

Chapin Hill Advisors, Inc. Market Comment
3-20-08

One Bear falls and another rises....

Who would have thought that in just 2 days, Bear Stearns would lose 96% of its value?

Last Thursday, March 13th, Bear Stearns closed at \$57 a share. That price was certainly a disappointment to shareholders as the stock was trading at almost \$170 a share less than one year ago. This summer's collapse of two of their hedge funds combined with write-offs from mortgage loans brought the stock down over the last several months. Jimmy Cayne, the long time CEO stepped down, took the role of Chairman as Alan Schwartz, another Bear veteran, took the reins in an attempt to bring confidence back in the firm.

Last week, Mr. Schwarz stepped out of a media conference in Palm Beach to conduct a CNBC interview in which he assured us that Bear had plenty of liquidity and collateral on hand to meet their capital needs. Just a few days later, Bear was struggling with the possibility of filing for bankruptcy!

Apparently, a "run on the bank" of a sort transpired quickly as a number of large hedge funds pulled their business from Bear's prime brokerage area and other institutions pulled back from doing business with the firm. These financial institutions – both banks and brokerage firms – are intertwined in many ways. A collapse of one has major ramifications on the other's fiscal health.

This news hit the wires before the market opened on Friday, March 14th and the stock opened down dramatically, closing at \$30 a share – a one day drop of 47%!

The Fed stepped up to the plate on Wednesday with a Term Securities Lending Facility (TSLF) providing brokerage firms with a revolving 28 day Treasury loan facility. Another \$200 billion deal - available as of March 27th. This was not going to be soon enough to bail out Bear Stearns so the Fed worked out a deal with JP Morgan to provide liquidity for Bear early Friday morning. This failed to calm investors and the majority of financial stocks fell as the trading began.

By the end of the day, investors were worried that Bear would not be solvent by Monday. The Fed, JP Morgan senior executives and Bear execs huddled over the weekend pouring over the books and trying to cobble together a deal to save Bear. Bernanke participated by conference call on Friday evening and the NY Fed chief spent the weekend at Bear, leaving for just a few hours sleep. Treasury Secretary, Henry Paulson was on the phone repeatedly to help broker a deal. They raced against the clock to allow them to make an announcement in time for the opening of Asian markets by late afternoon Eastern Standard Time on Sunday.

The Fed realized that allowing Bear, the 5th largest investment bank, to fail, might trigger a collapse in confidence in other institutions creating more panic both in the U.S. and overseas.

Yet, JP Morgan was hesitant to take on a “black box” and attempted to delve in to Bear’s holdings and balance sheet to determine liabilities. The amount of leverage and the complicated structure of some of these assets made valuation of current assets a very difficult task.

When I tuned in to CNBC early Monday morning to get my daily dose of the futures for each index and the overseas market results, I thought there was a typo when the announcement ran across the bottom of the screen that JP Morgan was purchasing Bear for \$2.00 a share. My weekend reading gave estimates of a value between \$20-30 a share. The building alone was supposed to be worth \$10 a share.

JP Morgan’s stock price vaulted up as trading started on Monday as many investors felt they got a “deal” and Jamie Dimon, CEO of JP Morgan was being lauded as a very smart man. He had been a Sandy Weil protégé but fell out of favor and was fired about 10 years ago. He headed for Ohio as CEO of Bank One and now reigns as CEO of JP Morgan. Many feel he’s determined to show his former colleagues that he is the winner.

Since Bear was being purchased for stock by JP Morgan, as JPM rose, Bear’s shares ran up as well, trading as high as \$5.50 intra-day. Rumors ran rampant that JP Morgan was not interested in anything but the prime brokerage business and that another buyer was going to appear for parts of Bear’s business. This also helped buoy the shares throughout the day.

The Bear Stearns story dominated the news all week. Bear’s 14,000 employees lost millions of dollars in their life savings as they own about 1/3 of the company stock. Now many may be facing the loss of their job along with their life savings.

Lehman’s stock fell on Tuesday as rumors swirled that they were facing the same type of liquidity concerns that Bear faced. Lehman denied these rumors but fear was in the air – but the stock fell over 30% intra-day.

More write-offs were reported as Goldman and Morgan Stanley reported earnings – profits down from last year – but not as bad as anticipated. Concerns about a collapse of a British bank rocked the European markets on Thursday.

Last week’s news on the Fed’s lending facility spurred a 417 point rally in the Dow. But this run-up was erased by Friday. This past week provided a similar wild ride with another 420 point rally on Wednesday, giving back half of that on Thursday and finishing with a 262 point gain on Friday as the dollar rose and commodities fell.

The Fed cut rates by another 75 basis points (.75%), hinted that more rate cuts will follow if necessary but there are still concerns about inflation. The markets initially fell on this news as there was hope for a full point reduction but as the news was absorbed the market rallied in the last hour.

In the past two weeks we saw record highs for oil as it hit \$110 a barrel and gold as it crossed the \$1000 mark. This week, the tables turned and all commodities fell drastically. Wheat was down 14% for the week, gold dropped almost \$200, silver, natural gas, cotton, etc. all followed suit. In my last comment, I cautioned investors not to jump in to commodities all at once and this type of volatility is the reason. It is sometimes very difficult to determine the consensus on anything as the smart investor tends to be the contrarian, but it seemed that lately everyone was talking about commodities as the “must have” asset of the day. Most of these commodities have been on a serious run since 2003. A pullback was to be expected.

Emerging markets continued to fall for most of the week with a bounce on Friday. Financial stocks ran up dramatically on Friday and of course the media was filled with reports of the end of the bear market.

Don't believe it!

This rally may have some legs and it is possible that we see it run through Monday or Tuesday and possibly even another few weeks. But in my opinion, this is nothing more than a bull rally in a secular bear market.

The problems we are facing in the country have not disappeared. The Fed's providing liquidity with the TSLF lending facility, the efforts to save Bear Stearns, and the increased limits and support for Fannie Mae and Freddie Mac mortgage facilities will help but cannot solve all our problems.

Unemployment is up; the average American is being squeezed by rising food prices and gasoline. Home prices are still falling and despite aggressive rate cuts, mortgage rates have not responded. Small and mid-sized developers are filing for bankruptcy protection. Their loans at local banks is going to drag down the banks' results. Credit card delinquencies are rising and the consumer seems to finally be flagging in their spending.

Consumer spending comprises 70% of our GDP. This is comparable to having one large client providing the bulk of your business. All is well and good if the customer remains healthy and keeps buying. However, a turn in the health of this large client can have disastrous results for your business.

The American consumer also comprises a large percentage of global consumption. One of my concerns is that a serious slowdown in spending by our consumers will have a big effect on Asia. While China and India are rapidly

increasing their foray into capitalism, they do not consumer a fraction of what they produce. I fear we can face a serious glut in these countries quickly.

If you were unhappy with your portfolio's return in the first few months of this year, use any rally to re-allocate your portfolio and reduce your downside risk. Be careful about rushing in to purchase stocks that seem like "deals" – there may be a lot more pain to come. Also, research commodities and decide on appropriate levels and vehicles if you want to add these asset classes to your portfolio. Long term, I do believe commodities are headed higher, but we have a number of investors who got in at the top so there may be further sell-offs before they begin to climb again.

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

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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.

