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HERE WE GO!

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For over a year we have been talking (warning) about the sub-prime mortgage market, the yen carry trade, and the extensive use of borrowed money to speculate. As expected, things are now imploding. Mortgage lending companies are going out of business literally overnight. Hedge funds are losing billions of dollars from one day to the next. Many will go out of business. Worldwide markets lost over \$2 trillion in value last week. This is not over but it will be over soon. It's like dominoes: Once it starts it won't take long to fully run its course.

Will we feel the effects? Sure. The truth is that you cannot have a bubble of this magnitude come to an end without having everyone feel at least a little of the pain. That will be true no matter what you do. But this is important. The money that survives this has to go someplace and the stock market is highly likely to be where a lot of that money lands. That's because it is also where a lot of money will have been protected from horrendous losses in the first place. Not many stocks will go to zero, but many hedge fund holdings will.

First, let's look at the sub-prime loans. By definition, these are loans made to borrowers with a questionable willingness or ability to repay the loan. They were used to purchase real estate in hot markets. The hope was that the real estate would appreciate in value fast enough to be sold for a quick profit, repay the loan, and keep a nice little profit for the buyer. The lender figured that even if the borrower couldn't repay the loan, the house would be worth more than the loan balance so the lender would still get their money back in a foreclosure sale. This all worked really well for as long as someone was willing to pay an ever higher price in hopes of doing the same thing. When prices stopped going up, and buyers stopped buying, and worse, the adjustable rate of loan interest was reset to much higher levels, the inability to repay the loan was suddenly a problem.

Every foreclosure of a sub-prime loan means that someone does not get paid back the money that was loaned to these borrowers. This is not limited to the original lender. The lender periodically bundles these loans together and resells them to investors. It is these investors, in addition to the original lenders, who will not be paid.

Many of these sub-prime loan packages were reorganized into new securities by the investment banks. They took the anticipated repayment schedules of borrowed principal and interest and rearranged them into new little pieces called tranches. Each tranche then has its own unique anticipated repayment schedule and level of risk that is different from the original loan package.

For example, maybe all of the first payments due on the original loans will fund the repayment of a particular tranche that will fully mature within the year. Since it is highly likely that these first payments on the loan will be paid, then it is also highly likely that this particular tranche will be repaid. For this reason, they get a "AAA" rating.

Now you take the next tranche and tell the computer to assume that since there were nearly no foreclosures for this entire upward price spiral, why, then there will be no foreclosures in the future either. If you keep doing this enough times and use enough assumptions and the right computer models, you will turn nearly all of these highly risky loans into AAA-rated securities. Voila! Junk into gold, just like that! Just tell the computer to assume there will be no defaults, and then you can pretend that this is the same thing as actually having no defaults.

Now enter the highly sophisticated managers running multi-billion dollar hedge funds. A difference in performance measured in hundredths of a percent may determine which hedge funds get the new dollars to invest and which do not. In this search for every extra dollar of profit, these high risk, but now AAA-rated, tranches look very enticing. They pay high rates like junk bonds but the AAA rating implies the safety of treasury securities.

The only surprise is that these investors, supposedly the smartest and most sophisticated among us, would fall for this. Again! Computer modeling and faulty pre-payment and default assumptions used to create the various tranches resulted in some unpleasant surprises back in the 1990's. But common sense alone should come into play at some point. When AAA-rated securities of a given maturity are paying 5%, and someone offers you AAA-rated maturities of the same maturity paying, say, 7%, wouldn't you be at least a little bit skeptical?

There is a considerable amount of additional detail that we could discuss. What matters is that a lot of this money will simply vaporize. It isn't as though someone had it and now someone else has it. It's just gone. Everyone who had exposure to these hazardous areas will have adjustments to their financial picture. Beyond the obvious, what we cannot anticipate is who, how much, and in what way.

What money is left will seek greater safety. Part of the difficulty with these exotic securities is that you don't really know what you own. That makes it pretty tough to evaluate them in any meaningful way. When people talk about the flight to safety, they mean they want significant assurances with regard to the backing, but they also want something they understand. Forget stupendous opportunity. They want treasury securities. The US government will pay you what was promised, when it was promised, and will tax us all to whatever extent is required in order to do so. They want CD's. The bank goes under and you are insured for up to \$100,000. But they also want to own the best companies in the world. They are the best in the world for a reason. That gives some assurance that they will remain in business and in demand for a while longer.

Over the last few months we have been moving out of wall street, financials, real estate, home builders, banks, savings and loans, REIT's, and mortgage lenders. We see tremendous opportunity in the infrastructure needs all around the world. We are moving into growth stocks in energy, basic materials, health, industrials, and technology. We also continue to emphasize shorter maturities in bonds. As always, we are maintaining stop loss levels on all positions. If they break to unacceptable levels they will be sold.

It is not yet time to switch from a defensive posture to that of an aggressive buyer. The time is coming. It may be another month or two but it will probably be soon. We will wait for the indicators to tell us when it's time to buy.

Insiders are already buying. Last week was astonishing! Companies were buying their own stock and insiders were buying their company stocks at a pace I haven't seen in years. One week does not make a trend, but it certainly bears watching when you see a sudden spike in activity of this magnitude.

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