

Chapin Hill Advisors, Inc. Market Comment
December 2, 2008

Deep Discounts Reel in Shoppers on Black Friday

Black Friday

Ever wonder why it is called Black Friday? This is the day most retailers move into the “black” or become profitable for the year. Most retailers do the bulk of their business in the last quarter and sometimes the holiday season sales push them into profits for the year. However, this year is not likely to rescue the bulk of retailers.

While there were 7.2% more shoppers than last year, 70% were only buying deeply discounted merchandise. Consumers have shut their pocketbooks so retailers of all types have been luring them in with a wide variety of discounts. Profit margins are being squeezed to bring in the gross revenue.

Saturday’s sales ebbed causing more angst among the retail crowd. A large number of shoppers indicated that rather than just beginning their holiday shopping, they were completing it! Not great news for any type of retailer. This may pour over into more bad news for commercial real estate as more stores get shuttered. Sears is closing locations, Linens ‘n Things is going out of business, Steve & Barry’s is liquidating and more will likely follow.

Auto Woes Continue...

November sales were reported for all the auto companies on Tuesday and they were miserable. Chrysler led the pack with a 47% decline in sales followed by GM with a 41% decline. Toyota which has been taking market share away from the domestic auto makers declined by 33% and Ford was the winner with a 31% drop! The motor chieftains are making their way back to DC asking for help, hats in hand. No business plans for turnarounds other than selling a few private jets as they got lambasted by Congress for flying in to beg for money in their jets.

GM is asking for \$18 billion and then CEO Wagoner will cut his salary to \$1 a year. Ford’s Mulally says they want \$9 billion in loans and he’ll cut his salary to \$1 and claims Ford will return to profitability by 2011. GM’s board is reserving bankruptcy as an option to the dismay of Wagoner. When Lee Iaccoca famously turned around Chrysler years ago, he did indeed take a \$1 as salary. However, he had a rock solid business plan for a turnaround. These guys seem to be missing the bottom line and feel that Congress “owes” them and won’t let one of the mainstay businesses of America fail. But Congress does not seem to be leaning towards being too generous here. More to come.

Pennsylvania's Pension Fund Losses...

The State of Pennsylvania had great returns for the past few years. But they did it with leverage and that leverage is coming back to bite them – *hard* - this year. They used something called “portable alpha” to use derivatives to fund their \$9.2 billion investment in hedge funds. These complex instruments have backfired as the credit collapse and the bear market took hold. The PA Pension fund is currently making cash payments of \$2.5 billion this year to their trading partners to cover the shortfall on the collapsing derivatives. These payments combined with the losses of the market on the \$27 billion fund will mean the State must **quadruple** their funding by 2012 to \$1 billion dollars. They cannot be the only pension fund to be caught in this squeeze so we will have to see if others adjust their contributions going forward. Where, in tight economic times, will these funds be found?

Asset Creep in reverse...

One of the challenges we often face as advisors is finding a small or midcap money manager who can stay within the parameters of that universe of market cap. Great stocks tend to grow, as they do their market cap increases. So midcaps become large cap stocks and small caps stocks become midcaps. We call that “asset creep”. Today's bear market is causing the reverse to happen as stocks shrivel in value and their market cap declines.

The S&P had to lower their market cap for inclusion in their index this year from \$4.5 billion to \$4 billion and they have deleted 30 companies, 16 of them since September 10th due to declining market cap. In the universe of small caps, 59% of the Russell 2000 index has fallen below \$10 a share and more than half trade with a market cap of under \$250 million. That level used to be the cutoff for microcap stocks.

The same thing is happening in the growth and value universe. As earnings shrink, former value stocks look like growth stocks. And growth stocks which have fallen dramatically in price now look like value stocks. This adds yet another challenge to the investor – both professional and individual - in managing their asset allocation.

Real rates of return are abysmal

We all know the market has dropped but the numbers are sobering. The S&P is down 43.22% through December 1, 2008. The 6 day run-up through November 28th on the Dow was largely erased on Monday when the Dow dropped 674 points. That brings the Dow's loss to 36.93% year to date. Nasdaq 100 is down 47.29% as the tech heavy index suffered with worries about future tech spending on both the consumer and corporate level.

The cumulative effect of these losses is staggering. The 10 year trailing real rate of return (adjusted for inflation) on the S&P is now -3.8%. That is worst than the 1974 bear market where the 10 year real return of -2.7%. Bonds are not providing much of a safe haven as the Lehman Global Aggregate index is down 1.03% through December 1 and high yield is down 29.82%. Investors are dismayed as they realize they gave up everything they made going back to 1998!

Credit crunch to hit States

Obama held closed door meetings on Tuesday with all the governors of the States as he is working on his rescue plan. The governors are all pleading poverty and looking for some economic relief from the Fed. There will be budget crisis on every level – State, City, local municipality and school districts. We are urging caution on buying municipal bonds. Be sure you evaluate where the income stream is coming from to pay you both your return and your principal on muni's.

Corporate debt issuance is miniscule. Finding yield is difficult as Treasury yields are nil and you might shop around for a CD at 3-4%. The credit crunch affects everyone at every level. So be careful about jumping in to something that seems too good to be true.

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

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