

Chapin Hill Advisors Market Comment 10-19-11

European Headlines Rule

Relief package announced...

As Merkel and Sarkozy fought to convince the entire 17 member European Union to carve out an acceptable deal to bail out Greece and reinforce the country's banks, the markets have rallied. After falling 20% from a peak in early July, the S&P fell 20% into the first week of October. It hit a low of 1075 and lots of technicians were predicting a fall to break the 1040 area and possibly hit 1000.

Instead, the market rallied 20% from October 4th through October 26thmostly on hopes that Europe would figure out how to solve their financial woes. As a "deal" was announced at 4am Eastern Daylight Time, the markets responded with fierce rallies. Germany, France and England rallied between 5-6% each while the Dow was up 4% at one point, selling off a bit into the end of the day to close at 3.3%. Quite a day!

Earnings season in the U.S. coincided with the rally period but the releases were mixed and while some announcements such as Netflix's loss of subscribers triggered a deep sell-off in the stock and hurt the Nasdaq, positive surprises such as Caterpillar's pick up in revenue, ignited a rally in the stock and pulled the Dow up. However, for the most part, earnings were ignored as rumors that Germany and France were closer to crafting a rescue package fueled the October rally.

Greece is front and center as their financial assistance from the other EU countries has been doled out in pieces. Riots in the streets continue as the general populace rises up against austerity measures. The real problem is not Greece but the possibility that if Greece defaults, this would trigger the domino effect of Portugal, Spain and then Italy. The sheer panic that this would cause would amount to losses in the trillions as worldwide markets react to a possible meltdown. So the pressure has been put on all the Euro leaders to craft a package with quantifiable losses – which might measure into multi- billion dollar losses –than to face an uncontrolled panic that could affect multiple countries and countless banks. This would bleed over to the U.S., as well, as many of our banks do have exposure to foreign debt.

A Greek Haircut....

A central issue is how much of a "haircut" the private sector must take on their outstanding loans to Greece in order to allow them to craft an additional package and not be buried in debt. As it is, Greece's debt to GDP ratio is 132!

The underlying problem with Greece's economy is that for every \$1 of revenue, they are spending \$1.15. That formula just doesn't work. So relieving their debt burden may allow them to temporarily pay their bills but without significant reductions in spending, they will continue to fall behind.

As part of the big package that was crafted on Thursday morning, the current bondholders agreed to take a 50% “haircut” and were given some type of guarantees in place of those losses. The details on the entire package are still sketchy and some of the success will hinge on whether or not the Chinese and Brazilians are willing to invest in their special purpose vehicle. The Chinese are sitting on some \$252 trillion of reserves and they already have significant holdings in bonds of various European countries, so they have a vested interest in protecting their investment.

Italy’s auction not a good sign....

While the equity markets celebrated the announcement of a deal in a big way, the credit markets did not react. The spread on Greek debt versus German debt remains at huge levels and some savvy investors and strategists feel that this is telling us that the “real money” doesn’t believe the deal has substance or will solve the crisis.

Michael Darda, chief economist and market strategist for MKM Capital was on Bloomberg radio the other day and he remained bearish on Europe. He feels that the debt is telling you something and if the credit markets do not turn around and back up the move in equities, we are likely to see a sell-off which would erase the recent rally. According to Mr. Darda, Europe is on its way to a multi-year recession; the fiscal austerity combined with the bailouts has sanitized the effect of a “tarp style” rescue package. He feels most economists and strategists who are bullish are wrong. Also on Bloomberg radio was a well-known currency trader who agreed with Darda’s views and is very cautious. He feels the bailout package is long on optimism and short on substantive details.

Their views certainly seemed to be backed up Italy’s 10 year auction took place Friday morning and the rate hit a new post-Euro high. The yield rose to 6.06% which is quite a pop from last month’s auction rate of 5.86%. Clearly, the bond investors seem to think all is not well with Italy!

Will the rally continue?

While certainly overbought on a short term basis, it is possible for the equity markets to continue to rally in the short term. In bear markets, the bull rallies are often steep but also very often short-lived. The average rally during a predominantly bearish trend lasts from 6-8 weeks and we just hit the 3-week mark.

Technicians are split on what the very short term looks like. Several we follow feel that there will be a pullback into early November before further continuation of the rally. More news may come out of Europe on details to fund the various vehicles they have set out to use to bail out Greece and allow for back up of Portugal and Spain which may fuel more enthusiasm.

We could rally up to the mid 1300’s on the S&P 500 which would represent another 5-8% from these levels. However, the underlying economy has not picked up. Warnings of future slowdowns and reduction in expectations were announced by many of the companies reporting this season. Unemployment remains stubbornly high. The Occupy Wall Street movement and the demonstrations taking place across the country seem to be picking up momentum and

certainly express the dissatisfaction that at least a portion of the populace feels with the country's state of affairs.

If you were unhappy with the volatility in your portfolio in the declines experienced in August and September, take the opportunity to reduce the risk in your portfolio. You can sell in to the rally or add hedges or non correlated asset classes to reduce the risk as further declines are in store as we progress in the bear market.

The decline from top to bottom in both the 2007 to 2009 bear and the 2000-2002 bear market was over 50%. If that repeats, any equity portion of your portfolio will suffer losses. Protection of principal, even if you miss portions of the occasional rally is key. A loss of 10% only needs a gain of 11% to break even. However, a loss of 50% needs a 100% gain to get back to even. And that kind of gain could take another 2 years following the completion of a bear cycle just like the previous rally from March 2009 to April 2011.

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

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