

Chapin Hill Advisors, Inc. Market Comment 10-5-11

Loaded for Bear??

Hitting Bear Market levels...

As a new month and new quarter began, the markets fell across the board. News from Europe was unsettling as Greece's problems remained front and center. Concerns rose that banks would be affected with the debt burden affected both U.S. and foreign share prices. Belgian-French owned Dexia SA tumbled 10% on Monday after Moody's Investors Service announced they were reviewing the bank for a possible downgrade. Dexia is a major player in the \$2.9 trillion market for municipal debt. Fallout from Dexia's downgrade could affect cities and states across the entire U.S. Moody's also downgraded Italy's debt rating by three notches to A2 and indicated it may lower their rating again soon.

The Dow fell 2.4% on Monday, down 16.8% from its April highs. The S&P500 also fell and hit a 19.4% loss since April – a hair's breath away from the 20% decline most analysts consider the definition of a bear market. A global manufacturing index created by J.P. Morgan showed contraction for the first time in 2 years as indexes of industrial output in Japan, Brazil and Europe showed signs of slowdown. This report trumped recent U.S. economic reports showing some pickup in September manufacturing activity, auto sales and construction spending...but all three still remain very soft.

Tuesday started off with major selling as most international indices were down 3-4% and the U.S. initially followed with a loss of 223 points in the Dow by mid-morning. Bernanke was speaking and hope that he would announce some other type of Fed-to-the rescue plan was crushed as he said Congress and the White House should share in any recovery efforts with the Fed.

However, late in the day, the markets reversed sharply as rumors flew that the European leaders were seeking to recapitalize European banks. The markets went from a negative 2.4% to a positive 1.5% in about 40 minutes. It seemed everyone was short and they raced to cover, driving the market up.

So now we will have to see if there is a follow through from oversold levels. If the S&P breaks above 1125 it is likely to continue to 1170 and possibly 1200. But if the markets cannot sustain the upward momentum, we are likely to see 1000 on the S&P before any significant rally takes place.

More Fizzle than Pop....

Apple Inc.'s Tim Cook stepped in to the spotlight for the first time as CEO as they introduced the fifth-generation of the company's smartphone. While the new version adds some features, it physically resembles the older version and doesn't seem compelling enough to make most folks upgrade. At least one technology analyst called it "underwhelming".

Bankruptcy rumors have affected several companies as Eastman Kodak hired law firm Jones Day to explore restructuring options. Real Mex Restaurants, operator of Chevy's and other Mexican restaurants, filed chapter 11. AMR Corps American Airlines is on the brink of filing for bankruptcy protection. Deutsche Bank missed earnings targets and is laying off 500 employees from their corporate and investment banking areas. Morgan Stanley is facing investors' concern that they have a lot of exposure to European debt.

The number of stocks hitting 52 week lows keeps increasing. Greece is now facing massive strikes which are shutting down hospitals, schools and transit across the country as the population rises up against austerity measures. The IMF announced that a capital infusion of as much as \$266 billion was going to be needed to shore up the European banks. It is hard to find good news as volatility increases.

Frugal Shoppers cannot Trade up...

Over the last few years, we saw a trend as consumers traded "down". The Bergdorf shopper went to Nordstrom's and the Target shopper went to Wal-Mart while the Wal-Mart shopper hit the dollar stores. This trend does not seem to be reversing itself as the consumer remains under pressure.

Wal-Mart Stores CEO Mike Duke recently told analysts that paycheck-cycling shopping is more pronounced than ever before. This is the trend of midnight shopping as welfare and benefit checks become available and shoppers making larger purchases shortly after getting paid toward the end of the month.

Retailers and manufacturers are figuring out how to appeal to the "forever frugal" consumer rather than pin hopes on an economic rebound. Some are waiting longer to pass on higher costs while others are reducing package sizes and adding lower price tags. Stores are adding more private label goods as they attempt to have better control over their profit margins.

The trends certainly seem to reflect a more cautious consumer as 75% now shop with lists compared with 45% in 2008. Grocery sales reflect 20% in private brands, up from 15% prior to the recession. And 44% of Americans are now shopping at bulk stores which is good news for Costco, BJ's and Sam's Clubs*.

Costco is expected to report a 10% increase in year over year sales. Costco continues to draw more affluent shoppers whose average household income is higher. They charge annual membership and feature discounted designer jeans and other merchandise in addition to groceries. I know I shop there regularly as I feed the bunnies, guinea pigs and my horses as well as pick up office supplies that are a fraction of the cost of Staples or Office Depot!

Global Deleveraging Continues...

A recent report from Wells Fargo discusses the three phases of deleveraging which will continue to take place. The first phase was in businesses as they underwent restructuring and deleveraging in the early to mid 2000's. We now see businesses with strong balance sheets and lots of cash. In fact, S&P 500 companies now have \$1.12 trillion in cash assets, more than \$310 billion than they had in 2008. Many businesses are finding it attractive to issue new debt at low levels while they reduce older outstanding debt with higher interest rates. The better companies benefit from a low interest environment while the weaker companies continue to face challenges as they cannot access capital.

According to Wells Fargo, we are now facing the deleveraging in both the consumer and government sectors. U.S. consumers were forced to deleverage in the financial crisis. As many accumulated consumer debt over the years and used their homes as piggy banks, they added both credit card debt and home equity loans. Consumers in developed markets are likely to continue to maintain more frugal spending habits and work at paying down their debts.

As our deficit hits all-time highs, States and Local municipalities grapple with reduced income from taxes from all sources and their debt levels become unsustainable. Governments stepped in to attempt to fill the gap in consumer spending to stimulate the economy but now government deleveraging must take place.

This will be a painful process as governments reduce spending, lay off workers and generally attempt to pare their debt. Policy makers will continue to face tough decisions and the flagging consumer and reluctant business owner is not likely to fill this gap.

Earnings Season Arrives...

This month we will begin to get results for the third quarter. While many companies are likely to meet their estimates, the focus will be on what they say about forward earnings and the outlook for the next quarter and following year. Companies would be foolish to stick their neck out and predict better expectations for next year as any miss is a death knell for their stock price.

So it is possible that we see good corporate earnings but a cautious outlook from a number of companies. If that is the case, the weaker forecasts combined with the global slowdown may be enough to drive the markets down to much lower levels. If we do hit the lower levels, we will once again be "oversold" and a year-end rally is likely to develop. So if you have not yet taken steps to protect your principal in the event of a protracted bear market, you may still have an opportunity. As most of you know, we firmly believe "buy and hold" is out cold and a more nimble, thoughtful approach is needed to protect your hard earned savings in this environment.

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

*Source: Zimmerman, Ann (2011, October 4). Shoppers Unable to Trade Back Up. *The Wall Street Journal*, pp. B1, B7

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