pre-financial crisis, to levels that were clearly unsustainable and caused so much pain for so many? Was it just those evil, greedy bankers that somehow tricked people into buying homes? Well, that's partially true, but is only part of the story and a misleading take on all that happened.

You can also thank the federal government for handing over another example of what I like to call, Lenore's Law of Unintended Bureaucratic Consequences by which what a bureaucrat tries to help is ultimately harmed by the interference. Traditionally non-FHA mortgages required a minimum of 20% down, but in 1994 the Department of Housing and Urban Development (HUD) ordered Fannie Mae and Freddie Mac to supplement and eventually to far surpass the FHA's efforts by directing 30% of their mortgages to low-income borrowers when previously the number had been much lower. This became pretty tough to do, so to meet that goal, Fannie Mae introduced 3% down mortgages in 1997.

In 2000 HUD increased the low income target to be 50% of all loans. Now think about that, what bank in their right mind would want to make 50% of their loans for the year to low income families with exceptionally low money down. That means 50% of your loans are in the riskiest category! To accomplish this Fannie launched a 10 year, 2 trillion dollar "American Dream Commitment" program to increase home ownership rates among those who previously had been unable to own homes. So when the government gets itself all focused on getting people into homes who previously couldn't afford one, is it really all that shocking that home prices rose like crazy?

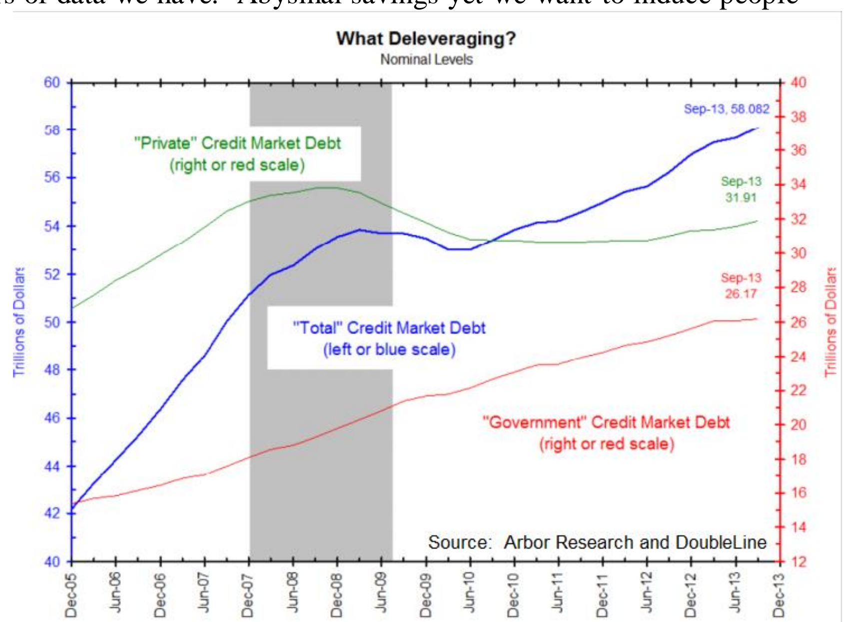
In 2002 Freddie joined with the "Catch the Dream" program to accomplish essentially the same thing. Then in 2005, HUD increased the target for low income loans again to 52%! Now here's a bit of irony. The government wanted more people to own homes, so it makes it easier and easier to get a loan. Now we've got more people out in the market to buy homes. Son of a gun, prices go up! Well now, isn't that exciting! Buying a home looks like a really great investment because the prices are just going through the roof! But wait, rising home prices are great for only half the equation. They are great for the owner who looks to sell but not much fun for the person trying to buy. So in their attempt to increase home ownership by making it easier to buy a home, the government made homes even less affordable.

Oh but that's OK as Fannie and Freddie are there to save the day and get you into that home that you really cannot afford with little to no money down and a variable rate mortgage that isn't a ticking time bomb at all! All these subsidies increased the supply of mortgages to low income homeowners, but what was the source of the money to fund these loans? Welcome to the Mortgage Backed Security. Yes, those weapons of mass destruction. Banks would pool together mortgages that could then be sold as a MBS, and with HUD's desire to get Fannie and Freddie to increase home ownership in the subprime areas, these two agencies were more than happy to back the MBS, which, because they are government sponsored entities, turned subprime loans with very little money down into AAA rated bonds! Serious fairy dust isn't it? Now the banks were running around gobbling these things up like there's no tomorrow. Why you ask? Well according to the Basel Accords, banks could seriously lower their reserve requirements by holding these GSE (Government Sponsored Entity) AAA rated bonds, which improved their profit margins.

So here we are supposed to all be fixated on getting us back to the essentially Fannie and Freddie heroin-like-induced excessively high levels of home ownership, when the household balance sheet is in no condition to go there. The personal savings rate is less than 4%, lower than it was in the 1930s and continuing to fall. It is at almost unprecedented low levels in the 81 years of data we have. Abysmal savings yet we want to induce people to buy homes?

The percentage of the population actually in the workforce is where it was over 30 years ago, so we have a lower percentage of the population working, but we want a higher percentage of the population buying a new home?

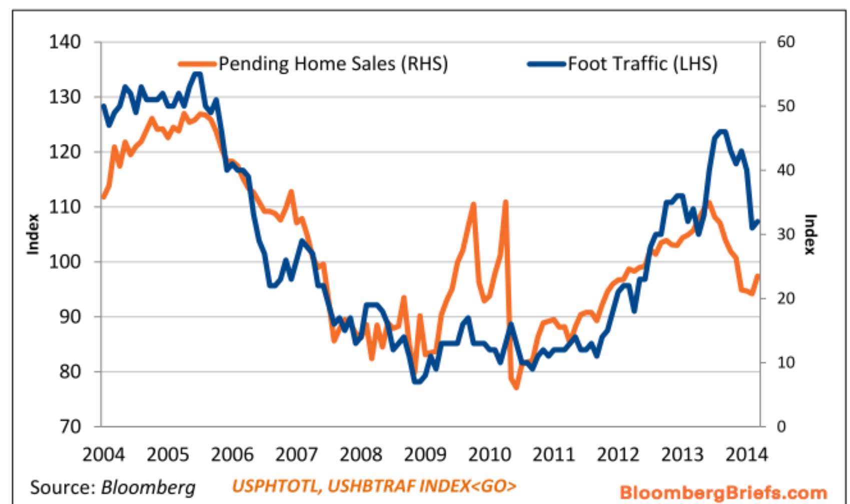
Oh, but we're told that households deleveraged, so it's all good. Well, if you look deeper into the data, households didn't reduce debt other than mortgages and that reduction was mostly due to write-downs, meaning the bank got involved and things got a bit ugly for a while. Not exactly a healthy process for the economy.



What about those homebuyers?

- The first-time homebuyer in the US has been virtually non-existent. Housing bulls will assume that this means there is pent-up demand, which sound reasonable, unless the reasons behind this decline are deeper changes in the makeup of the demand for housing.
- New household formation is still exceptionally low, which is a key step in the process of buying a home.
- Young adults are living at home at higher rates, and polls show they are pretty comfortable living with Mom and Dad, unlike earlier generations that just couldn't wait to get the out of there.
- There is a disturbing trend in homebuilders who are designing more and more homes with multiple entrances that make it more comfortable for multiple generations to live under the same roof. This is not a good sign if we want more people to own a home when we see a trend that increasing numbers of them are looking to share just one!
- Student loan debt is exploding while delinquency rates are also rising despite the story that the economy is improving. Want to know why? One reason may be we graduate more kids with degrees in psychology than in math, physics or engineering. The economy may be limping along, but maybe with all those newly minted psych majors maybe we won't feel so bad about it?
- The MacArthur Foundation recently conducted a poll that found that renting is more appealing than buying a home by a 30% margin, consistent across all age brackets.

On May 29th, pending home sales look to be coming in lower, with soft foot traffic, rising prices and higher mortgage rates relative to last year likely to continue to be headwinds to demand for new and existing homes sales.



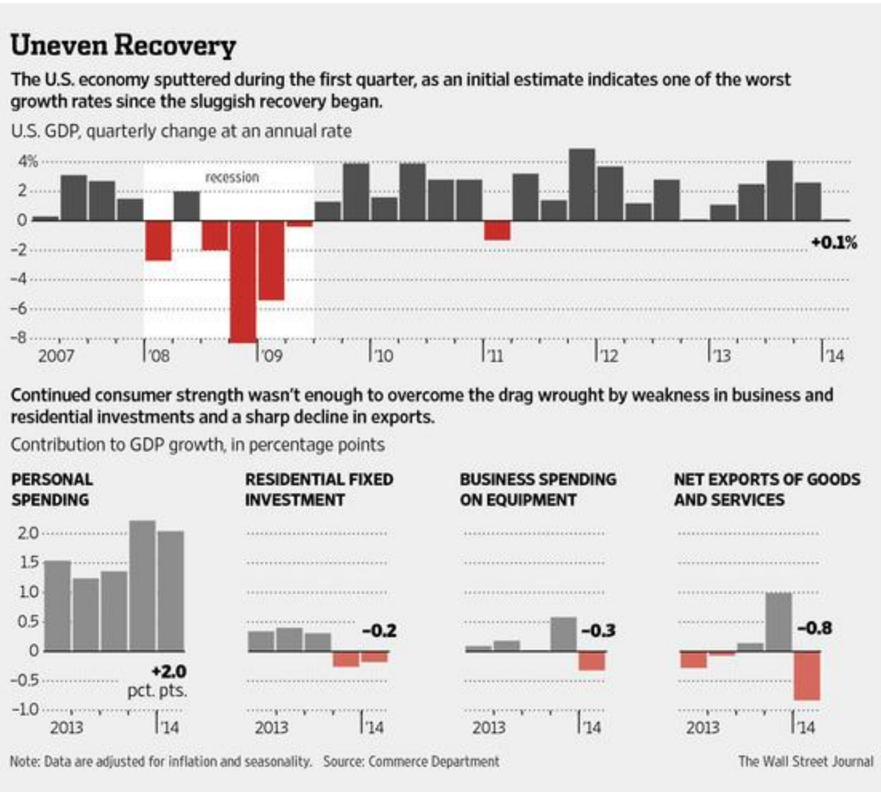
Bottom Line: *When investing it is critical to go into much greater detail than the headlines or lead story provide. At Meritas we go much deeper to understand the longer-term underlying trends and the critical factors that affect the headline topics. Housing has thankfully made a significant comeback in recent years, but we are skeptical that the improvements experienced 2013 will continue at a similar pace for the next few years without significant strengthening in the economy. Speaking of which…*

GDP Update

GDP was expected to grow by 1.3% in Q1, but came in at painfully slow 0.1%! Looking into the details we can see that capital expenditure was hit hard, with spending on equipment falling and residential spending falling alongside a decline in net exports of goods and services.

These are important stats as they indicate a willingness to invest for the future. If we dive into the numbers, we see that the only thing that really moved in the economy in Q1 was consumption. With nothing else adding to growth, it is clear that this consumption is driven by those spending the fruits of the wealth effect generated by the Fed's easy money policy which is largely responsible for propelling the stock market at the high end combined with the rest of us who are spending away thanks to the ZIRP-assisted (Zero Interest Rate Policy) low interest rate credit

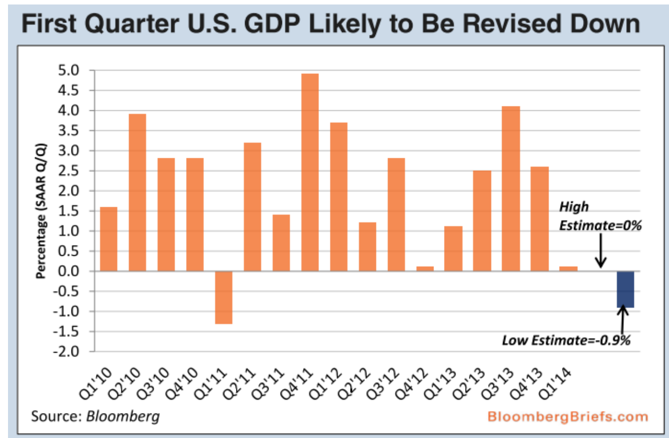
cards, student loans and the plethora of government assisted programs that have been increasing subscriptions at a rate comparable to the sale of Girl Scout thin mints!



Now if we go into the details of consumption, we find that 1.96% of the total 2.04%, was in services. So what's in that? Household consumption, which includes spending on housing and utilities and healthcare, which represented a total of 1.84% contribution. Well now doesn't that just say it all! All this spending isn't on Starbucks and new Jimmy Choo shoes, but rather on keeping the roof over your head, the lights on and seeing the Doc. These are all necessities and that's where all the spending is going.

In case that wasn't reason enough to be cautious, spending on recreation services and food both went negative. So after America paid its mortgage, gas, electricity and medical bills all it was able to afford was a night of Netflix and bag microwave popcorn. Ouch.

Further, according to a Bloomberg survey of economists, Q1 GDP revisions are expected to show even weaker growth.



Bottom Line: *Despite all the quantitative easing and "stimulus" programs, this continues to be the weakest recovery in history. Such weak economic growth is a headwind to stock prices as it limits the aggregate earnings growth potential. Without earnings growth, stock prices can only go up if PE (price to earnings) ratios rise, which was the primary driver of the rise in stock prices last year, as we've discussed in prior newsletters, and PE ratios can't expand indefinitely.*

Your Money with Greg Tull

Given the surprise (to the consensus view) move lower in domestic interest rates this year, this is a good month to discuss the value of having an allocation to core intermediate term bonds in your portfolio, even in a low interest rate environment like the present. There are three main ways that bonds can benefit your portfolio: stability, income, and potential capital gains created by price movements. We'll discuss these benefits after we define some terms. The Barclays US Aggregate Bond Total Return Index is the leading index of intermediate term domestic bonds. It includes about 98% investment grade (high credit quality) bonds, with about half of the bonds maturing

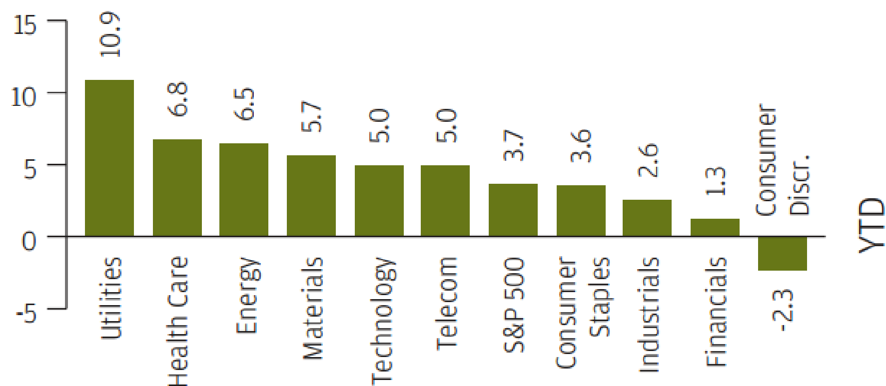
in less than 7 years. The bonds are in 3 main categories, government (Treasury), corporate, and securitized (mortgage). "Total Return" in bond terminology means interest income plus the gain or minus the loss from price movement in a given period.

Let's touch on each of the three benefits. First, consider stability. The two worst years out of the past 20 years in the Barclays bond index were 1994 (-3%) and 2013 (-2%), while the two worst years for the S&P 500 large company stock index were 2002 (-22%) and 2008 (-37%). As further evidence of the stability of bonds, in the two worst years for the S&P 500, the Barclays bond index was up 10% (2002) and up 5% (2008). In tumultuous times, investment grade intermediate bonds often benefit from a "flight to quality" out of stocks and into the relative safe haven of the "fixed income" of bonds. The second benefit is the interest income that bondholders receive from the issuer of the bond. Think of a bondholder like a bank, lending money to a borrower (the issuer of the bond), and being paid interest on the loan. In today's low interest rate environment, the Barclays bond index is yielding only about 2.2% annually. So for the first 4 months of 2014, the index has generated around 75 basis points, or 0.75%, in income. That leads us to the third benefit, potential capital gains. The surprise fall in interest rates (relative to the consensus market expectation that rates would rise in 2014), so far this year means that bond prices have risen. For the first 4 months of 2014, the Barclays bond index has gained 2.7%. One quarter of that 2.7% growth came from the interest income, and three quarters came from the increase in the value of the bonds. On an annualized total return basis, the bond index grew at an 8.1% (2.7% x 3) rate for the first 4 months of 2014. Despite the higher long run return expectations for stocks, the S&P 500 stock market index was up only 2.4%, or 7.2% on an annualized basis, for the first 4 months of 2014.

Market Recap

(as of May 23rd, 2014)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1901	1.25	1.84	3.68	17.59	54.06
Dow Jones 30	16606	0.74	1.23	1.12	11.14	44.81
Russell 2000	2799	2.13	-3.85	-2.77	15.93	44.29
Russell 1000 Growth	584.21	1.56	1.80	2.94	19.06	53.40
Russell 1000 Value	592.57	0.97	1.36	4.42	17.17	54.38
MSCI EAFE	1939	0.41	2.30	3.09	15.31	29.43
MSCI EM	1043	1.12	5.33	4.95	4.42	1.86
NASDAQ	4186	2.34	-0.10	0.73	22.55	57.53
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.22	0.00	1.62	3.49	1.66	11.05
U.S. Corporates	2.92	-0.15	2.03	5.03	3.13	18.47
Municipals (10yr)	2.21	-0.11	2.31	5.51	2.48	17.30
High Yield	5.83	0.05	1.24	4.25	6.67	28.49
			Levels (%)			
Key Rates	**5/23/14**	**5/16/14**	**3/31/14**	**12/31/13**	**5/23/13**	**5/23/11**
2-yr U.S. Treasuries	0.37	0.38	0.44	0.38	0.26	0.55
10-yr U.S. Treasuries	2.54	2.52	2.73	3.04	2.02	3.13
30-yr U.S. Treasuries	3.40	3.34	3.56	3.96	3.20	4.27
10-yr German Bund	1.41	1.33	1.57	1.94	1.40	3.02
3-mo. LIBOR	0.23	0.23	0.23	0.25	0.27	0.26
3-mo. EURIBOR	N/A	N/A	N/A	0.29	0.20	1.45
6-mo. CD rate	N/A	N/A	N/A	0.27	0.26	0.29
30-yr fixed mortgage	4.33	4.33	4.56	4.72	3.78	4.69
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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