

Chapin Hill Advisors, Inc. Market Comment

Indices fall to single digit gains and losses year to date!

What a difference a month can make. In mid-October, we hit highs on most of the indices and in a few short weeks this month, we gave all of it back!

Monday's trading brought more massive selling which accelerated in the last hour of trading. This is the opposite of what happened in the bullish days where the last hour brought strong gains. The market opened strong this morning and flipped around all day until 3:00pm and then the selling ran on.

The Dow gave up 240 points or another 1.8% today bringing its year to date return to 2.35%. The S&P lost 2.3% bringing its year to date return to a negative 0.72%. Nasdaq was up over 16% at its high earlier this year, but after today's trading, the year to date return is just 5.41%. The Russell 2000, the small cap index, is now in very negative territory with a -5.77% return.

The financial stocks and the housing stocks led the declines. It was hard to imagine a few months ago that Citibank at \$55 would hit \$30 in just a few months! That's a drop of 45% in 3 months. Today they announced that they would be laying off many more employees. This is after a wave of 17,000 earlier this year and firing their CEO.

We have consulted with a number of people laid off from Citibank and a good portion of their net-worth is concentrated in their company stock. Unfortunately, many of them cannot bear the idea of taking a "loss" and want to wait "until it comes back". They worked at the bank for years and feel they know it and can't bear to sell it at these prices.

These folks should look back in history at the folks who worked for EMC, Intel, Cisco or numerous other tech companies whose stocks rocketed away in the 90's only to fall to precipitously for the next several years. Many of them ended up in the low teens to single digits from \$70+. Despite big run-ups over the last few years, they are still down significantly from their dot-com highs.

This financial crisis may go on for years. The banks are continuing to get hit with credit cards defaults in addition to mortgage delinquencies and defaults. They will continue to tighten their lending standards and err to the side of cautiousness until the crisis is over. We still have a large number of ARM's (adjustable rate mortgages) which will reset – all the way through June 2008.

Monday morning's Wall Street Journal highlighted a couple who are struggling to keep their home as their mortgage rate was reset to 8% a few months ago and just reset to over 10%. Their payment has gone up 66% since they purchased their home. The average person is not equipped to handle these kinds of increases. Something has to give and if they are going to handle those mortgage increases,

then their spending will decline. While presently, the Nordstrom buyer is shifting to Target and the Target buyer is shifting to Walmart, overall spending could continue to decline. Black Friday (and Saturday and Sunday in many cases for stores who aggressively sought shoppers) brought in huge numbers of shoppers, their margins are thinner as they offer deals and the average spending per shopper declined. This is not great news for consumer stocks.

Of course, all the pundits in the media are adding to the furor with their comments and constant chatter about the drop in the market. If you listen to them all day as I do, you hear the same info over and over again. Where were all these “experts” giving signs of caution at the market highs?

Some of the infamous bears are turning bullish and predicting a year end rally. We may be close to a bottom as fear builds and individual investors’ confidence ebbs. Volatility is probably here to stay and if you did not lighten up on your equities, more than likely, the “horse is out of the barn” at this point.

Consumer Confidence hit a low not seen since 1992. Hedge funds which can invest in stocks and bonds but can also “short” the market have the lowest level of long positions in 4 years according to ISI’s Ed Hyman. This means that the market could be reaching what we call “oversold” conditions meaning there are too many people on one side of the market. If we are oversold, we could get a bounce and if conditions are right, the bounce could turn into a rally.

At Thanksgiving dinner, several people asked me what shorting meant. When you “short” something – generally a stock or an index – you sell it and hope it goes down so you can buy it back cheaper than the price for which you sold it. It is the opposite of buying something and hoping it goes up. It is not evil but it goes against most people’s optimistic view of the world. It is another way of making money, especially in a volatile market where we see big up days and big down days. You can capitalize on both if you are right (and nimble).

However, you must remember that if you were to sell a stock short, your risk is great as your loss technically is unlimited. When you buy something, all you can lose is your investment. So if you purchased a stock at \$40 and it went to zero, you lose your \$40. But if you shorted a stock at \$40, it could go to \$80, \$100 or even \$120 or more.

Another way of taking advantage of the downside is through the use of the many ETF’s (exchange traded funds) that exist and seem to come to market every day. Exchange traded funds are simply a version of a mutual fund that tracks an index or a sector and trades on an exchange like a stock. Many professionals like them as we can trade them intra-day and do not have to wait for end of day prices as you do with traditional mutual funds. You can also track them on a technical analysis program.

Many of these ETF's correlate both positively and negatively with a sector or an index. For example, you could bet with the Nasdaq 100 (NDX - the largest 100 stocks in the Nasdaq composite index) and purchase the QQQ's and gain whatever percentage NDX gains. Or if you wanted to bet against the market and thought the NDX would drop, you could purchase PSQ and make the inverse of what the NDX loses. If it drops 1%, PSQ goes up 1%.

They also have double inverse and double positive ETF's, meaning you get two times whatever that index or sector does – up and down –depending on what you own. While this may sound confusing and can indeed make your head spin, they do provide ways to leverage small amounts of money or to add protection to your overall account. Since you are purchasing an ETF, you are limiting your loss to the price you pay for the ETF. You should have professional advice if you decide to attempt this strategy or subscribe to some type of technical service to decide how to play these strategies.

In our core and satellite strategy, we employ a number of ETF's in an attempt to take advantage of the moves in the various sectors and indices in the markets. These have helped us provide an edge to clients as we bet against the consumer discretionary stocks, basic materials, real estate stocks, emerging markets and others. These ETF's have risen as those sectors have declined which offsets some of the downside risk in the “core” or traditional portfolio.

In this market, you must be nimble and often go against the crowd but do so in a measured, disciplined manner. By the time that everyone realizes that the dollar has dropped, oil is staying in the high double digits, the consumer is no longer spending, the sub-prime bleed may be bigger than initially projected, the housing crisis will probably last a few years... the stocks affected have dropped precipitously.

If you have not looked at your account over the last few weeks, you are most likely going to be unpleasantly surprised if this decline runs through the end of this week. If the volatility is too much for you or if you got too comfortable and perhaps a bit blasé with the gains the market has made since a low in July 2006, then you should use a rally to re-think your strategy.

The problems we have with inflation, housing, our dollar weakening, the sub-prime mess, slowing consumer spending and tighter lending standards are not likely to disappear even with a “Santa Claus” rally. If the Fed decides to lower rates on December 12th, it may provide some temporary relief. But 2008 is likely to be a tough year in the market.

You may want to move to a more conservative model portfolio, add some types of hedges, look at alternative investments for a portion of your portfolio or get some professional advice to help you offset some of the risk in your portfolio.

Due to the market volatility of the past year, many mutual funds are set to distribute large capital gains. If you purchase a fund at this time of year, you will be subject to those gains even though you own them for a few short weeks.

If you are underweighted in an asset class or want to participate if there is a Santa rally, consider using ETF's in this case as well. There is an ETF for each and every asset class as well as sectors and styles (growth versus value). The ETF's distribute gains to you at the time of sale unlike funds which must distribute their year's gains at the end of the year.

If you are overweighted in a stock or an industry, use any rally to re-think that position and either provide a hedge of some sort or decide on a disciplined strategy to lighten up some of your concentration.

As always, feel free to call us with questions or comments. And please pass this on to your friends and colleagues.

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