June 29th, 2014

MERITAS ADVISORS
Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

IN THIS ISSUE

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:

As we head into the gloriously warm days of summer, we thought we'd offer a slightly shorter newsletter this month. We apologize for it being a tad delayed thanks to the havoc wrought upon yours truly with the lovely strike by French air traffic controllers. The markets continue to churn higher despite a lack of significant economic growth, even to the point that the Bank for International Settlements felt it necessary to state in its annual report published June 29th, that "*Overall, it is hard to avoid the sense of a puzzling disconnect between the markets' buoyancy and underlying economic developments globally.*" We believe that much of the excess enthusiasm can be tied to actions of central banks around the world, which we will discuss at length this month.

We hope that you enjoy a fun and love-filled summer with copious amounts of laughter seasoned with great friends, gorgeous shared sunsets and countless memorable moments.

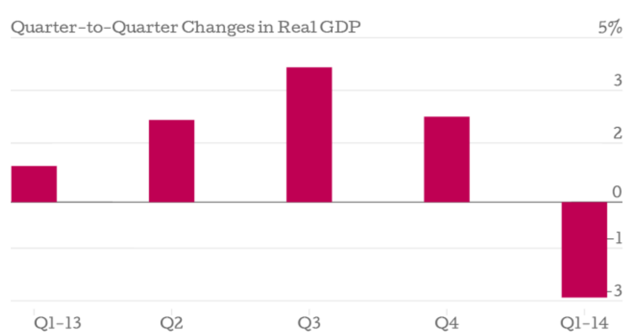
Lenore Hawkins, Principal

Market & Economic Overview – A Tale of Central Banking

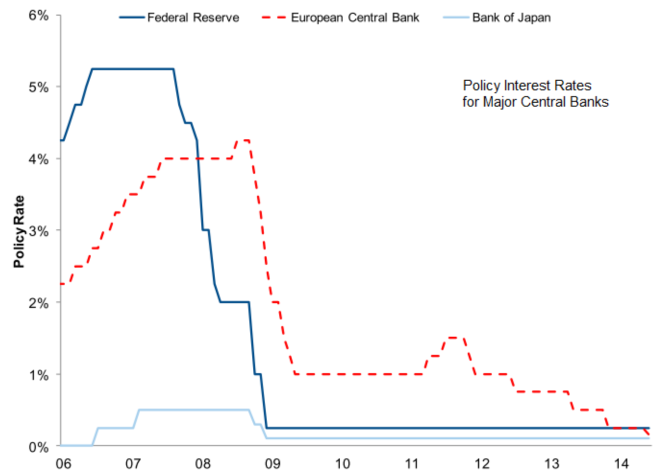
"The Future Ain't What it Used to Be"

Yogi Berra

Much of the recent economic data has been well below the hopes and expectations of governments and market pundits around the world. First quarter US GDP growth was revised down from +0.1% to an actual *contraction* of -2.9%, making the first quarter of 2014 the worst quarter since the first quarter of 2009, in the heart of the recession. The bulk of the revision came from weaker than expected personal consumption and a bigger than expected decline in exports. It is rare to see such a substantial decline without the economy being in a recession. That being said, most of the macro data for Q2 is looking like we'll see a rebound with the economy gaining momentum rather than entering a recession, but we are paying close attention.



European GDP growth was also decidedly lackluster, with Japan the only pleasant surprise, but its strong growth in Q1 is likely just pulled forward from Q2 when the nation's VAT increased 60%, from 5% to 8%. When a tax increase like that is approaching, people tend to buy things in advance and stock up knowing that prices are going to increase in the near future, distorting quarterly purchasing data (which frankly irks your meticulous author who has an arguably unhealthy love for clean data). China's growth in Q1 also fell below the government's target and grew at the slowest rate since quarterly data was first made available starting in Q4 2010. Meanwhile geopolitical tensions continue to mount, putting the U.S. in the odd position of now potentially working with Iran in order to improve the situation in Iraq. The saying that politics can make for strange bedfellows comes to mind!



Source: Investment Strategy Group, Datastream.

In response to the continued economic weakness, the monetary policy positions of the four biggest central banks, the US Federal Reserve (Fed), The European Central Bank (ECB) the Bank of Japan (BoJ) and the People's Bank of China (PBoC) remain quite easy (in monetary terms), with some even easing further in the belief that this will raise asset prices. This in turn is believed to be necessary to get the wheels of their respective economic engines moving faster. These regions represent about 60% of world GDP and 70% of the world's equity capitalization, thus their actions have an ability to dominate the markets. The chart above shows just how dramatically interest rates have been suppressed. This suppression has generated all kinds of wonky market ramifications as reasonable yield becomes more and more of a mythical unicorn.

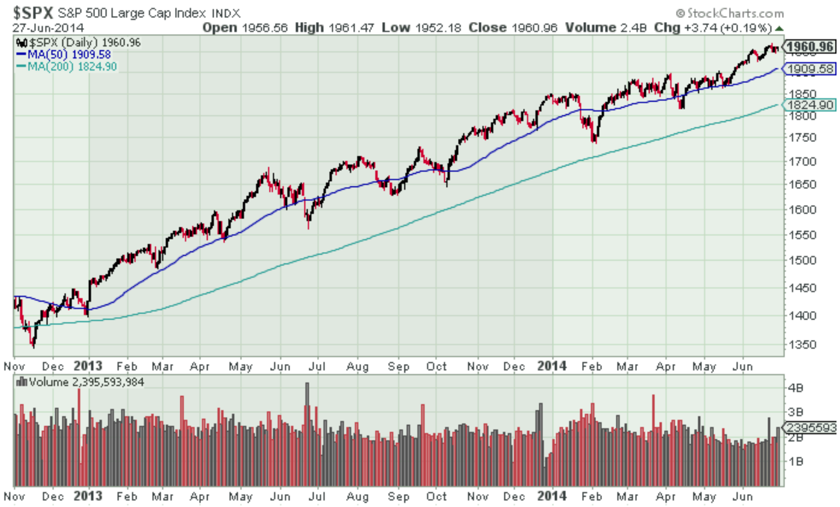
"Financial markets are euphoric, in the grip of an aggressive search for yield…and yet investment in the real economy remains weak while the macroeconomic and geopolitical outlook is still highly uncertain."
Claudio Borio, the head of the BIS's monetary and economic department.

On June 5th, the ECB announced that it will cut its deposit rate to -0.1%, which means it now *charges* banks for holding excess cash, an ironic move given the concerns over the quality of European bank balance sheets. It's a rather bi-polar relationship there with demands for the banks to clean up the quality of their loans on the one hand, and then penalizing them for not loaning out more on the other. Sounds like the makings of a central bank themed Lifetime channel movie! By Friday of that week yields on Italian and Spanish debt touched all-time lows. By the following Monday, Spain joined several other European countries, including Ireland, France and Germany, whose debt has lower yields than that of 10-year Treasuries. The markets appear to be following Salvador Dali's advice, "What is important is to spread confusion, not eliminate it."

On that note, the riddle of this relentlessly rising market has left many bewildered, with trading volumes, or the lack thereof, attesting to the consternation. Volatility has also plummeted, thanks in no small part to central bankers around the world who are hell-bent on driving asset prices up while purely by coincidence, (without a trace of sarcasm from your author) making sovereign debt easier to bear. We aren't the only ones to have noticed this and to be concerned.

"Volatility on the financial markets in the advanced economies has subsided to well below the historic norm, reaching levels that in the past sometimes preceded rapid changes in the orientation of investors."
– Ignazio Visco, Governor of the Bank of Italy
The lack of volatility is "eerily reminiscent" of the run-up to the financial crisis in 2007-2008.
– Charles Bean, Bank of England Deputy Governor

The S&P 500 has not dropped below its 200-day moving average since early November of 2012. It has continued to set a series of record peaks and has left volatility in the dust. The 10-Day A/D line (Advance/Decline Line) has been at extremely elevated levels (+2,500) since 5/30, excluding the first two trading days of June. As of June 30th, the S&P 500 has gone 409 days without going below its 200-day moving average. This has broken the previous record over the past 50 years of going 385 days without testing the 200 day-moving-average in 1995-1996.



There isn't much conviction around these highs, as the volume of trading has been quite low, illustrated in the chart at right. JP Morgan recently warned that its trading volume will likely be down by as much as 20% while Citigroup's CFO announced that he expects Q2 trading revenue to fall by as much as 25% compared to last year. Recently the performance of the iShares US Broker-Dealer ETF (IAI) has diverged dramatically from the S&P's upward march, illustrating this concern.

Last quarter S&P 500 profits grew by all of 2% over a year ago, while stock prices continued to move up more aggresively, despite consensus estimates for an 8.5% increase in profits. The pattern of stock returns by size is also concerning. In general, stocks with higher market capitalization are performing far better than those with smaller capitalizations.

Year-to-Date Style Returns (source: Morningstar indexes)

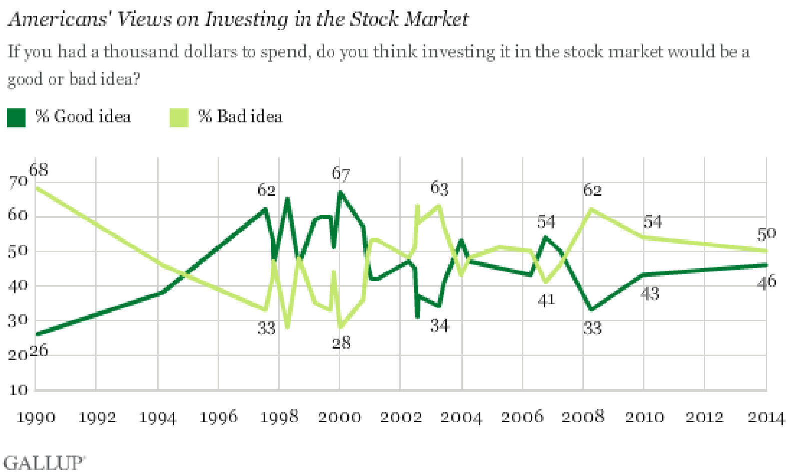
Large Cap Growth	Mid Cap Growth	Small Cap Growth
7.20%	5.24%	1.31%
S&P 500 (large cap)	S&P Midcap	Russell 2000 (small cap)
7.17%	7.01%	2.89%

So profits aren't great, which isn't terribly surprising given the dismal GDP growth rate for Q1 and larger capitalized companies are outperforming smaller. If we look a little deeper into just who is doing the buying, we find an explanation for some of this. Turns out, that the usual buyers of stocks such as hedge funds, pension funds, mutual funds etc. have been in aggregate *net sellers*, the *big buyers have been the companies themselves*! Hold on a minute. Stock prices have been going up because companies are buying back their own stocks? S&P 500 companies bought back $160 billion of their own stocks in just the first quarter of 2014. Now there isn't anything innately wrong with companies buying back their own stock and in fact we are often quite in favor of it, but there is a reason to be concerned when it appears that these buybacks are a significant driver of upward market momentum! We've seen a disturbing trend with these large companies issuing bonds in order to buyback their own stock, which we are sure has nothing to do with executive compensation packages tied to stock performance, (not even attempting to hide the snarky undertone here) such as with Monstanto, Apple, Cisco, and Fedex. As of February 26th 2014, companies had already raised at least $11 billion worth of debt in 2014 after having raised $19 billion in 2013 to help finance stock repurchases, according to the Financial Times. **Bottom Line**: *Stock price gains generated through repurchase programs funded by companies borrowing large amounts courtesy of central bank sponsored insanely low interest rates is something that ought to make everyone nervous. (Ok, so that was a mouthful, but it is an important point.)*

Main Street Missing Out

We all know the *Immutable Law of Investing; sell at the top and buy at the bottom*. Easy enough! The corollary to this law is the immutable truth that in reality most everyone does the exact opposite, buying at the top as they get caught up in the gold-rush style frenzy and selling at the bottom under the influence of widespread panic. In 2000 US mutual funds took in $259.5 billion right as the market peaked and then promptly crashed while in 2002, when the markets were poised to take off, investors pulled out $24.7 billion.

This time U.S. investors don't feel that they personally have benefited much from the record highs the stock market has been achieving, with 54% saying they benefited "a little" or "not at all," while 43% believe they benefited "somewhat" or "quite a lot," according to the Wells Fargo/Gallup Investor and Retirement Optimism Index survey.



The poll at left was taken in January of this year, and shows that half of Americans say investing $1,000 in the stock market would be a bad idea. So it is of no surprise that part of what is driving the reduction in trading volumes is increasing investor concern about the market run up. This time around we've had a market rally with a much smaller set of participants as globally, most retail investors elected to reduce their commitment to the market's dance floor, increasing their cash allocation from 31% in 2012 to 40% in 2014. In the US the change has been even more dramatic, rising from 26% to 36%. In Japan, land of the most ambitious quantitative easing program, cash allocation is at 57%.

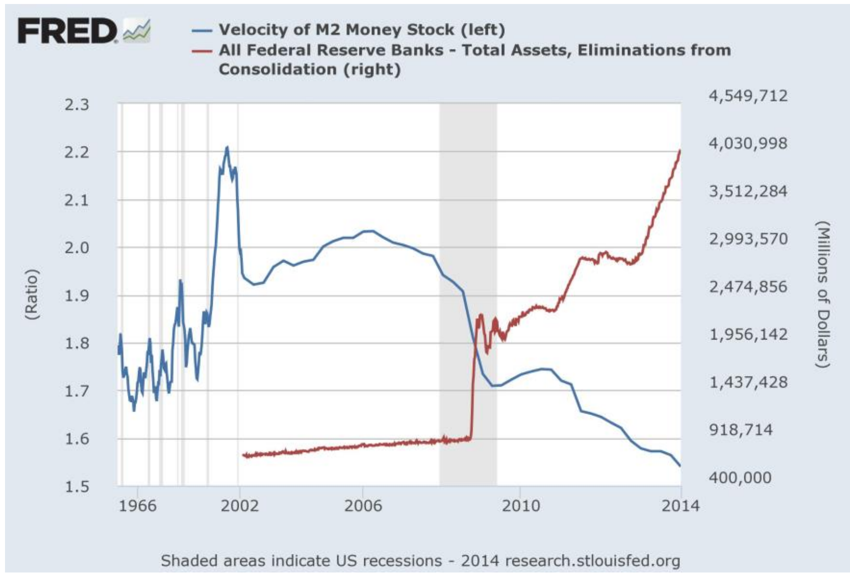
Bottom Line: *While the economic picture hasn't improved substantially, the amount of money sitting on the sidelines is a potential tailwind as investors could at some point capitulate and push some of that cash into the markets, as most are prone to do nearing market tops. It may also serve to dampen the impact of any pullback as the extra cash on the sidelines reduces the need to liquidate positions to cover shorts or other portfolio pains in the event of a pullback.*

Inflation

Core CPI has accelerated to a +2.3% annual rate in the first five months of the year versus +1.6% at the end of 2013, which is the fastest start to any year for core inflation since 2006. Last month's rise, while not extreme, was twice what economist had forecast while core prices, which exclude food and energy, (yes we too think that's an odd reference for something that excludes such silly extravagances as food and energy) were the highest since October 2009. Headline US inflation is now back above 2% a year. Core services are now at a +3.2% annual rate from January to May, a rate we haven't seen in seven years. Last week the BLS also reported that electricity prices have hit all-time highs.

We're also seeing the beginning of minimum wage price hikes in several cities, most notably Seattle and potentially San Francisco. Lower US unemployment doesn't appear to be attracting discouraged workers back to the workforce as the unemployment rate has already dropped below the level at which the Fed began tightening in 1994 and is only a tad bit above the level at which is did the same in 2004.

If you are unsure that we are seeing higher prices, we would suggest you read up on the Bacon Cheeseburger Inflation Index. Yes, an alternative to be sure, but we find it best not to rely solely on government issued data. According to the index, an average bacon cheeseburger costs 7.9% more now than it did at the same point in 2013. Lest you think the cheeseburger index is full of bull, a quick scan of Bureau of Labor Statistics (BLS) data confirms its findings, even though weather-related factors such as the drought in Western states and the extremely cold winter in the Midwest have contributed to food price increases. BLS data show bacon prices up 16.4%, from a year ago, while ground beef is up 10.5% and American cheese prices are up nearly 10%. We suspect more than a few people will be eating a few less bacon cheeseburgers when they fire up their grills this summer.



Whilst the Federal Reserve has grown its balance sheet enormously, (red line at right), the velocity of money has simultaneously fallen to all-time historical lows, (blue line at right) which has countered the potentially inflationary impact of the Fed's quantitative easing programs.

The danger lies in just how quickly this entire picture could change if the market's prevailing narrative shifts from the belief that inflation is unlikely to one where it is believes it to be a credible threat. Material rates of inflation could arise if the previously dormant excess liquidity is deployed, based on fears of rising prices. This in turn could spur an exodus from cash, increasing the velocity of money, making fears of inflation a self-fulfilling prophecy. We are assured that Fed officials are well aware of this danger, are keeping a careful watch, and have the tools and know-how to prevent such a crisis. We would like to point out however that the institution's track record on awareness of impending crises and its accuracy concerning economic forecasts don't offer much convincing evidence that we ought not fret. Investors should not rely on the saintly wisdom of bureaucrats to protect themselves. This is a very real threat that may not come to pass, but cannot be ignored, particularly in light of the evolving data.

Despite an inflation rate that has overshot its target every month from 2009 until last November, the Bank of England has maintained the easiest monetary policy in its history.

Bottom Line: *The Fed has lowered its GDP expectations a shocking 0.7% to 2.2% annual growth for this year and is becoming, at least in tone, increasingly dovish, making many wonder if an increase in rates is further out than six months. But now with inflation indicators starting to flash warning signs, that theory is going to come under pressure. One also has to wonder that with interest rates at 0% for over 5 years and the Fed's balance sheet quintupling in size, should we maybe look at other ways to strengthen the labor market?*

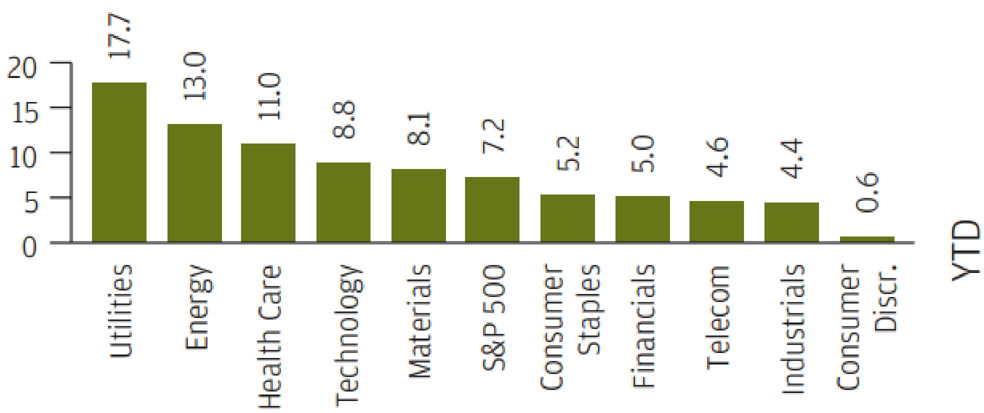
Your Money with Greg Tull

Let's discuss the mechanics of dividend payments and the relationship of the payment of the dividend to the security price. Whether we're talking about a mutual fund, an ETF, or an individual stock, there are three key dates to consider vis-a-vis dividend payments: the record date, the ex-date, and the payment date. Shareholders of record, on the record date, are the only shareholders who will receive the declared dividend for the current time period (the month, or the quarter, or the year, depending on the situation). The ex-date is the date that the dividend is removed from the security's price. And the pay date is when the dividend will be deposited into the shareholder's account as cash, or reinvested into the security, as per the standing instructions stipulated by each investor. To take a specific example, a mutual fund that many of our clients own had a second quarter record date of 6/26/2014, an ex-date of 6/27/2014, and a pay date of 6/30/2014. This means that every investor who owned shares of the fund as of the close of the market on 6/26/2014, is entitled to receive the dividend of $0.29872 or approximately 30 cents per share, in their account on 6/30/2014. On the ex-date, 6/27/2014, an interesting thing happens. The fund closed at $16.24 on June 26, and it closed at $16.00 on June 27. Therefore, it appears that the fund fell in value by 0.24/16.24 or 1.48% on June 27. However, that is not the whole story, because the shareholder will be receiving the nearly 30 cent dividend on the next business day. So, while the fund appeared to lose 1.48% in value on June 27, it turns out that the value of the investor's position actually gained by 0.06/16.24 or 0.4% when the dividend is added back in.

Market Recap

(as of June 27th, 2014)

Equities	Level	1 week	QTD	YTD	1 year	3-yr. Cum.
		Index Returns (%)				
S&P 500	1961	-0.06	5.27	7.17	24.12	63.59
Dow Jones 30	16852	-0.52	2.94	2.83	14.80	51.03
Russell 2000	2956	0.16	1.75	2.89	22.97	54.16
Russell 1000 Growth	602.02	0.31	5.08	6.25	26.36	62.50
Russell 1000 Value	613.15	-0.39	5.09	8.26	23.31	64.55
MSCI EAFE	1966	-0.82	4.03	4.83	23.85	33.43
MSCI EM	1046	0.31	6.22	5.83	16.78	2.49
NASDAQ	4398	0.70	5.06	5.93	30.90	69.88
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.24	0.43	1.94	3.82	4.38	10.61
U.S. Corporates	2.93	0.56	2.54	5.56	7.84	18.80
Municipals (10yr)	2.25	0.43	2.46	5.66	6.37	16.78
High Yield	5.71	-0.02	2.40	5.45	12.00	32.11
				Levels (%)		
Key Rates	**6/27/14**	**6/20/14**	**3/31/14**	**12/31/13**	**6/27/13**	**6/27/11**
2-yr U.S. Treasuries	0.45	0.50	0.44	0.38	0.36	0.41
10-yr U.S. Treasuries	2.54	2.63	2.73	3.04	2.49	2.95
30-yr U.S. Treasuries	3.36	3.44	3.56	3.96	3.54	4.28
10-yr German Bund	1.26	1.34	1.57	1.94	1.72	2.90
3-mo. LIBOR	0.23	0.23	0.23	0.25	0.27	0.25
3-mo. EURIBOR	N/A	N/A	N/A	0.29	0.22	1.55
6-mo. CD rate	N/A	N/A	N/A	0.27	0.25	0.32
30-yr fixed mortgage	4.33	4.33	4.56	4.72	4.46	4.46
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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