Chapin Hill Advisors, Inc. Market Comment 12-17-07

Volatility Continues!

We continue to see days where the DJIA moves dramatically intra-day, sometimes in 100-200 point swings. This week was another volatile ride!

The two trading prior to Tuesday's Federal Reserve meeting and announcement was quiet as traders hedged some of their positions but it was mostly "wait and see". The consensus was for a 25 point decrease in the Fed's rate but many were hoping for 50 basis point or ½ point cut. The language the Fed releases is also scrutinized carefully as everyone tries to determine what is coming next.

The Fed met and did cut rates by ¼ point or 25 basis points. But they essentially stated that they had concerns about inflation. As long as the Fed feels inflation is a risk, they will refrain from lowering rates too much as it can fuel further inflation. This was interpreted as "bad news" and the markets fell.

But the Fed is concerned about the entire "sub-prime mess" and the carryover effects on banks, mortgage lenders and insurance companies. So on Wednesday, the Fed announced a new plan to allow banks to borrow money anonymously through a new "term auction facility" which is being coordinated worldwide – something not seen since the tragedy of 911 struck.

Initially this was celebrated on Wednesday morning as the DJIA raced up almost 300 points within minutes of the opening. However, as this news was digested and further concerns about the economy were raised, the DJIA dropped almost 111 points. As the day went on, these losses were erased and the DJIA finished slightly positive. If you are sitting in front of a stock monitor or watching a ticker on CNBC, it is enough to give you heart palpitations!

The indices gave up their gains of the prior week with the Dow falling 2.1%, the S&P falling 2.44% and the Nasdaq dropping 2.6%. Small caps once again got hit the most as the S&P Small cap index dropped 4.27%.

The PPI (producer price index) was released on Thursday with a 3.2% jump in November – the biggest one-month rise since 1973. The CPI (consumer price index) followed on Friday with a 0.8% rise and 0.3% increase in "core" – that is ex-food and energy. This shows that we do indeed have inflation in our economy.

Oil to heat your home is generally more $3.00 a gallon. Gasoline in most states is approaching or has passed $3.50 a gallon. Rice just hit a 20 year high – which has far reaching global implications. Wheat, corn, meat, milk – most of our basic commodities continue to climb in price.

The government managed to cobble together a bailout plan of sorts for some homeowners who are faced with mortgages that are re-setting to unaffordable rates. However, execution of this plan could be a quagmire as they determine who is actually eligible.

On the positive side, retail sales did increase more than expected for November – by 1.2% and industrial production increased by 0.3%.

However, a survey of CFO's on their perspective for 2008 was gloomy and they have generally been a good leading indicator. Exports continue to be helped by our weak dollar but that hurts us as imports are more costly.

Auto loan defaults are increasing especially among sub-prime borrowers but there was a jump to 4.5% defaults on top rated borrowers from 2006 levels. There is purportedly a decline in elective surgeries such as laser eye corrective surgery – another sign of a consumer who is tightening their belt.

UBS reported another $10 billion write-down – bringing their total for the year to $12.7 billion – far larger than initially estimated. Citibank's new CEO took quick action to bring a number of off-balance sheet financing vehicles and the reaction on the Street was not positive as the stock got hit again. If the trend continues, Citi will need another capital infusion or they may be forced to cut their dividend (currently over 7% with the stock sitting about $30) which will save them $10 billion annually. Washington Mutual cut their dividend from $0.45 to $0.15 and the stock fell 9%. They are cutting 3,000 jobs, selling preferred stock and stepping out of the sub-prime mortgage business entirely.

Monday brought more downside as the Dow fell 1.29%, the S&P dropped 1.5% and the Nasdaq 2.32% as many techs got hit.

This week brings us more news on the housing sector. The housing market index was released on Monday with another record low and Tuesday we will get an update on November housing starts.

Moody's chief economist, Mark Zandi, released a chilling report which looks at housing prices in 80 cities across the U.S. Zandi expects prices to drop over 30% from peak to trough across a number of markets and the bottom not to be seen until sometime in 2009 with a recovery into 2010.

If he is right, this is not the news most homeowners and investors are hoping for as they expect spring 2008 prices to rebound from the winter doldrums. As homeowners see their neighbors' homes priced lower or sitting longer, it can make them accelerate their own plans to sell. This creates a domino effect and adds more inventory.

While we still feel there may be a short "Santa Claus rally" into year end, we are anticipating a tough start to 2008. The likelihood is that we have an inflationary environment coupled with a slowing economy, increasing mortgage rates, a big adjustment in home prices to move some of the inventory and all of this will add up to a consumer who may begin to think before they spend.

Be sure you have assessed the risk in your portfolio. Look back to the periods this year when the market had significant negative returns (these were short lived but could go on for longer periods in the future) and be sure you are ready to weather a potential storm. There has been a lot of volatility in almost every market this year including the bond market. That leaves an investor without much of a shelter from the "storm" unless you look long term.

Consider adding hedging mechanisms to your portfolio as other sectors can have a negative correlation with the equity markets. If you have concentrated positions, especially in the financial services arena, take pro-active action on any rallies and consider strategies to protect at least a portion of your position.

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