

September 30, 2007

### **A Busy Three Months**

So much happened during the third quarter of this year that it's hard to know where to begin. Stocks hit an all time high, lost a thousand points, and then gained it all back again. The mortgage market was thrown into disarray as liquidity was cut off to the sub prime sector of the market. The Fed cut interest rates by half a point to calm fears of an economic recession. By all accounts, it was a very news worthy and volatile three months for investors.

The sub prime mortgage collapse was the over riding event of the quarter and the main cause of most of the other events. The large run up in home prices the past five years was fueled in part by a huge increase in the number of sub prime, or high risk, mortgages being given to people who traditionally could not buy a home. One hundred percent financing, interest only loans, and low teaser rates allowed borrowers to over extend themselves. These borrowers expected home values to continue upward when they could then refinance their mortgage once they had acquired equity in their home. The combination of rising interest rates and falling home values made refinancing impossible, leading to a growing numbers of defaults.

The part of this that is spooking the markets is the fact that nobody knows the scope of the problem. Because almost all of these loans were made by non traditional lenders, (i.e., not banks), there is no way to know how many of these loans were made. These lenders would typically collect a fee for originating the loan, sell it, which would then be combined with other loans, turned into securitized pools and sold to investors. These investors, which believed they were buying low risk securities, are the ones that face the brunt of the potential losses.

The extreme volatility we experienced during this quarter was the result of the market trying to come to grips with the potential fallout from this turmoil. Uncertainty always alarms the capital markets, and this is a big uncertainty. A prolonged decline in the housing market would likely cause an economic recession. The Fed stepped in with a rate cut to reassure the market that they will respond to any crisis by adding liquidity. The stock market, which likes to see interest rates going down, responded with big gains late in the quarter.

A problem that took five years to create is not going away in a month, so we expect more volatility as the mortgage situation continues to unfold. While we do not expect the worse case scenario to unfold, we do feel that there is a heightened level of risk in the stock market in the short term because of this uncertainty.

**Wabash Capital**