February 25th, 2015

MERITAS ADVISORS
Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

IN THIS ISSUE
- Market Update
- Impact of share repurchases
- Greece is the word…again
- Damn it Janet - Yellin' isn't tellin'
- Your Money
- Market Recap

UPCOMING EVENTS
- 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, scheduled to be published in the summer and is currently 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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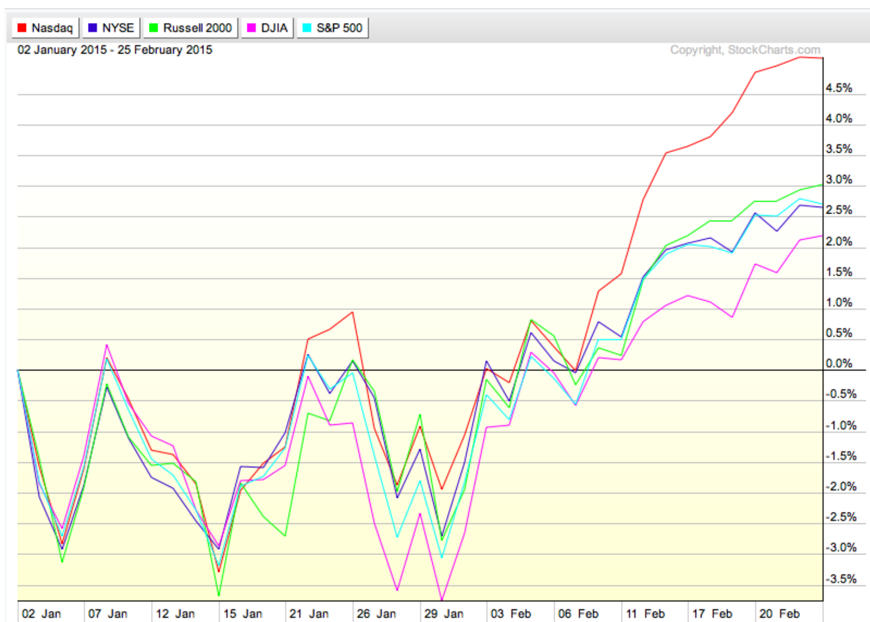
Dear Clients and Friends:
Disney's Elsa is on the Most Wanted list as the East hunkers down for continued artic vortex fun. Meanwhile Europe is back at it with intrigue to rival any daytime drama and Putin, well he's up to his usual "trust me" antics. So much to cover and so little time! --- *Lenore Elle Hawkins, Meritas Advisors Partner, economist and writer who perhaps has watched entirely too many musicals?*

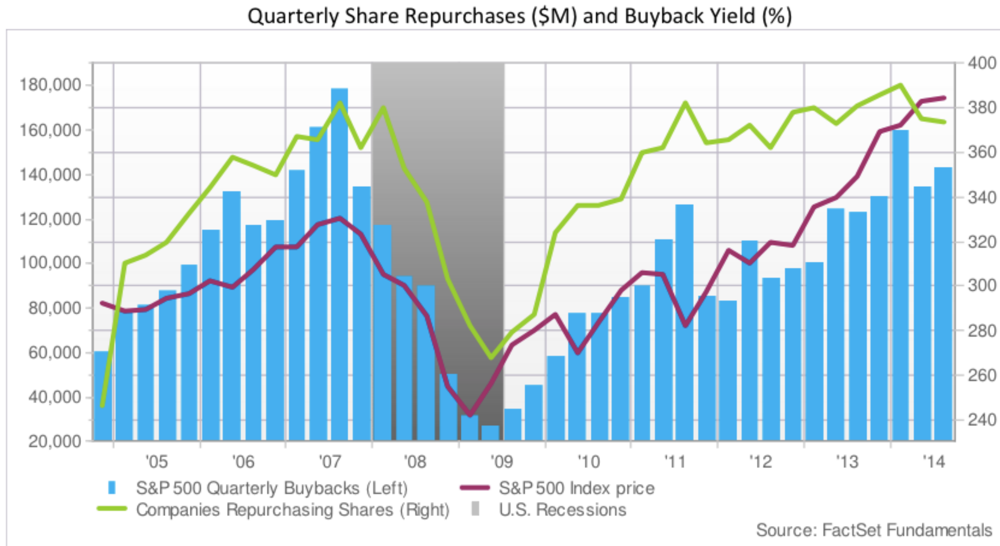
Market Update

U.S. equities have enjoyed quite the rally during February, erasing all of January's losses with most of the major indices at or nearing all-time highs. The NASDAQ is leading the charge by a significant margin, up just over 5% for the year as of Wednesday's close and nearing its all-time closing high of 5,048 reached back in 2000. Yes, you read that right. The NASDAQ is nearing its high from 15 years ago. Think about that when you hear people talk about how passive, index investing is the only way to go. The NASDAQ lost nearly 80% between 2000 and late 2002, during which time the S&P500 and the Dow lost 40% and 20% respectively.



The NASDAQ leadership indicates that the markets are in more of a risk-on environment, which is bullish for equities across the board. This is further supported by the relative performance of consumer discretionary stocks versus consumer staples stocks. However… we always want to go a bit deeper and see if there is any data that would alter our initial assessment as investing is all about probabilities, not certainties.

Share Repurchases



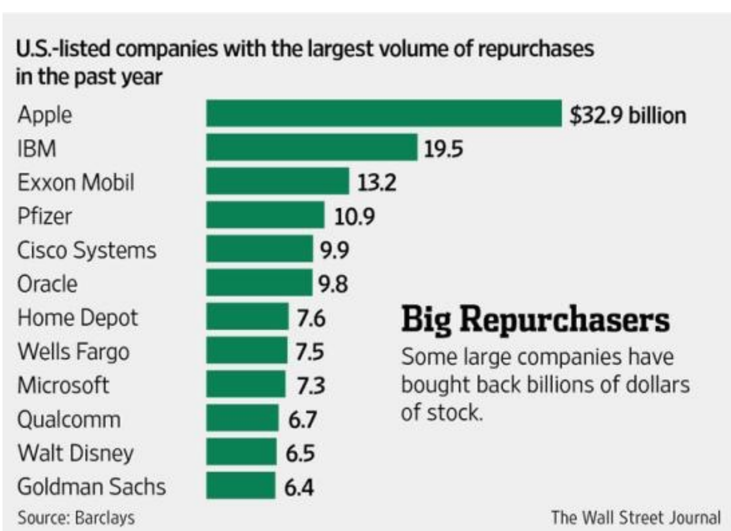
One market trend our regular readers have heard us discuss before concerns stock buybacks, which refers to when a company is buying back their own shares. We been seeing more and more companies buying back their own shares, with an increasing percentage of them issuing debt to do this, thanks in no small part to the quantitative easing programs which have kept interest rates at exceptionally low levels. The chart at right shows the increase in share repurchases.

When the interest rate paid on the bonds is lower than the dividend yield on the shares being repurchased, this is a cash-flow positive strategy. Here's the math, using small numbers to keep it simple.

A company's stock is trading at $100. The current stock dividend is 4% on an annual basis, which means it is paying $4.00 in dividends on every share per year.

The company issues $1,000 worth of bonds yielding 2.5%. This means that if you bought $100 of this bond, you would receive $2.50 a year in interest payments. The company uses the proceeds of the bond issuance, (the $1,000) to repurchase 10 shares of its own stock (10 * $100/share = $1,000). Now the company is paying only $25 a year in interest versus the $40 it was paying previously.

Looking at those equations one can see how low interest rates, (a la Federal Reserve Quantitative Easing) could make it more attractive for companies to buy back their shares and would put downward pressure on dividend yields. So let's look at the magnitude of share buybacks, (chart at left).



Well that sure seems like a lot of money going into share buybacks, and that is just the top 12 by volume (number of shares). Let's look at the top 10 companies by dollar-value and their share returns.

Top 10 Companies by Dollar-Value Buybacks – Trailing Twelve Months

Company	Sector	TTM Buybacks ($M)	% Change in Shares (TTM)	Dividend Outflows	1 Year Total Return
Apple Inc.	Information Technology	$55,949	(6.8%)	$11,126	39.9%
IBM	Information Technology	$19,270	(8.9%)	$4,201	(8.2%)
Exxon Mobil Corporation	Energy	$13,167	(3.1%)	$11,394	(6.6%)
Cisco Systems, Inc.	Information Technology	$8,898	(4.5%)	$3,817	35.1%
Oracle Corporation	Information Technology	$8,791	(2.9%)	$2,161	20.4%
Pfizer Inc.	Health Care	$8,648	(2.2%)	$6,524	5.9%
Home Depot, Inc.	Consumer Discretionary	$8,166	(6.4%)	$2,456	29.8%
Intel Corporation	Information Technology	$7,618	(2.3%)	$4,461	52.8%
Wells Fargo & Company	Financials	$7,246	(1.1%)	$7,810	26.9%
Microsoft Corporation	Information Technology	$6,909	(1.1%)	$9,270	29.6%

Looks like overall, this proved to be a strategy that is at the very least, correlated to shareholder-pleasing stock price gains. (Keep in mind that executives often have their compensation tied to improvements in share price.) How could these share buybacks affect share prices and not just reduce the amount of money companies pay out in dividends?

The price of a stock on any given day is just a function of supply and demand. The greater the demand (buyers) the more the stock price is pushed up until no more buyers are interested at the higher price. The converse is also true, the more that want to sell, the lower the price will go until no more sellers are interested in selling. (Real world example – when home prices are high, lots of people consider selling their homes, but when home prices fall, more people are happy to stay just where they are.)

So how big of an impact do these share buybacks have on demand? We can answer this by looking at fund flows, meaning money going into and coming out the markets.

The chart at right shows that the single largest source of funds going into the equity markets came from corporations. Households on the other hand were net sellers. This chart shows that in 2014, households took $183 billion out of the stock market while corporations put $415 into the equities market. *If no corporations had purchased equities, there would have been a net outflow of $237 billion dollars!* Talk about a reduction in overall demand.

Goldman Sachs forecast of 2015 US net equity flows (in $ billions)
as of January 7, 2015; summary statistics through 3Q 2014

	Net Equity Inflow / (Outflow)			
Category	**2012**	**2013**	**2014 Ann.**	**2015E**
Corporations	**$ 385**	**$ 389**	**$ 415**	**$ 450**
ETFs	133	167	121	**170**
Foreign Investors	127	(79)	103	**125**
Mutual Funds	(38)	163	133	**125**
Life Insurance	15	13	33	**50**
Pension Funds	(69)	(147)	(169)	**(175)**
Households	(241)	(55)	(183)	**(245)**
Other	2	3	(5)	
less				
Foreign equities by US	(51)	(212)	(231)	**(250)**
Credit ETF purchases	(52)	(12)	(39)	**(30)**
TOTAL	**$ 210**	**$ 229**	**$ 178**	**$ 220**

Source: Federal Reserve Board and Goldman Sachs Global Investment Research.

Now let's go back to the company making the decision to issue bonds, (borrow money) and use the proceeds to buy back shares of their own stock. There are a few things to keep in mind:

1) This is not a sustainable process. Companies cannot endlessly issue debt then use the proceeds to buy back shares – rather intuitive, but something to keep in mind as it is not a long-term way for a company to generate returns for shareholders.
2) If stock prices fall, then the entire equation we did above falls apart. How's that? Well I left out the impact of share price and the company's balance sheet in that analysis. (Tricky, aren't I!) So let's revisit that equation taking share price into account.

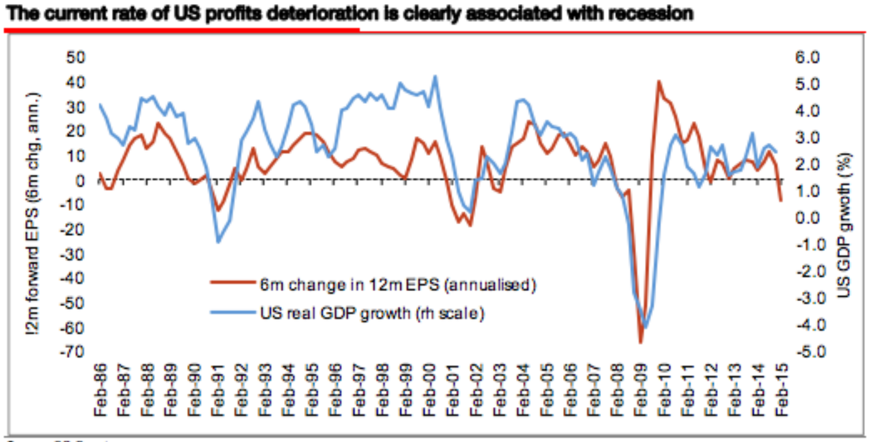
The company issues $1,000 worth of bonds and immediately buys $1,000 worth of stock, or 10 shares since the stock was trading at $100/share. So on the company's balance sheet there is now a liability worth $1,000, but an asset that is worth $1,000 counters it.

If the company's stock were to decline by say 15%, then those shares would be worth $850. The company now has a liability worth $1,000 that is countered by an asset worth only $850. This negative change in the company's net worth makes it less attractive than before the share price decline, so now it has a double hit. Its shares have been falling and now its balance sheet looks less attractive. That can put further downward pressure on the company's share price, which results in an even less attractive balance sheet and so on. This is another example of how debt can exacerbate problems when asset prices fall.

Now that I've mentioned asset prices… well that brings up the Fed and for that matter, most all central banks these days. The goal of loose monetary policy is to induce borrowing which is intended to generate economic activity and drive asset prices up, so if there is a material decline in asset prices, we wouldn't be surprised to see the Fed step in to try and push prices back up… that is if/until monetary policy is no longer capable of doing so. As the saying goes, "We live in interesting times."

One more little bit to contemplate is the relationship between company profits and the growth of the economy. The chart at right shows how the six-month change in 12-month forward earnings per share is closely correlated with changes in real GDP. Notice how most every time the change in EPS goes negative, the economy contracts – again we work with probabilities, not certainties, but one must always keep an eye on the data and the correlations.

The current rate of US profits deterioration is clearly associated with recession



Source: SG Quant

Greece is the word… again

Greece was all over the headlines again last week as the deadline for debt talks neared. The Maastricht Treaty, which created the European Union, is starting to sound an awful lot like the Eagles "Hotel California," with many in Greece left rethinking, "This could be Heaven or this could be Hell." The treaty provided a lengthy list of requirements to enter the Eurozone "hotel," but provides no way to exit, making all members, "…just prisoners here, of our own device." Greece, among quite a few others, didn't exactly meet the economic fitness requirements to obtain membership in the Eurozone. The current members were well aware that Greece was essentially doping to get the level of performance required and were all too willing to look the other way. After all, "We are programmed to receive. You can check-out any time you like, but you can never leave!"

After Greece made it onto the Eurozone team, things went quite well for a while. The global economy appeared to be performing in tip-top shape and "dealers" for Greece's performance-enhancing creative debt securitizations were ubiquitous. Now before anyone gives into the desire to finger wag, first recall that parts of the US economy also indulged in such performance-enhancing financial supplements, (housing and now the auto sector). Frankly, pre-financial crisis the proliferation of creative debt securitization on the global stage was a lot like an excerpt from a Lance Armstrong post-2012 doping deposition, "*Everyone was doing it. You had to if you didn't want to be left in the dust.*" Pssst, a version of this is still going on today, just ask any company that is juicing its EPS by using newly issued debt to fund stock buybacks such as Apple (AAPL), IBM (IBM), Monsanto (MON), CBS (CBS) and many more.

Today, global economic conditions are such that the hills have gotten a lot steeper, the pavement is full of cracks, there are powerful headwinds, rain flurries and Greece's pre-crisis performance-enhancing suppliers are nowhere to be seen. Debt-doping allowed the nation to get away with all kinds of economic sins, gorging itself on regulations and labor laws akin to years of multiple-pint nightly indulgences with my two favorite partners-in-crime, Ben and Jerry, followed by many a lazy day-after spent series-binging on "Ex-wives of Rock" while sprawled on the couch eating peanut butter Cap'n Crunch out of the box. *Now with no "supplements" available, an overweight, out-of-shape and endocrine-exhausted Greece is being told to get pedaling faster and faster on a bike with bald tires, a broken gearbox and gyrating handlebars.*

You would think that Germany, of all countries, would remember that driving a nation into the economic ground is never a good idea. Most economists and politicians refer to Germany's understandable fear of hyperinflation but that overlooks the much more relevant and painful lesson from the impossible demands placed on the country post WWI, which destroyed not only its relationship with its neighbors, but also its democracy and ultimately led to WWII. How ironic that the Maastricht Treaty, which was conceived in part to prevent another war between European neighbors, is now the cause of so much inter-European strife!

Greece simply cannot pay its debt, which is pretty much its standard operating procedure. According to Kenneth Rogoff and Carmen Reinhart, “from 1800 to 2008, Greece was in default 50.6% of the time,” so angry bondholders, how about a reality check? Buyer beware. Last week we mentioned that the nation’s economy had contracted by 26% from 2008-2013, yet it is still managing to remain current on its debt payments while running a primary surplus of about 1.5%. That would be a seriously crowd-pleasing performance on NBC’s The Biggest Loser! The problem is its creditors want Greece to increase that surplus, meaning ride even faster up that blasted hill! Even Jillian Michaels wouldn’t push that hard.

Last Thursday Greece formally requested a six month extension after four weeks of brinkmanship, which was quickly returned with an “I don’t think so,” from Germany. On Friday night a four month interim pact was reached that will once again kick the can down the road, albeit a much shorter road than after previous kerfuffles, conditional on Greece submitting a list of reforms by Monday, February 23rd. Greece submitted such a list close to midnight on Monday, which the Eurozone commission accepted.

Greece’s bailout money will continue to flow and the European Central Bank will continue to stand behind the nation’s banking system. However, all the finger-pointing and accusatory language has damaged relationships and backed both parties into difficult corners. The next round of talks in four months could be even more contentious.

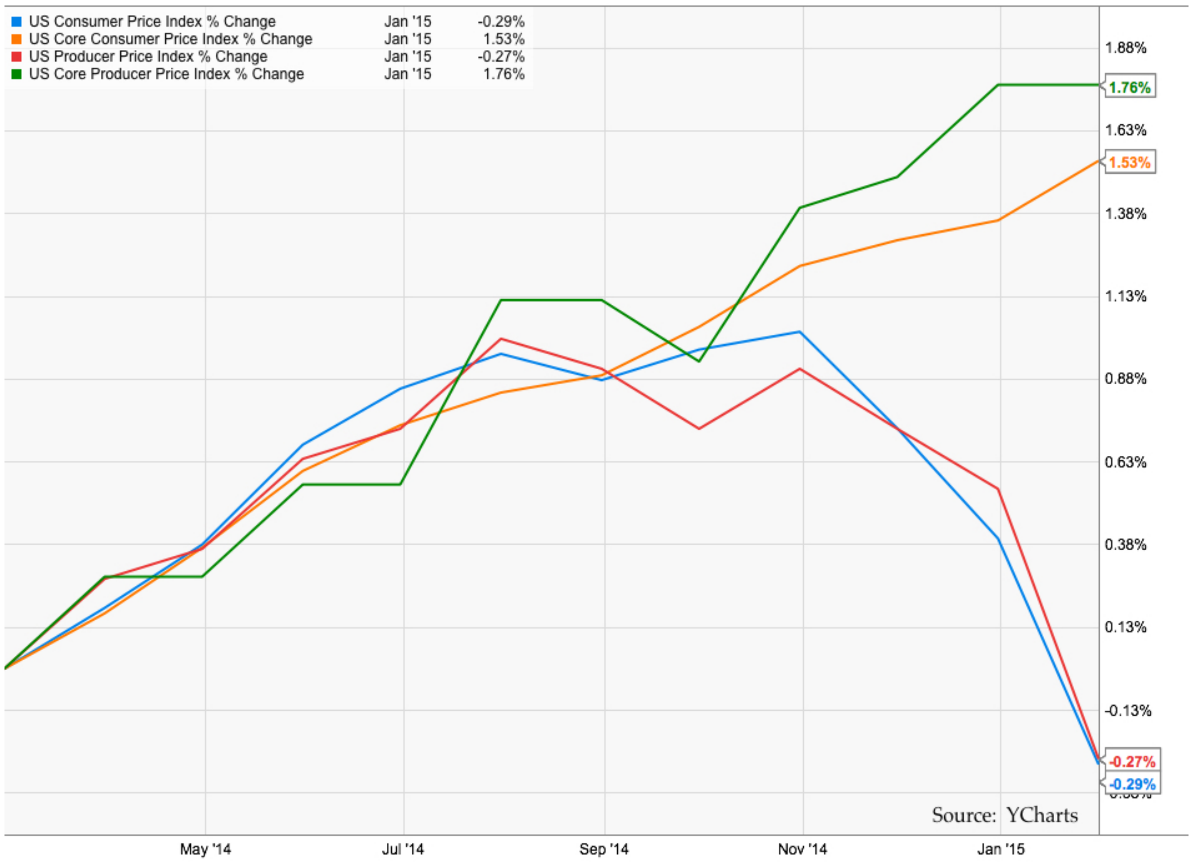
Damnit Janet, Yellen isn’t tellin’

This week Janet (I’m not tellin’) Yellen gave her annual two-day Congressional testimony, making it clear during Tuesday’s discussion that she wants to move away from the concept that Fed guidance is a pledge and appears to still prefer more tortoise than hare policy moves, assuring the markets that while the Fed will remove the word “patient” from its forward guidance at some point, that change in wording alone will be insufficient for investors to assume a hike is imminent.

Ms. Yellen reminded Congress of the Fed’s dual mandate under Humphrey Hawkins and pointed out that while employment has improved, the participation rate is lower than expected and wage growth remains sluggish, leaving room for improvement.

So according to Yellen’s testimony, part of the Fed’s dual mandate has made progress, but not enough. The dual mandate also refers to long-run growth and stable prices. For growth, Q4 was just revised down to 2.2% for 2.6% annualized. The exceptionally cold weather over much of the U.S. coupled with the West Coast port closures/work-slowdown give little hope for a strong Q1. For example, Macy’s (M) recently reported that while at year-end the port slowdown had not yet had a material impact, “Since then… inventory levels have been negatively impacted particularly in apparel and accessories. Approximately 12% of our first quarter merchandise receipts are being delayed and this will have some impact on our sales, gross margin and expense in the first few months of the year.” The recent posts on economic data, ISMs, retail sales, NAHB, NFIB, durables and even consumer sentiment have all lined up below expectations with payroll the only bright spot, but only time will tell if that was more reflective of a drop in productivity.

As for the stable price goal, which has evolved into a quest for around 2% annual inflation, the US Producer Price index is down 0.27% as of January on a year-over-year basis. US Core Producer Price index is up 1.76% as of January on a year-over-year basis. Consumer prices are also well below the target 2%.



While Ms. Yellen did say the Fed is becoming less patient with low rates, we continue to see this Fed as more dovish and the data isn't screaming inflation or a potentially overheating economy. Additionally, once the Fed does start rate hikes, we don't think it will follow its usually pattern of consistent hikes with every meeting after the increase is initiated. Lastly, even though the likely vector for rates is eventually higher, investors should focus on the velocity of those increases. The initial quarter point increase would only happen if the economy could digest it, how soon and how fast subsequent increases come is what will really matter.

What does this mean for investors? First, this time really is different. The Fed has never waited this long, (five years) into a bull market to raise rates, nor has the world ever seen so much monetary stimulus coming from so many of the largest central banks. Therefore, when looking at historical norms, they need to be discounted to a degree given just how far off the reservation we are this time…perhaps even as far as Peter Pan's Never, Never Land.

Investors also need to take into account just how many central banks around the world have been cutting rates. In the past few months, 16 central banks have cut rates: Albania, Australia, Canada, China, Denmark, Egypt, Europe (ECB), India, Pakistan, Peru, Romania, Singapore, Sweden, Switzerland, Turkey and Uzbekistan! All of the G7 and China are moving towards easing while the US alone is contemplating tightening. *Today government bonds of various maturities in about ten countries are selling at negative yields!* People are buying guaranteed losses. While Ms. Yellen didn't mention the strength of the dollar on Tuesday as she did in January, the Fed is most certainly aware that raising rates in the US, with so many negative yields around the world, would increase demand for the dollar, pushing the currency up even further, which while lovely for importers, is brutal for US exporters.

Your Money and Your Life with Michael Mink

It's Mike, pinch-hitting for Greg this month, and it's my pleasure to serve as the Manny Mota to Greg's Steve Garvey. This month we'll be discussing a topic that most likely all of you will at one time be confronted with, a rollover out of an employer-sponsored retirement plan. When leaving a job either due to retirement or simply moving on to another employer, it's often best to move the assets held in an employer-sponsored plan such as a 401k to a Rollover IRA. Employer-sponsored plans generally have limited investment options while much of the investing universe, including both public and private investments, can be accessed in a self-directed IRA. The first step is to establish the Rollover IRA, then to contact the employer plan administrator for the appropriate rollover documents. It's best to establish the IRA account first, prior to initiating the rollover, and instruct the employer plan provider to make the check payable to the IRA custodian (for your benefit) and to reference your new account number on the distribution check, and to have the distribution sent directly to the new IRA custodian. You may also take the distribution check in your name, but it must be deposited into another retirement account within 60 days of the distribution. Taxes and penalties on rollovers that violate the 60 day rule can get very expensive, which is why it makes sense to avoid taking possession of the check yourself and instead have the rollover sent directly to your new IRA.

A new rule for 2015 to keep in mind concerns rollovers from an IRA to another IRA or even to the same IRA. Beginning this year, you are only allowed one rollover per 12-month period, regardless of how many IRAs you own. However, there are some exceptions. The rule does not apply to Roth conversions, IRA trustee-to-trustee transfers, IRA to employer plan rollovers, rollovers from an employer plan to an IRA, or a rollover from one employer plan to another. More information on these new rollover restrictions can be found here.

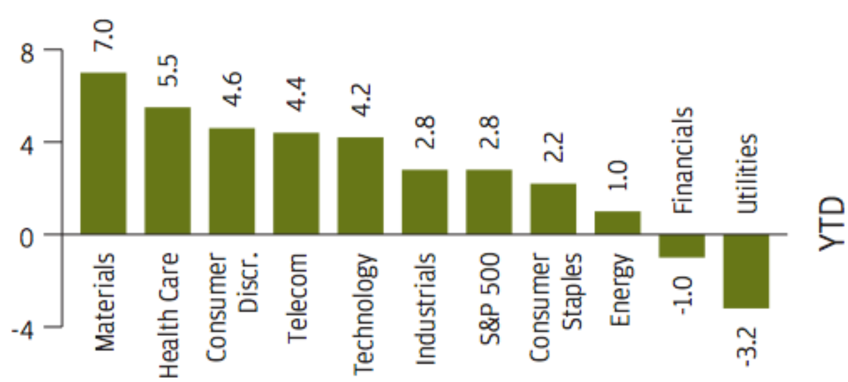
Market Recap

(as of February 20th, 2015)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	2110	0.68	2.82	2.82	17.08	65.36
Dow Jones 30	18140	0.71	2.16	2.16	15.08	50.75
Russell 2000	3061	0.72	2.36	2.36	7.40	54.88
Russell 1000 Growth	666.39	1.23	5.05	5.05	17.77	65.82
Russell 1000 Value	640.35	0.26	1.22	1.22	15.29	65.42
MSCI EAFE	1867	1.55	5.37	5.37	0.83	33.18
MSCI EM	984.42	-0.21	3.11	3.11	6.51	1.04
NASDAQ	4956	1.31	4.84	4.84	17.51	74.46

Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.22	-0.35	0.48	0.48	4.99	8.20
U.S. Corporates	3.04	-0.28	1.04	1.04	6.49	15.12
Municipals (10yr)	2.00	-0.10	0.55	0.55	6.70	11.45
High Yield	6.51	0.38	2.28	2.28	2.82	25.16

	Levels (%)					
Key Rates	**2/20/15**	**2/13/15**	**12/31/14**	**12/31/14**	**2/20/14**	**2/17/12**
2-yr U.S. Treasuries	0.67	0.66	0.67	0.67	0.34	0.29
10-yr U.S. Treasuries	2.13	2.02	2.17	2.17	2.76	2.01
30-yr U.S. Treasuries	2.73	2.63	2.75	2.75	3.73	3.16
10-yr German Bund	0.33	0.31	0.53	0.53	1.69	1.92
3-mo. LIBOR	0.26	0.26	0.26	0.26	0.24	0.49
3-mo. EURIBOR	N/A	0.05	0.08	0.08	0.29	1.05
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.51
30-yr fixed mortgage	3.93	3.93	4.04	4.04	4.50	4.09
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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