Cramer Takes on the Fed
Chapin Hill Advisors, Inc. Market Comment 8-14-07

Jim Cramer, the madman host of Mad Money on CNBC and the man many people love to hate made it to the #1 spot on YouTube this past weekend. If you've ever watched his show, you know Mr. Cramer can be very vocal and hams it up but he definitely went overboard on this clip.

He called Bernanke an academic and insisted that the Fed should "wake up" and put some liquidity into the system. He kept repeating that the Fed had "no idea" how bad it was out there and they needed to take immediate action.

Is Cramer right? Is this the beginning of a meltdown in the financial services arena? Will the Fed ride to the rescue and open the spigot of cheap funds? Only time will tell but the current liquidity crisis is certainly top of mind and continuing to play out daily in the stock and bond markets.

This past weekend, the focus in the financial news shifted to the "quant funds". These funds are managed by money managers who use quantitative models to make buy and sell decisions in their portfolios. Apparently, the models have misjudged the downside risk in some vehicles and a number of them are apologizing to their shareholders. One of Goldman Sach's flagship funds, the Global Alpha Fund is down 26% as of last Friday. This fund accounted for something along the lines of $700 million in fees last year for Goldman. If investors flee the funds, there are double whammy's as they must continue to sell into a downturn and lose lucrative income.

Jim Simon's Renaissance Fund (which has had a stellar long term track record) is another quant fund which was down over 7% through last week. He was quoted in a letter to his investors blaming the risk on the other funds out there de-leveraging their balance sheets.

As these funds attempt to de-leverage (leverage is a wonderful thing on the way up but boy, does it hurt on the way down), they must wholesale sell stocks where they have gains or positive outlooks to generate cash and close out short positions where they made money. This has the effect of pushing up values for weaker stocks and causing good quality stocks with no pending bad news to sell off. This adds to the frustration of many investors as they attempt to figure out what is going on.

We will likely see no end to this continued volatility. If investors panic and begin to pull money out of managed accounts, additional liquidations take place. As stocks fall, the total value of a portfolio decreases and if there is leverage at work, the sell off must continue. There is a lot of leverage in the system and when panic hits, it spreads quickly.

Last week, we saw the Dow climb 476 points from Monday through Wednesday, only to lose 387 in on Thursday and another 31 points on Friday. However, intra-day, the Dow was down over 200 points on Friday so it recovered quite a bit. Every morning, we look to the futures to get a window in to how the markets will open but this no longer seems valid as the days have these wild swings.

The Fed rushed in to add liquidity to the system and bring down the overnight Fed Funds rate to 5.5% where it was before demand drove it up to 6%. They released $24 billion on Thursday and another $38 billion on Friday. The European Central Bank also dumped funds in to their system, adding $83.8 billion on Thursday and $120 Billion on Friday. Some of this was triggered by BNP Paribas announcing that three of their funds would suspend liquidations due to investments in U.S. sub-prime mortgages. This caused the worries to spread that another shoe would drop as more and more managers 'fessed up to owning debt instruments under pressure.

The financial stocks continue to bear the brunt of the sell-off with Bear Stearns leading with a negative 32% return as of last Friday. Citibank, Merrill, Goldman, Bank of America, Morgan Stanley – the list is long and the losses are all in the double digits. They added to their losses on Tuesday with declines of 1-3% across the board.

The Producer Price Index (PPI) was released on Tuesday morning at a 0.6% increase for July – double expectations. Wednesday's Consumer Price Index (CPI) will be the focus as everyone attempts to discern the amount of inflation in our economy. The bet is that the Fed will ride to the rescue and a rate cut is predicted for September by most of Wall Street.

However, the Fed has clearly stated that they are concerned about inflation. Oil has dropped from its high of nearly $80 to the low $70's but this winter is supposed to drive the price of home heating oil back up as we do not have the supplies to meet demand.

The Fed may also be hesitant to add liquidity to the markets as they are seen as the source for the rampant borrowing that took place in the mortgage marketplace. Foreclosures continue to increase and it is not just the sub-prime area being affected as delinquencies and foreclosure spread to Alt-A and prime borrowers.

As if we need more to worry about, Tuesday brought renewed concerns about the consumer with weak retail sales figures. Wal-mart reported Tuesday and reduced their future estimates for earnings. They expressed concern that the consumer was under pressure from economic forces and they would continue to hold back on spending. Home Depot held firm to their estimates but also expressed concerns that the falling housing market was affecting consumers. This is the news we all feared may come to pass – the mighty American consumer is beginning to falter.

The housing news continues to be bad with two more mortgage companies filing for bankruptcy last week. Countrywide Credit, one of the largest and supposedly most sound mortgage companies indicated concern about the "unprecedented disruption" in the mortgage business and that drove their stock down 13% at the opening. The stock did get buyers flooding in and closed down less than 3%. Obviously, there are some hopeful investors out there who continue to bargain hunt.

This is a tough market to invest in and try to stay on course. It is being driven by the institutions and the average investor feels bewildered. The Dow and the Nasdaq are each up less than 5% as of Tuesday, the S&P 500 is just about flat for the year and the small cap Russell 2000 is approximately -5%. We have given up most if not all of what we earned in the first seven months of the year. Unless we get a strong rally in through the end of the year, this year is likely to be flat to down.

Investors who may have gotten over-confident with the gains made in the last year are now attempting to figure out how to protect their portfolios. One month has brought most portfolios back to where they were in April 2007. A continued decline can wipe out an entire year's return in your portfolio.

Take this time not to panic but to review your overall portfolio and your goals. Knowing "how much is enough" and what rate of return you need to average to be able to meet your goals is critical. If you have done this work to evaluate your overall situation, you should be able to wait through periods of volatility without panicking. Having some type of hedging strategy can be very valuable in times like this. Seek out professional advice so you do not make emotional decisions.

Please feel free to call us with questions or comments. We are happy to evaluate your current strategy if you are looking for a second opinion or want to know if you are on track for meeting your own financial goals and objectives.

Who is Chapin Hill?

Chapin Hill Advisors, Inc. is a boutique financial planning and investment advisory firm, providing our services to high net worth individuals or business owners. We use the full range of investment products and employ a core and satellite strategy to better facilitate the implementation of specific strategies.

We pride ourselves on the delivery of great service. Our delivery of service is customized to the clients needs and includes quarterly reviews as well as regular communication based on what you desire.

The Chapin Hill Advantage

A unique, process-driven approach to financial advice that combines expert financial knowledge with high-touch service**,** resulting in a personal investment strategy that leaves clients feeling confident and having "peace-of-mind". We take the time to understand you prior to making any recommendations. Our planning process covers *The Seven Tenets of Planning*: retirement, education funding, risk management, cash flow/debt management, taxation, estate planning and investment management. Our process can determine your probabilities of success based on the most appealing scenario of your choice.

The Chapin Hill Advantage was created by our founder Kathy Boyle. She has over 15 years' experience within national and regional investment banking and brokerage firms prior to founding Chapin Hill in 2000. Kathy is a regular commentator and guest on national television shows such as **CNBC**'s *Power Lunch*, **NBC**'s *Nightly Business News*, **ABC**'s *Businessweek TV*, **Fox**'s *Your World with Cavuto* and **Bloomberg** radio and personal-finance shows.