MERITAS ADVISORS
Comprehensive Wealth Management

July 29th, 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

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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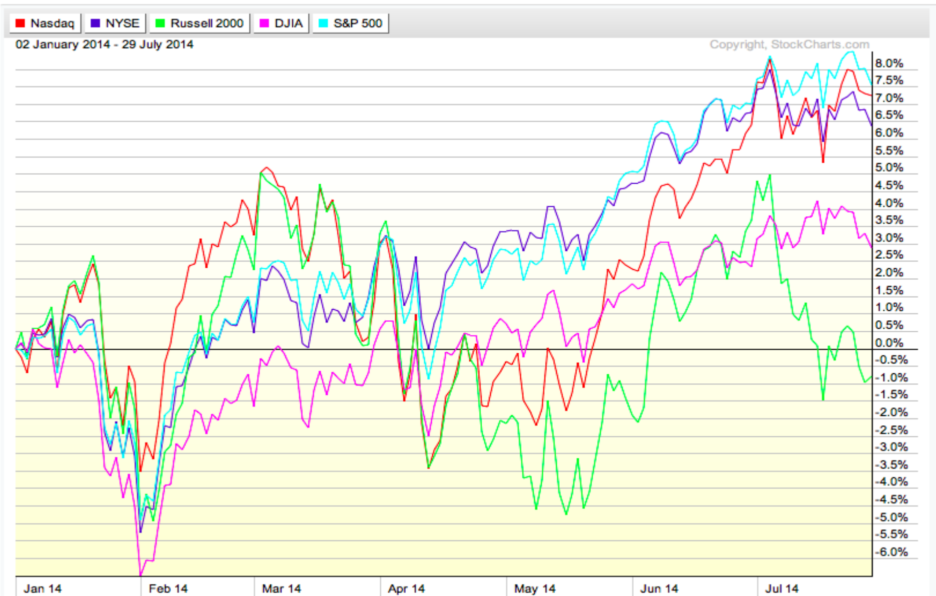
Dear Clients and Friends:
The world is awash with geopolitical tensions, from the shooting down of a Malaysia Airline plane over Ukraine (talk about an airline to avoid), to nightmare-making battles between Hamas and Israel, to Russia versus, well, the rest of the western world and Argentina's complicated partial default, yet again! The tensions have gotten so high that apparently Orlando Bloom threw a punch at Justin Bieber in Ibiza, Spain last week… and you thought we were only good for investment advice. We'll try to keep this month's letter short, as we're sure you'd all rather be out enjoying the gorgeous weather than reading our prose, as riveting as the ever-scintillating world of finance may be. As always, we thank you for your continued trust. – *Lenore Elle Hawkins, Meritas Advisors Partner and Irish woman desperately in search of a tan.*

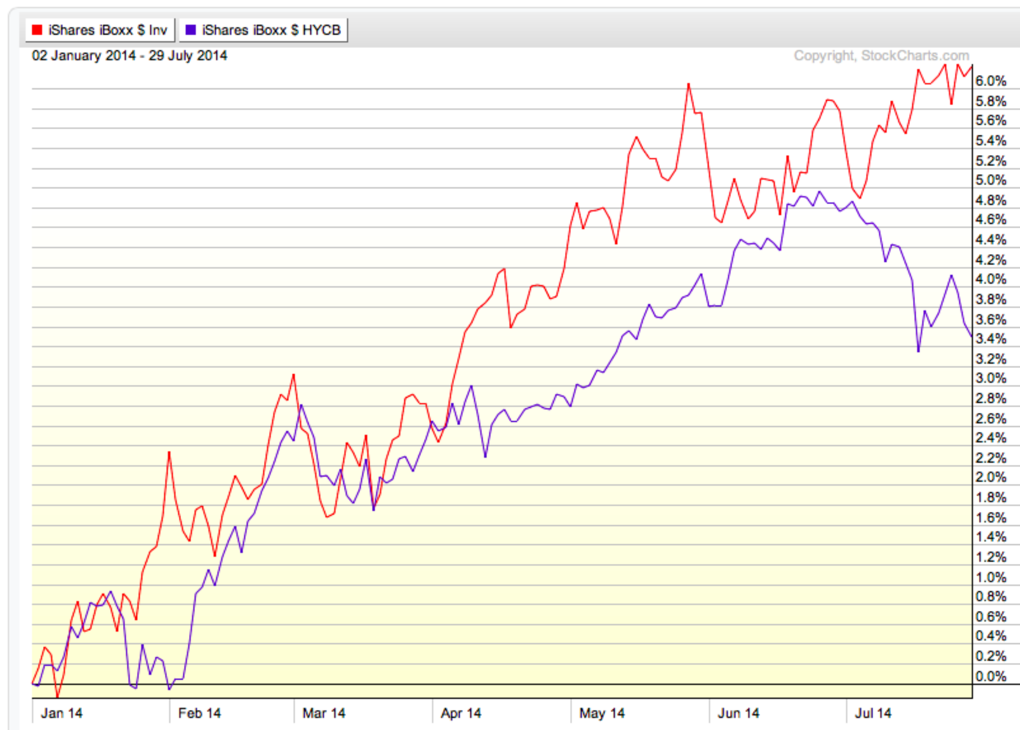
Domestic Market Overview

As July comes to a close, the markets have continued to push higher, albeit with some recent sputtering of that rocket, despite a cornucopia of geopolitical tensions and a weak, but (fingers crossed) strengthening domestic economy. All the major averages are up for the year… except what's that little green one down there? You'll notice that one tracked quite closely with the rest until recently. Hmmmm, that would be the Russell 2000 which is a subset of the Russell 3000 Index and represents approximately 10% of the total market capitalization of that index; it's the small publicly traded companies in the U.S. equity world. It is probably somewhat intuitive that smaller companies



are pretty much by definition riskier and less liquid. Just think about how many shares of Apple trade a day versus some very small company of which you've never heard. So we can see here that recently there has been a move away from less liquid stocks into more liquid, which are the larger capitalized, more widely traded stocks.

If we look at bonds, we see a similar move away from riskier, less liquid bonds. The chart below shows the performance of an iShares ETF for investment grade bonds (in red) and the performance for an iShares ETF for high-yield bonds (in blue), otherwise known as junk bonds.



You'll notice the same pattern here in which the performance for both was rather closely aligned until recently, when the high-yield bonds suddenly began a significant decline, as the concerns for increased liquidity started to appear. Much like the difference between small cap and large cap in the prior chart, high yield bonds are considered higher risk bonds (thus the higher interest rate) which means they are considered less safe and tend to be less liquid than the lower risk "investment" grade bonds, particularly when investment markets get nervous.

Bottom Line:
The markets appear to be preparing for the ending of the Federal Reserve's quantitative easing programs. These programs were designed to increase liquidity, thus a move towards those products that provide more liquidity in anticipation of the end of this program should come as no surprise. The Fed has stated that it will end this last round of QE in October. If that does in fact happen remains to be seen, but the market is clearly taking steps to prepare for its impact.

Earnings Season Reporting

So far earnings this season have been surpassing estimates, which is nice to see but needs to be viewed in the context of estimates that were quite subdued given the actual 2.9% contraction in the economy in Q1. The tough thing is that now the market is priced for perfection, which is a bit reminiscent of prom night expectations. According to data from Bloomberg, the S&P500 is trading around 17.4 current P/E and over a 16.2 forward P/E multiple, (translation – share prices for stocks in the S&P500 are about 17.4 times the current earnings) which is very much on the high side since 2007. This means the market is priced towards perfection. We've got some serious headwinds to these hopes with the geopolitical tensions, plus the ramifications of changes in Federal Reserve policy as now five Fed Presidents are pressing for not only the end of QE but also for a rate hike this year. July 30th we learned that not only did the economy grow much more in Q2 than expected, 4% versus 3% consensus expectations, but inflation hit 2.3% versus 1.4% in Q1. That inflation rate is above the Fed's target, so concerns

are increasing that the Fed will end up being behind the curve with respect to managing the impact of all this liquidity. In the QE world such good news for the economy can become bad news for the markets because, not only has the probability of getting cut off from more of that lovely QE addiction increased, but we are also more likely to get put on an exercise regiment with rising Fed fund rates as well! Although the Fed's QE exit plan is likely to result in some increased volatility across asset classes, we welcome monetary policy inching ever closer toward normalization.

Then there is the political side. Throughout history, occasionally a seemingly contained, regional conflict can have unanticipated ripple effects that increase global tensions to such a point as to have significant economic and political impact. Thus it should come as no surprise that a Potomac Research Group poll of institutional investors found that "Global unrest from Ukraine to the Middle East has changed the mindset and investing outlook of leading investment professionals." The poll of hedge fund, pension fund and money market managers found that nearly half believe foreign events will have a greater impact on the equity markets than domestic versus last year when 65.7% believe domestic events were more important. This is particularly troubling given that 88.6% of those surveyed believe that President Obama has been ineffective in dealing with foreign issues and incidents while only 5.7% said that the President's foreign policies were effective. So far only 32% claim that recent geopolitical events have driven them into less aggressive investments, which means that more shifting could occur if perception of the risks worsens sufficiently. For full details of the poll go to http://bit.ly/WDQwgO

Bottom Line: *Markets are priced for a goldilocks economy which while possible, is not likely. Most of what you can buy for your portfolio is priced pretty richly, but this seemingly ceaseless upward climb could continue for longer than anyone might imagine, putting traders in a challenging position. Do they choose safety, which may cost them participation in this powerful rally, or do they jump into the expensive end of the pool and risk losing in a pullback that will eventually come… the question is when. As we mentioned above, the early signs in stock and bond liquidity preferences are indicating that a pullback may come sooner than later.*

Your Money (with Michael Mink)

Given that it is the summer, I thought I'd give one of the hardest working men in the industry a month off from his "Your Money" piece. So for this month, consider this "Greg Tull's Your Money Guest Starring Michael Mink". As my partner Lenore pointed out, she is desperately in search of a tan, and heaven knows Greg falls in that category too. So Greg, please leverage the time I saved you from your writing duties and get to work, but be generous with the sunscreen.

This month we'll briefly discuss relative value on a geographic basis. The domestic equity markets appear to be fairly valued to slightly overvalued relative to their historical P/E multiple, yet earnings season for the second quarter has provided some reasons for optimism. Domestic equity returns expectations going forward may be moderated given how far the market has come in the last few years. So where can a value investor look with domestic equity indices trading slightly higher than historical average multiples? This is a time when a diversified equity portfolio across regions may be particularly beneficial for long term investors. Emerging market equities have been out of favor for a few years now, but of late investors have been looking to China with the hopes that recently enacted reforms help rein in some of the poor lending practices, and help usher China in to a more consumer driven, mature economy with more sustainable and less credit-driven growth. Chinese equities, once cheap, have become a bit less so, but still remain attractive on a relative value basis (the SPDR S&P China ETF currently trades at a 10 P/E). For a deep value investor, no market is presently as undervalued as Russia. Certainly it takes fortitude to invest in a region with so much headline risk and geopolitical peril, but that can create opportunity. The SPDR S&P Russia ETF trades at a 5 P/E. The largest position in this particular Russian ETF is natural gas extraction and transportation company, Gazprom. At present, Gazprom trades at a 2 P/E. Those stocks, on an earnings multiple basis, are relatively cheap. It's helpful to have some active managers in the portfolio that aren't restricted by a regional or market capitalization mandate searching for attractive global valuations such as these. Exposure to these regions through an ETF vehicle may be advantageous as well. Have a wonderful remainder of the summer!

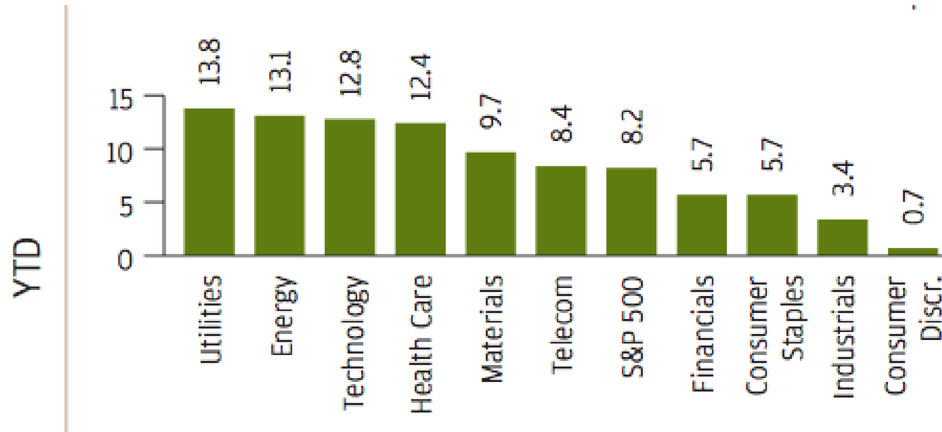
Market Recap

(as of July 28th, 2014)

Equities	Level	1 week	QTD	YTD	1 year	3-yr. Cum.
S&P 500	1978	0.01	1.03	8.24	19.50	57.92
Dow Jones 30	16961	-0.77	0.98	3.68	11.54	45.32
Russell 2000	2845	-0.59	-4.00	-0.94	10.01	43.61
Russell 1000 Growth	605.90	0.11	0.67	7.02	21.38	54.24
Russell 1000 Value	617.56	-0.05	0.83	9.18	18.03	61.07
MSCI EAFE	1960	0.43	-0.58	4.54	15.90	27.40
MSCI EM	1079	1.47	3.21	9.73	15.31	2.55
NASDAQ	4450	0.39	0.97	7.22	24.96	62.54

Fixed Income	Yield	1 week	QTD	YTD	1 year	3-yr. Cum.
U.S. Aggregate	2.28	0.09	0.10	4.03	4.48	10.68
U.S. Corporates	2.93	0.23	0.42	6.12	7.44	18.88
Municipals (10yr)	2.20	0.30	0.51	6.23	7.87	17.00
High Yield	5.92	0.18	-0.45	4.99	9.02	29.03

	Levels (%)					
Key Rates	**7/25/14**	**7/18/14**	**6/30/14**	**12/31/13**	**7/25/13**	**7/25/11**
2-yr U.S. Treasuries	0.53	0.51	0.47	0.38	0.32	0.42
10-yr U.S. Treasuries	2.48	2.50	2.53	3.04	2.61	3.03
30-yr U.S. Treasuries	3.24	3.29	3.34	3.96	3.65	4.31
10-yr German Bund	1.15	1.15	1.24	1.94	1.67	2.76
3-mo. LIBOR	0.23	0.23	0.23	0.25	0.26	0.25
3-mo. EURIBOR	N/A	0.21	N/A	0.29	0.23	1.64
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.33
30-yr fixed mortgage	4.33	4.33	4.28	4.72	4.58	4.57
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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