MERITAS ADVISORS
Comprehensive Wealth Management

August 27th, 2014

MONTHLY INVESTMENT OUTLOOK

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UPCOMING EVENTS

- 09/12: **Managing Climate Change** with John Hulls and Gabrielle Pecora of Lawrence Berkeley National Labs.
- 12/09: **Vital tax Changes and Your Checklist** with Coree Cameron of Cameron Coffey & Kaye
- 01/28: **New Tools for Maximizing the Value of your Privately Held Business** with David Ryan of Upton Financial

MORE FROM MERITAS

You can read more from our chief economist Lenore Elle Hawkins at TheStreet.com where she publishes weekly articles along with co-author Chris Versace, (not affiliated with Meritas Advisors).

Lenore and Chris are also writing a book on investing that is scheduled to be published in the Spring of 2015 by

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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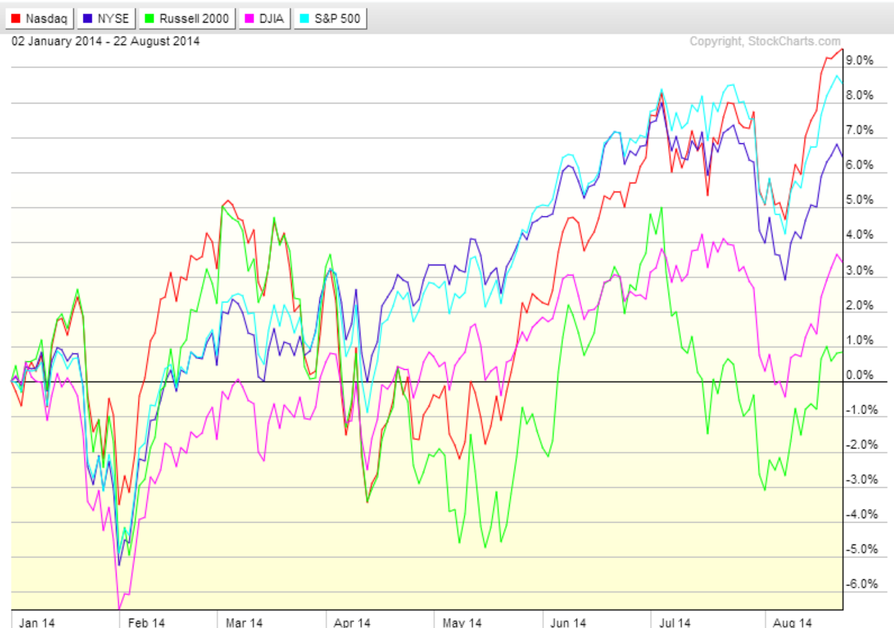
Dear Clients and Friends:

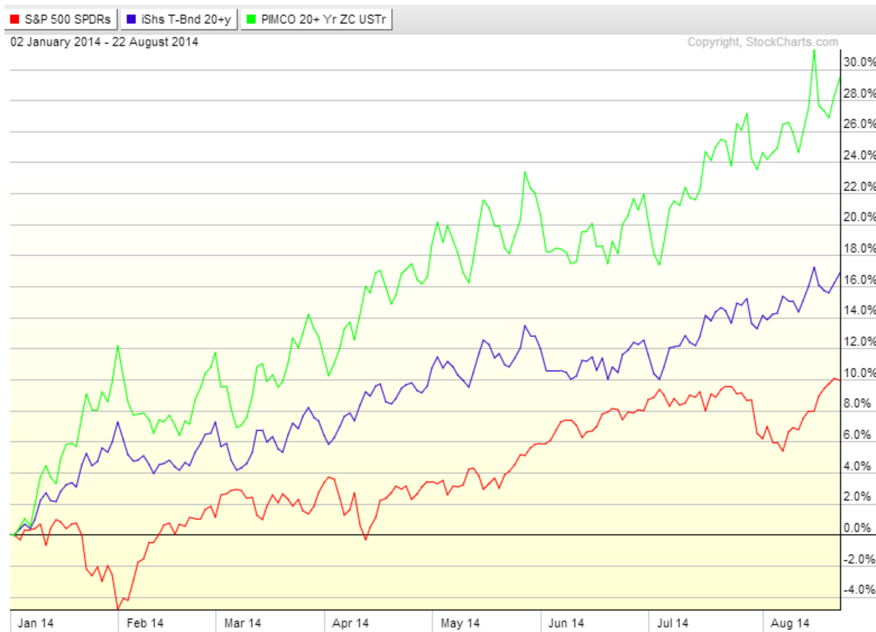
As summer wraps up the markets are again flying high with geopolitical risks fading, the U.S. economy giving some signs of strength while the Eurozone sinks further into malaise. We have a lot to discuss so let's get to it! *Lenore Elle Hawkins, Meritas Advisors Partner and economist in search of earthquake proof wine bottles.*

Market Overview

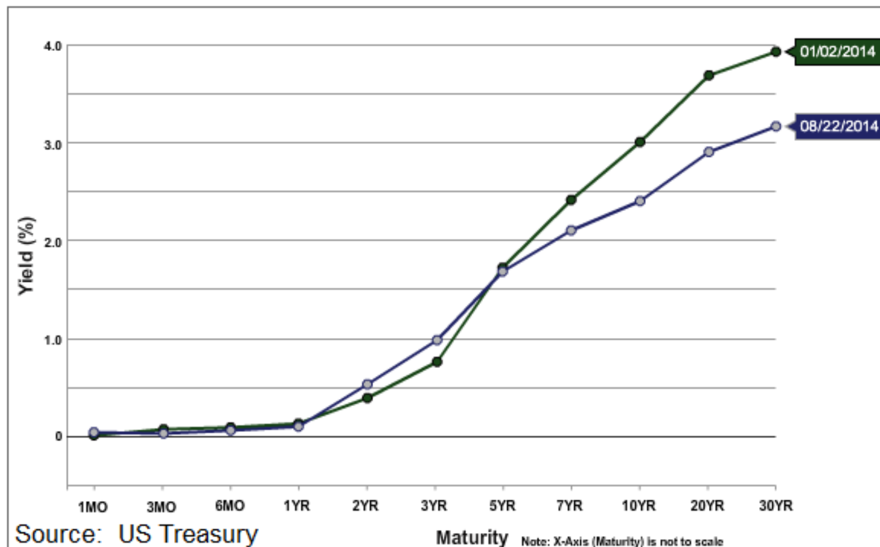
The stock market's meteoric rise sputtered in July and washed out during the first week of August, only to climb back to pre-July 4 levels and then to new all-time highs on Aug 25. As we know now, that move in the S&P 500 came about as international concerns have cooled (as best they can in the short term) as Europe is undergoing a sputtering of its own thereby making U.S. markets a haven of sorts. Alongside those international happenings, recent data points to a U.S. economy that is far from overheated – more on that in a bit – and that has in all likelihood pushed out the Fed's timing for eventual interest rate hikes thereby making U.S. markets even more attractive in the short-term.



The recent flight to safety has seen the 10-year Treasury trading back down to a 14-month low of 2.3%, going against the expectations of most Wall Street economists who believed it would end the year around 3.4% after starting 2014 at about 3%. Many well-known economists have found themselves dumbstruck by how Treasury bonds have outperformed practically every major asset class thus far in 2014. The ETF SPY which tracks the performance of the S&P 500 is up 9.5% since the start of the year, while the iShares ETF for 20-year+ Treasury bonds (TLT) is up 15.8% and PIMCO's 25+ year zero coupon Treasury Index ETF (ZROZ) is up 27.3%, a tough time for anyone in the bond vigilante camp. So much for 2014 being the death knell of the multi-decade long bond bull-run!



Additionally, we've seen the yield curve flatten since the start of the year. This is a widely watched indicator, as typically when the economy is improving, the curve steepens while an inverted yield curve typically heralds a recession. Yields for U.S. Treasuries continue to be above their compatriots' in Europe, but that's a function of higher growth expectations here than across the pond, akin to the U.S. being the most well-behaved kid in detention.



Last week the markets experienced yet another nervous shake when Janet Yellen's much anticipated debut speech at the Fed's annual Jackson Hole shindig was overshadowed on Friday by the wee early morning crossing of a Russian convoy into Ukraine, with the global press reporting the use of Russian artillery and weapons in the region ahead of the planned August 26 meeting between Presidents Poroshenko and Putin. **Bottom Line**: *We would expect the drama to continue to ramp up ahead of the 26th meeting and in all likelihood that means the return of volatility to the stock market, at least for the short-term.*

State of the Consumer

We are well into the 5th year of post-financial crisis recovery and yet Main Street continues to struggle with rising prices, tight paychecks and job opportunities that don't fit their backgrounds or give them a sufficient full-time position. According to the NFIB's small business optimism survey in July, the number of respondents reporting that there are "few or no qualified applicants" for jobs continues to rise, now at 42%.

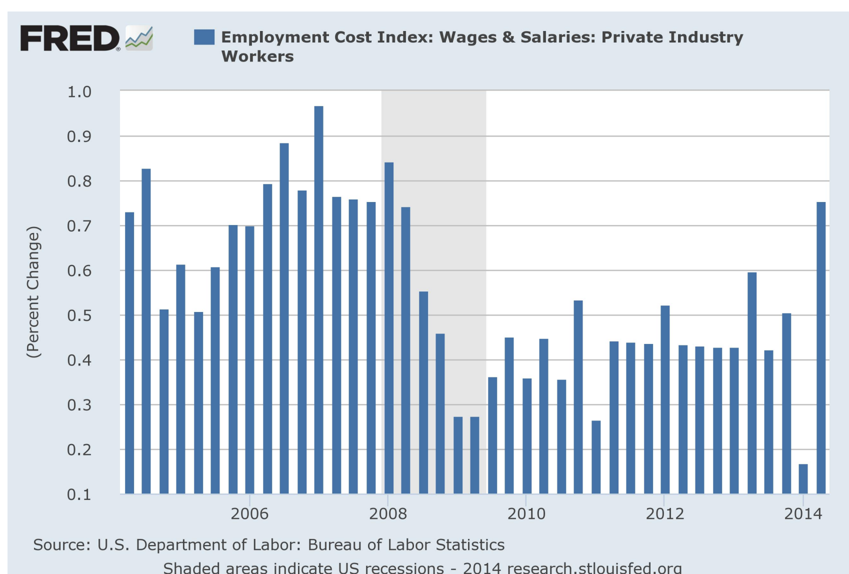
This is consistent with the latest Bureau of Labor Statistics Job Openings and Labor Turnover Summary, or JOLTS report, which is a Hawkins favorite. The report claims that job openings increased again in July to 4.67 million (versus expectations of 4.6 million) from 4.635 million in May. The hire rate improved slightly, up 0.1% to 3.5% while separation rate and quits rate were unchanged at 3.3% and 1.8% respectively.

So there are jobs out there, just not ones you can get. As for your paycheck, according to a report by the United States Conference of Mayors, workers are currently earning an average of 23% less from today's jobs than from the one's they had pre-crisis. Then there is an unusually elevated percent working part-time for economic reasons, according to a St. Louis Fed report. You'd be right to think this has us concerned about the consumer as we head into the consumer spending heaving second half of the year, but wait…there's more.

As if that wasn't bad enough, prices for basics like milk and proteins keep going up. Dean Foods (DF) reported a wider-than-expected quarterly loss earlier this month, citing rising milk costs and sluggish consumer demand. Raw milks costs reportedly have increased 31% in Q2 2014 over Q2 2013 and 6% over the prior quarter to an all-time high. We've seen this impact in the form of higher cheese costs that have plagued Papa Johns (PZZA), Dominos (DPZ) and others, as well as reduced cereal demand that has weighed on Post Holdings (POST) for example.

Given how tough things remain for Main Street, the lackluster report on July's retail sales shouldn't have been a surprise. Economists expected an increase of 0.2% compared to 0.3% gain in June, but overall sales were instead flat, with core sales excluding autos up 0.4% versus June's 0.6%. July's reading is the weakest since January, in the depths of a severe winter, and marks three consecutive flubs for the report.

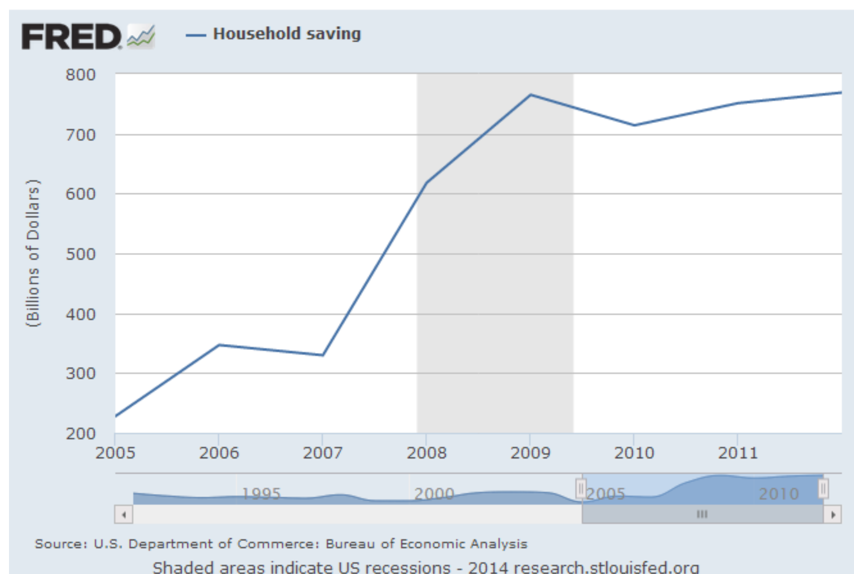
Meanwhile a recent report on employment costs got the market's attention as it provided yet another data point that the Fed ought to be concerned about inflationary pressures.



Employment costs recently rose by the largest amount since Q2 2008, sparking fears over the Fed raising rates sooner, which along with international tensions pushed the S&P500 down almost 3% a few weeks back. In hindsight, the Golidlocks-like July Employment report coupled with the tepid housing market and the sluggish cash strapped consumer likely means the Fed will hold off until mid-2015 to boost interest rates.

Fortunately, all the geopolitical tensions haven't put upward pressure on fuel prices, which is a positive for the average pocketbook and may help deliver a better than expected back-to-school shopping season. With regards to oil, we've seen a shift in crude transportation increasingly occurring via rail. In 2013, there were 415,000 carloads of crude transported versus 9,500 in 2008. New regulations were recently passed to upgrade the safety of railcars transporting flammable liquids, which means that all railcars used to transport oil need to be either replaced or retrofitted over the next two years. So we are seeing increasing demand for oil transport via railcar and if U.S. industrial production continues its strengthening trend, that demand may increase even more.

Bottom Line: *The minor increase in consumer prices combined with non-existent nominal sales growth tells us that consumer spending likely declined in real terms in July. With consumer spending accounting for over 2/3rd of GDP, that's bad news for Q3 GDP growth. Frugality is the new "it kid," as the chart below indicates. Household saving continues to increase from its 2005 lowest point, (data began being collected in 1992). The Fed must be frustrated as a cat with tape on her paws as they continue to artificially suppress interest rates in order to boost spending, yet the consumer refuses to forget the trauma of the Great Recession and continues to prefer saving to spending, despite the painfully low rates of return on savings.*



Housing

Next, take a look at the housing situation in the country. The terrors of the subprime crisis have left a mark, with current housing units per capita at about half of their 20-year average of 0.61% and dramatically below the pre-crisis peak of 0.93%. Residential construction as a percent of GDP is at its lowest level since WWII, which has pushed up demand for rental properties, and is decreasing rental supply and pushing prices up. That may be good news for existing homeowners who want to rent their homes out, but tough news for a fragile recovery when rental prices are rising 1% faster per year than wages.

Last week we learned that the National Association of Home Builders/Wells Fargo sentiment measure climbed to 55 from 53 in July, the highest level in seven months. That being said, builder enthusiasm is a lot like mall traffic during the holidays – just because you see it doesn't necessarily mean consumers are shopping. Had new loan

requests for home purchases, a leading indicator of home sales, climbed rather than fallen over the last few weeks to levels not seen since February, the NAHB's finding would likely carry more weight with us. We believe that checking multiple data points from multiple sources rather than relying on one data point from one source makes for more robust research and better investment decisions.

We also learned last week that U.S. housing starts rebounded strongly in July, up 15.7% on a seasonally adjusted annual basis after two months of declines. Additionally June starts were revised upward from 893k units to 945k. With household income levels still struggling, it came as no surprise that multi-family home starts jumped 33% in July, to the highest since January 2006 while single-family home starts rose only 8.3% in July, a difference worth noting. Homeownership rates in the U.S. hit a 19-year low in the second quarter of 2014 with rental vacancy rates also at their lowest levels in more than 19 years. Rental costs in July rose 0.3% MoM for the fifth consecutive month, up 3.3% YoY for the strongest annual rental inflation rate since February 2009. Keep in mind as you think forward from here that multi-family buildings tend to attract lower income earners than single-family homes and do not generate nearly as much economic activity.

On August 19th Home Depot Inc. (HD) reported a 6.4% increase in same store sales coupled with a raise of its full-year forecast, revealing an encouraging increase in purchases of big-ticket items such as appliances, but it is too early to think we'll see a significant jump in home sales. This jump could be in part due to pent up demand from the bad weather earlier this year, which may have postponed large appliance purchases and delayed landscape investments. It could also signal share gains in appliances from the likes of Best Buy (BBY) and hhgregg (HGG).

College graduates continue to be saddled with large student loans, plus employment and income levels for this cohort continue to incentivize many to move back home with mom and dad. Without a strong first-time homebuyer, the national housing market will likely struggle to get solid footing.

In keeping with Home Depot's results, Lowe's (LOW) also reported its quarterly earnings last Wednesday, with the results beating expectations by $0.02 per share. We would point out that even though the company beat top line expectations, a large factor in the beat was the 6.7% drop in the share count that added more than $0.06 per share to year over year EPS comparisons. Lowe's is but the latest company to deliver double digit EPS growth year over year and we believe investors should be focusing on operating profit and net income growth rates as they look to reconcile P/Es. That's the "good news" seeing as Lowe's cut its full-year sales forecast to 4.5% from 5% and same-store sales forecast to 3.5% from 4%.

Tuesday also brought us news that consumer prices in the U.S.in aggregate barely rose in July after a 0.3% rise in June for a 2.0% annual CPI versus June's 2.1%. Despite all the turmoil in the Middle East and the ongoing spat in Ukraine, energy prices fell broadly in July after rising for the prior three months; gasoline prices fell 0.3% after a 3.3% rise in June. On the other hand food prices rose again, up 0.4% in July after a 0.1% rise in June, driven in part by the brutal drought in California and a tough growing season across most of the world.

Bottom Line: *While the end of QE has many, including us, closely watching for signs of rising interest rates, the recent spate of weak economic data, such as last week's dismal retail report that showed zero nominal growth, coupled with yesterday's 2.0% annual CPI increase and a multitude of geopolitical challenges, is likely to give the Fed ample cover to keep its benchmark interest rate low for quite some time. The global growth story is getting more troubling and can keep downward pressure on rates as well, but there is also a possibility of eventual stagflation (low or no growth, plus inflation) in the US.*

Your Money and Your Life (with Greg Tull)

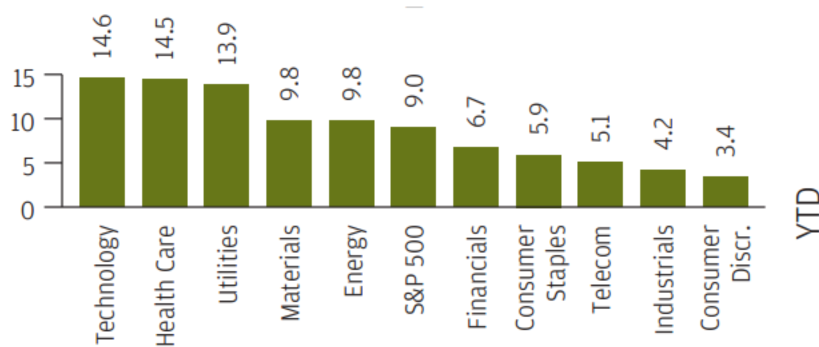
We'd like to invite you to a talk on Managing Harmful Climate Change on Friday September 12th at 8:30am in the Mill Valley Community Center by two Lawrence Berkeley National Laboratory scientists, John Hulls and Gabrielle Pecora. Their two cutting edge research efforts in progress are called DNA Everywhere, and the Thermopile Project. If you are interested in climate change, you will want to hear this talk. The three main

backers of their work to date include the Rathman Family Foundation (family foundation of the founder of Amgen (NASD: AMGN)), the 11th Hour Project (of The Schmidt Family Foundation of the former CEO of Google (NASD: GOOG), Eric Schmidt), and the Rotary Club of Ignacio. Much of their research is being done right here in Marin County. RSVP if you'd like more information, including the invitation flyer, cover letter, and an executive summary of the work.

Market Recap

(as of August 22nd, 2014)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1988	1.75	1.75	9.02	22.53	88.92
Dow Jones 30	17001	2.08	1.40	4.12	16.21	68.93
Russell 2000	2884	1.65	-2.60	0.50	13.44	85.79
Russell 1000 Growth	614.56	1.91	2.25	8.70	24.09	87.22
Russell 1000 Value	616.78	1.64	0.95	9.31	21.16	92.87
MSCI EAFE	1914	0.77	-2.71	2.29	13.70	46.80
MSCI EM	1083	0.82	3.84	10.40	20.79	22.24
NASDAQ	4539	1.69	3.16	9.54	26.26	101.01
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.27	-0.22	0.49	4.43	6.17	8.19
U.S. Corporates	2.93	-0.23	0.85	6.58	9.88	16.90
Municipals (10yr)	2.15	-0.12	1.11	6.86	9.24	14.30
High Yield	5.91	0.39	0.06	5.52	10.82	35.86
	Levels (%)					
Key Rates	**8/22/14**	**8/15/14**	**6/30/14**	**12/31/13**	**8/22/13**	**8/22/11**
2-yr U.S. Treasuries	0.53	0.42	0.47	0.38	0.42	0.22
10-yr U.S. Treasuries	2.40	2.34	2.53	3.04	2.90	2.10
30-yr U.S. Treasuries	3.16	3.13	3.34	3.96	3.88	3.42
10-yr German Bund	0.98	0.95	1.24	1.94	1.92	2.10
3-mo. LIBOR	0.24	0.23	0.23	0.25	0.26	0.31
3-mo. EURIBOR	N/A	0.20	N/A	0.29	0.23	1.56
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.41
30-yr fixed mortgage	4.29	4.29	4.28	4.72	4.68	4.39
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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