

INVESTMENT OUTLOOK

Third Quarter 2007 Review and Outlook

by Whitney Brown

- Stock market undergoes correction.
- Large cap stocks leading recovery.
- Market volatility increases.
- Fed cuts rates.



Judging by the table of third-quarter market returns at right, you could say it was a fairly benign quarter. Most of the major indexes finished with a modest gain. Sometimes looking at the final result tells you all you need to know, but not this time.

Thanks to a panic in the credit markets, investors put stocks through a genuine correction. In stock market parlance a correction is generally considered to be a decline of at least 10% from peak to trough. Until recently that had not happened in over four years. Starting around mid-July the market took a four-week nose dive. By mid-August the extent of the decline was right at 10%. Thanks largely to the Federal Reserve stepping in with a rate cut in mid-September, the market recovered by the end of the quarter. Please see the article on page 3 for more about the commotion in the credit markets.

With the correction having run its course, it would be easy to say that all's well that ends well. But, the nature of the correction and recovery gives important clues about how much further the market may have to run. Major market indexes such as the Dow Jones Industrial Average, S&P 500 and the NASDAQ all regained their pre-correction levels. Most of the popular indexes are weighted by market capitalization which means the larger constituent companies dominate the performance of the index. Equal-weighted indexes where each component carries equal influence such as the Value Line Composite and an equal-weighted version of the S&P 500 did not fully recoup and finished with losses for the quarter. Also, the Russell 2000, a popular index of smaller companies,

<u>Market Measures</u>	<u>3rd Qtr</u>	<u>YTD</u>	
S & P 500	2.0%	9.1%	
Dow Jones Industrial Average	3.6%	11.5%	
NASDAQ Composite	3.8%	11.8%	
Russell 2000	-3.1%	3.2%	
Morgan Stanley EAFE	2.2%	13.6%	
Lehman Bros. Aggregate Bond Index	2.8%	3.8%	
	<u>9/30/07</u>	<u>12/31/06</u>	<u>9/30/06</u>
10-Year Treasury Bond Yield	4.58%	4.71%	4.63%
Three-month Treasury Bill Yield	3.80%	5.02%	4.88%

finished the quarter lower. The chart on page 2 compares the returns of the cap-weighted and equal-weighted indexes.

These are indications that the average stock has not fared as well as the major indexes would lead one to believe. Investor interest has become more concentrated in the largest and most liquid stocks, and they are carrying the market higher. Such market action is consistent with the later stages of a cyclical bull market. Also, growth stocks are beginning to perform better than value stocks, providing more evidence that the market cycle may be down shifting. Growth stocks are companies whose businesses are less subject to the economic and interest rate

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Third Quarter 2007 Review and Outlook (continued)

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cycles, while value stocks are those whose fortunes tend to rise and fall with the economy and interest rates.

A very distinct feature of the recent correction has been the return of volatility. We have commented before on the moderate tone of this lengthy bull market. The advance clocks in at well over four years, but the cumulative return has been modest. Pullbacks over the period have been mild and orderly until now.

This time there was a dramatic display of volatility. Between July 19th and September 18th we saw ten days where the total volume and cumulative point movement on the New York Stock Exchange were both at least 90% in the same direction, either up or down. These so called 90% days are intense thrusts of buying or selling activity and occur infrequently. A series of several of them over a period of weeks or months often signals a significant

change in market direction. This kind of volatility is more closely associated with significant market bottoms but has occurred just after the market reached an all time high. To have so many 90% days in such a brief span is unprecedented and calls for very close scrutiny of the market action in the near future.

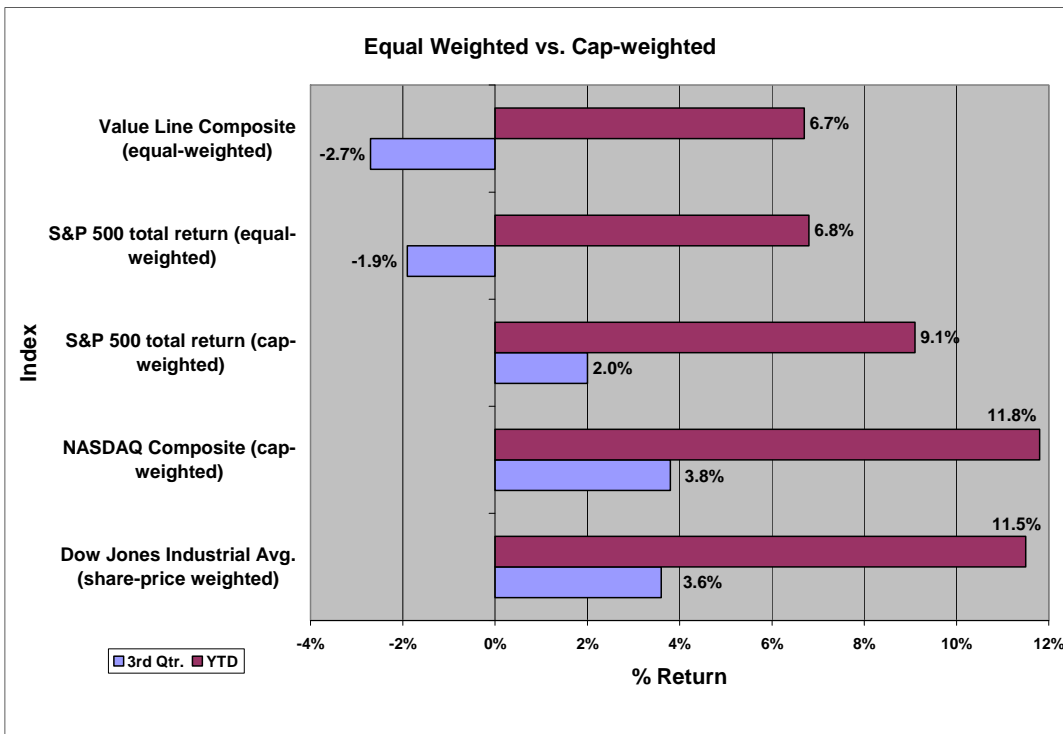
The month of October has delivered unwelcome surprises to the market in years past. Recently, there have been comparisons in the financial press of the current market environment to that of October, 1987, just before the Black Monday crash. There are some similarities but many differences. Most importantly, markets have evolved during the past twenty years. Markets have become more global with more participants, and information is distributed faster and more widely than ever before. While the market is still ruled by human nature, it is very effective at discounting known information. The

very fact that a repeat of the October 1987 crash has been widely discussed makes the likelihood of such a crash happening again at the same time for the same reasons very remote. The events that cause the most heartache for investors are usually things that have not been widely considered.

Looking ahead, conditions in the credit markets appear to be improving. That should help alleviate strain on the economy by avoiding further disruption of business and consumer spending patterns. The lack of any recovery in the housing market continues to weigh on the U.S. economy, but the labor markets are holding up well. We may still experience episodes of volatility as the financial markets sort out further damage from the sub-prime mortgage fiasco.

The stock market has, so far, continued higher in the days since quarter-end. As we have said before, the best indication of what the market is going to do is what it is doing. The Fed's decisive easing of monetary policy has been supportive of stocks in the near term. Over many years the adage "Don't fight the Fed" has been one of the most dependable on Wall Street.

However, until we see a return to a broader market advance and more evidence that corporate earnings can weather a prolonged economic slowdown, our approach calls for some caution. We'll continue to focus on strong areas of the market but also, wherever practical, be willing to keep some powder dry in the form of cash and short-term bonds.



The U.S. Housing Market and Sub-prime Mortgages

by Watt Dixon



For over 20 years, the U.S. economy has grown steadily with low inflation. The economic ups and downs have been moderate with only two mild recessions. Other countries have also experienced similar steady growth.

This long running period of steady economic growth can be attributed to many factors. Improvements in technology have allowed firms to have much better information on consumer and business spending habits, thus allowing for much tighter controls on inventory. Large backlogs of goods have all but disappeared for many industries.

Very important to the smoothing out of the economy has been the role of the Federal Reserve and other central banks in adjusting interest rates as needed to curb inflation or avoid recession. When inflation is high, spending patterns are distorted and real interest rates are more volatile.

This stable economy is a primary reason corporations and individuals have been willing to take on more and more debt, especially in the U.S. The financial market innovation of packaging loans and mortgages into marketable securities has also helped maintain economic growth by supporting consumption and the housing market.

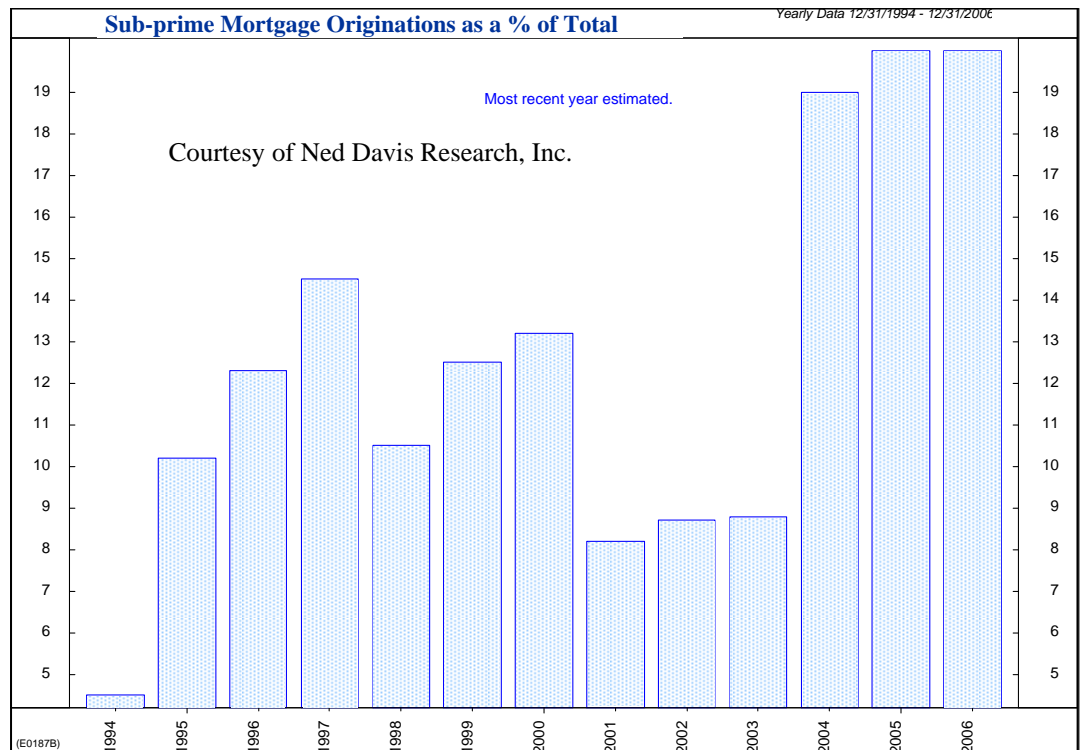
Bundling up loans and selling them off in the form of securities allows banks and other lenders to free up capital to use for other business purposes including making more loans. It also allows them to transfer the risk for the loans to other parties. These securities known as collateralized debt obligations (CDO's) are very complex. Most CDO's hold legitimate assets but many of them in recent years concentrated in sub-prime mortgages. Sub-prime mortgages are mortgage loans made to the least qualified borrowers.

Strong interest from hedge funds and institutional investors for CDO's as an apparently secure but high yielding investment caused a boom in sub-prime lending to fill the demand. When the housing

market was strong and mortgage rates were low, most qualified borrowers satisfied their need for loans. Lenders had to lower standards and make loans to less qualified borrowers to keep the pipeline full for the CDO's. Many sub-prime mortgages were made with artificially low interest rates for the first several years. In a disturbing number of cases, the loans were made under shady circumstances to people who had no way to repay them. The chart below shows the explosion of sub-prime mortgages in the past three years.

Several events have come together recently to create a serious problem in the market for CDO's and more trouble for the housing market. The U.S. housing market peaked last year. The market had become overheated because too many people were buying houses and condos for speculation instead of for their need for shelter. Market prices have declined in many areas, and demand for new and existing homes is way down.

Also, the initial "teaser" rates on many sub-prime and adjustable rate mortgages made several years ago have expired or are scheduled to expire soon. Mortgage defaults have been rising. Many borrowers who are stuck with properties bought on speculation and many who are now facing much higher payments are likely to default in the near



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The U.S. Housing Market and Sub-prime Mortgages (continued)

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future. The selling of foreclosed properties into an already sick housing market can only make matters worse.

The big issue for the financial markets recently has been the rapid erosion of the value of the securities backed by these questionable mortgages. In the U.S. and abroad, many hedge funds, banks and insurers have had to write down the value of their mortgage holdings and CDO's. Some highly leveraged hedge funds collapsed and a British bank had to be bailed out. A credit crunch has been created because many lenders are not willing to accept mortgages and mortgage-backed securities as collateral. There has been a very severe problem in the commercial paper market where many large corporations conduct short-term borrowing. A sizeable amount of commercial paper is backed by mortgages and other consumer loans.

A stable economy depends on smooth running credit markets. The Federal Reserve and other central banks have pumped liquidity into the economy and taken steps to ensure credit markets continue to function. Even so, there may be a cloud hanging over the issue for a while.

The full extent of the problem with sub-prime mortgage securities cannot be fully known in advance, and the problem is spread widely throughout the world among the holders of these securities. The good news is that biggest part of the problem is probably in the open by now. Wall Street usually likes to get the bad news over with as soon as possible.

America's housing boom after the stock market peaked in 2000 is considered by many as one of the main reasons we did not experience a recession at that time. The major concern now is that the economy will slip into a recession because of the weakness in the housing market compounded by the freezing up of the credit markets. The labor market is usually a better gauge for the health of the economy, and, so far, it is holding up well. We will need more time to tell how the complicated connections between the housing market, the securities markets, and the U.S. economy will play out. We are hopeful that the resilient U.S. economy and the intrepid American consumer can weather the storm.