March 30th, 2015

MERITAS ADVISORS

Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

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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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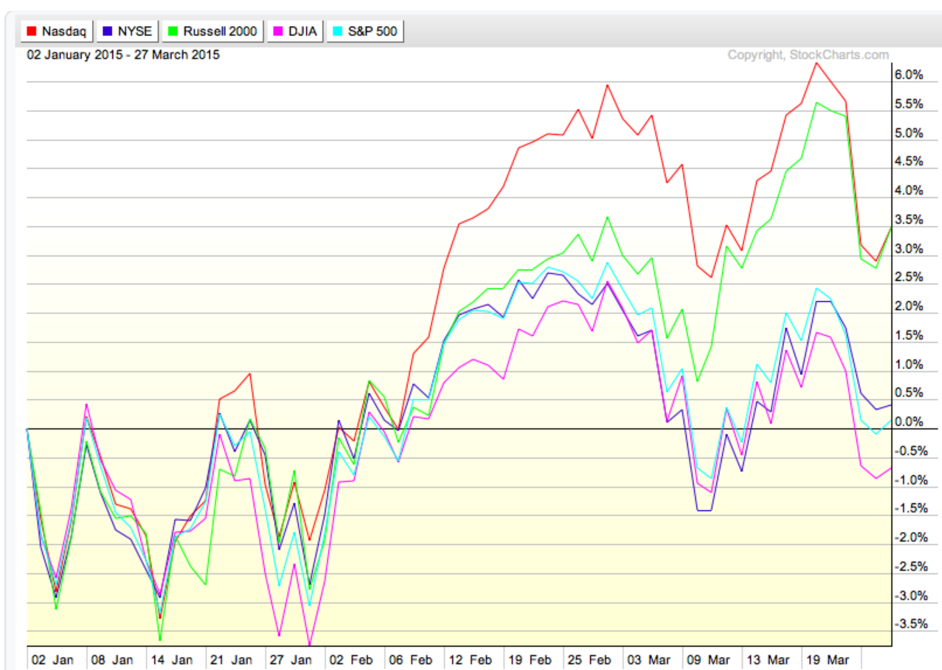
Dear Clients and Friends:
The markets have continued their roller-coaster ride this year, taking a serious beating this past week after having once again reached for new highs. Much of the ride appears to be driven by two things, the dramas surrounding oil and the ubiquitous magical promises of central bankers around the world. As of the writing of this letter, there have been 27 rate cuts by central banks since the start of the year, and the European Central Bank is on track with its purchase of €60 billion of government bonds every month, totally €1 trillion overall. Japan, the birthplace of quantitative easing, is still working through its $1.4 trillion plan, purchasing over $70 billion a month, yet still can't quite get that economy humming. --- *Lenore Elle Hawkins, Meritas Advisors Partner and economist*

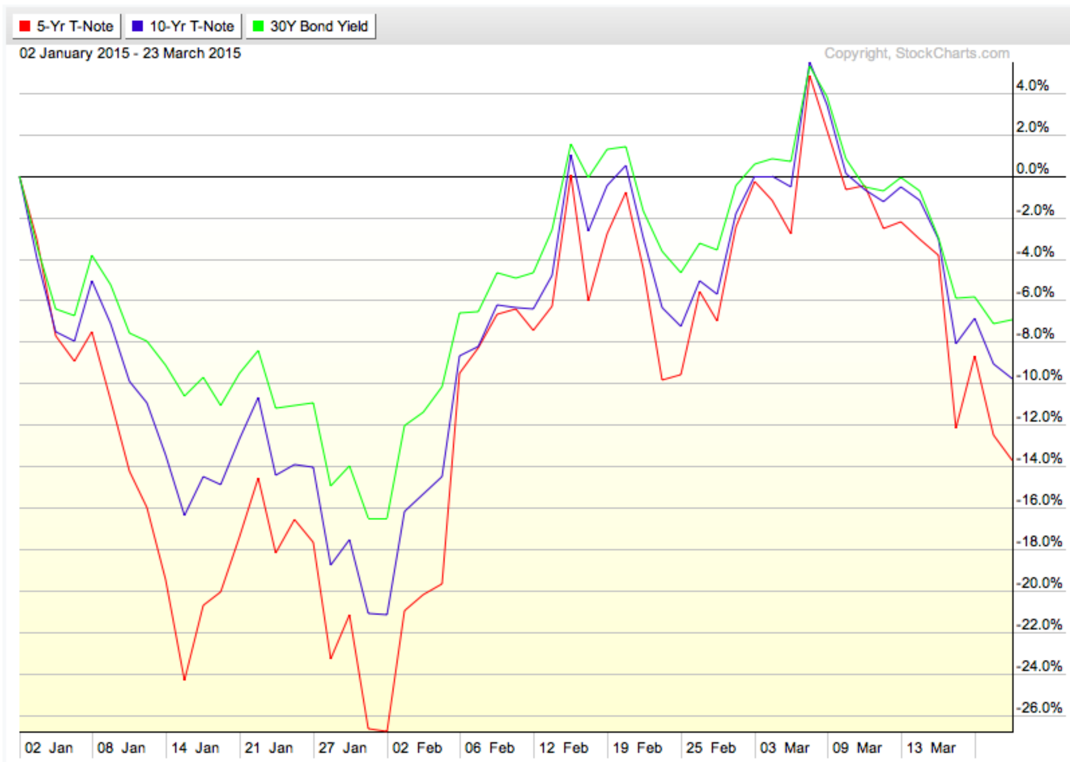
Market Update

So far 2015 has been a roller-coaster year with the markets bottoming out at the end of January, moving up throughout February to reach a peak in early March, then back down again through mid-March only to head back on up again.

Then things once again got dicey as last week the markets took such a beating that only the Russell 2000 (small cap stocks) and the NASDAQ are up more than 0.5% since the start of the year, with the Dow Jones Industrial Average in negative territory. So far, despite the flurry of share buybacks, which we discussed last month as drivers of improving stock prices, the majority of aggregate indices are relatively flat.



Bonds initially took off like mad in 2015, with yields on the 5-year through to 30-year plummeting by over 20% by the end of January, (remember that as yields go down, prices go up.) By early March bond yields had actually gone up for the year, most likely thanks to all the talk about the Fed raising rates. However, as the economic data has continued to roll in fairly weak, more on that later, expectations of a rate rise have been pushed back, thus yields are back down for the year. Before we talk about the economy and the likelihood of a rate rise in the near term, please indulge me in a quick rant on why I dislike how stocks are priced relative to the way bonds are priced.



Bond v Equity Pricing

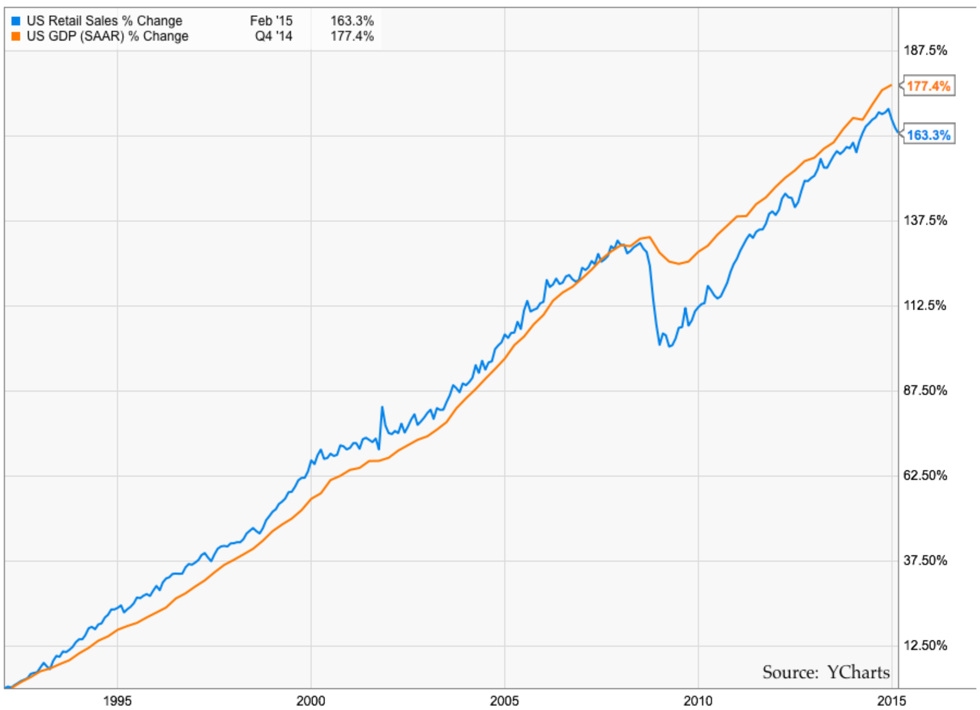
When we talk about bonds, the key metric is yield, which is the interest rate the bond pays. For example, the 10-year U.S. Treasury bond is currently trading at about 1.9%, while the German 10-year bund, is yielding around 0.19%. Yes, that is correct; U.S. 10-year Treasury bond currently pays 10x what the German bund pays. What this means is that for every $100 an investor puts into a U.S. Treasury bond, he/she will receive $1.90 in interest payments every year and $0.19 a year if they put that money into German bunds, (excluding of course changes in the exchange rate just to keep this explanation from being too painful.)

When we talk about equity pricing we talk about Apple trading at $127 or Exxon trading under $85. What does that mean? Is one a better price than the other? That piece of information by itself tells you nothing. While knowing a bond is trading at 1.5% tells you what you will get for your money, knowing Apple trades at $130 doesn't tell you a darn thing. As a woman in love with data and more than a little manic about efficiency, you can see why this can make me batty. You have to get a second piece of data, earnings per share or (EPS) to have any sense of how to compare the price of Apple (AAPL) shares to Exxon (XOM) shares. Recently Apple's trailing twelve-month earnings per share (EPS TTM) was $7.40 while Exxon's was $7.60. Now we can calculate the price to earnings ratio PE (trailing twelve months) for these two stocks.

PE Ratio (TTM) {This is the price to earnings ratio, trailing twelve months}

Apple's share price	= $130 / $7.40 (EPS)	= 17.16
Exxon's share price	= $84.9 / $7.60 (EPS)	= 11.18

What this tells us is that investors are willing to pay $17.16 for every $1 of Apple's earnings versus $11.18 for every $1 of Exxon's earnings. Now we have a way to better compare Apple's share price to Exxon's. From this we can see that Apple is trading at a more expensive multiple than Exxon. Generally, a higher PE ratio means that investors are anticipating higher future growth.



The Shiller PE Ratio, which is the price to earnings ratio based on average inflation-adjusted earnings from the previous 10 years for the S&P 500, has an average of 16.6. The current Shiller PE Ratio is 27.13. Its peak was 44.19 in December 1999. For comparison, the S&P 500 trailing 12 month PE ratio (current stock price divided by the training earnings per share for the past 12 months) was 20.52 on March 30th versus 17.97 a year prior. The forward PE (current stock price divided by the expected earnings per share over the coming year) is 17.62.

This tells us a few things:

1) Investors are paying more today for each dollar of earnings from the S&P 500 than they did a year ago and also more than the historical average.
2) Earnings for the S&P 500 are expected to grow over the coming year, which is why to forward PE ratio is lower than the trailing PE ratio.

$100 share price today / $10 earnings for the past 12 months	= 10.00
$100 share price today / $16 earnings forecast for the next 12 months	= 6.25

The Economy

Last Monday's Chicago Fed National Activity Index really threw the markets for a loop, although had folks been paying attention, they wouldn't have been so shocked. The Index came in at -0.11 versus expectations of +0.10. January was also revised *down* from +0.13 to -0.10. This means that the US economy expanded at the slowest rate in a year in February. Overall we still believe there is little reason to believe that a recession is imminent, but the weakening data warrants attention.

Last Wednesday's durable goods order came in below expectations again at -1.4% versus +0.4% that the Street expected. The most concerning part of the report is spending on non-core capital goods, which has now fallen every month since last September! This is not good news for the capital goods industry and companies like Caterpillar, Deere & Co. and Gencor.

For the first quarter of 2015, year-over-year (yoy) earnings for the S&P 500 are now projected (by Wall Street analysts) to actually *decline* by 4.8%, versus expectations for a 4.0% *increase* in Q1 as of the end of last year. That's a nearly 9% swing in the analysts' consensus projections. The last time yoy earnings growth was negative was in Q3 2012. So far 83 companies have issued negative guidance while 16 have issued positive revisions. The rising dollar and all those slowing economic indicators do mean something! We also learned Friday, from the US Department of Commerce's Bureau of Economic Analysis (BEA), that the BEA's third estimate of GDP growth for the fourth quarter of 2014 was at an annual rate of 2.2% compared to 5% growth in the third quarter and revised downward from previous 2.4% estimates.

Another metric that we've been watching closely is retail sales, which is flashing a warning. Sales have recently taken a serious pounding, which some claim is due primarily to the awful winter weather in much of the US. While the tough winter undoubtedly did have an impact, the chart below (which shows the month-over-month percentage change in retail sales and the quarter-over-quarter percentage change in US GDP) indicates to at least to yours truly that there is a bit more to the story.

Since November 2014, retail sales have dropped over 3%. The only time the drop has been larger was from June 2008 to December 2008 when sales fell by 13%. Retails sales have declined in 4 of the past 6 months and 8 of the past 12 months.

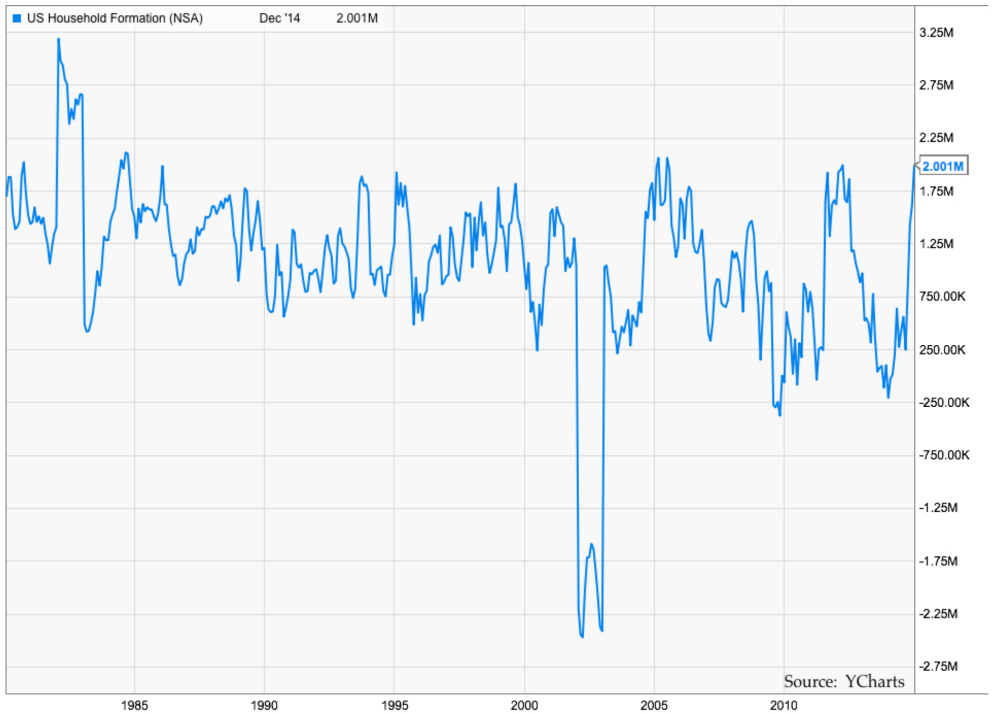
If we look at the broader picture of the consumer we see that:

- Consumer Confidence has fallen in 3 of the past 4 months and 7 of the past 12 months (trend is worsening)
- Personal Income has fallen in 6 of the past 12 months
- Personal Spending has fallen in 4 of the past 7 months and 5 of the past 12 (trend is worsening)
- Jobless claims have risen in 4 of the past 6 months and 7 of the past 12 (trend is worsening)
- Average hourly earnings have declined in 5 of the past 6 months and 8 of the past 12 (trend is worsening)
- Challenger job cuts have increased every month over the past 4 months (Not good!)
- For the economy as a whole, Bespoke Investment Group's summary of economic indicators is currently at its worst reading in a year and has only improved in one of the past 6 months!
- Last week we learned that real average hourly earnings fell by 0.1% in February.
- One good bit of news we received recently concerned housing, with new home sales hitting a 7-year high in February, jumping 7.8% to the highest level since February 2008.

Looking at the full picture of economic data, it certainly does not look to us like this is an economy about to overheat, needing the Fed to tightening the monetary belt. However, macroeconomic forces related to the unwinding, (driving by rapidly appreciating dollar) of the estimated $9 trillion borrowed outside of the US may force the Fed to take action. While it is foolish to believe one can accurately predict the behavior of bureaucrats, it certainly doesn't look like the Fed has a compelling reason to tighten rates in June. We believe it likely they will hold off raising rates until the data coming in looks stronger than it does today.

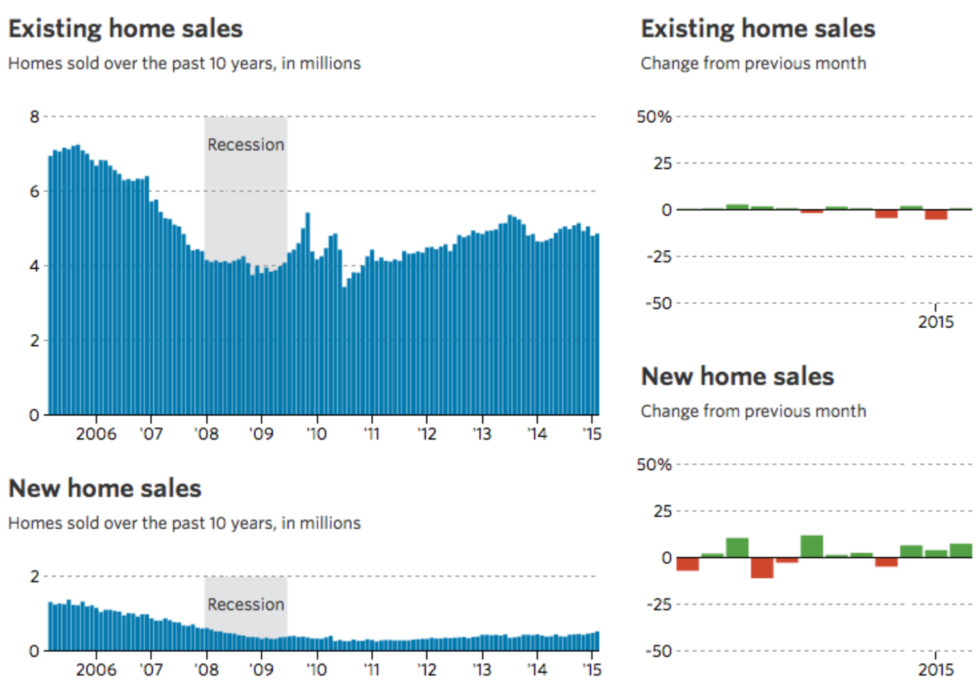
Housing

The one part of the economy that has been delivering some good news lately has been the housing sector. New home sales came in quite strong last week, especially given the awful weather in much of the country, delivering the largest beat versus expectations since the peak of the housing market in the mid-2000s! Additionally, inventories are falling down to just a 4.7 month supply, which is below the generally accepted ideal inventory level of 6 months. The mix of home prices was rather upbeat as well, with the mix skewing more heavily towards the lower price ranges – so it isn't just the already well-off that are buying. We also learned Wednesday that mortgage applications rose last week, up 12.3%. All that being said, the new home sales report is notoriously volatile.



We are also seeing a nice move up in US Household Formation in recent months, (Chart at right) with the December 2014 level of 2 million breaching the most recent high hit in March 2012 of 1.994 million and well above the median level of 1.2 million over the past half century. Obviously household formation is a key component of new home sales.

Sales of existing and new homes have improved since the recession, but remain well below their pre-recession levels.

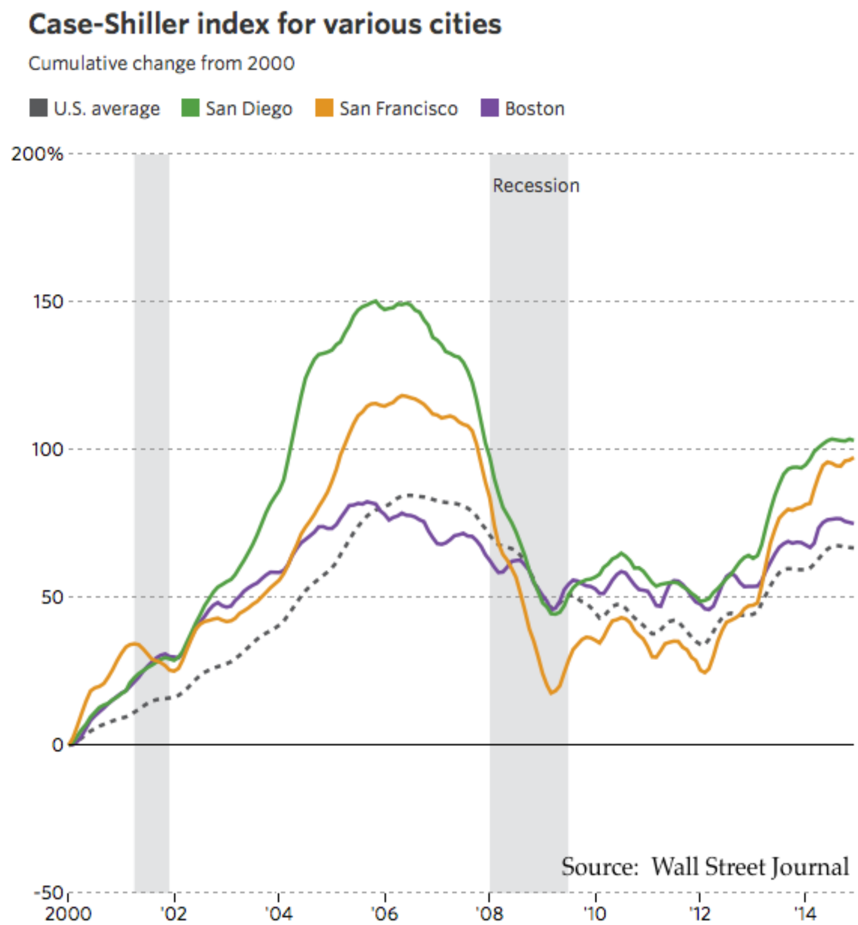


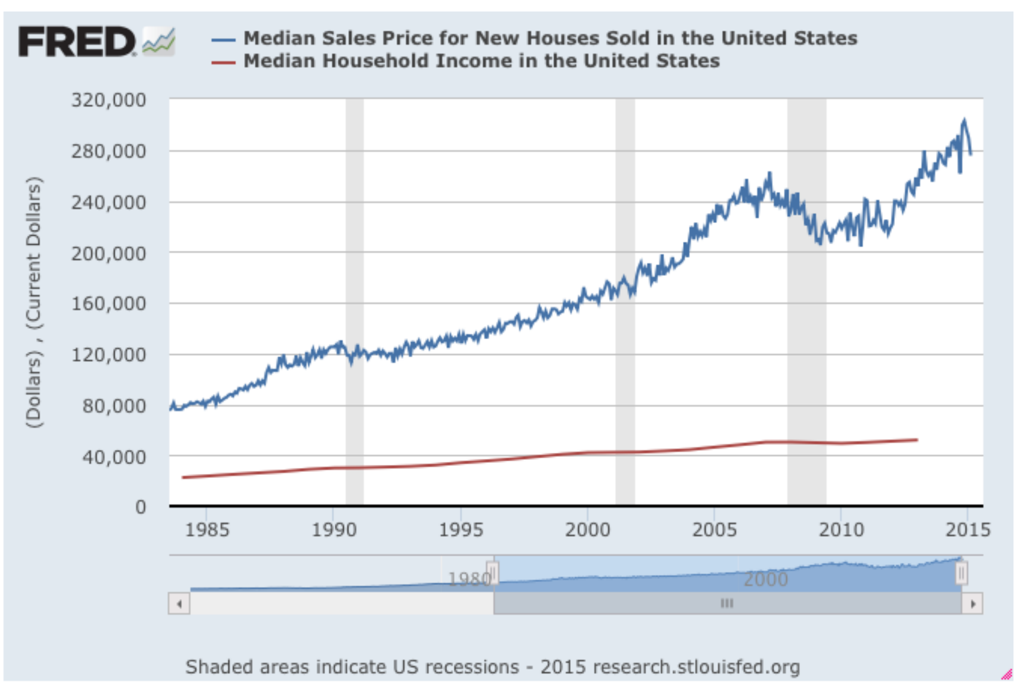
Source: Wall Street Journal

As the chart at right indicates, home prices have also increased from the depths of the recession, but the US average price and the average in many cities, remains below pre-recession levels.

We have two words of caution before getting overly excited about this development:

1) The Fed's impending interest rate increase could be pulling purchases from the future into the present as potential buyers decide to act earlier on concerns that interest rates will increase.
2) Once again home prices are increases at a rate that grossly outpaces income levels, as the chart below shows. In fact, according to a report by RealtyTrac, in the past two years home price appreciation nationwide has outpaced wage growth by a 13:1 ratio, with U.S.. median weekly wages rising 1.3% versus U.S. Median Home Price increase of 17.31%. That is simply not a sustainable trend.





Your Money with Greg Tull

A month ago today, Warren Buffet and Charlie Munger published their annual letter to shareholders commemorating their 50th year of operations and investment results with Berkshire Hathaway. Widely recognized as the most famous investor of all time, Buffett is a student and practitioner of the Benjamin Graham school of value-investing. From pages 24 to 43 of the letter, Buffett and Munger share insights into the organization and structure that underpins their spectacular success, how they learned from significant mistakes along their journey, as well as reflections on the future of their business.

On the first page of the letter, the 50 year annual and compound performance of the per share book value and per share market value of Berkshire, and of the S&P 500, are shown. Compounded results are astounding. The S&P 500 grew 9.9% on average, with a range of -37.0% to +37.6% per annum. The 50-year compound performance is 11,196%; a $10,000 investment in the S&P 500 in 1965 would have grown to $1,119,600. Berkshire's book value per share has grown 19.4% per year on average, with a range of -9.6% to +59.3%. If it were possible to make an investment in the book value per share of Berkshire, a $10,000 investment in 1965 would have grown by 751,113% to $75,111,300. It was possible to invest $10,000 in the market value per share of Berkshire, and those who did, and who held the shares for 50 years, have been handsomely rewarded. An investment in Berkshire stock in the past half century grew at a compound annual rate of 21.6%, with a range of -48.7% to +129.3%. Over 50 years, a $10,000 investment has grown by 1,826,163% to $182,616,300.

We can draw several conclusions and inferences from all of this data. First, we can see two important examples of the risk/reward relationship in investing. Market values in particular fluctuate over time, and in order to generate higher returns in the long run, higher risk and higher volatility are expected to go with the territory. Second, every extra percentage point of compound annualized return realized over a long period of time really adds up! For example, the 21.6% Berkshire stock return over 50 years led to an investment that grew 163x bigger ($182,616,300 / $1,119,600) than the same $10,000 invested in the S&P 500 over the same 50 years. Third, the book value per share of Berkshire Hathaway has been far more consistent than its market value. Buffett and Berkshire have much more control over the book value per share of their company, (by making shrewd acquisitions, pruning value destroying businesses, operating efficiently, and so on) than they do over the animal spirits of the market participants who collectively ascribe a constantly changing market value every second that the stock market is open and the shares change hands.

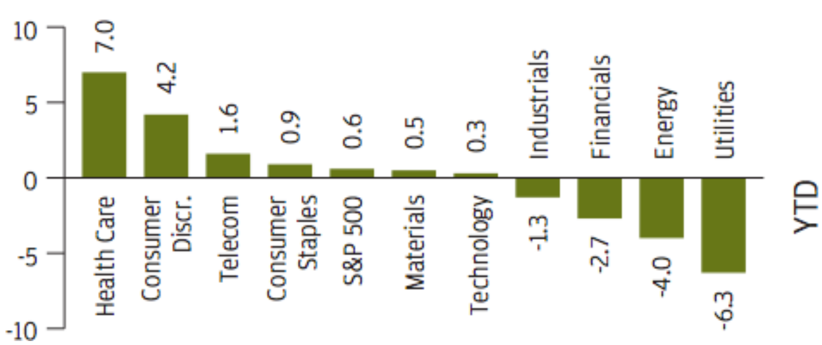
Market value/book value is another multiple that can be used to value stocks (like the price/earnings multiple described earlier in this issue of our newsletter), and like other multiples, the higher the multiple, the better the market is indicating it feels about the prospects for growth of the underlying company. Fourth, the S&P 500 has had 11 negative years, Berkshire's market value has had 10 negative years, and Berkshire's book value has had only two, single digit, negative years in the past half century. Herein lies the genius of the Benjamin Graham school of value-investing. It may take the market a while to recognize book value, but eventually the market will recognize and reward a sustainable and growing book value with a growing market value, just like it will eventually reward a sustainable and growing earnings stream with a higher market value. Fifth, the investment strategies of active portfolio management (as in Berkshire), and passive portfolio management (as in a Vanguard index fund or exchange traded fund), each have merit and each have a legitimate role to play in investor portfolios. While there are a lifetime of lessons for investors to learn from Buffett and Munger, here's a final takeaway. There are thousands of active investment managers for every one Warren Buffett, just like there are thousands of companies for every one Apple Inc. While hindsight is 20/20ish, there are always uncertainties and risks involved with forecasting the future performance of index fund managers, of active fund managers, and of individual companies.

Market Recap

(as of March 27th, 2015)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	2061	-2.20	0.60	0.60	13.76	55.60
Dow Jones 30	17713	-2.24	-0.02	-0.02	11.46	44.37
Russell 2000	3083	-1.99	3.27	3.27	9.14	53.90
Russell 1000 Growth	655.93	-2.16	3.57	3.57	17.25	56.51
Russell 1000 Value	623.21	-2.16	-1.29	-1.29	10.29	56.66
MSCI EAFE	1870	-0.69	6.15	6.15	1.84	31.44
MSCI EM	958.11	-1.10	0.54	0.54	1.06	-1.04
NASDAQ	4891	-2.67	3.56	3.56	19.22	62.88
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.10	0.01	1.49	1.49	5.41	9.36
U.S. Corporates	2.94	-0.03	2.21	2.21	6.42	16.06
Municipals (10yr)	1.95	-0.08	1.25	1.25	6.72	13.03
High Yield	6.63	0.28	2.36	2.36	1.97	23.76

	Levels (%)					
Key Rates	**3/27/15**	**3/20/15**	**12/31/14**	**12/31/14**	**3/27/14**	**3/27/12**
2-yr U.S. Treasuries	0.58	0.60	0.67	0.67	0.45	0.33
10-yr U.S. Treasuries	1.95	1.93	2.17	2.17	2.69	2.20
30-yr U.S. Treasuries	2.53	2.50	2.75	2.75	3.52	3.29
10-yr German Bund	0.18	0.15	0.53	0.53	1.54	1.88
3-mo. LIBOR	0.28	0.27	0.26	0.26	0.23	0.47
3-mo. EURIBOR	N/A	0.02	0.08	0.08	N/A	0.81
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.50
30-yr fixed mortgage	3.90	3.90	4.04	4.04	4.56	4.23
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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