## *Chapin Hill Advisors, Inc. Market Comment 6-16-11*

## *Sell in May and Go Away???*

### Equity Indices take a beating….

As the market heads towards its 7th week of losses, individual investors as well as the Wall Street crowd are wondering if the old adage will hold true this year. The Dow Jones has now fallen 7.13% since the correction started on May 2nd. The year to date return has dropped to 2.76%. This is the longest slide for the Dow since 2002. The S&P500 has lagged a bit more as it has fallen 7.20% since May 2nd and is now only up 0.62% for the year. We have not witnessed a slide this long in the S&P since July 2008. The Nasdaq and the Russell 2000 got hit much harder as those indices have dropped 8.42% and 9.98% respectively since May 2nd. That drop brings their year to date to negative returns, (0.77%) for the Nasdaq and (1.77%) for the Russell 2000.

### Sentiment shifts…

Both individual investors as well as advisors have increased their bearish count. The American Association of Individual Investors records 47.7% bears, 27.9% on the fence and only 24.4% as bulls. The Investor's Intelligence survey measures the advisor sentiment and despite generally being eternal optimists, advisors have become more cautious as the bulls have fallen to 40.9% from 45.2% last month and 57.3% in April (at what may prove to be a peak for the equity indices). Bears are up to 22.6% from 16% a month ago.

However the VIX which measures volatility and the "fear" that is in the market is still at very low levels. As the market plummeted on Wednesday on news of riots in Greece and a possible new Greek government being installed, the VIX spiked 16%. However it is still at very low historic levels in 2008 decline it hit 80 and currently it is just about 21). Until this volatility measure rises to past short term highs, it is unlikely we have reached bottom in the equity markets.

### Economic news…..

Concerns about the economic recovery have been with us for a while but while the Fed liquidity flowed and the "robo traders" for the institutional firms took over, bad news was ignored and the markets continued to climb. Now that QE2 is coming to an end and the Fed has made a number of statements indicating they are not prepared to follow it with QE3, it seems as though the sentiment has started to change. However, there are still lots of bulls around.

There are many money managers who must remain long and they are treating this as a "buying opportunity". You will see the talking heads on the media channels telling us what great historic valuations are available on the S&P, how we have an improving economy, that they hold a long term view of the market and expect it to recover after this "correction". Also, any bad economic news is now being referred to as a "soft patch" and numerous experts will tell you why we will not have a "double dip" recession and how things are expected to improve. We disagree.

## The state of the housing market….

Housing is not showing any signs of recovery and the job market is still very weak. Robert Schiller, the Yale professor who created the Case Schiller real estate index (which is now the S&P Case Schiller index) was speaking at an S&P housing conference last week. He was asked by the audience when the housing market would bottom. Mr. Schiller indicated he would not be surprised to see a further drop of 25% before housing finds a bottom.

For those who leveraged their homes and are underwater on what they owe versus what their house is presently worth, this is not good news. CoreLogic estimates that 40% of folks with home equity loans are underwater as opposed to 18% of those without HELOC's. On top of this stressful news, the IRS is now auditing anyone with over $50,000 of home equity mortgage deductions. Homeowners need to prove that these funds were used to improve their homes and not fund vacations or college tuition or pay up to the IRS.

Foreclosures are creating an overhang of inventory in the housing market and until this inventory makes its way into the marketplace, we are not likely to see a recovery in housing prices. Currently, there are 4.2 million people who are delinquent on their mortgages but they have not yet been foreclosed. These folks are not yet counted in the foreclosure numbers being reported. The banks are hesitant to push these folks into foreclosure as they struggle with their inventory of current delinquent loans and housing inventory.

## Financials go down hard….

As concerns about balance sheets and housing inventory rise, banks have taken it on the chin. Many of the big bank stocks have experienced 20% declines over the past few weeks. Dick Bove, a well-known bank analyst with Rochdale Securitites, now says that the Fed made a big mistake in opening up the liquidity floodgates. He has become bearish on a number of the banks. Now, remember this is the same analyst who praised the Fed's TARP strategy and was bullish on most banks just a few months ago. So you must be careful about when the listen to analysts and acting too quickly on their recommendations.

The new regulations are unclear, capital requirements may be raised and CEO's such as JPMorgan's Jamie Dimon have been very critical of the administration's policies. What many people do not realize is that a number of the money center banks have a fair amount of exposure to sovereign debt of the PIIGS (Portugal, Ireland, Italy, Greece and Spain). If Greece defaults, it will send a shock through the banking system.

## Europe's woes continue…..

The focus is now on Europe as Greece's problems seem to be getting worse not better. Greece is teetering on the edge of default and the yields on their government debt have skyrocketed. As of Thursday morning, 1 year Greek bonds were yielding over 18% and 2 year notes hit almost 30%! Riots in the streets are taking place daily and the scenes on the financial shows of police in riot gear battling back the crowds with tear gas is scary. This certainly doesn't help to stimulate tourism which is the primary driver for Greece's economy!

Germany is being looked upon by the world and the rest of the ECB as the savior for Greece. Germany is the world's second largest exporter and 70% of their GDP is the service sector much of which is connected to exports. Germany needs the Euro to stay high to maintain their economic growth. Greece relies upon tourism, so they would do better with a weak Euro. If they were not part of the ECB, they could devalue their own currency and stimulate tourism to help solve their problems.

The German citizens are pressuring their leaders not to bail Greece out without some sharing of the pain with other bond holders. If Greece does default or there is any type of restructuring of debt, Ireland and Portugal will be quick to ask for renegotiated terms on their bailouts. Spain and Italy are not in great shape either so the concern is that they would need help as well.

## Further abroad....

Over in Asia, India raised rates again and China has been trying to battle inflation and keep a lid on lending. A number of reports have been posted recently which are negative on the state of China's real estate market. The average Chinese real estate investor is very leveraged and has relied on cash flow to make their payments to their lenders. Occupancy rates have been shrinking leaving building owners struggling to meet their obligations. S&P just put China's real estate market on negative watch.

For the first time in history, China just had a mini rebellion as migrant workers stormed government buildings in the south. The Chinese military met the protestors with tear gas and tanks and suppressed the riots after a day. Many people did not think an uprising of any sort was possible in China as the communist government has always ruled with an iron hand.

News is still bad in Yemen, Syria and other parts of the Middle East. And concerns abound domestically about the costs of the US supporting the Iraq and Afghanistan wars and their aftermath. We now have four quarters of GDP totaling $564 billion while our federal debt has increased by $1.36 trillion. It has taken $2.40 of fresh Fed borrowing to fund $1 of GDP according to Douglas Cliggott of Credit Suisse US Equity Strategy. This is an area of concern for some strategists who feel we are in worse shape than Greece!

## Near term outlook....

Friday is known as quadruple witching day as four different types of options expire. Institutions and trading desks often use options to hedge their portfolios. As we approach expiration, traders may keep the indices in a range where most puts and calls lie so as not to lose money. The big guys have the buying power to do this so we may see a mini rally into Friday.

There are numerous bulls on Wall Street but the past several weeks have experienced a dearth of buyers rather than active selling. We are still hearing the average analyst tell us that things are fine, this is an anticipated "correction" and things will be back to the races soon. One concern we have is many of the Wall Street wizards have been long the equity market as they could not stay in cash. They all think they can get out the door first if the markets start a serious decilne. If we have some macro event rock the markets, the mass exodus of selling make be akin to a herd of elephants heading for a very small door.

Markets never go in a straight line so this may be a correction or the tide may have turned and we may be heading down and any rallies are short term in both size and length. Assess where you are and look at the worst case to be sure you can tolerate it if it happens.

As always, 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*, **Fox**'s *Your World with Neil Cavuto* and *Business Lunch Hour,* as well as **Bloomberg** radio.