MONTHLY INVESTMENT OUTLOOK

IN THIS ISSUE

You can read more from Lenore Elle Hawkins at TheStreet.com where she publishes articles individually and along with co-author Chris Versace, (not affiliated with Meritas Advisors) or at her blog, EllesEconomy.com. Lenore and Chris have also written Cocktail Investing, which will be released in 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 and Friday mornings on America's Morning News, click here for local stations.

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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:
As we head into the end of the year, I thought it would be useful to take a step back, see where we are in the big picture of it all and discuss what I think is likely to happen in 2016. In this month's newsletter I will attempt to breakdown what you've seen in the headlines and translate it all into what it means for investors. *Lenore Elle Hawkins, wishing you and yours much love, laughter and peace.*

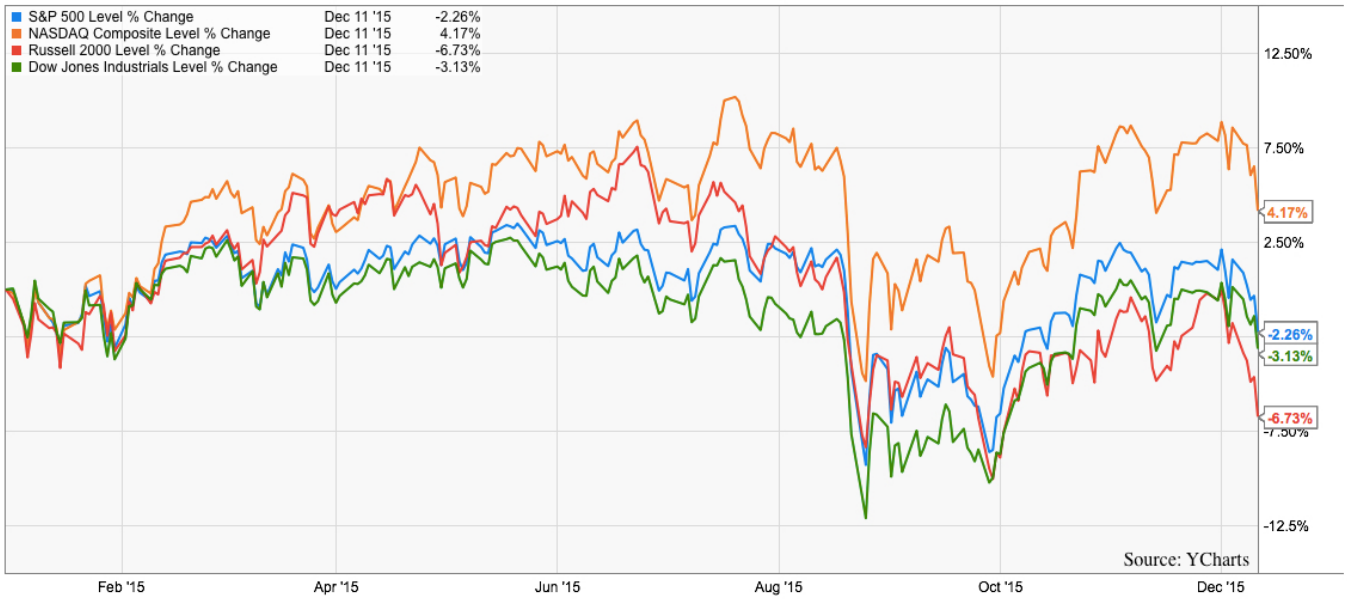
Market Update

The markets closed November mostly in the red, with the one exception of the small cap Russell 2000, which rose 1%. *By December 17th, the S&P 500 had moved back and forth across the flat-for-the-year mark 27 times, the most in history*, with all of the major indices as of the 17th down for the year except the NASDAQ which is up 5.6%; talk about a lot of sound and fury signifying nothing! Part of this movement can be attributed to the world's major central bankers, whose signaling to the markets has become increasingly convoluted. The lack of clarity and instability is serving as a headwind to longer-term growth as market participants, wary of the lack of visibility, operate in more of hunker down mode. In the U.S., the market is unclear as to what the Federal Reserves will do over the coming months and why; economic conditions are weaker now across a broad range than just six months ago, yet the Federal Open Markets Committee (FOMC) chose Wednesday to raise rates by 0.25%. On the one hand, well done as they'd been forecasting a hike for quite some time, on the other, odd timing given the various signs of weakening.

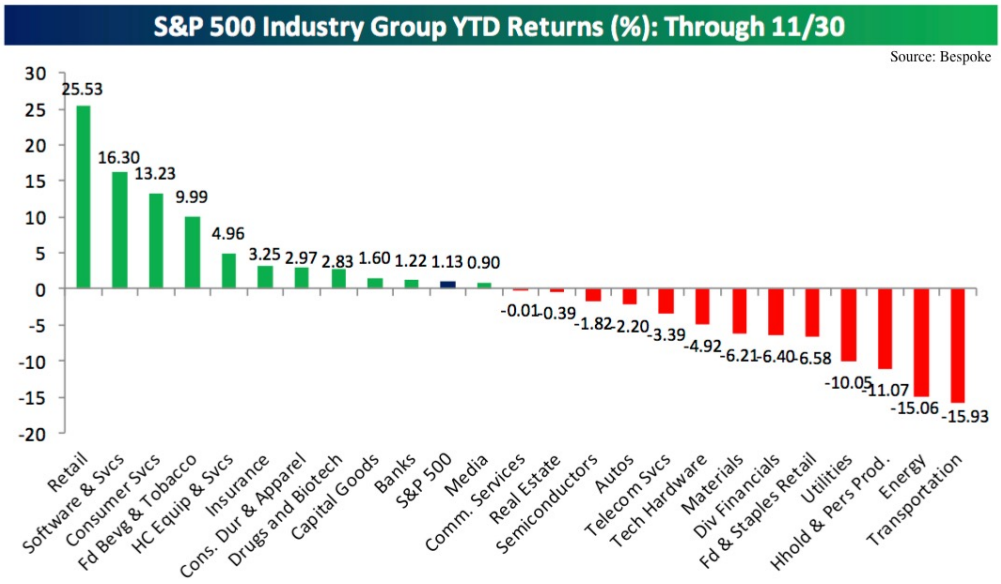
The markets demonstrated just how much they depend on central banker largess on December 3rd, when both the Dow Jones Industrial Average and the U.S. Dollar Index experienced their biggest one-day declines since 2009 when the European Central Bank (ECB) cuts its main interest rate by less than expected.

That move was then reversed in a joyous move to the upside Friday December 4th, when ECB Chairman Mario Draghi assured the markets that the ECB could and would do much, much more as needed. A sigh was heard around the world and equities rebounded. I suspect a little chitchat had ensued between the ECB and the Fed, with the ECB agreeing to give the Fed some wiggle room by not weakening the euro as much as it could have had it lowered rates even more.

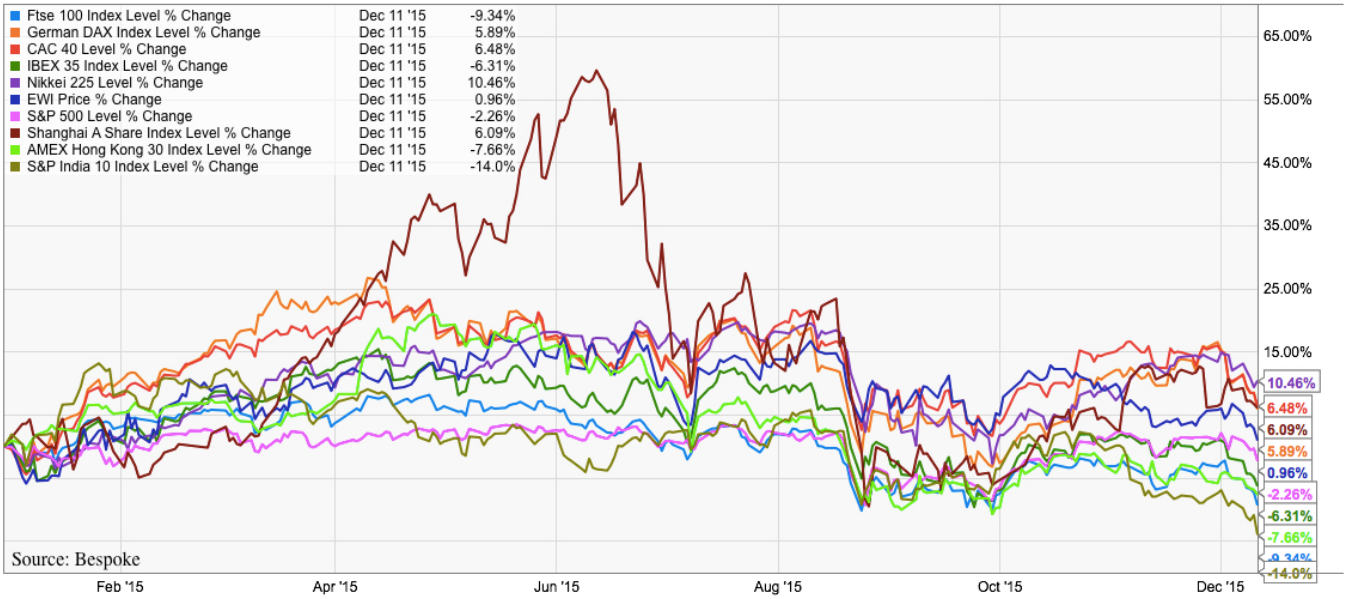
Last week the down-trend resumed, with the S&P 500 falling nearly 4% over the week and dropping below both its 50-day and 200-day moving averages with an RSI (Relative Strength Indicator) signaling the index is in oversold territory. This move was precipitated by problems in the high yield, (junk bond) market, which finally hit a tipping point. *The markets have also been heavily influenced by just a handful of high-fliers, with FANG (Facebook, Amazon, Netflix and Google) accounting for 3.6% of the S&P 500's return for 2015 as of December 11th.*



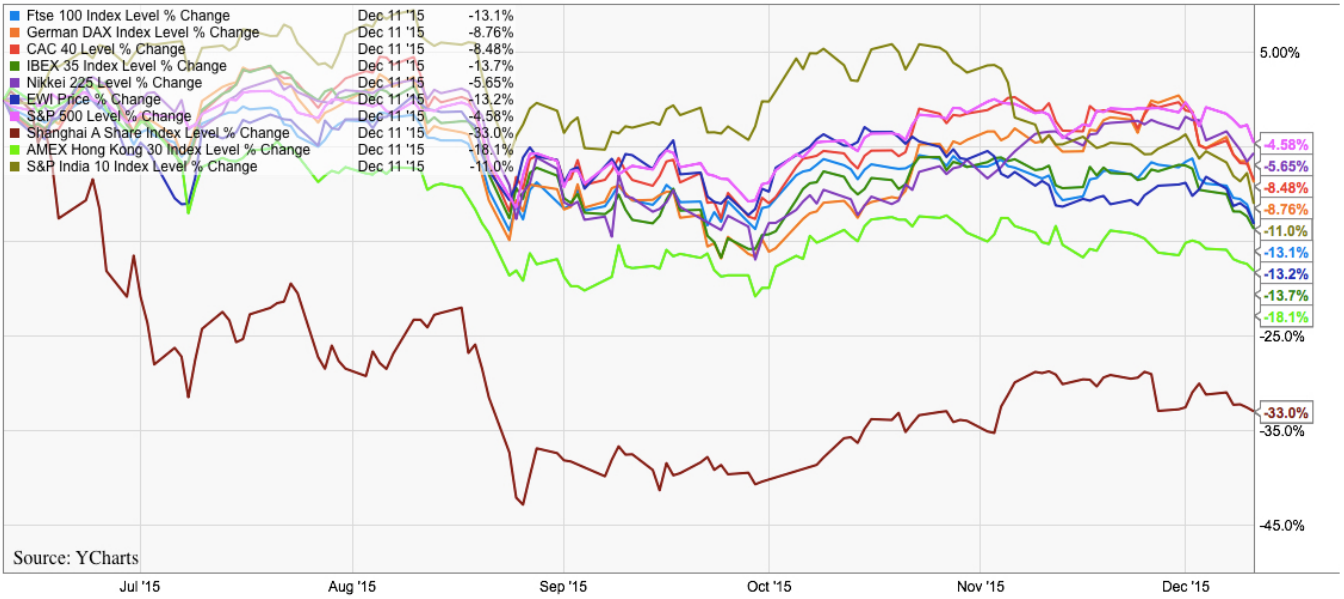
Looking at sectors through the end of November, there is a rather wide divergence in performance, with Energy and Transportation unsurprisingly the worst performers. Looking a bit deeper into heath care, the Biotechnology sub-sector is on track for its worst performance in five years, presenting a challenge for the Nasdaq which has benefitted greatly from many of the biotech high-flyers in yet another example of why it doesn't pay to blindly chase the out-performers from prior periods.



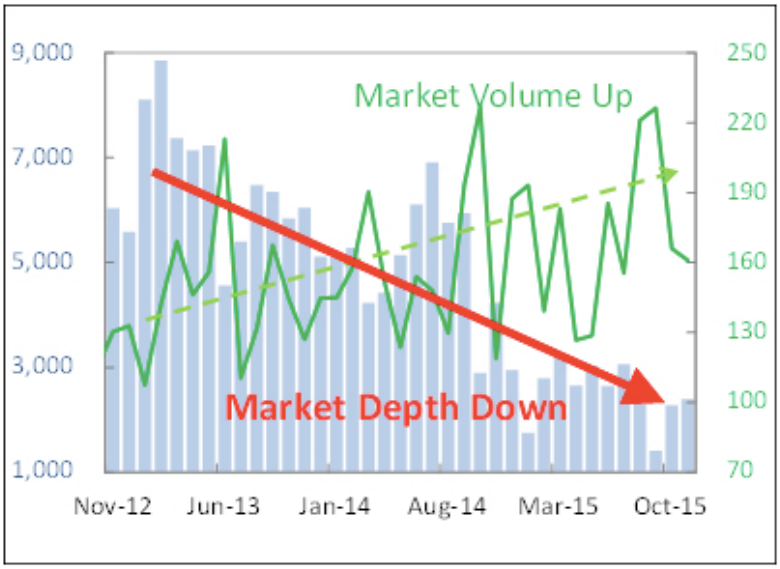
On a global perspective, Germany, France, Japan and China are still in positive territory in their primary indices year-to-date, while most of the rest of the world is flat to negative.



However, *all major global indices are negative over the past six months*.



We've also seen a *trend towards lower levels of market liquidity*, as is evidenced by decreasing depth. Market depth measures how many forward contracts can be bought or sold before the market moves approximately 1 point. If over time it takes fewer participants to move the market by the same amount, market depth is declining. Over the past two years, as indicated in the next chart, market depth has declined by over 60%. This means the market is less able to handle large shocks. When a surprise hits the markets now, there is a more dramatic response than there would be with greater levels of liquidity.



Source: J.P. Morgan QDS, Bloomberg.

As I mentioned earlier, the major move downward last week was driven in large part by the problems in the high yield markets reaching a tipping point. On Thursday, *Third Avenue Management announced that it is liquidating its $1 billion Focused Credit junk bond fund* (ticker symbol TFCVX) and will be blocking investors from redemptions in the process. The fund's collapse marks the biggest failure in the U.S. mutual fund industry since 2008. The fund lost 27% so far in 2015 and has seen its assets under management decline by about 2/3rd over the past seven months.

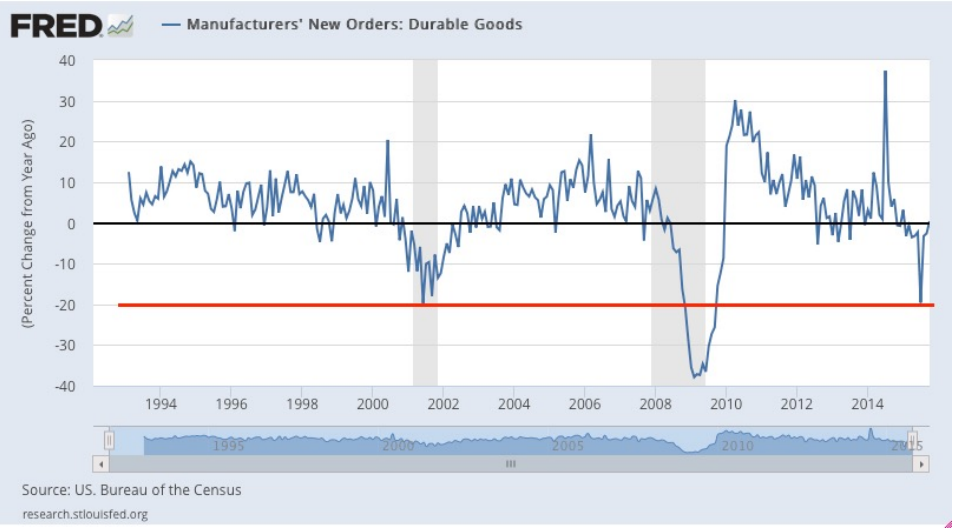
The pain spread to other parts of the high yield world, with HYG iShares iBoxx USD High Yield Corporate Bond Fund (HYG) and SPDR Barclays High Yield Bond Fund (JNK) suffering their worst one-day performance in four years. The plunge in high yield has been kicked off by pain in the oil and commodity sectors, such as steel, which I'll look at further later on in this piece. For those who keep their wits about them, all this pain will result in an abundance of opportunities. Howard Marks, Chairman of Oaktree Capital, recently remarked that opportunities to purchase distressed debt have not been this good since the period following the collapse of Lehman Brothers in 2008.

Bottom Line: *December is typically a strong month for equities, but so far this one hasn't fallen in line. Traditionally, the second half of the month is the strongest and with most of the indices now in oversold territory, a late Santa rally is certainly possible, although with the current market fundamentals, I think it improbable. The Fed's rate hike decision on December 16th coupled with the strains in high yield bond market will make it more expensive for companies to issue debt, which means less funds available for share buybacks. Those buybacks have provided an awful lot of price support for stocks, support which is likely to wane.*

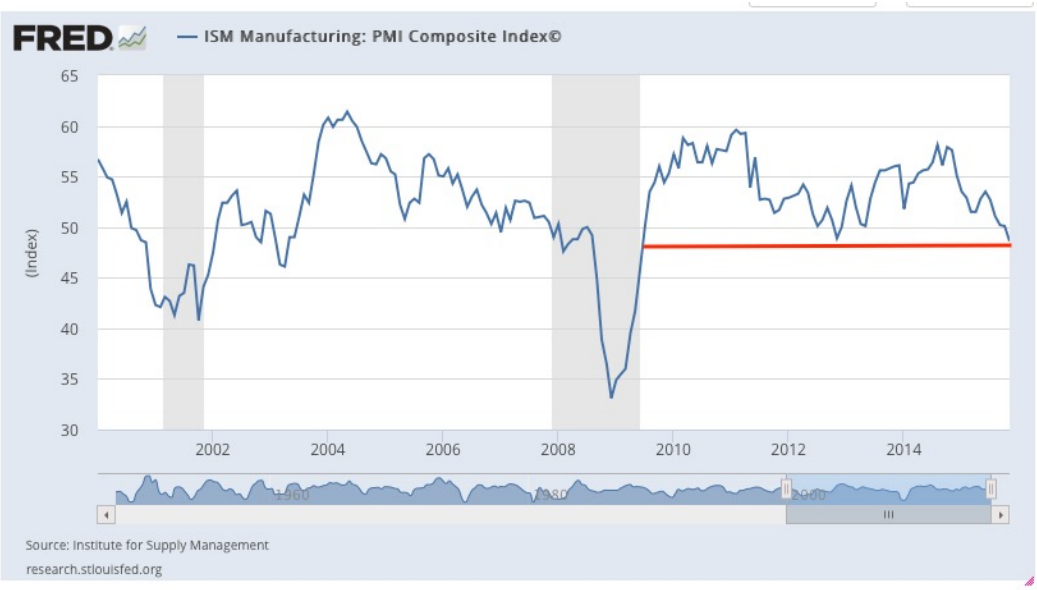
US Economy

The US economy has been showing signs of weakness lately, which made the Fed's decision to hike rates on Wednesday a bit of a head scratcher. In early December Citibank announced that given the turn in corporate profits and concerns over margin sustainability, it had raised the probability of a recession within the next year to 65%. Shortly thereafter JP Morgan put the probability of a recession within three years at 76%.

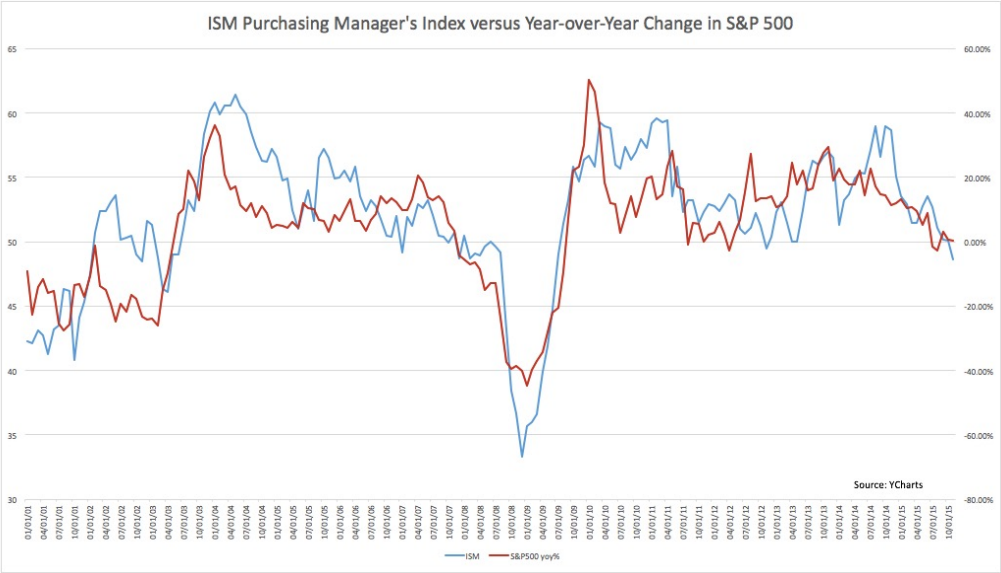
Durable goods orders have recently been at levels not seen outside of a recession.



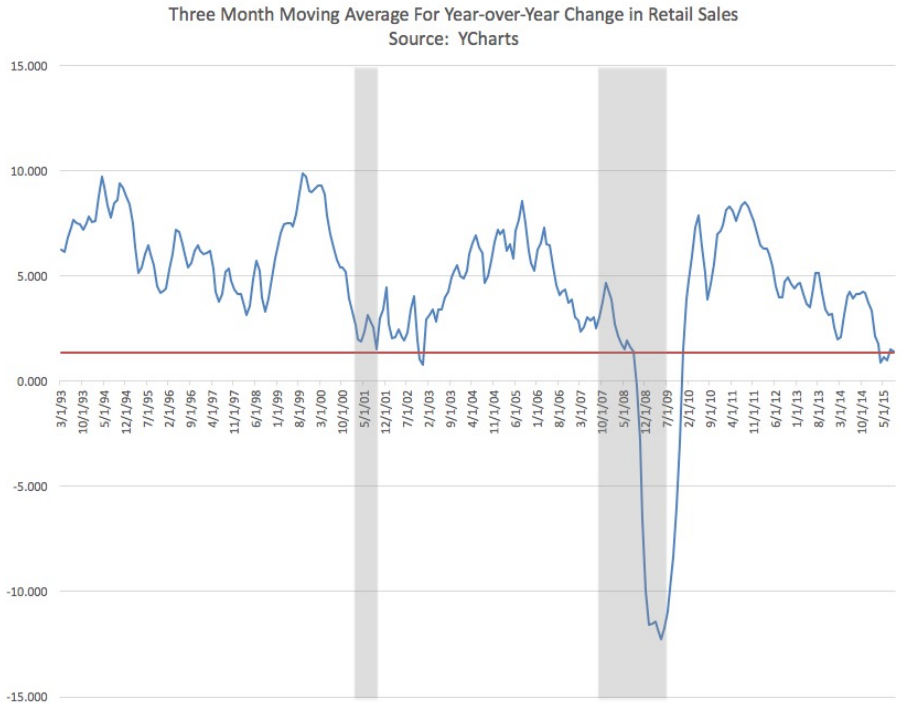
ISM Manufacturing PMI Composite Index just moved into contraction territory and is at its lowest level since June 2009. This is an index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.



When this data came out, many claimed that in the more service-oriented domestic economy, it can be disregarded because manufacturing has become a smaller part of the U.S. economy over the years. That is true, but there is also a strong correlation between the PMI index and the S&P 500, as is evidence in this next chart. Manufacturing itself may be a smaller portion of the economy, but it is still meaningful. This is all about probabilities, so I like to look at a wide range of data points to develop a perspective, this is a metric that many ignore, but to me looks like a fairly reliable indicator.



Retail sales have also been flashing warning signs, with the three month moving average of year-over-year changes in retail sales at levels not seen outside of a recession. I use the three-month average because retail sales are notoriously volatile on a month-to-month basis, materially affected by seasonal events such as Valentines Day, Easter, back-to-school and the holiday season.



If we also look at the economic cycle length, we can see that the economy is likely in the later stages of this business cycle, as we are 78 months from the last trough.

Length of Economic Cycles 1902–2009 from the United States National Bureau of Economic Analysis

Peak month	Trough month	Duration, peak to trough	Duration, trough to peak	Duration, peak to peak	Duration, trough to trough
September 1902	August 1904	23	21	39	44
May 1907	June 1908	13	33	56	46
January 1910	January 1912	24	19	32	43
January 1913	December 1914	23	12	36	35
August 1918	March 1919	7	44	67	51
January 1920	July 1921	18	10	17	28
May 1923	July 1924	14	22	40	36
October 1926	November 1927	13	27	41	40
August 1929	March 1933	43	21	34	64
May 1937	June 1938	13	50	93	63
February 1945	October 1945	8	80	93	88
November 1948	October 1949	11	37	45	48
July 1953	May 1954	10	45	56	55
August 1957	April 1958	8	39	49	47
April 1960	February 1961	10	24	32	34
December 1969	November 1970	11	106	116	117
November 1973	March 1975	16	36	47	52
January 1980	July 1980	6	58	74	64
July 1981	November 1982	16	12	18	28
July 1990	March 1991	8	92	108	100
March 2001	November 2001	8	120	128	128
December 2007	June 2009	18	73	81	91

1854–2009 (33 cycles)	17.5	38.7	56.4	56.2
1854–1919 (16 cycles)	21.6	26.6	48.9	48.2
1919–1945 (6 cycles)	18.2	35.0	53.0	53.2
1945–2009 (11 cycles)	11.1	58.4	68.5	69.5

Source: National Bureau of Economic Research

On Friday December 11th, we learned that November retail sales were weaker than expected, marking the twelfth consecutive month that sales were below expectations. The miss was driven by declines in auto and gas station sales. Over the past year, we've seen declining purchases at gas stations, for clothing, electronics and appliance but we do seem to be going out more as sales at bars and restaurants are up, as are motor vehicle and parts dealer sales. Overall though, retail sales are not painting a very robust picture relative to typical growth, but given weak wage growth, this isn't surprising.

Retail Sales By Category (% of Total Sales) 1-Yr Change

Source: Bespoke

Category	Current	One Year Ago	Change
Motor Vehicle and Parts Dealers	20.91	20.38	0.53
Food and Beverage Stores	12.77	12.68	0.10
General Merchandise	12.77	12.65	0.12
Bars and Restaurants	11.82	11.24	0.58
Non Store	9.29	8.78	0.51
Gas Stations	7.69	9.74	-2.04
Building Materials	6.22	6.17	0.05
Health and Personal Care	5.94	5.82	0.12
Clothing	4.76	4.81	-0.05
Miscellaneous	2.23	2.21	0.02
Furniture	1.96	1.88	0.08
Electronics & Appliances	1.95	2.03	-0.07
Sporting Goods	1.69	1.63	0.06

Many have been looking at housing starts claiming these indicate rebounding strength in the housing market, but I like to look a bit further as I suspect there is more to the story. In fact, according to the National Association of Realtors, *first-time homebuyers make up just 32% of all purchasers*, lowest level since 1987! If we look at the typical first-time homebuyer, Millennials, it isn't tough to see why. This group is saddled with unprecedented levels of student loans and have been facing one of the toughest job markets in decades. Yes, unemployment levels have been improving, but the mix of new jobs for these younger workers is skewed towards lower paying ones. They have lots of debt and are getting paid less than prior generations early in their careers, making it exceptionally hard to put together a reasonable down payment. Meanwhile home prices have been rising faster than median income levels thanks in large part to low inventory levels, making that first home more and more out of reach. This means that many *Millennials are effectively cut off from what has traditionally been a solid path to building wealth in America*, which will have long-term consequences as the senior generations look to downsize their homes, or their heirs look to sell their inherited residences.

Bottom Line: *While some parts of the economy are still looking decent, like employment, there are more concerning signs of underlying weakness, which is reasonable given that we are in the later phase of the business cycle. We've already experienced three consecutive quarters of declining year-over-year revenues and two consecutive quarters of falling year-over-year earnings for the S&P 500, which makes specific security selection all the more important as the market in aggregate isn't likely to grow dramatically in the near-to-mid term.*

The Big Picture

Looking out into the future, markets and economies will be driven in large part by a few major forces:

- Falling Oil Prices
- Crashing Prices and Excess Capacity in Commodities
- Diverging Monetary Policies and the Strong Dollar

Falling Oil Prices

Last week oil fell to $36/barrel, going below $40 for the first time in six years. Earlier in December OPEC had its final meeting for the year, and at this point I think it is fair to say OPEC has become completely irrelevant. *A cartel that has no ability to control the production of its members is no cartel.* OPEC can't control its members because Saudi Arabia already learned its lesson in the 1980s, when it cut production in response to falling oil prices and ended up mostly just losing market share. Other nations paid attention. On top of that, these countries' budgets are in dollars, as oil is priced in dollars, and they need to keep up their spending in order to maintain control over their citizen - the perpetual challenge for countries in which the primary source of national income is owned by the State.

So why are oil prices falling? Simply because *while demand is growing, it is growing at a slower rate than supply*. The high oil prices from years ago combined with the Fed's ZIRP (Zero Interest Rate Policy) and technological breakthroughs in oil extraction technology, led to an influx of investing in oil production capabilities which was funded in part by a lot of high yield debt. As the price of oil continued to fall, many of the companies have found themselves in violation of debt covenants. This is leading to rising defaults, (although the default rate today in aggregate is not at historically high levels) which then leads to tightening of credit conditions as lenders are forced to rebalance their lending portfolios. This make conditions even more challenging on these distressed firms, as credit is increasingly less available, which will eventually lead to bankruptcies for many of the more highly-levered firms. We saw a similar pattern back in the financial crisis as the real estate investing boom blew up in spectacular fashion when borrowers were unable to refinance on major portions of their real estate portfolios, even on properties that may have had more than 50% equity, resulting in a complete wipeout of their clients' invested capital in those properties.

The good news for investors is that this is also reminiscent of the heady days of the Dotcom boom when all the rage was broadband infrastructure, with high-fliers such as Global Crossing, which eventually flamed out in headline grabbing bankruptcies that wiped out most debt and equity holders alike. However, that led to the ability for those that survived the carnage to be able to pick up that infrastructure for pennies on the dollar, leading to materially lower broadband pricing, which facilitated the next wave in the Internet evolution. I think oil is likely to experience something similar, with those companies that have healthy balance sheets being able to pick up production capacity at pennies on the dollar, greatly improving their overall margins and providing the economy with lower-cost energy into the future, which will be a much appreciated tailwind. For now, I think it best to avoid this sector, but at some point in the near-to-mid future it will provide spectacular opportunities. This lower-price oil will also be a fantastic boon to those emerging economies that are big energy importers, helping their economies grow at a faster pace than was previously possible, providing investors with yet another great opportunity. U.S. lawmakers are also expected to lift the ban on oil exports as part of the current spending bill legislation, which will provide additional support for domestic producers.

For now, the defaults and struggle in oil will be a strain on the overall economy. For those who point out that oil and gas drilling accounts for only around 4.6% - 6.5% of GDP, residential housing makes up around 5% of GDP and we all recall just how much damage excessive investment and use of debt in that sector did.

Crashing Prices and Excess Capacity in Commodities

Commodity prices have been falling for years, with the CRB commodity index down 21% from just its May 2015 highs. An entire book could easily be written on this topic, so I'll narrow it down to just a few illustrative points in the interest of preserving your sanity! The last major commodity super-cycle began when China was allowed entrance into the World Trade Organization. Thanks to the enormous shift in its population from rural agrarian to industrial manufacturing, it was able to supply the world with cheap labor, which meant cheaper products for exports. The money it took it was funneled into gobbling up commodities to use in its eye-popping infrastructure build out; for example, China accounts for about half of the world's aluminum consumption.

During and after the financial crisis, the world greatly benefited from China putting its pedal to the metal on its infrastructure build out, effectively creating a floor under commodity prices and protecting commodity producers from what would have been a much more painful fall without China's purchasing. To put in it context, in 2009, with the markets crashing, oil stood around $100/barrel and steel plate was at $600, today oil has fallen below $40 and steel is at $260.

Today China's steel production capacity is around 400 million tons a year, which is nearly four times the U.S.'s capacity at 120 tons. With China's slowing economy, and more importantly rapidly slowing infrastructure build, it has more and more excess capacity. China's steel consumption is declining for the first time in two decades, with the nation's steel sector experiencing layoffs in the tens of thousands. Year-to-date the one hundred largest steel companies lave lost around $11 billion with 37 steel plants closing so far.

Most of China's excess capacity cannot be shipped to the U.S. as it is of lower quality and is barred by tariffs, but it can go to Europe where prices are crashing and has caused quite the crisis in the U.K. European players have been forced to continually lower prices and unlike China, they can export to the U.S.; despite the tariffs, U.S. steal producers cannot be totally insulated.

Many of these steel and oil mid-cap companies have "crossover" bond ratings, which means they are in-between investment grade and junk status, (BBB and BBB-). All it takes is one little nudge and they will be in junk territory, which means then that the funds that hold them will have to rebalance their portfolios which in turn affects the credit market as a whole. Here too, those producers that maintain healthy balance sheets and do what they can to raise cash, will be able to goggle up bankrupt production capacity at below-cost, lowering their margins and allowing for lower cost steel into the future, which will help not only domestic users, but will be particularly beneficial for those emerging market, commodity importing nations. While I've only talked about oil and steel in depth here, similar dynamics have and are occurring in other commodity markets across the globe.

Diverging Monetary Policies and the Strong Dollar

The strong dollar continues to be one of the most common problems cited by companies in their quarterly reports. So what does it mean, why is it happening and is it likely to continue to strengthen?

The dollar began strengthening when the Federal Reserve first pulled back on its quantitative easing programs. This directional shift marked the first step. Then it ceased quantitative easing altogether, whilst other nations continued or even accelerated their programs. Now the Fed has raised interest rates, which further strengthens the dollar against other currencies. As other nations around the world engage in stimulative monetary policies, the dollar will further strengthen against them.

Commodities are globally priced primarily in dollars. I just walked you through falling oil and steel prices and as those prices have fallen, dollars have essentially been disappearing into thin air. By that I mean, imagine you have drilled an oil well or built a steel plant. When you did so, you forecasted a certain productive capacity that would result in a dollar value of sales based on an assumption of price. Falling prices have cut your expected sales enormously, meaning dollars you expected to have in your pocket will never show up. This means that your investors and/or creditors are not in the same position they expected to be – you don't have the dollars you were expected to have, so no wonder there is an increased demand for dollars.

This brings us to the $9.5 trillion dollar carry trade which I've talked about before in the October 2014 issue, where I explained how the carry trade works, and again in August of this year. The higher the dollar goes, the greater the demand for dollars to pay back that dollar denominated debt. If we look at history, there are two main dollar bull markets. The first one was in the 1980s that only ended after the world's central bankers got together in the Plaza Accord to weaken the dollar after it had risen about 100%. In the late 1990s, we experienced a second bull run which ended in the Asian Crisis after the dollar had appreciated about 50%. During both, the dollar experienced pullbacks, but never of more than 10%, which gives us a potential metric to mark this bull run. Today, we have the largest global carry trade ever seen, which makes the bigger picture look closer to the 1980s. Looking at the data, there is a material probability that the dollar strengthening process could start to accelerate again, which will put more downward pressure on commodity prices. I think being long the dollar and even owning longer-term bonds while either being short or just staying away from the commodity complex would be the wiser move here. (Hat tip to Raoul Pal of Real Vision Television for some of the research on the dollar bull runs.)

As for longer dated bonds, if the Fed continues to raise rates and the economy is in fact slowing and the rate hikes weaken the economy further, then growth expectations will slow which will cause longer-dated bond yields to drop and bond prices to rise. If the Fed continues to raise short-term rates, an inverted yield curve, (in which short-term rates are higher than long-term rates) is possible, which would be very damaging for banks as they borrow short-term and lend long term. If the dollar continues its rally, demand for bonds will rise as well, which will push up bond prices and push down bond yields. Bond prices could however get hit if the Fed hikes, but hikes much more than is expected, which given the reasonably dovish commentary Wednesday, currently seems unlikely.

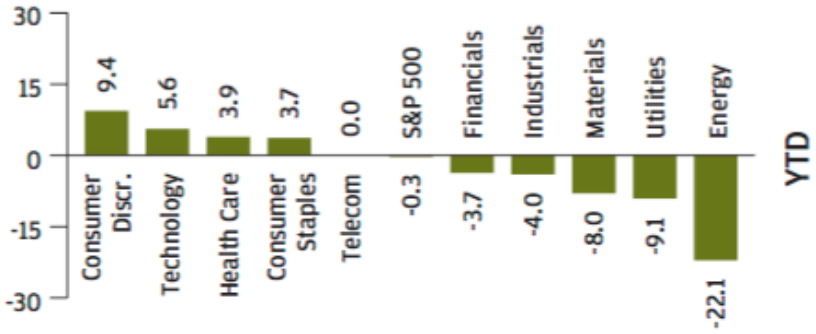
Bottom Line: *We are in unchartered territory in many areas; higher levels of sovereign debt than during the financial crisis, a bigger U.S. dollar carry trade than the world has ever seen, more excess reserves at the federal reserve than ever before, tectonic shifts in global economic power and rising political tensions throughout much of the world coupled with challenging demographic trends, (aging populations) in the U.S., Europe, China and Japan while many emerging economies are blessed with a much lower median age in their populations. Never before in the modern era of high-yield bonds has the Fed hiked rates when the high-yield bond spread was greater than 6.25%; today it is 7%. Over the next decade the "it" places to invest are likely to be economies that were previously not on many investors' radars. We are likely to face some challenging times, but those inevitably lead to wonderful opportunities. 2016 will probably give us some*

Market Recap

(as of December 11th, 2015)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	2012	-3.74	5.29	-0.27	0.96	50.12
Dow Jones 30	17265	-3.19	6.70	-0.72	0.57	40.20
Russell 2000	2792	-5.01	2.35	-5.56	-2.40	40.14
Russell 1000 Growth	652.82	-3.57	5.88	4.25	5.42	56.79
Russell 1000 Value	585.01	-4.05	3.61	-5.67	-4.13	42.61
MSCI EAFE	1690	-2.39	3.08	-1.98	-2.60	17.40
MSCI EM	773.56	-4.75	-2.16	-17.05	-15.94	-18.73
NASDAQ	4933	-4.04	7.06	5.34	6.00	69.40
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.47	0.47	0.04	1.17	1.37	4.92
U.S. Corporates	3.49	0.40	0.42	0.32	0.62	6.12
Municipals (10yr)	2.05	0.54	1.43	3.58	3.62	9.16
High Yield	8.83	-2.35	-2.12	-4.52	-3.53	5.48

	Levels (%)					
Key Rates	**12/11/15**	**12/4/15**	**9/30/15**	**12/31/14**	**12/11/14**	**12/11/12**
2-yr U.S. Treasuries	0.88	0.96	0.64	0.67	0.62	0.24
10-yr U.S. Treasuries	2.13	2.28	2.06	2.17	2.19	1.66
30-yr U.S. Treasuries	2.87	3.01	2.87	2.75	2.84	2.83
10-yr German Bund	0.54	0.68	0.59	0.53	0.68	1.32
3-mo. LIBOR	0.51	0.46	0.33	0.26	0.24	0.31
3-mo. EURIBOR	-0.13	-0.11	-0.04	0.08	0.08	0.18
6-mo. CD rate	0.34	0.35	0.36	0.39	0.38	0.47
30-yr fixed mortgage	4.14	4.14	4.08	4.04	4.11	3.47
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