Chapin Hill Advisors Market Comment 7-12-11

Disappointing Employment Report

Market Action….

After falling 7 out of 9 weeks between May 2nd through June 24th the equity indices did an abrupt about-face and marched upward with a vengeance for almost two weeks. The Dow tacked on 750 points while the S&P 500 added 87 points or 6.8%. The sectors which were most battered in the decline led the advance – with the exception of financials.

It looked like risk was ‘back on”. However, the unemployment report last Friday did dampen things a bit as economists missed the boat by a mile. Wall Street expectations were for an addition of 125,000 jobs and some analysts such as Deutsche Bank’s Joe LaVorgna had increased his estimate to 175,000 new jobs.

The report showed an abysmal increase of 18,000 jobs. The private sector added 57,000 but the government lost 39,000. This number still includes the BLS data – that is the birth death ratio the government creates to estimate the number of small businesses being “born” each month and adding jobs not captured in the report. The problem with this estimate is that in the current environment with a lack of lending, slow growth and increasing debt loads by the individual – there are no new businesses being formed. So the real lack of employment may be much greater than stated.

In fact, when the U6 data is used – which captures the “under-employed” – we have over 25 million people out of work or 16% of the available labor force. That is a staggering number and many of these people have had their unemployment benefits run out and have no reserves. We have seen a huge increase in programs offering assistance such as food stamps. Local food banks are seeing white collar folks coming in to get food for their families.

A Game of Chicken….

Many people would describe the battle over the deficit between Republicans and Democrats this way. The debt ceiling must be raised by August 2nd or the government runs out of money! This happened last week in Minnesota – the budget was not passed and the government shut down. If our debt ceiling is not raised, payments on various services from Medicare to military pay would stop or be delayed and our US Treasury bonds would suffer a big hit as the shock is felt globally. China and Russia each own and continue to purchase a huge amount of US Treasuries. They would not be happy to see prices drop dramatically if a budget is not passed.

Surveys show that the general public is disenfranchised with all the politicians and feel that they are only concerned about their political future, not the real issues at hand.

The Republicans want to cut spending which translates into cuts in Medicaid, Medicare, Social Security and other social service systems. Their latest smoke and mirror effort is to attempt to cut the inflation in government pensions and social security payments as they claim inflation has been "overstated" for all these years. Tell that to someone living on a government pension or social security while food prices and gasoline rise!

The Democrats want to add taxes and "tax the rich". The problem is in defining who are the "rich". The income level of $250,000 per family sounds like a lot of money, especially if you live in a small town in the Midwest. However, if you live in a high tax, high cost of living state such as New York or California, $250,000 in annual income is not rich. No one wants to pay more taxes but a fraction of the country pays the bulk of the taxes already. How much more pain should one segment bear?

The game continues to play out with Obama making speeches on TV and public pleas as well as threats of veto to the members of the House and Congress. The closer we get to August 2nd without a budget deal, the more nervous the equity markets will become.

Focus on Europe……

Greece's problems were front and center in May and early June and played a central role in the decline of equities. However, as a rescue package seemed to be imminent, Greece passed a new "austerity plan" and a rally was sparked. Many feel that they were "kicking the can down the road". Layering debt upon an already staggering level of debt with little hope of ever getting it paid is not a solution. Greece got their multi billion dollar payment from the International Monetary Fund (IMF) in early July and the concern about a default seemed to disappear.

However, Greece needs more help. They run out of money again in just a few months. In their austerity plan, they agreed to make more cuts in pensions, delay retirement ages, cut other services and privatize businesses which are currently run by the country such as airlines. Riots continue, the citizens are rebelling and sentiment is building against the "rich" who many seem to feel have avoided paying their share of taxes.

Last night, the Greek Prime Minister shook the markets as he declared that they would be unable to raise the target levels previously agreed to by privatizing businesses. George Soros wrote an editorial for the Financial Times on Monday stating that it was only a matter of time before Greece defaults and while he did not name the countries, he predicted several others would default and potentially leave the European Union.

Italy became the focus on Monday as their debt to GDP ratio hit 120% , not far behind Greece's debt ratio. GDP in Italy has only grown at 0.25% over the past 10 years so paying off a huge amount of debt without additional growth is not achievable. Italy is the second largest economy in Europe and is 3 times the size of Greece, Portugal and Ireland combined! There is not enough money to rescue Italy as well so the markets are once again focused on Europe. A default would shake the global markets and generally be unmitigated chaos. It seems that the IMF prefers to delay this event by losing quantifiable amounts of money in loans to countries which will be unable to pay them back. How long they can continue and how much money countries such as Germany, France and the United States are willing to extend is the big question.

Earnings Season is upon us….

Earnings season kicked off Monday night with Alcoa and Novellus reporting. A number of companies will report this week and next and the focus will be not so much on what they did last quarter, but what are they saying about the future. They may meet or beat analysts' estimates but if they do not have rosy things to say about next quarter, stocks are likely to sell off.

Corporations do have a treasure trove of cash but they are not using it to add jobs. In fact, Cisco announced on Tuesday morning that they would be laying off 10,000 people. The tech sector and the financials are both being watched for signs of stability and growth. The financial sector is down 10.5% from its February high while the S&P is only down 1.7% in the same period. Historically, equity markets have not been able to manage sustainable rallies without the financial stocks participating.

With the end of QE2, trading desks are not going to enjoy the excessive liquidity that helped profits. With real estate sales in the doldrums, banks are not lending, their inventory of foreclosures continues to weigh on their balance sheets and if Europe does have a default, US banks have exposure to this debt.

There are many bulls out there and the robo-trading systems go into action whenever the equity indices hit key areas and drive the markets up. We have bounced off the 200 day moving average for the S&P four times in the last year. If that level breaks, we will be looking at a significant sell off in the equity markets. However, until that level breaks, the tug of war continues and they could drive the market to new highs.

Caution is the word of the day. Missing some upside is much better than participating in significant downside.

As always, please call us or email with questions and comments.

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