

Chapin Hill Advisors, Inc. Market Comment 12-15-11

Risk on.....Risk off!!

Europe continues to muddle along...

Headlines across the Atlantic continue to drive the U.S. markets. After a sharp rally right after Thanksgiving, the equity market traded sideways for a week until rumors began on Thursday that the ECB (European Central Bank) was not going to extend more liquidity to the Euro-zone countries. Every whisper seemed to drive the market as the S&P dropped 2.5% on Thursday and closed in the 1226 range.

The market did indeed look like it was dropping to 1200 and possibly 1180 again to test the November lows. On Friday, however, news that a proposal to more closely integrate the European Union nations fiscally won support from 26 of the 27 members which drove the markets up. Risk was back on and the S&P rallied back up to the 1252 level, lifting 2.2% to end the week slightly up.

Britain refrained from participating on fears that they would be surrendering too much sovereignty. They rolled out a plan to have the European central bank lend the IMF (International Monetary Fund) 200 billion euros to redistribute to troubled European economies.

After the close, Standard and Poors put a damper on things as they put the sovereign debt of 15 euro-zone countries on credit watch/negative for possible downgrade.

Risk back off....

After the initial rally on hopes that Europe may be getting closer to solving their problems, the week opened up with a big sell-off. The U.S. is apparently pressing Europe to come up with a much bigger liquidity package along the lines of what the Fed did in 2008 during our financial crisis. There seems to be constant comparisons to a "Lehman-like" disaster befalling Europe if they do not take massive action to stem the continued decline of their currency and the fallout from some of the weak countries.

The Dow was down 243 points at the low of the day but the last 45 minutes brought a spurt of buying and the Dow closed down 162 points while the S&P traveled back up to close at 1230. Tuesday opened up with a small rally which held up into the Fed announcement. But the Fed put a damper on anyone expecting a QE3 in their stockings and the market rapidly dropped post-announcement. The Fed said things are gradually improving and the labor market has made some strides so while they will continue to keep rates low, no new stimulus is coming. The markets finished again with a small late rally, but the Dow was down 66 points and the S&P dropped to the 1218 level.

As everyone seems to be watching technical levels, if the 1215 area cannot hold on the S&P, we are most likely going to see 1200 and possibly 1180. However, there is enough cash on the

sidelines, lots of analysts who think stocks are a bargain at these levels, and those big firms who all made end of year predictions for the S&P to finish in the 1300-1400 level have the big guns to unleash buying so their predications can be closer to reality. So after a bit more weakness, we would not be surprised to see an end of year rally which could last in to the first few weeks of January.

Black Friday and Cyber Monday....

While the unemployment level hovers around 8-9%, it does mean that 91-92% of Americans have jobs. We have been trained to be very good consumers and consume we do. Black Friday was a blockbuster as was cyber Monday. Many retailers as well as analysts expected the shopping to continue and fuel gains in the retail sector.

However, the sobering news is that many consumers are done! Surveys show that 40% have finished their shopping as opposed to 28% at this time last year.* Even big bargains may not draw them out as they have apparently spent what savings they had and any other expenditure would add to debt.

The retail sector rallied 10% off its November 26th lows into last week but got smacked over the last few days as it dropped 3.3% in the last two days.** Retail earnings have been mixed and there is concern that massive discounting to lure the consumer is eroding profit margins which will ultimately show up in the price of the stocks.

More Concerns in Europe....

Italy held a 1 year bond auction on Monday and while it was well subscribed, the rate was 5.96% - only a hair below the 6.087 record set in November. An article in the Wall Street Journal over the weekend outlined how intertwined many of the European banks are with one another. They own protection on one another's debt and these derivatives and swaps could be another problem if there is a string of defaults.

Latvia's largest bank, Swedish owned Swedbank, experienced a "run on the bank" last Sunday as the equivalent of \$20 million dollars was withdrawn in one day. Rumors abound that the bank was facing legal and liquidity issues so many felt better safe than sorry and they stepped up to withdraw their cash. Latvia's 10th largest bank, Krajbank, has experienced problems and is in the process of being liquidated and depositors had to wait for weeks to get their cash.

Germany's bunds have been seen as the safe haven throughout the entire crisis. Germany has the most diverse economic platform as they do business around the world and not just in the EU. Saving the Euro and the Euro-zone may be seen as a very large burden on Germany and the analysts are split on whether the future is rosy or not. JPM and UBS both like German bonds and think they will do well over the next few years. On the other side of the aisle you have Goldman Sachs and Credit Suisse who feel the bunds are overdone and likely to fall. Certainly, year to date, bonds have outperformed equities. The Europe 600 stock index is down 10% as of last Friday while German bonds were up 7.5%.

Dividend stocks seem to be the mantra...

It seems everywhere you turn, analysts are recommending blue chip, big dividend paying stocks as a safety play. In fact, Barron's put together a list of their "10 Favorite dividend payers" in this week's issue. Barron's is predicting gains of 15-20% for a host of names.

We have heard this from several money managers as well as a few clients. While many of these stocks have a great, long history of paying consistent dividends, our concern is that if a strategy becomes too popular, it generally does not work.

If the markets experience as much turbulence as we fear it will in 2012-2013, even great names will suffer. Remember that these large cap names also offer instant liquidity when other asset classes may not. We have seen large cap value managers who invest in this type of strategy get hit hard in 2008 as investors needed liquidity and these managers were easy and instant sources of cash. When the markets drop, all stocks drop. It is simply a question of how much.

So be careful about blindly buying large dividend paying stocks assuming they will retain their price. If you receive a 4% dividend but the price of the stock drops 10-15%, you end up losing and it takes quite a few years of dividends to make up for principal losses.

Take advantage of any "Santa Claus" rally and prune your portfolio for weak holdings. Be sure you can withstand a downdraft in the markets. And review your allocation for risk and liquidity. Use the end of year to do tax planning. If you are using a money manager, it costs nothing to sell tax lots and if you wish to own them again, you can repurchase after 31 days to re-establish the position. Consider adding hedges to your portfolio if you cannot tolerate selling or have imbedded gains.

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

*Source: <http://www.mainstreet.com/article/smart-spending/are-consumers-done-their-holiday-shopping>. Survey from America's Research Group (<http://www.argconsumer.com/>).

**Source: Based on chart and price data from XRT (SPDR S&P Retail ETF). An exchange traded fund representing large components from the S&P 500 retail sector.

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