

## ***Chapin Hill Advisors, Inc. Market Comment***

### ***Sub-prime fallout – how deep will it go?***

There's been a lot of news coverage lately about sub-prime mortgages. This is the tier of mortgages made to those with low credit scores or no income verification loans. While the housing market was hot, the appreciation in housing prices made it easy to make these loans and attractive to the mortgage companies. They got very creative with no down-payments offers, longer mortgage terms, piggyback loans, less than diligent checking of facts and more.

Most institutions thought they limited their risk by packaging these loans into securities and selling them to other institutions. However, the last few weeks has brought surprising news as financial institutions such as HSBC announced that they misjudged the risk and are allocating additional reserves to make up for defaults.

HSBC is a large, global institution and while the damage is quite large relative to their US base of operations, it is rather minimal to the global bank. However, this is not the case with lenders who specialized in this arena.

The last few weeks have seen several of these lenders declare bankruptcy and others have seen their stocks beaten to a pulp. Novastar Financial fell 42% last Tuesday and this is after the news the week before from New Century Financial and HSBC. There is a financial derivative created to track this group of loans and it is down 33% since late 2006.

Almost one-fifth of the \$1.3 trillion mortgage securities is sub-prime. Larger financial firms are fairly well diversified however, many still have close to 10% or more of their mortgages exposed to this arena. As rates rise, the payments the home owner must make will increase and defaults will continue to rise. If housing prices sink, we will see more foreclosures in this sector.

While most of the larger brokerage firms do not hold on to these securities, there is still some risk to the group. One analyst was quoted in Barron's this weekend as estimating as much as a 5% hit to earnings in a worst case scenario. Mortgage lenders such as Indymac, Fremont General and Accredited Home Lenders are susceptible to credit deterioration. All lenders have become stricter about the types of loans they issue, stopping some practices such as zero down payments and being more thorough about fact checking. The days of the easy to get mortgage for the first time home buyer are over.

This weekend's Wall Street Journal quoted Lewis Ranieri, the man who made his fame and fortune in the mortgage backed marketplace, as very concerned about the fallout in this sector. He feels many of the latest products created may have more risk than estimated, especially if the housing market continues to decline.

Another risk in the bond market exists in the high yield marketplace. There is very little risk premium (spread over treasuries) to purchase bonds in this arena. The LBO and private equity deals are funded by these bonds and they are on a tear. This may be another shoe waiting to drop.

The markets last week took a pause but most sell-offs were met with buying. The markets seem to be getting topy yet there are no definitive technical signs of a top. The put call ratios are high enough to indicate caution in institutions however the individual investor seems to be apathetic and expect the markets to continue to run higher. The single digit returns of 2005 are long forgotten as investors compare the hot dots from last year and search for continued double digit returns.

One sign of caution is the total of free cash balances in brokerage customer's accounts. Available cash – that is free cash balances and assets minus margin debit –has declined to a negative \$39 billion. That is among the lowest levels since November 2000. Previous declines of this magnitude in July 2005 and April 2006, preceded market dips so this is worth watching.

The emerging market indices are quite extended and likely to fall the most. Last week, India, announced that inflation was running over 6% and that market dropped 5.8% in a week. There are two ETF's (exchange traded funds) that track the emerging markets – EEM and ADRE. I believe they are quite extended and are being held up by momentum which can turn at any point. If they come down to their 200 day moving average, it will be a significant, double digit decline.

Another concern is China's massive purchases of our Treasuries. Between 60-70% of China's trillion-dollar foreign reserves are invested in our Treasuries. Should they decide to diversify into other currencies, bonds of other nations or gold, the fallout would mean falling prices and rising yields.

China may make noise about controlling their growth rate but it is unlikely they can do much to dampen it or they face continued unrest from their constituents as the disparity between the have's and the have-not's increases. Concerns about their rising health care costs, a move to become an industrialized economy and the pressure to make the Olympics a success all factor in to this picture, one you cannot ignore as they will have a global affect.

There are many concerns about today's market levels and we prefer to take a defensive posture. We were too early in our call for defense in the last quarter of 2006, however we feel there is too much risk in most of these markets. We have added defensive positions and are quick to take gains if they meet our targets.

If you are not willing to see your portfolio decline with the market over the next few months, prune some of your holdings at these levels. It may be worth looking into ways to protect your portfolio. There are a variety of techniques available and we are happy to discuss these strategies with you.

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

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