Oil's Drop Fuels a Market Rally

Chapin Hill Advisors Market Comment 8-11-08

July 15th marked a bottom for the market and all domestic indices have been rallying with wild swings of 200-300 points most weeks. The Dow rallied 300+ on Friday despite slowing retail sales, decreased productivity and increasing unemployment claims. The Dow finished the week up slightly over 3% with 2.6% of that gain coming in on Friday. This brought the year to date return of -12%.

Dropping Oil Prices…

Oil has dropped from $148 to $113 over the last month and is probably heading under $100. The dollar has strengthened, while gold, silver, copper and other commodities have been dropping which has helped to fuel the market. Money has flowed out of the winners of the first half of the year and into technology, financial and health care stocks. Despite record profits, large oil companies, drillers, natural gas companies and other commodity related stocks have dropped to 2007 levels, disappointing many investors.

Who would have thought we would be excited about oil at $100 a barrel?

Transportation accounts for a major portion of our oil consumption and Americans have responded to higher prices at the pump by driving less – down 3.7% year to date. However, when the cold weather hits, folks are in for additional sticker shock as estimates on year over year heating prices is for a 90% increase! With the home equity piggy bank shut tight, coming up with the additional funds to pay for increased heating costs is going to continue to hamstring the average consumer.

Outlook for the markets….

Wall Street talking heads are calling for continued gains in the markets. They say the consumer is resilient, the housing market is bottoming, P/E's are reasonable and all is well. Talk about value is abundant as money managers recommend the financial stocks at these deflated prices. This week's Barron's covered the energy stocks and based on their recent sell-off and expected earnings in 2009, these stocks are considered cheap

We have a different opinion and believe we are in a classic bear market rally.

Slowing consumer spending…

Housing is far from a bottom despite a recent report with an up tick in sales of existing homes. Retail sales across the board were a disappointment as Walmart, JC Penny and TJMax reported under expectations. Back to school sales and tax refund spending did not provide the anticipated boost. People are more concerned about paying debt and focusing on their lack of job security than spending more money – even with great sales incentives.

The auto industry continues to flail as GM reported over a $15 billion dollar loss and even the leader – Toyota – reporting a decline in sales. Ford, Chrysler and GM are all scrambling to replace their gas guzzlers with fuel efficient vehicles. Will they all survive and can they be nimble enough to re-tool and reconfigure to get those vehicles out? They have all pulled back from leasing as they try to stem the bleeding.

Latest in credit markets….

Credit woes continue as the auction rate preferred debacle is yet another write-off for the money center banks and brokers. Citibank is taking a $7 billion loss and UBS a $19 billion dollar loss to restore investors' principal. UBS has wracked up $43 billion in losses so far. Bill Gross was quoted as saying we will have over $1 trillion on total losses before we are done. Fannie Mae and Freddie Mac reported massive losses last week and their stocks dropped by double digits.

The latest concerns are the lack of student loan funding as institutions burned in other areas have pulled back from issuing these loans leaving as many as 32,000 college students without funding for college this year. The gap between rising tuition costs and the amount of government loans available has continued to grow. Up to this point, the private loan business had stepped in to fill this gap. Now with the continued credit crisis, risk is being re-evaluated and companies are pulling back in any area where they are afraid of suffering more losses.

Monday's Wall Street Journal reported that the 5 largest credit unions have exposure to the mortgage market that could wipe out their net-worth. Credit unions were always perceived as the sleepy, low-risk choice for employees to deposit their payroll and savings. Failure of one or more of these institutions will send tremors across a broad swath of the nation.

Nouriel Roubini, the NYU professor who is the editor of the RGE Monitor blog was interviewed a week ago in Barron's. His prediction is dire as he feels as many as 700 institutions should be on the FDIC watch list. The bailout of Indy Mac will use about 15% of the FDIC's reserves. They underestimated the potential for failure and have under-charged the participating institutions and are now lobbying Congress for a rate hike. They are clearly under-capitalized for a large number of failures. If Professor Roubini is correct, we may be looking at as much as $1.7 trillion of losses before we bottom.

Credit card delinquencies continue to increase and investors are shying away from purchasing bonds backed by credit card receivables. Municipalities are facing tax shortfalls and services are likely to decrease. Higher oil prices affect everything from schools to municipal buildings. Increased foreclosures decrease the tax revenues as does reduced consumer spending.

This rally may have another few weeks to run. The depressed financial stocks are seeing inflows of money as hope that the worst is behind us abounds. Do not put all your faith in this rally. If oil does continue to decline, we are likely to see

enthusiasm for the markets continue. However, the bad news is not fully disseminated and the consumer is pulling back. Inflation is affecting a broad swath of the American public and we have more bad news to come.

Take advantage of the rally to re-position your portfolio especially if you have too much exposure to any sector for your risk tolerance.

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

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