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Financial Market Update – 11/8/07

Similar to August, we are witnessing a “flight to quality” style Treasury bond rally, and again the Municipal bond market is underperforming. Is it déjà vu all over again? The continued financial market turbulence has extended the mad dash to acquire Treasury securities. While there are some similarities to the August episode, additional fears and concerns have also crept into the financial markets.

Amidst the massive “write-downs” that banks and Wall Street firms are facing in their sub prime assets, the situation continues to worsen. Estimates for the future write-downs that need to occur seem to be escalating exponentially. At the root of the rush to revalue assets is the new Financial Accounting Standards Board rule 157 that becomes effective on November 15. What's at stake is the value of the assets sitting on Firm's balance sheets. The problem is that they don't hold traditional securities anymore; they hold lots of increasingly complex investments. ABS (asset backed securities), MBS (mortgage backed securities), CDO (Collateralized Debt obligations) just to name a few. While intricate in their structure, many of these assets are traded in the financial markets, and can thus be readily valued. By using the market price, “mark-to-market” valuation is transparent and thus, these securities carry a “Level 1” label. At the other end of the spectrum are Level 3 assets which I will refer to as “mark-to-bonus”. Here, there aren't observable prices to base the valuation on, but just some internal assumptions that the holders of the securities are making to estimate a value. As these assets come under increased scrutiny, we are finding out that Broker / Dealers own “Level 3” assets in size. For example, Bloomberg reported that Morgan Stanley, the second-biggest U.S. securities firm, has 251 percent of its equity in Level 3 assets, making it the most vulnerable to write-downs, followed by Goldman Sachs Group Inc. at 185 percent.

Spillover to Munis?

The monoline insurers who guarantee the timely payment of principal and interest also have exposure to the credit market turmoil. The extent to which it can affect the health of these insurers is not fully known. Their stock prices have been under extreme pressure as the Insurance companies just like the Broker / Dealers and Banks are wrestling with the valuation of their underlying investments.



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In fact, today, Fitch released an opinion that FGIC (Financial Guaranty Insurance Company) may be placed on negative watch in the coming weeks. Our sources tell us that even if this occurs, FGIC would still have an additional month to add the necessary capital before their credit rating is downgraded to "AA". If it was determined that FGIC needed to recapitalize and failed to do so, they may be downgraded to "AA". This would have profound consequences to their firm as their business model was developed around a "AAA-rated" claims paying ability. While this is certainly true, the municipal bondholder is still protected by both quality underlying credits on their own and a still very strong claims paying ability of "AA".

As a side note, while we don't take any of this lightly, of course it is important to mention our approach to selecting securities that are purchased on behalf of our clients. Our first criteria in the security selection process has been based on the strength of the underlying issuer as a standalone credit. We have always viewed the extra protection offered by the insurer as just that, a secondary layer of security.