

Chapin Hill Advisors, Inc. Market Comment 1-29-07

What Will The Markets Deliver in 2007?

Volatility is most likely something we should expect in 2007. While the last half of 2006 had few significant down days for any of the stock indices, January has started out with much more volatility. The Dow has not had a 2% correction in 135 days (as of Friday, 1/26/07), the longest positive stretch since 1958. That may change in the near term.

Last Thursday, the Nasdaq, S&P 500 and 600 all dropped more than 1% and the DJIA was down just under the 1% mark. A blast of cold weather across the nation, but more importantly in the Northeast which accounts for most of the oil consumption in the winter months, fueled a rally in oil. President Bush's State of the Union announcement that he was increasing the strategic petroleum reserves also fueled a run-up in the price of oil. Through early January, oil had dropped 33% from its \$78 peak in August 2006.

Added to the concerns about energy, hope for a Federal Reserve cut in interest rates faded and a lagging housing market and earnings forecasts that were generally more conservative weighed on the equity markets.

Last year ended with a 7 month rally however, that rally followed a 2 ½ month decline from early May through end of July. The last quarter rally was fueled in part by under-performing managers fearful of lagging their benchmark. They threw fresh cash into the markets as it continued to run up, adding more fuel to stocks that were running.

According to data gathered by Morningstar, 78% of active managers underperformed their benchmark indices in 2006. Large cap and small cap value has the largest percentage of managers lagging with 94% and 95% respectively under-performing their benchmarks. Large cap growth as a category turned in the lowest returns with an average of 6.93% versus the Russell 1000 Growth's return of 9.07%.

Investors need to pay heed to the appropriate benchmarks for their portfolio rather than focusing on the Dow or even the S&P. The Dow returned a 19.1% total return for 2006 but the 30 stocks in the DJIA is not representative of what most investors own in their portfolios. The top-performing stock in the DJIA for 2006 was the worst-performing stock in 2005. Many investors may not have been patient enough to wait out a two year period to achieve a positive return. The S&P 500 finished the year 16.32% (including dividends) but 12% of that return was the run-up from July through December. There are many reasons to think the market may "pause", "correct" or "tumble" depending on your point of view.

The first decade of the 21st Century (i.e. the 10 years beginning 1/01/00) is now 7 years old and has produced an annual total return of 1% for the S&P 500, so far. A 10-year annual average of 1.0% would rank as the worst decade for the stock market since the 1930's. (source: BTN Research).

Worries over rebounding commodity prices, a colder than usual February, inflation well beyond the Fed's comfort zone, rising interest rates, declining housing prices and increasing defaults for sub-prime mortgages are catalysts which could spark a decline or pullback.

Existing home sales for December slid 0.8% but sales for the full year fell by 8.4%, the worst in 17 years. The number of homes for sale declined by 7.9%, the largest monthly drop in 2 years, fueling speculation that we are approaching a bottom in the housing market. However, some people took their homes off the market for the winter months. We will have to see how many more homes for sale are added as we approach the spring selling season.

Foreclosures, while still low on a historical basis, increased 42% in 2006 with 1.2 million people defaulting. The majority of these defaults were in the sub-prime category and we should expect more as rates increase. Estimates run as high as 1.65 trillion defaults possible foreclosures as adjustable rate mortgages reset and the increased payment is more than the borrower can handle.

It is unlikely the Fed will lower in the next 2 quarters. Many of the governors have been outspoken about their concern for inflation. The Consumer Price Index (CPI) rose 2.6% for 2006, far above the stated "comfort zone" of 1-2% for the Fed. Bets on the Street turned from expectations of a Fed cut to fears of a possible hike in the next 2-3 meetings. Tomorrow's meeting and the notes of the meeting will be watched closely for clues as to what the Fed might do.

International markets have continued to out-perform the US. China is growing by 10-11% per year. They have an insatiable appetite for many natural resources. Their use of aluminum is projected to increase by 14% per year over the next several years. International markets may also pause as they generated significant double digit returns in 2006.

The markets may continue to have these sharp rallies and pullbacks. As we enter the New Year and you can delay paying any capital gains until April 2008, consider taking some profits, especially in the technology arena. Healthcare and consumer staples stocks may be a defensive way to invest a portion of your portfolio. Consider adding some type of hedge in case the markets decline over the next few months is as sharp as the run-up in the last quarter of 2006.

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

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