January 27th, 2015

MERITAS ADVISORS

Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

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UPCOMING EVENTS

- 01/28: **New Tools for Maximizing the Value of your Privately Held Business** with David Ryan of Upton Financial
- 04/22-24: **XIIIth International CIFA Forum in Monaco,** guest speaker Lenore Hawkins

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 in the Spring 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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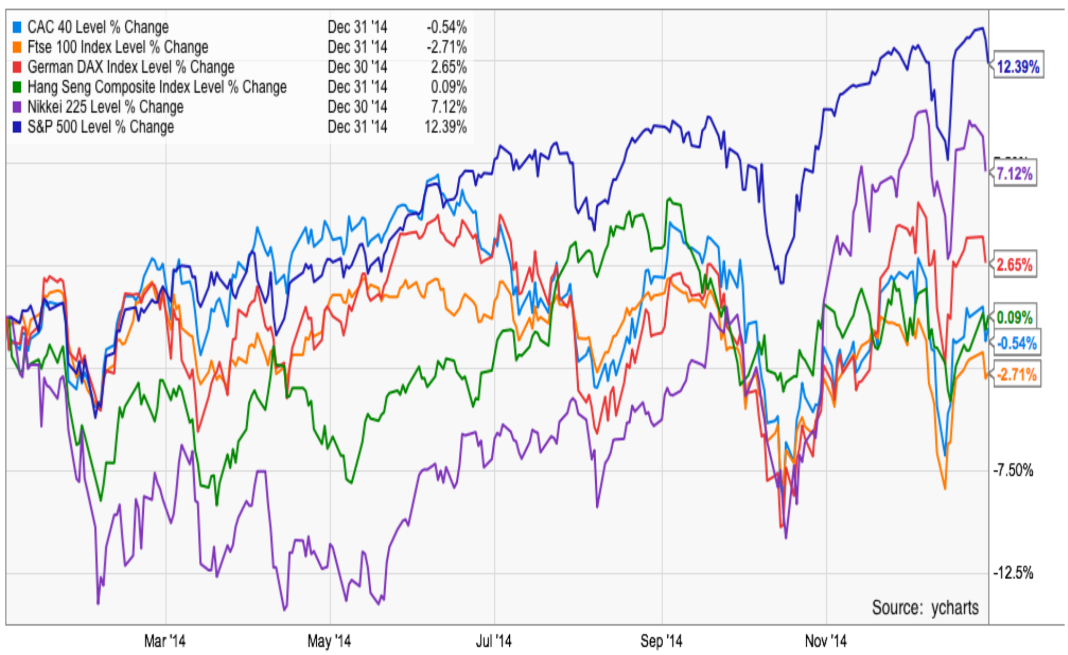
Dear Clients and Friends:
We are less than a month into the New Year and already 2015 is shaping up to be a tumultuous one. Now more than ever the markets are driven primarily not by fundamentals, but by the prevailing narrative and that narrative is under a lot of pressure with its primary message changing course. There is no sure thing when it comes to the markets, only probabilities, and this year we see increasing probability of a lot more volatility and with it increased risks as well as potential for reward. --- *Lenore Elle Hawkins, Meritas Advisors Partner, economist, writer and new Orange Theory devotee thanks to snug post-holiday waistbands … how **does** it go on so easily and off so slowly!?*

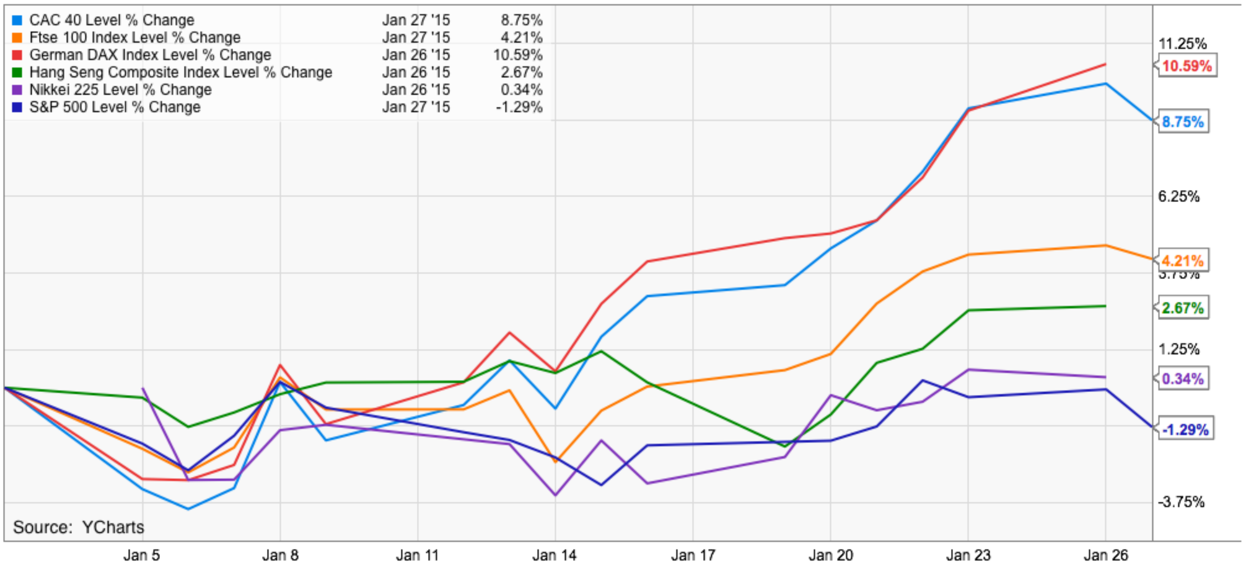
Market Update

For 2014, the S&P 500 was the strongest performer of the major international indices with Japan's Nikkei the second strongest, the remaining indices were relatively flat to slightly negative. From this we can see those areas with the most aggressively loose monetary policy had the strongest performing equity markets, something to keep in mind as policies diverge in 2015.

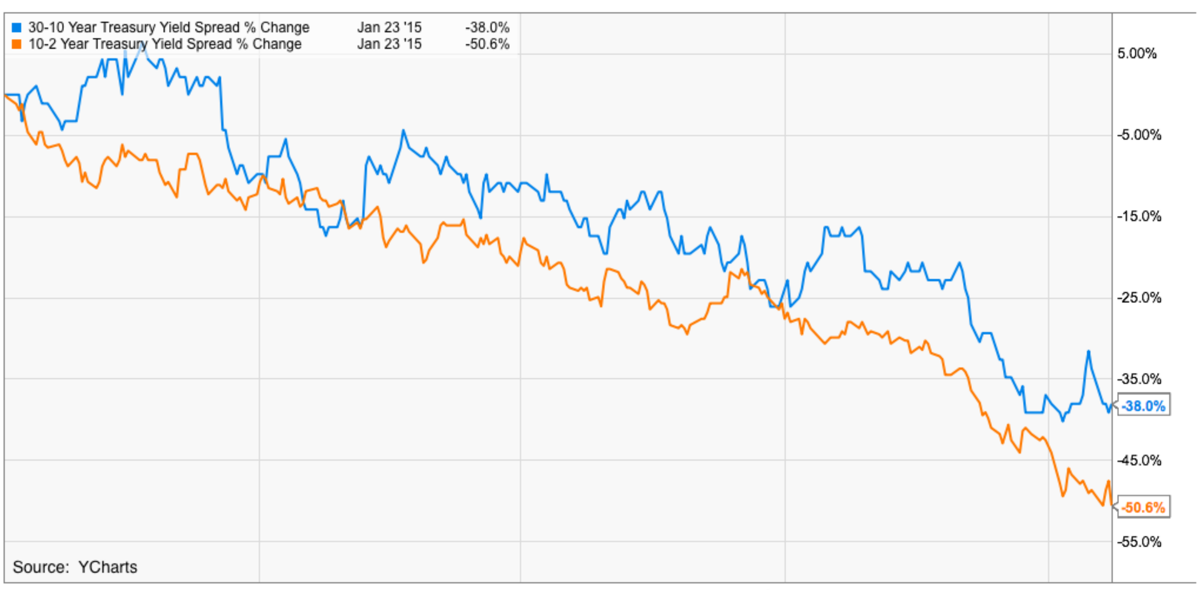


The New Year has been a volatile one in the markets to say the least. The average trading range for the S&P 500 in 2014 was 16.5 points. As of Friday's close, the average trading range for 2015 has been 30.3, which is nearly double that of 2014. The Chicago Board Volatility Index averaged 14.2 in 2014, but has averaged 33.3 in 2015, (a higher number means greater volatility.) With all that movement, the index is still below the year's open as of the close on Friday, January 23rd.

As we move into 2015, index performance once again is consistent with monetary policy current realities and future expectations. In the U.S. expectations are for tightening sometime this year, although with the recent weak economic data the market's expectations around that date is moving further out. Last week Europe launched a whopper of a quantitative easing program and Japan is treading water, having already launched mind-boggling levels of monetary stimulus last year.

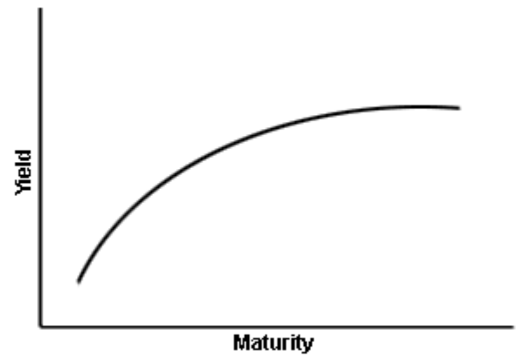


Fears of global slowing and divergent monetary policies have also resulted in the yield curve flattening considerably since the start of 2014. The spread between the 10- and 2-year Treasury has dropped from 261 basis points at the start of 2014, to 129 basis points as of yesterday's close, a more than 50% decline. The spread between the 30- and 10- year Treasury has fallen from 92 basis points at the start of 2014 to 57 yesterday a nearly 40% decline. The yield on the 30-year is hitting all time lows and is now where the yield on the 10-year was back in November.

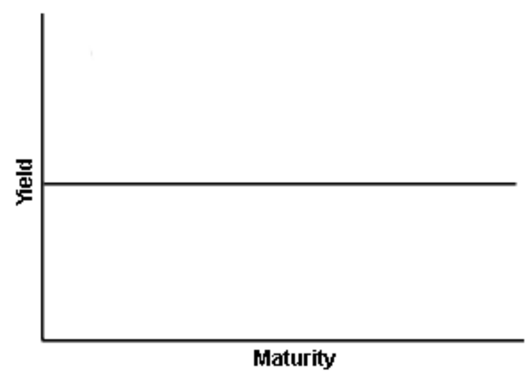


What's a Yield curve?

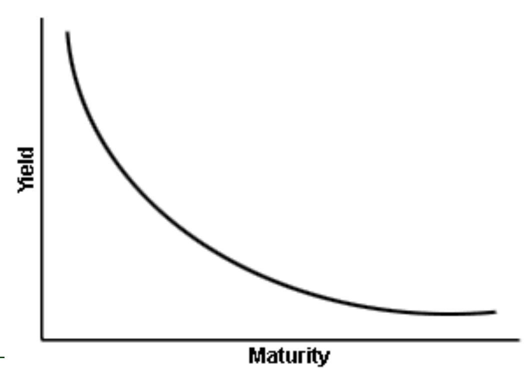
The yield curve is defined as **a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates**; translation, when people talk about the yield curve, they are typically referring to the different rates paid by U.S. Treasuries at different maturities, (meaning for different lengths of time such as six months, one year, five years, etc.) As we run through the business cycle the yield curve typically starts off with an upward slope, with short-term rates lower than long-term rates as is shown in the chart at right, which is referred to as a normal yield curve. This makes intuitive sense as lending someone money for six months is less risky than lending it to them for ten years. A lot can happen in ten years that can change the borrower's ability to repay the loan. A lot can happen that might make you wish you hadn't lent them the money by say year three. In order to compensate for the greater risks of lending for a longer period of time, the interest you get paid on that loan must be higher, the longer you lend.



When investors expect that interest rates are not going to change over time the yield curve flattens, so that short-term rates are the same as long-term rates, giving investors little incentive to lend for longer periods of time. The consequence to this is that borrowers tend to have shorter-term loans than they would like. For example, say you are building a factory and need to borrow a portion of the funds needed to build the factory. Given that it will take some time to build it and have the factory generating enough money to start paying off the loan, you would like to get a long-term loan. If investors are not interested in lending long-term thanks to a flat yield curve, you will need to either forgo the project or take the risk of borrowing on a shorter time frame than you would like. What's the risk there? Say you are only able to borrow the funds you need for 3 years. This means you need to either pay back the entire amount or get a new loan in 3 years time, but the factory isn't expected to be built and fully functional to the degree that it will generate sufficient cash to even pay the interest on the loan for 4 years. This factory is expected to generate an 8% return. Today you borrow at 3%, which means you make 5% net with this factory. You decide to risk it, but at the end of the third year interest rates have unexpectedly tripled to 9%. With this new cost of borrowing, the factory no longer makes financial sense because it actually loses money, (generates 8% but borrowing costs 9% so you lose 1%). No bank is going to lend you the funds you need at this point, so you default on your loan and now the lenders own a partially constructed factory that in the current climate never should have been built. Everyone gets hurt.



Sometimes the flat yield curve is an intermediary step to an inverted-yield curve, shown at right. This is when short-term rates are actually higher than longer-term rates. This is the rarest form and is often the precursor to a recession. The yield curve inverted in 2000 and again in 2006/2007, prior to the financial crisis.



State of the Economy

The flattening of the yield curve as interest rates fall is bad news for banks that make money by borrowing short-term and lending long, yet another sector that under current conditions is a headwind for the economy. Frustratingly, the yield curve isn't the only headwind to banks as last week, Morgan Stanley (MS) was the last of the major Wall Street firm's to report disappointing fourth quarter earnings citing, like many others, weak trading volumes. So far J.P. Morgan Chase (JPM), Bank of America Corp. (BAC), and Citigroup Inc. (C) all failed to meet expectations while Wells Fargo (WFC) met them and only Goldman Sachs Group Inc., (GS) was able to beat.

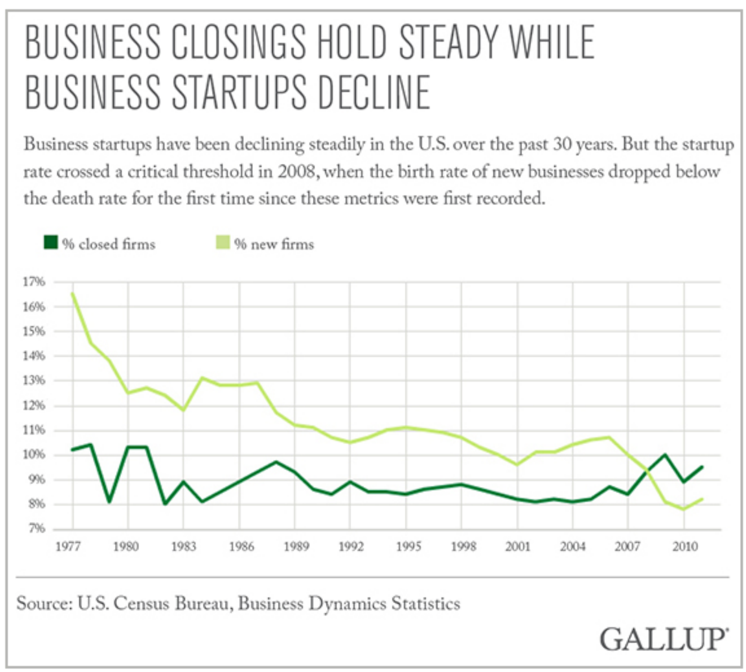
So just how is the economy doing?

Unprecedented Weak Growth: The long-run average growth rate for the United States is 3%. Typically the economy experiences several years of above average growth rates, which helps households and businesses recover from the recession. No such V-shaped rebound has occurred and we have yet to achieve even the long-term normal rate of growth on an annual basis. Although, the U.S. economy did grow at a 4.6% rate in the second quarter and an impressive 5% rate in the third quarter of 2014, which was the highest in 11 years.

Consumer is still suffering: The income of the median U.S. household was $51,900 in 2013, according to the U.S. Census Bureau. That's nearly unchanged from 2012, after adjusting for inflation, is 8% lower than in 2007, before the recession began and 9% below the all-time high from 1999! A decade and a half later and household income is still down 9%.

Fewer and fewer working: As of December 2014, the labor force participation rate was 62.7%. This rate peaked in early 2000 at 67.3%, but is now at levels not seen since the late 1970s. This is harmful to the economy because it means there is a smaller portion of the population working to support their families, pay taxes that fund government spending, and support programs such as Medicare and Social Security.

Weak Business Environment: For the first time in 35 years, American business deaths now outnumber business births. **The U.S. now ranks 12th among developed nations in terms of business startup activity**. Yes, you read that right. According to the US Census Bureau, Countries such as Hungary, Denmark, Finland, New Zealand, Sweden, Israel and even Italy all have higher startup rates than America does. *Keep that bit about Italy in mind as you read later on just how benevolent the business environment is in Italy relative to say… Rwanda.* This is a very, very big deal and explains a lot of income and employment. The key driver for employment in any economy is the growth of new businesses, and without it a significant level of new jobs and material income growth is darn near impossible.



Currency Wars, it's on!

Last Wednesday the European Central Bank (ECB) announced that it is launching its own quantitative easing program that was double what had been rumored, at an impressive €1.2 trillion. ECB Chairman Mario Draghi was able to pull off a program of this size by having some 80% of the bond-buying executed by national central banks. The agreement is that Germany will only buy German government bonds, France will only buy French bonds and so on. This was key to getting the program approved because if Spain or Italy goes off the rails, the German Bundesbank's balance sheet won't be immediately devastated. This is the main driver behind the rally in German bonds beyond the periphery bonds, which is also driving the rally in US bonds, as the markets can't indefinitely maintain such a large spread between the only perceived risk-free rates left!

Despite all the rhetoric concerning how the economy is so very ship shape and all is going well on at least this side of the Atlantic, last year the best performing sectors were defensive ones: utilities and healthcare. This year with the crash in oil prices, the energy sector is forced to significantly delay capital expenditures and will by necessity put downward pressure on wages. Gasoline and diesel prices across the US have now fallen for a record 16 straight weeks. For the rest of the economy, the threat of global slowing and deflation may make many businesses hesitant to invest aggressively in expansions.

Central bankers across the globe have been on the front lines of the newest form of international altercations, currency wars, which is driving yields into truly bizarre territory. Two weeks ago the Swiss National Bank removed the three-year currency cap on the franc and cut key rates having told the market just a month earlier that there were in fact no plans to remove the cap, sending markets into a veritable tizzy. India cut its key rate by 25 basis points and Bank of Korea lowered its outlook. Last week the Bank of Canada surprised everyone by lowering its main interest rate by a quarter percentage point for the first time since 2009. In Japan, Bank of Japan Governor Kuroda cut the nation's core inflation forecast to 1% from 1.7%. Earlier last week the International Monetary Fund cut its forecast for inflation in advanced nations almost in half. The result of these moves has left the Swiss 10-year yield in negative territory, the German 10-year at 0.52%, the French 10-year at 0.70% and the Japanese 10-year at 0.23% given that expected rates of inflation are all above these levels in their respective nations, 10-years in much of the develop world are now in negative real yield territory. The currency war is on!

Those negative real yields reflect that most European countries are in or nearly in a recession. Italy for example is in a recession for the third time in six years, suffering from a 9% drop in output since 2008, and with unemployment increasing steadily from 7.8% in 2009 to 13.4% in November 2014. The ECB is expected to inject a massive monetary stimulus in an attempt to bolster the economies of these beleaguered nations, but the root of the problem isn't monetary, thus the solution cannot solely be monetary. For example, in the January 10th edition of the Economist, **Rwanda, which was in a bloody civil war just 20 years ago, is now cited to be a better place to do business than Italy!** (Remember how we earlier mentioned that it is easier to start a business in Italy than in the U.S.?) No amount of monetary stimulus can fix those structural problems.

So we have defensive sectors outperforming and a material decline in trading volume, which tells you that investors are nervous. Which brings us to the recent turn around in the yellow metal. Gold has traditionally had an inverse relationship with the dollar. For example, over the past four years the SPDR Gold Shares ETF (GLD) has had a -0.45 correlation with the Amex Dollar Index (DXY). From December 15th through yesterday, that correlation had completely reversed to be 0.75. In 2015 so far, the correlation has been a mind-boggling 0.84! That's a nearly perfect positive correlation. With central bankers around the world under pressure to manipulate their currency so as to inflate asset prices rather than having elected politicians deal with the very real structural problems, we believe it is no surprise to see gold once again showing strength. It has long been viewed as one of the only reliable stores of value and as long as the currency wars wage, will likely show continued strength, albeit with bumps along the way.

Your Money and Your Life with Greg Tull

One of the rules of thumb in investing is "reversion to the mean." Each asset class tends to have an expected long run return associated with it. For example, here are the mean expected long run annualized returns for 3 asset classes: small cap U.S. stocks 11%, large cap U.S. stocks 9%, and core investment grade domestic bonds 5%. When an asset class underperforms or outperforms for a year or for several years, it is not uncommon for that asset class to "revert to the mean" in the following year or years. This tendency gives rise to the old adage that the big money in investing is made not in the buying and the selling, but in the waiting.

Globally, the strongest stocks of 2014 were large cap (large company) U.S. stocks. The S&P 500 index grew by 13.7% for the year. Small U.S. companies did not fare as well, with the Russell 2000 index of domestic small caps growing by only 5.0%. International stocks struggled, with the MSCI EAFE index of international developed companies declining by 4.9%, and an index of diversified international emerging markets shrinking by 3.8%.

It's not even the end of January 2015, and we've already seen some reversion to the mean in each of these 4 global indexes. For example, as of the middle of the last week of January 2015, the S&P 500 is off by 1.4%, the Russell 2000 is down by 0.8%, the MSCI EAFE is up by 1.9%, and diversified international emerging markets are up by 2.9%. So, the markets that were down for the full year 2014 are up for the first several weeks of 2015, and the markets that were up for the 12 months of 2014 have started 2015 in the opposite direction.

Another rule of thumb is that higher risk (or higher volatility) asset classes typically offer greater potential returns, as well as greater potential losses, over any given time frame. For example, investors demand greater long run returns from small caps, because they are riskier than large caps. It's easier for a small company to run into difficulties than a large company, and therefore investors require being compensated with higher long run expected returns when they take on the extra risk and uncertainty of owning smaller companies. And by their nature many small companies have more room remaining to grow than large ones do. Similarly, investors demand greater long run returns from emerging market stocks (e.g. in China or Brazil), than from developed market stocks (e.g. in Germany or the UK), because emerging economies are riskier.

When we combine the two rules, "reversion to the mean" and higher risk = higher potential reward, we can see the virtue of investing in a diversified blend of asset classes that we plan to hold for the long term through the ups and downs. Since asset classes often move in opposite directions in the short term, owning a blend of asset classes often has the effect of reducing volatility and smoothing returns, rather than taking the whole portfolio on a frequent roller coaster ride. Similarly, holding the riskier asset classes such as small caps and emerging markets that are expected to help generate higher long run returns, is much more bearable inside of a balanced portfolio where the short term gyrations of the riskier asset classes are muted by the stability of the overall portfolio. Lastly, owning the riskier asset classes in the appropriate proportion for each investor means there will be excellent rebalancing opportunities from time to time since each asset class, even the most stable ones, eventually go on sale.

Meritas Makes Music… with Mike Mink!

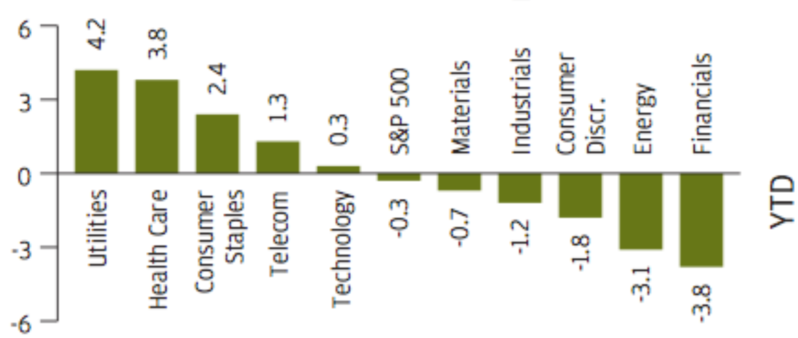
At Meritas Advisors, we aren't just about rocking and rolling with the markets. We also like to make music of our own. Our own Michael Mink joined a rock band workshop and last Monday night he debuted as singer and lead guitarist with the band at the Hopmonk Tavern. Click here to watch and listen as Mike shows us how it's done.

Market Recap

(as of January 23rd, 2015)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	2052	1.62	-0.26	-0.26	14.53	66.25
Dow Jones 30	17673	0.96	-0.65	-0.65	11.67	49.68
Russell 2000	2955	1.05	-1.28	-1.28	2.75	58.21
Russell 1000 Growth	638.86	2.14	0.57	0.57	14.18	66.46
Russell 1000 Value	628.63	1.18	-0.90	-0.90	13.70	67.04
MSCI EAFE	1788	2.64	0.75	0.75	-3.83	32.76
MSCI EM	990.89	3.50	3.65	3.65	5.81	8.10
NASDAQ	4758	2.67	0.49	0.49	14.12	77.52
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.03	0.14	1.50	1.50	6.42	10.01
U.S. Corporates	2.89	0.40	2.17	2.17	8.23	18.42
Municipals (10yr)	1.80	-0.17	1.52	1.52	8.53	13.48
High Yield	6.84	0.40	0.32	0.32	1.68	25.32

	Levels (%)					
Key Rates	**1/23/15**	**1/16/15**	**12/31/14**	**12/31/14**	**1/23/14**	**1/23/12**
2-yr U.S. Treasuries	0.52	0.49	0.67	0.67	0.39	0.26
10-yr U.S. Treasuries	1.81	1.83	2.17	2.17	2.79	2.09
30-yr U.S. Treasuries	2.38	2.44	2.75	2.75	3.68	3.15
10-yr German Bund	0.32	0.41	0.53	0.53	1.71	1.97
3-mo. LIBOR	0.26	0.26	0.26	0.26	0.24	0.56
3-mo. EURIBOR	N/A	0.06	0.08	0.08	0.30	1.18
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.57
30-yr fixed mortgage	3.80	3.80	4.04	4.04	4.57	4.11
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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