Chapin Hill Advisors, Inc.
Market Comment 3-5-07

Beginning of a Bear Cycle or Just a Correction?

Wall Street pundits, Fed Chairman Bernanke, Secretary of the Treasury (and former head of Goldman Sachs) Henry Paulson are each assuring us that last week's sell-off in the equity markets was nothing but a healthy "correction". Now, valuations are better, the economy is fine, fundamentals have not changed from one week to the next so there is nothing to worry about. In fact, if we listen to the gurus, the downdraft brought many stocks to a "reasonable valuation".

This past weekend, Maria Bartiromo interviewed a strategist from one of the big wirehouses and the head of TD Waterhouse on her *Wall Street Journal Report* on NBC. Each of these men was advising people that this sell-off created a buying opportunity. We heard that a lot as the market fell from 2000-2002. I can remember hearing so many reasons why we were at a "bottom" in 2001, why valuations were cheap at various times, why technology was going to rebound, how the average recession lasted 19 months and we were already at 22 months, etc. Believing the typical Wall Street gurus would have cost you dearly during that period of time.

Last week, stocks dropped about 5.5% from their February peak to the lows of the week, wiping out this year's gains and bringing some of the major indices into negative territory for year to date returns. Prior to Tuesday's 3.2% decline, the Dow has not suffered a one-day drop of more than 2% since May 2003.

The Dow lost 4.2% for the week, the S&P 500 lost 4.4%, the Nasdaq lost 5.8% and the Russell 2000 lost 6.2%. They all suffered the largest point drops since September 2001. There were not a lot of places to hide as all but 2 of the S&P 500 stocks participated in the downturn and 99 of 100 stocks in the Nasdaq 100 plummeted.

Wednesday's rebound was weak at best and did not carry across all sectors. Friday encountered steady selling all day with escalation in the afternoon. Monday morning brought news of more sell-offs in virtually of the international markets.

Maria Bartimoro's third guest this weekend was Jimmy Rogers known as the "commodity king". Many people do not know that Jimmy was
a founding member of a very successful hedge fund in the early 80's well before they were popular today. I have done a number of TV shows with Jimmy and he speaks very candidly. He rattled off an entire list of things he is concerned about and I would agree with many of his points such as:

Weak Housing Market:
Last week's new home sales were down 16.6% however some markets were down much more with the West Coast leading at 37+% fewer sales. We are coming in to the spring

selling season so perhaps things will pick up but we see inventory build-up and a resistance on the part of homeowners to be more realistic about what their home is really worth today. We will have to see how this plays out.

Sub-prime fallout:
These are the folks with poor credit scores or no income verification applications. Now that the tide has turned, we are seeing defaults rising and the issuers struggling.
The Fed is reacting after the horse has left the barn and increasing standards as are the banks. This will make it harder for new homeowners to get mortgages if they have any dings on their credit reports. It will also make it harder for those struggling with too much debt to resolve their situation. This is now leading to the next level – not quite prime borrowers – but the group between prime and sub-prime – known as Alt-A. We are seeing signs of deterioration here as well and this is a much larger slice of the overall mortgage pie.

Bank Loan Reserves:
Bank loan loss reserves are at the lowest levels in over 20 years. This works again as markets rise as all cash is deployed, however if we have defaults rising in mortgage areas and if high yield bonds begin to default, these banks can be in trouble. As a reaction to the rising default levels in the sub-prime market, most banks have increased the stringency of their loan provisions and will continue to seek stellar credit risks to offset risks that exist in their current loan portfolios. This makes access to credit more of a challenge for many people.

China:
While China's market cap is quite small relative to the size of the global markets and is largely closed to foreigners, the concern is that it has been a bubble waiting to burst. As the Chinese government sought to cool the speculation that was happening in their real estate market, the Chinese turned to their stock market. Up over 160% in the past year, many Chinese have been pledging their homes to pawn shops to free up cash to invest in the market. Similar to our dot-com bubble, this may come down very hard if it bursts.
If the Chinese equivalent of our Fed steps in to rescue the situation, this could affect the amount of money they invest in our Treasury bonds. Much of China's $1 trillion in foreign-currency reserves is now in US bonds and other assets. Pulling out of our Treasury market will affect prices (which will drop) sending yields up. In Barrons' the quote was "Reverse this flow and, perhaps, a butterfly flapping its' wings in Beijing could unleash a financial tornado in the U.S.".

Deals, deals and more deals:
Texas Utilities agreed to be purchased by several private equity firms last week to the tune of $32 billion with the assumption of $13 billion of debt. This is the latest in the furor of deals being consummated. The debt to fund these deals gets packaged into high yield bonds. Since our yield curve has been inverted and it has been hard to find income vehicles that are attractive, high yield has been purchased by a variety of managers and may be a larger portion of an individuals' portfolio than he/she realizes. This could have negative consequences if these deals do not carry through as planned.

You need not panic but if you have become blasé about your portfolio or have chased the "hot dot" of performance. However, you should review your portfolio carefully. No market goes straight up or straight down so use any bounces to lighten up on risky or high beta positions. Defensive groups may be big pharma, healthcare, consumer staples and utilities but these may be on a relative basis. However relative means that if the markets continue to drop, these will go down, just not as much as the overall market. This can still be upsetting to many people. No one likes to participate on the downside and see hard earned gains evaporate.

So evaluate your goals, your short term cash flow needs, the risk in your portfolio and your credit situation and make changes over the next few weeks if you are vulnerable.

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

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.

Securities offered through Linsco/Private Ledger
Member NASD/SIPC

The Opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly. OSJ 9 East 47th Street; NYC, NY 10017