

**Chapin Hill Advisors, Inc. Market Comment**  
**March 31, 2008**

**Will There Be a Spring Rally?**

Last week finished on a negative note for most of the indices. The Dow gave up 1.17% and is down 7.9% so far this year. The S&P gave up 1.17% while the NASDAQ squeezed out a 0.14% gain. This morning's Wall Street Journal attempted to make the case that the U.S. market was faring better than most global markets so it is not such a "bad place to hide".

So far this year, India is down almost 20% while China has fallen 32% and the benchmark indices in France, Germany and Japan are down in the mid teens. On a relative basis, losing 8% is better than 15-32%. My stance is that the average investor does not want to lose money – period - especially as they see their home values plummeting, their 401(k)'s shrinking and in many cases, company stock values plunging. All this taking place while 78 million baby boomers are marching closer to retirement with less time value to make up any losses in their portfolios.

The other consideration that the article failed to mention is that over the last 4 years, the U.S. indices produced single digit returns for most of that period while most foreign markets catapulted up 150-450%. If you had invested a portion of your portfolio in international markets over this entire period, most investors would still have a better net rate of return than most of the U.S. indices, even after steeper drops from the highs.

Short term, international markets are likely to be very volatile and continue to give back their gains. However, long term, they are likely to outperform the domestic indices. I would encourage you to figure out how much exposure to international stocks and bonds you should have in your asset allocation, when to add or reduce the allocation and whether you wish to protect your current profits with some type of strategy.

Consumer sentiment was reported on Friday and it was the lowest since 1973. Personal incomes still grew but if consumers are not confident, they will likely pull back on spending. JC Penny lowered guidance significantly on Friday and other retailers will be watched closely for signs of continued slowdown in consumer spending.

This market is very difficult to figure out. We have many mixed technical indicators. Most of the major indices crossed their 50 day moving averages but barely. They need to move across these averages with some conviction before we can take this as a positive signal. Momentum is fragile and this too needs to pick up steam to confirm a rally is beginning. Breadth was negative last week (how many stocks participate in rallies) – again, we want to see more stocks participate on the upside to confirm that we're on our way.

Investor sentiment is generally considered a contrary indicator. Investors Intelligence moved to 36.9% bulls from 30.9% the prior week. The American Association of Individual Investors (AAII) registered bullish readings of 41.6% - almost double the prior week. Barrons' Alan Abelson called some of the institutional crowd opportunistic bulls cloaked as contrarians. He also expressed concern that "most investors simply haven't a clue as to how bad things might get". Most investors (and most advisors) have the bulk, if not all, of their investing experience in the 80's and 90's – an 18 year secular bull market. They have not experienced a significant bear market, especially one like the 1966-1982 periods.

Another subject addressed in this week's Barrons was commodities. They quoted Steve Briese, an independent analyst, who analyzed the money flows into commodities. His position is that commercial traders – the "smart money" have net short positions on commodities – to the tune of \$79.2 billion. While individuals investors, largely through ETF's and pooled commodity funds are net long – to the tune of \$82.7 billion. He thinks the great commodity bubble is going to lose air and could see a 30% decline. The question is "when"?

The banks took it on the chin again on Friday. Oppenheimer's bank analyst, Meredith Whitney slashed estimates on a wide array of financials by 84%! She cut Citibank's estimates from a loss of (\$0.28) to a loss of (\$1.15) and says they must cut their dividend. She believes Merrill will take a loss of (\$1.60) versus a previously expected gain of \$1.30 and says their book value is low enough to command only a \$30 price target. Merrill was trading about \$40 a share when she made this announcement.

While Meredith has gained a lot of notoriety lately with her early and bearish calls on the financials, other analysts weighed in as well. Goldman Sach's analyst, Andrew Tilton, produced a report on the expected write-offs in leveraged loans across banks, broker dealers, hedge funds and government agencies. His prediction is downright gloomy with additional losses of \$460 Billion – after loan loss provisions are taken into account. He believes 15-20% of this will be related to commercial mortgages – which so far – have not experienced the fate of residential mortgages. Total losses are expected to top \$1.2 trillion and lead to tighter credit as the institutions become more and more risk averse and make fewer loans. This type of credit crunch can extend the bearish scenario.

JP Morgan made news in the beginning of the week and led an early rally by increasing the price they are paying for Bear Stearns to \$10 a share – 5 times the previous weeks offer of \$2 a share. Jimmy Cayne, chairman and former CEO of Bear, made news by liquidating his entire position – for a mere \$61 million. His stock was previously valued at close to \$1 Billion. Other well known investors, such as Legg Mason's respected value manager, Bill Miller, lost almost \$1 billion. The news of a higher price sparked a rally across the entire financial sector. However, many of these stocks faded by the end of the week.

We have met with a number of new clients over the last year that has been laid off from a variety of financial services firms. In many cases, these folks have huge amounts of their net-worth invested in the company stock. One woman, who spent her entire career at Citibank, saw her net-worth shrink by 55% from August until March due to the concentration of company stock.

It is often an uphill battle to convince clients to diversify their holdings. Most have a rationale for why their firm is “different” – I have heard this case made three times in the last week alone –with three different financial institutions. No one wants to pay taxes on gains and many people feel more comfortable with company stock as they understand the fundamentals better than other companies. If you have the majority of your net-worth concentrated in one stock, especially financial services companies, please look at strategies to diversify your holdings and reduce your risk.

The analogy I use is that of sitting in a boat when the tide goes out. Your boat will sink down as the water level goes down. It doesn't matter if you are in a rowboat or the Queen Mary; it is just a question of how much the water level declines. If the markets continue to trend down and the financial excesses of the housing boom continue to unwind, there will be very few financial institutions that will not be affected. Most stocks tend to move in groups and while this is certainly a stock picker's market – it is hard to find stocks that fight a sector's trend. So review your holdings and come up with a plan if you have concentrated positions.

Many people are blaming the Fed for our current woes. The rise in rates in 2000 to slow down the tech bubble caused a crash in the markets which lasted for 3 years. Then the ease in rates to 1% fueled the rise in housing which helped to cause the bubble in mortgages. The low rates also encouraged many individuals to use ARMs – Adjustable Rate Mortgages instead of locking in fixed rates which were higher than the teaser rates on variables. The following rise in rates caused these ARMs to adjust up to levels which many homeowners could not afford, spurring defaults. Now the reduction in rates is supposed to rescue us and there is concern about what new bubble these reduced rates will fuel. Commodities come to mind as low rates can fuel inflation.

The rescue attempt may not happen as quickly as we would like. Back in the 1990's when Citibank was trading at split adjusted cost of \$1.08 a share (currently about \$21), and the financial stocks had been in the doghouse since 1989, the Fed stepped in with cuts. However, it took 16 months for the bottom to form in the financial services stocks. We are about 6 months into the current cycle of Fed easing and the injection of massive amounts of capital. But the bubble is bigger this time and may take longer to “fix”.

The Fed is attempting to take a pro-active stance and respond to the crisis. This week's rollout was a “new” consolidated Fed oversight agency. Henry Paulson, a former Goldman CEO, understands the issues and wants to provide oversight to

the mortgage industry and streamline oversight of the financial institutions. Financial stocks rallied on this news as the myriad array of regulatory bodies does cost money and create confusion. However, in a year where we have a lame duck president and a divided House and Senate, this is not likely to make its way to reality quickly.

We may have the beginnings of a rally in the markets as financials lead the market up on Monday but I do not trust the predictions that the end is near. There is no easy place to invest with confidence as dividends on many financial stocks may be cut, growth prospects across the board are being downgraded, Treasury yields are miniscule, commodities may be hitting “bubble heights” and international stocks decline in the double digits. Combine this with the rising prices for oil, gas, gasoline and food which will continue to chip away at the consumer’s budget affecting the future prospects for a wide array of industries including travel and leisure, retail, home furnishings, automobiles, etc.

My view is that we are facing a long slide in the indices and any rally should be used to lighten up exposure to the more volatile or suspect sectors. There are a variety of strategies that can help offset some of the downside risk and decrease some of the volatility which you should consider implementing.

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

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