

Chapin Hill Advisors, Inc. Market Comment

Focus Still on Europe

1000 Points for 0.7% change...

Volatility in the market remains high, starting with a 582 point drop on Monday, October 31st and Tuesday, November 1st. The Dow recovered 519 points through the following Tuesday only to get socked 400 points on Wednesday, November 9th. The next two days the market rallied 371 points. The total of losses and gains was 1000 points, but a net loss of only 0.69% through November 11th. So if you were not paying attention you might think not much took place in the equity markets.

This week started out with a loss of 67 points followed by a modest gain of 17 points in the Dow on Tuesday. Wednesday was a seesaw day until Fitch announced that U.S. banks had “manageable” but “direct” exposure to the debt of European nations. The “manageable” was overlooked as everyone focused on the “direct” and the Dow fell over 200 points in the last hour to close down 190 points for the day.

Focus moves to Spain....

Initially, everyone was focusing on Greece and their problems, the soap opera-like story of G-Pap and his resignation and whether or not they would agree to more austerity measures to get the next infusion of capital from the European Union. Greece is a tiny country so many clients are asking me why the markets were so focused on Greece.

The reason for Greece’s significance is the risk of contagion to the other PIIGS (Portugal, Italy, Ireland, Greece and Spain). As Italy began to publicly struggle, the anxiety rose. Italy is the EU’s third largest economy, their debt is 130 times their GDP and there is not enough money to rescue this country. Italy’s bond yield rose over 7%, a level similar to Portugal and Ireland’s rates which triggered their bailouts. The cost of financing at those levels would continue to weigh on Italy and the fear in the market is that it will be too much to manage and default will begin.

Italy held a key short term auction last Thursday and everyone was watching to see if the entire \$3 billion auction would be filled. A lack of demand would have sent the markets tumbling worldwide. Relief hit the as the demand was there...although the rate was a record for post EU creation ...over 6.6% for short term notes. Rumors began that the ECB (European Central Bank) stepped in to buy, which is against their policy.

Silvio Bersculoni finally resigned. Mario Monti, a “technocrat,” was installed as the new prime minister of Italy and has attempted to put additional austerity measures into place. This was met with resistance from various parties and only served to make the markets more nervous.

This week, Spain is now front and center. Despite a few years of austerity, Spain is struggling to get their balance sheet back to good order. Unemployment remains very

high and is over 50% for young adults. Spain held an auction on November 17th and 10 year notes hit 6.57%...a spread of 4.77% over Germany's bonds.

France is feared to lose their AAA status and their 10 year auction also hit record highs of 6.975% while their five year notes hit 2.82%. Germany's Angela Merkel announced on Monday that countries would be allowed to leave the Euro as a currency while maintaining membership in the European Union opening the door for countries like Greece to leave. While Greece's economy is still battered, they would have difficulty paying the interest expense on their current debt leaving them in financial straits. This situation is not likely to resolve itself quickly and will keep the markets on edge.

Super Committee deadline approaching...

After the budget impasse and a temporary budget finally agreed upon this past August 2nd, a super committee of both Democrats and Republicans was formed to create a long term realistic budget. The deadline for the new budget is November 23rd.

Well, November 23rd is next week and it seems the Super Committee is trillions of dollars away from any agreement. AP wire reported last night that Congress was looking for alternatives if the Super Committee fails to come up with an agreement by the deadline. Since the focus has been entirely on Europe, we wonder when the markets will start to pay attention on the domestic side and the lack of a workable budget.

One of our health care managers gave us some insight into possible cuts which the committee may make. The government is responsible for \$0.67 of every dollar spent on healthcare in the country. This manager feels that the committee will be forced to cut spending in this area and his estimate is that \$250 billion of government spending on healthcare will be cut; that means social services which are already under pressure. If you think Occupy Wall Street is angry now, I am fearful of what type of unrest we will see if a big slice of government funding is cut in healthcare.

Another area of concern is Medicaid and Medicare funding which is paid for by each State. These costs are growing 8% annually and as we are all well aware, the States are struggling with budget deficits. They cannot keep up with the growth in these areas. Until this past summer, the Fed had given a supplement to the States which helped cover these costs. Now the States are coming to grips and being forced to address these escalating costs.

The trend is to hire companies to manage the execution of the care. So now you have a for-profit company deciding whether someone should remain in the hospital, the rehab center, receive additional mediations, etc. They will likely manage this aggressively to reduce costs which means some people will be denied care or treatments they may have received when the State was running the program. Good for these companies and the State budget, not so good if it is your mother or aunt or friend who is being denied care. This trend is also likely to increase the frustration and anger of the general populace. Medicare co-pays are expected to rise 40% by next year. For those retirees on a budget or those who are unemployed and need to work, this is going to be a big hit.

Good News...Bad news...

The recent economic reports in the U.S. have been mixed. The expectations in most cases were not that high and the economy is still soft but any positive news has been taken by the bulls to drive the markets up.

Jobless claims on November 17th came in with 388,000 new claims versus expectations for 395,000. October housing starts improved to 0.3% and building starts increased to 10.9%. CPI (consumer price inflation) was tame at -0.1% and ex-food and energy was down 0.8%. PPI (producer price index) also fell by 0.3% and ex-food and energy it was flat.

On the weak side, the Philly Fed survey was reported on Thursday morning at 3.6 versus 8.7 in September. This number is watched by many as a sign that manufacturing is picking up so this was disappointing. The high for the year was back in March at a not so stellar 43. Under 50 generally means a slowdown is in place.

While mortgage delinquencies declined a bit, the total number of mortgages in distress is at 12.2%. We have 75 million homes in the U.S. so this means that over 9 million are falling behind in payments. This does not include the ones already in foreclosure. The banks supposedly have a "shadow inventory" of as much as 6 million additional homes which have not yet been released as foreclosed. When this inventory hits, it will not help the housing sentiment or recovery.

Rents are increasing and demand for rentals has taken preference over purchasing a home. Many people would not have believed this possible had you predicted this even five years ago. How long before the housing market recovers is anyone's guess but with bank lending still remaining cautious, credit records stressed, high unemployment and a large inventory of foreclosures and distressed homes, demand for new housing is likely to be weak for the foreseeable future.

What's next?

As advisors, we take on the very difficult job of attempting to assess the future risks in the market and to help guide our clients to meet their financial goals and objectives. In volatile times, that job becomes more difficult as investors are nervous about their portfolios and look to us for guidance. I often tell people that if I had a crystal ball, I would trade for a few hours each day and then go off and ride my beautiful horse.

We subscribe to several technical services and rely on a chart system I have used for over 20 years. The S&P has been trading in a small range - between 1220-1270 since early October. It has created what most technicians call a "triangle pattern" and everyone has been watching to see if the upper band or lower band of that triangle will break. A break above would signal a rally to follow, possibly to the 1300-1350 range. A break below would likely lead to 1190 and possibly 1140 or lower.

Wednesday afternoon's decline brought the S&P right to the lower level of that trading band and in early trading Thursday continued down below it. Support was at 1225 and if broken, we are likely to see more downside over the next few days.

There are plenty of bulls, robo-traders and lots of cash so a decline could be met with buying to drive the market up into the end of the year. Our economic problems are systemic and we do not feel this market is a "value". That is our opinion. We are concerned that the next few years will trend primarily down and steps should be taken to reduce risk.

In our opinion, a rally should be used to gradually prune positions and add protection to your portfolio. The rule of losses is what you should remember. A 10% loss only requires an 11% gain to break even. However, as the losses increase the hurdle to break even rises. So if you suffer a 50% loss, you need 100% to just get even. If your portfolio can maintain the bulk of its principal while the markets decline, you are not under pressure to capture every move up as you did not lose as much as the average investor on the downside.

The S&P finished 1999 at 1462 and closed last night at 1236....that translates in to a loss of 15.5% over nearly 12 years! Buy and hold is out cold. If the next few years trend down, this number will get worse. If you can preserve your principal, you will not be under pressure to capture every bounce in the market. When the trend changes and a long term bull emerges, you may be in a better position.

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

Important Disclosures:

1-Securities and financial planning offered through LPL Financial, a Registered Investment Advisor, Member FINRA/SIPC

2-Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise and are subject to availability and change in price.

3-The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.