Global credit crisis fuels stock market turmoil

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The US stock market on Monday recouped some of the losses it suffered in last week's massive sell-off, and most stock exchanges in Europe and Asia registered modest gains. However, the panic selling that hit Wall Street and most global exchanges last week exposed a deep-going structural and systemic crisis of US and world capital markets that cannot be dispelled by a short-term rebound in share prices.

Even the near-term prospects for stocks remain in doubt under conditions of a credit crisis that threatens to seriously impact major commercial and investment banks in the US and internationally. The *Financial Times* of London posted an article on its web site following the close of trading in New York that focused on indications that the unraveling of the market in speculative securities based on US subprime home mortgages was impacting large European banks and financial institutions.

The newspaper began by noting: "The cost of insurance against credit defaults hit record levels on both sides of the Atlantic on Monday amid concerns that some investors were being forced to sell assets to cover losses on subprime mortgages." It had emerged, the *Financial Times* reported, that more European institutions had been impacted by the crisis in the US subprime mortgage market. The article reported that IKB, a German lender to small companies, and Commerzbank, the country's second largest bank, both warned that they would be hit by losses from home loans to American borrowers with poor credit ratings.

On Monday, the Dow Jones Industrial Index rose by 92.84 points to close at 13,358.31. Last week the Dow plunged a total of 585 points, its worse week in more than four years. Also on Monday, the Standard & Poor's 500 Index added 14.96 points, after falling by 4.9 percent the previous week, and the hi-tech Nasdaq Composite Index gained 21.04 points after last week's 4.7 percent fall.

What triggered last week's panic selling in both stock and bond markets were unmistakable signs that the pool of cheap credit on easy terms which had fueled the speculative run-up in the US stock market of the past two years was drying up. The collapse of the US housing market and associated rise in home mortgage defaults and foreclosures, which pulled the rug from beneath high-yield, high-risk securities linked to subprime home loans, was only one part of a broader, sudden contraction in credit. The credit crunch also impacted the leveraged corporate buyouts that have largely fueled the bull market.

One might say the stock market bubble burst because the credit bubble on which it was based had burst. What last week's stock and bond panic revealed was the extent to which the entire economy, both in the US and globally, has become dependent on an ever-expanding network of speculative investments generating hefty profits but increasingly distant from the production process.

The major events that sparked the sell-off were all related to the emerging credit crisis. The first was the recent decision by the investment ratings firms Moody's, Standard & Poors, and Fitch Ratings to downgrade securities linked to subprime home mortgages. That followed the collapse of two Bear Stearns hedge funds which were heavily invested in these securities.

The second was the quarterly report issued last week by America's largest home mortgage lender, Countrywide Financial. The firm reported that its second quarter earnings had fallen by 33 percent, and attributed the bulk of the drop to defaults of prime, rather than subprime, loans. In a conference call, Countrywide's chairman and chief executive officer, Angelo Mozilo, said home prices were falling "almost like never before, with the exception of the Great Depression."

The third was the unexpected failure of two private equity firms to obtain financing for the completion of corporate buyouts. The Wall Street banks underwriting the purchase of DaimlerChrysler's Chrysler division by Cerberus Capital Management failed to find buyers for the $20 billion in loans they had made to the private equity firm. Another private equity giant, Kohlberg Kravis Roberts, had similar difficulties finding buyers for $10 billion in loans meant to finance the buy-out of the British retailer Alliance Boots. These were only the most spectacular cases. At least twenty companies have postponed debt sales in recent weeks.

The big Wall Street commercial and investment banks—JPMorgan Chase, Citigroup, Goldman Sachs, Bear Stearns, Morgan Stanley—have become wedded to the highly profitable business of dividing up and repackaging their loans to private equity firms engaged in leveraged buyouts for sale to other hedge funds, private equity firms, banks, insurance companies and other big investors both in the US and internationally. These debt-based securities are called collateralized debt obligations, or CDOs.

The global market in CDOs has become a major driving force in a vast inflation in stock values and profits based on speculation in high-yield (because they are high-risk) investments. For the most part, the end product of this form of financial parasitism has been the creation of vast fortunes for corporate CEOs, hedge fund managers and big investors at one pole, and the decimation of jobs and living conditions for workers hit by corporate downsizing and wage cuts on the other.

To a large extent, the bull stock market of the past two years has been based on the wave of leveraged buyouts financed by means of CDOs. The buyouts drive up the share price of companies being acquired and inflate share values more broadly, in part because hundreds of other companies are considered potential targets for takeover by hedge funds and private equity firms. The inflated stock prices, in turn, enable companies to carry out buybacks of their own stock, sending their share values still higher.

The banks, the hedge funds and private equity firms, the brokers, institutional investors and middle-men of all sorts rake in money hand over fist as long as the tide of credit continues to rise. As *Financial Times* columnist John Gapper observed on Monday:

"Chuck Prince, Citigroup's chief executive, summed up the new world of banking neatly a couple of weeks ago when asked whether private equity buyouts were about to hit trouble. 'As long as the music is playing, you've got to get up and dance,' he said. 'We're still dancing.' A short while after he spoke, the music duly stopped."

The *New York Times* put it this way in a column published last Friday: "That was a popping sound. The buyout bubble was finally pricked yesterday as the market for debt—the jet fuel that had propelled it to dizzying heights—slammed shut.... Over the last two years, debt investors have been only too happy to snap up the bonds and loans at the heart of leveraged buyouts. So-called covenant-lite loans and pay-in-kind toggles, which allow bonds to be repaid by issuing more bonds, swelled in popularity and allowed companies to pile on more debt.

"But starting in June, the loan and bond sales for several buyouts were repriced or withdrawn. That trickle became a flood yesterday..."

The CDO market has, according to a written commentary put out by Standard & Poor's on July 19, "ground to a halt."

But the contraction in credit is not limited to junk-bond grade CDOs. It is spreading to the prime corporate bond market as well, making credit for normal business expansion more scarce and more costly. The *Financial Times* reported Monday:

"The problems in the financial markets are starting to affect high quality corporate debt too, with global issuance of investment-grade bonds falling to the lowest level for several years... figures from Thomson Financial show a significant decline in activity in the global investment-grade market—suggesting the impact of the market turmoil is spreading."

In a separate article, the *Financial Times* reported that the credit crisis is already impacting on hedge funds in potentially crippling ways. "Investment banks," the newspaper wrote, "are responding to rising credit concerns by imposing tougher lending terms on hedge funds, in a move that threatens to exacerbate investor unease in the financial markets.

"Prime brokerage departments at several investment banks have raised their margin requirements for certain hedge fund clients as they seek to insure themselves against the possibility of new hedge fund collapses as a result of the recent market turmoil."

But the greatest unease within financial circles is the potential impact on the biggest commercial and investment banks. It is estimated that major banks have a backlog of $300 billion in loans committed for leveraged buyouts that they hope to sell in the course of the rest of the year. The collapse of the CDO market and the worsening financial condition of hedge funds could force the banks to hold onto the loans for a protracted period of time.

As commercial interest rates rise, the value of these loans will sink, and the possibility that many of them will default will grow. Moreover, the banks depend on the fees and other earnings from the sale of CDOs for a significant portion of their profits. A widening credit crisis could lead to the failure of one or more major American or European bank.