

Chapin Hill Advisors, Inc. Market Comment April 14, 2009

Great Expectations Drive Market Rally

The markets began the week of April 6 with a sell off on Monday morning and the market spent most of the day down triple digits. However, the markets reversed in the last hour of trading with the Dow finishing down just 45 points. Tuesday was another down day so many of us thought the rally was on its last legs. Wednesday followed with a volatile day finishing down slightly.

This all changed when Well Fargo decided to release news of “record” first quarter earnings before the bell on Thursday morning. The news was cheered on by Wall Street, catapulting the Dow up 3.1% or 246 points for the day.

Leading sectors

All the financials joined the party with the group up over 20% for the day and many issues such as Well Fargo, Bank of America and Citibank up over 30%. The S&P was up 3.8% as it has a 16% component of financial service stocks. The financial stocks are up over 60% since the May 9th low while the general indices are up 22-25% in the same period.

News in the homebuilder sector on Tuesday also fueled the market’s rise as Pulte announced its purchase of Centex giving them huge market share and a lot of cash in their collective kitty. The news also fueled hope that the housing sector was beginning to bottom.

Emerging markets has been the leading sector in March with a year to date return of 12% through last Thursday. It is outpacing all the developed markets. The Dow is still down 7.9% through last week and the developed markets, without the US and Canada, is down 9% year to date. Emerging markets, one of the hardest hit sectors last year, were down over 55% in 2008 and another 16% in January so they were due for some kind of bounce.

The G-20 meeting was positive and they agreed to fund the IMF with a \$1 trillion injection. That is up from \$250 billion and let them lead with a big headline. This certainly drove the news and helped fuel the optimism, especially in foreign markets.

The leading sectors in this recent rally were miners, financials and emerging markets. This is a “red flag” of sorts as they were among the hardest hit groups last year. Generally, sustainable rallies are not led by the weak sisters.

Post Holiday pullback

This week started off less rosy as European markets were closed for the Easter holiday and news of more earnings shook the markets. Financials still led as optimism continued.

Goldman Sachs announced they were going to issue more stock to pay back the \$10 billion of TARP money they took in October. They would not be restricted on bonuses for their employees. They are going to issue \$5 billion of stock, diluting their current shareholders by 8%. They reported after the bell on Monday, April 13th with better than expected earnings. However, they decided to cut their dividend. Many on Wall Street wondered why they needed to cut their dividend and issue stock if their news was so terrific. The stock fell in after hours trading and fell almost 12% on Tuesday.

On Tuesday morning, retail sales were reported – much worse than expected – down 1.1% including autos. Without autos they were still down 0.9% - again more than expected. February's numbers were revised upward however, but the news was enough to take the smile off one of CNBC's perma bull broadcasters Steve Leesman. There was no great way to spin this number – consumers are shutting their pocketbooks.

Optimism reigns

There is a great sense of optimism in the markets. We have the “experts” on CNBC all telling us they invested on March 9th and “called the bottom”. It seems that everyone is now an expert and also a technician. We have average investors asking us about making the “bottom” in the market in March.

Comparisons abound with 1938's market. Take a chart from that period and it overlays our current market quite closely. But folks are also comparing our current markets to those in the depression, '82, '74, '32 and '02. Most of these were bear market territory. Fundamentals differ but we fear we are in the midst of a long term secular bear and we just experienced a bear market rally.

Folks are looking forward to the spring selling season for homes and hoping that there will be good news in the sector. Economists are reiterating the old adage that the markets move 4-6 months before signs of an economic recovery are seen. We all want to believe things are getting better.

Obama and company are making constant public appearances to instill a sense of “we can do it”, trying to provide hope and patience in the general public. Even the news of a possible bankruptcy filing for GM is not causing panic. I believe a sense of a plan is better than no plan and as long as we take action, things will improve.

Peeking under the top line numbers

The real story in the numbers lies beneath surface. This week's Barron's quoted a report by T2 Partners, a New York money management firm. They are quite

bearish and believe the housing market will fall 45-50% from the peak in 2006. Currently, we are down 32% so we have a lot further to go if they are correct.

T2 also pointed out that the uptick in January's existing home sales number that got everyone excited was mostly sales of distressed properties (~45%). They predict we will face a "tsunami of foreclosures" in the next two years. Another scary fact from their report was the fact that the securitized mortgage vehicles created by Wall Street over the last few years represent 16% of all mortgages but 62% of seriously delinquent mortgages. Not great news for the valuation of these instruments!

If you take a closer look at Wells Fargo's report, you'll see that most of their profits came from trading interest rates and currencies. Plain old vanilla banking – lending money to consumers and businesses did not increase. When Wells took over Wachovia, they front end loaded the losses and took them all in the dismal fourth quarter. So now they have the additional deposit base of Wachovia's network of branches to claim as their own.

A range of concerns

The unemployment rate is 8.5% and many feel it will pass 10% before we are finished. Consumer credit fell by 9.7% last month as credit card limits got cut and new ones are not being issued. Delinquencies continue to climb in the credit card arena and could be another shoe to drop for the banks.

GM is facing a possible bankruptcy filing. They have \$29 billion in unsecured debt, \$30 billion in UAW and VEBA liabilities and \$13.4 owed to the Fed. Bondholders are screaming as they feel they may get the short end of the stick. Chrysler is working with their creditors to attempt to strike a deal. Car sales continue to decline 40% or more.

This rally may take a breather and we could see a pullback into early May. We do anticipate a rally back to January's highs by early summer. The markets can rally on future hope and then give it back as the news is not as good as anticipated.

Rethink your strategies

The old buy and hold is not going to work if we are in the midst of a long term bear market. You must consider new strategies and be aware of the risks in the market. We are finding some investors leaping into investments they think will bring back their portfolios but are not assessing the risks completely. If you lost 35% of your portfolio, you will need 53% to get even. If the markets replicate the past secular bear markets, we are likely to see rallies followed by pullbacks with little progress being made in total. Take advantage of the rallies and pare back the weak sisters in your portfolio. Limit your exposure to equities if your risk tolerance is not what you thought it was.

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

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