

## **Chapin Hill Advisors, Inc. Market Comment 8-1-11**

### **Debt Ceiling Debacle and a Market Meltdown**

#### **11<sup>th</sup> Hour Decision....**

If you were not aware that we have had a crisis over raising the U.S. debt ceiling for the last month, you must have been living on an island with no internet access or media sources! Non-stop coverage of the debate in Washington DC made it front page news. The government would run out of money and have to stop paying some of its bills on August 2<sup>nd</sup> if the debt ceiling was not raised. The members of both the House and Senate took this opportunity to stage political theater and attempt to construct a more balanced budget in concert with any increase in the debt ceiling.

At \$14.3 trillion, our national debt is huge concern for many of us. The government is adding on 40 cents of debt for every dollar it spends. Cuts in spending are critical as well as adding in some type of additional revenue which means more taxes! However, how and what to cut and who to tax has been the crux of the disagreement between the Republicans and Democrats.

The Tea Party refused to add any new taxes and the Democrats wanted cuts on military spending and other items which the Republicans would not buy into so a deadlock took place. The debate went on for weeks and created frustration, anger and general disenchantment with politicians from their constituents. Apparently, the White House interns spent hours answering tweets, emails and phone calls from angry voters. Folks were on hold for 90 minutes to voice their frustration.

At the 11<sup>th</sup> hour on Monday evening, August 1<sup>st</sup> a deal passed the House and on Tuesday afternoon it passed the Senate. However, all the bill really did was to raise our debt ceiling by \$2.4 trillion and cut \$40 billion in spending. With that formula we run out of money again by first quarter of 2013!

#### **Market Reaction...**

The market has reacted negatively, with the major indices each losing about 4% for the last week of July bringing the month to date returns to negative territory. The first week of August initially started out as a “relief rally” and the Dow opened up 130 points in the first 30 minutes. That gain quickly faded and the markets continued down with the Dow losing 265 points on Tuesday. They tried to take it back up on Wednesday and we closed barely positive. But then, Meltdown Thursday arrived and the markets fell dramatically. A virtually bloodbath took place as the Dow lost 514 points – 4.3% in one day! Nasdaq lost 4.57%, S&P 500 was down 4.76% while the small caps really took it on the chin losing 6.42%.

What a difference two weeks can make! Heading in to the last week in July, the Dow was up 9%, Nasdaq up about 7% and S&P about the same. After Thursday's meltdown, the Dow is now slightly negative with a (0.09) year to date return, S&P is (3.42) and Nasdaq is (3.05)%.

Some of the hardest hit sectors were the financials and industrial stocks. There was no place to hide other than Treasuries as stocks of all types got hit.

### **Where do we go from here?**

It is always difficult to predict the market but everyone is always looking for that type of guidance. The problem is that the stock market has broken some key technical levels. Over the last few weeks, you probably heard or read about a "head and shoulders" pattern which had formed in the stock indices – specifically the S&P 500. This is a technical pattern which folks like us who look at charts of stocks and indices use to try to determine the direction of a trend and the depth of any movement.

The pattern is built with three tops with the middle top forming a "head" and the two sides forming the "shoulders". Oftentimes, this pattern can signal a market or stock which is topping. If the "neckline" breaks, meaning stocks plunge below the level that formed the neckline, it generally means that we have further downside to go.

That neckline point was broken on Wednesday when the S&P fell below 1252. Over the last year, the S&P has come down to this neckline several times but bounced and went back up. The most recent was June 2011 when the major indices gave up 6-9% and then rallied off the neckline in the last week of June.

This time however, the S&P has fallen far below this level – in fact the S&P closed today at 1199 today – a full 4.2% below the "neckline". Therefore, any technician is looking for the next levels of support which may be 1164 and then 1140 in the S&P. If they hit those levels, that would add an additional loss of 3-5% on the S&P. We may get some kind of bounce as the markets are what we refer to as very "oversold" after falling for 9 out of the past 10 days. But any bounce is likely to be met with selling pressure and we may see further downside over the next few weeks.

### **Global Slowdown....**

While our debt ceiling debacle was front and center, we all forgot about Europe and their problems. The Euro rallied and the dollar got beat up while the world watched and began to doubt the security of the U.S. China downgraded our debt, Moody's, S&P and Fitch's all threatened to downgrade our debt. Who would ever have thought that the United States government could lose its triple A rating?

While our trauma was taking place, Europe's situation has been getting worse. Italy has been back in the news as their debt to GDP is huge and yields on their bonds have skyrocketed. There is not enough money in the IMF to rescue Italy on top of Greece, Ireland, Portugal and Spain.

GDP in the U.S. was reported for the first half this week and missed expectations by a mile. Growth was only 1.3% through June with expectations of 2.2%. However, what gets lost in all the data is that the consensus for this report in May was 3.3%. We have shaved off 2% from

expectations just two months ago and it is not just us. We are seeing a global slowdown. And it is likely to get worse before it gets better. Consumer sentiment is down, spending is down, the manufacturing reports this week indicated slowing growth as well. Not a pretty picture and stocks need growth in order to go higher.

### **Employment picture...**

The employment picture has not been rosy for a long time. We have 16 million people out of work. While companies have a lot of cash on the sidelines they are not using it to add staff. In fact, we have had a plethora of companies who announced layoffs recently. HSBC plans to lay off 30,000, Lloyds 15,000, Cisco 13,000, RIMS 2,000 and the list goes on and on.

Obama came out and announced yet another program to stimulate jobs but every idea he has costs money. As we are bleeding red ink and have to come up with deep cuts to try to balance the budget, how can we spend money to attempt to create jobs? Nothing has worked so far and until we stabilize the economy, we are in for a bumpy ride.

Without jobs it is hard to fathom how we would have a recovery in housing. There are 1.5 million foreclosures sitting on the books of banks. One bank recently spent \$1 million to raze 100 homes in Detroit and donate the land to an organization who will “repurpose” it and create a green agriculture space. What does that tell you about the inventory on the books? They cannot get rid of it! With the inventory of foreclosed homes, it slows down any recovery in homes for sale or new homes being built.

### **What does an investor do?**

As you know from our past market comments, we have been bearish for a while. We did not think QE2 could solve our problems and we were worried about a sudden sell off. If you do not have hedges in your portfolio, you may consider adding something to offset equity risk. Seek out professional advice to review your options. There is nothing wrong with holding on to cash and earning very little as your principal is safe if you do not have the tolerance for downside risk.

We suggest that investors take a look at the 2008 return for the asset allocation in which they are currently invested to use as an example of what risk they may be facing. If we face those types of negative returns in equities again, you need to be able to withstand that downside or you need to review your allocation. Risk tolerance is always hard to judge in advance and painful to learn in the midst of a stock market correction.

There are always many opinions about the market. There are always buyers and sellers which is what makes it a market. It is easy to look back and have 20/20 hindsight but figuring out who is right and what to do in advance is difficult. The market never goes in one direction forever. We came down so hard that there is likely to be some type of bounce. If you do not have the right allocation for your risk tolerance, you can use these bounces to re-allocate.

This current equity correction does “feel” different and we may see more selling take place and opinions swing to the bearish side. We had a very big run-up from March 2009 through March 2011 and we may have put in a big top. We may now see another leg down which could last a while. The worst thing to do is panic. You need to have a plan of action in place and be sure you

have judged your risk tolerance correctly. There will be good buying opportunities and you need to have cash available to implement.

There are many ways to reduce your risk and a good advisor can help you put a plan in place.

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

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