

Chapin Hill Advisors, Inc. Market Comment
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Credit Concerns Weighing on Financial Services Sector

This week's Barron's had an interesting chart provided by Market Mavens' Stephanie Pomboy on the percentage of Adjustable Rate Mortgages (ARMS) which are presently in negative equity. The amounts are staggering and increasing dramatically.

Last year, 17% of ARMS were in negative equity, representing \$510 billion dollars. Presently, 23.1% are now in negative equity – a 35% increase – and a whopping \$693 billion! If recapture rates are at 70% (an optimistic goal), losses would amount to \$210 billion. A 50% loss would be \$346 billion – borne by a variety of financial institutions who rode the wave of the mortgage/housing boom.

If housing prices continue to decline, these numbers continue to grow. Another 5% decline in housing prices would increase the percentage of loans in negative equity to 30.6% - an increase of 10% - but it would add another \$225 billion to the amount in negative territory for a total of \$918 billion. A 30% loss on this amount is \$275 billion and 50% loss is \$454 billion.

Mortgages comprise approximately 55% of total bank loans. This does not include the trillions of dollars of mortgage-backed securities on the balance sheets. Commercial banks have the lowest loan loss provisions in 20 years and they have dramatically increased their exposure to real estate. Defaults would radically affect the bottom line.

In 2006, 40% of all new mortgage borrowers did not qualify as prime credit risks. With house prices dropping, rates are increasing as a huge number of ARMS arrive at their 3 year anniversary - the home "piggy bank" is empty. Lending institutions are tightening up their credit criteria as they attempt to shore up their overall loan quality. What will consumers use to finance purchases ranging from plasma televisions to gasoline to college tuitions?

On Tuesday, July 10th, Home Depot guided expectations for the full year down by 15-18%, blaming the weak housing market for their slowdown. Lowe's also lowered guidance, as did Sears. The homebuilding company D R Horton reported a 40% decrease in sales for the 3rd quarter.

Bernanke will deliver a speech this afternoon on his view on inflation and Wall Street will be attempting to read between the lines to determine if rates will rise, be lowered or stay the same.

The Fed continues to look at "core" inflation, which excludes food and energy. However, the biggest expenditures for most consumers after their

mortgage payment is feeding their family, filling their gas tank and either heating or cooling their homes. The average American is feeling the effects of \$3.00+ gasoline and increasing prices on everything from eggs to beef to tofu.

China is still on fire with their markets climbing over 70% year to date despite some big pullbacks. The average investor in China is a novice and my take on their market is a parallel to our dot-com bubble in the late nineties. When it will burst and how far it will fall is anyone's guess, but when it happens, it is likely to be ugly.

The U.S. markets have shrugged off the last few pullbacks in China. However, the 9% drop in February of this year did trigger a widespread sell-off. If the Chinese markets were to fall at a time when another round of sub-prime trouble or a global political crisis were announced, that might be enough to push the U.S. markets into a sustained sell-off.

China's trade surplus continues to grow despite pressure from the U.S. government to allow their currency to more freely fluctuate. The surplus grew 85.5% from a year ago and crossed the \$100 billion mark for the last 6 months. Inflation is a concern, as it rose 3.4% in May as prices continued to spiral up.

China and most of the other Asian countries primarily export; they are not consumers. If the global consumer, led by the leveraged U.S. consumer, were to slow down his/her spending, a surplus would build very quickly. The Asian exporters would aggressively cut prices which might help for a period of time but eventually inventories would rise, creating a glut of goods with few buyers.

Back in the U.S., in addition to the potential for a sub-prime mortgage meltdown, there is concern about the increasing amount of high yield debt used to finance the many takeovers that were announced recently. A few of the deals brought to market did not meet demand as investors began to look more closely at these loan covenants.

There is little protection in many of these for the lender and the debt has been sliced and diced and sold to the average investor as CDO's (collateralized debt obligations) and CLO's (collateralized loan obligations). The fact that Blackstone decided to cash in their chips by going public and KKR is following with a planned \$1.25 billion offering is a sign that the market for these lucrative deals is peaking. Selling to John Q. Public is a way for the founders to cash in on their past track record. As we all know, past performance is not indicative of future performance, so the rear-view investor may not realize his/her expectations by participating in these deals.

The massive amount of the latest announced deals (Hilton for \$26 billion and Bell Canada for \$48.5 billion) mean that more of this debt will be coming to

market. There's still plenty of liquidity sloshing around but if these deals do not deliver, the price of this instruments could sink like a rock.

Despite a slowing housing market, increased costs of borrowing, a potential sub-prime blow-up, rising oil prices, the markets have continued to rise. The S&P had a -1.1% return for June but it was up 1.6% in the first week of July. Nasdaq has held up better as techs are acting better than many other sectors.

Any pullback this week may be a buying opportunity for a run up to new highs later this month or in early August. However, you should not expect the markets to continue to deliver the return of the past year. This week is the beginning of earning season and much attention will be paid to future forecasts.

There are ways to hedge your portfolio against a significant pullback and there are many ETF's (exchange traded funds) which allow you to profit from a decline in high yield debt, a rise in gold prices and a decline in financial services stocks. It may be prudent to have some exposure to these instruments to add some protection against a cyclical bear period in the markets. No market goes up forever and this bull cycle is getting a bit tired.

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