

Europe's Woes Cascade

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Pain Mounts for Europe's Banks....

Rumors abounded last Friday that Greece was about to announce default and that Germany was preparing their banks for the possible outcome. At this point, \$3 Trillion Euros have been lent to the PIIGS (Portugal, Italy, Ireland, Greece and Spain) and if Greece were to default the fear is that it would trigger a domino effect and the other countries would be facing a 50% or greater loss on these loans.

While the powers that be are busy denying these rumors, the market does not believe them. Just days before Lehman collapsed, investors were being told not to worry. Now the fear is that a "Lehman style" default is going to happen and a meltdown in Europe will spell trouble for the rest of the world.

The overseas markets, and specifically their banks, have seen their shares plummet. Germany's index (DAX) lost over 20% in the month of August and was down 4% this past Monday. The big three banks in France have seen 50% sell offs over just the last month. US money markets have stopped extending short term capital to many of the sovereign banks triggering more concerns about a liquidity crunch.

Italy held an auction of bonds on Tuesday morning and it was not well received. Greek short term debt was yielding 100% at one point last week. Rumors that China was going to bail out Italy by buying their debt caused a rally on Monday in the US. Overnight, as the Chinese denied the rumor, the indices plummeted. Pre-market on Tuesday, more rumors surfaced that Merkel and Sarkozy were flying to Greece to work something out and the markets rallied. Then the wire services reported that there was no German-French initiative in the works and the markets fell.

Talk about headline risk!

US Banks Also Under Fire...

Bank of America has been under the gun as they attempt to assure investors that all is well and they will become a lean, mean machine. Last week, chief executive Brian Moynihan ousted Sallie Krawcheck as head of wealth management and moved other key players around to shore up management. On Monday, he announced a \$5 billion cost reduction plan which includes 30,000 job cuts.

Mr. Moynihan is riding a tight line as he tries to assure investors that he is serious about shrinking the nation's largest bank while not seriously damaging employee morale. Investors worry that Bank of America's exposure to the mortgage market will continue to weight them down at a time when it seems clear the economy is slowing down. While Bank of America aims to reduce their costs by 18%, Wells Fargo is targeting a 12% cut in overhead. The former has Over 5700 branches while the latter has 6285! The

largest four banks, which also include Citi and JPMorgan, employ over 1 million people. Layoffs here and at other banks are coming just at the time when Obama & company are trying to stimulate new hires.

Obama's newest stimulus....

President Obama was going to announce his new stimulus plan last Wednesday but realized he would be competing with the Republican debate so he moved it to Thursday. Much ado was made of the fact that he was now a warm-up for the Saints vs. Packers football game. Ahead of time many of the details were leaked and everyone expected a \$300 billion dollar plan. Obama surprised everyone by announcing a \$447 billion plan with spending incentives, payroll tax reduction and extension of unemployment benefits. Tax cuts alone totaled \$175 billion.

Since everyone is fed up with their D.C. representatives, the Republicans were rather careful in their criticism on Friday morning. Obama apparently said "please pass this" a number of times in his speech yet there was no specific bill to pass. One is being crafted and then the fun will begin!

There is likely to be much debate and risk of more bottlenecks as Senate and House debate this. The debt ceiling was raised in August and we have hit the limit by early September. Obama's plan is going to complicate the job of the special bi-partisan budget committee assigned to work out an actual plan for cutting costs. In the meantime, employers seem hesitant to hire no matter how many tax incentives they receive as business and the economy is slow and Obamacare represents unknown costs to carry with any new employees.

Dow 3,000....

Author and economist, Harry Dent announced his prediction this weekend that the Dow will fall below 10,000 near term and by 2013, it will hit 3,000. He says baby boomers around the world have peaked in their spending cycles and will be saving not borrowing. These baby boomers were responsible for driving up both real estate and stock prices for the past few decades as they spent and borrowed.

Added to this trend is the fact that total U.S. private debt has doubled over the last 8 years from \$20 trillion to \$42 trillion which is three times the size of the national debt. According to Mr. Dent, Americans are starting to deleverage this debt. Baby boomers already have huge debt burdens so no amount of government stimulus will convince them to borrow more.

He also states that the spending in the boom years led to the biggest global credit and real estate bubble in history. U.S housing prices have fallen 34% and he believes they will drop by another 30% before housing has hit bottom.

Carl Weinstein, the chief strategist for High Frequency Economics, is also concerned that the debt crisis in Europe will lead to a depression which will affect the entire global

economy. Soaring unemployment, deflation and zero interest rates are likely to persist for years. He also says that banks will stop lending and the governments will have to step in setting up enormous debt burdens and sky-high ratios of debt to GDP.

Dick Bove has now joined the camp predicting that Greece will default. I remember appearing with him on a Fox Business show last year and at the time he was staunchly defending Greece, the European's Union support of Greece and all the banks in the U.S., claiming that they were a great buy. That's part of the problem with the information overload we receive....it is very difficult to track the accuracy of analyst's calls as they change their opinion when things begin to go the other way!

A Climatic sell off....

If Greece does default it will lead to a massive sell off in global markets. That is likely to be a short term bottom. When things look really bad, it is always hard to predict what good news will cause a steep rally. If you look back in history, prior bear markets often staged steep but relatively short bull cycles.

If you are unhappy with your risk profile or asset allocation, use the next rally to reposition your portfolio, add hedges, and reduce risk as we are likely to face a very tough 2012-2013 period in the markets.

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

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