October 14th, 2014

Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

IN THIS ISSUE

UPCOMING EVENTS

- 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 Cocktail Investing that is scheduled to be published 03/2015 and is available for pre-order from Amazon.

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:
After a prolonged period of dampened volatility, (see the section "Coming out the Closet" for why) which has frustrated many fund managers, the moving and shaking is back with a vengeance! With so much to discuss, this month is a tad longer than usual so let's get started.

P.S. Anyone see the Chargers v Jets game? I think I just fell a little bit in love with coach Mike McCoy.
--- *Lenore Elle Hawkins, Meritas Advisors Partner and economist,*

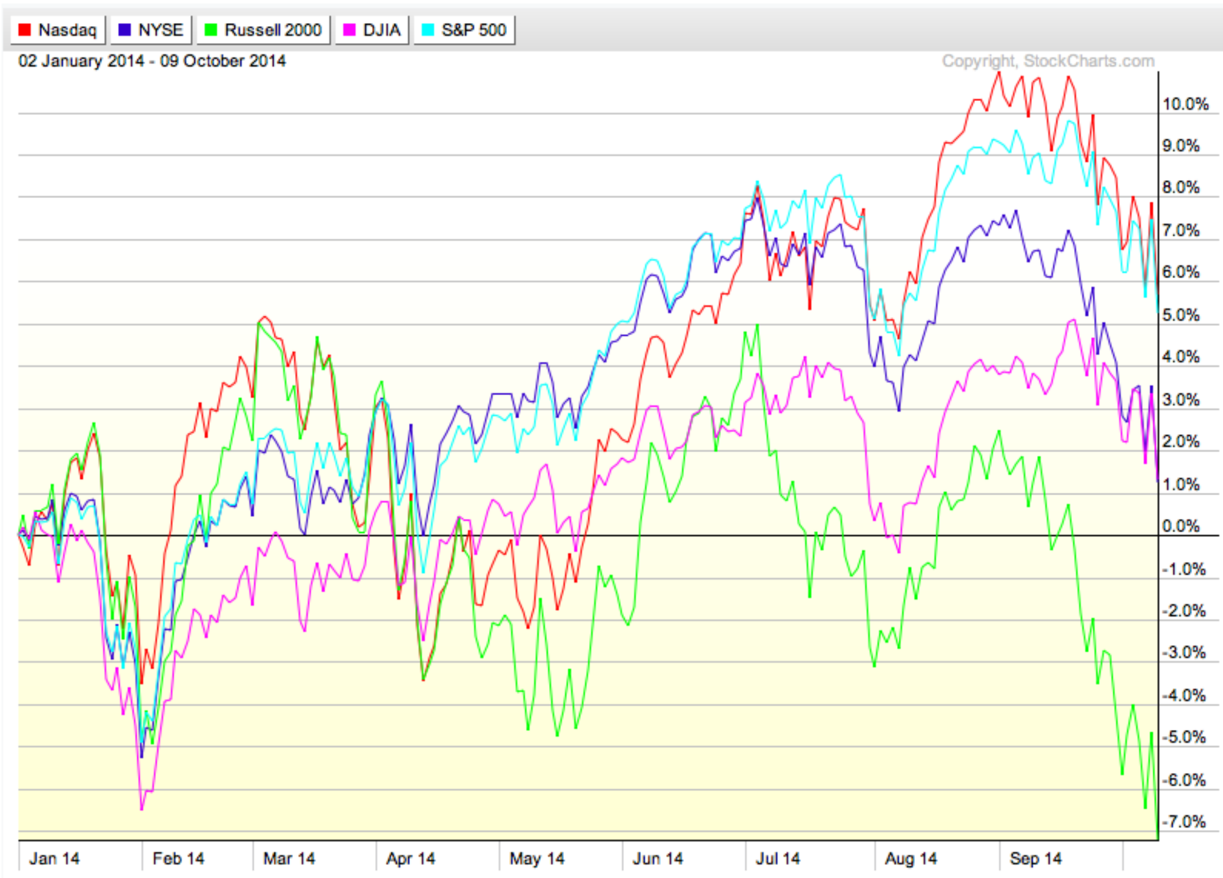
Market & Economic Update

By the beginning of October, the U.S. stock market rally had been going on for 66 months, since bottoming out in March 2009, enjoying a correction-free streak that had already been a year longer than average, despite corporate profit growth that was not only in the low single-digits, but was driven more by cost-cutting than revenue growth and EPS improvement driven often by share-repurchase programs rather than actual business improvements. During this time there was really only one significant correction from late April 2011 to early October 2011 when the Russell 2000 lost about 30% of its value and the S&P 500 lost nearly 20%.

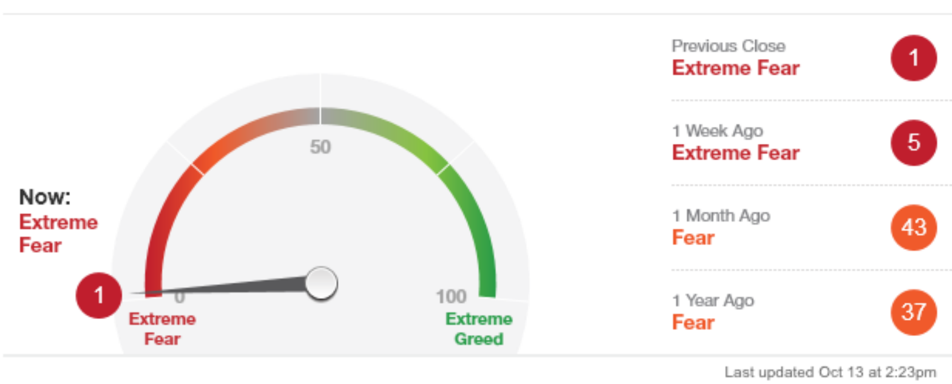
Then last week things changed. On Tuesday, the S&P 500 fell 1.5%. The next day, October 8th was the strongest day in the markets so far this year. The markets experienced the biggest intraday swing, started down then shot massively up, with the S&P 500 to close up 1.8%. What caused this rather dramatic upturn turn-around? The meeting minutes from the Federal Reserve's Open Market Committee meeting, indicated that there was great concern over global economic weakness and the strength of the dollar. So a struggling global economy AND the dollar has strengthened significantly which could hurt U.S. exports, harming the domestic economy? Market participants knew that the day before… what was newsworthy is that THEY are concerned which gave the market comfort that the Fed isn't going to raise interest rates in the near future. Yippeee! Oh, wait, but because things are still pretty rough out there…

So… the equity markets woke up the following day, on October 9th, and stocks once again dropped across the globe, with the S&P 500 reversing most of the prior day's rally to close down 2.07% and small caps tumbled even more on continued concern about global economic strength with the Russell 2000 (small cap index) falling 2.66%

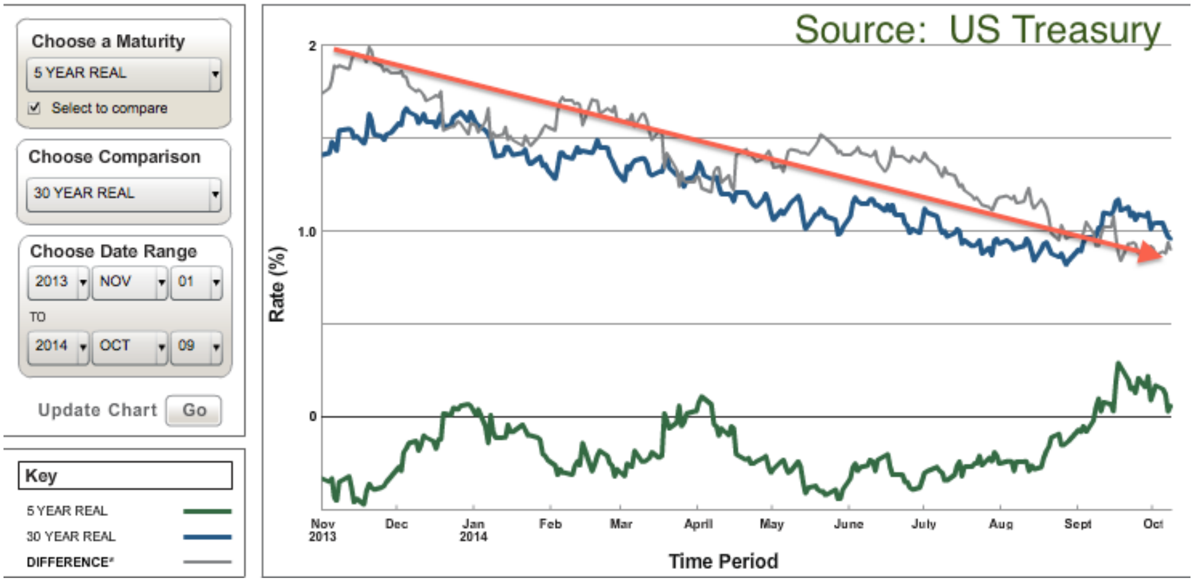
At this point small-cap stocks, as measured by the Russell 2000, have fallen below the 200-day moving average for the first time since November 2012. Almost half of the stocks in the Nasdaq are down 20% from their one-year highs, which means they are already in a bear market. Doug Kass of Seabreeze Partners has been calling this "The Ali Blah Blah Top," suggesting that the Chinese tech company's monster initial public offering on September 19th was a signal that markets were too frothy.



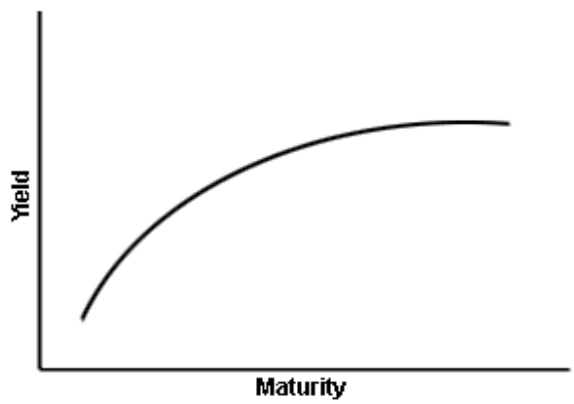
The CNN Money Fear and Greed Index sums up today's market sentiment fairly clearly.



We have seen some very interesting moves in the bond market this year as well. Over the past year longer-dated bond yields have fallen while the shorter-term (such as the 5-year) have actually risen, which is indicative of a flattening yield curve. The red line below shows the



In a normal environment the yield curve slopes upward, which makes intuitive sense. You'd charge someone more to borrow money from you for 10 years than 1 year.

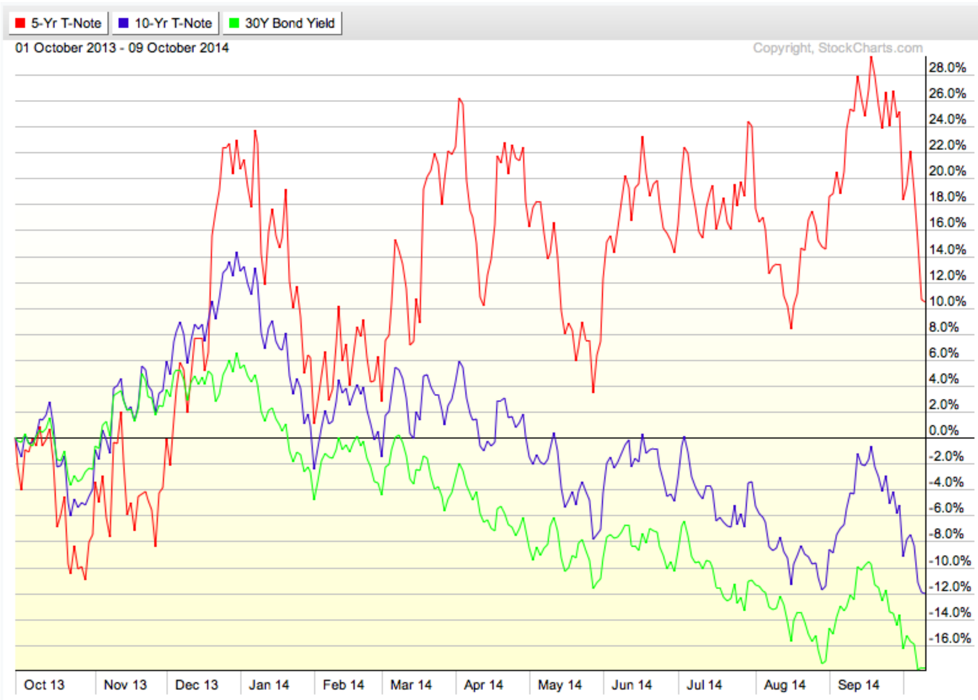


When the yield curve inverts, that means you would charge more for a 1 year loan than a 10 year loan which is counter-intuitive to say the least. This happens when the market believes that long-term prospects are grim, thus the longer you go out, the lower the yield. A flattening or inverted yield curve is often interpreted as a sign that the economy is starting to cool and that the Fed may start to lower short-term rates. In contrast, a steepening yield curve usually points to a strong economy with increased inflation expectations.

Currently, the yield curve is considered steep due to the difference between long- and short-term interest rates. The bond market has been in this steep yield curve due to the Fed's decision to keep rates near zero. However we are seeing the curve getting flatter as the prior chart illustrated, with the red arrow showing the difference between the 30-year rate and the 5-year rate declining. Looking ahead, the curve could flatten further, similar to what happened during the last increase in the federal funds rate, and may eventually invert.

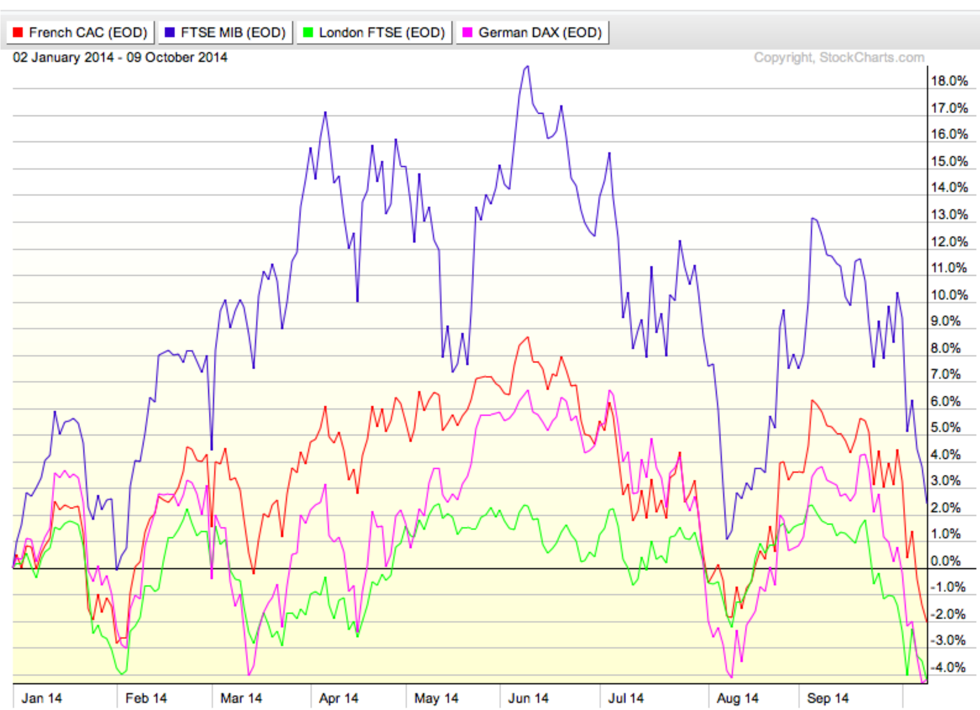
On September 9th, Jeffrey Gundlach, CEO and CIO of DoubleLine Capital, (whose fund Meritas utilizes) gave his thoughts on the recent flattening of the yield curve. Gundlach thinks that this trend is remarkable. He suggests that strong economic data are driving the short end of the yield curve higher on expectations that the Fed will start tightening sooner. However, the economy might be more vulnerable to rate hikes than is widely appreciated. He concludes that "if you read the tea leaves of the bond market, it might be if the Fed raises rates even moderately like to 1% or 2%, maybe the economy can't take it."

The chart below shows how the price of longer-dated bonds have been falling, which is what happens when yields go up, while the shorter term bond prices have been rising, which is when yields go down.

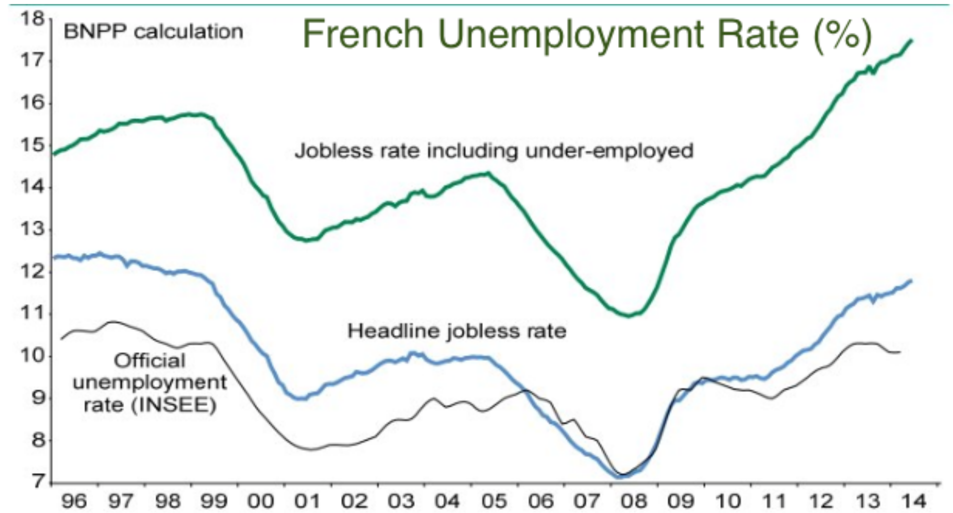


Eurozone

Across the Atlantic, European equities have followed a similar pattern to the U.S., peaking in early June, with the Italian MIB up almost 20%. All are now down for the year, with the exception of the Italian MIB, but it sure looks to be following suit!



As you've likely heard, Europe is now fighting to stay out of another recession, with the German economy, long the primary source of strength in the region, capitulating as well. This is material to the U.S. stock market as the U.S. stock market is not all about the U.S. economy. Foreign sales accounted for about 33% of aggregate revenue for the S&P500 in 2013 according to Goldman Sach's analyst Amanda Sneider. In addition to weakening international sales, the U.S. also has to worry about the impact of a strengthening greenback, (we'll have more on that later in this letter).



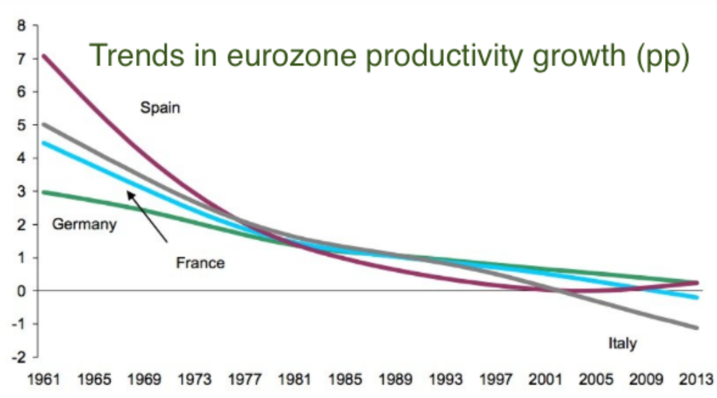
So just how tough is it in Europe? The French Prime Minister, Manuel Valls, enjoyed an approval rating of over 70% when President François Hollande gave him the position. Just six months later his approval rating has fallen to 22%, barely better than Hollande's. Valls recently reportedly said of the French economy that, "in three to six months, if the situation isn't reversed, we'll be *foutu*," a rather colorful way of saying the economy is in a very bad place, with unemployment still above 10% and GDP flat so far for the year.

Meanwhile France's two largest car-makers are pressing Hollande to quicken the pace of economic reform, primarily with respect to the nation's restrictive labor regime and high labor costs, in order to help them boost their competitiveness.

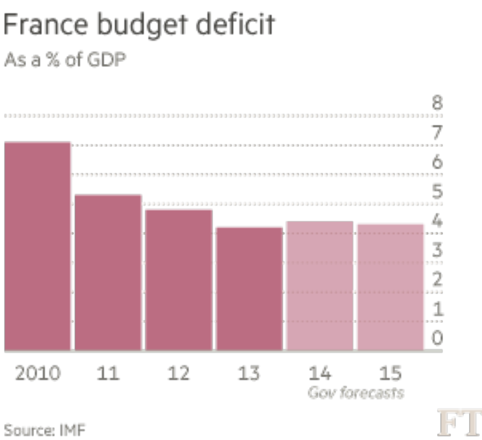
According to Carlos Ghosn, chief executive of Renault, "everything should be done to lower the cost of labor in France on conditions that are compatible with economic balance"

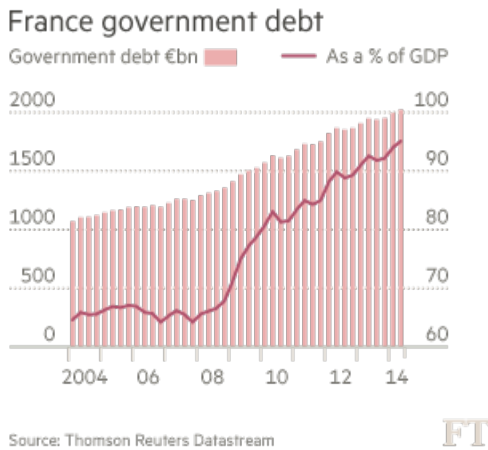
Maxime Picat, chief executive of the Peugeot brand added: "The level of taxation and (social) charges are putting huge pressure on labor costs. This is really the key and where we've got the biggest gap with the countries very close to France," he said. "With 1m cars (made in France) and such an exporting position, this is clearly key to us."

This isn't all that surprising if we look at the long-term trends in Eurozone productivity growth.



Source: Reuters Ecowin Pro, European Commission



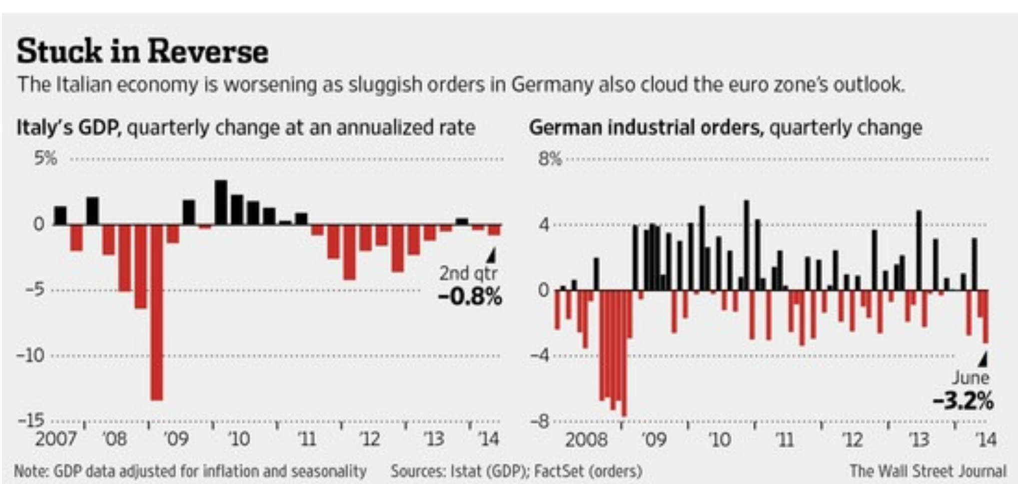


How's that French austerity coming along? Errr, not so much which is getting the ire up over in Germany. Despite all the talk of cutting spending, Government debt has continued to grow almost unabated while its debt to GDP ratio only gets worse.

Recently Finance minister Michel Sapin admitted that France's government will not be able to meet its EU deficit target until 2017, from these charts you can see no one ought to be surprised!

Meanwhile Italian Prime Minister Matteo Renzi claims that Italy will not follow in France's footsteps, but will instead remain within the 3% deficit-to-gross GDP ratio mandated by the EU, despite his nation's protracted recession. In August the youth (aged between 15 and 24) unemployment rate in Italy reached a new record high of 44.2% in August, while the overall unemployment rate was 12.3% v expectation of 12.6%, (see chart at right).

Imagine that! Almost half of the youth in Italy cannot find a job. Think about how that affects the nation for decades to come. At a time when the young most need to be developing skills and using all that energy to be productive, they are wandering around aimless and increasingly frustrated that their aging nation is giving them the cold shoulder in the workforce.



On October 6th we learned that German factory orders plunged the most since 2009, underlining the risk of a slowdown in Europe's largest economy. Orders, adjusted for seasonal swings and inflation, fell 5.7% in August versus expectations of a 2.5% decline, after climbing 4.9% in July, according to the Economy Ministry in Berlin. On October 9th Reuters reported that German exports plunged 5.8% in August, their largest amount since the height of the financial crisis, fueling debate on whether Berlin is doing enough to prop up the domestic and European economies. Hours after the trade data was released, a group of leading economic institutes joined the International Monetary Fund (IMF) in slashing forecasts for German growth. They are now expecting growth of 1.3% this year and 1.2% next, down from 1.9% and 2.0% previously.

With so many other Eurozone nations struggling, it isn't surprising that while Germany had a strong start to the year, it shrank by 0.2% in the second quarter. Evidence is now mounting that it barely grew in the third quarter and some economists are forecasting another contraction in that period, which would amount to a technical recession.

Bottom Line:

The U.S. economy is on a stronger footing, but one of the core facets is still struggling – what families take home at the end of the day. Yes, the unemployment rate has fallen, but so has the labor participation rate, (the percentage of the population in the work force). Granted, some of that is because of the aging population, but not all and either way, it means a smaller portion of the country is working towards growing the economy. Yes, there are more job openings, the number of jobs waiting to be filled in the U.S. has climbed to the highest level in 13 years. But those jobs are not being filled because we have a significant skill gap. Employers can't find the right people to fill the jobs. That hurts growth in two ways: (1) the person looking for work still isn't able to get a paying job and (2) the business isn't able to grow as effectively as it could if those positions were filled.

The U.S. is not an island. Countries all over the world that buy from the U.S. are struggling and a strengthening U.S. dollar isn't helping them. This impacts what types of companies will do well in this new era.

Suppressed volatility always leads to increased volatility; an immutable fact.

Now, more than ever, individual security selection is vital as is resisting the urge to act on emotional responses to these market swings. Have a plan and stick to it.

Coming out of the Closet

This month we are going to get a little personal. Lenore has decided that it is time for her to come out of the closet. Mike and Greg have for months counseled me that it is a choice, that it doesn't have to be this way, but after considerable introspection, I came to the conclusion that I was simply born this way and there is very little I can do about it. It is simply the way I'm wired. So here it is. I tend to think macro. There, I've said it.

Performance of global macro strategies have been rather poor over the past five years, much to my consternation, primarily due to a coordinated global monetary policy regime, (think Fed, ECB [European Central Bank], BOJ [Bank of Japan], and BoE [Bank of England]) that has squeezed out the historical patterns of difference between geographies and asset classes and done one heck of a bang-up job suppressing volatility. But recently, this changed. Macro funds were among the best performing strategies in September, with a gain of 1.1% on average. Monetary policies are becoming uncoupled. Divergent national growth rates are making the Fed and the BoE more hawkish and the ECB and BOJ more dovish. Now every major economic region is starting to have to fend for itself, giving macro strategies room to work, much to the relief of macro fund managers and strategists all over the world.

Now that you know my secret, we can confess we're worried. "Yeah, yeah, what's new?" you say. Fair enough, but that's our job and this time, our fears are a little different. For years we've been nervous, like many, about the unintended consequences of all this quantitative easing. The straightforward assessment was that if the world became flooded with dollars, the value of the dollar would decline. For those who are long-time readers of this monthly offering, you know that is a potential outcome that has been discussed at length. But over the past quarter or so there's been a shift in the markets that has us looking at a different potential outcome.

As a woman with macro-tendencies, one of my guilty pleasures is talking with other macro-minded folk about the global dynamics we see emerging. One of my favorite partners for this is Raoul Pal, who I believe is one of the smartest chaps around. Raoul was commenting on the impact of the appreciating dollar and its potentially deflationary effects, which got me thinking. What if… just what if the flooding of dollars is more akin to a really savvy drug dealer?

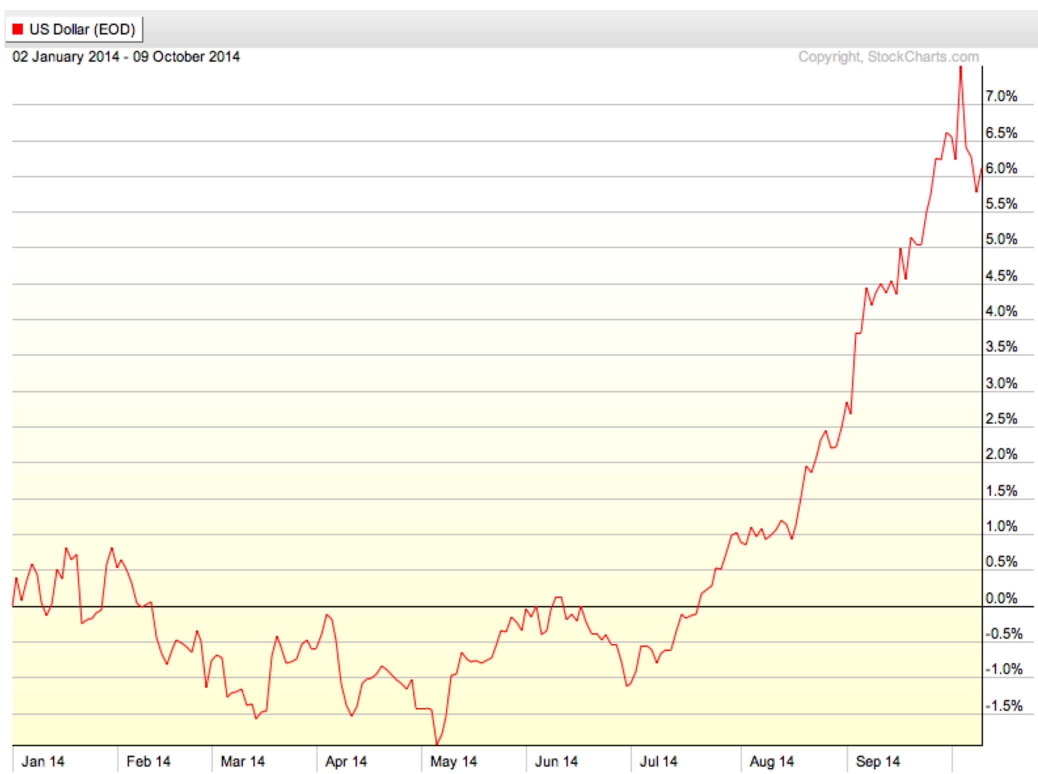
An enterprising dealer would be wise to flood the market with say cheap dopium, so much dopium that people who normally wouldn't even be interested sample it and find that it can help give them an extra kick in their day (yield) when injected into their blood (carry-trade). But they tell themselves they'll only use for just this month's really busy workload (challenging yield-generating environment). Once things get back to normal, (normalized interest rates) they'll get clean. But the workload (financial suppression) continues to be challenging. Meanwhile the flow of dopium continues unabated, (QE continues and the dollar remains relatively stable). So what really is the risk with a solid and steady supplier?

Recently the dealer (Fed) has come to the conclusion that to continue pushing so much dopium, (flooding the market with dollars by buying nearly all the new Treasury bonds and even MBS issued every month) may eventually be problematic, but rather than be mobbed by crazy addicts (investors) the dealer (Fed) decides to try and slowly reduce the flow. Now anyone who's found themselves staring nervously into an empty coffee cup during an interminable morning meeting with no potential for a refill in sight knows the power of addiction. Demand becomes increasingly inelastic, i.e. price becomes less and less relevant because you just *need* it, leading to….

Dollar Appreciation

After a period of relative stability, the USD has strengthened considerably, with the US Dollar Spot Index up nearly 9% since its recent low in early May.

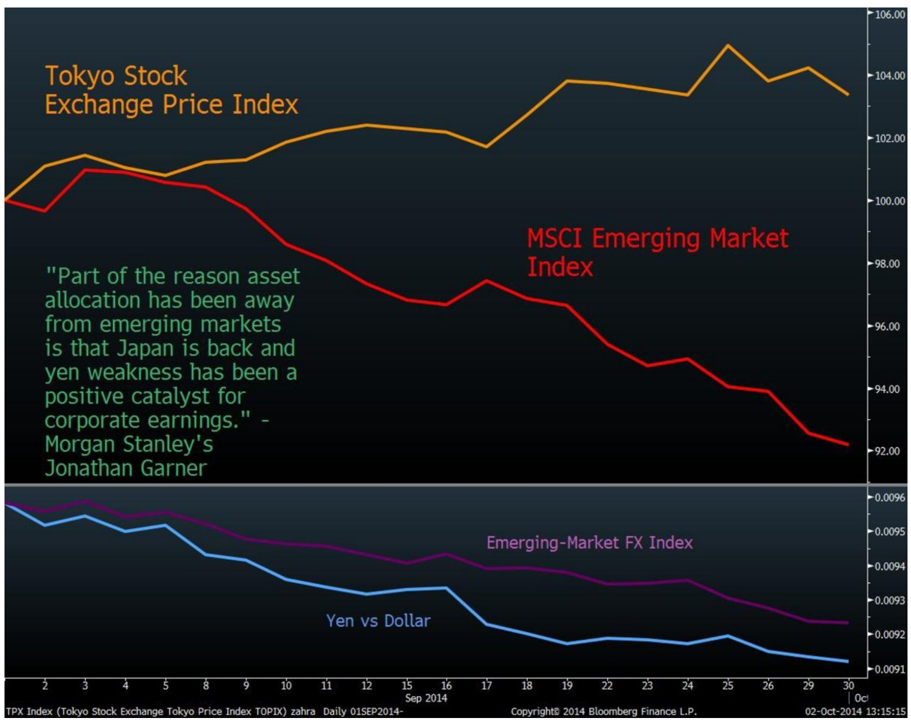
We think three of the biggest areas of concern with a rising dollar are the carry trade, emerging market equity performance and the commodities complex, particularly with respect to China.



Here's how the carry trade works:

1. Funds and/or traders for very large institutions borrow dollars at relatively lower interest rates than those in emerging markets. These dollars are then converted into the currency of the emerging market for the desired bonds.
2. This emerging market currency is then used to buy bonds that have a much higher interest rate than the US. The difference between the two interest rates is referred to as "positive carry."
3. The more traders that do this, the more the price of bonds in the emerging market rises, generating champagne worthy profits. This can get particularly profitable the more leverage is used.

If the dollar continues to strengthen against these currencies, then traders need more of the emerging market currency to pay off the interest and principle for the dollars borrowed and the greater the leverage, the worse the problem. As the dollar strengthens, the value of the carry trade unravels to the point of generating loss and this can happen in an accelerating manner if enough carry trades around the world need to be unwound simultaneously.



The second area of concern is emerging market equities, which have fallen dramatically in recent weeks, down over 9% since their recent high on September 5th and down 7.6% in the month of September alone, the most since May 2012, led by China and Hong Kong. The Japanese yen fell 5.1% in September versus the dollar to the weakest level since August 2008.

When emerging market stocks underperform relative to US equities with a strengthening dollar, additional pressure is placed on already vulnerable economies leading to further capital outflows.

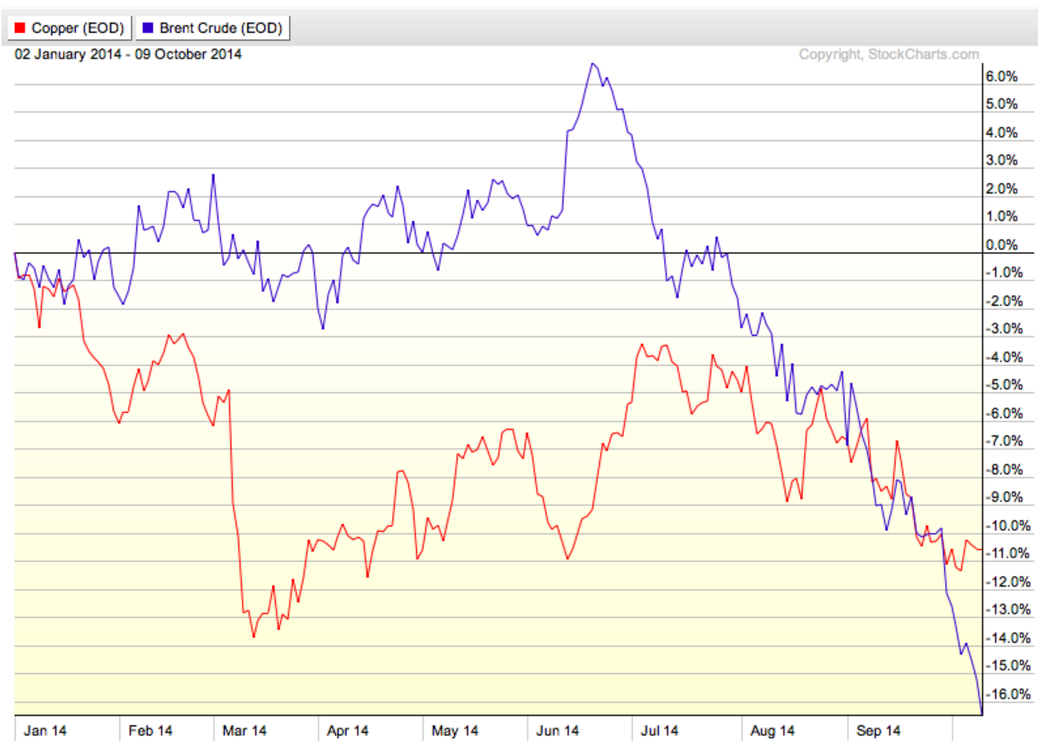
The third area for concern is the commodity complex as commodities are primarily priced in dollars, so if you want to buy oil or copper, for example, you need to first convert into dollars. The stronger the dollar, the more of the non-dollar currency you need and the less oil and copper you get for each dollar. It's all relative.

Now that Elle's come out of the closet she can openly put on her macro hat and look around the world and what we see is a lot of reasons to be nervous that a flight to safety could occur… and that means a further strengthening dollar, which itself is the very catalyst to cause the flight.
China is facing an economic slowdown that ought to have everyone paying attention, particularly since they've used their commodity inventory as collateral for borrowing. With commodity prices like copper falling, down 8% since its recent July 3rd high and oil down nearly 15% since its June 12th high commodity collateral is under pressure. China's political stability depends on continued economic growth. The renminbi is currently tied to the dollar, so a stronger dollar means a stronger renminbi, which means Chinese exports are relatively *more* expensive for their customers.

Granted, China is trying to develop its internal consumer consumption economy, but that takes time and it desperately needs to keep its people working and that work is dependent on people outside the country buying stuff made in China! So… would it really be all that surprising to see China alter its monetary policy to pull away from the dollar? For that matter, with the strains in the relationship between Beijing and Hong Kong from all these protests, might China also take steps to impact the Hong Kong dollar, a major source of strength for the island? Even just the fear of that possibility could result in a capital flight for all that mainland China wealth sitting in Hong Kong dollars.

Don't forget how this affects Russia! That country's oil revenues are its primary source of foreign currency reserves, which it needs to service its international debt. As these reserves come under pressure, so does Russian debt.

Just to top it off, European economies continue to struggle while in recent months the S&P500 has outperformed



the major European market indices, again potentially leading to inflows into the US, increasing demand for the dollar. The lack of traction from the ECB's latest QE attempts is only exacerbating concerns.

We've seen this story before, starting in 1981 in Latin America and then again in 1998 in Asia. While we think it is unlikely that this unwinding and potentially explosive dollar move up will happen in the very near term, there are a lot of factors in place to give it decent odds in the coming months, perhaps into early next year, albeit with the usual bumps along the way.

Bottom Line: *If the dollar strengthening story plays out, we would likely see the following:*

- *Negative impact on U.S. earnings (exports become relatively more expensive to non-U.S. buyers),*
- *Emerging markets would suffer from capital flight*
- *Commodities and commodity related-securities, (think oil companies, copper mining etc.) would suffer*
- *Earnings for Japanese and European exporters would benefit as their goods become relatively less expensive*
- *U.S. Treasury yields would fall…deflationary pressures increase*

Your Money and Your Life (with Greg Tull)

In this excellent animated video by Ray Dalio of Bridgewater Associates, Dalio provides a useful model for understanding "How the Economic Machine Works."

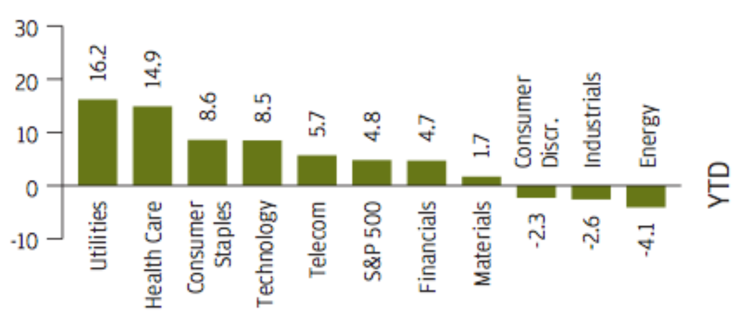
The only way to achieve sustainable increases in standards of living is through productivity growth. However, the expansion and contraction phases of the short term credit cycle (5 to 8 years) and long term credit cycle (75 to 100 years) both lead to periods of expansion and contraction that temporarily outweigh productivity growth as the determinant of living standards. Throughout the repeating booms and busts of the short term credit cycle, debt rises to higher and higher levels in both the public (government) and the private (corporate and personal) sectors. Over many decades, the accumulated debt burdens eventually become unsustainably high. Since 2008, we've been living through the 2nd great de-leveraging in the past 100 years in the U.S. The prior great de-leveraging was in the 1930s. The mechanics of raising and lowering interest rates that worked to get the economy back on track in all of the short term credit cycles is not sufficient to get the economy out of the enormous slump that comes at the end of a long term credit cycle. There are four ways that de-leveraging can take place, to bring private and public sector debt burdens back down to a manageable level. First, people, businesses and governments cut their spending to pay down their debts. Second, debts are reduced through defaults and restructuring. Third, some wealth is redistributed from the haves to the have-nots. And fourth, the central bank prints money. The first three ways are deflationary while money printing is inflationary. A "beautiful de-leveraging" is possible when the deflationary and inflationary forces are balanced. If the forces are not well balanced, either excessive deflation or excessive inflation can lead to social unrest due to severe economic hardship. In our own lives, we can make choices that strengthen our personal balance sheets and improve our productivity to help tilt the odds in favor of a beautiful de-leveraging.

Market Recap

(as of October 10th, 2014)

Equities	Level	1 week	QTD	YTD	1 year	3-yr. Cum.
		Index Returns (%)				
S&P 500	1906	-3.09	-3.29	4.78	14.95	70.24
Dow Jones 30	16544	-2.69	-2.86	1.63	11.83	55.94
Russell 2000	2618	-4.64	-4.36	-8.57	-0.22	60.34
Russell 1000 Growth	586.35	-3.42	-3.67	3.93	14.60	66.93
Russell 1000 Value	587.38	-3.23	-3.38	4.42	13.60	74.43
MSCI EAFE	1749	-2.41	-5.25	-6.18	-0.40	35.31
MSCI EM	989.87	-0.70	-1.49	1.21	0.35	20.04
NASDAQ	4276	-4.45	-4.82	3.33	15.09	73.11
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.22	0.63	1.00	5.14	5.10	9.23
U.S. Corporates	2.97	0.71	1.35	7.03	8.08	19.25
Municipals (10yr)	1.99	0.69	0.94	8.24	8.42	17.42
High Yield	6.52	-0.78	-0.23	3.25	6.21	37.81

Key Rates	10/10/14	10/3/14	9/30/14	12/31/13	10/10/13	10/10/11
	Levels (%)					
2-yr U.S. Treasuries	0.45	0.57	0.58	0.38	0.35	0.30
10-yr U.S. Treasuries	2.31	2.45	2.52	3.04	2.71	2.10
30-yr U.S. Treasuries	3.03	3.13	3.21	3.96	3.75	3.02
10-yr German Bund	0.84	0.88	0.90	1.94	1.87	2.08
3-mo. LIBOR	0.23	0.23	0.24	0.25	0.24	0.39
3-mo. EURIBOR	N/A	0.08	0.08	0.29	0.23	1.59
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.50
30-yr fixed mortgage	4.30	4.30	4.33	4.72	4.42	4.25
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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