July 30th, 2015

MERITAS ADVISORS

Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

IN THIS ISSUE

- Market Update
- US Economy
- Global Economy
- Your Money
- Market Recap

MORE FROM MERITAS

You can read more from our chief economist Lenore Elle Hawkins at TheStreet.com where she publishes articles individually and along with co-author Chris Versace, (not affiliated with Meritas Advisors). Lenore and Chris are also writing Cocktail Investing, scheduled to be published in early 2016 and is currently available for pre-order from Amazon. In addition to her frequent television appearances, Lenore also gives a weekly radio update on Monday mornings on America's

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

Northern California
4040 Civic Center Drive, Suite 200
San Rafael, CA 94903
415.690.8547

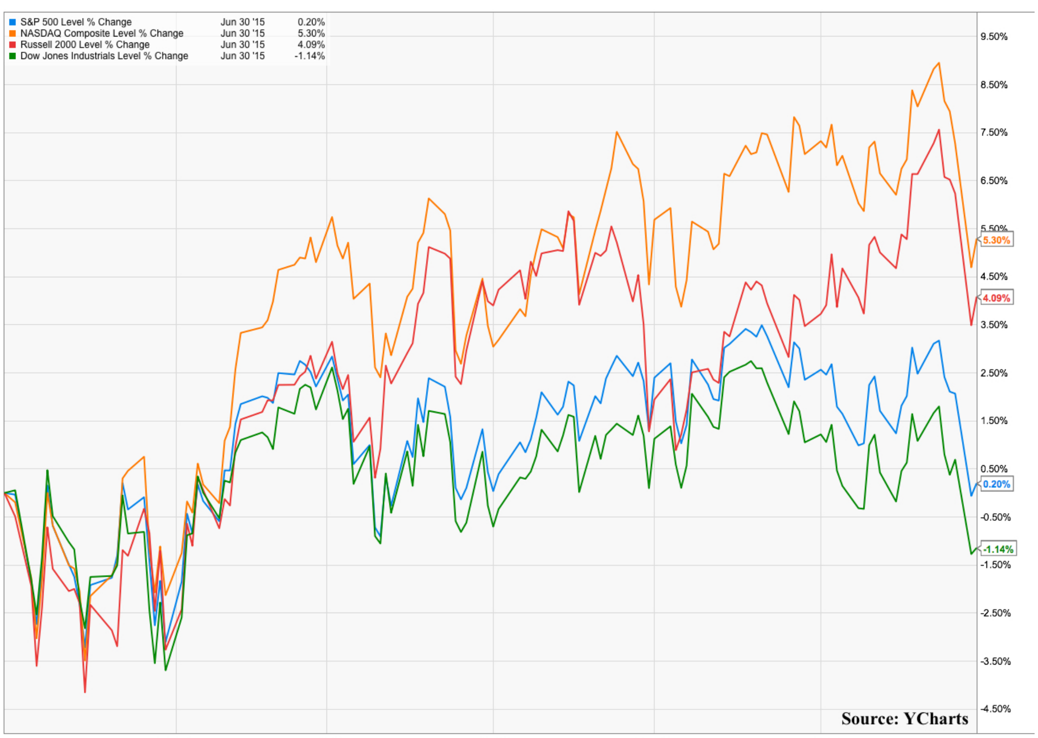
Southern California
11622 El Camino Real, Suite 100
San Diego, CA 92130
858.461.8547

Dear Clients and Friends:

Last week things really started rocking and rolling in the markets and this week is packed full of economic news as well as earnings releases. Given that we are heading into the last month of the summer, I'll do my best to keep this one a bit more concise… but you all know how I get when I'm excited so no promises! --- *Lenore Elle Hawkins, Meritas Advisors Partner, economist, writer and perpetual student of the markets, wondering how is it possible that my Irish skin appears to actually reflect sunshine? (Apologies to those of you who have had to shield your eyes from the glare as I hit the beach)*

Market Update

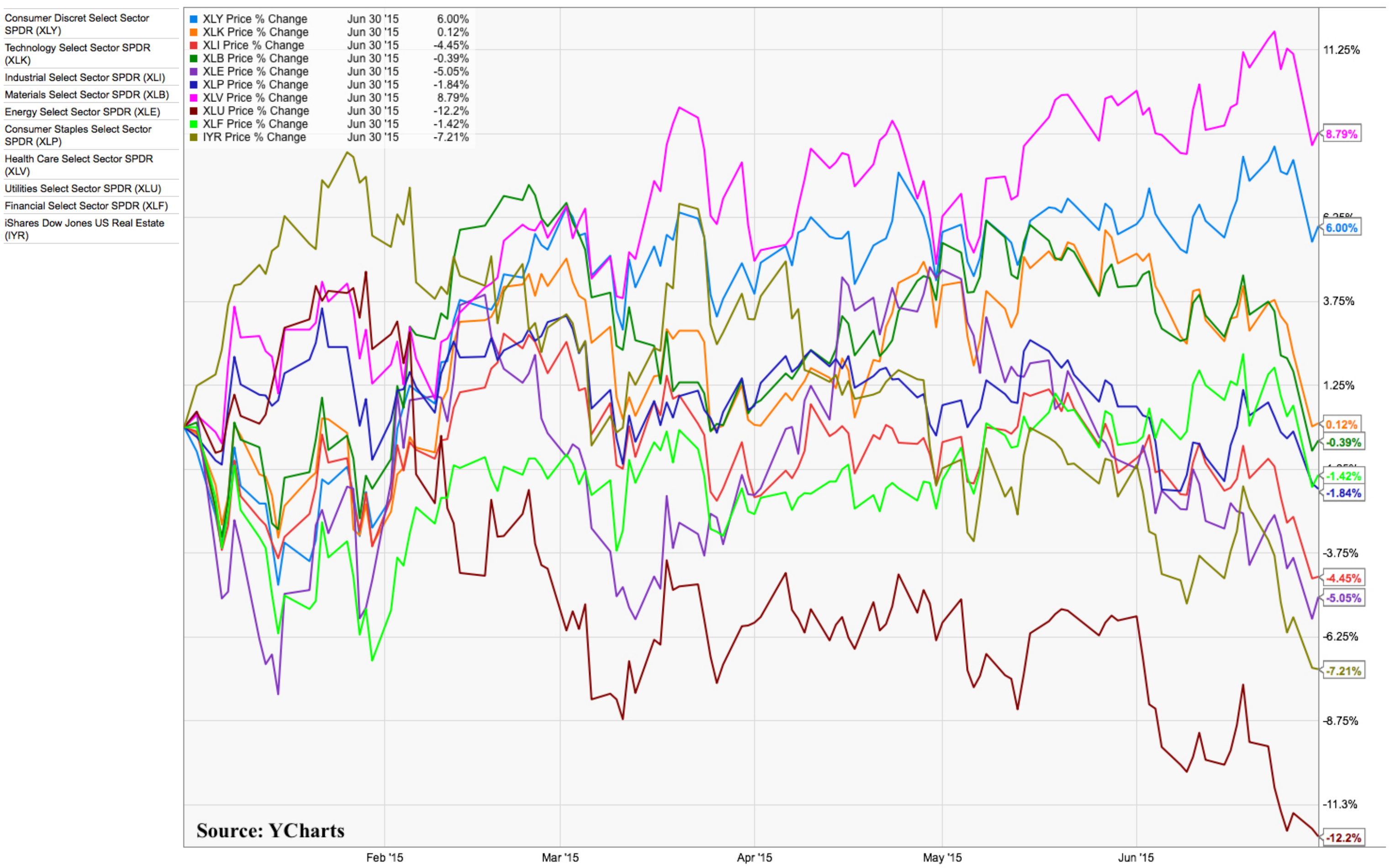
By the end of the second quarter, June 30th, despite all the headlines of this crisis or that enormous bull-run, the major U.S. equity markets were relatively flat, giving us a veritable Macbeth first half of the year, "*full of sound and fury, signifying nothing...*" The S&P500, which represents the larger companies on the NYSE or NASDAQ closed the first half up just 0.20% and the Dow Jones Industrials closed down -1.14% after having closed the first quarter also in the red, down -0.26%. The last time this index closed two quarters in a row in negative territory was in 2007… the time before that was 2000, neither of which were fun years. That doesn't mean that we are in the same market conditions today, but it does give us reason to look further for more corroborating evidence, but first lets look at sector performance over time.



Source: YCharts

We’ve also seen increasing sector divergence, with healthcare continuing to outpace all other sectors, with only the consumer discretionary sector coming anywhere close to it. Utilities, the strongest performer in 2011 and again last year in 2014, were in the first half of 2015, the bottom of the barrel by far! This is just one more example of the importance of diversification and paying attention to shifting sentiment and trends.

Despite all the talk about the explosion in technology stocks, the tech sector was not the strongest performer, barely in the green, as of the end of the first half. The sector has gained more in the past few weeks, but primarily because of just a few large companies such as Google that have enjoying a mind-boggling jump up based on its latest earnings report that upon deeper investigation doesn’t warrant such enthusiasm, given the constraints it faces on future growth potential that simply don’t support the valuation– signs of a market getting weird, (technical term there for you new to this newsletter.)



Recently many U.S. indices have been doing a rather jiggy dance around critical levels, with the S&P 500 recently dipping down below a key technical point, its 200-day moving-average, and no longer appears to be in an uptrend. Err what? Sorry about that – got a bit wonky there! Let me explain what that meant and why you care.

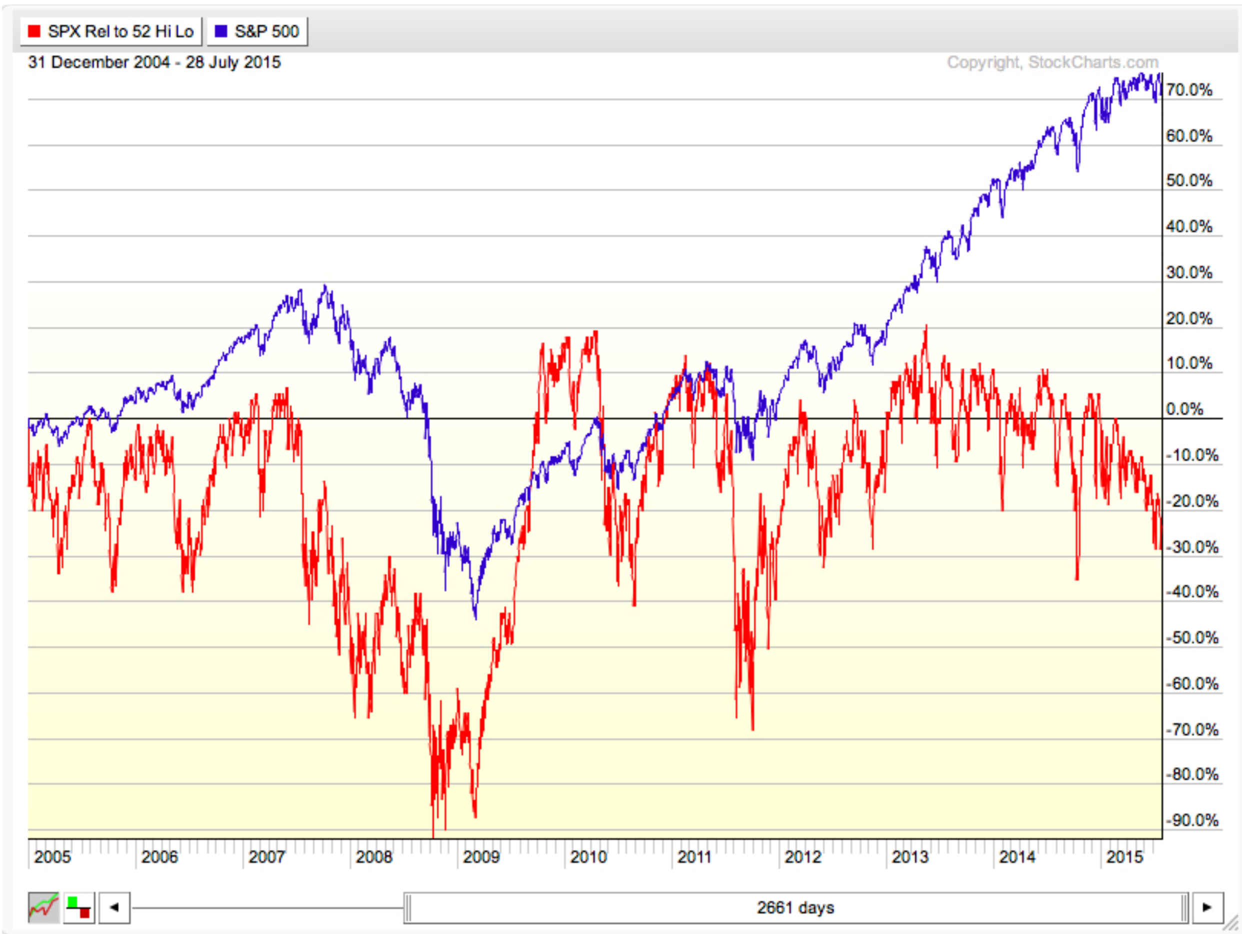
A *moving average is the most common method used to determine general movement of prices over time*. It simply takes the sum of all of the past closing prices over the time period and divides the result by the number of prices used in the calculation. For example, in a 10-day moving average, the last 10 closing prices are added together and then divided by 10. You simply repeat this again and again so that on day 10, the 10-day moving average is the average of prices from day 1 through day 10. For day 11, the 10-day moving average is the average of prices from day 2 through day 11, for day 13, day 3 through 13 and so on. By increasing the length of time, meaning 10-day versus 50-day versus 200-day in the calculation we can gauge the strength of the long-term trend versus shorter-term. By comparing a shorter to a longer time frame we can see the difference between the short-term trends and longer term – simple enough!

Now to my fancy little chart below. Market watchers tend to keep a close eye on *the difference between the 50-day and 200-day moving averages*. When the 50-day moving average is above the 200-day moving average, the trend is upwards. When the 50-day is below the 200-day, the trend is downward. When the price moves through a moving average it is said to have crossed-over, which is typically the first signal that the trend may be changing. The chart below shows the S&P 500 index along with its 50-day and 200-day simple moving averages, the common notation is just SMA. As you can see in the chart, the S&P 500 has fallen below the 50-day SMA and the 50-day SMA appears to be plateauing.

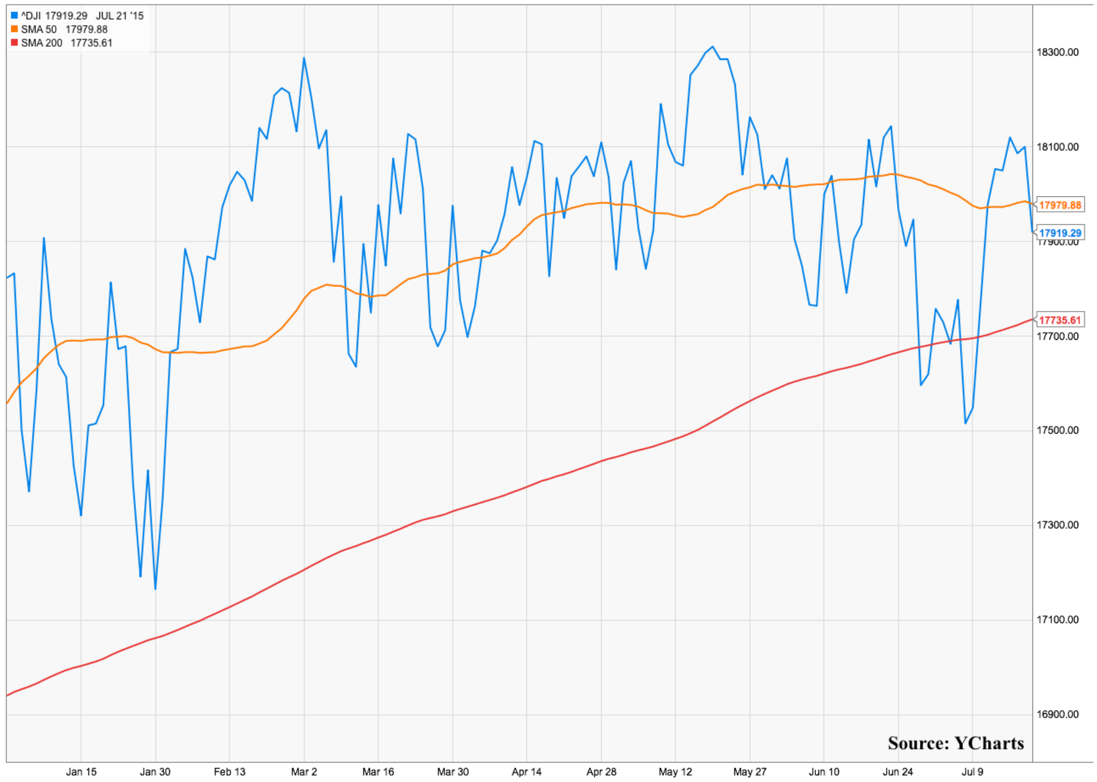
Another thing we look at is the relative strength of the trend. By that we mean just how many of the stocks within

an index are moving in any particular direction. Just one week ago the *S&P 500 was within one point of making a new all-time high*, yet the total number of stocks making *new 52 week lows was rising* – not a good sign. When an index is rising, we have more confidence in its direction when we see a growing number of stocks within that index all moving in the same direction – intuitive right?

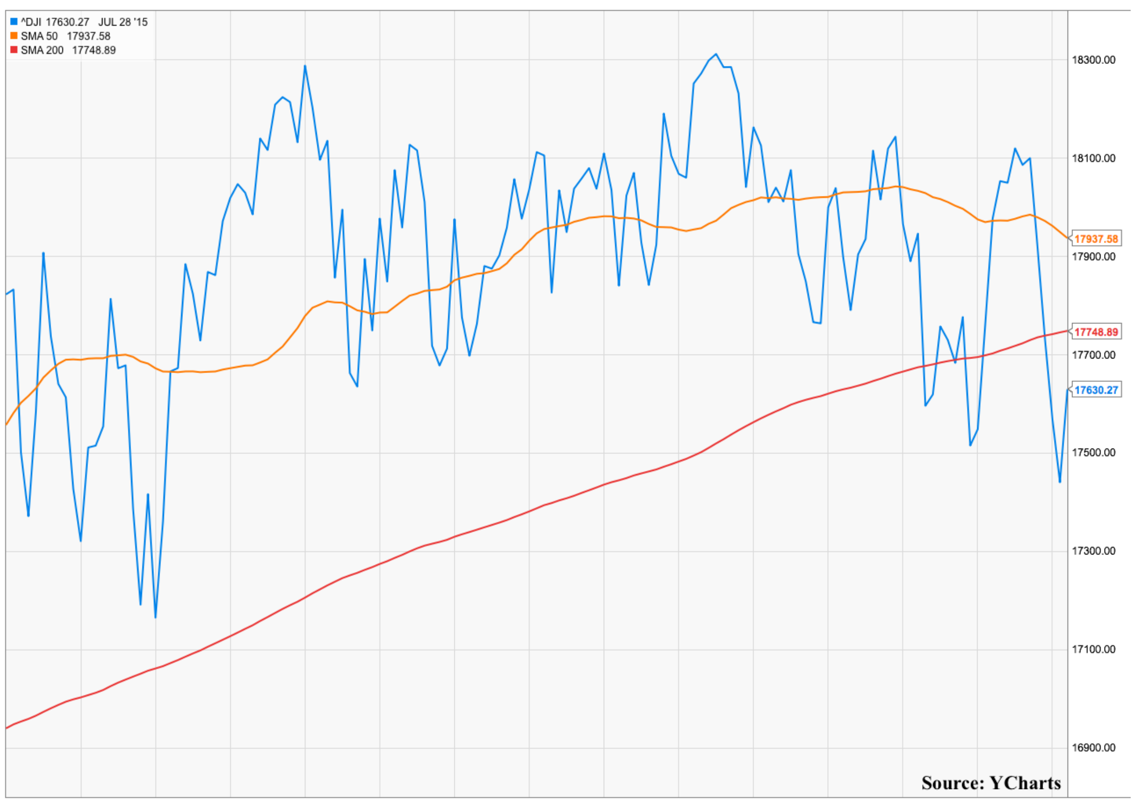
In this case, as the market has been making new highs over the past 13 months, each new high has been made with a lower percentage of stocks in an uptrend. The chart below illustrates this diverging trend with the S&P 500 continually moving upwards while the ratio of new 52 week highs to new 52 week lows continues to degrade. (When this ratio moves down, it means that more stocks are making 52-week lows than are making 52-week highs and vice versa.) This divergence cannot continue indefinitely and so far we aren't seeing much that has us thinking the number of 52-week highs is going to start improving.



If we look at the next two charts of the Dow Jones Industrial Average Index, the Dow is not in great shape either. The first chart shows the index as of Tuesday last week, notice it had just fallen below its 50-day moving average.

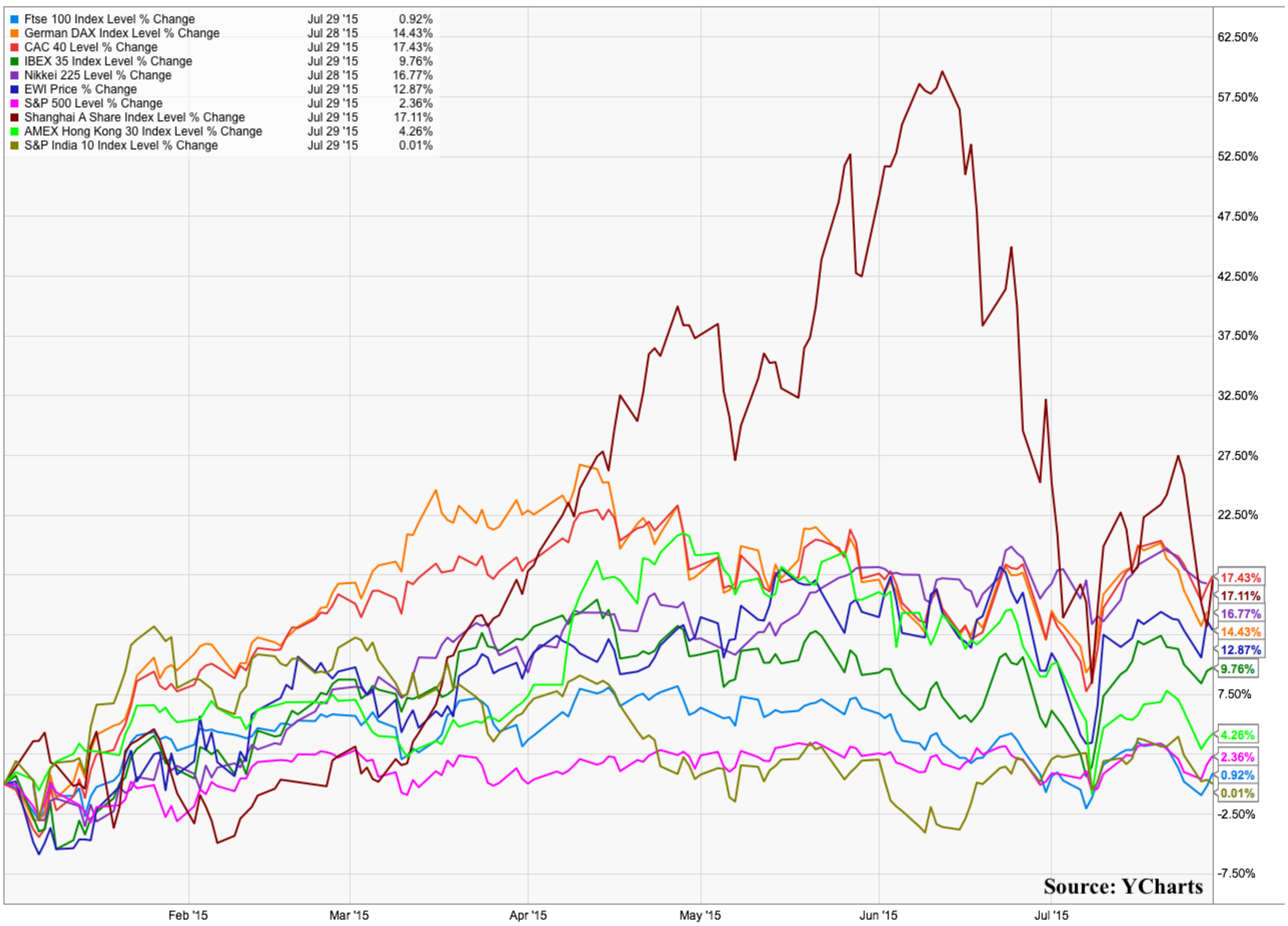


This next chart shows the Dow through Tuesday of this week; notice the drop well below the 200-day moving average. You can see that the chart has broken down to the bottom of a recent downtrend that began in mid-May. A bounce back higher off this downtrend is to be expected, but we will be keeping an eye on the Dow to see if it manages to break clear of the down trend and move back up with any real strength.



The NASDAQ as well has fallen below its 50-day moving average and is currently in the middle of its range over the past three months. The Russell 2,000, which tracks small cap companies, sits at a four month low, just barely holding onto its 200-day moving average. A further break lower here would be another bearish technical signal.

There you have just three (index trend lines, SMAs and relative strength) of the many things we look at to get an idea of where the markets are moving. We also look at more company specific results, particularly those that tend to give us insights into the economy, which we'll talk about in that section, but before we look at those, let's quickly take a look at the global markets.



Holy cow look at that brown line! If you've been reading the financial headlines lately you probably already guessed that one is the primary index for **China**. *(You may recall that we discussed how relatively under-represented Chinese companies are in global stock indexes a few months back. For a refresher click here and start on page 10.)* Year-to-date the Shanghai A shares index was up almost 60% a little over a month ago, (and was actually up 140% over the past year) only to drop dramatically down to now up just over 17%, (still up 75% over the past year.) That seems like a pretty scary decline, which has many nervous.

I was in a conversation recently in which a woman asked me if she should be concerned that China had just had its worst one-day decline, even after the government had pumped a ton of money into supporting stocks. Another gentleman added that he'd read something about *American investors having lost a nerve-wracking $41.8 billion in the Chinese stock market*. Sounds pretty scary doesn't it?

One of the most important mindsets to have in investing is **context**. It isn't too tough to put up charts that look very exciting, but the visual can be so jarring as to engender misleading conclusions. So let's walk through the actual data here and see what we are really looking at.

The US total market capitalization measures the total market value of the outstanding shares for all publicly traded companies in the US for which prices are readily available. It is the first and oldest measure of the total US equity market. It currently sits at just under 125% of GDP, which by the way is much, much higher than its long-term average of 77.43%. This is one of the metrics used by many to point out that the equity market is overvalued, but that is a conversation for another day.

With the US total market capitalization at about 125% of GDP, which is today around $18 trillion, the total US market capitalization is about $22.5 trillion - with numbers this large I'll indulge in a little rounding to preserve sanity! According to a recent USA Today article, "the 144 China-based stocks with primary listings on the major U.S. exchanges have erased more than $56 billion in paper wealth since the Shanghai Composite index peaked on June 12th." That sounds like an incredibly large amount of money, but in context, $56 billion is just 0.25% of the total market capitalization of the US – a quarter of 1%! There you go for context. Doesn't sound so scary now, does it? That being said, remember that the equity markets and the economy are very different animals. China's economy is much more impactful on the rest of the world than its equity markets – we'll go into that in the next section.

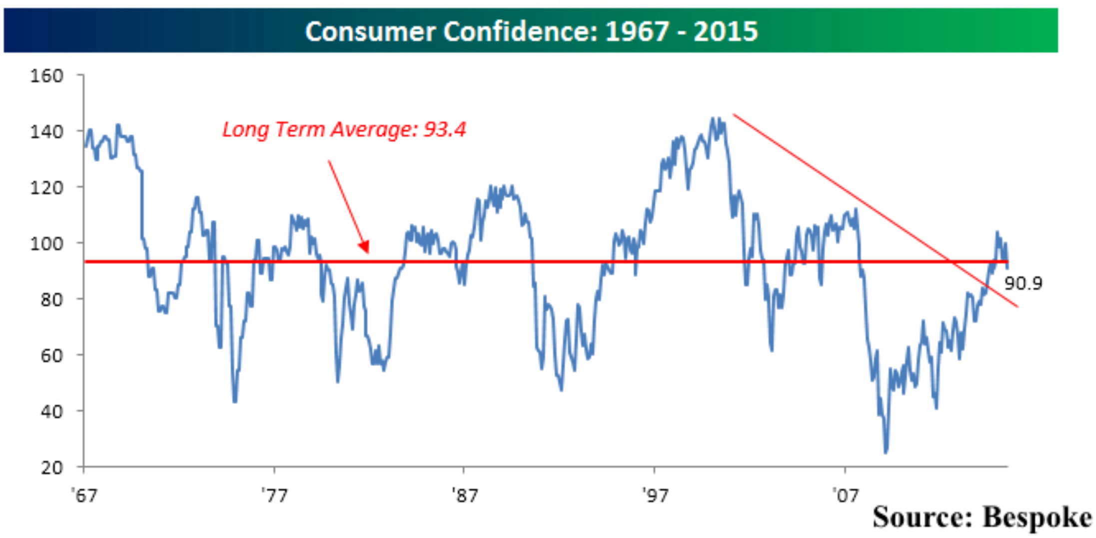
Looking at the rest of the global indices, it is really a tale of monetary policy, with those kicking the stimulus into high gear getting the bump up in asset prices. The U.S., not only no longer pushing the stimulus, but now continually batting around the potential for an interest rate hike, sits at the lower end of the performance spectrum, with the S&P 500 up a measly 2.4% while Japan is up almost 17%. The European Central Bank is certainly making progress with its quantitative easing-induced financial asset price inflation, with France up over 17%, Germany up nearly 14.5%, and Italy just shy of 13% year-to-date! So, while many of the non-US equity markets have been heading higher this year, how about the underlying domestic and global economies themselves?

US Economy

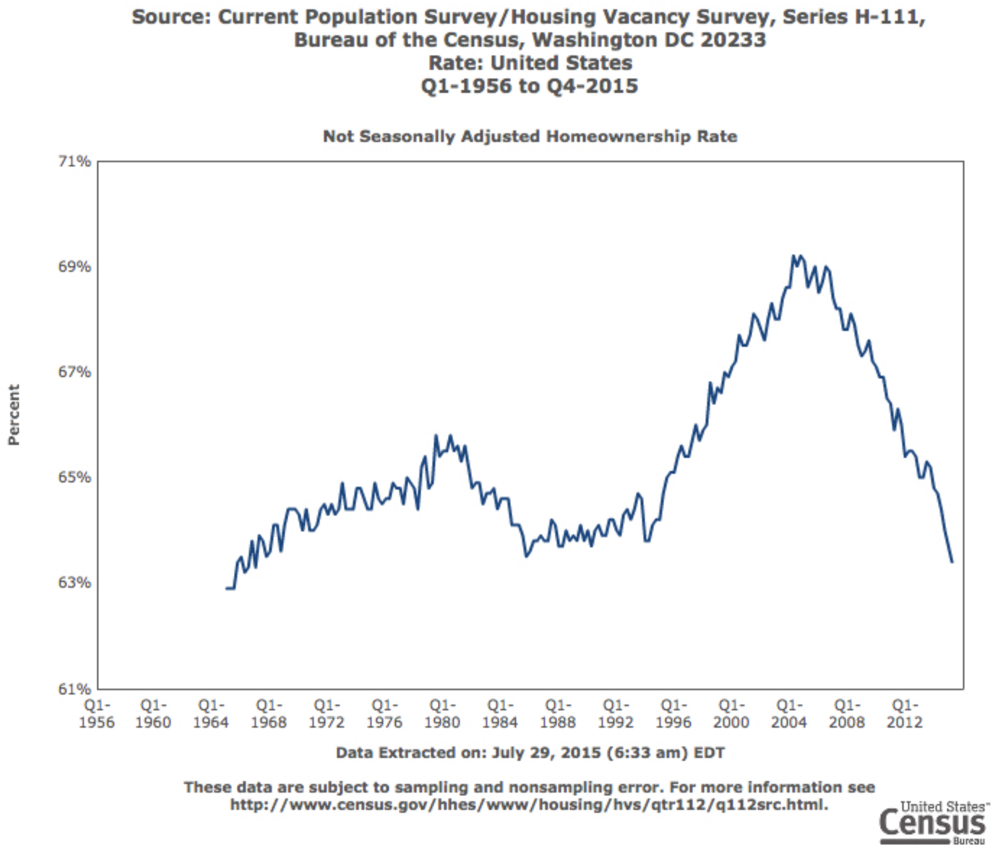
In addition to looking at trends in various indices and sectors, we also look at data coming out of key companies, such as United Parcel Service. UPS's business is highly cyclical and heavily dependent on the strength of the domestic and global economy, since economic growth is a key determinant of changes in package volume. Package volumes and economic strength are so tightly correlated that we think of changes in package volume as a barometer of growth. In 2014, UPS accounted for 19.6% of the global market share of express and courier services based on revenue, according to Statista, while FedEx accounted for 14.2%. Within the United States, UPS accounts for 52% of all parcel shipping, FedEx 30% and the U.S. Postal Service only 15%, according to a report by the Wall Street Journal. So you can understand how meaningful data is coming out of UPS.

This Tuesday the CEO of UPS, David Abney, reported that the company's revenue had fallen by 1.2% over the last 12 months and pointed out that back in January, estimates were for U.S. GDP growth of around 3.1%. Today that number has dropped about 25% to 2.3% - a very material change in growth prospects. He mentioned concerns that the continued strength of the U.S. dollar ahead of the impending Federal Reserve rate hike is having an impact on some areas of U.S. growth.

In a testament to the weaknesses to which the CEO of UPS was referring, on Tuesday we saw a painful drop in the Conference Board Consumer Confidence index, falling from 99.8 to 90.9 in July with the Expectations Index falling even further from 92.8 in June to 79.9 in July, which may give the Fed additional cover to hold rates steady past September's FOMC meeting. This makes the last real potential rate increase in December and we doubt the Fed would like to get the Ebenezer award around the holidays, so we're still seeing better than 50% odds for no hike this year. Almost every metric in the Conference Board report painted a consumer looking increasingly pessimistic, with those anticipating *more* jobs in the months ahead *falling* from 17.1% to 13.1% and the proportion expecting *growth* in their incomes *falling* from 17.6% to 17% with those expecting an actual *decline rising* from 10.6% to 11.2%; overall a bummer of a report with the index now below its historical average of 93.4 for the first time this year.



This week we also received the release of the quarterly U.S. Census data on household formation, which revealed that while *household formation continues to rise* steadily, *homeownership rates continue to fall*, now down to level not seen since the 4th quarter of 1965, nearly 50 years ago! Another reason to suspect the Fed may not raise rates just yet, despite their desperate desire to get to a more normal interest rate environment, since should the economy stumble before they do get there, they've got hardly any arrows left in their policy quiver.



The markets on Wednesday were waiting with breathless anticipation for the latest word coming out of the Fed, to see if the much anticipated rate rise is imminent. What we got was, not quite yet ladies and gents! There were however, enough changes in the commentary to leave a September rate increase an option. Looking at the Fed Funds Futures market, traders have all but ruled out September for a rate increase with the probability of a hike not reaching 50% until December. But given that Fed officials are imperfect humans with imperfect information and imperfect judgment, this is something that is impossible to predict with any reasonable degree of confidence. The Fed has continually cautioned that a hike could come at any meeting, and the GDP report Thursday could paint a much different picture of the economy for the Fed, so while a September hike does not seem likely right now, we don't discount the possibility entirely.

Yesterday the Bureau of Economic Analysis released estimates for GDP growth for the U.S. in the second quarter of 2015 and issued a major revision to prior year's numbers, from 2012 – Q1 2015. This revision revised last quarter's contraction into slight growth of 0.6%, but lowered most prior quarters to paint an ever weaker picture of U.S. growth. **The current recovery post-financial crisis was already the worst on record. After these revisions, we see that the economy only grew at an average 2.0% annual rate which is 0.3% lower than the prior estimates.**

Global Economy

Over in Europe, the situation with Greece reminds me of an interminable game of whack-a-mole. Just when you think you've nailed the sucker, he pops up somewhere else, seemingly undaunted by your ever more frustrated slams! According to the daily morning Athens newspaper, Kathimerini, Thursday the central committee of Greece's ruling Coalition of the Radical Left, aka Syriza, will hold an emergency meeting to address the growing internal chasm over acceptance of the criteria attached to the third Greek bailout, with several members demanding the government cease negotiations with creditors and instead follow an alternative path. While it is true that Greek GDP and debt doesn't amount to much on the global stage, the impact on the Eurozone and assumptions about its sovereign debt management are very important to global investors; best to not write this one off yet as a done deal.

Overall the European economies continue to grow, albeit at slower rates than in decades past, but still in positive territory. Recent data coming in however is giving us cause for concern as we are seeing indications of further slowing. For example, Germany, the region's largest economy, just saw its Markit Composite PMI index fall to 53.4 from 53.7, (a number over 50 indicates growth while under 50 is a contraction). The nation's factory gauge declined as well as did exports. France's Markit Composite dropped to 51.5 from 53.3 in June.

The manufacturing index for the euro region as a whole declined to 52.2 in July from 52.5 in June, while the services measure dropped to 53.8 from 54.4. Growth in new business across both industries also slowed this month, according to the report.

So what about China? In summary, it is slowing. How much? No way to be confident as the official data that is produced is suspect at best. The big problem? China has a mountain of loans that were used to build a bunch of stuff that it didn't need, but it wanted to keep people employed doing something. All that wasted money and all those loans with no productive assets to support the return of the borrowed money are a big problem. How big? Again… no way to be terribly confident in the numbers, but we have every reason to worry that it could be more than many believe and the impact could put heavy downward pressure on prices all over the world.

The global economy is increasingly interconnected, so the impacts of slowing in China and of the strengthening U.S. dollar are anything but simple. For example, Germany's top three export destinations are France, the U.S. and China. If China's economy weakens materially, it will buy less from Germany, which will hurt the German economy. One the other hand, the U.S. dollar is strengthening, (and likely to continue to do so) against the euro, making it less expensive for the U.S. to buy stuff from Germany, which makes us more likely to buy more, which obviously helps the German economy. Since China's currency is tied to the U.S. dollar, that appreciation also makes German imports less expensive for China which could help offset the reduced demand for stuff from Germany. However, since China's currency is tied to the U.S. dollar, an appreciating dollar makes China's exports more expensive, which reduces demand for them, and further weakens China's economy. In a nutshell, this stuff is not simple … but that is a topic for next time! We wanted to leave you with an enticing summer sizzler cliffhanger there so that you meet us back here in August.

Your Money with Greg Tull

Let's take a look at the impact that international monetary policy and exchange rate fluctuations can have on your summer vacation. Bottom line, it can make it 25% cheaper than the same summer vacation was last year! Here's how. We noted above that one of the reasons that UPS cited for slower expected growth of the US economy in 2015 is the continued strength of the U.S. dollar ahead of the possible Federal Reserve rate hike in 2015 or 2016. There are several reasons that a nation's currency tends to strengthen vs foreign currencies when a domestic interest rate increase is expected. First, tighter monetary policy tends to be a sign of a strengthening economy, since a major reason that policy makers increase interest rates is to keep an economy from over-heating. Second, all else equal, tighter monetary policy is generally viewed as a fiscally responsible move. Third, owners of capital who can invest globally prefer to receive a higher interest rate on their fixed income (bond) investments. All three of these factors tend to increase the demand for dollar denominated assets, which pushes up the demand for the dollar, and thus the price of the dollar relative to other currencies.

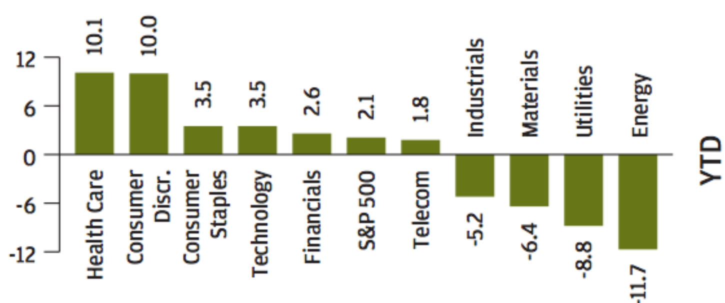
So, while a stronger dollar is not great news for US exporters, since it makes their goods and services more expensive to their non-US consumers, it's great news for US citizens who would like to travel abroad. Your dollars go further in foreign countries where you are traveling when the dollar is strong, like it is now. For example, the US dollar has appreciated 25% from July 2014 to July 2015 vs the Euro, and 22% vs the Canadian loonie in the same time frame. Last summer's $10,000 vacation across the pond will cost you only $7,500 this summer. So book your next trip to Europe or Canada today!

Market Recap

(as of July 24th, 2015)

Equities	Level	1 week	QTD	YTD	1 year	3-yr. Cum.
		Index Returns (%)				
S&P 500	2080	-2.19	0.90	2.14	6.77	65.60
Dow Jones 30	17569	-2.82	-0.13	-0.09	5.26	49.61
Russell 2000	3047	-3.23	-2.19	2.46	7.41	66.28
Russell 1000 Growth	669.12	-2.04	2.11	6.16	11.56	70.31
Russell 1000 Value	618.26	-2.29	-0.76	-1.37	2.03	63.74
MSCI EAFE	1861	-1.50	1.05	6.98	-2.71	49.56
MSCI EM	910.40	-3.28	-6.02	-3.09	-13.46	8.82
NASDAQ	5089	-2.32	2.07	8.09	15.10	84.67
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.40	0.27	0.37	0.27	2.33	4.43
U.S. Corporates	3.40	0.30	0.38	-0.54	1.01	7.45
Municipals (10yr)	2.26	0.44	0.64	0.75	3.12	8.56
High Yield	7.25	-1.00	-1.03	1.47	-1.02	19.25

Key Rates	7/24/15	7/17/15	6/30/15	12/31/14	7/24/14	7/24/12
	Levels (%)					
2-yr U.S. Treasuries	0.70	0.68	0.64	0.67	0.53	0.22
10-yr U.S. Treasuries	2.27	2.34	2.35	2.17	2.52	1.44
30-yr U.S. Treasuries	2.96	3.08	3.11	2.75	3.30	2.47
10-yr German Bund	0.65	0.73	0.77	0.53	1.18	1.23
3-mo. LIBOR	0.29	0.29	0.28	0.26	0.24	0.45
3-mo. EURIBOR	N/A	-0.02	-0.01	0.08	0.21	0.44
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.47
30-yr fixed mortgage	4.23	4.23	4.26	4.04	4.33	3.74
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



4040 Civic Center Drive, Suite 200 | San Rafael, CA 94903
11622 El Camino Real, Suite 100 | San Diego, CA 92130
info@MeritasAdvisors.com | www.MeritasAdvisors.com