

**Chapin Hill Advisors, Inc. Market Comment**  
**January 25, 2008**

**More Billion Dollar Losses!**

The latest scandal to hit the Street this week was a \$7.2 BILLION dollar loss at Société Générale due to a “rogue” trader. Apparently a 31 year old trader whose main expertise was in trading baskets of stocks such as the Euro Stoxx 50 decided to make huge bets on European indices with futures. Futures allow you to control large amounts of securities similar to options which works great... if you're right. But if you are wrong, things get ugly very quickly.

This trader had worked in operations before moving to the trade desk so he was familiar with the bank's operations and was able to hide the evidence of these trades for weeks. The scheme unraveled last Friday as a red flag was raised, bringing scrutiny to his trades. Apparently, the losses could have been 10 times worse – although the bank declined to comment on this.

Many feel that the unwinding of these positions contributed to the huge sell-off in overseas markets on Monday, January 21 – President's Day in the U.S. – with our markets closed for the day. The overseas markets cascaded down with India's market losing as much as 12.9% intra-day and others losing 4-6%.

This news caused the U.S. markets to open with huge losses first thing Tuesday morning. The Dow was down almost 500 points right after opening. The VIX – which measures the volatility on the exchanges – rose to 37, the highest level since October 2002.

Financial, housing and consumer stocks continued to fall until the Fed charged in and lowered rates by 75 basis points or 0.75%. This caused the markets to reverse but they opened down again on Wednesday. We had another wild day where the markets all reversed intra-day. The Dow made a 600 point turnaround from negative 300+ points to almost + 300 points.

The most economically sensitive stocks responded with double digit increases. Of course, they are coming off very depressed prices but it was nice to see green on the screen for a change!

Before the last few days rally, the Dow was down 9.8% so far this year. It rose 6.2% over the entire 2007 period so if you held the DJIA from January 2007 through the middle of this past week, you had a -3.6% return.

The same was true for the S&P hitting -11% in 2008 after rising 3.5% in 2007 – giving you a -7.5% return from 1/2007 – 1/23/07. The Nasdaq's drop was more severe as it dropped 14% after rising 9.8% in 07 – a loss for the same period of 4.2%.

I don't believe most investors actually realize how much damage has been done to their portfolios. They hear the news but in the last 15 months, the markets have had a lot of volatility but still ended with a positive rate of return.

They don't realize that the majority of return of the last 4 years, especially for the Nasdaq, happened in 2003. The next few years, the various markets (with the exception of international) largely provided single digit returns and the bulk of the year's return happened in the last quarter.

Also, a few stocks, namely Google, Apple and Rims (the maker of Blackberry's) accounted for a large percentage of the Nasdaq's return.

This type of market action is typical of secular bear markets. We have shorter cycles within the longer secular trend of both bull and bear runs. We had a bull run from August 2006 through December 2007. That period may have just ended and we are likely to see the bear take over for at least the first half of this year.

The news continues to be bad. Housing starts are awful; existing home sales fell 13% in 2007 – the biggest drop in 25 years. Prices slid 6% versus a year ago. The builders continue to report big losses and are writing off property.

The administrator tried to come to a bi-partisan solution with a \$150 billion dollar package to provide tax refunds to individuals and tax incentives to small business owners. Many feel this is not a solution and if it is, we won't see the effects of this or the Fed cut until well into the 2<sup>nd</sup> half of the year.

In 1986, builders broker ground on 1.8 million housing units and had to wait 5 years before they experienced a real recovery. Add the 78 million baby boomers looming retirement needs and poor savings habits, massive home equity loans to the present mix and we may have a longer wait.

Most people counted on their home to supplement, if not provide the majority of their retirement. Some folks went so far as to start building their retirement dream house while still sitting on their present home, assuming the value would either hold or continue up in price and use those funds to pay off the balance on the retirement home and put a little in the bank. Trying to get folks to understand how much risk they were facing was an uphill battle over the last few years.

In our financial planning practice, we have seen first-hand:

divorcees whose entire net-worth is in the family home yet they refuse to consider moving as the kids would have to be uprooted  
recent retirees who refused to lower the sale price on their home despite warnings from realtors – only to have the house still sitting 2 years later  
couples who really should be 2-income but the wife has been out of the work force and is still hoping to stay close to home for the kids  
people in debt with home-equity after using that to bail out their credit cards now being squeezed by lower home prices  
Various business owners who are now affected by the economic slowdown with the planned sale of that business to fund their retirement possibly in jeopardy  
Folks who insisted that their area of real estate was “recession proof” now realizing that a safe haven doesn't seem to exist  
Employees who were laid off yet had the bulk of their savings in company stock – not a pretty picture if that was a financial services company

Most of these people are now scrambling to figure out how they are going to amend their plans. If they leveraged the first home to purchase the second, they are now facing higher interest rate costs, a lack of buyers as well as renters who might be able to alleviate some of their financial burden.

Jobs in the financial services industry are really hard to come by. Talks of more layoffs are constant. Citibank is rumored to be laying off 10% of their global workforce – which translates into over 30,000 people losing their job. Morgan Stanley announced another 1,000 job cuts and Yahoo layoff announcements are a sign the tech industry is not sheltered either.

The news in the financial sector continues to be dismal as both Merrill and Citibank reported almost \$10 BILLION in losses for the year. Write-off's again approached the \$20 billion mark and you wonder what the folks at the helm were doing the last few years. Bank of America's revenue fell 31% and their earnings fell by 92%! Wachovia took a \$10 billion write-off and revenue fell 16.5% and earnings by 93%.

Ambac and MBIA, the biggest bond insurers are also suffering from the mortgage fallout. Ambac's stock fell 71% as they reported close to a \$4 billion loss and had to pull a preferred stock offering intended to raise capital. This week's rumor is that Wilbur Ross, noted vulture investor, may be swooping in. MBIA floated some bonds at 14%.

This has caused some tremors in the municipal bond market as these two institutions insured many municipal bonds. We heard fears of NYC filing bankruptcy which is not at all likely (if it were, we'd be in big trouble). One opportunity created by this fallout is the closed end municipal bond market. These funds trade on an exchange like a stock and many are trading below their net asset value with yields approaching 5-6% tax free.

The overseas markets continued to be volatile. China's growth rate is over 11% but the concerns about inflation remain. Once again, if the US consumer is flagging, this is a real problem for the Asian Tigers as they do not consume a fraction of what they produce. Inventory gluts can build up quickly and send the emerging markets into freefall. Be careful if you still have a lot of international exposure.

Gold continued to run. Oil is still over \$90 a barrel. The expectation is 100% that the Fed will cut next Tuesday. This means that the markets will fall if no cut is announced. The need to protect your portfolio is even greater now that the bear seems to be in charge.

Evaluate your portfolio and really look at how much risk you have. I find that many have become apathetic and assume that if they are in for the long haul, they can ignore the market's volatility. This may be so if you have the right portfolio for your risk tolerance.

However, remember that a \$50 stock that rose 100% is now \$100. A \$100 stock falls 20% and your gains have been cut down to 60%. If you purchased at \$100 and lose 20%, you need 25% to get even. The numbers get bigger as the losses increase. A 50% loss needs to grow 100% to get back to break even.

As your portfolio grows, losses can really add up. A balanced portfolio would have lost almost 5% through the first few weeks of this month. If you had \$2,000,000 invested, that's a loss of \$100,000. Be sure you are ready to withstand that much downside.

As always, feel free to contact us with comments and questions. We use inverse and plus ETF's to attempt to offset some of the market's downside risk as well as capitalize on the market's bear runs. If you are interested in hearing more, please email us at [HYPERLINK "mailto:info@chapinhill.com" info@chapinhill.com](mailto:info@chapinhill.com).

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