Chapin Hill Advisors, Inc.
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The "S-word Resurfaces – Stagflation Worries Rise

Could we be facing the combination of a looming recession with increasing inflation in prices of goods and services? That combination is knows as stagflation – growth that slows to a crawl while prices for goods and/or services continue to rise – not a pretty scenario.

Worries about stagflation surfaced this week as the Fed lowered their forecast for economic growth to 1.3 – 2% for the coming year – down 0.5% from their previous forecast while consumer prices jumped 0.4% in January and are up 4.3% over the past year. Prices for food and energy are up far more than 4% and those increases affect "mom and pop". If the economic malaise continues, consumers get squeezed on all fronts.

The continued slump in housing, tighter lending standards by all the banks, more write-off's, talk about bailouts in the bond insurer area contributed to the gloomy forecast for the year. One article this past week's Wall Street Journal talked about the "negative-feedback loop" that happens when things go from bad to worse on the economic front.

An example of this loop is the situation we have now with falling housing prices. As more families watch their homes decrease in value – to perhaps less than what they owe – this leads to more people putting their homes on the market. This adds to the supply and continues to push prices down. At the same time, tighter lending standards by the banks and mortgage firms make it harder for buyers to qualify for loans to purchase the increasing inventory. So the homes either sit on the market awaiting a new buyer or prices drop low enough to drive demand.

The drop in housing prices, the largest portion of the average American's net-worth, fuels consumers' nervousness and they tighten their purse strings. Lower consumer spending hurts the broader economy by putting pressure on a variety of industries from retailers to technology companies.

When an economy depends heavily on borrowed money, the loop becomes pernicious. Total outstanding household debt rose to $136.5 trillion in third quarter 2007 from $7.2 trillion in 2001 – a 10% annual growth rate. Mortgage borrowing more than doubled during this period.

Corporate borrowing was modest for the first few years of the period above but hit double-digit growth rates in 2006 and 2007 as private equity deals, stock buybacks and debt financed deals exploded. When times are good, this leverage fuels the rise in returns. However, when lending standards tighten, the loop closes quickly, taking many for surprise. Capital gets tight; credit dries up and exacerbates the cycle.

This is the "loop" we are in right now and it is likely to continue until the excesses have been wrung out of the markets. The financial institutions continue to be under pressure and it is not limited to the U.S. The large French bank, SocGen, took a huge write-off this week and Credit Suisse reported a $2.85 billion hit from trading gone wrong – just weeks after they were patting themselves on the back for escaping most of the credit crisis. I would not have wanted to be the manager who had to report this loss to the CEO!

The market volatility in the markets continued. Year to date, we have only had 1 day of trading in the major indices with less than a 1% move. That compares to this period last year with only 4 days with a 1% or greater difference. For all that activity, we are "range-bound" with the Dow trading between 11953 and 12,866 and the S&P trading between 1312 and 1418. It seems that we suddenly have a large increase in technicians and lots of talk of the "pennant formation" or "congested triangle" to describe the recent market range. These formations tend to break one way or the other –whether it will be up or down is the big question.

In the meantime, anything that comes from the ground is making new highs. Oil crossed the $100 mark. Gold made a 27 year high and copper was up 7.6%. Commodities have been on a tear and you must be careful about jumping in now. There could be a correction or at the very least a pause in their upward trajectory. While I believe we will continue to see global demand for commodities for the next several years, remember no trend goes one way forever. It seems that now, everyone is aware and talking about commodities and when the general public gets in – it is usually a bit late.

So pick your spots carefully and average in to positions if you are going to be adding these to your portfolio at this stage.

Countrywide made news last week as the Wall Street Journal broke a story about a skiing boondoggle for their top clients while the firm barely escaped bankruptcy before Bank of America rode to the rescue. The trip was cancelled over the weekend as the cost of the trip for 30 people outraged investors. This goes into the "what were they thinking" column and certainly bought them worse PR than they could ever hope for!

Speaking of bankruptcy, the market took its' toll on two retailers as both the Sharper Image and Lillian Vernon filed. Both rely on catalog sales for a good portion of their sales but they are at opposite ends of the market. Croc's stock got hit last week as the funny looking plastic shoes reported an 84% jump in fourth-quarter earnings but lowered guidance for the full year. The stock dropped 14% and was trading around $25 – down from the $75 it hit in October. So retailers of many types are feeling the pressure.

The market's volatility seems to be making investors nervous as they pulled out over $60 billion from stocks while adding $70 billion to money markets and CD's

– according to TrimTabs. This can be taken as a contrary indicator as most investors panic at market bottoms. However, I doubt we've seen enough of a decline to call this a bottom.

This week's Barron's quoted Merrill Lynch's strategist, David Rosenberg discussing the fact that generally widening credit spreads in bonds translate into losses in stocks 4-6 months later. Based on the recent increase in spreads of various bonds versus treasuries, he is predicting that the S&P will hit 1200 in March – that's an 11% decline from where are trading today.

Monday morning brought more bad news on the housing market as existing home sales were the worst in 23 years and inventories increased 5.5%. Inventory is now at a 10.3 month supply while the median price fell another 4.6%. Lowes reported net income down 33%, cut staff, they anticipate a 7% decline in same store sales and guided estimates down to $1.50-1.58 – quite a drop from the analysts anticipated $1.74. Nordstrom reports after the close of the market while Home Depot, Target and Macy's report on Tuesday and their news will be watched for more signs of a slowdown in consumer spending.

The market reversed dramatically on Friday afternoon on talks of a pending bailout of bond insurer, Ambac. Goldman, Bear Stearns, Morgan Stanley and Lehman close the books on their first quarter this coming Friday. If the bonds and credit instruments they are holding on their books are insured through an agency without enough collateral to insure the risk, the bonds will have to be marked to market as uninsured, lower credit rates – not a pretty sight. These companies and others have a lot riding on a bailout, buyout or restructuring so most likely we will see a deal this week.

These markets will probably continue to challenge the investor. Be sure you have a plan and execute it unemotionally. Do not chase performance – so be prudent about adding commodities after this big run-up. If you buy here, be prepared for volatility in that asset class as well.

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