Chapin Hill Advisors, Inc. Market Comment
February 12, 2009

A Chilly Start to the New Year!

Big declines in January…
One of the old market adages is "as January goes, so goes the rest of the year". If it holds true this year, we are in for more misery.

January was the worst year in 113 years of recorded history! The Dow, Russell 2000 and the S&P were down more than 8% each. Nasdaq led by being down "only" 4.97% while international markets fell another 14-16%. This is on top of 30-50% losses in most indices for 2008.

Bad news abounds…
The news is awful everywhere. Unemployment continues to climb with millions of people out of work. We are over 7% unemployment and fear we are heading for double digits. Foreclosures continue to build. Retail sales are abysmal. Auto sales continue to plummet. Banks continue to report massive write-offs. Delinquencies on credit cards continue to add up. The deficit is building – some economists are predicting that we will pass $3 trillion over the next few years.

Housing prices have yet to stabilize as more people lose their jobs and fall behind on payments. Home prices fell in 2008 by 12.4% - once again the most in recorded history. Inventories continue to build and home builders have tried a number of incentives to stimulate sales with little success.

Alt-A mortgage problems
The peak for issuance of "Alt-A" mortgages was 2004-2006. These were the folks who were not quite prime but were not subprime either. A large number of these mortgages are 5 years ARM's (adjustable rate mortgages). Adding 5 years on to 2004 brings you to 2009. These mortgages begin to hit their 5 year reset period.

The problem is two-fold. Banks are just not lending – no matter how much they protest while being grilled in Washington. So money is tight and credit ratings must be stellar for a bank or mortgage company to lend. Combined with the tighter credit market, the loan to value criteria is not working as house prices continue to fall.

For example, let's say you purchased a $1,000,000 home in 2004 and financed 75%. Therefore you established a $750,000 mortgage. In the first few years of any mortgage you generally pay mostly interest so the principal is not really reduced. Now that you need to refinance your mortgage value is close to your original mortgage.

However, if you home dropped even 10% in value (and many have dropped 15-20%), your house would be worth $900,000 not $1 million. But $750,000 is 83.3% of $900,000. No bank is going to give you a mortgage for that loan to value (LTV). In fact, many banks are not going to go beyond a 60% LTV and we hear it is very hard to get a loan in excess of approximately $600,000 which is where the Federal guarantee comes in to play.

The homeowner would be forced to come up with $200,000 or more to bring the loan into the bank's standards. Where is someone who did not have more than 25% as a down-payment 5 years ago going to come up with that much money now? In an environment where people are losing jobs and bonuses are being cut it is unlikely so the homeowner now faces default or a rate which may reset to an unaffordable level.

In my opinion, this factor will continue to weigh heavily on the housing market. Reports of higher defaults in this area are hitting the news now.

New administration stumbles…

Obama has had a very tough time getting started as he still seems to be campaigning and has failed to gain real bi-partisan support for his bailout plan. He has angered Wall Street with his income cap of $500,000. Three members of his administration were highlighted for failing to report income and pay the proper amount of taxes. On Thursday, his Republican nominee for Commerce Secretary, Senator Judd Gregg, withdrew over consternation about the stimulus package.

The new Treasury Secretary, Tim Geithner, failed miserably in delivering news about the administration's plan to fix the financial system. The market reacted by dropping almost 400 points on Tuesday. The announcement was delayed from Monday to Tuesday, leading most people to believe that final details were being worked out. Failing to manage expectations is a critical mistake.

Big banks testify to the Senate

This week, the Senate grilled the chiefs of the largest banks as well as Goldman Sachs and Morgan Stanley. The testimony was long (7 hours) and got brutal at times. Each CEO claimed they were paying oodles of dollars in taxes and swore they were lending and restructuring mortgages. They seemed to compete for who was taking the greatest vow of poverty with no bonuses and salaries of $1 a year. Vikram Pandit, CEO of Citigroup, apologized for ordering a $50,000,000 corporate jet (from a French company) after taking $45 million in TARP funds and laying off 73,000 employees. Quite a big gaffe.

The US testimony followed the UK grilling of their banking chieftains. Apparently, each of these corporate chiefs apologized and struggled to explain what happened and what they could do or could have done about the situation.

Global slowdown continues
We are in a global slowdown. Profit warnings abound. Sales are slowing in every area. China has at least 20 million of their 130 million migrant workers unemployed and heading back to dismal futures in their villages. The government is going to spend $120 billion on health care which is desperately needed. They face the possibility of unrest and uprisings as the effect of the economy slowing down hits more and more Chinese citizens.

Dubai and other governments are spending money in attempts to boost their flagging economies. No country seems to be immune.

Retail sales down and out
Bad news abounds as retailers close stores and lay off employees. Circuit City went bankrupt and stores like Duane Reade and Loehman's have fallen to the very bottom of the corporate debt ratings. Macy's is laying off 4% of their workforce or 7,000 people and closing stores in 9 States. These are anchor tenants in many malls so I worry about the future of many corporate real estate companies.

The slowdown in retailers is dragging commercial real estate down. The largest operator of malls in the US – General Growth Properties – is now trading at $0.62. That is a decline of 99% from a year ago.

Apartment buildings were seen as a "safe" portion of the corporate real estate market. But as families lose their jobs, they are moving in with other family members, vacancies are increasing and apartment rents are dropping in many cities. Some areas have a glut of condos and apartments on the market as they began the projects several years ago. The glut brings prices down as well.

Testing support in the markets
The market started off the beginning of January with a roar which quickly faded. The gains made from the November 21st low were erased in the last 3 weeks of January. February has been back and forth in a trading range.

Many people feel that the key area of support for the S&P is the 800 level. When that level was tested today, the market bounced. The Dow was down 240 points at 3:35pm on Thursday and closed down less than 7 points as news surfaced that the administration was hammering out a plan to subsidize mortgages to help stem the continued fallout in the housing market.

Our feeling is that the market has significant downside risk over the next several months. The market never travels completely in one direction so the ride is likely to be a series of bounces. We are concerned that there is a big sell-off possible in the next few weeks followed by a bounce and then further declines.

Meeting your risk tolerance
If you have not made adjustments to your portfolio to bring it in line with your risk tolerance, we would suggest you use any bounce to do so. Even “great’ companies are getting hit and experiencing double digit declines. There are few places to hide. We are concerned that the treasury bubble will continue to burst. The Lehman corporate bond index fell almost 3% in January and the yield on Treasuries increased quite a bit over the last month. This is likely to continue so be wary of extending maturity. Be careful about credit quality as well and do not over-weight your portfolio in any sector – whether it is debt or equity.

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

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