

Chapin Hill Advisors Market Comment 6-24-11

Greece – front and center!

Four Day Rally...

The equity markets took a small reprieve from their downward slide last week as they staged a four-day rally from Thursday through Tuesday. Optimism seemed to be building on the fact that Greece's new Prime Minister **Georgios A. Papandreou was going to pass his no confidence vote on Tuesday. The market rallied in anticipation. However, once the vote was taken and everyone realized that new austerity measures must be implemented and rioting and demonstrations in Greece continued, the market lost steam and fell on Wednesday.**

By Thursday, anxiety over Greece and the domino effect likely to take place with the rest of the PIIGS (Portugal, Italy, Ireland, Greece and Spain) sovereign debt, the Dow Jones quickly fell more than 200. The outlook was gloomy for most of the day and more bears are now appearing on the media channels with the focus on Europe.

The Dow was down 192 points at about 3pm and in literally minutes, it rallied 100 points. For those of us who watch the market all day long, we were amazed. At first, there was no news and we were puzzled as to what actually happened to cause the rally. When the news was released, it seemed anticlimactic. The news was that the IMF agreed to extend the previously agreed upon loan to Greece. This really doesn't solve anything; it is a band-aiding resolve to more debt. Greece's problems will still weigh on the markets. The Dow ended down 75 points, much better than the 213 points it was down earlier in the day but a far cry from a rally.

The Future of Greece....

Pimco's chief executive Dr. Mohammed El Erian stated this week that he expects Greece to default, and that waiting has only made the situation worse. He feels that the contagion will spread to the other countries and that the ECB balance sheet has become contaminated.

Dr. El Erian is not alone. Many savvy strategists and managers are concerned about the sovereign debt. One currency manager we spoke with this week believes that if a stress test was performed on the sovereign debt of most of the European countries they would fail. The large banks own a lot

of this debt and no one knows how well hedged they are for a major default. Speculation abounded this week that some banks may be the “next AIG” as they may have billions of dollars to pay out if they are backing some of this debt through derivatives and other institutional hedging vehicles.

Many US money markets have large exposures to the bank debt of these countries. This could pose a big problem if defaults start to take place. In the 2008 financial collapse, one money market “broke a buck”. The fear is that many others would follow if a collapse took place.

Bulls versus Bears....

The tug of war between bulls and bears has continued. The S&P has hit a critical support level several times and bounced off that level. We have heard from a number of long managers that they are using this sell off as a buying opportunity. For those of us who believe this is only the beginning of what could be a major sell off, we feel this is a replay of what we heard and saw in the summer of 2007. The market reached a peak in October 2007 and bulls were plentiful. They scoffed at anyone urging caution and felt the market could continue its upward trajectory.

From the peak in October 2007, the S&P 500 went on to fall 56% over the next 18 months through March 2009. If an investor has \$1,000,000 invested in the S&P, their portfolio would have fallen to \$440,000 over the next 18 months. If they managed to just hold on and not liquidate, the S&P500 rallied 105% over the following two years from March 9, 2009 through April 2011. The value would have increased to almost \$900,000 still down 10% from those October 2007 highs. If the S&P falls 20% from the April 2011 levels, that portfolio value would then be \$720,000. If this decline takes place by the Fall of 2011, the portfolio would have lost 28 % over 4 years. The investor is now 4 years closer to his/her goals and has less time value to make up for those losses. Not a pretty picture but that is what took place in prior secular bear markets.

If you view a chart of the bear markets in the 1930’s and 1960’s there were opportunities to double your money as well as lose 40-50% throughout the cycle and lasting months to years. In our opinion, the key is to attempt to avoid the deep drawdowns. If you can avoid losing 20-40%, you will not be under pressure to catch every rally. There are many ways to protect your portfolio and in our opinion, action should be taken to protect your current principal.

Greater volatility in today’s markets....

Sam Stoval was asked this week if he could have anticipated this recent market slide. He pointed out that neither fear nor greed was dominant back in April and the market seemed to be trading at a reasonable price earnings ratio. So it would have been difficult to time the high point of the market and anticipate a decline. If you listen to the fundamental analysts, all is well and price to earnings ratios are reasonable and the market should go up.

Mr. Stovall went on to point out that we have much more volatility in our current markets than we have historically. Since 1950, the S&P fell 1% on average 27 times a year and rose 1% 28 times. However, from 12/31/99-12/31/09, the S&P averaged 40 advances and 43 declines. There were two mega meltdowns of 40+% in that period. Again since 1950, the S&P500 had six one day declines of 2%. For the decade ending in 2009, the average increased to 15 and 54 just in 2009. More volatility and greater ranges make it harder to manage the equity landscape.

The outlook for the economy....

I was a guest on Bloomberg radio this past Monday and the focus on the questions from the hosts was all about earnings. We believe we are in a secular bear market similar to the period from 1966-1982 and 1929-1953. If we are in another bear market and if the tide has turned, we will now trend down with small stretches of rallies. Earnings will not matter as the backdrop of the market will be negative. Generally, after the markets do roll over, we see analysts adjusting their future earnings expectations downward.

We have many business owner clients and family offices who generally recognized their wealth by selling some type of business enterprise. Our clients have generally been cautious to negative on the outlook for our economy. Obama care is a negative for most business owners and until there is clarity, many would rather put off a fixed future cost to an employee. Even those businesses which have seen an increase in orders seem to be cautious to add new employees. We believe our clients have their “fingers on the pulse” of the real underlying economy and therefore we are cautious as well.

Last week, a client asked me to perform a favor for him and speak with one of his employees who had an option to retire and withdraw from his union pension. The employee was concerned as he liked to work and did not want to retire yet. However, he had been hearing rumors from other union

members that benefits may be cut. He has worked his entire life as a union employee and did not want to see his pension benefit cut.

Underfunded pensions....

So many of our pensions are underfunded and are counting on returns which are unreasonable and unattainable. Without factoring in the most recent decline, the return for the S&P500 for the past decade is only 2%! That is a far cry from the 8% assumption so many pensions are using in their formulas. This past week, the Wall Street Journal ran a report on which States were underfunded and what return was needed to become fully funded. Some of the States needed 30% a year – certainly not a reasonable expectation in the current environment.

We have 78 million baby boomers tipping in to distribution mode. Whether it is a corporate pension or a municipal pension, withdrawals will continue to increase. The same is true for the housing market and stock market – those who are retiring will downsize, sell second homes and pull funds out of the markets to fund their lifestyle.

Take a hard look at your overall picture; be sure you have a plan in place in case the worst scenario does happen. As always, please feel free to email or call us with questions or comments.

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Kathy Boyle, CFP® has over 25 years of experience in national and regional investment banking and brokerage firms. As founder and president of Chapin Hill Advisors, Kathy is an often-quoted financial specialist in print and a regular co-host and guest speaker on television including **CNBC's Power Lunch**, **NBC's Nightly Business News**, and **Fox's Your World with Neil Cavuto** and **Business Lunch Hour**, as well as **Bloomberg** radio.

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