# ZORBING

by Steve Brown

Zorbing requires the thrill-seeking banker to get into a big plastic bubble, hold onto a few straps and then hang on for dear life as one of his or her buddies gives the sphere a push and sends it hurtling down a steep hill. Unlike the fun one can enjoy when zorbing, market bubbles and corrections are usually not as entertaining. The thing about market bubbles is that they usually begin after some fundamental or economic issue that justifies upward movement. After that, investor confidence begins to rise and projections are made based on a recent and very rosy past. As people begin to feel good inside and relax, they begin to project those good feelings further into the future. This leads to what psychologists' term herding behavior, which refers to the phenomenon of large numbers of people acting in the same way at the same time. As the bubble expands, herding begets new investors, who begin to jump in. After a while, the bubble becomes fully inflated with happy stress free people Â– that is, until an economic or other fundamental "shock" convinces them things have changed. This shift in mentality causes the early players to flee, which results again in herding behavior for the larger group and an inevitable mass exodus. Yesterday, Treasury yields tanked 20bp, the stock market fell 311 points and the herd stampeded to safety. It is no surprise that the cause of all this mess is the subprime mortgage sector, but the impact is being felt far and wide. Investors have been anxious for awhile, as defaults in the sector have skyrocketed. As investors look down the road to the middle of next year, billions of dollars of adjustable-rate subprime loans begin to reset higher, adding even more discomfort. In fact, projected estimates put losses as high as $1 trillion. This has widened spreads as projections also show some collateralized debt obligations ("CDOs") will likely be wiped out. Remember that CDOs are investment vehicles that allow such loans to be structured and sold to investors. Over the years, hedge funds have been big buyers of these CDOs and unanticipated loan defaults have resulted in losses well beyond anyone's original projections. Since hedge funds make money by leveraging and borrowing, when things go bad it goes bad very fast and on a leveraged basis. Margin calls from lenders have accelerated, forcing liquidations into a market where no one wants to own such loans. This cycle leads to more margin calls and eventual collapse. To top things off, this is happening at the same time legions of large U.S. corporations try to issue debt. The result has been dislocation due to extreme illiquidity, widening spreads and rampant investor fear. The overall impact has been significant deleveraging and now the Fed Funds futures markets are pricing in a strong probability that the FOMC will have to CUT rates by the end of the year. At this point, our projection is that the FOMC will not cut rates unless the risk becomes systemic and a liquidity crisis is clearly in the offing. If they see that, look for a 50bp rate cut instead of 25bp, as the FRB seeks more rapid economic stabilization and a sharp boost in liquidity. It could be awhile before things get better, so be sure your plastic zorb is well cushioned and full of air before you pick up speed and zip down the hill.

## BANK NEWS

**M&A**

The HC of First National Bank ($1.5B, VA) will merge with Virginia Financial ($1.6B, VA) in a merger of equals.

**M&A**

KeyCorp ($89B, OH) will buy the HC of Union State Bank ($2.9B, NY) for approximately $575mm, or roughly 2.1x book. The move adds 31 branches to Key's franchise and significantly expands its operation in NY.

**Branching**

The governor of Alabama signed legislation allowing state chartered banks to branch into neighboring states and allow banks from other states to open de novo branches in the state.

**Closed**

Wells Fargo said it will close its entire subprime wholesale lending business, which represented 1.6% of the company's $397.6B mortgage loan volume in 2006.

**Loans for Citizenship**

The North Side Community Federal Credit Union ($9mm, IL) announced a loan program designed to help immigrants cover citizenship fees. The loans will start at $400 with a 10% interest rate and a fingerprint check.

**Employee Drug Use**

A new study finds over 8% of employees working at U.S. companies say they have used illegal drugs in the past month. By industry, restaurant and construction workers were at the top (at 17% and 15%, respectively), while by age group it was 18 to 25Y olds and 26 to 34Y olds (at 19% and 10%, respectively). Men were also 2x as likely to use drugs as women.

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