Chapin Hill Advisors Market Comment 8-26-11

A Focus on Jackson Hole

Will there be a QE3?

The trade is focused on expectations for what Bernanke and company will announce on Friday while meeting in Jackson Hole, Wyoming. At last year's rendezvous, Bernanke made up his mind to add liquidity to the system announcing bond purchases which would begin in November. While the bond purchases did not start until November, the market took off upon hearing the news in August anticipating the QE2 rescue. By the time liquidity hit the market in November, the S&P had risen almost 8.5% from the end of August. While the party continued until the end of April 2011, if you invested in November, you are negative at this point after the market's sell off since May 2nd.

After the Fed's July meeting, Bernanke & Co. announced that they would keep interest rates very low into 2013. This was met with disappointment in the market as many hoped they would do more. Now the focus is on Jackson Hole and hoping that things are bad enough that the Fed may have to act. In fact, a trigger for a big rally this week was the awful housing numbers as the news was so bad that the crowd anticipated a QE3 rescue plan.

The Street is split in predicting both what the Fed should do and what they may do. Many feel the Fed is out of ammunition and have not made any announcements which would lead anyone to think QE3 is coming. Others feel that we are slipping in to recession and Obama & Co. cannot afford to have that happen with one year remaining in Obama's first term. The deficit is weighing on everyone's mind and most people have lost faith in their representatives in the Capital. So extended more money to seemingly help Wall Street would not be met with praise from the average American.

Last week's PPI (Producer Price Index) and CPI (Consumer Price Index) both came in much higher than expected indicating that there is inflation in our economy. Fingers were immediately pointed at the Fed as some feel that all QE2 did was inflate prices and allow the "big boys" on Wall Street to have liquidity to trade and fatten their margins. Once again, Wall Street vs. Main Street!

Here come the revisions….

Friday morning will bring us the latest reading on GDP (gross domestic product) and it may be a disappointment. Revisions at the big houses have begun as Citi, UBS and Goldman among others have revised their outlook, lowering forecasts for GDP. Goldman has revised their expectations twice and have said that they expect the global slowdown to continue. The GDP figure is released before the market open on Friday. It is possible that expectations are "baked in" for a bad number and if it is "less bad" than expected, the market could rally.

It is pretty much the same story with Bernanke....it is possible that enough people think the Fed cannot make a move just now and any indication that they may do something would be regarded positively. No move may just be what the Street "expected" so nothing may happen. But the bad news continues to pile up and a bad number could also trigger another sell off. Too hard to guess and we are hesitant to make any big moves in advance of both GDP and any Fed announcement.

The problem with guidance from many of the large Wall Street firms is that when things turn, they revise their numbers. As we all get hit with so much information, who would remember that Goldman was calling for the S&P to hit 1450 before year end? The S&P closed at 1159 on August 23rd - a long way from 1450!. They have revised that estimate once so far and brought it down to 1400. Deutsche Bank and a few others were predicting even higher numbers for the S&P. There are still four months left in the year so we shall see but if things continue as they have in the last few months, we are likely to see more downward revisions. By the time we get to year end, no one can possibly remember who said what earlier in the year so if they have revised down enough times; they look like they were right.

The same thing could happen with earnings for individual companies. Currently, so many analysts are telling us what a value some stocks are and how the market is trading at such a reasonable PE (price over earnings). But if the "E" of that equation gets lowered the "P" comes down and often faster than you expected. So be careful to place too much faith on current PE's and future expectations.

Europe and beyond....

The economic slowdown can be seen in the Eurozone as well. The total growth for the 17 country zone as of June 30th was only 0.2%. This was a 2 year low. Expectations were 0.3% so not much of a miss however, just three months ago the consensus was for 0.8%. Once again, we saw revisions downward so one cannot remember the rosy expectations which so many of the analysts and economists were spouting at the beginning of the year.

Germany experienced a negative trade balance and a huge portion of their GDP is based on exporting so this is not good. They also had flagging consumption and weak construction. Concerns continue that Greece is not salvageable and any attempt at a joint Euro-bond deal will fail. A good portion of the market jitters has been caused by comparisons to a "Lehman like" failure of a major European Bank. In fact, last Thursday's sell-off (400 points in the Dow) was triggered by news that an unnamed European bank came to the Fed for a $500 million loan. This immediately triggered a wholesale selling of anything financial as everyone now remembers 2008's financial meltdown and collapse of Lehman, death of Bear Stearns and near-death experiences of many of our US banks.

The riots in London have calmed down but the rebels in Libya have stormed Tripoli and are searching for Ghadafi. His camp has been pilfered, his sons are captured and the entire world seems to think that oil will start flowing again from Libya. Oil

initially dropped and then rallied as reality set in. The reality is that it may take years before full output is restored and we have yet to see whether the rebels can put together a cohesive government. Celebratory gunfire can be heard in the background on any news report about the situation and last night, on CNN a reporter told of citizens walking around with metal pots on their heads to try to protect themselves from random gunfire! Glad to be living in the good ole US of A!

Housing Crisis continues...

This past week brought more bad news from the housing market as new homes sales, existing home sales and home starts were abysmal. The average price for a home has dropped from the mid $200 thousand range several months ago to $175,000. Mortgage delinquencies are increasing and the number of people missing one or more mortgage payments has continued to increase as well.

We have 75 million homes in the US and approximately 24 million have no mortgages. Of the remaining almost 50 million, 15 million are under-water. Almost 1/3 of homeowners with mortgages owe more on their home than it is worth! This is a little misleading as there is also a slice - possibly as much as 9% - which are already in or on their way to foreclosure. So the percentage underwater could be much higher. No uptick is in sight.

We experienced a very long (almost 25 years) housing boom and we all got spoiled. Borrow from your home if you were short of cash! Take out a home equity if you wanted to put on that addition, renovate the basement or create a mother in law apartment over the garage. Many used their homes as piggy banks. In fact, I remember in the early 2000's having to really try to get some clients not to take out a home equity and put those funds into the market. So many real estate folks were doing seminars urging homeowners to "free up" some of their value that some people were tempted. It was tough to tell people that a trend which had gone on for so long was coming to a close.

Without an uptick in jobs and the overall employment picture, we are not likely to see any type of rebound in the housing market. All I seem to hear on the radio are commercials urging folks to own investment property. Many feel the rental market will continue to boom as people cannot qualify for a mortgage or cannot afford a large downpayment or they had such a bad experience owning that they do not want to repeat it. Let someone else be responsible for the mortgage and maintenance while you pay rent. This would have been a heresy a few years ago.

Volatility continues....

Last Thursday, the market broke its short string of four up-days to fall over 400 points. Friday was another tug of war with a small trading range but selling accelerated in the last hour and the market lost 172 points. This week started off with a small gain, Tuesday was up over 300 points, Wednesday added 145 points, but then we gave a good portion back as Thursday lost 170 points.

The roller coaster continues and it is hard to keep up, even if you are a professional! This week, we started up big both Wednesday and Thursday. Both days lost value almost immediately but on Wednesday the bulls came in and squeezed the bears who covered their positions, fueling a bigger rally. Thursday was completely different as the morning rally, which was partially triggered by Warren Buffet making a large investment in ailing Bank of America, faded immediately and continued down - over 200 points by midday. An attempt at a rally took place mid afternoon, but the last hour saw selling and we finished down 170 points.

Once again, you have bulls and bears divided. The media will give you a plethora of bulls telling you it's a "once in a lifetime buying opportunity" or dividend stocks will be a "safe haven" where you can weather the storm while collecting some dividends. But the bears think we are going to continue to sell off and head down another 100 points or so on the S&P.

The market never goes in one direction forever. There is a lot of cash on the sidelines and if it is put to work, a fierce rally can take place - and quickly. The robo-traders are still out there and getting more scrutiny. They can trade in a millisecond and apparently account for 40-70% of the volume over the last few years. Once technical levels are hit, they go into action and either buy or sell. So it is really an institutional game if you trade.

It is hard to be a long term investor when you see 15% of your life savings evaporate in a few weeks. So many advisors are bullish and believe in the "buy and hold" approach. That worked in the 80's and 90's, but it certainly did not work in the 60's and 70's or the 20's and 30's. We are convinced that we are in the middle of a long term secular bear market. We just experienced a 2 year bull with 105% return from bottom to top (March 09 -April 11). As of Thursday morning, the Dow has lost almost 7% this month (after a 4% rally this week) while the S&P has lost just about 9% and Nasdaq 10.4%. That brings their year to date numbers negative 2, 6 and 7% respectively.

We feel there is further downside but it may be limited. We are likely to get a rally sometime in the next few weeks. It is possible that the S&P hits 1250 and even 1300. If that happens from current levels (1157) that represents a 9-13% rally. If it happens from 100 points lower, which is possible (1040-1060 on the S&P) then a rally of 19-24% could happen. If that type of rally takes place, many of the buy and hold crowd will be saying "I told you to hold on" and not be prepared for the next leg - which is likely to be down. We also are a nation of "ADD investors" and once things go up, we feel like we are safe and no need to take any action. We have had quite a few pullbacks over the last two years and if you sold into those you missed the next rally. This time could be different!

If we are in this secular bear, the next leg down could be even uglier than the one that we just experienced. In our opinion, buy and hold is out cold! If you do not have the time or risk tolerance to withstand these types of drops, you need to reduce your risk. In that case, any rally should be used to sell out the "weak sisters"

and add some types of hedges in your portfolio.

In 2008, bonds provided protection. It is possible that in this current environment, bonds may not be the safe haven they were in 2008. We may have stagflation happening and we have credit issues everywhere. Just take a look at the meltdown which took place this week in any credit attached to Bank of America. The cost of protection against default skyrocketed as concerns about the bank's viability grew. A prudent approach is to keep your powder dry and be very discriminating about duration, diversification and credit quality in any fixed income asset.

By the time you read this we should know what happened with Jackson Hole but the markets are sure to focus on the next big thing and volatility is not likely to reduce anytime soon. Do your best to remain unemotional. We also prefer to execute a financial plan for new clients to analyze the potential cash flow needs and attempt to prepare for the potential "what-if's" which may befall anyone. We have recently seen too many people who spent their entire life building a wonderful net-worth only to see it jeopardized by a series of events which was out of control of the investor. You cannot control the price of your home or your portfolio however you can take prudent steps to protect both and be sure you do not need to execute any "fire sales."

As always, please feel free to call us with questions or comments.

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Thank you,
Kathy Boyle
Chapin Hill Advisors

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Kathy Boyle, CFP®has over 25 years of experience in national and regional investment banking and brokerage firms. As founder and president of Chapin Hill Advisors, Kathy is an often-quoted financial specialist in print and a regular co-host and guest speaker on television including **CNBC**'s *Power Lunch*, **NBC**'s *Nightly Business News*, **Fox**'s*Your World with Neil Cavuto*and *Business Lunch Hour,* as well as **Bloomberg** radio.