October 15th, 2015

MERITAS ADVISORS

Comprehensive Wealth Management

MONTHLY INVESTMENT OUTLOOK

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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 Morning News, click here for local stations.

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

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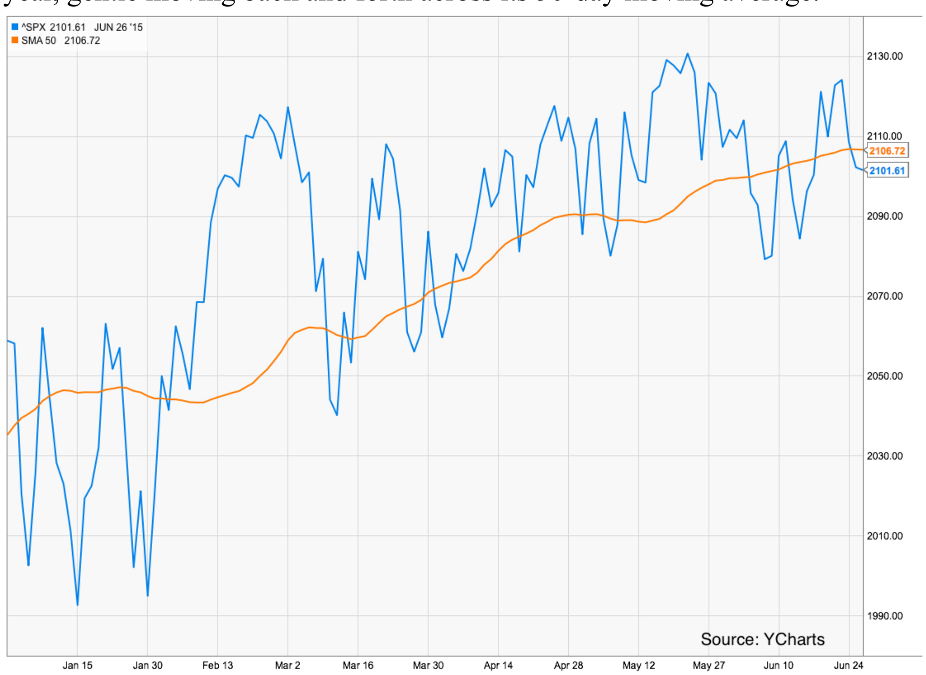
Dear Clients and Friends: After a fairly stable first half of the year, the third quarter has been a wobbly one, with a significant correction followed by last week's move higher, which after some seriously painful weeks in August and September, was one of the best weeks of the year. The economic data coming in for the U.S. and abroad has been mixed, with reasons for concern speckled with a smattering of optimism. We've much to discuss so let's get started.

Lenore Elle Hawkins, your Meritas Advisors chief economist, writer and woman in search of the ultimate pumpkin!

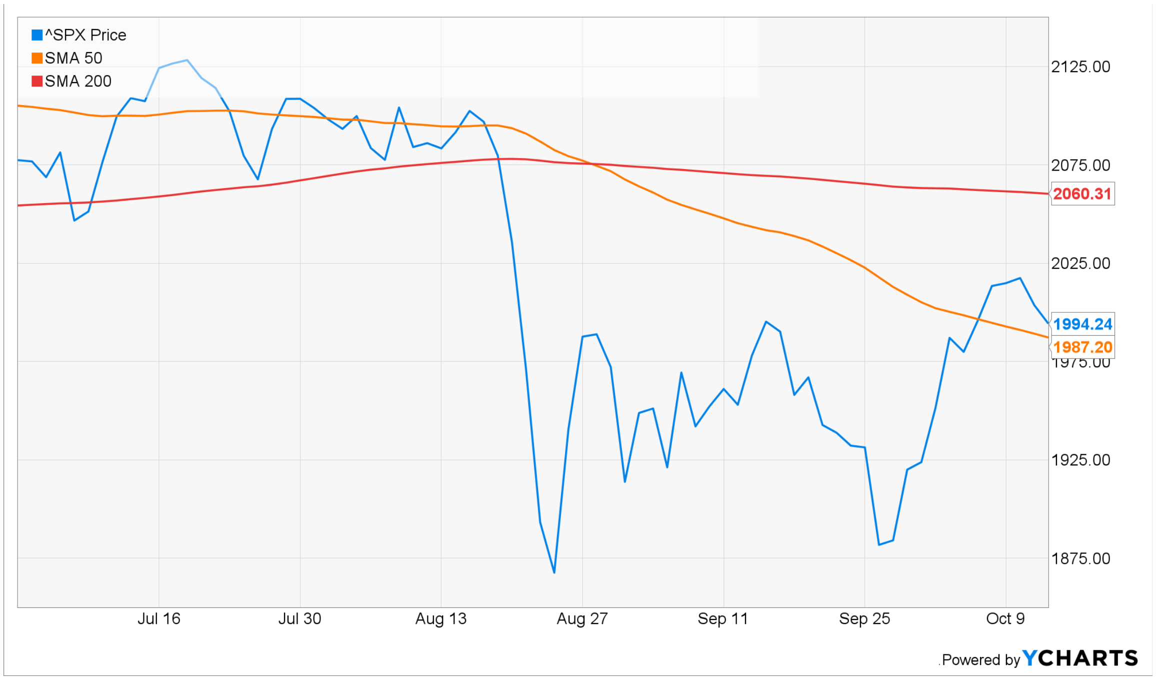
Market Update

To say the markets have been volatile lately would be the understatement of 2015! This year started out with the major U.S. indices trading in the narrowest range in history, something like Hitch's (Will Smith) dance instructions for Albert (Kevin James) in the 2005 movie Hitch, if you haven't seen it you owe to yourself to click here.

The chart below shows how stable the S&P 500 was for the first half of the year, gentle moving back and forth across its 50-day moving average.



Well that all changed… a bit like Albert's dance moves once he was out on his date with Allegra Cole, and the market started gyrating wildly in ways that would have left Hitch shaking his head.



This chart shows the movement of the S&P 500 starting with the third quarter and ending Wednesday, October 14th. Rather than oscillating gently around its 50-day moving average as was the case during the first half of the year, the index plunged below both its 50-day (yellow line) and 200-day (red line) with the 50-day moving well below the 200-day moving average. This indicated a material turn in the market's direction. Recently we've seen the markets get all dog-with-waggy-tail about the dour jobs report earlier this month as we return to a bad-news-is-good-news market sentiment. That made a Fed rate hike later this year even less likely which is like giving a triple espresso to your toddler to wash down his Halloween spoils! Early last week the index moved back up above its 50-day moving average, and last week the S&P 500 gave its strongest performance of the year, but that move now appears to possibly have been a failed rally. Market breadth, meaning the number of stocks moving up versus down, continues to have more moving down, which has us concerned that this upward trend is not sustainable.

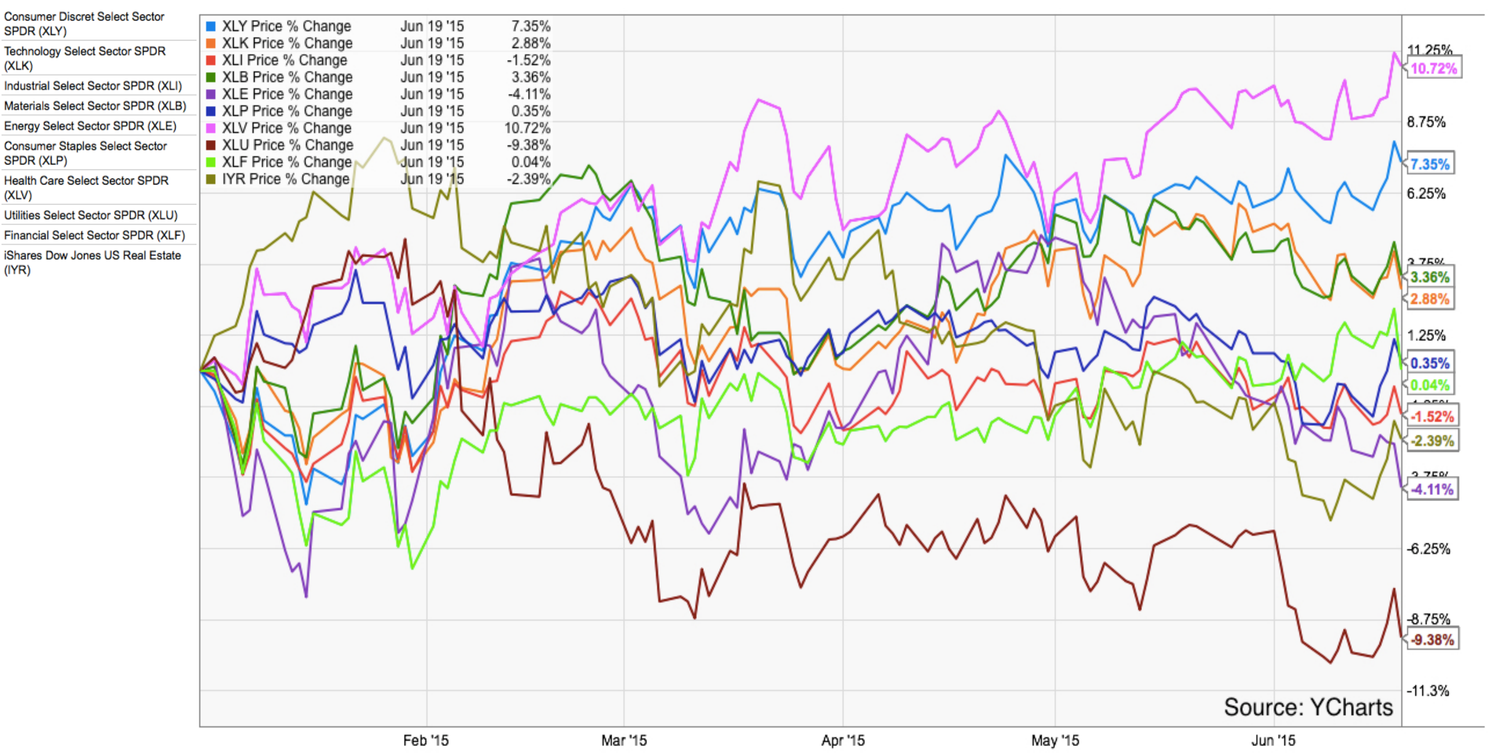
If we take a bigger step back, we see that the last time the 50-day moving average dropped below the 200-day, was back in August 2011 during the fun times of the government shut-down showdown. That time it took nearly six months for the 50-day to move back above the 200-day with the index declining 19.4% from the April 29th peak to the September 30th 2011 trough.

Thus one of the broadest indices for the U.S. has moved below both its 50-day and 200-day moving averages with its 50-day moving average having moved below its 200-day, indicating the index is in a downtrend. The Russell 2000, which is the standard index for small cap stocks finds itself in the same state of affairs, as does the Nasdaq, the primary technology index – in other words most of the indices are feeling rather peckish.

We also like to look at which sectors are leading the markets as that gives us an indication of market sentiment. Market movement is all about attitudes towards risk. **When investors are risk-seeking, the market moves up. When they are risk-averse, it tends to go down.** By looking at which sectors are strong and which are weak, we can get a feel for the general attitude towards risk in the markets.

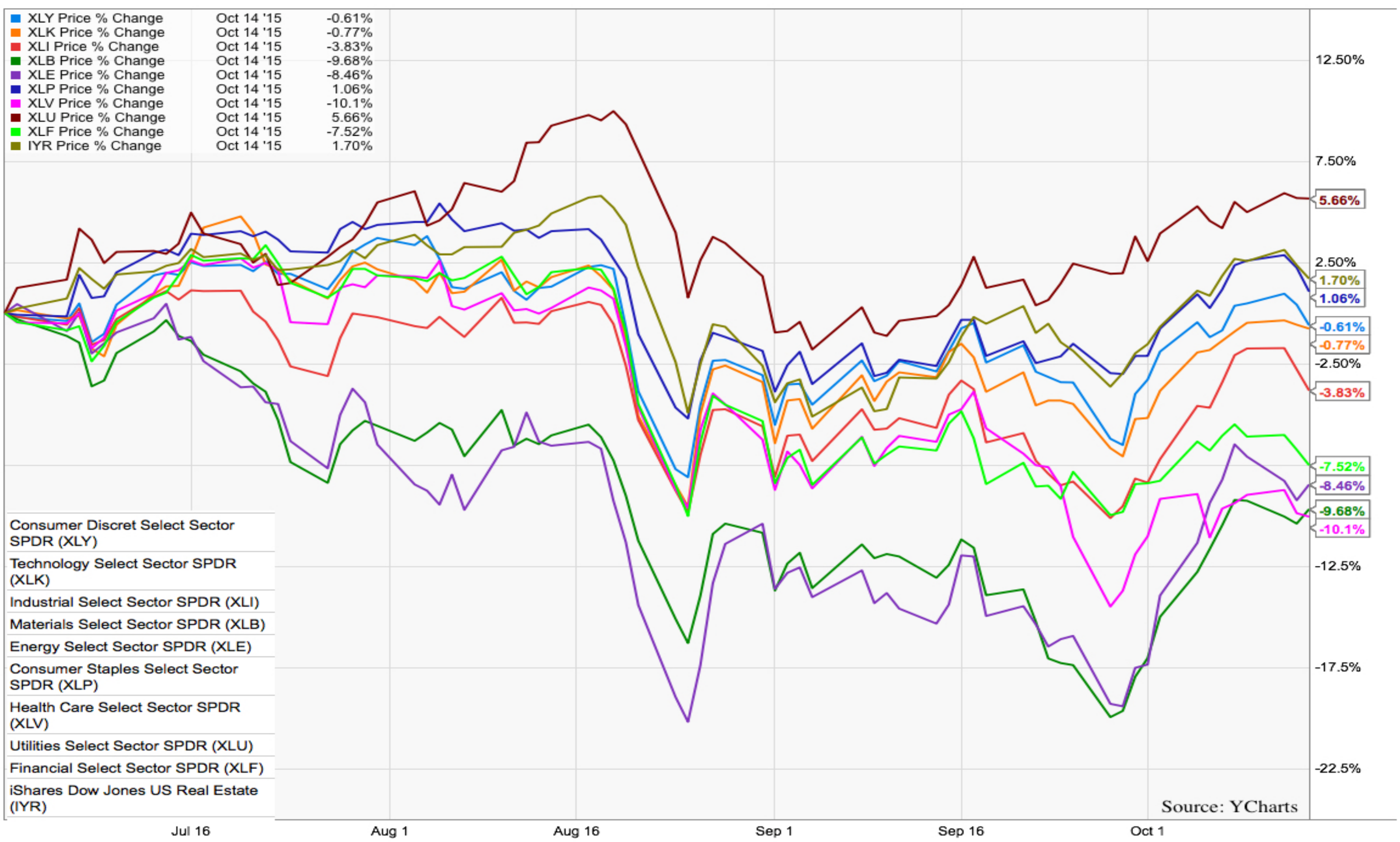
There are two primary classifications for sectors, cyclical and defensive. Defensive sectors are those in which companies tend to not suffer large changes in demand for their products or services during tough economic times. This includes things like basic consumer staples and utilities; people tend to keep buying toilet paper and taking showers even when things aren't going so well… thankfully. Cyclical sectors are those that enjoy increasing demand during good times, but suffer when families and businesses have to tighten their belts. Companies in the defensive sectors tend to outperform cyclical sectors in downturns and vice versa as investor attitudes towards risk and growth shift.

Healthcare has traditionally been considered a defensive sector, but that has changed in recent years. Since January 1st, 2011 the sector has outperformed every other by a hefty margin, which is not typical defensive sector behavior. This shift is driven by some enormous changes; first, the Affordable Care act significantly increases the demand for healthcare services. Second, aging populations in much of the developed world and China also serve to increase demand. Finally, the percentage of the healthcare sector that is represented by the high-growth biotech sub-industry has grown from a sub-10% weighting in 2001 to nearly 22% today. Conversely, Pharma's weighting has fallen from more than 70% at year-end 2001 to 42% today, according to Sam Stovall, a U.S. equity strategist at S&P Capital IQ. So despite its defensive heritage, today the sector behaves a bit more cyclically than in years past.



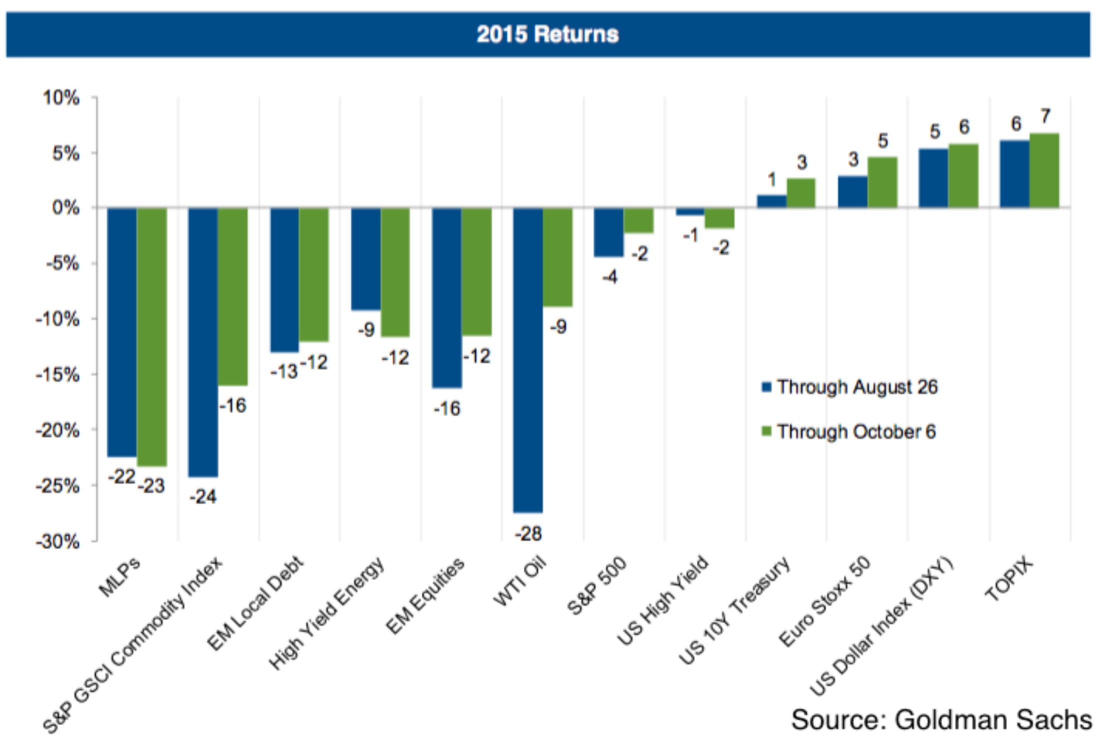
As you can see in the previous chart, for the first half of 2015, the Healthcare (cyclical now) and Consumer Discretionary (cyclical) sectors led by a significant margin, up 10.72% and 7.35% respectively while the Utilities (defensive), Energy (cyclical) and Real Estate (cyclical) sectors lagging the most, down -9.38%, -4.11% and -2.39% respectively.

However, starting July 1st, we see sector leadership shifted with the Utilities (defensive) sector now the strongest performer up nearly 6%, with Real Estate (cyclical) coming in second at 1.7% for the 3+ months while the former leader, Healthcare (cyclical) is now down -10.1%. Financials have also dropped precipitously, down 7.52% and with all the concerns over slowing growth in China, (and with that weaker demand for raw materials) we aren't surprised to see the materials sector has also dropped to nearly 10% down.



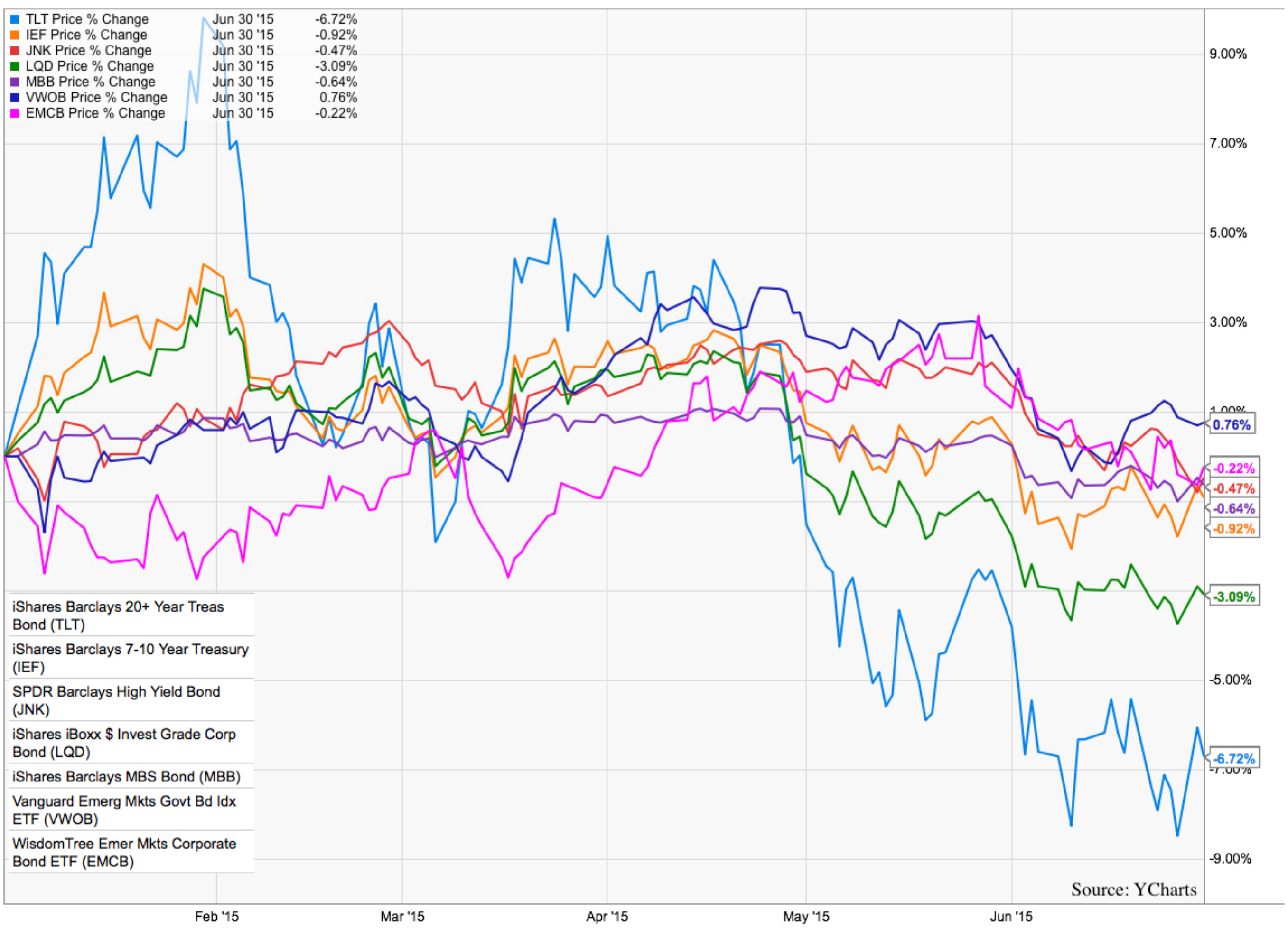
What this tells us is that investors are becoming more risk-averse. The pullback in healthcare is most evident in the iShares Nasdaq Biotechnology ETF which has just experienced a dramatic pullback, down over 20% from its all-time high.

In fact, year-to-date returns have been negative across most every asset class with commodities and emerging markets getting hit hardest, while Japan and Europe have outperformed the U.S., albeit modestly.

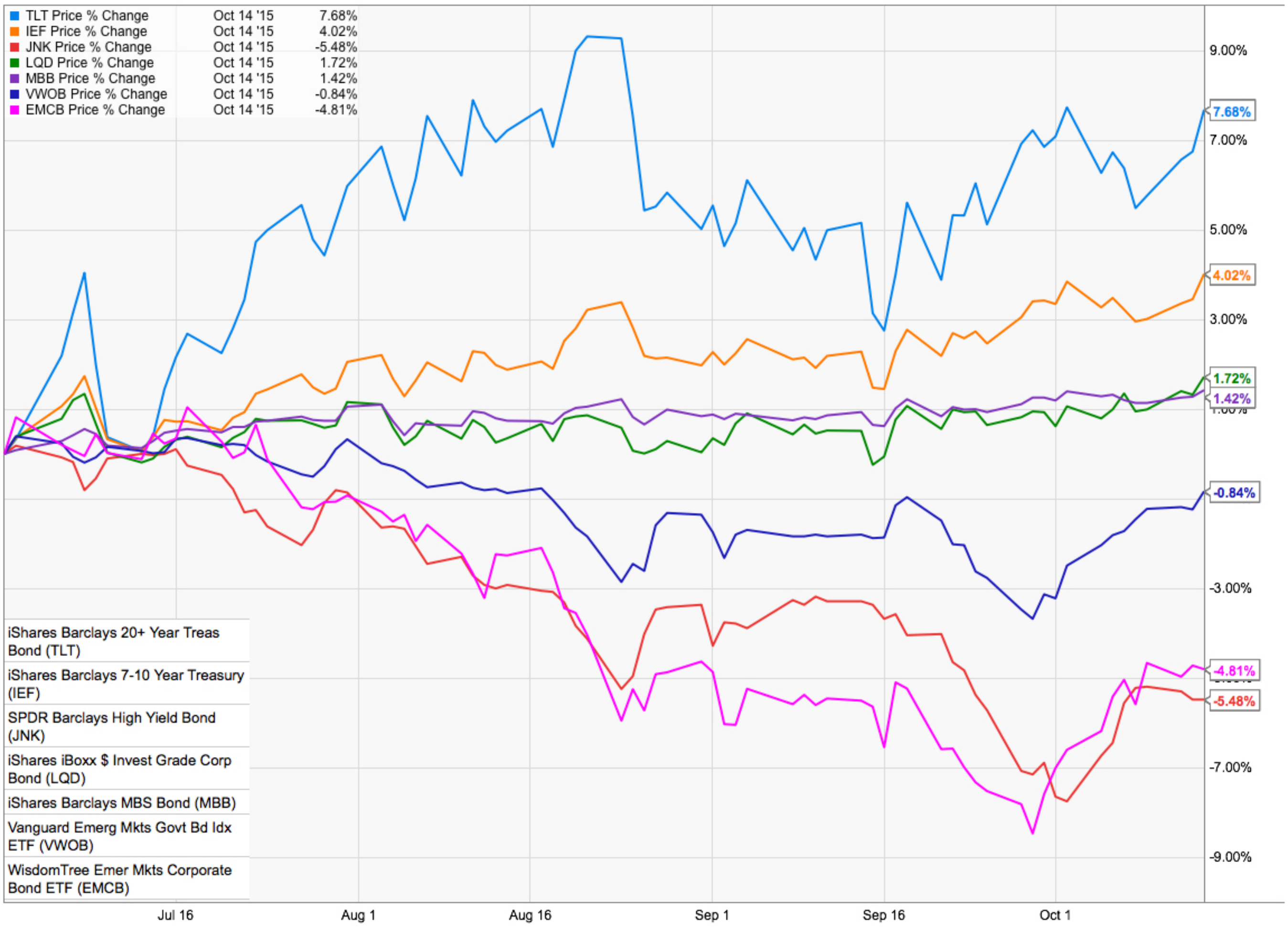


Putting it all together, investors have been pulling away from many of those equity sectors and indices that are riskier and moving towards those areas that are viewed as more defensive. In fact, the quarter ending September 30th delivered the worst quarterly stock-market performance since 2011 with the S&P500 falling 6.9% and investors pulling a net of $46 billion out of U.S. stock funds in July and August, according to the Investment Company Institute. Being busy little data beavers, we like to see confirmation of our hypothesis from a variety of sources, so let's also take a look at bonds.

The next charts show that **bonds experienced a similar trend to equities, with a "risk on" environment prevailing in the first half of the year and "risk off" bonds performing better in the third quarter**. For example, in the first half, the more "secure" types of bonds, such as domestic investment grade corporate bonds in the iShares iBoxx Investment Grade Corporate Bond fund (LQD) were lagging behind higher risk corporate high-yield bonds/ aka junk bonds like those in the SPDR Barclays High Yield Bond fund (JNK). Even emerging market bonds (high risk) like those in the Vanguard Emerging Market Government Bond ETF (VWOB) and WisdomTree Emerging Markets Corporate Bond (EMCB) were able to outperform longer-dated U.S. Treasury bonds like those in iShares Barclays 20+ Year Treasury bond fund (TLT), but towards the end of the second half things started to shift.

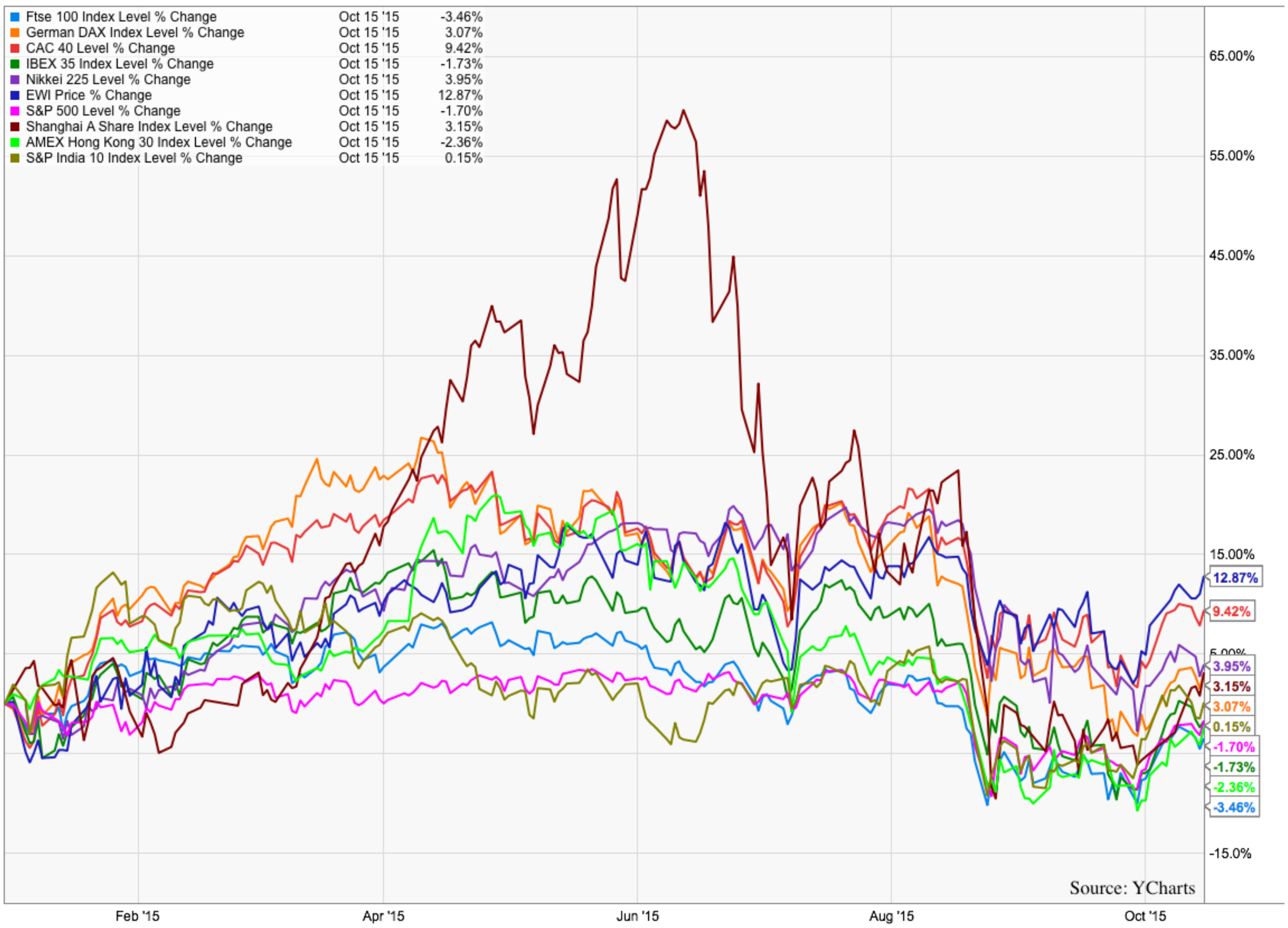


From July first through October 14th, we have seen a substantial reversal of bond sector performance from the first half. For instance, **the first half's worst performer, iShares 20+ Year Treasury bond ETF (TLT) outperformed all other bond funds on the chart in the third quarter's "risk off" environment**. Similarly, lower risk domestic corporate bonds such as those in SPDR Barclays High Yield Bond fund (LQD) significantly outperformed riskier domestic high yield bonds, such as those in SPDR Barclays High Yield Bond fund (JNK) and emerging market corporate bonds such as those in WisdomTree Emerging Market Corporate Bond fund (EMCB) and Vanguard Emerging Market Government Bond Index fund (VWOB).



So far we've seen consistent behavior from the various U.S. equity indices and sectors and we have confirmation from bonds that investor sentiment has shifted away from risk. So let's look around the rest of the world.

Across the globe, markets have all experienced pullbacks, with China's Shanghai A shares index fell briefly into the red for the year after having risen nearly 60% between January and June and are now up just a little over 3%. France and Italy have performed the strongest year-to-date with their indices up 9.42% and 12.87% respectively. Way to go Italy as it looks like Prime Minister Matteo Renzi's reforms are being well received by the markets! Germany and Japan managed to be slightly in the green, up 3.07% and 3.95% respectively. With the China's weakening economy affecting Germany and Japan's worsening domestic economy, we are on the lookout for more talk of stimulus measures in those areas, which could be a nice tailwind for stock prices.



Finally, the strong dollar, which has been getting a lot of air time over the past year, hasn't done much either way lately. The next chart shows how it has mostly been sideways since around April of this year, and in fact the AMEX Dollar Index is down -2% since early April and down -0.56% over the past three months. But don't think that means we are out of the woods just yet as we are already getting warnings from a variety of companies across a wide swath of industries that their earnings (earnings season is just kicking off) will be weaker than expected in part due to the strong dollar.

You'll notice on the next chart that the dollar hit a trough the day the markets had a major correction, on August 24^{th} and again the day the Fed announced that it would not be raising rates. Pardon a brief little pat on the back as I've been calling that one since May. With the data we were seeing, a rate hike looked nigh impossible, despite the proclamations by many on Wall Street that it was a fait accompli.

The Economy and the Fed's "Ooops I did it again!"

To the surprise of many, but not to those who regularly read this newsletter, the Fed did not hike rates in September, despite many assertions from members of the Fed's voting committee that a hike was almost assured. Why was I so confident? As I looked at the domestic economy, a still struggling Europe, increasing weakness in China and the continued headwind of a strong dollar, **I believed the Fed would perceive risks of a rate hike to outweigh the potential benefits, despite my strong desire, as a saver and an investor, to return to a normal rate environment**.

Industrial Prodution (Source: Federal Reserve)

Period	Measure	Change from prior
2015-01-01	105.85	-0.44
2015-02-01	105.80	-0.05
2015-03-01	105.82	0.02
2015-04-01	105.28	-0.54
2015-05-01	105.10	-0.18
2015-06-01	106.56	1.46
2015-07-01	107.49	0.92
2015-08-01	107.08	-0.41

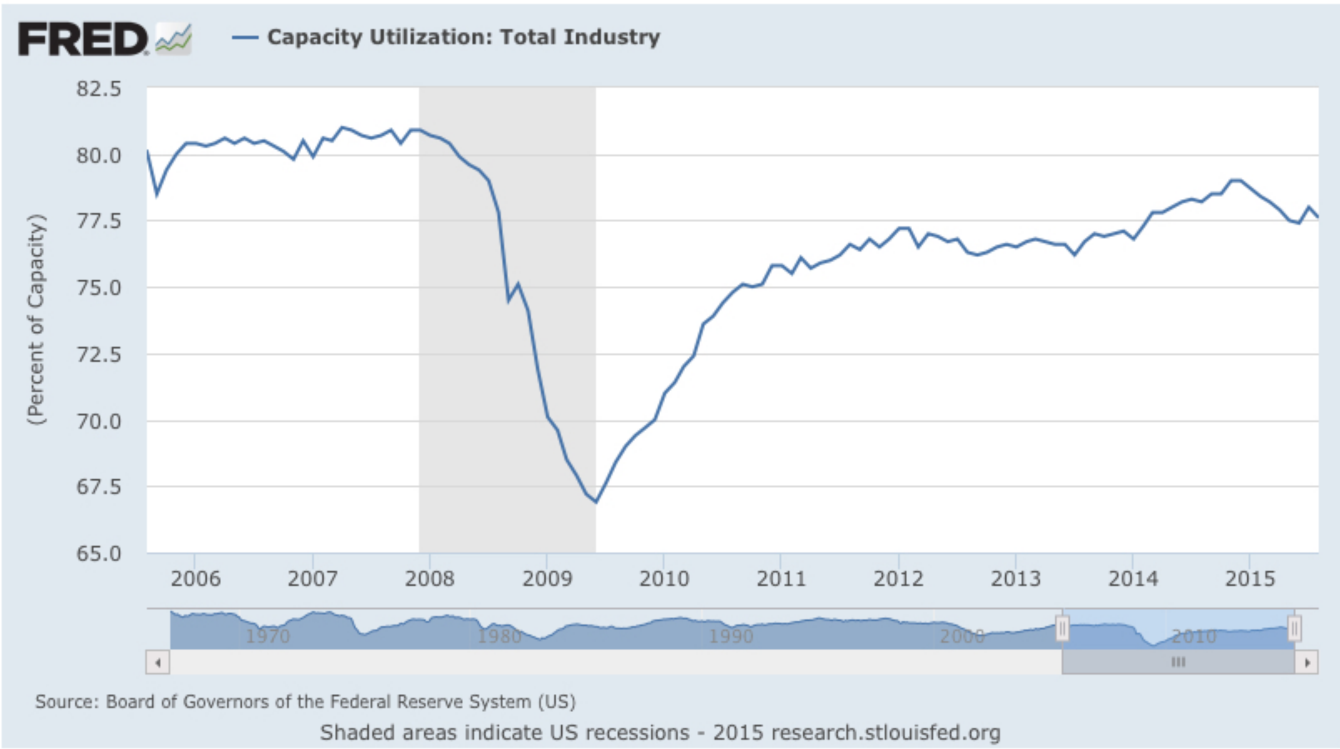
For example, the Industrial production index came in with another decline of -0.4% in September versus expectations of -0.2%, which makes it the 5th decline out of 8 reported figures in 2015. This part of the economy isn't exactly booming.

Capacity Utlization (Source: Federal Reserve)

Period	Measure	Change from Prior
Jan-15	-0.5	-0.5
Feb-15	-0.1	-0.1
Mar-15	-0.2	-0.2
Apr-15	-0.5	-0.5
May-15	-0.2	-0.2
Jun-15	-0.7	-0.7
Jul-15	0.6	0.6
Aug-15	-0.4	-0.4

Capacity utilization, which measures to what degree the economy is taking advantage of its ability to make stuff, was expected to drop from 78% to 77.8%. Instead, it fell further to 77.6%, for the 7th decline out of 8 readings in 2015. This means the U.S. continues to use less and less of its capacity to make stuff - hardly shocking given the wide misses in manufacturing data reported by regional Federal Reserve banks for August.

Taking a bigger step back, we see that capacity utilization is still below the 10-year highs achieved prior to the financial crisis. *While there has been a huge rebound from the 2009 capacity utilization lows, it doesn't yet look to us like this part of the economy is in danger of overheating.*



Overall, the economic data coming in lately has been mixed, giving no clear indication of either excessive strength or an impending recession. The data at right in green was improving and in red, weakening.

Indicator	Period	Actual	Survey	Prior
US Conference Board LEI %MoM	Aug-15	0.1	0.2	0.0
US Michigan Consumer Confidence	Sep-15	87.2	86.5	91.9
US Conference Board Consumer Confidence	Sep-15	103.0	96.8	101.3
US ISM Manufacturing	Sep-15	50.2	50.6	51.1
US ISM Nonmanufacturing	Sep-15	56.9	57.5	59.0
US GDP %QoQ	Q2 T	3.9	3.7	0.6
US Private Consumption %QoQ	Q2 T	3.6	3.2	1.8
US Retail Sales %MoM	Aug-15	0.2	0.3	0.7
US Industrial Production %MoM	Aug-15	-0.4	-0.2	0.9
US Construction Spending %MoM	Aug-15	0.7	0.5	0.4
US Housing Starts %MoM	Aug-15	-3.0	-3.8	-4.1
US Building Permits %MoM	Aug-15	2.7	2.5	-15.5
US New Homes Sales %MoM	Aug-15	5.7	1.6	12.0
US Durable Goods %MoM	Aug-15	-2.3	-2.3	1.9
US CPI %YoY	Aug-15	0.2	0.2	0.2
US Core CPI %YoY	Aug-15	1.8	1.9	1.8
US Core PCE %YoY	Aug-15	1.3	1.3	1.2
US Nonfarm Payroll (Thousands)	Sep-15	142	201	136
US Unemployment Rate (%)	Sep-15	5.1	5.1	5.1
US Participation Rate (%)	Sep-15	62.4		62.6
US Average Hourly Earnings %MoM	Sep-15	0.0	0.2	0.4
US Average Hourly Earnings %YoY	Sep-15	2.2	2.4	2.2

So why do we think the Fed is as nervous as a long-tailed cat in a room with of rocking chairs when it comes to raising rates? Let's look at the last eleven recessions.

Recession	Trigger
1948-49	Fed tightening
1953-54	Fiscal tightening
1957-58	Fed tightening
1960-61	Fed and fiscal policy tightening
1969-70	Fed tightening, GM strike deepens the recession
1973-75	Oil shock, Fed tightening
1980	Oil shock, Fed tightening, credit controls
1981-82	Fed tightening
1990-91	Fed tightening, oil shock, saving and loans crisis
2001-02	End of Information Technology bubble
2007-09	End of housing bubble and Fed tightening

Pretty clear why the Fed might be nervous about raising rates too soon. To further drive that concern home, **September retail sales came in below expectations**, rising a seasonally adjusted 0.1% from August versus expectations for 0.2%. The good news is the increase came from 1.8% month-over-month increase in auto sales. Overall retail sales, when we exclude autos and gasoline, have not grown since January.

On Wednesday, we learned that **U.S. producer prices in September posted their biggest decline in eight months**, at a drop of -0.5%, as energy costs fell for the third month in a row. This mean that the Producer Price Index is now down 1.1% year-over-year as of the end of September – not exactly an argument for the Fed to raise rates based on inflation fears. Wednesday we also learned that **U.S. total business sales also declined**, down -0.58% month-over-month and down -3.09% year-over-year as of August.

Thursday two different regional manufacturing measures **showed sharp slowing in the Northeast industrial sector** with the Empire State manufacturing index deep in negative territory for the third consecutive month, a first since the depths of the Great Recession. Similarly, the Philadelphia Fed's manufacturing index was negative for the second consecutive month. On a national level, the Institute for Supply Management manufacturing index has slowed from a peak of 58.1% in August to 50.2% in September – anything above 50 represents an expansion.

The tough thing now is that with a Fed that can't seem to make up its mind, investors are left wondering what to do, so the end up selling the good and the bad when they get nervous. **This will make for increased volatility, but that also means more opportunities for those that keep focused on the goal and don't get distracted by shorter-term market dramatics.**

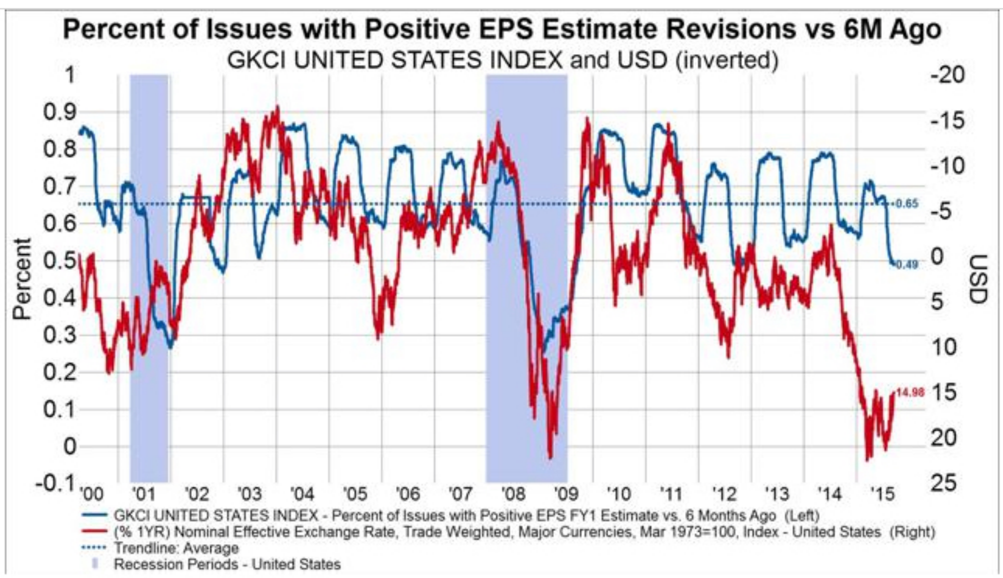
Global Economy (In Brief)

Earlier this week we learned that China's economy continued to soften in September, with imports dropping 17.7% year-over-year, accelerating August's decline of 14.3% year-over-year. This was the 11st continuous month of declines. Last week we learned that Germany industrial production decline 1.2% in August and factory orders fell 1.8%, with a good portion of the pullback being blamed on the weakness in China.

We also learned this week that Japan's industrial output unexpectedly fell in September, raising concerns that the nation may be slipping back into another recession. Production decline 0.5% in August following a 0.8% decline in July versus economists' expectations for a 1% gain. Inventories rose 0.4% in August over July, and expanded in five of eight months this year, which is a hindrance to future growth as with rising stockpiles of unsold goods, companies are less likely to expand output in the future.

We also just learned this week that Saudi Arabia has plans to cut its oil prices to Europe, which is good news for that region with respect to input costs, but will put further pressure on an already beleaguered Russia as it also sells oil there.

Earnings Season



Looking at the trend over a longer period of time, the chart at right shows that the level of positive revisions, (blue line) is low by historical standards. This chart shows that companies are finding that they are able to earns less than they had anticipated with every quarter.

Even more telling, not one sector has a positive revisions ratio. The best is utilities, which managed to net out even on upward versus downward revisions. Even more concerning is the rate of negative revisions has been accelerating since the start of September.

Add in that historically, (according to research from Bespoke) the latter part of September has seen negative returns across all sectors, on average, with the one exception of Consumer Staples, which has a median return over the past 10 years of 0.1%. All other sectors have experienced negative median returns with reliable consistency, as the percent of times they are positive is less than 50%. For example, Energy has generated positive returns only 20% of the time, (with a median return of -1.9%) and technology only 30%, (with a median return of -1.4%).

As we look towards reporting for the third quarter, which has kicked into gear this week, remember what we've experienced so far this year. **Revenues for companies in the S&P 500 have been declining all year**, dropping 2.9% year-over-year in the first quarter then 3.4% in the second and now they are expected to drop by around 3.4% in the third quarter, according to FactSet. The last time year-over-year revenues declines two quarters in a row was in 2009, during the Financial Crisis.

According to S&P Capital IQ, as of October 15th, **aggregate S&P 500 earnings are expected to decline 5.07% year-over-year, the first decline in earnings growth since the fourth quarter of 2009**. Three sectors are expected to be responsible for the drop in earnings, with the energy sector declining -65.9%, Materials down -19%, and consumer staples down -2.3% while utilities, information technology, and industrials are expected to be close to flat. Consumer discretionary is expected to lead earnings, up +11.9%, with telecommunications next at +9.6% and healthcare following at +7.4% and financials at +3.1%. If we exclude the energy drag on earnings, S&P 500 EPS growth is expected to be about +3.0%. Of the 47 companies that have reported so far, 33 have beaten analysts' estimates, 10 missed and 4 met for a 70% beat rate which is above the long-term average of 66%.

Putting it all together, it looks like we'd need an expansion of P/E ratios to get this market moving appreciably higher given current earnings expectations and the currently above historical average P/E ratios; the S&P 500 is trading at 16.6x forward 12-month price-to-earnings ratio, which is above the 16.0x fifteen-year average. That said, making dramatic moves in any particular direction under the current conditions is likely to do more harm than good. We'll be burning the midnight oil and likely consuming excessive amounts of coffee as we work through all the data that will be coming in from companies reporting in the coming weeks.

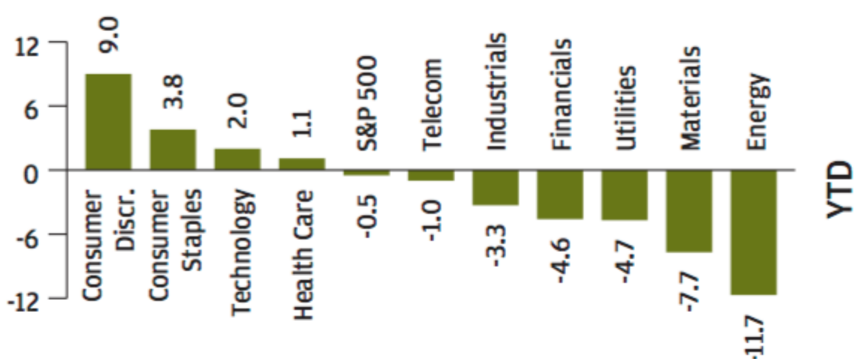
Your Money with Greg Tull

Two words, embrace volatility. We've had conversations today with two of the private alternative investment managers (hedge funds) that we work with. Both used the words embrace volatility at some point in the conversation. What they mean is, for skilled active managers, times of downside volatility such as this August and September present them with opportunities to buy the shares of excellent businesses at better prices. Talented active mutual fund managers are doing the same thing. For investors with index fund (ETF) portfolios, there is an analogous opportunity. Periods of downside volatility provide opportunities to "pick your spots" and lower the average price of each of your long-term ETF positions. There are several sources of cash that can be used to average down the price of your index fund and ETF positions. These include cash that you have had on the sidelines, investments that you've decided to prune from your portfolio for valid (non-emotional) and well analyzed reasons, additional cash that you have to put to work (either from income or liquidity events), and rebalancing from other parts of your portfolio such as your bond positions that likely held up well in the recent stock market selloff.

Market Recap

(as of October 9th, 2015)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	2015	3.30	5.01	-0.54	6.68	48.94
Dow Jones 30	17084	3.77	4.96	-2.26	5.10	36.30
Russell 2000	2896	4.61	5.90	-2.28	10.58	46.57
Russell 1000 Growth	646.25	2.64	4.51	2.90	10.23	54.12
Russell 1000 Value	598.84	4.00	5.57	-3.88	3.41	45.60
MSCI EAFE	1758	5.36	6.94	1.69	1.37	27.29
MSCI EM	859.32	6.92	8.55	-7.97	-12.35	-6.22
NASDAQ	4830	2.62	4.58	2.90	11.61	63.69
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.33	-0.27	0.05	1.18	2.02	5.41
U.S. Corporates	3.40	0.00	0.29	0.19	0.64	6.87
Municipals (10yr)	2.15	-0.25	0.07	2.19	2.73	9.36
High Yield	7.81	2.72	2.15	-0.36	-1.59	12.73
	Levels (%)					
Key Rates	**10/9/15**	**10/2/15**	**9/30/15**	**12/31/14**	**10/9/14**	**10/9/12**
2-yr U.S. Treasuries	0.65	0.58	0.64	0.67	0.46	0.25
10-yr U.S. Treasuries	2.12	1.99	2.06	2.17	2.34	1.74
30-yr U.S. Treasuries	2.94	2.82	2.87	2.75	3.07	2.93
10-yr German Bund	0.61	0.51	0.59	0.53	0.86	1.47
3-mo. LIBOR	0.32	0.33	0.33	0.26	0.23	0.35
3-mo. EURIBOR	N/A	-0.05	-0.04	0.08	0.08	0.22
6-mo. CD rate	N/A	N/A	N/A	0.27	0.27	0.35
30-yr fixed mortgage	3.99	3.99	4.08	4.04	4.30	3.56
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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